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"Is Ireland's corporate tax system creating tax-induced distortions on the location of investment?"

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Abstract

Conventional wisdom suggests, in the face of deepening European integration, that without some form of tax harmonisation "a race to the bottom" would ensue undermining the foundations of Europe's welfare states. Such wisdom can be questioned on two grounds. Firstly, Member States are not on the same "playing field" as there is great disparity between the various Member States in terms of industrial development, geographical location, wealth, not to mention market size. Market size is important because this permits viable local expansion without incurring the additional costs international expansion entails. Secondly, the necessity of constraining tax competition is questionable based on the new economic geography literature. This literature preaches that investment may not respond to marginal changes in tax if locked in by the presence of agglomerative forces. Ireland forms the case study of this paper for the following reasons: geographic location, traditional lack of industrial development, small domestic market size, growing levels of investment inflows, and the country's provision of a low tax regime. The paper determines that while taxation has been a factor in Ireland's successful attraction of investment it cannot be attributed to this factor alone. Rather domestic industrial policy has played a significant complementing role that has fostered the growth of agglomerative forces in Ireland. The legal sustainability of the Irish tax system against the Treaty of Rome is furthermore ascertained.

Methodology

Assessing taxation effects on the location of economic activity and investment presently occupies a high priority among Europe's "policy setters". The culmination of countless reports and initiatives are the Business Code of Conduct [COM (1997) 564], and more recently the Commission communication, "Company Taxation in the Internal Market" [COM (2001) 582]. Considering the large volumes of secondary research on the topic of European taxation, I felt urged to base my work on this research as I disagreed with the application of their findings to Ireland. Indeed the title of this paper is a partial quote from the Business Code of Conduct's definition of a potentially harmful tax measure (PHTM); that is, "tax induced distortions on the location of economic activity". My disagreement is largely founded on the new economic geography literature and the effects of agglomerative forces on the location of investment. In particular research conducted by Baldwin, R., and Krugman, P., (2001) has had a supportive influence in the direction this paper pursued. In the case of Ireland, the country's economic progress has been well documented in recent years. Ireland throughout the 1990s has been one of the fastest growing economies in the European Union and OECD, a growth which has lead the economy to be christened "the Celtic Tiger" by market analysts. Countless amounts of research have mapped this "economic transformation" but the application of this research to European tax law has not, to my knowledge, been highlighted.

To remain within the perimeters set by the Masters programme, the paper's guidelines were to give a demonstration of the collaboration of economic and legal thoughts within the European framework. I felt that for the purposes of my chosen topic, this demonstration would not suffer by being primarily based on secondary research for the reasons cited in the previous paragraph. That is why my paper is dominated by a manipulation and fusion of secondary research to further my arguments on why the constraint of tax competition is flawed with application to Ireland.

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1. Introduction

Cross-border tax harmonisation is notoriously difficult to achieve because sovereign states are unwilling to accept restrains on their powers to tax. It is therefore unsurprising that despite a long history of reports and initiatives on the issue that the 15 Member States continue to operate 15 distinct taxation policies. However, it is apparent there is an urgency at EU level to address this issue. Increased capital integration has given an impetus to capital mobility, and hence to the tax-sensitivity of investment decisions. It follows that Member States are increasingly encouraged to use tax incentives to promote and tailor their economies as the best alternative for the attraction and retention of investment.

The sensitivity of investment decisions to taxation policies has generated a debate fuelled by great concern and interest, as the constraint of tax competition may be regarded as benefical or distortionary depending on the observer's point of view. Those who defend tax competition[1] cite that it encourages operational efficiency in governments by constraining excess, and thus ensures that national governments remain responsive to citizens' preferences. Tax competition's defenders argue that competition provides the most efficient means to the end of harmonisation of tax rates and provisions. Market forces act as a vehicle that drive the national tax systems towards convergence in a world of freely moving goods, people, and capital. In contrast, opponents of tax competition[2], describe tax competition in terms of economic distortions on the location of investment, the lowering of tax yields and the deterioration of the welfare state.

A new departure at EU level addressing the taxation issue is the Code of Conduct on Business Taxation[3]. The Code embodies a new policy approach in that while earlier reports recommended harmonisation the emphasis of the Code is tax co-ordination[4], an approach that accords with the principle of subsidiarity[5]. The subsidiarity principle in the context of the Community means that, the greater the spillover effect of a particular national policy vis-à-vis other Member States, the greater the need for co-ordination at

[1] Ellis, M., (1999). Also see "Tax Competition: Harmful or Benefical?" Editorial Intertax, Volume 27, Issue 3. Kluwer Law International 1999.
[2] Hendricks, B., (2000).
[3] "A Package to Tackle Harmful Tax Competition in the European Union", COM(1997)564.
[4] The Ruding Report (1992) defined harmonisation as the occurrence of greater convergence as a result of action at Community level by the Commission or other agencies of the Community such as the European Court of Justice (ECJ). Coordination is defined as any action or measures taken by the Commission or some or all EU States to influence the tax policies of Member States.
[5] Art. 5 (ex 3b) of the Treaty of Rome establishes the principles of subsidiarity and proportionality and states that of attributed powers.

Community level. In effect it imposes a burden of proof to justify action by a higher level of governance firstly by assuring that action taken is justified and secondly that any action taken is the minimum necessary to achieve the desired objective. It follows that an evaluation of the Code under the principle of subsidiarity may alarm proponents of tax competition as it coaxes Member States from their entrenched positions towards co-ordination of their respective tax policies.

The principal assumption underlying the Code of Conduct is that but for preferential tax regimes the competitive tax position of all countries is equal[6]. However the issue of whether tax co-ordination is actually needed has been inadequately addressed. Attempts to neutralise the influence of taxation rates on investment choices may be misconceived for two reasons. Firstly, the Code attempts to level a playing field that by definition is uneven. It ignores the fact that there is great disparity between Member States, both on an economic and geographic level. Members at the advanced "core" of the Union are traditionally associated with generous welfare states and tend to be countries that have long been wealthy. These Member States offer large domestic markets permitting sustainable local expansion without incurring the major set-costs associated with unfamiliar territories, such as uncertainty costs and the costs of investigating new markets. In contrast, expansion for investors located in small domestic markets usually translates as investing abroad.

Secondly, conventional wisdom would suggest that without some form of tax co-ordination within the EU, there would be destructive tax competition, a "race to the bottom" that will undermine the long-term sustainability of Europe's welfare structures. However there remains little concrete evidence to suggest that there is "a race to the bottom" in Europe actually occurring. Adding the teachings of economic geography into the analysis may offer the reason why. "With agglomerative forces operating, perfectly mobile capital becomes a quasi-fixed factor and investment is not indifferent to location in equilibrium"[7]. Local expansion of a sector sows the seeds for further growth by increasing the supply of the factor that made the location attractive in the first place[8]. Favourable external economies emerge for investment such as the advantages of an established base of infrastructure, accumulated experience, established customer and supplier bases and well trained workforces. What develops is economic concentration, which encourages continued geographical concentration and its implications for tax competition is clear. In principle the less industrialised, periphery Member States could compete for the core's industrial bases by

[6] Today capital and income move world-wide in search of tax havens. Just as the Code seeks to define as harmful and control some of this movement in the EU, so has the OECD taken the initiative in defining harmful tax competition in the global scene.
[7] Baldwin, R., and Krugman, P., (2001).
[8] Head, K., Ries, J., and Swenson, D., (1995).

charging low taxes. But as the core has an agglomeration advantage, a zero tax rate might not be sufficient to induce firms to relocate.

However there is a point where investment will have an incentive to move away from the core and locate on the periphery. If the costs of investing rise relative to the gains of location within the core, investment has an incentive to move away from the core and settle on the periphery. With deeper European economic integration the decline in transport costs and improvements in communications will further spur investment flight away form the core. At this juncture, the Member State that offers the most honest and efficient regime will determine the choice of location on the periphery, if the benefits of location in this Member State offset or compensate for the disadvantages of locating away from the core. It follows that the Member State that is successful in the attraction of this investment can, combined with the establishment of the right institutional and support structures, start its own agglomeration economy.

The purpose of this paper is to further enrich the tax competition's proponents' viewpoint that tax competition does not induce tax distortions on the location of investment. Rather in the presence of agglomerative forces the effect low taxes have in inducing investment flight is qualified. Locational competition is not monopolised by taxation factors alone as governments can contribute to a country overall attractiveness. There are many other, non-tax, factors that are of equal importance, if not higher importance in investment location decisions[9]. For instance, location specific government expenditures on the quality of a country's social and economic infrastructure can have both a positive and a negative influence on a country's overall investment attractiveness. This according to Barry, Görg, and Strobal[10] can complement the growth and sustainability of an agglomeration economy, as through the provision of public goods, governments can determine the attractiveness of their country as a location for investment.

Ireland, as a country situated on the periphery of the Union, forms the centrepiece of this paper because despite the small size of Ireland's domestic market the country has been successful in attracting growing levels of foreign direct investment (FDI) in recent years. This growth of FDI would seem to add further fuel to the opponents' of tax competition fire. Ireland offers investors a low-tax regime, which for opponents' of tax competition is inducing economic distortions on the location of investment. Such an analysis, however, ignores that Irish Industrial Policy since EU membership in 1973 has been a more focused and deliberate targeting of investment in sectors where comparative advantage could be built. This "new" direction in policy has been complemented by the development over time of the support

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[9] "A Business View on Tax Competition: Prepared by the Business and Industry Advisory Committee to the OECD (BIAC)" June 1999.

structures needed to foster the development of agglomeration economies. This paper will demonstrate that Ireland's growth in investment inflows is not exclusively linked to a low tax regime but to the operation of agglomerative forces in Ireland which are functioning as a magnet in the attraction and retention of investment.

The paper is organised as follows. Part 2 will give a selective review of theoretical arguments concerning the influence taxation has on investment location. This review will be supplemented by considering the effects economic geography might have on investment location. Part 3 begins with a review of Irish industrial policy in relation to the attraction of investment. Since the mid-1970s Irish policy has focused on the development of industrial clusters. Part 3 shall further investigate if this policy has been successful in its objectives. Part 4 will contain an examination of the Irish corporate tax system in relation to Art.96 (distortion of competition) and the state aid rules of the Treaty of Rome to determine if the tax system is in violation of these rules. Part 5 will offer concluding remarks.

[10] Barry, F., Görg, H., and Strobl, E. (2001).

2. A Review of Literature on Taxation and Investment

2.1 To harmonise or to compete?

As noted previously, the constraint of tax competition may be benefical or distortionary depending on the observer's point of view. Tax competition has been defined as the process of tax policy decisions by which rational governments optimally respond to the tax measures of foreign governments, in order to improve the economic situation in their constituency[11]. The potential benefits arising from tax competition speak in terms of higher allocation efficiency and increased competition, as tax competition is regarded as a vehicle to tame over-expanded "Leviathan" governments[12]. Competition reduces political distortions that arise from politicians pursuing their own motivational goals that deviate from their citizen preferences such as realising their ideology, social prestige, and material gain. Politicians therefore have an incentive to take account of their citizens' preferences, to provide an efficient combination of taxes and public services, and are induced to offer the right amount of public services at the right price.

However despite the potential benefits competition may entail there is concern of the location effects on investment economic integration might have. The EU principle of tax neutrality in investment decisions suggests that goods produced in any Member State should be burdened with the same tax rates in order to allow suppliers to produce where the real costs are lowest. Tax harmonisation would seem to be the most appropriate and efficient means to realise tax neutrality, as harmonisation is the process that results in Member States reducing the fiscal externalities that result from non-cooperative strategic decisions. In effect, this means the adoption of a common tax rate. Reports such as the Ruding Report[13] favoured the harmonisation approach, but the Member States have remained disinclined to give up sovereignty on corporate tax matters.

The evaluation of tax competition has had a long and varied history in economic literature. "The point of departure for this literature is the coexistence of immobile and mobile factors of production in a group of politically sovereign jurisdictions, and the question to what extent public goods can be financed by means of taxes on mobile factors"[14]. The common cord connecting economic observations is that the level of taxation on mobile factors will be distorted downwards compared to a scenario where all factors are

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[11] Frey, Bruno S., and Eichenberger, R., (1996).
[12] Edwards,J., and Keen,M., (1994).
[13] Commission of the European Communities, Report of the Committee of Independent Experts on Company Taxation, 1992, ("Ruding Report")
[14] Andersson, F., and Forslid, R., (1999).

immobile. This according to Gordon[15] can be attributed to the inefficiencies of de-centralised policy making within a federal governance system, in that local government will ignore the effects of its decisions on the utility levels of mobile non-residents. Wildasin[16] further verifies the inefficiency argument by relating public expenditure levels to tax rates. His research finds that jurisdictions choose levels of public expenditures as strategic variables, in that, there is a reluctance to raise expenditures because the higher tax rates this would entail would reduce the amount of attracted capital. Therefore, capital tax competition implies that national governments strategically adjust their taxation policies to avail of new situations, particularly to tax rate changes of their competitors.

Other commentators have qualified the basic result that taxes are distorted downwards. Wilson[17] identifies the inefficiencies in government behaviour that are not apparent in models in which the terms of trade are exogenously given. The finance of public expenditures with taxes on mobile capital may lead to an inefficient supply and distribution of public goods. Capital taxation is shown to create an inefficient distribution of public goods outputs across regions, accompanied by an inefficient pattern of investment and trade. Wilson comments that in an attempt to attract investment via low tax rates, local officials may hold public expenditure below those levels for which marginal benefits equal marginal costs.

In light of the above, tax harmonisation, or any method of containing tax competition, seems an entirely reasonable proposition as tax competition has produced only sub-optimal tax rates. A tax harmonisation agreement among the various Member State governments of the European Union would seem to be like price-fixing cartels among firms (i.e. an attractive solution to all negotiating parties). However this is inconsistent with the fact that European barriers to investment flows have been falling almost continuously since the 1950s, an impetus inherent in the signing of the Treaty of Rome. It follows that if the traditional view of tax competition were correct, then the Member States should have already experienced a degree of tax competition, and falling tax rates would be expected, that is, "a race to the bottom".

According to a speech given by Zalm[18], there appears at first sight to be a race to the bottom. "On average, EU-statutory corporate income tax fell from around 38% in 1990 to 33% in 2000". However Zahm comments further that for a more accurate conclusion that there is actually a race to the bottom, one must

[15] Gordon, R., (1983).
[16] Wildasin, D., (1988).
[17] Wilson, J., (1987).
[18] Minister Zalm, "Tax Policy in the EU: some lessons from the past with relevance for the future". Conference "Tax Policy in the European Union", organised by the Netherlands Ministry of Finance in co-operation with OCFEB. Versie, October 18th 2001.

consider effective tax rates. Zahm cites that research conducted by the Netherlands Bureau for Economic Policy Analysis shows that the effective tax rates on corporations in Europe have not declined. In fact, the mean effective tax rate in the EU has remained almost constant. Staatssecretaris Bos further certifies this research by stating that "we have no empirical evidence yet of a race to the bottom in the EU"[19].

2.2 Why is there no evidence of a "race to the bottom"?

- Agglomeration economies

Through long developed relationships, certain regions develop expertise in specialised types of production that operate as a magnet for the attraction and retention of investment in particular production segments. Indeed investors may choose a specific country for investment based purely on its locational advantages as the following statement illustrates:
"The high costs of Standort Deutschland have so far been offset by other advantages of producing in Germany, not least the size of its national market and its location at the core of the European market".[20]

For a variety of reasons, it is often the case that concentrating investment in a single or a limited number of locations reduces industry costs, even if the individual firms in the industry remain small. When economies of scale arise at the level of the industry rather than at the level of the firm, there exists an agglomeration economy. Modern examples of industries where agglomerative forces are operating include the concentration of the semi-conductor industry in California's Silicon Valley, and the entertainment industry concentrated in Hollywood.

There are three main reasons why benefits accrue to firms who locate close to each other rather than to an individual firm in isolation:
(1). Knowledge spillovers between firms. Knowledge spillovers arise when one firm's innovative activity leads to new ideas and an enhancement of innovative activity in a second firm without the second firm having to compensate the inventor. An important source of knowledge spillovers is the informal exchange of information and ideas at a personal level. This kind of informal diffusion of knowledge is most likely to take place when an industry is concentrated in a fairly small area, so that employees of different firms can freely mix socially and exchange knowledge of technical issues. Or as Alfred Marshall puts it:

[19] Staatssecretaris Bos, "Corporate income taxation in the European Union: A re-visit to Robert Schuman and Jean Monnet". Conference "Tax Policy in the European Union", organised by the Netherlands Ministry of Finance in co-operation with OCFEB. October 18th 2001.
[20] Vording, H., (1999).

"The mysteries of trade become no mystery; but are as it were in the air…. Good work is rightly appreciated, inventions and improvements in machinery, in processes and the general organisation of business have their merits promptly discussed: if one man starts a new idea, it is taken up by others and combined with suggestions of their own; and thus it becomes the source of further new ideas"[21].

(2). The advantages provided by thick markets in specialised factors especially labour. If there are thick markets for specialised labour adjustment costs can be assumed to be low, as labour can move easily and hiring and firing costs are low. In such an environment, workers tend to move frequently between jobs, thus providing a readily accessible common labour market pool for existing firms and potential firms within the sector.

(3). The scope for backward and forward linkages between customer and supplier firms. In many industries, the production of goods and services requires the use of specialised equipment or support services, yet a single company does not provide a large enough market to keep the suppliers in business. The development of a localised cluster solves this problem by providing a market for suppliers.

Even if these efficiency conditions are not present, firms may find it rational to agglomerate spatially. In this case there may be a demonstration effect emanating as if there is an uncertainty about locations in which to invest, investors may exhibit a tendency to imitate each other's location decisions[22]. This arises because investors locating in a "good" location provide a signal to other investors, and to banks which provide the funds for investments[23]. Banks conclude that investments in good locations have higher probabilities of success and it follows that banks will have a higher propensity to provide funding for investments in "good" locations than for investment in "bad" locations. As other firms observe and become aware of this choice mechanism, they have an incentive to choose the same "good" location for their investment.

Likewise, consider the following scenario. Firms A and B are competitors in the same product segment exporting products to country X. If A establishes a manufacturing subsidiary in country X, firm B uncertain of the production economies that A might be gaining from manufacturing locally, faces the possibility that it could be underpriced by A. By establishing a manufacturing subsidiary in country X, firm B can protect itself and its market share should A resort to price competition[24].

[21] Jönsson, C., Tägil, S., and Törnqvist, G. (2000).
[22] Barry, F., Görg, H., and Strobl, E. (2001).
[23] Barry, F., Görg, H., and Strobl, E. (2001).
[24] Leahy, D. and Pavelin, S. (2001).

Baldwin and Krugman[25] suggest that tax competition is something subtler than a race to the bottom. The purpose of their research was to investigate the effects of agglomeration economies on international tax competition and market integration. In doing so, the authors divided Europe into two parts: an advanced 'core' that benefits from agglomeration economies, and a 'periphery' that does not. This division was associated with specific countries: Benelux, France, Germany and Italy with the core, and Greece, Portugal, Spain and Ireland with the periphery. From a theoretical viewpoint, their research demonstrated that by adding the influence agglomeration economies have on investment location nothing like a race to the bottom has been evident. Furthermore, within limits, this allows these States to retain investment even while levying higher tax rates than less advanced Members on the periphery of the Union.

Table 1 below offers supportive evidence of Baldwin and Krugman's research. The table highlights effective corporate income tax rates which take account of the implications of differences in tax base, allowances for depreciation, etc., that exists between the Member States.

Table 1: Effective corporate income tax rates across the EU, %[26].

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Austria	18	22	14	16	20	17	24	25	21	24
Belgium	17	16	22	23	23	24	23	22	21	17
Denmark	33	32	30	30	32	32	31	31	32	31
Germany	48	49	49	44	41	41	41	40	40	41
Finland	45	37	34	24	26	27	28	28	28	28
France	33	33	33	33	33	36	35	38	38	38
Greece	11	11	24	29	29	31	33	35	35	35
Ireland	20	22	19	20	17	22	21	21	24	22
Italy	38	41	47	50	44	46	45	43	44	40
Netherlands	31	32	32	31	31	31	32	31	31	30
Portugal	17	20	27	25	20	23	22	21	24	25
Spain	27	28	29	27	25	24	26	26	26	29
Sweden	31	32	30	19	28	27	28	28	28	28
United Kingdom	33	31	31	30	30	30	30	29	29	29
Average	28.7	29	30.2	27.7	28.4	29.3	29.9	29.8	30	29.8
Weighted Average*	35.5	36.1	37.3	35.7	34.1	35	35.1	34.8	34.9	34.6
Standard Deviation	10.6	9.8	9.1	9	7.4	7.5	6.8	6.7	6.8	6.5

[25] Baldwin, R., and Krugman P., (2001).
[26] *=weighted by a country's GDP. Source: Garretsen, H. "Lets (not) harmonize taxes: some data on the absence of a race to the bottom". www.few.eur.nl/few/people/vanmarrewijk/geography/ pdf%20files/tax%20competition.pdf [accessed 6th May 2002]

A few points are worth noting from table 1:

- The average effective corporate income tax rate for the EU as a whole has remained quite consistent over the profiled time frame
- Germany, France, and Italy have had tax rates consistently above the average rate for the EU
- The countries on the periphery of the Union (with the exception of Ireland) started out with below average tax rates in 1990, but their rates have clearly increased during the profiled time frame.

The influence agglomerative forces have on investment location can be aligned with the evolution of tax rates in the EU. Member States at the "advanced core" of the Union may demonstrate the actions of limit pricing monopolists towards less advanced "periphery" States. This is because investment may not respond to marginal changes in tax rates if locked in by the existence of agglomeration economies. This is what Krugman[27] refers to as "circular causation" in that production tends to become concentrated in one location, but the size of the market will be large where production is concentrated. The lure of an attractive tax system located in the small-market periphery would therefore have a minimal effect on investment location. This lends itself to the conclusion that integration does not necessarily translate as decreasing tax rates, and might well be consistent with the maintenance of large welfare States.

Analysing tax competition in the new economic geography framework offers a more complete picture of all forces influencing the investment decision. From this framework the scope for taxation is critically depended on whether economic activity is agglomerated or dispersed. Kind, Midelfart Knarvik, and Schjelderup[28] showed that the locational inertia created by agglomerative forces can be exploited as it gives rise to a rent that is taxable. Agglomerative forces are an important source of rents, with these forces becoming increasingly dominant as trade barriers and costs are lowered[29]. Governments can tax these rents without any trepidation or fear of losing mobile capital, as taxing rents does not create disincentives to international investment[30].

However, if transport costs decline significantly, the relative importance of location declines as well. At some critical point, investment will not necessarily need to be located close to the market and suppliers. This will permit the periphery to "gain the upper hand" on the core, as the periphery will be able to offer

[27] Krugman, P., (1991).
[28] Kind, H., K. H. Midelfart Knarvik, and G. Schejelderup, (1998).
[29] Vording, H. (1999).
[30] Vording, H. (1999).

potential investors the advantages of lower costs, which may be sufficient to offset the disadvantages of location away from the largest market and suppliers[31]. The possibility now arises that if a Member States is successful in inducing "flagship" investment projects away from the agglomerated core, that State combined with the provision of structures supportive of industrial clustering can start its own agglomeration economy. In doing so the agglomerative forces emanating become more dominant than the provision of a low tax regime in explaining investment attraction.

[31] Krugman,P., and Venables, A., (1995).

3. Irish Industrial Policy

Despite offering generous fiscal and financial incentives to investors over the past fifty years, Ireland has only in recent years experienced a surge in investment inflows. This section will attempt to determine if this phenomenon is just coincidence or have other factors helped mature Ireland's attractiveness as a base for investment.

3.1 Development of industrial policy

Since the 1950's Ireland has adopted a strategy aimed at the attraction of foreign direct investment (FDI), a strategy founded on the extensive use of both fiscal and financial incentives. The most obvious example of the extent of this strategy was the granting of a full tax holiday to all new sales made by foreign manufacturing companies, an incentive employed until 1982. Since 1982, manufacturing firms have been entitled to an automatic preferential corporate tax rate of 10% on all manufacturing profits, regardless of the location of where these profits have been generated. Profits that derive from eligible manufacturing and qualifying services are subject to the tax rate of 10% until the end of 2002. Thereafter, the Irish Government has reached agreement with the EU Commission for a corporate tax rate of 12.5% to apply to all trading activities[32]. The special 10% rate of corporation taxation has been widely recognised as one of the main if not the most significant factor inducing MNCs to locate in Ireland[33].

Recognising the negative effects of uncertainty on investment, Irish industrial policy towards inward investment has always attempted to maintain "reliability"[34]. Fiscal incentives offered to foreign investors had a long and certain time horizon. Promotional FDI policies were essentially removed from the annual budgetary process and independent from changes in government. Regarding financial policies certainty and reliability was achieved with payment of the grant up front with repayment required if the investment failed to live up to the agreed terms of the financial aid. Changes in government policy, especially government policies that affect inward FDI, create market imperfections that make FDI less likely[35]. Irish industrial policy has been successful in avoiding this as far as possible. By doing so, industrial policy contributed to lowering Ireland's political risk premium, an expression for unanticipated policy induced fluctuations in the rules of the market[36].

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[32] Agreement reached 22nd of July 1998.
[33] Malley, John (2000);
[34] O'Connor, T.P. (2001).
[35] Brewer, T., L. (1993).

While the use of fiscal and financial incentives were an adequate carrot in the attraction of investment, it was not clear that this was an adequate basis for development[37]. The success in attracting investment was qualified by the relative lack of success among indigenous enterprises in adjusting to international competition. As such, the economy was progressively becoming heavily reliant on inward investment, investment that located only certain stages of production in Ireland. For instance an ongoing concern was that high value-added functions in the production chain were remaining located outside Ireland. This concern peaked during the 1970's as the lack of linkages between foreign owned enterprises and the domestic economy became a major subject of research and policy concern. It was highlighted that the only significant impacts that foreign investment had on the Irish economic landscape were the hiring of labour and the relaxation of the balance of payments constraint. Further compounding this impression was the evidence that employment tended to decline in foreign enterprises after a few years. The extent and persistent differences between the foreign owned sector and the domestic economy- in technology, export orientation, product quality, and scale -prompted the description of Ireland as a "dual economy"[38]. This raised questions about the long-term viability of Irish industrial development and ignited the call for a rethink in what industrial policies sought to accomplish.

Given the high dependency Ireland had on foreign investment there presented the need to develop the institutional and support systems needed to integrate foreign investment with the domestic economy. The lack of linkages between foreign enterprises and the domestic economy was a major concern because there was no guarantee that the fiscal and financial incentives offer to foreign investors were enough to retain investment in the economy. In effect there lacked a meshing together of Ireland's factor endowments with the various incentives designed to attract investment. Government policy in the form of financial incentives increased Ireland's propensity to be invested in but the retention of investment posed significant problems due to the lack of support structures.

The Industrial Development Agency of Ireland (IDA) during the mid-1970's identified the electronic and pharmaceuticals sectors as providing the most beneficial and promising opportunities for investment in Ireland. These sectors are characterised by their high value to weight ratio or their "weightless", the precise sectors from which the periphery economies could build a comparative advantage to effectively compensate for location disadvantages. The location of these sectors was much less tied to comparative advantages based on natural endowments compared with the heavy industries of the industrial core of the Union. The access to specialised inputs and knowledge spillovers through the development of a highly

[36] Oxelheim, Lars (2002).
[37] O'Donnell, Rory (1998).

skilled and specialised workforce characterises comparative advantages in these industries, something that could be fostered and acquired in the right institutional and policy environment[39]. Furthermore these sectors were expected to experience high levels of growth during the 1970's with the United States (US) identified as the most likely source of investment given the significance of US firms in these sectors. All of the above implied a maximisation of benefits given the common language and culture shared between Ireland and the US[40].

What differed from previous policies in the attraction of investment was the specific identification by policy-makers of the creation of industrial clustering in the electronic and pharmaceutical sectors[41]. Thus the IDA became more deliberate in its identification and selection of investment[42]. Whilst previously the goal was simply the attraction of investment (shot-gun approach), the goal now was the focused development on a small number of key areas (rifle-shot approach)[43].

3.2 Was this policy successful?

Table 2 gives an indication of the relative importance of foreign direct investment (FDI) flows for Ireland. It is apparent that while FDI flows as a percentage of GDP for Ireland were lower than that in the EU for the period 1985-91, they increased substantially with time equivalent to more than twice the rate in the EU for 1995-96. This increase would suggest that Ireland has improved its attractiveness as a base for investment during the 1990's.

Table 2: FDI flows as a percentage of GDP [44]

	1985-91	**1992-94**	**1995-96**
Ireland	0.9%	2.2%	2.8%
European Union	1.1%	1.1%	1.2%

[38] O'Donnell, Rory (1998).
[39] McGowan, Padraig (2000).
[40] Görg, H., and Ruane, F. (1999).
[41] Dorgan, Sean (2000).
[42] O'Connor, T.P. (2001)
[43] O'Connor, T.P. (2001).
[44] Source: Görg, H., and Ruane, F., (1999).

The below table, table 3, offers a broad profile for Irish direct investment flows for the period 1987 until 1997. It is notable that throughout the period there has been a progressive increase in FDI inflows, and a sharp acceleration in these flows after 1993. What has caused this recent rapid growth in investment inflows? Ireland has always had qualified success in the attraction of investment through the provision of fiscal and financial incentives dating, as previously noted, back to the 1950's. This leads one to the conclusion that while these incentives may offer a partial explanation they cannot fully account for the rapid growth of recent years. Other factors must be at play. The table also indicates that Irish FDI flows have developed in an opposite direction to that of the EU as a whole. Figures for the EU's FDI flows indicate a substantial and growing net FDI outflow in contrast to Ireland net FDI inflows.

Table 3: Direct Investment Capital Flows[45]

US$ millions	1987-1992 average	1993	1994	1995	1996	1997
Ireland						
Inflows	615	838	1,447	2,618	2,743	2,920
Outflows	379	220	438	820	727	1,008
Net inflows	236	618	1,009	1,798	2,016	1,912
European Union						
Inflows	72,651	76,754	77,504	115,516	108,922	126,194
Outflows	103,758	98,799	160,411	181,817	218,428	386,161
Net Outflows	31,107	22,045	82,907	66,301	109,506	259,967

There are two possible explanations for the growth in investment inflows. Firstly, Ireland like most countries in the early 1980s had a very serious fiscal crisis. However Ireland was in a more critical state than other countries; indebtedness reached a peak of 118 per cent of GDP in 1987, the second highest in the OECD[46]. This permitted the London Times to famously write that international moneylenders were going "to pull the shutters down on Ireland". In addressing the fiscal crisis the newly elected Irish government in 1987 embarked on a major fiscal consolidation of public finances. This fiscal consolidation produced an expansionary effect on the economy, which has become documented in numerous studies[47]. While fiscal consolidation was undoubtedly an important contribution in improving Ireland's

[45] Source: O'Malley, J. (2000).
[46] OECD Economic Surveys - Ireland 1999, Paris, OECD.
[47] See Whelan, K., and Hogan, V. (2001)., and also December 1998, IMF Staff Country Report No. 98/126. Ireland: Selected Issues.

attractiveness as a location for investment, its expansionary effect on the economy was maximised by other considerations. To begin with there was a sizeable devaluation in 1986 a devaluation targeted at improving Ireland's international competitiveness. This devaluation coincided when Ireland's largest export market, the United Kingdom, experienced very strong growth[48]. In addition national output was well below potential levels depressing wages which was further restrained by high unemployment levels. Since the fiscal consolidation attempt in 1987, growth in Ireland has averaged over 5% a year, well in excess of the OECD average reflecting that the supply-side conditions in Ireland were ripe for economic expansion[49].

The second explanation for the growth in investment inflows is the de-regulation and liberalisation of national markets; a process set in train by deepening European integration. Proponents of the European integration cited the possible benefits that might accrue to countries such as Ireland through membership of a larger market[50]. The de-regulation and liberalisation of markets combined with lower transport costs and improved communication technology reduced the necessity for industry to be located in the largest market. Notwithstanding these opportunities, the full implications of greater European integration via the Single Market programme were viewed with trepidation by a number of Irish economic commentators[51]. Irish fears centred on a belief that the core countries of the EU would reap the most benefits from the Single Market Programme when this initiative was undertaking in the mid-1980's. This is because the returns to scale through greater production efficiencies were more likely to be available to the industrial core of the Union. Industries such as transportation equipment characterised by economies of scale were deeply embedded in the economies of the countries at the centre of the EU and therefore extremely difficult for countries on the periphery of the Union to dislodge the balance.

To avail of the opportunities offered by European integration, the IDA identified that the sectors where benefits were likely to accrue for countries located on the periphery, were the electronic and pharmaceutical sectors, for reasons cited earlier. The United States was identified as the most likely source of investment due to the high standing of US firms in these sectors. This would lead one to suspect that the periphery States have equally benefited from investment in these sectors with the Internal Market programme. However there is a clear divide emerging between Ireland and the other Member States on the periphery, namely Greece, Portugal, and Spain[52]. There is no evidence to suggest that these countries have

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[48] In 1987 the UK economy grew at 4.76% while in 1988 it grew at 4.98%, rates far above its post-1973 average of 1.62%.
[49] See Whelan, K., and Hogan, V. (2001).
[50] McGowan, P., (2000).
[51] McGowan, P., (2000).
[52] Görg, H., and Ruane, F., (1999).

been able to improve their attractiveness for investment in the "weightless" sectors as the research conducted by Baldwin and Krugman predicts[53] in contrast to Ireland as the following table illustrates.

Table 4: Share of US investment in Greece, Ireland, Spain, and Portugal
(Ratio of US capital expenditures in country over total US expenditures in the EU, average annual rates)[54]

Ireland	1973-79	1980-85	1986-88	1989-91	1992-95
Electronic Equipment	1.8%	5.4%	6.5%	5.5%	25.5%
Transportation Equipment	0.1%	0.7%	0.3%	0.3%	0.1%
Greece	1973-79	1980-85	1986-88	1989-91	1992-95
Electronic Equipment	0.2%	0.1%	0.0%	0.1%	0.0%
Transportation Equipment	0.0%	0.0%	0.0%	0.0%	0.0%
Portugal	1973-79	1980-85	1986-88	1989-91	1992-95
Electronic Equipment	0.3%	1.1%	n/a	1.3%	0.9%
Transportation Equipment	0.1%	0.4%	n/a	0.4%	0.5%
Spain	1973-79	1980-85	1986-88	1989-91	1992-95
Electronic Equipment	6.7%	6.2%	9.7%	7.0%	5.0%
Transportation Equipment	11.6%	5.4%	8.6%	8.5%	13.0%

It is apparent from the three tables (tables 2,3,and 4) that at the some stage at the beginning of the 1990's the attractiveness of Ireland as a location for investment was substantially improved. However Ireland's attractiveness as an investment location is confined to specific sectors. For instance Ireland's share of investment in the transportation equipment sector, a sector distinguished by its high transport costs[55], has remained below 1% between 1973 to 1995, as shown in table 4. In contrast Germany, at the heart of Europe's industrial core, has witnessed a growth of investment in this sector rising from 43.7% in the period 1973-79 to 52.1% in the period 1992 to 1995[56]. A comparison of these figures indicates that even

[53] Baldwin, R., and Krugman, P., (2001).
[54] Source: Görg, H., and Ruane, F., (1999).
[55] Görg, H., and Ruane, F., (1999) note that transport costs as a percentage of total production costs are five times higher for the transportation equipment sector than they are for the electronic equipment sector.
[56] Source: Görg, H., and Ruane, F., (1999).

with deepening European integration Ireland's share of investment in the transportation equipment sector has not improved.

An examination of the Irish economic landscape reveals that many of the "key players" in the electronic and pharmaceutical sectors are now located in Ireland. Because of this the country has become an attractive location for investment from other firms in the same industrial sector because of the availability of common pools of inputs such as infrastructure, skilled labour, and intermediate inputs. For example, computer firms located in Ireland include Apple, Compaq, Dell, Hewlett Packard, Xerox, and IBM, while the semi-conductor manufacturers Intel and NEC as well as software companies such as Microsoft, Lotus and Oracle also have invested in Ireland in recent years. Barry[57] through his research promotes the spin-off benefits of foreign investment such as a role as "incubators" for new entrepreneurs. An important externality in the case of Ireland is the high possibility that multi-national corporations (MNC's), when considering where to invest, focus particularly on areas which their rivals have explored and found to be satisfactory. Hence the development process exhibits self-sustaining or "positive feedback" characteristics once a critical mass of firms has been reached. It follows that the successful attraction and more importantly the retention of capital have embodied a positive signal for the continued attraction of investment. Barry[58] cites that surveys of foreign firm executives in the high-tech sector indicate that their location decision has been greatly influenced by the fact that other key market players were already located in Ireland. This results in a demonstration effect, which is a clear signal to other actors in the high-tech industry to consider Ireland as a suitable location within the European Market for new knowledge and skills intensive FDI projects[59].

3.3 Further evidence and observations

Barry's[60] research offers further conclusive evidence of the operation of agglomerative forces in Ireland. A concern of Irish economic commentators, as noted earlier, was the lack of linkages between the domestic economy and the foreign investment in Ireland. Barry, however, finds evidence of increasingly developing input-output linkages, which are a component of agglomerations, in Ireland over the period 1983 - 1995.

[57] Barry, F., (1999).
[58] Barry, F., (1999).
[59] Barry, F., Görg, H., and Strobl, E. (2001).
[60] Barry, F., (1999).

Krugman has further highlighted the possibility that agglomerative forces are operating in Ireland[61]. Firstly the Irish experience witnessed an initial clustering of similar industries (mainly foreign owned and in the areas of computer equipment and pharmaceuticals) supported by local suppliers of specialised inputs subject to economies of scale. These initial clusters fostered and generated a local skilled labour market that helped to further the growth of the clusters. Spillovers of information further encouraged growth in the electronics and pharmaceutical sectors and provided the basis for additional clustering effects, often in traditional areas that benefited from new technologies (e.g., food processing). Furthermore, Krugman[62] pinpoints the importance of the maintenance of a low-cost environment in Ireland through social concertation. Since 1987 the determination of pay has been conducted within a social partnership framework, encompassing government, employers, and unions. Successive national wage agreements beginning with 1987's Program for National Recovery have promoted wage moderation and employment growth[63]. In return the government has delivered tax reductions leading to increases in disposable income. Social Partnership ensured that growth was less likely to be choked-off by industrial unrest and additionally preventing any savings in producing on the periphery to disintegrate with rising real wages[64].

It seems reasonable to ask why agglomeration economies have emerged on the Irish economic landscape in the electronic and pharmaceutical sectors and not in other manufacturing sectors. One reason is the role Irish industrial policy has played in the attraction of investment in these specific sectors. A second reason connected to the first is the characteristics of these sectors, that is their "weightlessness". The high transport costs of other manufacturing sectors make them unsuitable to location on the periphery, which acts as an impediment to their successful agglomeration in Ireland. Further compounding this is the size of the Irish domestic market for industrial products. Investment locates in Ireland to serve the larger European market, not the domestic market[65]. A third and final reason is that there was an element of luck involved. One could imagine that if Greece, Portugal or Spain was the initial beneficiary of "flagship" projects investing in their countries they too could have developed the necessary structures supportive of agglomeration. As Krugman puts it: "Fortunately, Ireland got off on the right foot"[66].

[61] Krugman, P. (1997).
[62] Krugman, P. (1997).
[63] The pay terms typically involve a three year process. The current agreement "Programme for Prosperity and Fairness" is the fifth agreement.
[64] Dunning, J., H., (1987).
[65] O'Connor, T.P. (2001).
[66] Görg, H., and Ruane, F., (1999).

4. Legal sustainability of a low-tax regime

In improving a country's attractiveness, a government puts in place the institutional and support structures to facilitate the attraction of investment and the development of industrial clusters. If the efficiency effects of agglomeration are the most important determinate in the attraction of investment, governments can assist the build-up of clusters through educational policies, support of sub-supply industries, etc. On the other hand, if the demonstration effects of agglomeration attract investment, the importance of attracting investment that is capable of signalling the reliability of the host country is without question. These considerations will drive governments to structure their economies in the hope of establishing an environment supportive of investment. The involved tailoring and fostering of national economic structures must nevertheless be compatible with the functioning of the Internal Market and with the Union's overall competitiveness on the world stage. The purpose of this section is thus to ascertain if in pursuing the development of the national economy, Ireland's system tax system is divergent from the overall European goal. In effect, the permissibility of pursuing a low-tax regime is examined against selected tools available in the regulation of the Internal Market.

4.1 Evaluation of the Irish Corporate Tax System

The competition rules incorporated into the EC Treaty are primarily intended to promote a scenario in which the investment decision is based on economic rationality in a market free of public interference. The Member States are policed by these rules in so far as legislative measures in the fields of civil law, criminal law and administrative law should be reduced to the basic necessary and hence refrain from influencing the investment decision[67]. While a certain amount of redistribution and social legislation is needed in a civilised society, the various Member States should remain in the background, as the stress should be focused on free and responsible individuals[68]. Therefore, the influence of the State on the investment decision is minimised as the rules are intended to impose a burden of proof on the various Member States to justify intervention beyond the minimum necessary.

It has been common to argue for cross-border tax co-ordination on the grounds that low corporate taxes are like distortionary state aid. But this analogy is misleading. State aid is most suspect when it aims to give a substantial commercial advantage to a domestic firm with significant market power - relative, that

[67] Schön, W., (1999).
[68] Irish Independent 31st May 2001, "Peripheral Row is a Taxing Matter"

is, to other domestic taxpayers who provide the revenue to fund this aid (specific tax measures)[69]. But taxation measures of a purely technical nature such as the setting of taxation rates do not constitute State aid[70]. Taxes applying to all domestically established firms (general tax measures) reflect the costs of operating in a particular tax jurisdiction with its public goods and services and regulatory framework. The existence of taxation is a fundamental perquisite for the functioning of any economy as it enables the State to fulfil its duties in correspondence to its citizen's preferences. There is no reason to expect the cost of fulfilling these duties to be the same across Member States than to expect the cost of labour or of traffic congestion to be the same across States[71]. It is therefore preferable that each Member State is able to retain the right to influence their various economies through the matching of taxation policies with their individual requirements[72].

4.2 State Aid Rules

The purpose of the EC Treaty in setting out a regime for State aid rules was not to deal with the phenomenon of tax competition in itself or with its effects on the deterioration of the welfare state[73]. The regime was intended to complement the establishment of an Internal Market where competition among enterprises should not be distorted by any form of public protectionism of domestic enterprises. As such, the EC state aid rules were not designed to regulate unfair competition, as the rules may be an ancillary or complementary instrument, but never the central one in the regulation of tax competition[74].

While the fundamental freedoms of the EC Treaty do not distinguish between general and specific tax measures which have discriminating or restrictive effects, this distinction is paramount in the area of State aid law under Article 87 EC[75]. Article 87(1) EC prohibits aid, which distorts or threatens to distort competition "by favouring certain undertakings or the production of certain goods". Thus one is required to identify specific tax measures as opposed to general rules which are either not "aids" at all or which apply not only to "certain" undertakings or goods but to the whole economy.

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69 Beasley, and Seabright, (1999).
70 Schön, W. (1999).
71 Irish Times 29th May 2001, "Taoiseach defends low corporate tax policy". Bertie Ahern, Irish Taoiseach says "The Government's obligation is to ensure that there is sufficient tax take to sure that we can supply the money for services, for health and educational services. Other countries have an alternative way of doing it. I think our policies have worked extremely well. Our view is that if you can generate more activity in the economy then it works for you and you can have lower taxes."
72 Bos, W.J., (2000). See also Frits Bolkenstein "The Future of European Tax Policy", Conference "Tax Policy in the European Union", Rotterdam 18th October 2001.
73 Santos, A., C., (2000).
74 Hendricks, B., (2000).
75 Schön, W. (1999).

The fundamental freedoms are not affected when an individual Member State offers preferential treatment to foreign-based capital and companies. This is the main feature of the "unfair tax competition" debate, which focuses on tax rules designed to attract and retain foreign capital and other investments by giving incentives which are advantageous as opposed to the conditions of the domestic taxpayer. Since "reverse discrimination"[76] is not a problem of the fundamental freedoms but of domestic constitutional law, it is important to ascertain whether Article 87 EC contains any restriction on this practice[77]. The distinction between general and specific tax measures is relevant here again. If a tax incentive has a benefit only to a selected foreign company or a group of foreign companies operating in a specific business sector, the tax incentive will fall within the scope of Article 87 EC[78]. It is unlikely that a preferential tax measure that is offered to foreign investment irrespective of the investment's purpose would be regarded as selective State aid within the context of Article 87 EC[79].

4.3 European Court of Justice (ECJ) Case Law

A possible vehicle for materialising real corporate tax integration in Europe, the European Court of Justice, is in the meantime progressing forwards. Rulings such as Verkooijen[80] demonstrates that national legislators have little choice left but to bring to their tax statutes in line with a truly free market. The ramifications of this judgement are, as of yet, unclear. But the case opens the door to further litigation in relation to double tax relief for overseas dividend income. The outcome of any such litigation may also have profound implications for the permissibility of imputation systems within the EU as the latter may function by discriminating against dividends from overseas companies[81]. One possible interpretation of this judgement is that imputation systems that impute a tax credit to an individual only on dividends from domestic companies are not permissible under the Treaty.

Despite the impetus towards integration forthcoming from the ECJ, the Court's powers are limited, as its jurisdiction does not permit it to rule beyond the specific questions of law brought forward. Judgements on the application of the state aid provisions are confined to the particular case in question, that is, individual

[76] Member States are unlikely to impose restrictions on its own firms and individuals in their conduct of domestic business.
[77] Schön, W. (1999).
[78] Hamaekers, H., (2000).
[79] See An Roinn Airgeadais/ Irish Department of Finance Press Release 22nd July 1998 "Agreement with the EU Commission on Corporation Tax". The main provision of this agreement was the introduction of a general 12.5% tax rate for trading profits to apply from 1st January 2003.
[80] Staatssecretaris van Financien v BGM Verkooijen (C-35/98) ("Verkooijen").
[81] Lupo, A., (2000).

aspects of a general issue. The implementation of a decision, such Verkooijen, precipitates far reaching adjustments in national tax systems, however the confinement to an individual case leaves the possibility that incompatible tax system will remain even after the implementation of the decision[82]. The Court may correct the laws impeding the functioning of the fundamental freedoms, but it cannot create law. As such, the ECJ does not act as a guide for future direction or developments.

4.4 The Code of Conduct

Despite the evidence that the State aid rules are an imperfect tool to fight tax competition, the Commission has been testing the boundaries for the application of these rules as evident with the Code of Conduct[83]. The Code of Conduct attempts to deal with situations where "potentially harmful" tax measures are "unfairly" competitive by virtue of "a significant effect on the location of business activity". It in effect interprets the fight against "harmful" or "unfair" tax competition as aimed at not only a more effective use of the State aid rules but also at general tax measures which lure foreign investment away from their source country. It follows that where potentially harmful tax measures amount to State aid, a Commission enforcement action against the Member State in the European Court of Justice is possible. Despite the fact that the Code is not legally binding it mentions the possibility of Commission enforcement, and this has not gone unnoticed by the Commission as it has been laying groundwork for enforcement. The Commission has issued a Notice under the Code that sets forth the general criteria to determine whether tax assistance constitutes State aid within the meaning of the EC Treaty[84]. The criteria include measures that:

- (a) confer an advantage relieving recipients from a normal tax burden, such as a reduction in tax base, total or partial reduction in the amount of tax by exemption, credit deferral, rescheduling or cancellation
- (b) grant the advantage by State or State resource, including a regional or local body
- (c) impact on competition and trade between Member States
- (d) specifically protect certain undertakings or the production of specified goods.

The European Commissioner for Competition, Mario Monti, is committed to drawing the line between what constitutes general as opposed to specific tax measures[85], as the latter are under the control of the

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[82] Hendricks, B., (2000).
[83] Bratton, W., W., and McCahery, J., A., (2001).
[84] Bratton, W., W., and McCahery, J., A., (2001).
[85] FT, 22nd Feb. 2000 "EU Ready to Investigate Unfair Business Taxation". Says Monti: "I am firmly convinced of the synergy between the fight against harmful tax competition and rigorous enforcement of the competition rules."

State aid rules[86]. This will be accomplished by fleshing out the meaning of these criteria by studying their application to the potentially harmful tax measures identified by the Code[87].

Under the Code of Conduct, a Member State can continue to take a competitive posture with the introduction of an across-the-board tax reduction that benefits both existing businesses and potential investment. This stance aligns itself with the State aid rules, in that, specific tax measures are subject to the rules, whereas general tax measures are not. The Code furthermore permits that Member States should not be restrained from introducing a reduction in business taxes to stimulate the competitiveness of the domestic business environment. A Member State can pursue this strategy, so long as the measures introduced do not meet the definition of a potentially harmful tax measure. Therefore it would appear that a domestically motivated tax regime, as in the case of Ireland, would not be disqualified under the Code of Conduct.

4.5 A secret weapon?

- Article 96 EC

A mandatory implementation of the Code, however, may be based on the provisions provided by Article 96 EC[88]. Article 96 EC empowers the Commission to act where legal or administrative rules of a Member State distort conditions of competition in the European Union. Two conditions must be present before applicability of the Article can take place namely:

(a) there is a difference between the legislative or administrative rules of the Member States
(b) and this difference must interfere with the conditions of competition and thus cause distortion that should be eliminated.

If these conditions are present, the Council may adopt a Directive proposed by the Commission on the basis of qualified majority. Article 96 EC was mooted as a solution to problems tax discrimination in the 1960's and again in the early 1980's as its main attraction is its procedural provision that allows the Council to act by a qualified majority rather than unanimously[89]. Vanistendeal[90] views the abolishment of

[86] The International Tax Planning Association, Berlin 2001 Meeting. Frans Vanistendael speaking on company taxation states that the Commission approves of general tax competition, but believes that specific benefits are harmful, which is consistent with the Treaty of Rome.
[87] FT 11th July 2001 "Brussles Extends Crackdown Against Unfair Competition". Says Mario Monti, "We believe it is very important to bring to bear all our treaty instruments to ensure the process of integrating the single market is pushed as far as possible".
[88] Gromley, L. W., Kapteyn, P.J.G., van Thermaat, P., V. (1998).
[89] Farmer, P., and Lyal, R., (1994). EC Tax Law, pp 6-8.
[90] Vanistendael, F., J. (1998).

unanimous voting in relation to tax issues as a high priority. This would provide the secondary tax legislation which would define the "cohesion" of the national tax systems by spelling out the room left for manoeuvring left with the EC Treaty for national tax measures. However, this provision provided by the Article has never been used and according to Bolkestein it would be preferable if distortions of competition could be eliminated via the Code of Conduct and as a package of measures which balances the interests of Member States[91].

4.6 Concluding remarks

The elimination of economic obstacles to cross-border investment aims at removing tax from the investment equation i.e. tax neutrality in investment decisions. Investments displaying strong similarities should not face markedly different effective levels of taxation purely because of their country location[92]. EU policy in this respect is focused towards ensuring that goods produced in any Member State should be burdened with the same tax rates in order to allow suppliers to produce where the real costs are lowest.

The discourse on international tax neutrality is based on the notions of capital export neutrality (CEN) and capital import neutrality (CIN). CEN is necessary for production efficiency, in that, when CEN exists an investor faces the same effective tax rate irrespective of the location of investment[93]. There is no tax incentive to locate investment in one country rather than another. CIN is required for exchange efficiency and instead assures that in a given country there is no taxed induced competitive advantage of a domestic company over a foreign company. CIN holds if all investors face the same post-tax rate of return. CEN and CIN can therefore be employed as a yardstick for assessing the efficiency of taxes affecting cross-border company activity in the single market[94].

According to Devereux and Griffith[95], an optimal tax structure would preserve production efficiency (CEN) but not exchange efficiency (CIN). There are two conditions that must be met to achieve CEN overall. Firstly, the personal tax system should demonstrate CEN, and secondly, the personal tax system should exhibit both CEN and CIN. "The first condition ensures that the marginal portfolio investor equates post-corporate tax, pre-personal tax, rates of return received from different companies". If the second condition is fulfilled all companies should face the same effective corporate tax rate on all their

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[91] Bolkestein, F. (2000).
[92] Company Taxation in the Internal Market. COM (2001) 582 final, para. 7.
[93] Devereux and Pearson, (1995).
[94] ”Whither Tax Competition? The Changing Tax Agenda of the European Union”. Claudio M. Radaelli.
[95] Devereux and Griffith, (1998).

investments, which when combined with the first condition, should imply that pre-tax rates of returns correspond. CIN does play a role in the formation of the optimal tax structure, however, this is to ensure production efficiency ie, the reduction of economic distortions, not because it ensures exchange efficiency.

The most common methods for an investor to invest abroad are:

(a) buy shares in a company resident in country A which undertakes foreign direct investment in country B

(b) buy shares in a company resident in country B that invests domestically.

These two routes are likely to be taxed differently as one of the disadvantages arising from cross-border investments in shares may be that it is impossible for shareholders to obtain domestic tax relief for foreign share holdings as was the case for Verkooijen[96]. The economic impact of such measures is clear: investments in foreign companies may be subject to a higher overall tax burden in contrast to domestic share investments. As a result, capital markets may suffer from a higher segmentation, as there is a sufficient discouragement in investing abroad.

To achieve an optimal tax structure as proposed by Devereux and Griffith[97] for the European Union would necessitate some form of tax harmonisation. This would involve the individual Member State foregoing its optimal tax structures in favour of an optimal structure for the Union as a whole. Harmonisation is a legitimate goal on the demonstration of a market or politically driven distortion of economic choice. Nevertheless, Ireland, according to Mors, is an example of a small member state that has succeeded in fighting competition from larger member states while staying out of the "prohibited zone" of unfair tax competition and state aid[98].

The Ruding Report[99] noted that "there is no evidence to suggest that independent action by national governments is likely to provoke unbridled general tax competition, leading to erosion of corporate tax revenues of Member States". Combining this statement with the principle of subsidiarity suggests that an end to fiscal sovereignty would be premature. Tax harmonisation measures must be justified by clear empirical necessity, and must in turn be focused on minimising the interference with the Member States'

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[96] Staatssecretaris van Financien v BGM Verkooijen (C-35/98) ("Verkooijen").

[97] Devereux and Griffith, (1998).

[98] Tax Analysts, Worldwide Tax Daily, March 1, 2002. Panellists Debate EU Code of Conduct for Business Taxation.

[99] Commission of the European Communities, Report of the Committee of Independent Experts on Company Taxation, 1992, ("Ruding Report")

corporate tax systems[100]. The goal must be to allow the Member States the maximum freedom and flexibility in arranging their tax systems without interfering with the establishment of the Internal Market. However, the Community was created by and for the Member States, not the Member States for the Community. Therefore the end of national fiscal sovereignty and the equalisation of taxes this entails would not be the answer, but rather how tax diversity can be permitted without interfering with the establishment of the common market.

[100] Sinn, H-W. (1990).

5. Conclusion

There exists a considerable amount of empirical research to substantiate the belief that the sensitivity of investment decisions to corporate tax policies is increasing[101]. While this evidence suggests that the sensitivity of investment decisions to taxation is increasing, the role economic geography plays in investment location has been neglected in these studies. This paper has attempted to fill the gap by showing that agglomerative forces are more likely to be dominant than taxation considerations in influencing investment location. By adding economic geography to the analysis one can explain why even with the deepening of economic integration in Europe, there still remains little concrete evidence to suggest that cross-border economic activity has eliminated deep-seated differences between the various Member States[102].

Baldwin and Krugman[103] in their research have identified that the adoption of a "split-the-difference" harmonised tax rate in the European Union harms all Member States. The introduction of a single rate would not lead to shifts in investment location between States as investment would prefer to stay where agglomerative forces are strongest. Baldwin and Krugman cite that States on the periphery of the Union would remain without investment, as their pre-harmonisation tax rates were an unconstrained maximum. With agglomerative forces operating in the core of the Union, Member States on the periphery could in theory vie for investment via low tax rates. But as agglomerative forces are more dominant that taxation considerations, investment prefers to stay located in the core. This allows Member States on the periphery knowing that they will not attract investment via taxation, to adopt an optimal tax structure suited to their country's specific preferences. In addition the adoption of a common rate forces the core to lower its tax rate, when in fact it would have preferred to increase it. In consideration of the above it is obvious why Member States are unwilling to agree on a harmonised corporate tax rate, there is no mutual gain in harmonisation rather harmonisation would perpetuate the divide between the various Member States.

Ireland, as a country on the periphery of the Union, has succeeded in attracting increasing levels of investment, not just because of low taxes, but because industrial policy specifically targeted the precise sectors where the most benefits were likely to accrue for economies located on the periphery. There was a

[101] Two studies are of particular interest. Empirical research by Altshuler, R., Grubert, H., and Newlon, T., S., (1998) found that there were large estimated tax elasticities for investment abroad with the allocation of capital abroad becoming increasingly sensitive to differences in host country taxes in recent years. The results were found to be consistent with increasing international mobility of capital and globalisation of production. Research by Gropp, R., and Kostial, K., (2000) found strong evidence that FDI in (out) flows are affected by tax regimes in the host countries and FDI flows in turn affect the corporate tax base.

[102] Jönsson, C., Tägil, S., and Törnqvist, G. (2000).

element of chance in the initial attraction of "flagship" investment in Ireland, but the maintenance of a low cost regime combined with the gains from concentrating investment in Ireland has been sufficient to offset the disadvantages of location away from the largest market and suppliers. The adoption of a "split-the-difference" tax rate in the case of Ireland could be disastrous, as it would raise the overall cost of investing in Ireland. Such a rise in investment costs may force investment to relocate away from Ireland, a movement which may irreversibly undermine the agglomeration economies Ireland has built. Fortunately for Ireland without clear empirical evidence suggesting otherwise, the necessity and hence legibility of equalising the various tax systems throughout Europe is doubtful.

[103] Baldwin, R., and Krugman, P., (2001).

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