NEED AND PROSPECTS FOR TAX HARMONIZATION AMONG THE PRESENT SIX MEMBERS OF THE E. E. C.

Prof. Carl S. SHOUP
Columbia University

The need and prospects for tax harmonization among the present six members of the European Economic Community (Belgium, France, Germany, Italy, Luxembourg, the Netherlands) can best be understood by reviewing the articles of the Treaty of Rome that formulate the rules for tax harmonization, and noting the extent to which changes have been made, or are to be made, in the tax systems, in conformity with these treaty provisions.

The articles in question are Articles 95 - 99 of Chapter 2 of the Treaty. There are other articles that bear indirectly on tax harmonization, but they are relatively unimportant. I shall first review Articles 95 - 99 as a group, and then each one separately.

I

Articles 95 - 99 of the Treaty of Rome reflect an attemp to reach an agreement on how to prevent any member nation from granting a tax advantage for its business firms, with respect to inter - community trade, by means of tax favors for those firms and techniques of tax discrimination against the firms of other countries, favors and techniques that are not duplicated in the other member countries.

Although any such advantage for domestic firms might be effective for only a short period of time, since the other member countries could be expected to retaliate, the sequence of action, retaliation, further action, and so on, would be harmful, if only because of the uncertainties and consequent waste of resources.

Articles 95 - 99 therefore set up rules that the member nations must follow. At first sight these rules might appear to allow discrimination,

rather than forbid it. Exports may be exempted form sales taxes. Imports may be taxed. But if all six nations adhere to this type of differential treatment there is really no discrimination at all. If everyone obeys the same set of rules, the game can be played, efficiently.

Indeed, from one point of view this rule of exempting exports and taxing imports does not create even superficial discrimination, for the rule means that in any one country all consumers are treated alike, whether they buy home produced goods or imported goods. But it remains true that consumers in one country are treated differently from consumers in another country, if the tax rates differ from country to country. Even this difference may be acceptable under the standard of economic efficiency, if the consumers are given different levels of government services in the various countries. Generally speaking, however, it is likely to be economically inefficient (under a Pareto - optimum test) to have consumers in one country pay different prices for the same goods as consumers in another country (transport costs aside). In this sense the rule export - exemption, import - taxation does allow economic discrimination.

Article 98, dealing with direct taxes, that is, with "charges other than turnover taxes, excise duties, and other forms of indirect taxation", provides just the reverse set of rules from those applying to indirect taxes. Exports are taxed, and imports are not taxed. The income tax (including of course the corporation income tax) is no doubt what the framers of the Treaty of Rome had chiefly in mind. The adoption of this reverse set of rules for the income tax was apparently grounded on the commonly held belief that the income tax does not enter, at least not directly, into the prices of the products made by the firm that pays the income tax. There is much to support this point of view, though the facts remain in doubt, owing to the extreme difficulty of utilizing econometric techniques to separate out the tax causes of price changes, over a period of time when tax rates have been altered, through an analysis of time series of corporate or general business profits.

In its simplest form the argument runs as follows : If there is no income tax at all, a business firm will expand its output to the level where it is finally checked by continued increasing marginal cost. At this level the last unit of output the firm produces barely covers the cost of producing that unit. To produce short of that level of output would be to lose an increment of profit. To produce at a higher level would be to in-

cur an incremental loss on the last units of output, even though the firm's output as a whole might still show a profit. The firm is thus presumed, if it wishes to maximize profit, to expand its production up to the level where the next increment of cost will just equal the revenue to be obtained form selling the unit of output produced by that increment of cost. The revenue to be so obtained will of course be the price of the product per unit, in a perfectly competitive industry. If the firm is so large a factor in the industry that when it tries to sell more units of its product it finds that it depresses the price of that product on the market, it must accept a sligtly lower price for all of its output. Marginal revenue is less than price. Still, the usual conclusions about the short - run incidence of the income tax are applicable. Let us recall what these conclusions are, and how they bear on the question, whether to exempt exports form the income tax (and tax imports).

The usual argument runs that the firm can maximize its profit after income tax only if it maximizes its profit before tax. Under the tax it will therefore not change the amount of its product it offers on the market (if it is an atomistic competitor) or (if it is in an imperfect competition situation) will not modify its selling price. In either event the selling price will remain unchanged under the tax, at least in the short run. Therefore there is no occasion to exempt exports under an income tax, or to tax imports; the tax does not force the home producer to try sell at a higher price abroad.

A sales tax, on the other hand, coverts what had hitherto been the marginal unit of output for the firm into a money - losing unit of output. The firm must cut back production at once, retreating to a level of production where its marginal cost, before considering tax, is lower by enough to allow payment of the tax without incurring a loss on the marginal unit. Since all firms in the industry must act in this manner, the total of units produced in the industry declines, to a new tentative equilibrium level. If demand for the industry's product is unaltered, consumers bid against each other for the now reduced supply of the commodity, and its price rises. As price rises, each firm expands a little, back toward its former level of production, but not to it. A new equilibrium is established at a market price somewhat above that of the initial period but not above it by the full amount of the tax, since the unchanged demand will not take off the market the initial volume of production at a higher price (except in the unusual case of a perfectly inelastic demand).

By this chain of reasoning, the price of the taxed product must rise at once, when a sales tax is imposed, but by an amount somewhat less than the tax. If the taxed firm tries to market its product in some other country that has not imposed this tax, it finds itself priced out of that market.

Empirical testing of these theses is very difficult. For one thing, when taxes cover as wide a portion of the economy as do the sales taxes and the income taxes, the use that is made of the revenue raised by them cannot be neglected, if the problem is to be completely stated. We can scarcely talk about the incidence of the income tax, or of the incidence of the sales tax, but only about he incidence of a change from one tax to the other (differential incidence), or of an increase in tax plus an increase in specified governmental expenditures.

Still, it remains true the traditional, somewhat restricted, theoretical argument is plausible enough to warrant the distinction drawn by Articles 95 - 97 and Article 98 between indirect taxes and all other taxes. To be sure, even under this traditional theoretical argument the sharp difference between full rebate on export for indirect taxes and no rebate at all for income taxes is not quite justified. As noted above, the price of the taxed commodity might be be expected to have to rise only by something less than the sales tax, at least if there is to be any reduction in physical volume of output as a result of the tax. And the income tax customarily strikes something more than what was called profits in the analysis above, even in the short run. The firm must, for example, earn at least a normal interest return on its inventories, or it would do better to go out of business and loan the money on the market; that part of profit that represents a normal return on inventories is a short - run cost that must be met. Similar qualifications apply to other aspects of the income tax. And the income tax may possibly trigger some oligopolistic price increases that would have been profitable to make even without the tax, but which no one large firm dared make for fear the others would not follow. Yet it is difficult to see how these arguments could lead to agreement on just what fraction of the income tax should be rebatable on export, and just how much of the sales tax should not be rebatable, not to mention how much lower the compensating import tax should be (for sales taxation) and how much of a "compensating" income tax should be levied on imports. The lawmakers take the most extreme course, which, paradoxically, is the one which agreement can be most readily obtained, and allow rebate of all the indirect tax none of the direct tax.

Read literally, Chapter 2 does not require any member state to levy a compensating import tax on the products of any other member state. It does not therefore call, in so many words, for complete application of the "destination principle". That principle is the one described above for indirect taxes, whereby exports are exempt from the sales tax and imports are taxed. It is called the destination principle because products bear the tax rate of the country of destination, not the country of origin. Under the "origin principle" exports would be taxed, and imports exempt. All products would then be taxed according to the tax rate of country of origin.

No country is likely to exempt its exports and then exempt imports, too, from its sales tax. Such a tax would be discriminatory against domestic products consumed domestically, and would be the least appealing, politically, of any form of sales tax.

The destination principle has the grave disadvantage of requiring border control on movement of goods within the common market, It must be verified that goods that are claimed to be exported are in fact exported, if their exporter is to receive tax exemption and rebate of internal tax paid on the exported good, or its components, at earlier stages. Imports must not be allowed into the country until they pay the compensating sales tax, which is designed to put imported goods on the same competitive basis as domestic goods sold domestically.

To be sure, border control under the destination principle can be virtually eliminated if collection of the sales tax is deferred to the last stage, the retail sale. To evade the tax, consumers would have to travel to another country and bring their purchases back with them. They could do this if there were no border control, but it would prove too expensive and time - consuming for most purchases except possibly for consumers located near the border. Nevertheless, automobiles, refrigerators, and other 'big ticket" items would doubtless need to be checked on. This is done for automobiles, in the States of the United States that impose a retail sale tax. All such taxes are in principle on a destination basis, but there is virtually no border control. Purchase by mail order is another mode of evasion that can cause trouble under a retail sales tax without border control. Reciprocal agreements among the taxing countries to help police each other's taxes by obtaining information on where their mail order houses are shipping their commodities, and informing the tax officials of the country of destination, will be helpful. Such measu-

res are however really but another form of border control. "Border" control at the factory may be possible if the concern is large enough to make this kind of verification not too expensive per dollar of revenue. All such devices, however, seem out of keeping with the spirit of a common, free, market.

The sure way to avoid border control is to change all the sales taxes over to an origin basis with respect to trade among the member states. Exports would be taxed, imports exempted. Presumably the destination basis would be retained for trade with the outside world; we may speak therefore of a "restricted origin principle" (Shibata). But if sales tax rates differ among member countries, business firms in the high - tax rate countries will complain that they cannot compete in the markets of the low - rate countries. They could be restored to their former competitive position if the high - tax - rate country would devalue its currency by the same percentage as the difference in the rates of tax of the two member countries. But then such a country would be out of equilibrium with non - member countries, if it remained on a destination basis (exports exempt) with respect to those non - member countries. Morever, the devaluation would also affect financial flows, which are not subject to the sales taxes. Finally, once a common market is well under way, it must insist on stability of exchange rates among its members as a general principle.

Consequently, if the E. E. C. member countries ever do move over to the origin principle in order to eliminate border controls, they will not do so until the sales tax rates are uniform within the market, or almost uniform, at least wherever the tax applies to a stage prior to the retail - stage. The retail rates could differ appreciably, without inviting too much evasion. This solution is the one recommended by the Financial and Fiscal Committee of the E. E. C., chaired by Professor Neumark. It appears to be well on the way to adoption. Germany has enacted a value added tax, which is a sales tax that requires each business firm to pay the tax on the value that it adds, by its labor, and management, to the materials and services that it purchases from other firms. The cumulative base of the consumption type of value - added tax is in principle the same as the total of retail sales, hence the same as the base of a true and exclusively retail sales tax. Purchases of capital goods are not taxed

The value - added tax is the form of tax preferred by the Neumark Committee. The rate on the value added at retail may differ, if neces-

sary, from country to country. Each country could go farther, and add a true retail sales tax on top of a value - added tax.

France has extended its value - added tax to make it truly general. The Netherland is about to enact such a tax. Belgium, Luxembourg, and Italy will probably soon do the same. The rate differences however will remain substantial. The German rate is 11 per cent, in 1968. It is expected to be at least 13 per cent after the final transition to a pure consumption type of value - added tax, which will be put into effect by the abolition of the transitory so - called "investment tax". This is a tax on investment goods, which starts with a rate of 8 per cent in 1968 and ends with a rate of 2 per cent in 1971 and zero in 1972. The French rate is 20 per cent.

The change from a destination basis to an origin basis, if it occurs, will be a greater break with the past than the adoption of value - added taxation, for almost without exception the sales taxes of all the European countries in the twentieth century (and probably earlier) have always exempted exports and taxed imports. Similarly, the rules laid down in Chapter 2 for income taxes follow the practice that has been observed almost without exception; no exemption or rebate of income tax on exports, no compensating income tax on imports.

One general question remains, concerning Chapter 2 as a whole. The articles do not define indirect taxation, hence do not define direct taxation, and thus leave uncertain the status of real estate taxes, death duties and gift taxes, trade (the German *Gewerbesteuer*, for instance), and payroll taxes for social security programs. If the rationale given above for not exempting exports from income taxation is to be the guide (i e., the tax does not affect appreciably the cost of any firm's marginal unit of output (not, note, the "marginal firm" which either does not exist or is unimportant if it does), the tax on buildings, if not the tax on land, must be considered a candidate for rebate upon export of the product made in or with the aid of the taxes building. Payroll taxes certainly strike at the margin of operation. So too do taxes on net worth in so far as they apply to business property. Death and gift taxes, on the other hand, are direct taxes in this sense of not impinging on the margin of business activity.

The fact that one country does allow rebate or exemption, on export, of real estate taxes on factories, warehouses, etc., or of payroll taxes suggests that perhaps the important thing after all is that there be certain

rules of the game, observed by all, and that in the long run it does not matter too much just what those rules are, as long as they do not negate the spirit of a common market. The complex structure of a private-enterprise economy is often more adaptable to any set of circumstances than one might think, if only that set will remain unchanged, so that the process of adjustment, once completed, will not have to be repeated.

Once all tariffs on imports have been eliminated, protectionist minded members of the community might be tempted to consider how they could achieve much the same results that they obtained from tariffs, by imposing taxes that, ostensibly not aimed at foreign products, would nevertheless in fact discriminate against them. Article 95 of the Rome Treaty is designed to prevent such backsliding. Thus, if Country A produces only an inferior grade of Commodity X, a general tax on X might be imposed at rates that increased with the quality of the commodity, as indicated, perhaps, by the price per unit. The extra tax on what in practice are only imported goods would divert some consumer demand to the domestic product.

Article 95 goes even further: if Commodity X is a close substitute for Commodity Y, though they are distinct commodities, and if X is imported only, while Y is produced domestically, an excise tax that rests on the imported good X but does not extend to the domestic good Y would presumably be invalid under Article 95. This rule could be the source of much dispute. There is no economic definition of a "close" substitute. An arbitrary line might conceivably be defined, in terms of degree of elasticity of demand, more precisely, cross-elasticity of demand (the percentage change is amount of Y sold per percentage change in the price of X), but few if any reliable data are available on cross-elasticities of demand.

Moreover, the Treaty does not speak of substitutes. It merely says that "a Member State shall not impose, directly of indirectly, on the products of other Member States" either "any internal charges of any kind in excess of those applied directly or indirectly to similar domestic products", or "any internal charges of such a nature as to afford indirect protection o other products". The first of these prohibitions is strengthened, perhaps unnecessarily, by inserting the words "directly or indirectly" after the word "impose", as well as repeating that phrase after "applied". It is not self-evident what practices the framers of the Treaty had in mind for the first prohibition that would not be amply covered

by the second, alone. In any event the number of potential problems is almost endless and it will rest with those who administer and interpet the treaty to apply a strong dose of common sense in the settlement of disputes.

Intermediate goods or services as well as final goods are course involved. If, as was the case in the United States a few years ago, the government imposes a tax on freight transportation by common carriers but not on the imputed value of transportation by a firm of its own products in its own trucks, etc., importers of the same products will be at some disadvantage, since they will normally depend more on common carrier transportation.

The seriousness with which indirect protection was viewed by the framers of the Treaty is shown by the proviso that any existing provisions conflicting with Article 95 must be removed by the beginning of the second stage, which was scheduled to occur at the end of the fourth, fifth, or sixth year, depending on whether unanimity was achieved (see Article 8, (3)).

III

Article 95 may be considered to deal with imports of an article also produced domestically, if the word "similar" noted in the discussion above of that article is construed to mean "the same or similar". Then a certain symmetry exists between Article 95 and Article 96, for the latter clearly deals only with exports (to other Member States). ("Products exported to the territory of any Member State may not benefit from any refund of internal charges in excess of those charges imposed directly or indirectly on them.") As Article 96 permits an "internal charge" on an imported product equal to or less than the charge on the same product produced domestically, so Article 96 permits a tax refund and exemption on exports to Member States equal to or less than the internal charges that have been levied on the export.

Thus Articles 95 and 96 between them can be construed to permit, but not require, the use of the destination principle, and to prohibit overuse of the destination principle. Clearly, there is nothing in these Articles that prohibits one or more of the Member States from moving to an origin basis.

Article 96 uses the phrase "directly or indirectly", which is employed twice in Article 95 (along with word "indirect" in another phrase). If we deduce that this repetition was rather by association than by plan — and in view of the wording of Article 95, the framers of the Treaty could scarcely have forgotten this phrase when they came to Article 96 — there is perhaps an explanation for it, but as it stands it is a little curious. The prohibition would have been stronger if only those charges imposed "directly" could be rebated. In any event, the phrase "directly or indirectly" at this point seems to open potential loopholes rather than close them. Shall there be refunded, upon the export of an automobile to a Member State, a transportation tax levied on the trucking company that carried steal that was used to make the factory in which the automobile was produced? Fortunately, if that is the word, the kind of sales tax in force in five of the six countries when the Treaty was signed, the cumulative "cascade" type of general sales tax posed problems of backward tracing so difficult, indeed insoluble, that another article, Article 97, as we shall shortly see, had to be drafted, to permit use of rough averages even without considering the intricate kind of case given in the preceding sentence. But as the Member Countries adopt the value-added tax, they will find that it will be possible to trace the tax back, at least if the tax-from-tax method is used (which now is the case in Germany), since this method automatically does the tracing. This fact, incidentally, is creating uneasiness in nations outside the E.E.C. on the part of those entrepreneurs who must henceforth compete in world markets with E.E.C. firms that are not vertically integrated and hence will probably receive a larger rebate on exports, relative to the tax actually paid at earlier stages, than heretofore. Other E.E.C. firms (vertically integrated) will receive less rebate, relative to the tax actually paid at earlier stages, than heretofore.

IV

Article 97 allows "average rates (of tax) for specific products or groups of products" to be used in computing export refunds and import taxes under a multi-stage turnover tax. This article was relevant for five of the six E.E.C. nations (all except France) when the Treaty of Rome was signed, but, since the turnover tax is to be replaced by the value-added tax, it will soon have little significance.

The five States that levy the turnover tax have in fact established "average rates for specific products or groups of products" with respect

to imports and exports. This practice antedates the Treaty, but the average rates have been refined, under the stimulus of Article 97.

The formulation of these average rates has been the source of a good deal of dispute, both within the taxing country, between tax administration and taxed or rebated industry, and between countries. On more than one occasion the second pragraph of Article 97 has been called into play; the Commission has issued "appropiate directives or decisions to the State concerned".

If one had before him a complete input-output table for the country in question, he could in principle compute the amount of turnover tax that is embodied in any article at any stage, including the most remote taxes as in the steel-hauling case posed in an earlier paragraph above. (For the tecnique that would be used, see J. V. Salat, The Impact of Sales Taxes on Prices, *Manchester School*, Jan., 1962.) In practice, of course, such information is not available, and if it were it would have to be updated continuously, as input-output relationships change with technical progress and with changes in relative prices.

V

Article 98 allows temporary use of export exemptions and rebates and of compensatory charges on imports with respect to taxes other than indirect taxes upon proposal of the Commission adopted by a qualified majority of the Council (but in fact no use has been made of this provision). Otherwise it forbids such practices. In effect, all taxes other than indirect taxes must be on the origin basis, with respect to trade among Member States.

This has nothing directly to do with the choice between the residence principle and source principle (territorial principle) under the income tax; under neither of these principles are rabates of income tax granted upon export of a commodity or service, and no compensating import tax is levied on commodities or services. To be sure, it has been shown by Möller and others that if the revenue proceeds of an origin principle sales tax are devoted to supplying free government services to the taxes producer, and if the proceeds from a destination principle sales tax are used to supply free services to the taxed consumer, the major economic consequences for the two countries concerned are then very much as if

they had levied income taxes on a source basis or residence basis, respectively. In practice, however, there has been no indication of this kind of linking of sales tax revenue with particular services, so for all practical purposes it remains true that the distinction between the origin and the destination principle is quite a different one from that between source and residence.

It would indeed be difficult (if not impossible) to achieve an accurate rebate of income tax on exported products. Most concerns produce many products, and the income tax does not attach to separate products, but to the profit, en bloc, of the entire firm. It would be grossly inaccurate to distribute the profit, and hence the income tax, over the several products in proportion to their respective contributions to the total of sales, for some products require only a small rate of profit on sales, others a large rate of profit on sales, if they are all to earn an equal rate of return on the capital that has been used in producing them. This is because some products require very little capital per dollar of sales (for example, the service rendered by a retail store), others, a great deal of capital per dollar of sales (steel, for example). This same problem is posed for computation of compensatory taxes on imports. And this would be just the beginning, if all taxes were to be rebated on export, and supplemented by compensating import taxes: how would the amount of payroll tax that is embodied in each product be estimated, of property tax?

VI

The last article of Chapter 2 of the Treaty of Rome directs the Commission to "consider" how to harmonize indirect tax legislation, and to submit proposals thereon to the Council for unanimous vote. Oddly enough, the Commission is not directed to consider harmonizing direct taxes (or, all other taxes than indirect taxes), though of course other articles that are not specifically fiscal in nature (e.g. Article 101) doubtless give the Commission power both to consider and to propose.

The Commission and the Council, acting under this Article, have helped set in motion one of the most far-reaching tax reforms in European history, namely, the substitution of a value-added tax for the cumulative cascade type of sales tax, in the five countries that have the latter. The appointment of the Neumark Committee, the subsequent acceptance of

that Committee's Report, and the implementing measures taken since then have been among the most important actions taken in any of the fields with which the Common Market is concerned. Tax harmonization poses special problems for excise taxes, notably luxury taxes, and taxes on alcoholic beverages and tobacco. It also necessitates a certain degree of uniformity with respect to corporate income tax rates (but not personal income tax rates). These problems, together with those of payroll taxes, will be dealt with in the introduction to my next paper, Tax Harmonization with Respect to Future New Members of the E.E.C.