COMPARATIVE ANALYSE OF VAT SYSTEMS IN THE NEW EU MEMBER STATES

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Abstract

The common system of value added tax plays an important role in the European single market, with VAT being a major source of revenue for Member States as well as for the EU budget. EU VAT legislation is constantly changing until a single EU VAT area is created. One of the most important objectives of the European Commission is to harmonise VAT rules in order to significantly reduce the €50 billion lost each year to VAT fraud in the EU, with the highest levels in the new Member States. Directive 2006/112/EC aims to apply common rules for Member States in the intra-Community area, while leaving each Member State free to decide, within certain limits, on the level of rates and ceilings, deductibility, time limits for declaration and payment, refunds, etc. The aim of the paper is to analyse the similarities and differences concerning VAT in the new Member States of the European Union. To this end, standard and reduced VAT rates, exemption thresholds for small businesses, the share of VAT in GDP and the VAT Gap in these countries are highlighted. The results of the study are a starting point for identifying the most appropriate solutions to improve VAT collection in Romania and the other EU-13 Member States.

Keywords: *value added tax, standard VAT rates, reduced VAT rates, VAT share in GDP, VAT Gap.*

1. Introduction

Whether we are talking about products or services, VAT is borne by the final consumer. In the current context, as we emerge from the crisis caused by the Covid-19 pandemic and enter the crisis generated by the Russia-Ukraine war, Romania and the EU Member States are directly affected, with the economic effects becoming not only visible but also worrying. At least in Romania, the uncontrolled rise in prices is further burdening the population with low and even average incomes. In addition to this fact, which has a direct impact on consumption, there is also the tendency of the population to keep their savings, this time also at the level of the high-income population. The tendency to leave Romania, to spend money earned in Romania in other countries, and therefore to pay VAT in other countries, is an imminent danger which, in our opinion, requires special attention. In order to increase VAT revenue to the state budget, domestic consumption must be encouraged, because an increase in the VAT rate is pointless in the context of Romania's derisory VAT collection.

These days, the EU VAT system must aim, in addition to eliminating tax competition, to combine efforts to tackle the post-Covid economic crisis. This is why, at this point, challenges such as digitisation and modernisation of VAT with the aim of implementing a definitive tax system are taking a back seat. Exceptional provisions are needed, similar to those adopted for example by EU Decision 2020/4915 exempting EU Member States from VAT on imports of products needed to fight the pandemic, such as certain medicines, protective equipment and Covid-19 medical devices.

The analysis carried out in this paper focuses on the new EU Member States as, in our view, their economies appear to be more exposed in the current context than the economies of the other EU Member States. These are the countries that became EU members in 2004 (Cyprus, Czech Republic, Estonia, Hungary, Lithuania, Latvia, Malta, Poland, Slovenia, Slovakia), in 2007 (Bulgaria, Romania) and in 2013 (Croatia).

The aim of this paper is to highlight the similarities and differences between the EU-13 countries in terms of the level of VAT rates applied, the exemption thresholds for small businesses, the VAT revenue as a proportion of gross domestic product and the amount of VAT Gap. The study is based on current intra-EU legislation, the Eurostat database and recent European Commission VAT analyses.

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2. VAT rates in the new EU Member States

Directive 2006/112/EC on the common system of value added tax requires Member States to apply a standard VAT rate of at least 15%, but allows their governments to set the number and level of reduced VAT rates within certain limits.

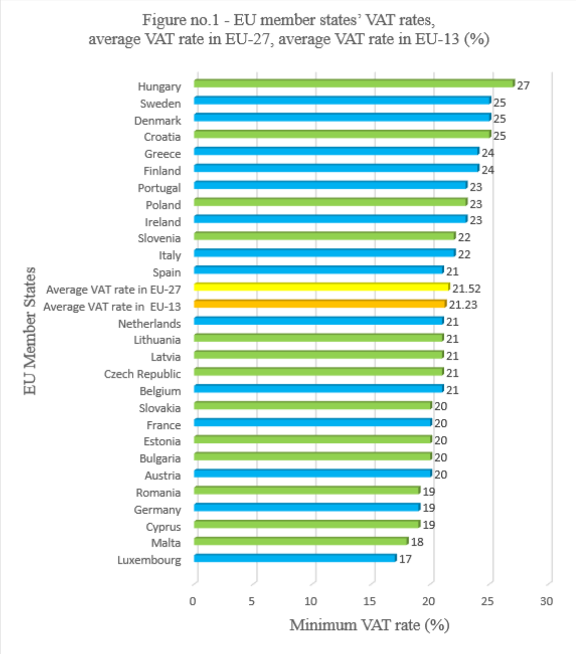
There are notable differences in the VAT rates applied between EU member countries. Thus, as Figure 1 shows, of the new EU countries, Malta has the lowest standard VAT rate of only 18% (only 1 pp. below the EU-27 minimum rate in Luxembourg). Romania and Cyprus follow with standard VAT rates of 19%, Bulgaria, Estonia and Slovakia with 20%, the Czech Republic, Lithuania and Latvia with 21%, Slovenia with 22%, Poland with 23%, Croatia with 25% and Hungary with 27%, which has the highest VAT rate in the EU.

The average standard VAT rate at EU-27 level is 21.52% and the average standard VAT rate at EU-13 level is 21.23%. Although the difference between the two average rates seems very small, we note that only 4 EU-13 countries (Slovenia, Poland, Croatia and Hungary) have rates above the average level and the remaining 9 EU-13 countries have rates below the average VAT rate. We can conclude that in general the new Member States have a lower standard VAT rate than the countries that became EU members before 2004.

The VAT Directive establishes the right of Member States to have, in addition to the standard VAT rate, a maximum of two reduced rates for goods and services listed in Annex III to the VAT Directive. These reduced rates must be a minimum of 5%.

According to Figure 2, all new EU Member States have reduced VAT rates, with Bulgaria, Estonia and Slovakia having only one reduced rate and the others two reduced rates. The highest reduced rate is in Hungary (18%), and 8 countries have reduced rates of at least 5%: Cyprus, Croatia, Latvia, Lithuania, Malta, Poland, Romania and Hungary. The only EU country with no reduced VAT rate is Denmark, which is not on the list of new Member States.[1]

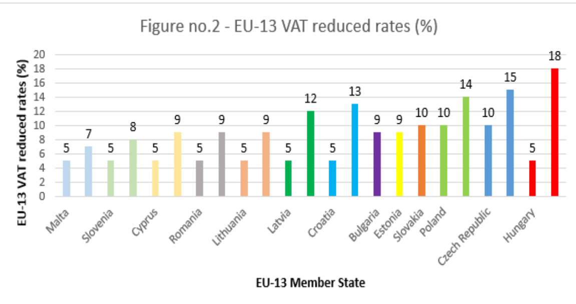
Unlike the new Member States, the founding Member States also have very low VAT rates and 'parking rates'. Rates of less than 5% or even zero apply to cultural services, delivery of newspapers, books, food, pharmaceuticals, etc. These include France with a super low rate of 2.1%, Luxembourg with 3%, Spain and Italy with 4% and Ireland with 4.8%. Parking rates are lower than the standard rate but equal to or higher than 12%, which apply to supplies of goods and services not listed in Annex III to the VAT Directive. Five Member States benefit from these rates: Luxembourg, Austria, Belgium, Ireland and Portugal.



Source: *https://ec.europa.eu/taxation_customs/tedb/taxSearch.html* (consulted on March 10, 2022)

In conclusion, there are significant differences in the level of standard and reduced rates applied in Member States, justified by the specific social and environmental objectives of each national economic system. A uniform common VAT system cannot exist when standard and reduced VAT rates differ or when only some Member States (those that joined the EU before 1992) have the possibility to apply very reduced rates or "parking rates".

Although reduced VAT rates may appear to help achieve social or environmental objectives, they are often ineffective because they do not reach the target groups and because they contribute to reduced tax revenues, increased administrative costs (due to controls and inspections) and compliance costs, and tax evasion.



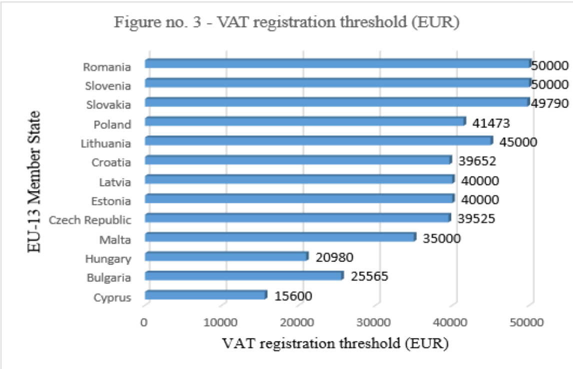
Source: *https://ec.europa.eu/taxation_customs/tedb/taxSearch.html* (consulted on March 10, 2022)

[1] https://europa.eu/youreurope/business/taxation/vat/vat-rules-rates/index_ro.htm.

However, the Covid-19 pandemic has shown that Member States need a certain degree of flexibility to deal with urgent or unforeseen situations. EU rules on VAT derogations have allowed governments to find solutions to the problems caused by the pandemic.

3. VAT exemptions and derogations in the new Member States

The common VAT system is becoming increasingly complicated to implement, not only because of the different VAT rates, but also because of the VAT exemptions.



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Thus, some Member States grant VAT exemptions for certain goods and services, such as education, healthcare, social care, sport, cultural or financial services. If taxable persons only carry out VAT-exempt activities without the right to deduct VAT on their purchases, they will not be registered as VAT payers and will not pay VAT to the budget of the state concerned.

Also, almost all EU countries have VAT exemption thresholds for small businesses (Figure 3). Small businesses can opt for the normal taxation scheme even if their annual income is below this threshold.

Romania[2], Slovenia and Slovakia have relatively equal VAT exemption thresholds for small businesses (€50,000), the highest exemption thresholds in the EU-13, and Cyprus has the lowest exemption threshold at €15,600 (Figure 3).

Compared to the EU-13 Member States, there are some peculiarities in the remaining Member States: Spain and the Netherlands do not provide for exemptions for small businesses, but there are also countries where the thresholds are higher than in the EU-13, such as France (€85,800), Ireland (€75,000) and Italy (€65,000). France and Ireland also have different exemption thresholds for supplies of goods or services.

4. The VAT Gap in the new Member States

Differences between standard and reduced VAT rates in the Member States and the increasing number of businesses with cross-border activities contribute to a shift of consumption to Member States with reduced VAT rates, to distortions in the collection of VAT revenue and to increased compliance costs for tax administrations.

It is well known that VAT plays an important role in strengthening the EU budget (almost 21% of total EU tax revenue) but also the budget of each Member State. For this reason, reducing the VAT Gap is an important objective on the European Commission's list. The causes of this gap are: legislative shortcomings, lack of digitalisation of tax administrations, tax evasion, ineffective control, etc.

The VAT Gap in absolute terms is the difference between the expected VAT revenue (or 'VAT Total Tax Liability' - VTTL) *i.e.* the VAT estimated that should be collected according to VAT legislation and the amount actually collected. The VAT Gap is due to tax evasion, but also to insolvency or bankruptcy of businesses, legal tax optimisation or administrative errors.

We note from Figure 4 that Poland, which has a standard VAT rate of 23%, collects the highest VAT revenue in 2019, amounting to over 42 billion EUR. In fact, in Poland VAT revenue accounts for about 40% of the Polish budget revenue. Poland is followed at a considerable distance by the Czech Republic, with a VAT collected of almost 17 billion EUR, Hungary and Romania with VAT receipts of around 14 billion EUR, with all other EU-13 countries below 10 billion EUR.

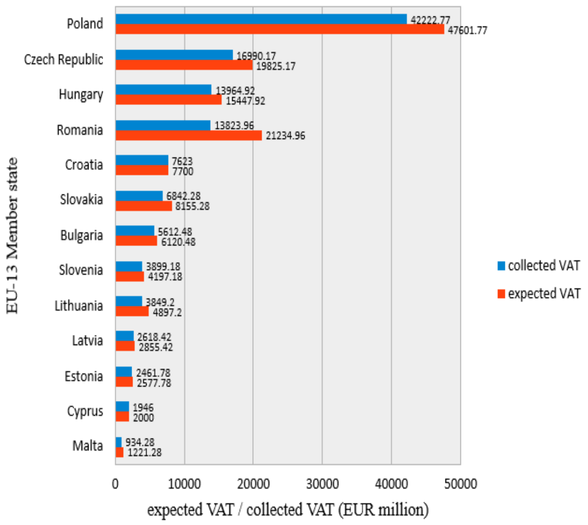
The order of countries according to the VAT Gap in absolute terms is different. In first place is Romania, with a VAT collection gap of 7.4 billion EUR, followed by Poland with 5.4 billion EUR and the Czech Republic with 2.8 billion EUR. Hungary has a VAT Gap in absolute terms 5 times smaller than Romania, although the VAT collected by the two countries are roughly equal.

Malta, the EU-13 country with the lowest standard VAT rate (18%) and the lowest real VAT revenue (below 1 billion EUR) has a VAT collection gap of 287 million EUR, the fifth lowest in the EU-13.

The smallest VAT GAP in absolute terms is recorded in Cyprus (54 million EUR), whose VAT collected is less than 2 billion EUR, ranking second after Malta in the EU-13 countries with the lowest VAT revenue.

[2] 300000 RON at the exchange rate of 4.9488 RON/EUR on 10.03.2022.

Figure no. 4 – VAT GAP in EU-13 (EUR million)



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The VAT Gap can also be calculated as a percentage, by relating the absolute value of the VAT Gap to the VTTL.

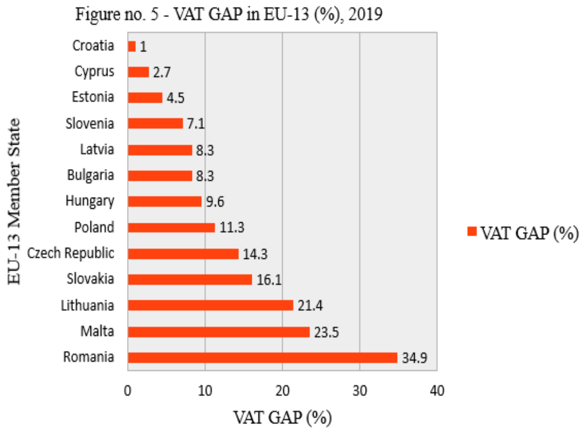
Analysing the VAT Gap in percentage terms (Figure 5), we see that Romania stands out in 2019, with a VAT Gap of 34.9%, the highest value ever recorded by our country and also the highest value in the EU-13 and EU-27.

At the opposite pole, Croatia, Cyprus and Estonia had the lowest Gap values, respectively 1%, 2.7% and 4.5%, followed by Slovenia with 7.1%, Latvia and Bulgaria with 8.3%.

From Figure 6 we see that the VAT Gap decreased in 2019 compared to 2018 in seven EU-13 Member States: Croatia, Cyprus, Lithuania, Bulgaria, Slovakia, Latvia and Poland.

The most spectacular decrease in the VAT Gap was recorded in Croatia, which recorded a value of 1% in 2019, compared to 7.4% in 2018 and 11% in 2015. In addition, VAT revenues increased significantly in 2019, despite the extension of the application of the reduced VAT rate to certain agricultural products, food and pharmaceuticals.

Also in Cyprus the VAT Gap decreased significantly in 2019 compared to 2018 and 2017 and reached 2.7%, the value it had been in 2006.



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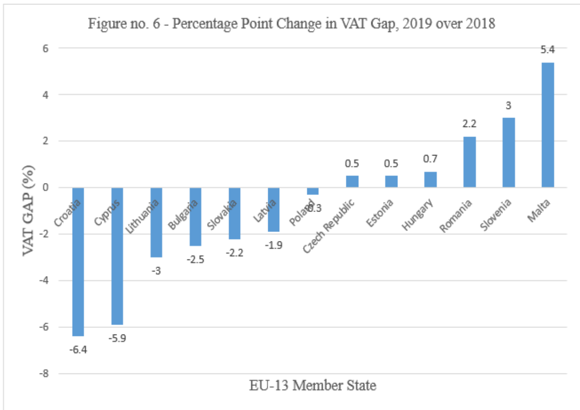

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By contrast, in Lithuania and Bulgaria the VAT GAP decreased in every year from 2015 to 2019. Bulgaria has seen one of the most remarkable decreases in the VAT Gap over this period, of 11.3 pp., as a result of the implementation since 2015 of a programme to reduce grey economy and tax compliance costs.

In 2019, the VAT Gap in Slovakia decreased by 2.2 pp. compared to 2018 and by 9 pp. compared to 2015, despite the fact that as of 2019, accommodation services are no longer taxed at the standard rate of 20%, but at a reduced rate of 10%.

Even though in 2019 compared to 2018 the reduction of the VAT Gap in Latvia was only 1.9 pp., in the period 2015-2019 the reduction was one of the highest in EU-13 (12.2 pp.)

Poland recorded the most significant decrease in the VAT Gap between 2015 and 2019 (13.4 pp.) not only in the EU-13, but in the EU-27. The biggest reduction occurred in 2016 as a result of the implementation of SAF-T[3]. It remains to be seen whether the implementation of SAF-T will have the

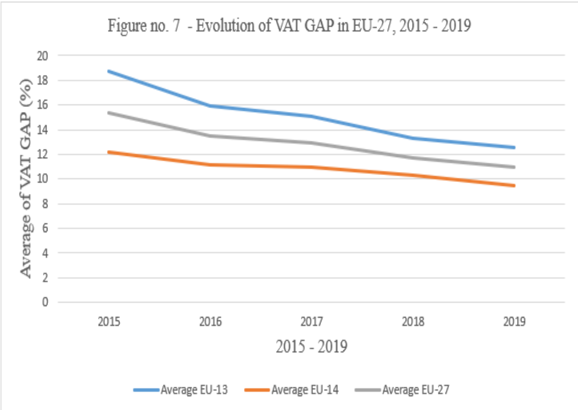
[3] The Standard Audit File for Tax (SAF-T) reflects the international standard for the electronic exchange of accounting data between companies and tax authorities or external auditors, developed by the OECD in 2005.

same effect in Romania[4]. For 2019, however, our country has seen an increase in the VAT Gap of 2.2 pp. compared to 2018.

A significant increase in the VAT collection gap (3 pp.) is also found in Slovenia, but the situation is not as serious as in Romania because in Slovenia the VAT Gap in 2019 is 7.1% compared to 34.9% in Romania.

The biggest increase in the VAT Gap in 2019 compared to 2018 is in Malta (5.4 pp.), which thus reaches a VAT Gap level close to that of 2015.

According to Graph 7, in the period 2015-2019, before the Covid-19 pandemic, there was a decrease in the VAT collection gap both at the level of the new Member States (EU-13) and at the level of the whole European Union.



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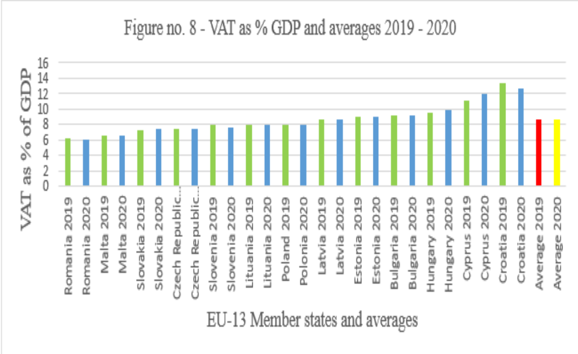
It is also noted that the VAT Gap in percentage terms is significantly higher in the EU-13 compared to the rest of the Member States, characterised by prosperous economies and higher living standards.

5. Evolution of the share of VAT revenue in GDP in the new Member States

The evolution of the share of VAT in GDP in the EU-13 over the period 2019-2020 is shown in Figure 8. The share of VAT in GDP calculated as EU-13 average increases by 0.005 pp. from 8.6283% in 2019 to 8.6333% in 2020.



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Croatia has the highest VAT revenue to GDP, i.e. 13.35% in 2019 and 12.59% in 2020, due to the high standard VAT rate (25%) and the VAT Gap of only 1%. It is followed by Cyprus with 11.03% in 2019 and 11.99% in 2020, which, despite having a low standard VAT rate (19%), has a VAT Gap of only 2.7%. The 3rd place is occupied by Hungary, with a VAT share in GDP increasing from 9.52% in 2019 to 9.83% in 2020. The explanation is given by the very high standard rate (27%) combined with a VAT Gap below the EU-13 and EU-27 average.

Romania and Malta, the EU-13 countries with the highest VAT Gaps (34.9% and 23.5%) and the lowest VAT rates in EU-13 (19% and 18%) are at the bottom of the EU-13 in terms of VAT to GDP ratio, with values of 6.13% and 6.52% in 2020 , down from 2019.

The share of VAT revenue in GDP remained stable in 2019 compared to 2018, with VAT being the largest source of consumption taxes in the EU-13.

6. Conclusions

VAT revenue is one of the most important sources of public revenue for Member States and a significant own resource for the EU budget, which is why a major objective of the European Commission, but also of national tax authorities, is to reduce the VAT Gap, especially in the context of the economic slowdown caused by the COVID-19 pandemic and the Russia-Ukraine war.

The VAT Gap is a measure of the ineffectiveness of the application of VAT compliance rules in EU countries and may be the result of miscalculations, tax fraud or bankruptcies. This affects the EU budget, reducing the funds available for development, conservation and environmental protection, digitisation, research, etc. Competitiveness between Member States, generated by different VAT rates, lack

[4] In Romania large taxpayers were the first required to submit the SAF-T file in February 2022, followed by medium-sized taxpayers in 2023 and small taxpayers in 2025.

of coherence, compliance and tax efficiency remain unresolved issues.

Each country adopts its own measures, in line with the already existing context. Economics is, above all, a feeling. Therefore, to better understand the phenomena in a country, you have to live in that country. In our opinion, encouraging consumption can move things in a favourable direction because it is the final consumer of goods or services who bears the tax. As far as companies are concerned, as they are the ones who collect and pay the tax, the producer-consumer chain must be shortened, as an incentive to consumption by maintaining or even reducing the price level, at least for basic products.

In 2022, some EU-13 governments have taken measures to help people cope with substantial price rises. For example, the Lithuanian government has decided to apply a 0% VAT rate (instead of 9%) for heating from 1 January to 30 April 2022. The Latvian government reduced the VAT rate for petroleum products from 21% (standard rate) to 12% from 1 April to 31 December 2022. From 30 April 2022 Estonia changes the reduced VAT rate on fuel from 9% to 5%.

The Romanian government is considering capping certain prices, given the massive increase in prices in recent times. However, a cap on food prices, for example, could bankrupt many food companies (such as poultry farms) whose costs have risen sharply due to rising electricity and gas prices, and the VAT reduction as a support measure in this case seems insignificant.

The fact that Romania has the biggest VAT Gap in the EU is not surprising. Entrepreneurs in our country are forced to 'borrow' from the state in order to carry on their business. The decline in purchasing power and the current geopolitical context are contributing to the deepening crisis we are facing.

One of the measures to reduce the VAT Gap is the E-invoice programme. This measure will also burden economic agents by obliging them to invest in equipment, specialised training, perhaps hiring specialised staff or contracting out the service. Slovakia has started implementing E-invoicing. In Poland it will become mandatory from January 2023, until then it is optional. France has already requested a derogation on mandatory implementation until 1 January 2024. From 1 July 2022 Romania will practice mandatory e-invoicing for high tax risk products (vegetables, fruit, alcoholic beverages, clothing, shoes, sand, gravel, new housing). The aim is to combat fraud and tax evasion by giving tax administrations the possibility to track VAT collection in real time. Businesses are being forced into digital transformation to comply, for many of them this is a new burden.

During the Covid-19 pandemic, support measures were put in place in Romania for entrepreneurs, who could benefit from payment instalments for outstanding obligations (including VAT). However, businesses with debts older than March 2019 could not benefit from the measures provided for in GO no. 11/2021[5].

We believe that less restrictive measures are needed to help any entrepreneur willing to continue a business, to give him the possibility to pay VAT arrears older than one year in instalments, without foreclosures and account freezes, which ultimately lead to the blocking of the activity. If businesses close down one after the other, the state will have nowhere to collect VAT. Moreover, following the enforcement procedure, goods are sold at derisory prices, after deducting three steps from the starting price at auction[6], plus enforcement costs, and the foreclosing party remains in debt, most of the time.

Perhaps it is time to focus more on cause than effect. In vain we try to manage, to fine, as if we are in the position of patching a bag that always snaps in other places. We all know that we can only temporarily get rid of the effect if we don't treat the cause, and the cause lies in the poverty of Romania's population. Where there is suspicion of tax evasion, there is a reason beyond the desire of a limited segment of people to get rich. We cannot categorize a country according to a few models that do not represent them. The many, the ones who are the true captains of a ship on an eternally troubled sea are the small businessmen who have the courage to go ahead, under any conditions and at any risk. Because this is what they have learned to do, they have made and are making numerous efforts and for this they must be respected, supported and guided[7]. It is certainly very important for the state to collect VAT, but it is essential to promote trust, transparency and a culture of tax compliance in all possible ways.

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