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# Tax competition among Eastern and Western European countries: With whom do countries compete?

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### ARTICLE INFO

#### Article history:

Received 1 August 2007

Received in revised form 12 March 2008

Accepted 23 June 2008

#### JEL classification:

H2

H3

C3

#### Keywords:

Tax competition

Strategic interactions

Corporate tax

Panel data

EU27

### ABSTRACT

In this paper, we investigate the existence of strategic interactions between the former EU15 countries and the countries of Central and Eastern Europe regarding corporate taxes. We estimate an empirical model of strategic interactions among 27 European countries for the period 1995–2005, using GMM. Our results confirm the existence of tax interdependence within Western Europe but show that strategic interactions among Eastern European countries are less common. Finally, we show that there are some interactions related to taxes between these two regions of Europe.

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## 1. Introduction

It is commonly believed that the reason for the decline in corporate tax rates in European countries is tax competition. It is argued that countries compete with each other's over flows of capital, by reducing the tax rates on corporate income. While average corporate tax rates in the former EU15 were reduced from 38% in 1995 to 30% in 2005, in the Central and Eastern European countries (CEEC), which underwent two processes of enlargement in 2004 and 2007, tax rates fell from 32% to 20% in the same period. Bellak and Leibrecht (2005) show that these countries' tax-lowering strategies have been successful for inducing shifts of production capacity since the mid-1990s. However, the literature on

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Foreign Direct investment (FDI) location decisions in CEECs is rather small. During the first part of the 1990s, a study by Meyer (1995) considered that the main factor attracting FDI to the CEECs was the local market. Disdier and Mayer (2004) show that the location decisions of French multinational firms in CEECs were positively influenced by the institutional quality of the host countries. However, when the institutional aspects of host countries are controlled for, the determinant of a location choice in Eastern Europe does not seem to differ significantly from the choice to locate to another EU member country.

Since the mid 1980s, a large theoretical literature on tax competition has developed following the seminal papers of Zodrow and Mieszkowski (1986), Wilson (1986) and Wildasin (1988) and Wilson's (1999) survey. While strategic interactions among governments have, for decades, been a central issue in the theoretical literature on public finance, empirical studies are more recent. Most papers concentrate on tax interactions among local jurisdictions using spatial econometric techniques (Brueckner, 2003). These models are usually implemented empirically through estimation of a fiscal reaction function, where the optimal tax rate in a jurisdiction depends on the tax rates in nearby jurisdictions (Revelli, 2005). Only a few papers consider international interactions (Goodspeed, 2000, 2002; Besley et al., 2001; Altshuler and Goodspeed, 2002; Devereux et al., 2008; Devereux et al., 2002; Redoano, 2007). All these authors find evidence of the existence of strategic interactions among countries. However, none of them study potential strategic interactions between Western European countries' fiscal decisions and Eastern European countries' corporate tax rates.

In this paper, we investigate the existence of strategic interactions between the former EU15 countries and the CEECs regarding corporate taxes. We estimate an empirical GMM (General Method of Moment) model of strategic interactions in corporate tax rates among 27 European countries in the period of 1995–2005. Since there is no reason to assume that patterns of tax interdependence are identical for Western and Eastern European countries, we also test for the existence of tax interactions among CEECs, and among the former EU15 member countries, by including different coefficients of tax interactions for each European region. First, we want to confirm the existence of tax interdependence within Western Europe and within CEEC. We also want to find evidence of tax interactions between these two regions.

The degree of tax competition between two countries does not depend on the same characteristics in every case. While the presence of strategic interactions between two countries in Western Europe clearly depends on leadership (demographic, economic characteristics, success in attracting FDI), tax competition between Western and Eastern European countries is strongly related to their relative economic characteristics (such as GDP and FDI). We find that the intensity of strategic interactions is weakly related to geographic proximity.

The paper is structured as follows. Section 2 presents some stylised facts about corporate tax rates in Western and Eastern Europe. Section 3 reviews the empirical literature in this area. Sections 4 and 5 present the empirical specification and the data set, and Sections 6 and 7 present the results. Section 8 concludes.

## 2. Stylised facts on tax rates within EU27

Corporate income tax rates are decreasing in Europe. The average corporate tax rate in the EU27 dropped from 35.3% in 1995 to 25.5% in 2005 (Graph 1). But this tendency towards lower tax rates began in the era of the EU15: countries such as Austria, Finland, Sweden and France have decreased their corporate tax rates quite markedly since the beginning of the 1980s. From the early 1990s, this downward trend has been fairly general in all the EU15 member states. In Austria and the Netherlands, in particular, the decrease in corporate tax rates has been very rapid and sharp while in France, Belgium, Denmark and Luxembourg, it has been more gradual.

Since the second half of the 1990s, corporate income tax rates across the whole of the EU have reduced dramatically. On the eve of the Eastern enlargement of the EU in May 2004, the majority of the accession countries lowered what were already low corporate tax rates. Slovakia embarked on reductions in 2000; in Poland reductions were quite gradual. The slight increase in Hungary between 1998 and 2000 was due to an increase in the local business tax. The biggest reductions occurred in Germany and Italy, countries with the highest rates in 1996. We can see that these two countries are

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