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**Article**

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## **Cost Effectiveness of Paying Value Added Tax from the Viewpoint of Businesses**

**Sopková Eva<sup>1</sup>**

### **Abstract**

*Value added tax has been part of the economic reality in the business environment of the Slovak Republic for more than 16 years. It is a tool of general indirect taxation of the final consumption. The aim of this paper is to present partial results of the value added tax complex analysis in terms of cost ratio. The object of this research involves the share of incurred cost of businesses and the amount of tax liability in case of value added tax. The classification of questionnaire research respondents is done according to the division of businesses into small, medium-sized and large businesses in Slovakia.*

**Keywords:** Value Added Tax, Incurred Costs, Small, Medium-Sized, Large Businesses.

**JEL classification:** M41, H25

### **Introduction**

From the historical perspective, indirect taxes are considered younger than direct taxes. From the very beginning these taxes burdened end consumers and did not take into account their incomes and property. Since its establishment on 1 January 1968 (the first country to introduce value added tax was France), value added tax has been considered unfair due to its rate equal for all subjects irrespective of the amount of income. On the other hand, businesses as registered taxpayers serve as unpaid collectors of this tax. Besides paying the tax (at the level of businesses), value added tax incurs, above all, macroeconomic effects as indirect taxes make a significant part of budget incomes in European countries. Every year the revenue from indirect taxes makes approximately 60 % of tax revenue of the Slovak state budget.

### **1. Value added tax in the Slovak Republic and other countries of the European Union**

There are a number of sources that bring different opinions and definitions of value added tax. Summarizing these opinions we can characterize this statutory, non-equivalent payment to the state in certain periods and amounts as a multi-phase excise tax of general character, which can be connected with the process of taxing the added value. Through the prices of goods and services it is a burden for the end consumer (Sopkova, Spisiakova, 2007). The payers of this tax are subjects that supply, import and export goods and services and that collect value added tax from customers.

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The tax is indirect in the sense that the taxpayer (bearer of tax burden) and the tax collector are independent subjects, which is a characteristic feature of excise taxes. The European Commission (2000, p.13) defines this tax as ‘a general consumption tax, which is directly proportional to the price of goods and services. It is collected fractionally, i.e. on each transaction in the economic chain, and is neutral’.

Compared to other turnover taxes, this tax has a great advantage in its final share of the price of outputs being set as a statutory rate and not discriminating commodities with several stages of processing.

### **1.1. International context of value added tax**

Besides the mentioned economic effects, value added tax has also an international dimension. The on-going discussion within the European Union is whether the harmonized system of this tax is efficient. The EU market consists of a number of economies with different legal systems and structures. The important instruments to harmonize value added taxes are various regulations and directives. The most important directive before 31 December 2006 was the Sixth Council Directive of 17 May 1977 harmonizing legal regulations of the member states for turnover tax – a common system of value added tax, a single base for its setting No. 77/388/EEC. Its main goal was to harmonize and exactly define notions related to value added tax. In order to make it simpler and more rational this directive was replaced by Directive 2006/112/EC on the common system of value added tax. It came into effect on 1 January 2007 and includes the rules on value added tax applied in the whole European Union. They are clearly formulated: the lowest base of value added tax must not go below 15%; member states can apply one or two lowered tax rates for exactly specified goods and services. Nevertheless, the rate must not be lower than 5%, and meeting the requirements, the countries can use the lowered rate with particular personal services. Yet, these rules are too complicated due to a number of exemptions allowed to some countries at their admission to the Union. These exemptions lead to a lack of consistency of the taxation system.

Currently, the base rate of value added tax in EU countries ranges from 15% to 25%. The average rate of the tax is 19.7%. The highest rate is levied in Sweden and Denmark and the lowest in Cyprus and Luxembourg. The so-called ‘parking’ rate can be 12% and more. At present, this rate is applied in four countries of the European Union, and these are: Belgium, Ireland, Luxembourg and Austria. Another exception is super lowered tax, which allows to levy a tax lower than 5% on some goods and zero rate completely exempts some goods and services from tax. Tax specialists from individual European countries search for optimum indirect taxes at different levels (Nerudova, 2007) and there are continuing discussions on tax harmonization in relation to the sources of finance. Implicit from this analysis is the fact that in spite of the effort to unify tax systems in Europe, it will not be an easy task.

## **1.2 Value added tax and small and medium-sized businesses**

Owing to the object of research we pay a closer attention to the Document 3.2 of the Council Directive of 28 November 2006 on the common system of value added tax, Title XII – Special schemes. In Chapter I titled Special scheme for small enterprises there are set simplified procedures for charging and collecting VAT. The basic principle is that member states that might encounter difficulties in applying the normal VAT arrangements subject to such conditions and limits as they may set, and after consulting the VAT Committee, can apply simplified procedures (e.g. flat-rate schemes). This is referred to in Articles 281 to 292 of the document.

The legislation on taxation of the Slovak Republic (Article 287) has exempted persons with a yearly turnover below a set limit. In Act No. 222/2007 on value added tax the limit was set at 1,500,000 Slovak crowns, which had been in effect from 1 May 2004. On 1 January 2009 an amendment (Act 465/2008) on value added tax set the limit at 35,000 euros of yearly turnover. Within anti-crisis measures the Slovak Republic applied for increasing the limit and since 1 July 2009 (Act No. 258/2009) this has been increased to 49,790 euros of yearly turnover. In case a business goes over the limit within a period of 12 successive months, it is obliged to register for VAT starting from the 20<sup>th</sup> day of the month following after reaching the limit.

The European Directive in its Articles 295 and 305 gives the possibility to apply simplified schemes also to agricultural, forestry and fisheries businesses. The Slovak Republic does not apply these special schemes in value added taxation.

The current rates of value added tax applied in the Slovak Republic (19% and 10%) correspond to the expected development of indirect taxation. It is necessary to point to the fact that it is just the rate which influences tax liabilities and from the point of view of the tax burden for the taxpayer, the amount of tax is one of the criteria to measure economic effectiveness of value added tax. The other criterion to determine economic effectiveness of paying value added tax is indirect administrative cost of taxpayers.

## **2. Administrative cost of value added tax**

Value added tax has a number of advantages, e.g. free movement of goods and services, neutrality of taxation, universal character of application or multi-phase character of the tax. On the other hand, it has also some disadvantages, and administrative cost for taxpayers and for the state is one of them. Owing to the subject of research, we will further pay attention only to the economic effectiveness of paying the tax for businesses, i.e. we will deal with value added tax from the microeconomic point of view.

In terms of taxes, Kubatova (2000, p. 40) speaks about transfer of money from individuals and businesses to public budgets, extra costs that lower the overall effectiveness of the economy. Vitkova, Vitek (2002, p. 142) divide the cost of tax system into administrative costs for the public and private sectors.

In the Slovak language incurred cost is also translated as ‘cost of adapting to the tax system’ on the level of the private sector. Effectiveness is an economic category encompassing the main aspects of the economic activity of businesses (Elexa, 2007). This notion has several meanings and is used in different contexts. Effectiveness is related to economizing, efficiency and quality. The indicator of cost or cent indicator expresses the proportion of inputs and outputs. The most reasonable expression of effectiveness is the ratio of cost and revenue. In our research we took the ratio of incurred cost of taxation of businesses and paid tax as a criterion of effectiveness. Due to a limited space we do not give details of the methods we used in calculating the economic efficiency of the process of applying value added tax. We chose effectiveness as the main indicator of the cost.

### **3. The effectiveness of value added tax scheme from the point of view of businesses**

In order to ensure objectiveness and content validity of the results of our research we used the method of standardized questionnaire.

#### **3.1. The content and structure of the questionnaire**

The questionnaire was divided into an introduction and four main parts (I – IV). Out of 29 questions in total, 14 were closed and 7 open. Eight questions with scaling answers were referring to numerical values (e.g. number of employees, amount of tax, amount of incurred cost, etc.).

The first part of the questionnaire (I) contained 5 questions and its aim was to obtain identification data on businesses, in particular:

- the legal form of the business
- the object and place of the business
- total number of employees
- yearly turnover.

In the second part (II) the questions focused on the value added tax and accounting of businesses. The 5 questions of this part were asking about type of accounting, who completes the VAT file and type of VAT registration (on a monthly, quarterly, optional, single basis, etc). The questions were also asking about the yearly amount of the paid VAT (exorbitant VAT allowances) for 2003 and 2004.

The third part of the questionnaire contained two sets of questions about the cost of taxation:

The aim of part III.A (questions 11 – 19) was to obtain data on the cost of taxation in internal processing of value added tax in a business with precisely defined types of incurred cost. The respondents could also add other types of incurred cost and give their absolute value.

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Part III.B (questions 20 – 23) was about the cost of taxation in external processing of value added tax. Two questions were referred to the type of suppliers and customers (e.g. domestic, end-users, from member or non-member states of the EU).

The last part of the questionnaire aimed to get the opinions of the respondents about the conditions of VAT taxation in the Slovak Republic (questions 24 – 29). The respondents could express their opinion on the taxation system and were proposing improvements, expressing opinions on the tax reform, etc.

The questionnaire was compiled to make an overall assessment of value added tax scheme from the viewpoint of businesses in the Slovak Republic.

### **3.2. Research sample**

We distributed 200 questionnaires via e-mail, regular post or personally, out of which 137 were filled in and returned. Some of them were incomplete and thus excluded from research. The final number of respondents was 114. The legal form of business of the examined subjects is given in the following table.

**Table 1: Legal form of business of the examined sample of respondents**

Legal form of business	Number of respondents	Percentage of the sample
Group 1: Individuals	63	55.26 %
A individual farmers	2	1.75 %
B freelancers	1	0.88 %
C sole traders	60	52.63 %
D others	0	0 %
Group 2: Legal entities	51	44.74 %
A private limited companies	31	27.20 %
B public limited companies/stock corporations	16	14.04 %
C cooperatives	2	1.75 %
D other	2	1.75 %
Total sample of respondents	114	100 %

Comparing the number of respondents, we came to a conclusion that the tendencies in the composition of sub-groups reflect the real legal forms of business in Slovakia. The sample was then divided into small, medium-sized and large businesses. We classified the businesses in compliance with the Directive of the European Commission No. 2003/361/EC, which defines individual categories of businesses from the quantitative point of view. Small businesses accounted for 85.1% and medium-sized and large businesses for 14.9%. The examined sample was also classified according to the amount of yearly turnover.

### 3.3. Results and discussion

Quantitative assessment of the results was based on the criterion of diligence and therefore we chose the year of the least changes in legislation and taxes in Slovakia, the year 2003, as the year of processing. The amount of cost is given in the following table.

**Table 2: Costs of applying value added tax according to quantitative division of respondents**

Quantitative division of businesses/indicators	Costs of businesses induced by value added tax	Value added tax paid	Costs of applying value added tax
Businesses in total	2,872,923	29,903,389	9.61 %
Small businesses	170,413	387,302	44 %
Medium-sized businesses	382,510	1,951,582	19.60 %
Big businesses	2,320,000	27,951,807	8.30 %

The resulting cost of paying value added tax by small businesses can be interpreted as follows: 10 Slovak crowns of paid tax incurred 4.40 crowns of social cost of paying value added tax. In medium-sized businesses 10 Slovak crowns meant 1.96 crowns of incurred cost of paying value added tax. In big companies – payers of value added tax – 10 Slovak crowns of paid tax incurred 0.83 crown of the cost of paying the tax. On the whole, in all responded businesses 10 Slovak crowns incurred 0.96 crown of the cost. The research continued also in the year of profound changes in taxation and legislative conditions. As it was expected, in that year the incurred cost increased and the most significant increase was recorded in the category of small businesses – by 5.31 percentage points. In medium-sized and large companies the increase of incurred cost of paying value added tax was 3 %. It is obvious that this development resulted in lower economic effectiveness of applying value added tax on the side of businesses (increase of 2.96%).

The indicator of cost was a quantitative synthetic output of the research. The primary data from the questionnaire were processed so they can be used to make further conclusions and initiate discussions and proposals of measures in value added taxation.

From other theoretical and practical conclusions we have chosen the following:

- more than half of respondents (58) considered the legislation as difficult to understand, complicated and time and material demanding,
- as the most positive change the payers reported flat-rate tax scheme, which was applied in Slovakia from 1 January 2004 till 2006; at the same time they expressed a requirement to lower the marginal tax rate to 15%,
- only 4 respondents (3.51%) considered value added tax as a financial means of running a business (in terms of cash flow),
- an overwhelming majority of responded businesses (84.21%) do not particularly follow or calculate the effect of VAT taxation.

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We have made recommendations and proposals to optimize the process of VAT taxation for different categories of businesses, in particular domestic businesses that produce for end-users, exporters, and/or suppliers within intra-community trading, customers within intra-community trading and for newly-established businesses. The recommendations should help businesses to make decisions about joining the value added tax scheme, i.e. either to register or not as a VAT payer.

## **Conclusion**

Our research on value added tax encompassed a wider range of issues of general indirect taxation in the Slovak Republic. We have come to an important conclusion that businesses are not able to quantify the real incurred cost of VAT taxation and do not follow the effects of taxation (e.g. as hidden financial reserves). They lack any procedure to follow, register and quantify them in spite of the fact that they are part of everyday economic reality. In terms of the quantified cost of the process of VAT taxation small businesses' administrative burden was five times as much as that of large companies and three times higher in comparison with medium-sized businesses. The results show that despite the long-lasting effort to simplify the taxation process in the Slovak Republic, its legislation should also consider other (simplifying) schemes of applying value added tax, especially with small businesses.

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