VALUE ADDED TAX: THE CONCEPT AND CURRENT PROGRESS TOWARDS HARMONIZATION IN THE EUROPEAN ECONOMIC COMMUNITY

DAVID V.G. de PASS*

Taxation is an essential element to the shaping of economic and social policy and has, in the past, provoked reactions as extreme as violent revolution. Value added tax (VAT) is no exception in that it is a vital element of the economic union of the European Economic Community (EEC), but, to date, it has not provoked such a turbulent reaction.

The Treaty of Rome\(^1\) seeks to establish an economically integrated Common Market\(^2\) in which would prevail conditions "analogous to an internal market," notably free movement of goods, persons, and capital and unified economic and social policies.\(^3\) This goal is inconsistent with the existence of numerous divergent national legal and fiscal systems throughout the various stages of the economic process. The Common Market is to be achieved \textit{via} a customs union,\(^4\) but even though internal tariff barriers have now been removed,\(^5\) other factors continue to have the equivalent effect of impeding economic unity.\(^6\) In particular, the

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2. It shall be the aim of the Community, by establishing a Common Market and progressively approximating the economic policies of Member States, to promote through the Community a harmonious development of economic activities, a continuous and balanced expansion, an increased stability, an accelerated raising of the standard of living and closer relations between its Member States. \textit{Id.} art. 2.

3. \textbf{REPORT OF THE FISCAL AND FINANCIAL COMMITTEE} 104 (H. Thurston trans. 1962) [hereinafter cited as the \textbf{NEUMARK REPORT}].

4. Treaty of Rome, supra note 1, art. 9. The effect of the customs union is the abolition of all customs duties on imports and exports, establishing more freedom of movement of goods as between the Member States of the EEC. \textit{Id.}

5. This customs union was achieved on January 1, 1970.

6. For example, although the customs union has removed tariff barriers, an increase in
incidence of taxation can have a marked effect on commercial activities and living conditions, resulting in incentives or disincentives to business and personal mobility. Article 99\textsuperscript{7} of the Treaty of Rome provides only for the harmonization of indirect taxes, but when read together with article 100\textsuperscript{8} and the Treaty's wider general provision for the approximation of laws which directly affect the functioning of the Common Market,\textsuperscript{9} it is clear that the harmonization of other types of taxation, such as direct tax and company tax, was also envisaged. Priority is, however, given to indirect taxes because of their direct effect on trade.\textsuperscript{10}

The purpose of this article is to examine the need for the harmonization of indirect taxation, the EEC's choice of the VAT system, the concept of the tax, and its role in the harmonization program. The recent Sixth Council Directive\textsuperscript{11} has brought the harmonization program to its current stage; the more significant provisions of this measure will be considered. Although it is beyond the scope of this study to examine in detail the economic aspects and impact of the harmonization program on each Member State, these considerations will be treated where directly relevant to the overall plan of harmonization.

I. THE NEED FOR HARMONIZATION OF INDIRECT TAXES AND THE CHOICE OF VAT

Article 99\textsuperscript{12} of the Treaty of Rome provides that the Commiss-

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7. See note 12 infra.
8. See note 94 infra.
12. The Commission shall consider in what way the law of the various Member States concerning turnover taxes, excise duties and other forms of indirect taxation, including compensatory measures applying to exchanges between Member States, can be harmonized in the interests of the Common Market.

The Commission shall submit proposals to the Council which shall act by means of a unanimous vote, without prejudice to the provisions of Articles 100 and 101.
sion shall consider how the legislation of Member States concerning indirect taxation can be “harmonized” in the interest of the Common Market, while articles 95 through 98 are transitional provisions designed to check abuses resulting from governmental manipulation of border tax adjustments until such harmonization is achieved. “Harmonization” is a vague term which implies that the indirect taxation systems of Member States need not be unified provided they do not disturb the functioning of a competitive economic union. The concept of harmonization assumes the existence of divergences in national policies and indicates the process of adjusting national fiscal regimes in order to bring them into line with the economic aims of the EEC.

When the EEC came into being, there were two formidable problems the solution of which called for a common, harmonized system of indirect taxation. These were the fiscal distortion of competition by the existing cascade turnover taxes, and the existence of tax frontiers between Member States. The Treaty of Rome calls for the institution of a system which ensures that competition is not

Treaty of Rome, supra note 1, art. 99.

The Commission consists of nine members appointed by the governments of the Member States acting in common agreement. The Commission performs the functions of ensuring application of the Treaty and formulating recommendations concerning its implementation. Id. arts. 155-163.

Article 95 provides, in pertinent part:

A Member State shall not impose, directly or indirectly, on the products of other Member States any internal charges of any kind in excess of those applied directly or indirectly to like domestic products.

Article 96 provides:

Products exported to the territory of any Member State may not benefit from any drawback of internal charges in excess of those charges imposed directly or indirectly on them.

Article 97 provides, in part:

Any Member States which levy a turnover tax calculated by a cumulative multi-stage system may . . . establish average rates for specific products or groups of products, provided that such States do not infringe the principles laid down in Articles 95 and 96.

Since the Member States have now adopted a common system of VAT enabling the precise tax element to be calculated, article 97 has become obsolete.

Article 98 provides, in part:

With regard to charges other than turnover taxes, excise duties and other forms of indirect taxation, exemptions and drawbacks in respect of exports to other Member States may not be effected and compensatory charges in respect of imports coming from Member States may not be imposed, save to the extent that the measures contemplated have been previously approved for a limited period by the Council

Treaty of Rome, supra note 1.


16. 2 C. SHOUP, FISCAL HARMONIZATION IN COMMON MARKETS 210 (1967).
distorted within this internal market. A sound competition policy requires that starting conditions be as equal as possible and that prices are not distorted by such artificial factors as monopolies, market sharing arrangements, or the manipulation of internal taxation systems. The intention is that producers should not be affected by national measures designed to protect trade and, as a result of the consequent free competition, that consumers would have a wider choice of goods at competitive prices. Furthermore, tax frontiers at which goods and factors of production would be inspected and subjected to tax adjustments were considered to be inconsistent with the objective of free movement of goods, persons, and capital.

Prior to the introduction of the common VAT system, the Member States, with the exception of France, levied taxes on goods at each transaction in the chain of production. A cumulative or “cascade” element resulted from the fact that there was no provision for offsetting prior tax payments, and, therefore, the tax was calculated on a price which already included an element of tax. Consequently, tax liability varied according to the number of production stages through which the item, its components, and equipment had passed. This liability could be reduced by decreasing the number of inter-firm sales, and thus, the cascade turnover tax system had anticompetitive tendencies in that it encouraged the vertical integration of business and penalized the specialist and nonintegrated manufacturer.

The cascade turnover taxes were levied according to the “desti-

17. Treaty of Rome, supra note 1, art. 3(f).
20. In addition, various “natural” factors, such as climate and geographical location, influence the cost of goods and services. It would not, of course, be realistic or desirable for the EEC to attempt to compensate for these.
21. Competition Policy, supra note 19, at 3.
22. France was the first European country to adopt a system of tax on value added. In 1954, the taxe sur la valeur ajoutée or “TVA,” as it was called, was introduced and initially applied to goods at the wholesale stage. However, in line with EEC policy, it was subsequently extended to cover the retail stage and the supply of services. For a discussion of the history and reform of the turnover taxes, see Schmolders, Turnover Taxes, in Developments in Taxation Since World War I iv-7, iv-53-56 (1966).
nation principle" under which goods were subject to the tax laws of the country in which they were consumed, irrespective of the situs of production. 24 This principle was used because one of the goals of indirect taxation is to tax the expenditure of final consumers, and it would therefore be contrary to the international rules delimiting fiscal sovereignty for one nation's tax on consumption to affect the purchasing power of foreign nationals. 25 To be consistent with the principle that these taxes are directed at taxing domestic consumption, they must be levied on both foreign and domestic goods; but, in order to avoid double taxation and competitive distortions, exports must be exempted. 26 Consequently, the prior taxes on exported goods are refunded so that the tax levied by the importing country is the only tax that the goods bear. Thus, in theory, both foreign and domestic goods receive equal tax treatment. This is in line with the provisions of the General Agreement on Tariffs and Trade (GATT) 27 which prohibit governments from subsidizing exports and discriminating against imports through manipulative use of internal taxation systems. 28

The difficulty with the cascade turnover taxes was that, since the tax component varied with the number of prior inter-firm transactions, it could not be calculated with precision, and therefore the border tax adjustments could only be mere approximations. The Member States resorted to "average rates" which were temporarily permitted by the Treaty of Rome. 29 These average rates did not provide the ideal neutrality required in international trade — namely, that the tax levied on imports should equal the tax levied on similar domestically produced goods, and that export rebates should equal the domestic tax burden that the exported goods have borne. 30 If a country overestimated the turnover tax element to be rebated on its exports, and thereby overestimated the turnover tax to be levied on its imports, the border tax adjustment would pro-

24. For a discussion of the "destination" and "origin" principles, see Neumark Report, supra note 3, at 145-49.
25. Border Tax Memorandum, supra note 18, at 3.
26. Id.
28. See id. arts. III & XVI.
29. See Treaty of Rome, supra note 1, arts. 97 & 98.
30. Shooup, supra note 16, at 445. It has been claimed, however, that it is not the rate differentials, per se, that reflect the competitive effects of the border tax adjustments, but rather the degree to which the taxes are shifted forward. See Surrey, Implications of Tax Harmonization in the European Common Market, 46 Taxes 398, 410 (1968).
vide a competitive disadvantage to these imports on the domestic market because the higher tax would artificially increase the cost of these goods as compared with similar domestically produced goods. Conversely, an underestimation of the amount to be rebated would provide a competitive advantage to imports. Prior to the establishment of the customs union, a competitive advantage of this type could be offset by a supplementary import duty. However, as customs barriers began to disappear, this was no longer possible and the Member States gradually increased their rates of rebate on exports and their levies on imports. This trade distorting effect was amplified when governments deliberately manipulated border tax adjustments for protectionist purposes.

Ultimately it is the objective of the EEC to produce a situation in which the "origin principle" will be used. This would mean that the tax laws of the country in which the goods or services are produced would govern regardless of the country of consumption and, therefore, the drawbacks and countervailing taxes would become obsolete. Internal fiscal frontiers would no longer exist, but the "destination" principle would be retained for trade with non-Member States.

In addition to the foregoing problems, the varying tax structures of the Member States contained their own inherent distortions and complexities. Therefore, solution of these problems required

32. See notes 4 and 5 supra.
34. Italy, for example, has engaged in border tax manipulations. See Agence Europe, May 5, 1969 as cited in H. Wallace, W. Wallace & C. Webb, Policy Making in the European Communities 267 n.5 (1977) [hereinafter cited as Wallace & Webb].
35. Neumark Report, supra note 3, at 147.
36. A. Tait, Value Added Tax 68 (1972). Tait explains the retention of the "destination" principle with respect to countries outside the EEC.

Under the destination principle, the country which exempts its exports from the VAT, automatically looses the revenue. This revenue accrues instead to the country that imports the goods and imposes on them a VAT equal to the VAT borne by similar domestic goods. Thus, under the EEC's present destination principle, the VAT revenue on an exported product does not accrue to the government of the country where the value is added. This is why the eventual aim of the EEC is to adopt the origin principle between member countries. But at the same time . . . , they would apply the destination principle to countries outside the EEC. In this way, the EEC members would apply the same VAT rate in each country and the revenue from this would accrue to the government of the country where the good was produced. Exports from the EEC would be exempted from the VAT, but imports into the EEC would be liable to the standard rate of the VAT on similar goods produced within the Community.

Id. at 17.
37. Surrey, supra note 30, at 398-99. The French taxation system provides an example
the institution of a common indirect taxation system possessing the necessary characteristics to avoid the abuses of the cascade turnover taxes and to form a basis for the subsequent abolition of tax frontiers. In addition to the above factors, the choice of a new system was governed by two further criteria; namely, it should guarantee a relatively high revenue yield and operate in such a way as to enable Member States to administer and collect the tax. 38

The decision to adopt VAT as the basis of the indirect tax harmonization plan was not taken immediately, since it was important that the new system should not raise more problems than it solved. After publication of the report of the first working group in December, 1959, 39 the Commission set up three subgroups of financial experts and appointed the Fiscal and Financial Committee, headed by Professor Fritz Neumark, to study the question of fiscal harmonization. Their reports, 40 published in 1962, recommended a value added tax system as being more economically neutral than the cascade turnover taxes and as a suitable instrument to lead to the abolition of tax frontiers through the application of standard tax rates 41 to a uniform tax base. The Commission was satisfied that these studies were valid and sufficiently thorough to constitute a basis for its decision. 42 Thus, it endorsed the VAT system as a method of making the Common Market function more efficiently and to “smooth” the way to economic integration. The VAT was also to be a source of direct revenue for the Community. 43 After some initial controversy and setbacks, 44 the Council formally

of the complexities in the internal structures of the Member States. The tax structure of France consisted of a 25% VAT on manufactured goods, a retail sales tax on handicrafts, a sales tax on services, and a variety of taxes on gasoline, entertainment, and food. In turn, each of these taxes provided exemptions and options leading to a maze of disparate tax rates and structures. Id. at 399.

39. See WALLACE & WEBB, supra note 34, at 252.
40. See note 3 supra.
41. Id.
42. Commission Statement, supra note 10, at 100.
43. Beginning in 1978, a percentage of each country’s returns was to be transferred to Brussels. WALLACE & WEBB, supra note 34, at 255.
44. Controversies and setbacks occurred at two levels of implementation of the VAT. Delays occurred at the intergovernmental level as between the members of the EEC and at the intragovernmental level with internal developments within the Member States. The problem at the intergovernmental level was deciding which common taxation method was appropriate to apply in nine countries with widely divergent fiscal backgrounds. Once the decision was reached, the problem remaining was how to implement that taxation method within the institutional framework of each individual government and its domestic constituencies. For
adopted VAT in its two Directives of April 11, 1967.\textsuperscript{45} In order to appreciate fully the role of VAT in the harmonization program, it is essential to understand the concept and operation of the tax.

II. VAT — THE CONCEPT AND HOW IT WORKS

Before examining the tax base, it is useful to bear in mind some of the main objectives of VAT. These objectives include: (1) the widest possible taxation of the consumption of goods and services, the tax being levied in installments at all stages of production and distribution; (2) the achievement of the same tax effects as a retail sales tax, irrespective of the number of prior transactions; (3) economic neutrality by avoiding discrimination against certain forms of industrial organization; and (4) impartiality in the treatment of domestic goods and imports.\textsuperscript{46}

There are basically three versions of value added tax: the "gross product" type, under which the tax base conforms to the gross national product; the "national income" type, under which the tax base is the total of the value added within the country; and the version adopted by the EEC, namely, the "consumption" type, under which the tax base is domestic personal consumption. The basic distinction between these three versions is reflected in the varying treatment of capital.

Under the gross product type, the tax base does not permit a deduction of input tax — the VAT paid by a supplier on his purchases — for the purchase or depreciation of capital assets.\textsuperscript{47} Under the national income version, however, the input tax can be spread over the estimated useful life of a capital asset.\textsuperscript{48} The consumption type differs from the other two versions in several re-


\textsuperscript{46} TAIT, supra note 36, at 1.

\textsuperscript{47} U.S. ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS, THE VALUE-ADDED TAX AND ALTERNATIVE SOURCES OF FEDERAL REVENUE 3, 19-20 (1973) [hereinafter cited as U.S. ADVISORY COMMISSION REPORT].

\textsuperscript{48} SCHENK, supra note 31, at 6-7. "Each year, the taxable person would claim an input tax deduction for a portion of the input tax charged on the capital purchases. Thus, the
spects. Its tax base allows input tax to be deducted at the time of purchase of capital assets.\textsuperscript{49} Additionally, instead of forming part of the national value added, exports are subtracted from, whereas imports are added to, the value added base, and the value of certain professional services do not form part of the tax base even though they add to the gross national product.\textsuperscript{50}

Various claims have been made as to the relative merits of the above types. On balance, however, it would appear that the consumption version has the most significant advantages. It provides the most neutral treatment between consumption and savings, and between the use of labor and capital services in production in that the tax does not alter the relative cost, to any particular class of individuals, of consumption and savings, nor the relative cost to any producer of using labor or capital production.\textsuperscript{51} In contrast, the national income type is biased against savings and capital, and the gross product type increases this bias\textsuperscript{52} since the input tax on both the purchase and depreciation of capital is not deductible and, therefore, must be absorbed by the firm making the purchase.\textsuperscript{53} The consumption type has administrative advantages in that there is no need to be concerned with arbitrary depreciation allowances, nor to distinguish between capital and intermediate goods.\textsuperscript{54} Furthermore, the consumption type assists new businesses in that the VAT element in capital expenditure can be deducted in the year of purchase; thus, it provides a tax incentive for capital investment.\textsuperscript{55}

In effect, the EEC consumption type is an \textit{ad valorem} tax on the domestic consumption of wealth, being distinguishable from a retail sales tax in that it is collected by fractions in proportion to the value added at each stage of production and distribution. Although

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\textit{national income version provides a depreciation-like recovery for the VAT component in purchased capital goods.} \textit{Id.} at 7.

\textsuperscript{49} \textit{Id.} at 7.

\textsuperscript{50} \textit{Tait, supra} note 36, at 19.

\textsuperscript{51} \textit{C. McLure \& N. Ture, Value Added Tax: Two Views} 72 (1972).

\textsuperscript{52} \textit{Id.}

\textsuperscript{53} \textit{Schenk, supra} note 31, at 6. The gross product version is not a consistent tax in that it imposes a double burden on investment goods while taxing labor only once. Investment goods are taxed first when they are purchased by a firm and then again when depreciation charges are reflected in the price of consumer goods. \textit{Shoup, supra} note 16, at 28.

\textsuperscript{54} \textit{U.S. Advisory Commission Report, supra} note 47, at 22. Computing allowances for depreciation of capital for a given year is a complex procedure that requires a determination of whether the asset is a capital asset entitled to depreciation. Since the entire value of the capital asset is deducted in the year of purchase, the consumption type avoids these administrative complexities. \textit{Id.}

\textsuperscript{55} \textit{Schenk, supra} note 31, at 7.
it is collected at each stage, the use of a tax credit system enables the ultimate burden to be passed on to the final consumer.

Consumer spending is a wide base and hence VAT is capable of producing large amounts of revenue at relatively low rates. Theoretically, it is desirable that VAT should apply as broadly as possible and, therefore, that exemptions should be limited. Nevertheless, provisions have been made for exemptions which can be grouped conveniently into three categories: exports; transactions which are wholly exempt; and transactions which are subject to a zero rating.

The EEC currently operates its VAT system on the destination principle. As noted above, this principle is designed to tax only the internal consumption of wealth. Therefore, in order to avoid the distorting effects of double taxation, this principle requires that exports be consistently exempted throughout the Member States until the origin principle is instituted.

In contrast, total exemptions and zero ratings are not, as yet, consistently applied in each Member State, though the Sixth Directive seeks to standardize these within the foreseeable future. Where a totally exempt transaction is involved, there is no liability to account for VAT nor, generally, are there any administrative requirements. The national exchequer receives the VAT paid by prior “taxable persons” who can reclaim their input tax, but “the burden of the tax falls at the exempt stage” since the trader undertaking the exempt transaction cannot invoice his purchaser and therefore cannot obtain a credit for the VAT invoiced to him. Total exemption is therefore not as advantageous as it might superficially seem, but it is useful for relieving transactions at the end of the chain where a measure of relief is considered worthwhile.

The zero rating differs from the total exemption in that it is a technical device designed to result in totally exempting certain transactions from VAT. Although the tax is technically applicable,

56. Both the Second Directive, supra note 45, and the Sixth Directive, supra note 11, have sought to limit and standardize exemptions.
57. See text accompanying note 24 supra.
58. Sixth Directive, supra note 11, art. 28.
59. Such administrative requirements include, for example, registration under the conditions set by the national administration.
60. Taft, supra note 36, at 20.
62. Id.
the fact that the actual rate is zero means that a credit can be claimed and offset against this nil liability, thus enabling recovery of the input tax. In the case of the total exemption, however, there is no tax liability against which the tax currently paid can be offset, and hence this input tax must either be absorbed or passed on. The zero rating is justified only in exceptional circumstances since both the Member State and the EEC must bear a loss whenever it is applied.

Generally, the wider the tax base, the lower is the VAT rate needed in order to produce a specific revenue yield; conversely, as the tax base is narrowed — for example, by providing increased exemptions — a higher rate is required to produce the same yield. Currently, there are wide disparities in the rates levied by Member States. The standard rate is as low as eight percent in the United Kingdom and as high as twenty percent in Ireland, while in the countries which levy multiple rates, the lowest reduced rate is one percent in Italy and the highest increased rate is forty percent in Ireland. These rate divergences reflect several factors, notably, the degree of reliance for yield on indirect versus direct taxes, economic, social, and political considerations. At present, the rates imposed are at the discretion of each Member State, although the ultimate plan is to adopt a common rate structure throughout the EEC.

In examining how the VAT operates, it will be helpful to consider the method of calculation before examining the procedure used to relieve intermediate suppliers from tax liability. The EEC chose the subtractive, tax exclusive, indirect method primarily be-

63. TAIT, supra note 36, at 32.
64. Id. at 33.
66. Answer to Written Question No. 231/77, Brussels 20/9/77 (copy on file with California Western International Law Journal).
67. The official view is that a common rate structure will bring economic neutrality. However, the point has been made that each country’s rate structure is geared to maintaining a domestic economic balance, and it is the interaction of these economic balances, rather than the mere divergences in rates, which may have a negative impact on trade. See Van Hooft, THE GENERAL IMPLICATION OF A COMMON MARKET, in VALUE ADDED TAX IN THE ENLARGED COMMON MARKET 11 (G. Wheatcroft ed. 1973). According to this viewpoint, the focus is on the degree of economic progress required in order for the full benefits of harmonization to be realized.
cause of its emphasis on the tax content, the lack of which was one of the major drawbacks of cascade turnover taxes.

The calculation is made by subtracting the cost of goods and services from gross receipts, applying the rate of tax to the tax base, exclusive of the tax element, and, finally, calculating the value added and the consequent tax liability. The VAT element is kept separate from the net cost of the goods or services and transmitted from stage to stage until ultimately paid by the consumer. The following example, using, for convenience, a VAT rate of ten percent, serves as an illustration.

<table>
<thead>
<tr>
<th>Transaction between &quot;taxable persons&quot;</th>
<th>Selling price (exclusive of VAT)</th>
<th>VAT at 10%</th>
<th>Value added by seller at each stage</th>
<th>Proportion of VAT paid by seller to national exchequer</th>
<th>Proportion of VAT received by seller in reimbursement</th>
</tr>
</thead>
<tbody>
<tr>
<td>A sells to B</td>
<td>40</td>
<td>4</td>
<td>40</td>
<td>4</td>
<td>—</td>
</tr>
<tr>
<td>B sells to C</td>
<td>90</td>
<td>9</td>
<td>50</td>
<td>5</td>
<td>4</td>
</tr>
<tr>
<td>C sells to D</td>
<td>250</td>
<td>25</td>
<td>160</td>
<td>16</td>
<td>9</td>
</tr>
<tr>
<td>D sells to E</td>
<td>600</td>
<td>60</td>
<td>350</td>
<td>35</td>
<td>25</td>
</tr>
<tr>
<td>E sells to Consumer (not a taxable person)</td>
<td>1500</td>
<td>150</td>
<td>900</td>
<td>90</td>
<td>60</td>
</tr>
<tr>
<td>Total Paid to National Exchequer</td>
<td></td>
<td></td>
<td>150</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

From this example it can be seen that the proportion of VAT paid to the national exchequer at each transaction is the equivalent of ten percent of the value added at that stage, and that the total amount of VAT ultimately received by the exchequer is ten percent of the final purchase price.

In order to achieve transmission of the VAT element, a procedure known as the "tax credit" or "invoice" system is used. This works by the deduction of inputs from outputs; in other words, the

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68. There are basically eight methods of calculating VAT in view of the following three sets of alternatives: (1) under the "addition method" a firm adds its payment to the factors of production whereas, under the "subtraction method," purchases of goods and services from other businesses are subtracted from gross receipts (for a discussion of the advantages and disadvantages of the addition method, see Tait, supra note 36, at 9-11); (2) the next alternative is whether to apply the tax rate to a base which is either "exclusive" or "inclusive" of an element of tax. In the latter case, the effective rate will exceed the nominal rate; and (3) the final alternative is whether to use the "direct" method whereby the effective rate is applied to the tax base or the "indirect method" whereby only the actual tax liability, and not the value added, is calculated. See Tait, supra note 36, at 2-5, 13.

69. See id.

70. An alternative procedure for achieving the same result is the "cost subtraction pro-
amount of prior tax invoiced by, and paid to, the supplier is credited against the amount of tax due on sales.\textsuperscript{71} Thus, in the above example, where the parties $A$ to $E$ inclusive are “taxable persons,” the invoice procedure would operate as follows. On supplying the goods or services to $B$, $A$ would be accountable for VAT of $4$ and would pay that amount to the exchequer. He would provide $B$ with an invoice showing separately the net price of $40$ and the resulting VAT of $4$. This invoice amounts to a tax credit with the exchequer, so that when $B$ sells to $C$, $B$ would become accountable for the VAT on that transaction, i.e. $9$, less the $4$ VAT shown on his invoice, with the result that he advances $5$ to the exchequer and reimburses himself for the $4$ which he previously paid. This procedure continues until sale to the consumer who, not being a “taxable person,” must bear the burden of the VAT as an element of his cost price.

The relative advantages and disadvantages of VAT vary, to some extent, with the context in which the tax is applied. However, a few of the overall claims are worth mentioning. The broad base — insofar as exemptions are kept to a minimum — has three positive effects: (1) it provides simplicity; (2) it enables a high revenue yield to be obtained even though a relatively low tax rate is used; and (3) the tax can act as a stabilizing element since it will respond to any branch of the economy which happens to be expanding at the time.\textsuperscript{72}

The fact that VAT is levied in installments has the effect of providing a more even distribution of the burden throughout the economic chain, whereas a retail or wholesale sales tax would fall completely on a single, and often the weakest, link.\textsuperscript{73}

The tax credit system has an inherent fraud-reducing mechanism. It is in the interest of each taxable person to ensure that his inputs and outputs are correctly calculated and fully reported so that, when the former is deducted from the latter and the balance paid to the exchequer, he will be reimbursed for the VAT installment that he has already paid. Also because each supplier is only a link in the production chain, the authorities will be able to ascertain, from other related returns, whether there has been a failure to

\textsuperscript{cedure” under which a firm would subtract its total outlays from its aggregate sales. SHOUP, supra note 16, at 16.}

\textsuperscript{71. Id. at 17.}

\textsuperscript{72. For a discussion of the VAT as a stabilizing factor, see TAIT, supra note 36, at 69, 139-41.}

\textsuperscript{73. See id. at 122.}
report total sales. It is, however, still possible to avoid VAT by purchasing an item in a country which either exempts such an item or taxes it at a lower rate, but this will not be possible when the EEC adopts the origin principle.\footnote{Id. at 123. For example, in the United States, a person can purchase goods in a neighboring state where possibly no sales tax exists. The original state obtains no revenue in that the tax is based on the place of purchase. The avoidance of the VAT will not be possible when the EEC adopts the origin principle because the tax revenue accrues to the government of the country where the good is produced regardless of where it is ultimately sold to the consumer. Id. at 17.}

An important advantage, as far as the EEC is concerned, is that VAT contains no cascade element and thus lends itself to the precision necessary to render border tax adjustments totally accurate and, hence, more neutral.\footnote{E. Schiff, Value-Added Taxation in Europe 48 (1973).} This was one of the major reasons why VAT was considered to be a suitable replacement for the cascade turnover taxes.\footnote{Neumark Report, supra note 3, at 124, 130.}

On the other hand, VAT has some distinct drawbacks. In countries where policy dictates the application of a progressive tax structure, a value added tax would be an impediment since persons on low incomes would spend a higher percentage of their wealth on necessities. However, the regressive nature of VAT can be adjusted through the tactical use of exemptions and multiple rates,\footnote{For example, certain countries levy VAT at a basic rate for “necessities” and a higher rate for so-called “luxury items.”} though this would be at the expense of the simplicity of the broad tax base.

Perhaps one of the most notable characteristics of VAT is its administrative burden. The tax credit system generates a considerable amount of paperwork because each transaction must be documented and proper returns submitted on a regular basis.\footnote{See note 189 infra.} Although administration costs are higher than with other means of achieving similar results, the collection costs remain constant regardless of the effective tax rate.\footnote{Easson, Value Added Tax, 115 Sol. J. 578, 581 (1971).} This could be considered either an advantage or a disadvantage according to how high or low the rate happens to be.

Finally, it has been claimed that VAT is inflationary because, by increasing the cost of general consumption, it restricts the purchasing power of the individual and thereby raises the cost of living. Further, its administrative costs give another twist to the inflationary spiral.
From the Community's viewpoint, the advantages of the broad base, the economic neutrality, the self-policing character, and the lack of a cumulative element outweigh the disadvantages of regressivity, administrative inconvenience, and VAT's inflationary aspects. The Council committed itself to the VAT system by passing the two Directives of April 11, 1967, and the first step in the harmonization program had thus been taken.

III. THE ROLE OF VAT IN THE INDIRECT TAXATION HARMONIZATION PROGRAM

Even though VAT was selected to solve the previously mentioned problems which existed within the EEC, there were various obstacles to the achievement of harmonization. A measure of national sovereignty and fiscal autonomy would have to be surrendered by each Member State in order for the EEC to gain the full benefits of such harmonization. The new indirect taxation system should not offend the differing fiscal traditions of each Member State. Moreover, it should also be compatible with the ability of each state to collect and administer the tax. Perhaps most significantly, a nation's fiscal policy is responsive to that country's own particular political, social, and economic characteristics. One way in which this is reflected is in the relative reliance on indirect versus direct taxes for revenue. The Commission acknowledged the existence of these obstacles and geared its policy towards a slow harmonization program which would proceed in stages in order to avoid economic disturbances or an abrupt modification of the budgetary sources of the Member States. Before considering the various stages of the harmonization program, a brief examination of the law-making process and the legal effect of Council directives will be helpful.

80. See note 45 supra.
81. Surrender of fiscal autonomy has been a gradual process clearly reflected in the progressive reduction in the number and quality of discretions available to the Member States.
82. WALLACE & WEBB, supra note 34, at 251.
83. Italy, France, and Belgium were predominantly dependent on the yield from indirect taxation whereas Germany, the Netherlands, and Luxembourg were dependent more on direct taxation. See J. CHRISTIAANSE, TAX HARMONIZATION IN THE EUROPEAN COMMON MARKET 3-4 (1971).
84. COMMISSION STATEMENT, supra note 10, at 100.
A. Procedure and Legal Effect of Council Directives

Article 100 of the Treaty of Rome provides that the Council, acting unanimously on proposals from the Commission, shall issue directives for the approximation of laws of Member States which "directly affect the establishment or functioning of the Common Market." Article 99 also provides that the Council shall act unanimously when legislating on the harmonization of laws concerning indirect taxation. Such unanimity is reserved for fundamental issues, with the result that each Member State, through its representation on the Council, can veto any basic proposals that it finds unacceptable.

A directive is a form of secondary legislation and, as such, may be declared invalid by the European Court if the drafting authorities are held to have exceeded their powers. The First, Second, and Sixth VAT Directives have therefore recited that they were made under the authority of Articles 99 and 100.

1. Procedure. The following outline shows the detailed and laborious procedures through which a directive must pass. A first draft is prepared by a division of the Commission, usually consisting of members of several different countries. It is then sent to a working group which prepares an agreed text. This text will usually reflect the wider EEC interest in view of the obligation of the members of the working group to give a subsidiary place to the views of their own particular country. The draft is then presented to one or more study groups consisting primarily of experts and national civil servants. The discussion at this stage is aimed at providing a draft that will be acceptable to the governments of all the Member States. The draft is then forwarded to the Commissioners via their chiefs of staff, and, after formal approval by the Commission, it is sent to the Council. At this stage the Committee of Permanent Representatives (COREPER) recommends whether

85. Treaty of Rome, supra note 1, art. 100. See also note 94 infra.
86. See note 12 supra.
88. Id. at 208.
89. Kerr, supra note 65, at 54.
90. The Commission is a collegiate body consisting of 13 commissioners appointed by the Member States. The Commissioners must act in the interests of the Community independently of their own national governments and of the Council.
91. The Committee of Permanent Representatives consists of the nine ambassadors of the Member States. It reviews Commission proposals, thereby aiding the Council in deter-
the Assembly92 and/or the Economic and Social Committee (ECSC)93 should be consulted. In the case of directives relating to the approximation of laws, such consultation is mandatory.94

In the Assembly, the draft is considered by the appropriate Parliamentary committee and then brought before an open session of Parliament. At this stage, the Commission is given the opportunity to explain or defend its position on any proposed amendments.95 In the ECSC, the appropriate specialized section, composed of specialists in the field in question,96 will produce an advisory opinion.

The opinions of the Assembly and ECSC are officially sent to the Council and the Commission. Sometimes, however, for practical reasons, the Council does not await these opinions before creating a working group to examine the draft, and, as a result, such opinions may reach the Council after the text has been further amended.97 Another problem is that these opinions are merely "advisory" and do not bind either the Council or the Commission. They are, however, very influential because if a measure is unacceptable to the Assembly, it probably will also be unacceptable to the governments of the Member States. Additionally, if a measure is unacceptable to the ECSC it probably will not be well received by trade unions or employers' organizations.98 The Council working group consists of experts acting on the instructions of their own governments and, although the national element is in the foreground when this working group carefully examines the draft, the Commission ensures that the European interest is safeguarded.99

92. The Assembly or "European Parliament" consists of 198 members appointed from their own members by the national legislatures. Its functions are mainly advisory.
93. The Economic and Social Committee consists of 144 members from varying sectors. The ECSC must be consulted on most major policy questions.
94. The Council, acting by means of a unanimous vote on a proposal of the Commission, shall issue directives for the approximation of such legislative and administrative provisions of the Member States as have a direct incidence on the establishment or functioning of the Common Market. The Assembly and the Economic and Social Committee shall be consulted concerning any directives whose implementation in one or more of the Member States would involve amendment of legislative provisions.
95. Glover & Levy, supra note 87, at 209.
96. Treaty of Rome, supra note 1, art. 197.
98. Kerr, supra note 65, at 55.
99. The Commission is represented in the working group and provides input from the European interests involved. Glover & Levy, supra note 87, at 209.
The results of the working group's deliberations are then sent to COREPER where the "real" decision is made. If this Committee reaches unanimous agreement on the draft, it will be sent to the Council and will usually be approved by the Ministers without further discussion. If the draft is accepted by a mere majority, there probably will be some amendments and further discussion in the Council. If final agreement is reached, the measure is translated into the official languages and formally adopted by the Council.

2. Legal Effect. Once adopted, the question arises as to the legal effect of such a measure. The Treaty provides that a directive shall be binding on each Member State "as to the result to be achieved . . . , but shall leave to the national authorities the choice of form and methods." Furthermore, if a directive imposes "an obligation which is unconditional and sufficiently clear and precise," it may confer upon individuals the right to invoke its provisions in municipal courts.

Further questions might also arise concerning disputes as to the meaning of the terms of a directive, and as to enforcement. The Treaty addresses the issue of interpretation and has been construed as conferring upon the European Court jurisdiction to interpret the Treaty and rules made thereunder. As to enforcement, however, it would appear that the only sanctions for noncompliance would be for other Member States and the Commission to exert pressure on the defaulting state. Consequently, it is essential that parties who would be affected by draft directives participate in the decision-making process prior to adoption of the draft by the Council, preferably at the Assembly and ECSC stages.

B. Evolution of the Harmonization Program

The harmonization program is designed to proceed in stages in order to avoid undue disturbances in the internal systems of the Member States. The first phase was the introduction of a common

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100. Kerr, supra note 65, at 55-56.
101. The official languages of the Community are now French, German, Italian, Dutch, English, and Danish.
102. Treaty of Rome, supra note 1, art. 189.
104. See Treaty of Rome, supra note 1, art. 177.
107. Id.
VAT system\textsuperscript{108} and the creation of a framework within which to operate the tax. At this point, the Member States were permitted considerable discretions to adjust the VAT to their own particular needs. The second phase provides the EEC with its own financial resources by designating a percentage of the VAT levy, while the current third phase is one in which the Sixth Directive seeks to provide a uniform tax base so that this levy will have a consistent impact in each Member State.\textsuperscript{109} The fourth phase involves the introduction of EEC rules concerning the collection and supervision of VAT. The fifth, and final, phase will be the adoption of a Community rate structure, though, at present, there is no exact deadline and this goal seems to be in the distant future.

1. \textit{The First and Second Phases}. The first phase was designed to eliminate the shortcomings of the cascade turnover taxes; this phase commenced with the introduction of the First\textsuperscript{110} and Second\textsuperscript{111} Directives on April 11, 1967. The First Directive instituted the new tax system\textsuperscript{112} and set out the basic characteristics of the VAT, which was defined as a tax on the consumption of goods and services, calculated in proportion to their cost, irrespective of the number of prior transactions through which they have passed.\textsuperscript{113} It was applicable to the retail stage but vested the discretion in Member States, subject to a consultation requirement,\textsuperscript{114} to limit application of the tax to the wholesale stage and apply a supplementary tax.\textsuperscript{115}

While the First Directive established the new system and defined the tax, the Second Directive established the basic framework within which the tax system would function. VAT was to be appli-

\textsuperscript{108} The reason for establishing a common system during the initial stage was that, even though economic neutrality could be achieved by each Member State introducing its own choice of a neutral system, this could not have formed a foundation for the elimination of tax frontiers. Community Topic No. 36, \textit{supra} note 23, at 5.

\textsuperscript{109} Sixth Directive, \textit{supra} note 11. The Preamble provides in part:

[The Council] has adopted this Directive.

\textsuperscript{110} First Directive, \textit{supra} note 45.

\textsuperscript{111} Second Directive, \textit{supra} note 45.

\textsuperscript{112} See note 108 \textit{supra}; First Directive, \textit{supra} note 45, art. 1.

\textsuperscript{113} First Directive, \textit{supra} note 45, art. 2.

\textsuperscript{114} \textit{Id.} art. 5. The Member States who choose to limit the application to the wholesale stage are required to approach the Commission in due time for consultation. \textit{Id.}

\textsuperscript{115} \textit{Id.} art. 2.
cable to the delivery of goods and the rendering of services for consideration within a country by a "taxable person"; the tax would also be levied on imports. The various integral concepts were defined; for example, a "taxable person" was "any person who independently and regularly engage[d] in transactions within the scope of the activities of a manufacturer, trader or a person who render[ed] services, whether or not for profit." "Delivery of a good" was defined to mean, *inter alia*, the transfer of the "power to dispose of a tangible asset as owner," while the term "rendering of services" covered any other transaction. The tax base constituted the consideration involved in the transaction including all costs and taxes with the exception of the VAT element itself. Exemptions were specifically to include exports, but otherwise each Member State was given the discretion, subject to a consultation requirement, to provide any other exemptions which it considered necessary. In addition, there was a requirement that each taxable person maintain a bookkeeping system sufficiently detailed to enable the tax to be applied and controlled by the administering authorities. Despite initial delays, there has now been substantial compliance with the first two Directives.

116. The Second Directive provides:

The following are to be subject to the tax on value added:

a) deliveries of goods and the rendering of services, effected for a consideration within the country by a taxable person;

b) importations of goods.


117. *Id.* art. 4.

118. *Id.* art. 5(1).

119. Article 6 provides:

1. The term "rendering of services" is to be understood as meaning any transaction which does not constitute a delivery of a good within the meaning of Article 5.

*Id.* art. 6(1).

120. *Id.* art. 8. *See also* note 77 *supra*.

121. A Member State may determine other exemptions which it considers necessary provided the Member State consults the Commission in due time. *Id.* arts. 10 & 16.

122. *Id.* art. 10.

123. *Id.* art. 12.

The Council Decision of April 21, 1970,\textsuperscript{125} set in motion the second phase of the harmonization program by providing the EEC with its own independent financial resources, and for replacing the existing system under which the Member States contributed to the EEC budget according to their relative shares of the EEC gross national product. The Council Decision provides that the first one percent of the VAT rate in each Member State shall be payable to the EEC's resources and be collected by each state in accordance with its own national provisions.\textsuperscript{126}

2. \textit{Phase Three: The Sixth Directive.} On June 29, 1973, the Commission submitted a proposal\textsuperscript{127} for a Sixth Council Directive on the harmonization of turnover taxes; various subsequent amendments were made before it was finally adopted on May 17, 1977. The Sixth Directive is designed to achieve a uniform tax base in order to enable the EEC to begin full operation of its "own resources" budget plan and so that application of the "community rate"\textsuperscript{128} will have the same result in each Member State. It repeals the Second Directive\textsuperscript{129} and, subject to the transitional provisions,\textsuperscript{130} provides for a compliance deadline of January 1, 1978.\textsuperscript{131} The Sixth Directive recites the Member States' conformity with the first two Directives and notes that further progress should be made in order to remove restrictions on the movement of persons, goods, services, and capital, and to aid economic integration.\textsuperscript{132} In particular, this Directive recognizes the need to clarify the definitions of certain basic concepts and to achieve a greater alignment on the issue of exemptions.\textsuperscript{133}

Although the Sixth Directive includes certain revisions, it pri-
marily amplifies and defines in greater detail the terms of the Second Directive. While the Sixth Directive restricts the discretions which were previously permitted under its predecessor,\textsuperscript{134} it nevertheless allows certain narrowly defined derogations.\textsuperscript{135} The following are some of the more significant provisions.

The definition of “taxable person” has been expanded to cover any person who performs certain enumerated transactions, even on an occasional basis. These transactions include mining, agricultural activities, professional activities, the exploitation of tangible and intangible property for the purpose of obtaining income therefrom on a continuing basis, and the supply of buildings and building land.\textsuperscript{136} This extension of the concept is in line with the idea that VAT is a general tax on consumption and is aimed at ensuring impartial application of the tax.\textsuperscript{137}

“Supply of goods” means the transfer of the right to dispose of tangible property as owner.\textsuperscript{138} Member States may consider “tangible property” to include certain interests in immovable property, namely, rights \textit{in rem} giving the holder a right of user and interests giving \textit{de jure} or \textit{de facto} rights of ownership.\textsuperscript{139} This generally follows the definition contained in the Second Directive. However, the definition of “supply of services” has been altered and broadly defined to cover any transaction which is not a supply of goods within the meaning of article 5.\textsuperscript{140} Under the Second Directive, the taxation of services was compulsory only when such services had a direct effect on the cost of goods.\textsuperscript{141} These areas of compulsory taxation of services were enumerated in an itemized list which included, for example, transfers of patents, commercial publicity services, and the transportation of goods.\textsuperscript{142} The discretion previously enjoyed by Member States regarding the taxation of non-listed services has now been removed, with the result that all services, except those covered by the current exemptions,\textsuperscript{143} are henceforth taxable.\textsuperscript{144}

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{134} See notes 121 and 122 supra, and accompanying text.
\item \textsuperscript{135} See notes 169-177 infra, and accompanying text.
\item \textsuperscript{136} Sixth Directive, supra note 11, art. 4.
\item \textsuperscript{137} Explanatory Memorandum, supra note 127, at 8.
\item \textsuperscript{138} Sixth Directive, supra note 11, art. 5(1).
\item \textsuperscript{139} \textit{Id.}
\item \textsuperscript{140} \textit{Id.} art. 6.
\item \textsuperscript{141} Second Directive, supra note 45, art. 6(2).
\item \textsuperscript{142} \textit{Id.} Annex B.
\item \textsuperscript{143} Sixth Directive, supra note 11, art. 6.
\item \textsuperscript{144} \textit{Id.}
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It was necessary to clarify the definition of the "place of taxable transaction" since determination of this question had previously led to jurisdictional conflicts between the Member States, especially regarding the supply of goods for subsequent assembly. In the case of transported goods, the place of supply is the place of location of such goods at the time of dispatch;\textsuperscript{145} but, where goods are assembled on behalf of the supplier, it is the place of assembly.\textsuperscript{146} Where, however, assembly takes place outside the country in which the supplier is located, the state of importation must take any steps necessary to avoid double taxation.\textsuperscript{147} The place of supply of non-transported goods is their place of location when the supply takes place.\textsuperscript{148} Under the Second Directive, the place of supply of services was the place where they were rendered,\textsuperscript{149} but this has now been altered to the place where the supplier has established his business or has a fixed place from which the services are supplied.\textsuperscript{150} In the absence of these alternatives, it is his permanent address or usual residence.\textsuperscript{151} Services connected with immovable property follow the traditional conflicts rule of the place of situs.\textsuperscript{152} Transport services require a mileage apportionment since the place of taxable transaction is the place where the transportation occurs.\textsuperscript{153}

The concepts of the "chargeable event" and "chargeability of tax" require harmonization in order to pave the way for application of the "community rate" and to eliminate the controversies caused by the use of varying definitions regarding the time of collection and the time when the tax is payable.\textsuperscript{154} The term "chargeable event" is defined as "the occurrence by virtue of which the legal conditions necessary for tax to become chargeable are fulfilled,"\textsuperscript{155} and the tax becomes "chargeable" when the authorities become entitled, under law, to claim it, even though the actual time of payment may be deferred.\textsuperscript{156} This is generally the time when goods are

\textsuperscript{145} Id. art. 8.
\textsuperscript{146} Id.
\textsuperscript{147} Id. art. 8(1)(a).
\textsuperscript{148} Id. art. 8(1)(b).
\textsuperscript{149} Second Directive, supra note 45, art. 6(3).
\textsuperscript{150} Sixth Directive, supra note 11, art. 9.
\textsuperscript{151} Id.
\textsuperscript{152} Id. art. 9(2)(a).
\textsuperscript{153} Id. art. 9(2)(b).
\textsuperscript{154} Explanatory Memorandum, supra note 127, at 12.
\textsuperscript{155} Sixth Directive, supra note 11, art. 10.
\textsuperscript{156} Id.
delivered or services are rendered, and, in the case of transactions which give rise to successive statements of account, the date of expiry. As far as imports are concerned, the chargeable event occurs and tax becomes chargeable when the imports enter the country.\[^{157}\]

The definition of the "taxable amount" must be sufficiently clear to enable its use at all stages of production and distribution, yet be drawn primarily for application to the final transaction\[^{158}\] since VAT is a tax on the consumption stage. The taxable amount is defined as the \textit{total consideration} and includes taxes — with the exception of the VAT itself — duties, levies, charges, and incidental expenses, but not discounts, rebates, or price reductions.\[^{159}\] The taxable amount on imports is the price paid by the importer. However, if there is consideration in another form, the taxable amount is the open market value at the marketing stage in the country of export.\[^{160}\] Again, this amount includes taxes, duties, levies, and other charges due outside the country of importation, and incidental expenses incurred up to the "first place of destination."\[^{161}\] However, the Member States must treat goods which have been temporarily exported and then re-imported as if the transactions had occurred therein.\[^{162}\] Furthermore, a reduction of the taxable amount for bad debts is permitted and the conditions for such are left for determination by the Member States.\[^{163}\]

With regard to VAT rates, the Sixth Directive, like its predecessor Second Directive, continues to permit these to be fixed by the Member States as a percentage of the taxable amount.\[^{164}\] The rate imposed on imports must, of course, equal the rate levied on similar, domestically produced goods.\[^{165}\] A move to align VAT rates will be the subject of the fourth phase in the harmonization process.

At this stage, one of the major questions is the extent to which exemptions will be permitted. As noted above, the Member States previously exercised broad discretions in this area. However, the Sixth Directive has eliminated these by providing a common list\[^{166}\] of the only exemptions which can and must be permitted. This is

\[^{157}\] \textit{Id.} art. 10(3).
\[^{158}\] Explanatory Memorandum, \textit{supra} note 127, at 13.
\[^{159}\] Sixth Directive, \textit{supra} note 11, art. 11(A).
\[^{160}\] \textit{Id.} art. 11(B).
\[^{161}\] \textit{Id.}
\[^{162}\] \textit{Id.}
\[^{163}\] \textit{Id.} art. 11(C)(1).
\[^{164}\] \textit{Id.} art. 12.
\[^{165}\] \textit{Id.}
\[^{166}\] \textit{Id.} arts. 13-15.
consistent with the EEC’s main objective since, in order to achieve uniformity in the transactions which must be taxed, it is necessary to provide uniformity of exemptions. The list of exemptions was drafted bearing in mind the exemptions currently in force in the Member States, and in accordance with the idea that exemptions should be restricted\(^{167}\) and harmonized so that the EEC’s own resources will be collected in a uniform manner.\(^{168}\)

The list of exemptions includes certain activities which are in the public interest; for example, the supply of postal services, hospital and medical care, milk, and education.\(^{169}\) Other exemptions relate to specific areas such as insurance, credit, and financial dealings\(^{170}\) which are justified on grounds of common policy.\(^{171}\) These enumerations will undoubtedly cause problems in certain countries, for example, food, books, and children’s clothing, which are currently subject to a zero rating in the United Kingdom,\(^{172}\) are not included and, therefore, must be brought within the charge to tax in order to comply. The effects of the Sixth Directive’s further restrictions on exemptions are mitigated, to some extent, by the transitional provisions which permit the continued application of zero ratings until the Council acts unanimously to provide for their discontinuance.\(^{173}\)

In addition to internal exemption provisions, there are rules governing exemptions on imports\(^{174}\) and exports,\(^{175}\) as well as spe-

\(^{167}\) Explanatory Memorandum, \textit{supra} note 127, at 15.

\(^{168}\) \textit{Id.} at 7. The idea is that, in order for the impact of the “own resources” plan to be consistent within each country, common rules must be laid down as to the area of application of VAT. This logically requires uniformity in the range of exemptions granted by each state. Application of the Community rate to the uniform tax base will then provide a fair apportionment of contributions between the Member States.

\(^{169}\) \textit{See} Sixth Directive, \textit{supra} note 11, art. 13(A)(1)(a)-(q).

\(^{170}\) \textit{Id.} art. 13(B).

\(^{171}\) Explanatory Memorandum, \textit{supra} note 127, at 15.

\(^{172}\) \textit{See} note 65 \textit{supra}.

\(^{173}\) On the basis of a report from the Commission, the Council shall review the abovementioned reduced rates and exemptions every five years and, acting unanimously on a proposal from the Commission, shall where appropriate, adopt the measures required to ensure the progressive abolition thereof.

\(^{174}\) Exemptions on imports include exemptions on final importation of goods which qualify for non-tariff exemption from customs duties, on reimportation of goods into the state from which they were exported, on importation of goods under diplomatic arrangements, and importation of goods by international organizations. \textit{Id.} art. 14.

\(^{175}\) The following are examples of exempted exports: goods dispatched to a destination outside the territory; goods for fuelling of vessels used for rescue at sea; and goods for fuelling of aircraft on international routes. \textit{Id.} art. 15.
cial exemptions for goods linked to international transit.176 These are based on general concepts of customs law with a view to bringing the VAT treatment of such transactions into line in order to simplify the administrative work involved.177

The rules governing deductions should be harmonized insofar as they affect the amounts actually collected, since divergences by Member States could cause disequilibria in the impact of the EEC's "own resources" plan. Where goods and services are used for taxable transactions, a taxable person can deduct the following from his outputs: (1) input tax; (2) VAT on imported goods; (3) the notional VAT on the business application of goods on which VAT, if they had been acquired from another taxable person, would not be deductible; and (4) the notional VAT on the supply of a service by a taxable person for the purposes of his undertaking where, if the service had been performed by another taxable person, VAT would not be deductible.178 Deductions are also provided for in cases where certain transactions are carried out abroad, where they are linked with international commerce, and where the customer is established outside the EEC.179 There exist detailed standardizing rules concerning the exercise of the right to deduct,180 calculation of the deductible proportion,181 and adjustments of deductions182

176. Article 16 provides the various exemptions for goods involved in international transit. The Member States may relieve certain goods from VAT which are not aimed at final use or consumption within the territory. Exempted goods include those intended for temporary storage and goods placed in customs warehousing. Id. art. 16.

177. In a variety of circumstances, such as importing goods under diplomatic arrangements or small consignments, the reasons underlying a customs duty exemption are identical to those for allowing a VAT exemption. Consequently, the systems can be merged, allowing a coordination of VAT and customs arrangements rather than maintaining two distinct systems. See Explanatory Memorandum, supra note 127, at 16.

178. Sixth Directive, supra note 11, art. 17.

179. Id. art. 17(3).

180. For example, in order for the taxable person to exercise the right to deduct, he must hold a detailed invoice or an import document or comply with the formalities established by each Member State. Id. art. 18.

181. The Directive provides:

1. The proportion deductible . . . shall be made up of a fraction having:
   —as numerator, the total amount, exclusive of value added tax, of turnover per year attributable to transactions in respect of which value added tax is deductible . . . ;
   —as denominator, the total amount, exclusive of value added tax, of turnover per year attributable to transactions included in the numerator and to transactions in respect of which value added tax is not deductible.

Id. art. 19.

182. Article 20 allows an adjustment of the initial deduction where the deduction was higher or lower than that to which the taxable person was entitled or where some change occurs in the factors used to determine the deductible amount after the taxable person's
which, because of their financial consequences, require the application of common rules.\(^\text{183}\)

Persons other than taxable persons may be required to pay VAT; it was therefore considered necessary to specify who should be responsible for payment,\(^\text{184}\) particularly with respect to services supplied by a person established abroad. In such a case, the Member States are given certain discretions to designate the person liable and the terms of liability.\(^\text{185}\)

Each taxable person is obligated to keep adequately detailed accounts and, where he supplies goods or services to another taxable person, must issue an invoice stating the net price, the VAT rate(s) and any exemptions.\(^\text{186}\) The Member States shall set the criteria for determining whether a document serves as such an invoice. Instead of the monthly accounting required by the Second Directive,\(^\text{187}\) sufficiently comprehensive returns must be submitted at intervals, determined by Member States, but not exceeding two months after the end of the taxation period.\(^\text{188}\) It is at this time that the net VAT must be paid. There is, however, a further discretion for Member States to release taxable persons from these obligations in certain circumstances.\(^\text{189}\)

Because of potential difficulties of subjecting "small undertakings" to the normal VAT system, Member States were permitted under the Second Directive to deal with these in any way best suited to their national requirements.\(^\text{190}\) This special scheme is retained by the Sixth Directive, but it is more strictly regulated than previously\(^\text{191}\) in view of the goal of producing a common policy in this area.

The common flat-rate scheme\(^\text{192}\) for farmers is considered to

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183. Explanatory Memorandum, supra note 127, at 19.
184. Sixth Directive, supra note 11, Preamble.
185. Id. art. 21.
186. Id. art. 22.
188. Sixth Directive, supra note 11, art. 22.
189. The Sixth Directive allows Member States to release taxable persons from payment where the debt is insignificant or from all obligations where the taxable person carries out only exempt transactions. Id. art. 22(9).
192. Id. art. 25. Farmers subject to the common flat-rate scheme are entitled to offset the value added tax charge on inputs by applying to the price of the agricultural products, and
be the only practical method for allowing farmers to offset, at a flat-rate, the deductible tax on their purchases.\textsuperscript{193} Member States may fix the flat-rate compensation percentage, subject to notifying the Commission before application, but it cannot be used to obtain refunds in excess of the input tax.\textsuperscript{194} This scheme mitigates, to some extent, the fact that, in the United Kingdom, the zero rating on food will eventually be prohibited. Travel agents are also subject to a special scheme. All the transactions in a journey are treated as a single service, taxable in the country of established business. The taxable amount, in such a case, is "the travel agent's margin."\textsuperscript{195}

The Council can authorize Member States to derogate from the provisions of this Directive in order to simplify procedures, to prevent abuses, and to avoid evasion, but it must act unanimously.\textsuperscript{196} The transitional provisions acknowledge that it is undesirable, for economic and social reasons, to abolish the zero ratings immediately and that it is necessary to allow national laws to be adapted gradually.\textsuperscript{197}

A notable innovation is the creation of a VAT Committee. This is an advisory committee consisting of representatives of the Member States and of the Commission. It will deal with points in the Sixth Directive which are subject to consultation and examine questions raised as to the application of the VAT.\textsuperscript{198}

\section*{IV. Conclusions}

From the foregoing it is clear that the VAT system plays a significant part in the attainment of the basic goals of the EEC. The wide disparities between the fiscal systems of the Member States are gradually narrowing as the harmonization program progresses. The gradual progression and democratic nature of the decision-making process have, so far, prevented insurmountable obstruction of the incremental surrender of national fiscal sovereignty. Draw-

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\textsuperscript{193} Explanatory Memorandum, supra note 127, at 24.
\textsuperscript{194} Sixth Directive, supra note 11, art. 25.
\textsuperscript{195} The "travel agent's margin" is defined as
the difference between the total amount to be paid by the traveller, exclusive of value added tax, and the actual cost to the \ldots agent of supplies and services provided by other taxable persons where these transactions are for the direct benefit of the traveller. \textit{Id.} art. 26.
\textsuperscript{196} \textit{Id.} art. 27.
\textsuperscript{197} \textit{Id.} Preamble.
\textsuperscript{198} \textit{Id.} art. 29.
\end{flushleft}
ing from past European experience, the Sixth Directive sets out to provide a uniform tax base, and, therefore, it contains numerous provisions considerably more detailed than those of the first two Directives. It marks a significant step forward insofar as it paves the way for the EEC's "own resources" plan, the final harmonization stage involving alignment of the VAT rates, and towards monetary union. The issue of exemptions might, however, cause problems in some countries, but, as progress is made in other fields, economic and social factors will be brought further into line, and there will be an enhanced possibility of uniformity in this area. After the Member States have complied with the terms of the Sixth Directive, practice will show whether there is a need for additional provisions in order to achieve the desired uniform tax base. Finally, as more progress is made in the harmonization of indirect taxes, distortions caused by other fiscal measures will be revealed, and the EEC's attention can then be directed towards their solution.