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Harmonization of indirect taxes in the European Union

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Abstract

Purpose – The correct functioning of the European Union Single Market requires the elimination of discriminatory or protective internal taxation of goods. This paper aims to provide an overview of developments in indirect tax harmonization within the European Union (EU).

Design/methodology/approach – The approach is to provide a history of tax harmonization and a description of the present functioning of the system within the EU.

Findings – The paper illustrates that through partial harmonization of indirect taxes (value-added tax and excise duties) the EU has reached a considerable degree of fiscal neutrality. The attitudes of Member States suggest that closer harmonization (or even unification) of tax rates may not be considered.

Originality/value – The paper provides a summary of the progress of tax harmonization in the EU.

Keywords Taxes, European Union

Paper type General review

1. The purpose of tax harmonization at the EU Internal Market and the need for a common tax policy

The establishment of the Common Market in the 1960s and its transformation into the Internal Market in the early 1990s[1] required the creation of a special common tax system that would allow the proper functioning of four basic freedoms between the EEC (EU) Member States on which the Common Market was (and still is) based, particularly the free movement of good and services. At the very beginning, economic and social structures of Member States differed in many ways. They had dissimilar tax systems that could distort flows of goods and services. The basic differences were related to the division of the tax burden as between direct and indirect taxes, and the technical organization of taxation.

The original idea of EEC as a single fiscal territory was soon abandoned as completely unrealistic, since it would require a too wide harmonization of tax systems and particular taxes in the EU. Member States were not ready for concessions, since taxes are the most significant source of revenues for their budgets. The goal of single fiscal territory was then substituted by the fiscal neutrality between Member States. Its purpose was to ensure the elimination of influence on trade flows within the Community and to establish equal conditions of competition among the Member States.

Fiscal neutrality means that custom barriers to internal trade, that wholly disappeared in 1969, could not be replaced by tax barriers. Products and services imported from another Member State cannot be discriminated against in favour of domestic ones. For this reason the value-added tax (VAT) in the intra-Community trade can be imposed only in the country of destination, and in the same way as for domestic products (details of this system see below). Excise duties are imposed according to their substance only in the country of destination (consumption).

The common system of taxes on consumption is needed also for another reason: it should create completely impartial conditions of competition in the Common Market. Different tax rates (not only VAT, but direct taxes as well – for instance, income tax of

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undertakings) may distort the competition creating different conditions for producers in different Member States.

The tax territory of the European Community is not identical with the geographical territory of Member States. Principal differences are:

- *France*: including Monaco, excluding French overseas departments;
- *Spain*: excluding Canary Islands and African territories (Ceuta, Melilla);
- *The Netherlands*: excluding Dutch West-Indies;
- *United Kingdom*: excluding Isle of Man and Channel Islands.

There are no exceptions for the territories of new members (2004 and 2007).

2. Tax discrimination

The correct functioning of the Single Market requires elimination of discriminatory or protective internal taxation of imported goods. Article 90 of the EC Treaty constitutes the basis for the prohibition of tax discrimination. It states that:

(1) No Member State shall impose, directly or indirectly, on the products of other Member States any internal taxation of any kind in excess of that imposed directly or indirectly on similar domestic products (discriminatory internal taxation).

(2) Furthermore, no Member State shall impose on the products of other Member States any internal taxation of such a nature as to afford indirect protection of other products (protective internal taxation).

Article 90 has direct effect. It means that any individual (undertaking) may invoke before the court those provisions to object discriminatory or protective taxation. Direct discrimination (different taxation of imported products) is in fact rather rare, since it is too clear and obvious. More often measures of indirect discrimination are taken, since they make no obvious difference between domestic and internal products, but their consequence is that importation of a particular product is made more difficult.

Indirect discrimination occurs often in the field of excise duties. Let us demonstrate this problem on a famous judgment of the European Court of Justice – Commission vs France 168/78 (alcohol excise tax). France had a substantially higher excise tax on strong alcohol derived from grain (whisky, rum, vodka, gin) than on those derived from wine of fruit (cognac, armagnac, calvados). France produced negligible quantities of grain-based alcohol, but substantial quantities of fruit-based alcohol (cognac). The commission challenged this tax structure in the proceeding against France as violation of Article 90.

Other well known examples include wine and beer taxes in the UK. The UK excise tax on wine was about five times that levied on beer (calculated per gallon). It represented 38 per cent of the consumer sale price for wine vs 25 per cent for beer. The UK produces almost no wine, but substantial amounts of beer. The Commission challenged the UK's wine tax as a violation of Article 90. The Court of Justice confirmed its findings (Commission vs UK 170/78).

3. Harmonization of indirect taxes – general remarks

The basis for the harmonization of indirect taxes is Article 93 of the EC Treaty providing that the Council is authorized to "adopt provisions for the harmonization of

legislation concerning turnover taxes (VAT), excise duties and other forms of indirect taxation".

This provision requires three comments:

(1) The Council must act unanimously. It means that every Member State has a veto power over a proposal of a directive by the Commission. The area of tax law is one of the rare areas where the unanimity has been kept so far.

(2) The European Parliament does not have the co-decision power, which is usual in other fields. It must be consulted, but the Council is not bound by its recommendation.

(3) The Council may only adopt a directive "necessary to ensure the establishment and functioning of the Internal Market". Consequently, a State hostile to a directive proposal may launch a policy debate as to the proposal's necessity.

The Council has made use of Article 93 to harmonize the substantive coverage and the procedural operation of national VAT systems and excise duties. The correct functioning of the Single (Internal) Market is not the only reason. Another purpose of the harmonization of the VAT is the fact, that the Community takes a percentage share of the VAT collected by each Member State, which constitutes an important part of the income of the EC budget.

4. Harmonization of indirect taxes – development

Let us examine now very briefly the development of the VAT harmonization from its beginning through the introduction of the Single Market in 1993 until now.

The VAT was invented in France in the 1950s and was introduced in the early 1970s by the First and Second Directives (67/227 and 67/228) in the European Economic Community as a general turnover tax replacing other taxes existing before. The implementation of the First and Second Directives was the first stage in the harmonization of the turnover taxes in the Community. This harmonization was only partial: differences subsisted in the field of agriculture, the retail stage, exemptions, etc. In some cases this resulted in double taxation or in the absence of taxation: intra-Community trade was in some senses distorted.

The second stage of harmonization was brought by the Sixth Directive on VAT, adopted in 1977 (77/388)[2]. New rules introduced by the Sixth Directive covered very important areas: territorial application, taxable transactions, their place, chargeable events and chargeability of tax, rates and exemptions, deductions, persons liable for payment of tax and their obligations. Special rules were introduced for special cases: small undertakings, farmers, travel agents, and second-hand goods[3].

The most pressing reason for the advanced harmonization was the Council decision of 1970 on the replacement of Member States contributions by the Community's own resources. From 1975, the budget of the Community included revenue accruing from the VAT by applying a rate of 1 per cent to an assessment basis which is uniformly determined for Member States according to the Community rules. As the result, the Community has been dependent on VAT as part of the Community's own resources. At present this rate is reduced to 0.5 per cent.

In 1986, the Single European Act (as the first revision of the EEC Treaty) provided for the creation of the European Single Market, achieved in 1993. One of the conditions was the removal of tax barriers between Member States. It was necessary to find a system that would facilitate the intra-Community trade by further reducing differences

in indirect taxation in the commerce. The same problem existed for individual travellers: differences in tax levels resulted in considerable price differences. People living in high-rate countries are crossing the border to shop in low-tax countries. The only possible reaction to this is the system of traveller's allowances, inefficient in the absence of border control after 1994.

The solution could be found in the approximation of tax rates (both VAT and excise duties). The original idea of the Commission on the unification or close harmonization of VAT rates was found to be unrealistic. An example of a similar system working more or less properly is that of the USA. Differences of up to 5 per cent in tax rates are acceptable even between neighbouring states. This led the Commission to an idea of the approximation of VAT rates giving a uniform rate (standard rate 16.5 per cent) and to permit to Member States the margin of 2.5 per cent either side. This would result in a standard rate between 14 and 19 per cent. As we shall see, Member States did not agree.

The further approximation of VAT focuses on the following areas:

- the common base;
- the number of rates;
- the level of rates.

As far as the number of rates is concerned, the Commission originally envisaged three rates: standard, reduced, and increased. The final decision accepted by Member States was two rates: standard and reduced. Some countries still use three rates on the basis of an exception (Luxembourg). The reduced rate covers (with the current practice in most States) items of basic necessity, mainly foodstuffs (with the exception of alcoholic drinks), energy products for heating and lighting, water, pharmaceutical products, books, newspapers and periodicals, and public passenger transport.

The approximation of the level of VAT rates resulted in 1992 in adopting a minimal standard rate (15 per cent) and the minimal reduced rate (5 per cent). A number of directives provides for a minimal rate for excise duties for pertinent products (different alcoholic beverages, tobacco products, and natural oils – mainly petrol products – see below).

Another problem was the elimination of tax frontiers, which are incompatible with a genuine single market. The original Commission proposals were not accepted by the Council. The system of VAT taxation in the country of origin seems not to be realistic, since different tax rates would artificially influence the flow of goods between Member States. The Council finally agreed on the text of Directive 91/680 on the abolition of fiscal frontiers. According to that Directive concerning the VAT: (a) for commercial movement of goods, the supply of goods in the country of purchase (of origin) is exempt from the taxation with the right to deduction. The goods are taxed in the country of destination (it means the keeping of the practice that existed before); (b) for individuals: the purchases by private individuals are taxed in the country of purchase. There are only two exceptions: new cars or other means of transport and distance sales.

5. Current functioning of the VAT system in the intra-Community trade

As mentioned above, the request of tax neutrality on the Single Market resulted in the system where the VAT charged locally by a seller at the local VAT rate is recoverable. The intra-Community VAT regime assumes that for any given transaction, the VAT should be paid only once – in the State where the goods or services are consumed (state of destination). This is a general regime that existed before 1993 and exists in relation with non-member States as well. Member States are thus allowed to retain the VAT

revenue corresponding to goods and services consumed within its territorial boundaries.

If the rule of the tax of the country of origin were adopted, there would be a risk of creating artificial trade flows based on different VAT rates and not on the difference of comparative costs. This would result in the pressure on Member States to approximate (or better to unify) their VAT rates. In that case, the fiscal frontiers could be removed. This ideal system cannot be put into effect, since Member States are not ready to modify their VAT rates as a result of external pressure.

The system of the tax of the country of destination makes it possible to eliminate the artificial influence of trade flows without approximation of VAT rates, since the tax is imposed in the country of destination in the same way as for domestic products or services.

What is an intra-Community transaction?

- movable goods are transported in another Member State;
- a service is carried out on movable goods conveyed to a Member State other than the one where the service was carried out (for instance construction works).

A physical displacement of goods between two Member States must have taken place.

New terminology has been introduced on this occasion: instead of "export" the notion of "intra-Communitary delivery" is used and instead of "import" the notion of "intra-Community acquisition" should be used.

New obligations have been imposed on the exporter and importer (the taxpayer): both must fill out recapitulative statements of intra-Community supply and acquisition. They are obliged to provide monthly statistical information on trade between Member States. In the absence of border controls economic operators acquired new administrative and declaratory obligations: all of the businesses involved in intra-Community trade have to periodically file declarations on the delivered goods. It must be done automatically, not at a request.

Information from both sides of the transaction is therefore placed into an intra-Communitary INTRASTAT database, which can be accessed by tax and customs authorities of Member States. This database allows those authorities to compare the declarations filed by the supplier and the recipient of goods. Any possible discrepancies must be subsequently explained.

6. Excise duties

Each Member State applies a number of special taxes on consumption (excise duties), which yield substantial revenue to the States. Tobacco products and mineral oils bear very high taxes, which on average yield more than 10 per cent of the tax revenue in Member States. The rate of those taxes depends not only on economic factors, but also on traditions, consumer habits, environmental protection, etc.

In order not to disturb the Internal Market, the structures of excise duties had to be harmonized, so as to remove taxation indirectly protecting national production. Taking account of these conditions, a general directive (92/12 and 2004/106) defines general arrangements relating to products subject to excise duty. The tax is payable when the product is put up for consumption and must be acquitted in the country of actual consumption.

Principal directives in this field are:

- 95/59 and 2002/10 (consumption of manufactured tobacco);

- 92/79 (cigarettes – total excise duty must constitute at least 57 per cent, not less than 60 EUR per 1,000 cigarettes);
- 92/80 (manufactured tobaccos other than cigarettes);
- 92/81, 92/82 (mineral oils – minimum 287 EUR for 1,000 L for unleaded petrol, 337 EUR for leaded petrol, etc.);
- 2003/96, 2004/74 (energy products and electricity);
- 92/83 (excise duties structures on spirits and alcoholic beverages);
- 92/84 (details: minimum excise duties – 550 EUR per hectolitre of pure alcohol, 45 EUR for intermediate products (aperitifs), 0 EUR for wine, 1.87 EUR per hectolitre per degree of alcohol in beer).

7. Conclusion

Through partial harmonization of indirect taxes (VAT and excise duties) the EU has reached a considerable degree of fiscal neutrality. It is now certain, that the following stage – EU as a common fiscal territory – cannot be envisaged for the near future. Attitudes of Member States, and let us confess that justified ones, do not permit closer harmonization (or even unification) of tax rates. Another problem represents the lack of harmonization of direct taxes, which is extremely difficult, slow, and still at the very beginning. Nevertheless, the current state seems to be quite sufficient for the proper functioning of EU Internal Market.

Notes

1. The EEC Common Market was achieved in 1969 after 12-years transitional period. It was transformed into the Internal Market in 1993, where the four freedoms (free movement of goods, persons, services, and capital) were broaden and supplementary common policies were introduced (consumer protection, environmental protection, and others).
2. That directive was modified and completed recently by the directive 2006/112.
3. The most important Sixth VAT directive 77/388 on a uniform basis of Assessment, sets out the harmonized provisions in elaborate detail. There are some problems of the interpretation of its provisions. Each year the Court of Justice decides several cases interpreting its provisions.

Further reading

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