EUROPEAN
ENTERPRISE
INSTITUTE

22, rue de Pascale
B-1040 Brussels
Tel.: (+32) 2 233 3837
Fax: (+32) 2 230 9218
e-mail: info@eei-net.org
www.eei-net.org

E E I Opinion Paper No V
25 October, 2004

Tax Competition: Opportunity or Threat for Common European Market?

* by Valdis Dombrovskis, Member of the European Parliament
The author is Former Minister of Finance of the Republic of Latvia.

"The principle of lower taxation is at the centre of the EPP-ED economic model. Competitiveness is at the heart of economic performance. We want fair and efficient competition of tax systems."

Priorities of the EPP-ED Group for 2004-2009

The enlarged European Union (EU) is on the way to form a framework for European political and economic cooperation. This is done in order to incorporate the dynamic and fast-growing markets of the new Member States into the general EU economic framework, without sacrificing their dynamism and their positive economical contribution to the EU as a whole.

Each of the ten new Member States of the EU has brought with them individual experience from economic reforms and their views about future development. Our achievements should therefore be embraced by the EU as one way forward to overcome our weaknesses.

As the EU expands, an important issue has come to the foreground among policy- makers.

Should the tax systems of the EU Member States to a substantial extent be "harmonised", or should direct tax policy remain within the remit of Member States to allow tax competition between the member states?

I would argue that tax competition is a key policy instruments that can enhance European competitiveness.

I would also remind that new Member States are constrained by economic and political hurdles that prevent them from rapidly reach the development level of the old Members. It is not a question of 5 or 10 years but for some of the countries it is a period of 15-35 years. It is therefore not surprising that, for instance, in Latvia, many people are convinced that the benefits from the Common Market and prosperity what European citizens can enjoy now will come only in lives of our children. The new Member states must achieve higher growth rates to ensure the real convergence with old Member states. It is therefore obvious that lower corporate tax rates in the new Member States are a valid way of achieving higher growth rates, stimulating business and inflow of capital.

In a recent communication, the European Commission has set the contours for a more coordinated tax policy in the EU with a long-term focus on creating a single corporate tax base.

*Questions or comments?
Please contact
EEI Executive Director
Jacob Lund Nielsen
on +32 2 233 38 37
or e-mail to
jnielsen@eei-net.org*

At the same time it is important to remember that each Member State understands its own specific conditions best and, therefore, can implement a country specific economic policy which aims to enhance the level of development and welfare. Tax policy is an essential part of the economic and entrepreneurship policy to achieve above mentioned targets.

In Latvia, for instance, the most extensive tax reduction was carried out in 2003. In particular, the corporate income tax was reduced from 22% to 19% and further to 15 % in 2004. Also in 2003 the mandatory social insurance contributions (social tax) were reduced from 35% to33%. Despite the reduction of tax rates, the tax revenues increased by 12% in comparison with previous year and surpassed nominal GDP growth rate. The aim of the reduction of corporate income tax rate in Latvia has been to foster the creation of new enterprises, to reduce the "grey economy", and to improve tax collection rates.

The practice of Eastern European and other countries demonstrates that the reduction of the tax rate does not automatically create the reduction of the tax revenue, since a lower tax stimulates business development and improves the discipline of tax payment.

Tax Competition as One of Instruments for Reaching Lisbon Goals

The Lisbon strategy launched in 2000 was discussed for the fourth time at this year's Spring European Council. In the context of enlargement, the opportunities should be seized to give a new impetus to economic reforms. There is much work to be done to achieve the aims that the EU has set for 2010. Lisbon challenges appear to be more demanding for the new Member States and this fact has to be adequately reflected in the new financial perspective. It has to be ensured that all Member States benefit from the EU financing targeted at achieving Lisbon goals.

If the EU wants to become the "most competitive economy in the world" by 2010, as stated by EU-leaders in Lisbon in 2000, I would recommend not ignoring growing competitive pressures of the global economy.

It is obvious that investment decisions of the global players are to significant extent dependant on the attractiveness of a tax environment. If the EU is to stay competitive for both domestic and foreign investors, it is essential to meet the reality of global tax competition.

The capital outflow from Europe should be minimized and capital inflow from other parts of the world should be maximized also through the means of taxation policy in order to reach the Lisbon goal to become the most competitive and dynamic knowledge-based global economy.

Competition between countries provides politicians with incentives to improve government efficiency and saves taxpayers money. With growing international labour and capital flows, national governments are becoming competitors for taxpayers across national borders. Tax competition helps to move tax systems in efficient direction, because the substantial economic growth generated by tax rate cuts demonstrates that tax competition can be beneficial for all countries. In those countries that have adopted more efficient taxation systems, economic growth is maximized and the citizens have higher incomes.

Questions or comments?
Please contact
EEI Executive Director
Jacob Lund Nielsen
on +32 2 233 38 37
or e-mail to
jnielsen@eei-net.org

By forcing the new Member States to adopt a policy of higher corporate taxation, thereby trying to pre-empt the possible capital outflow to these countries, the Lisbon goals cannot be reached, but instead it will lead to capital flight outside the EU.

To summarise – the EU must meet the reality of the global tax competition. The competitive tax environments of the new Member states demonstrates the experience the whole EU should apply in order to become the most competitive economy in the world.

This Opinion is a publication of the European Enterprise Institute

The EEI is a Brussels-based think tank aiming to promote entrepreneurship in the EU policy community and to provide a platform for the ideas and philosophy of the entrepreneurship throughout Europe. The EEI seeks to strengthen the network of likeminded think tanks and foster the Euro-Atlantic dialogue.

EEI activities are based in three main pillars: Analysis, Opinion and Network. The EEI publishes policy papers, e-opinions and the twice-yearly European Enterprise Journal. The EEI operates the website www.eei-net.org. EEI events are held on policy topics of current interest in and outside Brussels.

The EEI is not affiliated with any political party. The EEI is a non-profit international organization registered in Belgium and the United States. The EEI welcomes private contributions to its activities. EEI Membership is open to individuals as well as corporations and other legal entities.

Questions or comments?
Please contact
EEI Executive Director
Jacob Lund Nielsen
on +32 2 233 38 37
or e-mail to
jnielsen@eei-net.org