

THE RETURN OF THE VALUE ADDED TAX

A NEW OWN RESOURCE TO FINANCE THE BUDGET OF THE EUROPEAN UNION

Auke R. Leen
Leiden University, The Netherlands
Department of Tax Law and Economics
E-Mail: a.r.leen@law.leidenuniv.nl

Abstract. In the at February 8, 2013 by the European Council accepted budget for the European Union, the Union wants to introduce new own resources to finance the Union's budget. The proposed European taxes are a Financial Transaction Tax (FTT) and an EU Value Added Tax (VAT). For the last, on every sales slip, the consumer can see that a part of the VAT he or she pays, goes directly to Brussels. The FTT is now approved by 11 of the 27 Member States; the VAT is still open for discussion (European Council, 2012). In this paper we look at this last new own resource and the Union's decision-making process in view of the introduction of it. The question becomes why the existing VAT-based contribution of the Member States is unsatisfactory and why a direct contribution of the citizens to the Union would be an improvement.

After looking at the pros and cons of the new proposed EU tax, the regressivity of the VAT, the different levels of tax fraud in the Member States, and the EU decision-process itself do seem to stand out as the most fundamental obstacles to the introduction of the tax. The paper concludes with a sketch of a so-called declaratory EU VAT. In a declaratory tax, a country still pays its national, GNI-based contribution, but shows the contribution to the citizens as a percentage of the total VAT on every receipt.

Keywords: European Union, EU budget, own resources, EU VAT.

Introduction

In the Multiannual Financial Framework (MFF) for the European Union (EU or Union) for the upcoming seven year period, 2014-2020, the European Commission (Commission), the Union's executive arm, wants to introduce two new own resources to finance the general EU budget (European Commission, 2011a). The budget for the period is about 960 billion euro or one percent of the GNI of the EU Member States. The two proposed European taxes are a Financial Transaction Tax and an EU Value Added Tax. The Value Added Tax (VAT) is a general, broadly based consumption tax assessed on the value added to goods and services. It applies more or less to all goods and services that are bought and sold for use or consumption. For the first tax, the FTT carries a rate of 0.1% on trades in shares, bonds and other securities and 0.01%

on derivatives transactions. The FTT is now approved by 11 of the 27 Member States. For the second one, on every sales slip, the consumer can see that a part of the VAT paid, goes directly to Brussels. This last tax is still a work in progress and open for discussion (European Council, 2013).

In the paper we look at the policy and decision-making process in view of the introduction of a EU VAT as a new own resource. The central question of the paper is why is the existing VAT-based contribution of the Member States to finance the EU budget unsatisfactory, and why is a direct contribution of the citizens to the Union, a EU VAT, an improvement.

After the introduction, the paper starts with stating the role of the existing VAT-based contribution, in the past and present, as an own resource for the Union. Next the proposal of the Commission of a new VAT-based contribution is given. In the fourth part, we state the pros and cons of the proposal. In the final section we do answer our two main questions: (1) is the new VAT better than the old one, and (2) is the proposal viable in view of the decision-making process of the Union. The paper concludes with the option of a declaratory VAT. A declaratory EU VAT combines the strong points of the present GNI-based own resource with a EU VAT-based resource.

The VAT: from 1970 till 2013

In 1970 the EU made the milestone decision to replace national contributions with the Communities' own resources. Though already in Article 201 of the Treaty of Rome (Treaty), signed in 1957, it was stated that a system of own resources, or self-financing, was to be introduced at the end of a transition period. During the first period direct Member States contributions did finance the Union. Now, however, 75% of the EU budget is, again, financed by direct contributions, which also runs counter to the philosophy behind the Treaty. One of the new resources, introduced in the 70s of the last century, next to levies on agricultural and sugar trade with the rest of the world and custom duties on trade with third countries, were resources accruing from a proportion of national VAT revenues. They do derive from the application of a call rate to Member States' VAT bases set according to harmonized rules. At the beginning, the tax was to be no more than 1 percent (European Communities, 1970).

Though all three resources are called own resources, the first two resources mentioned are regarded as really or true own resources. They are called traditional own resources. They arise from Community policy instruments: the Common Agricultural Policy and the common commercial tariff. In general, they are not seen as a national contribution towards the Community budget. There was also from the beginning a distinct difference, though not in Community law, in the political perception at the national level between traditional own resources and the VAT based contribution. The VAT is generally perceived by governments and by national parliaments as a mere budgetary contribution (European Commission, 1998). The first two are, as

just-said, linked to EU policies while the VAT-based resource and the in 1988 introduced fourth resource: a GNI-based own resource, are based on statistical aggregates.

In 1970, the levies on agricultural and sugar trade were transferred immediately to the EU, the customs duties on trade progressively between 1970 and 1975. It took, however, until 1979 to get agreement on a harmonized VAT base.

Because successive trade negotiations reduced world tariffs, the traditional own resources declined as a proportion of total resources. The share of traditional own resources went from almost 50 percent of the budget in 1979 to just 20 percent in 1993 and, now about 15 percent. The VAT furnished in its heyday in 1990, 70 percent of the EU budget, in 2005, 16 percent and now about 10 percent of the total EU budget.

Until the introduction of the fourth resource: the GNI-based own resource in 1988, the VAT resource was the predominant resource. Because of growing expenses at the end of the seventies, the Commission identified a serious revenue problem. As a solution, next to some other taxes, e.g., part of the taxes on cigarettes and part of the taxes on petrol, a simple increase in the VAT rate was suggested. The result was that the VAT rate rose to 1.4 per cent at the Fontainebleau conference in 1984. Later the maximum VAT rate was maintained at 1.4 per cent but capped at 55 per cent of GNP for all Member States. When Jacques Delors was for the first time president of the Commission, 1988-1992, for the first time, a revenue limit was agreed for the whole EU budget: a ceiling of 1.2 per cent of the EU GNP.¹ In 1996 the maximum VAT rate was reduced to 1 per cent and capped at 50 per cent for the cohesion states, which at that time were Greece, Portugal, Spain and Ireland (Laffan, 1997). At present the VAT call rate is 0.3 % (with, over the period 2007-13, a reduced rate of 0.225 % for Austria, 0.15 % for Germany and 0.10 % for the Netherlands and Sweden) and VAT bases are capped for all Member States at 50 % of GNI. In 2011 this resulted for, e.g., Greece in a payment of 278 million euro, for France about 3 billion, and for the Netherlands 290 million. Under the just-agreed new MFF a reduced VAT call rate of 0.15% (rather than 0.30%) will apply for Germany, The Netherlands and Sweden.

The reason not to rely any longer on a higher VAT rate was an attempt to deal with the regressive nature of the VAT resource; consumption and hence the VAT tends to form a higher proportion of the GNP of the poorer states of the community. Moreover, Member States with a higher share of tourism, the so-called Marbella effect, also show a higher consumption rate. VAT contributions, also, as an indication of wealth, inevitable overstate the ability of the poorer Member States to pay. The capping of the proportion of VAT for calculations on the uniform base represented a search for more equitable burden-sharing in the budget. In general, it was agreed by the European Council (1987), consisting of the heads of state or government and the President of the European Commission, that the financial system should take

¹ The GNI-based resource (the 'residual' resource) is determined so that total revenue balances total expenditure.

greater account of the proportionality of contributions in accordance with the relative prosperity of Member States. It was concluded by the Commission that less prosperous states, the just-mentioned cohesion states, all had relatively high VAT bases and thus were disadvantaged under the 1988 system, even with capping. Especially since, at that time because of economic growth, the new introduced fourth resource, a topping up of the budget based on the GNI of the Member States was not that effective.

In sum, the problem remained of how to tackle the regressive nature of the existing VAT contribution. This because it, as just said, gave advantages to Member States with a low VAT base and penalized those, generally the poorer states, with a high VAT base. In general the Commission (1998) and the Member States declared their willingness to take greater account of the contributive capacity of individual Member States in the system of own resources (European Commission, 1998).

The VAT and the United Kingdom rebate

But the VAT rate also played another role from the point of ability to pay: the UK problem. Already before the accession it was known the UK would pay a disproportionate amount into the Community budget. The reason was its structure of trade and particularly the high level of imports from non-Community states. On the expenditure site, the UK was unlikely to benefit greatly from the Common Agricultural Policy. Also, next to the cohesion countries, the UK too paid a disproportionate contribution based on relative wealth to the budget. It was agreed that an equitable solution was needed. The resulting structural UK budgetary rebate, after some *ad hoc* solutions before, took form in a reduction of the VAT contribution. The refund to the UK is 66 percent of the difference between the receipts from the Union and the VAT contribution (European Council, 2007). But here too we do see the special position of the traditional own resources, which should not be calculated as a part of a net contribution. *Mutatis mutandis* other Member States saw their *juste-retour* problems repaired by a correction on their VAT contributions. Another important reason for the Union to introduce an EU tax is to counter the, just-mentioned, *juste-retour* behavior of the Member States. States favor expenditures that improve their net national benefits and contributions to the Union, rather than those with the greatest value added for the EU as a whole. Such purely self-interested behavior has been shown to be the result of the dominant way for financing the EU – with national, GNI-based contributions. This method of financing ‘places disproportionate emphasis on net balances between Member States [,] thus contradicting the principle of EU solidarity, diluting the European common interest and largely ignoring European added value’ (European Commission, 2011c).

In sum, the problem of regressiveness and the way it is solved, by capping the VAT base, has put the VAT in its distributional effects similar to the GNI resource (Heinemann, 2008). The disadvantages, however, compared to a purely GNI-based resource are severe. First, the present VAT own

resource creates high administrative cost as the harmonized based must be calculated for this purpose (European Commission, 2008). Second, it is, because of all the exceptions granted to individual Member States, unnecessarily complex and difficult to understand for the citizens. The VAT contribution has become a contribution based on GNP. As the Court of Auditors says, ‘the VAT resource is levied on a “virtual” basis (harmonized VAT base which may be subsequently capped and takes into account compensation arrangements for UK) which is complex to the point of incomprehensibility,’ (European Commission 2011b).² All in all, the result is that the Commission’s priority is to get rid of the existing VAT own resource.

An EU VAT

The existing VAT, based on a share of national VAT receipts, is, as just-said, complex, requires much administrative work to arrive at a harmonized base, and offers little or no added value compared to the GNI-based own resource (European Commission, 2011b). In search of new own resources the introduction of a new EU VAT is an option favored by the Commission and the European Parliament. The goal of the Commission is to make the VAT-based contribution as simple and transparent as possible, to strengthen the link with EU VAT policy and the actual VAT-receipts, and to ensure equal treatment of taxpayers in all Member States. What does the new VAT look like?

The Commission proposes to apply a single EU VAT rate. National authorities would still raise the money and then transfer the money to the EU budget. The option of a new VAT resource alongside Member States’ VAT poses serious technical implementation problems and has therefore been discarded (European Commission, 2011b). A genuine EU-wide tax base would replace the complex formula currently required to generate a theoretical EU VAT tax base. The Commission estimates a 1% EU rate applied to the standard rate of VAT in every Member State leads to revenue between 20.9 and 50.4 billion euro. This depending on how narrow/wide the chosen tax base is (European Commission, 2011b). At the moment, however, the main stumbling block to an EU VAT is the incomplete harmonization of Member States’ VAT systems. Hence, the policy could be a part of the wider EU policy on overhauling the existing VAT legislation. The aim of that policy is to come to greater standardization of rates and fewer reduced rates across EU Member States to increase the strength of the internal market (European Commission, 2010).

In sum, the introduction of an EU VAT means that the combined VAT rate in the Member States consists of the national and the EU rate. Member States still determine the national rate and the EU rate is defined separately in

² See for the incomprehensible correction for budgetary imbalances Art.1 European Commission, 2004/017 (CNS), Brussels 3.8.2004, p. 25. Cp. European Commission (2008), p. 234-244.

the framework of the own resource decision. Next to the national VAT payment, the EU VAT payments are clearly denoted on each individual invoice. The Member States collect the EU VAT and transfer the proceeds to the EU budget; it is a revenue transfer mechanism and not a parallel system to that of the Member States. The tax base corresponds to the smallest common denominator of national VAT systems. This means that a good subject to national VAT at the standard rate in a Member State is subject to the new VAT resource rate unless the same good is subject to a reduced rate or an exemption in another Member State (European Commission, 2011b).

The pros and cons of a new EU VAT

The Pros

On the positive side, there are some clear benefits. A first benefit of the Commission's proposal is its visibility and simplicity for EU citizens. On every sale's slip the consumer can see how much of the money paid goes to the Union and hence how much he or she pays to the budget of the Union. It could also fulfill the wish of the European Parliament and Commission to create a better bond between the EU citizens/corporations and the Union. The reason is that the Union has evolved from a bond between Member States to a bond between Member States and its citizens. If, as is proposed, for the citizens of the Union, the total taxation burden---indeed---stays the same after the introduction of the EU VAT, it can easily be introduced for the goods concerned. Of the present national rate, the EU rate of 1 % just has to be deducted.

Second, it is said that with a new true own resource, the financial autonomy of the Union would grow. *Juste-retour* behavior of the Member States would be less pronounced and hence there would be a more efficient allocation of EU economic resources. At the same time, because of higher visibility for EU citizens, there could be an increased political accountability for expenditure decisions.

Third, and related to the previous point, it brings into perspective for the citizens the size of the EU budget. At present the budget is about 130 billion euro. A 1% sales tax, as the Commission expects, could furnish about a third of the EU budget. The contribution of, e.g., Greece would be 1.1 billion euro, France 8.2 billion euro, and The Netherlands, 2.2 billion euro.

Fourth, another benefit of the EU VAT is, next to the fact that the VAT is a stable source of revenue, that tax receipts grow in line with increased spending without any change in the VAT rate. In this respect the VAT resembles the strong points of the present GNI contribution.

Fifth, the development of a common VAT system has been a cornerstone of the Internal Market. The existing complexity is considered harmful to the single market and to the competitiveness of EU business. The introduction of a new own resource could be underpinned by this trend of

broadening the tax base, reducing the scope for fraud, improving the administration of the tax and reducing compliance costs. At present, in particular for cross-border supplies the VAT system remains complicated and burdensome. For the Commission (2011b), a fraction of the gains derived from this reform could be attributed to the EU level.

Six, the system would closely link national policies for VAT with EU budget policies: a shift towards indirect rather than direct taxation.

Seven, if it are individual citizens that pay directly to the Union, the often cited Marbella effect would not be relevant anymore. As said, the effect places a relatively higher burden on the Mediterranean countries with their higher share of tourism. In the old to be discarded VAT it were national contributions, in the new VAT, however, it are individuals: tourists or locals, who do pay.

The Cons

On the negative side, some serious problems exist. First, probably only lip-service will be paid to earlier statements that the tax burden for citizens stays the same with the introduction of an EU tax (European Parliament, 2007). Probably, the total rate for the consumers will rise. Because of the high visibility, it could also be a problem if the citizens perceived the EU VAT as an additional burden rather than replacing a national contribution. Are not, as is said, at least halve of all revolutions in the world tax revolutions. The aim of the Union to get a direct bond with EU citizens could turn into the opposite. The Commission does not mention public support for an EU VAT, as it does mention a 65% support of European citizens for the FTT. A tax designed to discourage what it considers socially useless trading activities and let the banks pay for the crisis. And though consumers with an FTT can be fooled in thinking someone else does pay (Worstell, 2012) with an EU VAT this will not be the case. Compared to the FTT, if the total VAT cannot be raised, probably the measure will not be attractive for National Governments. An FTT does not only leave present tax receipt for Member States the same but it even adds revenue to the Member States.

Second, a genuine EU-wide VAT tax base would remove the possibility of Member States tailoring VAT rates to changing economic circumstances and to redress the regressive nature of the tax (Open Europe, 2011). In history, the regressive nature has always been taken seriously and can even be seen as the reason the present EU VAT contribution is no more than a GNI based contribution.³ In the past, the European Parliament (1994) already wanted to impose different rates on different categories of goods to mitigate the regressive effect of the tax. For the same reason the European Commission, (2011b) also looked at the option of a modulated VAT which would allow for different EU rates to be applied to different categories of goods.

³ Recently, however, the Commission (2011b, p. 107) did find a slightly negative---but not statistically significant---relationship between the potential revenues from the hypothetical new VAT resource and the GNI per capita of the Member States.

Third, as far as the actual introduction of an EU VAT goes, since the Member States did recently increase the existing VAT rates, the room to increase it any further in the near future is small. So an EU VAT will not solve the problem that the EU heavily rests on GNI-based resources.

Fourth, as of any change in the own resource system there will be distributive consequences. Based on calculations made by Heinemann (2008), the introduction of an EU VAT would cause major distributive consequences. Cyprus, e.g., would have to pay almost 70% more than under GNI proportionality, which is in fact the present VAT contribution. Denmark, on the other hand, would have to pay almost 20% less. Again, the reason is the regressive character of VAT which burdens the poorer Southern and Eastern Member States relatively more due to a higher consumption ratio. In short, in the decision-process, the old *juste-retour* hurdle has to be taken again.

Fifth, the regressive character of VAT contributions is not tackled. As far as the regressive character goes the switch from the burden in terms of national GNI to per capita consumption is non-essential.

Six, the decision-making process for a Treaty change in the own resource system is one of the most difficult of the Union. The proposal of the European Commission, after having consulted the European Parliament, must be adopted unanimously by the Council and the national parliaments of the 27 Member States. At the moment, for the European Parliament a reform of the own resources towards genuine own resources is a not negotiable point for giving its consent to the MFF. This process is at present still undecided.

Seven, because of national differences regarding tax fraud and administrative efficiency the postulate of horizontal equity is violated. In the 1990s, the rate of VAT evasion and fraud ranged from 2.4 percent in the Netherlands to 34.5 percent in Italy (Heinemann, 2008).

Conclusion and the option of a declaratory EU VAT

Given and affirming the pros, what cons do stand out as overriding the pros? Three problems seem to stand out most significantly in view of the introduction of a reformed EU VAT: the regressivity of the VAT, tax fraud, and the decision-making process. If, indeed, the total national VAT stays the same, regressivity, cannot be a problem. The *status quo* stays the same: for the consumer nothing does change. Though probably the total VAT rate will increase and regressivity will be on the fore front. The problem of tax fraud will not be that easy to overcome. This notwithstanding the Union's policy to get a better overall VAT. The policy will probably mostly reduce cross-border VAT fraud. In the short run, the official process of decision-making looks to be the most compelling obstacle. Since national contributions do change, the *juste-retour* behavior of the Member States will be pervasive.

Is there a compelling reason for introducing a new EU VAT? This since the present GNI-based own resource has some strong points and receives support from the Member States. Besides that, *juste-retour* behavior is natural

and hard to fight.⁴ National payments of the GNI resource are easy to calculate, understood by the citizens, and are seen as a good indicator for the national capability to pay. In short, the system is seen as a simple and fair way of financing. Though some countries, because of tax fraud, do underestimate their GNI. In sum, the GNI contribution is not much different from what the European Parliament wants to achieve with an EU. Save no direct relation exists with the EU citizens and, the financial autonomy for the European Union would not be changed.

Probably, however, with the new EU VAT, just as before, the Member States will still make the net contributor, net beneficiary balances. Besides, the goal of getting autonomy is, or ought to be, no goal for the Union. Though, of course, financial autonomy is something every bureaucracy wants (Alves & Afonso, 2008). Therefore, it can never be a goal per se. It can only be a goal because of some other goal that otherwise cannot be attained. For the Union this is clearly the goal of securing expenses with an added value for Europe as a whole. Though for the same reason, on the opposite, an EU tax may lead to less budgetary discipline on the European level.

The problem of autonomy is closely related to the fact that Member States interpret an EU tax as a loss of their fiscal sovereignty. Hence, the European Parliament (2007) emphasizes, 'fiscal sovereignty will be maintained, but only temporary the receipts of certain taxes will go directly to the EU'. From an economic point, however, the eternal socialization of an asset's return is the same of the socialization of the asset itself (Sinn & Feist, 2000). *Mutatis mutandis*, this goes too for the temporary pooling of the revenue of taxation.

A declaratory EU VAT

Is there another way to introduce an EU VAT without the just-mentioned difficulties? An EU Vat can also be introduced as a so-called declaratory tax. In a declaratory tax, a country still pays its national, GNI-based contribution to the EU, but shows its contribution to its citizens as a percentage of, e.g., the VAT on every receipt (Caesar, 2001). The amount is *pro forma* linked to a certain tax; a country can choose its own 'EU' tax. Since the preferred method of taxation differs between Member States, this is an advantage. Harmonization of tax bases between countries is not necessary. Another advantage is that no additional collection costs have to be made. The quality of the national tax authorities does not matter either, as it would be of importance, because of tax fraud, with a true new EU VAT. Because, at present, not every country collects the tax revenues it should in view of the existing tax-rate. With the new EU tax there would be no horizontal equity between the citizens of the Member States. Greece, for example, collected, with consumption amounting to two thirds of the GNI, about the same amount of VAT as the Netherlands: about 8 percent of GNI. In the Netherlands, however, consumption is something less than halve of GNI (Gros, 2008).

⁴ See Leen, A.R. (2011), 'What an EU Tax Means', *EC Tax Review*, 20 (4): 203-205.

Some disadvantages do exist. Because the VAT rates will differ in the Member States, no horizontal equity exists among the citizens in the Member States. But the main argument against it is that the public, in a sense, is misled. The Union still receives direct contributions from the Member States; the autonomy of the EU seems larger than it is.

In sum, the VAT as a declaratory EU tax combines the strong points of the GNI contribution with the visibility of a EU VAT.

Literature

- Alves, R. H. & O. Afonso (2008). *Reforming the EU Budget: How to Increase Financial Autonomy?* UACES Conference Papers, Edinburgh, UK.
- Caesar, R. (2001). 'An EU Tax?-Not a Good Idea,' *Intereconomics* 36(5): 231-233.
- European Commission (1998). *Financing the European Union. Report on the Operation of the Own Resources System*, COM (1998) 560 final.
- European Commission (2008). *European Union Public Finance*, Brussels.
- European Commission (2010). *Green Paper, On the future of VAT. Towards a simpler, more robust and efficient VAT system*, COM(2010) 695 final.
- European Commission (2011a). *Proposal for a Council Decision on the system of own resources of the European Union*, Com (2011)510 final.
- European Commission (2011b). *Commission Staff Working Paper, Financing the EU budget: Report on the operation of the own resources system*, SEC (2011)876 final.
- European Commission (2011c), *A Budget for Europe 2020*, Brussels, 29.6.2011, COM(2011) 500 final.
- European Communities (1970). *Council Decision of April 21, 1970 on the replacement of financial contributions from member states by the communities' own resources*, *Official Journal* L994, 28 April.
- European Council (1987). *Conclusions*, Brussels, June 1987.
- European Council (2007). *Council decision of 7 June 2007 on the system of the European Communities' own resources*.
- European Council (2012). *Multiannual Financial Framework (2014-2020)-Negotiating box*, Brussels, 29 October 2012, 15599/12.
- European Council (2013). *Conclusions (Multiannual Financial Framework)*, 8 February 2013, EUCO 37/13.
- European Parliament (1997). *Die Eigenmittel der Europäischen Union: Analysen und Entwicklungsmöglichkeiten*, Luxemburg.
- European Parliament (2007). *On the future of the European Union's own resources (2006/2205 (INI))*.
- Gros, D (2008). *How to Achieve a Better Budget for the European Union*, Paper prepared for the Conference on Public Finances in the EU, European Commission, Brussels.
- Heinemann, F., P. Mohl & S. Osterloh (2008). *Reform Options for the EU Own Resources System*, Heidelberg: Physica-Verlag.

Laffan, B. (1997). *The Finances of the European Union*, London: Macmillan Press.

Open Europe (2011). *Ten ways to introduce an EU tax*, August 2011, London.

Sinn H-W & H. Feist (2000). Seignorage wealth in the eurosystem: eurowinners and eurolosers revised. *CESifo Working Paper Series*, no. 353.

Worstell, T. (2011) "Who Pays Financial-Transaction Taxes? Just about everyone, except banks." *The Wall Street Journal*, June 22.