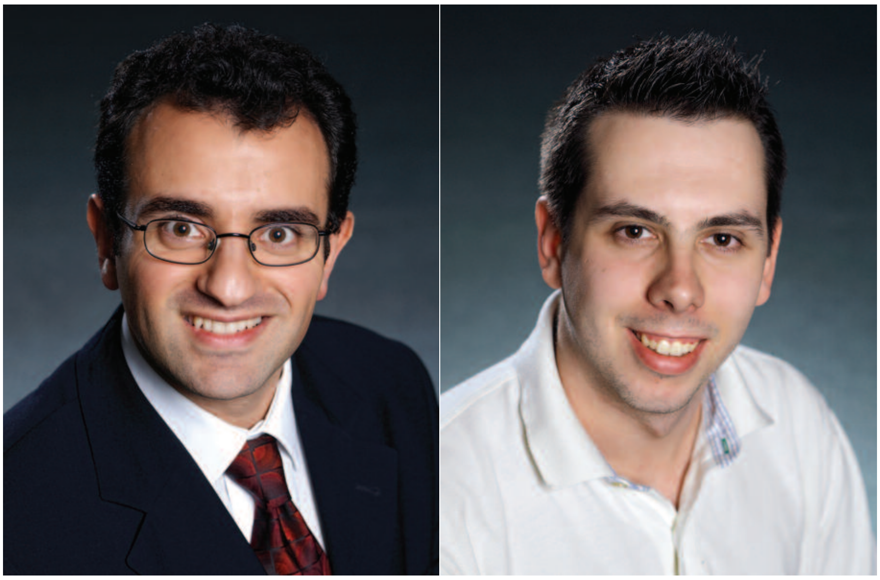
EU VAT reform could go much further

Stuart Adam and David Phillips of the UK Institute for Fiscal Studies look at the benefits of the EU's VAT reform plans, but argue that the European Commission could go much further in looking to abolish exemptions and reduced rates.

In December 2010, the Commission launched a debate on the future of VAT in the EU. The evidence-gathering process included a public consultation which elicited more than 1,700 responses from businesses, academics, citizens and tax authorities; and a study on the workings (and failings) of the existing VAT system commissioned from a consortium of economic research institutes led by us at the Institute for Fiscal Studies. In December 2011, the Commission published its outline proposals, aimed at making the EU VAT system simpler, more efficient and more robust. These proposals were broadly welcomed by the Council in May 2012, and further work is now ongoing with a view to bringing forward more detailed proposals. If implemented, how far would the Commission's reform agenda improve VAT across the EU?



Stuart Adam and David Phillips think abolishing VAT exemptions and reduced rates, while compensating poor households, would reduce complexity in the system

Easing compliance

One of the most important of the Commission's proposals is in fact for something *not* to happen. They propose to abandon the long-standing objective of moving towards a definitive VAT regime based on taxing cross-border trade in the country of export rather than the country of import. Since the economic argument for taxation in the country of export was always dubious and that it showed no sign of happening despite being official policy since 1967, finally renouncing this goal would be a positive development and would allow the Commission to focus wholeheartedly on measures to improve the operation of the existing EU VAT system.

The Commission's proposals include a number of such measures to improve the operation of VAT in the internal market, with the aim of reducing compliance costs for firms and increasing the capacity of revenue authorities to detect and prevent fraud. A central website which would provide information on VAT rules and rates for each EU member state is proposed, as is the provision of both more information about policy changes and improved facilities for consultation before policy changes. More radically, the Commission advocates a standardised VAT declaration across the EU (and, potentially, further standardisation of VAT procedures and forms) and the adoption of a wide-ranging one stop shop approach whereby many traders would only need to deal with the tax authority of one member state (generally the country in which they are based). While there are administrative costs to setting up and maintaining such arrangements, if successful they could significantly reduce compliance burdens for businesses engaged in cross-border trade, especially smaller businesses. Our study shows that reductions in the costs of complying with different VAT rules in different countries could boost cross-border trade, GDP and household consumption, so such efforts should be welcomed. Plans to encourage the sharing of information and best practice between national revenue authorities and to investigate the potential of a transnational anti-fraud team also seem sensible.

Reduced rates

Perhaps more controversially, the Commission envisages broadening the VAT base with efforts to reduce the use of exemptions and of zero and reduced rates. Making substantial progress on this is likely to prove politically difficult: Those sectors benefiting from them will lobby against their abolition, and it is unlikely to be popular with national electorates either. But doing so would bring real economic gains.

Exemptions, in particular, are anathema to the whole logic of VAT. Exempt sales are not subject to VAT but, in contrast to zero-rating, the firm cannot reclaim VAT paid on its inputs – thus breaking the chain of tax and offsetting credit that is the basis of any VAT. This creates significant distortions to decisions by firms of whether to self-supply or purchase goods and services from the market, and to competition between exempt and non-exempt firms and firms in different EU countries. There is also an increase in compliance and administrative costs for those firms that have to allocate input tax between exempt and non-exempt activities. Through these mechanisms, exemptions reduce productivity and output, impede the internal market and reduce the international competitiveness of European industries.

The Commission hopes to scale back VAT exemptions for public-sector bodies and services in the public interest – focusing ini-

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tially on areas where the distortions to competition between public and private bodies are greatest – and of passenger transport services. That would be a very sensible start if it can be achieved, but there is much further to go. No mention is made, for example, of the hugely damaging exemption of financial services – a more difficult area to deal with in practical terms, but one where there are several promising options that deserve further examination, and surely a more worthwhile avenue to explore for reform of financial sector taxation than the financial transactions tax.

The Commission also recognises that the plethora of reduced (including zero) rates of VAT increases the complexity of the system for relatively little gain. A review of the current rate structure of VAT is proposed, with the aim of abolishing reduced rates that are harmful to the internal market, or that apply to goods for which consumption is discouraged by other EU policies, while ensuring similar goods and services face the same VAT rate. Their proposals here are not very far-reaching; but as noted by the Commission, "the member states are primarily responsible for limiting as far as possible the scope of such [reduced] rates".

Reduced rates of VAT are not as damaging as exemptions, but the case for them is nonetheless weak in most cases. While VAT rate differentiation can be progressive, other taxes and transfers can target the rich and the poor more directly, achieving more redistribution for a lower cost. Poorer households typically spend a larger fraction of their budgets on the kinds of items that are subject to reduced rates, the rich typically spend more in absolute (cash) terms. This means that it is in fact to rich households that most of the cash the government is forgoing goes to – it is not a particularly effective tool for redistribution. Similarly, the particular features of VAT mean that it is rarely well targeted for encouraging the use of socially beneficial goods and services. Reduced rates of VAT only encourage purchases by final consumers, when often business use of the goods in question can be equally beneficial (such as for environmental products); and the encouragement provided is proportional to price, when often the benefit from consumption is no greater for more expensive varieties of the good in question.

Reduced rates of VAT, then, are rarely well targeted at social objectives. But they come at considerable cost in terms of both operational efficiency – the complexity they add to the system increases administrative costs, litigation costs and compliance costs – and economic efficiency. In principle reduced rates can be an efficient way to promote labour supply if targeted at goods and services associated with work, but that is rarely how they are used in practice. Their effect on behaviour is rather to distort households' spending patterns and thus reduce welfare. Because of the reduced distortion to households' spending decisions, it would be possible in principle to remove all zero and reduced rates of VAT, compensate all households, and, still have revenue left over – our study estimated about £1.1 billion ($1.6 billion) in the UK, for example (assuming no effects on labour supply). In practice it would not be possible to compensate all household exactly, but the Mirrlees Review of taxation showed how changes to direct taxes and transfers could be used to ensure that poor households were compensated on average while still protecting work incentives.

The Commission's proposals are a good step towards improving the functioning and structure of VAT in the EU. But it would be a shame if they were seen as *all* that was required to improve the system. A more fundamental broadening of VAT to eliminate almost all zero and reduced rates and (especially) exemptions could bring real gains, not least a significant reduction in complexity, and on average need not leave poorer households worse off.

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