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Speeding Up, Down the Hill: How the EU shapes corporate tax competition in the Single Market

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Speeding Up, Down the Hill: How the EU shapes corporate tax competition in the Single Market

ABSTRACT

We show that tax competition in the EU is shaped by four interrelated institutional mechanisms: 1) *Market integration*, by reducing the transaction costs of cross-border tax arbitrage in the Single Market, 2) *enlargement*, by increasing the number and heterogeneity of states involved in intra-EU tax competition, 3) *tax coordination*, by restricting the range of competitive instruments at the disposal of governments, and 4) supranational judicial review by limiting the scope of unilateral defences against tax competition (*judicialization*). As a consequence, tax competition is significantly stronger in the EU, and the race to the bottom in corporate tax rates more pronounced than in the rest of the world.

CONTENTS

Speeding Up, Down the Hill: How the EU shapes corporate tax competition in the Single Market[*]

I. DOES THE EU MAKE A DIFFERENCE?

The issue of international tax competition has raised a lot of scholarly interest in recent years. Given the normative concerns of most policy makers and analysts, the attention focused mainly on political and economic *consequences*: How seriously does tax competition constrain national tax policy autonomy (Adam & Kammas, 2007; Ganghof, 2006; Garrett, 1998a; Genschel, 2002; Swank & Steinmo, 2002)? How dramatically does it threaten the financial basis of the welfare state (Sinn, 1997; Tanzi, 1995)? How strongly does it push towards a cross-national convergence of tax policies? (Franzese & Hays, 2007; Swank, 2006; Winner, 2005).

The institutional *context* of tax competition has received less attention. Even the best empirical studies tend to neglect it. Thus, it is quite common in macro-quantitative research not to control for EU membership (e.g. Adam & Kammas, 2007; Ganghof, 2006; Garrett, 1998b; Stewart & Webb, 2006; Swank & Steinmo, 2002; Winner, 2005), assuming, at least implicitly, that tax competition is essentially similar inside and outside the EU. This assumption is wrong. International tax competition, as any form of competition, is shaped by its institutional setting. Different settings result in different competitive dynamics. Tax competition in the EU varies significantly from tax competition in other parts of the world.

We argue that corporate tax competition in the EU is shaped by four institutional mechanisms. The most obvious mechanism is market integration: the EU reduces barriers to cross-border economic transactions in the Single Market and, thus, facilitates international tax arbitrage among the tax systems of the member states (*integration effect*). The second mechanism is enlargement: by admitting new member states, the EU increases the number and heterogeneity of states involved in intra-EU tax competition (*enlargement effect*). The third mechanism is tax coordination: the EU provides a rich institutional infrastructure for intergovernmental bargaining and enforcement, which helps the member states to devise common rules for tax competition (*coordination effect*). The fourth mechanism is supranational tax jurisprudence: the EU submits the unilateral defences that member states have built up to protect national tax claims from

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international tax arbitrage to judicial review by the European Court of Justice (*judicialization effect*).

The upshot of these four mechanisms is to accelerate tax competition. We will demonstrate that corporate tax competition is significantly more pronounced in the Single Market than in the rest of the world. This is interesting news not only to students of the comparative political economy of taxation but also to policy makers like French President Nicolas Sarkozy who want to harness the EU as a protective device against the ravages of globalization, and to EU scholars. A strong body of recent EU studies claims that competitive races to the bottom are rare in the Single Market (e.g. Majone, 2005: 152; Moravcsik, 2005: 373; Pelkmans, 2007: 708; Radelli, 2004:4; Schmidt, 2007: 677). The basic argument is that the EU is a powerful “market maker” *and* “market modifier” (Caporaso & Tarrow, 2007:14) and that, consequently, reregulation rather than deregulation is the norm in European integration. Our findings deviate from this norm. Corporate taxation provides an exemplar case of a race to the bottom in the Single Market.

The structure of the paper is as follows. Section 2 reviews the literature on tax competition and derives predictions regarding the EU’s institutional effects on corporate tax competition. Section 3 presents descriptive evidence that tax competition is stronger in the EU than in the rest of the world. Section 4 provides a simple regression analysis showing how the EU’s integration and enlargement effects have contributed to the increase of corporate tax competition in the Single Market. Section 5 looks into the coordination effect. It traces efforts by the Commission, the Council and the member states to regulate corporate tax competition at the European level and explains why they have so far met with only limited success. Section 6 shows how the case law of the ECJ on corporate taxation has reinforced rather than restrained tax competition among the member states (judicialization effect). Section 7 summarizes our findings and provides predictions about the future of European tax competition.

II. THE INSTITUTIONAL EMBEDDEDNESS OF TAX COMPETITION

In this section, we provide a general framework for understanding the institutional shaping of tax competition. We start by reviewing two basic forms of tax competition, general v. targeted, and then discuss four institutional mechanisms that shape the competitive dynamics: integration, enlargement, coordination and judicialization. Finally, we derive implications for corporate tax competition in the EU.

Corporate tax competition can take two major forms (e.g. Keen, 2001): *General* tax competition affects the entire corporate tax base: governments lower taxes for the corporate sector as a whole in order to attract foreign investments and profits and shore up domestic ones. *Targeted* tax competition, by contrast, is limited to selected elements of the corporate tax base: governments offer preferential treatment, so-called preferential tax regimes (PTRs), to some, presumably very mobile and tax sensitive, parts of the tax base, but keep tax rates up for the rest.

The distinction between general and targeted tax competition has crucial strategic implications. The benchmark model of tax competition (Wilson, 1986; Zodrow & Mieszkowski, 1986) is about *general tax rate competition* among small states in an anarchic setting. In this model perfect capital mobility leads to declining rates of taxation, as governments enter a fiscal bidding contest for the internationally mobile tax base. The result is a prisoners' dilemma-type race to the bottom: all states suffer from the competition and would be better off without it – and since all states are equally small, they suffer equally: Tax competition is symmetric. This changes if states differ in size. Bucovetsky and others have shown theoretically that small states can gain more from tax rate cuts than large states (e.g. Bucovetsky, 1991; Kanbur and Keen, 1993). Since their domestic tax base is small compared to the rest of the world, the revenue loss from a general rate cut – i.e. revenue forfeited from the domestic base – will be more than compensated for by the revenue gain from the inflow of foreign tax base. This is not true for large countries, where a cut in the general rate will cause a relatively large revenue loss from the domestic tax base but only a comparatively small inflow of foreign base. As a consequence, small states have more to gain from the competition and will undercut the rates of large states to attract a disproportionately large share of the internationally mobile tax base in the competitive equilibrium. The strategic structure is no longer symmetric. If differences in country size are large, small states strictly prefer competition to non-competition (Dehejia & Genschel, 1999: 411; Holzinger, 2005:493; Zodrow, 2003: 655-656).

We assume that country size is less important in *targeted tax competition* because the spillover effect into domestic tax policy is less pronounced: PTRs mitigate the policy dilemma of large states (or small high-tax states) between external competitiveness and domestic revenue; governments can retaliate against "aggressive" foreign competition at less fiscal cost than under general tax competition. Targeted tax competition may still be collectively harmful, and, thus, resemble a Prisoners' Dilemma, but the Dilemma is more symmetric: all states, large and small, suffer from the competition and would be better off without it.

In a completely institution-free setting, it would be up to national governments to decide whether to open up to international tax competition at all, and if so, in what mode and how aggressively to compete. An institutionalized setting, by contrast, constrains these choices in at least four ways.

First, the institutional setting affects the transaction costs of international tax arbitrage. Private firms will engage in cross-border factor or profit shifting only if the gains in terms of lower foreign taxation outweigh the costs in terms of dealing with capital and investment restrictions, exchange rate volatility or political hold-up risks.[1] Any reduction in transaction costs will increase tax arbitrage, all else being equal. This is why institutional settings which reduce the scope of capital controls, exchange rate fluctuations or political hold-up risks, i.e. settings which further market integration, will increase tax competition. We call this the *integration effect*.

Second, the institutional setting determines the number and heterogeneity of states which compete at the institutionally-defined level of market integration. An increase in the number of states tends to boost tax competition because, intuitively, it reduces the relative size of each state, and, thus, amplifies the incentive to cut taxes (see Hoyt, 1991 for a rigorous treatment). Heterogeneity matters because, as argued above, governments are more likely to engage in aggressive tax competition if states differ in size than if they are of about equal size. Also differences in affluence are likely to increase tax competition because poor peripheral states are more likely to use tax instruments to attract business investments and profits than rich core states (Franzese & Hays, 2007). This is why institutional settings which increase the number and heterogeneity (in terms of size and affluence) of competing states are likely to strengthen tax competition. We call this the *enlargement effect*.

Third, the institutional setting affects the transactions costs of intergovernmental tax coordination. In principle, governments can curb tax competition collectively by harmonizing tax rates and/ or devising common restrictions on PTRs. In practise, this requires the solution of various bargaining and enforcement problems. To the extent that the institutional context facilitates the solution of these problems (just see Koremenos, Lipson, & Snidal, 2001), it tends to mitigate the force of (some forms of) tax competition. We call this the *coordination effect*.

Finally, the institutional setting determines the scope of unilateral defences against tax competition. Governments can reduce their vulnerability to international tax arbitrage unilaterally by devising so-called anti tax avoidance rules. These rules impose extra tax or administrative costs on cross-border activities which are typically used for base shifting purposes.[2] Of course, there is a high potential for conflict with internationally mandated rules of openness and market integration. Therefore, the scope of national anti avoidance legislation depends very much on who adjudicates conflicts between national and international rules. If this task is delegated to supranational courts, the

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1 Foreign investment involves a hold-up risk to the extent that it is vulnerable to expropriation by the host country government.

2 For a short list of standard anti avoidance measures see e.g. Kiekebeld (2004: 92-95).

scope will be more limited than if it is taken on in intergovernmental negotiations. This we call the *judicialization* effect.

What are the consequences for tax competition in the EU? Our theoretic discussion has ambiguous implications. The first is that we would expect more tax competition within the EU. The level of market integration is high. The tax and regulatory barriers to cross-border activities of multinational corporations are low[3], and so are the monetary and political risks involved (integration effect). On top of that, the most recent round of enlargement has markedly increased the size and heterogeneity of the EU membership (enlargement effect), and the adjudication of norm conflicts between national and European laws is firmly entrusted to the ECJ, the European Court of Justice (judicialization effect). The second implication is that we would expect less tax competition than in the rest of world. The EU has sophisticated institutional machinery for bargaining and enforcement. This should greatly increase the probability of successful tax coordination (coordination effect). Also, while the delegation of legal adjudication to the ECJ may restrict the scope of unilateral defences against tax competition, empirical investigations into the ECJ's non-tax jurisprudence suggest that it is unlikely to prohibit them completely. In several instances, the Court has allowed national restrictions of European market freedoms to stand because they appeared reasonable and proportionate in light of imperative requirements of public interest. Some observers claim, therefore, that the role of the ECJ is not only, and maybe not even most importantly, to further market integration but to provide legal templates for the political re-embedding of the integrated market (e.g. Caporaso & Tarrow, 2007; Stone Sweet, 2004: 134).

III. HOW STRONG IS TAX COMPETITION IN THE EU?

In this section we analyse descriptive evidence on the strength of tax competition in the EU. We look at two indicators: statutory tax rates and preferential tax regimes. We find systematic evidence that statutory tax rates have fallen faster since the 1990s, and reached lower levels in the EU than in the rest of the world. We also find anecdotal evidence that the incidence of preferential tax regimes is particularly high in the EU. Both findings suggest that tax competition is stronger in the Single Market than elsewhere.

Under conditions of *general* corporate tax competition we should observe a decline in corporate tax rates. If competition is stronger in the EU than elsewhere, this decline should also be stronger. To test this hypothesis, we focus on the statutory tax rate because it is the single most important determinant of the effective corporate tax burden (e.g. European Commission, 2001:6) and a key factor for corporate tax planning and

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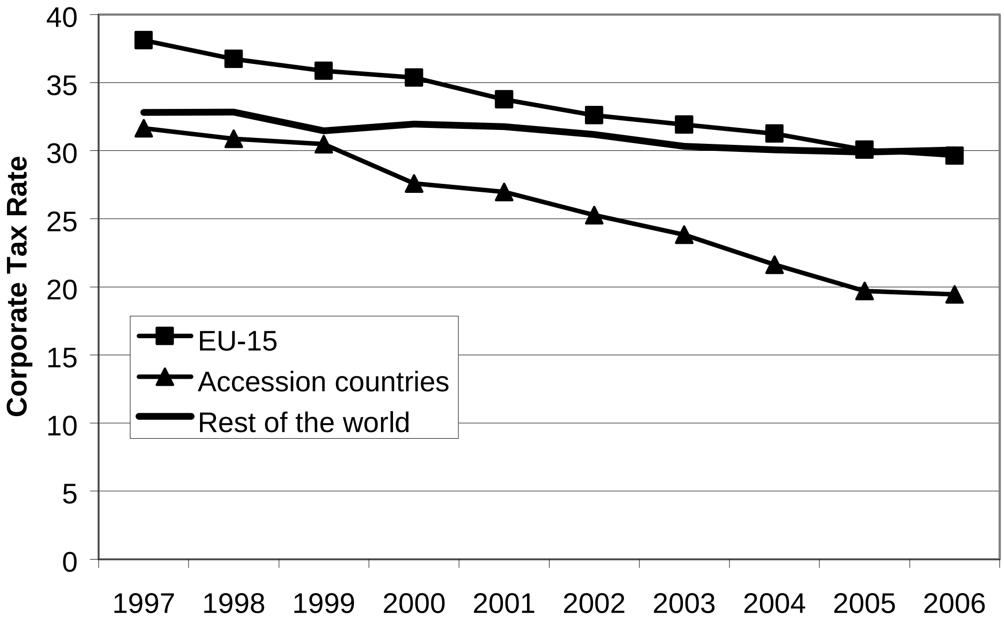
[3] See especially EC Treaty article 43 (freedom of establishment), article 56 (free movement of capital), and article 49 (freedom to provide services).

arbitrage (e.g. Devereux, Griffith, & Klemm, 2002). We limit our investigation to the time period between 1997 and 2006 because this gives us a maximum number of countries to observe. While general tax competition already emerged in the late 1980s (e.g. Ganghof, 2006; Swank, 2006), tax rate information for non-OECD states is too sketchy before 1997 to allow for a systematic comparison. Since Eastern Enlargement has changed the membership of the EU dramatically between 1997 and 2006, we sort the 61 countries in our data set[4] into three different groups: old EU member states (EU-15), new member states (Accession-12) and the rest of the world (RoW-34).[5]

Figure 1: The Development of Corporate Tax Rates, 1997-2006



Source: KPMG (1998, 2006), European Commission (2007), own calculation

4 The data set combines data from the European Union (European Commission Directorate-General Taxation and Customs Union, 2007) and the KPMG corporate tax survey (KPMG, 1998, 2006). Both data sets are highly correlated in 1997 (r = 98.98) and 2006 (r = 99.91) once obvious typing errors (data for Luxembourg and the Czech Republic in KPMG 1997) have been replaced by data from the 1998 of the KPMG survey.

5 The rest of the world includes Argentina, Australia, Bangladesh, Bolivia, Brazil, Canada, Chile, China, Colombia, Costa Rica, Dominican Republic, Ecuador, Fiji, Honduras, Iceland, India, Indonesia, Japan, Korea, Malaysia, New Zealand, Norway, Pakistan, Panama, Papua New Guinea, Peru, Philippines, Singapore, Sri Lanka, Switzerland, Thailand, Turkey, United States, and Vietnam. The accession countries are Bulgaria, Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Romania, Slovak Republic, and Slovenia. Finally, the well-known EU Countries are Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, and the United Kingdom. Note that our sample does not include pure tax havens such as the Cayman Islands or the Bahamas.

Figure 1 compares the *development* of statutory corporate tax rates in the three country groups. It clearly shows a universal decline: statutory rates have fallen in all three country groups. However, the decline is much more pronounced among old and new member states than in the rest of the world.

Under conditions of *targeted* tax competition we should observe an increase in the incidence of PTRs. If targeted competition is more pronounced in the EU than elsewhere, this incidence should also be more pronounced. Unfortunately, this proposition cannot be rigorously tested because PTRs are inherently difficult to quantify, and comparative data is scarce, especially for the ‘rest of the world’. Yet there is ample anecdotal evidence that PTRs have become more widespread since the 1980s, and that EU member states have been frequent users of PTRs.

As to the rising trend in PTR, we note that some preferential regimes are fairly old. Luxembourg’s special holding regime, for instance, dates from the late 1920s, the Dutch ‘cost-plus’ regime for multinational companies from the 1950s, and the Irish Export Sales Relief (ESR) for corporate profits from export and its tax breaks for the ‘Shannon Free Airport Zone’ also originated in that decade. However, with rising capital mobility, PTRs became much more popular in the 1980s and 1990s. The ‘first movers’ in the targeted tax competition game extended and refined their PTRs, while the ‘latecomers’ jumped on the PTR bandwagon. Ireland, for instance, replaced the ESR and the Shannon relief by a special reduced corporate tax rate of only 10 percent applicable to manufacturing activities in Ireland and to financial services provided in the Dublin Docks (Cunningham, 1995: 394-395). Belgium and Luxembourg set up preferential regimes for so-called ‘Coordination, Distribution and Services Centres’ in reaction to similar incentive schemes in the Netherlands (McKenzie, 1999: 317). Large countries responded by setting up their own regimes, for example, Germany (Monitoring and Coordination Offices), Spain (Basque Country and Navarra Coordination centres), Britain (Shipping), France (headquarter services) and Italy (Trieste off-shore financial and insurance services centre).

While PTRs are not uncommon outside the EU, they are particularly widespread in the EU. When the OECD monitored the prevalence of such regimes in its 30 member states in 2006, the EU-15 alone accounted for 55 of the 70 regimes on the list (OECD, 2006).[6]

[6] The list included 47 “potentially harmful regimes identified in 2000”, 14 “Holding Company Regimes and Similar Preferential Regimes” and 9 “preferential tax regimes introduced after 2000” (OECD, 2006:5-6).

IV. How integration and enlargement have boosted tax competition in the Single Market

Tax competition is only one reason why governments may want lower corporate taxation. But how do we know that it was competitive pressure and not, for example, "the spread of Neoliberalism" (Swank, 2006) that pushed corporate taxes down in the EU? To resolve this question, we focus on a simple indicator: country size. As explained above, the benchmark model of tax competition suggests that small states face stronger competitive incentives to cut tax rates than large states and, therefore, have lower rates in equilibrium. In line with this theoretical result, several empirical studies find a strong and comparatively robust correlation between country size and the level of corporate tax rates for different country samples: small states do indeed tend to have lower corporate tax rates than large states (Slemrod, 2004; Weichenrieder, 2005). Ganghof tracks this correlation over time and finds it to have grown substantially since the late 1980s in a sample of 21 OECD countries (Ganghof, 2006: 140). This suggests that tax competition has indeed been a major contributing factor in the universal decline of corporate tax rates.

Did tax competition also cause tax rates in EU states to decline faster than in the rest of the world? We compare the relationship between corporate tax rates and country size across the three country groups at two points in time (1997 and 2006). If the pressure is indeed higher inside the EU, the effect of country size on corporate tax rates should be stronger (and statistically more significant). This comparison is made more difficult by the recent round of accessions. While tax competition was largely restricted to the EU-15 states until the late 1990s, it increasingly extended to the Accession-12 afterwards. We therefore need to distinguish between two intersecting competitive effects in the EU, namely within-group competition among the EU-15 states (*integration effect*) and between-group competition between EU-15 and Accession-12 states (*enlargement effect*).[7] If within-group competition among the EU-15 states is stronger than in the Rest of the World, we would expect the tax rates of EU-15 states to display a greater sensitivity to country size than those of other states, i.e. similar changes in size should result in stronger changes of the rate. If competition between the EU-15 and the Accession-12 group is stronger than between the EU-15 and the rest of world we would expect the Accession states to have lower corporate tax rates compared with other states of similar size.

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[7] Of course, there is also within-group competition among the Accession-12 states. However, it is likely to be weak as compared to between-group competition with the EU-15. After all, Hungary and Slovakia compete not so much for each other's mobile capital but for mobile capital from Germany, Austria and other EU-15 states.

To test these predictions we perform two cross-sectional regressions each for 1997 and 2006. [8] The regressions relate statutory corporate tax rates to country size and to EU-15 and Accession-12 membership. We use the same tax rate data as in figure 1 above. In accordance with the literature, we measure ‘country size’ as the natural log of the population. In order to capture the integration effect, we construct a dummy for ‘EU-15’ membership and interact it with country size (EU-15 x Country Size). In order to test for the enlargement effect, we construct an ‘Accession-12’ dummy. This dummy allows us to check whether corporate tax rates are indeed lower in Accession states than in the rest of the world. In addition, we enter ‘affluence’ (i.e. the natural log of GDP per capita in purchasing power parities) as a control variable that summarizes a variety of domestic influences on the corporate tax rate. Tests of heteroscedasticity led us to use robust standard errors.

Table 1: The determinants of corporate tax rates, 1997 and 2006

	Dependent variable: corporate tax rate			
	1997		*2006*	
Independent variables	*A*	*B*	*A*	*B*
Country Size	1.29** (.59)	1.37** (.61)	1.17** (.55)	1.51*** (.44)
EU-15	4.58 (2.78)	3.99 (2.61)	-.08 (2.06)	-.63 (1.93)
EU-15 x Country Size	1.17 (1.94)	3.29 (2.27)	1.52 (1.52)	3.37** (1.40)
Accesssion-12	.60 (2.54)	.26 (2.59)	-8.36*** (2.13)	-9.38*** (1.80)
Affluence	1.38 (1.29)	1.18 (1.29)	.56 (.95)	.45 (.91)
Intercept	32.68*** (1.29)	32.57*** (1.30)	29.65*** (1.11)	29.42*** (1.04)
R2	0.21	0.26	0.46	0.62
Prob > F	0.04	0.02	0.00	0.00
N	61	59	61	59
Removed outliers	--	LUX, MLT	--	LUX, MLT

Sources: cf. footnote no. 4.
Notes: Robust standard errors in parentheses. ** $p < 0.05$, *** $p < 0.01$. Country size and affluence are both cantered.

How do the results (table 1) fit our theoretical expectations? With regard to country size, they confirm earlier findings: in all four models, corporate tax rates are positively and significantly related to country size. The evidence of this relationship is still weak in 1997. Auxiliary regressions excluding the interaction term show that in 2006 the relationship is slightly stronger and its significance considerably higher. We conclude that

8 The data set and a STATA 10 „do-file“ can be obtained from the authors.

tax competition is a global phenomenon and has become more pronounced since the 1990s.

The results also confirm the *integration effect*. The evidence is less straightforward, however, because the interaction term (EU-15 x country size) is distorted by outliers. A comparison of models a and b for the two years of observation shows that Luxembourg and Malta strongly influence the significance of the interaction term and the overall model fit (adjusted R^2 and F-Test). If we remove these two countries, the interaction term is positive and significant in 2006.[9]

The two outliers confirm the significance of targeted tax competition in the Single Market. With a population of less than .5 million people, Malta and Luxembourg have high statutory tax rates on a par with large countries such as Germany and Britain. This is not because they do not engage in tax competition but because they compete almost exclusively on PTRs. Small countries are free to compete on regimes or rates. If they opt for the former, their general tax rate will overshoot the level compatible with general tax competition (McKenzie, 1999). This is why our two most disturbing outliers are small states and why we have to exclude them in order to control for the effect of targeted tax competition on general rates.

Model b (2006) indicates that the sensitivity of the corporate tax rate to changes in country size is indeed stronger in the EU-15 than in the rest of the world: every time population size doubles, the average corporate tax rate in the rest of the world increases by about 1.5 percentage points, while in the EU-15 it climbs by almost five (1.5 + 3.4) percentage points. Note that the interaction term between country size and EU-15 membership is not significant for 1997: competitive pressures were not visibly stronger in the EU-15 than in the rest of the world in that year. We think this is no coincidence, given that since that year the EU became both more integrated (Monetary Union) and significantly larger (Eastern Enlargement). This interpretation is in line with the *enlargement effect*. In the regressions for the year 1997, the Accession-12 states cannot statistically be distinguished from the rest of the world. Ten years later, however, their corporate tax rates are far below what could be expected from their country size. According to model b (2006), they undercut the rates of other states of similar size by almost 9.5 percentage points. This highlights how strongly the enlargement process has increased the competitive incentive for the Accession countries.

In sum, our analysis demonstrates that it was the higher intensity of general tax competition that caused corporate tax rates in EU-15 and Accession-12 states to fall more quickly than in the rest of the world. In the case of the EU-15 states, this was mainly

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[9] We looked at partial plots and found that Luxembourg and Malta are clearly the most disturbing outliers. Removing another outlier, viz. Ireland, does not alter the results in any meaningful way.

due to the high level of within-group competition caused by European market integration. In the case of the Accession states it was mainly due to the high level of between-group competition with the EU-15 caused by enlargement. Our analysis also elucidates the interaction between general and targeted tax competition. For small countries, both forms of competition are close substitutes. Controlling for the PTR-based competitive strategies of Malta and Luxembourg therefore strengthens our findings about general tax competition.

V. LIMITED SUCCESS IN EU CORPORATE TAX COORDINATION

In the previous sections, we have shown that tax competition is stronger in the EU than in the rest of the world. In this section we analyse corporate tax coordination. We show that it is more advanced in the EU than in the rest of the world but still quite limited.

At the global level, corporate tax coordination is minimal and inconspicuous. There is a dense network of bilateral tax treaties to reduce tax barriers for cross-border economic activities, and there is the OECD "project on harmful tax practises" to stop international tax base "poaching". Launched in 1998, this project has suffered from serious disagreements among the member states, and seen its scope substantially reduced. The issue of corporate tax arbitrage is no longer covered (Rixen, 2008; Webb, 2004). At the EU level, by contrast, the issue of corporate tax coordination has been on the policy agenda since the 1960s with some partial success. While the member states have taken some steps to curb targeted (PTR) tax competition collectively, they have taken no action, to date, to contain general tax competition.

Already in 1960s, the Commission called for a harmonization of corporate tax systems, bases and rates in order to improve market integration and prevent tax competition (European Commission, 1967). However, the Council showed little interest and almost completely ignored the Commission's proposals. The Single Market program greatly increased the salience of corporate tax coordination in the 1990s. More coordination appeared to be needed in order to eliminate corporate tax obstacles that hindered the completion of the Single Market. With this purpose in mind, the Council adopted its first directives ever in the corporate tax field, the 'parent-subsidiary' and the 'merger' directive in 1990, and the 'interest and royalties' directive in 2003.[10] More recently, the Commission started to campaign for the introduction of a Common Consolidated Corporate Tax Base as a comprehensive solution to removing all remaining corporate tax

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[10] Two further directives amending the parent-subsidiary and the merger directive were passed in 2003 and 2005.

obstacles (Radaelli & Kraemer, 2008).[11] Many policy makers and tax experts felt that more corporate tax coordination was also required to curb corporate tax competition. In 1992, an expert report warned of a surge in general and especially in targeted tax competition in the Single Market, and presented a detailed list of countermeasures, including the introduction of a harmonized minimum corporate tax rate and of common restrictions on the use of PTRs (Ruding Report, 1992: 209-219). In 1996, tax Commissioner Mario Monti repeated both proposals in a memorandum on "Taxation in the European Union". Failure to take coordinated action on tax competition, he warned, would frustrate national efforts to boost employment and meet the 'Maastricht criteria' for Monetary Union (European Commission, 1996),

The 'Monti Memorandum' triggered an intense intergovernmental debate on corporate tax coordination. The debate quickly focused on the problem of targeted tax competition and set aside the issue of falling general tax rates. This narrowing of focus facilitated agreement for two reasons. First, the strategic structure of targeted tax competition is more symmetric than that of general tax rate competition, and, hence tax coordination to stop it less prone to distributive conflict (see section I above). Second, limiting tax coordination to PTRs offered something to everybody: it assured the self-perceived losers of corporate tax competition, such as France and Germany, that something was done against excessive competition while, at the same time, reassuring the champions of tax competition, such as Ireland, that the competition would go on, if only by restricted means.

In December 1997, the member states agreed on a soft law code of conduct for business taxation containing a non-binding political commitment to abandon ("rollback") "harmful" PTRs, and to refrain from introducing new ones ("standstill") (Cattoir, 2006). A group of high-ranking national officials (Code of Conduct or "Primarolo" Group) was assigned the task of reviewing existing tax incentive schemes in light of the Code's criteria of harmfulness. In November 1999, the group presented its final report, containing a blacklist of 66 harmful PTRs in the EU-15 states and their dependent territories ("Primarolo Report"). With the exception of Sweden, each member state was represented by at least one entry on the list. This highlighted the symmetry of the underlying cooperation problem. The Council formally adopted the list in 2003, and decided to make compliance with the principles of the code a condition for EU membership. What was soft law to the old EU-15 states became hard law for the accession states. The

[11] The common consolidated corporate tax base combines three elements: a) a common definition of the tax base, b) group consolidation, and c) a common sharing rule for tax base allocating among the member states (formula apportionment).

European Commission screened their corporate tax codes for PTRs and identified 30 harmful regimes, which had to be abolished before accession.

Even for the EU-15 states, the Code of Conduct was not entirely soft law because it contained a self-commitment by the Commission to apply strictly the state aid rules (articles 87-89 EC Treaty) to PTRs. Shadowing the work of the Primarolo Group, the Commission re-examined all existing PTRs, and, in 2001, opened official investigations into 15 tax regimes on the Primarolo blacklist (Radaelli & Kraemer, 2008: 327). This sent a clear signal to the member states that the Code of Conduct operated in the "shadow of competition law", and, arguably, increased incentives for voluntary compliance.

Some member states, including Malta and Luxembourg complied by "amending" their PTRs so as to circumvent the Code's formal criteria of harmfulness. Others abolished "harmful" PTRs completely but, at the same time, slashed their general tax rates. The most prominent example is Ireland, which cut its standard corporate tax rate to 12.5 percent in return for abolishing its special 10 percent rate regime. Hence, to the extent that the Code is effective in constraining targeted tax competition, it tends to fuel general tax rate competition (Keen, 2001).

In 2004, Germany and France launched a new bid for a common minimum corporate tax rate to mitigate general tax competition (Ganghof & Genschel, 2008: 58). However, the prospects of reaching an agreement were even less auspicious than in the 1990s. The integration effect of Monetary Union and an arbitrage-friendly tax jurisprudence of the ECJ (see below) had deepened the structural conflict between large losers and small winners of tax competition, while the enlargement effect of the Eastern accession had greatly increased the number of winners: Germany and France were no longer up against the resistance of Ireland alone but also that of Estonia, Slovakia and other new member states, intent on copying Ireland's low corporate tax strategy. The Commission also refused to support the Franco-German initiative (Kovács, 2004), partly out of fear that it could derail its priority project, the common consolidated corporate tax base.

Many observers attribute the limited success of corporate tax coordination to the persistence of the unanimity rule in tax matters (e.g. McLure, 2007: 124; Radaelli, 1995: 160; Ruding Report, 1992: 45). However, this explanation is not entirely convincing, because the unanimity requirement makes agreement difficult but by no means impossible, as the long list of harmonization measures in indirect taxation clearly indicates (Terra & Wattel, 2005: ch.6 and 7). Also, more fundamentally, decision rules are endogenous to the underlying cooperation problem and, hence, have to be treated as part of the explanandum (Genschel, Rixen, & Uhl, 2007: 752-753). It is not by coincidence that Germany and France campaigned for the introduction of qualified majority voting in tax matters during the negotiations on the European Constitution, while Ireland and

Estonia were among the most outspoken critics of this proposal (see Department of Foreign Affairs, 2005: 55; Fischer & Villepin, 2002: 4; Parts, 2003: 4).

In conclusion, in marked contrast to the rest of the world, there have been sustained efforts to curb collectively corporate tax competition in the EU. However, these efforts met with only limited success. While the member states managed to agree on a Code of Conduct to limit (some forms of) targeted tax competition, they failed at tax rate harmonization. In fact, to the extent that the Code is effective in curbing targeted tax competition, it may, indirectly, fuel general tax competition and thus further aggravate distributive conflicts over tax rate harmonization.

VI. THE CORPORATE TAX JURISPRUDENCE OF THE EUROPEAN COURT OF JUSTICE

If attempts to curb corporate tax competition collectively have met only limited success, why don’t member states recur to anti tax avoidance legislation? Actually they do, but are increasingly constrained by the case law of the ECJ.

Outside the EU, national anti tax avoidance legislation is not subject to any supranational judicial review. While most bilateral tax treaties contain a so-called mutual agreement procedure to resolve conflicts of treaty interpretation, this procedure is diplomatic rather than judicial in nature. Judicialization is low. With respect to the compatibility of national anti avoidance measures and international tax treaty law, national governments have the last word (Rixen, 2008).

Table 2: The corporate tax jurisprudence of the European Court of Justice

Year	*Cases∗*	*of which:*	
		Preliminary rulings	*“lost” by Member State∗∗*
1958-1992	1	0	1
1993-1997	5	5	4
1998-2002	17	16	14
2003-2007	20	19	12
∑ 1958-2007	43	40	31

Source: Eur-Lex, own calculations

Notes: ∗ cases refer to judgements of the ECJ dealing with corporate tax issues. Judgements on state aid/ competition policy are excluded even where they involve corporation taxation. Orders are also excluded. ∗∗In the case of preliminary rulings, actions are coded as “lost” if the operative part of the judgement contains a statement to the effect that the relevant provisions of EU law “are to be interpreted as precluding legislation of a Member State, such as the tax legislation in question in the main proceedings”. If by contrast, the Court rules that the national legislation are “not precluded” by EU law either in part or in total, the case is coded as “not lost”.

In the EU, by contrast, all national tax legislation is subject to judicial review by the ECJ. Starting in 1986, the ECJ has developed a significant body of case law in the corporate tax field. Table 2 shows some pertinent features of this development. First, the number of cases is still low but has been increasing regularly. The case load quadrupled from only 5 cases in the time period 1993-1997 to 20 cases between 2003 and 2007.

Second, almost 95 percent of all corporate tax cases (40 out of a total of 43) have reached the Court by way of the preliminary reference procedure: they start with a claim, brought forward by a taxpayer in a national court, that a particular national corporate tax provision is inconsistent with EU law. The national court refers the case to the ECJ for an authoritative judgement of the relevant provisions of EU law. On the basis of this judgement, the national court finally decides the case. Since taxpayers are willing to incur the costs of litigation only when they hope that success will lower their tax burden, the cases that reach the ECJ usually concern national tax laws which are costly to taxpayers but essential to tax authorities, such as, notably, anti tax avoidance provisions. Hence, the prevalence of the preliminary rulings procedure implies an inherent tax reduction bias of the cases brought. The best outcome a member state can reach in these cases is to defend the tax policy status quo (Graetz & Warren, 2007: 293)

Third, the member states rarely obtain the best possible outcome. Between 1986 and 2003, they "lost" more than 80 percent of the corporate tax cases before the ECJ (19 out of 23). While their chances of success have recently improved (12 cases lost out of 20 between 2003 and 2007), the odds against victory are still considerable. Frequently, the Court regards incriminated national tax rules as submitting cross-border transactions to less favourable tax treatment (in terms of tax burden and/or compliance costs) than essentially similar domestic transactions, and, consequently, rules them to be inconsistent with the "four freedoms" of the EC Treaty (free movement of goods, services, persons and capital).

To be sure, not all national laws of a restrictive nature automatically violate the Treaty. In its non-tax case law the Court has repeatedly allowed (non-discriminatory) restrictions to the free movement of goods and services to stand because (a) they serve imperative requirements of public interest and (b) are proportionate to the objective pursued (i.e. protect the public interest in the least restrictive way) (e.g. Nicolaidis & Schmidt, 2007; Pelkmans, 2007; Stone Sweet, 2004: ch.3). In its corporate tax case law, by contrast, the Court has been extremely reluctant to accept justifications for restrictive national provisions (Aujean, 2007; Terra & Wattel, 2005: ch.2). Perhaps most importantly, it has consistently refused to accept revenue requirements as an imperative requirement of the public interest: it does not allow member states to uphold restrictive tax laws simply because removing them would result in a loss of revenue. If corporations exploit the lower level of taxation in another member state, this is, according to the Court, not an abuse to be stopped but a legitimate right to be protected in the Single

Market (Terra & Wattel, 2005: 146)[12]. Only “purely artificial” arrangements are considered abusive by the Court: letterbox companies do not enjoy Treaty protection. However, even in these cases the Court has been very reluctant to accept the need for efficient fiscal supervision as a justification for restrictive national tax rules. It has usually taken the view that mutual administrative assistance among the member states can guarantee the same outcome in a less restrictive way, and, therefore, struck down national anti avoidance rules for lack of proportionality.[13]

The ECJ corporate tax jurisprudence restricts the freedom of the member states to rely on national anti tax avoidance rules for protection from international tax competition. By providing guidelines for what is or is not lawful corporate tax policy, the jurisprudence also has an indirect harmonization effect (see Stone Sweet, 2004: 134). The Commission tries to steer and enhance this harmonization effect by issuing interpretive communications on specific Court rulings (e.g. European Commission, 2007a). The key message is usually that the member states have to tear down the protective walls they built around their domestic tax claims in the past either unilaterally or, preferably, by supporting the Commission’s initiative for a common consolidated corporate tax base. The communications are non-binding but serve as common reference points for national governments, potential litigants and also the ECJ, and, thus, synchronize perceptions and decisions.

In conclusion, the ECJ’s tax jurisprudence has restricted the scope of national anti tax avoidance legislation and, thus, indirectly fuelled corporate tax competition in the Single Market. By forcing the member states to grant equal treatment to essentially similar domestic and cross-border corporate activities, it has come close to giving corporations “an option where to be taxed” (Lang, 2007: 53). Recent judgements have been less strict, allowing some restrictive tax rules to stand and acknowledging, at least implicitly, that national tax systems may not only be something to be pried open but also as something to be protected.[14] It is still too early to say, however, whether this indicates a fundamental change of the ECJ’s corporate tax jurisprudence.

VII. THE FUTURE OF EUROPEAN TAX COMPETITION

In this paper, we have shown that corporate tax competition in the EU is shaped by four interrelated effects. The *integration effect* of one market (Single Market program), one currency (monetary unification) and one law (acquis communautaire) reduces the trans-

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[12] See e.g. the *Eurowings* case (C-294/97) concerning German anti avoidance measures applied to a company making use of the Irish ‚Shannon Free Airport Zone’.

[13] However, see the recent *Kofoed* case (C-321/05) 2007.

[14] See e.g. the cases *Marks & Spencer* (C-446/03) 2005, *Oy AA* (C-241/05) 2007, or *Lidl Belgium* (C-414/06) 2008.

action costs of cross-border tax arbitrage in the Single Market. The *enlargement* effect of the recent accession of Eastern countries greatly enhances the heterogeneity of the EU membership in terms of country size and affluence, and thus increases the competitive constraints on governments. The *coordination effect* of the code of conduct for business taxation restricts the scope of targeted tax competition, and diverts competitive pressures to general tax rates. The *judicialization effect* of the ECJ's corporate tax jurisprudence limits the ability of national governments to fight tax competition unilaterally by national anti tax avoidance legislation. All four effects combined have given corporate tax competition a boost since the 1990s. We presented systematic evidence that general tax rate competition is significantly stronger in the Single Market than in other parts of the world. We also offered anecdotal evidence that intra-EU targeted tax competition is stronger (or at least has been stronger until recently) than extra-EU competition.

What is the future of tax competition in the EU? The answer depends very much on the further development of the four above-mentioned institutional effects. We offer the following predictions.

The integration effect is unlikely to relax very much. The Single Market and the acquis communautaire are shared by all 27 member states, while other important policy areas (money, defence, justice and home affairs) follow, de jure or de facto, the logic of differentiated integration. Therefore, any backtracking on market integration and legal integration would immediately raise the question what else could keep an increasingly diverse Community together.

The enlargement effect also seems unlikely to relax. Eastern Enlargement was the EU's only major success in recent years. It is unpopular in some old member states but the foreign policy rationale for further enlargement is strong (e.g. The Economist, 2008). Croatia, Macedonia and Turkey already enjoy candidate status while Albania, Bosnia, Montenegro, Serbia and Kosovo are considered as potential candidates. All of these countries are poor compared with the EU average and most of them are very small. Once admitted to the club, the incentive for them to engage in aggressive tax competition would be very high.

The coordination effect is difficult to predict. There is concern that the effectiveness of the Code of Conduct could be undermined by the avoidance strategies of member states, which adapt their PTRs to the letter but not the spirit of the Code. However, there is also talk about the possible widening of the scope of the Code. This could potentially increase its effectiveness (Cattoir, 2006: 14.). More importantly, the Commission's project to establish a common consolidated corporate tax base has the potential to bring about a fundamental transformation of tax competition in the Single Market. Many experts argue that its adoption would not reduce and could quite possibly increase competitive pressure on the statutory tax rate, partly because the statutory rate would be the one remaining policy variable in an otherwise comprehensively harmonized corporate tax system (e.g. Sørensen, 2004). However, precisely because it is so tightly linked to the tax rate, it could also make tax rate harmonization more likely. While the Commission denies it (e.g. European Commission, 2007b: 6, 8), some observers view the common consolidated corporate tax base as just a “stalking horse” for achieving tax rate harmonization (Graetz & Warren, 2007: 298). Many small member states including Ireland, Malta, Slovakia, Lithuania, Latvia, Cyprus and Estonia have raised objections to the project (Weiner, 2007). To pre-empt their opposition, the Commission has proposed that the common consolidated base could be adopted by a coalition of the willing rather than the entire membership (“enhanced cooperation”). This would create two areas in the Single Market, in which corporate tax competition follows different institutional rules.

The judicialization effect is equally difficult to gauge. A lot depends on whether the recent (moderate) softening of the ECJ’s corporate tax jurisprudence marks just a temporary aberration from its earlier more activist case law or a permanent change towards more judicial self-restraint. The temporal coincidence with Eastern Enlargement may be purely accidental. However, it could also signal an implicit acknowledgement that a heterogeneous Community of 27+ member states cannot be held to the same standards of negative integration, i.e. tax competition, or positive integration, i.e. tax harmonization, as the much more homogenous EU-15 group.

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