



Article

Issues of Improving Value Added Tax

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Abstract: This article examines the challenges and improvements needed in the application of Value Added Tax (VAT), an indirect tax widely adopted globally. VAT's regressive nature and burden on low-income groups are highlighted, along with its influence on consumer demand and inflation. The paper analyzes VAT's advantages, such as its wide tax base and automatic adjustment to inflation, which make it crucial for fiscal efficiency. It reviews various VAT calculation methods, exemptions, and rate-setting practices, discussing the economic impact of these factors. Through a literature review and comparative analysis of VAT practices, the study identifies key areas for reform, including rate optimization, reduction of exemptions, and tackling the "VAT gap" to enhance revenue and compliance. In this research work, the features of VAT application, tax rate setting and consequences of VAT exemption are considered. A review of scientific literature on VAT was carried out. The assessment of VAT, rate setting, imbalances in tax exemptions and tax breaks are analyzed. As a result of the analysis, relevant conclusions were formed.

Keywords: Indirect Tax, VAT, Tax Base, Tax Rate, Tax Relief, Business Entities, Financial Services.

1. Introduction

The most criticized disadvantage of indirect taxes is that they are inversely proportional to the ability of consumers to pay, and indirect taxes are a fiscal burden on low-income groups. At the same time, it has been shown that indirect taxes affect demand by increasing the price of goods and are a source of cost-push inflation. Indirect taxes, with all their advantages and disadvantages, are a necessary condition for the effectiveness of the fiscal system. Indirect taxation is one of the means by which the tax system can be optimized. Thus, any tax on a product affects the behavior of business entities, and you can only change the tax liability by reducing the purchase of the relevant product. If different tax rates are applied to different goods and some goods are generally exempt from taxation, the impact of indirect taxes on economic choice cannot be eliminated (Stiglitz, 1997). One of the most widespread indirect taxes in the world is the value added tax (VAT), which has been successfully applied on a large scale for more than 50 years in most countries that have transitioned to a market economy. Today, VAT is introduced in the tax systems of more than 170 countries around the world, and it accounts for a quarter of the budget revenues of most developing countries. According to current tax legislation, the amount of VAT that a taxpayer must pay to the budget is determined by this taxpayer as the difference between two indicators: the amount of VAT collected on purchased products and the amount of VAT calculated on sold products.

When we, as a consumer, buy a product on the market, we can see in the payment document that VAT is included in the sales price. However, VAT is not only levied on goods or services sold to the final consumer, but also on all previous transactions between

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business entities in the supply chain, similar to turnover tax. Failure to make adjustments to the VAT amount would lead to a cascade of taxes (tax on tax), which would create major economic distortions. To avoid this, VAT uses a credit mechanism, in which business entities are entitled to credit the VAT paid on their business expenses (input VAT) against the VAT charged on their sales (output VAT). Thus, the final VAT amount is only borne by the final consumers (de Mooij and Swistak, 2022).

Literature review

One of the most important advantages of VAT over the consumption tax introduced in the USA, Canada and a number of other countries is that VAT has a wider range of taxable objects. This allows to reduce the dependence of tax revenues on individual stages of the movement of goods, in particular, on retail trade turnover. VAT is an indirect tax levied on the added value created at each stage of production. The use of VAT in the tax systems of different countries demonstrates its tax efficiency due to a number of its features: coverage of a wide tax base, including turnover related to the sale of goods and services, transfer and sale of property rights, transfer of property in exchange for other goods, free transfer of property, lease of property, transfer of goods and material resources under loan agreements, etc.; provides automatic indexation of budget revenues depending on the level of inflation, since when determining VAT on the sale of taxable goods by the seller to the buyer, the taxable base includes the cost of material resources and other expenses incurred by the manufacturer; is charged at each stage of the delivery of the product to the consumer and is characterized by a short reporting period, ensuring the uniformity of budget revenue receipts; as a result of pricing and inclusion in the selling price, it is relatively neutral for the payer due to its transformation into the final consumer, which reduces their desire to evade payment (Kononchuk, 2018).

The general principles of VAT application are universal for all countries. However, the methods of their implementation in the tax systems of countries have their own characteristics, determined by the specific institutional environment of the budget and tax traditions, as well as the strategic and current tasks that national governments must solve at each specific stage of socio-economic development. Maiburov et al. (2010) note that from an accounting point of view, there are four options for calculating the amount of VAT payable to the budget. If we determine that the tax is levied at a rate of t , the following methods lead to the same calculated tax (VAT). 1. Direct additive (balance) involves applying a tax rate as a result of adding up the components of value added. 2. Indirect additive, since there is no calculation of value added and a tax rate is applied to each component of value added. 3) Direct deduction method, i.e. based on applying a rate to the difference between the sales and purchase amounts. 4) When using the indirect deduction method (offset method, compensation method), the amount of VAT is calculated as a percentage of the value of goods, works or services sold, corresponding to the tax rate, reduced by the amount of deductions established as a percentage of the value of purchased goods, works and services, corresponding to the tax rate. The indirect deduction method, which is widely used for VAT, is relatively well developed from a legal, informational and technical point of view, and in this case the time of occurrence of VAT obligations and the essential terms of the transaction are formalized, for example, by delivery documents or invoices. This approach simplifies tax control and allows for cross-checks. In addition, this method of calculating VAT alone allows the tax system to apply multiple tax rates, including zero for exports of goods and services, as well as reduced or increased tax rates for goods (Vishnevskiy, 2006).

An important element in creating an optimal VAT taxation system is the choice of the rate. Today, most countries have zero, reduced and standard VAT tax rates of varying degrees. The reduced VAT rate is a privilege for certain types of taxable goods and services. The main arguments for the application of preferential VAT rates are usually the state's desire to create incentives for the consumption of goods and services (this applies to books, newspapers, public transport), as well as the redistributive (social) nature of

reducing the prices of certain goods (medicines, food, children's clothing) (Balakina, 2010). In addition to the reduced VAT rate, two more types of privileges are applied to this tax - VAT exemption and the use of a zero rate. Their main difference is as follows. If the sale of a particular good is not subject to VAT, then the business entity does not collect VAT from buyers when carrying out such transactions, but at the same time does not receive the right to deduct the VAT paid on the purchase of materials used in the production of non-taxable goods. As a rule, groups of goods and services are not subject to VAT if it is not possible to accurately determine the tax liability from an administrative point of view or the administrative costs exceed the expected profit, as well as if these goods have social significance or are supplied by a state enterprise. In accordance with this rule, financial and insurance services, as well as social services provided by state enterprises, such as education, healthcare, postal and other communication services, are exempt from VAT in many countries. In particular, Grubert and Mackie (2000) argue that the main argument for excluding financial services from the VAT base is that they do not fall within the utility function of the consumer and are considered a form of investment. However, Edgar (2001) concludes that there is a consensus in the scientific literature that financial services should be treated as taxable consumption. This position is supported by some authors, who have shown that the provision of financial services creates added value and consumes real resources (Hoffman, Poddar, and Whalley, 1987; Barham, Poddar, and Whalley, 1987). In particular, Huizinga (2002) argues that the exact taxable financial margin is unknown, since it is difficult to calculate the amount of money and the risk premium for each transaction. Thus, the cost of insurance and spread, the added value of interest margins for each transaction is unknown. According to Goncharenko (2004), the bulk of tariffs for banking services is not based on a specific calculated value, and the level of tariffs for banking operations is influenced by various factors, such as credit risks, interest rate risks and currency risks (including the possibility of hedging currency risks). It should be noted that the subjection of financial products and services of financial sector entities, including banks, to VAT is a very complex and controversial issue. For this reason, in most countries, the exemption of financial products and services from VAT is a widespread practice, which means that consumers are not taxed, but the tax paid on the relevant costs is not recovered.

Most of the goods and services exempted from VAT have a certain social or public purpose (funeral services, social and communal services, public transport, sports), but are in no way determined by the complexity of tax administration. On the other hand, the inclusion of certain groups of goods and services that are usually exempt from tax in the taxable base is probably due to political considerations aimed at maintaining social justice and increasing state revenues (Balakina, 2010). In some cases, the application of VAT exemptions leads to the loss of the tax's own characteristics. This disrupts the entire chain of tax deductions and creates a cumulative (cascade) effect. As a result of the exemption from VAT of one of the business entities in the chain of production and delivery of goods to the final consumer, it loses the right to tax deductions. The VAT paid by this business entity in the price of the product purchased is added to the production costs and increases its value. As a result, since the business entity does not collect VAT on the sale of its goods, its buyers pass on the entire amount of tax as expenses to the next buyer and are not entitled to tax benefits. The result is double taxation for all business entities at the beginning of the production and consumption chain. Exemption from VAT, as a privilege applied to individual business entities, when examined in detail, is not very effective, but rather leads to an increase in the tax burden (Mayburov, 2011).

In most countries, VAT is applied at a zero rate to export transactions, this procedure for taxing export transactions is a manifestation of the so-called "fixed place" principle, when used, exports are completely exempt from VAT paid in the exporter's domestic market. It should be noted that the VAT rates in force in the importer's national market are applied to imported goods. Thus, VAT guarantees the same conditions for

indirect taxation of both domestically produced and imported goods. As a result, only domestic consumption is taxed, so domestic producers are on an equal footing with foreign competitors in importing and exporting goods. The most serious drawback of the fixed place principle is the need to charge administrative costs for maintaining customs services involved in calculating VAT when goods are imported into a fixed country, as well as the need to charge administrative costs for organizing VAT refunds to exporters and resolving related technical issues. In addition, there is a real possibility of fraud associated with the refund of VAT levied in the country of origin of the goods (Lytyakov, 2014). In particular, the VAT gap in the budget revenues of EU countries amounted to 61 billion euros (EC, 2023). The VAT gap is the amount of actual tax liability that is not paid voluntarily and on time. The VAT gap, or tax gap, is the difference between the amount of taxes that taxpayers should pay and the amount they pay voluntarily and on time, and has been a problem for decades. The size of the Tax Gap can change depending on the actions of the taxpayer in the tax administration and updated methods of assessing the tax gap, changes in economic activity, changes in tax legislation and administration.

2. Materials and Methods

Scientific studies on the imposition of VAT, the establishment of tax rates and the use of tax benefits were studied in the research work, and a review of scientific literature was carried out. The analysis of VAT from the theoretical and practical point of view has been carried out. The article examines issues related to the improvement of VAT collection. Methods such as scientific abstraction, analysis and synthesis, induction and deduction, descriptive statistics, comparative analysis, expert assessment, and analysis were used in the research.

3. Results

In the EU, VAT payers are legal entities and business entities in the field of business, i.e. enterprises, private entrepreneurs and sole traders. Private individuals are in most cases not VAT payers, since they do not carry out entrepreneurial activities (although there are certain exceptions for the sale of transport and real estate). In the EU, VAT applies to a very wide range of transactions involving the sale of goods and the provision of services. Transactions subject to VAT in the EU include:

- 1) All transactions related to the sale of goods within the EU, including imports of goods from third countries.
- 2) The provision of various services within the EU, including consulting, transport and logistics services, information technology services, construction, restaurant services, etc.
- 3) Sales of goods and services between different EU Member States.
- 4) Transactions between companies registered for VAT in the EU.

There are categories of goods and services that are completely exempt from VAT or that are subject to reduced rates. For example, exports of goods and services outside the EU are generally not subject to VAT, and there are special VAT regimes and rates for certain categories of goods or services, such as food, medical services or books.

Table 1. Composition of VAT rates in European countries in 2023 (Campio Group, 2024)

Countries	VAT rates (in %)		
	standard	preferential rates	Minimal
Austria	20	13	10
Belgium	21	12	6
Bulgaria	20		9
Hungary	27	18	5
Germany	19		7
Greece	24	13	6

Denmark	25			
Ireland	23	9	13,5	4,8
Spain	21		10	4
Italy	22	10	5	4
Cyprus	19	9	5	
Latvia	21		12	5
Lithuania	21	9	5	
Luxembourg	16	13	7	3
Malta	18	7	5	
Netherlands	21	9		
Poland	23	8	5	
Portugal	23	13	6	
Romania	19	9	5	
Slovakia	20		10	
Slovenia	22	5	9,5	
Finland	24	14	10	
France	20	10	5	2,1
Croatia	25	13	5	
Czech Republic	21	15	10	
Sweden	25	12	6	
Estonia	20		9	

The general minimum VAT rate in the EU is 15%, but the final rates are set individually in each country. Thus, VAT rates in European countries vary from 16% to 27%. For example, the lowest VAT rate in Europe is set in Luxembourg, where the tax rate is 16%, and the highest rate in Hungary is 27%. The average VAT rate in the EU and the most common rate are 20-21%. Some countries have reduced tax rates for certain categories of goods, such as food or books. The minimum VAT rates in the EU are lower than 5%, and these measures are aimed at supporting certain sectors or social groups (Table 1). In addition to reduced rates for this tax, EU countries also apply the practice of complete exemption from VAT. Thus, in Europe, full exemption from VAT is usually applied to certain categories of goods and services that are of particular importance to society or business in a particular country. It should be noted that EU countries can change VAT rates every year, and the rules for applying reduced rates depend on the economic situation in the country and the demand for a particular good or service. Optimizing VAT calculations is one of the important tasks for business entities, since the correct choice of rates can have a significant impact on financial flows and the tax burden. When choosing VAT rates effectively, it is important to pay attention to setting standard and reduced rates and keeping separate records of exempt turnover. Through effective management of VAT rates, companies can reduce their tax burden and become competitive in the market. However, it is important to comply with all tax laws and requirements in order to avoid negative consequences in the form of financial penalties and fines.

According to OECD (2014), in 2006, insurance and financial services consumed in Spain amounted to 25,192 million euros, and the estimated VAT payable (at the current 16% tax rate in 2006) was approximately 4,031 million euros. VAT revenue in Spain in 2006 amounted to 2,455 million euros, with additional VAT collected accounting for more than 0.1 percent of the country's GDP. In the EU, financial services are exempt from VAT and financial services provided by banks are not subject to VAT and VAT on expenses incurred is not recovered. However, some paid services are exempted, such as deposit box fees, financial advisory services and exported financial services. López-Laborda and Peña (2018) argue that while many approaches to VAT taxation of financial services have been developed over the past decade, none have been able to resolve this issue. They propose a

new approach to taxing financial services, the “mobile-ratio” approach. In this approach, the value added of a financial institution is calculated using an accrual method and is redistributed to each transaction using a periodically updated “mobile-ratio” approach. Each transaction is taxed at a uniform VAT rate. Thus, this approach is a transaction-by-transaction approach.

There is probably no debate, at least in principle, about taxing B2B transactions. The clear consensus is that these transactions should not be taxed, and this can be achieved in two ways: by a full tax regime or by a zero-rate regime for B2B transactions. These two methods are equivalent for B2B transactions. Furthermore, research suggests that if there is a corrective income tax, the expected returns from fully taxing financial services may be even greater, so that less efficient firms are excluded from the market and capital is allocated to more efficient firms. There are different views among economists on the taxation of B2C transactions. According to Mirrlees (2011), exempting goods and services from VAT is contrary to the principle of taxation, leaving it impossible for financial institutions to recover the VAT they have collected, and thus disrupting the chain. This is a clear violation of the essence of the tax, as the exemption directly turns VAT into a production tax. The financial consequences of VAT exemption are illustrated by comparing the performance indicators of two business entities: a business entity exempt from paying VAT and a business entity paying VAT at a rate of 20% (Table 2).

Table 2. Comparative analysis of business entities in different conditions for VAT, financial indicators in notional monetary unit

Indicators		When exempted from paying VAT	When VAT is applied at the rate of 20%
1	Net sales proceeds	1000	1000
2	VAT on sales	-	200
3	Production costs are exclusive of VAT	472	472
4	The purchase price of the product is excluding VAT	200	200
5	VAT on expenses	40	-
6	Deductible VAT amount	-	40
7	Taxable profit (line 1–line 3–line 4–line 5)	288	328
8	Corporate tax (7 lines x20/100)*	57,6	65,6
9	Net profit (line 7–line 8)	230,4	262,4
10	Profitability (9 line/1 line x 100)	23	26,2
11	Tax burden (8 lines – 6 lines)/1 line x 100)	5,8	2,6

Source: prepared by the author based on conditional numbers.

The table shows that the net profit of a VAT-exempt business entity is lower than that of a VAT-registered business entity, and the tax burden is higher, all other things being equal, compared to net income. Perhaps the greatest imbalance is the incentive for financial institutions to contribute to the reduction of non-deductible VAT in order to ensure vertical integration. This indicates that the increase in costs due to VAT exemption, which reduces efficiency indicators, hinders firms from entering the market and forces them to exit the market.

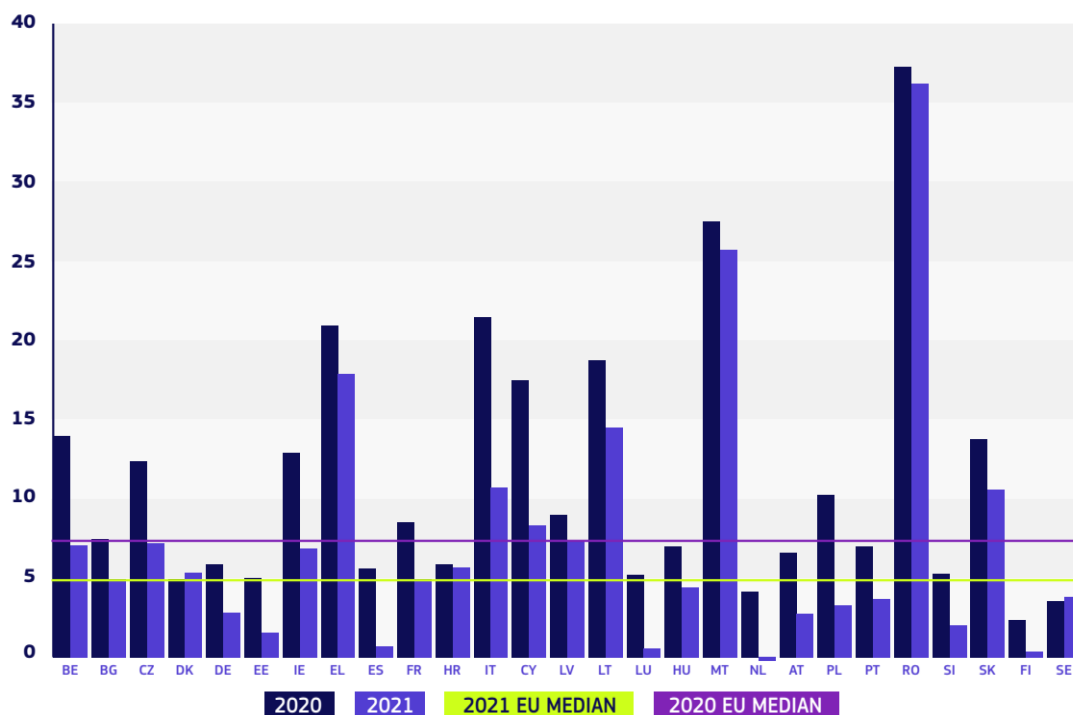


Figure 1. VAT losses due to the Tax Gap in EU countries (% of VAT revenues lost), (EC, 2023)

The amount of VAT revenue losses due to the Tax Gap in EU countries amounted to 99 billion euros in 2020, although it decreased by 38 billion euros in 2021 compared to 2020, while the amount of refunds amounted to 61.0 billion euros, which shows that the high level of its share in tax revenue remains across EU countries (Figure 1). Any loss of VAT revenue, especially those associated with VAT refund fraud, causes significant damage to the budget revenues of states. To identify tax gaps, the non-payment of VAT to the budget by counterparties in the second, third and subsequent links of the supply chain of goods (services) is also taken into account. Their actions are of a consensual (legal, economic or other control) nature. Today, under the details of counterparties in the EHF, the cut-off coefficients are displayed in a colored box. Based on them, one can assess how risky it is to work with a particular counterparty from a prudential point of view.

Despite the reduction of the VAT rate in the republic from 15 percent to 12 percent, due to the expansion of the tax base and the coverage of taxpayers, VAT value-added tax revenues in 2023 amounted to 57.9 trillion soums compared to 2022, which is an increase of 5.7 trillion soums (+10.9%) compared to 2022. In particular, while the number of VAT payers in 2022 was 164,449, by 2023 the number of taxpayers reached 183,488 (Ministry of Economy and Finance, 2023). The circle of VAT payers has been expanded, and foreign individual entrepreneurs are considered VAT payers. In addition, a number of VAT benefits have been abolished, in particular, VAT benefits for the sale of medical, veterinary, communal services, and pharmaceuticals, starting from April 1, 2024.

Also, from May 1, 2023, when individuals included in the "Unified Register of Social Protection" make purchases of goods at retail outlets, a refund of the amount of value added tax paid on the purchase amount has been introduced from the republican budget. The amount refunded in this direction for the reporting period amounted to 25.1 billion soums. To compensate for the negative difference from VAT, VAT and cashback amounts in the amount of 21.6 trillion soums were refunded to taxpayers during 2023 (27.2% of VAT revenues). For comparison, in 2022 and 2021, a total of 19.3 trillion soums and 14.4 trillion soums were refunded to taxpayers for these purposes, respectively. During the reporting period, 90 large taxpayers used the opportunity to offset the amounts of value added tax paid when importing goods and selling goods (services) to enterprises under the

administration of the Interregional Tax Inspectorate for Large Taxpayers, and 2.0 trillion soums were offset (Ministry of Economy and Finance, 2023).

4. Conclusion

VAT has a wider range of taxable objects. This allows you to reduce the dependence of tax revenues on individual stages of the movement of goods, in particular, on retail trade turnover. VAT is an indirect tax levied on the value added created at each stage of production.

Optimization of VAT calculations is one of the important tasks for business entities, since the correct choice of rates can have a significant impact on financial flows and the tax burden. When choosing VAT rates effectively, it is important to pay attention to the establishment of standard and reduced rates and separate accounting of exempt turnover.

Exemption from paying VAT leads to a decrease in the amount of net profit of business entities and a higher level of tax burden relative to net income, all other things being equal. The abolition of the exemption from tax on financial services, the deduction of VAT on financial products and services and the reduction of banks' costs by reducing their costs. It is recommended to abolish the exemption from VAT on financial services and apply VAT to banking products and paid services that are not related to the main activity in general. Taxing financial products at a zero rate will reduce VAT revenue, but this will be compensated to some extent by increasing tax revenues from the increase in banks' profitability.

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