JUDGMENT OF THE COURT
12 December 2003

(Failure of a Contracting Party to fulfil its obligations – free movement of services -higher tax on intra-EEA flights than on domestic flights)

In Case E-1/03,

EFTA Surveillance Authority, represented by Niels Fenger, Director, Legal & Executive Affairs, and Elisabethann Wright, Officer, Legal and Executive Affairs, acting as Agents, 74 Rue de Trèves, Brussels, Belgium,

Applicant,

v

The Republic of Iceland, represented by Anna Jóhannsdóttir, Legal Officer, Ministry of Foreign Affairs of Iceland, acting as Agent, Rauðarárstígur 25, 150 Reykjavík, Iceland, assisted by Kristín Helga Markúsdóttir, Legal Officer, Ministry of Transport, Ragnheiður Snorradóttir and Ingvi Már Pálsson, Legal Officers, Icelandic Ministry of Finance,

Defendant,

APPLICATION for a declaration that, by maintaining in force the Icelandic Act on Air Transport Infrastructure Budget and Revenues for Aviation Affairs No 31/1987 (*Lög nr. 31 frá 27. mars 1987 um flugmálaáætlun og fjáröflun til framkvæmda í flugmálum*), which subjects flights from Iceland to other EEA States to a higher tax rate than that charged for domestic flights and flights to Greenland and the Faroe Islands, the Republic of Iceland has failed to respect its obligations under Article 36 of the Agreement on the European Economic Area and Article 3(1) of Council Regulation (EEC) No 2408/92 of 23 July 1992 on Access for Community air carriers to intra-Community air routes.

THE COURT,

composed of: Carl Baudenbacher, President , Per Tresselt (Judge-Rapporteur) and Thorgeir Örlygsson, Judges,

Registrar: Lucien Dedichen,

having regard to the written pleadings of the parties and the written observations of the Commission of the European Communities, represented by John Forman, Legal Adviser, and Mikko Huttunen, Member of its Legal Service, acting as Agents,

having regard to the Report for the Hearing,

having heard oral arguments of the Applicant, represented by its Agents Niels Fenger and Elisabethan Wright, the Defendant, represented by its Agent Anna Jóhannsdóttir, Legal Officer, Ministry of Foreign Affairs of Iceland, acting as Agent, assisted by Kristín Helga Markúsdóttir, Legal Officer, Ministry of Transport, Ragnheiður Snorradóttir and Ingvi Már Pálsson, Legal Officers, Ministry of Finance, and the Commission of the European Communities, represented by its Agent John Forman, at the hearing on 17 October 2003,

gives the following

Judgment

I Facts and pre-litigation procedure

1 By an application lodged at the Court on 20 January 2003, the EFTA Surveillance Authority filed a request for a declaration that, by maintaining in force its Act on Air Transport Infrastructure Budget and Revenues for Aviation Affairs (*lög um flugmálaáætlun og fjáröflun til framkvæmda í flugmálum*, the "Aviation Infrastructure Act"), which subjects flights from Iceland to other EEA States to a higher tax rate than that charged for domestic flights and flights to Greenland and the Faroe Islands, the Republic of Iceland has failed to fulfil its obligations under Article 36 of the EEA Agreement and Article 3(1) of Council Regulation (EEC) No 2408/92 of 23 July 1992 on Access for Community carriers to intra-Community air routes which was made part of the EEA Agreement by Decision No 7/94 of the EEA Joint Committee of 21 March 1994 and is listed in point 64a of Annex XIII to the EEA Agreement.

2 By a letter of 28 April 1998, the Applicant wrote to the Defendant requesting information concerning the Icelandic air passenger tax. In its response of 27 May 1998, the Defendant stated that the tax is a very important source of income for

the financing of the airport infrastructure in Iceland and that it is used to finance the construction and operation of domestic airports.

3 On 16 December 1998, the Applicant sent a letter of formal notice to the Defendant concluding that, by maintaining legislation subjecting air passengers travelling from Iceland to other EEA States to a higher tax than those travelling on domestic flights and flights from Iceland to Greenland and the Faroe Islands, Iceland has failed to comply with its obligations under Article 36(1) EEA and Article 3(1) of Council Regulation (EEC) No 2408/92. For the sake of order it must be said that the EEA Agreement does not apply to the Faroe Islands and Greenland.

4 In its reply of 21 May 1998, the Defendant argued that the matter in question involved only taxation, which falls outside the scope of the EEA Agreement and that for geographical reasons, there is no breach of Article 36 EEA, since domestic and international air transport services in Iceland are not comparable; the longest domestic route being 379 km whereas the shortest international route is 1382 km. The Government of Iceland deduced from this fact that there is no competition between national and international routes, and thus no special advantage conferred on the domestic market.

5 The Applicant issued a reasoned opinion to Iceland on 16 September 1999. It maintained its view that the measures at issue were in breach of the EEA Agreement. It contended that an international air route between two EEA States was, by its nature and definition, a cross-border activity, which was adversely affected when it was subject to stricter conditions than those of a domestic air route. It argued that the tax applicable to most cross-border flights is higher than that applied to national flights, and is therefore liable to act mainly to the detriment of foreign service providers. In support of the existence of a cross-border element, the EFTA Surveillance Authority also contended that liberalisation of air transport would not have been necessary if all relevant elements were already confined within each individual EEA State.

6 In a reply of 17 November 1999, the Defendant maintained its view that the measures at issue were in compliance with EEA law. It argued that there was no cross-border element because there was no basis for any kind of comparison between flights within Iceland and international flights.

7 After the matter had been discussed by representatives of the parties the Defendant informed the Applicant that a bill would be put before the Parliament in October 2002 according to which airport taxes would be the same for domestic and international flights. The Applicant therefore refrained from initiating proceedings before the EFTA Court. However, when no additional information was received from the Defendant regarding the progress of the legislative process, it filed the application which gave rise to the present case.

II Legal background

EEA law

8 Article 36 EEA requires the abolition of all restrictions on the provision of services within the EEA in respect of nationals of EC Member States and EFTA States who are established in an EC Member State or an EFTA State other than that of the person for whom the services are intended.

9 Article 38 EEA states that the freedom to provide services in the field of transport shall be governed by the provisions of Chapter 6 of Part III of the Agreement. Article 39 EEA further provides that Articles 30 and 32 to 34, including the provision in Article 33 permitting special treatment of foreign nationals on grounds of public policy, public security or public health, shall also apply to the freedom to provide services.

10 The provisions of Articles 36, 38 and 39 EEA mirror the provisions of Articles 49, 51 (1) and 55 EC (ex Articles 59, 61(1) and 65 EC).

11 Article 7 EEA provides that acts referred to or contained in the Annexes to the Agreement or in decisions of the EEA Joint Committee shall be binding upon the Contracting Parties, and be, or be made, part of their internal legal order.

12 Council Regulation (EEC) No 2408/92 of 23 July 1992 on Access for Community air carriers to intra-Community air routes was incorporated into the EEA Agreement by Decision No 7/94 of the EEA Joint Committee and is listed in point 64a of Annex XIII to the EEA Agreement.

13 Regulation 2408/92 constitutes an element of what is known as the third "package" on air transport, which aims to ensure the freedom to provide air transport services and the application of the Community rules in this sector.

14 Article 3(1) of Regulation 2408/92 provides that subject to this Regulation, Community air carriers shall be permitted by the Member State(s) concerned to exercise traffic rights on routes within the Community.

15 "Traffic rights" are defined in Article 2(f) of Regulation 2408/92 as the right of an air carrier to carry passengers, cargo and/or mail on an air service between two Community airports.

The contested national legislation

16 Article 5(1) of the Aviation Infrastructure Act (*lög um flugmálaáætlun og fjáröflun til framkvæmda í flugmálum*), reads as follows:

> "A separate airport tax shall be paid in respect of each individual travelling by aircraft from Iceland to other countries."

Article 6(1) of the Aviation Infrastructure Act, reads as follows:

> "The airport tax shall amount to ISK 1250 for each passenger travelling from Iceland to other countries…"

Article 7(1) of the Aviation Infrastructure Act, reads as follows:

> "Airlines engaged in the transport of passengers within Iceland or to the Faroe Islands or Greenland shall pay a tax amounting to ISK 165 for each passenger travelling on these routes …"

III Arguments of the parties

17 The application is based on the plea that the Defendant has failed to comply with its obligations under Article 36 of the Agreement on the European Economic Area and Article 3(1) of Council Regulation (EEC) No 2408/92 of 23 July 1992 on Access for Community air carriers to intra-Community air routes.

18 It is not contended that the Icelandic legislation in question entails discrimination based on nationality or place of residence. However, the parties disagree as to whether that legislation constitutes a hindrance to the free movement of services.

19 The *Applicant* claims that since the amount of airport tax directly and automatically influences the price of a journey, a difference in tax of the degree at issue makes the provision of intra-EEA services more difficult than the provision of services solely within Iceland. Whether the effect on the provision of intra-EEA flight services is considerable or not, is, according to the Applicant, immaterial since there is no scope for a *de minimis* rule in respect of restriction on the freedom to provide services. Nor can the question of whether there is a competitive relationship between different routes play a role.

20 As far as a possible justification of the restriction is concerned, the Applicant maintains that the Defendant has not shown that the difference in the amounts levied on international and domestic passengers corresponds to a similar difference in costs for providing the services to the two groups of passengers, as would be required by the principle of proportionality. The Applicant, moreover, maintains that the public interest aims invoked by the Defendant, however laudable, cannot justify a difference in air passenger taxes dependant on whether they are charged for domestic or international air travel.

21 The *Defendant* maintains that the provisions at issue in no way restrict or impede the free provision of air services within the EEA. In its view the legislation in question does not produce any effect as to the provision of intra-EEA services. The Defendant submits that the Applicant has not established that the effects of

the difference in the amount of tax levied on domestic and international passengers are such that the freedom to provide services is in any way restricted.

22 The Defendant further contends in this regard that the markets and services for international and domestic flights are not comparable, particularly in light of the geographical situation of Iceland: the longest air-route within the domestic market being 379 km, while the shortest route in service between Iceland and the rest of the EEA is approximately 1350 km. As Iceland is an island, there are no other means of rapid and convenient transport between the country and the rest of Europe. Geography, differences in services and customer demand, as well as the types and size of aircraft, lead to fundamental differences in competitive conditions for domestic and international air services in Iceland, with the consequence that any competition between the two markets is excluded. Hence, there is no possibility of a special advantage being secured for the provision of domestic flight services.

23 According to the Defendant, the taxes compensate airport services and facilities necessary for the processing of passengers, where the cost of these services is proportionately higher for international flights than for domestic flights.

24 The Defendant also argues that the tax rate on international flights is in line with comparable intra-EEA passenger charges. Moreover, the Defendant submits that the lower tax rate for domestic services is aimed at maintaining and stimulating competition in providing services in the small and isolated Icelandic market. Such indirect market support will, in the Defendant's view, benefit all service providers willing to offer their services in this market.

25 In the alternative, the Defendant contends that if the tax regime in question is considered a restriction on the freedom to provide services, it is in any event justified by compelling reasons of public interest since it constitutes a necessary source of revenue for maintaining and building airports and airport facilities both for international and domestic flight services. As these facilities are essential for residents of the peripheral regions to gain access to a population centre where administrative, medical and commercial services as well as education and culture are available, the reduced tax rate on domestic services is both necessary and proportionate. In that respect, the Defendant invokes both public policy and public security reasons. It contends that providing basic airport services to the many remote parts of Iceland is essential, for economic, environmental and social reasons, to maintain habitation in all parts of Iceland, and to protect social cohesion.

IV Findings of the Court

26 The *Court* notes that, as a general rule, the tax system of an EEA/EFTA State is not covered by the EEA Agreement. The EEA/EFTA States must, however,

exercise their taxation power consistently with EEA law (see Cases E-6/98 *Norway* v *EFTA Surveillance Authority* [1999] EFTA Court Report 74, at paragraph 34; E-1/01 *Hörður Einarsson* v *The Icelandic State* [2002] EFTA Court Report 1, at paragraph 17).

27 As stated in Article 1(1) EEA, one of the main objectives of the Agreement is to create a homogeneous European Economic Area. This objective has consistently informed the jurisprudence of the Court, (see, inter alia, Case E-9/97 *Sveinbjörnsdóttir* v *Iceland* [1998] EFTA Court Report 95, at paragraph 49; Case E-6/01 *CIBA* v *Norway* [2002] EFTA Court Report 281, at paragraph 33). In this regard, Article 6 EEA provides that the Court is bound by the relevant rulings of the European Court of Justice given prior to the EEA Agreement, and the second paragraph of Article 3 of the ESA/Court Agreement provides that the Court has to pay due account to later case law. The Court notes that the European Court of Justice in a recent case evoked the aim of the EEA Agreement, which is the realisation of the four freedoms within the whole of the European Economic Area, so that the internal market is extended to the EFTA States. In that context, the European Court of Justice noted the need to ensure uniform interpretation of rules of the EEA Agreement and the EC Treaty, which are identical in substance (see Case C-452/01 *Ospelt*, judgment of 23 September 2003, not yet reported, at paragraph 29).

28 Article 36 EEA requires not only the elimination of all discrimination based on nationality or place of residence, but also the abolition of any restriction, even if it applies without distinction to national providers of services and to those of other States party to the EEA Agreement. A measure that is liable to prohibit or otherwise impede the provision of services between EEA Contracting Parties as compared to the provision of services purely within one EEA Contracting Party constitutes a restriction (see, with regard to Article 49 EC, Case C-76/90 *Manfred Säger* v *Dennemeyer & Co. Ltd* [1991] ECR, I-4221, at paragraph 12; Case C-205/99 *Analir* [2001] ECR I-1271, at paragraph 21). Council Regulation (EEC) No 2408/92 of 23 July 1992 on Access for Community air carriers to intra-Community air routes which is referred to in point 64a of Annex XIII to the EEA Agreement defines the conditions for applying the principle of the freedom to provide services in the air transport sector. That regulation must be interpreted in light of the general principle enshrined in Article 36 EEA. The question must therefore be examined whether the Defendant's legislation at issue is liable to make more difficult or render less attractive the provision of intra-EEA flight services.

29 The Defendant has rightly emphasised that comparability of services is a basic prerequisite for determining whether differences in fees or treatment are restrictive. As the Applicant has pointed out, the nature of air service is not altered by the fact that it crosses borders. In relation to the comparability of the services in the case at hand, the Defendant refers to factors that do not affect the nature of the service provided, such as geographic distance, and fails to show that the relevant domestic and international air services are by nature different. Comparability within the context of the freedom to provide services does not call

for a market definition as developed in competition law. The Defendant's argument that domestic flight services and intra-EEA flight services cannot be compared must therefore be rejected.

30 Article 36 EEA and Council Regulation (EEC) No 2408/92 of 23 July 1992 on Access for Community air carriers to intra-Community air routes aim at securing the freedom to provide services within the single market envisaged by the EEA Agreement. They confer a right upon individuals and economic operators to market access. This right precludes any unjustified restriction, however minor (see, with regard to Article 49 EC, Case C-49/89 *Corsica Ferries France* [1989] ECR 4441, at paragraph 8). Therefore, the realisation of the freedom to provide services cannot depend on whether an effect would be material.

31 As regards the existence of a restriction in the present case, it is sufficient to note that the amount of air passenger tax to be paid will directly and automatically influence the price of the journey. Differences in the taxes to be paid per passenger will automatically be reflected in the transport costs, and thus access to domestic flights is favoured over access to intra-EEA flights (see, for comparison, Case C-70/99 *Commission* v *Portugal* [2001] ECR I-04845, at paragraph 20). In the present case, the tax levied per passenger travelling on intra-EEA flights is more than seven times higher than the tax levied per passenger travelling on domestic flights. This clearly constitutes a restriction on the freedom to provide services.

32 The Defendant has argued that the passenger tax rate on international flights is in line with comparable intra-EEA passenger charges, and that the airport taxes and charges in most EEA States are higher than or similar to the rates on Icelandic international flights. These contentions are not relevant in the case at hand, where the basis for comparison is limited to domestic flights within Iceland and intra-EEA flights from Iceland.

33 Moreover, the invocation of the fact that the Commission of the European Communities had not undertaken action against the taxation regime of the United Kingdom concerning the Scottish Highlands and Islands cannot lead to the conclusion that the taxation regime of the Defendant is compatible with EEA law.

34 The Court now turns to the issue of whether the aforementioned restriction is justified. With respect to the Defendant's argument that additional and different services are offered to intra-EEA and international passengers, it suffices to state that according to the Defendant's own submissions the purpose of the contested legislation is to secure a special source of revenue to construct and maintain airports and airport facilities for air services in Iceland. The reduced air passenger tax on domestic flights is, in essence, indirect market support for air service providers who are willing to offer their services in this difficult and small market. In order for a difference in the type of services provided to domestic and to intra-EEA passengers to justify a difference in the air passenger tax, there must be a genuine connection between the costs related to providing the respective

services and the amount of the tax. The Defendant has not shown that such a connection exists, and the argument must therefore be rejected.

35 A restriction on the freedom to provide services which is prohibited under Article 36 EEA can in principle be justified on grounds of public interest such as securing access to medical, cultural and commercial infrastructure for the inhabitants of outer regions of Iceland and to prevent migration from rural areas. These goals must, however, be pursued in compliance with the principle of proportionality, according to which any measures taken have to be suitable and necessary. The Defendant has not shown that the differentiated air passenger tax is a necessary means to achieve the public interest goals in question. Moreover, whilst Regulation 2408/92 does, in certain circumstances, permit the imposition upon air carriers of public service obligations, which may be the subject of financial compensation, those obligations must be defined beforehand and any financial quid pro quo must be capable of being identified as specific compensation for the obligation in question (see, for comparison, Case C-70/99 *Commission* v *Portugal* [2001] ECR I-04845, at paragraph 34). It is undisputed that this has not happened in the case at hand.

36 Whether the special situation of the Defendant would entitle it to seek the EFTA Surveillance Authority's approval under the State aid rules is immaterial in a case brought under the combined provisions of Article 36 EEA and Article 3(1) of Regulation 2408/92.

37 The Court therefore holds that by maintaining in force the contested legislation, the Defendant is restricting the freedom to provide services in a manner that is incompatible with its obligations under Article 36 EEA and Article 3(1) of Council Regulation (EEC) No 2408/92 of 23 July 1992 on Access for Community carriers to intra-Community air routes.

V Costs

38 Under Article 66(2) of the Rules of Procedure, the unsuccessful party is to be ordered to pay the costs if they have been applied for in the successful party's pleadings. The EFTA Surveillance Authority has asked for the Republic of Iceland to be ordered to pay the costs. Since the latter has been unsuccessful in its defence, it must be ordered to pay the costs. The costs incurred by the Commission of the European Communities are not recoverable.

On those grounds,

THE COURT

hereby:

1. **Declares that by maintaining in force the Icelandic Act on Air Transport Infrastructure Budget and Revenues for Aviation Affairs No 31/1987 (*Lög nr. 31 frá 27. mars 1987 um flugmálaáætlun og fjáröflun til framkvæmda í flugmálum*), which imposes a higher tax per passenger travelling from Iceland to other EEA States than per passenger travelling on domestic flights, the Republic of Iceland has failed to respect its obligations under the combined provisions of Article 36 of the Agreement on the European Economic Area and Article 3(1) of Council Regulation (EEC) No 2408/92 of 23 July 1992 on Access for Community air carriers to intra-Community air routes**.

2. **Orders the Republic of Iceland to pay the costs of the proceedings.**

Carl Baudenbacher Per Tresselt Thorgeir Örlygsson

Delivered in open court in Luxembourg on 12 December 2003.

Lucien Dedichen
Registrar

Carl Baudenbacher
President