The evolution of tax policy reforms in the 10 post communist new EU member states within the context of EU integration

Abstract: *The process of EU enlargement caused massive policy adaptation in both the old EU members and the new members, both before and after the point of accession. This article explores evolutions in the area of corporate and personal income taxation and its relationship with the modification in the area of indirect taxation. Competitive pressures to attract FDI as well as increased revenues from the EU aquis determined excise taxes offered the 10 EU New Member states room for maneuver to significantly cut their direct taxes.*

Keywords: *Personal Income Taxation, Corporate Income Taxation, EU integration, FDI*

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In this article, I examine the evolution of EU's positioning vis-à-vis business tax policies undertook by members and non-members of the EU within the last three decades and discuss whether the evolutions of Corporate Income Taxation in the 10-NMS (New Member States) can be labeled as harmful tax competition. According to Winner (2005, 669) tax competition is described as "a situation where the fiscal activities in one jurisdiction induce fiscal externalities in other jurisdictions. Accordingly, governments independently (or 'non-cooperatively') impose taxes to maximize the welfare of their domestic residents, although factor mobility implies that this choice affects the tax bases of foreign countries." According to the 2007 Eurostat report Taxation Trends in the European Union , the EU is an economic area characterized by a high level of taxation, with an average of 39.6% of GDP in 2005. While Nordic countries (i.e. Sweden, Denmark and Finland) rely primarily on direct taxation, Mediterranean countries, in particular Portugal and Greece, have relatively high shares of indirect taxes (2007, 6). Denmark is a peculiar case since its welfare spending is not financed through SSC but through general taxation, making its share of direct taxation the highest in the EU. Germany and France collect the highest share of SSC but the lowest share of direct tax revenues. Although between 1995 and 2000 the EU-17 exhibited a small tax/GDP ratio decrease, by 2005 the ratio had started to climb again. For the 1995-2008 period, while countries with high tax ratios maintained relative stability, they varied in those countries with the lowest tax rates, especially for NMS. According to OECD (2009), despite the tax cuts, the taxation pool has increased and thus the

CIT and PIT percentage in GDP have come back on a slow positive trend since 2003. One trend that appeared to parallel the cuts in corporate taxes, namely labor taxes, had stopped by 2007 (OECD 2007, 8).

Given the increase interdependencies among the EU member states, any policy reform in the area of taxation has to answer the question: How could the desired effects of tax policy be achieved given the policies of other countries? While developing countries are in a process of continuous adaptation of their taxing capacity, contemporary developed states have developed highly capable state bureaucracies and thus, they are more able to implement tax measures with a predictable effect. As the EU integration have decreased more and more the EU's national state ability to use particularistic policy instruments in the area of tax policy, and given that the effects of national policies have increasingly and indirectly influenced the policies of other states, national tax policies have inherently became strategic. Considering that tax policies directly affect the viability of the common market and principles of loyal competition, the EU institutions had to inevitable position themselves vis-à-vis various tax policies. In the following section I will discuss how this positioning has evolved.

1. Harmful tax competition and the EU-aquis in the area of tax policy

While the idea of tax competition could not be condemned, some forms of tax competition, especially those using particularistic measures had to be limited. A non-discriminatory form of tax competition can be defined as any measure that is applied identically irrespective of the characteristics of the taxpayer whose activities generate tax obligations toward a jurisdiction. Nevertheless, countries can compete through forms of targeted tax policy measures aimed at specific taxpayers. Thus, discriminatory (or targeted) tax competition measures are designed for specific categories of taxpayers. The most important examples are target fiscal stimulus offered for FDI (on regional or firm base) and the creation of special juridical regime for non-residents. Since the exact line between non-discriminatory and discriminatory tax competition measures may be blurred, and since this subject has become more and more important for developed countries, especially within the single European market, the EU and the OECD have dedicated important efforts to clarify these issues and started to tackle these problems.

By the early 1990s, the idea of tax competition had started to become a subject of discussion at the OECD and EU level, especially given the spread of tax havens. Nevertheless, the EU position on tax coordination has changed over time. If the Neumark (1962) and Tempel Committee (1970) were proposing a full CIT harmonization, the Ruding Committee (1990) proposed a minimum 30% CIT. While the EU-aquis in the area of taxation is rather limited compared to other areas, the required adaptations in terms of accounting practices, statistics, administrative transparency and elimination of most types of subsidies should have had a positive effect on the fiscal capacity of their administration. Given the limitations in other areas of national policy imposed by regulations regarding the internal market and the elimination of passive and active trade barriers, the field of tax policy has become more important. In May 1996 the OECD's Ministers of Finance meeting underlined the need to develop a series of measures designed to fight the distorting effects of 'harmful tax competition.' Thus, the concept of 'tax competition' as the main source of concerns has not been replaced with the concept of 'harmful tax competition.' According to Bellak and Leibrecht (2007, 14) the separation between tax competition and 'unfair' tax competition implicitly shows that the European Commission favored the non-discriminatory forms of tax competition.

In 1997 the EU 'Code of Conduct' regarding business taxation explicitly defined for the first time harmful tax competition and set its goal of unilaterally tackling tax measures that distort cross-border capital allocation in order to reduce distortions in the single market, prevent significant losses of tax revenues and stimulate the development of employment friendly policies . In addition, the EU directive on harmful tax competition was aimed at limiting measures that would be used by national states to attract FDI. Nevertheless, according to Bellak and Leibrech (2007, 14) the EU Code of Conduct in business taxation represents a very loose form of coordination that would not lead to any tax harmonization. *According to the report, the harmful tax competition arises:*

"A. Without prejudice to the respective spheres of competence of the Member States and the Community, this code of conduct, which covers business taxation, concerns those measures which affect, or may affect, in a significant way the location of business activity in the Community.

B. Within the scope specified in paragraph A, tax measures which provide for a significantly lower effective level of taxation, including zero taxation, than those levels which generally apply in the Member State in question are to be regarded as potentially harmful and therefore covered by this code.

Such a level of taxation may operate by virtue of the nominal tax rate, the tax base or any other relevant factor.

1. Whether advantages are accorded only to non-residents or in respect of transactions carried out with non-residents, or

2. whether advantages are ring-fenced from the domestic market, so they do not affect the national tax base, or

3. whether advantages are granted even without any real economic activity and substantial economic presence within the Member State offering such tax advantages, or

4. whether the rules for profit determination in respect of activities within a multinational group of companies departs from internationally accepted principles, notably the rules agreed upon within the OECD, or

5. whether the tax measures lack transparency, including where legal provisions are relaxed at administrative level in a non-transparent way.

C. Member States commit themselves not to introduce new tax measures which are harmful within the meaning of this code. Member States will therefore respect the principles underlying the code when determining future policy and will have due regard for the review process referred to in paragraphs E to I in assessing whether any new tax measure is harmful.

D. Member States commit themselves to re-examining their existing laws and established practices, having regard to the principles underlying the code and to the review process outlined in paragraphs E to I. Member States will amend such laws and practices as necessary with a view to eliminating any harmful measures as soon as possible taking into account the Council's discussions following the review process."

The most important aim of Code of Conduct was to help in defining measures that would limit or ban tax policies granting preferential tax treatments. If the first and the third type clearly define tax heavens[5], the fourth and the fifth refer to arbitrary policies tailored in order to attract companies to set their location in that country.

The issuing of the 'Code of Conduct' has been accompanied by a request from the European Commission toward the OECD to undertake an in-depth study on the issue. As a response to this request, the OECD's Committee on Fiscal Affairs studied the issue and proposed a report in 1998 . The report focused on defining the harmful preferential tax regimes and tax havens as well as proposing a series of measures to counter the negative effects of these practices. According to the OECD's report, the shifts produced by the tax heavens and the harmful tax competition have generated a significant shift in the structure of taxation, and have weakened the ability of states to apply progressive PIT and undermined the redistributive capacity of policies. According to the report, the most important form of harmful tax competition is the "poaching" of tax bases by "bidding aggressively for the tax base of other countries" through measures like setting "up special regimes designed to attract investment or savings that originate elsewhere or to assist MNEs or individuals in avoiding another country's taxes" (Blumber 2001, 20).

Further, in November 1999, the Code of Conduct Group (Business Taxation) (Primarolo Group) issued a report at the request of the European Commission, analyzing the type of measures undertaken by different states that fall under the category of harmful tax competition. The report defined three areas where most measures under this category have been taken: business taxation, taxation of savings income and the issue of withholding taxes on cross-border interest and royalty payments between companies. Overall, the report has identified 66 tax policy measures that can fall under the definition of harmful tax competition, measures that were practiced by most EU members. Among other aspects, the following measures fall under the category of harmful tax competition:

"- they provide for a reduced nominal rate of tax

- they provide fixed margins for pass-through financing without a regular review of those margins against normal commercial criteria

- they allow the creation of substantial reserves which are in excess of the real underlying risks and which reduce taxable profits

- or they permit the profits to be allocated between a Head Office and a branch in a formulaic way contrary to the arm's length principle that can lead to a reduced effective rate of tax for the company as a whole." (DG 1999, 12)"

Nevertheless, the report avoided clearly recommending a minimum CIT rate under which tax competition becomes harmful. Further, the commetee have not discussed the goal of establishing an EU-level minimal CIT rate, and this issue has not reappeared in the public debate until 2010.

The most important EU legislation with an indirect effect on the overall taxation of capital in the EU is the Parent-subsidiary Directive, initially adopted in 1990 and expanded in 2003. While the 1990 directive attempted " abolishing withholding taxes on payments of dividends between associated companies of different Member States and preventing double taxation of parent companies on the profits of their subsidiaries," the 2003 directive "updated the list of companies that the Directive covers; relaxed the conditions for exempting dividends from withholding tax (reduction of the participation threshold); and eliminated double taxation for subsidiaries of subsidiary companies." From the point of view of tax competition, the most important effect of these developments is that it has significantly limited the space to maneuver the tax policy of member states. According to the calculations of Bellak and Leibrecht (2008, 22) the implementation of the 2003 directive has significantly reduced the BEATR among the EU member states in 2004.

Overall, the EU legislation continues to allow for a large space of maneuver in the area of direct taxation such as capital tax competition, personal income tax competition and labor tax competition, and the European Commission implicitly favors most forms of tax competition within the EU. In fact, by clearly defining those measures that fall under the category of harmful tax competition, most of them creating discriminatory tax regimes for specific taxpayers (usually non-residents), the EU has encouraged non-discriminatory forms of tax competition, forms that fall within the definition of tax competition. In addition, despite the attempt by France and Germany to push for an EU regulation imposing a minimum 25% CIT rate, the EU Commission did not support their efforts. Given that the pressure created by the abolition of most commercial and capital barriers within the EU has generated a significant competitive pressure on the EU members, we can expect that most pre and post-accession evolutions in the 10-NMS in the area of direct taxation be inextricably linked with the competitive pressure created by the EU.

2. Expectations on the divergence and convergence among the 10-NMS and the EU-17

The lengthy and detailed discussion in the previous section aimed to clarify the reader regarding the conceptualization of various forms of tax competition. Within this section I will discuss evolutions of tax policies in the 10-NMS in comparison with the old EU members (EU-15) and analyze the extent to which these can be labeled as harmful tax competition and also the potential expectations regarding the convergent evolutions. This section will proceed as follows: the most important hypothesis regarding the comparative evolution of the EU-17 and the 10-NMS will be elaborated. The main expectations relate to the first research question: Did the effects of the EU aquis in the area of taxation and the competitive pressures generated by the EU accession set the 10-NMS on a diverging or converging path with the EU-17 in terms of tax competition policies and their revenue effects?

The conceptual analysis undertaken in the first section has revealed that any answer to the first research questions must be formulated in terms of dimensions of tax policy. Before presenting the data that will indicate the answer to the research question, in this sub-section I will explicitly elaborate the main expectations that stem from the discussion undertaken so far. The main sources of pressure that influenced the evolutions of the 10-NMS are the: (1) evolution of the tax policies in the EU-17, (2) the EU aquis and other direct obligations generated by the EU integration, (3) the indirect pressures generated by the EU integration, (4) the previous behavior of the 10-NMS during the transition process.

(1) Evolution of the tax policies in the EU-17

Given the nature of the tax competition phenomenon and the fact that the FDI flow was expected to be unidirectional – from the EU-17 toward the 10-NMS, it can be expected that the 10-NMS would adjust their tax policies in direct consideration of the evolution in the EU-17 countries.

(2) The EU-aquis and other direct obligations generated by EU integration

The effects of the EU integration can be split into legal obligations generated by the EU-aquis and in the pressures generated by the informal mechanism. The most important direct effects are exercised by the compulsory EU aquis in the area of indirect taxation – minimal VAT rate, minimal excise for fuels, electricity, tobacco and alcohol – legislation that limits the potential for tax competition in the area of consumption taxes. One indirect effect of this limitation is that the expected increased revenues from indirect taxes would increase the space for tax competition on other dimensions of tax competition.

The accession to the Stability and Growth Pact, which carries strict commitments to limit public deficits to a maximum of 3% and the obligation to contribute 1% of their GDP to the EU budget, limited their ability to use a deficit to finance expenditures and simultaneously increased the revenue pressure on the state budget. Overall, this intense pressure leads to the expectation that the overall effects of any form tax competition to tax/GDP (is) neutral. The EU aquis in the area of business taxation, the informal code of business taxation, the Parent-Subsidiary directive, the legal definition and politicization of the harmful tax competition – decrease the space of maneuver for discriminatory tax policies and evolutions that would stimulate classical non-discriminatory tax competition in the area of capital tax competition.

(3) The indirect pressures generated by the EU integration

One of the most important effects of EU integration is the overall increase in the institutional capacity, an aspect that would lead to an increased capacity to collect taxes. Nevertheless, this pressure could lead either to an increased tax/GDP ratio or to a larger room of maneuver for tax competition.

(4) The previous behavior of the 10-NMS during the transition process.

In comparison with their FSU counterparts, the 10-NMS have become consistently and relatively homogenous during the transition period. The main important general expectations are that whatever the trend, the 10-NMS would behave like a relative homogenous group.

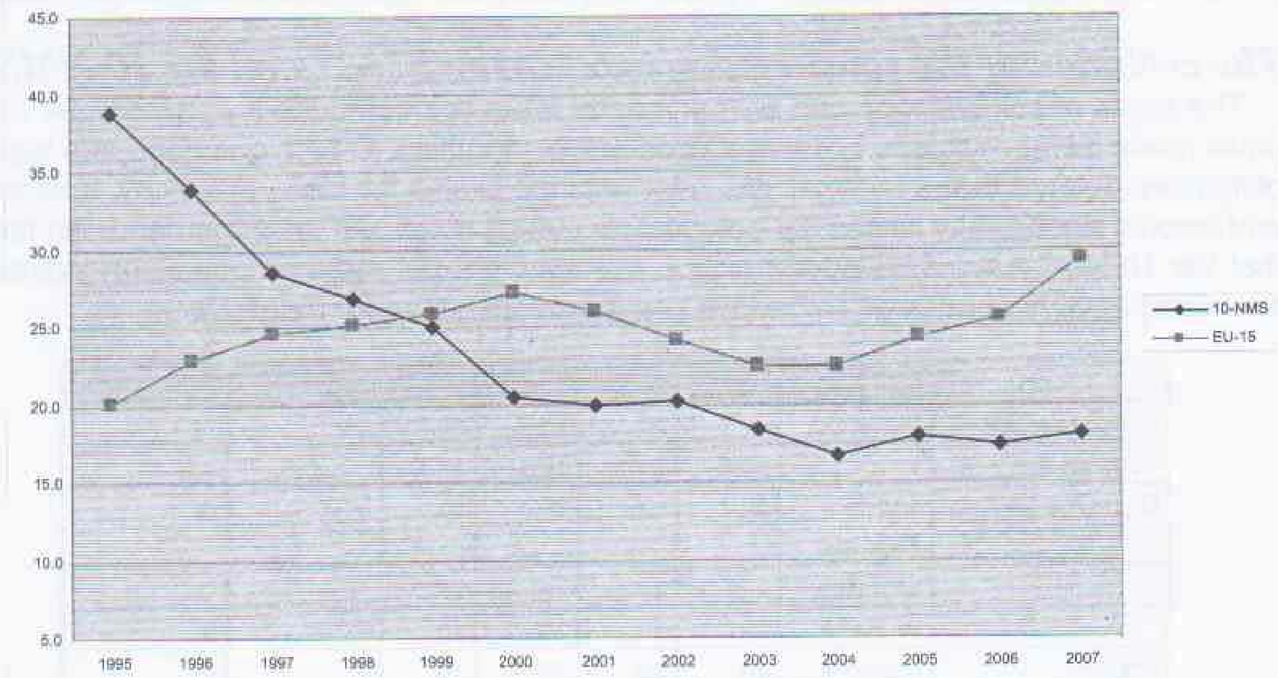
All in all, the factors I have analyzed advance expectations in the area of capital tax competition, and consumption tax competition, but no expectation for the areas (as already stressed, these forms of tax competition are partially overlapped), of personal income tax competition and labor tax competition. As such, the main important conclusion is that whatever the evolutions in these areas are, they are probably influenced more by national internal dynamics and/or by regional dynamics.

3. Evolution of tax policy in 10-NMS vs. EU-17

In this sub-section I analyze data regarding the evolution of tax competition on the four identified dimensions comparing the EU-17 evolutions with the 10-NMS. The analysis compare the evolutions of the two regions between 2000 (since the accession negotiations started in December 1999 this is the first year the effects of the EU integration process should be measured) and 2007-2008 (the latest data available varies for different indicators; the advent of the 'Great Recession' after September 2008 exerts a special effect on most of the variables under study). As discussed in the conceptual sub-section, the phenomenon of tax competition refers strictly to the micro-level effect of the tax policy change. Further, the macro-level indicators should supplement the analysis in order to understand the effects of the tax competition. The answer to each of the four sub-questions will be discussed in relationship with the expectations presented in the previous sub-section.

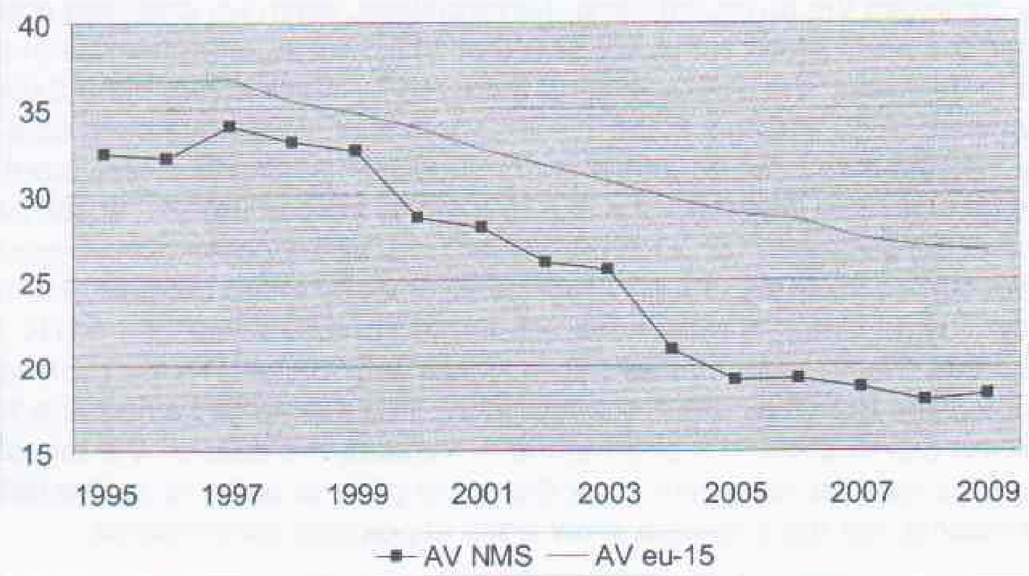
Data in figure 1. regarding the evolution of Implicit tax rates on Corporate income shows that the 10-NMS started an abrupt downward trend in 1995 and by the start of the EU accession negotiations they reached a level similar with the average EU-15 and subsequently continued the divergent trend. Nevertheless, when we analyzed data in figure 2. regarding the nominal tax rates, we saw that while average the tax rate in the EU-15 continued to decrease, the overall income gathered by these states did not continue the same downward trend. Instead, in the 10-NMS both evolutions have been consistent, aspects that indicate that these countries enacted policies aiming to create more attractive conditions for FDI. Most important, the EU-15's capital tax competition, accompanied by a redefinition of the tax base (OECD 2009, 34), actually had contrary effects, increasing the average tax burden for every unit of corporate income. By sharp contrast, in the 10 NMS, the 50% tax cuts of statutory rates have actually led to a 50% loss of the ITR. As data in figure 1.9 show, the 10 NMS started with a significantly higher ITR on business but had 'out-competed' the EU-15 by 1999; subsequently, they maintained a negative trend while the ITR in the EU-15 showed a positive trend. Instead, the data on the overall revenue from CIT of the total tax revenues show the same general patterns as the data for total corporate income, but the data also show signs of possible convergence.

Figure 1. Implicit tax rates in %: Corporate income



Source: Eurostat. 2009. Taxation trends in the European Union, European Commission Table 5

Figure 2. The evolution of CIT rates in the EU-17 and 10 NMS (1995-2009)



Source: Eurostat. 2009. Taxation trends in the European Union, European Commission

The evolution of the consumption taxes in the EU-17 and the 10-NMS

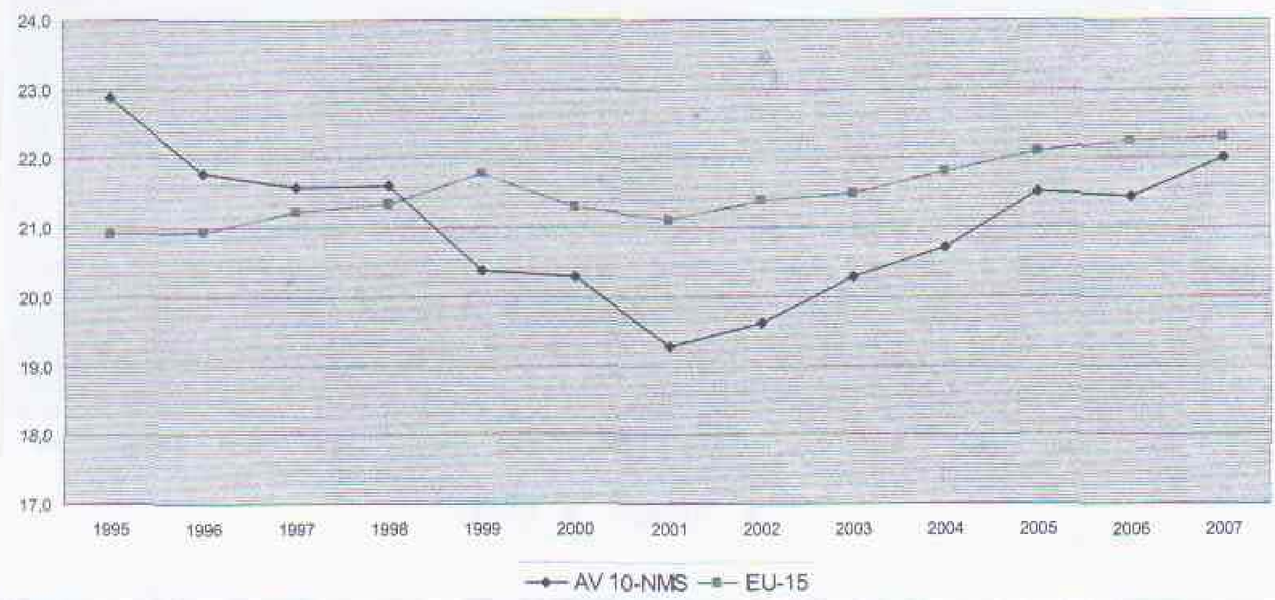
The areas of consumption and environmental taxes represent the area where the EU aquis made it improbable to observe a direct tax competition. On the one hand, the legal obligations related to the minimal VAT rate, minimal excise for fuels, electricity, tobacco and alcohol significantly limited the potential for cutting taxes. On the other hand, the fact that the 10-NMS have developed taxation systems that put more emphasis on indirect taxes and have high rates of VAT added some potential room for maneuver.

	Country	1997	2003	2007	2010	1997-2003	2003-2010
EU-17 average		-	20.1	19.4	22.3		
10-NMS average		20.6	20.2	19.4	21.1		
Decrease	Czech Republic	22	22	20	19	0	-3
	Slovakia	23	20	19	19	-3	-1
	Bulgaria	22	20	20	20	-2	0
Stable	Slovenia	20	20	20	20	0	0
	Hungary	25	25	20	25	0	0
	Poland	22	22	22	22	0	0
Increase	Romania	18	19	19	24	1	0
	Estonia	18	18	18	20	0	2
	Latvia	18	18	21	21	0	3
	Lithuania	18	18	19	21	0	3

Sources: Eurostat. 2009. Taxation trends in the European Union, European Commission; OECD .2007. Taxation trends in the EU. Paris. http://www.worldwide-tax.com/

Data in table 1. show that the average VAT rates over the two regions have remained remarkably similar over the 2003–2010 period, with a slight increase in both regions following the advent of the Great Recession. The ITR on consumption evolution, shown in Figure 3 reveals that after a decrease between 1995 and 2001, the 10-NMS have converged back to the average of the EU-17. In addition, in terms of the effects of these changes on tax revenues, the effects are straightforward. Both the importance of VAT and total taxes on consumption increased in the 10-NMS after 2000 while remaining relatively constant in the EU-17.

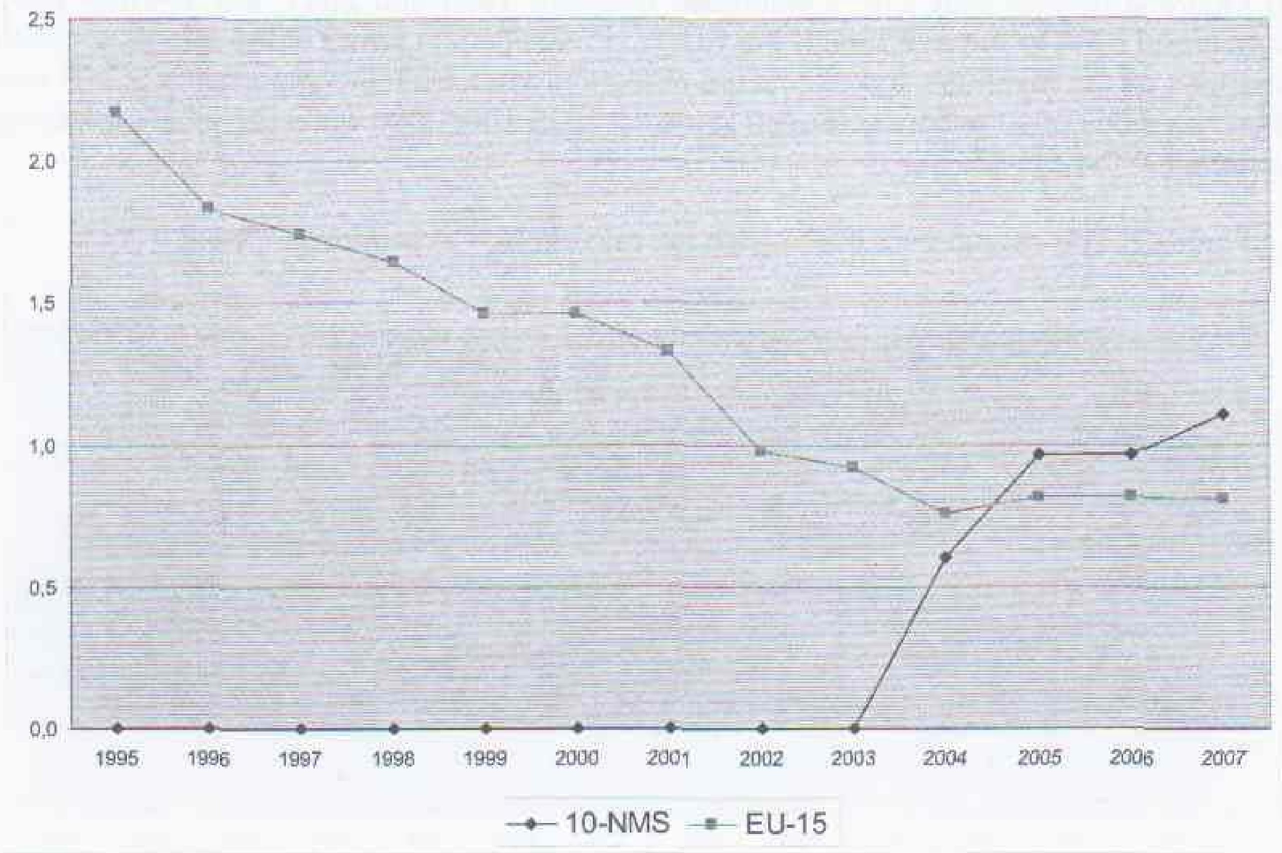
Figure 3. The evolution of the Implicit tax rates in %: Consumption (Table II-2.1)



Source: Eurostat. 2009. Taxation trends in the European Union, European Commission

While data for the revenue from taxes on consumption as % of GDP are available for the 10-NMS just since 2004, we can clearly discern a patter of abrupt increase of revenues from these taxes. As such, this significant revenue increase have opened substantial/ considerable room for maneuver for decreasing the tax rates in the are of personal and corporate taxation.

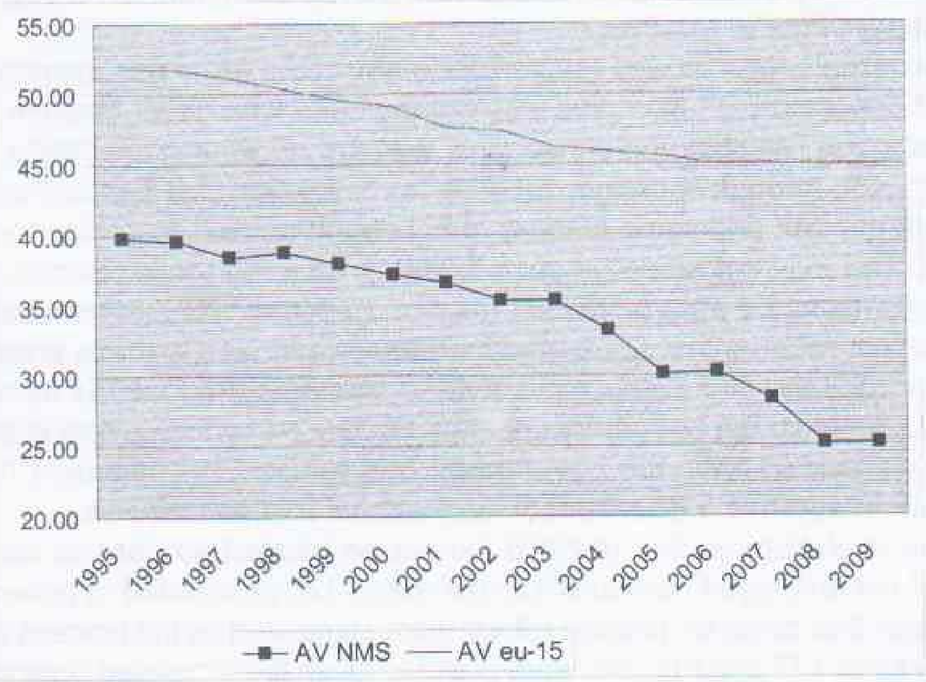
Figure 4. Comparative evolution of taxes on Consumption as % of GDP: Total Note (Table C.1_T:)



Source: Eurostat. 2009. Taxation trends in the European Union, European Commission

The single most divergent evolution in terms of tax policies can be observed in the area of Personal Income Taxation. Data in figure 5 reveal that the 10-NMS constantly cut their average top PT rate from 40% in 1995 to just 25% in 2009. These evolutions, coined under the name The Flat tax revolutions transformed this area in one of the most tax competitive region in the world. Furthermore, while both regions manifested a downward trend, the magnitude is different, with only a 15% decrease in the EU-15 in comparison with a 38% decrease in the 10 NMS. The results of the minor modifications in the Social Security Contributions (SSC) rates and significant PIT

Figure 5. The evolution of the top PIT rates



Source: Eurostat. 2009. Taxation trends in the European Union, European Commission

Conclusions

By all standards, tax policies have significantly changed in the 10-NMS in the post communist period. In addition to the divergence of CIT and PIT maximal rates in the 10 NMS compared with the EU-15, what gives most essence to the divergence argument is the fact that the 10 NMS is one of the few regions where the actual tax burden on capital and labor (ITR) has significantly decreased. This development leads to a different qualitative nature of 'neoliberal' tax reforms in these countries. Swank and Steinmo (2002) claimed that the initial wave of neoliberal tax reforms, beginning in 1986 with the Ronald Reagan's overhaul of the US tax system, were not meant to cause a decrease in the overall tax burden; instead, they were intended to cause a redistribution of this burden according to the principle of horizontal equity. Given that they also "eliminated a broad array of investment credits, exemptions, and grants that had substantially lowered effective corporate tax rates on reinvested profits," (Swank and Steinmo 2002, 633) effective capital taxation has remained relatively stable. Thus, even in the face of potential revenue loss caused by tax competition, the OECD countries retain FDI and "collect taxes from it if the investment comes from nations that provide credits for foreign tax payments and that tax reinvested profits themselves. In addition, reductions in statutory marginal tax rates send important signals about domestic investment environments to transnationally mobile capital" (Swank 2006, 851). Instead, CIT and PIT reforms in the 10 NMS not only cut statutory tax rates but also decreased revenues from direct taxation further accentuating the decreasing progressivity of their tax systems. Despite the overall decrease of capital and labor taxation as percentage of GDP, data in figure 1.16 reveal that the overall tax revenues as percentage of GDP have remained stable in most countries and shown no sign of convergence with the EU-15. The fact that the lost revenue from direct taxation has been replaced by increasing revenues from VAT excises further strengthens the neoliberal character of these reforms.

Although external pressure was relevant for many of the other post-communist reforms in the area of consumption taxes, this was not the case with direct taxation. While some of the reforms in the "Washington consensus" wave of reforms in the 1990s could be described as diffusion through coercion, the Flat Tax revolution clearly does not fit in this category, as both the IMF and some leaders of EU countries manifested opposition against such reforms. The EU integration process indirectly affected these reforms, as it conditioned some reforms in the area of indirect taxation (minimal VAT and minimal excise) and business taxation, reforms that generated increased revenues in these areas. Finally yet importantly, in 2009 the IMF pressured Latvia to eliminate the Flat Tax as a presumably efficient tool to diminish the budgetary imbalances caused by the severe economic crisis. Despite Latvia's vulnerability, the government has refused to implement this measure, forcing the IMF to approve a government loan without this concession.

Overall, the evolutions in the 10-NMS cannot be labeled as harmful tax competition since they did not employed particularistic tax deals, but proceeded to general tax cuts.

We can assert that direct tax policies reform were stimulated by the process of EU integration especially since CIT and PIT cuts were possible given the increased revenues from consumption taxes; revenues generated by the imposition of minimal excises given the EU aquis.

Notes

1. OECD. 2007. Taxation trends in the European Union. OECD Paris
2. Value Added Tax – minimum rate of 15%
3. European Commission, Communication from the Commission to the Council and the European Parliament, a package to tackle harmful tax competition in the European Union, COM(97) 564 final, 5 November 1997 [europa.eu.int/comm/taxation_customs/].
4. Code of Conduct for business taxation was set out in the conclusions of the Council of Economics and Finance Ministers (ECOFIN) of 1 December 1997
5. According to a 1994 study, tax havens accounted for 1.2% of the world's population, 3% of the worlds GDP and 26% of the global assets.25
6. Organization for Economic Co-Operation and Development. "Harmful Tax Competition: An Emerging Global Issue". Paris: OECD, 1998
7. N 4901/99 DG
8. Grouped in the following categories: (i) Financial services, group financing and royalty payments
   (ii) Insurance, reinsurance and captive insurance
   (iii) Intra group services
   (iv) Holding companies
   v) Exempt and Offshore Companies
   (vi) Miscellaneous measures
   vii) Other
9. Council Directive 90/435/EEC
10. Council Directive 2003/123/EC
11. http://ec.europa.eu/taxation_customs/taxation/company_tax/parents-subsidiary_directive/index_en.htm
12. De Mooij, Ruud A. (2004) : A minimum corporate tax rate in the EU combines the best of two worlds, Intereconomics, ISSN 0020-5346, Vol. 39, Iss. 4, pp. 180-182

13. The other post-communist countries could have been used as a control group to further strengthen the argument. Nevertheless, given the absence of measurements for most of the indicators used in this research this task is impossible.
14. That widened type of incomes falling under the CIT rate, significant cuts or even the elimination of targeted and general investment incentives, or if the capital depreciation calculation becomes less generous.
15. Diffusion though coercion takes place when a powerful country directly or indirectly influences the probability that a specific reform will be implemented though various mechanisms (e.g. physical force, the manipulation of economic costs and benefits, and/or even the monopolization of information or expertise).

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