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Insight into the own resources system of the EU through the spectacle of the Hungarian VAT based payment[1]

The article firstly gives a short summary concerning the own resources system financing the budget of the EU and the state of the VAT based resource within this system. Afterwards, with the help of the Hungarian VAT base statement, it specifies the methodology of the calculation of the harmonised VAT base and the own resource itself. Finally it presents an overview of the reform concepts for the future of the own resources system.

THE ORIGINS OF THE OWN RESOURCES SYSTEM AND ITS SUCCESSIVE REFORMS

The own resources system of the European Coal and Steel Community (ECSC) was ensured as soon as the Treaty of Paris entered into force in 1952. Signed in 1957, the Treaties of Rome provided for the two Communities (European Economic Community, Euratom) set up by the Treaty to be financed by contributions from the Member States for a transitional period before changing over to a system of own resources. Contrary to the contributions of the Member States in the case of own resources there is no need for any subsequent decision by the national authorities for calling in, thereby own resources provide financial autonomy for the Community. The "natural" own resources could be derived from Community policies (the customs union and the common agricultural policy). As a result of that, the own resources decision of 21 April 1970 replaced national contributions by a system of own resources comprising agricultural levies, customs duties and a budget-balancing resource calculated by applying a maximum rate of 1 per cent to the VAT base. However, because of delays in harmonising the base, the VAT resource was not generally applied until 1980. The system was subsequently modified by successive new own resources decisions.

The Decision of 7 May 1985 (following the Fontainebleau European Council) introduced a correction mechanism for budgetary imbalances, the so-called UK rebate, amounting to 66 per cent of the UK's net contribution. The cost of financing the UK rebate was shared between the other Member States according to their shares of VAT payments (except for Germany whose share was reduced by a third). Furthermore, the increase of the maximum VAT call-in rate to 1.4 per cent was also decided to coincide with the accession of Spain and Portugal. This increase was designed to meet the costs of enlargement.

The reform of the Community's finances in 1988 altered and broadened the composition of the Community's own resources by the cre-

ation of a new budget-balancing category of revenue, based on Member States' gross national product (GNP) and derived from the application of a percentage rate to the sum of the GNPs of all the Member States. The Third Decision of 24 June 1988 (following the Brussels European Council) set an overall ceiling of the budget rising to 1.20 per cent of total Community GNP in 1992. Pending a new Decision on new resources, the 1.20 per cent ceiling remained applicable in 1993 and 1994.

As agreed at the 1992 Edinburgh European Council, a new Decision on the system of own resources was adopted on 31 October 1994. This Decision raised the own resources ceiling to 1.21 per cent of GNP in 1995, and, in stages, up to 1.27 per cent of GNP in 1999. The maximum VAT call-in rate was gradually reduced from 1.4 per cent to 1 per cent in 1999 and the VAT base to be taken into account for own resources purposes was reduced ('capped') in stages, at 50 per cent of GNP instead of 55 per cent previously. The Member States eligible for assistance under the Cohesion Fund had their VAT base capped at 50 per cent of GNP already in 1995. The reasons for these measures were the regressive aspects of the VAT based own resource for the least prosperous Member States.

The possibility of replacing the 1994 (fourth) own resources decision by a new one for the Financial Perspective 2000–2006 did not become concrete until the date of the March 1999 Berlin European Council approached. The Berlin European Council of 24–25 March 1999 reached a political agreement on the new financial perspective for 2000–2006 and on the revision of the EU's financing system. The Council's conclusions were the basis of the new own resources decision (2000/597/EC, Euratom) adopted on 29 September 2000, which, after ratification by all the national parliaments, entered into force on 1 March 2002 with retroactive effect from 1 January 2002.

The UK rebate and the own resources ceiling of 1.27 per cent of GNP was confirmed. The 2000 own resources decision provides for an increase, as from 1 January 2001, in the percentage of traditional own resources retained by Member States to cover their collection costs, which increased from 10 to 25 per cent. The maximum call-in rate for the VAT resource was reduced to 0.75 per cent in 2002 and 2003 and to 0.50 per cent as from 2004. New rules regarding the financing of the UK correction were also established. Firstly, the share of Austria, Germany, the Netherlands and Sweden is reduced to 25 per cent of its normal value. Secondly, the so-called windfall gains for the UK caused by the increase in the percentage of traditional own resources retained by Member States are neutralised and an amount of so-called enlargement windfall gains is, furthermore, deducted from the rebate.

Finally, the current own resources decision extends the application of the 1995 European system of accounts (ESA 95) to the area of the EU budget. In ESA 95 the concept of gross national product (GNP) has been replaced by gross national income (GNI). In the new own resources decision GNP is therefore defined as being equal to GNI for the purposes of own resources. However, in order to maintain unchanged the amount of financial resources put at the disposal of the Communities, the ceiling of own resources as a percentage of EU GNI had to be adapted[2]. The new ceiling equals 1.24 per cent of the GNI of the EU.

The current own resources can be divided into the following categories (the figures below refer to the 2006 budget amounts to about 112.6 billion EUR adopted in December 2005):

- *Traditional own resources (TOR)* consist of customs duties, agricultural duties and sugar levies. These own resources are levied on economic operators and collected by Member States on behalf of the EU. However, Member States keep 25 per cent

as a compensation for their collection costs. Customs duties and agricultural duties are levied on imports of products coming from third countries, at rates based on the Common Customs Tariff. Sugar levies are paid by sugar producers to finance the export refunds for sugar. TOR account for around 12.7 per cent of total EU revenue.

- *The own resource based on value added tax (VAT)* is levied on Member States' VAT bases, which are harmonised for the purpose of equal treatment in accordance with Community rules. The so-called uniform[3] rate is levied on the harmonised base of each Member State. However, the VAT base to take into account is capped at 50 per cent of each Member State's GNI. This rule is intended to avoid that the less prosperous Member States pay out of proportion to their contributive capacity, since consumption and hence VAT tend to account for a higher percentage of a country's national income at relatively lower levels of prosperity. The VAT-based resource accounts for around 14.1 per cent of total EU revenue.
- *The resource based on gross national income (GNI)* is used to balance budget revenue and expenditure, i.e. to finance the part of the budget not covered by any other sources of revenue. The same percentage rate is levied on each Member States' GNI, which is established in accordance with Community rules. The GNI-based resource accounts for around 72.1 per cent of total EU revenue.
- A specific mechanism for correcting the budgetary imbalance of the United Kingdom (the *UK rebate*) is also part of the own resources system. The current UK rebate mechanism was introduced in 1985 to correct the imbalance between the United Kingdom's share in payments to the Community budget and its share in Community expenditure allocated to the Member States. This mechanism has been modified on several occasions to compensate for changes in the system of EU budget financing, but the basic principles remain the same. This imbalance is calculated as the difference between the percentage share of the UK in EU expenditure paid in the Member States ("allocated expenditure") and the UK share in total VAT-based and GNI-based own resources payments. The difference in percentage points is multiplied by the total amount of EU expenditure allocated to the Member States. The UK is reimbursed by 66 per cent of this budgetary imbalance. The cost of the correction is borne by the other 24 Member States. The distribution of the financing is calculated on the basis of each country's share in total EU GNI. The financing share of Germany, the Netherlands, Austria and Sweden is, however, restricted to one fourth of its normal value. This cost is redistributed across the remaining 20 Member States. (According to a Council proposal, the amount of the rebate would be gradually reduced from 2009 by some expenditures oriented towards new members who joined since 2004.)

THE ANNUAL STATEMENT ON THE VAT-BASED OWN RESOURCE

The VAT-based resource relies in the first place on calculations made by Member States' authorities in conformity, in particular, with Council Regulation (EEC, EURATOM) N°1553/89 on the definitive uniform arrangements for the collection of own resources accruing from value added tax. This Regulation has to be applied together with the rules of the Council Directive No. 77/388/EEC (so-called

6th Directive) by the Member States. For the year concerning the VAT base statement, the rules of the operative national Act on VAT have to be compared with the rules of the Directive in the calculations.

The process of calculation of the harmonised VAT base is briefly the following:

The annual VAT revenue on cash basis has to be adjusted by corrections regulated in the 6th Directive. Calculating the intermediate VAT base the above-mentioned corrected VAT revenue (so-called net VAT revenue) will be the "numerator". The denominator is the weighted average rate of VAT (WAR), which has to be calculated with four-figure accuracy. Determining the final harmonised VAT base, the intermediate VAT base is required to be adjusted by compensation items in order that the possible differences (e.g. tax exemptions) between the national VAT regulations and the rules of the 6th Directive do not affect the base of the VAT based own resource. If the final harmonised VAT base exceeds 50 per cent of the Member State's GNI, the VAT-based own resource must be paid to the budget of the EU on the basis of 50 per cent of GNI.

The Commission verifies the annual statements of the VAT bases submitted by Member States in order to fix the amounts that each Member State must pay to the budget. In this work the Commission is guided by three principles:

- *Transparency:* it must be clear how the VAT base has been determined;
- *Uniformity:* so far as possible Member States must use identical methods and draw on the same sources of information;
- *Equity:* each Member State must be treated the same.

Each Member State sends an annual statement showing the total VAT tax-base, including adjustments to take account of variations in national VAT practices, to the Commission by 31 July of the year following the year concerned. The statement contains not only the figures but also information about data, sources, methods and formulae used to establish and adjust the base. After preliminary checks to verify the credibility and plausibility of the figures, the Commission's control unit sends the data to the unit that manages budget receipts.

Subsequently, each statement is the subject of an on-the-spot control visit in the Member State concerned. It is now usual to control 2 or (increasingly) 3 years at one time. The control is carried out by officials of the Budget Directorate-General, usually supported by officials from the Taxation Directorate-General and the Statistical Office of the European Communities (Eurostat).

Within 3 month following a control, the controllers draw up a Control Report presenting their findings and indicating in particular any reservations concerning the figures or problems of sources or methodology, as well as cases where it appears that Community law has been disregarded. The Member State then sends its Observations on the Control Report within 3 months, during which it either accepts the Commission's findings and makes appropriate changes or contests the findings. After an analysis of these Observations, the Commission's controllers draw up a Summary Report within 3 months, which presents the resulting state of affairs and lists any reservations that remain. These may be the subject of continuing bilateral discussions and/or will be re-examined during the following control mission. If there is no agreement regarding the debated point, the Commission may initiate infringement proceedings against the Member State and if no agreement is reached the case may go before the European Court of Justice.

The Control Report, the Member State's Observations and the Summary Report are jointly discussed at the next available meeting of the Advisory Committee on Own Resources

Figure 1

SUMMARY ACCOUNT FOR CALCULATING THE AMOUNT OF THE VAT ASSESSMENT BASE

1. Gross collected VAT revenues
2. Fines and interest payments for delays to be deducted from revenues
3. Collection costs to be added to revenues
4. Correction (negative) for small enterprises with an annual turnover not exceeding EUR 10 000
5. Other corrections
6. Taxes not collected due to graduated tax relief
7. Correction (positive) for flat-rate farmers
8. Net VAT revenue
9. Weighted average rate (with 4 decimals)
10. Intermediate VAT base
$\frac{\text{net VAT (8.) x 100}}{\text{weighted average rate (9.)}}$
11. Compensations related to exemptions
11.1. Compensation (positive) for small enterprises with turnover exceeding EUR 10 000
11.2. Compensation (positive) for simplified entreprenurial tax (EVA)
12. Compensations related to Annexes E, F, G of Council Directive No 77/388/EEC
12.1 Compensation (positive) related to the domestic leg of international passenger transport
13. Compensation resulting from the restriction of the right to deduct VAT
13.1. Compensations for passenger cars
13.1.1. Negative compensation related to passenger car purchases
13.1.2. Positive compensation related to the sale of second-hand cars
13.1.3. Negative compensation related to the purchase of second-hand cars
13.1.4. Negative compensation related to closed-end leasing
13.1.5. Negative compensation related to fuel and diesel oil used by passenger cars
13.1.6. Negative compensation for repair and maintenance costs of passenger cars
13.2. Compensation based on Article 17. Section (7) of Council Directive No 77/388/EEC
Total compensations
14. Final (harmonized) VAT base
(intermediate VAT base + positive compensations - negative compensations)
15. GNI
16. Final (harmonized) VAT base capped in 50% of GNI

(ACOR) in Brussels, where representatives of every Member State have an opportunity to examine and discuss the treatment of other Member States. This is how respect for Community law and also the principles of transparency, uniformity and equity are ensured.

In 2006, control visits will be carried out in 9 Member States. This is more than usual and results from the fact that the Commission at first time will also examine the annual VAT statements of five New Member States for 2004.

Gross collected VAT revenues

According to Council Regulation No. 1553/89/EEC gross VAT revenue means the amount of VAT actually collected by the budget on cash basis (which is called net VAT revenue in Hungarian terminology, that is, VAT payments reduced by refunds). The Treasury provides figures constituting the base for VAT based own resources. Gross tax revenue represents the total of the cash balances of three VAT accounts, which is included in the central

budget in the line “Value Added Tax”. The contents and typical features of the three VAT accounts are summarised below.

- *General value added tax account:* The account is managed by the Tax and Financial Control Authority (TFCA). It contains net VAT revenues originating from payments made on the basis of domestic sales and VAT refunded on domestic purchases (including products imported appearing in the first domestic phase of sales) until 30 April, whereas since 1 May it includes net VAT revenues resulting from payments made on the basis of domestic sales, imports and intra-community purchases and VAT refunded in connection with them. Due to the introduction on 1 May 2004 of the system based on self-declaration of VAT on imports and intra-community purchases registered on this account instead of levying by the Hungarian Customs and Finance Guard (HC&FG), the positive balance of the account is considerably higher compared with previous years. This latter effect was to a lesser extent moderated by the reintroduction of levying of VAT by HC&FG concerning a limited range of importers as of 1 July 2005.
- *VAT account for imported products:* This account contains payments of VAT on imports and refunds related to customs procedures collected, managed and recorded by HC&FG.
- *The VAT account for tobacco products* is also managed by the customs authority. Besides the excise duty, the tax seal also contains the VAT on tobacco products, and so collected by HC&FG. The general functioning of this account has not been affected by the administrative changes resulting from Hungary's accession to the EU.

In order to ensure the integrity of accounts between the Treasury, the tax authority as well as the customs authority, the balances of the accounts between Treasury and TFCA, and Treasury and HC&FG are recorded in an official document each year.

Fines and interest payments for delays to be deducted from revenues

In the Hungarian budget, these items are managed separately, and are recorded on a different account, and therefore they do not influence gross VAT revenues.

Collection costs to be added to revenues

In Hungary the VAT accounts do not contain collection costs, and therefore the collected VAT revenues do not need to be adjusted with this item.

Correction for small enterprises with turnover not exceeding EUR 10 000

In accordance with EU regulations, Member States can choose to leave out the transactions of taxable persons whose annual turnover specified on the basis of Article 24 Section (4) of the 6th Directive on VAT does not exceed EUR 10 000. Regarding the 2-million-forint limit of eligibility for exemption, Hungarian legislation has changed: since 1 January 2004, the above limit was increased to HUF 4 million. Since HUF 4 million exceeds EUR 10 000, there is no more need to calculate correction for this item.

Other corrections

Other corrections include VAT refunds, which are shown separately in accounting; some of the VAT amount is reported under different accounting categories; revenues shown in accounting as a result of the application of Hungarian VAT regulations concerning areas not governed by measures applicable to own resources; special VAT refund options provid-

ed in the Hungarian Act on VAT. The correction items may increase revenues, or they have to be deducted from revenues:

- Some of the amounts received in the foreclosure deposit account of the tax authority (TFCA), typically the ones that are paid in during the last two weeks of the year, are not allocated on 31 December. VAT revenues must be increased with the amount in the deposit account on 31 December of year *n*[4] to be allocated in year n+1. On the other hand, revenues must be reduced with the amount on the closing balance of the deposit account for the year *n*–1 to be allocated in year n.
- Since 1 May 2004 the customs deposit account kept by HC&FG functions in the same manner as the deposit account of TFCA. The positive correction of revenues relating to the account consists of three parts: the remaining amount from previous years' customs security accounts to be accounted for and concerning year n; the remaining amount from previous years accounted for year n+1, but concerning year n; and execution deposit payments in year *n*–1 accounted for year n+1, but concerning year n.
- VAT on regional HC&FG accounts must be added to gross VAT revenues.
- VAT items not paid into VAT accounts must be added to gross revenues, whereas non-VAT amounts paid into VAT accounts must be deducted from revenues.
- Amounts written off at HC&FG and TFCA for equity considerations entail a positive correction of revenues with the amounts concerned.

As noted by the DG Budget of the European Commission, further positive corrections should also be made, because the community regulations do not allow the application of certain provisions included in the Hungarian Act on VAT. The following items belong to this category:

- Gross VAT revenues are to be increased with the amount of VAT refunds concerning projects subsidised from PHARE and ISPA funds preceding EU accession. PHARE/ISPA contracts have not been concluded any more after the EU accession, therefore after the realization of projects financed through contracts made prior to the date of our accession there will not be new ones.
- The refund in certain cases of VAT on costs financed with foreign aid entails a positive correction of gross VAT revenues.
- Refund of non-deductible VAT to social organisations, churches and foundations must be added to gross VAT revenues.

Tax not collected due to graduated tax relief

Hungary does not apply the graduated tax relief system, therefore VAT revenues do not need to be adjusted with this item.

VAT not collected from flat-rate farmers

In accordance with Hungarian VAT regulations, taxpayers engaged in agricultural activities determined in the Act on VAT are not obliged to pay tax with regard to such activities except for product import and certain transactions being free of charge, but they cannot deduct the tax either. In transactions the buyer is obliged to pay a compensation premium to the taxpayer engaged in agricultural activities (12 per cent for plant products, 7 for livestock and animal products and for agricultural services), in addition to the purchase price, but included in the price. The buyers are entitled to account the compensation premium as 'pre-charged tax' (deductible VAT).

Calculations give an estimate of how much

the compensation premium covers irrecoverable VAT on inputs of flat-rate farmers. In the case of over-compensation gross VAT revenues must be increased with the surplus (which means VAT shortfall) and vice versa. The calculation method is the following:

a) determination of the ratio between VAT deducted and the tax base from data provided by TFCA (VAT returns);
b) estimate of the intermediate consumption (IC) of flat-rate farmers;
c) calculation of VAT on IC;
d) estimate of gross fixed capital formation (GFCF) of flat-rate farmers;
e) calculation of VAT on GFCF;
f) estimate of production of flat-rate farmers;
g) ratio between irrecoverable VAT on inputs and production of flat-rate farmers = (c+e)/f;
h) the difference between the ratio of VAT deducted to the tax base and the ratio of irrecoverable VAT on input to production (a-g), multiplied by the tax base = correction (positive).

Since Hungarian Central Statistical Office (HCSO) does not have direct data with regard to flat-rate farmers, the necessary data had to be estimated on a residual basis. The basis for the calculations carried out by the Hungarian Central Statistical Office are the so called "product balance sheets" (PBS) which are compiled at commodity level from pure statistical data collections. The product balance sheets are compiled separately for institutional sectors (households and non-financial enterprises). PBS of households includes private entrepreneurs with tax number and households of natural persons producing for the market and/or own consumption. We have information on the sales of private entrepreneurs from the VAT statements broken by crop- and animal production, as well as agricultural services. By deducting the data of private entrepreneurs from the households sector data, we get the data of those households which are flat-rate farmers or produce solely for own consumption. Figures for IC and production of year n are estimated from the Economic Accounts for Agriculture of year *n*–1 with the estimated index of flat-rate farmers. In the case of GFCF there is no need for indexation, because fact figures for year n are available at the time of drafting the report.

When calculating VAT on IC and on GFCF the relevant tax rate is assigned to each category of products and services within the main categories of plant products, livestock & animal products and agricultural services. Detailed data for private producers from the Farm Accountancy Data Network (FADN)[5] system were used for weighting where the categories covered several items with different VAT rates.

When calculating production, from total production PBS item of intermediate production had to be deducted to avoid redundancy. Production figure of flat-rate farmers includes production for own consumption, at the same time – for the sake of consistency – purchased IC of production for own consumption is included in purchased IC of flat-rate farmers. Sales data for agricultural entrepreneurs are available from the VAT returns. It is assumed, that the structure (for example, the proportion of direct sales to the total sales value) of PBS of entrepreneurs is similar to that of agricultural enterprises. Thus, by using the weights (structure) of enterprises, the missing details of PBS of entrepreneurs are calculated.

Net VAT revenues

Applying the positive and negative correction items specified above to gross VAT revenues we get net VAT revenues.

Weighted Average Rate of VAT (WAR)

The statistical offices of the Member States carry out the calculation of the weighted average rate with four-figure accuracy according to the regulations. The HCSO calculates the WAR for the Hungarian VAT base statement.

In order to calculate the weighted average rate of VAT for year n, the basic data are taken from the National Accounts (NAs) for year *n*–2 in accordance with Article 4 of Council Regulation No. 1553/89. These data and the provisions of the VAT Act are used for identifying the transactions subject to non-deductible VAT and classifying them by the VAT rates applicable for year n.

The Council Regulation No. 1553/89 allows the application of data prior to year *n*–2 only in very justifiable cases. However, for the purpose of breaking down these transactions by VAT rates, the structure of the Supply and Use Tables (SUT) (CPA 60 by NACE[6] 60) for year *n*–3 is applied. The EU did not make objection to this, since the Use Table is applied only for the structural breakdown of figures, which are available in National Accounts on macro level. The National Accounts have been compiled in accordance with the ESA'95 (European System of Accounts) accounting system. In the WAR calculation the breakdown of transactions by statistical category is based on the data taken from the NAs. As the NAs do not contain a breakdown according to VAT rates, supplementary data sources are used, e.g. the Household budget survey for getting more detailed manner of household final consumption expenditure and the Use Table for estimating the intermediate consumption-structure.

The weights used in the average VAT rate are calculated on the basis of NAs for year *n*–2, and the VAT rates applicable in year n are weighted with the taxable base net of VAT. From year *n*–2 to year n changes of the VAT rates and goods or services shifted from a VAT rate to another have to be taken into consideration as well. Since in both above-mentioned cases there is a delay between the entry into force of VAT rate and its effect on the VAT revenues corrections, approximately 1-month time lag has to be applied.

Accordingly, for the final household consumption, the intermediate consumption of the general government and non-profit institutions serving the households sector (NPISHs) and for the other sectors 1/12 of the purchases net of VAT was attributed to the “former” rates in force in year *n*–1 and the remaining 11/12 to current rates of year n. There was no need for time lag adjustment in cases when the rates changed already during the year.

In accordance with the Council Regulation No 1553/89/EEC, the following categories are identified for the calculation of WAR:

- Household final consumption expenditure (including also agricultural on-farm consumption and direct sales by flat-rate farmers to final consumers);
- Social transfers in kind to households purchased by government from market producers;
- Intermediate consumption of the general government sector;
- Intermediate consumption of the non-profit institutions serving households sector (NPISHs);
- Intermediate consumption of the other sectors liable to non-deductible VAT;
- Gross fixed capital formation (GFCF) of the general government sector and the NPISHs sector;
- Gross fixed capital formation of the other sectors liable to non-deductible VAT with housing investments;
- Expenditure in respect of the restriction on the right to deduct for business cars.

Methodology for the calculation of the final household consumption

In the calculation of the weighted average VAT rate, the household final consumption expenditure in domestic terms needs to be taken into account. In the WAR calculation the data of household consumption come from the National Accounts for year *n*–2. The expenditures are classified on the COICOP codes and on basis of the VAT rates specified either in the VAT Act for year *n*–2 or for year n. The expenditures net of VAT for year *n*–2 are reclassified by VAT rates for year n and applied as weights in the calculation.

In those cases, where more detailed breakdown needs to be used, the household budget survey and various special statistics, which serve as a basis for the NAs (e.g. cultural statistics, telecommunications statistics, etc.), are applied. The household final consumption expenditure includes the owner-occupied housing services as an imputed item. The purchases related to this imputed item (repair and maintenance) are classified under the imputed rentals of owner-occupiers heading under the standard rate in the detailed table for household final consumption.

The WAR calculation includes an adjustment in accordance with the compensation calculation for small exempt firms with turnover above EUR 10,000 and for the enterprises applying the simplified taxation scheme ('EVA'). The supplies to final household consumption of the above-mentioned firms are presented in a separate row in the category of the household final consumption expenditure.

The household final consumption includes the on-farm consumption and direct sales to final consumers by flat-rate farmers. These data are taken from the flat rate farmers calculation carried out for the year *n*–2. The input rate used in the calculation for on-farm agricultural consumption and direct sales by flat-rate farmers is taken directly from the calculation of the correction part of statement for year *n*.

The social transfer in kind from government is also included in the WAR calculation. In the NAs the social transfer in kind from government consists of individual goods and services provided as transfers in kind to individual households by government units, whether purchased on the market or produced as non-market output by government units. In this part of the WAR calculation only the taxable social transfers in kind to households purchased by government from market producers are involved. The figures for social transfers in kind to households purchased by government from market producers are calculated from the budget statistics. These items are the following: pharmaceutical products and other medical instruments, public transport. The social transfers in kind from NPISHs consist only of non-market output of the NPISHs.

Intermediate consumption of the general government sector

Institutions belonging to the public sector are primarily engaged in tax exempt activities, but they have some output on which they can reclaim the VAT. In order to identify the expenditure subject to non-deductible VAT accounted in the intermediate consumption of the general government sector, the pro-rata method is applied. For this method the data (gross output and intermediate consumption) are taken from the National Accounts for year *n*–2 (by activity, NACE in two-digit level). At first, the ratio of activities that have the right to VAT refund to the gross output is identified. The calculation of pro-rata of taxable activities is based on the sector account data (gross output is divided into social transfers in kind from non-market output, collective consumption and sales) and from this the sales were further examined by types and activities.

In the next step, the intermediate consumption related to government output that have the right to reclaim the VAT is extracted by means of pro-rata of deductibility. The intermediate consumption of government sector by activities is taken from the production account of general government sector for year *n*–2. After taking out the intermediate consumption belonging to the output subject to VAT, the breakdown by products and services on the basis of Use Table (at two-digit level) is made. Those product and service groups that were not homogeneous according to the VAT rates, were subdivided on the basis of the detailed table of current purchases from the annual budget report. Afterwards the net intermediate consumption can be identified with help of the net of VAT expenditures for year *n*–2 reclassified and summed up by the VAT rates for year. It is noted, that the tax-exempt items are not included in the calculation of the weighted average VAT rate.

CALCULATION SCHEME OF THE INTERMEDIATE CONSUMPTION FOR THE GOVERNMENT SECTOR LIABLE TO NON-DEDUCTIBLE VAT:

1. Identification of the taxable activity-share of gross output, which are subject to deductible VAT (pro-rata of deductibility). It is done by type of activities.
2. Taking out the intermediate consumption belonging to the output, which are subject to VAT refund by means of the pro-rata of deductibility.
3. Breakdown of intermediate consumption belonging to the activities liable to non-deductible VAT by VAT rates on the basis of the structure in the Use Table.
4. Further breakdown of the intermediate consumption structure by means of supplementary information.
5. Deduction of the VAT according to the VAT rates for 2002 from the intermediate consumption at purchasers' prices.
6. Regrouping the taxable intermediate consumption (excluding VAT) by VAT rates for 2004 (generation of eights), taking into consideration the time lag, as well.
7. Calculation of the weighted average VAT rate for this category.

Intermediate consumption of non-profit institutions serving the households sector (NPISHs)

In the National Accounts the non-profit institutions are mainly classified into the NPISHs sector, but some of them are reclassified into the general government, financial and non-financial corporations sectors in accordance with ESA'95 rules. The data of non-profit institutions classified into other sectors than NPISHs are included in the calculations for those sectors. On the basis of the VAT statistics, for this category it is possible to estimate the ratio of activities subject to VAT within the gross output, by type of activities, which is calculated alike the above-mentioned (pro-rata) method.

Intermediate consumption of the other sectors liable to non-deductible VAT

The most significant part of this item is the intermediate consumption of the financial corporations sector and other financial activity accounted in the households sector. Financial services and supplementary financial services are tax exempt activities with the exception of safe services and financial leasing. For the NACE 65 (Financial intermediation, except for insurance and pension funding) the part of output related to the financial leasing can be derived directly form the sector account. The NACE 66 (Insurance, except compulsory social insurance) activity is completely exempt. For the NACE 67 (Financial supplementary activities) the 'pro-rata' of the output is calculated on the basis of the VAT statistics both for the financial sector and the households sector. The calculation scheme is the same as for the general government sector and for the NPISHs sector.

Besides the financial services the following

activities belong to the 'other exempted' category: dental technicians, national postal services, real estate services (partly), education (except non-accredited education), human health care services and social services classified into the non-financial corporations and household sector (sole proprietors), other membership organization services reclassified into the non-financial corporations sector, public service radio and TV programming, gambling services.

There were several changes concerning the deduction of VAT charged on local and long-distance telephone services, and mobile telephone services, and on Internet-protocol-based voice transmission according to the VAT Act. Currently 50 per cent of the tax charged on these services cannot be deducted but this deduction restriction should not be applied to taxable persons who re-invoice at least 50 per cent of these services. As the deduction restriction also extends to the business sector estimation should be carried out for calculating the expenditures in respect of the partial restriction on the right to deduct for telephone in the business sector.

The WAR calculation includes an adjustment in accordance with the compensation calculation for small exempt firms exceeding EUR 10,000 and for the enterprises applying the simplified taxation scheme ('EVA').

Gross fixed capital formation (GFCF) of the general government sector and non-profit institutions serving the households sector

The data on GFCF of the general government sector and the NPISHs sector are taken from the NAs for year *n*–2. The data on GFCF of the NACE K 'Real estate, renting and business activities' in the government sector have a negative item because of the privatization of the housing by local government. In order to make the calculation accurate the data on the privatization of the housing was removed from the proxy. In accordance with the principle of transparency, for the GFCF of the general government sector and the NPISHs the same 'pro-rata method' is used as for their intermediate consumption. GFCF of the general government sector and the NPISHs sector that have right to VAT refund are taken out by applying the pro-rata of the taxable activities described above.

GFCF for other sectors liable to non-deductible VAT

GFCF for other sectors liable to non-deductible VAT, excluding housing investments

The calculation of GFCF for other sectors liable to non-deductible VAT is also based on the 'pro-rata method'. For the calculation of the non-deductible VAT of GFCF and the intermediate consumption of the other sectors, the above-mentioned unified method was applied. The standard rate is applied to all capital goods taken into account in the calculation.

Housing investment by households

In the scope of the Capital Accounts, within the National Accounts, the dwelling investment of households was revised and in the frame of this improvement, a detailed calculation was carried out concerning the non-deductible VAT content of housing investment. For the purpose of the WAR this calculation was applied directly.

Taxable base in respect of the restrictions on the right to deduct for business cars

On the basis of the restrictive provisions of the VAT Act, business enterprises cannot deduct

VAT for their passenger car purchases. Similar restriction is applied for the purchase of the fuel and the repair and maintenance services in connection with passenger cars. The taxable base for this category should be taken from the car compensation calculation of the VAT base statement for year *n*–2.

Transactions related to gold

The consideration of transactions related to gold as a weight was taken out of effect in a regulation before the accession (Council Directive No 98/80/EEC), therefore there is no need to calculate with this item.

Intermediate VAT base

Using net VAT revenues and WAR, the formula for calculating the intermediate VAT base is the following:

$$\frac{(\text{net VAT revenues x 100})}{\text{WAR}} = \text{intermediate VAT base}$$

Compensations related to VAT exemptions

Small exempt enterprises with an annual turnover exceeding EUR 10 000

According to the legislation of the European Union small enterprises with a turnover not exceeding EUR 10 000 are eligible for exemption. In Hungary, in the case of private entrepreneurs and companies the limit for exemption is HUF 4 million, whereas for family estate farmers (belonging to the category of small enterprises according to Article 24 of the 6th Directive) and for flat-rate farmers HUF 6 million. Since these amounts are higher than the limit of the European Union, for entrepreneurs with annual revenues between HUF 4 or 6 million and the HUF equivalent of EUR 10 000 a positive compensation needs to be made for their sales revenues, and a negative compensation must be calculated for the net value of their inputs.

In the calculation, the proposal of the Committee is taken into account, according to which the ratio of sales to final consumers is generally higher than the average in the economy, so the proposed ratio of 75 per cent is applied. Calculations contain data separately for companies. Since Hungarian authorities do not have fact data for year n regarding this category at the time of drafting the report, estimation had to be made using input/output data of year *n*–1 and the appropriate indexes. The method of calculation is the following:

a) determination of total annual revenues of enterprises concerned through tax returns and indexes;

b) application of the 75 per cent ratio to revenues as proposed by the Commission, thereby we get revenues concerning final consumption;

c) calculation of inputs falling under VAT through tax returns and indexes;

d) net revenues concerning final consumption *(b/1+WAR) (positive compensation);*

e) net value of inputs *(c/1+WAR) (negative compensation);*

f) balance of compensations *(d–e) (positive).*

Enterprises paying simplified entrepreneurial tax ('EVA') with a turnover exceeding EUR 10 000

Since 1 January 2003 private entrepreneurs and companies operating in certain fields of activity have the right to apply the simplified taxation scheme, hereinafter referred to as 'EVA'.

EVA base shall be the total revenue including VAT received by an eligible taxpayer in a tax year, subject to some modifications. EVA rate is 15 per cent of the tax base. Since those under this scheme are exempted from – among others – VAT, a compensation of the VAT base needs to be calculated for this item. The procedure examining compliance of EVA with the 6th Directive has not been finished yet. The upper eligibility limit of EUR 100 000 for EVA exceeds the limit of EUR 35 000 set for exemption during the accession negotiations of Hungary. Until further decision, the Commission proposed that compensation for EVA should be presented as a type of VAT exemption.

Regarding the fact that the EVA is a separate tax, compensation for the VAT base in respect of the EVA scheme can only be calculated indirectly, with approximation. EVA base of private entrepreneurs and companies are determined from the tax returns for year n, which is then cleared from VAT. During further steps of the calculation only subjects with a net base above EUR 10 000 are taken into account.

As a starting method, the ratio of output vested on final consumption was determined using VAT returns. The amount of purchases of VAT subjects from EVA subjects (presented in VAT returns as indicative data) divided by sales of EVA subjects gave the ratio of output not directed to final consumption, whereby we got to the ratio of final consumption. Regarding the fact that it cannot be determined from VAT returns whether purchases were made from EVA subjects under or above the 10 000 EUR limit, for the calculation of the ratio the total output of EVA subjects was taken with the total purchases from EVA subjects presented in VAT returns.

Since EVA returns do not contain any data on inputs (purchases subject to VAT), as a starting method, they were determined as a ratio of output using a cost ratio gained from the tax returns of enterprises not subject to EVA in year n or *n*–1, under similar activity sector identification numbers with revenues between EUR 10 000 and the upper eligibility limit for EVA. In the case of private entrepreneurs under the Act on Personal Income Tax, the returns for year n were used, whereas for companies under the Act on Corporate Tax, the return for year *n*–1 had to be used (the difference is due to the differing deadlines for returns). The amount of compensation is the difference between output adjusted with the final consumption ratio and inputs calculated above, both cleared from VAT.

Taking into consideration the fact that – due to its unique nature – for EVA there is not any agreed compensation methodology in the EU, the Hungarian authorities are developing the above calculation method working together with the Commission. In order to improve estimates, for example, the possibility of using data from sectoral input-output tables and national accounts instead of indicative tax-return data for calculation of the ratio of outputs vested on final consumption, as well as data from former VAT returns of EVA subjects for estimation of the input ratio have been considered as future development.

Compensation related to transactions identified in annexes E, F and G of the 6th Directive

Article 6 Section (3) of the 6th Directive gives an opportunity to Member States either not to take into account differences originating from transactions listed in Annexes E, F and G of the Directive, or to use estimates during the calculation of the VAT own resources base.

Annex F of the Sixth Directive contains transactions which are subject to VAT in EU regulations, but in individual Member States they may be exempted from tax for a tempo-

rary period (which is five years on the basis of Article 28 Section 4 of the 6th Directive) or permanently (on the basis of Article 28 Section 3.b of the 6th Directive). If there is such a difference, the hypothetic VAT base of the Member State concerned must be increased with the net value of the transaction (positive compensation). However, at the same time, we need to take into account that providing that the given transaction is exempt from VAT on the basis of the provisions of the 6th Directive, the party conducting the transaction cannot deduct VAT on inputs. On the contrary, in the Member State concerned the input VAT can be deducted, and thus the hypothetic VAT base must be reduced with the same amount (negative compensation).

In recent years, Hungarian VAT regulations have been modified to have the highest possible level of harmonisation with the 6th Directive concerning tax exemptions. As for Annex E, all the necessary modifications of the Act on VAT have been carried out in 2004, therefore there is no more need to calculate compensation regarding this part. In the case of Annex F only one item remains for which compensation needs to be made (domestic leg of international passenger transport). There are not any items in Annex G for which compensation must be calculated. Following the recommendation of the Commission, for items phased out, a one-month time-lag adjustment was calculated.

Compensation related to the domestic leg of international passenger transport (F 17)

According to the Hungarian VAT regulation the international passenger transport is taxable with zero rate. By the Council Directive No. 77/388/EEC Article 28. 3.b) Paragraph Hungary can maintain the received derogation (with the right of tax deduction) regarding international passenger transport after the accession. However a compensation item related to the domestic leg of international passenger transport should be calculated, which increases the harmonised VAT assessment base.

The calculation of this item is based on the revenue of the transportation companies for year n. In the case of air transport revenue, domestic leg of international transport has no sense in Hungary, because flights cannot be used for travelling inland. Therefore the revenue on the domestic leg of international railway and road transport is needed for the calculation, which is provided by the Hungarian transport companies.

Taking into consideration that no statistical data is available on the revenue deriving from the domestic leg of international transport, Hungarian authorities need to apply estimation. Therefore Hungary, like other new Member States, made an application for authorisation to the Commission. This application was accepted by the Commission at the meeting of the Advisory Committee on Own Resources (ACOR-VAT) on 13–14th October 2005. An authorisation will, however, not exempt the Member States from increasing permanently the accuracy of the calculation. From the point of view of Hungary the problem is that up to the present no information is available about the revenue of foreign bus companies deriving from the Hungarian leg of international transport. Therefore this component of the compensation fails from the Hungarian VAT base statement, which was pointed out by the Commission as well.

■ *Railway transport*

In respect of railway transport the Hungarian State Railways (HSR) gets revenue only from performance on the domestic leg of international passenger transport. Namely the HSR transfers only that part of its revenue to other railway companies which was taken from the use of foreign lines and in contrary, HSR gets that part of the revenues of other railway

companies as transfer which accrued from the use of Hungarian lines. As a result of that, in case of railway transport the revenue from transportation on the domestic leg is equal to the HSR's total revenue from the international passenger transport and this amount is the railway component of the compensation as well.

■ *Road transport*

In case of international transport the main Hungarian bus companies (Volán companies) adopt two schemes for accounting with their foreign partners. Except for the Eurolines routes, Volán bus companies apply individual accounting, which means, that company is entitled to get the total amount of the revenue, which operates the coach service. Therefore the total revenue deriving from tickets sold abroad is also transferred to the operator company. If a Volán company operates coach service, according to the individual accounting it gets the total revenue for the total distance, thus revenue of Volán companies contains revenue deriving from the foreign leg of the international passenger transport too. To detach this effect, the revenue of the Volán bus companies was adjusted in the calculation of the compensation on the basis of domestic performance of the operators in terms of passenger kilometres in international passengers.

Regarding the long and busy Eurolines destinations of Volánbusz Plc. pooling accounting is applied, where one pool for a destination has 2–3 or more member companies. In this scheme costs are deducted from the total sales revenue of the pool and then net income is allocated equally to the members of the pool. After that this allocation is further adjusted by taking performances of members (passenger kilometres driven) into consideration. Therefore the amount of the proportional adjusted revenue of Volánbusz Plc. is to be calculated for the compensation.

The Association of Volán bus companies presents the total revenue from international passenger transport, incorporating regular (scheduled), non-regular (contracted, special) service as well. Taking into consideration that the members of the Association of Volán bus companies are only the greatest operators, therefore performance data (in terms of passenger kilometre) of international passenger transport published by HCSO is used for extrapolation. Therefore the total revenue of the Hungarian bus companies derived from the performance provided on the domestic leg of international transport can be calculated with help of extrapolation of the Volán companies' market share.

Consequently the compensation related to the domestic leg of international passenger transport is calculated by the sum of the total revenue of railway and road transport derived from the domestic leg, where the latter can be estimated by an extrapolation of the revenue of the Volán companies.

Compensations in respect of the restriction of the right to deduct

Compensation for passenger cars

Regarding compensations for passenger cars, Article 17 Section (6) of the Council Directive No 77/388/EEC provides guidelines in the legal practices of the European Union. On the basis of the provisions of this Directive, no VAT can be deducted for inputs, which are not strictly related to business purposes. The Directive set a four-year deadline for the exact definition of strictly business-type expenses, in the case of which the restriction of the right to deduct can be applied. Since the Commission did not do it, in theory the right to deduct can be applied to the entire range of business expenses. With regard to expenses related to passenger cars, the Hungarian Act on VAT does not allow VAT to be deducted (based on

Article 33 Sections *1/c* and *2/b* of Act on VAT). Therefore the intermediate VAT base must be adjusted accordingly [see Council Regulation No 1553/89/EEC, Article 6 Section (4)]. Compensation can only be applied to passenger car and fuel purchases for business purposes, passenger car leasing and repair and maintenance expenses.

Compensation related to new passenger car purchases

On the basis of the provisions of Article 33 Section *2/c* of the VAT Act, no VAT can be deducted in the case of passenger car purchase if the purchase is not made for re-sale. Only purchases for business purposes need to be taken into account, because this is the area where the Hungarian Act on VAT is different from the EU regulations.

The estimation of new motor-car acquisitions by sectors is basically based upon direct data collections of HCSO. Investment data collected contained the values of the acquisitions of new and second-hand passenger cars, and the value of passenger cars obtained in the framework of financial leasing. This widened range of collected figures on passenger car acquisitions provided the possibility to base our calculations on direct data of year *n*–1. Data collection on the quarterly product structure of retail trade (NSSP 1646), administrative data on the number of passenger cars put into operation for the first time from the database of the Ministry of Interior and experts' estimation on the non-surveyed part of the economy (corporations and sole proprietors employing less than 5 employees) were taken into account in the estimation process of industrial and sectoral breakdown of new passenger car acquisitions apart from the investment data.

The urge on harmonizing these statistical calculations with the preliminary estimations of National Accounts, especially with the consumption of households by function within this area is possible now with the wider range of applicable statistical sources. The basis of the estimation of total acquisition value of passenger cars, and its sector breakdown is the value calculated as the number of new cars sold multiplied by the estimated average price that adds up from the consumption of households and the investment of production units. The average price of a passenger car is calculated by taking into account the relevant retail trade figures from the retail trade statistics and the number of cars registered in the administrative database of Ministry of Interior. The number of cars of import origin was estimated from the information of the Hungarian Car Sellers' Association. The result of the above-described estimations is the breakdown of the value and volume of the new passenger car purchases by legal and natural persons.

The industrial and sector breakdowns of car investments were calculated from the final figures of the investment questionnaire for year *n*–1. The data collection covered the purchases of cars and the value of cars acquired via financial leasing constructions for corporations and sole proprietors working with more than 20 persons, and for all budgetary units. For units working with 5–20 employees there was a sample survey carried out, and the grossed-up results were available to support our estimations. The whole investment value of motor-cars estimated for year n follows the sector structure of the final data for year *n*–1 when the total figure for year n is allocated to budgetary units, financial and non-financial corporations. Estimation procedure is solely applied for small units to distribute passenger car investments. The investment value for corporations and sole proprietors working with 5 or less employees for year n was estimated from their assumed Capital Stock values and replacement patterns. In case of sole proprietors, the whole investment value of transport equipment is determined by experts' estimations. The pat-

tern applied to cut off the share of motor-cars is identical to the share of motor-cars/all vehicles observed on corporations.

According to that the value of the new passenger cars purchased by legal persons can be broken down to non-financial corporation, financial corporation and governmental sectors. Taking into consideration that data also include the value of cars acquired in the framework of financial leasing constructions and the compensation related to closed-end leasing is calculated further on separately in the VAT base statement, therefore data of new passenger car purchases must be decreased by the value of financial leasing purchases. For the value of financial leasing purchases the Hungarian Leasing Association provides data from its member companies, therefore with help of extrapolation the total value of the financial leasing purchases is available. Besides that data of new passenger car purchases must be reduced also by VAT exempt purchases for calculating the compensation. According to the Act on VAT deduction of VAT with regard to expenses related to passenger cars is not allowed except for some special cases. According to Hungarian authorities expenses of entities with the right of VAT deduction are insignificant. The calculation of the compensation item is the following:

> New passenger car compensation = – (net VAT base of new passenger car purchases for business purposes – net VAT base of car purchases within the frame of financial leasing – net VAT base of passenger car purchases by exempt entities) x ratio of car use for business purposes

For increasing the accuracy of calculation the Commission requested the Hungarian authorities to decrease the amount of the compensation by the net VAT base of new car purchases by those sectors that have a right to deduct (e.g. taxi) as well. The examination of the database is in process.

Positive compensation related to the sale of second-hand cars

According to the provisions of Article 39 Section *3/a* of the VAT Act, a proportionate amount of the undeducted VAT on the passenger car sold by a taxpayer can be deducted within 5 years from the purchase. During the calculation of compensation for passenger cars, this was not taken into account, and therefore the intermediate VAT base needs to be increased with this amount (positive compensation).

Second-hand car sales of taxable persons are taxed according to the Hungarian VAT regulation. Yet correction is possible during the monitoring period of the VAT for tangible assets (Article 20(3) of the 6th Directive, 3rd indent of the Article 39(3) of VAT Law). Through this there is an opportunity of additional tax deduction but only in the ratio of using the car by a person other than the taxpayer. The re-sale of a second-hand car is a new taxable transaction, which is carried out by the taxpayer as such. It is also expressed by the value of the transaction, by the tax base. Since there is a tax devolution, a tax is to be paid, even if there is no longer any correction of the deductible tax, in case of a sale after the five-year monitoring period.

The estimated value of sales of second-hand cars registered for the first time in Hungary in year n comes from the multiplication of two matrices. The first matrix includes the volume broken down by years respectively by legal form of operators (natural persons, legal entities, total), the second matrix includes the appropriate values of depreciation function composed by the Institute for Transport Sciences (KTI) calculated by using the prices of new cars. The volume data are based on the register of Central Data-Processing, Registration

and Electoral Office of the Ministry of Interior and price data are based on the car price list of Auto2 specialist journal. The problem is that the register of the Ministry of Interior does not allow further breakdown of operators (by private entrepreneur, sectors etc.) and there is also a difference between the vehicle merchants and the HCSO how to define new cars. Furthermore, the vehicles fleet registered for the first time in Hungary reflects a fixed temporary state and there is no follow-up of car owners afterwards.

Positive compensation for second-hand passengers cars (1) =

$$\sum_{i=n-4}^{n-1}$$

(compensation for new passenger cars x ratio of second-hand passenger cars x proportion of the value of second-hand passenger $cars_i$ x average deduction $ratio_i$ x price change for second-hand passenger $cars_i$), where "i" signs the given year.

The price changes, the average deduction ratio in the current year, the estimated breakdown of second-hand vehicles and their turnover ratio compared to new passenger cars need to be taken into account in the calculation. The number of passenger cars licensed for traffic by non-financial companies was estimated in the following way: the ratio of the second-hand passenger car purchases of non-financial companies and legal persons was multiplied by the number of new passenger cars licensed for traffic by legal persons. In case of passenger cars licensed for traffic more than one year ago it was assumed that all the cars were licensed by non-financial companies, since purchases of second-hand cars are not typical by financial companies and by the governmental sector at all. In that way the share of the second-hand cars can be estimated from the compensation for new passenger cars.

The Commission recommended simplifying the calculation of the positive compensation for second-hand cars. The improvement of the calculation is expected to be carried out in that way.

Negative compensation related to the purchase of second-hand cars

Some of the second-hand cars are purchased by enterprises, which cannot deduct VAT on these purchases. Thus negative compensation occurs in such cases again.

Negative compensation for second-hand passenger car = – (Compensation for new passenger car purchases x ratio of second-hand passenger cars x average value of second-hand passenger cars compared to new passenger cars)

Estimates are needed again for not having direct data, taking into account the ratio of second-hand passenger cars, and their average value compared to new cars. The ratio of second-hand passenger cars compared to the new passenger cars was estimated by the following way: net value of passenger cars licensed for traffic by non-financial companies divided by the number of second-hand passenger cars multiplied by the number of passenger cars licensed for traffic by non-financial companies divided by the net value of new passenger cars. In case of passenger cars licensed for traffic more than one year ago it was assumed again that all the cars were licensed by non-financial companies, since purchases of second-hand cars are not typical by financial companies and by the governmental sector at all.

According to the Act on VAT deduction of VAT with regard to expenses related to passenger cars is not allowed except for some special cases. According to Hungarian authorities expenses of entities with the right of VAT deduction are insignificant.

The Commission criticized using estimation, instead of that more reliable direct statistical data would be required. Moreover, this negative compensation item should concern second-hand car purchases by companies, instead, the data used in the calculation concern supplies, therefore this estimation is also a concern for the Commission. Because of the lack of direct statistical data and improvement of the methodology, the Commission recommends eliminating this compensation item from the calculation; otherwise the Commission expects to place a reservation. If there is no agreement after making a reservation on this item, the question could be brought before the European Court of Justice.

Compensation related to closed-end leasing

Leasing firms can deduct VAT if on the basis of the lease contracts they pass on the ownership title of the passenger car to the lessee at the end of the term (this is the closed-end leasing which, for the purpose of change of ownership, is different from financial lease in a way that in the case of financial leasing a purchase option can also be agreed on at the end of the term). However, in the case of closed-end leasing the lessee cannot reclaim the VAT and the lease fee (in fact this is a sales transaction). In the case of an open-end lease (classified as a service) the leasing firm cannot deduct the VAT on the passenger car for the purpose of the VAT Act the lease contract is practically a rental contract, without re-sale. In addition, we should also take into account that the tax exempt group indicated above (for example financial service providers) cannot deduct VAT on purchased passenger cars irrespective of the restrictions on the right to deduct indicated above, and therefore compensation cannot apply to such amounts. Similarly, amounts belonging to companies (for example taxi companies), which can deduct VAT on passenger cars in certain cases, should also be deducted.

In the case of closed-end leasing, the leasing firm can reclaim VAT on the passenger car. However, in such cases the VAT on the lease fee cannot be deducted (VAT Act Article 6 Section 2). In the case of business-type use, this could be deducted, and therefore negative compensation occurs. The calculation of this compensation item is based on the financed value of passenger cars put on financial leasing, which is provided by the survey of the Hungarian Leasing Association among its members. The Hungarian Leasing Association also presents expert estimations concerning the share of that stock belonging to business companies having the right to deduct, share of closed-end leasing total stock of financial leasing related to passenger cars and the market share of the member companies of the Hungarian Leasing Association. Consequently there is an extrapolation in the calculation as well.

Compensation for closed-end leasing = – (net VAT base of the annual stock of financial leasing related to passenger cars – ratio of private use – tax exempt entities and entities with the right to deduct) x (ratio of close-end leasing within the financial leasing) x (ratio of car use for business purposes)

A survey was conducted within the framework of National Statistical Survey Programme (NSSP) by HCSO for closed-end leasing. After data processing, the harmonisation of data provided by the Hungarian Leasing Association and NSSP together with the elaboration of a more accurate methodology is currently proceeding. The Commission also prefers calculations based on statistical data.

Compensation related to fuel and diesel oil used by passenger cars

Pursuant to the provisions of Article 33 Section *1/c* of the VAT Act, no VAT can be

reclaimed for fuel, providing it relates to the operation of passenger cars. In this case, there is a need for further negative compensation, because on the basis of the Council Directive No. 77/388/EEC, VAT for business consumption could be deducted. The negative compensation amount can be calculated with the following formula:

> **Compensation for fuel** = – (net value of fuel consumption of passenger cars owned by enterprises – tax exempt entities and entities with a right to deduct VAT) x (ratio of use for business purposes) – net value of diesel consumption of passenger cars owned by enterprises – tax exempt entities and entities with a right to deduct VAT) x (ratio of use for business purposes)

- *Fuel*

On the one hand, in the case of fuels, the restriction of the right to deduct applies not only to passenger cars, but also to total consumption according to Article 33 Section *2/a* of the Act on VAT. For the calculation the volume data concerning fuel use for business purposes are provided by the Energy Centre Non-profit Company, the fuel average prices are provided by HCSO. The volume data are reduced by the fuel consumption of flat-rate farmers, as there is a particular correction item for them. Fuel consumption not related to passenger cars is considered insignificant.

- *Diesel*

For estimating the consumption of passenger cars running on diesel, the passenger car statistics of HCSO can be used with an assumption, namely the average mileage of passenger cars used for business purposes is independent from the consumed fuel. Data on the breakdown of petrol and diesel operated passenger car and diesel average price data are provided by HCSO.

Compensation for repair and maintenance costs of passenger cars

On the basis of Article 33 Section *1/a* of the VAT Act, VAT cannot be deducted if the expense does not relate to the economic activities of the taxpayer. The net VAT base of car maintenance was calculated on the basis of the relevant data of the National Accounts for the purchased consumption of households (using the ratio of expenses for fuel and repair and maintenance) and assuming that the proportions were also the same for car use for business purposes. In the VAT statement for 2004 the HCSO turned to the quarterly estimation of household consumption on the group level of four digits. It means, that from 2004 the (estimated) data of the appropriate COICOP groups are available for the calculation of this negative compensation.

> **Repair, maintenance compensation** = – (absolute figure of total fuel compensation) x (value of repair, maintenance and vehicle components according to household statistics)/(fuel-consumption according to household statistics)

Compensations applied on the basis of Article 17 Section 7 of Council Directive No. 77/388/EEC

The right of VAT deduction is not restricted on the basis of Article 17 Section 7 of Council Directive No. 77/388/EEC in Hungary.

Final (harmonised) VAT assessment base for year n.

The final single (harmonised) VAT base is calculated by adding positive compensations to and deducting negative compensations from the intermediate VAT base. On the basis of the

provisions of Article 2 Section (c) of No. 2000/597/EC Euratom Council Regulation, the harmonised VAT assessment base of the member states, which is the basis of the VAT-based contribution, cannot exceed 50 per cent of the GNI of the member state concerned. If the harmonised VAT base exceeds 50 per cent of the GNI, the VAT-based own resource must be paid to the general budget of the EU on the basis of 50 per cent of GNI.

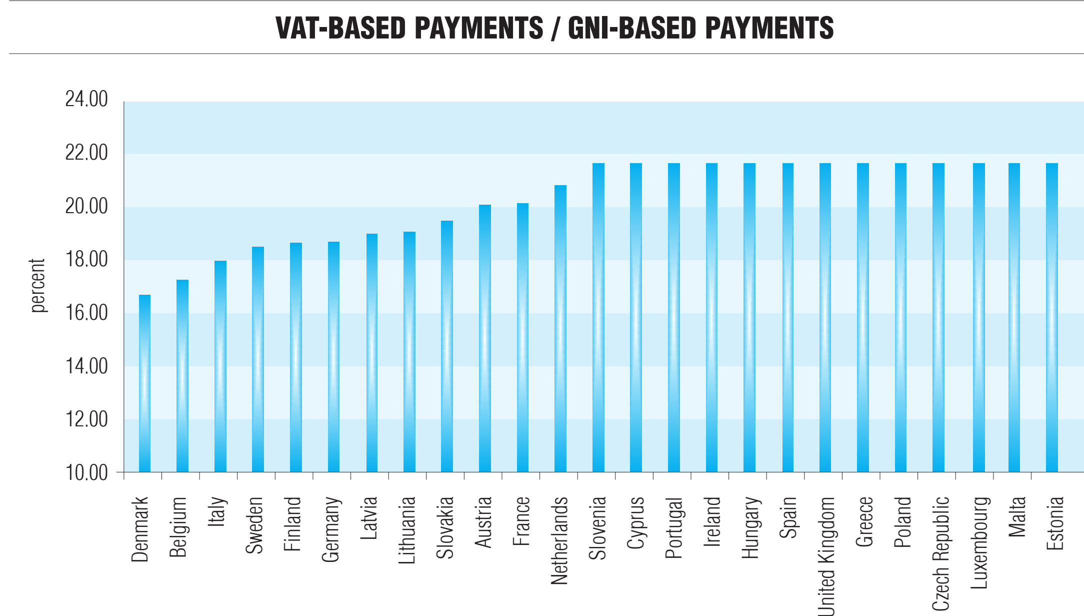
PAYMENT OF THE VAT OWN RESOURCE, QUESTIONS ABOUT THE FUTURE

Calculation of the VAT based payment maximized in 50 per cent of GNI (capped VAT base) is the following. Determination of the frozen rate taking into account the UK rebate constitutes the most important part of the method: the theoretical contribution of Germany, Austria, the Netherlands and Sweden (net contributors) to the financing of the UK rebate is deducted from the sum of the UK rebate, the figure is then divided by the aggregate capped VAT bases of the remaining member states. Deducting this rate from the maximum call-in rate fixed at 0.5 percent we get the uniform rate with which the capped VAT base of a given member state is multiplied, thus giving the amount of the VAT own resource payment to be effected by the given member state. The above method shall change from 2007 concerning the uniform rate which will be fixed at 0.3 per cent (except 0.225 per cent in Austria, 0.15 in Germany and 0.1 per cent in Sweden and the Netherlands).

Regarding the amount of VAT own resource payments set for 2005, the biggest contributor is Germany, followed by the UK, France, Italy and Spain. The order of countries is the same as far as GNI based contributions are concerned. It is useful though to examine the structure of countries' payments, showing which countries pay relatively more and which pay relatively less VAT resource. The following diagram shows the proportion of VAT based and GNI based payments.

Figure 2

VAT-BASED PAYMENTS / GNI-BASED PAYMENTS



Source: payment appropriations for the budget in 2005

According to the above data, Denmark pays proportionately the least VAT own resource (less than 17 per cent), it is followed by Belgium and Italy. As can be seen in the diagram, in the payment of most new members states the weight of the VAT based part is relatively higher than in older member states, reaching 21–22 per cent. Due to the capping of the VAT base (in 50 per cent of GNI) the rate does not increase beyond a certain limit, it never reaches 22 per cent. The difference of the above rates between countries can be explained by the following factors.

- Differing rates of consumption and savings measured in proportion to national income: countries with a lower propensity to save pay relatively more VAT own resource.
- Difference between the effectiveness of tax administrations: ineffective systems produce less VAT revenues.
- Significant discrepancies between cash-based and accruals-based VAT revenues for a given year. As the report on the harmonized VAT base takes a cash-based approach, revenues carried forward between years affect yearly VAT based contributions to the EU, too.
- Reliability of estimates used for corrections and compensations: different countries may have different databases and methods for calculations of adjustments necessitated by the difference within certain limits between VAT regulations of the member states, it is up to the Commission's judgment whether a methodology is accepted or not. It happens that lacking the requisite data, a member state is not permitted to calculate a negative compensation of the VAT base for a certain item.

In theory, the difference of VAT rates between member states – ceteris paribus – does not affect the amount of the national VAT based payment, since for the calculation of the intermediate VAT base the weighted average VAT rate is applied. However, taking a dynamic approach – depending on price elasticities and tax incidence – high VAT rates discourage (registered legal) consumption, resulting in a more moderate VAT base. The influence of VAT exemptions of certain entrepreneurs permitted within certain limits is supposed to be neutralized by compensations of the intermediate VAT base, consequently, these exemptions differing from one country to another do not influence the final (harmonized) VAT bases in a static approach. However, differences in exemption of certain products and services can have an effect on the harmonized VAT base.

Regarding the future of own resources, in the short term (until the end of the next EU budget cycle) the three present sources (GNI based, VAT based and traditional own resources) will continue to assure the financing of the common budget. Although the present system ensures the stability of revenues for the EU, it makes the common budget increasingly dependent on transfers from national treasuries. On preparing and evaluating its study on own resources, the Commission proposed the reform of the current system to the Council. In assessing the system of own resources[7], the Commission applied the following criteria:

- transparency and simplicity,
- financial autonomy,
- efficient allocation of resources,
- sufficiency,
- cost-effectiveness,
- stability,
- equity.

The conclusion is that though the present system of own resources ensures the stability and sufficiency of resources, the system has a low level of transparency, does not ensure the efficient allocation of resources, furthermore, it restrains the financial autonomy of the EU.

The Commission put forward three alternatives for financing the EU budget in the future (all would retain traditional own resources).

1. maintaining the present financing system unchanged;
2. adopting a purely GNI-based financing system;
3. adopting a financing system based on fiscal own resources.

The Commission does not approve the 1st version, because the system in its present form does not assure a direct link between the EU and its citizens who tend to judge EU policies and initiatives exclusively in terms of their national allocation.

According to the Commission, the 2nd version is simple and easy to understand but does not reflect the status of the EU, which is more than an international organization. It would imply an idea of the Union in which citizens would be only indirectly represented by their Member State, something that is unacceptable to the Commission.

The 3rd version means that part of the present GNI based resource and the statistical VAT resource would be replaced by a fiscal own resource (or fiscal own resources). This could increase the financial autonomy of the EU and introduce a direct link to citizens. The participation of citizens and economic operators in the EU budget would go hand in hand with a reduction in the level of contributions by Member States and ensure higher visibility and increased political accountability for expenditure decisions. However, a fully tax-based system does not appear appropriate to the Commission because of the threat to balanced budgets. Therefore, the retention of a limited GNI resource together with an increase in the share (maybe to 50 per cent) of taxed-based resources seems preferable. A prerequisite for the functioning of the system would be the harmonization of tax bases. The increase of tax-based own resources does not call for any new taxes because the EU share could be levied as part of the national rate paid by taxpayers. The Commission put forward three options:

- Fiscal resources related to energy consumption: Under the new directive on energy taxation, most energy products are subject to Community taxation. However, the Commission proposes limiting the Community levy to the tax base related to motor fuel used for road transport, which is already harmonized at a Community level. It could be supplemented with a levy on aviation fuel or the related emissions. This option could be implemented within a short period of time (around 3 to 6 years);
- A fiscal VAT resource: In place of the present statistical VAT resource, the EU rate would be levied as part of the national VAT rate paid by taxpayers, together with the national rate on the same taxable base. Citizens would not have to bear an additional tax burden as the EU rate would be offset by an equivalent decrease in the national VAT rate. The main stumbling block to this measure is the incomplete harmonization of member states' VAT systems. Technically, the introduction of this option would be possible within a period of up to 6 years;
- A resource based on corporate income. This option would require a prior definition of a common consolidated tax base, thereby boosting cross-border economic activity, which is hampered by 25 national tax systems and a myriad of laws. This option would imply setting a minimum tax rate for the harmonized tax base and would be the longest to implement.

The proposals have been discussed in the Own Resources Working Groups of the Council on several occasions. Instead of arriving at political decisions, the object of the working groups was to discuss the technical details of the proposals and the positions of member states

with regard to them. The negotiations will continue during next presidential cycles.

Changing of the financing system of the EU requires unanimous decision of the Council (i.e governments of the member states). In order to reach a political consensus, coordination of the divergent interests of the member states and elaboration of a compromised proposal are indispensable. As discussed at the beginning of the article, the development of the own resources system was, in itself, the result of a long, multi-staged process, therefore the introduction of a new element is possible at the earliest in the framework of the financial perspective beginning 2014. It is certain that until that time the current statistical VAT own resource will remain, at the maximum some methodological changes are possible pending mutual agreement of the member states.

Notes

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[2] See COM (2001) 801 final of 28.12.2001

[3] The uniform rate is equal to the difference between the maximum call-in rate and the frozen rate. The frozen rate is equivalent to the ratio between the gross amount of the UK correction (estimated at about 180 per cent of the UK correction) and the sum of the Member States' capped VAT bases.

[4] Year n stands for the year discussed in the report.

[5] A representative information system managed by the Institute of Agricultural Research and Informatics providing data on the performance and profitability of different groups of agricultural enterprises on a regional and state level.

[6] NACE = Nomenclature statistique des Activités économiques dans la Communauté Européenne

[7] Report from the Commission "Financing the European Union": Commission report on the operation of the own resources system (11752/04 FIN 364 RESPR 5 CADREFIN 29 + ADD 1 (COM(2004) 505 final))

Sources

Main data sources applied for the calculations:

- Statistics of Hungarian Central Statistical Office
- Data of Hungarian State Railways
- Data of Volán bus companies
- Data of the Hungarian Leasing Association
- Data of Energy Centre Non-profit Company

Ministry of Finance of Hungary: Statement of the VAT Own Resources Base (July 2005)
Homepage of the European Commission (http://europa.eu.int/comm)

Rules of the EU:

- Council Regulation No. 1553/89 (EEC, EURATOM)
- Council Directive No. 77/388/EEC (6th Directive)
- Adaptation of the ceiling of own resources and of the ceiling for appropriations for commitments following the entry into force of Decision 2000/597/EC, Euratom COM (2001) 801 (2001.12.28)