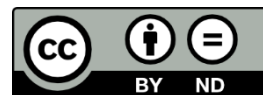


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TAX HARMONISATION VERSUS TAX COMPETITION: AN ENDLESS PERPETUAL DEBATE?

DAŇOVÁ HARMONIZÁCIA VS. DAŇOVÁ SÚŤAŽ: VEČNÁ DISKUSIA BEZ VÝSLEDKU?

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Abstract: *The aim of this paper is to refer to tax harmonization and tax competition in the European Union, as concepts that are in the focus of international tax law. Both concepts, over the last decade, are in the focus of interest in the international organizations, academic circles and business society. Even though, tax harmonization and tax competition are vastly emphasized as antipodes, both of them, have advantages over the tax systems of the member states.*

This paper compares the arguments for tax harmonization and tax competition and explores the interplay between these concepts through a literature review.

Summing the effective operation of the internal market, looking through the prism of the European Union, and based on theoretical arguments, the member states should aim towards higher tax harmonization, or at least towards tax coordination due to the current processes of enhanced globalization and digitalization. Those processes have impact on tax systems of member states through enhancing the tax evasion, aggressive tax planning and double non-taxation of cross border activities of the persons, especially the multinationals enterprise groups. Hence, even though the “good” tax competition has its advantages, the member states should refrain from further eroding its own and other countries tax bases.

Keywords: tax harmonization, tax competition, tax coordination, EU *acquis*, globalization, corporate tax

JEL Classification: H20, H25

INTRODUCTION

The existing pressure for enhanced international cooperation in the area of taxation undoubtedly imposes the need for greater harmonization in the area of direct taxation. Tax evasion, tax avoidance, aggressive tax planning are some of the reasons why, on international level, via the work of the Organization for Economic Cooperation and Development (OECD), the G20 countries, including the European Union (EU) have joined the process of international tax coordination with the adoption of many international documents which, to a certain extent, unify the tax rules in relation to cross-border operations of multinational groups. The momentum with the intensified globalization and the integration of the economic streams of the

countries, but also the increasing digitization are in the background of this action, and it was established that the current tax system is not relevant for the new social and economic conditions.

On the other hand, the countries are in a constant struggle to optimize their tax system in order to attract foreign capital in their jurisdiction. There is nothing irrelevant about diversity, which is ideally a desirable thing because it offers more choice. Seen through the lens of tax law, diversity means that taxpayers will direct their operations to those countries that, taking into account the specifics of the case, will suit them best for their activities. With this process, the countries enter into tax competition.

1. RESEARCH AIM AND METHODOLOGY

The objectives achieved in this paper relate to analysis of the concepts of tax harmonization and tax competition within the European Union, as one of the main tax themes in international tax laws, considering that each of these concepts has its advantages over the tax policy of member states. This paper provides a brief analysis of the advantages of the two concepts based on already existed theoretical foundations present in the tax literature. The analysis of the concepts of tax harmonization and tax competition, identifications of its advantages contribute to the existing body of academic knowledge.

The purpose of this paper is to elaborate the arguments and the tenets for tax harmonization and tax competition, observing them at the level of European tax law. The two concepts, often perceived as antitheses, can have advantages on the tax systems of the member states.

The question that this paper will answer is the following: *Is tax harmonization, taking into account the current processes of globalization and digitalization, something that the EU member states should strive for, and at the expense of that to refrain from engaging in tax competition?*

In order to discuss the arguments on tax harmonization and tax competition, it is a must to provide insight into the literature review, the meaning of these two concepts, their historical beginnings, as well as their current situation and policy measures.

Descriptive research method is used for testing the theory and the hypothesis set in this paper. The research question will be answered by applying the deduction method, as a process of drawing valid conclusions based on theoretical and logical approach.

This paper is of importance for directing the tax policies of those countries that aspire to be full members of the European Union and which should continuously undertake activities for harmonization of the domestic tax legislation with the EU acquis, but at the same take should refrain from introducing tax measures that classify as "harmful" tax competition.

2. TAX HARMONIZATION CONCEPT: THEORETICAL BACKGROUND AND POLICY MEASURES

Tax harmonization is a concept that is as old as the European Union. In the area of European tax law, it dates back to 1957. The purpose of establishing the European Union (at that time the European (economic) community) was to avoid further military conflicts on the European continent, but also to strengthen Europe and be market competitive in relation to other markets. In order to meet the latter, the European Community had to operate as a single market for all member states.

In order for the internal market to work efficiently and effectively, it is necessary to remove all the obstacles that stand in the way of smooth realization of the basic freedoms: freedom of movement of people, freedom of movement of goods and services and freedom of movement

of capital. The diversity of tax systems has been noted in many past reports as obstacle to efficient and effective operation of the internal market (Neumark Report, Van den Tempel Report, Serge Report, etc.).

Indirect taxes, such as value added tax and excise duties, are directly related to the internal market and the movement of goods and services. The efforts for tax harmonization in the European Union are therefore undoubtedly aimed at indirect taxation. It is precisely in this part that the European Union is very successful and it managed to harmonize the indirect taxes in all the member states of the European Union.

It is a totally different story when we talk about tax harmonization in the area of direct taxes, which include the profit tax of legal entities and the personal income tax of natural persons. It is here that countries still strive to preserve their tax sovereignty. The overall economic policy of a country is influenced through tax policy. There is no doubt that the economic, social, social and cultural differences between the member states are reflected in the tax policy. Consequently, the European Union is not very "successful" in harmonizing direct taxes.

From historical perspective, back in the times when the European Union was being established, there were much more ambitious efforts for tax harmonization in the field of direct taxes. Ideas for tax harmonization of corporate tax rates, harmonization of the tax base and harmonization of rules for avoiding double taxation were discussed. The work of the European Union in the field of direct taxation is related to adoption of several directives, recommendations and opinions that started back in the 1990s, which are primarily about facilitation of cross-border operations, protection against tax evasion and increasing of administrative cooperation in the field of the taxes.

In recent years, with the intensified processes of globalization and digitalization, the European Union, following the work of OECD and G20, is involved in efforts to prevent tax evasion, aggressive tax planning and exploitation of gaps and inconsistencies between different tax systems by multinational groups. As a result, the process of tax harmonization in direct taxation has intensified.

2.1 Arguments in favor of tax harmonization: Literature review

Tax harmonization and tax competition, as a two widely divergent views dominate academic literature since the earliest efforts to establish some degree of tax coordination at the EU level.

In this line, Kopits (1992) presents a groundbreaking paper on tax harmonization within what was then the European Community. It discusses how the lack of sufficient harmonization may inhibit the completions of the single internal market. This is primarily because the harmonization of tax bases enhances transparency in economic decision-making, while the harmonization of tax rates is expected to improve efficiency and welfare across the Community. Similarly, Faria (1995) discusses the tax harmonization through the prism of double taxation of foreign-source income where competing tax jurisdictions must employ unilateral bilateral or even multilateral schemes of coordination and harmonization in order to obtain long-term objective to create tax-level playing field.

Based on the discussions, tax harmonization is expected to contribute to the efficient functioning of the internal market, as it removes the distortions that arise as a result of differences in the tax systems of the member states. These differences are particularly evident in the mobile factors of production, such as capital and labor. Their mobility is even more evident in a situation of globalization, hence the single tax treatment in relation to these categories will contribute to the facilitation of the work of the entities between different member states, thus affecting the efficient functioning of the internal market.

The different tax treatment of taxpayers (residents and non-residents) and the different tax rules of member states can violate the economic neutrality of operations, trading, investment and establishment of companies. Because of these things, the tax differences of the member states impose the need for integration at the EU level via harmonization of tax systems or, at the very least, their tax coordination, for the purpose of facilitating the cross-border activities of entities. Seen through the eyes of taxpayers, these differences may represent an advantage in performing cross-border activities, depending on the circumstances of the specific case. The diversity of tax systems also brings opportunities for taxpayers, including taking advantage of the opportunity to shift taxable profits from countries with high taxes to countries with low taxes.

It is evident that the initial discussions on tax harmonization were largely disconnected from processes such as globalization and digitalization, as these developments were not anticipated at the scale we witness today.

More recent literature considers tax harmonization and tax competition in the context of digitalization and globalization. Backer (2007) even suggests that harmonization is sometimes used as a synonym for globalization. Notably, Hines (2023) states that tax harmonization can advance collective objectives only if the standard deviation of tax rates is less than the average effect of tax competition.

Several proposals for tax harmonization in the area of direct taxation within the EU aim to reduce the compliance costs associated with operating in the internal market. Notable examples include the Common Consolidated Corporate Tax Base (CCCTB) proposed in 2011 and the more recent Business in Europe: Framework for Income Taxation (BEFIT) proposal introduced in 2023. Barrios et al., (2020), assess the impact of the CCCTB, using a general equilibrium modeling approach and determine that reduction in tax compliance costs would be associated with greater economic efficiency. Similarly, Konstantinova Popova (2011), argues that tax harmonization in the European Union would contribute to the reduction of these costs.

Tax harmonization affects the reduction of administrative costs for taxpayers and tax administrations. The tax harmonization, in the broader sense of the word, is expected to yield greater transparency in making economic decisions and efficient allocation of resources, as well as equalization of the effective tax burden for taxpayers in different jurisdictions of the member states. Seen from the point of view of the cross-border activities of the entities which are enhanced during the ongoing processes of globalization and digitalization, the argument for tax harmonization is the reduction of the taxpayer compliance costs and reduction of administrative costs for the tax administrations. In that regard, the differences in tax systems make it difficult for entities to do cross-border operations, mainly due to the need to know 27 different tax systems before making a decision to invest or operate in another member state, and in addition to that, the compliance costs of the multinational groups that have cross-border activities can be burdensome.

3. TAX COMPETITION CONCEPT: THEORETICAL BACKGROUND AND POLICY MEASURES

Just like tax harmonization, tax competition is also a topic that is of particular interest in a situation of intensified globalization. In order to understand the relationship between tax competition and tax harmonization, one must start from the process of increased globalization and the growth of cross-border trade, which have an impact on the increased allocation of resources, which today is present everywhere, even within the European Union.

Tax competition, as a concept, was first mentioned by Tiebout (1956), where he presented a model in which local jurisdictions offer different tax benefits, and tax competition is seen

through the existence of free riders and the lack of identification of the real price of the public good. For these reasons the market cannot provide an efficient allocation of public goods between individuals. Tiebout states that individuals orbit between local jurisdictions and choose to base themselves where taxes are lower and where better public services are offered. In these situations of local tax competition, intervention by the Government is not needed in order to achieve efficiency in the public services market.

Michael Keen (2008) equates tax competition with strategic tax regulation in the absence of cooperation between jurisdictions, where each of the countries introduces parameters of its tax system in relation to the taxes regulated by other countries. Wilson and Wildasin (2004) define tax competition in a broader sense as any form of non-cooperative tax regulation by independent governments, while in a narrower sense tax competition incorporates the requirement for impact of one country's tax measure on the other countries' tax revenues.

Countries engage in tax competition for the purpose of attracting foreign capital in their jurisdiction (direct investments and portfolio investments) and for the purpose of attracting entities in their territory (natural and legal entities). For these purposes, countries use different tax instruments (tax rates and tax bases) with which they try to make the tax system more efficient for their taxpayers, but also for other entities trying to attract them to their territory.

Tax rules are not the key tools that countries have at their disposal to achieve these goals, so the efficiency of the tax system also depends on the workforce, administrative rules for doing business, public services, infrastructure, etc.

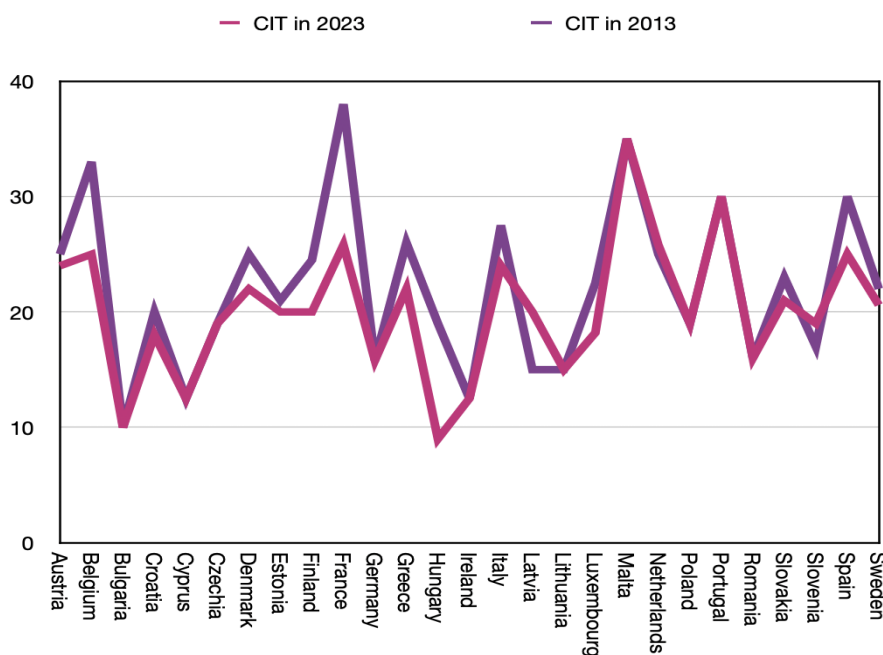


Figure 1: Level of profit tax rates in MS in EU for the in 2013 and in 2023

Source: Own evaluation based on data from stats.oecd.org

The tax instruments that countries use for these purposes are reduction of tax rates and modification of tax bases (tax exemptions and tax reliefs). These tax instruments can influence the attraction of the mobile production factors (capital and labor) which, in turn, influence the neutrality of their movement, especially within a geographical unit such as the European Union. The above mentioned, if seen from the EU aspect, may in turn affect the efficiency of the internal market, as one of the key objectives of the establishment of the European Community.

Articles 101 to 109 of the Treaty on the Functioning of the European Union guarantee normal conditions for competitive behavior between member states within the internal market, that is, ensuring a level playing field within the internal market. With tax competition, countries enter the race to the bottom, i.e. the trending reduction of profit tax rates Zodrow and Mieszkowski (1986) and Wilson (1986). In recent years, EU countries have undertaken tax reforms focused on reducing on individual and corporate income tax rates Enache (2022).

Analyzing the data included in the above table that includes profit tax rates for a 2013 and 2023, that is, which covers a 10-year period of analysis, it can be concluded that the trend in relation to profit tax rates is decreasing in almost all countries, and as a consequence of this, taking into account that the reduction of profit tax rates is one of the instruments which is used for tax competition between countries, the conclusion is that tax competition is present in almost all countries. The table shows us that the profit tax rates in some of the member states that have a flat profit tax rate remain the same during the analyzed period and are still lower in relation to the progressive rates of profit tax.

It is especially important to make a clear distinction between fair tax competition and unfair tax competition. Fair tax competition is one that yields positive effects in the tax system as a whole, and thus influences the fiscal discipline of the Government authorities. Pendovska et al., (2021). Unfair tax competition can affect the budget revenues of other member states, so efforts are being made at the international level to reduce or eliminate it.

The European Commission has been particularly active in the area of prevention of harmful tax competition, which appeared in the 1980s with the introduction of more favorable tax rules for the purposes of attracting foreign direct investment. The Commission's focus was and still is harmful tax competition, for the prevention of which the Code of Conduct for Business Taxation was adopted in 1997. The Code is a non-binding legal instrument for tax coordination of the tax systems of the member states, on the basis of which countries commit themselves to remove harmful tax measures from their systems and refrain from introducing such measures.

An international tax reform was introduced under the leadership of the OECD and the G20 countries. This reform, known as the “Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalization of the Economy,” aimed at tackling tax competition among countries and ensuring a level playing field for multinational enterprises. As a result, a global minimum tax was introduced, which anticipates an effective tax rate of 15% among participating jurisdictions in the Inclusive Framework on Base Erosion and Profit Shifting (BEPS). At the end of 2022, this international tax reform was implemented at the European level with the Council Directive on ensuring a global minimum level of taxation for multinational enterprise groups and large-scale domestic groups in the Union (Pillar Two Directive). The Pillar Two Directive codifies the global minimum tax rate into EU law and establishes an effective tax rate of 15% for multinational groups. Since then, a vast majority of countries have already introduced the global minimum tax, and it remains to be seen how it will affect tax competition among countries.

3.1 Arguments in favor of tax competition: Literature review

Since tax harmonization was inevitably considered in relation to tax competition, arguments in favor of the benefits of tax competition were present even before the first attempts at coordination at the EU level. Tiebout (1956) examined the concept of tax competition and posited that competitive tax rates among local authorities can enhance the efficiency of public goods provision. On the contrary, McLure (1986), even though he refers to the Leviathan model in one of his theories regarding tax competition and explains that the absence of tax competition between jurisdictions may act against the best interests of their constituents, concludes that tax competition is undesirable and should be avoided. Kehoe (1989) discussed the tax competition

throughout tax rates their responsiveness to economic conditions and public preferences. Sinn (1990), in the context of direct taxation, advocates for the harmonization of tax bases rather than tax rates, while ultimately supporting tax competition. Razin and Sadka (1991) present a more subtle relationship between tax harmonization and tax competition, defined through the level of coordination between countries. These authors state that if there is a sufficient level of coordination between countries, then tax competition will lead each country to apply the residence principle of taxation, and there will be no gains from tax harmonization in this situation. In the absence of coordination between countries, tax competition will lead to lowering capital income taxes, where the tax burden will be borne by internationally immobile factors. Wilson (1999) notes that early contributions largely characterized tax competition as wasteful, whereas more recent studies suggest that it can play a role in enhancing efficiency for countries. Similarly, Edwards and Keen (1994) argued that tax competition can lead to lower tax rates by limiting the power of governments to levy taxes.

Tax competition has been extensively debated, particularly in relation to corporate tax rates and the persistent trend of their gradual reduction. Faria (1995) stated that the downward trend in effective tax rates in corporate income tax was already observed as a consequence of increased mobility and the removal of border controls between countries.

The tax law literature includes many arguments that go in favor of tax competition, similar to tax harmonization.

Some authors consider the tax competition as a desirable situation that contributes to the efficient allocation of resources, and tax reforms should be aimed at encouraging tax competition between countries (Elkins, 2016). Tax competition has many benefits on the economy through its impact on the market, companies and government (Teather, 2005). Tax competition promotes responsible tax policy. In the absence of tax competition politicians can act as monopolists and introduce excessive tax rates without fear of consequences (Mitchell, 2001).

It is evident that the theoretical literature has yet to reach a consensus on whether tax competition is ultimately a beneficial or harmful development.

Tax competition, especially fair tax competition, can have a positive impact on the tax systems of the countries. In that regard, tax competition can act as a protector in relation to the level of tax rates, in a sense that the member states are refraining from unjustified increase in the tax rate levels, in situations where other countries maintain a lower tax rates. Furthermore, in a situation of lower tax rates, countries bear more responsibility in the allocation of the tax revenues. Considering the objectives for which the countries engage in tax competition, it can be said that it has an impact on the movement of the capital in the direction of promoting investments in other countries.

The tax competition makes it possible for the tax sovereignty of the countries to come to the fore and the freedom to regulate the tax systems is expressed through it. Therefore, tax competition can provide an incentive for tax changes inspired by changes in other tax systems.

CONCLUSION

This paper does not aim to definitively resolve the ongoing debate between tax harmonization and tax competition, nor does it take a stance on the often polarized perspectives surrounding these concepts. Instead, by examining the theoretical foundations of both, it becomes apparent that while tax harmonization may appear advantageous in theory, the discussion remains complex and multifaceted.

In a situation of globalization, the tax policies of countries influence each other, and the domestic tax systems can no longer function in isolation from each other. The European Union

is an example of the effect the globalization has on the tax policy and the challenges this policy is facing. The economic integration and globalization have increased the mutual influence of the tax systems between the countries on the one hand, and on the other hand have encouraged tax competition between countries. After all, countries have embarked on designing enticing tax schemes in order to attract mobile capital to their territory and to attract highly profitable individuals and entities to their jurisdiction.

Tax harmonization, although it can be seen as a limitation of the tax sovereignty of the member states, a reasonable understanding still requires such a limitation for the purposes of efficient functioning of the internal market. In that respect, and taking into account the benefits for the internal market, seen through the lens of the European Union, countries should strive for *tax harmonization, or at least tax coordination, taking into account the current processes of globalization and digitalization, and at the expense of refraining from engaging in tax competition, especially harmful tax competition.*

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