Non-technical summary

Title: **Capital Mobility and Tax Competition Between Old and New EU Member States**

Małgorzata Jakubiak
Małgorzata Markiewicz
CASE – Center for Social and Economic Research

Accession of new member states with lower corporate taxation has raised fears on tax competition within enlarged Europe. Our paper addresses the issue by calculating effective tax rates and showing relative tax burden in the new and old member states. Then, the issue of tax competition and its effects on investment is examined indirectly by looking at the responsiveness of FDIs to taxation. The tax competition is also examined directly by testing tax mimicking behaviour amount the EU countries.

The fear is based on tax competition theory assuming that fall in statutory tax rate in one country causes the capital inflow there. At the same time other countries collecting fewer taxes have to limit the amount of public goods provided. The fall in nominal rates has been widely observed in the EU, yet the consequences are not very well researched. The NMS have lower tax rates and have decreased them much faster than the old EU-15 countries in recent years. It is not clear whether these actions have brought some results measured in additional investments inflows and to what extent countries respond to their neighbour's tax policies. This is what was examined in this paper.

The study confirms that both effective and statutory taxation motivates investment decisions within the enlarged Europe; along with relative prices of labour, size of the sending and the receiving countries and geographical distance between them. However, the influence of taxation over capital flows to and from the "new" EU states is different from what one might have expected. Response of FDI flows to relative tax rates seems to be asymmetric. Basically, we found no proof for FDIs flowing from "old" to "new" member states, being motivated by lower tax rates. It was found, though, that higher than at home statutory and effective tax rates discourage FDI outflow. This effect is especially visible in case of relatively small capital flows originating in "new" EU countries.

Even though investors do not seem to react to lower taxes in "new" EU member countries, it seems that governments nevertheless compete in setting statutory tax rates. Lower statutory and effective tax rates of other countries seem to motivate governments to cut their own statutory CIT rates. This effect is stronger for "new" member countries.

Determinants of effective taxation seem to be more complex. Perhaps this is for the reason that effective taxes are observable only with a time lag. Nevertheless, we found that fiscal authorities of European countries are responding to the other countries' changes in statutory tax rates in the same direction. And that NMS are much more sensitive to changes in nominal tax rates of the others. Moreover, effective tax rates tend to be higher in larger and richer countries, and in those with higher capital outflows.