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PRESS RELEASES

New VAT rates proposed for the European union

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On January 18, 2018, the European Commission proposed new rules to provide more flexibility to Member States in setting VAT rates.

The current EU VAT system was established in 1993, after all routine fiscal and customs controls at internal EU borders had been abolished. However, common VAT rules then adopted at the EU level have become outdated and too restrictive over time. Therefore, the EU adopted an *Action Plan on VAT towards a single EU VAT area* in April 2016, to make the system better, simpler, more flexible, fraud-resistant and business-friendly. The proposed VAT rate system, presented by the Commission on January 18, 2018, is a further step towards that goal.

Over the last 25 years, the VAT rate system has become too rigid, allowing the application of reduced rates to only a limited number of products. Moreover, Member States consider VAT rates to be an important domestic economic policy instrument. By proposing the new VAT rate definition rules, the Commission grants Member States more autonomy in this respect, while simplifying the current VAT rate system.

The new legislative proposal will be submitted to the European Parliament and the European Economic and Social Committee for consultation, and to the Council of the EU for adoption.

1 Current status

According to the basic legislation governing the common VAT system, i.e. the Council Directive on the common system of value added tax, each Member State applies:

- a standard rate for the supply of most goods and services which may not be less than 15%; and
- no more than two reduced rates for specified supplies of goods and services, which may not be less than 5%.

The Directive provides the list of goods and services to which the reduced rates may be applied. Some Member States may, in certain cases, derogate from the VAT rules, i.e. they may apply additionally reduced rates. This means that the common rules do not equally apply to all Member States (there are over 250 reduced rates and exemptions allowed), which grants certain countries more flexibility in setting their VAT rates compared to other Member states. This has led to unevenness and inconsistency in the EU VAT system.

2 The manner of VAT rate determination in the future

The newly proposed rules provide an equal level of flexibility to the Member States in setting VAT rates. In addition to a standard rate of at least 15%, Member States would now be able to introduce:

- two separate reduced rates of between 5% and the standard rate set by the Member State concerned;
- one exemption from VAT (or 'zero rate'); and
- one reduced rate set at between 0% and the reduced rates.

The current, complex list of goods and services, specified in the Directive, to which reduced rates can be applied, would be abolished an replaced by a new, 'negative list' of products, such as weapons, alcoholic beverages, gambling, tobacco products, etc., to which the chosen standard rate would **always** be applied. Another novelty is that the weighted average VAT rate may not be lower than 12%, in order to ensure sufficient revenues in the Member States' budgets and the EU budget[1]. Also, under the new regime, all rates different from the standard rate can continue to be applied.

3 The application of VAT rates in the EU vs. Croatia

Standard VAT rates range from 17% in Luxembourg to 27% in Hungary, whereas the majority of Member States use standard rates between 20 and 24%. Following Hungary, Croatia has the highest standard rate, together with Denmark and Sweden.

All Member States, except Denmark, apply reduced VAT rates. Most of them have two reduced rates ranging between 18% (Hungary) and 2.1% (France). Croatia applies reduced rates of 5% and 13% to twenty groups of goods and services, and they do not significantly deviate from the rates applicable in other Member States.

Table 1 VAT rates applied in the EU, 2017 (in %)
(According to standard rate)

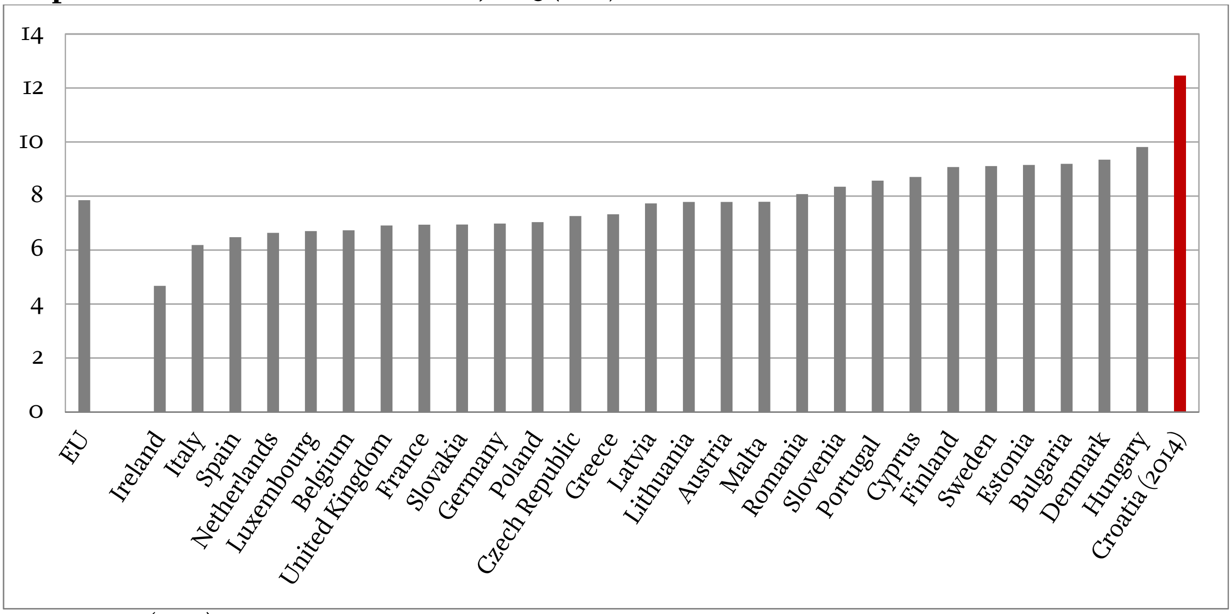
Member State	Standard rate	Reduced rates
Luxembourg	17	3; 8; 14
Malta	18	5; 7
Cyprus	19	5; 9
Germany	19	7
Romania	19	5; 9
Austria	20	10; 13
Bulgaria	20	9
Estonia	20	9
France	20	2,1; 5,5; 10
Slovakia	20	10
United	20	5
Belgium	21	6; 12
Czech	21	10; 15
Latvia	21	12
Lithuania	21	5; 9
Netherlands	21	6
Spain	21	4; 10
Italy	22	4; 5; 10
Slovenia	22	9,5
Ireland	23	4,8; 9; 13,5
Poland	23	5; 8
Portugal	23	6; 13
Finland	24	10; 14
Greece	24	6; 13
Denmark	25	-
Croatia	25	5; 13
Sweden	25	6; 12
Hungary	27	5; 18

Source: IBFD (2017)

[1] The Member States' VAT revenues are among the bases for the calculation of the amounts paid into the EU budget.

Croatia has one of the highest standard VAT rates in the EU. However, the revenues collected from VAT in, e.g., 2014 were as high as 12.5% of GDP, i.e. considerably above the 2015 EU average (7.8%), and the most of all EU Member States.

Graph 1 VAT revenue as a share of GDP, 2015 (in %)



Source: IMF (2017)

4 The importance of VAT in the EU vs. Croatia

VAT revenues (standing at 1 trillion euros in 2015) play a key role in Europe's single market. Regretfully, however, there is also a revenue loss, or the so-called 'VAT gap' (i.e. the difference between the expected and actually collected VAT revenues) which amounted to 151bn euros in 2015 or 12.7% of the VAT total tax liability[2]. Moreover, the EU loses 50bn euros each year due to cross-border tax fraud. These are substantial losses of funds which may otherwise be used for supporting economic growth, creating jobs, for schools and hospitals, etc. By introducing the new rules, the Commission intends to reform the VAT system and make it more flexible, while reducing revenue losses. Such policy is much more effective than introducing new or increasing current „more harmful" types of taxes, in order to offset VAT revenue losses. In fact, VAT is considered to be one of the least "harmful" forms of tax and particularly friendly to economic growth.

Croatian tax system is largely based on the 'economy-friendly' VAT which is the key budget revenue generator (in 2016, it accounted for HRK 45bn or 63% of state budget tax revenues). Hence, even a slight change in VAT rates results in huge revenue changes. Reducing the standard VAT rate will only be possible after a long-term and sustainable rationalisation of government expenditures had been achieved. Even then, however, it would perhaps be more recommendable to reduce "harmful" labour and capital taxes in order to stimulate economic growth and employment, while offsetting such reductions by the 'friendly' VAT. The flexibility in setting VAT rates, proposed by the European Commission, will certainly facilitate the adjustment of domestic VAT to economic priorities in Croatia.

[2] Interestingly, Croatia recorded the third lowest VAT gap in the EU in 2015 (3.9%) after Spain and Sweden.