# THE 'ANTI-ECONOMICS' OF THE EUROPEAN COMMON MARKET

*With Special Reference to the Problem of Tax Harmonization*

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I WOULD like to preface my comments by extending a personal but public note of appreciation to the administrators, faculty and students of the Royal University for inviting me to visit and address this distinguished audience of scholars, business men and government officers, this evening on the theme of the 'Anti-Economics' of the European Common Market and its relation to the tax harmonization program of the Community.

Perhaps the title of my talk warrants clarification? What is precisely meant by the 'anti-economics' of the European Economic Community for one; and what is meant by 'tax harmonization' for the other? And even more important, why should this distinguished gathering be interested in either one of them?

By 'anti-economics' I mean simply the subordination of economic policy to political objectives – or more simply, the use of economic means for political ends. Before discussing these political motives in the EEC, the question arises as to the proper role for economic research when it is accepted that the objective of government policy is non-economic in nature? The question is a controversial one, which resolves itself into two essentially conflicting points of view. The first tacitly accepts the non-economic objective of government policy and tries to work within it – so to speak – by developing analyses whose purpose is to achieve the non-economic objective at a minimum cost in terms of foregone real income to the community. The second approach to non-economic government asks what are the economic consequences (costs or perhaps benefits) of government's economic 'irrationality' and poses the question as to whether the non-economic benefits are worth the net economic costs. One important by-product of such research is the questioning of the value of the non-economic objective and the possibility of its rejection should its costs to the community be deemed greater than its benefits.

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Can the title of 'anti-economic' be fairly ascribed to the various policies that are a part of or at least promise to be a part of the EEC landscape? Are EEC policies concerning economic and monetary union, tax harmonization and agriculture 'anti-economic' in the sense that I have defined the term? To answer this question, one either must have sufficient knowledge of the motivation behind EEC policies or, lacking that, compare EEC policies with known and accepted economic criteria – efficient resource allocation, economic growth, internal and external equilibrium (that is, the desired combination of internal inflation and unemployment consistent with balance-of-payments equilibrium). Should the EEC policies prove deficient from the perspective of these criteria – and there is wide consensus that they do – we are left either with the conclusion that the Common Market authorities do not know what they are doing – which I choose to reject for obvious reasons – or that they do know what they are doing but they are not doing what we – that is, the economists – want them to do. The weakness of this second procedure of comparing Common Market policies to economic criteria is that while it can satisfactorily establish what the motive for Community policy is *not*, it does not establish what the motive for Community policy in fact is. For this, the economist must venture outside the convenient world of abstract theoretical models that we have so painstakingly constructed for ourselves.

Under these conditions, implying the motive of Community policy from the facts of experience would seem to be more within the mandate of the political rather than the economic analyst. But a few comments or observations would seem to be warranted if I may be so allowed. Community policy at present appears to be imbued with what can be called 'Europeanism', but which in a less public relations-oriented context is known simply as supra-nationalism or federalism. Three types of federalism can be discerned in Western Europe today – the Dutch type, associated with the names of such men as Sicco Mansholt and Jan Tinbergen, who view a first step towards world socialism which they feel is necessary to achieve a redistribution of the world's income and wealth from the rich nations to the poor ones; the French type, which is strictly an economic federalism, by which I mean the achievement of a common European economic policy which they, the French, hope to control for purposes of restoring lost French prestige and grandeur; and a less well defined but more pervasive type which has as its goal European independence of both the Americans on one side and the Russians on the other. Without commenting on the merits and demerits of these motives from a non-eco-

nomic viewpoint, I think that they are capable of making sense out of the seemingly non-sensical policies of European Economic and Monetary Union, where member-states must adopt common rates of inflation; the Common Agricultural Policy where the form of free trade hides the fact of protectionism within the Community, with no such attempt being made to camouflage the blatant protectionism of the CAP with respect to the Community's relationship with third countries; and Tax Harmonization, the subject of my lecture this evening.

The tax harmonization program of the EEC, as set out in the 1963 Neumark Report, consists of three parts; the adoption of the value-added tax, the abolition of tax frontiers between member-states with respect to their intra-union trade, and the equalization of value-added tax rates. Properly interpreted, the adoption of the value-added tax, which refers to a method of taxation and not to some specific new kind of tax on economic activity, is not essentially a matter of tax harmonization, a concept whose underlying principle is that tax system in no way interfere with the benefits accruing to the members of an economic union from trade liberalization; but is more a matter of tax reform, in that in most of the Common Market countries, with the prime exception being France, the value-added tax has replaced the cumbersome, inequitous, and inefficient gross turnover or cascade-type sales tax, a change warranted more by the desire to bring a greater degree of equity and efficiency into the tax structure than by participation in an economic integration project. Still perhaps because of the success the Benelux countries and Germany are making of the transition to a system of value-added tax, itself in no small part due to the fact that politicians have seized upon the introduction of the new tax as a convenient smokescreen behind which they could raise average sales tax rates and blame it on the new tax, the value-added tax has become the symbol if not the essence of the EEC tax harmonization program.

Because the value-added tax is largely an unfamiliar tax, and also because it may become relevant to Malta, it seems appropriate to go into more detail concerning its nature and mechanics. The value-added tax is a device for levying taxes on a piecemeal basis, stage by stage, while avoiding double taxation, so that the tax collected in relation to final product will be precisely equivalent to that obtained by a single stage tax levied on the same aggregate base with the same *ad valorem* rate. In a closed economy, it can readily be shown that there are three major types of value-added tax: (1) a 'gross-product' VAT, which is equivalent to an equal rate-fully-general sales tax on all final goods and services –

that is, G.N.P.; (2) an 'income type' VAT, equivalent to an equal proportional tax on total factor income; and (3) a 'consumption type' VAT, equivalent to a tax on final consumption goods only. In its most popular version as a consumption tax, the VAT base may be set equivalent to that of any of the familiar sales taxes (manufacturers', wholesale, retail). In fact, until Denmark led the way in 1967 with a VAT extending through to the retail stage, no VAT extended further than the wholesale (i.e. sales to retailer) level. At the present time, however, all European examples of VAT are consumption taxes of more or less the Danish type; the only current examples of the income and product varieties of VAT are taxes recently proposed in several Latin American countries.

There are several ways of calculating and collecting value-added tax, the 'addition' method, the 'substraction' method, and the 'tax credit' method, but only the 'tax credit' method of consumption type VAT will be demonstrated. With this method firms apply the *ad valorem* VAT levy to their gross sales, and then receive full credit for the VAT embodied in any supplies suitably invoiced to prove that supplying firms have paid their VAT assessment. This self-policing feature is considered by government officials to be one of the main advantages of a VAT as compared with a single-stage levy where Inland Revenue itself must insure that the proper amount of tax is being paid. Let us use a simple arithmetical example to see how a value-added tax works with the tax-credit method of collection.

| | TAX EXCL. PRICE | TAX ON TRANS. AT 10% | PAY. TO TAX AUTH. | VALUE ADDED |
|---|---|---|---|---|
| 1. Manufacturer (1) | 25 | 2.50 | 2.50 | 25 |
| 2. Manufactuerr (2) | 50 | 5.00 | 2.50 | 25 |
| 3. Wholesaler | 75 | 7.50 | 2.50 | 25 |
| 4. Retailer | 100 | 10.00 | 2.50 | 25 |
| Tax-Exclusive price paid by consumer | 100 | | 100 | |

Fiscal economists have long been interested in the effects of taxes on efficient resource allocation. Traditionally, these discussions have ignored the method by which the taxes are imposed because on the one hand, application was, after all, only a question of administration, while, on the other, the underlying analytical model considered the factors of production as 'original', thus implying a simplified productive process in

which intermediate products were ignored. However, once the productive process is conceived of as a series of steps along which value is added at each level to that supplied by the original productive factors, it becomes apparent that the method of taxation, by discriminating between different forms of business enterprise, can effect the method of doing business. Indeed, once it is realized that the output of one industry may very well be the input of some other industry, and that a tax on the former constitutes one on the latter as well, it becomes necessary to focus analytical attention on the effect of the entire tax structure on productive *processes* rather than on the effect of a single tax on *commodities* produced by these processes.

Arguments along these lines have been important in leading the EEC and other European countries to replace their gross turnover taxes by a VAT to improve efficiency. Because the amount of tax a given commodity bears with a VAT, unlike a gross turnover tax, is independent of the number of transactions undergone by that commodity during the process of production and distribution, and independent of the relative amounts of value-added accrued at the several stages of production and distribution, a VAT will be neutral with respect to the structure of business enterprise. In addition, since the tax is levied as a constant proportion of value added at each stage in the production-distribution process, it is a constant proportion of total value added, and thus readily identifiable when, under the destination principle, export rebates and import compensatory duties are effected for goods crossing international borders. This condition will permit precise border tax adjustments, so that a tax intended to be reflected in higher prices to consumers (with destination principle adjustments) does not affect an industry's international competitive position by altering relative commodity price ratios. Such precision is quite unattainable with a gross turnover tax, although there have been no empirical studies indicating the degree to which vertical integration and imprecise border tax adjustments have in fact been encouraged by the gross turnover tax in continental Europe.

Adoption of the value-added tax has become part of the membership dues for new entrants into the Community – proof of one's Europeanism – and Britain presently is busy preparing itself for the changeover that is scheduled to occur this Spring. In Britain, where the value-added tax is replacing a set of selective excises and the unpopular SET (Selective Employment Tax), the efficiency argument for VAT is that it will bring a greater degree of generality into the fiscal structure. Be that as it may, what one is really struck with in present Britain is the pressure being

applied to Treasury by all sorts of special interest groups, each armed with incontrovertable evidence as to why it should be exempt from the new tax. The result of all this is that the tax that is supposed to be general soon degenerates into something resembling the set of selective excises that it is replacing. Inroads into generality take three paths; that of different rates for different products, tax exemption and zero-rated tax. The difference between a zero rate and a tax exemption can be illustrated by use of a simple table.

| | TAX EXCLUSIVE PRICE | TAX ON TRANSACTION | TAX PAYMENT WITH ZERO RATE | TAX PAYMENT WITH EXEMPTION |
|---|---|---|---|---|
| 1. | 25 | 2.50 | 2.50 | 2.50 |
| 2. | 50 | 5.00 | 2.50 | 2.50 |
| 3. | 75 | 7.50 | 2.50 | 2.50 |
| 4. | 100 | 0 | –7.50 | 0 |
| | 100 | | 0 | 7.50 |

The prime objective of the tax harmonization program, however, is not the adoption of the value-added tax but the abolition of tax frontiers between member-states in their intra-union trade, though retention of tax frontiers is envisaged with respect to trade between third countries and the Community. Tax frontiers refer to destination principle border tax adjustments, which are one of the two possible principles of border tax adjustment that a nation can apply to its international trade – the other being the origin principle. Under the destination principle, explicit export tax rebates and import compensatory duties are intended to guarantee that all goods consumed within the taxing jurisdiction are equally taxed regardless of where they are produced; while under the origin principle exports are taxed and imports exempted to insure that all goods produced within the taxing jurisdiction are equally burdened regardless of where they are consumed. Most sales taxes in the world today – not just those collected by the VAT methods – are on the destination basis. The introduction of value-added taxation and the adoption of a principle of border tax adjustment are, of course, logically quite separate questions.

It should be mentioned in connection with the issue of border tax adjustments that there is an essential distinction to be drawn between a *border tax*, which properly understood is a tax on the crossing by trade of international frontiers (a tariff, for example) and hence restricts trade

volumes below what would be indicated as desirable by the principle of comparative advantage; and a *border tax adjustment*, which is an adjustment of the taxes imposed on a producer when the goods he produces cross an international border. Tax frontiers and customs frontiers thus serve opposite functions in the world economy, the former being a trade liberalizing one, the latter being protectionist. Though this often has been misrepresented or misunderstood in EEC policy circles, the objection to tax frontiers, at least by the better informed Neumark Committee, has not been based on reasons of efficient resources allocation, but a political supranationalistic one.

Abolishing intra-Community tax frontiers implies that, with respect to such trade, exports will be taxed at a rate equal to that borne by domestically produced and consumed goods, and imports admitted to the taxing jurisdiction tax free; accordingly, such change will tend to produce balance-of-payments deficits in those countries with relatively high average rates of value-added tax and balance-of-payments surpluses in countries with low average rates. For this reason the Neumark Report has recommended that value-added tax rates be equalized in all member-states before tax frontiers are abolished, a proposal vigorously defended by the supra-nationalists though one presumes more for the 'common-action' it implies than for reasons of the balance of payments. For high-tax member countries this implies a smaller public sector and for low-tax countries a larger public sector than would exist in the absence of the EEC tax harmonization commitment or, if the size of the public sector is to be maintained, a change in the mix of direct and indirect taxes that had hitherto been deemed appropriate. When one considers the vast differences existing between EEC members in respect to both the size of their public sectors and the optimal mix of direct and indirect taxes (income as opposed to sales taxes), the 'anti-economic' aspects of the EEC tax harmonization program cannot be easily exaggerated.

A case in point is the Benelux Economic Union where the two major partners, Belgium and The Netherlands, follow widely divergent fiscal policies. Because of strong regional and cultural differences with Belgium, the national government in that country has found it difficult to collect income tax and thus relies more heavily on sales taxes than do the Dutch, who have a greater sense of national cohesion. The point is that there are sharp differences between Belgians and Dutch and these differences are reflected in their fiscal structures. Erasing the differences between the fiscal structures of the two countries, however, will not erase the differences between the Belgians and the Dutch. The failure

to equalize tax rates in the Benelux Economic Union despite considerable effort to that effect should serve as a lesson to the EEC that ambitious anti-economic programs have little chance of success unless they serve the needs of the people as they in fact exist rather than as the supra-nationalists imagine them to.

The equalization of value-added tax rates in the EEC clearly is related to the desire to eliminate tax frontiers between member states – that is, the switch from destination to origin principle border tax adjustments with respect to intra-union trade; – and the question arises as to why this change is felt to be necessary within the EEC. As I have previously argued, scientific economics has demonstrated that tax frontiers do not interfere with efficient resource allocation or any other known economic objective to my knowledge. The purpose of the abolition of tax frontiers in the Community, and the Neumark Report is very clear on this, is not related to economic objective, however, but the political one of establishing within the Community conditions analogous to those of an internal market. After all, it is argued, internal markets are seldom partitioned by tax frontiers, and since this is envisioned to be the goal to which the Common Market aspires, tax frontiers have been deemed incompatible with the Common Market concept. But the question arises as to whose Common Market concept the tax frontiers are incompatible with?

In the case of the Neumark Report, it is clear that the Common Market referred to is that of the establishment of a United States of Europe, though one assumes the name will be different. It is not only the Neumark Report's call for the abolition of tax frontiers with respect to intra-union trade that implies this interpretation of tax harmonization in the EEC, it is also its call for the adoption of value-added taxation and the equalization of value-added tax rates. With respect to this last-mentioned factor, it should be pointed out that given differences in average sales tax rates between the partners, high tax countries will suffer a deficit in their balance-of-payments *vis à vis* their partners regardless of whether tax frontiers are removed or not, since the equalization of sales tax rates behind tax frontiers implies a reduction in destination principle border tax adjustments whose balance-of-payments effect is identical to that which would occur if tax frontiers are removed without tax rate equalization. The point is that the high-tax country cannot avoid the balance-of-payments implications of removing tax frontiers by equalizing tax rates before their removal as has been assumed by the Community. In any event, the issue of border tax adjustments is essentially a mone-

tary one; so long as taxation is general, different rates of commodity taxation in different countries are compatible with efficient resource allocation regardless of whether there are tax frontiers or not. Balance-of-payments deficits or surpluses induced by the removal or adjustment of tax frontiers can be expected to be absorbed either by the currency exchange rate or, if this is held fixed, the internal level of prices and incomes. To translate this rather abstract piece of analysis to the real world of policy, its implication is that participation by a country in an economic union requires neither large-scale structural changes between direct and indirect taxation; nor substantial changes in the level of tax rates, nor modification of existing systems of border tax adjustment for reasons of efficient resource allocation. The sole adjustment necessary is to make the effect of the tax system as general as possible – a conclusion that should come as no surprise to those well-versed in the public finance literature.

As I have previously argued, the proper role of economic research when it is accepted that the motivation of economic policy is political rather than economic is to ascertain the economic costs of such policies and ask the question – which the public alone can answer – as to whether the economic costs are worth it or not. In the case of EEC tax harmonization, the economic costs are clear: member countries are forced to abandon tried and true methods of raising public revenues for new and untried methods. The adoption of the value-added tax in Italy, for example, has been chaotic; in the U.K. less chaotic but just as painful adjustments will have to be made. If such change were to guarantee a more efficient equitable fiscal structure, economists could applaud it, though even in this case the question remains as to why these countries have waited until the change has been virtually forced upon them. But if, as is the case, the motive for the change is strictly political – indeed a political motive that the countries do not equally share – economists must be first in pointing out the costs the member states are inflicting upon themselves in the form of deviations away from optimal fiscal systems – optimal, that is in the sense of long-standing cultural, sociological, and political patterns – and ask whether these costs are worth the political benefits of such action, an issue that up to now the politicians have avoided by falsely claiming that the move to value-added taxation has been rendered necessary solely by economic considerations. Every club must have its symbol, and the value-added tax has become that symbol for the EEC (it is interesting in this respect to speculate what the EEC would do if the United States were to adopt a value-added tax,

which by the way is presently being considered by the Nixon Administration. Would the nations of Europe then go back to cascade-type turnover taxation one wonders?).

A question that has probably struck more than one of you by now is what would be the implications of EEC tax harmonization for Malta should at some future date the islands decide to become a full-fledged EEC member, with all its rights, privileges and, of course, responsibilities. This, to many, would seem now a greater possibility than previously thought to be the case given what British entry and the loss of Commonwealth Preference, combined with the Common Agricultural Policy and perhaps a high Common External Tariff might mean for the Maltese economy.

The most important implication for Malta surely would be the necessity to adopt the value-added tax. And though such adoption would clearly be a political pre-condition for entry, it would be consistent with the Stolper Report's Recommendation of some years ago that 'the Government actively consider the introduction of a general tax in retail sales'.

There has been, in recent years, considerable support for the use of a broad-based general value-added tax in developing countries. Most recently, in a yet unpublished paper, Ronald McKinnon most forcefully and convincingly has argued the benefits of such a tax, especially in economics where customs duties constitute a large percentage of public revenues – the Maltese case. One of his arguments relates to distinction made, in a Maltese context, by Salvino Busuttil who noted the difference between revenue or fiscal tariffs on the one hand, and protective tariffs on the other. The main purpose of revenue tariffs is to raise money for the public exchequer; the main purpose of protection tariffs is to subsidize local industry. The two are not entirely disconnected, however, since protective tariffs rather than direct production subsidies are often used for subsidization of local enterprise in developing countries, because local governments do not have the financial where-with-all to finance the subsidies from exchequer funds. The beauty of the tariff is that it gives the impression that it is the foreigner who pays; but the argument is a false one, since the domestic consumer pays as well by having to pay a higher price for the good than would otherwise be the case.

Drawing on his experience from Ethiopia, McKinnon warns us to the danger of using tariffs for revenue purposes because, 'they tend to become "protective" as capital becomes available for industrialization. Resources are drawn into industries – particularly those producing "luxury" consumer goods – by historical accident, since it is precisely these

goods that tend to be taxed for revenue purposes.' The result can be a mis-allocation of scarce resources to industries that are not appropriate to a country's economic development. A further shortcoming of heavy reliance on customs duties for revenue purposes pointed out by McKinnon is that they tend to be inelastic to rising income, since import-substituting industrialization which takes place behind tariff walls initially designed to raise revenue empties the public exchequer as imports decline. On the other hand, a broad-based VAT – on the destination principle – would enable a country like Malta to preserve its revenue base in foreign trade more easily as it industrializes.

It should be mentioned in this respect that should a value-added tax be adopted by Malta, the Community's expressed desire to eliminate tax frontiers between member states could have a disasterous revenue effect for the Islands, since so much of Malta's trade is carried on with the Community, especially now with British entry. This, of course, is an argument against abolishing tax frontiers not against adopting a value-added tax. A further argument related to budgetary revenue and Community policy is that of the effect of adopting the common external tariff on such revenue. We are all familiar with the famous 'trade deflection' argument by now – how with different tariffs *vis à vis* the outside world and no tariffs *vis à vis* member states, goods would tend to enter the high tariff country through the low-tariff one. Presumably 'rules of origin' can handle such situations. But if in the name of the 'New Europeanism' Malta is asked – indeed required – to adjust its tariffs to those of the other member states, revenue tariffs may have to be lowered on some items and raised on others in a manner that is not consistent with Maltese standards of equity and need. The point is that with a value-added tax, Malta would be in a much better position to adjust the burden of taxation as *it* sees fit than it would be under the present system of revenue duties should Malta join the EEC in a customs union.

Besides preventing accidental protection by having revenue tariffs become protective ones, the use of a value-added tax could have another substantial efficiency advantage in a LDC by enabling governments to discontinue their present practice of using the tariff for protection of local enterprise. With a broad-based value-added tax, tax exemption could be pinpointed at the desired stage in the production-distribution process and government have enough fiscal reserve to withstand these intrusions on its revenue even if the tax were imposed at relatively modest rates. The value-added tax is a selective instrument of control. In comparison, the tariff is a clumsy one, hitting consumers unnecessarily and granting

protection indiscriminately to all stages of domestic enterprise.

A final argument that can be registered for the value-added tax that could be relevant for the Maltese situation is that use of a general consumption tax would preclude the need for further personal income taxation. The Busuttil Report was very convincing on this point: in an economy that wants and needs entrepreneurship, a tax on personal income can be very costly in terms of industrialization foregone.

To summarize, there would appear to be substantial advantage for Malta from adoption of a broad-based value-added tax of the consumption variety. These advantages would hold true – indeed be exaggerated – should such adoption be independent of the EEC. Membership in the EEC might force upon Malta an increased reliance on personal income taxation that has hitherto been deemed undesirable. Abolition of intra-union tax frontiers could substantially cut into the budgetary revenue gains that Malta could expect from the tax. Unilateral adoption of a value-added tax, on the other hand, may convince the powers that be in Bruxelles that Malta is indeed European, or at least subscribes to the EEC conception of what Europeanism means, and thus be more sympathetic to Maltese terms in the forthcoming second round of negotiations for tariff reductions.

My remarks to this point have focussed on what can be called the 'micro-economic' or resource allocation aspects of tax harmonization in the EEC. Some attention must now be paid to the 'macro-economic' or economic stabilization aspects of this program.

In a 'macro-economic' context, the prime question of relevance is whether individual member countries will have the ability to run autonomous fiscal policies within their overall commitment to the EEC tax harmonization program. Two types of autonomy can be usefully distinguished, 'nominal' autonomy and 'effective' autonomy. Nominal autonomy refers to the ability of a member government to run a different budgetary when budgetary policy simply refers to the budget itself and not the effect that the budget might have on macro-economic variables. Such nominal autonomy depends on the scope or coverage of the tax harmonization proposals. A program that constrained all countries to the same community-determined level of taxes and expenditure would preclude even this modicum of fiscal independence. The EEC program, however, is not nearly so thorough-going, and there would seem to be no present statutory limitation on the freedom of individual countries to varying expenditure levels and tax rates as they see fit, though the commitment to equalize VAT-rates implies that direct taxation would have to be used for this

purpose. 'Effective' autonomy, on the other hand, does not simply refer to the ability of a member-state to have a different budgetary policy from that of its partners, but from having a different macro-economic result from that budgetary policy in terms of the rate of inflation that the given country wants to pursue. Can a member-state run a different rate of inflation from that of its partners because of different budgetary policies within its overall tax-harmonization commitment?

The answer to this question depends on the context in which the autonomous policy is attempted. Abstracting from other harmonization policies, there would appear to be no reason why even 'effective' autonomy could not be achieved. This, however, is not the present case in the EEC where monetary union is being attempted. EEC monetary union requires that all countries run the same rate of inflation, regardless of the repercussion of this policy for unemployment levels in the various states. Given such a commitment, 'effective' fiscal autonomy clearly is not possible – hence, the argument that the unemployment consequences of monetary union can be offset by fiscal action is not tenable. An effective monetary union would take all macro-economic initiatives out of the hands of the member states, leaving a void that could only be filled by some new supra-nationalistic institution.