CAN THE EUROPEAN COMMON VAT MAKE A FISCAL UNION?
- CREATION OF THE EC'S COMMON VAT SYSTEM AND OWN RESOURCE FOR THE EC BUDGET -

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Value-Added Tax in the Contemporary World

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Introduction

- April 1967: First and second Directives of the Council related to the creation of a common value-added tax in the EEC
- May 1977: Sixth Directive of the Council –harmonization of tax basis of the common VAT

→ Real “European tax”

- December 1977: Regulation permitted to transfer to the EC’s budget a part of the revenue from the common VAT (new resource for the EC)

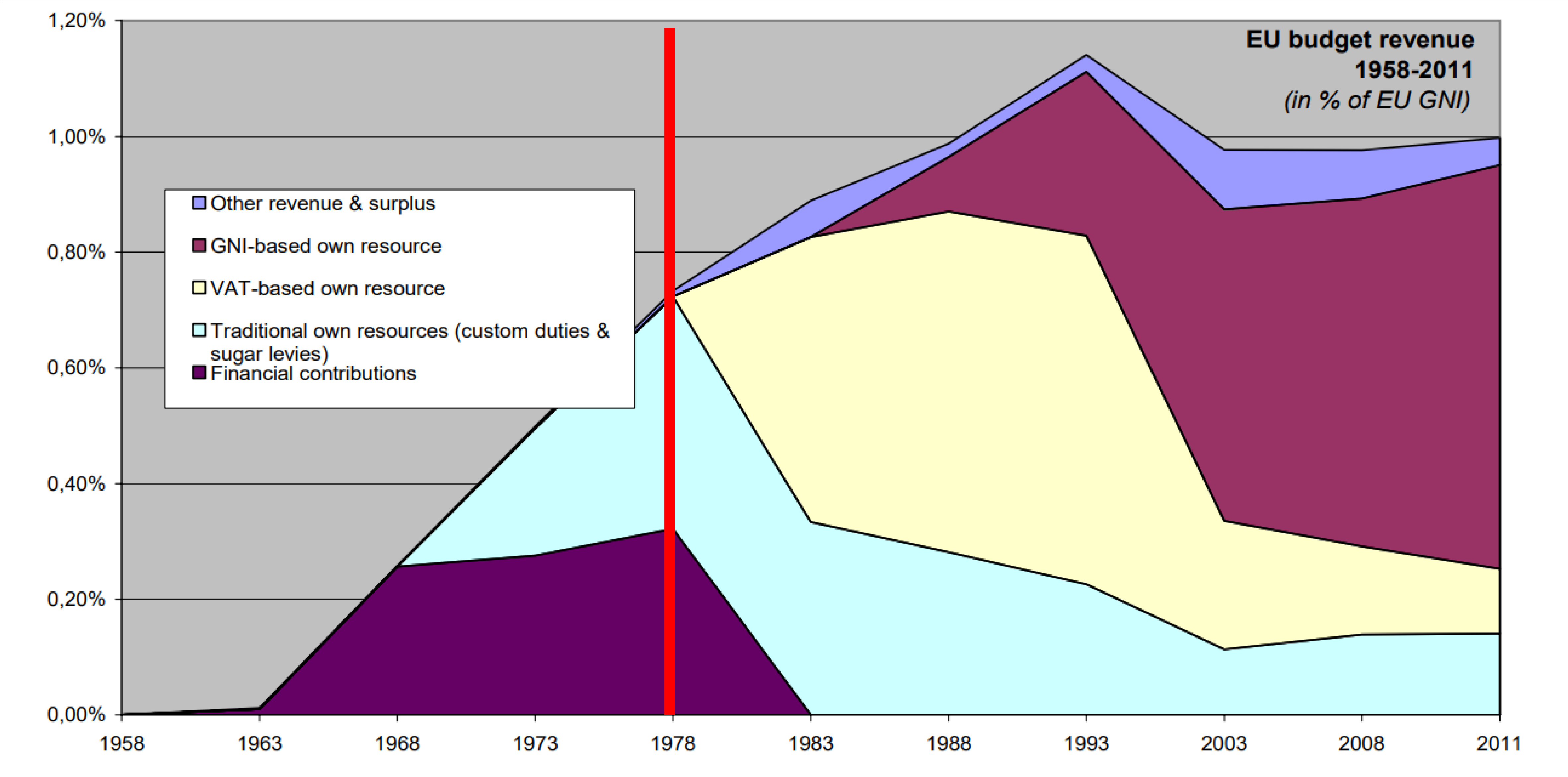
→ Direct election of representatives to the European Parliament from 1978
<u>Federalization and democratization of the EC</u>

→ Contributions paid by each member state have gradually been replaced by the revenue from the common VAT = it has contributed to covering an increase in EC expenditure

- However, from the second half of the 1990s onwards, the revenue from the common VAT in the EC budget has declined.

→ the GNI-based own resource has become the main resource of the EU budget since 2003.

EEC-EC-EU budget revenue structure



European Commission (2011), p.8.

Introduction

<Three main questions>

- Why was VAT chosen as a common turnover tax for the EEC?
- How did the common VAT become an EC's dedicated budgetary resource afterward?
- Why did the common VAT stop playing a leading role in the EC budget's revenue?

PART I
WHY WAS VAT CHOSEN AS A COMMON TURNOVER TAX FOR THE EEC?

Background: Negotiations for Treaty of Rome

- **Sales tax systems before the Directives**

- West Germany, Luxembourg and Italy : general cumulative tax for all products

- Belgium and Italy : mix system (**cumulative tax system** and single flat-rate tax)

- France : VAT (**non-cumulative tax**)

→ This diversity can distort the market price among the Member States (MS).

→ In Article 99, possibility of harmonization of indirect taxes

- **Conflict: France "destination principle" vs West Germany "origin principle"**

- **Destination principle**: exports *not* taxed, imports taxed → requires border tax adjustment

- **Origin principle**: exports taxed, imports *not* taxed → abolish border tax adjustment

First Reason : The initiative of fiscal problem directorate of the European Commission

- <u>Directorate-General IV – Competition (DG IV) and Fiscal Problem Directorate (FPD)</u>

- FPD treated fiscal harmonization in the Commission
- **Hans von der Groeben (West German):** German Commission's member and the chief of DG IV
  → DG IV was influenced by West Germany's policy
  = Sales tax harmonization for abolition of tax border adjustment

- <u>Initiative of the FPD for sales tax harmonization</u>

-In 1959, FPD proposed three types of **non-cumulative** sales taxes:
= Single sales tax, manufacturer's tax with retail sales tax, VAT

France: unwillingly supported a common VAT ⇔ **Other MS**: didn't give up their cumulative sales tax

→ **FPD leaded discussion on sales tax harmonization**

Second reason: exchange of ideas between tax administrators of the MS

- Tax administrators' exchanged their ideas in Brussels

- Strong opposition by the MS against fiscal harmonization

→ European Commission created ABC subcommittee
fiscal experts from governments and those of the Commission (FPD)

- Research from technical perspective
- The tax administrators gathered frequently and shared their tax system and experiences

→ French tax administrators transmitted the merits of VAT to administrators of other MS.

The idea of "fiscal neutrality" has been gradually accepted by MS's administrators

Third Reason: Sales tax reforms favorable to common VAT in France and West Germany

- France

Eextension of the VAT to the retail stage too (January 1966)

- New generation (more daring than the previous generation) arrived in the French fiscal administration

→ Two French tax officials who had contributed to the extension of the VAT attended tax officials' meetings in Brussels and **shared French experiences with the VAT**. (**Fiscal neutrality**)

- West Germany

- Transformed their **cumulative-type general sales tax** into the VAT(more neutral than the French VAT (1966))

→ the French and German sales tax systems came close together

→ the other MS can accept a common VAT more easily

As MS, especially France, didn't want to accept advanced tax harmonization which would be required if they abolish tax border adjustment, they decided not to abolish it.

PART 2
HOW DID THE COMMON VAT BECOME AN EC’S DEDICATED BUDGETARY RESOURCE AFTERWARD?

Agreement on creation of VAT-based resource for the EEC

- <u>The end of transitional period of the common market made discussion possible</u>

- **Summit conference in The Hague on December 1-2 1969**

  Framework for financing the EC + approval of the affiliation of the UK, Denmark and Ireland

  Budgetary power of the European Parliament + its direct elections

- **April 1970, a decision to replace financial contributions from MS with the own resources**

  Creation of a VAT-based resource was officially proposed for the first time

  From January 1, 1975, the EC budget will be financed entirely from the own EC own resources

  (agricultural levies, customs duties, VAT-based revenue)

The sixth Council's directive: harmonization of the common VAT tax basis

- <u>May 17, 1977: Decision fixed the harmonized tax basis for the common VAT</u>

 - however, the tax basis has not been completely harmonized.

- <u>Regulation on December 19, 1977 officially fixed its introduction</u>

 - VAT-based resource was to cover the EC's budget shortfall (tax rate up to 1%)

- <u>Three merits of the VAT based resource</u>

- As the VAT's basis was harmonized, VAT would equally charge all citizens in the EC.
- VAT would reflect the "ability to pay" of each country so that it would be a fair tax.
- Such a sales tax has a broad basis in nature so that it could produce considerable revenues for the EC budget

PART 3
WHY DID THE COMMON VAT STOP PLAYING A LEADING ROLE IN THE EC BUDGET’S REVENUE?

Two reasons and consequence

1) **Conflict over an increase in the limit of the VAT-based revenue rate**

- MS were naturally reluctant to accept an increase (+ worsening budgetary situation of each country)

→ “net contributors” (UK and West Germany) especially opposed to the increase

2) **VAT-based revenue became unpopular because it didn’t meet horizontal equality nor vertical equality.**

- Horizontal equality. Although the tax basis of the common VAT have been harmonized by the sixth directive of the Council in principal, the tax basis vary from one country to another in practice.
- Vertical equality. The VAT rate for the EC budget was the same for all member states regardless of their economic size, so that its burden was heavier for relatively poorer countries.

Conclusion

- <u>Why did the MS choose a VAT for a common sales tax system?</u>

1) Sales tax harmonization was deemed necessary for creation of a **common market**.

→ The **Commission**'s initiative was important

2) The VAT was adopted by both **France and West Germany**

→ However, their objectives were never the same

West Germany: A common sales tax system in order to **abolish fiscal borders**

France: A common VAT to make a common sales **tax more neutral and investment-promoting**

→ <u>**separate national interests became an important driving force for the common VAT**</u>

- <u>The common VAT for EC budget</u>

- The common VAT was seen a new dedicated resource for the EC budget **but its tax basis could not been completely harmonized** with the sixth directive → No real EC tax → limited European Parliament's power on revenue → difficult to create a fiscal union

- <u>EU's new own resources for common European policy for Next Generation EU</u>

A carbon border adjustment mechanism.

A revised EU emissions trading system (ETS).

A share of the residual profits of the largest and most profitable multinational enterprises

→ Is it no longer possible to create a "common tax", like VAT, that is not a **political tax**?