



**CEPII**

**CENTRE  
D'ÉTUDES PROSPECTIVES  
ET D'INFORMATIONS  
INTERNATIONALES**

# Tax competition in Europe?

Eur-Ifri conference

*Enlargement and Globalisation:*

*Location and competitiveness of firms in Europe*

Amina Lahrèche-Révil

CEPII



**CEPII**

**CENTRE  
D'ÉTUDES PROSPECTIVES  
ET D'INFORMATIONS  
INTERNATIONALES**

# Tax issues in an enlarged Europe

- Need foreign capital
  - Increasing integration might make tax incentives more efficient in attracting capital
  - End of the privatisation process might call for different tools for attracting foreign capital
- Maastricht
  - No more room for competitive devaluation
- Theory
  - Small countries more prone to tax competition

⇒ tax competition?



**CEPII**

**CENTRE  
D'ÉTUDES PROSPECTIVES  
ET D'INFORMATIONS  
INTERNATIONALES**

# What's the problem (if any) with tax competition?

- Tax externalities
  - International level. Tax decisions by a country can affect its neighbours, and force an undesired tax change (race to the bottom)
  - Intra-national level
    - for a given level of public expenses, higher burden on immobile taxable income / free lunch for firms ⇒ fairness
    - Narrowing tax base and tax revenues vs. national preferences for public spending ⇒ preferences
- But
  - Increased efficiency of public spending
  - Less distortions



**CEPII**

**CENTRE  
D'ÉTUDES PROSPECTIVES  
ET D'INFORMATIONS  
INTERNATIONALES**

# Should we fear tax competition?

## The unanswered question...

- Three conditions before fearing tax competition
  - (i) *mobile bases do respond to tax cuts through relocation*
  - (ii) tax cuts produce a loss in fiscal receipts at least in some countries
  - (iii) this revenue loss needs to be compensated for by a welfare-decreasing tax increase on other, less mobile bases, likely (non-qualified) labor.

**Q2: Do FDI flows react to (CI) tax differentials within the enlarged EU?**



**CEPII**

**CENTRE  
D'ÉTUDES PROSPECTIVES  
ET D'INFORMATIONS  
INTERNATIONALES**

# Is “tax competition” measurable?

- Tax differentials: statutory, ex-post, ex-ante
- ~~Specific measures~~
  - Micro + law; Difficult to quantify
- But some tax differentials might be sustainable
  - For instance, larger and central countries should structurally attract more capital, and display larger tax rates
  - Tax competition much more difficult to detect

**Q1: Are there sustainable tax differentials?**



**CEPII**

CENTRE  
D'ÉTUDES PROSPECTIVES  
ET D'INFORMATIONS  
INTERNATIONALES

# Q1: Are there sustainable tax differentials within the EU?

- New economic geography
  - Structurally more attractive countries should display higher rates...
  - ... but only up to a given level of real integration, so that ...
  - ...in highly integrated economies, tax differentials should cancel out, even though some countries are larger





**CEPII**

**CENTRE  
D'ÉTUDES PROSPECTIVES  
ET D'INFORMATIONS  
INTERNATIONALES**

# Sustainable tax differentials: estimates

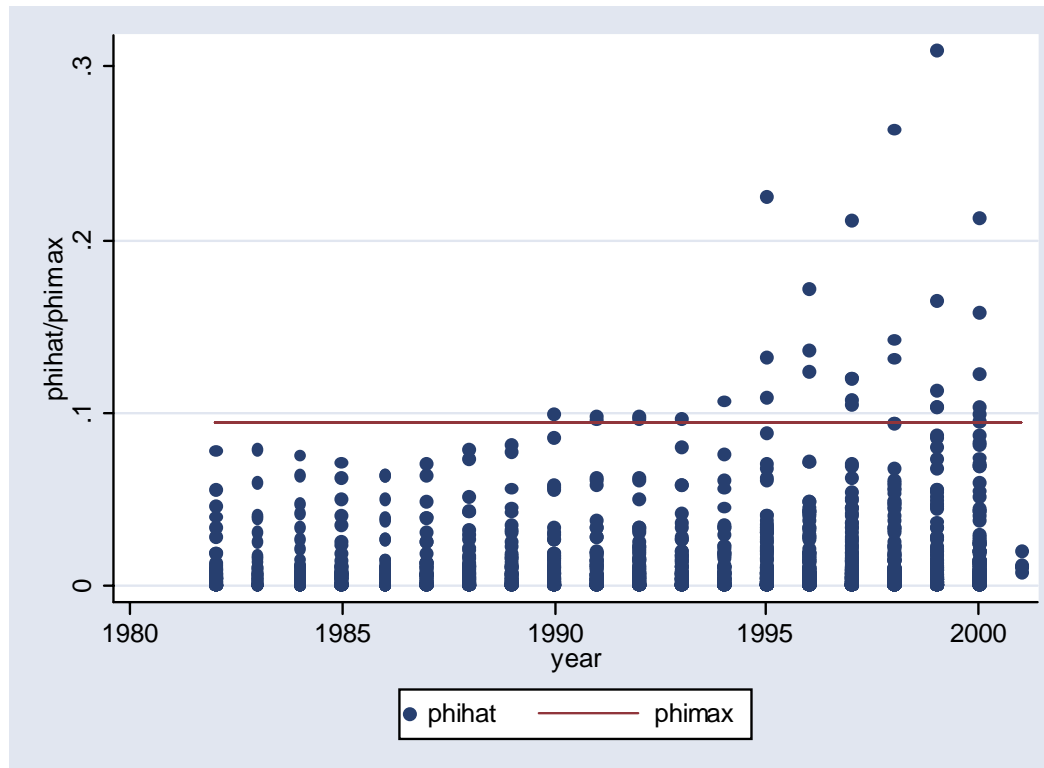
- In the EU15, tax differentials do depend on GDP differentials and real integration
- They are indeed non linear
- We find sustainable tax differentials to be as high as 17 percentage points for the “average” country.



**CEPII**

CENTRE  
D'ÉTUDES PROSPECTIVES  
ET D'INFORMATIONS  
INTERNATIONALES

## Where is the EU15?



- Only 32 countries above the red line, but integration increasing faster since 1995  $\Rightarrow$  sustainable tax differentials may be declining



**CEPII**

**CENTRE  
D'ÉTUDES PROSPECTIVES  
ET D'INFORMATIONS  
INTERNATIONALES**

## Q2: Does FDI react to tax differentials?

- What do we know?
  - The OCDE
- What happens in Europe?
  - with tax differentials
  - when sustainable tax differentials are taken into account?



**CEPII**

CENTRE  
D'ÉTUDES PROSPECTIVES  
ET D'INFORMATIONS  
INTERNATIONALES

## Previous results

- What did we learn from the OECD?
  - Tax differentials do affect FDI location decisions
  - But only higher taxes divert FDI
  - Non-linearity according to the size of tax differentials and the double-taxation regime in the investor's country.
    - Only very large tax differentials impact FDI, mostly when the exporter's country applies tax credit
  - Competition from third countries

**What are there stylised facts in the EU25?**

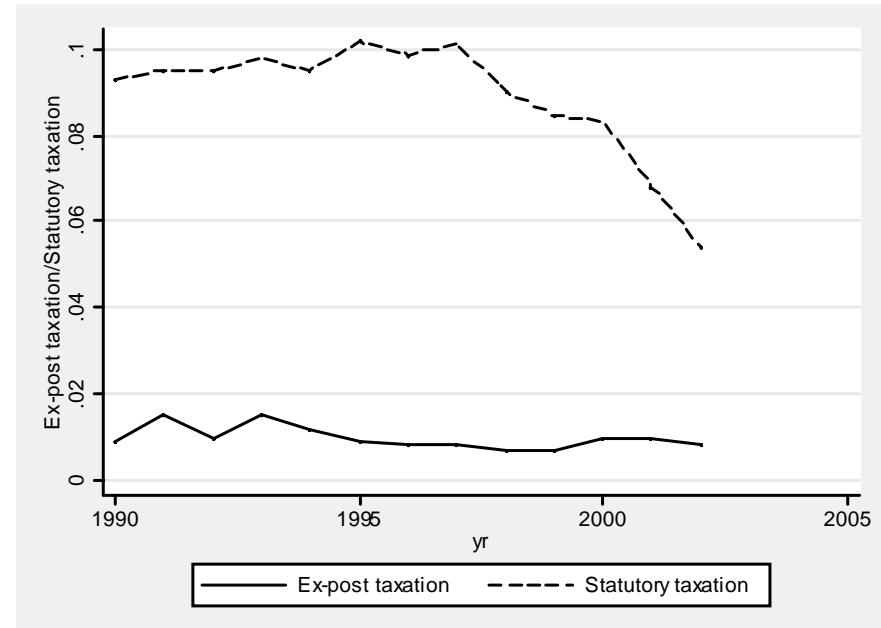


CEPII

CENTRE  
D'ÉTUDES PROSPECTIVES  
ET D'INFORMATIONS  
INTERNATIONALES

# Stylised facts: Unevenly converging tax levels

- Decline in statutory taxes all over (enlarged) Europe
- Ex-post taxation more cyclical, almost no convergence



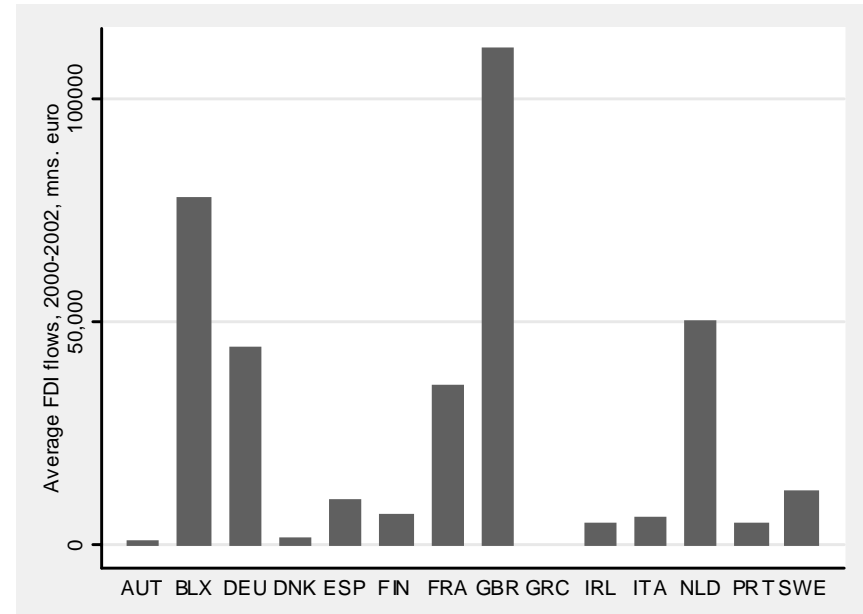
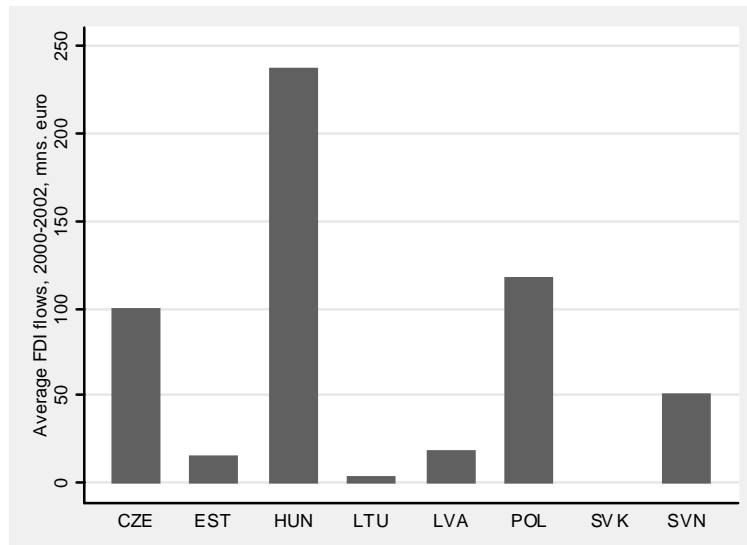


CEPII

CENTRE  
D'ÉTUDES PROSPECTIVES  
ET D'INFORMATIONS  
INTERNATIONALES

# Stylised facts

## Inward FDI flows



- Three recipients in the NMS, but level of FDI does not compare with the EU15



**CEPII**

**CENTRE  
D'ÉTUDES PROSPECTIVES  
ET D'INFORMATIONS  
INTERNATIONALES**

# Measuring the tax-sensitiveness of FDI inflows

- Gravitational analysis (market potential)
  - Bilateral FDI flows from EU15 to EU15 and NMS
  - Controlling RER and ULC
- 1990-2002, annual
- Statutory + ex-post tax differentials
  
- Differentiating estimates according to the geographical belonging of the destination country
  - Do tax incentives have the same impact in EU15 and NMS?



**CEPII**

CENTRE  
D'ÉTUDES PROSPECTIVES  
ET D'INFORMATIONS  
INTERNATIONALES

## Main results

- Statutory taxation non-significant or positive
  - (measurement error)
- Ex-post taxation affects FDI, but
  - Overall impact is weak
  - Because **taxation only affects FDI flowing to the EU15**
- Cost variables only affect FDI flowing to the EU15
  - real exchange rate depreciation  $\Rightarrow$  more FDI inflows
  - increase in relative ULC  $\Rightarrow$  more FDI inflows (quality mismeasurement?)
- The negative impact of higher taxes in the destination tends to reverse for high tax differentials
  - Take better account of sustainable tax differentials?



**CEPII**

**CENTRE  
D'ÉTUDES PROSPECTIVES  
ET D'INFORMATIONS  
INTERNATIONALES**

## Third countries taxation

- On the whole EU25:
  - Higher taxes in the recipient country discourage FDI
  - Higher taxes in potential alternative locations raise inward FDI
- But looking at regional belongings:

**Competition comes from the EU15, not the NMS**



**CEPII**

CENTRE  
D'ÉTUDES PROSPECTIVES  
ET D'INFORMATIONS  
INTERNATIONALES

# Some conclusions

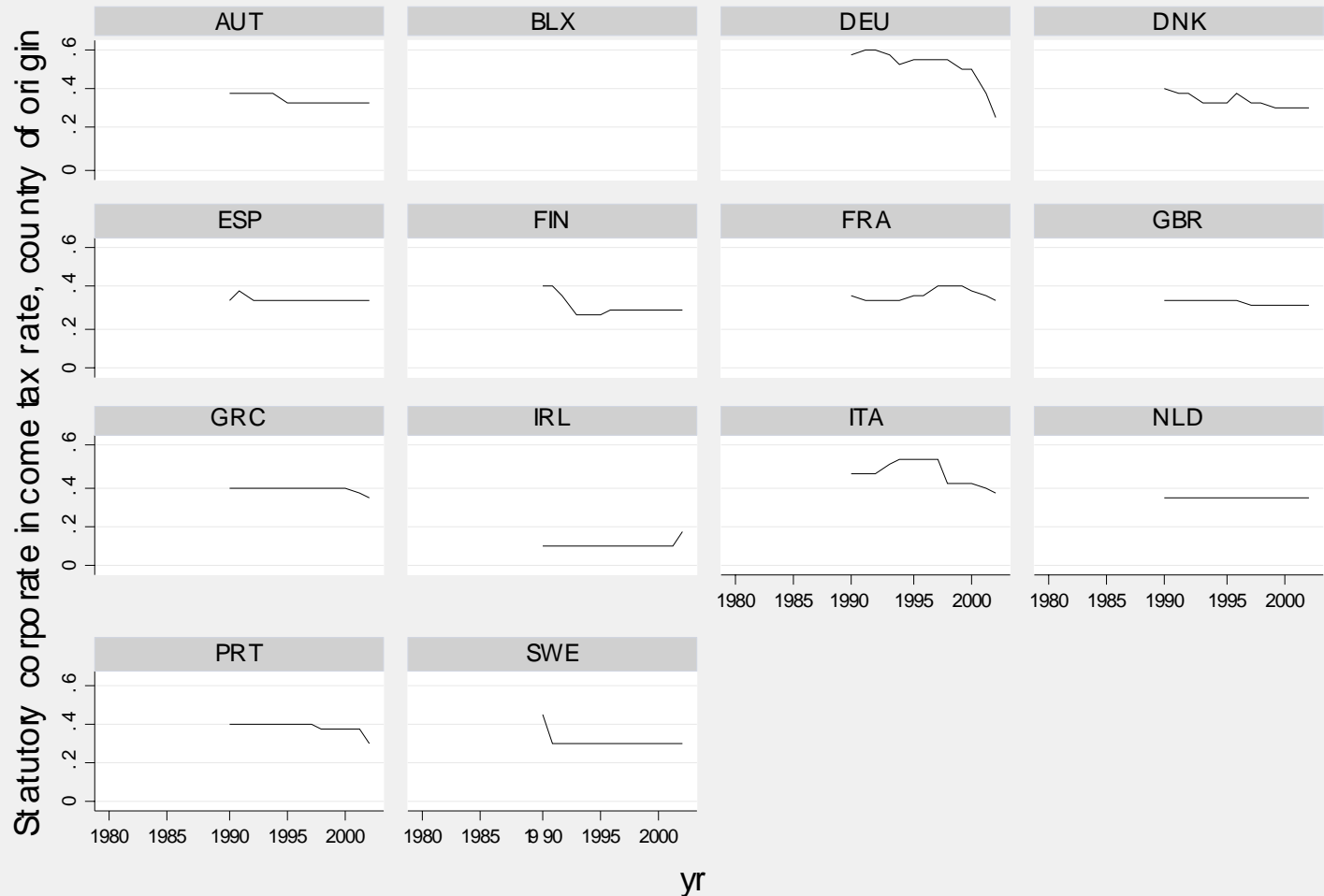
- Tax differentials do impact FDI, but caution needed
  - structural determinants even more important (market potential, public investment)
  - Mostly true within the EU15
  - Sustainable tax differentials still important ⇒ race to the bottom / tax competition should be limited in the near future.
- What about the future?
  - Structural behaviours should converge between the EU15 and NMS ⇒ more tax competition?
  - Rising integration could make tax differentials less sustainable ⇒ more tax competition, again?



## CEPII

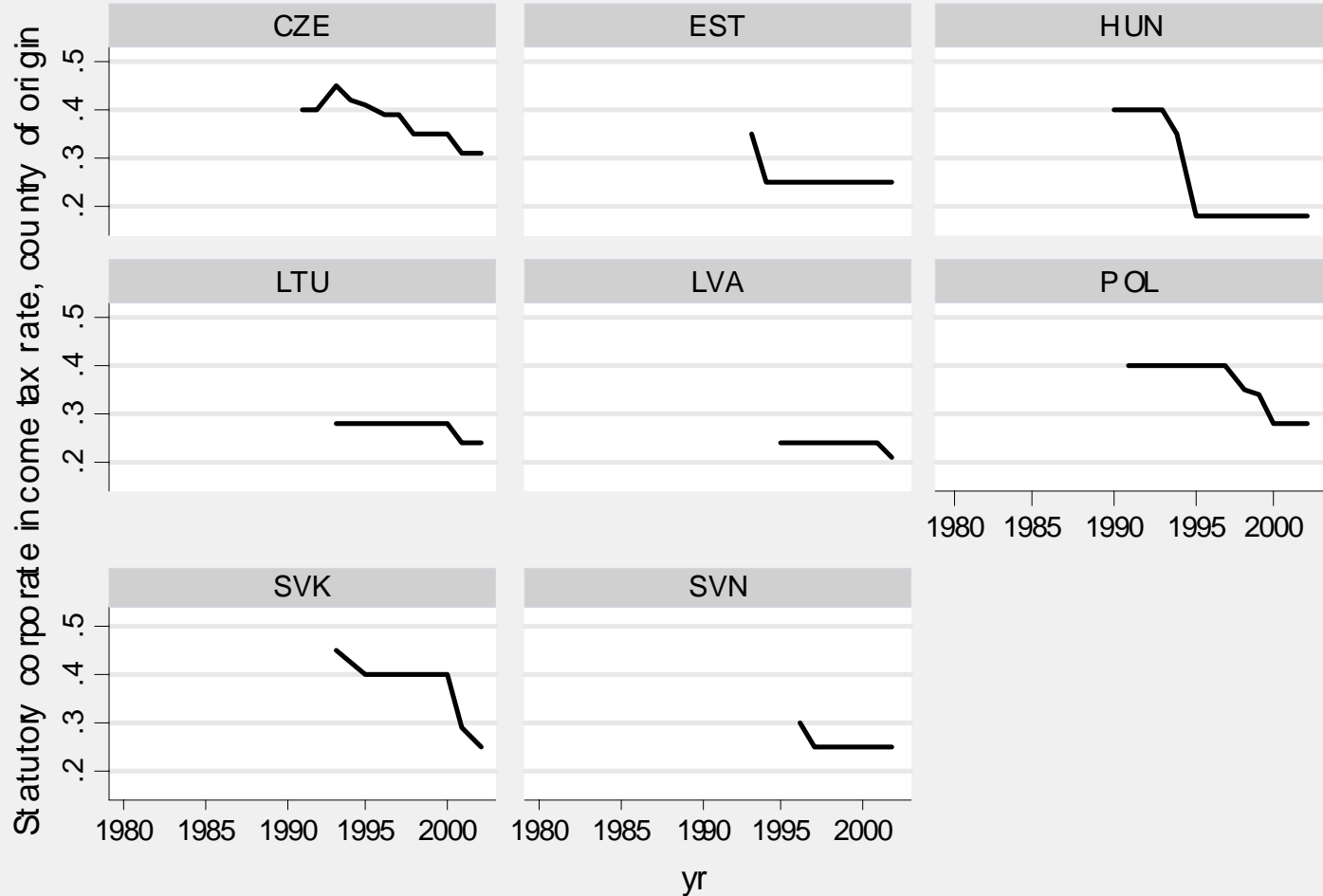
CENTRE  
D'ÉTUDES PROSPECTIVES  
ET D'INFORMATIONS  
INTERNATIONALES

# Stylised facts EU15. CIT



Graphs by c\_o

# Stylised facts NMS, CIT



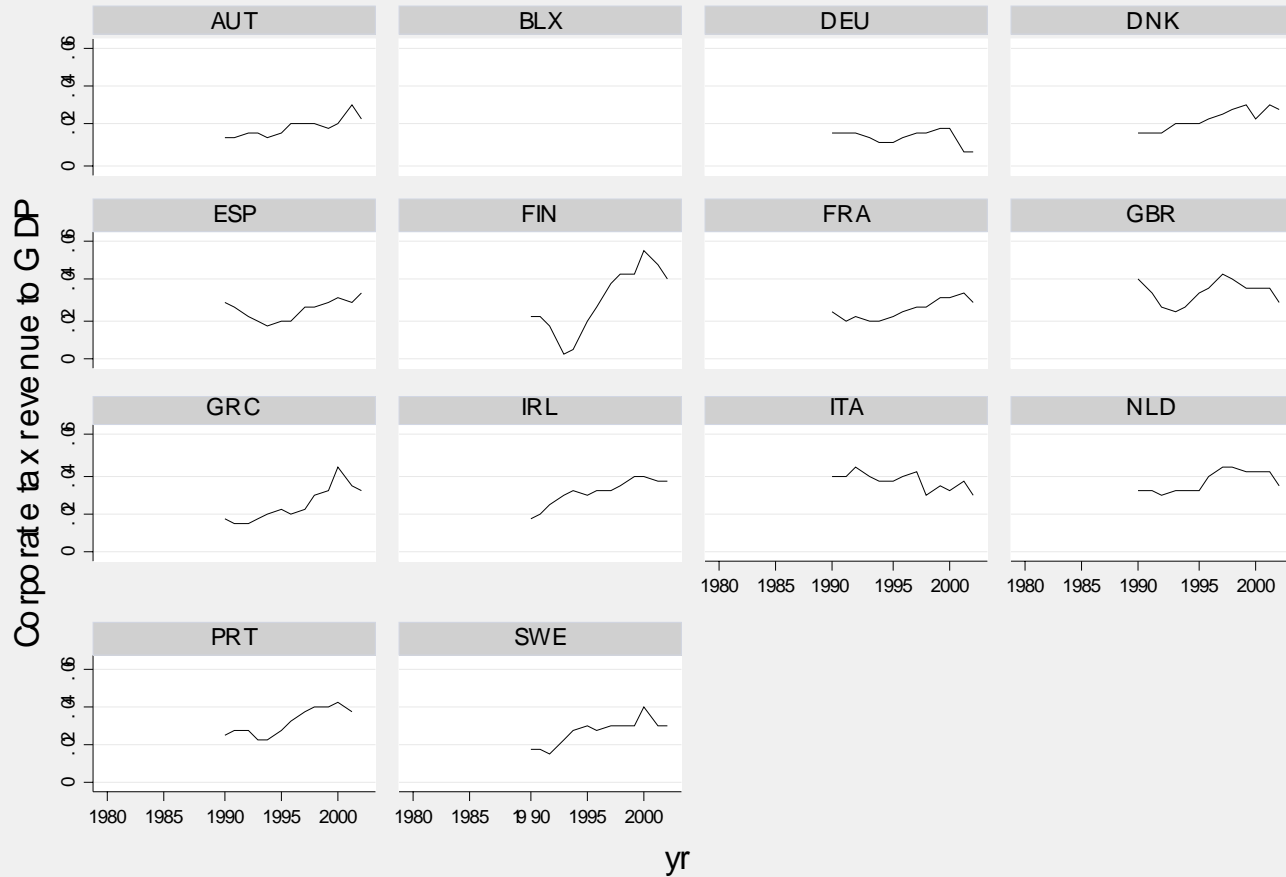
Graphs by c\_o



**CEPII**

CENTRE  
D'ÉTUDES PROSPECTIVES  
ET D'INFORMATIONS  
INTERNATIONALES

# Stylised facts EU15, ex-post taxation



Graphs by c\_o

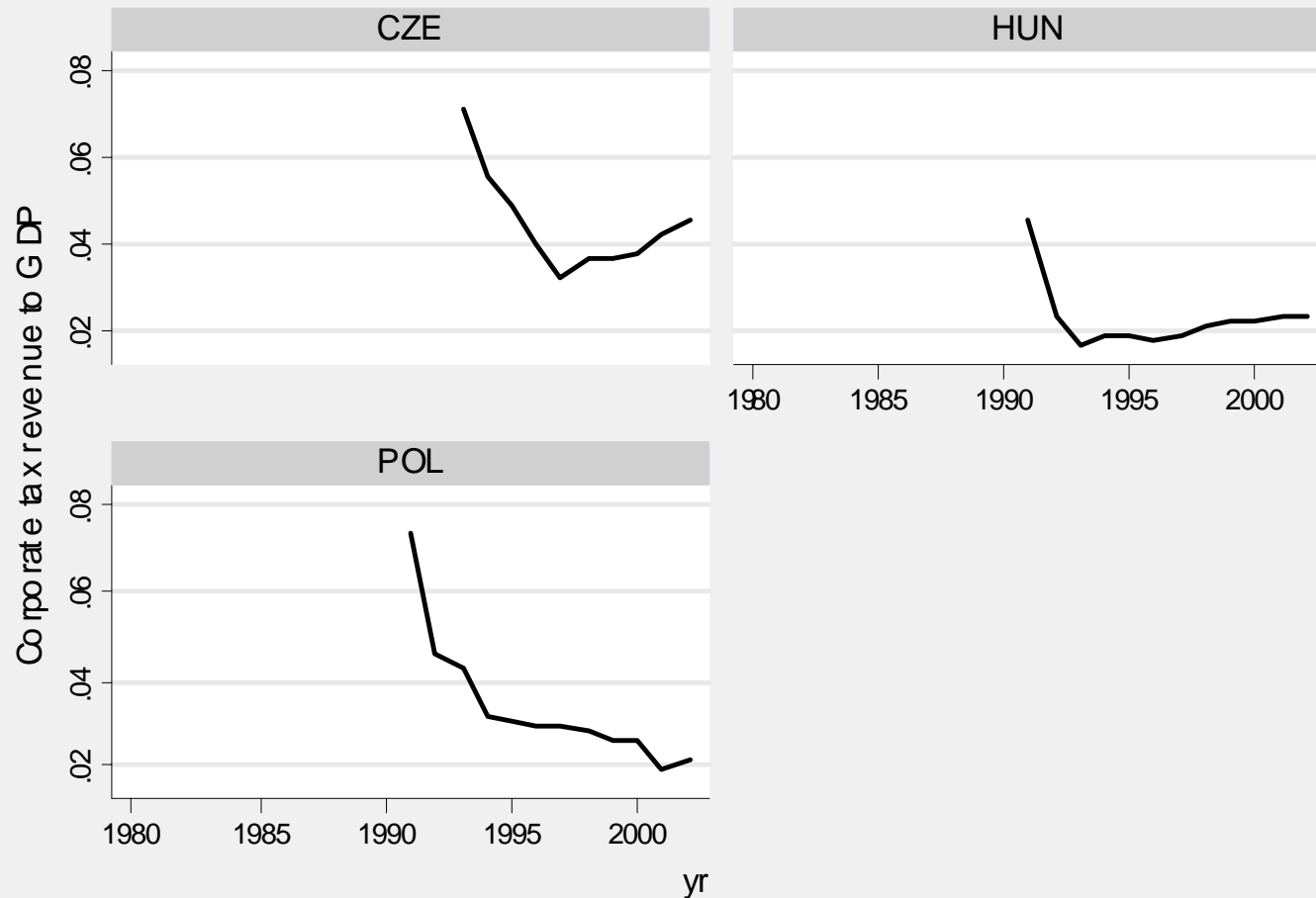


**CEPII**

CENTRE  
D'ÉTUDES PROSPÉ-  
RITÉ ET D'INFORMATI-  
QUE INTERNATIONALE

# Stylised facts

## NMS, ex-post taxation



Graphs by c\_o



**CEPII**

CENTRE  
D'ÉTUDES PROSPECTIVES  
ET D'INFORMATIONS  
INTERNATIONALES

# Main results

Figure 1: The non-linear impact of tax differentials

