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VAT MISSING TRADER INTRA-COMMUNITY FRAUD: THE EFFECT ON TRADE STATISTICS

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VAT MISSING TRADER INTRA-COMMUNITY FRAUD: THE EFFECT ON TRADE STATISTICS

1. Introduction

1. Data for UK trade on a Balance of Payments basis released by ONS on 9 July 2003 included revisions to imports and the balance of trade in goods for the period since 1999 to reflect initial adjustments for the impact of VAT missing trader intra-Community (MTIC) fraud.

2. The purpose of this article is to explain how the fraud causes the trade deficit to be understated, how the Office for National Statistics has made the revisions, and what their impact is on UK/EU asymmetries.

2. Background

The VAT system and EU trade statistics

3. The measurement of trade in goods within the European Union is based on the Intrastat system which relies on the VAT system.

4. As part of the VAT return which firms complete each quarter, there is a declaration of the total value of exports of goods to customers in other EU Member States and the total value of imports of goods from suppliers in other EU Member States. These returns provide a direct estimate of the size of UK exports to and imports from the EU. They are also used to underpin a requirement to fill in a more detailed, monthly Intrastat return (if the value of the declarations on the VAT return exceed a given threshold - currently £233,000 per annum in the UK).

5. The Intrastat system therefore relies on the VAT returns providing an accurate and comprehensive record of trade flows.

VAT missing trader fraud

6. In recent years a particular type of cross-border fraud, based on the VAT system, has come to light which is now known to have caused the trade deficit to be understated. This EU-wide fraud is known as VAT missing trader intra-Community fraud (MTIC fraud).

7. This type of VAT fraud was highlighted in November 2001 in the HM Treasury and HM Customs and Excise paper, *Tackling Indirect Tax Fraud*, which was published as part of the *2001 Pre-Budget Report*. In this paper, MTIC fraud was described as follows:

"VAT intra-Community missing trader fraud is a systematic criminal attack on the VAT system, which has been detected in many EU Member States. In essence, fraudsters obtain VAT registration to acquire goods VAT free from other Member States. They then sell on the goods at VAT inclusive prices and disappear without paying over the VAT paid by their customers to the tax authorities. The fraud is usually carried out

very quickly, with the fraudsters disappearing by the time the tax authorities follow up the registration with their regular assurance activities."

8. The 2002 Pre-Budget Report provided an update on the situation.

9. There are two main types of VAT MTIC fraud: acquisition and carousel fraud:

Acquisition fraud is where the goods are imported from the EU into the UK by a trader who then goes missing without completing a VAT return or Intrastat declaration. The 'missing trader' therefore has a VAT free supply of goods, as they make no payment of the VAT monies due on the goods. He sells the goods to a buyer in the UK and the goods are available on the home market for consumption.

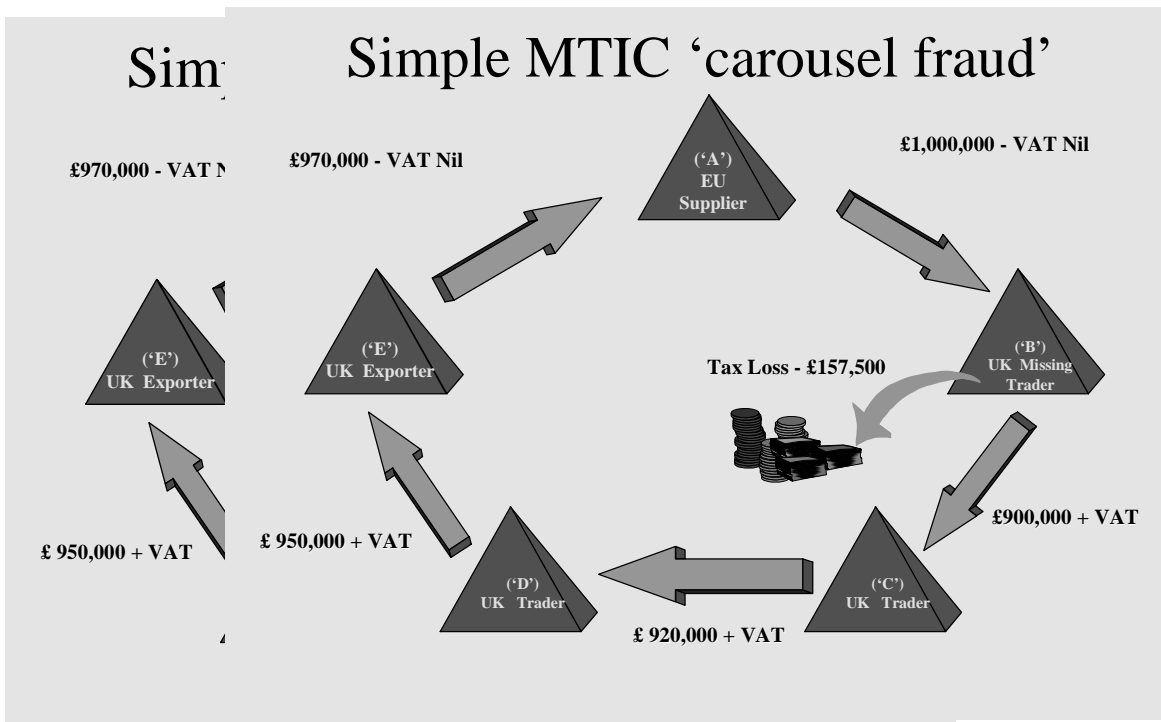
Carousel fraud is similar to acquisition fraud in the early stages, but the goods are not sold for consumption on the home market. Rather, they are sold through a series of companies in the UK and then re-exported to another Member State, hence the goods moving in a circular pattern or 'carousel'.

10. Carousel fraud is currently regarded as the dominant type in terms of loss of government revenue. For reasons explained later, the adjustments described in this article relate only to part of the carousel variant. The fraud is not exclusive to the UK. Because these VAT arrangements apply throughout the European Union the fraud can be perpetrated between any two or more Member States.

The impact of MTIC fraud on the trade statistics

11. As discussed earlier the intra-EU trade in goods statistics rely on the VAT forms being a correct record of trade transactions. MTIC fraud affects the measurement of trade in goods through the role of the missing trader.

Figure 1



12. The carousel fraud is illustrated in Figure 1. The UK Trader B imports goods from the EU supplier A. Trader B should pay VAT on sales to Trader C and fill in a VAT return. Trader B ceases operation as soon as it has sold the goods on to Trader C, keeping the VAT and hence not filling in VAT forms. Without the VAT form there is no record of the transaction for UK import statistics. The carousel then involves various traders selling the goods on (in this example, C and D) until the goods reach Trader E. Trader E exports the goods to non-UK Trader A; Trader B imports them again from Trader A, and the carousel continues. The transaction of the UK exporter E will be recorded alongside his VAT return because insufficient evidence of export would result in the exporter being required to charge and account for VAT on his onward sale. The VAT system (and therefore the Intrastat collection of trade statistics) picks up the exports of any 'carouselled' goods, but does not pick up the associated import at the time the carouselled goods entered the UK. The balance of trade, exports minus imports, is therefore overstated.

13. The treatment of this imbalance in the trade statistics published by the ONS is guided by the European System of Accounts methodology. Since the conclusion drawn for National Accounts purposes is that adjustments for fraudulent activity such as this be included in the accounts, it was concluded that any revisions to account for the impact of MTIC fraud in the trade statistics should be added to the imports and therefore included in turn in the National Accounts. Revised National Accounts estimates up to and including 2003 quarter two are published on 30 September. Approximate estimates of the effect of these adjustments on the National Accounts can be found in a fuller version of this article¹.

14. The detailed Overseas Trade Statistics (OTS) published by Customs & Excise have not been adjusted to account for these revisions. Trade statistics on a Balance of Payments basis include a number of adjustments, for example estimates of alcohol and tobacco smuggling, which are not included in the detailed OTS. The treatment of these revisions is therefore in line with existing practice. The revisions are aggregate adjustments that cannot simply be slotted in to the detailed data, which are based on detailed transactions. In addition, any adjustment would constitute a methodological change and need to be agreed at European level. Part of an ongoing programme of work will involve discussions with Eurostat and other Member States on how to take forward the issue of dealing with the impact of MTIC fraud in the OTS. It is believed that other EU members do not make adjustments for MTIC in their detailed trade statistics, and any adjustment to the OTS needs to be introduced by all member states to avoid inconsistencies between different countries' data.

3. Estimation of the impact of MTIC fraud on trade statistics

15. The measurement of illegal activity is by definition an inexact science; statisticians are required to estimate figures in areas where traders are seeking to conceal their identity or otherwise to trade covertly. At present there is no internationally approved methodology for including adjustments for the impact of MTIC fraud in the trade figures and the National Accounts.

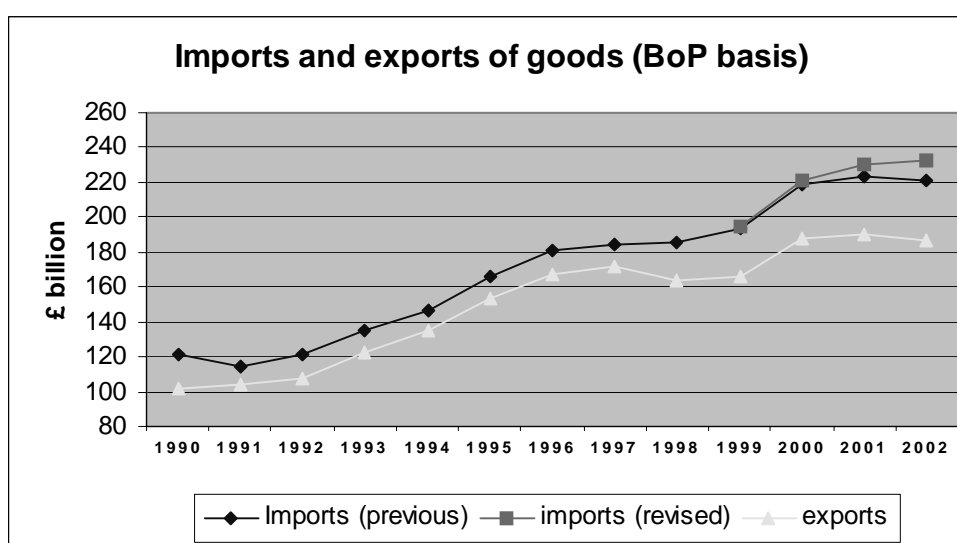
16. ONS in partnership with HM Customs & Excise have developed a methodology to estimate these adjustments. The method used relies heavily on information uncovered during HM Customs & Excise's operational activity. As such it cannot be detailed for risk of prejudicing current activity, including criminal investigations and prosecutions, and more generally undermining HM Customs & Excise's ability to tackle the fraud effectively. The method is applied only to some of the transactions involving mobile phones and computer components - the commodities of choice of the fraudsters. It specifically excludes other commodities, and adjustments for the acquisition variant of the fraud which cannot be quantified at present.

17. This adjustment has been assessed for coherence with other data. In particular ONS Supply and Use balances, used for the construction of GDP estimates, have been used to validate and inform the relevant sizes of adjustments on the specific products that are predominantly used to carry out the fraud.

The asymmetry analyses (see Section 4 - EU asymmetries, below) have also been used as further input to this process. The revisions for the impact of MTIC fraud on the trade statistics are, however, just one of a number of factors influencing the asymmetry discrepancies. These other factors are detailed in Annex A.

18. The revisions involve upward adjustments to imports of £1.7 billion in 1999, £2.8 billion in 2000, £7.1 billion in 2001 and £11.1 billion in 2002. There are corresponding downward revisions to the balance on trade in goods. Chart 1 shows imports of goods from 1990 onwards both including and excluding the revisions to account for the impact of MTIC fraud as well as exports of goods.

Chart 1



19. As discussed, the nature of the activity means that any adjustments made for the impact of the fraud are necessarily subject to a large margin of error. This was particularly so prior to 2002 when less transaction data were available. Nevertheless there is no doubt that the adjustments improve the coherence of the trade statistics and National Accounts.

20. At a future date it may be necessary to update calculations as a result of further research. An updating of these calculations may involve an adjustment for carousel fraud in other commodities and for acquisition fraud. As stated, the present adjustments relate only to mobile phones and computer components. It is likely that this constitutes a sizeable proportion of the carousel fraud, but a fuller assessment has not been possible at this stage.

21. The annual revisions have been broken down into monthly and quarterly components in the 9th July *Trade First Release* for the purpose of introducing the adjustment into the published figures in this release only. In the future, as with other balance of payments adjustments, ONS will make annual adjustments available with the publication of the *Pink Book* each year. Monthly and quarterly figures and commodity and country breakdowns will not be made available as the quality of the estimates obviously deteriorates at more detailed levels of disaggregation. Furthermore, HM Customs & Excise advise that publication of detailed adjustments is likely to affect their ability to tackle the fraud effectively and reveal information which risks prejudicing ongoing and future criminal investigations and prosecutions. Within these constraints, ONS and HM Customs & Excise are considering what might be done to help users interpret short-term movements in exports and imports.

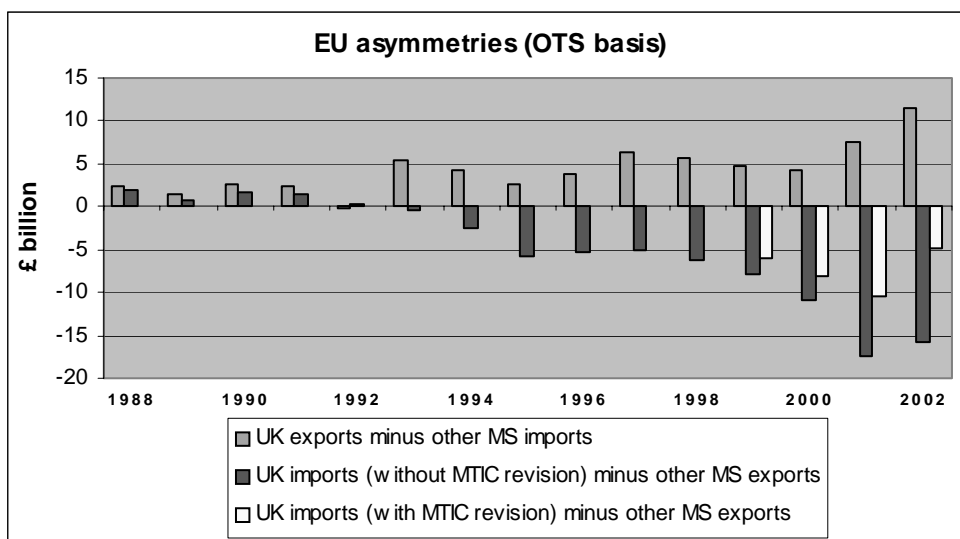
4. EU asymmetries

22. It is now clear that MTIC fraud has made a major contribution to increased asymmetries between EU Member States trade figures.

23. Asymmetry analyses arise because trade can be looked at from the perspective of either of the countries involved. For example, the UK's estimate of its exports to country X should be the same as country X's estimates of its imports from the UK, and the UK's estimates of its imports from country X should be the same as country X's estimates of its exports to the UK. These types of checks are known as mirror statistics and the divergences between the mirror statistics, as asymmetries. In practice there are a number of technical and methodological reasons that means these theoretical identities will not hold. However comparisons of this type have long been recognised as helpful cross-checks on trade data. Annex A discusses a number of possible explanations of why there are non-zero asymmetries.

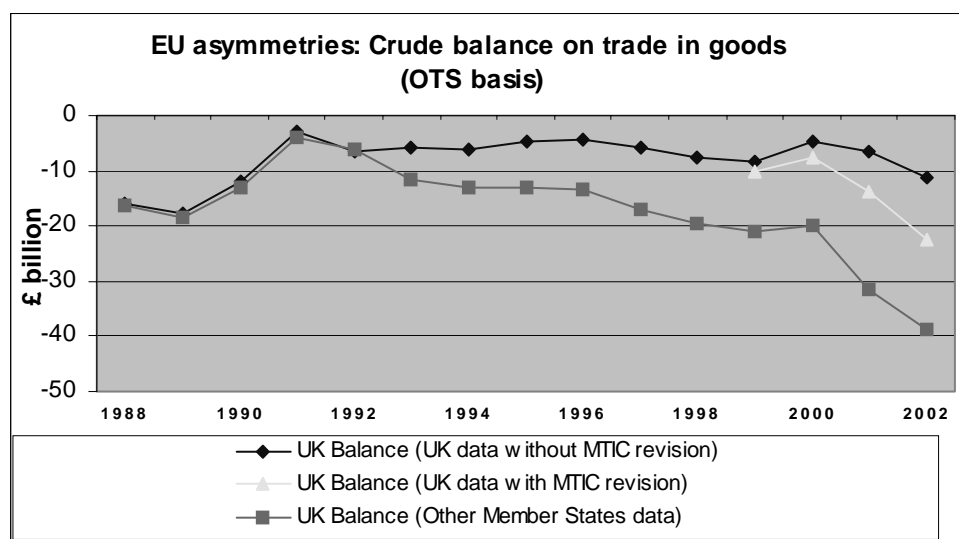
24. The Statistical Office of the European Communities (Eurostat) produces an analysis of all Member States asymmetries. Chart 2 shows the two mirror relationships for the UK. This chart shows the import asymmetries on an Overseas Trade Statistics (OTS) basis both with and without the MTIC adjustment, although it should be borne in mind that the OTS statistics will not be revised to take account of the impact of MTIC fraud.

Chart 2



25. The mirror statistics show both higher imports and lower exports than UK trade data. In recent years, both differences – so-called asymmetries - act in the same direction as far as its effect on the trade balance is concerned. A mirror estimate of the UK balance of trade is therefore substantially below the UK estimate as shown at Chart 3 below, which also includes an estimate of the deficit on trade in goods that takes into account the revisions to account for the impact of MTIC fraud set out in this article.

Chart 3



26. Prior to 1993 the scale of the divergence was relatively small, an average of £1.8 billion a year in the five years up to 1992. However, since the introduction of the single market in 1993, the figures have been diverging to an increasing extent. The increasing divergence is largely driven by the imports data. The dramatic divergence has meant that in 2001 the UK balance of trade deficit based on the EU mirror data was £31.5 billion, set against an estimate of £6 billion based on UK data. Following the revisions discussed in this article, the UK balance of trade in goods deficit for 2001 is now estimated at £13.1 billion. A significant part of the divergence is therefore now resolved.

27. More generally the Eurostat mirror statistics show that other EU member states have import and export asymmetries in the same directions as those shown for the UK in Chart 2. MTIC fraud is likely to affect the trade statistics in many EU economies because the conditions for it apply throughout the EU.

28. It should be emphasised that MTIC fraud is not the only cause of the EU asymmetries. Chart 2 demonstrates that the revisions to account for the impact of MTIC fraud will account for a significant amount (and the rapid increase in recent years), but another article in this edition describes many other causes of the asymmetries. Some of these causes are not specifically related to membership of the EU. For example, the UK has significant export and import asymmetries with the USA, and these, by definition, are not related to the MTIC fraud.

5. Conclusion

29. The figures presented in the 9th July UK Trade First Release, published by the ONS, contained revisions to imports of goods due to the introduction of an adjustment for the impact of MTIC fraud. Such an adjustment was necessarily tentative and subject to uncertainty, but it is clear that making and publishing this adjustment improves the coherence of the Balance of Payments and the wider presentation of the economy in official statistics.

Annex A

Factors Influencing EU Asymmetries in Trade in Goods

1. While the adjustments for the impact of VAT MTIC fraud, described elsewhere in this edition, have made a major contribution to increased asymmetries between UK and other EU Member States' trade figures there are a number of other factors which also contribute to these asymmetries. This article describes some of these other factors influencing EU asymmetries in trade in goods.

2. The agreed international guidelines for trade statistics are those published by the United Nations 'International Merchandise Trade Statistics: Concepts and Definitions'. This is the standard to which most countries aspire. It consists of recommended guidelines rather than hard and fast rules, which can lead to inconsistencies between countries because some are easier to implement in one country than another. The list below sets out the known reasons for these inconsistencies:

- Valuation differences

For statistical purposes the valuation bases recommended in the *International Merchandise Trade Statistics Concepts & Definitions* published by the United Nations and adopted by Customs are:

The valuation of exports is on a *free on board* (f.o.b.) basis, i.e. the cost of goods to the purchaser abroad, including:

- packaging;
- inland and coastal transport in the UK;
- dock dues;
- loading charges; and
- all other costs such as profits, charges and expenses (e.g. insurance) accruing up to the point where the goods are deposited on board the exporting vessel or aircraft or at the land boundary of Northern Ireland.

The valuation of imports is on a *cost, insurance and freight* (c.i.f.) basis including:

- the cost of the goods;
- charges for freight & insurance; and
- all other related expenses in moving the goods to the point of entry into the UK (but excluding any duty or tax chargeable in the UK).

When goods are re-imported after process or repair abroad the value includes the cost of the process or repair as well as the value of the goods when exported.

Because of its link with VAT, the primary valuation for trade in goods with EU countries is that required for VAT accounting purposes, usually the invoice value. Regular sample surveys are conducted by HM Customs & Excise to establish conversion factors to adjust the invoice values to produce the valuation basis required for statistical purposes. Separate factors are imputed for a range of different delivery terms and for trade with each Member State.

The value recorded for imports and exports includes any duties or levies that have been applied to goods originating in non-EU countries but which have since cleared EU Customs procedures in one EU country prior to moving onto other EU countries.

- Exchange rate:

The value recorded must be in the national currency even if the transaction was completed in another currency. Use of different exchange rates by the exporter and the importer can cause discrepancies.

- Timing differences resulting in movements of goods reported in different months by exporting and importing countries.
- Goods classified to different commodity codes by importer and exporter
- Reporting concessions and simplifications:

Countries allow special concessions for large traders. For example shipments of mixed products (e.g. vehicle parts) can be reported under one commodity code. Countries may have different thresholds below which value or tonnage a detailed commodity breakdown is not required.
- Methodological discrepancies in reporting:

The trade statistics compiled by HM Customs & Excise are in accordance with the ‘general trade’ system of recording which is described in *International Merchandise Trade Statistics Concepts & Definitions* published by the United Nations. They comprise all merchandise crossing the national boundary of the UK including goods imported into and exported from HM Customs & Excise warehouses and free zones. Imported goods are recorded whether or not at the time of importation they are intended for use in the UK or for re-export. Import statistics therefore include British goods re-imported and goods imported for process or incorporation with other goods and subsequent re-exportation. Such re-exports are not distinguished from exports of UK produce.

Goods in transit through the UK (even where transshipment is involved) are not included in the statistics.

The ‘special trade’ system of recording that is used for data supplied by HM Customs & Excise to Eurostat records transactions across the customs boundary (e.g. on release from a Customs & Excise warehouse).
- Differences in method of recording leased goods.
- Goods may be traded while in transit from one country to another (e.g. grain and crude oil).
- Reclassification of goods for confidentiality.
- Suppression of data to avoid disclosure of confidential information.
- Differences between country of consignment and country of origin and between country of consignment and country of final destination.
- Fraudulent declarations.
- Errors in data collection and processing.

All the above can apply equally to EU trade and to non-EU trade.

A lack of consistency between Member States in implementing the Intrastat system for EU trade introduced some additional causes of discrepancies for trade within the EU:

- no common approach to adjustments for non-response and below threshold trade;
- differences in the treatment of distance selling arrangements (e.g. mail order); and
- transactions between a reporting trader in one Member State with a trader below the threshold in another Member State so that the transaction is not reported in both countries.

Note:

1. A fuller version of this article was published with the *Trade First Release* on 9th July 2003 and appears on the National Statistics website at www.statistics.gov.uk/CCI/article.asp?ID=402 and the August edition of *Economic Trends*.