THE COMPETITIVENESS THROUGH TAXES IN THE CENTRAL AND EASTERN EUROPEAN COUNTRIES

Lecturer PhD Daniela Pîrvu[1]
Lecturer PhD Martina Eckardt[2],

[1]University of Piteşti
[2]Andrássy University Budapest

Abstract: *In the last few years, many countries Central and Eastern European countries have reduced their corporate income tax rates with the purpose of attracting multinational companies. Various studies indicate the fact that the level of the corporate income tax represents an important advantage that drives the decisions to place foreign direct investments. Many European Union member states have initiated corporate income tax reforms, in order to generate the increase in the competitiveness of national economies. In the case of the Central and Eastern European countries, where the decrease in the corporate income taxes was higher, these reforms brought profound changes in the economic environment.*

Key words: competitiveness, corporate income taxes, foreign direct investments

JEL codes: F5; H3

1. INTRODUCTION

In the literature specializing in foreign direct investments we can notice that there are many studies focused on the role of the factors that influence the flow of foreign direct investments. Taking into account the main reasons of multinational companies for the internationalization of their assets (financial and monetary advantages, comparative and competitive advantages and advantages resulted from the market imperfections), specialists' attention has usually been focused on the following decisive reasons in attracting foreign direct investments: the size of the internal market, the trend of the exchange rate, the cost of labour and the economic integration. The role of taxation in attracting foreign direct investments within integrated economies was rather neglected up to the moment when it was noticed that the relaxed fiscal policy adopted by the Irish authorities after the adhesion to the European Economic Community in 1973 soon generated the attraction of an important volume of foreign investments and a significant increase in prosperity as compared to other countries (Greece, Portugal and Spain) that, in the moment of their adhesion, had a similar level of economic development. Currently, all the authors of empiric studies concerning the impact of taxation on capital movements admit that the level of taxation influence the decisions related to the localization investments made by multinational companies and capital flows, with an important impact on inter-affiliate profit transfers. However, the opinions related to the sensitivity of foreign direct investments to the level of taxation vary. A number of studies on the evolution foreign direct investments in the European countries (K. Edmiston, S. Mudd and N. Valev, 2003 or K. Carstensen and F. Toubal, 2004) suggest the fact that taxation has a relatively low impact on foreign direct investments, due to the reduced influence of taxes on relocation costs. Other authors (M. Leibrecht and C. Bellak, 2005) argue that a high level of corporate income taxes discourage the inflows of foreign direct investments even if other factors, among which the volume and quality of public goods and

services, would favour the attraction of foreign direct investments. The two authors analyzed the flows of foreign direct investments among 7 countries of origin of multinational companies (Austria, Germany, France, Italy, the Netherlands, Great Britain and the United States) and 8 host countries (Bulgaria, Croatia, Czech Republic, Hungary, Poland, Slovakia, Slovenia and Romania) in the period 1995-2003. The results of the study indicate the fact that the level of corporate income taxes represents a decisive factor for the decisions of localization made by foreign companies, being almost as important as the labour cost factor. A decrease by a certain percentage in the effective corporate income tax rate may lead to a maximum increase in the inflows of foreign direct investments of 4.5%. Following the analysis performed by R. A. DeMooij and S. Ederveen (2003) concerning the impact of taxation on capital movements, an elasticity of -2.4% was assessed. Consequently, the decrease by 1 percentage point of the tax will generate an increase of capital flows by 2.4%.

Agnès Bénassy-Quéré, Lionel Fontagné and Amina Lahrèche-Révil (2003) have studied the sensitivity of foreign direct investments to the differences in the level of taxation among 11 OECD member countries, in the period 1984-2000, reaching the conclusion that the level of corporate income tax rate plays a significant role in the localisation foreign direct investments. Thus, while the low level of the tax rate has a significant contribution in attracting foreign direct investments, a high taxation discourages the inflows of foreign direct investments. On the other hand, the positive impact of the differences in the level of taxation is not the same in all the countries that choose to decrease tax rates with the purpose of attracting foreign capital. The flows of foreign direct investments are directly proportional with the differences among the levels of taxation in various countries.

There are intense debates concerning the importance of corporate income tax effects on the localization of foreign direct investments, given the fact that many of the empirical studies concerning the elasticity of foreign direct investments in relation to the corporate income taxes have been focused exclusively on the issue of taxation, ignoring the possible effect of the business environment of the host countries. These studies have also ignored the possibility that flows of foreign direct investments might also be driven not only by fiscal policies and by the bilateral agreements between the countries of origin and the host countries, but also by the fiscal policies of the countries that may represent alternatives for the localization foreign direct investments (Hajkova, D., Nicoletti G., Vartia L., Kwang-Yeol Yoo, 2006).

2. THE ROLE OF CORPORATE INCOME TAXES ON FOREIGN DIRECT INVESTMENTS IN THE EUROPEAN UNION

Due to the elimination fiscal advantages for foreign investors, many countries in the Central and Eastern Europe, who became member states chose to reduce their level of taxation both for foreign investors as well as for the local ones in the attempt of maintaining the attractiveness of their economies. Consequently, the level of taxation, and especially the level of the corporate income tax rate have been included in the complex formula that describes national competitivenss.

In order to emphasize the role of the corporate income taxes on foreign direct investments we need to present a few implications of taxation on the decision of external implantation made by multinational companies.

In their choice among several countries in which they could establish new affiliates, multinational companies will prefer locations that generate the highest after-tax profit. Consequently, the impact of the corporate income taxes on foreign direct investments may be assessed by comparing the before-tax profit with the after-tax profit. The proportion of the before-tax profit taken over by taxation is measured through the effective level of the tax rate.

This level depends on the manner in which the taxable profit is determined and on the level of the legal profit tax rate. In some cases, the level of the effective tax rate is influenced by the fiscal treatment of the repatriated profit. Multinational companies can "delocalize profits", by financial or commercial transactions within the group with the purpose of decreasing total tax liabilities. A simple way of transferring profit from countries with a high level of taxation to countries with a low level of taxation is represented by inter-affiliate loans granted among the affiliates of a multinational company, given the fact that payments made by a company are usually tax exempt, whilst collections are taxable. Another possibility is represented by the manipulation of the inter-affiliate transfer product prices: if an affiliate in a country with a high level of taxation manufactures intermediary goods used by affiliates located in countries with low levels of taxation, the price used for the inter-affiliate transfer of these goods may be set at a very low level, thus generating the diminution of the profit in the countries with a high level of taxation.

Consequently, from the fiscal point of view, the external implantation decision of multinational companies depends both on the level of the corporate income tax rate, as well as on other provisions of the law that can prevent the transfer of profits among countries.

A simple comparative observation of the evolution of the corporate income tax rate with the inflows of foreign direct investments in the European Union countries (see table 1) allows us to draw the conclusion that the diminution of the corporate income tax rates in the new member states was one of the causes of the migration of investments towards the areas with a low level of taxation. The net taxpayers to the budget of the European Union (Germany, France, Italy) took a stand against this situation, stating that the new member states should increase taxes so that they should not generate unfair competition to countries with high levels of taxation. This proposal was, of course, contested by the states counting on a relaxed fiscal policy in their attempt of attracting investments and, due to the fact that the income tax policy is still an instrument that can be used by the governments of the member states to influence national economies, we can currently witness a real "race for the reduction of business taxation". For example, in 2008 as compared to 2006, in Germany, the corporate income tax rate was decreased by 8.9 percentage points, from 38.7% to 29.8%, in Spain by 5 percentage points, from 35% to 30%, in Italy by 5.9 percentage points, from 37.3% to 31.4%, and there are some other examples that can be mentioned.

Between 1995 and 2008 the average level of the corporate income tax rate recorded in the 27 member states of the European Union decreased from 35.3% to 23.6%, and in the countries of the Euro Area from 37.45 to 26.5%. Due to the fact that this phenomenon has increased with the expansion of the European Union, as can be seen in figure 1, we can argue that the mobility of capital makes governments reduce corporate income taxes in the attempt of attracting foreign capital.

In the analysis of the impact of taxation on foreign direct investments it is useful to underline the role played by corporate income taxes on decisions of placing investments made by multinational companies. The decision of establishing the location for an investment can be influenced by:

- The level of the effective tax rate (for which fiscal advantages such as, for example, the recognition of the depreciation of buildings and amortization of fixed assets are taken into account);
- The net profit distribution and fiscal treatment policy applied by the authorities of the country where the investment is to be localized to the benefits transferred into the country of origin of the company.

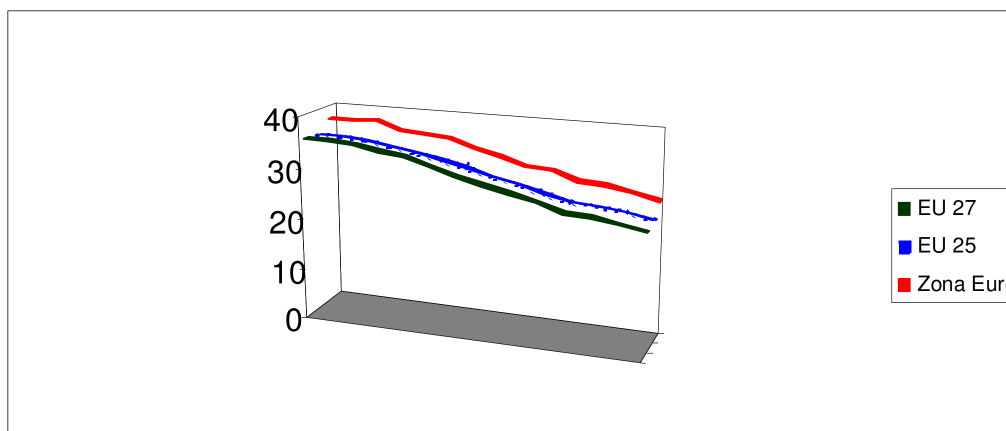


Figure no. 1 Average level of rate of corporate income tax in 1995-2008

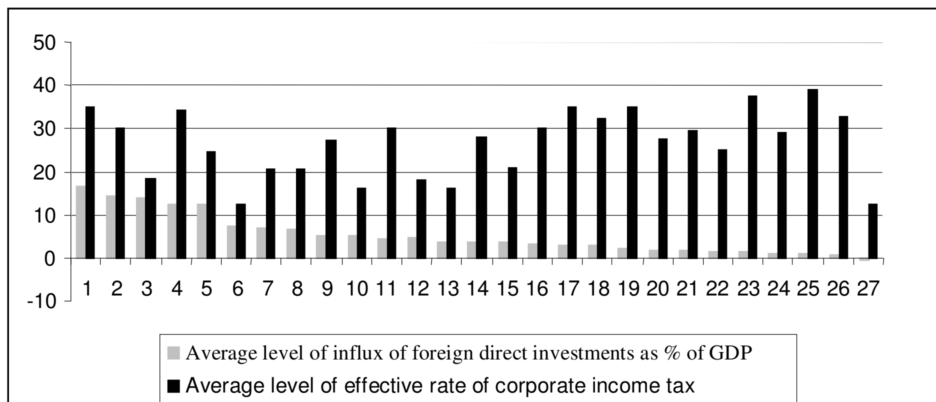
Source: Taxation trends in the European Union, 2008, p. 88

On the background of a low level of the corporate income taxes and benefiting by the advantage of membership of future membership into the European Union, the Central and Eastern European countries became an important target for foreign direct investments in the last few years. With a total population of over 100 million inhabitants, EEC – 10 (Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia) attracted 174.1 billion $ through foreign direct investments between 2001 and 2006. In the same period, Brazil (with a population of 186 inhabitants) received 99.8 billion $ from foreign direct investments, Russia (142 million inhabitants) 65.7 billion $ and India (1.1 billion inhabitants) 37.1 billion $.

Due to the fact that the positive evolutions of foreign direct investments attracted in the emergent countries are influenced by a combination of factors, besides the level of corporate income taxes (the progress made in the integration into the European structures, economic growth, the exchange rate, etc) we have made an analysis of the inflows of foreign investments within certain groups of European Union member states with a similar level of economic development. Based on the average level of the gross domestic product per inhabitant recorded in the period 2003-2006 we have identified 6 sampling intervals of the 27 European Union member states. Romania is part of the group of countries with the least developed economy, together with Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, and Slovakia (between 3337.5-16088.3 U.S. dollars/inhabitant). With an average level of the gross internal product per inhabitant of 16877.25 U.S. dollars in the period 2003-2006, Slovenia is the only country in the former block of socialist states that does not fit the profile of the above-mentioned group of countries.

By comparing the evolution of the corporate income tax rate with the inflows of foreign direct investments as percentage in GDP, we can estimate that there is a connection between fiscal competitiveness and the attraction of foreign direct investments. Whilst the reduced level of tax rates contributes to the attraction of foreign direct investments, high taxes discourage inflows of foreign direct investments (see fig. no. 2).

Figure no 2. Influx of foreign direct investments and effective rate of corporate income tax, among 2003-2006



Legend: 1-Malta, 2-Luxembourg, 3-Bulgaria, 4-Belgium, 5-Estonia, 6-Cyprus, 7-România, 8-Slovakia, 9- Czech Republic, 10-Latvia, 11-United Kingdom, 12-Hungary, 13-Lithuania, 14-Sweden, 15-Poland, 16- Portugal, 17-France, 18-Netherlandns, 19-Spain, 20-Finland, 21-Austria, 22-Slovenia, 23-Italy, 24- Denmark, 25-Germany, 26 - Greece, 27-Ireland

Source: UNCTAD handbook of statistics, 2008, p. 346 şi p. 395 and Eurostat Statistical books, Taxation trends in the European Union, 2008, p. 88

For example, Bulgaria and Romania successfully attracted an average volume of foreign direct investments representing 15%, and respectively 8% of GDP with a corporate income tax rate of 15% and 16%. Hungary and Slovakia managed to attract an average volume of foreign direct investments representing 6% of GDP with a corporate income tax rate of 17.5%, and respectively 19%. On the other hand, in the countries that applied high corporate income tax rates (Spain, Germany, Italy, and France) inflows of foreign direct investments, as percentage in GDP, were modest. A few exceptions from this rule are represented by Cyprus, Luxemburg, Malta and Belgium, countries that currently have characteristics specific to tax heavens and that have managed to attract foreign capitals through other instruments than the low level of the corporate income tax rate (for example, the possibility of establishing "off-shore" companies, income tax exemption for companies that invest in high technology, dividend tax exemptions and others).

On average, the group of countries with the least developed economies, designated A (excluding Malta), managed to attract, in the period 2003-2004, foreign direct investments representing 7% of GDP, by applying an average corporate income tax rate of 20.3%. The other groups of countries, with a higher level of economic development, successfully attracted, in the same period, a much lower volume of foreign direct investments (2% of GDP, and respectively 2.5% of GDP), by applying an average corporate income tax rate higher by approximately 10 percentage points.

Insofar as the reduction of the corporate income tax rate generates very low levels (for example, levels of 15% in Bulgaria, 16% in Romania, 15% in Latvia, applied in the year 2006), the dynamics of the inflows of foreign direct investments will be higher. The low level of the corporate income tax rate in Bulgaria generated the highest increase in the inflows of foreign direct investments as a percentage in GDP in the period 2003-2006, even if the increase in the GDP/inhabitant of 2006 as compared to 2003 (43.48%) was lower than the one recorded in other countries with a similar level of economic development (87.15% in Romania, 65.12% in Latvia, 53.13% in Estonia and 51.85% in Slovakia)[1]. Consequently, the diminution of the corporate

[1] Calculated based on the Yearbook of Statistics of Romania, International Statistics, 2007

income tax rate can be considered an efficient measure within the strategy of attracting foreign direct investments insofar as it succeeds in reaching very low levels of this rate.

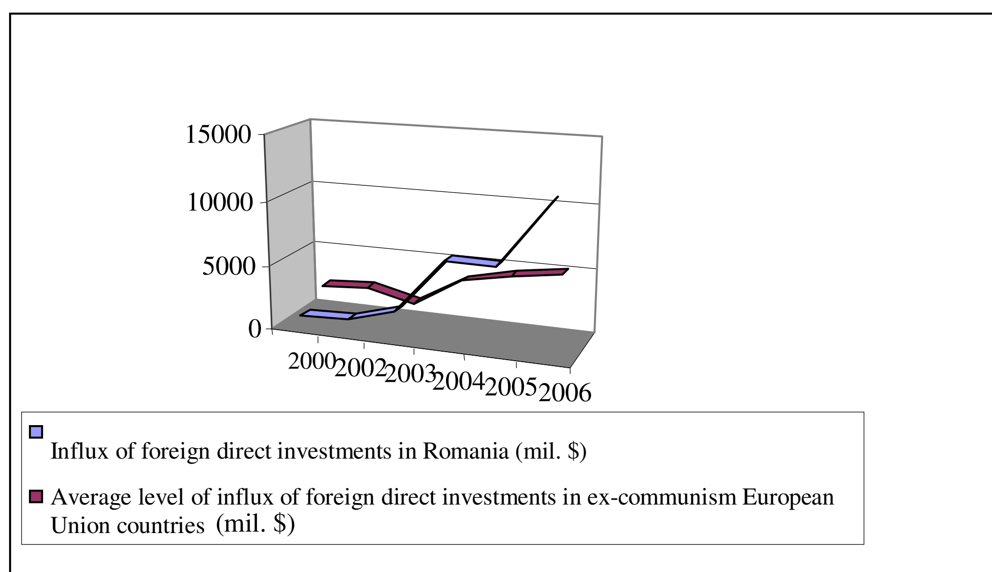
3. THE ROLE OF CORPORATE INCOME TAXES ON ROMANIA'S COMPETITIVENESS

In the current period, the official Romanian government officials' stand towards foreign direct investments may be viewed as a conventional one. For example, an idea is stated according to which the international movement of entrepreneurial capital contributes to the Romanian economy growth, which in its turn, is a source of social progress and of improvement of human condition, if there is a fair distribution of the welfare increase generated through foreign direct investments between investing companies and host countries.

The policy of attracting direct foreign investments represents an important part of the development strategy in Romania. By increasing the degree of attractiveness for foreign investors, conditions are created for the increase in the number of jobs, in the level of incomes, as well as for the intensification of transfers of technologies and knowledge. The attraction of foreign direct investments in Romania was stimulated by tax subsidies granted until the moment of the adhesion of our country to the European Union. The important increase in the GDP after the year 2000, the geographical position of Romania, the foreign companies' possibility to access cheap material and human resources and the transparent and largely stable and predictable operational institutional and legislative framework have been the advantages of the Romanian economy in attracting foreign direct investments.

According to the macroeconomic context that characterized Romania after 1990, the evolution of the foreign direct investments flows has been highly variable up to now. Starting with 2000, we can notice an increase in the inflows of foreign direct investments, the value of which was, however, in the first years, below the average of those recorded in the economies of the European Union countries in the former socialist block, and then higher than this average (see figure no. 3).

Figure no 3 Influx of foreign direct investments in Romania and in ex-communism European Union countries among 2000-2006



Source: UNCTAD handbook of statistics, 2008, p. 346

Foreign direct investments made in Romania were mainly localized in the processing industry, the proportion of which gradually decreased from 2003, when it accounted for 51% of

the total, until 2007 (32.9% of the total) in favour of financial intermediations and insurances that represented 23.3% in 2007. On average, in the period 2003-2007, the appropriation of the net profit gained from the incomes from foreign direct investments was 57% and the distributed dividends were 39%.

The evolution of the distribution of foreign direct investments in Romania on countries of origin, a distribution made function of the country of the immediate holder of at least 10% of the social capital of the resident direct investment companies, is as follows:

Table no 1 The evolution of the distribution of foreign direct investments in Romania on countries of origin in 2003-2007

	2003 as % of FDI	2004 as % of FDI	2006 as % of FDI	2006 as % of FDI	2007 as % of FDI
Netherlandns	18,9	16,3	19,5	17,1	16,3
Greece	11,1	8,2	8,5	7,8	7,5
France	10,3	10,3	8,4	8,0	8,8
Italy	8,3	4,8	6,9	6,7	6,1
Germany	7,3	8,6	10,7	10,1	11,7
Austria	6,4	15,7	15,4	23,0	21,4
Sweden	-	1,8	1,4	1,0	0,9
Belgium	-	1,4	1,3	0,9	1,1
Spain	-	-	0,6	0,8	1,1
Luxembourg	-	-	1,0	1,2	1,5
United Kingdom	-	-	-	1,0	0,9
Cyprus	4,2	4,0	3,7	4,8	4,7
Hungary	-	1,8	1,9	1,9	1,7
Czech Republic	-	-	1,3	0,9	0,8
Switzerland	3,3	3,0	7,1	6,9	5,1
Netherlands Antilles	7,5	8,8			
United States	3,4	4,3	2,6	1,8	1,4
Turkey	-	1,5	1,9	1,3	1,9
Israel	-	-	-	0,6	0,4
Canada	-	-	-	0,3	0,6

Source: Statistical information regarding the foreign direct investments in Romania, Romanian National Bank

During the analysed period, we can notice the increase in the number of countries the investment of which exceeds 100 million Euros in Romania. For example, in 2007 the number of the countries the investments of which exceeds 100 million Euros in Romania increased to 23 as compared to 11 countries recorded in 2003.

We can see that the most important source of foreign direct investments attracted in Romania is represented by the countries with developed economies in the European Union, located at less than 2000 kilometres away from out country (Greece, Austria, Germany, and Italy). The increase in the distance between the country in which the parent company is located and the host country (Romania) is accompanied by the diminution of the percentage of the investment made by the respective company in the total of foreign direct investments.

It is by no mere coincidence that, in the countries that have accounted for most of the investments made in our country, the level of the corporate income tax rate is above the average level recorded in the European Union: 32.5% in the Netherlands, 38.95 in Germany, 29.5% in Austria, 32.75% in Greece, 35% in France.

4. CONCLUSIONS

Multinational companies represent the main vectors of fiscal competition. They can modify the geographic distribution of their profits through two mechanisms that do not exclude each other:

- multinational companies are confronted, on one hand, with the national taxation systems that have different characteristics. The fiscal optimisation strategies allow them to avoid becoming subject to the taxation of the country in which some of their activities are located. In this case, we can talk about the "delocalization of profits", which is made by financial or commercial transactions within the group;
- on the other hand, multinational companies can compare various systems when they decide where to locate production investments. In this case, we can talk about the "delocalization of activities". The criteria involved in this choice can be related to either the fiscal aspect in itself, or to other aspects (the quality of the infrastructure, the education and qualification of labour, etc).

By comparing, in some the European Union countries, the evolution of the corporate income tax rate and the level of taxation with the flows of foreign direct investments, we can argue that there is a direct relation between fiscal competitiveness and the attraction of foreign direct investments. Whilst the low level of tax rates contributes to the attraction of foreign direct investments, high taxes discourage inflows of foreign direct investments. The significant differences between the level of corporate income tax rates applied in various European Union states lead to distortions related to the distribution of investments.

REFERENCES

1. Agnès Bénassy-Quéré, Lionel Fontagné şi Amina Lahrèche-Révil, "Tax Competition and Foreign Direct Investment", *CEEPII,* nr. 17, 2003
2. Carstensen, K. şi Toubal, F., "Foreign direct investment in Central and Eastern European countries: a dynamic panel analysis", *Journal of Comparative Economics,* no. 3, 2004.
3. DeMooij, R. A. şi S. Ederveen, "Taxation and foreign direct investment: a synthesis of empirical research", *International Tax and Public Finance,* no. 10, 2003
4. Devereux, Michael, "Taxes in the EU New Member States and the Location of Capital and Profit", *University of Warwick, IFS and CEPR*, 2006.
5. Edmiston K., Mudd, S. şi Valev, N., " Tax Structure and FDI: The deterrent effects of Complexity and Uncertainty", *Fiscal Studies* , no. 24, 2003
6. Hajkova, D., Nicoletti G., Vartia L., Kwang-Yeol Yoo, "Taxation, business environment and FDI location in OECD countries", *Economics department working papers*, no. 502, OECD, 2006
7. Leibrecht, Markus şi Bellak, Christian, „Foreign Direct Investment in Central - and East European Countries: A Panel Study", *Department of Economics, Vienna University of Economics, Vienna*, 2005.
8. Moffet, A. Stonehill, D. Eiteman – Fundamentals of Multinational Finance, Adison Wesley, 2003
9. UNCTAD handbook of statistics, 2008
10. Eurostat Statistical books, Taxation trends in the European Union, 2008
11. Romanian National Bank, Statistical information regarding the foreign direct investments in Romania