VAT AND THE FINANCING OF EUROPE[1]

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The European Communities are financed in part with what are known as 'VAT resources'. As there are various interpretations of those resources and the manner in which they are determined, I believe it is wise to put the situation into perspective. This article presents a historical overview of VAT payments to Europe and discusses the operation and future of the current system in detail. References to the 'Council' and the 'Commission' should be understood to mean the relevant European institutions.

1. Development of European institutions

The first European community, the European Coal and Steel Community (ECSC), was formed by France, West Germany, Italy and the Benelux countries on 18th April 1951. The ECSC was to serve as a basis for the future European Federation. The highest body of the ECSC, the High Authority, was supranational and authorised to take decisions without consulting the states involved, albeit only with respect to coal and steel. The ECSC Treaty was concluded for a period of fifty years.

In 1957 the members of the ECSC signed the Treaty of Rome, establishing two new European organisations. The first was the European Atomic Energy Community (Euratom or EAEC), which focused on the non-violent use of atomic

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energy. The second organisation was the European Economic Community (EEC), which focused in particular on creating a common European market.

The Single European Act of 1986, by which the community treaties were amended, served as a prelude to the establishment of the common market towards the end of 1992. The Act also contained the procedures for what was called European Political Cooperation (EPC). According to Article 1 of the Single European Act, the objective of the European Communities and EPC was to contribute to 'making concrete progress towards European unity'. Six years later, under the Maastricht Treaty, the European Communities (i.e. ECSC, EEC and Euratom) were incorporated into the newly established EU.

The EU had (and still has) three pillars. The first (and by far the most important) pillar is made up of the three European Communities. The ECSC, the EEC and Euratom continue to exist as independent international organisations, albeit embedded in the EU. The second pillar consists of a common European foreign and security policy, and the third pillar consists of police and judicial cooperation.

The name of the EEC was shortened under the Maastricht Treaty. The adjective 'economic' was deleted, to emphasise that the Community's sphere of influence reaches beyond the economy. This led to the coexistence of the European Union, the European Community (formerly the EEC) and the European Communities (EC, Euratom and ECSC). When the ECSC Treaty expired on 23 July 2002, coal and steel were brought within the scope of the general EC regime. In other words, the European Communities now consist of *the* European Community and the European Atomic Energy Community. The latter is reported to lie dormant, so it is safe to say that the European Communities consist primarily of the European Community.

2. Financing of the Communities

Throughout its existence the ECSC applied a system of levies and loans, which rendered it self-sufficient. The EEC and Euratom were initially financed with Member State contributions based on the formulas agreed in the relevant treaties. That financing methodology was to be amended as soon as the customs union had been created. That union was established in 1968, which provided opportunities for the Communities to raise their own revenue. The provisions governing those resources were laid down in the first Own Resources Decision of 21st April 1970. The first resources to be addressed were the agricultural levies. The Decree defined them as 'levies, premiums, additional or compensatory amounts, additional amounts or factors and other duties established or to be established by the institutions of the Communities in respect of trade with non-member countries within the framework of the common agricultural policy, and also contributions and other duties provided for within the framework of the common organisation of the markets in sugar'. All the agricultural levies were included in the Communities' budget with effect from 1st January 1971. The second type of own resources were customs duties: 'Common Customs Tariff duties and other duties established or to be established by the institutions of the Communities in respect of trade with non-member countries'. However, the European Council was aware that the disappearance of that income could have a major impact on the budgets of the respective Member States. The customs duties were therefore transferred to the Communities' budget gradually. The transfer was completed in 1975. The system of agricultural levies and customs duties has hardly changed since then. Levies were and are imposed on taxpayers. The Member States act as tax levier and tax collector but are required to contribute all of the proceeds to Europe. However, each year a percentage (10% then, 25% now) of the payments they make is refunded as collection costs. Agricultural resources and customs duties together are known as 'traditional own resources'.

The budget of the European Communities may not have a deficit or a surplus. Pursuant to the EEC Treaty, 'the budget revenue and expenditure appropriations must be in balance'. Since it was clear as early as 1970 that the traditional own resources would be insufficient in the long term to ensure a balanced budget, the Member States looked for additional sources of income. VAT resources turned out to be the most suitable for that purpose. The VAT resources were to be determined on the basis of a common contribution rate applied to a uniform VAT rate established for the Member States. The VAT resources were to take effect on 1st January 1975, provided that there was a common contribution rate and a uniform VAT rate at that time. If not, the Member States' contributions would be provisionally determined on the basis of their GNPs. Before long, the VAT contribution rate was defined. The first Own Resources Decision stipulated that the common VAT contribution rate would be determined annually in the Community budget procedure but would never exceed 1%. It took considerably longer to establish a uniform VAT base.

3. The road to a uniform VAT base

Although every Member State charged VAT, in practice there were nine different VAT systems. A uniform base therefore required additional legislation. The uniform VAT base was not implemented until 1977. The first step was the Sixth Council Directive of 17th May 1977. The purpose of this Directive was to harmonise the laws of the Member States relating to turnover tax, including concepts such as 'taxable base', 'chargeable event', 'charge to tax' and VAT exemptions. It was possible to calculate a uniform VAT base on the basis of the harmonised concepts. The Implementing Regulation of 19th December 1977 indicated how those calculations were to be performed. It offered the Member States the choice between two methods to determine the VAT base: either by means of cumulative returns or by means of the revenue method. In 1989, the returns method was abolished and the revenue method, which was declared reliable by the European Council the same year and was already used by most Member States at that time, has been applied ever since.

4. Subsequent Own Resources Decisions

In 1985 the maximum VAT contribution rate of 1% appeared insufficient to balance the budget. The maximum contribution rate was therefore raised to 1.4% in the second Own Resources Decision. That Decision also contained a special arrangement for the United Kingdom, whereby a lower VAT rate would apply for that Member State. The Council believed that this exceptional position was justified because the United Kingdom carried an excessive budget burden in proportion to its relative prosperity. Although that may also have been true (and may still be true) of other Member States (including the Netherlands), they were not given the preferential treatment that the United Kingdom received. The Council probably bowed to political pressure. As this increase of own resources turned out to be insufficient, the third Own Resources Decision was implemented in 1988. This Decision introduced a new type of own resources: a contribution based on the gross national product at market prices (GNP). In fact, this GNP surcharge was the balancing item, as the Communities' deficit was divided between the Member States in proportion to their respective GNPs. The intention was to bring the contribution of resources more in line with the various Member States' contribution capacity. The size of the black economy in some Member States was reported to also play a role. As the contribution was based on the levy of VAT on private consumption, only a portion of GNP was taxed. Countries with a sizeable black economy (and consequently substantial undeclared VAT) contributed relatively less than Member States whose VAT fraud was less profuse. The Communities mitigated that effect by claiming a percentage of GNP in addition to the VAT component from then on, although it was determined that the total own resources should not exceed 1.2% of the GNPs of all the Member States. The maximum VAT contribution rate remained 1.4%. For Member States to be selected at a later stage, the possibility was created to cap the VAT base at 55% of GNP.

The fourth Own Resources Decision followed at the end of 1988. Pursuant to this Decision, the maximum VAT contribution rate was gradually reduced to 1% by 1990. In addition, the VAT base was eventually capped at 50% of GNP. It was decided that the Communities' own resources should not exceed 1.27% of the total GNP of all the Member States.

The fifth Own Resources Decision – which is still in effect today – entered into force on 1st March 2002 after having been ratified by all the Member States, a procedure that applies to all decisions regarding 'the Community's system of own resources'. Under this Decision, the maximum VAT contribution rate was reduced to 0.75% in 2002 and 2003 and will be reduced to 0.50% in 2004. The capping of the VAT base at 50% of GNP will remain applicable. The correction covering the budget imbalances in favour of the United Kingdom still requires complex calculations under this Decision. Finally, it is worth noting that the collection costs payable to the Member States for the traditional own resources have gone up from 10% to 25%, so it is all the more important for the Member States to apply stricter collection rules. Apparently, not every the Member State made the same effort to collect those EU resources.

It is plain that VAT resources are becoming less important. Not only has the contribution rate been reduced to 0.50%, but also the amount payable will increasingly depend on the amount of GNP. Whereas VAT resources previously constituted nearly 50% of the EEC budget (even 69.9% in 1990), that share has dropped to approximately one-third today.

5. From VAT base to VAT resources

Currently, the VAT base is determined annually on the basis of the revenue method described in Council Regulation (EEC, Euratom) No 1553/89. The total net VAT revenue collected is used as a basis. That revenue is divided by the weighted average rate, i.e. the weighted average of the various VAT rates applicable to transactions in which the VAT is non-deductible, e.g. direct sales to final consumers. The scope of those 'transactions subject to non-deductible VAT' is derived from the national statistical accounts, so statistics play an important, if not decisive, role. This makes the direct relationship between the European VAT payers and the Community budget envisaged by the Commission rather loose. The European Court of Auditors noted the following in that respect: 'In fact, its link to fiscal reality is very tenuous, in particular because the calculation of VAT resource involves considerable use of statistical sources'.

As the VAT resources are based on the VAT actually collected, undeclared VAT is always excluded from the base. Consequently, the black economy has no direct effect on the VAT contributions to Brussels. However, the 'informal' economy, if present, should be taken into consideration when determining the VAT resources. The VAT resources are determined on the basis of the calculated

GNPs of the Member States. The economic activities in the black economy must be included in the calculation of that 'harmonised' GNP. For the purpose of calculating the GNP in the Netherlands, the Dutch Central Bureau of Statistics therefore includes an explicit estimate of the black economy's added value. According to the Dutch Minister of Finance, the *illegal* economy does not form part of the GNP. The difference between the informal and illegal economies is nevertheless likely to remain obscure in most cases.

6. The future

In view of the EU's eastward expansion, the relative importance of VAT resources will decline further, partly due to the capping of the VAT base at 50% of GNP. The cap entered into force for four Member States in 1999, and the number is expected to rise. It is expected that all new acceding countries will be subject to the capping rule, which will make the GNP an increasingly decisive factor. In fact, the VAT resources ceased to be transparent long ago, because the ultimate amount of VAT resources depends on statistical variables. That would be different only if the rates applied within the EU were harmonised or, better yet, if a common VAT rate applied. As that is unlikely to happen, statistics remain important and there is no direct relationship between national tax revenues and contributions to Brussels. That effect is reinforced by the complicated correction for the United Kingdom. In other words, the current system lacks transparency. European citizens are entitled to know how and to what extent they finance the EU. The current system of VAT resources does not satisfy that requirement.

Meanwhile the Council has instructed the Commission to review the own resources system. The review is expected to be completed by the end of 2004. The discussions on the subject of the European Convention are relevant to this review, as the VAT resources and GNP resources are subject to heavy criticism in those discussions. The criticism focuses on the fact that the EU's resources are not its own but consist of national contributions. The EU should nevertheless provide citizens with insight into the contributions it receives, *e.g.* by levying a separate European tax or by linking a Member State's contribution to its national taxes. The discussions about a new system for own resources are ongoing, and if things are as they seem, the era of transparent VAT resources will come to an end. The abolishment of those resources may influence the VAT harmonisation between Member States, as the most important reason for VAT harmonisation was to create a uniform system of VAT resources. If the need to maintain uniform VAT revenues is lost, that might affect day-to-day practice.