Community Topics 30

Harmonizing taxes - a step to European integration

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european community
information service

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Introduction

In the first ten years of its existence the European Economic Community has put down firm roots. It can still spread more widely throughout Europe, but it can no longer be torn up. The customs union has been completed. Rather than being the final stage of a development, however, the customs union forms the basis of a Community which can and will come to full stature only in the future. The possibilities inherent in the European Economic Community, though very remote when the Rome Treaty was signed, are today drawing steadily closer.

Article 2 of the Treaty sets out as aims of the Community: harmonious development of economic activities throughout the Community, continuous and balanced expansion, increased stability, speedier improvement in the standard of living and promotion of closer relations between the member states. The targets set out in this article of the Treaty are, then, in part political. They constitute more than a non-committal political program. They have legally binding force. To make sure that these objectives are achieved, the Treaty has provided an impressive legal and organizational framework such as had never been seen in the history of international treaties: the European Economic Community was endowed with legal personality and with sovereign rights previously reserved exclusively to states.

The Community creates law, administers justice, makes administrative decisions and can take political action. Nevertheless, the Community is not a state, nor even a federal state. Its powers are limited to what is needed if the objectives of the Treaty are to be attained. The dynamic nature of the task put to the Community by Article 2 requires continuous growth and internal expansion. The functional restrictions on its powers indicate its legal limits. These are the two poles between which its institutions operate.

Foundations of harmonization

The Rome Treaty and the Community structure it provides constitute the legal framework into which tax harmonization (or approximation) must fit. What are the bases of our policy in this field? In what way is this work of importance for European integration? Integration, to use the terminology of the Rome Treaty, means "establishing a common market and progressively approximating the economic policies of member states" (Article 2). According to Article 3, approximation of economic policies means a common commercial policy, a common agricultural policy and a common transport policy, and coordination of the remaining aspects of economic policy in the member states, particularly short-term economic policy and monetary policy. Article 3 of the Treaty shows that the common market means a common external customs tariff, the free movement of goods, persons, services and capital and undistorted competition within the Community.

These are the practical criteria the Rome Treaty provides for determining what importance a given type of tax and the differences in that tax from one member country to another will have for integration, whether and to what extent harmonization is necessary and in what direction any changes should be made.

Taxes must therefore be harmonized with the double aim of ensuring freedom of movement within the economy and equal conditions of competition. This work must also be guided by the Community objectives already mentioned, namely economic expansion, stability and improvement of the standard of living. Some of these objectives are laid down in detail in special provisions of the Treaty dealing with short-term economic policy and the balance of payments.

Tax harmonization is not an end in itself. It is not included among the special aims of the Treaty, but is one of the ways by which the Community can carry out its tasks.

Under the heading "Policy of the Community", Article 100 of the Treaty provides for the harmonization of those legislative and administrative provisions which have a direct incidence on the establishment or functioning of the common market. This is a general provision on the approximation of laws which extends beyond the scope of the measures already foreseen under special provisions in this

field. Article 100 becomes operative if a special provision on the approximation of laws does not exist or is insufficient, i.e. covers one aspect only or does not enable the Community to issue directives.

Article 100 therefore supplements Article 99 of the Treaty, which provides for the approximation of turnover taxes and excise duties. Article 99 does not contain exhaustive rules on the approximation of tax law and therefore expressly applies without prejudice to Articles 100 and 101. It is thus acknowledged in the Treaty itself that tax laws and in particular direct taxes are to be harmonized on the basis of the general provisions to the extent this is required for the establishment or the functioning of the common market.

As has been shown, the Treaty provides a fairly clear definition of what is to be understood by the common market. What legal provisions have direct incidence on it and to what extent they do so depends in part on the stage of development reached at any given moment, and consequently special provisions can define these points only incompletely if at all. A general clause was therefore needed conferring the power and the duty to harmonize any legal provisions that affect the establishment or the functioning of the common market. The Community institututions have to determine, in accordance with Articles 100 and 101, what measures are needed at each particular stage of development to create within the Community conditions similar to those obtaining on a domestic market.

The most important instrument the Rome Treaty provides for attaining this objective is the directive. Under Article 99 – that is in connection with indirect taxes – it is also possible to use regulations and decisions. The directive, like the others, is an instrument of Community law. However, it is binding only on the member states, and its binding force is confined to the objects or results to be achieved. The choice of means is left to the authorities in the member states. Under Article 100, therefore, the Community may not enact, by way of regulation, Community law which binds the private individual. Directives can, in addition, be issued only if the member states agree on them unanimously.

Integration is regarded as a process in which it may at a certain stage be necessary for individual member states to exercise certain powers only in close coordination, but without the sovereign rights of the member states being limited more than is needed if the common market is to work. The instrument of the directive has proved to be both necessary and, as a rule, sufficient where tax provisions have to be harmonized. In saying this I have consciously ignored matters which relate, not to the approximation of law on national taxes themselves, but to the conflict of laws (e.g. avoidance of double taxation) or to the creation of new European law (e.g. European company).

In principle the contracting parties have therefore allowed for the fact that states are accustomed to considering their financial sovereignty as an essential part of their sovereign powers and are known to be particularly sensitive about any restriction of this sphere. What changes will have to be made when the integration process advances further, and whether they will have to include changes in the instruments available, is a matter into which we need not go at this stage.

General aims of tax harmonization

In the first ten years of the Common Market, the main tasks were to establish the customs union and to abolish discrimination against other member states' nationals in the movement of persons, the supply of services, the right of establishment and capital movements. For goods the main task was to remove specific obstacles to trade and eliminate distortions of competition.

Consequently, the first task in the tax field was to remove restrictions on the movement of goods and to abolish distortions of competition and measures of discrimination. Numerous individual procedures were instituted in accordance with Articles 95–97 of the Treaty. The introduction of a system of tax on added value throughout the Community was proposed and accepted.

In the past, the European Economic Community concentrated on introducing free movement of goods and removing distortions of competition and measures of discrimination. In the years ahead, it will have to develop the customs union, with its system of equal treatment for all Community nationals, into one common market with complete freedom of movement for the factors of production and with one system of competition based on the law; in other words, it will have to create conditions similar to those in a domestic market. Freedom of movement for the factors of production will be illusory unless we manage, among other things, to go beyond simply abolishing discriminatory action in the field of capital movements and gradually build up a European capital market with free

access to the sources of capital and harmonized investment possibilities. This calls for a number of fiscal measures which are discussed below.

Conditions similar to those in a domestic market – that is complete freedom of movement for the factors of production – can, however, be created only if steps are also taken to remove the impediments which company and tax laws place on mergers and the acquisition of holdings across the internal frontiers of the common market. Here, too, action must be taken to set up the system stipulated by the Treaty for safeguarding competition in the common market against distortion. Today we refer to these and other measures as industrial policy or, preferably, policy on the structure of industry.

Thus it is becoming more and more necessary to supervise the subsidies which member states grant for structural development and as part of their regional policy. Member states must not entice firms away from other member states, nor must they try to outbid each other in the attempt to attract firms from non-member countries. This is one of the spheres in which tax concessions play a special role. The European Commission realizes that it will not be possible to issue detailed provisions on this question. The member states will have to be induced to present their program to one another and agree on a reasonable way of applying the outline provisions adopted for regional policy and structural policy.

Today, moreover, it is generally recognized in the member states that the free-market economy must be supplemented by overall measures to guide demand. This means that we shall have to advance steadily in coordinating financial and monetary policies. There will have to be a European monetary system. The fact that financial policy often involves fiscal means – as, for instance, in the German economic stabilization law – will also call for close coordination among the member states; otherwise measures needed for financial reasons may distort competition in the common market and, perhaps, cancel out the harmonization already achieved. This applies in particular to rules allowing faster or slower depreciation.

This, then, is the framework in which the Community's policy of tax harmonization will have to operate during the next stage of integration, when economic union is being established. The possibilities of isolating individual tax problems are limited; on the contrary, harmonizing measures in individual fields – particularly harmonization of certain types of tax – cannot fail to influence total tax revenue, the composition of the budget and spending policy. An obvious case in point is harmonizing the rates of turnover tax.

We shall therefore have to move cautiously, allowing for the facts of the situation, differences in historical development and the political situation in the individual member states. These factors must not, however, serve as pretext for a restrictive attitude. Our endeavour should rather be to find solutions which take into account the current requirements of the common market and to avoid making demands on the member states which at the time appear to be excessive.

Tax harmonization and free movement of goods and services

Among the tax-harmonization measures actually taken by the Community are those relating to the movement of goods. They are important for integration because a common market means in the first place unimpeded movement of goods across the internal frontiers, in uniform conditions of competition throughout the Community.

GOODS

1. Turnover tax

With the final abolition of customs duties and quotas on July 1, 1968, the main impediment to the movement of goods across the frontiers is now the adjustment procedure for turnover tax and other consumption taxes. As long as all member states apply the principle of taxation in the country of destination, these taxes must be refunded on exports and levied on imports.

As with customs duties, the procedure for levying the equalization tax normally means frontier checks, bureaucracy and complying with formalities. It involves time, work and expense. Like customs frontiers, then, tax frontiers impede the movement of goods both physically and in terms of time and money, not to speak of the psychological effects. Consequently, what the completion of the customs union has contributed to integration may be at least partly offset by the retention of tax frontiers. In addition, the free play of supply and demand across frontiers is hampered by the adjustment procedure, and this means that the full benefits expected from the market economy are not attained. The movement of goods continues to be a matter of importing and exporting, and the political frontiers between the

member states are still doubled by economic frontiers. We are still left with a group of national markets.

Free movement of goods cannot therefore be ensured simply by removing the inadequacies of the adjustment procedure, i.e. by harmonizing the structure of turnover and consumption taxes. The tax frontiers themselves should be eliminated. We should make it possible for a product to move as freely from Frankfurt to Lyons as from Frankfurt to Kiel. The adjustment procedure will, however, be indispensable as long as rates of turnover and consumption taxes vary. The rates must therefore be aligned. This alignment is also necessary because the difference in rates can contribute to differences in the price level between one member country and another, and so hamper both the merging of national markets into uniform common markets and the proper functions of the price mechanism involved in the movement of goods across frontiers. What is more, the price differences caused by different tax rates, and which the adjustment procedure incorporates and perpetuates, can restrict or dampen competition in the Community. In view of all this, the Commission intends to submit to the Council of Ministers a proposal for a directive to eliminate tax frontiers affecting trade in the Community.

Except for the rates, as far as turnover tax is concerned, the conditions of competition imposed by the state will be the same throughout the Community once all member states have introduced the new Community system of tax on added value. In April 1967 the Council of Ministers of the Community, acting on a proposal from the European Commission, adopted two directives which require the changeover to be made by January 1, 1970, and which lay down the structure and methods of the common system. The Commission has recently submitted to the Council a proposed directive extending the system to agriculture. The intention is to shape turnover taxes so that they do not affect conditions of competition in trade across frontiers or domestic trade, and in particular so that they do not influence the degree of vertical integration of firms.

These three directives represent a major step towards establishing a system "ensuring that competition in the common market is not distorted" (Article 3 [f]). The transition from customs union to common market will then include the turnover-tax field. The most important regulation in the field of restraints of competition by firms dates as far back as 1962.

2. Consumption taxes

Tax adjustments based on specific consumption taxes also impede free movement of goods. Different consumption-tax systems, structures and rates distort competition across the frontiers and lead to discrimination against imported goods.

Like turnover taxes, these consumption taxes must be aligned in three stages: system and structure; rates; and elimination of tax frontiers. This applies at any rate to taxes on tobacco, petroleum products and alcohol, which are important sources of revenue and of great economic significance. Decisions taken on these taxes will have to allow for the special requirements of agricultural, energy and transport policies.

SERVICES

The common market calls not only for free movement of goods but also for freedom to supply services; here, too, conditions of competition will need to be uniform. Factors which help create conditions similar to those in a domestic market include the structure and rates of turnover tax. France, for example, took this into account when it extended its added-value tax system to the whole economy. The Community's directives will also try to settle this problem.

Differences in indirect taxes on insurance contracts and transport services can also inhibit freedom to supply these services and hamper competition in these fields. The Commission has taken the first steps to harmonize these taxes.

Tax harmonization and free movement of persons and firms

The section of the Rome Treaty providing for free movement of persons and firms across internal frontiers and freedom of establishment throughout the Community is intended to bring about mobility not only for products but also for the factors of production, with the state creating similar conditions of competition everywhere. What has to be established, then, is not just a common market for goods and services, but also a common market for the factors of production. Only free mobility of all factors playing their parts without let or hindrance, will enable a number of separate national economies to integrate. Only when this one economy has been formed will it be possible to arrive at an optimum combination of the factors of production and so produce optimum effects on growth and prosperity.

Only through a common market for all the factors of production, and the necessary harmonization and coordination of the member states' economic policies, will the objectives laid down in the Rome Treaty – economic expansion, stability and prosperity – be fully achieved.

The situation in harmonizing direct taxes is the same. It is a *sine qua non* that fiscal measures should not artificially divert or impede the necessary mobility of the production of factors. The greater the mobility of the other factors of production, the greater the importance that will attach to any differences in the structure and the level of direct taxes. Persons, companies, manpower and capital can seek the haven of the lowest taxation. Location of headquarters, siting of firms, the form and the volume of investment and the financial return will depend in part on direct taxes and the differences between them in the member states. The cost factor represented by direct taxes will therefore have to be aligned throughout the common market and a system of undistorted competition established in this field as in others.

1. Corporation tax and taxes on industry and trade

Corporation tax and taxes on industry and trade are the direct taxes which have the most important effect on the free movement of persons and companies. Real estate and property taxes and, to a certain extent, income tax must also be taken into account.

For technical reasons, direct taxes on goods moving across frontiers cannot be compensated for at the frontier. Where, however, these taxes are part of production costs, they have their full effect on competition in international trade. Therefore, as long as they have not been aligned, there will inevitably be competition between producers in the common market whose production costs contain differing amounts of direct tax.

Producers point out that such differences in tax costs constitute artificial competitive advantages or disadvantages, because the taxes, being a compulsory payment introduced and fixed by the state, can neither be equated with natural site costs nor be influenced, like other production costs, by the business acumen of the taxpayer, by rationalization or by technical innovation.

In this field as in others, the Community intends to proceed gradually and pragmatically rather than to strive for too perfectionist a solution. The first aim is to level out those differences in the tax burden which have a direct and particularly heavy incidence on production costs. The Commission has thus proposed that the member states should rapidly adopt certain common rules on the starting point and calculation of depreciation and on the provisions requiring firms to effect depreciation. It has also proposed a procedure for consultation prior to the granting of special depreciation allowances.

Later on, common rules will have to be drawn up on the tax treatment of gains on fixed capital which accrue to firms in the course of normal business and on valuation of stocks and constitution of reserves. For the more distant future, then, the Commission is aiming at the introduction of a uniform and comprehensive tax applicable to company profits, with the same structure in all member states and a large measure of similarity in rates and methods of assessment. If there is to be complete neutrality in competition, the methods used for collection and control of this tax will also have to be aligned.

2. Personal income tax

Income tax payable by individuals may on the other hand be allowed to differ from country to country for some time to come, because change of residence for tax reasons alone is less common and in any case less detrimental than the transfer of firms of international stature, which within an economic community are free to choose where they want to establish their offices. The Commission has proposed that the composite general tax levied on personal income should for a long time yet be allowed to vary from member state to member state; this would leave member states some room for making adjustments in the light of changes in the volume of expenditure.

3. Taxation of international merg rs

Free movement of firms enables companies in one member state to merge with or acquire a holding in the companies of another member state. As long as such moves run into obstacles caused by rules on taxation and provisions of company law, conditions similar to those of a domestic market have not been established. The factors of production concerned lack mobility across frontiers.

This situation has so far given an artificial advantage to internal or "national" mergers to the detriment of mergers at European level. This can impede the adjustment of firms and industries to the requirements of the large internal market that is being created and to the conditions of international competition. Extraneous disadvantages may thus be created, and these can distort international competition with firms from non-member countries.

The tax obstacle to these mergers results from the fact that at the time of take-over untaxed gains in the assets of the company taken over are disclosed. All member states have taken measures to ensure that in the case of national mergers such capital gains are not taxed in the same way as they would be if the company were really being wound up. These arrangements do not, however, apply to mergers between companies from different member states, mergers which will be made possible by work currently under way in the field of company law. Under present rules, companies which merge with a foreign company are regarded as liquidated and tax is levied in the normal way. This may make the merger impossible.

In the memorandum it submitted to the Council of Ministers in June 1967, the Commission had contemplated a solution which was based on the principle of normal taxation of capital gains, but provided for the spreading of the tax burden over a period of ten years. Meanwhile, however, it has been found that this arrangement would still be too harsh if applied without modification. The range of possible cases would have called for a more flexible solution to take into account the merits of almost each individual

case; the proposed system would therefore have become rather complicated.

At present, the Commission's experts favour a uniform solution in the form of a general deferment of tax payments for all capital gains disclosed at the time of merger. This would offer the advantage of being simple. Under such an arrangement payment of tax on capital gains would be postponed until the company that takes over actually realizes these gains. Consequently no tax would have to be paid on capital gains at the time of the merger.

4. Taxation of international holdings

For holdings in other companies, the first need is to ensure that profits earned through a subsidiary and paid to the holding company as dividend are not taxed a second time as profit made by the holding company if it has a major holding in the subsidiary. The problem has by and large been solved for cases where both companies are in the same member state, and much progress has been made towards solving it for holdings in foreign companies. Nevertheless, there still are certain relationships between companies from different member countries to which the domestic arrangements can be applied only in part, if at all.

A related problem is the levying at source of tax on dividends paid out by a subsidiary to its parent company, which in certain cases leads to double taxation. This situation can and must be remedied rapidly if the establishment and development of subsidiaries in other member countries is not to be impeded.

Tax harmonization and free movement of capital

Tax harmonization is also important for the creation of a common capital market. Free movement of capital is just as necessary for the establishment of the common market as free movement of goods. Capital, as the factor of production which by its nature is the most mobile, and which is of great importance for economic expansion, and competitive strength, is bound to play a decisive part in the process of integration.

A free capital market means not only an end to discrimination against foreigners, but also free access to all sources of capital, freedom of investment and no distortion in these conditions established by the state for competition on the capital market. This is a comprehensive program and requires a series of measures, as proposed in the report, *The Development of a European Capital Market*[1] prepared by a group of experts appointed by the European Commission, and published in 1966.

Harmonizing taxes that affect the free movement of capital must therefore increase capital's freedom to move and promote more equal conditions of competition. A major contribution to these aims can be made by harmonizing taxes on dividends and on interest from debentures. The pace and ease with which a common market for securities and capital investment develops in the Community will depend on the extent to which the tax burden on securities is aligned.

[1] Available from H.M. Stationery Office, P.O. Box 569, London SE1, at 34s., or from the European Community Information Service, 808 Farragut Building, 900-17th Street NW, Washington D.C. 20036, at $4.

1. Taxation of bond interest and divid nds

Taxation of bond interest at source varies from zero in Germany and the Netherlands to 31 per cent in Italy. Capital seeking investment may thus be attracted into those countries which levy no tax at all. Moreover, taxes levied at source and the methods used to levy them often lead to double taxation, to difficulties for the investor and consequently to a further obstruction or distortion of capital movements across frontiers; the merging of the capital markets of the various countries is therefore hampered.

Similar considerations apply to taxation of dividends at source. Here, rates vary from nil in France for residents and for non-resident Germans to 25 per cent in Germany and the Netherlands. For non-residents the rates range from 15 to 30 per cent.

To avoid distortion or deflection of capital movements the Commission advocates common rates. Such a move would mean that throughout the Community there would be comparable tax incentives to expand investment and the financing facilities available to companies – and it would in this way lead to a more unified capital market. Common rates would expose the terms and costs of new issues to the pressure of competition and would thus promote their harmonization.

The Commission has suggested that dividends should be taxed at a rate of 25 per cent and has mooted a rate of 10 per cent on debenture interest. Studies are, however, being made to see whether taxation of interest at source cannot be abolished.

The argument advanced for taxation at source is that,

for lack of an automatic check on the beneficiary, levying a minimum tax leads to a more equitable distribution of the tax burden. The economic argument for abolition of taxation at source is that appreciable encouragement is at present given to saving in the form of investment in bonds, to the detriment of investment in shares, and that this would be reduced to a point where balance could be restored in the methods of obtaining corporate finance. Even the supporters of this thesis agree, however, that the tax treatment accorded to the various types of investment need not be standardized.

The points against taxation at source are that it results in higher financing costs for firms, induces investors to prefer other types of investment, and leads to the danger of capital moving to non-member countries and the Eurodollar market where there is no taxation at source.

Much will, however, depend on the level of the common rate. While to the investor it is the net yield that matters, the decisive point for the borrower is gross cost. Some experts believe that for residents in Germany and the Netherlands 10 per cent deducted at source would have only a slight effect on interest rates, since they are liable to income tax. These experts believe that the other member countries would then attract more foreign capital than previously, which could lead to a lowering of interest rates. As, in their opinion, a tax of 10 per cent deducted at source would be modest and as the possibilities of evasion are fairly limited, no serious reduction in the supply of capital from non-member countries need be expected. (It is only in Scandinavia and Austria that no tax is deducted at source; in addition various states in the USA and certain tax-haven countries allow non-residents to use the services of a holding company, so that the actual issuer avoids taxation at source.)

There are, however, powerful groups who consider that the simplest solution under fiscal law and the best one from the angle of capital-market policy lies in abolishing any special tax treatment of interest income from bonds. Only through freedom of movement, they contend, could an important and really attractive common capital market of the Six be created. A European system of taxation at source would have the opposite effect.

The final decision on this matter must allow for all the many factors which affect the supply of and demand for capital.

To avoid double taxation, the purpose of taxation at source must continue to be the collection of an advance payment that can be set against the income tax of the beneficiary. In addition, the authorities must eliminate the numerous and cumbersome formalities that at present have to be complied with in order to escape double taxation.

In practice this means, firstly, that any tax withheld at source should be allowable in full or be refunded where the beneficiary's tax liability is less than the amount withheld or where he is not liable to tax. The common solution means, secondly, that the refund is made by the tax authorities of the beneficiary's country of residence, even if the income was earned in some other member state. The resultant problem of compensatory payments between the member states should be solved on the lines of an overall clearing arrangement rather than by the current method of dealing with cases as they arise.

2. Taxes on firms and corporation tax

Additional tax factors which influence the yield of shares are the various company taxes – some are deductible for purposes of calculating taxable profit, some are not – and corporation tax. The shareholder, however, scarcely feels this influence directly. He is inclined to look only at the dividends and to examine critically only the final tax levied on the individual dividends. For this reason corporation tax is not of major interest to the private investor when he compares yields.

On the other hand, the practice of granting an *avoir fiscal* to French and a *crédit d'impôt* to Belgian residents to offset part of the corporation tax paid by French or Belgian companies discriminates against shareholders who are not resident in these countries. What is more, the relief applies only to dividends from companies which have their registered offices in France or Belgium. These measures, being an incentive to Frenchmen to invest in French companies and to Belgians to invest in Belgian companies, help maintain national capital markets and distort investment conditions in the common market.

While the recent extension of this preferential treatment to shareholders of French companies residing in Germany is a step in the right direction, it does not go far enough: the advantage should be extended to cover shareholders in any Community country. Again, there should be similar treatment for dividends distributed by companies from other member states and accruing to persons residing in France. It must, however, be recognized that the German system of a double rate of corporation tax produces similar results and gives preferential treatment to all buyers of German shares, wherever they reside.

The Commission has not yet decided which solution to advocate, but has simply referred the whole complex of problems to the Council of Ministers. Finding a solution has become urgent. For this reason additional studies are now under way, on which the Commission should be able to base its proposals.

Great importance attaches to tax harmonization if economic integration of Europe is to be a success. Tax harmonization comes close to customs union as one of the most important elements in the common market. The present situation contains factors which greatly favour this harmonization and it is our most powerful ally. Producers, traders, consumers and the general public are urgently calling for action. The legal and institutional means are available, and the first major steps have been taken. Further substantial progress towards harmonization can be made over the next few years.

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