CENTRAL AND PERIPHERAL REGIONS IN EUROPE: CAN TAX COMPETITION ATTRACT FOREIGN DIRECT INVESTMENT FOREVER?

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Abstract

This paper studies the linkage between tax competition and foreign investment in Europe. Although the majority of economists consider a link between these two phenomena to be unambiguous, the literature ignores its long-term implications. To gauge the economic rationale of this issue, the paper considers experience in western and eastern Europe, which are understood as "central" versus "peripheral" regions, respectively, and distinguishes between short- and long-term perspectives. In this paper, it is argued that policymakers, who want to attract foreign investment but have incomplete information over optimal taxation policy, may be inspired to initiate cuts in tax rates. Because other countries may be tempted to respond similarly, a dynamic tax- policy response would cause methodical tax rivalry among peripheral regions, as well as between peripheral and central regions. The current reality in Europe shows that tax competition benefits peripheral regions in the short-term but that a continuing tax competition would make short-term tax advantages to peripheral regions either disappear or exert negligible weight on international investment decisions over the long-term.

Key Words
Tax competition, "central" versus "peripheral" regions competition, foreign capitals, eastern and western Europe

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1. **Introduction**

After the German general elections held on September 18, 2005, it was widely expected that the new government would be able to introduce tax reforms aimed at enhancing the country's business climate. In actuality, then former opposition leader Angela Merkel and, especially her chief advisor professor Paul Kirchhof, were advocating substantial tax reforms. Paul Kirchhof favored a 25 percent flat tax rate for individuals and corporations. However, after the election, which proved inconclusive, and due to the country's budget troubles, the new Chancellor Angela Merkel and the "grand coalition" of the centre-right and centre-left parties did not introduce any fiscal cuts. In contrast, the new government increased tax rates for individuals with higher incomes (i.e., in early May 2006 the government agreed to a top rate of 45 percent rather than the current top rate of 42 percent, with the change slated to go into effect in 2007). In addition to this policy change, a range of measures were proposed to reduce government spending by closing tax loopholes, gradually raising of the retirement age from 65 to 67 years and increasing the value-added tax from 16 percent to 19 percent – measures that were to go into effect in 2007. (Additional policies aimed at reducing overall labor costs, i.e., the tax wedge, were considered[1].)

Although recent German policy choices came as a surprise to international observers, what actually occurred in Germany precipitated a relevant debate concerning tax- competition policies among governments. This question has been regaining strong momentum in light of mounting tax-competition policies in central and eastern Europe, which has been benefiting international investors. Notably, economies from these regions are becoming subject to reduced tax rates on personal income and profits—the direction of change is homogenous across all countries in

[1] Note that main valued-added taxes in the European Union range from 12% in Luxemboug to 25% in Denmark and Sweden.

central and eastern Europe when it comes to taxes of profits and should be interpreted as a "central" versus "peripheral" tax-competition game.

Therefore, as there is no doubt that tax incentives might fuel locational decisions in the short-term, the main purpose of this article is to evaluate the long-term effectiveness of tax slashes as a strategy for attracting foreign investors, as well as the concept of tax rivalry. Such a strategy is supported by the belief that a country could attract substantial foreign investment inflows by offering competitive tax rates. But, even if we accept this proposition as true, we have no definitive answer regarding the long-term effects of such a policy, that is, whether or not the policy can accommodate the country's long-term policy goals. In particular, attention must be paid to the fact that tax policies aim to achieve two equally important, but not necessarily complementary purposes. First, tax policies can work to redistribute income from better off to less wealthy individuals. But tax policies, if correctly designed, can enhance the health of the economic environment, provide work incentives, as well as increase foreign investment inflows. In one scenario, market efficiency may be compromised, in the other, social losses in terms of a less equitable distribution of income must be reckoned with and assorted effects that may directly or indirectly influence a country's overall competitiveness (Oates, 1972). The issue of balancing social welfare with market competitiveness is highly important in the Europe Union (EU), where countries are attempting to maintain a sustainable social model.

Governments have long financed growing expenditures from the welfare sector through the use of progressive income taxes. Major ruptures with this tax strategy have occurred in the United States, Europe, and Asia. For example, Singapore embarked on a policy of tax reduction during the 1960s, a trend that has continued. In the United States and the United Kingdom, respectively, President Ronald Reagan and Prime Minister Margaret Thatcher become the

paladins of tax bands and tax-rate demolition in the 1980s.[2] Saudi Arabia reformed its tax system in 2004, and 18 of the 26 cantons in Switzerland intend to lower their taxes in 2006 in an effort to compete for wealthy residents, an effort that is gaining momentum among the different cantonal governments.

No doubt, supply-side economists inspired by Arthur Laffer influenced these new tax strategies, which were devised to enhance private incentives and pre-empt inflationary trends. In a sense, these strategies were responses to the mounting inflationary pressures present in the US during the 1970s, during which time a substantial portion of taxpayers found themselves moving into higher marginal tax brackets. While the Keynesian view suggests that tax changes influence output and revenue primarily by changing the demand for goods and services, the supply side view counters that lower tax rates could serve to spur production, which in turn would create greater total revenue. Taxes that exceed an optimal rate, by contrast, may cause total revenues to fall by reducing the incentive to produce. In other words, appropriate tax strategies, competitively oriented, ensure fairness and an efficient use of resources.

Those who opposed tax reforms in the US during 1975-1986, argued that it would be unrealistic to expect an increase in tax revenues from lower tax rates unless it could be assumed that the labor supply was highly elastic (i.e., an increase in after-tax wages would encourage greater hours worked). Empirically, however, tax cuts initiated in the US during the 1920s (supported by the Secretary of the Treasury Andrew Mellon) and in the 1960s (the Kennedy-

[2] President Reagan's Tax Reform Act resulted in two rates of 15% and 28% individual income (most of the poor were exempted from paying taxes), down from the top rate of 70% before Reagan took office in 1981. Nevertheless, the top rate in the US has increased to 39.6% since 1991 (with individual tax brackets being indexed for inflation). Lower top rates have been offset by broadening the tax base for both individuals and business, as well as by increasing several additional sources of tax revenue (e.g., an increase in Social Security tax rates and in some excise tax rates, as well as a scaling back of a number of deductions). On net, the federal revenue share of GDP decreased by one percentage point to 19.2% in 1989 from the level in fiscal 1981. The corporate income tax rate had been reduced from 48% to 34%.

Johnson tax cuts) supported the supply-side position: tax revenue collected from low-income taxpayers decreased while revenues collected from high-income taxpayers increased.

However the ultimate consequence of supply-side policies is discerned for the US economy, the key issue being here explored is why several decision-makers and experts favor innovative tax policies for Europe. New competitive tax policies can arguably discourage tax evasion, persuade unemployed workers to seek employment or encourage those, who are employed, to work more productively – each of which promote the marketplace's efficiency and act as a break on corruption. Central and eastern European countries are holding fast to all of these rationales, although the novelty here is to turn a new tax strategy into an effective tool for luring international investment. Countries in greatest need of reviving their economies are at the forefront of the new fiscal strategy. Overall, new tax policies already promulgated have been meeting with success. There is no doubt that firms tend to establish operation centers abroad and move investments and profits to low-production-cost countries, characterized as tax havens. These developments generate short-term benefits. Countries adopting these policies must keep a view to the long-term implications of its tax strategy.

All aspects of competitive tax policies and tax rivalry in Europe will be considered in greater detail in the following sections of this paper: section 2 reviews related literature; section 3 reviews competitive tax schemes in eastern/central Europe; section 4 analyzes corresponding schemes in western Europe; section 5 discusses the challenges that arise for decision-makers and business; section 6 offers ideas regarding the need for a new business strategy and section 7 concludes this paper. In particular, the remainder of this article calls attention to the importance of a country's overall competitiveness, rather than focusing on the narrow immediate-term effect of competitive tax policies. As will be seen, decision-makers tend to overemphasize the all-cure

virtues of international tax competition without considering some of the factors that can exert cumbersome penalties on entrepreneurs. Endless tax rivalry can accelerate a race to the bottom, which would, *de facto,* ultimately eliminate the competitive advantage designed to attract foreign investment in the first place.

2. Related Literature

This section reviews two strands of the literature: one that focuses on the link between tax-policy changes and the level of foreign investment attracted; the other concentrates on the relationship between taxation and economic freedom.

According to the literature, firms discriminate against location advantages and disadvantages (Caves, 1996; Devereux and Freeman, 1995; Dunning, 1993), and foreign investors either take advantage of favorable tax conditions or move away from highly taxed locations (see e.g. Devereux and Griffith, 1998; Grubert and Mutti, 2000; for a synthesis of empirical research, de Mooij and Ederveen, 2003).

Desai, Foley, and Hines (2003, 2004) found that both direct and indirect taxes exert a strong impact on investment location by multinationals. These investigators further document that the direct tax-rate elasticity figures at 7.7 for European countries and 2.3 for other countries.

High capital mobility may escalate the trend towards investment decisions based on fiscal-policy (e.g., Kubicova, 2004, Zodrow, 2003). Experts believe intergovernmental tax competition is a desirable means to enhance domestic efficiency (e.g., Blankart, 2002; however, they are not certain whether distortions from fiscal competition. Moreover, it is not clear to what extent distortions exist in the case of asymmetric competition between small and large countries.

This latter case, known as the "central/peripheral region" hypothesis, advanced by Baldwin and Krugman (2004), suggests that central regions tend to agglomerate, thereby enabling them to levy higher taxes with no risk of losing investment to the peripheral regions. In other words agglomeration might compensate for the tax advantages offered by peripheral countries to investors (Baldwin and Krugman, 2004).

Egger and Winner (2004) discern a link between economic freedom and taxation policy. And, positive arguments demonstrating that economic freedom fosters growth can be found in a large part of the literature (e.g., de Haan and Sturm, 2000). Egger and Winner estimate the impact of economic freedom on national tax policy (corporate tax revenues to GNP) for 46 developed and less developed countries between 1980 and 1997. The study found that firms would be willing to pay more in exchange for economic freedom. That is, economic freedom would attract investors, and this increase in demand would enable governments to levy higher business taxes. Egger and Winner's work reveals that changes in economic freedom have equalized the international distribution of corporate tax revenues to GNP; Huizinga and Nicodeme (2003) have shown countries that witness foreign investment tend to have higher corporate taxes than other countries.

Seen from a different perspective, increasing economic integration among countries may lead to strategic statutory tax setting. This development has been documented by Devereux *et al.* (2002a) for selected OECD countries during the 1980s and 1990s, generating similar effects on corporate income tax/GDP ratios. Besley *et al.* (2001) find a like trend in evidence among twenty-nine OEDC countries.

Decreasing taxation rates have been found by Devereux *et al.* (2002a). Statutory corporate tax rates and effective tax rates (note that the statutory tax rate does not mirror the effective tax rate)

fell for the two last decades. Grubert (2001) observed that average effective tax rates shrank by ten percentage points between 1984 and 1992 in a sample of sixty countries.

In addition, Devereux *et al.* (2002b) attempt to investigate tax competition as a means to attract investment by calculating a "fiscal reaction function" for twenty-one OECD countries during 1983-1999. They do this by developing two models, one that looks at firm mobility, with the other at capital mobility. These models show that countries would compete only over the statutory tax rate or the effective average tax rate if attempting to attract foreign firms, while countries compete only over the effective marginal tax rate if the goal is to lure foreign capital. In this same study, the investigators estimate the parameters of "fiscal reaction functions" and prove that countries compete over all the three measures, particularly over the statutory tax rate and the effective average tax rate. In contrast, another study Grubert (2001) maintains that tax rates shrank over time, but did not converge. This observation implies that tax competition has been absent.

As an alternative strategy, some experts have suggested that the EU harmonize corporate income tax rate. But others have countered that harmonization strategies are not sufficiently compelling (Zodrow, 2003), and some fundamental issues must first be addressed. For example, peripheral regions may need with a more competitive tax policy to compensate for the advantage conferred by agglomeration that is present in the central regions; harmonization would aggravate the central/peripheral relationship (Baldwin and Krugman, 2004). When facing the trade-off between tax autonomy and fiscal neutrality in coordinating taxes on consumption, labor, and capital, EU member states should first proceed with their own tax reforms before embarking on tax harmonization because the cost of distortions within member states may be greater than the gains from reducing intergovernmental tax competition, states (Cnossen, 2003).

Two main issues, then, surface in the literature: the long-term sustainability of tax competition and its degree of fairness in Europe. The question of whether competitively driven tax rates would effectively spur economic growth in the new market economies of Europe is another subject of interest that goes beyond the purpose of this paper.

3. Dynamic Tax Policies in East-Central Europe

Central and eastern European countries have campaigned for the lashing of tax rates since the mid-1990s (Table 1) and have pushed, in particular, for a flat tax rate implemented at the national level. Policymakers in these countries argue that such a tax strategy reduces red tape and discrimination among taxpayers, working, in effect, to counterbalance tax evasion, create more incentives to work, as well as to save and invest. The success of the flat tax scheme depends, however, on the actual level of the tax rate imposed: the lower the rate, the more likely it will increase total tax revenues collected by fostering economic growth.

In 1991, Estonia became the first country to implement a flat tax rate (26 percent) for all incomes. Country officials articulated a highly favorable attitude toward foreign investment, which was exemplified by the "Law on Foreign Investments." This law aimed to instate liberal policies in order to attract foreign investment. After the 1991 policy change, Estonia further reduced the flat rate for all incomes: to 24 percent in 2005, with a 20 percent rate set to go into effect by 2007. Latvia followed suit, as did Lithuania; both countries have implemented a level 15-percent corporate tax rate and tax rates on personal income at 25 percent and 33 percent, respectively.

Surprisingly, Russia launched a truly radical tax scheme, that went into effect on January 1, 2001. President Vladimir Putin's first step was to introduce a 13-percent personal income flat tax

rate, which replaced a three-bracket tax scheme, with a top rate of 30 percent. Effective January 1, 2002, Putin also introduced a 24-percent corporate flat rate, down from 35 percent. Since January 1, 2003, small business enterprises have been granted a choice between a 20-percent flat tax on profits or an 8-percent flat tax on revenues. Small business enterprises have also been exempted from the value-added tax, sales tax, property tax and social insurance tax (Ivanova, Keen, and Klemm, 2005). Recently in September 2005, both President Putin and Prime Minister Viktor Khristenko are seriously considering the introduction of tax breaks for oil companies to encourage the exploration of new oil fields (Table 1).

Still other countries have taken up this new trend. Serbia and the Ukraine adopted new tax codes in 2003. Serbia introduced a comprehensive 14-percent flat tax on personal income and corporate profits, though the country has been implementing a 10- percent flat tax for most forms of personal income. The Ukraine implemented a 13-percent flat tax on personal income (replacing a five- bracket tax scheme, ranging from 10-40 percent) and a 25-percent tax rate on profits (down from 30 percent). Moldova is bringing its corporate tax rate down to 20 percent from 25 percent and lowering the top tax rate on personal income to 22 percent from 32 percent. Hungary lowered corporate tax rates to 16 percent and Poland cut its rate by 8 percentage points to 19 percent. In 2002, Slovakia reduced its rates from 29 percent in 2000 to 25 percent; effective on January 1, 2004, the effective rate was further decreased to19 percent.

In 2005, comprehensive tax reforms took effect in Georgia and Romania, as well. In Georgia, a 12-percent flat tax on personal income was inaugurated by parliament. In Romania, the government of Prime Minister Calin Popescu Tariceanu implemented a flat income tax rate of 16 percent and adopted a flat corporate income tax rate of 16 percent, which was to be enforced starting January 1, 2005. The new tax scheme aims to prevent tax evasion, corruption and attract

foreign investment. The new system, enforced by special ordinance, replaced the previous personal income tax scheme, which consisted of five tax brackets (with a top rate of 40 percent); the top business-profit rate had been set at 25 percent.

Overall, a definitive move towards flat tax rates is in evidence and officials are arguing for even lower tax burdens than those in place in western Europe and North America, as the "index of economic freedom" as defined by Miles *et al.* (2005) demonstrates. Poland's former Finance Minister, Mirosaw Gronicki, suggested the implementation of a flat tax rate of 18 percent on personal income and business profits, with the same rate attributed to the value-added-tax. This proposal was an attempt to win back voters in the September 2005 election, by undercutting the proposal made by the opposition party, Civic Platform, which aimed to introduce a 15-percent flat tax on personal income and profits. Two major right-wing coalitions secured victory in the elections; consequently, we should expect a major change in Poland's tax policy. Similar political dynamics have played out in the Czech Republic, the opposition party, the Civic Democratic Party, suggested a 15-percent flat tax rate for individuals and corporations.

4. Recent Tax Strategies and Unveil Tax Plans in Europe

In Ireland, decisive steps undertaken to rearrange the country's tax system have received wide attention, and, consequently, have influenced many countries throughout Europe. The most radical tax strategy adopted in central and eastern European economies reflect their transition to a market-oriented economy (i.e., strategies that include a personal income tax, a corporate income tax, and a value-added tax); these reforms started at the end of the 1980s and continued into the 1990s. This paper has already described some of these reforms. These reforms are, of course, of great importance and interest for their own sake, but I would suggest, their effects are

further reaching than one might imagine. As has been suggested earlier in this paper, the new tax approaches have been designed by national policymakers not only to modernize their economies, by making their systems more efficient and transparent. These measures have been adopted, in particular, to render their systems highly attractive for foreign investment. The trend toward lowering taxes on personal income, which began in the 1990s, and the passage from the turnover tax to the value added tax, has attracted attention. Also, the direction of change in corporate income taxes and the associated tendency to engage in a competitive tax game between peripheral and central regions in Europe, which started in the 1990s and accelerated during the 2000s, was and is a remarkable event in itself. Some observers, though, have come to believe that this tax practice is has generated harmful events in the countries under consideration.

A campaign against the so-called "harmful" tax practices began in May 1998, when the OECD published its report, *Harmful Tax Competition: An Emerging Global Issue*. The main logic undergirding the report deserves a coherent analysis. This is particularly true for Europe, which is characterized by poor and advanced areas, or rather central and peripheral regions.

One way to gain perspective on the issue is to consider tax policies initiated in Ireland and other western European nations. As alluded to earlier in this paper, Ireland adopted a "friendly" tax scheme for income, capital and corporations in the 1980s. This policy switch—together with other investment incentives to investors— resulted in an astounding economic success story, transforming Ireland into one of the wealthiest countries in the EU. The overall tax burden in Ireland now figures as one of the lowest in Europe, and the tax on trading income has settled at12.5 percent, down from 24 percent in 2000. This rate is coming into line with the European Commission's plan to replace the 10-percent tax rate on manufacturing profits in place since

1981. A phasing out regime applies to industrial manufacturing until 2010, licensed Shannon operations approved on or before May 31, 1998, and other services operations.

As Ireland has been the first country in Europe to embark on tax-policy reform as a main instrument of economic recovery, have other countries in western Europe attempted to follow Ireland and engage in a tax-competition game? As we have seen, countries from central and eastern Europe do seem to have been influenced by the Irish example, as evidenced by the similar tax strategies adopted in these countries.

Statistical figures available substantiate a similar pattern observed for western Europe. Austria, for example, cut the tax rate on corporation profits from 34 percent in 2003 to 25 percent in 2005 and Portugal, from 33 percent to 27.5 percent. Belgium reduced its corporate income tax from 40.2 percent to 33 percent in 2003; Denmark, from 32 percent in 2000 to 30 percent in 2001; and Greece, from 40 percent in 2000 to 35 percent in 2003. Finally, Iceland cut corporate tax rates to 18 percent in 2002 from 33 percent and Luxembourg, from 37.5 percent to 30.4 percent.

Recently, the Spanish Prime Minister Zapatero has been considering the implementation of a flat tax rate on income, following the recommendations of Miguel Sebastian, one of the government's advisors (i.e., a 30-percent flat rate instead of the current tax bands, which top out at 45 percent; the highest corporate rate figures at 40 percent). In the Netherlands, with unemployment totaling over 6 percent of the workforce, the Dutch government wants to offer tax breaks and boost spending for education and the environment. Presumably, in a response to low approval ratings just before the general elections in 2007, Dutch Prime Minister Jan Peter Balkenende plans to reduce tax rates for middle-income families with children and reduce corporate tax rates, as well: the proposed budget calls for the corporate tax rate to fall to 29.6

percent from 31.5 in 2005 (the rate was set at 34.5 percent in 2004). The Dutch government is proposing another tax cut in 2007. Similarly, in Sweden, the Social Democratic government faces high unemployment, and the government wants to reduce taxes on lower- and middle-income workers, as well as lower payroll tax rates for new hires by small, one-person firms (the Swedish political opposition would like to curb taxes and jobless benefits).

Germany provides an enlightening example of a large European economy suffering from the relocation of production facilities within its own boundaries to countries in central Europe, where corporate taxes and labor costs are comparatively competitive. IN fact, Germany's unemployment rates hit a post-war high in March 2005, with a 12- percent jobless rate recorded (according to seasonally adjusted figures), compared with , roughly, 5-percent rates in both the UK and the US (seasonally unadjusted figures fare worse). Former Chancellor Schröder announced in March 2005 an extension of the labor market reform known as "Agenda 2010," whereby he would push through tax reforms and drop federal tax rates on profits from 25 percent to 19 percent. Note, however, that this move slashes the 38.3 percent rate to roughly 32 percent when taking into account local business taxes and the solidarity tax. Closing tax loopholes and raising taxes on dividends will mostly offset Germany's tax cut rate, and this fact represents a key issue that will arise in the next debate. In spite of announcements to the contrary before the general election in 2005, the new German government has announced that it will not push for tax slashes.

Switzerland provides an example of strategically setting its tax policies. The country boasts some of the lowest corporate tax rates in the world, attracting multinational companies that have established holdings among its 26 cantons. A recent survey showed that 18 cantons intend to lower their tax rates in 2006, as well as to slash the levy on wealth and share dividends to attract

wealthy residents and businesses. This strategy gained momentum particularly in some cantons, including Zug, Schwyz, Nidwalden, and Obwalden. In fact, the competition intensified when Obwalden introduced the lowest corporate tax rates among all cantons, effective January 1, 2006. The system is regressive in it reduces rates as income rises (especially for those earning over $233,000 a year). Empirical evidence shows that Swiss taxpayers reside where income taxes are low, which motivates cantonal governments to engage in strategically setting their respective tax policies (see Feld and Reulier, 2005; Schmidheiny, 2004).

To summarize, the unweighted average corporate income tax rates decreased from 33.6 percent in 2000 to 30.8 percent in 2003 among OECD countries; within the EU-15 the rates decline from 35.1 percent to 31.7 percent. Figure 1 depicts this tendency in the EU-15 and the ten new member states over the prior ten years, showing a decline on both sides of the EU, though the decline is more marked among the new member states. Note, however, when gauging tax competition, policymakers from OECD countries should bear in mind that taxes on corporate income provide some 8 percent of their countries' overall tax revenues and that the average ratio of corporate income taxes to GDP has been constant over the past twenty-five years. Moreover, these parameters may not be easily altered among non-peripheral regions, nor is it always clear how to set an unvarying optimal tax policy in theory. Finally, we cannot rule out the hypothesis that policymakers cannot discern the optimal trade-off because of incomplete information; on the contrary politicians may interpret tax policy opportunistically prior to a general election (Figures 1 and 2).

With reference to the fiscal burden, the shift in policies characterizing some countries in eastern Europe has been remarkable. Figure 2 illustrates the drop in fiscal burden among

countries in Europe after 1996. Note the sizeable reduction in the fiscal burden of Slovakia (extreme right hand side in the figure).

Last but not least, a brief look at the competition between Europe and the US is noteworthy. The US corporate tax rate is set at 39.4 percent, following major corporate tax reductions in the 1980s. However, Martin A. Sullivan reported in *The Wall Street Journal Europe* (28-30 January 2005, p. A9) that the effective tax rate for US companies operating in Europe in 2002 would have been 9 percent in Portugal and in the Netherlands; 12 percent in Belgium; and 13 percent in Spain. By way of comparison, the effective 2001 (corporate?) tax rate in the US has been calculated at some 32 percent by Jane Gravelle of the U.S. Congressional Research Service; this figure is approximately 10 percentage points higher than the European average, as calculated by Margie Rollinson at Ernst & Young (Gravelle's and Rollinson's studies are quoted in *The Wall Street Journal Europe*, 28-30 January 2005, p. A9). Nevertheless, a comparison between statutory corporate tax and the average effective tax rate across the Atlantic is not straightforward. Firs, the discrepancy is a result of peculiarities of the American system that taxes labor and consumption less than what characterizes policies in Europe. Second, the distribution of tax revenue from among major taxes sources explains differences between the two sides of the Atlantic. While Europe relies more on social security contributions, the US collects more money from personal income and property taxes. Third, in 2003, the tax-to GDP ratio was 25.4 percent in the US, lower than the 40.6 percent average for the EU-15 (these figures are from national sources and Owens (2005), Fig. 1, p. 26). Therefore, the US tax base is comparatively narrowly defined; consequently, our reported figures and tax policies should be assessed with more caution.

5. Peripheral Versus Central Regions Tax Competition in Europe

The decline in tax revenue among economies in transition has been a stylized fact throughout the1990s and up until the present time. After more than fifteen years in transition, the tax ratio has fallen below the levels typical of advanced market economies (for a theoretical analysis, see Turley, 2006). Indeed, central and eastern European countries are jumping on the flat-tax bandwagon. Because this strategy has been argued to be a magnet for investment and economic growth, these have been accused of unfair "tax competition" and "tax dumping." That is, some governments are being charged with strategizing their tax rate schemes at the expense of other countries' competitive attraction. It has been claimed, for example, that statutory corporate income tax rates in the EU-15 declined from 35.1 percent in 2000 to 31.7 percent in 2003, partially to offset tax rate competition and to avoid losing further business activities. This was allegedly due to "an unequal corporate-tax burden in Europe," according to former German Chancellor Schröder. Recall that Germany is the largest European economy suffering from the fact that many companies located in the country are shifting production to countries in eastern Europe, where corporate taxes and labor costs are comparatively lower.

Fears of negative effects on labor markets are scattering across Europe, as new EU-member states could lure companies, jobs and investment flows away from the original members. To thwart risky tax competition, a tax corridor has been proposed through which minimum and maximum corporate tax rates could be secured in place. In addition, European Commissioner for Taxation, Laszlo Kovacs, has revived the desirability of harmonizing the corporate tax base in line with the suggestions made in the Bolkstein Report and published by the European Commission in 2001. This report suggests ways to skip unfair competition for foreign investment

and to prevent uneven foreign investment distribution.[3] In fact, some member states complain that their contributions to the EU budget to support structural and cohesion funds for new members could end up subsidizing their tax cuts. More to the point, some leaders of Europe's strongest economies (e.g., Gerhard Schröder and Sweden's Prime Minister Goran Persson) are afraid that policymakers from transition economies can cut taxes because any lost revenue is more than compensated by subsidies from Brussels. According to Schröder, it is unacceptable that his country, being EU's biggest net payer, finances "unfair tax competition." If the former German Chancellor dubbed this practice dangerous "tax-dumping," former French Finance Minister Nicolas Sarkozy expressed the same sentiment by suggesting that European transfers be cut for states engaged in tax competition. In addition, Sarkozy suggested that new EU members with below-average tax regimes should not receive aid funds from Europe. Transition states have repeatedly refuted this argument.

My discussion of key issues will be summarized in three main points. The first point concerns whether "tax dumping" is at work in the EU. Undeniably, central Europe has lower corporate tax rates than those recorded for western Europe, with tax burdens on corporate profits figuring at approximately 15-20 percent; eastern European countries also offer several investment incentives. All the same, these facts reveal nothing about the effective tax burden and how the tax base is formed (i.e., a company's debt, machinery depreciation, etc.). For this reason, it can be deceiving to compare countries directly. First, the statutory corporate income tax rates have fallen in the EU countries during the 1990s, but this development has been accompanied by a broadening of the base rate. Second, several European governments grant deductions, exceptions and kinds of tax relief (e.g., R&D, investment in poor areas). As a result, effective tax rates vary

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[3] Note that initiatives toward tax harmonization in Europe date back to the early 1960s at the time of the Neumark Report, published in 1962.

from statutory tax rates. To take an example, Germany's tax system is so thorny that the effective corporate tax rate is estimated to be only half of the statutory rate, and some of the largest companies enjoy so many tax breaks that their effective tax rate is zero (Barysch, 2004).

The second point concerns whether the EU is actually financing the tax cuts of its "peripheral" countries through its common budget. The EU put aside approximately €40 billion for enlargement in 2004-2006. While the newcomers have to pay their dues into the EU budget, they are still notionally left with a net balance closer to €25 billion. The EU financial support is earmarked for regional development and agricultural support, which means that it will only help to keep central and eastern European taxes low as long as it can cover national budget spending. The current tendency towards tax-base harmonization in Europe should also be reviewed more critically. The European Commission has already, adopted several common rules concerning the tax base, and this policy coordination is expected to continue. One study that simulates the effects of tax coordination (Sorensen 2001) concludes that the welfare gains from such policy coordination would be modest in the EU, between 0.16 percent and 0.35 percent of GDP. This is true particularly for coordination policies within the EU. By contrast, only regional tax coordination can confer advantages for non-participant countries, as they may become even more attractive for investors. Nevertheless, the EU cannot oblige member states to design a specific tax system (apart from common rules for those taxes that shape the functioning of the single market, such as the value-added tax, excise duties, and some aspects of direct taxes). The EU can only exercise policy options to aimed at fighting against perceived "harmful" tax competition. In fact, the EU has asked the newcomers from central and eastern Europe to phase out all discriminatory tax incentives, and have cut overall statutory tax rates for both domestic and foreign investors in the run-up to membership.

The third point relates to the question of how much of a country's competitiveness with regard to foreign investment is tax-driven in the peripheral regions in Europe. How much of foreign direct investment (FDI) and consequent economic growth achieved in central and eastern Europe was realized through tax slashes? While the importance of tax incentives on economic growth cannot be denied, economic growth in central Europe and the first wave of foreign investment flows have been more obviously rooted in the economic reforms undertaken, which also generate positive expectations about the investment climate (Sergi, 2003). Privatization schemes were carried out, but so were competitive tax schemes during the 1990s. Growth in central and eastern European countries could have occurred on the basis of these privatization schemes, and the ensuing positive expectations about economic expansion thereby made possible. Still, the positive impact of changes in the tax systems comprises one of the factors contributing to buoyant foreign investment during the 2000s.

6. Toward a New Form of Competition

It is well known that competitive effective tax rates on corporate profits have provided a significant tool by which to attract foreign investors in central and eastern Europe. Tax rates will continue to be an important policy tool over coming years. Investors and policymakers, however, should focus more on the importance of the overall investment climate, as several other factors besides tax rates determine a country's competitiveness over the long-term. Indeed, competitiveness in an interacting and multifaceted international business environment requires that labor-market costs keep pace with workers' productivity growth. In addition, regulatory restrictions must be eliminated whenever possible, to reduce the high tax wedge and payroll taxes so that the cost of hiring can be reduced. Further labor-market rigidities must be overhauled.

Without these changes, countries are likely to experience negative consequences concerning the long-term strategies for investors. Hungary's experience is very revealing in this regard: several large foreign investors, such as IBM and Philips, moved some or all of their Hungarian operations to lower-cost regions further east and to the south in Europe. In a short-term attempt to lure further resources stave off the trend and compete more strongly with other neighboring markets, Hungary cut corporate tax rates to 16 percent from 18 percent and dropped the top tax rate on personal income to 38 percent from 41.5 percent (Table 1).

Perhaps less valued is the fact that international and regional competition depends on the strength of several factors that drive the business process. As competition is growing increasingly fierce, policymakers in Europe have cut tax rates (and introducd other incentives such as cash grants, fixed-term tax relief, and labor subsidies) to attract investors. Because policymakers do not have complete information regarding optimal tax rates, a country's first move is normally followed by another country's reaction (i.e., without regard to determining all implications of the policy change).

The implication of this action-reaction tax policy has not been thoroughly assessed. Although I have not calculated in this paper the extent to which FDI is highly elastic, or not, to tax-policy changes (see section 2 in this article for a survey of the literature), the tax competition argument is compelling when confined to the short-term; the argument is less convincing when we the analysis shifts from the short-term to the long-term. Policymakers in "peripheral" regions compete against each other because they emphasize tax breaks as a long-term panacea, or rather, they simply fail to spot the optimal tax rate; both these facts push policymakers to initiate an endless tax game. In this scenario, resorting to systematic tax slashes necessarily exerts no

impact on investors' international strategic decisions over the long-term simply because effective tax rates would converge to the same level. The competitive advantage would thereby be lost.

Further aspects need to be considered. Buoyant economic growth in Europe's peripheral regions helps to maintain state revenues in budgetary equilibrium. What then would happen to public finance should economic growth slow sometime in the future without a serious restructuring of policy priorities and public revenues in parallel? Therefore, the debate has to be firmly based on discerning the long-term wisdom of tax strategy among peripheral and central regions, without overlooking competitiveness taken as a whole. If competition in Europe calls for innovative policies, rejuvenating peripheral regions in Europe implies the need for technological innovation, less rigid labor-market regulations, and the minimization of the tax wedge. If the European Commission, by contrast, continues to place priorities on the introduction of a definitive tax-harmonization policy, the tax competition race could hit a new level. Should the latter be the case, fiscal advantages derived during the short-term would dissipate among peripheral regions over the medium- and long-term.

To help understand this point, one property of any tax system contributing to a significant increase in FDI is that tax advantages are "generous" and "persist" over time; these two characteristics secure the attention from foreign investors. While it is difficult to measure precisely the relative contribution of tax advantages to FDI, recent statistical figures indicate that favorable changes in the tax systems of new European markets appear to have attracted a substantial amount of FDI. However, given the dynamic noted above, this advantage accruing to any one country is likely to vanish over the long term.

Unit labor costs, other non-tax-rate-based financial incentives, and geographical location figure equally importantly in a firm's decision to locate abroad. Laying emphasis on tax

advantages would be an oversight in the long-term. In addition, shifting profits to tax havens provides another way for firms to avoid national tax disadvantages; in this scenario, firms need not necessarily locate abroad. It follows that tax advantages may not be enough to attract FDI. Simply, the phenomenon of FDI, outsourcing, and international business in Europe requires a comprehensive rather than a narrow focus on policies that may work to attract and sustain foreign investment.

7. Conclusion

In this paper I review potential economic consequences of tax competition that is spreading across the world. I emphasize lessons learned from Ireland, among other countries, impressive economic growth occurred after "friendly" tax policies had been initiated. Inspired by the examples, governments in central and eastern Europe introduced one-size-fits-all tax regimes, as well as new labor-market regulations during their transition from command to market economies.

No doubt, the new tax policies entailed different implications for the behavior of economic agents and international business competitiveness, as explained by economic theory. Low taxes on corporate profits augmented these countries' ability to attract international investors and multinationals. In addition, their unique tax policy encouraged better governance, increased the willingness of people to work, reduced the tendency towards tax evasion, and magnified the positive effects of entrepreneurship in a number of other respects.

Yet, policymakers who initiated this kind of tax-competition policy need to consider business-oriented policies that will generate long-lasting positive effects on their economies. Policymakers have overemphasized the virtues arising from tax reduction, which produces advantages, but

only over the short-term. Moreover, triggering international tax competition in order to energize national economies carries several implications. For example, European peripheral regions provided tax rebates in order to entice foreign investors without incurring a consequent budgetary crisis. Although one possible answer to this paradox is that these economies are still experiencing sustained economic growth rates, a country's competitiveness will still be challenged by waves of systematic tax reduction among competing nations. This is because statutory and effective tax rate differences among countries trim shrink over time and converge to equilibrium; this fact means that tax advantages cannot, by definition, be "generous" and "persistent" over time – the attributes needed to attract long-term foreign investment. Therefore, a successful policy strategy would be one that focused on both short- and long-term consequences.

In conclusion, any strategy aiming to attract international investment inflows should shift from a narrowly focused national tax-advantage approach to one that considers the overall picture of business competitiveness. Foreign investment may address an endogenous shortage of capital in any one country over the short term, but sustaining a competitive business climate will require more comprehensive reform measures.

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Table 1. Personal income tax and corporate tax rates (flat or top) in Central and Eastern Europe, 2005

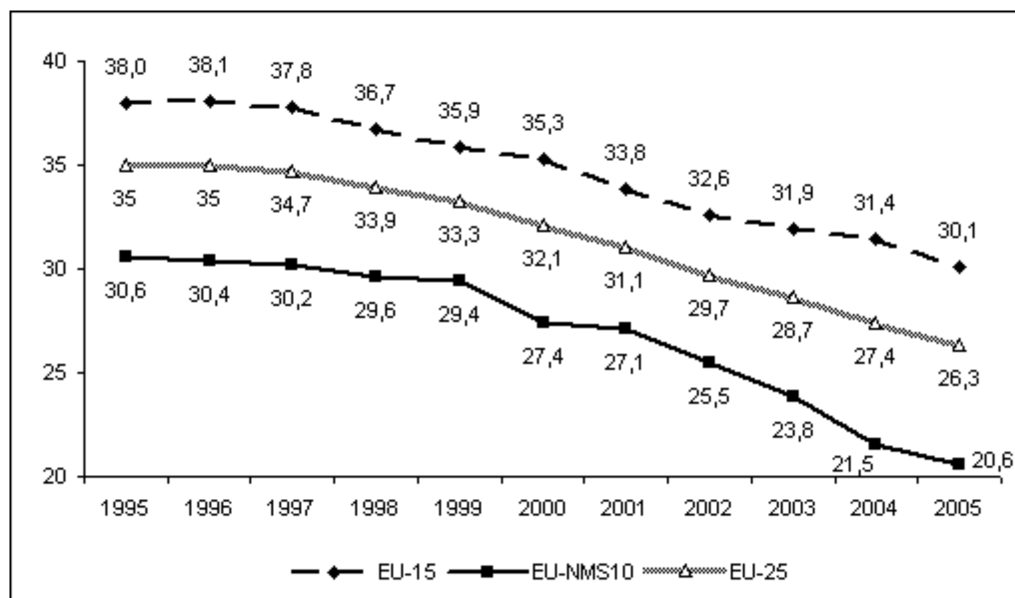
	Income tax	Corporate tax
Albania	25	25
Bosnia-Herzegovina	5	30
Bulgaria	29	19.5
Croatia	15 – 45	20
Czech Republic	15 – 32	28
Estonia	24	24 *
Georgia	12	20
Hungary	18 – 38	16
Latvia	25	15
Lithuania	33 **	15
Macedonia	15 – 18	15
Moldova	22	20
Poland	19 – 30 – 40	19
Romania	16	16
Russia	13	24
Serbia-Montenegro	14 ***	14
Slovakia	19	19
Slovenia	17 – 50	25
Ukraine	13	25

Notes: *) none in case of reinvested profits. **) Income earned from a second job is taxed in the range 10-35%. ***) 10% for most of personal income.

Sources: Miles, M. A, Feulner, E. J. and M. A. O'Grady (2005) and various governments statistics.

Figure 1. Development of effective top statutory tax rate on corporate income in Europe, 1993 – 2005

	EU-15	EU-NMS10	EU-25
1995	38	30,6	35
1996	38,1	30,4	35
1997	37,8	30,2	34,7
1998	36,7	29,6	33,9
1999	35,9	29,4	33,3
2000	35,3	27,4	32,1
2001	33,8	27,1	31,1
2002	32,6	25,5	29,7
2003	31,9	23,8	28,7
2004	31,4	21,5	27,4
2005	30,1	20,6	26,3



Source: Structures of the Taxation Systems in the European Union. Data 1995-2003, 5th Edition. Luxembourg: Office for Official Publications of the European Communities (2005).

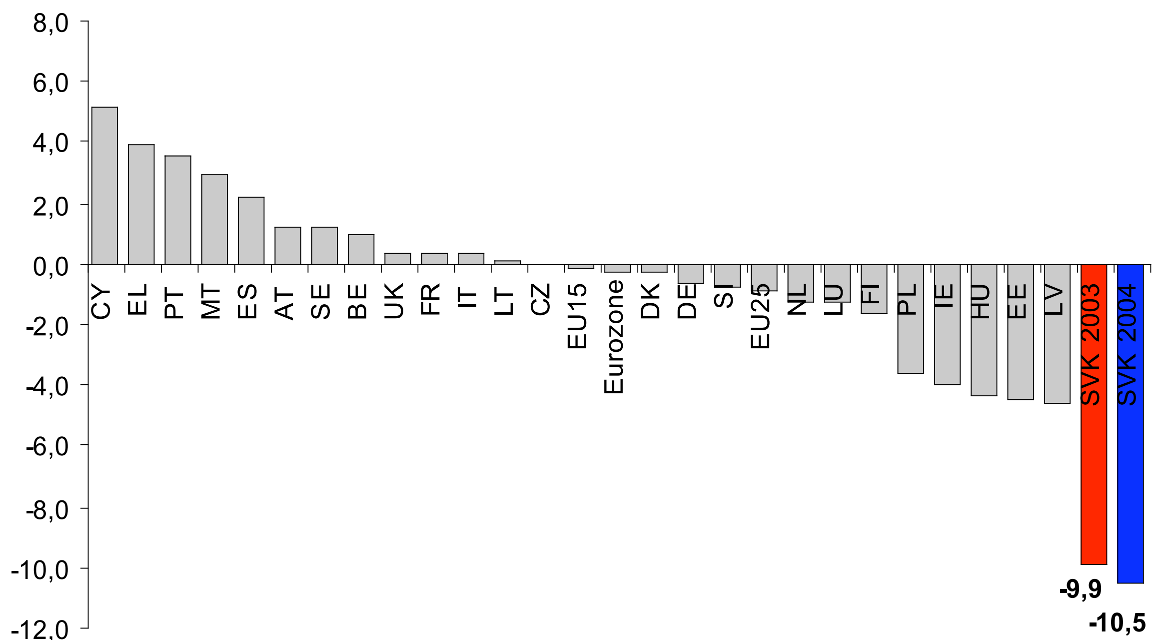


Figure 2. Reduction in fiscal burden in Europe, 1996 – 2003

Source: Structures of the Taxation Systems in the European Union. Data 1995-2003, 5th Edition. Luxembourg: Office for Official Publications of the European Communities (2005).