THE ALTERNATIVES OF SUB-NATIONAL VALUE ADDED TAX

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In recent years, the possibility for sub-national governments to operate a VAT has been largely discussed especially through the experiences of the European Union, dealing with the tax harmonization among states members. Possible models of VAT taxation and problems that may emerge from the operation of the tax are analyzed below.

From the political economy point of view, macroeconomic considerations, and the reluctance of central governments to admit “tax room” regarding sub-national governments in so important tax base, have contributed to the opposition to decentralize this tax. From the technical point of view, fraud incentives dealing with sales destination in cross border trade, within a geographical area with no border controls, and the consequent administration difficulties for the enforcement of the tax, have delayed the adoption of a Sub-national VAT design of general acceptance in most countries.

The great challenge is to design a sales tax, that guaranteeing sub-national autonomy to fix the tax rate will satisfactorily perform on efficiency and enforcement grounds, in a common geographical space divided into several jurisdictions, states or provinces, without border controls of goods and services. Before analyzing this challenge, a sub-national VAT’s taxonomy containing a brief characterization of each alternative is hereby presented.

“Pure” Origin VAT. Sales are taxed in the state or province where vendors reside. Fiscal credits recognized in each jurisdiction correspond exclusively to purchases inside the same jurisdiction. Whereas exports are taxed, imports from other jurisdictions do not generate fiscal credits.

In this case there are not incentives for fraud at destination but generates incentives to sub-national governments for tempting firms to locate within their territory manipulating the tax burden, allowing the possibility of “tax wars”. Exports are taxed while imports are not, generating an anti-export or pro-import bias.

“Restricted” Origin VAT. Sales inside the region or federation are taxed in origin, that is, where vendors reside, with an agreement to equalize tax rates in all jurisdictions. Sales outside the region are zero-rated. The clearinghouse is avoided; states revenues will depend on – and each state will win or loose revenues according to- the interstate commercial flow, that won’t be affected by the rate regime, since the tax rate is the same in all states, provinces or jurisdictions.

“Hybrid” Origin-Destination VAT. Interstate transactions are taxed in origin with reduced rates (smaller that the intrastate ones) in order to transfer resources, or potential revenues, from the “producing” states to the “consumers” states. The system is operative in Brazil at a state level. It consists on the application of differential rates centrally regulated by the federal government – initially 7%, now 9% -, for sales from developed states to less developed states; and initially 12%, now 11%, to the rest. States have the obligation to tax intrastate sales with a tax rate higher than the one ruling interstate sales (usually 17%).

“Prepaid” VAT. The registered vendors in any state or province should apply the local tax rate to all sales, unless buyers residing in another state or province provide them with a certificate that corroborates the tax has been already paid in their jurisdiction. By this way, firms that want to buy goods from another province should make two payments before the exporter makes the shipment of goods. One payment to the exporter, in concept of “price before tax” of the goods, and another to the state of his or her residence for the destination tax of such purchases. On getting such a certificate, exporter will be able to burden his or her sale to other state with zero tax rate and justify that situation at his or her provincial revenue service.

This kind of VAT adds financial advantages for revenue services, but it doesn’t solve the elimination of fraud at destination, in spite of the biggest bureaucracy that requires for tracking interstate sales. Any merchant can buy a prepaid certificate in the province with the lowest tax rate.

“Dual” VAT. It is used in the province of Quebec and in the European Union, but with the particularity in Canada of coexisting with the federal VAT. Both taxes (federal and provincial) burden the same tax base; each government fixes its own rate and, administration of both taxes is assigned to one of the two revenue services.

The problem is that “Dual” VAT seems not applicable to countries with weak tax administrations.

As we can see, the performance of the VAT at sub-national level carries on problems that are not present in the case of national VAT. The basic reason is the uniformity of the national tax rate for all goods and services independently of sectors and places of origin and where such goods and services are used or consumed.

When the VAT is applied to domestic interstate transactions by the sub-national governments, the consequences with are resumed in the expression “cross border trade problem” emerge with different characteristics according to the Sub-national VAT alternative chosen.

The basic problem arises in all cases when tax rate differentials among states or provinces are relevant. In all alternatives, experts hope for narrow sub-national tax rates differentials. But if tax rates differentials were near zero, any kind of VAT would be viable though not necessarily recommended from the fiscal correspondence principle point of view. Anyhow, other difficulties have been found in national VAT performance that naturally will be present in the sub-national version of VAT.

As a concluding remark, the review of all the imaginable alternatives for a Sub-national VAT generate serious doubts on an efficiency of it. For some reason, very few countries have at present implemented the Sub-national VAT.:

the Province of Quebec in Canada and Brazilian states (ICMS). Problems faces with ICMS are evidence of a bad tax design. It seems that Quebec BAT is the only successful experience.