

# Value Added Taxes in OECD Countries

Šárka Sobotovičová, Beáta Blechová, Jana Janoušková

**Abstract**—Value added tax is the most widespread general consumption tax in the world having been implemented by over 150 countries and in 33 of the 34 OECD member countries. In each country, there are different approaches to the application of this tax, both in terms of tax rates, exemptions and exceptions, as well as in terms of the status of VAT in the tax mix.

This article deals with selected indicators of general consumption taxation within the OECD countries. The analysis of their dependence is determined on the basis of the correlation matrix. Comparative analysis showed that the performance of the VAT in OECD countries has a low dependence on all investigated factors. Generally it can be said, that the performance of VAT depends on five main factors, which are the structural features of the tax, the evolution of consumption patterns, place of taxation, capacity of tax administration and the rate of tax compliance by taxpayers and the interaction between these factors is crucial.

**Keywords**— Registration threshold, tax performance, tax rate, VAT Revenue Ratio.

## I. INTRODUCTION

THE value added tax is a relatively new tax but during its existence, it has gained a significant position in the tax systems of most countries which have introduced it. Originally, a German businessman Wilhelm von Siemens came up with the idea of the value added tax in 1920. Maurice Lauré, who was then the joint director of the French tax authorities, developed the idea and created the system. The value added tax was introduced in France and was accepted by all member countries of the European Community [3]. VAT is the first consumption tax that has successfully integrated the taxation of goods with the taxation of services [6].

Currently, the value added tax is introduced in more than 150 countries worldwide. In the European Union, which comprises 28 member states, the adoption of the VAT is a prerequisite for membership because it is uniquely equipped to tax imports on par with domestically produced goods and services and to free exports from tax. Australia is the latest industrialized country that has converted to VAT. Value added taxes (VAT or GST) are the principal form of taxing consumption in OECD member countries. As Charlet and

Owens [2] state, developed countries can be divided into countries charging VAT based on French (European) model and the countries applying different type of the tax.

The first group of countries, many of which are members of the European Union, widely applies one or more reduced rates in addition to the standard tax rate, or even a super-reduced rate or a parking rate plus a number of exceptions. Directive allows EU member states to have a standard rate that cannot be lower than 15 percent and up to two reduced rates that cannot be lower than 5 percent [1]. Also, the directive grants older member states “reserved rights” according to which they can continue applying a reduced rate lower than the minimum indicated in the directive if that rate was in place before 1991 [14].

The second group of countries (including Australia, Canada, Korea, New Zealand, Singapore, and South Africa) has much wider base for standard rates. The majority of developing countries also prefer a system with one tax rate. For instance, of the 21 African countries that adopted a VAT between 1990 and 1999, 14 have a single-rate system. Eight of the nine African countries that have adopted a VAT since 2000 have a single-rate VAT system. Countries with a wider base at the standard rate frequently have a standard rate less than the EU minimum of 15 percent.

In many countries the implementation of one or several reduced rates is traditionally justified by the assumption that the poorest households spend a high proportion of their income on essentials. Thus, the poor would suffer more from a VAT on food. Reduced VAT rates reduce the supposed regressivity of the tax and achieve some level of redistribution to the poorest households. But this neglects the view that the wealthiest also benefit from the reduced rates and rich people typically consume more of the necessities than the poor [2].

There are many differences in the way VAT is implemented in each country. The existence of a wide range of exemptions and special measures often pursues political goals. In terms of the EU, value added tax is the most harmonized tax because the single internal market within the states of the European Community was created [5]. Nevertheless, some differences among the particular member countries still remain. Not only that there was a failure to unify tax rates, but some states have not limited even the number of tax rates the use of which has been allowed for transitional period based on exemptions.

Continuing globalization puts more pressure on the international aspects of VAT outside the EU [10]. Different systems of VAT applicable in each country cause many problems to both businesses and tax administrations. The lack of uniform rules for international deliveries of goods reduces the ability of governments to collect taxes and creates

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uncertainty for businesses. Therefore, great attention is currently paid to improve and streamline the system of the value added tax not only within the EU, but also in OECD countries.

## II. VAT IN OECD COUNTRIES

In OECD, VAT is applied in 33 of the 34 member countries and the only country that has not introduced VAT yet is the USA. The United States continues to deploy retail sales taxes. Both the position of the value added tax in the tax systems and the way of imposing the tax vary from state to state. Common basic principles are necessary to ensure a required degree of cohesion, which can help prevent double taxation, unintentional non-taxation, tax evasion, or distortion of competition. Among the factors that could improve the efficiency of the value added tax, we can include the introduction of a broad base for the standard rate of tax with a minimum number of exceptions, a single rate of tax and the registration threshold, which allows the tax administration to focus on the important taxpayers.

Although many studies, among which we can mention Copenhagen economic study 2007 [4] for example, show that the VAT system with a wide base and preferably with a single tax rate would be very close to ideal, purely excise duty and would lead to a reduction of administrative costs. As for the application of the number of the value added tax rate, there are many approaches within countries. As Šíroký [15] has stated, a differentiation in tax rates has occurred in the vast majority of countries under the influence of socio-political pressures. The lower tax rate is therefore imposed on products and services that provide basic necessities of life. A wide variability in tax rates however leads to a breach of the principle of tax neutrality, price distortion, arising of distribution effects, and the distortion increases. According to Kubátová [9], one rate of VAT has a regressive impact with regard to pensions as the propensity to consume is declining with the growth of income and distinguished tax rates can provide an application of greater fairness to taxation under the principle of ability to pay.

Practical experience also shows that VAT rate reductions may affect compliance. Recent OECD studies suggest that a multiple VAT rate structure with numerous exemptions would be more difficult for taxpayers to comply with and for the revenue bodies to administer than a VAT with a single-rate structure and few exemptions [12].

As stated by Keen and Mintz [7] one of the most important decisions in the field of the value added tax is the correct determination of the turnover threshold for compulsory registration. Too high turnover threshold reduces tax revenues from the value added tax. On the other hand, too low threshold may bring high costs of tax subjects. Different tax treatment of companies, whose turnover is above and below the turnover threshold, can also distort a competition [8].

As it is shown in Table 1, there are still large differences of standard rates among member countries of OECD. Standard rate ranges from 5 % (Canada and Japan) to 27 % (Hungary, which is the only country with the standard rate higher than 25 % in the European Union).

Table 1 Standard and reduced rates in OECD in the year 2012

Country	Standard Rates	Reduced Rates
Australia	10.0	0,0
Austria	20.0	10.0/12.0
Belgium	21.0	0.0/6.0/12.0
Canada	5.0	0.0
Chile	19.0	-
Czech Republic	20.0	14.0
Denmark	25.0	0,0
Estonia	20.0	9.0
Finland	23.0	0.0/9.0/13.0
France	19.6	2.1/5.5/7.0
Germany	19.0	7
Greece	23.0	6.5/13.0
Hungary	27.0	5.0/18.0
Iceland	25.5	0.0/7.0
Ireland	23.0	0.0/4.8/9.0/13.5
Israel	16.0	-
Italy	21.0	4.0/10.0
Japan	5.0	-
Korea	10.0	0
Luxembourg	15.0	3.0/6.0/12.0
Mexico	16.0	0.0
Netherlands	19.0	6.0
New Zealand	15.0	0
Norway	25.0	0.0/8.0/15.0
Poland	23.0	5.0/8.0
Portugal	23.0	6.0/13.0
Slovak Republic	20.0	10
Slovenia	20.0	8.5
Spain	18.0	4.0/8.0
Sweden	25.0	0.0/6.0/12.0
Switzerland	8.0	0.0/2.5/3.8
Turkey	18.0	1.0/8.0
United Kingdom	20.0	0.0/5.0

Source: own processing [11]

The unweighted average of the standard rate in the all OECD countries rose to 18.7 % compared to 18 % in 2000 (as shown in chart 1). The average standard rate has started to rise since 2008 after a period of relative stability. This suggests that many countries have increased their standard VAT rates to raise more revenues to consolidate their budgets. Sixteen OECD member countries have increased the standard or reduced rates between January 2009 and January 2012. These changes mainly occurred in European Union countries. On the other hand none have decreased their rates in the same period. Since January 2012, further rate increases have been implemented (in the Czech Republic, Finland, Israel, Netherlands, Poland and Spain). This should result further hike of the OECD average standard VAT rate to 19%. When

comparing the average basic rate tax in the member countries of OECD among one another, which are members of the EU, and non-EU countries, the average tax rate is 21.2 % in the countries of OECD and EU at the same time, while in the OECD countries outside the EU it is only 14%.

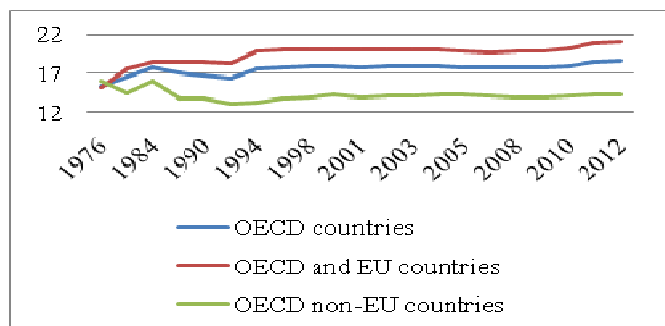


Fig. 1: Unweighted average of the standard rate in OECD, source: own processing [11]

With the exception of Chile, Israel and Japan, all OECD countries have one or more reduced rates (including internal zero rates and supplies exempt from tax with right to deduct input tax). When comparing number of reduced rates in the member countries of OECD among one another, which are members of the EU, and non-EU countries, the countries of OECD and EU use in average two reduced rates (with the exception of Denmark, which as the only country in the EU apply only the basic rate) at the same time, while in the OECD countries outside the EU it is only one reduced rate. EU member states may apply reduced rates to goods and services enumerated in a restricted list or to the labour-intensive services [13].

The use of reduced tax rates and exemptions is a diversion from the basic logic of VAT. In this context, exemption means that no VAT is chargeable for supplier and the supplier is unable to recover any input tax incurred in the process of making such supplies. All OECD countries (with the exception of New Zealand and Turkey) exempt a number of specific sectors that are considered to be necessary because of social reasons (e.g. health care, education and charitable organizations). Most countries also use exemptions for practical reasons (e.g. financial and insurance services) or for historical reasons (postal services, letting of immovable property, supply of land and buildings).

One of the exceptions is also an exemption from the application of the value added tax for small businesses below registration threshold. What results from the exemption is that the taxable person does not have to charge VAT on his supplies, and also has no right to deduct input tax. Such taxable person is given the possibility of voluntary registration. The thresholds in individual OECD countries are shown in the following chart.

As we can see from the chart, thresholds in individual countries vary considerably and in this respect, the countries can be divided into three groups:

- member countries with a relatively high threshold (more than USD 30000),
- member countries with a relatively low threshold (between 2000 USD and 29999),

- member countries without established threshold values (Chile, Mexico, Spain and Turkey).

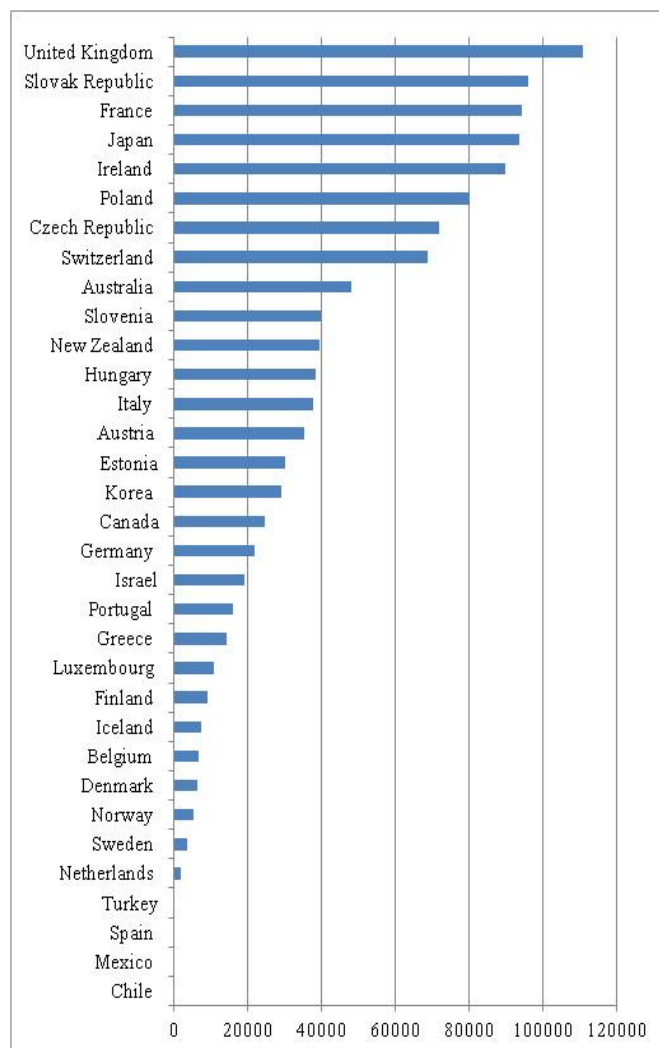


Fig. 2: Thresholds in OECD countries, source: own processing [11]

When comparing the average threshold in the member countries of OECD among one another, which are members of the EU, and non-EU countries, the average threshold is 38 217 USD in the countries of OECD and EU at the same time, while in the OECD countries outside the EU it is only 27 748 USD. In OECD countries, which are members of the EU the only country without established threshold is Spain, while in OECD non-EU countries there are three countries without established registration threshold.

There is no consensus amongst OECD countries on the need for, or the level of, registration thresholds. The main reason for excluding small firms are that the costs for the tax administration are disproportionate to the VAT revenues from their activity and, similarly, VAT compliance costs would be disproportionate for many small businesses. The level of the threshold is often the result of a trade-off between minimizing compliance and administration costs and the need to increase revenues [11].

### III. TAX PERFORMANCE

As indicated above, each country has a specific rates mix, exemptions and exceptions which are applied with regard to historical, economical, social, and political reasons. One of the options how to ensure higher yields from VAT without an increase of the basic tax rates is the improvement of the tax performance. It includes a broadening the tax base, limited use of reduced rates and exemptions, effective tax administrations and better compliance. Theoretically, the value added tax is the most efficient when it is imposed as a flat rate on all goods and services and one tax rate is applied. The value added tax was not designed and constructed as a tool for the implementation of social and redistributive functions. Copenhagen Economics Study 2007 [4] has showed that exceptions and reduced rates increase additional compliance and administrative costs which reduce the efficiency of the tax.

OECD, among others, also deals with the performance measurements of VAT in its analyses. One of the tools which is considered to be a suitable indicator of VAT performance is the VAT Revenue Ratio (VRR). Therefore, VRR measures the difference between the VAT revenue actually collected and what would theoretically be raised if VAT was applied at the standard rate to the entire potential tax base and all revenue was collected. VAT Revenue Ratio can be calculated by the formula:

$$VRR = \frac{VR}{B \times r} \quad (1)$$

where: VR = Actual VAT revenues,  
B = Potential tax base,  
r = Standard VAT rate.

The main problem with the VRR consists in the fact that there is no standard definition of the potential tax base. In case of the absence of such data, the expenditure of final consumption from national accounts are included in the calculation, and are calculated according to the standard norms of international system (SNA 1993, System of National Accounts), but have to be further adjusted. As a result, the VRR is calculated as follows:

$$VRR = \frac{VR}{(FCE - VR) \times r} \quad (2)$$

where: VR = Actual VAT revenues,  
FCE = Final consumption expenditure,  
r = Standard VAT rate.

The main measure of consumption in national accounts is final consumption expenditure. This includes the consumption by households, non-profit organizations and general government.

The optimal value VRR equals 1, but this is a theoretical situation that all expenditures on final consumption are subject to VAT at the standard rate and all the tax is collected. On the other hand, the low value of VRR shows a small tax base for the standard rate of tax, or a significant failure of the state in collecting the tax due.

In practice, the VRR rarely equals 1. A number of complex factors may influence the results. These include:

- tax compliance never reaches 100 per cent,
- in many countries, a wide range of goods and services are subject to reduced rates,
- some goods and services are usually exempt from VAT,
- some distortions may be created by the place of taxation rules applicable to international trade,
- small traders are exempt from VAT in many countries,
- on some supplies businesses don't pay VAT but they are in tax credit situation.

These factors include both policy decisions and compliance levels and the VRR is combination of Policy Efficiency Ratio and Compliance efficiency ratio. [11] Values of the VRR in OECD countries are listed in the following table.

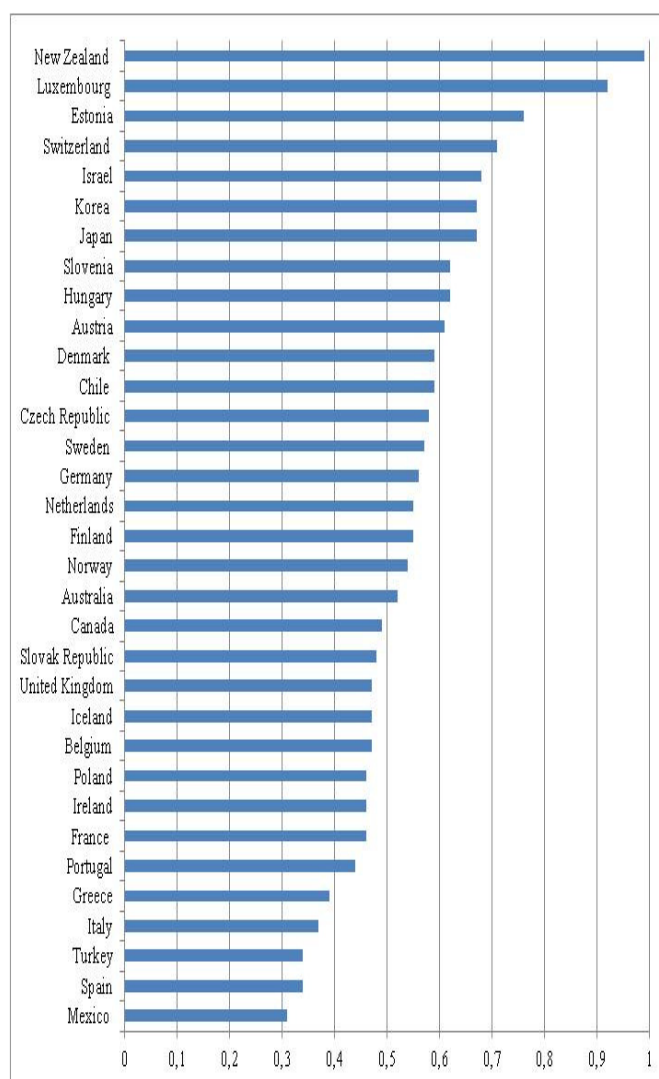


Fig. 3: Vat revenue ratio in OECD countries in 2009, source: own processing [11]

VRR value ranges from 0.31 in Mexico to 0.99 in New Zealand. Two countries have VRR higher above the others, namely New Zealand (0.99) and Luxembourg (0.92). New Zealand is a country in which a broad base is applied for the basic rate of tax with limited exceptions and limited zero rates. This fact, together with the proportionally high value of

investments in residential housing that generates GST revenues distorts the ration as these investments are not included in the consumption figures, affects the value of VRR. A high value in Luxembourg may indicate a significant income acquired through exceptions applied in the financial services industry.

Most countries (26) have their VRR below 0.65, of which 14 countries have the ratio below 0.50. The OECD average is 0.55. This suggests that the modes of VAT, with many reduced tax rates and exemptions from taxation, are responsible for significant tax expenditures in comparison with fully effective mode of VAT.

It also appears that the level of the standard rate has a limited influence of VRR. Countries with comparable standard rates can have very different VRRs. Luxembourg and Mexico, for example, both apply a standard rate of 15% in 2009 but their VRR is respectively 0.92 and 0.31 [11].

The developing of average VRR in countries of OECD and VRR in New Zealand and Mexico is shown in the chart below.

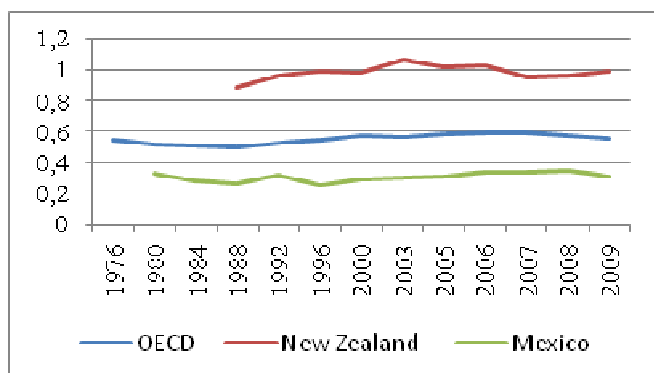


Fig. 4 Developing of VRR in OECD countries, source: own processing [11]

IV. VAT POSITION IN THE TAX SYSTEM OF OECD COUNTRIES

Revenues from taxes on consumption, particularly in the form of VAT revenue, stabilized after 2000 in the tax mix of OECD countries. Over the longer term, OECD member countries have relied increasingly on general consumption taxes. Since 1965, the share of these taxes as a percentage of total taxation increased from 11.9% to 20%.

When comparing the unweighted average of VAT revenues as percentage of total taxation in the member countries of OECD among one another, which are members of the EU, and non-EU countries, the average is 20.38% in the countries of OECD and EU at the same time, while in the OECD countries outside the EU it is 20.27%. There is a slight difference between these averages.

The share of VAT in total tax revenues varies in particular countries, namely from 9.6% in Japan to 38.7% in Chile, as it is shown in the following chart. The average share of VAT in total tax revenues in OECD member countries is 19.7 % and the Czech Republic moves with 20.4 % slightly above this average.

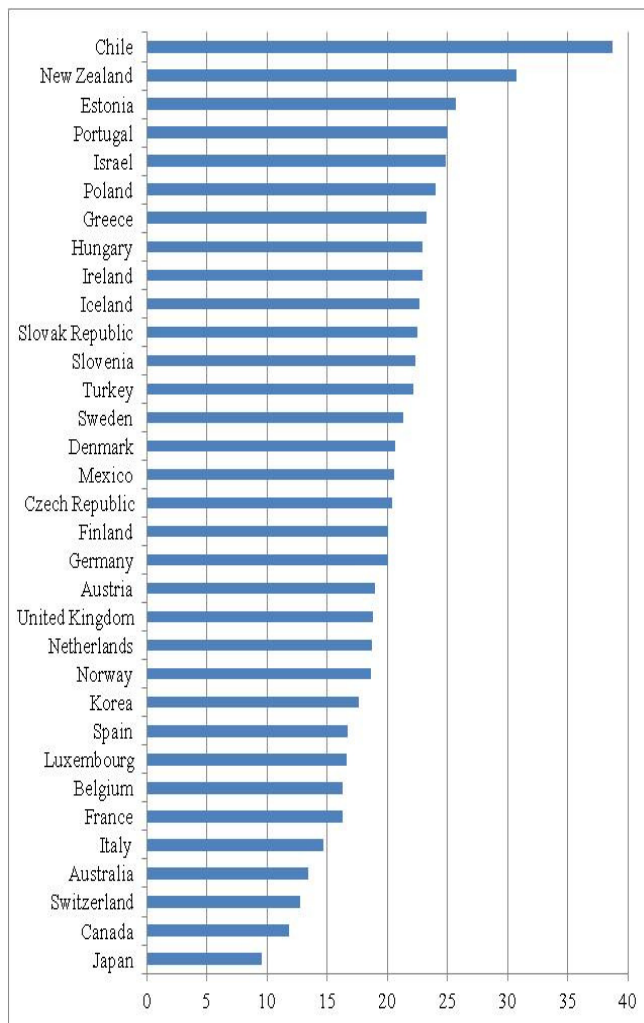


Fig. 5: VAT as percentage of total taxation in OECD countries, source: own processing [11]

V. COMPARISON OF SELECTED VAT INDICATORS

In the following correlation matrix, there are relation results of indicators VAT revenue ratio, VAT as percentage of GDP, VAT as percentage of total taxation, standard rate and threshold.

	VRR	VAT as % of GDP	VAT as % of total taxation	Standard rate	Threshold
VRR	1.0000				
VAT as % of GDP	0.2880	1.0000			
VAT as % of total taxation	0.1780	<b>0.5888</b>	1.0000		
Standard rate	-0.2608	<b>0.7965</b>	<b>0.4656</b>	1.0000	
Threshold	0.0518	-0.2194	-0.2071	-0.2690	1.0000

Table 2: Correlation matrix of selected indicators, source: own processing

A strong dependence between VAT as percentage of GDP and the standard rate was demonstrated.

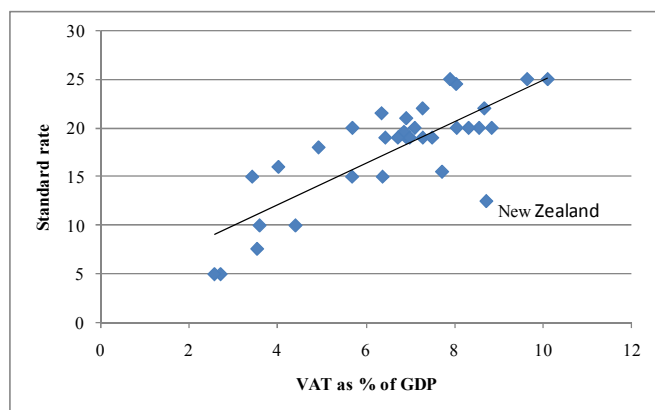


Fig. 6: Correlation between VAT as percentage of GDP and standard rate Source: own processing

New Zealand represents an exception there because it has a relatively low tax rate (of 12.5 %, and since 2010 has been increased to 15 %), while the share of VAT as percentage of GDP is the fourth highest. This can be explained by the fact that there are no reduced tax rates and few exceptions are applied, so the figure of VRR is 0.99, which is the highest of all the countries, as shown in figure 6.

The share of VAT as percentage of GDP is less than 5 % only in 8 countries (Japan, Canada, Mexico, Switzerland, Australia, Spain, Korea and Turkey). In these countries, the standard rate is lower (in case of Turkey 0.3 % higher) than the average in OECD countries.

Moderately strong correlation was found between VAT as percentage of GDP and the standard rate as shown in the following Figure 7.

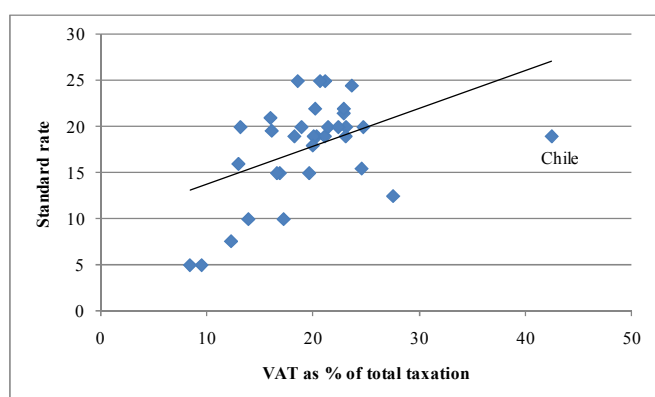


Figure 7: Correlation between VAT as percentage of total taxation and standard rate, source: own processing

Countries, in which VAT represents a higher percentage of the total tax revenues, are mostly applying a higher standard tax rate. Chile is the exception, because VAT makes a contribution 42.5% of total revenue in comparison with other countries, which is the amount above-standard. The standard tax rate in Chile moves only slightly above the OECD average, but the reduced tax rate is not applied there.

The lower value of the VRR can be affected by lower tax morale.

Correlation between VAT as percentage of GDP and VAT as percentage of total taxation is also statistically significant as shown in the Figure 8.

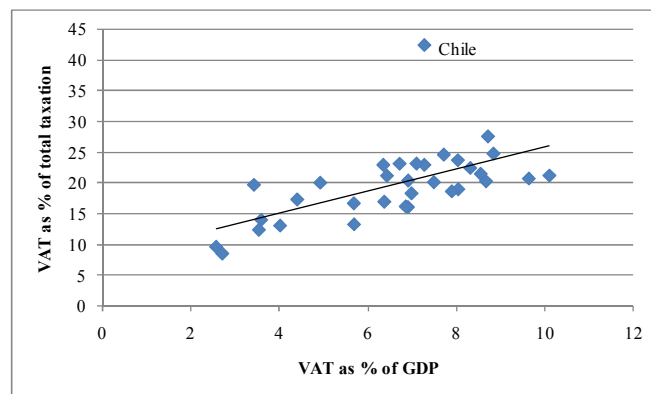


Figure 8: Correlation between VAT as percentage of total taxation and VAT as percentage of GDP, source: own processing

The exception stands for Chile again, because of the high proportion of VAT on tax revenues, as it is already mentioned above. Indirect taxes are generally higher in countries where direct taxes cannot provide sufficient income, whether it is caused by the low income of population, or bad tax compliance. Calculation of tax quota, and thus the VAT share in GDP, is influenced by many factors, not only from the view of terms of tax revenues, but also in terms of the actual quantification of GDP.

On the contrary, a weak correlation was found for all parameters in relation to the VAT revenue ratio. The level of the standard rate exhibits a weak negative correlation towards VAT Revenue Ratio. It is clear from the data that the countries with comparable standard rates can have very different VRR. Weak correlations were also found in relation to the threshold for the mandatory registration, which can be explained by the fact that the threshold affects more administrative costs than tax revenues.

## VI. CONCLUSION

Approaches, leading to the determination of the tax mix, focus mainly on mutual ratio of direct and indirect taxes. In some countries there is a widespread belief that higher taxes on consumption should be preferred and this will enable lower taxes of incomes. Referring to the value added tax, its participation in tax revenues increases in most countries since it has been introduced, and the average in OECD countries was 19.74 % in 2010.

Comparative analysis showed that the performance of the VAT in OECD countries has a low dependence on all investigated factors. Generally it can be said, that the performance of VAT depends on five main factors, which are the structural features of the tax (i.e. rates, exemptions, rules and thresholds), the evolution of consumption patterns, place of taxation (in international trade), a capacity of tax administration which enables tax administrations to be

effective, and the rate of tax compliance by taxpayers. The interaction between these factors is crucial. For example, a high standard rate may encourage evasion while multiple lower rates often lead to misclassifications and create high compliance and administrative burdens. Reasonably high registration or collection thresholds may ease the burden on tax administrations by allowing them to concentrate on the larger taxpayers. Exemption by sectors of activity may create distortions and incentives for evasion, which require additional administrative capacities. Inefficient tax administration, and burdensome administrative requirements and complex VAT mechanisms may also reduce the degree of compliance of taxpayers.

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