Editorial

Neutrality in VAT and the Organ-Grinder

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The keyword in Value Added Tax is neutrality. The VAT system has been set up with the idea to establish a general consumption tax at which neutrality in tax burden exists. Internal neutrality within the country, contrary to the former so-called cascade systems, and as a consequence thereof external neutrality in the sense that goods and services can leave or enter the country without any hidden tax burden or subvention.

This system was set up in 1967 in the first and second EC Directives, although France already had a kind of such a system. The ideas and the necessity for such a neutral system became apparent under the Coal and Steel Community when the Tinbergen report in 1953 pointed to the neutrality of taxation on the product flow between the Member States. That idea was adopted in the Treaty of Rome in 1957 in the Articles 95–99.

On the basis of the last article, the EC Commission had to investigate the manner in which tax harmonisation should take place. This mandate could be interpreted in various ways but even the most restricted interpretation in various ways but even the most restricted interpretation would lead to a neutrality in taxation. By introducing a common VAT system in any of the Member States without the opening of frontiers or unifying of rates with other Member States, the neutrality should be achieved. The same kind of neutrality would be reached with a single stage tax at the retailers stage, but that system was rejected in the so-called ABC (Jansen) report in 1962 for obvious reasons, although nowadays mixtures of the two systems are applied and could be applied more in future.

Neutrality in this sense means an equal tax burden on particular goods or services at a particular place within the community, whether they are produced in the country involved or imported, and produced in an integrated production or not. Also competing products should have an equal tax burden. In this type of neutrality an intercommunity unification of rates or even a national unification (i.e. one rate on all commodities) does not exist and is not required.

This present kind of neutrality has been achieved already in principle from the beginning of the harmonisation in 1967. It has been maintained in the system up to 1993, during which time each Member State had his own rates and border settlement in the classic way at custom. This does not change with the opening of frontiers in 1993 by way of shifting the bordercontrol to the intracommunity transactions system and it will also not change in a system of tax credit clearing mechanism which is forseen for the period after 1997. It is only in a situation where one unified rate (and exemption) would be installed that one can speak of a higher ultimate degree of neutrality. A two (or more) rate system has been accepted in general without conflicting with the present neutrality, provided goods under various rates are not really competing with each other.

The emphasis so far in the discussions within the European Community and Union has been on the external neutrality already reached with the introduction of a fully fledged VAT system under the Second Directive of 1967, improved by the Sixth Directive, and as I see it, that stage will last for decades or even longer.

However, with relation to the internal neutrality, within a country itself, an evolution in neutrality is to be mentioned. That evolution is rooted in the nature of a general tax on consumption whose character the European VAT should have according to Article 2 of the First VAT Directive. Consumption taxes and in general indirect taxes have a very long history. For centuries the West European towns, counties and countries have applied all kinds of excise duties and in- and export duties, whereby the technics of levying came down to counting, measuring and weighing of commodities.

Around the nineteenth century stamp duties and registration taxes came into force, using contracts on paper as the carrier and making use of the terminology of the civil law. General consumption taxes were introduced only at the beginning of this age in Germany (von Siemens) and in the USA.

If a new kind of tax starts it is understandable that legislators make use of the existing framework in case they look alike. As for instance happens with the definitions of deliveries, services, enterpreneur, consideration etc. However, in countries in which a taxation is introduced on all commodities and services, one has noticed that the former (civil law) terminology they had taken over did not work satisfactorily. In a tax system where the objective is to tax all facets of an economic society with all of its complexity it appears to be a necessity, e.g. to avoid unfair competition, to adapt the notions very strictly to the ideas that are present in that economic society, by way of laying down the notions in new legislation or interpreting these notions in an economic manner. This has happened in Germany and, from 1938 onwards, in the Netherlands. Beginning with civil law definitions one started to adapt legislation to economic notions or in general to interprete the existing notions. In particular the interpretation given to the description of the taxobject, 'the transaction'. It is interpreted in Germany as 'im wirtschaftlichen Sinn' and in the Netherlands as 'in het maatschappelijk verkeer'. From the original six EC Member States the Southern countries, however, did not apply one general type of tax before they introduced a VAT. They used a more fragmentary taxation based on kinds of registration taxes or excise duties on many commodities but not on all. They used civil law notions and there are no need to draw economic lines because taxation on all activities in the economy did not exist.

The two opposite trends confronted each other in the sixties at the preparations of the First and Second VAT Directive. And again each group tried to maintain its legal practice. This is the reason why in Article 2 of the Second Directive defining the scope of the tax to the supply— of goods and services 'for consideration' the German text reads: 'gegen entgelt' and the French text: 'effectués à titre onéreux'. The former is a general economic notion whilst the latter stems from the – Napoleontic – civil law and is difficult to translate into English.

In all the 25 years of VAT this difference still remains but it is worth noting that the Southern countries now apply a general tax which has moved to a more economic interpretation. Also in the Sixth Directive many economic notions in place of notions out of the contract rules of the the civil law are laid down.

The more one approximates the idea to tax the whole economic community the better the legal instruments will have to be adapted to achieve that aim. This law of nature, however, is not always recognised and so discussions in the Netherlands are going concerning my thesis that the scope of VAT should contain all performances in economic transactions; not more and not less. Not more as sometimes is done at indemnifications or subsidies and not less as in he case of the Dutch organ-grinder.

This case passed judgment at the Court of Justice in Luxemburg on 3 March 1994, No. C-16/93. Mr. Tolsma makes music on the public roads, he receives money but payment is not compulsary. The Court decided it is not taxable.

It started from the Dutch text or the French text – French being the working language of the Court – both stating 'prestation de service, effectués à titre onéreux' but did not realise that other languages use a more economic notion like 'for consideration, gegen entgelt' etc. And as a result the Court decided in a civil law conception: no contract, no taxation.

It is clear that in general a tax on consumption in an economic society on the music of an organ-grinder should be taxable, irrespective of whether he collects on the street or that he is – as is common – contracted to play both on and off the street. The verdict did not mention the arguments of Germany and the Netherlands; whether hey have referred to the differences in languages and moreover to the general interest of the judgment for the economic approach in VAT which is also laid down in the directives and even in the EEC Treaty, strengthened by Article 3A(1) of the Union treaty. The proceedings in the case do not refer to it; the chamber of the Court refrained even from a normal verbal hearing of the parties.

The decision runs transverse to the historical line given herewith and all arguments for economic rules and interpretation of a VAT. Even so transverse that a change in the directives seems desirable. If this does not happen the neutrality of the VAT system will take a big step backwards. That would be a pity because neutrality in taxation makes it more acceptable to the taxpayers because of less discrimination and it is an important requirement for good taxation.