The EC Tax Journal

TAX COMPETITION: A NATIONAL DEBATE

Timothy Lyons[1]

In this journal recently we have carried a number of articles concerned with the EU's and OECD's views of tax competition. The matter is, of course, of fundamental interest to individual governments too. The web-site of the Netherlands' Ministry of Finance[2], for example, deals specifically with tax competition and has formed the basis of some press comment in the UK. The UK, for its part, has enjoyed a lively debate on the topic, the quality of which will undoubtedly be enhanced by a report from the House of Lords Select Committee on the European Communities entitled *Taxes in the EU: Can Co-ordination and Competition Co-exist?*[3] The report received evidence from a wide variety of sources within commerce, the professions and government, including the German Federal Ministry of Finance, the French Ministry of Finance, the Acting Commissioner for Internal Market, Financial Services, Customs and Indirect Taxation at the European Commission and the Head of Fiscal Affairs at the OECD.

Apart from tax competition, the report addresses a wide range of issues including the taxation of interest and royalty payments, the proposals to ensure a minimum of effective taxation of savings income, VAT proposals and energy taxation and excise duties. It is impossible to provide, in the space of this article, a thorough review of all aspects of the report. What follows is a short summary of some points of particular interest in relation to tax competition and the EU's Code of Conduct for

---

1 Timothy Lyons, Tax Barrister, 24 Old Buildings, Lincoln's Inn, London WC2A 3UP.
Tel: (0171) 242 2744 Fax: (0171) 831 8095.
The Managing Editor.

2 See www.minfin.nl/uk/taxation/TaxCompetition/taxcomp.htm

3 House of Lords Select Committee on the European Communities, 15th Report, Session 1998-99. HL Paper 92, ISBN 0-10-409299-8, The Stationary Office Limited. £20.

business taxation.[4]

Tax Co-ordination

The Committee took the logical but difficult step of attempting to define the terms used in the title to its report. So far as tax co-ordination is concerned, it concluded that:

> "...we understand "co-ordination" as having fewer connotations of compulsion and imposition from above than "harmonisation", and as leaving more room for variations as between Member States. But, whatever terminology is used, in our view the crucial point is that it is no longer practicable for Member States to establish some elements of their tax regimes in isolation, without recognising their interdependence with other Member States...We note from the outset, however, that despite all the attention which it is receiving we believe that there are more important issues currently facing the European Union."[5]

In preferring tax co-ordination over harmonisation the Committee was supported by a number of Member States. The German government said that "direct taxes should be co-ordinated, but in no circumstances harmonised...We, the Germans, do not want tax harmonisation because the development [in EU Member States] is so different..."[6] The Irish government said: "Improving tax policy co-ordination in the EU, which Ireland supports...should not be confused with harmonisation of tax rates, which does not form part of the EU's agenda."[7] For Luxembourg, the Minister of Justice and the Budget is quoted as saying: "...Tax harmonisation is not desirable, or desired by many Member States. What is really needed is some co-ordination of tax provisions in order to prevent unfair tax competition."[8] So far as the French government was concerned, it declared that it was in favour of a *rapprochement* between national tax systems "...but only on some questions and certainly not systematically on every single question...We totally approve of

---

4 COM (97) 564.

5 See paragraph 56 of the Report.

6 See paragraph 68 of the Report.

7 See paragraph 67 of the Report.

8 See paragraph 69 of the Report.

competition as being something that is perfectly healthy for the European Union."[9] So far as the United Kingdom government was concerned, it favoured some approximation of tax law and some collective action but concluded that: "We do not think that what is known as harmonisation is necessary to complete the Single Market..."[10]

The views of the governments on this point were not, perhaps, shared by all those who gave evidence to the Committee. Acting Commissioner Monti urged more co-ordination with "quite extensive harmonisation"[11] in excise duties, VAT and energy taxes. Deutsche Bank favoured some increase in harmonisation, for example in the assessment bases for direct business taxation but did not believe harmonisation of tax rates to be necessary.[12] Nevertheless, on the issue of co-ordination as opposed to harmonisation, the views of the governments of the Member States must be likely to prove determinative.

Tax Competition

Turning to "tax competition" the Committee asked "What is tax competition? When is it harmful?"[13] These two questions are, of course, inextricably linked. So far as the first is concerned, the view advanced on behalf of the UK Treasury was that tax competition occurs "where countries use low taxes to attract internationally mobile capital and business."[14] So far as the second question was concerned, Professor Michael Devereaux supported the idea that "any form of tax competition *can* be harmful".[15] In his view "...there is no economic justification for distinguishing between different forms of tax competition in the way attempted by the Code of

---

9 See paragraph 70 of the Report.

10 See paragraph 66 of the Report.

11 See paragraph 63 of the Report.

12 See paragraph 63 of the Report.

13 See paragraph 57f of the Report.

14 See paragraph 57 of the Report.

15 My emphasis. See paragraph 58 of the Report.

Conduct"[16]. This immediately raises the question whether the Commission has adopted the correct approach to the problem it perceives. An alternative approach, as Professor Devereaux makes clear in the paper referred to below, would be to adopt sufficiently strong controlled foreign company and transfer-pricing rules.

The Committee noted, however, that as one might expect, many of those giving evidence to it did consider that there was a distinction to be drawn between fair and unfair tax competition. Mr. Peter Wilmott observed in his evidence that one can distinguish as harmful "particularly aggressive reductions in tax rates or the introduction of new exemptions which target people in neighbouring Member States...that is a phenomenon which amounts to a beggar thy neighbour policy which ...is fundamentally destructive if allowed to continue.[17]" The OECD thought tax competition could be beneficial, but regarded "tax poaching"[18] as harmful. The Institute of Directors, however, would welcome what was called the "race to the bottom". In its view "[i]t is very unlikely that one would end up with no money to pay for schools or hospitals...But to apply a bit of pressure to governments to see if they can manage with less and become more efficient in the provision of services...is a good thing. That is something businesses face all the time."[19] One may or may not agree with the views of the Institute, but they serve to remind us that the Code of Conduct is not, primarily, a technical response to a technical problem, but a political response to a situation not universally regarded as problematical.

The conclusion of the Committee in answering the questions "What is tax competition? When is it harmful?" was as follows:

> "We do not believe either that tax competition is always harmful or that it never is. In other words, we accept that some types of tax competition may

---

16 *Supra*. See also the notes of his evidence at pp.153-4 of the Report and his memorandum at p138f. He has also outlined his contentions in a recently published paper "Prospects for Co-ordination of Corporate Taxation and the Taxation of Interest Income in the EU: A Comment" *Fiscal Studies* (1999) vol. 20 no.2 pp.155-161. See particularly pp.156-7 of the paper, where Professor Devereaux advances the contentions noted above, and questions the arguments put forward by the EC Commission in justification of the Code of Conduct. The paper was originally presented as a discussion of Andreas Haufler's paper "Prospects for Co-ordination of Corporate Taxation and the Taxation of Interest Income in the EU" *Fiscal Studies* (1999) vol. 20 no.2 pp.133-15

17 See paragraph 61 of the Report.

18 *Supra.*

19 See p109 (Question 283) of the Report.

> be harmful, though we note that they are not easy to define exactly, and that they may bring benefits to one Member State at the expense of others. We noted a possible analogy between predatory pricing, a recognised concept in competition policy, and what one might term "predatory tax measures".[20]

Having stated this conclusion the Report of this Committee goes on to consider a number of other issues, for example, whether progress on the single market for financial services requires tax co-ordination, whether EMU requires more tax co-ordination, whether tax co-ordination requires centralised control and whether tax changes could be imposed on the United Kingdom. It then moves on to consider the Code of Conduct.

The Code of Conduct

The Committee considered four specific issues, first, whether the Code endangers the principle of unanimity in relation to the matters it covers, secondly, the secrecy surrounding the Code, thirdly, the effect of the code on dependent territories, and finally the relationship between the Code and state aid measures. It is worth looking at each of these four issues.

Unanimity

The Committee heard evidence from the Paymaster General, Dawn Primarolo, who chairs the Code of Conduct Group. She observed that the Code is "a political agreement" and that Member States "will be free to make their own decisions as to how to respond to the final report."[21] On the other hand the evidence from the French government stated that: "[The Code] is not legally binding but only because there are no legal sanctions, at least at this stage...I do think we shall sooner or later have to look into this and see what legal power we can give the work of this Group."[22] Mr Keith Marsden said that: "a Code of Conduct for business taxation is really a dishonest device to sidestep EU treaties that require unanimity...Of course, members of a club who have agreed to a new 'Code of Conduct' would be expected to honour it... Once there's a commitment, it will become as powerful as

---

20 See paragraph 61 of the Report.

21 See paragraph 123 of the Report.

22 See paragraph 125 of the Report.

any [EC] Directive, because no country will want to be seen breaking its word."[23]

In my opinion, this latter view rather underestimates the willingness of Member States to look after their own interests when their financial life-blood is at stake. There is, however, considerable merit in questioning whether a political agreement which is not legally binding is an appropriate means of advancing progress in the EU. One of the great strengths of the EU is that it is a union based on the rule of law. It is not a union based on the rule of political expediency. It is for this reason that legal solutions, not political ones, are essential in respect of the issues confronted by the Code. The fact that there exist some precedents for political action, such as employment guidelines agreed at the Luxembourg summit in 1997 and the 1998 Cardiff peer review on product and capital markets, may be a partial explanation of why a non-legal approach was adopted, but it is not a justification of it. The differing views of the Member States as to the binding nature of the Code led the Committee to conclude that the fundamental question was "whether a Code of Conduct approach can work, and work equitably, in a body with such diverse styles of government as the European Union. We think that Parliament deserves a much clearer explanation of how the system is supposed to work than the Government has so far provided."[24]

Secrecy

The issue of secrecy proved troublesome. The Committee was refused sight of the report of the Code of Conduct Group to ECOFIN. The Committee said that it was "disagreeably surprised by this response",[25] although it noted that other governments also adopted a policy of confidentiality. The justification for secrecy was said by the Paymaster General to be that the issues under discussion were sensitive for Member States. No doubt this is true. Much political debate is sensitive for the politicians involved. That is no reason, however, to let them work in the secrecy sometimes needed by diplomats. As Mr Peter Wilmott said: "If the Code of Conduct leads to an increased amount of discussion behind closed doors at the Council, I think that is intrinsically bad...and it is worrying from the point of view of the accountability of the people who then take decisions and actions based on those decisions."[26] The

---

23 See paragraph 127 of the Report.

24 See paragraph 128 of the Report.

25 See paragraph 129 of the Report.

26 See paragraph 133 of the Report.

Committee's conclusion on this matter included the statement that "the lack of transparency in the handling of this matter shows both the Council of Ministers and the Government in a very poor light...We call upon the Government to seek agreement from other Member States that the progress reports which the Code of Conduct Group makes to ECOFIN should be published, and should be subject to Parliamentary scrutiny in the normal way."[27] It is to be hoped that the Committee's call for transparency strikes a chord with politicians across the EU, especially as the Finnish presidency has stated that "To strengthen the confidence of its citizens, the Union must operate in a transparent and responsible way."[28]

Dependent territories and state aids

So far as the impact on dependent territories is concerned the Paymaster General stated that the Code "certainly cannot be legally binding on dependent territories given our constitutional arrangements with them. We do not have authority over the tax systems of our dependent territories."[29] The Committee for its part, observed that transparency was, if anything, even more important in relation to dependent or associated territories and hoped that they had been kept fully in touch with the Government's position. In relation to the fourth issue raised, that of the relationship of the Code with state aid measures, the Committee said it wondered "whether the Code of Conduct Group is actually being seen as a method for identifying measures to be tackled by the Commission under the State aid provisions, and whether this explains the Government's apparent lack of concern about the way in which the findings of the Code of Conduct Group will be implemented."[30]

Conclusion

This report is likely to be of considerable interest outside as well as inside the United Kingdom. It is wide-ranging and, as I indicated at the beginning of this article, I have done no more than note some aspects of it that may be of particular interest in relation to the Code of Conduct. Quite how important the Code will prove to be is,

---

27 See paragraph 136 of the Report.

28 See the "Summary of the Programme for the Finnish EU Presidency": www.vn.fi/vn/english/vn711e_summary.htm

29 See paragraph 140 of the Report.

30 See paragraph 146 of the Report.

perhaps, somewhat difficult to determine at the moment. To quote the Paymaster General one last time:

> "The code of conduct is not beginning the process for a legal directive; it is a political agreement to explore issues. At the end of it, individual Member States will be free to make their own decisions as to how to respond to the final report."[31]

From the evidence received by the Committee, it seems unlikely that all Member States' representatives would express themselves in exactly these terms. There is clearly a great deal of debate to come, particularly as the Finnish presidency has said in the summary of its programme that it "considers it important to prevent harmful tax competition and to reach a decision on a comprehensive tax package by the Helsinki European Council meeting."[32]

---

31 See page 160 of the Report (Q.421).

32 See the "Summary of the Programme for the Finnish EU Presidency" *supra*.