Chapter 2
Corporate Income Tax Competition and the Scope for National Tax Policy in the Enlarged Europe

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2.1 Introduction

Tax competition for mobile capital has recently emerged in the political debate of several European Union (EU) Member States against the background of the enlargement of the EU. Governments in Central and East European Countries (CEECs) have frequently been accused of engaging in tax competition for mobile capital in general and Foreign Direct Investment (FDI) in particular at the cost of the "old" EU member countries. A number of empirical studies have attempted to analyse the existence of tax competition for mobile capital (e.g. Devereux et al. 2004, Slemrod 2004). These studies mainly deal with tax competition between highly developed OECD countries and do not have a focus upon CEECs. These studies use different indicators of the corporate income tax burden, e.g. corporate income tax revenues as percentage of total tax revenues, effective tax rates or statutory tax rates (STRs) as the dependent variable in an econometric model to check for the presence of tax competition. Several studies find that tax rates indeed fall with an increased openness of economies (e.g. Rodrik 1997; Slemrod 2004) or that there is strategic interaction in the tax setting of governments (Devereux et al. 2004).

But these results do not establish the existence of tax competition *per se* as falling tax rates and interdependencies in tax rates may be due to driving forces other than tax competition (e.g. Brueckner 2003, Slemrod 2004; Griffith and Klemm 2005; Nicodème 2006). For example, reductions in corporate income tax rates may not be triggered by the aim to attract mobile capital but may be motivated by the need to reduce "national distortions" of corporate taxes. One example in this respect is the attempt to reduce the deadweight loss of taxation via tax-cut-cum-base-broadening (Griffith and Klemm 2005). Moreover, tax rates may fall in case of joining an economic union, which has a tax law in force that disallows various types of taxes. An example in this respect is the EU parent subsidiary directive. Furthermore tax rates may fall due to yardstick competition

or a shift in the political stance towards less government influence (e.g. Griffith and Klemm 2005, Musgrave 1990).

This chapter has two main goals, first to examine if corporate income tax competition for FDI is a likely scenario in the enlarged Europe and second to discuss the implications of corporate income tax competition for the scope of national tax policy in Europe.

To answer the question whether tax competition is likely in the enlarged Europe we do not follow the approaches outlined above. Rather we proceed by giving a definition of tax competition and by deriving preconditions for the existence of tax competition from this definition. The fulfilment of these preconditions is analysed empirically. The four preconditions for tax competition analysed are (i) FDI is technically possible and Multinational Enterprises (MNEs) use this possibility; (ii) governments use the tax instrument actively; (iii) using the tax instrument is explicitly motivated by attracting FDI or not to loose it to competitors; and (iv) taxes are a significant determinant of FDI. Using this approach it is possible to deal more directly with the aim of tax rate cuts (precondition three) than the econometric approaches outlined can do. The first part of this chapter concludes that since all four preconditions are fulfilled, corporate income tax competition for FDI is indeed a likely scenario in an enlarged Europe.

In the second part of the chapter we answer the questions whether there *should* be scope for national tax policy from an economic point of view and whether it *will* be likely, given the political position towards tax competition in the EU. The answer to the first question is derived on the basis of the theoretically predicted and empirically simulated economic effects (esp. efficiency and tax revenue effects) of corporate income tax competition and tax coordination, respectively. To this end we summarise some main results of various theories of tax competition and results from simulation models. The second question is answered based on the Commission's position towards corporate income tax coordination as shown in official EU documents. We conclude that there should and will be sufficient scope for national tax policy in the future.

The chapter starts with a section on definitions of tax competition and its preconditions (Sect. 2.2). Measures of corporate income tax burden are discussed in Sect. 2.3. Section 2.4 reviews the major changes in corporate tax law in selected CEECs during the last decade. Empirical results on the significance of taxes as a determinant of FDI in CEECs are reported in Sect. 2.5. Section 2.6 discusses whether there should and will be scope for national tax policy within an enlarged Europe.

2.2 Definitions and Preconditions of Tax Competition

Until recently, the literature on tax competition devoted little attention to providing a clear definition of tax competition. This gap was filled by Wilson and Wildasin in 2004. They define tax competition in a broad sense as "any form of non-cooperative tax setting by independent governments." (Wilson and Wildasin, 2004, p. 1066) This definition includes other forms of competition where taxes play a role, notably yardstick competition between independent jurisdictions. Yardstick