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A Question of Sovereignty: Tax and the Brexit Referendum

Maria Kendrick¹

It isn't right that unelected bureaucrats in Brussels impose taxes on the poorest and elected British politicians can do nothing.

Vote Leave²

I. INTRODUCTION

The debate about sovereignty in the Brexit referendum campaign was cast in terms of power, competence, and ultimately freedom to legislate. The proposition that the UK could take back control from the EU was expressly referred to in the context of the principle of Parliamentary Sovereignty. Paradoxically, Parliament was purported to require an exercise in direct democracy, through the referendum, in order to provide the legitimacy necessary for it to reassert its own sovereignty to legislate over matters which fall, or were perceived to fall, within the competence of the EU. The question of sovereignty therefore asked which legal order should actually be supreme; the national or the supranational. This discussion consequently implies issues of territoriality as the 'boundary line is the line of sovereignty'.³ The paradigmatic quality of a sovereign body is the power to tax,⁴ because it is inextricably linked with the power to govern. Consequently, and unsurprisingly, the debate on sovereignty included a debate on competence in taxation.

A corollary to the issue of territoriality is the issue of harmonization. The latter denotes an eradication of difference between the territories to which it applies and in the context of taxation can consequently reduce individual member state control. Therefore, the objections voiced in the debate on sovereignty could be construed as objections to harmonization, especially on the subject of tax. It is the intention of this article to discuss the constitutional theory in the context of tax, and as space precludes a survey of different taxes, this article will focus on the classic example of EU tax harmonization, VAT.

However, the constitutional theory cannot be detached from pragmatic considerations, because there is no escaping the fact that the debate on sovereignty does not occur in a vacuum. In reality, it is the economic expediencies which will be an unavoidable influence on post referendum policy decisions. Therefore, it is also the intention of this article to address the practical aspects of the referendum in relation to tax, specifically VAT, in addition to the constitutional aspects, while reflecting on the questions of sovereignty and flexibility.

¹ Visiting Lecturer in Public Law and PhD Candidate, King's College London.

² Boris Johnson, Michael Gove and Gisela Stuart, 'EU'LL never believe it' *The Sun*, 30 May 2016, quoted in 'EU Referendum: Vote Leave wants power to axe fuel VAT', *BBC News*, 31 May 2016, <http://www.bbc.co.uk/news/uk-politics-eu-referendum-36414761> (accessed 25 September 2016).

³ Beale, '*Jurisdiction to Tax*' [1919] 6 (XXXII) *Harvard Law Review* 587, 588.

⁴ *Ibid.*, 588.

II. SOVEREIGNTY

The question of sovereignty was prayed in aid by the Leave campaign in the referendum on the UK's membership of the European Union, as the quote at the start of this article indicates. It was done in many semantic forms and epithets but few more potent than the slogan to 'take back control'. Of the many connotations to this slogan was the suggestion to take back control of all EU legislative influences and reinstate the principle of Parliamentary Sovereignty proper.⁵ Of the many legislative influences rightly, or wrongly, attributed to Brussels during the referendum campaign, the reach of EU law as regards fiscal policy was pertinently included. It is unsurprising that in the discussion as to which legislative body is sovereign, the debate encompassed not just issues of power and competence, but also territoriality. Which legal order is ultimately supreme; the national or the supranational? Beale identified that the issues of sovereignty and territoriality are inextricably linked to the power to tax, '[t]he sovereign who has power to tax is that sovereign who by personal ownership of the territory has the general control of it.'⁶ Fiscal sovereignty, as far as the Member States are concerned, includes the freedom to design and enforce policies on taxation. This is certainly true for the UK and as tax is the traditional province of the State, any intrusion, whether apparent or indeed illusory, can be acutely felt:

The power to tax, both as a means of gathering revenue and as an instrument of economic management, is one of the most basic and jealously guarded prerogatives of the state, and it might be expected that the Member States would be reluctant to allow the Community to trespass on their jurisdiction in this area. How a Member State raises the money necessary for the functions of its government is, it might be argued, entirely its own affair ... its system of taxation is no business of other states or of supranational organizations.⁷

This statement could be considered a presentation of the opinions of at least some of the Leave campaigners. However, the writers, Paul Farmer and Richard Lyal, continue by describing this opinion as 'wholly untenable'.⁸ They do so because in a Union, and indeed a globalised world, where the intention is to maximise and encourage free trade, a protectionist stance in relation to taxation and trade barriers would be illogical. Consequently, what is revealing about the roles played by taxation and sovereignty in the referendum are the practical considerations surrounding the constitutional theory. The debate on sovereignty does not occur in a vacuum. In reality, it is the economic expediencies that will be an unavoidable influence on post referendum policy decisions. The attachment between the constitutional theorising on sovereignty in relation to taxation, and its practical considerations will now be addressed in relation to a concept that relates to the question of sovereignty, but which received comparatively fewer references during the referendum campaign; flexibility.

⁵ On the debate regarding the Parliamentary Sovereignty paradox, which saw both politicians and lawyers alike cite the preservation of Parliamentary Sovereignty as the reason for supporting Brexit, whilst at the same time backing the use of a referendum because of a lack of legitimacy in the Parliamentary system, see the Parliamentary debates on the EU Referendum Bill *Hansard* HC vol 599, col 110 (7 September 2015) and my own previous comment on the subject at the time of the Bill's enactment Maria Kendrick, 'EU referendums and renegotiations', *eutopia law*, 15 September 2015 on Matrix Chambers blog, <https://eutopialaw.com/2015/09/15/eu-referendums-and-renegotiations/> (accessed 25 September 2016).

⁶ Beale (n3) 587-8. See also Professor Sir Francis Jacobs, 'General Editor's Foreword' in Paul Farmer and Richard Lyal (eds), *EC Tax Law* (Clarendon Press Oxford, 1994).

⁷ Paul Farmer and Richard Lyal (eds), *EC Tax Law* (Clarendon Press Oxford, 1994) 1.

⁸ *Ibid.*, 2.

In referring to the concept of flexibility, this article is referring to those arrangements which govern the UK's membership of the European Union and that have made provision for the constitutional preferences of the UK. A pertinent example was discussed in the recent House of Commons debates on the Finance Bill 2015–16 to 2016-17 in the context of the 5% reduced rate of VAT, which applies to a pre-defined list of certain goods and services as a matter of EU law.⁹ It has, for some time, been the desire of a selection of MPs to see the UK provided with the flexibility to apply the 5% reduced rate, and the zero% super-reduced rate, to those goods and services which the UK Parliament deems appropriate, as and when it deems it appropriate. As a sovereign legislature, it can be argued, it is important that Parliament is able to decide the rate of tax, even in relation to VAT, which is a tax that not only applies to the EU Member States but has also been adopted in other countries around the world.

These varied VAT rates originally stem from 'transitional' arrangements which the UK, among other Member States, agreed with the EU in the context of harmonization of VAT rates in the internal market.¹⁰ A form of flexibility arrangement, the UK maintained its selection of reduced rates on certain products in the face of a desire by the Commission to achieve complete harmonization in the internal market in relation to VAT. However, the Commission has subsequently published its 'Action Plan on VAT' in April 2016,¹¹ and although space precludes a detailed discussion of the proposals contained in the Action Plan, suffice it for present purposes to highlight the comment made by the Commission in relation to the continuation of the flexibility arrangements of the Member States, including the UK. In its Q&A document, the Commission stated its approach, '[t]his proposal aims to modernise VAT rates policy and give more flexibility to Member States on VAT rates. It is not about scrapping existing reduced (or zero) rates.'¹² This has not, however, satisfied the Eurosceptic Conservative MPs, some of whom remain convinced that the Commission does not intend to provide more flexibility, rather 'the whole thing was steered towards more rigidity, harmonization and uniformity...'.¹³

On the question as to whether Parliament should just legislate now in the Finance Act 2016 2015-2016 to 2016-2017¹⁴, before the invocation of Article 50, to establish its own deadline for the removal of VAT on selected products and services, an action presumably premised on a reassertion of legislative sovereignty, Jane Ellison MP stated that to do so 'would impose a requirement on the Government to act illegally. We would be in breach of Articles 1 and 110 of the Principal VAT Directive'.¹⁵ It appeared that practical considerations were not far behind concerns regarding sovereignty, '[w]hatever Members' views are of what the Directive requires ... I would be surprised if the Members of Her Majesty's Official Opposition, or indeed any Member of the House, thought we could disregard it at such a crucial juncture,

⁹ Agreement on legislation to harmonize VAT rates across Member States was reached in June 1991, and provided by Directive 92/77/EEC of 19 October 1992. As part of this agreement, Member States have the option of applying a reduced rate of a minimum of 5% to certain specified goods, as listed in Annex H of the Directive. These provisions are now incorporated in Article 98 and Annex III of what is known as the principal VAT Directive, Council Directive 2006/112/EC of 28 November 2006 on the common system of Value Added Tax OJ L 347/1, 11 as amended by Council Directive 2009/47/EC of 5 May 2009 amending Directive 2006/112/EC as regards reduced rates of value added tax OJ L 116/18.

¹⁰ For more detail on the historic application of VAT rates see HC Library Briefing Paper Number 2683, 20 May 2016, by Antony Seely.

¹¹ Available at http://ec.europa.eu/taxation_customs/business/vat/action-plan-vat_en (accessed 29 September 2016).

¹² European Commission MEMO 16-1024, Action Plan on VAT: Q&A, 7 April 2016 available at http://europa.eu/rapid/press-release_MEMO-16-1024_en.htm (accessed 29 September 2016).

¹³ Christopher Chope MP, *Hansard* HC vol 614, col 165 (5 September 2016).

¹⁴ The Bill received Royal Assent on 15 September 2016.

¹⁵ Jane Ellison MP, *Hansard* HC vol 614, col 169-70 (5 September 2016).

when the disregarding of the Commission's and other nation's obligations towards us could be significantly against the UK's national interest'.¹⁶

Disquiet and dissatisfaction as to the level of flexibility on offer, or potentially on offer, would seem to originate from the aspect of the sovereignty debate that objects to harmonization. For many years it has been the EU's, and specifically the Commission's, intention to harmonize indirect taxes, especially VAT, in order to remove barriers to trade in the internal market. However, this has aroused disagreement on the part of Eurosceptics (not just British Eurosceptics) who disagree with harmonization as a constitutional concept. A corollary of the territoriality argument, the development of policies on the approximation of laws on taxation are symptomatic of a loss of control.

However, the desire to assert sovereignty and escape the harmonizing intentions of the Union, cannot be detached from practical considerations, particularly in relation to tax and economics. It is revealing to observe the post referendum response to tax harmonization. As the new Secretary of State for Exiting the European Union, The Rt Hon David Davis MP, made a ministerial statement to the House of Commons on 5 September 2016 on the work of the new Department.¹⁷ Following this statement, the Minister took questions on the post referendum reality, including on the subject of VAT. The Minister's responses were discussed later that day in the House of Commons debates on the Finance Bill 2015–16 to 2016-17, which featured a Government tabled amendment¹⁸ setting a deadline for a VAT rate reduction as 'the earliest date that may be appointed consistently with the United Kingdom's EU obligations.'¹⁹ Paula Sherriff MP pointed out that the meaning of the amendment is that forthcoming Brexit negotiations may include an agreement to maintain that VAT rates be set by the European Union. She continued by stating that, 'when I challenged the Secretary of State for Exiting the European Union on that earlier today, he certainly did not rule it out. Instead, he reflected that ability to set a zero rate was just one reason why people may have voted to leave, but did not actually pledge to deliver it'.²⁰ It therefore appears, in stark contrast to the statement quoted at the beginning of this article, that those in favour of the UK leaving the EU for reasons of tax sovereignty, would not maintain the vehemence of their criticism of the EU in practice, in light of the post referendum economic reality.

III. HARMONIZATION

It has transpired from the discussion above in relation to taxation and sovereignty, that flexible arrangements are not necessarily flexible enough for those with a distinct objection to the EU's harmonizing objectives. They are either considered insufficient in terms of retaining Member State control over taxation policy, or there is scepticism as to their underlying rationale. However, the consequence of the application of practical considerations is that legal sovereignty can be limited outside the EU by economic dependency in the post referendum reality. Therefore, the constitutional theory behind Brexit, and the practical considerations of Brexit, can conflict. This certainly makes the view of the Leave campaign quoted at the

¹⁶ *Ibid.*

¹⁷ A full transcript of the statement can be found at <https://www.gov.uk/government/speeches/exiting-the-european-union-ministerial-statement-5-september-2016> (accessed 30 September 2016).

¹⁸ The amendment was referred to as amendment number 161 at that time and regarded the lowering of the VAT rate on women's sanitary products to zero%.

¹⁹ *Hansard* HC vol 614, col 162 onwards (5 September 2016).

²⁰ *Ibid.*

beginning of this article appear naïve at best. It is therefore necessary to consider the interrelationship between harmonization and sovereignty in more detail.

The opinion was expressed at the start of this article that a corollary to the issue of territoriality is the issue of harmonization, which denotes an eradication of difference within the territory in which it applies and subsequently the loss of individual member state control. This is particularly pertinent in relation to taxation. In the famous *Marks & Spencer* case²¹ Advocate General Maduro opined that legislative harmonization may have the objective of correcting market distortions, however, he identified the conflict that may exist ‘between the *power* conferred on the Member States to tax income arising in their territory and the *freedom* conferred on Community nationals’²² (emphasis original) as a result of market harmonization. Thus, the issue of territoriality, which is an aspect of sovereignty, ‘gives rise to a tension between two opposing systems and to the need to establish an equilibrium in the allocation of competences as between the Member States and the Community’.²³ It is unfortunate that the Leave campaign, in focusing on the ‘boundary line is the line of sovereignty’²⁴ aspect of constitutional theory, have risked highlighting rather than reducing this tension with the aim not of assisting the achievement of equilibrium but rather of compromising its achievement.

Farmer and Lyal²⁵ suggested, back in the mid-1990s, that both the need and nature of harmonization required in the EU is determined by the aims of the then European Community.²⁶ However, because the impetus and objective behind harmonization is based on economic imperatives, the notions of the control aspect of sovereignty should be viewed in a different light. The concept of the single market was not about Brussels controlling all aspects of the imposition of taxation on the citizens of the EU in order to render elected national politicians helpless, as the quote at the beginning of this article states. EU taxation policy is premised on the desire to bring about the elimination of fiscal obstacles in order to enable people, goods, services and capital to move freely across political frontiers, for their own economic benefit.²⁷ Following the argument of this article, that practical considerations do not always complement but rather conflict with constitutional theory, it is unsurprising that one of the economic expediencies affecting post Brexit referendum taxation policy decisions is the necessity to maintain, or even increase, domestic tax revenues. In fact, this may well be the influential factor precipitating what appears to be a change of perspective on the role played by elected British politicians in setting rates of taxation in the UK by the Leave campaign. Contrary to that campaign’s propoundment, we have seen that there is evidence, in the form of a response to a Parliamentary question, that in the face of a potential decrease in revenue the EU’s approach to VAT does not look so objectionable.

In actual fact it is ironic to observe that the ultimate outcome of the practical considerations of Brexit could be harmonization through the unilateral action of Member States. Professor Rita de la Fiera, has suggested that what influences the harmonization of VAT systems across the EU is the economic imperative of revenue raising and that this is actually more effective than

²¹ ECJ, 13 December 2005, Case C-446/03, *Marks & Spencer plc v David Halsey (Her Majesty’s Inspector of Taxes)*, ECR I-10837.

²² Opinion of AG Maduro, 7 April 2005, in Case C-446/03, *Marks & Spencer v David Halsey (Her Majesty’s Inspector of Taxes)*, ECR I-10840.

²³ *Ibid*, ECR I-10841.

²⁴ Beale (n3) 588.

²⁵ Farmer and Lyal (n9).

²⁶ Farmer and Lyal (n9) 8.

²⁷ Farmer and Lyal (n9) 8.

the legislative endeavours of the Commission.²⁸ De la Fiera describes the economic imperative, ‘[r]eviewing the rate structure has been part of every Commission’s attempt to reform the EU VAT system—and with good reason. A recent study commissioned by the EU Commission indicates that a 50% reduction in the dissimilarity in VAT rates structures between Member States could result in a rise of 9.8% in intra-EU trade and an increase in real GDP of 1.1%’.²⁹ She continues to identify however that, ‘these studies in themselves have traditionally been insufficient to convince Member States to act. On the contrary, what has now made many Member States act at a domestic level has been the pressing need for extra revenue’.³⁰ The statistics are very revealing ‘[s]ince 2009 twenty-five of the thirty-three OECD countries have increased their VAT rates, resulting in a broad convergence of VAT standard rates across the EU around the 20% mark.’ An unforeseen practical consequence of the sovereignty argument which effectively runs counter to the stance of the Leave campaign expressed in the quote at the beginning of this article, is that the ‘latest developments raise the possibility that Europe might be finally entering a process of convergence of VAT rate structures, not by EU initiative but by domestic necessity’.³¹

Another unforeseen but far more unfortunate consequence of the constitutional theory on sovereignty propounded by the Leave campaign is the impact on cross-border trade between the UK and the Republic of Ireland. One possible post referendum reality is that a ‘hard border’ may be imposed between Northern Ireland, as part of a UK terminating its membership of the EU, and the Republic of Ireland, which will remain a Member State. This could potentially involve customs border controls. The practical consequence is that either tariff barriers, or more likely non-tariff barriers, would follow. It is therefore relevant to briefly consider this feature of the cross-border element of taxation in the context of harmonization.

The EU’s perspective on harmonization is that it is necessary in order to allow businesses to operate freely, raising capital throughout the Union.³² Harmonization therefore enables movement across frontiers. This is as true in relation to the removal of obstacles to trade that may result from company taxation as it is in relation to VAT.³³ Distortions to cross-border trade can therefore occur because of a lack of a harmonized tax base and tax rates, simply as a result of an interaction between differing national tax systems.³⁴ Non-tariff barriers in particular, were defined broadly by the OECD as: ‘all measures other than tariffs that restrict or otherwise distort trade flows.’³⁵ Given the breadth of this definition, it is likely that some forms of non-tariff barriers would be imposed at the UK border with the Republic of Ireland.³⁶ This is

²⁸ Rita de la Fiera, *EU VAT Rate Structure: towards unilateral convergence?*, Oxford Centre for Business Taxation Working Paper WP13/05, 2013.

²⁹ *Ibid*, 18. The Commission Study referred to is: European Commission, *A Retrospective Evaluation of Elements of the EU VAT System*, December 2011.

³⁰ Rita de la Fiera (n30) 18.

³¹ Rita de la Fiera (n30) 1.

³² Farmer and Lyal (n9) 10.

³³ Space precludes detailed discussion on both the historic and the present EU proposals on harmonization in the sphere of company taxation. For further elaboration on this subject see Terra and Wattel, *European Tax Law*, sixth edn (Kluwer Law International, 2012).

³⁴ Farmer and Lyal (n9) 10.

³⁵ OECD Trade Policy Studies, *Looking beyond tariffs: the role of non-tariff barriers in world trade*, 2005, The Executive Summary, 11.

³⁶ On the impact of customs related non-tariff barriers see T. Lyons QC, *The Interaction of Customs and Non-tariff Barriers*, in C. Herrmann et al. (eds), *European Yearbook of International Economic Law*, (Springer, 2015) 21.

especially so should the UK follow a ‘hard Brexit’³⁷ option. In these circumstances it is unlikely that the issue will be fully resolved by simply relying on the application of the WTO rules, as has been suggested by several well-known Leave campaigners. Although a detailed discussion of the WTO rules and the situation of the UK in relation to them, is beyond the scope of this article, suffice it for present purposes to say that the WTO itself is not at as far a stage of discouraging non-tariff barriers as some may assume. Negotiations on a new Trade Facilitation Agreement finally reached a conclusion in December 2013, having commenced as long ago as July 2004.³⁸ It was anticipated that improvements to GATT 94, designed to alleviate the situation in relation to non-tariff barriers to trade, would be included in section I of the Agreement. The Agreement on Trade Facilitation set the deadline of 31 July 2014 for the insertion of a Protocol of Amendment in Annex 1A of the WTO Agreement. However, a consensus on the agreement could not be reached between the members in time and therefore a further agreement on an amended protocol text was required but was not reached until November 2014.³⁹ As the Agreement only comes into force when two-thirds of WTO members have completed their domestic ratification processes, further delays have occurred. At the time of writing the number of member signatories is still short of the overall number required.⁴⁰ Consequently, it is likely that the UK will need some form of bilateral association agreement with the EU that addresses customs tariffs and non-tariff barriers. From a practical perspective, this would be in order to avoid less favourable treatment to imports. It is also necessary in order to avoid the constitutionally unthinkable consequences for trade and travel over the Northern Irish and Republic of Ireland border.

IV. CONCLUSION

This article started with a quote from the Vote Leave referendum campaign which was premised on the Parliamentary Sovereignty paradox. The practical considerations of the referendum, as they relate to taxation sovereignty, revealed that the EU does not legislate in a vacuum, and neither does the UK. Ultimately, it is becoming clear from the debates thus far held in the House of Commons that what happens in practice does not always reflect constitutional ideals. It appears conclusive that the reality of post Brexit economic expediencies will feature as an unavoidable influence on post referendum policy decisions, with potentially unfortunate consequences for the UK’s border with the Republic of Ireland.

Should the UK agree in a Brexit deal with the EU to maintain part of the current economic reality, specifically in relation to VAT, this would presumably be in accordance with the Commission’s harmonization objective, although not necessarily including flexibility arrangements. As a concept which spans both constitutional and practical considerations, tax harmonization is ‘a difficult and sensitive process since it does not relate merely to technical issues ... [but] reflects economic, social and political conditions and budgetary requirements’,⁴¹ which are often conflicting factors which Leave campaigners are realising are not easily controlled. The post referendum reality seems set to take a form contrary to the sentiments quoted at the beginning of this article. While this may please the present writer, it is a concern that the majority of voters look set to be disappointed.

³⁷ A colloquialism referring to the UK exiting the single market completely as a result of the referendum result. See further <http://www.bbc.co.uk/news/business-37500140> (accessed 30 September 2016).

³⁸ See T. Lyons QC (n38) 20.

³⁹ See T. Lyons QC (n38) 20.

⁴⁰ See https://www.wto.org/english/news_e/news16_e/fac_28oct16_e.htm (accessed 28 October 2016).

⁴¹ Farmer and Lyal (n9) 2.