Harmonization of VAT in the European Union. Achievements and Perspectives

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Abstract: *The drafted study pursues the development of the generalization process of using VAT in the EU member States, and the advantages they represent. The negotiations and compromises implied by this process are presented, as well as the current stage of harmonization of the taxation base and of the VAT shares in the member countries. The impact of the economic-financial crisis on the harmonization process is also emphasized, in the context of budgetary restrictions that the governments of the member States had to deal with.*

Key-words: tax harmonization, tax coordination, internal neutrality, external neutrality, standard share

JEL Classification: H2, H3

1. Introduction

The need to eliminate mutual suspicions between member States concerning the discriminations related to the import of goods and the granting of masked subventions on exports has constituted the reason of the generalization of the value added tax in the European Economic Community, and the target of the tax harmonization processes that followed.

The main moments of the VAT harmonization in the European Union have been: the insertion of VAT in all member States (until 1973); the uniformization of the taxation base for VAT (beginning with 1977) and of VAT shares (in percentage); the passage to a transitory system for VAT, together with the creation of the unique market and with the dissolution of customs borders (January 1, 1993); the simplification of the VAT system and the cooperation of the member States to reduce the tax fraud.

Before 1967, only France applied VAT, the other member States using various forms of indirect taxes applied in waterfall. Apart from other disadvantages, this form of taxation obstructs the liberalization of the trade between member countries due to the *lack of neutrality* (it penalizes the long production and distribution circuits) and to the *lack of transparency,* which makes it impossible to correctly determine the tax adjustments that must be made at the border (pay back the indirect tax incorporated in the price of the exported product and apply the indirect tax of the country of destination on the imported product). In addition, it does not stimulate the investment process, the products destined to investments being taxed as those destined for consumption.

These disadvantages are eliminated from the taxation system through VAT which, in addition, also has other benefits:

- Stimulates compliance by the mechanism to exercise the right to deduct the VAT paid "upstream" (in the previous stages);
- It is a consistent and relatively stable source of income, which also explains the usage of VAT as financing source of the community budget;

- It has a high tax output, and the ratio between the collected amounts and the administration expenses is high.

Under these circumstances, the introduction and generalization of VAT in all the countries of the Community proved to be the only solution to respect the principle of total tax neutrality, both internally, and at the community level Dracea N.M. (2012, p.110).

The internal neutrality claims that the amount of the charge included in the sale price of the products should be the same, regardless of the length of the goods' route in the successive processing and distribution stages so that certain circuits should not be privileged in relation to the integration manner of participants in the manufacturing and trading of the goods.

The external neutrality implied, on its turn, that the same amount of the charge should be added to similar products manufactured on the national territory the same as for the imported ones. This constraint has proven to be extremely important, because the tax loyalty of the competition between partners is indispensable for the union to survive. However, in order to provide the external neutrality, it was enough to untax exports and to tax the important products, the same as the similar autochthonous products.

2. The evolution of the generalization and harmonization process of VAT in the European Union

The proposal that all EEC member countries should pass to VAT was drafted in the Neumark report (1963). On these grounds, the European Community Commission proposed two drafts of Directive (knows as the "first" and "second" VAT Directive), approved by the Council in 1967, and which entered in force on January 1, 1970. They imposed on the member States the adoption of VAT (replacing the cumulative and one-stage tax), and specified the general regime of the new tax, leaving however a wide autonomy to the member States, mainly as regards the application shares and manners. The generalization of the VAT system at the community level lasted for several years (1967-1973), and the main coordinates set by the two directives were:

- apply the tax in every stage of the economic circuit, but only on the added value in the relevant stage, thus avoiding the "snowball" effect characteristic to the waterfall tax;
- return the VAT paid in the previous stages (make use of the deduction right) making the tax to be borne by the final consumer in the desired amount, regardless of the number of intermediate links;
- the application of the "zero share" (exemption with right of deduction) in the case of exports, so that the tax should not affect the price competitiveness on the international market;
- the right to charge VAT belongs to the States on whose territory the goods and services are consumed, regardless of their origin (autochthonous production or import).

The adoption of VAT as community tax contributed to:

- the provision of neutrality in relation to the structure of production and distribution circuits;
- the elimination of the cumulative effect;
- the stimulation of investments of European companies (due to the immediate deductibility of the tax that has hit investments);
- the elimination of competitive distortions between products coming from various States (according to the destination country principle).

The application of VAT has become one of the mandatory conditions in order to adhere to the Community. Nevertheless, certain discriminations continued to exist. They were due to structural differentiations of the techniques to impose the added value at the level of each community State. More precisely, they were generated by the *existence of divergences related to:* application scope (taxable persons, taxable and exonerated operations), determination of bases, territoriality, exigibility, imposition shares, particular regimes. The board of ministers established on April 21, 1970 that a certain amount of VAT cashed in from the States should be destined to the financing of the community budget. The community institutions have become directly interested in the application technique and accuracy of VAT cash-ins by the member States. On their turn, the States started to be interested in providing the fair distribution of the tax obligation according to the economic activity of the member States to the community budget.

Once the obligation of the member States to contribute to the EU budget with a portion of the cashed-in VAT was instituted, it was proceeded to the harmonization of the taxation base for VAT (categories of goods and services subject to taxation), respectively every member State applies VAT, in general, to the same transactions (*the sixth VAT Directive of EU, adopted on May 17, 1977*). This directive, often presented as a "European VAT code", has given a new impulse to the harmonization process, instituting a joint VAT trim, defining the fundamental concepts of payer and of taxable activity, in other words it specified the subject and object of the charge.

After the structural harmonization of VAT, *in order to create a domestic market, shares had to be harmonized,* to be able to eliminate tax borders. In the absence of harmonized shares for VAT and excises, the control at the borders had to be maintained. Therefore, the joint system of taxes on consumption had to have the same structure, as well as close or unified shares, as much as possible. Or an analysis of the European Commission (of 1987) on VAT rates practiced in the Member States emphasized the existence of big discrepancies as regards:

- the number of taxation rates practiced (from 2 in Germany to no less than 6 in France);
- the dispersion between the highest rate and the minimum rate practiced in a member State differs from one country to the next;
- the diversity of special regimes, targeting exonerations, special deduction mechanisms, VAT returns;
- the inclusion of the same goods in different taxation categories by different States.

The different shares applied to the consumption of products influenced it in different manners and distorted the competition between the enterprises of the member States. When the tax sampling of products was lower in one country compared to the other, if the competition conditions are identical, the companies manufacturing products in the first country are in more favorable competition conditions than in the other country. Why? Because the *demand may be bigger and profits higher.* In exchange, the harmonization of shares eliminates the tax barriers, providing the liberalization of exchanges.

The European Commission believed that eliminating tax borders would generate distortions, transfers of incomes and the occurrence of the tax fraud risk, unless acting on the VAT shares and regime applicable to the inter-community trade.

Following the suggestions made in the White Charter of Lord Cockfield (1985), the Commission proposed to the Council in 1987 a system based on two imposition shares, whose levels should be established within "strips": a "low share" of 4-9%, and

an estimated "standard share" that could vary between 14 and 20 %, each State having the right to choose the suitable level within the limit of 5 percentage points.

However, the reduction of shares proposed by the Commission generated budgetary losses for many countries. The direct imposition regime of the inter-community transactions deprived the States from a direct control of imports entering their national territory, and generated losses of tax incomes. Some States claimed that the deviation of 5-6% of shares was too big, while others wished that every State should decide freely on shares and, consequently, the market forces should be left to act freely.

To unblock the situation, the European Commission proposed, in June 1989, to establish a *minimum normal share* (between 14 and 20%), upon which each member State should establish freely the share level that they wanted, and the set-off system should be calculated based on macroeconomic data.

Eventually, the Council only agreed to adopt minimum levels of taxation by VAT, a solution adopted by the Directive 92/77/EEC applicable since January 1993. According to its provisions, the Member States were to apply a ***standard share of minimum 15 % and one or two reduced shares, but not smaller than 5%,*** for certain products of cultural and social interest. In this sense, a list was set, including 17 goods and services of primary necessity, such as food, medicines, supply of drinking water, transport of passengers, books, newspapers and magazines, radio and television, sanitation services, etc. At the same time, the increased shares practiced by some States for luxury products (especially motor vehicles) have been cancelled, authorizing the temporary maintenance (for a transition period) of the zero share and of the special reduced shares. Subsequently, by the Directive 2004/15/EEC enforced in February 2004, the application facility of the reduced shares was also extended to certain services based on the intensive use of labor force (hotel field, certain types of restaurants, etc.).

Although supported with strong social arguments, the practice of using reduced VAT shares (even in the conditions of a relatively small list of goods and services) is sometimes criticized because it seriously contradicts the principle of tax efficiency (generating losses of budgetary incomes), it increases the complexity of the VAT system, which complicates the authorities' assessment of the tax compliance degree, on the one hand, and the tax-payers' charge, on the other hand.

In general, although the member States agree that a VAT system with an unique share is more efficient and reduces the costs of its administration, however the tax practice uses several shares, usually for social reasons.

We must underline the fact that the different level of the VAT shares existing in the member States of the European Union, in the conditions of the destination principle, *does not distort the allocation of resources for production,* as regards the exported products and services, because they are excepted from the payment of VAT. Obviously, the different level of VAT shares *directly affects the VAT-bearing product and service consumers.*

3. The current harmonization stage of taxation shares for VAT

It is certain that, at present, if, as regards the contents of the taxation base for VAT, a certain homogeneity has been achieved in the Member States, there are still important differences as regards the type and level of the shares used, as revealed by table no.1.

From the analysis of the illustrated data, numerous conclusions may be drawn as regards the harmonization stage of VAT shares in the EU:

a) as regards the *type of shares used,* we may notice a certain progress, although some differences still persist. There are States that use one share (standard), such as Denmark, while the other States, together with the standard share, use one or two low shares and even super-low shares;

b) as regards the *level of the shares used,* the following evolutive tendencies may be noticed:

- at the level of EU-27, *an increase of the level of the standard share has been noticed* (arithmetic means) by 1.8 percentage points, from 19.2% in 2000 to 21% in 2012. If, in the interval 2000-2008, the standard shares have been maintained relatively constant (the European average growing by only 0.2 p.p.), in the last 4 years they were increased in almost all Member States, making the European average grow by 1.6 p.p.;
- as regards the deviation between the highest level (Denmark) and the lowest level (Cyprus) of the standard share, it had the tendency to be reduced from 15 p.p. in 2000 to 10 p.p. in 2003. Following the effects of the financial crisis and of the budgetary restrictions that forced the States to frequently change the VAT shares in the last years, the harmonization trend was disturbed, and the deviation grew, in 2012, to 12 p.p. between the country with the highest level of the standard share (Hungary – 27%) and the one with the lowest level (Luxemburg – 15%);
- at the level of the Member States, between the limits of the analyzed interval, the *quasi-general trend was to increase the standard shares of VAT*. Only 7 of them (Belgium, Bulgaria, Denmark, France, Luxemburg, Austria and Sweden) maintained the standard share unchanged, while in the other 20 Member States the standard share was changed, in general being increased. The highest growths were registered in Cyprus (7p.p.), Portugal (6p.p.), Greece and Romania (5p.p.), Latvia (4p.p.), Germany, Lithuania and Malta (3p.p.). Although in some States (the Czech Republic, Hungary, Portugal, Slovakia, Great Britain, Ireland) there have been attempts to reduce the standard share, they had a temporary character (usually between 1 and 3 years), in the end only the Czech Republic and Slovakia registering a decrease of the share in 2012 compared to 2000;
- at the level of 2012, only 3 States (Belgium, Italy and Lithuania) use a standard share that coincides with the European average, in 14 the States the standard share used being below this average, while in other 10 States, it is superior to the European average (see fig. 4.2.); at present, the highest standard shares are met in Hungary (27%), Denmark and Sweden (25%), Romania (24%), and the lowest are in Luxemburg (15%), Cyprus (17%), Spain and Malta (18%).

Interesting evolutions may be noticed in relation to the *low shares*:

- if in 2000 there were 4 Member States that did not practice such shares, in 2012 only Denmark was in this situation, Latvia (since 2003), Romania (since 2004) and Bulgaria (since 2007) making appeal to one or two low shares;
- the number of the States using two low shares doubled from 6 (in 2000) to 12 in 2012, reducing accordingly the number of those using one low share or which did not use such share;
- usually, in the last 4-5 years, the Member States did not increase only the standard shares, but they operated increases on the low share (shares) as well; in some States (see Hungary), the level of the so-called low share (18%) exceeded the standard share of Luxemburg or Cyprus.

Finally, we must also notice that in 2000, seven of the Member States still continued to use a *super-low share* (below 5%), their number reducing to 5 in 2012, Greece (2010) and Poland (2011) renouncing such shares; in the other States, the level of the super-low shares remained unchanged throughout the interval.

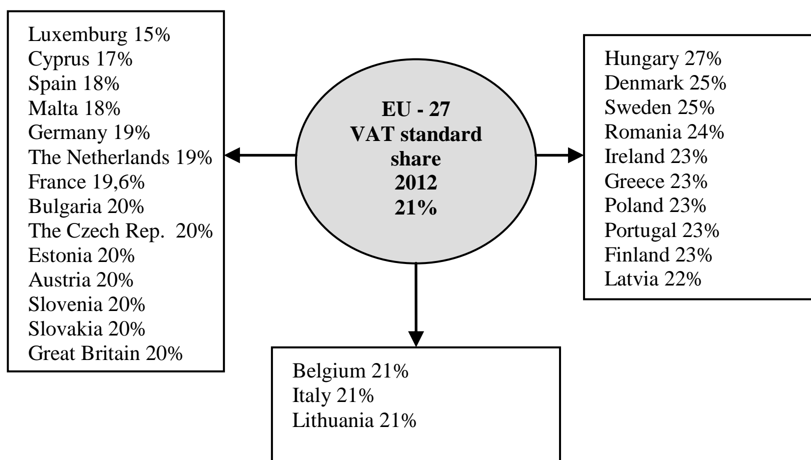

Fig. 1. VAT standard rates in the European Union States

4. Conclusions

The performed analysis shows that the measures to harmonize VAT rates did not have an important effect of mitigation of the disparities existing between the Member States. The shy harmonization trend manifested in the first part of the last decade was disturbed by the economic and financial crisis initiated after 2008, determining the Member States to ignore the harmonization process and to increase the VAT shares in order to cope with the budget restrictions. There is no coincidence that, except the Northern countries, the States practicing standard shares above the European average are those dealing with financial difficulties and strong pressure for the budget consolidation needs.

This measure remains, in our opinion, debatable both in terms of the increase of the tax incomes drawn (considering the compression and remodeling of consumption), and most particularly in terms of tax equity and distribution of crisis costs in the social plane. Not least, we must also notice that such measure is not capable of stimulating consumption, and thus it contributes to the re-launching of the European economies and to the coming out of the recession.

The process of harmonization of the taxation bases and of VAT shares is far from being over, and new efforts are necessary, especially as regards the overall reduction of the standard shares, the rationalization and the simplification of the low shares, the revision of derogations and their uniform application in all the Member States, to eliminate the distortions generated by the unequal application of the low VAT shares in the Member States.

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