The Long Shadow of the European VAT, Exemplified by the Dutch Experience

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Main conclusions

1. Exemptions distort competitive conditions
2. Reduced rate is ill targeted instrument to help lower-income groups

Main recommendations

1. Harmonize rate structure
2. Permit member states to have better VAT than allowed under Common EU Directive

Introduction

- The VAT is mainly a revenue-raising instrument, not a tool to pursue other objectives

- The European VAT can learn much from the insights gained in countries with a modern VAT: broad base, no or few exemptions, single rate

- The European Commission is evaluating the harmonized VAT

- *FinanzArchiv* article is intended to contribute to the discussion about the future of the VAT

How should VAT be evaluated?

- As a revenue-raising instrument, the VAT should be evaluated on the basis of its:

$$\text{C-efficiency} = \frac{\text{actual yield}}{\text{potential yield}}$$

- Potential yield equals the product of the standard rate and total consumer expenditures (households + government + non-profit sector)

- The difference between potential and actual yield consists of: (1) the policy gap (exemptions, government, reduced rate), and (2) the compliance gap

- The policy gap is substantially larger than the compliance gap in the EU member states

Composition of VAT-yield in the Netherlands, 2010

	euro billion	%
Potential yield = Standard rate * Total final consumption	74,7	100,0
Policy gap	33,0	44,2
- exemptions	(19,6)	(26,2)
- government	(5,3)	(7,1)
- reduced rate	(8,1)	(10,9)
Compliance gap	1,5	0,2
Computed actual yield (C-efficiency)	40,1	53,6

Yield of the current Dutch VAT

Consumption expenditures	Base of modern VAT (in billions of Euro)		Yield Dutch VAT (in billions of Euro)	
	Amount	%	Amount	Effective tax rate
A. Households	**334,1**	**85,0**	**35,8**	**10,7**
			Output taxed	
Standard rate (19%)	102,6	26,1	19,5	19,0
Reduced rate (6%)	62,5	15,9	3,7	6,0
			Input taxed	
Exemptions	168,9	43,0	12,5	7,4
Medical services, welfare	*61,7*	*15,7*	*2,6*	*4,2*
Education	*30,0*	*7,6*	*1,1*	*3,5*
Banks, insurance	*20,5*	*5,2*	*2,3*	*11,1*
Sports, recreation, lotteries	*2,3*	*0,6*	*0,3*	*10,8*
Other	*10,0*	*2,5*	*0,9*	*8,9*
B. Government	**58,9**	**15,0**	**5,9**	**10,0**
C. Total consumption	**392,9**	**100,0**	**41,6**	**10,6**

Conclusions from the table

- Only 40% of total consumption expenditures is taxed ‘normally’ at the rates of 19% and 6%
- 60% of expenditures is exempted from VAT or ‘out-of-scope,’ but inputs (intermediate goods and fixed assets) are taxed
- Taxation of producer goods violates fundamental economic insight that tax distortions should be placed in consumer instead of producer markets (Diamond and Mirrlees, 1971)

Exemptions and 'out-of-scope' supplies

Households

- Medical services, welfare
- Rents and rental values, but taxation of newly created dwellings is reasonable substitute
- Financial and insurance services
- Sports, recreation, lotteries
- Other

Government

Effects of exemptions and out-of-scope activities

- Distortion of input choice
- Distorted choice in favor of do-it-yourself supply instead of outsourcing
- Distortion of exports and imports
- Violation of competitive conditions in respect of sectors which are not exempted or out-of-scope
- Contentious tax allocation; tax avoidance

\- Most distortions are also applicable to government

\- *Copenhagen Economics*: efficiency loss is 0,34% GDP; ± 2 billion Euro in the Netherlands; especially hurts SMEs

Solutions

- Under modern VATs, education, health care and governments are taxed at the standard rate: no distortion of input and outsourcing choices: Australia, New Zealand, Singapore, South Africa
- Second-best alternative: refund VAT on inputs — no distortion of input and outsourcing choices, but still distortion of competitive conditions; is what Canada does with regard to MASH sector
- No feasible solution in sight yet for financial services (but available for insurance): Australia, New Zealand and Singapore apply zero rate to B2B services and exempt B2C services; South Africa taxes fee-based financial services

PM. No justification for exemption of farmers and small-firm exemptions too low in the EU; compliance costs are also a form of tax

Reduced rate

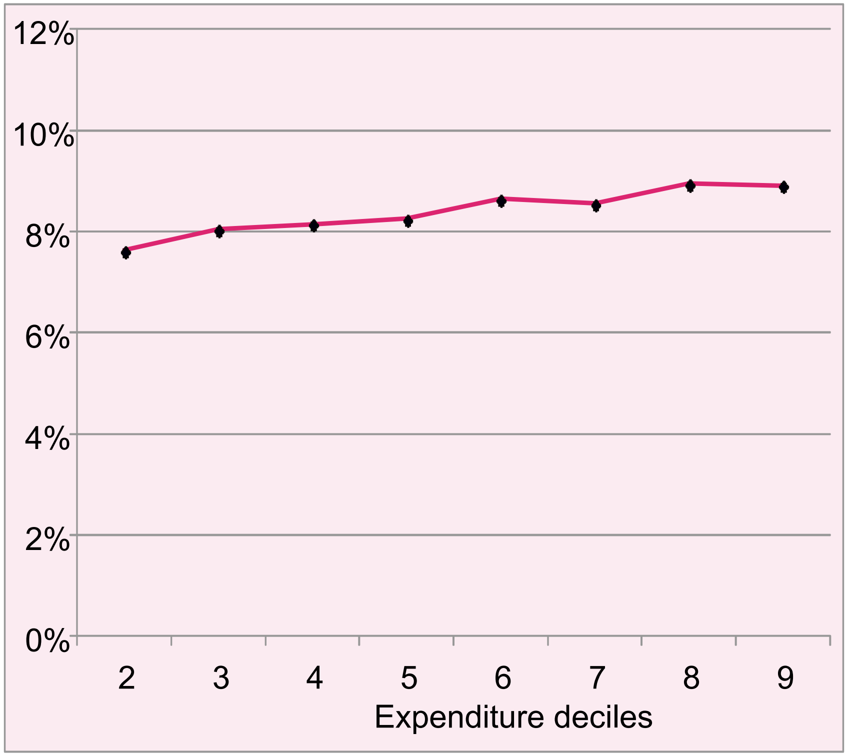
- Foodstuffs
- Hotels and restaurants
- Medical goods and dressings
- Passenger transportation
- Cultural activities
- Reading matter
- Some other goods and services

Arguments for reduced rate

- Essential foodstuffs should be taxed lower to mitigate tax burden on lower-income groups
- A reduced rate can correct for labor-supply distortions of the income tax
- To stimulate employment labor-intensive services should be taxed at a lower rate
- The consumption of ‘merit’ goods deserves to be stimulated through a lower rate

- Politically, the first argument is most important

What is the burden distribution of the Dutch VAT? (in 2004)



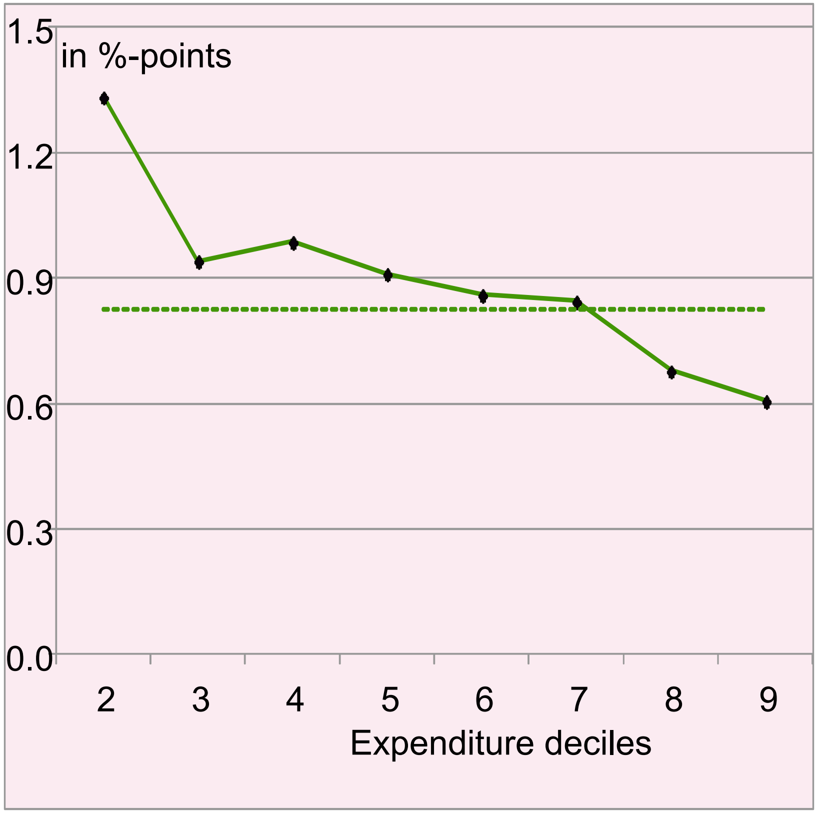
Arguments against lower rate

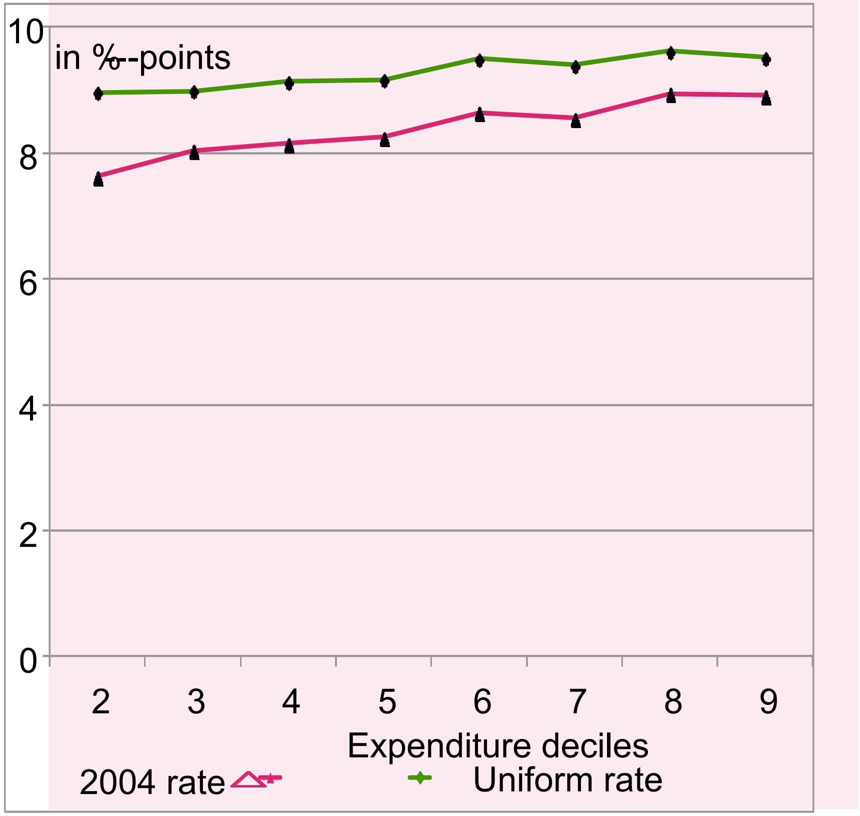
1. In Euro terms, higher income groups benefit 1.8 times more from the reduced rate than lower-income groups; ill targeted way of helping the poor

2. Reduced rate distorts consumer and producer choices; this implies a welfare loss

3. Reduced rate complicates the operation of the VAT = form of taxation

What does the adoption of a revenue-neutral rate of 15,6% imply for the VAT burden distribution across households?





Extra: Examples of gross value added nonsense of reduced rate

Reduced rate	Standard rate
Books, newspapers, coloring book	e-books, digital newspapers, writing pads
Rabbit feed	Guinea pig feed
Bird feed (≥ 95% grains)	Bird feed (≤ 95% grains)
Fish offal	Fish feed
Dried flowers; flower bouquets	Painted flowers, flower arrangements
Flee poison for cat, pill administered by you	Flee poison for cat’s basket, pill by veterinarian
Walker	Walking stick
Liquid and distilled water	Frozen and demineralized water
Straw	Sawdust
Haircut human being	Haircut dog
Admission ticket for lecture, piano recital	Admission ticket seminar, counseling piano rehearsal
Bicycle repair	Repair moped

Summation

Findings

- Exemptions and out-of-scope activities distort consumer and producer choices
- Reduced rate ill targeted instrument to help the poor

Violates EU objectives

- EU is about promoting free trade and competition by eliminating distortions, but VAT introduces distortions

Conclusion

- Why put up with bad VATs?
- If 28 member states cannot agree to adopt a modern VAT, why not permit individual member states to do so?

Thank you!