

## Potential Difficulties in the Administration of VAT at the Accession to the EU<sup>1</sup>

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1. The administration of the regular (“invoice based”) value-added tax assumes customs control of imports and exports of goods and a tax (crosscheck) control of accounts (sales and purchases) of the taxpayers in internal transactions. For this reason, in the countries with federal or even looser (confederate) arrangements, the value-added tax is more difficult to implement. The main reason are separated information flows on the transactions of taxpayers. In fact, the information systems (access and processing of data bases) are separated by the federal units. The difficulties are even greater in places where the customs service is organized by statute only at the federal level. That makes crosscheck control of taxpayers all the more difficult, owing to it being dependent on an additional large number of information exchanges (communications) among the tax services of federal units and between tax and customs services. Even in the best case scenario, that is on the assumption that the communication among tax services is ideal, control of the taxpayers is significantly more time-consuming. The difficulties may arise even in the politically centralized states provided the tax service is decentralized, and even with a centralized tax service, in the case the service is organized by the type of tax rather than by the [type of] taxpayer. The reason is the same: the information flows on transactions, and (potentially) separate information systems for different types of taxes.

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3. See for example *Application of Council Regulation (EEC) No. 218&92 on Administrative Cooperation in the Field of Indirect Taxation (VAT)*, 1994/5.

In a confederation or in an economic union of states (such as, for instance, the EU) the difficulty with administration of the value-added tax is even significantly higher if effective customs control has been abolished among the members (of a confederation or a union); that is, this abolishes one of the two key pillars of administration of the value-added tax (specified according to the principle of destination).

2. In 1992, the EU abolished customs control among its members. In order not to disrupt the administration of value-added tax, in transactions among the members (sales and purchases between taxpayers of different members) the crossing of border was simulated (transactions between taxpayers of the member countries were defined as “supplies” and “acquisitions” instead of exports and imports, respectively)<sup>3</sup>. At the same time, the VIES system (VAT Information Exchange System) was introduced, which has facilitated (direct electronic) drawing of information on transactions between members and on the activities (personal-controlled) of taxpayers from separate information systems of VAT member countries. In addition, in each member country a single institution (CLO, Central Liaison Office) was established for all communications among the members required for the administration and putting into force of VAT (in principle, it should enable access to all information for control of the taxpayer taxation).

3. Despite this set-up of the system, the difficulties in acquiring information on transactions between the taxpayers inside the EU are ever greater. Great delays in responses also allow systematic abuse – tax evasion on a large scale because the delays are so great that in the intervening period fictitious enterprises are still being able to be opened and closed. In fact, the agreed deadline for replies (3 months) in certain countries is missed by far (in Italy, for instance, 20 percent of all claims miss the deadline, in France 17 percent, in the Netherlands 13 percent and in Germany 9 percent). Such delays occur even with the current very small number of claims; out of 1.5 million transactors-payers within the member countries, the assistance through the CLO system of other member countries was requested on average for only 30,000 payers (2 percent). And even with such a low number the EU commission

estimates that member states give too few resources and too few staff in support of the control of these transactions (for CLO and VIES).<sup>1</sup>

4. A comparison of the effectiveness of administration in the EU with similarly developed economies<sup>2</sup> outside of the union would correctly demonstrate the (in)effectiveness of value-added tax administration in the EU only in the case that the value-added tax in the economies under comparison had similar basic characteristics of value-added tax as in the EU. I am not aware of any published analysis which deals with such a comparison. Different ideas for an increase in the effectiveness of value-added tax administration are currently in circulation. For instance, one can track proposals to increase the effectiveness of value-added tax that rely on the substitution of the principle of “source” for the principle of “destination.” If one takes into account the current difficulties in tax administration, such substitution would be only partly useful because even in such a version of VAT the customs service would have a leading role at the border (in this version of value-added tax, the export good would cross the border as taxed, while the import good would not be taxed).

Slovenia introduced an “EU” value-added tax (with some nonstandard products in the group that is taxed at a lower rate<sup>3</sup>). Furthermore, Slovenia is underdeveloped in comparison with the EU. Notwithstanding that, tax revenues in Slovenia are higher; the average tax revenues are 9.5 percent of GDP, and revenues per unit of standard rate are slightly higher than 0.5 percent of GDP, while in the EU the average revenues are 6.5 percent of GDP and the simple average of revenue per unit of standard rate is 0.36 percent of GDP. Such a large difference in payment of taxes (“compliance” of taxpayers) very probably is not only the consequence of a lower effectiveness of taxation in the EU; in any event, the difference indicates great potential vulnerability of Slovenia at the accession to the EU because.

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1. *Taxation: the Commission proposes strengthening cooperation to combat VAT related fraud*, IP/01/857, 2001

2. The development of the economy to a large degree determines the scope of taxation (“compliance” of taxpayers (see, C. Silvani and J. Brondolo, 1993, *An Analysis of VAT Compliance*, Technical Papers and Reports of the CIAT Technical Conference , Italy)

3. For instance, preparation of food and wine.

Owing to a relatively poor communication of the member countries in control of taxpayers, Slovenia would “come up short” for at least three reasons: great openness of the economy, large sales and purchases in the EU and the small size of the economy. One has to take into account small likelihood of preparedness (of tax services) of partners to support control of transactions of Slovenian taxpayers in key export markets of Slovenia (Italy, Great Britain, Germany and others) which would be at least similar to that in the cases of much larger and long-standing members of the EU, because the response (even though slow) of CLO units (that is, tax services of the member countries) is (and will be) quite certainly linked to the size of their counterclaims – and those are negligible with respect to the transactions of other resident taxpayers (because of miniature size of Slovenia).

5. Hypothetically, it is possible to produce an approximate estimate of the decrease in revenue due to a change in administration of value-added tax in transaction “in” and “out” of the EU. It is reasonable to assume that, with the existing (actual) level of support of control of the taxpayer taxation among the member countries, the accession to the EU would lower the effectiveness of administering the taxation of value-added tax approximately to the effectiveness of taxation of corporate income. Because with the income tax approximately 9.6 percent of the tax is collected through direct control of the taxpayer, and because the number of controls (checks) of VAT payment with juridical persons would fall from the current near 20 percent to 2 percent, the corresponding lowering of revenue on value-added tax from imports (with the absence of customs service at the border) could reach up to 8.6 percent in comparison to the current rate of revenue; therefore, the tax service would be able to identify that much less tax evasion due to dependence of control of the taxpayers on (small) available scope of information from tax services of other EU member countries. In the meantime, while the tax service currently checks tax payments of about 20 percent of taxpayers (among the juridical persons), in the EU it would have support for control of only about 2 percent of all taxpayers who would be participating in transactions with the taxpayers from member countries of the EU. Because the imports from EU account for approximately 68 percent of all imports, the shortfall (under other conditions being the same as in 2001) would easily exceed 0.5 percent of GDP.

6. The burden of DURS [Tax Administration of the Republic of Slovenia] is much higher than the standards in the EU. In the EU, there are 3,000 inspectors who annually conduct 600,000 checks (20 checks per inspector a year), while in Slovenia an inspector conducts around 35 checks a year<sup>1</sup>. Because, in the estimates of the EU commission, even now the system that provides overall support of the VAT administration in transactions among different member countries (CLO and VIES) is too weak in most of the member states in terms of staffing and material resources, it is likely that the EU requirements for the establishment of a CLO and VIES system (both in terms of resources and staff) would be substantially higher than those that are expected in Slovenia.