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EU tax harmonisation and tax competition – lessons to Hungary

This study explains the correspondence between tax harmonisation and tax competition, focussing its arguments around the notions of competition and competitiveness. The development of the European integration, the particular forms of integration and the particularities of the common budget give rise to the necessity of developing and operating a common tax policy and a system of taxation, with the harmonisation of national tax policies and systems of taxation as a minimum requirement. With deepening globalisation and a gradual phase-out of discriminative tax allowances incompatible with market economies, however, it is not only countries or their companies and sectors that compete but also their tax policies and systems of taxation – primarily in reducing their tax rates. As a consequence of this, however, a requirement follows for Member State tax policies and systems of taxation to compete and be tendered in competition.

An overview of a few general issues of tax harmonisation places corporate taxation in a broader context; such an overview is the focus of this study. Our purpose is to analyse what factors influence EU harmonisation and tax competition, whether harmonisation or competition will be the decisive factor, and how the expected trends will affect the competitiveness of Hungary and the local corporate taxation.

What makes this subject topical is, among others, that the latest enlargement added countries to the European Union where the corporate income tax (hereinafter referred to as corporate tax in short) rate was low, what is more, some of the acceding countries even reduced this rate before accession. Such a step was conceived by old Member States as tax competition, or directly as "tax dumping".

SOME GENERAL ISSUES OF TAX HARMONISATION

According to a generally accepted definition, tax is a recurring liability of the various participants of the economy, and revenue gained from it is used to cover public expenses. Tax liability is incurred by a unilateral will of the public authority, involves no direct consideration, and is enforceable on non-performance (Vigvári, 2002, page 144). In addition to covering public expenses, tax is also an essential macro-economic regulator and a means of orientation. Tax-rises curb economic growth, while exemption from taxes, or tax allowances may induce growth both in certain parts or the whole economy. Taxation also affects the distribution of income among the participants of the economy (business sector, households) and the utilisation of production factors (workforce, capital).

Accordingly, tax policy and the tax system need to pursue two contradictory objectives simultaneously: the income necessary to perform government duties must be catered for, while economic activities and an efficient utilisation of production factors should not be restrained, but possibly promoted, and competitiveness should be improved.

In the European Union, the issues of tax policy and the tax system are met at the level of integration on the one hand, and at the level of Member States on the other hand. The budget of the European Community differs from the budgets of both the individual states and of international organisations. The EU budget reallocates a much smaller portion of the GDP (a maximum of 1.045 percent in the period between 2007 and 2013) compared to the Member States (40–55 percent); at the same time, the EU budget is much higher than that of international organisations, and much lower than of all Member States. The common budget contains restrictions that are inconceivable in a country. Accordingly, no taxes are levied at the community level, and the expenses of the common budget are covered from Member State taxes and contributions collected. The Community has no organ dedicated to taxes, Member State contributions are limited, budget deficits cannot be funded from loans, and a seven-year statutory financial budget limit planning precedes the production and acceptance of the budget. The expense side of the common budget has more limited functions of allocation compared to individual states. The conflicted targets of ensuring revenues and encouraging economic activities at the same time are not applicable to the common budget.

From the viewpoint of the European Community, the tax policy and the tax system of Member States are a material component of the economic environment, which is inseparable from the free movement of goods, servoices and production factors (capital and workforce) among Member States. Indirect taxes are levied to product and service sales, and, consequently, they directly affect the operation of the customs union and the single market including the customs union. Direct taxes are applicable to the income of natural persons and legal entities, accordingly, are linked to a smaller extent and directly to the movement of goods and services among Member States, however, they may affect the movement of production factors (workforce and capital) among Member States, i.e. the operation of the common market and the included single market.

The treaties of the European Union consider competition as an engine to economic development, consequently, aim at breaking down all factors hindering competition, which also affect trade among Member States. The differences between tax policies and tax systems of various Member States undoubtedly distort competitive conditions among Member States. The significance of this distorting effect increases with transition to new forms of regional economic association (free trade zone, customs union, common market, single market, economic and monetary union). As a consequence of this, a requirement to unify the tax policies and tax systems of Member States, and even to develop a common tax policy and a tax system. At the same time, the tax systems of individual countries also compete each other in the integration, which may have positive effects on economic growth, and – in a broader context – on economic development and competitiveness.

The harmonisation of tax laws aims at eliminating differences between tax conditions in Member States, which also caters for the convergence of tax provisions. Harmonisation can be complete, for instance, if a uniform adoption of a European corporate tax is set as an objective. For partial tax harmonisation, the tax rates of individual Member States are intended to be adjusted to one another. In case of positive tax harmonisation, community legislation is applied to converge tax-related provisions. Negative tax harmonisation means seeking to avoid arbitrary discrimination or protectionism that would be caused by differences in the tax legislation in individual countries, while the differences themselves persist. Finally, in case of the weakest form of legal harmonisation, relying on the principle of subsidiarity[1], national tax laws primarily use Member State legislation to reach compatibility among national tax provisions. In such cases, direct community legislation becomes unnecessary (Deák, 2001, page 166).

Negative legal harmonisation appeared as early as in the Treaty of Rome with a view to preventing taxes generating protectionism from influencing trade among Member States (Fazekas, 2002, page 52). Under Article 90 of the currently effective EC Treaty "no Member State shall impose, directly or indirectly, on the products of other Member States any internal taxation of any kind in excess of that imposed on similar domestic products. In addition, no Member State forbids the imposition on imported products of any form of taxation of such a nature as to afford indirect protection to other products." Under Article 91, "where products are exported to the territory of any Member State, any repayment of internal taxation shall not exceed the internal taxation imposed on them whether directly or indirectly."

Article 92 stipulates that "in the case of charges other than turnover taxes, excise duties and other forms of indirect taxation, remissions and repayments in respect of exports to other Member States may not be granted and countervailing charges in respect of imports from Member States may not be imposed unless the measures contemplated have been previously approved for a limited period by the Council acting by a qualified majority on a proposal from the Commission."

Finally, under Article 93, "the Council shall, acting unanimously on a proposal from the Commission and after consulting the European Parliament and the Economic and Social Committee, adopt provisions for the harmonisation of legislation concerning turnover taxes, excise duties and other forms of indirect taxation to the extent that such harmonisation is necessary to ensure the establishment and the functioning of the internal market within the time limit laid down in Article 14" (Fazekas, 2002, page 52).

The direction, contents and pace of legal harmonisation within the Community are directly related to the four freedoms (general turnover tax: free movement of goods and services; profit tax: establishment of enterprises and movement of capital; personal income tax: free movement of labour, i.e. what eligibility can be obtained in another country against public dues paid in one country).

In terms of regulating taxation, two contradicting views are distinguished in the European Union. One concept aims at unity and unification, which is directed at eliminating differences among the tax policies and tax systems in Member States, and at unifying tax types and tax rates. The other concept considers also the interests of Member States, and, accordingly, recommends a differentiated approach, and settles for cooperation among Member States in terms of tax policy. Followers of this concept attribute positive growth and efficiency effects to competition among various tax types. They emphasize that taxes should be paid or collected in a Member State subject to the location of the respective taxable activity. Considering that the location of economic activity can be freely selected, governments are forced to compete for tax revenues. In a single market, the conditions of competition requires no harmonisation of Member State tax policies; coordination of tax policies is sufficient. The latter refers to eliminating withholding taxes on money and revenue transfers (interest and royalty payments) between associated enterprises, and to coordination in terms of regulation concerning pricing and cost settlement, among others.

The harmonisation of tax law in the European Union has been implemented in various forms of compromise between these two concepts. The main reason for this lies in the fact that the specific forms of tax harmonisation affect the volume of tax revenues, and, through them, public finances and the current balance of payments, while in the case of indirect taxes, the redistribution of revenues generated by the common budget among Member States is affected. The most advanced state of legal harmonisation is seen in the field of direct taxation (taxes on the exchange of goods and services: general turnover tax, excise duties) (positive harmonisation), which is related to the fact that the first to be implemented was customs union. Due to converging market conditions, the operability of the common budget and the registration system, the current agenda item for the general turnover tax has been a transition from the principle of the country of destination to the principle of the country of origin – for over fifteen years now. In terms of corporation tax, negative harmonisation addresses the elimination of tax evasion and harmful tax competition, and positive harmonisation aims at the convergence of conditions of corporate taxation (tax bases, tax rates, conditions of allowances and exemption, a uniform taxation of capital revenues). For the taxation of personal income, negative harmonisation is focused on prohibiting discrimination. In the distant future, the systems of personal income tax and contributions may converge. The differences present in the systems of personal income tax have the least impact on trade between Member States. Despite a relatively slow progress, the acquis communautire concerning taxation has grown to comprise over 140 provisions. Henceforth, this study focuses on the corporate tax, and only addresses other tax types inasmuch as those are related to it.

COMMUNITY HARMONISATION EFFORTS IN CORPORATE TAXATION

According to a widely used – and substantiated – concept, the role of tax systems, in general, is secondary when making investment decisions. Companies make investment decisions considering a number of other aspects influencing the return on investment (market size, availability of workforce of sufficient quality and quantity, volume of labour costs, development of infrastructure, etc.). Competitiveness does not primarily depend on taxation, while taxation, and, in a broader sense, the system of public dues, affects the competitiveness of companies and national economies though a number of mechanisms (Akar, 2006, page 101). Various experts assess the role and significance of these mechanisms in different ways.

Differences in taxes levied on corporate profits by country are brought to the foreground in investment decisions (and become factors of competitiveness) when all other conditions provided by the countries are nearly identical. Rules of profit taxation may advance to play a crucial role and be a competitiveness factor, in particular cases, in an intensifying competition for foreign working capital investments. The tax competition has other implications, too: a non-negligible branch is to supplement the narrow domestic tax base with the broad foreign tax base and the realisation of any associated profits.

Arguments among those against the harmonisation of direct taxes, and, accordingly, the profit tax equally include ones of economic and political nature. A political argument is that community institutions – except for the European Parliament – have no democratic legitimation, given that the members are not directly elected. To be able to levy Community taxes, representation would be necessary. (This argument may be easily refuted by referencing the particularities of the Community's system of institutions.) A more significant fact is that the redistribution preferences of Member States are different. The burdens of stabilisation policies are also left to the public finances of individual Member States: it would generate great difficulties to establish a community stabilisation fund; however, slight is Member State interest in developing public policies that require high expenses (Nicodeme, 2006, page 6). Underlying to these arguments is probably the fact that tax policy is a crucial symbol of financial sovereignty, which (in combination with financing public expenses and redistribution) individual Member States do not wish to give up. After all, the right of levying taxes is an exclusive right of states, while other participants of the economy (including supranational institutions) are not authorised to do so.

A key argument of those in favour of community tax harmonisation is that economic integration and the mobility of production factors may induce a situation where Member States develop a “harmful” strategy to attract and retain the most mobile production factor, i.e. capital, while tax burdens are imposed unilaterally on a less mobile production factor, i.e. workforce. The avoidance of such factors also necessitates coordination at the community level. Various tax-related obstacles prevent completing internal market unification. These can only be eliminated at the level of the community, and not within Member States. This comes from the fact that taxes have certain impacts that are easier to handle at the community level than within individual Member States. Despite all limitations of the role of the community in stabilisation and redistribution, Member States may retain more resources to finance their policies through cooperation at the level of the integration. Finally, a common monetary policy also necessitates monitoring impacts on production and stability (Nicodeme, 2006, pages 6–7).

Application of the principle of subsidiarity alone, as specified in the EC Treaty, to taxation restricts influence at the community level. For community decisions on taxation, unanimity i.e. agreement by all countries is required in the Council to accept community provisions. Previously, the United Kingdom and Ireland prevented tax harmonisation in terms of corporate tax.

Tax harmonisation necessarily violates the national sovereignty of individual states; consequently, community intervention may only take place in duly justified cases. Tax competition, however, is also a breach of Member State sovereignty. Irrespective of all these, the Treaty allows for intensified community action in the case of indirect taxes and state subsidies, ensuring the principle of no discrimination, eliminating the obstacles to unifying the internal market, multilateral supervision of economic policy and certain specific actions.

The harmonisation of profit taxes was first proposed in 1962 in the so-called Neumark report. This report was used to develop a draft directive in 1975, which was, however, withdrawn in 1990. Any subsequent legal harmonisation has had rather modest aims since. Three principles are applicable to the harmonisation of profit tax systems. The principle of mergers eliminated tax-related disadvantages to cross-border organisational changes and reorganisations. The principle of parent companies and subsidiaries aims at abolishing double taxation on profit paid to the parent company (dividends) in cases where the parent company and the subsidiary are seated in different countries. Finally, the principle of interest and royalties has eliminated taxation on interest and royalty payments for associated enterprises in the EU Member States where these payments originated.

The code of conduct adopted in 1997 on profit taxation is seen as a particular "weak" form of legal harmonisation, which is deemed to be a non-binding recommendation (Joumard, 2001, pages 48–49). The underlying legal base is Articles 90-93 of the EC Treaty. By adopting it, Member States assume a unilateral obligation to comply with the standards of conduct defined in the code. With certain exceptions, no sanctions can be imposed on the violation of standards of conduct set forth in the code. The exceptions are related to the fact that a number of non-compliant practices of taxation are applicable to state subsidies under the competence of the EC Treaty, which belongs to the European Commission to sanction.

It must be noted that in 1998 OECD issued guidelines with similar contents to those of the community code of conduct, which are applicable to 30 states in the organisation. Beyond a different geographical scope, the main difference between the two documents is that while the code addresses business activity in general, the OECD guidelines focus on financial and other services (OECD, 1998).

The countries signing the code of conduct have assumed an obligation to provide one another with information on their existing or proposed tax-related provisions and procedures governed by the code, under the notion of transparency. No tax-related measures that prejudice the Community will be adopted, and any such measures in effect would be eliminated until the end of 2003. The code considers taxation in a broad context (laws, other provisions, practice of taxation, etc.). It is applicable to enterprise-related taxes that have a significant impact on the location of business activities.

Under the code, all activities that result in lower actual taxes compared to the rate customary in the given Member State are deemed non-compliant: reducing the tax base by way of, for example, special depreciation write-offs or accumulation of tax-free provisions, full or partial reduction of the tax rate, deferral of or exemption from tax payment obligations in cases where the allowance was provided from state resources (Erdős – Földes – Őry – Véghelyi, 1999, pages 137–138). A subsequent examination identified 66 non-compliant tax provisions and practices that encouraged business activities to be pursued in one EU Member State to the disadvantage of another one.

However, non-compliance is not applicable to allowances that do not affect the trade among Member States and that may be used by any enterprise under equal conditions (accrual of loss, allowances related to R&D, etc.).

The intensive competition in the field of profit taxation is not contrary to the letter and spirit of the code of conduct and the OECD guidelines. An increasing number of countries wish to achieve an international competitive advantage by reducing their corporate tax rates. If a low rate of corporate tax is applicable to all enterprises registered in the given Member State, it is in line with the provisions of the code of conduct, considering that a tax burden lower than the customary rate imposed on some participants of the economy is not the case. What could be questionable here is how significantly a reduced corporate tax rate affects the location of business activities.

A review of community proposals on profit taxation would go beyond the scope of this study (European Commission, 2001). (For a summary of such proposals, see Mintz, 2002). In the light of community decision-making, no decision is expected within a short time. The ministers of finance of Member States agreed on a tax harmonisation package in June 2003, which contains an obligation not to use corporate tax as a means of unfair competition.

SOME THEORETICAL CORRELATIONS OF TAX COMPETITION

According to some followers of an approach to this concept, capital is the most mobile production factor that moves into countries that apply the lowest rate of corporate tax – especially in circumstances where there is a strong global competition for investments of foreign working capital. Related to this is the fact that large transnational corporations also use various methods (management fees, transfer prices, ownership loans, etc.) to regroup their profits to countries with low tax burdens. All these encourage governments to reduce corporate tax rates and, in a broader context, taxes on capital revenues on a continuous basis, which may result in a race to the bottom (or even to zero) (Wilson, 1999). As a consequence, the centre of gravity for tax burdens is transferred to immobile production factors, and within those to workforce, as this may balance public finance revenues lost due to lower capital taxes. Harmful effects may be avoided by tax harmonisation or coordination of economic policy.

The paradoxical nature of this situation is indicated by the fact that raising taxes imposed on companies is, from a political aspect, an apparently easier and more grateful duty than raising personal income taxes. Company owners are fewer in number compared to the employees, whose votes represent a greater part on elections. According to the economic theory, it is not companies but ultimately persons that pay taxes, namely, company owners, and, in a broader sense, capital owners. It is only one side of the coin that increased corporate taxes impose more burden on the rich than on the poor because it is primarily them that hold shares and other forms of capital ownership (the core deposits of limited liability companies in Hungary, for instance).

There are more details to the effects than mentioned so far. On the one hand, in developed countries, and particularly in the Anglo-American states, share ownership has spread at a high pace wide across the society. In the USA, over half the population holds shares directly or indirectly (in investment funds, pension funds, etc.), although share ownership itself is fairly concentrated. Despite, rises in corporate taxes affect an extending ownership group.

On the other hand, a response given by companies to raised corporate taxes may be to increase the prices of goods and services, or to freeze or reduce employee wages (the latter, at least nominally, is quite a difficult case, as wages are known to be rigid downwards). Raised corporate taxes already afflict "common people", i.e. – put in a more sophisticated way – a portion of taxes imposed on companies is paid by employees and consumers (Stiglitz, 2000, page 576).

According to the relevant theories, raising corporate taxes does not encourage savings, as higher tax rates make savings and investments less attractive. Lower investments mean lower capital stock, less capital per employee, and, consequently, lower wages. Many studies have established a negative correlation between investments and corporate tax rate: the higher the corporate tax rate in a country, the fewer the investments.

Globalisation further intensifies these effects. In such circumstances, capital is quickly transferred from countries with high corporate tax rates to those with low ones. As a result, in countries with high corporate tax rates, fewer investments are implemented, and real wages are lower. Winners of this process are employees in countries with lower corporate tax rates.

Disregarding other conditions, in small and open economies the impact of low corporate tax rates on wages and investments is more significant than in less open, large countries. In small countries, productivity improves at a fast pace with direct foreign capital investments. As a general rule: according to a generally accepted model of tax competition, it is the size of the country that counts from the aspect of tax competition – and, normally, the winners are small countries. At the same time, not even small national economies are able to stand the pressure of the tax competition, but they have much more to win. They have a low domestic tax base, but a high foreign tax base. Gains from a considerable foreign tax base may neutralise their losses resulting from a reduced corporate tax rate on the domestic tax base (Ganghof – Genschel, 2006, page 103).

It is probably related to this that the highest corporate tax rates are found, of all developed market economies, in Japan and the USA. When tax rates were reduced in the USA (e.g. under the presidencies of *Ronald Reagan* and *George Bush*, Sr.), it was never the corporate tax but the personal income tax that was decreased. Due to higher corporate tax rates, large masses of companies are unable to leave the USA and Japan – it is not possible because of the size and the geographical position of the country. Germany is also a country with large economic dimensions, but there, expatriation of various sectors and corporate activities to countries with lower cost levels and tax rates has reached such an extent that the government decided to reduce the corporate tax rate of nearly 40 percent deemed to be the highest in Europe to 30 percent. Corporate tax rates in smaller countries are generally lower than those in large ones. Based on experience gained in the past two decades, the correlation between the country size (dimensions of national economy) and the corporate tax rate is strong. The smaller a country, the lower the corporate tax rate.

Certain theoretical approaches deny the necessity of tax harmonisation. Considering the impacts of geographical distance, the intensifying competition in applying lower and lower tax rates is not indispensable, and tax harmonisation is outright harmful to all countries. According to the economic geographical theory, the factors that form the decisions on selecting business premises in companies are centrifugal and centripetal forces. High transportation costs, for example, force companies to recede from the centre, while a large selection of workforce, favourable infrastructure available in the centre and synergies resulting from the presence of a high number of companies attract economic organisations. The latter provides a facility for countries in a central position to keep high tax rates compared to those on the periphery. Low corporate tax rates in peripheral countries are not aimed at obtaining competitive advantages, but at eliminating competitive disadvantages. Peripheral countries do not encourage central countries to reduce their tax rates; the latter ones may raise their corporate tax rates without detrimental consequences. On these grounds, it is no accident that the tax rates of large countries are generally higher compared to small peripheral ones.

This line of thought appears convincing at first glance. It is rather difficult to support it with empirical data, though. This argument does not address the relation between dimensions of national economy, or the level of economic development and the corporate tax rate. In addition to the relation between the centre and the periphery, these factors also affect the rate of corporate tax.

As for an empirical testing of theories, a high number of analyses have been conducted on the correspondence between changes in the effective tax burden (actual burden, i.e. considering allowances) and capital influx. According to a study prepared in 1999, a 1-percentage point rise in the corporate tax rate in the USA is coupled with a 0.5 to 0.6-percentage point drop in working capital investments (Hines, 1999).

Relatively little empirical research was administered to quantify correspondence between corporate tax rates and wages. One such investigation carried out by the staff of the American Enterprise Institute tried to find correspondence between the corporate tax rates and the wages of employees in the processing industry in 72 countries, considering data relevant to 22 years (Hassett – Mathur, 2006). The purpose of the investigation was to test a logical conclusion whether differences in corporate tax rates have affected wages, certainly also considering the other factors forming wages (productivity, negotiating force of trade unions, etc.). The research results revealed that a 1-percentage point rise in the corporate tax rate was coupled with a 0.8-percent reduction of wages in the next five years in the countries considered in the examination. This correspondence was stronger in small countries than in large ones. International tax competition was also important: a 1-percentage point reduction in corporate tax rates in the neighbouring countries resulted in a 0.5-percentage point reduction in wages at home.

The specific figures representing the described analysis may be exaggerated. Despite – like it or not –, it seems confirmed that the rate of corporate tax, as well as the direction and rate of any change to it play an important role in the dynamics of wages. Raising the corporate tax rate does not result in a proportionate increase in corporate tax burdens, because an increasing portion of burdens is gradually shifted to the workforce. At the time of globalisation, the main propelling force is the movement of working capital; companies invest in countries with low corporate tax rates, and transfer an increasing portion of their production and service activities there.

CAUSES AND CONSEQUENCES

The average corporate tax rate in the European Union of 15 decreased from 50 to 30.4 percent between 1984 and 2005. One group of experts attributes a key role to tax competition in the process, facilitated by the community harmonisation of tax law (including the code of conduct). With the unification of the internal market, a reduction in the transaction charges of cross-border tax arbitrage also had a hand in that. According to the other approach, the reason why governments reduced the corporate tax rates was not international tax competition, but because experience gained from the recessions in the 1970s and 1980s shed light on the disadvantages of a system based on a combination of high tax rates and allowances. This system encouraged harmful domestic tax arbitrage (Ganghof-Genschel, 2006, page 102). A tax rate reduction coupled with the elimination of discriminative allowances added transparency to the system of corporate tax rate. (See Table 1)

The harmonisation of tax provisions and the code of conduct have established an appropriate framework for Member States to reduce their corporate tax rates, while the transparency of tax systems in Member States has also been improved by eliminating a significant portion of discriminative allowances (non-compliant tax-related measures). Consequently, community regulation is in harmony with both lines of thought, and can be used to confirm both. The second line of thought, however, is only valid for the period up to the mid-1990s, and, certainly, not exclusively even for that. Subsequently, the effect of tax competition seen among Member States and globally was dominant, however, certainly, not alone but combined with other factors.

At the same time, it is important to emphasize that a corporate tax rate defined by law is just a component in international tax competition; it does not show the position and the role of a country in the international ranking order, or only to a limited extent. A considerable modifying factor is an often complicated system of tax allowances, as well as the calculation of the tax base. The definition of the tax base has been different in each individual Member

Table 1

STATUTORY CORPORATE TAX RATES IN THE EU MEMBER STATES

	1980	1990	1995	2000	2005
Austria	55	39	34	34	25
Belgium	48	41	40.17	40.17	33.99
Cyprus	n.a.	42.5	25	29	10
Czech Republic	n.a.	n.a.	41	31	26
Denmark	n.a.	40	34	32	30
Estonia	n.a.	n.a.	26	26	24
Finland	59	41	25	29	26
France	50	37	36.67	36.67	34.93
Federal Rep. of Germany	52.8	57.7	56.8	51.63	38.29
Greece	43.4	46.0	40.0	40.0	35.0
Hungary	n.a.	50	19.64	19.64	17.68
Ireland	45	43	40	24	12.5
Italy	36.3	41.8	52.2	41.25	37.25
Latvia	n.a.	n.a.	25	25	15
Lithuania	n.a.	35	29	24	15
Luxemburg	n.a.	39.4	40.9	37.45	30.28
Malta	n.a.	32.5	35	35	35
Holland	48	35	35	35	31.5
Poland	n.a.	40	40	30	19
Portugal	n.a.	36.5	39.6	35.2	27.5
Slovakia	n.a.	n.a.	40	29	19
Slovenia	n.a.	n.a.	25	25	25
Spain	33	35	35	35	35
Sweden	n.a.	40	28	28	28
United Kingdom	52	34	33	30	30
Average of EU-15	n.a.	40.4	38.0	35.3	30.4
Average of new Member States	n.a.	n.a.	30.6	24.8	18.2

Source: Nicodeme, 2006, page 18

Note: For some countries, adjusted with local corporate (business) tax

State. Considering tax allowances and the tax base, the business sector's actual tax burden may vary from what is suggested by the nominal tax rates specified in law.

The reduction of corporate tax rates in the EU Member States has not yielded reduced revenues of corporate tax rates, either as an absolute value, or in proportion to the GDP, and has not eroded the welfare state. (If it took place in certain countries, it was not caused by the tax competition.) Stagnating or increasing tax rates – at least for small countries – allow for a conclusion that the loss incurred by a reduced tax rate on the domestic tax base was offset by gains related to an increased foreign tax base. As for large countries, tax revenues increased as a result of eliminating allowances were able to offset the impacts of reduced tax rates. The tax competition and the decreasing rate of corporate tax also promote reforms to the expense side of the budget. The tax competition may contribute to reinforced financial discipline, and to an improved balance of tax burdens and state services (Hetényi, 2006, page 89). At the same time, tax evasion is still possible by way of a proper selection of the location of economic activities, and by representing profit in a country with a more favourable tax rate (Nicodeme, 2006, page 36).

With the enlargement of 2004, tax competition, or the debate on the subject has gained new impetus in the European Union. This has been substantiated on the fact that the average corporate tax rate in 2004 was approximately 10-percentage point lower in new EU Member States compared to the old ones. The difference between old and new Member States between 1995 and 2004 grew from 7.3 to 10.8 percentage points, i.e. corporate tax rates were reduced to a greater extent in the new Member States than in the old ones. The majority of new Member States have used the last moment before accession to the EU to reduce their corporate tax rates; accordingly, as of 1 January 2004, the rate was reduced from 27 to 19 percent on Poland, from 31 to 28 percent in the Czech Republic, from 19 to 15 percent in Lithuania, and from 25 to 19 percent in Slovakia. It is worth noting that Rumania, which is to become a member of the EU as of 2007, decreased its corporate tax rate from the earlier 25 to 16 percent in 2005. The eastern European tax dumping voiced in the western media and occasionally in the literature is not a comprehensible notion. Dumping is referenced if a company sells goods abroad below the production costs, and causes a disturbance to the market. No such dumping is present in profit taxation.

Also in the course of enlargement, the correlation between the dimensions of national economies and the rates of corporate tax was confirmed. On an EU scale, small countries acceded, where, compared to the large countries of the EU, the corporate tax rates are low.

The rate of corporate tax is closely related to the highest of personal income tax rates. If the reduction of the corporate tax rate is not followed by a reduction of at least the highest rate of personal income tax, a facility of tax arbitrage is available, which is harmful at the level of the national economy, because it leads to tax evasion. This means that private individuals transfer themselves to the business sector in increasing numbers, and convert their wage revenues into profit revenues, thus saving tax. This process is curbed by the fact that entrepreneurs do not only have the personal income tax rate to consider, but also public dues on wages, which makes tax arbitrage less attractive.

On reducing the corporate income tax rate, either the highest rate of the personal income tax needs to be reduced, or harmful tax arbitrage needs to be considered, i.e. the fact that taxable revenues flow from personal income taxation to corporate taxation. In both cases, the tax revenue potential and/or the progressivity of the personal income tax system is decreased, which affects the whole tax system, and, hereby, may also influence the competitiveness of the national economy (Ganghof – Genschel, 2006, page 110). An intention of avoiding harmful tax arbitrage may also have had a hand in the propagation of single-key tax systems in various forms. An analysis of this would exceed the scope of this study both in terms of contents and extent.

In order to restrict harmful tax competition, the necessity of adopting a common minimum corporate tax rate emerged in the European Union. On the one hand, the common minimum tax rate would set a lower limit for tax competition among EU Member States, while it would not completely eliminate tax competition. On the other hand, a minimum tax rate increases the space available to Member States for movement towards developing competitive tax rates. Member States with high tax rates may reduce their rates, while they need not be afraid of uncontrollable tax competition beyond a certain limit. Countries with a low tax rate may carry on using their corporate tax to involve foreign working capital, or may compensate their peripheral position with a lower tax rate (Ganghof – Genschel, 2006, page 111).

In tax cases under Article 94 and section (2) of Article 95 of the EC Treaty, Member States pass unanimous decisions. This makes the adoption of a common corporate tax rate minimum more difficult but not impossible. The time requirement of such a process is unforeseeable for the time being.

The efforts of the European Commission for legal harmonisation have recently been directed at harmonising the corporate tax base (an optimised common consolidated corporate tax base for enterprises conducting business in Europe) (European Commission, 2001, 2005, 2006). The proposals produced so far do not affect the corporate tax rate, consequently, leave tax competition unchanged. The Member State support of harmonising the corporate tax base is higher than that of harmonising rates, or of adopting a common minimum rate, although the former efforts also leave important issues open (such as the distribution of the tax base). Depending on the support from Member States, draft legislation is expected to be produced before the end of 2008.

RECENT TENDENCIES IN THE HUNGARIAN TAXATION POLICY

Hungary harmonised most of its tax provisions prior to the accession to the EU. The burdens of tax-related and other provisions enacted based on the New Balance programme announced in June 2006 are distributed among the participants of the economy: employees, or, in a broader sense, households or consumers, the business sector and public finances. The Government expects the adoption of the solidarity tax as of 1 September 2006 on the one hand, and the so-called expected tax, on the other hand, to be a contribution of the business sector towards the reduction of the public finance deficit. Further revenues are expected from the tax levied on the cash-on-hand kept by enterprises, which is applicable to higher amounts of cash held by enterprises compared to what is justified by their course of business. Finally, and parallel to tax increases, the Government annulled its multiannual programme adopted in 2005 to reduce taxes, including the earlier provision of law whereby the local business tax, which had an outstanding deteriorating effect on the competitiveness of enterprises – and whose compliance with community provisions was also debated – would be eliminated in 2008.

The solidarity tax base is the pre-tax profit of an enterprise, which cannot be reduced by allowances. The tax rate equals 4 percent of the tax base. In terms of contents and function, the solidarity tax is, at first glance, similar to the corporate tax, i.e. its introduction could, in theory, have been replaced by a 4 percentage point increase in the 16 percent corporate tax for medium-sized and large enterprises. Adoption of the new tax type was justified by the fact that the first time the corporate tax rate can be changed is 1 January, while a new tax type, such as the solidarity tax, can also be enacted during the year (i.e. on 1 September).

Parallel to the solidarity tax, the Government also raised the highest rate of the personal income tax by 4 percentage points, which is also termed a solidarity tax. It eliminated any possibility of harmful tax arbitrage, although the space for the participants of the economy is rather limited in this respect in Hungary, due to the high rates of contributions payable on wages.

At the same time, the bases of the solidarity tax and the corporate tax are different. The solidarity tax base is not the corporate tax but the pre-tax profit of the company not considering any allowances. This is not in harmony the government's effort to make the state encourage research & development and investments by way of tax allowances. The adoption of the solidarity tax may also result in some foreign corporations that brought their financial, research & development and service centres to Hungary because of corporate tax allowances, or received allowances under other titles, considering withdrawal. This affects approximately one hundred companies, each with significant lobby power.

At the same time, the solidarity tax base does not include income from foreign premises and dividends received. This slightly eases the tax burdens of companies that possess foreign premises, or receive dividends. Finally, the negative impacts of adopting the solidarity tax are also somewhat reduced by changes anticipated in terms of development tax allowances.

The so-called expected tax is a flat-rate corporate tax. The Government justified the adoption on the grounds that a significant portion of enterprises appear to generate deficit for years, and do not pay profit taxes. As of 1 September 2006, all taxpayers subject to corporate tax must pay a corporate tax amount expected as a minimum to persist in the economy. This new tax type is primarily aimed at remedying tax evasion of small and medium-sized enterprises. The sector of large corporations that determines the competitiveness of the Hungarian economy may suffer a disadvantage of eliminating accrual of loss, because a tax must be paid on 2 percent of the revenue even if the company generates a deficit. This may primarily be a disadvantage to new corporations appearing in Hungary, and may discourage efforts of this nature, implementing new, large-scale greenfield projects. It is easily possible that these corporations will generate deficit in the first one or two years due to high amortisation. In this respect, it should be considered that the construal of this provision of law is ambiguous on the one hand, and the government may take measures to offset this disadvantageous effect, on the other hand.

The Hungarian government, as it appears, has contradicted the conclusions of economic theory and the trends in a globalising world economy when – probably attentive to short-term political aspects – did not reduce but increased the tax burdens of the corporate sector. This is not a fortunate message to potential foreign investors and the ones already settled in Hungary (neither to domestic companies). The 4-percent solidarity tax applicable to the company profit has also significantly reduced the earlier tax advantage of Hungary in general, and has eliminated it when compared to some countries competing for foreign investments, and, what is more, has turned advantage into disadvantage. Earlier, the Hungarian corporate tax rate of 16 percent was – behind Ireland – the second lowest in the European Union. (Currently, the 10-percent rate of Cyprus is the lowest.) In the wake of introducing the solidarity tax, however, Hungary has been pushed back in the international ranking order chiefly in comparison with the new EU Member States in a way that the increase of burdens have not been offset by other tax-related measures (accelerated amortisation, etc.).

SOME COMMENTS AND CONCLUSIONS IN SUMMARY

In issues of taxation in the European Union, the principle of subsidiarity is used, scopes of competence are concentrated in the Member States, community-level decisions are passed by the Member States unanimously, there are no community institutions competent in tax issues, and the Community has no licence to levy and collect taxes. Individual tax types correspond to one of the four freedoms: the general turnover tax and the excise duty to the free movement of goods and services; the corporate tax and other taxes on companies and capital to the free movement of capital; the personal income tax to the free movement of labour. The harmonisation of tax provisions has been closely related to the development of integration, most strikingly in the case of turnover tax types, as these taxes have the most effect on the trade among Member States.

The harmonisation of profit tax, a key element of which are a legally non-binding recommendation issued in the form of a code of conduct, a flexible framework for Member States, and a compromise solution between the theoretical and practical concepts emphasizing the importance of benefits related to tax competition and also to the elimination of obstacles persisting in the internal market and distorting the conditions of competition among Member States. The code of conduct has eliminated a significant part of discriminative components that restricted the competition (non-compliant tax-related measures) from the tax system of Member States, although has not fully eliminated tax evasion. At the same time, no limits have been set to the tax competition among Member States as represented in the reduction of corporate tax rate. Tax competition has become more transparent, and shifted the centre of gravity of the competition from various allowances to a changed rate of corporate tax.

The tax policies and tax systems of individual countries face a particular conflict of targets. Considering that capital is the most mobile one of the production factors, in addition, in the current development phase of the world economy, capital – as a resource for growth – is appreciating in value for a number of reasons not detailed here, economic rationality requires capital, and within it, the business sector, to be taxed to a smaller extent compared to the other production factor, workforce. At the same time, it is not companies but individuals that vote on parliamentary elections, consequently, using requirements of political rationality results in a higher tax burden of the business sector. The conflict of targets is a lot more visible in small countries open to the world economy and more in need of foreign working capital investments than in large national economies. What is more, the increment in the tax burdens of the business sector, or a part of it is ultimately paid by the workforce or the consumers.

With globalisation propagating, this conflict of targets has been deepened by the international tax competition intensifying parallel to the competition for foreign capital investments. An increasing number of countries intended to improve their international competitiveness and, within that, their ability to attract capital by reducing their corporate tax rates. As a result of that, the corporate tax rate has decreased in the past 20–25 years in the Member States of the European Union, although the race to the bottom has not yielded a zero tax rate in any of these. Tax competition within the European Union has further intensified with the enlargement; most of the new members reduced their tax rates prior to acceding to the EU. A drop in the corporate tax rate may also necessitate a decrease in the highest rate of the personal income tax, or else a facility of harmful tax arbitrage would be available, which may involve loss of turnover tax revenue at the level of national economies.

In the European Union, cutting back on corporate tax rates has not yielded a drop in tax revenue in the period after 1980. Small countries benefited from offsetting the disadvantages derived from decreasing corporate tax rates by advantages resulting from the extended international tax base.

In order to stop the tax competition rampaging in the European Union, a necessity to establish and adopt a common corporate tax rate minimum has emerged. This would not eliminate tax competition among Member States, but would set a lower limit to reducing the corporate tax rate, and would provide sufficient space to countries with both high and low tax rates. As for the rate of the common minimum tax floor, experts have not taken up positions yet. Adoption of a common tax rate is doubtful because of the principle of subsidiarity applied within the Community for issues of taxation. More probable is the development and adoption within a foreseeable time of a legal provision for an optimal common consolidated corporate tax base.

For the Hungarian tax policy and tax system, the community regulation is satisfactory; it provides sufficient space to enforce the strategic national interests. Irrespective of this, the tax-related measures adopted in 2006 in Hungary under the New Balance programme impose increased tax burdens on the business sector, and are inconsistent with the conclusions of economic theory drawn particularly for small countries, contradict the international tendencies, and, consequently, weaken Hungary's international competitiveness.

Hungary is interested in adopting a common corporate tax rate minimum, which would set a lower limit to tax competition among Member States smaller and/or less developed than Hungary. For added transparency, Hungary is also interested in establishing a common consolidated corporate tax base.

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