The Definitive Regime for VAT:

An Assessment of the European Commission's Proposals

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Published by

The Institute for Fiscal Studies
7 Ridgmount Street
London WC1E 7AE
Tel: +44-171-636 3784
Fax: +44-171-323 4780
Email: mailbox@ifs.org.uk
Internet: http://www.ifs.org.uk

ISBN 1-873357-71-0

Printed by

KKS Printing
The Printworks
12–20 Rosina Street
London E9 6JE

Preface

This report draws on the programme of research funded by the UK Economic and Social Research Council through Research Centre funding for the Institute for Fiscal Studies (grant no. M544 28 5001).

The views expressed in this report are those of the author alone, and not of the Institute for Fiscal Studies, which has no corporate views. The author is grateful to Andrew Dilnot, Michael Keen and Claire Lefebvre for comments on an earlier version.

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Contents

1. Introduction

The European Commission has proposed a fundamental reform of VAT in member states, aimed at establishing a durable, or 'definitive', regime, compatible with the requirements of the increasingly integrated European single market. The proposals for the form of the definitive regime had been awaited for some time; in agreeing on the interim arrangements (the 'transitional regime') to be established when border controls between member states were abolished at the start of 1993, member states had agreed that proposals should be brought forward by the start of 1995 for the definitive regime, so that they could be adopted and implemented from the start of 1997. This deadline has not been met; instead, the Commission's proposals were not released until the summer of 1996, and these, in turn, envisaged a further plan of more detailed work extending through to mid-1999.[1]

The main issues at stake in the formulation of the definitive regime concern how goods traded between member states should be treated by the VAT system and the amount of harmonisation of VAT rates that is required. The Commission's package has five main elements:

- a single place of taxation for each business;
- abolition of the current arrangements for export zero-rating of intra-EU trade, to be replaced by extension of the VAT 'chain' to include cross-frontier transactions. Between firms located in different member states, goods will be traded bearing VAT in just the same way as transactions between firms located within the same member state are treated. The revenue authorities of the purchasing member state will give credit for the VAT paid on the purchases made by VAT-registered businesses;
- allocation of VAT revenues to member states to be based on statistics of aggregate consumption, rather than on the derivation of revenues or on other data relating to individual tax payments or individual transactions;
- complete uniformity in the scope and definition of VAT, and uniformity, or very close convergence, in rates;
- co-operation and EU supervision of VAT administration, collection and control operations in member states.

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[1] If the specific proposals developed during this period are agreed by member states, they would not, under the Commission's proposals, enter into force for at least a further two years, to give businesses and tax administrations time to adapt (Commission of the European Communities, 1996, p. 34).

It will be seen that, contrary to the expectations of many commentators, the proposals for the definitive regime do not simply revive the Commission's 1987 proposals for the post-1992 VAT regime. Instead, the proposals take a new direction, addressing difficulties and issues that had not been the main focus of attention in 1987. Some of these issues have, indeed, only really become apparent since the abolition of border controls in 1993.

This Commentary sets out to evaluate the Commission's proposals and to assess their merits in comparison with the current 'transitional' regime and other available alternatives. The paper begins by setting out the context of the proposals for the definitive regime, in order to clarify the nature of the 'problems' to which the Commission's proposals are to be seen as a possible 'solution'. The preliminary discussion in Section 2 also considers economic criteria by which it may be desirable to judge the VAT regime; in particular, it sets out in some detail the key criterion of neutrality and identifies a number of ways in which the VAT regime might seek to achieve neutrality.

Section 3 then discusses the individual elements of the Commission's package. These are interrelated, and some would be difficult to envisage without other parts of the overall package. Section 4 considers the alternatives available and their merits in comparison with the Commission's proposed measures. Some conclusions are drawn in Section 5.

2. Background to the proposals

2.1. What is the VAT problem?

While there were frontier controls, the VAT policies of member states were, to a very large extent, their own concern. Differences in VAT rates had no impact on the competitive position of national firms, since national VAT was refunded before goods were exported, and they had little impact on individual purchasing in other member states, since the travellers' allowances for tax-paid goods were small. Within the constraints governing the coherence of the overall system provided by the Sixth VAT Directive and other EU agreements, member states could set VAT rates, and administer and enforce the tax, largely independently of what was happening elsewhere in the EU.

With the abolition of frontier controls, the insulation of domestic VAT policy has ended, and member states' VAT policies affect the interests of other member states in two respects. First, with free movement of goods by individuals, there is now more scope for individual cross-border shopping, to take advantage of rate differences between member states. Second, without border controls, member states have lost one control instrument. Effective enforcement requires more co-operation than when border controls are available as a control option.

These developments naturally required changes to the VAT systems of EU member states, and, in the years up to 1992, discussion centred on a package of proposals from the Commission (Commission of the European Communities, 1987).[2] This proposed that member states' VAT rates should be confined within two bands of permitted variation and also proposed a major change to the procedures by which cross-frontier transactions would be taxed. In the event, however, relatively modest measures were actually implemented for the start of 1993. The more ambitious Commission proposals had foundered on the unwillingness of member states to accept that their revenues would be partly dependent on an EU allocation procedure and to expose their VAT revenues to the risk of lax enforcement by other member states. When these measures were agreed, however, it was far from clear how well they would work in practice. In particular, there were — and, indeed, still are — concerns about the durability of the post-1992 'transitional' regime. There are risks that certain features of the system could be exploited and that over time its vulnerability to fraud and evasion could grow. For this reason, provisions were agreed for an early review of the post-1992 arrangements, with the aim of identifying a more durable 'definitive' regime.

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[2] See Lee, Pearson and Smith (1988) for an assessment of the proposals.

What are the basic issues that need to be addressed in identifying an appropriate long-term VAT regime? The one feature of the definitive regime prescribed in the amendments made to the Sixth VAT Directive in 1991 is that it should be 'based in principle on taxation in the member state of origin of the goods or services supplied'.[3] This requirement, however, merely serves to narrow down (perhaps excessively — see Section 4.1 below) the field of possible systems that might be considered and provides no indication of the objectives that the proposed system should seek to achieve. In discussion by the European Council, agreement was reached on a more relevant list of requirements for the definitive regime: it should have 'clear advantages over the present transitional arrangements'[4] and should impose fewer administrative burdens on business and tax administrations, without reducing member states' revenues or increasing the risk of tax fraud, and it should preserve the neutral effect of VAT on competition.

Not all of these criteria are independently attainable, and there are important trade-offs between the different objectives. In particular, there will often be a need to balance better enforcement against administrative burdens; the compliance costs borne by business and the administration costs of the tax authorities will tend to be increased by measures designed to tighten up on fraud and evasion.

More fundamentally, there is a trade-off of some considerable importance between the objectives of 'subsidiarity' and 'neutrality' in the design of the EU's VAT system. Subsidiarity is reflected in the Council's criteria by the requirement that member states' VAT revenues should be maintained. Other things being equal, it would be desirable not to constrain member states' powers to determine VAT rates more than is necessary, and the Council's criteria could be taken to imply that the powers retained by member states in the definitive regime should be consistent with at least the current pattern of VAT revenues across member states.[5] Neutrality, noted explicitly in the Council's criteria, has a number of relevant dimensions, which are considered at some length in Section 2.2. The general idea behind neutrality, however, is that the tax system should not distort the pattern of private sector activity, especially, in the EU context, the pattern of competition between member states. It will be seen that this may be liable to run counter to the subsidiarity objective of preserving member states' revenue-raising autonomy. Much of what is at issue in the design of arrangements for VAT in EU member states has to do with limiting the severity of the conflict between subsidiarity and neutrality. Whilst neither can be fully achieved without in some way encroaching on the other, many of the

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[3] Sixth VAT Directive, as amended 16 December 1991, Article 28l.

[4] Conclusions of the Council discussions of 24 October 1994 (press release 9753/94).

[5] An alternative interpretation of this criterion is that only the aggregate VAT revenues of member states should remain unchanged. It will be noted that only in this sense do the Commission's recent proposals meet this criterion.

options available allow considerable discretion to be retained by member states, without severely compromising on neutrality.

2.2. Neutrality

It is, in general, a good objective for taxation that it should not induce changes in taxpayer behaviour solely for tax reasons. This objective has been reflected in the concept of neutrality, which has proved a powerful organising concept in the economic assessment of tax reform (Kay and King, 1990; Leape, 1990). It clearly relates closely to the more fundamental notion of economic efficiency: where large changes in private sector behaviour are induced by taxation, this is likely to be an indication that the system involves correspondingly large 'distortionary' or 'dead-weight' costs of raising revenues. Other things (such as considerations of equity and administrative cost) being equal, a good tax system will tend to be one that raises the required revenues whilst imposing the least disturbance on private sector decisions and behaviour.

The priority that should be given to neutrality in different parts of the tax system varies. In particular, Diamond and Mirrlees (1971) have shown that it is particularly important that taxes should not distort the prices of intermediate goods used as inputs to production; the burden of revenue-raising sales taxes (and, hence, any distortions) should fall only on goods and services purchased by final consumers. The VAT systems of EU member states have this desirable property; since VAT-registered firms can reclaim the VAT they pay on purchased inputs, their purchasing decisions are — in the main — unaffected by the VAT on the goods and services they buy. Final consumers, on the other hand, cannot reclaim the VAT on their purchases, and their consumption decisions are liable to be affected by VAT.

Neutrality is also important in relation to location decisions and the pattern of competition between businesses in different member states. It has been a fundamental principle of the EU's internal market policies that competition between businesses in different member states should reflect their underlying efficiency and natural advantages; it should not be influenced by government policies, whether in the form of tariffs, non-tariff barriers, subsidy or discriminatory taxation. The concept of the 'level playing field', which has been a regular theme in discussion of internal market policy, has its economic justification not as a matter of sporting fairness, but as a statement of the conditions required for neutral taxation, and for neutral, non-distortionary, policies more generally.

An assessment of the neutrality of the European VAT system requires consideration of two aspects of the VAT regime — tax rates and tax compliance costs.

The first aspect of the VAT system relevant to the issue of neutrality concerns the impact on the market for goods and services of differences in VAT rates between member states.

- As far as business purchasing decisions are concerned, neutrality has, to date, been assured by the operation of a VAT system consistent with the destination principle.[6] Under the destination principle, the tax burden on a particular sale reflects the country where the goods are being sold, rather than the country or countries where the goods were produced. For example, Danish bacon sold in British supermarkets bears a VAT rate of zero — the British rate of VAT on food — rather than the Danish rate of 25 per cent. This has been achieved up until now by, in effect, zero-rating exported goods, so that no trace of the VAT rate of their country of production remains when they are exported, and the burden of tax then reflects only the VAT rate of the country of final sale. As a result, the VAT system exerts a neutral effect on intra-EU transactions between VAT-registered traders. The British supermarket buying bacon can choose between Danish and British suppliers on the basis of their prices excluding VAT, and the VAT rates in Britain and Denmark do not distort the supermarket's decision.[7]

- A second-order issue is the possible cash-flow advantage that may arise as a result of the tax treatment of intra-EU transactions. In the present system, this favours importing goods from a supplier in another member state over purchases from a domestic supplier, since, for the period between export zero-rating and the next stage of taxation in the importing member state, an imported good bears no tax and is therefore less of a burden on the firm's cash flow than if the same good had been purchased from a domestic supplier. The effect, however, is small and depends on the timing of VAT payments and recovery; it could even be reversed if the refund of tax on exports were to be slower than the application of tax at subsequent stages. In the

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[6] The terms 'destination' and 'origin' principle are being defined here in terms of the conventional usage in the economics literature on sales taxation. As Messere (1994) has pointed out, three aspects of the tax treatment of an international transaction are potentially of interest: (i) which country's tax rates determine the final tax burden and the total revenue raised from production and sale of a good? (ii) which country benefits from the revenues? and (iii) which country collects the tax? In the current EU VAT system, all three coincide. The tax rate of the importing country determines the final tax burden levied on a good traded between member states and the total revenue raised; this revenue accrues to the importing country; and the importing country levies the tax. In some of the alternatives to the current system, the three criteria diverge. Where this happens, the destination principle is defined here by the first criterion: in other words, it holds if the final burden of tax on an international transaction, and consequently the aggregate revenue, is governed solely by the tax rates ruling in the importing country. This corresponds to long-standing usage in the economics literature. It will be noted, however, that in recent years there has been an increasing tendency outside the economics literature to use the terms 'destination' and 'origin' to reflect the country collecting the tax; this has led to some confusion about the economic attributes of different systems.

[7] It should be noted that, although the destination principle secures this outcome, there are also circumstances in which taxes levied on the origin principle would also be neutral in this sense, even if tax rates differ between member states. These circumstances are, however, limited: the conditions for 'equivalence' between origin and destination bases include the requirement that a single sales tax rate be imposed in each country, and that this rate should apply uniformly to all goods and services. See the discussion in Genser and Haufler (1996) and Keen and Smith (1996).

main, the effects of the VAT regime on cash flow are not the most important issue[8] in intra-EU VAT, though the cash-flow advantage that the current system gives to intra-EU trade transactions may provide some opportunities for tax planning and avoidance activities.

- Purchasing by individuals and by entities that are not registered for VAT is treated differently from purchasing by VAT-registered businesses. The freedom to purchase abroad gives individuals an opportunity not open to businesses — to gain genuine benefit from purchasing in lower-tax member states. Such cross-border shopping by individuals is generally, also, an issue of lesser importance than the VAT treatment of transactions between businesses, although there are some borders where VAT differentials may give rise to an appreciable level of cross-border shopping (FitzGerald et al., 1988; Bode et al., 1994). There is also a risk, which is currently hard to evaluate, that opportunities for more extensive cross-border shopping may develop through 'agency' purchasing schemes[9] and other trading innovations.

The second aspect of VAT neutrality concerns the possible impact of compliance cost differences on the pattern of trade. Compliance costs — the form-filling burden and other administrative costs that businesses incur as a result of the operation of the tax system — may have both transaction-related ('variable') and 'fixed' components. Both of these may, potentially, distort the patterns of activity and trade.

- *Transaction-related compliance costs* could operate as an impediment to trade if the tax compliance costs on trade transactions are greater than the compliance costs on purely domestic transactions. Much of the '1992' programme of measures to complete the internal market of the EU was motivated by a concern that border formalities could increase the costs to a firm of doing business in other member states in the European market; indeed, there was a concern that, on occasions, member states may have employed frontier bureaucracy as a form of trade protection against products from other member states. In order to remove the opportunities for such non-tariff barriers to arise, the 1992 programme abolished internal EU frontier formalities. In its original proposals for the VAT mechanism to operate after 1992, the Commission would have gone further than this, and would have also put in place a VAT mechanism for cross-frontier transactions that was as close as possible to that applying to domestic sales, in order to minimise the possibilities that any significant difference in compliance costs could arise between the two types of transaction. In practice, however, the measures adopted for the post-1992 VAT regime apply very different procedures to trade within, and trade between, member states. To the extent

[8] Although some commentators have given them greater prominence — see Vanistendael (1995).

[9] Under such schemes, an individual might engage a firm to acquire goods in another member state and import them on the individual's behalf. Until a number of such schemes have been tested in the courts, it cannot be said with certainty that large-scale schemes of this sort are unlikely to develop.

that the procedures applying to trade between member states involve higher compliance costs on each transaction than do the procedures applying to trade within a single member state, the tax system may discourage complete integration of the European market.

- *Fixed compliance cost differences* may also arise, and could also segment the European market by discouraging entry by firms into export markets in other member states. The notion of fixed compliance costs covers those aspects of the administrative burden that firms bear that are not related to the volume of taxed transactions, but that are incurred in making *any* taxed transactions of a particular sort. In this way, tax compliance costs could function as an 'entry fee' to exporting, which must be paid in order to export at all or to export at all to a particular market. They may include the initial costs of training and tax advice that an exporter must bear before being able to enter a new market, and the ongoing annual burden of dealing with tax authorities in more than one member state. Such costs could inhibit the entry of new firms into exporting, and may be particularly damaging in the case of smaller firms seeking to make the transition from a business orientated purely to the domestic market to one trading throughout Europe. They could thus distort both the pattern of trade and the size structure of industry, by favouring larger firms, for which the fixed compliance cost burden is a smaller proportion of total costs.

3. The European Commission's proposals for the 'definitive regime'

The European Commission's proposals for the definitive regime are designed to address three failings that it identifies in the present VAT system:

- ***complexity***, arising especially from some of the modifications introduced into the VAT system to cope with the abolition of fiscal frontiers. In particular, the Commission points to the following sources of complexity:

  (i) the *place of supply rules*, which identify the place where a transaction should be taxed and, hence, the member state to which the tax is due; in the case of certain types of transaction, definition of the place of supply is not straightforward and depends on a number of factors, some of which individual traders cannot assess with certainty. As a result, some traders may play safe by levying tax on transactions that need not be taxed, whilst others, especially small firms, might choose to avoid intra-EU trades altogether;

  (ii) the treatment of *non-established operators*, which can lead to firms having to pay tax in member states where they are not established,[10] requiring them to deal with unfamiliar legislation and procedures, and in some cases to incur the costs of employing a fiscal representative to handle their tax affairs in the foreign member state;

  (iii) the *special schemes*, for mail order, motor vehicles and sales to VAT-exempt organisations such as public bodies in other member states. These were introduced in order to deal with specific difficulties arising from the abolition of border controls, and involve departures from the basic VAT system for certain types of transaction.

- ***outdated features*** of the VAT system, especially its dependence on monitoring the physical movement of goods. Although the abolition of frontier controls means that there is now much less scope to observe and control the movement of goods between member states, the system still depends on criteria that are based on physical movement. The Commission observes that this is 'no longer suited to modern business practices' and 'a source of legal uncertainty for operators and administrations alike, since they are both faced with the difficulty of satisfying themselves of points of fact ... without any real means of proving them conclusively' (Commission of the European Communities, 1996).

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[10] Examples include firms selling large amounts by mail order to another member state and firms supplying services to customers in other member states.

- ***differences in application*** between member states. Despite the co-ordinated introduction of VAT in all member states and EU legislation such as the Sixth Directive defining the characteristics of the common VAT system, there are, in practice, major differences in the way in which VAT is applied among the member states. These differences arise because of differences in the way in which the VAT directives have been transposed into national legislation, because of the amount of discretion given to member states in the Sixth Directive, because of many derogations (including those allowing member states to continue practices established prior to the Sixth Directive) and because of differences in interpretation of the provisions of the directives which can only be resolved through a lengthy legal process.

The Commission argues that, taken together, these three factors give rise to problems with the current system that cannot be resolved by further efforts at simplification. The current system imposes costs on traders operating outside their own member state, who have to deal with a complex system and face differences in application and interpretation in different member states. The source of the complexity, and of the burdens placed on traders, is, the Commission argues, 'principles that resulted from earlier choices made on the basis of the existence of member states surrounded by frontiers'.[11] Fundamental reappraisal of the VAT system in the light of the current frontier-free internal market leads the Commission to propose a radically different approach for the definitive regime.

The five main elements of the Commission's new approach are:

- a single place of taxation for each business; businesses will deal with a single member state's VAT system, and the VAT treatment of their trades will depend on the place of taxation of the businesses involved, and not on the location of the transaction, or the location or physical movement of the goods and services traded;

- abolition of the current arrangements for export zero-rating of intra-EU trade, to be replaced by extension of the VAT 'chain' to include cross-frontier transactions. Goods will therefore be traded bearing VAT between firms located in different member states, in just the same way as transactions between firms located within the same member state are treated. The revenue authorities of the purchasing member state will give credit for the VAT paid on the purchases made by VAT-registered businesses;

- allocation of VAT revenues to member states to be based on statistics of aggregate consumption, rather than on the derivation of revenues or on other data relating to individual tax payments or individual transactions;

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[11] DG XXI/1156/96, p. 21.

- complete uniformity in the scope and definition of VAT, and uniformity, or very close convergence, in rates;

- co-operation and EU supervision of VAT administration, collection and control operations in member states.

These elements are interrelated and form an interlocking package. Some of them could not be implemented without the others. This section aims to describe and evaluate the various elements proposed and to show the interrelationship between them.

3.1. The single place of taxation

This is the striking new element in the Commission's 1996 proposals. It had not been envisaged in earlier discussions and proposals.

The single place of taxation is designed to avoid the need for businesses to deal with the tax authorities in more than one member state. To the extent that some businesses may have faced high fixed VAT compliance costs in entering new markets because of the need to deal with an unfamiliar VAT system or to incur the costs of appointing a fiscal representative, the system may reduce compliance cost distortions to the single market.

A second attraction of the single place of taxation is that it eliminates the need for a definition of the location of transactions (at least as far as transactions within the EU's boundaries are concerned) and means that the VAT system no longer needs to concern itself with questions concerning the physical movement of goods. VAT would become due when goods are transacted between firms, and the movement of goods between member states would become irrelevant to VAT. The tax authorities of different member states would become involved in a particular transaction only because the participating firms were domiciled for VAT in different member states.

These difficulties are, however, replaced in the Commission's proposals by a new problem, that of determining the single place where each VAT taxpayer would be located or 'domiciled'. There are a number of questions that need to be addressed, some of them of considerable difficulty.

- How should the scope of a business entity entitled to a single place of taxation for VAT be defined? Would the rule simply be that each incorporated business would have one VAT domicile? If not, what other types of related businesses or business activities would qualify for the 'single place' treatment?

  One possibility would be for the definition of VAT domicile to coincide with the equivalent rule in the field of corporate taxation. There would be some advantages to this, in that it would allow a business to keep similar tax accounting systems for VAT and corporate taxation and would allow the revenue authorities to cross-check data

from VAT and corporate tax enforcement. However, the Commission has argued against using for VAT the concept of 'fixed establishment' which determines whether a taxpayer is subject to corporate taxation in a particular jurisdiction. In the case of a business with sales outlets in different member states, this would make it liable for VAT in each member state, reducing the simplification that might otherwise be gained from the 'single place' system.

- For a business that satisfied the criterion for taxation as a single entity for VAT, would taxation as a single entity then be a *requirement*, or simply an option that could be chosen? A business operating in more than one member state might, for example, judge that VAT compliance costs would be lower if the VAT from each of its branches could be handled locally than if its branches in all member states were subject to VAT monitoring and enforcement by officials from a single member state.

- For a business defined as a single VAT entity, would there be an element of choice concerning the place of VAT domicile? If not, what rules would specify the place of domicile?

  It will be noted that, unless the single place is defined in terms of the pattern of activity of the firm, the single place becomes *de facto* a choice variable for any firm, since it would always be possible to arrange for take-over by a company established for the purpose in the preferred member state. However, giving firms a free choice of the member state in which they would be domiciled for VAT is clearly problematic. Although it has no revenue implications for member states (since, as Section 3.3 discusses, the Commission's proposals envisage that revenues would be pooled and allocated between member states according to the pattern of consumption), the choice of domicile by a firm could greatly affect the administration costs borne by the fiscal authorities and the effectiveness of compliance and enforcement activities. Even if tax rates were uniform across the EU, it is unlikely that businesses would be indifferent between VAT domicile in different member states; they would, other things being equal, be likely to prefer VAT domicile in member states imposing a low compliance cost burden and with lax VAT enforcement. Whilst choice of domicile on the former basis might lead to efficiency gains, there are clear dangers in allowing firms to opt for ineffective enforcement!

3.2. Abolition of export zero-rating

Abolition of export zero-rating is effectively entailed by the choice of a single place of taxation for each business. Movement of goods between member states within the same business would be untaxed. Sales between businesses, whether they involve transactions between member states or within the same member state, would be taxed on the same basis.

The abolition of export zero-rating and its replacement by a system where goods are traded between member states bearing VAT has, in itself, no implications for the final burden of tax on a particular chain of production and sale. In the former case, the importer has no VAT to reclaim; in the latter case, the VAT on imported goods can be reclaimed in full by the importer as a credit against the importer's output VAT liability. There is, however, a cash-flow difference, although the value of this depends on the timing of VAT payments and receipts and, at current rates of interest, is of a relatively low order of magnitude. (Arguably, it may help to offset some of the higher VAT compliance costs on intra-EU transactions.)

With the Commission's proposals for a single place of taxation, the cash-flow advantage accrues to transactions that now remain within a single business, at the expense of those that take place between businesses. Effectively, the 'single place' system would tend to create a (modest) fiscal bias in favour of vertical integration of business activities.

3.3. 'Macro' allocation of revenues

Under the Commission's proposals, the level of VAT revenues collected in member states will change, both because of the change in the basis on which VAT is levied and because of the harmonisation of rates that is envisaged. The former will change the allocation of tax revenues, for a given pattern of tax rates, between member states. This reallocation will have two aspects.

- One is the reallocation that arises because of the extension of the VAT 'chain' of credit and refund across intra-EU borders. Member states that find they give more credit for VAT paid elsewhere than they collect in new VAT on exported goods will lose revenue, and those for which the reverse is true will gain. This reallocation had been one of the most contentious aspects of the 1987 proposals. Member states with a large surplus in intra-EU goods trade would have stood to gain considerable sums of additional VAT revenue at the expense of those with intra-EU trade deficits, and the mechanisms that had been proposed to deal with the revenue reallocation had not gained the confidence of member states, which feared that they were either unduly bureaucratic or liable to be unacceptably inaccurate.

- A second reallocation arises in the case of the 1996 proposals which was not present in the 1987 scheme. This reflects the new 'single place of taxation' now proposed for firms trading in more than one member state. The scale and direction of this reallocation is more difficult to assess than in the case of the 1987 reallocation (which could be predicted simply on the basis of trade statistics). To assess the revenue reallocation arising from the single place of taxation, it is necessary to know what proportion of trades between EU member states are made between VAT-registered entities which would, if the 1996 proposals were implemented, be able to register as a single entity, entitled to a single place of taxation. Considerable research, involving

new data collection by the statistical authorities, would be needed to produce even quite vague estimates of the revenue redistribution involved, because existing trade data do not distinguish trade flows according to whether the VAT-registered entities that are trading are part of the same business or not.

In the practical operation of the system, the Commission proposes that the revenue allocation between member states should be based on a statistical exercise using aggregate macroeconomic data and should not, therefore, try to identify the member state entitled to the revenues from any individual transaction, or to make an offsetting revenue redistribution to reflect the pattern of tax payments and input VAT credits on transactions involving tax authorities in different member states.

The Commission observes that revenue reallocation at the level of individual transactions would require data to be provided in firms' tax returns and that 'this would clash with the fundamental principle that domestic and intra-Community transactions are treated in the same way. The simplification involved in eliminating this distinction would be cancelled out if, for the purposes of compensation, operators had to continue identifying intra-Community transactions in their tax returns'.[12] This statement surely exaggerates the problems in providing such information. For most traders, the routine costs of operating a system in which sales and/or purchases are separately identified according to the member state involved would be minimal, once appropriate computer systems had been adopted. Indeed, the data required would be little different from the EU Recapitulative Statements (Sales Lists) listing sales to other member states, which businesses have to provide in the current transitional regime; these do not appear to involve an onerous compliance burden, or to be a major fiscal obstacle to intra-EU transactions.

Whilst the reasons given by the Commission to want to avoid revenue reallocation based on data derived from individual transactions are less than convincing, there are rather more substantial grounds for avoiding transaction-based revenue reallocation. As Lee, Pearson and Smith (1988) discussed, revenue reallocation on the basis of data relating to individual transactions requires that member states will be motivated to collect the appropriate data. Unfortunately, since the purpose of the data would be to redistribute revenue from the exporting member state to the importing member state in any individual transaction, there might well be a tendency for member states to take greater pains to enumerate all relevant imports (since these would lead to reallocation receipts) than to track down all relevant exports (since these would increase their reallocation payments). As an alternative to computing the tax adjustments using data derived from transaction records, it would be possible, as Keen and Smith (1996) discuss, to compute the required revenue redistribution using aggregate trade data to estimate the adjustments that should be made on intra-EU trade transactions. Keen and Smith point out that the accuracy of trade data has been undermined by the abolition of intra-EU border

[12] DG XXI/1156/96, p. 35.

formalities, and suggest that, once the scale of the revenue reallocation has been broadly assessed, member states might reach a multi-year agreement on the scale of the appropriate fiscal adjustments to reflect the shift in the basis of taxation.[13]

The direction taken by the Commission's current proposals is fundamentally different. Reallocation of the revenues on the basis of data on aggregate consumption would ensure that individual country entitlements to revenues are 'decoupled' from the amount of VAT revenue actually derived from the firms registered in each country. The number of firms registered in a country, and the revenues derived from their EU-wide trading activities, determine the administrative workload that the country bears in VAT administration and enforcement. However, if all of the revenue is then pooled and allocated to member states in proportion to actual consumption, then the revenues that the VAT authorities collect have no bearing on the revenues to which a country is ultimately entitled. This has advantages: the pattern of VAT revenues across member states would be subject to little disturbance (aside from the effects of the rate harmonisation that the proposals require), and countries would not be given an incentive to compete with each other for VAT registrations in order to maximise their revenues. However, it also has disadvantages: countries bear an administration burden which is not necessarily commensurate with the revenues ultimately derived (unless compensated for administration costs, we might see countries compete *not* to have VAT-registered firms), and countries might be inclined to treat their VAT taxpayers lightly (in the interests, perhaps, of maximising the profitability of 'their' companies) and would not be restrained in this by the revenue sacrifice that they would then face.

3.4. Uniform base and rates

The system implies rate uniformity (or something very close to uniformity), though the Commission has not stipulated what the harmonised rate would be.

There are currently considerable differences between member states in the rates of VAT. As Table 1 shows, the standard VAT rate ranges from 15 per cent in Germany and Luxemburg (since 1992, the minimum permitted in the EU) to 25 per cent in Denmark and Sweden; the unweighted average across member states is 19.3 per cent. There is also considerable variation in reduced rates, although there has been some convergence in the scope of reduced-rate VAT as a result of the pre-1992 agreement.

Table 2 shows that member states also vary widely in terms of the scale of the overall tax burden and in the contribution of VAT to total fiscal receipts. Total tax receipts exceed 50 per cent of GDP in Denmark and Sweden but are equivalent to only about one-third

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[13] Such a deal would lead to undesirable tax-rate-setting incentives for member states in the context of the Commission's 1987 proposals, but, as Section 4.3 discusses, these would not arise in the case of Keen and Smith's VIVAT proposal.

Table 1. VAT rates in member states (at 1 July 1996)

	Standard VAT rate	Reduced and intermediate rates
Countries with a standard VAT rate above the EU average		
Denmark	25	—
Sweden	25	6, 12
Finland	22	12, 17
Belgium	21	1, 6, 12
Ireland	21	0, 2.8, 12.5
France	20.6	2.1, 5.5
Austria	20	10, 12
Countries with a standard VAT rate below the EU average		
Italy	19	4, 10, 16
Greece	18	4, 8
Netherlands	17.5	6
UK	17.5	0, 8
Portugal	17	5, 12
Spain	16	4, 7
Germany	15	7
Luxemburg	15	3, 6, 12
Unweighted EU average	19.3	

Note: Countries are shown in descending order of the standard VAT rate.

of GDP in Portugal and the UK; the unweighted EU average is 42.5 per cent of GDP. VAT revenues contribute more than 20 per cent of total tax receipts in four member states and less than 15 per cent in two; the unweighted EU average is 17.8 per cent.

The degree of fiscal adjustment that would be necessary if member states were required to levy VAT at a common EU-wide rate would clearly be substantial. If the common rate were set somewhere near the current average of member states' rates, there would need to be significant fiscal adjustments in some member states with VAT rates above and below the common rate. In a number of member states, increases in revenue from other taxes, or reductions of public spending, equivalent to more than 1 per cent of GDP would be necessary. In other member states, the increase in VAT rates required could

Table 2. VAT revenues in member states, 1994

	VAT revenues as a percentage of total revenues	Total fiscal receipts as a percentage of GDP	VAT revenues as a percentage of GDP
Portugal	22.8	33.0	7.5
Greece	21.6	42.5	9.2
Austria	20.9	42.8	8.9
Ireland	20.0	37.5	7.5
UK	19.8	34.1	6.7
Denmark	19.4	51.6	10.0
Germany	18.1	39.3	7.1
Finland	17.1	47.3	8.1
France	16.9	44.1	7.4
Sweden	15.9	51.0	8.1
Spain	15.5	35.8	5.5
Belgium	15.4	46.6	7.2
Italy	15.4	41.7	6.4
Netherlands	14.7	45.9	6.7
Luxemburg	13.5	45.0	6.1
Unweighted EU average	17.8	42.5	7.5

Note: Countries are shown in descending order of VAT revenues as a percentage of total revenues.

Source: Own calculations, based on data from OECD (1996).

easily be of the order of 4–5 percentage points, implying a sizeable shock to the price level and the need for appreciable macroeconomic adjustment.

The rate at which member states should harmonise their VAT is not specified by the Commission. The choice of this rate would naturally be contentious; the rates currently levied by member states presumably reflect social and political preferences and the fact that high VAT rates can be more effectively enforced in some member states than in others. The Commission appears to favour, if anything, a harmonised rate somewhat higher than the current EU average, on the grounds that the extra revenue would allow labour income taxes to be cut and would hence help to promote higher employment. This argument appears to reflect a fundamental misapprehension: the reward, in terms of additional standard of living, from a marginal hour's work is reduced equally by high direct taxes on labour income and by higher prices resulting from higher VAT, and there

is no good reason to believe that shifting the balance of taxation away from income taxes towards higher VAT will have any beneficial impact on employment levels.

The Commission has suggested that some small amount of variation in member state VAT rates could be contemplated — in the form of a difference in VAT rates of perhaps one or two percentage points. Although not necessarily desirable in the context of this system, small VAT differences would clearly be feasible. If businesses cannot freely change their country of registration for VAT purposes, the tax authorities of a particular member state have considerable scope, especially in the short-to-medium term, to raise the VAT rate applying to the firms registered with them without immediately driving all of the firms concerned out of business; as with corporate profits taxes, rents (supernormal profits) can provide a source of tax revenues even when one country raises its tax rate above the rate elsewhere. Moreover, even if companies can freely change their country of VAT registration, an individual member state may be able to raise its VAT rate above the prevailing level, to the extent that some firms derive location-specific rents from VAT registration in that country. With a wholly free choice of country of residence, these rents could only derive from characteristics of the tax administration (such as, perhaps, straightforward compliance procedures, or simply language).

However, even if member states do have scope to vary their tax rates, this is not necessarily desirable. Since VAT taxes all sales, and not simply those sales on which rents are being earned, VAT-rate variation would be liable to induce distortions in the pattern of location and in the competitive position of different firms. Such distortions involve dead-weight costs, and although these costs may be predominantly borne in the member states that choose to set higher VAT rates, choosing a VAT system that gives rise to these costs cannot be a matter of indifference. It is also clear that the distortions that would arise from a (say) two-point increase in a member state's VAT rate under the Commission's proposal would substantially reduce the benefit of being able to make this two-point increase compared with making a similar two-point increase under the present, largely non-distortionary, VAT regime.

A further difficulty of the suggested power for member states to make limited variations in VAT rates has to do with its interaction with the revenue allocation procedure. As discussed above, it is intended that the aggregate VAT revenues would be divided between member states using statistics of aggregate consumption. The system does not, therefore, have any direct link between the VAT revenues collected from firms by the tax authorities of a particular member state and the revenues that that member state ultimately receives. What then would be the outcome of raising the VAT rate on the firms taxed by a particular member state? Two options might be considered. One, which would be at odds with the statistical apportionment of VAT revenues applied to the 'baseline' receipts, would be for the member state simply to retain the additional revenues collected from these firms. The member state's revenue entitlement would depend on the total EU-wide turnover of the firms that it has registered for VAT, and there could be considerable inequity between member states: those with a large per capita

tax base would benefit most from the powers to vary VAT rates.[14] An alternative approach would be to give a member state that increased its tax rate by 1 percentage point the equivalent of a 1 percentage point increase in the rate of tax on its aggregate consumption. The problem with this is that the entitlements of member states could either exceed or fall short of the aggregate revenues available (the latter would happen, for example, if a member state with few taxpaying firms relative to its consumption were to raise its VAT rate).

3.5. Administrative co-operation

Administrative co-operation is of crucial importance in the scheme proposed by the Commission, for two main reasons.

First, the revenue entitlements of member states no longer depend on the revenues they collect, but instead are the result of a formula-based apportionment of aggregate revenues. This means that the incentive for member states to devote resources to the collection of revenues and to VAT enforcement operations is low, since, on average, a member state would only retain one-fifteenth of the additional revenue yield. Of course, there is some limit to how little effort member states could put into collection and enforcement activities without their inactivity becoming apparent to the other member states; if the ratio of VAT receipts to aggregate consumption were to fall well below the level in other member states, then there would come a point at which suspicions of lax enforcement would be aroused. But this still provides considerable leeway for laxity, since the ratio of receipts to consumption may vary for many legitimate reasons. There is already some variation in this ratio (corrected for differences in VAT rates and base) across member states, even in the current system where member states face a direct, pound-for-pound, incentive to devote resources to increasing revenues. The variation in the ratio of receipts to consumption would be increased under the Commission's proposals, since the revenues collected by a member state would depend on the taxable turnover of the firms registered as taxpayers in that member state, and this might be very different from the level of consumer spending. This ratio would then become a much poorer guide than at present to relative collection efficiency. There would, indeed, be no obvious source of alternative aggregate data to provide a reliable indicator of effectiveness in revenue collection. To be useful, such data would need to be derived independently of fiscal processes. However, no existing aggregate data correspond at all closely to the VAT base under the Commission's proposals, since this depends on the turnover of the firms registered with a member state's VAT authorities. The 'boundary' of the VAT base under the Commission's proposals is essentially defined by the boundary of the activities of a group of firms rather than by geographical boundaries,

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[14] The number of firms registered with a member state would presumably also be affected by the VAT rate that it sets.

and it is the latter which generally define the statistical data that are available from sources independent of the VAT system.

A second reason for greater administrative co-operation is the extension of the chain of VAT charging and input VAT credit to include cases where the firms concerned are registered with the VAT authorities of different member states. As with the Commission's 1987 proposals, it then becomes necessary for the VAT authorities of one member state to assess the validity of invoices being presented to them as the basis for claims for input VAT credit for VAT paid to the revenue authorities of another member state. As with all such invoices, it is necessary for the revenue authorities to establish that the invoices correspond to a genuine supply of goods or services, on which VAT was previously paid.

In the present regime, credit for input VAT only arises in the case of transactions between firms in a single member state. The zero-rating of transactions between member states ensures that the revenue authorities of the importing member state do not have to give credit for input VAT on imported inputs. In the Commission's current proposals, and in its 1987 proposals, credit would have to be given for VAT paid to the authorities of another member state. Administrative co-operation would be needed between the revenue authorities of the buyer and seller to establish the validity of the claims being made for input VAT credit.

Such co-operation would naturally be complex, and effective procedures will take time to be established (a major reason for the failure of the 1987 proposals). One important question in assessing the relative merits of the Commission's current proposals and of schemes such as the 1987 proposals under which credit would be given for intermediate goods transactions between member states is the *number* of such transactions that would have to be handled under each system. Are there more or fewer transactions where the buyer and seller are subject to the revenue authorities of different member states under the Commission's current proposals than under alternative schemes? Specifically, are such transactions likely to be more frequent where the revenue authorities involved depend on the VAT 'establishment' of the firms rather than on the geographical location of buyer and seller? One factor that would tend to reduce the number of transactions involving revenue authorities in different member states is the smaller number of VAT registrations that would arise under the Commission's scheme (since a firm trading in many member states could be registered only once and transactions between its constituent parts would no longer be subject to VAT). However, this could easily be outweighed by a tendency for firms to trade more with customers in the same geographical locality. Unfortunately, it seems unlikely that this important issue can be readily resolved by quantitative evidence, given (as noted above) the lack of statistics organised according to whatever would be the VAT 'establishment' of firms under the Commission's proposed system.

4. Other options

The requirements that the European Council laid down for the definitive regime were that it should offer clear advantages over the existing transitional regime and should meet the following criteria:

- a lower administrative burden on firms and tax authorities;
- no reduction in member states' tax revenues;
- no increase in the risk of tax evasion;
- tax neutrality in terms of competitiveness.[15]

As discussed above, the system now proposed by the Commission would have large effects on the revenues of individual member states, though not necessarily on the revenue of member states in aggregate. It also has the drawback that member states would have little direct incentive to ensure effective VAT enforcement, since their revenue entitlement would be largely independent of the revenues they collect; this suggests that there could be a significant risk of higher evasion. In addition, whilst the system would, in broad terms, maintain the neutral effect of VAT on competition between member states, it would do so only at a high price in terms of member states' control over revenues, since complete uniformity in VAT rates would be necessary. It is therefore worth considering what alternatives exist to the Commission's proposals and how far they could meet the Council's requirements.

4.1. Retention of the transitional regime

Long-term retention of the transitional regime would appear to be ruled out by the terms of the Council agreement — that the definitive regime should be 'based in principle on the taxation [of trade between member states] in the member state of origin of the goods or services supplied'.[16] Apart from this, however, longer-term retention of the transitional regime — with possible modifications — could have some attractions.

One is that it would not require any fundamental reorientation of the focus and priorities of VAT administration. Although the increasing integration of the European market and the loss of border controls as a possible mechanism for enforcement have introduced new problems for VAT enforcement, the basic issues and concerns remain unchanged,

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[15] Conclusions of the Council discussions of 24 October 1994 (press release 9753/94).

[16] Sixth VAT Directive, as amended 16 December 1991, Article 28l.

and existing practice and expertise accumulated over the past 25 years continue to be relevant in operating and enforcing the transitional regime.

Whether the transitional regime is, in the long run, sustainable without exposure to excessive fraud, or, alternatively, without requiring onerous enforcement operations with high business compliance costs as the price for adequate enforcement, cannot yet be judged. Only after some years of operation, when taxpayers and the tax authorities have fully adapted to the post-1992 arrangements, will it become clear whether the break in VAT cumulation at member states' boundaries leads to unacceptable opportunities for fraud and evasion. If it does, then it may be necessary to contemplate one of the range of available schemes in which VAT cumulation extends to business transactions between member states. These schemes include the Commission's 1987 proposal and the 'VIVAT' proposal of Keen and Smith (1996), as well as the Commission's current proposal.

Possible directions for modification of the transitional regime include many of the moves to simplify the EU VAT system that the Commission proposes as part of its package — including measures to remove differences in scope, implementation and interpretation between member states. These would substantially reduce the complexity of the current VAT system and reduce the fixed compliance cost associated with entry to new markets. The fundamental obstacle appears to be the unwillingness of member states to accept the elimination of the differences in legislation and practice which are the source of complexity. It is far from clear that member states' reluctance to accept greater uniformity in practice would be any less in discussion of the package proposed by the Commission than if, instead, attempts were to be made to improve the functioning of the existing 'transitional' regime.

4.2. The 1987 proposal

This would extend VAT cumulation across frontiers, avoiding the enforcement problems associated with the potential diversion to untaxed consumption or shadow economy of goods that are zero-rated for export. It would, on the other hand, introduce the need for new arrangements for enforcement of claims for credit for VAT paid in another member state.

Unlike the transitional regime, the 1987 proposal would achieve symmetry between domestic and intra-EU transactions taking place between separate VAT-registered firms; differences in 'transaction-related' compliance costs would not distort trade. On the other hand, as with the other systems discussed in this section, it would not tackle the issue of 'fixed' VAT compliance costs (such as the cost of employing a fiscal representative) which may be involved in selling to each member state.

If goods are traded bearing VAT between businesses in different member states, the initial allocation of VAT revenues between member states would change. The VAT

Clearing-House proposed in 1987 would have provided for periodic offsetting revenue adjustments between member states, based on data derived from operation of the VAT system, in order to restore the pattern of revenues arising under export zero-rating. The Clearing-House would give rise to problems of misdirected incentives for enforcement and/or rate-setting, and, because of these, Keen and Smith (1996) advocate their alternative VIVAT approach (see Section 4.3). However, the enforcement difficulties with the 1987 proposal are substantially less than the corresponding risk of poor enforcement under the Commission's current proposals. As observed above, the arrangements to allocate revenues on the basis of aggregate consumption data mean that member states would reap negligible rewards from their enforcement efforts. The system currently proposed would therefore logically require centralisation, to the EU level, of VAT administration and enforcement.

With the 1987 proposal, national macroeconomic data can provide some independent check on the effectiveness of enforcement. Under the Commission's current proposals, this opportunity is not available. The VAT receipts of a member state would depend on the turnover of the firms with VAT domicile in that member state, and this cannot be inferred from macroeconomic data.

4.3. VIVAT

The 'VIVAT' scheme proposed by Keen and Smith (1996) provides an alternative mechanism for making VAT adjustments on goods that are traded across intra-EU frontiers. Keen and Smith's analysis pays close attention to some of the 'incentive' defects of the other main schemes, in terms of both enforcement incentives and rate-setting incentives for member states. The VIVAT scheme aims to avoid some of the major enforcement and rate-setting problems that would be encountered under other schemes, such as the Commission's 1987 'Clearing-House' scheme, without altering in any way the current ability of member states to choose to increase or reduce the burden of VAT and consequent VAT revenues.

The main feature of the scheme is that a uniform EU-wide rate of VAT would be applied to transactions between VAT-registered traders, while member states would retain the power to determine the rate of VAT on sales by traders to final consumers. The uniform rate of VAT on transactions between VAT-registered traders would apply to all such 'intermediate' transactions, both between traders in the same member state and between traders in different member states.

- The scheme would thus satisfy one of the primary objectives for the VAT regime, set out in the 1985 White Paper (Commission of the European Communities, 1985), of applying uniform procedures to transactions within and between member states. A business in Munich would apply the same VAT procedures in selling to Manchester as in selling to Mannheim. Small firms exporting for the first time to a business customer

in another member state would not be faced with new and unfamiliar VAT procedures, and the VAT system would not therefore place obstacles in the way of intra-EU trade transactions.

- VIVAT would also have the attraction, as compared with the current transitional regime, that it would maintain the cumulation of VAT revenues across intra-EU frontiers. The main virtue of VAT in comparison with retail sales taxes such as are operated in the United States is that the tax revenue is collected in stages, throughout the chain of production and distribution, with additional revenues being collected at each intermediate sale (equal to the difference between the tax on the value of sales at this stage and the tax on the value of sales at the previous stage). This reduces the potential gain from tax evasion at the retail stage (since a retailer who does not declare sales will find it difficult to obtain credit for the corresponding input VAT); at earlier stages of the chain, the tax is effectively self-enforcing, since business customers are indifferent to the VAT on their supplies, since they can reclaim it. The disadvantage of the transitional regime is that the chain of cumulation is broken when sales are made across intra-EU frontiers, and this gives rise to the danger that these sales may be diverted, tax-free, into an untaxed shadow economy. VIVAT would avoid this danger, by continuing the chain of VAT cumulation across intra-EU frontiers.

- Also, the VIVAT scheme would not require any further restrictions on the ability of member states to vary the VAT rates applying to domestic consumption and consequently to increase or reduce the revenues they derive from VAT. Whilst the scheme requires a uniform EU-wide rate of VAT to be applied to intermediate transactions, this does not in any way affect the revenues that a member state ultimately derives from VAT; the rate of VAT applying to intermediate transactions only affects the rate at which revenues cumulate, and not the scale of revenues finally collected. The revenues are determined solely by the rates of tax applying to sales at the retail stage. Since these rates of tax are under the control of member states in the VIVAT scheme, there would be no change to their ability to vary revenues by varying their rates of VAT.

The above attractions of VIVAT are also features of the Commission's 1987 proposals, under which member states would have applied their own rate of VAT to intra-EU exports. In comparison with this system, the attractions of VIVAT have to do with enforcement and rate-setting difficulties, as noted above. Some of these arise through compensating member states for the change in their revenues, compared with the existing regime of export zero-rating, due to the extra VAT they would collect on their intra-EU exports and the VAT credit they would have to give on intra-EU business purchases. Under the Commission's 1987 Clearing-House proposals, this compensation would need to be given on an exact basis, related to the exact aggregate value of individual transactions, necessitating complicated (and permanent) arrangements for measuring the required clearing flows. This would suffer from the fundamental flaw that it would undermine the incentive for member states to enforce the validity of claims for

VAT credit on imported goods; the cost of giving this credit would be underwritten by the Clearing-House, and there would be little incentive for member states to spend resources in reducing fraudulent claims.

A one-off compensation settlement (perhaps involving agreed annual revenue flows), reflecting the scale of the anticipated revenue changes, would restore the incentive for member states to detect fraudulent claims for VAT credit on imports, but would introduce a new problem, in that it would give rise to undesirable incentives for member states to raise their VAT rates in order to increase their revenues from the taxation of exports. Since the importing member states would be required to give credit for whatever rate of tax was applied to exports, there would be no competitive restraint on this; the only limit would be the willingness of domestic customers to accept the higher VAT rates that would also apply to domestic sales. For smaller member states, with a high ratio of exports to domestic sales, the revenue gain from higher taxes on exports could be particularly attractive. VIVAT could operate with revenue redistribution which was based on an agreed settlement, without introducing this incentive for escalation of member state VAT rates.

A further attraction of VIVAT is that it may be possible to be more relaxed about certain types of transaction than in the current system. Thus, for example, the case of sales to non-registered entities, such as public sector organisations (hospitals, universities, local governments, etc.), poses great difficulties in the present system, and it is necessary for the system to operate rules (which are almost unworkable) requiring them to declare their purchases in other member states, in order to ensure that the appropriate VAT adjustments are made (by the revenue authorities of the importing country). With VIVAT, it would be possible, for example, to provide them with the power to purchase at the intermediate-goods rate; since this would not vary between member states, it would be possible to envisage that the VAT that they would then pay on inputs might not be refunded, without it providing them with any incentive to select a low-VAT member state for their purchases.

What would be the costs of VIVAT, by comparison with the alternative systems? The principal disadvantage is that it would require a distinction to be made — and enforced — between the sales that a business makes to other VAT-registered businesses and the sales that it makes to final consumers. These would be taxed differently under VIVAT, and there would be additional compliance costs to businesses and extra administration costs for the tax authorities in accounting separately for these two categories of sales and in handling difficult borderline cases. Assuming that the VAT rate on intermediate sales was never higher than the rate on final sales (e.g. the uniform EU-wide rate on intermediate sales might be 15 per cent and the rates on final sales, as at present, range from 15 to 25 per cent), the issue would be one of firms justifying claims to apply the intermediate-goods rate. This might involve use of VAT registration numbers as at present to identify VAT status. But it would be possible to apply the rules rather more stringently than at present, without serious damage to the firms concerned. If a firm

failed to substantiate a claim to be allowed to apply the intermediate-goods rate, it would have to apply the final-goods rate, which in some countries would be very little higher. It might also be possible to credit input VAT claims at that rate where it could be shown that the final-consumer rate had been wrongly applied to an intermediate goods transaction.

5. Conclusions

The Commission's proposals for the definitive regime address a wholly different set of problems from those that were the concern of the Commission in advancing its 1987 proposals. The 1987 proposals were concerned with the tax treatment of a firm located in a single member state, which might be trading with business customers both internally within that member state and externally in other member states. The definitive regime proposals are concerned with the impact of the EU VAT system on a different type of firm — a business operating in more than one member state. Does the tax system place barriers in the way of firms of this sort, which do not equally apply to firms that operate solely within a single member state?

There is only limited evidence on whether VAT procedures are really impeding trade within the internal market. The Commission's paper refers to opinion survey evidence collected from EU business which indicates a preference for some of the key elements in the Commission's package. What is less clear is the extent to which these answers reflect a full appreciation of the options available and the issues involved, and whether they show that, in fact, significant damage is being done by the current arrangements. Further research is needed on the extent to which the transitional regime imposes costs on businesses trading across frontiers which negate the cost reductions from the abolition of frontier formalities. Further research is also needed on the practical significance of the problems identified in the Commission's current proposals, concerning the existence of significant fixed VAT compliance costs associated with market entry. What types of business activity are adversely affected by such costs, and what is the extent of the economic distortion that these costs impose?

Even if it could be shown that the fixed VAT compliance costs in each member state are sufficiently high to have deterred some firms from trading on an EU-wide basis, it by no means follows that the Commission's proposals for a single place of taxation ('domicile-based VAT' in our terms) represent the best way forward. They would require an extensive programme of legislative harmonisation in member states and clearly entail substantial restriction on the capacity of member states to set VAT rates in the light of national economic conditions and budgetary requirements. It would also be necessary to accept procedures for allocating VAT revenues between member states on the basis of statistical data, in a way that would tend to undermine the incentive for member states to devote adequate resources to VAT collection and enforcement. Moreover, unlike schemes in which VAT administration is based on national rather than business boundaries, there would be relatively little scope for national economic data from non-fiscal sources to provide an independent check on the effectiveness of enforcement.

Given these drawbacks, it may be worth paying attention to alternatives that would address some, at least, of the problems with the current transitional regime. This Commentary has suggested three possible routes, each of which has some merits. One

would be to try to eliminate the most unattractive aspects of the transitional regime — for example, through procedures to reduce the fixed compliance cost burden involved in starting trade in other member states, especially for small firms. Another would be to return to the Commission's 1987 proposals, which would tackle the problem of asymmetric compliance costs for internal and intra-EU transactions, but at the cost of introducing revenue-redistribution and incentive problems. The third alternative route to reform, VIVAT, would introduce a new EU-wide rate of VAT on intermediate goods transactions, whilst leaving member states with unchanged control over VAT rates on consumer spending, and hence over their VAT revenues. As with the Commission's 1987 Clearing-House proposals, VIVAT would equalise VAT compliance costs on transactions within and between member states, whilst avoiding some of the incentive problems that would be created by a straightforward *ex-ante* resolution of the issue of revenue reallocation.

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