A COMMON VAT SYSTEM FOR THE EUROPEAN UNION

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A Brief Analysis of the Commission's Outline Work Programme

The Programme[2]

The main points are summarised in Annex I. However, the real interest lies in the Commission's reasoning behind the programme, and in the arguments it advances to justify such an ambitious agenda.

The Commission's Approach

The key ingredients are a critical appraisal of the present system, a description of the common VAT system that the Commission thinks is necessitated by the internal market, and an indication of the changes that are needed to attain this goal.

The Commission is critical of the present system. The main complaints are that it:

- requires firms to master up to fifteen separate VAT legislations and legal systems, with attendant complications and uncertainty about their ultimate tax liability

- (so the Commission claims) costs firms up to six times as much for intra-Community transactions as for comparable national transactions

- is open to abuse and fraud

- threatens growing revenue instability for Member States' governments

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2 COM 328(96) final.

- acts against the interests of consumers in the internal market.

In its place the Commission proposes a genuine common VAT system, which

- promises substantial simplification, with the introduction of a uniform tax system for the EU and the removal of a multitude of exceptions, exemptions and Member State options

- would provide for firms to register once in the Community (as opposed to up to fifteen times), and to pay tax to and be controlled by a single national administration

- would make it easier for administrations to control firms' declarations of their liabilities, would discourage avoidance,[3] make evasion and fraud harder to commit, and would thus help to stabilise revenues across the internal market

- would widen consumer choice through the removal of the remaining tax barriers to purchases in other Member States

- could yield tax revenues for deployment in other policy contexts (e.g., the reduction of taxes on labour), or for overall reductions of the VAT burden.

The changes that the Commission argues are needed to usher in a fully fledged common VAT system include:

- abolition of the distinction between national and intra-Community transactions, leaving just two tax regimes (one for sales within the internal market, the other for transactions with third countries) instead of many

- improvements in the law and practice underpinning co-operation between Member States, including in the recovery of tax debts, and in the formulation and management of all Community VAT law (raising the issue of directly applicable law at Community level, and of the transformation of the VAT Committee into a regulatory committee empowering the Commission to adopt implementing rules within the VAT system)

- general application of the principle that all transactions within the Community are taxable, accompanied by rules requiring businesses to

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[3] Avoidance is a legitimate activity aimed at minimising a firm's tax liability by exploiting particular features of the tax and structuring the company's affairs accordingly. It is different from evasion and fraud, which involve non-payment of tax due and are illegal.

register for tax, to charge tax and to deduct tax paid on their business purchases at one single place in the Community.

Analysis

Past talk of "the definitive system", or "the origin system", has yielded to "the common system of VAT". VAT, as the Community's main consumption tax, has a long pedigree. It spread through the Community in the Sixties and Seventies, accompanied by a growing collection of common rules (First and Second Directives, Sixth Directive, and so on), and was in tune with the then fashionable ideas of convergence (economic and political) within a framework of increasingly harmonised law. VAT became part of the own resources system (indeed, some Commission officials thought of it as a future Community tax, devoted entirely to the Community budget). The fall of the Community's internal tax frontiers was forecast in the very first VAT texts, which saw in the tax's mechanisms a way of integrating Member States' tax territories into a single Community tax area through the removal of the distinction between internal tax matters and those arising in cross-frontier commerce.

The internal market has now arrived, against the backdrop of controversy over the Maastricht Treaty and growing unease with earlier integrationist visions of Europe. However, the notion that VAT needs to be harmonised across the EU - or even that the same tax system should apply in all Member States - is still alive. Is this a relic of bygone thinking, a fiscal fossil in the rock from which Europe is being built, or a valid exception to the current doctrines of subsidiary and "doing less, but better"?

The language of the Commission's paper suggests that the Commission is convinced that an integrated VAT system is necessary, but not that it has to struggle particularly hard to impose its views on a sceptical Europe. In support of its approach, the Commission quotes European business:

> 85% favour harmonisation (including over two respondents in five who want VAT rates and exemptions to be harmonised)
>
> a "large majority" deplores the divergent ways in which Member States apply existing VAT law.

If these responses reflect the genuine views of European business - and there is no reason to think that they do not - it remains nonetheless true that tax policy is made on the basis of more than commercial perceptions of gain or loss. The right to have a say in the taxes that they are liable to pay is one that the citizens of all Member States cherish, while national Parliaments are understandably jealous of their law-making prerogatives in the fiscal field. Changing tax laws usually splits citizens and business into groups of losers and winners, the former complaining vociferously and the latter, generally, keeping complacently silent. The target of complaints is normally the national government, and Ministers are justifiably keen to keep control of the levers of power that generate either complaint or complacent satisfaction (some governments, though, will increasingly blame tax rises on the EU, while claiming the credit themselves for tax cuts). Handing over complete control to the Brussels machine (whether Council or Commission) raises weighty political issues. All the Commission's eloquence will need to be deployed in future communications if these prejudices are to be overcome. The present document falls far short of what is required.

Let us assume that sufficiently convincing arguments are deployed in due course, and that the EU's Finance Ministers are at least prepared to listen to the Commission's pleas. What are the lines on which the common VAT system will develop?

The central assumption is that all similar transactions in the EU need to be treated in the same way if the internal market is to deliver up its benefits, untrammelled by the VAT system. At present this is not so, as the tax treatment of a sale can vary significantly, depending on factors such as the status and location of the customer, the responsibility for transporting the goods, and so on. The biggest variation is between sales within a Member State and those that cross an EU frontier; the former are generally taxable, whereas the latter may be taxable if the purchaser is not registered for VAT but zero-rated if he or she is. It is this fact, above all others, that, for VAT purposes, sets trade between Member States apart from trade within Member States, and leads to the cost increases for the former of which the Commission rightly complains.

The problem is that each Member State represents a (more or less) uniform tax jurisdiction, with a unified legal framework, a single control authority (or, where federal arrangements intervene, highly co-ordinated control authorities), the same tax rates and exemptions across the whole territory, and - of course - an obligation on taxable companies to register, once but only once, with the tax authorities. The EU as a whole is the antithesis of this picture of order and discipline. There are fifteen jurisdictions, with fifteen exchequers and legal systems, no single control authority (and little co-ordination between those that exist), a considerable range of tax rates and exemptions, and - potentially at least - an obligation on taxable companies to register in each Member State in which they make taxable supplies of goods or services.

Harmonisation can deal with some of these problems, but not with others. For example, the tax jurisdictions of the Member States will remain separate - there is no suggestion that VAT should accrue to some central Community exchequer[4] or be managed by some central European administration. The power to control taxpayers will remain vested in national governments, and extensive co-ordination, rather than integration of the control function across Europe, is the (second) best hope of those looking to improve compliance and fight fraud. It is, however, possible to unify the legal framework (by turning Community VAT law into directly-applicable Regulations, for instance), and to reduce or eliminate the variations in tax rates and exemptions from one Member State to another. The most promising and revolutionary change, though, is to be sought in the VAT mechanism itself - in the basic rules defining how businesses charge tax and to which authority they are answerable for the tax liabilities that they create.

This is the core of the Commission's strategy. By requiring all businesses operating in the EU to charge tax to their customers, wherever they may be situated in the EU and whatever their tax status, the Commission hopes to simplify and unify VAT practice across the Community. The corollary is that all business purchases shall similarly give rise to a right to a VAT deduction, wherever in the EU the purchase was made. In formal terms this means the introduction of the "origin" principle. It is, however, easier to think of the change as extending across Europe the simple basic rule of VAT that all registered businesses at national level live by every day - charge VAT on your sales and deduct VAT on all your business purchases.

Nevertheless, this simple idea yields few benefits if taxpayers are still answerable to a multitude of different tax administrations across the Community. As soon as they have to break down their sales or their purchases by Member State, as they do now, they are caught up in an administrative nightmare that multiplies costs and sends the level of compliance plummeting. It follows, as the Commission argues, that the origin system by itself is of little value if it is not accompanied by a simplification of taxpayers' obligations. The biggest simplification is making them answerable to just one tax authority for all their Community VAT affairs.

So far, so good. But this approach creates new problems.

First, a company registered in one Member State but selling in (or into) another will follow the tax rules of its country of origin. To do otherwise would plunge companies back into the confusion of rules that vary by country, with allegiance being owed to tax authorities in every jurisdiction in which taxable supplies were made. In making a supply, a trader has two key decisions to make - is the supply taxable, and if so at what rate? Answering these questions requires the company to look at the schedules of exemptions and rates that its tax authority has laid

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4 This idea surfaces from time to time in the debate about financing the Community budget. It has little chance of being accepted in current political circumstances, which are likely to prevail well into the next century.

down. Concretely, this means that a UK company selling into France would charge VAT under UK rules and at the UK tax rate. At present many supplies of goods are zero-rated in the UK but subject to a positive (even if low) rate of tax in France - examples include foodstuffs and books. It is equally conceivable that goods taxed at a reduced rate in one country could be subject to the standard rate in another (Denmark has no reduced rate, for example). Either way, the result is massive differences in tax rates for the same goods. This does not necessarily translate into an equally massive distortion in the market place, since there are other, non-tax, influences on prices, and because the tax paid by businesses on their purchases is deductible.[5] Sales to final consumers (who cannot deduct VAT) carry the full weight of tax rate differences, though, and buying decisions are much more likely to be influenced by the tax rate.

Second, a taxpayer dealing with just one tax authority passes all his tax payments and deductions through that authority. Since some of the tax remitted will have been paid by foreign customers, and since some of the deductions claimed will relate to tax that has ended up in foreign exchequers, there is a mismatch between the net revenue that accrues to each national exchequer and the theoretical yield of the tax in the tax jurisdiction in question (which ought to be the product of total taxable consumption and the weighted average tax rate). Taken globally, tax revenues shift *from* Member States that run a trade deficit with their partners *to* Member States that are net exporters. The Council has already made it clear that any new VAT system should not disturb the current revenue accrual patterns. Member States would not accept the changed tax revenues that this phenomenon would produce. An essential component in the Commission's VAT strategy is therefore the mechanism for re-allocating revenues to the country of (presumed) real consumption.[6] There is also a doctrinal point here. VAT is nominally a tax on value added. However, governments regard its real purpose as to tax final consumption, and the tax collected in instalments at each stage in the distribution process where value is added "rolls forward" to the final purchaser (who cannot deduct it), and is equal in its sum to the product of the value of the final sale and to tax rate to which it is liable. Hence the taxation of value added becomes a mere mechanism for collecting the tax rather than the underlying goal of the tax. This logic requires the creation of a re-allocation mechanism if the purpose of the tax is to remain the same. The alternative view, that VAT is generally a tax on value

[5] This reduces the incentive to buy in a low tax country, but does not eliminate it; if the purchaser has to finance the VAT paid on his purchases for an appreciable period before getting his refund, there is a cash flow incentive to pay as low a rate as possible. Other businesses, depending on the terms of trade, might be able to claim the refund of tax before they have paid it - here the incentive is negligible or even reversed.

[6] This is the so-called "clearing" problem, although the notion of a clearing house has now been dropped in favour of the more technical term "re-allocation".

added, would be incompatible with a re-allocation of revenue; and since this view has never been shared by governments,[7] it is not a helpful model for current purposes.

Tackling these two fundamental problems is not easy. Changing tax rates has an immediate impact on the public finances in Member States with tax levels significantly different from the EU average (which is the point towards which, one imagines, the Commission would propose convergence). Removing exemptions could be harder still, since the revenue effects would be compounded by political problems. It is wrong to think that putting a positive tax rate in place of an exemption would be good news for governments - tax systems usually rest on a precarious balance between various needs and interests, and any upset in that balance can cause economic or political difficulties. The most striking example is perhaps that of the UK zero rate, where the gain in revenue would be overshadowed by the howls of anguish from those who believed that they, or those whose causes they championed, had lost out. Furthermore, any rise in a consumption tax has an immediate effect on the consumer price index, which does not necessarily go away if the revenue is "spent" in tax reductions elsewhere in the system. There is a complex economic debate here - beyond the scope of this short analysis - which helps to explain the apparent rigidity of most fiscal systems in the Member States. Even modest changes in tax rates can be hard to agree. Where agreement was possible, it would be quite likely that governments would seek to phase the changes over a period of perhaps years.

This is, however, not the end of the tax rate saga. Once locked into a Community scheme, changes in the rates become difficult or impossible to realise. Although there is much debate about the role of tax changes in the management of an economy, there is little doubt that Finance Ministers see some attraction in being able to vary tax levels to meet economic or political circumstances. Until (or unless) there is a genuinely unified European economy, perhaps managed through mechanisms that are much more highly integrated than today's, it is unlikely that all Member States will accept the need to change tax rates in the same direction at the same time. There is therefore a real prospect of economic tensions building up between the countries of the EU through their inability to move rates, or of growing divergence in tax levels, directly contrary to the declared aim of tax harmonisation. Finally, the existence of a single currency would offer little comfort. It would be an important component in the economic unification of Europe, but would by no means resolve, by itself, the difficulty described above. Nor can it be said, at present, that there is a real prospect of the single currency being adopted by all Member States within the short term future. Indeed,

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[7] I am not aware of any political discussion of this point of doctrine in the past twenty years of VAT history. However, the insistence by Finance Ministers that an origin system without a clearing mechanism (to use the old terminology) was unthinkable shows that they think of VAT only as a tax on final consumption.

differences between the "euro club" and those Member States that did not use the euro could exacerbate the problems posed by tax rate approximation.

The re-allocation of revenue raises equally difficult issues. There is a direct trade-off between the accuracy of the re-allocation process and the reporting burden imposed on businesses. For complete accuracy it would be necessary to know everything about all cross-border transactions in the Community. Businesses would need to file returns in enormous detail on their sales to (and perhaps purchases from) other Member States. However, this would not be needed for their purely domestic transactions, and the compliance costs of cross-border trade would be substantially out of line with those for domestic transactions. It is doubtful, too, whether the EU could usefully manage such a mass of data. The alternative, as proposed by the Commission (correctly, in my view), is for a more rough-and-ready scheme. Since VAT is a tax on final consumption, the statistics for final consumption in each Member State should provide a usable key for redistributing the "displaced" VAT receipts. This is correct in theory, but raises problems in practice.

First, governments would have to accept a degree of inaccuracy in the re-allocation process, since consumption statistics are subject to error. This should not pose insuperable doctrinal problems, since the Community budget, on the income side, has similar imperfections, which Member States appear to accept. However, we can expect a prickly debate, particularly from the net importing countries, or from those belonging to the "I want my money back" school of Community thought. Second, statistics are rarely up to date. Re-allocation would therefore follow the pattern of current VAT contributions to the Community budget, where calculations are made on old data. There would, of course, be the option of readjustment in the light of updated figures, but this would lag months or years behind reality. Third, it would not be sufficient for some Member States to await an annual calculation of the sums to be re-allocated. The cash flow effect would be too severe. Instead, there would have to be some form of payment on account, from surplus countries to their deficit partners. Although this process would improve with time, there could be some difficult days and harsh words in the early months of the scheme. Fourth, re-allocation on the basis of consumption statistics raises the thorny question of tax evasion and fraud. The so-called "black economy" is a phenomenon in every Member State. However, there have been no completely reliable estimates of its size (for very good reason - illegal activity is normally clandestine and unreported). Nor is it reasonable to think that all Member States suffer to the same extent. Adjusting the statistics to compensate would therefore be a perilous undertaking.

Conclusion

It is hard to deny the logic of the Commission's case. Put simply, it is as follows:

- VAT is the EU's main consumption tax, is charged at historically high rates, and has a major impact on the price of goods and services

- Trade in goods and services is a mainstay of the internal market, and the impact of VAT is therefore important in evaluating the success of the internal market

- VAT is currently divisive, in that the differences between rates, rules and practice in the fifteen Member States drive up business costs, reduce consumer freedom and choice, and compartmentalise the market

- This reduces the EU's internal economic effectiveness, and - in very broad terms - its international competitiveness

- It is not in the interest of the EU to perpetuate this situation, and the VAT rules must therefore change

- Beneficial change means convergence of rates, law and practice, which, in turn, means harmonisation

- Half-baked measures are insufficient - change must be whole-hearted and thorough-going.

This vision, old-fashioned though it may be in some respects, is compelling. However, it is likely to founder on the rock of national resistance. This resistance will be a mixture of economic reasoning in a Community still far from economic integration, of the hard-headed politics of gainers and losers, of vaguer and more muddled-headed notions of "sovereignty", "fiscal independence" and the like, and - for those with some experience of meetings of the EU's Finance Ministers - sheer bloody-mindedness.

However, the vision is not enough. In any event there is reason to doubt this Commission's ability to drive through its policies on the basis of politics alone - there are few political giants in the Commission capable of taking on the heavyweights in national governments. Beyond this, though, is a doubt about the technical feasibility of these plans, at least in the short to medium term. The problems are tough ones, and the approach suggested is probably the best available in the circumstances. However, it rests on a premise of co-operation and trust between Member States. Experience over the past thirty years, in the tax field at least, suggests that these qualities are in short supply. Integration of VAT systems increases the risks when a number of administrations are poorly managed, under-funded, or led by Ministers to whom integration is a dirty word. Tax is still a local issue, and the "europeanisation" of a major tax is a risky business.

Finally, the Commission's timetable is excessively optimistic. Producing it, and the valiant but unremarkable document that contains it, has taken over twelve months, since schemes of exactly this kind were being discussed at technical level in the Commission in the summer of 1995. Yet over the next three years the Commission hopes to produce a volume of new tax legislation never yet dumped on the Council's table. And progress from one stage of the programme to the next will be heavily influenced by the Council's attitude. Technical deadlock or political faint-heartedness will stop the clock ticking and set back the programme by months or years.

Does this mean that the whole enterprise is doomed, or - worse - unjustified? Not necessarily - it is still the best way forward in an important, if difficult, field. Just take optimistic timetables and the ambitious visions on which they rest with a pinch of salt. However, nobody can deny that this work programme comes at a time when many assumptions about the European Union and its mechanisms, and particularly the notion of centrally driven harmonisation, are being challenged. There is little or no external spur to making major changes to the VAT system, since the Commission's arguments are based on its own view of the single market's internal efficiency. We may find that Finance Ministers are increasingly sceptical of such grand programmes, and reluctant to make sacrifices in a sensitive area - still governed by unanimous decision - fòr little apparent domestic political gain. In this sense the political cards looked stacked against the Commission.

Perhaps this is a case of the Commission being right, for the right reasons, at a time when the European Union's politicians are in no mood to listen . If so, the real losers are not Commissioners, or Commission officials, but the citizens and businesses of Europe, counting the cost of their leaders' failure to match the machinery of the internal market to its ambitions.

Annex 1

A COMMON VAT SYSTEM FOR THE EU: THE COMMISSION'S WORK PROGRAMME

Period	Action
Mid 1996	Outline of new common VAT system (communication) Work programme (communication)
Late 1996	Council adoption of existing rate proposal (standard rate to be between 15% and 25%) New status for VAT Committee (legislative proposal) Improved mutual assistance for recovery (legislative proposal?) Improved administrative co-operation (programme)
Mid 1997	Modernisation of VAT system (legislative proposal(s)): • physical scope of tax and definition of taxable transactions • concept of taxable person • determination of taxable amount • recasting of system of exemptions • rules on deductions
Late 1997	Second round of VAT rate approximation (legislative proposal)
Mid 1998	Territorial scope of VAT (legislative proposal) Place of taxation (legislative proposal) Community-wide organisation of tax control (legislative proposal)
Late 1998	System for reallocating revenue (legislative proposal) Abolition or harmonisation of special schemes (legislative proposal) Transitional measures (legislative proposal)
Mid 1999	Final round of VAT rate harmonisation (legislative proposal) Remaining features of the common VAT system (legislative proposal)
Throughout	Minimum of two years between adoption of measures and their entry into force.