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## The Legal Aspect of the Tax Competition in EU: Case of Kosovo

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**Abstract:** The aim of this paper is to analyse the tax competition -fiscal competition within the EU Member States. The complexity of the tax competition concept in the EU will be addressed in two dimensions: the impact of tax competition on the growth of foreign investments and the increase of revenues that preserves the neutrality of common market. In the case of the functioning of tax competition, the Kosovo tax system will be compared to the tax system of the EU. Compilation qualitative methods, individual case study methods, and normative analysis methods were applied in this study. From the results of the treatment one may notice that through increased tax competition, the attractiveness of their tax systems increases automatically through the provision of lower tax rates that may result in foreign investment inflows. Given that resident and non-resident persons within the jurisdiction of a State have equal treatment from a fiscal point of view. It is concluded that the principle of neutrality is fully implemented in the EU Member State and those that express aspirations for joining the EU. The current changes in the tax system of Kosovo, made the system more competitive within the EU area.

**Keywords:** Kosovo; Tax Competition; Tax Harmonization; Tax System.

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### INTRODUCTION

One of the main determinants of the economic development of each state is the structure of its taxation. A State through its tax structure, presents the manner of fiscal treatment of residents and non-residents within its jurisdiction. Thus, the reform of tax systems should be in harmony with economic trends.

Practically, the harmonization of the of tax systems is not always a harmonic process. The harmonization is a complex process, as there may be different interpretations. The effect of the tax structure of a country on its economy depends on the various factors such as: level of economic development, per capita income, number of inhabitants, etc. However, trans-frontier transactions, integration and free movement of people, goods, capital and services have made to take unilateral measures to harmonize their tax systems. An influencing factor for tax harmonization is the competitiveness of tax rates within States for attracting foreign direct investment.

Nowadays, significant changes are made in dealing with tax harmonization in

the spectrum of international tax law and not just within national legal systems. Moreover, if a tax system remains unchanged for several decades despite regional or global economic changes, it loses market competition-

In adopting national tax systems, fair competition is one of the EU's main objectives. In 1996, the European Commission document on taxation issues in the EU, a proposal for a package of measures designed to curb harmful tax competition, approved by the Council of Ministers of Economy and Finance (ECOFIN). Also, the ECOFIN established a high-level group on taxation issues within the EU area. That was chaired by the Commissioner for tax matters and the common market, Mario Monti. This group aimed to report on tax system developments within the EU, the group also considered the need to create an appropriate tax environment. Enhancing the economic activities and creating a suitable environment for multinational companies to increase their market sharing<sup>1</sup>. The data presented in this report were published by the EC with the title Taxation in the European Union, the report on tax system development (1996).

According to the report:

1. Financial-tax sovereignty is a major part of state sovereignty
2. Any action in the field of taxation should be based on the principles of subsidiarity and proportionality.

In order to eliminate financial barriers, it is imperative to take the necessary measures from the EU to harmonize tax systems and to safeguard free trade development conditions based on free competition

<sup>1</sup> Patterson and Serrano, *Tax Competition In The European Union*, Luxembourg: European Parliament, 1998, p14.

rules.<sup>2</sup> In order to increase and develop the common market economy, one may reduce tax losses in EU area and design a tax structure that will lead to employment growth.

In general, there is a demand for a more convenient tax system:

1. Companies are looking to reduce tax rates in order to be able to carry out the economic-financial activity;
2. At those countries that the rate of tax is low, the unemployed may get better. Therefore, the tax burden is shifting preferential tax systems.
3. Small companies are in the disadvantage in choosing fairer competition and they are not able to shift to a jurisdiction that provides the most appropriate tax system due to their lack of capital. Many EU member States (Germany 15, Romania 16%, and Slovenia 19%) have applied lower tax rates of Corporate Income Tax (CIT) and Personal Income Tax (PIT). In the cases of unfair tax competitions, conflicts arise between EU member capital States. However, increasing coordination among the member States is *conditio sine qua non* to take concrete steps to help create and maintain employment thanks to a co-ordinated approach in the field of taxation.

The 1997 proposal for addressing the harmful tax competition, called the Monti Package, included the following measures<sup>3</sup>:

1. Code of Conduct for Business Taxation and State Aid Budget Package prepared by EC;
2. Measures to eliminate obstacles affecting the collection of capital income tax;

<sup>2</sup> The Commission of the European Communities. "Communication from the Commission to the Council and the European Parliament: A package to tackle harmful tax competition in the European Union," COM (97) 564 final (November 1997) [hereinafter: COM (97) 564 final (November 1997)], p5.

<sup>3</sup> COM (97) 564 final (November 1997). *Note 2*, p6.

3. Measures for the elimination of source tax on cross-border interest payments and royalties between companies;
4. Design of measures to eliminate harmful and unfair competition in the field of indirect taxation;

Code of conduct for business taxation - is yet soft law i.e. has no direct legal effect, although it has a significant role in setting a standard of desired behaviour.<sup>4</sup> The code is considered the key factor in this package. Under this code, member States are obliged to respect the rules on free competition and to avoid the application of harmful tax measures that hinder the operation in the common market.

Measures to eliminate barriers to collect a tax from Capital is considered as a highest mobility characteristic considering the possibility of capital movement (money, labour, etc.) from one country to country, directly affects the level of public revenues collected from taxation. Therefore, taking measures to eliminate barriers within the common market was more than indispensable.<sup>5</sup>

Measures to eliminate withholding taxes on cross-border interest and royalty payments between companies, therefore, the EC sought a compromising model among member States, which should be based on several principles. The model should be built upon several factors, such as<sup>6</sup>:

1. Finding a suitable and common solution for all Member States, in the form of a directive on tax treatment in terms of taxation.
2. The provided solution limits the payment of interest to non-resident persons

in the jurisdiction of a certain member state.

3. Under the EC proposal, a Member State must accept a model called a co-existence model in order to ensure taxation of non-resident savings income.
4. This model should provide a measure to ensure the tax competition in EU markets in relation to global economic markets.
5. The elements for an EU solution to the taxation of income from savings and an agreement to eliminate withholding taxes on interest and royalty payments between companies.
6. In cases of non-exchange of information between the Member States in this case source tax on interest, the respective State shall apply a minimum rate of tax at the source which is considered sufficient for cross-border savings.
7. The measures to eliminate harmful and unfair competition in the field of indirect taxes - came as a result of the divergence between the EU member states in the application of the common transitional Value Added Tax (VAT) system.

## RESEARCH METHODS

The methodology of these researches is based in normative, comparative and legal methods.

### The development of the “phenomenon” of tax competition

Although the phenomenon of tax competition is called fiscal competition between States, it is not considered a new phenomenon, but rather a phenomenon that has arisen along with the legal arrangements of States. Each State claims to offer a more attractive tax system than other States do. The attractiveness of their tax systems is enhanced through the provision of lower tax rates, which encourage the flow of foreign invest-

<sup>4</sup> Weber, Dennis (ed), *Traditional and Alternative Routes to European Tax Integration*, Amsterdam: IBFD, 2010, p5.

<sup>5</sup> Weber, Dennis (ed). *Note 2*, p8.

<sup>6</sup> Weber, Dennis (ed). *Note 2*, p9.

ment. The question arises: If a country applies low tax rates, does it automatically mean reducing public revenues and hence reducing public expenditure? How will the lacked of public services will be realized?!

We can accept different answers, depending on the aspect of the analysis. First, it can be considered that lowering tax rates to increase fiscal competition reduces government efficiency in meeting public needs. In the second theory, the reduction of tax rates due to increased fiscal competition, not which means reducing public expenditure but reducing public revenues that will affect the preservation of the status quo of the social welfare level in general. In the third theory, the reduction of tax rates encourages the growth of private sector investment and thus contributes to the increase of public revenues.

The concept of tax competition is closely related to the concept of tax harmonization. Cross-state relations require an agreement in the field of harmonization of tax systems because a kind of "coexistence" of different tax systems is necessary.<sup>7</sup>

Therefore, it is required for practical and theoretical reasons to distinguish the concepts: tax harmonization; approximation; coordination; uniformity; coexistence and tax competition. By providing a theoretical approach, we will dwell on the treatment of common and distinctive elements between concepts: tax harmonization *vis-a-vis* tax competition. Simply means the definition of these two complex concepts requires firstly analysing the concept of tax harmonization

<sup>7</sup> Ćemalović, Uroš, 2015, "Framework for the Approximation of National Legal Systems with the European Union's Acquis: From a Vague Definition to Jurisprudential Implementation," *Croatian Yearbook of European law & Policy*, 11 (11), p242.

as a necessary condition for the unification of the legal system at a higher level in the EU.<sup>8</sup> In many cases, usually the notion of *tax harmonization* is used when referring to EU regulations, laws and directives. According to TFEU, harmonization is mentioned in cases of adoption of necessary measures both by EU institutions and by member states. Also, in more detail on the issue of taxes, see Article 113 of the TFEU.<sup>9</sup>

The notion of approximation is used to describe a continuous process within the EU member States dot.

However, the concept of tax harmonization is used to describe the undertaking of some measures in terms of functionalization of the common market. From the analysis of the primary sources of the EU, one could not identify any difference between these two concepts.

Thus, tax harmonization, elimination of fiscal, administrative and physical barriers among EU member States that may lead to the application of the same measures in reforming their tax systems and eliminating double taxation among States. The concept of tax competition can be defined as "competition between different tax jurisdictions in order to encourage individuals and businesses to locate in a given space."<sup>10</sup> The concept of tax competition involves three important dimensions, of efficiency, equali-

<sup>8</sup> Ćemalović, Uroš, *Note 7*.

<sup>9</sup> TFEU, Article 113: "... adopt provisions for the harmonization of legislation relating to turnover taxes, excises and other forms of indirect taxation to the extent such harmonization is necessary to ensure the establishment and functioning of the market internal and avoid distorting competition."

<sup>10</sup> James, S. and Oats, L, 1988, "Tax Harmonization and the Case of Corporate Taxation", *Revenue Law Journal*, 8 (1), p45.

ty, and democracy<sup>11</sup>: According to the efficiency dimension, tax competition undermines optimal allocation of global investment. According to the perspective of equality, tax competition is analysed in the spectrum of equal capital taxation in different jurisdictions.

This dimension got two effects: Among individuals that tax equality determines the appropriate tax rate in cross-border transactions. In the inter-state ratio, it shows that the tax equality determines the differentiation of the tax base between States.<sup>12</sup>

According to the dimension of democracy, each State has the autonomous right to define its own tax system, which may increase tax competition among States.<sup>13</sup> In this way the issue of tax harmonization appears as a complex process with its specifics of political, economic, social and technical character. Harmonization of taxation systems is considered a delicate matter given the different differences and development of the economic and social systems of member states. One of the aspirations of the Republic of Kosovo in the field of economy should be to create a common market that enables the free movement of goods, services, capital and persons across the state border. The European Union's approach to the Western Balkan states has been gradual by providing technical assistance and financial support, understood as a preliminary cooperation to evaluate cooperation further. In 1993, the European Council made a decision regarding the provision of membership for all Central and Eastern European countries, provid-

ed that these countries meet the criteria known as the Copenhagen Criteria relating to the rule of law, the functioning of democracy, human and minority rights, as well as the functioning of the free market economy.

Therefore, this form of membership provision is known as the SAA and it is required by the claiming states to harmonize their legislation in general and the tax system in particular. The Stabilization and Association Process was officially launched at the Zagreb Summit in 2000. Then at the 2005 Thessaloniki Summit, it was confirmed that Kosovo was included in the framework of the Stabilization and Association process.

In the early 1990s, the transition process in Southeast Europe began, as post-communist states characterized by tax systems designed for the planned economy and not for the market economy, while budget revenues were mainly collected by public enterprises.

The reform of the tax administration has also played a significant role in the process of transition to the private sector of fiscalisation and the increase of the number of taxpayers, with the budget revenues increasing significantly. Therefore, reforming the tax structure also depends on the state's economic development and political status. Kosovo after the declaration of independence (2008) with the deployment of the UNMIK mission together with the Central Fiscal Authority, the European Commission and the International Monetary Fund, began work on formulating measures and strategy for establishing the Kosovo tax system.

It should be noted that Kosovo's tax system that was drafted by UNMIK was a sui generis case. The highest fiscal authority was the United Nations Special Representative of the Secretary-General (SRSG). Prob-

<sup>11</sup> Avi-Yonah, Reuven S, 2000, "Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State," *Harvard Law Review*, 113 (7), p1578.

<sup>12</sup> Avi-Yonah, Reuven S. *Note* 11, pp1611-1616.

<sup>13</sup> Avi-Yonah, Reuven S. *Note* 11, p1576.

lems that followed Kosovo's economic development over the years (1999) related to: lack of electricity, privatization of public enterprises, lack of foreign investment, unfair trade competition for domestic products compared to large imports of products from Serbia, Macedonia, and the difficulties in the free movement of people, capital, goods and services. In the September-December 1999 period, the tax structure of Kosovo was dominated by the participation of tax forms, such as customs, excise and sales tax. While in 2000, the share of tax revenues in the consolidated budget was realized in the amount shown in the table below.

The recent developments in free market economies and facilitation of the movement of capital, due to the international tax law rules tax-fiscal competition, has led to creation of tax heavens.

There are different approaches to the analysis of the concept of competition, some arguments are listed as:

1. Tax competition increases the efficiency in the economy;
2. Tax competition may have a negative effect on economic efficacy. From the first perspective, the governments lower tax rates from the narrowest tax base to the broader one. Tax competition also necessitates reform in the taxing structure of the country with holding an eye on the tax structures of the neighboring countries. From the second perspective, the reduction of tax rates may create the situation of misallocation of public revenue sources that may have a negative effect on the national welfare of the country.

Therefore, in cases of tax cuts, problems can arise in the management of tax forms and the prognosis of their participation in general public revenues. It also points out that tax competition leads fiscal States turn

into the fiscal crisis by shifting the tax burden from capital to the labour market and therefore destabilization of the taxing system.

The process of European economic integration is a common element for tax harmonization and it requires the progress of the integration process turns into a common market by eliminating all legal, fiscal and administrative obstacles. In PIT, tax competition is manifested as a result of many factors: work, family, social security, etc. Losses of income from PIT are difficult to calculate because of the free movement of people within the EC area.

Tax Competition on Corporate Income Taxes is presented differently in contrast to PIT because, in CIT, public revenue decreases in a country due to tax competition which leads to the movement of large companies from higher tax rate countries to lower tax rate countries.

While in Value Added Tax (VAT) same as known in some countries as a goods and services tax (GST), the tax competition may take the form of a particular country.

VAT, can affect consumption growth and at the same time increases the public revenues despite the reduction of taxes.

Obviously, the governments that try to avoid tax competition through high tax rates will lose to governments that choose low tax rates.

According to the OECD, different tax legislation in the different States does not disagree with the fundamental issues of international tax planning. Joint measures should be taken by the governments.

So, they prohibit the creation of favourable or disadvantaged conditions. The governments must provide equal conditions for

exercising the economic activity of domestic and foreign companies within a jurisdiction. This program aimed to eliminate, within five years (2000-2005), harmful tax competition and unfair tax in countries that are considered *tax havens* or *tax oasis*, such as Bermuda, Iceland, Cyprus, Malta, Mauritius and San Marino<sup>14</sup>.

The globalization process is significantly affecting the growth of tax competition among states and businesses<sup>15</sup>. In the illustrative aspect of competition that is developed for tax competition among EU member States, the main and only remedy is the change of tax rates.<sup>16</sup>

If we consider the comparison made by Schon to the concept of tax harmonization v. tax competition<sup>17</sup> from an economic point of view, the views of pros and cons of tax competition are included of: can be listed as follows:

1. Pro Harmonization - cost reduction, fiscal transparency, tax neutrality in order to continue optimum allocation of resources and support individual and cross-country tax equality, redistribution of tax effects.
2. Against tax competition - pressure on reducing the tax burden, fiscal discipline, achieving the balance between tax rate and public goods.

Through tax competition, taxpayers demand balance from the aspect of cost-benefit-ratio and tax burden, while on the other hand, the government is looking for public procurement procurements with the

taxation level.<sup>18</sup> Through taxation it presents the fiscal treatment manner of the residents and non-residents within its jurisdictions. Therefore, the reform of tax systems should be in harmony with economic trends.

On the contrary, if a tax system remains unchanged for several decades despite regional or global economic changes, it loses market competition in terms of the fiscal package it offers. The complexity of tax systems extends into two dimensions, namely competition and the preservation of neutrality. According to the first dimension, competition is the determining factor in increasing foreign investment in a country and increasing revenues through their taxation in order to finance public spending. Under the second dimension, neutrality represents equal treatment within the jurisdiction of a resident and non-resident state. Addressing the phenomenon of tax competition comes to the fore after the initiation and concretization of the process of harmonization of the tax systems of different states which are EU members and of those countries claiming EU membership

Each country claims to be attractive and competitive in terms of the tax system it offers compared to other states. Kosovo's tax system, since its independence, has been subject to numerous changes in terms of completing, modernizing and approximating with the legislation of the EU (*acquis communautaire*). The political transition has directly affected the transition of Kosovo's economy, from an informal economy to a stable, functional and to a modern free-market economy. Therefore, despite the great importance of PIT harmonization, in cases that a person works in a State while

<sup>14</sup> Hammer and Owens, 2001, "Promoting Tax Competition," *International Tax Review*, 12 (45), p45.

<sup>15</sup> Hammer and Owens, *Note* 14.

<sup>16</sup> Wilde, 2014, "Tax Competition within the European Union – Is the CCCTB Directive a Solution?" *Erasmus Law Review*, 1, p2.

<sup>17</sup> Schön, W. (ed), *Tax Competition in Europe - General Report*, Amsterdam: IBFD, 2003, p6.

<sup>18</sup> Schön, W. *Note* 17, p7.

his/her source of income is coming from another country such as: flat rent, dividend, interest etc. In these situations, the probability of double taxation and fiscal evasion increases. Achieving the goal of European economic integration of economies of different countries in a common market is a long and complex process of harmonizing and coordinating fiscal policies between the European Community and certain states.

Regarding the level of harmonization of direct taxes with the *acquis communautaire*, it depends on the level of cooperation and the legal way of regulating the issue of taxing the income of individuals who acquire them in different jurisdictions. In the field of direct taxation, states usually exercise their jurisdiction in the form of extra-territories. Both in the past and today, the movement of persons from one State to another is done for a variety of reasons (political, economic, social, health, educational, etc.) whereby the preconditions for income generation are created and obligations for paying taxes arise. The dilemma of the direct link of persons with personal income tax has been exceeded by the fact that persons exercising their activity earn income from different sources.

Therefore, the structure of the tax system is considered the main determinant of the economic performance of the particular country.

The index analyses the participation of the main forms of taxation and their ranking in terms of participation in general state revenues. There is a decrease in revenues from the tax rate margin of CIT and Personal Income Tax (PIT) and a significant increase from the source of income, Value Added Tax (VAT). According to the 2016 index, New Zealand is considered the most reforming country of the tax system.

## **PROGRAM FOR FISCALIZATION OF TAX SYSTEMS OF EU MEMBER STATES**

The European Commission is responsible for the implementation of the fiscal system for tax systems of EU member States, the so-called Fiscalis 2020 program. As part of this program, the main objective is to improve the functioning of tax systems within the common market by increasing cooperation between the tax authorities and the tax administration of the participating Member States in order to increase mutual support in the fight against fiscal evasion, tax fraud, and aggressive tax planning.

Through the establishment of a common European information system, it is possible to exchange information in the area of taxation, reducing the administrative barriers between the fiscal authorities of member States. Member States are authorized to negotiate the adoption of provisions for the harmonization of the legislation in a taxable manner on indirect taxes and the necessary extension of harmonization in the field of competition to eliminate / avoid unreasonable competition between corporations.

In this context, some steps have been taken in reforming fiscal legislation in order to harmonize with the EU directives. EU founding treaties do not have explicit provisions regarding the harmonization of direct taxes, such as CIT and PIT. Taxable income for individuals generally includes: salaries, wages and earnings from self-employment, rents, dividends and interests.

The initiative of taxation systems within the EU has started since 1993 the project is known as the Matthaesus Decisions. In 1998 the EC decided to unify the language used at the common information system in the field of taxation. The programs are continued an-



nally with the goal of functionalization of this system.

## CONCLUSION

From the aspect of the Republic of Kosovo, tax competition can be allegedly may have two effects on the economy of the State:<sup>19</sup>

1. First, integration into the common market through free movement of capital, goods, services, and people within EU area it is notable to say that, tax harmonization process is not yet completed and the attractiveness of the third country tax system in relation to foreign investors is a major factor in beginning tax competition. Moreover, third countries may adopt high levels of tax harmonization among UE member States and this lead to even lower tax rates in national jurisdictions.
2. Secondly, the political and economic pressures on the European market imposed by the US and East European economic markets makes the EC constantly seeks greater tax harmonization in order to maintain the system's compactness by guaranteeing neutrality, equity, the elimination of fiscal barriers and the simplification of administrative procedures to enable the free movement of capital, goods, services, and people.

There is an International Tax Competition (ITCI) Index that analyses the tax systems of OECD member States from the aspect of incorporating two important elements of fiscal policy: competitiveness and neutrality. Competitiveness requires the application of low tax rates in order to maximize investments. Neutrality is also required for increasing the income and reducing the level of tax evasion. This index is used more than 40 at variable fiscal-tax policy. Thus, the structure of the tax system is a major main determinant of the economic perfor-

mance in a particular country. The index analyses the participation of the main forms of taxation and their ranking in terms of participation in general state revenues. There is a decline in revenues from the tax rate margin of CIT and Personal Income Tax (PIT) and significant increase from the source of income VAT. According to the 2016 index, New Zealand is considered the most reforming country in its taxing system.

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<sup>19</sup> Schön, W. *Note* 17, pp38-39.

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