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FOREWORD

At the request of the European Parliament's Committee on Economic and Monetary Affairs and Industrial Policy, this study has been carried out by the Internal Market Division of Parliament's Directorate-General for Research.

Its objective is to provide Members of the Parliament and others with background briefing on the Community's Value Added Tax system, and an examination of options for a "definitive" VAT system after 1997.

The main conclusions are summarised in the final section. There is also a short bibliography, and an index to the document as a whole.

DIRECTORATE-GENERAL FOR RESEARCH

EXECUTIVE SUMMARY

Introduction

At midnight on the 31st. December 1992 a new system of charging Value Added Tax on trade between Member States came into existence. The tax became generally payable at the place of delivery rather than at internal frontiers, making it possible to abolish all border tax controls.

It is intended that this system should be only "transitional". The legislation required the Commission to make proposals for a "definitive" system before the end of 1994, and for this to come into effect at the beginning of 1997. It was to be based on the "origin principle", rather than the currently-applied "destination principle" - that is, goods would be invoiced tax-included when sent to another Member State, rather than free of tax as at present.

The Commission, however, has not so far published any proposals. Instead it has decided to carry out an extensive consultation exercise with traders, tax authorities, academic bodies, etc. on the form the "definitive" VAT system should take. This working document is a contribution to the debate.

The history of VAT

The principal advantage of VAT over other forms of indirect taxation - for example, the "cascade" turnover tax once used in Germany, or the single-stage Purchase Tax in the UK - is that it is possible to calculate exactly the tax-content of a product at any stage of a production/distribution chain. VAT was chosen as the main form of indirect taxation in the European Community because exports could be entirely de-taxed, and then re-taxed at the rate of the importing country, so preventing distortions of competition.

In the 1970s, a percentage VAT also became one element of the Community's "own resources"; and the purpose of the Sixth VAT Directive of 1977 was to ensure that the tax would cover the same transactions in all Member States - i.e. that the "VAT base" would be harmonized.

Finally, a major objective of the 1985 Single Market programme was the abolition of "fiscal frontiers". The Commission's initial proposal was an immediate move to the origin principle: firms would invoice deliveries to other Member States in exactly the same way as domestic deliveries. However, this ran into two problems. If major shifts in revenue between Member States were to be avoided, a "clearing system" would be needed to repay VAT to the countries of consumption; and there were sharp disagreements as to the extent VAT rates would have to be aligned. In the end, the current transitional compromise was reached.

The transitional system

The VAT system that came into effect at the beginning of 1993 is a hybrid.

- As far as most ***final consumers*** are concerned, the ***origin principle*** applies. Once VAT has been paid in one Member State, the goods are in free circulation throughout the Community.

- In the case of ***commercial transactions***, and also of certain sales to final consumers under three "special regimes" (distance sales; cars, boats and 'planes; and sales to exempt bodies) the ***destination principle*** applies. Traders must keep records of all sales *to* another Member State and all acquisitions *from* other Member States. Every trader must have a VAT number, so that sellers are able to check the tax status of their customers through a "VAT Information Exchange System" (VIES).

Reactions to the new system have been mixed. Though the abolition of controls at frontiers has reduced traders' costs, many have found these savings offset by new administrative burdens. Evidence indicates that these are due more to the Intrastat trade-statistics requirements than to the VAT system itself.

The abolition of VAT option

VAT was originally chosen to replace all other general turnover and consumption taxes within the Community because it permitted accurate de-taxing and re-taxing - i.e. application of the destination principle. If it is now intended that this system should end with a change to the origin principle, might it not be preferable, instead, to abolish VAT altogether?

The main alternative would be a Sales Tax, such as that charged by the individual States in America. The advantage would be that revenue would automatically go to the country of consumption. However, considerations of control and competition would mean that the rate of tax would be limited to a maximum of about 8%.

The place-of-establishment option

Under the transitional system, particular problems arise in determining *where* a transaction takes place for tax purposes: for example, in the case of services like transport, and of "triangular" or "chain" transactions.

In principle, services are taxed where the supplier has his business; but in practice most transactions are an exception to this rule. Supplies of goods are taxed on the basis of where they are physically located when the sale takes place. The effect is to oblige traders to register for VAT in every Member State in which they do business; to appoint a fiscal agent; or to obtain refunds of VAT through the complex procedures provided by the 8th. VAT Directive.

These problems would no longer exist if *all* transactions were to be taxed on the basis of where the supplier's business was established. On the other hand, there would be problems of revenue transfer between Member States; of distortions of competition as a result of VAT-rate differences; and of finding a clear definition of "establishment".

The VAT-ring option

When firms move goods between Member States, even if there is no change of ownership, a taxable transaction is deemed to take place. The administrative burdens are considerable. Were VAT to be suspended in such cases, about 80% of all movements between Member States could be taken out of the system.

Suspension could apply to movements within firms; between firms in the same group; or any firm linked in a "VAT ring". In effect, tax would only be payable when a sale took place to a final consumer.

The federal VAT option

The most complete solution - and also the cheapest both for firms and administrations - would be to make the European Union, for VAT purposes, a single fiscal area. There would be a single structure of VAT rates; and all revenues would be paid into the Community Budget. It would no longer matter where transactions were assumed to take place.

The loss of revenue for Member States could be offset by refunds from the Budget, or Community expenditure programmes. Amounting to about 9% of Community GDP, the Budget could be used as a fiscal instrument at Community level.

The origin option

Current legislation (Article 35a of the Sixth VAT Directive) requires the "definitive" VAT system to be based on the origin principle. If this were applied without a clearing system, there would be considerable shifts of VAT revenue between Member States.

Such a clearing system could be ***bi-lateral*** (i.e., each Member State would work out its net position in relation to each of the others); or it could be ***multi-lateral*** (i.e. net positions could be cleared through a central account). The Commission proposed the latter in 1987.

Clearing could also be either ***micro*** (based on traders' VAT returns), or ***macro*** (based on overall trade statistics, national consumption figures or sampling).

A bi-lateral, micro system would produce the most accurate results; but would place the greatest administrative burdens on traders.

VAT rates

Differences in VAT rates between Member States would also create problems under the origin principle. Were the differences too great, competition might be distorted. Moreover, there are currently 27 different VAT rates in the Community (plus exempt supplies), which would greatly complicate the deduction of input tax by purchasers.

However, application of the origin principle since 1993 to purchases by most final consumers does

not so far appear to have altered patterns of cross-border shopping. VAT rates have in any case been gradually converging, so that only three Member States (Denmark, Finland and Sweden) currently have a standard rate outside a 15-21% band (the Commission considered a 6% spread compatible with an end to fiscal frontiers in its 1987 proposals).

The main problems are the multiplicity of reduced rates and derogations; and the selection and definition of the categories to which a reduced rate can apply.

The "status quo" option

In adapting from the pre-1993 VAT system to the present transitional one, businesses and administrations have incurred considerable start-up costs, offset by the ending of tax controls at frontiers. Many doubt whether the new costs of adapting to yet another system in a few years' time could be justified by likely new savings.

Instead, the basic structure of the transitional system might be retained, but its application simplified: for example, by:

- abolishing the special regimes;
- harmonizing VAT thresholds;
- coordinating VAT and Intrastat requirements;
- standardizing the information on invoices;
- abolishing Sales Listings;
- providing for a single Community VAT registration and number.

In addition, the Sixth VAT Directive might usefully be modernised. For example:

- the right to deduct input tax should be clarified (draft 12th. Directive);
- the scope of exemption from VAT might be reduced;
- pending legislation on the taxation of gold, passenger transport, etc. should be adopted;
- the VAT treatment of SMEs should be clarified and improved;
- "economic activity" should be defined;
- the taxation of services linked to the supply of goods (and *vice versa*) should be simplified.

Conclusions

The choice between these options will involve various trade-offs: for example, between simplicity and efficiency in the VAT system itself, and the preservation of national fiscal sovereignty. The "bottom line" will be a trade-off between the advantages (and costs) of change, and the advantages (and costs) of keeping things much as they are.

The timetable for adopting the definitive system outlined in the Sixth VAT Directive cannot now be met. At the very earliest it could only be in effect in 1998. Whatever the eventual date, it will be important to ensure that uncertainty and impermanence come to an end and that businesses have a stable tax environment.

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INTRODUCTION

At midnight on the 31st. December 1992 all tax controls on the internal borders of the European Community disappeared. Traders no longer became liable for Value Added Tax as their goods crossed between Member States. Returning holiday-makers were no longer restricted to a 45 ECU "VAT-paid allowance" of goods bought abroad - at a stroke, the allowances became infinite. It was a visible sign that the European Single Market was for real.

To achieve this ending of tax controls, agreement had been necessary on major changes to the system for applying VAT to intra-Community commercial transactions. It was only at the eleventh hour, however, that the necessary legislation was put in place. The Commission's original proposals - first outlined in the Single Market White Paper of 1985 - were the subject of inconclusive debate until October 1989, when it was realised that the time was then too short for their implementation by January 1993. Instead, a less ambitious alternative was devised, making possible the ending of frontier tax controls while retaining key features of existing arrangements.
It is this alternative VAT system that is now in effect.

The legislative text, however, makes it clear that the new system was intended to be only "transitional". It places an obligation on the Commission, before the end of 1994, "to report...on the operation of the transitional arrangements and submit proposals for a definitive system"; and on the Council, after consulting the European Parliament, to "decide before 31 December 1995 on the arrangements necessary for the entry into force and the operation of the definitive system". Meanwhile, the transitional system would apply until the end of 1996[1] .

This timetable, of course, cannot now be adhered to. Although the Commission reported on the operation of the present system in November 1994, no proposals for a definitive system appeared - nor have they yet. It is a safe assumption that the contingency provisions for the extension of the transitional arrangements beyond the end of 1996 will be activated. There is time to consider the options: the purpose of this working document.

One clear option is to do nothing: to declare that the present, "transitional" system is from now on "definitive", and leave it at that. There are some powerful practical arguments for doing so.
A more revolutionary alternative would be make VAT a genuine "federal" tax. Many thorny problems would vanish were it to be charged at the same rates throughout the Union, under the same tax laws, and paid directly into the Community Budget.

Or VAT might be abolished altogether, and replaced by something simpler. This is perhaps the option which should be considered first, since discussion of it will cast light on some of the basic issues to be decided.

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[1] See Article 35a of the Sixth VAT Directive (77/388/EEC, OJ L145 of 13.6.1977 and L149 of 17.6.1977), as amended by the "Fiscal Frontiers" Directive (91/680/EEC, OJ L376 of 31.12.1991 and L272 of 17.9.1992)

1. THE HISTORY OF VAT

There is a logical elegance about Value Added Tax that betrays its Gallic origins. As products weave their way through the complexities of a modern economy towards final consumption, every transaction is taxed - but taxed only once. It is broad-based, falling equally on goods and services. To some extent it is both self-administering and self-policing. It is buoyant as a source of revenue. No wonder some fifty countries throughout the world have introduced it in one form or another!

1. 1 Origins

The merits of VAT as compared to cruder alternatives are illustrated by its history.
After the First World War a number of European countries, including both France and Germany, introduced taxes on the gross turnover of businesses. As long as the rates were at a very low level (the 1918 rate in Germany was 0.5%) the economic effects were small. As rates rose, however, it became clear that the system created certain undesirable distortions.

These were the consequences of tax "cascading". When one manufacturer sold goods to another, tax would be levied on the whole value of the product, including the tax element. Thus the fewer the transactions, the lower the final tax: an incentive to otherwise uneconomic vertical integration, or for firms to form artificial tax groupings (*Organschaften*).

While Germany kept the gross turnover tax throughout the '30s, '40s and (in the West) the '50s, France began experimenting with alternatives. Various combinations of turnover tax and purchase tax were tried until 1936, when both were replaced by a production tax. Since this was levied on many raw materials and other business inputs, it could have had the same "cascade" defects as a tax on gross turnover. To correct this, a *régime suspensif* was introduced, exempting businesses from taxation of their physical inputs.

However, because goods were transferred between businesses with tax suspended, revenue was delayed. Accordingly, in 1948, the system of "fractional payments" was created. Instead of goods being transferred tax-free, businesses at any stage were allowed to offset taxes paid on physical inputs against their own liability. This still only applied to the limited range of goods covered by production tax, and in particular excluded capital goods. The final part of the jigsaw fell into place in 1954, when "financial" as well as "physical" deductions were allowed. It was at this point that Maurice Lauré[2] coined the phrase *Taxe sur la Valeur Ajoutée.*

Meanwhile, in Germany - where the rate of turnover tax had reached 4% by the early 1950s - attempts were made to correct the cascade effects by differential tax rates. These created as many distortions as they cured. The differences between a tax on gross turnover, which cascades, and one on net turnover (VAT), are illustrated opposite.

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[2] *Inspecteur général des Finances*. In 1954 Professor at the *Ecole nationale d'administration*.

ILLUSTRATION 1: A CASCADE TAX ON GROSS TURNOVER COMPARED TO VAT

The models show the effect on final price, and on total tax payable, when a 10% tax is applied to the turnover of five companies in a production chain. In the case of a gross turnover tax, shown in Model 1, the whole value of the product, including the tax content, is taxed at each stage. There is a powerful incentive to reduce the number of links in the chain: if all five companies were to integrate, the tax on total value added could be reduced from 34.31% to only 10%.

Model 1: A tax on gross turnover

Firm	purchase price	+ value added	= price	+ tax @ 10%	= total sale price
A	0	20	20	2	22
B	22	20	42	4.2	46.2
C	46.2	20	66.2	6.62	72.82
D	72.8	20	92.82	9.282	102.102
E	102.102	20	122.102	12.2102	134.3122
Total tax				34.3122	
Tax as %					25.55

In the case of Value Added Tax as shown in Model 2, (here illustrated using the "invoice method") only the value added by each firm is subject to tax. The result is that the tax on total value added would be the same 10%, no matter how many firms were in the chain.

Model 2: Value Added Tax

Firm	purchase price	- input tax	+ value added	= price	+ tax @ 10%	net tax	final price
A	0	0	20	20	2	2	22
B	22	-2	20	40	4	2	44
C	44	-4	20	60	6	2	66
D	66	-6	20	80	8	2	88
E	88	-8	20	100	10	2	110
Total tax						10	
Tax as %			10				9.09

In the case of both Models, it is possible to calculate the final rate of tax in two ways: as a percentage of the *tax exclusive price* (i.e. the tax on value added); or as a percentage of the *tax inclusive price*. With gross turnover taxes, the tax inclusive basis has been generally used. In the

case of VAT, both forms were once in use, but it is now normal to express VAT rates on a tax exclusive basis.

1.2 VAT and the EEC

It was the growth of trade in Western Europe, however, that conclusively revealed the advantages of VAT.

Where it is intended that a tax should fall on final consumption, it should logically be levied on imports, but not on exports. In consequence, when goods are exported, any tax already paid should in some way be rebated; and a tax should be charged on imports equivalent to that borne by competing domestic products.

With most forms of indirect tax, however, this is virtually impossible. The cascaded tax content of a product that has borne gross turnover tax at a number of stages cannot be determined precisely, creating scope for covert export subsidy by overpaying rebates, and covert protection by overtaxing imports. In the case of a single stage Purchase Tax - such as that developed in the UK in the 1950s and '60s - exports can be exempted; but there is no accurate way to rebate the indirect tax content of exporters' inputs.

With VAT, these problems do not exist. At any stage of production and distribution - including export - the tax content of prices can be precisely calculated.

Tax adjustments at national frontiers soon became a critical issue for the six countries of the EEC. The Fiscal and Financial Committee set up by the Commission in 1960 under the chairmanship of Professor Fritz Neumark made its priority objective the elimination of distortions to competition caused by disparities in national indirect tax systems. Its report[3] recommended that "no EEC Member State should retain a 'cascade' system of turnover tax".

It is worth recalling, however, that the Neumark Report was less clear-cut about the alternatives. It recommended replacing taxes on gross turnover "by a tax on value added, or eventually by a tax levied at a single stage". A majority thought the "best compromise" to be:

- "a system of tax on net turnover (i.e. VAT)..as a basic tax with the same or nearly the same rates", levied up to, but *not* including, the retail stage; and
- "a tax levied at the retail stage which Member States could adjust - notably in respect of rates - according to their particular needs"[4].

This conclusion followed from the Report's earlier analysis of the differences in fiscal structure and in political/fiscal objectives between the six EEC countries. Member States' revenue requirements varied too much for full harmonization to be feasible. VAT would become a common turnover tax, to which varying State sales taxes could be added.

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3 "*Rapport du Comité Fiscal et Financier*" (EEC Commission, 1962)

4 *op.cit.* p.44

The First and Second VAT Directives of April 11 1967[5] nevertheless made a decisive choice in favour of value added tax. By the beginning of 1970 (subsequently postponed to 1972 by the Third VAT Directive in 1969[6]), Member States were required "to replace their present system of turnover taxes by a common system of value added tax.." Article 2 made it clear that VAT should "be applied up to and including the retail trade stage", although a separate retail tax was permitted as a temporary derogation. The preamble to the Directive also observed that adoption of VAT as a common EEC system would result in neutrality of competition "even if the rates and exemptions are not harmonized at the same time". Since the tax content of export prices would be known, "exact equalisation of that amount may be ensured".

1.3 The Sixth

The common system of VAT was successfully introduced in all Member States by the early 1970s. VAT was also adopted by the countries which joined the Community at the beginning of 1973 - and not solely in preparation for membership. In the United Kingdom, for example, the advantages of VAT over the then existing combination of Purchase Tax and Selective Employment Tax had already persuaded the Government of Ted Heath to make the switch.

The next major development within the European Community, however, arose from quite different considerations. In April 1970 a decision had been taken to replace the financing of EEC expenditure through direct payments from Member States by a system of "own resources". These were to include, in the words of the preamble to the Sixth VAT Directive of 1977, "those accruing from value added tax and obtained by applying a common rate of tax on a basis of assessment determined in a uniform manner according to Community rules".

The choice of VAT as an element of own resources was based on another advantage of the tax over the alternatives: its coverage could be made broad enough to reflect, more or less, a country's Gross Domestic Product. Unlike Purchase or Sales taxes, there were few problems in applying it to services and capital goods. It would result in equitable contributions from Member States provided that their coverages were much the same. The primary purpose of the Sixth Directive was therefore to harmonize *the VAT base* - to ensure as far as possible that "application of the Community rate to taxable transactions leads to comparable results in all Member States".

In the light of widespread subsequent misunderstanding, it is perhaps important to note that the *actual rates of VAT* charged by Member States were irrelevant to what was then the Directive's main objective. The "own resources" VAT rate - currently 1%. - is applied uniformly to all transactions, whether the actual tax rate paid by consumers is a standard rate, a reduced rate - or, indeed, a zero rate. By contrast, whether a transaction is *exempt* is of crucial importance.

Almost as soon as it was adopted, therefore, the Sixth became the subject of numerous amending Directives, designed to reduce the loopholes, uncertainties, exceptions and derogations contained in the original text. Some of these have taken a very long time indeed to work their way through the

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[5] First Directive (67/227/EEC) and Second Directive (68/227/EEC) both OJ 71 of 14.4.1967

[6] The Fourth (1971) and Fifth (1972) Directives were solely concerned with giving Italy a further postponement until the beginning 1973.

Community's decision-making system: the Seventh VAT Directive on the taxation of second-hand goods, works of art and antiques, for example, was published in 1977, but was not finally adopted by Council, in a revised form, until 1994.

1.4 VAT and the Single Market

In 1985 the focus shifted yet again with the publication the Commission's Single Market White Paper, Part III of which dealt with "the removal of fiscal barriers". This was followed in 1987 by eight tax documents, including a "Global Communication[7]" which outlined the main issues. Meanwhile, the Single European Act strengthened the legal base for action in the tax field by reformulating Article 99 of the EEC Treaty. Where this originally required the Commission to:

> *"consider how the legislation of the various Member States concerning turnover taxes, excise duties and other forms of indirect taxation..can be harmonized in the interests of the Common Market",*

it now reads:

> *"The Council shall..adopt provisions for the harmonization of legislation concerning turnover taxes, excise duties and other forms of indirect taxation to the extent that such harmonization is necessary to ensure the establishment and functioning of the Internal Market ...."*

The first major objective of the Single Market programme was to abolish physical controls at the Community's internal frontiers (the benefits of so doing were later quantified in the Cecchini Report[8]: a 0.4% increase in GDP, a 1% fall in prices and 200,000 extra jobs). And the single most important reason for internal frontiers was the VAT system: it was necessary to check that de-taxed goods actually left the country of origin and were re-taxed in the country of destination. Hence the infamous lorry queues on the Franco-Italian frontier and the 60 million, 50-box Single Administrative Documents (SADs) filled in each year for intra-Community trade. The solution proposed by the Commission was therefore to end the system of de-taxing and re-taxing. Goods moving between England and France, for example, would be treated in the same way as goods moving between England and Scotland: i.e. with tax paid included in the invoice. The French purchaser, like the Scots, would deduct this as input tax.

In making this proposal, the Commission was doing no more than implementing the provisions laid down in 1967 by the First VAT Directive. Article 4 of this required the Commission to:

> *"submit to the Council, before the end of 1968, proposals as to how and within what period the harmonization of turnover taxes can achieve the aim of abolishing the imposition of tax on importation and the remission of tax on exportation in trade between Member States, while ensuring the neutrality of those taxes as regards the origin of the goods or services."*

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[7] "Completion of the internal market: approximation of indirect tax rates and harmonization of indirect tax structure" (COM(87)320)

[8] The Economics of 1992: an assessment of the potential economic effects of completing the internal market of the European Community (EUROPEAN ECONOMY no 35, March 1988 ISSN 0379.0991.)

Yet the proposal immediately met a storm of objections. Two problems stood out: the "clearing" of VAT revenue, and the harmonization of VAT rates.

1.5 Clearing

The first was an issue of critical importance to finance ministers: the flow of revenue. When a Scots purchaser deducts from his VAT bill the input tax invoiced by an English supplier, there is no loss of revenue to the UK Exchequer: the money goes to the same place, whether paid by a Scotsman or an Englishman. It would not be the case, however, were a French purchaser to do the same: there would be a transfer of revenue from the UK to France.

This would not matter were the VAT deductions made by French purchasers from the UK to be equalled by those of UK purchasers from France; but the likelihood of this occurring over a normal tax period is very small. The necessary conditions are a function, not just of the balance of trade, but also of the structure of VAT rates. For example, even were Franco-UK trade to be in exact balance in those commodities and services covered by standard-rate VAT, there would be a net transfer of tax revenue from the UK to France, since a UK purchaser would be deducting input tax of 20.6% paid in France, a French purchaser only 17.5% paid in the UK.

In the multi-lateral context of the Single Market, the chances that every Member State would be in VAT revenue balance are to all intents and purposes nil. The Commission's own estimates[9] (based on 1986 trade figures, and assuming harmonized VAT rates) were that Germany, the Netherlands, Belgium and Luxembourg would gain revenue (the Netherlands substantially), and that all the rest of the then Member States would lose (see Table 6, page 57)

The Commission's solution was to establish a clearing mechanism which would re-allocate revenues through a central account. The figures for payments and withdrawals would be based on VAT statements by traders of sales to, and purchases from, other Member States. Revised proposals in 1989 suggested that clearing might take place, instead, on the basis of macro-economic data.

Neither alternative proved acceptable to Member State governments.

1.6 VAT rates

The second problem was that of tax rates. Variations between Member States both in the structure and levels of VAT rates would not only complicate the operation of any clearing mechanism, but would also make the collection of the necessary statistics more onerous for businesses - as has indeed been found to be the case under the present transitional system.

More important, however, was the issue of competition. Under a system of de-taxing/re-taxing, differences in VAT rates between countries are to a large extent "sterilised", since all commercial imports enter a national tax system at zero. However, where exports are made inclusive of tax, and where this tax is deductible in the country of import, competition can be distorted by rate

[9] See Annex A to "Completing the Internal Market - the Introduction of a VAT Clearing Mechanism for Intra-Community Sales" (COM(87)323, 5.8.1987)

differences. These can result not only from differences between Member States' standard rates (the spread is now 15-25%) but also from the placing of goods in different tax categories: the spread on some products is between 0% and 25%.
It is important to be clear as to why this should be so. In terms of net tax payable, no competitive advantage (except through fraud) is to be gained from buying inputs at 0% as opposed to 25%, since this merely means that less is deductible.

There is, however, an advantage in terms of cash flow. One criticism of the present transitional system, indeed, is that zero-rated deliveries from another Member State have a competitive advantage, as a result of cash flow differences, over positively-rated domestic supplies[10]. The system is nevertheless neutral as between source Member States - all supplies come in at zero. This would not be the case were de-taxing/re-taxing to end. There would be a cash-flow advantage in purchasing from low-tax as opposed to high-tax countries.

Something like 95% of goods crossing internal Community frontiers do so within the VAT system - that is, at present de-taxed. Much of the argument about rates during the 1987-92 period, however, concentrated on the 5% that do not. Wide differences in rates, it was alleged, would stimulate massive cross-frontier shopping by final consumers. Every mail-order customer would buy from a firm in Luxembourg and pay only 12% VAT, and every mail-order company would move there! Exempt bodies like hospitals which can make no input deductions would likewise buy all their equipment in low-taxed countries.

The Commission's proposal was for a harmonization of rates within two tax bands: a standard rate between 14-20%, and reduced rate between 4-9%. This was attacked by two schools of thought, which might be described as the "French" and the "British". The first argued that a spread of six percentage points was too wide to prevent distortions of competition, and should be reduced. The second argued that harmonizing VAT rates was an unacceptable infringement of national fiscal sovereignty, and that rates would converge in any case through market forces.

Both the issue of clearing and that of tax rates were temporarily resolved by the decision effectively to retain de-taxing/re-taxing in the transitional system. The "special regimes" for distance selling and "exempt legal persons" (see later) solved the problems of mail order and hospitals. As far as final consumers were concerned, research by both the Commission and organisations like BEUC[11] revealed that "differences in VAT rates are not the main cause, and not even a major one, of price differentials"[12]. Nevertheless, a precautionary 15% minimum standard rate *was* agreed, together with limitations on those goods and services on which a reduced rate could be charged (see Annex H of the revised Sixth Directive). The Commission was meanwhile charged with making proposals for a permanent system by the end of 1994.

The fact that it has not done so is in part the consequence of unfortunate timing: the ending in January 1995 of the Delors Commission's term of office, combined with enlargement of the

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[10] See, for example, the article "Proposal for a definitive VAT system: Taxation in the Country of Origin at the rate of the Country of Destination, without clearing" by Prof.F.Vanistendael in *EC Tax Review* no 1. 1995

[11] *Bureau Européen des Unions de Consomateurs*

[12] "The role of VAT in explaining price differentials across the Member States" (Internal Commission paper, D-G XXI, 1989)

Community. The most important reason, however, is that the problems are not just technical. They arise from theoretical ambiguities at the very heart of Value Added Tax.

2. SOME PROBLEMS OF VAT THEORY

It is possible to place the blame for the difficulties facing the Community in the field of indirect taxation squarely on the shoulders of Maurice Lauré. By coining the phrase "Value Added Tax" he created the impression that it was a tax on value added. As at present applied, it is not. Were it to be so, ending the de-taxing/re-taxing system would present fewer problems. There would be no need for a clearing system. Revenues would accrue to the country *where the value was added at any stage of production.*

Nevertheless, VAT is usually considered to be a general tax on consumption. Though the tax is *collected* at different stages of the production and distribution chain, it is passed down the chain for payment by the final consumer. It seems logical, in consequence, that the revenue should accrue *where the goods or services are consumed.*

2.1 Methods of calculation

The difference between VAT seen primarily as turnover tax and VAT seen primarily as general consumption tax is re-inforced by the way in which liability is calculated. At its simplest, value added is the value of outputs (o) less the value of inputs (i). Thus the tax liability can be simply calculated as a percentage (t) of this net figure: $t(o-i)$.

In practice, the characteristics of such a system are that the liability of each company is determined in isolation. No tax is shown on invoices, but is passed on wholly or partly in the price. Moreover, the tax is most easily levied on aggregates for inputs and outputs over a period of time, which is administratively cheap, but makes it impossible to calculate the tax-content of individual products.

Alternatively, liability can be calculated as the tax on outputs less the tax on inputs: $t(o)-v(i)$. The characteristics of this method are that tax *is* shown on the invoice (for this reason it is usually called the "invoice method"), and the tax liability of each firm is linked to the tax liabilities "up-stream" and "down-stream". In consequence, there is an element of self-policing, since administrations can cross-check the tax on a transaction paid by a vendor with the claim for deduction of input tax made by the purchaser. Finally, the tax-content of each product is known at any stage of the transaction chain, an essential requirement for the de-taxing/re-taxing of exports.

It is therefore not difficult to see why the second method has been adopted in the Community.

2.2 VAT as general consumption tax

Added to these theoretical considerations has been the practice of governments and tax authorities. Despite the fact that in its country of invention VAT evolved from a simple tax on gross company turnover, most other countries which have adopted a VAT[13] have substituted it for various sales taxes.

[13] The most recent is Ghana, where a number of people were killed in the subsequent riots, and where the introduction of VAT has now been suspended after only three months.

When the UK adopted VAT in 1973, for example, its structure - notably application of a zero rate to a wide range of goods and services - echoed that of the abolished Purchase Tax. Yet during the debate which preceded that decision, substituting VAT for Purchase Tax was not a foregone conclusion. The value added at any stage of production is a function of wages plus profits; and VAT can be calculated at a tax on profits plus wages: $t(p+w)$; or as a tax on profits plus a tax on wages: $t(p)+t(w)$. Thus VAT could be seen as substituting, not for Purchase Tax, but for the then existing Profits and Selective Employment Taxes.

In an early study of the issue, the then Professor of Financial and Monetary Economics at Strathclyde University, Alan Tait, advocated just this change, keeping Purchase Tax at a uniform rate of 15%. Observing that the VAT then being adopted by the EEC was intended to be passed forward to the consumer, he noted that "many of the persuasive arguments in favour of VAT in promoting business efficiency are based on an assumption that the VAT is *not* passed forward"[14].

Discussion of these matters is also complicated by other theoretical problems.

2.2.1 The classification of taxes

First, the distinctions between different forms of tax are anything but clear-cut. In its section on tax systems in general, the Neumark Report observed that dividing taxes into "direct" and "indirect" was controversial both in theory and in practice. It preferred the terms "taxes on income" and "taxes on the use of income" (i.e. consumption).

Consumption, however, is Income less Savings; and a tax on consumption (for example, in the form of an Expenditure Tax) is equivalent to a tax on income with 100% allowances for savings.

This puts into perspective many of the arguments about whether it is better to tax incomes or to tax spending. Consumption taxes are widely believed to be more "regressive" than income taxes, because they take a higher proportion of poorer than of richer people's incomes. A flat-rate income tax, however, would be similarly regressive, while a consumption tax with low or zero rates on certain basic items, as in the case of VAT in the UK and Ireland, can be mildly *pro*gressive - but at the cost of narrowing the tax base.

This issue of tax base is, indeed, of considerable economic importance. The cheapest form of tax to collect is a customs duty on imports; but its long-term costs in terms of economic welfare are probably the highest. Next cheapest to collect are excise duties on specific products, which are particularly buoyant sources of revenue when levied on essentials (e.g. salt, windows) or habit-forming drugs (tobacco, alcoholic beverages, coffee, etc.). Such primitive taxes, however, result in both economic and social distortions: the "*gabelle*", we are told in school, was one of the causes of the French Revolution. By contrast, comparatively sophisticated taxes like VAT and income tax are more expensive to collect, but distort less and give rise to fewer injustices.

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[14] "Value Added Tax" by Alan A Tait (McGraw Hill, 1972). p. 9 . See also, in particular, Chapter 2.

2.2.2 *What is "consumption"?*

Secondly, there is the problem of defining "consumption". A later study[15] by Alan Tait, now Deputy Director of the Fiscal Affairs Department of the International Monetary Fund, contains a chapter on "difficult-to-tax goods and services". Should **transfers of land**, for example, be subject to VAT? The purchase of land "is not a consumption expenditure in the usual sense since nothing is taken out of the gross national product". On the other hand, the treatment of land "is bound up with appropriate VAT liability of the entire sector, including the development of land, building, leasing land and building and rental property". Transfers of agricultural land are generally exempt from VAT. Where the land is used for construction, however, all kinds of problems can arise.

In the UK, for example, the construction and alteration of houses is zero rated (a situation confirmed by a judgement of the Court in 1988[16]). Repair or maintenance work is not. The result has been series of fascinating but ultimately absurd interpretations at the margin:

> *"if an existing building was razed to its foundations, the new building using the old foundations would be zero rated, as would a new building using the wall of the old previous building; however, if more walls were left, constituting a shell even without floor or roof, VAT at the standard rate would be liable"* [17].

The taxation of **second-hand goods** provides other theoretical problems - it is no accident that it took 17 years to adopt the Seventh VAT Directive[18]. Most second-hand goods in the market have already been "consumed" at least once, and have borne VAT on their purchase price when new. Were the price at which they change hands a second time to be subject to the full VAT, there would be a tax "cascade". The problem was specifically addressed by the Court in the Schul judgements of the early 1980s[19]. It declared that when VAT is levied on a second-hand item moved by an individual from one Member State to another, account had to be taken of "the residual part of the value added tax paid to the Member State of exportation which is still contained in the value of the product.."
In the case of second-hand goods, it does not help much to consider VAT a tax on "value added" either. Where the product is an antique and is *rising* in value, VAT can be levied on the difference in purchase price and sale price. But what if the product is *falling* in value?

The eventual solution has been to direct attention away from the product itself and to tax, in effect, the service provided by the dealer or auctioneer instead.

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[15] "Value Added Tax: International Practice and Problems" (IMF, 1988), see pp. 80 & 81

[16] Judgement of 21.6.1988, Case 416/85

[17] Customs and Excise Guidance note, referred to in Tait, footnote to p.83.

[18] Directive 94/5/EC of 14.2.1994: special arrangements applicable to second-hand goods, works of art, collectors' items and antiques (OJ L69 of 3.3.1994)

[19] Judgements of 5.5.1982 (case 15/81) and 21.5.1985 (case 47/84). Attempts were then made by the Commission to harmonize the implementation of these judgements through the draft Sixteenth VAT Directive (COM(84)318 of 18.7.84 and COM(86)163 of 21.3.86).

2.2.3 *Who pays?*

Finally, the extent to which *any* tax - including a tax on retail sales - is paid by the final consumer depends ultimately on the elasticity of demand for the product or service in question. If demand is totally inelastic at that level of prices, a tax is likely to be passed on entirely to the consumer. If it is totally elastic, it will be absorbed entirely by the producer.

In real life, and subject to the general fiscal and monetary context, the incidence will be divided in some proportion between the two. Studies into adopting the original Commission proposals on VAT rates and charging a 4% VAT on food in the UK, for example, refuted the popular belief that food prices would rise by 4% as a result. About half would have been passed on, and resulted in switches in purchasing patterns. The other half would have been absorbed by producers and distributors, and resulted in keener competition[20]. International studies[21] show that there is no automatic link between VAT rate changes and changes in rates of inflation, although the introduction of VAT has sometimes tempted traders to "mark up" prices disproportionately.

From the point of view revenue-raising, it does not matter much whether VAT is to be regarded as a tax on business turnover or on consumption, or whether it is paid by consumers or producers. This is only true, however, given *that the context is a single tax area with a single Treasury*. When separate tax areas are involved, the distinctions become important.

2.3 "Destination" and "origin"

In the context of international trade, the issue of whether VAT is to be seen as a tax on consumption or a tax on business turnover is encapsulated in the well-known alternative principles of "destination" and "origin". Should *all* the tax accrue where goods are ultimately consumed: the country of destination? Or should *some* of the tax be retained where the goods are produced: the country of origin. The consequences of each principle are illustrated below.

These principles do not, of course, just apply to VAT. In the field of both company taxation and direct personal taxes there are differences of opinion as to whether revenues should go to the Exchequer where business activities take place, or to the Exchequer where a company is registered or a shareholder is resident.

However, as the Neumark Report noted, the origin principle generally applies in the fields of company tax and personal income tax for reasons both of administrative efficiency and equity: companies and individuals ought to contribute to the overheads of "the countries in which they make their money". If VAT is a tax on corporate turnover, should not the same principle then apply as in the case of taxes on corporate profits?

On the other hand, it can also be argued that individuals should contribute to the overheads of the countries in which they live. The Neumark Report cited the argument that, under the destination principle, "the consumer has neither the possibility of avoiding his share of contributions to public

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[20] see "VAT: the Zero Rate Issue" by Ben Patterson MEP (EDG 1987)

[21] See Tait, Table 10.2, p.211

expenditure in his own country by buying a foreign product, nor an obligation to contribute to the public finances of another country."[22]

The principal case for applying the destination principle to VAT, however, rests on the need to avoid distortions of competition. "A consumer in country A should always pay a price containing the same element of tax, no matter in which country the goods have been produced."

The Neumark Committee's conclusions, which were duly reflected in Article 4 of the First VAT Directive, were that there would be advantages in applying *a single principle across the whole field of taxation.* Since "the general application of the destination principle to all categories of taxation is impossible", it was necessary to discover a way of applying the origin principle to turnover and consumer taxes in a way that did not distort competition. Only in the case of excise duties would this prove impossible.

22 *op.cit.* pp. 77-78

ILLUSTRATION 2: APPLYING THE 'DESTINATION' AND 'ORIGIN' PRINCIPLES

The following diagrams illustrate how VAT is accounted for in trade between two countries, "Franland" and "Germark", under the destination and origin principles. A manufacturer (A) sells to a wholesaler (B) in Franland, who sells to a distributor (C) in Germark. VAT is at 10% in both.

Figure 1: Destination Principle

	"Franland"			"Germark"	
Firm	A	B		C	
	sells	*buys*	*sells*	*buys*	*sells*
Price	10	10	20	20	30
VAT at 10%	1	-1	0		+3
Net VAT	1		-1		
Revenue		0			3

When the destination principle applies, B charges no VAT to C, and also receives back the input tax paid on the purchase from A. The goods leaving Franland are therefore "de-taxed": i.e. sent to Germark at a zero VAT rate. C has no input tax to deduct, but charges VAT to the consumer in the normal way. The 3 units of VAT paid by the final consumer all accrue to Germark.

Figure 2: Origin Principle

	"Franland"			"Germark"	
Firm	A	B		C	
	sells	*buys*	*sells*	*buys*	*sells*
Price	10	10	20	20	30
VAT at 10%	1	-1	+2	-2	+3
Net VAT	1		1		1
Revenue		+2		+1	
Clearing		→		3	

By contrast, under the origin principle, the tax is passed on from B to C as within the same country. The 3 units of revenue are now split between Franland (2) and Germark (1). The 2 units can, however, be "cleared" from Franland to Germark so that all three units accrue to the latter, as under the destination principle.

2.4 The case for abolishing VAT

Arguments both of theory and practice have therefore led the Community to make application of the origin principle to VAT its consistent long-term goal. This is reflected in all the legislation, from the end-1968 deadline in the First VAT Directive to the current target date of 1st January 1997 for the introduction of the "definitive" system.

As we have seen, however, the choice of VAT as the Community's single broad-based indirect tax was largely made *precisely because it permitted a strict application of the destination principle.* If there is a move to the origin principle, and de-taxing/re-taxing no longer has to be carried out, this once again becomes an open question.

What of VAT's role as a basis for the Community's "own resources"? Despite the provisions of the Sixth VAT Directive, VAT has always been a shaky foundation for equitable national contributions to Community expenditure. Since imports are included, but not exports, it penalises countries with trade deficits. More seriously, it does not take account of variations in the proportion of national economies that are VAT-registered. This was clearly recognised by the Community itself when, in 1992, it brought into being the GNP-related "fourth resource" and reduced the maximum VAT rate from 1.4% to 1%. Since total contributions are now governed by a GNP ceiling, the case for a separate VAT element is not now obvious.

2.5 The Sales Tax Alternative

The main alternative to VAT would be a broad-based, single-stage tax, as was recognised by the Neumark Committee (see page 4). If this were to be applied at the retail stage, there would be only a minimal shift of revenue between Member States, removing the need for any clearing system. This advantage of a retail sales tax over a multi-stage tax within the context of a Single Market is, indeed, the principal reason for its continued survival in the United States, despite several attempts to introduce VAT.

There would, it is true, be some tax "cascading", since businesses would no longer be able to deduct any sales tax paid on their inputs. Since the tax would only be levied at the single, final stage, however, there would not be the same incentive to vertical integration as with a turnover tax levied at each stage. Moreover, *within* the Single Market, "cascading" would cause little resulting distortion of competition, since it would apply in all Member States. Distortions in competition as result of differences in rates would likewise be very limited.

A possible problem would be that of exports: that is (since the concept of "imports" and "exports" no longer exist for internal trade) the need to de-tax fully transactions with third countries. At present, however, the world is very far from being a free trade area, let alone a common market. Rough-and-ready tax rebates, such as those operated by Germany before the abolition of its cascade turnover tax, could be applied (subject, of course, to any disciplines applied by the World Trade Organisation). Like the United States, Japan has not yet adopted VAT, despite attempts to do so by the Government.

Though the central administrative costs of VAT - estimated at about 2% of revenue on average[23] - are lower than those of income tax, this does not take account of the costs to firms, all but the smallest of which must be VAT-registered. A single-stage sales tax would be a lot cheaper.

A broad-based sales tax levied at the retail stage nevertheless has one important disadvantage, which can be observed in the experience of the US. Unlike VAT, the whole of the revenue must be collected from the final link in the commercial chain. Moreover, this link is disproportionately made up of very small businesses, for which being within the tax net can constitute a considerable burden. The conclusion of Tait is that "a single point retail sales tax is efficient at relatively low rates, but is increasingly difficult to administer as rates rise"[24]. In the US, all state sales taxes are below 8.25%. "At 5%, the incentive to evade tax is probably not worth the penalties of prosecution; at 10%, evasion is more attractive, and at 15-20 percent becomes extremely attractive". Only Iceland, with a 25% sales tax, has ever attempted the levels attained by VAT.

In conclusion, a tax levied solely at the retail stage would be an efficient substitute for VAT only if the rates were kept comparatively low. Other taxes might have to be raised to make up revenue - though the effective "capping" of consumption tax might be widely welcomed.

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23 See "Misconceptions about Value Added Tax" by Alan A Tait (Finance and development, IMF. Washington DC. Vol.26 no.1. March 1989)

24 "Value Added Tax: International Practice and Problems" p.19

3. THE TRANSITIONAL SYSTEM

The VAT system that came into effect at the beginning of 1993 is based neither fully on the origin principle, nor fully on that of destination. As the Commission's end-1994 report[25] on the operation of the arrangements observes, it is a "hybrid", arising out of the guide-lines established by the ECOFIN Council in November 1989. These, says the Commission, proved "particularly hazardous and difficult to achieve", given that they included concurrently the free movement of goods, no distortion of competition and a lightening of administrative burdens. Moreover, it all had to be done "without affecting the autonomy of each Member State in exercising control over transactions".

For most final consumers, the origin principle applies. Individuals can now buy goods, VAT-paid, in any Member State and to take them to any other Member State without being subject to either further tax or further controls[26].

From this basic principle, as the Commission's report puts it, there are a number of "derogations for a transitional period", to which the destination principle applies. "Special regimes" apply to mail-order; to new cars, boats and aeroplanes; and to purchases by various exempt bodies (e.g. hospitals or banks). Where goods are also subject to excise duties, the right is also limited to genuine end-users: a British traveller who has bought tax-paid wine or cigarettes in France cannot re-sell it back home whether he is VAT-registered or not.

3.1 The consequences for business

The largest "derogation", however, applies to commerce between VAT-registered traders - in effect to 95% of all cross-frontier transactions within the Community. From the point of view of firms, the result is that three general VAT regimes are now in operation:

i) domestic sales and purchases

As before, VAT-registered traders must charge tax on all sales to customers in the same Member State. If the purchaser is another VAT-registered trader, VAT paid can be deducted as input tax.

ii) trade with third countries

Likewise as before, goods exported by a VAT-registered trader are de-taxed, and goods imported are taxed, as they cross the Community's *external* frontier. Transit arrangements also apply as before 1993.

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25 "Report from the Commission to the Council and the European Parliament on the Operation of the Transitional Arrangements for Charging VAT in Intra-Community Trade (presented in accordance with Article 28l of Directive 77/388/EEC) COM(94)515 of 23.11.1994)

26 Though a Eurobarometer poll (no.41.0 by INRA (Europe) of 5th. July 1994) discovered that 43% of Community citizens were unaware of the right, and under 20% had up to then made any use of it.

iii) intra-Community supplies and acquisitions

A new mechanism now applies when sales are made to a customer in another Member State. Legally (as the Commission explains it), for every "economic transaction" there are *two* "taxable transactions": the *supply* of goods in the Member State of departure; and "*the intra-Community acquisition of goods*" in the Member States of arrival. The two taxable transactions are "quite separate". The system "enables each of the Member States in question to satisfy itself about the conditions for taxing or exempting the transactions carried out on its territory, independently of events in the other Member State[27]".

The consequences are that the seller and the purchaser are separately answerable to their own authorities for the way they handle VAT. Sellers can only "de-tax" goods (i.e. invoice them at zero) when they can show that the customers are VAT-registered in another Member State. From the point of view of purchasers, it means "re-taxing" at the rate in that destination Member State. If the VAT is then deductible, it of course effectively means purchase at zero.

This may seem rather a complex way of putting it. For most straightforward sales the change could perhaps be more simply described as the removal of the tax point from the internal frontier to the place of delivery. The legalistic framework, however, needs to be borne in mind for one reason at least: the separate liability of supplier and purchaser helps explain much of the unpopularity of the transitional system among traders. Though the Commission states that there is "complementarity, both spatially and over time" of the two transactions, this is not necessarily the case in practice.

From the point of view of the national tax administrations, the complementarity is an important element of control. Though the "two taxable transactions" system enables each Member State to retain full fiscal sovereignty, a Regulation adopted in 1992[28] considerably extended and strengthened the existing systems for co-operation between national tax authorities. Both regular exchanges of information, and the provision of information on request, facilitate the "matching" of data on supplies to data on acquisitions[29].

The legislation has been supplemented by joint exchange and training courses for national tax officials through the MATTHAEUS[30] programme, which is now in its second phase. A new 5-year "action programme for Community customs (Customs 2000)" has now been proposed by the Commission[31].

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27 COM(94)515 p.16

28 Regulation 218/92/EEC of 27th. January 1992 (OJ L24 of 1st.February 1992)

29 A first report on the working of the administrative cooperation system in the field of VAT was published in mid-1994 (COM(94)262)

30 So-called because St. Matthew, before becoming an evangelist, was a tax collector. For details of the programme, see Decision 91/341/EEC of 20.6.1991 (OJ L187 of 13.7.1991); Decision 94/844/EC (OJ L352 of 31/12/94); and also the "Report from the Commission to the Council, the European Parliament and the Economic and Social Committee on the experience gained in the application of the Matthaeus programme (COM/93/661 final).

31 COM(95)119, 04.04.1995

3.2 Establishment of the system

A Communication from the then responsible tax Commissioner, Christiane Scrivener, gave the first official report on the new system[32]. It was entitled "six months' operation of the new indirect tax regime: a broadly positive assessment", and reflected information received from Member State Governments, from tax authorities *via* the regular meetings of the Standing Committee on Administrative Cooperation, and from traders represented on the Enterprise Consultation Committee which the Commission established at the beginning of 1993.

The main thrust of the report was that, despite the late adoption of much of the legislation, the new system had been set up on time (i.e. by the 1st. January 1993 deadline), and was fully operational. In particular, a VAT Information Exchange System (VIES) had been on-line since November 1992, and had enabled traders making sales into another Member State to check their customers' VAT numbers. The VIES system had also made possible the first two quarterly "mass transfers of turnover data from each Member State to its partners".

The communication also drew attention to certain revenue effects. From the point of view of traders, one immediate advantage of the change in system had been that VAT was no longer payable when goods crossed internal frontiers, and therefore no longer had to be pre-financed. This "represented an appreciable advantage in terms of liquidity". By the same token, however, it represented a considerable postponement of revenue receipts for national treasuries. As a result, many Member States had taken steps to limit the effect by shortening the time-period for making VAT returns or delaying the right to deduct input tax. This the Commission could "only deplore".

The issue is, in fact, one which had already been the subject of considerable debate during the - ultimately unsuccessful - attempt to introduce a system of "postponed accounting" (PAS) for all intra-Community trade through the draft Fourteenth VAT Directive[33]. This would have retained the internal frontiers as the tax point, and would not have eliminated all physical checks there; but would have allowed importers to settle their tax liabilities through their normal VAT returns. At the time, PAS was already applied in Benelux and by the UK, but was resisted by other Member States as involving an immediate, though once-for-all, revenue loss. In 1984 the UK (like Ireland two years earlier) abandoned it - thereby making a once-for-all revenue *gain* of £1.2 billion. The draft Fourteenth Directive was withdrawn by the Commission in 1987.

The matter would perhaps be of only historical interest were it not for the fact that a switch to the origin system would result in a major one-off effect in the opposite direction. The VAT on intra-Community acquisitions would once again have to be pre-financed by traders, to the extent that invoices would contain the VAT already charged in the country of origin, only reclaimable in the normal way. Member States' Treasuries would enjoy a corresponding once-for-all gain.

The 1993 Commission report concluded by highlighting what were then perceived to be the main problems: continuing disparities in national VAT legislation; the system of "tax representatives"; the "special regimes"; and the new Intrastat system for collecting statistics *via* VAT returns.

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[32] Statement to the ECOFIN meeting held on 25th. October 1993

[33] COM/82/402 (OJ C203 of 6.8.82)

As it happens, two "*nettoyage*" Directives have already been found necessary since the main legislation on the transitional system was adopted in 1991. The first was agreed just before the introduction of the new system, on 14th. December 1992[34]. The second was proposed in March 1994, but was not adopted until March 1995[35], to come into effect at the beginning of 1996.

3.3 Reactions of traders

The Commission's November 1994 report draws attention to a number of surveys which have been conducted among traders into the operation of the transitional system. It summarises them, once more, as representing "a broadly positive overall assessment", observing that the transitional VAT arrangements have generally been welcomed by traders. The principal gain from the change in system - as predicted by Cecchini - is seen to be the reduction in costs as a result of ending customs formalities at internal frontiers. These had been put at 8 billion ECU a year in administrative costs and waiting time.

The favourable opinions are, however, balanced by criticisms. The Commission report itself notes a general complaint "that VAT has become highly complicated". Certain operators even considered that "their costs, due to the new obligations, exceeded their savings"[36].

The most explicit reservation of this kind is contained in the study carried out for the German Ministry of Finance by a specially-appointed "Country of Origin Commission"[37], which comprised a wide range of representatives from the business community, the tax-advising professions, academic and expert bodies, tax official and the German *Länder,* as well as the Federal Government itself.

"Following the elimination of frontier controls," it reported, "the majority of German undertakings have failed to register substantial costs reductions in intra-Community goods traffic." Savings due to ending frontier formalities had been outweighed by new administrative burdens. As a result, "the expectations which entrepreneurs and tax authorities had placed in the European internal market have not been fulfilled.."[38] Precisely this point also appears in the "Single Market Policy Evaluation"[39] carried out in the UK, and based on the views of some 570 companies and trade bodies. Disillusionment with the new VAT system "has served, we believe, to colour many businesses' view of the benefits of the Single Market regime".

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34 92/111/EEC, OJ L384 30.12.1992

35 95/7/EC, OJ L102 of 5.5.1995

36 *op.cit.* pp.25 & 26

37 "Formulation of the definitive scheme for imposing turnover tax on the intra-Community trade in goods and services and for a functional clearing procedure" (*Bundesministerium der Finanzen*, April 1994)

38 *op.cit.,* p.6

39 HM Customs and Excise, December 1993

3.4 Evaluation of the evidence

It is of course possible to discount much of this adverse opinion as being the inevitable concomitant of any change in established practice. The surveys of business opinion quoted were largely carried out in 1993, when most traders were facing the one-off costs of adaptation.

The surveys which the Commission has taken into account also vary in statistical significance. Some of the most damning evidence against the post-1993 system, for example, appears in a report by KPMG Peat Marwick[40] published at the beginning of 1994. "Over half of the respondents described cross border delivery times as the same following the changes introduced on 1 January 1993. Only 19% had experienced faster delivery times, and of these, 56% claimed no savings had ensued". The data, however, was derived from questionnaires returned by 320 firms in the South East region of the UK, a response-rate of only 5%.

By contrast, a contemporary report by Deloitte Touche Tohmatsu International[41], based on replies from over 600 firms in all Member States and with a response-rate which varied between 15% and 33% (the latter in Denmark, Ireland and Belgium), gave a more favourable picture. In this case, 61% believed the 1993 changes to be beneficial, with 39% finding that goods were reaching destinations more quickly.

A report[42] published in April 1995 showed that a majority of the 140 SMEs questioned by the Euro-Info-Centres about the benefits of the Single Market had enjoyed substantial cost savings as a result of the lifting of border controls. Particularly important had been the reduction in transport costs and delivery times (apparently amounting, in the case of one Spanish company, to 98%). Only 11 of the companies surveyed mentioned VAT as a source of difficulty, as compared to 32 which complained of failures in the field of technical standards, and 20 which complained of excessive delays in cross-border payments.

As against this, however, a follow-up survey by KPMG[43] published at much the same time found traders only marginally more satisfied with the system than the year before. In this case the survey was based on replies from 392 UK-based firms (a 13% response rate), mostly with turnovers between £1 million and £50 million. Still only 23% of respondents found that deliveries to other Member States were faster than before January 1993, while 14% found them slower. Indeed, 42% echoed the German findings in stating that the abolition of customs documentation had *not* compensated for the reporting requirements of the VAT and Intrastat systems. On average, firms spent nearly 20 man-hours a month on reporting; but transportation companies spent over 100 man-hours a month.

This second KPMG survey also provided evidence of the difficulties faced by firms involved in

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40 "1993: a survey of the impact of the Single Market VAT changes"

41 "VAT across the European Community: a survey of the impact on business of the new Single Market VAT rules"

42 European Commission Spokesman's Service, IP(95)364, Brussels 10 April 1995

43 "VAT & the Single Market '95 Report"

multiple VAT registration (see section 6.3); and in "triangular" and "chain" transactions (see section 6.1 and 6.2). Nearly 30% of the respondents were involved in trade of this kind, in particular the larger companies with turnover greater than £500 million; and nearly half of these larger UK-based companies had also registered for VAT in either France or Germany. The simplification of triangular transactions introduced by the *nettoyage* I Directive at the beginning of 1993 was not seen as having made trading much easier, while the delay in implementing the *nettoyage* II Directive had meant that the problems of those involved in chains remained unresolved.

3.5 Some preliminary conclusions

More precise details of the cost/benefit balance of the change in VAT system will be available once the overall evaluation of the Single Market currently being carried out by the Commission ("Cecchini II") has been completed. Specifically, the firm of Price Waterhouse has been commissioned to examine the impact of the change in VAT system on firms throughout the Community. In addition, the European Parliament has itself commissioned a study into the costs for SMEs, relative to larger companies, of both the transitional VAT system and Intrastat requirements.

Meanwhile, a number of preliminary observations can be made.

For example, one clear point emerges from almost all the surveys: more burdens are seen to be created for businesses by the need to complete Intrastat returns (which are only incidental to the VAT system itself), than by the requirement to complete regular European Sales Listings (which are part of the VAT control system). The Deloitte Touche report noted that "not many of the companies surveyed have had problems obtaining VAT numbers or completing the EC sales lists. Approximately 50%, however, had difficulties with the Intrastat reports."[44] The second KMPG survey produced similar results: 22% of respondents had found difficulties with VAT Sales Listing, but 39% with Intrastat.

Some reasons for the diverging opinions of traders can also be discerned. The Commission makes the point in its report[45] that "logistic departments frequently give a more favourable assessment than accounts departments" (though it should be noted that this observation appears to be drawn from the first KPMG report[46]).

The Commission also points out that much of the work in handling both VAT and statistics on intra-Community trade now carried out "in-house" was formerly performed by customs agents, and was seen as a business overhead. It now appears as a direct cost in terms of staff time.

The conclusion one can draw here is that the abolition of tax-checks at frontiers has resulted in clear cost savings for firms; but also to some extent in a *shift* of costs within firms rather than in overall

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44 Summary of main results, p.5

45 *op.cit.* p.

46 see para. 4.5.1., page 10

cost reductions. And this partial falsification of expectations has given rise to some resentment - particularly in the case of firms which, no longer needing customs agents, have nevertheless been obliged to employ external agents in order to complete statistical returns.

Criticisms of the transitional VAT system therefore need to be examined with care. In each case, the following questions might be put:

- ♦ **Is the problem merely a temporary one, arising from the changeover at the beginning of 1993?**
- ♦ **If not, is the problem one that can be solved (or has already been solved) by an adaptation of the present system?**
- ♦ **If not, is the problem one which can be solved *only* by abandoning the present system and moving to one based on the origin principle?**
- ♦ **Or is the problem one which an origin system would *not* of itself remedy, but which could be corrected only by other major changes to the VAT system?**

3.6 Problems in obtaining information

Commissioner Scrivener's October 1993 report to ECOFIN referred to "the huge information campaign" which preceded the switch to the transitional VAT system. Both the Commission itself and Member States' tax authorities published guides for the use, in particular, of SMEs. Advice and information was available from the national VAT authorities themselves, and also commercially from tax accountancy firms and consultants.

Insufficient or late information has nevertheless been one of the more frequent complaints of operators. Though the purely domestic documentation and reporting requirements were apparently well explained and understood, the need for detailed knowledge of VAT legislation in *other* countries appeared to take many by surprise. The UK Customs and Excise evaluation, for example, reported businesses as saying that "many of their problems are tied up with the requirements in other Member States and not with the UK regime".

In part, this problem can be seen as purely transitional. In many Member States the VAT Directives introducing the new system were not transposed into nation legislation until the very last moment at the end of 1992. This meant in some cases that information on the details of the new laws were not available to firms until after they had come into effect.

In part, however, the problem is permanent. Whereas before 1993 traders selling to, or buying from, another Member State merely needed to account for VAT as goods left or entered their own country (though for services the system was already more complex), there are now numerous circumstances in which they can be subject to the VAT regimes of one or more others.

In addition - and in contrast to the previous system - traders also need to take into account both the structure and levels of VAT rates in all the countries with which they do business.

These problems have been exacerbated by the numerous discrepancies between Member States in the implementation of the same Community legislation. The German Country of Origin Report draws attention to several: the lack of a uniform legal status for tax representatives, different legal interpretations of "change of function" in the context of contract processing, different formats of VAT identification numbers, variations in the information required on invoices, differences in the periods covered by quarterly VAT statements, different rules on exchange rates, etc., etc.

The Commission study also notes the problems created through the choice by Member States of different tax thresholds for acquisitions by exempt legal persons, distance sales and VAT exemption for SMEs. In the latter case, an SME can be below the registration threshold in its home Member State, but find itself obliged to register for VAT in one or more others!

These discrepancies, like those arising from the pre-existing derogations and options provided for in the Sixth VAT Directive, can theoretically be corrected within the transitional system.

The fact that traders can find themselves subject to the VAT laws of more than one Member State is, however, inherent and on-going. The German study refers to the added costs arising from the need "constantly to update computer programmes and to adjust business operations in the light of changes in the law and tax rates in the Member Countries"[47]. Theoretically, indeed, the information requirements of firms are now fifteen times greater than before.

The consequences for one firm are described later in this study (see section 11.9).

3.7 Buying

These complexities are apparent to traders both in relation to their *purchases from other Member States* and to their *sales to customers in other Member States*. A key element of the system is the regular recapitulative statement to the tax authorities of intra-Community transactions.

The "two taxable transaction" principle means that a firm purchasing from a supplier in another Member State is liable for the VAT on the acquisition - assuming, of course, that the supply has been made free of tax. Although the legislation states that invoices "shall state clearly the price exclusive tax and the relevant tax at each rate as well as any exemptions"[48], the German Origin Commission observes that "in a number of Member States it is not compulsory to point out the tax exemption of intra-Community supplies in the invoice"[49]. Indeed, the legislation leaves it up to each individual Member State to determine whether a document can be considered an invoice at all![50] As a result, firms making intra-Community acquisitions incur the costs of examining incoming invoices with particular care.
In theory problems of this kind are entirely soluble within the context of the transitional system.

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47 *op.cit.* p.7.

48 Sixth VAT Directive, Article 22.3(b)

49 *op.cit.* p.16

50 Sixth VAT Directive, Article 22.3(c)

During the pre-1992 discussions on the system the possibility of a standard VAT document, separate from the invoice, was rejected as involving unnecessary duplication. The alternative is the development of standard-format invoices, physical or electronic.

3.8 Selling

The difficulties experienced by traders in relation to sales, however, appear to be more serious. Indeed, one aspect of the system about which there were already considerable reservations during the passage of the legislation is the requirement that traders should know the tax status of any customer in another Member State. In accordance with the "two taxable transaction" principle, a supplier is liable for the VAT on a sale unless it can be shown that the purchaser is a *bona fide* "taxable person", or falls into a category where input tax is payable by the purchaser.

To make this possible, the Commission notes that "a new mechanism central to the entire system has been introduced: that of identification for VAT purposes"[51]. Member States are required to issue a VAT number to every taxable person capable of carrying out intra-Community transactions. Those making supplies are then able to list the VAT numbers of those customers to which they have made untaxed supplies. The VIES system can be used to check on the accuracy of the numbers.

The German Origin Commission report nevertheless attributes much of the additional costs of the transitional system to "a host of inquiries aimed at determining and clarifying foreign turnover tax identification numbers"[52]. The Commission report itself surprisingly points out the limitations of the VIES system: "regarding the conditions of exemption for intra-Community supplies of goods, it should be noted that such verification is neither necessary nor sufficient to justify exemption of the supply transaction in question. In addition, such verification is merely a 'snapshot' of a purchaser's position at a particular moment and does not allow any conclusions to be drawn about his position before or after that moment"[53].

If in doubt, vendors are therefore obliged to invoice customers in another Member State tax-included (i.e. as if an origin system were already in operation), or risk having to pay the tax themselves. The Commission paper draws attention to a simple operation to which this situation can give rise. A firm in a country with a relatively high VAT rate purchases from a country with a relatively low one, *not* communicating any VAT number. The goods are then received as if by a final consumer, and disposed of through "parallel circuits of resale". The difference is pocketed.

Some of the difficulties experienced by traders in verifying the tax status of customers immediately after the transitional system came into effect were due to the late issuing of VAT numbers in certain Member States, and therefore only temporary. Improvements in procedures may make verification easier and less costly.
The main problem is, however, inherent in the transitional system. If goods are to be traded between Member States tax-unpaid, a control mechanism is needed to ensure that the VAT is eventually

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[51] COM(94)515, p.17

[52] *op.cit.* p.6

[53] *op.cit.* p.31

collected. Some burden of proof on the *vendor* is inevitable, even if this goes in the opposite direction from that intended in the creation of the Single Market by discouraging intra-Community trade. It is one area where adoption of the origin principle would be a clear solution.

3.9 Proof of departure

A further facet of the same problem is illustrated by another possible fraud. In this case, a purchaser acquires goods in the normal way from a seller in another Member State, giving a VAT number and being invoiced tax-exempt. He undertakes, however, to take physical delivery in the country of origin, arranging the transport himself to the country of destination. However, the goods never arrive. They are sold instead in the country of origin, untaxed.

Once again, the "two taxable transaction" principle means that the vendor can in these circumstances be liable for the VAT. The Origin Commission reports complaints that confirmation of goods' arrival "can frequently be received only subsequent to repeated written or oral reminders", and concludes that "following the elimination of controls at frontiers, the tax risks for suppliers have increased..."[54]. The Commission observes that some suppliers therefore refuse to sell unless they themselves carry out delivery or obtain proof of delivery by an independent haulier. This, in turn, can force honest purchasers who undertake transport themselves to register for VAT in the country of origin. "It is unacceptable", comments the Commission, "that the exemption or taxation of an intra-Community supply of goods should depend on the person assuming responsibility for the transport of the goods supplied..[55]".

In addition, there are variations between Member States as to what constitutes proof of departure. In the draft form originally discussed by ECOFIN's "*ad hoc* working party on the abolition of fiscal frontiers"[56], the transitional system would have required a copy of the invoice stamped by the tax authorities in the country of the recipient to discharge the supplier from potential tax liability. The final version, however, does not specify the documentary requirements.

It is true that this kind of fraud was also possible under the pre-1993 system, when goods de-taxed for export could "go missing" before departure. However, the physical controls at frontiers, combined with the need for customs documents, made this a difficult fraud to carry out.

As in the case of the need to verify VAT numbers, the root cause of the problem is that goods generally move between supplier and purchaser untaxed. The consequent need for proof of the right to exempt intra-Community supplies of goods is seen by the Commission as the first of the four "main difficulties encountered in applying the new rules".

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54 *op.cit.* p.14

55 COM(94)515, p. 30

56 See the "FISC" reports from the ad hoc group circulated by the Council secretariat during 1989/90.

4. THE SPECIAL REGIMES

The second feature of the transitional system identified by the Commission study as giving rise to difficulties is the existence of three "special regimes". In two cases these require the application of the destination principle instead of the origin principle when goods are sold to final consumers. The third requires the registration for VAT of bodies which would normally be exempt.

4.1 Distance selling.....

The first "special scheme" covers distance selling: not just the mail-order business and commercial sales by telephone or Minitel (and in the near future, presumably, to "electronic shopping malls" on the Internet), but any despatch of goods to a final consumer in another Member State.

During the discussions following the publication of the Commission's original tax proposals in 1987, it was widely recognised that mail-order provided a critical test-bed for the removal of fiscal frontiers. Even where VAT rates differed between countries, the scope for physical cross-border shopping after the ending of frontier tax controls would be limited by considerations of distance and product characteristics. Delivery by mail or courier, however, eliminated the distance factor. For consumers in higher-taxed countries the gain from paying a lower rate of VAT would almost always exceed packaging and delivery charges.

The initial response of the then tax Commissioner, Lord Cockfield, was that the consequent distortion of competition would end once VAT rates had been "approximated". As the chances of this happening receded, other measures had to be examined.

The experience of the United States, where tax controls at State frontiers do not exist, but where State Sales taxes vary, proved relevant[57]. Out-of-State purchases have in theory been made subject to "user taxes", the collection of which has however proved extremely difficult. Attempts have been made to limit the activities of mail-order firms to States in which they have "nexus" (i.e. in which they are registered for business).

The solutions chosen for the transitional system were similar. Rather than the application of a special tax, the VAT rate chargeable is in principle that of the country of the purchaser. To ensure that the tax is correctly collected, and paid to the Treasury of the country of destination, mail-order firms have also to register for VAT in all the countries in which they do business. If necessary, they have to appoint a local tax representative. However, this system only applies *once the level of sales in any particular Member State has exceeded a certain threshold* (see Table 1). But in the case of *goods subject to excise duties as well* (e.g. cigarettes), the special scheme *always* applies.

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57 See the paper by Michael A. Kuhn and Glenn W. White: "Examination of Differences in U.S. and State Local Taxation as they relate to Interstate Commerce" (INTERTAX, March 1986)

Table 1: VAT thresholds

Country	Distance Sales (ECU)	Non-taxable legal persons (ECU)
Austria	100 000	11 200
Belgium	35 000	10 000
Denmark	35 000	10 000
Finland	35 000	10 000
France	100 000	10 000
Germany	100 000	12 255
Greece	35 000	10 000
Ireland	35 000	41 600
Italy	35 000	10 000
Luxembourg	100 000	10 000
Netherlands	100 000	10 000
Portugal	35 000	10 000
Spain	35 000	10 000
Sweden	35 000	10 000
UK	100 000	57 500

Source: Commission

The Commission paper reports[58] that businesses have found this scheme so complex as to constitute a "real barrier to intra-Community trade". The German Origin Commission study refers specifically to the need for the constant monitoring of sales in relation to thresholds, and observes[59] that "if necessary, the entrepreneur must switch, in the course of the calendar year, from taxation in the country of origin to taxation in the country of destination".

Meanwhile, a *purchaser* from a firm in another Member State has no means of knowing whether the firm is below or above threshold, and whether the correct VAT rate is being charged.

The German paper also makes the significant point that the whole system can in any case be circumvented with ease. "At present, the Member State of destination has no possibility of supervising whether undertakings exceeding the supply threshold....have fulfilled the obligation of being registered." Moreover, "by distributing the activities among a number of affiliated enterprises it is easily possible to multiply the application of the threshold..."

58 *op.cit.* p.34

59 *op.cit.* p.9

4.2 .....or distance buying?

The system has recently been subjected to a more fundamental test. Lawyers are currently studying the implications of a commercial operation whereby cigarettes have been supplied to consumers in the United Kingdom from Luxembourg, with both VAT and excise duty being charged at Luxembourg rates. Final prices are up to 40% below those normal in the UK

The orders were solicited by a UK-based company, Tobacco Direct, which undertook to act as a purchasing agent. The goods were then bought from a Luxembourg-based supplier, with delivery taking place in Luxembourg itself. The UK-based company then arranged for carriage to the UK.

As far as the VAT is concerned, this is *not* a case of distance selling. The Commission makes it clear[60] that "a distance sale is defined as any supply of goods for which the transport operation is effected by the vendor or on his behalf. Hence it is sufficient for the transport to be provided by the purchaser *or on his behalf* for the special arrangements not to apply".

It is perhaps ironic - though not surprising - that the situation has arisen in the case of excisable goods. Not only was it intended that the full special regime should apply to these without thresholds, but the Commission made it clear in proposing Single Market legislation on the movement of excisable goods[61] that application of the destination principle would in this case not be transitional, but permanent.

The legal provisions as regards VAT may indeed be in conflict with those on liability to excise. Article 8 of the movement of excisable goods Directive limits the right to apply the origin principle in the case of excise duties to "products acquired by private individuals for their own use *and transported by them*". It was been on these grounds that the English High Court ruled on 26th. May 1995 that the use of an agent to arrange the transport of excisable goods on behalf of a purchaser did not avoid liability to UK tax.

Leave to appeal was granted on grounds of public importance, and the matter has now been referred by the Court of Appeal for a ruling by the European Court of Justice in Luxembourg.

4.3 Cars, boats and ’planes

The second special regime applies to certain "new means of transport". The original legislation defined "new" as meaning less than three months old, or having travelled not more than 3,000 kilometres in the case of land vehicles, 100 hour sailing in the case of boats, and 40 hours flying in the case of ’planes. At the beginning of 1995 this changed to six months and 6,000 kilometres in the case of land vehicles as a result of the "second-hand goods" Directive[62].

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60 COM(94)515 p.20

61 see COM(90)0431 and Directive 92/12/EEC of 25.2.1992 (OJ L76 of 23.3.1992)

62 94/5/EC of 14.2.1994, OJ L60 of 3.3.1994

The purpose of the regime is to ensure that all purchases of such means of transport, whether by a final consumer or not, are taxed in the country of destination. The Commission notes the difficulties inherent in applying such an arrangement[63]: "the risks of the acquisitions not being taxed or being taxed twice are not negligible".

The main control system in the case of most cars is the need for registration in the country of use, and this is certainly an effective deterrent to those hoping to save VAT by buying in a country of relatively low rates. Indeed the Commission observes that the "strongly dissuasive effect" of the complex formalities involved "is at odds with the objectives of the internal market and contributes to the continued existence of segmentation of distribution networks"[64].

4.4 Exempt purchasers

The special regime applying to "taxable persons not entitled to deduct input tax and non-taxable legal persons" - in effect, exempt bodies like hospitals, banks and public authorities - is a mirror-image of that applying to distance sales. Where mail-order firms are obliged to apply the destination principle when their sales are over a certain threshold, the exempt bodies are required to pay the tax when their *purchases* from other Member States exceed a threshold. These, too, vary between countries (see Table 1). The exempt bodies can, however, opt for registration and taxation in their own Member State whether they reach the threshold or not.

The problems are also a mirror-image. Companies selling to such an exempt customer in another Member State have no certain means of telling whether the purchaser is under or over threshold, and whether the goods should or should not be invoiced tax-unpaid. For the purchaser, the complexities of the system can amount to a deterrent to buying in another Member State, and hence a barrier to trade. It can also limit the extent to which public purchasing contracts are genuinely open to Community-wide tender.

The regime also applies in principle to those SMEs which fall below the level of turnover required for compulsory VAT registration (see Table 14). Since, however, the special regime thresholds are set at or above the level for VAT registration, the circumstances in which such SMEs are likely to find themselves obliged to register in their *own* country as a result of the special regime would be exceptional: for example, the purchase of capital equipment financed over a number of years.

4.5 Solutions

A number of measures might be taken to improve the operation of the special regimes. In the case of distance sales, the Commission report mentions two: revision of the arrangements concerning tax representatives; and the harmonization of thresholds[65]. In the case of new means of transport the

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63 COM(94)515 p. 36

64 *op.cit.* p.37. It should be noted, however, that the Commission itself can be said to contribute to the segmentation of distribution networks through the "block exemption" which these enjoy, and which has just been renewed.

65 *op.cit.* p.35

German Origin Commission suggests that, instead of charging the full VAT in the country of destination, the VAT paid on purchases in relatively low-taxed countries could be "topped up" to bring the total up to the destination country rate - in effect, the US "user tax" solution. Finally, the Sixth VAT Directive might be amended so as to reduce drastically the number of bodies exempt from VAT, or otherwise not enjoying the right to deduct input tax.

In general, however, it is difficult to disagree with former Commissioner Scrivener that "in the light of the further development of the Single Market, we can hardly put up with such special regimes for much longer"[66].

Abolition of the special regimes, however, would effectively mean application of the origin principle in these areas. All those final consumers and exempt bodies involved would have an immediate incentive to purchase in the country of lowest VAT rates. The consequences would be the distortion of competition as a result of the VAT-rate differences; and revenue would shift from the countries in which the purchasers were located to the countries from which the goods were bought - precisely those effects which the "special regimes" were set up to prevent.

Whether the special regimes can be abolished under *either* the present transitional system *or* under a system based on the origin principle is therefore likely to depend on the extent to which the rates of VAT converge or are harmonized.

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66 Communication to ECOFIN of 25.10.1993

5. THE TAXATION OF SERVICES

The third area of difficulty identified by the Commission's report on the transitional arrangements is the intra-Community supply of services. These are seen to arise not only from the introduction of the new system in January 1993, but also - indeed largely - from "applying the general principles of the Sixth Directive"[67].

Although one of the theoretical advantages of VAT over sales or purchase taxes is that it can be applied equally to goods and services, the taxation of services in an international context has always been a source of trouble.

5.1 Article 9

The Sixth Directive itself provides ample evidence of the fact. Article 9 states with apparent clarity that "the place where a service is supplied shall be deemed to be the place where the supplier has established his business or has a fixed establishment from which the service is supplied..". VAT should in consequence be charged at the rate prevailing in that country of establishment and accrue to that country's Treasury.

Article 9, however, then continues with a long and complex list of derogations and exceptions. In the case of work on buildings, the place of supply is where the building is located (Article 9.2.a). In the case of transport, it is where the journey takes place (Article 9.2.b). In other cases the place of supply is where the service is carried out (Article 9.2.c), except if the customer is VAT-registered in another Member State, when the place of supply is where that *customer* is established (Article 9.2.e).

The effect of this, as the Commission notes, "is to reduce the scope of the principle of taxation in the place where the supplier is established to the point where its application is marginal.."[68].

5.2 Services under the transitional system

The coming of the transitional system made only limited changes to these arrangements. When taxation was levied at the frontier, services ancillary to the delivery of goods - e.g. transport costs (see below) - were normally added to the taxable amount of the goods themselves. This will continue to be the case for imports from third countries, irrespective of the Member State into which the goods are imported and of the Member State of final destination[69]. In the case of internal movements of goods, however, any VAT-registered customer is now liable for the tax, unless the supplier of the service is registered in the same Member State.

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67 *op.cit.* p.37

68 COM(94)471, p.9

69 See second *"nettoyage"* Directive (COM(94)58) and OJ L102 of 5.5.1995

These arrangements, says the Commission, "are functioning in a satisfactory manner"[70]. Suppliers have only to find out whether their customers are VAT-registered; and, if so, whether the registration is in another Member State from their own.

Unfortunately, as the Commission also goes on to point out, there is a snag: these simple rules only apply when the service is ancillary to an intra-Community supply of goods. It reports those providing services such as loading and unloading being unable to discover whether this is the case, or to prove it.

Other complications exist in such fields as the carrying out of repairs, when the work can either be carried out on the spot, or the product moved to another Member State for specialist attention. Such services are normally taxable in the place where they are physically carried out (with consequences for the right of deduction of that tax which will be examined later).

In the case of contract work, however, the operation can in certain circumstances be treated as a supply of goods (see section 11.9). Effectively, this can apply when only two Member States are involved, although the Commission reports that "patient analysis...has made it possible to devise within Working Party 1 practical arrangements that will simplify many transactions"[71].

"Given the complexity of these taxation rules", the Commission nevertheless comments, "the interested parties do not yet seem to appreciate fully their implications."

5.3 Transport

Article 9.2(b) of the Sixth VAT Directive states that "the place where transport services are supplied shall be the place where transport takes place, having regard to the distances covered". As a statement of principle, this seems logical. As a basis for levying VAT it is virtually unworkable.

Applied *à la lettre*, it means that any journey across two or more Member States is taxed in "slices", corresponding to the distances covered on each territory. Each slice may be taxed at a different rate; and the revenue from each slice must be paid to a different Treasury. Transport operators must therefore register separately for VAT in all the Member States covered by journeys. Since the beginning of 1993, moreover, the abolition of checks at internal frontiers has made it impossible to monitor accurately the distances covered in each territory.

It is therefore not surprising, in the words of the Commission, that under the transitional system "another criterion..had to be found"[72]. By way of derogation from the general principle, the place of supply of transport services in the intra-Community transport of goods is determined by the rules applying to services in general, and outlined above.

In the case of passenger transport the situation is - again in the words of the Commission - "fairly

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[70] COM(94)515, p.37

[71] COM(94)515, p. 56

[72] COM(94)515, p.58

chaotic"[73]. Since attempts to tax "slices" of air or sea transport would obviously be futile, these are generally exempt throughout the Community; and a majority of Member States have given up attempts to tax "slices" of international rail, road or inland waterway journeys as well.

In other Member States, however, VAT *is* levied, generally at the reduced VAT rate. Operators are therefore theoretically obliged to divide up each fare charged according to the distances covered in each Member State, and pay VAT on the appropriate portions, at the appropriate rates, to the appropriate Treasuries. It is "a moot point", says the Commission, "whether these rules..are effectively applied.."

A general exemption for all such journeys would appear one obvious solution. However, since most Member States levy a positive rate of VAT on *internal* passenger transport - again generally at the reduced rate - there would be the obvious danger that competition would be distorted: for example, a coach journey taking place within a Member State would be taxed, one travelling the same route, but either starting or ending in another Member State, would not.

Article 28.5 of the Sixth Directive lays down that this situation shall end once the "definitive" VAT system is in place, when "passenger transport shall be taxed in the country of departure for that part of the journey taking place within the Community..." The Commission, however, came to the conclusion that the situation demanded earlier action, and proposed in 1992 a move to the "country-of-departure" principle[74].

Such a system would certainly make the taxation of passenger transport simpler and more enforceable; but it would not necessarily end distortions of competition. As the Report of the European Parliament's Economic and Monetary Affairs and Industrial Policy Committee[75] observed, there would be problems for "Member States which do apply standard rates and have as neighbour those States which apply zero- or reduced rates. This may incite carriers to fix the point of departure just at the other side of the internal frontier..."

The solution advocated by the *rapporteur* was "a common, uniform reduced or even zero-rate on passenger transport.."

The German Origin Commission rejected the country-of-departure principle entirely. Besides the danger of competition distortion referred to in the Harrison Report, it would "cause considerable additional burdens for the entrepreneurs concerned since they would have to register for turnover tax in every Member State in which they start a transport of goods or passengers"[76]. Instead, the report advocates a return to the principle of taxation at the place where the supplier has established his business, irrespective of where the service is carried out.

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73 *ibid.*

74 Proposal for a Council Directive amending Directive 77/388/EEC as regards the value added tax arrangements applicable to passenger transport (COM(92)416)

75 A3-0427/92, *rapporteur* Mr. Lyndon HARRISON (OJ C42 of 15.2.1993)

76 *op.cit.* p.44

5.4 Tour operators

It is not uncommon for problems and distortions in one sector of an economy to spread out into related sectors; and this is has inevitably occurred in the case of VAT on transport. Article 26 of the Sixth VAT Directive lays down a "special scheme for travel agents", under which "all transactions performed by the travel agent in respect of a journey shall be treated as a single service.." The taxable amount is "the travel agent's margin, that is to say, the difference between the total amount to be paid by the traveller, exclusive of value added tax, and the actual cost to the travel agent of supplies and services provided by other taxable persons.."

Problems have arisen, however, both because of differing applications of the Article by different Member States, and because of the variations in VAT rate applied to air transport. The commission paid to a travel agent who acts as an intermediary for an airline is generally based on the tax regime, in terms of territoriality, applied to the main activity (though this is not the case in France). The exemption, taxation at a zero rate or at a reduced rate of air transport thus "spills over" into the taxation of travel agents.

As a recent paper[77] from the European Tour Operators Association (ETOA) and the Group of National Travel Agents' and Tour Operators' Associations within the EU (ECTAA) has pointed out, however, the problem has "spilled over" further to create distortions of competition between consolidators and tour operators on the one hand, and air carriers and travel agents on the other. "Whilst the commission of travel agents is based on the same principles as that of the air carrier, the margin of consolidators and tour operators is subject the VAT regardless of destination".

The paper calls for the abolition of this distortion under the definitive regime, but correctly recognises that "no valid proposals can be put forward ...before agreement has been reached on the definitive regime applicable to air carriers".

5.5 Fundamental issues

It is clear from these examples that the problems of taxing services do not arise from the transitional system alone. Nor is the issue simply one of "origin" versus "destination".

One obvious answer to many of the current problems, for example, would a general application to all services of the German Origin Commission's recommendations in the field of transport. The whole of Article 9 of the Sixth VAT Directive would be deleted, apart from the first sentence. All providers of services would then invoice their customers from the Member State in which they were established, irrespective of where the customers were located.

This would have a number of consequences.

As in the case of a shift to the "origin" system, there would then be a competitive advantage for suppliers of services located in countries with relatively low VAT rates. This would cease to be a problem, of course, were rates to be harmonized.

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77 "The Taxation of Tourism in the European Union" (March 1995)

Were the customers to have the right to deduct the VAT paid, there would also be the problem of revenue-shift (see section 1.5). This might be accepted *without* a clearing mechanism; but it should be noted that the justification for doing this would be less obvious than in the case of goods, where "origin without clearing" can be justified in that the tax would accrue where the value was added. In the case of services a large part of any addition to value as a result of the service takes place in the country where the service is carried out - i.e. precisely where the tax currently accrues under the Article 9 derogations.

Finally - and irrespective of any shift from destination to origin - this would result in a new problem. While services would be taxed in the country of establishment, Article 8 of the Sixth VAT Directive makes transactions in goods normally taxable *in the country where the goods are located.* The discrepancy would be certain to cause problems - unless, of course the principle were to be applied to *all* transactions.

6. THE "PLACE-OF-ESTABLISHMENT" OPTION

A general application of the place-of-establishment principle would certainly also solve many of the more complex problems faced by traders in goods as well as services.

The current rules governing the place at which a transaction in goods takes place - and hence the rate and payment of the tax - were laid down at the very start of the Community VAT system by Article 5 of the Second VAT Directive[78]. The place of supply is defined as being where the goods are physically located when sold.

For the majority of simple one-to-one transactions, this presents no problems: a supplier sells, a customer takes delivery, and the VAT is paid in the country of destination. In the real world of commerce, however, matters can be more complicated.

6.1 Triangles....

Supposing, for example, that a particular product is sold by a manufacturer in one Member State to a wholesaler in a second, and then from the wholesaler to a retailer in a third. The "invoice trail" will run from the first country to the second to the third; and there will be no problems if the goods themselves do the same.

What happens, though, if the goods are delivered directly from the manufacturer to the retailer? No taxable transaction has taken place in the country of the wholesaler; and yet he must be liable to account for VAT somewhere. Does it mean that he must register for VAT in the country of the retailer as well as in his own?

This would indeed have been the case had it not been for the first "*nettoyage*" Directive of December 1992, which introduced a special simplified regime for such "triangular" transactions. The liability to account for VAT on the sale from wholesaler to retailer is in effect shifted from the former to the latter. The wholesaler needs to be registered for VAT only in his own country of establishment.

It was, says the Commission report[79], "a major source of satisfaction" that this simplification measure was already in place by the beginning of 1993. But it did not take some traders long to spot that the special procedure provided a useful tax loophole. Once a VAT-registration has been obtained in one Member State, it can theoretically be used solely for moving goods between other Member States. A ruling by the Irish High Court has found that an Irish VAT number cannot be withheld, even if a firm carries out only one transaction on Irish territory. "While this principle cannot be questioned", comments the Commission report, "there are grounds for asking how long such an identification number should remain valid...if it is used by the firm only so that it can participate in triangular transactions.."[80]

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78 67/228/EEC of 11 April 1967 (OJ 1303/67)

79 *op.cit.* p.61

80 *ibid*

6.2 ..and chains

Such transactions, by definition involving at most three firms and three countries, are nevertheless simple compared to many, particularly in the field of commodity trading. A particular consignment can be the subject of a whole "chain" of transactions, sometimes being transported to the country of the current owner, sometimes not.

A paper published in February 1994 by UNICE[81] gave an example of the complexities that can arise in the case of a chain with five links:

> "*1. An entrepreneur, (Entrepreneur A), registered in Italy, who is the original supplier of the goods. He has arranged and paid for the transport to France. (Subsequent sales are therefore on a carriage, insurance and freight paid basis).*
>
> *2. Before the goods leave Italy, Entrepreneur B acquires the ownership. He is registered for VAT in both Italy and Germany.*
>
> *3. Still before the movement of the goods commences, Entrepreneur C takes ownership. He is registered in Spain.*
>
> *4. Entrepreneur D now acquires the goods. He is registered in both Italy and the Netherlands.*
>
> *5. The goods now move to France where they are acquired by Entrepreneur E who is registered in France*."

This "simple five-entrepreneur chain" raised problems about the right to exempt supply, the taxation of the transport, the declaration of an acquisition, etc. These were made more difficult in that each link in the chain might only be aware of the two links "upstream" and "downstream", not the entire picture. Indeed, "a purchaser may..not wish his supplier to know where he is taking the goods in case the supplier identifies the customer and in future deals cuts him out".

Before the abolition of internal frontier controls, products which were the subject of such chain transactions were generally held under customs-controlled tax-suspension arrangements. With the abolition of customs controls at on the Community's internal frontiers, however, this could only apply to goods coming in from third countries. In the case of goods *within* the Community, each of the traders involved was in principle required to register for VAT and apply tax in the country where the transaction was taking place: i.e. where the goods were stored.

The UNICE paper examined a number of solutions, each based on unilateral simplification measures adopted in different Member States. It was tempted, in particular, by the German practice of determining the place of supply by reference to the place of establishment of the purchaser; and by the systematic shifting of the liability for tax onto the final customer in a chain.

However, it is the third solution which has now been adopted in the second "*nettoyage*" Directive:

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81 "Tax Treatment of Chain Transactions" (*Union des Confédérations de l'Industrie et des Employers d'Europe*)

extending the principle of VAT-suspension to warehousing arrangements other than those supervised by customs at the external frontier. This change will not only simplify treatment of chain transactions, but remove the distortion of competition in favour of imports (which could benefit from tax-suspension) as compared to goods traded solely within the Community (which could not). It will be in effect from the beginning of 1996.

The Commission report nevertheless makes clear its opinion that such remedies are, at best, only "patches" on a system which is fundamentally suspect. In general, it points out, the current rules governing the place of taxation of transactions "require traders to satisfy identification, declaration and payment obligations in every Member State in which they operate"[82].

6.3 Multiple registration

This requirement lies at the heart of many business complaints about the operation of the transitional system. For example, in its submission to the Commission on a definitive VAT regime, the European Computer Industry Tax Association points out that the kind of multinational companies that comprise its membership are anxious to treat the Community as a genuine Single Market in relation to their purchasing activities, the location of stocks, the issuing of invoices, etc. They face, however, not only "the enormous duplication of effort which is involved in setting up multiple VAT registrations", but the added complication that "the variety of VAT registration and representation procedures renders it impossible to develop standard processes and systems.."[83].

The solution proposed by ECITA is a "pan-European VAT registration", either through the mutual recognition by all Member States of registration in any one Member State, or a system of central Community registration[84]. This it would combine with the possibility of central accounting, so that VAT records did not have to be kept in - or transported to - each Member State for separate auditing.

Such a change would clearly cut down on some of the administrative burdens placed on companies. By itself, however, it would not remove the core problem, which is that payments have to be made to the separate tax authorities of each country in which the firm has a VAT liability. The fear is even expressed by firms obliged to enter into relations with a number of separate national VAT authorities that these relations will "spill over" into possible corporation or other direct tax liability, creating the danger of double taxation, complications with transfer pricing, etc. The total effect, particularly for SMEs, is a disincentive to trade at all.

ECITA envisages that, once the origin principle is adopted, and a clearing system is in place, companies operating in several Member States could submit a "multi-country VAT return". The correct revenues would then be passed to the appropriate national Exchequers centrally. Such an outcome, however, would only be possible were the clearing system to take a multi-lateral form (see

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82 *op.cit.* p.66

83 ECITA submission to the European Commission: "A Definitive VAT Regime" June 1995

84 Or perhaps every company should register for VAT in Ireland and make all transactions between other Member States "triangular"!

section 9.2.2), or were VAT to be paid directly into the Community Budget (see section 8).

Meanwhile, the need for multiple registration also has another undesirable effect: that multi-national companies operating global purchasing policies can find it cheaper and simpler to source supplies from *outside* the Community, using customs procedures, rather than from within the Community when this involves both supplier and customer registering for VAT.

Multinational companies with subsidiaries operating in a number of Member States can also find each subsidiary having to register separately in every Member State in which it carries out a transaction; or, alternatively, to make wholly unnecessary movements of goods out and back into the same country. One obvious simplification would be to allow such companies to use the VAT registration of the subsidiary in the country of the transaction.

The transitional system, it is true, does provide some alternatives to multiple registration. Under Article 21 of the Sixth VAT Directive, there is an option for Member States "to adopt arrangements whereby the tax is payable by another person". This can be "*inter alios*, a tax representative; or the person for whom the taxable supply of goods or of services is carried out.."

6.4 Tax representatives

Appointing a tax representative, says the Commission is: "a procedure which entails major difficulties and considerable costs"[85].

The German Origin Commission study observes that many of the problems "result from the fact that the conditions for designating a tax representative are different from one country to another and that there is no uniform legal status of tax representative for value added tax purposes.."[86] This was a matter which had indeed already been noted when the transitional system was adopted in 1992. The Commission at that time undertook to present a report on the implementation of the tax representative concept, and, if necessary, to make proposals for harmonizing legislation.

This report was published in November 1994[87]. Its principal conclusions were:

- that "the use of tax representatives was only one facet of the more general problem of determining the person liable for payment of the tax"[88]; and that

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85 COM(94)471 (see footnote 87)

86 *op.cit.,* p.7

87 "Common system of value added tax: arrangements for taxing transactions carried out by non-established taxable persons", Commission Communication and Commission Report to the Council and the European Parliament (COM(94)471 of 03.11.1994)

88 *op.cit.* p.3

♦ tax representatives were, in any case, "an inappropriate solution"[89] to the problem.

The difficulties encountered by traders were partly the result of the wide diversity of conditions and procedures for appointing tax representatives; and partly of the costs of the system: in particular, that the tax representative "passes on to the client the financial cost of the risk that he will be made personally liable for transactions about which the non-established taxable person has not warned him"[90]. The result was that "non established taxable persons - in particular SMEs - encountered many difficulties in finding persons prepared to act as their tax representatives". Some simply decided, as a result, not to carry out transactions in other Member States.

Nevertheless, concludes the report, these difficulties did *not* outweigh the advantages of the tax representative system compared to the alternatives. Besides enabling a firm to be represented by someone with local knowledge, it made possible the deduction of input tax in the normal way. This is not the case with the otherwise much simpler solution to the non-establishment problem: the shifting of the tax liability onto the customer.

6.5 The Eighth and the Thirteenth

Under the transitional system, there are a number of circumstances in which the customer is *always* liable for the payment of VAT on transactions: triangular transactions, intra-Community goods transport and ancillary transport services, the services of intermediaries and intangible services. To this can be added the optional cases. The advantage of the arrangement is that traders doing business in a country in which they are not established do not need to be identified for VAT there or make VAT declarations, either directly or through tax representatives.

However, as the Commission observes in its Communication, "they all regret having then to exercise their right to deduct under the refund procedure.."[91]. Even before the coming of the transitional system, the most common complaint about the European Community's VAT system concerned the delays experienced by firms established in one Member State in obtaining re-payment of input tax from the authorities of another[92].

The legal framework for transfers of this kind are contained in two VAT Directives: the Eighth[93], which covers such refunds in general; and the Thirteenth[94], which covers refunds to firms not established in the Community. These were adopted in 1979 (to come into effect in 1981) and 1986

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89 *op.cit.* p.7

90 *op.cit.* p.57

91 COM(94)471, p.58

92 As an MEP, I myself was regularly asked to intervene with the tax authorities of more than one Member State in order to speed up such payments.

93 79/1072/EEC of 6.12.79 (OJ L331 of 27.12.79)

94 86/560/EEC of 17.11.86 (OJ l326 of 21.11.86)

(to come into effect in 1988) respectively - not entirely in accordance with Article 17(4) of the Sixth Directive, which provided that the Council should "endeavour before the 31 December 1977" to lay down the necessary arrangements. Until then, each Member State determined its own refund methods; but discrepancies between national systems were giving rise to deflections of trade and distortions of competition.

The refund mechanism established by the Eighth Directive requires claimants to submit an application, attaching originals of invoices or import documents; produce evidence that he is a taxable person; and satisfy complex time-scale criteria[95]. In principle, the claimant should get the money after six months; even so, as the Commission points out, "given the refund delays, (traders) are compelled to prefinance the tax over lengthy periods[96]". Adding insult to injury, the Directive also states that bank charges for a transfer shall be payable by the applicant.

In practice, at least one Member State (Ireland) avoids the costs this procedure creates for both firms and tax administrations by waiving liability to VAT in cases where the result would be an Eighth or Thirteenth refund application. Why, then, is a refund mechanism needed at all?

Supposing, for example, that a trader neither established nor with a tax representative in a particular Member State sells a product (which, of course, is already in that country - otherwise it would be a normal intra-Community supply) to a registered customer there. The first problem is the *payment* of the VAT due on the transaction.

Were the place-of-establishment principle to apply, the tax would be paid in the country where the seller *was* registered. When the customer came to deduct the sum as input tax, however, the money would be in the "wrong" national Treasury - the vendor's Member State would be gaining revenue, the purchaser's would be losing. A systematic application of the place-of-establishment principle would indeed lead to movements of VAT revenue from countries of consumption to countries in which firms were established; and this would be aggravated were firms to take the logical step of locating themselves in countries with relatively low tax rates.

One alternative is to designate the *customer* as liable to pay the tax. This solves the revenue problems of the Member State in which the transaction took place. It does, however, create another: what happens when the seller comes to deduct *his* input taxes? There are at least three possible answers:

a) To give no right of deduction. The result would be an element of tax "cascading".

b) To allow the seller to deduct input tax in his own Member State. In that case there would be a transfer of revenue from the *vendor's* Member State to that of the purchaser.

c) The seller could try to obtain a refund of the input tax from the Member State in which the transaction had taken place - the solution provided for in the Eighth Directive.

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95 see Articles 2 and 7 of the Directive

96 COM(94)471 p.58

6.6 Defining an establishment

If the place-of-establishment principle is to be introduced, it will be necessary to define clearly a firm's "place of establishment". Were the principle to be applied *à la lettre*, this would be its head office within the Community, from which all invoices would be issued and all VAT accounted for.

In its examination of the option[97], however, the German Origin Commission observes that, at least in cases of supply of goods, "the unadulterated place of business model" would have to be modified. It was "nearly inconceivable" that any Member State would allow business to be carried out on its territory, untaxed, by branches of a firm operating out of another Member State. The separation of jurisdiction would make controls over the operation of the VAT system extremely difficult without very much closer administrative co-operation between national tax authorities.

Apart from the company HQ, therefore, each "fixed establishment" of a firm in other Member States would have to be treated for VAT purposes as a separate place of business. But what *is* a "fixed establishment"? Definitions do exist for the purposes of direct tax, which the Origin Commission believes are "too restrictive for turnover tax purposes".

Earlier the study examines one possible definition: "a branch, an office, a factory or a workshop, as well as a building site or construction or installation project lasting longer than twelve months"; but *not* "storage facilities, exhibitions or marketing facilities, buying organisations or advertising and research facilities". This it also rejects as inadequate. "Fixed establishments" would have to include all "small selling units, consignment stores and other outside stores". Even street traders coming across a frontier from a relatively low-taxed country would have to be included.

Defining "fixed establishment" in such a way would probably remove most of the dangers of unfair competition and revenue-shift. Unfortunately, it would also go some way to defeat the objective of the system: the avoidance of multiple VAT-registration. It could hardly be applied to most services; and there would also be general problems in determining which particular part of a company should account for VAT on particular transactions

One way out of this dilemma would be to define as a separate establishment only those branches which sell to final consumers. The result would be that all such final sales would continue to be taxable in the country where the goods were located or the service was carried out. Transactions between registered traders, however, would be taxable in the country where the company head office was established.

Even such a system would nevertheless involve problems of both competition and control. By ensuring that invoices were issued in countries with relatively low VAT rates, firms could improve the cash-flow position of their customers (see section 1.6).

In addition, as a discussion paper prepared by the UK Customs and Excise[98] notes, "a system based on multiple establishments would have to be combined with an obligation that tax on supplies must be accounted for at the establishment in that Member State (if applicable), independent of where

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97 *op.cit.* p. 27 and p.49

98 "VAT definitive system: discussion paper" (UK Customs and Excise, 1979)

the invoice is issued. This means that *goods* trails would have to be followed for transactions from Member States where there is an establishment and *invoice* trails for those where there is not".

6.7 Conclusions

An examination of the problems faced by non-established traders under the present transitional system therefore leads to a number of conclusions.

- First, the long-standing provision that transactions are located, for VAT purposes, at the place where goods are situated or services supplied lies at the root of many of the their problems.

- Secondly, none of the currently-applied remedies

  : registration for VAT in all the countries where a trader operates;
  : the appointment of tax representatives; or
  : the transfer of tax liability to the customer

  is entirely satisfactory.

- Thirdly, the systematic application of the place-of-establishment principle to transactions of in both goods and services would provide a solution to these problems.

- Fourthly, however, it would create others

  : the transfer of revenue between Member States;
  : distortions of competition as a result of differing VAT rates; and
  : problems in defining "establishments".

In theory, the place-of establishment principle could be applied under *either* a destination *or* an origin based system. Two of the main problems - transfer of revenue, and the need to align VAT rates - are nevertheless identical to those associated with a full move to origin. For this reason, place-of establishment is generally considered an option only when an origin-based system is in place (for example, by the German Country of Origin Commission).

Under two conditions the pure place-of-establishment principle, like the full origin principle itself, could clearly be applied without difficulty: that VAT rates were harmonized; and that the Community became a single fiscal area, with all revenues accruing to the same Treasury - the "federal" option.

7. THE VAT RING OPTION

Before considering the arguments for such a move, however, it is worth examining one further problem of the current VAT system. This is the tax treatment of goods which move between Member States, though without a change of ownership.

7.1 Goods owned by individuals

Before 1st. January 1993 *all* such movements were in principle subject to VAT controls as they crossed internal frontiers. At one time, it was even considered advisable when taking a camera or tape-recorder on holiday to take the receipt as well; otherwise one risked being stopped by customs and charged VAT a second time when bringing the equipment home!

Goods over the value of the 45 ECU "travellers' allowance" which *had* been bought in another Member State were liable for VAT on importation, whether VAT had already been paid on purchase or not. In practice, most shops would sell to tourists VAT-free, classifying the goods as exports (and giving rise to many possibilities for fraud). Alternatively, VAT could be reclaimed when one left the country in which it had been paid.

Happily, all this came to an end with the arrival of the Single Market.

The same kind of problems faced individuals travelling on business who needed to take items of equipment or trade samples with them. It was necessary to go through complex procedures to classify and control such goods as "temporary imports".

Likewise, special arrangements were necessary in the case of certain goods permanently taken into another Member State: personal and household effects when moving house; goods imported on the occasion of marriage; personal property acquired by inheritance; the "school outfits, scholastic materials and other scholastic household effects" of students studying abroad; "imports of negligible value" (i.e. 10 ECUs); horses not more than six months old born to mares which had been temporarily exported to give birth; etc., etc. Under Article 14(1)(d) of the Sixth VAT Directive, all these were in principle exempt from VAT as they moved across internal frontiers. However, an examination of the legislation by which the scope of the Article was clarified[99] indicates that the issues were anything but simple.

These problems, too, have now largely ended for individuals.

7.2 Transfers within firms

This is not, however, the case for firms: for example, a company wishing to move a piece of equipment from an establishment in one Member State to an establishment in another. Within the transitional system, under the new and cumbersomely numbered Article 5(5a)(b) of the Sixth

[99] Directive 83/181/EEC (OJ L195 of 23.04.1993); Directive 85/346/EEC (OJ L183 of 16.7.85); Directive 88/331/EEC (OJ L151 of 17.6.88): and Directive 89/219/EEC (OJ L92 of 5.5.89).

Directive, they must be "treated as supplies of goods effected for a consideration".
The justification for this provision is much the same as for the special regime covering exempt legal persons. Any firm with branches in both relatively high VAT-rated and relatively low VAT-rated countries would otherwise have every incentive to buy equipment for use in the first branch *via* the second. As in the case of bodies like banks and hospitals without the right of deduction, the result would both be a distortion of competition as a result of tax levels, and a shift of revenue away from the country of consumption.

Yet for firms attempting to treat the Community as a genuine Single Market the requirement appears irritating, not to say absurd.

Such "deemed transactions", moreover, do not merely occur when office equipment or furniture is being moved. Raw materials, parts for assembly or stocks of finished products within the ownership of the same company or group or companies are taxable when transferred from one Member State to another.

The problems caused by the system are illustrated by the treatment of goods sent on consignment. These are products which are sent to a distributor for sale, but remain in the ownership of the dispatcher until a buyer has been found. Despite this, goods sent on consignment to another Member State are treated as a VAT-able supply; and the owner is also required in principle to register in the country to which the goods are dispatched in order to account for the tax there.

7.3 Tax-free Rings

The opinion of traders on the "deemed transaction" system is reflected in a paper from the EC Committee of the American Chamber of Commerce in Belgium[100]. The conclusion is not only that there should be a move to the full place-of-establishment principle for both goods and services, but also that all "transfers of goods and services between branches or permanent establishments of the same legal entity" should take place outside the scope of VAT altogether.

Moreover, this is not just the opinion of large multi-nationals. The administrative burdens created - for example, the need to include such transactions in the monthly recapitulative VAT statement - are aggravated by differences in national law. As the German Origin Commission study observes, in Germany and some other Member States every supply of goods to a firm's own stock in another Member State is treated as an intra-Community supply. In other Member States, under certain conditions, it does not. The result of the legal uncertainties is that "..small and medium-sized undertakings doing subcontracting work are priced out of the market by the cost increases in the distribution channels."[101]

It is estimated that transactions between companies already linked in a group, or related in some other way, account for over 80% of all intra-Community trade. Removing them from the VAT system would considerably reduce costs both form the firms concerned and for tax administrations. In particular, were there to be change to the origin principle, the operation of any clearing

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100 "The Definitive VAT Regime", September 1994

101 *op.cit.* p.9

mechanism would become a great deal easier. This was indeed the opinion of the Commission when it produced its revised proposals on clearing in 1989 (see section 9.3)

Were such a change to be made, a definition of a "group" for VAT purposes would be necessary. Certain Member States already operate a VAT-exemption system of this kind within their own tax area, which could be extended to intra-Community transactions. In the UK, for example, firms are eligible to be treated as part of a group for VAT purposes if one controls the other, or if both are controlled by the same third party.

But there is no need for the principle to stop there. The AMCHAM paper goes on to advocate the possibility of creating "pan-European VAT Groupings" (otherwise known as "tax-free rings") within which companies could associate for VAT purposes. The VAT regime applied could then take one of two forms:

- *Liability* to VAT could be ended entirely on transactions between such companies. Only when the products left the ring, which would usually be for final consumption, would there be any need to account for tax.

- Alternatively, accounting for VAT would continue, but *payment* would be suspended until products left the ring.

Such a system would not only reduce costs. Tax would generally continue to accrue in the country of final consumption without any de-taxing/re-taxing as goods crossed internal frontiers.

7.4 The drawbacks

On the other hand, allowing the creation of tax-free rings would raise certain problems. The alternative making the greatest cost savings - that is, ending all *liability* to VAT, with no further requirement to include such supplies in VAT returns or summary listings - would also undermine the "self-policing" characteristic of the VAT system, as movements of goods could no longer be monitored by the tax authorities.

Collecting accurate statistics on trade between Member States would also become a problem. The cost savings made as a result of excluding such supplies from the VAT system would be nullified if they nevertheless had to be included on Intrastat returns. Were they excluded from both, the Intrastat system itself would become of only limited value. The best option in such circumstances might then be to abolish Intrastat altogether - which many might consider no bad thing in any case - and rely on sampling techniques.

A third problem would be potential distortions of competition were firms taking part in a ring to enjoy cost advantages over those which did not. It might be expected that larger companies, already operating on a Community-wide scale and already with establishments in two or more Member States, would be able to benefit immediately. It would take time and expense for smaller companies to find foreign partners and integrate into pan-European groupings.

Some way of integrating Small and Medium-sized Enterprises into the system would nevertheless be important. Certain large industries - for example, motor manufacturing - are increasingly operating on a Community-wide basis, with SMEs in different Member States acting as sub-contractors for the large design, assembly and distribution firms. Any VAT-

suspension system would have to apply to all such supplies if competition were not to be distorted in favour of vertically-integrated companies.

As against this, it can be observed that such grouping for VAT purposes already exists *within* Member States without creating unacceptable distortions of this kind. In addition, it could be argued that confining the suspension of VAT liability to genuine groups (defined, perhaps, as in the UK) would encourage the creation of true European companies**.** Such a development would fit in well with the eventual adoption of a European Company Statute.

7.5 Back to a *régime suspensif ?*

Supposing, however, that *all* companies, large and small, were eventually to find themselves within a grouping. Trade between Member States would effectively take place outside the VAT system, while tax would be levied only at the stage of release for final consumption. The destination principle would apply intact; but the system would be less like VAT as we know it and more like the pre-1948 *"régime suspensif"* in France (see section 1.1).

In default of the European Community becoming a single, integrated tax area, this outcome has its attractions. A recent paper by the European Centre of Enterprises with Public Participation[102] observes that "piecemeal payments systems, which may be suitable in a restricted economic area, appear to be unsuitable for trade carried out within a continent".

Put more precisely, the system of "fractional payments" which led to Maurice Lauré's *Taxe sur la Valeur Ajoutée* only operates efficiently when revenues are paid into a single Exchequer. Where tax at different stages has to be paid into separate Exchequers, the costs of administration outweigh the advantages of revenue-receipts at each stage.

Opponents of a return to a *régime suspensif* are nevertheless right in arguing that such a move would effectively destroy VAT as we currently know it. The logical outcome would be to go one step further and replace VAT altogether by a single-stage Sales Tax - the option examined in section 2.5 of this paper.

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102 "Definitive VAT System" (*CEEP opinion, CEEP.95/AVIS 7, June 1995)*

8. THE FEDERAL OPTION

The most complete solution to the problems of taxing transactions involving more than one Member State would be to make the Community, at least for VAT purposes, a single fiscal area. The full **origin principle** would be applied to all intra-Community transactions, defined on **place-of-establishment basis**. VAT-registered sellers would invoice all customers within the Community with VAT included; and VAT-registered purchasers would be able to deduct this as input tax.There would be **a single structure of VAT rates** throughout the Community. The VAT-base would be harmonized, with an end to the current options, exceptions and derogations provided for in the Sixth VAT Directive. There would be a single Community VAT rate or rates. Finally, all **revenues** from the Community VAT would be paid into the Community Budget.

In such circumstances, fiscal frontiers would genuinely cease to exist. There would be no need for special regimes, fiscal representatives or complex arrangements to deal with services and chains. Firms would be able to treat sales to another Member State in *exactly* the same way as domestic sales. Value Added Tax would become a "federal" tax in much the same way as it now is within Germany. Such a proposal of course raises serious economic and political issues.

8.1 Fiscal consequences

On average, Value Added Tax currently accounts for about 18% of Member States' total tax revenues. Transferring these resources to the Community Budget would theoretically necessitate either an equivalent cut in national expenditures or an equivalent increase in other taxes.

In practice, the fall in national revenues could be offset in a number of ways. The money might be immediately rebated to Member States on the basis of a fixed formula. Or equivalent transfers could be made through the Budget itself: for example, through structural and cohesion funds. Alternatively, the Community might assume full responsibility for certain areas of public expenditure currently falling within the national domain (the transfer likely to result in the greatest overall savings would probably be defence procurement).

The consequences of the "federal VAT" option for national fiscal policies, however, go far beyond the issue of gross revenue transfers. During the discussions on the Commission's 1987 tax proposals, a report from the European Community's Economic Policy Committee[103] drew attention, in particular, to two.

8.1.1 Counter-cyclical policy

The first would be a limitation on Member States' ability to raise or reduce tax levels in general: i.e. a reduction in "the room for manoeuvre in cyclical policy". As compared to other taxes, VAT can be a particularly useful fiscal instrument, since the effects of a change in rates on revenue are immediate and calculable. A number of points can be made in answer.

First, it is a matter of both academic and political controversy whether fiscal stimulation or

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[103] Report to Council and Commission, 6 April 1988 (II/066/2/88)

contraction are effective counter-cyclical policies at all. The Economic Policy Committee report itself also noted that "scarcely any use was made of changes in VAT in most countries in the past as an instrument of cyclical management". An examination of alterations to Member States' VAT rates over the last twenty years or so (see Table 5) certainly bears this out in general terms, although it is perhaps possible to identify certain exceptions (for example, the application of VAT to domestic energy supplies by the UK in 1993).

Finally, the reduction in the ability of Member States to carry out counter-cyclical policy would be partly compensated for by a new ability to use the Community Budget for the same purpose. Under current conditions, a recent study[104] assumed that "no explicit Community-wide stabilization role" could be foreseen for the Community Budget, which amounts to a little over 1.25% of GDP. The addition of VAT revenues would increase this to not far off 10% of GDP - a figure once identified[105] as the minimum necessary for the conduct of meaningful fiscal policies.

Table 2: EC budgetary and national VAT receipts, 1994

	ECUm.	**% of EU GDP**
EC Budget	72 366	1.26
VAT receipts, EU total	426 615	7.5
TOTAL	498 981	8.76

Source: European Economy no.58 1994

8.1.2 The balance of taxes

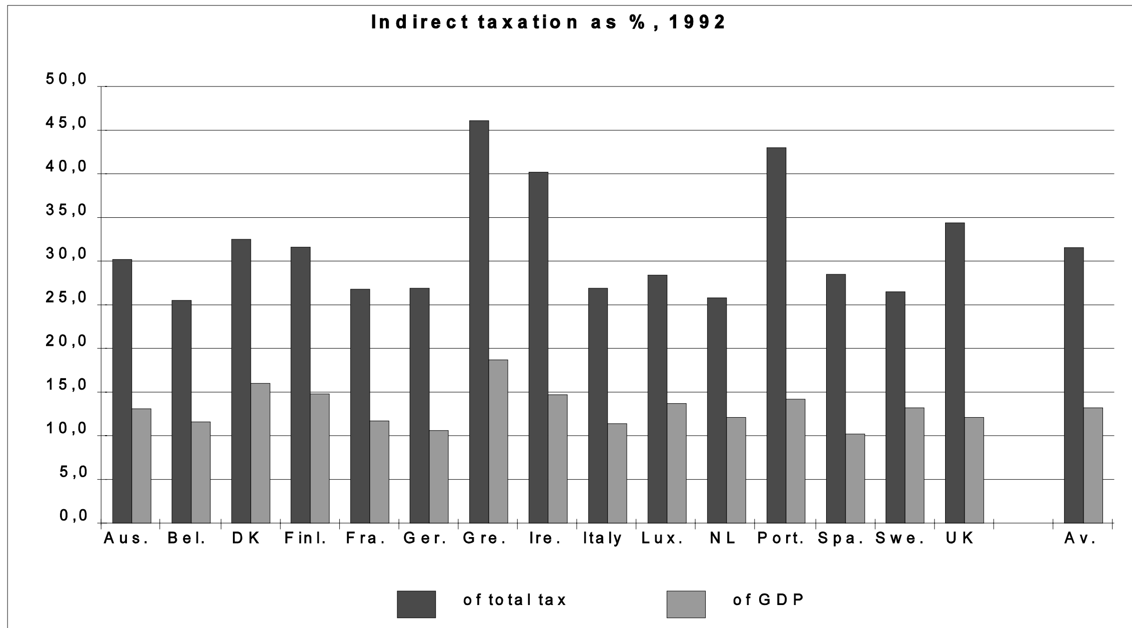
A more serious consequence for Member States' fiscal policies would be the restriction on the choice of tax instruments. Not only would Member States no longer benefit directly from the revenues from VAT which, being linked to general consumption, are remarkably buoyant. In addition, they would no longer be able to change the rates of VAT. As the Economic Committee report observed, "scope for increasing tax revenue in order to finance public expenditure will increasingly have to be sought in the field of direct taxes or social security contributions. This may create serious problems in some cases". The problems would be that much more acute in that the role of both indirect taxes in general, and VAT in particular, varies between Member States (see Tables 3 and 4). In the words of an official French report of 1988[106], "the tax system of each country is the often complex product of national characteristics, in which economic, social and political factors play a part."

104 "Stable Money - Sound Finances: Community public finance in the perspective of EMU" (European Economy no.53, 1993)

105 by the McDougall Report to the Commission of 1977: "Report of the Study Group on the Role of Public Finance in European Integration"

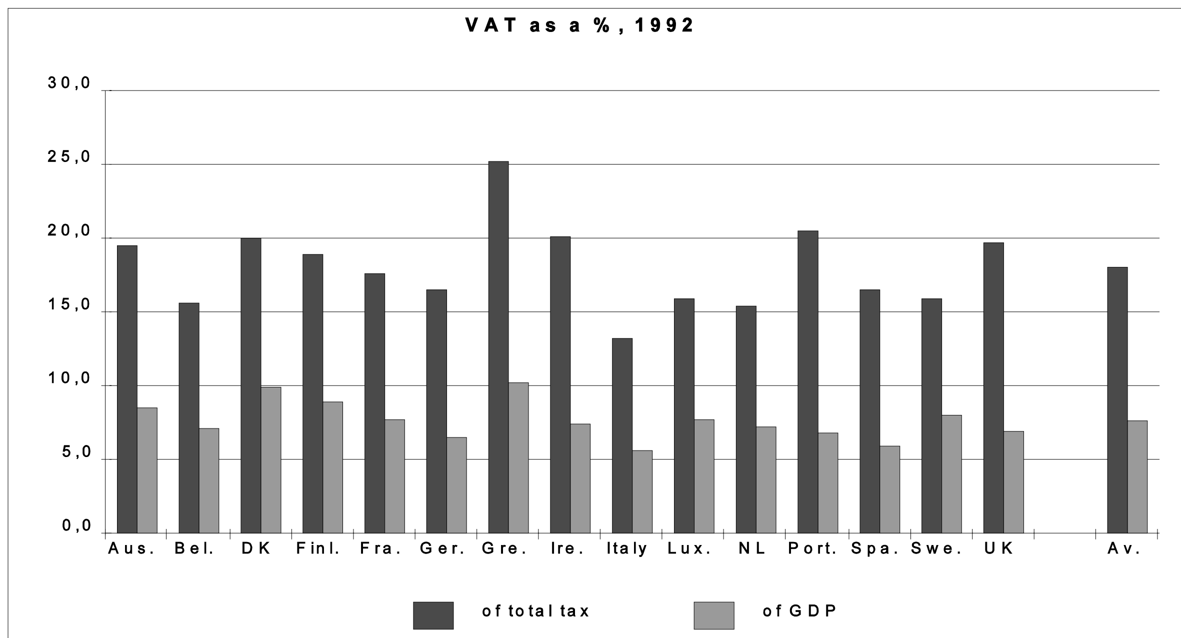
106 "*Fiscalité et marché unique européen*" by Boiteux and Achard (Ministère de l'économie, des finances et de la privatisation 1988)

Table 3



Source: OECD

Table 4



Source: OECD

Table 5 shows, however, that over the last twenty years there has been a gradual convergence in the proportion of total tax accounted for by general consumption taxes, now VAT in all Member States, particularly since the early 1970's. It is likely that this convergence of tax systems will naturally continue within the context of the Single Market and later of EMU.

Table 5: General consumption taxes as a proportion of total tax, 1965-92

Country	1965	1970	1975	1980	1985	1988	1989	1990	1991	1992
Austria	18.7	18.5	19.8	20.1	21	20.6	21.1	20.8	20.3	19.5
Belgium	21.1	21	15.9	16.8	15.4	15.9	16.3	16	16.1	15.6
Denmark	9.1	18.8	16.9	22.2	20	20.1	20.3	20.7	20.4	20
Finland	18.5	19.3	16.8	18.7	19.6	21.2	21.8	20.6	19.6	18.9
France	23.3	25.5	23.4	21.1	20	19.6	19.2	18.8	17.8	17.6
Germany	16.5	17.1	14.6	16.6	15.8	15.6	15.5	16.6	16.5	16.5
Greece	10.3	16.8	18.3	13.2	17.2	25.5	24.8	26.4	25.9	25.2
Ireland	5.7	13.1	14.7	14.8	20.6	20.7	21.6	20.6	19.9	20.1
Italy	12.9	13.2	14.3	15.6	14.5	15.2	14.1	14.7	14.3	13.2
Luxembourg	12.4	10.3	12	10.8	12.9	13.8	13.6	13.9	14.9	15.9
Netherlands	12.4	14.6	14.4	15.8	16.2	16.5	16.3	16.5	15.6	15.4
Portugal		8.4	11.2	16.2	12.6	20.3	20.1	19.6	18.9	20.5
Spain	22.2	20.3	15.3	10.2	14.7	17.1	16.7	16	15.9	16.5
Sweden	10.4	10.3	12	13.4	14	13.4	13.6	14.9	16.7	15.9
UK	5.9	6.5	8.8	14.4	15.2	16.7	16.7	16.5	18.6	19.7
Average	13.3	15.6	15.2	16	16.6	18.1	18.1	18.2	18.1	18
Standard dev.	5.63	5.09	3.5	3.36	2.79	3.2	3.3	3.2	2.85	2.85

Source OECD

8.2 Political consequences

Turning VAT into a federal Community tax raises two basic questions of fiscal sovereignty:

- who is to decide the structure and levels of VAT rates? and
- how is the allocation of the revenue to be determined?

One answer to the first question already exists under current VAT legislation. The amended Article 12 of the Sixth VAT Directive covers both the provision for reduced rates and the setting of a 15% minimum for the standard rate, and was adopted by unanimous decision of the Council under Article 99 of the Treaty. Paragraph 3(a) of Article 12 further states that, on the basis of a Commission Report, "the Council shall decide unanimously before 31 December 1995 on the level of the minimum rate to be applied after 31 December 1996 with regard to the standard rate". Article 28.2.(g) likewise calls for a Council decision, on the basis of a Commission report, on the coverage

of reduced VAT rates. The reports were duly published at the end of 1994[107].

An interesting feature of this procedure is that it involves the Commission and Council, but not the European Parliament. Were it to form the model for deciding upon harmonized tax rates within the definitive VAT regime, the European Union would become perhaps the only democratic polity in the world where tax rates could be determined *without* the consent of the tax-payers' directly-elected representatives. It is worth recalling that the British King, Charles I, was beheaded in 1649 for operating just this system; and that the United States of America declared independence from Britain because one of his successors, George III, tried the same.

A more technical objection to the procedure is that it could easily lead to paralysis. It is conceivable that an initial structure of VAT rates could be set, after long and determined negotiations. Given the need for the unanimity, it is difficult to see how changes could thereafter be made within a normal budgetary cycle. This would certainly result in VAT rates being stable over a period of years; and it is an open question, in any case, how far Member States are free to vary tax in the face of global market forces (an issue discussed further in section 10.9). But such stability would, *ipso facto*, rule out use of the tax as a counter-cyclical fiscal instrument.

As far as decision-taking procedures are concerned, two solutions suggest themselves:

8.2.1 Amendment of Treaty Article 99

The Single European Act of 1987 significantly changed the text of Article 99 of the EEC Treaty (see section 1.4), in particular linking the harmonization of indirect taxation to the establishment of the Single Market. However, though new Article 100a introduced weighted majority voting in Council for the bulk of Single Market legislation, the principle of unanimity was retained in Article 99. Further changes to general - especially Single Market - legislative procedures were made in 1993 as a result of the Maastricht Treaty. Article 99, however, remained as it was.

The Inter-Governmental Conference in 1996 will provide another opportunity for reform. In the field of legislation, almost all the accumulating evidence points to a need for simplification, greater clarity and a reduction in the multiplicity of separate procedures. Ideally, this could result in the use of the Article 189b (co-operation) procedure for all Single Market legislation, including the harmonization of indirect taxation.

It is clear, however, that a number of Member State governments are currently unwilling to accept the possibility of being outvoted on a matter of "vital national interest", and that taxation is considered just such an interest. Recent thinking has in any case been developing the concept of a legislative "hierarchy", with appropriate procedures for adopting general policies, framework legislation, implementing legislation and derived regulations and instruments. Generally, unanimity would be required for major changes, various majorities for derived legislation.

Such a hierarchical system would imply unanimity in Council for the adoption of the taxation system; but majority voting on tax rates. Unfortunately, it is precisely the loss of the ability to fix

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107 Report from the Commission to the Council in accordance with Articles 12(4) and 28(2)g of the Sixth Council Directive of 17 May 1977 on the harmonization of the laws of Member States relating to turn-over taxes - Common system of value added tax: uniform basis of assessment (COM(94)584 final, 13.12.1994)

tax *rates* that most alarms national governments and parliaments. As far as Finance Ministers are concerned, *how much* revenue is raised is generally of greater importance than *how* it is raised; while the power of parliaments traditionally rests on trading the "granting of supply" for the "redress of grievances".

Nevertheless, Article 99 might be usefully revised so that rules implementing the general principles outlined in the Sixth VAT Directive could be adopted by weighted majority voting in Council. This could both unblock many of the subsidiary Directives now before Council (see sections 11.3 to 11.8) and prevent discrepancies arising in the application of the Community VAT system in different Member States. A proposal to this effect has been made by the Chairman of Parliament's Committee on Economic and Monetary Affairs and Industrial Policy. [108]

8.2.2 The Community's Budgetary Procedure

Within the narrow limits set by the overall budgetary ceilings fixed by the Edinburgh European Council in 1992, Parliament can partly determine the level of Community revenue by partly determining Community expenditure. Parliament and Council are, jointly, the Community's budgetary authority, with Parliament responsible for the Budget's formal adoption.

The budgetary procedure is outlined in Article 203 of the Treaty.

- ♦ The Commission draws up a *preliminary draft budget* on the basis of estimates from each Community institution.
- ♦ On the basis of this text, the Council adopts the *draft budget* by qualified majority, and forwards it to Parliament
- ♦ Parliament can amend the "non-obligatory" section of draft budget by a majority of current Members, and modify the "obligatory" section by majority of votes cast.
- ♦ Council can modify Parliament's amendments, and accept or reject Parliament's modifications, by weighted majority voting.
- ♦ Finally, Parliament can re-affirm its amendments by a majority of its Members and three-fifths of the votes cast, and declare the Budget adopted; or, alternatively, reject the Budget as a whole by a majority of Members and two-thirds of the votes cast.

This model is not perfect - in particular the distinction between "obligatory" and "non-obligatory" expenditure is artificial and superfluous. As a procedure for establishing tax rates, however, it would clearly be a considerable improvement on that contained in the existing VAT legislation. Initially at least, the procedure could continue to be based on estimates for expenditure, which would include rebates of VAT revenue to Member States. The VAT rates for the coming financial year would then be set to cover this expenditure - a system of the most stringent fiscal rectitude. As the system developed, however, it might prove politically acceptable to budget for surpluses or deficits, depending on the requirements of overall fiscal policy.

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[108] Opinion for the Committee on Institutional Affairs, *rapporteur* Karl VON WOGAU MEP (PE212.319)

A system for determining VAT rates based on the present budgetary procedure would also provide an answer to the question of revenue-allocation. Initially at least there would have to be a strong element of *juste retour*. Depending on political acceptability, this might be modified over the years to allow expenditure patters to be determined more by overall policy priorities, irrespective of the Member States in which the expenditure was actually made. The pace of development would depend on the political development of the European Union itself.

8.3 Compromise options

The economic and political issues raised by proposals to make VAT a federal Community tax bear strong similarities to those already being debated in the context of EMU. Indeed, there are arguments for introducing the definitive VAT system and a single currency at the same time, as two elements of economic union.

As in the case of the single currency, however, it is extremely unlikely that the agreement of all Member States can be reached within the time-scale foreseen by existing legislation: that is, 1997. Even in 1999, it is probable that the ECU will be the single currency of only some Member States. A "multi-speed" system, however, is not an option for VAT.

It is therefore worth considering some alternatives which, though retaining the "federal" character of VAT, would go less far than the pure model outlined above. A considerable body of literature already exists on the problems and options for VAT within a federal system, particularly in relation to the many proposals that have been made for a federal VAT or sales tax in the United States. A detailed analysis of them can be found in Chapter 8 of Alan Tait's IMF study. Those most applicable to the European Community would be:

8.3.1 The German model

The simplest alternative to dealing with VAT entirely through the Community's budgetary procedure would be to rebate fixed proportions of the revenue to Member States, in the same way that VAT revenue is re-allocated to the German *Länder.* This could be done on a strictly statistical basis (e.g. in proportion to population, to GNP, to consumer spending, etc.), which would make the system very similar to the simplest form of VAT clearing mechanism (see section 9). As in Germany, there could be redistribution to States with low *per capita* national incomes.

8.3.2 A Community VAT plus national VATs

The Community VAT would be levied at harmonized rates and the revenue would be paid into the Community Budget. In addition, Member States would also be able to levy a separate, additional VAT. The tax base for these would be the same for the Community and all national VATs; but rates could differ. Solutions would be needed to a number of problems.

First, could *both* Community and national VAT be deducted as input tax? This would be possible *within* Member States. In the case of transactions involving more than one Member State, however, exactly the same problems of competition and revenue transfer would arise as in the case of the existing VAT.

Were the national rates to vary only marginally - which would be likely if they were set at rates akin to US State sales tax - this might be tolerated. Alternatively, the right of deduction might be confined to the Community VAT, making the national VATs, in effect, gross turnover taxes.

Or, finally, *both* Community and national VAT might be deductible *within* Member States; but only the Community VAT would be deductible on intra-State transactions. This is similar to a proposal already in circulation of raising the existing "Community rate" - which is zero - to the present minimum national rate of 15%. This is examined further in section 9.6.

8.3.3 A Community VAT plus national sales taxes.

This was the system favoured by the Neumark Report (see section 1). It is important to recall, however, that Neumark recommended that VAT should *not* itself be levied at the retail stage.

If VAT continued to be charged on retail sales, retailers would in effect have to account for two separate taxes on each sale. If it were not, the VAT base would shrink considerably, and the self-policing nature of the tax would be diminished by the removal of the last stage. Indeed, the advantages of the system might be little greater than the abolition of VAT altogether.

9. THE ORIGIN OPTION

There is a presumption within existing VAT legislation that, sooner or later, intra-Community supplies must take place tax-included. Article 35a of the Sixth Directive defines the "definitive" system as being "based in principle on the taxation in the Member State of origin of the goods or services supplied". From the First VAT Directive onwards the legislative texts refer to the aim of abolishing de-taxing/re-taxing in trade between Member States (see section 1.4).

For example, the derogation which allows the United Kingdom and Ireland to retain a zero VAT rate on certain basic goods derives from Article 17 of the Second VAT Directive. "Exemptions with refund" are permitted for "clearly defined social reasons and for the benefit of the final consumer", but only until "the abolition of the imposition of tax on importation and the remission of tax on exportation in trade between Member States".

The Commission's first - and so far only - attempt to implement these provisions has been described in Section 1. In summary, it failed for four basic reasons:

- the assumption that revenue from VAT should accrue to the country of final consumption, and that revenue shifts as a result of a move to origin should be avoided;
- a reluctance, nevertheless, to accept any of the mechanisms then proposed for "clearing" revenues back to the countries of consumption;
- a fear that competition would be distorted without a harmonization of VAT rates; but
- resistance on the part of Member States to the necessary ceding of fiscal sovereignty.

Any new proposal to introduce and origin principle must therefore aim to change the first factor *or* the second; *and* also change the third factor *or* the fourth.

9.1 Origin without clearing

If the first assumption could be changed, moving to the origin principle would be extremely simple. As in the case of a "federal" VAT, traders would be able to account for the VAT on transactions within the Community in exactly the same way as transactions within their own Member State. The need for the separate identification of acquisitions from, and supplies to, other Member States would end.

The consequent revenue shifts between Member States would depend (as explained in Section 1) both on the net flows of trade and on the structure of VAT rates. The Commission's estimates based on 1986 figures[109] assumed harmonized VAT rates of 16.5% (standard) and (6.5%) reduced. No figures were given for flows assuming the *actual* VAT rates then applying in Member States, which varied considerably: in addition to standard and reduced rates, several countries also applied "luxury" rates (see Table 10).

On this basis, the approximate gains/losses in revenue in 1986 would have been:

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[109] Annex A to COM(87)323 of 5.8.87

Table 6: gains/losses of revenue under origin, 1986[110]

Member State	gain/loss (ECUm.)	As a % of GDP
France	- 2 421	-0.34
Belgium/Luxembourg	747	0.62
Netherlands	1 509	0.86
Germany	3 534	0.38
Italy	-147	-0.03
UK	- 1 845	-0.33
Ireland	-52	-0.21
Denmark	-680	-0.82
Greece	-437	-1.08
Portugal	-77	-0.26
Spain	-132	-0.06

Source: COM(87)323

Origin without clearing at that time would therefore have produced serious revenue losses for France, the UK, Ireland and Portugal, and very serious losses for Denmark and Greece.

The latest year for which dependable intra-Community trade statistics are available is 1992, after which the Intrastat system came into use. On the basis of harmonized VAT rates harmonized at the then Community average of 18% (standard) and 6% (reduced), approximate equivalent figures might have been:

110 The Commission figures were presented in the form of net receipts from (+) and net payments to (-) the clearing system. Table 6 reverses the positive/negative to show the position *without* clearing.

Table 7: gains/losses of revenue under origin, 1992

Member State	gain/loss (ECUm.)	As a % of GDP
France	- 1 100	-0.11
Belgium/Luxembourg	150	0.08
Netherlands	2 550	1.03
Germany	1 700	0.11
Italy	-600	-0.06
UK	-650	-0.08
Ireland	700	1.8
Denmark	400	0.36
Greece	-950	-1.58
Portugal	-900	-1.38
Spain	-1 300	-0.29

Sources: COMEXT, EUROSTAT

The positions of Ireland and Denmark would both have improved significantly, while those of Greece and Portugal would have deteriorated.

At present, however, VAT rates are not harmonized. Standard rates vary between 15 and 25%, and reduced rates between 0% and 13%. Accurate calculations of revenue loss as a result of moving to origin without clearing would require detailed figures of trade flows classified by liability to different rates in each Member State - i.e. to the kind of figures required for the operation of a clearing system. Two broad assumptions can nevertheless be made:

- ♦ countries which charge relatively high VAT rates, and apply reduced rates to a small proportion of transactions, would make extra gains in revenue as compared to what might be expected from the trade flows; and

- ♦ countries which charge relatively low rates, and apply a reduced or a zero rate on a high proportion of transactions, would make correspondingly disproportionate losses.

Origin without clearing would therefore produce pressures for the harmonization of VAT rates in an *upward* direction, and for broadening the tax base. This would perhaps counteract any pressure for competitive rate reductions.

9.2 Origin with clearing

The Commission's 1987 tax proposals did not, however, envisage moving to a VAT system based on the pure origin principle. Its initial working document on a possible VAT clearing mechanism took it as "given that the total tax charged on goods must continue to accrue to the country of final

consumption (for national budgetary reasons and in accordance with the principles of VAT as a general consumption tax)"[111].

In this light, VAT with clearing can be seen not so much as a full move to the origin principle, as the ending of de-taxing/re-taxing while *preserving* the principle of destination.
The establishment of a clearing mechanism requires solutions to a number of issues.

9.2.1 The basis of calculation

For any pair of Member States (*A* and *B*), the revenue to be cleared between them will be **the net balance between the totals of VAT charged by suppliers in each country to customers in the other**: *vA-vB*. A country may have collected a "surplus" either because it has a positive trade balance with the other, or because it charges higher rates of VAT than the other (see section 1.5).

Equivalent figures can also be derived **from the net balance of claims for deduction of input tax made by firms in each country on purchases from the other**: *dA-dB*.

In practice, both sets of figures will be used. Each Member State will calculate separately the **total of VAT charged by suppliers *less* the claims for deduction by purchasers**: *vA-dA* and *vB-dB*. The "deficit" country will then make a claim for compensation; the "surplus" country will state how much it thinks it owes*: (vA-dA)-(vB-dB).*

In theory, all methods of calculation should come out with much the same result. For a variety of reasons this is improbable. Some are technical: the treatment of purchasers without the right to deduction, differences in the timing of VAT returns, exchange-rate fluctuations, etc. A significant factor, however, is likely to be what been called the "asymmetry of enforcement".

The system of VAT control in each country depends on ensuring that claims for deduction of input tax by a purchaser are not conceded unless there is evidence that the tax has been paid by the vendor. If input tax is deducted but not paid, revenue suffers. In inter-state transactions, however, two different revenues are concerned. In the environment of a clearing system, each country optimises its revenue by *underestimating* VAT charged to customers, and *overestimating* input tax deducted by purchasers.

For this reason, the German Origin Commission report outlines an extremely thorough procedure for resolving differences in sums claimed and sums offered[112]. Since errors in calculation might occur within the jurisdiction of either Member State, "the only equitable solution appears to be placing the burden of differences equally on both Member States".

9.2.2 Bi-lateral or multi-lateral?

The German Origin Commission's proposal is for a system based on bi-lateral clearing: that is, each

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[111] COM(87)323, p.2

[112] *op.cit.* pp.61-76

Member State would need to determine its own net position, and reach agreement, in relation to every other. In a Community of fifteen Member States, this would require, in total, the establishment of 210 net positions, and 105 separate agreements.

The solution envisaged by the Commission in 1987, however, was multi-lateral: each Member State would need to establish its own net position only in relation to a central account. "Net exporting countries would be required to pay into the account and net importing countries would receive payments from the account"[113].

Originally, the Commission proposed that clearing would be calculated entirely from Member States' figures for deduction of input tax on purchases from other Member States (the *dA-dB* basis). It was eventually decided that this provided too narrow a basis of control, and that figures for tax charged on supplies should also be used. The final version of the working document therefore based clearing on Member States' net position (the *(vA-dA)-(vB-dB)* basis).

Such a system would clearly reduce dramatically the number of separate calculations needed. Instead of a Member State needing to establish separate figures for VAT on supplies to, and purchases from each other Member State (a series for country A $v_b - d_b$, $v_c - d_c$....$v_o - d_o$, a similar series for country B, and so on), each country would need only to calculate the total for VAT on supplies to all other Member States and the total for deductions of VAT for purchases from all other Member States: $v_{b..o} - d_{b..o}$.

This proposal for multi-lateral clearing met a number of objections, of which the first was political. The proposal required Member States "to provide to the Commission Services a monthly statement indicating its total VAT input and output figures for intra-Community trade for the month in question". The Commission would necessarily become directly involved in the administration of VAT, supervising and managing the clearing account, co-ordinating the investigation of complaints and monitoring the control checks. Despite effective retention of the country of consumption principle, the system would therefore affect national fiscal sovereignty.

More important, perhaps, were doubts about the feasibility of accurate accounts. It was the contention of the Commission that "the abolition of zero-rating for intra-Community exports will in itself extend the self-policing nature of the domestic VAT system to the intra-Community level. Under the new system traders will have a positive incentive to declare their purchases in other Member States in order to reclaim the input tax incurred.[114]" In addition, there would be "an inbuilt automatic self-checking characteristic", in that the clearing operation would be in permanent surplus (see below), and changes in the surplus could be used to monitor error trends.

Given the "asymmetry of enforcement" problem, however, others doubted whether the controls envisaged by the Commission would be adequate. The European Parliament's *rapporteur*, Karel de Gucht, envisaged the situation in which "requests for reimbursement" might "exceed total payments received", and therefore recommended an initial "float" from Member States[115].

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113 COM(87)323, p.6

114 *op.cit.* p.11

115 Explanatory Statement to the Report drawn up on behalf of the Committee on Economic and Monetary Affairs and Industrial Policy, 14th.December 1988 (A 2-314/88)

The *rapporteur* for the Economic and Social Committee, Mr. Della Croce, observed that the gains in simplicity achieved by multi-lateral clearing would be offset by "a total lack of transparency in bilateral trade between two given Member States"[116]. While giving general support to the Commission, it was the opinion of Parliament that any multi-lateral clearing mechanism should "undergo a trial period of at least one budgetary year"[117].

Both the Parliament and ECOSOC reports also observed that no system of multi-lateral clearing would be practicable without a high level of mutual trust between Member States. It is likely that an essential feature would have to be a thorough procedure for dealing with disputes, similar to that outlined by the German Origin Commission in relation to bi-lateral problems. This would inevitably be extremely complex.

As against this, the administrative burdens on *enterprises* would be very much greater under a bi-lateral system (and assuming clearing based on VAT returns) than under a multi-lateral system. As the German Origin Commission report concedes, "it adds somewhat to the burdens of entrepreneurs that....transactions to another Member State shall be recorded separately for each Member State". [118]

9.2.3 Handling exempt purchasers

Whether the VAT clearing system is bi-lateral or multi-lateral, an important consideration will be which transactions are included and which left out.

For example, the treatment of purchases by bodies *without* the right or with only a partial right of deduction is likely to be critical. In the Commission's 1987 model each Member State would be contributing all the cross-frontier VAT charged on intra-Community sales; but claims on the system would relate only to the input tax claims of VAT-registered traders able to deduct input tax. Hence the projected permanent surplus in the central account. In order that this revenue should also be cleared to the country of consumption, the Commission envisaged "that this surplus will be distributed periodically to the Member States", on a basis which was to be examined further.

In the German Origin Commission model, such revenue would be cleared to the Member State of consumption as part of the mechanism itself. However, given that there would be by definition no figures for input tax deduction, an element of guess-work would be required. The study quotes a 1989 Commission estimate that "approximately 1.5 to 6% of the intra-Community supplies of goods are carried out to private end-consumers who are not entitled to deduction and to public authorities"[119]. Adding to this supplies of services, and the effects of the Single Market (in particular the opening up of tendering for public contracts), "it appears quite realistic to assume that this

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[116] Opinion of the Section for Economic, Financial and Monetary Questions, 24th.May 1988 (CES 1217/87; ECO/107)

[117] Resolution of DE GUCHT Report, paragraph 9.

[118] *op.cit.* p. 97

[119] *op.cit.* p.65

turnover will make up approximately 8 to 10% of total intra-Community turnover". This figure would then represent an acceptable "margin of deviation" between claims by Member States of destination and estimates for payment by Member States of origin.

A third solution would be to modify the "special regime" established for non-registered traders under the transitional system. Under this, purchasers without the right of deduction are currently required to register and themselves pay VAT at their domestic rate on the zero-rated purchases, over a certain threshold, from other Member States (see section 4). With a change to the origin principle, these purchases would be taxed at the rate of the country of supply. The purchasing body could be required to register and declare this tax as input tax - though, since the trader would otherwise be exempt, there would of course be no tax liability from which this actually could be deducted.

9.2.4 Final consumers and distance sales

Since the origin system *without* clearing is already in effective operation for normal purchases by final consumers, it would now be unreasonable to attempt any integration of these into the clearing system. The 1987 Commission proposal *did*, however, envisage including "mail-order sales between Member States". The German Origin Commission went further in including all "supplies of goods dispatched or transported to end consumers without any threshold", as well as "all supplies of new means of transport" and transfers of goods within undertakings[120] (these would be included in the 8-10% "margin of deviation"). Only "goods collected by private persons from other Member States" would be excluded.

Both the de Gucht and Della Croce reports, however, questioned the inclusion of mail-order in clearing. It could only be effective through a continuation in some form of the current much-criticised "special regime" (see section 4.1), with fiscal agents remaining responsible for declaring input tax. De Gucht observed that a distance sale was basically of the same type as a shop-sale to non-resident, "the only distinction being *the responsibility for transporting the goods* from the vendor's premises to the consumer's residence".

Distance selling, in any case, is primarily an issue of competition rather than revenue-attribution (see section 4.5). Consequently, solutions should be found in the area of VAT rate approximation rather than of clearing.

9.3 Micro or Macro clearing?

Both the Commission's paper of 1987 and the German Origin Commission report proposed that the data for clearing would be drawn from traders' VAT returns. Each Member State would obtain its net position in relation to the system "by aggregating all the VAT charged by registered persons on sales to other Member States and all the VAT input tax claimed by them on purchases made in other Member States"[121] (i.e. *vA-dA).*

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[120] 9 *op.cit.* p.5

[121] COM(87)323, p.6

The compilation of such "micro-economic" data would of course only be feasible if there were to be a continuing requirement for businesses to monitor and list supplies to, and acquisitions from, other Member States, either collectively or individually.

In other words, traders would still have to treat sales to customers in other Member States differently from sales within their own Member State. Though "fiscal frontiers" would have been abolished as far as the *tax rates* shown on invoices were concerned, they would continue in respect of how the invoices would have to be handled.

Both for this reason and in order to reduce the overall cost and administrative complexity of clearing, various proposals have been made for collecting the necessary data from other sources.

Following the criticisms made of its initial proposals, the Commission itself suggested in its "new approach" paper of 1989[122] a "macro-economic approach to the clearing operation, which would present appreciable operational advantages..." To make this "politically acceptable", it would be necessary to reduce substantially the number of transactions covered by clearing. This, the Commission suggested, could be achieved primarily by enabling the intra-Community sales between enterprises linked within the same group to take place without VAT being applied. The arrangement could also be extended to associated small and medium-sized firms. "Macro-economic" clearing, in sum, would become feasible following the adoption of the "tax-free ring" option outlined in section 7.

Data for macro-economic clearing might be drawn from a number of sources.

9.3.1 Trade statistics

In the "new approach" paper, the Commission itself proposed that clearing should take place on the basis of the statistics for trade between Member States. Besides resulting in a relatively light administrative burden on firms and tax authorities, this would also solve the technical problems of dealing with bodies without the right of deduction. However, "an essential condition of such a system would be the maintenance of a high quality statistical system in the Community..."[123]

Before the 1st. January 1993, statistics on intra-Community trade, like those for trade with third countries, were compiled on the basis of customs documents. Since these were linked to the physical passage of goods across internal frontiers, the results could be relied upon, over a period of time, to give a reasonably accurate picture of trade flows. Since the abolition of tax controls at internal frontiers, however, the collection of statistics on trade between Member States has depended on declarations by firms through the Intrastat system. So far, there have been some doubts about the accuracy of the results.

Those firms required to make Intrastat declarations are in any case having to make use of much the same data as are required for the current system of VAT returns. For these, the administrative

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122 "Completion of the Internal Market and Approximation of Indirect Taxes"; Communication from the Commission to the Council and to the European Parliament (COM(89)260 of 14.6.1989)

123 *op.cit.*, p.9

burdens involved in "macro-economic" clearing would not be much different from those resulting from a "micro" system. As the German Origin Commission study points out, trade statistics could not be a reliable basis for clearing unless they distinguished clearly the tax status of supplies, including the rates of tax charged. In addition, the statistics would also have to cover fully supplies of services.

"*As matters stand today*", the report concludes, "*a clearing procedure on the basis of the data of the internal trade statistics does not yet appear to feasible*"[124].

It is nevertheless possible that a refinement of the trade statistics system could one day provide such a basis. The Origin Commission suggests that a "macro" system based on the trade figures could be established in parallel to a "micro" based on VAT returns. Starting with "guesstimates" such as those in Tables 6 and 7, the methodology could then be refined until there was a high and consistent degree of congruence between the two sets of figures. At that point, the "micro" system could be dropped.

9.3.2 VAT own resources basis

Every Member State is already obliged to calculate, for the purposes of financing the Community Budget, the product of a uniform VAT rate applied to all its domestic taxable transactions: that is, its national figures for taxable consumption. These calculations are based on actual VAT receipts, and other national economic performance data. Could these figures not also provide an extremely simple basis for clearing?

Unfortunately, there are problems. The national VAT base currently includes both imports and acquisitions from other European Community Member States, but not exports or supplies to other Member States. Following a switch to the origin principle, acquisitions from other Member States would *not* form part of the base, but supplies to other Member States would. In order to derive figures for net national consumption both these figures would have to be quantified, producing exactly the same problems as would exist in the case of clearing based on trade statistics.

In addition, there is still some way to go before the VAT base is fully harmonized (see section 11.2). The German Origin Commission also observes that national accounting systems would also need to be harmonized, "in particular with a view to covering the shadow (i.e. "black") economy"[125].

In other words, the same doubts would exist about the figures as a basis for clearing as prompted the Edinburgh summit in 1992 to downgrade the VAT element as a source of own resources.

9.3.3 National consumption figures

National taxable consumption figures could, however, be established without reference to VAT own resources. Once trade with third countries was excluded, it would then be possible to estimate net movements between Member States, on which clearing would be based. Those with consumption

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124 *op.cit.*, p.88

125 *op.cit.* p.88

figures higher than production figures would be claimants; those with higher production than consumption would be contributors.

The German Origin Commission considered that such a system might be realised "in a rather distant future". Meanwhile, however, the lack of any uniform statistics on production and consumption within the Community made it impractical.

9.3.4 Sampling

One option not examined by the German study, however, is to base clearing on the systematic sampling of intra-Community transactions. The methodology would be the same as for "micro" clearing: that is, it would be based primarily on the VAT returns of companies. Unlike the full "micro" system, however, only a limited number would need to be considered.

To this data would be added the results of sample surveys of final consumers and of bodies without the right of deduction.

To begin with, it is unlikely that the figures produced by such a system would prove an acceptable basis for clearing. As in the case of the Intrastat figures, however, the results might initially be checked against those derived from full "micro" clearing, and sampling techniques gradually improved. Once a high degree of congruence between the full figures and the sample figures was being systematically obtained, the latter could be accepted as the sole basis for the clearing mechanism.

9.4 Conclusions on clearing

The establishment of any VAT clearing system will involve a trade-off between *accuracy* and *simplicity*.

The most accurate figures will be obtained by the system proposed by the German Origin Commission study: that is, bi-lateral clearing on the basis of full VAT returns. This system will also place the greatest administrative burden on companies and national VAT authorities, since it will involve the former in keeping separate records for transactions with each Member State, and the latter in establishing, in total, 210 net positions.

The simplest system would rely only on figures for intra-Community trade or national consumption; and clearing would be multi-lateral. Given the current lack of harmonization in the statistical bases, such figures would be broad aggregates, with relatively wide margins of error.

Initially, the only basis for clearing likely to be acceptable to Member States is that producing the highest degree of accuracy. The proposals of the German Origin Commission therefore provide a plausible foundation for a move to origin with clearing.

At the same time, preparations could be made for replacing such a system with one placing fewer administrative burdens on companies and tax authorities. In addition to the full system, two multi-lateral "shadow" systems might be established:

- **one based on intra-Community trade statistics; and**

- **one based on sampling techniques.**

The results from these would be compared to those obtained from the full system, until a sufficient degrees of systematic congruence was established for the latter to be replaced.

9.5 The right of deduction

In addition to the establishment and operation of a clearing system, a move to the origin principle - in the sense that suppliers would invoice customers in other Member States tax-included - will present certain other problems. One, to which the German Origin Commission report draws attention, is the handling of such invoices by the customer for the purposes of input-tax deduction.

In the case of transactions *within* a particular Member State, the number of alternative tax rates on invoices is limited to those in force there: a standard rate; one or more reduced rates (including a possible zero rate); and, of course, an exempt supply. When tax-included invoices can come from any one of the fifteen Member States, however, the number of possible rates rises to twenty-seven (0, 1 ,2 , 2.1, 2.5, 3, 4, 5, 5.5, 6, 7, 8, 10, 12, 12.5, 13, 15, 16, 17, 17.5, 18, 19, 20, 20.5, 20.6, 21, 22 and 25), plus exempt supplies. How is the customer to know that the right rate is being charged for that particular supply?

There are also legal problems. Are disputes concerning an invoice to be settled under the law of the Member State where it issued and where the tax is to be paid, or under the law of the Member State where the right of deduction is exercised? When a new product comes onto the market, how are discrepancies between Member States in its classification to be handled?

The issuing of an incorrect or fraudulent invoice creates legal problems not only for the supplier, but also for the purchaser. Article 21 of the Sixth VAT Directive requires anyone who issues an invoice specifying VAT to pay the stated tax, whether the supply is made or not, and whether the issuer is VAT registered or not. This is in order to prevent the purchaser deducting the sum as input tax without it ever having been paid in the first place.

However, the Court has also ruled[126] that a purchaser does *not* have the right to deduct the tax stated on a fraudulent or incorrect invoice. At present this situation can only arise within a single Member State; but after a switch to origin such invoices might come from anywhere within the Community. Checking that the tax shown is correct will place an extra administrative burden on purchasing companies.

The German Origin Commission report suggests a number of measures to mitigate such a problem. The first would be to standardise invoices (see also section 3.7). The second would be for purchasers to use the VIES system in order to check the tax status of their *suppliers*. The system of VAT identification numbers would therefore have to continue. But its role would be the reverse of the one it now has under the transitional system, which is to enable companies to check the tax status of their *customers*.

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126 Judgement of 13.12.1989 (Case C-342/87)

9.6 Some "half-way houses"

Given the political problems involved both in establishing a clearing system and in harmonizing VAT rates (see sections 1.5 and 1.6), a number of ideas have been advanced for "half-way houses" between the destination and origin principles.

For example, one possible way of reconciling an at least partial move to the origin principle with continuing variety in rates might be the creation of **a special "intra-Community" VAT rate**. In effect, the present mechanism of intra-Community supply and acquisition would be retained; but supplies to taxable customers in other Member States would be taxed at a common, positive rate - for example 10% or 15% - rather that at zero, as at present.

Such a system would have a number of advantages over both the transitional system and a pure origin-based system. Since goods would no longer move between Member States untaxed, as at present, the scope for evasion and fraud would be reduced. At the same time, all invoices, from whatever Member State and whatever the product, would bear the same rate of tax. Revenue-clearing would still, of course, be necessary; but the operation of a clearing system would be that much simpler in that all intra-Community transactions would take place at the same rate. Member States' net positions would no longer be a function both of trade balance and of relative VAT rates, but only of trade balance. "Macro-clearing" would become more feasible.

Such a solution, however, would leave several of the more important problems unanswered. For example, the tax rate to be applied in those areas covered by the special regimes would still be an issue, since the "Community rate" would cover only transactions between VAT-registered traders. Moreover, if the system would have some of the advantages of both the destination and origin principles, it would also have some of the defects of both.

The establishment of a clearing system would still be necessary, even if it could be somewhat simpler. Yet the principle benefit of the origin system - that suppliers could treat customers in other Member States in exactly the same way for VAT purposes as domestic customers - would still be largely unrealised. Only if the Community rate were identical to the national standard rate would this be the case (for example, for Germany and Luxembourg were the rate 15%) and then only for standard-rated supplies. Traders in other countries would find little advantage in applying the special Community rate over applying the existing zero rate.

The alternative would be a ghastly system of invoice-splitting, with the customer's right of deduction limited to the Community rate, anything extra probably having to be recouped through the Eighth VAT Directive procedure.

It is true that the creation of a such a Community rate would itself promote the alignment of rates, to the extent that there would be advantages in setting national standard rates at the same level (see above). This would, however, raise the tricky issue of the level at which the Community rate should be set. Since it would apply to all transactions, including those lower-rated by most Member States, should it be set *below* the minimum national standard rate (say 10%)? Or should it be set *at* the minimum standard rate (15%)? Or perhaps at the *average* or *weighted average* standard rate (19% or 17.5%), obliging some Member States to tax intra-Community supplies at a higher rate than domestic supplies? Each choice would affect relative competitive positions differently.

A further alternative system, which would avoid the need for clearing, has recently been advanced by Prof. F. Vanistendael of KU Leuven in an article intriguingly entitled "**A proposal for a**

Definitive VAT System: Taxation in the Country of Origin at the Rate of the Country of Destination" (see footnote 10, page 8). This system would involve two essential elements:

- firms making supplies would invoice their customers in other Member States tax-included, *but at the rates applying in the customer's country*; and

- firms making such supplies would pay the VAT collected *to the tax authorities of the customer's country.*

Such a system, however, would have some severe defects. In essence, it would generalise the mechanism now applying to over-threshold distance sales under the transitional system, and produce much the same problems for traders. It is true that, in order to avoid a situation in which all traders would have to register for VAT or appoint fiscal agents in every Member State, Prof. Vanistendael would require, instead, all Member States to operate offices for tax collection in all other Member States. The Professor himself admits, however, that the life of traders would be complicated by having to keep track of tax rates in every country to which they made supplies.

Though such "half-way house" solutions certainly merit further examination, they may turn out to have few advantages over the more orthodox approach of aligning national rates.

10. VAT RATES

As described in section 1.6, the decisions of 1991-2 establishing the transitional VAT system were preceded by intense discussion on the extent to which the rates of VAT should be harmonized. This was not, however, a new debate.

The Commission's first proposal for a harmonized structure and level of rates had already been made in 1970. The EEC Member States at that time generally applied three or more rates (France, for example, had a reduced rate, an intermediate rate, a standard rate and a luxury rate). The Commission proposed that by 1975 there should be only two: a reduced rate between 5.5% and 7.5%; and a standard rate between 12% and 18%. By 1978, the width of the standard-rate band would be reduced from 6 to 3 percentage points, as a prelude to full harmonization on a single rate.

No action resulted.

10.1 The Single Market package

In 1987 Commissioner Lord Cockfield once again proposed the initial step of this VAT harmonization programme in the context of the Single Market - though in reflection of the general increase in average VAT rates since the 1970s (see Table 5), the suggested bands became 4% to 9% and 14% to 20%. However, no proposals or timetable for an eventual complete harmonization were put forward on this occasion.

In the end, the Council's main decisions were:

- On the percentage **standard rate**. Under Article 12(3)a of the amended Sixth VAT Directive, *"from 1 January 1993 until 31 December 1996, this percentage may be not less than 15%".*

- On the **reduced rates.** Under the same Article, *"Member States may apply either one or two reduced rates"* which:

a) may be not less than 5%; and
b) can apply only to certain items listed in Annex H of the Directive.

- ♦ Article 28(3) of the Directive also permitted, or permitted to continue, a number of **derogations and special rates** during the transitional period. In particular, a rate of not less than 12% could apply to transactions which certain countries would have to move from the reduced to the standard category as result of their not being listed in Annex H; and Ireland and the UK would be able to maintain their extensive zero-rating.

These provisions were all made subject to review.

- ♦ As far ar the **standard rate** is concerned, *"on the basis of the report of the operation of the transitional arrangements and proposals on the definitive arrangements to be submitted by the Commission...the Council shall decide unanimously before the 31 December 1995 on the level of the minimum rate to be applied after December 1996..."*

- ♦ Under Article 12(4), *"on the basis of a report from the Commission, the Council shall, starting in 1994, review the scope of the **reduced rates** every two years. The Council, acting unanimously on a proposal from the Commission, may decide to alter the list of goods and services in Annex H."*

- ♦ The **derogations** were to be re-examined by the Council before the end of 1994 on the basis of a report from the Commission. *"In the event of significant distortions of competition arising"* appropriate measures would be adopted.

Of these Commission review documents only one, the proposals for the definitive arrangements**,** did not appear before the specified deadline. That covering the reduced rates, Annex H and the derogations was published on 13th. December 1994.[127]

Significantly, the main recommendation was "no change". It was largely based on evidence arising from the actual operation of the transitional system, and on developments in the structure and level of national VAT rates since the publication of the Commission's original tax proposals in 1987.

10.2 Cross-Border Shopping

The preservation of the destination principle for transactions between VAT-registered traders has meant that differences in tax rates can distort competition only very marginally in the case of about 95% of intra-Community trade.

In the case of cross-border purchases by final consumers, however, the origin principle is already applied (see page 16) There has been a *prima facie* danger that disparities in rates across particular frontiers and applying to particular goods would cause deflections of normal purchasing patterns for purely fiscal reasons.

Research carried out *before* the opening of the Single Market indicated that such effects would be

127 COM(94)584 (see footnote no.106)

limited. A study by the Commission's DG XXI presented to a hearing of the European Parliament's Economic and Monetary Affairs and Industrial Policy Committee in 1988[128] found that only between a twelfth and a twentieth of price differentials could be attributed to VAT differentials.

A more detailed survey carried out by BEUC[129] similarly found that "price differentials between countries are much greater than the differences in VAT rates". The final price of a film for a camera, for example, was roughly the same on the French and English sides of the Channel, although VAT at the time was 15% in the UK and 33.3% in France. In Belgium the film was *cheaper* than in the UK, although VAT was ten percentage points higher, at 25%.

Table 8. Photographic equipment, April 1986
Average price levels (VAT included)

Country	films	SLR cameras	Compact cameras	VAT (%)
Belgium	122	129	127	25
Denmark	170	144	153	22
Germany	104	101	100	14
Spain	120	128	145	12
France	133	125	131	33.3
Ireland	160	141	138	26
Italy	100	136	135	18
Netherlands	138	123	124	19
Portugal	156	207	174	16
UK	131	100	105	15

Source: PE 123.347/An.V

In the case of compact cameras, there *was* an apparent relationship between the VAT rate and final price. In that of SLR cameras there was not. Similarly disparate results were obtained from a survey of prices for gramophone records, cassettes, personal stereo systems, sports shoes and tennis racquets.

Following the start of the transitional regime in 1993, the Commission initiated a detailed study to establish whether the abolition of fiscal frontiers had, in practice, led to changes in consumers' cross-border purchasing patterns. This was published in August 1994[130]. Though it found evidence

128 See footnote 12

129 *Bureau Européen des Unions de Consomateurs* evidence presented to the European Parliament's Economic and Monetary Affairs and Industrial Policy Committee hearing on the 15th. April 1988 (included in PE 123.347 of 26.5.1988)

130 "VAT and Excise Duties: Changes in cross-border purchasing patterns following the abolition of fiscal frontiers on 1 January 1993". Report prepared by Price Waterhouse for the Commission of the European Communities, Directorate-General of Customs and Indirect Taxation (DGXXI/C-3)

of increases in cross-border shopping where the goods were subject to excise duties (for example, beer and tobacco bought by British shoppers in France), this was not so for goods subject only to VAT. "Apart from the frontier of Germany and Denmark, the study did not reveal at the level of individual purchasers a major change in their decision-taking processes, following the abolition of fiscal frontiers, due to differences in the rates of VAT alone".[131]

Table 9. Cross-border shopping (XBS) in reduced-rated goods

Product	Cross-border shopping	Changes since 1.1.93	Comments
Foodstuffs	Some	None	
Children's Clothes	Negligible	None	
Books, etc.	Negligible	None	
Pharmaceuticals	Negligible	None	
Plants, cut flowers	Negligible	None	Fraud reported

Source: Price Waterhouse study, p.58

This was true even where VAT rate differences were large, as in the cases of zero-rated foods and children's clothes and footwear in the UK and Ireland. In the latter instance, cross-frontier shopping was "negligible, and limited to 'opportunistic' shopping by holiday-makers, business travellers and lorry drivers"[132]. There had been no change since 1 January 1993 (see Table 9).

These findings are explainable in a number of ways. The Price Waterhouse study observes that in Europe "there is little firm evidence on the responsiveness of XBS (cross-border shopping) to tax incentives and price differentials"[133]. For the most part, shopping is not the most important reason for cross-frontier journeys: the incidental opportunity to shop is created by business or holiday travel. And where the objective of travel *is* to shop in another country, many factors other than that of price play a part: design and style, curiosity value, the opening hours of shops, etc. Not all consumer goods are, as is camera film, absolutely identical in every Member State.

In economic terms, the responsiveness of shoppers to price differences will also depend on the opportunity cost of making the purchase, which will in turn partly depend upon geography and product characteristics. As a rule of thumb, the higher the value of an item and the greater the tax advantage in relation to distance and transportability, the bigger the incentive to "tax shopping". Added to this are the probable exchange and transaction costs of using a foreign currency, and in many cases the inconvenience of having to use a foreign language.

Finally, there is the question of how far price differences can in any case be accounted for by tax differences. The theoretical answer, outlined in section 2, is that it all depends on the elasticity of

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131 *op.cit.* p. 8

132 *op.cit.* p.56, para 271

133 *op.cit.* p.64, para.306

demand at that level of prices. The Price Waterhouse study, on the other hand, draws attention to "meagre" empirical evidence - largely from the United States - that "after an adjustment/lag period, the totality of the burden of tax is reflected in higher prices"[134]. Whether this is true or not for overall tax levels, however, evidence such as that provided by BEUC shows that the situation can vary markedly between individual products, even those sold in the same shops. This is more consistent with classical theory.

The Commission concludes that most of the Price Waterhouse findings "are a matter of common sense". It draws attention to the finding from a Eurobarometer poll carried out across the Community in April and May of 1994[135], that only 20% of those aware of the Single Market changes made use of them. "Cross-border shopping is by its nature something which only a relatively limited number of people will ever be in a position to take advantage of"[136].

It is nevertheless possible to conclude from the same evidence that it is still too early to tell what the full effects of the Single Market will be for cross-border shopping. When more European citizens have become aware of the opportunities (Eurobarometer found 43% still unaware in mid-1994) a greater number may make use of them.

There is also recent evidence that more traders are perceiving new opportunities. The Kent Chamber of Commerce, for example, has recently launched a campaign to attract French buyers of children's clothes and shoes, which are VAT zero-rated in the UK.

Though the role of differences in VAT rates in stimulating cross-border shopping is therefore always likely to be limited, it may become greater than existing studies have concluded.

10.3 Other cross-frontier purchasers

In addition to most purchases by final consumers, the origin principle also applies during the transitional period to certain other cross-frontier transactions. These are acquisitions by SMEs operating under registration thresholds; by non-taxable legal persons (see section 4.4) below the total purchase threshold; taxable persons carrying out transactions which are exempt under Article 13 of the Sixth VAT Directive; and "flat-rate farmers" under Article 25 of the Directive, where input tax is deduction is on the basis of flat-rate compensation percentages rather than actual tax paid.

All of these might have an incentive to buy in countries with lower VAT rates than their own.

A separate study into the extent of such purchases was carried out for the Commission[137] in the context of calculating the VAT element of own resources. It found "no evidence of significant changes in cross-frontier purchasing behaviour....at any borders between Member States with

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134 *op.cit.* Appendix 1, p.1.

135 Eurobarometer 41.0 by INRA (Europe), 5.7.1994. See also footnote 26.

136 COM(94)584, p.10.

137 "The extent of transboundary transactions taxed according to the origin principle" (*Deutsches Institut für Wirtschaftsforschung*, September 1994)

important differences in VAT rates"[138]. The only identified exceptions were German flat-rate farmers who "consistently purchase chemical fertilisers and pesticides, which in Germany are subject to the standard rate, directly from Luxembourg, France, the Netherlands or Belgium where such products are taxed at reduced rates".

The Commission here takes the robust view that this is legitimate competitive behaviour, pointing out that Germany too has the option of charging a reduced rate on the products which are covered in Annex H of the Sixth Directive.

10.4 Convergence of VAT rates

One major reason cited by the Commission for the absence of tax-induced trade distortions since January 1993 is the convergence of VAT rates that has already taken place.

In 1987, the standard rate of VAT varied in the then twelve Member States between 12% in Luxembourg and Spain, and 25% in Ireland. By 1994, the spread among the same twelve countries had been reduced to only between 15% in Germany, Luxembourg and Spain and 25% in Denmark.

Taking the now abolished "luxury" rates into account, however, the spread has fallen from between 12% and 38% (Italy) in 1987, to between 15% and 30%, though the Portuguese "luxury"rate was the subject of legal action by the Commission, and has now been abolished.

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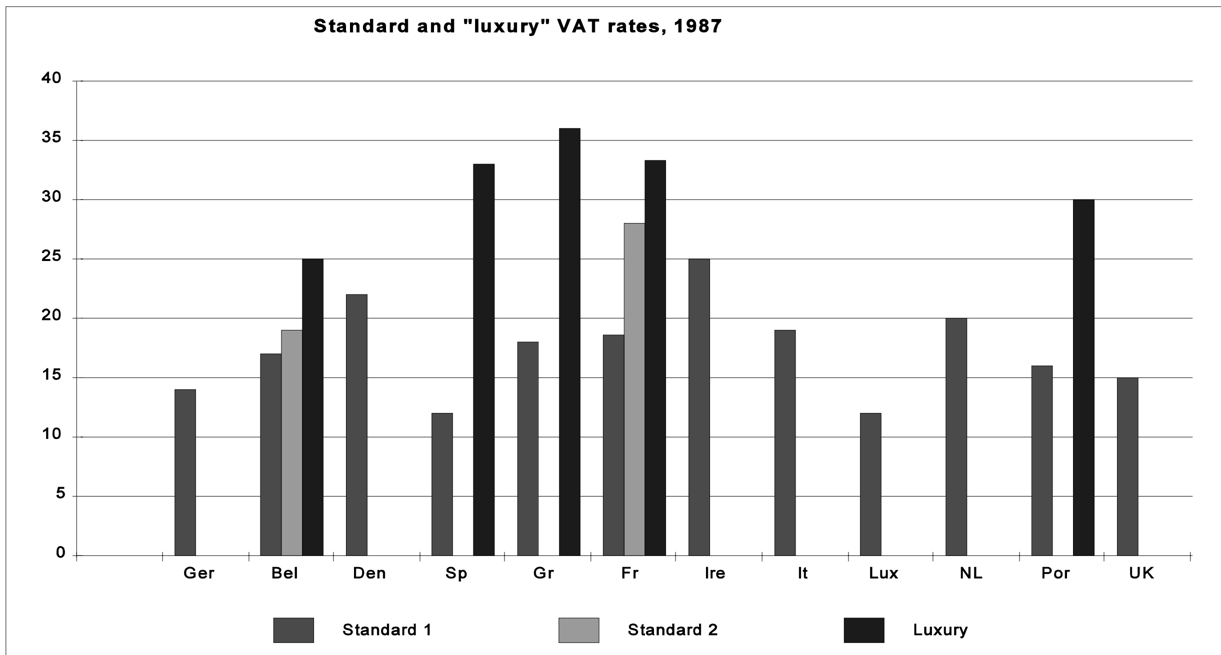
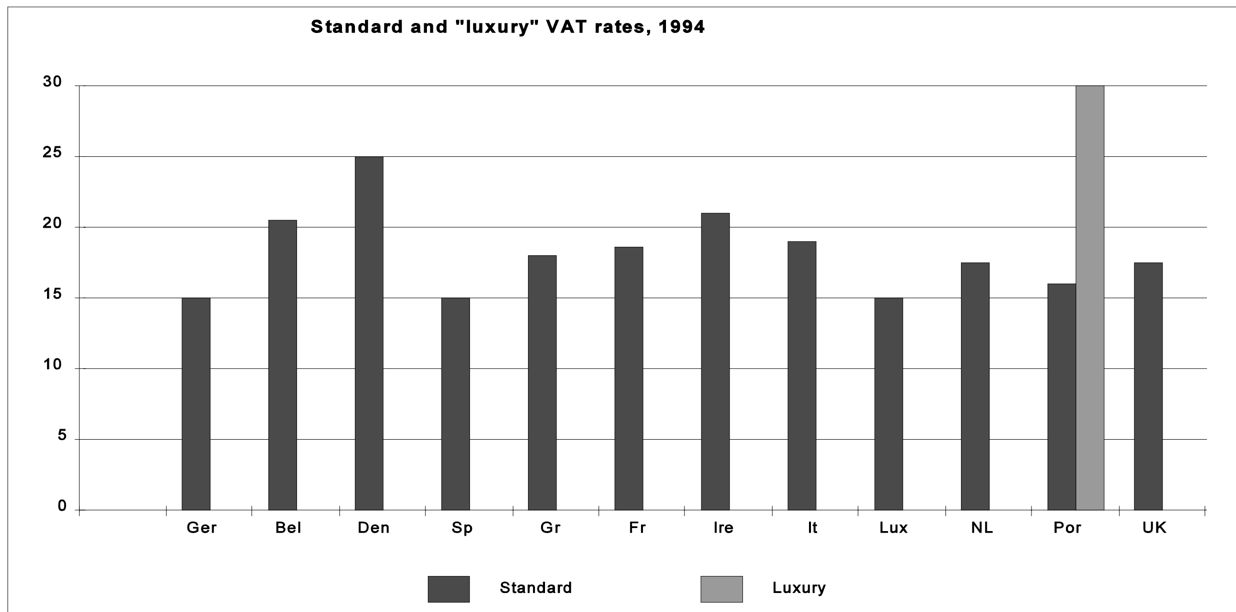
[138] CO M(94)584, p.11.

Tables 10 and 11





Source: Commission D-G XXI

In the case of reduced rates there has been less convergence. In 1987, 19 reduced rates (not including zero) were applied throughout the Community, with 13 different percentage levels ranging between 1% and 13%. In 1994 there were 21, including various "parking" rates, still with 13 different percentage levels, and still ranging between 1% and 13%.

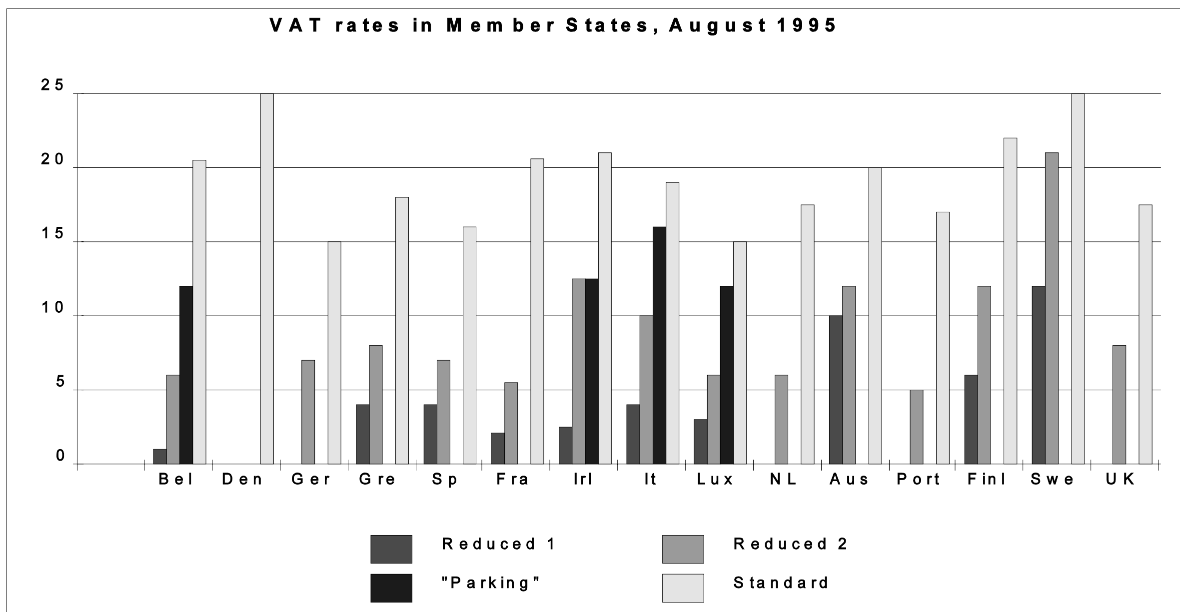
By April 1995, with the three new Member States, this had risen to 28 non-standard rates, with 15 different percentage levels, ranging between 1% and 21%. Most countries also continue to apply more than two rates (assuming that zero is included) - all, indeed, except Denmark, Germany and the Netherlands.

Although the Commission, in its report of December 1994, points to "the reduction in the number of rates applied by Member States" as being evidence of convergence, this has only been modest and is almost entirely accounted for by the abolition of the "luxury" rates. There has so far been no reduction in the number of rates below the standard. Indeed Spain and the United Kingdom have gained an extra lower rate, while Belgium, Ireland, Italy and Luxembourg have intermediate or "parking" rates between 12% and 15%. The situation would have looked considerably worse had France not cut the number of its reduced rates from five to two.

It is nevertheless true that the standard rate of VAT is converging on a level somewhere between the current weighted average of 17.5% and the absolute average of 19%.

The Commission in 1987 proposed that a spread of six percentage points (14% to 20%) was sufficient convergence to allow the removal of fiscal frontiers. Only one of the twelve Member States of 1987, Denmark, now has a standard rate outside a six percentage points band of 15% to 21%. Of the three new Member States, Austria is also within such a band.

Table 12



Source: Commission D-G XXI

10.5 Coverage of the reduced rates

The continuing multiplicity of reduced or special "super-reduced" rates is one reason for agreeing with the Commission that "convergence still has some way to go to produce a consistent Community-wide system of VAT rates"[139]. In addition, the reduced rates are not applied to the same goods and services in all Member States.

The Commission's 1987 proposals on VAT rates would have made the application of a reduced rate of VAT *mandatory*, but would have applied it to only a limited range of transactions.[140] These were:

- foodstuffs, excluding alcoholic beverages;
- energy products for heating and lighting;
- water supplies;
- pharmaceutical products;
- books, newspapers and periodicals; and
- passenger transport.

When these proposals were debated within the European Parliament, however, it became clear that a great number of national and special interests were anxious to have the list enlarged. Some 50 amendments were tabled in the Committee on Economic and Monetary Affairs and Industrial Policy to the first version of Parliament's opinion on the proposals[141].

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139 *ibid.* p.7.

140 see Article 1 of COM(87)321

141 draft METTEN Report, PE127.040 of 16.12.1988

The final version of Parliament's opinion[142] therefore suggested *two* lists of goods and services. The first, covering six items, for which a reduced rate would be *mandatory*; and a second list covering twenty-four products and services, for which a reduced rate would be *optional*. This second list broadly covered transactions where differences in VAT rates could not distort competition because the products in question were not generally traded between Member States.

In the end, the Council accepted this strategy, but combined the two lists into a single *optional* one. This became Annex H of the Sixth VAT Directive, which covers 17 products and services.
In addition to Annex H, the revised Sixth VAT Directive also provided for reduced VAT rates to be applied to certain products by exception or derogation. Under Article 12.3.b a reduced rate can be applied to "supplies of natural gas and electricity provided that no risk of distortion of competition exists".

Article 12.3.d. allows those countries which apply a reduced rate to "agricultural outputs other than those falling within category 1 of Annex H" (the most important products covered being flowers and garden plants) to continue doing so, pending legislation. The draft amending Directive[143] proposes to allow other Member States to apply the reduced rate as well during the transitional period. Also during the transitional period, under Article 28.2.d., countries which at the beginning of 1991 applied a reduced rate to "restaurant services, children's clothing, children's footwear and housing" can continue to do so.

The result of the reduced rate options has been considerable variation in the rates applied to the transactions covered by Annex H and Articles 12 and 28. Most Member States have applied a reduced rate or a zero rate to the "core" categories proposed by the Commission in 1987. Other transactions are variously taxed at the standard rate, at a reduced rate, at zero or are exempt.

Moreover, the classification of goods and services falling within each Annex H category also varies between Member States. "This means that while superficially there may seem to be a good deal of similarity between the practices of Member States in terms of Category selection, coverage of any individual category may in fact differ from Member State to Member State depending on how Member States choose to define goods or services within any given category in their own national legislation"[144].

The studies carried out for the Commission, however, have shown that this variety in tax treatment has not given rise to a change in cross-border purchasing patterns. This is not surprising in most cases: in accordance with Parliament's basis of listing, the services and goods in question are not likely to be generally traded between Member States. Where such trade might on the face of it be feasible, and where VAT rates differ widely, the studies showed that other factors "play a more determining role in influencing a consumer's choice: e.g. cultural or language considerations in the case of books, newspapers and periodicals, or prescription regimes and reimbursement schemes in

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142 Resolution of 12th.June 1991 (OJ C183 of 15.7.1991)

143 Proposal for a Council Directive amending Directive 77/388/EEC on the common system of Value Added Tax (taxation of agricultural outputs) COM(94)584 of 13.12.1994

144 *ibid.*p.14.

the case of pharmaceuticals and medicines"[145]. In the case of food, VAT rates did not seem a factor at all: Germans still bought higher-rated products in Denmark, and the French were not flocking to buy zero-rated British foodstuffs.

Given this background, the Commission therefore recommended that no change be made to Annex H. Though, like Parliament, it had "received numerous representations from various trade and industry federations pleading for inclusion of their sector in the scope of the reduced rate at the occasion of the next review", the Commission's view was that making changes would be "more manageable" in the context of moving to the definitive VAT system[146].

The Commission did not, however, state on what basis any changes should be made. So long as the de-taxing/re-taxing mechanism is in operation, it is certainly true that the wide variety in rates and coverage of the transactions in question causes little distortion of competition and imposes few administrative burdens.

Were there to be a move to the origin principle, however, such variety could cause serious problems, particularly for the reasons outlined in at the end of the last section. A number of changes would then have to be considered:

- **uniform classification of the goods and services within each Annex H category;**

- **a *mandatory* reduced rate for the most important categories;**

- **a reduction in the number of reduced rates applied; and**

- **harmonization of the reduced VAT rate percentages**.

10.6 The basis of classification

The basis for the current contents of Annex H is explained in the Commission's report. The Council had "generally followed the approach advocated by the Commission which was that the list should contain only those categories of goods and services which were taxed by a majority of Member States at reduced VAT rates"[147].

Parliament's approach had been somewhat different. The goods and services included in the *optional* reduced rating were broadly those where any cross-frontier transactions were extremely unlikely, and where disparities in VAT rates could not lead to distortions of trade or competition. *Compulsory* reduced rating had been retained, however, for most of the goods and services listed in the initial Commission proposals, some of which could be traded across frontiers: foodstuffs, pharmaceutical products, books, newspapers and periodicals and passenger transport (though, as noted earlier, disparities in the rates applied to these does not so far appear to have led to changes in purchasing

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145 *ibid.* p.15.

146 *ibid.* p.13

147 COM(94)584, p.13.

patterns).

Parliament's listing criteria also included certain broad political objectives. Included in the compulsory category were admission to cultural events and "all products and services designed to improve the situation of physically and mentally handicapped persons", while the optional category included "supplies to, and the activities of, welfare and charitable bodies, as defined by the appropriate legislation in each Member State[148]."

Most recently[149], Parliament has sought to extend Annex H to include services which would especially promote employment and goods which are approved at Community level as being environmentally friendly. When the Council adopted Annex H in 1992, a declaration was appended, to the effect that especial consideration should be given to supplies of environmentally friendly and energy-saving goods and services when the scope of the reduced rates was reviewed.

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148 In most Member States a large proportion of these are currently exempt under Article 13 of the Sixth VAT Directive. An option for taxation at a reduced rate, however, would enable them to recover input tax.

149 See report of Alman METTEN for the Committee on Economic and Monetary Affairs and Industrial Policy (PE 213.491)

Table 13. Proposed and eventual goods and services eligible for tax at reduced rate

Product	1987 proposal	EP mandatory	EP optional	Annex H	Arts.12 & 28
Foodstuffs	x	x (human)	x (animal)	x	
Pharmaceuticals	x	x (human)	x (animal)	x	
Books, etc.	x	x		x	
Passenger transport	x	x (public)		x	
Water	x	x		x	
Heating/lighting	x		x		x
Cultural events		x		x	
Supplies for handicapped		x		x	
Children's shoes/clothes			x		x
Non-movable goods			x		
Geogr. restricted services			x		
Welfare services			x		
Repair and maintenance			x		
Meals			x		x
Agricultural outputs			x	x	
Social housing			x	x	
Output of writeres, etc.			x	x	
Hotels, camp sites			x	x	
Sports facilities			x	x	
Sports events			x	x	
Charities			x	x	
Burials, crematoria			x	x	
Medical care			x	x	
Cleansing and refuse			x	x	
Education			x		
Social catering			x		
Plants and flowers			x		x

10.7 The case for aligning VAT rates

There are a number of arguments for a harmonization or "approximation" of VAT rates under the definitive VAT system, whether this includes a general move to the origin principle or not.

10.7.1 The special regimes

The conclusion of Section 4 of this paper was that he special treatment of distance sales, new means of transport and purchases by non-registered legal persons could only be ended if VAT rates either converged or were harmonized. The extent of tolerable divergence would probably be determined by mail order. In principle, and given uniform delivery charges, all mail order businesses would be most profitably operated from the country or countries with the lowest VAT rates. The extent to which businesses could operate successfully from countries with higher rates would determine how far such rates could survive.

10.7.2 Service industries

Similar considerations would arise from application of the principle that services are taxed on the basis of where the supplier is established, as provided for in Article 9 of the Sixth VAT Directive. Some services - especially those which can be carried out, for example, *via* telecom networks - would naturally try to locate themselves in low VAT countries. (Indeed there is a possibility that such firms will increasingly operate from outside the Community altogether).

10.7.3 The place-of-establishment option

Finally, were transactions to be more generally taxed on a place-of-establishment basis, differences in VAT rates would become an important factor for most firms' location decisions. Where firms had places of establishment in several Member States, invoices would as far as possible be issued from those in lower-taxed countries.

These arguments for an alignment of VAT rates hold good even if there is a decision to retain present transitional system and make it "definitive". A move to a system based on the origin principle would add several more.

10.7.4 The administrative burden on firms

As has been noted in the preceding section, taxation on an origin basis means that firms making acquisitions from other Member States will need to deal with invoices showing tax at those countries' rates. Both the administrative costs of verifying the rates charged, and making the correct input tax deductions will be reduced to the extent that rates are harmonized.

10.7.5 The operation of clearing

The harmonization of rates would also simplify the operation of any clearing system. A country's net position for clearing is not merely a function of its trade balance, but also of any differences in tax rates on the transactions in question. A "macro" solution will therefore be that much more

feasible the more Member States charge the same rates on the same categories of transaction.

10.7.6 Cash flow and competition

Finally, there are the possible distortions of competition that could arise under the origin principle were rates to diverge too widely. In trade between VAT-registered companies these would arise mainly from cash-flow factors (see section 1.6), and should not be exaggerated. Sufficient harmonization would nevertheless be necessary to ensure that discrepancies in rates are not too great as a result of a particular product or service being standard rated, reduced or "super-reduced" rated or exempt in different Member States.

10.8 Harmonization or market forces?

The creation of the Single Market, and the partial abolition of fiscal frontiers, has in some measure brought the tax systems of Member States into competition with each other. The fact that final consumers can now purchase VAT-paid goods anywhere in the Community without any further tax liability or controls inevitably limits the ability of national governments to set disproportionately high rates.

This observation is not contradicted by the findings the Price Waterhouse study. The general abolition of the "luxury" VAT rates in advance of Community legislation indicates that governments had already anticipated the effects of market forces *before* the new VAT system came into effect. Further evidence is provided by the gradual convergence of standard VAT rates within a 15-21% band.

The position under the transitional system has indeed been a compromise between the "French" and "British" schools of thought of the 1987-91 discussions (see section 1.6). The case for harmonization through legislation was won by the "French", in so far as a minimum standard rate was set to prevent competitive tax-rate reductions. The case for market forces was won by the "British", in so far as no upper limit was set: high-taxing Member States were left free to calculate for themselves the trade-off between loss of revenue from cutting rates and loss of revenue as the result of cross-border shopping.

It is true that, in the absence of full rate harmonization, market forces were limited in certain other ways: for example, through the "special regimes" and the limitations placed on Danish cross-frontier shoppers. In the case of goods subject to excise duties the extent of the freedom allowed to market forces is still being tested (see section 4.2). Nevertheless, continuing the de-taxing/re-taxing mechanism for commercial transactions has meant that the operation of the transitional system has been compatible with moderately varying VAT rates.

As outlined above, however, a move to origin strengthens the case for the alignment of VAT rates. The question then arises: can this still be left largely to market forces; or will it be necessary to legislate?

On the one hand, it can be argued that full harmonization through legislation is *not* necessary to abolish the "special regimes", switch to the place-of-establishment basis of taxation or meet the competitive effects of the origin principle. Certain high-tax countries could certainly expect to have an initial rough time from market forces; but they could either anticipate them (as France did in the

case of its luxury VAT rates) or be given a transitional period to adjust.

On the other hand, market forces are unlikely to produce the *absolute* harmonization of rates needed to limit administrative complications. In particular, they would be unlikely to harmonize the reduced rates, or cut the number of different levels.

If there is a move to the origin principle, some further harmonization of VAT rates through legislation would probably be necessary. The most urgent problem, however, would be to reduce the *number* of different rates. Alignment of standard rate levels might be left to market forces - though the Commission has recently proposed a 25% upper limit to prevent any widening of the present spread.[150]

10.9 Political issues

If VAT rates are aligned, the result will be a reduction in Member States' ability to make changes in rates of tax. Two consequent problems have already been examined in Section 8:

- how decisions on rates can be taken, given the unanimity provisions of Article 99; and
- the management of fiscal policy.

Moreover, the complete or partial transfer of the power to determine the level of VAT from national to Community level also affects the ability of national governments to determine the levels of other taxes. Different taxes are to some extent substitutes for one another: the "mix" can be varied to suit political preferences.

Within an open trading system such as the Single Market, however, the ability of national governments to vary tax levels is already limited by the need to maintain competitivity. Tax "mixes" can vary, but exist within the constraints of an overall tax level. Even where overall tax levels vary, competitivity requirements produce compensating adjustments in other cost factors such as the returns on capital or labour.

Very high levels of car taxes, for example, tend to depress profit margins and pre-tax prices. It was for this reason that, before the Single Market, there was a flourishing trade in right-hand-drive cars for sale to British customers by suppliers on the Continent, and constant attempts to limit the trade by manufacturers in order to protect the higher profit margins in the UK.

Within the context of general limits on tax levels, especial factors apply in the case of taxes on traded goods and services. An examination in 1991 of tax levels in the US States of Massachusetts, Connecticut, New Hampshire, New York, Rhode Island, Vermont and Maine (the size and geographic relationship of which are similar to those of the EU Member States) showed how market forces limit the ability to change tax levels in the absence of tax frontiers[151]. Department of Revenue analysts in the State of Massachusetts, for example, carried out a study into "border leakage" in

[150] Proposal for a Council Directive COM(95) of 20.12.1995. (This was subsequently rejected by both Council and the European Parliament).

[151] See report on the approximation of indirect taxation for the European Parliament's Committee on Economic and Monetary Affairs and Industrial Policy, *rapporteur* Ben PATTERSON (PE 146.286)

cigarette purchases as a result of tax differences. This found "that for each 1 cent difference in the tax rate between Massachusetts and New Hampshire, Massachusetts loses 1.08 packs per capita annually."[152]

Similar calculations - though not yet to that degree of precision - are now being carried out by British brewers and tax authorities in the context of beer movements between the UK and France.

Member States are therefore likely to face the fiscal consequences of VAT-rate approximation *whether this is the result of Community legislation* or *of market forces.* Indeed a general convergence of tax systems is likely as the Single Market develops.

152 Massachusetts Economic Indicators (Massachusetts Dept. of Revenue, Bureau of Analysis, Estimation and Research, January 1987).

11. THE *STATUS QUO* OPTION

Though the present Community VAT system is described as "transitional" - and even sometimes as "transitory"[153] - there are powerful arguments against its early abolition.

Though there have been numerous complaints from both traders and administrations about its operation; and though the current text of the Sixth VAT Directive commits the Community to an origin-based system in 1997, many of the problems which have been identified could be solved *without* a move to origin; and others would not necessarily be solved *with* such a move.

11.1 The costs of change

In adapting from the pre-1993 VAT system to the present one industry and commerce incurred considerable start-up costs, which firms should now be recouping as a result of the abolition of customs procedures, etc. In the United Kingdom, Customs and Excise has estimated the total one-off costs to have come to about £100 million, while the savings in a full year should be £150 million. However, repayment rates will not necessarily be the same for all companies.

There has also been considerable intangible investment in the transitional system, by both firms and administrations, in terms of experience in problem-solving. The system as a whole has had to be "run in", and adaptations made as difficulties have been identified - at Community level, for example, through the work of the VAT Committee and working parties. Were there to be an early move to an origin-based system, much of this investment would have to be written off.

In addition, a change in system would create new costs of adaptation. Would these be recouped as a result of new cost-savings?

In the view of some traders[154], they would not. They believe that the most significant cost-saving change has already been made: the abolition of fiscal checks at internal frontiers. The additional savings to be made from being able to invoice intra-Community supplies in the same way as domestic supplies would not offset the changeover costs.

There are even fears that an origin-based system would actually create no cost-savings at all. If there is to be a transactions-based clearing system, firms will still be required to keep separate records of intra-Community supplies and acquisitions. Though the *issuing* of invoices might become simpler, handling *incoming* invoices might be more complicated (see section 9.5).

A more fruitful approach might therefore be to retain the basic structure of the present "transitional" system, but to simplify and adapt it in the light of experience. In particular, many of the VAT problems faced by traders predate the system introduced at the beginning of 1993. They arise from defects in the Community's primary VAT legislation: the First and Second VAT Directives, and above all the Sixth.

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153 See, for example, "The new intra-Community value added tax (VAT): basic outline of the transitory regime" by J.A.F.Velilla and M.A.Royo-Villanova (International Business Law Journal, no.2. Paris 1993)

154 See, for example, "VAT and the Needs of Business" (Food and Drink Federation, January 1995)

11.2 Modernising the Sixth

The Sixth VAT Directive is sometimes described as the "cornerstone" of the Community VAT system. A more accurate metaphor, perhaps, would be some rambling administration block, put up haphazardly over several centuries. Since the original text was adopted in 1977, there have been a large number of amending provisions which have added or deleted Articles and Annexes; effected major or minor alterations through exception and derogation; and in at least one instance (in 1991) effectively changed the whole style and purpose of the edifice.

In addition, much of the wording of the Directive is intentionally or unintentionally vague. This has had a number of consequences:

- transposition into national law has given rise to discrepancies in the application of the Community VAT system in different Member States;
- uncertainties have made necessary frequent interpretations by the European Court of Justice, often with retrospective and - for national Exchequers - expensive effect; and
- the difficulties of interpretation have constituted a deterrent to trade, particularly for Small and Medium-Sized Enterprises, which are unable to afford specialist legal advice.

Finally, a number of changes have taken place in the business environment since the text was written in the 1970's, two of which are of especial significance:

- the role of trans-European and multi-national companies has grown, for which many of the provisions of the Directive constitute an unnecessary administrative burden; and
- the relative importance of the service sector has steadily increased - precisely the sector where the provisions of the Directive are least satisfactory (see Section 5).

Various "shopping lists" for reform of the Sixth Directive already exist. Among these are the legislative proposals which have already been made by the Commission, and which await decision by the Council, which include the draft Twelfth VAT Directive, measures to harmonize VAT exemption, a special scheme for gold and proposals on the VAT treatment of SMEs.

11.3 Non-deductible expenditure: the draft Twelfth

Article 17 of the Sixth Directive covers the "origin and scope of the right to deduct". Broadly, a taxable person can deduct from his VAT bill the tax paid on purchases, as long as these "are used for the purpose of his taxable transactions". Paragraph 6 of the Article states that "Value added tax shall in no circumstances be deductible on expenditure which is not strictly business expenditure, such as that on luxuries, amusements or entertainment".

Unfortunately, these provisions leave considerable scope for interpretation. Certain expenditure -for example, entertainment - can be partly for business and partly for private purposes. The position should have been clarified through an amending Directive no later than four years after the adoption of the Sixth. Meanwhile Member States were allowed to retain all the rules on input tax blocking which existed at the beginning of 1978.

The Commission duly produced the draft Twelfth VAT Directive at the beginning of 1983.[155] It made an attempt to define common rules on such contentious matters as company cars, business travel, hotel bills and entertainment, gifts and "luxuries". Its basic approach was to make most of such expenditure non-deductible, as a defence against fraud. Both in Parliament and in Council, however, this approach was considered too harsh: "no measures can be considered that would lead to an appreciable increase in the burden on industry"[156]. The Directive has not been adopted.[157]

Now, within the Single Market, differences in national provisions on non-deductible expenditure are in danger of creating both fraud and distortion of competition.

11.4 Exemptions

Since the Sixth Directive was first negotiated, the Commission has been steadily trying, with mixed success, to harmonize the categories of transaction which are exempt from VAT. Despite detailed provisions in Article 13, considerable variations still exist between Member States.

Exempt transactions within a VAT system are in any case a source of tremendous complexity and of persistent problems. There exists a popular presumption that exemption from VAT results in *less* VAT being paid. This, however, is only true when the exemption applies to the final or retail stage. Where an exempt transaction takes place at some intermediate stage an element of tax "cascading" is introduced. The result is usually a *higher* rate of VAT for the final consumer.

Transactions can be exempted for a variety of reasons. Alan Tait lists three:[158]

i) "rightly or wrongly", to make the VAT system less regressive;

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155 COM(82)870 final of 25.1.1983 (OJ C37 of 10.2.83)

156 Report of Parliament, *rapporteur* Bouke BEUMER (PE 86.173) of 3.10.1983

157 New proposals, combining a reform of the 8th.VAT Directive with rules on the right of deduction, has now been tabled by the Commission (COM(98)0377).

158 "Value Added Tax: International Practice and Problems", p.56

ii) the transactions are so "meritorious" that they deserve to be tax free; and

iii) it is too difficult to administer the tax.

11.4.1 Exemption v. reduced rating

The first of these reasons is evidence of some confused thinking. Since a body carrying out an exempt transaction cannot recover input taxation, there is always some VAT on the goods and services in question. And where the exemption is at an intermediate stage (see above) the result could be to make the system *more* regressive.

It is true that the value added by an exempt trader bears no tax, so that - provided exemption is at the retail stage - the final tax-included price should be lower than if the product were standard-rated. But in certain cases, were it to be taxed at a *reduced VAT rate* rather then exempted, final consumers might pay a *lower* price still. This will be the case, for example, where inputs are standard-rated, and the value-added at the final stage is a relatively small proportion of the final price. If the objective is reduced regressivity, the best option is not exemption but *zero rating*.

11.4.2 Charities and public bodies

The same factors are relevant in considering the taxation of "merit" goods and services. For example, most charitable activities within the Community are exempt from VAT under the provisions of Article 13. This means, however, that they are obliged to pay the full VAT on their inputs, and in some cases might be in a better position were they taxable.

But this is not the only problem created by the exemption from VAT of activities carried out "in the public interest". First, there is the difficulty of deciding borderline cases: for example, does "the provision of medical care in the exercise of the medical and paramedical professions" cover acupuncture, massage, slimming centres, thermal cures, yoga and alternative medicine?

Secondly, bodies whose "meritorious" activities are exempt can find themselves involved in normal commerce: for example, money-raising by charities. This is especially true of government, national and local, and of other "bodies governed by public law". Article 4(5) of the Sixth Directive specifically provides for the activities of such bodies *not* to be exempt "where treatment as nontaxable persons would lead to significant distortions of competition", and lists activities which are "in any case" taxable in Annex D. Increasingly, however, the distinctions are becoming blurred as the public sector becomes commercialised, and as many "public interest" services are carried out by the private sector.

Distortions of competition can work in both directions. For example, public air traffic control bodies are lobbying to be treated as taxable persons now that the privatised German air traffic control service has acquired the right to deduct input tax. Conversely, exempt public providers of welfare services are often in competition with taxable providers in the private sector.

11.4.3 Financial services

Few people would describe financial services as particularly "meritorious". They are generally exempt under Article 13B of the Sixth Directive because of the peculiar difficulties of levying VAT on, for example, interest payments (which are already subject to direct taxation). Yet the costs of exemption are "loss of revenue, loss of information that would be generated by a tax, distortions in the economy, and loss of both real and perceived equity".[159]

Alan Tait describes a number of attempts to apply VAT to financial services: for example, in New Zealand and Israel. In the latter case the result was a tax based on a global calculation of value added - $t(p+w)$, see page 10 - which could not therefore be deducted as input tax. In the case of New Zealand, VAT was eventually applied only to insurance premiums. An effectively decisive difficulty is the increasingly electronic and global nature of financial services - any attempt to apply VAT would probably send them all offshore.

It is nevertheless important to be aware of the distortions created by the exemption of financial services. The "cascade" effect of exemption at intermediate stages of production and distribution means that both hidden tax and "tax on tax" is widespread within the VAT system. Conversely, exemption can also provide a vehicle for evading VAT: for example, by drawing up contracts so that a large proportion of the price of new television sets, hi-fis or used cars is exempt insurance cover rather then the goods themselves; or by using offshore telecommunication services and paying for them by exempt credit card.

Partly for such reasons, Article 13(C) of the Sixth Directive does provide Member States with the possibility of allowing providers of financial services (like the property, building and land sectors) an *option* to be subject to VAT. Most Member States, however, do not do so. This has led the European Parliament, on a number of occasions, to propose an amendment which would *oblige* Member States to introduce such an option. The matter is currently under examination.

11.5 Annexes E, F and G

The concept of an option to allow an option in Article 13(C) well illustrates the complexities of the Sixth VAT Directive, particularly in the field of exemption. Further examples are provided by the transitional provisions of Article 28(3) which refer to three Annexes:

Annex E, which lists goods and services which Member States may *continue to tax*, although they would normally be exempt;

Annex F, which lists goods and services which Member States may *continue to exempt*, although they would normally be taxed; and

Annex G, which sets out the conditions under which *an option for taxation* may be provided to the goods and services listed in Annexes E and F.

The application of these provisions unsurprisingly created a substantial degree of disparity between Member States in the application of exemption, which it has been the intention of the Commission

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[159] Alan Tait, "Value Added Tax: International Practice and Problems", p.100.

to eliminate over time. An Eighteenth VAT Directive was proposed in 1984[160] to reform Annexes E and F, and was partially adopted in 1989[161]. This reduced the number of Annex E derogations from 13 to 4, and the number of Annex F derogations from 27 to 14. New proposals - the "son of Eighteenth" - abolishing most of the remaining derogations were presented by the Commission in July 1992.[162]

Continuing simplification of the Sixth VAT's provisions on exemption will need to continue, whatever other changes are made to the VAT system. In addition, a very substantial reduction in the scope of exemption might also be considered. The EC Committee of the American Chamber of Commerce's position statement on the definitive VAT regime, for example[163], suggests that financial services might be taxed at the "super-reduced" rate of 0.5%, with "merit" transactions zero-rated rather than exempt.

Alan Tait concludes that the liability of public bodies to VAT should be made as wide as possible, and advocates the system which has been introduced in New Zealand[164]. All supplies of goods and services both made *to* and *by* "the government and its departments" should be taxed, as should "supplies made between departments". The tax would however apply "only to the operating expenses and not to the grants and transfers administered". From the point of view of revenue, the change would only be a book-keeping operation - though one, of course, involving some administrative cost.

11.6 The taxation of gold

One proposal in the draft Eighteenth VAT Directive which was not eventually adopted in the final legislation was the deletion from Annex F of "transactions concerning gold other than gold for industrial use". A draft proposal[165] was made in October 1992, but still lies on the table.

The taxation of gold raises complex issues and some passion. When the European Parliament's Economic Committee first debated the subject in the context of the draft Eighteenth VAT Directive[166], it adopted an amendment declaring that "gold transactions shall, in principle, be exempt from value added tax since they involve no added value". The Committee held a public hearing[167] on the 1992 proposal in order to disentangle the conflicting opinions before adopting its

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160 COM(84)649

161 Eighteenth Council Directive (89/388/EEC of 18.7.1989, OJ L226 of 3.8.1989)

162 COM(92)215, OJ C205 of 13.8.1992, revised version in OJ C231 of 27.8.1993

163 *op.cit.* p.3.

164 *op.cit.* p.78

165 COM(92)441 (OJ C3 9441/92)

166 see second report of the Committee on Economic and Monetary Affairs and Industrial Policy, *rapporteur* MR. R. WEDEKIND (PE 95.881)

167 Held on 12th. October 1993. See documentation annexed to Working Document PE 204.822.

report[168]. The root problem is that "gold" can exist in different forms: as a raw material for jewellery or industrial use; as physical bullion; and as a financial security represented in paper form. The Commission's proposal was to separate physically-delivered gold from "paper gold", applying VAT to the first but not to the second.

Parliament's alternative was to distinguish between gold as a raw material and gold - whether physically delivered or not - used as instrument of investment. The Council has so far not acted.[169]

11.7 The VAT treatment of SMEs

Accounting for VAT has always constituted a considerable burden for smaller businesses. As a proportion of tax paid, compliance costs tend to run in inverse proportion to size of enterprise: at the extremes, research in the UK has shown that they are something like 40 times higher for SMEs than for large companies. Moreover, under the current transitional regime the burdens have been potentially even greater for those involved in intra-Community transactions.

VAT has also created especial problems for tax administrations in its dealings with smaller firms. They are numerous, but pay relatively small amounts of revenue (in the UK, for example, the 75% smallest firms registered for VAT account for only about 7% of total VAT revenue). There is no way of verifying the VAT returns of retailers through claims for input tax deduction.

Both to reduce costs for the businesses themselves and to avoid levying a tax that costs more to administer than it raises in revenue, most VAT systems therefore apply special schemes to SMEs. In the European Community Article 24 of the Sixth VAT Directive enables Member States to exempt firms whose turnover is below a particular threshold, and to apply simplified procedures to others. However, thresholds, criteria and systems vary widely.

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[168] PE 207.401, *rapporteur* Mr. Peter BEAZLEY. (OJ C91 of 28.3.94)

[169] However, a revised version of the draft Directive, incorporating most of the European Parliament's approach, is under active discussion.

Table 14. VAT exemption and simplification thresholds for SMEs

Country	Exemption (annual turnover in ECU)	Min. years.	Simplification (annual turnover in ECU)
Austria	under 3 070	5	under 22 400
Belgium	under 5 000	irrevocable	under 500 000
Denmark	under 2 400	1	
Finland	under 10 000		
France	under 10 000	2	under 543 140
Germany	under 12 255	5	under 135 000
Greece	under 6 000 (2 000 fo r services)	0	under 20 000
Ireland	under 50 000 (18 540 for services)	0	retailers scheme
Italy			under 4670 (1680 for services)
Luxembourg	under 10 000	5	under 473 000 or 190 000
Netherlands	under 2 000 (graduated)	0	under 36 000 and retailers
Portugal	under 6 125 (8 700 for retailers)	5	under 205 000
Spain			under 312 000 and retail scheme
Sweden	under 10 000	0	
UK	under 57 500	0	under 361 445

Sources: Commission and OECD

Most - but not all Member States - exempt SMEs below a certain annual turnover, with an option for taxation. In some countries there is minimum registration period. In the case Belgium (and also of Spain's simplified scheme which *does* involve registration) this is combined with a special "equalisation tax" to reduce potential distortions of competition.

Apart from straightforward exemption, all Member States then apply various simplification schemes, often applying up to relatively high thresholds. An OECD study of the subject[170] gives details of the most common: reductions in net tax payable; longer return and payment periods; accounting for tax on the basis of payments received and made; and simplified calculation of liability and simplified records. Special schemes often apply to retailers.

The study also makes an important general point: that "in countries with straightforward VAT systems (i.e. one rate with a broad base), there tend to be fewer concessions (or more restrictive eligibility criteria) than in countries with multiple rates and/or a wide range of exempt or zero-rated goods and services". In other words, simplified schemes tend to be a "second best" offset for complexity in the general VAT system.

170 "Taxation and small businesses" (OECD, Paris, 1994)

Several other problems complicate the task of relieving SMEs of administrative burdens.

11.7.1 The legislative framework

The first source of difficulty lies in Article 24 itself. The rules laid down were that:

- Member States could keep or introduce simplified schemes for SMEs, provided the result was not a loss of revenue;

- where a Member State had no exemption for SMEs, or had an exemption threshold which was less than 5 000 ECU, a threshold up to that level could be introduced;

- however, where a Member State already had an exemption threshold *above* 5 000 ECU, they could not only keep it, but increase it in line with inflation.

The Article also required the Commission to report on the effects of these provisions, which it did at the end of 1983[171]. Some countries (Belgium, Italy and Spain) had no exemption limit; some (Denmark, Luxembourg and France) were "frozen" below the 5 000 ECU limit; and some (Germany, the Netherlands, Ireland, the UK and Portugal) had various schemes above 5 000.

As a result, the Commission proposed a Directive[172] re-writing Article 24. Instead of the 5 000 figure there would be:

- a 10 000 ECU threshold below which exemption would be *mandatory*;
- a 10 000-35 000 ECU band within which exemption would be *optional*; and

- a threshold of 150 000 ECU below which Member States would apply *mandatory* simplified schemes.

Despite a favourable opinion from the European Parliament[173], however, the changes have not yet been adopted by Council.

11.7.2 What is an SME?

The definition of "small" or "medium-sized" is itself matter of controversy, as are the criteria to be used. At Community level, SMEs are usually defined in terms of the number of employees (as, for

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171 COM(83)748 of 15 December 1983

172 COM(86)444 and COM(87)524, OJ C310 of 20.11.1987

173 Report of the Committee on Economic and Monetary Affairs and Industrial Policy, *rapporteur* Ingo FRIEDRICH (PE 112.096, OJ C190 of 20.7.1987).

example, in the recent Commission communication on the fiscal environment of SMEs[174]).

Table 15. Employees in SMEs

Maximum no. of employees	% of private sector employment
500	77
100	55
10	30

Source: COM(94)206

In the field of *direct* taxation, as the Commission points out in its Recommendation on the taxation of SMEs[175], "how an enterprise is taxed generally depends on its legal form rather than on its size". For VAT purposes, however, figures for annual turnover are generally used, sometimes for the current year, sometimes for the preceding year and sometimes for both.
Some Member States apply special schemes only to the very smallest companies; others see advantages in the highest possible threshold. The resulting variations can have consequences not only for competition, but also for the budgetary own resources base.

11.7.3 Effects of exemption

Relieving SMEs of VAT burdens by exempting them from tax below the chosen threshold has certain undesirable side-effects. For example, where the threshold is set at a relatively high level, the result can be to give SMEs an unfair competitive advantage over firms obliged to register in the normal way. This problem is particularly acute at the margin: that is, in the case of competition between firms just below the threshold and those just above. It is for this reason that Belgium, for example, charges exempt SMEs the additional "equalisation tax".

There are also problems at the margin for individual firms: what should happen, for example, when an SME's turnover expands? Exemption is usually based on turnover in the *preceding* year; but certain Member States (for example France and Germany) also set a supplementary threshold for the *current* year which triggers liability to VAT if exceeded.

When business turnover rises above the threshold, liability to tax can also result in *lower* profitability on the *higher* turnover (a familiar problem in the field of social welfare, where the phenomenon is known as the "poverty trap"). This can be corrected only by applying VAT progressively above the margin, as is the case in the Netherlands, and as advocated by Parliament in the Friedrich Report. This creates, in effect, special reduced rates.

11.7.4 Alternatives to exemption

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174 "The Improvement of the Fiscal Environment of Small and Medium Sized Enterprises", COM(94)206 of 25.05.1994

175 C(94)1305 of 25 May 1994

As outlined in the OECD study, a variety of models exist for the simplification of VAT for SMEs rather than exemption. The special schemes for small retailers applied by several Member States allows VAT liability to be estimated from input figures and standard mark-ups, with flat-rate deductions for input tax. The option to account for VAT on the basis of cash-accounting, which already exists in the United Kingdom below a £350 000 (ECU 445 000) threshold, was recommended in the Commission's 1986 proposal; and the merits of annual, bi-annual or quarterly rather than monthly returns is a subject of debate (see below).

One obvious option is to extend to all SMEs the "flat rate" system applied to small farmers under Article 25 of the Sixth VAT Directive. Under this, the farmer does not need to register for VAT. Unlike a normal exempt trader, however, he *is* able to recover input taxes by charging a "flat rate" supplement to customers, which can then be deducted by them as input tax as if it were normal VAT. Various flat-rate schemes of this kind are already applied more generally to SMEs in countries with VAT systems.

11.7.5 Late payments

One problem faced by SMEs which grew in severity during the recent recession is late payment of bills by customers - often larger firms or public bodies. The Commission has recently published a Recommendation on the subject[176], which observes that the adverse effect of late payments on businesses cash flow

> *"can be compounded, particularly for SMEs, by the pre-financing of VAT on transactions for which they have not yet been paid. As things stand, VAT is usually collected before the customer has paid the seller".*

The Recommendation draws attention to Article 10(2) of the Sixth Directive, which provides for the possibility of VAT payments being deferred until invoices have been paid (only France, Germany and the UK currently provide for this possibility).

It also draws attention to the possibility of lessening the adverse effects of long delays in payment by allowing VAT returns to be submitted on an annual basis, as permitted by Article 22(4) of the Sixth VAT Directive.

Lengthening the period for VAT returns, however, has for some time been a matter of controversy. Although longer periods relieve SMEs of some administrative burdens, experience has shown that a build-up of VAT liability can also create problems, and that some SMEs would prefer *shorter* payment periods

11.7.6 The problem of services

Small firms providing services create special problems for a VAT system. Where a firm supplying goods normally has a regular flow of purchases and sales, with stable figures for value added, suppliers of services typically make few, low-cost purchases on a regular basis, but occasional large capital purchases. Over a normal VAT accounting period, value added can be a high proportion of

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[176] Commisssion Recommendation of 12 May 1995 on payment period in commercial transactions (COM(95)1075)

final price. It is for this reason that some Member States have a lower threshold for the exemption of SMEs providing services than for others.

11.7.7 The option to register

In principle, under Article 24(6) of the Sixth Directive, a trader eligible for exemption has the right to opt for normal VAT or for a simplified procedure. Whether it is advantageous to do so depends partly on the proportion of final price accounted for by value added (i.e. the amount of input tax that could be recovered through registering); and partly on whether sales are largely to final consumers or to VAT-registered traders who will wish to recover input tax. SMEs with low value-added selling to other traders should normally register.

*

Though Article 24 of the Sixth VAT Directive clearly needs revision, the wide range of existing practice in the treatment of SMEs for VAT purposes indicates that a preferred option is by no means obvious. As a general principle, simplification of the VAT system *as a whole* is probably superior to a multiplicity of special schemes for SMEs. For example:

- ♦ **VAT and Intrastat reporting could be better co-ordinated, as recommended by the Molitor Group of independent experts[177];**
- ♦ **or recapitulative statements (Sales Listings) could be abolished altogether. Aggregate figures for intra-Community supplies and acquisitions would be used instead.**

11.8 "Economic activity"

Article 4 of the Sixth VAT Directive is intended to define "taxable persons": that is, those liable to pay VAT on their transactions unless specifically exempted. A "taxable person" is one "who independently carries out in any place any economic activity", comprising "all activities of producers, traders and persons supplying services including mining and agricultural activities and activities of the professions"; and also "the exploitation of tangible or intangible property for the purpose of obtaining an income therefrom on a continuing basis.."

The amount of litigation concerning the meaning of "economic activity", however, is evidence of the need for more precise definitions. Yet these may prove extremely difficult to arrive at. A private individual selling a single item of second-hand furniture to a friend is not engaging in an activity which is in this sense "economic". What if several items are sold to several friends? Certain services like repair work, catering, writing software, etc. often begin as hobbies. At what stage do they become trades? Accounting benchmarks like the generation of profit do not help, since non-profit-making activities can also be liable to VAT. Criteria such as the regularity of activity, the economic significance of the sums involved, the making of supplies to the public rather than to only personal contacts, etc. are bound to involve a degree of interpretation.

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177 Report on legislative and administrative simplification (COM/95/288 of 21.6.1995)

11.9 Goods and Services

The general problems of applying VAT to intra-Community supplies of services have already been examined in Section 5. Even greater complexities arise, however, when it not entirely clear-cut whether what is being supplied is a service or a good.

The problem frequently arises in the case of contract work. Repair and reconditioning of an existing product is clearly a service. Assembly from existing parts, however, can give rise to a supply of goods: Article 5(5) of the Sixth Directive specifically allows Member States an *option* to treat as such "supplies under a contract to make up work from customer's materials". Similar problems arise when a firm is supplying goods ancillary to providing a service (spare parts)**,** or a service ancillary to supplying goods (e.g. installation and testing).

Problems of this kind are compounded for the firms concerned - particularly SMEs - by the difficulties of obtaining clear advice from either the tax authorities or from tax advisers. A recent letter to a British MEP, Bryan Cassidy, illustrates the issue.

> *"I represent a UK company...who are specialist contractors in pre-installation works for X-Ray machines, Computerised Tomography Scanners, Magnetic Resonance Imaging Units and the like. Up till this time their work has been restricted to the UK, but as a result of several visits to the main X-Ray machine providers, whose European operations are based in Paris, the firm has been asked to tender for the installation of Magnetic Resonance Imaging Units in all Member States of the EU plus those in EFTA."*
>
> *"...I have tried to discover the point of payment of the VAT....Goods will be purchased in the UK and sent to a Member State...We are told that VAT needs to be paid on the goods in the UK, even though they are for export. We then need to register for VAT in each of the 18 other countries in order to be able to make a taxable supply to the client, who is in France. We will have no guarantee of work in any particular Member State. ..The VAT Authorities tell us that the invoice for payment by the client in France will have to have the UK address plus the VAT registration number of the State where the work was done."*
>
> *"...I cannot believe that this is the procedure that we must follow, because can you imagine having a small company with 20 employees having to deal with the VAT books for 19 countries?"*

The simplest solution in all such cases would be to treat the totality of such contracts as the supply of a service, taxable on one of the bases set out in Article 9.

12. CONCLUSIONS: THE CHOICE

The minutes[178] of the 1781st. **Council** meeting on Economic and Financial Questions, held on 27th. July 1994, record

> "*a consensus on the main criteria which the future definitive [VAT] system must meet, namely:*
>
> - *fewer administrative obligations and fundamental simplification of taxation;*
> - *no reduction in Member States' income from turnover tax;*
> - *no increased tax fraud;*
> - *preservation of the neutral effect of turnover tax on competition.*"

The Council's *ad hoc* Working Party on VAT was instructed "actively to continue" its work on the major aspects of the future system in the light of these objectives.

The approach of **the Commissioner** now responsible for tax matters, Prof. Monti, was outlined even before his formal appointment. His written submission[179] to the European Parliament's Committee on Economic and Monetary Affairs and Industrial Policy, provided in advance of the Committee's hearing to examine Commissioner-designates on 5 January 1995, states:

> *"Although the transitional VAT system is working reasonably well, on the whole, I do not believe that it provides a satisfactory basis for a permanent set of tax arrangements. In particular, the scope for further simplification of the existing VAT arrangements appears close to its limits. We must improve our common VAT system to ensure equal treatment for domestic and intra-Community transactions by embracing an approach implementing the principle of taxation in the country of origin."*

Professor Monti, however, went on to observe:

> *"Given the present state of affairs, the deadline of 1.1.1997 may well prove too early to allow full and orderly discussion of our proposals, plus adequate preparation by businesses, consumers and tax administrations."*

Subsequent statements by the Commissioner have confirmed these positions. Instead of draft legislative proposals, a "consultative document" has been promised for the middle of 1995; and the second post-1992 annual report on the operation of the Single Market[180] states that the Commission "intends to present guide-lines for the definitive VAT system...*as soon as possible"*.

The views of **the European Parliament** are contained in its resolution of June 1991 on the

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178 Council of the European Union, Press Release 8718/94 (Presse 158)

179 Letter to the Committee Chairman, Karl VON WOGAU, of 3rd.January 1995.

180 "The Single Market in 1994" (COM(95)238 of 15.06.1995). See para. 230.

approximation of indirect taxation in the Community.[181] This reaffirmed that "fiscal frontiers within the Community must be abolished", and observed that

> *"in the case of Value Added Tax, this cannot be fully achieved until the system of charging tax on imports and remitting tax on exports in trade between Member States is ended".*

In consequence, Parliament

> *"accepted the transitional arrangements for a common system of Value Added Tax on the understanding that both Commission and Council are committed to the full abolition of fiscal frontiers at the earliest possible date".*

It is clear that devising a "definitive" VAT system involves more than a simple choice between the destination and origin principles. Indeed, there are a number of measures which should probably be implemented whatever the choice of principle.

12. 1 Measures to be implemented whatever the choice of VAT system

- *Simplify the structure* of VAT rates, in particular the number and spread of reduced, "super-reduced" and other special rates (9.5 and 10.5)

- Implement pending VAT legislation:
  : Twelfth VAT Directive (11.3)
  : "Son of Eighteenth" VAT Directive (11.5)
  : VAT on gold (11.6)
  : VAT on passenger transport (5.3)
  : VAT on certain non-food agricultural products (10.5)

- Co-ordinate the system of applying VAT to SME's (11.7)

- Take other measures to "tidy up" the Sixth VAT Directive: e.g.
  : define "economic activity" (11.8)
  : clarify tax on contract work (11.9)
  : option for taxation for financial services and charities (11.4.2, 11.4.3)

- Remove discrepancies in the transposition and implementation of existing VAT legislation by different Member States (11.2)

In addition to such minor adjustments to the present system, a number of more radical changes are in principle compatible with a system based on *either* destination *or* origin, though each might have major revenue implications.

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181 Report of the Committee on Economic and Monetary Affairs and Industrial Policy, *rapporteur* Ben PATTERSON. (PE 146.286, and OJ C183/117 of 15.7.91)

12. 2 Major changes compatible with either destination or origin

♦ Place-of-establishment basis for:
: services only (5.5)
or
: all transactions (Section 6).

♦ No "deemed transactions", and a *régime suspensif* (Section 7) within:
: companies
: groups
: "tax-free rings"

♦ A drastic reduction in the number of exemptions (11.4), in particular for:
: financial services (11.4.3)
: public bodies and bodies governed by public law (11.4.2)

There is then a choice between several basic options. Two that have been examined in this study can perhaps be dismissed as unlikely to command much support: the **complete replacement of VAT by a US-style Sales Tax**; and a switch to **the origin system *without* clearing**. The first goes in the opposite direction from general international developments. The revenue-transfers involved in the second would almost certainly prove unacceptable to national governments.

Three options then remain:

12.3 Option 1: retention of the present system, with modifications (see Section 11)

♦ Harmonize:
: thresholds for distance sales (4.5)
: thresholds for exempt legal persons (4.5)
: the status of tax representatives (6.4)
or

♦ Completely abolish the special regimes (4.5)

♦ Align the system of VAT numbers:
: standard format (3.8)
: single registration (6.3)
: central auditing (6.3)

- Co-ordinate more closely the Intrastat and VAT reporting requirements (11.7)

  or
- Abolish recapitulative statements (European Sales Listings) altogether (11.7)

- Standardise the information required on invoices (3.7)

12.4 Option 2: a system based on the origin principle, with clearing (see Section 9)

- Invoices to any customer within the Community to be issued VAT-inclusive, at the rates of the sellers' Member State

- All VAT shown on such invoices to be deductible as input tax

- Bi-lateral, micro-clearing (perhaps with optional bi-lateral macro-clearing)

  or
- Multi-lateral micro-clearing

  or
- Multi-lateral macro-clearing

- Approximate VAT rates (10.7)

12.5 Option 3: VAT to become a "federal" Community tax (see Section 8)

- Origin basis for all intra-Community transactions (see above)
- Place-of-establishment basis for all taxation (Section 6)
- A single structure of VAT rates throughout the Community, established through the budgetary procedure (8.2)
- All VAT revenues to be paid into the Community Budget (8.1)
- Possible clearing through fixed rebates or expenditure programmes (8.2)

12.6 Trade-offs

As in most choices of this kind, trade-offs will have to made between alternative objectives. One of the most fundamental will be between

- *simplicity and efficiency in the VAT system itself, and*
- *the preservation of national fiscal sovereignty.*

The current transitional system, for example, both maintains national control over revenues and over VAT rates. The costs, however, are the complex "two taxable transactions" system (see Section 3); the special regimes (see Section 4); multiple registration, tax representatives, the Eighth Directive procedure (see Section 6); and many of the problems arising from the Sixth Directive which are described in Section 11.

The "federal" VAT option, making the Community a single fiscal area, would be the simplest and cheapest for all concerned. The cost would be the effective removal of VAT from the control of national governments and parliaments.

Likewise, in the choice of clearing system under origin (see Section 9), there is a trade-off between:

- *the precision with which revenue accrues to the country of consumption, and*
- *the simplicity of the clearing mechanism itself.*

The system proposed by the German Origin Commission study (bi-lateral clearing based on firms' VAT returns) would probably achieve a degree of accuracy acceptable to Member States; but would impose the greatest administrative costs on firms. Multi-lateral clearing based on macro-statistics or sampling, by contrast, would impose few burdens on business; but would (initially at least) result in perhaps unacceptable margins of error.

Finally, the "bottom line" in 1996 or 1997 will be a trade-off between:

- *the costs of changing the present transitional system, and*
- *the potential savings to be made from the changes.*

Although research is currently under way into the cost/benefit balance of the changes made at the beginning of 1993, any such evaluation of future changes is bound to be imprecise. A rough, qualitative evaluation is contained in Table 18.

12.7 Business opinion

A considerable amount of information is available - or will shortly be available as a result of ongoing Commission and Parliament research - on the views of firms concerning the working of the present transitional system. Business opinion on the contents of the future definitive system are less precise.

For example, in 1994 the Confederation of British Industry surveyed the opinions of its member companies not only on the operation of the Single Market but also on possible developments leading up to the 1996 Intergovernmental Conference[182]. One question concerned attitudes towards "moving to an 'origin' system of VAT". The results were:

Table 16: UK companies' opinions on a move to origin

Strongly support (%)	Support (%)	No opinion (%)	Against (%)	Strongly against (%)
4	22	66	8	0

Source: Confederation of British Industry

In the case of at least one Member State, therefore, it appears that a move to the origin principle is clearly supported (or at least not opposed); but that most businesses have not yet given the issue much consideration.

Evidence that business opinion is much the same in other Member States was reflected in a cautious statement by UNICE[183] in 1994. Though agreeing in principle that "within a single market domestic transactions should be treated on the same basis as intra-Community transactions", it concluded that "the priority of the Commission should be to resolve the problems which have already been identified in the transitional regime".

The issues to be negotiated were in any case "wide-ranging and fundamental" and the way they were handled by Member States "should be open to greater external scrutiny so that the governments of the individual member states may be required to justify domestically their negotiating stance..."

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182 "The Single Market and the Future Development of the European Union" (CBI survey, November 1994)

183 "VAT Definitive System" (*Union des Confédérations de l'Industrie et des Employeurs d'Europe,* 17.6. 1994)

12.8 Procedure and Timing

It is now reasonable to assume that the timetable for the adoption and introduction of a the definitive VAT system outlined in Article 35a of the Sixth VAT Directive is not longer operative. This required the Commission to submit proposals before the end of 1994, and for the Council , having consulted the European Parliament, to take the necessary decisions before the end of 1995. No date is actually laid down for the new system to come into force, though the transitional system is provisionally due to lapse at the end of 1996.

The steps leading to the application of a definitive VAT system are now - on the most optimistic scenario - likely to be as outlined in the following table.

Table 17: An optimistic programme for the introduction of a definitive VAT system

Publication by the Commission of a consultative document	mid-1995
Consultations with business, tax administrations, academics, etc.	1995 and 1996
Council Working Party and Eyuropean Parliament Committee discussions	1995 and 1996
Publication by the Commission of draft Directive(s)	late 1996
Formal consultation of the European Parliament and the Economic and Social Committee	late 1996
Adoption of the Directive(s) by the Council	early 1997
Transposition of the Directive(s) into national legislation	1997
Entry into force of the definitive VAT system	1.1.1998

This timetable pre-supposes extremely rapid legislative procedures, both at Community and national level. Such an outcome is only likely if the changes to be made turn out to be minimal: i.e. if the choice is effectively the "status quo" option.

In the event of a decision being made to adopt a system based on the origin principle, it is probable that an interim period will be needed to test and "run in" the clearing system, as recommended by the European Parliament in 1988 (see section *9.2.2*).

One further factor is the procedure to be adopted in Council. Article 35a of the Sixth Directive requires action by unanimity. In this, the text is merely reflecting the provisions of Article 99 of the Treaty[184].

However, it is just conceivable that a change might be made in the Treaty as a result of the 1996 Inter-Governmental Conference, which would enable the Council to act by weighted majority voting (see section *8.2.1*). This, in turn, might enable Council to reach a decision more rapidly; and perhaps to adopt one of the more radical options.

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184 Though the Directive does not reflect the Treaty provisions in their entirety, since the Council is only required to consult the European Parliament, but not the Economic and Social Committee as required by Treaty Article 99.

Above all, it will be important to make a choice which is genuinely "definitive". The Community VAT system introduced in 1967 by the First and Second VAT Directives has always been in some sense "transitional". Hints of fundamental change have been contained within the legislation itself, for which various deadlines have been set: for example, the end of 1968 in the First Directive, and now the beginning of 1997.

If business is to have a stable tax environment within the Single Market, the uncertainty and impermanence must now come to an end. All those involved in the debate - and in particular Parliament - have the opportunity to provide, at last, a durable solution.

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ADDENDUM

Under Article 35a of the amended 6th.VAT Directive, the Commission was required to "submit proposals for a definitive system" before the end of 1994, and for the Council to reach a decision on it before the end of 1995. However, no formal legislative proposals appeared. Instead, the Commission published two discussion documents:

♦ ***"A Common System of VAT: a programme for the Single Market"*** *(COM(96)328 final of 22.07.1996).* This outlines a timetable, running from late 1996 to mid-1999, during which the new system will be introduced in stages.

♦ ***"Description of the General Principles, Commission Services technical note"*** *(XXI/1156/96)*, which was launched at a special conference on 4th/5th. November 1996. The essentials were:

- the "place of taxation" would no longer be where goods are located, or services provided, but where the suppliers' business is established;

- invoicing and deduction of input tax would be according to the origin system;

- VAT rates would be harmonized "within a rather narrow band";

- the allocation of VAT revenues would be separated from the VAT system itself, and be carried out according to national consumption statistics;

- the 6th. Directive would be revised to make the system simpler, with fewer derogations, exemptions, options and special régimes;

- steps would be taken to avoid differing national interpretations of VAT law; the role of the VAT Committee would be strengthened; and cooperation between tax authorities improved.

In pursuit of this final objective, a draft Directive was proposed to give the **Committee on Value Added Tax,** which consists of national representatives and is chaired by the Commission, more powers of decision (COM(97)325).

Meanwhile most of the other VAT issues mentioned in this study have also remained unresolved: tax-exemption thresholds for **SMEs** (*COM(87)525*), the taxation of **gold** (*COM(92)441*), of **passenger transport** (*COM(92)416*) and of various **non-food agricultural products** (e.g. wool, flowers, timber) (*COM(94)584*).

However, new proposals to replace the **8th. VAT Directive** with a system of deduction in the country of registration, and linked proposals on **eligibility for deduction** (the draft 12th. Directive) have now been published (COM/98/377). A **decision on gold** is also expected by the end of 1998.

Most recently, the growing importance of **information technology** has focused attention on the application of VAT in this area. The Commission has proposed a Directive on **value added tax arrangements applicable to telecommunications services** (COM(97)0004), following a decision by Council to apply a temporary derogation from the normal provisions of the 6th Directive, and apply a "reverse charge" procedure. The Commission has also published a **European Initiative in Electronic Commerce** (COM(97)157) and a Communication on **Electronic Commerce and**

Indirect Taxation (COM(1998)374 final).

VAT Rates

The first Commission report (*COM(94)584*) on the working of the transitional VAT system, as far as rates of VAT were coincerned, concluded that it is working satisfactorily. There were no significant changes in cross-border purchasing patterns since 1st.January 1993, nor any significant distortions of competition or deflections of trade through disparities in VAT rates. The Commission therefore proposed (*COM(95)731 of 20.12.1995)* no change in the 15% minimum; but suggested **a new maximum rate of 25%** (no Member State has a rate higher than this).

The Council in December 1996 accepted the first of these proposals; but only agreed to make "every effort" not to widen the current 10% span. No new proposals on VAT rates were made, either, in the Commission's 1997 Report on the working of the system (COM(97)559). However, a Communication was published in November 1997 on "**Job creation: Possibility of a reduced VAT rate on labour-intensive services for an experimental period and on an optional basis"** (SEC(97)2089).

Parliament's views

Following the publication of the Commission's programme for a Common System of VAT, Parliament gave its own views in the RANDZIO-PLATH report (PE 221.256). While supporting an eventual move to the system proposed by the Commission, the report gives higher priority to making immediate improvements to the system currently in force.

Parliament has since voted *against* the proposed 25% upper limit on the VAT standard rate. It has also pressed for Member States to be given the option of applying a reduced rate to certain labour-intensive or environmentally-friendly activities - pressure which has eventually resulted in some Commission action (see above). Parliament's most recent views are contained in the report from M.Bernard CASTAGNÈDE (PE 226.732 of 19 May 1998), which urged action to ensure a uniform application of rules on reduced VAT rates.

VAT RATES APPLIED IN MEMBER STATES
1st January 1998

Member State	*Super-reduced*	*Reduced*	*Standard*	*"Parking"*
Belgium	0* /1	6	21	12
Denmark	0*	-	25	-
Germany	-	7	15	-
Greece	4	8	18	-
Spain	4	7	16	-
France	2.1	5.5	20.6	-
Ireland	0** /3.3	12.5	21	12.5
Italy	4	10	20	-
Luxembourg	3	6	15	12
Netherlands	-	6	17.5	-
Austria	-	10/12	20	-
Portugal	-	5/12	17	-
Finland	0*	8/17	22	-
Sweden	0***	6/12	25	-
UK	0**	5	17.5	-

* The zero rate in these countries applies only in the field of books, nespapers and periodicals.

** The zero rate applies widely to food products, publications, pharmaceuticals, etc.

*** The zero rate applies only to pharmaceuticals.