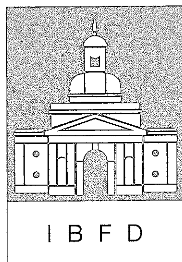

ET EUROPEAN TAXATION

SPECIAL ISSUE

EUROPEAN UNION

TACKLING HARMFUL TAX COMPETITION
– A ROUND TABLE ON THE
CODE OF CONDUCT

■

EC UPDATE

■

DEVELOPMENTS IN
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Point J of the Code of Conduct or the Primacy of Politics over Administration

António Carlos Santos*

I. INTRODUCTION

Tax competition exists because the tax systems of states are quite diverse. Such diversity results from the economic structure and level of development of a given country, but also from its political history, technical and administrative culture, type of legal system and collective psychology. Regardless of a country's tax policies, such factors are the fundament of tax competition in the "international tax market".

This "market", which includes countries with low tax levels (general or per sector), is exploited by transnational companies to (artificially) minimize their production costs through the adoption of tax planning strategies. Countries often stimulate such a "market" through tax policies aimed at attracting investment and promoting competitiveness. At stake is a form of state intervention which is different from classical protectionism: rather than erecting barriers to the external factors of production, tax barriers are partially or wholly dismantled in order to attract these factors, notably mobile ones such as capital.

The use of tax policy to attract investment, whether direct or financial, as well as to attract services, commodities, technology or cross-border consumers, was up until quite recently seen as a natural phenomenon. This is because it emerged from the ideas of free competition and the tax sovereignty of states.

The competition thus created by the tax policies of various countries, notably in the field of savings and the taxation of companies, was encouraged or at the very least tolerated by international and supranational bodies. This is because tax competition represented a tool for the avoidance of excessive tax burdens, the control of public expenditure and the increase in the efficiency of public services. In addition, preferential tax regimes promoted the free flow of capital and helped to mitigate the competitive disadvantages (geographical, lack of resources, etc.) of a given country or region, in particular of those countries which merely have a formal independence.

II. THE BACKGROUND

Until the nineties, the phenomenon of tax competition between sovereign states within the European Community or around the world was not a matter of special concern and even less subject to any kind of international or Community regulation. It is true that EC countless surveys, reports and proposals favored direct tax harmonization, or at least a considerable degree of approximation (even if selective), of Member States' corporate tax laws. Had they been implemented, these proposals would have contributed to diminishing the impact of tax competition. However, diminishing tax competition was not the goal of these studies and proposals.

It was not until recently that tax competition became a real concern of the Community – curiously, this happened at the time when the European Union had abandoned the harmonization approach in favour of a more flexible form of tax coordination and principle of subsidiarity had come to be regarded as the appropriate principle for allocating competence between the Member States and the Union, with the inherent strengthening of Member States' tax sovereignty. The programme for the Single Market as set out in the Single Act, but more notably monetary unification and the creation of a European financial area are factors which led to additional attention for tax competition. The Ruding Report was the first official study to address tax competition. The social and theoretical parameters for tackling tax competition had thus begun to be put in place. It was then only necessary that political action be taken and that the route toward implementation be determined.

In theory, there is general agreement that "harmful" tax competition between Member States is not compatible with the Community's goal of solidarity among Member States. Solidarity has as its corollary the principle of cooperation. This entails that Member States refrain from adopting measures that may jeopardize the achievement of the objectives of the Community laid down in the EC Treaty. This specifically means that in the internal market competition may not be hampered and that due regard must be given to the effects of one Member State's decisions on the other Member States. However, these principles are tempered by the principle of subsidiarity, which (anchored both in the rule of unanimity in tax matters and in the territoriality principle of tax laws) means that Member States may only intervene (by means of individual or joint action) to secure the achievement of EC objectives whenever the actions in question do not belong to the exclusive competence of the Community. In other words, the principle of subsidiarity is not applied when the Community has exclusive competence.

For joint action against "harmful" tax competition to succeed, awareness, both by the Member States and among the public, of the need for regulation is necessary. Two aspects were decisive in creating this awareness. The first was the growing recognition of the fact that, at a time when the leitmotiv had become job creation, tax competition could lead to fiscal degradation, and especially to the erosion of Member States' tax bases as well as to the tax

* Instituto Superior de Economia e Gestão (Universitade Técnica de Lisboa), former State Secretary for Tax Affairs of Portugal and member of the Code of Conduct Group.

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burden shifting from the more mobile factors of production such as capital, to the less mobile ones such as dependent employment. The second was based on the recognition that within integrated areas such as the European Union the phenomenon of tax competition, in line with other experiences in fiscal federalism, has both an internal dimension (tax competition among the countries integrated in the same area) and a significant external dimension (tax competition between economic blocs or countries in different areas). For these reasons, from the European standpoint, the phenomenon of fighting unfair tax competition cannot be confined to the EU area. This is all the more so because the EC tax or customs territory does not coincide with the political-administrative territory (in a broader sense) of the Union as a whole.[1]

III. EC INITIATIVES

A. The first steps

The path followed by the European Union is well known. At the informal ECOFIN in Verona in April 1996, the Union agreed upon a programme to fight unfair tax competition based on three pillars:

(1) a *normative* one (savings taxation: proposal of a Commission Directive of 4 July 1998) aimed at an effective minimum level of taxation on savings within the European Union;
(2) an *administrative* one based on the Commission clarification of the rules of the game with respect to fiscal State aid in compliance with Articles 87 to 89 EC (formerly Articles 92 to 94 of the EC Treaty) in the Communication of 11 November of 1998 (98/C 384/03, OJ 384/3 of 10 December 1998); and
(3) a *political* one, through concerted political action by means of a Council Resolution and the approval by the representatives of Member States on 1 December 1997 of a Code of Conduct, pragmatically restricted to company taxation, a field in which approximation of Member States' laws was almost non-existent (OJ C2 of 6 January 1998, at 2).

In theory, the last pillar is the most innovative and important because it is the only one aimed both specifically and generally at regulating tax competition. In addition, the Edinburgh Council (1992) had previously recommended that the use of soft law such as codes of conduct is preferable to the legislative tools set forth by the EC Treaty.

B. Towards a new International Tax Order?

For many years tax competition had been viewed positively and had not been the subject of specific regulations. It was therefore necessary to make the fight against tax competition more effective at the international level. Traditional measures, sponsored by OECD, with a general character, such as the use of treaties for the avoidance of double taxation, transfer pricing rules and mutual agreement procedures between tax authorities, had been only marginally devoted to the issue of tax competition. In this respect, the Code of Conduct imposes on the various Member States the commitment to promote the adoption of the principles aimed at eliminating harmful tax practices within the widest possible geographical framework; this seems to point not only to its applicability to Member States' associated or dependent territories but also to a strategy in keeping with the OECD Recommendation of 9 April 1998 concerning harmful tax competition – one only has to remember the position of Luxembourg). At stake is the beginning of a new International Tax Order with all problems of the legitimacy and effectiveness that go with this.

IV. STATE AID PROVISIONS AS AN IMPERFECT TOOL TO FIGHT TAX COMPETITION

New intervention in this field involves showing that existing instruments were inadequate. Strictly speaking, the only tool available (and one that was very seldom used until the 1980s) was the judicial and administrative control of the EC Treaty provisions on State aid of a fiscal nature. Nevertheless, these provisions are not sufficient to serve as the foundation of a real policy of regulating tax competition. The purpose of the EC Treaty in setting out a regime for State aid was not to deal with the phenomenon of tax competition in itself or with its effects on public revenue or on employment, but rather the regime was intended to deal with the implementation of an internal market where competition among enterprises should not be distorted by new forms of public protectionism of "domestic" enterprises.

The EC State aid regime was not designed to regulate unfair competition. Despite the efforts of the Commission to more broadly reformulate the State aid regime in order to clarify the criteria adopted for the application of exemptions to the principle of incompatibility, it is not a suitable tool. State aid may be an ancillary or complementary instrument, but never the central one in the regulation of tax competition. The main role should be played by other instruments.

The regulation of tax competition should be based on the idea that tax competition is a double-edged sword. On the one hand, it may be useful insofar as, within the Union, it is a factor fostering economic development, which may also promote a certain degree of de facto harmonization between the tax systems of the Member States. On the other hand, beyond a given limit, it may have detrimental effects on public revenue and social policies. Tax competition is then mainly a political issue and an element of institutional competition, in that it interferes with the conditions that, in each country, determine the levels of tax revenue, and consequently, the parameters of the welfare state. The definition of the limits to tax competition (in other words, which practices are to be regarded as harmful

1. The free movement of capital was beginning to become a reality in Europe and all over the world. The financial sector itself started to defend the need for regulation of the financial system lest it would become exposed to serious crisis. It became quite evident to a significant number of people that the dysfunction resulting from the volatility of financial capital must be avoided as well as non-taxation. It is clear that in an increasingly interdependent world the tax measures adopted by a state affect other states and that tax competition has not only positive aspects, but rather may involve, among other things, the erosion of tax revenue of other states.

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or unfair?) as well as the routes to enforce such limits are the critical questions.

V. THE RELATIONSHIP BETWEEN THE CODE OF CONDUCT AND STATE AID

A. The Code

The most interesting issue in the "tax package" is, most likely, that of the relationship between the Code of Conduct and the State aid regime. The former is regarded as a political tool, although it may have some legal effects, or from another point of view, an instrument of international soft law disregarded for the purposes of being invoked before the Court of Justice. The latter is a classic legal tool derived directly from the EC Treaty rules on competition. Decisions on the Code of Conduct lie with the Council, whereas decisions on State aid are the exclusive prerogative of the Commission, subject to control by the European Court of Justice (ECJ).

The Code of Conduct is a specific instrument for the regulation of harmful tax competition. The State aid rules are ancillary tools. The former is constrained by political imperatives to the taxation of companies, despite questions as to whether or not it covers social security contributions. The latter covers both taxes and social security contributions and assimilated charges.

The Code of Conduct itself refers to the regime on fiscal State aid not only to compel the Commission to publish guidelines on the application of rules concerning fiscal aid, but also to require the Commission to analyse or reanalyse, on a per-case basis, the tax regimes in force, in order to ensure coherence and equal treatment in the application of the norms and in achieving Treaty objectives. Nevertheless, any analysis of the relationship between the Code and State aid involves making some additional observations about the Code itself. The procedure for tax policy coordination inherent in the Code is inspired by the mechanisms of coordinating economic policies. The technique adopted consists in the neutralization of tax measures considered to be harmful, since they may have a considerable influence on where economic activities within the Community are located; the harmful character of a tax measure is assumed whenever it leads to an effective level of taxation that is significantly lower than that in the Member State in question. The ultimate objectives are to establish limits to tax competition by eliminating harmful measures and, simultaneously, to safeguard the principle of subsidiarity, i.e. that Member States have a tax policy of their own. Multilateral supervision of potentially harmful measures is the basis for enforcement. The most important types of supervision are the "right" to information and analysis (*droit de regard*) by each state of other Member States' tax measures and the strengthening of administrative cooperation. These mechanisms will make it possible for the "standstill" clause, that is to say the commitment to not introduce new provisions that may hamper competition, to be effective. This standstill provision may be regarded as the one real advantage of the Code (doubts can be cast as to the effectiveness of the roll-back commitment (removal of measures and practices which might be considered as harmful)).

Neither the Code nor the resolution which approved it are legal instruments. They do not integrate the sources of EC law nor can they be invoked before the ECJ. They represent political acts. Above all, the Code of Conduct represents the outcome of a political process: for example, the setting-up of the Primarolo Group charged assessing what is considered a harmful tax measure. This Group was inspired by a model (that of the Monetary Committee) which deviates considerably from the traditional pattern of the working groups on tax matters that already existed in the Council (compare the ad hoc groups and the group on financial issues). In addition, the chairwoman of the Primarolo Group is not formally determined (i.e. the chair is not assigned to the representative of the Member State that in a given period holds the Presidency of the Union) but, at least in theory, is chosen by election for a two-year term.

Also political was the non-clarification of the decision-making process within the group, whereby any kind of decision based on voting procedures was systematically avoided. The Group favoured decisions taken on the basis of a broad consensus. However, when the 66 measures named in the final list are analysed, it is easy to come to the conclusion that only rarely did real consensus exist about the decision to include a specific measure or not.

A good example of this is the Madeira Free Trade Zone regime (measure B6 in the evaluation process), which was authorized on a temporary basis under the State aid provision for regimes with a regional character. The Portuguese position was that such a regime was safeguarded by the paragraph G of the Code of Conduct which sets out a specific evaluation form (as well as a harmfulness exclusion clause) for the measures aimed at boosting the development of regions which are economically depressed due to their very remote location. This view was based on the fact that for the Azores and Madeira the new wording of Article 299 of the EC Treaty (formerly Article 227)) specifically requires such a safeguard. To support its position, Portugal delivered a very detailed technical report to the Primarolo Group. This report was never discussed in the Group. The Commission's view was that the Madeira regime was not proportional to its objectives. However, what was meant by proportionality was never clarified. In the end the measure was put on the list, in spite of Portuguese opposition and before the embarrassed silence of the other Member States.[2]

2. This has led to the insertion under the final rapport of the "Group of Conduct" to the ECOFIN of 29 November (SN 4901/99, of 23 November) of a footnote that reads as follows (No. 8, at 12): "The Portuguese Delegation has asked paragraph 32 to be amended by the addition of the sentence (on the positive evaluation of the measure given by the Group) with the addition of the sentence 'based exclusively on the assessment against criteria of paragraph B of the Code' in order to clarify that measure B6 was not assessed under the provisions of paragraph G of the Code". In fact, no Member State has expressed its opinion either on the concept of proportionality in relation to measure B6 foreseen in paragraph G of the Code, or on the assessment of measure B6 in face of the remote location of Madeira, or on the contents of the report presented by Portugal on this matter and, consequently, it is not possible to assume that this general silence on this subject means that measure B6 was duly assessed in the ambit of paragraph G of the Code.

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B. The fiscal State aid regime

The Code acknowledges that there is a certain overlap with the State aid regime. However, it does not provide criteria to determine the applicability of one regime or the other. An analysis of fiscal State aid made in the light of the newest Commission guidelines reveals that a large number of the measures subject to the Code also fall within the scope of the State aid rules. Given the distinct nature of both instruments, this means that the scope of the Code is dependent on the scope of the fiscal State aid rules, which are somewhat more specific than the general regime for State aids.

Basically, the principle of incompatibility applies to any fiscal advantage (which by definition involves public resources) received by enterprises, in the widest sense, regardless of what kind of advantage it is[3] that is imputed, directly or indirectly by the state (central, regional or local) and which, being selective, fulfils two conditions: it affects intra-Community commerce and it distorts or threatens to distort competition.

Given the broadness of certain elements in the definition of aid (such as state, advantage, enterprise), the primacy of the theory of effects, and the intertwining in the interpretation of the conditions, the critical factor in determining the scope of the State aid regime lies in the notion of selectivity. Since non-selective measures (i.e. general measures) fall outside the State aid rules, determining what is a fiscal competitive advantage becomes the key question. Bearing in mind administrative practice, ECJ case law as well as the new guidelines of the Commission (Commission notice on the application of the State aid rules to measures relating to direct taxation of 11 November 1998), one might say that the question of selectivity entails at least two tests: the specificity test and the exceptionality (or abnormality) test. The former aims at identifying measures that, despite having been formally presented, in general have the objective of favouring de facto one or more enterprises, sectors or areas of production in a given state. The questions to be raised are the following:

- is the measure applicable to the entire national territory;
- does it apply only to limited sectors or types of activities;
- does it benefit certain general functions of enterprises; and
- is it discriminatory under the law or in practice?

The last point aims at preventing those measures which meet the first test but which nevertheless fit coherently in the national tax system. To use the Commission's formulation: differentiating fiscal measures whose economic rationality renders it necessary or functional vis-à-vis the effectiveness of the tax system are not regarded as State aid. This formulation is not particularly clear, but it seems to point toward distinguishing between those measures of which the objectives are inherent in the system itself and the measures aimed at objectives which are external to it (driven by non-tax purposes). An example of the former is that the tax rate structure is a measure justified by the nature of the system (general tax measures). All other measures would be regarded as exceptional (abnormal) and, thus, selective.[4]

It follows from the above that the Code of Conduct applies autonomously to tax measures of a general nature. It works in practice as a political alternative to the legal mechanism (to date never used) provided for in Article 96 and 97 (formerly Articles 101 and 102) of the EC Treaty. Basically, it means that if a Member State has a tax policy which e.g. grants significant advantages to holding companies and capital investment in such a way that they are induced to move to its territory, distortion of the conditions of competition occurs which may lead the application of Articles 96 (regarding pre-existing disparities) and 97 (regarding supervening disparities) of the EC Treaty.

VI. CONCLUSION

On balance, almost three years after the Code of Conduct was approved, the results that have been achieved are not ones to be praised. The limitation inherent in the decision to use soft law as the chosen route is becoming apparent. The non-binding legal character of the Code offers little guarantee of impartiality. Political sanctions may be most easily used against the smaller economies. The Code has been relegated to being a subsidiary instrument in relation to the State aid regime. In addition, its effective application is dependent on the approval of a tax "package" of which the date of entry into force is unknown, since the Savings Directive is not likely to see, in the short term, the light of day. Given the expected enlargement of the European Union with countries having highly preferential tax regimes, one cannot afford to forget that the issue of knowing whether or not the Code is part of the acquis communautaire is going to be raised. From a legal standpoint the answer seems to be negative; politically, a negative answer is unacceptable.

In this situation the only pillar that will allow progress to be made is the administrative and the judicial control of fiscal State aids. This is precisely the pillar that, despite the new Commission guidelines, is not meant to fight tax competition: thus, what is supplementary will take over the role of what should be essential. The work on the evaluation of the Code risks becoming a kind of preparatory guideline for an increasingly restrictive application by the Commission of State aid rules, which, as is well known, neither include general tax measures nor are applicable outside the Community. In this way tax competition is likely to increase. Countries have become more aware of other countries' preferential tax regimes and will be tempted (or forced) to establish them, too. Re-evaluation of a given regional State aid regime, which may lead to its limitation or elimination before the period in which it was permitted has elapsed, is likely to work as a factor to boost tax competition conducted by countries with dependent or associated territories which are not part of the Community territory and to which the EC State aid rules are not applicable. In practice, such an administrative decision will

3. For example reductions on tax base or on tax rate, deferral or debt restructuring, discriminatory administrative practice, etc.

4. The Commission notice seems to allow that the measures pursuing objectives of general economic policy through a reduction of the tax burden related to certain production cost (research, training, employment, environment) can be justified, in which case they would not be regarded as selective.

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represent an advantage to the non-EC territories to the detriment of, in particular, remote territories which are part of the EC territory and to which, in accordance with Article 299(4) (formerly Article 297) of the EC Treaty, the Community's special support must be given. The coherence and equality of treatment will be damaged in relation to the objective of economic and social cohesion contained in the EC Treaty as well as in relation to the spirit in which the Code of Conduct was formulated. The Member States' lack of political will to overcome this, along with other problems (such as the financing of the Community Budget), and their tendency to take dead-end paths, makes a movement for the refoundation of the Community itself very tempting.

In the meantime some countries with less attractive tax measures will be damaged vis-à-vis others where such measures or practices have remained largely effective. There is nothing new in the world. As the Portuguese proverb says *quando o mar bate na rocha quem se trama é o mexilhão* ("when the sea breaks against the rocks, the little mussels are in trouble").

A Business View on Tax Competition

Prepared by the Business and Industry Advisory Committee to the OECD (BIAC)

June 1999

I. INTRODUCTION

The multinational business community speaks with a single voice when it puts forth the view that tax competition, generally, is a healthy phenomenon, from the points of view of both government and business. We believe that it is not erroneous to state that it is unwarranted taxation by governments, rather than competition among them in the tax area, that is stifling to economic and business development. After all, countries do compete in other ways to attract business to their territories, so why single out taxation of one relatively limited form of activity as harmful? Tax competition tends to keep tax burdens lower, which creates pressure for less wasteful, and, therefore, more efficient use of public funds. In addition, it fosters increased efficiency in the allocation of scarce resources. Lower tax burdens also translate into lower cost for multinationals operating within the territory and internationally.

II. THE FUNDAMENTAL ISSUE

It is a well-accepted notion that each country is free – indeed obligated – to decide its own fiscal destiny, unless, of course, it is a member of a supranational institution, such as the European Union. Therefore, each nation should establish its system according to its fiscal needs, i.e. its budget, and collect the required revenue under the tax system of its choice to meet that budget. Such a situation creates the environment wherein tax systems and tax levels vary from country to country, a reality we have to live with and which is not per se a bad thing.

Likewise, in a world which generally espouses free cross-border trade and investment, multinationals are, in major part, free to structure and operate their business activities as they see fit, generally in a manner that makes the most sense from a business point of view. In analysing the various costs of carrying on a business, whatever the structure or modus operandi, tax burden is taken into account when making business decisions. When viewed in this context, tax differentials among countries are not harmful. Such differentials may affect activity location decisions, but this is an expected phenomenon in a world supporting, and in a sense relying on, free trade and cross-border investment.

BIAC understands the valid concern of governments to protect their revenues from unwarranted erosion. In this regard, BIAC rejects any form of fraudulent behaviour, and we do not in any way support preferential tax regimes established to promote and facilitate fraudulent practices. Such tax fraud not only distorts competition but is injurious to the general well-being in a market economy. Nevertheless, the target of efforts to combat tax fraud should not be so broad as to attack every nation that has a favourable tax climate which attracts businesses from other states.

III. THE OECD REPORT *HARMFUL TAX COMPETITION*

BIAC has studied with great interest the document *Harmful Tax Competition: An Emerging Global Issue* (Report) which was prepared under the auspices of the OECD's Committee on Fiscal Affairs and approved by the OECD Council on 9 April 1998. To our disappointment, BIAC

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