Example 22.1
Tax Competition in the EU and the European Court of Justice*

THE ECONOMICS OF TAX COMPETITION AND TAX HARMONISATION

The advocates of *tax competition* suggest that a one-tax-fits-all approach is inefficient. They suggest that taxation should only be raised to pay for the level of government services people desire. If there are different preferences for government services across countries then they argue that there should be different taxes. For example, suppose the Irish demand lower levels of public services than the French (by 'demand lower levels' we mean 'are willing to pay for lower levels'). This situation is represented in Table E22.1a.

Table E22.1a: Quantity of Public Service Demanded by French and Irish

Price	French	Irish	Average
9	5	1	3
8	7	3	5
7	9	5	7
6	11	7	9
5	13	9	11
4	15	11	13
3	17	13	15
2	19	15	17

Suppose, also, that the cost of supplying each unit of the public service is a constant 6 units. The situation is presented in Figure E22.1.

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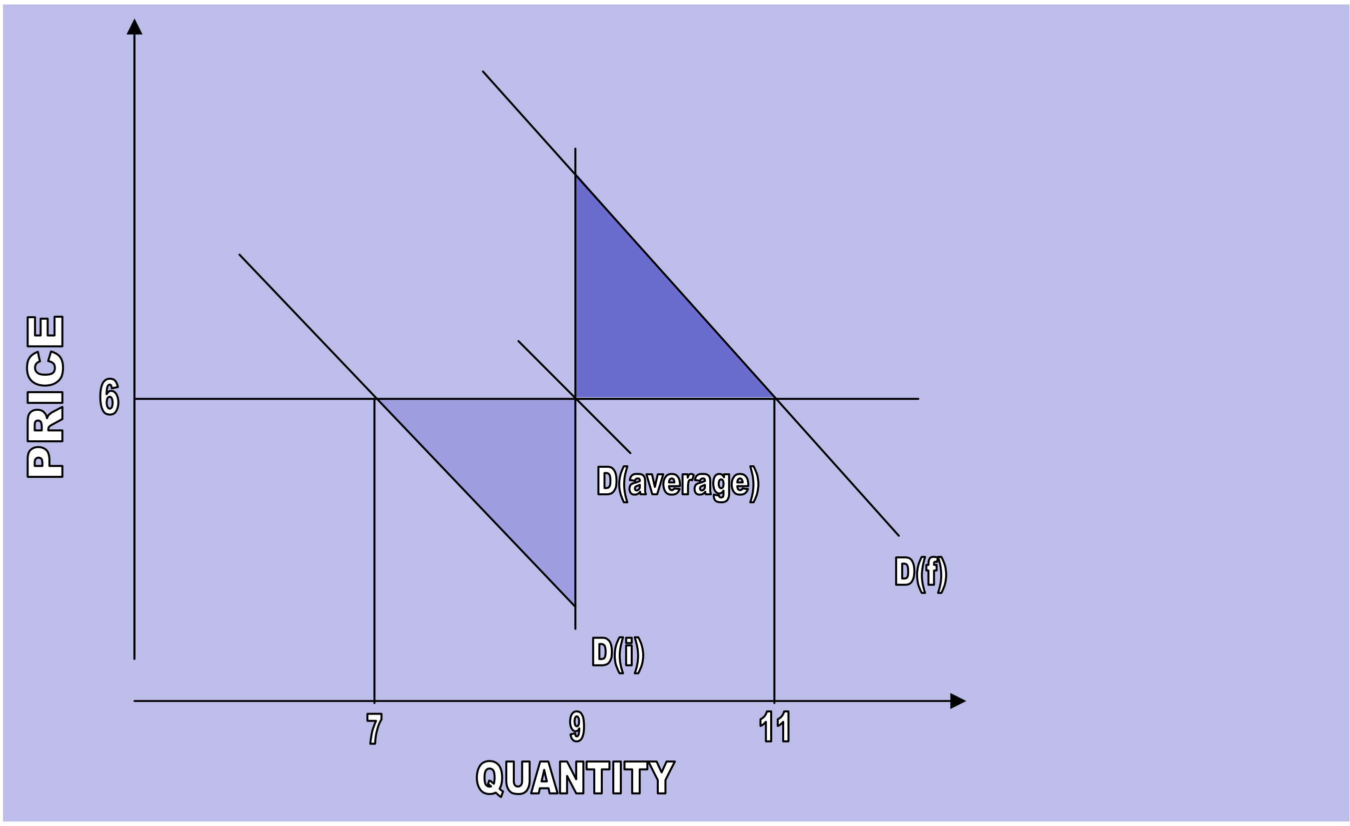
Figure E22.1: Quantity of Public Service Demanded by French and Irish



Left to their own devices, the French would demand 11 units of the public service and require 66 units of taxes to pay for it (i.e 6 x 11). The Irish would demand 7 units and would require 42 units of taxation to pay for it. Therefore, all other things being equal, Ireland would require a lower tax rate to fund the public service.

If the public service is provided by an EU policymaker based on 'average' demand, then 9 units of the service will be supplied to each country, with each country needing 54 units of tax. In this case the both the Irish and French are worse off than if they had made their own decisions. The French are getting less of the public service than then want (and would be willing to pay for). The Irish are paying for more of it than they want.

On the other hand, those who argue in favour of *tax harmonisation* (and against tax competition) suggest that allowing each country to determine its own tax rate leads to a Prisoners' Dilemma problem. The result, they suggest, is a race-to-the-bottom in which countries compete on taxes, producing a sub-optimal outcome. Table E22.1b illustrates this point. Two countries (A and B) can levy either high or low tax rates. The table shows the tax revenues collected in each country for all possible combinations of tax rates they might choose. The tax revenue in country A is listed in the lower left-hand corner of each box and the tax revenue in country B in the upper right-hand corner. If both levy high tax rates, they each collect 300 in tax revenue. If both levy low tax rates, they each collect 200 in tax revenue. If country A chooses a low tax rate and country B a high tax rate, then the tax revenues in country A rise to 400 because firms move from country B to country A to take advantage of A's lower tax rate. At the same time, country B's tax revenue falls to 100. The situation is reversed, and symmetric, if country B chooses a low tax rate and country A chooses a high tax rate.

Table E22.1b: Race-to-the-Bottom Selection of Tax Policy

		Country B	
		High Tax	Low Tax
Country A	High tax	B: 300 A: 300	B: 400 A: 100
	Low Tax	B: 100 A: 400	B: 200 A: 200

Suppose both countries want to raise as much tax revenue as possible, and they are not sure what the other country will do. Consider the decision from the point of view of country A. If country A thinks country B will choose a high tax rate, then the best strategy is for country A to chose a low tax rate (because 400>300). If country A thinks country B will choose a low tax rate, then the best strategy for country A is again to choose a low tax rate (because 200>100). Therefore, country A chooses a low tax rate no matter what it thinks country B will choose. Country B reasons the same way, so they both choose a low tax rate, with revenues of 200 each, even though they would both be better off if they both chose a high tax rate (because 300>200). This is the so-called Prisoners' Dilemma that leads to the 'race to the bottom' in tax rates.

A better approximation of the situation in the EU, however, is captured in Table E22.1c, which shows the tax revenues for choices of low or high tax rates in small and large countries.

Table E22.1c: Tax Competition is Not an Optimal Policy for One Country

		Large (France)	
		High Tax	Low Tax
Small (Ireland)	High tax	L: 500 S: 30	L: 250 S: 10
	Low Tax	L: 380 S: 40	L: 200 S: 20

In Table E22.1c, it is always better for small countries (like Ireland) to select a low tax option (because 40>30 and 20>10) and for large countries (like France) to select a high tax rate (because 500>250 and 380>200). The result is tax revenues of 40 for the small country and 380 for the large country. Again this is sub-optimal because the overall tax take is maximised when both countries select high tax rates.

The difference between the situations illustrated in Tables E22.1b and E22.1c is that, in Table E22.1c, it does *not* benefit the large country to attempt to compete with the small country on taxes. Although the large country might lose some footloose business to the small country if the small country applies a lower tax rate, it would lose even more tax revenue if it lowered the taxes on those businesses that stay within its jurisdiction. Consequently, neither the small nor the large countries favour tax harmonization.

TRENDS IN EU TAXATION

To judge by the evidence on corporate taxation, it would seem that the preference of policy makers is for tax competition. An excellent summary of the recent trends in EU taxation is provided in a recent paper by Carone, Host Schmidt and Nicodeme.[2] The authors argue that, since 1970, the total tax burden (measured as tax/national income) rose in all EU countries. The increase in tax was driven by increases in expenditure. Expenditure (and taxes) have settled at somewhere between 35% and 50% of national income. However, corporate tax rates have fallen.

When measuring corporation tax rates one can examine the rates themselves or one can include exemptions and allowances to derive the effective tax rate. Overall, both statutory rates and effective rates have fallen in the EU over the last twenty years. In the EU-15, average rates have dropped from 50% to 30% over the last two decades as governments have responded to the movement of capital. The overall take from corporate taxes has not fallen despite the decline in rates because of the higher level of economic activity. Corporate tax rates in the New Member States (NMS) of the EU are on average 5%–10% lower than in the older EU-15.

ANOTHER POTENTIAL PROBLEM WITH TAX COMPETITION: TRANSFER PRICING

A company with subsidiaries in different countries that transfers intermediate goods and services between the subsidiaries must select a price at which to transfer the goods and services. The selected price is the transfer price. However, the term ‘transfer pricing’ has become synonymous with a strategy by companies to maximise

[2] Giuseppe Carone, Jan Host Schmidt and Gaetan Nicodeme, ‘Tax Revenues in the European Union: Recent Trends and Challenges Ahead’, *European Economy, Economic Papers*, Number 280, European Commission, 2007.

after-tax profits by choosing transfer prices that locate profits in low corporate tax jurisdictions independent of the true prices of the good and services being transferred. By selecting appropriate transfer prices a subsidiary in a low tax country can be made more profitable and a subsidiary in the high tax country less profitable.
The following example illustrates.

Suppose a company has a production subsidiary in Country A and an assembly subsidiary in Country B. A decision has to be made on the price at which to transfer the component parts from the production subsidiary in Country A to the assembly subsidiary in Country B. This decision determines the location of the before-tax profits between Country A and Country B, and hence, the tax to be paid and resulting after-tax profits. The cost and revenue data at each facility are:

- Final sales of gadget X from the assembly subsidiary in country B: €100 per gadget
- Production costs of component parts at the production subsidiary in country A: €20 per gadget
- Assembly costs of component parts at the assembly subsidiary in country B: €10 per gadget
- Country A's corporate tax rate: 10%
- Country B's corporate tax rate: 50%

For the sake of the example, assume there are no legal impediments to deciding on the transfer price for the component parts between the production and assembly subsidiaries, except that neither subsidiary can report a loss. The overall profit is €70 per gadget, equal to the $100 sales price of a gadget minus total costs of €30 per gadget, consisting of the production costs of the component parts (€20 per gadget) and the assembly costs of the component parts (€10 per gadget). The company would clearly want to report as much of the $70 profit as possible in Country A so that it is taxed at 10% rather than 50%. The way to do this is charge the assembly subsidary in country B a transfer price for the component parts of €90 per gadget. This leads to a profit of €70 at the production subsidiary in country A (€90 per gadget transfer price of the component parts minus €20 per gadget to produce the parts) and zero profit at the assembly subsidiary in country B (€100 sales price per gadget minus the sum of the transfer price paid for the component parts [€90 per gadget] and the assembly cost of the compnent parts [€10 per gadget]).

To combat transfer pricing that is designed purely to transfer tax liability rather than to reflect the economic value of the goods and services being transferred, EU law requires the transfer price to reflect:

- The degree of physical presence of the subsidiary in the host state, and
- The nature of the activity given the competence of the staff and the level of decision-making in the subsidiary.

US tax authorities combat this type of transfer pricing by taxing the overall level of profits regardless of where they are earned. This is what the US tax authorities do by levying a 40% corporate tax on profits made worldwide, against which companies can offset any tax paid in a county with a double-taxation agreement with the US.

SOME CASE LAW ON WHERE PROFITS SHOULD BE TAXED: CADBURY SCHWEPPES

On the 11 October 2002, Ireland was removed from the list of countries exempt from UK Controlled Foreign Company legislation. Controlled Foreign Company (CFC) legislation taxes in the home country income arising in a foreign low-tax-rate country as if that income had been distributed to the home country (even though it has not been). Ireland's removal from the list was a result of the reduction in Ireland's corporate tax rates.

On 29 April 2004, the Special Commissioners in the UK referred the *Cadbury Schweppes* case to the European Court of Justice (ECJ). Cadbury Schweppes plc owned two subsidiaries operating from the International Financial Services Centre in Dublin and was therefore subject to a 10% corporate tax rate. The UK Inland Revenue taxed the subsidiaries under its CFC legislation.

On 2 May 2006 Advocate-General Leger issued his opinion. He argued that Article 43 of the EC Treaty prohibited restrictions on freedom of establishment and that national tax legislation could not restrict such a freedom. Cadbury Schweppes plc was allowed to establish the Irish companies. It was only in cases where 'wholly artificial arrangements' were established for the purpose of tax avoidance that the CFC legislation could be applied. If it could be proved that the subsidiaries were not 'wholly artificial arrangements' then they were exempt from CFC legislation.

On 12 September 2006, the ECJ delivered its decision. It agreed with Advocate-General Leger. It argued that establishment alone could not prove an attempt to evade tax. Moreover, it accepted the legitimacy of tax competition, and that it might influence location decisions, but it argued that restrictions on such tax competition were a political matter. [3]

The legal opinion, like the evidence from the movement of corporate tax rates, might suggest that tax competition is the preferred option of the EU member states. However, when one considers that each of the original member states has a veto over tax matters then it is possible that the policy is been driven by those who benefit more from tax competition rather than from tax harmonisation.

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[3] For a fuller discussion see Rosemary Healy-Rae and Frank Barry, *Who's Afraid of the ECJ? Implications of the European Court of Justice Decisions on Ireland's Corporate Tax Regime*, published jointly by The Institute of European Affairs and the Irish Taxation Institute, 2007.