

A Hybrid VAT System in the European Union

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Abstract

The principle of the common system of Value Added Tax (VAT) in the European Union involves the application of a general tax on consumption to goods and services exactly proportional to the price of the goods and services, irrespective of the number of transactions which take place in the production and distribution process before the stage at which tax is charged. Thereby, under the current system, VAT, calculated on the price of the goods or services at the rate applicable to such goods or services, is chargeable on each transaction after deduction of the amount of input value added tax borne directly by the various cost components. Within this framework of harmonized VAT in the European Union, Germany and Austria recently submitted a proposal for the implementation of a reverse charge mechanism for business-to-business transactions within the territory of a single Member State of the EU above a certain threshold value in order to combat certain forms of VAT fraud.

With the reverse charge mechanism, the recipient rather than the supplier would be liable to pay VAT. However, the customer is entitled to deduct the input VAT under the general conditions. Applying the reverse charge mechanism for business-to-business transactions, the VAT would take on the characteristics of a mere retail tax. Since the VAT system shall formally be maintained and still be applied in the conventional way for sales below a certain threshold value, implementation of such general reverse charge mechanisms within the framework of the VAT Directive would lead to a hybrid system of consumption taxation.

The paper identifies criteria for a successful implementation of such a reform and how such system would resolve the problems of the existing VAT rules. It makes a balanced proposal for a system of taxation of sales of goods and services within a Common Market such as the European Union which would combat VAT fraud effectively.