

6. EU-15 countries, new member states and harmonization of corporate income tax

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The idea of common corporate income tax (CIT) in EU gains even more attendance. However, there are several features of particular EU countries, which make the benefits of EU-wide harmonization dubious and its effects could be unequally distributed. Among these features are inter alia: (i) requirement for capital, (ii) size of the economies, (iii) differences in labor taxation, (iv) set of public goods available to taxpayers, (v) agglomeration externalities, (vi) richness of societies and (vii) tax culture including tax morale. The differences within the EU are particularly visible taking into consideration two groups of countries i.e. the Old EU and New Member States. Based on some approximation of the economies of EU-15 and EU-12 countries, the article shows the obstacles for future CIT harmonization.

Keywords: Corporate Income Tax, Macroeconomic Policy, Fiscal Policy, Optimal Taxation

1. Introduction

The EU seeks to foster its internal market. This process involves also taxation. Therefore, it intends to harmonize taxes among the Member States. Following that path several indirect taxes (i.e. Value Added Tax, customs duty and excise duty) has been already unified to a great extend. Currently, the European Commission focuses on unification of direct taxes and particularly on CIT.

In view of the above, the European Commission proposed to introduce in the EU a unified method of calculation of the tax base (i.e. so called Common Consolidated Corporate Tax Base or CCCTB). According to the project, multinational corporations will be free to choose between CCCTB and existing national taxation rules. The decision on the tax rates under CCCTB should be left to the discretion of Member States. However, in the future a natural step forward should be both elimination of national regulations and harmonization of the tax rates to achieve full unification of CIT. Especially countries with elevated tax rates may be the strong advocates of such developments, in the hope that this will diminish their competitive disadvantage against Member States with low tax rates.

It is of course a future and uncertain matter and therefore cannot be subject to scientific verification. However, a question arises whether the whole EU, taking into

consideration current features of Member States, is economically able to accommodate a fully common CIT. Unfortunately, the EU seems not to be an optimal single fiscal area. This is because particular countries differ vastly. In this article I will show these varieties only based on general and approximated features two groups of countries represent – namely New Member States¹ and the Old EU countries.² In the following sections I discuss the differences, which are particularly relevant for CIT purposes for these regions.

2. Requirement for capital

Globalization of the world economy reveals in increased abilities of the international firms to shift taxable profits between countries and easiness of abroad investments. This has led to tax competition between the states. Not surprisingly Member States also take part in the so called “race to the bottom”.

The most vivid feature of any tax system are taxation rates and therefore, they are often used in tax competition. Countries are encouraged to lower the CIT rates because they perceive them as an important factor, which either lures or deters foreign investments. Such reasoning is especially vivid, when the process is analyzed from the perspective of two groups of countries i.e. the New Member States and the EU-15. The Old EU on average significantly cut their CIT rates. The New Member States have responded to the CIT competition pressure and decreased their corporate income tax rates even more. This forced again the EU-15 to further tax rate reductions. The trend of disparity of average CIT rates in the Old EU and New Member States is depicted on the below graph.

Based on the below Figure it seems that New Member States were more “in need” of capital than the Old EU, where the capital was already installed. After the fall of communism and in the years of transformation capital in Central Europe was scarce, which was unlike the Western countries. Even now the disparity is significant. Whereas according to the Eurostat data for 2012 the stock of foreign direct investments (“FDI”) in EU-15 was EUR 6.1 trillion, this Figure for the New Member States was just EUR 0.5 trillion – a value much lower taking even into consideration the population of respective areas.

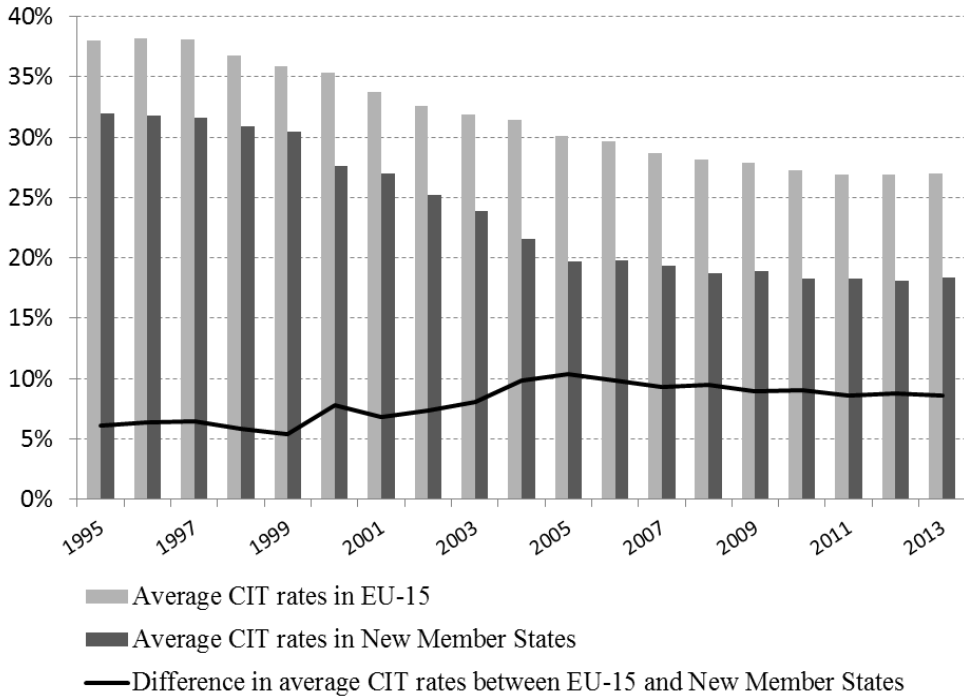
Taxation of foreign capital is always tempting. For example Huizinga and Nicodème estimated that a one percentage point increase in foreign ownership of the

¹ 12 countries, which joined the EU in 2004 and 2007 (Croatia, which accessed EU in 2013 is not included in the analysis).

² 15 countries, which formed EU before 2004.

companies increases the average CIT rate between a half and one percent (Huizinga–Nicodeme 2003). Therefore, the New Member States should constantly put more pressure on CIT competition than the Old EU and as a result full EU-wide CIT harmonization may not be beneficial for them.

Figure 1. Difference between average top CIT rates

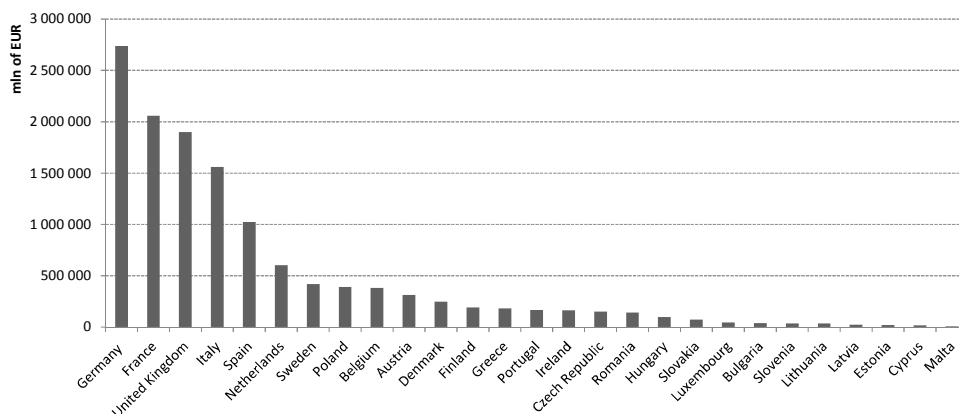


Source: Own construction based on data from Taxation trends in the European Union (2013)

3. Size of economies

The appropriateness of lower CIT burden levied on companies in the New Member States can be explained also by the differences in size of those countries. New Member States are on average smaller, if not always in terms of population, then at least measured by the size of the economy. Such comparison is presented below.

Figure 2. Size of the economies of Member States in 2013 (measured in GDP)



Source: Own construction based on data from Eurostat

As for 2013 among the twelve smallest economies of the EU, eleven were New Member States. The only exception was Poland with the economy of the size just in the middle of the stake of remaining 15 countries.

It may be stated that in fact independent tax jurisdictions share a mobile CIT base by competing for scarce capital. Classic economic models claim that assuming perfect capital mobility the optimal CIT rate for a small open economy equals to zero (Diamond–Mirrlees 1971, Zodrow–Mieszkowski 1986, Wilson 1986)). Small economies are proportionally more affected by the steady increase in capital mobility than the large countries. This is due to the fact, that outflow of certain amount of capital from a small economy could trigger more severe consequences for such state than the loss of the same amount of capital for a large country.

Gordon and Varian conclude that bigger countries may have some market power in the world capital market, which supports taxation of capital (Gordon–Varian 1989). Large jurisdictions, which have some monopsony power, are able to “export” part of its tax burden to non-residents in the form of their reduced after-tax returns to capital (Zodrow–Mieszkowski 1983). Thus, quite an intuitive conclusion would be that small countries, like New Member States, could improve national welfare by cutting CIT rates more than the big countries as the response from capital owners would be there higher. It seems, that at present those states follow this conclusion in reality.

Bucovetsky and Wilson show that a small country should tax only labor, which supply elasticity, unlike in case of capital supply, is finite (Bucovetsky–

Wilson 1991). Large regions on the other hand, which can influence the equilibrium of after-tax returns on capital, can tax capital on a source-basis.

Summarizing, small economies should keep the CIT burden on the low level. Therefore, countries belonging to the Old EU can tax corporations more heavily than smaller New Member States, which now happens in practice. Consequently, disparity in size of the economies is the following argument against full harmonization of CIT.

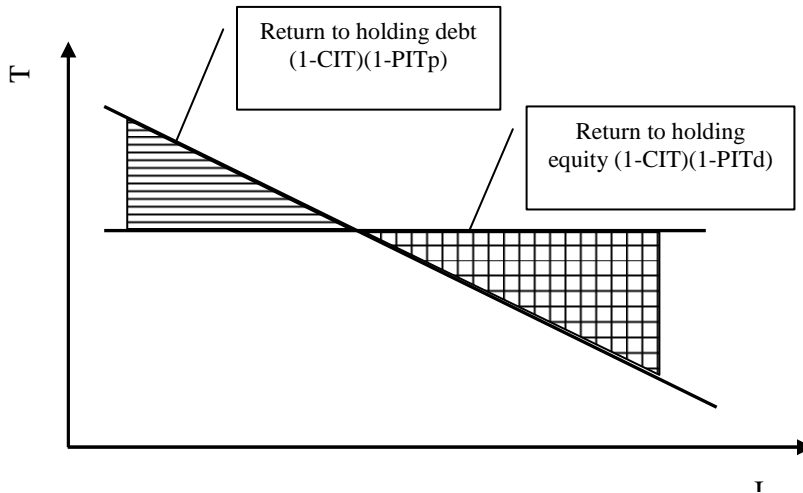
4. Labor taxation

A company, which as a rule is subject to CIT, is not the final income taxpayer. A company is always owned by individual or a group of individuals. Therefore, individual shareholders are always subject to double taxation both at the level of a company (with CIT) and at their own level (with PIT). It is worth considering the actual income tax burden of the individuals.

This relation partially explains Miller in his model (Miller 1977). The after-tax return from equity income is $(1 - CIT)(1 - PIT_d)$, where CIT is the corporate income tax rate and PIT_d is the personal income tax rate imposed on dividends. If instead of dividends the investor derives income from debt, the net income would be $(1 - PIT_p)$, where PIT_p is the progressive PIT rate. Thus, as long as the following inequation is met $(1 - CIT)(1 - PIT_d) > (1 - PIT_p)$ the investor should prefer to hold shares in a company rather than gain an interest income. Consequently, from this perspective the investor who takes a decision whether to buy shares or gain income from non-corporate sources should compare (i) the after-tax returns on investments in corporate sector (subject to CIT and subsequently PIT on dividend distribution) with (ii) the after-tax returns in non-corporate sector, which would be subject to progressive PIT tax rates but no CIT would be charged at any stage.

From purely tax point of view investments in non-corporate sector could be more profitable for the majority of population because most people are subject to low PIT rates as they are in low taxation brackets. However, a relatively small percentage of individuals with the highest income hold a significant number of shares in companies. Hence, as they are subject to high progressive PIT rates, they may prefer to derive income from corporate sources. The reasoning is shown on the below Figure.

Figure 3. Debt vs. equity investing under different income and PIT brackets of the taxpayer



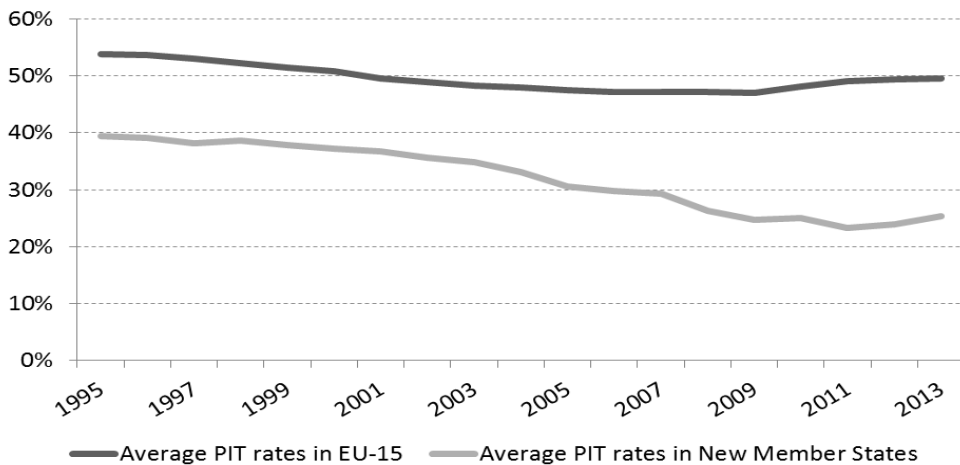
Source: Own construction based on Miller (1977)

Thus, more affluent people, who are subject to higher PIT rate brackets should prefer equity income, which is not taxed with progressive PIT rates (depicted by gridded field). However, those who earn less and are subject to lower progressive PIT rates should be better off if they do not invest in equity (depicted by the stripped field) but in debt instruments. Assuming that among EU-15 countries there are more affluent people, this partially explains the capacity of those countries to maintain higher CIT rates, which on the other hand may turn out to be too high for the New Member States (if full tax harmonization is executed) and significantly decrease the profitability of local companies.

The following reason supporting maintenance of the CIT wedge between the New Member States and the EU-15 is also disparity in the level of PIT rates. Namely, CIT is often seen as a part of progressive tax system and a backstop for PIT. The reason is that some taxpayers could choose whether to pay PIT or CIT, depending on what taxation system they perceive as more favorable to them. In the absence of CIT or with more favorable regulations of CIT than PIT those taxpayers, which pay PIT would feel incentive to incorporate to avoid income taxation. Consequently, the PIT revenues would erode and the income taxation practically would cease to exist. Thus, as evidence shows, the CIT rates are usually higher in countries, which impose high top PIT rates. Slemrod found in his cross country analysis a strong association between the top statutory CIT rate and the top statutory PIT rates (Slemrod

2004). Therefore, unification of CIT should be accompanied by harmonization of PIT. Otherwise too high CIT burden in low CIT countries (mostly New Member States), would erode there the taxation base, because entities would feel incentive to change their legal form in order to become PIT payers (which still could be lower). On the below graph is presented the development of the average top PIT rates for the EU-15 and the New Member Countries.

Figure 4. Average top PIT rates in EU-15 countries and New Member States



Source: Own construction based on data from Taxation Trends in the European Union 2013

Taking into consideration the above on average top PIT rates in the EU-15 are higher than among New Member States. Therefore, having in mind that PIT functions as a CIT backstop this is a following argument against unification of CIT across the whole EU.

5. Public goods

A tax in general is an enforced contribution without direct counter service. Naturally, so is also CIT. Therefore, any taxpayer should be interested in paying least possible taxes. Public goods are accessible to all free of charge. Hence, if taxes weren't obligatory, the free rider problem would arise i.e. taxpayers would feel no incentive to pay (indirectly) for public goods, as public goods are available for the whole society, also for those, who do not pay public contributions.

The Tiebout model assumes that different regions offer certain basket of goods at various prices (Tiebout 1956). Those goods are public goods and their availability corresponds to the taxation burden imposed by each tax jurisdiction. Given that (i) taxpayers have different preferences with respect to the scope of government services they require and (ii) the price they are ready to pay in form of taxes varies, they move between different tax jurisdictions. In course of the choice process of the taxpayers and through appropriate reactions to that choices of particular regions, economic agents and tax jurisdictions determine the equilibria in a number of countries where the taxpayers maximize their utility functions by moving to the tax jurisdiction, which they found most suitable. The model proposed by Tiebout was designed originally for individuals. Fischel, White and more recently Wellisch suggested, however, that the theory can be also easily adopted for multinational firms, which can change their residence according to their preferences depending on the mix of public goods and taxes (Fischel 1975, White 1975, Wellisch 2000).

Consequently, particular countries provide for different set of public goods. Therefore, although generally investors may be inclined to pay lower taxes, concurrently they are interested in usage of public goods, which are financed by those taxes and accessible only on the territory of that particular state. As a result, higher CIT is justified in the EU-15. Concurrently, if CIT was on the same level among the New Member States, the investors could resign from locating capital there.

6. Agglomeration externalities

The economic geography literature claims that companies focus on the size of host domestic market and take into consideration its density i.e. concentration of the demand around specific centers (Brakman et al. 2001). The key is thus the market potential connected with a particular location. Hence, the preferable choice are usually agglomerations, where investors could save on logistics and take advantage from agglomeration externalities. Those benefits include inter alia access to new technologies, well educated labor force, financial, social and political stability. To the extend this factors are financed from taxes, high taxes should not discourage investments but even attract FDI (Campbell 2005).

In high tax locations residents demand high level of public services and support elevated CIT as a financing source. Governments can impose high CIT in agglomerations, which would not trigger outflow of capital as the tax would be imposed largely on location-specific rents. Baldwin and Krugman claim that this holds for European area appointed by the triangle between London, Hamburg and Milan

(Baldwin–Krugman 2004). This means, that CIT should not discourage capital in these locations to flee.

Thus, governments – like those of Old EU – compensate investors for higher CIT (Slemrod 2004, Devereux et al. 2008). As investors perceive CIT as price for availability of agglomeration externalities, they will accept high income taxation. This is also the reason why they expect New Member States to keep CIT on the lower level. Unification of CIT may harm these states also from this perspective.

7. Richness of the societies

There are five commonly accepted features a good taxation system should meet. One of them is justice, which means that a good tax system should provide for just treatment of various economic agents. However, according to this idea justice is not exactly what it may seem. There is a concept of so called vertical justice, which states that parties capable of paying higher taxes should simply pay them.

Taking into consideration the above, imposing on entrepreneurs in different locations the same amount of CIT is not appropriate. Namely, EU-15 countries levy on average higher CIT burden than New Member States, because taxpayers in those countries are typically more affluent and therefore capable of paying proportionally more taxes (according to vertical justice concept).

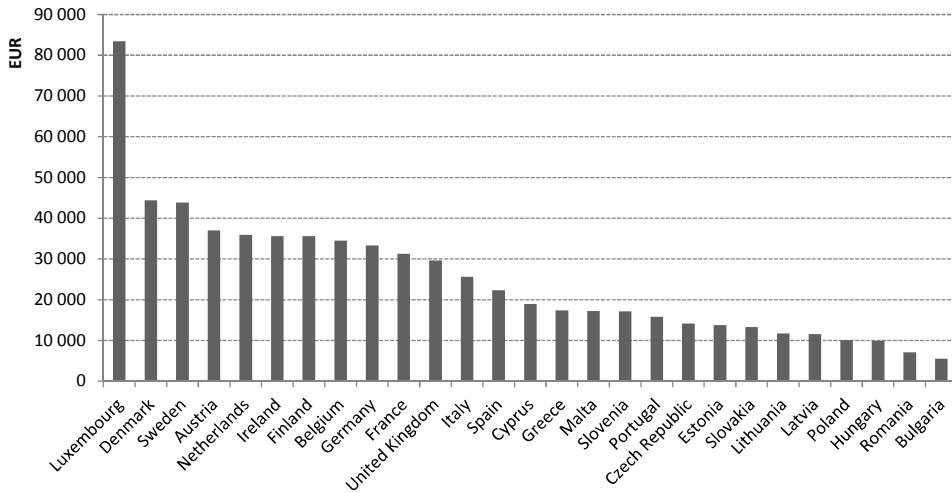
Moreover, people who earn more, save also more (Żyżyński 2009). Therefore, without major loss in their well-being they could bear more CIT (assuming that the economic cost of any tax – including CIT – is eventually born by individuals and not by companies, which was broadly discussed in the literature).

It should be underlined that CIT bear not the companies but their ultimate owner, which are individuals. The richness of residents of various EU countries is presented below.

Taking into consideration the above thirteen countries, where the GDP per inhabitant is highest belong to EU-15. The only exceptions are Greece and Portugal. However, still those states are in the middle of the stake. Importantly, the above Figure compares only the current incomes. However, if the total possessions were taken into consideration the discrepancy between an average EU-15 and New Member State resident would be even greater.

Consequently, the same tax for the whole EU would not be just according to the concept of good taxation system. The cost of tax should correspond to a particular economy of each Member State.

Figure 5. GDP in Euro per inhabitant in 2013



Source: Own construction based on data from Eurostat

8. Tax morale

Several researchers claim that most standard economic models fail to grasp the tax compliance of the taxpayers properly. In particular tax compliance cannot be explained solely by deterrence, risk aversion, tax burden or density of tax regulations. For example Alm et al. as well as Frey and Feld argue that most economic models assume too much tax evasion (Alm et al. 1992, Frey–Feld 2002). In fact several taxpayers do not even seek ways to evade taxes and cannot be seen as simple utility maximizers, although in certain situations omitting taxes could be more favorable to them.

Frey underlines that tax morality differs across countries (Frey 1997). He points inter alia social norms and societal institutions, which are important determinants of tax morality and vary between states. Therefore, assuming that tax morale is higher among Old EU, these countries are able to impose higher CIT burden with lower risk of tax evasion.

Torgler and Schneider found strong negative correlation between shadow economy (Torgler–Schneider 2007) and tax morale. According to their study the lower is tax morale, the more likely is that the shadow economy will be bigger. They claim that if taxpayers perceive government as helpful rather than wasteful, they tend to comply with own tax obligations and stay in the official sector. Shadow

economy differs in the EU and tends to be greater among New Member States. Assuming that the level of tax morale follows the size of shadow economy, this also supports the claim that CIT burden in the New Member Countries should be lower than among Old EU.

Abed and Gupta claimed that among former soviet states institutional weaknesses and corruption was one of the major obstacles to market reforms (Abed–Gupta 2002). If economic agents feel that they are cheated, the corruption is widespread and that they are not well protected by law, they are more inclined to be active in the informal sector and evade taxes. Hence, this also supports our hypothesis.

Religion also supports tax morale as it acts as a “supernatural police” (Anderson–Tollison 1992). Alm and Torgler found that higher church attendance leads to greater tax morality (Alm–Torgler 2006). Again, most post-communistic New Member States do not feature high religiosity.

Anyway, customs are very difficult to change. Taxes have a long tradition in the Old EU and local citizens appreciate it. In general state tax administration seems there also to be more responsive and less corrupted. Economic agents probably evade there taxes less than in Central Europe partially because they have higher tax morale. All these features, which however are difficult to measure, suggest that equalization of the corporate tax within the whole EU could be counterproductive. Even if the CIT burden is set on some medium level both the Old EU and New Member States might lose tax revenues but for different reasons – i.e. Western Europe because reduction of taxation and Central Europe because of increase of corruption and shadow economy in general.

9. Conclusion

Harmonization of CIT in the EU is recently on the agenda. It should contribute to a common market and ease the life for the multinational companies. However, potential harmonization of CIT will include also several consequences, which are far more reaching than taxation only. Economies of Member States differ significantly and may not be ready for a common taxation. In this article I tried to highlight several arguments, which support this hypothesis. Among them are inter alia such issues as: (i) requirement for capital, (ii) size of the economies, (iii) differences in labor taxation, (iv) set of public goods available to taxpayers, (v) agglomeration externalities, (vi) richness of societies or (vii) level of tax morale.

Introduction of CCCTB indeed could be appropriate solution for the whole EU. Surprisingly, it may even foster the tax competition, because comparison of corporate income taxation burden will be easier with a unified tax base. However,

taking into consideration different features of the economies of particular Member States, it seems that EU is not homogenous enough to adopt full CIT harmonization (i.e. including tax rate).

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