

# 2. EUROPEAN AND INTERNATIONAL CONSTRAINTS ON IRISH FISCAL POLICY

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## 2.1 Introduction

In a world of increasing interdependence, fiscal autonomy of individual nations has increasingly been constrained. Ireland is no exception. Yet it is possible to exaggerate the degree to which fiscal autonomy has been lost. The purpose of my talk today is to explore some of the dimensions of external constraints on fiscal policy, focusing on the role of the European Union, other international governmental pressures, and international market pressures. It is convenient to distinguish between two rather different types of constraint: those that limit a government's flexibility in setting tax rates, and those that limit a government's ability to run a temporary deficit.<sup>1</sup>

I will argue that, despite the considerable recent focus on our European Union commitments as a constraint on aggregate fiscal policy, these have so far been of much less importance than the EU's influence on tax rates and tax design. International governmental pressures on tax rates are also growing in importance. Market forces can provide the most decisive of constraints but, so far as policy on the overall budgetary stance is concerned, these may have reached their full extent – indeed may have actually declined – though they will continue to grow so far as tax rates are concerned.

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## 2.2 Deficits

The most spectacular European Union initiative in the area of fiscal policy has undoubtedly been the Maastricht criteria for Economic and Monetary Union (EMU) membership. Suddenly, and more or less out of

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<sup>1</sup> I will not discuss expenditure policy.

the blue, a set of mechanical rules of thumb for an adequate fiscal deficit policy were promulgated and clearly framed much of the fiscal policy debate of many EU countries in the 1990s. In the event, the famous 3 per cent deficit and 60 per cent debt ceilings were not rigidly enforced,<sup>2</sup> and I think that it is not much of an exaggeration to say that any member that really wanted to was allowed to join EMU in the first wave. Nevertheless, this outcome was long in doubt, and there is general agreement that the ceilings did have a real impact on budgetary policy, notably in countries such as Italy, which had been struggling with problems of fiscal excess.<sup>3</sup>

But it would be quite wrong to include Ireland as one of these countries constrained by Maastricht. Because Ireland had for long been in heavy deficit, but by the deadline had become among the countries most compliant with the Maastricht criteria it is sometimes inaccurately stated that it was Maastricht that constrained Irish fiscal decisions to bring the deficit under control. A glance at the data shows, however, that the timing of events is quite against any such interpretation (see Appendix Figures A1-A6.). Indeed, Ireland's deficit was already well under control and within the magic 3 per cent guideline by 1989, the year in which the Delors report was completed, and well before the Maastricht criteria had been hammered out (that Treaty was signed in December 1991). The Appendix Figures also reveal that for several years thereafter there was not much improvement in the deficit, suggesting that, far from providing a ceiling to the deficit, the Maastricht numbers may have taken the pressure off a government which might otherwise have chosen to move into surplus earlier.<sup>4</sup> Even if this is going too far, it is quite clear from the timing that the Maastricht criteria were not drivers in the fiscal correction of the late 1980s.

Just when the Maastricht finishing line was in sight, in the sense that achieving EMU membership would remove the main sanction against those with weak budgets, the rather euphemistically termed Stability and Growth Pact (SGP) emerged to provide a tougher and potentially more enforceable framework to govern deficit policy among euro area members.<sup>5</sup> Critiqued by many macroeconomists as likely to reduce further the range of economic stabilisation instruments available to a set of countries which has already put monetary and exchange rate manipulation behind it, the SGP also focuses on the 3 per cent deficit ceiling. In place of the carrot of euro area membership, the pact carries a stick: fines for countries that exceed the deficit ceiling. The ceiling is, however,

<sup>2</sup> Of course the debt ceiling had a built-in escape clause in that it required only that the debt ratio be "sufficiently diminishing and approaching the reference value (60 per cent) at a satisfactory pace."

<sup>3</sup> A most interesting analysis of the way in which the Maastricht criteria may have influenced budgetary policy in each of the EMU countries is presented in von Hagen *et al.* (2001).

<sup>4</sup> To be sure, it took longer for the debt to GDP ratio to come below the target of 60 per cent of GDP: this milestone was not reached until 1995. (It might even seem that there was some backsliding in the first year of operation of the Maastricht Treaty, namely 1993; however, this was simply due to the valuation effect of the devaluation of January 1993 – that is why it is in the "foreign-held" segment that we see a jump.)

<sup>5</sup> The Stability and Growth Pact was adopted in June 1997, having emerged in discussions over the previous eighteen months. Nevertheless, it could be said to have been foreshadowed in the original Delors Plan for monetary union of April 1989.

augmented by a rather complicated set of escape clauses, designed to ensure that no country will pay a fine if its excessive deficit has been triggered by economic recession.<sup>6</sup>

Evidently with the current delicate condition of economies the world over, the exception clauses could possibly be activated in the not too distant future for some euro area members, if one believes some recent forecasts.

We do not really have any very precise indication yet of how sharp the fiscal adjustment in Ireland will be to the global slowdown. Standard estimates suggest a deficit increase of 0.5 per cent of GDP for every fall of 1 per cent in GDP below potential (Fitz Gerald *et al.*, 2000). But the eventual outturn will depend not only on the severity of the world downturn, but also on the degree to which the Irish economy is affected, and on how fiscal policy (not just the automatic stabilisers) responds. It may very well be that our remarkable and sustained boom over the past decade and a half has reflected a heightened responsiveness of the Irish economy to global growth; if so, we could see this greater elasticity also working to our disadvantage on the way down. It would certainly be unwise to suppose that Ireland has somehow acquired a structural strength in its fiscal accounts that makes it permanently immune from SGP barriers. As government social expenditures increase to catch-up, at least partly, with the increase in living standards and in private consumption, the Government's surplus, recorded at close to 5 per cent of GDP in 2000 will certainly shrink sharply this year. It is a long way down from plus 5 per cent to minus 3 per cent. However, the possibility emerges that a sharp fall-off in growth could send the Irish budget deficit back towards or beyond the 3 per cent level even if it was not severe enough to trigger the exception clauses of the SGP. I should stress that I do not regard this as the most likely outcome for 2002 or 2003, but even the possibility makes the question of how the SGP would be applied in practice of much more interest for Ireland than may have appeared only a few months ago.

Would the SGP actually constrain Irish fiscal policy in such circumstances? This is a question of political economy. This year's earlier experience does suggest that words of censure or criticism may have limited effect, especially when they are not backed by an intellectual consensus that commands general acceptance. Whatever about the view of Irish commentators on the budgetary stance adopted for 2001 (see Fitz Gerald, 2001), I think it is fair to say that opinions were very divided on the merits of the critique from the European Commission in that it was not clear whether tightening policy in Ireland would have been good for the rest of the EU. In practice the scale of any expenditure effect would have been negligible. (It is not always appreciated abroad just how small Ireland's economy is relative to that of the Union as a whole.)

But my personal view is that here was a matter of principle, not of expenditure spillovers. If budgetary policy in large economies must be constrained for the general good of the EU, then it seems right to me that

<sup>6</sup> For a discussion of other aspects of the SGP, see Cronin (2000). Whatever about temporary recession conditions, Ireland's optimal fiscal balance will, in the medium term, continue to be governed by the kinds of issue discussed in Cronin and McCoy (2000).

policy in small countries should also be subject to this categorical imperative. But my view in this regard seems not to have been so widely shared as to have created any great difficulty for the Government in facing down the critique.

What if EU censure in the matter of fiscal deficits was backed by fines, as with the SGP? Would this add significantly to the leverage that can be obtained through merely verbal censures? Though the pact is explicit enough on the matter of fines, this area remains untested. It also involves, as is well-known, a degree of measurement uncertainty which could *de facto* introduce discretion in its application (much as happened with Maastricht). Here too, I believe, the political context will be key, and enforcement will depend as much on winning the intellectual debate as on what has been written down in the pact. Any crude attempt to bring the SGP into play in the middle of a global growth slowdown, and applied to a country that might, by then, have experienced a sharp growth fall-off (albeit not severe enough to trigger the escape clauses) could present political risks for the Commission. (This would be especially so if many countries were in the same position.) In effect, although the EU has the legal power to constrain Irish fiscal deficits, and although the quantitative limits could become empirically relevant over the coming years, there is room for doubt as to whether the Union would in fact wish to invoke it against a government that was pursuing a credible counter-cyclical policy.

Nor is any wider international public forum likely to do more than contribute to the analytical debate.<sup>7</sup> Ireland has never made any conditional borrowings from the IMF, for example. No crisis is on the horizon that could conceivably alter that unbroken record. There may have been a time when calling on the IMF (in the manner of Turkey or Argentina today – and even for OECD members like Korea in recent years) might conceivably have been a viable, even desirable, option for the government, but that is years ago and it is hard to imagine a recurrence.

An international constraint, more likely to pinch earlier, is the reaction of foreign lenders. Even here, the effects are not at all as strong as they were in the years before we waved goodbye to the independent Irish pound almost three years ago. With an independent currency, a worrying fiscal evolution invariably triggered concerns about the medium and long-term strength of the currency. And not without reason. Although it would be wrong to see the weakness of the Irish pound against the DM during the 1980s as being wholly or even largely attributable to the heavy foreign borrowing and overall fiscal weakness of the time, it is equally fair to say that an appreciating currency in such circumstances would have been an unlikely configuration. It is hard to disentangle the distinct causes of the very high interest premium paid by Ireland on average during the EMS days, but the interlinked issues of devaluation risk and fiscal pressure were evidently important. Removal of devaluation risk has greatly reduced this channel of market influence on aggregate fiscal policy.

Incidentally, it is easy to underestimate the role of the international financial markets in contributing to the fiscal turnaround of the late 1980s.

<sup>7</sup> The IMF already offers comment and criticism of Irish budgetary policy and did argue in its 2001 consultation report that Ireland's fiscal stance this year was too lax (IMF, 2001).

The Appendix Figures also reveal an interesting pattern, not much discussed in the literature, whereby the share of foreign-owned debt in the total jumps just as the fiscal accounts were turning around.<sup>8</sup> Stockbrokers who were at the coal-face remember the roadshows organised at the time of this turnaround, and how it became progressively easier to sell Irish paper into a rising market; but these happy circumstances in turn were only possible because the budget was at last on a credibly sustainable path. Previously, foreign lenders were reluctant to buy Irish pound-denominated paper, and the resulting heavy reliance on the domestic bond market shows unmistakable evidence of crowding out up to 1987.

In summary then, although our European partners could, in some circumstances, choose to exercise considerable control over aggregate Irish fiscal policy, they seem unlikely to choose to do so. With the influence of wider international governmental influence through such organisations as the OECD and the IMF coming largely through their contribution to the intellectual debate, what remains is chiefly market pressures – and these have been with us for several decades. Curiously, the removal of exchange rate risk as a result of EMU thus has the effect that we are much less vulnerable to changes in financial market sentiment. To that extent we are much more “on our own” when it comes to deciding on aggregate fiscal policy

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## 2.3 Tax Rates and Tax Design

If the external pressures inhibiting a completely free national decision on fiscal balance have been diminishing in recent years, the international influences on tax rates have been rapidly increasing.

### 2.3.1 EU INFLUENCES ON IRISH TAXATION

For Ireland, agreements at EU level have been a decisive constraint on indirect taxation. Apart from the complete harmonisation of customs duties, the replacement of turnover tax with VAT and the establishment, in 1992, of minimum rates of excise (with moves now afoot to increase these rates for tobacco and alcohol in order to promote convergence of rates), there is of course active discussion of common initiatives in energy and environmental taxes. The pressures to remove the VAT complications that inhibit completion of the internal market will not go away for long, and, even if the Commission has abandoned this particular effort for the time being (European Commission, 2001) they do point to eventual common VAT rates and base in the Union.

Despite the failure of efforts to harmonise corporation tax at the EU level (a fact partly attributable to the fact that unanimity is still required for tax directives), and despite the Commission’s official position that “*direct tax systems require only limited harmonisation*” (Bolkestein, 2001) there has been continued pressure towards reducing (i) the distortions caused by differences in direct taxation as well as (ii) the complications caused by international flows of capital, and of remuneration of capital, within the

<sup>8</sup> The first of the debt figures shows both the national and EU definitions; the latter being relevant to the Maastricht criteria. IEP and FX indicate the currency of denomination. Domestic and foreign indicate the residence of the holders of the debt.

EU. Since 1997, “harmonisation” has here been largely superseded as the catchword by “harmful tax competition”, and avoidance of this within the EU was the focus of the tax package approved by Ecofin in late 1997, and which has been in the process of implementation since then. The package has three components: (i) a code of conduct on business taxation (some 66 measures across Europe have been identified as harmful, including Ireland’s two-tier corporation tax – on which more below – which had already fallen foul of the prohibition of State aids to industry); (ii) an approach to taxation of savings designed to reduce cross-border distortions<sup>9</sup> and (iii) issues related to withholding tax on cross-border payments of interest and royalties between companies.

The direct tax pressure points now identified by the Commission for future work include cross-border issues in personal income tax and the tax treatment of savings, and the whole question of corporate or business tax, on which a high-level committee is sitting.

### 2.3.2 INTERNATIONAL TAX COMPETITION

Standing back from these details, it becomes evident that, in a globalised world, tax rate differences between countries begin to be seen primarily as a source of arbitrage opportunities. The same is true of international differences in the tax base, for example the way in which taxable corporate income is defined and calculated. (Formally speaking that too is a difference in rates, if we subdivide the elements of income, each can be seen as having its own tax rate in each country.) Naturally, the fiscal authorities of different countries are induced to start thinking about co-operative measures to eliminate such arbitrage opportunities, especially for mobile tax bases such as capital. The issue goes well beyond completion of the EU internal market and the OECD has become increasingly involved in applying this thinking to a wider international canvas.

In this way international pressures at the intergovernmental or diplomatic level have come to bear on national tax decisions. Recently, the OECD has taken some controversial initiatives in the area of unfair tax competition, especially regarding financial services.<sup>10</sup> Let me illustrate these issues in the context of Ireland’s corporate tax regime, especially as it applies to financial services.

### 2.3.3 IRELAND’S CORPORATE TAX REGIME

Although it may not have started that way, the Irish corporate tax regime can be interpreted *ex post* as a clever way of turning tax arbitrage to local advantage. Openness to – indeed active encouragement of – inward FDI has been the hallmark of Irish industrial promotion strategy since the 1950s. Despite waves of hand-wringing about the need for a stronger indigenous corporate sector, there has never, during the past half-century,

<sup>9</sup> A form of “tax-or-tell” compromise on taxation of interest was agreed by Ecofin in late-2000. It forms the basis of a directive proposal presented by the Commission in July, 2001.

<sup>10</sup> Other examples of inter-governmental co-operation potentially leading to constraints on national tax behaviour would be the Kyoto Protocol (in so far as it is relevant to environmental taxation), and the WTO.

been any relaxation of the efforts of the various industrial promotion agencies in the global MNC market, seeking out likely candidates for investing in Ireland among foreign firms worldwide, and marketing Ireland's packages of grant assistance and, above all, the tax regime. For already in the 1950s Ireland was encouraging industry, both indigenous and foreign, to establish through tax concessions. Until 1979 the major concession came in the form of exemption from corporation and personal income tax of profits derived from exports. Thereafter, in order to comply with European Union (EU) requirements of non-discrimination (as between production for the home market and that for exports to other EU states), the regime was changed to apply to manufacturing and certain internationally traded services. The exemption from tax was replaced by a low 10 per cent corporation tax rate.<sup>11</sup>

The consequences of such an open and generous regime for foreign investment were very considerable indeed, although they took their time in coming. By the mid-1980s over one half of employment in manufacturing was in foreign-owned firms, and this ratio, already quite exceptional in the industrial world, increased in subsequent years. There was also a distinctive character to the type of firms that predominated among the investing MNCs. To a substantial extent these were firms characterised by products with high fixed development costs and low unit costs of production, such as pharmaceuticals, retail software and computer products and proprietary soft drinks (Conroy, Honohan and Maitre, 1998). These were essentially the sectors that found it advantageous to locate production in Ireland in order to exploit the tax arbitrage opportunities created by the Irish corporate regime. Evidently the use of proprietary inputs, for which (despite the international agreements brokered by the OECD on the definition of transfer pricing) the concept of an arm's length price does not narrow things down very much, allowed these firms to report very high profits on their Irish operations. These operations were typically production facilities and did not include much research and development. With a high proportion of their worldwide profits thus being taxed at the low 10 per cent rate, these MNCs were able to achieve a much lower overall tax rate than would have been possible if they were producing in a high tax environment.<sup>12</sup>

There can be little doubt that the low corporation tax strategy that has been followed in Ireland for many years now has contributed to the inflow of foreign manufacturing capital. We can even hope to quantify the effect if we are prepared to attach some credence to recent estimates made by

<sup>11</sup> By not retaining exemption from personal income tax for dividends drawn from export profits, this change greatly reduced the benefit to Irish residents. Non-resident individuals had not benefited from this aspect of the previous tax exemption, so they were relatively unaffected by the change.

<sup>12</sup> For US-based companies, which account for a very high proportion, worldwide foreign income is taxed at US rates when repatriated, with only a credit for foreign tax paid. At first sight it might seem that the Irish tax concession is merely a deferral, and not an overall reduction in the rate. However, many companies also have taxable income in jurisdictions with higher-than-US corporation tax rates. Having some of their profits taxed at low Irish rates allows such companies to use excess tax credits (arising in other countries and which would otherwise be forgone) for the purpose of US corporation tax. In this way, the Irish concession does actually lower the overall tax rate paid.

US tax economists Rosanne Altshuler, Harry Grubert and Scott Newlon (1998) in a paper entitled “Has US investment abroad become more sensitive to tax rates?” They carefully extracted information from foreign subsidiaries controlled by US manufacturing companies in 58 countries worldwide. Running a cross-country regression of the total value of the stock of these corporations’ investment on the average effective tax rate, as well as on the degree of openness to trade and controlling for country size, they found that tax seemed to have a strong and statistically significant effect in determining investment location. Their best estimate of the elasticity of investment with respect to (one minus) the tax rate is a sizeable 2.68. When I apply this estimate to the difference between Ireland’s actual effective tax rate for US corporations, and the lowest figure for the rest of the EU, I find that it implies that the stock of US manufacturing investment is 70 per cent higher in Ireland than it would be if Ireland had lifted its tax rate even to the next lowest in the EU. The effect is even more dramatic if the comparison is made at the average tax rate in the EU. I need hardly remark that these are very substantial differences indeed, and they provide quantitative justification for the perspective being adopted here that international tax rate differences matter.<sup>13</sup>

### 2.3.4 THE IFSC AND INTERNATIONAL TAX COMPETITION

By the 1970s, the role of tax arbitrage and tax competition in Ireland’s industrial development policy had become more self-aware. Pushing the envelope of the strategy, the Government decided to extend the scope of this type of tax regime after 1987 to approved international financial services offered to non-residents of Ireland from the Dublin International Financial Services Centre (IFSC), defined as a physical location in the inner city’s docklands. Broadly similar corporation tax concessions were introduced, together with relief from property taxes in the IFSC.

The economic activity created at the IFSC has been considerable. By 2001, the official figure for employment creation at the Centre has risen to 11,000, which corresponds to a quarter of total financial sector employment in Ireland. There can be some debate about the extent to which this employment is truly additional, as Irish banks have moved substantial parts of their operations physically into the IFSC, in order to be able to claim the low rate of tax on their non-resident business. On the

<sup>13</sup> An interesting alternative approach, based on cross-country regressions of the data for aggregate FDI flows on tax rates and other explanatory variables, has also found very substantial effects. Specifically, a simulation of the consequences for Ireland of a forced harmonisation of corporation tax rates implies that net FDI flows to Ireland would fall by almost 1½ per cent of GDP while corporation tax receipts would be lower by 1 per cent of GDP (Gropp and Kostial, 2000). A somewhat similar econometric set-up, employed by Bénassy-Quéré *et al.* (2001), confirms the existence of sizeable effects. They simulated the impact of an increase in the Irish manufacturing tax rate from 10 per cent to 12.5 per cent and found that even this would result in a reallocation of about \$300 million in FDI from Ireland to the rest of the world. That would have been equivalent to ½ per cent of Irish GDP in the relevant year, but to only 0.3 per cent of total FDI – thus, a sizeable impact for Ireland, but almost negligible for other countries.



other hand, the Centre's boast of considerable complementary factor employment outside the IFSC itself is not an empty one.

Undoubtedly, tax arbitrage is a key element of what attracts financial firms to do business in the IFSC. The variety of activities undertaken in the docklands is immense, but some examples are illustrative of this point. For example, Irish banks can afford to participate in big international loan syndications by virtue of the tax advantage, which offsets other cost penalties from which they might suffer and which would make it unprofitable for them to get involved. There is also a large number of captive insurance firms, i.e. wholly-owned subsidiaries of large non-financial MNCs set-up to manage the accounting and tax aspects of self-insurance for these firms. Another example is mutual fund type business (under a variety of legal forms). Interestingly, some of these fund management concerns appear to be structured in such a way that the gross income of funds that are managed in Dublin only in a limited technical sense gets the benefit of the low tax rate.<sup>14</sup>

As an aside, I should deal with the widespread view that the tax concessions created Ireland's "miracle" rates of economic growth since 1987 and especially since 1993. But it is clear that they can at most have been a contributory factor. Again consideration of timing seems decisive: the tax concessions were in place for manufacturing and computer services long before 1987, and as already noted they were even more generous before 1979. Though the IFSC did start in 1987, the scale of its activities is again too small (the IFSC's 11,000 direct jobs account for just 0.7 per cent of total employment) to have been a major driver of an economy-wide boom which has seen more than half a million jobs created over the same period.

I like to think of the logic of the Irish approach to using the tax system as a means of promoting the growth of the financial services sector (and of manufacturing and other sectors to which it has been applied) can be thought of as inherently one of tax rate discrimination, not as between one country and another, but as between different sectors. The discrimination is against the sectors that are sheltered from international competition and in favour of those that are exposed. A sheltered sector such as retailing bears a high tax with relatively little deadweight; a mobile sector such as software bears a low tax, encouraging inward migration. This makes sense if, as is plausible, the elasticity of capital formation is higher in the mobile sector than in the sheltered or non-traded sector. Under these circumstances, a net increase in capital formation will result, at least so long as the other countries do not respond. It is unclear what happens if all countries try to play the same game. Furthermore, this game requires much use of available tax treaties, and as such it could potentially be hazardous, potentially risking difficult negotiations with tax treaty partners.

### 2.3.5 THE EU AND IRISH CORPORATION TAX

<sup>14</sup> This kind of arrangement – and not a surge in manufacturing FDI – is likely to account for much of the enormous scale of inward FDI flows that have been registered for Ireland in the OECD's statistics in several years of the past decade or so.

More generally, these features of the Irish corporate tax regime (especially for the IFSC) have proved controversial in the EU context, in view of the element of beggar-thy-neighbour tax competition that appeared to be involved. The Commission did acquiesce in the IFSC at first, but eventually pressure from this quarter did result in the IFSC tax concession window being closed to new start-ups. This is a clear example of EU-wide pressure on the exercise of national autonomy in setting tax rates that were seen as resulting in harmful tax competition.

From the EU's point of view, one particular difficulty is the use of multiple tax rates as an industrial promotion device, and the Irish authorities have now responded to this pressure by announcing convergence of both corporation tax rates to a low 12.5 per cent. By being non-discriminatory, this new regime, which will be fully effective by 2003, is expected to escape censure by the European Union – at least for the time being.<sup>15</sup>

The Irish government could afford to lower the non-concessionary rate of corporation tax (which is paid by such sectors as retail and wholesale commerce, consumer and business services including financial services provided to residents) partly because of the very high yield of the 10 per cent rate, not least from the IFSC which alone has been yielding upwards of 0.5 per cent of GDP in corporation tax revenue alone. In effect, the profits which migrated to Ireland to benefit from the tax rate have thus been very high, so that the benefit to Ireland of the scheme has been both through its ability to generate economic activity and value-added, and also importantly to expand the tax base.

### **2.3.6 THE OECD AND HARMFUL TAX COMPETITION FROM OFFSHORE FINANCIAL CENTRES**

It is not surprising, that the tax regimes of offshore financial centres such as the IFSC have recently been attracting wider inter-governmental attention in the form of the OECD's initiative on "harmful tax competition".<sup>16</sup> In the event, following scrutiny from the OECD, Ireland's regime, like many other offshore centres in advanced countries, but unlike many of the tiny island tax havens in the West Indies and elsewhere, was adjudicated as only "potentially harmful" in the OECD's 1998 report, and Ireland is deemed to be a jurisdiction which is "co-operating" with its partner countries in the OECD. Nevertheless, this initiative from the OECD is the first indication of a move towards partial tax-harmonisation at an international level, i.e. at a higher level of aggregation than the EU. Of course, the OECD's membership only accounts for two dozen of the more advanced economies (and in particular does not include most of the "non-cooperating" tax havens

<sup>15</sup> It may be considered somewhat paradoxical that the EU's focus on internal tax differentials has had the result of widening the international difference between Ireland's normal corporation tax rate and that in the other countries of the Union.

<sup>16</sup> Concern about offshore financial centres is not confined to tax issues, but also relates to their use in money laundering and to weaknesses in prudential regulation. The IFSC has received a clean bill of health in these dimensions (IMF, 2001).

which were recently threatened with sanctions if they persisted with “harmful tax competition”).

There have been some interesting differences of emphasis between the focus of EU and the OECD when considering spillover effects from other countries’ tax systems in the area of financial services. For the EU, a major issue has been the question of whether the offshore regime is different from the basic or mainline tax system. This is what has driven the Irish tax authorities to move towards a single corporation tax rate. For the OECD, however, the major concern<sup>17</sup> appears to have been more on issues of transparency and information exchange.<sup>18</sup> The differences may derive partly from the greater expectation in the EU, as between member states of what is a much tighter organisation, that spillovers would be minimised.<sup>19</sup>

One way or another, though, it is evident that the OECD’s harmful tax competition initiative is just a harbinger of things to come and that wider international concern with tax competition will not go away. Tax competition does raise complex and unresolved issues of global policy – and not just in financial services. For both the EU and the OECD there is a legitimate concern when a member country starts to use the tax system in this way that it could trigger a competitive “race to the bottom” in corporation tax rates. This in turn could erode the global tax base and thereby limit governments’ capacity to fund public goods. Indeed, taxation externalities are in the nature of a global public good which can require the attention of the international community. This international public good argument could be made for a wider international agreement on tax competition, but as yet there is no forum for delivering on this; no “International Tax Authority” where these matters could be hammered out. (Of course, the World Trade Organisation does restrict some forms of taxation, especially taxation of international trade; but the scope of its jurisdiction on tax matters remains very limited. For example, what about the global issues involved in environmental taxation?)

### **2.3.7 INTERNATIONAL MARKET PRESSURE ON TAX RATES**

In many instances, Ireland has been an aggressive tax competitor.<sup>20</sup> As such, the external pressures from the EU and other official sources have

<sup>17</sup> To be sure, the OECD’s definition of a tax haven is broader than this. Such an entity (i) charges only nominal tax on relevant income (from mobile financial and other service activities) and is seen as a place where non-residents can escape tax in their country of residence; (ii) facilitates foreign-owned entities without local substantive presence (or prohibits them from having any commercial impact on the local economy); (iii) lacks transparency; and has no effective exchange of information.

<sup>18</sup> These and related issues do have significant resource implications: Ireland employs 53 staff dealing with offshore banks and funds.

<sup>19</sup> But the EU cannot ignore the rest of the world, as has been painfully evident in the tortuous negotiations surrounding the attempt to negotiate a common agreement on taxation of savings.

<sup>20</sup> Though it should be noted that while the total tax take in Ireland (inclusive of social security contributions), is second lowest in the EU if expressed as a percentage of GDP, it is tenth of the fifteen if expressed as a percentage of GNP. The whole question needs to be

tended to be such as to restrain such competition. International official or diplomatic pressure thus tends to be in the direction of raising Irish tax rates.

However, in some other cases, market pressures have been brought to bear in the opposite direction, i.e. pressures for Ireland to respond to low tax rates elsewhere. One example (so far unimplemented) is the case of shipping tonnage tax, an alternative to corporation tax for that industry whereby a presumptive tax is payable per ship on the basis of its tonnage, rather than on a calculation of profitability. To match the tonnage tax regime in effect in the UK, Netherlands and elsewhere, such a tax would be “regressive” in terms of a ship’s tonnage in that large ships pay a lower rate of tax per ton than small ships. (The threshold for the lowest rate of tonnage is 25,000 gross registered tons – a figure exceeded by only one ship on the Irish register.)

A difficulty with tonnage taxes (and one which provides the link with the above discussion of taxation of international financial services) is, of course, that with the corporation tax they represent a two-tier system which can be gamed with financial engineering to shelter tax earned from non-shipping activities. Those with long memories will hear echoes of the leasing and “Section 84” lending that underpinned the spectacular growth of GPA and other aircraft leasing companies in previous decades, and will not need to be convinced that these loopholes can be massively important. Complex ring-fencing has to be adopted to limit such financial engineering, an inelegance which could easily explain a lack of Revenue enthusiasm. Nevertheless, it is also easy to see why affected sectors will lobby for harmonisation of the Irish corporation tax in order to match any concessions such as the tonnage tax which appears to threaten their competitiveness. In this way, international market pressure can have the effect of placing downward pressure on Irish tax rates. (More generally, it would be interesting to explore to what extent the lowering of Irish income tax rates in recent years can be at least partly attributable to international market pressures, as so many other countries lowered their top income rates also. To take just one example, could the recent removal of the employers’ ceiling on PRSI – a dramatic increase in what must, from the economic point of view, be considered the effective rate of income tax on top earners – have been considered had it not been that no ceiling now applies in the UK? This topic would, however, take us too far afield).

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## 2.4 Concluding Remarks

Despite this year's fuss over EU pressure to target a particular overall, fiscal stance, I have argued that international pressures on the overall fiscal policy stance have, if anything, declined in recent years.

The framework for debate provided by the Stability and Growth Pact is arguably more important than the mechanical sanctions built-in. Winning the debate intellectually and politically at any given moment will be the decisive factor in what pressures are actually brought to bear, whether by the EU or other international agencies.

considered at a much more disaggregated level. One interesting approach in this direction is Martinez-Mongay (2000).

The importance of such debates is heightened by the reduced role of the international financial markets in disciplining fiscal excess in a single member country.

In contrast, tax rate competition is hotting-up as an issue, notably at a wider-than-EU international inter-governmental level. Market pressures are also increasing the importance of tax arbitrage as a factor in taxation design.

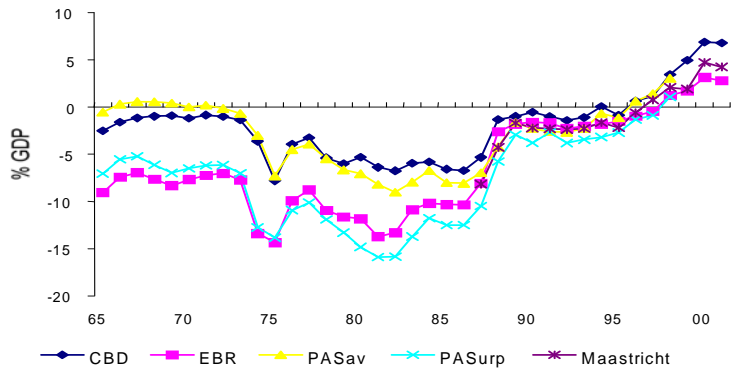
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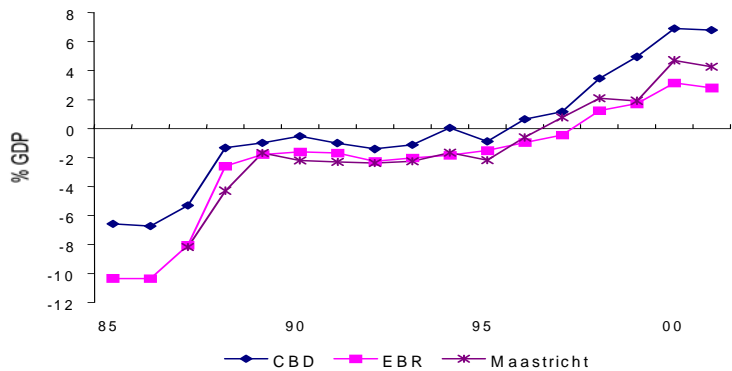
# APPENDIX 2.1

Figures A.1 to A.3 show the main indicators of budgetary balance. In the legend, CBD denotes current budget deficit; EBR denotes exchequer borrowing requirement; PASav and PASurp denote public authorities saving and surplus respectively using National Accounts concepts; Maastricht, General Government surplus definition as used for the Maastricht criteria.

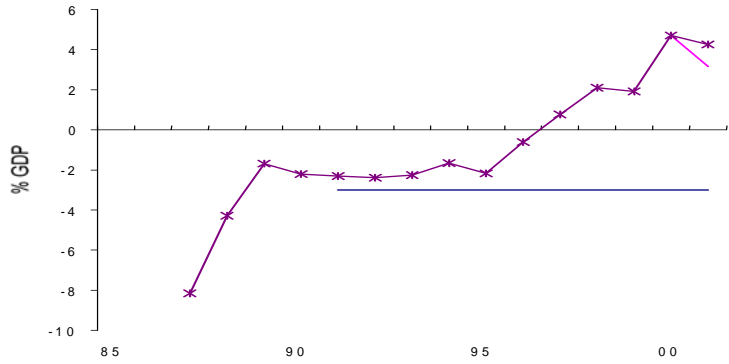
**Figure A.1: Government Surplus, 1965-2001**



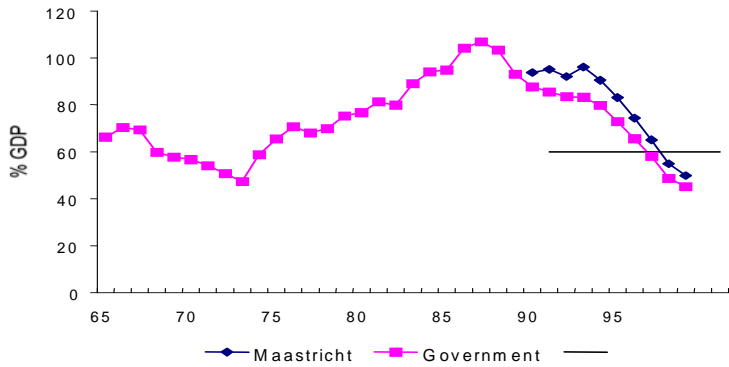
**Figure A.2: Government Surplus, 1985-2001**



**Figure A.3: Government Surplus, 1987-2001<sup>21</sup>**

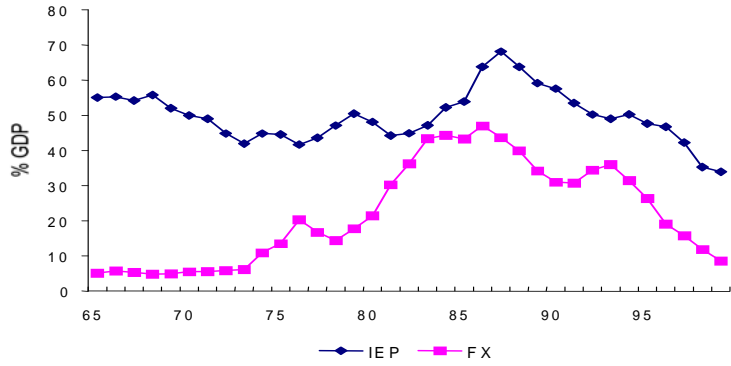


**Figure A.4: Government Debt, 1965-1999**



<sup>21</sup> The two readings for 2001 in the third figure indicate the budget estimate and a recent estimate.

**Figure A.5: Government Debt, 1965-1999**



**Figure A.6: Government Debt, 1965-1999**

