THE WALL STREET JOURNAL 30 MAR 1989

The Flaw in Europe's Tax Strategy

By Alfred Boss

KIEL, West Germany – Many politicians as well as economists feel that the creation of a common market within the European Community and the abolition of tax borders have to be accompanied by tax harmonization. In their view more similarity of the rates of indirect taxes – i.e. value added taxes and taxes on the comsumption of specific goods like tobacco – is necessary. The EC institutions have been busy preparing measures along these lines of reasoning. Nevertheless, it is doubtful, whether harmonization is necessary as a precondition for a common European market.

The value added tax systems prevailing in all member countries are characterized by the destination principle – i.e, exports are tax exempt, whereas imports are taxed at the domestic value added tax rate. In such a system, tax borders are necessary to ensure that domestic consumption is taxed at national VAT rates. As a result national private consumption expenditures are taxed; investment expenditures normally are tax free. The national tax revenues depend upon the country's consumption expenditures. The same principles are applied to excise taxes on such items as tobacco, coffee, wine, beer, and oil.

Within the common value added tax system, the tax rates differ among the EC countries. The rates are relatively high in Denmark, Ireland, Belgium and France, but relatively low in the Federal Republic of Germany, Britain and Luxembourg. As to specific excise taxes there are also differences between national rates.

The EC Proposals

In 1987, the Commission of the EC proposed a number of measures that should be introduced while abolishing the tax borders with the EC. The proposals include the:

- introduction of a two-rate value added system – general rates of 14% to 20% and reduced rates of 4% to 9% – in all EC member countries;
- introduction of a "clearing-system" that would guarantee that tax revenues are distributed to member countries according to their national consumption expenditures and;
- harmonization of the rates of specific excise taxes.

The West German government shares the EC Commission's view that some kind of tax harmonization is necessary as a result of the abolishment of tax borders.

According to the Commission, harmonization of indirect taxes is a precondition for a common market because these taxes are a component of prices for goods and services. Abolishing the tax borders without narrowing the differences between tax rates would mean major price differeces and thus changes in the flows of goods between EC countries.

Is the view of the EC Commission correct? The answer can be found by analyzing what would happen were tax borders abolished without harmonizing taxes.

This would mean that the origin principle instead of the destination principle would become effective; the origin priniciple is characterized by the fact that the net value added is taxed in that country in which economic activities occur, i.e. in which net value is added. Consequently, countries with low VAT rates would realize higher exports; their goods and services would become cheaper for foreigners as a result of the elimination of the tax borders because the prices would only include the low "origin" VAT rate, but not – as in the system prevailing – high foreign "destination" VAT rates. At the same time in low VAT rate countries imports would decrease because goods from abroad would remain taxed by the high tax rates prevailing there.

But this would not yet be the final outcome. Higher exports and lower imports of low rate countries and the opposite effects in high VAT rate countries would induce exchange rate changes. Countries with low VAT rates would realize an appreciation of their currency, while high rate countries' currencies would depreciate. Thus, the relative competitive positions would not change despite differences in the average level of VAT rates.

What is the conclusion? Harmonization of average VAT rates within the EC is not necessary as a precondition for abolishing tax borders. There would be no adverse effects on trade because the exchange rates would adjust in such a way that different levels of VAT rates would be compensated. As to the European Monetary System, however, when tax borders are abolished without adjusting or harmonizing the national VAT rates, exchange rates within the EMS would have to be allowed to float – at least for some months to allow for necessary adjustment.

Apart from the differences in the average value added tax rates there are differences as to the rate structure. Some countries have high tax rates for "luxury" goods, many countries tax food or energy by a relatively low rate or even not at all. If tax borders are abolished, producers in low tax rate countries would benefit, others would lose market shares; the adjustment of exchange rates would only eliminate differences in the average tax rate levels. But this would only be the first round effect. National governments would adjust their tax rates. Why?

The Effects of Adjustment

High rate countries would – as a result of the origin principle – lose tax revenues; they would reduce their rates in order to get more revenues. Low rate countries probably would increase their rates; this would be possible because of the higher demand for these countries' products. The outcome would be "harmonization" as a result of competitive forces. The same kind of process would start because of national differences in the special excise tax rates. What does this mean? Harmonization is unnecessary not only for the VAT rate structure but also for rates of excise taxes.

It is important to realize that the specific VAT or excise tax rates would approach each other at a level that is below the average now prevailing in the EC countries and proposed by the EC Commission for all countries. Competitive forces would guarantee this by means of the consumers' decisions vis-a-vis price differentials induced by different specific tax rates. Lower overall tax revenues in the EC countries on average probably would induce lower government expenditures, at least in the relation to gross domestic product. Harmonizing rates according to the ideas of the EC Commission would mean the contrary: higher tax rates and more government power as a result of a cartel solution.

Tax rate harmonization is not necessary as a precondition for realizing the Common Market within the EC, and it is not desirable from the viewpoint of economic efficiency. As to direct taxes, international capital mobility is a strong impediment for an autonomous national tax policy. Harmonizing the rates of direct taxes would reduce competitive pressures on national governments and would reduce efficiency. Fortunately, forces in the EC have not yet taken to the idea of overhauling the entire direct taxation system.

Mr. Boss is director of the finance department at the Kiel Institute of World Economics.

THE WALL STREET JOURNAL 31 MAR 1989

EC Panel Seeks Strict Curbs On Ads by Cigarette Makers

AP-Dow Jones News Service

BRUSSELS – The European Community Commission proposed banning advertisements for non-tobacco products made by cigarette companies and requiring visible health warnings on all ads for tobacco products.

The proposal would ban all commercials for clothes, shoes or other non-tobacco items that use an emblem, symbol or trademark closely associated with a cigarette brand.

The commission adopted a list of 12 health warnings, any one of which would have to be used by tobacco producers operating in the EC and which would have to cover at least 10% of the ad's total surface.

The warnings include: "Smoking kills," "Smokers die prematurely," "Protect children from tobacco smoke" and "To be healthy, don't smoke."

The commission also proposed that only the cigarette packet be pictured in ads and that the cigarettes' tar content be clearly shown.

France already has such legislation, but among the 12 member states only Portugal and Ireland have a total ban on tobacco advertising. In Greece, Luxembourg and Spain there are no or few restrictions. In the six other member states, printed commercials for tobacco must be accompanied by the same health warning that appears on the packet.

The commission's proposals have to be submitted to the European Parliament for its opinion and must be approved by EC member states.