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## Is It any EU Corporate Income Tax Rate-Revenue Paradox?

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### Abstract

As a consequence of globalization, countries competitively undercut their corporate tax rates in order to lure and boost foreign capital investments. This context induces a race to the bottom in corporate income taxes and threatens the corporate tax revenues collection. This paper aims to establish if there is a paradox in relation to the corporate tax rate and corporate-tax-to-GDP-ratio in the European Union (the corporate tax rates reduction did not cause a corporate-tax-to-GDP-ratio drop), as this trend was observed by researchers. In order to assess the outcome of corporate tax competition as it is reflected by the firms' behavioural responses, a panel data for EU countries was used. The findings do not confirm that the downward pressures on corporate tax rates are not translated in a fall in corporate revenues over the time.

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### 1. Introduction

In the context of a high mobility of capital and/or labour, countries compete for business, tax receipts, and jobs. Tax competition, the process of uncooperative setting of tax rates (especially by undercutting them) in order to attract mobile tax bases and boost investment and the yardstick competition, a government tax mimicking behaviour, have fuelled fears of a race-to-the-bottom. The corporate income tax is the subject of competition for mobile bases because corporations represent a valuable tax base for every economy.

Tax competition has as the main consequences the inefficiency in the international capital allocation and tax base erosion which causes underprovision of public goods and jeopardizes the welfare states.

But reality appears to contradict the theory, mirroring a rate-revenue paradox. Thus, in Europe, the decline in the

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corporate tax rates has not been reflected in the tax-to-GDP ratios.

The motivation for corporate tax rate reductions was associated to a positive economic development even if this fact was not clearly proved empirically. Furthermore, empirical studies provide evidence on the fact that corporate tax rate decreases were compensated by a broadening of the corporate tax base in the form of reduced investment tax credits, less generous loss offset rules, and limitations on interest deductibility and depreciation. Recent research also suggests that there has been a shift from the non-corporate to corporate business-forms, the latter being more attractive in terms of limited liability.

The main aim of this article is to disclose the trends in the corporate tax rates (legal tax rates - statutory corporate tax rate and forward-looking measures of effective corporate tax rates), corporate tax revenues (the results of the tax competition) and in other measures of taxation (implicit tax rates), for EU countries, and to interpret these fluctuations in the light of tax competition.

Further, in the present study the size of corporate tax revenues will be explained by changes in corporate income tax rates and other variables. All 28 European Union member countries were chosen as testing ground, over 10 years, between 2002 and 2012.

This paper is organized as follows. The first section creates the framework for the analysis. The second section surveys empirical studies of corporate tax competition. The third section presents an overview of the corporate tax rates in the European Union accompanied by few charts in order to depict the developments in corporate taxation. The fourth section explains the data and methodology adopted, the fifth section presents the empirical analysis and results; and the last section outlines the main conclusions and the policy implications that arise due to the findings in this study.

## 2. Literature review

Empirical studies provide evidence on the tax competition subject, basically concluded that the evolution of the statutory corporate tax rates and effective corporate tax rates seems to be driven by tax competition.

The Ruding Committee (1992) explored the trends in the statutory corporate tax rates and tax revenues and asserted that tax competition leads to lower tax rates because statutory tax rates have declined in Europe while bases have become broader in the 1980s. For the 1990s, effective average corporate tax rates marked a clear downward pattern (more for more profitable activities than for less profitable activities) while marginal tax rates remained almost unchanged. (Devereux et al., 2002)

Devereux, Griffith and Klemm (2002) investigated data on corporate income tax revenue as a proportion of GDP in advanced economies, over 1960-1999 and concluded the following: statutory tax rates have fallen; tax bases have been broadened; effective tax rates have fallen, especially for investments with high rates of profitability; tax revenues have remained stable as a share of GDP; tax revenues have fallen as a share of total tax revenue since the 1960s, but have stabilized since the 1980s and marginal tax rates remained almost unchanged.

Similar results, but for another period 1982-2004, were obtained by Sorensen (2006). Indeed, a clear downward pattern for effective average corporate tax rates was found in the European Union over 1995-2005.

Among the sources of variation of the size of corporate tax revenues and the rate-revenue paradox are considered the process of incorporation (Piotrowska and Vanborren, 2008) and income shifting between personal and corporate income (Sorensen, 2006; De Mooij and Nicodeme, 2008), the corporate profitability volatility (Auerbach and Poterba, 1987), the size (widening) of corporate income tax base or the level of deductions (Devereux et al., 2004; Creedy and Gemmell, 2008), the extent of "risk subsidy" to entrepreneurial activity and "risk sharing" with the government (Cullen and Gordon, 2007).

Clausing (2006) identifies a parabolic relationship between tax rates and revenues, thus, tax-to-GDP ratio is greater in countries with greater share of corporate sector in the economy and in countries with higher corporate profit rate. His study was conducted on the OECD countries, over the period 1979-2002. Also, a rising share of the financial sector in the economy was seen as a reason for the growing share of corporate profits in the economy. (Devereux et al., 2004)

Another strand of the literature mentions that the relatively stability of the corporate tax revenues over time in the context of tax competition (statutory corporate tax rates and effective corporate tax rates cuts) is explained through a lower personal tax revenue due to a change in the legal form from the non-corporate into the corporate form.

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