

# Europe's failing VAT system

## Biography

**Ben Terra is a professor of law at the Universities of Amsterdam in the Netherlands and Lund in Sweden. Until 2003, he was Head of Ernst & Young's global indirect tax practice. In 2007, he became doctor economiae honoris causa at the University of Lund.**

The EU VAT system is in a mess. It is a dizzying mix of rates with a huge number of exemptions and special cases across its 27 countries. The VAT gap is now a stunning €100b, which is steadily rising due to fraud resulting from the fact that there is no taxation on EU cross-border purchases by businesses. At the same time, companies, which effectively act as unpaid tax collectors, are facing a growing compliance burden. While governments agree they should reduce such costs and obligations, many are adding more compliance obligations and implementing disproportional sanctions, as they increasingly rely on VAT to help plug their fiscal gaps.

It is a bad combination: endemic fraud, an increased compliance burden, disproportional sanctions, and an increasing reliance on VAT as a source of revenue. In turn, this has serious economic and financial consequences, with a large, but unpredictable, impact on competition.

Europe's current VAT system was meant to be a transitional one, but there are no signs of any alternative emerging. Indeed, most European governments are dragging their feet and don't seem to want to do anything to get to the root of the problem. The popular solution right now essentially involves putting a sticking plaster onto the problem, by simply seeking to increase VAT rates, rather than fixing the underlying system.

There is no doubt that tax harmonization is an important goal. We need to have a VAT that suits an internal market, with a single rate across the community. This should ideally do away with multiple rates across Member States. But such a move seems unfeasible, not least due to legislation needing to be accepted unanimously by all 27 members. It also seems to be the case that the EU is not willing to take the final consequences of what a true internal market implies, which is one that makes no distinction between domestic sales and sales to the rest of the internal market. Until that recognition is made, we will only ever get stopgap solutions.

The European Commission has had all kinds of ideas to deal with these VAT problems, but these focus more on politically realistic solutions rather than on ones that would repair the situation. The results are not only costly, but also simply not what business needs. As one example, the Commission is looking at "a one-stop shop" system for VAT, allowing

companies to account for VAT due in all Member States via a central website, a portal, in their home country. This sounds very practical, but in reality will be hugely difficult, given that a business operating in all 27 Member States will still need to know the different rules for each state – from different invoice rules and rates, through to different exemptions and varying sanctions. It does nothing to resolve the underlying issues within the system.

A lot could be learnt from outside the EU. Take New Zealand, which has a simple and effective VAT system, with virtually no VAT gap as a result. It has one rate, few exemptions, and compliance is very simple. There are other good VAT systems in Australia, Canada and South Africa, too.

So we can see what a top-class VAT system should look like. Moreover, a perfect solution to today's fragmented system has long been proposed. This would allow charging domestic VAT to all economic operators in the EU and provide for centralized multilateral clearing between Member States. The system is very straightforward, especially when it is understood that 60% of the trade in Europe is conducted between related parties and there is therefore no reason to charge VAT on cross-border transactions between pan-European groups.

But this idea has been ignored. Underlying all this is a fundamental unwillingness of national governments within the EU to agree to a proper solution. There is a lot of distrust right now, with little sign of any real solutions emerging. The OECD understands that the system needs to be overhauled and they have, for example, agreed on guidelines of neutrality in VAT and GST. But it is not able to force through any direct change by itself.

All this is a pessimistic message. I'm a genuinely optimistic person, but it is hard to see light in the tunnel with regards to Europe and VAT right now. Notwithstanding the gravity of the situation, few politicians appear to have the will to deal with this problem. What will be needed is a change of attitudes within Member States and for leaders to find a new resolve to deal with VAT problems. Let's just hope it doesn't come too late.

**Ben Terra,  
Professor of law at Amsterdam and  
Lund Universities**