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A COMMON SYSTEM OF VAT
A programme for the Single Market

(presented by the Commission)

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INTRODUCTION

Since 1993, when the present, so-called transitional VAT-system was put into place, substantial developments have taken place at Community level.

While it was a major step forward to substantially abolish the internal frontiers of the European Union, this only partly reflects the process of economic integration that has taken place. The level achieved is much more visible when it is recalled that the European Union is today in the process of introducing a single currency. It is not about having a common symbol on coins and bank notes but about showing that the European Union has developed into a single economy.

Ministers of Finance have agreed, against this background, to discuss the more general lines of a fiscal policy able to respond to two of today's major challenges: promoting economic growth and reducing unemployment.

At the heart of all such considerations is the single market. Its aim was, and still is, to convert 15 separate national markets to a single European market, to open up new opportunities for our industry by giving immediate access to over 350 million consumers, and so to strengthen our economies' competitiveness in the world. The rapid progress towards an increasingly global economy demonstrates how important it was to prepare for this steadily increasing internationalisation.

A further strengthening of our single market policy is necessary if full advantage is to be taken of its initial conception. This is particularly true for a tax like VAT, for the following reasons:

- o VAT is a tax on goods and services the free circulation of which is a basic element in the construction of the single market.
- o VAT is - in its conception and basic legislation - a Community tax and one of its characteristics and objectives is to introduce a **common** system of VAT.

The limitations of the present VAT system the so called "transitional regime" and the reasons why it is so called and has to be replaced are explained in detail in this document. It should, however, be stressed here that the present system clearly imposes unnecessary costs on our enterprises and, consequently, on consumer prices. This is because, on average and based on preliminary estimates, the cost for companies of administering transactions carried out in other Member States is 5 or 6 times more than the costs would be for similar transactions in their home countries

Elimination of those costs would undoubtedly contribute to improving our economy's competitiveness in the world. It would at the same time allow our own SMEs, for whom such a cost is likely to be an insurmountable barrier, to finally penetrate the single market. When discussing the Commission's White Paper on Growth, Competitiveness and Employment, all Member States agreed with the analysis that growth and employment are best promoted by SMEs. A change of the VAT system reducing costs and providing radical **simplification** can substantially contribute to reaching that goal.

In the process of achieving economic and monetary union with a single currency, taxation policy must further take account of constraints put on Member States e.g. with regard to the objective of reducing and/or stabilising budgetary deficits. Taxation policy should indeed contribute to reaching that objective by, at least, stabilising tax receipts.

Once again, the best way to achieve this goal is to promote growth and employment thus increasing overall tax receipts and reducing expenditure. Another aspect could be to make tax collection more effective by simplifying the tax and thus making it easy to apply and by reducing the tax system's susceptibility to fraud. Today, under the transitional system, goods worth more than ECU 700 billion circulate VAT-free in the European Union and some of that amount may well be diverted to the black economy. A change towards a situation in which goods would circulate tax paid, making the tax system simpler and thus better protected against evasion would therefore be a major contribution which VAT fiscal policy can make to fulfilling the Maastricht criteria.

In forming the **work programme** which is set out here together with its associated calendar, the Commission has given particular attention to maintaining coherence with economic and monetary union. The Commission will continue to pay particular attention to this in implementing this programme while stressing that progress towards a single currency is independent of the setting up of the common VAT system which is presented here.

I. HISTORICAL BACKGROUND

Since work first started on the introduction of a system of VAT in the Community, the question of abolishing tax frontiers (ending of tax remission, taxation of intra-Community transactions) has been discussed, the ultimate objective being the creation of a common system of VAT under which sales within the Community would be taxed from the point of origin. The view has also been taken that taxation of goods and services in the Member State of origin would meet the needs of a common market provided an answer could be found to two fundamental political questions: the harmonisation of rates and the allocation of revenues to the Member State of consumption.

The general approach and the proposals made in 1987 only confirmed these choices as far as intra-Community trade was concerned by suggesting the following answers to these political questions:

- an "adequate" approximation of rates within a harmonised structure of two rates;
- a compensation mechanism for revenues displaced by the system of taxation.

The Ecofin Council, recognising in 1989 that it would be impossible before 1 January 1993 to achieve the harmonizations necessary to move onto a unified system of taxation in the Member State of origin, decided to introduce a transitional system aimed at circumventing these difficulties which would preserve the principle of taxing transactions from the point of origin while still allowing tax to be collected in the Member State of destination in a number of situations (taxation of transactions between liable persons and various special arrangements).

Thus, the taxation of transactions and the actual collection of tax continued to be carried out in the Member State of destination, which was considered to be the country in which, in all probability, the goods or services sold would be consumed and to which the revenues generated by taxation should therefore accrue. Given this situation of taxation at destination, it was possible to make do with minimum rules on the approximation of tax rates and legislation, and the autonomy of the Member States was largely preserved. The situation has changed little since the introduction of the Commission's initial proposals on the single market in 1987. No progress has been made on approximating the Member States' laws, and the level of harmonisation of VAT rates has remained modest.

This summary of the historical background helps us to understand why many people still expect the Commission merely to come forward with proposals which are based on the same approach as in 1987, i.e.:

- **taxation at the place of origin**, i.e. the place at which the goods and services are situated at the time when they are sold by the enterprise;
- **approximation of VAT rates and legislation** to the extent which is strictly necessary to limit the risks of competition being distorted;
- a **compensation mechanism** which the Member States are likely to accept to ensure that revenues continue to accrue to the Member State in which consumption takes place.

Without repeating the detailed observations presented in the Report on the operation of the transitional arrangements (COM (94) 515, 23 November 1994), it must be stressed just how much our experience with the transitional system has fundamentally changed the assessment which may be made of the "solutions" previously envisaged and has led the Commission to attempt to redefine the characteristics which a common system of VAT for the single market should display.

It might be argued that the objective of eliminating checks at the Community's internal borders, which is a precondition for completion of the single market, has been achieved by means of the transitional system. However it is increasingly becoming clear that the actual process of harmonising the Member States' laws on turnover taxes and the prospect of introducing a common system of VAT and its transition to the definitive system go well beyond that achievement and cannot be dissociated from two other fundamental objectives of the European Union:

- that of ensuring the **neutrality** of taxation in respect of trade within and between Member States alongside the general development of European integration;
- that of establishing "an internal market characterised by the abolition, as between Member States, of obstacles to the free movement of goods, persons, services and capital" (Article 3(c) of the Treaty).

In preparing its proposals to the Council on the transition to a new common system of VAT for the single market, the Commission has been guided by these objectives and by the essential criteria which the Council itself defined for the transition to a definitive system. These are a clear affirmation of its wish that the definitive system should offer significant advantages as compared to the existing transitional system and meet the following essential criteria, which are considered to be of equal importance:

- an easing of the administrative obligations incumbent on enterprises and administrations and a significant simplification of taxation;
- no reduction of Member States' tax revenues;
- no increase in the risk of tax evasion;
- maintenance of tax neutrality in terms of competitiveness.

It very quickly became clear that the implementation of all of these criteria and objectives could not be achieved simply by amending the tax rules introduced for the transitional period but that, instead, detailed work would have to be carried out on the very principles of the operation of the entire common system of VAT.

This work has proved to be so extensive that the Commission was not able to present its proposals before 31 December 1994, as was initially envisaged. This is because it has been necessary to explore as many solutions as possible in order to identify the one best able to lead to a system of VAT which is genuinely suited to the demands of the single market and which enables the competitiveness of the European economy to be strengthened.

In these circumstances, the Commission considers that it would be premature at this stage to present proposals for legislation governing the transition to a new common system of VAT. Consequently, this document contains a **WORK PROGRAMME** which the Commission intends to follow in the coming years for the purposes of presenting suitable proposals for shifting over to a new common system of VAT which is suited to the single market.

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II. A SYSTEM OF VAT WHICH IS SUITED TO THE DEMANDS OF THE SINGLE MARKET

1. THE LIMITATIONS OF THE PRESENT SYSTEM

1.1. A complex and subjective system

The present VAT system is designed in such a way that VAT revenues are collected directly by the state on whose territory the consumption of the goods and services is deemed to take place. To achieve this objective, complex rules have had to be introduced for defining the location of a transaction. Thus, there are no less than 25 different rules for determining the place at which a transaction should be taxed, which means, *inter alia*, that operators are required to divide their turnover up between the various Member States which are competent to tax them, and this serves to compartmentalise the single market.

Consequently, VAT has lost the objectivity it should have since the applicable tax system depends on a range of diverse factors which have to be taken into account by the seller of goods or services:

- the place at which the seller and buyer are established,
- the tax status of the person to whom goods or services are supplied,
- the VAT identification number of the person supplied,
- the location of the goods at the time of supply,
- the person who organises transport and the place of departure or arrival,
- the nature of the services supplied,
- the turnover achieved by the seller in the Member State in which the goods are supplied.

On top of these difficulties in ensuring correct taxation, firms also face problems in obtaining the deduction or refund of VAT paid in Member States in which they are not established.

1.2 A system which is poorly suited to the new economic challenges

Since the present system is still based, where possible, on physical monitoring of the movement of goods, it is no longer suited to modern business practices. This heritage from the past prevents taxation from being based on commercial transactions as accounted for within firms and is a very major obstacle to the development which a genuine single market should enable each and every one of them to achieve, and in particular for small and medium-sized enterprises, which should be able to benefit fully from the new opportunities offered by the European market. The maintenance of the

status quo is also a source of legal uncertainty for operators and administrations alike since they are both faced with the difficulty of satisfying themselves of points of fact, such as whether goods have indeed been transported to another Member State, without any real means of proving them absolutely conclusively.

Moreover, the present system is **poorly suited to the development** of the most buoyant segment of the European and world economy, i.e. those **international services** which evade or increasingly might evade VAT on consumption within the Community. Current legislation is incapable of ensuring correct taxation in areas such as telecommunications, in which very rapid technological developments have occurred. Likewise, activities which were previously the exclusive domain of public services are increasingly being taken on by private firms: the derogations introduced for the private sector have thus become obsolete and give rise to distortions of competition which are increasingly damaging to both the public and private sectors.

1.3. Divergences in application between Member States

By dint of the manner in which the common system was set up (directives leave the Member States with a lot of powers and options), divergences in its application have existed from the outset. However, the impact of these divergences has been reinforced by the fact that operators are now affected to a greater degree by legislation - and above all the manner in which it is applied - of Member States other than the one in which they are established or pursue their usual activities.

Increasingly denounced as being the most damaging barrier of all within the single market, the divergences in the application of the common system of VAT between Member States have a variety of origins: special arrangements, options and powers granted by the directive (66), temporary or transitional derogations which have not been repealed, other derogations authorised by the Council (some 130), shortcomings in transposition or differences in the interpretation of common provisions.

The result is an extremely complex situation in which there is no legal certainty whatsoever for most operators, and this in itself constitutes **yet another obstacle to transnational economic activities** and consequently gives rise to many obligations for firms, which today have to be familiar with the details and practical implementation of the legislation of fifteen Member States in order to be able to operate in the Community.

In addition, operators exploit these divergences using clever tax accounting, and this distorts any fairness of competition which might otherwise exist in the single market (as illustrated by the problems encountered in the car leasing sector).

1.4. The criticisms voiced by businesses

At a conference organised by the Commission in June 1994 on the future definitive system, the wish was clearly expressed for there to be a comprehensive debate on ways to bring about a general and effective improvement of the existing system.

The Commission departments have also received a not insignificant number of contributions from professional circles in which the latter express their lack of satisfaction with the current VAT system and their hopes with regard to the new system.

Almost 80% of operators are in favour of replacing the exiting transitional system with a definitive system.

These same operators are broadly in favour (85%) of harmonisation of Member States' legislation, particularly in the following areas: charging procedures and declaration obligations (74%), right to deduct (52%), VAT rates and exemptions (43%). A large majority of them also regret the divergences in application which they observe at present.

These pressing demands reveal the dissatisfaction caused by the current system, which is often seen by operators as an obstacle to any extension of their economic activity to the Community territory as a whole.

1.5. Conclusion

The combined effect of all the difficulties associated with the present system is far from negligible, and given that it extends to businesses, consumers and tax administrations alike, it is proving to be a significant burden to the competitiveness of the European economy.

Consequences for operators

- *the need to become familiar with the specific legislation* applied in the different Member States, which may be an insurmountable obstacle to SMEs;
- *discrimination between purely domestic and intra-Community transactions*; this goes completely against other EU policies for which Community law guarantees the same access for all European firms; on the contrary, the VAT system introduces significant barriers including, for example, for public procurement;
- *legal uncertainty* due to the various factors which sellers must take into account in determining whether and where their sales are to be taxed; this continually exposes them to the financial risk that the tax administration might come up with a different interpretation, which effectively means that it is operators which have to bear the cost of maintaining autonomy between the Member States.
- *major costs*, which have a particularly penalising and deterrent effect for SMEs, and prevent the benefits of the single market from being fully reaped (especially in terms of economies of scale):
 - transactions carried out in a Member State other than the one in which a business is established remain more expensive than purely domestic transactions, in particular because they are required to use tax representatives (according to some estimates, the average costs can be five or six times greater than those of a domestic transaction);
 - the application of the transitional system generates costs which some businesses put at 20% of their total tax costs.

Consequences for consumers

- *a major restriction on their freedom to obtain supplies on the market conditions of other Member States*: their purchases in other Member States are subject to tax in either the country of origin or of destination depending on factors such as the seller's turnover in their country, the nature of the goods purchased (new means of transport, for example), or whether or not they organise transport to their country themselves;
- *they do not benefit from all the advantages which the single market should offer*: the complexity of the conditions governing whether their purchases may be made inclusive of tax in another Member State (travel to the country themselves, organise the transport or undertake to pay VAT at the destination) is a deterrent to consumers, who will therefore tend to buy at home; this helps maintain a segmented market and compartmentalises competition, the result of which is that major differences continue to exist in prices charged from one Member State to another.

Consequences for administrations

- *loss of sovereignty over monitoring*: the apparent defence of national sovereignty in a system of taxation which ensures a direct allocation of VAT revenues between Member States gradually leads to a real loss of sovereignty over tax matters; this is because the fragmentation of the activities of taxable persons between the various Member States prevents administrations from being able to monitor the overall activity of a firm and to satisfy themselves that any deductions made are justified;
- *the opportunity to commit tax evasion or avoidance*:
 - the circulation between Member States of goods which are totally exempt from tax may encourage the development of "black markets": the amount of tax involved, based on the volume of trade between Member States, is some ECU 100 billion *per annum*;
 - the *complexity* of the situation encourages operators, disheartened by the cumbersome nature of their obligations and the scale of their costs, not to declare their activities or to declare them in the country in which their costs would be lowest; it also creates a feeling of lack of effective control, which is particularly damaging to the proper application of the tax.
- *impact on VAT revenues*: wrong application of the tax rules or their circumvention by means of clever tax accounting may lead to a reduction of revenues or even a displacement of activity to third countries where no Community VAT is payable.

These difficulties are too fundamental to be solved on the basis of the existing framework. Simplification measures have reached their limits and attention must now be directed at the actual source of these problems, which lies in some of the basic choices made in the past on the basis of the existence of nation states surrounded by a frontier.

In order not to invite the same criticisms as the present system and to meet fully the objectives of the single market, **the new system of VAT will have to satisfy the following criteria:**

- it must *abandon the segmentation* of the single market into 15 tax areas;
- it must be *simple and modern* so as to rise to the challenges of the 21st century;
- it must guarantee *equal treatment of all transactions* carried out in the Community;
- it must ensure *effective taxation* and guarantee *proper monitoring*, thereby maintaining the level of VAT revenues.

2. THE SYSTEM UNDER CONSIDERATION

Such a common system of VAT can be defined solely by reference to the general objectives of the Treaty, and in particular the pursuit of economic integration and convergence as symbolised by the concept of the single market.

In this context, the common system of VAT must be given the characteristics of a genuine Community tax area in which domestic and intra-Community transactions are afforded equal treatment, this being the unavoidable consequence of the ultimate objective which has been pursued ever since the First VAT Directive was adopted, i.e. the eventual creation of a "common market within which there is healthy competition and whose characteristics are similar to those of a domestic market".

2.1. The essential characteristics

2.1.1. Elimination of any distinction between domestic and intra-Community transactions

The single market should function on the same conditions and in the same way as a domestic market, and this also applies in the field of VAT. It absolutely must offer operators the opportunity to carry on business in all the Member States, and the new common system of VAT must therefore ensure that no activity is more difficult to exercise in one Member State than in another and that any purchase can be made on the same terms throughout the Community. At the same time, a transaction involving several Member States should not be allowed to result in more obligations than one carried out within a single Member State. Any other approach implies costs which would penalise European businesses.

Eliminating the distinction between domestic and intra-Community transactions must enable operators to reduce to only two the number of tax systems currently applicable: transactions involving a third country and transactions carried out within the Community. Thus, it will be possible to achieve a major simplification to the benefit of operators, consumers and administrations alike, and one which is fully consistent with the Council's conclusions concerning the essential conditions for the transition to a definitive system.

2.1.2. Taxation of all transactions carried out within the Community

It being established that all transactions carried out within the Community should be afforded equal treatment, it is necessary, to guarantee both the simplicity and the effectiveness of the system, that the principle be generally applied of taxing all transactions carried out within the Community, and this in preference to a generalisation of the exemptions currently applicable to intra-Community transactions. This approach is a suitable means of restoring the objectivity of the tax, which has gradually been lost, and implies that two essential characteristics of VAT be strengthened:

- the mechanism of **fractioned payments**, which ensures that the tax system is self-checking;
- the **clear sharing out of responsibilities** between the supplier (correct invoicing of the tax due) and the buyer (correct proof of the taxes he deducts).

These characteristics guarantee that VAT is able to provide the advantages it offers in terms of effectiveness and monitoring over other consumption taxes (retail taxes, for example). This goes a long way to explaining why it has been introduced in the large majority of OECD countries and why it was chosen by the European Community. Consequently, **the remission/taxation mechanisms for trade between Community Member States must be abolished.**

In this way, the principle of taxing transactions carried out within the Community from their point of origin is complied with: all that remains is to draw the necessary conclusions for the mechanisms to be established for its implementation, in particular regarding the determination of the place of taxation.

2.2. Key features

2.2.1. Single place of taxation for operators - a major simplification

Experience with the transitional system has shown that as long as the tax rules require operators to distinguish their sales according to the place at which they are deemed to take place in the Community, no genuine simplification can be achieved and the single market will continue to be segmented and compromised. It is unthinkable that a French firm should be required to declare its sales in all the various towns of France in which it has customers, but this is what is at present required at Community level if the same firm decides to sell goods in Cologne or carry out work on property in Rome. At national level, the Member States apply the very sound rule that a taxable person is **registered only once**, and there are convincing reasons for so doing:

- it is **easier for operators**, who are able to meet their obligations (declaration and payment of tax) and exercise their rights (right to deduction) at one place;
- it is **easier for consumers**, who are able to obtain supplies without constraints from the trader of their choice;
- it is **easier and more efficient for tax administrations**, who are able to monitor all the activities of a taxable person and the deductions carried out in relation to those activities.

The Commission is convinced that this approach must also be adopted at Community level and that, consequently, **all the transactions of a given operator will have to be taxed at one place for the entire Community**, whereby a distinction will no longer be made according to the Member State in which they are carried out. This approach also implies that the right to deduct must be exercised strictly and exclusively at that place.

Requiring taxation and deduction to be administered by a single tax administration would strengthen the monitoring of the tax, although there will still be a need for close collaboration between the 15 administrations.

2.2.2. End of the direct allocation of VAT revenues by the tax system

Any system which opens up the possibility of deducting in one Member State VAT which has been collected in another involves a displacement of the VAT revenues directly collected by each Member State.

As early as in 1987, the Commission considered a compensation mechanism as a means of reallocating any revenues which might be displaced following a reform of the system of taxation.

In 1994, when defining the essential conditions for the transition to the definitive system, the Council insisted that the changeover should not lead to a 'reduction of Member States' tax revenues.

The system advocated by the Commission creates a Community tax area and abandons the direct allocation of VAT revenues by the actual tax system, replacing it with a reallocation mechanism.

In this respect, the Commission would stress that **the reallocation of revenues between Member States cannot be based on data provided in the tax returns of taxable persons**. Indeed, such an approach would be incompatible with the choice of a single place of taxation because this would reintroduce the monitoring of the physical movement of goods. Also, this would necessitate making a distinction between domestic and intra-Community supplies and by this clash with the fundamental principle that domestic and intra-Community transactions should be treated in the same way. The simplification involved in eliminating this distinction would be cancelled out if, for the purposes of compensation, operators had to continue identifying intra-Community transactions in their tax returns. Any correction of the allocation of revenues must therefore be based on data not taken from the tax returns filed by operators.

Given that the Council stressed in its above-mentioned conclusions that VAT has the character of a general tax on consumption, the Commission considers that **the best means of determining the revenues of each Member State in terms of taxed consumption which occurs on its territory is to quantify consumption by means of statistics**.

Indeed, on the basis of the consumption side of National Accounts, appropriate input-output tables and other information (statistical surveys, annual reports, etc.), it is possible to establish the yearly consumption of the various economic sectors, such as the private sector and the State sector, both classified by function and broken down into more detailed figures. Such information is also available for other sectors and sub-sectors, such as non-profit-making private bodies, the credit sector, insurance companies, the health sector, etc.

Those parts which - though being final consumption - are not subject to taxation need to be eliminated from these consumption figures. Those figures which have been inserted into the GNP calculation for the black economy must consequently be deducted again. After doing so, the statistical consumption figures correspond, in principle, to the appropriate tax base (taxable amount of the underlying transactions) that - under the destination principle as applied for the revenue allocation - would give rise to VAT receipts in the Member State establishing this calculation. It is, therefore, possible to group the classifications of sectors and sub-sectors used in the National Accounts according to their VAT treatment (out of scope, exempted with or without right of deduction, taxed at the standard rate, taxed at a reduced rate) and thus - by applying the appropriate weighted VAT rate - calculate the theoretical VAT receipts of the country concerned.

The share of each Member State in the total of all Member States' theoretical VAT revenues will be the key to redistributing the total VAT revenue of the Community among the Member States.

In practice, this system of macro-economic reallocation of Member States' VAT revenues could be easy to implement using the accounting methods applied to the VAT own resource.

In its eagerness to preserve the Member States' budgetary situation, the Commission will be particularly attentive to the setting up of suitable mechanisms intended to ensure that Member States have access to the revenues generated by VAT whenever they are entitled to them without having to wait for the final outcome of the calculations to be carried out on a statistical basis.

Such a system would lead to a much more accurate and complete allocation of VAT revenues based on all final consumption taking place on the territory of each Member State than occurs with the present system.

Application of the principle of taxation in the country of origin, even if it is not very widespread today in view of the particular systems in force, has already led to a certain displacement of revenues between Member States without any compensation having been deemed necessary. Strengthening the principle that the revenues generated by VAT should accrue to the Member State of consumption would be one means of stabilising the overall tax revenues of Member States.

2.3. Consequences

Once it is the case that all the economic activities of a given trader are taxable in a single Member State, **very extensive harmonisation of tax mechanisms is inevitable** to ensure uniform application demanded by operators; besides, if the tax is to remain neutral vis-à-vis the conditions of competition between businesses a certain degree of harmonisation of VAT rates is equally necessary. In any case, irrespective of the specific arrangements proposed, **the system needs to be completely modernised** in order to take up the challenges of the twenty-first century.

2.3.1 Harmonisation measures

Harmonisation of rates

The degree of harmonisation of VAT rates which needs to be achieved must be considered in the light of what is judged necessary to avoid damaging distortions of competition for the Community as a whole.

Indeed, one of the essential characteristics of VAT is its neutrality vis-à-vis the conditions of competition: consequently, maintaining the possibility of applying too many different rates from one Member State to another would endanger this neutrality with the risk that business locations would be influenced, which would be inconsistent with the very principles of the single market.

Otherwise, the Member States cannot be expected to accept from the outset a system of taxation which might seriously damage their own operators if there is not a sufficient degree of harmonisation of VAT rates.

Consequently, the Commission intends to address the matter of rates as follows.

As far as the *standard rate* is concerned, the introduction of a single rate would provide a perfect solution avoiding any tax-related distortion of competition and, above all, ensuring that the tax is applied simply and uniformly throughout the Union - nevertheless, an approximation within a band could prove sufficient.

The decision setting the rate should be a political one and should take account of the general need for sufficient revenue, **the need to share the burden** among the main types of statutory contributions and charges (direct taxation, indirect taxation, social contributions) and the thrust of **medium-term tax policy**.

Consequently, the question of rates must form part of the wider debate launched at the informal Council meeting in Verona on the **general tax policy** of Member States and the Community as a whole. In this context, the debate is not limited to identifying the rate of tax necessary to guarantee a level of revenues comparable to the present one, but it might also include other political considerations. In particular, it might be envisaged to provide, by way of the VAT, the budgetary resources needed to reduce other contributions and charges.

As regards the *reduced rate(s)*, harmonisation of their number and scope is necessary from a purely technical standpoint. The Commission remains convinced that **only a small number of rates is compatible with the objective of simplifying the tax.**

Other harmonisation measures

Harmonisation of many other aspects of the common system of VAT is absolutely necessary. Mention should be made here of topics such as the extent of and conditions for **exercising the right to deduct, exemptions, the tax treatment of small firms or other special schemes.** Although it has not been possible to achieve significant progress so far, there is no escaping the fact that these aspects must be harmonised in order to ensure healthy competition and sufficiently uniform application of the tax across the Union, factors which are closely linked to the simplicity and effectiveness of the tax system. The entire range of options, authorisations and derogations allowed by the existing system also need to be reviewed.

The Commission is, however, already convinced that the proposals currently on the Council table cannot be used as a basis for the in-depth discussions that need to be launched on these topics with a view to the changeover to the new common system of VAT. They will therefore be withdrawn to make way for proposals expressly concerned with introducing the new VAT arrangements.

2.3.2 Uniform application

The harmonisation of rates and other aspects of the common system of VAT will be a definite step forward. It is nevertheless indispensable to ensure that a more unified approach is taken to interpreting the legislation. To that end, the Commission intends shortly to propose that the **VAT Committee** be turned into a **regulatory committee**, with the Commission being given powers to take measures implementing acts adopted by the Council.

Thought will also have to be given to the strategy to be taken, in terms of the type of **legal instrument** (a directive or a regulation?) and the **decision-making process** (unanimity or qualified majority?), for arriving at a system of VAT that is genuinely common and uniformly applied.

2.3.3 Modernisation of the existing system

The need is making itself felt today for a re-examination of the approach taken in the 1970s in a number of fields, e.g. areas excluded from the scope of the tax (activities carried on by public authorities, holding companies, etc.), or transactions exempted because they relate to certain activities carried on in the general interest (public postal services, activities of public broadcasting organisations, etc.) or because of the technical difficulties involved in applying the tax (telecommunications, real estate, financial and insurance services, etc.).

Attempts will also have to be made to achieve a better match between the Union's tax territory and its customs territory.

In any event, the modernisation exercise will have to be carried out in such a way as to establish as **wide as possible a scope** for the tax and will require a **debate on the possibility of widening the scope still further by limiting exemptions and all other derogations** to the tax system currently in force so as to ensure that the taxation arrangements are as neutral, as simple and as effective as possible, taking into account their likely effects on income distribution. Moreover, it cannot be ruled out from the outset that this debate might make it possible **to reduce rates overall** while guaranteeing an unchanged level of revenues or to eventually **compensate** for any reduction of non wage labour cost.

Such a reappraisal will be no easy task and will be feasible only in close liaison with the economic operators concerned; however, it would be inconceivable to ignore, in a single market, the impact on neutrality and competitiveness of the choices made with regard to the scope of VAT.

2.3.4. Administration, control and collection in the new system

The considerable simplification of the system proposed offers the additional benefit of simplifying administration of the tax in three important ways.

- o Firstly, the abolition of the distinction between domestic and intra-Community transactions and of exceptions to the general rule will reduce the existing opportunities for evasion.
- o Secondly, a single VAT supervisory relationship will provide a more complete understanding of each business to the benefit of effective control.
- o Thirdly, the abolition of the VAT-free circulation of good in intra-Community trade will eliminate the key condition for the main intra-Community VAT frauds, as set out under point 1.5 earlier.

All these imply that the burden on administrations will be reduced, permitting resources to be concentrated where they are most needed.

This simplification benefit is however a net gain both for administrations and taxpayers. If the simplification of the tax reduces the burden on administrations, the overall burden of obligations on the taxpayer also requires reconsideration. The existing obligations on the taxpayer were put in place to ensure control and collection in the present, more complex, system. A simpler system requires the detailed re-examination of the justification of each of the existing obligations on business.

In reconsidering each of these obligations, the question of what each taxpayer has the right to expect of the tax administration (the obligations of the administration to the taxpayer) must also be considered. The compliant taxpayer should have, at least, the right to expect clarity of his obligations, fair and correct administration of the tax and an avoidance of unnecessary disruption of his economic life. Fulfilling these basic obligations is inherently in the interests of the tax administration.

Fulfilling them encourages voluntary compliance which frees resources to be concentrated on non-compliant traders. Some expression of these rights of the taxpayer (or obligations on the administration) should be enshrined in Community law. If the relationship between taxpayer and administration is seen properly as a whole, obligations on the administration towards the taxpayer must be considered simultaneously with the obligations on the taxpayer.

This re-examination of the justification for these obligations from the standpoint of burdens on business will be intimately linked to the establishment of the sufficient minimum of obligations on taxpayers set out below.

The new system also has two major implications for the administration of the tax: **collective responsibility** and a **greater emphasis on cooperation**.

Collective responsibility

Under the existing system, each Member State is responsible for the administration, control and collection of the tax which contributes directly to its own national Budget. Consequently each Member State grants itself the powers and resources which it thinks necessary to achieve this goal. Certainly no Member State can achieve this goal satisfactorily without the cooperation of other Member States, as provided for in Community legislation. But the primary responsibility for successful administration of the tax in all its aspects rests with each Member State alone.

In the proposed system this individual responsibility will be replaced by a collective responsibility. All the Member States will be responsible collectively for the global tax receipts which are due to each of them according to their consumption. The effectiveness with which each Member State administers, controls and collects the tax will directly affect the national Budget of each other Member State.

That said, the change from individual responsibility to collective responsibility must also be reinforced by its corollary, mutual confidence between Member States. If each Member State will be directly affected by the effectiveness with which each other Member State administers, controls and collects the tax, then each Member State must be confident that each other Member State will carry out these collective tasks effectively.

The Member States need to be made confident in each other in three ways: powers, tasks and performance.

- o Each Member State must be reassured that each other Member State has a sufficient **minimum level of national control and collection powers**. These will include a sufficient minimum of common obligations on the taxpayer, in particular accounting and record keeping obligations that are to the greatest possible extent founded on normal commercial practice. What constitutes a sufficient minimum will need to be determined.

However in determining this minimum, it is also important both to protect revenue and to ensure that legitimate businesses are not undermined by unfair competition from unscrupulous operators who do not respect the law. It is particularly important to ensure that criminal organisations cannot benefit from differences between Member States to make illegal gains at the expense of legitimate businesses.

Determining this minimum must therefore take place in the light of the need to ensure that appropriate means exist to detect and punish tax evasion and fraud. Such measures should apply evenly across the Community to ensure that fraudsters do not profit from important differences in enforcement rules and penalties for fraudulent behaviour. Taking these considerations into account will, as stated earlier, be intimately linked to the re-examination of the obligations on the taxpayer described previously.

- o Each Member State also needs to be reassured that a sufficient **minimum of common control and collection tasks** will be carried out. What constitutes a sufficient minimum of common control and collection tasks will also need to be determined.
- o Finally each Member State needs to be reassured that the **quality of performance** of these tasks will meet acceptable standards.

Ensuring this quality of performance implies transparency on the performance of each Member State. The way to achieve this transparency is to replicate at Community level the management systems and tools (performance indicators and statistics) available to the Member States for monitoring the performance of their own regional and local administrations. Responsibility for this close monitoring should rest primarily with the Commission, assisted by an advisory committee composed of representatives of the Member States.

The actual performance of each Member State against the standards would then need to be evaluated. If the evaluation showed that the acceptable standards had not been met, and that consequently the VAT revenues of all the Member States had been put at risk, these losses would have to be compensated through the system for macroeconomic reallocation of VAT revenue.

Greater emphasis on cooperation

Administrative cooperation will become more central in the operation of the new system. Although for tax purposes all transactions will take place in the Member State of registration, physical aspects of the transaction may take place in another Member State. To ensure that the Member State of registration can control all aspects of the transaction, these physical aspects will need to be verified. This requires full cooperation between the Member State of registration and the Member State where the physical aspects of the transaction take place. In short, a level of cooperation between the Member States at least equivalent to that currently achieved within each Member State will be required.

The new collective responsibility will of course give a great incentive to this cooperation. Indeed it will be in the same ultimate financial interest of each Member State to provide cooperation as it will be to concentrate on domestic administration. Further, the monitoring and evaluation of each Member State's performance must also include their performance in cooperation. Nevertheless three further initiatives are needed.

Firstly, the existing **legal framework** for mutual assistance and administrative cooperation requires extensive reform. In particular the obligations to cooperate need to be strengthened and the arrangements for monitoring performance in cooperation made explicit. There will also be a need to strengthen cooperation on enforcement and investigative procedures and to ensure that both administrative penalties and penalties under the criminal law of the Member States are adequately structured to take account of the new regime. There will be a particular need to ensure a high level of judicial cooperation.

Secondly, effective control and collection under the new system will require agreed common control methodologies. These will be necessary to ensure that control and collection can be as effective in a Member State where only the physical aspects of a transaction take place as within the Member State of registration. Experiments in developing these control methodologies have already taken place under the transitional system.

Also, new **tools and methodologies** for cooperation will be needed. In developing these tools, the infrastructure and experience of the transitional regime, notably the VAT Information Exchange System (VIES) will be important.

Finally a new spirit of cooperation between individuals in national tax administrations, based on a much deeper mutual understanding and confidence, needs to be established. A programme to achieve this, building on past experience, needs to be put in place before the entry into force of the new system.

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III. CONCLUSION: THE COMMISSION PROPOSES A WORK PROGRAMME

The transitional system gives Member States the illusion of having retained full sovereignty in determining their revenues and the overall operation of the VAT system: in reality, the system's complexity and subjectivity, the fact that it is ill-suited to new economic challenges and the divergences which exist with regard to its application have a detrimental effect on the competitiveness of businesses without guaranteeing the Member States the certainty of being able to receive the revenues to which they are entitled.

The system proposed by the Commission involves a complete overhaul of the common system of VAT, with major consequences for the Community as a whole and for each Member State individually. This requires the Member States to embark on a legislative harmonisation process which is more extensive than has ever before been contemplated in the field of indirect taxation, and in particular that of VAT, in order to restore the economic efficiency of VAT as a system of taxation.

That said, the question that has to be faced is the following: is it genuinely possible to achieve the objectives set for the new common system of VAT by any other means while avoiding the consequences described in the foregoing?

The Commission has come to the clear conclusion that this is not possible and that this course should therefore be pursued. This is because, if any of the key features of the planned system or the indispensable harmonisation measures resulting from it were to be given up, the new common VAT system could not in any way guarantee the tax's neutrality, avoid the risks of evasion and loss of revenue and, at the same time, achieve extensive simplification. The consequences of this would be particularly disastrous: not only would the new system be doomed to preserving many of the shortcomings of the present system (e.g. divergences in application) but it would also generate particularly damaging distortions of competition which would seriously undermine one of the essential characteristics of VAT, i.e. its neutrality. This might give rise to economic activities being shifted to Member States with the most favourable tax arrangements, thus separating still further the Member State of taxation from the Member State of consumption, with all the repercussions that would inevitably have for the revenues to be reallocated between Member States. The operation of a system of taxation at the place of origin would consequently become practically impossible.

In conclusion, it is only on the basis of the proposed VAT system that it will be possible to achieve the completion, implementation and unobstructed operation of the single market and thus to continue the process of strengthening the competitiveness of European businesses at world level.

Much remains to be done, however, in order to take all the measures necessary for changing over to the new common system of VAT proposed by the Commission with a view to meeting the needs of a genuine single market. In this context and given the scale of the tasks still to be completed, **it would be unreasonable to endeavour, at the same time and in a single package of proposals, both to settle the immediate problems that are calling for an early solution geared to the present situation (e.g. the tax treatment of telecommunications services) and to adopt the other measures necessary for introducing a genuinely common system of VAT based on the origin principle.**

The Commission has therefore decided to draw up a **work programme** together with a timetable for putting forward proposals based on a step-by-step approach for progressing towards a common system of VAT for the single market.

The work programme is set out in **Annex A**.

ANNEX A: THE COMMISSION'S WORK PROGRAMME

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1. INTRODUCTION

Introduction of the proposed new common system of VAT will have major repercussions in terms of the harmonisation of all aspects of the Member States' VAT legislation. The fact is that the situation has not changed much since the Commission tabled its initial proposals for the single market back in 1987.

The first part of this paper clearly demonstrated that the present situation has unfavourable consequences at various levels:

- for the Community as a whole, since its general policy objectives are being held back;
- for the Member States, which are finding it increasingly difficult to control the proper application of the tax;
- for businesses, which are still paying the price, not of "non-Europe", but of the absence of a genuinely common system of VAT.

Given the scale of what still remains to be done, the Commission has decided to draw up the following **work programme** based on a step-by-step approach for progressing towards the new common system of VAT.

2. PROPOSALS FOR THE CHANGEOVER TO THE NEW COMMON SYSTEM OF VAT: PROVISIONAL TIMETABLE

2.1 PHASE ONE

Preparatory work

LATE 1996:

Proposal already on the Council table

On 20 December 1995 the Commission put forward a proposal on the:

- *standard rate of VAT.*

The proposal provides for a minimum rate of 15% and a maximum rate of 25%. It is the very first step towards the approximation of rates.

It should be adopted before 31 December 1996.

Proposal to be presented

The Commission is to put forward a proposal on:

- *changing the status of the VAT Committee.*

All the limitations of this advisory committee have become apparent: the guidelines which it adopts - even unanimously - have no binding legal force and traders are not systematically informed of the topics it discusses and the guidelines it adopts. It should therefore be turned into a regulatory committee whose task would be, by delivering opinions by a qualified majority, to assist the Commission in exercising its powers to implement Community legislation on VAT in accordance with the procedure provided for in Article 2(III)(a) of Council Decision 87/373/EEC on committee procedures.

- *improving the arrangements on mutual assistance on recovery*

This is part of the renewal of the existing legal framework for cooperation. In the recovery area, a renewal of this framework is needed more urgently as the present arrangements are not sufficiently effective for even the transitional system. Reform of the arrangements will also take account of the requirements of the new system of VAT.

- *Programme to establish a new spirit of administrative cooperation*

The need to establish a new spirit of cooperation between Member States at an individual level requires a new departure in scale and ambition. The Commission will propose a programme which will provide a framework for the development of the tools and activities necessary to make cooperation a reality. This spirit of cooperation cannot be introduced overnight and therefore needs to be fostered in preparation for the introduction of the new system.

2.2 PHASE TWO

Communication of the basic options and the work programme

MID-1996:

Presentation of this paper

The Commission will present to the Council and Parliament:

- *the broad lines of the new common system of VAT which it is contemplating;*
- *the work programme it intends to follow with a view to achieving the objectives set.*

2.3 PHASE THREE

General principles of VAT

First package of formal proposals

MID-1997:

The Commission will present its proposals concerning the **broad general principles governing the operation of VAT** and its essential features.

These proposals, which will have to take account of the need to modernise the existing provisions, will relate to:

- determination of the *physical scope* of the tax, including the precise definition of taxable transactions (uniform definition of the supply of goods, the concept of the supply of services, the fact that the supplies are made for consideration, etc.); the precise determination of the territorial scope of the tax will be looked into in phase three;
- definition of the *concept of the taxable person* for VAT purposes (which involves reviewing the VAT status of public bodies, the consequences of treatment as a non-taxable person, etc.);
- determination of the *taxable amount* for taxable transactions;
- *exemptions*: maintenance or abolition and, in any event, harmonisation of exemptions, consequences for the right to deduct, etc.;
- the *right to deduct*: conditions giving rise to and governing exercise of the right to deduct, procedures, harmonisation of the non-deductibility of certain items of expenditure, deductible proportion (general proportion, actual application), i.e. the ratio of deductible transactions to non-deductible transactions (because exempt or outside the scope of the tax).

LATE 1997:

The Commission will propose:

- a second round in the *approximation of Member States' VAT rates*.

This first package of proposals will lay down the bases on which VAT is to operate and will represent a major step towards adopting the harmonisation measures which are indispensable for the proposed new common system of VAT.

2.4 PHASE FOUR

Scope and place of taxation

Second package of formal proposals

The cornerstone of the proposals for the new common system of VAT is the radical change, as compared with the present situation, in the role played by the place of taxation: it will no longer have to be used to determine the territorial scope of the tax or to determine which Member State is allocated the tax revenue.

MID-1998:

The Commission will present proposals relating to:

- definition of the *territorial scope* of VAT;
- the *place of taxation* for transactions falling within the scope of the tax;
- *Community-wide organisation of the control* of taxable persons carrying out taxable transactions in the Community (obligations, methods of control, etc.).

The second package of proposals will lay down rules for taxing transactions based on the place of consumption within Community territory and stipulate the consequences in terms of the obligations incumbent on taxable persons and factors of control by the administrations.

2.5 PHASE FIVE

Re-allocation of revenue between Member States and overall finalisation of the system

Third package of formal proposals

Since revenue will no longer be allocated between the Member States by the tax system, special machinery and the necessary statistical measures will have to be set in place for ensuring that Member States receive a level of revenue commensurate with consumption within their territory.

Consideration will also have to be given at this final stage to the question of whether the special schemes (for small firms, farmers, second-hand goods, travel agencies, etc.) should be maintained and whether any specific measures should be introduced or maintained in a harmonised fashion in the Member States. Transitional measures will have to be planned for changing over from the present system to the new system of taxation in the country of origin, and the final round in the harmonisation of VAT rates begun in 1995 will have to be implemented.

LATE 1998:

The Commission will present its proposals relating to:

- the machinery for *allocating the tax revenue*;
- *special schemes* (abolition, harmonisation);
- *transitional measures*.

MID-1999:

The Commission will present its proposals relating to:

- the final round in the *harmonisation of rates*.

In this third and last package of measures the Commission will put forward all the remaining proposals necessary for introducing a new common system of VAT for a genuine single market.

Clearly, this timetable in no way prejudices the date of adoption of the various measures by the Council. Nevertheless, the Commission will in any case ensure that the new measures enter into force not less than two years after their adoption by the Council, in order to allow economic operators and administrations enough time to introduce the new system smoothly.