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Value-Added Tax and Excises: Commentary

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VAT COORDINATION ISSUES IN THE EUROPEAN UNION

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Commentary on the Mirrlees Review paper on VAT and Excises

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1. Introduction

A large body of research analysing the properties and workings of the value-added tax (VAT) is now available.[1] The best practice that can be distilled from the literature, particularly as it applies to the European Union (EU), strongly indicates that the consumption base of the VAT should be defined as broadly as possible and that all goods and services should be taxed at a uniform rate. This promotes fiscal neutrality and administrative simplicity. On both counts, the VATs of the EU member states leave much to be desired, compared with the new VATs of New Zealand, Canada, Australia and various other countries. The "standard exemptions" (sic!) of the harmonized EU-VAT[2] defy the logic and inherent integrity of the VAT, and the differentiated rate structures in most member states are ill-targeted instruments to affect the VAT burden distribution, yet increase administrative complexity and compliance costs.

Another, perhaps more topical, point of discussion concerns the most appropriate treatment of intra-community trade. It is widely agreed that VAT revenue should be allocated among member states in line with consumption, i.e. on the basis of the destination principle,[3] but there is no consensus on how this principle should be applied in the EU. Currently, intra-community supplies (exports) are zero-rated and intra-community acquisitions (imports) are subject to VAT in the state of importation. This is called the 'transitional regime,' because the European Commission believes that it should be replaced by a definitive regime based on exporter rating, i.e. the taxation of intra-community exports by exporting member states and the use of the revenue thus collected to finance equivalent tax credits provided in importing states.

Crawford *et al*. (2008) also believe that the EU should change over to exporter rating. In their view (p 33) zero rating at export breaks the "gradual cumulation [of VAT] at each stage of the chain of production and distribution," which invites fraudulent practices.[4] These practices are documented in Keen and Smith (2006, p 39), who conclude that "a fundamental redesign of the VAT treatment of intra-community trade may be required," preferably in the form of a viable integrated VAT (VIVAT) (Keen and Smith, 1996). VIVAT envisages an EU-wide, uniform, dual VAT rate on all pre-retail (intermediate) transactions by registered firms within and between member states (with credit for VAT in importing member states), supplemented by a surtax at retail (in fact a retail sales tax (RST)) if governments wish to exploit the VAT base more intensely.

This Commentary argues that the current system deserves another hearing. While zero rating and exporter rating are identical in terms of revenue allocation, VIVAT involves substantial additional administrative complexity and may violate tax autonomy (subsidiarity), because it requires some form of central involvement in settling net VAT balances. More importantly,

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[1] See, for instance, Bird and Gendron (2007) and Ebrill, *et al*. (2001), and the literature cited therein.

[2] It should be noted that the 2006 VAT Directive on the Common System of Value Added Tax (Council Directive 2006/112/EC) merely recasts the 1977 VAT Sixth Directive (Council Directive 77/388/EEC), incorporating a previous directive and various subsequent amendments. The new date is misleading to the extent it suggests that substantive design changes have been made.

[3] By contrast, under the origin principle, VAT accrues to the state of production. Accordingly, value added up to the export stage is taxed in the state of production, while imports are not taxed. Below, the choice of principle is briefly discussed.

[4] The reference here and below is to the 24 January 2008 draft of the Crawford, *et al.* paper.

the Commentary argues that it is not the break in the VAT-collection chain at intra-community borders that is a matter of concern, but rather the break in the VAT-audit trail, broadly defined as the jurisdictional reach of each VAT administration's ability to control compliance. Accordingly, VAT coordination efforts should focus on improving information exchange between member states and on establishing bilateral and multilateral VAT audit and investigation units to monitor compliance with VAT obligations regarding intra-community transactions.

Against this background, the Commentary is organised as follows. Section 2 dwells briefly on the history and current treatment of intra-community transactions in the EU, essential in understanding and evaluating the current regime against the various reform proposals. Subsequently, section 3 highlights the proposals that the European Commission has made to replace the transitional regime by some form of exporter rating. Next, section 4 does the same for the exporter rating proposals made in the tax literature. Whatever proposal is ultimately adopted, the proper treatment of intra-community transactions would be facilitated by various VAT base broadening measures, as argued in section 5. Section 6 concludes.

In passing the Commentary notes that VAT does not "cumulate throughout the production process."[5] Just as under a retail sales tax (RST), no net VAT is collected within the ring of registered firms, provided, quite plausibly, that the average length of time required for remitting tax and for processing any refunds is the same as the average length of time required for settling accounts receivable and payable.[6] Net VAT is collected only after the consumer (or unregistered trader) has been invoiced for the full amount of VAT on his purchases. Subsequently, this amount is collected fractionally throughout the production process. In essence, suppliers are made tax collectors on behalf of the government for the consumer's VAT on the rationale that retailers (and other firms) are less likely to default on tax invoiced by their suppliers than on tax payable directly to the tax office (Cnossen, 1987).

2. VAT and intra-community transactions

In discussing the VAT treatment of intra-community transactions (and the full implications of the transitional and various definitive regimes), it is useful to make a distinction, generally overlooked in the economics literature, between the cross-border VAT treatment of goods and that of services.

a. Cross-border transactions in goods

[5] Accordingly, in this sense, there is no break in the VAT-collection chain at export. An exporter would still be entitled to a refund for the VAT he has paid to his suppliers if in any VAT return period he would not export the goods he holds in inventory. However, there is a break in the VAT-chargeability chain, because exporters have to make a distinction between domestic and foreign buyers.

[6] To be sure, cash flow benefits (or costs) do arise if a registered firm's collection period (the period during which the tax is collected before being handed over to the tax office) does not coincide with the grace period (the period after the collection period but before the latest day designated for handing over the tax). This will happen under RST if sales are made against cash but the tax is remitted, say, every three months, or if accounts receivable are settled earlier than tax is remitted to the tax office. If the tax payment conditions are similar, the effect also arises under VAT, but part of the tax-induced cash-flow benefit may be spread upstream if retail purchases, including VAT, are also made against cash.

Prior to 1993 (the year in which intra-community border controls were abolished in the EU), most member states included imported goods in the domestic VAT base by taxing them at their borders under the supervision of customs authorities, while a credit for the VAT was provided when the goods entered the domestic production process. Similarly, the VAT on exports was refunded at the export stage and border controls could be used to check whether the goods had actually left the country. These "border tax adjustments" (BTAs) ensure that the VAT is levied on the destination principle, while border controls can be viewed as a helpful backstop for enforcement and verification (in lieu of the audit trail).

From 1993 onward, physical controls for VAT at interstate borders have been replaced by accounting controls at the first inland stage of the production process. Registered firms of taxable imported goods have to include these goods (intra-community acquisitions are deemed to be a separate chargeable event) in the return due for the period in which the goods are imported. The VAT is self-assessed, as it were, and a credit is provided at the same time. Accordingly, no net VAT is due and payable, unless the acquisition is made by an exempt firm. This arrangement is called "deferred payment" (Cnossen, 1983, p 156), because the VAT does not have to be paid upfront at the border.[7] In 1982, the European Commission proposed the EU-wide introduction of deferred payment (Draft Fourteenth VAT Directive),[8] but changed its position three years later (European Commission, 1985) in favour of exporter rating. The member states, however, insisted on deferred payment, which had proven its feasibility in the Benelux, ever since Belgium, Luxembourg and the Netherlands introduced their VATs in the late 1960s and early 1970s.[9]

Deferred payment places the charge to VAT on the purchaser of imported goods rather than the supplier: the charge to VAT is reversed, as it were. Reverse charging, generally applied, is believed to take care of the "missing trader," i.e. the trader who charges VAT on his supplies but then disappears, while his customer takes credit for VAT that has not been accounted for. The missing trader may be an importer, but can also be a domestic trader. Reverse charging, applied to domestic transactions, would nullify the fractional collection nature of the VAT, under which the tax office has a lien, as it were, on suppliers for the tax payable by their customers (ultimately the retailers that collect the VAT from consumers). Austria and Germany have requested permission to apply reverse charging to transactions above €5,000, but the European Commission (2006) has denied the requests on the ground that reverse charging would increase compliance control problems at the lower end of the production

[7] Although correct if looked at from the border VAT point of view, deferred payment is a misnomer when viewed in the domestic context, because it treats imported goods exactly on a par with domestic goods (the right to a tax credit arises at the same time that the VAT on supplies is accounted for). Particularly, it eliminates the previous cash flow disadvantage, i.e. the interest foregone by the importing firm on the VAT paid at import before this VAT was credited (or refunded) against the domestic VAT payable on sales. Some member states used to neutralize this cash flow disadvantage by allowing importing firms a grace period of, say, 6 weeks, before the import VAT had to be paid.

[8] Without abolishing border controls. Importers of VAT-liable goods still had to hand over VAT documentation to customs authorities at the point of importation without actually being assessed for VAT at that point.

[9] Prior to 1993, deferred payment was also practiced for some time in Ireland and the UK where it was called postponed accounting.

chain where most small businesses can be found.[10] This commentator believes that comprehensive reverse charging would throw the baby out with the bathwater.

At the time the transitional regime was introduced, customs controls were replaced by a functionally equivalent, if perhaps less certain, VAT information exchange system (VIES) (Council Regulation 218/92/EEC).[11] VIES requires registered firms to report their intra-community supplies (exports) to registered firms in other member states (indicating their VAT identification numbers preceded by a country code) on a quarterly basis (listing requirement) to the VAT office. Similarly, the purchaser has to report the total of his intra-community acquisitions. The information is fed into a central data bank and should enable the various VAT administrations in the EU to match total intra-community acquisitions per trader against individually reported supplies. VIES imposes differentially higher compliance costs on interstate traders – a source of discrimination and trade distortion.[12]

b. Cross-border transactions in services

Although services are economically equivalent to goods, their VAT border-crossing treatment differs. Prior to 1993, arrangements for BTAs on goods through border controls could not deal effectively with (non-tangible) services whose location of supply or purchase is difficult to ascertain. Obviously, interstate differences in VAT rates would generate distortions if the liability to tax was determined by the state in which the service was supplied. But if the purchasing firm's state would be the taxing locus, it would be difficult to tax purchases by final consumers.[13]

Article 43 of the 2006 VAT Directive (previously Article 9 of the 1977 Sixth VAT Directive) provides a workable solution to the issue by taxing services, in principle, in the state where they are performed. Highly significant exceptions, however, are made for services rendered by banks, insurance companies, professional firms, advertising agencies, and various other services (nearly all B2B transactions). Upon export, these services are exempt, although the exporter retains the right to a credit for the VAT in respect of any inputs used in performing the services. In the importing state, furthermore, the services are treated as if they are inputs supplied by the importing firm itself. If, subsequently, their value would be included in the value of domestic goods or services, no credit would be available for the VAT on "import", because there is no import VAT. In essence, prior to 1993, the current transitional regime for goods was already being applied to services, albeit implicitly because a self-declaration was

[10] For Germany, see PSP Peters Schönberger GmbH Wirtschaftsprüfungsgesellschaft (2005). The European Council (Decision 2007/250/EC), however, has permitted the UK to apply reverse charging to supplies of mobile phones, computer chips and some other goods.

[11] Furthermore, a statistical data collection system, referred to as the Intrastat system, was set up to collect trade data on goods (not services) between member states (Council Regulation 3330/91/EEC, replaced by 638/2004/EC). Recently, the Intrastat obligations have been simplified (COM(2008) 58 final).

[12] See Verwaal and Cnossen (2002) who point out that most of the differential costs should be attributed to Intrastat obligations (see footnote above), not to VAT obligations.

[13] Note that the much feared wave of cross-border purchases of consumer goods (Sinn, 1990) was already a non-issue for services prior to 1993. In fact, the treatment of border-crossing services, before and after 1993, indicates that the implications of the break-in-the-VAT-chain for goods when border controls were abolished, was not an unfamiliar phenomenon.

not required. There was no need to change this arrangement in 1993 (it had worked before). Later on, however, the VIES reporting obligations for goods were extended to services.

Initially, there was no need to have separate rules for the acquisition of out-of-state services similar to the rules for goods bought by exempt entities, sold by mail order firms or individually imported means of transport – which are all taxable in the destination state. Few high-value services were bought out-of-state in low-VAT countries. This changed dramatically, however, with the advance and privatization of telecommunication, radio, television and electronic services. Firms providing these services sprung up in Luxembourg (which has one of the lowest VAT rates in the EU) to the chagrin of the member states where the services were consumed and supposed to be taxed.[14]

To remedy this situation and, more generally, to put the VAT treatment of services on a par with the treatment of goods, recently, new rules (which will take effect in 2010) for the place where services are deemed to be rendered have been promulgated with the primary goal of taxing services as much as possible at the place of consumption or use (Council Directive 2008/8/EC of 12 February 2008). In effect, the deferred payment system for goods will be extended to B2B services under an identical reverse charging system. Basically, the exceptions have become the main rule: B2B services will de deemed to be provided where the customer carries on his business. Overriding exceptions are provided for immovable property, cultural services and education, restaurants and catering, transportation of persons, and short-term rentals of vehicles, which are deemed to be provided where the services are actually performed. As is the case with goods, the VAT identification number will play a crucial role in verifying compliance.

The main rule for B2C services, as before, is that they are deemed to be provided at the place where the provider of the services carries on his business. To limit administrative costs, a mini one-stop shop arrangement will be provided for telecommunication, radio and television services (effective 2015). The tax on these services will be payable in the state where the services are provided. Subsequently, that state distributes the VAT revenue to the member states where the customers are located according to an agreed formula. In fact, this is a mini-form of exporter rating!

c. Improving compliance and enforcement symmetry

Basically, the latest directive unifies the VAT treatment of intra-community transactions in goods with similar transactions in services (not, of course, for trade with third countries). Deferred payment/reverse charging (VAT in the destination state) is explicitly applied to goods and B2B services. B2C consumer services are taxed in the state where the services are actually performed, similar to cross-border purchases of goods which are taxed, with minor exceptions, on an origin basis. VIES reporting obligations for goods as well as services, potentially extend the verification trail across borders. Compliance symmetry between instate and out-of-state transactions has been enhanced by requiring instate suppliers to show their VAT identification number and that of their customers on invoices, as out-of-state suppliers have to do. What remains to be done is the establishment of tax audit units with EU-wide investigative powers to monitor VAT compliance with intra-community transactions. In other words, verification should be complemented by audit control. For all practical purposes, the

[14] In addition, complications arose regarding third-country providers of services which had to choose a member state of domicile to discharge their VAT obligations.

new arrangements for services seem to transform the transitional regime into the definitive regime, although, as shown below, the debate on some form of exporter rating instead of deferred payment continues.

3. Exporter rating systems proposed by the European Commission

Very different, perhaps more exciting if less practical, proposals have been made in the tax literature and by the European Commission, which focus mainly on repairing the supposed hole in the VAT collection chain. In the early 1980s, Cnossen (1983), argued that the destination principle[15] could be maintained without border controls if intra-community exports would be taxed at the VAT rate of the exporting member state, invoiced to the importer in the importing member state, and credited by him against his VAT liability on sales. To restore the revenue allocation under the destination principle, the importing state would have to reclaim the importer's credit from the exporting state. In essence, only net balances (VAT collections on exports over VAT credits on imports) would have to be settled between member states. This could be done on an EU-wide basis through what Cnossen (1983) called a clearing house system. The idea was adopted by the European Commission (1985) in a paper known as the Cockfield White Paper,[16] and forms the basis of subsequent exporter rating proposals.

The Commission's arguments, however, failed to persuade the governments of the member states which wanted to retain full control over the VAT administration of imports and exports, and, therefore, opted for the deferred payment system, although they agreed that exporter rating should receive a second hearing before 1997. In the tax literature, moreover, Lee, *et al*. (1992) had criticized the Commission's clearing house proposal, pointing out that it had an adverse impact on enforcement incentives, because importing member states might not be inclined to root out fraudulent claims for import VAT credits (after all these would presumably be paid by exporting states), while exporting states would have little incentive to uncover fraudulent failure to charge VAT on exports. Solving this problem would require uncoupling the clearing house flows from taxes actually paid.

Subsequently, the European Commission (1996) made another attempt to persuade the member states of the benefits of exporter rating. The fresh proposal was called home-state taxation, because firms involved in intra-EU trade would have to deal only with the VAT

[15] Early on, the origin principle was viewed as the only way of doing away with border controls for VAT (Neumark Committee, 1963, p 145-149). In fact, the doctrine of the "restricted origin principle" (applied in the EU but not to trade with third countries; Shibata, 1967, pp 193-194), became a standard tenet in public finance textbooks; see e.g. Due and Friedlaender (1975, p 519), Musgrave and Musgrave (1980, p 644), and Shoup (1969, p 644). For an analysis in the US setting, which reaches the same conclusion, see McLure (1980, pp 127-139). Subsequent writings, however, emphasized that origin taxation violated production efficiency – a more important criterion than exchange efficiency (Diamond and Mirrlees, 1971) – and that it involved contentious transfer pricing problems (Cnossen and Shoup, 1987, pp 72-73). After weighing the theoretical and technical arguments, Crawford, *et al*. (2008, p 8) conclude that the destination principle is the best lode star for practical VAT design.

[16] Interestingly, as perceived by the European Commission, exporter rating seemed to be in line with the erstwhile pronouncement on origin taxation in Article 4 of the First VAT Directive (which called for the abolition of "the imposition of tax on importation and the remission of tax on exportation in trade between member states"), since intra-community supplies were taxed in the state of origin even though revenue would be allocated on the destination principle. Accordingly, to this day the Commission continues to insist on dubbing exporter rating as origin taxation, confusing principle and method for the sake of an outdated point of view.

system of the member state in which they were established.[17] Cross-border sales would be taxed in the same fashion as domestic sales, although cross-border movement of goods within the same business would go untaxed. VAT revenues on intra-community transactions would be allocated between member states on the basis of national accounts statistics of aggregate consumption. Complete uniformity in the scope and definition of VAT would also be necessary, as well as close cooperation and EU supervision of VAT administrations.

In an eloquent commentary, Smith (1996) pointed out that the new proposal would put substantial limitations on member states autonomy to set rates, require an extensive programme of legislative harmonization, cause difficulties in identifying firms entitled to be taxed in a single member state, and a flight of businesses to least-taxed locations or, if rates were the same, to states where VAT evasion would be less tightly controlled. Also revenue allocation rules would undermine incentives to devote adequate resources to VAT collection and enforcement.

The proposal did not leave the drawing board, but was briefly resurrected in 2004 as the one-stop shop proposal under which exporters would be able to discharge all their obligations with respect to border-crossing transactions at one place only, i.e. their place of establishment.[18] This time clearing would not be necessary because exporters would be required to remit the gross VAT collected by them and calculated at the destination-state rate directly to the state of final destination, an idea which had earlier been proposed by Vanistendael (1992).[19] Few details were provided. In the meantime, the Commission seems to believe that the transitional regime will be around for some time to come: in the 2006 VAT Directive, the transitional measures are no longer grouped together, but integrated with related provisions.

4. Should VIVAT be laid to rest?

In the belief that the supposed break in the VAT-collection chain threatens VAT's integrity, Keen and Smith (1996) have made an imaginative, high-profile proposal for a viable integrated VAT (VIVAT), which would impose a harmonized dual EU-VAT rate, administered by member states, on all pre-retail (intermediate) transactions by registered firms within and between EU member states, supplemented by a surtax at retail (in fact an RST integrated with a member state's VAT) if governments wish to exploit the VAT base more intensely. Clearing would be provided if the VAT collected on exports exceeded the VAT credits provided for imports.

According to Keen and Smith (1996), as well as Crawford, *et al*. (2008), VIVAT would bolster the destination principle and hence subsidiarity in taxation. The commonality of the EU dual rate would lessen the pressure on the clearing system and enforcement. Traders

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[17] Since intra-EU exports were zero rated under deferred payment, the European Commission (1996) noted that more than €700 billion worth of goods circulated VAT-free in the internal market, and observed that due to the break in the VAT-collection chain "some of that amount may well be diverted to the black economy." In light of the above discussion, it will be noted that all goods and services, not just intra-community traded products, circulate VAT free within the ring of registered firms.

[18] Some details can be gleaned from IP/04/1331 and MEMO/04/249.

[19] The one-stop shop proposal may receive further scrutiny in the run up to the implementation by 2010 of the Services Directive (Council Directive 2006/123/EC), which calls for "points of single contact" in each member state where traders can discharge all their obligations in other member states.

would be able to report exports and imports in aggregate rather than per member state. The uniform dual rate would remove the incentive for strategic rate setting, i.e. the incentive member states would have under exporter rating with non-harmonised rates to tax exports higher because the VAT would anyway be creditable in importing states.[20] The hassle of the clearing system could be resolved through a one-off deal, i.e. a system of lump sum transfers between member states, obviating the need for future clearing.

VIVAT, however, would not be without its own problems. Uniform exporter rating may appear to repair the break in the VAT-collection chain, but does nothing to solve the break in the VAT-audit trail. Importing member states would still not be able to audit importers' invoices (received from exporters in other member states) for which they have no authority. This would provide a powerful incentive to fake importers' invoices, showing VAT eligible for credit instead of no VAT as under the current regime. In fact, bogus export invoices might simply be replaced by bogus import invoices.

Keen and Smith's (1996) proposal that the excess of collections on exports over imports should be allocated on the basis of export and import listings by businesses of aggregate rather than individual transactions would undermine enforcement efforts, since it would not be possible, as under VIES, to link individual transactions to monitor compliance for audit purposes. VIVAT's harmonised dual rate could ease the treatment of triangular and chain transactions (changes in the ownership of goods, and hence VAT obligations, while the goods are shipped across various member states), but may complicate the treatment of inter-company transactions if arm's length values would have to be established.

Furthermore, under VIVAT, member states with a greater than average preference for VAT would have to impose an additional RST. In other words, they would have to incur higher administrative and compliance costs than currently and than member states making do with the revenue collected under the VIVAT rate. Registered traders, moreover, would have to make a distinction between sales made to other registered traders (taxable at the VIVAT rate) and sales made to non-registered persons, i.e. individuals and exempt entities (taxed at the RST-inclusive rate) – "not a trivial burden," as Keen and Smith (1996, p 406) admit. The RST-element would have all the drawbacks of a normal RST, noted in the literature (e.g., Cnossen, 1987).

Beyond that, it is difficult to envisage a uniform dual VIVAT rate in light of the established, if perhaps misguided, preference for greater rate differentials shown by the member states. Also, reduced rates are levied on a product-specific basis. Their application (with revenue consequences) to intermediate transactions would complicate VIVAT and open up other avenues for fraud, particularly if it is not possible to audit import invoices. Politically, VIVAT would further entrench the (high) VAT rate agreement in the EU, making it more difficult to convert the differentiated rate structures into single uniform rates or to reduce the VAT rates in individual member states at some future date.

Other proposals for VAT coordination in the EU have been made by McLure, and Bird and Gendron. McLure (2000), building on a proposal by Varsano (1999) for the Brazilian states, suggests that a separate uniform rate EU-VAT (which he calls "compensating value added tax" or C-VAT) should be introduced, administered by a central agency (or a consortium of

[20] It is difficult to view this as an advantage of VIVAT, since any attempt at strategic rate setting would be stopped in its tracks by the European Court of Justice on the ground that it would be a gross violation of the non-discrimination principle.

states), on all interstate exports matched by a credit for tax on all interstate imports (accordingly, there would be no need for a clearing mechanism). State VATs would be retained along with the deferred payment system for interstate trade. In essence, C-VAT is functionally equivalent to VIES but involves greater administrative complexity.

Bird and Gendron's (1998) dual VAT (D-VAT), based on the experience in Canada (which has a federal VAT, while Quebec operates a state VAT), envisages a central VAT (next to the state VATs), which would apply to all instate and interstate sales. Unlike the C-VAT, the D-VAT would raise revenue for the centre. As Keen and Smith (1999) have pointed out both C-VAT and D-VAT currently are not options in the EU if there is to be a central administration. Bird and Gendron (1998, p 439), however, do allow for a virtual, functionally equivalent D-VAT in the form of "some closely coordinated overarching administrative structure which would, for example, facilitate and insure information exchanges, development of agreed audit plans, and so on," in order to give states the capacity to monitor cross-border transactions. It is this idea that is also central to the gist of this Commentary.

It is hard to avoid the impression that VIVAT, C-VAT and D-VAT are heavily predicated on the assumption that a solution has to be found for the VAT treatment of interstate trade in (physical) goods[21] – so central to the EU's 1992 programme – while the practice and experience with (intangible) services, is just as or even more important. Bringing services into the equation emphasizes the point that it is the break in the VAT-audit trail that should be the focus of concern. Deferred payment involves fraud, of course, but the answer to fraud, it seems, is audit, investigation and prosecution, not another system that may be equally susceptible to abuse. Substituting a tried and proven system of deferred payment by some form of exporter rating may turn out to be a costly risk. It is quite telling, perhaps, that the Netherlands (which has had deferred payment for nearly 40 years!) has the lowest VAT evasion rate (the VAT gap as a percentage of hypothetical revenue) among ten member states for which figures are available (Gebauer and Parsche, 2003), although it is the most open economy of all.

5. VAT base broadening

One of the contentious issues under deferred payment is the treatment of cross-border acquisitions by exempt entities, which have to self-assess their intra-community acquisitions (which are zero rated in the supplying member state). Self-assessment with its attendant complexity would not be necessary if the entities would be not be exempt but registered for VAT purposes like other businesses. More generally, the EU-VAT exemptions violate the logic and functionality of the tax. They distort input choices, harm exports, and complicate administration because the VAT on inputs has to be denied with respect to exempt supplies if performed in combination with taxable transactions. Accordingly, a strong case can be made for repealing most of the "standard exemptions."[22]

The case against the exemption of cultural services is particularly strong. Admissions to theatres, concerts, museums, sporting facilities and the like compete with taxable forms of entertainment, such as travel and reading, and should therefore be taxed. Similarly, public radio and television broadcasts compete with taxable privately financed broadcasts and other

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[21] See, for instance, Keen and Smith (1999, p 743-744) who make their case for VIVAT against the background of the abolition of "effective border controls."

[22] This section draws heavily on Cnossen (2003).

forms of communication. This applies also to postal services (which compete with taxable private letter or parcel carriers), newspapers and periodicals. Since it is difficult to justify these exemptions on externality grounds, withdrawal seems indicated. Various member states, including the UK, are coming around to the view that cultural services should be taxed, but taxation is by no means universal in the EU.

Even the exemptions for healthcare and for education services hardly stand up to close scrutiny. Admittedly, the externality arguments are stronger than in the case of cultural services, but if health and education services should be provided below cost, then (an increase in) budget subsidies (or a zero rate) would be the appropriate policy response. The exemptions violate production efficiency because the institutions providing healthcare and education services are induced to perform laundry, cleaning, food preparation and various other services in-house in order to save the payment of VAT on the labour element of these services, which would be payable had they been acquired from outside, taxable establishments. This hampers the contracting-out of these services (privatization) and thus the efficient functioning of the institutions. Exemption also raises the cost for companies wishing to conduct research through hospitals and universities, because they cannot take implicit credit for the VAT on the inputs used by the exempt institutions. These considerations become more important as the private provision of health care and education grows relative to public provision, as is happening in the EU.

Administratively beyond reach so far are financial transactions, because the intermediation charge, which should be taxed, cannot be separated from the pure interest rate, premium or rate of return which should not be taxed. Perhaps the cash flow approach, pioneered by Poddar and English (see Poddar, 2003), deserves further scrutiny. The EU has closely considered their ingenious idea, but doubts remain about its practicability. There is little doubt about the desirability of taxing public bodies more widely, particularly local and provincial governments. Competition is distorted to the extent government services compete with similar services provided by the private sector. As with hospitals, universities and financial institutions, taxation would obviate the need for delineation between taxable and exempt government activities as well as for self-assessment if taxable goods and services are acquired out-of-state.

Another anomaly are the flat rate schemes for the agricultural sector which exempt farmers from the obligation to register for and pay VAT, but compensate them for the tax borne on inputs. The schemes provide only rough justice and, just like the old turnover tax, can be used to subsidize farmers. Best practice would be to make farmers fully liable for VAT, subject to the small-business exemption. Similar comments can be made about the various small-business schemes, which add greatly to administrative and compliance costs without contributing much to revenue. Experience in new VAT countries indicates that the simplest small-business scheme is a fairly generous exemption without any strings attached. Indeed, this is also the outcome of the formula discussed in Crawford, *et al*. (2008).

6. Conclusions

This Commentary has argued that exporter rating does not seem to have obvious advantages over deferred payment for the VAT treatment of intra-community transactions and may complicate VAT administration. Instead, the search should be for a workable system that extends the VAT audit trail by setting up cross-border tax audit and investigation units to monitor intra-community transactions. Precedence for this can be found in police and judicial units with cross-border pursuing and investigative powers. If this is done, the current transitional regime (VIVAT with a common rate of zero, as Crawford, *at al*. (2008) point out) can be retained. Furthermore, explicit reverse charging should remain the exception rather than become the rule.

Last but not least, the 2006 VAT Directive, which is based on its 1977 predecessor (long before the wall came down), has not stood the test of time. Efficiency in production and tax collection is not served by the large number of so-called standard exemptions. Admittedly, improvements to the 2006 VAT Directive require the consent of 27 member states, which is hard to come by.[23] If the member states are not to be locked into outmoded VATs, perhaps they should be permitted to have better VATs than provided by the 2006 VAT Directive. The time has come to support Crawford, *et al*.'s (2008) call for allowing more experimentation than has hitherto been the case.

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[23] Crawford, *et al*, (2008) argue that a common VAT base is helpful in determining the VAT-contribution to the EU's "own resources," but this contribution is calculated by statistical agencies on the basis of national accounts, divorced from actual VATs.

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