

Policy Department  
Economic and Scientific Policy

VAT  
Current Issues of Interest  
Workshop

This workshop was requested by the European Parliament's committee on Economic and Monetary Affairs (ECON).

Only published in English.

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Report completed in January 2008.

The opinions expressed in this document do not necessarily represent the official position of the European Parliament.

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**DIRECTORATE-GENERAL INTERNAL POLICIES OF THE UNION  
- DIRECTORATE A -  
ECONOMIC AND SCIENTIFIC POLICIES**

**Workshop on VAT - Current Issues of Interest**

23 January 2008  
European Parliament Brussels  
Room ASP 5G2, 15.00-18.30  
Interpretation - EN DE FR

**15.00 - 15.05**      **Introduction**  
*Chair: Pervenche Berès (MEP, ECON Chairwoman)*

**15.05 - 17.00**      **Session I - VAT Fraud**  
*Chair: Pervenche Berès / Sharon Bowles (MEP)*

**Proposition:**      **Starts with first 4 experts presenting for a max. of 8 minutes each, after which first short round of questions. Then next 4 experts of the session followed by questions and more extensive discussion.**

**Topic area 1:**      ***Analysis of the present situation***

- Fraud mechanisms (e.g. missing trader, carousel schemes),
- Quantification of levels of losses in Member States,
- Determinants of fraud in different environments.

Focus on description of the problem. The part-session features presentation of research on VAT fraud in the EU from universities and research institutes as well as selected concrete experiences in Member States through their administrations and treasuries (7-8 minutes per expert).

**Experts:**

Stephen Smith  
*Professor of Economics, University College London*

Ruediger Parsche  
*Researcher, Ifo Institut, Munich*

Gabriele Himsel  
*Head of VAT Unit, German Ministry of Finance, Berlin*

João Durão  
*Deputy Director-General for Tax Inspection, Portuguese Tax Administration*

**Topic area 2:** *Remedies - more effective administrative cooperation and/or changes to the system?*

- Administrative cooperation - striking the right balance between the fight against fraud and the burden on businesses,
- Changes to the system: reverse charge, taxation of intra-community supplies, and other possible changes.

Focus on remedies and solutions. The part-session aims to present best practices proposed as well as different solutions to VAT fraud, including their advantages and drawbacks. It also aims to benefit from existing extensive parliamentary investigations into the subject (7-8 minutes per expert).

**Maximum of 8 minutes each**

**Experts:**

David Holmes

*Head of Unit, Consumption Taxes, OECD Centre for Tax Policy and Administration, Paris*

Jean-Claude Bouchard

*TAJ Lawyers, Paris,  
Chairman of VAT Europe and Intl. VAT Association*

Baroness Cohen of Pimlico

*Chairwoman of UK House of Lords Scrutiny Committee on Missing Trader Fraud*

Alexander Wiedow

*Director, Indirect Taxation and Tax Administration, DG TAXUD*

**Note: All speakers in Session I are invited to contribute to all discussions, also beyond their respective part-session focus. The above structure merely serves the purpose of providing a more structured sequence of interventions.**

**17.00 - 18.30**

**Session II - VAT Rates**

*Chair: Pervenche Berès / Ieke van den Burg (MEP)*

**Topics discussed:**

- Reduced VAT rates on labour-intensive services, on locally supplied goods and services and on basic good and services,
- Distortionary impacts resulting from differentiated VAT rates and from the lack of a consistency of the existing set of derogations and exemptions,
- Competition effects of differentiated rates on the industry - SMEs vs. big industry.

This session aims to discuss the rationale behind reduced and differentiated VAT rates in the single market and the current regime of derogations, taking into account, amongst others, the Commission communication of 5 July 2007 (COM(2007) 380).

**Experts:**

Alexander Wiedow

*Director, Indirect Taxation and Tax Administration, DG TAXUD*

Sigurd Naess-Schmidt

*Senior Economist, main co-author of the study on the impacts of reduced rates in Member States, Copenhagen Economics, Denmark*

Tomasz Michalik

*Chairman of the VAT Working Group in the Polish Confederation of Private Employees Lewiatan*

Per Hultengård

*European Newspaper Publisher Association (ENPA) representative, Director of Legal Department at the Swedish Newspaper Publishers' Association*

Additional panellists (tbc): all interested speakers from Session I that Members may want to involve in the consultations.

# **Session I**

## **VAT Fraud**

### **Topic Area 1**

### **Analysis of the Present Situation**

*European Parliament Workshop on VAT  
23 January 2008*

## **VAT Fraud in the European Union**

Stephen Smith  
*Department of Economics  
University College London*

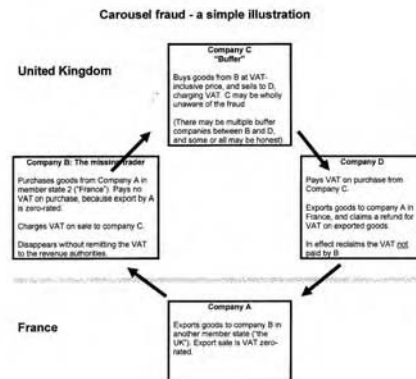
### **VAT evasion and fraud**

- ***The case for VAT is primarily that it is an effective way of raising revenue***
- ***But it is also vulnerable to distinctive risks of fraud, due to extensive refunds***
  - "A VAT invoice is a check written on the government" (Richard Bird)
- ***Recent alarm over revenue losses through VAT "carousel" frauds***
  - The Guardian's main headline on 9 May 2006: "Revealed: the £5bn-a-Year Tax Fraud"
  - Concern that VAT fraud is so large that trade statistics are distorted
- ***"Carousel" frauds exploit***
  - export zero-rating – which refunds VAT to exporters
  - "deferred payment" mechanism for collecting VAT on imported goods
- ***HMRC estimates VAT "gap" in the UK of 14.5% of potential VAT revenues***
  - roughly a quarter of this reflects organised fraud



## Missing-Trader Intra-Community (MTIC) Frauds (“Carousel fraud”)

- “Carousel fraud” exploits:
  - export zero-rating
  - “deferred payment” mechanism for collecting VAT on imported goods
- The diagram illustrates the underlying mechanism  
...but is a major simplification
- Carousel frauds differ from other tax evasion
  - organised criminal attacks
  - VAT refunds obtained through synthetic transactions
  - no natural limit: VAT revenue unbounded below
- Real-world carousel frauds involve
  - Speed (to maximise revenue before “missing trader” vanishes)
  - Complexity (to disguise the carousel)
  - Innovation (to stay one step ahead of the authorities)



## VAT carousel fraud: policy options

- **Administrative responses**
  - eg slowing VAT refunds to exporters (so that less revenue is lost before the carousel is detected)
  - or making more checks on firms registering for VAT, to verify that they are genuine businesses
  - These measures can also impose costs on genuine businesses, who have to wait longer for legitimate refunds, etc
- **Reverse charging**
  - Liability for VAT placed on buyer rather than seller in a B2B transaction
  - Frustrates carousel fraud by passing on liability to missing trader's customer (Firm C in diagram)
  - If used for commodities most exposed to carousel fraud (eg mobile phones), frauds could move on to other commodities
- **Reverse withholding**
  - Used in various countries in Latin America
  - Purchaser in B2B transaction must remit all/part of the VAT on its purchase direct to tax authorities
  - But seller remains liable for output VAT, and receives a credit for the amount withheld and remitted by the purchaser.
- **VAT accounts** (Sinn, Gebauer and Parsche, CESifo Forum, 2004)
  - As previously in Bulgaria
  - Requires traders to deposit VAT charged to customers in special account
  - VAT refunds only paid when payment has been made to account.
- **Third party guarantee** Ainsworth (Tax Notes International, 2006)
  - In diagram, company B must obtain a bank guarantee that its VAT payments would be made
- **Fundamental reform to VAT treatment of trade**
  - Replace zero-rating

## Alternatives to zero-rating

- **Ending zero-rating**
  - extends the "VAT chain" across intra-Community frontiers
  - exports taxed in exporting country
  - credit given to importer for VAT paid on imports at the rate actually paid
  - achieves neutrality in business purchasing with respect to the VAT rate (ie "neutrality")
  - Eliminates scope for carousel fraud, since no longer any VAT refunds to exporters
- **Various possibilities for the rate to be applied**
- **"Exporter-rating"**
  - as proposed by Commission prior to 1992
  - Exports taxed at rate applying to domestic production
  - Symmetrical treatment of domestic and export sales
  - But some undesirable rate-setting and enforcement incentives
- **Uniform rating**
  - Special rate for intra-EU cross-frontier transactions (eg 15%)
- **VIVAT**
  - All B2B sales (including those internal to a member state) taxed at EU-wide rate (eg 15%)
  - Symmetrical treatment of domestic and export sales
  - But need to operate "end user" distinction (albeit only with respect to tax differences)

## VAT Fraud in the European Union

*Briefing paper for the European Parliament Workshop, 23 January 2008*

Professor Stephen SMITH, University College London

### Executive summary

The recent growth in revenue lost through missing trader and carousel frauds by the UK and some other countries has attracted widespread attention. Nevertheless, such frauds accounted for less than a quarter of the £12.7 billion lost by the UK through VAT evasion and fraud in 2005-06. Much of the VAT revenue lost arises through more mundane forms of evasion and fraud of the sort that affect all sales taxes.

Missing trader and carousel frauds exploit the VAT zero-rating of exports to milk the VAT system through a series of contrived trade transactions.

Some measures can be taken within the context of the existing VAT system to reduce its vulnerability to systematic fraud, including tighter checks on firms seeking to register for VAT, requiring guarantees in dubious cases, slowing down the payment of VAT refunds relative to the collection of VAT due, etc. There are limits to how far these can be taken, because of the collateral damage in obstructing legitimate businesses.

More fundamental policy options for "designing-out" the opportunities for carousel fraud within the VAT system include the following:

- ***Selective reverse charging*** for certain commodities. This might help to check the growth in carousel fraud, but has the risk that frauds would simply move on to other commodities.
- ***General reverse charging*** is unattractive because it would introduce new risks of revenue loss through other routes.
- ***Reverse withholding.***
- A system of '***VAT accounts***'.
- The compulsory use of a ***third party to guarantee VAT payments.***

These various options all have weaknesses, either in creating other opportunities for fraud and/or in increasing taxpayers' compliance costs. The underlying problem is unlikely to be resolved without a fundamental reform to the VAT treatment of international transactions, which would end the zero-rating of exports. Export zero-rating requires substantial amounts of VAT receipts to be paid back as refunds (about 40% of gross VAT receipts are refunded in the UK), and a system that requires refunds on such a large scale creates opportunities for correspondingly large-scale revenue fraud.

## 1. Analysis of the present situation

Like all taxes, VAT is subject to evasion. For example, traders may fail to register for the tax, they may under-report sales or, where different goods are subject to tax at different rates, they may reduce their tax payments by misclassifying sales into the category subject to a lower rate (or zero rate) of tax. In some respects, the particular structure of VAT may reduce its exposure compared with other systems of sales taxation. In particular, the gradual cumulation of the tax at each stage of the chain of production and distribution may reduce the amount of tax at stake at each stage, and hence the gains to be made from making untaxed sales. This does not make the VAT 'self-enforcing', as some have claimed, but it does reduce its exposure to evasion compared with alternative single-stage sales taxes levied at a comparable rate, such as the retail sales taxes common in the US.

In other respects, however, VAT offers distinctive opportunities for evasion and fraud, especially through abuse of the credit and refund mechanism. Revenue may be lost through exaggerated claims for credit for VAT paid on inputs to production. Moreover, the opportunity exists for outright fraud through the construction of business activities with the sole purpose of defrauding the exchequer, because some categories of business can be entitled to net refunds of VAT from the revenue authorities. These can include firms selling predominantly zero-rated goods while claiming credit for significant amounts of VAT paid on standard-rated production inputs. While zero-rated domestic sales can create opportunities of this sort, the main point of vulnerability in the current system arises because of the VAT zero-rating of exports.

The VAT systems of the member states of the European Union tax trade transactions (both between member states and with the rest of the world) on a 'destination' basis. Exported goods are VAT zero-rated, meaning not only that a tax rate of zero is applied to their sale but also that the seller is entitled to reclaim the VAT paid on taxed production inputs. Symmetrically, imported goods are taxed on their full value by the importing country.<sup>1</sup> Businesses that make a high proportion of sales to customers abroad can thus be entitled to net payments from the exchequer. The level of VAT refunds can be a high proportion of gross VAT receipts – in the UK (which zero-rates around 13% of consumer expenditure – including items such as food, books and newspapers – as well as zero-rating exports), refunds amount to about 40% of gross VAT receipts.<sup>2</sup>

'Missing trader intra-community' (MTIC) frauds, of which 'carousel frauds' are the best-known example, exploit the refund of VAT to exporters to milk the VAT system of revenues through a series of contrived transactions.

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<sup>1</sup> Tax is imposed on import from goods imported from non-EU countries, and a deferred payment mechanism applies for imports from other EU member states, under which any VAT due is included in VAT accounting and payments of the importing firm.

<sup>2</sup> G. Harrison and R. Krellove, 'VAT refunds: a review of country experience', IMF Working Paper WP/05/218, 2005 (<http://www.imf.org/external/pubs/ft/wp/2005/wp05218.pdf>).

The diagram illustrates the mechanism involved with a simple example<sup>3</sup>; in practice, many layers of additional complexity are added to the simple structure in order to obscure the fraud. The two key features of the VAT that are exploited in the carousel fraud in the diagram are the *VAT zero-rating of exports* and the system of '*deferred payment*' for VAT on imports, adopted in the EU since the removal of fiscal frontiers in 1992.<sup>4</sup>

Under deferred payment, VAT on imports from one member state into another is levied not at the border but at the time of the importer's next periodic VAT return. As a result, there may be a considerable time lag between the date at which the importing firm (Company B in the example) imports the goods and the time at which the VAT authorities seek payment of the VAT due. In the mean time, the goods are sold on, via complicit – or perhaps unwitting – 'buffer' companies in the UK, to Company D, which exports the goods, claiming a refund of the VAT that it paid when it purchased the goods from Company C. In the basic carousel illustrated, the exported goods are then re-imported by Company B, and so on, following a cycle in which VAT refunds are claimed repeatedly whenever the goods are exported, while the corresponding import tax liability accumulates but is never paid. After a while, Company B, which would be liable to a substantial level of VAT on its imports, disappears, without paying any VAT.

As noted above, the basic structure of the fraud may be concealed by further complications. Innovation has been a constant feature of these forms of fraud, as those perpetrating them seek to stay one step ahead of the authorities' ability to detect fraudulent transactions.

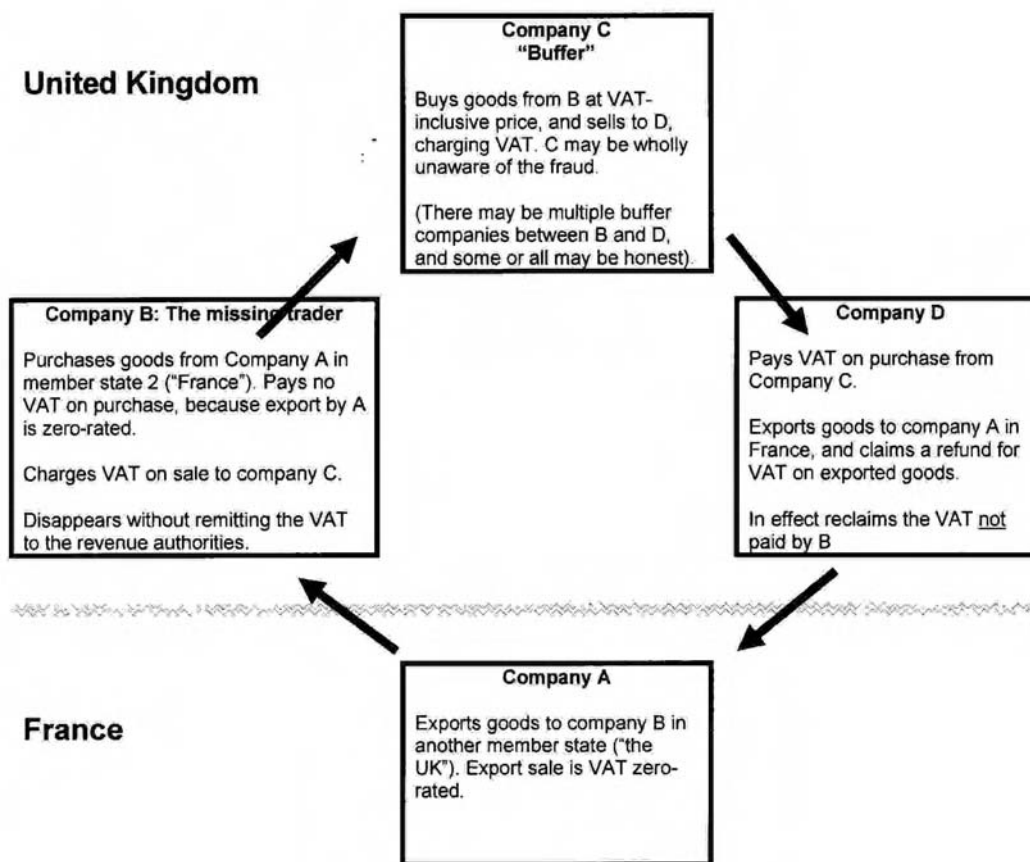
The problems for enforcement are compounded by the difficulty of identifying which of the traders are actively and knowingly involved. With the exception of the key player, the eventual missing trader, and the exporter, to whom the financial benefit of the fraud accrues in the form of VAT refunds, the other participants need not be knowingly involved in the process. Some may have their suspicions, and some may be more actively engaged – for example, in adjusting prices so as to transfer the benefit of the VAT refunds to other players in the carousel.

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<sup>3</sup> The diagram names the two countries as "France" and the "United Kingdom" for concreteness, but it is important to recognise that all EU countries are liable to be involved on both sides of such frauds, and - albeit to varying degrees - exposed to consequent revenue losses.

<sup>4</sup> There are indications that the general level of VAT revenue losses in the UK rose by about one-third by the mid-1990s compared with pre-1992 levels (table 2.1 of HM Customs and Excise, *Measuring Indirect Tax Losses*, 2002, <http://www.hm-treasury.gov.uk/media/389/E5/admeas02-297kb.pdf>). It is unclear what has sparked the recent sharp growth in organised, large-scale fraud.

## Carousel fraud - a simple illustration



Key design features of the VAT system influence the extent to which it is exposed to systematic missing trader frauds. Many of these, such as the stylised carousel fraud illustrated in the diagram, exploit opportunities provided by the VAT zero-rating of exports to claim fraudulent refunds for contrived transactions, while at the same time failing to pay VAT due on imports. Aspects of the VAT system that affect the scope for profitable carousel fraud include the extent to which the system allows intending missing traders (such as Company B in the diagram) to register for VAT, and the relative timing of VAT payments and receipts. These design features play a critical role in preventing revenue loss through carousel fraud. *Ex post* audit and investigation, while important, is unlikely to forestall considerable loss of revenue, because the essence of the fraud is that money is made quickly, in the time gap before the missing trader is required to remit the VAT it has supposedly charged on its sales. Once the money has disappeared into the complex web of transactions, tracing and recovering unjustified VAT refunds becomes time-consuming and costly.

## 2. Remedies - more effective administrative cooperation and/or changes to the system?

Two broad approaches may be taken to designing-out the opportunities for carousel fraud within the VAT system. One is essentially administrative, in the sense that it retains the zero-rating of intra-community supplies, and seeks to control carousel fraud through more intensive investigation, and/or procedural reforms - more or less radical - that reduce the vulnerability of the regime. The other, more fundamental to the structure of the tax itself, removes export zero-rating altogether.

### Administrative and procedural reform

Less-radical measures that could be taken within the context of the existing system include, for example: tighter checks on firms seeking to register for VAT (for example, with an on-site visit) and requiring guarantees in dubious cases; slowing down the payment of VAT refunds relative to the collection of VAT due (although this can impose severe cash-flow burdens on legitimate businesses); adopting or strengthening joint and several liability rules by which traders can be held responsible for fraud elsewhere in the chain that they might reasonably have been expected to be aware of; and establishing better and quicker information exchange between national tax authorities (so that the country of import can become promptly aware that exports to it that have been reported in another member state have not shown up in its own VAT system). However, while measures of this sort may reduce the risk of VAT fraud, some of them may have less-desirable side-effects. More bureaucratic VAT registration procedures and slower payment of VAT refunds might harm legitimate businesses as well as discouraging fraud, and these effects may outweigh the enforcement gains. The authorities have a difficult balance to strike, between ensuring that VAT administration does not impose excessive burdens on business in general and ensuring that it is not unduly exposed to fraud. Some level of VAT evasion may well have to be tolerated in the wider business interest.

More radical measures within the context of a system that preserves zero-rating include:

The use of '**reverse charging**', by which liability in a business-to-business (B2B) transaction is placed on the buyer rather than the seller. This would deal effectively with the carousel fraud in the diagram, because the VAT due on the sale by B (the missing trader) would become the responsibility of the buyer, C. In turn, the tax due on the sale from C to D would be the responsibility of D. The zero-rating of the subsequent export sale would then offset D's tax liability on its purchases from C, reducing the tax payment by D but not requiring outright refunds. The opportunity to make fraudulent gains by claiming refunds of tax that have not in fact been paid would thereby be eliminated.

The difficulty of **reverse charging limited to certain products** – such as the UK measures relating to mobile phones and computer chips – is that MTIC frauds may simply move on to other goods, not covered by reverse charging. There would also be new enforcement issues, at the 'boundary' between commodities subject to reverse charging and those subject to 'normal' VAT.

By contrast, **universal reverse charging** – such as the arrangements mooted by Austria and Germany – avoids these difficulties but, in effect, turns the VAT into something closely akin to a single-stage retail sales tax, with tax payments suspended until goods are sold to final consumers (albeit with the possibility of cumbersome reporting procedures for B2B transactions). The danger of this is obvious: by ending the gradual cumulation of VAT payments through various stages of production and distribution and instead collecting all VAT revenue at the final sale, the system is exposed to substantially greater risks of revenue loss through unreported sales to final consumers. With a retail sales tax all tax revenue is lost if a sale to final consumers somehow goes unreported, while with a VAT the losses are limited to the difference between the VAT due on the final sale and the VAT already collected at earlier stages. Extensive reverse charging might help to stem losses from MTIC frauds, but might expose the VAT to other risks of revenue loss through more mundane forms of evasion.

**‘Reverse withholding’** schemes would tackle VAT frauds in a broadly similar way to reverse charging, by requiring the purchaser in a B2B transaction to make a direct payment to the authorities of part or all of the VAT due on its purchase. The difference is that the seller would remain liable for output VAT, receiving a credit for the amount withheld by the purchaser. Depending on the proportion of the VAT that the purchaser is required to withhold, this would diminish or even eliminate the scope to generate revenues through fraudulent refund claims, since exporting firms will themselves have paid part or all of the VAT on their purchases that they subsequently reclaim on export. The principal drawback of reverse withholding (which is quite common in Latin America but untried in Europe) would be its administrative complexity, which arises because of the need to ensure that the seller is given credit for withholding only when this has actually taken place.

Adoption of a system of **‘VAT accounts’**, under which traders would be required to open a distinct bank account into which they would transfer the amount of VAT charged to their customers. VAT refunds would only be paid if the authorities were able to verify that the corresponding VAT payment had been made. This has been proposed by Germany’s CESifo research institute<sup>5</sup> as a solution to the problem of VAT fraud, and a system of this sort has been running in Bulgaria. The key feature is that it requires the VAT payment to be made *earlier* than in the present system, so that when refunds are paid, they can be checked against past payments made. Apart from this matter of timing, however, it does not fundamentally alter the situation. It is not clear that cross-checking refund claims against past payments to a bank account would be any easier, or more reliable, than checking that past payments have been made to the revenue authorities themselves.

The compulsory use of a **third party to guarantee VAT payments**, either in general or for particular sectors, as set out by Ainsworth.<sup>6</sup> In the example set out in the diagram, Company B, the future missing trader, would be required to obtain a guarantee that its VAT payments would be made.

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<sup>5</sup> H-W. Sinn, A. Gebauer and R. Parsche, ‘The Ifo Institute’s model for reducing VAT fraud: payment first, refund later’, *CESifo Forum*, 2, 30–4, 2004.

<sup>6</sup> R.T. Ainsworth, ‘Carousel fraud in the EU: a digital VAT solution’, *Tax Notes International*, 1 May, 443–8, 2006.



The principal difficulty with this is the cost involved; it is far from clear that banks or other potential guarantors would be any better placed than the revenue authorities to prevent firms disappearing with outstanding VAT liabilities, and the premium required to cover this risk would place substantial burdens on honest firms operating in the sectors most subject to VAT fraud.

### **Alternatives to zero-rating of intra-EU trade**

These various administrative solutions all have weaknesses, either in creating other opportunities for fraud and/or in increasing taxpayers' compliance costs. A more durable solution to the problem of missing trader fraud requires a fundamental redesign of the VAT treatment of international transactions. The opportunity to claim fraudulent VAT refunds arises principally because of the break in the VAT chain that occurs as a result of the zero-rating of exports. Export zero-rating requires substantial amounts of VAT receipts to be paid back as refunds (about 40% of gross VAT receipts are refunded in the UK), and a system that requires refunds on such a large scale creates opportunities for correspondingly large-scale revenue fraud. Ending VAT zero-rating for trade between EU member states would sharply reduce the scale of refunds and eliminate some of the most tempting opportunities for missing trader frauds.

There are good reasons to want to retain a VAT system in which differences in national VAT rates have a neutral effect on business sourcing decisions - the principal attraction of export zero-rating. As discussed below, however, there are a number of possible alternatives which will achieve this outcome. Different schemes have a range of advantages and disadvantages, and the case for any change - and the choice between possible replacement regimes - should be governed by the broad range of consequences, and not simply the implications for VAT fraud.

In addition to its vulnerability to frauds which exploit the refund of tax on exports, a second drawback of the current regime is the sharp difference in VAT procedures applied to domestic sales and exports when exports are zero-rated. As a consequence, VAT compliance costs to business (the form-filling burden and other administrative costs which businesses incur as a result of the operation of the tax system) are liable to differ between domestic sales and exports. These differences in compliance costs, if severe enough, have the potential to distort the patterns of economic activity and trade.

In its 1987 proposals for the VAT mechanism to operate after 1992, the European Commission sought to put in place a VAT mechanism for cross frontier transactions which was as close as possible to that applying to domestic sales, in order to minimise the possibilities that any significant difference in compliance costs could arise between the two types of transaction. The "transitional" regime finally adopted post-1992 has, however, had exactly the opposite effect on relative tax compliance costs. Very different procedures apply to trade within, and trade between, member states, and the new procedures introduced to prevent VAT evasion on intra-EU transactions in the absence of frontier controls may well have magnified tax compliance costs on these transactions.

A number of alternative VAT mechanisms can be envisaged which would achieve economic outcomes similar to the current system, without making use of export zero-rating. Some, in addition, would apply identical procedures to exports and purely-domestic transactions, to avoid the risk that trade transactions are deterred by unfamiliar or onerous VAT procedures. There are a range of possibilities, including:

**“exporter rating”** - the system proposed by the Commission in 1987 would have taxed intra-EU exports at the rate of the country from which the goods were exported. Exports and domestic sales would thus be taxed identically, which may be an advantage, since it reduces the danger that firms may be deterred from exporting by the need to deal with an unfamiliar export tax regime. The problem, in the 1987 version of the scheme, is that the exporting state can determine the rate of tax, and hence the scale of the additional tax revenue gained from exports, and the size of the VAT credit that other countries must give on imports. In some circumstances, that this can create undesirable incentives for member states to set higher VAT rates on goods that they predominantly export (in order to benefit from a shift of total revenues), without paying any penalty in terms of competitiveness from so doing.

**“uniform rating”** - intra-EU exports would be subject to a uniform VAT rate, determined by the Community, regardless of the tax rate that would be applied to corresponding domestic sales in the member state concerned. Exports and domestic sales are subject to different tax treatments, and there is a danger that firms might perceive the compliance costs involved in operating the export tax regime as a deterrent to exporting.

**VIVAT** –the main feature of this scheme, proposed by Keen and Smith (*Economic Policy*, 1996), is that a uniform Community wide rate of VAT would be applied to transactions between VAT registered traders, while member states would retain the power to determine the rate of VAT on sales by traders to final consumers. The uniform rate of VAT on transactions between VAT registered traders would apply to all such "intermediate" transactions, both between traders in the same member state, and between traders in different member states. The scheme satisfies one of the primary objectives for the VAT regime, set out in the 1985 Commission White Paper, of applying uniform procedures to transactions within and between member states, achieving symmetry in the VAT treatment of domestic and intra-EU sales. At the same time, it aims to avoid some of the major enforcement and rate setting problems which would be encountered under other schemes, without altering in any way the current ability of member states to choose to increase or reduce the burden of VAT, and consequent VAT revenues.

In conclusion, my view is that systematic reform that eliminates the root cause of missing trader fraud would be a much more appealing long-term strategy than the combination of resource-intensive enforcement operations and ad hoc ‘fixes’ such as extended reverse charging, which may provide temporary relief but do not address the underlying problem.

# VAT Fraud in the European Union

European Parliament

Brussels 23.01.08

Rüdiger Parsche

**ifo** Institute for  
Economic Research

## Calculation of VAT gap rate based on national accounts data

$$\text{VAT gap (in \%)} = 100 - \frac{\text{actual VAT receipts adjusted}}{\text{hypothetical VAT revenue}} * 100\%$$

**ifo**

Countries with lower VAT gap rates:

Denmark, France, Germany,

Luxemburg, Netherlands and UK

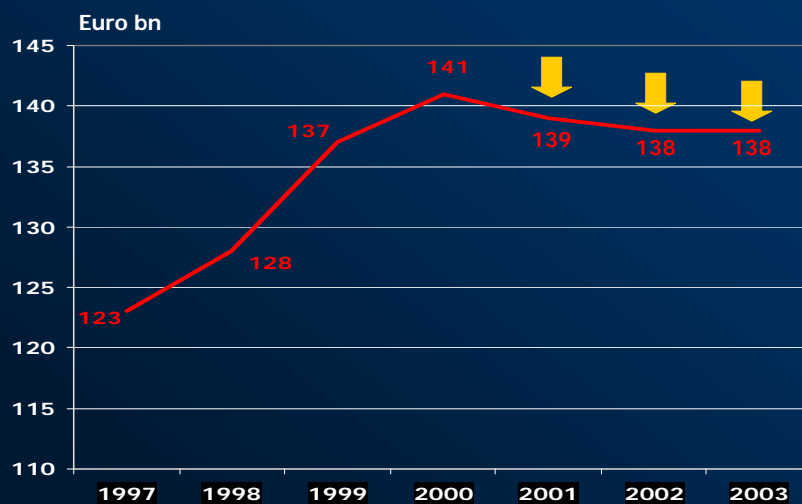
Countries with higher VAT gap rates

Belgium, Greece, Italy, Portugal,

Spain

## The German case

### Figure 1. VAT receipts in Germany



### Table 1. VAT gap 2001 - 2003

Year	2001	2002	2003
VAT gap in %	11	11	11
VAT shortfall (€ bn)	17	17	17

Quelle: ifo Institut.

ifo

## Table 2. VAT gap 2005 - 2007

Year	2005	2006	2007
VAT gap in %	11,5	9	9
VAT shortfall (€ bn)	18	15	17

Quelle: ifo Institut.

ifo

### 1.3. Possible reasons for the revenue shortfall

- bankruptcy
- evasion
- fraud (especially carousel fraud)

**Table 3. VAT gap classification**

	<b>Revenue shortfall (€bn)</b>	<b>percent</b>
<b>General noncompliance by VAT-registered firms</b>	3,1	18
<b>Bankruptcy</b>	3,7	22
<b>General evasion</b>	8,4	49
<b>Carousel fraud</b>	1,8	11
<b>Total</b>	<b>17,0</b>	<b>100</b>

Quelle: ifo.

ifo

# VAT Fraud in the European Union

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## I. Analysis of the Present Situation

### 1. VAT Gap for Selected EU-Countries

#### a. The Ifo Approach to Estimate VAT Evasion

Although there are controversies existing about the definition of tax evasion and the shadow economy, their size seems to be growing steadily in most EU countries. In particular, the burden of direct and indirect taxation, the complexity of the entire tax and social transfer system as well as the intensity of government regulation have been empirically identified as the major causes of encouraging such illegal or hidden economic activities. To a certain extent, the Single Market appears to have stimulated firms' and households' evading behaviour with regard to paying value added taxes in the EU Member States, whereas the tax evasion and fraud has traditionally been most serious in the field of corporate and personal income taxation. In other words, the abolition of the border controls for intra-EU trade accompanied by the less intact administrative co-operations of the (rather problematic) nation-specific EDP (electronic data processing) control systems has probably provided further opportunities to easily implement their VAT evasion efforts in the EU.

Unlike the larger share of conventional empirical analyses which emphasise the predominance of direct taxation and measure the total size of tax evasion for the entire domestic economy of a country, the ifo approach primarily deals with the narrow aspect of tax evasion in the specific area of EU value added taxation. Value-added tax is among the most remunerative of taxes and thus plays a leading part in many tax systems. Consequently, small increases or even reductions in revenues, the latter almost certainly due primarily to tax evasion in the VAT sector and especially to carousel fraud<sup>1</sup>, create considerable commotion. However, a few official figures are available for estimating the extent of VAT evasion. Some time ago, therefore, the Ifo Institute calculated the loss in tax revenues in the VAT sector via a macroeconomic estimate of hypothetical tax revenues on the basis of the national accounts data (NAD), and quantified tax evasion rates for selected EU countries (Gebauer et al., 2005).

For the calculation of the hypothetical VAT revenues of a country, national accounts data and input-output tables published by the national statistical office, annual reports of various state-owned companies and other relevant statistics are adopted as the VAT base. In particular, the statistics and data on private consumption, intermediate consumption and investment of central and local governments (mainly for acquiring real estate, buildings, machinery, instruments etc.) apparently play the most important role for the assessment, together with those on the business performance of banks and insurance companies which are not entitled to deduct input VAT.



The next step was to split the principal components of national accounts data (private consumption, intermediate input and investments by the state, credit institutions and insurance companies, private non-profit organizations as well as the other sectors not eligible to input-tax deduction) up into tax-liable and tax-exempt items. The theoretical VAT revenues could then be derived by assigning the corresponding (normal or reduced) tax rates to the tax-liable components. If an item cannot be unequivocally assigned to a single tax rate, but consists of various sub-items subject to different tax rates, then a weighted VAT rate must be applied. The weighting is either determined from more detailed statistical sources or is estimated.

A problem for the quantification of VAT evasion based on national accounts data is caused by the discrepancy between the tax revenues on an origin basis (i.e. the creation of tax liability) and the collected cash revenues in a given period of time. The latter differs from the former owing mainly to the factors like payment periods, back payments and deferred payments. In other words, the calculation of hypothetical revenues for a fiscal year is made on the basis of current national accounts data, which delivers, therefore, the sum of VAT revenues on an origin basis for the same year. In practice, however, the VAT imposed on household consumption (and on the investment and intermediate consumption of governments, financial institutions, private non-profit organisations, etc.) made at the end of December of the preceding year, for example, can only be effectively (i.e. in cash terms) transferred by firms to tax authorities in January of the current year. At present this type of formal VAT collecting process usually takes approximately a month (see e.g. the case in Germany). As a consequence, a significant share of tax revenues actually originated from the purchases of goods and services in December of the preceding year is (in cash terms) collected later and recorded as January revenues of the current fiscal year. For the adjustment of such a time-lag problem the January revenue value of the individual years is thus particularly relevant.<sup>1</sup>

The VAT collection rate could then be determined by comparing the adapted cash revenue with the hypothetical revenue:  $\text{Collection rate} = \text{Collected VAT revenue} / \text{Hypothetical VAT revenue}$ . Because this collection rate will always be less than 100 percent, the difference is obtained as the tax evasion rate:  $\text{Tax evasion rate or tax gap (in \%)} = 100 - \text{Collection rate (\%)}$ .

#### b. Results for Selected EU-Countries

The results of these calculations reveal that very different levels of VAT evasion can be observed in the various European countries. The ranking of VAT evasion rates determined in this way for selected European countries during the period 1994 to 1996 (1991 to 1993) is shown in Table 1.

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<sup>1</sup> Since the monthly amounts of collected tax revenues are hardly ever available for the investigated EU Member States, a tenth of the following year's revenues on a cash basis is simply allocated for all countries as the part of the corresponding type of VAT revenues for the current fiscal year.

Netherlands, Denmark and France show very low evasion rates throughout this period, whereas Italy, Spain, Greece and Belgium are uncontested front-runners with particularly high evasion rates. Moreover, a certain south-north gradient can be observed with regard to VAT evasion, so that evasion rates tend to decline the further north the country lies.

Only Belgium is a clear exception to this pattern with an evasion rate significantly higher than its immediate neighbours. The comparison of tax evasion rates together with other calculations on the general shadow economy allows the conclusion to be drawn, despite the differences in the survey methods and approaches applied, that the tax evasion rates estimated by the Ifo Institut are relatively well founded.

Table 1 Comparison of the rankings of the average VAT gap ratio for 1994-96 with the average shadow economy size as % of GDP for 1994-95 in the EU

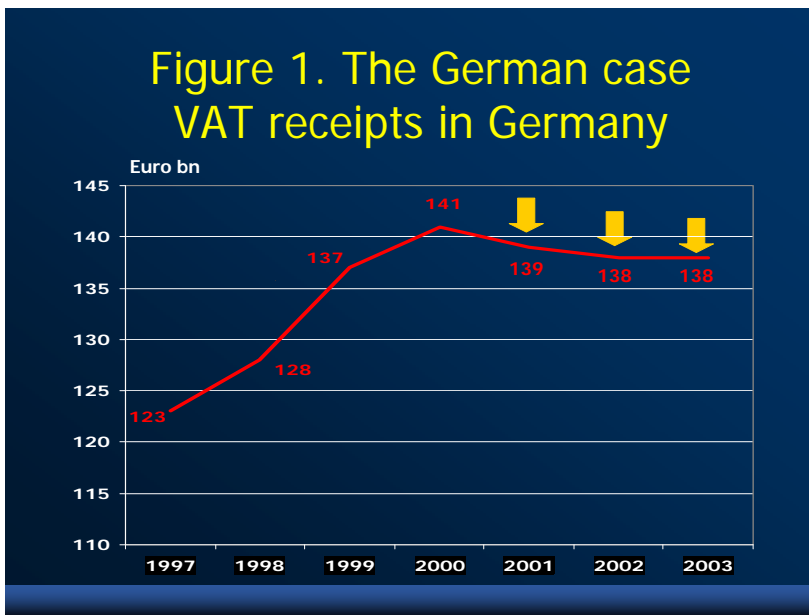
	Ranking of the average VAT evasion ratio from highest to lowest in a descending order	Ranking of the average shadow economy size from the highest to lowest in a descending order
Denmark	8	6
Belgium	4	5
France	6	7
Italy	1	2
Greece	3	1
Netherlands	10	8
United Kingdom	9	10
Portugal	5	4
Spain	2	3
Germany	7	9

Source: Calculations of the Ifo institute; Schneider and Enste (2000), Shadow Economies: Size, Causes, and Consequences, Journal of Economic Literature, Vol. 38, No.1, 77-114.

Another major reason for the different trends in the various countries could lie in the varied density of monitoring. Thus Germany experiences problems in this regard due to its federal structure and the associated separation of monitoring responsibilities. These problems are in many cases exacerbated still further by insufficient staffing of the responsible authorities, obsolete technical equipment and incompatible computer systems.

### c. VAT Evasion in Germany

Unlike the projected €2.5 billion growth of the VAT revenues at the beginning of 2001, Germany's current (collected) VAT revenues decreased in 2001 by approximately €2 billion and reached only €138.9 billion (Figure 1). Rather surprisingly such a trend was accompanied by an increase in the (macroeconomic) VAT base of €3.2 billion. The total sum of VAT revenue gap (evasion) amounted to about €15 billion in 2001, to which an amount of ca. €2.5 billion was contributed by the fast expansion of carousel fraud (Dziadkowski *et al.*, 2002).



Source: Federal Ministry of Finance.

Consequently, the German legislative body installed at the beginning of 2002 an extra liability provision (Article 25d *Umsatzsteuergesetz* - Sales Tax Law) through the Law of Prohibiting Tax Avoidance (*Steuerverkürzungsbekämpfungsgesetz*) in order to erode the success of carousel fraud. Neither did this law achieve the expected additional tax revenue of €2.5 billion, nor did it effectively prevent carousel deals. The VAT revenues declined once more. Among the measures included in the law was one that demanded collateral of newly established firms, because in a large number of cases firms were only established for the purpose of VAT fraud. This measure, too, proved ineffective because the people reacted swiftly by “stocking up” on newly established firms. In addition, such firms are increasingly abused for carousel deals that had been in the market inconspicuously for years in order to give the tax authorities the impression of orderly management. Only the VAT follow-up, i.e. unannounced tax audits, seems to have achieved some success in reducing tax fraud. The tax gap amounted to ca €17 billion in 2003 (see Table 2).

Table 2 Changes of the VAT gap in Germany (2001-2007)

Year	VAT gap in €bn	Approximate VAT gap rate (%)*
2001	17	11
2002	17	11
2003	17	11
2004	18	11.5
2005	18	11.5
2006	15	9
2007**	17	9

\* VAT gap rate (%) = 100 – Collected VAT revenue / Hypothetical VAT revenue  
 \*\* Estimates

Source: Calculation of Ifo Institute.

A large number of direct and indirect measures have been implemented by German federal government to detect and to prevent the underground economic activities. In the following two years the VAT gap remained around 11.5% with amounts about €18 billion. In 2006 and 2007 the rate further declined to 9%. This is in parts due to the enhanced public efforts to fight against the tax evasion. This pleasant development seems to be rather contorted by the increase in the basic tax rate from 16 to 19% in 2007. More precisely, purchases of consumer durables were made to a larger extent in 2006 rather than 2007. So without these distortions the 2006 VAT gap rate should be a bit higher while the 2007 rate a bit lower consequently.

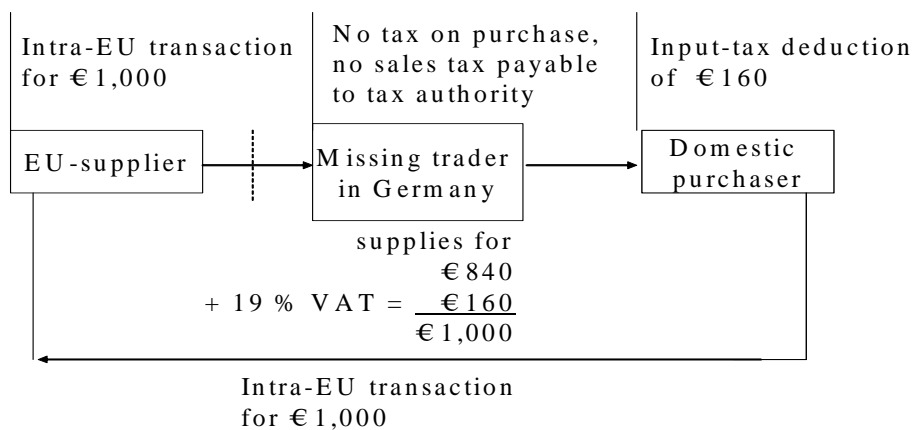
d. Possible Reasons for the Revenue Shortfalls

One of the major causes of the revenue losses is input tax deduction. In the present system, the seller presents the buyer with a bill showing the VAT, and the buyer can deduct the VAT from his tax liabilities if he is eligible for input tax deduction. This may even lead to net refunds if input tax entitlements exceed the VAT owed on one's own sales. The refund of the input tax is independent of whether and when the bill is paid and also independent of whether the seller has paid over the VAT shown in the bill to the tax authorities. It further does not matter whether or not the buyer has received sales revenue that is subject to VAT and must therefore pay VAT himself. Since investments are VAT free, the refund of the input tax that is independent of one's own tax payment is an essential element of the VAT. This procedure leads to an undesired loss of revenue if the buyer demands the refund of the input tax by presenting a bill, but fails to pay the bill because of bankruptcy. Tax losses also occur when the seller fails to pay over the VAT, which the buyer has already paid as part of the total sum billed, either because he himself goes bankrupt or because he does not declare the revenue subject to VAT on his tax statement.

Tax defrauders have thought of a multitude of tricks for taking advantage of loopholes in the system. Especially profitable are carousel deals. These are deals in which a good is actually or at least on paper shifted several times between several firms in order to qualify for fraudulent input tax refunds. Crossborder transactions frequently play a role in this because they make tax-free imports or exports possible and make controls by the tax authorities more difficult. For example, mobile phones are imported from abroad and sold to a domestic commercial firm which ships them back to the initial shipper. The importer (the so-called missing trader) may buy the mobiles tax-free according to the present country of destination principle. By selling them to the domestic commercial firm, he includes the VAT in the invoice but does not pay it over to the tax authorities. The commercial firm receives the input tax refund and sells the mobiles tax-free to an importer in another EU-country. From there the good may be sent again to Germany and the carousel keeps going round and round. By the time the tax authorities detect the scam and try to collect the VAT from the importer, the participating firms have, as a rule, dissolved and the owners cannot be found.

The carousel aspect of this fraud scheme is that not only one but many such purchasing and selling transactions take place before the goods reach their final destination, if they have not already disappeared beforehand.

Figure 2      Carousel fraud



Source: Ifo Institute

Apart from the losses in VAT revenue collected, there is also a negative side-effect of artificial price reduction on the market if indeed the carousel goods do reach the final consumer.

For example, if a French firm sells refrigerators to a German firm (missing trader) for €1,000 a piece, the missing trader purchases the same products without paying VAT on them. The missing trader then further sells the refrigerators to another German firm, who then collects the 19% VAT tax refund on this purchase from the *Finanzamt*, and eventually sells the refrigerator on the market at €840, even though the assumed original price was €1,000. It can only afford to do so because of the 19% VAT refund collected. Continued over a period of time, such firms may contribute to artificial price reductions of specific goods, although this effect on the market seems to be small.

The goods traded in this context can of course be of other nature. Usually they are quite valuable to generate substantial amounts of pre-tax deductions. Since the defrauders may be able to change quickly between industries the concentration of fraud preventive and control measures on the certain types of branches makes problematic. Analogously it may not be wise to concentrate tax administrative efforts only on the start-ups.

**Table 3. Apportionment of the VAT Gap  
Bottom-Up Estimates**

	Revenue shortfall (€bn)	percent
General noncompliance by VAT-registered firms	2,4	14
Bankruptcy	5,7	34
General evasion	6,8	40
Carousel fraud	2,1	12
<b>Total</b>	<b>17,0</b>	<b>100</b>

Quelle: PSP und ifo.

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## II. Remedies

### 1. *More Effective Administrative Cooperation*

Before a radical change is made to the VAT system with unforeseeable results, all available possibilities to make the present system more fraud-secure should be exhausted. It is not evident why the financial means required for the establishment of extensive control mechanisms in a new system could not also be used for the improvement of present system. For example, in Germany the improvement of present system could be achieved and fraud could be curbed by the following measures:

- strengthening the administration with appropriate human resources;
- improvement of the technical equipment;
- promotion of cooperation between authorities and construction of common databases<sup>2</sup>;
- enabling of a non-bureaucratic, mutual access to data at the level of individual authorities and adaptation of computer systems;
- creation of tax auditing at the federal level instead of only a state (*Bundesland*) responsibility;
- homogeneous tax numbers at the federal level;
- better control possibilities through new databases for VAT purposes at the federal ministry of finance;
- strengthening of the control activity and realisation of unannounced audits;
- implementation of a risk management system;
- new regulation of the input-tax deduction and restrictions on the reimbursement of deductible taxes;
- intensified penal laws.

### 2. *Reform of VAT System*

A further possibility is a radical change to the system. In the following we will discuss two relevant approaches: the reverse charge model and the Ifo approach.

#### a. Reverse Charge Model with Invoice Limit of €5,000

A long discussed alternative to the present system, which is to prevent the present VAT losses, is the so-called reverse-charge model with invoice limit (Groß et al., 2006). The consideration of different levels of invoice limit has a direct impact on the scope of *Ameisenkriminalität* caused by the misuse of such identification number.

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<sup>2</sup> The European Commission frequently complains about the lacking cooperation between the individual member states (Europäische Kommission, 2001). Therefore it is also necessary to strengthen the administrative cooperation between the EU-member states.

For identification purposes, those firms entitled to the input-tax deduction receive the so-called R-number. This number guarantees the transmission of tax liability. To enable the cross-check the supplier has to report sales to the tax authority under the notification of recipient's R-number as well as declare them in his turnover tax advanced return and in the additional collective declaration.<sup>3</sup> The prerequisite for this action is that the supplier should examine the validity of the recipient's R-number (also his name and address), for which the establishment of online-inquiry systems is in need.

Based on such reports the tax authorities can carry out the R-check which primarily aims at identifying and preventing abuses related to the untaxed final consumption. In this context the supplier's declaration of sales in turnover tax advance return (together with additional collective declaration of taxable sales) reported on the cash basis for the recipient is compared to the recipient's declaration of sales tax liability and input-tax deduction from purchase in turnover tax advance collective declaration (together with additional collective declaration of payment) reported on the cash basis for the supplier. Due to a huge number of relevant data, a sort of risk management system appears to be desirable, which delivers the checking results automatically. Without such a mechanism, an efficient control procedure seems to be unthinkable for tax administration.

The reverse charge system with R-check is generally assessed as a suitable measure for reducing VAT frauds and other system-related revenue shortfalls caused by bankruptcies. At first glance the ideas for reforming the VAT system are promising, but as always the devil lies in the details. The elimination of the problems in the current VAT system should not lead to new abuses which have significant negative effects on VAT revenue. One of the main problems after a system change would seem to lie in the future coexistence of two VAT systems, which would apply for most enterprises, as well as the fraud potential of the R-number accompanied by additional high tax administration costs.

Input-tax reimbursements are now illegally claimed primarily by the holder of an invoice, whereas the multiple use of an invoice for fraudulent purposes plays no major role. In future, however, it is possible that the multiple use of R-numbers accessible to everyone by unauthorised third parties could lead to significant tax revenue shortfalls. In this context it must be noted that many small cases of fraud can also cause enormous damage and in terms of control are even more difficult to manage than a few large cases. Also it would be a mistake to overestimate the control possibilities.

#### b. The Ifo model

The Ifo Institute proposed a modified value added tax procedure, which legally remains as close as possible to the present system, but prevents fraud effectively (Sinn et al. 2004; Gebauer, Lohse & Parsche 2007). Referring to such a withholding tax system, the supplying company no longer pays the tax in the process of VAT collecting, which is owed but instead the customer (the recipient of performance) must immediately remit to the tax authorities the charged VAT.

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<sup>3</sup> In addition to the recipient's R-number such a report to *Finanzamt* includes tax code of supplier, number and date of receipt, assessment base for R-sales (Groß et al., 2006).



The customer would transfer the net amount to the supplier and at the same time the VAT stated on his bill as a withholding tax to his tax office. In order not to unduly burden the economic participants in the settlement of their bills by two payment transactions, a VAT-related transfer procedure is to be created that would be integrated into the non-cash payment forms that are common today.

The essence of this remittance method consists, on the one hand, in the customer having to give only one remittance order to his bank for the settlement of a bill and, on the other hand, the bank of the supplying company transmitting the VAT owed by it from the invoice amount immediately to its revenue office. In order to provide the bank of the payee with the necessary information, the forms for the VAT transfer do not contain an amount field for the total transfer as current forms do but two amount fields: a remuneration field and a withholding tax field. For the payment of bills with separate VAT IDs, the customer can enter the net sum owed to the supplier in the first field and the tax amount to be transmitted to his revenue office by the bank in the other. Recipients of services that wish to claim the source tax as prior tax payment are to be legally obliged to use the VAT transfer procedure and must list on the transfer form their VAT ID number and the invoice number of the supplier.

In light of new civil law regulations that will be necessary, the bank that receives the money on such a form for one of its customer's bank accounts may only credit the amount from the net-amount field to this account. At the same time it must transfer the amount in the withholding tax field to the revenue office of this customer without the VAT amount having been credited to the customer. In this way the amount of withholding tax is not accessible to creditors in the case of a later insolvency of the customer. Involving the banks in the VAT transfers will necessitate new civil law regulations in all sectors of the economy.

### *3. Taxation of Intra-community Supplies*

In spite of the introduction of Single Market and the abolition of border controls, the so-called destination principle still dominates in the EU, particularly concerning the VAT application on the commodity trade between the Member States. These tax-free supplies between the Member States stimulate carousel frauds. With the introduction of the "real" common market and the taxation of intracommunity supplies according to the origin principle supplies such opportunities would be largely diminished. Yet there are some problems still persisting. Differences in tax rates between the individual member states could motivate companies to forgo the registration of intra-community acquisition and sell their goods in their own country without paying VAT – in particular when prevailing greater positive differences between the VAT rates in country of origin and that of destination.

In order to avoid these types of tax frauds Varsano (1999) and McLure (2000) proposed a special compensating VAT for the intracommunity supplies that would be fully creditable in the importing country. This approach is a scheme for implementing a destination-based VAT on cross-border trade within a group of nations.

Sales to national purchasers (registered traders, households, and unregistered traders) would be subject to the national VAT, but intra-community supplies would be zero-rated for state VAT and subject instead to a “compensating value added tax (CVAT)”.

Credit would be allowed for tax on purchases by registered traders: for the state VAT on intrastate purchases and for the CVAT on intra-community purchases. But to avoid the problems mentioned above, the CVAT rate must be on the highest level of the national rates. Another problem is that exports are treated differently from domestic sales.

As a solution of the last mentioned problem, Keen and Smith (1996 and 2000) proposed the VIVAT with a single rate – common to all states – on all B2B sales, whether domestic or across border. Here the problem is that it is necessary to know whether or not the customer is registered for VAT. But this is already required (Keen and Smith, 2007). And this single rate must be also on a high level to avoid the problems of non-compliance by VAT-registered firms.

Nevertheless, the possibility of evading VAT (in forms of avoiding the due VAT payment and also of fraudulent claim of input-tax reimbursement) still maintains in all the cases, of which effort can be primarily triggered by the existence of large differences of the national tax rates in the EU, as mentioned above. In particular when a high VAT rate prevails, significant VAT frauds take place with the manipulated invoices accompanied by the fraudulent claim of input-tax reimbursement. The scope of such a type of VAT evasion could even well exceed that of carousel frauds in the EU. In the EU single market it is not easy for the individual national tax authorities to clearly identify the entitlement of claim when reimbursing the input-tax. Quite often tax authorities have problems to detect the fraudulent input-tax claims in their own countries, although they have all the necessary enforcement possibilities to the involved traders (see the case with the carousel frauds). If this is the case, one can hardly expect that they can assess the correctness of invoices with input-tax claim made by firms abroad. A better cooperation between the national tax authorities would not solve such a problem adequately.

#### *4. Problems Surrounding the Clearing Mechanism*

The taxation of intracommunity supplies causes a further problem. *Ceteris paribus*, the planned movement to the origin principle with the cross-border pre-tax system on a full-scale would, however, lead to changes in VAT revenues in the individual EU countries. For example, those countries with trade surplus and higher VAT rates would be significantly better off. For this reason, a clearing mechanism is necessary to rectify this type of revenue imbalance among the Member States in the case of implementing the origin principle to collect VAT in the EU.

Ideally the VAT clearing among the EU countries should take place on the basis of the sum of pre-tax repayment of firms which are involved in the intra-EU trade. Yet the willingness of the individual member states appears to be rather limited, since the success of correct coverage of amounts and the thorough examination of claim qualification would primarily make the country of demanding payment better off. An importing country has little interest in verifying claims for credit on imports from other member states (Keen and Smith 2007).

On the other hand those exporting countries are also less interested in the enlightenment of fraudulent claim of input-tax reimbursement of importing firms, because such efforts would primarily increase the tax income of importing countries.

As an alternative, Germany discussed a macroeconomic clearing approach based on national accounts data (BMF 1994). Although the practical implication of such a macroeconomic approach based on national accounts data appears to be still premature for the establishment of VAT clearing system in the EU, Gebauer et al. (2005) explicitly highlights the fact that different VAT gaps are an important obstacle. A clearing approach based on national accounts data (without reflecting the different VAT gaps) would prefer member countries with high VAT gaps. So the reduction of tax evasion in several EU members to an acceptable level is one of the most crucial prerequisites to accomplish the 'true' European single market equipped with the so-called origin principle and a clearing on the basis of a macroeconomic approach. If the clearing based on national accounts data is not feasible, a new, widely acceptable method of calculating VAT gap can also be developed which can make the clearing possible in order to compensate the tax revenue shortfalls caused by the involvement of cross-border trade in the EU.

For the same purpose one can think of an institutional solution – the foundation of a central, supra-national tax authority, which is responsible solely for the managing the problems caused by VAT payment and input-tax reimbursement claims related to the intra-EU trade. Therefore, this central EU institution can well reduce the work burden of national tax authorities regarding the VAT collection matters. In addition such a supra tax authority can more rapidly and efficiently act and also coordinate, if there are mismatches to be clarified among the national tax authorities in the EU.<sup>4</sup>

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<sup>4</sup> In this context the terms of tax payment should also be modified in order to achieve the better control possibilities.

### **III. Conclusions**

The value added tax replaced the cumulative all-stage turnover tax in the 1960s. While it has many theoretical advantages, its collection has proven more difficult over time than expected. Especially the present practice of input-tax refunding is highly problematic. It has invited fraud. The amount of revenue reductions and especially fraud charges has reached a high extent. The state must act without delay in order to stop a further erosion of one of its major taxes. In hat in Germany the VAT gap (in percent) is no more increasing. But the gap is high enough. And in many European countries the gap is much higher.

There are public discussions on radical changes to the system like the reverse charge approach. Yet one should bear in mind that such reforms could also cause some additional problems at the same time. At first glance the ideas for reforming the VAT system are promising, but as always the devil lies in the details. The elimination of the problems in the current VAT system should not lead to new abuses which have significant negative effects on VAT revenue. And we have to take into account the right balance between the fight against fraud (and the possible gains) and the burden on business.

Hence, before a radical change is made to the VAT system with unforeseeable results, all available possibilities to make the present system more fraud-secure should be exhausted. It is not evident why the financial means required for the establishment of extensive control mechanisms in a new system could not also be used for the improvement of present system. Firstly, it is necessary to make the national tax administration more efficient through the implementation of more IT supports (incl. risk management systems) in the existing system. Secondly an improvement of cross-border cooperation between the EU-countries should continuously be pursued in the fields of information exchange, tax administration and collection as well as monitoring.

If the proposed measures to strengthen the existing system still do not bring the desired success with respect to the current tax revenue shortfalls, another solution must be found. A purely national implementation of such a reform proposal appears to be impossible. For this reason an all-European solution should be the target. In this context it is necessary that in addition to the widely discussed reverse charge model other changes to the system for decreasing tax frauds and increasing VAT revenues should also be seriously discussed, especially the taxation of the intra-community supplies with the normal rates for B2B supplies and a European tax office with a clearing house.

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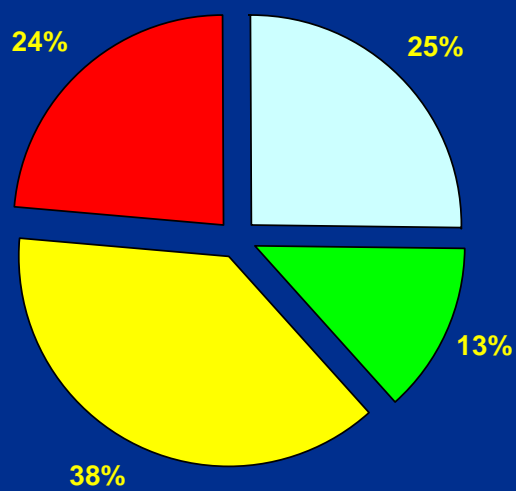
# WORKSHOP ON VAT

## Analysis of the present situation

João Durão

2008.01.23

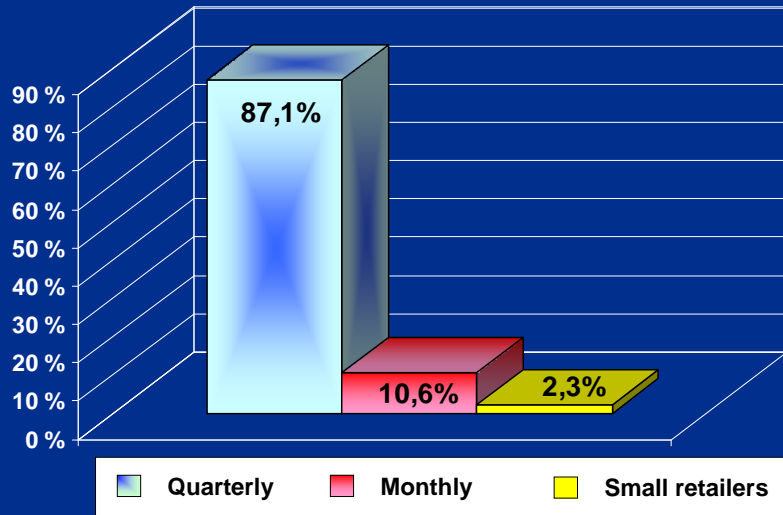
### TOTAL TAX REVENUE



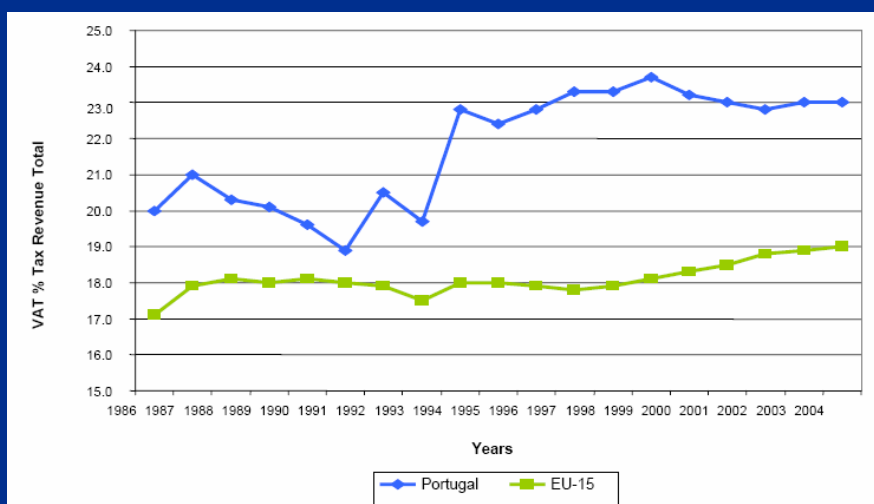
■ Personal Income ■ Corporate Income Tax ■ VAT ■ Others



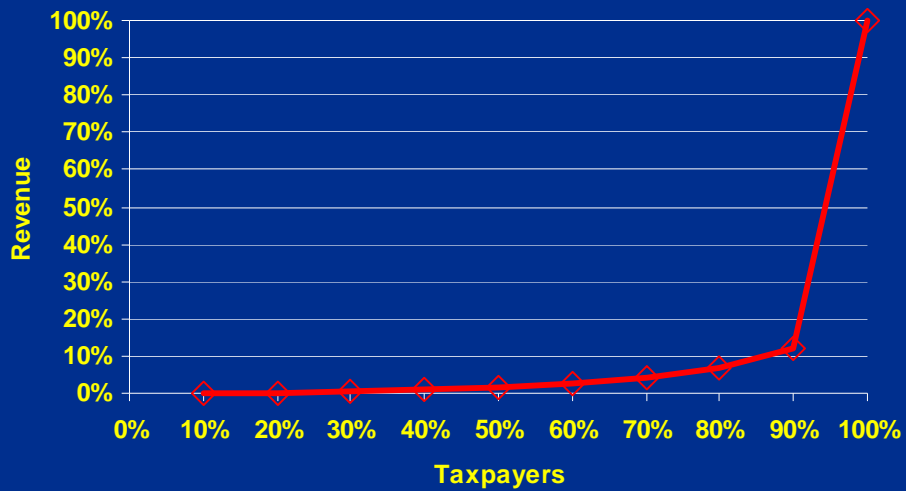
## VAT TAXABLE PERSONS PER TAXATION SCHEME (%)



## VAT / TOTAL TAX REVENUE (%)



## CONCENTRATION OF THE VAT REVENUE



## FRAUD MECHANISMS

### INTRA-COMMUNITY TRANSACTIONS

- *Traditional carousel fraud*
- *The “simple” missing trader fraud*
- *Abuse of the margin scheme*
- *Abuse of the customs procedure 42.00*

### DOMESTIC TRANSACTIONS

- *Undue deductions*
- *False invoices*
- *Undeclared sales*

## MEASURES

### LEGAL

- *Joint or several liability*
- *Reverse charge in specific activity sectors*
  - *Construction industry*
  - *Metal scraps*

### TAX CONTROL

- *Control techniques at pre-registration stage*
  - *Address confirmation*
  - *Compulsory Bank account*
- *Control of VAT refunds*
- *Detection and follow-up of Brokers*

**Benjamin Franklin said:**

*“In this world nothing can be said to be certain, except death and taxes”*

**Everybody says:**

*As long as there are taxes ... there will be fraud !*

## ESTIMATION OF FRAUD

- *Fraud is part of the black economy*
- *Difficult to estimate*
  - *Specific type of fraud – Intra-Community VAT Fraud*
- *Awareness of the amount based on the investigated cases*

## DETERMINANTS OF FRAUD

### **POLITICAL**

*Disagreement with economic, social and tax policies*

### **PSYCHOLOGICAL**

*Social tolerance of avoidance and evasion*

### **TECHNICAL**

*Complexity of the tax system*

### **ECONOMIC**

*Pressure to reduce costs in a competitive market*

## CHANGE THE VAT SYSTEM ?

### GENERALISED OPTIONAL REVERSE CHARGE

- *Complexity*
- *Compliance costs*
- *VAT paid in the retail phase*
  - *Greater risk of fraud and control difficulties*

## IMPROVE EFFICIENCY IN TAX CONTROL ?

### COMMUNITY LEVEL

- *Reduce timeframes for submission of recapitulative statements – VIES*
- *Improve data quality – VIES*
- *Improve administrative co-operation – reducing timeframes to exchange information*

### NATIONAL LEVEL

- *Early detection of fraud schemes*
- *Enhance co-operation with Police Authorities*
- *Accelerate the trial of the investigated cases*

# **Session I**

## **VAT Fraud**

### **Topic Area 2 Remedies**



# VAT ABUSES: A GLOBAL PERSPECTIVE

David Holmes (OECD)  
EUROPEAN PARLIAMENT:  
23 JANUARY 2008



## The OECD



- Membership: 3 NAFTA, 4 Asian-Pacific countries and 23 European countries
- Setter of “soft” and occasionally “hard” rules
- A forum for discussing the economic and social challenges of interdependence and globalisation
- A provider of comparative data, analysis and forecasts to underpin multilateral co-operation



## The Committee on Fiscal Affairs



What are we?

A forum for senior policy makers and administrators

What do we cover?

All international and related domestic tax issues

How are we organised?

- Biannual meeting
- Eight subsidiary bodies
- Centre for Tax Policy and Administration

3



## International Co-operation

- OECD has long experience in supporting exchange of information – Model Tax Convention now covers all taxes
- Recognise limitations
- Recent Court of Auditors report in line with recent OECD survey
- For VAT – OECD now facilitates exchange of generic information on latest VAT frauds and aggressive tax planning





## Joint Council of Europe/OECD Convention

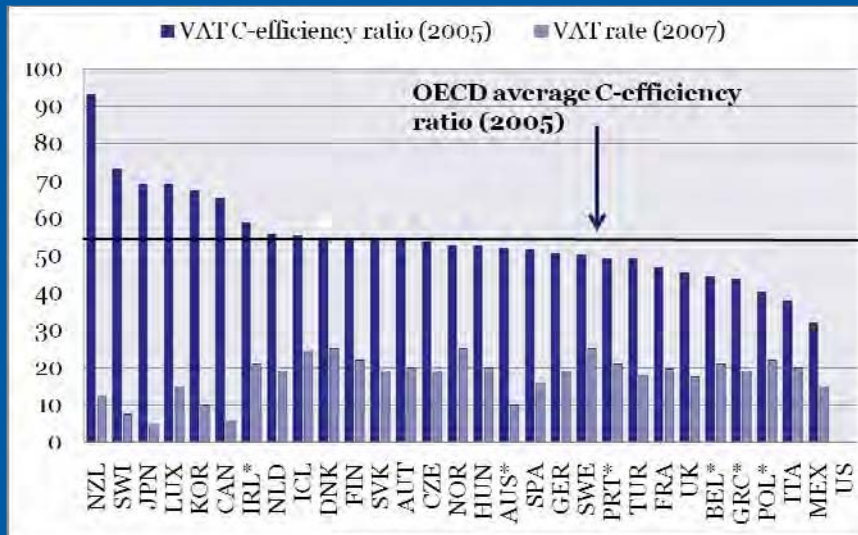
- Allows for exchange of information on all taxes (not all bilateral treaties allow exchange for VAT)
- Useful for exchanges with non-EU countries
- Opened in 1988 to all OECD and CoE countries
- Slow start – only 6 countries by 1995
- Now 15 with 4 signing in last 4 years, including France, Italy and UK. Canada and Ukraine in process
- Encourage all EU Member States to participate



## VAT In Europe


- Narrow base – high standard rates + reduced rates
- Non-EU: often broad base – low standard rates
- High standard rates – may be incentive for fraud
- Low standard rates – less incentive for fraud
- Reduced rates (and other EU processes) add to complexity:
  - Higher administrative costs
  - Higher compliance costs
- **Reduced rates favour the wealthier**
- **Results in an inefficient VAT system**

## VAT C-efficiency ratio (2005)



## VAT Losses – Who’s Counting?

- Measuring the “VAT Gap”
- UK – annual estimates based on top-down/bottom-up methodology: VAT and Excise
- Sweden & Denmark – measuring losses in all taxes
- Germany – auditors have done some work on VAT losses
- Argentina and Chile have also done work on this
- US working on federal tax shortfalls
- “Reckon” outcomes will be informative (2009)
- **More work needs to be done on VAT losses and causes in order to develop effective responses**




• **Remedies against VAT fraud: a more efficient cooperation between tax authorities and/or changes to the VAT system?**

• *Jean-Claude Bouchard*

23 janvier 2008

Member of  
Deloitte Touche Tohmatsu



- 1 The diagnosis
- 2 The remedies
- 3 Carousel fraud

## I- the diagnosis

- We can identify 3 sources of VAT fraud
  - The incomplete harmonization of texts by Member States
    - *false transposition in some legislations leading to abusive practices: article 9-3 of the 6th VAT directive transposed to article 58 of the 2006-112 directive*
  - The possibility left by the Member States' legislation to choose between two possibilities
    - *Second hand vehicules*  
Article 311 to 343 of the directive 2006/112/CE transposed to the Article 297 A of the FTC
    - *Distance sales :*  
Article 33 and 34 of the directive 2006/112/CE transposed to Articles 258 A and 258 B of the FTC determine the threshold at 100,000 € for France
- Undue eighth directive refunds

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## I- the diagnosis

- The withdrawal of the tax representative has favoured this kind of « sport »

*A fatal error: the VAT invoicing by firms of another State and the absence of its transfer to the State which it belongs to*

***The « former » borders protect the fraudsters***

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## II- Remedies

### A/ IMPROVE LEGISLATION

- Avoid legislative measures which offer a choice
- Distance sales:
  - *unique place of sale declarations*
  - *Monitoring and auditing by the State where the declaration is made*
- Eighth directive refunds : the claim should be first examined by the Tax authorities of the country in which the claimant is established

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## II- Remedies

### B/ Increased cooperation between the tax authorities

- Can a tax administration remain a passive spectator of a fraud perpetrated in another State?
- Application of the principle of mutual and reciprocal confidence (WURMSER case, ECJ, 11 May 1989)
- Possibility for the tax administration of a country to collect all the VAT due belonging to another State

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### III- Carousel fraud

- Causes of the carousel fraud:
  - The present legislative system:
    - *The identification number*
    - *The breach in the invoicing chain*
  - The absence of a definitive regime
  - The lack of cooperation between the Member States
- Aims to be achieved:
  - Eliminating the fraudsters from the invoicing chain
  - Establishing a definitive regime

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### III- Carousel fraud

- Criterion given by the jurisprudence and applied by the French Legislation :
  - Proof that the businesses « ought to have known »
- **CAUSE OF FISCAL UNCERTAINTY**
- VAT and Businesses:
  - A business is not only a taxable person
  - Businesses act as « tax collectors »
  - They need proper guidance and fiscal certainty

#### PREREQUISITE IN VAT

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### III- Carousel fraud

- Eliminating the fraudsters from the invoicing chain thanks to:
  - A VAT intracommunity passport
    - *Authorised economic operator*
    - *85% of intra-community traffic is performed by 10% of businesses*
  - For smaller businesses: obtaining from the tax authorities an annual quota of EC sales
  - Invoicing :
    - *An EU model of intra-community invoices*
    - *Invoices monthly reported in intrastat returns*
    - *The non-inscription in the intrastat returns would entail the responsibility of the State of origin, in case of fraud*

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### III- Carousel fraud

- The definitive VAT regime
  - EC deliveries can ultimately be subject to a community tax rate of 15%
  - Reverse charge of the difference
  - This tax will be offsettable if the invoice is shown on the intrastat returns
  - The entrepreneur must have immediate access to usefull data:
    - *Date of departure*
    - *VAT registration number*
    - *Agreement to EC trade*
- Organization of a real solidarity between Member States via the setting up of information systems between tax authorities in real-time
- Setting up a body of tax inspectors with cross-border competence

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### III- Carousel fraud

- Generalizing the use of the reverse charge mechanism ?
  - Consequences for businesses regarding the level of reporting obligations
  - Degree of legal certainty needed to verify the tax status of the customer.
  - Effects on the cash flows
  - Impacts on business decision? For example : the choice of the business location, frequency and value of transactions, the choice of suppliers and customers...



## *Introduction*

- Details of Committee
- Webpage
- Name and link to report



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## *Three criteria*

- Right tax in right place
- Minimal fraud and non compliance
- No unreasonable burden



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## *Two types of change*

- Administrative
- Updating the system



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## *Administrative Changes*

- Removal fraudulent trades from VAT system
  - Have to prove the trader did not know of fraud in the supply chain: “extended verification”
  - Large burden on business to check customers and customers’ customers.
  - Allows the fraud to move to other products.



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## *Administrative Changes*

- More pre-registration checks
  - But creates delay for legitimate business
  - Could hold security until firm has proved its worth
- Real time trade logging
- Real time payment of VAT



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*Prevention is better than cure: a wide ranging change is required.*



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## *Possible changes to the VAT system*

- Must make sure that any changes do not export the problem or move it to other products
- Reverse charge: the current UK derogation is limited so will allow fraud to shift
- Proposals for country-wide Reverse Charges may affect neighbours



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## *Changes to zero rating?*

- Harmonise all VAT rates
  - Political opposition
- Remove the zero rate and replace it with a harmonised rate
  - Complicated by derogations
- Destination system
  - High costs for business and governments
- Origin system



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## *Origin system*

- Charge VAT at the rate of the exporting country
- Simple for firms...
- ... but Member States would need to pass revenue between each other
- A clearing house could simplify this process
- As could a harmonised rate for cross-border trades.



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## *Conclusion*

- Action is required
- While there will be adjustment costs in the short run, designing out fraud is better than a system which easily allows it
- Remember the three criteria:
  - Right tax in right place
  - Minimal fraud and non compliance
  - No unreasonable burden




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 Taxation and Customs Union

# *VAT fraud*

## *Views of the Commission on how to tackle it*

 Taxation and Customs Union

## VAT fraud - Changing the VAT system

Reverse Charge:

- would largely reduce “missing trader” fraud (MTIC fraud) and other deduction related fraud
- would introduce new risks of increased untaxed final consumption
- would introduce new complications and burdens
  - for taxable persons
    - Second - parallel VAT system
    - Threshold
    - Reliance on status of customer
    - More administrative obligations for taxpayers

29.1.2008 2

## VAT fraud - Changing the VAT system

Taxation and Customs Union



### Reverse charge cont'd

- for tax administrations
  - New control challenges and possibly needs of resources
  - Cost of change
- there is no empirical experience with such system (need of a pilot?)
- runs counter VAT strategy to seek simplification and complicates possibilities for further harmonisation

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## VAT fraud - Changing the VAT system

Taxation and Customs Union



### Taxing intra-EC supplies

- would reduce attraction for MTIC fraud
- could add scope for other types of fraud
- would impact on cash-flow (positive/negative)

### Depending on concept (departure/destination)

- necessitates clearing (departure)
- a single rate for EC supplies (departure)
- requires full One Stop Shop scheme (destination)

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## VAT fraud – improving current system

Taxation and Customs Union

More accurate information to tax administrations

- Improve data on intra EC supplies
- More / more uniform reporting

MS to integrate EU dimension

- Equal protection of revenue of other MS
- Facilitate data exchange (database?)
- Better risk management (eg Eurocanet)

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5

## VAT fraud – improving current system

Taxation and Customs Union

Reliable VAT status of taxpayers

- Better control of VAT identification numbers
- Certainty for business and administrations

Enhance possibilities to collect VAT

- Improved mutual assistance for recovery
- Specific rule on joint and several liability

Co-operation with legitimate business

- Labelling of businesses
- Advantages for co-operative business

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6



# **Session II**

# **VAT Rates**



## *VAT rates: possible way forward*

Workshop European Parliament  
23 January 2008

1



## *Possible way forward?*

### Main questions:

- Is tax competition acceptable in the field of VAT?
  - Under which conditions?
  - Within which framework?
- Reduced rates to be optional/compulsory?
- What is achievable with unanimity rule?

2



## *Possible way forward?*

- Communication of 5 July 2007 COM(2007)380
  - responds to the request of the Council to present an overall assessment report on the impact of reduced rates by the end of June 2007
  - Report back on main results of study
  - Presents **material for discussion and explores ways forward** in the field of reduced VAT rates
  - Intended to launch a **broad debate** in the Council, the European Parliament and with other stakeholders

3



## *Possible way forward?*

### The mainlines of the Communication

- Simplification is needed
- more autonomy to the Member States is possible
- proper functioning of the Internal Market
- avoid disproportionate costs for business involved in intra-Community trade
- need of policy coherence

4



## *Possible way forward?*

### The Communication

- Recognizes some usefulness for reduced rates for locally supplied services
- Postulates equal treatment of Member States
- Launches the idea of distinguishing two reduced rates
  - A lower for social aspects (incl. zero rate)
  - A higher for other policy objectives
- Establishes the need for a full review of the list of eligible items
- Questions the effectiveness of using VAT reduced rates for the promotion of certain goods/services beyond specific cases

5



## *Possible way forward?*

- No guidance from Council in December 2007
- Council intends to organise a discussion “on the economic impact of reduced rates and whether or not reduced rates are an appropriate instrument to achieve sector political aims”
- From preparatory discussions clear:
  - MS not prepared to accept abandoning special rates
  - 5% minimum for reduced rate to be maintained
  - Little willingness to enter into full revision of Annex III

6



### *Possible way forward?*

- Commission to address in the short term urgent matters (proposal planned for mid 2008)
  - Labour intensive services
  - Restaurants
  - Housing?
  - Locally supplied services?

7



### *Possible way forward?*

- What about the categories of
  - Energy saving materials and environmentally friendly products
  - Electronic products (CDs, internet etc)
  - Others
- What about future rate structure and specific rates
  - Zero rates
  - Super-reduced rates
  - Parking rates

8

## Reduced VAT rates

### – Arguments for and against in an EU perspective

Helge Sigurd Næss-Schmidt | Brussel | 23th January 2008

INFORMED DECISIONS



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## Agenda: Reduced VAT rates

- **How used are they and where?**
- **Pros and cons**
  - > Country dimension: jobs, productivity and income distribution
  - > EU dimension: internal market and "tax competition"
- **Conclusions**
  - > in which industries can member states reach gains?
  - > where do they create problems for EU as a whole?

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## Almost all EU countries use reduced VAT rates

- **One rate:** Denmark and Slovakia
- **Reduced and super reduced:** France, Spain, Luxembourg, Italy, Greece, Poland
- For half of EU countries, the revenue loss exceeds 1 per cent of GDP

		Zero rating		Reduced rates		Super reduced rates		Revenue loss
		Yes	No	Yes	No	Yes	No	Share of GDP
Gr 1	DK	√			√		√	0.0-0.1
	SK		√		√		√	
Gr 2	EE, LT, LV, DE	√		√			√	0.1-0.4
Gr 3	CZ, AT, SI, FI, IR	√		√			√	0.6-0.9
	NL		√	√			√	
Gr 4	SE, HU, UK, BE	√		√			√	1.0-1.2
	FR, ES, LU, IT	√		√		√		
Gr 5	EL, PL	√		√		√		1.3-1.7
	PT, CY, MT	√		√			√	

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## VAT structure of private consumption in Europe (1)

- **Lowest rates (average between 4 and 8 per cent)**
  - > Food
  - > Books
  - > medical products
  - > passenger transport
- **Low rates ( average between 10 and 12 per cent)**
  - > Electricity
  - > Heating
  - > post and telecom services
- **Standard rates (19 per cent)**
  - > On 2/3 of EU household consumption

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## VAT structure of private consumption in Europe (2)

Groups	Sector	% Value added	VAT rate	Value added	VAT rate
1 Food	Hotels (III)	1.1	12.6	4.4	9.7
	Restaurants (p)	1.8	14.7		
	Foodstuff (III)	1.5	8.0		
2 Merit	Medical & books (III)	0.5	7.2	1.9	9.0
	Culture & entertainment (III)	1.4	10.8		
3 Network	Electricity & heating (p)	1.5	12.4	7.2	10.4
	Postal, telecom & financial services (p)	3.6	10.8		
	Passenger transport (p)	1.7	3.7		
	Social housing (III)	0.4	16.4		
4 Local	Locally supplied services (IV)	2.0	17.2	2.0	17.2
5 Public	Government services	17.7	4.1	17.9	5.2
	Street cleaning (III)	0.2	11.2		
6 RoE	Rest of the economy	67.0	19.1	67.0	19.1
	<b>Total</b>	<b>100.0</b>	<b>14.7</b>	<b>100.0</b>	<b>14.7</b>

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## pros and cons (1): the national dimension

- **Reduced rates are costly**
  - > burdensome administration
  - > consumer choice distorted
  - > higher tax on other products = less spending elsewhere
  
- **So are the gains big enough?**
  - > **Productivity**
    - > get the doctor off the roof and on to the hospital, ie. less Do-It-Yourself work (DIY)
  - > **Jobs**
    - > Shift demand to services produced by low skilled workers
  - > **Income distribution**
    - > lower rates on goods bought by low income families.
  - > **Promote "good" products**
    - > Books, theater should be attractive and affordable

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## Taxes, Do-It-Your Self work and productivity

- High VAT promotes DIY and underground activity
- DIY affect cleaning and repair work not computer production
  - >DIY account for 80 per cent of minor repair work on own houses in high tax countries Sweden, Denmark and Germany
- Reduced VAT on repair work/cleaning can increase productivity sizeable by shifting work efforts from amateur to professional work

Country	White	DIY	Underground
Denmark	20	75	5
Norway	18	79	2
Sweden	14	80	5
Germany	14	80	6
UK	34	51	15

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## Boosting the demand for low skilled workers

- Unemployment rates highest for for low skilled workers.
- Could lower VAT rates for low skilled industries help?
  - > ex. locally supplied services and restaurants?
- Effects seem small.
  - >So-called low skilled industries few and small
  - >Most low skilled workers employed in other sectors
  - >very large VAT reductions needed for even small effects
- Conclusion
  - >Job effects not large enough to justify VAT cuts
  - >But targeted sectors (repair work, cleaning etc) also prone to DIY
  - >Job effects are additional reasons, not stand alone

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## Lower VAT on food = more equal income distribution, but..

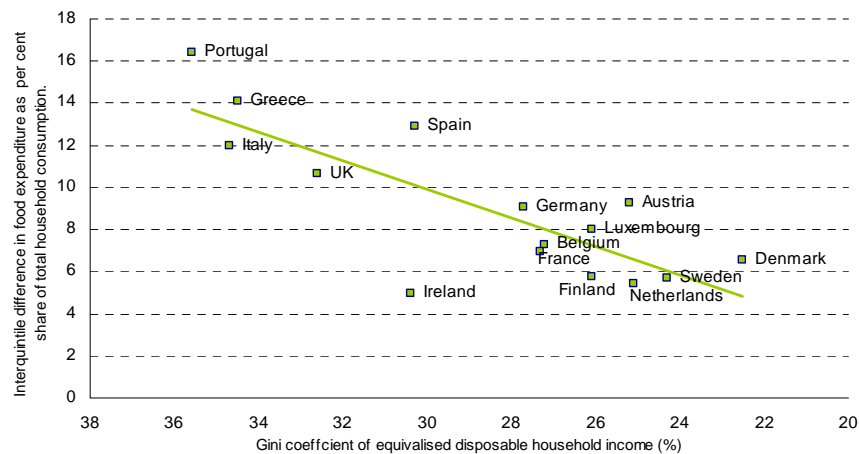
- Food
  - > Low income families spend larger part of income on food than high income families
  - > Food is still an important overall part of spending
- No other expenditure item share these two characteristics to the same extent
- Low VAT rate on food can serve distributional goals
- But:
  - > small effect in countries with narrow income distribution (e.g. Sweden)
  - > direct social policy measures more targeted and effective

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## Food expenditures vs. income distribution, EU15



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## Community pros and cons overview

- **Reduced VAT rates can create problems at EU level:**
  - > Distortions of competition between traders in different countries
  - > Loss of tax revenues for high tax rate countries as trade is dislocated
  - > These two issues of course closely related
- **When are these problems happening?**

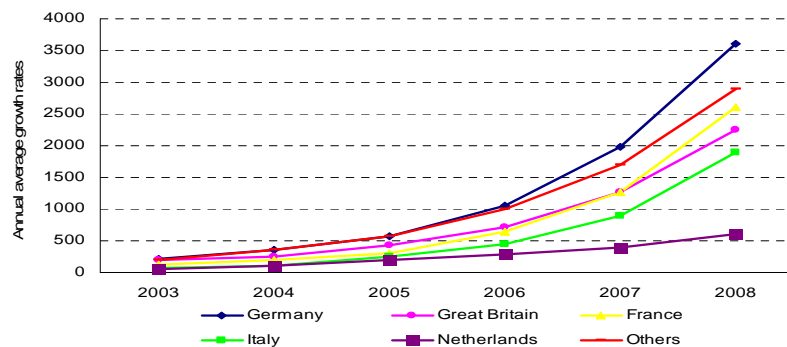
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## Avoid reduced rates in goods easily traded between borders

- High value, branded and transportable goods most traded
- Avoid low rates on books, CDs, computers, sports equipment etc.
- Even more important with strong growth in "e-commerce"
  - > Sales expected this year to 5-20 times levels just 5 years back



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## Special case: lower rate on energy efficient consumer appliances

### Objective:

- Climate change and energy security challenges
  - > buy low consuming bulbs, freezers etc.

### Problems:

- The ETS already provides incentives to save electricity and central heating
  - > instruments on top have zero effects on emissions at EU level
  - > So focus on non-central heating etc (ex domestic boilers)
- Net effects not always clear
  - > more energy efficient hair dryers
  - > but also more buying of dryers and other high "energy" products
  - > More certain effects: raise taxes on heating!
- Targeted products high value, well branded
  - > cross border sales an issue unless **obligatory** for all countries
  - > Use direct consumer subsidies applying to sourcing from all countries
  - > Focus on better labeling, perhaps more grades of energy efficiency

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## A balanced scoreboard approach to reduced VAT rates

- Use/Allow reduced rates when national effects are (very) positive, ie. (dark) green..
- ...and when the red light of community problems is *not* blinking at the same time.
- Check if other instruments not more effective
  - > Five countries have income tax and expenditure programmes providing incentives to cut DIY work and promote low skilled jobs

Group	Sectors	Prod.	Jobs	Income distrib	Merit	Cross border	Distance selling
1 Food	Hotels					Tourism	
	Restaurants					Tourism	
	Food						
2 Merit	Medical, books						Books
	Culture and entertainment,						Music
3 Network	Electricity, district heating						
	Post, telecom & finance						
	Passenger transport						
	Social housing						
4 LSS	Locally supplied services	Cleaning	Cleaning				

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## Reduced VAT rates

**Tomasz Michalik**

**MDDP**

**Polish Confederation of Private Employers  
LEWIATAN**



## Reduced VAT rates – issue of economics?

- As it clearly results from the Copenhagen Economics research and Commission communication of 5 July 2007, the best solution from the purely economical perspective is to apply either one unified VAT rate or unified standard rate + unified reduced rate across EU.
- This is also clear that in the foreseeable future introduction of unified VAT rate(s) is rather not expected.
- Therefore it should be emphasized that merely political and, to certain extent, social reasons will decide about the existence and shape of the system of reduced VAT rates in EU.

## Reduced VAT rates



Therefore the following needs to be seen among the objectives of a new system:

- Minimisation of negative economic effect for Internal Market and local economies in order to avoid any real threat to the EU competitiveness in a global economy
- Avoidance of an unfair VAT competition within EU
- Minimisation, to the possible extent, of the compliance cost

## Unified rate/reduced rates and potential distortion of competition



If the differences in VAT rates cause the distortion of competition than the basic reason for such a distortion is the fact that standard rates varies across EU

This is clear that only an unified VAT rate in 27 Member States will allow to avoid any distortion of competition caused by the rates differences.

Due to the limited applicability of the reduced rates their impact on the distortion of competition within EU is also limited.

## Internal market – possible distortion of competition



Supply	Distortionary impact
Locally supplied services (e.g. hairdressing, repairing etc.)	none
Services that may have a cross-border character	Exists if the place of supply (taxation) is not where the customer is established (and not at the place of use and enjoyment); scale depends on a rate's difference
Services that in certain cases, may have a cross-border character	Exists if the place of supply (taxation) is not where the customer is established (and not at the place of use and enjoyment); scale depends on a rate's difference

## Reduced VAT rates - Internal market possible distortion of competition



In order to minimise any potential impact on the competition within Internal market

- reduced rates should be applied, in principle, to local supplies. That also includes a supplies of food.
- The list of supplies to which a reduced rate may be applied should be closed.
- Current list and recently applicable derogations may be a good base for a future list of supplies that may be subject to reduced rates.

## Reduced VAT rates – complete list of supplies subject to reduced rates



Major strengths	Major weaknesses
Possibility to introduce clear, precise and unified rules across EU	<ol style="list-style-type: none"><li>1. Need to create a closed, exhaustive list of goods/services</li><li>2. Need to assure a proper „translation” into national legislations</li><li>3. Every amendment to the list will require a relevant change of the EU regulation</li></ol>

## Domestic distortion of competition – compliance cost



- The basic reason for the distortion of competition within a Member State is the compliance.
- In order to avoid a compliance cost the list of supplies subject to reduced rate needs to be complete and crystal clear.
- Polish example of the compliance cost

Majority of the reduced rates are applicable on a basis of a statistical classification. In practice the statistical office decision determines whether the reduced rate is applicable or not. This causes that same/similar goods/services supplied by different taxpayers may be subject to different treatment.



## Reduced VAT rates vs incentives



This is quite certain that the similar (political, social) effect may be achieved by using a incentives/subsidies instead of reduced VAT rates. Moreover, this is possible that use of targeted, flexible subsidies may bring even better results.

Use of subsidies instead of reduced VAT rates have certain important weaknesses, such as:

- A need to introduce a clear and identical on a EU level set of incentives. Lack of such rules may lead to an unfair competition between Member States
- In order to achieve a common application the rules on a public aid will have to be respectively amended

## Reduced VAT rates



In the situation where there will be no unified rate(s) there is no reason not to give Member States a possibility to introduce reduced rates in particular on locally supplied goods and services.

Major political/social benefits of keeping reduced VAT rates are:

- Reduced costs of selected, „politically/socially preferred” goods/services for final customers
- Possible minimising of a grey economy as well as Do-It-Yourself activities
- Possible minimising of unemployment especially of a lower skilled employees.



## **VAT on Newspapers in Europe: ENPA Presentation**

European Parliament Workshop  
23 January 2008



### **Presentation of ENPA**

- ENPA - the European Newspaper Publishers' Association - is a non-profit organisation of **5100 titles from 25 European countries**.
- ENPA represents the interests of **newspaper publishers** to the European Institutions. More than **120 million copies of newspapers** are sold or distributed each day and read by over **240 million people in Europe**.
- Newspapers online have **a significant number of unique visits on their sites** on daily basis.



Newspapers – just like any other goods or services?



### **Facts and Figures Structure of VAT rates in Europe**

On 27 EU Member States

- **17 Member States apply a VAT rate between 0 and 5% (zero and super reduced rates) on printed newspapers' sales**
- 8 EU Member States apply a VAT rate between 5 and 15% (reduced rates)
- Only 2 EU Member States apply a VAT standard rate (between 15 and 20%)

## Facts and Figures: Structure of VAT rates in Europe

Austria	10%
Belgium	0%
Bulgaria	20%
Cyprus	5%
Czech Rep	5%
Denmark	0%
Estonia	5%
Finland	0% subscriptions 22% street sales
France	2.1%
Germany	7%
Greece	4.5%

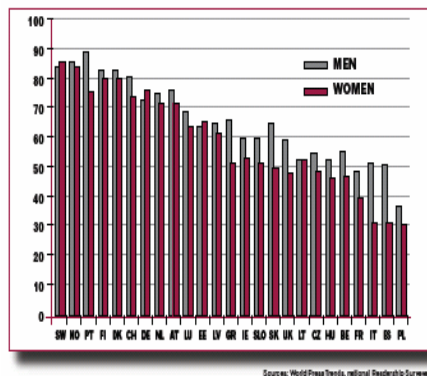
Hungary	5%
Ireland	13.5%
Italy	4%
Latvia	18% subscriptions 5% street sales
Lithuania	5%
Luxembourg	3%
Malta	5%
Netherlands	6%
Norway	0%
Poland	7%
Portugal	5%

Romania	9%
Slovakia	19%
Slovenia	8.5%
Spain	4%
Sweden	6%
Switzerland	2.4%
UK	0%

## Facts and Figures Europeans Read Newspapers!

Figure 1.

Readership of daily newspapers Men and Women



Newspaper reach (2006) in Europe

		%			
		All adults	Men	Women	Main household shopper
Sweden	SW	84	84	84	84
Norway	NO	83	83	84	
Portugal	PT	82,3	89,1	76,1	
Finland	FI	82	83	80	
Denmark	DK	82,5	84,3	80,8	82,8
Switzerland	CH	77,5	80,5	74,6	76,9
Germany	DE	73,7	75,7	71,9	
Netherlands	NL	72,5	73,9	71,1	72,3
Austria	AT	72,7	74,7	70,9	74,2
Luxembourg	LU	66,7	66,5	64,9	68,9
Estonia	EE	66,5	65,3	69,9	68,5
Latvia	LV	64,7	65,9	63,7	64,9
Greece	GR	15,9	10,2	11,7	
Ireland	IE	53,7	57,2	50,3	51,7
Slovenia	SI	51,6	54,6	48,6	
Slovakia	SK	40	45	40	
United Kingdom	UK	33,2	35,3	30,9	31,6
Lithuania	LT	56,1	56,5	55,8	56,5
Czech Republic	CZ	49,9	52,9	47	53,2
Hungary	HU	50	54	46	48
Belgium	BE	51,7	56,1	47,5	50,8
France	FR	41,5	47,9	39,5	42,5
Italy	IT	41,8	53,2	31,2	34,5
Spain	ES	41,8	50,9	33,1	34,2
Poland	PL	65,7	69,4	61	64,5

## Facts and Figures: Europeans Read Newspapers!

- Every day, 262 million Europeans turn to their newspapers.
- Europe counts for 11% of newspaper readers in the world and a quarter of all newspapers sold every day.
- The level of newspaper readership in Europe is 53%.
- Europe is therefore the world most important newspaper market and the most competitive and diverse.

## Facts and Figures: Newspapers are local products

### Percentage of newspapers' cross-border sales

Country	Total percentage of the country's newspapers' sales in other EU countries	Total percentage of foreign newspapers' sales in your country
Denmark	0,13%	0,54%
Estonia	0,74%	6%
Finland	0,5 %	0,1 %
France	3%	
Germany	7 %	7 %
Greece	0,65%	4.86
Norway	1.5%	0.1%
Slovakia	0.3%	4.7%
Spain	0.94%	
Sweden	0.58%	

**ENPA position  
« Don't tax newspapers »**

- Good conditions for **freedom of the press** cannot be ensured without the lowest possible VAT rate -ideally zero rate-on newspapers
- Newspapers are essential contributors to **literacy, knowledge and access to quality information** for all citizens without discrimination

**ENPA position  
« Don't tax newspapers »**

- **Newspapers activities are mainly on the national and regional markets.** Cross-border businesses remain a marginal part of newspaper publishing companies activities
- Lower VAT on newspapers has a **positive impact on advertising and sales**
- Lower VAT contributes to the preservation of **pluralism and cultural diversity**



**ENPA**  
European Newspaper  
Publishers' Association

### Commission's Communication on VAT reduced rates: ENPA reaction

- The need to respect the **subsidiarity principle** and **Member States' competence** in the field of indirect taxation.
- Newspapers should be part of the **first category: from 0 to 5%.**
- Newspapers' activities have **no impact on the Internal market.**
- Newspapers' activities do not create **distortions of competition** so there is therefore no compliance cost for business.



**ENPA**  
European Newspaper  
Publishers' Association

### Commission's Communication on VAT reduced rates: ENPA reaction

- **Substituting VAT reduced rates with subsidies is dangerous** for cultural/historical reasons in certain EU Member States (independence of the press) and creates **economic uncertainty.**
- If newspapers fall in the second category: from 10 to 12%: **direct negative impacts on readers and newspapers' price.**
- **Production costs/investments for printed newspapers** are high and would not afford an increase of VAT.