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The EU VAT System and the Internal Market

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Table 3.1: VAT rates applied in the Member States

	Zero rate	Super reduced rate	Reduced rate	Standard rate	Parking rate
Austria[474]	–	–	10	20	12
Belgium	Yes	–	6	21	12
Bulgaria	–	–			–
Cyprus[475]	Yes	–	5	15	–
Czech Republic	Yes	–	5	19	–
Denmark[476]	Yes	–	–	25	–
Estonia	Yes	–	5	18	–
Finland[477]	Yes	–	8/17	22	–
France[478]	–	2,1	5,5	19,6	–
Germany[479]	–	–	7	19	–
Greece[480]	–	4,5	9	19	–
Hungary	–	–	5/15	25	–
Ireland	Yes	4,4	13,5	21	13,5
Italy[481]	Yes	4	10	20	–
Latvia	Yes	–	5	18	–
Lithuania	–	–	5/9	18	–

474. A special rate of 16% applies in Jungholz and Mittelberg.
475. Transactions originating in or intended for the United Kingdom Sovereign Base Areas of Akrotiri and Dhekelia are treated as transactions, originating in or intended for the Republic of Cyprus. The application of the acquis is suspended in those areas of the Republic of Cyprus in which the Government of the Republic of Cyprus does not exercise effective control.
476. The Faroe Islands and Greenland are not part of the European Union; consequently, under the CVSD, VAT is not applicable in these territories.
477. The Aaland Island is not part of the European Union.
478. Special rates apply in Corsica and the overseas departments (DOM). In Corsica, the following apply: 0.90% for certain theatrical shows and circuses, sales of live meat, and charcuterie animals to persons not liable to pay tax; 2.10% for goods supplied in Corsica to which the reduced rates are applicable in mainland France; 8% for certain work on immovable property, agricultural equipment, and sales for consumption on the premises, sales of electricity supplied at low voltage; and 13% for petroleum products. The standard rate applicable in Corsica is the same as in the rest of the country, i.e., 19.6%. In the overseas departments, but not French Guiana, a reduced rate of 2.10% and a standard rate of 8.5% are applicable; and goods and services supplied to or from the Principality of Monaco are regarded as having been supplied to or from France.
479. For VAT purposes, the country does not include the island of Heligoland or the territory of Busingen.
480. For the departments of Lesbos, Chios, Samos, the Dodecanese and the Cyclades, and on the Aegean islands of Thassos, the Northern Sporades, Samothrace, and Skiros, the rates of 4%, 8% and 18% have been reduced to 3%, 6% and 13% respectively. These rates apply to imports, intra–Community acquisitions, supplies of goods and services affected in these islands and supplies of goods from other areas of Greece to persons established on these islands. This preferential system does not, however, apply to tobacco products and means of transport. Mount Athos is excluded from the scope of VAT.
481. The following territories are excluded from the scope of VAT: Livigno, Campione d'Italia and the territorial waters of Lake Lugano.

	Zero rate	Super reduced rate	Reduced rate	Standard rate	Parking rate
Luxembourg	–	3	6	15	12
Malta	Yes	–	5	18	–
Netherlands	–	–	6	19	–
Poland		3	7	22	
Portugal[482]	–	–	5/12	20	–
Romania	–	–	9	19	–
Slovak Republic	Yes	–	–	19	–
Slovenia	–	–	8.5	20	–
Spain[483]	–	4	7	16	–
Sweden	Yes	–	6/12	25	–
United Kingdom[484]	Yes	–	5	17,5	–

As regards the "old" Member States, six (Greece, Spain, France, Ireland, Italy, and Luxembourg) continue to apply a reduced rate lower than the minimum laid down in Article 12(3) Sixth Directive (a "super reduced rate"); three (Belgium, Ireland, and Luxembourg) still apply a reduced rate not lower than 12% (the "parking rate"); five Member States (Belgium, Denmark, Finland, Italy, and Sweden) apply a zero rate on a marginal and restricted basis; while Ireland and the United Kingdom continue to make extensive use of this derogation.[485] The situation is not significantly different within the new Member States: six (Cyprus, Czech Republic, Estonia, Latvia, Malta, and Slovakia) apply a zero VAT rate and all most have been granted authorisation to introduce/maintain the application of rates which derogate from Articles 98 and 99 of the CVSD.[486]

The complexity of the system is increased by the lack of clarity of the rules set out in Articles 96 to 130, and Annexes III and IV to the CVSD. The apparent simplicity of the rates structure rules described *supra* conceals a system susceptible to different interpretations and applications, namely in respect of the list of goods/services which may be subject to reduced rates. As the Commission recognises:

> "While superficially there may seem to be a good deal of similarity between the practices of Member States in terms of category selection, coverage of any

482. Special rates apply in Madeira and Azores: reduced rate of 4%; parking rate of 8%; and standard rate of 15%.
483. For VAT purposes, the country does not include the Canary Islands, Ceuta, and Melilla.
484. Goods and services supplied to or from the Isle of Man are regarded as having been supplied to or from the United Kingdom.
485. The data is reported on the Commission's report on reduced VAT rates, COM(2001) 599 final, 22 October 2001, n. 463 above. An analysis of the rates in force on 1 January 2008 shows that the situation has not improved and, if anything, it has worsened.
486. Articles 123 to 130 of the CVSD.

> individual category may in fact differ from Member State to Member State depending on how Member States choose to define goods or services within any given category in their own national legislation."[487]

According to the Commission, complaints regarding uneven transposition of Annex III categories are frequent.[488] Additionally, the lack of clear definitions of the categories of goods and services, which may be subject to reduced rates, leads Member States to introduce extremely subtle distinctions. The following cases are examples of the subtleties of determining which rate applies to a specific product: in *Belgium*, replacement of a front bicycle wheel is subject to a standard rate whereas replacement of the back wheel is subject to reduced rate because the labour component is greater [CVSD basis, Annex IV(1)]; in *France*, the reduced rate applying to food products only applies to chocolate under certain very complex conditions: products containing chocolate are subject to the standard or reduced rate according to their form, presentation, or actual composition [CVSD basis, Annex III(1)]; in *Ireland*, cold pizza is zero rated, whilst warm pizza is subject to 13.5% if sold as take-away [CVSD basis, Annex III(1)]; in *Portugal*, fresh fish is subject to 5% rate; if it is cooked prior to being frozen is subject to 19%; and if it forms part of a ready meal to be taken away or consumed on the spot, it is subject to 12% [CVSD basis, Annex III(1) and Article 116]; and in the *United Kingdom*, raw and unprocessed nuts are zero-rated; so are roasted and salted nuts still in their shells; a fruit and nut mix can be zero-rated if the weight of the roasted nuts is less than a quarter of the whole; however, if nuts are shelled and roasted or salted, or if they have been coated with chocolate or yoghurt, the standard rate applies [CVSD basis, Annex III(1)].[489]

Symptomatic of these interpretative/application difficulties caused by the rates' rules, and in particular the rules regarding reduced rates, are the several cases brought by the Commission before the Court of Justice, all of them relating to the application of reduced rates (including zero rate) by Member States to supplies of goods or services. In all but one case, the Court found the Member State to be in violation of what are now Articles 98 and 99 of the CVSD. The Court's judgments show, *prima facie*, that the rules regarding VAT rates not only leave considerable freedom to Member

487. In COM(94) 584 final, 13 December 1994, n. 288 above, at 14.
488. *Report from the Commission to the Council and to the European Parliament in accordance with Article 12(4) of the Sixth Council Directive of 17 May 1977 on the harmonisation of the laws of the Member States relating to turnover taxes – Common system of value added tax: uniform basis of assessment*, COM(97) 559 final, 13 November 1997, at 5.
489. *See* M. Dibben, "Is the shop nuts to charge me VAT?", *The Observer*, 2 October 2005, at 12.

States to establish their own rates structure, but also are sufficiently, and perhaps suitably, unclear as to allow Member States significant liberty to choose which supplies are subject to reduced rates through the adoption of convenient interpretations of Articles 96 et seq. and of the categories listed in Annex III. National courts too have been struggling with similar interpretative/application difficulties, and in this regard, some recent rulings by courts in the United Kingdom discussed below are telling.[490]

2.1.2.2. *Critical evaluation of the lack of rates convergence*

The impact of the lack of rates convergence on intra-community trade should be evaluated from two different perspectives, namely from that of private consumption, and from that of businesses. The Commission's 1987 VAT proposals, and the 1991/1992 VAT legislation which followed, placed significant emphasis on the impact of the abolition of fiscal frontiers on private consumption and cross-border shopping.[491] Rates convergence was seen as fundamental if cross-border shopping was to be avoided after 1993. Fifteen years later, it has become evident that the overall impact of the lack of rates convergence on cross-border shopping is relatively limited. Instead, it is the impact that this lack of convergence has had, and continues to have, on businesses that constitutes a serious obstacle to the establishment of the internal market.

From 1993 onwards, the Commission undertook the role of monitoring the impact of the lack of convergence of VAT rates on consumption patterns. It has done so, not solely based on its own internal research, but through the commissioning of outside experts. In 1994, the Commission contracted an outside consultant, PriceWaterhouse, to assess "the effect of the abolition of fiscal frontiers [and implicitly the lack of convergence of VAT rates] on cross-border purchasing patterns". The results of this study were presented in the Commission's 1994 report on VAT rates.[492] Insofar as VAT was concerned, the overall conclusion of the PriceWaterhouse study was that, generally speaking, there were no major changes in the patterns of cross-border purchasing behaviour due to differences in VAT rates alone.[493] The

490. *See* Chapter 4 below.
491. This view was shared by some authors namely C. Lee, M. Pearson, and S. Smith, see n. 242 above, at 23.
492. *See* COM(94) 584 final, 13 December 1994, n. 261 above.
493. *VAT and Excise Duties: Changes in cross-border purchasing patterns following the abolition of fiscal frontiers on 1 January 1993*, Final report prepared for the Commission, Directorate General of Customs and Indirect Taxation (DGXXI/C-3), August 1994.

study pointed out that cross-border shopping was of heightened importance at some frontiers, namely Germany/France (for domestic durable goods), Germany/Denmark (for domestic durable goods), and Luxembourg/ Belgium (for jewellery and watches). However, the study concluded, this cross-border shopping had not increased dramatically since January 1993.

Despite the results of the PriceWaterhouse study, some specific cases were brought to the Commission's attention in the years that followed:[494] German farmers, subject to flat-rate VAT schemes, were purchasing fertilisers and pesticides, which in Germany were subject to the standard rate, in neighbouring Member States where those products were taxed at reduced rates; French customers tended to buy their domestic fuel such as coal in Belgium, where the applicable rate was significantly lower; and other cases involved sales of beverages like soft drinks and mineral water from France to Belgium or from France to Britain. Although the Commission accepted that these were minor cases, it considered that the sum of such cases might, however, be relevant as there was always the possibility of significant regional impact. In this context, in 1996, the Commission subsidised another study by an outside consultant on the impact of tax factors on behaviour patterns.[495] The study focussed on border regions, which had been identified as "sensitive", and it was carried out by means of an exhaustive written survey and expert interviews. This study confirmed the results of the PriceWaterhouse study, i.e., that VAT rates had no significant impact on consumer patterns.[496]

Based on these two studies, the Commission concluded that "a sufficient degree of VAT rate approximation had taken place in January 1993",[497] and that "both the assessment of general trends regarding cross-border transactions and the particular results of the study provide insufficient evidence to justify major changes of the current VAT rate system."[498] The overall assessment of the adequacy of the VAT rate structure was that:

494. *See* COM(97) 559 final, 13 November 1997, n. 488 above, at 5.
495. The study entitled *Retail strategies to benefit from indirect tax differences* was carried out by Jurgen Ratzinger, ifo Institute for Economic Research in March 1996.
496. However, the study did confirm that where conditions for cross-border shopping were favourable, VAT-induced deflections of trade did take place. In this context, the study corroborate numerous complains of Austrian operators about VAT induced deflections of trade towards Germany (e.g., for electric appliances).
497. In COM(94) 584 final, 13 December 1994, n. 261 above, at 9.
498. In COM(97) 559 final, 13 November 1997, n. 488 above, at 7. Even though, it added that "it is probable that these trends will be considerably boosted by the advent of the Single Currency and by the increasing use of electronic commerce. It is therefore, likely that the restrictive effects of the current VAT rate structure will become more aggravating in the future", at. 8.

> "The present VAT rates structure is not, Community-wide, an obstacle which prevents the transitional VAT arrangements from functioning. In general the VAT rate differentials do not hamper cross-frontier purchases but there is evidence that they sometimes impact on consumer decisions in a distortive manner. Retailers increasingly tend to benefit from the existing purchasing potential beyond borders. Apart from specific regions and/or specific goods there have been no really significant broad Community-wide distortions of competition or deflection of trade brought about as a result of excessive disparities in VAT rates between Member States."[499]

The Commission's conclusions were based firstly on the situation in the late 1990s, prior to the explosion of the e-commerce, and secondly, on the assumption that the adequacy of the current level of VAT rates convergence should be evaluated solely on the basis of its impact on cross-border shopping and the distortions to competition which could arise thereof. It was an erroneous assumption, which led to erroneous conclusions.

As discussed in Chapter 2, the Commission's view on the interconnection between VAT rates convergence and cross-border shopping dates back to the introduction of the internal market policy: during the years which followed the presentation of the White Paper, the Commission argued that VAT rates convergence was fundamental if cross-border shopping was to be avoided whenever fiscal frontiers where abolished. The Commission was justified in assuming that there was a serious risk of VAT-induced deflections of trade once frontiers were open. However, several factors, not related with taxation, contributed to stop this deflection from happening on a significant scale, at least initially.[500] Probably, one of the most important of those factors is the almost insignificant impact that reduced rates (or zero rates) have on prices. Price comparisons within the EU have shown that a product which is subject to a reduced VAT rate in a Member State is not necessarily less expensive in that Member State than in any other Member State which applies a standard VAT rate to the relevant product.[501] However, recent data presented by the Copenhagen Economics, in their 2007 study, points towards somewhat different conclusions.

Whilst acknowledging that very little is known about the extent of cross-border shopping, the study goes on to point out that "the few existing studies indicate

499. Id at 29.
500. Both studies list several factors, categorised as follows: price-related factors, like transportation costs; non-price-related factors, like product range and quality; and obstacles, like language and distance.
501. *Comparison of prices and VAT rates for certain sectors – 1999*, source: Eurostat – EU level=100, 1999 data, in COM(2003) 397 final, 23 July 2003, n. 466 above, at Annex 2.

a significant potential for cross-border shopping (of goods)",[502] with the main characteristics of goods particularly suited for cross-border shopping being high price per unit weight/volume, low perishability (during transport), and limited cultural specificity. The example given is a recent study by the Danish tax authorities where the cross-border shopping at the Danish-German border was estimated to about two per cent of total consumption in Denmark, driven by a difference in VAT rates of 9% between the German standard VAT rate of 16%,[503] and the Danish standard 25% VAT rate. Distance sales of goods and services are, in principle, of limited concern because they as a main rule are subject to the VAT rate in the country of destination. However, the study notes distance sales of electronically delivered products (books, games, film, and music) as an exception which is likely to become much more important in the future as digital goods are currently experiencing very significant growth rates.

Notwithstanding the above, adequacy of the current level of VAT rates convergence should be evaluated not only on the basis of its implications from the perspective of private consumers, but equally from the perspective of businesses. In this regard, it would appear that businesses operating in Member States which apply reduced rates have a competitive advantage over businesses working in the same trade in other Member States which apply standard rates. This clearly distorts competition. Moreover, this is just one of the ways in which the lack of VAT rates convergence has a negative impact on intra-community trade. From the businesses' perspective, it not only distorts competition within the Community, but is also a true obstacle to the free movement of goods and services, and thus, to the internal market.

Traders' reports and complaints to EU institutions in relation to the VAT rates structure are common. As the Commission recognised, it regularly receives reports and complaints about specific cases where VAT rates discrepancies are said to be the reason for significant distortions between operators. Many of these complaints relate to distortions of competition within a Member State, stemming from the uneven application of Annex III categories, and thus, do not fall within the Commission's responsibility.[504] Others, however, relate to the impact of the VAT rates structure on

502. *See* Copenhagen Economics, *Study on reduced VAT applied to goods and services in the Member States of the European Union*, Taxation Papers, Working Paper No. 13, 2008, at 19.
503. As applied before 1 January 2007.
504. The Commission considers, however, that even though these complaints do not fall within the Commission's responsibility, they are certainly reason for concern. In fact, under the principle of neutrality, identical foods and services cannot be taxed at different rates, as confirmed by the Court of Justice in case C-481/98, *Commission v France*, [2001] ECR I-3369, see Chapter 4 below.

intra-community trade.[505] In its 2001 report on reduced rates, the Commission listed the traders' main complaints:[506] the optional nature of applying reduced rates; the huge variations between reduced rates and super reduced rates; the lack of Community definitions for categories of goods and services in Annex III, and its restrictive nature; the uneven way in which the reduced rates are applied, as the option exercised by one Member State does not oblige it to apply this reduced rate to all goods and services of the category or categories chosen; the conflict between the principle of a single rate of VAT and the possibility of applying reduced rates; and the complexity resulting from the permanent or transitional nature of the derogations. It has also been reported that BusinessEurope, the Confederation of European Business representing 40 national business federations in 34 countries, has recently emphasised the need to urgently agree on a new legal framework for reduced VAT rates that would lead to rationalisation and simplification of the present system and to give companies legal certainty.[507] In light of these complaints, the Commission has accepted that "in many cases only an experienced tax expert can determine with any certainty what rate is to be applied by comparing legislation and the exact characteristics of the products in question",[508] and therefore, the current rates structure has, at least partially, failed.

> "An analysis of the current structure of VAT rates, and in particular, the scope of the reduced rates, has revealed two factors which may hamper the proper functioning of the internal market and create distortion of competition:
> – the optional nature of applying reduced rates for Member States; and
> – the lack of common definitions for the categories in [Annex III]."[509]

The traders' complaints regarding the current VAT rates structure confirm this analysis and seem to support (even if on a different basis) the Commission's earlier (1987) view: that a higher level of convergence would be required in order to establish the internal market. This is confirmed by the Copenhagen Economics 2007 Study:

> "There is a strong argument for having uniform VAT rates in the European Union. Uniform rates is a superior instrument to maintain a high degree of economic efficiency, to minimise otherwise substantial compliance costs and to smooth the functioning of the internal market."[510]

505. *See* COM(97) 559 final, 13 November 1997, n. 466 above, at 8–9.
506. *See* COM(2001) 599 final, 22 October 2001, n. 463 above, at paragraph 23.
507. *See* H. Kogels, "Proposed New EU Rules on Reduced VAT Rates" (2008) *EC Tax Review* 17(5), 194–196, at 195.
508. *See* COM(2003) 397 final, 23 July 2003, n. 466 above, at paragraph 42.
509. Id. at paragraph 30.
510. *See* n. 465 above, at 6.

In fact, the current VAT rates structure, and more specifically, the lack of convergence of VAT rates, cause significant economic distortions from the perspective of businesses, as follows:

- *Increased compliance costs*: the difficulty establishing the VAT rate applicable to a determined supply in another Member State, amplifies companies' compliance costs, thus decreasing economic efficiency. Engaging in the most basic business transaction in another Member State entails extensive study of the rates applicable in that State, and in many situations, as discussed above, the resort to external tax expert advice, creating a significant additional financial burden.

- *Infringement of the principle of VAT's neutrality and distorted competition*: the wide disparity of VAT rates across the EU can potentially cause significant distortions of competition by infringing the principle of VAT's neutrality vis-à-vis the conditions of competition.[511] As mentioned above, there are strong indications that lower and reduced rates can be a factor in corporate profitability; companies trading in a Member State applying a lower standard rate, a reduced or zero rate of VAT may be able to take higher profit margins, giving them an advantage over competitors in other Member States. This is confirmed by Copenhagen Economics 2007 Study, which concludes that "conflicts between the desirability of fiscal neutrality between like products and protecting a well functioning internal market to be an issue of probably rising importance".[512]

  Distortions of competition can also arise from a form of VAT avoidance labelled by the Parliament's Directorate General for Research, as the "place of establishment option".[513] Where transactions are taxed on the place of establishment of the business [e.g., general rule for supply of services – Article 9(1) Sixth Directive], differences in VAT rates (can) act as the decisive factor for businesses' location decisions: where companies have places of establishment in several Member States, invoices would as far as possible be issued from those in lower-taxed Member States. Additionally, some companies, namely within the services industry, take the "place of establishment option" further, and on a VAT planning motivated shift, locate themselves in Member States which apply

511. As discussed in Chapter 4, the principle of VAT's neutrality has various corollaries.
512. *See* n. 502 above, at 85.
513. *See* n. 302 above, at 84.

lower rates of VAT.[514] E.g., under the E-Commerce Directive,[515] non-EU companies supplying services by electronic means to non-taxable persons within the EU, can avail of a special scheme which entails registration for VAT purposes in one of the Member States; this means there was a widespread concern that most companies would probably choose Luxembourg to locate and register for VAT purposes, as it is currently the country with the lowest level of VAT rates.[516]

– *Creates obstacle to intra-community trade*: the difficulty determining the VAT rates applicable in other Member States, because of the high compliance costs it entails, can constitute a deterrent for traders, namely for small and medium size businesses, to engage in intra-community trade. Again, this conclusion is confirmed by the Copenhagen Economics 2007 Study:

> "Without doubt, a bewildering set of different VAT rates across EU for the same products will create some barriers to the internal market as non domestic

514. The first described "place of establishment option" situation seems to be a case of VAT avoidance, while the second, a case of VAT planning. The differences between the two situations might seem insignificant, as both cases contain the same motivations (to minimise VAT payments) and similar results. However, the means used in order to achieve those objectives are substantially different: in the first situation there is a "fictitious" location of the supply; in the second situation the location of the supply corresponds to reality, even if motivated by VAT considerations. For a comprehensive analysis of the delimitations between avoidance and planning, see Chapter 4 below.

515. Council Directive 2002/38/EC of 7 May 2002, OJ L128, 15/05/2002, 41.

516. It has been confirmed by former Commissioner Bolkestein that Luxembourg has been the most popular "one stop shop", even though he considers that in itself the Directive has no bearing on the choice by a business of which Member State to establish itself on. Rather, are the rules of Article 43 et seq. of the CVSD, according to the former commissioner, which encourage providers of B2C services capable of remote delivery to locate themselves where VAT rates are the lowest – see *Follow-up on the workings of Council Directive 2002/38/EC on the application of VAT to digital services, Written Question E-1984/04 by Charles Tannock (PPE-DE) and Theresa Villers (PPE-DE) to the Commission*, 2 September 2004. This position was confirmed by the amended proposal on place of supply of services, which stated as its main objective "to ensure taxation of services at the place of consumption and to avoid relocation of companies", see *Amended Proposal for Council Directive amending Directive 77/388/EEC as regards the place of supply of services*, COM(2005) 334 final, 20 July 2005, at 5. The current one-stop-shop proposal is in practice an extension of the current special scheme applicable to E-commerce operators, and thus, the question is whether, if approved, could potentially give rise to these type of difficulties, see COM(2004) 728 final, 29 October 2004, n. 95 above. It has been suggested, however, that the problem will not be a choice based on rates (as the VAT rates of the country of destination will apply) but rather a choice based on the efficiency levels of the tax administrations of the several Member States. It has emerged that tax authorities which regard themselves as efficient are concerned that traders will located themselves in less efficient countries, and thus the level of Revenues will go down, i.e., tax administrations do not trust each other to collect their own taxes.

> sellers will have to spend more time finding how about the proper VAT rate in other countries and therefore be at the margin more hesitant about marketing products in other countries. As for compliance costs, it is likely that such barriers are most important when the VAT variation is at the first level of aggregation, i.e., when you have to study very carefully what VAT to apply when you sell your goods and services to other countries."[517]

By increasing the compliance costs, the lack of convergence of VAT rates stops companies from fulfilling their potential in terms of competitiveness. Thus, it has a preventative impact, stopping the EU market from achieving the objectives set out in the Lisbon Strategy: "to become the most competitive and dynamic knowledge-based economy in the world".[518] By infringing the principle of neutrality of VAT, the lack of convergence of VAT rates negates one of the basic principles of the EU VAT system, as set out in the CVSD. By distorting competition within the Community, the lack of convergence of VAT rates negates one of the main EU economic principles, as set out in Article 3 of the EC Treaty, namely undistorted competition, and the concept of internal market. Finally, by creating an obstacle to intra-community trade, the lack of VAT rates convergence constitutes an obstacle to the free movement of goods and services.

2.2. EU VAT system as an obstacle to the functioning of the internal market

2.2.1. EU VAT system as a direct obstacle to the functioning of the internal market: Non-deductible input tax

The taxable persons' right to deduct input VAT incurred on their business expenses is one of the fundamental characteristics of the VAT system introduced by the First Directive. Its essence is expressed in what is now Article 1(2) of the CVSD, which reads:

> "On each transaction, VAT, calculated on the price of the goods or services at the rate applicable to such goods or services, shall be chargeable after deduction of the amount of VAT borne directly by the various cost components."

Three principles emerge from this provision, which form the foundation of the Community's VAT system of deduction. The principle of integral deduction, according to which full deduction of the tax paid is allowed, provided

517. *See* n. 502 above, at 99.
518. *Lisbon European Council, 23 and 24 March 2000 – Presidency Conclusions*, at paragraph 5. For a more detailed analysis of the challenge presented by the Lisbon Strategy, see below.

the goods and services bought are used for the purposes of taxable activities.[519] The principle of global deduction, under which deduction will apply in respect of all activities, rather than it being applicable to specific activities only. Finally, the principle of immediate deduction, which contrasts with, for example, a system whereby deduction is allowed only when purchased goods or services are actually used.[520] The current EU VAT system, as set out in Articles 167 et seq. of the CVSD and in the Eighth and Thirteenth Directives' provisions, is largely based on the application of these principles, despite providing for several exceptions.[521] Amongst those exceptions are some of the rules which limit the right to deduct input tax, which can constitute either general limitations, or specific limitations to the right to deduct.[522]

2.2.1.1. *General restrictions to the right to deduct*

Article 168 of the CVSD provides that VAT paid on input transactions can be deducted "insofar as the goods and services [acquired] are used for the purposes of the taxed transactions of a taxable person".[523] Implicit to this provision are two general limitations to the right to deduct, namely the non-deductibility of input tax incurred in relation to goods and services used for the purposes of exempt activities,[524] and the non-deductibility of input tax incurred in relation to goods and services used for non-business purposes.

519. This principle precludes Member States from applying systems of partial deduction, as confirmed by the Court of Justice in case 50/87, *Commission v France*, [1988] ECR 4797.

520. Connected with this principle is the issue of deductibility of the so-called "preparatory activities". In this matter, the Court of Justice has consistently reiterated that a taxable person is entitled to deduct the VAT payable by him on goods or services supplied to him for the purposes of being used in connection with taxable transactions, even where for reasons beyond his control they were not used for that purpose, or those taxable transactions did not take place, see cases C-37/95, *Ghent Coal Terminal*, [1998] ECR I-1; C-110/98, *Galbafrisa and Others*, [2000] ECR I-1577; and C-400/98, *Breitsohl*, [2000] ECR I-4321.

521. The first two principles relate to the scope of the right to deduct and are reflected mostly in Articles 168 et seq. of the CVSD. The third relates to its origin and is reflected in Article 167 of the same directive. The Court has ruled that both paragraphs 1 and 2 of Article 17 of the Sixth Directive, now Articles 167 and 168 of the CVSD, have direct effect, see case C-150/99, *Stockholm Lindopark*, [2001] ECR I-493.

522. For a review of these rules, see also C. Celorico Palma, "IVA – Algumas notas sobre os limites das exclusões do direito à dedução" in C. Celorico Palma (ed.), *Estudos de Imposto sobre o Valor Acrescentado* (Coimbra: Almedina, 2006), 139–162

523. Article 170 of the CVSD extends further the scope of the right to deduct to include situations where the input VAT has been incurred by a taxable person established outside the territory of the country, referring the regulation of the matter to the Eighth and Thirteenth Directives.

524. Article 11(2) of the Second Directive referred specifically to the non-deductible nature of expenditure incurred for the purposes of exempt activities or activities not subject to VAT.

The non-deductibility of input tax in relation to exempt activities, which has been interpreted as entailing the establishment of a link between the goods and services, on which VAT has been charged to the taxable person (input transaction), and the goods and services supplied by the taxable person (output transaction),[525] undoubtedly constitutes a limitation to the right to deduct. However, it does not represent an exception to the principle of integral deduction but rather stems from it. The essence of the right to deduct, and more particularly the principle of integral deduction, is the correlation between input tax and output tax. Therefore, where there is no output tax, this correlation can no longer be established and the *ratio* behind the right to deduct ceases to apply.[526] The non-deductibility of input tax in relation to non-business expenditure should equally be regarded as a limitation to the right to deduct which cannot be qualified as an exception to the principle of integral deduction. In fact, this limitation stems primarily from the very nature of EU VAT as a tax on consumption: where taxable persons incur expenditure which is not business related they are acting as consumers rather than as traders, and as such should bear the VAT costs. This limitation is also coherent with the right to deduct *ratio,* as in these circumstances not only is there no output tax (as in the case of exempt activities) but moreover, there is actually no correlation with an output transaction. Finally, this limitation is fundamental in an area which is particularly vulnerable to tax fraud.

These restrictions constitute general restrictions to the right to deduct, which are coherent with the principles of EU VAT and which are essen-

525. In most cases, the establishment of this link will be a straightforward operation; however, this is not always the case, namely in cases involving apportionment of tax, i.e., where the taxable person engages both in activities in respect of which tax is deductible and activities in respect of which tax is not deductible (Article 173 of the CVSD). In *Midland Bank*, case C-98/98, [2000] ECR I-4177, the Court of Justice ruled that "[Articles 168 and 173 of the CVSD] must be interpreted as meaning that the existence of a direct and immediate link between a particular input transaction and a particular output transaction or transactions giving rise to entitlement to deduct is necessary before the taxable person is entitled to deduct input VAT and in order to determine the extent of such entitlement." Previously in *BLP*, the Court had already indicated its willingness to extend the application of the concept of "direct and immediate link" to the interpretation of the right to deduct rules, see case C-4/94, *BLP Group*, [1995] ECR I-983. The concept is a jurisprudential construction originally introduced in relation to what is now Article 2 of the CVSD as a test to determine the existence of a link between supply and consideration, see cases 154/80, *Dutch Potato*, [1981] ECR 445; 102/86, *APDC*, [1988] ECR 1443; C-16/93, *Tolsma*, [1994] ECR I-743; C-258/95, *Julius Fillibeck Sohne*, [1997] ECR I-5577; and C-172/96, *First National Bank Chicago*, [1998] ECR I-4387.

526. There are several exceptions to this rule. Article 169 of the CVSD, for example, extends the scope of the right to deduct to input tax incurred for the purpose of some exempt activities, including exports or are transactions which are part of the international trade.

tial to the efficient functioning of the tax. However, the EU VAT system and mostly Member States' domestic VAT systems, include several other restrictions, which should at best be regarded as exceptions to the principle of integral deduction, and at worst as contraventions of both this principle, and the principle which it ensures, the principle of fiscal neutrality.

2.2.1.2. *Specific restrictions to the right to deduct*

Many of existing restrictions on the right to deduct input VAT are based on Article 176 of the CVSD, which currently reads:[527]

> "The Council, acting unanimously on a proposal from the Commission, shall determine the expenditure in respect of which VAT shall not be deductible. VAT shall in no circumstances be deductible in respect of expenditure which is not strictly business expenditure, such as that on luxuries, amusements or entertainment.
>
> Pending the entry into force of the provisions referred to in the first paragraph, Member States may retain all the exclusions provided for under their national laws at 1 January 1979 or, in the case of the Member States which acceded to the Community after that date, on the date of their accession."

This provision contains three distinct, yet interdependent rules, namely: a limitation to the right to deduct in respect of expenditure which is "not strictly business"; an instruction to the European institutions regarding the harmonisation of the rules on non-deductible expenditure; and an authorisation for Member States to maintain their rules regarding non-deductible expenditure until such harmonisation comes into effect, known as the "standstill clause".

(1) *Non-strictly business expenditure*. Article 176 of the CVSD adds a further limitation to the two aforementioned general restrictions to the right to deduct: the non-deductibility of input tax in respect of expenditure which is "not strictly business expenditure". This limitation is fundamentally different from the limitation regarding non-business expenditure. As opposed to the limitation regarding non-business expenditure, the limitation regarding not strictly business expenditure does not stem from the nature of EU VAT or the essence of the right to deduct. Rather, it constitutes an exception to the principle of integral deduction, guided by two practical concerns: firstly, the difficulties determining in some cases and as regards some types of expenditure, the extent to which they constitute business expenditure; and secondly, as a consequence of the first

527. The CVSD amended slightly the original wording in Article 17(6) of the Sixth Directive.

concern, the serious risk of tax evasion by passing consuming expenditure as business expenditure. In this context, the limitation regarding the non-deductibility of not strictly business expenditure can be regarded as essentially an anti-evasion measure. The measure, however, creates serious difficulties, namely because it shifts the practical concern of how to determine the extent to which expenditure can be qualified as business expenditure, to another practical concern which is how to determine which expenses should be qualified as not strictly business. Instead of providing a general criterion to resolve this impasse, Article 176 opts for indicating some of the expenses which should be regarded as not strictly business "luxuries, amusements, or entertainment". However, this provides little help, not solely because the list is exemplificative, which is clearly indicated by the use of the expression "such as", but equally, because the terms themselves are not entirely clear. For example, a trader organises an afternoon of golf for clients in order to promote its business – should this be seen as entertainment for the purposes of Article 17(6)?[528] Is it strictly business or not strictly business expenditure?

These difficulties were to be dealt with soon after the entry into force of the Sixth Directive, and the measure was seen as temporary until the approval of measures which would harmonise the rules on non-deductible expenditure. However, as discussed below, 30 years since the entry into force of the Sixth Directive, these harmonising measures have not yet been adopted and there is little hope that they will be in the near future. In this context, Member States have been left to interpret and apply the concept of "not strictly business expenditure" freely, which has lead to severe discrepancies between the various domestic VAT legislation regimes as regards the type of expenditure which is deductible, and to what extent.

(2) *Harmonisation of non-deductible expenditure*. According to the original version of Article 176, the rules regarding non-deductible expenditure were to be harmonised before the end of 1983 at the latest, i.e., four years after the entry into force of the Sixth Directive. With a view to fulfilling the provision's deadline, the Commission presented a proposal for a Twelfth Directive on expenditure not eligible for deduction of VAT at the beginning of 1983.[529] Subject to certain conditions,

528. An affirmative answer to this question seems to be actually given by the Commission in 1998: "expenditure on amusement and entertainment would cover expenditure designed to give (potential) clients a positive image of the taxable person and his business and expenditure defrayed solely to encourage clients to do business and employees to perform their duties", COM(98) 377 final, 17 June 1998, n. 306 above, at 15.
529. *See* COM(82) 870 final, 25 January 1983, n. 233 above.

this proposal basically excluded from the right to deduct expenditure relating to the following goods and services: passenger cars; transport services/business travel; accommodation, food, or drink; and entertainment, amusement, and luxuries. Following on Parliament's recommendations, in February 1984 the Commission presented an amended version of the proposal,[530] which included two significant changes, as follows: introduction of a four-year transition period in the case of expenditure on passenger cars and transport services; and introduction of a "safeguard clause" whereby a taxable person may deduct input tax on expenditure relating to most goods and services listed in the proposal,[531] where he is able to show that that expenditure was incurred exclusively for business purposes. Despite these amendments, the proposal failed to be approved by the Council. According to the Commission, some delegations felt that the exclusions provided for were too wide-ranging, while others were opposed to its very purposes in spite of the mandatory nature of Article 17(6).[532] In this context, the Commission finally decided to withdraw the proposal in November 1996.[533]

However, in June 1998, the Commission put forward a new proposal as regards the rules governing the right to deduct VAT.[534] This new proposal dealt with two subjects, namely the deduction of the VAT paid in a Member State where the taxable person is not established, which would entail the abolition of the Eighth Directive, and expenditure which is not eligible for full deduction.[535] As regards the expenditure which is not eligible for full deduction, the new proposed rules did not differ substantially from the rules included in the Twelfth Directive proposal (post 1984 amendments). The limitations to the right to deduct applied basically to the same categories of goods and services, i.e., passenger cars, accommodation, food, drink, entertainment, amusement, and

530. *Amendments to the Proposal for a Twelfth Directive relating to the common system of value added tax: expenditure not eligible for deduction of value added tax*, COM(84) 84 final, 16 February 1984.
531. Excluded from this safeguard clause would be expenditure incurred in relation to entertainment, amusement and luxuries.
532. *See Second report from the Commission to the Council on the application of the common system of value added tax, submitted in accordance with Article 34 of the Sixth VAT Directive 77/388/EEC of 17 May 1977*, 1984.
533. *See Withdrawal of certain proposals and drafts from the Commission*, OJ C2, 04/01/1997, 2. According to the Commission the withdrawal was also the logical consequence of the adoption in July 1996 of the work programme for the introduction of a definitive VAT system.
534. *See* COM(98) 377 final, 17 June 1998, n. 306 above.
535. As regards the first aspect, this proposal was already referred to above when discussing the current system in relation to "inter-jurisdictional issues".

luxuries.[536] However, only expenditure in respect of entertainment, amusement, and luxuries would be blocked from the right to deduct,[537] whilst other goods and services would be basically deductible at a 50% rate. Similarly to what occurred in relation to the Twelfth Directive, the Council failed to reach an agreement in relation to this proposal. According to the Commission, the budgetary impact for some Member States of this proposal was the principal difficulty preventing its approval, and the Council urged for a more flexible approach. Although the Commission has opted not to withdraw this proposal (yet), over seven years since its presentation it seems unlikely it will ever become legislation.[538]

In this context, the Commission decided to put again forward a new proposal in 2004 to, at least, harmonise the scope of the expenses for which exclusions of the right to deduct may apply.[539] Under this 2004 proposal, Member States would be able to apply exclusions from the right to deduct to, as follows: motorised road vehicles, boats, and aircraft; travel, accommodation, food, and drink; and luxuries, amusements, and entertainment. According to the Commission, this proposal would oblige Member States to abolish the tax blockings applied to goods and services other than those identified within the proposal. However, for goods and services identified in the proposal, it would provide Member States full flexibility of reviewing their national restrictions which they do not currently have under the standstill clause.[540] As discussed above, the 2004 proposal has been partially approved, but the section on non-deductible expenditure has been excluded from the final text. Thus, Member States remain free to interpret the concept of "not strictly business", and what is somewhat more problematic, to take full advantage of the standstill clause.

(3) *Standstill clause*. The Second Directive allowed Member States to maintain and introduce limitations to the right to deduct on VAT expenditure incurred in relation to goods and services, which were "capable of being

536. Excluded from this new proposal was expenditure on the transportation, which accordingly would be fully deductible under the general right to deduct rules. Equally different is the fact that this proposal, as opposed to the amended proposal for a Twelfth Directive, does not include a "safeguard clause".
537. B. Terra and J. Kajus question this block, namely the Commission's examples of what should constitute "expenditure on luxuries", see *A Guide to European VAT Directives – Introduction to European VAT Directive and other taxes*, Volume 1, (Amsterdam: IBFD, 2004), at 836.
538. On this aspect, B. Terra and J. Kajus comment that "the history of the never adopted Twelfth Directive shows that Member States are reluctant to give up their national provisions on expenditure not eligible for deduction", id at 845.
539. *See* COM(2004) 728 final, 19 October 2004, n. 95 above.
540. Id. at 8.

exclusively or partially used for the private need of the taxable person or his staff".[541] Member States made use of this provision in significantly diverse manners, and according to the Commission "in moving over to the system provided in the Sixth Directive, have to a considerable extent simply retained in their legislation the exclusions for which they had already opted when the common VAT system was set up".[542] The possibility to maintain these exclusions was given by what is now Article 176 of the CVSD, which allows Member States to maintain in force the limitations to the right to deduct which were provided for under their national laws when the Sixth Directive came into force.[543]

Similarly to the rule on the non-deductibility of input tax in respect of expenditure which is "not strictly business expenditure", the standstill clause was meant as a temporary, transitional measure until the introduction of harmonising rules on non-deductible expenditure within a four years period set out in the original wording of Article 176. However, as described above, these harmonising rules were never approved, thus giving rise to questions over the validity of the standstill clause, namely whether the standstill clause was only valid during the four-year period, or whether it is valid until the entry into force of harmonising measures, regardless of the four-year deadline. The Court was finally called to decide upon the issue in *Royscot Leasing*, concluding that, what is now Article 176 of the CVSD, in its original wording, authorised Member States to retain the exclusions of right to deduct VAT under the standstill clause, even though the Council had not decided, before the expiry of the period laid down in the first subparagraph, which expenditure should not be eligible for deduction of VAT.[544]

The Court's judgment put a definitive end to any doubts on the validity of the standstill clause. Member States are thus free to maintain any exclusions or limitations to the right to deduct which were introduced before the entry into force of the Sixth Directive. This freedom is, however, subject to some restrictions, which are not imposed by the CVSD provisions, but rather by the Second Directive. In fact, exclusions or limitations introduced prior to the entry into force of the Sixth Directive

541. Article 11(4) of the Second Directive.
542. In COM(82) 870 final, 25 January 1983, n. 233 above, at 2.
543. Article 17(6) of the initial proposal for a Sixth Directive did not include a standstill clause and, in fact, the wording of the Twelfth Directive proposal's rules (prior to amendments) is reminiscent of its wording. For a detailed description of the legislative history which led to the final wording of Article 17(6) Sixth Directive see B. Terra and J. Kajus, n. 240 above, at 58–60.
544. Case C-305/97, [1999] ECR I-6671, see Chapter 4 below.

> would have been introduced when the Second Directive was in force, and thus, would have to respect its provisions, i.e., the right to deduct could only be limited (or excluded) where expenditure was incurred in relation to goods and services, which were "capable of being exclusively or partially used for the private need of the taxable person or his staff".

The situation described *supra* regarding the consequences of Article 176 of the CVSD and the lack of harmonising measures regarding expenditure which is not eligible for deduction, is further aggravated by the "cyclical economic reasons" clause, and Member States' widespread recourse to derogations. The cyclical economic reasons clause is set out in Article 177 of the CVSD, which provides that Member States may, for cyclical economic reasons, and subject to consultation with the VAT Committee, exclude totally or partially, the right to deduct in relation to all or some capital goods or other goods.[545] Apart from raising serious questions in relation to its effectiveness,[546] this provision seems to be rather vague and broad, and thus, somewhat dangerous. Firstly, the term "cyclical economic reasons" is suitably vague enough to include almost any economic justification, and the expression "all or some capital goods or other goods", suggests that the limitations to the right to deduct can be introduced in relation to any type of goods, and to more than one type – the reference to capital goods seems to be merely indicative.

Additionally, there are the issues of accountability and legal certainty, as the activities of the VAT Committee are neither published officially, nor publicly available. The official justification for this lack of publicity is that the VAT Committee is a mere advisory body, whose guidelines have no legal force, cannot be invoked in court by parties in litigation and Member States are not obliged to apply them.[547] However, in the case of Article 177,

545. Furthermore, according to Article 177 Member States may, in order to maintain identical conditions of competition, instead of refusing deduction, tax the goods manufactured by the taxable person himself or which he has purchased in the country or imported, in such a way that the tax does not exceed the value added tax which would have been charged on the acquisition of similar goods.

546. As pointed out by B. Terra and J. Kajus, see n. 240 above, at 130.15.

547. In November 2000, the Commission was questioned by a member of the European Parliament on why the guidelines of the VAT Committee were not made public, see Commissioner Bolkestein's answer on behalf of the Commission, *Written Question E-3729/00 by Michel Hansenne (PPE-DE) to the Commission*, OJ C174E, 19/06/2001, 128. More recently, the Council has approved a proposal for a Regulation which includes the VAT Committee's guidelines, see Council Regulation (EC) No. 1777/2005 of 17 October 2005, OJ L288, 29/10/2005, 1. However, this Regulation does not include the VAT Committee's other activities, such as its activities as a consultation body under Article 177.

consultation of the VAT Committee is the only formal requirement imposed to Member States before introducing measures, which will limit or exclude altogether the right to deduct in relation to certain goods, and thus, have a significant impact upon the domestic VAT system of Member States involved, in both the EU VAT system and ultimately also in the functioning of the internal market. In this context, it seems unreasonable that publication is denied in relation to documents such as Member States' requests and the Committee's response opinions.[548] Fortunately, according to the Commission, Member States have rarely resorted to this provision. In their Second Report on the functioning of the VAT system, the Commission noted that only Italy had consulted with the VAT Committee twice regarding the exclusion for cyclical reasons.[549] More problematic is Member States' recourse to derogations.

Article 395 allows Member States to introduce measures which derogate from the Directive's provisions under specific circumstances and pending an authorisation from the Council. As acknowledged by the Commission, the widespread use of this provision by Member States has had an extremely negative impact upon the overall functioning of the EU VAT system. However, few areas of this system have been as much a target for derogations as the provisions relating to the right to deduct, in particular Articles 167 to 171 of the CVSD.[550] Although there are only five Council Decisions authorising Member States to introduce measures derogating from Article 168

548. In 2000, the question of access to the minutes of the VAT Committee was put before the Court of Justice of First Instance in the case of *Elder & Elder*, see case T-36/00, [2001] ECR II-607. The case concerned a request by Mr. & Mrs. Elder to the Commission, for access to minutes of the VAT Committee in relation to a possible consultation by the United Kingdom prior to enacting in 1994 and 1997 legislation based on Article 11 of the CVSD. The Commission refused the request on the basis that the disclosure of those minutes would undermine the protection of confidentiality as requested by the legal person that supplied the information and the protection of the institution's interest in the confidentiality of its proceedings. In February 2001, the Court ordered the Commission to produce to the Court the minutes from the VAT Committee to which access had been refused to the applicants. By order of May 2001, the President of the First Chamber of the Court of First Instance ordered the removal from the register of this case.

549. *See* n. 532 above. The first time requesting an exclusion, until 31 December 1985, of the right to deduct VAT in respect of the purchase or importation of motor vehicles and of the purchase of fuels and lubricants for use therein, and the second time to request an extension of this exclusion until 31 December 1987.

550. Other areas of the EU VAT system, which have been the target of several Member States' derogations include the following: subjection to VAT (Article 2); territorial application (Article 5); place of supply of services (Article 43); taxable amount (Article 73); persons liable to payment of tax (Article 193); and obligations under the internal system (Articles 262, 265 and 269).

of the CVSD, which restrict the right to deduct, are currently in force,[551] with many other Council Decisions having ceased to have effect.[552] Several of these authorised Member States to limit, or more rarely, to exclude, the right to deduct expenditure in relation to specific goods or services, namely vehicles, fuel, accommodation, food, hospitality, entertainment, and more generally, goods and services where private use of those goods and services accounts for as little as 50% of their use.

Albeit approved under Article 395's procedure, the contents of some of these authorisations have been questioned in light of the principles of the EU VAT system, and the Court has twice been called already to decide on the validity of Council Decisions which authorised Member States to introduce limitations or exclusions on the right to deduct expenditure.[553] In both cases, it is interesting to note that the Council Decisions under litigation authorised Member States to introduce measures, which did not depart radically from the rules put forward on the proposal for the Twelfth Directive. However, the Court found these measures to be, in one case partially, and in the other totally, invalid.[554]

551. These are, as follows: as regards *Austria*, Council Decision 2004/866/EC of 13 December 2004 (OJ L371, 18/12/2004, 47); as regards *Germany*, Council Decision 2004/817/EC of 19 November 2004 (OJ L357, 02/12/2004, 33); as regards *Denmark* and *Sweden*, Council Decision 2000/91/EC of 24 January (OJ L28, 03/02/2000, 38), as last amended by Council Decision 2007/132/EC of 30 January 2007 (OJ L57, 24/02/2007, 10–11); as regards *Italy*, Council Decision 2007/441/EC of 18 June 2007 (OJ L182, 27/06/2007, 33–34); and finally as regards the *United Kingdom*, Council Decision 2007/884/EC of 20 December 2007 (OJ L346, 29/12/2007, 21).

552. These are, as follows: as regards *France*, Council Decision 89/488/EEC of 28 July 1989 (OJ L239, 16/08/1989, 21), and Council Decision 93/109/EEC of 15 February 1993 (OJ L43, 20/02/1993, 42–43); as regards *Germany*, Council Decision 2000/186/EC of 28 February 2000 (OJ L59, 04/03/2000, 12), and Council Decision 2003/354/EC of 13 May 2003 (OJ L123, 17/05/2003, 47–48); as regards the *United Kingdom*, Council Decision 95/252/EC of 29 June 1995 (OJ L159, 11/07/1995, 19–20), and Council Decision 98/198/EC of 9 March 1998 (OJ L76, 13/03/1998, 31), as last amended by Council Decision 2004/855/EC of 7 December 2004 (OJ L369, 16/12/2004, 61–62). The great majority of these derogations ceased to have effect whenever the period for their application expired.

553. Joined cases C-177/99 and C-181/99, *Ampafrance and Sanofi*, [2000] ECR I-7013, on the validity of Council Decision 89/487/EEC of 28 July 1989 (OJ L239, 16/08/1989, 21); and C-17/01, *Sudholz*, [2004] ECR I-9243, on the validity of Council Decision 2000/186/EC of 28 February 2000 (OJ L59, 04/03/2000, 12). The Court had already been called to decide previously on the validity of a Council Decision authorising a Member State to introduce derogating measures in the case of *Direct Cosmetics*, case 138/86, [1988] ECR 3937. This case, however, related to Decision 85/369/EEC of 17 May 1977 (OJ L199, 31/07/1985, 60) which authorised the United Kingdom to introduce a measure derogating from what is now Article 73 of the CVSD rather than Article 168. In any event, the Court found this Decision to be valid.

554. *See* Chapter 4 below.

2.2.1.3. *Critical evaluation of lack of uniform criteria for non-deductible input tax*

The legal framework described above – namely regarding the "standstill clause", the "cyclical economic reasons clause", the derogations, and ultimately, the lack of harmonisation as regards non-deductible expenditure – led to the current situation where there is a wide discrepancy amongst Member State domestic VAT systems in the applicable criteria to determine which expenditure, if any, is excluded, partially or totally, from the right to deduct. Annex 3 highlights the rules regarding non-deductible input tax currently applicable in the 25 Member States.[555]

In 1983, when presenting the proposal for a Twelfth Directive the Commission noted that "the situation is not consistent with the requirements of a uniform basis of assessment and a non-discriminatory system of taxation".[556] Today, whether the rules contained in that proposal would be ideal is arguable, namely in light of the Court of Justice's judgment in *Ampafrance and Sanofi*. However, what seems incontestable is that the current situation is not consistent with the requirements of an internal market as it gives rise to serious difficulties for traders, which have a clearly negative impact and directly impair the functioning of such a market. In fact, the following consequences arise from the current legal framework:

- *Inequality between traders established in different Member States*: thus distortions of competition within the internal market – traders established in a Member State in which tax is fully deductible (except for the general limitations) are in a beneficial situation in comparison with traders established in Member States which limit or exclude the right to deduct in relation to expenditure on specific goods or services.

- Economic inefficiencies within the internal market by *increasing compliance costs for businesses engaging in intra-community trade*: due to the disparities between Member States' domestic legislation, it is somewhat difficult for businesses engaging in intra-community trade to establish which expenditure is deductible in other Member States without resource to external tax experts. This is particularly

555. The contents of that Annex was based on information supplied by the Member States' tax authorities and compiled by the European Commission in 2007, see *VAT in the European Community – Application in the Member and Accession States, facts for use by administrations/traders information networks etc...* ,TAXUD/1032/07.
556. *See* COM(82) 870 final, 25 January 1983, n. 233 above, at 2.

problematic in the case of Eighth Directive refunds, as the refund is subject to the rules on deductible input tax applicable in the Member State of refund.

- Additionally, further inefficiencies within the internal market by *creating economic drawbacks for industries* which are specifically affected by limitations to the right to deduct. As reported by the Commission, the fact that certain Member States limit the right to deduct in relation to expenditure on specific goods or services has economic drawbacks for the industries involved in the trade of those goods or services, e.g., the motor vehicle industry and the hotel and catering industry.[557]

As opposed to the situation in relation to inter-jurisdictional issues and rates of VAT, the current rules regarding non-deductible input tax do not constitute an obstacle to the establishment of the internal market. However, they do give rise to serious difficulties which have a negative impact in the functioning of that market. In this context, the creation of an efficiently functioning internal market demands their alteration.

2.2.2. EU VAT system as an indirect obstacle to the functioning of the internal market: VAT treatment of public sector bodies

In most countries that apply a VAT, the activities and transactions undertaken by public sector bodies are not subject to full taxation.[558] They are either deemed to be zero-rated, exempt, outside the scope of VAT, or, as in the case of EU VAT system, and depending on various circumstances, all of the above. The rationale usually invoked to justify lack of full taxation is of a mixed conceptual and political kind. On one hand, public sector bodies have a diversified nature, engaging in different type of activities from policing to the provision of health and education services.[559] This has resulted in the view that the activities of those bodies are hard to tax and that, in practice, it is almost impossible to establish a single VAT treatment applicable

557. Id. at 2.
558. *See* R. Bird and P.P. Gendron, n. 197 above, at 86–87; A. Schenk and O. Oldman, *Value Added Tax – A Comparative Approach* (Cambridge University Press, 2007), at 282–283; and L. Ebrill *et al*, n. 195 above, at 91 et seq.
559. M. Aujean, P. Jenkins, and S. Poddar, divide government activities into three groups: redistribution of income and wealth; provision of public goods and services; and provision of other goods and services which are similar to those supplied by the private sector, see "A New Approach to Application of VAT to Public Sector Bodies" (1999) *International VAT Monitor* 10(4), 144–149, at 144.

to all of them.[560] On the other hand, and more importantly, there is a perception that exclusion of the products supplied by public sector bodies from full taxation, achieves social and distributional aims. The argument is twofold: first, non-taxation should increase consumption of so-called merit goods; second, non-taxation of these products is said to diminish the natural regressivity of consumption taxes.[561]

The rule under the EU VAT system is that supplies by public sector bodies are non-taxable, i.e., they are outside the scope of VAT.[562] In practice, this means that they will not charge any VAT on their supplies, but neither will they be entitled to deduct input VAT incurred on the supplies made to them. This basic rule is, however, subject to various exceptions and the VAT treatment of public sector bodies is actually extremely complex, determined by the interaction of several different provisions of the CVSD, and in particular Articles 13 and 132, and Annex I therein. As discussed below, despite the Commission's expressions of interest in changing the status quo, for the most part, these provisions have remained unaltered since their introduction in 1977. This status quo can be summarised into three basic rules, as follows:

- Where public legal entities engage in activities as public authorities, they are not regarded as taxable persons and thus, these activities are outside the scope of VAT [Article 13(1) of the CVSD].

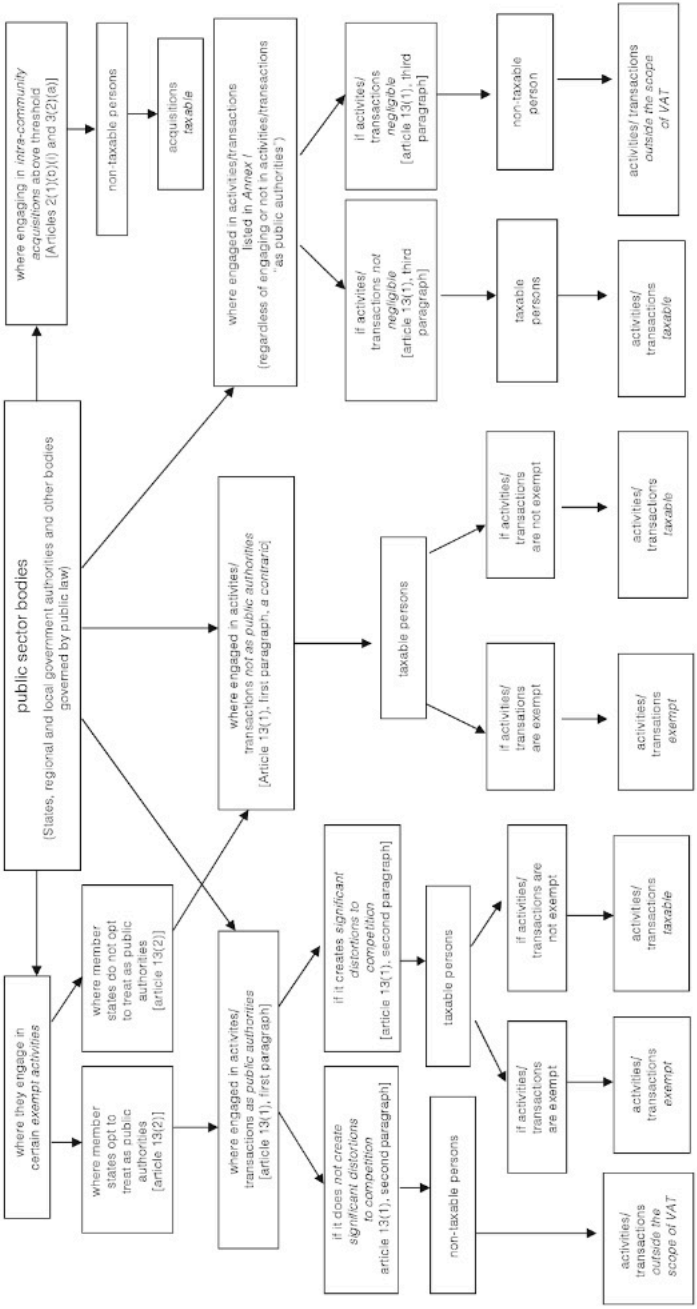
- However, where public bodies engage in supplies listed in Annex D they are regarded as taxable persons, and therefore, those supplies are within the scope of VAT and taxable, provided that they are not carried out on such a small scale as to be negligible [Article 13(1) of the CVSD].

- Additionally, where public bodies are taxable persons their activities might still be regarded as exempt [Articles 13(2) and 132 of the CVSD].

Despite this apparent clarity, as demonstrated by the outline in Diagram 3.3 the application of these basic rules to particular cases is far from straightforward.

560. *See* L. Ebrill *et al*, n. 195 above, at 92; and P.P. Gendron, "Value Added Tax Treatment of Public Sector Bodies and Non-Profit Organizations: A Developing Country Perspective" (2005) *Bulletin of International Taxation* 12, 514–526, at 516.
561. For a comprehensive discussion on the regressive nature of VAT, or otherwise, see G.N. Carlson and M.K. Patrick, "Addressing the Regressivity of a Value Added Tax" (1989) *National Tax Journal* 42(3), 339–351.
562. As explained by R. Krever the option in Europe is explained by the fact that "when the traditional VAT was introduced in Europe, public bodies played a central role in many areas of the economy", see "Designing and Drafting VAT Laws for Africa", in R. Krever (ed.), *VAT in Africa* (Pretoria: Pretoria University Press, 2008), 9–28, at 26.

Diagram 3.3: Current VAT treatment of public sector bodies



2.2.2.1. *Concept of taxable person*

The first step towards establishing the VAT treatment of a particular activity/transaction undertaken by a public sector body is to determine whether the public sector body in question is regarded as a taxable person or a non-taxable person, for the purposes of that activity. Under the first paragraph of Article 13(1) of the CVSD, where States, regional, and local government authorities and other bodies governed by public law engage in activities or transactions as public authorities, they are regarded as non-taxable persons in respect of those activities or transactions, i.e., those activities will be deemed to be outside the scope of VAT.[563] Despite this apparent simplicity, the application of this provision does in fact give rise to many complications, notably due to the fact that the terms used are both unclear and susceptible to different interpretations. There are two key elements to the provision, namely the identity of the supplier, "bodies governed by public law", and the manner in which the supply is undertaken, "activities or transactions in which they engage as public authorities", with both expressions having given rise to ECJ case law.[564]

The general rule in the first paragraph of Article 13(1) of the CVSD, according to which the activities undertaken by bodies governed by public law will be deemed to be outside the scope of VAT, where they have been engaged in by those bodies as public authorities, is subject to four exceptions.[565] Three of these exceptions limit the scope of the main rule, establishing that even where activities fall within the scope of that rule, they may still be regarded as taxable provided certain conditions are present, as follows: where treating those activities as outside the scope of VAT would lead to significant distortions of competition [Article 13(1), second paragraph]; where at stake are certain activities, provided they are not carried out on such a small scale as to be negligible [Article 13(1), third paragraph and Annex I]; and where the activities in question are intra-Community acquisitions, above a certain threshold [Articles 2(1)(b)(i) and 3(2)(a)]. On the contrary, the final exception to the main rule seems to extend its scope. Where public sector bodies engage in activities not as public authorities, Member States may still regard them as falling under the scope of the main

563. It is important to note that the wording of the provision is largely based in the civil law traditional distinction between private and public law, something which is not present, at least with the same emphasis, on common law countries.
564. *See* Chapter 4 below.
565. The suggestion that Article 13 of the CVSD was divided into main rule and exceptions was also put forward by Advocate General Mischo in joined cases 231/87 and 129/88, *Carpareto Piacentino and Rivergaro*, [1989] ECR 3233.

rule: where exempt activities, listed in certain articles of the CVSD [Article 13(2)], are at stake.

(1) *Open clause exception*. Under the second paragraph of Article 13(1) the main rule in the first paragraph of the article will not apply where its application would lead to significant distortion of competition. The clause's objective is clearly to introduce an element of flexibility into the rigidity of the main rule and, as the Court itself has stated in *Halle*, to ensure fiscal neutrality.[566] In practice, however, the expression "significant distortions of competition" has caused significant difficulties of interpretation and application.[567]

(2) *Certain activities or transactions where not "negligible"*. Under the third paragraph of Article 13(1), where public sector bodies engage in the activities listed in Annex I to the CVSD, they will be regarded as taxable persons, unless they are carried out on a negligible scale.[568] Similarly to the main rule in the first paragraph of Article 13(1), the application of this exception appears to be dependent on the establishment of two cumulative elements: first, whether the activities at stake fall within the scope of those listed in Annex I; second, whether they are *not* being carried out on such a small scale as to be considered negligible. This, however, does not seem to be the Court's understanding.[569] Moreover, neither the definition of activities listed in Annex III, nor the circumstances under which they should be carried out in order to be regarded as "negligible", are clear.

(3) *Exempt activities clause*. Under Article 13(2) of the CVSD, where public sector bodies engage in exempt activities, listed in certain articles of the CVSD, *not* as public authorities, Member States may still regard them as falling under the scope of the main rule, and thus, non-taxable for the purposes of those activities. This exception to the first

566. Case C-430/04, [2006] ECR I-4999, at paragraph 24.
567. *See* Chapter 4 below.
568. Annex I lists the following activities: telecommunications services; supply of water, gas, electricity and thermal energy; transport of goods; port and airport services; passenger transport; supply of new goods manufactured for sale; transactions in respect of agricultural products, carried out by agricultural intervention agencies pursuant to Regulations on the common organisation of the market in those products; organisation of trade fairs and exhibitions; warehousing; activities of commercial publicity bodies; activities of travel agents; running of staff shops, cooperatives and industrial canteens and similar institutions; and activities carried out by radio and television bodies.
569. *See* Chapter 4 below.

paragraph of Article 13(1), extending its scope, is based on a complex interconnection between this article and provisions on exemptions. One of the questions it raises concerns the scope of the optionality granted therein to the Member States. This has been the subject of a recent reference to the ECJ.[570]

Although, this exception to the main rule was already present in the original version of the Sixth VAT Directive, its wording has been changed slightly post-recast. Under the original version, the then fourth paragraph of Article 4(5) referred exclusively to exempt activities under what are now Articles 132, 135, 136, and 371, 374 to 377, 378(2), and 379(2). Yet, the current provision refers to various other exemptions, which had not been previously set out within those articles, but rather in the various Acts of Accession. This broadening of the scope of the exception should be seen in the context of previous jurisprudence on the matter and has various legal implications.[571]

(4) *Intra-Community acquisitions above the threshold.* Article 2(1)(b)(i) of the CVSD read in conjunction with Article 3(1)(b), (2)(a) and (b), and (3) of the same Directive, mean that intra-Community acquisitions by public sector bodies will not be subject to VAT if they are below the €10,000 threshold, unless the body opts otherwise. However, once that threshold is exceeded, or if it has been exceeded in the previous calendar year, all intra-Community acquisitions will be taxable. The ECJ has until now, never been called upon to interpret these provisions.

In practice, therefore, and as discussed in more detail in Chapter 4, the Directive's provisions leave a large number of possibilities for differing interpretations and applications. The main difficulty rests in the fact that the VAT classification of a particular public sector body as a taxable person, a non-taxable person, or a "mixed VAT status" person – i.e., a legal person which in respect of some activities is a taxable person and in respect of others is not – and thus, the VAT treatment of the activities it performs, is dependent upon all these interpretations and applications. However, even where the public sector body is a taxable person under Article 13 and Annex III of the CVSD, the activities/transactions in which they engage, although subject to VAT are not necessarily taxable.

570. *See* Chapter 4 below.

571. For a comprehensive analysis of this legal development see R. de la Feria, "The EU VAT Treatment of Public Sector Bodies: Slowly Moving in the Wrong Direction", *Oxford University Centre for Business Taxation Working Paper Series*, WP08/08, June 2008.

2.2.2.2. *Exemptions*

Having determined the taxable status of a particular public sector body, the second step in order to determine the VAT treatment of its activities is to establish whether those activities are listed in any of the exemptions' provisions in the CVSD, in particular in those listed in Article 132 therein. At present, it is unclear whether all exemptions could potentially apply to activities undertaken by public sector bodies, or merely the ones listed in Article 132, which refer specifically to the public nature of the supplier, as there is no jurisprudential guidance on this matter. These are, as follows:

- the supply by the public postal services [Article 132(1)(a)];
- hospital and medical care and closely related activities undertaken by bodies governed by public law [Article 132(1)(b)];
- the supply of services and of goods closely linked to welfare and social security work, including those supplied by old people's homes, by bodies governed by public law [Article 132(1)(g)];
- the supply of services and goods closely linked to the protection of children and young persons by bodies governed by public law [Article 132(1)(h)];
- children's or young people's education, school or university education, vocational training or retraining, including the supply of services and goods closely related thereto, provided by bodies governed by public law [Article 132(1)(i)];
- certain cultural services and goods closely linked thereto supplied by bodies governed by public law [Article 132(1)(n)]; and,
- activities of public radio and television bodies other than those of commercial nature [Article 132(1)(q)].

As with Article 13 of the CVSD, these exemptions are of difficult interpretation and application, and have given rise to significant case law from the Court of Justice.[572] Although they have never been subject of amendment, this has not been due to lack of initiation on the Commission's part. In 2003, the Commission put forward a proposal to amend the VAT treatment of the postal services, by eliminating the current exemption applicable to these services, under Article 132(1)(a) of the CVSD, and thus, making them taxable.[573] However, the proposal was the target of criticisms by the European Parliament.[574]

572. *See* Chapter 4 below.
573. *See* COM(2003) 234 final, 5 May 2003, n. 329 above.
574. *See Report on the proposal for a Council Directive amending Directive 77/388/EEC as regards value added tax on services provided in the postal sector (COM(2003) 234 – C5–0227/2003 – 2003/0091(CNS))*, A5–0122/2004, 11/03/2004.

Further to the Opinion of the European Parliament, the Commission decided to present an amended proposal,[575] which included the possibility of applying reduced rates of VAT to postal services, in order to avoid or to limit the price increases to a minimum. Yet, despite these amendments, the discussions in the Council proved slow, with some Member States appearing to strongly oppose it. On 7 January 2004, during the Prime Minister questions and answers' session in the parliament, the then UK Prime Minister, Tony Blair, confirmed that his government would continue to oppose any move from VAT exemption for postal services. Similarly, in Ireland, the move has not been without controversy, as demonstrated by the number of written questions addressed by Irish members of the European Parliament to the Commission on the contents and consequences of the proposal.[576] Four years since the presentation of the amended proposal, it seems clear that its approval is now unlikely.

Meantime, early indications that reform of the current EU VAT regime applicable to public sector bodies was to be expected in the near future have not been fulfilled. In 2000, the Commission published a VAT strategy, aimed at improving the operation of the internal market. Under the heading "other potential future priorities", the Commission set out the areas, which it considered, warranted a thorough review. The first item on this list was the treatment of subsidies, public authorities, and services in the public interest:

> "Increasing privatisation of activities which were traditionally the exclusive reserve of the public sector has led to greater distortions of competition between exempt, non-taxable and taxable services. The VAT system for such services needs to be modernised taking into account of all interests involved [...] Exemptions without the right to deduction for social, educational, cultural and other activities also need to be reviewed to see whether they meet current needs."[577]

The Commission's intention to reform the VAT treatment of public bodies was again reiterated in 2003, in their review and update of the VAT strategy. It stated then that preparatory work for reform of this area was already under way, and despite its complexity, a final proposal would be presented in the

575. *See* COM(2004) 468 final, 8 July 2004, n. 329 above.

576. There has been a total of four written questions, as follows: *VAT on postal services, Written Question E-1667/03 by Proinsias De Rossa (PSE) to the Commission*, 19 May 2003, [2004] OJ C783E/34; *Exemption from VAT on postage for charities, Written Question E-2400/03 by Avril Doyle (PPE-DE) to the Commission*, 10 July 2003, [2004] OJ C65E/142; *Consultation with charities with regard to the proposal relating to the imposition of VAT on postal services, Written Question E-3631/03, by Proinsias De Rossa (PSE) to the Commission*, 5 December 2003, [2004] OJ C78E/617; and *VAT on postal services, Written Question E-0922/04 by Proinsias De Rossa (PSE) to the Commission*, 16 March 2004, [2004] OJ C88E/551.

577. *See* COM(2000) 348 final, 7 June 2000, n. 303 above, at 11.

fourth quarter of 2004.[578] Yet, four years on from that date, the Commission has not only failed to do so, but equally there are no obvious signs of an intention to initiate the consultation process, which would usually precede such a move.[579] This sequence of events raises the obvious question: why does there seem to have been an abandonment of the intention to reform the VAT treatment of public services? Most of the other items listed in the Commission's review of the VAT strategy seem to have indeed been the subject of a legislative proposal, albeit in many cases a belated one.[580] It is, of course, impossible to answer with any level of certainty, but the suspicion is that Member States' reaction to the postal services proposal might have given the Commission an inkling as to the political sensitivities involving the public services area.

2.2.2.3. *Critical evaluation of the VAT treatment of public sector bodies*

The current VAT treatment of public sector bodies gives rise to serious consequences, at both legal and economic levels.[581] From a legal perspective, the current regime gives rise to definitional and interpretative problems, creates difficulties in calculating the portion of deductible VAT, constitutes an incentive for engaging in aggressive tax planning, and has the additional

578. *See* COM(2003) 614 final, 20 October 2003, n. 317 above, at 11 and Annex 2.

579. See, however, comments by M. Aujean, in "Application of VAT to Public Bodies: the EU VAT System, Current Issues and Proposals" in R. Krever (ed.), *VAT in Africa* (Pretoria: Pretoria University Press, 2008), 71–79, at 79.

580. The only other item listed in the document, in relation to which there appears to have been no initiative is "survey of various options, facilities and transitional provisions"; others items listed have also not been subject of proposal as of yet, but consultation processes are currently under way, as it is the case with "promotions and payment cards" and "elimination of double taxation in individual cases", see Commission of the European Communities, *Public Consultation on "Modernising the Value Added Tax Treatment of Vouchers and Related Issues" – Summary of Results*, May 2007, and *Report on the Outcome of the Consultation on ''Introduction of a Mechanism for Eliminating Double Imposition of VAT in Individual Cases"*, October 2007.

581. Many of these difficulties are common to those faced by charities and other non-governmental organisations, see J. Warburton, "Charities and Business: A VAT Conundrum" (2007) *British Tax Review* 1, 73 et seq. The relevance of those difficulties for these bodies is demonstrated by the fact that in its 1997 report on reduced rates the Commission admitted that some exempt bodies, like charities, had put forward requests advocating the application of reduced VAT rates, instead of exemptions for their supplies, see COM(97) 559 final, 13 November 1997, n. 488 above, at 17. Although recognising the advantages that such a shift would bring for exempt bodies, namely in terms of deduction of input tax, the Commission refused the requests arguing that the application of reduced rates to these supplies would be contrary to the basic goal of simplifying the VAT system and reducing compliance costs.

problem of being conceptual incoherent with the general principles of the EU VAT system. From an economic perspective, the restrictions to the deduction of input tax, which are the consequence of the current regime, have also resulted in considerable distortions. In addition, there is no definite economic evidence that exclusion of the products supplied by public sector bodies from full taxation, achieves the social and distributional aims that are often pointed out as the main reason for their current EU treatment. Finally, these inefficiencies should be contextualised in the demands of the EMU and the Lisbon Strategy. In this light, it is argued that the current VAT treatment of public sector bodies constitutes an indirect obstacle to achieving the full potential of the internal market.

(1) *Definitional and interpretative problems*. As mentioned above, the legal provisions determining the current VAT treatment of public sector bodies, in particular Articles 13 and 132 and Annex I to the CVSD, are unclear, and thus, susceptible to sustaining differing interpretations and applications. In the last 30 years, the ECJ has struggled with the meaning of these provisions, leading to a steady increase in references from national courts to the ECJ, focussing on the interpretation of these provisions, is significant, and is also symptomatic of two facts.[582] First, it reflects the out-dated nature of the existing provisions. These are unable to deal with a new economic environment, where competition between public and private bodies is common occurrence,[583] and the pressure to increase efficiency in the provision of public services has witnessed increased resort to subcontracting and outsourcing. Second, it relays the current climate of legal uncertainty whereby both public sector bodies and tax administrations alike, are increasingly unsure as to whether a specific activity is outside the scope of VAT, exempt or taxable.[584] This uncertainty in turn had the effect of increasing compliance and administrative costs, as more time and resources will be devoted to establishing the correct VAT treatment of each activity undertaken by that public sector body.

(2) *Calculation of recoverable input VAT and apportionment of tax*. One of the most obvious legal consequences of the existing VAT treatment

582. *See* Chapter 4 below.
583. *See* S.D. Coleclough, "The Sixth VAT Directive and the Need for Reform" (1995) *British Tax Review* 4, 378–384, at 380.
584. This climate of legal uncertainty is also reflected in Member States' discrepant transposition of the provisions in Article 13 of the CVSD into domestic legislation, see interesting account provided by O. Jimenez, "VAT and Public Bodies in EC Member States" (2008) *Intertax* 36(6/7), 268–281.

of public sector bodies is the fact that it gives rise to apportionment of input tax situations. Fully outside the scope or exempt, public bodies are probably a rarity. More common will be the situation whereby one particular body has a mixed VAT nature, engaging in activities which are at the same time outside the scope, exempt and taxable. This means in practice that most will be able to deduct at least part of their input VAT, under Articles 173 to 175 of the CVSD. The difficulties reside in the fact that calculation of deductible VAT, as prescribed in those provisions, is itself problematic, and has given rise to considerable case law.[585] Although a comprehensive analysis of the different methods of apportioning input VAT is outside the scope of this article, it is worth noting that there are essentially two methods of determining the proportion of deductible input VAT, namely direct allocation and pro-rata. Member States can use either of these methods, or a combination of both, and in this respect they display significant discrepancies.[586] However, whichever the preferred method, the process tends to be complex, as with the definitional and interpretative problems highlighted above, thereby entailing high administrative and compliance costs.[587] As the Commission itself has recently acknowledged:

> "This process generates considerable administrative charges for economic operators and fiscal authorities and is a continuous source of litigation, creating an atmosphere which reduces the level of legal certainty for businesses and increases budgetary insecurity for Member States."[588]

(3) *Planning and aggressive planning*. For any partially exempt or non-taxable legal person, faced with the reality of non-deductibility of all their input VAT, there are two basic methods of curtailing VAT costs: minimizing VAT input, by acquiring less goods and/or services, which are subject to VAT; and maximising VAT output, by increasing the number of taxable supplies, and thus, the overall percentage of deductible input VAT. Whilst the legitimacy of engaging in VAT planning has been acknowledged by the Court of Justice in joined cases *Gemeente*

585. *See* point 2.2.1.1 above.
586. See general overview provided by C. Amand, "VAT for Public Entities and Charities – Should the Sixth Directive Be Renegotiated?" (2006) *International VAT Monitor* 6, 433–443, at 434. *See also*, H. Huizinga, "Financial services VAT – VAT in Europe?" (2002) *Economic Policy*, October, 499–534, at 501.
587. For a commentary on the administrative and economic consequences of Member States' discrepancies in his area, see K. Zacharopoulos, "Value Added Tax: The Partial Exemption Regime" (2001) *Canadian Tax Journal* 49(1), 102–126.
588. *See Consultation Paper on Modernising Value Added Tax Obligations for Financial Services and Insurances*, 2006, at 7.

Leusden and Holin Groep,[589] often non-tax reasons will prevent legal persons from adopting measures, which will reflect either of these methods. It is in this context that so-called aggressive VAT planning, or VAT avoidance, schemes, will often emerge.[590] In fact, two recent cases, *University of Huddersfield* and *Centralan*, have demonstrated how VAT costs, resulting from the exclusion of the right to deduct input tax, can act as a catalyst for public bodies in general, and universities in particular, to engage in aggressive VAT planning.[591]

(4) *Conceptual incoherencies*. From a conceptual perspective, the current VAT treatment of public sector bodies is also defective. By treating these bodies as de facto final consumers, in respect of many of their activities, the current regime is arguably contrary to the principle of VAT as a tax on consumption,[592] which constitutes one of the fundamental principles of the EU VAT system.[593] Not only should final consumers be, by nature, physical persons,[594] but equally the treatment as final consumers of public bodies does not accurately reflect practice, as goods and services supplied to those bodies will unavoidably be used as inputs to the activities, in which they are engaged in. Furthermore, the current regime applicable to public sector bodies inherently contravenes the principle of fiscal neutrality, as set out in Article 1 of the CVSD and developed by the ECJ – another fundamental principle of the EU VAT system.[595] As Advocate General Jacobs so clearly stated in *Waterschap Zeeuws Vlaanderen*, a case concerning the right to deduct of public sector bodies:

589. Joined cases C-487/01 and C-7/02, [2004] ECR I-5337.

590. For a analysis of the development of the Court's jurisprudence on aggressive VAT planning see Chapter 4 below; for an analysis of its catalysts see R. de la Feria, "The European Court of Justice's solution to aggressive VAT planning – Further towards legal uncertainty?" (2006) *EC Tax Review* 1, 27–35.

591. Cases C-223/03, [2006] ECR I-1751 and C-63/04, [2005] ECR I-11087, respectively.

592. P. Gottfried and W. Wiegard go so far as to state that "contrary to common belief, VAT no longer equals a consumption tax when exemptions are granted", in "Exemption versus zero rating – A hidden problem of VAT" (1991) *Journal of Public Economics* 46(3), 307–328, at 308.

593. *See* D. Butler, "VAT as a Tax on Consumption: Some Thoughts on the Recent Judgement in *Parker Hale Ltd v Customs and Excise Commissioners*" (2000) *British Tax Review* 5, 545–553.

594. As highlighted by M. Aujean, P. Jenkins and S. Poddar, n. 559 above, at 145.

595. S. Cnossen comments that exemptions "defy the logic and inherent integrity of the VAT" in "Value Added Tax and Excises: Commentary", Report of a Commission on Reforming the Tax System for the 21st Century, Chaired by Sir James Mirrlees, Institute for Fiscal Studies, London, 2008.

> "It is inherent in the existence of exceptions to the VAT system that they will interfere to some extent with the application of the principles of neutrality and of equality treatment. Whatever the merits of the decision to treat public sector bodies as final consumers, it forms an integral part of the Directive. In that in comparable situations, the treatment of taxable persons and persons excluded from the VAT system will inevitably be different."[596]

(5) *Tax cascading*. One of the main side effects of treating activities as outside the scope of VAT or exempt, and the consequent non-deductibility of related input VAT, is the possibility of tax cascading.[597] Tax cascading will occur where the service supplied by the public sector body is an intermediate step in the production, and therefore, the VAT levied until then becomes a hidden cost (as it cannot be deducted). The higher the VAT rate applicable to input supplies, the potentially higher the amount of hidden VAT included in the supplies of services by public bodies. Moreover, according to economic commentators, this is especially true in the case of public services.[598] This is all the more important when considering that avoiding tax cascading effects is, not only one of the main principles of commodity taxation,[599] but equally one of the principle reasons behind the introduction of the EU VAT system.[600]

(6) *Erosion of VAT base/break of VAT chain*. Connected to the problem of tax cascading is another negative consequence of the current EU VAT treatment of public sector bodies. Whilst, it is widely accepted within the economic literature that VAT efficiency levels are directly related to its taxable base,[601] the current regime erodes the VAT base and breaks the VAT chain. Moreover, some authors have drawn attention to the phenomenon of "creeping exemptions". They contest that, as more exemptions are granted, other sectors of the economy will be tempted to claim exemptions for themselves, thus further eroding the tax base.[602] As regards the activities of public sector bodies, this

596. Case C-378/02, [2005] ECR I-4685, at paragraph 38.
597. Also known as "multiple taxation", see G. de Wit, n. 344 above.
598. See economic analysis by P. Gottfried and W. Wiegard, n. 592 above, at 323.
599. *See* E.H. Davis and J.A. Kay, "Extending the VAT Base: Problems and Possibilities" (1985) *Fiscal Studies* 6(1), 1–16, at 4.
600. *See* Chapter 2 above.
601. *See* S. Cnossen, "Is the VAT's Sixth Directive Becoming an Anachronism?" (2003) *European Taxation* 12, 434–442, at 435.
602. *See* A.A. Tait, *Value Added Tax – International Practice and Problems* (International Monetary Fund, Washington DC, 1988), at 50.

phenomenon is particular evident in the recent Court of Justice case law concerning intermediary and subcontracted services.[603]

(7) *Self-supplies vs. outsourcing: bias away from outsourcing*. Another important consequence of the current VAT treatment of public sector bodies is the fact that it encourages self-supplies. The reason is clear: in the case of self-supplies, the public bodies will only have to pay VAT on the purchase of goods or services involved; on the contrary, where there is outsourcing or subcontracting of services to a private entity, VAT will be charged on the full price of those services. As the right to deduct input VAT of public bodies is limited, VAT charged on outsourced or subcontracted activities will represent an extra cost, whilst, where there is a self-supply this extra cost will be avoided. This bias is all the more serious when considering that recent economic literature indicates that contracting out government services is economically more efficient and saves taxpayers' money, with some commentators suggesting as much as 20 per cent savings. Although many have focussed particularly on refuse collection,[604] some economic studies indicate that the private sector is found to be more efficient in other areas, such as fire protection, cleaning services, and waste-water treatment.[605]

With a view to counteracting these distortions, some Member States, namely Denmark, Finland, Sweden, the Netherlands, and the United Kingdom, have opted for financing the VAT costs of public sector bodies through the introduction of a refund mechanism. Usually operating outside the VAT regime,[606] these refund or compensation schemes aim to create a level playing field between self-supply of services and outsourcing.[607] Whilst they vary considerably, the refund schemes

603. *See* Chapter 4 below.
604. *See* E. Dijkgraaf and R.H.J.M. Gradus, "Cost Savings of Contracting Out Refuse Collection" (2003) *Empirica* 30, 149–161.
605. For a detailed overview of these studies see M.C. Wassenaar and R.H.J.M. Gradus, "Contracting out: The importance of a solution for the VAT distortion" (2004) *CESifo Economic Studies* 50(2), 377–396.
606. Although, reportedly not in Finland, where the provisions allowing for VAT compensation are included within the VAT legislation, see X. Yang, "VAT Treatment of Government procurement: a comparative analysis" (2005) *International VAT Monitor* 5, 342–348, at 346.
607. Although no connection has been directly established between tax cascading and the introduction of VAT refund schemes, presumably these schemes would also have the side effect of preventing any cascading. The rationale for introduction of such schemes has, however, been heavily criticised, see W. van der Corput, "Hollow-sounding arguments" (2005) *International VAT Monitor* 2, 92–93.

generally apply to local governments, but VAT compensation may also operate at the level of central government.[608] Overall, studies seem to indicate that in general these schemes are having an impact on public sector bodies' choices, with the level of outsourcing of governmental activities increasing in Member States where refund schemes apply.[609] However, despite their potential advantages, these schemes also give rise to difficulties. Firstly, only in the Netherlands is refund given for non-national costs, thus creating inequality between national and non-national suppliers, as the level playing field is only achieved in relation to national suppliers. Secondly, in the Netherlands and the United Kingdom, the refund is only given for VAT costs relating to outside the scope activities, whilst in Denmark, Finland, and Sweden the refund also applies in relation to exempt activities. Both options have disadvantages: excluding exempt activities from the refund scheme signifies that in relation to these activities, VAT considerations will continue to influence the choice between self-supplies and outsourcing; on the other hand, the inclusion of exempt activities within the scope of the scheme will lead to an unequal treatment between private and public suppliers, as most exemptions will also apply to private suppliers.[610] Finally, the existence of these schemes in only some of the Member States creates inequality within the Community. Although public sector bodies of different Member States will typically not be in direct competition, the private enterprises offering outsourcing governmental services might be. In this context, private companies established in Member States, which have a refund scheme in place, will be at a competitive advantage to private companies established in Member States, which do not have such a scheme.

These special compensation schemes have traditionally been regarded as purely a financial operation and budgetary expenditure. As such, the Commission has so far considered them as falling outside the

608. Generally, a global distinction can be made between open and closed models; for a more detailed view of the several types of refund schemes applied see M.C. Wassenaar and R.H.J.M. Gradus, n. 605 above, and. H. van Dijk and G. Lubbers, "The VAT Compensation Fun(d)?" (2000) *International VAT Monitor* 1, 6–9.

609. *See* M.C. Wassenaar and R.H.J.M. Gradus, n. 605 above, at Tables 1 and 2. However, the effectiveness of Dutch scheme has been recently placed into question, see M.C. Wassenaar, E. Dijkgraaf and R.H.J.M. Gradus, "Contracting out: Dutch Municipalities reject the solution for the VAT-distortion", *Free University Amsterdam, Faculty of Economics, Business Administration and Econometrics, Series Research Memoranda No. 3*, 2007.

610. Norway operates a similar scheme for non-profit organisations, see O. Gjems-Onstad, "Refund of Input VAT to Norwegian NPOS" (2004) *International VAT Monitor* 4, 244–246.

scope of the EU VAT system.[611] Yet, consideration should be given to the recent ECJ jurisprudence, namely *Heiser*,[612] which indicates the Court's willingness to extend the principles it has developed as regards state aid to the field of VAT.[613] In light of the above, and in particular taking into account potential distortive effects to intra-Community trade amongst private enterprises offering outsourcing governmental services, it is conceivable that the Court would regard these schemes as illegitimate state aid, in contravention of Article 87 of the EC Treaty. It is worth to point out that most of these difficulties could disappear if a refund scheme was introduced at EU level, thus allowing for a set of harmonised rules to dictate compensation to public sector bodies for irrecoverable input VAT. Such a move would not necessarily be the best way forward however.[614]

(8) *Lack of effect on regressivity of VAT*. As highlighted above, there is a perception that exclusion of the products supplied by public sector bodies from full taxation, achieves social and distributional aims by increasing consumption of so-called merit goods, and diminishing the natural regressivity of VAT. Yet, the effectiveness of this tactic is far from clear. Firstly, in order to achieve both these aims the exclusion from the tax base must be reflected in consumer prices, and it is not obvious whether this is actually the case. In fact, recent experiments with recent VAT rates seem to indicate that the opposite is true.[615]

611. The compatibility of these refund schemes with the CVSD has been subject of a Parliamentary Question; former Commissioner Bolkestein replied on behalf of the Commission that such schemes do not conflict with the EU VAT system, see *Common VAT system – Eighth Directive, Written Question P-2861/99*, 7 January 2000, [2000] OJ C225E/211.

612. Case C-172/03, [2005] ECR I-1627, concerning Austria's transposition of the exemption applicable to medical services [Article 132(1)(c) of the CVSD].

613. *See* J. Swinkels, "State aid and VAT" (2005) *International VAT Monitor* 5, 311–316.

614. The argument is developed in R. de la Feria, n. 571 above.

615. In particular, the so-called "labour-intensive experiment", implemented in 1999, and whose aim was to test the impact of reduced rates of VAT on job creation, see Council Directive 1999/85/EC of 22 October 1999, OJ L277, 28/10/1999, 34. In 2003, a report from the Commission confirmed that the impact of the introduction of reduced rates of VAT on prices was minimal: when conducting price surveys, Member States found that reduced rates of VAT were reflected in consumer prices only partially or not at all and that at least part of the VAT reduction was used to increase the margins of service providers; where the VAT reduction had been passed on to the consumer Member States found that this was only a temporary measure and prices would subsequently increase – see *Experimental application of a reduced rate of VAT to certain labour-intensive services*, Report from the Commission to the Council and to the European Parliament, COM(2003) 309 final, 2 June 2003; and *Evaluation report on the experimental application of a reduced rate of VAT to certain labour-intensive services*, Commission Staff Working Paper, SEC(2003) 622, 2 June 2003.

> Secondly, it is widely accepted by economic commentators that indirect taxes are not an effective means of pursuing distributional goals, and it is far more efficient to tax as broadly as possible, using the yield to compensate low-income households.[616]

As a final point, and in light of the all-time goal of the efficient allocation of resources by governments, it is worth noting that all the difficulties highlighted here place extra costs and economic inefficiencies upon bodies, which are by nature funded by the taxpayer. Moreover, these costs should be put in the context of budgetary restraints – including, but not exclusively those resulting from the Economic and Monetary Union and the Stability and Growth Pact – which should imply not only cutting fiscal spending, but equally levying taxes more efficiently.[617]

3. New challenges facing the EU VAT system

The difficulties highlighted *supra*, which are generated by the current EU VAT system should be put in the context of the new challenges facing the EU, namely Economic and Monetary Union, the Lisbon Strategy, and the process of EU enlargement.

3.1. Economic and Monetary Union

In 1999, the European Union enter the third and final stage of the Economic and Monetary Union with the introduction of the Euro and the irrevocable establishment of conversion rates for the euro vis-à-vis the currencies of the

616. *See* A.A. Tait, n. 602 above, at 218. See also C.L. Ballard and J.B. Shoven, "The Value Added-Tax: The efficiency cost of achieving progressivity by using exemptions" in M.J. Boskin (ed.), *Modern Development in Public Finance: Essays in Honor of Arnold Harberger* (Oxford, B. Backwell, 1987), 109–129; and E.H. Davis and J.A. Kay, who provide amusing examples, illustrating the shortcomings of using the VAT structure as a mean to diminish its regressivity, n. 599 above., at 11–12.

617. As B. Genser and P. Winker highlighted in 1997, "fiscal consolidation is one primary target of all EU member countries in order to meet the fiscal discipline criteria of the Maastricht treaty. This not only implies cutting fiscal spending, but also levying taxes most efficiently. The important loopholes under general discussion are the erosions of the income tax base, giving rise to consolidating tax policy measures following a 'tax cut cum base broadening' strategy. There is much less discussion on loopholes in general commodity taxation through VAT exemption", in "Measuring the Fiscal Revenue Loss of VAT Exemption in Commercial Banking" (1997) *FinanzArchiv* 54(4), 563–585, at 563.

participating Member States.[618] As the European Union faces this new level of integration, the question which should be asked in the context of the EU VAT system is: what are the implications of this new challenge?

According to the Commission, one of the main benefits of the introduction of the Euro is the "reaping of full benefits of the EU's single market".[619] In fact, there is the expectation that a single currency will constitute a natural complement to the internal market, allowing it to function more efficiently and making it more conducive to growth, namely through the elimination of exchange rate fluctuations and of various transactions costs, enhanced competition, and price transparency.[620] Yet, the distortions to competition and the increased business costs, which as demonstrated *supra* are caused by the current EU VAT system, constitute an obstacle to achieving these objectives, and therefore, impede traders and consumers from taking full advantage of the economic advantages emerging from the EMU. Consequently, in the context of the EMU, dealing with the problems caused by the current EU VAT system has become (increasingly) imperative.

A further dimension to this challenge is the Stability and Growth Pact, which is regarded as one of the pillars of the Economic and Monetary Union aimed at ensuring budgetary discipline and low public debts within the Euro-zone after the entry into force of the third stage of the EMU. Adopted in 1997,[621] the Pact strengthened the Treaty provisions already in force as regards fiscal discipline in the EMU – Articles 99 and 104 of the EC Treaty – as well as the provisions included in Protocol on the Excessive Deficit Procedure annexed to the Treaty. Under these provisions, the following basic budgetary rules apply: Member States' budget deficits cannot exceed 3% of Gross Domestic Product; and government debt cannot exceed 60% of Gross Domestic Product. Whenever a Member State exceeds the public deficit criterion, the Commission will trigger the excessive deficit procedure in accordance with the rules established in Council Regulation

618. However, the process of transition to the Euro was only completed on 28 February 2002 when the former national currencies lost their status as legal currency.
619. See http://europa.eu.int/comm/economy_finance/euro/benefits/benefits_2_en.htm.
620. Prior to the introduction of the Euro, one of the main arguments in favour of a single currency was its link with the single market: "The Single Market will provide underlying economic support for Monetary Union and the euro will provide added value and efficiency to the Single Market", in *Action Plan for the Single Market*, Communication from the Commission to the European Council, CSE(97) 1 final, 4 June 1997, at 1–2. This idea was also captured vividly in the Commission's often used slogan, "one market, one money".
621. *See Resolution of the European Council on the Stability and Growth Pact*, Amsterdam, 17 June 1997, OJ C236, 02/08/1997, 1.

(EC) No. 1467/97 of 7 July 1997.[622] This procedure can ultimately lead to the imposition of sanctions and fines by the Council.

Despite being subject to constant criticisms,[623] the Pact continued to be implemented by the Commission, with several excessive deficit procedures being initiated against Member States.[624] In September 2004, the Commission finally initiated the official process of reforming the Pact by setting up its views in a Communication to the Council and the European Parliament.[625] Following the Commission's Communication, the Council delivered a report to the European Council outlining its proposals for "strengthening and clarifying the implementation of the Stability and Growth Pact". The report, however, which was endorsed by the European Council in March 2005,[626] does not include substantive reforms, but rather procedural ones, with the 3% and 60% reference values being maintained.[627] In this context, it is (particularly) imperative that all measures be taken in order to maximise efficiency within public finances. As highlighted *supra*, the current

622. OJ L209, 02/08/1997, 6.
623. The Pact has been the subject of controversy ever since it was approved; however, the controversy deepened in 2002, as several countries struggled to respect the deficit limits imposed by the Pact. In October 2002, the then head of the Commission, Romano Prodi, expressed his opinion to the French newspaper *Le Monde* that the Pact was "stupid" and "rigid". The Pact was immediately nick-named by the media as "stupidity pact", see "Budget rules are 'stupid', Prodi says", *BBC News*, 21 October 2002; "Farewell to the stupidity pact", *The Economist*, 22 October 2002; S. Castle, "'Stupidity Pact' crumbles as euro's foundation stone", *The Independent*, 23 October 2002. The controversy continued into 2003 to 2005, see "Budget compromise attracts EU ire", *BBC News*, 25 November 2005; S. Schifferes, "How to save the EU Stability Pact", *BBC News*, 5 December 2003; Q. Sommerville, "Stability Pact squabbles shake the euro", *BBC News*, 6 January 2004.
624. In the cases of France and Germany, these procedures have been particularly controversial and were at the core of a recent decision from the Court which opposed the Commission to the Council, see case C-27/04, *Commission v Council*, [2004] ECR I-6649. For an in-depth analysis of the Court's decision see D. Doukas, "The Frailty of the Stability and Growth Pact and the European Court of Justice: Much Ado about Nothing?" (2005) *Legal Issues of Economic Integration* 32(3), 293–312. Information on ongoing excessive deficit procedures can be obtained from Commission's Directorate-General for Economic and Financial Affairs website: http://europa.eu.int/comm/economy_finance/about/activities/sgp/procedures_en.htm.
625. *See Strengthening economic governance and clarifying the implementation of the Stability and Growth Pact*, COM(2004) 581 final, 3 September 2004. For a detailed overview of the several proposals, which have been put forward with a view to reforming the Stability Pact, see M. Buti, S. Eijffinger and D. Franco, "Revising the Stability and Growth Pact: Grand Design or Internal Adjustment?" (2003) *European Economy*, European Commission Economic Papers, No. 180, January 2003.
626. *See European Council Brussels 22 and 23 March 2005 – Presidency Conclusions*, paragraph 3 and Annex II, available at:
http://ue.eu.int/ueDocs/cms_Data/docs/pressData/en/ec/84335.pdf.
627. *See* D. Doukas, n. 624 above, at 310–312.

EU VAT system constitutes a clear obstacle to achieving this objective, and consequently, the need to attain it imposes extra pressure and urgency on the reform of the EU VAT system.

Finally, and still in the context of the EMU, it is important to note the role of tax sovereignty as a last instrument of economic policy. In economic terms, it is traditionally said that the Member States have three main instruments of economic policy: exchange rate policy, monetary policy, and fiscal policy. With the introduction of the Euro, two of these instruments are excluded, the other limited. In fact, the possibility of using the exchange rate policy and monetary policy, if limited before, is now inexistent. On the other hand, the access to fiscal policy is severely limited by the budget deficit restrictions imposed by the Stability and Growth Pact. This leaves Member States with little else other than the tax policy as an economic policy instrument, and as such, fiscal sovereignty has become even more important to Member States.[628] In this context, reaching unanimous Member States' agreement in relation to reforms of the EU VAT system, which will limit their power/freedom to establish their own VAT structure, will be particularly difficult.

The above clearly demonstrates what an immense challenge the EMU represents for the EU VAT system: on one hand taking full advantage of the benefits of the Euro and respect of the Stability and Growth Pact criteria demand an immediate reform of the EU VAT system; on the other hand, the fact that tax sovereignty will virtually be the last instrument of economic policy left to Member States, most likely implies that agreement on such reform will be almost impossible to achieve.

3.2 The Lisbon strategy

In March 2000, the European Council held a special meeting in Lisbon to agree on a new strategy for the European Union in order to strengthen

628. Even before the introduction of the Euro, authors highlighted the problem of fiscal sovereignty in face of the establishment of an EMU. A.J. Easson pointed out in 1993 that: "the fiscal implications of EMU are obvious and considerable. Of the three main instruments of economic policy, Member States will soon relinquish all control over exchange rate policy and will gradually, over the next five years or so, lose much of their control over monetary policy. They will, thus, be left with fiscal policy alone, yet the requirements of the Internal Market are such that a substantial degree of convergence of fiscal policies is also required. Moreover, there is a clear linkage between fiscal and monetary policy, with the result that decisions taken within the framework of the EMU must necessarily have an impact upon national fiscal policies", n. 220 above, at 18–19.

employment, economic reform, and social cohesion as part of a knowledge-based economy. From this meeting emerged a new strategic goal for the next decade (2010): "to become the most competitive and dynamic knowledge-based economy in the World, capable of sustainable economic growth with more and better jobs and greater social cohesion".[629] In order to achieve this goal, the Council established an overall strategy aimed at, amongst others objectives, "stepping up the process of structural reform of competitiveness and innovation and completing the internal market".[630]

Four years since the approval of the Lisbon Strategy – as it is known – the EU institutions remained committed to its goal and objectives as reiterated by the Brussels European Council meeting held in March 2004, which stated that "the continuing validity and relevance of the Lisbon process is not in doubt".[631] This commitment was also significantly reinforced from the recently published report from the High Level Group, chaired by Wim Kok, set up to carry out an independent mid-term review of the Strategy. The report concluded that although some of the targets will be missed, the ambition to achieve the strategic goal is "needed more than ever".[632] The results of this report have been effective in convincing the European Council that "urgency is called for" and on the need for the "relaunch the Lisbon Strategy without delay".[633] The Lisbon Strategy was finally re-launched in 2005 with a new emphasis: Growth and jobs. In December 2007, the Commission showed optimistic about the results post re-launch, highlighting that "the economy is performing much better than it was in 2005" and that "the growth figures are strong".[634] At the same time, it also launched a programme of activities for the period 2008-2010, designated Community Lisbon Programme (CLP). Amongst the main objectives stated is to "strengthen the single market, increase competition in services", and on this regard, it reiterated that "work will continue to reduce compliance costs resulting from the tax fragmentation of the internal market in particular from SMEs".[635]

629. *Lisbon European Council 23 and 24 March 2000 – Presidency Conclusions*, at paragraph 5.
630. Id. at paragraphs 5 and 14 to 23.
631. *Extracts from Presidency Conclusions on the Lisbon Strategy by Theme*, European Councils: Lisbon (March 2000) to Brussels (June 2004).
632. *Facing the Challenge – the Lisbon Strategy for Growth and Employment*, Report from the High Level Group chaired by Wim Kok, November 2004, at 12–13.
633. *See* n. 626 above.
634. *Strategic report on the renewed Lisbon strategy for growth and jobs: launching the new cycle (2008–2010) – Keeping up the pace of change*, Communication from the Commission to the Spring European Council, COM(2007) 803 final, 11 December 2007, at 2.
635. *Proposal for a Community Lisbon Programme 2008–2010*, Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, COM(2007) 804 final, 11 December 2007, at 8 and 9 respectively.

The implications of the Lisbon Strategy and the CLP for the EU VAT system are clear:[636] VAT obstacles to intra-community trade which prevent the establishment of the internal market, which directly and indirect impair the efficient functioning of the internal market, and which distort competition, have to be removed if the strategic goal is to be achieved.

3.3. EU enlargement

In May 2004, ten new Member States joined the European Union: Czech Republic, Cyprus, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, and Slovenia. In 2007, two more countries became Member States: Bulgaria and Romania. Additionally, there are also three so-called candidate countries – Croatia, Former Yugoslav Republic of Macedonia, and Turkey – and many more proposed candidate countries. Overall, within a few years the European Union will have expanded from 15 Member States to potentially 40. Such a sizeable enlargement has had, and will continue to have, various implications in terms of the EU VAT system.

Similarly to the Economic and Monetary Union, enlargement of the European Union constitutes a great opportunity not only for economic growth across Europe, but also for achieving the ultimate goal of the Lisbon Strategy. However, the difficulties which the current EU VAT system poses to those engaging in intra-Community trade, namely in terms of costs, and the distortions to competition which emerge from that system, constitute an obstacle to fulfilling these opportunities and taking full advantage of the economic benefits which may emerge. In this context, dealing with the problems caused by the current EU VAT system has also become imperative if all Member States (both current and future) want to take full advantage of the opportunities which may arise from enlargement.

636. The connection between the Lisbon Strategy and the reform of the EU VAT system has been established more than once at official level, most notably in the recent Communication from the Commission entitled *The Contribution of Taxation and Customs Policies to the Lisbon Strategy*, Implementation of the Community Lisbon Programme, COM(2005) 532 final, 25 October 2005. See also a Communication from the Commission on the consolidation and extension of the Lisbon Strategy reflecting the need to amend VAT rules in relation to e-commerce and electronic invoicing, *Realising the European Union's potential: Consolidating and Extending the Lisbon Strategy*, Communication from the Commission, Contribution of the European Commission to the Spring European Council, Stockholm 23–24th March 2001, COM(2001) 79 final, Vol. I, 7 February 2001. Finally, the Kok Report also made specific reference to the need to minimise VAT compliance costs and the importance of establishing a one-stop-shop, n. 632 above, at 28.

Additionally, it is important to acknowledge the challenges posed by enlargement in the context of the legislative procedure applicable to VAT: achieving agreement on amendments to EU VAT rules will undoubtedly prove to be a much more difficult task as the enlargement continues. On one hand, and as discussed in Chapter 1, under Article 93 of the EC Treaty, approval of VAT legislation requires the unanimity of the Council – achieving the unanimous agreement of 15 Member States has proven to be extremely difficult, achieving the unanimous agreement of 29 Member States might prove impossible. On the other hand, the political willingness to compromise, which naturally exists prior to accession, might not be there post-accession.

In this context, it would seem that the wisest approach would be to undertake the much needed reform of the EU VAT system prior to further enlargement, not only in view of the fact that a reform is imperative in order to take full advantage of the opportunities which can emerge, but also because reform post-enlargement will be much more testing to achieve. Unfortunately, the opportunity for reform prior to the 2004 enlargement has been missed. The challenge is then not to miss the opportunity for reform prior to future enlargements.