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Trump Tariff Plan and EU Value-Added Taxation

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Overview

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- Sales taxation: 3 methods
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- VAT: primitive trade barrier
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- VAT policy gap
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Trump promised “reciprocal tariffs” to VAT

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Trump promised “reciprocal tariffs” to VAT

- US president Trump signed in February a memorandum (executive order) “Reciprocal Trade and Tariffs”: a review of non-reciprocal trade arrangements and allows the USTR and Secretary of Commerce to propose new levies on a country-by-country basis to counter unfair trade practices.
- Memorandum includes value-added taxes in the list of discriminatory or extraterritorial taxes imposed by US trading partners
- Opposition: International Chamber of Commerce: “VAT and tariffs are substantially different not only in scope but also in terms of the impact they have on trade and the overall economy. VAT is neutral by design.“
- Opposition: Erica York (Tax Foundation): “VAT is neutral with respect to trade,” said “If you are a person who operates under this ideology where exports are good and imports are bad, a foreign VAT seems like it is discriminatory. But that ignores all the economic effects that VAT has.”

Sales taxation: 3 methods

- Retail sales tax (US)
- Credit-invoice VAT (e.g. EU)

  = turnover tax with deduction of the same input (turnover) tax
- Subtraction VAT (Japan till 2023)

Prices with different types of 10% sales taxes ($, taxes paid in parentheses)

Production stage	No tax	Retail sales tax	Credit-invoice VAT	Subtraction VAT
Farmer	300	300 (0)	330 (30)	330 (30)
Miller	700	700 (0)	770 (70 – 30)	770 (40)
Baker	1,000	1,100 (100)	1,100 (100 – 70)	1,100 (30)
Total tax	0	100	100	100

International VAT/GST guidelines

- OECD (2017): fundamental economic issue in relation to the VAT international application is whether the levy should be imposed by the jurisdiction of origin or destination
- Destination principle: tax is ultimately levied only on the final consumption that occurs within the taxing jurisdiction
- Origin principle: tax is levied in the various jurisdictions where the value was added
- Key economic difference: destination principle places all firms competing in a given jurisdiction on an even footing whereas the origin principle places consumers in different jurisdictions on an even footing

International VAT/GST guidelines

- **Destination principle is the international norm and is sanctioned by World Trade Organization ("WTO") rules** (OECD Legal)
- **Destination principle achieves neutrality in international trade: exports are not subject to tax with refund of input taxes (that is, "free of VAT" or "zero-rated") and imports are taxed on the same basis and at the same rates as domestic supplies**
- **VAT is a tax on consumption → revenue should accrue to the jurisdiction where the final consumption takes place**

EU Council directives for the common VAT system

- **Council Directive 2006 establishes a temporary VAT system based on the origin principle, to be replaced by a definitive system. „This however has not happened yet despite the latest VAT system having been set up approximately two decades ago. The temporary nature of the current VAT system brings several challenges, including the fact that it is more susceptible to VAT fraud”** (Remáč, 2017)
- **“Transitional VAT system“ was set up until a definitive destination-based system could be established“** (Remeur, 2019)

VAT: sale of goods within EU and to US (20% rate)

Company	Purchase (net)	Sale (net)	VAT credit	VAT invoice	Effective taxation	Sale (gross)
1	0	1,000	200	0	200	1,200
2: sale to EU	1,000	2,000	400	200	200	2,400
2: sale to US	1,000	2,000	0	200	0	2,000

VAT: primitive trade barrier

- EU exports to US (outside the EU) are not taxed → de facto subsidized by the EU countries
- Imports from US are burdened with a “hidden” import VAT tariff in the same extent (e.g. 20%)
- Exports are exempt and imports are taxable → VAT is a primitive trade barrier, without any reason!
- UK Mirrlees´ tax commission (2011): “retain a destination basis for VAT while ending the zero-rating of exports“

Value added taxation

- Predecessor: turnover tax („temporary measure“ after WW1)
  - Engliš: turnover tax is not part of a normal tax system
- EU: „first-generation“ VAT
- EU: missing taxation of financial services (lobbying) → additional taxes?, variety of rates (politicians „like“ differentiation ?!)
- NZ, Australia, Canada, Korea + 2 : „second-generation“ VAT (uniform taxation)
- US: (retail) sales tax!
- Most successful fiscal innovation of the last half-century?
- Czechia: higher VAT gap, (EU) reform desirable

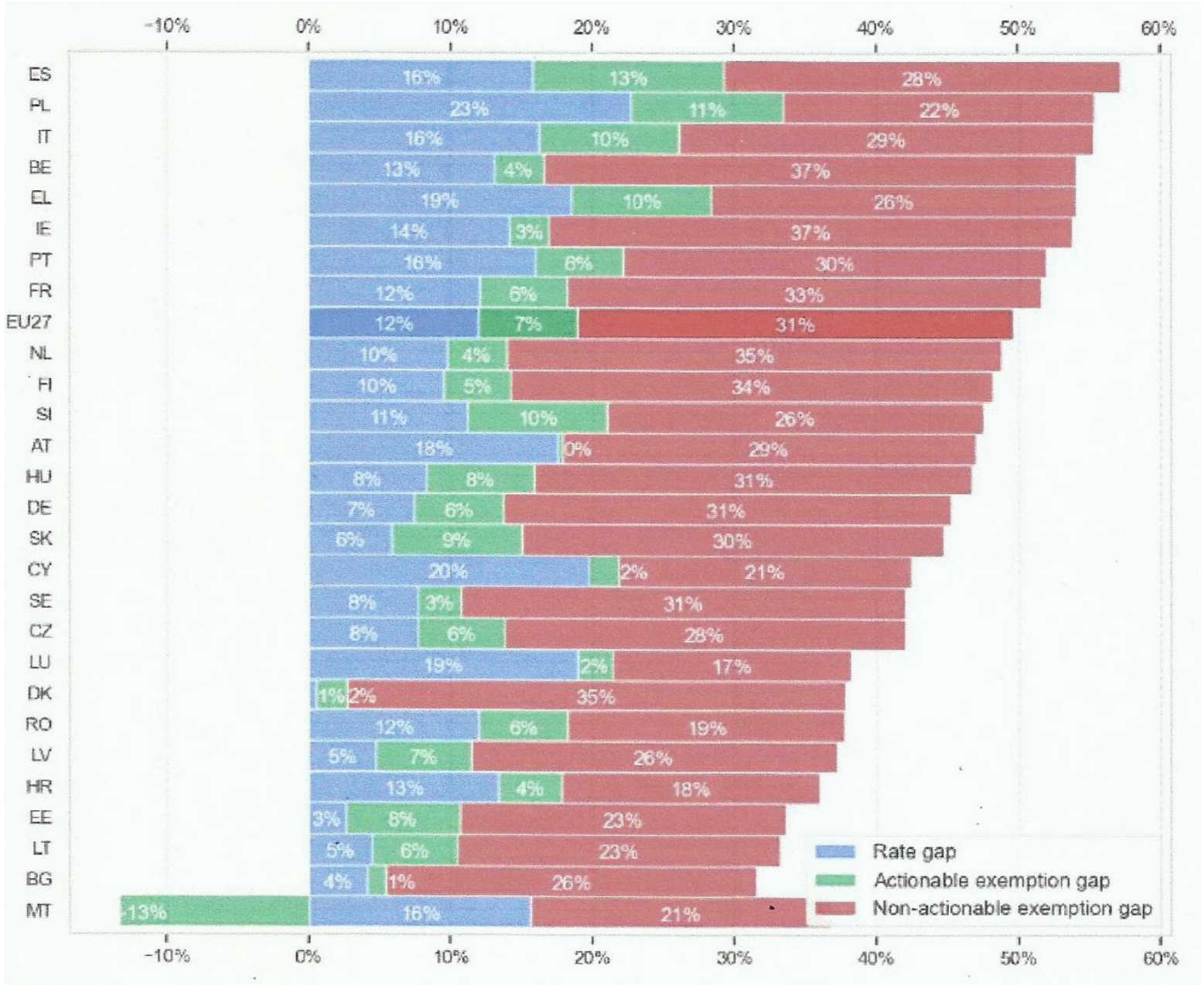
VAT revenue ratio: actual tax revenue to the maximum possible revenue (2018)

Cnossen (2020), Mengden (2024) citations

- **The harmonized European value-added tax (VAT) is anything but a modern consumption tax that taxes all goods and services at a uniform rate. As exemplified by an analysis of the Dutch version, some 60% of the base is exempted, that is, not taxed on output but on inputs. This has serious consequences. The VAT exemptions distort input choices, stimulate uneconomical self-supply, and complicate administration and compliance. The welfare costs of the exemptions can be estimated at one half of one percent of gross domestic product (GDP). Research shows that under an equal yield assumption, the elimination of the exemptions and the introduction of a single rate in conjunction with a reduction in the standard rate should foster economic growth. The Member States of the European Union (EU) should be allowed to replace their defective VATs with a modern version. This would strengthen competitive conditions (Cnossen, 2020).**
- **Scrapping VAT-reduced rates in EU countries will allow standard rates to drop under 15%**

VAT Policy gap

- Policy Gap: indicator of additional VAT revenue that could theoretically be generated if a uniform VAT rate is applied to final domestic use of all goods and services
- Policy Gap = Rate Gap + Exemption Gap
- Rate Gap = loss in VAT revenue due to reduced VAT rates
- Exemption Gap: loss in VAT revenue due to exemptions
  - The largest part of the Exemption Gap is composed of exemptions on services that cannot be taxed by VAT in principle, such as imputed rents, the provision of public goods by the government, or financial services (remaining level of so-called “Actionable” Exemption Gap is about 7% on average)
- Czech Policy Gap (2022): 8% + 6% = 14%
  - Basic VAT rate 21% minus Policy gap 14% = 7%
  - → Czech VAT could be transformed into direct taxation of value added (wages and profit) at a rate of 7%



VAT policy gap (% of national ideal revenue, 2022)

„Flat tax“ (Hall + Rabushka, 1985)

- Tax Policy Center (2024): their flat (19%) tax is a two-part VAT
- „Business tax“: value added except wages is taxed at the business level (deduction of wages, pensions, material costs and capital investments)
- „Wage tax“: on wages in excess of an exemption level
- Hall + Rabushka's concept of tax reform was relatively successful in the post-communist countries, but ironically it did not (and could not) replace the EU mandatory VAT (the same, flat rate)
- "Probably the most consistent, elaborate and thus the most attention-deserving tax reform towards a flat tax is the Slovak version with a uniform rate of 19% for personal income tax, corporate income taxation and VAT (true flat tax), i.e. the rate recommended by Hall and Rabushka" (Czech MF, 2008)

Conclusions

- Destination principle is the international VAT norm but it does not achieve neutrality in international US/EU trade: exports to US are not subject to VAT + input VAT is refunded, imports from US are subject to VAT
- VAT is a primitive trade barrier for US imports and exports that must be abolished immediately
- EU has a first generation of VAT (low revenue ratio), with no tendency to a second-generation VAT (ideally: applicable to all sectors, uniform /and lower/ tax rate)
- VAT taxes the sale of goods (turnover), with the tax liability being reduced by "input" VAT; taxing value added actually would mean to tax profits and labour costs directly (Hall + Rabushka: „flat tax“ = payroll tax + business tax)
- Harmonized European VAT is anything but a modern consumption tax that taxes all goods and services at a uniform rate

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Thank you for your attention!

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