Fiscal Discord & 1992

INTRODUCTION

This paper provides a cursory overview of the current initiative to remove fiscal barriers between EC nations. It is divided into four sections. The first of these examines the rationale behind the programme to bring about fiscal harmonisation. Section two looks briefly at some of the difficulties which have been encountered during the implementation of this programme. The third section examines what progress has been made. Finally,section four adopts a longitudinal perspective in high-lighting the significant role that confidence and expectations will play in determining the ultimate outcome of the programme.

WHY FISCAL HARMONISATION?

To ensure the proper operation of the aggregate market envisaged by the EC in its 1985 White Paper, 'Completing the Internal Market', all factors which cause distortions of competition and artificial price differences between Member States need to be dealt with. These factors can usefully be classified under the headings of physical, technical, and fiscal barriers. It is with the third of these that this paper is concerned.

As Colchester notes, 'Customs posts are, above all, a matter of tax'(1988:12). Whenever goods are moved from one country to another, they are elaborately documented at the border so that the relevant fiscal authorities can collect the VAT and excise duties to which they are entitled. These frontiers create debilitating compliance costs and hence promote inefficiency. The Commission estimates the opportunity cost of customs formalities to be close to 12 billion ECU (IRú9.3 billion) per annum. This is why, as Colchester notes, of all the problems of creating an open market, the tax issue was the one on which the White Paper lavished most attention.

If fiscal frontiers are to be removed, we must ask ourselves what purposes they serve, how many of such purposes need to survive, and how those that need to survive can be otherwise achieved when frontiers are removed (Periodical 4/1987:49).

Fiscal frontiers serve two main purposes. Borchardt writes that these controls serve 'to ensure that less heavily taxed imports which could undercut home products gain no unfair competetive advantage'(1987:35). Secondly, they have a significant role to play in the fight against fraud and evasion.

Indirect taxes act as a levy on all commodities that enter consumption. The present system of indirect taxation in Europe is designed to ensure that this is what occurs when goods are traded internationally. Suppose that Irish goods are exported to Germany. It is the German consumer who should bear the tax, not the Irish manufacturer. Under the current system the desired result is achieved by the Irish government refunding the tax to the Irish exporter, and the German customs authorities collecting the tax from the importer. The importer then passes the duties down along the tax line to the final consumer. The operation of this system depends crucially on the existence of fiscal frontiers.

The scope for fraud and evasion in the absence of frontier controls is obvious. If goods were not checked at borders, it would be easy for traders to invoice goods as zero-rated for export. They could then sell them at home and either undercut their competitors or pocket the tax element themselves. However, the presence of fiscal frontiers ensures that all goods that are zero-rated are accounted for.

Thus it is clear that, although the existence of frontier controls promotes major inefficiences,their absence would promote even greater distortions under the present system of taxation. Hence the desire for fiscal reform and harmonisation.

The EC White Paper proposes that sales and purchases across national borders be treated in exactly the same way as domestic sales and purchases. Far from being a radical proposal, this is exactly what was set out in article four of the very V.A.T. directives of 1967.Three of the major perceived advantages of such a procedure would be:- (i)International trade would soon become a natural way of expanding indigenous business.(ii)Fiscal administration for traders and national authorities would be greatly simplified, and compliance costs significantly reduced.(iii)A major incentive for fraud and evasion - zero-rating of goods for export - would be eliminated.

However, such a system would not of itself allocate tax revenues correctly between member states. It would also leave scope for other forms of fraud and/or evasion besides zero-rating, especially unregistered trading. 'In the absence of any frontier controls, significant price differences resulting from differences between indirect tax differences on each side of any border would provide an irresistible incentive for those in highly taxed countries to provision themselves in the low-tax country next door' (Periodical 4/1987:52).

In answer to the first of these problems, the Commission proposes the establishment of a clearing mechanism, such as that operated by the banks and airlines. Balances could be settled between nations on a daily, weekly or monthly basis.

In answer to the second problem, the commission proposes the reduction of disparities between member states' tax rates to the point where they no longer provide an incentive to the diversion of trade. Note that this does not necessarily entail complete uniformity. The experience of the U.S., where the spread of sales tax rates across all states is 9%, shows that contiguous states can maintain differences of up to 5% without significant distortionary effects. This was the rationale behind the decision by Cockfield to aim for a spread of 5% in the White Paper targets for the eventual VAT levels.

Why was it that the Commission decided to pursue pre-emptive harmonisation rather than to allow market forces bring rates into line? One reason was that the Commission feared that those countries with high rates would refuse to lift their fiscal barriers because of the large revenue loss that such action would entail. This issue of revenue loss is returned to below, but it should be noted that in going for 'active' harmonisation, the Commission made a departure from its general 1992 tactic of 'getting members committed to a simple-sounding goal, chivvying them towards it, and letting them cope with the consequences later

But in practice the removal of fiscal barriers has proved to be the thorniest of all the proposals which Lord Cockfiekd's White Paper contained. Colchester was prompted to write that, 'There is no issue like tax to show how the good intentions behind 1992 are running into the sands of sovereignty'(1988:12). What are the difficulties which have been encountered? In regard to VAT, part of the problem is theoretical. The governments of the E.C. insist on collecting VAT on the full value of something acquired on their territory - even if most of its value was added elsewhere in Europe. This makes the market much harder to unify. But what is perhaps more significant is, as was already mentioned, the potential revenue loss facing those governments in the Community which levy the higher rates of VAT. The Irish government is a case in point. Already it and its Danish counterpart have 'illegally' restricted the standard EC tax-free allowance of 350 ECUs to genuine' travellers. Finance Minister Albert Reynolds has indicated that the harmonisation of EC tax rates could cost the Irish exchequer IRú600 million, equivalent to 3% of GNP. The corresponding figure for Denmark has been put at 6%.

The divergence in member states' excise rates has proved to be an even greater problem. The Commission came up with a list of fixed compromises that would alter the price of alcohol, tobacco and petrol significantly. Various countries have posed objections to this list. For example, the British government feels that such compromises constitute bureaucratic meddling, and insists that it will maintain its own high rates on drink and tobacco for health reasons.

This reflects the fundamental basis of excise duties. There are certain goods for which the individual consumer's preferences may not reflect what is actually best for him or her (e.g. alcohol, tobacco). Levying heavy excise taxes on these goods is, thus easily justified. The problem arises when different governments adopt divergent views regarding what is an appropriate excise levy on a particular good.

However, this argument concerning the social consequences of reductions in excise duties is only half the story. Some goods on which excise taxes are levied,such as petrol and motor vehicles,obviously do not manifest the same consumer welfare characteristics as, say, tobacco and alcohol. Ironically it is these 'other' goods which are proving to be more of a stumbling block. Objections from France and Italy to the introduction of a common excise duty on motor vehicles caused the plans to be dropped in 1989.

Other difficulties have been encountered. The clearing-house plan is viewed by many to be untenable. Both France and Britain favour more reliance on market-driven convergence. Furthermore, a community-wide trade policy towards the rest of the world, which would be the inevitable consequences of a custom free Europe, would directly contravene article 115 of the Treaty of Rome, which allows individual member states the right to protect their own trading interests. This implication has to date been largely sidestepped, underlining the Commission's admittance that, so far as 1992 is concerned, 'Foreign trade is an unopened book' (Colchester,1988:23). Finally, the real motivating force behind fiscal harmonisation, Lord Cockfield himself, has now stepped down to be replaced by Mrs. Scrivener, a capable tax commissioner who nevertheless lacks the dogmatism and charisma of her predecessor.

It is these and other issues which justify some of the current cynicism about 1992.

A CAUSE FOR OPTOMISM

But only some of it. At the current juncture, it is still unclear whether EC citizens will be able to bring as much as they want across community borders by 1992. The implementation of a completely fraud-proof VAT system has been postponed until at least 1996. And individual governments are manifesting a certain tardiness in implementing those proposals which have been adopted concerning the internal market.

Yet progress has been made. As Flynn notes:

'The past year was one in which the relentless momentum towards 1992 managed to sweep aside many of the rules which inhibit free and open competition' (Irish Times, 1989).

The recent agreement by EC foreign ministers on 18 December 1989 provides a good example. It was decided that a watered down version of the Cockfield proposals would be adopted. The new accord proposes that a standard VAT rate of 14% be achieved by 1991. No country with a standard rate in excess of 25% will be permitted to sanction an increase in this. Those countries with a standard rate below 14% will not be compelled to reduce this any further. In addition, it was agreed that those countries which stand to lose substantial indirect tax revenues due to harmonisation, are to be compensated.

The Commission is also very much aware of the delayed-response syndrome which afflicts some governments once they have agreed to implement certain measures. The Commission's report for 1989-1990 states that 'the completion of the internal market is proceeding rapidly ...[However] Governments must set up the introduction of these decisions into their national legislation if the decision-making process is not to be seen as losing momentum' (quoted by Conlon in Business and Finance Nov. 9 1989). Of course, recognition of a problem does not imply an imminent solution.

On the home front, the standard VAT rate was reduced from 25% to 23% in

the recent budget. It remains the highest standard rate in the Community, just one point ahead of the Danish rate. However, the change still counts as a move in the right direction.

Finally, some of the criticisms of the Commission's proposals are ,themselves, untenable. For example proponents of more reliance on market-driven convergence, including the British and the French, are simply shirking the issue. Ultimately, it is the government of each country which will have to sanction changes in indirect tax rates, and whether this occurs in one great community-wide levelling, or piecemeal, country by country, is academic - with the exception of the situation in which a strategically planned VAT reduction might garner valuable support in the run-up to a national general election.

Hence, it appears that the doom and gloom predictions of some commentators should be tempered.

A LONGITUDINAL PERSPECTIVE

However, it is ultimately by adopting a more long-term perspective that the current 'Eurphoria' can best be understood. Such a longitudinal perspective places 1992 firmly in context.

Following a decade and a half of no more than marginal progress and indeed perhaps overall regression, the EC suddenly came alive in 1985. This surge of activity can be paralleled to the dynamism of the community in its formative days. Then a number of factors combined to blunt enthusiasm. Despite the good economic intentions of the community members, failed attempts to move the EEC forward bore adequate witness to the fact that more than good intentions were needed.

The Fouchet plan was mooted in 1961, but it and its successor died because they were too direct in their attempts to compromise the sovereignty of members' (Colchester,1988). The 1970 Werner plan for Economic Monetary Union also died a quick death. Subsequently, an ambitious programme for 'European Union' proposed by the Belgian prime minister, Tindemans, foundered on the sharp rocks of nationalism. In contrast to the heady optimism of the 1960s, a mood of despondancy was palpable on the floors of the Berlaymont building during the 1970s and into the early 1980s.

In the same way, the current 'Eurphoria' may be transigent. Efforts to bring about fiscal harmonisation could easily founder. This is not to adopt a cynical attitude towards 1992. Indeed the opposite is the case. The confidence which the community has built up over the last five years is now its most valuable asset. For it is when confidence is high that changes take place, in spite of the difficulties which exist.

CONCLUSION

In this paper, the current programme tor E.C. fiscal harmonization has been summarily reviewed. Section one examined the reasons why harmonisation is considered desirable. Section two discussed some of the difficulties which the programme has so far encountered. Section three reviewed progress to date. Finally, ection four adopted a more long-term stance.

It may be concluded that the ultimate fate of harmonisation will depend on the degree of confidence and the level of momentum which can be sustained throughout the continent. From this perspective, one of the greatest dangers lies in pessimistic predictions, which, through their impact on confidence, may become self-fulfilling prophesceies. As Colchester notes, 'So far, the crash-programme to complete the great market has shrugged aside an impressive number of fatal trials predicted for it'(1989:24). Its ultimate success or failure will depend on its ability to continue 'shrugging off' such trials.

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