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P. Bernd Spahn*

The Future of Value-added Taxation in the European Community

The completion of the Single Market by 1993, with the removal of internal borders which this involves, means that the European Community's present VAT system has to be reformed.

Although the basic choice as to the future VAT system has been made recently, the long-term destiny of VAT is still open. Professor Spahn examines the various alternatives.

Western Europe is aiming at the achievement of a unified Single Market by 1992. Government interference and internal protectionism will gradually be reduced and all economic borders abolished, be they material, technical, or fiscal in nature. The Single European Act of 1987 and further agreements among Community Members culminating in the Maastricht accord of December 1991 have speeded up the process of economic integration in Europe and unleashed an avalanche of change sweeping before it all nationalistic self-interest which had hitherto prevented the EC from becoming a truly single market. By the end of 1992 European companies will share a home market potentially larger than any other in the free world. More recently, the creation of an economic zone in conjunction with EFTA – some of whose members have already applied for admission to the Community as full members – and the according by the Community of associate member status to Poland, Czechoslovakia and Hungary, have increased this potential even further. And toward the end of the century, Western Europe will move into an Economic and Monetary Union (EMU) with a unified currency for core countries. Major institutional reforms are expected to accompany this process.

This paper looks into a particularly important aspect of realising the Single Market: the future system of value-added taxation (VAT) in Europe. This seemed to be a major obstacle for the integration process since it tends to affect not only the tax burden of EC citizens, but also the revenue collection of national governments. Although the basic choice has been made recently, the long-term destiny of VAT is still open.

Today, all member states of the European Community operate systems of VAT as the principal indirect tax on

goods and services. By zero-rating exports¹ and taxing imports at the rate applied to domestic sales, the present VAT system guarantees full tax neutrality for international trade: zero-rating of exports ensures that goods sold to another country bear no VAT of the origin country; the corresponding import tax will generally raise the price of imports to the consumer price level of the country of destination (destination principle).² Hence, French material sold in West Germany, for instance, bears the German (standard) VAT rate of 14 per cent, *not* the French rate – which is 18.6 per cent.

In addition, this treatment of international trade ensures, for intra-Community fiscal relations, that revenue from VAT is assigned to that member state where goods are actually being consumed.³ It should thus be stressed that the present regime realises the destination principle in a double sense: (i) as regards the allocation of tax burdens, or (formal) regional tax incidence; and (ii) as regards the allocation of tax revenue among the fiscs of member states, or regional fiscal assignment. This is important to keep in mind when discussing VAT reform proposals.

Currently, fiscal frontiers form an integral part of VAT systems. They are necessary to ascertain that zero-rated

¹ Zero-rating for VAT means that no output VAT is charged, and the VAT paid on inputs is all refunded.

² Zero-rating of exports only applies to goods; see, for instance, § 4 No. 1 of the German VAT law which reserves these concessions to "Ausfuhrlieferungen" (according to § 6 Gegenstände), and "Lohnveredelungen an Gegenständen". Services are generally taxed in the country of origin, hence the origin principle applies here.

³ For a review of the destination principle and its counterpart, the origin principle, see in Sijbren Cnossen, C.S. Shoup: Coordination of value-added taxes, in: S. Cnossen (ed.): Tax coordination in the European Community, Deventer 1987, pp. 59 ff.; R. Parsche, B. Seidel, D. Teichmann: Die Beseitigung der Steuergrenzen in der Europäischen Gemeinschaft, DIW Sonderheft No. 145, Berlin 1988; E. Janeba: Ökonomische Probleme der Umsatzsteuerharmonisierung bei der Vollendung des EG-Binnenmarktes, Europäisches Parlament, Sammlung Wissenschaft und Dokumentation, Reihe Wirtschaftspragen No. 15, Strasbourg 1988.

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exports have in fact left the country. And, as goods enter the country, VAT has to be paid to the revenue authorities of the importing country which, again, requires fiscal controls. Without these controls, companies might use goods for untaxed sales on the domestic market – pretending to have exported them – or they might simply import goods tax-free.

The present VAT system is to be reformed for intra-Community trade after the completion of the Single Market by 1993, when internal border posts will have been removed. First, it seems that without border controls, the EC would have to adopt the origin principle for its intra-regional trade, for both regional tax incidence and fiscal assignment. Second, this system would seem to call for uniform tax rates throughout the EC – since differentiated rates would invite consumers to realise gains from tax arbitrage by shopping in low-tax countries – with the consumption in high-tax countries remaining free of additional charges. Third, it would also lead to a massive *revirement* of tax revenue to be re-assigned to member states governments horizontally.

Border Controls Unnecessary

As Cnossen⁴ has pointed out, border controls are, however, *not* absolutely essential for fiscal neutrality to be achieved while retaining the destination principle. He discusses essentially two proposals in this context:

□ *Deferred payment scheme.* Under this scheme, exports are free of tax, and no import tax is levied at borders. In order to bring the value of the imported good to the domestic price level, the credit mechanism of VAT is relied upon, ensuring that the first taxable unit in the importing country implicitly pays the tax. This occurs because there is no offsetting credit for imported goods unless imports are declared. The recipient of the good – not necessarily the importer himself – reports and computes the compensatory import tax, but may take credit for that tax at the same time. Since, as a rule, the import tax is not paid until the product is resold, import taxes are deferred, hence the name of the scheme. This system has been operating in the Benelux States under the name of PAS since 1966; it was also used in the UK until November 1984.⁵

⁴ Sijbren Cnossen: Dutch experience with the value-added tax, in: Finanzarchiv, Vol. 39 (1981), pp. 223-254; Sijbren Cnossen: Coordination of sales taxes in federal countries and common markets, in: Financing Federal and State Governments, edited by the OECD, Centre for Cooperation with European Economies in Transition, Committee on Fiscal Affairs, Paris 1991.

⁵ The system operating in the Benelux states is more fully described in: J. B. van der Zanden, B. J. M. Terra: The removal of tax barriers: The White Paper from the Commission to the European Council, in: Intertax, No. 6, 1987, pp. 130-142, here pp. 135 ff.

A few remarks regarding this system may be appropriate:

- The destination principle can only be realised for trading among firms liable for VAT. It cannot be applied to direct imports by consumers. Thus, for direct imports the origin principle applies to both regional fiscal assignment and regional tax incidence.
- Documentation still has to be provided at customs posts in order to assure that tax-free exports have in fact left the country. The main advantage of the scheme seems to be that border formalities due to the levying of import VAT are reduced.
- Adopted at the Community level without border controls, the scheme seems to exhibit incentives to cheat on import-tax credits – through collusion between exporters and importers – where the tax rate of the importing country is higher than that of the exporting country.⁶ In order to avoid this collusion, cumbersome administrative procedures would have to be set up.⁷

It seems obvious that the deferred payment scheme would not be operational under the Single Market; however the method was proposed by the Commission in article 23 of the Sixth Directive.⁸

□ *Tax credit clearance system.* Under this scheme, exporters to other EC countries would pay full VAT to their own governments, i.e. exports are no longer zero-taxed. However, the importing firm would receive a tax credit for out-of-state taxes paid from its own fisc. Border tax adjustments are simply shifted to the account books of firms residing in importing member states. The EC-wide VAT system would thus work in the same way as national VAT systems do now; the EC would form a truly Single Market for VAT.

⁶ This incentive is negligible for the Benelux countries where tax rates – at least for Belgium and the Netherlands – are reasonably close together (17/19 per cent in Belgium, 18.5 per cent in the Netherlands, but 12 per cent in Luxembourg), and border controls continue to play a role for potential cross-checking. Nevertheless, there seem to be problems of tax fraud associated with PAS even in the Benelux states; cf. J. B. van der Zanden, B. J. M. Terra, *op. cit.*, p. 136.

⁷ In discussing a recent French proposal for the adoption of PAS, Smith underlines the substantial administrative burden on both government and companies that is related to an extension of PAS to all EC member states. It would require exports to be accompanied by multiple copies of documents. Entitlement to zero-rate intra-EC exports would require proof of the exported good's having been subject to VAT in the country of destination, which could be effected by returning one of the documents, certified by the importer's tax office, to the exporter's tax authorities. Although border controls would be eliminated under such a system, the transaction costs would be significantly higher on intra-EC transactions than those on purely domestic trade; this would effectively discriminate against trade in foreign goods. Cf. Stephen Smith: The European Community's priorities in tax policy, Institute for Fiscal Studies, Working Paper Series No. W90/2, London 1990, p. 15.

⁸ Cf. Sijbren Cnossen: Coordination of sales taxes ..., *op. cit.* The proposal was, however, not accepted by the Council of Ministers.

Again, a few remarks regarding this system may be appropriate:

- Although the system would continue to secure the destination principle for regional tax incidence, it would apply the origin principle for regional fiscal assignment. Net-exporter nations would levy *more* taxes than before, since they no longer have to exempt exports, while net-importer nations would *lose* tax revenue through the tax credit given on out-of-state taxes. In order to correct for resulting horizontal fiscal imbalances, the system would have to install a clearing mechanism by which exporter countries re-imburse importer countries for tax credits accorded to their importing firms. Such a mechanism may prove to be very difficult to administer.
- As under the deferred payment scheme, the destination principle can only be realised for trading among firms liable to VAT. It cannot be applied for direct imports by consumers where the origin principle would work for both regional tax incidence and regional fiscal assignment.⁹
- Apart from the problem of revenue allocation among member states, the system may create severe regional distortions if tax rates vary widely across regions: the "mixed tax principle" would encourage consumers to arbitrage on tax differentials via direct purchases of high-value goods (like cars, yachts, antiques, jewellery) in low-VAT countries. Cross-border shopping would thus lead to tax competition among member states with the danger of beggar-thy-neighbour policies that may drive tax rates below efficient levels.¹⁰

Need for Supplementary Rules

The potential for tax competition among EC member states based on existing VAT rates is illustrated by the diversity expressed in Table 1.¹¹

It seems obvious that the tax credit clearance system is an interesting option for post-1993 VAT systems in the

⁹ Since final consumers and VAT-registered traders are subject to different tax rates, the scheme was characterised as following a "mixed tax principle". Cf. Andreas Haufler: Die Abschaffung der Steuergrenzen im gemeinsamen Markt: EG-Vorschläge 1989 und alternative Lösungen, in: Umsatzsteuer- und Verkehrssteuer-Recht, No. 5, 1990, pp. 131-139.

¹⁰ Alternatively, a strong diversity in tax rates would distort locational decisions of firms which would settle in low-tax jurisdictions where cross-border shopping is important.

¹¹ Cf. Commission of the European Communities, internal document XXI/311/90-EN.

¹² Cf. Sijbren Cnossen: Co-ordination of sales taxes ..., op. cit.

¹³ The Cecchini Report estimates economic costs of border controls to be in the order of ECU 8-9 bn. Cf. Paolo Cecchini: 1992: The European challenge: The benefits of a single market, 2nd. ed., Aldershot 1988.

Community, yet it requires supplementary rules – apart from the clearing mechanism – "that exempt or regulate intracommunity imports by nontaxable persons such as individuals and exempt organizations and institutions, including governments".¹² Special provisions would also have to apply to mail-order firms that could otherwise exploit the potential for tax arbitrage inherent in differential tax rates. Furthermore, it requires central coordination on tax-rate policies in order to avoid horizontal tax competition induced by the effects of cross-border shopping. This could effectively be achieved by negotiating a price floor for VAT rates.

Summarising the discussion of present VAT and its alternatives, it is obvious that both the existing system as well as the deferred payment scheme would impede the realisation of a Single European Market. Both systems zero-rate exports, and for such systems extensive controls would have to remain in place. These controls are costly in several ways. They cause delays in transporting goods across frontiers, and national authorities have to utilise resources to maintain frontier posts. Moreover, costs are imposed on companies when complying with border formalities.¹³ Even if alternative administrative procedures without border controls were applied, they would entail large transaction costs that would discourage potential trade and market integration.

The tax credit clearance system would in fact eliminate the need for fiscal border controls, yet it would either lead to the adoption of the origin principle for regional fiscal assignment – with consequential regional imbalances in

Table 1
VAT Rates Applicable
in EC Member States as of 1st April 1991
(in per cent)

Member State	Reduced rate	Intermediate rate	Increased rate
Belgium	1/6	17/19	25/25+8
Denmark	–	22	–
France	2.1/5.5/13	18.6	22
Germany	7	14	–
Greece	4/8	18	36
Ireland	0/2.3/10/12.5	21	–
Italy	4/9	19	38
Luxembourg	3/6	12	–
Netherlands	6	18.5	–
Portugal	8	17	30
Spain	6	12	33
United Kingdom	0	17.5	–

Source: EC Commission, internal document II-B-1, EC/dc, of 1. 10. 1991.

tax collection – or require the setting-up of a clearing mechanism by which the present destination principle for fiscal assignment can be preserved. Moreover, regional tax incidence is affected through cross-border direct purchases by consumers to which the origin principle applies. This entails the need for greater horizontal cooperation among member states with tax arbitrage forcing governments to harmonise tax rates down to the price floor to be set by the Community.

The Commission's Proposals

The Commission has made several proposals for tailoring VAT to the needs of a Single Market without border controls. The more relevant later models can be summarised as follows:

□ *Proposal of 1987 (COM (87) 320)*. This proposal resembles the tax clearance system sketched above. The destination principle for regional tax incidence is preserved for the taxable sector (companies); the destination principle for regional fiscal assignment is achieved through a budget-neutral clearing mechanism based on the individual accounts of traders (microeconomic clearing) – a procedure that would involve large administrative costs.

For direct purchases the switch to the origin principle is accepted. The proposal thus exhibits a “mixed tax principle”; the emphasis is on destination, however. In order to reduce horizontal tax competition resulting from cross-border shopping, the Commission proposes a narrower band of VAT rates, where the standard rate is between 14 and 20 per cent and the reduced rate between 4 and 9 per cent. Furthermore, the range of products to which each rate applies is defined in a harmonised fashion. The proposal was criticised mainly for the heavy administrative burden of the clearing mechanism, and for its disallowing domestic sales under zero-rating.

□ *Proposal of 1989 (COM (89) 260)*. This proposal basically acknowledges the origin principle for regional tax incidence on intra-Community trade. Yet the scope for horizontal tax competition that may result is reduced by continuing the application of the destination principle for a number of important intra-Community transactions, notably for the individual purchase of cars, for mail-order firms, for transborder trading among firms belonging to the same supranational concern, and for tax-exempt public corporations and financial institutions. Again, the proposal exhibits a “mixed tax principle” where the emphasis is on origin, however.

For fiscal assignment, the destination principle is preserved, i.e. the relative position of member states

regarding VAT collection is maintained. This requires, again, a clearing mechanism. However, the number of transactions is substantially reduced by basing tax clearance on macroeconomic indicators (trade statistics), not on individual traders' accounts (macroeconomic clearing).

As far as tax competition is concerned, the Commission announced that it proposes floors for standard and reduced VAT rates. As a compromise, zero-rating is allowed for a “very reduced number of products” (COM (89) 260, No. 11).

□ *Proposal of 1990/91 (ECO/FIN 3 and 10 June 1990, and 24 June 1991)*. The Ecofin Council reached a – non-binding – political agreement on introducing a VAT system in accordance with the Commission's philosophy adopted in the 1989 proposal – hence a hybrid system with “mixed tax principles” for tax incidence (emphasising, however, the origin principle), and the destination principle for fiscal assignment (to be achieved by a macroeconomic clearing system). This system is to be introduced on January 1st, 1996, subject to revision before the end of 1995.

From 1st January 1993 on, an intermediate system will be put into operation that preserves the destination principle in both regards. With border controls removed, companies will be required to submit the amounts of intra-EC purchases and sales in their quarterly VAT returns, which puts most of the administrative burden on private firms. In order to monitor tax-exempt exports effectively, firms have to exchange their registered VAT numbers, and numbers of trading partners will have to be reported in VAT returns. This allows verification of returns through normal commercial documents (invoices). The largest firms will have to submit statistical returns which can be used for cross-checking. The transitory scheme is scheduled to end in 1995.¹⁴

As from 1993 on, a minimum standard VAT rate of 15 per cent is to be applied. Concessions were made to different member states as regards reduced (or zero) rates.

The Future Development of VAT

Given that a basic agreement has been reached on a definitive EC VAT system, future trends seem to be pointing in the following direction:

□ Despite the special provisions made to preserve the destination principle for tax incidence on car sales, mail-order sales and long-distance sales, the origin principle will eventually dominate European VAT systems. Tax competition and/or informal tax leadership of important economies within the EC are likely to harmonise tax rates

in the longer run according to the Swiss experience of the centre government's formal leadership, or to that of dominant economies. There will be a tendency toward more uniformity in value-added taxation, national tax autonomy being increasingly sought in the realm of direct taxation where effective constraints on policy-making are less pronounced. The 15 per cent line will mark a floor, but it is not necessary for tax rates to be driven down to that level by tax competition under all circumstances. Tax leadership as well as horizontal tax coordination may well allow other rates, although not substantially higher.

□ The continuing governance of the destination principle with regard to fiscal assignment (or the apportionment of VAT proceeds) will require a clearing mechanism that is likely to be based on macroeconomic indicators. The (budget-neutral) flows of funds resulting from such a scheme may be incorporated in the EC budget; they may also operate under a separate fund. According to our analysis of the administrative costs involved in resolving the corresponding principal-agent problem, the more effective solution would be to centralise such clearing functions under the (interested) supervision of the EC. The interest of the EC in operating this scheme effectively is warranted by the EC budget's participation in the proceeds from VAT through revenue sharing.

In the longer run, European national VAT systems are not only likely to converge to uniform taxation under the origin principle (which would then allow the abolition of the special provisions made for mail-order firms, car sales etc.); it is also likely to be transformed into a fully fledged tax-sharing scheme with horizontal perequation effects. Two options seem to be open to the Community:

- decentralised tax collection with horizontal tax cooperation through the clearing mechanism and the centre government participating in the proceeds from taxes; or
- centralised tax collection with vertical tax sharing – according to the German arrangements for sharing VAT among the federal government and the Länder – together

with an apportionment formula for the regional distribution of proceeds from VAT.

It is not unlikely that the German model of VAT sharing will shape fiscal federal relations between the EC and its member states in the longer term, especially if EC functions expand more rapidly with a greater share of VAT to be handed to the centre government. It is unlikely, however, that governments will accept a per capita distribution formula—as in the German case—which would exhibit far-reaching perequation effects; if existing political intentions regarding the future macroeconomic clearing mechanism are interpreted correctly, the horizontal distribution formula is likely to be based on criteria of general economic well-being, such as GNP, or perhaps, on needs.

Summary

To summarise the discussion on VAT as a possible future revenue source for the EC budget: it is absolutely certain that VAT will continue to shape EC finance in the future; it is likely that VAT sharing will become even more important for the EC budget after the completion of the Single Market, because the EC will be regarded as a neutral arbiter, and yet an effective – because interested – administrator of the clearing fund. Furthermore, VAT is likely to become more uniform under EMU, rendering it suitable to become an EC tax in the longer run, possibly even subject to EC legislation. VAT is, however, likely to remain a shared tax – similar to the German system – with some regional perequation embedded in the distribution formula governing horizontal fiscal relations. This may also be achieved implicitly through VAT financing of the cohesion fund. The perequation element will be rather weak initially; it may become stronger as regional economies will move toward greater economic cohesion under EMU.

¹⁴ The Commission is required to present a report to the Council on the functioning of the transitory regime as well as on the details of the final regime itself. The Council will have to decide on the definitive scheme before 31st December 1995.

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