TAX HARMONIZATION WITH RESPECT TO FUTURE NEW MEMBERS OF THE E.E.C.*

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My preceding paper, "Need and Prospects for Tax Harmonization among the Present Six Members of the E.E.C.", was devoted chiefly to general sales taxation and the harmonization measures to be taken by countries who are already members of the E.E.C. The present paper starts with some observations on tax harmonization with respect to excise taxes, income taxation and payroll taxes, and goes on to consider the particular problems of tax harmonization that are faced by future new members of the E.E.C.

I

Excise taxes on luxuries and on alcoholic beverages and tobacco are imposed at widely differing rates in different countries. These differences in tax rates reflect differences in social attitudes toward the consumption of luxuries and the consumption of what I shall call "addictives", that is, alcohol and nicotine. The question now arises, should a common market take the position that these differences in social attitudes should not be allowed free play in the tax system, but should be put to one side so that excise tax rates might be made uniform?

If this is attempted, so that cigarettes, for example, would be taxed at the same rate in all member countries, beer at the same rate in all countries, and so on, the origin principle could be substituted for the destination principle that is now universally in use. Exports would be taxed instead of being exempted, as they now are, and imports would be free instead of being subject to a compensating import tax. So border

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controls would be needed for the excise taxes, as between member countries.

Such a régime would accord well with the spirit of a common market. But we may ask whether this advantage would be purchased at too high a price, since it would ignore the differences in social values among the member nations, differences that reflect fundamental attitudes towards the individual and his place in society. These differences are often large, arising from opinions firmly held. They are historical products of differing paths in social evolution.

The answer will probably not be the same for the short run of ten or twenty years as for the long run of, say, several decades. In the short run the differences in social attitudes toward luxuries and addictives will be decisive, and each excise tax will probably continue to be imposed at different rates in different countries. The destination principle will be retained, and border control will continue to be necessary. But over a long run of several decades, the increasing mobility of workers and capitalists and entrepreneurs within the common market will tend to reduce these differences of social attitude. Eventually it may be possible for the member countries to agree on a uniform, market-wide tax rate for any one commodity. The origin principle may then be adopted, and border control, at least as between contiguous countries (I take up this matter below) removed.

This conclusion suggests that, because of these excise taxes, there will be pressure to move to an origin basis for the general sales taxes, as discussed in my preceding paper. If border controls must be retained for decades, in any event, because of the excise taxes, the reduction in such controls that would be possible by moving to the origin basis for the general sales taxes would be correspondingly smaller.

II

The corporation income tax poses a quite different problem in harmonization. It is not the issue of the destination principle versus the origin principle, for, as I stated in my last paper, the origin principle is universally employed for the income tax; exports are not exempted from the income tax; no compensating tax is imposed on imports. Instead, the issues are the following. First, shall the member countries agree to impose the

corporation income tax on the basis of residence, or the basis of source? Second, shall the rate of the tax be uniform throughout the common market?

Under the source basis the income tax strikes all income originating in the taxing country, including income flowing to investors residing abroad, but does not strike income of residents that they receive from investments abroad. This source basis is used by certain less developed countries where the tax administration is not sufficiently strong to compel wealthy residents to reveal how much income they are earning on their investments abroad.

Under the residence basis the income tax applies to all income, wherever earned, of all residents of the taxing country, but does not reach the income of non-residents, even though it arises within this country. No country employs the pure residence principle, but most of the industrialized nations use it in a modified form. They allow a credit against their tax for tax paid abroad on income arising abroad. And they also commonly impose a moderate, flat-rate tax on income originating in the country that flows to non-residents abroad. Thus what purports to be a residence basis tax bears a close resemblance to a source-basis tax, with this important exception: the tax does reach income earned abroad by residents in so far as that income is not taxed by the country in which it originates.

If two countries, A and B, impose income taxes, and if A taxes on a pure residence basis and B on a pure source basis, an investor living in B and investing in A will pay no income tax at all. An investor living in A and investing in B will pay two income taxes. These anomalies of course cannot be allowed to exist in a common market, since they would distort the flow of capital and the residence of capitalists. In practice, as I have noted, these anomalies are not apt to exist in this extreme form; all the countries of the E.E.C. employ the residence basis, in a modified form. Nevertheless, some adjustment of the present systems may be required, since there are a number of differences, from country to country, in the provisions for crediting tax paid abroad and for taxing income arising in the country and flowing abroad. Crediting provisions and tax treaties will require some change.

The second issue, shall the corporation income tax rate be uniform throughout the common market, is even more important. As mobility of capital within the market becomes greater, through improvements in the

capital markets, and dissemination of knowledge about investment opportunities, differences in corporation income tax rates will affect the allocation of capital more readily. This fact will increase the temptation for any one country to lower its corporation income tax rate in order to attract capital and increase its rate of growth, at the expense of the other members of the community. The Treaty of Rome says nothing about this.

The problem is complicated by two other facts.

First, the real burden of the corporation profits tax can be lightened considerably by provisions for accelerated depreciation, investment credits, and similar devices. What may appear to be a nearly uniform market-wide corporate tax rate may turn out to be a number of disparate rates (on this point, see Peggy Musgrave, in her contribution to the second volume of the two-volume work edited by me, Fiscal Harmonization in Common Markets, published by the Columbia University Press in 1967).

Second, the countries differ in the treatment they give to distributed profits relative to retained profits, and an investor who is deciding in which country to take up residence will take into account not only the corporation income tax but also the personal income tax treatment of dividends. For example, Germany reduces the corporation income tax rate considerably on that part of the profits that is distributed to domestic shareholders, and France has been allowing similar tax relief, but at the shareholder level, through a tax credit on account of corporate tax paid on the distributed profits.

In summary, there are many ways, some of them difficult to compare readily, by which the flow of capital within a common market can be influenced by the corporation income tax. The members of the E.E.C. may find it necessary to reach a somewhat more formal agreement on limiting the tax concessions they offer to capital, if they are not to find themselves giving tax revenue away in a competitive struggle for corporate investment.

III

The same remarks apply, but with less force, to the investment undertaken through partnerships and sole proprietorships. Such capital is less mobile than corporate capital, partly because it goes chiefly into farming and in construction of dwellings or office buildings, where close supervision of the business by the investor himself is usually necessary;

in fact he usually operates the business, alone or with partners. If a French capitalist is to invest in farming or construction of a dwelling or office building in Germany, he may have to move to Germany, at least temporarily, to supervise the activity. In any event, it seems hopeless to attempt uniformity of tax rates in these cases, since the particular personal income tax rate applicable will depend, in view of the progressive rate scales, on how much total income the individual has from all sources. Finally, the individual investor will not reduce his tax unless he takes up permanent residence in the lower taxing country, as long as the modified residence basis is used. All in all, labor is not apt to flow from one country to another in large amounts just because the rates of personal income tax differ.

The differences in rates of payroll tax, however, are so great that labor might indeed be influenced to change residence, were not these taxes linked to social security benefits. Since they are so linked, a higher payroll tax may mean merely that the wage payment is being deferred —and perhaps ultimately increased — to take the form of a higher old age retirement payment. Again, the Treaty of Rome offers no explicit guideline on this.

IV

Let us now consider which of these issues of tax harmonization are likely to be the most important for countries that are not yet members of the E.E.C. but that are applying for membership, or are considering doing so.

The answer, if we are to judge from actions already taken by such countries, and by the discussions that are developing within them, is that harmonization of the general sales tax is of overwhelming importance. Denmark has already adopted a comprehensive value-added tax of the type that now exists in France and Germany. The United Kingdom is discussing seriously whether they should replace their corporation income tax, or perhaps their selective employment tax, by a value-added tax, to facilitate entry into the common market.

But I am not sure that this issue is as important for the countries not yet in the E.E.C. as it has been for the original six members. The problem that those six countries faces was that five of them were levying the old-fashioned turnover tax (cascade tax), while France was using the modern

value-added tax, although restricted to the manufacturing level (optional for wholesalers) and not including services. These two types of general sales tax are especially incompatible for a common market, because of the problem of estimating the proper export rebate and proper import compensating tax under a cascade type of tax, relative to the much simpler problem of estimating these amounts under a value-added tax. Moreover, the cascade type of tax favours vertically integrated concerns (and also favours value-added at a late stage, for example retail value-added), and these kinds of hidden subsidy to certain ways of doing business are not in the spirit of a common market, especially when they are not employed in all the member countries. For these reasons alone, as well as others mentioned in my last paper, there has been strong pressure on the cascade-tax countries to repeal that tax. The most suitable replacement seems to be a value-added tax, though in some quarters there has been support for a manufacturers single-stage tax, or a wholesalers tax.

In contrast, few of the countries now applying for membership of the E.E.C. employ the cascade type of tax, the turnover tax. They levy either a single stage tax at the wholesale or manufacturing level, or a retail sales tax, and these taxes resemble the value-added tax in the ease with which proper tax exemptions or rebates can be given upon export, and proper compensating taxes, if any are needed, can be levied upon imports. They do not favour vertically integrated concerns. They do indeed (except for the retail sales tax) favour value that is added at the retail stage, by not including it in the tax base, and this may be important socially, since many of the luxuries that the wealthy purchase are heavily loaded with lavish retail services. But I doubt that this latter fact alone will be sufficient to induce a changeover to a value-added tax. This is not to say that a value-added tax would not be a good thing for these countries; undoubtedly tax harmonization would be more nearly complete if a value-added tax or a retail sales tax were used.

There is still another reason why harmonization of general sales taxes, though desirable, is not as important for most of the prospective members as it has been for the original six. This is the matter of contiguous borders, Border control, we recall, can be abolished between these six, if they can first make their general sales taxes uniform and then move to an origin basis, taxing exports and exempting imports. But what if no part of the border of one sountry touches the border of the other country? Both coun-

tries must then still retain the apparatus of border control, in order to check all incoming shipments to ascertain whether any one shipment is from a member country or from a country outside the common market. If it is from a country outside the common market it will have to pay import tax; if it is from a member country it will be admitted free (under the origin principle). Similarly, as to exports, if an export is destined to a member country there will be no tax refund (under the origin principle) but if it is destined to a non-member country there will be a tax refund (destination principle), hence each export must be checked to make sure where it is going. If the two member countries are joined by a common border, there is no need to check each export, since every export that crosses this border of course goes, at least in the first instance, to a member country, and so gets no tax refund (under the origin principle). And each import obviously comes from a member country. The border control that was in effect under the customs duties and the destination principle sales tax can be abolished under the origin principle sales tax, provided the countries are contiguous. border control must be retained.

It so happens that most of the countries that are prospective future members of the E.E.C. do not have any border of either the existing E.E.C members or those two prospective members. For such countries, there is little or no likelibood that harmonization of sales taxes even to a uniform rate on the origin basis will gain anything in the form of removal of border controls.

There may be some temptation for new members to impose a high-rate general sales tax, if they do not already have one, on the argument that, as long as the destination principle is kept - and that is likely to be for a good many years, as we have seen, exports will be encouraged, by the rebate of taxes upon exportation, and imports discouraged, by the compensating tax on imports. The country thus hopes to improve its balance of trade. But this argument is often not correct; it all depends on what tax the general sales tax replaces. The argument probably is correct, technically, if a general sales tax (destination principle) is levied to replace a payroll tax, which by its nature is levied on the origin basis (no refund of payroll taxes is made when the goods produced by the taxed labour are exported, and no compensating payroll tax is imposed on imports). The argument is probably, though less certainly, correct, if the sales tax is levied to replace a corporation income tax, or, say a

real estate tax. But what the change amounts to, then, is a disguised devaluation of the currency, for trade purposes (it does not, of course, affect financial flows). I question the political wisdom of a disguised devaluation of say 5 or 10 per cent, would it not be preferable to obtain the consent of the other nations to an open devaluation affecting both trade and financial payments?

This temptation, as I have termed it, is not restricted to prospective member countries. But it is stronger when a country is considering tax revision because it is thinking of joining a common market, and when the virtues of the value-added tax, which are very real indeed, are pictured as being simultaneously a road toward a trade surplus.

As more and more new members are added to the common market, the average distance between their marketing centers increases, and this fact has some implications for use of the origin principle (exports taxable, imports exempt). We recall that under the origin principle the domestic import-competing firms in the countries with high rates of general salex tax will be in an unfavourable competitive position because of this tax. Imports, subjected only to the tax of their country of origin, will compete with domestically produced goods that pay the high domestic tax rate. But this tax disadvantage may be limited by differences in transportation cost. The importers will have a tax advantage, but if the distance is too great, the domestic producers may be fairly well protected after all, and at least are not likely to lose all their trade to imports. This relation of transport costs to tax differentials is a subject worthy of further study. An interesting beginning has been made by William McNie in his contribution in *Fiscal Harmonization in Common Markets*. For the time being the subject is of limited practical importance, since the origin principle, as we have seen, is not likely to be adopted by countries that are close to each other until their value--added tax rates are nearly uniform. But when, if ever, uniformity is achieved, a geographical broadening of the common market make tolerable slightly larger differences in saes tax rates, owing to transport costs.

V

The corporate income tax, on the other hand, is in my view a most important subject for tax harmonization on the part of those countries who are considering entry into the common market. To take an extreme case, if the existing corporate income tax in the United Kingdom were

repealed, in order to find room for a value-added tax in their tax system, the net result would be tax disharmonization, not harmonization. The United Kingdom would then be the only country without a corporation income tax, and would gain a competitive advantage, at least for certain forms of investment.

On the other hand, capital may not be as mobile between the present six members and certain of the non-member countries as it is within the six. To this extent the need for harmonization of corporate income taxation is somewhat less. But no general statement seems possible on this score; it all depends on the circumstances of the particular country, its capital market, the investing habits of its capitalists, and the like.

One technical problem in this area is the treatment that each country gives to foreign capital coming from countries outside the common market. Capital flowing from the United States, for example, may go to any one of the six member countries, or to countries not yet members but applying for entry, and some measure of uniformity of treatment of the profits, royalties, interest, and rentals arising from such third-country investment may be necessary in order to avoid charges, recriminations, and even retaliation by some member countries (or applying countries) and others. The problem is mitigated by the credit granted by the United States for foreign tax paid, but it is not entirely solved.

If some of the countries desiring entry are less developed than the existing six, the former may want to be allowed to offer concessions in the form of tax holidays, highly accelerated depreciation, and similar devices, to spur economic growth, in excess of what the more developed countries allow. Perhaps the latter will readily agree that some such tax favouritism will be allowable. It would be a matter for negotiation among the countries before entry was agreed upon.

VI

Differing degrees of tax evasion may easily hinder attempts to harmonize tax systems. A general sales tax, for instance, may be levied at the same rate in several countries, but this uniformity will only be apparent, not real, if in one of the countries tax administration is so lax and inefficient, and taxpayers are so inclined to evade, that the amount of revenue actually collected is a far smaller percentage of actual sales than the tax rate alone might indicate. The firms in the tax-evading country then have

an unfair competitive advantage over those in the country where the tax rate is no higher, but the tax is strictly enforced.

This point is of some importance already, with respect to the existing six members of the E.E.C, and studies have been undertaken to ascertain, if possible, the importance of the differences in evasion. Of course this is a very difficult subject to obtain any data on, since the tax evaders are careful to keep this information to themselves. But it is sometimes possible to compare the aggregate tax base as indicated by the tax collections with the true tax base as shown by national income data or other compilations, that may obtain their information from other sources, perhaps by sample surveys, or by deducing the aggregate value from the relations of certain other aggregates in the national income accounts.

As membership of the E.E.C. expands, the likelihood of differences in degrees of tax evasion grows. Some of the new member countries may have tax administrations that are even more efficient than any of those of the initial six; others may be experiencing a rate of evasion higher than that in any of the six. It is with these latter countries that the chief problem arises, and it is not an easy one to solve.

One solution, not a very good one, is simply to admit that degrees of evasion will always differ markedly from one country to another, and to allow for differences in tax rates that may be supposed to compensate for those differences. This procedure has little attraction for tax harmonization unless all taxpayers are evading the tax to just about the same degree. And this is not likely to be the case. Imports, for example, may well be taxed more efficiently than domestic production; the destination principle then imposes an unfair disadvantage on the other members of the common market, whose firms seek to sell in the market of the country in question. Foreign firms may be more closely supervised, under the income tax, than domestic firms - or vice versa. If the origin principle were adopted for the sales tax, a country that imposed a high tax rate might nevertheless gain a competitive advantage in another member country, if this high tax rate were associated with a high degree of tax evasion.

In practice, I believe that these differences in degrees of tax evasion are likely to be one of the most difficult problems, if not the most difficult problem, in achieving tax harmonization, and I suggest that any country that wishes to enter the common market would find it useful to

analyse its existing methods of tax administration to seek means of improvement: It might also want to consider the possibility of joining with the other member countries in setting up an international exchange of information on taxpayers, incomes, holdings of assets, purchases, and the like. For this purpose a Common Market Tax Administrators' Association might be formed, to hold annual meetings, to set up study committees, and to learn from each other new techniques of checking tax evasion. The recently formed Inter-American Tax Administrators Association, which held its first meeting last year in Panama, and which includes virtually all the countries in North America, Central America and South America, is a path-breaking venture that may experience a degree of success unexpected by even its most optimistic supporters. A similar organization within the E.E.C. would be especially useful if the number of member countries increases.

If one member country — entirely apart from tax evasion — takes a much smaller proportion of its gross national product in taxation than does another, the higher-taxing country may complain that it is thereby at a competitive disadvantage within the common market, where capital, goods, and even some labour flow freely within the market. The merits of this allegation I shall consider below. Here, I note that as the E.E.C. brings in new members, the disparities may or may not increase, but in some instances certainly can increase beyond what they are now.

According to the Neumark Report (p. 106, IBFD translation), the ratio of taxes to gross national product in the six E.E.C. countries in 1959 ranged from 24.6 per cent (German Federal Republic) to 17.6 per cent (Belgium). France and the Netherlands were close to Germany, with 23.8 per cent and 22.0 per cent respectively. This range is not great enough to cause much concern with respect to competitive advantages, and, as I shall note shortly, these advantages may not be very large in any case, when we consider that higher taxes usually mean a higher level of free government services.

These percentages are much higher in every case if social insurance contributions are included. The range for 1959 is then from 34.3 per cent (Germany) to 24.4 per cent (Belgium), France being 33.4 per cent and the Netherlands 30.0 per cent. But the social insurance contributions are more or less matched by the benefits paid out, and the combination of social security taxes and social security benefits makes it possible for the employing firms to reduce the take-home pay of their labour force, more

or less correspondingly. Therefore, even if one country had far higher social insurance taxes and benefits than another, it would probably not be appreciably disadvantaged thereby. In fact, it appears from the figures above that the differences in this respect are not great. The range in percentage points of taxes to gross national product is 7.0 points if social insurance contributions are excluded, and 9.9 points if they are included.

Some of the countries considering membership in the E.E.C. raise a smaller total of gross national product in taxes than do any of the present six members. Probably none raises a higher percentage. The problem, if there is one, therefore arises from the low percentage of gross national product taken in taxes by some potential new members.

I do not myself consider that this is an important problem from the viewpoint of tax harmonization. To be sure, it does imply that the rates of tax are lower in the country with the low percentage of taxation to gross national product. But this fact in turn usually implies that the government is supplying a lower of services to households and to business firms, and from that point of view the business firms in this country suffer a competitive disadvantage. They do not obtain as much protection against fire and theft, for example, as do firms in the higher-taxing countries. They do not have as good an infrastructure - highways, docks, and communications systems, for example (I recall one observer remarking that the capital markets of many of the European countries could never hope to become as broad and active as those of the United Kingdom and the United States until the telephone systems were radically improved). On the other hand, if the high percentage of taxation to gross national product results chiefly from large expenditures on a military establishment, that country's firms are indeed at a competitive disadvantage. Such a country is poor, in the sense that so much of its gross national product must go to a totally unproductive use (military expenditure). If the billions of dollars that the United States has poured into its vast military establishment over the past two decades could have been spent for education (thus increasing the degree of skill and efficiency of its labour force), more highways and better ports (thus lowering the cost of transport), and the like, the competitive position of American firms in the world market would have been enormously enhanced. Our competitors may well be thankful, from the narrow competitive point of view, that we have diverted so much of our resources into what is a holding operation at the best, not an efficiency-increasing operation

(aside from the relatively minor fall-out of technical improvements traceab to military efforts).

In the last analysis, then, the ratio of tax revenue to gross national product tells us little about the competitive position of the various countries. Much depends on the nature of the government services that are rendered. Indeed, a case can be made for the following proposition: the larger the percentage of gross national product taken in taxes the better is the competitive position of the country in the markets of the world, for, aside from expenditures on the military establishment, the higher percentage usually implies a higher level of literacy (more money is being spent on education), a finer network of transportation and communication, and so on. No industrial nation has ever been built on a foundation that included low levels of literacy, since industrial workers must be able to read complex instructions — and sometimes write them — and must have the habits of precision of thought and action that literacy does so much to promote. Parenthetically, I believe that if free postal service were granted to all households for letters and postcard — the resulting postal deficit to be made up by increased taxes on the more well-to-do part of the society — the level of literacy of many countries would be greatly improved, as adults would sieze the opportunity to communicate with friends and relatives, and thus sharpen their abilities to read and write.

To pursue this side of the subject farther, however, would take us away from the subject of these two lectures, tax harmonization, into the as yet largely unexplored field of expenditure harmonization (but see the contribution by Norbert Andel in *Fiscal Harmonization in Common Markets*).

VII.

The concluding remark that I should like to make with respect to prospective future members of the E.E.C. and tax harmonization is that tax harmonization is, among other things, a state of mind, which is to be evidenced in a willingness to abstain from changing a country's tax system unless the change is in harmony with the objectives of the common market. This is only a general prescription, not at all specific, as I have worded it. But it has a definite practical meaning. It means that a prospective country will consult with the existing E.E.C. countries and with the other prospective member countries before it undertakes any substantial change in its tax system, to ascertain whether from their point

of view this change would contain elements inimical to the progress of the common market.

This is not to say that the prospective member country should yield its sovereignty in this field. It may, after all, decide to go ahead with the change in the tax system even if it finds that the member countries and prospective members consider it incompatible with the aims of the common market. Of course if it does so, it reduces thereby the likelihood that it will eventually enter the market. But be that as it may, prior consulation would seem to be the minimum requisite for any country that is taking seriously the prospect of entering the common market.

One difficulty with this prescripion is that the machinery for prior consultation may not have been set up. The country in question may not have a tax policy office or division, which can give careful consideration to tax reform proposals and prepare a statement to be given to the member countries and prospective members. The other prospective member countries may be in the same position. The six E.E.C. countries, thanks to their able and extensive secretariat in the public finance field, at Brussels, are reasonably well equipped to enter into discussions of this prior-consultation type, but even they may find it advisable to expand these facilities.

In effect, I am suggesting that on the policy level there be established an international, or at least inter-member (and prospective member) organization, more or less formal, to hold harmonization discussions on the policy level analogous to the discussions that would be held on the administrative level by a body of inter-member tax administrators. This body would consist largely of economists speecializing in public finance. Meeting fairly regularly, though not too often, they could anticipate and avert some of the problems that would otherwise be considered too late. And of course the tax economist and the tax administrators should be continually in touch with one another, since harmonization is an intricate mixture of principle and practice. The new future members of the E.E.C. have much they can contribute in these ways to a better understanding of a problem that is one of the most significant of all for the success of a common market.