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**Developments in Fiscal Aid:
New Interpretations and New Problems with the Concept of Selectivity**

Phedon Nicolaides¹

¹ Professor, European Institute of Public Administration, Maastricht (NL). I am grateful to Anne-Marie Suren for research assistance.

Introduction

Policy and practice on state aid in the form of tax advantages is evolving rapidly. This kind of state aid, also known as fiscal aid, lies on the boundary of the division of competences between the European Community and member states.

I have analysed policy developments and the case law for the period 1997 – 2005 in a number of other papers.² In this short paper I focus on three recent cases that seem to be breaking new ground and therefore deserve particular attention: (i) C-88/03, Portuguese Republic (Azores) v European Commission; (ii) C-526/04, Laboratoires Boiron v ACOSS ; (iii) T-210/02, British Aggregates Association v European Commission.

These cases deal with the perennial problem of fiscal aid: selectivity. The Azores case addresses the issue of regional selectivity. The Boiron case is about taxes that are used to neutralise a selective disadvantage caused by other forms of government intervention. The British Aggregates case concerns selectivity that may arise out of taxes that are applied on specific products.

The paper argues that while these three cases clarify certain aspects of fiscal aid, they also raise a number of new issues which create new ambiguities and even contradictions.

I. Portuguese Republic v European Commission, C-88/03: The issue of regional selectivity

Portugal sought the annulment of Commission Decision 2003/442 which found that the system of taxation in the Azores was a form of state aid that was incompatible with the common market. The European Court of Justice found in favour of the Commission and dismissed the appeal.

The Azores enjoys a degree of tax autonomy. The issue was whether that degree of autonomy was sufficient to characterise the tax system of the Azores as a general system or whether its autonomy was more limited so that, as a consequence, its system was a mere derogation from the national Portuguese system. Derogation of this kind would signify that the system was selective.

The Commission had argued in its Decision that “in so far as the element of selectivity in the concept of aid is based on a comparison between two groups in the same reference framework (those which benefit from the scheme and those which do not), it can only be established in relation to taxation defined as normal.” [paragraph 26]. In its view, the fact that the regional government of the Azores had obtained the permission of the Portuguese government to reduce the rates of corporate taxation applicable in the Azores proved that

² See The Boundaries of Tax Autonomy: Comments on the Opinion of A-G Geelhoed on Case C-88/03, Portuguese Republic v. European Commission, European State Aid Law, 2006; State Aid and Sub-national Taxation, European State Aid Law Quarterly, 2005; Fiscal State Aid in the EU: The Boundaries of Tax Autonomy, World Competition, 2004; Operating Aid and Fiscal Aid in the EC: A Critical Review of Current Practice, World Competition, 2001.

the normal system of taxation was that which applied to the rest of the country and was determined by the Portuguese government.

The Court explained that “the concept of State aid does not refer to State measures which differentiate between undertakings and which are, therefore, *prima facie* selective where that differentiation arises from the nature or the overall structure of the system of charges of which they are part.” [paragraph 52]

It went on to agree with the Commission that “as regards the assessment of the condition of selectivity, which is a constituent factor in the concept of State aid, it is clear from settled case-law that Article 87(1) EC requires assessment of whether, under a particular statutory scheme, a State measure is such as to ‘favour certain undertakings or the production of certain goods’ in comparison with other undertakings which are in a legal and factual situation that is comparable in the light of the objective pursued by the measure in question.” [paragraph 54] “In order to determine whether the measure at issue is selective it is appropriate to examine whether, within the context of a particular legal system, that measure constitutes an advantage for certain undertakings in comparison with others which are in a comparable legal and factual situation. The determination of the reference framework has a particular importance in the case of tax measures, since the very existence of an advantage may be established only when compared with ‘normal’ taxation. The ‘normal’ tax rate is the rate in force in the geographical area constituting the reference framework.” [paragraph 56] Therefore, the question turned out to be whether the normal rate was that prevailing in the rest of Portugal or whether the area of responsibility of the regional government could constitute the reference framework.

The Court stated that “it is possible that an infra-State body enjoys a legal and factual status which makes it sufficiently autonomous in relation to the central government of a Member State, with the result that, by the measures it adopts, it is that body and not the central government which plays a fundamental role in the definition of the political and economic environment in which undertakings operate. In such a case it is the area in which the infra-State body responsible for the measure exercises its powers, and not the country as a whole, that constitutes the relevant context for the assessment of whether a measure adopted by such a body favours certain undertakings in comparison with others in a comparable legal and factual situation, having regard to the objective pursued by the measure or the legal system concerned.” [paragraph 58]

The Court then rejected one of the arguments of the Commission “that such an analysis is rendered inadmissible by the wording of the Treaty and the well-established case-law in that field cannot be accepted.” [paragraph 59] This is because “it cannot be inferred ... that a measure is selective, for the purposes of Article 87(1) EC, on the sole ground that it is applicable only in a limited geographical area of a Member State.” [paragraph 60]

For the Court the decisive criterion was whether the regional government had sufficient autonomy to set its own tax rates. It said that “in order to determine the selectivity of a measure adopted by an infra-State body which, like the measure at issue, seeks to establish in one part of the territory of a Member State a tax rate which is lower than the

rate in force in the rest of that State it is appropriate ... to examine whether that measure was adopted by that body in the exercise of powers sufficiently autonomous vis-à-vis the central power and, if appropriate, to examine whether that measure indeed applies to all the undertakings established in or all production of goods on the territory coming within the competence of that body.” [paragraph 62]

The Court then elaborated three conditions that had to hold in order to determine whether the autonomy of the regional government was sufficient or not. “In order that a decision taken in such circumstances can be regarded as having been adopted in the exercise of sufficiently autonomous powers, that decision must, first of all, have been taken by a regional or local authority which has, from a constitutional point of view, a political and administrative status separate from that of the central government. Next, it must have been adopted without the central government being able to directly intervene as regards its content. Finally, the financial consequences of a reduction of the national tax rate for undertakings in the region must not be offset by aid or subsidies from other regions or central government.” [paragraph 67]

So, the Court has for the first time defined that a sub-national body can levy taxes which deviate from those applied in the rest of the country, provided it is, first, politically separate from central government; second, the central government has not interfered in the decision of the sub-national body; and third, the central government does not make up any short-fall in tax revenue as a result of lower local taxes.

On the basis of these three criteria, the Court concluded that the Azores system was a deviation from the national Portuguese system because the revenue short-fall was made good by the Portuguese government.

In essence, what the Court has said is that for a sub-national system to be regarded as the relevant framework of reference, it must be able to act independently and must not depend on the national system. In the case of the Azores, its constitution requires that the regional government obtains the permission of the central government before it implements a tax reduction. Moreover, any reduction may not exceed a certain ceiling. One wonders whether it would make any substantive difference to the ability of the Azores to lower taxes had the constitution not imposed that requirement and had it set a pre-determined level of budgetary transfers, as it happens in the case of the Basque Country in Spain. A pre-determined level of transfers necessarily implies that it is the regional government that bears the consequences of any revenue short-fall.

Certainly, the three criteria expounded by the Court will be tested in future cases as member states seek to adjust their domestic constitutional arrangements to confer advantages to specific regions without falling foul of state aid rules. It is likely that they will attempt to do it by eliminating from their constitutional arrangements any clauses that stipulate that tax decisions are subject to the approval of the central government and by making transfers automatic rather than discretionary.

A last issue of note that was examined by the Court was whether the policy objective of solidarity and reduction of regional disparities could be regarded as a legitimate tax objective and therefore fall outside the scope of Article 87(1).

The Court reiterated that “a measure which creates an exception to the application of the general tax system may be justified by the nature and overall structure of the tax system if the Member State concerned can show that that measure results directly from the basic or guiding principles of its tax system. In that connection, a distinction must be made between, on the one hand, the objectives attributed to a particular tax scheme which are extrinsic to it and, on the other, the mechanisms inherent in the tax system itself which are necessary for the achievement of such objectives. Measures such as those at issue, which apply to all economic operators without any distinction as to their financial circumstances, cannot be regarded as ensuring that for the purpose of redistribution the criterion of ability to pay is observed. Although it is true that the disadvantages related to the insularity of the Azores might, in principle, be suffered by all economic operators regardless of their financial circumstances, the mere fact that the regional tax system is conceived in such a way as to ensure the correction of such inequalities does not allow the conclusion to be drawn that every tax advantage granted by the authorities of the autonomous region concerned is justified by the nature and overall structure of the national tax system. The fact of acting on the basis of a regional development or social cohesion policy is not sufficient in itself to justify a measure adopted within the framework of that policy.” [paragraphs 81-82]

In other words, solidarity and the differentiation of tax rates may be justified by the nature of the tax system, but it cannot be presumed that every tax payer in a poor region is automatically poor and therefore eligible for the lower tax rates. Regional or cohesion objectives are not inherent in tax systems.

II. Laboratoires Boiron v ACOSS, C-526/04

This case was a reference for preliminary ruling in relation to French proceedings brought by Laboratoires Boiron SA (“Boiron”) seeking repayment of the sum which it had paid to the Agence Centrale des Organismes de Sécurité Sociale (Central Agency for Social Security Bodies) (“ACOSS”) by way of a tax on direct sales of medicines. Distributors of pharmaceutical products are exempted from this tax. Boiron essentially argued that exempting wholesale distributors from the disputed tax amounted to unlawful state aid within the meaning of Article 87 EC.

In its ruling, the Court first reiterated the principle that “those liable to pay a charge cannot rely on the argument that the exemption enjoyed by other businesses constitutes State aid in order to avoid payment of that charge or to obtain reimbursement.” [paragraph 30]

The Court then went on to make a very important distinction. In the earlier cases which established that principle, the exemption concerned relief of certain operators from a tax of general application. By contrast, the present case did not concern a taxation scheme,

but rather a charge for which only one of two categories of competing operators, namely pharmaceutical producers, was liable. The other category comprised pharmaceutical distributors. Since there was unequal liability, the aid derived from the fact that producers were in direct competition with distributors who were exempted. The absence of liability was a deliberate objective of the tax on direct sales.

This is because the aim of the tax on direct sales was “to restore the balance of competition between the two distribution channels for medicines which ... is distorted by the imposition of public service obligations on wholesale distributors alone.” [paragraph 36]

Once the Court identified the issue of liability as being of critical importance, it went on to rule that “if it were shown that the absence of liability to the tax on direct sales leads to an overcompensation of the wholesale distributors, to the extent that the advantage in not being liable exceeds the additional costs that they bear in discharging the public service obligations imposed on them, the liability of a pharmaceutical laboratory such as Boiron to such a charge would constitute an act giving effect to an aid measure.” [paragraph 37] “In this case, the measure alleged to constitute an aid is the tax on direct sales itself and not some exemption which is separable from that tax. In such a case, it should be accepted that an economic operator such as Boiron may plead that the charge on direct sales is unlawful, for the purposes of applying for reimbursement, on the ground that it amounts to an aid measure.” [paragraphs 39-40]

This interpretation is significant because it adds a second situation where a tax measure, rather than a tax exemption, is subject to the rules on state aid. The first situation is when an aid measure, of which the tax which finances it is an integral part, is implemented without prior notification to the European Commission. In this situation, the ECJ has said in *Van Calster* (C-261/01, paragraph 54), that national courts must in principle order reimbursement of taxes, charges or contributions levied specifically for the purpose of financing that aid. A tax is regarded as forming an integral part of an aid measure when it is “hypothecated” to the aid measure, in the sense that the revenue from the tax is necessarily allocated for the financing of the aid (see, in particular, *Air Liquide*, C-393/04).

The second situation arises in the present case of a tax on direct sales. A special feature of this tax measure is the tax itself and the aid measure “constitute two elements of one and the same” tax measure which are inseparable. The tax and the aid are “more closely linked than in the case of a parafiscal charge” whose revenue is hypothecated to an aid measure as in *Van Calster*.

In *Ferring* C-53/00, an earlier and very similar case, the Court found that a tax imposed on producers of pharmaceutical products was state aid “to wholesale distributors only to the extent that the advantage in not being assessed to the tax on direct sales of medicines exceeds the additional costs that they bear in discharging the public service obligations imposed on them by national law.” [paragraph 29] This means that to avoid granting illegal aid, the relevant tax authorities have to ensure that the reduction in the tax

liabilities of wholesale distributors do not exceed their own extra costs from fulfilling the public service obligations imposed on them. It is not clear how these extra costs are to be determined, but at least in theory they must be determined in relation to the costs borne by those undertakings when they carry out their public service obligation.

But in the Boiron case the Court added that payers of the tax could claim reimbursement from the relevant authorities. However “such reimbursement can be granted only if it is shown that those sums or, at the very least, the part of those sums for which reimbursement is claimed, amount to an overcompensation of wholesale distributors and thus, by this measure, confer an economic advantage on the latter, if, in addition, the other conditions referred to in Article 87(1) EC for a measure to be classed as State aid are also fulfilled.” [paragraph 47]

This is a virtually impossible condition. How can a tax-paying producer of medicines know the extent to which the tax advantage granted to distributors of medicines exceeds the extra costs of the public service obligations imposed on them? Not only must the producers know the costs of the distributors but they must be in a position to calculate the extra costs. The latter is a task that is difficult for the distributors themselves, let alone competitors such as the producers of medicines.

Indeed the referring national court raised precisely this issue in its request for preliminary ruling. The ECJ was forced to face the question of how its ruling could be enforced. In the end it circumvented it by passing responsibility to the national court. The ECJ explained that “in order to ensure compliance ...if the national court finds that the fact of requiring a pharmaceutical laboratory such as Boiron to prove that wholesale distributors are overcompensated, and thus that the tax on direct sales amounts to State aid, is likely to make it impossible or excessively difficult for such evidence to be produced, since inter alia that evidence relates to data which such a laboratory will not have, the national court is required to use all procedures available to it under national law, including that of ordering the necessary measures of inquiry, in particular the production by one of the parties or a third party of a particular document.” [paragraph 55]

This is not a satisfactory answer. First, in order for a national court to order an inquiry, a complainant must first persuade the court that it has grounds for its complaint. How will the complainant prove that in the absence of the needed information? Second, and most seriously, in most member states there are numerous distributors of medicines or, more generally, undertakings subject to public service obligations. What should be the conclusion of a national court when it finds out, as a result of its inquiry, that some of the beneficiaries of the tax exemption are overcompensated while others are not? By which extent should the tax paid by tax-payers be reimbursed to them?

Indeed the extent of possible reimbursement is likely to be a vexing issue. It is not clear from the judgement whether the amount that can be claimed for reimbursement is the amount by which the savings from not paying tax exceed the extra costs of public service obligation [i.e. to be determined by comparing costs and tax liabilities of non-tax-payers]

or whether in case there is an overcompensation, the tax payers can claim reimbursement of all their own tax payments.

Moreover, this judgement suffers from the same fundamental problem as the Ferring judgement. It is easier to understand the nature of this problem by reference to the criteria for compensation laid down in the Altmark case [C-280/00]. In Ferring as in Boiron, the relevant cost is the cost of the beneficiary undertakings. By contrast to Ferring, Altmark's fourth criterion stipulates that the undertaking which receives compensation should not have costs higher than those of the "typical" undertaking in the same sector. In other words, Altmark requires that the recipient of aid is reasonably efficient. This means that when public authorities grant aid to undertakings regardless of their ability and efficiency to fulfil the public service obligation imposed on them, these public authorities can no longer claim that there is no state aid involved. This makes sense because such inefficient undertakings would not survive in the market without public subsidies. The public service obligation that appears to impose a burden on them, in fact allows public authorities to keep them artificially alive.

As shown in the Annex, a similar situation may develop in the present case of compensation through taxes imposed on competing undertakings. The tax eliminates the extra burden of the public service obligation by handicapping the competitors. If those who are exempt are inefficient, the handicap imposed on the competitors must correspondingly be more severe. This deviates from the logic of the Altmark case and it cannot be presumed, as the Court does in the present case, that the tax "restores the balance of competition".

III. British Aggregates Association v European Commission, T-210/02

British Aggregates Association appealed against Commission Decision C(2002) 1478 final concerning state aid case N 863/01. British Aggregates Association comprises small independent quarrying companies in the United Kingdom.

Aggregates are chemically inert granular materials used in construction. Aggregates can be produced from quarrying of rock or sand or from by-products of other processes such as china making. The UK imposes a levy on aggregates extracted from nature, so-called virgin aggregates, while it exempts aggregates resulting from spoils or waste generated by other processes. The objective of the levy is to reduce environmental damage. In order to prevent distortions to trade, the UK also makes available a tax credit to operators whenever taxable aggregate is exported from the UK.

In its Decision, the Commission found that the levy did not comprise any elements of state aid within the meaning of Article 87(1), inasmuch as its scope was justified by the logic and nature of the tax system. The dispute in this case related to the application of the criterion of selectivity by the Commission.

The Court of First Instance began its analysis by stating settled case-law that when reviewing the selective nature of a measure, it is necessary to consider whether "the

differentiation between undertakings, as regards advantages or burdens, introduced by the measure in question, arises from the nature or the general system of the overall scheme which applies. Where such a differentiation is based on objectives other than those pursued by the overall scheme, the measure in question will, in principle, be considered as satisfying the condition of selectivity laid down under Article 87(1) EC.” [paragraph 107]

The CFI explained that “a levy may be described as an environmental levy where ‘the taxable base of the levy has a clear negative effect on the environment’, as the Commission stated in its Notice of 26 March 1997 on environmental taxes and charges in the single market (COM (97) 9 final, point 11). An environmental levy is thus an autonomous fiscal measure which is characterised by its environmental objective and its specific tax base. It seeks to tax certain goods or services so that the environmental costs may be included in their price and/or so that recycled products are rendered more competitive and producers and consumers are oriented towards activities which better respect the environment.” [paragraph 114]

According to the CFI, “it is open to the Member States, which, in the current state of Community law, retain, in the absence of coordination in that field, their powers in relation to environmental policy, to introduce sectoral environmental levies in order to attain [certain] environmental objectives... In particular, the Member States are free, in balancing the various interests involved, to set their priorities as regards the protection of the environment and, as a result, to determine which goods or services they are to decide to subject to an environmental levy. It follows that, in principle, the mere fact that an environmental levy constitutes a specific measure, which extends to certain designated goods or services, and cannot be seen as part of an overall system of taxation which applies to all similar activities which have a comparable impact on the environment, does not mean that similar activities, which are not subject to the levy, benefit from a selective advantage.” [paragraph 115] [emphasis added]

The CFI is making two different statements here. First, member states are free to choose the activities or products on which to impose environmental taxes. Member states are not required to tax all products that harm the environment or tax more heavily those products that harm the environment more than others. In other words, member states do not have to carry out a general assessment of environmental impact or devise a general scheme that applies to all products with similar impact on the environment. This is a statement on the boundaries of the discretion of member states in tax matters and therefore one accepts that courts may set those boundaries in perhaps an axiomatic manner.

However, the second point made by the CFI is based on logical inference and as such it can be more critically assessed. The second point is that, because member states have discretion to choose which products to tax, similar products that escape from taxation do not obtain a selective benefit. As a statement of fact, this is plainly wrong. Similar products would not benefit only if they are not competing with products which are subject to taxation. It is the foundation of competition analysis that competing products are those which are interchangeable in the eyes of consumers. Therefore, if one product

becomes more expensive as a result of a tax, consumers will substitute it with a similar product which is cheaper because it is not taxed.

Moreover, the objective of the tax in this particular case was to “promote” and “encourage” the use of aggregates that did not harm the environment. This is precisely the purpose of a selective measure.

However, to be fair to the CFI, it is possible that the word “similar” can be interpreted in a different way. A “similar” product need not be one which is interchangeable in terms of use but has a similar effect on the environment even though it is not used by consumers for the same purpose. For example, the use of insecticides in the production of apples and potatoes may have the same effect on the environment, even though consumers would not substitute apples for potatoes. By taxing the production of apples, the state does not confer a selective benefit to the production of potatoes.

The CFI also considered whether the exemption from the aggregates levy could be regarded to be of the same quality or same nature as other tax exemptions which had been found in other cases to constitute state aid [e.g. *Spain v Commission*, C-409/00; *CETM v Commission*, T-55/99; *Diputación Foral de Álava v Commission*, T-127/99]. Most fiscal state aid is in the form of exemption. The CFI rejected this comparison on the grounds that “unlike an environmental levy, which can be distinguished precisely by its particular scope and purpose, and thus cannot in principle be related to any overall system, ... measures of tax relief ... were an exception to the system of burdens normally imposed on undertakings.” [paragraph 116].

So, it is clear that when a measure is an exemption from a tax that has wider application, that exemption is likely to qualify as state aid, provided all the other conditions in Article 87(1) apply. Although the CFI does not say so explicitly, this is precisely the reason why the aggregates levy did not confer a selective advantage. Virgin aggregates are not in the same situation as waste aggregates. The former cause environmental degradation while the latter do not. They are similar products in terms of use but dissimilar products in terms of impact on the environment. The tax sought to remedy the latter effect.

That this must be the interpretation of the CFI’s ruling is reinforced by the fact that the CFI contrasted the present case with the landmark *Adria-Wien* case [C-143/99] where at issue was an exemption from an environmental tax levied on consumption of electricity. In that case the ECJ held that there was no justification, based on the nature or general scheme of the tax in question, for the exemption of manufacturing from that tax, given the fact that service companies could have similar rates of electricity consumption as manufacturing companies. In the case of aggregates, virgin aggregates have different effect on the environment than waste aggregates.

Lastly, the CFI examined the exemption of exports from the aggregates levy. The levy applies to the use or commercial exploitation of virgin aggregates in the UK. Virgin aggregates are subject to a levy on importation and the exportation of those materials is exempt in order to ensure equality between virgin aggregate produced in the UK and that

produced in other member states. The Commission justified that exemption in its Decision by the fact that the UK authorities had no control over the use of aggregates outside their jurisdiction.

The CFI concluded that “it is clear from case-law that a specific tax measure which is justified by the internal logic of the tax system is not subject to the application of Article 87(1) EC. In the present case, the exemption for exports cannot therefore be considered to confer a selective advantage on exporters since it is justified by the nature of the aggregates levy as an indirect tax. It was open to the Member State concerned to grant priority to considerations linked to the structure of the tax scheme concerned over the environmental objectives pursued. The applicant’s assertion that other Member States take a different approach is irrelevant.” [paragraphs 152-153]

It appears that at this point the CFI performed a leap in its reasoning. The internal logic of this particular tax is environmental protection. The exemption for exports undermines that logic because it allows virgin aggregates, whose extraction damages the environment, to be produced and sold abroad. Undoubtedly, the exemption levels the playing field between UK producers and producers based in other member states where similar taxes may not exist. But this must not be an issue of concern for a tax whose objective is not to ensure fair competition but rather to penalise environmentally damaging activities.

Conclusion

This paper has reviewed three very recent rulings dealing with fiscal state aid. The Azores case has clarified that regional authorities must have considerable autonomy and must bear the consequences of their tax decisions if their tax measures are not to be regarded as deviations from the national systems.

The Boiron case has shown that, contrary to the general principle in the case law, taxes themselves can, under certain circumstances, be a form of state aid. However, it has defined virtually impossible standards of proof.

Lastly, the British Aggregates case has shed light on the meaning of the internal logic of tax systems. It has also made clear that member states have considerable discretion in levying specific taxes, especially for environmental protection purposes. However, the extension of the internal logic to exports seems to go beyond the objective of environmental protection.

We will have to wait for new cases to deal with the issues that have been left unclear.

Annex: The Effect of Taxes on Competing Products

In order to understand the problems with the reasoning of the Court in the Boiron case, it is necessary to analyse the economic effect of taxes on competing products and see whether there is any straight forward relationship between taxes paid by producers of one group of producers and the gains enjoyed by another group who do not pay such taxes.

Diagram 1 shows such a case. Line DD indicates the demand for pharmaceutical products which are sold by producers, group **j**, and distributors, group **i**. Assume that the costs of these two groups are the same and that they act as price-takers so that they have identical supply lines, indicated by **Si,j**. Their joint supply or market supply is given by **S** [which is **Si,j** added to itself]. **S** intersects the demand line at point **a** and therefore, before any tax is levied, the market price is **f** and market output and consumption are shown by **x**. At price **f**, each group produces at point **n** of their supply lines and the sales of each group are given by point **q**.

Assume now that the government imposes a public service obligation that raises the costs of group **i** so that its supply line shifts to **Si'**. If nothing else happens group **i** will produce at point **z**, group **j** at point **m** and their combined sales will be **v**. Consumption declines from **x** to **v** and price rises from **f** to **e**.

The government addresses this competitive imbalance by imposing a tax on group **j**. The tax shifts its supply line to **Sjt** and the total output is now **u**, while market price rises even higher to point **d**. This situation is equivalent to a tax levied on both groups. If a tax at the rate of **bw** is levied on the sales of both groups, they produce at point **k**, price increases to **d** and sales and consumption decline to **u**.

Note that using a tax levied on just one group to restore fair competition between the two groups is a very inefficient policy because it harms consumers who are supposed to be served by the public service obligation. Consumption declines and price increases. Society would be better off without the tax. The optimum policy here would be a subsidy to the group that bears the extra costs of the public service obligation.

The tax collected by the government per unit of sale is **kt**, which means that the total tax revenue from the sales of group **j** is given by the rectangle **ktgd**. The extra costs of group **i** are shown by the triangle **kth**. Note that the area **ktgd** may or may not be equal to the area **kth**. A tax that attempts to impose the same handicap as an increase in costs may or may not result in an equivalent amount of taxes paid on the sale of the taxed product.

But for the sake of argument assume that rectangle **ktgd** is smaller than triangle **kth**. There is no possibility of over-compensation. Diagram 1 also shows the case of inefficient companies where the public service obligation results in much higher costs. The supply line in this case is shown by **Si''**, and the extra costs are indicated by the area **kthy**. Tax revenue, shown by **ktgd**, is definitely smaller than **kthy**. This means that to use a tax to restore competitive balance between the two groups, the government must raise the tax.

This case illustrates the fundamental problem in using taxes to restore the “balance of competition”. Because the distributors of medicines are less efficient than the producers of medicines in complying with the public service obligation imposed on them, the tax eliminates the competitive advantage of the latter. Without any knowledge of the efficiency of the two groups, it cannot be presumed that, in general, a tax of this kind restores competition. In fact, it may do precisely the opposite.

Diagram 1
Effects of taxes on competing products

