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DEFICIENCIES OF THE VALUE ADDED TAX SYSTEM IN THE REPUBLIC OF MOLDOVA FROM THE PERSPECTIVE OF EU DIRECTIVES

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Abstract: *Public revenues collected from the value added tax (hereinafter - VAT) ensure the financing of 47% of the total state budget expenditures in the Republic of Moldova, which demonstrates the main function of this type of indirect tax to contribute to the formation of budget financial resources. At the same time, VAT can be used by public decision-makers to stimulate or make the consumption of certain types of products more affordable, especially those of social importance (food, medicines, etc.).*
From the perspective of economic processes, it is essential to ensure the principle of VAT neutrality, which materializes in the economic value chain of goods and services through the right to deduct VAT amounts.
This principle must ensure that companies operating under similar conditions must be subject to the payment of the same amount of VAT.
The compliance with this principle should be analyzed in a comprehensive manner, on the entire value chain of production of goods and provision of services. A priori, we can mention that tax systems that are characterized by a host of exemptions and reduced quotas are more likely to create dysfunctions of the principle of neutrality and, respectively, of economic processes. The principle of neutrality is the basis of EU Directives, but also of the caselaw of the European Union in the field of VAT. This article proposes an analysis of the VAT system in the Republic of Moldova and the identification of elements that do not correspond to the principle of neutrality, creating impediments in the development of the national economy.

Key words: *VAT, exemptions, reduced rate, neutrality, harmonization.*

JEL CLASIFICATION: H21, H22.

INTRODUCTION

VAT in most countries, including the Republic of Moldova, represents one of the critical instruments for the collection of budget revenues and financing of public expenditures. The capacity of VAT to raise revenue in a neutral and transparent manner is the main topic that should of relevance to political decision-makers in the process of reforming tax systems. This can be achieved if the current legislation or the proposed measures are analyzed by respecting the VAT system's fundamental operating principles. Next, we propose to analyze the importance of VAT, the principles of operation, how VAT can be used to achieve development objectives, the existence of deficiencies in the VAT system, and recommendations for overcoming them.

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THE NEED TO RESPECT THE PRINCIPLES OF THE VAT SYSTEM IN ORDER TO ACHIEVE THE OBJECTIVES OF PUBLIC POLICIES

The principles of operation of VAT in the EU

The VAT system in the EU is regulated in particular by Directive 2006/112/EC – the common value added tax system of the European Union (hereafter Directive 2006/112/EC), and is based on two fundamental principles:

- General Consumption Tax;
- Neutral tax (the right to deduct).

These two principles emerge from the provisions of Article 2 of Directive 2006/112/EC ,,The principle of the common system of VAT entails the application to goods and services of a general tax on consumption exactly proportional to the price of the goods and services, however many transactions take place in the production and distribution process before the stage at which the tax is charged. On each transaction, VAT, calculated on the price of the goods or services at the rate applicable to such goods or services, shall be chargeable after deduction of the amount of VAT borne directly by the various cost components."

The first principle ensures the VAT function of mobilizing the budget revenues necessary to finance budget expenses following the collection of a part of the value of the general consumption of goods and services. The second principle ensures that the collection of VAT to the budget is carried out without distorting the economic activity, the same tax being applied regardless of the number of value chains of production and sale to the final consumer.

Compliance with the first principle presupposes the existence of a limited number of VAT exemptions or reduced rates, and the second is manifested by the right to deduction or refund of VAT, as the case may be.

Yet, whilst as general tax on consumption VAT should apply to all consumption, the decision was made in the 1960s by the EU legislator to exclude certain consumption from the tax base. The rationale for excluding consumption from the tax base in 1960s/1970s was essentially two-fold, namely, to replicate exclusions from the tax base that was applicable under previous cumulative taxes, and to reflect the existence of technical obstacles to the application of VAT to some services, the so-called difficult-to-tax services. Over time, three additional explanations were given for the use of (merit) exemptions, and reduced rates, namely:

1. Vertical equity: idea that these concessions limit the natural regressivity of VAT, i.e. that the tax weights more heavily on poorer income households; therefore, so applying exemptions to key products (e.g., food, healthcare, and education) would limit the impact of the tax on those households;
2. Positive externalities: idea that these concessions increased consumption of so-called merit goods (e.g., books, cultural events, and sport activities);
3. Increase employment: idea that application of reduced rates will ultimately lead to increased employment in labor-intensive industries (e.g., hairdressing), or areas where price is particularly elastic (e.g., electronics), or both (e.g., restaurants) (de la Feria, 2016).

Thus, to ensure the maximum efficiency of the VAT system, it is essential to respect the above principles, namely a limited number of exemptions and reduced rates applied to goods and services intended for final consumption and the right to deduction (IFS, 2011).

Taxing only final consumption means that no net tax is levied on intermediate inputs (purchases made by firms for their business). This is crucial for preserving production efficiency: in other words, for ensuring that there is no unutilized scope for the economy to produce more of one good without having to produce less of others, which would clearly be wasteful.

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To comply with the above principles the European Union's common system of value added tax is based on the following key points:

(1) VAT is applied to all transactions carried out in the EU for payment by a taxable person. Imports by any person are also subject to VAT.

(2) Taxable transactions include supplies of goods or services within the EU, acquisitions of goods between EU Member States (goods supplied in and dispatched or transported by a business from one Member State to a business in another) and imports of goods into the EU from non-EU countries.

(3) VAT is charged when the goods or services are supplied, according to the nature of the transaction.

(4) The taxable amount for supply of goods and services and the acquisition of goods between Member States includes all payments to the supplier.

(5) The standard rate of VAT to be applied by all Member States to goods and services is at least 15%. Member States may apply one or two reduced rates of at least 5% to specific goods or services listed in the directive.

(6) The directive allows for exemptions from VAT. Most of these are exemptions without the right to deduct (e.g. medical care, social services or financial and insurance services). Exemptions with the right to deduct also exist (e.g. supplies of goods between Member States or exports of goods to a non-EU country).

(7) A taxable person may deduct the amount of VAT paid on acquired goods or services used for taxed transactions in the Member State where these goods or services are acquired. This input VAT can be deducted from VAT payable on taxed transactions (e.g. domestic supplies of goods or services).

The role of VAT in ensuring the achievement of sustainable development objectives

Taxation and effective revenue mobilization are crucial in implementing sustainable development goals. The taxation system can influence the achievement of development objectives in two ways:

1. The structure and level of taxation (stimulation of activities, work, changing behavior, fair redistribution of income through progressive taxation, etc.);
2. Financing of public expenditures, especially those related to development objectives.

When we talk about VAT, the primary role should be to mobilize budget revenues necessary to finance public policies undertaken for the development objectives. The importance of the taxation system is determined, in essence, by its finality, namely the achievement of budget expenditures. However, the primary purpose of the taxation system should be to generate sufficient revenues to ensure the financing of budget expenditures, which are meant to implement the state's priorities in various fields like social, economic, educational, etc.

Besides financing public expenses, VAT should be analyzed from the perspective of its elements and way of operation. Thus, in part related to economic activities, the VAT system should correspond to the principle of neutrality mentioned above. In terms of people and the social aspect, many countries, including the Republic of Moldova, apply VAT exemptions or reduced rates to increase the population's access to specific categories of socially important products (food products, medicines, etc.).

However, empirical studies (Warwick R, Harris T, Phillips D, Goldman M, Jellema J, Inchauste G, Goraus-Tańska K., 2022) demonstrate that the use of VAT exemptions or reduced rate to support the poorer population is not the most effective measure, therefore direct interventions

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through social spending policies are proposed. Social spending policies are much better targeted. Also, the government in developing countries is more constrained by administrative capacity and overall resources in terms of available policy options (Goñi, E., López, J. H., & Servén, L., 2011).

In developing countries, VAT exemptions and special rates should also be minimized as they erode the revenue base and reduce the opportunity to finance redistributive spending. Indeed, even poorly targeted public spending is better for the poor than reduced VAT rates. However, where capacity constraints prevent spending programs from reaching the poor, the case for some differentiation in VAT rates, for example, for basic foodstuffs, can be strong.

In conclusion, we can mention that VAT system can be used to achieve development objectives based on the following:

- mobilize the revenue to finance public spending regarding sustainable development objectives (infrastructure, education, etc.)
- maintaining a short list of goods on which VAT exemptions or reduced rates apply;
- ensuring VAT neutrality.

VAT DEFICIENCIES IN THE REPUBLIC OF MOLDOVA FROM THE PERSPECTIVE OF EU STANDARDS AND ECONOMIC GROWTH

VAT revenues represent an essential component of the accumulation of revenues to the budget, constantly increasing both in nominal values and as a share in GDP. Thus, during 2016-2021, VAT revenues increased from 14.6 billion lei to 25.5 billion lei, and as a share of GDP, from 9.06% to 10.55%.

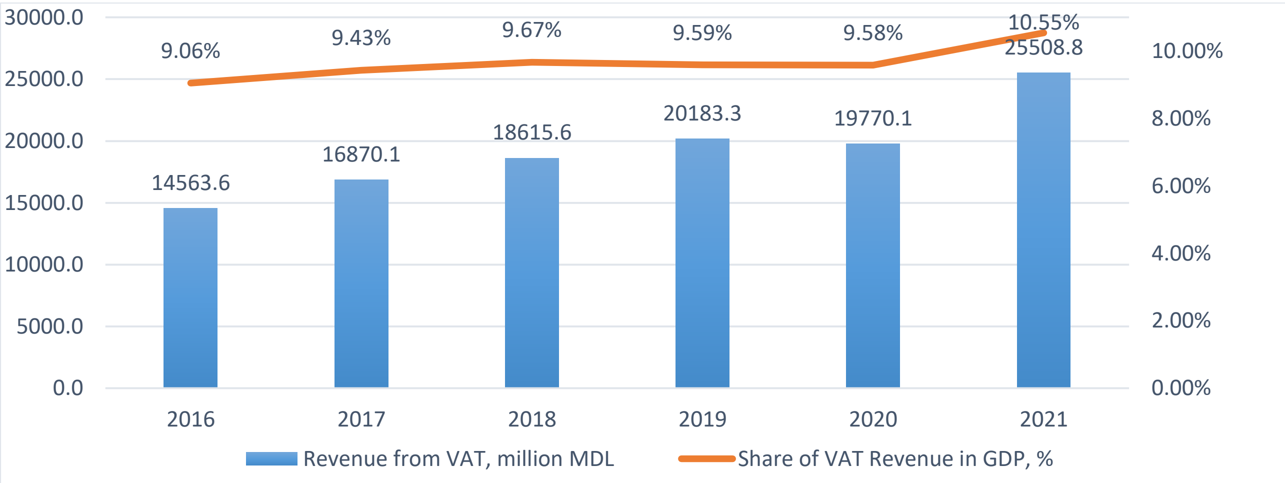

Figure 1. Evolution of VAT revenues and share in GDP, Moldova
Source: developed by the author based on Ministry of Finance of RM data

The Republic of Moldova has a high indicator of VAT revenues in GDP of 9.6% compared to the 6.9% average of the European Union countries. However, the high indicator does not reflect an increased efficiency of VAT but the result of the structure of the national economy, namely a consumption base, where imports significantly outweigh exports. In developed countries with a high level of exports that contribute significantly to the formation of GDP, the level of VAT revenues in GDP is lower because exports do not have a VAT component, being exempt from VAT with the right to deduct, and respectively the right to refund VAT, paid for inputs.

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The ones described above demonstrate the critical role of VAT in the formation of budget revenues and, respectively, the financing of budget expenses, including those related to development objectives.

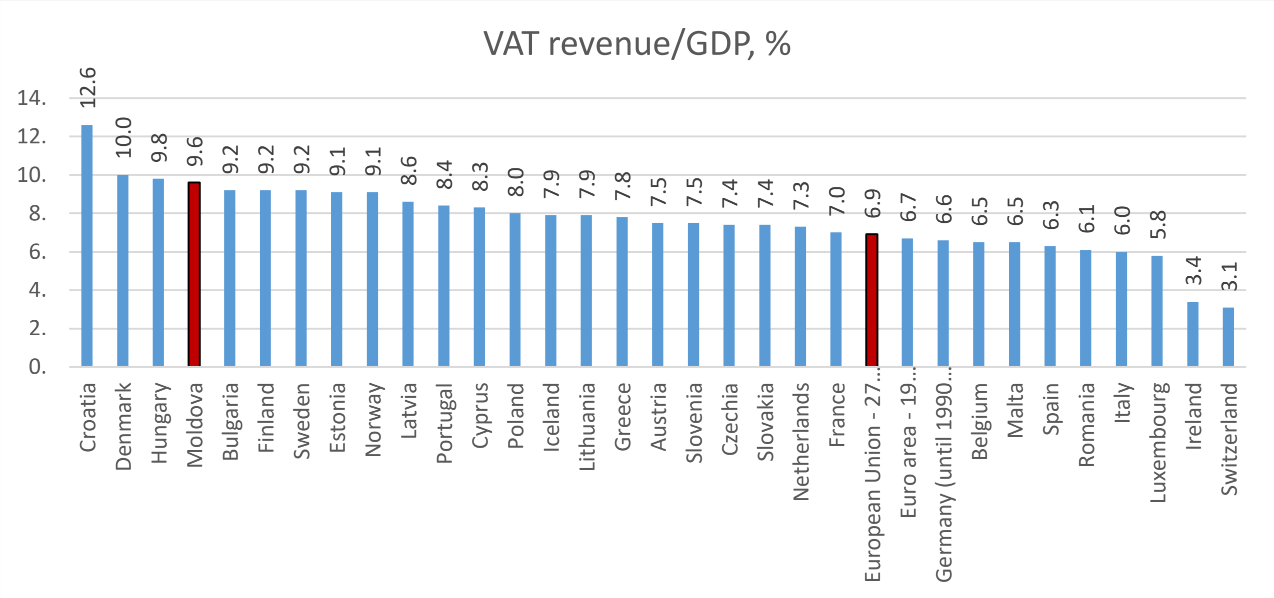

Figure 2. Share of VAT revenue in GDP in UE countris and Moldova, 2020

Source: developed by the author based on European statistics and Ministry of Finance of RM data

On June 23, 2022, the Republic of Moldova was granted the status of candidate for accession to the European Union. In this context, achieving the objective of european integration requires harmonizing the national legislation with the Community one so that the tax legislation is not an exception to this process.

Specifically, the Republic of Moldova has undertaken to gradually harmonize the national legislation with the EU legislation, namely with the provisions of Directive 2006/112/EC of the Council of November 28, 2006, regarding the common system of the value added tax in the terms stipulated in the Association Agreement.

The main challenges of the process of harmonization of national VAT legislation are:

- the system of exemptions and reduced rate that exceeds the provisions of the Directive;

- the right to VAT refund.

The subject related to exemptions and reduced rate is a socially sensitive one, especially in the context of inflation following the pandemic and the regional conflict, but it creates some inefficiencies related to:

1. erosion of the tax base, respectively, of the budget revenues. In this regard, to increase the access of vulnerable population to socially important products, the VAT system of reduced rates and exemptions is the most expensive since it benefits all people, including those with high incomes;

2. creates economic distortions on two dimensions:

- the application of exemptions without the right of deduction within the value chain and not on final consumption. VAT represents a percentage of consumption, and the amount of VAT to reach the budget must be equal to the price of the final product multiplied by the VAT rate. This is ensured as a result of the right to deduct VAT, and each participant in the value chain have to pay a tax on their added value, which is determined as VAT output minus VAT input. If a VAT exemption without the right to deduct is applied in the production value chain of a product, the input VAT is not

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recovered, it is included in the costs, and later the VAT is calculated from the VAT. This fact is demonstrated in Figure 3.

The above example shows that due to the fact that agricultural equipment is exempt from VAT without the right to deduct, the amount of VAT (20 m.u.) is included in the costs, and in addition, VAT is calculated from the VAT (20% from 20 m.u.), a fact that ultimately leads to a price increase by this amount (24 m.u.).

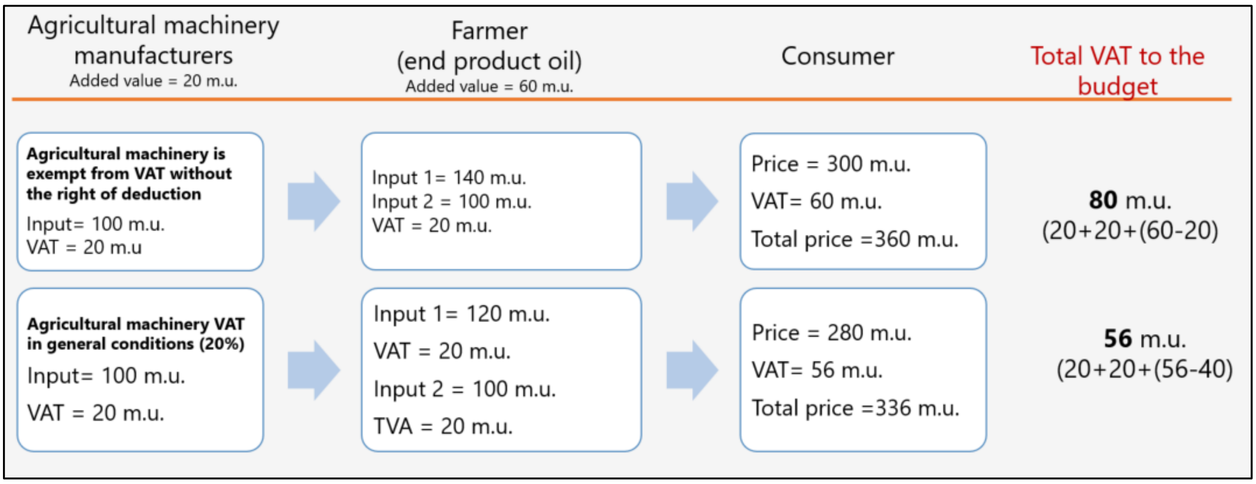

Figure 3. Example of the effect of applying the VAT exemption within the value chain.

- the application of reduce rate without the right to refund VAT if the amount of VAT related to inputs exceeds the amount of VAT related to outputs. This is particularly the case in the agricultural sector, where a reduced VAT rate of 8% applies without the right to a VAT refund. Consequently, farmers pay a higher VAT amount than the delivered agricultural production multiplied by the reduced rate.

It should be mentioned that these two problems described above are not present in the case of imported goods which makes domestic production uncompetitive, respectively economic distortions occur.

CONCLUSION

Following the research and analysis carried out, the following conclusions and recommendations result:

1. Achieving the development objectives from the perspective of VAT should be done by taking into account the primary function of VAT, namely the financing of budget expenditures;

2. There are deficiencies in the VAT system in Moldova, which create economic distortions, the following measures are being proposed:

- optimizing tax exemptions in part related to value added tax in accordance with EU Directives;
- increasing the VAT rate in agriculture up to 12% while reducing the VAT rate from 20% to 12% for fertilizers;
- refund of the VAT amounts accumulated in the account in the amount of salary taxes paid;
- transition from monthly reporting and payment of the VAT amount to quarterly for micro-enterprises.

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