8. Value-added tax harmonisation in the EU: An evaluation of the new commission proposals

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1. Introduction

Tax harmonisation is the area where not much progress has been done in the context of the single market programme, which otherwise seems to have been quite successful. Progress lagged behind expectations not only in the case of direct taxes, where very little has been achieved since the inception of the Community 40 years ago, but also in the case of indirect taxes, and especially of the VAT, where satisfactory progress has already been made. As a result, all member countries had, before the single market programme was introduced, adopted a common system of VAT applying under broadly similar rules concerning taxable persons and transactions, tax exemptions, deduction of input tax etc. The number and size of tax rates was a major area where wide divergences existed between the member countries, but these divergences did not create considerable problems under the destination principle.[1]

The abolition of border controls in 1993 however, made the application of the destination principle at the intra-union borders impossible and led the Council adopt a transitory system of a hybrid origin/destination nature. According to this system, supplies to persons outside the VAT system (e.g. final consumers, exempt traders) are taxed on an origin basis, whereas supplies to persons registered for VAT are taxed on a destination basis. The latter however applies in the interior of the member countries rather than at intra-union borders, as was the case before. Thus, intra-union acquisitions are no longer taxed at the borders, but at their first supply in the domestic market, whereas tax refund on intra-union supplies is based on book information and not on any border inspection, as before. This transitory system was to be substituted by a definitive system to be based on the origin principle by 1997, which the Commission was charged by the Council to propose before the end of 1994 (see European Commission, 1991).

2. The new Commission proposals

Instead of making proposals for a direct changeover from the destination-based transitory regime to an origin-based definitive regime, within the context of the 6th Directive however,[2] the Commission came up with a long-run harmonisation programme for VAT, suggesting a wide revision of basic provisions of this Directive (European Commission, 1996). Most important changes concern the place where the tax liability is born, and consequently the tax is levied, which also determines the country to which the revenues acrrue. Instead of using the place where the goods are when the supply takes place or where those rendering services are established, as are the existing rules, the Commission proposes that everyone doing business in the Community uses a single place of supply (e.g. the head office) for one's total transactions, everywhere in the single market. This means that a British company, say Marks and Spencer, doing business in many European countries, will choose a single place of supply – probably the one with the lowest tax rate – and will apply the value-added tax of the self-chosen country, irrespective of where in the Community is doing business. The company will submit a single return, including the sales in all member countries and will pay the tax to the tax authorities of the self-chosen country. This, according to the Commission, will simplify the procedures and will reduce the administration and compliance costs of the tax. To avoid distortions of competition, the Commission suggests a close approximation of rates – maximumdeviation 2-3 percentage points for the standard rates, and perhaps larger for the reduced rates.

The proposed scheme will however transfer substantial amounts of revenues among the member countries, with capital or activity exporting countries benefiting at the expense of capital or activity importing countries. The Commission suggests a macroeconomic mechanism of compensating revenue losers at the expense of revenue gainers, based on the taxable base. In particular, it proposes that revenues from the VAT be allocated to member countries on the basis of the allocation of the VAT base, to be calculated from macroeconomic data coming from national accounts statistics.

3. An appraisal of the new Commission proposals

3.1 The major issues in tax harmonisation

To evaluate the new Commission proposals, it is of interest to first look at the major issues that form the core of the discussions on tax harmonisation and then consider how the new proposals fare in view of those issues. Four questions seem to dominate discussions of tax harmonisation in the European Union:

First, should rates be equalised among the member countries, in order for resources to remain unchanged under the origin principle or could the price mechanism and/or flexible exchange rates prevent such reallocation even under unequal rates? In other words, on efficiency grounds alone, is the origin principle equivalent to the destination principle without rate equalisation?

Second, if reallocation of resources takes place under the origin principle, is the new state necessarily Pareto inferior, so that equivalence would be a desirable property? Under what conditions, the new allocation of resources is Pareto preferred?

Third, how large will be the inter-country revenue transfers to result from the origin principle, what factors determine their size and how should one take care of such transfers?

Fourth, if rates and/or other aspects of the VAT system are to be approximated, should this necessarily come as a result of Directives decided at Community level or could one leave some room to healthy tax competition, which will lead member countries towards convergence rather than divergence?

3.2 The necessity for equalising rates under the origin principle and the new Commission proposals

The issue of whether tax rates should be equalised or not, if the origin principle is to leave resource allocation unaffected – the so-called equivalence property of the origin principle – has extensively been discussed in the literature. Despite some optimistic views, expressed even recently, that equivalence holds if a so-called reciprocal restricted origin principle[3] or a unified restricted origin principle[4] apply, the conditions for their holding are so restrictive that they offer no practical solution to the EU problem (Georgakopoulos, 1998). Equivalence in both cases requires that VAT is levied at a uniform effective and not only nominal rate, as is implicitly assumed in the literature. It further requires that the tax be applied at a uniform rate on all items in the balance of payments, including all services and capital items. Finally, it requires that the origin principle is applied on all intra-union trade. In the case of the unified restricted origin principle, an additional condition is necessary for equivalence and this is the absence of tariffs in trade with third countries.

None of the above conditions seems to hold in the case of European VAT. The tax is not levied at the same effective rate because of the various exemptions and special regimes, which lead to tax cascading and effective rate differentiation among the various products, even though nominal rates are not that different. Further, the tax does not cover, nor can it cover, all items in the balance of payments and cannot effectively apply the origin principle on all intra-union trade, since trade by taxable traders will continue to be taxed at the destination country's tax rate, even after the origin principle applies.[5]

Finally, tariffs exist in the European Union on trade with third countries and this prevents equalisation of border tax adjustment rates from ensuring equivalence, as Genser's unified restricted origin principle suggests. In addition, the ability of the price mechanism to account for inter-country tax differentials of the order[6] of 40 percent, as suggested by the Lockwood, de Meza and Miles non-reciprocal restricted origin principle, should be doubted.

However, even if equivalence, in the strict sense, does not apply in practice, one could, at least, argue that the reallocation of resources to be caused by tax rate differentials of the order of, say 5 percent, could be bearable and not cause much discontent. A number of reasons could be offered. First, even if wages and prices are not perfectly flexible to account for tax differentials of the order suggested by the non-reciprocal restricted origin principle, some flexibility exists and this will partly counterbalance differentials of a small scale. Second, factors of production in the European Union are far from totally immobile among the member countries and this will further cushion the situation. Third, a number of other factors introduce cost differentials among the member countries, some of which may also partly compensate for small tax differentials. Fourth, with the tax credit method in force, it is only trade by exempt traders and final consumers, and not total intra-union trade, which will be affected by tax differentials among the member countries, so that the extent of any reallocation will be limited. Fifth, save for neighbouring areas, cross hauling by final consumers, as well as intra-union acquisitions by exempt traders, involves additional costs and this may also counterbalance part of the tax differential among the member countries. Leaving strict theory aside, and coming to practical policy aspects therefore, one could expect that tax differentials of the order of 5 percent could exist, without undue reallocations, as the experience of federal countries, after all, teaches.

The situation is totally different with the newly proposed system. Under this system, two firms operating under otherwise similar conditions, e.g. paying similar wages and being subjected to similar other charges (income taxes, social security contributions etc.), or having the same infra-structural facilities etc., will have to pay different value-added tax rates. Under competitive conditions, tax differentials will be shifted backwards to prices of productive factors, so that differentials in the product market will be translated into differentials in the factor market. Such differential taxation of productive factors will probably cause effects parallel to those of the corporation income tax, which also covers one factor in one sector. This will probably create considerable problems especially to firms with relatively small profit margins. Problems will be created not only because of real differences in actual tax rates, but also as a result of consumers' illusion, because firms taxed at lower rates will probably advertise it, using general slogans of the type "this is a low VAT shop". Such advertisements will, most probably, intensify distortions of competition, irrespective of actual size of tax rate

differentials among different firms. It appears therefore that, with the new system in force, close approximation, if not complete equalisation, of tax rates is necessary among the member countries. Such approximation must be closer in the case of the reduced rates, where profit margins are small, rather than in the case of standard rates, as the Commission suggests.

3.3 The desirability of rate equalisation under the origin principle

The question of whether rate equalisation (or even rate approximation) is desirable or not is also an issue that has extensively been discussed in the literature in the last 40 years, after the publication of the Neumark Report. Using otherwise optimal world models without tariffs, early works in the field have established a presumption in favour of the destination principle. To put it in the words of two well known authors in the field, "although the origin principle – since it appears to make border tax adjustments and hence controls redundant – is given the benefit of doubt, the destination principle is the preferred choice [Cnossen and Shoup (1987), p. 67]. Such a conclusion should not come as a surprise, since, under the assumed conditions of perfect competition and no other distortions but the tax, resources were optimally allocated under the destination principle – at least as far as the production side is concerned. Therefore, the introduction of the origin principle could not improve the situation. However, a similar result would also hold true, in the case of a customs union formed under otherwise optimal conditions. Indeed, if the pre-union situation was not distorted by the tariff, the creation of the customs union could not bring about any trade creation, so that free trade rather than the customs union would always be the preferred choice. It is the existence of the distortion introduced by the tariff that makes the analysis of the customs union an interesting paradigm of second best and creates conditions for welfare improvement or deterioration.

Using a customs union model with the common external tariff, Georgakopoulos and Hitiris (1992) showed that the introduction of the origin principle causes positive efficiency effects in the high-tax member country, while no efficiency effects take place in the low-tax member country. The intuition is that the origin principle discriminates against importables and highly protected products and favours exportables and lightly protected products, thereby, partly or wholly, compensating for the tariff. Parallel results hold true, if one introduces deflection costs, the only difference being that reallocation takes place from products with low deflection costs to products with high deflection costs. This however is again Pareto preferred, if products with low deflection costs bear higher tariffs than products with high deflection costs, as is probably the case in practice. Georgakopoulos (1997) shows that these results do not only hold in the case of the Newmark-Shibata restricted origin principle, where all intra-union trade is

subjected to the origin principle. They also hold in the case of the so-called partially restricted origin principle, whereby, as is the case with the European VAT, only trade by other traders is charged at the destination country's tax rate. He further shows that positive efficiency effects are reaped not only by the high-tax but also by the low-tax member country. These efficiency gains are higher the higher is the tax differential, a conclusion suggesting a policy opposite to the equalisation approach followed by the EU Commission.

The situation is again totally different with the new Commission proposals. The tax differentials, and, consequently, the relative price changes do not refer to different groups of products (e.g. exportables vs. importables) but to different firms, depending on where each one of them chooses the place of supply of goods or rendering of services. We have therefore commodity tax rate differentiation according to economic agent rather than according to type of activity and product, as is the usual case we analyse. Within an otherwise optimal world model, such rate differentiation would clearly cause undersirable reallocation of resources and lead to a Pareto inferior state. The new allocation to result under the origin principle of taxation will, most probably, also be inferior even within the second-best world of a customs union.

3.4 Inter-country revenue transfers and the new Commission proposals

The introduction of the origin principle will result in inter-country revenue transfers, in the case of supplies to both registered and non-registered traders or final consumers. In the case of registered traders, tax revenues will be paid to the tax authorities of the origin country and will be credited against the tax liability of the buyer in the destination country. In the case of non-registered traders or final consumers crossing borders, tax will be paid to the country of origin, while no further adjustment will be made in the destination country. In both cases a transfer of revenue will take place from the origin to the destination country. Some countries will be gainers, whereas other countries will be losers. Within the otherwise optimal world model, Shibata (1967) has shown that in a two-country union, trade deflection will result in the high-tax country losing all its tax revenue to the benefit of the low tax country. Within the customs union model, this strange result no longer holds; trade deflection will now take place only in the case of products for which the tax differential is higher than the tariff rate. Further, if deflection costs are taken into account, such deflection will take place only in the case of products for which the tax differential is higher than the tariff rate, increased by the deflection cost. In the European Union practice, with the common external tariff in force and the considerable deflection and cross-hauling costs, therefore, revenues may be transferred either from the high- to the low-tax country or vice-versa. The result depends upon the

balance and structure of intra-union trade, as well as upon the size of the tax rates levied in the member countries.

Assuming trade deflection will not be substantial, which may be true in the case of VAT in Europe, one can use the pre-harmonisation intra-union trade matrix, as well as the existing VAT rate structure, to estimate the revenue transfers to result from the introduction of the definitive VAT. Such estimates are given in Table 1, for the year 1993. As these estimates show, half of the member countries will experience net revenue gains, while the remaining half will suffer losses. Greece and Portugal will be heavy losers, followed by Spain, the UK and Germany. Austria and France are also losers but their losses are relatively small. On the other hand, Ireland leads the gainers, followed by Belgium-Luxembourg and Sweden, while Finland and the Netherlands experience smaller, but still considerable gains. Italy and Denmark are also gainers, but their gain is considerably smaller. The equalisation of rates will affect these balances considerably, as the last three columns of the table indicate. Although Greece and Portugal continue to be the big losers, Austria's losses are now much bigger, while Germany becomes a winner. Netherlands' gains increase, while the gains of all other gainers fall.

Table 1 :Balance and structure of intra-union trade, as well as revenue transfer to result from the definitive VAT system, in the EU

Country	Ratio[1]	Intra-union trade subject to standard rate		Nominal VAT rates under system A[2]		Revenue gains (+) / losses (-)[3]					
						System A			System B		
	S/A	S	A	Standard	Reduced	(a)	(b)	(c)	(a)	(b)	(c)
Austria	76.7	95.4	92.9	20.0	10.0	-2.1	-0.6	-0.17	-10.0	-2.9	-0.82
Belg./ Lux.	112.5	86.1	86.4	20.5	6.0	25.9	6.5	1.82	11.0	2.8	0.77
Denmark	105.9	70.1	87.0	25.0	5.0	5.0	1.0	0.49	-1.8	-0.4	-0.17
Finland	125.5	97.6	91.0	22.0	12.0	14.2	3.5	1.16	8.0	1.9	0.65
France	92.1	82.2	87.9	18.6	5.5	-1.9	-0.6	-0.14	-3.2	-1.0	-0.24
Germany	99.3	91.1	86.3	15.0	7.0	-5.0	-1.4	-0.34	0.9	0.3	0.07
Greece	39.2	69.8	80.4	18.0	8.0	-18.9	-6.4	-1.42	-20.7	-7.0	-1.55
Ireland	146.3	73.1	84.3	21.1	5.0	36.6	8.3	2.61	24.1	5.5	1.72
Italy	119.6	91.6	81.9	19.0	9.0	9.7	1.8	0.55	7.3	1.4	0.41
Netherlands	132.2	77.2	84.3	17.5	6.5	14.1	3.3	0.98	17.5	4.1	1.22
Portugal	66.5	96.1	87.7	16.0	5.0	-19.5	-5.3	-1.20	-18.3	-4.9	-1.13
Spain	79.1	82.1	87.6	15.0	6.0	-13.1	-3.1	-0.66	-9.2	-2.2	-0.47
Sweden	116.7	93.7	94.1	25.0	12.0	18.1	4.3	1.54	5.1	1.2	0.43
U.K.	80.5	89.7	87.2	17.5	5.0	-6.7	-1.4	-0.43	-5.8	-1.2	-0.37

Notes:

1) S = supplies, A = acquisitions.
2) System A, is a system of minimal harmonisation, where member countries abolish all existing derogation and adopt two rates not lower than the agreed thresholds, 15% for the standard and 5%, for the reduced, rate. The latter applies on foodstuffs, pharmaceutical products, agricultural inputs other than capital goods etc., as provided for in Annex II of the sixth ED Directive. System B is a system of maximum harmonisation, where rates are equalised at the average of existing rates (19% standard, and 5%, reduced rate).
3) (a) percentages of revenues from the VAT, (b) percentage of total general government tax revenues excluding social security contributions, (c) percentages of GDP.

Source: Own estimates based on data from OECD, Foreign Trade by Commodities, 1993, Paris, 1994.

The above wide inter-country revenue transfers that are expected to result from the introduction of the definitive VAT regime, even if rates are equalised, must cause much more concern than the possible misallocation of resources, which may not be substantial if rates are approximated. The European Commission has indeed produced alternative proposals in the past, in an attempt to meet with this problem. In its 1987 proposals concerning the definitive system, the Commission proposed a microeconomic method for solving this problem, whereby all intra-union traders would submit periodic (monthly) statements of their intra-union transactions, vis a vis all other member countries and the tax due on them. Tax authorities would process these statements and claim the balance, if losers, or pay in, if gainers, to a compensating mechanism centrally run by the Commission services. The high administrative cost that such a compensation mechanism would require caused considerable discontent with the member countries and made the Commission abandon it. In a later opinion in 1989, the Commission announced that the solution of the revenue transfer problem should be solved via a macroeconomic approach to be based on either the intra-union trade matrix, on total consumption or any other macroeconomic variable, without giving any further specific details.

It is within this same spirit that the new Commission proposals are made. The allocation of revenues according to the taxable base in each member country is clearly a solution free of the high administrative cost that the 1987 proposal would involve. It has however a big disadvantage, which makes it hardly practicable and does not, in all probability, give it much chance to be approved by the Council. It makes revenues from the VAT a public good to which every member country has an access, irrespective of what each one contributes. This will not only reduce incentives of the member countries to collect the revenues from the VAT, but requires complete harmonisation of the member countries VAT systems. As a result, all “may’s” in the sixth Directive should now be changed into “must’s” for the member countries, which otherwise will tend to exploit any room for manoeuvre.

3.5 Tax harmonisation via Directives versus tax competition

The issue of whether tax harmonisation in the European Union should be achieved via Directives from the Union or should, at least partly, come as a result of tax competition among the member countries has also extensively been discussed. The European Commission seems to have a preference for harmonisation via community action and, in all its proposals for tax harmonisation, either fixes upper and lower limits for tax rates or even goes further and fixes a single rate for all member countries. On the contrary, member countries always seek much more freedom in managing their tax systems, arguing in favour of tax competition rather than harmonisation via community action. As

a result, the Council of Ministers is usually against fixing upper limits for tax rates, on the counts that a lower bound is sufficient to prevent unhealthy tax competition. On the contrary, upper limits are unnecessary, since member countries can, in their absence, trade-off the benefits of larger revenues with the costs of losing competitiveness.

Tax competition would, under the existing system, lead to convergence of tax rates, as well as of all other aspects of the tax system that could distort competition and harm resource allocation. The situation is however different under the proposed new system. Since tax revenues are now a public good, from which all member countries can benefit irrespective of whether and how much they contribute to it, they will tend to exploit any possibility for differentiation. It is only in the case where such differentiation will be taken into account, when distributing revenues among the member countries, that tax competition will not necessarily cause divergence. As a result, the room for tax competition to lead to tax harmonisation is now limited and closer harmonisation via Community action is necessary.

4. Conclusions

The preceding analysis leads to the conclusion that the new Commission proposals require harmonisation not only of tax rates but also of all aspects of the VAT. Closer approximation of tax rates is necessary in the case of low rather than standard rates, as the European Commission suggests in its proposals. Such harmonisation must be achieved via Community Directives, since tax competition will not, at least in some cases, necessarily lead to tax convergence but to divergence.

Notes

1 The destination principle refers to a situation where domestic taxes cover imports and not exports and is contrasted to the origin principle, where exports are taxed and imports are tax-free.

2 This is the basic Directive on which the harmonised system of value-added tax is levied in the member countries. See European Commission (1977).

3 The term non-reciprocal restricted origin principle refers to a situation, where members of an economic union apply the origin principle on all trade, i.e. trade with both member and non-member countries. This is contrasted with the Neumark-Shibata restricted origin principle, where only trade with member countries is taxed according to the origin principle, while trade with third countries is taxed according to the destination principle. See Lockwood, de Meza and Miles (1994).

4 This term covers a situation where member countries apply the Newmark-Shibata restricted origin principle at unequal domestic rates, but they equalise the rates of

border tax adjustments (taxation of imports and refund of exports) with third countries.

5 This, of course, presupposes that the tax credit method will continue to apply after the introduction of the origin principle. However, if another method is adopted, the origin principle will no longer be possible to apply at a single effective rate on all goods and services, even if a single nominal rate is applied in each member country and all exemptions and special regimes are abolished.

6 A differential of this order can exist between a member country and the non-member countries, since a member country's exports to third countries will be taxed in both the exporting member and the importing non-member country, while imports to member countries will be taxed neither in the exporting non-member nor in the importing member country (Lockwood, de Meza and Miles, 1994).

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