TOWARDS A EUROPE WITHOUT FRONTIERS

The approximation of European tax systems

European File

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To transform the European common market into an area without internal frontiers by 1992: that is the objective set out in a European Commission white paper on 'Completing the internal market'. The objective was approved by the Heads of State or Government at the Milan European Council in June 1985. It is formally asserted by the new draft European treaty, which is meant to supplement the Treaty of Rome and which national parliaments should ratify before the end of 1986. The abolition of internal customs duties has already been passed into EEC law; the creation of an area without frontiers involves abolishing also the physical, technical and fiscal barriers which still obstruct trade between the countries of the European Community.[1]

In line for abolition are a whole range of national 'preserves', created especially by differing national laws and technical standards, as well as by public procurement practices. At the same time, a closer approximation of the different systems of VAT and excise duties will make it possible to eliminate fiscal barriers: these are the counterveiling measures (remission of tax on exports and taxation of imports) and frontier checks arising from excessive divergences in levels of taxation. In this way the European Union which is in course of formation will become a tangible reality for its citizens. The other effect will be to give a boost to the European economy, to its international competitiveness and to the number of jobs it can provide:

- Trade between Community countries will begin again to grow faster than trade with the rest of the world, as happened when internal customs duties were dismantled;
- Competition will be intensified among businesses that can take advantage of a large area without frontiers, which will favour economies of scale and make investment in advanced technology profitable;
- A range of costs will be lowered by this increased competition, as well as by the elimination of formalities and loss of time at frontiers.

So European firms, having available to them an internal market of continental dimensions, will be able to compete on equal terms with their American and Japanese rivals. Above all, the Community's 320 million citizens, consumers and taxpayers will gain better employment prospects, and will save the tens of thousands of millions of ECU[2] that are the cost of today's 'non-Europe'.

The Community and taxation

The volume and role of taxation have increased with the growth of government intervention in social affairs and in the economy. Still, nobody is suggesting that the

[1] This file replaces our No 10/84.
[2] 1 ECU (European currency unit) = about £0.63, Ir. £0.71 or US $0.92 (at exchange rates current on 10 April 1986).

Community implement a fiscal policy analogous to those of Member States. The reason is twofold:

- ☐ Though financed by the Community's own resources (customs duties and levies on products imported from the rest of the world, as well as a share of VAT), the Community budget represents only about 3% of the sum of national budgets.

- ☐ Though the countries of the Community are increasingly fixing certain economic objectives in common (curbs on inflation, growth rates, etc.), the elaboration of economic and social policy and the means of putting them into effect (fiscal means in particular) are generally left to the discretion of each Member State.

In general, therefore, the Community's activity in the area of taxation is limited to those tasks which are essential for the achievement of its principal objectives, particularly:

- ☐ The establishment and completion of a common market, based on the free circulation of people, goods, services and capital between Member States, and on conditions of healthy competition. It is in this context that the countries of the Community are now called upon to accelerate the approximation of their systems of indirect taxation, so that fiscal barriers can be eliminated.

- ☐ The implementation of certain common policies (agricultural, regional, social, industrial, research, etc.) which can entail the removal of other obstacles or distortions of a fiscal nature.

- ☐ The alignment of the economic policies of Member States, as part of the gradual achievement of an economic and monetary union.

Despite these limited aims, Community activity in this field has proved especially arduous. Every decision relating to taxation effectively requires unanimous agreement of the Council of Ministers.

- ☐ As a result, the pace of achievement has up to now been very slow. This is all the more understandable in that taxation policy is traditionally an essential element of national sovereignty. Moreover, it is a complex field, extremely technical, varying considerably from one country to another, and it is a subject on which public opinion is very sensitive (a type of tax relatively well accepted in one country may be much less so in another).

- ☐ Contrary to the provision being made for other fields of Community activity, the current revision of the European treaties will unfortunately not eliminate this unanimity requirement. It can only be hoped that the importance of what is at stake, together with the interdependence of the different measures required for the completion of the internal market, will help bring about a consensus.

Indirect taxation: ways and means of approximation

The approximation of indirect taxes imposed on the production or consumption of goods and services is one of the three central themes of the European Commission's white paper on completing the internal market. Effectively, the existing differences between national systems:

- ☐ can cause distortions in production costs and selling prices, and hence in the conditions of competition;
- ☐ force Member States as a result to maintain frontier formalities and controls, in order to forestall these distortions and prevent deflection of trade and the growth of tax evasion.

The present situation can be described as follows:

- ☐ *VAT.* Two Community directives adopted in 1967 provided for the general application of value-added tax. They eliminated the remaining 'cascade' taxes, the cumulative nature of which hampered economic activity and the growth of trade. A feature of VAT is its economic neutrality. At each stage in the making or marketing of a product, the tax paid at the preceding stage is deducted from that payable by the vendor. In this way the tax burden remains proportionate to the value of the goods or services, no matter how many transactions they have been through. The common VAT system is already applied in Spain, which joined the Community at the start of 1986. It is due to apply in Greece from 1987, and the Portuguese system will be brought into line with the Community model between now and 1989.

  In 1977 the Community Member States reached agreement on a common basis for assessing VAT, albeit subject to many exceptions. It was enough to enable the Community to collect on this basis part of its own resources for the financing of its budget. The VAT available to the Community was subject to a maximum rate, which has just been raised from 1% to 1.4% on the uniform basis. Later directives harmonized the rules for reimbursement of VAT to taxable persons residing in another Member State, as well as the arrangements for hiring-out of moveable tangible property, certain final or temporary imports, etc.

- ☐ *Excise duties.* These duties are imposed on certain specific products such as alcoholic drinks, manufactured tobacco, and fuels. Despite numerous proposals by the European Commission, the only common regulations so far adopted relate to the structure of duty on cigaretts. Acting on complaints by the Commission, the European Court of Justice has also delivered judgments which made several Member States give up fiscal measures favouring home-produced spirits to the detriment of imported products.

- ☐ *Tax-free allowances.* Allowances free of VAT and duty have been established for travellers, but the European Commission has to keep up a constant fight to see

that they rise in line with the cost of living. At the moment these allowances cover limited quantities of tobacco products, spirits, coffee, tea and perfume, as well as imports to the value of £207 for each traveller, or Ir. £252 for each adult and Ir. £64 for each child.[1] Specific allowances have also been established for small postal consignments (£58 or Ir. £72), for temporary importation of certain means of transport, and for final importation of personal property in case of removal of residence, marriage or inheritance.

So, however uneven or incomplete its successes, the Community is not inexperienced in the approximation of tax systems. What is now required is to go further and faster, so that fiscal barriers may be removed in 1992.

How close does the approximation have to be? Close enough to avoid distortion or deflection of trade, or effects on competition. The experience of the United States is instructive: there one finds scarcely any problems as long as the tax rates of neighbouring States diverge by no more than 5% of the value of a product. In other words, it is not necessary to go as far as having identical rates of taxation; because of other factors (convenience, quality of service, habits, etc.), the consumer is relatively insensitive to price differences resulting from a tax rate of, say, 14% in one place and 19% in another.

Another point to note is that, in most countries of the Community, VAT and excise duties together represent between 9% and 12% of gross domestic product (see diagram). In global terms, levels are sufficiently comparable to be brought more closely into line with scarcely any effect on average price levels or on State revenue.

There are, however, real problems for countries like Denmark and Ireland, where VAT and excise duties are markedly higher than the Community average, and represent together more than 15% of GDP. Other difficulties, shared by all Member States, arise from the widely varying distribution of the tax burden, as between VAT and excise duties, and as between different products and services.

- ☐ A recent comparison shows that standard rates of VAT range between 12% (Spain and Luxembourg) and 23% (Ireland). However, there are higher rates which go up to 38% (in Italy), as well as numerous lower rates: generally below 10%, and as low as 0% in Ireland and the United Kingdom (see table).

- ☐ The excise duty on a litre of wine ranges from 2.7 ECU in Ireland to zero in Germany, Greece and Italy. 75 centilitres of spirits are taxed at about 9.6 ECU in Denmark and 0.16 ECU in Greece. Denmark and Greece are also at the two extremes for duty on a packet of 20 cigarettes: 1.96 and 0.28 ECU respectively. Duty on a litre of premium petrol varies from 0.20 ECU in Luxembourg to 0.49 ECU in Italy (all rates as of March 1985). Besides these excises which are common to all, or nearly all, Member States, there are more original ones in some countries: on salt, matches, coffee, tea, etc.

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[1] However, Ireland applies a tax on individual objects above Ir. £55 in value.

Tax revenue: trend and breakdown in the countries of the European Community (as % of gross domestic product)

* Greece, Spain, Portugal: general taxes on consumption.

** On the basis of 1979 figures.

Source: OECD, 1985.

Rates of VAT in the Community Member States (situation as of January 1986) [1]

	lower	*standard*	*higher*
Belgium	6 and 17	19	25 and 33
Denmark	–	22	–
Germany	7	14	–
Spain	6	12	33
France	5.5 and 7	18.6	33.3
Ireland	0 and 10	23	–
Italy	2 and 9	18	38
Luxembourg	3 and 6	12	–
Netherlands	5	19	–
Portugal	8	16	30
United Kingdom	0	15	–

[1] Greece has not yet introduced VAT.

Bringing such practices more closely into line is no easy task, but once again a limited degree of variation can perfectly well be allowed. Moreover, the necessary adjustments would be spread in time between now and 1992, so that they should not give rise to any major difficulty, provided certain possible exemptions are considered, as a last resort. The rest is mainly a question of political will: are the European governments ready or not to make the effort required to bring about a large unified market?

The main lines of the strategy advocated by the European Commission for the approximation of indirect taxation are as follows:

☐ *VAT*

- The uniform basis of assessment must be fully established; that is to say it must be completed and tidied up by doing away with a range of exemptions. The Commission insists on rapid adoption by ministers of its proposals in regard to second-hand goods, works of art, coach transport, flat-rate schemes for farmers and small and medium-sized businesses. Food products, subject to zero-rate VAT in Ireland and the United Kingdom, present a particular problem which should be tackled.

- There must be a gradually closer approximation of the number of rates in force in each country, of their levels, and of the list of goods and services to which each rate applies: differences remaining in 1992 should be insufficient to warrant frontier controls. As a first step, the European Commission wants to avoid any widening of the present divergences in Member States' legislation. It has sent to the Council of Ministers a proposal for a directive

to implement a 'standstill': a freeze on the number of rates and on the gap between them and the Community average. The only changes allowed would be those that made for closer alignment. During a second phase, the Council of Ministers is asked to fix common central rates of VAT and to determine their number, the ranges of variation to be permitted to Member States, and the procedure for gradually approximating the rates by 1992.

- A clearing house system should be set up, using modern information technology. This would simplify intra-Community transactions, by enabling them to be treated in the same way as purchases and sales within a single member country: tax would no longer be collected at the frontier, but in the exporting Member State, with deduction being made in the importing country.

□ *Excise duties*

- The European Commission urges the ministers to adopt without delay the proposals it has tabled on the structure of the duties on alcoholic drinks and tobacco and mineral oil products. It also asks Member States not to introduce or increase excises on other products involving imposition or remission of tax or controls at frontiers.

- As in the case of VAT, the Council of Ministers is asked to fix 'bands' or ranges of variation for tax on alcoholic drinks and tobacco and mineral oil products. National rates could then no longer be changed except to bring them gradually into closer alignment by 1992. In the same period all other excise duties would have to be abolished, unless they did not distort trade or require frontier controls.

- Finally, bonded warehouses – where products destined for export are often stored, with the duty payable on them suspended – should be linked together, in order to complete the arrangements for abolishing frontier controls.

Other initiatives

The Community's efforts are not concentrated entirely on VAT and excise duties. Completion of the internal market also requires certain measures relating to personal income tax and, most importantly, to corporation tax and the taxation of capital formation. At the same time there is a need for improved cooperation among Member States to combat tax avoidance and evasion.

□ *Personal income tax.* In 1979 the European Commission sent to the Council of Ministers a proposal, which is still on the table, to abolish the tax discrimination that often affects those who do their work in a Member State other than their country of residence. This aspect of personal income tax was singled

out because of its direct interest for frontier workers. Beyond that, the Commission has no aspiration to get involved in personal income tax, which is considered to be a national instrument of economic policy.

☐ *Taxation of capital formation and companies.* There are three Community directives to harmonize taxes on the raising of capital. However, it is necessary to go much further. The creation of a large unified market on a European scale requires that capital be able to circulate freely, that industrial cooperation be facilitated, and that conditions of competition become less unequal. It is for that reason that there must be some approximation of the tax burden on businesses, so that production costs, the siting of investments, and the return on invested capital are not unduly influenced by the differing tax systems of Member States. To this end the European Commission has presented several proposals, which still await decision by the Council of Ministers. They include:

- Proposals made in 1969 on tax arrangements for companies merging across national frontiers and companies which have subsidiaries in other Community countries; also a 1976 proposal to eliminate certain instances of double taxation;

- A proposal made in 1975 for a common system of corporation tax. The aim was to achieve as much fiscal neutrality as possible, so that movements of capital would be determined by economic considerations, rather than by the fiscal conditions prevailing in one State or another. The Commission proposed bringing the rates of tax more closely into line, as well as adopting a common system of tax credit which would give partial relief from the double taxation of dividends (as both company profit and shareholders' income). The harmonization of national systems of company taxation also requires agreement on the scope of the tax and on the basis on which it is assessed. The tax arrangements for partnerships, for example, vary from one country to another: perhaps it should be made general practice to allow a choice between taxation of the company and taxation of the persons of whom it is composed. The definition of a common assessment basis poses numerous problems, because of the very magnitude of the issue and the differences that exist between national legislations.

Other proposals presented by the European Commission relate to the carrying over of company losses from one financial year to another, and to the harmonization of indirect taxation on trade in securities.

A Commission white paper on company taxation is intended to take stock of these different proposals, while examining the possibility of new initiatives. The Commission has a particular interest in fiscal measures for stimulating investment of risk capital and promoting innovation. Coordination on the basis of common criteria should make it possible to avoid unfair discrimination and Member States outbidding each other, while improving the competitiveness of European firms *vis-à-vis* their rivals in other major industrialized countries.

☐ *Fighting tax avoidance and evasion.* In 1977 and 1979 the Community countries adopted two directives organizing reciprocal assistance between their tax authorities, in the areas of direct taxation and of VAT. This cooperation increases the effectiveness of anti-evasion measures at national level. It will also help to ensure fairer competition among European firms ■

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