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Summary

Ireland has for a long time been at the forefront of tax competition. Since the late 1950s incentives have been used in Ireland to increase industrial development. Prospective investors have been offered a broad range of financial and fiscal incentives, including capital grants, training grants and various forms of tax relief. The groundwork for this strategy was laid with the redirection of economic policy, with a move away from protectionism, import substitution and restriction on foreign ownership of Irish manufacturing industry, which was introduced during the 1930s. This approach helped to foster the recent explosion in the Irish economy, leading Ireland to be dubbed the “Celtic Tiger”

Recently a new and more proactive stance adopted by the European Commission towards the issue of State aid, together with the current opposition towards unfair tax competition, has, however, meant that Irish tax incentives have come under fire and that some of the tax incentives previously available, are now under the executioners ax. Instead the corporate sector in Ireland as a whole will be tax privileged. This is accomplished with the new 12,5% rate, effective 1 January 2003, applicable to trading profits generally, whether arising from the manufacture and sale of goods or otherwise.

With the realisation of the European Monetary Union a new set of rules have been implemented that further restricts the fiscal policies of the Member States. The rules have not been created in order to restrict tax competition but to provide stability for the European Economy and the new EURO currency. The effect of these rules can, however, sometimes lead to restrictions in the fiscal policies of Member States. Ireland is of course once again at the forefront of developments, already with a public reprimand by the European Commission over its budget policy.

Despite this increasing pressure on Ireland to change its tax system and abandon its low tax rates, it seems that Irelands love affair with inward investment is likely to persist for the indefinite future and that the “Celtic Tiger” will be well placed to pounce on the opportunities being opened up by the new electronic technologies.

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Abbreviations

BEPG	Broad Economic Policy Guidelines
CFC	Controlled Foreign Company
CFI	Court of First Instance
EC	European Community
ECJ	European Court of Justice
ECOFIN	Economic and Financial Council
EEC	European Economic Community
EMU	European Monetary Union
ESR	Export Sales Tax Relief
EU	European Union
GDP	Gross Domestic Product
IEP	Irish Pound (Punt)
IFSC	International Financial Services Centre
IMF	International Monetary Fund
OECD	Organisation for Economic Co-operation and Development
SGP	Stability and Growth Pact
TCA	Tax Consolidation Act

1 Introduction

1.1 Purpose & Outline

Since the late 1950s incentives have been used in Ireland to increase industrial development. Prospective investors have been offered a broad range of financial and fiscal incentives, including capital grants, training grants and various forms of tax relief. The groundwork for this strategy was laid with the redirection of economic policy, with a move away from protectionism, import substitution and restriction on foreign ownership of Irish manufacturing industry, which was introduced during the 1930s. The introduction of tax incentives was a key element in the drive to modernize Ireland.¹

In my opinion, another key element was Ireland's accession to the EC in the 1970s. It is inconceivable that without EU membership Ireland would have developed the same broad diversity of trading partners, of sources of inward investment, of new sources of labor and of knowledge-intensive industry. However, a new and more proactive stance adopted by the European Commission towards the issue of State aid, together with the current opposition towards unfair tax competition, has meant that Irish tax incentives have lately come under fire.

The purpose of this thesis is to examine the development of the Irish corporate tax system and its, through EC tax competition rules, sometimes forced evolution. For this purpose an overview of the past, present and future of Irish corporate taxation will be given. This is followed by a description of the rules concerning State aid, the Code of Conduct on Business Taxation and the effects of these regulations on Irish tax incentives.

With the genesis of the European Monetary Union a new set of rules were introduced to address budgetary discipline concerns. Reflecting the importance of getting the right balance between cutting taxes and pursuing deficit reductions, the ECOFIN Council of 28 February 2000 broadly endorsed four criteria for assessing whether a Member State has the capacity to cut taxes safely without jeopardising the EMU commitments. The effects of these criteria and relating regulations will be covered in part five.

Finally, in part six, an attempt is made to predict the future of Irish fiscal policy. A tougher stance against harmful tax competition, EMU and economic convergence, and greater demand for tax harmonization all means that national tax disparities will be brought into sharper focus.

¹ See further sec. 2.1

1.2 Method

This thesis is mainly based on studies of regulations, legal cases, official publications, books, articles and electronic sources. Due to the subject at hand it has, in the course of this thesis, been necessary to make comments on the legal and fiscal system of Ireland. I have taken every care to ensure that the comments are accurate in relation to them but it has not, due to the time limit and the unavailability of material, been possible to study the preparatory works of the Irish tax system. Instead, I have been obliged to put my trust in the different literature and articles that I have been reading.

In addition, I have had the pleasure of discussing the different issues of this thesis with Anette Bruzelius at the Faculty of law in Lund. Anette has been a useful source of information, particularly concerning the State aid rules and the Code of Conduct for Business Taxation.

There has been a lot of debate whether the word “unfair” or “harmful” should be used when discussing tax competition. I have chosen not to take a stance in this debate. Thus, whenever unfair/harmful tax competition is discussed in this thesis, the words “unfair” and “harmful” are interchangeable.

1.3 Limitations

The subject is extensive and I have therefore been obliged to restrict this thesis.

For obvious reasons the whole of Irelands tax system is not covered in this paper. Instead I have chosen to focus on corporation taxation and the tax incentives existing in that area. Tax subjects such as sole traders, trusts and individuals are therefore not examined.

It is possible to write endless amounts of text on the subject of State aid and the Code of Conduct on Business Taxation. This is however not the object of the paper and thus I have restricted myself to give a basic outline of the two regulations and then concentrated on the parts that are relevant for the corporation taxation in Ireland.

The Stability and Growth Pact have received a similar treatment. This is a massive subject and worthy of greater examination. Somewhere else.

2 Genesis of the Irish tax revolution

2.1 Export Sales Tax Relief (ESR)

Ireland achieved independence from the United Kingdom in 1922. The 26 southern states broke free from the United Kingdom of Great Britain and Ireland under the name of the Irish Free State, leaving the six northern counties under British rule. For many years thereafter the Irish economy languished in the shadow of its neighbouring country.²

The 1950s were a particularly bad period for Ireland. The country fell significantly behind in terms of industrial development, with agriculture still being the dominant sector. The level of inward investment was low, while a philosophy of protectionism created inefficient domestic businesses with an inward-looking attitude.³ A key element in the drive to modernize Ireland was the introduction of tax incentives.

In 1956 Ireland introduced a system of Export Sales Tax Relief (ESR), which applied a zero rate corporation tax to profits that related to the export of goods manufactured in Ireland. Initially, only 50% exemption was available. This was extended to full exemption in 1957. The duration of the tax holiday was initially five years, extended by subsequent Finance Acts to ten and then fifteen years, with an additional five years of gradually tapering relief.⁴

An almost identical relief was introduced for licensed activities carried on within the Shannon Free Airport Zone. This relief was extended and modified in step with ESR, expiring on the same date.

ESR was available only in respect of profits from the sale of “goods”, and Shannon Relief available only to certified “exempted trading operations” carried on within the Shannon Airport Free Zone. In both cases, trading with local enterprises diluted the benefit of the exemption. Both definitions continue to be of fundamental importance today for purposes of the tax incentive that replaced ESR and Shannon exemption, the so-called “Manufacturing Relief”.⁵

² Microsoft Encarta, 1996 Edition, Keyword: Republic of Ireland

³ Ward, John, Fiscal Politics for the Economic Enterprise in Ireland, Bulletin for Int. Fiscal Documentation, Vol. 54 nr. 2, p. 59

⁴ Cunningham, William T., Irish Incentives for Inward Investment, Bulletin for Int. Fiscal Documentation, Vol. 50 no. 9, p. 394

⁵ McNally, Donal, A New Tax Regime for the 21st Century – Corporation Tax Aspects, Bulletin for Int. Fiscal Documentation, Vol. 39 no. 1, p. 5

This was the first of many tax incentives introduced to simulate the Irish economy. On Ireland's accession to the EC in the 1970s, the EC Commission pointed out that this regime was not compatible with the EC Treaty. It was finally abolished in 1990 after a transitional period of 10 years.⁶

2.2 The 10% “Manufacturing Rate”

In 1980 a 10% corporation tax for the manufacturing sector was introduced until 2000. The Commission considered at the time that the new scheme was a general taxation measure and that it did not constitute a state aid under article 92 of the EC Treaty. Consequently they raised no objections. The new tax regime replaced ESR from 1 January 1981 for new companies. The manufacturing sector was later extended to cover approved internationally traded software development, telemarketing operations and other data-processing services including call-centres.⁷

The word “manufacture” is not defined in the Tax Consolidation Act.⁸ The Irish courts have ruled that the word “manufacture” is “descriptive of the process to which the raw material is subjected, that that process must impinge itself on the raw material in such a way as to bring about some change in that raw material, and that the end product resulting from the process must be commercially different from the raw material subjected to the process”.⁹

Manufacturing relief has been extended over the years to some activities which are only marginally “manufacturing” in the above sense of the word and in some cases involve no “manufacturing” at all. Activities include plant cloning, fish production, meat processing, design and planning services, ship repairing, certain qualifying shipping activities and newspaper production to name a few. These activities are listed in Secs. 443(2) to (21) TCA 1997.

Ireland was however in the mid-eighties still one of the poorest countries in the EEC. There was a consistent and rapidly climbing budget deficit. The level of national debt had trebled to over IEP 24 billion since 1980, representing a debt/GDP ratio of almost 120%. Ireland's GDP per capita at the time stood at only 63% of the equivalent figure for the United Kingdom. Inflation peaked at 20% in 1981. From then on it started falling but remained unacceptably high for many years thereafter. Unemployment continued to rise sharply and emigration

⁶ McNally, Donal, A New Tax Regime for the 21st Century – Corporation Tax Aspects, Bulletin for Int. Fiscal Documentation, Vol. 39 no. 1, p. 5

⁷ Haccius, Charles, The Irish Corporation Tax Revolution, Bulletin for Int. Fiscal Documentation, Vol. 54 nr. 3 2000, p. 123

⁸ Sec. 443(1) TCA 1997

⁹ Haccius, Charles, The Irish Corporation Tax Revolution, Bulletin for Int. Fiscal Documentation, Vol. 54 nr. 3 2000, p. 129

was a big problem. When Ireland joined the EEC in the 1970s, the previously sheltered economy was suddenly opened up to foreign competition and, as a result, many Irish firms collapsed. This downsizing of local enterprise was not counterbalanced by foreign investment.¹⁰

In 1990 the government decided to extend the 10% rate for the manufacturing sector until 2010. The Commission still raised no objections, since the scheme was not regarded as state aid.¹¹

Because of the awkward position of Ireland and its relatively small population, the Irish government saw the 10% rate as a crucial instrument in attracting foreign investment. The manufacturing rate was backed up by other incentives, such as capital grants and other operating subsidies provided by government agencies such as the Irish Industrial Development Authority (IDA).¹²

It was clear that the 10% rate for the manufacturing sector itself was not at the time regarded as a state aid by the commission.

2.3 The International Financial Services Centre

2.3.1 Background

In 1987 the commission approved the IFSC under the State Aid rules for a three-year period, taking account of the serious socio-economic situation in the area. Initial progress in the area was slow.¹³ In 1990 when the Irish government extended the 10% “manufacturing rate”, the commission also approved the continuation of the rate for the IFSC up to 31 December 2000, and in subsequent approvals the extension was approved up to 31 December 2005, for enterprises approved before 31 December 2000. Little by little companies began realising the advantages of doing business in the IFSC and by 1993 over 170 IFSC companies were operational, with a number of further projects approved but not yet announced.¹⁴

In an international context this extension to manufacturing relief is, together with the Shannon regime, perhaps the best known. Compared to the 10% “manufacturing rate”, which was seen as a general taxation measure, these

¹⁰ Ward, John, Fiscal Politics for the Economic Enterprise in Ireland, Bulletin for Int. Fiscal Documentation, Vol. 54 nr. 2, p. 59

¹¹ McNally, Donal, A New Tax Regime for the 21st Century – Corporation Tax Aspects, Bulletin for Int. Fiscal Documentation, Vol. 39 no. 1, p. 5

¹² Ward, John, Fiscal Politics for the Economic Enterprise in Ireland, Bulletin for Int. Fiscal Documentation, Vol. 54 nr. 2, p. 59

¹³ Code of Conduct (Business Taxation) / Primarolo Group, Sec. B1

¹⁴ Price Waterhouse, Doing business in the Republic of Ireland, p. 57

extensions on the other hand did not apply on a general basis to these services and were therefore regarded as state aids by the Commission.

Around 23 % of the projects are believed to be of Irish origin, 37 % of EU origin and 40 % from non-EU countries.¹⁵

2.3.2 Tax Incentives

The IFSC is located in the docklands area of Dublin. Incentives are granted to companies locating and carrying on “relevant trading operations” in this area. Qualifying activities include fund management, asset financing, treasury management, financial advice, dealing and brokerage operations, insurance and reinsurance and back-office operations. To qualify for these incentives the company must first obtain a certificate from the Minister of Finance licensing the proposed operations.¹⁶

IFSC approved projects must be engaged in financial services activities which have substance and which contribute to the development of the IFSC. All projects approved for the Centre must commit to creating a minimum number of new jobs. At the end of 1997 IFSC projects employed 4500 people directly with the commitment to increase this number to 6000 in the next few years. The numbers employed in individual projects range to more than hundred. Brass plate operations are not approved. Benefits are available to financial services carried out with non-residents of Ireland.¹⁷

Amongst the benefits available are:

- 10 % rate of corporate income tax,
- Exemption from rates (local property taxes) for ten years,
- Double deduction of rent expenses in the centre for lessees for ten years,
- 100 % write off in the first year of new building costs in the centre for owner occupiers,
- 54 % write off in first year of new building costs in the centre for lessors and write-off of the balance at 4 % annum thereafter,
- 100 % write-off in the first year of expenditure on new equipment.¹⁸

¹⁵Code of Conduct (Business Taxation) / Primarolo Report, Sec. B1

¹⁶Price Waterhouse, Doing Business in the Republic of Ireland, p. 17

¹⁷Code of Conduct (Business Taxation) / Primarolo Report, B1

¹⁸Price Waterhouse, Doing Business in the Republic of Ireland, p. 18

2.4 Shannon Airport Zone

2.4.1 Background

Shannon Airport was established in 1947 as a customs-free port. To encourage the use of Shannon Airport as an international trading and distribution centre, the Irish government decided to extend the 10% rate to this area. In 1981 the Commission approved the extension of the 10% corporation tax until 31 December 2000 to newly established service companies in the Shannon Customs-Free Airport Zone.¹⁹

The Shannon area was also subject of further approvals expanding the coverage of the 10% rate in the 1990s. In 1994 the Commission approved the extension of the Shannon 10% services regime to 31 December 2005 for enterprises approved before 31 December 2000, i.e. the same regime as for the IFSC.²⁰

It was clear that both IFSC and Shannon regimes were regarded as state aid, but were nevertheless approved by the Commission on terms favourable to Ireland.

2.4.2 Tax Incentives

Over 120 high-technology manufacturing companies and international service companies are located in the Shannon Free Zone. The companies must be engaged in activities which are “significantly oriented” towards Shannon Airport, including activities directly related to aviation and activities generating freight or passenger movement through the airport. The “significantly oriented” requirement is interpreted broadly.²¹

Qualifying activities include activities similar to those in the IFSC, as well as broader international services, including aircraft management, trading, leasing or training; aircraft servicing; repair or parts distribution; warehousing and distribution of consumer and industrial products, components or materials; International headquarters operations, sales, accounts or administration; catalogue publication and technical documentation; importing, exporting and debt factoring; consultancy and research; and certain mail-order activities.²²

The following incentives encourage companies to locate in the Shannon Free Zone:

- A 10 % corporate tax rate for qualifying profits.

¹⁹ PriceWaterhouse, Doing Business in the Republic of Ireland, p. 17

²⁰ McNally, Donal, A New Tax Regime for the 21st Century – Corporation Tax Aspects, Bulletin for Int. Fiscal Documentation, Vol. 39 no. 1, p. 5

²¹ PriceWaterhouse, Doing Business in the Republic of Ireland, p. 18

²² PriceWaterhouse, Doing Business in the Republic of Ireland, p. 18-19

- Exemption from withholding and other taxes.
- Free repatriation of profits.
- Grants for certain fixed-asset costs and training programmes offered to the manufacturing industry.²³
- 100 % write-off in the first year of new building costs for owner-occupiers.
- 54 % write of in first year of new building costs for lessors and write-off of the balance at 4 % annum thereafter.
- 100 % write-off in the first year of expenditure on new equipment.²⁴

The availability and level of assistance depend on the merits of each proposal and its potential contribution to the Irish economy.

²³ PriceWaterhouse, Doing Business in the Republic of Ireland, p. 19

²⁴ Code of Conduct (Business Taxation) / Primarolo Report, D17

3 Current reforms of the corporate tax regime

3.1 A new approach

Since the middle of the eighties a radically new approach to the management of the economy and the sensible deployment of EU subventions in developing both the human and physical infrastructure have helped to significantly strengthen the Irish economy. Irelands stable low-inflation economy and its commitment to join the European Monetary Union combined with a package of tax incentives have certainly helped to make it an attractive location for inward investment. Also, Irelands industrial relations have improved significantly due in large part by a series of agreements between the government, employers and trade unions. Finally the tax authorities have adopted a very positive and friendly approach in their contacts with foreign investors.²⁵

This new approach has certainly helped to foster the recent explosion in the Irish economy, leading Ireland to be dubbed the “Celtic Tiger”.²⁶ The current public debt ratio is currently projected to decline to 53% of GDP by 2001 and employment is projected to increase steadily at around 2% to 2.5% in the next few years. Ireland, traditionally a net exporter of people, has for the past few years experienced a pattern of immigration. Current population 15 years and over stands at around 3 million. Growth, which peaked at 10% in 1994, is projected to fall, but to remain comfortably above EU average in the next few years. GDP per capita now surpasses that of the United Kingdom and is close to the EU average. There have been budget surpluses in the five successive years to 1998 with a projected surplus equal to 3% of GDP for 1999.²⁷

The agricultural sector is now dwarfed by industry, which accounts for 38% of GDP and 80% of exports. Exports are clearly the primary engine of Irelands economic growth. There are currently more than 1000 foreign-owned industrial operations based in Ireland, the majority of which have located there within the last 20 years. 40% of these are US-owned, 20 % German-owned. It has been estimated that 30-40% of all US investment in the European Union is located in Ireland. The United Kingdom and Japan are also significant sources of inward investment.²⁸

²⁵ Irland lockar med låg bolagsskatt, Statstjänstemannen 6/98 p. 30

²⁶ Irland lockar med låg bolagsskatt, Statstjänstemannen 6/98 p. 30

²⁷ The Irish Central Statistics Office, <http://www.cso.ie/principalstats/princstat.html>

²⁸ Ernest & Young, Doing Business in the Republic of Ireland, p. 5

3.2 Overview of tax reform

In the middle 1990s awareness was growing at EU level and in particular among Member States of the issue of tax competition. A number of sensitive relocations of individual projects from some Member States to Ireland heightened these concerns. A particular concern among the member states was financial services where, it was felt, the opportunities for tax-driven activity was far greater than with more substantive manufacturing activities. In 1996 the Commission view had changed. In November they advised Ireland that they were looking at the 10% corporation tax regime to see whether it constituted a state aid.²⁹

As a result of the Commissions changed views on the manufacturing relief and the Shannon and IFSC regimes the Irish government instituted a programme of tax reform extending over a five-year period. Some radical changes were made concerning the taxation of corporate profits and dividends paid out of those profits. Further modifications were announced in the Budget proposal for the year 2000, to which legislative effect was given later that year. Most of the proposed reforms have now been accomplished.³⁰

The reforms include the phasing out of the “manufacturing relief”. Manufacturing relief in respect of the profits accruing to companies from trades set up and commenced on or after 23 July 1998 will cease with effect from 31 December 2002.³¹ Manufacturing relief will cease with effect from 31 December 2010 if the manufacturing trade was commenced before 23 July 1998.³²

Manufacturing relief in respect of trading operations carried on in Shannon Airport or the International Financial Services Centre will also cease with effect from 31 December 2002.³³ The exception is if the Irish Minister for Finance approved the “trading operations” on or before 31 May 1998. Manufacturing relief will then cease with effect from 31 December 2005.³⁴

The relief is being replaced by a rate of 12,5%, effective 1 January 2003, applicable to trading profits generally, whether arising from the manufacture and sale of goods or otherwise.³⁵ Corporate profits arising from other sources than the carrying on of a “trade” are now taxed at the rate of 25%.³⁶

²⁹ Proposal for appropriate measures under Article 93(1) of the EC Treaty concerning Irish corporation tax, O.J. C 395, 18 December 1995, at 19

³⁰ Budget 2000, <http://www.revenue.ie/wnew/corp00.htm>

³¹ See the definition of “relevant accounting period” in Sec. 442 TCA 1997.

³² Sec. 442(1) TCA 1997

³³ See Secs. 445(2)(b) and 446(2)(b) TCA 1997.

³⁴ Secs. 445(2)(a) and 446(2)(a) TCA 1997.

³⁵ Sec. 21(1)(f) TCA 1997

³⁶ Sec. 21A(3) TCA 1997

The 12,5% rate will be reached by reducing the normal rate of Irish corporation tax applicable to trading profits with 4% annually. Thus, the tax applicable to trading profits, currently 24%, is reduced to 20% in 2001, to 16% in 2002 and to 12,5% in 2003. These rates will, as explained before, co-exist with the reduced rate of 10%, which will continue to apply to corporate profits arising from the manufacture and sale of goods until 31 December 2002.³⁷

The budget proposals for the year 2000 also announced an immediate reduction in the current rate of Irish corporation tax for companies whose corporate profits do not exceed IEP 50,000 in any 12-month accounting period. In 2001 this reduction was extended to companies whose profits do not exceed IEP 200,000. The corporation tax for these companies was reduced from 24% to 12,5%, effective 1 January 2000.³⁸

During the transitional period commencing on 1 January 2000 and terminating on the 31 December 2002, the Irish system of taxing corporate profits will be somewhat complex. Depending on their nature and source, corporate profits can be taxed at any one of four different rates during 2001.

- 20% (previously 24%) for trading income
- 25% for non-trading income
- 12.5% for small and medium-sized enterprises where the trading income does not exceed £200,000 (provision for marginal relief where income does not exceed £250,000).
- 10% for Manufacturing, IFSC and Shannon companies

If the accounting period of the company does not coincide with the calendar year, its profits may be taxed at no less than five different rates.³⁹

3.3 Corporation tax rates

3.3.1 On trading profits and other income

The goal for the Irish government is to reach a position by 2003 whereby the profits arising from a “trade” “carried on” by an Irish resident company, or by a non-resident company through a “branch or agency” situated in Ireland, will be subject to Irish corporation tax at the rate of 12,5%.⁴⁰ Other income arising from an Irish resident company, or from a non-resident company from “property or

³⁷ Sec. 21(1)(f) TCA 1997

³⁸ Budget 2000, <http://www.revenue.ie/wnew/corp00.htm>

³⁹ Haccius, Charles, *The Irish Corporation Tax Revolution*, Bulletin for Int. Fiscal Documentation, Vol. 54 nr. 3 2000, p. 122

⁴⁰ Sec. 21(1)(f) TCA 1997

rights” “used by” or “held by or for” such a company’s “branch or agency” in Ireland, will be subject to Irish corporation tax at the rate of 25%.⁴¹

The distinction between profits arising from a “trade” and income arising from other sources is of vital importance. Depending on the outcome profits can be taxed at either 12,5% or 25%. The absence of any statutory definition of the all-important word “trade” is therefore quite remarkable.

*As pointed out by the English House of Lords in J.P Harrison (Watford) Ltd. v. Griffiths, 40 TC 281: “Parliament did not vouchsafe an answer. It did not define a trade. Try as you will, the word trade is one of those common English words which do not lend themselves readily to definition but which we all of us think we understand well enough. We can recognize a trade when we see it, and also an adventure in the nature of trade. But we are hard pressed to define it” (299 per Lord Denning).*⁴²

In Ireland in *Veterinary Council v. Corr* 3 ITC 59 a judicial definition was attempted. *“In its ordinary meaning [trade] connotes and includes the almost inexhaustible pursuits of commerce and industry, the manufacture, distribution, purchase, sale or exchange of commodities or goods: and dealings of any kind in land, moneys, investment, property or goods” (64 per Maguire J).*⁴³

As previously described Sec. 21(1) TCA 1997 provides for the gradual reduction in the rate of corporation tax. As mentioned earlier the tax is payable on “profits” arising from the “carrying on” by a company of a “trade”.

If a company’s “period of account” does not coincide with the calendar year, the profits of the company for that period are taxed at the corporation tax rate appropriate to the portion of those profits attributable on a time apportionment basis to each successive “financial year”.⁴⁴

3.3.2 Chargeable gains

Chargeable gains are normally subject to Irish capital gains tax at a flat rate of 20%.⁴⁵ Corporation tax is payable in respect of “profits” at the rates mentioned in Sec. 21(1) TCA 1997. “Profits” are defined in Sec. 4(1) TCA 1997 to include chargeable gains.

⁴¹ Sec. 21A(3) TCA 1997

⁴² Haccius, Charles, *The Irish Corporation Tax Revolution*, Bulletin for Int. Fiscal Documentation, Vol. 54 nr. 3 2000, p. 127-128

⁴³ Haccius, Charles, *The Irish Corporation Tax Revolution*, Bulletin for Int. Fiscal Documentation, Vol. 54 nr. 3 2000, p. 128

⁴⁴ Sec. 4(6) TCA 1997

⁴⁵ Sec. 28(3) TCA 1997

In order to ensure that the amount of corporation tax payable to the company in respect of a chargeable gain does not exceed the amount of capital gains tax which would normally be payable, the amount of the chargeable gain must first be adjusted. This is done by dividing the normal capital gains tax rate of 20% by “the rate specified in Sec. 21(1) TCA 1997”.⁴⁶

If the company’s accounting period does not coincide with the “financial year”⁴⁷, “the rate specified in Sec. 21(1) TCA 1997” is calculated in the following way:

$$(A \times C)/E + (B \times D)/E$$

Where

A= the Irish corporation tax in force in the first-mentioned financial year.

B= the Irish corporation tax in force in the succeeding financial year.

C= the portion of the company’s period of account included in the first-mentioned fiscal year.

D= the portion of the company’s period of account included in the succeeding financial year.

E= the length of the company’s period of account.

Thus, if a company accrues a chargeable gain of 100,000 in its financial year ending 31 March 2001 the calculation would look like this:

First the rate specified in Sec. 21(1) TCA 1997, to which regard must be had when adjusting the amount of the chargeable gain, has to be calculated.

$$(24\% \times 9)/12 + (20\% \times 3)/12 = 18\% + 5\% = 23\%$$

According to the provisions in Sec. 78 TCA 1997 the gain would be subject to the standard rate of 20%. This means that the maximum capital gains tax payable by the company would be 20,000. To achieve this the amount of the chargeable gain must be adjusted by multiplying it with the fraction of 20/23. 23 is the rate calculated above according to Sec. 21(1) TCA 1997.

$$20/23 \times 100,000 = 86,956$$

This amount is subject to Irish corporation tax at the rate specified in Sec. 21(1) TCA 1997 (in this case 23%). 89,956 is taxed at 23%, and the corporation tax payable is 20,000. This is equal to the capital gains tax, at the rate of 20%, which would normally be payable on a chargeable gain of 100,000.

⁴⁶ Sec. 78(1)-(3) TCA 1997

⁴⁷ Sec 4(1) TCA 1997

3.3.3 Exceptions

There are a number of exceptions to the general rule that profits accruing from the carrying on of a “trade” are taxed at a rate specified in Sec. 21(1) TCA 1997, while other income is subject to Irish corporation tax at the rate of 25%.

1. Profits arising from an “excepted trade” are subject to Irish corporation tax at the rate of 25%.⁴⁸ “Excepted trade” is defined in Sec. 21A(1) TCA 1997 as a “trade” which consists of “excepted operations”. “Excepted operations” are defined as “trades” involving; dealing in and developing land; working minerals; and petroleum activities.
2. The 10% “manufacturing rate” is still in force. Profits arising from the “sale” of “goods” “manufactured” by a company in Ireland are taxed at the 10% rate. Companies in the IFSC and Shannon Airport areas are also subject to manufacturing relief.⁴⁹ Manufacturing relief in respect of the profits accruing to companies from trades set up and commenced on or after 23 July 1998 will cease with effect from 31 December 2002.⁵⁰ Manufacturing relief will cease with effect from 31 December 2010 if the manufacturing trade was commenced before 23 July 1998. Manufacturing relief in respect of trading operations carried on in Shannon Airport or the International Financial Services Centre will also cease with effect from 31 December 2002.⁵¹ The exception is if the Irish Minister for Finance approved the “trading operations” on or before 31 May 1998. Manufacturing relief will then cease with effect from 31 December 2005.⁵²
3. Companies whose profits do not exceed IEP 200,000. The corporation tax for these companies was reduced from 24% to 12,5%, effective 1 January 2000.⁵³ The limit of IEP 200,000 is reduced if the company in question has one or more associated companies⁵⁴, or the duration of the company’s accounting period is shorter than 12 months.
4. Corporate profits arising from the sale of residential land will be taxed at the corporation tax rate of 20% instead of the normal rate of 25%.”Residential land” is defined by reference to Sec. 649A TCA 1997.

⁴⁸ Sec. 21A(3) TCA 1997

⁴⁹ The 10% “manufacturing rate” and the IFSC and Shannon extensions are covered in detail in sections 2.2 – 2.4.

⁵⁰ See the definition of “relevant accounting period” in Sec. 442 TCA 1997.

⁵¹ See Secs. 445(2)(b) and 446(2)(b) TCA 1997.

⁵² Secs. 445(2)(a) and 446(2)(a) TCA 1997.

⁵³ Budget 2000, <http://www.revenue.ie/wnew/corp00.htm>

⁵⁴ Sec. 432(1) TCA 1997

4 State Aid and Code of Conduct

4.1 State Aid

4.1.1 Article 87 (1)⁵⁵

Article 87 (ex Article 92)

1. Save as otherwise provided in this Treaty, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, insofar as it affects trade between Member States, be incompatible with the common market.

Article 87 lays down the basic tests for state aids. It covers aid given to public undertakings which come within article 86, as well as aid given to private companies. Paragraph (1) establishes the general principle that state aids are incompatible with the common market. Paragraph (2) provides certain exceptions to the main rule where the aid “will be deemed” to be compatible with the common market. Finally, paragraph (3) provides cases where the aid “may be deemed” to be compatible with the common market.

The ECJ and the Commission have adopted a broad view of what constitutes state aid. The reason for giving state aid is not relevant for the definitional task performed under Article 87(1).⁵⁶ Also, substance not form is the criterion when defining aid. The Commission has provided a full list of the varying types of aid. These include among many others tax incentives. The list is of course not exhaustive, and can be added to if needed.

General measures of economic policy, such as interest-rate reductions, while benefiting industrial sales, will not in themselves be classified as state aid. In this sense a non-sectoral measure of general taxation policy will remain within the area of state fiscal sovereignty. It is, however also clear that a measure will be classified as aid even if it benefits a whole range of undertakings, as in the case of a general export aid.

If it is decided that there is a state aid, which has been granted by a member state, the Commission has to check whether the aid could “distort or threaten to distort

⁵⁵ This section is based on Craig, Paul and De Burca, Grainne, EU Law, Second Edition, pp. 1077-1082

⁵⁶ Case 173/73, Italy v. Commission [1974] ECR 709, [1974] 2 CMLR 593; Case C-241/94, France v. Commission [1996] ECR I-4187, [1997] 1 CMLR 983

competition by favouring certain undertakings or the production of certain goods”. If the position of the relevant company has improved after the receipt of the aid, then the condition will have been met. It is no defence for the state to argue that the aid is justified because its effects is to lower the costs of a sector of industry which has higher costs than other industrial sectors.⁵⁷

The final element in Article 87(1) is that there should be an “effect on inter-state trade”. If aid strengthens the financial position of one undertaking as compared to others within the community then inter-Community trade will be affected.⁵⁸

4.1.2 Article 87 (3)⁵⁹

Whereas the exceptions in Article 87 (2) *will* be deemed to be compatible with the common market, the exceptions in Article 87 (3) are discretionary.

3. The following may be considered to be compatible with the common market:

(a) aid to promote the economic development of areas where the standard of living is abnormally low or where there is serious underemployment;

(b) aid to promote the execution of an important project of common European interest or to remedy a serious disturbance in the economy of a Member State;

(c) aid to facilitate the development of certain economic activities or of certain economic areas, where such aid does not adversely affect trading conditions to an extent contrary to the common interest;

(d) aid to promote culture and heritage conservation where such aid does not affect trading conditions and competition in the Community to an extent that is contrary to the common interest;

(e) such other categories of aid as may be specified by decision of the Council acting by a qualified majority on a proposal from the Commission.

The Commission develops the general policies within this area. The decisions are of course subject to judicial review by the ECJ and CFI. However, the assessment of the exceptions may involve complex evaluations of social and economic data. For that reason it is not likely that the ECJ and the CFI will substitute their view for that of the Commission. The ECJ will in these cases often make reference to the Commission’s considerable discretion concerning state aids, and will normally only overturn a decision if the applicant can show a procedural defect, deficiency of reasoning, factual inaccuracy, a manifest error in assessing the facts, or some misuse of power.⁶⁰

⁵⁷ Case 173/73 n. 19 above.

⁵⁸ Case 730/79, Phillip Morris Holland BV v. Commission [1980] ECR 2671, [1981] 2 CMLR 321.

⁵⁹ This section is based on Craig, Paul and De Burca, Grainne, EU Law, Second Edition, pp. 1082-1090.

⁶⁰ Among others Case C-56/93, Belgium v. Commission [1996] ECR I-723.

In general terms aid can be designed to restructure an undertaking, to rescue an undertaking or to help it with operating costs. The Commission has provided guidelines on the first two of these.⁶¹

Operating aid relieves an undertaking of expenses which it would normally incur in its day-to-day operation, with no technical or structural alteration in the character of the recipient. Common forms of operating aids are various kinds of tax reductions. It is generally regarded as objectionable by the Commission and the Court⁶² and is normally only authorised to cope with specific regional or sectoral problems. Operating aid can therefore only be used together with Article 87 (3) (a) or (c).⁶³

There is a connection between Article 87 (3) (a) and Article 87 (3) (c), in that both relate in a general sense to regional development. The wording of Article 87 (3) (a) makes it clear that it can, however, only be used where the problem which troubles an area is especially serious. The Commission has taken the view, which has been upheld by the court, that the seriousness of the regional problem must be judged in a Community context, not a national.⁶⁴

4.1.3 Analysis

In 1998, in the light of the stricter rules now prevailing concerning the granting of aid and because of the growing awareness of the effects of harmful tax competition, the European Commission reviewed the State Aid approval previously given for the Financial Services Centre and Shannon Airport.⁶⁵ This review also included the wider preferential rate of 10% tax for manufacturing activities.

These preferential tax rates constitute operating aid, which is aid aimed at reducing a firm's current expenses without any technical or structural alteration in the character of the recipient.

As explained above⁶⁶, the Commission considered at the introduction of the 10 % "Manufacturing rate", that the new scheme was a general taxation measure and that it did not constitute state aid. The new guidelines on the application of the

⁶¹ Community Guidelines on State Aid for Rescuing and Restructuring firms in difficulty [1994] OJ C368/12.

⁶² Case T-459/93, Siemens SA v. Commission [1995] ECR II-1675, upheld on appeal in Case C-278/95P, Siemens SA v. Commission [1997] ECR I-2507.

⁶³ Aldestam, Mona, Skatteåtgärder som staligt stöd enligt artikel 87 i Unionsfördraget, Skattenytt 2001, p. 95.

⁶⁴ Case 730/79, Philip Morris Holland BV v. Commission [1980] ECR 2671, [1981] 2 CMLR 321, Para. 24-25

⁶⁵ Proposal for appropriate measures under Article 93(1) of the EC Treaty concerning Irish corporation tax, O.J. C 395, 18 December 1995, at 19

⁶⁶ 2.2 The 10 % "Manufacturing rate"

state aid rules to measures relating to direct business taxation,⁶⁷ published by the Commission in 1998, has made it clear that a measure will be classified as aid even if it benefits a whole range of undertakings, as in the case of a general manufacturing aid. The Commission therefore set out a timetable to bring the measure to an end.

The IFSC and Shannon regimes on the other hand were, at their introduction, regarded as state aids by the Commission, since they did not apply on a general basis. They were nevertheless approved by the Commission on terms favourable to Ireland.

Under the Commissions State Aid rules, this form of aid can only be authorised in regions qualified as areas where the standard of living is abnormally low or where there is serious underemployment (Article 87 (3) (a)).⁶⁸ The IFSC and Shannon regions lost their status of “troubled regions” at the end of 1999.

The Commission set out a timetable to bring all state aid measures to an end. However, the Commission made transitional arrangements with Ireland for existing projects with legitimate expectations to a preferential rate on the basis of previous decisions.⁶⁹

The Commissions decision to terminate Irelands exception under Article 87 (3) could of course have been contested in the ECJ. The IFSC- and Shannon- regions are, however, hardly areas “where the standard of living is abnormally low or where there is serious underemployment” any longer. Also, due to the complex evaluations of social and economic data involved in such a review, the court will think twice before substituting their view for that of the Commission.⁷⁰

4.2 Code of Conduct

4.2.1 The Code of Conduct

In 1996 discussions were taking place among the member states in a high-level tax policy group chaired by Commissioner Monti on how to combat unfair business tax competition at EU level. These discussions culminated in the Code of

⁶⁷ Community Guidelines on the application of the state aid rules to measures relating to direct business taxation, O.J. 98/C 384/03

⁶⁸ Aldestam, Mona, Skatteåtgärder som statligt stöd enligt artikel 87 i Unionsfördraget, Skattenytt 2001, p. 95.

⁶⁹ Kok, Coraline, Irish Corporation Tax considered state aid, Bulletin for Int. Fiscal Documentation, February 1999, p. EC-5-EC-6

⁷⁰ The growing discontent among Member States concerning harmful tax competition probably also played a large role in the decision.

Conduct for Business Taxation adopted by Finance Ministers on 1 December 1997.

The first measure aimed at applying the Code in practice was a “standstill”:
Member States committed themselves not to introduce new tax measures that were harmful within the meaning of the Code. Member States would therefore respect the principles underlying the Code when determining future tax policy.⁷¹

The second measure was “rollback”: Member States committed themselves to re-examining their existing laws and established practices, having regard to the principles underlying the Code and to the review process outlined. Member States undertook to amend their tax laws and practices to eliminate “harmful” measures, taking into account the Council's discussions following the review process.⁷²

The code envisages Member States taking action to counteract and roll back “measures which affect, or may affect, in a significant way the location of business activity in the Community”.⁷³ The tax measures covered by the code include both laws or regulations and administrative practices. The measures identified as potentially harmful are tax reliefs, which provide for a significantly lower effective level of taxation, including zero taxation, than that which applies generally in the member state in question. Some member states wanted the Code to apply to low rates of tax relative to the general level in the EU countries as a whole.⁷⁴ This was not however agreed.

Account will also be taken of:

1. Whether the benefits are available only to, or in dealing with, non-residents;
2. Whether the benefits are ring-fenced from the domestic market, so they do not affect the national tax base;
3. The level of real economic activity taking place;
4. Whether the rules for profit determination in respect of activities within a multinational group of companies departs from internationally accepted principles, notably the rules agreed upon within the OECD;
5. The tax transparency of these measures.⁷⁵

Member States also undertake to inform each other of existing and proposed tax measures which might fall within the scope of the Code. At the request of a

⁷¹ Code of Conduct (Business Taxation) Art. C. See also Tax co-ordination in the European Union, Economic Affairs Series ECON 125 EN, p. 28

⁷² Ibid.

⁷³ Code of Conduct (Business Taxation) Art. B. Also Code of Conduct (Business Taxation) / Primarolo Group, Para. 3.A

⁷⁴ Donal McNally, A New Tax Regime for the 21st Century – Corporation Tax Aspects, European Taxation, Vol. 39 no. 1, p. 4

⁷⁵ Code of Conduct (Business Taxation) / Primarolo Group, Para. 3.B

Member State, other Member States are required to provide information on any tax measure that appears to fall within the scope of the Code. When it is feasible that tax measures need parliamentary approval, such information is also to be given to Parliament.⁷⁶

Under the Code, any Member State may request the opportunity to discuss and comment on a tax measure of another Member State that may fall within the scope of the Code. This way an assessment can be made of whether the tax measures in question are harmful, in the light of the effects that they may have within the Community.⁷⁷

4.2.2 The "Primarolo Report"⁷⁸

Both Parliament and Council immediately accepted the idea of the Code, and the Council of Finance Ministers adopted the final text on 1st December 1997. The "follow-up" Group was established by ECOFIN on 9th March 1998, and met for the first time on 8th May 1998, when it elected as its first chairman the UK Treasury Minister, Dawn Primarolo. It has therefore become known as the "Primarolo Group".

The Group's first task was to examine a list, compiled by the Commission largely on the basis of information supplied by Member States, of national tax provisions which *prima facie* fall within the scope of the Code. The Commission has identified a number of tax schemes and classified them under five headings:

1. Intragroup services.
2. Financial and insurance services, including "offshore" financial services in territories under the jurisdiction of a Member State (e.g. in Gibraltar).
3. Special tax treatment for certain industrial or service sectors (e.g. the film industry).
4. Tax advantages for certain geographical areas (e.g. the Canary Islands).
5. Other measures, including tax incentives for certain kinds of company (e.g. "micro" enterprises).

The Group's report was published at the end of 1999. It had examined 271 tax measures, notified to it under the terms of the Code, and identified 66 which affected "in a significant way the location of business activity in the Community". The Group's mandate has now been extended to monitor the "roll-back" of these measures, and to ensure that the "standstill" on new measures is maintained.

⁷⁶ Code of Conduct (Business Taxation), Para. E.

⁷⁷ Code of Conduct (Business Taxation), Para. F.

⁷⁸ This section is based on the Code of Conduct (Business Taxation) / Primarolo Group report

4.2.3 Analysis

Of the 271 tax measures examined by the Primarolo group 14 were Irish. After careful consideration 5 of these received a positive evaluation, meaning the measures were considered harmful.

The IFSC and Shannon regimes fall within the financial services group. Measures belonging to this group received a positive evaluation if they were aimed in whole or in part at providing exemptions or reduced levels of tax to financial services companies.⁷⁹ Both measures were consequently considered harmful.

In addition, the IFSC received a positive evaluation as a measure relating to group financing. In this category particular attention has been paid to whether the measures;

- provide for a reduced nominal rate of tax;
- provide fixed margins for pass through financing without a regular review of those margins against normal commercial criteria;
- allow the creation of substantial reserves which are in excess of the real underlying risks and which reduce taxable profits;
- permit the profits to be allocated between a Head Office and a branch in a formulaic way contrary to the arm's length principle that can lead to a reduced effective rate of tax for the company as a whole.⁸⁰

Of course the main criteria (the measure needs to provide for a significantly lower effective level of tax) is still the starting point of the evaluation. It is however unclear whether any or all of the additional features needs to be present for a measure in this group to be considered harmful. According to the report "particular account" should be taken "of whether some or all of the ... features are present".⁸¹ This seems to suggest that evidence of a significantly lower effective level of tax alone is sufficient for a measure to be considered potentially harmful. If this is the case, the presence of one or more of the features listed, serves as an assumption of a lower effective level of tax.

The IFSC certainly provide for a reduced nominal rate of tax. On the other hand the terms of the tax certificate of a company in the IFSC will generally require that all transactions with associated companies be priced on an arm's-length basis.⁸² Thus, IFSC measures do not permit profits to be allocated in any way contrary to the arm's-length principle.

The 10% "manufacturing rate" do not fit into the broad groups listed above. This measure has nevertheless been given a positive evaluation on the grounds that it

⁷⁹ Code of Conduct (Business Taxation) / Primarolo Group, Para. 32

⁸⁰ Code of Conduct (Business Taxation) / Primarolo Group, Para. 34

⁸¹ Code of Conduct (Business Taxation) / Primarolo Group, Para. 34

⁸² Doing business in the Republic of Ireland, Price Waterhouse 1993, p. 160

applies a lower rate of tax to certain categories of activity. Another measure, a 25% tax rate applying to petroleum exploration and extraction, also received a positive evaluation on the same grounds.⁸³

The fifth and final tax measure in Ireland to receive a positive evaluation is the foreign income regulation. This measure applies to dividends and foreign branch trading profits received by Irish resident companies, which can be exempt from Irish corporate income tax. A certificate must be obtained from the Minister of Finance on the basis of an investment plan. To obtain the certificate the dividends or foreign branch trading income must be applied for the purposes of an investment. This plan must be directed towards the creation or maintenance of employment in trading operations carried on in Ireland.⁸⁴

Double taxation relief for the repatriated dividends is provided by way of an exemption from Irish corporation tax rather than the normal way of giving double taxation relief through a credit for foreign tax. Double taxation relief for the foreign branch trading profits is provided in the same way. Related capital gains are also exempted from capital gains tax.⁸⁵

These kinds of measures are often referred to as participation measures. The measures may allow the exemption of foreign source dividends in circumstances in which the profits giving rise to the dividends, have been taxed at a significantly lower level in the source country than they would have been if they had arisen in the state of the receiving company. If no CFC legislation exists the measures may allow income from tax havens to be received tax free.

To include participation exemptions in the report was somewhat controversial. The Irish delegation could not agree that any evaluation criterion under the code should take account of the level of taxation applied in another country. "The code is explicit in providing that the benchmark is the tax generally applying in the Member State. The fact that participation exemption regimes do not fit easily within the criteria in the Code is not a justification for coming up with entirely new criteria that go far beyond the Code."⁸⁶

The Primarolo group nevertheless gave the measures a positive evaluation in cases where participation exemptions were not combined with an appropriate CFC legislation (as in the case of Ireland).⁸⁷ Positive evaluations were also given to measures that exempt capital gains, provided that they were asymmetrical e.g. gains are exempt but losses are tax deductible.⁸⁸

⁸³ Code of Conduct (Business Taxation) / Primarolo Group, Para. 57

⁸⁴ Code of Conduct (Business Taxation) / Primarolo Group, Sec. E7

⁸⁵ Doing business in the Republic of Ireland, Price Waterhouse 1993, p. 161

⁸⁶ Code of Conduct (Business Taxation) / Primarolo Group, footnote 21

⁸⁷ Code of Conduct (Business Taxation) / Primarolo Group, Para. 48

⁸⁸ Code of Conduct (Business Taxation) / Primarolo Group, Para. 51

Of the five measures discussed above the IFSC, Shannon and the “Manufacturing aid” regimes are already in the process of being phased out, since they are also incompatible with the rules governing State Aid.⁸⁹ This is noted in the report.⁹⁰

Although some overlapping exists, it is clear that the scope of the Code of Conduct is much wider than the State aid rules. All of the tax measures covered by the State aid rules are also covered by the Code. In addition two other measures, the petroleum tax and the foreign income regulation, are covered.

What is not covered by the Code is the new 12,5% measure on trading income. Since the code only covers tax measures which provides for a significantly lower effective level of taxation than that which applies generally in the member state in question, and the new 12,5% scheme is a general taxation measure, it is not covered by the Code.

This is also the point. In my opinion some degree of tax competition is desirable between national tax systems as a tool to increase the competitiveness of the European economy. Coordination is, however, justified when particular features of a tax system distort competition.

⁸⁹ More on this topic under Sec. 4.1.3

⁹⁰ Code of Conduct (Business Taxation) / Primarolo Group, Sec. B1, D17, C24

5 EMU and the Stability Pact

5.1 The Stability and Growth Pact

Budgetary discipline is an essential ingredient in ensuring the success of EMU. However, the importance of sound public finances goes beyond the question of EMU. As recalled in European Commission (1998), low deficits and debt help in maintaining low interest rates and ‘crowding in’ private investment; foster low and stable inflationary expectations; by reducing the interest burden, help the restructuring of public spending and reduce taxation; allow an increase in public saving to make room for the budgetary consequences of ageing populations; and, finally, create room for fiscal policy to cope with adverse economic disturbances.⁹¹

The Stability and Growth Pact (SGP) is the concrete EU answer to the budgetary discipline concern. Adopted in 1997, the SGP strengthened the Treaty provisions on fiscal discipline in EMU. The full provisions took effect when the euro was launched on 1 January 1999.

The pact consists of three parts. The first part is a preventive element, which through regular surveillance aim at preventing budget deficits going above the 3 % reference value. This is accomplished through Regulation 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies.⁹² With the adoption of Regulation 1466/97 the council sought to set out the framework for the operation of Art. 99 EC.⁹³

The second part is the dissuasive element of the pact. In the event of the 3 % reference value being breached, it require Member States to take immediate corrective action and, if necessary, allow for the imposition of sanctions. These elements are contained in Council Regulation 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure.⁹⁴

The third part is a political commitment by all parties involved in the SGP (Commission, Member States, Council) to the full and timely implementation of the budget surveillance process. These are contained in a resolution agreed by the Amsterdam European Council of 17 June 1997: the European Council resolution on the Stability and Growth Pact;⁹⁵ This political commitment ensures that

⁹¹ Public finances in EMU – 2000, 24 May 2000, p. 45

⁹² O.J. 1997 L 209/1, This regulation is based on Art. 103(5) EC.

⁹³ Art 1, Regulation 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies

⁹⁴ O.J. 1997 L 209/6, This regulation is based on Art. 104(14) EC, 2nd subpara.

⁹⁵ O.J. 1997 C 236/1, EU 6-1997, point I.27

effective peer pressure is exerted on a Member State failing to live up to its commitments.

5.1.1 The Pact's surveillance procedure

To ensure that budgetary discipline is maintained in EMU, a comprehensive surveillance procedure has been set-up to monitor budgetary policies. This monitoring system is one part of the Stability and Growth Pact. Formal requirements concerning the submission and examination of the stability and convergence programmes are spelled out in Council regulation 1466/97 of the Stability and Growth Pact.

The procedure involves several steps. Each EU country must submit a programme to the Council and the Commission, in which it sets out its budgetary policies for the coming year. Updates of the programmes have to be submitted each year.⁹⁶ Countries participating in the euro-area submit stability programmes, while those countries not having adopted the single currency submit convergence programmes. The procedure for assessing these two kinds of programmes is similar. Both the Commission and the Economic and Financial Committee must assess the programmes. The Commission adopts a recommendation on each programme, in which it passes its views on to the Council. On the basis of the Commission's recommendation and after consulting the Economic and Financial Committee, the Council delivers an opinion on each programme. The Council can invite a Member State to adjust its programme if it considers that the objectives and contents need to be improved. The whole procedure must be completed within tight timeframes. The Council must carry out its examination and adopt an opinion within two months of receiving the stability programme.⁹⁷

The Pact specifically specifies what kind of information that needs to be included in the stability programme. Member States have to present their "*medium-term objectives for budgetary positions close to balance or in surplus*" in the programmes. The programmes also have to include information on the adjustment path towards these targets, on expected economic developments, on budgetary and economic policy measures envisaged to reach these targets as well as a sensitivity analysis. Countries submitting convergence programmes also have to set out their medium-term monetary policy objectives.⁹⁸ Furthermore, Member States have agreed, in a new code of conduct on the content and format of

⁹⁶ Art 4(1), Regulation 1466/97

⁹⁷ Art 5(2), Regulation 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies

⁹⁸ Art. 3(2), Regulation 1466/97

stability and convergence programmes⁹⁹, to include additional technical information in the programmes in order to allow the Commission and the Economic and Financial Committee to carry out an in-depth assessment and close monitoring of these programmes.

Reflecting the importance of getting the right balance between cutting taxes and pursuing deficit reductions, the ECOFIN Council of 28 February 2000 broadly endorsed four criteria for assessing whether a Member State actually has the capacity to cut taxes safely without jeopardising the SGP commitments. These criteria are:¹⁰⁰

1. Uncompensated tax reductions (i.e. where reductions are not matched by compensating reductions in public expenditure) can only be envisaged in an EU Member State that meets the medium-term budgetary target of being close to balance or in surplus;
2. Tax reductions must not be pro-cyclical as this could result in an overheating of economy and, therefore, in increased inflation;
3. Account must be taken of the level of government debt and long-term budget sustainability; and
4. Tax reductions should form part of a comprehensive reform package, which should be intended to increase output and employment.

The Commission intends to apply these criteria when assessing budgetary plans for 2001 and future updates to stability and convergence programmes.¹⁰¹

The Pact also points out the areas that the Council needs to pay special attention to when making its examination of the programmes. Among other things the Council should look especially at whether the policies presented in the Stability programme, are consistent with the Broad Economic Policy Guidelines (BEPGs).¹⁰² This document sets out the framework for economic policy co-ordination in the EU. The 1999 BEPG recommended Member States to:

1. meet fully their 1999 budgetary targets;
2. achieve budgetary positions close to balance or in surplus no later than by the end of 2002; and
3. improve simultaneously the 'quality' and sustainability of public finances.

⁹⁹ Opinion of the Monetary Committee on the content and format of stability and convergence programmes, document MC/II/482 final of 16 September 1998, endorsed by the ECOFIN Council of 12 October 1998.

¹⁰⁰ Public finances in EMU – 2000, 24 May 2000, p. 5

¹⁰¹ Public finances in EMU – 2000, 24 May 2000, p. 5

¹⁰² Art 5(1) 2 subpara., Regulation 1466/97

These objectives have been reiterated in the 2000 BEPG.¹⁰³

In the event that the Council identifies significant divergence of the budgetary position from the medium-term budgetary objective, or the adjustment path towards it, it shall, with a view to giving early warning in order to prevent the occurrence of an excessive deficit, address a recommendation to the Member State concerned to take the necessary adjustment measures.¹⁰⁴ If the Council in its subsequent monitoring judges that the divergence is persisting or worsening, the Council shall make a recommendation to the Member State concerned to take prompt corrective measures and may make its recommendation public.¹⁰⁵

5.1.2 The Pact's excessive deficit procedure

Article 104 (formerly Article 104c) provides for a monitoring procedure against the existence and continuation of excessive government deficits. The core of this mechanism is formed by the main rule, namely that the Member States must avoid excessive government deficits,¹⁰⁶ and by the criteria set out in Article 104(2) which are further worked out in the Protocol on the excessive deficit procedure.¹⁰⁷ These are:

- 3 % for the ratio of the planned or actual government deficit to GDP at market prices;
- 60 % for the ratio of government debt to GDP at market prices.

Regulation 1467/97 was adopted to speed up and to clarify the excessive deficit procedure set out in Article 104 of the Treaty in order to deter excessive general government deficits and, if they occur, to further their prompt correction. The provisions of this Regulation, which are adopted under Article 104(14) second subparagraph, constitute, together with those of Protocol (No 5) to the Treaty, an integrated set of rules for the application of Article 104.¹⁰⁸

The Commission monitors compliance with the criteria set out in Article 104(2). The evaluation is not mechanical in the sense of deviation from the criteria automatically leading to action. Article 2 of Regulation 1467/97 provides that the Commission may take account of trends and “exceptional” circumstances. A recession is considered “exceptional” if there is an annual fall in real GDP of at

¹⁰³ Council Recommendation of 19 June 2000 on the Broad Guidelines of the Economic Policies of the Member States and the Community

¹⁰⁴ Art 6(2), Regulation 1466/97

¹⁰⁵ Art 6(3), Regulation 1466/97

¹⁰⁶ Art. 104(1) EC

¹⁰⁷ Protocol (No 5) on the excessive deficit procedure annexed to the Treaty establishing the European Community

¹⁰⁸ Regulation 1467/97 Para. 1

least 2 %.¹⁰⁹ A fall of GDP of less than 2 % could nevertheless be considered exceptional in the light of further supporting evidence, such as the abruptness of the downturn or the accumulated loss of output relative to past trends.¹¹⁰ In any event, there is agreement that Member States would not invoke the exceptionality clause for recessions involving a fall in GDP of less than 3/4 of a percentage point.¹¹¹

The excess of the deficit over 3 % of GDP will be considered ‘temporary’, and thus allowed by the Pact, only insofar as the “exceptional” conditions mentioned above persist.

The SGP specifies the scale of sanctions in the event of persistent excessive deficits. Sanctions are applied only on members of the euro area.¹¹² In the first year when sanctions are imposed, the Member State concerned must pay a non-interest bearing deposit composed of a fixed component equal to 0.2 % of GDP and a variable component equal to one tenth of the difference between the deficit and the 3 % reference value.¹¹³ A ceiling of 0.5 % of GDP is set.¹¹⁴ In each subsequent year until the excessive deficit decision is abrogated, only the variable component will be applied.¹¹⁵ As a rule, a deposit is to be converted into a fine after two years if the excessive deficit persists.¹¹⁶

To ensure that the excessive deficit procedure has real teeth, strict time limits are set for each step in the excessive deficit procedure. Tight deadlines are provided also for Member States to take corrective action so as to bring their deficits back below the reference value.¹¹⁷

As a whole, Article 104 EC, including these implementing measures, is a most remarkable provision, as it confers on the Community powers giving it a far-reaching influence in the decision-making of the national budgetary legislator. The EC Treaty confers the central authority, in this case the Community authority, more far reaching powers than the German Grundgesetz.¹¹⁸

¹⁰⁹ Art. 2(2), Regulation 1467/97

¹¹⁰ Art. 2(3), Regulation 1467/97

¹¹¹ Public finances in EMU – 2000, 24 May 2000, p. 22

¹¹² Art. 109k(3) EC.

¹¹³ Art 12(1), Regulation 1467/97

¹¹⁴ Art 12(3), Regulation 1467/97

¹¹⁵ Art 12(2), Regulation 1467/97

¹¹⁶ Art 13, Regulation 1467/97

¹¹⁷ See for example Art. 3(3-4) and Art. 5-8 Regulation 1467/97

¹¹⁸ Kapteyn P.J.G. and VerLoren van Themaat, P., Introduction to the Law of the European Communities, p. 980

5.2 Analysis

The Irish economy continued to grow rapidly in 2000, with real GDP growth of 10,7 %.¹¹⁹ Employment growth in 2000 was 4,5 %, with the unemployment rate declining further to 4,1 % on average. Projections for the period 2001 to 2003 show an average surplus ratio of 4,2 %, with the debt ratio declining further to less than one quarter of GDP by 2003.¹²⁰

Ireland fully and comfortably fulfils the stability and growth pact obligations. The projected general government surplus is clearly sufficient in each year to provide a safety margin against breaching the 3 % of GDP reference value in the event of normal cyclical fluctuations.

Perhaps the biggest threat to the Irish economy is inflation. Average inflation rose to 5,6 % in 2000. It has since fallen to 4,6% but this figure still exceeds by far the maximum limit set by the European Central Bank. While this upsurge in price inflation is partly due to external and temporary factors, which are expected to fall gradually out of the consumer price index, domestically generated inflation has increased too, house price inflation remains very high and wages are rising rapidly.¹²¹

Economic experts from IMF, OECD and the European Commission have recommended economic restraints to correct the situation. Ireland did exactly the opposite. In the Budget for the month of December Charlie McCreevy, the Irish Minister of Finance, among other things, lowered the income tax rates.¹²² In an interview by Financial Times he justified this by saying that tax raises and reductions in public expenditures could not be motivated in the current booming economy.¹²³

On 12 February a decision was made by ECOFIN, on the recommendation by the Commission, to warn Ireland that it was in non-compliance with the Stability Pact.¹²⁴

“The Council considers that Irish fiscal policy in 2001 is not consistent with the broad guidelines of the economic policies as regards budgetary policy. The Council has therefore decided, together with this Opinion, to make a

¹¹⁹ Brown, John, Murray, Dublin wins plaudits from OECD, Financial Times, May 22, 2001

¹²⁰ The Irish Central Statistics Office, <http://www.cso.ie/principalstats/princstat.html>

¹²¹ Brown, John, Murray, Dublin wins plaudits from OECD, Financial Times, May 22, 2001

¹²² Budget 2001, <http://www.revenue.ie/wnew/budget1.htm#bud01>

¹²³ Brown, John, Murray, Dublin wins plaudits from OECD, Financial Times, May 22, 2001

¹²⁴ Council Opinion of 12 February 2001 on the 2000 update of Ireland's stability programme, 2001-2003 (2001/C 77/07)

recommendation under Article 99(4) of the Treaty establishing the European Community with a view to ending this inconsistency.”

In support of the decision the ECOFIN Council says, “*The stimulatory nature of the budget for 2001 poses a considerable risk to the benign outlook in terms of growth and inflation portrayed in the 2000 update. The budget, the main measures of which are indirect and direct tax cuts and substantial increases in current and capital expenditure is pro-cyclical. The supply effects are likely to be small in the short term, thereby aggravating overheating and inflationary pressures and widening the positive output gap.*”¹²⁵

The key word in the decision is *pro-cyclical*. The Council has for the first time used the criteria for assessing whether a Member State actually has the capacity to cut taxes safely without jeopardising the SGP commitments, endorsed by the ECOFIN Council of 28 February 2000. Specifically it’s the second criteria which The Irish budget does not meet:

Tax reductions must not be pro-cyclical as this could result in an overheating of economy and, therefore, in increased inflation.

The question is of course whether the new budget will actually lead to an overheating of the economy and thereby in increased inflation. There is hardly any question that the Irish economy is currently working at full throttle, but what is the immediate inflationary effect of tax cuts and spending increases?¹²⁶ In a technical sense how much inflation will result from a given amount of fiscal stimulus? The best estimate available is that each 500m IEP expansion would add only about 0.13 percentage points to Irish inflation after three years. Thus the 1.2bn IEP package of tax cuts in the budget might increase inflation by just 0.31 percentage points after three years. The effect on euro-zone inflation would be virtually zero.¹²⁷

The Council has of course arrived at different results. In any event this highlights a problem with the criteria used. The wording of the criteria is far too vague to create effective guidelines. This is most probably the result of political compromise. The vagueness makes the criteria hard to apply and the results always open to debate. It also highlights the potential flaws in a one size fits all monetary policy.

A second problem is the lack of connection between the pact’s surveillance procedure in Article 99 and the excessive deficit procedure in Article 104.

¹²⁵ Council Opinion of 12 February 2001 on the 2000 update of Ireland's stability programme, 2001-2003 (2001/C 77/07)

¹²⁶ Budget 2001, <http://www.revenue.ie/wnew/budget1.htm#bud01>

¹²⁷ Harney, Mary, Ireland’s misunderstood budget, Financial Times, Feb 5 2001

Although a formal “recommendation” under Article 99(4) of the Treaty has been taken against the December budget the pact’s surveillance procedure do not permit any harsher sanctions.¹²⁸ A reasonable assumption, in the case of non-compliance of the recommendation, would be that sanctions in the pact’s excessive deficit procedure are triggered. This is however not the case. The sanctions contained in the excessive deficit procedure such as the non-interest bearing deposit, potentially converted into a fine, are only triggered in the event of an excessive budget deficit. A *potential* excessive deficit is not enough. Ireland fully and comfortably fulfils the stability and growth pact obligations concerning excessive budget deficits and thus there is no possibility of any harsher sanctions being applied.

Political pressure however is not to be underestimated, but in the case of a question as important as this one, it is probably not enough. Irish diplomats are of course hard at work pressing the Commission to drop its insistence that the December budget be changed. Political pressure can also work in the other direction. Ireland is one of only a few states that intend to hold a referendum to ratify the Nice Treaty.¹²⁹ The timing is critical; the referendum is to be held on June 7th, just two days after European Union finance ministers meet to sign off on individual country assessments.¹³⁰

In spite of these problems, the decision to publicly reprimand Ireland over its budgetary policy is still an important one, in that the decision creates a precedent that can be used against other EU-countries violating the Stability Pact.

It remains to be seen whether the pact’s surveillance procedure and excessive deficit procedure will be as effective in practice as its authors intended. The lack of connection between the two parts is in my mind a big problem that will need work in order for it to function effectively. Already a *potential* excessive deficit should be sufficient to impose sanctions on a Member State.

¹²⁸ Art 6(3), Regulation 1466/97

¹²⁹ The referendum was held shortly after finalization of this thesis. The NO camp scored a victory, partly because of the low participation numbers.

¹³⁰ Brown, John Murray, Dublin wins plaudits from OECD, Financial Times, May 22 2001

6 Summary & Analysis

The purpose of this essay has been to look at the development of the Irish tax system and its, through the issue of tax competition, sometimes forced evolution. Competing with taxes has been a reality in Ireland since the 1950s. With the introduction of Export Sales Tax Relief (ESR) and the Shannon Free Airport Zone relief in 1956, Ireland began to move away from protectionism, import substitution and restrictions on foreign ownership of Irish manufacturing industry. ESR was however found incompatible with the EC Treaty and finally abolished in 1990 after a transitional period of ten years but other tax incentives were introduced to take its place. In 1980 a 10% corporation tax for the manufacturing sector was introduced until 2000 and in 1987 the commission approved the IFSC under the State Aid rules. The introduction of tax incentives was a key element in the drive to modernize Ireland.

Another key element was Irelands accession to the EC in the 1970s. It is inconceivable that without EU membership Ireland would have developed the same broad diversity of trading partners, of sources of inward investment, of new sources of labor and of knowledge-intensive industry. The country would not have received the external push that was required to help it deregulate the telecommunications and utilities sector and introduce competition in the consumer's interest. Ironically the two key elements that played a large part in the modernization of Ireland are now in conflict.

Since competing with low taxes has been a reality in Ireland since the 1950s, tax competition rules have not only played a major role in the development of the Irish tax system, the opposite is also true. Particularly the Code of Conduct is a concrete example of this. A number of sensitive relocations of individual projects from some Member States to Ireland heightened concerns about harmful tax competition, and served as the starting point for talks about a possible Code. Also one might suspect that the new implementing rules concerning state aid have something to do with the IFSC, Shannon and 10% "manufacturing rate".

This new and more proactive stance adopted by the European Commission towards the issue of State aid, together with the current opposition towards unfair tax competition, has meant that the corporate sector in Ireland as a whole will now be tax privileged. This is accomplished with the new 12,5% rate, effective 1 January 2003, applicable to trading profits generally, whether arising from the manufacture and sale of goods or otherwise. Corporate profits arising from other sources than the carrying on of a "trade" are taxed at the rate of 25%. It seems unlikely that the government can claw back these additional benefits to any extent without infringing European law. The extension of low rates of corporate tax to virtually all activities may encourage foreign investors to move higher risk/higher

reward activities into Ireland. Examples might be electronic commerce operations, which Ireland should be fiscally well placed for.

The debate concerning unfair tax competition is of course still very much alive and the new 12,5% rate has not silenced the protesters. Indeed other countries have expressed concern that the low Irish rate is denying them potential revenue from taxation. But, whether competition between tax systems can be considered "fair" or "unfair" is at heart a political question. Given that all EU Member States are democracies, it is hard to argue that they should not be able to make choices in favor of relatively low tax levels, or of particular tax structures, even if the result is an apparent competitive advantage.

With the realisation of the European Monetary Union a new set of rules have been implemented that further restricts the fiscal policies of the Member States. The rules have not been created in order to restrict tax competition but to provide stability for the European Economy and the new EURO currency. The effect of these rules can, however, sometimes lead to restrictions in the fiscal policies of Member States. Ireland is of course once again at the forefront of developments, already with a public reprimand by the European Commission over its budget policy.

It remains to be seen whether Ireland will be forced to withdraw its December budget or not. As has been discussed above, there are no real sanctions the European Commission can use except political pressure. Political pressure can of course sometimes be very effective but with the upcoming Irish referendum on the Nice Treaty, a more compromising approach from Brussels can be expected. Concerns have already been raised that the budget dispute with Brussels may boost the NO camp. It is not unlikely that the Commission therefore can be persuaded to tone down the wording of its official recommendation.

If on the other hand Ireland is forced to withdraw its December budget a new dilemma surfaces. With a 12,5% rate on corporation income, a 20% rate on income taken in the form of capital gains and a 46% top rate of tax on personal income the disparity between the different rates will be quite large. To sustain such a disparity may require considerable anti-avoidance controls and measures such as more extensive surcharges on undistributed corporate income to avoid tax sheltering. However, undistributed reserves are also used to fund corporate growth and investment. How should such a surcharge system allow for that aspect without creating a very complicated taxation regime? The answer to this is not obvious.

The Council's recommendation can of course also be completely reversed due to the lower economic growth that Europe and particularly the United States currently are experiencing. Because of Ireland's dependence on US companies, less investments by these companies means lower inflation. The December budget

can, in that case hardly be seen as pro-cyclical. Lower economic growth combined with the lower tax rates may also result in a budget deficit. The excessive deficit procedure will in that case kick in and sanctions becomes available. In that case it will be the first time the procedure, described in Regulation 1467/97 is used. In view of the high demands which Regulation 1467/97 makes of the Commission, the Council and defaulting Member States through the strictness of the deadlines for decision-making, it remains to be seen whether in practice it will be as effective as its authors intended.

Greater demand for tax harmonization at EU level will of course also be a factor in the future of the Irish tax system. Accomplishing such harmonization would require unanimity among Member States. It is generally accepted that one cannot harmonize corporate tax rates without harmonizing the tax base including the accountancy and tax rules for determining profits in any particular accounting period. The introduction of majority voting in taxation policy has been discussed but Ireland is not alone in opposing this. Fiscal policy is still a sacred cow among Member States and it is highly unlikely that tax harmonization will be a reality in the immediate future.

In spite of the increasing pressure on Ireland to change its tax system and abandon its low tax rates, that seems like an unlikely scenario at the present. The new 12,5% rate is not incompatible with neither the State aid rules nor with the Code of Conduct on Business Taxation. The SPG commitments can maybe force Ireland to change its December budget, but this will, at least to begin with, only affect personal income taxation. Tax harmonization is not an issue at present. Unanimity is required for such a decision, and besides, Ireland is not the only country opposed to the idea.

Overall it seems that Irelands love affair with inward investment is likely to persist for the indefinite future and that the “Celtic Tiger” will be well placed to pounce on the opportunities being opened up by the new electronic technologies.

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