

THE FUTURE OF VALUE ADDED TAX IN THE EUROPEAN UNION

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When the First and Second Directives were adopted in April 1967, the Community entered into a legal and political commitment, as part of its objective to create the most efficient possible common market, to establish a common VAT system under which the taxation of imports and non-taxation of exports in intra-Community trade would be abolished.² Today, nearly thirty-five years later, the European Union is no closer to achieving that goal than it was then.

Despite the manifold and serious weaknesses of the existing transitional arrangements, which are widely acknowledged, businesses and national administrations alike have been forced to struggle to come to terms with their inconsistencies and complexities for more than twelve years and there is no prospect of any significant improvement in this situation in the foreseeable future. These transitional arrangements (it would be inaccurate to describe them as a system) were introduced in 1989, as a temporary measure, because it had become obvious that it would be impossible to secure the necessary political consensus on the Commission's original proposals (in 1987) for a new definitive system, which had been scheduled to come into effect on 1st January 1993, to coincide with the creation of the Single Market and the abolition of border controls on the movement of goods.

A revised target date of 31st December 1996 was set for the introduction of the new definitive system, based on the principle of taxation in the country of origin, but that deadline has also receded into history and it is obvious that the Commission, despite its continued dedication to this as a long-term objective and notwithstanding the Council's reaffirmation, both legally and politically, of its commitment to introduce such a system, has ceased to regard it as politically attainable. Europe is thus

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² Directive 67/227/EEC.

condemned to the perpetuation of a ramshackle regime that is complicated, outmoded and susceptible to fraud.

It is an indictment of the Member States that a concept which was accepted in principle thirty-five years ago is still so far from realisation. The history of VAT legislation in Europe is a catalogue of failure, not on the part of the Commission, which has acted with commendable consistency and application in attempting to move the situation forward, but on the part of the Member States, who have continually frustrated these efforts. Motivated primarily by a desire to protect what are perceived to be national interests, they have not only refused to accept a new definitive system based on taxation in the country of origin but have consistently opposed Commission proposals for even minor modifications to the present transitional arrangements, designed to improve their operation and alleviate some of the problems which they create.

For example, from 1st January 1993, a minimum level of 15 per cent. has been set for the standard rate of VAT, although Member States have the option of applying one or two reduced rates, equal to or greater than 5 per cent., to a limited list of categories of goods and services; transitional derogations also exist, enabling certain Member States to apply a zero-rate to specified categories. In order to maintain the minimal degree of harmonisation already achieved and to prevent any further widening of the existing discrepancies in rates between Member States, the Commission has twice³ brought forward a proposal for a standard rate band with a minimum level of 15 per cent. and a ceiling of 25 per cent. Despite the fact that the standard rates in force in all Member States fall within these limits, both of these proposals were rejected by the Council, which kept only the principle of the minimum rate. The preservation of Member State autonomy in taxation matters was deemed to be more important than the efficient working of the Single Market.

In fact, the current transitional arrangements are incompatible with the principles of the Single Market. It is an anachronism that, in what is supposed to be a single, internal market, transactions between traders located in different Member States are treated as 'exports' and 'imports'. In a true single market, these concepts should be reserved for transactions with external traders. In the Single Market, traders should be able to deal with intra-Community transactions in exactly the same way, and subject to the same laws and regulations, as they deal with transactions within their own Member State. From the present perspective, this is just a pipe-dream.

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COM (95) 731 final & COM (98) 693 final.

The wide variety of rules for determining the place where a transaction is taxed and, consequently, the place where the tax is deducted or refunded, and the lack of uniformity in the way in which the present arrangements are applied, means that the Single Market is effectively segmented into fifteen tax areas, creating confusion, additional workloads, administrative complication and legal uncertainty for businesses. Thus, traders have to know the law, and the way in which it is applied, in each and every Member State where they carry out taxable transactions and in those Member States where they incur VAT-bearing expenditure. For example, because of the different thresholds which exist for exemption from VAT registration, traders who conduct business in a Member State other than the one in which they are established may have to register for VAT in that Member State even though they are not required to register in their own country.

Conversely, traders can exploit these differences by resorting to clever tax accounting or manipulation. This not only deprives the Member States of the revenue to which they are entitled but also distorts that fairness of competition which is supposed to be the hallmark of the Single Market.

As long as VAT is collected by fifteen different tax authorities in Member States with different legal and regulatory traditions, interpretations, processes, systems, languages, customs, practices and working methods, it is pointless to pretend that cross-border transactions, which involve two or more tax and legal jurisdictions, can be taxed identically to domestic transactions involving only one jurisdiction. This would be so even if there were a single currency zone involving all fifteen Member States. Far from contributing to the achievement of a Single Market, the transitional arrangements constitute one of the greatest barriers to its completion; they introduce distortions of competition and create disincentives to cross-border trading activity, especially for small firms.

Moreover, it is not only businesses but also national administrations which find it difficult to cope with the current situation; the transitional arrangements have signally failed to keep pace with the development of modern commerce and the different ways in which it can be transacted. For instance, it is far from obvious which country has the right to tax a transaction, say, between traders who are temporarily domiciled in Austria and Belgium but whose respective normal places of residence are Portugal and Italy, which is carried out electronically by computers located in Sweden and Germany and which concerns goods originating in Greece and being transported by a Dutch carrier to Finland. It is equally difficult to determine how the liability is to be assessed or the tax collected. The difficulties are compounded when one or more of the countries involved are located outside the EU.

An example of the way in which the transitional arrangements have failed to keep pace with modern business practices is provided by the difficult situation that has arisen in relation to the supply of telecommunications services⁴, where Article 9(1) of the Sixth Directive establishes the tax point as the location of the supplier. This means that, in most cases, EU suppliers are required to charge VAT to all of their customers, whether located inside or outside the EU, while non-EU traders are able to make VAT-free supplies to their EU customers. This was creating so many problems for EU operators that all of the Member States sought and obtained an identical derogation, which effectively established the place of supply as being the location of the customer. Where the supply is made by a VAT-registered trader in one Member State to a VAT-registered customer in another Member State, the customer pays the VAT to its own Member State under the 'reverse charge' procedure and reclaims the tax paid as input tax on its periodic VAT return.

The Commission felt, not unreasonably, that it was inappropriate to retain legislation which was the subject of a universal derogation. In 1997, it therefore sought to regularise the situation by putting forward a proposal for an amended Directive⁵ which would have removed telecommunications services from the remit of Article 9(2)(e) (and, hence, from 9(3)(b)) and placed them under a new Article 9(2)(f); this, in effect, would have determined the place of supply as being the place where the customer is located if either the supplier or the customer are based outside the EU but the place where the supplier is located if both the customer and the supplier are based in the EU, whether or not they are located in the same Member State. This is still on the Council agenda as certain Member States refused to accept these proposals, with the result that these services continue to be regulated by a Directive that has no legal effect because every Member State has a derogation.

VAT is, by its nature, a tax that imposes a heavy compliance burden on businesses and this would be true regardless of what system of VAT were in force. However, this burden is being unnecessarily increased because the present arrangements lack objectivity and impose unacceptable costs on traders by consequence of the diversity of factors that they are required to take into account. These include the tax implications of:

- the place where the seller and the buyer are established for tax purposes
- the tax status of those to whom goods or services are supplied

⁴ See *ECTJ* 5/3 [2001] p.127.

⁵ COM (97) 4 final – 97/0030(CNS).

- the VAT identification number of the buyer
- the location of the goods at the time of supply
- the nature of the goods or services supplied
- who provides transport and the point of departure or arrival
- the turnover of the seller in the Member State(s) in which the goods or services are supplied
- the need to report intra-EU purchases separately from other purchases and to account for VAT on them
- the need, as a rule, to treat the transfer of own assets to another Member State as though it were a sale and purchase

For some small businesses, particularly in certain Member States, the compliance costs are greater than the amount of the tax that they are liable to pay.

In addition, there are other important defects in the existing arrangements. Traders face problems in obtaining the deduction or refund of VAT paid in Member States in which they are not established and may have to provide proof that VAT has actually been paid. The Sixth Directive establishes the principle that every taxable person is entitled to the deduction or refund of VAT, regardless of the Member State in which the VAT-bearing expenditure was incurred. The Eighth Directive harmonised, throughout the EU, the arrangements for the refund of VAT to taxable persons established in a Member State other than that making the refund. The main objective of the Eighth Directive is to place taxable persons who are not established in the Member State where they pay VAT on a similar footing to taxable persons who are established in that Member State and who exercise their right to deduct by directly setting-off the tax against their output tax liability on their periodic returns.

In practice, the Eighth Directive refund procedure has fallen into widespread disrepute, both amongst traders and the representatives of national administrations. For a start, all negotiations have to be conducted in the official language of the Member State from which the refund is claimed and all the relevant documents have to be translated into that language; claims have to be submitted within strict time-limits; frequently, traders are forced to employ local advisors to handle their claim. At best, the procedure is so complicated, adversarial and time-consuming that traders are exposed to uncertainty and often consider it more cost-effective not to submit a claim while, in the worst cases, the stance adopted by some Member States is so obstructive that pursuing a claim is largely a waste of time. The result is that, in an

unacceptably high proportion of cases, traders are effectively discouraged from obtaining a refund. They are therefore being deprived of a right conferred upon them by the Sixth Directive. This is incompatible both with the basic principles of VAT and the concept of the Single Market.

By the same token, the Eighth Directive procedures involve national administrations in long-winded and tortuous verification processes that yield no gain to their national exchequers. They find these so complex and costly to administer that the vast majority of them have sought derogations. Clearly, a situation where derogations are the rule rather than the exception must be untenable.

Recognising that the existing arrangements were fundamentally flawed, the Commission brought forward a proposed amendment in 1998⁶ which would have permitted traders to deduct VAT paid in Member States where they were not established by setting it off against the tax due in Member States where they were registered for VAT. The Member State which had suffered the deduction would, in turn, reclaim the tax deducted from the Member State where the tax had originally been paid. Although this proposal would have involved traders and national administrations in providing some additional information, it would have been infinitely preferable for both sides to the burdensome arrangements of the Eighth Directive procedure.

However, it followed logically from the proposed amendment that the amount of VAT eligible for deduction would henceforth be determined according to the rules of the Member State of establishment and no longer according to the rules of the Member State which collected the tax, as is the case under the Eighth Directive procedure. So far, the Member States have proved unwilling to forego some of their subsisting options to impose limitations on the right to deduct and to apply national interpretations to the definition of what constitutes an allowable business expense for VAT purposes. This eminently sensible proposal, which would make life easier for traders and national administrations alike, is therefore still before the Council while attempts are made to reconcile the conflicting positions of various Member States. The Spanish Presidency has indicated that they do not regard this as a priority issue.

The Commission has, over the years, introduced a number of other proposals for amendments to the Sixth Directive, most of which have been praiseworthy attempts to bring some clarity and coherence into the framework of VAT legislation and to improve the way in which it works. In particular, they have been concerned on many occasions to reduce the compliance burden on businesses. Thus, in 1997, in

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COM (98) 377 final.

an attempt to restore the neutrality of the tax, which was being impaired by the differences in interpretation and application of the common VAT rules between the Member States, the Commission proposed⁷ that the VAT Committee be changed from an advisory committee to a committee acting within the framework of the so-called 'Regulatory Committee' procedure. This would have enabled the Committee to decide on a common application of provisions in the Sixth Directive and thereby reduce the existing differences between the Member States in the incidence of the tax and in administrative procedures. Not surprisingly, given the history of Member State reactions to Commission initiatives and the manner in which they jealously safeguard their prerogatives, this proposal fell on deaf ears.

Another area in which the wide differences in the way in which VAT is applied and administered in the various Member States can create problems for businesses is in the determination of the person liable for payment of VAT. Article 21 of the Sixth Directive establishes the principle that, with certain important exceptions, the trader who carries out taxable transactions in any given country is himself the person liable to pay tax to the authorities in that country. However, the many options that Member States are allowed in this area result in a situation of extreme complexity. Where the trader is not established in the Member State where he carries out taxable transactions, Member States have the option of requiring payment of the tax by someone else. The person for whom the supply of goods or services is intended may be designated for this purpose or the trader may be required to appoint a tax representative to guarantee that his tax obligations will actually be met. Member States also have the option to require that someone other than the person responsible for paying the tax is held jointly and severally liable for payment of the tax.

In 1998, the Commission proposed⁸ to amend the Directive to remove the right of Member States to designate the recipient of the goods or services as the person liable for payment of the tax except in certain specified circumstances. The proposal would also have abolished the right of Member States to require the appointment of a tax representative except in a limited number of specific situations. The Commission's proposals, as submitted, were rejected but it was agreed that the right of Member States to require the appointment of a tax representative would be phased out from 1st January 2002. Member States would, however, retain the onerous right to designate a person other than the person liable for payment of the tax as being jointly and severally liable for payment of the tax.

⁷ COM (97) 325 final.

⁸ COM (98) 660 final.

Not the least of the problems with the present situation is the lack of clarity and coherence in the relevant legislation. The present body of law has grown piecemeal, with numerous amendments to many sections and, frequently, amendments to the amendments. New regulations to deal with specific problems are often tacked on to existing legislation that was not conceived for that purpose. The result is a legal text which is at times conflicting and is, at best, of such labyrinthine complexity that its interpretation has become the preserve of a few highly specialised lawyers. This raises issues concerning the rule of law; ignorance of the law is no excuse but many small businesses, especially those which engage in trans-border commerce, are in danger of being forced to operate on the wrong side of the law because they find it impossible to determine the nature and extent of their legal obligations. In the final analysis, the law must be accessible to those whom it affects.

In 2000, the Commission, despairing of securing political agreement within the foreseeable future on the introduction of a new definitive system based on the principle of taxation in the country of origin, presented a communication entitled, 'A strategy to improve the operation of the VAT system within the context of the internal market.'⁹ This strategy was based on the following objectives: -

- simplification and modernisation of current rules
- more uniform application of current rules
- closer administrative cooperation

In association with this document, the Commission produced an action programme. The first priority of this programme was to secure the enactment of the amendments which had already been proposed, notably those on the Eighth Directive recovery procedure, the right to deduct, the changes to the status of the VAT Committee and the designation of the person liable for VAT. Although the Member States have indicated their agreement in principle to support the Commission's strategy, it is highly doubtful whether they will be prepared to make a reality of the action programme by supporting proposals which they have previously rejected, sometimes on more than one occasion.

The next phase of the Commission's action programme is aimed, *inter alia*, at those areas where the discrepancies between the regulations and practices in various Member States make life difficult for businesses attempting to engage in intra-

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COM (2000) 348 final.

Community trade and where technological and commercial evolution has undermined the effectiveness of the existing legislation. It includes:

- proposals for amended rules on invoicing, including electronic invoicing
- proposals on amendments to cover e-commerce transactions
- renewal of the minimum standard rate provisions
- a revision of the rules on mutual cooperation and assistance
- proposals for the taxation of postal services
- a report on the application of the reduced rate

The first four elements of this programme have already been introduced.

The current provisions of the Sixth Directive concerning the obligation to issue an invoice (Article 22(3)) are sketchy and leave considerable freedom of interpretation to the Member States. In the first place, it is left to the Member States to lay down the criteria which determine whether a document may be considered an invoice. This leaves each Member State free to decide for itself whether, and under what limitations, it is prepared to permit self-billing, summary invoices and the outsourcing of invoicing operations. Such practices, for which there are sound commercial reasons, are very common and have been so for a long time but they are not universally acceptable within the EU. Member States may also specify what information is required to be shown on a VAT invoice and the rules are very different from one Member State to another. Traders are therefore required to familiarise themselves with the regulations governing invoicing in each of the Member States in which they do business. They may also be forced to depart from procedures that are standard practice in their own country in respect of their transactions with traders in other Member States.

Furthermore, the concept of electronic invoicing, as such, is entirely absent from the Sixth Directive. The result is that, not only are Member States able to choose whether or not to allow this practice, but the conditions under which such a framework may be established also vary widely. Under the Sixth Directive, traders are obliged to keep a paper copy of every invoice that they issue but this provision does not make much sense in relation to an electronic invoicing system.

As part of its action programme, the Commission put forward proposals in 2000¹⁰ to remove some of these difficulties. The proposed amendment would have established the principle that an invoice may be issued in any medium, whether physical or electronic, and would have provided for the obligation to keep copy invoices to be satisfied by storage in electronic form; it would also have required Member States to accept the practices of self-billing, summary invoicing and the out-sourcing of invoice preparation. The information required on each invoice would have been standardised, with twelve items of information required on every invoice and an additional four elements that would apply in certain specified conditions. Member States would not have been permitted to require any additional information to be included on an invoice for VAT purposes. Once more, the Member States have been unwilling to accept this curtailment of their freedom to follow their own national customs and practices and are insisting on compromise proposals which would leave Member States with much greater discretionary powers than the Commission has proposed.

The advent of e-commerce has created new problems related to the sale of digitised products, with which the existing transitional arrangements are ill equipped to cope. The issue is not primarily one of revenue retention at this stage, as the total existing volume of sales of digitised products is relatively low, but the potential for growth in e-commerce is exponential and it is essential to get the tax structure right before revenue loss reaches serious proportions. There is also the need to establish a level playing field in this area between EU-based traders and those established outside the EU. At present, the regulations stipulate that, with a few exceptions, the place of supply of such services is the country where the supplier is established. This means that EU-registered traders are required to charge VAT to customers located outside the EU and traders located in third countries are entitled to supply such services to customers inside the EU free of VAT. This creates distortions of competition and places EU-based suppliers at a disadvantage vis-à-vis non-EU operators.

Accordingly, the Commission included in its action programme proposals to rectify the situation¹¹ and these were introduced in 2000. The remedy proposed was, as a basic rule, to transfer the taxation of the services caught by this proposal to the place where the customer has established his business or has a fixed establishment to which the service is supplied or, in the absence of such a place, the place where he has his permanent address or usually resides. This would have the effect of enabling EU-based traders to make supplies of these services to customers located outside the EU without charging VAT and would require suppliers based outside the EU to charge

¹⁰ COM (2000) 650 final.

¹¹ COM (2000) 349 final.

VAT when making supplies to customers in the EU. The problem with this proposal is how the latter requirement could be enforced against suppliers who were not registered in the EU. Obviously, it would be naive to expect their voluntary compliance. The difficulty in the area of e-commerce lies in knowing that the transaction has even taken place.

The Commission has put forward various suggestions for methods of securing compliance but none of them are very convincing. There is an implied threat in the Commission's paper that non-EU operators who refused to comply might have protection for their industrial intellectual property rights withdrawn in the EU. This would be a strong inducement, given that many of the products involved in e-commerce are easily pirated, but such a course of action would put the EU in breach of international agreements which it has concluded and would also risk violating WTO rules. Another approach would be to require credit card companies to levy VAT on the transactions charged to each card but, apart from being difficult to implement, this would require the consent of the credit card issuers, most of whom are controlled by banks who might be reluctant to release this information; in some cases, they may be constrained by legal restrictions in their Member States. In any case, credit card payments are likely to be superseded by other payment systems for e-commerce transactions.

The Commission looks towards new tools to ensure enforcement against non-compliant businesses and expects such tools to become available as technology and e-commerce procedures develop but experience suggests that legislation, especially in the field of taxation, tends to lag behind technology. The balance of technological advantage lies with the evader rather than the legislators.

It is difficult to escape the conclusion that, even if the Commission's proposals were to be accepted by the Council in their present form, which is not particularly likely, the transitional arrangements, as amended, would not be capable of coping effectively with the problems posed by the advent of e-commerce, nor would they have the effect of removing the existing distortions of competition or restoring a level playing field between EU and non-EU traders.

The provisions concerning the minimum standard rate of 15 per cent. which Member States were permitted to apply expired on 31st December 2000. Accordingly, in 2000, the Commission put forward a proposal to extend the period of application to 31st December 2005.¹² This was accepted. The fact that the Commission did not feel able to put forward a proposal for a minimum rate band on this occasion, as it had

¹² COM (2000) 537 final – 2000/0223(CNS).

done in 1993 when the minimum rate was set for the period to 31st December 2000, indicates the extent to which the Commission lacks confidence in a change of heart on the part of the Member States.

The two other items in the Commission's work programme, the taxation of postal services and the report on the operation of the reduced rates, are so politically sensitive that the Commission has delayed taking action on them.

The delay in producing proposals on the taxation of postal services is yet another example of failure to produce much-needed improvements in the VAT legislation. The privatisation of services that were previously supplied by public-sector bodies has created anomalies, both within those Member States where privatisation has been partial and public-sector organisations which are now in competition with private-sector firms and between Member States where a service is provided by the public sector in one country and the private sector in another. The difficulty arises from the fact that the public-sector providers are exempt from VAT, thereby creating distortions of competition. The problem exists in several areas but is most acute in relation to the provision of postal services. The failure to even produce proposals on this topic cannot fairly be laid at the door of the Commission. Given the history of intolerance by Member States of proposals which appear to threaten their national interests or working practices, it is not difficult to understand the Commission's reticence in drafting legislation for regularising the situation in this sensitive area. There is, after all, little point in putting forward proposals that stand no chance of being accepted.

The most satisfactory solution, from a business and consumers' perspective would be to zero-rate all such services, regardless of whether they were provided by the public or private sectors. However, zero-rating is a practice which is frowned on by most Member States, many of which would like to see an end to the derogation which enables the UK and Eire to zero-rate a wide variety of goods. The alternative, taxing all such services regardless of the status of the supplier, would increase the burden of indirect taxation and would be difficult to operate in practice; it would also create the anomaly of governments being in the position of levying tax upon themselves, an absurdity which legislators have thus far been concerned to avoid. The other solutions that have so far been proposed have necessarily been so complicated as to raise doubts about their workability in practice.

The Commission has promised to produce its report on the operation of the reduced rate in the near future. In a report on the functioning of the VAT rate system, produced in January 1993, the Commission declared that, 'with regard to the application of various types of reduced VAT rates (super-reduced rates, zero-rates, 'parking' rates etc) no major distortion of competition had been ascertained under the transitional arrangements for taxation of intra-Community trade that could be

attributed to the application of various types of reduced VAT rates.' It is probable that an objective report on the current situation would reiterate this conclusion but such a finding is unlikely to be politically welcomed in some Member States.

It will be obvious from the foregoing that there are many unsatisfactory elements in the current transitional arrangements but the most serious weakness arises in relation to its inability to prevent or inhibit VAT fraud. One of the principal reasons for this is the fact that transactions between traders in different Member States are treated as imports and exports and are therefore invoiced on a VAT-exempt basis. The buyer is required to pay VAT on importation at the rate ruling in his Member State but, with the abolition of border checks on the movement of goods, this obligation is easily evaded. By the same token, it is a simple matter for sellers to avoid paying output tax on their sales by billing them as exports when the goods have not, in fact, left the country.

The scale of losses to national exchequers arising from VAT evasion in this and other ways is staggering. The European Court of Auditors has estimated¹³ that the gap between the aggregate amount of VAT actually collected in the EU and the nominal amount due is as high as 70 billion Euros per annum. The accuracy of this figure has been questioned but some authorities consider that it is as likely to be understated as overstated; without more detailed information than is currently available, it is impossible to place an upper limit on the possible extent of the defalcations. Even if the figure were only half of the Court of Auditor's estimate, it would represent a massive loss of revenue for the Member States and constitute an indictment of the way in which they have been managing or, rather, failing to manage, VAT controls.

The volume of the losses could be significantly reduced by a high level of administrative co-operation between the national authorities but this has been conspicuously lacking. VAT controllers in almost all of the Member States evince little or no interest in transactions involving sales by traders in their jurisdiction to customers in another country. Nor do they exhibit much enthusiasm for pursuing enquiries within their jurisdiction on behalf of the authorities in other Member States. Such enquiries involve considerable effort and are unlikely to result in any benefit to the national exchequer.

The mechanisms for co-operation between the VAT administrations of different Member States exist but they have been heavily under-utilised and are deficient in many respects. For a start, there are two legal bases for administrative co-operation, Directive 77/799/EEC and Regulation (EEC) No. 218/92. However, the two

¹³ OJC 349, 17-11-98, pp 15-17.

instruments have different operating rules and there is no synergy between them for VAT control purposes. The Regulation applies only to intra-Community supplies and acquisitions of goods; the Directive must be referred to for intra-Community supplies of services and other VAT transactions. The situation is exacerbated by the fact that certain transactions are considered as supplies of goods in some Member States and of services in others.

Moreover, the Regulation does not cover all the transactions that could give rise to fraud, being limited to intra-Community supplies and acquisitions, whereas most VAT-fraud schemes concern both intra-Community and domestic transactions. For these reasons, Member States mainly use the Directive as a legal base for co-operation in fraud cases. However, as this Directive was originally designed for the exchange of information on direct taxation and has not been adapted for coping with the specific need for strengthened co-operation following the introduction of the current transitional arrangements, it exhibits several shortcomings.

The Regulation made provision for a VAT Information Exchange System (VIES) but the information exchanged automatically or on request under this system is not available sufficiently quickly to be effective as a counter-measure against fraud. Tax authorities are required to produce information in response to a specific request from officials in another Member State within three months, or one month if the requested information is already in their possession, but there is a growing problem with the number of instances where this deadline is exceeded. Moreover, a suspect has to be informed that the information relating to his case has been exchanged, thereby alerting him to the actions of the authorities and giving him ample time to conceal or destroy evidence. Information exchanged automatically under the VIES system is only available after six months.

The biggest stumbling block in the fight against intra-Community VAT fraud is the fact that information exchange must be through the 'competent authorities' and hence cannot take place directly between the services of two different Member States. In accordance with the requirements of the Regulation, Member States have set up Central Liaison Offices (CLOs) to act as official channels for the exchange of information under the Regulation but some Member States have put a different entity in charge of the exchange of information under the Directive. In too many instances, CLOs are used to form a political judgment as to whether information should be exchanged and therefore act as a bottleneck to the exchange of information rather than a conduit. CLOs could also play a greater role in informing control officials of the possibility of exchange of information, particularly in relation to the control of special schemes, refunds under the Eighth Directive and services provided in accordance with Article 9(2)(e) of the Sixth Directive. However, a number of CLOs have said that they have neither the powers nor the resources to fulfil this role; one is inevitably led to the conclusion that, in many cases, they do not have the will. The

Directive also provides for the conclusion of bilateral agreements between the Member States on the exchange of information but very few such agreements have been signed.

It is small wonder that the report of the Court of Auditors commented that there exists a Single Market for fraud but none for law enforcement.¹⁴ In January of last year, the Commission, as part of its action programme, put forward proposals¹⁵ for improving administrative co-operation and mutual assistance between the competent authorities of the Member States. These proposals would, inter alia, require Member States to designate a single CLO responsible for co-operation with the authorities of other Member States, remove the requirement to inform traders that information concerning their case was being exchanged and permit information exchanged to be used in judicial or administrative proceedings initiated as a result of infringements of tax law. However, the exchange of information would still have to be routed through the CLOs rather than by direct contact between the officials of the relevant administrations, the extended deadlines for producing the information requested would remain and Member States would be left with too many pretexts for refusing to provide information.

Despite the fact that they have obviously been drafted with a view to being politically acceptable to the Member States by leaving them with more freedom to follow their own practices than is really desirable, it is by no means likely that these proposals will be enacted in their present form, as several Member States have already expressed reservations of varying degrees of seriousness. Even if they are, they will probably do little to improve the existing situation. Their main weakness is that they constitute enabling legislation; little or nothing requires the Member States to avail themselves of the opportunities for improved co-operation and mutual assistance which these proposals provide. The existing instruments for co-operation have been grossly under-utilised and, in some cases, ignored. Although most Member States express support for the idea of intensified exchange of information, such information is rarely, in fact, exchanged. This situation will not be transformed merely by the introduction of new legislative instruments; it requires a fundamental change in the attitudes and priorities of Member State administrations and Member State governments.

Even with the most thoroughgoing co-operation between the tax authorities of the Member States, the tide of VAT fraud would only be partially stemmed. The weaknesses of the transitional arrangements are so fundamental that the scope for tax

¹⁴ Op. cit.

¹⁵ COM (2001) 294 final - 2001/0133(COD) - 2001/0134(COD).

evasion would be only moderately reduced. The fact that goods can be transported across frontiers without VAT being paid constitutes an invitation to fraud.

This situation could be remedied by the introduction of a new definitive system based on the principle of taxation in the country of origin of transactions giving rise to consumption in the Community. Under such a system, VAT-registered traders would be required to charge VAT at the rate ruling in the country of origin on all transactions, regardless of whether they were domestic or intra-Community. They would not of course have to charge VAT on genuine exports to countries outside the EU. This would improve the efficiency of the control system immeasurably. The tax on all transactions would be owed by all traders to their own national authorities, who would find it simple to exercise effective controls because every trader who had a tax liability to them would lie within their jurisdiction and be registered with them. There would no longer be a need to have documents translated into the language of the competent authority or to rely on information obtained, or not obtained, from the authorities of other countries. Corrective action could be taken immediately a discrepancy was revealed rather than waiting on the long-winded and uncertain mutual assistance procedures.

There can be no doubt that such a system would have the effect of significantly reducing the appalling losses of revenue which are currently resulting from the widespread incidence of VAT fraud. It would also simplify the operation of the VAT system for national authorities and businesses alike. By reducing the compliance burden on businesses, it would encourage more small enterprises to register for VAT and thus reduce the other major source of lost revenue. Studies have shown that many businesses which fail to register for VAT despite being above the threshold are motivated more by a desire to avoid the administrative burden of completing the VAT returns than by the wish to evade payment of the tax.

A system based on taxation in the country of origin would place EU traders on a par with those in non-EU countries, remove the distinction between goods and services and resolve the ambiguities concerning the place where a transaction is taxed and the person liable for payment. It would also simplify the process of obtaining refunds; registered traders would deduct the VAT paid to suppliers in other Member States as input tax on the returns to their national authorities; the national authorities would then reclaim the input tax deducted from the Member State which had received the output tax. In addition, there would no longer be a requirement for traders to know the VAT status and VAT registration numbers of their customers; there would also be no need to take account of who provided the transport, the means of transport and the place of despatch. Traders would not need to be conversant with the VAT regulations in other Member States, as the applicable rules would in all cases be those of their own Member State.

Why then has such a system, which offers so many obvious benefits in comparison with the existing arrangements, been so consistently rejected by the Member States? One of the major stumbling blocks is that such a system would require relatively close harmonisation of VAT rates across the EU. There would clearly be distortions of competition if the standard rate continued to vary from 15 per cent. to 25 per cent. While trading between registered businesses, which accounts for 95 per cent. of all intra-Community transactions at present, would not be affected by rate differences because the registered traders could reclaim the tax paid, non-registered customers, who cannot reclaim the VAT, might be tempted to source their purchases from the country with the lowest rates; the increasing availability of on-line shopping would facilitate this process.

A standard rate band of no more than 2 per cent. would be required to make the system workable and, ideally, there should be a single standard rate. The same considerations apply with even greater force to the reduced rates. Member States are reluctant to forego their freedom to set the rates of VAT at levels which suit their particular macro-economic policy mix. They are also concerned about the possibility of loss of revenue. In every Member State, VAT is an important source of revenue - as a percentage of total taxation (excluding social security contributions) it varies from 18.7 per cent. in Luxembourg to 30.3 per cent. in France and as a percentage of GDP from 5.6 per cent. in Italy to 10 per cent. in Denmark.¹⁶

Another objection to a system based on taxation in the country of origin is ideological. VAT is regarded as a tax on consumption. Accordingly, it is argued that the revenue from this tax should accrue to the state where the consumption takes place. Clearly, that would not be the case where a non-registered person resident in, say, Germany purchases goods from Austria; the tax would accrue to the Austrian government. Various schemes have been postulated for rectifying the fact that the revenue would go to the 'wrong' government. These have involved the creation of 'clearing houses' or other mechanisms which have inevitably been so complicated that they were deemed to be unworkable, particularly as the bulk of the work in this case would have fallen on the national administrations!

However, this objection is theoretical rather than practical. Although VAT has been described as a tax on consumption, there is no compelling reason why it should be so. VAT is a tax, pure and simple and its purpose is to raise revenue for the government; it requires no other justification. It does not have to be regarded as a tax on consumption; it is not an hypothecated tax; if one removes this psychological barrier, the problem disappears. Unfortunately, it is replaced by another. In the

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Source: Commission services (1998 figures).

process of diverting revenue from the Member State of consumption to the Member State of origin, there would be winners and losers amongst the Member States. Notwithstanding that only some 5 per cent. of intra-Community transactions would be affected, those Member States who fall into the latter category are unwilling to countenance the potential loss of revenue involved. Member States are also unwilling to accept the loss of 'sovereignty' involved in the necessary harmonisation of rules concerning such matters as the right to deduct and the definition of allowable expenditure.

A system based on taxation in the country of origin is not a panacea. There would remain a number of problems, chiefly arising from the discretionary powers given to the Member States, which have resulted in widespread discrepancies concerning VAT thresholds, the timing of VAT returns, special schemes, the VAT treatment of subsidies, options, exemptions, rights and derogations. The present situation with regard to the latter is rightly described by the Commission as 'chaotic'¹⁷. Nevertheless, it would bring about a massive reduction in the current incidence of VAT fraud, simplify the operation of the tax for businesses and national administrations alike and help to make a reality rather than a mockery of the Single Market. This is clearly highly desirable but it is not going to happen at any time in the foreseeable future. Can nothing then be done to improve the situation?

There is one solution that would produce even greater benefits than a system of taxation in the country of origin but its political acceptability is even more doubtful. VAT is a European tax; all Member States are required to levy VAT and are not permitted to have any similar consumption-based tax. The UK and many other Member States did not have VAT until they were negotiating accession and it is doubtful whether they would have introduced VAT were it not for the requirements of membership. Why not then make VAT, which is a European tax in conception, a European tax in reality; in other words, it would be levied by a central European authority and all VAT returns and payments would be submitted to that authority, which would retain the revenue. This would have the advantage that there could be a single standard rate and harmonised reduced rates throughout the Union; adjustments to these rates would be made by the central authority. There would also be a single set of rules governing every aspect of the administration of the tax, including the form of the VAT invoice, electronic invoicing, the timing of VAT payments, the turnover threshold for VAT registration, the right to deduct, the person liable for payment and the definition of allowable expenditure. All existing national options, derogations, exemptions and special schemes would be swept away. Traders would know exactly where they stood because the regulations would be the

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Op. cit.

same in every country and the text of the legislation could be greatly simplified. There would be direct contact between traders and the central authority, with whom every trader would be registered; this would improve the quality of VAT controls, as all intra-Community transactions would become 'domestic' transactions. The Single Market would be brought much closer to realisation at a single stroke.

A few other adjustments would also serve to reduce the compliance burden on businesses and, therefore, the incentive to avoid registration. It is contended that the system of fractionated payments helps to improve controls and reduce fraud but there is no substantiation for this theory. What it undoubtedly does is to increase the compliance burden exponentially. Where taxable transactions take place between registered traders, there is no benefit to the exchequer; any output tax that is received from the supplier is refunded to the buyer by way of input tax deduction. All that has been achieved is to involve the traders and the tax authorities, but principally the traders, in a great deal of paperwork to no purpose. It is only when the transaction takes place between a registered trader and a non-registered customer or an exempt trader that there is any gain to the exchequer from the tax levied and it is only at that point that there is any real purpose in making a return or a payment to the authorities. Abolishing the system of fractionated payments would represent the greatest single contribution that could be made to the reduction of the compliance burden on businesses. It would thereby reduce the incentive to avoid registration and increase the tax yield.

It would, however, be very difficult to convince the legislators of this; the Commission, in particular, is very much attached to the concept of fractionated payments. In the event that it proved impossible to persuade them to abandon this position, another measure that would considerably reduce the burden would be to extend the arrangements for Group Relief that exist in some Member States across the Union. In the proposed system, where national VAT administrations no longer existed, there should be no obstacle to granting group relief across borders as well as within national territories.

Member States would, of course, have to compensate for the loss of revenue to their national exchequers by adjusting the rates and bases of other taxes. This should not present any insuperable problems. After all, they managed without VAT prior to joining the Union, so can presumably do so again.

Another major benefit of this proposal would be that the proceeds of the centralised VAT could be used to fund the operation of the EU. At present, this is done by contributions from each Member State, which are based on the yield from a notional VAT rate of 1.4 per cent. on all taxable sales, regardless of whether they are standard-rated, reduced-rated or zero-rated. This has the effect of relating the contribution level to the approximate level of consumption in each Member State and

establishes a rough relationship between gross contributions to the EU budget and national GNP. However, because of differences in the amount which Member States receive from the EU, principally through the Common Agricultural Policy and the Structural and Cohesion funds, there is no such relationship with the net contributions, which are more visible and, arguably, more relevant.

This imbalance between national GNP and the net contribution to the EU budget has become the source of considerable unrest in Europe. The cases of Eire, which has a per-capita GNP of 106 per cent. of the EU average but is still deemed to be eligible for Cohesion Fund assistance and is a net recipient, and of France, which is only marginally a net contributor despite accounting for 18 per cent. of EU GNP¹⁸, are creating resentment in other Member States, particularly Germany and the UK, which are two of the main net contributors. There is also a continuing and growing tension between the 'North' and the 'South', i.e. between the relatively wealthy contributing nations and the supposedly less-advantaged recipient nations. The latter want substantial increases in the EU budget to fund structural assistance, improve social benefits and maintain the Common Agricultural Policy while the former are determined to resist calls for higher spending. These pressures will increase significantly with the first wave of enlargement, which, according to present prognostications, will admit ten new members in 2004, the most prosperous of which have a per-capita GDP, calculated on Purchasing Power Parities, which is well below the EU average.

Using the proceeds of a European VAT to fund the Union would resolve these issues. It would also remove the question of national contributions from the political agenda. The EU budget could be approved by the European Parliament, as at present, which would also set the rate(s) of VAT required to fund it. It has been calculated that the present budget could be funded by a standard VAT rate of between 5 per cent. and 8 per cent., depending on the scope of reduced and zero-rated items.

There would be another, not inconsiderable, benefit to this proposal. Every European citizen would have a better idea what European citizenship is costing him or her. For that reason alone, it is unlikely to be adopted but the main obstacle is that it would be seen by the Member States as representing an undesirable degree of centralisation of power within the Union. That political considerations should stand in the way of practical improvements is regrettable but, perhaps, inevitable.

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1998 figures.