Tax Competition and EU Law
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CHAPTER 1 - THE ISSUE OF (HARMFUL) TAX COMPETITION

1.1 What is Tax Competition?

1.1.1 Basic Concept of Tax Competition

Generally speaking, ‘tax competition’ is referred to as the lowering of the tax burden in order to improve a country’s economy and welfare by increasing the competitiveness of domestic business and/or attracting foreign investment. This concise definition highlights both the objective and subjective aspect of the concept of tax competition.

The objective aspect regards the alleviation of the direct tax burden imposed in a certain country on all or on specific categories of taxpayers. Such alleviation is achieved through a number of different tax incentives (see in detail at 1.1.3). As for the subjective aspect, it concerns the goal pursued by a country through the lowering of the direct tax burden. This concept implies that there may be a ‘good’ or desirable form of tax competition as opposed to a ‘bad’ or harmful form depending on whether the alleviation of the direct tax burden is intended to boost a country’s economy and to benefit all taxpayers or it is mainly directed at attracting foreign business or capital at the expense of other (neighbouring) countries’ economies. In short, there is “good” and there is “bad” tax competition depending on the interplay of the objective and subjective aspects and of the externalities of the measures taken (see section 1.2, especially 1.2.6).

1.1.2 Main Categorisations of Tax Competition

The basic concept of tax competition may be further clarified by reference to a few distinctions. A first is the one between tax and non-tax competition among countries. The former encompasses every measure implemented through the fiscal system and

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2 It is worth noting that the scope of this study is limited to direct taxation, as indirect taxes are harmonised within the EU and the relevance of the issue of (harmful) tax competition is almost exclusively linked to direct (i.e. income) taxes.
affecting the tax burden imposed on taxpayers. The latter occurs with respect to measures other than taxes that have a similar objective of improving the competitiveness of a country’s domestic business or of attracting foreign investment. For example, policies and measures concerning the setting of interest and exchange rates are forms of non-tax competition, as well as the direct concession of monetary grants, preferential loans, and other financial incentives.

Linked to the latter example is the distinction between fiscal and financial incentives granted by countries. Fiscal incentives are granted by a country through the tax system and are targeted at specific economic goals. They are referred to as ‘tax expenditures’ by economic literature if they are enacted as special provisions deviating from a country’s general tax system. Tax expenditures are mostly hidden in the tax system and are non-transparent since they are usually not quantified in money terms and are not disclosed to the public opinion. By contrast, direct financial grants are more transparent in that they are quantified or easily quantifiable beforehand and they are mostly subject to parliamentary approval and inserted in the annual budgetary law. Furthermore, the funds are usually administered by a special agency or body, which ensures a higher degree of control for both government and private organisations as well as potential recipient of funds (and their competitors).

Another fundamental distinction is that between vertical or intergovernmental tax competition and horizontal or inter-jurisdictional tax competition. Vertical tax competition occurs between governments or bodies provided with a different degree of autonomy and power, and that are at different levels within a country’s constitutional hierarchy. Tax competition between the federal government and state governments in federal countries (e.g. the USA), or between regional and provincial or local governments in countries conferring some tax autonomy on decentralised bodies constitute examples of vertical tax competition. Conversely, horizontal or inter-jurisdictional tax competition is the one between sovereign countries, or between governments or bodies having the same or comparable powers at international level or within a certain jurisdiction. This kind of tax competition, which is the focus of this study, occurs for instance among Member countries of the OECD.

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3 On the distinction between financial and fiscal incentives see e.g. A.J. Easson, Taxation of foreign direct investment - An Introduction, Kluwer 1999, p. 19.

4 This distinction was first elaborated by Prof. Stanley Surrey of Harvard Law School in the 50s and has since constantly been endorsed and followed by other fiscal theorists and economists over the years. For a thorough analysis of the main tax expenditures throughout the world, see also OECD, Tax Expenditures: towards a Transparent Fiscal Policy, OECD, Paris, 1/1/1996.

5 Tax expenditures are exceptional provisions usually enacted by the executive power of a country (i.e. the government) as they are rather technical, and therefore they mostly escape parliamentary debate. Furthermore, while there are only a few countries whose law requires calculation in monetary terms of the anticipated amount of each tax expenditure enacted in the annual budgetary law (e.g. USA and France), the overwhelming majority of countries worldwide lacks such a rule (see OECD, Tax Expenditures, cit.). However, at EU level the Commission does (try to) quantify the amount of State aids granted by each Member State within the meaning of Art. 87 Treaty, including fiscal state aids taking the form of tax expenditures, in its Surveys on State Aid in the European Union: see in detail in Chapter 3, especially at 3.2.4. Even though not taking into account all Member States’ tax expenditures, but only those having EC cross-border relevance and known to the Commission, the Surveys provide a clear indicator of Member States’ behaviours in this respect.

6 In fact, the origin of the funds needed to finance these incentives usually must be clearly indicated in the budgetary law by the country granting them.

7 This distinction is indicated in all the major studies carried out by the economists cited in footnote 1. See e.g. Kenyon & Kincaid, pp. 1-2. See also W. Schön, Tax Competition in Europe - the legal perspective, EC Tax Review, 2/2000, p. 90, at 92-95.
and Member States of the EU. It also encompasses interstate, interprovincial and interlocal competition among governments or other local bodies at the same constitutional level within federal countries or countries with (more or less) autonomous local bodies, such as tax competition among the states in the US, the provinces in Canada, or the cantons in Switzerland.

Even though this distinction is clear in theory, in practice it needs to be established if and to what degree the various sub-forms of tax competition within the same category are comparable and may be analysed together. For instance, it is debatable whether horizontal competition among EU Member States or OECD Member countries is comparable to horizontal competition among state governments or provincial governments in federal countries such as the US and Canada. As will be seen, this issue is not purely theoretical but it has practical consequences with regard to the significance of studies on interstate competition within federal countries (namely, the US) for the analysis of tax competition in the EU and the OECD. A last important distinction linked to the subjective aspect of the concept of tax competition must be made between tax measures targeted at domestic business and those targeted at foreign investors. In an international context, tax incentives meant to boost exports of domestic business by way e.g. of subsidies or rebates for exporters give rise to ‘outbound’ tax competition. By contrast, tax incentives aimed at attracting investment and capital from abroad such as tax holidays for local manufacturing activities undertaken by multinational companies are referred to as ‘inbound’ tax competition. The present study is exclusively concerned with the latter kind, since at the moment it is the most significant form of (horizontal) tax competition in the EU and is potentially able to cause a number of harmful effects in the internal market.

1.1.3 Main forms and features of tax incentives

Tax competition occurs through an array of different tax incentives relating to the (corporate) tax rate(s), the taxable base, or the final tax due in a certain country. A common form is the reduction of tax rates or a complete exemption on income derived from corporations. This reduction or exemption may also cover withholding taxes on passive income, i.e. dividends, interest, and royalties. Other incentives are granted in the form of deductions, accelerated depreciation, or tax credits linked to investment e.g. in capital assets, R&D, labour etc. Furthermore, there are tax incentives, which are usually coupled with the above incentives for corporations, in the area of individual taxation (e.g. reduced tax burden on income and/or fringe benefits of highly-skilled expatriates) and/or social security contributions, as well as in the area of indirect taxation (e.g. exemption or lower rates for import duties, VAT, capital duty).

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9 For a detailed explanation of the types of tax incentives as well as their main features addressed in this paragraph, see A. J. Easson, *Tax Competition and Investment Incentives*, EC Tax Journal 2/96-97, at 78 ff., and Easson, *FDI*, cit., at 20 ff. As will be seen, the features of tax incentives explained in the text are fundamental in determining whether a country is engaging in desirable vs. harmful tax competition.
All of the above tax incentives may be general or specific. The former apply to all kinds of income, both active and passive, and to all taxpayers located in the country, both residents and non-residents. The latter are limited to a specific kind of income, to a specific sector of business activity or corporate function, or to a specific category of taxpayers. For instance, a generalised reduction of the statutory corporate tax rate or the abolition of withholding taxes on any corporate payment regardless of the nature of the income or the status of the recipient constitute general tax incentives. By contrast, a reduced tax rate limited e.g. to income from manufacturing or financial activities or to income earned by foreign-based taxpayers, or the abolition of withholding taxes on interest paid to non-resident taxpayers represent special incentives. Other examples of specific tax incentives are the tax holidays, which usually feature a reduction of corporate tax rates limited in time (usually five to ten years) for foreign investors, or the creation of special economic zones (i.e. tax-free or T-zones) within a country, which offer a reduced or nil corporate tax rate coupled with a number of other incentives covering e.g. capital duty, property taxes, and indirect taxes.

Also important for the above distinction is the introduction of the tax incentive in the statutory tax law of a certain country or by way of a specific provision constituting an exception to it. In other words, the tax incentive may form part of the general, ‘benchmark’ tax system of that country, or it may constitute a specific deviation from that benchmark, in which case it constitutes a tax expenditure (see at 1.1.2). Sometimes it may be difficult to ascertain whether a tax incentive must be considered part of a country’s general tax system or rather an exception to its general structure, such as in the case of accelerated depreciation schemes or tax credits for certain investments. Another relevant feature of tax incentives is their applicability automatically or on a discretionary basis. The former, usually general tax incentives part of the benchmark tax system, apply upon satisfaction of all the required conditions set out in the tax law. The latter are granted on a case-by-case basis upon a discretionary assessment by a country’s competent authorities, and are usually specific tax incentives introduced by an administrative act and require the issue of a ruling by the local tax administration.

As already mentioned, a fundamental feature of tax incentives is their targeting, which is linked to the underlying policy goal(s) pursued by a country and to the subjective aspect of tax competition (see at 1.1.1 and 1.1.2). By and large, tax incentives may be meant to boost domestic investment and/or employment (e.g. a tax credit or immediate expensing for tangible assets or new employees), to attract foreign direct investment (e.g. a tax holiday for income from the manufacturing of products in domestic plants) or foreign passive (i.e. portfolio) investment and capital (e.g. exemption from income tax and withholding taxes on passive income earned by non-residents), or to favour the development of a certain depressed area (e.g. creation of a tax-free area offering exemption from corporate income tax and indirect taxes). The goal of tax incentives is decisive for choosing the appropriate form and mechanism. This, in turn, is needed to assess their effectiveness, that is their ability to

10 Synonymous for ‘specific’ tax incentives used by economic literature (as well as hereinafter in this book) are ‘special’ or ‘selective’.

11 On the targeting of tax incentives, see in detail Esson, FDI, cit., at 23.
achieve the said goal. In particular, a tax incentive is effective where it actually influences investment patterns and investors’ behaviour in the way aimed at by that country, and is ineffective or even counterproductive if it does not succeed in this respect.

A last important feature of tax incentives is their efficiency, i.e. their ability to bring about substantial benefits for a country that outweigh the costs borne for their implementation. For this purpose, the cost/benefit analysis of each incentive will indicate whether the goal aimed at by a country (e.g. to boost domestic investment and/or employment or to increase foreign direct investment) has also proven profitable for that country as the revenue forgone (e.g. the lower corporate tax collected) has been more than compensated for by other revenues and benefits (e.g. additional income tax on new employees’ income, reduced public allowances paid out to the unemployed, additional indirect taxes on increased domestic sales).12

1.1.4 Concept of tax competition in an international context

In order to get to a more refined version of the concept of competition in the international tax area, it is important to understand the main factor behind this phenomenon: the progressive globalisation of trade and investment and the consequent integration of national economies.13 The advent of technology on the one hand and the disappearance of exchange controls and other impediments to capital movements on the other hand have made it relatively easy to effect investments and shift capital worldwide. Also due to increased and improved transportation and communication technology, the world has become smaller and the various economies more integrated in what is likely to become just one single world marketplace. This has in turn fuelled the internationalisation of multinational companies and their cross-border transactions and business deals, also facilitated by the presence of supranational international organisations such as the EU, the NAFTA, the OECD, the WTO, etc.14

In this scenario, direct taxation policies pursued by the various countries have been gaining a significant role in the attempt to influence the patterns of such cross-border investment and of the international flows of capital. This is also a result of the progressive disappearance or reduced effectiveness of other means of competition such as interest rates and currency fluctuation policies, especially within the EU after the introduction of the single currency in twelve Member States. The effort of countries to attract foreign investment and capital mainly stems from the widespread consensus that they bring about a number of positive effects in terms of likely economic growth and consequent higher tax revenue generated from increased corporate profits, wages paid to new employees, as well as increased demand in goods and services caused by higher disposable income available to consumers and

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12 For a thorough analysis of the effectiveness and efficiency of tax incentives as well as related economic evidence, see Easson, FDI, cit., at 21-22.
more in general economic welfare. Furthermore, there is evidence that also the home country of firms investing abroad potentially benefits from this as a result of increased efficiency of these firms and their gaining a competitive advantage in international markets, which may eventually turn out in taxable profits being repatriated as well as in other sources of tax revenue such as royalties payable on the license of intellectual property.

In view of the above, tax competition occurs at international level as countries worldwide lower their direct tax burden (objective aspect) in order to attract foreign investment (subjective aspect). For a better understanding of this concept and its desirable versus harmful form in an international context, it seems at this stage useful to make a parallel with the concept of competition as elaborated in private law, i.e. between private parties engaged in the same line of business or economic activity. This competition is defined as "the struggle between rivals for the same trade at the same time; the act of seeking or endeavouring to gain what another is endeavouring to gain at the same time." Consequential to such definition is a distinction between 'fair' and 'unfair' competition. The former refers to lawful and loyal means of achieving a larger market share and is encouraged as a means of benefiting both the final consumers in terms of a wider range of products available, lower prices, and better quality and services, as well as and the market as a whole in terms of automatic mechanisms forcing producers to increase their productivity and efficiency, research and innovation, and quality of products. By contrast, 'unfair' competition entails dishonest and deceptive means of substituting one's own goods or services in the market in lieu of someone else's by way of fraudulent business practices. This is strongly fought on the grounds that small producers should be protected against innovation-hostile efforts of big competitors to force them out of business and, in general, that higher market share should be gained on the basis of improved economic efficiency and productivity and better service rather than of sheer power and abusive practices.

In order to adapt these concepts to the peculiarities of tax law in an international context, one needs to single out the relevant differences, which lie in that:

- the subjects involved in the struggle are sovereign countries rather than private entrepreneurs;
- their endeavour is directed towards gaining a higher share of tax revenue deriving from foreign investment, as opposed to the goal of gaining a higher share of a certain market sector;
- the countries most actively engaged in it are small ones, which try to redirect taxpayers and investment from big countries mainly in order to compensate for their natural handicap of not having a large home market.

Based on this, a more refined concept of tax competition in an international context might be understood as the endeavour by sovereign countries to gain a higher share in the international division of the taxable base deriving from inbound investment through the lowering of the tax burden on the income generated therefrom. For the

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15 See also Easson, FDI, cit., at 9 ff., and bibliography and studies cited therein.
16 See Easson, FDI, cit., at 11-12, and bibliography and studies cited therein.
17 See Black's Law Dictionary, West Publisher, under the term "Competition", p. 284.
18 See Black's Law Dictionary, West Publisher, under the term "Unfair Competition", p. 1528.
purpose of this definition, the international tax base exclusively encompasses income from inbound investment, both foreign direct investment and passive investment (see also at 1.2.4). Therefore, the scope of the present study is limited to inbound inter-jurisdictional (i.e. horizontal) tax competition (see at 1.1.2) between sovereign countries, mainly the Member States within the EU.

The above definition seems very much apt to summarise the current situation surrounding the issue of tax competition in an international (rectius EU) context. The globalisation and integration of world economies led the various countries to try to lure foreign investment pursuant to their national sovereignty in the direct tax area, which is largely unaffected from the international legal order and also from the EU legal order as concerns the EU Member States. However, such integration also entails that tax policies pursued by these countries inevitably affect the situation of other countries due to the spillover effects likely caused by them. As a result, before implementing their policies (also) in the international tax area countries should (and usually do) carefully weigh such effects to avoid potential tensions associated with negative effects possibly spilling over to other countries. In other words, globalisation and the integration of the world economies invariably ends up diminishing countries’ sovereignty (also) in the direct tax area. This, in turn, creates a number of issues as to how to deal with these situations in which tax policies may bring about positive and/or negative spillover effects, and in particular whether to intervene at all by trying to set out common principles or rules or seeking some form of more integrated cooperation or convergence in the international tax scenario. These issues are particularly important with regard to tax competition, as the international tax policies implemented by sovereign countries have a number of ramifications from both a public and private perspective. As for the former, they are potentially able to affect other countries’ economies and interests by causing a number of different economic repercussions (see at 1.2.2 through 1.2.4), which in turn stimulates diverse reactions by other countries (see at 1.2.5). With regard to the private aspect, countries’ tax policies affect the behaviour and the situation not only of private individuals, firms, and (multinational) companies, but indirectly also of their investors and shareholders, their creditors, as well as their employees. These considerations give a flavour of the array of complex issues surrounding the phenomenon of tax competition in an international context, and in particular its desirable and harmful from, as well as the possible approaches to cope with it.

1.2 Upside and downside of tax competition: ‘harmful’ tax competition

1.2.1 Introduction

The most important distinction from a policy point of view is the one between ‘good’ or desirable versus ‘bad’ or harmful tax competition. There are two major questions

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19 A synonym for ‘inbound,’ which is referred to in the text and will hereinafter be referred to, is ‘inward.’ Traditionally, the international tax base encompasses both domestic income earned by non-resident (i.e. foreign-based) taxpayers (i.e. income from inbound or inward investment) and foreign-source income earned by resident taxpayers (i.e. income from outbound or outward investment).

20 See in this regard Tanzi, cit., in the Preface, at xvi ff., and the OECD Report on Harmful Tax Competition, cit, at 15-16, especially paras. 26 and 29.
that need to be asked in this respect: does this distinction really exist? If so, what earmarks a measure as 'desirable' as opposed to 'harmful' tax competition, or in other words which are the criteria on the basis of which to distinguish between them?

Answering these questions is no easy task. For this purpose, one has to be able to show convincing evidence supporting these answers. Such evidence, however, is very difficult to find, and the differing and contrasting views of economists, politicians, and legal scholars on the matter do not help much in this respect. These difficulties are exacerbated by the inconsistency of economic studies and research in this area (this issue will be discussed at 1.3). Despite all the uncertainties, it will be seen that there is enough economic evidence showing that tax competition indeed exists and that it may have both beneficial and harmful effects. The thorniest issue remains where to draw the line between these two forms: as it turns out, this may be done through a careful and balanced assessment of both the objective and subjective aspect of each tax incentive offered by countries engaged in tax competition.

1.2.2 ‘Good’ Tax Competition

A generalised reduction of the tax burden is usually acceptable and to be welcomed if it is directed towards internal tax efficiency and improving a country’s attractiveness relative to other countries. ‘Good’ tax competition forces governments to maintain reasonable levels of public expenditure and improves the efficiency of the public administration ultimately leading to a reduction of its size and to a rationalisation of public services. This counters the so-called ‘Leviathan effect,’ that is the tendency of big governments to grow bigger by inter alia raising taxes. As a result of tax competition, they are to find an appropriate balance between the total tax burden imposed on taxpayers and an acceptable size of the government and level of public services and infrastructures provided. Eventually, this process should lead to a lower tax burden and more broadly to spontaneous approximation of tax systems and to a downward convergence of tax rates (see with regard to the EU, at 1.4.4). This would ultimately entail greater fairness and neutrality in the countries’ tax systems due to such changes in their overall tax structure as broadening of taxable base and lowering of tax rates, implying a more equitable distribution of the tax burden among taxpayers and an improved system of wealth redistribution.

From a broader macroeconomic perspective, this process would likely bring about other benefits for countries, such as economic growth and development of their territory, increased employment, and eventually an increased overall domestic welfare. From a business perspective, this would translate into a favourable environment to undertake investments and free up capital. As taxation is one of the costs of doing business, tax competition is beneficial in that it provides the best economic environment at the lowest possible (tax) cost for entrepreneurs.

Reasoning a contrario from the above, the elimination of interjurisdictional tax competition between sovereign countries would imply some form of coordination or

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21 For economic evidence relating to the good aspects of tax competition summarised in this paragraph, see especially at 1.3.2, 1.4.4, and 1.4.5.
harmonisation of their tax systems. The fear is that they would tend to form a ‘cartel’ meant to raise their overall tax burden, which would mean alignment of tax burdens at the highest possible level.\textsuperscript{23} This would cause opposite effects, such as increased inefficiency of the public sector, penalisation of taxpayers that will have less disposable income, adverse economic environment for investors and entrepreneurs, and ultimately a number of other potentially negative consequences on the countries’ economies and employment.

As a result of (desirable) tax competition, each country will have its own ‘offer’ of (reduced) tax burden and (appropriate level of) public services, and individuals and firms will be free to choose the one that best suits their needs. In the broader picture, each country will opt for its optimal ‘tax mix’, or distribution of a country’s overall tax revenue needed to fund the public services among the various taxable bases (i.e. direct taxes on individual and corporate income, social security contributions, indirect taxes on consumption, environmental taxes, etc.) Under this theory, linked to the private law concept of competition (see at 1.1.4), what is important to determine a country’s attractiveness for investors and to drive their decisions on where to invest is this overall ‘offer’ of each country rather than merely direct taxation. This also means that tax competition in the direct tax area is \textit{per se} beneficial or at least not harmful in an international context, as investors are free to choose among the various countries’ offers depending on their needs.

\textbf{1.2.3 ‘Harmful’ Tax Competition}

Economic theory has shown that tax competition may also cause a number of harmful economic effects.\textsuperscript{24} The most dangerous is the so-called ‘fiscal degradation,’ that is the loss of tax revenue borne by countries engaged in the lowering of taxes on income derived from inbound investment or, in other words, the excessive erosion of their taxable bases on such income. This is mainly the result of the various countries bidding against each other in minimising the tax burden in order to attract foreign investment through dangerous beggar-thy-neighbour policies, also referred to as ‘poaching’. As a consequence of this \textit{race to the bottom}, countries to which investment shifts due to the implementation of favourable tax regimes gain little tax revenue and other benefits, whereas countries from which investment shies away lose large amounts of tax revenue: in the end, everyone winds up poorer (except some internationally-mobile taxpayers). Also ‘inter-nation’ equity is affected by this phenomenon, as countries losing revenue on such mobile taxpayers poached by other jurisdictions will in most cases still provide public services to them, which become ‘free riders’ paying low taxes (if at all) therein.\textsuperscript{25}

The negative consequences caused by fiscal degradation and beggar-thy-neighbour policies are several. First, the reduction of tax revenue entails a decrease in the resources available to governments to fund their public spending. This, in turn, leads either to a decrease in the quality of public services and of a country’s welfare system,

\textsuperscript{23} It is interesting to note that also the theory of the ‘cartel’ is based on the notion of competition in the private sector and in particular of its unfair aspect, as seen above at 1.1.4.

\textsuperscript{24} For a survey of the economic studies showing the negative effects of harmful tax competition, see below at 1.3.2, and with regard to the EU in section 1.4.

\textsuperscript{25} See on this Schön, \textit{cit.}, at 94.
or to the need to seek alternative sources of revenue. In the latter case, undesirable distortions are brought about especially by an increase in the taxation on labour (i.e. on wage earners) due to the potential impact on unemployment and to the replacement of labour with capital in the production process. Furthermore, there may be tax equity concerns with regard to both vertical and horizontal equity. These are likely to be negatively affected in that the tax burden is proportionally much higher on wage earners than on capital owners and, from an international point of view, in that domestic taxpayers are more heavily taxed than foreign taxpayers.

Some economic data confirms these trends.\(^{26}\) In general, tax revenue as a percentage of GDP has constantly increased between 1965 and 1995, with an average of 37.6% of GDP in 1994. The share of corporate income tax and individual income tax as a percentage of all tax revenue has been stable, at a level of 8-9% and of 26-27% respectively. There has been a substantial increase in taxes on consumption (i.e. VAT) especially in developing countries, and a considerable rise in social security taxes from 18% to 25% of total tax revenue especially in OECD countries (for the EU, see at 1.4.3). Furthermore, effective tax rates on capital have decreased over the last years (see e.g. at 1.4.4), suggesting an erosion of the capital taxable bases and a shift from capital to labour taxation, which would contribute to higher unemployment.

Significant are also the economic inefficiencies acknowledged to be caused by harmful tax competition. The main one is a misallocation of economic resources caused by investment decisions significantly or exclusively determined by tax considerations. Put in another way, if an investment in a certain country would not have been made in the absence of a targeted tax incentive, this means that the resources are not in the best possible location and are not used in the most efficient way from an economic point of view. Lastly, ‘bad’ tax competition entails drawbacks from a political and democratic point of view. In fact, national jurisdictions outbidding each other surrender themselves to the market, although they are convinced that they are retaining their fiscal sovereignty. In other words, their tax policies end up being dictated by internationally mobile and rich taxpayers rather than by the goal of imposing a reasonable part of the cost of public expenditure on every production factor, including the mobile capital one (see also at 1.4.3).

### 1.2.4 More on Harmful Tax Competition: Foreign Direct Investment vs. Portfolio (Passive) Investment

As seen above, tax competition in an international context mainly concerns the lowering of tax burden by sovereign countries in order to attract inbound investment, which encompasses both foreign direct investment (hereinafter: “FDI”) giving rise to active income and portfolio (i.e. passive or mobile) investment giving rise to passive income (see at 1.1.3 and 1.1.4). This distinction is fundamental with regard to harmful tax competition, and in particular to both its objective aspect concerning the potentially limited applicability of certain tax incentives to only one of these two

\(^{26}\) These data may be found in Avi-Yonah, *cit.*, at 1619 ff., in which there are a number of tables showing them. See also below at 1.3.2 and in section 1.4.
categories and the subjective aspect of the targeting these incentives towards either category. 27

FDI occurs when investors based in a certain country undertake a real (substantial) business activity in a foreign country in order to exploit specific business opportunities in that market. 28 The main reason for effecting FDI is that the investor finds specific competitive advantages in the foreign market in which he is investing as compared to his home market and the other foreign markets potentially attractive to him. FDI is characterised by some sort of physical presence of the investor in the foreign country (e.g. a production plant, a branch, an office etc.) and usually involves a medium- to long-term business presence horizon and a relatively low degree of mobility of the investment.

There is an increasing number of countries worldwide offering some type of tax incentives (also) targeted at attracting FDI. Countries offering these kinds of incentives have been referred to as 'production tax havens' as they try to increase productive activities carried out by foreign companies. 29 They are usually not considered to be engaged in harmful tax competition whenever they have a general low tax rate on productive activities for both resident and foreign investors. The main reasons are that: (i) it is up to each country to set its general tax rate on income from productive activities, (ii) the attraction of FDI usually brings about positive effects such as increased development and employment in that country, and (iii) direct taxation does not play a determinant role with respect to the location of production plants due to their low degree of mobility, as companies look at many more factors before locating a production facility in a specific country (see 1.3.6).

However, there is a tendency especially among less developed or small countries to offer tax holidays and/or other special tax incentives for FDI limited to foreign multinational companies (hereinafter: "MNC") while maintaining a high tax burden on active income earned by resident investors. 30 The number of production tax havens offering special tax incentives to attract FDI has constantly increased in the last years. 31 Also the amount of investment effected in these countries is quite substantial in terms of both assets and income earned therein. 32 The main harmful effects in these cases are that equity among domestic and foreign taxpayers is impaired, and large foreign-based multinationals are able to enjoy public goods without contributing significantly to their provision through the payment of corporate tax.

28 See Easson, FDI, cit., at 2 ff.
29 See Avy-Yonah, cit., at 1588 ff.
32 See once again the data reported by Avi-Yonah, cit., at 1588-1589, as well as the examples of how two well-known US-based multinationals (i.e. Intel Corporation and General Motors) take advantage of such countries in setting up their production facilities.
These problems are made worse by MNCs being able to take advantage of the tax holiday in the host country and then leave to another competing production tax haven upon its expiration. Often, also 'round-tripping' occurs, that is the practice of disguising domestic investment as foreign investment in order to benefit from tax incentives. This behaviour ultimately leads to a race to the bottom (also) on active income earned by MNCs, and to only limited and temporary benefits gained by production tax havens. These trends are exacerbated by the developments occurred in recent years, and in particular the globalisation of the economy and the progressive removal of barriers to transnational investment especially for the presence of organisations such as the EU, WTO, OECD etc. As a result: (i) MNCs are able to shift much more easily also production facilities relating to FDI throughout the world; (ii) the size and business opportunities in the home market where FDI takes place are almost irrelevant, due to a centralisation of the production function by MNCs in a convenient location different from the final destination markets to which the output of such production are exported; (iii) direct taxation has become a much more important factor affecting the MNCs' choice on where to locate centralised production facilities.

Within the EU, the most notable example of production tax haven used to be (and still is) Ireland, which offered a special 10% corporate tax rate on manufacturing income earned from production facilities established in its territory known as 'manufacturing relief', as opposed to a general corporate tax rate of over 30%. Due to political pressure from the EU, Ireland has abolished the manufacturing relief and at the same time has lowered its general corporate tax rate on active income to 12.5% (see in detail especially in Chapter 3, section 3.5).

The situation is different with regard to tax incentives meant to attract highly mobile activities performed in a multinational group or foreign portfolio investment generating passive income. These incentives are almost always specifically targeted at a certain activity and include inter alia management, financial, coordination, insurance, distribution, and other service activities. These are usually centralised by MNCs into 'centres' in order to reduce the overall costs of the group. Countries offering incentives for this kind of foreign investment have been referred to as 'headquarters tax havens.'

These countries are considered to be engaged in harmful tax competition as they grant incentives to attract mobile tax bases at the expense of other countries without any significant improvement of real wealth. In other words, they usually gain little tax revenue and the countries from which the activities and capital are relocated lose big. If other countries retaliate with the same kind of tax incentives, this causes fiscal degradation and the need to seek alternative sources of revenue without bringing about substantial advantages for any of the countries involved. All the other negative effects typical of harmful tax competition are also likely to occur.

The ultimate result is that a large part of (passive) income of MNCs winds up not being subject to any tax at all, and the taxable bases of high-tax countries are also substantially eroded by tax planning techniques leading to international tax avoidance. These techniques are sometimes meant to create artificial deductions through the use of intra-group centres benefiting from favourable regimes offered by

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33 See Avi-Yonah, et al., at 1593 ff.
headquarters tax havens, which deductions are set off against active income earned by MNCs in high-tax jurisdictions. In this respect, there are specific studies showing the ability of MNCs to lower the overall tax burden on their worldwide profits (see at 1.3 below). The effectiveness of incentives offered by headquarters tax havens in attracting ‘centres’ performing the said activities has also been proved, in particular the fact that the choice of their location is affected to a significant extent by tax considerations.34

Nowadays, there is a substantial number of countries offering tax incentives in order to encourage this type of inbound investment. In the EU, notable examples of coordination, distribution, and services centres regimes are present in the Netherlands, Belgium, France, Spain, whereas finance regimes are present in Luxembourg, Netherlands, Belgium, France, Ireland, and Portugal. These regimes will be discussed at length below in Chapters 3 and 5.

To sum up, the increased presence of both production and headquarters tax havens both in the EU and worldwide has benefited especially large multinational companies since their income, whether active or passive, is subject to a low overall tax burden. Globalisation and increased mobility of capital and, to a lesser extent, of production facilities, have favoured this trend.35 At the same time, a decreasing gap between the factors other than taxation affecting companies’ decisions on where to invest has made the tax variable increasingly important in this choice. These considerations explain the increased tax competition between countries to attract both FDI and passive investment by way of specific tax incentives. Given the said features of these tax incentives and consequences likely to be caused by them, one may reasonably assume that they must be considered to give rise to harmful tax competition.

1.2.5 ‘Active’ versus ‘Passive’ Tax Competition and the Prisoner’s Dilemma

An important distinction having a close relationship with the issue of (harmful) tax competition targeted at FDI and/or portfolio investment is the one between active and passive or implicit competition.36 This is based on the subjective aspect of tax competition and in particular to the underlying reason for a country enacting a certain tax incentive.

‘Active’ tax competition arises where a country introduces a tax incentive (or another measures) to improve domestic economic conditions and/or to attract (foreign) investment. ‘Passive’ or ‘implicit’ tax competition has close links with the economic theories of the prisoner’s dilemma and the assurance game.37 In short, in the area of

34 See e.g. the studies cited in Avi-Yonah, cit., at 1595-1596. See also in more detail on this point at 1.3.6.

35 The recent migration of a number US-based multinationals to tax havens by moving their tax residence out from the US has urged the US Treasury to undertake a study on this issue with a view to proposing harsh anti-avoidance measures. Under these measures, expatriation would be disregarded if its main motive was US tax avoidance, i.e. in case they were owned for more than 80% by US shareholders, or for more than 50% if they were not active in the market to which they had moved their residence. Preliminary research on four large US multinationals moving their tax residence to the Bermuda showed that some $525 million in US taxes had been avoided. See the US Department of the Treasury Office of Public Affairs, Treasury announces study on U.S.-based multinational corporations reincorporating in foreign countries, 28/2/2002, in 2002 Tax Notes Today, 1/3/2002, 41-35.


37 See Kenyon & Kincaid, ibid., and Avi-Yonah, cit. The prisoner’s dilemma game is as follows (see Kenyon & Kincaid, at 21, citing Kreps): “The police have apprehended two criminals whom they strongly suspect of a crime
tax competition in an international context, these concepts refer to the behaviour of countries that are forced to enact or maintain a certain tax measures to preserve themselves from potentially adverse consequences caused by active tax competitive measures introduced by other countries. The dilemma is the choice of these countries between (i) adopting similar measures (also) driven by the fear to lose competitive edge in the international arena, causing active tax competition, or (ii) simply doing nothing or enacting unilateral countermeasures specifically targeted against measures of countries actively engaged in tax competition, giving rise to passive or implicit competition. In the former case, the country involved is doing (or feels force to do) what it reproaches other countries, which is likely to ignite further retaliation or the adoption of a similar behaviour (i.e. tax measures) by other countries: a race to the bottom is almost inevitable. In the latter scenario, that country will almost certainly lose tax revenue, which may be curtailed presumably to a limited extent if appropriate countermeasures are adopted.

The assurance game in this context refers to the possibility for the ‘players’ (i.e. countries) to agree to a co-ordinated or harmonised approach to improve their situation, such as gain more tax revenue. Together, they may form what is referred to by economists as a ‘collusion’ or ‘cartel’ to end (tax) competition between them (see also at 1.2.2). This, however, is not always possible and is indeed very unlikely where there are too many players or their respective situations are too different, in which case economists draw a parallel with firms that are price-takers in a perfectly competitive market. In the tax competition area, it is close to impossible for all countries to agree on a coordinated approach to deal with this issue, and even for a more limited group of countries, as shown by the problems faced by the OECD in the attempt to fight harmful tax competition (see in detail Chapter 4, section 4.8).

Within the EU, a coordinated approach is more likely to succeed, as the number of players is rather small and the interests at stake pursued by the Member States are largely consistent (see in Chapter 4, especially sections 4.2 and 4.3).

An example may better clarify the above concepts. If a country enacts a tax holiday or a special incentive to attract FDI or a special tax regime for coordination centres, it can be said to be engaged in active tax competition. Other (neighbouring) countries may decide not to enact any specific tax measure to attract FDI and/or coordination centres to compete with that country, or to enact specific countermeasures to undo the effects of its measure(s): this causes passive or implicit tax competition. As said

(And who in fact committed the crime together). But the police lack evidence ... and must release the two prisoners unless one provides evidence against the other. They hold in separate cells and make the following offer to each: Implicate your colleague. If neither of you implicates the other, each of you will be held for the maximum amount of time permitted without charges being made. If one of you implicates the other and is not implicated, we will release the first and prevail the judge to give...the maximum sentence ... If both of you implicate each other, then both will go to jail, but the judge will be lenient... The story suggests that of the four possible outcomes for a prisoner, it is best to implicate and not be implicated, second best neither to implicate nor be implicated, third ... to implicate and be implicated, and worst to be implicated while failing to implicate ... we are led to predict that each side will implicate the other since this is a dominant strategy for each.”

An example of targeted countermeasures is CFC (i.e. controlled foreign corporation) legislation, which would subject to current taxation the profits of the foreign entity benefiting from the tax incentive on FDI or of the foreign coordination centre in the hands of the resident parent company or headquarters. An alternative countermeasure could be the denial of the participation exemption on profits distributed by the entities enjoying the tax incentive for FDI or the coordination centre. On the issue of countermeasures and their compatibility with EC law, see extensively in Chapter 5.
above (at 1.2.4), nowadays there is a number of production and headquarters tax havens engaged in active tax competition as they are offering this kind of special incentives. There are also a number of countries using general or targeted countermeasures against these tax havens, and thus engaged in passive or implicit tax competition. Most of these countries are becoming aware of the harmful effects caused by this kind of tax competition, but in the impossibility to reach agreement on a coordinated approach they are forced to keep their special tax incentives or their countermeasures, or else they would suffer from relocation of investment and capital in other countries or would lose additional tax revenues. This suggests that these countries are in a prisoner’s dilemma or assurance game situation in which they are worse off and do not end up in optimal situation for them due to the impossibility to reach a compromise on how to deal with this issue.39

1.2.6 Where is the Borderline?

In theory, the distinction between desirable and harmful tax competition is easily explained by reference to the main effects caused by a certain tax measure along the lines discussed above. In particular, whenever this measure is likely to bring about desirable economic effects such as a generalised reduction of the tax burden and an increased efficiency in the public sector, it is considered ‘good’ tax competition. In the opposite case that it most probably leads to such harmful consequences as fiscal degradation and the need to increase the burden on alternative bases to compensate for it, then it will be categorised (and fought) as ‘bad’ tax competition.

In practice, however, no clear criterion has been singled out to draw the line between these two categories of tax competition. Nevertheless, based on all the above considerations it seems appropriate to base the distinction on the assessment of the objective and the subjective aspect of tax competition as explained above (see at 1.1.1. and 1.1.4). The main factor concerning the objective aspect would be the general versus the specific character of a certain tax measure, or in other words its deviation from a country’s ‘benchmark’ tax system: general measures would not be considered to give rise to harmful tax competition, whereas specific measures would.40 The main criterion concerning the subjective aspect would be the country’s main goal to stimulate economic growth, favour the development and employment in depressed areas, and compensate for its small size, versus the goal to attract foreign (mobile) investment at the expense of other countries mainly in a non-transparent way (i.e. tax policies intentionally meant to cause negative spillover effects in other countries’ economies): harmful tax competition would only take place in the latter case.41

39 As will be seen, the EU has been trying to coordinate the tax policy of Member States to limit harmful tax competition through the Code of Conduct on Business Taxation, but there are still problems in its implementation by each Member State (see in Chapter 4, at 4.2 and 4.3).
40 Avi-Yonah, at., at 1628, bases the distinction between desirable and harmful tax competition exclusively on this criterion of general vs. special tax measure, as this would catch both ‘production’ and ‘headquarters’ tax havens (see at 1.2.4). Also the EU Economic and Social Committee, in its opinion on fiscal competition and its impact on company competitiveness, CES 526/2002 EN/O/vh, Brussels 25/4/2002, points out that “whatever their basic fiscal policies, states may make exceptions, derogations, etc. with the specific aim of attracting and retaining company presence in the country. This is defined as harmful tax competition.”
41 The OECD Report on Harmful Tax Competition specifically refers to these criteria on the main policy goal aimed at by countries: see especially at 15-16, paras. 26-29 (discussed in Chapter 4, at 4.8.2 and 4.8.3).
In order to ascertain the general vs. the specific character of a certain tax measure and a desirable vs. an adverse policy goal mainly pursued by this measure, a number of additional criteria may be used.\textsuperscript{42} With regard to the objective aspect, a tax measure should be considered special, and hence harmful, where it is: (i) limited to certain categories of income (e.g. active or passive income); (ii) limited to certain business activities (e.g. financial, distribution, and other service activities performed by 'centres'); (iii) limited to certain taxpayers only (e.g. non-residents or local divisions of multinational companies, also referred to as 'ring-fencing'); (iv) a deviation from the standard internationally-accepted principles (e.g. the OECD transfer pricing rules).

As for the subjective aspect, a country's 'bad' intention is usually shown by a tax measure: (i) lacking transparency and applied on a discretionary basis by a country's tax administration; (ii) applying regardless of a substantial economic presence of its beneficiary(ies); (iii) lacking adequate anti-avoidance provisions limiting their use in abusive situations exploited by its beneficiary(ies).

From a practical point of view, the application of some of the above criteria may give rise to problems, especially the subjective ones. Furthermore, some of them concern both the objective and subjective aspect of tax competition, such as the applicability of a tax incentive only to income from mobile investment. To overcome these problems, one has to thoroughly weigh all characteristics of a tax measure and its underlying goal in order to see whether its desirable versus harmful features prevail. All in all, despite the application of the suggested criteria is not easy, it seems the best solution to ensure that a line between good and bad tax competition is drawn, and that it is drawn in the right place.\textsuperscript{43}

1.3 (Harmful) tax competition: Theory, evidence, and methodological issues

1.3.1 Overview

This section contains a survey of theories and economic studies on tax competition. The main purpose of these studies is to identify its main effects and in particular whether this phenomenon is prevalently beneficial or harmful, and thus whether it needs to be regulated in some form or not. The studies analysed concern mainly horizontal or interjurisdictional tax competition between the states of the US and other localities (i.e. municipalities) as they contain a wealth of findings and constitute the first step on whose basis there has been an attempt to elaborate a general theory on tax competition. The survey of the main such studies shows somewhat conflicting results, mainly caused by the different economic models and underlying assumptions relied on by the economists. Furthermore, the significance of these studies for the EU context is rather limited due to the differences between the US federal system and the supranational character of the EU. Despite this, the US experience is fundamental in

\textsuperscript{42} The criteria indicated for this purpose in the text are based on those indicated in the EU Code of Conduct on business taxation of 1997 and in the OECD Report on Harmful Tax Competition of 1998 (see Chapter 4, at 4.2.2 and 4.8.2). See on this also Schön, EATLP 2002 Report, cit., at 4-6.

\textsuperscript{43} For the literature on the fiscal federalism and tax competition in the US, see supra in footnote 1. See also J. R. Rogers, State Tax Competition and Congressional Commerce Power: The Original Prudence of Concurrent Taxing Authority, 7 Regent University Law Review, 1996, p. 103; A. K. Kleverick, Constructing a new federalism: Jurisdictional competence and competition - Theoretical paradigms, Yale Journal on Regulation, 1996, p. 177.
singling out a methodology able to study the phenomenon of (harmful) tax competition in an international context by comparing different tax systems of various countries.

The last issue regards methodologies able to show the impact of tax competition on firms' behaviour and on investment patterns, which is fundamental to ascertain the detrimental effects caused by harmful tax competition. Despite the absence of an effective general methodology used for this purpose, there is sufficient evidence proving the relationship between direct taxation and investment decisions, especially those concerning 'mobile' activities. The theories and methodologies discussed below are fundamental in understanding the studies specifically focusing on tax competition in the EU, which will be analysed in the next section.

1.3.2 Theories and evidence on interjurisdictional tax competition in the US experience

The earliest and richest economic literature concerning interjurisdictional tax competition may be found in the US with regard to competition between governments of the US states and to a lesser extent between municipalities. This is mainly due to the peculiar features of the US federalism, which relies on an incredibly high number of decentralised authorities provided with a relevant degree of autonomy covering *inter alia* the need to raise revenue to finance local expenditure. Several economists have been studying and analysing this interjurisdictional tax competition in order to sort out its main features (i.e. its beneficial versus detrimental effects) and ultimately to elaborate a general theory on this phenomenon.

The father of the US theorists on interjurisdictional tax competition between US states has been Charles Tiebout, who back in 1956 analysed the benefits and drawbacks of tax competition and has since been followed or criticised by several other economists.44 According to Tiebout, tax competition is desirable and must not be restricted in any way as the individuals/voters pick the most suitable location for them based on their subjective evaluation of the balance between tax burden and public services offered. This, in turn, leads to efficiency as to the right quantity and quality of public services offered (i.e. allocative efficiency) as well as to the minimisation of the corresponding costs (i.e. productive efficiency).45 The assumptions behind this theory are several: (i) the only taxes paid are benefit taxes, i.e. those commensurate to the services provided to taxpayers rather than those having redistributive goals and based on taxpayers’ ability to pay; (ii) individuals are fully mobile and are provided with perfect information on the tax systems of the different jurisdictions; (iii) there are no spillover effects caused by the different tax measures of the various jurisdictions. Tiebout’s theory is also restricted in that it only takes into account individuals and not companies.46

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44 See C. Tiebout, *A Pure Theory of Local Expenditure*, Journal of Political Economy, vol. 64, 1956, pp. 416 ff. The theory of Tiebout and of all the other economists reported hereinafter are excellently summarised in Kenyon, *cit.*, pp. 18 ff., which has been largely relied upon in drafting this paragraph.


Subsequently, other theorists used models relying on assumptions similar to Tiebout's model and reached similar conclusions. Studies focusing on mobile capital rather than individuals, or on both firms and individuals, also highlighted that the main desirable aspect of tax competition was to force governments to achieve productive efficiency and to maximise the welfare of their community. However, these studies also found that tax competition may have 'destructive' results by causing horizontal and vertical inequities, the former stemming from the fact that less-mobile taxpayers tend to bear a higher tax burden than mobile taxpayers earning the same amount of income, and the latter from the fact that rich mobile taxpayers tend to enjoy specific tax incentives.

The potential harmful effects of tax competition have been stressed by public finance theorists relying on assumptions different from those used in Tiebout's (and his followers') model. According to a model focusing on taxes other than benefit taxes, such as taxes on capital, optimal productive efficiency will not be achieved as local governments prefer to impose a head tax rather than a tax on capital due to the fear of capital flight from their territory. Thus, whenever they are forced to reduce such tax the quality or level of public services will inevitably decrease. Other models critical of the Tieboutian one and reaching an analogous conclusion that tax competition essentially causes harmful effects stress the fear of local governments to impose taxes on mobile capital, which itself leads to a forced underprovision of public services, as well as to other distortionary effects caused by the imposition of a tax on the less mobile labour factor, such as a reduction on the supply side and, ultimately, the same effect of driving capital out of that jurisdiction.

Another interesting study analyses in general the various forms of governmental competition from both a political and an economic perspective and reaches a balanced conclusion. Its starting point is that the differences between horizontal and vertical competition (see at 1.1.2) as well as those within these two categories must be analysed separately because of a number of differences. More specifically, it is stressed that while competition between states in the US is meant to attract business through favourable corporate and tax laws thereby causing a race to the bottom, local competition between municipalities induces governments of big cities to increase taxes in order to finance increasing expenditures, which may cause rich taxpayers to move to the suburbs. The conclusion is that interjurisdictional (tax) competition may have both desirable effects as regards improved efficiency in the provision of public services and detrimental effects as to economic inefficiencies and instability created at local level. This theory stresses the fundamental role that the federal government may

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49 The survey of the studies summarized in the text is based on Avi-Yonah, cit., at 1611 ff.
(and should) play in this scenario in eliminating or at least smoothening the inefficiencies brought about by detrimental competition. This may be done by implementing specific regulations or granting incentive packages aiming to limit interjurisdictional competition and at the same time to provide some relief for needier states or localities. The noteworthy core of this theory lies in the acknowledgement of both desirable and detrimental effects caused by interjurisdictional (tax) competition at the various levels, and in the call for action by superior governmental bodies only to the extent necessary to limit its detrimental effects.53

1.3.3 Significance of US studies and experience for the EU

The findings of the economic studies and theories on interjurisdictional tax competition in the US are interesting for the analysis of interjurisdictional tax competition within the EU.54 The US experience provides a number of lessons to be learned by the EU due to the large number of states and local authorities as well as to the variety of assumptions and models used in the various studies to identify the main effects of tax competition. The significance of these findings for the EU, however, depends on the similarities and differences of the respective US and EU institutional (and legal) framework, and in particular on the powers and degree of autonomy of the jurisdictions tested, i.e. states (and other localities) for the US versus sovereign Member States in the EU, as well as of their superior governmental bodies, i.e. the US federal government and the EU institutions (mainly the EU Council and Commission) respectively.55

The US is a federal country in which states are in principle provided with a broad autonomous power in the tax area, as they are free to shape their direct and indirect taxes in the way they deem most appropriate.56 There are constitutional limits to this power,57 but the federal government generally refrains from intervening in the area of

53 See on this issue also S. B. M. Princen, The California effect in the transatlantic relationship, doctoral thesis presented at University of Utrecht, April 2002. The author analyses four cases of international trade policy competition between the EU and the US (States) relating to the higher standards of protection advocated by the EU (e.g. with regard to genetically-modified products, or to the protection of animals in the trade of furs). The research showed that no race to the bottom took place in three cases, as the EU did not lower its standards, nor did the US adapted to the EU standards. However, in one case (i.e. concerning the policy on the trade of furs) it turned out that the EU's higher standards were indeed adopted by the state of California, leading to increased protection in that policy area (i.e. 'the California effect'). This suggests that in some cases (international trade) policy competition is beneficial as the standards are raised rather than lowered, and thus no race to the bottom is caused.

54 See, on the significance of these studies and the main differences between the US and Europe, among others S. G. Utz, Tax Harmonization and coordination in Europe and America, 9 Connecticut Journal of International Law, 1994, p. 767.


57 The main federal constitutional limits to the states' taxing power are the commerce clause and the due process clause. According to the former, the US states are prohibited from discriminating against interstate commerce in any form whatsoever, including through the imposition of (special) taxes that have the result of imposing a heavier burden on interstate commerce. The application of the due process clause to the fiscal area implies that taxes may only be imposed on activities having sufficient connection to the taxing state, which is banned from extending its fiscal jurisdiction beyond its boundaries.
state taxation through harmonisation laws or other legally binding instruments. As a result, (also) in the corporate tax area there are significant differences with regard to states’ tax rates, tax bases, special incentives, as well as taxation of companies active in several states as for the allocation of their taxable income between them.\textsuperscript{58}

In this scenario, tax competition among states has proliferated over the years, as a result of the federal government not regulating this phenomenon. Furthermore, the large number of competing states (as well as localities) has practically made it impossible for them to collude with each and to adopt a coordinated approach instead of competing.\textsuperscript{59} In the absence of convincing evidence to the contrary, tax competition among US states is in general not perceived as a harmful phenomenon, and thus is likely to continue in the future years.

The institutional situation in the EU context is very much different. As for the political structure, the EU is a supranational body provided with specific powers in certain areas, but is still very far from being a federal country like the US. In the area of direct taxation, Member States enjoy sovereignty and the EU institutions have very limited powers to interfere with this sovereignty (see in detail Chapter 2, especially section 2.1). Furthermore, there are a number of additional non-tax differences between Member States that are not present (to the same significant extent) between the US states. To name a few, differences in language, culture, and social habits, and in the legal area differences in the legal systems and cultures (e.g. common law versus civil law systems) between Member States, are all quite widespread.

In the tax competition area, these considerations entail that some of the assumptions made for the US-based studies and theories are not valid also with regard to the EU. For instance, one should assume that the mobility of both individuals and companies is not wholly comparable to that of the US because of the said (and other) differences. However, the constant progress for the setting up of a truly internal market in the EU and the introduction of a single currency in twelve Member States have been favouring their integration, as has the shrinking of other differences between them. As a result, the US and the EU realities are nowadays much closer, despite a number of significant differences in the institutional area and on other areas still remain.

For our analysis, the above considerations suggest that the studies and theories on interjurisdictional tax competition in the US are also significant for the EU, but to a more limited extent. This depends on how valid the underlying assumptions and simulations concerning the US states would be in the EU context. This also implies that the methodologies used to analyse tax competition in the US may be used to study this phenomenon in the EU as well, especially if the necessary adjustments are made to reflect the specific features of the Union as will be explained in next paragraph.

\textsuperscript{58} In this respect, several states adopt a three-factor formulary apportionment based on sales, payroll and assets regardless of the internal accounting of the companies. Other states determine companies’ taxable income on the basis of separate accounting done by the entities of the group. A few states do not impose a corporate tax but rely on alternative taxes. See on this Weiner, \textit{Formula Apportionment, cit.}, at 418 and 436.

\textsuperscript{59} A coordinated approach would probably have led to collusion, which is very difficult to achieve where there are too many players in the assurance game (see at 1.2.5). As a consequence, the US states end up in a prisoner’s dilemma situation, in which they are forced to be actively engaged in tax competition for fear to lose attractiveness for potential investors.
1.3.4 Methodologies to study tax competition in an international (and EU) context

The above survey shows that there is a high degree of uncertainty in the economic literature as to how to achieve meaningful results to scientifically analyse the phenomenon of tax competition and its desirable versus harmful form. The results of the economic studies carried out with regard to the US states all depend to a large extent on the model used and the various assumptions considered in the simulations. However, in the more recent years some general methodologies based on these studies have been singled out that are able to analyse in a more coherent way the issue of tax competition. The main such methodologies have been systematically categorised in a theoretical way by economic literature, so that a more scientific approach is reached in their use depending on the intended goal of the economic studies relying on them.60

The common aim of such methodologies is to calculate the effective tax burden on income from different investments in a number of countries so as to compare various tax regimes and their specific incentives. This is needed to identify their interrelations and try to determine the way they affect business decisions concerning investment, location, and financing, and ultimately the way they distort competition and capital flows. For this purpose, a number of factors are taken into account in the determination of the effective tax burden, which affect the outcome of each study. The main ones are: (i) relevant taxes, which may be corporate taxes (i.e. statutory and special tax rates) and all other taxes on corporate profits and non-profit taxes on investment; (ii) relevant tax bases, which depend on the statutory rules on the computation of taxable income and possibly on special tax incentives; (iii) relevant taxpayers, which can be corporations, but also shareholders subject to taxation on distributions of profits and other items of income such as interest and royalties.

The main models based on a combination of these (and other) factors have been distinguished into two categories based on whether the methodology relied on is backward- or forward-looking. Backward-looking models aim to calculate the effective tax burden on the basis of existing microeconomic or macroeconomic data. As for the microeconomic approach, it looks at the effective tax rate on income borne by specific firms expressed as the percentage of tax liability relative to the profits from their consolidated accounts. The main problem with this approach is its inaccuracy in an international context, as it neither measures the impact of taxation of the shareholders, nor is it able to precisely calculate the tax burden on the firms' foreign-source income. The approach based on macroeconomic data focuses on a country's overall corporate tax revenue as a percentage of overall corporate tax profits, corporate operating surplus, or GDP. Also this approach has a number of flaws, namely linked to the inaccuracy or unavailability of complete data on the factors taken into account, as well as on other taxes levied on corporate profits or borne by taxpayers other than corporations. In addition, both backward-looking approaches are not able to identify the effects of special tax incentives offered in the

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60 For a thorough explanation of the methodologies dealt with in this paragraph, see especially O. H. Jacobs and C. Spengel, Measurement and Development of the Effective Tax Burden of Companies - An Overview and International Comparison, Interfax, 2000, p. 334. See also the recent Commission Study on Corporate Taxation in the EU of 2001, pp. 68 ff., explained in detail below at 1.4.5.
various countries, which makes their use in an international comparison perspective rather meaningless.

The forward-looking approaches calculate the effective tax burden by reference to a hypothetical future investment undertaken by a firm. Instead of actual tax burdens as in backward-looking approaches, these methodologies estimate what the effective tax burden would be in the future if a certain investment were undertaken by a certain firm. The commonest methodology to calculate the effective tax burden is the 'King & Fullerton' approach,\(^61\) which has subsequently been revised and tailored by other economists to analyse e.g. tax competition in an international context.\(^62\) It is intended to calculate effective marginal tax rates (hereinafter: "EMTR") on a hypothetical marginal investment generating a rate of return just sufficient to be considered worth undertaking by the investor. Both corporate tax and taxes on shareholders' return on investment may be taken into account for the computation of the EMTR, as well as all statutory rules on the computation of the tax base and special tax incentives. The model to calculate EMTRs relies on a number of assumptions relating e.g. to the types of assets of the corporation (e.g. machinery, buildings, intangibles, inventory, financial assets) as well as to different forms of financing of the marginal investment (e.g. through debt, equity, or retained earnings), whose possible combinations lead to different outcomes.

A variation of this methodology is aimed at calculating the effective average tax rates (hereinafter: "EATR") on a hypothetical future investment. The main difference with the EMTR methodology is that the rate of return of the hypothetical investment is presumed to be much higher than the market interest rate otherwise earned by the investor. The EATR is given by the net present value ("NPV") of corporate tax revenue as a proportion of the NPV of the pre-tax income stream generated by the project. Also this model may take into consideration all relevant taxes as well as rules on the computation of the taxable base. The hypothetical investment project considered is either based on the King & Fullerton method's (see above) industry-specific mix of assets or on a hypothetical specific firm of a certain sector of the economy with different percentages of types of assets and sources of finance of the investment.

A recent approach specifically tailored to the EU is the so-called 'European Tax Analyser', set out by the University of Mannheim and the Centre for European Economic Research (ZEW).\(^63\) This is a computer program used to calculate and compare the EATR for corporations located in different (Member) states. The EATR is given by the difference between pre-tax and post-tax return on equity of the corporation divided by the pre-tax return. This model focuses on a hypothetical investment of a model corporation taking into account all applicable taxes able to affect decisions on investment and ways of financing for both corporation and shareholder, elements of statutory tax law for the computation of the taxable base, as well as special tax incentives meant to boost new investment (e.g. investment


\(^{63}\) On this model, see in detail Jacobs and Spengel, cit., at 339 ff., and bibliography cited therein in footnote No. 36.
allowances, investment and R&D tax credits, and grants). The assumption is that the investment generates a higher return than the market interest rate, and the model is applied by reference to a number of situations consisting of a different weight of the corporation's assets and different forms of financing the investment.

1.3.5 Direct taxation and its impact on companies' locational decisions

Despite the significant progress achieved by economic theory on the calculation of effective tax burdens in an international context, there still is high uncertainty as to how different tax burdens affect companies' decisions on where to locate. This issue is fundamental because only if direct taxation is decisive in affecting the actual behaviour of companies and in particular their locational decisions is (harmful) tax competition likely to be a real problem (see also at 1.2.4 and 1.4.2-1.4.5). In other words, if direct taxation were not (so) relevant in this respect, one would probably have to agree that there should be no need to worry about harmful tax competition altogether.

Even though several studies have been carried out on this issue, none of them has clearly proven the relationship between direct taxation and companies' locational decisions and the extent to which the former actually affects the latter for the lack of an effective general methodology currently used for this purpose. More specifically, some of these studies are based on economic models mainly relying on macroeconomic or microeconomic data (e.g. figures on foreign direct investment or investment patterns of specific multinational companies). The shortcomings of these models are linked to the lack of exhaustive or appropriate data or to other assumptions in the analysis. Other studies are based on empirical evidence, and are meant to analyse the behaviour of companies through questionnaires filled out by them or interviews with their management. Their effectiveness suffers mainly from the limited number of responses received, as well as from the bias of companies' representatives providing the answers and feedback used to draw conclusions.

Despite this, a number of interesting and rather consistent conclusions may be found in these studies, mainly effected in the US. As a matter of principle, it appears that taxation is merely one of several factors influencing companies' decisions on the location of their investment, the others being other political, economic, and social factors. All these factors are treated in a hierarchical way to single out a group of suitable locations, which is usually referred to as 'macro-location' decision. It is only at this stage that taxation would play a more important role in affecting the actual locational decision, which is known as 'micro-location' decision.

The above general finding is true only to a certain extent. In particular, ceteris paribus or in situations in which all the other factors are largely equivalent, direct taxation does tend to play a fundamental role in companies' locational decisions. Some studies analysing the effect of the different US states' (and Canadian provinces') formulas used for income apportionment under unitary taxation (see at 1.3.3) on the location of

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64 As will be seen, an interesting application of the empirical approach in the EU may be found in the Ruding Report of 1992, analysed at length below (see at 1.4.2).
65 For a summary of these studies, see Avi-Yonah, cit., at 1590-1592, and the EU Commission Study of 2001, at 85-87 (see below at 1.4.5).
66 See the economic studies cited in the EU Commission Study, at 87.
companies have identified that they may offer an incentive to locate the factors used for the computation of the taxable base in low-tax areas. Furthermore, with regard to the distinction between FDI and passive investment (see at 1.2.4) it has been shown that direct taxation: (i) has a "significant" influence on the magnitude and location of FDI, even though it rarely seems to be the determinant in the final decision on where to locate production facilities; (ii) determines to a significant extent companies' location decisions of intra-group administrative, distribution, and financial activities, especially through transfer pricing or thin capitalisation.

With more specific regard to tax competition, it would be interesting to identify a methodology able to find out how it affects actual firms' decisions on where to invest. As mentioned above (at 1.2.2), it is believed that one of the effects of (desirable) tax competition in an international context is the convergence of tax burdens and their levelling downwards (see all the studies analysed at 1.4). Even in the absence of models and studies showing the relationship between this consequence of tax competition and its influence on corporate locational decisions, from US-based studies it is possible to identify a consistent finding: tax competition has led to a significant decline in the effective tax burden suffered by US MNCs abroad, which has made foreign investment more sensitive to taxation in the decision on where to locate capital.

From the above it may be concluded that the existing methodologies used to prove the relationship between taxation and companies' decisions on the location of their investment have all some flaws. Nevertheless, there is sufficient evidence of the influence direct taxation has on such decisions. This influence is more significant with regard to the location of mobile investment generating passive income than of FDI. Within the EU, one must also consider that direct taxation is likely to play an even more significant role in companies' locational decisions, as all the other factors used for the 'macro-location' decision are largely equivalent in the Member States.

1.4 Economic evidence of (harmful) tax competition in the European Union

1.4.1 Introduction

While up to some time ago there was only a very limited economic literature on the phenomenon of tax competition in the EU, in the recent years a number of studies has been carried out on corporate taxation in the various Member States and the distortions to the internal market their differences are likely to cause. Some of these studies specifically focused on the effects caused by harmful tax competition in the EU. A comparison of these studies' findings shows a number of consistent trends and

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67 See e.g. Weiner, *Formula Apportionment*, cit., at 381 and 383, and literature cited in notes 3 and 11-13.
70 Ibid. previous two footnotes.
conclusions, which suggest that both desirable and harmful tax competition do exist in Europe.

This chapter focuses at first on the Ruding Report of 1992, which contains a comprehensive study on corporate taxation in the EU. A brief analysis of the Monti Memorandum and the subsequent Commission Report of 1996 follows, as well as a summary of other studies dealing with tax competition in the EU carried out subsequently. The last part focuses in detail on the recent Commission study on corporate taxation in the EU released in 2001, which (also) contains a wealth of information and studies relating to tax competition.

1.4.2 (Harmful) Tax Competition and the Ruding Report

1.4.2.1 The Ruding Report (1992) and the Commission Reaction

The Ruding Report, released in 1992, contains the outcome of a two-year study carried out by a committee of tax experts chaired by Mr. Onno Ruding on request by the EC Commission. The goal was to provide an answer as to whether the differences in the Member States’ corporate tax systems created significant distortions in the internal market that needed to be eliminated. In case of an affirmative answer, the Ruding Committee was asked to recommend whether there was a need to adopt measures at EC level and if so, which measures would be appropriate.

The Ruding Report found major differences in tax regimes of Member States with regard to tax rates and bases, methods to relieve double taxation, and methods to tax dividend distributions in the hands of shareholders. The Report concluded that such differences caused several distortions in the internal market as they ultimately generated significant differences in the cost of capital for investment effected in the various Member States (see next paragraph). This was likely to affect companies’ choices on the location of their investments as well as their decisions on the legal and financial aspects of such investments (see below at 1.4.2.3).

The Report contained a set of detailed recommendations for the elimination or the reduction of such distortions as well as deadlines within which they should have been implemented. In particular, the Report recommended the elimination of double taxation on all payments between related companies (i.e. dividends, interest, and royalties), and called for the adoption of measures for the cross-border offsetting of losses derived by different EC companies belonging to the same group. Furthermore, it proposed the approximation of corporate tax rates within a certain range and the harmonisation of corporate tax bases of the Member States in the longer term.

Apparently, the scope and impact of such recommendations were quite ambitious and far-reaching, especially considering that back in 1992 the degree of integration in the EC and of the harmonisation of other areas of law was still limited. In addition, the previous failures of the Commission’s efforts to reach adoption of harmonisation

proposals in the area of direct taxation made the Ruding Committee’s recommendations sound outside of the European reality especially since at that time everybody was happy with the recently formulated ‘subsidarity’ principle (see Chapter 2, at 2.2.3). It is true that the Ruding Committee did not show an extreme respect for that principle, but had it done so, virtually nothing could have been recommended. Thus, one must acknowledge that the Ruding Report should have received more credit than it received.

This explains why the reaction of the Commission to the Report was not as warm and enthusiastic as one might have expected, despite praising the valuable substance of the Report as a reference for future debate at EC level and its fine quality from both a theoretical and empirical perspective as well as the political independence of the members of the Committee. On the contrary, the Commission issued a Communication\textsuperscript{74} in which it partly denied endorsement to its content and made clear that it did not share the approach of the Committee on the desirable degree of EC-driven harmonisation. As for the proposals put forward in the Report, the Commission rejected the most politically-sensitive ones by affirming that they went beyond the mandate of the Committee. Instead, the Commission stuck to its subsidiarity approach in the fiscal area, by making it clear that it would consult each Member State before putting forward any further proposals, especially those concerning the harmonisation of their corporate tax systems. As for the proposals for the fixation of a band of a minimum and a maximum corporate tax rate and for tax base harmonisation, they were flatly rejected. The Commission endorsed exclusively the Report’s less sensitive tax proposals meant to eliminate clear, limited, and well-defined distortions to the internal market, namely the proposals to broaden the scope of the Parent-Subsidiary Directive and to adopt the directives on taxation of intra-group payments of interest and royalties and on the EC-wide offsetting of losses.

1.4.2.2 Main differences in Member States’ tax systems

Despite the Commission critiques, the Ruding Report is to be considered a milestone in the area of EC direct taxation and tax competition as its findings are an invaluable research tool. This is also confirmed by the recent Commission study on corporate taxation in the EU, which has stressed their validity and significance and their reference as starting point for the study (see at 1.4.5.2). Therefore, the parts of the Report on tax competition in the EU are worth further analysis.

The Ruding Committee addressed the issue of tax competition within EU in different ways throughout the Report. In analysing the Member States’ tax systems, it found significant differences in their statutory corporate tax rates, which ranged between 10% on manufacturing activities in Ireland and 57.5% in Germany.\textsuperscript{75} Furthermore, it stressed that there were a number of special incentives granted by Member States in various forms, such as depreciation allowances, tax credits, or direct grants for investment. The Report also noted the existence of tax-free areas such as the Dublin

\textsuperscript{74} Commission Communication SEC (92) 118, of 27 July 1992.

\textsuperscript{75} These figures refer to the corporate tax rates as at 1 January 1989: see the Ruding Report, at 64. Interestingly, as for the corporate tax rates of the other federalist countries surveyed in the Report (i.e. the USA, Canada and Switzerland), Switzerland appeared to have the broadest spread of tax rates (i.e. 13.51 to 39.44%) depending on the canton of establishment of corporations.
International Financial Services Centre, the free zone in the Portuguese island of Madeira, and the reconversion and T-zones in Belgium and France, which all provided for tax advantages limited in time. Furthermore, the Report stressed the presence of a number of tax advantages aimed at attracting financial, management, and other activities mainly performed by ‘centres’ in countries like Belgium, Ireland, and Luxembourg. Lastly, the Report showed that there were wide differences in the withholding taxes levied on dividends, interest, and royalties paid to non-residents.

Other interesting findings contained in the Report regard the calculation of cost of capital, marginal effective tax wedges and rates, and average tax rates according to the King & Fullerton methodology (see at 1.3.5). The study considered the hypothetical taxation of a marginal investment undertaken by the firm and yielding a return just sufficient to make it worth effecting (i.e., just above the economic rent). As for the assumptions, the investment was considered to be in the manufacturing sector, and three types of assets (i.e. machinery, buildings, and inventory) and three forms of financing (i.e. new equity, debt, and retained earnings) were used in the simulations.

The results of these simulations showed significant differences in the cost of capital and in the effective tax burden on the various hypothetical investments undertaken by the firm. Such differences were found in the case of a purely domestic investment both between the various EU countries and within them depending on the assets (machinery was treated more favourably) and the form of financing of the hypothetical investment (debt enjoyed a lower burden). Also the transnational case considering an investment by a company in another Member State through a wholly-owned subsidiary was treated differently as to the cost of capital and the effective tax burden (see at 1.3.5). The Report also points out that the most important factors for the determination of the cost of capital were the statutory corporate tax rates and the rules on the computation of the tax base. Interestingly, the Report showed that neither CEN nor CIN were achieved in the EU, and that the underlying tax distortions would be significantly reduced if statutory corporate tax rates were harmonised. Lastly, other noteworthy conclusions found in the study were a more reduced effective tax burden on domestic investment undertaken by resident companies as compared to a similar investment undertaken by a non-resident company, and a higher tax burden on investments undertaken abroad by domestic companies as opposed to domestic investments undertaken by them.

1.4.2.3 Survey on the Impact of Taxation on the Firms’ Locational Decisions

An interesting part of the Ruding Report tries to shed light on the issue of the impact of differences in Member States’ tax systems on companies’ decisions on the location of their investments (see also at 1.3.6). This issue was part of the analysis as to
whether these differences caused major distortions in investment decisions and competition in the EC.

In the absence of a generally accepted methodology used for this purpose (see in detail at 1.3.5), the Report relied on an empirical study based on a specific survey. The survey was distributed to a number of companies based in EU countries as well as in EFTA countries (i.e., at that time Austria, Finland and Sweden, who later joined the EU, and Switzerland and Iceland). Responses were provided by 965 companies (especially UK, Dutch, and German), or about 11% of the companies to which the survey had been distributed. These companies were active in the majority of cases in the industrial (i.e. manufacturing) sector (i.e. some 68%), and in a smaller number they represented the retail and the financial sector. The outcome of this survey, further supported by other surveys and pieces of research contained in the Report, provides some meaningful findings.

The first part of the survey was meant to assess the impact of taxation on the location of real business activities, in other words of foreign direct investment. The companies indicated that taxation was ‘always’ or ‘usually’ a relevant consideration in the their locational investment decisions. The percentage of answers showing that taxation was considered ‘a major factor’ was in general much lower. Interestingly, for the location of a ‘financial service centre’ taxation was found to be considered ‘always’ or ‘usually’ a ‘major factor’ 78% of the times, and a ‘relevant consideration’ 85% of the times. Also for the establishment of coordination centres (57% and 78% respectively) and production plants (48% and 72% respectively) taxation played quite an important role. The survey also showed that the factors of a country’s tax system considered most important for locational decisions were the statutory corporate tax rate, the withholding taxes for outbound payments, and special investment incentives.

The second part of the survey dealt with the impact of taxation on the choice of the legal form and the way of financing of the investment, which are notoriously affected to a greater extent by tax considerations. The survey confirmed this, showing percentages in the range of 70-80 points as to the impact of a country’s tax system on the choices between branch vs. subsidiary, debt vs. equity financing, domestic versus foreign financing, and repatriation of income to the ultimate parent company or the use of holding or intermediary companies located in different jurisdictions. Lastly, from the survey it appeared that the tax planning and compliance costs of investing abroad were not higher than those borne for domestic investments.

79 See the Ruding Report, Annex 5A, The Effects of Taxation on International Investment and Economic Efficiency, by P. B. Sørensen, pp. 313 ff. In particular, the Annex to the Report focuses on the recent trends and the determinants of international capital flows, and then analyses the capital and corporate taxation on both portfolio and foreign direct investment (on the point, see infra in the text).
81 In particular, Annex 5A of the Ruding Report focuses on the effects of taxation on foreign direct investment as shown by different types of research, i.e. based on simulation studies, econometric studies, business surveys, and a case study. The evidence of such studies seems to be consistent with the outcome of the business survey analysed in the text.
1.4.3 The Monti Memorandum, the Commission Report and (harmful) tax competition: the ‘Monti Cross’

After some years of little Commission activity in the area of direct taxation, the Commissioner for the Internal Market, Mr. Mario Monti, gave new momentum to this area through intensive consultation with the Council as well as the Member States with a cunning and fruitful strategy. His approach was based on the reaffirmation of the principle of subsidiarity and sovereignty of the Member States in direct tax matters. Nonetheless, he managed to establish a constructive dialogue with the Council and the representatives of the EU countries supported by specific economic studies showing the main problems faced by the EU in the direct tax area.\(^{82}\)

In his first Memorandum released in March 1996,\(^{83}\) Mr. Monti described the current state of affairs for the areas of both direct and indirect taxation and laid down some questions/proposals to stimulate a debate with (and within) the Council on the sensitive tax topics addressed in it. The main three challenges identified in the Memorandum were the need to (i) stabilise tax revenue in the Member States, (ii) ensure a proper functioning of the single market, and (iii) promote employment. With respect to the first, the Memorandum pointed out that unfair tax competition could negatively affect Member States’ tax revenue by causing an erosion of their taxable bases and other distortive effects. As for the second, it listed a number of distortions impeding the creation of a truly internal market, e.g. certain VAT problems, the impossibility of offsetting losses for companies operating in different Member States, and the existence of double taxation on cross-border payments of interest and royalties. With regard to the third issue, the Memorandum, referring to a document previously released by the Commission,\(^{84}\) stressed that tax base erosion in the field of capital income was leading to an increasing of the tax burden on employees and labour, and therefore that unfair tax competition resulted in higher unemployment in the EU. The Memorandum also called for a more coordinated approach in the (harmful) tax competition area on the grounds that “the apparent defence of national fiscal sovereignty has gradually brought a real loss of fiscal sovereignty by each Member State in favour of the markets, through tax erosion, especially on the more mobile tax bases.”

Following the Monti Memorandum, the ECOFIN Council (i.e. the Finance Ministers of the Member States) agreed to form a High Level Group in charge of studying more closely the issue of (harmful) tax competition and to actively cooperate with the Commission on the best approach to cope with it. A first outcome of the subsequent discussions and studies carried out was included in the Commission Report on the development of tax systems in the EU, released in October 1996, which dealt closely with the issue of (harmful) tax competition.\(^{85}\)

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82 For an analysis of the political approach of Commissioner Monti and the documents discussed in the text, see L. Hinnekens, Ruding Revisited?, EC Tax Review 2/1996, p. 91. See also Terra & Wattel, cit., at 189 ff.
84 See the Commission White Paper on Growth, Competitiveness and Employment, COM (93) 700.
This Report contains the calculation of the total tax burden and of the relative burden on each of the production factors in the EU over a period of 15 years. It turned out that between 1980 and 1994 the combined tax burden and social security charges expressed in percentage of GDP had increased of about 2 points. Such increase was almost entirely represented by social security contributions, which went up about 1.5 points, especially in the last years screened by the study. The Report also analysed the trends in the tax burden on the production factors, namely capital and employed labour. It emerged that while the implicit tax rate on employed labour had been increasing steadily from 34.7 to 40.5%, the implicit tax rate on the other factors (namely, capital, self-employed labour, energy, and natural resources) had been decreasing almost correspondingly from 44.1 to 35.2%. The implicit tax rate on consumption, on the other hand, had remained stable, with a very small increase from 13.1 to 13.8%. This combined effect of sharp increase of taxation on employed labour versus decrease of taxation on capital and self-employment was named the 'Monti cross' due to its resemblance to a cross shown in the corresponding graph.66

The Report stressed that while the cross was partly due to structural changes in the European ageing population and to the ease and stability of employment income as taxable base, another factor was probably the fiscal degradation caused by harmful tax competition. This had likely forced Member States to reduce taxation on capital and on the most internationally mobile tax bases and correspondingly to increase taxation on labour, which was necessary to maintain an acceptable level of public spending for the financing of the social security net. The Report concluded that despite the lack of clear evidence of tax base erosion caused by excessive tax competition, there was some evidence that effective taxation on income from passive investment was undermined due to the shift of such investment purely for tax reasons to other EU countries or outside the EU where special incentives for this kind of income were available.

1.4.4 Further Economic Evidence of Tax Competition in Europe

In the more recent years, in addition to the studies carried out by EU institutions a number of other studies has analysed the issue of tax competition in the Union. Below there is a summary of some of these studies, which show a large degree of consistency as to the main findings and trends singled out.

A study conducted in 1996 tried to calculate the distribution of the effective tax burden in four EU Member States (i.e. Germany, The Netherlands, Spain and the UK) in the period from 1980 to 1992.87 The data concerning the 'tax mix' of these countries suggests that all of them had a relatively high taxation on personal income and social security contributions, with the Netherlands having the highest combined tax burden as a percentage of GDP (some 30%) and the UK the smallest (some 17%). The research also shows an increasing trend in the share of personal income tax and social security contributions (with the exception of the UK) as opposed to corporate income taxation

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87 C. A. de Kam, J. de Haan et al., *Who Pays the Taxes? The Distribution of Effective Tax Burdens in Four EU Countries*, EC Tax Review, 4/96, p. 175. The authors explain that the significance of the study is relevant as the four countries account for over 50% of the EC GNP.
and consumption taxation, which had a steady to decreasing trend (with exception of the UK). The study concludes that even though there were some differences in tax mix, tax rates, and tax bases in the four EU countries, the distribution of the effective tax burdens was very similar and appeared to converge as countries with high nominal marginal rates offered more incentives to reduce the tax burden of wealthier taxpayers. These results seem consistent with the outcome of the 1996 Commission Report, showing a higher relative weight of taxation on the less mobile personal income as opposed to taxation on corporate income and consumption.

Another important research commissioned in 1998 by the Netherlands Ministry of Finance to two private firms and a university calculated the effective corporate tax burden in the various Member States. They carried out three separate studies based on different methodologies (see at 1.3.4). The study from MARC was based on a backward-looking approach considering microeconomic data resulting from the tax return of 3,000 EU-based listed companies for the period 1990-1996. The B&M study calculated the effective marginal tax rate (EMTR) of a hypothetical investment based on the King & Fullerton methodology taking into account tax systems in effect in the ten-year period 1990-1999. The PWC research calculated the effective average tax rates (EATR) in the same scenario and under the same assumptions as the B&M study.

The outcome of these studies shows that despite the use of different methodologies, common trends can be singled out from the research. The main finding is that throughout the EU the effective tax burden on corporate profits is much lower than the statutory tax rates, mainly as a result of special tax incentives granted by Member States in different forms. In addition, the research shows that effective tax rates are higher in the larger EU countries (e.g. Germany and Italy) than in the smaller countries (e.g. Ireland). According to the Netherlands Ministry of Finance these findings prove the existence of tax competition between the Member States especially by way of tax incentives and reductions that substantially lower their statutory tax rates on corporate profits. Such incentives are targeted at boosting different forms of investment, such as R&D, environment-friendly goods, or regional development. Given the difficulty in drawing a line between positive and negative aspects of tax competition, the conclusion is that there should be increased coordination in tax policy in the EU with a view to eliminating the most apparent tax-induced distortions in the internal market. The findings of this research tally with another study on the relationship between country size and corporate tax burden. The idea behind this study is that the 'level playing field' in tax competition must take into account not only the statutory tax rates and the tax bases, but also the size of the various countries due to the objective disadvantages the smaller ones face. The calculation of EMTRs taking into account the tax-related costs of cross-border investments and the country size leads to the

88 The research was commissioned to: (i) the University of Maastricht's Accounting and Audit, Research and Education Centre (hereinafter: "MARC"), (ii) the law firm Baker & McKenzie (hereinafter: "B&M"), and (iii) the accounting firm PriceWaterhouseCoopers (hereinafter: "PWC"). They are available on the Netherlands Ministry of Finance Web Site at http://www.minfin.nl. The main findings are summarised by W.A. Vermeend, Effective Tax Rates in Europe, EC Tax Review, 3/1999, p. 160. For a comparison of the Baker & McKenzie study with the 2001 Commission study on corporate taxation in the EU, see below at 1.4.5.4.

conclusion that small countries may have lower tax rates than large countries. The small size of these countries and other disadvantages that the investors face when investing in their territory (e.g. small market, small tax base against which to offset losses and credits) would (and should) justify their imposing a lower effective corporate tax rate without their being necessarily considered to engage in harmful tax competition. The underlying reason would be that the incentives offered by smaller countries are a justified compensation for the disadvantages inherently connected to their size, such as the impossibility to offset foreign losses against domestic profits.90

Two more recent studies show consistent results with the above studies. A comparative survey of seventeen European countries’ tax systems (i.e. 11 EU Member States with exclusion of Belgium, Finland, Ireland and Luxembourg, plus the Eastern European countries Czech Republic, Hungary, and Poland, and the non EU states Norway and Switzerland) identifies their similarities and differences by reference to the years 1965, 1980, and 1997.91 Even though the study focuses on different blocks of EU and non-EU countries and the way EU policy affects the latter’s policies, there are several interesting findings for our analysis. The research finds that there were significant changes in the tax burden and the tax mix of almost all countries, especially in the period between 1965 and 1980. The total tax revenue as a percentage of GDP varied considerably between the tested countries, but the variation between high- and low-tax countries narrowed from 20 points in 1965 to 12 points in 1997. The share of income tax revenue both from individuals and corporations to total tax revenue remained quite stable over the whole period, with a only a few countries showing large variations from the average values. Also meaningful are the findings that the share of revenue from social security contributions significantly increased over the period, especially between 1965 and 1980, whereas consumption taxation tended to decline over the same period.

A more recent study exclusively based on the EU specifically focused on the competitiveness of Member States’ tax systems.92 The development of EU tax systems shows a progressive change from relatively high statutory corporate tax rates coupled with narrow tax bases into a combination of significantly lower statutory tax rates with a broader tax base. This translates into a steady effective tax burden on corporate income and corresponding steady revenue flow for the Member States. Recent trends indicate that there are less special tax incentives and a more equitable distribution of the tax burden, which derives from the approximation of effective corporate tax burdens to statutory tax rates. This, in turn, means increased transparency and less distortions caused by EU states’ tax systems. The study concludes that these desirable trends are probably (also) the result of tax competition in the EU, and the increased competition in statutory tax rates rather than hidden incentives would inter alia acknowledge the positive effects caused by EU action in this area since the 1996 Monti memorandum.

90 See also Avi-Yonah, cit., at 1613, who refers to some authors to stress that smaller regions tend to benefit from tax competition as capital is more sensitive to taxation. This also explains why they are more aggressively engaged in tax competition by forcing tax rates cuts in larger regions and are reluctant to seek forms of coordination with them as their residents would be worse off.


A last question arises as to how companies are taking advantage of this tax competition (within the EU). A study shows that they are becoming increasingly sensitive to direct taxation in their choices as to the location of their investments, especially in the EU internal market. Consistently with the above findings, this study shows that Member States (and more in general OECD countries) have maintained stable corporate tax revenue as a percentage of GDP over the last years, suggesting that tax competition has not caused relevant tax base erosion. However, the study also notes that corporate (taxable) profits have significantly increased globally over the same period, which suggests that tax planning may have lowered the effective tax burden on their profit. From countries’ perspectives, this finding would also entail that tax competition has indeed caused harmful effects, as there has been no increase in their corporate tax revenue despite a high increase in companies’ overall global profits earned in the economic boom occurred throughout the 90ies.

1.4.5 The 2001 Commission study on company taxation in the EU

1.4.5.1 Overview

The most recent and comprehensive study on corporate taxation in the EU has been conducted by the Commission and released in October 2001 with the title “Company Taxation in the Internal Market” (hereinafter: the “Study”). The main findings of the Study and the consequent recommendations put forward by the Commission were included in a separate communication released at the same time. The Council’s mandate to the Commission to undertake the Study asked to highlight the differences in effective corporate tax burdens in the EU and identify the main tax provisions posing obstacles to the functioning of the internal market. The Commission was also asked to recommend appropriate solutions to such obstacles taking into account the respective powers and competence of EU institutions and Member States. The mandate and the underlying need for the Study are explicitly linked to the EU effort to curtail harmful tax competition as previously indicated in the Monti Memorandum (and in the subsequent Code of Conduct, see Chapter 4), especially since more recent and concrete evidence and research were needed from a political point of view to support this effort at EU level.

The Study is contained in a long document of almost 500 pages and is divided into four parts (i.e. Parts I through IV). Part I explains the need for a comprehensive study on corporate taxation in the EU, highlights the importance and the differences of the
Ruding Report as compared to this Study, and summarises the main developments in the EU since the release of that Report. Part II contains a qualitative and quantitative analysis of the corporate tax systems in effect in the Member States, in particular estimating the level of effective tax burdens in each of them (and in addition in the USA). Part III of the Study focuses on the main obstacles created by the different Member States’ corporate tax systems to the correct functioning of the internal market and contains an interesting update of the conclusions contained in the Ruding Report. Part IV features the Commission recommendations to eliminate or reduce the most important distortions singled out in Part III: for this purpose, the Commission proposes a two-track strategy based on the adoption of specific acts for each of the said distortions and on a more far-reaching comprehensive approach meant to provide a consistent solution for all of them.

It took more than two years for the Commission to complete the Study, mainly due to the complexity of the economic analysis and to the broad mandate as well as to the need to accommodate differing views and positions of Member States in the corporate tax area and in particular in the fight against harmful tax competition. The Commission availed itself of two independent panels of experts for the carrying out of the Study, one advising on the methodology for the calculation of effective tax burdens and on the interpretation of the results contained in Part II of the Study, and the other advising on the tax obstacles to the internal market from the perspective of the business community and the social partners highlighted in Part III of the Study.

This section will exclusively focus on Parts I and II of the Study, which are specifically concerned with the current situation of corporate taxation within the EU and contain a number of interesting conclusions stemming from economic studies and research. The other two parts of the Study will be analysed in the last chapter of this book as they are (also) related to the possible solutions to the issue of harmful tax competition in Europe (see in Chapter 6, section 6.3).

1.4.5.2 Relationship with the Ruding Report; key developments in the EU

The Commission Study has links to the Ruding Report in several respects. First, the mandate to the Commission explicitly stated the importance of “taking into account, inter alia, the results of the report of the Ruding Committee.” Second, the Commission acknowledges that the findings of the Ruding Report are still viable, stressing that the failure to achieve significant progress at EU level in the corporate tax area has mostly resulted in the deepening of the problems singled out in that Report. Third, the analysis of the Study builds on the conclusions of the Ruding Report, and largely updates them especially in the light of the developments occurred in the EU in the last decade.

In this latter respect, the Study refers to the increased globalisation of the economy, which has resulted in a reorganisation of the functions and business structures within multinational companies active in the EU as well as in a number of EU cross-border mergers and acquisitions. To support these statements the Commission cites a sharp increase in:97 (i) the number of multinational companies from 7,000 at the end of the 1960s to about 40,000 at the end of the 90s to a most recent figure of 63,000 parent

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97 See the Study, Box 1, p. 21.
firms with 690,000 foreign affiliates worldwide; (ii) international production, trade, and investment, as shown by multinational companies accounting for 1/10th of global GDP as opposed to 1/20th in 1982, and by an amount of sales of foreign affiliates worldwide of US$ 13.6 trillion in 1999 as opposed to US$ 2.5 trillion in 1980; (iii) foreign direct investment (FDI), whose ratio of inflows to gross domestic capital formation is 14% in 1999 as compared to 2% twenty years ago, with a ratio of FDI stock to global GDP jumping from 5% to 16% in the same period; (iv) the number and value of mergers and acquisitions, the cross-border ones rising from a value of some US$ 100 billion in 1987 to US$ 720 billion in 1999, with the global number of mergers and acquisitions growing 42% per annum between 1980 and 1999.

The Study also mentions the challenges posed by the advent of electronic commerce and the increased mobility of the factors of production, which have favoured the development and use of the tax havens and offshore centres (as already predicted by the Ruding Report). No data, however, is provided in support of these statements, or more in general of the potential threat to the erosion of Member States’ taxable bases. On the contrary, the Study strikingly shows that Member States’ corporate tax revenue expressed in percentage of GDP has maintained rather stable if not increased in the past 10 years,98 suggesting that there should be no over-exaggerated fears of a race to the bottom.

Additional fundamental developments after the Ruding Report are the setting up of an internal market without internal barriers and of the Economic and Monetary Union (EMU) leading to the introduction of the single currency in twelve Member States. As for the former, the Study refers to the increased competition between companies due to the progressive removal of barriers to intra-EU trade and the increased globalisation of business. This has favoured the creation of pan-European structures considering the EU as a whole as just one market from a business perspective. This has also spurred internal reorganisations aimed at centralisation of the various business functions such as production, services, marketing, R&D etc. (see also at 1.2.4). The result is an increased number of intra-group transactions between related companies, which makes the transfer pricing issue more important than ever. As to the EMU, it has further facilitated the integration process for companies, translating into a single pricing of products for each manufacturing unit and into easier performance of (intra-group) financial services, also due to the unfettered liberalisation of capital movements.

1.4.5.3 Comparison of Member States’ ‘benchmark’ tax systems (Qualitative analysis)

The qualitative analysis is meant to picture the structural elements of Member States’ tax systems as at the end of 1999.99 This is the preliminary step to calculate the effective tax burden in each Member State, which mainly depends on the nominal tax rate and the rules for the computation of the taxable base. The qualitative analysis is also interesting as it allows to group together Member States that treat similarly various items of the taxable base in their statutory laws. Furthermore, it is

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98 See the Study, Box 2, p. 22.
99 The qualitative analysis and the summarising tables annexed to it are contained at 31-67 of the Study.
fundamental in understanding the interaction between these items within each tax system, which is usually able to explain the policy behind the various provisions as well as to assess the overall coherence (or incoherence) of each tax system.

The analysis focuses on ten structural features of the Member States’ tax systems: statutory corporate tax rate, tax accounting rules, rules on depreciation, provisions, losses, capital gains, mergers and acquisitions, tax consolidation (including intra-group dividends), inventory, and expense deductions. These are presumed to be the fundamental elements of a country’s ‘benchmark’ tax system and are also needed for the carrying out of the quantitative analysis (see next paragraph). The main finding of the qualitative analysis are that there are several differences in Member States’ tax systems as concerns each of the elements taken into account. As for corporate tax rates, the Study takes into account not only the standard tax rate, but also dual rates, surcharges, or reduced rates so as to get as close as possible to the actual statutory tax burden on corporate profits. Ireland turns out to have the lowest rate (i.e. 10%, subsequently increased to 12.5%), followed by a number of States in the range of 30% (e.g. Sweden, Finland, UK). The highest tax rates are in the range of 40% (i.e. in Greece, Belgium, and Italy). The tax accounting rules also turn out to be different, especially as a result of the lack of harmonisation in the EU. The main distinction concerns the connection between financial accounting and tax accounting, which is more important in certain countries than others.

Member States’ rules on depreciation and on the formation of provisions are fundamentally based on the same broad principles, even though the schedules of depreciation or the conditions to contribute before-tax profits into provisions tend to differ depending on the business activities as well as on the policies pursued, and the incentives granted, by the various countries. The rules on the use of losses and on the tax treatment of capital gains (or losses) also show a certain degree of convergence, with differences in the number of years for the carry-forward and the carry-back (if available) of losses, and in the tax rates on capital gains mainly based on the respective statutory income tax rates applicable in the various countries. Also the rules on mergers and acquisitions are largely similar as for the granting of tax deferral on unrealised gains, especially as a result of the extension of the provisions of the EC Merger Directive\textsuperscript{100} to purely domestic situations by a number of Member States.

The Study shows that there are significant differences with regard to Member States’ benchmark tax systems as concerns group consolidation of profits and losses, which is usually allowed in a purely domestic context but not in all the EU countries (i.e. Belgium, Greece and Italy exclude it altogether), whereas Denmark (and France to a lesser extent) grant it on a worldwide basis provided a number of conditions are met. Also the tax treatment of intercompany dividend distributions is different in several Member States, even though the more recent trend is to grant a participation exemption provided the conditions of the Parent/Subsidiary Directive\textsuperscript{101} are met. Lastly, Member States’ rules on the valuation of inventory and on the deduction of expenses do not show significant differences but broadly follow the same general principles.


In summary, the qualitative analysis shows that there still are significant differences as regards the structural elements of Member States’ tax systems, the most evident ones being statutory corporate tax rates. While it is not possible to single out a number of EU countries to be considered the international (or the EU) standard as none follows to a significant extent the same broad principles, a general conclusion can nevertheless be drawn that usually Member States with higher tax rates have a narrower tax base and vice versa. This also explains the compensatory effect of the different structural elements of Member States’ tax systems. The next question is how these differences interplay in the internal market and in particular how they are able to potentially affect investment patterns in the EU, which is the goal of the quantitative analysis.

1.4.5.4 Comparison of effective tax burdens in the Member States (Quantitative analysis)

The quantitative analysis relies on the findings of the qualitative analysis to calculate the effective corporate tax burdens on domestic and cross-border investment in the EU Member States. The aim of this analysis is to show the relative attractiveness of each Member States’ tax laws for various kinds of investment effected domestically or abroad and to assess the most important features of tax regimes in the determination of the effective tax burden on such investment. For this purpose, a number of Member States’ tax provisions are taken into account, both general provisions and special tax incentives.\(^\text{102}\)

The Study contains a calculation of effective marginal tax rates (EMTR) and effective average tax rates (EATR) on the basis of the ‘King & Fullerton’ methodology as set out by Deveraux & Griffith and of the ‘European Tax Analyser’ model as set out by University of Mannheim and ZEW (see at 1.3.5). These calculations are effected with respect to a base case and other cases taking into account different combinations of five types of assets (industrial buildings, machinery, intangibles, financial assets, and inventory) and three forms of financing (equity, retained earnings, and debt) of a hypothetical investment. A subdistinction is made between a domestic case in which the investment is supposed to be effected in the same Member State, and an international case in which the investment is supposed to be undertaken in a different Member State.

As for domestic investment, the Study shows that there are considerable differences in the effective tax burden in the range of 37 percentage points with regard to a marginal investment (i.e. EMTRs between -4.1% and 33.2%) and of 30 points with regard to a more profitable investment (i.e. EATRs between 10.5% and 39.1% with the King & Fullerton approach and between 8.3% and 39.7% with the European Tax Analyser model). Another important finding is that the effective tax burden does change substantially depending on the type of investment undertaken and the source of finance, as there is a strong incentive to invest in machinery and intangible assets and to finance through debt rather than equity or retained earnings.

With regard to cross-border investment, this case regards an investment by a parent company located in a Member State through a wholly-owned subsidiary located in

\(^{102}\) For a summary of the tax provisions used in the models, see the Study, Box 4, p. 76.
another Member State and calculates the effective tax burden on investments both to and from other EU countries. Again, the Study shows differences of over 30 percentage points in both cases of different locations of the parent company and different locations of the subsidiary. This suggests that companies may have an incentive to effect their investments in the most tax-effective country for them, which may not necessarily be the most efficient location from a merely economic point of view.

Furthermore, the Study shows that neither capital export neutrality (i.e. CEN) nor capital import neutrality (i.e. CIN) are achieved in the internal market. This implies that the playing field for companies (and countries) is far from levelled, and thus that taxation may have a significant impact on investment decisions and distort them. The Study supports this conclusion by showing that usually outbound and inbound investment are in principle more heavily taxed than domestic investment, but also that foreign-based multinationals are subject to a lower cost of capital in the host country than domestic companies if they are free to choose the most favourable tax location as a result of tax planning.

The following part of the quantitative analysis deals with an assessment of alternative hypothetical tax policy scenarios in the EU. The purpose is to ascertain whether the mentioned distortions would be reduced, and if so to what extent. The simulations consider 15 alternative policy scenarios: some concern the structural elements of tax systems, others focus more specifically on the international features of EU countries’ tax systems. Some of these simulations show remarkable results. The most striking ones are linked to the introduction of a common statutory corporate tax rate throughout the EU (i.e. hypotheses 1 through 3), which would significantly reduce the differences in effective tax burdens and in cost of capital in the EU for all types of investments taken into account. A corollary of this policy scenario would be a further progress towards CIN, as the host country would subject the local income earned by a foreign investor to the same (or similar) tax burden of the home country of the investor, and would have priority to tax that income. Given the same or similar tax burden charged in both the host and the home country, also the method used by the home country of the investor to relieve international double taxation would affect to a very limited extent, if at all, the move towards CIN caused by this policy scenario.

A broader conclusion linked to this simulation is that the dispersion between effective tax burdens depends largely on the statutory corporate tax rates of each country: the closer the band of rates, the less the dispersion. This also means that the dispersion would tend to be minimal if the tax rates were harmonised at EU level. Furthermore, it is also shown that harmonisation of tax rates at EU level would have little impact on economic efficiency, as the main determinant in this respect is a reduction of the dispersion between tax rates.

As for the other tax policy scenarios, the simulations show that they would not have such an important impact on the reduction of tax distortions to investment decisions in the internal market. In other words, harmonising (some of) the elements of Member States’ taxable bases would not have the same significant impact in reducing

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103 See the Study, pp. 135 ff. For a discussion of CEN and CIN from an EC law point of view, see in Chapter 5, at 5.4.2.1.
104 The simulations based on alternative tax policy scenarios are summarised in the Study, Box 8, p. 152.
locational inefficiencies in the EU as corporate tax rates approximation or harmonisation. The same conclusion has been reached by the simulations concerning international elements of the EU countries' tax systems, such as the abolition of withholding tax on intra-group interest payments or the harmonisation of the tax treatment of intercorporate dividend distributions.

The Study also contains an update of the quantitative analysis just summarised by taking into account the Member States' tax system in effect in 2001. While most countries turn out to have a broadly unchanged cost of capital and EMTR, a few countries show a reduction of effective tax burdens mainly due to a decrease in their statutory corporate tax rates (i.e. France, Greece, and Portugal). In other three Member States (i.e. Austria, Germany, and Italy) there appears to be a substantial reduction in the EMTR brought about by more comprehensive corporate tax reforms. Nevertheless, the bulk of the analysis based on the Member States' tax systems in 1999 seems unaffected by the mentioned changes, and so does the relative ranking of each country, with only minor differences being present. Instead, the trend of decreasing effective corporate tax burdens over the years seems confirmed by the latest developments in the mentioned Member States.

1.4.5.5 Comparison with the Ruding Report and the Baker & McKenzie studies

The last part of the quantitative analysis of the Commission Study compares the findings of the Commission Study with those of the Ruding Report of 1992 and the Baker & McKenzie study of 1999 commissioned by the Dutch Ministry of Finance (see at 1.4.4) and revised by the firm in 2001. They have been chosen for a comparison with the Study because they carry out a similar analysis on effective tax burdens in the EU and they use a similar forward-looking methodology. However, some of the assumptions relied on by these studies differ from the Commission Study, which may explain some differences in the outcome of their analysis.

The Ruding Report sought to identify the differences in the Member States' tax systems and their impact on firms' investment decisions (see at 1.4.2). It calculated the EMTRs and the cost of capital on a hypothetical marginal investment in the manufacturing sector. The Baker & McKenzie study relied on the King & Fullerton methodology to compute the EMTR in the EU countries in the case of a hypothetical marginal investment in the manufacturing sector. The main differences between their assumptions concern the types of assets considered, their relative weight, the inflation rate, and the rate of return on the investment.

The comparison with the Ruding Report shows remarkable differences with the findings of the Commission Study. In particular, the cost of capital is generally lower in the Ruding Report and also the ranking of the Member State differs in the two studies. This may be due to the different assumptions as well as to the enactment of corporate tax reforms occurred in the decade after the release of the Ruding Report.


106 For a comparative table summarising the different assumptions of the three studies, see the Study, Box 13, p. 205.
Nonetheless, some common patterns may be found as regards the wide range of variations in the cost of capital as well as the differences in tax burdens depending on the assets and financing of the investment. More consistent results are shown by the comparison between the Commission Study and the Baker & McKenzie study as at 1999. Probably the main differences are explained by the different assumptions used by them. Both studies show a range of about 30 percentage points in the EMTR of EU countries, and the ranking of countries tends to be largely the same. Similar results are also found with regard to the effective burden on the different assets used in the hypothetical investment and on the different ways of financing this investment. As for the comparison between the 2001 update of the Baker & McKenzie study with the Commission Study, in principle there are larger variations in the outcomes of their 1999 versions. However, they are largely due to the changed parameters and assumptions used between them as well as by the different impact of the corporate tax reforms enacted (e.g. in Germany, Ireland, Italy, Austria).

1.4.5.6 Synthesis

The recent Commission Study contains a comprehensive qualitative and quantitative analysis on Member States’ corporate tax systems and their effective tax burden imposed on different hypothetical investments. Its importance lies in that it considers a broad range of parameters concerning Member States’ tax rates, tax bases, and special incentives, as well as alternative policy scenarios and simulations based on different methodologies and assumptions. Its findings are a comprehensive set of numbers and data that do not aim at providing universally accepted values, but rather to compare the relative position of each Member State and to show the interrelations between their tax systems. The main weakness of the Study is the absence of research meant to show the impact of the differences in Member States’ tax burdens and their tax incentives on firms’ investment decisions. The Study points out that this has not been done due to the absence of a proven effective scientific methodology for this purpose (see also at 1.3.5). Its main findings may be summarised as follows:

- There are significant differences in the statutory corporate tax burden as well as in the effective tax burden throughout the EU, which are in the range of about 30 points for both domestic and transnational investments.
- There is a constant pattern in the relative ranking of Member States: Ireland, Sweden, and Finland are usually at the lower end as regards their tax burden and attractiveness for investment, whereas France and Germany tend to be at the upper end.
- The statutory corporate tax rate is the single most important factor in determining the differences in effective tax burdens in the EU and in influencing firms’ investment decisions; the harmonisation at EU level would significantly reduce the distortions caused in the internal market.
- Tax systems tend to favour investment in certain assets (i.e. intangibles and machinery) and their source of financing through debt rather than equity or retained earnings.
Neither Capital Export Neutrality (CEN) nor Capital Import Neutrality (CIN) are achieved in the EU; CIN in general prevails, and would further prevail if tax rates were harmonised in the EU.

There is a constant trend of declining statutory tax rates and of effective tax burdens especially in high-tax countries, which may also be the result of tax competition between Member States.

With regard to tax competition, the Study stresses that it is difficult to draw conclusions as to its main effects despite the wealth of economic evidence and data from the comprehensive research. The Study does suggest that given the lack of harmonisation in the internal market direct taxation is an effective competition tool for Member States in the attempt to attract investment. The conclusion is that there are welfare implications of tax competition for the EU, such as approximation of tax rates and diminution of tax burdens, but also that special tax incentives and preferential tax regimes must be curtailed to prevent harmful effects in the internal market.107

1.5 Main Conclusions

Tax competition may be defined as the reduction of the tax burden by sovereign countries in order to improve their economy by increasing the competitiveness of domestic business and/or attracting foreign investment. The objective aspect of this definition concerns the alleviation of the tax burden, which may occur through a number of tax incentives such as reduction of corporate tax rates, deductions from the taxable base, tax credits, collection leniency, and the like. The subjective aspect regards the underlying policy objectives aimed at by countries through the reduction of the tax burden.

In an international context, tax competition is seen as the endeavour of sovereign countries to gain a higher share in the international division of the taxable base deriving from inbound investment. There are beneficial and harmful effects brought about by tax competition. The main beneficial effects are a decrease of countries’ tax burdens coupled with an improved efficiency in the public administration and a reduction of its size. The main harmful consequences are an erosion of countries’ corporate taxable bases, an increase of taxation on more immobile bases such as labour, which may cause a rise in the unemployment, and an economic misallocation of resources.

The distinction between desirable and harmful tax competition should be based on a combination of its objective and subjective aspect. The main criterion based on the objective aspect should be the general versus the special character of a certain tax incentive. The main criterion based on the subjective aspect should be a country’s goal to improve its (unhealthy) economic situation, favour employment and development (in remote areas), or compensate for its smaller economic size (i.e. to create economic activity and investment), versus the goal to attract passive mobile income mainly at the expense of other countries (i.e. to merely shift economic activity and investment already undertaken).

107 See the Study, pp. 67 ff.
A number of studies have tried to single out the main effects of tax competition in order to get to a general theoretical and methodological framework. These studies are mainly carried out with regard to tax competition between US states and between municipalities. They show that tax competition may be both beneficial and harmful, which also depends on the model used and the assumptions made. From these studies, it is possible to identify a number of general methodologies used to scientifically study the phenomenon of tax competition in an international (and EU) context and its main effects.

As for the EU, these studies are significant mainly for the underlying economic theory and the methodology used. This has favoured the carrying out of extensive research on tax competition in the EU especially in the last decade. From the analysis of the 1992 Ruding Report, the 1996 Monti Memorandum and Commission Report, and the 2001 Commission Study on Member States’ corporate tax systems, a number of findings may be singled out. There is a high degree of tax competition in the EU, as shown by the significant differences in statutory corporate tax rates and in effective tax burdens on corporate profits over the years. In the more recent years, a steady decline in the Member States’ statutory corporate tax burden has occurred, with corporate tax revenues remaining substantially steady. This would be a result of desirable tax competition. However, there is also evidence of a number of special tax incentives enacted by Member States to attract foreign direct investment and/or passive income earned through coordination, distribution, services ‘centres’, as well as other (intra-group) finance entities. These incentives have proven successful in attracting mobile income. This would be a result of harmful tax competition between Member States.

Even in the absence of unrebuttable economic evidence and quantitative studies showing the prevalence of harmful versus desirable tax competition within the EU, there is enough evidence that direct taxation does play a significant role in companies’ decisions, especially for the location of the mentioned intra-group ‘centres’ and finance entities. This is also a result of the fact that the other factors usually considered when making an investment are largely equivalent within the Union, as Member States’ economies are closely integrated due to the removal of barriers by the EU four fundamental freedoms. From a Member States’ perspective, this entails that direct taxation constitutes the last significant competition tool in order to gain foreign investment from both other EU and extra-EU countries, especially after the introduction of the single currency. These considerations call for a need to closely scrutinise the issue of tax competition by both EU institutions and Member States so as to encourage its desirable effects while at the same time countering the harmful ones distorting the internal market.

To summarise the current state of affairs of tax competition in the EU, it seems appropriate to borrow what was written in the Ruding Report back in 1992, which is still quite topical: “These results suggest that there are welfare costs for the European Community as a whole as a result of distortions to competition arising from taxation. No direct evidence has been presented on the size of such welfare costs, but the strong impact of taxation on economic activity is prima-facie evidence that they might
be large. If so, there would be gains in reducing the distortions arising from taxation.\textsuperscript{108}

\textsuperscript{108} See the Ruding Report, Chapter 5, at 109. See on this also Chapter 4, section 4.2, and Chapter 6, section 6.2.