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LESS TAX IN THE EAST

The tax cuts which have been introduced in most European countries in recent years have led to fears of tax competition which could worsen inequalities, weaken the quality of public infrastructure and public services, or lead public finances to be unsustainable. The enlargement of the European Union has deepened such concerns. Taxes in Eastern Europe are generally far lower than in the EU15, and these countries seem to have adopted a low-tax strategy for mobile tax bases, so that companies are taxed relatively little, often far less than their distance from "the heart of Europe" would justify. In contrast, taxes on labour and VAT are generally at levels close to those observed in the former EU. Such a tax strategy by the new members, which favours foreign direct investment, is debatable as it risks favouring tax optimisation rather than employment.

The enlargement of the European Union on 1 May 2004 has raised a certain number of worries in the West. Won't the lower income levels of the 10 new member states, their greater labour market flexibility, and lower taxation accelerate the relocation of labour-intensive industries and company headquarters by Europe's firms?

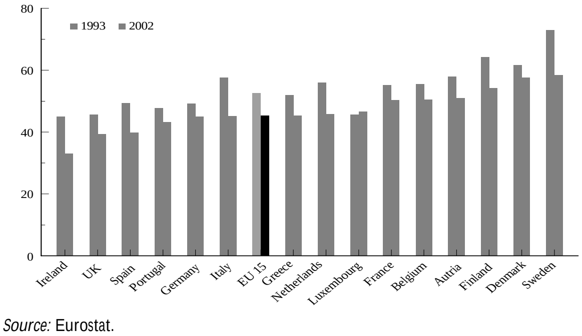
The fears in the East are exactly symmetric. Will the 10 new member states still be able to continue to attract foreign direct investment inflows given that their privatisation programmes are coming to an end and given that their growth prospects, based on economic catch-up and demographic growth, are returning to more normal levels? To this should be added the rigidity of several exchange rate regimes which makes relative price adjustments difficult and constrains monetary policy. Tax policy thus appears as an interesting tool because it allows the production costs of foreign companies working in Eastern Europe to be modified.

This situation raises the question of whether the ten new Members States may not straightaway be inclined to adopt competitive tax policies and so put pressure on tax regimes in the EU15. Close examination of this issue indicates that this risk cannot be ruled out. But paradoxically, tax competition threatens Western Europe less than Eastern Europe, where tax regimes may become unbalanced at a cost to less mobile tax bases or public deficits which could assume unreasonable proportions.

The Tax Context of Enlargement

Following several decades of continuous increases in the tax burden, most members of the European Union have, to varying degrees, cut the share of taxation in GDP, especially since the latter peaked during the recession of 1993 (see Graph 1). This overall reduction has been accompanied by a re-distribution of revenues taken in taxes and excise. According to calculations by the European Commission[1], the "implicit" tax rate on labour (the ratio of employer and employee social security contributions and income tax relative to total labour income) has begun to fall since the late 1990s, after rising steadily for nearly thirty years (1970-1996). This fall has occurred through cuts in both social security contributions and income tax rates. In contrast, implicit tax rates on capital and

Graph 1 – Trends in the overall tax burden in the EU15, 1993-2002
(*% of GDP*)



Source: Eurostat.

1. European Commission, "Public Finance in EMU" (2001), p.78 and "Structures of the taxation systems in the European Union", Edition 2003.

consumption have remained stable, except in recent years when tax rates on capital have increased (the Commission remains cautious about the permanency of this latter rise)[2].

These common trends in the tax policies of the Member States are not the result of a cooperative strategy. Taxation remains largely the responsibility of each Member State, apart from VAT which has direct consequences for the functioning of the internal market. Turning to corporate tax, the European Commission has limited its role to apply a "code of conduct" under which Member States committed themselves, in 1999, to dismantle 66 "damaging" practices, and not to create new distortions. In 2001, the Commission put forward more ambitious proposals, which consist, on the one hand, of ending certain specific distortions (for example, by extending the field of application of the 1990 Parent-subsidiary Directive which suppresses the double taxation of profits). On the other hand, the proposals include establishing a single tax base in the long term. Under this system, each Member State would be attributed a share of the consolidated single tax base (for example, as a function of its share of total turnover, the wage bill and/or of the physical capital a company). This share of the tax base could then be taxed according to national discretion. It should be noted that such a system, which would avoid problems of tax evasion via the relocation of declared profits, could nevertheless encourage competition in tax rates due to greater transparency. No political agreement has been reached so far, however, for such a measure still requires unanimity among Member States. But, an agreement has finally been reached for the taxation of savings, whereby Member States will, in time, exchange information.

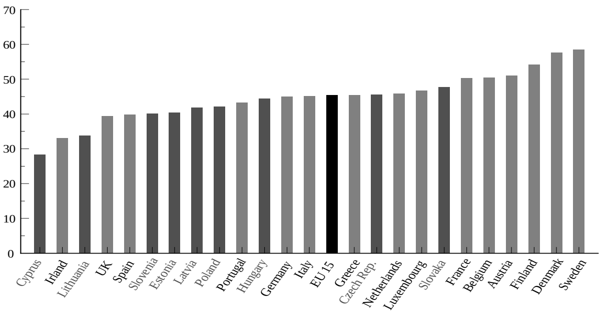
The issue of tax cooperation was recently rekindled by the European Commissioner Frits Bolkenstein, who has called for enhanced cooperation[3]. The idea, which was written into the Amsterdam Treaty and specified in the Nice Treaty, is to permit a group of volunteer countries (at least eight) to press on with integration in this field, on the condition that the door is left open for other Member States which may seek to enter into such cooperation in the future. This mechanism of strengthened cooperation is a way of resolving the dilemma between enlargement and deepening, and it is significant that it was put forward less than two months before the 1 May 2004 enlargement.

The Tax Policy of the New Members

The tax systems of the ten new Member States follow on from the reforms launched as of 1989 in Poland and Hungary, and as of 1993 in the other countries of Central and Eastern Europe, Cyprus and Malta. Each country has developed its own, specific system, without there being any move to regional harmonisation[4]. The only common criterion for these reforms has been the prospect of future membership of the EU.

Generally speaking, the overall tax burden in the ten new members lies below the average of the EU for the Baltic states, Cyprus, Slovenia and Poland, and near the average for Hungary, the Czech Republic and Slovakia (see Graph 2).

Graph 2 – Overall tax burden in the EU15 and the new Member States *(2002, % of GDP)*

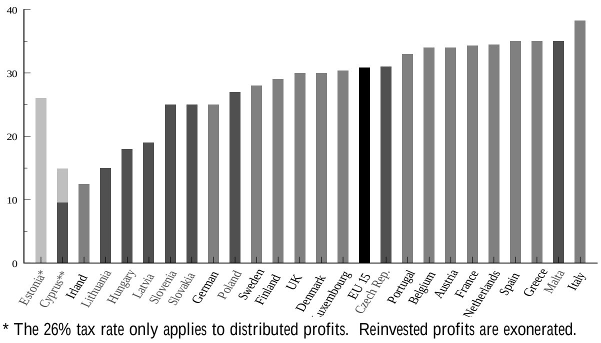


Sources: Eurostat; OeNB, Focus on transition 2003-2 (Hungary & Poland); national sources (Cyprus: <http://www.mof.gov.cy> & Slovenia: <http://www.stat.si>).

That said, this relative overall homogeneity masks quite profound structural differences compared to the tax regimes of EU existing members:

- the nominal corporate tax rate lies significantly below the average for the EU15, with the exception of Malta and the Czech Republic (Graph 3). Estonia is in a special situation as its 26% tax rate is only applied to distributed profits, whereas reinvested profits are exonerated. For Cyprus, the 10-15% rate applies only to domestic companies, with foreign companies facing a rate of 4.25% through to the end of 2005[5];

Graph 3 – Nominal corporate tax rates *(2003, %)*



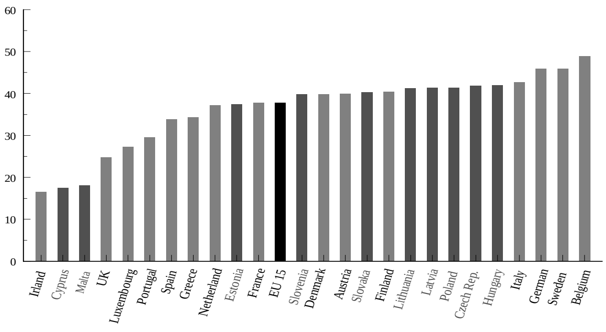
* The 26% tax rate only applies to distributed profits. Reinvested profits are exonerated.
** For tax years 2003 and 2004, a 5 point surcharge has been applied to profits exceeding Euro 1.7 million.
Sources: KPMG survey 2004, for the EU15, <http://www.kpmg.or.jp/tax/newsletter/pdf/Taxsurvey0404.pdf>; for the new members: ZEW, Ernst & Young (2003), "Company Taxation in the New EU Member States".

2. Such data must be treated with care, given methodological problems. It may nevertheless be noticed that the implicit taxation of capital is on average lower in the European Union than in the United States.
3. Communication to the Economic and Monetary Affairs Commission of the European Parliament, 16 March 2003.
4. Apart from in the Czech Republic and Slovakia, which both voted the same tax reform on 1 January 1993.
5. Such discrimination based on companies' country-of-origin is in fact contrary to the European "code of conduct".

▪ top income tax rates are also considerably lower than the average of the EU15;

▪ in contrast, VAT rates are on the whole comparable for the 10 new members to those in the former Union[6];

Graph 4 – Tax rates on gross wages
(2002, % of labour costs of low incomes)*



* full-time wages below 67% of the average wage – *Source*: Eurostat.

▪ taxation of low incomes (social security contributions and income tax) is generally higher than the average for the EU15, with the notable exceptions of Cyprus[7] and Malta (Graph 4).

Thus, the ten new members would appear to be betting on taxing mobile tax bases lightly, through low corporate and income taxes, with tax rates being relatively higher for less mobile tax bases.

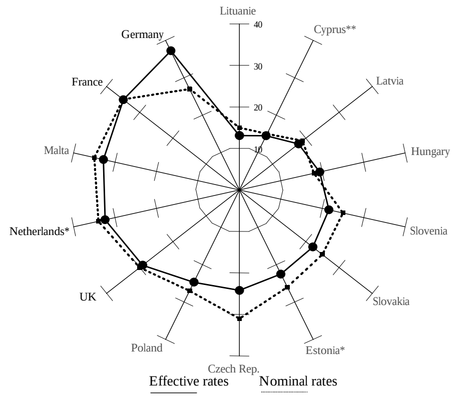
This observation, which is based on nominal tax rates, is confirmed by an analysis of effective tax rates that take into account differences in tax bases. As far as corporate tax is concerned, for which the differences between nominal and effective tax rates are most important, taking into account tax bases accentuates the advantage of new members, while the German rate rises to the French rate (Graph 5).

Lastly, special regimes must also be taken into account. The demarcation of free trade zones, various measures taken in favour of leading-edge industries and R&D, as well as the total exoneration of profits for fixed periods are among the most common tax incentives. Taking into account such measures, which it should be remembered do not apply to all types of economic activity, reduces effective tax rates on company profits to a significant degree in the Czech Republic, Slovakia, Malta and the Baltic States (see Table).

This overview of taxation in the new Member States is far from being final. Some countries have decided to substitute cuts in nominal corporate tax rates for tax incentives. Such cuts in nominal rates (which vary from 21% to 33% depending on the country[8]) will reduce the effective tax burden on companies, without taking into account the type of investment, the economic sector companies operate in, or the regions in which investment is taking place. To finance such nominal cuts in corporate tax rates, the Czech Republic is proposing to cut public spending (by reducing production subsidies, raising public sector wages moderately, and making savings in health and pensions). It also plans to increase tax earnings through higher indirect taxes (excise duties, sales taxes). Slovakia, meanwhile, introduced a single tax rate of 19% in 2003, which concerns both households and companies. All goods and services will also face a flat 19% VAT rate.

From a tax point of view, enlarged Europe is very far from being homogenous. The Baltic States, Cyprus, along with Ireland, have resolutely opted for tax regimes that are little constraining, though at a cost of limited social security schemes. The other new members are closer to the European "tax average", though they place a heavy emphasis on indirect taxation rather than direct taxation. But all countries appear to be tempted by a strategy to reduce corporate taxes, doubtless with the aim of attracting foreign direct investment despite their geographic location, which for some of them is peripheral or insular[9].

Graph 5 & Table – Corporate tax: a comparison of nominal and effective rates *(2003, %)*



	Nominal rates	Average effective rates (a)	Average effective rates taking into account special regimes
Lithuania	15	13	7
Cyprus**	15	15	13
Latvia	19	18	11
Hungary	18	19	17
Slovenia	25	22	19
Slovakia	25	22	11
Estonia*	26	23	11
Czech Rep.	31	24	16
Poland	27	25	24
UK	30	29	nd
Netherlands	34	32	nd
Malta	35	33	23
France	35	35	nd
Germany	27	37	nd

* and ** see Graph 3; (a) the spread on returns before and after taxation, calculated on a gross return of 20%.
Sources: ZEW, Ernst & Young (2003), "Company Taxation in the New EU Member States" and "Studie zur effecktiven Unternehmenssteuerbelastung in den EU-Beitrittsstaaten".

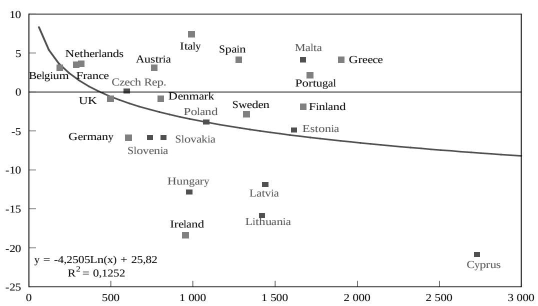
6. See R. Hugounenq (2004), "Quel avenir pour la fiscalité en Europe?", *Euro et gouvernance économique*, Cahiers français, n° 319.
7. Cyprus is a special case in as far as it is constantly among the three countries with the lowest taxation, whatever the tax base.
8. As of 2004, Poland, the Czech Republic and Hungary cut their nominal rates by 19%, 28% and 16%, respectively. In the long term, rates are planned to be 24% for the Czech Republic, 12% for Hungary, 15% for Latvia, and 19% for Slovakia. Source: ZEW, Ernst & Young (2003), *op. cit.*.
9. Econometric studies confirm the impact of taxation on FDI, once geographic location is taken into account (see A. Bénassy-Quéré, L. Fontagné & A. Lahrèche-Révil (2003), "Tax Competition and Foreign Direct Investment", *CEPII Working Paper*, No 2003-17, December).

Does Taxation Diminish with Distance?

Theoretical and empirical studies about the location of economic activity stress the prime importance of market size as a determining factor: a company invests in a country above all to be close to a market. Factors relating to costs follow: wages, productivity, the price of land, taxation *etc.* From this point of view, the low tax policies of the Baltic States and Cyprus may be interpreted as following from their geographic isolation from the "heart" of the European market. These countries seek to compensate for their low geographic attractiveness through strong tax competitiveness. Ireland's success shows that such a strategy can work, even if Ireland has clearly benefited from a host of other factors such as its qualified labour force, the structural funds it has received and the use of English.

Corporate tax policies across Europe, however, do not seem to fit this theory. If the city of Luxembourg may be considered as the "heart" of the European market, then Cyprus is indeed the country which is the most peripheral Member State, with the lowest tax rates (Graph 6). However, the Baltic States (including Estonia, if the rate on non-paid out profits is used) and Hungary have tax rates which are too low compared to their distance to the centre. This is also true for Ireland. Taking country size into account does not resolve this anomaly: several "small" countries (Greece, Malta and Portugal) have tax rates that are above levels "justified" on the basis of distance.

Graph 6 – Spread between the nominal corporate tax rate and the EU15 average, as a function of distance from Luxembourg



Source: See Graph 3 for the data and <http://www.cepii.fr/anglaisgraph/bdd/distances.htm>.

It is the planned cuts in rates by most new Member States, rather than present levels of corporate tax, which appear to indicate their desire to attract foreign investments. Such plans are being launched as privatisation programmes are coming to an end and there is a risk that investment inflows may fall. This would in turn threaten the financing of current account deficits, which are quite large in some cases. The maintenance of social security contributions that are generally quite high, in most new members, coupled with a planned increase in indirect taxation which will reduce households' purchasing power, contrast quite strongly with the trend to reducing corporate taxes. So far, relatively high taxes on labour have not been an obstacle to attractiveness, given that wages are far lower than those prevailing in the EU15. Nevertheless, the convergence of wages could, over time, undermine this tax strategy by biasing investment in favour of relocating company headquarters rather than labour-intensive activities. If there is no agreement on a single European tax base, then very low corporate taxes could lead to a relocation of where companies declare their profits, towards the new Member States, without there being any automatic spillover on jobs. For countries with high levels of unemployment, especially Poland and Slovakia, the benefits of such a tax trade-off are debatable.

As for the Western Member States, they should not worry too much about their lack of tax competitiveness: economic activities will not be able to relocate massively towards economic centres of gravity in the Baltic States, without leading to an explosion of land prices, which would partly re-balance trade-offs. They should pay far more attention to supporting the conditions of economic catch-up at a sustained, rapid rate, even if this leads to temporary tax dumping. From this point of view, the idea of enhanced cooperation on taxation is justified as a temporary solution, prior to tax coordination at the level of the Union as a whole[10].

Agnès Bénassy-Quéré & Delphine Prady
Contact : lerolland@cepii.fr

10. See the report by the French Planning Agency (2003), "Autour de l'euro et au-delà: l'UEM et les coopérations renforcées", April, <http://www.plan.gouv.fr/intranet/upload/publications/documents/rapportUEMcooprenf.pdf>.

LA LETTRE DU CEPII

EDITORIAL OFFICES

Centre d'études prospectives
et d'informations internationales,
9, rue Georges-Pitard
75015 Paris.
Tél. : 33 (0)1 53 68 55 14
Fax : 33 (0)1 53 68 55 03

PUBLISHER:
Lionel Fontagné
Director of the CEPII

CHIEF EDITORS:
Agnès Chevallier
Bronka Rzepkowski

TRANSLATION:
Nicholas Sowels

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Laure Boivin

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