Tax Competition and EU Law
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2.1 Introduction

This chapter deals with the impact of EU law on tax competition between Member States. In the absence of specific Treaty provisions dealing with this phenomenon, and more in general with the area of direct taxation, various general provisions that may be relevant to the tax competition issue need to be analysed. Establishing a consistent EU legal framework for tax competition on this basis is no easy task. Although there have been a number of initiatives at EU institutional level on this issue, none of them has focused on general existing EU law rules in this respect. Attention has been paid almost exclusively to the application of the Treaty state aid rules to tax measures, which prove the most effective legal tool (also) to counter harmful tax measures enacted by Member States (see in detail in Chapter 3). There has been little attempt by the EU institutions to use general EU law within the tax competition arena. This is probably due to the direct tax area being historically a sensitive area in which Member States enjoy (almost) unfettered sovereignty and are reluctant to give up even small pieces of it in favour of the EU institutions. Correspondingly, the Commission has been wary especially in the last decade not to improperly interfere with this sovereignty, which might be counterproductive.

The general legal framework is important, however, especially since Member States are now cooperating with the EU institutions to deal with the issue at a political level and they are (or at least seem) determined to fight harmful tax competition. It is also crucial to understand the legal weapons EU institutions have at their disposal, which they may decide to use in case Member States unilaterally break the political compromises reached in this area. Last but not least, analysing the general EU legal framework is important for the compatibility assessment of protective measures Member States have adopted to unilaterally undo the harmful effects of fellow States' tax measures.2

2.2 Fundamental Treaty Provisions and Tax competition

2.2.1 Main economic objectives and means of attainment; Member States' sovereignty in direct taxation

The main objectives aimed at by the EU as laid down in the EC Treaty are of an economic nature.3 Historically, this is explained by the Union being a descendent of

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1 On the EU economic studies, see Chapter 1, section 1.4. The EU political initiatives are discussed in Chapter 4, especially sections 4.2 and 4.3, and in Chapter 6, section 6.3.
2 This issue will be dealt with in Chapter 5. The importance of the EU legal framework on the issue of (harmful) tax competition is also summarised in Chapter 6, at 6.2.2 and 6.2.3.
the European Economic Community founded in 1957. Although the EU is currently more integrated and pursues more far-reaching goals, the pillars of its existence are still its economic functions. The fundamental principles are enshrined in Art. 2 of the Treaty:

"The Community shall have as its task, by establishing a common market and an economic and monetary union and by implementing common policies or activities as referred to in Articles 3 and 4, to promote throughout the Community a harmonious, balanced and sustainable development of activities, a high level of employment and of social protection, ... sustainable and non-inflationary growth, a high degree of competitiveness and convergence of economic performance, ... the raising of standard of living and quality of life, and economic and social cohesion and solidarity among Member States."

This provision is framed so that the fundamental economic objectives are easily distinguishable from the means to achieve them. The main such objectives are the achievement of economic development in a non-inflationary manner, a reduction of unemployment, and economic cohesion and solidarity between Member States, which should favour an improvement of the standard of living and the welfare of EU citizens. For this purpose, the Treaty considers two fundamental means: the establishment of (i) a common market and of (ii) an economic and monetary union (hereinafter: "EMU").

With regard to the establishment of a common market, the EU must pursue activities and implement common policies in the areas laid down in Art. 3, which states:

"For the purposes set out in Article 2, the activities of the Community shall include, as provided in this Treaty....:

(c) an internal market characterised by the abolition, as between Member States, of obstacles to the free movement of goods, persons, services and capital;

(g) a system ensuring that competition in the internal market is not distorted;

(h) the approximation of the laws of Member States to the extent required for the functioning of the common market; ....."

As for the achievement of EMU, Art. 4 specifies that:

"For the purposes set out in Article 2, the activities of the Member States and the Community shall include, as provided in this Treaty ... the adoption of an economic policy which is based on the close coordination of Member States’ economic policies, on the internal market and on the definition of common objectives, and conducted in accordance with the principle of an open market economy with free competition."

The above fundamental provisions are further regulated in the Treaty as regards the specific rules applying to each of the means and EU activities needed to achieve the main objectives set out in Art. 2. Leaving aside for the moment their analysis (see


4 See on this W. Schön, Tax Competition in Europe - the legal perspective, EC Tax Review, 2/2000, at 90-91. The analysis of this author, contained in the first article on the EU legal framework applicable to tax competition, is the starting point of this chapter.
below at 2.3 through 2.6), one must note that the Treaty says nothing about direct taxation as such, neither with regard to its objectives nor with regard to its means. This implies that as a matter of principle Member States enjoy full sovereignty in direct taxation and are free to pursue the tax policies deemed most appropriate for them. This is a corollary of the generally accepted public law principle of ‘no taxation without representation’, under which only representatives of voters that must ultimately pay taxes are allowed to make binding decisions in this area by virtue of the voters’ mandate.

The silence of the Treaty with regard to direct tax policy does not mean that this is to be considered extraneous to the attainment of its objectives altogether. In fact, Member States must pursue their domestic policies, including in the areas in which they are sovereign, in conformity with the Treaty so as not to frustrate its fundamental objectives and means of achievement. This has been repeatedly ruled by the European Court of Justice (hereinafter: the “ECJ” or the “Court of Justice”) also in a number of cases on the applicability of the Treaty to direct taxation (see at 2.3.2) by pointing out that, although direct taxation does not fall within the competence of the EU, Member States must nevertheless exercise their prerogatives in this area consistently with EU laws and policies.

This is a corollary of the so-called ‘negative’ integration entailed by EU law given its supranational character and superior force over Member States’ domestic legislation. It means that in areas of no exclusive competence of the EU (see Art. 3 (2) of the Treaty) Member States must exercise their sovereignty in compliance with the Treaty rules and objectives, with jurisdictional control entrusted on the ECJ. In direct tax matters, negative integration translates into a number of limitations imposed by the Treaty provisions and objectives, which must not be frustrated by Member States’ direct tax measures. Negative integration may also lead to indirect or spontaneous harmonisation or approximation of certain areas of Member States’ tax systems especially as a result of rulings issued by the ECJ on the fundamental freedoms and the State aid provisions (see in section 2.3). By contrast, ‘positive’ integration is brought about by the adoption of Community legislation in areas falling into EC competence, such as regulations and directives. In the direct tax area, the adoption of these acts leading to harmonisation or coordination of Member States’ tax laws is exceptional, given their sovereignty and their reluctance to give it up in favour of the EU institutions (see also at 2.2.2).

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5 The sovereignty of Member States in direct tax matters is also indirectly implied by Arts. 94-95 of the Treaty, which will be discussed in detail in 2.2.2. More in general on the subject, see Terra & Wattel, cit., at 14-15; R. J. Jeffrey, The impact of State Sovereignty on Global Trade and International Taxation, Kluwer; A. H. M. Daniels, Sovereign affairs, 29 Intertax, 2000, p. 2.

6 On the fundamental principle of ‘no taxation without representation’ in the context of EU (direct tax) law, see recently F. Vanistendael, No European taxation without European representation, 9 EC Tax Review, 2000, p. 142.

7 See on this Terra & Wattel, cit., at 29, referring to established case law of the ECJ. For an overview of EC direct taxation principles and of the main decisions of the ECJ, see P. Baker, A summary of the acquis communautaire on direct taxation, The EC Tax Journal, Vol. 4, Issue 3, 2001, p. 203.

8 On the concept of ‘negative’ integration and its distinction with ‘positive’ integration, see in general Kapteyn, cit., at 114; with regard to taxation, Terra & Wattel, cit. at 22.

9 An example of spontaneous harmonisation is the granting of personal allowances by each Member State to non-resident taxpayers earning their income entirely or almost exclusively within their territory as a result of the Schumacker case (Case C-279/93, Finanzamt Köln v Roland Schumacker, [1995] ECR I-225), which also urged the Commission to issue a Recommendation to that effect (Commission Recommendation 94/79/EC, 21 December 1993, OJ L 039/22, of 10/2/94).
The above considerations suggest that, despite Member States' sovereignty in direct taxation as a matter of principle, this area is far from alien to the fundamental Treaty objectives, as it must be designed in such a way that their attainment is not undermined. This also entails that Member States' direct tax policies must take into account their spillover effects on the EC policies and activities concerning the setting up of the internal market and the EMU. The current pace of globalisation and integration of EU countries and economies makes all the more important for the achievement of the fundamental Treaty objectives that consistency between national fiscal policies and EU (harmonised) policies be ensured.

2.2.2 More on direct taxation: means of harmonisation and the subsidiarity principle

The sovereignty of Member States in direct taxation must be further analysed in conjunction with the subsidiarity principle laid down in Art. 5 of the Treaty and the rules on the means of (tax) harmonisation contained in Arts. 94 and 95 of the Treaty. The common feature of these provisions lies in that they deal with the procedural means of achieving a common market and that they lack substantive content. They set out a division of competences between EU institutions and Member States as well as the means to exercise these competences by specifying when, to what extent, and in what way (i.e. with which act) the former and the latter may (and should) intervene.

Harmonisation in direct tax matters is regulated in Chapter 3 of the Treaty on the approximation of Member States' laws required for the establishment and the correct functioning of the common market, as envisaged in general in Art. 3 (1)(h) of the Treaty (see at 2.2.1). For this purpose, Art. 94 provides the possibility to adopt directives for the approximation of laws, regulations or administrative provisions of Member States. Under Art. 95 (2), directives in the direct tax area must be approved by the Council under the unanimity rule, i.e. with the consensus of all Member States. In order to understand how this power is to be exercised (also) in the direct tax area, one must read them in conjunction with the subsidiarity principle contained in Art. 5 of the Treaty:

“(1) The Community shall act within the limits of the powers conferred upon it by this Treaty and of the objectives assigned to it therein. (2) In areas which do not fall within its exclusive competence, the Community shall take action, in accordance with the principle of subsidiarity, only if and insofar as the objectives of the proposed action cannot be sufficiently achieved by the Member States and can therefore, by reason of the scale or effects of the proposed action, be better achieved by the Community. (3) Any action by the Community shall not go beyond what is necessary to achieve the objectives of this Treaty.”

Without going into the detail of the history and the substantive aspects of this principle, which is outside the scope of this study, suffice it to make a few remarks

10 See e.g. A. J. Easson, Tax Law and Policy in the EEC, Sweet & Maxwell, at 401-402.
11 On the issues dealt with in this paragraph, see Terra & Wattel, cit., at 14-15, and Schön, cit., at 101-104.
on how it is applied in the direct tax area in conjunction with Arts. 94 and 95(2). By
and large, the subsidiarity principle was recognised as a fundamental principle by the
Maastricht Treaty to institutionalise the issue of the division of competence between
the EU and the Member States where there is concurrent competence and possible
overlap between EU and Member States’ action. The Member States were concerned
of the tendency by the Community institutions, especially the Commission, to
regulate vast policy areas at EC level, thus undermining their sovereignty and
identity. Art. 5(1) clearly shows that concern by sanctioning the necessity to act at EU
level only where it cannot be done more efficiently at Member States’ level. The
underlying philosophy of this principle, as also highlighted by the Maastricht Treaty,
is to take decisions as close as possible to the citizens that have to bear their
consequences, similar to the principle of ‘no taxation without representation’ in the
direct tax area.

The combined rules laid down in Arts. 94 and 95(2) and Art. 3 of the Treaty applied to
direct taxation confirm the Member States’ sovereignty without interference by EU
institutions as a matter of principle. This interference is only allowed for tax measures
directly affecting the establishment and correct functioning of the internal market,
such as measures frustrating the exercise of the fundamental freedoms or distorting
competition between enterprises (see also above at 2.2.1 and below in section 2.3). In
the event that direct tax measures are such that the negative consequences on the
functioning of the internal market may not effectively be removed at the level of
Member States due to their magnitude or effects, then the EU institutions can resort to
approximation of tax laws by way of directives adopted by the Council on the basis of
the unanimity rule.

A last limit set out in Art. 5(3) is the respect of the proportionality principle, which is
also referred to as reasonableness principle. This requires that, if Community action is
indeed needed, it must be proportional and apt to the achievement of the Treaty
objectives (e.g. the elimination of the obstacle to the freedoms or the distortion of
competition) and not pursue other, more far-reaching objectives. As has been pointed
out, this principle concerns not only the degree of intervention at EU level, but also its
quality, i.e. the choice of the appropriate instrument suitable to the situation
concerned (e.g. a legally-binding directive or a softer non-binding
recommendation).

2.2.3 Loyalty principle

Another fundamental principle included in the Treaty is the requirement of
Community loyalty or solidarity. Despite its general character, it does have influence

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*case of competition policy*, 16 International Review of Law and Economics, 1996, p. 363; N. Bernard, *The future of
Kirchner, *The principle of subsidiarity in the Treaty on European Union: A critique from a perspective of constitutional
economics*, 6 Tulane Journal of International and Comparative Law, 1998, p. 291. With regard to its history and
application in direct taxation, see Terra & Wattel, *cit.*, at 178 ff.

13 The Treaty on the European Union (“TEU”) was signed in Maastricht on 7 February 1992.

14 See e.g. Bernard, *cit.*, at 634-635.

15 See especially Kapteyn, *cit.*, at 144 ff.

16 For a thorough analysis of the principle of loyalty see in general Kapteyn, *cit.*, at 148 ff; S. Weatherill, *Law and
in the direct tax area especially as it reinforces the duty of Member States to exercise their sovereignty consistently with the Treaty. This principle is laid down in Art. 10 of the Treaty:

“(1) Member States shall take all appropriate measures...to ensure fulfilment of the obligations arising out of this Treaty or resulting from action taken by the institutions of the Community. They shall facilitate the achievement of the Community’s tasks. (2) They shall abstain from any measure which could jeopardise the attainment of the objectives of this Treaty.”

This provision clearly shows the two aspects of the loyalty principle, i.e. the positive and the negative one.17 The former implies that EU countries must strive to achieve the goals and objectives of the Treaty as well as implement the underlying policies stemming from the competent EU institutions both unilaterally and in cooperation with each other and with the EU institutions. The latter postulates that Member States should in no way frustrate the achievement of the Community goals and policies on a unilateral, bilateral, or multilateral basis.

The scope of the loyalty principle is very broad as it is theoretically applicable to all areas having directly or indirectly to do with (primary and secondary) EC Law and the Treaty objectives and goals. This implies that usually this principle does not stand on its own, but applies in conjunction with another provision or principle explicitly laid down in the EC Treaty or deriving from another Community act, such as a regulation or a directive. Nonetheless, the loyalty principle does pose a more general rule of solidarity and cooperation that goes beyond the specific EC rules and goals to be adhered to by the Member States, entailing a general code of good conduct for Member States in this respect. This is also supported by the ECJ, which has ruled that “Article 5 [i.e. now Art. 10] does more than merely set out a programme which is relevant solely in the determination of the objectives of the other provisions of the Treaty” and that it “may under certain circumstances transcend specific legally binding duties laid down elsewhere.”18 From this and other case law it may be deduced that this principle may have far-reaching consequences in terms of rendering directly effective a provision normally lacking this feature or reinforcing certain Community acts with non-binding character.19 Lastly, the loyalty principle may be held (co-) responsible for the duty of national courts to apply reconciliatory interpretation of domestic law in the light of EC law, especially EC Directives, and for Member States’ liability for improper, non-application, or non-implementation of EC law.20

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17 Legal commentators subdivide these two broad aspects into different categories of positive and negative duties deriving from this principle for both Member States and EC institutions (see e.g. Kapteyn, cit., at 156 ff., and literature cited therein). The analysis of the principle contained in the text is limited to the aspects relevant for the main object of this study.


19 See in detail Temple Lang, cit., especially at 668-669, showing the applicability of the loyalty principle with respect to a non-legally binding resolution in the interpretation of the ECJ.

As for the relevance of the loyalty principle in direct tax matters and more specifically tax competition, especially in conjunction with other Treaty provisions, it is interesting to analyse the case *Hurd v. Jones*,\(^1\) which gives a flavour of how broad the scope of this principle may be. Mr. Hurd, an English citizen and resident for tax purposes, was a teacher employed by a European School located in the UK. A number of European Schools had been opened throughout Europe after the foundation of the European Coal and Steel Community to provide children of expatriates working for the Community with education in their own language. These Schools had intergovernmental (i.e. EC) status and their rules were laid down in a Statute ratified by the six founder Member States (subsequently adopted by acceding States.) The teachers, usually seconded to Schools in other Member States, were entitled to a salary equal to their national salary, which was payable and taxable in their home country, plus a European allowance financed by the Schools’ budget (and ultimately by the EC) and exempt from tax in their home countries. This exemption applied by virtue of an agreement signed between the School’s representatives (i.e. the Board of Governors) and each Member State, and was limited to non-national teachers seconded to Schools in other Member States.

In the case at hand, the UK tax authorities sought to tax both the salary and the allowance earned by Mr. Hurd as he was a UK resident and national, and the European School where he was teaching happened to be located in the UK. It is noteworthy that, unlike the other Member States, the UK had not ratified any agreement with the Board of Governors of the School ensuring the exemption of the allowance for non-national teachers. Asked whether the loyalty principle barred the UK from taxing the allowance earned by Mr. Hurd, the Court indeed found a breach of this principle on the grounds that this behaviour was detrimental to the Community, namely to the functioning of the European Schools and to the Community budget out of which the payment of the allowance was ultimately financed. Given the lack of direct effect of Art. 5 in the absence of sufficiently clear and unconditional object, the Court acknowledged that it was up to the UK to choose the method best suited to prevent taxation of the allowance paid to Mr. Hurd by the UK-based European School.

This judgement shows that the Court applies the loyalty principle even in the direct tax area, which is outside the scope of the Treaty as expression of Member States’ sovereignty, and even in the absence of a legally-binding Community primary or secondary legal measure. Focusing on tax competition, this principle does not affect the ability of Member States to implement general favourable tax measures applying to both resident and non-resident taxpayers, including for instance a low standard corporate tax rate. On the other hand, they may only do so to the extent that no other fundamental Treaty objective is jeopardised, as this would constitute a breach of the loyalty principle in its negative aspect, possibly in conjunction with another (specific) EC Treaty provision. From this it may be inferred that Member States’ special harmful tax regimes, whose likely effect(s) would be to distort competition in the EU, increase unemployment, and/or create budget deficits hindering the stability of the single currency and thus the EMU policy, would constitute a violation of Art. 10 *juncto* Arts. 2, 3, 87 and/or 96, and/or 99 ff. of the Treaty (see on these provisions in sections 2.3 through 2.5). On the other hand, if Member States’ (aggressive) regimes are

nevertheless compatible with the Treaty objectives, then there would be no breach of loyalty as the general rule of tax sovereignty would apply. As will be seen, in our analysis the loyalty principle will mainly come into play in conjunction with other Treaty provisions allegedly breached by the implementation of potentially harmful tax regimes or by the use of unilateral countermeasures adopted by Member States (see in Chapter 5).

2.2.4 Tax competition as the norm

The fundamental Treaty provisions analysed above entail that under EU law tax competition between Member States is the norm.22 As a matter of principle, they enjoy sovereignty to choose their domestic rules on the (corporate) tax base, tax rate(s), and all other elements of their tax system. They are in principle also free to grant tax incentives to pursue fiscal policies meant to boost the economy, favour employment in their territory, and encourage the development of remote regions.23 From a legal point of view, these conclusions are based on the exclusion of direct taxation from the EU institutional competences provided in the Treaty, on the unanimity rule provided for the adoption of directives in this area in conjunction with the subsidiarity principle requiring EU intervention only where necessary, and on the general Treaty provisions setting out the EU objectives and means of attainment.

The underlying philosophy of this conclusion is consistent with the fundamental principle of 'no taxation without representation'. From an economic point of view, the logic is that within a common market it is desirable to have different tax systems competing with each other, as this means a wide choice for the market actors, i.e. individuals and undertakings, as to the tax burden they want to bear relative to the infrastructure, services, and market opportunities offered by each Member State. In other words, behind this logic is the creed that (fair) tax competition causes beneficial consequences for both Member States, which must reduce inefficiencies and set the tax burden at a reasonable level to stay competitive, and the common market actors, which are able to take full advantage of the fundamental freedoms (see also at 2.3.3).

However, the Treaty provisions analysed above also set out limits to Member States' fiscal sovereignty and have an impact on tax competition between them. This is the case where the smooth functioning of the internal market is jeopardised by tax competition, which justifies EU intervention provided Member States are unable (or unwilling) to take appropriate remedies or this result can be better achieved through concerted action at EU level. Based on this, one may infer that as an exception to the norm that tax competition in the EU is desirable and compatible with the Treaty, the EU legal framework allows the institutions in Brussels to interfere with Member States' sovereignty in all cases in which tax competition causes harmful effects to the internal market able to jeopardise the attainment of its objectives.

The main instrument provided by the Treaty for this purpose would be a directive adopted by the Council on the basis of unanimity voting under Arts. 94 and 95(2).

22 See also Terra & Wattel, cit., at 146-149, and Schön, cit., at 103-104.

23 On the goal to favour the development of remote areas, see especially the Treaty state aid rules explained in Chapter 3, especially in section 3.7, as well as Art. 15 of the Treaty, explained at 2.3.1.
Directive in this area would lay down rules for the approximation of certain aspects of Member States' tax systems necessary to prevent the harmful effects of excessive tax competition. From an EU law point of view, the adoption of such a directive would be justified by the need to prevent obstacles to the smooth functioning of the internal market caused by misallocation of resources and investment flows exclusively or predominantly driven by tax reasons, distortion of competition between taxpayers entitled to special tax incentives and those not entitled to them, and increased labour costs created by the need to compensate the tax forgone by taxing more heavily the more immobile labour factor of production. Even in the absence of clear economic evidence of these consequences of excessive tax competition, there is sufficient evidence justifying recourse to a directive against harmful tax competition based on Arts. 94 and 95(2). 24

The possibility of using this instrument in the harmful tax competition area is also being considered by the Commission, which in its communication on tax policy for the future years stated that: 25

"In the case of direct taxation of mobile tax bases, the need for a certain degree of co-ordination has already been recognised, in particular: in the exchange of information on savings income; in the Directives in the field of company taxation already adopted (under Article 94 of the Treaty; in the Code of Conduct for business taxation; and in the proposed Directive on interest and royalties. However, it may be necessary to adopt a more ambitious approach in the near future. The Treaty (in Article 94) provides for the “approximation” of those direct tax rules that “directly affect the establishment or functioning of the common market.” The Commission is examining whether more can be done to tackle direct tax obstacles to the Internal Market, notably in the field of company taxation, while respecting the sovereignty of Member States. Certainly, further coordination of national tax systems in the area of company taxation would help eliminate situations of double taxation or unintentional non-taxation as well as the above-mentioned tax obstacles. More analysis is therefore needed, taking into account on the one hand those distortions which could threaten the proper functioning of the Internal Market, and on the other hand the effects of tax competition. The level of taxation in this area is however a matter for the Member States to decide, in accordance with the principle of subsidiarity."

However, in the (harmful) tax competition area a coordination instrument (i.e. soft law) would probably be more appropriate than a directive, which would achieve positive integration rather than a negative obligation by Member States to abstain from engaging in excessive competition detrimental for the internal market. 26 Furthermore,

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24 See especially the recent Commission Study on corporate taxation in the EU, which does provide a number of consistent conclusions in support of this, explained in Chapter 1, section 1.4. See also the considerations in Chapter 6, especially at 6.2.2, 6.2.3, and 6.4.2. In support of the conclusion in the text see also Schön, cit., at 101-102 and especially at 104, referring to the adoption of the Mutual Assistance Directive (Council Directive 77/799/EEC of 19/12/1977, in O.J. L 336, 27/12/77, p. 15) and to the recent Proposed Directive on the taxation of savings (Proposal for a Council Directive to ensure effective taxation of savings income in the form of interest payments within the Community, 2001/0164 (CNS)) part of the “Package to Tackle Harmful Tax Competition” (see Chapter 4; Section 4.2) to argue that a directive on harmful tax competition might indeed be based on Arts. 94 and 95(2) due to the need to prevent budgetary losses, distortion of flows of capital, and distortion of competition in the internal market.


26 On this issue, see in detail in Chapter 6, at 6.4.2, which indicates a non-legally-binding instrument as appropriate to regulate the phenomenon of harmful tax competition. For more thorough comment on the current balance of powers in the EU and a proposal for a change in the direct tax area, see F. Vanistendael, Memorandum on the taxing powers of the European Union, 11 EC Tax Review, 3/2002, p. 121.
a major problem linked to the adoption of a directive would be to gain the necessary consensus for its approval under unanimity voting. In the impossibility to reach this consensus among Member States for reluctance to give up (part of) their sovereignty in direct taxation, mainly as a result of a prisoner’s dilemma situation (see in Chapter 1, at 1.2.5), the Treaty features other provisions potentially applicable for EU intervention to counter harmful tax competition. They will be analysed in the following sections in more detail.

2.3 Internal market rules and (harmful) tax competition

2.3.1 Establishment of the ‘internal market’

One of the two main EU means of achieving the fundamental Treaty objectives is the creation and the smooth functioning of a common market through the policies and activities specified in the Treaty (see Art. 2 of the Treaty, at 2.2.1). For this purpose, two such activities are the establishment of an internal market and the creation of a system ensuring that competition in the internal market is not distorted (Art. 3 (1) (c) and (g) of the Treaty, see at 2.2.1). The Treaty uses a different terminology in Arts. 2 and 3, referring to common market in the former and to internal market in the latter. Without going into the detail of this different terminology, suffice it to say that the term common market was used in the EEC Treaty without being defined. This concept encompasses the common policies necessary to achieve the Treaty objectives set out in Art. 3 of the Treaty, including the establishment of the internal market, and is based on the microeconomic view that a free trade area and a level playing field must be created between Member States for undertakings to freely compete without external distortions affecting their business decisions and behaviour. The ECJ has further specified this concept by pointing out that “the elimination of all obstacles to intra-Community trade” is necessary “to merge the national markets into a single market bringing about conditions as close as possible to those of a genuine internal market.”

The term internal market is defined by Art. 14 (2) of the Treaty as “an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the provisions of this Treaty.” This concept is based on a macroeconomic perspective as it is addressed to all Member States required to remove the obstacles and barriers so as to ensure free mobility of the factors of production. This is crucial to achieve a common market between Member States, i.e. a level playing field for undertakings analogous to a domestic market. Furthermore, Art. 15 allows to take into account the existence of more underdeveloped economies or areas in the Community, which could justify derogations to the general rule laid down in Art. 14, as long as they are “of a temporary nature and ... cause the least possible disturbance to the functioning of the common market” (Art. 15(2)).

29 It is worth noting that occasionally also the term “single market” is used in more recent EC documents, but this must be considered interchangeable with, and thus synonymous of, “internal market.” see Mortelmans, Common market, cit., at 107.
The Treaty contains specific rules on the Community policies and activities concerning the establishment and the functioning of internal market in its Part Three. Two fundamental sets of rules are those on the four fundamental freedoms and on undistorted competition. Even though they deal with different aspects of the internal market, their combined application has a fundamental impact on tax competition in the EU. They will be analysed under this perspective in this section, highlighting both the legal and the economic aspects.

2.3.2 Fundamental freedoms and (harmful) tax competition

The Treaty rules on the fundamental freedoms aim at setting up an internal market with no obstacles to intra-Community circulation of goods (Arts. 28-31), persons (i.e. both individuals and legal entities, Arts. 39-48), services (Arts. 49-55), and capital (Arts. 56-60) so as to promote *market access* throughout the Union. These rules also promote *market equality* by prohibiting any discrimination by Member States based on the origin of goods, the nationality of persons or the place of investment of capital. The concept of discrimination encompasses direct or overt discrimination consisting of treating differently the same or similar situations or treating alike the same or similar situations. As a matter of principle, the Treaty forbids any rule enacted by Member States providing for different treatment on the basis of origin of products or nationality of persons. The Treaty also prohibits indirect or covert discrimination, whereby the different treatment, even though not directly based on the criterion of origin or nationality, in effect acts mainly or exclusively at the detriment of foreign goods or persons. There are a few exceptions to this general prohibition of overt and covert discrimination linked to the presence of acceptable and proportionate justifications, which are outside the scope of this analysis.

The provisions on the fundamental freedoms affect the direct tax area in terms of negative integration, which means that in spite of their sovereignty Member States may not enact direct tax provisions at odds with the prohibitions set out in the Treaty (see also at 2.2.1 and 2.2.4). The Court of Justice has also played a fundamental role in this respect by asserting its jurisdiction to rule on the compatibility of Member States' direct tax provisions with these rules (see at 2.2.2). Even though the Treaty provisions on the fundamental freedoms do not specifically deal with the issue of (harmful) tax competition in the EU, they do have an impact in this respect. The analysis of relevant

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31 In general on the four freedoms, see Kapteyn, *cit.*, at 575 ff, and Steiner, *cit.*, at 151 ff, and 90 ff. On the four freedoms and their applicability to direct taxation, see Terra & Wattel, *cit.*, at 30 ff. See also Schön, *cit.*, at 98. For a more thorough discussion of the freedom of establishment (of legal entities) and of capital movement as applicable to unilateral measures against harmful tax competition, see in Chapter 5.


33 See Terra & Wattel, *cit.*: for a summary of the accepted justifications, at 31-34; for their application in direct tax matters with regard to the freedom of movement of workers and undertakings, at 60 ff. For a discussion on the applicability of the main justifications to countermeasures against harmful tax competition, see in Chapter 5, especially section 5.3.2.
case law of the ECJ concerning the two mentioned aspects of market access and market equality shows this impact for the purpose of our analysis.

Starting with the latter, as explained above (in Chapter 1, especially at 1.1.4 and 1.2.6) tax competition consists of a reduction of the direct tax burden directed at attracting inbound investment from other Member States, implying an advantageous rather than discriminatory treatment for foreign investors. This is often the case with regard to tax incentives usually limited to foreign(-based) investors (i.e. multinational corporations), and especially to their passive income and other mobile activities (i.e. intra-group financial, coordination, and service activities performed by their ‘centres’). This in turn means that the result of tax competition may be so-called ‘reverse discrimination,’ consisting of worse treatment by a Member State of its own nationals, i.e. of resident taxpayers not entitled to the same tax incentives exclusively available for non-resident taxpayers.34

Under settled case law of the ECJ, reverse discrimination does not fall within the Treaty rules on the fundamental freedoms because it concerns ‘purely internal situations’ to Member States. In these cases, the Court has consistently held that Member States are free to do what they want, even to lay down an unfavourable tax treatment (i.e. a discrimination) of their national (i.e. resident) taxpayers, and that the fundamental freedoms do not help as they are designed to prevent discriminations or restrictions where there is a cross-border economic element.35 Nor is the general non-discrimination provision contained in Art. 12 of the Treaty applicable to cases of ‘reverse’ discrimination,36 as this provision is only relevant within the scope of application of the EC Treaty and thus not with regard to purely internal situations not covered by the Treaty. Therefore, it may be concluded that the fundamental freedoms and market equality do not affect Member States’ favourable tax regimes only available for foreign-based taxpayers and hence tax competition to attract inbound investment.

2.3.3 Exercise of fundamental freedoms and tax competition

The second issue regards to what extent the principle of market access allows market operators (i.e. individuals and undertakings) to exercise the Treaty freedoms in order to benefit from the existence of different legal systems of Member States in areas not falling into EC competence. Put differently, in the absence of harmonisation or coordination of legislation at EC level in these areas, the question arises as to whether market actors may take advantage of competition of different Member States’ legal regimes via the exercise of the fundamental freedoms. For the purpose of our

34 On the special tax regimes in favour of the centres, see especially Chapter 3, at 3.8.1 and 3.8.2, and Chapter 4, section 4.5.


36 Schön points out that in these cases the only remedy left to taxpayers is the reliance on domestic legal principles such as general non-discrimination provisions included in most constitutions (see Schön, cit., at 99). The author also shows, with regard to Germany, that the recourse to domestic constitutions to strike down reverse discrimination may prove difficult.

37 On this provision, see in general Kapteyn, cit., at 163 ff; Weatherill, cit., at 39 ff.; and Bater, cit., at 12; Terra & Wattel, cit., 23 ff.
analysis, this translates into the question whether individuals and undertakings can (and should) take advantage of tax competition between Member States as a result of the establishment of the internal market. From the answer to these questions one is also able to draw more general conclusions as to whether Member States are free to engage in competition between their direct tax systems.

Case law of the ECJ turns out to be very helpful to clarify these issues. In the Gilly case, the Court had to rule on the compatibility of double tax conventions concluded between two Member States (i.e. France and Germany) with the free movement of workers. Without going into the detail of the case, suffice it to say that the ECJ restated Member States’ sovereignty “to determine the criteria for taxation on income and wealth with a view to eliminating double taxation - by means, inter alia, of international agreements.” Furthermore, the Court made clear that as for “the differences between the tax scales of the Member States concerned ... in the absence of any Community legislation in the field ... the determination of those scales is a matter for the Member States.” These principles acknowledge that the fundamental freedoms do not imply limitations to Member States’ competition through their general tax systems inter alia by setting different tax rates to ensure progressivity of the system and by adopting different methods to relieve international double taxation (including by way of tax treaties).

In the Centros case, the Court tackled the issue of the distinction between lawful exercise of the freedom of establishment and abuse of EC law with regard to the attempt by individuals to take advantage of competition of corporate law systems between Member States. A Danish couple incorporated a UK limited liability company for the more favourable UK minimum statutory capital requirements for the formation of companies as compared to Danish law requirements. They sought to register a Danish branch of the UK company to carry out business activity in their country, but registration was denied by the Danish authorities. The issue was whether this denial was compatible with the Treaty, and more in general whether the behaviour of the Danish couple constituted a lawful exercise of the freedom of establishment or instead an abuse of EC law to circumvent the application of unfavourable domestic corporate law rules. The Court stated that “the right to form a company in accordance with the law of a Member State ... is inherent in the exercise, in a single market, of the freedom of establishment” and that “the fact that company law is not completely harmonised is of little consequence.” This conclusion endorses the opinion of the Advocate General (hereinafter: “AG”) La Pergola, who stressed that in the absence of harmonisation at EU level, (also) in the corporate law area competition among Member States’ systems was the norm, and as a result that

39 See Gilly, cit., para. 24.
40 See Gilly, cit., para 47. See also paras. 34 and 48 of the judgement.
individuals were entitled to take advantage of the system better suited to their specific needs.43

A case more specifically concerning the issue of EU special tax regimes and the exercise of the freedom to provide services is \textit{Eurowings}.44 A German (trade) tax law rule resulted in higher taxation on the provision of services performed in Germany by a company resident in Ireland and enjoying the special low corporate tax rate of 10%.45 The German authorities asked the Court whether this circumstance was relevant in justifying the compatibility of the German tax provision with the Treaty freedom to provide services. Firmly rejecting this argument, the ECJ explicitly ruled that “that difference of treatment can also not be justified by the fact that the lessor established in another Member State is there subject to lower taxation.” The Court went on to state that “any tax advantage resulting for providers of services from the low taxation to which they are subject in the Member State in which they are established cannot be used to justify less favourable treatment in tax matters given to recipients of services established in the latter State” since “such compensatory arrangements prejudice the very foundations of the single market.”46

The above case law confirms that the Treaty freedoms do not affect the ability of Member States to choose the structural elements of their tax systems (e.g. the scale of tax and the method to relieve double taxation) and to grant special tax incentives in accordance with the Treaty. From the perspective of Member States, this is consistent with the conclusion that tax competition is the norm and is desirable in view of the establishment of the internal market (see at 2.2.4). From the perspective of individuals and undertakings, the above case law confirms that in the absence of harmonisation of a certain legal area at EC level they may freely resort to the exercise of the fundamental Treaty freedoms to take advantage of competition between Member States’ legal orders. This is one of the very cornerstones of the internal market, which allows as a matter of principle a choice of the most appropriate legal system for market actors provided they do not claim the freedoms for purposes wholly alien to the Treaty.47 These principles are certainly applicable to the direct tax area, which is not harmonised at EU level and is not of Community competence. Therefore, it may be concluded that individuals and legal entities may take advantage of competition

\begin{footnotesize}
\begin{enumerate}
\item It is worth noting that the AG explicitly referred to the opinion of AG Darmon in a related case, in which he stated that “the right which is accorded to natural persons of setting up a company in another member-State .... is the logical consequence of the rights guaranteed under the Treaty. Moreover, it is consistent with the objective behind the inclusion of the freedom of establishment in the EEC Treaty, namely the need to promote the free movement of persons and .... the achievement of a common market. In that respect, the fact that a national of a member-State may take advantage of the flexibility of United Kingdom company law and may exploit the effect of the attraction .... an Anglo-Saxon designation has for his customers must be viewed in that context.” See Case 79/85, Segers v Bestuur van de Bedrijfsvereniging voor bank- en verzekeringswezen, groothandel en vrije beroepen, 10/07/86, [1986] ECR 2375, opinion of AG Darmon, para. 6. See also the comment on this case by Roth, cit., at 151-152.
\item Case C-294/97, \textit{Eurowings Luftverkehrs AG v Finanzamt Dortmund-Unna}, [1999] ECR 1-7447. For a detailed analysis of this case, see in Chapter 5, at 5.3.2.7.
\item This low corporate tax rate was available for companies established in the Shannon airport (i.e. the so-called “Shannon relief”) and had been approved by the Commission under the State aid rules: see in Chapter 5, section 3.5.
\item See \textit{Eurowings}, cit., paras. 43-45. As will be explained in Chapter 5, at 5.3.2.7, \textit{Eurowings} concerned unrelated parties, and thus its reasoning does not apply also to abusive situations involving related parties.
\item In other words, the exercise of the Treaty freedoms to take advantage of the best legal system is lawful and conform to EC law unless there is an abuse of this exercise for purposes alien to the Treaty objectives: see in detail Chapter 5, especially sections 5.3.2 and 5.4.2.2.
\end{enumerate}
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between Member States’ tax systems (as long as no abuse of EC law is afoot, see Chapter 5), and that Member States are prevented from imposing a higher tax burden or compensatory charges to undo the effect of favourable tax regimes enacted in other Member States.48

2.3.4 Treaty rules on competition between undertakings and State aid

Another pillar of a truly internal market is free competition among undertakings on an undistorted level playing field (Art. 3(1)(g) of the Treaty, see at 2.2.1).49 The competition provisions are contained in Chapter 1 of Title VI of the Treaty and are divided in those directed at private undertakings (Arts. 81-85) and those directed at Member States as regards aids granted by them (Arts. 87-89). The broad goal of this set of provisions is to promote economic activity and an efficient allocation of resources and investment by ensuring a free flow of goods and services exclusively governed by market forces according to the model of ‘pure’ or ‘perfect’ competition. This is a corollary of the completion of the internal market, which presupposes such free flow to take advantage of the economies of scale of Member States’ markets together and ultimately to achieve an increased welfare for both consumers and undertakings competing in the market. For this purpose, the specific goal of these rules is to eliminate the potential distortions to competition created either by unfair behaviours of private undertakings or by Member States’ behaviours.

The Treaty provisions directed at undertakings forbid the conclusion of anti-competitive agreements or concerted practices, as well as the abuse of dominant positions for individual undertakings or groups of undertakings. They apply to EU cross-border situations in which there is a potential threat to intra-Community trade, interpreted as any situation capable of having a direct or indirect, actual or potential effect on the flow of trade between Member States on the basis of objective legal or factual criteria.50 With regard to anti-competitive agreements and concerted practices, an additional cross-border element is that they must have “as their object or effect the prevention, restriction, or distortion of competition within the common market” (Art. 81 Treaty), which is broadly interpreted by the Court relying on presumptions based on a number of elements.51 Despite these provisions are directed at undertakings, the ECJ extends their scope also to the conduct of Member States. In the Meng case, the Court stated that “Article 85 [i.e. now Art. 81], read in conjunction with Article 5 [i.e. now Art. 10] of the Treaty, requires the Member States not to introduce or maintain in

48 This is a conclusion valid as a matter of principle, but as will be seen Member States may adopt countermeasures against harmful tax measures enacted by other Member States that do not comply with the Treaty rules and objectives against abusive situations: see in detail in Chapter 5.
49 See in general on the Treaty competition rules Kepteyn, cit., at 773 ff., and Steiner, cit., at 192 ff.
50 The Court has adopted a consistent interpretation with regard to the Treaty rules on the fundamental freedoms (e.g. in Case 8/74, Procureur du Roy v Dassonville, [1974] ECR 837) and in the competition rules directed to private undertakings (e.g. Case 56/65, Société Technique Minière v. Maschinenbau Ulm GmbH, [1966] ECR 235, and Case 161/84, Pronuptia de Paris GmbH v Pronuptia de Paris Irmgaard Schilligalis [1986] ECR 353). See also Steiner, cit., at 222-223, and Mortelmans, Convergenze, cit., at 623, citing the Grundig case (Cases 56 & 58/64, Etablissement Constena SA and Grundig GmbH v Commission [1966] ECR 299), as also inspiring Dassonville, cit., para. 5. This consistent case law also shows the common thrust of the two sets of provisions jointly analysed in this section (see at 2.3.5).
51 These criteria include the nature and quantity of products concerned, the position and size of the undertakings concerned, the isolated or recurrent nature of the agreement: see Steiner, cit., at 224-226, and case law cited therein.
force measures, even of a legislative or regulatory nature, which may render ineffective the competition rules applicable to undertakings."  

The second set of the Treaty competition provisions prohibit "any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods ... insofar as it affects trade between Member States" (Art. 87 Treaty). These provisions aim at safeguarding the level playing field in the common market from Member States' intervention potentially distorting competition between undertakings. The underlying philosophy is that the smooth functioning of the internal market endorsing the 'perfect' competition model must prevent also market failures caused by Member States, which may potentially harm its correct functioning as badly as private undertakings' unfair behaviours. The criteria regarding the cross-border element are similar to the Treaty rules addressed to undertakings as to the threat of distortion of competition as well as the impact on intra-Community trade. The most important requirement for the applicability of the state aid rules to direct tax measures is the 'specificity' criterion, which entails that these measures are only prohibited to the extent that they are granted to limited (category of) recipient(s) or to a certain sector of business activity (see in detail in Chapter 3, especially at 3.3.1 and 3.6.3). As will be seen, the Commission has the necessary powers to ensure the application of these rules (also) against selective harmful tax measures of Member States as the guardian of the Treaty.

The State aid provisions have a major impact on tax competition between Member States. In particular, they strictly limit Member States' tax sovereignty to enact special tax incentives favouring certain categories of taxpayers (e.g. foreign-based multinational companies) or certain kind of income (e.g. from financial activities). However, they do not imply any restrictions with regard to measures part of the general (i.e. 'benchmark') tax system of Member States as the specificity criterion is not satisfied in these cases. From this it may be concluded that also the Treaty rules on competition and in particular on State aid are consistent with the distinction between 'good' tax competition between general tax systems (i.e. 'benchmark' tax bases and tax rates) of Member States, considered healthy for the internal market, and 'bad' tax competition caused by selective tax incentives mainly directed at non-resident taxpayers and mobile activities, considered to bring about distortion to competition in the internal market. The impact of the state aid provisions on competition between Member States' legal (i.e. tax) systems has also been analysed by the EC. The road hauliers case concerned the compatibility with the state aid rules of a tax credit granted by Italy to road hauliers on the purchase of diesel for commercial transportation. The credit was granted in the form of a bonus, which the road hauliers could offset against their individual income tax, VAT, or municipal taxes due. The Italian scheme also provided for an equivalent of the credit in the form of compensatory payments to foreign transport undertakings linked to their consumption of diesel in the Italian

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53 For a thorough discussion of the EC State aid provisions and their applicability in tax matters, see in Chapter 3. See also, in general, Schön, cit., at 99-101.
54 On the distinction between desirable and harmful tax competition, see in Chapter 1, especially at 1.2.6.
55 Case C-6/97, Italian Republic v. Commission, [1999] ECR I-2981 (referred to as "road hauliers").
As the Commission found this measure to constitute a prohibited state aid under Art. 87 of the Treaty, the Italian government sought to justify it *inter alia* on the grounds that the tax burden of Italian excise duty on diesel was higher than the tax burden in other Member States, and thus the tax credit did not distort competition but merely restored the conditions of competition at Community level. The Court referred to previous case law to reject this justification, upholding the Commission's claim that "a difference in the tax burden imposed on one particular activity cannot, by itself, justify the grant of State aid" and clarifying that "the fact that a member State seeks to approximate, by unilateral measures, the conditions of competition ... to those prevailing in other Member States cannot deprive the measures in question of their character as aid." Consistently with the *Centros and Eurowings* cases (see at 2.3.3), this case implies that Member States may compete with their benchmark tax system, but they are not allowed to undo the lower tax burden imposed in other Member States through a specific compensatory tax measure.

### 2.3.5 Legal and economic considerations of internal market rules and impact on tax competition

Although the Treaty rules on the fundamental freedoms and on competition say nothing specific about tax competition, nor more in general about direct taxation, they do have an impact in this respect mainly in terms of negative integration. In particular, they entail a (negative) obligation for Member States to refrain from imposing (or maintaining) barriers to the four freedoms and from distorting competition by favouring certain undertakings or certain sectors of business activity. As for the relationship between these two sets of rules, they are closely linked by their main aim to establish a common market between Member States in which goods, persons, services and capital may circulate without restrictions and may compete under the same conditions in a level playing field, as also confirmed by the ECJ. In this light, their combined application is of vital importance to ensure the two main principles of a truly common market, i.e. market access and market equality. They are both based on a microeconomic approach protecting individuals and economic operators, which are the ultimate beneficiaries of an internal market without obstacles.

This is also shown by the common element required for their application, i.e. a cross-border situation which might have an impact on intra-Community trade. These considerations support the idea that the interpretation and application of both sets of rules should be consistent. As seen above, the ECJ is moving in this direction.

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56 See the *road hauliers* case, paras. 20-21.
57 In other words, Member States may restore legislative parity with the other Member States only by amending their benchmark tax legislation. In the case at hand, the Italian government should have lowered the general tax (i.e. excise duty) burden on diesel rather than granting a specific aid limited to professional road hauliers.
60 See on this Mortelmans, *Convergence*, *cit.*, at 621 ff., and especially F. Vanistendael, *Fiscal support measures and harmful tax competition*, EC Tax Review, 3/2000, p. 152, at 155, suggesting that even though the term used with regard to the fundamental freedoms is 'discrimination,' they in fact have to do with competition in the internal market, just the same as the state aid rules.
by ensuring consistency not only between the different Treaty provisions relating to the four freedoms on the one hand, and the competition and state aid provisions on the other, but also between the former and the latter in the light of their common aim.61

From a tax competition perspective, these Treaty provisions indirectly confirm the general principle of Member States’ sovereignty in direct tax matters and the legitimacy of tax competition between them. In an internal market, this is considered desirable for its beneficiaries as they can choose the Member State offering the best tax environment for their investments, and ultimately the market with the best combination of economic opportunity, taxation, and public services. A genuine internal market, however, must not be distorted by any behaviour of Member States imposing obstacles to the fundamental freedoms or distortions to competition. The behaviour prohibited by the Treaty regards the granting of special tax incentives limited to certain (foreign-based) taxpayers or to certain (mobile) activities giving rise to certain (passive) income. This boils down to an inherent prohibition of harmful tax competition in the light of the negative integration these Treaty provisions postulate, which is necessary to prevent serious distortions to the flow of goods, persons, and capital, as well as to free competition based on a level playing field for all economic operators in the market.

2.4 Treaty rules on market distortions and tax competition

2.4.1 Treaty structure and main goal of internal market distortions provisions

The EC rules on internal market distortions are contained in Arts. 96 and 97 of the Treaty as part of the common rules on approximation of laws. These articles envisage the prevention or lifting of any serious distortions of the conditions of competition within the internal market created by differences between legislative or administrative provisions or practices adopted in two or more Member States.62 The broad goal of Arts. 96 and 97 has been pointed out by the ECJ in the benchmark Costa v. Enel case:63 “This Article [i.e. Art. 97], placed in the chapter devoted to ‘Approximation of Laws’, is designed to prevent the differences between the legislation of the different nations with regard to the objectives of the Treaty from becoming more pronounced. By virtue of this provision, Member States have limited their freedom of initiative by agreeing to submit to an appropriate procedure of consultation.”

This judgement clearly indicates the difference with the Treaty rules on the approximation of laws of Member States contained in Arts. 94 and 95, which lead to the adoption of legally binding directives necessary for the establishment and functioning of the common market on the basis of unanimity voting in tax matters (see at 2.2.2). While Arts. 94-95 broadly refer to all legal areas in which approximation of Member States’ laws is crucial for the functioning of the common market, which may

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61 The Centros, Eurowings and Road hauliers cases are an emblematic example of this. See on this issue also Chapter 3, at 3.4.3.

62 See, in general on the interpretation of Arts. 96 and 97, Kapteyn, cit., pp. 802-810, at 802; see also Easson, cit., at 201 ff., and Terra & Wattel, cit., at 17.

63 Case 6/64, Flaminio Costa v. ENEL, [1964] ECR 585, 15 July 1964. Even though the object of the judgement was specifically Art. 97, the explanation of the Court is also valid for Art. 96.
not be better achieved by legislation adopted by Member States pursuant to the subsidiarity principle (see at 2.2.2), Arts. 96 and 97 apply only where there is the need to eliminate a serious distortion in the internal market jeopardising the Treaty objectives, meaning that their scope is more limited and thus special as compared to the former. There are more substantive and procedural differences between the two sets of rules, as will be seen below.

The Treaty rules on internal market distortions have played an insignificant role in the history and case law of the EC up till now. This gives rise to a number of uncertainties on their interpretation and application, which requires a more thorough analysis of both substantive and procedural aspects to understand their possible impact on (harmful) tax competition. This analysis will be based on the legislative history the EC Treaty (i.e., on the Spaak Report) and on legal literature.

2.4.2 Article 96: substantive and procedural requirements

Art. 96 (1) reads:

“(1) Where the Commission finds that a difference laid down by law, regulation or administrative action in Member States is distorting the conditions of competition in the Common Market and that the resultant distortion needs to be eliminated, it shall consult the Member States concerned. (2) If such consultation does not result in an agreement eliminating the distortion in question, the Council shall, on a proposal from the Commission, acting by qualified majority, issue the necessary directives. The Commission and the Council may take any other appropriate measures provided for in this Treaty.”

Three conditions must be satisfied in order for this provision to apply: (i) a disparity in Member States’ laws, regulations, or administrative practices, causing (ii) a distortion of competition in the internal market, which (iii) the Commission finds that it needs to be eliminated.

The scope of Art. 96 is quite broad, as it encompasses not only laws but also every kind of administrative act or practice enacted by Member States regardless of the form and the body issuing them. The rules contained in any of these sources must be different, i.e., must lay down a distinct treatment with respect to the same or similar situation in other Member States. In other words, disparity is the very feature of Art. 96, meaning objective or subjective differentiation of treatment of a certain situation within the internal market created by divergent legal and/or administrative rules or practices of two or more Member States adopted pursuant to their legal sovereignty. This concept is different from the concept of discrimination, which refers to a different treatment of the same or similar situations in the legislative or administrative system within one jurisdiction by a single Member State and not justified by acceptable grounds. By contrast, disparity or different treatment of the same or similar situation within the meaning of Art. 96 occurs due to the interaction of different provisions

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64 For a summary of the main Commission Decisions and Court cases in which Arts. 96 and 97 have been invoked, see Kapteyn, cit., at 810, footnote 220.
66 See Kapteyn, cit., at 802 ff.
67 See Kapteyn, cit., at 171, and Terra & Wattel, cit., at 41 ff. See also supra at 2.3.2.
implemented by at least two different Member States and may be the result of several factors, such as different policies or divergent economic and/or social goals aimed at by them.

In the direct tax area, disparities within the meaning of Art. 96 are caused by a different tax treatment laid down by one or a limited group of Member States in their statutory tax system or in special tax regimes with regard to a situation or a taxpayer subject in (the majority or totality of the) to a (more or less) consistent treatment. On the other hand, discrimination arises where a domestic tax provision of only one Member State lays down a different tax treatment of the same or similar situations merely on the basis of the residence of taxpayers or of the territory where the income is generated.

The second condition required for the application of Art. 96 is that the difference in the law or administrative practices of two or more Member States give rise to a 'distortion' of competition in the common market. The concept of distortion is fundamental to understand the exact scope of this provision: as neither the Commission nor the ECJ have defined this concept within the meaning of Art. 96, it is necessary in its demarcation to resort to the Spaa Report and the interpretation of legal commentators, as well as to a systematic interpretation of similar Treaty provisions. In general, a distortion is considered to occur when a certain measure adopted by public authorities has a significant impact on the allocation of the factors of production in the internal market.68 The Spaa Report sets out a distinction between 'global' and 'specific' distortions. The former are based on macroeconomic criteria and arise due to the differences in governments' spending, in tax burdens, in social security charges imposed on firms, and the like. The latter are based on microeconomic parameters and are considered to be differences in financial burdens between different groups of firms within the same country not justified by corresponding benefits granted to the other firms and not existing in other Member States.69 This distinction is further specified by literature with reference to 'generic' distortions occurring at the 'meso level' of sectors, regions or categories of the economy, which seems to coincide with what the Commission considers specific or selective aids for the purpose of the application of the state aid rules.70 The Spaa Report endorses a narrow interpretation of Art. 96 as encompassing only 'specific' distortions under the theory that the generic ones would naturally be averaged at macroeconomic level by market forces. However, in practice this Report specifically indicates as examples of such distortions caught by Art. 96 differences in costs and financial burdens borne by competing firms operating in different Member States, such as direct or indirect taxes, differences in funding of social security, and differences in price regulations, implicitly acknowledging that also 'generic' distortions fall within its scope.71

68 See Kapteyn, cit., at 803 ff.
69 See also C. Melia, The Law of the European Community - A Commentary on the EC Treaty, Matthew Bender & Co., at 3-576.50 ff. On this point, the author concludes that as Art. 96 does not explicitly distinguish between these two categories, it may be assumed that both global and specific distortions fall within its scope.
70 See Kapteyn, cit., at 803 ff. On the selectivity criterion for the state aid rules, see in Chapter 3, at 3.3.1 and 3.6.3.
71 See on this issue Melia, cit., 3.576.55, pointing out that the Spaa Report is rather confusing on the interpretation of the concept of distortion and that it is preferable not to stress this distinction. This author explicitly refers to Art. 87 for the interpretation of the concept of distortion within the meaning of Art. 96 by stressing the need to interpret it more narrowly as opposed to that envisaged in Art. 3 (g) and Arts. 81-85 of the Treaty (see also at 2.2.1.
The need to avoid a narrow interpretation of the concept of distortion is also supported by a systematic interpretation in the light of other Treaty provisions, namely with reference to the interpretation of this concept by the ECJ (and the Commission) in the light of the Treaty rules on competition and State aid provision contained in Art. 87 (see at 2.3.3 and extensively in Chapter 3).\(^7\) This is based on the consideration that the aims and the ratio legis of the two sets of provisions are the same and the scope is very similar, and thus coherence of interpretation is required in these cases (see at 2.3.5). Based on all the above, it may be concluded that the concept of distortion within the meaning of Art. 96 includes both 'global' and 'specific' as well as 'generic' distortions meeting three criteria: (i) a group of firms in a Member State is subject to higher or lower charges (e.g. taxes, social security contributions, and price regulations) as compared to firms of one or more other Member States; (ii) this differentiation is not present for other firms in other Member States with respect to the same or similar situations; and (iii) there is no compensation by other counterbalancing charges in the first Member State.\(^7\)

The third substantive condition laid down in Art. 96 requires the distortion to be of such a significance that "the Commission finds that...needs to be eliminated." Once again, in the absence of further specification or clarification in the Treaty and in case law, given the similar wording of Art. 87 the interpretation of the ECJ on this provision may also be used with regard to Art. 96.\(^7\) As a result, in order to be relevant for the purpose of Art. 96 the distortion must be of a certain significance from both a quantitative and a qualitative point of view. As for global distortions, this requirement implies an analysis on the effect of the disparity on the actual cross-border flow of investment or goods in the internal market and in general on the detrimental effect to the market from a macroeconomic perspective. With regard to the concept of specific distortions, the quantitative aspect requires to measure in terms of money or other economic indicators the financial advantage conferred on the beneficiary(ies) of these measures (i.e. undertakings) as a result of the disparity between the laws or administrative practices of the Member States involved.

The qualitative aspect means that the policy goal underlying the disparity laid down in Member States’ legislation and giving rise to a differentiated treatment must be evaluated. For this investigation, it may be affirmed that the grounds underlying the State aid exemptions laid down in Art. 87 may be used as relevant criteria (see in Chapter 3 at 3.3.2). As a result, a disparity in the laws of Member States leading to a

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\(^7\) See also Melia, cit., at 3.576.53. This author explicitly refers to Art. 87 for the interpretation of the concept of distortion within the meaning of Art. 96 by stressing the need to interpret it more narrowly as opposed to that envisaged in Art. 3 (g) and Arts. 81-85 of the Treaty (see also at 2.2.1 and section 2.3 above). Disagreeing, Kapteyn, cit., at 806, stresses the need not to interpret narrowing the requirement of distortion in the absence of other Treaty provisions available to counter 'generic' distortions. This latter view seems preferable in the direct tax area, especially as the state aid rules often may not be used against harmful tax measures implemented by Member States as they are general provisions and fail to meet the specificity criterion (see also in Chapter 3.)

\(^7\) See Kapteyn, cit., at 803 ff., summarising the requirements for the interpretation of Art. 96.

\(^7\) See Melia, cit., 3.576.56, who also explicitly mentions the need to use Art. 87 for this purpose and refers to the quantitative and qualitative aspects mentioned in the text.
distortion of competition in the internal market might not be considered by the Commission detrimental to Treaty objectives and thus caught by Art. 96 where it could be justified on the basis of the need to favour the economic development or boost the employment in depressed areas of the Member State(s) involved. Lastly, one has to imply from the wording of Art. 96 systematically interpreted with reference to the state aid rules that the Commission has broad discretionary powers as to whether to resort to the use of this instrument, and if so what type of remedy to seek. This brings us to the procedure envisaged in Art. 96, which is divided in two stages. The first stage starts on the initiative of the Commission, which must consult the Member State(s) concerned where it finds that the substantive conditions for the application of Art. 96 are fulfilled. Such consultation is made by way of an exchange of letters and/or informal meetings between representatives of both Commission and Member State concerned. In case an agreement is reached on how to eliminate the market distortion, there will be no need to undertake stage two of the procedure. If consensus on the elimination of the distortion is not found, the Commission resorts to the second stage: Art. 96 provides for the possibility to propose a directive to eliminate the distortion in question, which may be approved by the Council according to the qualified majority rule. The practical consequence is that the majority of Member States are able to vote out another Member State's distortive (tax) policy by issuing a legally binding directive towards such Member State. It is also possible, however, that the directive addresses more than one Member State in order to make them align their national policies in such a way that the distortion is lifted. In the event that the Council is not ready to vote the directive as proposed by the Commission, it may make changes and draft a new text provided unanimity is reached on this as required by Art. 250 of the Treaty. Alternatively, should the Council require the Commission to amend the text of the original directive proposed, it may do so by sticking with the qualified majority rule, which will then be used to approve the final text as amended by the Commission. Lastly, it is worth noting that Art. 96 provides that the Commission and the Council may decide to resort to any alternative instruments laid down in the Treaty, such as non-legally binding acts (e.g. recommendations), depending on what they feel is the most appropriate to achieve the elimination of the distortion in question.

24.3 Article 97 of the EC Treaty

The substantive requirements for the application of Art. 97 are the same as those under Art. 96, as it follows from its wording: "Where there is reason to fear that the adoption or amendment of a provision laid down by law, regulation or administrative action may cause distortion within the meaning of Article 96..." The explanations and

75 According to Kapteyn, cit., at 806, the qualitative aspect linked to the subjective motive for the disparity would be relevant mainly in deciding the legal remedy to use towards the Member State(s) causing the distortion; namely whether to act through a directive on the basis of Arts. 94 and 95, or through a directive or another appropriate act (e.g. a 'soft law' act) on the basis of Art. 96. This author also places importance on the possibility of spontaneous harmonisation to take place, which would justify a non-intervention by the Commission in consideration of the Member States' policy for the measure giving rise to the disparity, also in consideration of situations in which there is a prisoner's dilemma scenario.

76 See Melia, cit., 3-576.52.
remarks made with respect to Art. 96 are therefore also valid with respect to this provision.

The main difference between them lies in their procedural rules. Under Art. 97, the initiative for the consultation procedure with the Commission is to be undertaken directly by the Member State concerned rather than by the Commission as required by Art. 96. This entails that Art. 97 is meant to prevent a distortion of competition in the internal market beforehand, whereas Art. 96 is meant to eliminate already existing distortions through a contentious procedure on the initiative of the Commission against one or more Member States, possibly through the intervention of the Council. In response to the request for consultation by a Member State, the Commission must issue a recommendation on how to amend its legislative or administrative measure in such a way that it is no longer distortive of competition. The effectiveness of Art. 97 depends on the political responsibility and sensitiveness of the various Member States, which ought to be diligent in informing the Commission of any measure planned to be adopted capable of distorting competition within the meaning of Art. 96. Very seldom has this happened, probably because Member States feel they would surrender their national sovereignty to the Commission should they consult the latter on all domestic legislative and administrative acts and practices potentially able to create internal market distortions.

The duty imposed by Art. 97 should be seen in the light of the duty of loyalty imposed on the Member States by Art. 10 of the Treaty (see at 2.2.3), which requires them to cooperate in the achievement of the Treaty objectives and to abstain from any behaviour which might jeopardise the attainment of such objectives. As to the legal nature of this duty of consultation under Art. 97, it is interesting to refer to the ECJ interpretation in the Costa v. Enel case (see at 2.4.1): the Court affirmed that this provision does not have direct effect and “does not create individual rights which national courts must protect.” The Court also specified that “the Commission is bound to ensure respect for the provisions of this Article, but this obligation does not give individuals the right to allege... failure by the State concerned to fulfil any of its obligations or breach of duty on the part of the Commission”. From this it may be implied that the remedies for failure by Member States to consult the Commission in case of the adoption of potentially distorting measures rest exclusively with the Commission itself, which may initiate the procedure provided for by Art. 96 in this event. In other words, it is entirely up to the Commission to respond to any breach by the Member States of the duties stemming from Art. 97 juncto Art. 10 of the Treaty.

One may wonder why the Commission has failed to do so for so many years. Probably, the main reason is that Art. 97 entails a subjective and discretionary evaluation of the consequences of the implementation of a certain legislative or administrative policy by a Member State as to its potential of creating internal market distortions. It is very difficult to establish distortions and even more difficult to establish what exactly causes them. Moreover, it is politically dangerous to activate Art. 97, because it may lead to the need for the Commission to activate Art. 96, which may in its turn lead to the adoption of directives under qualified majority voting even in such areas in which Member States enjoy sovereignty as direct taxation. On the other hand, in case of failure to reach adoption of a measure via the procedure under

77 See Melia, cit., 3-576.61.
Art. 96, this could result in Member States feeling free not to take these provisions too seriously. In a nutshell, it may be concluded that Arts. 96 and 97 may be more effective on the shelf than in real action.

### 2.4.4 Impact on (harmful) tax competition

As seen above, Arts. 96 and 97 are also applicable to the direct tax area. Any fiscal measure implemented by a Member State of a legal, regulatory or administrative practice nature may fall within their scope if:

1. it contains a significant differentiation in the fiscal treatment of individual(s) or firm(s) as compared to individual(s) or firm(s) of another Member State(s) in the same or similar objective situation, and
2. it results in a significant distortion of competition within the internal market from both a qualitative and quantitative point of view, which the Commission thinks must be eliminated.

With regard to tax competition, the above shows the potentially significant impact of Arts. 96 and 97. This is mainly due to the broad scope of these rules, which cover any disparity caused by Member States' general tax measures contained in their laws, regulations, or administrative practices, including those forming part of their general (i.e. 'benchmark') tax system. It follows that both statutory tax provisions and special tax incentives fall within the scope of these rules, as long as they lay down a tax treatment different from other Member States' tax treatments of the same or similar situations under requirement (i) above.

This requirement leaves mostly intact the tax sovereignty granted by the Treaty to Member States, as only their tax measures providing for a tax treatment blatantly different from that adopted for similar situations by all or most of the other Member States satisfy this requirement. This entails that Member States' rules on the setting of corporate tax rates or on the determination of the taxable base are in general not in breach of Arts. 96 and 97 and their sovereignty in this respect is safeguarded. This conclusion is once again consistent with the underlying theory embedded in the Treaty that tax competition is legitimate and desirable in an internal market for its operators. However, if a Member State implements a general tax measure significantly different from the corresponding general tax measures in all or most of the other Member States, this could fall within the scope of Arts. 96 and 97. An example would be the adoption by only one Member State of a nil or very low corporate tax rate (e.g. 5%) as opposed to the average statutory corporate tax rate adopted in the other Member States close to 30% (on this, see in Chapter 1, section 1.4.5). However, in these cases the need to prove all the requirements and the discretionary initiation of proceeding by the Commission under Art. 96 suggests that in practice Member States' tax sovereignty is not subject to a significant limitation as a result of other Member States' different tax measures (and policies) part of the benchmark tax system. As for specific tax incentives adopted by only one Member State or a small group of Member States, they are a fortiori able to meet this requirement and fall within the scope of these provisions as they clearly lay down special tax treatments for certain taxpayers and/or certain situations likely to be significantly different not only from those of
other Member States’ tax systems, but also from the treatment laid down under their own general tax system.

As for the requirement under (ii), Member State’s tax measures laying down a different tax treatment must also cause a serious distortion of competition in the internal market. Following the interpretation of the Spaak Report and of the ECJ with regard to the state aid rules (see at 2.4.2), one may conclude that harmful tax measures would seem to meet them given their effects on the internal market. By and large, these measures are acknowledged to cause ‘global’ distortions to the internal market as they reduce Member States’ corporate tax revenue and correspondingly the quality and level of public services. Furthermore, they are potentially able to distort the allocation as well as the use of the factors of production (i.e. labour versus capital). They are also detrimental to the internal market as they may entail tax revenue losses for other Member States and may cause higher unemployment. As for ‘specific’ (and ‘generic’) distortions, harmful tax measures usually favour certain firms (e.g. large multinational companies) or certain activities (e.g. mobile activities giving rise to passive income) vis-à-vis the majority of firms or activities not entitled to the special tax treatment provided by them.

The last requirement is that the Commission considers it necessary to eliminate the said distortions on the basis of their quantitative and qualitative significance, which significance might be difficult to prove. Even if there is consensus about harmful tax competition bringing about substantial losses of tax revenue for other Member States and substantial gains for the beneficiaries of the special tax incentives (i.e. multinational companies) in terms of lower tax burden as well as possibly increased unemployment in the drained Member States, it is extremely difficult to quantify these effects in monetary terms or in terms of other economic indicators. This problem is exacerbated by the difficulty to prove the causal link between (harmful) tax measures and these distortions, which are also caused by a number of other structural factors and specific factors of the various Member States’ economies. A further obstacle is the proof of this link where there are more Member States adopting similar special regimes for certain taxpayers or activities, which makes it all the more difficult to ascertain the distortion and the impact each of them has in this respect. As for the underlying policies pursued by the Member States in enacting (harmful) tax measures (i.e. the qualitative aspect), there may be no sound policies other than attracting mobile income at the expense of other Member States, which would certainly justify the Commission resort to these provisions. The situation, however, would be different if their underlying policy would (also or) mainly be to promote the development of a certain depressed area or of an underdeveloped sector of the economy, or would be motivated by the need to offset structural handicaps linked to the small size of the domestic market. In these cases, the Commission might find it inappropriate or even contrary to the Treaty to act on the basis of Arts. 96 and 97, or it may resort to ‘softer’ instruments to eliminate the distortions such as a recommendation rather than a legally-binding directive approved under qualified majority voting.
2.4.5. Potential significance of Articles 96 and 97 against harmful tax competition in the future

Despite the internal market distortions rules might theoretically constitute a powerful legal tool to counter harmful tax competition, one doubts that they will play a significant role in this respect. First, the applicability of Arts. 96-97 gives rise to several uncertainties as to their scope and the satisfaction of their substantive requirements. The concept of disparity involves a comparison of all Member State’s tax rules or practices, which requires a complicated analysis and a deep understanding of all of them. Furthermore, there is an objective difficulty to evaluate the serious distortive effects. Lastly, the sensitivity of the direct tax area postulates a strong political support by the Commission to challenge harmful tax measures of Member States on the basis of Arts. 96 and 97, especially considering that their applicability to general tax measures might seriously restrict their sovereignty in this area. The fact that these provisions have almost never been used to date constitutes an additional disincentive to their use.

However, recent case law and other developments show that the tide might turn. The Ramon din case concerned the compatibility with the state aid rules of a tax credit and a tax holiday available in one of the Basque provinces, which had been declared by a Commission decision. One of the arguments put forward by the Basque authorities was that the Commission misused its powers conferred by the state aid rules to strike down the Basque tax incentives in order to achieve (a certain degree of) harmonisation, for which Arts. 96 and 97 should have been used instead. The Court of First Instance (hereinafter: "CFI") ruled that misuse of power must be proved by several objective consistent factors showing that a Community instrument (e.g. a decision under the state aid rules) has been issued with the exclusive or prevalent purpose to achieve goals other than those for which it is intended. In the absence of evidence showing that tax harmonisation occurred as a result of the said Commission decision, the CFI rejected the claim of the Basque authorities. In the more recent case on the Gibraltar offshore regimes for exempt and qualifying companies, also dealing with the compatibility of these regimes with the state aid rules, the Gibraltar authorities argued that the Commission should have taken a more equitable approach by resorting to Arts. 96 and 97 given the potential dramatic consequences on the Gibraltar economy a final decision of incompatibility would mean. Also in this case the CFI rejected this claim by ruling that “the economic risks caused by the decision ... cannot of themselves affect the legality of such a decision.”

The question still remains as to whether the significance of these provisions to tackle harmful tax competition will become relevant in the future. This might be the case especially if the other Treaty provisions and/or the political attempts to solve this issue fail to succeed. More specifically, if the harmonisation rules (i.e. Arts. 94-95) are

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78 See also Kapteyn, cit., at 810, indicating a number of reasons for the failure to use these provisions, mainly the fact that other Treaty provisions are perceived as more important or easier to resort to by the Commission, such as the state aid rules.

79 Joined Cases T-92/00 and T-103/00, Territorio Histórico de Álava - Disputación Foral de Álava and Ramon din v Commission, 6/3/2002, nyr. For its explanation, see in detail Chapter 3, at 3.7.6.

80 See the Ramon din case, cit., paras. 83-85.

not used by the Member States due to the impossibility to find unanimous consensus for the adoption of a directive on harmful tax competition, the Commission might probably justify the resort to Art. 96 as the qualified majority rule may lead to the adoption of such a directive. Needless to say, this will only happen if the Commission is able to gain the necessary political support, especially by the large Member States. The result might be an effective solution at once and in a legally binding way of the issue of harmful tax competition. The Commission might also resort to the use of Arts. 96 and 97 against harmful tax competition in cases in which the other relevant Treaty provisions are not applicable. As seen above (at 2.4.4), this might be the case with regard to general tax measures not falling into the scope of the State aid rules because the ‘specificity’ criterion is not met, but causing harmful effects for the internal market. Lastly, a failure in the implementation of the Code of Conduct (see Chapter 4) might trigger the application of Art. 96. If Member States do not repeal or amend their harmful tax measures as envisaged by the Code because of its lack of binding force, the Commission might well decide to propose one directive or a number of directives addressed to each Member State to be adopted on the basis of qualified majority. Chances that the Commission would win sufficient political support for such directive(s) to be approved may not be not so slim, with economic growth slowing down Member States getting fed up with each other’s competitive measures and Ireland dropping its corporate tax rate to 12.5% (see Chapter 3, section 3.5).

To sum up, the use of Arts. 96 and 97 might become reality sooner than expected. This is supported by the awareness of Member States on their potential applicability and more equitable consequences to counter harmful tax competition (as compared to the state aid rules) emerging from the Ramondin and the Gibraltar offshore regime cases. Moreover, the Commission has explicitly made clear in its most recent policy document on the strategy in direct taxation policy for the future years that it will consider resorting to these provisions: “It may also be recalled that Article 96 of the Treaty provides a legal basis for the Commission to take action to deal with distortions of the conditions of competition in the Internal Market, including proposing directives, which may be adopted by qualified majority.” This is even more likely after the release of the comprehensive Study on distortions caused by the differences in Member States’ direct tax systems, which provides some evidence in this respect (see Chapter 1, at 1.4.5)

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82 On this issue, see P. J. Wattel, Belastingconcurrentie, staatssteun, de EG-gedragsCode en de Nederlandse CFM, in Nederlands Tijdschrift voor Europese Recht, 1-2/1998, p. 17. The author argues that in this case the consultation requirement of stage one of the Art. 96 procedure would have to be considered fulfilled on the basis of the constant discussions between Member States’ representatives and the Commission before and after the approval of the Code of Conduct and the subsequent release of the Primarolo Report: see Chapter 4, especially sections 4.2 and 4.3.

83 See the Commission Communication of 23/5/2001, cit., at para. 4.2. See also the Commission Notice on fiscal state aid of 11 November 1998, OJ C 2, 6/1/98, p. 1, para. 3: “Some general tax measures may impede the proper functioning of the internal market... some disparities between planned or existing general provisions in Member States may distort competition and create distortions that need to be eliminated on the basis of Articles 101 and 102 (i.e. now Arts. 96 and 97)” (this Notice will be discussed at length in Chapter 3, at section 3.6).
2.5 Economic and monetary union (EMU) and tax competition

2.5.1 EMU and direct tax policies of Member States: Basic legal and institutional framework

The establishment of the Economic and Monetary Union ("EMU") is the second fundamental means to achieve the main EU objectives (Art. 2 EC Treaty, see at 2.2.1). For a better understanding of the EMU rules, an historical overview of its progressive development into the current Treaty provisions is helpful. The idea of setting up an economic and monetary union by inter alia coordinating Member States’ economic policies and eventually leading to a single currency in three progressive stages was formalised by the European Council of Madrid in June 1989. The first stage (1990-1993) was meant to start bringing the budgetary and economic policies of the Member States closer. During that period, the European Monetary System ("EMS"), based on limited fluctuation bands of the EC countries’ currencies against the then European Currency Unit ("ECU"), progressively fell apart due to instability in the international capital markets and divergent currency and interest rate policies in the various Member States. The second stage (1994-1998) aimed at preparing the introduction of the single currency by forcing Member States to meet strict convergence criteria to reduce budgetary deficits and inflation rates and to ensure price stability. The third stage (1999-2002) was needed for the progressive adoption of the single currency in business transactions and finally in day-to-day transactions with replacement of Member States’ national currencies by the euro.

The key principles of the EMU are specified in Art. 4 of the Treaty:

"The activities of the Member States and the Community shall include ... the adoption of an economic policy which is based on the close coordination of Member States’ economic policies, on the internal market ... conducted in accordance with the principle of an open market economy with free competition. (2) ... These activities shall include the irrevocable fixing of exchange rates leading to the introduction of a single currency ... and the ... conduct of a single monetary policy and exchange-rate policy the primary objective of both of which shall be to maintain price stability and, without prejudice to this objective, to support the general economic policies in the Community. (3) These activities ... shall entail compliance with the following guiding principles: stable prices, sound public finances and monetary conditions and a sustainable balance of payments."

The wording of Art. 4 clearly summarises the main objectives of the EMU and the division of competences between the Community and the Member States: a single

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64 On the EMU history, see e.g. Kapteyn, cit., at 951 ff., and S. Weatherill and P. Beaumont, EC Law, Penguin 2nd Ed., at 652 ff.
65 These criteria were: (i) average inflation rate not higher than 1.5% of the average of the three best performing EU countries; (ii) budgetary deficit not higher than 3% of GDP and overall public debt ratio not higher than 60% of GDP; (iii) long-term interest rate not higher than 2% of the average interest rates in the three best performing EU countries; (iv) domestic currency with normal fluctuation margins within the EMS for at least two years.
monetary policy is pursued at EU level and a coordinated economic (and budgetary) policy at Member States’ level, with the supervision by the EU institutions. The introduction of the single currency in twelve Member States so far meant the conferment of monetary policy associated with the euro on a central body performing the same tasks previously performed by the national central banks (or by governments), i.e. the European Central Bank (hereinafter: “ECB”).

The ECB is wholly independent of the Member States’ political power and national central banks as well as of the other EU institutions and has the power to issue legally binding acts (i.e. regulations and decisions) in the areas of its competence (see especially Art. 110 of the Treaty). The monetary policy, which affects the money supply and the monetary relationship with non-EMU countries, must pursue the fundamental objective of price stability. The policy tools available to the ECB for this purpose are the setting of interest rates, the setting of foreign exchange rates with third countries, the management of official money reserves, and the issue of banknotes in the Member States (see Arts. 105, 106 and 111 of the Treaty).

The economic policy of EMU States must be closely coordinated so as to be consistent with the ECB monetary policy in order to ensure price stability. This is explicitly confirmed in Arts. 98 and 99 of the Treaty, which also provide for a mechanism of control of Member States’ domestic economic policies by the Commission and the Council. In particular, the Council adopts broad economic policy guidelines (hereinafter: “BEPG”) on the basis of a proposal by the Commission containing recommendations on the long-term EMU common economic policy objectives. The Council must closely monitor the economic policies of the EMU countries and their consistency with the BEPG on the basis of regular reports submitted by the Commission. To this end, Member States must provide the Commission with the necessary information and developments on their domestic economic policies. This mechanism is also meant to ensure a peer review of each EMU State on its fellow States’ economic policies. In the event that EMU States’ economic policies do not comply with the BEPG, the Council has the power to issue recommendations to the non-compliant State(s) adopted under Art. 99 (4) of the Treaty by qualified majority.

There is another constraint to Member States’ economic policies deriving from the Treaty EMU provisions. These require budgetary discipline and sound public finances as a result of the so-called “Stability and Growth Pact”, adopted with a view to ensure price stability and economic growth in the EMU countries. Under the Pact,
Member States’ budgetary rigor is deemed to be respected provided their public deficit does not exceed 3% of GDP and their public debt does not exceed 60% of GDP (see Art. 104 (1), (2), and (6) of the Treaty). Furthermore, Member States are required to progressively reduce their deficit and achieve a balanced (or positive) budget over the next few years. If the thresholds set out in the Pact are exceeded or the EMU States’ economic policies are likely to undermine compliance with them, the Commission initiates the so-called “excessive deficit procedure” by submitting to the Council a report with an early warning for the Member State(s) concerned. After consultations with this Member State(s), the Council may issue a recommendation to take appropriate measures to reduce its deficit on the basis of qualified majority voting. In case of persistent failure of the Member State(s) concerned to comply with this recommendation, the Council may impose a number of sanctions, including a non-interest bearing deposit equal to up to 0.5% of its GDP or of appropriate fines (see Art. 104 (11) of the Treaty).

What is the impact of the EMU rules on direct tax policies of EMU Member States? Potentially, it may be relevant. One has to consider that direct taxation is a major element of the economic (and budgetary) policy of each country, as it is a fundamental means of securing tax revenue needed to finance government spending for public services and infrastructures. The Treaty rules clearly acknowledge as a matter of principle the priority of monetary policy and of price stability over EMU States’ economic policies, including their direct tax policies. This implies that in shaping their tax policies, EMU countries must take into account this objective and design them consistently with it. The powers conferred on the EU institutions to ensure compliance with the EMU provisions are relevant, as they are crucial for the strength of the single currency and ultimately the functioning of the internal market and its competitiveness at international level.

2.5.2 The case of the Irish 2001 Budget

A recent case concerning the Irish 2001 budget shows the potential impact the Treaty EMU provisions might have on (harmful) tax competition in the EU. The Council of Economic and Finance Ministers (hereinafter: “Ecofin”) addressed to Ireland a recommendation to reprimand the 2001 Budget on the basis of Art. 99(4) of the Treaty, which states:

“Where it is established ... that the economic policies of a Member State are not consistent with the broad guidelines referred to in paragraph 2 or that they risk jeopardising the proper functioning of economic and monetary union, the Council may, acting by a qualified majority on a recommendation from the Commission, make the necessary recommendations to the Member State concerned.”

91 For a thorough explanation of the excessive deficit procedure, see A. Italianer, The excessive deficit procedure: A legal description, in Andenas et al., cit., at 191 ff.; Hahn, cit., at 92 ff.;
This procedure consists of two stages. In the first stage, the Commission warns the (Ecofin) Council that a Member State’s economic (i.e. budgetary) policy is either inconsistent with the broad economic policy guidelines (“BEPG”, see at 2.5.1) issued by the Council under Art. 99(2), or threatens the smooth functioning of the EMU, because they undermine the objective of price stability. In these cases, the Commission issues a recommendation as a result of its constant monitoring of EU countries’ budgetary policies in the context of Art. 99(3). The second step of the Art. 99(4) procedure provides that the Ecofin may issue a recommendation based on the Commission recommendation under qualified majority voting. Such recommendation is directed to a specific Member State and must indicate the reasons for considering its budgetary policy non-compliant with the BEPG or threatening the functioning of the EMU.

In the Irish case, after receiving the proposed Irish 2001 Budget the Commission found it inconsistent with the BEPG issued by the European Council in Feira in June 2000 and issued a recommendation to that effect. Endorsing the Commission opinion, the Council recommended to Ireland to amend its budget so as to make it consistent with the BEPG. Apparently, Ireland disagreed with the Council’s position as it considered its 2001 budget consistent with both the BEPG and the Irish Stability Program 2001-2003. In a nutshell, the Ecofin was concerned that the expansionary budgetary policy adopted by Ireland mainly through direct (and indirect) tax cuts could have a significantly adverse impact on the price stability in the euro zone. According to the Ecofin, the planned Irish tax measures could have spurred demand and consumption in an already overheating economy, which would likely have increased the already high Irish inflation as compared to the EU average inflation. By contrast, Irish officials claimed that these fears were unjustified because Ireland is a small economy whose influence on the euro zone economy and on the average inflation is limited. Moreover, they maintained that the Irish budgetary policy was well tailored to the Irish economic situation and that the fellow EMU States were envious about the excellent condition of the Irish economy. Lastly, Ireland stressed that budgetary (and direct tax) policy is a matter for the various countries, which enjoy sovereignty in this respect despite EMU membership.

After the first reluctant reaction to take appropriate measures in compliance with the Council recommendation, the Irish government did so by limiting expenditure through spending cuts and (partially) withdrawing direct tax incentives. In particular, in the 2002 budget the Irish government decided to raise some indirect taxes and to postpone the direct tax cuts previously announced mainly because of the change of the Irish economic situation, experiencing rising unemployment, reduction in demand, and low inflation concerns as compared to the florid economic situation in the year 2000. This move by the Irish authorities resulted in a subsequent positive decision by the Council on the compliance with its previous recommendation. Regardless of the outcome of the Irish 2001 budget case and the fact that Ireland amended it as it was forced by the unexpected circumstances relating to the Irish

93 See the 2329th Ecofin Council meeting Nr: 5696/01 (presse 35), Brussels, 12 February 2001, available on the Council Web Site at http://ue.eu.int/Newsroom.

economy and the effects of a global economic recession, this case clearly shows that the EMU rules do constitute another constraint to Member States’ direct tax policy and may be an additional tool to counter harmful tax competition.

2.5.3 Application of EMU provisions as an additional tool against harmful tax competition?

The considerations on the Irish case as well as other recent developments in the application of the EMU provisions Member States highlight the impact they might have on harmful tax competition in the EU. The strict approach of the EU institutions and the sanctions allowed under the Treaty against Member States suggest that this might prove a powerful tool also for this purpose. For its use, a direct link between a preferential harmful tax regime enacted by a Member State and its potential negative impact on the common EMU objective of price stability is needed. In the absence of additional requirements for the applicability of the EMU provisions, the EU institutions might resort to their use in direct tax matters where the other Treaty provisions are inapplicable (e.g. the specificity requirement is not met for the application of State aid rules, see Chapter 3, at 3.3.1 and 3.6.3) or ineffective (e.g. lack of sufficient political support for the application of the internal market distortions rules, see section 2.4).

An example may better clarify this point. Ireland is due to introduce in 2003 its new corporate tax system relying on a 12.5% rate on trading income and 25% rate on non-trading income, which complies with the (fiscal) state aid rules (see Chapter 3, section 3.5). This new system will likely have a significant impact on the Irish budget and may ultimately lead to an expansionary policy potentially undermining price stability or to an excessive public deficit if the (likely) reduction in Irish corporate tax revenue is not offset by an increase in other taxes or by corresponding spending cuts. If the Council (with the Commission’s support) feared that this direct tax policy may cause either effect, it could address to Ireland a recommendation on the basis of Art. 99 (4) (see at 2.5.2), or it could initiate an ‘excessive deficit procedure’ on the basis of Art. 104 of the Treaty that could lead to the imposition of harsh (see at 2.5.1).

One may draw more general conclusions from this example. In the relationship between monetary and fiscal policy, the EU model has endorsed the ‘convertibility principle’, under which the former prevails over the latter. This is another unique peculiarity of the EU institutional structure, relying on monetary policy dictated by an independent central body as the ECB and at the same time on a coordinated

95 The recent developments on an early warning addressed to Germany and Portugal by the Commission under the excessive budget deficit procedure (see at 2.5.1), despite not being subsequently formalised by a recommendation of the Ecofin Council due to the exceptional economic circumstances in both countries, further confirms the strict surveillance in the application of the EMU provisions and suggests that the Ecofin, with the support of the Commission, will stand up for their application even against the most powerful EMU countries: see 2407th Ecofin Council meeting, 6108/02 (Presse 28), Brussels 12/2/2002, available at http://ue.eu.int/Newsroom.

96 The same conclusions would be true with regard to the tax cuts the Irish government is planning with regard to individual income taxation, which would also show the relevance of the EMU rules in the direct tax area.

economic policy and on direct fiscal policy expression of Member States’ sovereignty framed by governments politically accountable to the electorate. The key goal pursued by monetary policy to ensure the credibility and strength of the single currency is price stability. This goal entails constraints to the economic and fiscal policies of EMU States, which are not free in the pursuit of opposite economic policies such as those aimed at full employment. These policies rely on expansionary measures possibly leading to inflation and/or budget deficits possibly exceeding the parameters of the Growth and Stability Pact. The EU institutions, and in particular the ECB as well as the (Ecofin) Council and the Commission, have broad powers to limit the economic policy sovereignty of EMU States and their (harmful) direct tax measures likely to undermine the said fundamental EMU objectives. Even as research shows the effectiveness of the model based on the convertibility principle to achieve sound monetary and economic policy, one may not ignore that the ramifications and constraints for the direct tax policy area are potentially able to take away a large chunk of Member States’ sovereignty. From a tax competition perspective, this is desirable if it serves as a means against harmful tax competition, but it would not be as desirable were the broad powers conferred on EU institutions used to limit EMU states’ sovereignty giving rise to good tax competition.

2.6 Conclusion

The EC Treaty does not contain any explicit provision dealing with tax competition, nor more in general with direct taxation. This does not impede to identify a consistent EU legal framework affecting tax competition both in its desirable and its harmful form, by putting together a number of provisions scattered throughout the Treaty (and their interpretation by the European Court of Justice). The economic rationale underlying these provisions is also relevant in the assessment of this framework and its applicability to the tax competition area.

By and large, the Treaty leaves it up to Member States to design their tax systems pursuant to their sovereignty and autonomy as expression of the fundamental principle ‘no taxation without representation.’ Within the logic of the establishment of a common market, it is desirable that Member States compete with their tax systems so that there is a wide choice for EU citizens and economic operators as to the most suitable tax system for them and their investments, and more in general as to the most

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98 See on this Vanistendael, cit., at 75, and his proposal for institutional changes at 78-79.
99 It is worth noting that exceptional circumstances (e.g. severe economic recessions or wartime) may constitute valid reasons for EMU States not to comply with the strict EMU parameters with the consent of the Council (and the Commission); see Art. 100 of the Treaty.
100 See Bordo and Jonung, cit., whose study illustrates the convertibility principle and the influence between monetary and fiscal policy in a period of 115 years and concludes that this principle should be able to ensure the objective of price stability, especially if fiscal policies are consistent with EMU policy.
101 It is worth noting that the parameters contained in the Stability and Growth Pact are currently under discussions at EU level as some Member States feel they are too strict and pose a significant constraint on their (expansionary) direct tax policies relying mainly on reductions of tax rates. In this respect, during the European Council of Seville of 21-22 June 2002 the representatives of Member States agreed to grant more time to France to bring its budget into balance according to the Pact. The same is true with regard to Italy, Germany, and Portugal, which will also have difficulties to comply with the Pact and will likewise have additional time to reach parity in their budgets. This shows once again the issues linked to the ‘convertibility principle’ adopted at EU level, given that tax policy is the last significant tool in the hands of Member States to attract investment and give a stimulus to the economy during a recession.
appealing ‘offer’ of tax burden and public services offered by the various Member States. In short, tax competition is the norm.

However, in a common market the said choices should not be distorted or should be distorted as little as possible by direct tax considerations, since the whole idea behind it is to achieve the most optimal allocation of resources and factors of production as well as ensure a system of free competition and a level playing field for undertakings. To this end, the Treaty imposes a number of limits to safeguard its main objectives that also affect the direct tax area, entailing that tax competition is not unrestricted within the Union. In particular, Member States’ tax measures must not breach the rules contained in the Treaty and the common policies falling within the areas of EU competence, nor must they jeopardise the attainment of the fundamental Treaty objectives. Excessive (i.e. harmful) tax competition is deemed to occur where Member States’ tax provisions are likely to undermine the establishment of a common market and an economic and monetary union to promote economic development and growth, a high level of competitiveness, employment and social protection, and a high standard of living and quality of life. In other words, excessive tax competition brings about distortions to the level playing field and thus to competition, decreased (corporate) tax revenue and thus budget deficits and/or reduced level of public services, higher unemployment, and misallocation of resources and factors of production.

In order to limit excessive (i.e. harmful) tax competition and reduce the said consequences, the Treaty provides a number of instruments. First, there is the possibility for Member States to harmonise by way of directives (only) those aspects of their direct tax systems leading to harmful tax competition, which would still leave intact most of their tax sovereignty and would respect the subsidiarity principle. Second, the Commission may use the State aid rules to counter Member States’ special tax incentives by declaring their incompatibility with the Treaty (see also in Chapter 3). Third, the internal market provisions provide for a mechanism leading to the adoption of directives under qualified majority or any other (soft-law) instrument to counter harmful tax measures, which might be resorted to where no unanimous consensus is reached for the adoption of a directive under Art. 94 or where the State aid rules are not applicable, for instance because the specificity condition is not met. Fourth, the Treaty allows to fight harmful tax measures undermining price stability in the euro zone or causing serious budget deficits for EMU countries through the EMU provisions, which rely on a cooperation between the (Ecofin) Council and the Commission and provide sufficient legal remedies and sanctions to ensure compliance with the fundamental EMU objectives.

In the light of the above, one final question arises: is this legal framework adequate and effective to counter harmful tax competition while at the same time promoting desirable tax competition in the EU? In practice, each set of rules has some flaws for this purpose, as the experience of these years has also shown:

- The Treaty harmonisation rules are practically ineffective as they require unanimous consensus between Member States for the adoption of directives, which is close to impossible to reach in the harmful tax competition area given the different interests of Member States, the differences between big and small
economies, and ultimately the reasons linked to the theories of the prisoner's dilemma and the assurance game (see in Chapter 1, especially at 1.2.5);

- The Treaty State aid rules are an effective means against Member States' special (harmful) tax incentives, but their scope is rather limited and their applicability may be avoided by Member States, and moreover they can lead to harsh consequences for both Member States and companies (see in Chapter 3);
- The Treaty internal market distortion rules have (almost) never been used due to the substantive requirements for their application and the difficulty for the Commission to build political support for their use, especially in the direct tax area in which Member States enjoy sovereignty;
- The Treaty EMU provisions are difficult to use against (harmful) tax measures as they are limited to EMU countries, require sufficient evidence that such tax measures undermine price stability and/or cause excessive budget deficits, and apply in the broader economic policy area in which Member States also enjoy sovereignty as a matter of principle.

To sum up, the Treaty provides sufficient instruments to counter harmful tax competition in the EU, but in practice they prove either inadequate or ineffective for this purpose.