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A NEW VAT FOR THE EUROPEAN UNION: TAXING CONSUMPTION AND FINANCING THE BUDGET

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A New VAT for the European Union: Taxing Consumption and Financing the Budget

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1 Introduction

There is much irony in the history and development of VAT around the world. Its success has been remarkable and the spread of VAT should be considered as "the most important development of taxation over the last half-century. Largely unheard of, outside of France, in the 1950s, it has now been adopted by about 136 countries and in these countries it typically accounts for about one-quarter of all tax revenue"[1]. Notwithstanding its continuing spread, real VATs face many challenges, from the improvement of the administration to the reduction of the scope of evasion. But there is a more important paradox in its expansion: the spread has been largely determined by the beliefs of its neutrality in treating international trade and taxing consumption in federation and economic unions. But exactly at the top of its success, economists and government officials have gradually realized that VAT tends to be not so neutral with trade commodities. The key issue with VAT is when countries decide to enhance economic integration and move to an economic union or a federation. As the EU experience shows, many difficulties arise when VAT taxing powers are attributed to member states of a common market or a federation[2]. It is not a simple coincidence if some of the most important federal countries have

[1] See International Tax Dialogue (2005).
[2] See Keen (2000).

been reluctant to employ it. In these contexts the use of VAT tends to raise serious issues of coordination between the different levels of government, more generally, the question of whether VAT can be managed autonomously by lower-level governments or instead a federal VAT is the only option available.

The aim of this paper is to discuss how consumption taxes can be reformed in the EU in the light of a new tax assignment framework. To do that, first of all, we briefly review the working of VAT in the EU history, from the single market to the 1996 proposal of a definitive regime. We discuss issues and drawbacks of this regime, in particular the choice between the origin and destination principle and the clearing mechanism. In the third paragraph, we address the issue of the inter-jurisdictional coordination of sales taxes, by considering the experience of federal countries and the menu of possible options for taxing consumption at the state level. In the following paragraph, we discuss the possible real solutions to the current working of VAT in the EU: the retail sales tax (RST), the pre-retail VAT with a RST, the dual and compensating VAT. In the fifth paragraph, we deal with the issue of the EU budget financing. After considering the major issues of current framework, we suggest a new possible solution working on a new VAT mechanism. Some final remarks conclude.

2 Taxing Consumption in the EU

2.1 The Working of VAT in the European Union

VAT is the tax on sales and international trade applied by all EU countries. From 1973 – the date of its effective adoption by the EEC – up to now, the working of the tax has however had considerable modifications in order to harmonize its application and the base taxed in the different countries[3]. To fully realize the integration of the European economies, the European Commission believed necessary to abolish any forms of frontiers among member countries – in particular, the fiscal frontiers, as those at the customs posts to the national boundaries[4]. The launch of the single market from January 1st, 1993 and the definitive elimination of

[3] The effort for indirect taxes harmonization, in particular VAT, has been a constant of the Community history: already in the Rome Treaty (art. 95-99) this need was precisely individuated in its meaning of removing obstacles to international and intra-EU trade and of allocating resources efficiently. Most important episodes were the adoption of the VI Directive in 1977, which brought about the harmonization of VAT base, the White Paper of 1985, Cockfield's and Scrivener's proposals (in 1987 and 1989 respectively), the adoption of a transitional regime since 1993 and, finally from 1996 the launch of a common program for VAT – see Commission des Communautes Europeennes (1996).

[4] See the Cockfield package of 1987.

fiscal frontiers – the *border tax adjustments* (BTA) – have finally arisen the issue of the criteria to be used in taxing transactions, in particular, whether the destination or the origin principle has to be applied.

With the long term aim to shift to a definitive origin-based regime, from the 1st January 1993 a *temporary regime(TR)* has meanwhile been adopted. This regime still applies the destination principle but it does so without using the fiscal adjustments to frontier posts (BTAs). The temporary regime has however considerably increased the risk of tax fraud and has been criticized by national administrations, apart from this motive, also for weakening the VAT chain[5]. This regime still applies *de facto* the destination principle – goods and services are still taxed according to the rate of the importing country, where final consumption takes place – even if this principle is used with a different working mechanism. If before 1993, tax adjustments among countries, for the application of a zero rate to exports, were made at customs posts, where the imported good was taxed, now BTAs are instead implemented by the first importer who takes into account in his books the tax related to imports[6].

The abolition of fiscal frontiers, even if necessary to fully accomplish the single market and increase the degree of integration of European economies, has however arisen some relevant questions: whether the *multistage sales taxes*, such current VATs, are really *compatible* with a *single market*[7]*;* whether they can work in the European context without giving rise to distortions, market segmentation and incentives to evasion; finally, whether consumption taxes in an Economic and Monetary Union (EMU) should use some forms of fiscal frontiers more or less visible[8]. These issues

[5] In the document for a new common system of VAT (COM96, 328 final, p. 13) the Commission has admitted that the current temporary regime provokes "*une perte de souveraineté dans le contrôle, […] une perte réelle de souveraineté fiscale de chaque État membre: le morcellement de l'activité des assujettis entres les différents État membres met chacun d'eux dans l'impossibilité d'assurer un contrôle global de l'activité d'une enterprise; […] un'opportunité de fraude ou d'évasion fiscale : la circulation entre État membres de marchandises totalement exonérées de taxe peut favoriser le développement de marchés noirs*".

[6] In the previous regime, imports taxation took place at custom posts and the first importer deducted the VAT paid on purchases at custom from the VAT on sales; now VAT on imports appears only in accounting books of the first importer.

[7] See on this Marè-Sarcinelli (1991).

[8] It is meaningful that the founding father of VAT, Maurice Lauré (1993, p. 233 e p. 242), has written: « *ce sont les contrôles aux frontières qui permettent de maîtriser l'application de la TVA, là où d'autres prélèvements sont contrôlés à partir de la souscription de déclarations. Il apparaît donc que la TVA est un impôt dont le recouvrement ne peut être assuré qu'à la condition d'exercer, aussi bien à l'importation qu'à l'exportation, un strict contrôle aux frontières. […] Le rendement de la TVA sur un territoire donné ne peut pas être connu sans exercer des perceptions ou des contrôles aux frontières de ce territoire.*

have been partially neglected in theoretical literature and European circles, even if they are crucial for the development of European integration[9].

On the whole, the temporary regime[10] have raised very delicate issues:

a) according to the TR, in the European area do now exist *three different taxing regimes* given the different types of transactions: domestic, intra-EU, extra-EU. These regimes make the working of the tax very complex, give rise to huge compliance costs for taxpayers and firms and render the monitoring by the national administrations difficult and complex.

b) The existence of these three different regimes produces a *market segmentation* – between the domestic and the intra-EU market[11] – and therefore violates one of the basic principle of the single market, which requires that goods produced for the domestic market have to be tax *in the same way*, as those produced for the EU market.

c) This market segmentation is strengthened by the existence of a considerable number of *exemptions and dispensations*[12], of *special regimes* (agriculture, small firms, etc.) and of different rule of application in various countries.

d) The existence of *zero rates* in many countries: just to quote some examples, food (IRL, UK), books, newspapers, magazines, clothing for children (UK), housing, medicines (UK, IRL), passenger transport (UK), etc.. And, of course, … exports

e) Some *territories* are excluded from the application of VAT – in France, Denmark, UK, etc.

9 As a proof of it we can consider what has happened in Canada and the USA, where the dilemma single stage vs. multistage taxes has had a key role in the debate for a federal consumption tax.– as well as in some European and non European countries before the introduction of VAT.

10 See on temporary regime, Aujean (1995).

11 More precisely, between the domestic market and fourteen – from the 2004, twenty-four – other foreign markets.

12 Most famous cases of exemption are: passenger transport (Dk, Irl, I, L, NL), cultural services (theatres, movies, museums, sports events, use of sports facilities), social services, health and dental care, building areas (all countries, except E, F e I). The same rule in reality applies also to *Public Administrations, financial services, insurance and banks, small business, farmers***.** For the postal services, the recent Directive removes the exemption. The best summary of irrationality of all this mess of exemptions is made by Cnossen (2002): "In UK the exemption of foods depends on various circumstances such as timing of consumption, temperature, saltiness, number, volume, sugar content, use of fingers in consumption, etc. […] In Belgium, soap is taxed at 6% (one smells the difference). In Ireland, zero rates is imposed on candles (devotion deserves to be stimulated). In the Netherlands, flowers are taxed at 6% (who would dare to question this in tulip country, except the Dutch?). In France, monuments and memorial receive a favorable treatment (Gallic glory must be preserved in stone).". I add, to be politically correct, that Italy applies a zero rate on some transports and of course the rate of 4% on .... food (who dares to question the Italian cuisine?).

f) Notwithstanding the considerable efforts for a closer harmonization, the divergence in tax rates in various countries is still relatively high (see Table 1 and 1bis).
g) The temporary regime has shown an evident weakness in terms of tax evasion[13]: in particular, repeated and important episodes of tax fraud has been detected and documented[14] in some sectors – meat, computer, cars, services, etc. – which has negatively affected the tax revenue[15]. For tax administrations the BTA abolition has meant the lost of an important tool for monitoring trade flows and the relatives taxes. The cooperation among national administrations has not yet produced considerable outcomes. Therefore, the conclusion is that the temporary regime has produced an increase in VAT evasion.
h) The *zero rating* of exports, without BTAs, ends to interrupt the *VAT chain*, i.e., the conflict of interests – the self-policing mechanism – which is one of the most important advantages of multistage taxation. Given that exchanged goods circulate free of tax, the presumed robustness of VAT with respect to evasion and collection is strongly affected.

The Commission has repeatedly admitted the problems of the temporary regime and reaffirmed the intention to reform the European VAT. For long time, the only direction suggested has been that of a movement to the origin principle on the intra-EU trade. However, in the last two years the debate has strongly progressed and some real improvement seems near to be accomplished.

2.2 The 1996 Commission's proposal for a definitive regime

In July 1996, the Commission presented a program for a common VAT system in the EU[16]. This program entailed some relevant changes to the VAT system and aimed at introducing the following modifications:

a) To apply the *origin principle* on intra-EU exchanges and to allow the right to deduction for VAT paid on imports;
b) To create a genuine community tax area, in which an equal tax treatment is given to domestic and intra-EU transactions, so as to reduce the current market segmentation[17]

[13] It has been observed that (Quigley, 1995, p. 9) the main pitfall of the temporary regime is the weakness in the chain of controls caused by the mechanism of *zero-rating* on intra-community exchanges.
[14] See Convenevole (1996, 1997) and Guardia di Finanza (1996).
[15] In COM(96) 328 final (p. 13) Commission affirms that "*la mauvaise application des règles d'imposition ou leur détournement par le recours à l'ingénierie fiscale peut aboutir à une réduction des recettes des États membres*".
[16] Commission des Communautes Européennes (COM(96) 328 final).

c) To introduce a *single place of taxation* – for taxable entities and firms, not for exchanges or operations. The same fiscal rule should be applied on the full amount of transactions, both for those within a country and intra-EU[18];
d) Firms and taxpayers *registration* has to occur in a *single place* – "taxable person is registered only once"[19] – i.e., in a single country. VAT taxpayers must pay and register in the same single place;
e) VAT revenue has to be reallocated according to a *clearing mechanism*. The aim of this mechanism is to redistribute the revenue according to the deduction of VAT on imports, to the countries who have allowed this deduction to importers. The clearing should assure that VAT revenue flows to the country where final consumption takes place, not where goods are produced and exported;
f) The *clearing mechanism* should be based on a *macroeconomic statistic indicator*, not on VAT domestic returns. This indicator should be elaborated by the national statistical offices, by mutual consent with Eurostat.
g) to close further the tax rate among countries.

2.3 Difficulties and Drawbacks of the Definitive Regime

The definitive regime shows merits and drawbacks. One important advantage is the intention to introduce a single place of taxation; in the same way, the aim to reduce or fully abolish the special regimes at present working in the EU, is very much worthwhile. These measures could make VAT more neutral, increase market integration and reduce *compliance costs* for firms. However, on the whole, the definitive regime has also many weakness and drawbacks both on conceptual and operational dimension.

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[17] "A transaction among different Member States cannot have as effect that to create more obligations of that within a single state" (1996, p.14).

[18] "The same rule should apply for **all transactions** within the Community, and therefore that **a single place of taxation** should be established. That means that the right to deduct must be exercised at the same place.[…] All the transactions of a given **operator** will have to be taxed at **one place** for the entire Community" (Raponi, 1996, p.135) "whereby a distinction will no longer be made according to the Member State in **which they are carried out**" (bold added) (Terra, 1996, p. 234). See also the discussion in Vanistendael (1995). This intention has been reaffirmed in Commission (2000) where it is stated that the new system should be based on "the principle of taxation in function of the "fiscal **domicile**" of the operator in order to establish a **single place of registration** and a **compensation mechanism of reallocation** based on official statistics (new macroeconomic approach)" (p. 4, bold original).

[19] COM(96) 328 final, p. 15. and "**all the transactions of a given operator will have to be taxed at one place for the entire Community**, whereby a distinction will no longer be made according to the Member State in which they are carried out" (p. 16) (bold original).

Being VAT a tax on consumption, the *rationale* of the shift to the origin principle is far from being clear and one might be quite skeptic on its advantages – perhaps, the only true reason is the desire to reduce costs for firms and business. In fact, the *origin principle is per se incompatible with any consumption tax* that can be fully achieved only with some version of destination principle. The origin regime in its pure form – and much more in its hybrid form, whose the Commission planned to introduce – shows various shortcomings, requires a complicated clearing mechanism and above all, a *complete rates unification* across countries. In fact, with the origin principle, exports are taxed while imports go untaxed. However, this rates unification is not only politically unachievable, but highly distorsive and harmful for state autonomy. Moreover, the clearing mechanism needed to reallocate revenue among countries, tends to rise imperfections and frauds, and a never-ending tax disputes among countries.

a) <u>The effects of a single place of taxation</u>

The introduction of a single place of taxation aims at simplifying life for VAT taxpayers and firms and fostering market integration. However, the definition of a single place raises some questions: in fact, in the plan of the definitive regime, this is surprisingly linked to *operators* rather than to *operations*. The place of taxation would not be the criterion for defining the territorial scope of VAT[20]. The impersonal, indirect nature of VAT will be lost in favour of the characteristics of taxpayers. Any taxpayer would be taxed in the same way, in the country where he (she) has the fiscal residence, independently from where he (she) carries out and realizes taxable sales and operations. But this choice tends to move away VAT from a true indirect tax on consumption, which requires that any single act of consumption – or final sale – be taxed where it takes place[21].

b) <u>Tax allocation and single rate</u>

The above criterion would dramatically affect revenue distribution between member countries – the English store would pay the tax to his country of origin – and violate states sovereignty in tax matters. Which country would really be able to accept that

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[20] Terra (1996, p. 235) notes that "*it will be interesting to see which criteria will be developed for the place where the Community-wide sales must be declared, whether the concept of a pan-European single taxable person will be adopted*". See also Cnossen (1998, 2002).

[21] A very simple example makes the implications of this choice very easy to understand. If this rule were applied, then a British supermarket operating in Italy true a selling post – a "physical nexus" – should apply on its sales the British rates, not the Italian ones, and to pay the VAT collected on taxable operations made in Italy to the British Treasury – since the store has the fiscal residence in Britain[21]. This solution would strongly ease firms' tax obligations and reduce their compliance costs but all with detriment to the nature of tax applied.

domestic tax revenue will vanish away? What will be possible the consequences on tax competition and economic firms location?

Moreover, this rule should require not only a reduction in rates divergence[22], but somewhat an identical single rate for all countries, in order to avoid economic distortions and bad incentives for strategic tax competition. This full harmonization would be very harmful for the EU, not only for the difficulties to get the countries support[23] on the choice of rates level, but also because such harmonization is not required in federal and multi-levels context, where to subnational units of government is always left a large room of manoeuvre in setting tax rates.

c) Origin and destination principle

The choice between the two international principles of taxation – destination (DP) and origin (OP) – dates back since the onset of the EEC and has had a very long story in economic circles and academia[24]. All started with the well known '*equivalence theorem*' between DP and OP. One first initial statement or version of it was made by Tinbergen Committee in 1953, as the "exchange rate argument": "whatever the national levels of tax rates, as long as the rates are uniform within the countries, the domestic gross and net price ratios of any two commodities are identical. It therefore should not make a difference for the real allocation of resources whether competition equates gross or net prices across the countries. In a monetary economy, price level or exchange rate adjustments alone would be sufficient to compensate for the switch from the DP to the OP". Or putting in a slight different way, "a tax on exports is equivalent to a tax on imports. In the event of a change from one principle to the other, compensating domestic price movements (or exchange rates) would ensure that real trade and investment are not affected"[25].

The two principles are *not in general equivalent* and it makes a difference whether the destination or origin principle applies. A very simple example can make this argument clear – see the box 2. Leaving aside theoretical technicalities, it is very easy

[22] As with the previous example, it is very easy to understand what will happen if a foreign store could sell in Italy food or clothes with a zero rate. It is interesting to note that the Commission, in Com.(2000, 348 final p. 4), admits that "it is needed a very high level of rates harmonization.

[23] The history of VAT in the EU shows a strong countries reluctance to bring closer tax rates (see again Table 1 and 2).

[24] See on this, among others, Shoup (1955), Berglas (1980), Whalley (1979), Grossmann (1980), Feldstein-Krugman (1993), Sinn (1991).

[25] Cnossen (2002, 14).

to understand and prove that the assumptions for the equivalence theorem to hold are very severe and restrictive[26]. In fact, the equivalence theorem requires to hold:

a) an exchange rates movement….but this is quite odd in a Union with a single currency!
b) trade must be balanced initially – no comment!
c) The VAT should be an ideal pure VAT. In real world, the VAT used is not the ideal one, it is not so comprehensive, but rather a tax with zero-rates, exemptions, and special rules. Moreover, the VAT used in the EU but also elsewhere is a tax on consumption that *exempts investment goods* (Sinn, 1990) and therefore it makes a difference whether or not one of the two principles is applied.
d) In real VAT world, there are many, very different rates (see Table 1bis); the equivalence theorem requires instead *rates uniformity*;
e) The third country problem (restricted origin system). Countries will keep destination principle with other non EU member countries. This tends to produce trade deflection.

But there are other equally significant problems to accept the equivalence theorem. First of all, Bovenberg (1994) has shown the existence of intergenerational effects linked with the OP: it will benefit the relatively wealthy and old at the expense of relatively young and poor. Moreover, the existence of many rates meets better different individual and social preferences in various countries. Last but not least, as pointed out by Keen, there is the question of coherence with the Diamond-Mirlees (1971) theorem: production efficiency should take precedence over the pursuit of exchange efficiency and *production efficiency is assured only by DP*. Finally, two other negative consequences of the adoption of the OP might be that countries will try to expand production of goods in which they have a comparative tax advantages (Sinn (1990)) and that tradables will be taxed less heavily than non-tradables (Feldstein-Krugman (1990).

The failure to introduce the definitive regime before 1997, with the shift to the origin principle, is due to many factors. First of all, we have the presumed *equivalence* between the two principle which is far from being granted. Notwithstanding a revival of interest for the origin principle in the last years[27], there in no doubt that the destination principle is preferable when we consider the effects of VAT on

[26] See on this the very insightful comments by Keen-Smith (1996) and Cnossen (2002).

[27] See Lockwood (1991, 1993), Lockwood-de Meza-Myles (1994a, 1994b, 1995), Genser-Haufler-Sorensen (1995), Haufler (1993), Fehr-Rosenberg-Wiegard (1994).

neutrality, efficiency and consumption choices[28]. Only the destination principle meets the neutrality criterion of taxes on goods, since its application would not imply an alteration of relative prices between goods produced domestically and those produced abroad and imported. Differently, the origin principle requires tax uniformity which appears distorsive and redundant in the perspective of optimal taxation within a federal Europe.

If we want to tax consumption but leave to the states a certain autonomy in taxing goods and services, then the destination principle is the best criterion[29]. What the EU needs is instead a VAT actually compatible with the destination principle and with a single market without fiscal frontiers. Taxing consumption requires a more or less simplified version of the destination principle, which is the only way to tax goods in countries where final consumption of them take place.

There have been however a vast debate on the real meaning of the two principles – and on the practical version applied – in particular, in relationship with multistage taxes[30]. The general common definition used is that adopted by GATT, according to which we have to take into consideration three main criteria – see Table 2 – to distinguish the origin from the destination principle: a) the final rate applied on trade; b) the country who gets definitively the revenue; c) the place where the tax is applied. With the destination principle the three criteria correspond with the importing country, i.e., the country where final consumption of good occurs, while with the pure origin principle they coincide with the exporting country, who also gets the tax revenue – this is the *key point* of all the story.

As shown on table 2, the temporary regime now in use still applied the destination principle, while the definitive regime would use that of origin but in a *hybria*[31] form*:* to leave to VAT the nature of a tax on final consumption, for obvious reasons of economic policy and national sovereignty, the revenue coming from goods taxation should be definitively reattributed to the *importing* countries, not to the exporting one. All this would require the use of a *clearing house*, a compensation mechanism through which revenue collected on exports by the exporting country might be

[28] On the *equivalence theorem* see Dosser (1967), Whalley (1979), Berglas (1981), Cnossen-Shoup (1987), Feldstein-Krugman (1989), Cnossen (1992), Keen (1991, 1993) and Keen-Smith (1996). See also Marè-Sarcinelli (1991) and Marè-Vitaletti (1996).
[29] Cnossen-Shoup (1987), Cnossen (1998), Keen (1991, 1993), Keen-Smith (1996). See also (Shoup, 1969), .Shibata (1967) and Cnossen-Shoup (1987).
[30] See on this Dosser (1967) and Messere (1994) and Keen-Smith (1996).
[31] In general terms, the definitive regime proposed by the Commission may be defined as an *origin-destination based* principle, since it allocates tax revenue to the importing country.

reallocated to the importing country. But what seems a *simple administrative detail*, a technical adjustment to give back revenue to countries where final consumption takes place, is the *key point* of the whole story; is what should make clear that the origin principle is suboptimal.

In a more general context, we should realize that, given its multistage nature, VAT shows a low federal capacity; the paradox is that VAT is optimal for taxing international trade among sovereign states but becomes less appealing when it has to be applied in economic union or federal settings. A crucial moment is arrived in the tax history of the European Union: the moment to adapt VAT to the new economic and political situation.

d) <u>The clearing mechanism</u>

A last important difficulty of the definitive regime is the definition of the *clearing mechanism* which is needed to redistribute the revenue to the country where final consumption of goods occurs, once the origin principle is introduced.

The clearing mechanism raises many problems:

- First of all, it implies heavy *administrative and political costs*.
- Secondly, the mechanism would produce adverse impact on *incentives* of Member States to undertake appropriate levels of enforcement activities. Just to give an example, imports would arrive in the importing country with a VAT to be credit; traders would have an incentive to produce false invoices overstating the tax paid on imports. If member states were able to recover the costs of financing these claims simply by billing the clearing house, they would have no reason to root out such fraud[32].
- Finally, it is not clear what should be its administrative nature: a *macro mechanism*, based on trade statistics or on estimation of final consumption made by the Central Statistical Offices and Eurostat; or rather, a *micro clearing* based on tax returns. In both cases, there is the risks of never ending controversies over the amount of revenue which has to be redistributed and on its allocation by country.

The decision to found the clearing mechanism on a macro mechanism, i.e., a statistical indicator of national consumption, is far from being satisfactory. The statistical data of national consumption can offer at best a theoretical estimate of this aggregate, but *gross* of tax evasion, since this aggregate does not consider the

[32] See on this point Keen-Smith (1996).

different level of VAT evasion existing in various countries. Of course, tax evasion can also be estimated autonomously and additionally, but this would raise expected controversies on its exact scope. The use of tax returns, even if perhaps more complex in administrative terms, would otherwise let emerge the different national levels of tax evasion[33].

The compensation mechanism would require however, in the first place, an extensive exchange of information between national tax administrations and statistical offices, that at this time appears very difficult to accomplish. Apart from the obvious difficulties to build electronic archives, many countries are not inclined to 'exchange information' with other countries. In second place, the mechanism would let arise foreseen disputes on the truthfulness of information exchanged and on the scope of tax evasion in the different countries. What will happen if the declarations of two countries would not coincide? Or if the estimates of tax evasion, supplied by a country, would not be accepted by the other Member States? Who is going to decide the countries' disputes, the Commission, the European Court of Auditors or Eurostat? There is the risk to give rise to a never ending controversy which would make VAT refunds very slow and complex. In third place, procedures are costly and awkward, and paper work and expenses for monitoring activities would tend to largely increase. Finally, the macroeconomic approach would be inaccurate on the methodological ground since biased by errors in estimates not uniformly distributed[34].

2.4 The New Commission Guidelines

The European Commission, in COM(2003)614 final (20th October), has recently launched a new strategy. The new VAT guidelines try to overcome the impasse which has lasted for too much time. The most important Commission's new guidelines are:

1. "VAT is fundamentally conceived as a general consumption tax, with *revenue going to the Member State where actually consumption takes place*. […] In practice, this means that rules governing the place of taxable operations are devised to ensure that the *tax goes to the Member States of consumption*" and … "regardless of

[33] See for more details on this point Marè (2002, 2003) and Marè-Vitaletti (1996, 1998).

[34] By the way, we want to remark that a retail sales tax, by taxing only the last stage, it would solve automatically the issue of tax revenue redistribution. Being the taxation concentrated only in the last stage, no revenue is collected in the previous stages and therefore…. *there is nothing to be reallocated.* A retail sale tax is a more genuine federal tax than VAT. Of course, this raises the issue of merits and drawbacks of single stage vs. multistage taxation, which we discussed in paragraph 4.

the *place where the taxable person* carrying out the transaction *is established*, it is *taxed at the rate applied in the Member State of consumption*. (emph. add.).

2. The individual amendments to the rules made at the time the Single Market was set up, […] *shift taxation from the service's provider place of establishment to the customer's* (p. 16)"[35]. (emph. add.).
3. "We should consider an across-the-board *switch from the origin to the destination principle*" (p. 16)" and most importantly "the Commission accepts that the developments outlined above show the common system of VAT *moving away from a regime based on the origin principle*" (18) (emph. add.). Of course, "there are limits to the application of this principle. The rules cannot result in excessive tax obligations on traders which might hamper business activity".
4. The Commission reaffirms as a long-term goal the origin regime but admit, "so long as *there is no political will to switch to an origin-based system*, any improvements to the existing common VAT system must be in line with the structure of the system as it exists. To ensure that the revenue goes to the Member state of consumption, *transaction should be taxed as close as possible to the place of destination (consumer) rather than the place of origin (supplier)*. This regime still allows Member states a degree of flexibility in setting rates" (emph. add.). (p. 18).

This shift of emphasis is very much welcomed. The new guidelines move in the right direction, the only compatible with a true and genuine taxation of consumption. The Commission seems to accept that the destination is the unique principle compatible with a true tax on final consumption. Of course, in designing the new regime, costs and burdens – that are not negligible – for firms and VAT taxpayers have to be taken carefully into consideration, as well documented by previous Commission's document. But in doing so, we must not forget that VAT is a tax on final consumption. However, there are some possible modifications to the current working of VAT that could make this tax more respectful of state's tax autonomy without prejudicing the single market and tax revenue. To the analysis of these possible improvements, we dedicate section 3 and 4.

3 What Kind of Consumption Tax in a Multilevel framework?

[35] And also that "the current rule (taxation at the service provider's place of establishment) is very straightforward for traders, but when services can be provided remotely it does not ensure that the tax goes to the Member State of consumption, and it increasingly likely to distort competition" COM (2003)614 final (p. 16),

3.1 Inter-jurisdictional Coordination of Sales Taxes

In the choice of sales taxes, in the allocation of taxing and auditing powers among lower-level governments in mature federations but also in pre-federal entities and economic unions, the key issue is, as suggested by Musgrave[36], 'Who Should Tax, Where and What?'.

When we have to decide how to subdivide the power to tax in a federal structure, a very important issue is the possible forms of vertical coordination of sales taxation; that is to say, how to allocate the taxing power among the different levels of government, what form of sales tax is better to use, how to define the tax rates and bases, and finally how to assign the tax revenue[37]. In Table 3 we present the 9 possible options available, including the case of no taxation, for the two most important levels of government, the federal and the state. We limit our analysis only to the two superior – and from an economic point of view, identical – forms of consumption taxes: the VAT and the retail sales tax (RST)[38]; and we do not also consider other lower levels of government.

If we abstract from the case of no taxation – cell 9 – the first two interesting options are those situated along the principal diagonal (1 and 5), i.e., the case of a dual VAT and a dual RST. The most appealing are instead, as we discuss more in detail in the following section, options 2 (VAT + RST) and 8 (RST at the state level). Option 7, as it is well known, is currently used in the European Union where a form of taxation by the federal level is not still contemplated. The European Union should look for in this menu the best possible combination of consumption taxes suitable for the current economic and political situation.

3.2 The Experiences of Federal Countries

In Table 4 we illustrate the current situation in most important federal countries and in the EU. As it can be observed, countries with an older federal tradition, such as the United States, Canada but also India and Brazil, use forms of sales taxation which are different from that utilized by the European Union. The United States apply a retail sales tax at the state level, without making use of other form of taxation

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36 Musgrave (1983). See also Musgrave (1969).

37 A very good discussion of these aspects is made by Bird (1989), Burgess-Howes-Stern (1995), Bird-Gendron (1998).

38 Here we do not consider the other possible forms of VAT – for example, all the variants of the VAT income-type, etc. – or the other forms of single stage taxation, such as, for example, the producer tax – as the *manufacturer tax*, previously existing in Canada – or the tax on the wholesaler – like the British *wholesale tax*.

at the federal level. Canada uses instead different forms of VAT on both levels of government, and in some provinces, a federal VAT with a retail sales tax. Germany utilizes VAT even if it is centrally managed and then given back to the Länder with a tax sharing mechanism – and the same occurs in Switzerland, Austria and Australia even if in these cases states autonomy is practically inexistent. Finally, the European Union does not make use of any federal tax on consumption and VATs are levied only at the state level – in a similar situation we also find Argentina, even if with some different criteria of application from EU.

In Table 5 we explain in details the rather differentiated Canadian situation. The menu of consumption taxes used in this country represents an interesting experimental laboratory for the attempts to use different taxes on consumption across the different levels of government and it could be very useful for the reform undertaken in the European Union. Alberta is the only province to use a single federal VAT, while in other two groups of four and one provinces, the federal tax (the GST) is used jointly with a provincial RST, even if between the two groups there are important differences in the practical application. In the last group of three provinces, the two-tiers VATs are completely harmonized and managed at the federal level, while in Quebec to the federal GST is associated the Quebec Sales Tax.

3.3 Taxing Consumption at the State Level

The real and concrete options states face to tax consumption at the state level are a quite neglected matter, both in theoretical and empirical literature on European matters. This is quite strange since this has been one of the most crucial and long debated issue in federal countries[39].

An astonishing example of the possible options and dilemma federal countries have to face with regard to state taxation is the Canadian evolution of the sales taxes: from two different sales taxes to by and large an unique form of consumption tax, namely the VAT. For long time, the federal level used a tax on the stage of production, which was levied on the manufacturers' selling price for domestic goods and on the duty-paid value for imports[40]. Differently, most of Provinces used sales taxes at the retail stage. This structure raised many issues of efficiency, lack of

[39] Perhaps the only exception is Poddar (1990, 104) who wrote that "when state governments impose general indirect taxes, they use a single-stage retail sales tax. […] It is generally believed hat without such frontiers state VATs would need to be based on the origin principle (as opposed to the destination principle) for interstate sales. An origin-based VAT could, however, distort the location of economic activity unless the tax was imposed at a uniform rate in all the states".
[40] See on previous Canadian sales taxes, Poddar (1988).

neutrality, tax cascading and complexity. Therefore, given the many advantages Canadian government envisaged at that time in integrating federal and states sales taxation, the entire structure of taxation has been strongly coordinated. Practically, a jointly operated national sales tax was introduced: the VAT launch at the federal level – in a similar fashion to the EU VAT – as well as in many provinces have solved and simplified the previous quite complex structure. A crucial point is that in the solution chosen "the tax would have a *common base, a common federal tax rate, and variable provincial tax rates*. The major issue arising under this tax is *how to account for the tax on inter-provincial sales if goods and services are to be taxed according to the destination principle*" [41]. In the end, the idea of having a common federal tax working jointly with several states retail sales taxes is at the core of the debate since many years.

In abstract terms, with regard to sales taxes, there are 4 possible general options for the states – see table 6: 1) a national-state tax with a revenue sharing mechanism; 2) an origin-based tax, with two possible suboptions of a VAT with uniform and variable rates; 3) a destination-based tax, such as a retail sales tax or a VAT with the same suboptions of a uniform and variable rates; 4) finally, a joint federal-state tax (the dual VAT)[42].

Option 1 could be considered as the simplest way of taxing consumption for states within a multitiers government. In this option, the tax is imposed at a uniform rate across the nation, and the interstate trade of goods does not require any special adjustment. The tax revenue collected, both directly by the federal government or more simply by the states, is then shared between the national and the state governments on the basis of some formula of apportionment – for example, population, final consumption, etc. Germany and Austria extensively use this type of arrangement in the working of VAT. Notwithstanding its simplicity, this option removes any fiscal autonomy for the intermediate levels of government in defining tax rates and bases; for this reasons it does not seem to be a good option for the EU, at least in its current stage of development.

Option 2 would use the origin principle on inter-states sales, not the destination. The solution to leave states free to use and managed different rates raises many issues: first, the presence of multiple rates with the origin principle tends to produce a misallocation of resources and business activities. Trade and the location of production activities would be affected, while for tax administration the system of

[41] Cnossen (1988, p. 392, emph. add.).
[42] Most of the analysis is based on Poddar (1990).

revenue collection and compensation would be very difficult to manage[43]. On the other hand, the other suboption of a VAT with a uniform rate, would ease the economic negative effects[44] but would abolish states autonomy and leave unaffected the issue of the revenue redistribution among the Member States. Moreover, a uniform rate is not politically achievable in the current situation.

Option 3 would apply the destination principle and use the solutions of a Retail Sales Tax or a VAT. Both of them might allow that the final revenue of taxation goes to the jurisdictions where final consumption of goods and services takes place. It is clear that, from the economic point of view, the destination based taxes meet the criteria of economic neutrality and fiscal autonomy[45]. However RST and VAT have different properties with regard to the need of fiscal frontiers and border adjustments and to compliance and administration. The presumed superiority of VAT over the RST if far from being assessed and a thoughtful analysis is needed. Quite the opposite, by definition a RST is superior to VAT in terms of border tax adjustments and the need of a clearing mechanism to reallocate the tax revenue. In fact RST, differently to VAT, does not need any special provisions to relieve interstate sales from the tax they may have borne in the state of origin; and also on the issues of compliance and administration, VAT advantages in real world are much less evident. However, this aspect is discussed below in par. 4.1 and 4.2.

Finally, there is the interesting option (4) of a dual VAT, i.e., of a joint national (federal)-state VAT. This option is similar to option 1 but instead of using a revenue-sharing arrangement is organized with two components: a federal (national) VAT levied at a uniform rate across the country and a state VAT with variable rates across the states. This solution offers many positive aspects, mainly the possibility of piggy-backing between the two taxes and the potential strengthening of tax enforcement

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[43] Multiple rates would induce business and firms to locate their activities in states with the lowest tax rate; in the same time, other strategic behaviors would be possible: e.g., importers would change their shipments so that "the initial point of entry would be the state with the lowest rate", or again the different rates would encourage activities such as "direct shopping in low-tax jurisdictions and sales through mail order" (Poddar, 1990, p. 107). Moreover, as discussed above, the equivalence theorem demonstrates the theoretical similarity between the origin and the destination principle but this identity is based on some conditions which do not exist in real world, and particularly in the nowadays EU: perfect flexible exchange rates, full flexible prices, immobile factors of productions and balanced trade.

[44] This is not at all evident given that if the rates of VAT were identical across the states, then "it could be argued that firms would have no incentive to misstate the values. […][But] even if firms were indifferent about the division of tax base among states, the *states would not be*" (emph. add.) (Poddar, 1990, 106).

[45] See on this the three criteria discussed in point 4.4.

and collection. All this requires however some extensive degree of coordination among the federal level of government and the states. However, the EU does not seem ready and prepared to adopt this option, nor the foreseeable political developments induce to be optimistic on this regard. This solution is discussed in par. 4.3.

4 Menu of Consumption Taxes in a Multilevel Government

It is time to wonder whether the reform of VAT in the European Union has to be a marginal adjustment, or rather, a more radical change with explicit federal implications; more in particular these are the possible viable solutions:

a) a Retail Sales Tax (RST), as in the American and Canadian tradition – but also that of Australia, Switzerland, India;

b) a pre-retail European VAT together with a retail sales tax at the state level;

c) a dual or compensating VAT, i.e., a VAT levied by the two levels of government, the federal and the state;

d) finally, a common VAT in the European context – the VAT as a tax of the European Union.

4.1 Taxing consumption at a single stage

Moving to the analysis of different possible solutions, we start by considering the benefits would come from a shift from the current VAT to a RST. After all, the most important drawback is that VAT is not a genuine federal tax, suitable for operating in a multilevel setting without frontiers. The paradox of VAT comes out from the European experience: the efforts to achieve VAT harmonization essentially testifies the difficulties to get rid of the fiscal frontiers with VAT without hampering the working of the single market. At least on a theoretical perspective, we believe that the best solution for the EU would be a single sales tax, at the stage of the retail, like in the USA, which would solve by definition the problems of international trade, revenue allocation[46] and tax rates divergence. It would be a useful experiment to evoke the reasons of why VAT has been the preferable solution for taxing consumption in the European context[47].

It might be worthwhile to consider, at least in a long-term perspective, whether a retail sales tax would not be an easier and more neutral way of taxing consumption

[46] If one wants to use the destination principle *without* making recourse to fiscal frontiers at customs, then a form of taxation *compatible* with the attainment of this objective should be used.

[47] There is not only a question of culture and tradition, or the presumed economic effects, but also and especially a matter of professional interests which have given a certain degree of rent and monopoly power to VAT practitioners and lawyers.

in the European Union. Differently to VAT, which requires a zero rate on exports and the taxation of imports, a retail sales tax does not indeed necessitate of any border tax adjustments or compensation mechanism (fiscal frontiers), since by definition it only impinges on final sales to consumers, independently from the place where goods are produced. Exports would leave the country free of taxation and imports would enter free of tax; the aim to get rid of whatever form of fiscal frontiers could be achieved. Therefore, the retail sales tax is still an ideal solution for states in treating inter-states transactions, given that it is intrinsically[48] a destination-based tax – no interstate border tax adjustments are required.

Moreover, a retail sales tax would leave a large tax autonomy to the European countries, which seems much needed in the present context and in perspective of an increasing degree of economic and political integration. The RST is the only tax that shows, after all, a very genuine federal nature[49.] But if the superiority of single stage over multistage way of taxation is clear and uncontroversial in a multilevels structure of government, the key question then becomes: are the single stage really superior to the multistage forms of taxing consumption from the point of view of tax neutrality and technique?

In the past, the mainstream public economics and the largest part of national administrations have favored the multistage forms of taxation. However, if reexamined at the light of the new international context many arguments which have been brought forward in support of VAT – and hence claiming its superiority with respect to a RST – tend to be less grounded. The presumed theoretical superiority of VAT seems sometimes a common place; if we analyze the actual working of the two taxes in the real world, the superiority of VAT is far from being ascertained.

4.2 Multi or single stage of taxation?

Under the same bases and rates, and the same hypothesis of forward shifting, the tax revenue we get from a retail sales tax and a VAT such as that used in the European Union is clearly the same. To render the RST the most possible close to the VAT,

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[48] Sijbren Cnossen, surely the strongest advocate of VAT acknowledged that "only the retail sales tax and the value added tax are inherently suitable for ensuring neutral treatment of internationally traded goods in relation to domestically produced goods. The retail sales tax is perhaps somewhat more neutral to the extent that the import tax does not have to be prepaid" (1990, p. 50).

[49] "*While nation states can enforce the destination principle through border controls, states or provinces in a federal system wishing to impose sales taxes have to apply the principle without such controls which are prohibited by law. For this reason, historically, retail sales tax has been the preferred form of sales tax for subordinate units of government in the US and Canada, because it is nearly inherently destination based*" (Cnossen, 1983).

we should fully include services in the base of the retail sales tax – RST usually tends to exempt more services than VAT – and to allow the inputs exemption as with the VAT. These aspects, more than an intrinsic imperfection of the tax, are due to the historical evolution of the RSTs in countries like Canada, USA and Australia. It has been demonstrated[50] however, that also with a RST it is possible to tax services adequately (and more or less completely) and to exempt productive input/intermediate goods[51].

On the other hand, it is very important to stress that in the case of VAT, its presumed superiority to tax services and to allow deduction for the intermediate goods is only theoretical or good for textbooks. In fact, in real world, VAT tends to exempt – for the same reasons of the RST – a large part of services – banking, financial services, insurances, public administrations, etc. The use of forfaits in taxing firms and taxpayers is a common practice with VAT; moreover, as a consequence of the numerous limitations to a full deductibility of purchases, VAT fails to achieve the full deduction of VAT paid on purchases, and therefore the VAT chain breaks down[52].

With the RST, the fractioned payments mechanism of VAT cannot be applied. Therefore, the risk of evasion could be larger than with VAT. With VAT the evasion is, *prima facie*, at least on a theoretical ground, more difficult since the tax is multistage. If one evades the tax in a stage, the government loses only the tax on the value added of this stage, not the full tax. With the retail sales tax, instead, if one succeeds in evading the tax, then all the tax is lost. Official data on VAT evasion in some countries show however that even the multistage forms of taxation are not so robust in dealing with tax evasion and that the real weak point of any kind of sales tax, in particular for VAT, is the last one – the stage of the retail.

[50] Due (1973, 1988).

[51] Due (1987) showed that instead of exempting, we could tax services at the moment of their supply and then to allow their deductibility: the system of tax credit – that is of the deduction of the tax paid on purchases from the tax collected on sales – could be easily used also with the *retail sales tax*. In addition, even with VAT it is quite difficult to tax financial services, some specific sectors – one for all, the agriculture – and small firms; and for this reason usually they are exempted – or are treated with a regime of favor – in VATs existing in the European Union. See on this Marè-Sarcinelli (1991) and Leccisotti-Marè (1992).

[52] There are in many countries large form of VAT *rémanences* from the stages preceding that of the retail, because of the existence of extensive limitation of purchases deductibility and an imperfect tax shifting on prices. See Longobardi (1990, p. 58).

But there are many other important considerations that weaken the presumed advantages of VAT. Even in the case of VAT, in fact, the last operator – the retailer – by increasing illegally the volume of purchases, may avoid the full payment of the tax. Moreover, what it is generally believed to be the most important advantage of VAT, i.e., the existence of a conflict of interests – the so called self-policing mechanism – between the buyer and the seller is instead, as anyone who is familiar with the working of VAT in real world knows, an only hypothetical and apparent conflict. In real world indeed, the buyer and the seller have sometime an interest in colluding rather than conflicting – via a reduction of the price paid by the purchaser, who tends to prefer it to the right to a future tax deductibility, when he has to file the tax return, and the benefit for the seller of a reduced turnover.

To reduce these shortcomings, single stage sales taxes could be used jointly with some other sales taxes: in particular, with a common pre-retail VAT in the European context or with some other forms of production taxes. But even with a single stage retail sales tax it could be studied some adjustments – for example, to allow taxpayers to partially deduct some spending items in their annual income tax declarations, in particular, for sectors in which the suspect of a large tax evasion is more grounded[53] – in order to narrow the space taxpayers have to escape from taxation. Finally, it is important to stress that with a multistage form of taxation the monitoring activities have to be carried out across all the stages, with evident negative effects on collection costs and the complexity of auditing strategies – given the huge number of taxpayers and operations involved. Differently, a retail sales tax would show many advantages in terms of the auditing costs and the efficacy of controls – only the retail stage should be checked out – given the smaller number of taxpayers and operations involved. These checks could give a more productive outcome since they could be concentrated only on a single stage, the retail one, that is the stage where almost the whole cases of evasion happen.

The reform of the European VAT is therefore the big chance to realize a more neutral form of consumption tax by member states and to make more explicit the taxation of consumption which takes place with VAT. This chance, besides to possible improvements to the VAT system, it would also offer the case to rethink fiscal decentralization in the European Union.

[53] Very interesting examples, perhaps a little extravagant, come from Taiwan and China, where a lottery has been established for the number of tax receipts: this solution should conspicuously limit the possibilities of fraud and invoices falsification. See Economist (2002).

The experience of federal countries, in particular USA, Canada, Switzerland and Australia, shows that the removal of customs and fiscal frontiers has very strong and precise implications for the development of the federal structure, principally for the allocation of competences among the different levels of government. The resistances and impediments that the US federal government have so far met for introducing a federal VAT at the central level show quite well the difficulties which inevitably have to be overcame to give to VAT a federal nature, at least in a context where states are jealous of their tax autonomy[54] and much concerned of their tax revenue.

4.3 The Dual and Compensating VAT

… to be completed

4.4 Separating the Stage of Retail from VAT: the pre-retail VAT + RST; or 'How I Learned to Stop Worrying and Love the ….VAT'

The proposal for a definitive regime contains a fundamental contradiction: there is a substantial incompatibility between the origin principle, needed to abolish fiscal frontiers in the EU, and a tax on final consumption such as VAT. Taxation with the origin principle shifts in fact the revenue from the country where the importer is located – the country of destination – to the country where the supplier is established – the country of origin. When a tax collected in a member country – the country of origin – has to be reallocated to another country – the country of destination – then a compensation mechanism which allows this shift is needed.

The European Union therefore is now facing a dilemma: the origin principle requires, to leave to VAT the nature of a consumption tax: i) to build up a very complex and expensive mechanism of compensation for tax revenue between the different countries; ii) tax rates uniformity across the European countries. This development would modify the fundamental nature of European VATs (see Table 1 and 1bis), and would considerably limit the autonomy of member countries. Rates uniformity, it is not only impossible in real term, given the strong refusal by member countries to revise their rates – *in primis*, United Kingdom and Denmark – but it also unnecessary and suboptimal in a design of a common market/federal Europe. All considered, the origin principle is incompatible with autonomous forms of consumption taxation within an economic union. Moreover, this principle does not assure tax neutrality (it does not leave prices unchanged), therefore it will tend to

[54] For an analysis of merits, drawbacks and effects of the introduction of a federal VAT see, among others, Shoup (1973, 1990), Due (1973, 1990), CBO (1992), Metcalf (1995), McLure (1993), Boyer-Russel (1995).

affect international trade and the choices of production. Instead, if we want to allocate the tax revenue to the country where final consumption takes place, the destination principle is required. However, if enforced with multistage sales taxes, this principle requires some forms of fiscal frontiers – more or less virtual – which are nevertheless incompatible with the new EU single market after January 1993.

Therefore the key issue in the European Union is: what is the best way for taxing consumption? Any solutions should however be well-suited with the current political and economic stage of development of the EU and should be compatible and meet at least the three following criteria:

a) to allow a large states autonomy in the choice of taxes – if not in the taxes themselves, at least in tax rates;
b) to ensure that the consumption tax would not cause economic distortions; i.e., to be neutral in the choice of production and location of firms and to not hamper the working of the single market;
c) to not require any interstate border controls or forms of tax adjustments.

Putting it differently, there is an important paradox in the expansion of VAT. Its spread has been largely determined by the beliefs of its neutrality in treating international trade and taxing consumption in federation and economic unions. But real experience have shown that VAT tends to be imperfect with international trade commodities. The key issue with VAT is when countries decide to enhance economic integration and move to an economic union or a federation. As the EU experience shows, many difficulties arise when VAT taxing powers are attributed to member states of a common market or a federation. Although convinced on relative merits of a RST in a pre-federal dimension as compared to VAT, we have to admit that such a change will imply many costs and problems. Therefore, the road of practicable solutions in the reform of sales taxes in the EU is to look for a concrete adjustment of current VATs in the direction of a true consumption tax. All considered, the base of consumption in current VAT is not well defined.

For the reasons we have explained above we believe that "VAT is not well suited to serve as a decentralized consumption tax imposed by separate jurisdictions within a federal union. With a single currency, and therefore no possibility of exchange rate flexibility, as well as a high degree of factor mobility, imposition of VATs at variable rates will distort trade and factor flows within the union unless border tax adjustments allow for the rebating of exports and compensating of import taxes. This would require all the administrative apparatus of border controls and itself present a costly impediment to intra-union trade. This problem might be avoided by requiring each jurisdiction of destination to rebate on its imports the taxes imposed by the jurisdictions of origin with simultaneous imposition of its own tax at the destination rate. However, the distribution of tax base would be very different in each case […] and there may need to be provision for inter-jurisdictional compensatory payments to be made. […] The existence of differential rates would inevitably distort location choices for production and consumption within a federation. Common-rate VATs are needed to avoid these problems, but then the VAT might better and more efficiently be assigned to the central government with appropriate distribution of the revenue to states[55]". Thus, apart from the solution of a federal, European VAT, which is impossible to set up in the current EU– this option would not leave any room of manoeuvre to Member States in taxing consumption – are there any other possible options for taxing consumption in the EU? The only possible solution is to put together the advantages of VAT with those of the RSTs.

Therefore, to avoid the difficulties of a single RST, in particular the possible weakening of the VAT chain, the introduction of a pre-retail federal VAT jointly with a RST at the state level[56] could be the ideal solution. The pre-retail VAT should be used with a single harmonized rate, while in the same time a considerable degree of freedom could be left to states in the taxation of the retail stage.

This solution shows many advantages: the RST could be strengthened by using the typical chain of VAT – the mechanism of fractioned collection, i.e., the self-policing mechanism[57] – with its robustness in monitoring the tax collection that usually a multistage tax tends to have. The opportunities of evasion, perhaps stronger with a RST, would be therefore partially reduced from the jointly use of the RST with a VAT. This solution could also present – with respect to the case of a single RST at the state level – some other advantages in terms of the tax base determination, given the presumed greater capacity of VAT to tax services and exempt inputs.

Operatively, a single identical rate should be applied within the European Union on the transactions[58] between VAT registered taxpayers – identified by the VAT number

[55] Musgrave (2001, p. 114).
[56] This solution has been proposed for the European Union by Marè-Sarcinelli (1991).
[57] As we have already stated we believe these merits largely overstated.
[58] A recent proposal by Keen-Smith (1996, 1999) and Keen (2000), along this line has suggested to employ at the European level a viable integrated VAT (VIVAT) and to leave to states the taxation of sales in the retail stage.

– while many different rates should instead be used on the final sales to consumers – in general with rates higher than that employed to intermediate goods sales, see box 1. A first very important advantage of this solution is that the existence of a single identical rate on intermediate transactions would not hamper the freedom of the states to tax autonomously and in an independent way the final consumptions. The need to harmonize the rate on intermediate transactions should not hurt the sensibility of the enemies of tax harmonization, since that, as it is obvious, there would not be *no harmonization at all*, given that the real burden of this structure of taxation would be set from the rates applied to the last stage of the chain, i.e., the rates on the retail. Moreover, the use of a single rate could finally make possible to tax in the same way sales made within a single country and sales carried out within the European Union, therefore achieving the integration needed within the single market. Last but not least, by definition this solution would apply the destination principle[59].

A uniform VAT on taxpayers transactions and the taxation of the stage of retail could however give rise to incentives to make purchases always as VAT taxpayers, even if in an illegal way, given the tax saving taxpayers could take advantage from the application of a reduced rate. Even if the use of a single rate on VAT taxpayers transactions would represent a leveling of the playing field, therefore reducing the risk of strategic behavior, another problem raised by this solution, perhaps more important than the previous one, is the need of some form of clearing mechanism to reallocate VAT revenue from states with a trade surplus toward states with a trade deficit[60]. This could come up again with all the difficulties and problems of the definitive regime we have already discussed above.

A very interesting variant of this proposal could be that of using a zero rate as a rate on the intermediate transactions between VAT taxpayers and to charge a positive rate only to sales to final consumers. The merits of this solution it would be that the clearing mechanism is no more needed: if taxes on exports are null, then the system can work without any clearing mechanism. The existence of a VAT chain, even if with a zero rate, could strengthen the managing of the RSTs and to spread the benefit of the VAT chain to the single stage tax. However it should be noted that the application of a zero rate on the pre-retail stages could strongly weaken the merits of VAT chain – the conflict of interests, the self-policing mechanism[61].

[59] Keen e Smith (1996, p.404).
[60] See Baldwin (1996).
[61] See Keen e Smith (1996)

In practical terms, VAT would work until the stage of retail and then a consumption tax would be levied on in a similar way to the RSTs of USA. VAT taxpayers should apply a single identical rate on transactions with other registered VAT taxpayers. This rate should be applied only on such transactions and not on sales to final consumers. In practice, this is equivalent at levying a VAT until the stage of retail and superimposing on this stage a state retail sales tax. The single rate on intermediate purchases would not mean in any case a form of full rate unification, assuming that the final burden of any consumption tax is given by the rate levied in the last stage on final sales. Therefore this solution could reduce distortions on intra-EU trade, the scope of the clearing mechanism, and most of all, it would allow Member States a remarkable autonomy in consumption tax setting.

Looking at the practical working of this solution, we have two possible options: a) the first one is to put on intermediate transactions the lowest among the reduced rates currently used within the EU– or an average of them – let us say a rate included between 6 and 10%. A small part of this rate could also be then paid directly to the EU budget – 1 or 2% – and this would be the new source of VAT revenue for the EU budget; b) the second option would directly apply a rate of 1-2% on transactions among VAT taxpayers and in the same way as above, this amount would flow to the EU budget. This solution has many advantages: first of all, it reaffirms the destination principle in the working of EU VAT, which is the only criterion compatible with a genuine consumption tax; secondly, it solves the old dilemma of the definitive regime, by leaving Member States free of taxing their consumption and to get the corresponding revenue; thirdly, it can significantly reduce tax evasion, by both reducing the scope of carousel fraud and supplying the right incentives to firms and administrations. Last but not least, it can be a practical and efficient means to finance the EU budget as we will discuss in the next paragraph.

5 Financing the EU budget

5.1 Drawbacks and issues of the EU Budget

The system of own resources for financing the EU budget is coming at a turning point. The recent crisis forces member States to find a stable and viable solution to the Community finances. In this respect, one crucial feature is re-examining the rationale and working of the European budget. More significantly, setting up a new financing mechanism for the EU budget would not only cope with its recent crisis but would also offer a good chance of rethinking EU mission and role. The issue of financing has been surprisingly neglected in the last months discussions which have been essentially concentrated on expenditure side. This paragraph reviews the main issues of current financing mechanism and suggests some possible ways of reforming the VAT regime and the budget financing of the European Union.

There are some clear standpoints from which to start:

a) budget revenue must be founded on tax-based own resources and relies only residually on the GNI 'fourth resource';

b) budget financing has to become more transparent and less complex. European citizens have to be fully informed and aware of what and how much they pay as tax revenue to the EU;

c) the methodology to calculate net balances is not well grounded in economic terms. It does not take into account the economic theory of tax incidence and therefore the final picture is misleading. Net balances calculations aiming at assessing the real beneficiaries of the EU budget resources are biased;

d) these are some of the reasons to quickly find a new system of financing the EU budget. VAT is the best candidate for this role, given its broad spread, the large harmonization of the tax base and of the working rules.

However, the current working of VAT shows some drawbacks and therefore the existing VAT is inappropriate for this purpose. VAT needs to be ambitiously reshaped – in particular, its practical functioning – so as to achieve a genuine, neutral consumption tax, whose revenue should flow to countries where final consumption takes place.

The best economic and practical solution is to move to a pre-retail VAT coupled with a retail sales tax at the state level. This new VAT[62] could not only solve the old question of the VAT 'definitive regime', but also be a perfect source of revenue for the EU budget. This solution could be implemented with some very easy adjustments to current working of VAT. The mechanism would simply rely on a single, identical rate – but not for this harmonized – levied on transactions among VAT taxpayers within the EU, whose revenue might flow to the EU budget.

5.2 The EU budget

If we compare the European budget with those of federal countries, many asymmetries tend to emerge. Apart from its size, the EU budget is quite rigid and inflexible: the spending is defined in a multiyear framework, and resources shifting

[62] There is no need to change the name of the tax but a perfect candidate will be a **FCT** (final consumption tax).

among the different sectors are not allowed. Moreover, the budget has to be annually balanced, i.e., debt is not permitted. Finally, the responsibility for the management is in theory attributed to the Commission, but, in reality, is shifted away to member states who are the real executor of the agriculture policy, the structural funds and the financing as well. A last point, perhaps the most important, is that the expenditure is essentially concentrated on two sectors. Roughly, more than 50 per cent of total resources goes to agriculture and a remaining 30 per cent is devoted to structural funds, such as the regional fund and the like. Small amounts are devoted to research and innovation as well as to traditional public goods such as defence, foreign policy, immigration control, security, etc[63].

5.3 The structure of revenue

Moreover, in recent years, the system of revenue financing has dramatically changed. In Table 7, we show the different weight of TOR (traditional own resources – essentially custom duties), VAT and GNP/GNI resource as a % of the total revenue from 1996 to 2005. Traditional own resources (TOR) have declined from less than 20% to the 11.4% of the total budget. Revenue from VAT has also dramatically fallen in the period considered, by plummeting from 51.3% in 1996 to 14.1% in 2005. The weight of GNP/GNI resource has instead strongly increased, from its level of 30 per cent in 1996, to an astonishingly three-quarter of total revenue in 2005 (74.5%). According to the existing financial perspective, by next year, nearly 90 per cent of EU budget revenue will come from national contributions.

As a matter of fact, increasing national contributions would inexorably change the nature of the EU budget, coming closer and closer to the financing system of purely international organisations, such as the UN and moving away from a traditional budget with tax-based own resources. This means that budget resources are not automatically collected but decided each time by member countries in a fully discretional way. This is contrary to the basic principles and spirit of the then EEC and now of the EU. Furthermore, the higher the role of national contributions, the wider the disagreements ~~c~~on net bal~~k~~ance calculations and the stronger the logic of 'juste retour' on the European setting. A rising role of the fourth resource will force governments to focus on a simple logic of net balance, to look to the 'credit and debit' structure.

[63] In this note, we do not discuss the reasons and possible benefits it might come from an EU public goods budget – the spillovers for the entire area – nor which these might be. See, among others, Tabellini (2002), Goulard-Nava (2002), Buti-Nava (2003), Cipriani-Marè (2004), Begg (2005), Lefebvre (2005), Gros-Micossi (2005).

5.4 Net Balances Calculations

More importantly, the computation of net balances raises many doubts in economic terms. Net balances calculations are usually estimated by taking the nominal amount of expenditure transferred to each member country. But it is easy to understand that this is not the same as to assess the real incidence of the expenditure. In fact, net balances, by considering only the nominal destination of the expenditure, and not its final impact, give a quite misleading picture of real beneficiaries. The map of benefits resulting from the European budget is rather incomplete. The concept of net balance disregards the fact that direct expenditure in favour of a Member State can have significant effects on other Member States' economies. The single market and the high openness of national economies would leave to overflow for most countries a considerable part of the benefits – which will end to translate in imports, by benefiting countries with a positive external balance[64].

By using an input-output methodology, a recent study[65] has carried out a new estimation of the real and final effect of the Community expenditure on member states. The picture that comes out is quite dissimilar from the nominal allocation of different spending items and the final incidence of EU budget resources in geographic terms tend to be quite different. Therefore, the net balance approach would conduce in the end, if performed correctly and fully, to very surprisingly results.

5.5 The new VAT resource for the EU budget revenue

A strong increase in the degree of transparency of European public finances would help to avoid recurrent crisis and bring the Union closer to European population; most of all, it might be a perfect game to play, to reveal the true wills of European nations on Europe's future. A way of moving far from egoism and 'juste retour' approach and to step in for the building of a new Europe.

The composition of revenue has to be changed. National contributions that foster egoism and lessen solidarity must be reduced and scaled down and a new base for a European tax has to be found. This tax has to put into a closer connection the EU to the European citizens and increase people awareness of costs and benefits of Europe. The share of tax-based own resources in the total budget have to be

[64] See Cipriani-Marè (2003).
[65] Cipriani-Pisani (2004).

increased. The reform of the financing system should be based on a tax that explicitly aims at financing the European institutions and the budget and removing the main pitfalls of the current system, i.e. the absence of a direct link with EU citizens.

No much time is needed for finding this ‘new fiscal resource’ for EU. Current VAT has already a sufficient harmonization of the tax base. The existence of regional arbitrariness or the presence of cross-border externalities are strong arguments for assigning all or part of the corresponding tax revenue to the EU level[66]. However, given the current VAT, the definition of a new tax resource for the budget, “imply a decision on sharing either revenue or tax rates between the national and the EU level”, which nevertheless should finance half of the budget[67]. For example, the EU share could be levied “as part of the national rate paid by taxpayers. The total EU budget, anyway limited by the own resources ceiling to a maximum of 1.24% of EU-GNI, would not increase, as revenue from the tax-based resource would be offset by a corresponding decrease of the current GNI-based resource” (European Commission, 2004). The current GNI-based resource will remain as the residual balancing resource. The merit of VAT, as a new fiscal resource, is that it would allow to replace the ‘statistical VAT’ – i.e., the current way of calculating the VAT tax base for the European budget by national administrations – with the real working of the tax – i.e., the tax returns.

For visibility purposes, the EU VAT and the national VAT could appear as separate taxes on the invoice or receipt that a taxable person provides to his customer (assuming that one wants the EU VAT to be visible, for currently taxpayers barely know that they are paying part of their VAT to the EU). Independently of visibility, separating the stage of the retail from the previous ones of the VAT chain is the core of the solution. In the medium term, some more ambitious options could be envisaged, such as a ‘devoted national rate’ to the European budget or a form of a European VAT.

5.6 VAT Estimates and the Underground Economy

to be completed

[66] See European Commission (2004).

[67] For example, the EU share could be levied “as part of the national rate paid by taxpayers. The total EU budget, anyway limited by the own resources ceiling to a maximum of 1.24% of EU-GNI, would not increase, as revenue from the tax-based resource would be offset by a corresponding decrease of the current GNI-based resource”, European Commission (2004).

TABLE 1

VAT RATES APPLIED IN THE MEMBER STATES, July 2005

Member States	Code	Super Reduced Rate	Reduced Rate	Parking Rate	Standard Rate
Belgium	BE	-	6	12	21
Czech Republic	CZ	-	5	-	19
Denmark	DK	-	-	-	25
Germany	DE	-	7	-	16
Estonia	EE	-	5	-	18
Greece	EL	4,5	9	-	19
Spain	ES	4	7	-	16
France	FR	2.1	5.5	-	19.6
Ireland	IE	4.4	13.5	13.5	21
Italy	IT	4	10		20
Cyprus	CY	-	5	-	15
Latvia	LV	-	5	-	18
Lithuania	LT	-	5/9	-	18
Luxembourg	LU	3	6	12	15
Hungary	HU	-	5 / 15	-	25
Malta	MT	-	5	-	18
Netherlands	NL	-	6	-	19
Austria	AT	-	10	12	20
Poland	PL	3	7	-	22
Portugal	PT	-	5 / 12	-	21
Slovenia	SI	-	8.5	-	20
Slovakia	SK	-	-	-	19
Finland	FI	-	8 / 17	-	22
Sweden	SE	-	6 / 12	-	25
United Kingdom	UK	-	5	-	17.5
Average					19,87

Table 1bis
VAT Rates in the EU

Country	Standard Rate	Other Rates
Single Rate		
Denmark	25	-
Slovakia	19	-
Two Rates		
Czech Republic	19	5
Cyprus	15	5
Estonia	18	5
Germany	16	7
Latvia	18	5
Malta	18	5
Netherlands	19	6
Slovenia	20	8.5
United Kingdom	17.5	5
Multiple Rates		
Austria	20	10/12
Belgium	21	6/12
Finland	22	8/17
France	19.6	2.1/5.5
Greece	19	4.5/9
Hungary	25	5/15
Ireland	21	4.4/13.5
Italy	20	4/10
Lithuania	18	5/9
Luxembourg	15	3/6/12
Poland	22	3/7
Portugal	21	5/12
Spain	16	4/7
Sweden	25	6/12

Other OECD Countries

Canada	7	
Japan	3	
Iceland	24.5	14
Norway	23	
New Zeeland	12,5	
Australia	7	

Fonte: EC (2005) and OECD (2002, 2004).

Table 2

Criteria of taxing goods in the international context

Criteria	Destination	Origin (pure)
Rate applied on trade	Importing country	Exporting country
Country who gets tax revenue	Importing country	Exporting country
Place of application of the tax	Importing country	Exporting country

	Current Regime EU (temporary regime)	Definitive regime EU (hybrid origin)
Rate applied on trade	Importing country	Exporting country
Country who gets tax revenue	Importing country	Importing country
Place of application of the tax	Importing country	Exporting country

Table 3
Vertical Coordination in Taxing Consumption

		STATES		
		VAT	**RST**	**No Taxation**
FEDERATION	**VAT**	1 Dual VAT	2 VAT + RST	3 Federal VAT
	RST	4 RST + VAT	5 RST + RST	6 Federal RST
	No Taxation	7 State VAT	8 State RST	9

Table 4
Vertical Coordination in Taxing Consumption

		STATE		
		VAT	**RST**	**No Taxation**
FEDERATION	**VAT**	Canada Brazil	Canada India	Germany Austria Switzerland Australia Belgium
	RST			
	No Taxation	EU Mexico Argentina	USA	

Table 5
Consumption Taxation in Canada

Provinces	Federal Level	Provincial Level
1) Quebec	GST	QST
2) British Columbia, Ontario, Saskatchewan, Manitoba	GST	RST
3) Prince Edward Island	GST	RST
4) Newfoundland, Nova Scotia, New Brunswick	HST	HST
5) Alberta	GST	

GST is the federal VAT which is used in all the provinces but 2) and 3). In group 4) a common federal-provincial VAT is applied, the Harmonized Sales Tax (HST) which is managed by the federal government. Quebec instead has a provincial VAT, the Quebec Sales Tax (QST).

Table 6

Possible Forms of Sales Tax at the State Level
1) National Sales Tax with a Revenue-Sharing Mechanism
2) Origin-based Taxes • VAT with uniform rates • VAT with variable rates
3) Destination-based Taxes • Retail Sales Tax • VAT with uniform rates • VAT with variable rates
4) A joint federal-state VAT (dual VAT)

Box 1

Pre-retail VAT + RST

Identified only with VAT #

VAT registered firm $\xrightarrow{t_{EU} \text{ unified}}$ **Other VAT regis. firms**

(without distinguishing whether domestic or EU)

$\downarrow$ t_n state

final consumer (no VAT number)

$$\boxed{t_{EU} < t_n}$$

Tax burden is given only by t_n i.e., rate(s) applied on sales to final consumer

Table 7

Table 1 – The composition of EU own resources
(in per cent of total own resources; cash basis)

OWN RESOURCES 1996-2005										
	1996	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**[1]	**2003**	**2004**[2]	**2005**[3]
TOR	19,1%	18,8%	17,2%	16,8%	17,4%	18,1%	11,9%	13,0%	12,0%	11,4%
VAT	51,3%	45,5%	40,3%	37,8%	39,9%	38,7%	28,8%	25,4%	14,6%	14,1%
GNP/GNI	29,6%	35,7%	42,5%	45,4%	42,7%	43,2%	59,3%	61,6%	73,4%	74,5%
Total own resources (€ billion)	**71,1**	**75,3**	**82,2**	**82,5**	**88,0**	**80,7**	**77,7**	**83,6**	**93,3**	**108,5**

1 As from 2002 the % of TOR retained by Member States as a compensation for their collection costs was raised from 10 % to 25 %. This difference represented about € 2.2 billion in 2002 as well as in 2003.

2 Preliminary draft amending budget 8/2004 (EU-25).

3 Preliminary draft budget 2005.

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Box 2

Principles of Taxation and Tax neutrality

There are two countries, 1 e 2 and a good that can be produced in both countries. If 1 produces the good, p^1 is the price, if the good is produced by 2, price is p^2 (this will be also the price if the good is imported from 2 by country 1). In the case of no taxation, production relative prices are p^1/p^2 . (that is equal to MRT) and the trade between the two countries of the good will take place at the same relative price.

Let assume now that the two countries decide to tax consumption with a VAT and that the existing rates were in the two countries: t^1 the rate applied in country 1, t^2 the rate in country 2. Let assume that there is a rates divergence in the two countries, i.e. that $t^1 \neq t^2$. Obviously, now the presence of taxes will have relevant effects on the equilibrium and on the price ratio (see Sinn, 1990; Keen 1993, 2000; Keen-Wildasin, 1999; Lockwood, 1998).

A) Destination Principle (PD)
DP is when the good is taxed in the country where final consumption takes place, not in that where it is produced and exported. Therefore, the exporting country will apply a zero rate on exports and the importing one will apply to the imported good the same rate as the one levied on goods produced domestically, that is to say, as if the imported good were produced domestically.

The price of the good for consumers are now in **Country 1**:
$p^1(1 + t^1)$ for the good produced in Country 1; $p^2(1 + t^1)$ for the good imported from Country 2. Therefore, we have now that relative prices p^1/p^2 do not change. The DP does not modify relative prices and it is hence neutral.

B) Origin Principle
The prices of good in question in Country 1 are now :
$p^1(1 + t^1)$ for the good produced in Country 1; $p^2(1 + t^2)$ for the good imported from Country 2

Given that $t^1 \neq t^2$ we also have that $\frac{p^1(1 + t^1)}{p^2(1 + t^2)} \neq \frac{p^1}{p^2}$

Taxation will end to be not neutral and will modify relative prices and therefore trade between the two countries. Consumer prices of the same good in country 1 will be different because of the effect of the tax and of the rates divergence. This is holds also if $p^1 = p^2$ (i.e., costs are equal in the two countries). As a consequence of taxation, the imported good will be sold to a different price from that of the good domestically produced. The only solution to leave relative prices unchanged is that to set $t^1 = t^2$ that is to realize a complete tax rate harmonization.