Community Topics 29

Tax harmonization in the European Community

european community
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July 1968

This booklet is based on a series of lectures given by Johannes Jansen, Head of the Indirect Taxation Division, Commission of the European Communities

Tax harmonization and the Rome Treaty

Like all other modern states, the six member countries of the European Community today use taxes not merely to raise revenue but also to stabilize their economies and to facilitate social change. Their tax systems vary, of course, because of differences in their economic and social policies and in the practical conditions of collecting taxes. However, taxation has become such an important instrument in shaping business and living conditions that some measures of alignment of the six member countries' tax policies is unavoidable if they are to achieve the economic union described in the Rome Treaty.

The Treaty itself contains only one clause which explicitly mentions tax harmonization. This is Article 99, and even here the only reference is to the harmonization of indirect taxes, the most important of which are turnover (i.e. sales) taxes and excise duties. Article 99 requires the Commission to propose to the Council of Ministers ways of harmonizing national legislation on indirect taxes in so far as this is in the interests of the Common Market.

The fact that the Rome Treaty does not explicitly mention the harmonization of direct taxes – such as income tax and corporation tax – does not justify the conclusion that there is no basis in the Treaty for this to be done. The authority for action in the field of direct taxation can be found in a general clause (Article 100) which instructs the Commission to propose directives to the Council for the "approximation of those provisions imposed by law, regulation or administrative action in member states as directly affecting the setting up or operation of the Common Market". Article 100 therefore implicitly covers harmonization of direct taxes.

It seems clear from the marked difference between the approach to harmonization of indirect taxes on the one hand, and of direct taxes on the other, that the authors of the Rome Treaty regarded harmonization of turnover taxes and excise duties as a matter of primary importance. The Commission has therefore from the outset given high priority to the harmonization of indirect taxes, and particularly of turnover taxes.

The Treaty lays down that economic union be brought about through a customs union. It is therefore logical that, as tariffs are removed, emphasis should be placed on other import levies which may have effects similar to those of customs duties. Turnover taxes and excise duties are the most obvious examples.

Turnover taxes

Turnover taxes are taxes on consumption: they are added to the price of the taxable products. They are levied according to the "country-of-destination" principle (in contrast to the "country-of-origin" principle). This means that exports are exempted from turnover tax and the tax already paid on them in the exporting country is reimbursed. On the other hand, imported commodities have to be taxed in the same way as similar domestic products. In other words, tax adjustments have to be applied at the frontier to ensure that the same tax is levied on imported goods as on comparable domestic products.

Since the customs union in the Community came into effect on July 1, 1968, trade between the member countries has been free of customs duties, but indirect taxes are still levied and reimbursed, and physical controls are still carried out at the Community's internal frontier.

These export rebates (or drawbacks) and import-equalization taxes could easily be used for purposes incompatible with one of the main objectives of the Common Market, namely free, undistorted competition. For instance, if a higher compensatory tax were levied on imports than the tax on comparable home-produced merchandise, the difference would have the same protective effect as the customs duties that had been abolished. If the export rebate were too high, then the difference would amount to an export subsidy, which is prohibited.

To prevent this type of discrimination, Articles 95 and 96 of the Treaty stipulate that the indirect tax on imports must not be higher than that which would be charged on similar domestic products, and that the export rebate must not exceed the amount of tax actually paid. Experience has shown that these prohibitions are very difficult to enforce properly in the Community, at least as far as turnover taxes are concerned.

Existing turnover-tax systems

There is a great disparity in the existing turnover-tax laws of the six Community countries, not only because of differing financial and tax policies, but also because of differences in the practical conditions of enforcement. However, the six systems can be reduced to three categories.

1. First, there are the cumulative, multi-stage "cascade" systems used in Germany (until the end of 1967), Luxembourg and the Netherlands (where, however, the tax is not levied at the retail stage). Under this system the tax is levied on the gross value of output at each stage of production.

2. Secondly, there is the tax on value added, a non-cumulative, multi-stage system, which has been applied in France. This is a tax levied only on the net value (tax on gross output minus tax on the cost of all materials used).

3. Finally, there are the mixed systems. These are basically cumulative multi-stage systems applied down to and including the wholesale stage, but incorporating taxes applied at a single point for some goods. These mixed systems have been used in Belgium and Italy.

In a cumulative multi-stage system, the tax liability accrues at each stage in the course of production and distribution, i.e. every time a product changes hands. As a consequence, it is never possible to know how much turnover tax has been paid on a product at any given point in the production or distribution process, for this depends entirely on how many stages the product itself, its components, and the equipment and services utilized have passed through. Even in a single industrial sector this can vary considerably from product to product.

At each taxable point, the tax paid accumulates on top of the tax levied at earlier stages. This so-called cascade effect results in a lower total tax burden on goods produced and distributed in a short than those subject to a long production chain. Consequently, the cascade effect benefits vertically-integrated concerns. It also constitutes a tax obstacle to specialization of production (which may be desirable on economic grounds), because each extra link in the economic process leads to extra taxation. Cascade systems, then, are not economically neutral. They distort competition in internal as well as in international trade.

As noted above, Articles 95 and 96 of the Treaty restrict the amount of compensatory taxes on imports and of rebates on exports. But as these amounts cannot be determined accurately in cascade systems, Article 97 permits countries with cascade systems to use average tax rates as a temporary measure. Even if accurately calculated, average rates must, by definition, give rise to discrimination because a domestic product on which the tax actually paid is less than the average rate has an automatic and unwarranted advantage over an imported product. On the other hand, exports have an advantage on foreign markets if the average rate of rebate exceeds the amount of tax actually paid on any one product.

In the early days of the Common Market, this problem was not serious. If the turnover tax on imports was too low, it was usually supplemented by an import duty which

normally provided a big enough margin – although at the expense of its protective function – to offset the advantage of the low compensatory tax.

However, the situation changed as import duties between the Six began to disappear. Insufficient turnover taxes on imports were increasingly regarded as placing imports at an unfair competitive advantage. For this reason, most governments concerned gradually increased their compensatory rates.

These border tax adjustments can cause considerable problems. It is difficult in practice to check whether the limits prescribed in Articles 95 and 96 have been overstepped. But even where these increases cannot be held to conflict with the letter of the Treaty clauses, their effects, which can be compared with changes in a country's exchange rate, give rise to serious objections. Repeated alterations in these price components are a factor of great uncertainty for international trade, since they vary the competitive position of products.

Constant increases in the compensatory taxes on imports and the reimbursement on exports do not affect intra-Community trade alone, but are just as harmful to trade with countries outside the Community, so that non-member countries, too, have every interest in seeing a stable and neutral competitive situation attained as soon as possible.

The choice of the added-value method

To eliminate these fiscal distortions of competition, the Council of Ministers decided on April 11, 1967, to institute a common turnover tax system based on the added-value method of taxation. Later on, the tax rates will also be harmonized. The decision was made in the form of two directives to the member states which leave the national governments free to decide how to incorporate the system into their legislation. Other directives will later complete the harmonization.

The first directive outlines the general program for turnover tax harmonization, the methods of accomplishing it, and its purposes.

Its aims are:

to remove fiscal distortions of competition by instituting the common added-value-tax (AVT) system by January 1, 1970;

to eliminate tax frontiers between the member countries in a second stage of harmonization.

By 1970, when all six Community members have switched over to the common AVT system, comparable products in each EEC country will be subject to the same system of turnover tax (even if rates applied vary), and exact compensatory measures will be possible in both intra-Community trade and trade with the rest of the world. Nonetheless, compensatory import levies and export rebates will still exist after January 1, 1970, in trade between the member countries, because the first stage of harmonization merely introduces a common tax system. Within the common system, each member country will decide its own tax rates and tax exemptions. As long as differences remain in the effective tax loads between the Six, there will still have to be equalization at the Community's internal frontiers in order to prevent distortion of competition.

These tax frontiers will be removed during the second phase. No time limit has been specified for the beginning of this stage; but, according to the first directive, the Commission must by the end of 1968 submit to a Council a draft directive specifying the action needed to remove tax frontiers, and stating how and when it should be done.

Why was a common system prescribed for the first phase of harmonization? This is a matter of some significance.

Economic neutrality, the first objective of harmonization, could just as well have been achieved had each country simply introduced a neutral system of its own choice. France could have kept the AVT system it had, and the countries that had cascade-systems could have selected from among various types of non-cumulative and neutral turnover taxes the one best suiting their needs.

The European Commission, in fact, did suggest this approach at first, but the Finance Ministers rejected it because only a common system could eliminate tax frontiers. Furthermore, the Ministers were reluctant to have to amend their legislation drastically twice within a relatively short period – first, to replace their current systems by neutral systems and then, a few years later, to replace the new system by a harmonized common system. The Commission therefore proposed that a common system be instituted right away.

Four criteria governed the choice of this system. It had to:

- affect competition as little as possible;
- facilitate subsequent elimination of tax frontiers;
- guarantee a relatively high tax yield;
- work in such a way as to enable all member countries to administer and collect the taxes due.

The Six agreed that the common system would have to be a general tax on consumption, normally payable on all goods and on services. (There is, therefore, a considerable

difference between such a tax and the British purchase tax, which is levied on certain goods only and not at all on services.)

The experts considered and rejected three possible types of turnover tax system. A single-point retail tax, which would have been ideal as regards neutrality and elimination of frontiers, would have put the whole turnover tax burden on the retailer, economically the weakest link in the chain of distribution and at the most difficult point of collection. It would also have meant a relatively high rate of tax in the member countries – in France, for instance, about 20 per cent.

A second possibility was a single-stage wholesale tax, corresponding to British purchase tax as regards methods of collection. This would have created equal conditions of competition in the production and wholesale stages, but its impact on consumer prices could have varied with retailers' profit margins. However, the main objection – as with a retail tax – was a practical one: tax evasion. Most member countries thought it too risky to levy a relatively high turnover tax at only one point.

The third possibility, a single-stage production tax, was rejected for similar reasons.

A system of taxation on value added was therefore finally accepted. The second Council directive outlines the structure of the common AVT and its application.

How th added-value tax works

Collection of an AVT levied down to the retail stage can best be explained by comparison with a single-stage tax levied only on retail transactions. If the rate is 10 per cent, the retailer pays a tax of £10 on a turnover of £100.

With a 10 per cent tax on the value added, the retailer takes 10 per cent of his turnover and deducts from that amount the taxes his suppliers have already paid on the goods and invoiced to him. If the retailer's purchases amounted to £80 of his £100 turnover, then he would owe the tax collector £2 (10 per cent of £100 less 10 per cent of £80). This amount corresponds to 10 per cent of £20, the value added by the retailer to the product. As with the single-stage system, he will have to pass on to his customers the full 10 per cent of £100 in order to recover the amount in tax that he has paid – indirectly, through his suppliers, £8, and directly to the tax authorities, £2. The tax is levied in the same way at the wholesale level, and at all the steps in production before the wholesaler. (See Annex I).

The tax liability is thus spread over every stage through which a product passes before reaching the consumer. What the tax authorities collect in one amount under a single-stage retail tax has the same incidence as an AVT levied up to the retail stage. In either case, the retail price is taxed only once, so that both systems are non-cumulative and neutral with regard to competition. The only real difference consists in the methods of collection: at one point, in the case of the retail tax, and spread over all stages in the case of AVT.

It is generally agreed that if the scope of the tax is made as wide as possible, the AVT system represents the optimum in simplicity and economic neutrality. The scope of the tax should therefore extend from the first stage of production to the last stage of distribution. If the retail trade is excluded, retailers might bypass wholesalers and go directly to manufacturers to save the tax on the value added at the wholesale stage.

Practical, political, or psychological reasons in some countries make it difficult to include the retail trade in the tax system. This is why the Council's directive makes the common system compulsory to the wholesale level only, and lets the member states decide whether to include retailers or to levy a separate supplementary tax on retailers. Investigations have shown that different treatment of retailers in the six countries need not necessarily lead to substantial distortions of competition in intra-EEC trade.

The added-value tax after 1970

Although a single added-value tax system will be in force throughout the Community on January 1, 1970, this field of tax harmonization will not be complete. Member countries will still be free to decide whether the AVT should be applied to retail trade and to a large part of the service sector. Only a limited number of services, namely those that directly affect production and distribution – among them, the transfer of patents and trade marks, advertising, and transport and storage of products – must be subjected to the common AVT.

The member countries will have the option of imposing AVT on all other services, such as those normally supplied to private individuals only (for example by doctors, banks, and hairdressers). Member states may also work out their own provisions, depending on national requirements and practical circumstances, for the application of AVT to small businesses.

However, selection of tax rates is the most important freedom left to the member countries during the first phase

of harmonization. So even after January 1, 1970, there will still be considerable differences between the six countries' standard and higher or lower rates, and the exemptions they grant. The normal rate on January 1, 1970, is likely to be roughly 20 per cent in France and Belgium; 10–12 per cent in Germany, the Netherlands and Italy; and 9–10 per cent in Luxembourg.

There are also other areas where harmonization need not yet be applied, and where the member countries are entitled to provide for national regulations. The most important instance is that, when economic considerations warrant such action, every member country is free, after consulting the Commission and the other member countries, to disallow some or all of the tax deductions for expenditure on capital goods or to allow deduction for this equipment by annual instalments only.

During a transitional period after the AVT is introduced, the member countries may – even without prior consultations – restrict tax deductions for expenditure on capital goods. Germany, in fact, did so in its new AVT law which came into force on January 1, 1968. The German restriction – a temporary one – was necessary on budgetary grounds, and was also intended to prevent a temporary halt to investment before the AVT was introduced.

The added-value tax and international trade

As long as each of the Community countries applies a different AVT rate, set at a level that maintains the total incidence of the preceding cumulative turnover tax, imports from abroad into these countries will, under the new AVT system, be taxed at the same rate as similar products produced in these countries. In countries with a cascade system where compensatory taxes on imports were too low, the introduction of the AVT will mean that imported goods will lose their unwarranted competitive advantage. Conversely, exports from those EEC countries to non-member countries will lose the competitive disadvantages from which they may have suffered because of an inadequate rebate under the cascade system. Competitive conditions in foreign markets will also be equalized in trade between the EEC countries themselves.

These effects will not, however, always be felt immediately, because governments are likely to take transitional measures for budgetary reasons. In Germany, for instance, stocks of merchandise and capital goods existing on December 31, 1967, were not completely relieved from the old turnover tax paid on them. Moreover, the AVT paid on capital goods bought during the first five years after the introduction of the new system in Germany is only partially deductible. These measures will, during the depreciation period for capital goods, involve a supplementary charge on German products which will neither be reimbursed on exports nor equalized for imports. German experts estimate that this extra charge could increase the overall German price level by about 1·5 per cent in 1968 and 1 per cent in 1969. This supplementary charge will gradually disappear. Obviously this price rise has reduced or even neutralized any advantages German industry could otherwise have expected from the introduction of the AVT.

Aligning added-value tax rates

The second phase of tax harmonization will eliminate tax frontiers between the Community's member countries after common AVT rates have been introduced. The effects of this will be much more serious, both on trade among the member countries themselves and on their trade with non-member countries. No timetable for this has yet been set.

One of the first consequences of the alignment of AVT rates is that the member countries will have to surrender virtually all their sovereignty in turnover taxation. The opportunity to use turnover taxes for purely national economic and social aims will then be minimal: countries will retain their freedom of action only in certain areas (in the retail trade, perhaps, and services to private persons).

The repercussions on the national fiscal pattern and on the tax burden should also be radical in several Community countries. Depending on whether the overall burden is now lighter or heavier than the burden of the common rate, the introduction of a common rate will result in a higher or lower yield from the turnover tax and a corresponding increase or decrease in the tax burden.

The level of the common rate is not yet fixed, but it might be in the region of 15 per cent. In that case, introducing a common rate would increase the burden of turnover tax in Germany, the Netherlands, Luxembourg and Italy, and reduce it in France and Belgium. The first three countries could therefore lower direct taxes while France and Belgium would need to raise them. Italy would be able to abolish many of its special taxes on production and consumption.

Harmonization of turnover taxes could thus constitute an important step towards bringing into line the ratio between direct and indirect taxes in the six member countries. (See Annex II). This would help to ensure equal conditions of competition.

Excise duties

Although harmonization of turnover taxes is being given priority, other taxes will also have to be aligned if the envisaged economic union is to come into effect, and in 1967 the Commission put before the Council a program to this end.

Because the "country-of-destination" principle also applies to excise taxes, there is, as with turnover taxes, a tax rebate on exports, and a duty on imports. The present measures are by no means always compatible with Articles 95 and 96 of the Rome Treaty, which ban discriminatory treatment based on the origin of products because they often do discriminate against imported products. Some of these forms of discrimination have been abolished at the insistence of the Commission, but a number of others can be eliminated only by harmonizing the method of collection. If tax frontiers between the member states are to be completely dismantled, rates of excise duties will have to be brought into line.

At present excise duties are extremely disparate. The number of duties also varies appreciably from one country to another. Consultations between the Commission and the Permanent Committee of heads of revenue departments in the member countries have produced agreement in principle on the way in which excise duties could be harmonized. Common excise duties would be levied on a limited number of items, in particular manufactured tobacco, spirits, beer, petroleum products, and perhaps wine and sugar. The Commission thinks that collection methods should be harmonized as soon as possible. The harmonization of rates, which is normally essential for the removal of tax frontiers, would come later, perhaps at the same time as the harmonization of turnover-tax rates.

A second category of existing excise duties – for instance those on salt, matches, playing cards and certain tropical products such as tea and coffee – could be abolished or incorporated in the common AVT.

A third category of unimportant excise duties that are purely local and do not affect trade between the member countries would not need to be harmonized. So far, a draft regulation for the harmonization of tobacco excise duties has been submitted to the Council. Working parties, including government experts, are studying the other duties.

Direct taxes

In 1967 the European Commission submitted to the Council a memorandum setting out the harmonization program for direct taxes. The economic and social aims of this program are:

1. To ensure that the effects of taxation on the cost of production and on the yield on invested capital do not differ too widely between one member country and another.
2. To ensure that capital movements depend on economic rather than on fiscal factors.
3. To eliminate tax obstacles to mergers and to the setting-up of European companies – and so help firms adjust to the larger scale of the Common Market, and hold their own against increasing competition in world markets.
4. To coordinate fiscal policies of the member states – especially the use of taxation as an instrument of economic and social policy – and bring them into line with the Community's policies.

Each tax must be considered in the context of the overall tax structure, which should not be distorted by too many adaptations to special situations. At the same time, tax harmonization should leave the member states sufficient autonomy and room for manoeuvre in their budgetary policy to influence, if necessary, their national economies in the framework of the Community policy.

Tax harmonization will, of course, serve little purpose unless the methods of inspection, verification and collection are also harmonized.

Three sources of revenue

In the opinion of the European Commission, the tax revenue of the six EEC countries should, in the long run, be based mainly on three sources:

1. The harmonized added-value tax, plus a limited number of harmonized excise duties.
2. A corporation tax, which would have the same structure and similar rates throughout the Community.
3. A personal income tax whose rate might differ, even in the long run, from one member country to the other.

Harmonization of direct taxation therefore affects mainly company profits and dividends. In the long term a single tax system for profits would be needed.

There are, however, some problems which have to be solved soon. These questions are dealt with in a short-term program divided into three chapters: ensuring the free movement of capital; facilitating industrial concentration; and avoiding the distortion of competition caused by different tax rules for depreciation of capital goods.

Fre dom of capital movement

The Commission points out that to overcome the fragmentation of capital markets and to create a free, common capital market, the international double taxation of dividends and interest must be eliminated. So, too, must all fiscal factors likely to cause "abnormal" capital movements, that is to say, movements springing from causes other than traditional economic or financial considerations.

The Commission therefore proposes, first, the extension and improvement of the existing inadequate network of bilateral conventions for the avoidance of international double taxation on interest and dividends. This would pave the way to the conclusion of a multilateral convention between the Six.

A second step is the establishment of a single method of relief from "economic double taxation" of dividends, which are taxed first as company profits, and then as part of the income of the individual shareholder. At present two methods are practised within the Community. Germany applies a reduced rate of company income tax for distributed profits. France and Belgium, on the contrary, grant the relief within the scope of personal income tax. They allow the shareholder to deduct from his personal income tax a part of the corporation tax paid by the firm distributing the dividends.

The other member states (the Netherlands, Italy and Luxembourg) have no measures to avoid this form of double taxation. The present French and Belgium systems will need to be modified soon because they allow this tax relief to residents only and, moreover, solely for dividends distributed by companies established in the country itself. Obviously, this makes it more attractive for French and Belgian investors to buy shares in national companies than in companies established in the other member states. At the same time, residents from other member countries are discriminated against if they hold shares in French and Belgian companies. This situation is clearly incompatible with the principle of free movement of capital.

The Commission proposes, thirdly, that the very different arrangements for withholding at source the tax on dividends and bond interest should be harmonized. The existing tax situation varies from country to country, and in one and the same member country, according to the country where the income arises, and sometimes according to whether the income is collected in that or in another country.

The European Commission suggests that common rates for tax withheld at source in the Community be introduced. It regards a rate of 25 per cent as feasible for dividends. For bond interest, a lower rate – say a maximum of 10 per cent – could be applied.

Any tax withheld at source would have to be deducted in full from the beneficiary's income tax and be reimbursed to the extent that it exceeded the beneficiary's tax liability. The Commission stresses the need to simplify the numerous and complicated formalities which must at present be complied with to avoid international double taxation.

The Commission also suggests that a member state could be authorized to refrain from levying the common withholding tax on dividends paid to its residents, provided that the shareholder's tax office is informed immediately by the paying agency. This is the current practice in France, where withholding tax is levied only on dividends paid to foreigners.

Two other measures proposed in connection with the establishment of a free capital market are the removal of tax rules which handicap investment trusts and funds in comparison with direct investments, and an examination of the present tax arrangements to which holding companies are subject, to see if they can be harmonized.

Helping company m rg rs

The removal of fiscal obstacles to company mergers is necessary to facilitate, or at all events not to hinder, the growth and modernization of firms. At present, mergers are generally impeded by the fiscal cost of the transaction

itself, while the acquisition of a shareholding in another company is discouraged by the tax rules subsequently applicable to the parent company and its subsidiaries.

In order to create equal conditions of competition for investments, the Commission proposes, to begin with, that the basic rules for depreciation of fixed assets be harmonized. These rules are an important element in the assessment of the tax on company profits. Before member states introduce special depreciation provisions liable to constitute particular incentives to investment, they will have to consult the Commission and the other member states. National investment incentives not in line with the general policy defined by the Community institutions are undesirable, the Commission points out.

In the longer term, a harmonized definition and method of calculation of taxable profits must be adopted. To this end, the Commission's proposals for the depreciation rules will have to be supplemented by common provisions for the appreciation in value of fixed assets, the valuation of stocks, the carrying-forward of losses and tax-exempted reserves.

Annex I: Invoicing under the added-value tax system

The simple example below illustrates how one firm invoices another under the AVT system. Assume that:

A sells B sheet-metal for £100;

From this material B manufactures kitchen utensils, which he then sells to C, a wholesaler, for £200;

- C then resells these utensils to D, a retailer, for £250;

The rate of AVT is 20%.

A invoices B (manufacturer). A invoices B £100 plus 20% AVT = £120. A receives £120, £20 of which he pays to the revenue authorities.

B invoices C (wholesaler). The price paid by B can be broken down like this: £100 (price before tax) plus £20 (tax which he has paid, and which is passed on by A to the revenue authorities).

B's invoice to C is £200 (i.e. £100 purchase price plus £100 value added) plus 20% AVT = £240. B receives £240, £40 of which is added-value tax. But since A has already paid £20 to the revenue authorities, B only pays the difference, i.e. £40 less £20 = £20.

C invoices D (retailer). The price paid by C can be broken down as £200 (price before tax) plus £40 (tax which he has paid to B and which is passed on by the latter to the revenue authorities).

C's invoice to D amounts to £250 (i.e. £200 purchase price plus £50 value added) plus 20% AVT = £300. C pays to the revenue authorities: £50 less £40 paid by A and B = £10.

This example shows that the revenue authorities received £20 from A, £20 from B and £10 from C. The total, £50, corresponds to 20% of the final selling price, £250.

How is AVT levied?

In practice, payments and deductions of tax are not effected at the time of each transaction, but all together at the end of a given period. Let us suppose that this period is one calendar month – as it is, in fact, in the AVT systems applied in France and Germany and recommended by the Community authorities. During this month the taxpayer will record, in two columns:

1. His purchases and, opposite, the tax paid to suppliers;
2. His sales and, opposite, the tax received from customers.

If the sum of the tax received exceeds that of the tax paid, the taxpayer will owe the revenue authorities the difference. If the sum of the tax paid exceeds that of the tax received, then they will owe him the difference. If, for instance, the monthly total of the tax paid on purchases amounts to £80 and that of the tax received from sales to £100, the taxpayer will pay the revenue authorities £100 less £80 = £20.

This system differs from the cumulative multistage or "cascade" system where tax is paid by sticking revenue stamps on the invoices after completing each transaction. Under the AVT system, the tax is paid as a lump sum on all the transactions carried out during the given period of time. This process therefore involves the submission at set periods – monthly, in our example – of a detailed tax declaration, together with payment if the balance is in favour of the revenue authorities.

What is m ant by 'deduction'?

The French and German schemes authorize the taxpayer to deduct the tax which has been levied on certain goods from the AVT he owes.

There are two types of deduction:

1. Deductions for purchases and imports of raw materials and for products which are required in the composition or manufacture of goods liable to AVT, or which lose their individual properties in the course of a manufacturing process. Deductions can also be made on work done for production of these goods.

2. Deductions on purchases, imports and deliveries of goods and services – other than those mentioned under (1) above – which are acquired for operational purposes.

This category includes:

- Investments in industrial fixed assets: workshops, warehouses, drawing and study offices, accommodation for social services;
- Investments in movable assets: industrial plant; machinery; production or handling appliances; typewriters, and calculating, invoicing and photocopying machines; drawing boards; typing tables, filing cabinets; teleprinters; essential social-service equipment; spare parts and supplies for repair and maintenance of goods eligible for tax deductions;
- General expenses for heating and lighting industrial, administrative and commercial buildings; production costs (energy, working clothes); marketing expenses (publicity, samples);
- Cost of services, such as bank charges, transport costs, expenses arising from the renting of factories or material, publicity costs.

How are these deductions made? Suppose that, during a given month, a manufacturer invoiced supplies to his customers for a total of £5,000. If the AVT rate is 20%, he would invoice £5,000 plus 20% = £6,000.

He therefore owes the revenue authorities the tax he has received, i.e. £1,000. But he may make the following deductions:

1. In the course of the month he purchased raw material costing £2,000, on which he paid £400 tax. This tax is immediately deductible in its entirety.

2. During the same month he acquired a machine valued at £900 which was subject to £180 tax. This tax will only be deductible piecemeal, according to the way in which the value of the machine is depreciated. If depreciation is spread over a five-year period, the amount deductible each year will be:

$$\frac{£180}{5} = £36 \text{ a year, or } £3 \text{ a month.}$$

At the end of the month, the manufacturer will therefore owe the revenue authorities:

£1,000 less £400 and less £3 = £597.

Deductions are not, however, effected so simply in practice. First, certain AVT systems do not allow the total of the reimbursable taxes to exceed the total of the taxes due, since this would result in the revenue authorities paying money out instead of receiving it. Secondly, where some of the goods sold are exempt from AVT (except exports), the deduction is scaled down to a percentage corresponding to the percentage of those sales attracting tax in total sales.

Conclusions

The above examples show that the AVT system has a number of advantages over other turnover tax systems:

1. AVT ensures equal distribution of the tax burden between similar products, irrespective of the length of the production and marketing processes, whereas under other systems the tax burden weighs more heavily on unintegrated firms.

2. AVT exempts sub-contracting from taxation, whereas in other systems tax is levied on the sub-contractor every time the product liable to tax is processed.

3. AVT is not levied on goods when they are exported, whereas under other systems exports are also taxed.

4. AVT exempts goods on which tax has already been paid from further liability to taxation. Under other systems, the tax is always levied on an amount which includes the taxes paid at previous stages.

5. AVT exempts from tax purchases of capital goods and certain general expenses essential for running a business.

Annex II: How taxation is raised

Total tax s (including social security contributions) as a percentage of GNP at factor cost in 1966

	Total taxes & contributions	All taxes	Taxes on income			Taxes on expenditure	Social s curity contributions
			on households	on corporations	total		
Belgium	35·3	25·2	8·1	2·2	10·3	14·9	10·1
France	45·8	28·7	5·4	2·3	7·7	21·0	17·1
Germany	40·2	28·5	9·5	2·6	12·1	16·3	11·7
Italy	33·0	21·8	5·6	2·0	7·6	14·2	11·1
Netherlands	39·5	26·1	11·8	2·8	14·7	11·5	13·3
EEC average	**38·8**	**26·1**	**8·1**	**2·4**	**10·5**	**15·6**	**12·6**
United Kingdom	36·2	30·6	11·2	2·3	13·5	17·2	5·5
USA	30·7	25·2	10·6[1]	5·0	15·5	9·7	5·5
Japan	20·8	16·7	4·7	3·8	8·5	8·2	4·0

[1] Including estate and gift taxes

Source: OECD Annual Review 1967

Annex III: Further reading

Report on the problems raised by the different turnover tax systems applied within the Common Market (Tinbergen Report). 1953

General Report of Sub-Groups A, B and C on the harmonization of turnover taxes. 1962 (in Community languages only)*

Report of the Fiscal and Financial Committee (Neumark Report). 1962 (in Community languages only)*

*An English translation of the two reports has been published in one volume under the title 'The EEC Reports on Tax Harmonization – The Report of the Fiscal and Financial Committee and the Reports of the Sub-Groups A, B and C, by the International Bureau of Fiscal Documentation, Muiderpoort, Sarphatistraat 124, Amsterdam-C, Netherlands

Revenue from Taxation in the EEC, 1958-1965
European Community Statistical Office. 1967

Report of the Committee on Turnover Taxation (Richardson Committee). 1964. HMSO Cmnd. 2300

Tax Harmonization in Europe, by Arthur Dale
Taxation Publishing Co. Ltd. 1963

Fiscal Harmonization in Common Markets
Vol. I Theory, Vol. II Practice
Ed. Carl S. Shoup. Columbia University Press. 1967

The EEC value added Tax and the UK, District Bank Review. December 1967 by A. R. Prest

Taxes in the EEC and Britain, by Douglas Dosser and S.S. Han
PEP/Chatham House. 1968

Community Topics

An occasional series of documents on the current work of the three European Communities
Asterisked titles are out of stock, but may be consulted at the London and Washington offices of the European Community Information Service.

*9. **Energy policy in the European Community** (June 1963)

*10. **The Common Market's Action Program** (July 1963)

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*12. **The Common Market: inward or outward looking, by Robert Marjolin** (August 1964)

*13. **Where the Common Market stands today, by Walter Hallstein** (August 1964)

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*21. **Agriculture in the Common Market** (November 1965)

*22. **Social policy in the Common Market 1958–65** (July 1966)

23. **Euratom's second five-year program** (Topic 7 revised October 1966)

*24. **Regional policy in the European Community** (December 1966)

*25. **Towards political union** (November 1966)

26. **Partnership in Africa: the Yaoundé Association** (December 1966)

27. **How the European Economic Community's Institutions work** (Topic 11 revised December 1966)

28. **The common agricultural policy** (Topic 21 revised July 1967)

29. **Tax harmonization in the European Community** (July 1968)

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Printed for the European Community Information Service by Edwin Snell & Sons, Printers, Yeovil, England