

Note: First published in European Taxation, December 2005

State Aid Reform 2005/09: Regional Fiscal Autonomy and Effective Recovery

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1. INTRODUCTION

At the beginning of 2005, the Commission announced that it would conduct an extensive review of the State Aid regulations as part of its State Aid Action Plan.¹ The review also affects fiscal State Aid. In this article, the author considers two issues that deserve proper attention as part of this review. First, the author reflects on the Commission's approach to regional autonomy as reflected in its Gibraltar decision, which, at the time of writing, was subject to an appeal before the Court of First Instance² (hereinafter: the CFI) (see 2.). Second, the author addresses some issues with regard to the recovery of (fiscal) State Aid (see 3.).

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¹ State Aid Action Plan - Less and better targeted state aid: a roadmap for state aid reform 2005-2009 (Consultation document), at http://europa.eu.int/comm/competition/state_aid/others/action_plan/saap_en.pdf. Comments on the Action Plan were required by 15 September 2005.

² CFI, action brought on 9 June 2004, Case T-211/04, *Government of Gibraltar/Commission*, Official Journal (EC), C 217/27, 28 August 2004.

2. STATE AID: REGIONAL FISCAL AUTONOMY

2.1. The Commission's viewpoint

When considering regional aid regimes, including regional tax regimes, it is necessary to determine whether or not certain regimes and measures are of a regional nature with regard to the Member State involved. From a State Aid perspective, "regional" refers to regional regimes that diverge from the national regime that normally applies. In contrast, measures introduced by a regional authority in its own right, which do not replace or amend the general and/or national rules that normally apply, are usually not considered to be regional aid.

In the Commission's 2004 report on applying the State Aid rules to direct business taxation, the Commission adopted a firm stance with regard to fiscal autonomy, i.e. there is none, except when "all local authorities of a particular level [are allowed] to introduce and levy local taxes with no reference at all to national taxation".³ In the Commission's opinion, the reference framework to determine whether or not there is a benefit to an enterprise is defined as the territory of a Member State.

What if, however, provinces or municipalities are allowed to set their own tax rates for property occupation taxes, under which the tax base is determined in accordance with national rules? And what if an autonomous region decides to duplicate the national tax legislation without being legally required to do so? In addition, could an autonomous region decide to introduce a lower tax rate despite using a tax base similar to that applying in the rest of a particular Member State? Finally, as this article addresses the subject of the drafting tax law, do the State Aid regulations require local authorities at all times to follow the classic textbook designs of taxes?

2.2. The case of Gibraltar

The final issue referred to in 2.1. recently arose in the case of Gibraltar. With regard to Gibraltar, the United Kingdom notified the plans for the reform of Gibraltar

³ Report on the implementation of the Commission notice on the application of the state aid rules to measures relating to business taxation, 9 February 2004, at para. 33.

corporation tax to the Commission. Under the reform, Gibraltar proposed to replace profits-based taxation with a general payroll tax and a business property occupation tax. In contrast to "classic" payroll and property taxes, however, both of the taxes proposed by Gibraltar taken together were capped at 15% of business profits.⁴

The Commission concluded that regional selectivity would arise as a result of the proposed differences between the UK corporation tax regime and the Gibraltar tax regime producing, in turn, a lower level of taxation for companies in Gibraltar compared to that in the United Kingdom.⁵ Despite the existence some selective elements in the Gibraltar regime, the Commission's basic concern was that the maximum statutory rate of tax in Gibraltar would generally be 15% instead of the UK's 30%. In addition, in contrast to the United Kingdom, capital gains would be excluded from taxable profits and capital allowances would be increased in Gibraltar, which would effectively widen the gap between the effective tax rates in Gibraltar and the United Kingdom. As the lower level of tax would only be available to companies in a particular region of a Member State, in the Commission's opinion, the proposed tax regime amounted to regional State Aid.⁶

2.3. The Commission's decision

2.3.1. No "fiscal autonomy defence"

Despite the Commission referring to its settled practice, the author considers that the Commission's arguments are barely convincing. The Commission's main contention was as follows:

[T]he United Kingdom's argument according to which benefits of limited territorial scope become general measures in the region concerned only because they are established by the regional rather than by the central authority, and that they apply throughout the territory under the region's

⁴ Commission Decision of 30 March 2004, Official Journal (EC), L 85/1, 2 April 2005. Not all of the issues in respect of the notified regime are addressed in this article, as most of the "suspect" elements, including special tax benefits for a defined region within Gibraltar that would amount to regional State Aid under any definition, were removed from the original proposals by Gibraltar in response to the Commission's preliminary investigation.

⁵ Id., at paras. 100-102.

⁶ Id.

jurisdiction, cannot be reconciled with the concept of aid. ... A decision based solely on the body that decides the measure would remove all effectiveness from Article 87 of the Treaty, which seeks to cover the measures concerned exclusively according to their effects on competition and Community trade. ... Such aid therefore cannot be treated differently from measures which have the same objectives, use the same resources and have the same effects on trade and competition, according only to the formal criterion of the degree of autonomy of the infra-State authority that establishes it.⁷

It may be wondered whether or not the Commission's reluctance to accept what the author would refer to as a "fiscal autonomy defence" can be explained by the possibility of the abuse of this autonomy to circumvent restrictions on (regional) State Aid as imposed by the EC Treaty and secondary legislation. There is, indeed, a substantial risk that allowing regional fiscal autonomy could jeopardize some of the Community's objectives in this respect. Then again, the division of political powers in the internal constitutional order of a Member State is still not, at least not to a substantial degree, a matter of Community legislation.

If the Commission took account of regional autonomy, it would not per se make Art. 87 of the EC Treaty ineffective. What the Commission is trying to say is that the lower tax regime in Gibraltar influences trade and competition and that this should be considered, but this is not what the Gibraltar case is about. Specifically, the question is not whether or not lower taxes could benefit the trading position of Gibraltar companies, as this would also be true for any Member State that reduced its level of taxation. This argument is a distraction from the real issue, i.e. is it necessary to take into consideration the intra-Member State autonomy of the Gibraltar authorities? The author submits that, if it is the Gibraltar government and legislature that decides when and how to raise taxes, it is not necessarily "the same resources" as the budget resources of the UK government, even though there may be some contribution by Gibraltar to the UK budget or vice versa.

⁷ Id. at para. 105.

The Commission, therefore, appears to be reticent regarding the creation of internal administrative organizations within the Member States that could allow regional authorities at below Member State level to make changes to the general tax system. This is not, however, the issue in the case in question. The question should be what is the general tax system, which is not necessarily the general UK regime. This became even more evident when the Commission argued that:

[C]lassing these measures as aid does not call into question the tax autonomy of Gibraltar, resulting from the relevant constitutional arrangements and practices. It seeks merely to ensure that, in cases where Gibraltar exercises its autonomy by reducing the amount of tax levied at the national level, the tax benefits granted thereby comply with the Community rules on regional aid ...⁸

The misconception is that Gibraltar supposedly wanted to reduced the amount of tax levied at the national level. The UK's argument that the UK rate of tax would not apply in Gibraltar anyway was rejected as being "formalistic", although the author would rather argue that this is a very important and material statement. The Commission continued:

Whenever a central government decides to give up its powers to establish a uniform taxation framework for enterprises and allows a sub-national entity to reduce the tax rate or to introduce another taxation system that is more advantageous, the result of this decentralisation of power is a derogation from a common system of reference.⁹

Even though the United Kingdom argued that Gibraltar is not part of the United Kingdom, has its own institutions and constitutional order and is autonomous, self-governing and economically self-sufficient, the Commission rightly points out that that the United Kingdom is responsible for ensuring respect for Community Law in Gibraltar.

⁸ Id., at para. 109.

⁹ Id., at para. 114.

As far as the use of the resources of Member States is concerned, the Commission stated that, in its decision to open a formal investigation, the budgetary resources concerned are those of Gibraltar and not those of the United Kingdom.¹⁰ If this is true, then how can fiscal autonomy lead to State Aid? This would be an affirmation of Gibraltar's argument that its proposal for a new tax system falls within the limits of its autonomy without creating regional selectivity. Gibraltar's resources, i.e. tax revenue raised or foregone, would, therefore, be used for Gibraltar's purposes.

In the author's opinion, the Commission's handling of this case is too narrow. The Commission's intention is to safeguard the effectiveness of Art. 87 of the EC Treaty at all cost. The primary issue is, however, whether or not recognizing fiscal autonomy would compromise Art. 87 of the EC Treaty. The Commission states that "the fact that the budget of a given territory is self-sufficient is not immediately relevant for the assessment of State aid rules".¹¹ This may be true, but this issue must be considered in the proper perspective. If the government of a territory is allowed to be politically autonomous and to manage its budget autonomously, why should fiscal autonomy be omitted? It is true, as the Commission points out, that Gibraltar benefits from a number of services provided by the United Kingdom, such as defence, but the question is whether or not Gibraltar citizens pay their fair share for these services. The fact that the United Kingdom is financially responsible for Gibraltar in the last resort may be of importance. However, as long as there is no indication whatsoever that the proposed tax reform would necessitate the intervention by the United Kingdom for constitutional reasons, this is not very relevant in the author's opinion.

Safeguarding the effectiveness of Art. 87 of the EC Treaty would not be easy if fiscal autonomy is involved, but it must be considered that some fiscal autonomy is inherent in the political and social autonomy of some regions. The question is, therefore, not what would justify the granting of territorial tax reductions to undertakings located in "an independent part of a State's tax jurisdiction", as it is not

¹⁰ This issue as such was not addressed in the final decision, but neither did the Commission retract its preliminary findings. See Official Journal (EC), C 300/2, 4 December 2002, at para. 35.

¹¹ Note 4, at para. 125.

the Member State's tax jurisdiction that is at stake when (full) fiscal autonomy is concerned.¹² Or, as the Gibraltar government put it:

the [Commission's] decision concerns two tax jurisdictions which are *entirely separate and mutually exclusive* so that Gibraltar's tax laws cannot be treated as derogations from tax law in the United Kingdom (emphasis added).¹³

For the record, the author has not formed an opinion on whether or not the United Kingdom and the Gibraltar tax systems are actually "entirely separate and mutually exclusive". This is for the CFI to decide.

2.3.2. "Textbook taxes" only

With regard to the proposal to restrict the combined liability of payroll and business property occupation taxes to 15% of profits, the Commission argued that this gives rise to selectivity, apart from regional selectivity, as companies that do not realize profits would effectively be exempt from the taxes that they would normally have to bear. The Commission then refers to the textbook definition of a payroll tax stating that "it is in the internal logic of a payroll tax system that each and every employee should result in a corresponding payroll tax liability for the enterprise that employs them".¹⁴ But how a Member State, or in this case a sub-national authority, designs its general tax system within the scope of its autonomy is not an issue for the Commission to address as long as the State Aid regulations are observed. Why then should a hybrid system, such as that proposed by Gibraltar, not be allowed?

The author submits that it is possible to detect the nature and the general scheme of the Gibraltar system. The question is, given a payroll and business property occupation tax capped at 15% of profits, whether or not this cap as such is selective. It is not an issue whether or not the cap is considered to be a normal part of a payroll

¹² In contrast, see P. Rossi-Maccanico, "State Aid Review of Member States' Measures Relating to Direct Business Taxation", *European State Aid Law Quarterly*, 2004/2, pp. 229-251 at p. 246. As for full tax autonomy, the author agrees with Rossi-Maccanico that, when the national legislator must first authorize the regional legislator to introduce a tax incentive, there may not be actual fiscal autonomy after all.

¹³ See note 2, at p. 28.

¹⁴ Note 4, at para. 131.

tax.¹⁵ There may be reasons of equity not to introduce this kind of tax, but, in the end, it is for the Gibraltar Parliament to decide what kind of system it introduces or rejects. The Commission argued that the cap would be selective because the beneficiaries of that cap would be labour-intensive companies with low profits in relation to their number of employees and occupation of business property. This may well be true, but this consideration is based on the assumption that there would be textbook payroll and property taxes without a cap to refer to in the proposed Gibraltar tax system.

The Commission then considered that:

As for the suggestion that without a regressive element, a labour tax could trigger mass layoffs and instability in times of cyclical market fluctuations, the Commission would simply note that this is an inherent feature of such a system.¹⁶

Is, however, a government not at liberty to attempt to mitigate the inherent adverse effects of a tax system? In the textbooks, payroll taxes have generally to be paid per employee, even if the employer company is about to go bankrupt. This is logical from a traditional perspective, despite the attempts of most governments to prevent mass layoffs. Yet the Commission's task, as set out in Art. 87 to Art. 89 of the EC Treaty, is not to promote textbook tax systems, but to consider whether or not the tax system as proposed by Gibraltar contains State Aid. Whether or not the introduction of a profit related cap on a payroll tax as such is wishful thinking from an economic, social, fiscal or political perspective is not the issue, even though, on a personal note, the author would not promote such a system without reservations. It is, therefore, the author's hope that the Commission will reconsider the issue of regional fiscal autonomy as part of its review of the State Aid rules.

¹⁵ The author refers to the fact that, for the purpose of applying the State Aid rules, the only reference framework is the Gibraltar tax system and not the tax systems used in other Member States or model methods of payroll or business property taxation as reflected in academic literature.

¹⁶ Note 4, at para. 139.

3. STATE AID: EFFECTIVE RECOVERY AND HOW MUCH?

3.1. Effective recovery

In its State Aid Action Plan, the Commission concludes that "the implementation of recovery decisions by Member States is not satisfactory".¹⁷ Accordingly, the Commission will, *inter alia*, examine whether or not independent authorities in Member States could play a role not only in the detection of State Aid, but also in the execution of recovery decisions.¹⁸ The author has doubts in this respect. It must be considered that such an authority would partly be in a position in which it would have to examine the adopted legislation of its national legislature and government, as it would be acting pro-actively. Independence from both the executive and the legislative branches of government would, therefore, be a key issue for such an authority, as, in these cases, if State Aid is "willingly" granted, there are often political motives for doing this.

The Commission also tries to encourage competitors and other stakeholders to ensure that the State Aid rules are respected by focussing on private litigation in national courts.¹⁹ Although private litigation may sometimes be necessary because of time restraints (consider, for example, a competitor on the verge of bankruptcy because of illegal aid granted to its competitor), the author still prefers the filing of a complaint with the Commission. The author is also in favour of increasing the awareness of company auditors of the State Aid rules.²⁰ Such an awareness on the part of company auditors could have a proactive effect, as receiving (fiscal) State Aid illegally could make it necessary to disclose potential financial liabilities, i.e. the (potential) recovery of the State Aid, especially with regard to listed companies.

The author appreciates the Commission's commitment to strive for the more immediate execution of its recovery decisions so as to uphold the credibility and effectiveness of the State Aid regime.²¹ In order to stimulate prompt compliance, the

¹⁷ Note 1, at para. 53.

¹⁸ *Id.*, at para. 51.

¹⁹ *Id.*, at para. 55.

²⁰ *Id.*

²¹ *Id.*, at para. 53.

author submits that consideration should be given to introducing a directive that requires every Member State to have an effective State Aid recovery procedure in place instead of implementing ad hoc measures after the receipt of an order to recover State Aid. An existing procedure could reduce the time required to comply with a recovery decision, whilst, in the meantime, providing some safeguards for the recipient of the State Aid by, for instance, establishing a framework to determine the exact amount to be recovered (if not already determined by the Commission). This issue deserves attention. Specifically, of the recovery decisions taken in the period 2000/04, approximately 48% of the amount of the State Aid to be recovered is still outstanding.²²

3.2. Gross or net recovery?

If enterprises become aware of the risk of recovery of a fiscal incentive, they tend to consider the face value of the tax benefit received, i.e. the gross advantage. Should not, however, the actual, net financial advantage be considered instead? The purpose of the recovery of State Aid is to restore the competitive status quo prior to the distribution of the aid. As the European Court of Justice (ECJ) points out:

[R]ecovery of unlawful aid is the logical consequence of the finding that it is unlawful. Consequently, the *recovery* of State aid unlawfully granted *for the purpose of re-establishing the previously existing situation cannot* in principle be regarded as *disproportionate* to the objectives of the Treaty in regard to State aids (emphasis added).²³

The CFI clarified what is meant by re-establishing the status quo, i.e.:

²² For background information regarding this, see N. Mariñas, "Enforcement of State aid recovery decisions", *Competition Policy Newsletter*, 2005, No. 2, at pp. 17-21.

²³ ECJ, 21 March 1990, Case-142/87, *Kingdom of Belgium v. Commission of the European Communities (Tubemeuse)* [1990] ECR I-959, at para. 66. See also ECJ, 14 January 1997, Case C-169/95, *Kingdom of Spain v. Commission of the European Communities* [1997] ECR I-135, at para. 47.

[T]he restoration of the situation as it was prior to the payment of the illegal aid presupposes that *all of the financial advantages* resulting from the aid which adversely affect competition in the common market *have been eliminated* (emphasis added).²⁴

In a later judgement, the CFI, however, observed that:

[A]s the elimination of an illegal aid through recovery of the *amount of aid disbursed plus interest* is the logical consequence of a finding that this aid is incompatible with the common market, its *sole purpose* being to restore the previously existing situation, that obligation cannot in principle be disproportionate ... (emphasis added)²⁵

The purpose of recovery, as accepted by the ECJ and the CFI, is to restore the previously existing situation (the status quo) by removing the financial advantage. Recovery is not intended to set enterprises back beyond this status quo. The actual advantage to an enterprise does not, however, necessarily have to be equal to the amount of the State Aid received (plus interest). In the author's opinion, removing the financial advantage necessitates the calculation of an enterprise's net benefit. Be that as it may, the ECJ has put the removal of the competitive advantage on a par with the repayment of an amount equal to the face value of the aid received (plus interest).²⁶

In the opinion of the ECJ, the repayment of State Aid cannot be viewed as a sanction.²⁷ If the purpose of recovery is merely to restore the status quo, then what is the legal basis for going beyond this?²⁸ What is the legal basis for recovering the

²⁴ CFI, 8 June 1995, Case T-459/93, *Siemens SA v. Commission of the European Communities* [1995] ECR II-1675, at para. 97.

²⁵ CFI, 15 June 2000, Joined Cases T-298/97, T-312/97, T-313/97, T-315/97, T-600/97 to 607/97, T-1/98, T-3/98 to T-6/98 and T-23/98, *Alzetta Mauro and others v. Commission of the European Communities* [2000] ECR II-2319, at para. 169.

²⁶ ECJ, 17 June 1999, Case C-75/97, *Kingdom of Belgium v. Commission of the European Communities (Maribel bis/ter)* [1999] ECR I-3671, at para. 65 and ECJ, 29 April 2004, Case C-277/00, *Federal Republic of Germany v. Commission of the European Communities* [2004] ECR I-3925, at para. 81.

²⁷ ECJ, 17 June 1999, Case C-75/97, *Kingdom of Belgium v. Commission of the European Communities (Maribel bis/ter)* [1999] ECR I-3671, para. 65.

²⁸ It is a principle of Community law that penalty payments cannot be imposed unless they rest on a clear and unambiguous legal basis. See ECJ, 25 September 1984, Case 117/83, *Karl Könecke GmbH & Co. KG, Fleischwarenfabrik, v. Bundesanstalt für landwirtschaftliche Marktordnung* [1984] ECR 3291, at para. 11 and

gross amount of the State Aid received if, in order to restore the status quo, the extraordinary costs incurred by the recipient of the aid are not taken into account in determining the actual financial advantage? In comparison with a competitor who did not receive unlawful State Aid, it is the net advantage that affects competition, which may be either greater or less than the face value of the State Aid. For instance, if an enterprise incurred extraordinary costs to be eligible for a tax benefit (for example, having a special accountant's statement drawn up or an environmental expertise report drafted), these costs should reduce the recoverable amount if it can reasonably be argued that the reports would not have been required in the normal line of business. The author would, therefore, argue that, if the net financial benefit is less than the gross amount, the State Aid recovery should be limited to an amount equal to the net benefit, including interest.

There are still numerous unanswered questions in this respect that require guidance from the Community's courts. What about investments that would not have occurred without the prospect of receiving what seemed a State Aid-proof tax incentive? Or how about companies that postponed transferring their business abroad because of the attractiveness of once undisputed arrangements in their national tax system despite higher wage costs at home? It is, as yet, unclear whether or not, and, if so, to what extent, these factors may be taken into account.

4. CONCLUSIONS

The Commission's reform of State Aid reform will be of importance to proposals regarding fiscal State Aid in the future in areas such as aid for small and medium-sized enterprises, risk capital, research and development and services of a general economic interest. The author has only considered two of the issues that could (or should) be taken into account in the ongoing reform of State Aid, i.e. regional fiscal autonomy and restricting the recovery of State Aid to net benefits. It is notable that these topics have not been included in the Commission's consultation documents despite the many questions that are still to be answered regarding these issues.