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Towards an [Unlawful] Modernised EU VAT Rate Policy

Rita de la Feria and Max Schofield*

In late 2015, the European Commission announced a monumental U-turn on VAT rates policy. After decades of advocating the benefits of harmonisation of VAT rates across the EU Member States, and after many failed legislative attempts at achieving it, the Commission has announced its intention to do the opposite, namely to disharmonise VAT rates across Europe. The announcement was followed by the VAT Action Plan, and a public consultation on the reform of VAT rates, which, under the guise of modernisation and consistency with the destination principle, presented two options for reform, both of which would give Member States further freedom and flexibility in the application of reduced rates. Against this background, the aim of this article is not to restate the benefits of VAT rate harmonisation, but to assess whether the EU has legislative competence to approve disharmonising VAT legislation. The article concludes that Article 113 TFEU could not be used as a legal basis for a Directive aimed at disharmonising VAT rates, and that any such Directive, therefore, would lack legal basis and be consequently unlawful under the EU constitutional principle of conferral of powers.

I. Introduction

In late 2015, the European Commission announced what can only be characterised as a monumental U-turn on VAT rates policy.¹ After decades of advocating the benefits of harmonisation and rationalisation of VAT rates across the EU Member States, and after many failed legislative attempts at achieving it, the Commission has announced its intention to do the opposite, namely to disharmonise VAT rates across Europe.² The announcement was followed by the VAT Action Plan,³ and a public consultation on the reform of VAT rates,⁴ which, under the guise of modernisation and consistency with the destination principle,⁵ presented two options for reform, both of which would give Member States further freedom and flexibility in the application of reduced rates. Under the first option the list of goods and services eligible for reduced rates would be extended and reviewed regularly so as to adapt existing rules to the modern economy, and evolving political priorities. The second option envisages the abolition of the pre-defined list of goods and services to which reduced rates can be applied, as part of a

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¹ For an earlier brief comments see M. Schofield and R. de la Feria, "Section 126: VAT: Women's sanitary products" (2016) *British Tax Review* 5, at 616.

² European Commission, *Commission Work Programme 2016 – No time for business as usual* Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, COM(2015) 610 final, 27 October 2015, at 8.

³ European Commission, *Action plan on VAT – Towards a single EU VAT area*, Communication from the Commission to the European Parliament, The Council, The European Economic and Social Committee, COM(2016) 148 final, 7 April 2016.

⁴ European Commission, *Open public consultation on the reform of VAT rates (proposal for a Council Directive amending Directive 2006/112/EC on the Common system of value added tax as regards the rules governing the application of VAT rates)*, available at: http://ec.europa.eu/taxation_customs/consultations-get-involved/tax-consultations/public-consultation-reform-rates-vat-towards-modernised-vat-rates-policy_en (accessed December 2016).

⁵ C. Herbain, "Towards a Single EU VAT Area" (2016) *British Tax Review* 4, 402-407, at 406.

decentralised system,⁶ under which Member States would be free to set their domestic reduced rates and to apply them to their choice of goods and services.

Against this background, the aim of this article is not to restate the benefits of VAT rate harmonisation,⁷ but to assess whether the EU has legislative competence to approve disharmonising VAT legislation. Competence to approve VAT legislation is conferred upon the EU by Article 113 of the Treaty on the Functioning of the European Union (TFEU), which provides the legal basis “for the harmonisation of legislation concerning turnover taxes” subject to specific conditions. The key question, therefore, which has not been addressed within the ongoing debate, is whether disharmonising legislation of the type being considered for VAT rates, respects those conditions. In the second part of this article, the background to the current proposals will be discussed, with consideration given to the various attempts to harmonise VAT rates prior to 2015, as well as to the political economy dynamics that have always permeated discussions regarding VAT rates, particularly since the 2008/2009 financial crisis. In the third part of this article, the EU competence under Article 113 TFEU is considered, with particular regard to the link between the legislative competence conferred therein and the aim to establish an EU Internal Market. The article concludes that Article 113 TFEU could not be used as a legal basis for a Directive aimed at disharmonising VAT rates, and that any such Directive, therefore, would lack legal basis and be consequently unlawful under the EU constitutional principle of conferral of powers.

II. EU Harmonisation of VAT Rates

The harmonisation of rates has been a point of contention for the EU VAT system since its inception.⁸ The early Directives established only a basic framework, affording Member States full autonomy over the numbers and levels of their rates, and the Sixth VAT Directive, approved in 1977,⁹ had limited impact, focussing primarily on harmonisation of the base rather than the rates, given the inability to reach agreement on the latter. In the decade that followed the approval of the Sixth VAT Directive, progress in achieving further harmonisation remained slow, and until the late 1980s only three VAT legislative proposals of significance reached agreement, none of which concerned harmonisation of rates.¹⁰

The second attempt to harmonise rates came in the late 1980s, following the European Commission’s presentation of the White Paper on the completion of the Internal Market.¹¹ The White Paper concluded that a close level of ‘approximation’ within VAT was required in order to establish a true internal market, and that the abolition of

⁶ “Option 2: Abolition of the list” in fn. 3 above.

⁷ See amongst others: R. de la Feria, *The EU VAT System and the Internal Market* (IBFD, 2009), at Chapter 3; H. Kogels, “Towards a single VAT rate in the Netherlands?” (2010) *International VAT Monitor*, at 173; A. Charlet and J. Owens, “An International Perspective on VAT” (2010) *Tax Notes International*, 943-954; and A. Van Doesum and G.J. Van Norden, “EU 2011, EUtopia and EU 2020: the European Commission’s Green Paper on the future of VAT” (2011) *British Tax Review*, at 271.

⁸ See R. de la Feria, fn.7 above, at Chapter 2.

⁹ Sixth Council Directive 77/388/EEC of 17 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes — Common system of value added tax: uniform basis of assessment (Sixth VAT Directive).

¹⁰ Eighteenth Council Directive 89/465/EEC of July 18, 1989 [1989] OJ L226/21; Eighth Council Directive 79/1072/EEC of December 6, 1979 [1979] OJ L331/11; and Thirteenth Council Directive 86/560/EEC of November 17, 1986 [1986] OJ L326/40.

¹¹ European Commission, *Completing the Internal Market – White Paper from the Commission to the European Council*, COM(85) 310 of 14 June 1985,.

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physical frontiers required, in particular, further harmonisation of rates.¹² The Commission's follow-up legislation proposal in 1987 was widely regarded as ambitious,¹³ calling for a dual-rate system, a compulsory list of goods and services to which reduced rates could apply, and the repeal of temporary derogations. The proposal was met with significant political opposition, as was an alternative proposal tabled in 1989.¹⁴

In the early 1990s, the then designated transitional VAT system was born, and some much diluted rules on the harmonisation of rates were finally approved in the Approximation of VAT Rates Directive.¹⁵ The new Directive, which was largely a product of political compromise,¹⁶ prescribed, inter alia, a lower limit of 15% for the standard rate, and of 5% for reduced rates applicable to a list of specific goods and services; and a standstill clause that allows the temporary maintenance of several exceptions to those rules, including the application of a zero rate to the products taxed as such before 1 January 1991, or the application of reduced rates to products not listed. Table 1 below provides a comparative overview of the three proposed VAT rate structures.

TABLE 1: VAT Rate Structures: Comparative Overview

1987 Proposal	1989 Alternative Proposal	1992 Directive
Two rates system (standard rate and reduced rate)	Two rates system (standard rate and reduced rate)	Five rates system (standard rate, three reduced rates and zero-rate)
Standard rate band (14% to 20%)	Standard rate minimum	Standard rate minimum (15%)
Reduced rate band (4% to 9%)	Reduced rate band (4% to 9%)	Reduced rates minimum (5%) in theory; in practice no minimum applies
6 items which may be subject to reduced rate	6 items which may be subject to reduced rate	22 items which may be subject to reduced rates
Compulsory nature of list of goods / services subject to reduced rate	Compulsory nature of list of goods / services subject to reduced rate	Optional nature of list of goods / services subject to reduced rate
Abolition of zero-rating	Maintenance of zero-rating for a limited range of products	Maintenance of zero-rating

Background to the ongoing consultation

The transitional system, originally intended to last for four years after 1 January 1993, failed to be superseded by proposals for a definitive, origin-based system,¹⁷ and by 2011 the Commission had abandoned the ultimate aim of establishing a definite system, and had embraced the destination principle.¹⁸ The Commission continued to review

¹² R. de la Feria, "Blueprint for Reform of VAT Rates in Europe" (2015) *Intertax* 43(2), at 155.

¹³ European Commission, *Proposal for a Council Directive completing the common system of value added tax and amending Directive 77/388/EEC – Approximation of VAT rates*, COM(87) 321 final/2, 21 August 1987.

¹⁴ *Completion of the Internal Market and Approximation of Indirect Taxes*, Communication from the Commission to the Council and to the European Parliament, COM(89) 260 final, 14 June 1989, at 1.

¹⁵ Council Directive 92/77/EEC of 19 October 1992 supplementing the common system of value added tax and amending Directive 77/388/EEC (approximation of VAT rates) [1992] OJ L316/1.

¹⁶ R. de la Feria, fn.12 above, at 155.

¹⁷ R. de la Feria, fn.12 above, at 156. See also, European Commission, *A common system of VAT – A programme for the Single Market*, COM(96) 328 final, 22 July 1996.

¹⁸ R. de la Feria, "The 2011 Communication on the Future of VAT: Harnessing the economic crisis for EU VAT reform" (2012) *British Tax Review* 2, 119-133. See also European Commission, *The future of VAT—Towards a simpler, more robust and efficient VAT system tailored to the single market*, Communication from the Commission to the European Parliament, the Council and the European Economic and Social Committee, COM(2011) 851 final, 6 December 2011.

and assess the VAT rate structure, reporting that reduced rates and their complexity was the primary cause of requests and questions received, but ultimately all initiatives to simplify and rationalise rates (including, most notably, the 2003 proposal) failed miserably.¹⁹ It is of further significance that during this period, rate structures across the EU not only continued to vary considerably but did so increasingly, which, to a large extent, was due to the labour intensive services experiment, which despite having failed to achieve its objective of reducing unemployment in those industries,²⁰ became a permanent feature of the EU VAT system in 2008.²¹ The move, which whilst increasing differentiation did not constitute disharmonisation *per se*, recognised the strong political will to maintain reduced rates, emphasising that some flexibility could be afforded as long as it respected Article 93 of the [then] ECT (now Article 113 TFEU), which required this flexibility to be balanced against the need to ensure the continued proper functioning of the Internal Market.²²

In 2008, in the wake of the economic and financial crisis and after a prior period of relative stability since 1996, the EU average standard rate of VAT started to rise, and several Member States made substantial broadening amendments to their VAT base, moving goods and services from the reduced to intermediate rate, or from the reduced and intermediate to the standard rates. Overall, a staggering twenty-three out of the twenty-eight EU countries changed their VAT rate structures post-2008.²³ These uncoordinated movements at a national level raised the expectation / possibility that decreased divergence and even approximation of VAT rates structures across the EU may happen; not through a process of EU harmonisation, but instead through a process of natural convergence of national VAT policies.²⁴ Alas, this was not to be.

Over the years, several Member States expressed reservations over the harmonisation of rates, but it is undeniable that within the realpolitik of EU policy circles, the UK has played a significant role in determining the fate of the collapsed initiatives, as demonstrated by their *cri de coeur* in relation to children's clothing,²⁵ which the Commission—backed by evidence—quickly dismissed.²⁶ More than merely blocking further harmonisation, it was suggested that it had, for some time, been the desire of a selection of UK Members of Parliament to see the country provided with the flexibility to apply reduced rates to those goods and services which the UK Parliament deems appropriate, as and when it deems it appropriate.²⁷ This is the first of several ironies regarding the role of the UK

¹⁹ European Commission, *Proposal for a Council Directive amending Directive 77/388/EEC as regards reduced rates of value added tax*, COM(2003) 397 final, 23 July 2003.

²⁰ European Commission, *Experimental application of a reduced rate of VAT to certain labour-intensive services*, Report from the Commission to the Council and to the European Parliament COM(2003) 309 final of 2 June 2003; and European Commission, *Evaluation report on the experimental application of a reduced rate of VAT to certain labour-intensive services*, Commission Staff Working Paper, SEC(2003) 622, 2 June 2003.

²¹ European Commission, *Proposal for a Council Directive amending Directive 2006/112/EC as regards rates of value added tax*, COM(2008) 428 final, 7 July 2008. See also Council Directive 2009/47/EC of 5 May 2009 Amending Directive 2006/112/EC as regards reduced rates of value added tax, OJ L116, 09/05/2009, 18-20.

²² European Commission, *VAT rates other than the standard VAT rates*, Communication from the Council and European Parliament, COM(2007) 380 final of 5 July 2007.

²³ R. de la Feria, fn.12 above, at 160 et seq.

²⁴ R. de la Feria, fn.12 above, at 172.

²⁵ M. Schofield and R. de la Feria, fn.1 above, at 614.

²⁶ European Commission, *Reduced rates of VAT: Frequently asked questions*, Press Release, Brussels: MEMO/03/149, 16 July 2003.

²⁷ M. Kendrick, "A Question of Sovereignty: Tax and the Brexit referendum" (2016) *King's Law Journal* 27(3), at 368.

in EU VAT rates policy: that whilst national court decisions on disputes regarding the interpretation of VAT reduced rates rules multiplied, continuously and consistently highlighting limitations of the current rules on VAT rates;²⁸ the political debate was firmly centred on the need to expand the scope of reduced rates, and further erode the base. Nowhere was this more evident than in the debate which ensued in 2015 regarding what became known as the tampon tax: the possible application of reduced rates of VAT to women sanitary products.²⁹ Few could have predicted, however, the impact that this debate would have on EU VAT rates policy.

Ongoing consultation

For the last four decades, the European Commission's approach to VAT rates had been to convince Member States that harmonisation was essential for the establishment and the functioning of the European Internal Market. Yet, neither promises of trade benefits of harmonisation, nor evidence of domestic economic efficiency, nor even the appeal for consolidation of public finances, could surpass the political pressure of maintaining, or even extending, the scope of reduced rates.³⁰ Now, and only months after success in the CJEU against an errant UK reduced-rate,³¹ the Commission performed a remarkable volte-face.

With the stated aim of giving more flexibility in the application of reduced rates, the 2015 Action Plan outlined two options for reform of the EU VAT rate structure. The *first option* is to extend the list of goods and services eligible for reduced rates. This would maintain the 15% standard rate and the current list but have regular reviews of the products included therein to take into account political priorities of the Member States, with any potential changes assessed on the basis of their risk to the functioning of the single market and to competition. This is the less revolutionary option, which would limit the nevertheless unavoidable increase in rate differentiation; however, it is also unclear what the benefits of such a system would be when compared to the status quo, in particular given that the Action Plan is silent as to the details of the process by which the European Commission would assess future requests for review of the list. The *second option* is the more radical approach: proposing to abolish the list of goods and services eligible for reduced rates, remove the minimum standard rate, and give Member States, prima facie, freedom in their application of VAT rates. It is suggested that, in order to prevent unfair tax competition in cross-border shopping and the narrow targeting of sectors for "unfair tax relief", the Commission may, nevertheless, limit the total number of reduced rates applicable in each Member State.

The public consultation begins with a discussion on the objective of the consultation. It argues that the framework was established for a definitive, origin-based denouement which necessitated rate uniformity and that the abandonment of the definitive system for an improved destination-based system allows for greater rate differentiation, opening up the possibility of reform to the rules on rates to make them less constraining on Member

²⁸ On some of these decisions see G. Morse, "Proctor & Gamble UK v HMRC (*Pringles Two*) — a very peculiar UK practice — the characterisation of food products for zero-rating" (2009) *British Tax Review* 59; and I. Roxan, "Interpreting exceptional VAT legislation: or, are there principles in *Pringles?*" (2010) *British Tax Review* 699; M. Schofield, "Snowballs and windfalls: VAT reduced rates lead to unpredictable and unreasoned jurisprudence", *Durham European Law Institute Blog*, 24 July 2014; and M. Devereux and R. de la Feria, "VAT — Unjust Enrichment", *Tax Journal*, 12 May 2008, 13–15.

²⁹ For a detailed account, see M. Schofield and R. de la Feria, fn.1 above.

³⁰ R. de la Feria, fn.19 above, at 128.

³¹ Case C-161/14, *Commission v UK*, ECLI:EU:C:2015:355. See commentary on the case at M. Schofield, VAT Reduced Rates? Save your Energy, *Bloomberg BNA International Tax Blog*, 11 June 2015.

States.

The harmonisation of rates has been the *bête noir* of EU VAT policy throughout its existence. As to why the Commission changed its mind, many may speculate. There are numerous potential triggers, from the need to adapt to modern technologies and new goods or markets,³² to the number of rates cases clogging the CJEU dockets,³³ and interpretative difficulties arising from the need to balance the inherent conflict between the fundamental principle of strict interpretation of exceptions to the base and the principle of fiscal neutrality.³⁴ The truth is probably rather more prosaic, however: faced with decades of resistance and increasing pressure from Member States to allow exceptions to existing rules, the Commission finally broke the political impasse in the context of the tampon tax,³⁵ ceding power in the favour of the Member States.

A detailed assessment of the (de)merits of such a shift in the legislative paradigm are beyond the scope of this article. As a mere compendium, if disharmonisation is to be permitted, not only is differentiation set to increase, but crucially, once the bureaucratic shackles are discarded, the “creeping exemptions” phenomenon will flourish,³⁶ further eroding the tax base. This is discussed in more depth in a previous paper, but needless to say the potential consequences to the internal market are sobering.³⁷ EU-wide complexity is likely to increase—potentially deterring trade; market distortions will proliferate as competing products are treated differently; and the eroded base will reduce national and EU budgetary pots. Domestically, reduced revenue would be compounded with costs in administering a protean patchwork of rates; industries will lack certainty with potential for increased changes that will likely favour the most vocal and well-resourced lobbyists, compliance costs will increase accordingly; there is a potential for fraud and aggressive planning to be incentivised; it may distract from redistributive measures within the direct tax system; and there will certainly be increased definitional litigation. Yet, Eurosceptic Conservative MPs in the UK have, bizarrely, still criticised the Action Plan for steering towards “more rigidity, harmonisation and uniformity.”³⁸ Whilst the impetus of the economic and budgetary imperative on harmonisation has been noted,³⁹ this would be a factor with or without the legislative backbone, and in that context, the Action Plan can hardly be seen to be proactively promoting harmonisation. Regardless, the focus of this paper is not upon the potential economic effects of disharmonisation of VAT rates, but rather on the legality of such a move.

III. EU Legislative Competence on VAT

One of the fundamental principles of the EU legal order is the principle of conferral powers, set out in Article 5(1)

³² For example, on the on-physical books issue: cases C-219/13, *K Oy*, ECLI:EU:C:2014:2207; C-479/13, *Commission v France*, EU:C:2015:141; and C-502/13, *Commission v Luxembourg* EU:C:2015:143.

³³ “To date, the Commission has had to open more than 40 infringement proceedings against over two thirds of Member States.”, see fn.3, at 11.

³⁴ See R. de la Feria, “EU VAT Principles as Interpretative Aids to EU VAT Rules: The Inherent Paradox” in M. Lang, et al. (eds), *Recent VAT Case Law of the CJEU* (Vienna: Linde, 2016), 1-17.

³⁵ M. Schofield and R. de la Feria, fn.1, at 616.

³⁶ L. Ebrill, et al., *The Modern VAT* (IMF, 2001), Ch.8.

³⁷ M. Schofield and R. de la Feria, fn.1.

³⁸ Christopher Chope MP, Hansard HC Deb 5 September 2016, vol 614, col 165, in M. Kendrick, fn.29, at 369.

³⁹ R. de la Feria, “EU VAT Rate Structure: Towards Unilateral Convergence?” (2013) *Oxford Centre for Business Taxation Working Paper* WP13/05.

TEU, according to which the EU may only act within the limits of the competences conferred upon it in the Treaties, to attain the objectives provided therein. The scope for exercising the Union's competences is determined by the Treaty provisions relevant to that area, and insofar as indirect taxation is concerned, the Union's competence is enshrined in what is now 113 TFEU.

Article 113 TFEU

Article 113 TFEU states,

“The Council shall, acting unanimously in accordance with a special legislative procedure and after consulting the European Parliament and the Economic and Social Committee, adopt provisions for the harmonisation of legislation concerning turnover taxes, excise duties and other forms of indirect taxation to the extent that such harmonisation is necessary to ensure the establishment and the functioning of the internal market and to avoid distortion of competition.”

The provision establishes clear limits as regards the legislative procedure applicable (procedural limits), and the aim of the legislation approved (substantive limits). The procedural limits are not in contention here: the provision determines the application of the so-called consultation procedure, which establishes that the competence for approval of legislation rests solely with the Council, voting by unanimity, with the European Parliament and the Economic and Social Committee relegated to a mere consultative role.⁴⁰ The substantive limits, however, present a significant difficulty for the Commission's new Action Plan. The provision requires the legislation for approval to be harmonising in nature, with a view to ensure the establishment and the functioning of the internal market and to avoid distortions to competition. It is unclear, however, as to how a proposal on the disharmonisation of VAT rates could qualify as harmonising in nature, and necessary for the establishment and the functioning of the internal market or to avoid distortions to competition.

Whilst the precise definition of harmonisation is unclear,⁴¹ the reference in Article 113 TFEU indicates that the legislator has favoured, what has been termed, a centralised constitutional approach to harmonisation,⁴² whereby the Union has the obligation to legislate to replace national laws that are incompatible with the aims of the integrated market, with harmonising EU legislation. Moreover, the use of the word “shall” in the beginning of the provision indicates that not only is the Treaty conferring competence on the Community to harmonise VAT laws, but that there is indeed an obligation placed upon the European institutions to do so.⁴³ The Union's competence in the field of VAT legislation is, therefore, limited to harmonising measures, and it lacks legal basis for the adoption of provisions for the disharmonisation, or – arguably – even maintenance of the status quo, of indirect taxation. The Commission's new Action Plan, on the contrary, intends explicitly to remove constraints on Member States; change the balance between harmonisation and Member State autonomy; and allow greater rate differentiation than the VAT Directive currently entitles, either through Option 1's extension of the list or Option 2's abrogation of

⁴⁰ See detailed analysis at R. de la Feria, fn.7, Chapter 1.

⁴¹ See D. Vignes, “The Harmonisation of National Legislation and the EEC” (1990) *European Law Review* 15, 358–374; P.J. Slot “Harmonisation” (1996) *European Law Review* 21, 378–397; and M. Dougan, “Minimum Harmonisation and the Internal Market” (2000) *Common Market Law Review* 37, 853.

⁴² Or a ‘mitigated centralised model’, see: R. de la Feria, fn.7, at 22-23.

⁴³ R. de la Feria, fn.7, at Chapter 1.

the list. Both represent different degrees of the flexibility that could be granted to Member States, which imply a reduction in harmonisation levels, even if harmonisation were to occur extrinsically.⁴⁴ This is particularly so in the case of Option 2, which would seek to impose the elimination of harmonising EU measures, and their substitution by national measures. Neither option could therefore be said to reflect provisions for the harmonisation of legislation concerning VAT. Any legislation would be, arguably, outside the EU competence, as set out in Article 113 TFEU.

This conclusion is further reiterated by considering the second substantive limit set out therein, namely that the legislation is aimed at *ensuring the establishment and functioning of the internal market and avoiding distortions in competition*. This limit to harmonising legislation permits an area of wiggle room for competition between legal orders, for uniformity of law in itself is not an objective, but can be justified by the necessity of a level playing field in the internal market.⁴⁵ In practice it means that, as it has been noted before, the Union's legislative competence on VAT, as it other areas, is to a great extent dependent and limited by the concept of internal market,⁴⁶ a term which is highly significant within the EU legal and political context, but which remains nonetheless uncertain in scope and meaning.⁴⁷ For the last 25 years, however, the CJEU sought to clarify the concept, in a line of case-law that started with the decision in *Titanium Dioxide*,⁴⁸ where the Court adopted a broad, and at the time controversial,⁴⁹ definition of the internal market, to include the elimination of distortions to competition – thereby sparking a common constitutional power struggle in politics of enumerated powers.⁵⁰ This decision was codified in subsequent Treaty amendments, and Article 113 now has the express addition of “avoiding distortions in competition” in its wording.

The landmark judgment in *Tobacco Advertising* followed just under a decade later.⁵¹ The case concerned a Directive on the approximation of the domestic laws relating to the advertising and sponsorship of tobacco products, adopted as a harmonising, internal market measure, which was disputed by Germany on the grounds of lack of competence. The Applicant (Germany) contended, inter alia, that the proposed measure created new obstacles to trade, and that measures “must actually contribute to the improvement of the internal market” if what

⁴⁴ As defended in R. de la Feria, fn. 41.

⁴⁵ As per former Advocate-General W. van Gerven, see: “Two Twin-Principles of EU Law: Democracy and Accountability, Consistency and Convergence” in U. Bernitz, J. Nergelius and C. Cardiner (eds.) *General Principles of EC Law in a Process of Development* (The Hague: Kluwer Law International, 2008), at 44.

⁴⁶ R. de la Feria, fn.7, at 14.

⁴⁷ G. de Búrca, “Reappraising Subsidiarity’s Significance After Amsterdam”, *Harvard Jean Monnet Working Paper Series*, WP 7/99, at 9.

⁴⁸ Case C-300/89, *Commission v Council*, ECLI:EU:C:1991:244.

⁴⁹ See J. Usher, “Case C-376/98, *Germany v European Parliament and Council (tobacco advertising)*. Judgment of the Full Court of 5 October 2000, [2000] ECR I-8419” (2001) *Common Market Law Review* 38, 1519–1543, at 1527 et seq; S. Crosby, “The Single Market and the Rule of Law” (1991) *European Law Review* 16, 451– 465; and R. Barents, “The Internal Market Unlimited: Some Observations on the Legal Basis of Community Legislation” (1993) *Common Market Law Review* 30, 85–109.

⁵⁰ The obvious example is the federal-state dichotomy in the US such as the Commerce Clause requiring definitions of what counts as commerce and inter-state, see for example: *Wickard v. Filburn*, 317 U.S. 111 (1942) at 125, 63 S.Ct. 82. Insofar as the EU is concerned see S. Weatherhill, “Better Competence Monitoring” (2005) *European Law Review* 30(1), at 23; and K. Mortelmans, “The relationship between the Treaty rules and Community measures for the establishment and functioning of the internal market – Towards a concordance rule” (2002) *Common Market Law Review* 39, at 1315.

⁵¹ Case C-376/98, *Germany v European Parliament and the Council*, ECLI:EU:C:2000:544.

is now Article 115 TFEU was to be used as a legal basis for its approval. The Court agreed, affirming recourse to that Article as a legal basis, “is possible if the aim is to prevent the emergence of future obstacles to trade resulting from multifarious development of national laws. However, the emergence of such obstacles must be likely and the measure in question must be designed to prevent them.”⁵²

Particularly significant in that case is also the preceding Opinion of AG Fennelly, in which a bipartite test was proffered in order to determine whether an EU measure pursued internal market objectives.⁵³ First, it must be ascertained whether the preconditions for harmonisation exist, that is, disparate national laws which either constitute barriers to the exercise of the four freedoms or distort conditions of competition in an economic sector; second, the action taken by the Union must either intend to eliminate those barriers or distortions.⁵⁴ The Court did not explicitly refer to this test but essentially followed the reasoning with a few additional qualifications. In *Tobacco Advertising* the above criteria were scattered throughout the judgment—and the Opinion—in a relatively unsystematic fashion, but the Court has moved towards a more consistently expressed formula in *Vodafone*.⁵⁵

These decisions provided not only some clarification on the internal market concept but, crucially also, on the limits to the use of Article 113 as a legal basis. As it follows from the decisions of the Court, that this provision cannot be equated with creation of a general power to regulate the functioning of VAT within the internal market. The legislative competences set out therein are exclusively to remove obstacles to the fundamental freedoms resulting from divergences in national VAT laws, or equalise the conditions of competition within the internal market insofar as VAT is concerned; any measure adopted thereunder must genuinely have as its object the improvement of conditions for the establishment and functioning of the internal market with the aim of preventing obstacles to trade.⁵⁶ It also follows from the decisions, read in conjunction with the Opinion of AG Fennelly, that the exercise of these powers necessitates the presence of two cumulative conditions, namely: the existence of disparities in VAT law that constitute barriers to the fundamental freedoms; and the intention of the proposed action to be the removal of those disparities. Pursuant to Article 113, therefore, the Council may only adopt provisions harmonising the VAT system, which have their centre of gravity in the removal of disparities in VAT law that constitute barriers to the fundamental freedoms or that create appreciable barriers to competition.

Action Plan

The legality of the most recent Directive on VAT rates, approved in 2009, is contestable. Indeed, to the extent that it resulted in an increase in disparities in national VAT rules,⁵⁷ it could be said to have fallen short of the substantive limits set out in Article 113 TFEU, and thus lacking legal basis for its approval. However, both options for reform of the EU VAT rates system now under consideration pursuant to the Action Plan go much further, allowing for a

⁵² *Ibid.*, at para 86.

⁵³ Opinion of Advocate General Fennelly in case C-376/98, *Federal Republic of Germany v European Parliament and the Council of the European Union*, ECLI:EU:C:2000:324, at para 93.

⁵⁴ R. de la Feria, (2009) fn.7, at 21.

⁵⁵ Case C-58/08, *Vodafone and Others*, ECLI:EU:C:2010:321, at paras 32–33. See also S. Weatherill, “The Limits of Legislative Harmonisation Ten Years after *Tobacco Advertising*: how the Court’s Case Law has become a ‘Drafting Guide’” (2011) *German Law Journal* 12, 827.

⁵⁶ T. Perišin, “Balancing sovereignty with the free movement of goods in the EU and the WTO” (2005) *Croatian Yearbook of European Law and Policy* 1, at 12.

⁵⁷ See further on this point, R. de la Feria, fn. 12, at 158 et seq.

significantly higher level of differentiation amongst national VAT laws. As such, it is argued that both options under consideration would, if pursued, result in legislation which would fall short of the substantive requirements set out in Article 113 TFEU, since neither would be, as follows:

- (a) an harmonising measure;
- (b) intended at removing current disparities in national VAT laws that constitute barriers to the internal market;
or
- (c) intended at removing distortions to competition caused by current disparities in national VAT laws.

In fact, quite the opposite: both options would result in disharmonising measures which would increase the disparities in national VAT law, likely to create further distortions to competition. Measures of this nature would therefore fall outside the scope of the legislative powers conferred upon the EU by Article 113 TFEU, and indeed outside the scope of the legislative powers conferred it by Article 115 TFEU, the legal basis normally used for the approval of EU legislation on direct taxes, but which, given its broad wording, there may be the temptation to use as a substitute legal basis. Since there are no other Treaty provisions that could act as legal basis for the of such legislative measures, approving EU legislation in line with the options presented in the European Commission's Action Plan falls outside the scope of EU competence, and would therefore be unlawful. Legislation that trespasses beyond the scope of the mandate conferred by the Treaty should not be adopted, and where the rules are infringed the legislation is susceptible to annulment by the Court.⁵⁸

IV. Conclusion

In 1985, when launching the Internal Market programme, the European Commission appealed directly to the political will of the Member States:

“What this White Paper proposes, therefore, is that the Community should now take a further step along the road so clearly delineated in the Treaties. To do less would be to fall short of the ambitions of the founders of the Community, incorporated in the Treaties; it would be to betray the trust invested in us; and it would be to offer the peoples of Europe a narrower, less rewarding, less secure, less prosperous future than they could, otherwise, enjoy. That is the measure of the challenge which faces us. Let it never be said that we were incapable of rising to it.”⁵⁹

Yet the political dynamics of tax policy are such that the instrumental nature of both EU legislation and CJEU jurisprudence is often forgotten, and the instrument becomes the end in itself. As Figure 1 illustrates, the Treaties establish a constitutional instrumental chain where the ultimate aim is the establishment of a European Internal Market. Approving EU (tax) legislation is not self-contained, as an end in itself, but an instrument to increase

⁵⁸ S. Weatherhill, fn.53, at 25.

⁵⁹ European Commission, *Completing the Internal Market – White Paper from the Commission to the European Council*, COM(85) 310, 14 June 1985.

neutrality and a level-playing field, thus establishing a true European Internal Market,⁶⁰ that will in turn result in increased welfare and economic growth.⁶¹

FIGURE 1: The EU constitutional instrumental chain



The Treaties, and principally Article 113 TFEU, do not confer upon the EU unlimited powers to legislate on VAT, but confer only the necessary powers to approve legislation that will further the establishing an EU Internal Market. Neither legislation intended at merely regulating the internal market nor legislation that will undermine the internal market by decreasing neutrality or the level-playing field, fall within the jurisdictional purview.

Regardless of any economic considerations on the potential negative effects of disharmonisation of VAT rates, the European Commission's Action Plan fails to acknowledge, by putting forward these proposals, the inherent constitutional constraints to which the EU legislative power is subject. The EU simply lacks the power to approve VAT legislation of the type being now considered. Furthermore, approving such legislation is not only unlawful, it constitutes a fundamental betrayal of the trust invested upon the EU institutions to offer the peoples of Europe a more prosperous future; for that is the challenge to which one should always aim to rise.

⁶⁰ The instrumental nature of the fundamental freedoms to the realisation of the internal market has been expressly recognised by the Court in case C-265/95, *Commission v France*, ECLI:EU:C:1997:595, at para 30; see also P. Caro de Sousa, *The European Fundamental Freedoms: A Contextual Approach* (Oxford: Oxford University Press, 2015), p.55.

⁶¹ R. de la Feria and C. Fuest "The Economic Effects of EU Tax Jurisprudence" (2016) *European Law Review* 41(1), at 42 et seq.