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TAX COMPETITION AND THE RELOCATION PROCESS

SUMMARY

In this article the author discusses the problem relating to the tax competition in the context of relocation as a process resulting from the ongoing globalization of economic activity. For this purpose the author discusses the essence and causes of tax competition and relocation. The conclusion is that relocation leads usually to an increase in the competitiveness of enterprises, their development, and thus to the development of the economies of individual countries. Healthy competition leads to streamlining the fiscal policies of competing countries and to the creation of a business-friendly atmosphere. Therefore, the role of governments, particularly in the developing countries, is such action, including the use of fiscal instruments, that would enable the achievement of competitive advantage in the international market and socio-economic development.

Keywords: taxation, tax competition, relocation

JEL Classification: F20, H25

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INTRODUCTION

Unquestionable positive effects of globalization are an increase in trade[1] based on comparative advantage, cross-border investments, institutional development, the competitiveness of individual companies and whole economies, as well as other desirable for societies, regional and national consequences arising from the more creativity of people in the world disappearing barriers and boundaries. Of course, one can not disregard some negative effects that may affect countries at the periphery of the importance of government, as well as beyond the sphere of economic interest of investors[2].

The existing tax competition between countries is often seen as a manifestation of their competition to attract the potential investors and capital to enhance the growth of national economies. The mobile factors of production (e.g. capital) are easily relocated to countries with low tax levels, which limits the possibility of taxing them excessively[3]. The clou of tax competition frequently lies in the belief that a minimum fiscal burden is the main determiner of the economic development of the area involved and of its attractiveness for new investments. According to Robert W. McGee, countries with the lowest tax rates tend to have the highest rate of economic growth, as lower taxes leave more field for private capital, which normally operates far more efficiently[4]. Creating incentives for investment is especially important for the countries which are under economic transformation because the transformation process is largely affected by FDIs[5]. Since the general level of capacity for market competition and investment attraction is obviously related to the fiscal environment, it would be hard to deprive individual countries of their right to develop their own fiscal models to match their potential and needs.

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[1] See R.L. Thompson, *Globalization and the benefits of trade*, „Chicago Fed Letter", The Federal Reserve Bank of Chicago, No. 236/2007.

[2] D. Rodrik, *Globalisation, Social Conflict and Economic Growth*, „The World Economy", Vol. 21, No. 2/1998, p. 143-158. B.M. Gilroy, *Globalisation, multinational enterprises and European integration*, MPRA, Paper No. 17972/2001, http://mpra.ub.uni-muenchen.de/17972/ (12.02.2013).

[3] See G.R. Zodrow, *Capital Mobility and Source-Based Taxation of Capital Income in Small Open Economies*, „International Tax and Public Finance", Vol. 13, No. 2-3/2006, p. 269.

[4] R.W. McGee, *The Philosophy of Taxation and Public Finance*, Kluwer Academic Publishers, Boston-Dordrecht-London 2004, p. 105-107.

[5] M. Sedmihradsky, S. Klazar, *Tax Competition for FDI in Central-European Countries*, CESifo Working Paper, No. 647/2002; B.S. Sergi, *Slashing taxes on corporate profits. Does it help entrepreneurship?*, „Transformations in Business & Economics", Vol. 4, No. 2(8)/2005, p. 21-35.

The purpose of this article is to present the issues relating to the relocation of companies in terms of striving for optimal income taxation by using tax competition. Moreover, this article is intended as a contribution to the response to the still relevant question: what is the importance of the relocation process for the economies, for whom is it more potential opportunity, and for whom it may pose some risk due to the dynamic development and increase competitiveness in the globalizing world.

1. THE NATURE OF TAX COMPETITION

Business activity is profit-oriented by nature, and every tax burden means a reduction in the present or future capital assets of taxpayers. With regard to the corporate income tax, direct taxation reduces the scale of either consumption or business expenditure. Therefore the natural taxpayers' response is avoidance of such consequences of taxation or the drive to at least minimize its negative impact. The taxpayers' responsive behaviour may involve tax optimization within the limits allowed by law, i.e. making use of the tax structure flexibility, or tax-driven migration, frequently referred to as relocation[6], i.e. moving the operations to another country. Therefore, the natural behavior of the taxpayer is to avoid such tax consequences or to minimize its negative impact. Proceedings taxpayer may bring, among others, to legally optimize the level of taxation through the use of flexible tax structure or by tax migrating to countries with lower tax weights, taking advantage of the tax competition between countries.

Tax competition is a phenomenon which consists in the governments' applying fiscal instruments to increase the competitive advantage of their territories by attracting or keeping the capital engaged in economic activity. It should also be remembered that multinational corporations[7] are to a large extent motivated by their drive to reduce tax burdens applicable to their operations. Therefore, they appear highly sensitive to the level of taxes levied on their line of business in any given country[8]. Tax competition may be perceived as beneficial and may develop – per analogiam to business competi-

[6] See E.E. Leamer, *The Effects of Trade in Services, Technology Transfer and Delocalisation on Local and Global Income Inequality*, „Asia-Pacific Economic Review", 1996, p. 44-60.

[7] See P. Dicken, *Global Shift: Transforming the World Economy*, Paul Chapman Publishing, London 1998.

[8] See M.P. Devereux, R. Glenn Hubbard, *Taxing Multinationals*, NBER, Working Paper 7920/2000.

tion – to approximate the ideal competition[9] in which the countries or regions compete for mobile factors of production.

Observation of a process of tax competition allows one to distinguish two forms of this phenomenon[10]: crawling tax competition and – following the terminology of the European Commission – unfair tax competition. The first form involves a long-term, comparatively slow process where states are underbidding (as initiators or as reaction to the measures of the other players) the tax rates of their competitors in several rounds so that gradually the tax rates of all participating players are converging downwards.

Crawling tax competition refer to regular tax systems and usually concern all investors regardless whether they are domestic or foreign[11]. Of particular relevance is direct tax competition for foreign direct investment (FDI) and portfolio investment (PFI) via reductions in the nominal corporate tax rates, but also the introduction of dual income tax systems in several member countries to privilege capital incomes[12].

The unfair tax competition comprises isolated attacks of single states with the only aim to undercut the other states in the direct competition for foreign investment; therefore it is sometimes called "tax dumping"[13]. It is worth mentioning, however, that economic literature explains this concept in different ways. An opinion may be found that reduction of tax rates for all economic agents (both domestic and foreign) is treated as tax competition. However, tax privileges only for foreign investors should be treated as tax dumping[14]. The professional literature also includes an approach in which tax competition may lead to a "race to the bottom" in lowering the tax rates. The coun-

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[9] C. Tiebout, *A pure theory of local expenditures*, „Journal of Political Economy", Vol. 64, No. 5/1956, p. 416-424.

[10] J. Sepp, R.M. Wróbel, *Tax Competition and EU Enlargement: Strategies within a Developing Political-Economic Environment*, [in:] U. Ennuste and L. Wilder (ed), *Essays in Estonian Transformation Economics*, Estonian Institute of Economics at Tallinn Technical University 2003.

[11] A. Krajewska, S. Krajewski, *Is Corporate Income Tax Harmonization Possible in an Enlarged European Union?*, „Buletin Stiintific", International Society for Intercommunication of New Ideas, 2007, p. 154.

[12] M. Schratzenstaller, *Corporate Taxation in Europe – Possibilities, Problems and Options for Reform*, Network of Alternative Economists in Europe, Workshop in Stockholm, Working Paper, No. II/29/2000.

[13] H.G. Grigat, *Verlagerung von Unternehmensgewinnen in das Ausland und Steuerdumping*, WSI-Mitteilungen, No. 6/1997, p. 404-414.

[14] See G. Krause-Junk, *Was ist fairer Stenerwettbewerb?*, [in:] R. Hasse, K. E. Schenk, A. Wass von Czege, *Europa Zwischen Wettbewerb und Harmonisierung*, Nomos, Baden-Baden 2002.

tries competing in tax burdens bring them lower and lower to prevent the mobile factors of production from running away from high-tax countries to low-tax ones[15]. Hans-Werner Sinn claims that the "race to the bottom" – leading to a zero tax in the extreme – would ruin the economy[16]. Countries with relatively inefficient tax systems can experience significant welfare losses if, as a byproduct of financial integration, they find themselves competing over capital income taxes against countries with relatively efficient tax systems[17].

It should be emphasized, however, that a straightforward comparison of nominal CIT rates is merely a starting point for any comparative analysis of national tax systems and does not offer a complete picture of their actual arduousness to companies. This is so because individual countries calculate the tax base in different ways. There are many sources of such differences: the range of costs qualifying as business expenses, the depreciation method applied, the method of reserves creation and accounting for losses, the applicable tax reliefs and credits and so on. Therefore, getting a complete picture requires the use of effective rather than nominal tax rate for comparison. It is only the more favourable effective tax rate that may induce businesses to move their operations as foreign direct investment into countries offering less burdensome taxation.

Besides, we should remember that tax burden is just one of several reasons for transferring production to another country[18], and not the most important one at that. The business attractiveness of any country has numerous aspects, including the levels of social security, transport costs, infrastructure development, labour education or the condition of natural environment[19]. The main factors are invariably the cost and quality of labour as well as the size of markets and the distance from key customers. It is only when those non-fiscal factors look favourable that the tax burden really comes into play.

From the comparison of the CIT rates offered and the ranking of economies by their competitiveness it can easily be inferred that it is not the tax

[15] A. Razin, E. Sadka, *International Tax Competition and Gains from Tax Harmonization*, „Economics Letters", Vol. 37, No. 1/1991, p. 69-76.

[16] H.W. Sinn, *How Much Europe? Subsidiarity, Centralization and Fiscal Competition*, „Scottish Journal of Political Economy", Vol. 41, No. 1/1994, p. 85-107.

[17] E.G. Mendoza, L.L. Tesar, *Why hasn't tax competition triggered a race to the bottom? Some quantitative lessons from the EU?*, „Journal of Monetary Economics", Vol. 52, No. 1/2005, p. 163-204.

[18] J.M. Gryko, M. Kluzek, *The influence of the tax factor on investment effectiveness in selected Central and Eastern European countries*, „Transformations in Business & Economics", Vol. 7, No. 3(15)/2008, p. 65-74.

[19] Economic and Social Committee, *Economic and Social Committee Opinion On Direct company taxation*, ECO/091, CES 850/2002, Brussels 2002.

burden (resulting from the effective tax rate), but other factors like the efficiency of public institutions, the transparency of public management or the quality of natural environment that secure any country's high position in the attractiveness ranking[20]. By way of an example, if we rank European countries by their CIT rates, the lowest rates are offered by Albania, Bulgaria and Cyprus while the highest by Malta, Belgium and France. However, when the GCI is used to build a competitiveness ranking, the most competitive economies are those of Switzerland, Finland and Germany and the least competitive ones – Serbia, Albania and Greece.

In conclusion, the countries which are keen to retain investors' interest with more friendly taxation earn more tax revenues from new investors despite lowering the tax burden, and this is attributable to the effect of scale. On the microeconomic scale the same effect is achieved by a business which earns huge profits despite a small profit margin. It manages to do so through large sales volumes, reached through offering good value for money.

2. THE IMPLICATIONS OF RELOCATION TO THE ECONOMIC SPHERE

Relocation is a relatively new form of business adaptation to a changing environment[21]. The relocation process is manifest in the transborder flows of foreign direct investment. The actual scale of this phenomenon is hardly measurable, the difficulty lying inter alia in the fact that relocation functions alongside offshoring and outsourcing. Due to the disparity between the economies of the EU Member States, and between that of the EU as a whole and those of Asian countries, there are certain factors that encourage company relocations: cheaper supply, tax advantages, potential access to new markets, technology and lower labour costs.

Relocation is a form of adaptation to a changing business environment. In the literature one can find three main causes of migration enterprise: 1) internal factors (status, ownership, size, age, employment growth, acquisitions, mergers,), 2) factors related to the location (location of company headquarters, the type of industrialization and characterization objects), 3) external factors (market size, labor market issues, government policies and general economic

[20] See World Economic Forum, *Global Competitiveness Report 2010-2011*, Geneva, Switzerland 2010 and KPMG International, *KPMG's Corporate and Indirect Tax Survey 2012*, www.kpmg.com (15.09.2013).

[21] J. van Dijk, P.H. Pellenbarg, *Firm relocation decisions in The Netherlands: An ordered logit approach*, „Papers in Regional Science", Vol. 79, No. 2/2000, p. 191-219.

conditions)[22]. While the list of internal factors is almost complete, knowledge about the external factors is not exhaustive. Full knowledge of these particular factors may be crucial to explain the reasons for the migration of enterprises[23].

The development of business and the need for adequately large space for the production represents here the main drivers for the migration. When an entity reaches the limits of its capacity is somehow forced to relocate their activities. Another reason for the relocation is cost optimization, therefore companies use all circumstances and are looking for other places conditions, which are favorable, e.g. using economies of scale, improved access to raw materials and energy sources, differences in the level of wages, raw material prices and energy, as well as any incentives made by local authorities.

In addition, companies are motivated by a specific government policy using fiscal instruments, including grants, low taxes, tax etc. It should be emphasized, that this strategy was used by the authorities in most industrialized countries since the 50s 20th century, mainly in order to reduce income disparities between regions and employment growth. Here one can mention the following types of migration enterprise[24]: 1) integral migration - the whole company moves to a new place, and partial migration - part of the company is transferred to another location for a period of reconstruction/development, 2) the permanent or temporary migration - the entire company or a part thereof is transferred to another location for the duration of reconstruction/extension, 3) vertical migrations - the company moves from the big city to the suburbs or to a smaller town, and horizontal migration - the company moves to another city or another area of the same rank 4) inter-regional, intra-regional or international.

According inter alia to Leo Sleuwaegen[25], nature of the relocation changes over time. Decades ago, the phenomenon was somewhat reflected the life-cycle model. The production of some goods after reaching the peak phase of the growth cycle was transferred from the more developed countries to less developed countries, which prolonged the life expectancy of these products and ensure profitability. But now, the significance of economies of scale,

[22] See J. van Dijk, P.H. Pellenbarg, *Demography of firms; spatial dynamics of firm behaviour*, „Netherlands Geographical Studies", University of Groningen, No. 262/1999; J. van Dijk, P.H. Pellenbarg, *Firm relocation…*, *op. cit.*, Vol. 79, No. 2/2000, p. 191-219.

[23] A.E. Brouwer, I. Mariotti, J.N. van Ommeren, *The firm relocation decision: a logit model*, European Regional Science Association conference papers, 2002, p. 1.

[24] E. Małuszyńska, *Delokalizacja przedsiębiorstw*, „Wspólnoty Europejskie", No. 3(172)/2006, p. 3.

[25] E. Pennings, L. Sleuwaegen, G. Monmaerts, *Relocation, an Element of Industrial Dynamics*, Federal Planning Bureau, Brussels 2000, p. 4-5.

and the process of globalization and greater flexibility in the operation of enterprises, result in the formation of transnational corporations.

The relocation process manifests itself in the form of international flows of FDIs, but the actual scale of this phenomenon is difficult to measure. The reason for this difficulty lies in the fact that in addition to the concept of relocation also operate offshoring and outsourcing concept. The relocation of the enterprise would be rather identified with the transfer of production existing in the other place, which is associated with job losses at existing operations. However, determination of offshoring and outsourcing is not clearly indicated[26]. Offshoring is understood as the transfer of production (or procurement) of the country where the company is located in another country, usually characterized by lower labor costs. This phenomenon may, but need not, take place within a company.

However, the phenomenon of outsourcing is the contracting out of a business process to a third-party[27]. Relocation thus provides both a simple production function (offshoring) transferred to countries with more favorable economic conditions, as well as services and other activities carried out so far in the home country of the investor (highly developed economies). These activities are aimed at maintaining competitive advantage by corporations globally. They decide to deepen expertise in key strategic activities for the company while releasing and giving out less significant strategic actions. Outsourcing these activities on behalf of another, cooperating, specialized in the field of the company allows enterprises to significantly reduce operating costs. This results not only from the lower rates offered to the workforce, but also to make better use of information and communication technologies that enable the collection, processing, transmission, and flexible delivery services to the customers in remote locations around the world, in terms of work for two or three shifts and different time zones[28].

In the opinion of the European Economic and Social Committee (EESC) relocations can be estimated due to the positive and negative consequences associated with it. Moreover it should be mentioned that relocation of industrial production can, at best, help to promote social rights in countries receiving investment and necessarily involves the regular transfer of know-how; conse-

[26] E. Małuszyńska, *op. cit.*, p. 4.

[27] E. *Kawecka-Wyrzykowska, Narodowe regulacje na rynku wewnętrznym UE: nowe bariery we współpracy, [in:] E. Kawecka-Wyrzykowska (ed.), Unia Europejska w gospodarce światowej – nowe uwarunkowania, SGH, Warszawa 2007.*

[28] M. Wdowicka, *Ewolucja działania korporacji transnarodowych i jej znaczenie w go-spodarce lokalnej*, [in:] J.J. Parysek, Bogucki (ed.), *Wybrane problemy miast i aglomeracji miejskich na początku XXI w.*, Wydawnictwo Naukowe, Poznań 2009, p. 73-74.

quently relocation can make a considerable contribution to further increasing the competitiveness of the relocated businesses[29].

However, the negative effects would be rather linked to the relocation outside the EU, particularly, when the relocation phenomenon, apart from being the direct cause of job losses, could also bring other, associated problems, such as an increase in social security costs for governments, increased social exclusion, lower tax revenues to the budget and less economic growth overall, partly as a result of a general demand shortfall. In addition, European companies may be somewhat forced to compete with companies with lower costs. This reduces the pressure to increase spending on R&D and the effect of reducing their potential for innovation. Assuming that it's inevitable occurrence of the relocation, the EESC believes that the best way of tackling the understandable concerns over the negative consequences of company relocations is to develop and properly implement social policies that promote a positive attitude to change, enable workers to adapt and upgrade their skills, and encourage job creation[30].

The analyzes also show that the assumption underlying the criticism of relocation, it's not always true, and the scale of the impact of relocation phenomenon is exaggerated. So that the "export" of jobs to low-cost countries, to which production is transferring, contributes to the rise in unemployment in European countries. The jobs moving overseas doesn't have to mean the loss of jobs in developed countries. On the contrary, it may be even increase the number of jobs in the home country, because foreign subsidiaries are not necessarily in competition with national production company, but often they're complementary to it and help improve the efficiency, quality and reduce production costs, which results in increased sales. This may lead to increased employment in the home country. However, an advantage in attracting new investment and jobs are mainly those countries which produce at competitive prices[31].

It should be noted that relocation to countries with low wages and low skills are very limited scope in terms of the whole economy. The negative impact of competition from low-wage countries is concerned especially at the low qualifications[32]. According to the European Commission report on em-

[29] See Economic and Social Committee, *European Economic and Social Committee Opinion On the scope and effects of company relocations*, OJ C 294/09 of 25.11.2005.

[30] *Ibidem*.

[31] N.G. Mankiw, P. Swagel, *The Politics and Economics of Offshore Outsourcing*, American Enterprise Institute for Public Policy, Research Working Paper No. 122/2005.

[32] J. Gorter, P. Tang, M. Toet, *Relocation from the Netherlands: motives, consequences and policy*, Netherlands Bureau for Economic Policy Analysis, CPB Document No. 76/2005.

ployment, nearly three quarters of the total number of jobs lost due to internal restructuring, more than 13 percent is the result of bankruptcy or closure, 3 percent is the result of mergers and acquisitions, and for more than 7 percent be attributed to relocation of production activities, including 2.5 percent attributable to outsourcing. Similar assessment of the scale of relocation due to the UNCTAD study. The majority of relocation takes place within individual countries, and the migration of business on an international scale covers only 1-2 percent of cases[33].

All in all, the relocation process should be beneficial for the whole global economy. Firstly, it makes the highly developed countries get rid of the less advanced sectors of economy and utilize their highly skilled labour more efficiently in the high-tech industries – the use of comparative advantages will facilitate their sustainable economic growth and welfare. Secondly, the host countries gain not only new jobs, but also an increased inflow of FDIs and know-how, thus securing their own economic growth. One can only have some concerns if the process of relocation refers to the business, which was financed with public funds, especially from the EU funds under cohesion policy. This was, incidentally, reflected in legislation restricting the use of the Structural Funds[34].

CONCLUSIONS

Tax policy set to reduce tax rates seems a very reasonable one, provided that it leads to the overall diminishing of tax burdens, made up of not only rates but also other elements of the tax system structure. Douglas Holtz-Eakin and Harvey S. Rosen demonstrated that raising the tax rates results in a slow-down in business activity as companies accumulate less capital and create fewer jobs[35]. Their study covered the years 1985-1988 and thus managed to embrace the outcomes of Ronald Regan's tax reform.

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[33] European Commission, *Employment in Europe 2004. Recent Trends and Prospects*, International Publication, Paper 36/2004, http://digitalcommons.ilr.cornell.edu/intl/36 (21/03/2013), p. 218.

[34] See *Council Regulation (EC) No 1260/1999 of 21 June 1999 laying down general provisions on the Structural Funds*, OJ L 161 of 26.6.1999 and *Council Regulation (EC) No 1083/2006 of 11 July 2006 laying down general provisions on the European Regional Development Fund, the European Social Fund and the Cohesion Fund and repealing Regulation (EC) No 1260/1999*, OJ L 210 of 31.7.2006.

[35] D. Holtz-Eakin, H.S. Rosen, *Economic Policy and the Start-up, Survival, and Growth of Entrepreneurial Ventures*, Small Business Administration Office of Economic Research, May 2001, p. 24.

Healthy competition leads to streamlining the fiscal policies of competing countries and to the creation of a business-friendly atmosphere. The competition for investment capital is not a zero-sum game which must have its winners and losers, especially in long-term perspective. The competing parties behave rationally in their efforts to secure the optimum environment for economic entities, increasing the efficiency of their public finance systems on the way. This should translate into improved living conditions of the population.

However, we must remember that the income taxation level is not the most significant in making a national economy competitive. Countries which enjoy high-quality infrastructure, stable and transparent legal and tax systems and a large proportion of highly-qualified labour need not fear that investors will seek greener pastures and can keep their taxation relatively high. Conversely, the countries which are at a relatively lower level of development and have less capital offer lower taxation in compensation for their infrastructural shortcomings to remain at least moderately attractive for investors.

Creation of a stable framework for business activity and supporting the investment and developmental projects become more and more important today as globalisation of economic processes eliminates those who cannot keep up with their competitors and gain a sustainable competitive advantage.

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