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INDIRECT TAXATION IN THE EUROPEAN UNION

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Indirect taxes are levied on the production and consumption of goods and services. They influence the retail price, and hence affect patterns of trade and consumption. Indirect taxes are ultimately paid by the final consumer. Sales and turnover taxes, excise duties and tariffs are the basic indirect taxes. In contrast with direct taxes, indirect taxes are seldom progressive. The principles for the levying of these taxes will be considered before the analysis of indirect taxes.

European Union, Indirect Taxes, Value-Added Tax, Excise Duties

Principles Of Destination And Origin

Tax authorities are aware of the possible impact that indirect taxes have on trade in goods and services. Therefore, they introduced a safety device in the form of the destination and origin principle for taxation. This is of great importance to those countries that integrate. According to the principle of destination, taxes on goods are applied in the country of their consumption. This is the norm accepted in the World Trade Organisation. However, according to the principle of origin, taxes apply in the country of their production.

The *destination principle* states that consumption of all goods in one destination should be subject to the same tax, irrespective of the origin of their production. This principle removes tax distortions on competition between goods on the consuming country's market. The goods compete on equal tax conditions. This principle does not interfere with the location of production. It is widely accepted in international trade relations even though it requires the existence of fiscal frontiers among countries. The problem is that this principle may give the illusion that it stimulates exports and acts as a quasi-tariff on imports. This issue will be discussed shortly.

The *origin* or *production principle* asserts that all goods produced in one country should be taxed in that country, despite the possibility that these goods may be exported or consumed at home. If the production tax on good X in country A is lower than the same tax on the same good in country B, then if exported at zero transport and other costs, good X produced in country A will have a tax advantage in country B's market over country B's home-made good, X. This introduces a distortion that interferes with the spatial location of production between the countries. For allocational neutrality, a harmonised rate of tax, between countries, is a necessary condition.

Even within a customs union or a common market, there may exist fiscal frontiers if the member countries accept the principle of destination. The fiscal authorities of each country should know where and when they are entitled to tax consumption of goods or services. The origin principle may have an advantage, for it does not require fiscal frontiers. This conserves scarce resources.

Taxes levied according to the destination and origin principles differ regarding their revenue impact. These two principles determine to which government the proceeds accrue. A full economic optimisation cannot be achieved if there are different tax rates levied on various goods. The principle of destination offers a chance for tax evasion that is unavailable (if the records are not faked) with the origin principle. If taxes differ, then a consumer may be tempted to purchase a good in the state in which the relative tax burden is lower and consume it in the country where the tax burden is relatively higher. Consumers may easily purchase goods in one country and send or bring them to another one, or order these goods from abroad. This tax evasion depends on the differences in taxation, cost of transport and cooperation of buyers and sellers who do not inform the tax authorities if they know that the objective of certain purchases is tax evasion. The revenue effect of a standard tax at a rate of 40 per cent in a country where tax evasion is widespread (for example, the 'olive-oil belt' or Club Med countries of the EU) may be much smaller than the revenue impact of the same tax at a rate of 10 per cent in the country where tax evasion is not a common practice.

Both the destination and the origin principles are imperfect. The destination principle for taxation is able to accomplish efficiency in the location of production, but not efficiency in trade. The origin principle has an inverse effect. If taxes are applied according to this principle, then trade may be efficient, but the location of production may not be efficient.

Sales And Turnover Taxes

Sales and turnover taxes are payments to the government that are applied to all taxable goods and services except those subject to excise duties. Turnover tax is applied during the process of production, while if the tax is applied during sales to the final consumer it is called a sales tax. There are two methods for the collection of the sales tax. One is the cumulative **multistage cascade method**, while the other is called **VAT**. Apart from these two multiphase methods for the collection of the sales tax, there is also a one-stage method, applied only once, either at the stage of production or at the wholesale or retail sales phase. The following analysis will deal with the multiphase methods.

Cumulative Multistage Cascade Method

According to the cumulative multistage cascade method for the collection of sales tax, the tax is applied every time goods and services are transferred against payment. The tax base includes the aggregate value of goods that includes previously paid taxes on raw materials and inputs. The levying and collection of this tax are relatively simple, the tax burden may appear to be distributed over a larger number of taxpayers and the rate of sales tax applied by this method is relatively lower than the rate applied by the VAT method. Firms may be stimulated by this method of collection of sales tax to integrate vertically in order to pay tax only at the last stage of the production process. This may have a favourable impact on the expansion of the business activities of firms (diversification). It may, however, cause a misallocation of resources. This artificial vertical integration may erode the advantages of specialisation and the efficiency of numerous SMEs if the vertically integrated firm ceases to use their output or if it absorbs them.

Value-Added Tax

This method of collection of sales tax is applied every time a good or service is sold, but it applies only on the value that is added in the respective phase of production, which is the difference between the price paid for inputs and the price received for output (hence, value added). The application of VAT starts at the beginning of the production process and ends up in the retail sale to the final consumer. VAT avoids double or multiple taxation in the previous stages of production (addition of value). Every taxpayer has to prove to the tax authorities, with an invoice, that the tax has been paid in the previous stages of production. Hence, there is a kind of self-regulating mechanism.

VAT based on the principle of destination is accepted in the EU as the method for the collection of sales tax. The method is harmonised, but there is a wide range of differences in the rates of this tax among EU countries. If the objective is to have a single rate of this tax, then there is considerable room for improvement in the future. The elimination of fiscal frontiers in the EU in 1993 and the creation of the Single European Market placed a certain market pressure on tax authorities to 'align' national VAT rates and prices, otherwise firms would lose business, in particular in the frontier regions. The creation of the eurozone (1999) and the introduction of the euro in circulation in 2002 added to this pressure. A White Paper (European Communities, 1985) proposed the setting up of the EU Clearing House System. Its role would be to ensure that the VAT collected in the exporting member country and deducted in the importing member country was reimbursed to the latter. The crucial feature in this system would play across EU bookkeeping and computerisation. This system would, in principle, create a situation for taxable persons within the EU identical to the one that prevails in the member countries. In spite of the potential benefits of such a tax system, it was criticised on the grounds that it would be bureaucratic and costly.

In practice, however, the existence of widely diverging rates of tax and tax exemptions may expose the system to the risk of fraud and evasion. The EU was aware that some fraud and evasion already existed, but the scale of such distortions after the removal of fiscal frontiers and the introduction of the euro would increase without tax harmonisation. Therefore, a minimum standard VAT rate of 15 per cent on most goods became a legal obligation in the EU from October 1992.

It is relatively understandable for Britain (as well as Ireland and Greece) to oppose this type of tax alignment since cross-border shopping is not a common feature in those countries as they have no common land frontier with the rest of the EU. However, for Austria, the Benelux countries, France and Germany, where cross-border shopping is common, it is easy to accept such arguments.

A move towards the origin principle (collection of tax during production) would require a system for redistribution of revenues (refunds) from the country where the goods were produced and taxed to the one where they are consumed. The effect of such a system would be as if the tax had been levied on consumption. Although there were concerns in some member countries because of the need to find alternative employment for thousands of customs officers, the fiscal frontiers between EU countries were removed in 1993. This was the most visible benefit of the implementation of the Single European Market. Consumers are now free to purchase goods in any EU country and bring them home with very few restrictions, provided that the imported goods are only for their personal consumption. There are, of course, exceptions, but only two: the purchase of new cars is taxed in the country of registration, while mail-order purchases are taxed either at the rate applying in the country of destination or at the rate in the seller's country (depending on the seller's annual sales volume in the country of destination).

Border tax adjustment without border controls was preserved in the EU.The former border controls were shifted by the interim system (introduced in 1993) to exporting and importing firms (centralised costs were replaced by decentralised costs in firms). The transitional system was extended in 1997 for an indefinite period, because EU countries were and still are unable to agree on the final shape of the VAT system based on the principle of origin. This system replaced time-consuming tax controls and payments at the EU internal borders with a demanding centralised reporting system carried out by the companies themselves. The final system will allow firms to pay VAT in the country of origin, as if all EU member countries were a single country. The burden of redistribution of VAT revenue will then fall on the member states. This would be advantageous to businesses as they would not have to differentiate between domestic and intra-EU sales. None the less, there will be two problems. First, a clearing house system will have to redistribute revenue around the EU as countries that export a lot will benefit from the system, while those that import a lot will lose. Second, the origin-based tax system will enhance the need for a higher harmonisation of VAT rates. In the meantime, the current transitory system seems to be operating quite well. This will, of course, be taken into account during the reassessment of the tax system.

This gradual approach was extremely difficult to implement. EU member states showed little enthusiasm in practice for the move towards the origin system. There is a reluctance to move towards a greater degree of harmonisation of VAT rates even though this is a precondition for the definitive system. Bearing in mind the potential and actual resistance concerning tax harmonisation, the European Commission has a patient long-term goal of origin-based taxation based on small steps, relating simplification, modernisation and administrative cooperation among member countries. Table 1. illustrates differences in VAT rates in the EU countries.The lower rates apply to food, clothing and other essential items. Portugal has lower rates in its autonomous regions. Ireland and Britain use the zero rate for food, books and children’s clothing. The other countries generally apply an exception with credit (which comes down to the same thing as a zero rate) to exports and supplies assimilated to exports, such as supplies to embassies, to ships leaving the country and the like. In Ireland and Britain these supplies are also covered by the zero rate.

The EU rules assert that goods should be taxed at between 15 and 25 per cent, except for a series of commodities that carry reduced rates. In order to simplify the EU’s maze of VAT rates, the European Commission proposed a plan (in 2003) that would require Britain and Ireland, which have zero VAT rate on children’s clothes and shoes, to apply VAT on these goods. Otherwise, this would distort the Single European Market. The British Treasury declared that it would use the veto to block this plan if necessary as one of the election promises was to keep a zero rating on these goods. A broad-based VAT can be criticised on the grounds that it is regressive. The reason for the regressive impact of VAT in the EU can be found in the structure of national demand. Consumption to which VAT applies usually embraces a relatively higher proportion of the GDP in the less-advanced member countries than in the richer ones. Other components of demand, such as investment, which is presumably higher in the more advanced countries, are not burdened by VAT.

Table 1. VAT rates in the EU countries

Member states	Super reduced rate	Reduced Rate	Standard Rate
Belgium	-	6	21
Bulgaria	-	7	20
Czech Republic	-	5	19
Denmark	-	-	25
Germany	-	7	19
Estonia	-	5	18
Greece	4.5	9	19
Spain	4	7	16
France	2.1	5.5	19.6
Ireland	4.4	13.5	21
Italy	4	10	20
Cyprus	-	5/8	15
Latvia	-	5	18
Lithuania	-	5/9	18
Luxembourg	-	6	15
Hungary	-	5	20
Malta	-	5	18
Netherlands	-	6	19
Austria	-	10	20
Poland	-	7	22
Portugal	-	5/12	21
Romania	-	9	19

Slovenia	-	8.5	20
Slovakia	-	10	19
Finland	-	8/17	22
Sweden	-	6/12	25
United Kingdom	-	5	17.5

Excise Duties

Excise duty is a type of indirect tax that is levied for the purpose of raising public revenue. It is applied in almost every country to tobacco, spirits and liquid fuels. While the VAT is proportional to the value of output, an excise duty may be based either on the *ad valorem* principle (retail or wholesale price) or it may be a specific tax.Within the EU, tobacco products are subject to both. There is a specific tax per cigarette and an *ad valorem* tax based on the retail price of the cigarettes concerned. There is a wide variety in charges that come from excise duties among the countries. This difference is due to the various choices of fiscal and health authorities. If the difference in excise duties among countries exceeds the costs of the reallocation of resources or transport, it will have a distorting effect on the geographical location of resources or pattern of trade. The difference in the excise duty on 1000 litres of petrol of €210 between high-duty Germany and low-duty Austria is significant when one bears in mind that it costs just a few euros to transport this amount of fuel by pipeline. The VAT is calculated on the price of a good that includes the excise duty.

Any change in the excise duty will produce differences in the VAT revenue. Hence the need for a certain harmonisation of excise duties too. In the US, each federal state has its own liquor duty. Liquor and cigarettes should bear the national tax authority stamp. Only the nationally stamped goods can be purchased legally within a state. Import for personal consumption is unlimited, while bulk intra-EU commercial transport and trade in these goods without the proper tax clearance is forbidden and punishable. The harmonised rates proposed by the European Commission should be viewed only as a yardstick, as it would be extremely difficult to try to unify excise duties throughout the EU member countries.

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