Tax Competition in Europe

General Report

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A. Introduction

Speaking about Tax Competition in Europe is not the same as speaking about tax competition as an abstract economic concept. It is speaking about the behaviour of economic agents and public institutions in a specific geographic, political, economic and legal setting.

First of all, Europe is a geographic entity, a continent the limits of which stretch from Gibraltar to Svalbard and from the Channel Islands to Lithuania. Some of the national reports which we have received make clear that we have to extend our legal notion of Europe even farther, when Madeira and its “Free Zone”\(^1\) or the French départements d’outre-mer\(^2\) come into play. But it is essentially this old continent with a common cultural heritage – mostly of Christian background – which sets the scene for our work. Thus, large economic and political entities as the USA or East Asia do not play a crucial role in our perspective, but they should not be ignored as they are powerful competitors of Europe and its countries on the world stage and have to be taken into account when we look at the competitiveness of Europe as whole in a global setting\(^3\).

Secondly, Europe is now – after the fall of the Iron Curtain – a continent which consists of democratic and industrialised states both in East and West. Therefore we do hardly find the specific tax problems we address in relation to Third World countries or to socialist and other dictatorial states\(^4\). In all European countries, parliamentary systems prevail. It is the taxpayers themselves who – in their role as *citoyens* – choose the government they prefer and control the budgetary and fiscal policies in their country. We shall see that “tax competition” has brought a new dimension to this old ideal of institutional government control by the people of a state.

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4. It should not go unnoticed that the transformation process for countries in Eastern Europe has been accompanied by heavy tax competition, see: Easson, Tax Competition heats up in Central Europe, IBFD-Bull.1998, p.192 et seq.; McLure, Tax Holidays and Investment Incentives – A Comparative Analyses, IBFD-Bull.1999, p.326 et seq.
Furthermore, economic freedom within Europe has reached a high level. This does not only refer to the technical requirements for international business starting with well interconnected traffic systems and ending with (nearly) perfect banking services all over Europe, but also the far reaching abolition of legal impediments to the free movement of economic factors within Europe. This holds especially true within the jurisdiction of the EC Treaty, but has also to be accepted with respect to the European Economic Area and many other European countries which have done away with legal borders to persons, capital, goods and services by means of bilateral treaties. Europe is now widely open for physical and legal persons to establish economic activities throughout the continent. Moreover, the mobility of production factors is enhanced by the fact that direct investment in a jurisdiction is not any more a requirement for market access as enterprises can cater to the world market from single locations. Nevertheless one should not forget that the economic integration of Europe is not at all as advanced as in the United States. When we read mainstream U.S. economic literature about the advantages of tax competition we have to bear in mind that in the United States both the labour market and the financial market are fully integrated with high mobility for all production factors. Contrary to this, in Europe we have to distinguish between a highly integrated financial market, a pretty advanced market for goods and services and a labour market which still faces many non-legal impediments such as different languages or cultural backgrounds of the European citizens.

The larger part of the countries of Europe is by now a member of the European Union or a candidate for accession. Within the European Union, the EC Treaty and a huge array of secondary legislation provide a set of rules which are binding both for the economic agents – the taxpayers – and the Member States themselves. Here we find specific legal instruments – such as the fundamental freedoms of the EC Treaty, the state aid provisions, the EC directives in tax matters or newly established European “soft law” (e.g. the Code of Conduct) which define the limits to the fiscal and economic behaviour of the Member States and the market citizens respectively. Of course, there are also some institutional arrangements at a world-wide level: The OECD has for some years done work in the field of “harmful tax competition” and the World Trade Organization has – some months ago – shown its muscles when they decided against the USA in the long-standing dispute on Foreign Sales Corporations. But neither the

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6 infra, B.2.c.
OECD nor the WTO can rely on the same legal powers and institutional strength as the European Union.

Nevertheless, the emergence of tax competition poses new questions to the legal order of the European Community. The fundamental freedoms were meant to get rid of discrimination of foreign workers or investors – but the discussion of tax competition takes the opposite view, looking at the specific tax advantages granted to workers or investors from other Member States. The state aid provisions enshrined in the EC Treaty aim specifically at subsidies given to certain domestic enterprises or branches – but how can they provide rules for changes in the tax systems with respect to foreign taxpayers or specific activities within an enterprise like management or research & development? And the power to harmonise national tax law was given to the European institutions in order to further the economic freedom of the citizens of Europe, not to provide a safety net for national budgets. Therefore, tax competition forces us to rethink the fundamental values and the hard law of the EC Treaty and its secondary legislation.

B. General Aspects of Tax Competition in Europe

1. Tax Harmonisation versus Tax Competition

Among the institutions of the European Union, the traditional view has always been that disparities between the tax systems of the Member States have to be alleviated by way of harmonisation. In the early days of the European Economic Community, the “Neumark-Report” laid out the vision of an integrated economic area where economic agents simply decide on the allocation of resources with respect to physical, technical or other strictly economic parameters. Tax disparities were regarded as impediments to an optimal allocation of production factors within the Community. The idea of “tax competition” as a means of furthering the economic aims of the Member States and the Community was not even mentioned in these early documents. We still find this positive attitude towards far-reaching harmonisation in the latest publications of the European Commission, notably the much-discussed communication

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8 Schön, Tax Competition in Europe – the legal perspective, EC Tax Review 2000, p.90 et seq.
10 It should be noticed that the preamble of the proposed savings income directive dwells extensively on the distortions of the capital market by differing tax regimes mentioning the fiscal motivation of this proposal only in second place.
“Towards an Internal Market without tax obstacles”\textsuperscript{12} and the report on “Business Taxation in Europe”\textsuperscript{13} which were released in October 2001. These documents again emphasize the positive effects of tax harmonisation on the European economy: The abolition of disparities will lead to a massive reduction of “compliance costs”, it will improve the “neutrality” and thus the efficiency of tax systems and will alleviate economic decisions by providing transparency of tax systems within Europe\textsuperscript{14}.

The opposite concept of “tax competition” has for some decades been around in economic science but reached the level of the European Institutions not before the 1990s. In a seminal article\textsuperscript{15} published in 1956 Charles Tiebout discussed the situation of local communities which try to attract rich inhabitants by offering a reasonable mix of taxes and public goods. It is in this article that the famous concept of “voting with the feet” was established in the economic world. People do no longer influence the behaviour of governments only by casting their vote in general elections but by moving themselves or at least their tax base to other jurisdictions. This leads to an effect which – in a phrase coined by the German philosopher Friedrich Nietzsche - may be called a “revaluation of values”. The taxpayer is no longer the passive “subject” of the government, but it is the government who has to adjust to the needs and wishes of its taxpayers, especially the economically powerful members of the society. The idea of a “market” which was formerly restricted to the production and sale of private goods and services is now extended to governments which have to consider a reasonable “cost-benefit-ratio” when they offer public goods to the inhabitants of their country. This economic analysis of government behaviour has given rise to an abundant literature in the field of public finance\textsuperscript{16}. The “democratic” problem which is posed by tax competition becomes all too clear when rich individuals or foreign investors who do not belong to the constituency of a country gain massive influence on the fiscal politics of a state\textsuperscript{17}. From the perspective of the “Public Choice” theory which was founded by nobel laureate James Buchanan this “exit op-

\begin{flushleft}
\textsuperscript{12} COM (2001) 582 final.
\textsuperscript{13} SEC (2001)1681.
\textsuperscript{14} See also James, Can We Harmonise our Views on European Tax Harmonisation?, IBFD-Bull. 2000, p.263 et seq.
\textsuperscript{17} One national report (Dahlberg, National Report Sweden, 3.1) points out that rich families threatening to emigrate have forced the government to abolish wealth tax on substantial shareholdings in companies listed in the stock market. There will be equivalent experiences in other countries.
\end{flushleft}
tion” for taxpayers constitutes a valuable improvement of democratic control\(^{18}\). Writers who adhere to the traditional model of democratic institutions complain about the intransparent and illegitimate influence of economically potent agents on governmental decisions which endangers the policies of welfare and redistribution\(^{19}\).

When we compare the economic pros and cons of tax harmonisation versus tax competition we can distinguish as follows:

**Pro tax harmonisation:**
- Reduction of compliance costs
- Transparency for the taxpayer
- Tax neutrality in order to further the optimal allocation of resources and to support individual and inter-nation equity of taxation
- Redistributive effects of taxation

**Pro tax competition:**
- Downward pressure on tax burden
- Fiscal Discipline
- Proper balance of tax level and public goods

It should not go unnoticed that in the European Commission’s recent documents on tax policy the merits of tax competition seem to be accepted somewhat low-key\(^{20}\). On the other hand, the ECOFIN Council has – most notably in the “Code of Conduct” documents – stressed the “positive effects of fair competition”\(^{21}\). In its recently published report on the Commission’s communication on business taxation in Europe also the European Parliament took a more positive stance on the merits of tax competition. It “believes that tax competition between Member States, in the context of rules preventing improper conduct” can “encourage a positive approach by the Member States, helping to prevent tax pressure reaching excessive levels” and that “tax competition is not at odds with the completion of the internal market which

\(^{18}\) Brennan/Buchanan, The power to tax, 1980.

\(^{19}\) Sinn, European Economic Review 34 (1990), p.489 et seq.


\(^{21}\) Council Conclusions of the ECOFIN Council Meeting on 1 Dec 1997 concerning taxation policy, O.J. of 6 Jan 1998, C 2/1, Annex 1, p.3.
does not entail a total levelling-out of competitive conditions in each country and certainly not those relating to taxation”22.

2. “Fair” versus “Harmful” Tax Competition

a) The economic concept

The “general” dichotomy between tax harmonisation and tax competition must not be confused with the “specific” antagonism of “fair” and “harmful” tax competition. The latter notion has been at the heart of two initiatives by the European Union and the OECD which were started in the late 1990s.

In order to understand the debate on “harmful” tax competition we have to bear in mind that the positive economic effects of tax competition are seen in its disciplinary function from the perspective of the government which has to balance the procurement of public goods with the level of taxation and from the perspective of the taxpayer who is also going to evaluate the “cost-benefit-ratio” of his tax burden. This equilibrium doesn’t exist any more when the taxpayer doesn’t care about the level of public goods offered by a country (skilled labour or good infrastructure) or when a government offers specific tax incentives which do not affect its budgetary situation as a whole. This can – it is said – lead to a “beggar-thy-neighbour” policy. Therefore, according to the OECD report on “harmful tax competition”, specific tax practices are considered harmful

“as they do not reflect different judgments about the appropriate level of taxes and public outlays or the appropriate mix of taxes in a particular economy, which are aspects of every country’s sovereignty in fiscal matters, but are, in effect, tailored to attract investment or savings originating elsewhere or to facilitate the avoidance of other countries’ taxes”23.

Starting from this definition it is easy to identify situations which might give rise to tax incentives constituting “harmful” tax competition in this sense:

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- For the government it is important to grant specific tax incentives which do not affect the general fiscal situation of “ordinary taxpayers” (e.g. incentives only for foreign taxpayers or for selective enterprises, goods or services).
- For the taxpayer it is important that his investment does not require too high a level of infrastructure or other public goods (e.g. a purely financial investment).

As opposed to “harmful” tax practices, “fair” competition would include general aspects of the tax system, e.g. a general reduction of tax rates along with a broadening of the tax base. A change in the general tax rules of a country would on the one hand affect a great bandwidth of taxpayers, thus including all sorts of economic activities. Moreover, such general policies exert substantial constraints on the budgetary policy of the government, thus forcing the government to exercise “fiscal discipline”.

Both the European Institutions and the Committee on Fiscal Affairs of the OECD have tried to identify elements of a tax regime which might be regarded as “harmful” in this sense. Here’s a short list\textsuperscript{24}:

- No or low effective tax rates
- “Ring-Fencing”, i.e. specific tax incentives for foreign taxpayers
- Lack of Transparency
- Lack of effective exchange of information
- Artificial definition of the tax base
- Failure to adhere to generally accepted transfer pricing principles
- Exemption of foreign source income
- Negotiable tax rate or tax base
- Secrecy Provisions
- Treaty Network
- Active Promotion of Tax Schemes
- No real economic activity\textsuperscript{25}

Looking at this list it should be borne in mind that the true relevance of these elements is highly controversial in the international discussion. Some of them even belong to the standard conditions of

\textsuperscript{24} OECD, Harmful Tax Competition \textit{supra}, par.61 et seq.; Council Conclusions, 1 Dez 1997, \textit{supra}, Annex 1, B.

\textsuperscript{25} This element has been erased from the OECD list (OECD, The OECD’s Project on Harmful Tax Competition: The 2001 Progress Report, par.23 et seq.).
repertoire of “normal” industrialized states (exemption of foreign source income, secrecy provisions, treaty network). Furthermore it has been noticed in economic literature that from the position of a single (e.g. developing) country specific tax incentives for foreign investment or certain sectors of the economy might prove much more efficient than general changes in the tax system. Even tax haven practices have been justified as they represent the only chance for certain very small countries to compensate for structural disadvantages without doing too much harm to other jurisdictions while a “normal” tax system will not bring much benefit to these disadvantaged places.

In the end, one should not confuse preferential tax practices which confer legal (but economically problematic) incentives for cross-border investment with tax evasion structures (e.g. non-declaration of capital income) which are made easier by bank secrecy provisions or missing exchange of information.

b) The EU Initiative

Under the auspices of Commissioner Monti, the Commission took new approach to tax harmonisation in 1996, taking into account the notion of “tax competition” for the first time. In a “reflection document” on “Taxation in the European Union” the Commission recognized the impact of tax competition on the tax situation in Europe. Moreover, tax competition was regarded as an ambivalent concept, on the one hand an instrument to improve the way governments steer their tax policy, on the other hand a threat to the equity and neutrality of tax systems. Tax harmonisation was not any more regarded to be the only convincing policy option: the new distinction was drawn between “fair” and “harmful” tax competition. The Commission pointed to two specific problems:

- the “erosion of the tax base”, i.e. the degradation of revenue when taxpayers use their “exit option” and force governments to lower their tax burden; this could lead to an

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under-supply with public goods and to a restriction on the government’s power to further the aim of redistribution within an economy;

- the differences between the economic power of production factors: capital is much more mobile than labour, so that capital is able to force governments to reduce the tax burden on income from financial sources, thus shifting the tax burden to the immobile tax bases, especially human labour. This would undermine the domestic and european initiatives to fight unemployment within the European Union.

In this perspective, tax harmonisation gains another dimension. Its role is not any more solely directed at the abolition of impediments to the Internal Market but it is employed to strengthen the fiscal powers of the national governments and to guarantee equity and neutrality within the domestic tax systems. The Commission points to the counterproductive effects of the Member States’ reluctance to adopt common policies: “The apparent defense of national fiscal sovereignty has gradually brought a real loss of fiscal sovereignty by each Member State in favour of the Markets”\textsuperscript{30}. \textit{Vanistendael} has aptly described this situation as the “European Tax Paradox”\textsuperscript{31}: Member States have to shift their fiscal sovereignty to the Community level in order not to lose it to powerful economic agents.

In December 1997 the ECOFIN-Council passed a “tax package”\textsuperscript{32}. In this document, three different proposals were accepted by the national ministers of finance with regard to “harmful tax competition”:

- A “Code of Conduct” which contained the political pledge of the Member States to abolish tax incentives which were not in line with good fiscal behaviour (“roll-back”) and to refrain from introducing new ones (“stand-still”). In this document, the above mentioned general features of “harmful tax competition” were laid down. This Code of Conduct was to be handled by a high-level-group of representatives from the Member States set up in 1998\textsuperscript{33}. This group (the so-called “Primarolo Group”) delivered a report in 1999, marking 66 tax incentives provided for in the law of the Member

\textsuperscript{30} European Commission, 20 Mar 1996, \textit{supra}, par.IV.
States, which was made public by the Council in 2000\(^{34}\). In November 2000, the ECOFIN Council discussed the ongoing process of the Code of Conduct group and extended the date for the abolition of tax incentives to 31 Dec 2005\(^{35}\).

- A proposal for a directive on private savings income; this proposal has reached general consensus among Member States in 2000\(^{36}\), but it requires further negotiation with other countries, notably Switzerland and the US\(^{37}\).

- A new initiative on intercompany interest and royalty payments; a draft directive was presented by the European Commission in 1998\(^{38}\).

Furthermore, the Commission announced to employ its powers to examine the Member States’ fiscal rules under the state aid provisions of the EC Treaty. In 1998, it released a communication which laid out the legal framework for these proceedings\(^{39}\). In July 2001\(^{40}\) and February 2002\(^{41}\) the Commission commenced state aid proceedings against different Member States with respect to several preferential tax regimes regarded as illicit state aid by the Commission\(^{42}\).

c) OECD

In 1998 the OECD published its report on “harmful tax competition – an emerging global issue”\(^{43}\). According to the OECD’s international approach, this report is aimed at the fight against tax havens all over the world – from the Caribbean Sea to the Pacific Basin. Never-

\(^{36}\) European Commission, Proposal for a directive on the effective taxation of private savings income, COM (2001) 400 final
\(^{37}\) According to the conclusions of the ECOFIN Council on 7 May 2002 negotiations with third countries are under way (although not formally instituted with Switzerland). The Netherlands and the UK are asked to take measures concerning their dependent or associated territories.
\(^{42}\) Hocine, Aides Fiscale, Competition Policy Newsletter, 2002, p.85 et seq.
theless, also large industrialised states are addressed in this report – not as “tax havens” in the true meaning of the word but as states granting “preferential tax regimes” to foreign investors under specific circumstances which might be regarded as “harmful” and should be abolished. Members of OECD were asked to use their political clout and to cooperate in order to force tax havens to comply with international standards of taxation and to abolish specific tax incentives in their own legislation. Only two OECD members – Luxembourg and Switzerland – did not agree to support the work of the new “Forum on Harmful Tax Practices”; these two countries regarded the 1998 report as not impartial, especially as it did concentrate on harmful preferential practices in the field of “financial services”.

In 2000 the OECD presented a report on the progress of its work under the title: “Towards Global Tax Cooperation”. An update was presented in 2001 under the title “The OECD’s Project on Harmful Tax Practices: The 2001 Progress Report” (but not approved by Belgium and Portugal). With the presidency of George W. Bush and the politics of “unilateralism” in the USA this OECD initiative seemed to lose some of its momentum. Nevertheless, the OECD managed to contact more than forty jurisdictions which were regarded as tax havens, asking them to “cooperate”, i.e. to comply with certain requirements of transparency and exchange of information. By 18th April 2002, thirty-one jurisdictions from all over the world have committed themselves to cooperate with the OECD; only seven countries have not yet submitted to the demands of the OECD. It should not go unnoticed that among these seven jurisdictions three belong to Europe (Andorra, Liechtenstein and Monaco). In its 2001 report, the OECD called on its Member States for collective action against non-cooperative jurisdictions. As far as Member States of the OECD themselves are found “guilty” of harmful preferential tax regimes, the OECD has announced to discuss with these countries the options to get rid of these specific tax incentives for foreign investors.

C. Tax Competition and National Tax Systems in Europe

The following chapter of the general report gives an overview of the political, legal and economical implications of tax competition in several European Countries. It draws heavily (in

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44 OECD, Harmful Tax Competition supra, par.44 et seq.
45 OECD, Harmful Tax Competition supra, p.73, p.76.
fact: almost completely) on the national reports which have been prepared for the Lausanne Conference of the EATLP on “Tax Competition in Europe”. These national reports were (mostly) drafted according to a questionnaire which was meant to serve as a guidance to the National Reporters and to provide for the participants of the conference a framework in order to compare the different attitudes and policies in the respective countries.

I. General Aspects of the Domestic Tax Situation

1. The Notion of “Tax Competition” in domestic legal and economic science

When we look at the way legal and economic science deal with the concept and the material implications of “tax competition” we find huge differences among European countries within and without the European Union. In countries which have got rid of their socialist heritage just some years ago – like Poland\(^{50}\) – the discussion has not developed at all, while in countries with a long standing debate on its role in international affairs – like the Netherlands\(^{51}\) – scientists show much interest in this subject.

Many reports point out that much more economists participate in the discussion on tax competition while lawyers tend to be silent on this subject\(^ {52}\). Therefore it does not come as a surprise that lawyers look in quite different directions when they think about tax competition. The Italian Report, for example, stresses the relationship between the legal aspects of tax competition and the traditional subject of tax avoidance\(^ {53}\). The Portuguese report\(^ {54}\), on the other hand, takes the Community Law perspective, linking the idea of “tax competition” to the legal discussion of the fundamental freedoms, especially the freedom of companies to choose their residence within the European Union. In Germany\(^ {55}\), to take another example, there is a specific discussion among lawyers as to the question whether tax competition undermines the constitutional foundations of the tax system, i.e. the institutional power of parliament as the most prominent tax legislator and the material principle of equity which requires a non-discriminatory approach as to the different sources of income without respect for the economic mobility of the tax base.

\(^{49}\) OECD, Progress Report supra, par.28, 36.
\(^{50}\) Brzezinski/Kardach/Wojcik, National Report Poland, I.
\(^{51}\) Meussen, National Report Netherlands, I.1.
\(^{52}\) Blanluet supra, I.1.
\(^{53}\) Sacchetto, National Report Italy, I.1.
\(^{54}\) Noiret Cunha supra, I.1.
The economic evaluation of tax competition seems to be in line with general trends of economic thinking in different countries. Swiss economists came to the general conclusion that tax competition has positive effects on the economic development of the country, thus confirming their general positive attitude towards a liberal view of economic systems\textsuperscript{56}. Also the Luxembourg report emphasized the “competitive environment” which has to be provided by the legislator. But the Luxembourg report also points out that many other factors – e.g. the general regulatory framework for financial services – play a decisive role in the game to attract foreign investment\textsuperscript{57}. On the other hand, some Dutch writers tend to stress the negative effects of tax competition and ask for a legal framework for tax competition in Europe in order to keep up the level of social welfare in the Netherlands\textsuperscript{58}. A similar attitude was found in Sweden where for many years the discussion on the merits of “fair” and “harmful” tax competition has been going on.

2. The Political Attitude of the Government towards Tax Competition

a) Regional and Local Tax Competition

Most European governments have over the years developed a specific attitude towards the merits of international tax competition and the position of their respective country\textsuperscript{59}. But one should not forget that there is a number of countries which have experienced the effects of tax competition for decades with respect to autonomous regions or local communities within their jurisdiction\textsuperscript{60}. Of course, the most famous example is the United States where the fifty states of the Union have a long tradition of institutional competition in many fields of the law, notably in company law and tax law. But also in Europe we find examples of intra-state tax competition. The Swiss cantons try to attract persons or investment in the same way as autonomous regions in Spain or local communities within Germany. But along with tax competition everywhere evolved the insight that some rules seem to be necessary for this game. Accordingly, in Switzerland cantons have in 1948 agreed upon a “code of conduct” with respect to

\textsuperscript{55} Hey, National Report Germany, I.1.b.
\textsuperscript{56} Waldburger, National Report Switzerland, I.1.
\textsuperscript{57} Steichen, National Report Luxembourg, II.A.1.
\textsuperscript{58} Meussen supra, I.1.
\textsuperscript{60} Easson supra, p.267.
tax holidays or individual tax arrangements. Moreover, in 2000 at the federal level a far-reaching harmonisation of the cantonal tax base was enacted. This leaves the tax rate as a welcome means of tax competition in Switzerland. Spain goes beyond that: the autonomous regions are by a recently enacted law bound to “observe the principle of solidarity among all Spanish citizens, pursuant to the relevant provisions of the constitution; (...) and they shall maintain an overall effective tax burden equivalent to that existing in the rest of Spain”.

b) International Tax Competition

aa) Support of EU/OECD Initiatives

Most Member States of the European Union officially support the initiative of the European Institutions with respect to “harmful tax competition” and most Member States of the OECD take the same stance towards the OECD project mentioned above. (Switzerland, which signed the original OECD mandate, abstained from participating in the further work; Luxembourg left the OECD forum as well, but supports the European initiatives).

bb) Minimum Taxation?

Moreover, most states agree that tax competition with respect to the general tax situation in a country is “fair”, especially a policy to reduce tax rates and broaden the tax base. But this is not undisputed. In the Netherlands, leading politicians have expressed the view that not only specific preferential tax regimes must be regarded as harmful, but also (corporate) tax rates which are too low; it is demanded that the Member States should set a minimum tax rate in order to protect the corporate tax base within Europe. This is not in line with the situation in Ireland where the general corporate income tax rate has reached the lowest level within the European Union. Other reports, e.g. the Luxembourg paper, have doubts whether it is possible to identify a “normal” level or even a “minimum” corporate income tax rate. Also in the

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63 Bayona Giménez, National Report Spain, I.1.
64 supra B.II.c.
65 Meussen supra, I.2.
66 Steichen supra, II.A.2.
political debate preceding the Code of Conduct, the idea of a “minimum tax” did not find a consensus.

cc) Compensation for geographical or other “structural” disadvantages

According to some national reports even specific preferential regimes are defended by their home country; the Belgian report on coordination centres, distribution centres and service centres gives a good example for this position. A general problem is raised by those countries which employ tax incentives in order to compensate for structural disadvantages of a region: the Portuguese government stresses the necessity to justify specific tax rules for Madeira in order to compensate for the evident geographical and economical disadvantages of this place which lead to great economic and social problems; the same is brought forward by Norway with respect to Svalbard, by Spain referring to the Canary Islands, Ceuta and Melilla or by Poland concerning “Special Economic Zones” with high unemployment.

The Luxembourg report has emphasized the general necessity for “smaller” countries to set up a competitive environment which shall compensate for economic disadvantages. There can be no doubt that smaller countries are more dependent than others to rely on a non-discriminating international tax structure which does away with legal or economical double taxation. But it is an open question whether the size of a country can per se justify preferential tax regimes.

dd) “Offensive” or “Defensive” Measures?

According to the national reports, in Europe we find a large group of countries which regard themselves not as active players in the game of tax competition but as passive players who have recognized the necessity to take measures to defend themselves. These countries typically have a strong “welfare state” tradition. Denmark lowered its corporate income tax rate to 30 percent in order to compete in the European setting but did not reduce personal income tax

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68 Malherbe/Neyrinck, National Report Belgium, II.
69 Noiret Cunha supra, I.2.
71 Bayona Giménez supra, I.1.
72 Brzezinski/Kardach/Wojcik supra, II.5.2; this has been a reaction to corresponding measures in other Central European States, cf. Easson supra, p.268.
as there seems to be no substantial threat as to the emigration of individuals\textsuperscript{74}. In addition, Denmark tends to apply measures in order to fight harmful tax practices in other countries. Sweden regards itself as one of the driving forces behind the fight against “harmful tax competition” and has commissioned research on the revenue losses caused by harmful practices in other countries\textsuperscript{75}. The same can be said of Finland where the government is adamant about the consequences of tax competition for the maintenance of the welfare state and high public expenditure and regards itself to be in a “defensive” position\textsuperscript{76}. Germany may also be ranked among these states but has during the last years developed an ambivalent position: on the one hand the latest business tax reform was a major step in order to make the German tax system more competitive, on the other hand Germany supports the “Code-of-Conduct”-process and is one of the main supporters of a directive on interest taxation\textsuperscript{77}. The same can be said of France which recognized the need to react to tax competition starting elsewhere\textsuperscript{78} and is concerned about the number of taxpayers leaving the country\textsuperscript{79}. These countries seem to support the “soft law” approach of the Code of Conduct and the OECD process but are no fervent adherents of fully fledged tax harmonisation. Norway did – so we learn from the national report – for many years not take into account the tax policies in other states, raising taxes over the years and only just beginning to make comparisons between the Norwegian tax law and foreign tax systems\textsuperscript{80}.

\textbf{3. The distinction between fair and unfair competition}

It is agreed upon that it is very difficult to agree upon a borderline between fair and unfair competition. The economic merits of this distinction have been laid out above (I.2.a). From the legal point of view it is even more problematic to find a starting point for this distinction at all\textsuperscript{81}. The Swiss report rightly states that there are no explicit legal rules which would allow such a definition\textsuperscript{82}. The same sceptical view is expressed in the Belgian report\textsuperscript{83}.

\begin{footnotesize}
\begin{itemize}
\item[74] Winther-Sorensen, National Report Denmark, I.
\item[75] Dahlberg supra, 2.4.
\item[76] Tikka, National Report Finland, 1.
\item[77] Hey supra, I.2.
\item[78] Blanluet supra, I.2.
\item[79] Blanluet supra, I.4.b.
\item[80] Gjems-Onstad supra, I.
\item[81] Pinto, EU and OECD to Fight Harmful Tax Competition: Has the Right Path been undertaken?, Intertax 1998, p.386 et seq., 394.
\item[82] Waldburger supra, I.3.
\item[83] Malherbe/Neyrinck, I.D.
\end{itemize}
\end{footnotesize}
Some reports try to find a legal basis in the EC Treaty itself. In these reports it is especially controversial whether the European rules on state aid provide a reliable basis for the distinction between “fair” and “unfair” tax incentives. The judicature of the European Court of Justice and the practice of the Commission distinguish between general features of the tax system which are the expression of the fiscal sovereignty of the Member States and selective deviations from the general tax system which work as a subsidy toward certain enterprises, sectors of the economy or specific regions.\textsuperscript{84}

As these rules were conceived for selective aids to the domestic economy it is hard to apply them to general incentives for foreign-based investors; at least they are probably not framed to address all problematic cases covered by the Code of Conduct. Moreover, one should bear in mind that when a tax incentive is identified as state aid it is not \textit{per se} illicit but can be recognized by the European Commission if it is meant to attain a legitimate aim. The Spanish report relies on this legal basis and proposes to introduce a general “proportionality” test which should require a substantive “justification” of a preferential tax regime.\textsuperscript{85}

Another legal basis brought forward are Art.96, 97 of the EC Treaty which enables Member States to take measures against severe distortions of the Internal Market. But it has to be seen that this legal basis has – up to now – never been employed by the European Institutions.\textsuperscript{86}

In the end, the “Code of Conduct” did not refer to a set of rules already enshrined in the EC Treaty or secondary legislation but tried to identify some “elements” which might constitute harmful tax competition. Most Member States seem to have accepted this definition as a starting point, knowing that these are no strictly legal, but economical and political criteria.\textsuperscript{87}

\textbf{II. Elements of Tax Competition in the Domestic Tax System}

\textbf{1. Tax Rates}

It is accepted in most Member States that in recent years tax rates (corporate income tax rates, but also individual income tax rates) have fallen all over Europe due to the pressure of tax competition. Corporate income tax has reached an average of ca. 30\%. This is in itself not

\textsuperscript{84} European Commission, Communication, 28 Nov 1998 \textit{supra}; Schön \textit{supra}, p.932.

\textsuperscript{85} Bayona Giménez \textit{supra}, I.3.

\textsuperscript{86} Hey \textit{supra}, I.3.

\textsuperscript{87} See e.g. Tikka \textit{supra}, 1.
regarded as problematic and has in most cases been compensated by a broadening of the tax base, by a shift to other (indirect) taxes or by budgetary cuts. Moreover, general reductions of the tax rates on reinvested profits (Italy\textsuperscript{88}) or options for non-incorporated business to enjoy low corporate income tax rates (Denmark\textsuperscript{89}) seem to belong to the undisputed general tax system of a country. The present “leader” is Ireland which has lowered its standard corporate income tax rate to 12.5%. It has already been mentioned that this has brought up again the discussion of a minimum tax rate. On the other hand, personal income taxes have not been lowered in proportion, thus creating a shift of the tax burden to labour\textsuperscript{90}.

Nevertheless, many countries apply specific reduced (no or low) tax rates which might give rise to discussion under the perspective of “harmful tax competition”:

- regional reductions of the tax rate (Madeira, Svalbard, Trieste, Canary Islands, Ceuta/Melilla, Special Economic Zones in Poland, but also in France); most of these reductions raise the question whether geographical or other structural disadvantages may be compensated by means of tax incentives;
- sectoral preferential tax rates (shipping, financial services); these reductions are mostly regarded as problematic state aids; in France we find zero-rates for authorised telecom financing companies, agricultural cooperatives, oil storage agencies.
- no or low tax rates for specific legal forms (investment companies or investment funds; Luxembourg 1929 holding companies); some of these tax rate reductions are meant to do away with economic double taxation of the underlying profits of subsidiaries (see below).

2. Tax Accounting

When we take a look at the domestic rules on tax accounting we must be aware of the fact that the definition of the tax base has for a long time been a playing field for political interventions in the tax area. On the other hand there is no generally accepted definition of which gains and losses should be included in the notion of “income”. Therefore, it is very hard to distinguish those features of the tax base which simply constitute the definition of “income” and which must be regarded as “tax incentives”. Moreover, many tax incentives which we find in do-

\textsuperscript{88} Sacchetto supra, II.1.1.
\textsuperscript{89} Winther-Sorensen supra, II.1.
\textsuperscript{90} This is especially true for the “Nordic” Model, see Tikka supra, 1.McLure supra, p.330 et seq.
mestic tax accounting law were not meant to engage in “tax competition” in order to attract foreign investment but simply to strengthen all or some sectors of the domestic economy. Cases in point are depreciation rules on capital investment or preferential depreciation for small and medium enterprises and for start-up-companies.

To give some examples from the national reports: Is the adherence of some countries (Germany, Luxembourg) to traditional commercial accounting (which follows the “prudence” and “realisation” principles and which leads (e.g.) to a full write-off for research & development expenses) a tax incentive? Is roll-over-relief (Austria, Germany, Portugal) an expression of an economic concept of “income” or an investment incentive? Loss carry-forward may be regarded as a natural element of periodic income taxation (Germany) or as a tax expenditure (Italy).

But of course there are some examples where domestic tax legislation evidently departs from generally accepted rules of tax accounting under the influence of tax competition. Here are some of the features which we find in the national reports:

- Specific accounting rules for coordination centres and similar institutions (Belgium, France, Germany, Basque Country and Navarre, Luxembourg); these preferential regimes have been criticized by the Primarolo Group and have been attacked by the European Commission under the state aid rules. Some of the involved countries have pledged to repeal the respective tax provisions.
- Specific tax free or low-taxed reserves have been introduced by the Netherlands (Risk Reserve for financial companies) or Sweden (Tax Allocation Reserve); the international discussion also covers several risk reserves for insurance companies the economic justification of which is doubtful (
- The most striking example which has developed in many countries within a few years are the specific tax accounting rules for the shipping industry. Many states have up to now introduced a “tonnage tax”, i.e. a tax on the profits of the shipping business which does not rely on the actual profit or loss situation but taxes a (low) percentage of the gross tonnage shipped. It should be stressed that most states declare their measures to

91 Blanluet supra, II.3.b.
92 supra
93 Meussen supra II.1.
94 Dahlberg supra 4.1.2.
95 Blanluet supra, II.3.a.
be simply “defensive” in an international competitive situation. The Norwegian report points out that this tax on gross income has in a loss situation a negative effect on the business.  

A feature which is difficult to evaluate under the perspective of “tax competition” are tax regimes which provide a specific regime for foreign business which is not in itself preferential but can – according to the actual economic situation of the foreign business – work to the advantage or the disadvantage of the foreign business, e.g. taxation on a gross receipts basis but at a low tax rate. If there is not a clear bias in favour of the foreign taxpayer one should not regard these specific regimes as elements of harmful tax competition but as admissible means of tax simplification.

3. Taxation of Individuals

When it comes to the taxation of individuals, the economic theory of tax competition tells us that highly-skilled and mobile persons which seem to be valuable for the economic success of a country will attract preferential tax regimes. Therefore it should not come as a surprise that in several European countries we find tax legislation granting favourable tax treatment to foreign “experts”, “researcher”, “managers” and so on. In Sweden, 25 % of their income is tax-exempt, in the Netherlands 30 %. In Denmark we find a reduced 25 % rate, in Norway a 15 % lump-sum deduction for expenses for a four-year-period and in Finland a 35 % withholding tax instead of progressive income taxation for a 24 months-period. This concentration of tax incentives in the Nordic countries gives rise to the suspicion that there might be a specific competitive situation among the Scandinavian jurisdictions. It should be noted that the “Code of Conduct” expressly does not address these preferential tax features for individual taxpayers.

4. Taxation of Companies

The taxation of companies belongs to the most controversial issues which we find in the international discussion of tax competition. This is due to the fact that on the one hand there is

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96 Gjems-Onstad supra, II.5.
97 Dahlberg supra, 4.2.1.
98 Meussen supra, II.2.
99 Winther-Sorensen supra, II.2.1.
100 Gjems-Onstad supra, II.1.
no general standard as to the “normal” treatment of company profits, especially to the reduct-
ion or abolition of economic double taxation when profits are distributed as dividends to in-
dividual or corporate shareholders. Nevertheless, the way dividends are taxed in a country are
of utmost importance for shareholders, e.g. international holding companies choosing their
residence within Europe or individual shareholders allocating their capital to investment com-
panies or investment funds.

In order to give an (approximately) clear picture of the problems involved we have to distin-
guish between the treatment of company profits and dividends in a domestic setting and the
treatment of cross-border dividends at the international level. Although many states have by
now established non-discriminatory tax treatment of dividends irrespective of the national or
international character of the parent-subsidiary situation it seems advisable to concentrate in
this context on the domestic situation (the international situation will be addressed in the next
paragraph).

Many countries have over that past decades introduced mechanisms to their domestic tax law
which are aimed at the reduction or abolition of economical double taxation of profits which
have been taxed at the level of the subsidiary and are later distributed to (individual or corpo-
rate) shareholders. Among these systems we find:

- Imputation systems (e.g. Finland; France; Germany until 2000; Norway; Poland)
  which grant a tax credit to the shareholder but are under attack from the perspective of
  free movement of capital within Europe as they tend to discriminate against foreign
  shareholders/shareholdings.
- Participation exemptions for corporate shareholders (Denmark; Finland; Germany
  from 2000 on; Netherlands; Sweden (proposed legislation)).
- Deduction of distributed profits from the corporate tax base (Portugal)
- Zero-Rates for investment companies or investment funds (France; Germany; Luxe-
  mburg 1929 holding companies; Sweden; Netherlands; Switzerland).
- Fiscal Unity regimes (e.g. Germany, Netherlands, Poland) which not only get rid of
double taxation of profits but also enable parent and subsidiary to offset profits and
losses within a tax group.
It is quite clear that these tax regimes are valuable when multinational (or even small- and medium-sized companies) choose the location of a holding company. Therefore, the Swedish and the Finnish report emphasize that the recent Swedish and Finnish deliberations to introduce a participation exemption for capital gains to its corporate tax law is a result of international tax competition\(^{101}\). But one has to accept the fact that the abolition of economical double taxation in corporate structures is an aim which has been supported by legal and economic science for many decades and can hardly be regarded as a “harmful” measure\(^{102}\). Therefore it does not come as a surprise that in the Primarolo Group there is no consensus as to the “appropriate” taxation of holding companies\(^{103}\). It does not seem to be convincing to mark a tax regime as “harmful” or even as “preferential” if it only tries to minimise the negative tax effects of incorporation. On the other hand the Primarolo Group pointed out that “asymmetric” tax regimes can be regarded as harmful, e.g. rules according to which capital gains in a subsidiary are tax-free, but capital losses may be offset against other parts of income\(^{104}\).

5. International Taxation

When we try to look for features of tax competition in Europe in international – both unilateral and bilateral - tax law it seems commendable to start with the distinction between country of source and country of residence.

a) Source Country (Permanent Establishments, Withholding Taxes)

Any country in Europe will have to think about the influence of source taxation on the influx of foreign investment. It is quite clear that – unless there is full compensation in the country of residence – any taxation at source will work as a disincentive. We all know that the practice of international tax law has developed typical ways for source taxation to work. The profits generated in permanent establishments are in most cases taxed according to the standard rules of domestic tax law, thus creating “capital import neutrality” in the state of source. Therefore one might think about the influence of tax competition when contrary to this practice the state of source waives his right to tax branches. The Luxembourg report tells us that this is the case with Swiss branches in the financial sector under some of the Double Taxation

\(^{101}\) Dahlberg supra, 4.2.4; Tikka supra 2.1.3.
\(^{102}\) Easson supra, p.119 et seq.
\(^{103}\) Primarolo Group supra, Par.45.
\(^{104}\) Primarolo Group supra, Par.50 et seq.
Conventions concluded by Switzerland\textsuperscript{105}. These branches are not only tax-exempt in the source country but also subject to specific rules of profit accounting. Another problem is raised by the Polish report\textsuperscript{106}: when the tax administration does not screen the existence of permanent establishments very closely, the result is a “factual” tax incentive for foreign companies.

On the other hand, also some tax practices which most of us will regard as traditional “natural” features of international tax law have strong influence on the competitiveness of a jurisdiction. Many states in Europe (e.g. France, Germany, Norway) do not levy withholding tax on interest paid to foreign residents without examining whether the state of residence does levy a tax on the interest or this state is obliged to give a full tax credit for a withholding tax. The same can be said in some states with respect to withholding taxes on royalties or dividends. Of course most international tax lawyers will say that a source country should not be obliged to levy a withholding tax at all, thus creating a unilateral measure against double taxation of interest, royalties or dividends. But it cannot be denied, that this waiver is in most countries also seen as a welcome means to attract foreign investment.

b) Residence Country (Holding Companies, Exemption Method)

The discussion of the merits of tax competition makes another turn when we look at “preferential features” granted by a country of residence. The tax regime addressed is the exemption of foreign-source income – be it by means of unilateral measures (e.g. participation exemption) or by means of international treaties (exemption method under Art.23 A OECD Model). Therefore we have to ask whether there are tax regimes to be found in Europe which influence the competitive situation of a country by means of exempting income deriving from other jurisdictions. The case in point is the regime for holding companies in Europe. Under the tax law of many countries holding companies may rely on participation exemptions as to the dividends from foreign subsidiaries or receive tax credits for the underlying foreign corporate tax of the subsidiary. Moreover, some countries apply the above-mentioned “exemption method” to foreign branch profits or dividends deriving from foreign subsidiaries under their double taxation conventions (or the parent-subsidiary-directive). There can be no doubt that a holding company located in a country which adheres to tax exemption of foreign source income will be better off than a holding company located in a country where no tax reductions

\textsuperscript{105} Steichen supra, II.B.1.a.(3).
are granted with respect to foreign source income or the “credit method” is applied as the “ex-
emption method” leaves to the holding company the advantage of low taxation in the country
of source. Therefore, the application of a tax-exemption for dividends or branch profits has
the strongest competitive impact when the country of source is a low- or no-tax-country. This
has received the attention of the international working parties on harmful tax competition. It
should be noted again, that in the OECD list of elements constituting “harmful” tax practice
even this tax exemption of foreign income is named\textsuperscript{107}. Moreover, in the ongoing work of the
Primarolo Group there seem to be strong tendencies to prescribe the application of the “credit
method” as a means to avoid double taxation when the other state is a low tax jurisdiction\textsuperscript{108}.

The legal problem of an attractive holding company regime can therefore be put like this: Is a
country obliged to take away from holding companies resident within its jurisdiction the ad-
vantages of low taxation in the country of source. Does it constitute “harmful tax competi-
tion” if the country of residence refrains from fighting against measures of “tax competition”
taken by the country of source?

Countries relying on the exemption method with respect to foreign source income will bring
forward two arguments in their favour\textsuperscript{109}:

- In most cases, the tax exemption of foreign-source income is part of the general do-
  mestic tax system which tries to abolish features of economic double taxation; there-
fore, it should be self-evident that a participation exemption which covers domestic
and foreign subsidiaries alike, cannot be called harmful at all. Moreover, the recent ju-
dicature of the European Court of Justice prevents Member States of the European
Union to distinguish beween domestic and foreign participations, thus forcing member
states to apply participation exemptions both to domestic and foreign subsidiaries\textsuperscript{110}.
  Even cross-border loss consolidation which seems to be particularly attractive\textsuperscript{111} does
  not seem to be an “incentive” as it puts the foreign investment simply on the same
  footing as a domestic investment.

\textsuperscript{106} Brezinski/Kardach/Wojcik supra, III.3.2.b.
\textsuperscript{107} OECD, Harmful Tax Competition supra, par.104 et seq.
\textsuperscript{108} Nijkamp supra, p.150 et seq.; Thömmes, § 8b KStG und EG-Recht, Der Betrieb 2001, p.775 et seq.
\textsuperscript{109} OECD, Towards Global Tax Cooperation supra, par.12.
\textsuperscript{110} Case C-251/98 (Baars) 2000 ECR I-12787, at 2819 par.40; Case C-35/98 (Verkooijen) 2000 ECR I-4071, at
  4132 par.55 et seq.; Joint Cases C-397/98, C-410/98 (Metallgesellschaft/Hoechst) 2001 ECR I-1727, at. 1787
  par.61 et seq.
\textsuperscript{111} See the description of “Bénéfice Mondial” and “Bénéfice Consolide” by Blanluet, II.4.
- The “exemption method” is not only included in the OECD model and thus recognized as a valuable means of avoiding international double taxation; it is also the expression of the economic and political concept of “capital import neutrality” as opposed to “capital export neutrality” (which is the idea underlying the “credit method”). From an economic standpoint, both features of “tax neutrality” have their merits. It is a long tradition to which many European states have submitted and sound fiscal policy as well to set up a tax system according to the ideal of “capital import neutrality” (Otherwise, it could one day be called “harmful” if a country declines to introduce strict CFC-regulations into its national tax law). Renowned scholars have only recently pleaded for the exemption method as the only method which is compatible with the economic ideal of the Internal Market as it does not interfere with the tax policy of the other state. It sounds strange to mark the application of this method as “harmful tax competition”.

Nevertheless there might be some particular situations where a tax exemption for foreign source income goes beyond the treatment granted to domestic income, thus constituting a bias in favour of cross-border investment which might be regarded as “harmful tax competition”. The German report points out that dividends both from domestic and foreign sources are equally covered by the participation exemption laid out in sec.8b par.1 Corporate Income Tax Law. But when it comes to the deduction of corresponding expenses, the foreign subsidiary enjoys (in most cases) a more favourable regime as the non-deductibility of expenses which has been introduced with respect to domestic dividends is restricted to 5 % in the case of foreign-based subsidiaries.

An even more striking examples is described in the Austrian report: According to sec.10 Corporate Income Tax Law, intercorporate dividends are tax-exempt, not regarding the residence of the subsidiary. Only when the subsidiary is resident in a low-tax jurisdiction, the law switches to the “credit method”, thus raising the tax burden of the investment and neutralizing tax avoidance schemes. Unfortunately, this switch-over is restricted to the situation that the

114 Hey supra, II.3.d.
115 Sutter, National Report Austria, II.1,3.
majority of the shareholders of the Austrian holding company is not proved to be foreign residents – the Austrian government simply did not see the necessity to fight tax avoidance by holding companies if the shareholders of the holding company are not at all residents of Austria. This rule has been scrutinized under the “harmful tax competition” initiatives – but again we have to ask whether it really constitutes harmful tax competition if a country just refrains from fighting foreign low tax regimes on a full scale.

6. Administrative Practices

Apart from the substantive aspects of the national tax systems, also the behaviour of the tax authorities in a country can have evident influence on the competitiveness of a tax jurisdiction. Of course, in this respect we find examples for huge differences rooted in the tradition of public institutions: While the Netherlands have established an “Addressing Point for Potential Foreign Investors” in order to ease the route for foreign capital into the Netherlands, the national report for Poland perceives an “unfriendly” attitude of the administration towards foreign investors.

Among the basic features to strengthen the competitiveness of a country from the administrative point of view we find the instrument of advance rulings or advance pricing agreements (APAs) in many European countries (e.g. Luxembourg, Netherlands, Norway, Spain etc.). The Spanish reporter emphasizes the merits of this administrative practice: As long as advance rulings serve the aim of legal certainty, they do not constitute harmful tax practice as they fulfil a legitimate expectation of any taxpayer. On the other hand, tax rulings which serve to deviate from the general principles of tax law and to offer tailor-made tax regimes for single investors, there seems to consensus as to the harmful effects of such procedures. There can furthermore be not doubt that such a preferential ruling towards a single enterprise will be qualified as a “state aid” under Art.87 par.1 of the EC Treaty. It should be noted that the Dutch practice of advance rulings has been reviewed and reformed under the auspices of the EU/OECD initiatives on harmful tax competition.

116 Meussen supra, II.4.
117 Brzezinski/Kardach/Wojcik supra, I.
118 Bayona Giménez supra, II.4.
119 Schön supra, p.
120 Meussen supra, II.4; the Dutch practice is defended by Stevens, Ruling Policy increases Administrative Transparency, EC Tax Review 2001, p.70 et seq.
Other aspects of administrative tax law which have influence on the cross-border flow of capital are regulations on bank secrecy and international exchange of information. Within Europe, most countries know rules to protect the confidentiality of informations given by the taxpayer to the tax authorities or by the client to a financial institution (bank, insurance company). On the other hand, all countries (from which we have national reports) have a limited exchange of information under unilateral rules or bilateral/multilateral conventions. Within the European Union the directive on mutual assistance deserves to be mentioned.

Nevertheless there are differences as to the extent of confidentiality exercised by the tax administrations in international matters. Some countries limit the exchange of information to cases in which there are specific suspicions of tax fraud\(^\text{121}\). The proposal for a directive on the taxation of savings income would go far beyond that and oblige the Member States and participating third countries to supply foreign tax administration with across-the-board information about the taxable savings income of foreign investors. It does not come as a surprise that this proposal is heavily discussed and the alternative – i.e. a compulsory withholding tax the revenue of which is to a large extent allocated to the country of residence – seen as a minor infringement of confidentiality.

### III. Measures against “unfair” tax competition

#### 1. General

For countries which face tax competition from other jurisdictions, there are two possible reactions. The first one may be described as the “If You can’t lick ‘em, join ‘em” approach, i.e. the state will introduce corresponding tax incentives in the domestic tax system which shall prevent domestic taxpayers from emigrating or shifting their tax base to other jurisdictions. As far as “fair” tax competition is concerned, these measures may be regarded as part of the game, leading to downward fiscal pressure and to a better allocation of resources within an economy. A case in point is the general trend to reduce corporate income tax rates in Europe. As far as “harmful” tax measures are replicated in several countries, there is of course the danger of a “race to the bottom” which will distort neutrality and equity all over Europe; an evident example is the taxation of the shipping business where we have seen “tonnage taxes” spreading all over Europe in a few years.

\(^{121}\) Waldburger \textit{supra}, II.3.
Another way to “defend” the domestic tax base and equity and neutrality of taxation is the implementation of “counter-measures” which shall neutralize the advantageous effects of preferential tax regimes installed in other countries. Among these “counter-measures” we find the application of tax abuse rules or principles, CFC legislation, rules on residence and emigration, the denial of tax treaty entitlements, the application of transfer pricing rules or the non-deductibility of certain expenses. It should be noted that especially the OECD initiative on harmful tax practices urges OECD Member States to apply these counter-measures – either unilaterally or in concert with other states form inside and outside the OECD\textsuperscript{122}.

Nevertheless it is doubtful whether all of the advocated counter-measures are themselves in line with traditional principles of international tax law as they are laid down most prominently in the OECD model. The justification of counter-measures is even more doubtful under the EC Treaty as some of these measures tend to erect new impediments to the international flow of goods, services, capital and persons and lead to spill-over effects between Member States of the European Union which affect the fiscal sovereignty of them.

2. Anti-Avoidance Rules

All countries have a tradition of anti-avoidance law albeit in quite different forms. Most countries know general concepts of “abuse of law” while others – notably the UK - only include particular provisions in their tax law to fight specific tax avoidance schemes. The way the general notion of “tax abuse” is applied differs from country to country: In some jurisdictions we find across-the-board principles like “substance over form” or the “economic interpretation” of statutory law while others have included general provisions on tax avoidance in the written tax legislation. Poland, to give another example, has transferred its civil law concept of “abuse of law” to the tax law area\textsuperscript{123}. The different approaches to tax avoidance have been covered by the reports presented at the 1998 EATLP conference in Osnabrück\textsuperscript{124}.

In the context of European tax competition we have to look at the question how these general or specific rules on tax avoidance work in an international setting. The national reports point

\textsuperscript{122} Harmful Tax Competition \textit{supra}, par.85 et seq.
\textsuperscript{123} Brzezinski/Kardach/Wojcik, III.1.
\textsuperscript{124} European Taxation 1999, p.92 et seq.
to two specific problems which have to be addressed when the concept of “abuse of law” is applied to international tax structures within Europe.

The first question has been raised in proceedings before the Supreme Court of Austria\textsuperscript{125}. The Court was asked whether the general anti-abuse provision of Austrian tax law (sec.22 Federal Order on Levies) has to be applied when a tax scheme is aimed at the avoidance of the tax claim of a foreign jurisdiction. The Court held that Austrian tax law is not conceived to protect the fiscal interest of other countries. Anti-avoidance law strictly protects the domestic tax base. If this judgment can be generalized, it becomes clear that it is up to every single state to use its own anti-avoidance rules to protect its revenue.

The second question has been raised in the international discussion of the last years all over Europe\textsuperscript{126}: Is it compatible with the obligations of the Member States under the EC Treaty to apply tax avoidance provisions to schemes which shift the tax base within the Internal Market to another jurisdiction? As far as similar transactions would not be subject to anti-avoidance measures if they were executed in a domestic setting, this looks like a discrimination of or restriction on cross-border movement which infringes the fundamental freedoms of the EC Treaty. In the “ICI vs. Colmer”\textsuperscript{127} case, the European Court of Justice allowed the Member States to apply anti-avoidance rules aimed at international tax structures only if the taxpayer employs an “artificial” scheme without substantial economic activity, but this decision does not give Member States very much leeway.

In the German discussion the question of the compatibility of anti-avoidance rules with EC law has been given another twist when it was asked whether it is allowed to apply anti-avoidance rules to foreign tax regimes which have been recognized by the European Institutions under the state aid procedure\textsuperscript{128}.

3. CFC legislation

\textsuperscript{125} Sutter supra, II.1.
\textsuperscript{127} Case C-264/96 (ICI vs. Colmer) 1998 ECR I-4695, at 4722 par.26; Case C-478/98 (Commission v. Belgium) 2000 ECR I-7587, at 7626 par.45.
\textsuperscript{128} Hey supra, III.4; Rädler/Lausterer/Blumenberg, Tax Abuse and EC Law, EC Tax Review 1997, p.86 et seq.; see also Luja, Anti-tax-avoidance Rules and Fiscal Trade Incentives, Intertax 2000, p.226 et seq.
The OECD has asked its Members to apply their CFC legislation strictly or even to introduce CFC legislation where it does not exist hitherto in order to fight harmful tax regimes in other jurisdictions. This reflects an international trend towards CFC legislation: Some European countries did adopt CFC legislation in the aftermath of the US subpart F-legislation of the 1960s (e.g. France, Germany, UK). But during the last decade, many more European countries have passed CFC rules (e.g. Sweden in 1990, Norway in 1992, Portugal in 1995, Italy in 2001, Denmark in 2002). In Austria there is a fervent discussion whether the introduction of CFC rules is advisable. Countries which do not contain specific CFC rules in their legal order, often attain the same effect by applying general rules of tax avoidance and of beneficial ownership (Luxembourg) or other look-through-approaches (Netherlands)\(^\text{129}\).

Although there are differences in the details, most CFC rules in Europe follow the same pattern: The income of a foreign-based company is attributed to its domestic shareholders (irrespective of an actual distribution) if the foreign-based company is based in a low-tax country, restricted to certain “passive” income, e.g. from financial services, and controlled by domestic shareholders.

From the perspective of tax competition, there is a remarkable antagonism in the international discussion of CFC rules. On the one hand, due to the OECD initiative and the policy options of governments in capital-exporting countries, CFC legislation has spread enormously during the last decade. On the other hand, it becomes more and more doubtful whether CFC legislation is in line with international law. It is highly controversial whether CFC legislation constitutes an override of treaty obligations (especially those treaties which follow the OECD model)\(^\text{130}\). It is even more problematic whether CFC legislation must be regarded as an unjustified restriction of the free movement of capital and the freedom of establishment under the EC Treaty\(^\text{131}\).

4. Residence and Emigration

\(^{129}\) For an overview see: Sandler, Tax Treaties and Controlled Foreign Company Legislation, 1997.


\(^{131}\) Schön, CFC Legislation and European Community Law, British Tax Review 2001, p.250 et seq.; Siegingen, Are Controlled Foreign Company Rules Compatible with the European Union?, EC Tax Journal 2002, p.21 et seq.; the Finnish Supreme Court has held that Finnish CFC rules are compatible with a tax treaty and EC law.
As tax competition results in the emigration of persons, the setting up of foreign subsidiaries or the transfer of assets to other jurisdictions, the borderline between unlimited and limited tax liability gains influence on the competitive situation of jurisdictions. Countries which do not want to lose revenue will tend to extend the borderline in favour of unlimited tax liability.

In this perspective it does not come as a surprise that in many national report the definition of “residence” under domestic tax law is mentioned as a way to fight international tax competition. Although it has been common ground in most European jurisdictions for a long time that the residence of an individual does not only refer to his or her domicile but also to his or her habitual abode and the residence of a company is not only determined by its registered office or place of incorporation but first and foremost by the place of effective management and control it has to be emphasized that this broad approach as to the definition of residence constitutes a traditional instrument for a tax legislator against tax competition\(^\text{132}\).

When an individual leaves a jurisdiction some countries apply specific rules in their domestic tax law in order to keep the taxpayer for a limited period of time within the reach of unlimited tax liability. Germany did in the 1970s develop the concept of “extended limited tax liability” which broadened the tax liability of German nationals who emigrated to other countries but kept substantial economic interest in Germany\(^\text{133}\). In 2001 Norway introduced the rule that an emigrating tax payer has for 10 years after his emigration the burden of proof that he or she has actually abandoned substantial economic links to the Norwegian jurisdiction\(^\text{134}\). A similar three-year-rule is employed by Finland\(^\text{135}\).

Moreover, under the tax law of many countries the act of emigration itself can give rise to tax liabilities. This refers to “hidden reserves” in shareholdings, business assets or (a case discussed at the last EATLP meeting in Lisbon) in pension rights\(^\text{136}\). According to most writers, this “exit taxation” is principally in line with the fundamental freedoms of domestic tax law as it does protect the “coherence” of domestic tax systems.

5. Tax accounting

\(^{132}\) McLure supra, p.335 et seq.  
\(^{133}\) Hey supra III.2.b.  
\(^{134}\) Gjems-Onstad, III.3.  
\(^{135}\) Tikka supra, 3.3.  
\(^{136}\) European Taxation 2001, suppl.1.
It is quite clear that different methods of tax accounting can be applied by tax jurisdictions in order to avoid the shifting of revenue to other jurisdictions. In the national reports we find three related rules which try to protect the domestic tax base against tax avoidance.

a) Transfer Pricing

All national reports pointed out that the respective country adheres to traditional principles of transfer pricing. The arm’s-length-standard seems to be supported equivocally in all Member States of the European Union. The Code of Conduct Group did some work on the application of the different transfer pricing methods in Member States. But it has to be remarked that the latest communication of the European Commission proposes to abolish traditional inter-company transfer pricing rules and replace them with “formulary apportionment” following U.S. and Canadian examples.

b) Restrictions on Deduction

Another way to prevent taxpayers from diverting their tax base to other (low-tax) jurisdictions is the denial or restriction on the deduction of business expenses paid to related companies which are resident in no- or low-tax jurisdictions. It is not in doubt that these expenses have to be scrutinized very closely, but the national reports reveal gradually different approaches. In Switzerland, the general principle applies that expenses are deductible if they are economically justified. Other countries (France, Germany, Italy, Portugal) provide explicitly for a shifting of the burden of proof to the taxpayer as to the effective character of the payment. Poland requires domestic taxpayers to supply the tax authorities with extensive documentation of the economic background of these expenses. The strictest approach seems to be employed in Spain where expenses to entities based in certain “black list” jurisdictions are not recognized at all. The Spanish reporter raises the question whether this rule is out of proportion and should be changed accordingly.

c) Thin Capitalisation

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137 Nijkamp supra, p.150 et seq.
138 European Commission, Business Taxation in Europe supra, par.
139 Waldburger supra, III.4.
140 Brzezinski/Kardach/Wojcik supra, III.4.
141 Bayona Giménez supra, III.4.
Of course, special regimes on “thin capitalisation” belong nowadays to the “standard” instru-
ments of tax jurisdictions stretching from Poland to Portugal. But not all countries employ 
these rules (Italy is a notable exception\textsuperscript{142}) and the European Court of Justice will soon decide 
in a German case on the compatibility of thin capitalisation rules with the fundamental free-
doms of the EC Treaty\textsuperscript{143}.

6. Tax Treaties

Finally, any country which wants to engage in fighting “harmful tax competition” must re-
view its own tax treaty policy. The national reports reveal some “standard solutions” which 
are applied in many contexts.

Of course, the most effective approach which can be employed is may be called the “absti-
nence approach”, i.e. the denial to conclude tax treaties with certain countries. This abstinence 
is exercised by many European countries with respect to “tax havens” which do not comply 
with fundamental rules of international taxation. As far as the treaty network between indu-
trialized states is concerned, a number of “clauses” has evolved over time which are meant to 
serve as an instrument in order to fight international tax competition. The most relevant 
clauses are:

- “Exclusion Clauses”, which exclude certain types of taxpayers or situations from the 
  benefits of the Treaty. An example mentioned in various national reports are treaty 
  clauses which exclude the so-called Luxembourg 1929 holding companies from treaty 
  entitlements on dividend taxation. This is accepted by the Luxembourg reporter as 
  Luxembourg tax law provides for zero-taxation of these companies, thus granting 
  unilateral tax relief\textsuperscript{144}.
- “Limitation-on-Benefits Clauses” which restrict the treaty entitlements to companies 
  with real economic links to the contracting states; it is controversial whether these 
  Clauses are compatible with the fundamental freedoms enshrined in the EC Treaty\textsuperscript{145}.
- “Switch-Over Clauses” or “Activity Clauses” which replace the favourable exemption 
  method with the credit method when passive income is concerned.

\textsuperscript{142} Sacchetto supra,
\textsuperscript{143} Case C-324/00
\textsuperscript{144} Steichen supra, II.B.3.a.
\textsuperscript{145} Thömmes/Becker, Limitation on benefits – the German View, European Taxation 1999, p.9 et seq.
- “Subject-to-Tax Clauses” which require an effective taxation in the country of source in order to justify any tax exemption in the state of residence.

As has been mentioned above, even the simple application of the “credit method” can be regarded as a counter-measure against tax competition as it neutralizes the low tax regime applied in the state of source, thus leading to capital export neutrality which is compatible with the concept of world-wide-income taxation. Furthermore, the ongoing discussion in international tax law with respect to the application of domestic anti-avoidance provisions to tax treaties must be seen in the context of international competition.

It is worth noting that in some of the most recent tax treaties which have been concluded in Europe, special reference has been made by the contracting states to “harmful tax competition”:

In the updated version of the double taxation convention between Austria and Germany we find Article 28 par.2 which reads:

“The State of Residence can apply its national anti-abuse legislation against tax evasions in order to respond to abusive tax planning or unfair tax competition”.

In the Protocol of this Treaty “unfair tax competition” is defined in direct reference to “the work in the OECD or in the EU”. The Austrian reporter states that in this article “the soft law instruments that are per se not legally binding” are transformed “into legally relevant facts triggering the application of national anti-abuse rules”\(^\text{146}\).

Another example can be found in the recently signed double taxation convention between the Netherlands and Portugal which refers to the Code of Conduct as well\(^\text{147}\). Residents of Portugal and the Netherlands that enjoy a favourable tax treatment will not be entitled to the provisions of Chapter III of the treaty which provides for reduced withholding tax. Also residents of Portugal and the Netherlands that benefit from tax measures which are “harmful within the meaning of the EC Code of Conduct” shall not be entitled to the benefits of Chapter III of the treaty. On the Netherlands side it has been clarified that treaty benefits will no longer be

\(^{146}\) Sutter supra, III.1.  
\(^{147}\) Meussen supra, IV.1.
available as of the day that the State Secretary of Finance issues a resolution specifically stating that a specific regime is considered harmful.

7. Private Savings Income

The problems raised by the taxation of private savings income – although addressed in the 1997 “tax package” and now subject to negotiations on a proposed directive – are of a quite different character than the questions which have been dealt with before. This is due to the fact that there is virtually no disharmony between the Member States (and to a certain extent, worldwide) when it comes to the allocation of taxing rights between jurisdictions: It is generally accepted that the state of residence has the power to tax interest from private savings irrespective of the country of source, i.e. the country where the debtor is resident or payment has to be executed. Therefore, there is no “tax competition” in a material sense when we look at the decision of private taxpayers to invest their wealth in foreign based bank accounts, securities or investment funds. There is – as the Luxembourg reporter points out – a real competition as to the return on investment or the regulatory framework of financial services, but it is accepted that the tax situation doesn’t change when an individual taxpayer shifts his financial assets abroad.

The specific problem which has to be discussed when we deal with private savings income is tax evasion, i.e. the non-compliance of taxpayers with their domestic procedural obligations. It is not in doubt that non-declaration of foreign income has led to significant revenue losses for several European Member States in the past. As the assets are not within the reach of the domestic tax authorities Members States have to rely on administrative support from other states, i.e. the countries of source. Although within the European Union the Mutual Assistance Directive supplies Member States with an instrument to demand cross-border information in specific cases and most tax treaties contain clauses which save the same purpose the existing international network does not suffice to supply the states of residence with the across-the-board information they need in order to verify the accuracy of taxpayers’ declarations.

This is the background for the negotiations on a directive on private savings income which have been started in the late 1980s and have gained momentum after the 1997 tax package found consensus in 1997. The discussion has focused on three alternatives:
- leave the situation as it is, thus creating large tax loopholes for private investors;
- introduce a withholding tax in the country of source, thus “levelling” the tax situation compared to the country of residence;
- establish a broad-based exchange of information between the Member States of the European Union (and other states, notably Switzerland and USA).

The introduction of a withholding tax in the country of source would mean a “significant departure from the rules enshrined in the OECD and US Model Tax Conventions and numerous bilateral treaties”\(^{148}\) as such a withholding tax would contravene the idea that the country of residence should have the power to tax private savings income. Nevertheless, taxation of interest income at source would be a pragmatic solution as it does not require the establishment of a complicated administrative network in order to exchange sensitive information about individual taxpayers. Therefore, in the international economic discussion it has been widely accepted that “although it is not desirable to tax capital on a source basis it is not administratively feasible to tax capital on a residence basis”\(^{149}\). Avi-Yonah\(^{150}\) has concluded from this situation that it would be a workable second-best-solution to institute a world-wide minimum withholding tax on interest, at least in the industrialized countries, as any financial investment in a tax haven will eventually flow into productive investment in industrialized region, thus being subject to corporate income tax or a withholding tax on interest.

In the proposal for a private savings directive which has found general approval by the ECOFIN Council, the withholding tax model is only accepted as a transitory regime for 10 years. There are indeed two problems arising from this concept which will lead to complications. First of all, the existence of a withholding tax “levelling” the playing-field within Europe does not change the principal claim of the state of residence to receive the revenue derived from this withholding tax. Therefore, Member States have to find a “clearing mechanism” allocating the tax on interest income to the involved jurisdictions according to the residence of the investor. Moreover, a withholding tax does in itself not solve the problem of tax evasion. If progressive taxation in the state of residence is higher than the withholding tax in the country of source taxpayers investing abroad will still be required to report their foreign income and to pay the difference between the withheld tax amount and the respective amount of domestic tax. Thus, a withholding tax will only gradually improve the situation.

\(^{148}\) McLure supra, p.341.
\(^{150}\) supra, 1667 et seq.
The ECOFIN Council has embarked on the approach of across-the-board exchange of information. This may be called the “systematic” way as it is in line with the principal power of the state of residence to tax its taxpayers according to their “synthetic” world-wide income. Nevertheless, it is doubtful whether such an enormous administrative network can be erected and sustained. Moreover, compliance by all states involved – particularly states outside the European Union – is difficult to attain. In the end, there might be the choice between a pragmatic but workable solution (withholding tax) and a logical but impractical solution (exchange of information).

C. Tax Competition in Europe – Europe as a Competitor?

The intricate questions concerning the taxation of private savings income go down to an even more complicated problem which has to be addressed in all areas we have mentioned with respect to tax competition in Europe – the relationship between Europe (or, even narrower: the European Union) and third countries, notably large industrialized regions (USA, East Asia), developing countries or simple tax havens. The third country perspective brings along two specific adjustments to the discussion about tax harmonisation and tax competition:

First of all, it is clear that in an integrated world where we have a free flow of capital, goods, services and persons between Europe and third countries, tax competition does not stop at Europe’s borders. The progress of tax harmonisation within Europe will not change the competitive attitude of third countries which will use their tax incentive inventory in order to attract investment from European investors. Therefore it has been said that as long as tax harmonisation is restricted to the European Union Member States will lose their competitive edge compared to third countries who can exploit the tax wedge between the “high” harmonised level in Europe and the “low” tax level offered by their jurisdiction. From this perspective, tax harmonisation will not achieve the aims of neutrality and equity or stop “fiscal degradation” in Europe but simply put the Member States of the European Union in a straitjacket preventing them from defending their competitive situation in a globalized economy.

On the other hand one could argue that the existence of large economic areas outside Europe does support the necessity to harmonise tax systems within Europe. Behind this argument is the idea that Europe as a whole constitutes an integrated economy which competes with other
economic entities such as the USA or the Far East. In order to improve the competitive strength of Europe as a whole compared to these large economies Europe has to align the legal situation within its boundaries, establish equity and neutrality of taxation and reduce transaction costs and compliance burdens. From this point of view, the positive effects of tax competition, i.e. the downward pressure on the tax level, will not disappear when tax harmonisation goes on in Europe as there will still be enough competitive pressure from outside the European Union to exercise control on the fiscal and budgetary policies within the European Union.

D. Competition and Harmonisation – are they the same?

The whole discussion on the merits of institutional competition refers to the concept that there exist two levels where decisions may be taken: a “federal” level where some central institution has the power to enact laws binding the whole community and a “regional” level where local institutions are in the position to frame the legal situation. When we look at the state of the European Union we have – superficially – the impression that there exists an antagonism between the institutions of the European Union which embody the “federal” tendency to harmonise and the Member States which defend their fiscal sovereignty. Taking a closer look, we discover that the fundamental policy decisions which shape the development of European tax law are taken by the European Council where the representatives of the Member States convene in order to discuss the options they have for the future structure of taxes in Europe. In this Council, according to the principle of unanimity laid down in Art.95 par.2 EC Treaty, no decision in tax matters can be taken unless all Member States agree to a specific measure. From this legal context it seems clear that there is no real difference between policies at the “European” and the “domestic” level. It is always the Member States themselves who either act in concert or go it alone. It’s not “Brussels”, it’s them! Therefore, in our present situation, the difference between tax harmonisation and tax competition in Europe boils down to the difference between consensus and dissensus among the Member States of the European Union. From this perspective it should be clear that the question whether Member States should adhere to this principle or move towards majority voting in tax matters, is of paramount importance for the future of European tax law. So far, Member States have (last time in Nice\textsuperscript{151}) not dared to go this way. On the day they change this attitude, the alternative between tax harmonisation and tax competition will be back on the table.

\textsuperscript{151} Vanistendael, How nice was Nice to European Taxation?, EC Tax Review 2001, p.2.