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GUEST EDITORIAL

SLASHING TAXES ON CORPORATE PROFITS. DOES IT HELP ENTREPRENEURSHIP?[1]

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ABSTRACT*. *Government revenues can flourish despite cutting tax rates by expanding the tax base or if a favourable business cycle occurs. This causes a wide debate among economists on the mechanism behind spurring economic growth in the short run. Nevertheless, for the experts who do not view the disseminating tax competition among governments tentatively, the appraisal of current tax changes in Europe distinguishes a trade off. On one side, decision-makers might have no complete information about the long-term optimal taxation policy and they set a government's strategy in a way that national level revenue-neutral reforms rest on either shifting expenditures to local administrations or restructuring public expenditures according to precise underpinnings. Still, rethinking such public expenditures is not straightforward. On the other side, decision-makers overemphasise the all-cure virtues arising from tax reduction. Apart from the sureness that the tax instrument is precious to incentive workers and the business community alike, the recent international tax competition that is approximating an endless tax rivalry makes happen a pursuit to such an height that if statutory and effective tax rate differences among countries compress, tax incentives that have been employing to win international investment flows could fade away before not long. This outcome would rest on the fact that a country's attractiveness would no longer be based upon tax advantages because they would disappear or have a little importance in the overall international investment decision.

KEYWORDS: tax competition, foreign investment, Central and Eastern Europe, transitional economies.

JEL classification: E62, F23, H21, H25.

Introduction

Debates about fiscal policy have regained strong momentum due to rising competition among countries. Although mounting beliefs on the benefit that a country can secure by competing on taxes, we have no definitive answers because policymaking spans two equally important, not complementary purposes. In verity, tax regimes can redistribute income from better off to fewer wealthy classes; friendly tax policies can strengthen economic activities and exalt workers' propensity to work. These two alternate options show up at the expenses of market efficiency when a government gets strongly involved in economic matters or the ability open to a prosperous government to opt for redistributing income. A second deprivation for a government would be that lower taxes could not provide resources to offer adequate economic infrastructures and efficient levels of local services supply reducing country's competitiveness (Oates, 1972). Besides difficulties about how to set an unvarying optimal tax policy in theory, we cannot even rule out the hypothesis that decision-makers cannot observe the optimal trade off because of incomplete information or rather they plan to interpret tax policy demagogically head of a general election.

To put our discussion under a historical perspective, a flat tax type regime that might be a novelty in today's domestic affairs has been applied quite frequently among countries that were industrialising at the time of Karl Marx's *Communist Manifesto* in 1848. Successively, to enable governments to finance growing expenditures on the welfare sector, they have introduced progressive income taxes to provide resources to governments. In addition, Keynesians added to this tendency during the 20th century. Major ruptures with the tendencies that industrial countries have exhibited during the 20th century have been taken in

the US and Europe. The US President Ronald Reagan and the UK Prime Minister Margaret Thatcher become the paladins of tax bands and tax rates smash in the 1980s.[2]

Surely supply-side economists influenced new tax policies then. New economic theories became shaping tax policies on the Arthur Laffer view to incentive private incentives and to pre-empt new inflationary pressures, of the type occurring to a large part of US taxpayers whom high inflation moved into higher marginal tax brackets during the late 1970s.[3] If higher tax rates might amplify revenue though tax rates above certain levels cause revenue to fall, lower taxes would spur production, that in turn reflects in a positive revenue response and report incomes to the taxman. A friendly tax system causes fairness and use resources efficiently, is the other main tenet of the new tax approach.

Nevertheless, opponents who were not few during the "tax debate" of 1975 to 1986, argued that expecting an increase in tax revenues on lower tax rates was unrealistic apart from a large elasticity of labour supply (i.e. an increase in hours worked due to higher after-tax wages). Yet empirically, tax cuts in the US during the 1920s (inspired by the Secretary of the Treasury Andrew Mellon) and 1960s (the Kennedy-Johnson tax cuts) supported the supply-side position: tax revenue collected from low-income taxpayers decreased while revenues collected from high-income taxpayers increased.

These aspects come together in this paper. Why do several decision-makers and experts in Europe are favouring this political lead in line with libertarian/classical liberal thinkers? What does explain this round of innovative tax policies in Europe? In theory, this approach can discourage tax evasion. Second, it can persuade unemployed to find a job or for whom are already at work to work harder. These two principles would promote the marketplace's efficiency and act as a break on corruption. Third, to seize international investment flows. Central and Eastern European countries are sticking to all these rationales though the novelty is to lure international investment. Especially the countries that need reviving their economies are at the forefront of the new fiscal approach. Overall, new tax policies have been meeting with some success although its long-term strategy has to be built with awareness; more advanced economies in Europe are attempting to follow in kind. To investigate tax competition and flat tax at the national level, we reflect about tax rivalry in Europe. Sections 2 and 3 illustrate tax reforms which are transforming Western and East-Central Europe in a tax-competition-experiment. Section 4 provides the challenges that arise for decision-makers and businesspeople. This article calls attention to the importance of overall competitiveness instead of reducing taxes or competing on taxes. Decision-makers overemphasise the all-cure virtues of international tax competition while some factors do exert cumbersome impact on entrepreneurs. Endless tax rivalry brings tax rates to the bottom and drives countries to lose this as a tool for attracting international investment because tax advantages when comparing countries with one another would disappear at some point in time. The paper is concluded with final remarks on tax business practices of European economies in the international context.

[2] President Reagan's Tax Reform Act resulted in two rates of 15% and 28% on individual income (most of the poor were exempted from paying taxes), down from the top rate which was 70% before Reagan took office in 1981. Nevertheless, the top rate in the US has increased to 39.6% since 1991. They indexed the individual tax brackets for inflation. Broader tax base for both individuals and business, and several tax increases offset this tough (e.g. an increase in Social Security tax rates, some excise tax rates and deductions were either reduced or eliminated). On net, the federal revenue share of GDP decreased by one percentage point to 19.2% in 1989 from the level in fiscal 1981. The corporate income tax rate had been reduced from 48% to 34%.

[3] Note that the Keynesian view suggests that tax changes influence output and revenue primarily by changing the demand for goods and services.

1. Major lines of thinking in regard to tax rivalry

There is no doubt that firms establish operation centres abroad and move their investments and profits to low-producing cost countries, low-taxes havens. Largely, firms discriminate against location advantages and disadvantages (Caves, 1996; Dunning, 1993), and resort to a country's tax advantages. This tendency has been reinforcing over time (Kubicova, 2004; see also Zodrow, 2003) to such magnitude that some experts deem intergovernmental tax competition enviable to enhance domestic efficiency (e.g. Blankart, 2002). Some suggest that the European Union (EU) should harmonise corporate income taxes though the claim that tax competition requires corporate tax rate harmonisation is not yet compelling (Zodrow, 2003). When facing the trade offs between tax autonomy and fiscal neutrality in coordinating taxes on consumption, labour and capital, EU member states' tax reforms should precede tax harmonisation because the costs of distortions within member states may be greater than the gains from reducing intergovernmental tax competition, states Cnossen (2003). Egger and Winner (2004) find a link between economic freedom and taxation; a large part of the literature has already suggested with positive arguments that economic freedom fosters growth (e.g. de Haan and Sturm, 2000). Egger and Winner estimated the impact of economic freedom on the national tax policy (corporate tax revenues to GNP) for forty-six developed and less developed countries between 1980 and 1997: firms would be willing to pay more in exchange for economic freedom. Economic freedom would attract investors and this enables governments to levy higher business taxes. Egger and Winner's work reveals that changes in economic freedom have equalised the international distribution of corporate tax revenues to GNP.

Under a different perspective, increasing economic integration among countries could lead to decreasing taxation rates, Devereux *et al.* (2002a) found.[4] Statutory corporate tax rates and effective tax rates fell for the two last decades. Grubert (2001) observed that average effective tax rates shrank by ten percentage points between 1984 and 1992 in a sample of sixty countries. In addition, Devereux *et al.* (2002b) attempt to assess tax competition with each other to attract investment: they calculate a "fiscal reaction function" for twenty-one OECD countries in 1983-1999. They develop two models with firm mobility and capital mobility, by that countries compete only over the statutory tax rate or the effective average tax rate in the first case; with capital mobility, countries compete only over the effective marginal tax rate. Devereux et al. (2002b) estimate the parameters of "fiscal reaction functions" and prove that countries compete over all the three measures, particularly over the statutory tax rate and the effective average tax rate. In contrast to this, Grubert (2001) maintained that tax rates shrank over time but tax rates did not converge and this implies that tax competition has been absent.

Besides international tax rivalry, a national level flat type tax rate is understood to reduce red tape and inequity among tax payers, counterbalance tax dodging and cheating, create more incentives to work, save and invest. The theory supports that too high taxes could not discipline governments, which would instead spend through imposing high taxes by that increasing ineffectiveness and inefficiencies. A conclusion cited by several researchers is that the flat tax type success depends on the actual level of the tax rate: the lower it is, the more efficient become to swell tax revenue and spark off economic growth. Yet, this generates two main issues: how fair is tax competition in European? Did downward pressures on taxes really work as an effective tool for spurring socio-economic growth in new market economies in Europe? A few years before, a campaign against the so-called "harmful" tax practices began in May 1998, when a book by the OECD *Harmful Tax Competition: An Emerging Global*

[4] The paper is about statutory corporate tax rates in sixteen OECD countries in 1982-2001.

Issue argued this. The report also identifies thirty-five jurisdictions as tax havens. These issues deserve a coherent analysis.

2. Recent tax strategies and unveil tax plans in Europe

Does current tax competition in Europe resemble Ireland's strategy? Ireland had adopted a friendly tax regime on income, capital and corporations in the 1980s. This resulted – with other investment incentives to investors – in a foundation stone of an economic success, becoming one of the most wealth countries in the EU. The overall tax burden in Ireland is now one of the lowest in Europe, and the tax on trading income 12.5 per cent, down from 24 per cent in 2000. This rate has been agreeing with the European Commission to replace the 10 per cent tax rate on manufacturing profits in place since 1981. A phasing out regime applies to industrial manufacturing until 2010, licensed Shannon[5] operations approved on or before 31 May 1998 and other services operations.

The debate that followed the Irish experience concerned tax policy and several countries have adopted the idea of competing on taxation. Few figures substantiate occurrences in Western Europe. Austria cut the tax rate on corporation profits from 34 per cent in 2003 to 25 per cent in 2005; Portugal from 33 per cent to 27.5 per cent; Belgium reduced its corporate income tax from 40.2 per cent to 33 per cent in 2003. Denmark agreed upon slashing corporate income taxes from 32 per cent in 2000 to 30 per cent in 2001; Greece to 35 per cent in 2003, from 40 per cent in 2000. Iceland cut corporate tax rates to 18 per cent in 2002 from 33 per cent; Luxembourg to 30.4 per cent from 37.5 per cent.

Recently, the Spanish Prime Minister Zapatero is taking into consideration a flat tax rate on incomes in that following the recommendations of Miguel Sebastian, one of the government's advisors (i.e. 30 per cent instead of the current tax bands, which tops out at 45 per cent; the corporate top rate is 40 per cent). To face unemployment now 6.75 per cent of the workforce, the Dutch government want to offer tax breaks and boost spending for education and the environment. The Prime Minister Jan Peter Balkenende attempt face low approval rating ahead of general elections in 2007 plans to reduce taxes at middle-income families with children and reduce corporate taxes: the budget has been proposed on 20 September and calls for a corporate tax rate to fall to 29.6 per cent from 31.5 in 2005 and 34.5 in 2004. The Dutch government is proposing another tax cut in 2007. Also, the Swedish Social Democratic government is facing unemployment (6.5 per cent in August 2005) and the government wants to reduce taxes on lower- and middle-income workers, lower payroll tax on new hires by small, one-person firms (the Swedish political opposition would like to curb taxes and jobless benefits). Germany is a very enlightening example being the largest European economy suffering from companies that are shifting production to countries in Eastern Europe where corporate taxes and labour costs are comparatively competitive. Germany's unemployment rates hit a post war high in March 2005, with a 12 per cent jobless rate (according to seasonally adjusted figures), compared with about 5 per cent in the UK and the US (the non seasonally adjusted figures are even worse). Schröder announced in March 2005 an extension of the labour market reform known as "Agenda 2010" in such a way that he would push through tax reforms and dropping federal tax on profits from 25 per cent to 19 per cent. Note, however, that this slashes the current 38.3 per cent to roughly 32 per cent when taking into account local business taxes and the solidarity tax; closing tax loopholes and raising taxes on dividends will mostly offset Germany's tax cut rate, and this fact represents a key issue to debate next. At the time of this writing, the former opposition leader Angela

[5] The 1947 established Shannon Free Airport, become an export-processing zone in 1959, benefiting of a special tax status.

Merkel – who has not obtained a solid majority on 18 September general elections – is strongly considering revising the country's tax policy and her main advisor Paul Kirchhof who could become the country's finance minister is a supporter of a 25 per cent flat tax for individuals and corporations.

To sum up, the non-weighted average for corporate income taxes decreased from 33.6 per cent in 2000 to 30.8 per cent in 2003 in OECD countries, from 35.1 per cent to 31.7 per cent in the EU-15.[6] Whatever slashing corporate taxes in Europe, the US corporate tax rate is at 39.4 per cent, after major corporate tax reductions in the 1980s. To clarify the gap between Europe and the US, the effective tax rate for US companies operating in Europe in 2002 would have been 9 per cent in Portugal and in the Netherlands, 12 per cent in Belgium and 13 per cent in Spain, according to Martin A. Sullivan.[7] By way of comparison, the effective tax rate in the US has been calculated at some 32 per cent in 2001 by Jane Gravelle of the US Congressional Research Service, or approximately 10 percentage points higher in the US than the European average as calculated by Margie Rollinson at Ernst & Young.[8]

Nevertheless, a comparison between statutory corporate tax and the average effective tax rate across the Atlantic is not straightforward. This is a result of the American system that taxes less labour and consumption than the practice in vogue in Europe. Second, the distribution of tax revenue among major taxes explains differences between the two sides of the Atlantic. While Europe relies more on social security contribution, the States collect more money from personal income and property taxes. Third, the tax-to GDP ratio was 25.4 per cent in the US while 40.6 per cent in the EU-15 in 2003.[9] In fact, the US tax base is narrowly defined and our reported figures and tax policies should be judged with more carefulness when making comparison.

Saudi Arabia and few more enlightening cases

In a larger international context – though geographically far from Europe and the US – few more cases are informative. For instance, Saudi Arabia has cut the corporate tax rate on 15 August 2004. The country's tax system had remained unchanged since 1948 and new flat tax rate of 20 per cent applies to all industries, except gas projects that remain at 30 per cent, and oil and hydrocarbons at 80 per cent. Perhaps this also eased the country's entry into the WTO as well, surely main purpose of slashing corporate tax burdens was to trigger foreign investment, though taxpayers should also benefit from a new defined set of tax rules. Singapore has embarked on a policy of tax reduction since the 1960s, when the top personal rate was 55 per cent in 1961. The Singapore government's Economic Review Committee recommended in 2002 a further step: a 20 per cent for both corporate and personal income tax within three years. The top personal and corporate tax rates now stand at 22 per cent. Hong Kong has a dual income tax system under which individuals are taxed between 2 per cent and 20 per cent or at a flat rate of 16 per cent on their gross income, depending on which liability is lower. The top corporate tax rate is 17.5 per cent.

The lessons we can draw from this section are that Singapore and Hong Kong have grown impressively. Ireland is one of the richest countries in Europe nowadays. Finally, if Western Europe in being enjoying lower effective tax rates on corporations' profits than the US, Central and Eastern European countries are accelerating on having an even more friendly tax system than Western counterparts.

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[6] These figures are from national sources and Owens (2005), Fig. 3, p. 27.
[7] As quoted in *The Wall Street Journal Europe*, 28-30 January 2005, p. A9.
[8] Both Gravelle's and Rollinson's studies are quoted in *The Wall Street Journal Europe*, 28-30 January 2005, p. A9.
[9] These figures are from national sources and Owens (2005), Fig. 1, p. 26.

3. Dynamic tax policies in East-Central Europe

The Irish experience and decisive steps in rearranging tax systems throughout Europe have received large attention. Eastern European countries have campaigned for lashing taxes since the mid-1990s (*Table 1*). The first country to implement an uniform flat tax for all incomes (26 per cent) has been Estonia in 1994 and this country is setting further to reduce the rate down in stages: to 24 per cent in 2005 and down to 20 per cent by 2007. Latvia followed in 1995, and together with Lithuania have a corporate tax of 15 per cent. Surprisingly, Russia moved towards a new tax model effective 1 January 2001. President Putin's first step has been to introduce a 13 per cent personal income flat tax rate, which replaced three-bracket tax with a top rate of 30 per cent. Effective 1 January 2002, it was also introduced a 24 per cent corporate flat rate down from 35 per cent. Since 1 January 2003, small business enterprises have been granted either a 20 per cent flat tax on profits or an 8 per cent flat tax on revenues. Small business enterprises have also been exempted from value-added-tax, sales tax, property tax and social insurance tax (Ivanova, Keen and Klemm, 2005). Recently in September 2005, both Vladimir Putin and the Prime Minister Viktor Khristenko are seriously considering introducing tax breaks for oil companies to encourage exploring new fields.

Other countries took up this new trend recently. Serbia and Ukraine adopted new tax codes in 2003. Serbia introduced a comprehensive 14 per cent flat tax on personal income and corporate profits, though the country is being setting up a 10 per cent flat tax for most forms of personal income. Ukraine implemented a 13 per cent tax on personal income (replacing five brackets 10-40 per cent) and a 25 per cent tax on profits (down from 30 per cent). Moldova is bringing its corporate tax rate down to 20 per cent from 25 per cent and lowering top tax rate on personal income to 22 per cent from 32 per cent. Hungary lowered corporate taxes to 16 per cent; Poland cut the rate by 8 percentage points to 19 per cent, Slovakia from 29 per cent in 2000 to 25 per cent in 2002 and 19 per cent effective 1 January 2005.

Table 1. Personal Income Tax and Corporate Tax Rates (Flat or Top) in Central and Eastern Europe, 2005

Country	Income tax	Corporate tax
Albania	25	25
Bosnia-Herzegovina	5	30
Bulgaria	29	19.5
Croatia	15 – 45	20
Czech Republic	15 – 32	28
Estonia	24	24, 0 in case of reinvested profits
Georgia	12	20
Hungary	18 – 38	16
Latvia	25	15
Lithuania	33 *	15
Macedonia	15 – 18	15
Moldova	22	20
Poland	19 – 30 – 40	19
Romania	16	16
Russia	13	24
Serbia-Montenegro	14 (10, for most of personal income)	14
Slovakia	19	19
Slovenia	17 – 50	25
Ukraine	13	25

Notes: *) Income earned from a second job is taxed in the range 10-35%.
Sources: 2005 Index of Economic Freedom and various governments' statistics.

Table 2. The Index of Fiscal Burden, Europe and North America, 2004

Rank	Country	Fiscal Burden
1	Cyprus	1.8
1	Slovak Republic	1.8
3	Estonia	2.0
3	Hungary	2.0
3	Macedonia	2.0
6	Latvia	2.1
7	Armenia	2.3
8	Bulgaria	2.4
8	Georgia	2.4
10	Ireland	2.5
11	Iceland	2.6
11	Canada	2.6
11	Moldova	2.6
11	Bosnia and Herzegovina	2.6
11	Ukraine	2.6
16	Lithuania	2.8
16	Albania	2.8
18	Poland	2.9
19	Switzerland	3.0
19	Croatia	3.0
21	Russia	3.1
22	Luxembourg	3.3
22	Romania *	3.3
24	Slovenia	3.4
24	Belarus	3.4
26	Finland	3.5
26	Germany	3.5
28	Denmark	3.6
28	Czech Republic	3.6
28	Turkey	3.6
31	Norway	3.8
32	Sweden	3.9
32	Portugal	3.9
32	Mexico	3.9
35	United Kingdom	4.0
35	United States	4.0
35	Greece	4.0
38	Belgium	4.3
38	Italy	4.3
38	Malta	4.3
38	France	4.3
42	Austria	4.4
42	Spain	4.4
44	The Netherlands	4.5
45	Serbia and Montenegro	-

Note: *) The index does not take into account tax changes adopted by the government in late 2004.
Source: 2005 Index of Economic Freedom.

In 2005, comprehensive tax reforms took effect in Georgia and Romania. In Georgia, a 12 per cent flat tax on personal income has been inaugurated by parliament. In Romania, the new government of Prime Minister Calin Popescu Tariceanu has introduced a flat corporate and personal income tax of 16 per cent to be enforced starting 1 January 2005, which aims at

preventing tax evasion, time corruption and attract foreign investment. The new system enforced with a special ordinance on 29 December 2004, replaced the previous personal income tax, which consisted of five brackets (top of 40 per cent), and top business profits rate of 25 per cent.

In other countries, tax burdens are already low though it is advocated a definitive move towards a flat tax. Poland's Finance Minister, Mirosaw Gronicki, is proposing a flat tax rate of 18 per cent on personal income, business profits and value-added-tax attempting to win back voters in September 2005 and overcome the proposal made by the opposition Civic Platform party to introduce a 15 per cent flat tax on personal income and profits. Since the general elections took place and two major right-wing coalition parties won the majority, we should expect a major change in Poland's tax policy. The Czech opposition Civic Democratic Party is suggesting a 15 per cent flat tax on individuals and corporations.

Fiscal burdens in Europe and North America

Table 2 gives a broad picture of fiscal burdens in Europe, reporting the index of fiscal burden for forty-four European and North American states (unfortunately, the score for Serbia and Montenegro is not available).This index is part of that calculated by Miles, Feulner and O'Grady (2005) on behalf of the Heritage Foundation and the *Wall Street Journal* 2005, to form the overall Index of Economic Freedom. The fiscal burden of government is made up of three components: the top marginal income tax rate, the top marginal corporate tax rate, and the year-to-year change in government expenditures as a share of GDP. The lower is the calculated score the lower is the involvement of the government in the economic sphere. It is unambiguous that apart from notable exceptions of Cyprus, Ireland and Iceland, all Eastern and Central European economies are in the highest position in the index while all remaining rich Western European economies follow. Belarus and the Czech Republic are in the middle-rank.

4. Tax dumping and the so-called unfair tax competition

If Central and Eastern European countries jump on the flat tax bandwagon could be a magnet for investment and economic growth, this has lead to the accusation of unfair "tax competition" and "tax dumping", simply that some governments are strategically their tax rates at the expenses of other countries attractiveness. To sum up, statutory corporate income tax rates in the EU-15 declined from 35.1 per cent in 2000 to 31.7 per cent in 2003, partially to face tax rate competition and avoid losing business activities because of "an unequal corporate-tax burden in Europe", stated the German Chancellor Schröder. Germany is the largest European economy that is suffering from many companies that are shifting production to countries in Eastern Europe where corporate taxes and labour costs are comparatively lower. Fears of negative effects on labour markets are scattering in Europe as new EU-member states could lure companies, jobs and investment flows. To thwart risky tax competition, a tax corridor has been proposed through which minimum and maximum corporate tax rates would be in place.

In addition, European Commissioner for Taxation, Laszlo Kovacs, recommended harmonising corporate tax base (in line with the recommendation made by the European Commission in 2001) aimed to skip unfair competition for foreign investment and prevent uneven foreign investment distribution. In fact, some complain that their contributions to the EU budget to support structural and cohesion funds towards new members could end up paying for tax cuts. Some leaders of Europe's strongest economies (e.g. Gerhard Schröder and Sweden's Prime Minister Goran Persson) are afraid that transition economies can cut taxes

not least because any lost revenue is more than compensated by subsidies from Brussels. According to Schröder, it is unacceptable that his country being EU biggest net payer finances "unfair tax competition". If the German chancellor dubbed this practice a dangerous "tax-dumping", the French Finance Minister Nicolas Sarkozy expressed in the same kind as Schröder and indeed suggested cutting European transfers to states practicing it. In addition, new EU members with below-average tax regimes should not receive aid funds from Europe, stated Sarkozy. The transition states that could undergo negative effects have repeatedly refuted this argument.

Yet, whether national decision-makers are willing to give up tax autonomy is questionable. Nevertheless, key issues are in regard to "tax dumping" and if the EU is financing Eastern European tax cuts. Undeniably, Central Europe has lower corporate tax rates and tax burdens on corporate profits are approximately 15-20 per cent in the East, compared to tax rates in western Europe states that can be twice as high, and the East proffers several investment incentives too. All the same, this reveals nothing about the effective tax burden and how the tax base is formed (i.e. a company's debt, machinery depreciation, etc.). This approach can be deceiving when comparing countries. First, the statutory corporate income tax rates have fallen in the EU countries during the 1990s but this has been accompanied by a broadening of the base rate. Second, several European governments grant deductions, exceptions and kinds of tax relief (e.g. R&D, investment in poor areas). As a result, effective tax rates vary from statutory tax rates. For instance, Germany's tax system is so thorny that Barysch estimates that the effective corporate tax rate is only half of the statutory rate, and some largest companies enjoy so many tax breaks that their effective tax rate is zero (Barysch, 2004).

Under a different angle, it results only partially-true that Europe is financing Eastern European tax cuts through its common budget. The EU has put aside approximately €40 billion for enlargement in 2004-06, while the newcomers also have to pay their dues into the EU budget, leaving them notionally with a net balance closer to €25 billion. The EU financial support is earmarked for regional development and farmers, which means that it will only help to keep Eastern European taxes low as far as it replaces national budget spending.

Tax base competition opposed to harmonisation

Nevertheless, there has been a tendency to harmonize tax base in Europe. The European Commission just adopted several common rules about tax base, and this policy aimed to adopt partial common rules is expected to continue. The **Commission** suggests that there is no need for an across-the-board harmonisation of the member states' tax systems. One study that simulates the effects of tax coordination Sorensen (2001) concludes that the welfare gains from such coordination would be modest in the EU, between 0.16 per cent and 0.35 per cent of GDP. This is true particularly in the case this sort of coordination should remain within the EU. In contrary, only regional tax coordination can end with advantages for non-participant countries, as they may become even more attractive for investors. Nevertheless, the EU cannot oblige member states to design a specific tax system (apart from common rules for those taxes that shape the functioning of the single market, such as value-added tax, excise duties and some aspects of direct taxes), except fighting against what it is perceived a harmful tax competition. In doing so, the EU has asked the newcomers from Central and Eastern Europe to phase out all discriminatory tax incentives,[10] and they have cut overall statutory tax rates for both domestic and foreign investors in the run-up to membership.

[10] Especially the incentives that were available to certain sectors or companies. Note that in 1999 an expert group listed more than sixty such harmful tax measures in the EU-15.

In spite of effective corporate tax rates being conducive to attracting foreign investors, observers should focus more on the importance of the overall investment climate. Several other factors besides taxes determine a country's competitiveness is possible. Competitiveness in an interacting and multifaceted international business environment ask for continuous efforts to keep labour costs under control, to eliminate regulatory restrictions whenever possible, to reduce the high tax wedge and payroll taxes to cut the cost of hiring, and further overhauls. By way of example, Hungary's experience is very revealing: the country has witnessed close to ten foreign investors, such as IBM and Philips, move some or all of their Hungarian operations to cheaper place further East and South. In an attempt to lure resources and compete more strongly with other neighbouring markets, Hungary cut corporate tax rates to 16 per cent from 18 per cent and dropped the top tax rate on personal income to 38 per cent from 41.5 per cent.

Turning now to a country's competitiveness, it is worth resorting to the recent "FDI Confidence Index" for 2004 published by A.T. Kearny (2004). This is a survey concerning CEOs and other top managers of world's largest 1,000 firms and this should typify their perception concerning best FDI destinations. The most competitive European countries are Russia and Poland, which however lost grounds as Russia ranks 11th attractive market globally but moving down from the 8th place in 2003; Poland 12th from the 4th place. (Note that most Asian economies jumped in the highest position in the index: China maintained its position as the best and most attractive FDI location and India jumped from sixth to third most convenient place). The survey shows some fading confidence about investors' attractiveness and expected profitability. While the Czech economy ranks 14th from the 13th, the first Balkan country is Hungary ranking 19th down from the 17th post. And "With the novelty of EU membership fading, corporate investors are anxious to see how these markets perform given the challenges that the EU accession poses" (Kearney, 2004, p. 21).

A recent survey pinpoints the most important risks to the competitiveness of the new ten new EU member states (*Table 3).*

Table 3. Most Serious Risks to Competitiveness in the New EU Member States, 2004

	Percentage of total respondents
Poor infrastructures	67
Corruption/lack of transparency	60
Erosion of low cost advantage	53
Macroeconomic instability	41
Inefficient supply chain	35
Poor labour skills/education	28
Managing market reform	28
Labour market rigidity	27
Political instability	27
Low purchasing power	20
Phasing out special investment zones	13
Limited offshore/outsourcing opportunities	13
Completion of privatisation Programmes	11

Source: A.T. Kearney (2004), Fig. 9, p. 21.

How can this table be read? Analysts vary in scoring these risks and perhaps a blend of factors would affect competitiveness but to back up fast growth rates and improve business the whole business environment is at least as important as low-wage, high-skilled workers and

business oriented tax system. The two most important risks are poor infrastructures and corruption. We could see a partial role for a broad tax policy in a few cases (e.g. "erosion of low-cost advantage", "labour market rigidities", "low purchasing power", phasing out special investment zones), but they have not directly reported tax competition in the survey and it seems not to be crucial to investors.

Towards a "neutral" tax policy setting

Fierce competition from Asia is growing increasingly important. To keep attracting investors in merging markets, decision-makers respond by cutting tax rates and underscore the importance of additional incentives (e.g. cash grants, fixed-term tax relief, labour subsidies). Yet, how much of a country's competitiveness and investment decision is tax-driven? How much of the economic growth achieved in Central and Eastern Europe was realised through tax slashes? The two questions continue to be controversial issues and perhaps the tax competition argument has been emphasised especially if one regard it as leading to a convergence in tax burdens across countries in the end, leaving this fiscal tool with no impact or a "neutral" one on investors' international strategic decisions. I do not want to deny that the importance of tax incentives on economic growth, yet the economic growth in Central Europe has been rooted in the economic reforms. Foreign capitals have helped to carry out privatisation largely but no one can deny that the current tax competition was not yet in place during the 1990s. Granted a new tax system with precedent economic growth in Central and Eastern Europe is not entirely truthful: the economic growth could happen in the 1990s on positive expectations on economic expansion.

Current buoyant economic growth helps maintain adequate state revenues and that tax collection is increasingly more effective (e.g. Russia) are additional pieces of information to summon up. Nevertheless, what happens to public finance should the economic growth slowdown sometimes in the future without a serious restructuring of policy priorities and public revenues? If the set of information is incomplete and decision-makers keep competing against each other (in the simplest hypothesis, the East against the West) while missing knowledge of the optimal tax rate, they could catching-up endless games.

Therefore, the debate has to be firmly based on the long-term cleverness of this strategy but we cannot overlook competitiveness taken as a whole. If competition in Europe calls for innovative policies, rejuvenating Europe rests on technological innovation, less rigid labour regulations, less tax wedge and the like. Hence, if the European Commission does not introduce rules of the same kind, a further tax competition race could hit a new level soon. This tax rivalry could equalise effective tax burdens or very close to a nominal balance, and this outcome in terms of fiscal policy advantages would become "neutral" in the end. Second, aside from a narrow tax-on-corporate-profits approach, labour costs are equally important towards investment decisions, such as wages, payroll taxes, and so forth (World Bank, 2005). Laying emphasis on tax advantages - especially in case of a big investor who wants a long-term commitment in a given country - is an oversight. Third, shifting profits to tax havens is another way to skip national tax disadvantages and this could induce big corporations to have plants in one country and exploit another country's tax advantage on profits the same time.

Simply, the phenomenon of FDI, outsourcing and international business whether conduct in Europe or globally requires a comprehensive rather than narrow tax-policy scrutiny.

Final Remarks

Governments in East-Central Europe started introducing and developing one-size-fits-all tax regimes and friendlier labour market regulations with the endeavour of boosting paternalistic economic structures to market efficiency along with domestic and international business competitiveness. This unprecedented tax policy should encourage better public policies, leave more money to invest in the economy and increase the citizens' willingness to work harder and pay their taxes. Likewise, low taxes on corporate profits augment chances for a country to receive international businessmen's awareness and likely larger flows of investment both in the short- and long-run.

However, ameliorating domestic economies has been done trough carrying out tax reforms at the risk of triggering international tax competition, which took indeed place. Besides tax competition, perhaps more interesting is to consider the puzzle of balancing short- and long-term strategy under a unique policy strategy. For now, we need to acknowledge a basic dilemma as we have enlightened it in the previous sections. Any government has to carry out short-term economic policies to deal with contingent domestic state of affairs but also to conceive long-term policies. For governments who subscribe to tax reduction, a government's revenues might augment in the short-run while tax rates plummet on condition that either tax base stretches or a robust economic growth occurs. European governments have been trying to undergo tax rebates thanks to escalating growth rates. On the contrary, a long-term government strategy meant to reduce tax rates enduringly while securing balanced government budgets entails either shifting public expenditures to regional and local administrations or restructuring public expenditures. Following tax experimental policies in East-Central Europe intended to energize growth, the antagonists here are those Western European economies believed to lose investment and jobs. Most Western European countries are seriously thinking or already embarking on comparable tax strategies. Also in Western Europe, a buoyant economic growth can proxy a neglected restructuring on the side of expenditure policies over a short horizon, but comprehensive expenditure rethinking will become unavoidable in the long-term.

In the light of decision-makers who might not have a complete set of information about the long-term optimal taxation policy but still seek to implement revenue-neutral reforms while reducing tax rates, shifting expenditures to local administrations or restructuring public expenditures became an important argument. Notwithstanding, decision-makers overemphasise the all-cure virtues arising from tax reduction and there are no doubts about the effectiveness of the tax instrument in shaping investment decisions. Conversely, an endless tax rivalry causes statutory and effective tax rate differences among countries trim down, then winning international investment flows would shift from mere national tax advantages to the country's overall business competitiveness.

Aside, let us not forget the long-term focus of this paper's quest to evaluate the tax business practices of European economies. We must interpret the business community's view with reference to whether it is right whether some tax advantages might shape regional investment decisions disregarding other important variables. Surely, the main message of this article is that a country's competitiveness engineered in a way that captivates international investors through tax slashes could disappear over time as long as a country's tax advantage is systematically neutralized by the others.

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KORPORACINIO PELNO MOKESČIO MAŽINIMAS. AR TAI PADĖS ANTREPRENERYSTEI?

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SANTRAUKA

Valstybės biudžeto pajamos gali ir toliau nesekti dviem atvejais: 1) mažinant mokesčių normą ir praplečiant mokesčių bazę; 2) bendram verslo gyvavimo ciklui esant palankioje stadijoje. Pasaulio ekonomistai nesutaria dėl vieningos mechanizmo idėjos, kuris pagyvintų ekonomikos augimą per trumpą laiką. Todėl tiems ekspertams, kurie nepalaiko preliminariai paskirstomos mokesčių konkurencijos tarp vyriausybių, nūdienos mokesčių pokyčių vertinimas Europoje gali būti tam tikras kompromisas.

Iš vienos pusės, sprendimų priėmėjai gali neturėti pakankamos informacijos apie ilgalaikę optimalią mokesčių sistemos politiką, o jie gali formuoti Vyriausybės strategiją pagal nacionalinį lygmenį, kur biudžeto pajamoms neutralios reformos grindžiamos tuo, kad valstybės biudžeto išlaidos perskirstomos ant vietinių administratorių pečių arba restrukūrizuojant viešąsias išlaidas pagal konkrečias paskirtis.

Iš kitos pusės, sprendimų priėmėjai perdėtai pabrėžia mokesčių mažinimą kaip panacėją nuo visų ligų. Apžvelgiant esamą padėtį tarptautinėje mokesčių konkurencijoje, galima teigti, jog mokesčių paskatos, kurios buvo propaguojamos tarptautinių investicijų srautams pritraukti, gali nebeegzistuoti netolimoje ateityje.

REIKŠMINIAI ŽODŽIAI: mokesčių konkurencingumas, užsienio investicijos, Centrinė ir Rytų Europa, pereinamosios ekonomikos.