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Editorial

How state aid affects tax competition

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The globalization and liberalization of trade, together with the drive towards completion of the Single Market within the European Union, and the implementation of European Monetary Union, have contributed to a realization by EU Member States of the need for an increased convergence of their economic policies. Their commitment to such increased convergence implies a move towards strengthened coordination and monitoring in the field of fiscal policies. In fact, such strengthened coordination is also required to meet the objective of the Growth and Stability Pact of endeavouring to ensure that budgets of Member States are balanced or in surplus. With full respect for the subsidiarity principle enshrined in Art. 5 (formerly Art. 3b) of the Treaty, action at a Community level in this field can be justified because it may prove more effective in achieving these aims than any measures taken at national level. As Commissioner responsible for the Single Market, Financial Services and Taxation for the past five years, I have been a fervent advocate of measures to increase the coordination of economic policies.

Such efforts will have to be combined with improvements in the efficiency in the EU of both economies and tax systems. As a first step in this direction and in response to the Cardiff European Council of June 1998, the Commission, in close cooperation with Member States, has recently embarked on a process of economic monitoring. This monitoring process, which involves quantitative aspects, is designed to identify the structural reforms needed at national and European level to improve the efficiency, flexibility and integration of European markets. The Commission Communication of 20 January 1999, 'Economic Reform: Report on the functioning of Community product and capital markets', contributed to this process by attempting to identify the economic reforms necessary to increase prosperity, stability and employment. It laid particular emphasis on competition policy, pointing out that 'State aid expenditure remains one of the major sources of distortions within the Single Market'. In addition to stressing the importance of a rigorous enforcement of competition policy by the Commission, the Communication recommended that Member States:

> 'should consider the level and appropriateness of public intervention in market activities, by fixing precise objectives and a timetable for the reduction of overall aid budgets. Member States should also modify the structure of remaining State aids to redirect them away from the ad hoc and sectoral aids and towards aids pursuing aims of common interest.'

In principle, state aids distort competition, and fiscal aids are one form of state aid. In this context, I must stress that competition policy constitutes a field in which the Commission traditionally exerts the plenitude of its powers – the Treaty entrusts the Commission with the task of ensuring that competition is not distorted within the internal market and that Member States do not grant incompatible aid.

More generally, tax distortions, obstacles and disadvantages to doing business within the Union must be tackled. In the longer term, a tax-neutral environment conducive to business and wealth creation is one of the best ways of improving the competitiveness that is essential in an international context.

The EU is marked by a significant diversity of company tax systems. This diversity is to a certain extent historical in origin, since certain tax systems are older than others. It also has cultural roots, linked to the different roles played by tax authorities and to the types of legal system. Finally, it is partly technical in nature given that taxation procedures vary significantly from one country to another. Beyond this diversity, it is to be noted that in all Member States tax incentives exist for certain activities or certain companies. Some of these incentives are recent, and may reflect a certain emulation or competition between Member States. This competition is to be welcomed, as long as it results in dynamism and improvements in tax systems. Such 'fair' competition benefits taxpayers by causing a reduction in overall tax burdens, and increasing the efficiency of tax systems thereby making them less complex for enterprises.

However, such tax incentives can also lead to 'unfair' tax competition significantly influencing the location of business activity within the Union. This is the case, for instance, where Member States set up special schemes which involve lower levels of taxation than generally apply in the Member States in question and are targeted to non-residents. This unfair 'beggar-thy-neighbour' tax competition generally aims at the most mobile activities at an international level. Because it depends on an exploitation of the diversity of tax systems, such unfair tax competition exists mostly in non-harmonized fields, and particularly in direct business taxation.

Many such tax incentives are state aids. Others, as will be seen below, may not be considered state aids because they do not fulfil all the relevant criteria. Until recently, only the state aid aspect had been considered, but we have now enlarged our approach to ensure that tax incentives which affect the location of business in the European Union are addressed.

The need for action at the Community level to fight against harmful tax competition was recognized approximately three years ago, at the Commission's instigation, following the informal meeting of Economic and Finance Ministers at Verona in April 1996. The current and likely future negative effects of such tax competition were noted. First, it was recognized that the erosion of national tax bases through unfair tax competition represents a threat to the tax revenues of the Member States. The greatest risks to the tax bases are in the field of internationally mobile business and capital, examples of which are generally financial services, multinational group management, headquarters and treasury management which benefit from specific tax measures. As Member States compete with each other for the attraction of these bases, they are forced to reduce their tax levels. This can significantly reduce fiscal revenues, thereby leading to a sub-optimal provision of public goods or force a further shift in the balance of the tax burden towards the labour factor. This is the second effect of harmful tax competition. The taxation of labour has been increasing, whilst the taxation of other production factors has shown an overall decrease. It is recognized today that the tax burden cannot be weighted on labour without leading to negative effects on the cost of labour and employment.

Thirdly, harmful tax competition hinders the smooth functioning of the Single Market as it undermines its very basis, namely a level playing field in terms of fair competition between companies.

Finance Ministers at Verona agreed that fiscal erosion could ultimately endanger the achievement of vital Community objectives. As a result, they called for a common approach within the Union. On 1 December 1997, Member States adopted, on a proposal of the Commission, a Code of Conduct for business taxation to curb harmful business tax measures. It covers both laws or regulations and administrative practices. The Code particularly identifies those measures which are targeted at non-residents; which are ring-fenced from the domestic market so they do not affect the national tax base; which are granted even in the absence of any real economic activity and substantial presence within the Member State concerned; which have profit determination rules in respect of activities within a multinational group of companies that depart from internationally accepted principles (notably those agreed upon within the OECD); and/or which lack transparency.

As a matching commitment to the political agreement to the Code, many Member States urged the Commission to re-examine its policy in the field of fiscal state aid and to make full use of its powers under the Treaty rules in order to combat harmful tax competition, and the Commission undertook at the ECOFIN Council on 1 December 1997 to draw up guidelines in this area. It is in this context that the Code of Conduct for business taxation was adopted, calling for the combination of a collective action of the Member States and the Commission. Accordingly, in November 1998, the Commission published a notice on the application of the state aid rules to measures relating to direct business taxation (98/C 384/03). This text not only aims to link the provisions of the Treaty and related rules on state aid to the fight against harmful tax competition, it also has the wider objective of clarifying and reinforcing the application of state aid rules generally to reduce distortions of competition in the Single Market.

In order to clarify the application of state aid rules, these guidelines illustrate how they specifically apply to direct business taxation. They specify, for instance, that a tax measure the main effect of which is to promote one or more sectors of activity constitutes aid. A derogation from the basic rate of corporation tax for an entire section of the economy may therefore constitute a state aid.

Equally, certain assessment criteria are strengthened in order to reinforce the application of state aid rules. This is particularly the case with regard to fiscal aid intended to promote the economic development of particular areas, where the compatibility with the Treaty is examined through the criteria of 'targeting and proportionality' to the aims sought. The implementation of these criteria implies a deeper examination of the justification and the appropriateness of these aids to the desired objectives. These criteria thus make it possible to exclude measures which, although purporting to have a regional purpose, are actually aimed at attracting activities which can be easily relocated and which are of limited benefit to the region in terms of employment, real activity or local economic development (offshore activities for instance).

Finally, it is important to note that the Commission is committed to a broad implementation of these guidelines. Thus, the Commission will examine not only the plans for tax aids notified to it and tax aid illegally implemented, but will also review existing systems. This commitment given by the Commission at the ECOFIN Council on 1 December 1997, is intended to ensure that the rules and the objectives of the Treaty are applied consistently and equally to all.

It is still too early to make an assessment of the contribution of competition policy to the fight against harmful tax competition. One must nevertheless be aware that such an exercise has its limits.

However desirable action by the Commission may be, this alone will not be sufficient to eliminate harmful tax competition at the Community level. I can see two series of limitations. First, there is a limitation in its scope. The assessment by the Commission of the compatibility of fiscal aid is limited to those which are considered to be state aid, which implies the cumulative meeting of four criteria:

(1) the measure must confer on recipients an advantage which relieves them of charges that are normally borne from their budgets;
(2) the advantage must be granted by the state or through state resources;
(3) the measure must affect competition and trade between Member States;
(4) the measure must be specific or selective, favouring 'certain undertakings or the production of certain goods'.

While a particular measure may be perceived as being harmful by other Member States, it would be outside the control of the Commission if one of these criteria were not met.

Nevertheless, where a measure would fall outside the scope of state aid rules, it could still be caught by the Code of Conduct, as these are two independent procedures. In such a case, the Code Group could ask the Member State concerned to roll back or amend the harmful measure. Secondly, the action of the Commission is limited to the Community competences. In other words, the Commission can only deal with measures granted by Member States, and it would of course not be possible to consider under EU state aid rules measures granted by third countries. The Commission supports Member States in their determination to maintain a certain discipline and it can also associate applicant countries to this aim. However, it does not have the means to act directly on harmful tax competition by non-member countries of the Union. This is a delicate issue, given that such harmful tax competition by third countries could affect the current process within the Union.

Of course, action against harmful tax competition should ideally be taken at a worldwide level. The ongoing efforts within the OECD towards tackling harmful tax practices are a valuable first step in this direction. However, the significant size of the EU economy and the importance of the Single Market for economic activity in the European Union, mean that action at the EU level need not and should not, in my view, be delayed.

Furthermore, proving our willingness to act within the European Union would be a strong signal to the outside world. Community dynamics would unquestionably have a driving effect on the fight against harmful tax competition within the OECD.

This is why I consider it important to obtain concrete results in the short term in the fight against harmful tax competition in the EU by mobilizing all available tools and by removing any remaining reticence on the part of Member States.