Library Briefing
Library of the European Parliament 27/10/2011

Value Added Tax (VAT) & the impact of increases

Despite being a relatively new tax, VAT is now operated in over 130 countries worldwide and raises around 20% of the world's tax revenues. This is a reflection of its effectiveness in collecting revenue.

Most of the VAT raised by Member States (MS) is for national budgets; a small share goes to the EU budget. However, the fact that it is a tax on goods and services sold means that it has an effect on the functioning of the single market. Thus, there is EU legislation. This mainly requires some harmonisation of MS tax rates: a minimum standard rate of 15% and no more than two lower rates for a limited number of goods.

Since the start of the economic crisis, VAT rates in MS have changed often: mainly increasing, to try and help reduce national budget deficits by collecting more tax. Other effects of an increased VAT rate are a rise in the inflation rate, slower economic growth and greater strain on low-income households' finances. Indeed, as a tax on consumption it penalises those with lower incomes. Rate rises can also have a negative psychological impact on consumers and businesses and encourage greater fraud and evasion of the tax.

However, it is hard to predict the effects since a rise cannot be taken in isolation. For example, although higher VAT means increased prices, it brings about slower growth which normally results in downward pressure on prices.

In this briefing:

"Purely from a revenue point of view, VAT is probably the best tax ever invented."

S. Cnossen, adviser to the Dutch Bureau for Economic Policy Analysis (CPB).

Context

Almost unknown in 1960, VAT is now present in more than 130 countries and affects about 4 billion people. Its introduction in the EU dates back to the 1960s. Many prospective candidate countries introduced it in the 1990s as it is a requirement of EU membership.

It is a particularly effective way of raising tax revenue, though administratively it is more cumbersome than the sales tax that it has often replaced. It raises around 20% of the world's tax revenue. MS rates have risen over the long term and MS are now raising or planning to raise rates further in order to help reduce their budget deficits.

The tax is applied at each stage of the production and sales process. Every VAT-registered seller adds the tax to the sales price and must then pay the tax collected over to the authorities on a regular basis. The trader can, however, deduct any VAT paid on purchases.

VAT is in principle a broad-based tax on all commodity sales, whether to consumers or to other businesses.

VAT is a proportional - not progressive - tax, since it was not designed to meet social or

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redistributive objectives. It is a form of consumption tax.

Proportional (or flat) tax: takes the same percentage of income from everyone regardless of how much (or little) the person earns.

Progressive tax: the higher your income rises the more it takes.

EU VAT data

VAT collected (2009)

	€ million
Austria	22 158
Belgium	23 600
Bulgaria	3 156
Cyprus	1 546
Czech Republic	9 784
Denmark	23 261
Estonia	1 227
Finland	15 004
France	129 421
Germany	177 680
Greece	14 912
Hungary	7 820
Ireland	10 227
Italy	86 537
Latvia	1 109
Lithuania	1 961
Luxembourg	2 360
Malta	457
Netherlands	40 086
Poland	23 056
Portugal	11 973
Romania	7 852
Slovakia	4 221
Slovenia	2 984
Spain	43 396
Sweden	30 354
United Kingdom	90 420

Source:DGs Taxud & Budget

VAT is a major source of revenue for MS national budgets. It is added to the price of goods or services rather than being levied on persons or organisations. As such, it is an indirect tax and has an immediate impact on the functioning of the single market. It is therefore subject to EU-level harm-onisation rules.

Council Directive 92/77/EEC of 1992 limits MS' freedom to set VAT rates.

It established a standard VAT rate of 15% or higher, with the option of applying one or two reduced rates (minimum 5%) to certain specified goods.

Although rates were stagnant between 2002 and 2009, since the crisis they have changed often, mainly upwards.

VAT paid into the EU budget

One of the 'own resources' which go into the EU budget based on MS' VAT receipts. In 2000, VAT covered 38% of the budget, but this was down to an estimated 11% in 2011. The calculation of amounts to be paid by each MS is harmonised but there are some exceptions:

- The VAT base to be taxed is restricted to a maximum of 50% of Gross National Income (GNI). This is to protect less prosperous countries from having to pay a disproportionate amount.
- The VAT collected is divided by the weighted average rate of VAT in the MS, taking into account that the MS may have a number of rates.
- A rate of 0.3% is applied to the result of this calculation to establish the amount to be paid, though there are lower rates for some countries and a special adjustment for the UK.

Effect of rate rises

The effects of a VAT rate rise can be hard to determine as isolated events, insofar as a rise will have an impact on other elements. For example, although it may in isolation result in an increase in general prices, the fact that it reduces economic activity is, in contrast, deflationary.

A rise in VAT, in isolation:

- Increases the inflation rate, as it results in price rises.
- Raises government revenues.
- Results in slower economic growth.
  - ➢ Retailers in particular are most affected as consumers spend the same but are able to buy less.
  - ➢ It may have a lesser effect in certain areas such as food, children's clothing, newspapers and magazines, which may have lower VAT rates.
- Affects the poorest / low-income groups the hardest because these groups tend to spend a bigger share of their incomes on taxed goods.
- Increases business' input costs and so affects their ability to invest in merchandise.

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- Can have a negative psychological effect on the behaviour of both consumers and businesses.

A rise in a tax rate has been used by businesses in the past to increase their prices by more than the strict rate of the tax rise, in order to increase their margins. Equally, some businesses have said that they will absorb the rise, i.e. no increase in prices, as a marketing ploy though this may only be short term.

The Centre for Retail Research, which provides independent research of the retail and services sectors, estimated that the rise in the standard rate of VAT in the UK from 17.5% to 20% in January 2011 will increase inflation by between 0.6% and 0.8% and cut economic growth by between 0.5% and 0.8%. It should also raise an extra £13 billion (approximately €15 billion) in taxes.

The timing of the effects may be skewed, as people bring forward purchases, in particular of non-perishable goods, to benefit from lower prices before the rate goes up.

Evasion and fraud

VAT, like any other tax, is vulnerable to evasion and fraud. Rising rates encourage more of both, since the potential gain increases.

Evasion can be via non-recorded transactions. In this case, even if the traders pay input tax on purchases, which they may not be able to recover, they will gain more because their unrecorded output tax is higher. This may also allow them to unfairly compete by undercutting legitimate operators.

'Simple' frauds involve registering a business to charge customers VAT but then disappearing before paying tax to the authorities. Another method is to declare bankruptcy before tax is paid, taking the VAT cash owed out of the business beforehand.

Standard VAT rates (%)

	2000	2009	2011
EU27	19.2	19.8	20.7
Austria	20.0	20.0	20.0
Belgium	21.0	21.0	21.0
Bulgaria	20.0	20.0	20.0
Cyprus	10.0	15.0	15.0
Czech Rep.	22.0	19.0	20.0
Denmark	25.0	25.0	25.0
Estonia	18.0	20.0	20.0
Finland	22.0	22.0	23.0
France	19.6	19.6	19.6
Germany	16.0	19.0	19.0
Greece	18.0	19.0	23.0
Hungary	25.0	25.0	25.0
Ireland	21.0	21.5	21.0
Italy	20.0	20.0	20.0
Latvia	18.0	21.0	22.0
Lithuania	18.0	19.0	21.0
Luxembourg	15.0	15.0	15.0
Malta	15.0	18.0	18.0
Netherlands	17.5	19.0	19.0
Poland	22.0	22.0	23.0
Portugal	17.0	20.0	23.0
Romania	19.0	19.0	24.0
Slovakia	23.0	19.0	20.0
Slovenia	19.0	20.0	20.0
Spain	16.0	16.0	18.0
Sweden	25.0	25.0	25.0
UK	17.5	15.0	20.0

Source: Eurostat

2011 = May 2011
EU figures are the arithmetic average

Different VAT rates and non VAT-able (exempt) items including imports and exports are also areas that attract frauds. All can apply in the EU as intra-EU supplies of goods between businesses are VAT exempt in the MS of origin with taxation taking place in the destination MS.

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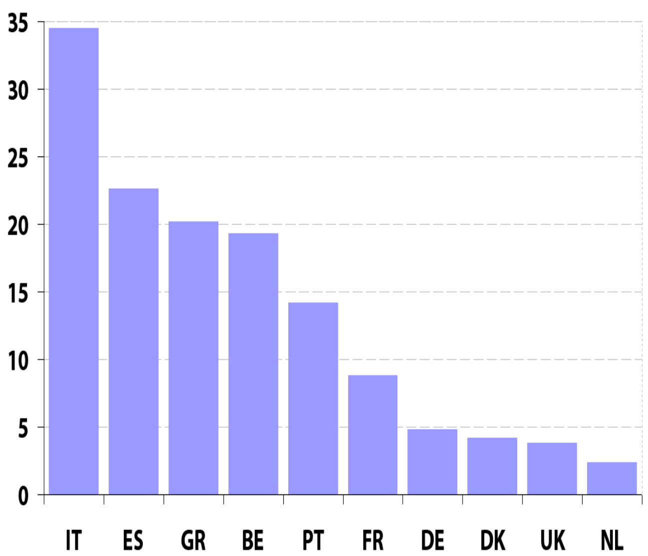
Import / export frauds typically involve setting up a number of companies. Called 'Carousel' frauds, they operate in a number of ways. In simple terms:

- Goods are imported VAT free. The trader sells the goods, VAT included, but then disappears without paying over the VAT to the authorities. If this occurs in the EU it is known as 'missing trader intra-Community' (MTIC) fraud.
- Another variation is to benefit from reclaiming input VAT but having no tax to pay on zero-rated exports.

There is little publicly available information on VAT non-compliance. The European Commission (EC) reported in 2004 a 'VAT gap' – the difference between actual VAT receipts and what national governments should have expected to receive – of up to 10% in some MS. The German Federal Audit Court estimated losses of 11% there in 2003.

A 2003 top-down approach (shown graphically below) estimated VAT evasion percentages for ten MS. The calculation compared actual VAT collected to a hypothetical 'maximum' revenue - based on consecutive three-year periods between 1991 and 1996 (e.g. Denmark 1994-96 or France 1991-93).

Estimates of the VAT gap (% evasion)



Source: Calculated from Gebauer and Parsche data (2003).

Lower VAT rates

A reduction in the VAT rate will have the opposite effects to those noted above.

The temporary reduction in VAT from 17.5% to 15% for 2009 in the UK produced an estimate of GDP raised by less than 0.5% relative to what would have happened without the VAT increase. Consumption and GDP were expected to reduce when the VAT rate was put back up again.

For certain essentials such as food, children's clothes, and domestic fuel and power, reduced and zero rates can play an important role in supporting lower income groups, trying to ensure that the VAT burden is not disproportionate for these groups.

Lower VAT rates have been recommended for some very specific sectors in an economy. For example, locally supplied services and some parts of the hospitality sector may be relatively costly and subject to substitution through do-it-yourself or undeclared workers. A lower VAT rate could boost employment for lower skilled workers (e.g. in hotels and restaurants) and encourage tourism.

Main references

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