

Stehn, Jürgen

**Working Paper — Digitized Version**

## Turnover taxation in the EC: options for future reforms

Kiel Working Paper, No. 613

**Provided in Cooperation with:**

Kiel Institute for the World Economy – Leibniz Center for Research on Global Economic Challenges

*Suggested Citation:* Stehn, Jürgen (1994) : Turnover taxation in the EC: options for future reforms, Kiel Working Paper, No. 613, Kiel Institute of World Economics (IfW), Kiel

This Version is available at:

<https://hdl.handle.net/10419/654>

**Standard-Nutzungsbedingungen:**

Die Dokumente auf EconStor dürfen zu eigenen wissenschaftlichen Zwecken und zum Privatgebrauch gespeichert und kopiert werden.

Sie dürfen die Dokumente nicht für öffentliche oder kommerzielle Zwecke vervielfältigen, öffentlich ausstellen, öffentlich zugänglich machen, vertreiben oder anderweitig nutzen.

Sofern die Verfasser die Dokumente unter Open-Content-Lizenzen (insbesondere CC-Lizenzen) zur Verfügung gestellt haben sollten, gelten abweichend von diesen Nutzungsbedingungen die in der dort genannten Lizenz gewährten Nutzungsrechte.

**Terms of use:**

*Documents in EconStor may be saved and copied for your personal and scholarly purposes.*

*You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.*

*If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.*

# Kieler Arbeitspapiere

# Kiel Working Papers

Kiel Working Paper No. 613

**Turnover Taxation in the EC:  
Options for Future Reforms**

by

Jürgen Stehn\*

February 1994

521383



Institut für Weltwirtschaft an der Universität Kiel  
The Kiel Institute of World Economics

Institute of World Economics  
Düsternbrooker Weg 120  
24105 Kiel  
Federal Republic of Germany

Kiel Working Paper No. 613

**Turnover Taxation in the EC:  
Options for Future Reforms**

by  
Jürgen Stehn\*  
February 1994

The author himself, not the Kiel Institute of World Economics, is solely responsible for the contents and distribution of each Kiel Working Paper.

Since the series involves manuscripts in a preliminary form, interested readers are requested to direct criticisms and suggestions directly to the author and to clear any quotations with him.

\* I am indebted to Alfred Boss, Harmen Lehment, Karl-Heinz Paqué, Astrid Rosenschon and Horst Siebert for helpful comments on a former version of the paper.

## **Contents**

Abstract .....	3
1. Introduction.....	4
2. Steps towards the Intermediate System: Proposals and Reactions .....	4
3. The Intermediate System: Shaping and Consequences.....	7
4. Options for a Future Turnover-Tax System in the EC.....	8
4.1 The Modified Destination Principle.....	9
4.2 The Origin Principle.....	11
4.3 The Sales Tax System .....	14
References .....	17

**Abstract**

After the removal of intra-Community borders, the traditional VAT system of the EC which was based on the Destination principle and fiscal border controls had to be reformed. The ECOFIN-Council decided to preserve the Destination principle for a transition period from January 1, 1993 to December 31, 1996 by shifting fiscal controls from national borders to exporting and importing firms as well as national tax authorities. In 1997, the intermediate system shall be replaced by a definite VAT system for trade among member states of the community. The aim of this paper is to search for a definite system of turnover taxation being both economically efficient as well as politically feasible. After retracing the steps of the Commission towards the intermediate system and a brief description and economic evaluation of the transition scheme it examines the various options for the shaping of turnover taxation in the community after 1996 both from an economic viewpoint and with regard to the political acceptability of the alternatives. It is shown that an introduction of a sales-tax system according to the model of the United States is the first best strategy because this system requires neither a harmonisation of tax rates nor an administratively burdensome clearing mechanism and confines the tax competition among member states to direct consumer purchases. Under this scheme, only sales of goods and services to private consumers are taxed; trade among firms stays free of tax. Since a sales tax, like a value-added tax, taxes the whole value added of an economy, the tax base stays unchanged after an introduction of the new scheme. Hence, it is possible to retain both the level and the sectoral graduation of tax rates.

## **1. Introduction**

As a visible outcome of the completion of the internal market, almost all physical border controls within the EC belong to the past. The consequences of an opening of national borders have been intensively discussed in academic and political circles since the ratification of the Single European Act in 1986, which formed the basis of the European internal market. Above all, the discussion has focused on the fiscal effects of eliminating the border controls, especially with a view to the future of value-added taxation (VAT) in the Community. Until the end of 1992, the Destination principle was applied by zero-rating exports and taxing imports at the domestic rate. Hence, the former VAT system guaranteed full tax neutrality for intra-Community trade. In order to prevent tax evasions it has been necessary to ascertain that tax-exempt exports have in fact left the country of origin, thus border controls have been an integral part of the former VAT system.

Although various reform proposals have been made by both economists and the Commission of the EC, the governments of the member states have not yet agreed on a definite European VAT system. In 1991, the ECOFIN-Council decided to preserve the Destination principle for a transition period from January 1, 1993 to December 31, 1996. Tax evasions are to be prevented by a shift of fiscal controls from national borders to exporting and importing firms as well as national tax authorities. In 1997, the intermediate system shall be replaced by a definite VAT system for the trade among member states of the Community "based on the principle of taxation of goods and services supplied in the member state of origin" (COM, 1991). However, a proposal of the Commission based on this principle was already rejected by the member states in 1987. Thus, the shaping of the future VAT system in the EC is rather blurred, especially if one takes into account that the intermediate system will be prolonged if the members of the EC-Council are unable to find a compromise solution by the end of 1995.

The aim of this paper is to search for a definite system of turnover taxation which is both economically efficient as well as politically feasible and thus leads to a happy end of the seemingly never ending story of reforming VAT in the EC. After retracing the steps of the Commission towards the intermediate system and a brief description and economic evaluation of the transition scheme we will examine the various options for the shaping of turnover taxation in the Community after 1996 both from an economic viewpoint and with regard to the political acceptability of the alternatives.

## **2. Steps towards the Intermediate System: Proposals and Reactions**

Although the mutual recognition of rules and regulations had been given priority over the harmonisation of national law in the Commission's "White Book" on the completion of the

internal market, the Commission first aimed at a harmonisation of VAT rates in the member states. However, national resistance against uniform tax rates was stronger than expected. High-tax countries like Denmark and Ireland (Table 1) feared considerable revenue losses and low-tax countries like Germany and Spain were not in a position to prevail over strong public opposition against tax increases.

Table 1: VAT Rates in the EC, 1993

Member State	Standard Rate	Reduced Rates	Increased Rates
Belgium	19	1; 6; 17	25; 33
Denmark	25	-	-
France	18.6	2.1; 5.5	22
Germany	15	7	-
Greece	18	4; 8	36
Ireland	21	2.3; 10; 12.5	-
Italy	19	4; 9	38
Luxembourg	15	3; 6; 12	-
Netherlands	18.5	6	-
Portugal	17	8	30
Spain	15	6	28
United Kingdom	17.5	-	-

Source: BMF-Informationsdienst zur Finanzpolitik des Auslandes vom 23.09.1991. - Own actualisation according to newspaper articles.

Hence, in its proposal of 1987 (COM, 1987) the Commission renounced a harmonisation of tax rates, but was still striving for a preservation of the Destination principle. Since a border-tax adjustment is no longer feasible after the removal of fiscal frontiers it proposed to apply the tax-credit method, which is currently confined to domestic sales, to intra-Community exports. Under this scheme, exporters are charged with the turnover tax of their home country and importers receive a tax credit for the VAT included in imports from their national fiscal authorities. Border-tax adjustments are simply shifted to the account books of firms residing in importing member states and the EC-wide VAT system would work in the

same way as national VAT schemes currently do. Although this system would retain the Destination principle for regional tax incidence, it would turn to the Origin principle for regional fiscal assignment. Net-exporter countries would levy more taxes compared with the current scheme, because they no longer have to exempt exports, while net-importer countries would lose tax revenue due to the tax credit given on out-of-state taxes. In order to ascertain a regional tax distribution according to the Destination principle the Commission intended to install a tax-clearing system based on single accounts of importers and exporters (microeconomic clearing).

In substituting the tax-credit method for fiscal border controls this system would lead to the Origin principle for direct purchases of private consumers. In order to curb the resulting horizontal tax competition, the Commission proposed to confine the band of national tax rates to a spectrum between 14 and 20 per cent of the standard rate and 4 and 9 per cent with regard to the reduced rate. Due to the necessary, but rather moderate, changes in national tax rates, this proposal was rejected by the member states. In addition, the proposal was criticised for the heavy administrative burden resulting from a microeconomic clearing system (Spahn, 1992).

As a reaction to the criticism the Commission published an alternative approach in 1989 (COM, 1989). This approach, like the proposal of 1987, is based on a switch from physical border controls to the tax-credit method, but reduces the scope for horizontal tax competition by extending the Destination principle to individual purchases of cars, mail-orders and trans-border trading among firms belonging to the same multinational enterprise. Moreover, the Commission renounced the narrowing down of the tax-rate band and proposed the introduction of floors for standard and reduced VAT rates. With regard to regional fiscal assignment it was intended to reduce the administrative burden by basing the tax-clearing system rather on trade statistics (macroeconomic clearing) than on individual trader accounts. Again, the proposal of the Commission was rejected by national governments. Above all, the member states expressed their fundamental reluctance to clearing systems of any kind. Especially the net-importer countries in southern Europe feared considerable revenue losses (Klezath, 1992).

Although the ECOFIN-Council reached a nonbinding political agreement in 1991 on introducing a VAT system which seems to be in accordance with the Commission's proposal of 1989, the future of turnover taxation in the EC after 1996 is rather ambiguous. According to the compromise solution, an intermediate system preserving the Destination principle was put into operation on January 1, 1993, for a transitional period of four years. If the member states cannot agree on the concrete shaping of a VAT system "based on the principle of taxation of goods and services supplied in the member state of origin" before the end of



1995, an outcome that seems rather likely in face of the reluctance of national governments to the proposals which have been made by the Commission, the intermediate system will be prolonged for an indefinite period.

### **3. The Intermediate System: Shaping and Consequences**

By introducing an intermediate system, the Commission aims at preserving the existing border adjustment without border controls. As under the former scheme, intra-Community exports of taxable firms stay free of VAT and imports are taxed in the country of destination. However, in order to confine the "border adjustment" to intra-Community trade, the concepts of "exportation" and "importation" have been replaced by the concepts of taxable intra-Community acquisitions of goods and tax-exempted intra-Community supplies. Since it is necessary to ascertain that tax-exempted goods have in fact been exported to other member states, the former border controls are shifted into exporting and importing firms. For the trade between taxable persons this system leads to a regional tax incidence and a regional fiscal assignment according to the Destination principle. Exceptions exist for farmers eligible for the flat-rate scheme, taxable persons not entitled to deduction of VAT, and public bodies. Intra-Community purchases of these persons are only treated as intra-Community acquisitions when they exceed 10,000 ECU in the current year or exceeded the threshold in the previous year; otherwise the Origin principle is applied.

Contrary to the former system of border adjustment, direct purchases of private consumers in foreign member states will, as a general rule, be taxed in the country of origin. There are, however, exceptions to this rule with regard to purchases of new vehicles and distance sales. By restricting the taxation of private consumer purchases in the country of origin, the Commission aimed at reducing the competition of tax systems resulting from the relatively broad spectrum of VAT rates in the Community. Purchases of new vehicles are generally taxed in the country of destination. The rules regarding distance sales provide that distance sales of goods to private persons are to be taxed in the country of arrival, if the supplies of the distance seller to the respective country of destination exceed 100,000 ECU in the current year or exceeded the threshold in the year before.

The system of border adjustment without border controls only works, if the necessary controls are shifted into importing and exporting firms. Thus, the new directive places taxable importers and exporters under additional book-keeping obligations. Above all, detailed information on intra-Community trade is to be provided in the periodical tax returns and in a newly established quarterly "recapitulative statement". Additional controls are also requisite to ascertain that direct consumer purchases of new vehicles and trans-border distance sales are in fact taxed in the country of destination. Moreover, the intermediate system requires an exchange of value-added tax information on intra-Community transactions by electronic

means between member states. Therefore, the new directive provides that national governments are to establish a new administrative authority being responsible for data collection and data exchange.

It is obvious that the intermediate system involves high administrative costs for entrepreneurs as well as tax-authorities. The cost reductions due to the removal of border controls which were estimated to be in the range of 8-9 billion ECU in the famous Cecchini report (Cecchini, 1988) may not even be approximately attainable under the conditions of the intermediate systems. It rather involves additional administration costs, because central controls at intra-Community borders have been replaced by various decentralised steps of control in importing and exporting firms. It seems to be paradoxical that, contrary to the economic principle of subsidiarity, the decisions made on the summit of Maastricht aim at a centralisation of competences on the EC-level, whereas the costs of supervising supranational rules are shifted to national administrative authorities and enterprises.

The intermediate system terminates at the end of 1996. To be sure, it will be prolonged if the Council of Ministers cannot agree on the concrete shaping of a definite VAT system "based on the principle of taxation of goods and services supplied in the member state of origin" (COM, 1991) until the end of 1995. This formulation does not mean that the Council of Ministers intends to introduce an Origin principle in the true economic sense. Other publications of the EC (COM, 1989) reveal that the Council rather prefers a VAT system based on the Community principle, i.e. the extension of the tax-credit method to cross-border, intra-Community trade.<sup>1</sup> Although in this case exports are charged with the domestic tax rate, consumers have to bear the tax burden of the country of destination due to the credit mechanism of the system. Since the provision of Article 281 is rather regarded as a proposal than a binding rule, the Commission and the member states are free to qualify the concrete shaping of a definite VAT system until the end of 1994. In what follows, we will discuss the various options for a future turnover-tax system in the EC with regard to their economic efficiency as well as their political acceptability.

#### **4. Options for a Future Turnover-Tax System in the EC**

After the removal of fiscal border controls there are various alternatives for the taxation of cross-border trade in the internal market. Within the framework of a value-added tax

---

<sup>1</sup> This formulation of the EC-guideline has led to a considerable confusion in the public and scientific discussion. Even the responsible Commissioner of the EC, Mrs. Christiane Scrivener, seems to mix up the Origin and the Community principle in saying that after 1996 "taxation will be reserved for the country of origin". According to other publications of the Commission (e.g. COM, 1989), the origin principle will be applied only to direct imports of private consumers. See also Krause-Junk (1992).

system, taxation can be based on a modified Destination principle, the Community principle with or without clearing, or the Origin principle with or without clearing. Another option, not yet discussed in depth in the literature, is the introduction of a sales tax as an alternative to the value-added tax.

It is impossible, however, to retain the "true" Destination principle which has been applied until the end of 1992, since this principle requires both the taxation of all goods being transferred to another member state with the tax rate of the country of destination (fiscal incidence in the country of destination) and an assignment of the whole tax revenue to the country of destination. A taxation according to the "true" Destination principle without border controls is even theoretically impossible, because direct purchases of private consumers are to be taxed in the country of origin after the removal of fiscal frontiers. The intermediate system, which involves a complex supervision apparatus, also deviates from the current scheme, for it provides, apart from purchases of new vehicles and distance sales, a taxation of direct consumer purchases according to the Origin principle.<sup>2</sup> Even a complete harmonisation of VAT rates combined with a clearing mechanism in the EC would not lead to a regional fiscal assignment according to the Destination principle, since direct consumer purchases cannot be prevented and a micro- as well as a macroeconomic clearing system can only redistribute revenues resulting from cross-border trade between firms being liable for VAT.

#### 4.1 The Modified Destination Principle

In an often cited article Crossen (1981) pointed out that the Destination principle can be retained even without border controls. His argumentation refers to the "deferred payment scheme" which has been operating in the Benelux States since 1966 and was also applied to trade in the United Kingdom until November 1984. Under this scheme, both exports and imports are free of tax. The credit mechanism of VAT ensures that cross-border trade is "automatically" taxed in the country of destination. Given that the importer resells the imported good, the purchaser reports and computes the compensatory import tax, but receives a credit for the tax paid from his domestic fiscal authority at the same time, i.e. import taxation is deferred to the next stage of production. However, this system is not an appropriate substitute for border controls since the Destination principle can only be retained for trading among firms liable for VAT; to direct consumer purchases the Origin principle is applied. Moreover, the deferred payment scheme still requires a documentation at customs posts in order to assure that tax-exempted goods have in fact left the country of origin. Even in case of a deferred taxation border controls are thus a necessary condition for

---

<sup>2</sup> In this case, not only the regional incidence but also the regional fiscal assignment deviates from the "true" destination principle.

a regional tax incidence and a regional fiscal assignment according to the "true" Destination principle. Hence, after the removal of border controls only a modified Destination principle which at least partially preserves a tax incidence and a tax assignment in accordance with the current scheme can be applied to cross-border trading. The intermediate system is an, if economically inefficient, example for such a scheme.

A less expensive variant of the modified Destination principle is a taxation according to the Community principle.<sup>3</sup> Under this scheme, the tax-credit method, which is currently used for the taxation of domestic trade in all member states of the EC, is also applied to cross-border trading. This implies that exports are taxed with the rate of the country of origin and imports stay free of tax. The importer receives a tax credit from his domestic fiscal authority for the foreign tax included in the price of the imported good. If he resells the good, it will be charged with the VAT rate of the country of destination. The Community principle thus involves a regional tax incidence according to the Destination principle for all goods traded among firms liable for VAT. The resulting regional fiscal assignment, however, is not in accordance with the Destination principle, for the importer receives a tax credit from his domestic fiscal authority although the tax is levied abroad. An introduction of the Community principle thus implies that net-exporter countries as well as high-tax countries will realise a higher tax revenue than before, while net-importer nations and low-tax nations will lose tax revenue. Moreover, under this scheme, the Destination principle can only be retained for trading among firms liable for VAT. It cannot be realised for direct consumer purchases which will be taxed in the country of origin. The Community principle is thus a mixed system based on both the Destination as well as the Origin principle.

By introducing a clearing system, the resulting revenue losses, apart from the losses due to direct consumer purchases, could be compensated. The reimbursement of importer countries for tax credits accorded to their importing firms could not only be based on individual trader accounts (microeconomic clearing) but also on general trade statistics (macroeconomic clearing). However, the proposals of the Commission providing a combination of the Community principle and a microeconomic or macroeconomic clearing system were rejected by the member states. It was feared that both systems would only partially be able to ascertain a fiscal assignment according to the Destination principle. Moreover, the microeconomic clearing mechanism was criticised because of the resulting heavy administrative burden. In face of the opposition of member states against a clearing mechanism of any kind it is rather surprising that the ECOFIN-Council suggested a nonbinding compromise

---

<sup>3</sup> For a discussion of the Community principle see Biehl (1969; 1986) who can be regarded as the "father" of the Community principle.

solution advocating the introduction of a Community principle combined with a macroeconomic clearing system in 1997.

From an economic point of view, this solution is superior to the intermediate system, for a macroeconomic clearing involves less administrative costs than the tight network of controls induced by the intermediate system. Moreover, the Community principle is advantageous, because its technical shaping is directly linked to the credit method which is applied to internal trade in all member states of the EC. However, some authors fear that under a Community principle national fiscal authorities would have only weak incentives to check the tax-credit demands of their domestic firms since revenue losses could be re-demanded from fiscal authorities abroad. This would lead to considerable tax evasions by importing firms (Parsche, 1991). This argument, however, is no longer valid when a macroeconomic clearing system based on actual commodity flows is installed.

Since a macroeconomic clearing system still involves administrative costs, a Community principle without clearing would be preferable. In this case, the clearing mechanism could be replaced by a system of intergovernmental fiscal adjustment rather guided along regional criteria like infrastructure indicators than along a fiscal assignment according to the Destination principle. Introducing an intergovernmental fiscal adjustment within the system of turnover taxation could form the basis for a retreat of the EC-Commission from active regional policy measures, which would also be in line with the economic principle of subsidiarity (Klodt, Stehn et al., 1992). However, taking into account the current political interests in the Community, a combination of turnover taxation with an intergovernmental fiscal adjustment system seems hardly feasible. The governments of the member states have announced in an unmistakable manner that they will reject any change of the current fiscal assignment. Thus, it is highly likely that mixing turnover taxation with regional policy measures would lead to a prolongation of the intermediate system. This would certainly be the worst alternative.

#### 4.2 The Origin Principle

Another option for the taxation of cross-border trading after 1996 is the introduction of the Origin principle. Under this scheme, exports are charged with the tax rate of the country of origin, imports are free of tax. With regard to regional fiscal assignment, net-exporter countries are the winners, net-importer nations the losers compared to the Destination principle. However, a clearing mechanism can act to reimburse net-importer countries. From a more technical point of view, the transition towards the Origin principle can be managed by applying the subtraction method to intra-Community, trans-border sales. In this case, an importing firm does not get a refund for the foreign VAT paid, but deducts the

purchase price of the imported good from its taxable sales revenue.<sup>4</sup> However, there are some complications with this method when an imported good passes through various stages of production within the importing country, since the share of the value-added created abroad has to be recalculated from step to step (Andel, 1986). An alternative method preventing problems of this kind is the fictitious tax-credit method. Under this scheme, the importer gets no tax credit for the actual tax payment to the exporter, but gets a reimbursement according to the domestic VAT rate (Krause-Junk, 1990).

The economic advantages of the Origin principle have mainly been discussed in comparison to an ex-ante harmonisation of VAT rates in the EC.<sup>5</sup> It has been justly feared that a harmonisation would lead to an adjustment of tax burden on the highest existing level in the EC. As an economic preferable alternative the introduction of the Origin principle has thus been suggested. Under this scheme, the fiscal neutrality of trans-border trade will be abolished. Hence, exporters in high-tax countries would realise a deterioration of their competitive position compared to exporting firms in low-tax countries. These changes in competition advantages might influence the tax policy of member states, for countries with relatively high VAT rates would lose tax revenue due to the decreasing foreign turnover of domestic exporters and the increasing direct purchases by private consumers. Hence, it can be expected that high-tax countries would reduce their VAT rates to prevent further revenue losses, while low-tax nations would gain fiscal space to increase VAT rates. This competition of locations would finally result in a competitive adjustment of VAT rates.<sup>6</sup>

However, the discussion of the reform proposals of the Commission clearly elucidates that national governments reject any kind of tax competition in the EC. In order to prevent both an ex-ante harmonisation of VAT rates and a tax competition, it has been suggested to allow a once for all exchange rate adjustment in the European Currency System (ECS) after the introduction of the Origin principle.<sup>7</sup> In this case, the currencies of high-tax countries would devalue according to the differences in weighted average VAT rates and consequently there would be no tax competition. To be sure, the exchange rate mechanism can only adjust for differences in the level, not for differences in the structure of VAT rates. Given the fact that the number of VAT rates in individual EC-countries is as different as their structure, the

---

<sup>4</sup> A combination of the Origin principle with the subtraction method was proposed e. g. by Siebert (1989a; 1989b) and Boss (1989).

<sup>5</sup> See in particular Giersch (1988), Siebert (1989a; 1989b), Donges (1989) and Boss (1989).

<sup>6</sup> However, under certain conditions, an international tax competition can also lead to suboptimal low tax rates. See Klodt, Stehn et al. (1992).

<sup>7</sup> The exchange rate argument was first brought into discussion by the Tinbergen Committee (1953). Later, various authors applied this argument to the European internal market: see e.g. Whalley (1979), Berglas (1981), Giersch (1988), Siebert (1989a) and Boss (1989).

Origin principle necessarily leads to a tax competition, even in case of a once for all exchange rate adjustment.<sup>8</sup>

Thus, the introduction of the Origin principle will hardly be accepted by national governments. The economic arguments in favour of a taxation according to the Origin principle have also lost importance because an ex-ante harmonisation is no longer intended. Moreover, at the time of the introduction of a definite VAT system the European Currency Union might have already been completed, so that exchange rate adjustments will no longer be possible. Thus, from an economic point of view, only an Origin principle without exchange rate adjustment is superior to the Community principle because of the resulting pressure to reduce VAT rates in high-tax countries. However, this theoretical advantage is no more than a fiction since the member countries have rejected any kind of tax competition. Given the fact that the administratively expensive intermediate system will be prolonged if no agreement on a definite VAT system can be reached until the end of 1994, the introduction of the Community principle combined with a macroeconomic clearing system has to be given priority.

However, the Community principle was recently rejected because it would lead to an "unfair" competition of tax systems (Krause-Junk, 1990, p. 261). Under a "mixed system" like the Community principle it would be possible to export goods via importers liable for VAT to a low-tax country and then to re-transfer these goods by a tax-exempted direct import. In this way, the tax burden will in fact be reduced to the level of the low-tax country if consumers not liable for VAT are ready to personally call for the goods beyond the domestic borders. The resulting tax competition would be "unfair" since firms would be in a position to gain from the public infrastructure of a high-tax country and at the same time would pay their "(commodity-)taxes" in a low-tax country. However, this argument does not take into account at least three important issues:

- Firstly, in face of the existing transport and transaction costs, trade diversions of this kind may, apart from trade between border regions, not play a major role.<sup>9</sup>

---

<sup>8</sup> The exchange rate argument was also rejected because a revaluation under the conditions of a value-added tax of the consumption-type would discriminate producers of investment goods in low-tax countries against producers of consumption goods (Sinn, 1990a and 1990b). This argument would be right, if the tax credit method were applied at national borders. This restriction was also pointed out by Sinn (1990a, pp. 493). However, applying the tax credit method to trans-border sales does not lead to an Origin principle in the true economic sense, but to the Community principle. Thus, Sinn mixes up the two principles. See also Krause-Junk (1992) for a discussion of Sinn's argumentation.

<sup>9</sup> Krause-Junk himself admits that transport and transaction costs will curb tax competition to a considerable extent (ibid, p. 258).

- Secondly, this argumentation presumes that an above-average VAT burden in fact improves the institutional settings of a location. However, a strong fiscal equivalence of this kind can hardly be observed in any industrial country. In face of the existing differences in VAT burdens, assuming a fiscal equivalence would lead to the doubtful conclusion that the locational conditions in Sweden (regular VAT rate: 25 per cent) or Ireland (21 per cent) are superior to those in Japan (3 per cent) or Germany (4 per cent).
- Thirdly, it can be expected that even as with the Destination principle consumers will have to bear the VAT burden after the introduction of the Community principle. Thus, consumers, not entrepreneurs, are the actors in Krause-Junk's scenario.

However, the introduction of the Community principle has also been rejected by the member states. Given the fact that national governments not only refuse a tax competition but also a harmonisation of VAT rates and the introduction of a clearing mechanism, it is necessary to consider an economically efficient system of turnover taxation which complies with the requirements of member states.

#### 4.3 The Sales Tax System

An alternative solution not yet discussed in depth in the academic literature is the replacement of the existing all-stage net turnover tax by a sales tax according to the model of the U.S.,<sup>10</sup> i.e. a one-stage turnover tax. Under this scheme, only sales of goods and services to private consumers are taxed; trade among firms stays free of tax. This implies that a sales tax, like the value-added tax currently in operation in all member states of the EC, exempts investment goods. Thus, the sectoral allocation stays unchanged after the introduction of a sales tax. Taxes are only levied at the stage of sale to private consumers, basically at the retail and service business since most sales to the private sector are made by these firms. Due to occasional consumer purchases at wholesalers and producers, a small part of the tax revenue is also levied at preceding stages of production. Since a sales tax, like a value-added tax, taxes the whole value added of an economy (apart from the value added resulting from the production of investment goods), the tax base stays unchanged after an introduction of an one-stage turnover tax. Hence, it is possible to retain both the level and the sectoral graduation of tax rates.

With regard to the taxation of cross-border trade in the internal market, a sales tax involves the least administration costs of all alternatives discussed in the literature up to now, since under this scheme intra-Community trade among firms is free of tax. Taxes are only levied

---

<sup>10</sup> For a discussion and evaluation of the sales tax system in the U.S. see e.g. Baldwin (1985); Due, Mikesell (1983); Fisher (1980); Fox (1986); Walsh, Jones (1988).



when goods are sold to private consumers in the country of destination. Thus, an introduction of a sales tax induces a regional tax incidence and a regional fiscal assignment according to the "modified" Destination principle. Neither a harmonisation of tax rates nor an installation of a clearing system is necessary. With respect to cross-border trade among firms there is no tax competition; only direct consumer purchases abroad are taxed in the country of origin and thus result in a tax competition among border regions. Hence, for direct consumer purchases a sales-tax system leads to similar results as all models of value-added taxation without border controls (including the intermediate system).

Of course, controls within the borders of member states are also necessary in a sales-tax system in order to prevent tax evasions. However, the necessary controls can be managed by the existing supervision apparatus and therefore will not involve additional administration costs. Two stages of supervision are inevitable. Firstly, as with the current VAT system it has to be provided that all taxable sales of retailers and all taxable services are reported to the national fiscal authorities. With respect to retailers, estimations of the actual retail turnover can be deduced from their records on stock receipts, which in turn can be controlled by a comparison with the records of the contractors who are interested in correctly recording their deliveries to other entrepreneurs, because otherwise they would be liable for sales tax (Pohmer, 1980, p. 682). Since the actual turnover resulting from services cannot be calculated from the value of intermediate inputs, both the value-added tax system and the sales-tax system cannot quite avoid tax evasions in services.

Secondly, under a sales-tax system consumers are in a position to evade taxation by directly purchasing at wholesalers or manufacturers. With reference to the sales tax model of the U.S., this can be prevented by issuing resale certificates to firms indicating that the purchaser is entitled to buy goods free of tax. Every sale is assumed to be a retail sale liable for sales tax unless there is evidence to the contrary. In order to avoid tax evasions due to arrangements between seller and purchaser, the seller is liable for sales tax unless he presents a copy of a valid resale certificate for the respective turnover in his periodical tax return. The issue of resale certificates could easily be linked to the registration of business and would thus not involve additional administration costs. According to the experiences of the U.S., the remaining tax evasions are only of minor importance: they amount to about 1 per cent of the potential tax revenue (Due, Mikesell, 1983).

Taking into account economic and political arguments, there are only two alternatives for a definite system of turnover taxation in the EC which are not only economically efficient but also politically feasible, namely the introduction of a Community principle combined with a macroeconomic clearing system and a shift to a sales-tax system. The main disadvantages of the Community principle are the transaction and administration costs resulting from the

establishment of a macroeconomic clearing mechanism and the political resistance of member states against any kind of clearing schemes. Political opposition against a sales-tax system can arise if the shift to a one-stage turnover tax is regarded as too radical. However, the administrative costs of introducing a sales tax might be not as high as the costs resulting from an establishment of a clearing system, since a sales-tax system requires only moderate changes of the supervision apparatus within member states and makes a documentation of cross-border sales superfluous. The turning of the scale in favour of an introduction of a sales tax could be induced by the fact that this system is in accordance with the main demands of member states, for it requires neither a harmonisation of tax rates nor a clearing mechanism and confines the tax competition among member states to direct consumer purchases. In any case, a sales tax has to be given priority over the administratively expensive intermediate system and proposals advocating a Community principle combined with a clearing system based on the supervision apparatus of the intermediate system.<sup>11</sup>

---

<sup>11</sup> An introduction of the Community principle combined with a clearing system based on the supervision apparatus of the intermediate system was recently proposed by Parsche (1991).

## References

- ANDEL, N., "Sollte man in der EG im Rahmen der Mehrwertsteuer zum Ursprungslandprinzip übergehen?". Finanzarchiv, N.F. 44, 1986, pp. 484-488.
- BALDWIN, J. R., "The Use of Interstate Agreements in Sales Tax Enforcement". In: FEDERATION OF TAX ADMINISTRATORS (Ed.), Revenue Administration, Washington 1985.
- BERGLAS, E., "Harmonization of Commodity Taxes". Journal of Public Economics, 16, 1981, pp. 377-387.
- BIEHL, D., *Ausfuhrland-Prinzip, Einfuhrland-Prinzip und Gemeinsamer-Markt-Prinzip*. Köln 1969.
- , "Die Beseitigung der Steuergrenzen in der EG". Wirtschaftsdienst, 66, 1986, pp. 518-524.
- BOSS, A., "Steuerharmonisierung und Realisierung des EG-Binnenmarktes". Wirtschaftsdienst, 69, 1989, pp. 249-251.
- CECCHINI, P., et. al., 1992: *The European Challenge. The Benefits of a Single Market*. London 1988.
- CNOSEN, S., "Dutch Experience with the Value-Added Tax". Finanzarchiv, N.F. 39, 1981, pp. 223-254.
- COMMISSION OF THE EUROPEAN COMMUNITIES (COM 1987), "Vollendung des Binnenmarktes - Einführung eines Clearingmechanismus für die Mehrwertsteuer im innergemeinschaftlichen Handelsverkehr". Ratsdokument 8202/1987.
- COMMISSION OF THE EUROPEAN COMMUNITIES (COM 1989), "Mitteilung der Kommission der Europäischen Gemeinschaften an den Rat und an das Europäische Parlament über die Vollendung des Binnenmarktes und die Annäherung der indirekten Steuern". Ratsdokument 6762/1989.
- COMMISSION OF THE EUROPEAN COMMUNITIES (COM 1991), "Richtlinie 91/680/EWG zur Ergänzung des gemeinsamen Mehrwertsteuersystems und zur Änderung der Richtlinie 77/388/EWG im Hinblick auf die Beseitigung der Steuergrenzen". Amtsblatt der Europäischen Gemeinschaften, No. L376, 1991.

- DONGES, J. B., Die EG auf dem Weg zum Binnenmarkt? - Erwartungen, Konsequenzen, Probleme. Institut für Weltwirtschaft, Kiel Working Papers, 360, 1989.
- DUE, F., MIKESELL, J. L., Sales Taxation: State and Local Structure and Administration. John Hopkins University Press, Baltimore 1983.
- FISHER, R. C., "Local Sales Tax: Tax Rate Differentials, Sales Loss and Revenue Estimation". Public Finance Quarterly, 8, 1980, pp. 171-188.
- FOX, W. F., "Tax Structure and the Location of Economic Activity Along the State Borders". National Tax Journal, 39, 1986, pp. 387-402.
- GIERSCH, H., Der EG-Binnenmarkt als Chance und Risiko. Institut für Weltwirtschaft, Kiel Discussion Papers 147.
- KLEZATH, P., "Umsatzsteuer und Binnenmarkt - Die Übergangsregelung zum 1.1.1993". Umsatzsteuer-Rundschau, 41, 1992, pp. 61-66.
- KLODT, H., STEHN, J., LAASER, C.-F., MAURER, R., NEU, A. D., SOLTWEDEL, R., Die Strukturpolitik der EG. JCB Mohr, Tübingen 1992.
- KRAUSE-JUNK, G., "Ein Plädoyer für das Ursprungslandprinzip". In: F. X. BEA, W. KITTERER (Eds.), Finanzwissenschaft im Dienste der Wirtschaftspolitik: Dieter Pohmer zum 65. Geburtstag. JCB Mohr, Tübingen 1990, pp. 253-266.
- , "Die europäische Mehrwertsteuer und das Ursprungslandprinzip". Finanzarchiv, N. F. 49, 1992, pp. 141-153.
- PARSCHE, R., "Europäische Umsatzsteuerharmonisierung, Clearing-Verfahren und Steuerhinterziehung". Ifo-Schnelldienst, 44, Heft 27, 1991, pp. 7-15.
- POHMER, D., "Allgemeine Umsatzsteuern". In: F. NEUMARK unter Mitwirkung von N. ANDEL und H. HALLER (Eds.), Handbuch der Finanzwirtschaft, Bd. II, 3. Aufl., 1980, pp. 650-707.
- SCRIVENER, C., "Harmonization of Tax Law within the Community". European Taxation, 30, 1990, pp. 335-358.
- SIEBERT, H. [1989a], "Perspektiven zur Vollendung des Europäischen Binnenmarktes". Kyklos, 42, 1989, pp. 181-201.
- [1989b], Harmonisierung der Mehrwertsteuer oder Anpassung der Wechselkurse? Institut für Weltwirtschaft, Kiel Discussion Papers 156, 1989.

- SINN, H.-W. [1990a], "Tax Harmonization and Tax Competition in Europe". *European Economic Review*, 34, 1990, pp. 489-505.
- SINN, H.-W. [1990b], "Can Direct Taxes and Indirect Taxes Be Added for International Comparisons of Competitiveness?" In: H. SIEBERT (Ed.), *Reforming Capital Income Taxation*. JCB Mohr, Tübingen 1990, pp. 47-65.
- SPAHN, P., "The Future of Value-added Taxation in the European Community". *Intereconomics*, 27, 1992, pp. 70-74.
- TINBERGEN COMMITTEE, *Report on Problems Raised by the Different Turnover Tax Systems Applied within the Common Market*. 1953, mimeo.
- WALSH, M. D., JOHNES, J. D., "More Evidence on the Border Tax Effect: The Case of West Virginia, 1979-1984". *National Tax Journal*, 41, 1988, pp. 261-266.
- WHALLEY, J., "Uniform Domestic Tax Rates, Trade Distortions and Economic Integration". *Journal of Public Economics*, 11, 1979, pp. 213-221.