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Harmful Tax Competition in the EU with Reference to Croatia*

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Abstract

The process of globalisation has led, among other things, to harmful tax competition. This paper considers the efforts within the EU in combating harmful tax competition (Code of Conduct on Business Taxation) and their effects when taking into account the EU regulations in relation to state aids. Considering a number of problems in the implementation of the Code, and the numerous criticisms with regard to the validity of the combat against harmful tax competition – it is difficult to give a final answer about its success. Croatian tax system, and the corporation tax in particular, are analysed in the light of the aforementioned problems. The advantages of the equal treatment of domestic and foreign investors, as well as the certain elements of state aids in tax benefits, are pointed out.

JEL Classification: *H21, H26*

Key words: *globalisation, harmful tax competition, effects, Croatia*

1. Introduction

The process of globalisation, as the consequence of socio-economic trends, has caused and introduced numerous economic phenomena on the international scale. Among them is the phenomenon of tax competition, with harmful tax competition becoming a growing problem within its framework. Tax competition, on its own, is not harmful since it exerts pressure on the state apparatus and encourages more

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[3] Such tax systems are recognized on the basis of the OECD and EU criteria as outlined further in the text

efficient management of public incomes and expenditures. However, under certain conditions (when the tax system of a particular country is directed exclusively towards attracting capital, at the expense of other countries[2]), tax competition becomes harmful and poses a threat to the balance of public incomes and expenditures, which, in turn, brings about numerous economic, fiscal, social and other effects.

In preventing harmful tax competition, a need for taking initiatives at a global level has arisen. Numerous world integrations and organisations have been included (OECD, EU, WTO, G7, UN, etc.).

The purpose of this research is to explain the EU model of combat against harmful tax competition in business taxation; to analyse the reasons, justifiability and historical trends that have led to the very drafting of The Code of Conduct on Business Taxation; and, to analyse the effects of the guidelines of the Code with regard to both transition countries and Croatia in particular.

While researching this topic, numerous questions occur that need to be answered. They are the following: Which economic processes have led to the occurrence of the phenomenon of harmful tax competition? How to define it? What are the modalities for its prevention? What is the influence of the adoption of The Code on the EU economy? What is the attitude of economic theory towards tax competition? How do transition economies deal with the aforementioned processes? And lastly, what are the reflections on the economy of the Republic of Croatia?

Harmful tax competition, however, is still not a sufficiently investigated economic phenomenon. Problems start with the very defining, that is, determining whether a certain tax measure is harmful or not. The reason for this is in the complexity of elements constituting the phenomenon in question, and which are of economic, political, ethical, legal and other nature.

As with regard to the Republic of Croatia, we undertake to evaluate its legal regulations from the standpoint of potentially harmful tax measures (which would attract political pressure from the EU).

The paper consists of nine units. Following the introduction, the interaction between globalisation and harmful tax competition is analysed, and the reasons for drafting and the provisions of the EU Code of Conduct on Business Taxation are pointed out. Further are the analysis of the effects of harmful tax competition and an overview of the progress made in combating harmful tax competition. Experience of transition economies is also presented. Finally, the aforementioned topics are applied on the Republic of Croatia. The conclusion synthesises the results obtained in the paper.

2. Globalisation and Harmful Tax Competition

Firstly, it is necessary to show the very reasons for the occurrence of harmful tax competition and the need for its restraint. This phenomenon is yet another in the series of consequences of the globalisation process. Simultaneously with the increase in the mobility of capital, people, information and other factors, there came a growth and development of socio-economic conditions for the occurrence of tax competition. The process in question has its own chronology to be described further below.

Historically speaking, tax policies have primarily addressed domestic economic and social concerns. The forms and levels of taxation, established on the basis of the desired level of publicly provided goods and transfers, abided by the principles of allocative, stabilising and redistributive aims of a particular country. Their international dimension was reflected in that they affected the amount of tax imposed on foreign source income of residents and domestic source income of non-residents. The interaction of tax systems was relatively insignificant, given the limited mobility of capital. Decisions on tax rates and tax forms and the use of tax incentives were made on the basis of domestic concerns and had effects on domestic economy.

The process of globalisation of trade and investments had a significant influence on the relationships among domestic tax systems. The removal of non-tax barriers to international commerce and investment and the resulting integration of national economies have increased the potential impact of national tax systems on other economies. Globalisation, as a process, has also been one of the driving forces behind tax reforms in the form of base broadening and tax rate reductions, thus minimising tax induced distortions. Globalisation has also encouraged countries to continual reassessment of their tax systems and public expenditures with a view to creating adequate “fiscal climate” for attracting investment. Globalisation and the increased mobility of capital have also had an impact on the development of financial and capital markets and have encouraged the reduction of tax barriers to capital flows as well as the modernisation of their tax systems so as to reflect these changes.

The process of globalisation has led to increased competition among businesses in the global market. The development and growth of multinational enterprises has led to the weakening of their links with their base countries, and the physical location of their management and other activities has become much less important. International capital markets continue to develop and influence the global welfare enhancement through multiplication of cross-border capital flows. This process has led to the improved welfare and living standards around the world by way of more efficient allocation and utilisation of resources.

Globalisation has also had negative effects in the sense of opening up new opportunities for companies and individuals to tax avoidance and for countries to develop tax policies aimed primarily at diverting financial and other geographically

mobile capital. It is the OECD's view that these actions induce potential distortions in the area of trade and investment and reduce global welfare. The OECD reports state that these schemes can erode national tax bases, may alter the structure of taxation (by shifting the tax burden from mobile to relatively immobile factors and from income to consumption) and may hamper the application of progressive tax rates and the achievements of redistributive policy. This sort of pressures can, by spill-over effects, result in the changes of tax bases of all countries, even though a more desirable result could have been achieved through intensifying international co-operation (OECD 1998, p.8).

There are two initiatives attempting to restrain harmful tax competition. The first initiative, by the OECD, is of a broader scope and addresses the OECD non-member countries as well. The second initiative is by the EU – the so-called "Code of Conduct on Business Taxation" which is limited on its members, but has great significance for the potential future members as well.

Tax competition as a term refers to the race between national economies to increase the competitiveness of their economies or to attract FDI through tax policy (tax incentives, lowered tax rates, etc.). However, how do we determine when the tax competition is harmful? In defining harmful tax competition, the important aspect is the aim of a certain tax measure. If such a measure has the exclusive function of attracting capital by way of low or zero rates of particular tax forms, then it has as a consequence a series of harmful economic effects (such as the erosion of tax bases of other countries, etc.). Precise definition of harmful tax competition was provided by both the OECD and EU (The Code) through the criteria that serve as the basis when assessing whether tax measures are harmful or not.

Wilson and Wildasin (2004., p. 3.) define tax competition as non-cooperative tax setting by independent governments, under which each government's policy choices influence the allocation of a mobile tax base among "regions" represented by these governments (includes competition for allocation of workers, firms, capital, or shoppers, for example)[4].

It is important to distinguish "good" and "bad" tax competition. Good tax competition denotes tax competition that corrects distortions that would otherwise exist in the private or public sectors, or it optimally allocates factors of production across locations. Therefore, factors should be taxed according to their marginal costs (see Wilson and Wildasin, 2004.). Determining whether governments follow this rule could be the criterion for harmful tax competition. If competition drives the tax rates on mobile capital substantially lower – that is an indicator for bad tax competition.

[4] The term "region" denotes country or state or localities within countries, depending on the context

Mostly, the theories of tax competition are based on propositions of Oates (1972) and models of Zodrow and Mieszkowski (1986., acc. Wilson and Wildasin, 2004.) and Wilson (1986, acc. Wilson and Wildasin, 2004.). They stand ground on thesis that competition for capital leads to inefficiently low tax rates and public expenditure levels. Recent models highlighted some positive effects of tax competition. They are based on Brennan and Buchanan's (1989, acc. Wilson and Wildasin, 2004., p. 1066.) model of government as a Leviathan. One of the surprising conclusions of Wilson and Wildasin (2004.) is that tax competition can lead to higher public expenditures and taxes on mobile factors, and that effects can be a sign of efficiency-enhancing tax competition.

There are a quite large number of models covering the issue of tax competition developed from 1980-ies. All of them are based on different conditions and restraints and so it is difficult to compare them and determine the most appropriate one. Also, they cover wide area of issues connected with tax competition like firm location theory, the size of government, problem of tax exporting, taxation, economic integration and other. Instead of entering in depth analysis of particular models it is more useful to draw some of the conclusions related with subject of this paper (see Wilson and Wildasin, 2004.):

- tax competition leads to efficient division of firms across the regions (based on models of White (1975), Fishel (1975), Wellisz (2000), Black and Hoyt (1989), King, McAfee and Welling (1993)
- tax competition lowers the size of government (Leviathan model - Brennan and Buchanan (1980) and Zodrow-Mieszkowski model (1986) and it's welfare effects are ambiguous
- there are cases where tax competition is welfare-improving but leads to a greater size of government (Wilson, 2001)[5]
- tax competition causes regions to reduce their taxation of mobile factors relative to immobile factors (Keen and Marchand (1997), with the size of the reductions depending on the number of competing regions in a world economy of a given size (Bucovetsky and Wilson (1991)[6]

[5] It is based on the assumption that tax competition causes increase of the sensitivity of tax revenue to public input provisions. So, decline in the effective marginal cost of productive public expenditures leads residents to increase their demand for these expenditures.

[6] Recent studies, for instance, differ from earlier models and indicate welfare-enhancing effects of tax competition. Several instances are identified where positive connection between tax competition and welfare is determined. Janeba (1998) points out that tax competition is welfare improving because it leads to higher taxes or lower subsidies on mobile factors of firms. This result is surprising, but logical. No country would offer a positive subsidy because the transfer of subsidy revenue to the foreign firm would harm the country. Few studies, on the other hand, state that capital mobility can improve welfare while leading to higher taxes is obtained by assuming that a region's capital uses costly public services. Competition for mobile capital would drive the tax rate per unit of capital to a level equal to the amount of public expenditure per unit of capital, which could be substantially greater than zero (see Wilson and Wildasin, 2004.).

– mobility of capital, high-income households, or other net resources that are net contributors to fiscal system can undermine the ability of governments to finance redistribution and insurance programs (Sorensen, 2004)

Recent econometric studies on the historical evolution of corporate tax burden of EU and OECD countries showed no evidence of a competitive "race to the bottom" in capital taxation, and little evidence of even a harmonization of the tax burden. However, there are indications that there may have been some modest harmonization within smaller groups of countries (see Stewart and Webb, 2003.). These results go ahead with Mendoza and Tesar (2003.)[7]. They found that gains from tax coordination in the wide area of taxation issues are small. The results of their studies have some important conclusions. According to them, countries with relatively inefficient tax systems can experience significant welfare losses if, as a by-product of financial integration, they find themselves competing over capital income taxes against countries with relatively efficient tax systems. In that case, harmonization of indirect taxation is undesirable because it forces countries to respond to the adverse effects of tax competition on tax revenues by raising highly-distorting labour income taxes. Harmonization of taxation on immobile factors and freedom to adjust consumption taxes to make up for the tax revenue loss from capital income tax competition would be far more desirable. In the case in which the consumption taxes are adjusted to maintain the fiscal solvency, they found that Nash competition in capital income taxes produces a staggering "race to the bottom" in capital tax rates. Next, for European countries, welfare gains obtained from drastic cuts in capital income taxes replaced by consumption taxes are almost negligible (although they are welfare improving) (see Mendoza and Tesar, 2003.).

Sorensen (2004) analyses situation of high mobility of capital between the "tax union" and the rest of the world. He points out that the welfare gain from regional capital income tax coordination is only a small fraction of the gain from global coordination, even if the tax union is large relative to the world economy. This result could be indicative for further policies of OECD and EU. Apparently, tax coordination within these integrations has no significant positive effects. So, the solution is to support worldwide tax coordination or, in contrary, liberalise tax coordination demands.

Parry (2003) concludes that the welfare costs of tax competition that leads to suboptimal tax rates appear to be fairly modest (less than 3% of capital tax revenue). These costs are even smaller when the possibility of Leviathan behaviour is attached. So, this is one more argument against setting up the minimum rates of capital taxes across of block of regions, like European Union, for example.

[7] Their model is based on different outcomes of tax competition in one-shot games over capital income taxes by strategically-determined tax rates.

Theoretical and empirical findings on issues of tax competition show that there are no easy solutions on dealing with its potential harmful effects. It can be seen that recent studies unlike majority of previous, give stance for more positive considerations on tax competition issues. Some useful guidelines for taxation policy can be drawn from mentioned models. Especially because they show that effects of tax competition will largely depend on some specific features of particular country tax system. Formulation of "Code of conduct" goes in line with negative arguments towards tax competition. Guidelines of this document are analysed in following section.

3. The Reasons for Drafting "The Code of Conduct on Business Taxation"

The document in question is based on the discussions held at an informal meeting of the ECOFIN Ministers in Mondorf-les-Bans on 13 July 1997. Based on the work of the ECOFIN Council and the Taxation Policy Group – a package to prevent harmful tax competition, including the Code of Conduct on Business Taxation, was put forward. There followed a series of meetings of the Taxation Policy Group where the guidelines of The Code were worked out. In October 1997, the EU Council adopted the Code as part of a broader package of tax measures. The adopted package consisted of The Code Of Conduct on Business Taxation, measures to ensure the effective minimal level of taxation of income from savings, and measures to eliminate taxes on cross-border interest and royalty between companies[8]. The Code of Conduct on Business Taxation is not legally binding, but some of the tax measures covered by the Code fall within the scope of the Maastricht Treaty on state aid, on which the European Commission has some legal powers if it is considered to distort competition[9].

According to the EU's approach a coordinated action at European level is needed in order to reduce distortions to the Single Market. The fundamental aims are to prevent significant losses of tax revenue and to reverse the trend of an increasing tax burden on labour as compared with more mobile tax bases.

Tax competition is deemed welcome as a means of the welfare of citizens and the cause of the pressure from below on national consumption. However, it also has the following negative repercussions (European Commission 1997, p.2):

[8] http://europa.eu.int/comm/taxation_customs/taxation/information_notes/taxation_package.htm (29 Mar 2004)

[9] Tax breaks are recognised as equivalent to cash subsidies. The European Commission draws a distinction between state aids and general measures. General measures are not deemed to constitute aid and therefore are not controlled by Article 87 of the EC Treaty. Measures are considered general when there is no specificity in terms of sector, region or category; the eligibility for the aid is based on objective criteria, without any discretionary power of the authorities; and the measure is in principle not limited in time or by a predetermined budget (Joumard 2002, p.145).

- unrestrained competition for mobile factors can simultaneously direct tax systems in such a way as to harm employment and hamper the even and structured reduction of excessive tax burden;
- it reduces the room for manoeuvre and abidance by the other EU goals such as protecting the environment;
- tax competition can hinder the efforts for the reduction of budget deficits (as provided for by the Maastricht criteria and The Stability and Development Agreement);
- market integration, if not accompanied by tax coordination, further restricts the freedom of the member states in their choice of preferential tax regime, including the broadening of tax base as well as the lowering of rates.

In Mondorf-les-Bains, some of the economic reasons were outlined that served as the basis for the proposal of The Code of Conduct on Business Taxation. The trends in the last 15 years show an increase of tax burden on labour. The implicit tax rate (tax revenue/tax base) on the employed has increased more than 7 percentage points, while on the other production factors it decreased over 10% (capital, self-employed, energy, natural resources). Within the labour factors framework, the burden of taxation has moved onto the least qualified (skilled) and less mobile employees, while the "highly qualified" employees are highly mobile and sensitive to differences in taxation. Further, small businesses and enterprises – important for creating jobs – have been punished when compared with bigger companies that have greater opportunities for saving on taxes due to tax differences and tax competition. Tax competition is one of the important factors in shifting tax burden onto less mobile bases. High mobility rate of certain bases may force member countries to lower the taxation on such bases below the level that is considered to be desirable and necessary when compared with the raising of taxation on less mobile bases. This trend in tax regimes needs to be reversed. Researches have indicated a strong negative effect of high taxation on labour factor on the employment level and labour in Europe[10]. It is estimated that several percentage points of the current unemployment are the consequence of this raise of taxation on labour income (European Commission 1997, p.3).

While the liberalisation of capital is useful, the removal of borders on capital flows together with tax breaks and exemptions increases the opportunities for tax base avoidance; cross-border frauds affect all taxes (including consumption taxes, even though they are balanced to a greater extent than the direct ones).

It is the EU's approach that the contribution of tax policies to the EU goals should be directed towards the development of the single market. However, tax policies also contribute to the importance of taxation as a competitive factor. With the introduction

[10] On the other hand, even though a tax system can have a negative effect on the employment, there is relatively little that can be done exclusively within the tax system for the employment to rise (Cnossen 2003, p.633-634).

of a single currency (elimination of currency risks and reduction of transaction costs) the differences between national tax systems have a greater importance in making decisions on capital allocation as well as a stronger impact on the efficiency of these decisions. It is also pointed out that tax policy can contribute to the employment rise in the EU – at a time when combating unemployment is the first priority.

Besides economic, social elements also occur. If tax coordination is lacking, it poses a threat to the social dimension as well, in the form of redistributive effects on the increase of labour taxation (especially lower skills). But the most prominent is the global threat in the view of the market – because of the tax distortions effects on the single market.

Tax policies must also take into account global competitiveness of the Union and the international relations within the WTO. Globalisation and enormous international trade and capital flow increase the risk of harmful tax competition. Simultaneously, technological innovation and development of electronic trade enhance the mobility of certain forms of economic activity, especially in the sector of services and capital flow, and can increase the influence of tax differences on business decisions. The need for coordination at global level occurs – with the OECD and G7 working on it (European Commission 1997, p.6).

4. The Provisions of the Code of Conduct on Business Taxation

Prior to the description and analysis of the provisions of The Code Of Conduct On Business Taxation, it is necessary to point out that the Code is not a legally binding provision for tackling the issue of harmful tax competition. The text to be analysed may be understood as a strong political guideline for the member countries, as well as the countries concerned with this issue, whether in the respect that their tax policies encourage harmful tax competition (on purpose or to a great extent) or that they have to balance only certain areas in their efforts to join the EU.

The Code consists of ten guidelines that are to be respected for preventing harmful tax competition when creating tax legislation (tax policy) of the Union, and that should also be respected by every member country. The Guidelines are as follows: political commitment, the scope of tax measures (potentially harmful), provision and revision of information, standstill in cases of introducing new harmful tax measures and rollback of the existing ones, anti-avoidance and tax evasion, state aids, geographical extension, monitoring and annual progress reports and revision of the content of the Code (by the Council).

At the outset of the Code its political importance and the reasons for its adoption are emphasized. Potentially harmful tax measures are identified, member countries are provided with a framework within which they can follow the commitment and the

principles of fair competition, and a request is put forward for them to adopt and implement the principles and code of conduct. While recognizing the positive effects of fair competition, and the need to maintain world-wide competitiveness, the Council, in this document, also notes that unrestrained market competition for mobile forms of business threatens to cause economic distortions and to erode tax bases within the EU. It underlines its concern especially in relation to measures that deal with international finance and services activities. The Council condemns the use of tax measures that harm the common interests of the EU member countries, including the effective operation of the single market, and it accordingly encourages member states not to introduce such measures (and to roll back the existing ones).

It is evident that the Code is not legally binding for the member states and can not be sanctioned by the European Court Of Justice. The question arises – how will the guidelines for rollback and standstill be applied? Will there be sanctions against members that do introduce harmful tax measures? How to force the member countries to eliminate any established harmful tax measures? Experiences of transition economies show that political pressure was powerful mechanism on the side of EU (see section 7).

The Council has specified the term of harmful tax competition, that is to say – the specific types of tax measures that are potentially harmful. In the first place, those tax measures provide for a significantly lower effective level of taxation than that which generally applies in the EU member states (including zero taxation). It is important to point out that the low general tax rate is explicitly excluded. A more detailed evaluation of tax measures is based on the following criteria (European Commission 1997, p.7):

- whether lower tax level applies only to non-residents or in respect with transactions carried out with non-residents;
- whether tax breaks are ring-fenced i.e. isolated from the domestic market (domestic economy is in some other way excluded from providing tax advantages – so they do not affect the national tax base);
- whether advantages are granted even without any real economic activity and substantial economic presence in the member country;
- whether the rules for profit determination within multinational companies depart from internationally-accepted principles, notably those agreed upon within the OECD;
- whether the tax measures lack transparency, including where legal provisions are relaxed or changed at an administrative level.

The following guideline refers to the provision of information between member states on existing and proposed tax measures that fall within the scope of the guidelines of the Code. Any member state may seek information from another

member state on any tax measure that might show indications of potential harmful tax competition. The Council requests that a Commission coordinates the exchange of information between member states, where the states themselves have the obligation to provide the information to the Commission.

Besides information exchange, the Code establishes a working Group to be at the disposal of all member states and to discuss their tax measures. The Group will provide the basis for reviewing the effects of tax measures within the Union, and its work will provide the member states with a better assessment of the harmfulness of a particular tax measure. The Council invites the Commission to provide the organisational assistance for the work of the Group, and to oversee the process of information exchange and analysis. The Group will issue a report of the review of each measure to the Council for its consideration, and, if appropriate, for publication. The Council also emphasizes the need to assess carefully the effects of tax measures on other member states, and to respect the fact that, in so far as they are used to support the economic development of particular areas, it is necessary to evaluate the extent to which the measures are effective in achieving their aims.

Further guidelines refer to the Council's demand for the elimination of existing measures and refraining from introducing potentially harmful measures with regard to tax competition. The special emphasis is on the protection of common interest and effective operation of the single market.

The Council also stresses the importance of coordination and information exchange between member states for the purpose of preventing tax evasion and avoidance. As fundamental instruments in counteracting these problems the Council states the countermeasures contained in tax laws and in double tax treaties.

Special attention is given to the role of state aids. It has been noted that certain forms of state aids may fall within the scope of harmful tax measures. Therefore, the implementation of the Code may have practical application in reducing the need for the EU intervention in the area of taxation, and in relation to state aids. The EU Commission is expected to provide assistance in the application of state aid rules to fiscal aids and to take into account the negative effects of those aids in the light of the Code that deals with preventing harmful tax competition.

The European Union defines state aid as financial support of a particular country from its own funds to selected companies and industrial sectors, thereby influencing the trade between member countries in the form of distortion or the threat of distortion of competitiveness in the single market (Kresner-Škreb, Pleše and Mikić, 2003, p.4). State aids comprise a whole series of measures, such as: direct subsidies from the state budget, state guarantees, tax benefits, direct state capital investments, etc.

State aids can have a positive and negative effect on the overall welfare of a particular state. In case of aids to inefficient companies that produce low-quality products at high costs, the effect of state aid is negative. On the other hand, it is beneficial for the welfare and economy if the state aid is aimed at correcting the errors made by the market. However, the existence of market failures is not a sufficient reason for conducting state aid measures. It is necessary to determine whether the public sector can solve a particular problem and which form of state aid is the most appropriate in a given economic situation (particular forms of aids have different economic effects). Numerous economic effects of state aids on the economy suggest caution when resorting to such measures (more on this topic in Kresner-Škreb, Pleše and Mikić, 2003).

State aids fall under the provisions of Articles 87-88 of the Treaty Establishing The European Community. In the core of the law is the conviction of the legislator that uncontrolled favouring of particular companies and economic sectors can endanger the operation of the single market. Certain categories of state aids are, however, permitted. Those are the aids to small and medium-size businesses, for the education of the workforce and employment aid. Aids in smaller amounts are also permitted (de minimis rule- state aids to companies in the amount less than 100 000 EURO over a three-year period are considered too small to have an effect on the operation of the market).

The Council considers that in combating harmful tax competition it would be beneficial that the principles supporting fair competition be adopted as widely as possible. To this end member states are called for to promote their adoption at an international level, and in particular in their dependent or associated territories. The fact that the Code has geographical extension (applying on the territories dependent on or associated with member states) leads to the question whether it has sufficient constitutional and political power to implement changes in the legislation of local taxes in those territories.

In order to ensure the effective implementation of the Code, the Council invites the Commission to report to it annually. In addition, the Council will review the provisions of the Code when it has been in operation for two years. The purpose of this decision is to consider extending the guidelines of the Code onto general tax business regimes of member states in the areas where the taxation level is significantly below the EU average (European Commission 1997, p.11).

There is another unknown factor related to the effects of the adopted guidelines. Instead of tax competition in the form of particular tax measures, there is the option for competition on the basis of nominal and effective tax rates. If deprived of the freedom to introduce special tax regimes to attract mobile capital, the countries may go for the reduction of general corporate tax rates. Therefore, the Code might have an effect that is contradictory to its original purpose – combating the "race to the

bottom" of corporate tax revenues in the EU. This could lead to the situation where the revenues based on business taxation may end up being smaller than they would have been without the Code.

The Code of Conduct represented a strategy for eliminating the possible distortions of internal market by harmful tax competition. It is already stated that Code is based on peer political pressure. This pressure has strongest influence on new member states – they are hurriedly adjusting their tax system according the EU legal and political propositions eliminating harmful tax incentives and reducing tax rates[11].

It is useful to compare Code of Conduct with model of eliminating tax competition of OECD. It's already mentioned that scope of the Code of Conduct is wider than that of the OECD model. The OECD guidelines (1998) are clearly limited to financial and other service activities, whereas the Code looks at business activities in general, although with an emphasis on mobile activities. On the other side OECD is geographically more extended. Area of indirect taxation and direct taxation on individuals are not included in both documents. Also, Code of Conduct is part of package of measures whereas the OECD guidelines are accompanied by 19 detailed Recommendations relating to the specific issues of harmful tax competition. Great deal of attention within the OECD report is focused on tax havens.

Although, documents are very similar, it is necessary to adduce few differences. In OECD report (1998) as criterions to identify harmful tax measures, among other, are explicitly indicated: no or only nominal taxes and certain economic indicators. These criterions are only implicitly stated within the Code. Furthermore, lack of effective exchange of information (banking secrecy legislation) is not substance of EU document. This matter is covered by other regulations. On the other side, within the OECD model the need for the enhancing of information exchange about the contents important for taxation is stated. It is important to mention that OECD and EU in creating the model to fight against harmful taxation start from different positions. EU has much more arguments in demanding the elimination of harmful taxation within its members and accession countries. By entering in EU, countries loose part of their sovereignty. On contrary, there is a question of how far can OECD go in imposing restraints on its members and other countries mentioned within OECD reports (especially tax havens).

5. Progress in Combating Harmful Tax Competition

The "Code of Conduct Group" or "Primarolo Group" has made current estimates on the basis of the Code framework (the report was submitted to the Council on 29 November 1999). Of the eighty tax measures that were singled out as possibly

[11] More on that matter in section 7

harmful (and listed in November 1998), 66 were evaluated by the Group as harmful, out of those 40 in the EU member countries, three in Gibraltar and 23 in dependent or associated territories (former colonies of certain member countries). With 10 harmful tax measures the Netherlands is the top-ranked country in the EU.[12]

On 27 November 2000 the ministers of finance of the EU member countries agreed that harmful tax measures should be effectively abolished by 1 January 2003, while individual harmful arrangements (relative to individual companies) which were estimated on a case-to-case basis, can be continued until 31 December 2005.

With regard to the EU policy towards state aids, somewhat longer coordination deadlines are applied. Accordingly, in June 2001 and February 2002 the Commission held sessions to consider the member countries' state aid policies, placing emphasis on several preferential regimes. In a particular political agreement, the Council permitted the prolongation of preferential treatment for the mentioned regimes as late as 2010/2011 (Belgian coordination centres, 1929 holding companies in Luxembourg, Dutch finance companies and the Madeira free-trade zone). (ECOFIN Council, 2004).

6. The Effects of Harmful Tax Competition

In order for it to function efficiently, global economy needs acceptable rules as a conduct guide for the countries and for the business sector. Such a framework can help the business sector in transferring the capital to locations where it can optimise its rebates without threatening the national governments' goals of realising legitimate expectations of their citizens for a proportionate share in the costs and benefits of globalisation. From the viewpoint of economic theory it could be asserted that tax competition is the result of numerous economic processes, its consequences therefore being numerous as well. Only some of these shall be mentioned below.

A potential consequence of tax competition (which is not coordinated) is the attraction of foreign investments by countries with increasingly lower taxes. This could be seen as the so-called "race to the bottom" which can ultimately lead to the lowest possible level of public goods offered by the country in question. It is the point at which fair tax competition turns into an unfair one and where total tax revenues become too low for the authorities to finance the sustainable and sufficient level of public services.

According to some studies, FDIs are very flexible to tax rates applied in business taxation. On average, if a country reduces its average corporation tax rate by 1% it attracts FDI to the amount of 3.3% (Mooij deRuud and Ederveen Sjef, as taken from

[12] http://europa.eu.int/comm/taxation_customs/taxation/law/primarolo.htm (28/04/2004)

Meussen, G., p. 7). Gorter and Pankh (2000, as taken from Cnossen, 2003, p. 638) have determined that such a reduction amounts to 4.3 %. There is a considerable variation in the elasticity of investments here depending on the type of investment that the tax rate refers to. The effective tax rate must be taken into consideration since it also includes aspects of tax incentives or reliefs, such as accelerated depreciation, tax alowances, tax credits and the like. What will be inevitable in the future is at least the minimal level of harmonisation of tax base employed in business taxation.

It is necessary to stress the importance of agreement on the minimum and maximum levels of corporation tax rates, although this idea has found little support in Europe. Corporation tax has only a moderate role as compared to total tax revenues. According to the OECD statistics, corporation tax of European countries, OECD members, in 1999 stood at the level of about 8.2% (OECD, 2001, p. 69) of their total tax revenues. Therefore, value-added tax and income tax have a much greater influence on the internal EU market. However, it cannot be denied that the corporation tax is a significant factor when selecting a business location. Harmonisation at the level of the Union, which still allows the member countries to make the decision on tax rates, will in the long term lead towards the decrease in the differences between nominal tax rates in Europe.

In addition, tax competition and the interaction of tax systems can have effects that some countries may view as negative and others as positive. For example, one country may view investment incentives as a policy instrument to stimulate new investment, while another may view investment incentives as diverting real investment from one country to another. Countries with specific structural disadvantages, such as poor geographical location, lack of natural resources, etc., frequently consider that special tax incentives and tax regimes are necessary to offset non-tax disadvantages, including any additional cost from locating in such areas. Similarly, within countries, certain regions often experience difficulties in promoting their development and may, at certain stages in this development, benefit from more attractive tax regimes and tax incentives for certain activities. Although the international community may have concerns about potential spillover effects, these decisions may be justifiable from the point of view of the country in question.

Harmful effects may also occur because of unintentional mismatches between existing tax systems, which do not involve a country exploiting the interaction of tax systems to erode the tax base of another country. Such phenomena, however, may be exploited by taxpayers to the detriment of both countries. The undesirable effects of such mismatches are dealt with by unilateral or bilateral measures (OECD, 1998, p. 15).

Tax havens or harmful preferential tax regimes that drive the effective tax rate levied on income from the mobile activities significantly below rates in other countries have the potential to cause harm by (OECD, 1998, p. 16):

- distorting financial and, indirectly, real investment flows;
- undermining the integrity and fairness of tax structures;
- discouraging compliance by all tax payers;
- re-shaping the desired level and mix of taxes and public spending;
- causing undesired shifts of part of the tax burden to less mobile tax bases, such as labour, property and consumption; and
- increasing the administrative costs and compliance burdens on tax authorities and taxpayers.

So far the focus was on the countries whose taxation policies caused difficulties. To a certain degree, countries may protect themselves from the negative effects by modifying their own tax regulations.

In the OECD reports it is stated that the available data do not permit a detailed comparative analysis of the economic and revenue effects involving low-tax jurisdictions. It has also proven difficult to obtain data on activities involving preferential tax regimes, given the problems in separating their effects from aggregate data in countries with otherwise normal tax systems, and the fact that such regimes often are non-transparent. However, the available data do suggest that the current use of tax havens is large, and that participation in such schemes is expanding at an exponential rate. For example, foreign direct investment by G7 countries in a number of jurisdictions in the Caribbean and in the South Pacific island states, which are generally considered to be low-tax jurisdictions, increased more than five-fold over the period 1985-1994, to more than $200 billion (OECD, 1998, p. 16).

According to the OXFAM[13], the losses of profit by developing countries due to the effects of tax competition and non-payment of tax through capital flight amount to a minimum of US$50 billion annually (OXFAM, 2000, p. 2). The influence on developing and transition countries is enormous, taking into account the problems of these countries when it comes to capital accumulation (countries need to finance their ongoing and major expenses on financial markets rather than from their own tax revenues). Another problem lies in the fact that small and medium-sized businesses are positioned unfairly when compared with multinational companies. Preferential tax regimes favour big businesses, whereas smaller ones cannot benefit from the advantages of such regimes[14]. In contrast, the tax burden on their business activities is even greater due to the decrease of state revenues. All of the stated above stresses the question of income distribution since tax competition permits the exemption of the wealthiest social classes from socio-economic obligations.

[13] The Oxford Committee for Famine Relief (the international NGO, dealing with matters of economic development, aid and promotion)

[14] one of the best examples are the benefits for large investments in Croatian corporation tax

Furthermore, the question arises of sovereignty and principle of extra-territorial enforcement of another country's tax system. It means the complete destruction of privacy as a social value, notwithstanding its status as a human right under some constitutions (e.g. in the U.S.A.).

The argument that tax competition is harmful rests on the assumption that the production factors – labour and capital – are fixed in their total worldwide supply. The increase in national welfare is influenced by the shift from the taxation of mobile bases onto the immobile ones. In accordance with Ramsey's principle of efficiency – greater taxation of those goods that are less elastic in supply, the models used in developed countries are based on the assumption of a fixed worldwide supply of capital. In that case, their conclusions are valid. However, when one starts from the premise that the world supply of capital is not fixed, but rather that it depends on the net rate of return, the conclusions change. If all countries increase the tax burden on capital income, the world accumulation of capital is reduced and economic growth will slow down.[15] The conclusion would follow that the optimal tax rate on capital income from all sources amounts to zero.

7. Tax competition and transition economies

After successfully growing from 6 to 25 members, the European Union is now preparing for the next enlargement. As regards the 3 remaining candidate countries, Bulgaria and Romania hope to join by 2007, while Turkey is not currently negotiating its membership. Negotiations between Croatia and European union are expected to start during the year 2005.

Criteria's that have to be fulfilled in order to become a Member state of the European Union are determined on meeting of European Council at Copenhagen on June 1993. According to them the prospective member must[16]:

- be a stable democracy, respecting human rights, the rule of law, and the protection of minorities;
- have a functioning market economy;
- adopt the common rules, standards and policies that make up the body of EU law.

Issue of tax competition regarding the transition economies (new Member States and candidates for accession) is in the scope of last two criteria – economic and political. The Code of Conduct for business taxation represents a political commitment by

[15] For a more detailed account of the mentioned model of optimal taxation see in Dwyer, 2000, p. 57

[16] http://europa.eu.int/comm/enlargement/enlargement.htm

Member States to tackle potentially harmful tax measures. They are committed to not introducing new tax measures which are harmful within the meaning of the Code and to examine their existing laws and practices with regard to the principles of the Code and to amend them where necessary as soon as possible. Concerning the State aid, the EU rules concerning limits depending on the companies' size (up to 50% of the eligible investment costs for large companies and up to 65% for small and medium-sized enterprises) should be taken into account.

EU Commission agreed that some transitional periods limited in time could be accepted, insofar as the impact on competition or on the internal market was considered to be limited, and a social need for candidate countries was clearly demonstrated[17]. In considering whether transitional measures could be accepted, the consideration was taken for need to safeguard the proper functioning of the internal market in the field of taxation, as well as the political, economic and social implications for the candidate countries.

Granting tax incentives was a common policy in the new member states for attracting foreign direct investments.Majority of these tax incentives include (see Jacobs et al., 2003.):

- accelerated depreciation and tax-free reserves (reductions in taxable income)
- tax free investment reserve (reduces the taxable base in addition to regular depreciation, which results in a higher tax relief overall)
- in some countries, reduced tax rates are available for investments in special economic zones, or they are offered generally to foreign investors
- some countries grant tax holidays if certain conditions are fulfilled[18]
- some of the new member states allow crediting part of the amount invested against the company's tax liability (tax credit) if certain conditions are fulfilled.

Some of the major tax incentives are presented on table below. Majority of incentives that were considered harmful from the EU point of view were already abolished. For the rest of the incompatible tax incentives (with the propositions of EU Treaty) transitional period is given. Results of the political pressures are obvious – in medium term there will be no harmful tax measures left within tax system of new EU members. This is certainly proof of power of political and legal arguments of European Union and also important indicator for Croatian behaviour regarding the tax competition policy.

[17] http://europa.eu.int/comm/enlargement/negotiations/chapters/chap10/index.htm

[18] A tax holiday means that a company is exempt from taxation for several years. Therefore, a tax holiday can be classified as a tax rate reducing incentive over a certain number of years.

Table 1: Tax incentives in new EU member countries

Country	Reduction in Taxable Income	Reduction in the Tax Rate
Cyprus		- 4,25% for international business companies – can be continued for a transitional period of three years (from year 2003 to 2005)
Czech Republic		- for newly established enterprises, income tax relief for a period of 10 years equal to the amount of their tax liability - for existing enterprises, income tax relief for a period of 5 years equal to the amount of the increase in their tax liability as compared to the higher tax liability of the previous 2 years
Estonia	- dividends distributed to a parent company in an EU Member State cannot be subject to any withholding tax at source. This includes deferred corporate income tax charge triggered at the level of Estonia companies when dividends are distributed – transitional period was given until 1 December 2008 to amend for incompatible legislation.	
Hungary		- Hungarian offshore regime (introduced in 1997.) The profits of Hungarian offshore companies[19] are subject to 3% (4% as of 2004) corporate income tax. This regime has been attacked by the OECD and classified as a potentially harmful by Code of Conduct for Business Taxation Committee. It was also qualified as incompatible State aid. Entire offshore regime must be phased out by 31 December 2005. - 10 year tax holidays already granted may not be utilized after 2001. SMEs may utilize them until 2011, provided that they do not participate in transformation and other entities may utilize already granted incentives subject to serious imitations, which try to eliminate the major concern of the EU i.e. that they are not determined as a percentage of the investment costs, but apply to the overall profits. The repealed incentives are replaced by a new tax credit for the promotion of development, approved by the EU. Namely, it is in accordance with the Commission opinion that a tax incentive is more transparent if given in the form of a tax credit or a reduction in the tax rate. EU approved also investment tax credits for SMEs (for interest paid and new capital assets.
Latvia		- free-port and special economic zone regime – considered legitimate until the Latvia's average standard of living attains 75% of EU average
Lithuania	- for certain groups of fixed assets, accelerated depreciation or amortization is possible	- company registered in a free economic zone are not obliged to pay corporate income tax for 6 tax years, and for 10 following tax years the corporate income tax rate applicable to the company will be reduced by 50% (only for companies that generate at le

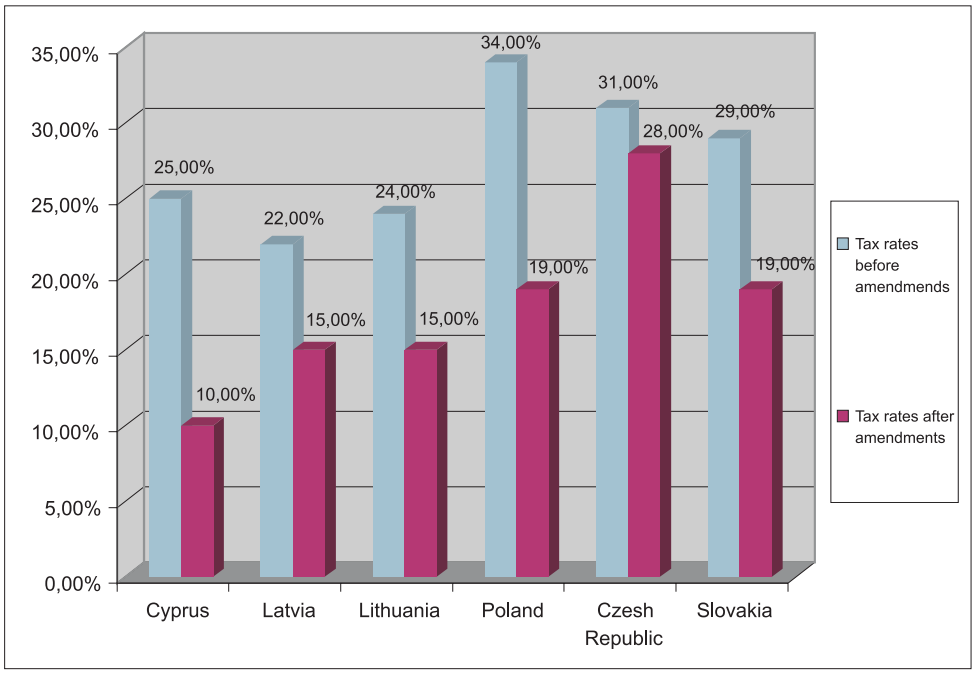
[19] Other companies are taxed by nominal corporate income tax rate at 16%

Malta	- an investment tax credit amounting to 50% of capital expenditure (65% in case of SMEs)	- reduced tax rate of 5% for first seven years of operation, followed by a 10% tax rate for the subsequent six years and a 15% tax rate for the next five years – termination of these tax incentives is scheduled by the end of 2008.
Poland	- accelerated depreciation in respect of certain fixed assets is allowed	- tax holidays in special economic zones in Poland are declared inappropriate, according to both the Code of Conduct and State aid. For small/medium sized enterprises they will last up to 2011/2010 and for large companies up to 2006 and up to different aid (investment costs) ceilings. Under the new regime (2001) the exemption from income tax is 50% of qualifying expenditures and 65% for SMEs.
Slovak Republic		- tax holidays for FDI (will be abolished in 2007) are under transitional provisions approved by the state aid. New tax credit for the "strategic investors" is introduced.
Slovenia		- preferential tax treatment is guaranteed until 2010 to companies operating in two special economic zones. The benefits include a 10% corporate income tax rate on income derived from activities carried out in the zones

Source: IBFD: The EU Accession States Tax Memo, Amsterdam, (2003). and European Tax Handbook (2004)

During the negotiations with accession countries, EU commission in checking potentially incompatible taxation in terms of Code of conduct used framework already applied on tax systems of EU-15. Negotiations are considered as successful – on 27 of 30 potential regimes that were found like potentially harmful accession countries agreed on their abolishing. In spite of these successes, on the other side, "old" EU members are concerned by fact that corporate income tax rate in new member countries is much lower. In 2003. average tax rate in accession countries was 20,5% and in old members (EU-15) 29,8% (Jacobs, H. Otto et al., 2003). Governments of the "old" EU members fear that EU enlargement will stimulate tax competition due to efforts of attracting the FDI. Trend in new members is in further reducing the corporate income tax rates (see graph 1). This situation could trigger the same process in old EU countries – that is the case in Austria where corporate income tax rate is planed to reduce on 9%.

Figure 1: Recent reduction in corporate income tax rates in new EU members



Source: Wiener, Joann M.: Bojazan u EU od porezne konkuencije novih država članica, Porezni vjesnik, Ministarstvo financija, 11, 2004., p. 58-67

Mobility of capital and labour is important element for determining the effects of tax competition on economy. While labour mobility has remained quite limited throughout the region of transition economies, some countries have been able to attract significant capital flows, mainly in the form of FDI (EBRD, 2003.). Due to effects of war, Croatia had some different position than EU new member countries. Consequences consist of later integration on international financial markets and regions more affected by war activities. This resulted in reduced influence of tax incentives on attracting foreign investments and limited mobility of labour and capital due to political, financial and economic circumstances. This situation emphasised more other factors of economic activity. Also, it is doubtful how much success in attracting of FDI belongs to tax incentives in Croatia. Rather high FDI[20] in comparison to new EU members can be explained by structure off these investments. The foreign investors were focused on highly profitable economy sectors – reduction of the tax burden was not primary factor of investment location. With improving the overall economic conditions tax matters came to focus. In following section,

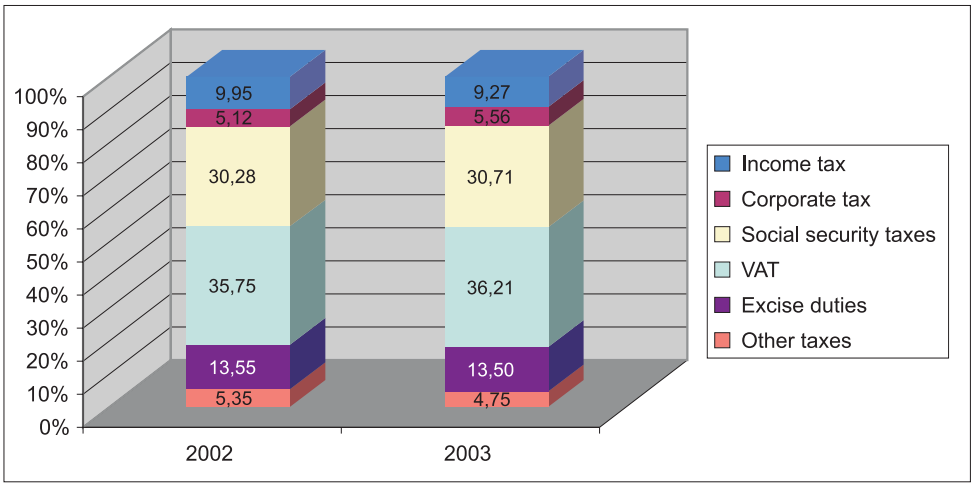
[20] FDI mainly comes from privatisation, "green-field" investments are rare.

incompatible elements of Croatian tax system with propositions of EU Treaty and Code of Conduct are analysed.

8. Croatia in the Context of Harmful Tax Competition

The Republic of Croatia, as a candidate country for the admission into the EU, should devote special attention to the guidelines of the Code of Conduct for Business Taxation. Experience of the EU new member countries show that provisions that contravened the guidelines given within the Code were either abolished or EU gave some transitional period for their elimination. This situation denotes high level of political pressure towards the prospective candidates for entering the EU. These countries are not in position to preserve tax incentives that are considered harmful by EU Commission. Therefore, in this section we shall analyse the legal provisions in Croatia which refer to business taxation and are potentially harmful in terms of market competition.

Figure 2: Structure of the tax revenues of general government budget for the years 2002 and 2003



Source: Ministry of finance (2004)

Before analysing potentially harmful tax measure within the Croatian economy it is necessary to shortly describe some details on Croatian tax system. The structure of the tax revenues of Croatian general government budget for the year 2002 and 2003 can be seen at graph 2. The fiscal importance of particular taxes is presented. Corporate income tax and direct taxes in whole take low share of total tax revenues. This figures show that elimination of certain incentives will not present significant

trade-off in terms of losing budget revenues. Even reducing the nominal tax rate of corporate income tax should not have significant economic and fiscal effects. Although, the reduction in the effective corporate income tax rate from the beginning of 2005. from 32% to 20% is rather significant.

Because harmful tax competition has its roots mostly within the provisions of corporate income tax, it is useful to describe model of the Croatian corporate income tax in short lines. All of the provisions of corporate income tax equally relate on residents and non-residents. Basically, there are three time periods where model of corporate income tax differs. From its introducing to Croatian tax system till the year 2000 nominal tax rate was set up at 35% and there was no withholding tax paid on dividends and profit shares. From the year 2001 to 2004 nominal tax rate was reduced on 20% but withholding tax on dividends and profit shares is introduced at rate of 15%. Effective corporate income tax rate was 32%. Finally, as it was mentioned, from the year 2005 withholding tax is abolished and nominal tax rate remains at 20%. Taxation of dividends and profit shares was argument in purpose of stimulating reinvestments from the profits of companies. Recent changes are guided by efforts towards simplicity and relaxation of tax burden onto the economy. Some consequences will be analysed further bellow.

Tax measures that are potentially harmful or whose features are those of (harmful) state aid[21] can be noticed through legal regulations by which foreign investments in the Republic of Croatia are arranged. The Company Law, the Investment Promotion Law, the Corporation Tax Law, the Income Tax Law, the Areas of Special State Care Law, the Free Zones Law and other laws regulate this area. Special attention should be paid to state aids.

We should primarily mention the provisions formally marked as "investment incentives" (although different elements of the corporate tax system, either through tax relieves or through specific lowered rates, and even lower general rate may be considered as tax incentives). The very important positive fact is that both foreign and domestic investors are treated equally when it comes to investment incentives.[22] We are dealing here with the so-called "tax holiday" – tax exemption or lower tax rate for newly established businesses (additionally conditioned by the size of the investment and the number of employees). In addition, it should be stressed that this measure, as is usual for tax holiday, is time-restricted (10 years) for all users. Each of the measures mentioned above deviate from the criterion of 'generality' of the measure. It should also be noted that large businesses are thus favoured and put in a

[21] As was already stated in section 3, some of the tax provisions of the Code also fall under the scope of the Maastricht Treaty on state aid whose criteria are even more strict than those in the Code

[22] As opposed to the legislation in the late 1980s and early 1990s where the corporate tax rate paid on foreign investments was two times lower, which was typical of other transition countries as well. This could certainly be evaluated as negative from the point of view of "harmful tax competition".

better financial position than the smaller ones.[23] Furthermore, if we assume that domestic businesses are of fewer financial resources and of insufficient capital, especially for additional investments of greater proportions, we can infer that there is a possibility of foreign investors indirectly receiving a preferential treatment. Here then we are dealing with sector support (see also Škreb, Mikić, 2003, p. 126).

Other benefits within the Corporation (and Income) Tax Law need to be pointed out as well, such as benefits for taxpayers from the areas of special state care, mountain areas and benefits and exemptions for taxpayers from the City of Vukovar. The said benefits are typically those of regional character, time-restricted to ten years and applied for taxpayers that employ more than five employees (50% of them have to be residents). Taxpayers of City of Vukovar are tax exempt. Taxpayers within mountain areas have to pay 75% of the corporate income tax rate. Areas of special state care consist of three groups. First group is tax exempt. Taxpayers within second group pay 25% of the corporate income tax rate. Residents of third group have to pay 75% of corporate tax income.

Finally, accelerated depreciation (immediate expensing (write-off) included) and the latest research and development tax allowance should also be accentuated. The accelerated depreciation and immediate write off are limited to the following categories – "equipment" and "commercial premises", as well as immaterial property used in research and development, but definitions of these categories are rather broad. Recent amendments within the Corporation Tax Law eliminated immediate write-off but the possibility of accelerated depreciation remains.

As already was stated, one of the changes within the Corporation Tax Law relates on withholding tax, on dividends and profit shares. Tax rate on withholding corporate tax and tax rate on income of dividends and profit shares set up at 15% was eliminated. It is important to mention that certain jurisdictions are considered as tax havens because of exemptions or reductions of withholding tax rates (these are applied on their residents on the basis of double taxation treaties). In this way final taxation of income on dividends and income shares in Croatia that is paid to non-residents will depend on fact whether or not Croatia has signed double taxation treaty with particular economy (and on terms within the particular contract). From now on, residents of Croatia that invest in foreign countries which haven't signed treaty on double taxation with Croatia suffer heavier tax burden in compare to residents of Croatia that invest in countries that have signed this treaty with Croatia and also non-residents that invest in Croatia.

Effects of abolition if withholding tax are in scope of international double taxation issues. There are different models of avoiding double taxation but the majority of

[23] The benefit itself has its quantity (value) limit: the amount of the investment

countries use model developed by OECD[24] (Croatia too). There are several methods comprised in mentioned model and each of them has different effects in terms of tax revenues and incentives for investments. Exemption method is focused on resident tax base – excludes foreign incomes and profits from domestic tax base. It has two variations – full exemption that entirely eliminates taxation of foreign based income and profits and exemption with progression when foreign income is only used to enlarge taxable base for the purposes of progressive taxation. Credit method consists of deducting the tax paid abroad on foreign income from the tax that resident has to pay according to his worldwide income. There are also two variations. Full credit denotes that entire amount of foreign tax is deducted from the total tax liability of resident. By application of ordinary credit method tax paid abroad is deducted from the domestic tax liability but only to the maximum amount of domestic personal or corporate income tax. Reduction of tax revenues and tax burden for taxpayers will depend on the method for avoiding double taxation applied in particular country. From the perspective of Croatian tax system it would be optimal that country of foreign investor uses exemption method. In this way income of foreign residents in Croatia is taxed only by corporate income tax in Croatia. On the other side, if the foreign country uses credit method tax difference between the tax liability in foreign country (on the bases of worldwide income) and corporate income tax liability in Croatia will accrue to tax revenues of foreign country. In that way, there is no tax incentive for investors in Croatia and tax revenues that would otherwise belong to Croatia (in case of taxation of income from dividends) are given to foreign country. Advantage is only present due to deferred taxation because taxpayers have to pay for their liability later. Same effects are engaged in case of investments of Croatian residents abroad. Of course, non-compliance or transfers over certain country with preferential tax regime (tax heaven) are possible options – there are different countermeasures of the international tax planning by which this could be partly or completely eliminated.

Similarly to other transition countries, Croatia too has established free zones. Thirteen free zones with certain privileges have been created in total. Their users can be both domestic and foreign persons under completely identical terms, including tax benefits. However, the exemption from corporation tax on investments over 1 million Kuna has a time limit (5 years) and a value, i.e. amount, restriction (up to the amount of the means invested). Taxpayers within free zones on the area of the county of Vukovarsko-srijemska are tax exempt for period of ten years. Government of the Republic Croatia can approve further tax incentives in case of economic interest for particular zones or for the purposes of stimulating certain activities.

By signing the Stabilisation and Association Agreement, the Republic of Croatia has made a commitment to harmonise its legislation concerning the regulation of state

[24] Model tax Convention on Income and on Capital

aids in accordance with the provisions of the Treaty Establishing the European Community. The State Aids Act took effect in April 2003 (N.N., 47/2003). Its provisions are very similar to those of the mentioned EU document. Under the law, the Agency for the Protection of Market Competition should manage the state aids programme. However, the EU Commission evaluated that the said Agency is not fully functional, and the presence of economic transactions is still very high and takes the form of implicit subsidies, sponsored contracts and guarantees. Additional problem is in limited data on the use of state aid very low transparency in the Croatian economy. There are no reliable state aid inventory. This inventory is crucial for determination of compatibility of certain state aid with provisions under Article 87 of the EC Treaty.

In order to fully comply with the EU aquis in the State aid field, Agency for the Protection of Market Competition must be entitled to authorize state aids. At the moment, within the Law, it is regulated that Agency has to give opinion on particular aids. In case of state aids that were given in contrary of regulations, Agency suggests returning of funds given by these aids. Instead of that, the Agency should be given a credibility of enforcement and control of the state aids. Of course, this improvements demand higher administrative capacity and additional funds – in order to monitor and control state aid schemes it is necessary to obtain all the information about proposed aid projects from aid granting bodies.

Within the State Aid Act, especially problematic is Article 4. Although, it explicitly denotes that state aids that distort competition in the internal market are not permitted, there are some exceptions mentioned. Among those, state aids that facilitate the development of certain economic activities or of certain economic areas are not compatible with the EU legislation and have to be amended. It is not clear on what activities this provision relates but it should be applied only for exceptional circumstances.

Finally, it can be concluded that Croatian tax system conforms to the EU harmful tax competition guidelines. There are deviations only in minor scale. Positive fact is that these potentially harmful measures can be easily amended and elimination of these measures does not represent significant trade-off in terms of budget revenue losses. Some of the most portentous questionable measures are accelerated depreciation, tax holidays, some provisions within the State Aid Act and position of established free zones. On the basis of experience of recent EU members, during the negotiation process some transitional period for abolishing these measures will be given.

9. Conclusion

Harmful tax competition is a negative consequence of the globalisation process. Attempts are being made to eliminate it through global initiatives of international

organisations. It poses the biggest threat on the budgets of developed countries since they are the most liable to harmful effects due to their supply of capital.

Accordingly, the EU has produced a document entitled "The Code of Conduct On Business Taxation" which contains guidelines for the abolishment of harmful tax regimes and tax measures on the territories of member countries and their dependencies. It is doubtful whether these efforts of the EU will bear fruit since the implementation of the model itself is accompanied by numerous difficulties. A lot of criticism is directed at the initiatives of the EU and the OECD concerning the justifiability of the combat against harmful competition (from the point of view of economic theory, but also from ethical and other criteria). In addition, the complexity of the issue has influenced the fact that the drafted documents that regulate tax competition are not legally binding.

When the Republic of Croatia is considered, foreign and domestic investors are equal in their rights in terms of investment benefits, which is a positive fact from the Code criteria viewpoint. Still, certain elements of state aid in tax benefits and incentives are found as well. The amendments of certain provisions within the Free Zones Act, Investment Promotion Act, Corporate Tax Act and State Aid Act will be necessary. It only remains to see if the improvements will be applied before entering the negotiations with EU accession or will be demanded by EU Commission.

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Štetna porezna konkurencija u EU uz osvrt na Hrvatsku

Saša Drezgić[1]

Sažetak

Proces globalizacije vodeo je i do šteten porezne konkuencije. U radu se razmatraju naporu u okviru EU u borbi protiv štetne porezne konkurencije (Kodeks ponašanja pri oporezivanju poduzeća) i njihovi učinci uzimajući u obzir i regulativu EU u vezi državnih potpora. Teško je dati konačan odgovor o uspjehu borbe protiv štetne porezne konkurencije, s obzirom na mnoge probleme u implementaciji Kodeksa, te mnoge kritike u pogledu opravdanosti borbe protiv štetne porezne konkurencije.

U svjetlu navedene problematike analizira se hrvatski porezni sustav, prije svega porez na dobit. Ističe se prednost jednakog tretmana domaćih i stranih ulagača, ali i određeni elementi državnih potpora u poreznim olakšicama.

JEL klasifikacija: *H21, H26*

Ključne riječi: *globalizacija, štetna porezna konkurencija, učinci, Hrvatska*

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