The Brussels Tax Forum: An efficient VAT system

Panel on “rates, exemptions, broadening the tax base”

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Key points of intervention as panelist

Essentially, my intention is to summarize the main arguments that have been brought forward in academia from both, an economic and a legal perspective, for the elimination of exemptions & reduced rates and additional base broadening measures, while at the same time pointing out possible limits and trade-offs involved.

- Reduced rates / zero rates pursue mainly the following policy objectives:
  1. Introducing an element of progression into the VAT system / redistributive aims
  2. Subsidizing merit goods & services (e.g. cultural or sporting events)
  3. Subsidizing certain labor-intensive sectors of the economy

Recent empirical studies show that objective (1) is usually achieved, but to a rather limited extent, and at enormous revenue costs (due to windfall effects / deadweight effects to the benefit of better-off consumers). Furthermore, reduced rates add complexity to the VAT system. They facilitate international tax competition, because they are optional for Member States, to the extent that they are applied to goods or services for which the origin principle still applies (as would currently still be the case for e-book trading within the EU) or consumers are mobile (e.g. in the tourism industry). Against this background, and assuming a holistic view of the tax system, progressive taxation can be ensured in a much more targeted and efficient way by the income tax system. Reduced rates motivated by redistributive aims should therefore, in general, be abolished. They could be substituted, with large net revenue gains, by targeted transfer payments to the poor. Exceptions might have to be made where transfer payments do not have equivalent effect due to behavioral effects.

Similar arguments call for the elimination also of the reduced rates of type (2) and (3): there are usually better targeted, less costly measures available.
However, reduced rates or, preferably, zero rating could exceptionally be upheld or introduced where the expenditure for certain goods or services does typically not indicate any consumer taxpaying capacity (also not in case of better-off consumers), because it will typically (independent of quantity and quality consumed) be incurred as costs of minimum subsistence (e.g. pharmaceuticals on prescription, or water).

- Exemptions (without credit) are the “original sin” of the VAT system: due to the corresponding denial of input VAT deduction, they have similar effects as reduced rates, but in addition they cause significant distortions & complexity (e.g., they may undermine efficiency gains that could be obtained by outsourcing back-office activities in exempt sectors; they raise administrative and compliance costs by requiring complex allocation of input VAT in case of mixed businesses; they fuel tax planning, etc.)

**Tax policy implications:**

- Maintain only those exemptions which have been introduced for technical reasons regarding services that are “hard to tax” (e.g. margin-based financial services) or where taxation could cause disproportionate compliance and administrative costs while generating little extra revenue (possibly, leasing & letting of residential property); and even in these cases, periodical monitoring of whether their justification is still valid is needed (as IT technology progresses)
- All other exemptions should be
  1. either eliminated, based on the same reasons as in case of reduced rates (esp. exemptions introduced for merit goods or with redistribution objectives)
  2. or, from a more pragmatic viewpoint, at least converted in reduced rates to avoid the additional distortions and complications associated with input tax denial
  3. or – exceptionally - converted into zero-rating, esp. where the expenditure for certain services does not indicate any tax capacity, measured by consumption expenditure, because they constitute investment expenditure (for instance, acquisition of shareholdings and securities)

- Other measures to broaden the VAT base and to reduce the tax policy VAT gap include
  - Gradually phasing out the special treatment for public sector entities (in general, fee-based public services imply consumptions expenditure indicating taxpaying capacity)
  - Reducing the threshold for VAT registration in some Member States; however, this will depend on the efficiency of the domestic tax administration and should, in any event, not be done in the time of crisis
- Reducing the potential for base erosion by internationally coordinated efforts to align place of supply rules, oriented towards the destination principle