

# Ten Reasons in Favour of a Uniform Rate of a Value Added Tax

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**Kesner-Škreb, Marina**

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# NEWSLETTER



Institute of Public Finance, HR-10000 Zagreb, Katančičeva 5 Croatia

P.O.Box 320, Phone: (385 1) 4819 363; Fax: 4819 365; e-mail: office@ijf.hr; www.ijf.hr

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**Marina Kesner-Škreb M.Sc.**

## Ten reasons in favour of a uniform rate of Value Added Tax

Almost two years have passed since the initial implementation of VAT (or PDV in Croatian). But not even after this amount of time have the polemics about this new form of taxation ceased; on the contrary, in recent times they have actually been stepped up. There have been many criticisms of the new tax; however, an analysis of them would tend to show that most of the complaints have referred to the implementation of a uniform rate of taxation. Some taxation experts, politicians, the media and the citizenry hold that the system of VAT with a single rate is regressive, i.e. it tends to hit the poor relatively hard, since they spend more of their income and save less. In order to palliate the regressive effect of VAT, what is almost always recommended is the introduction of a large number of rates (at least two), even the introduction of a zero rating for basic necessities. In addition, representatives of some branches of the economy (the tourist industry in particular) have been making themselves heard, claiming that their survival is threatened by the implementation of a single high rate of VAT, and seeking the introduction of a lower rate.

Behind these criticisms there are a number of key questions. Is a single rate VAT regressive? Should its regressive effect be corrected by the introduction of several rates? Does VAT really put the growth of certain branches of the economy at

risk? We shall attempt to give an answer to these questions in ten theses.

1. The question of what is regressive is hard to define unambiguously. It is questionable because it is not a matter of indifference as to which base one looks at – income or consumption, or to what period the observation relates. VAT covering most products and services, levied at a single rate, has by definition a proportional effect when it is measured according to consumption and a regressive effect when it is measured according to income. The reason for this is that savings as a part of income increase when income rises. Accordingly, when progressiveness is discussed, there should be some mention of what base it is observed in connection with, consumption or income.

The conception of regressiveness also changes when it is looked at over the long period. Then the burdening of income by VAT may become proportional. Consumption taxes (which include VAT), as their very name implies, put a burden on consumption and not savings. Since savings are deferred consumption, they are, when converted into consumption, subject to VAT. Thus the rich, though they save more, are in the end not exempt from VAT. They do pay it at the moment when they turn their savings into consumption. Thus, looking at it dynamically, not statically as when just the

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household budgets of the well-to-do and the poor are observed over the period of a single year, the concept of regressiveness changes essentially. When income is observed as lifetime income, then, assuming that the whole of the income is spent by the end of a lifetime, and that savings are not transferred to heirs, it is equivalent to consumption. And the proportion of VAT in income is proportional, because VAT burdens all expenses on consumption equally. Rich man and poor man are now equally burdened by VAT. If income is observed over the whole of a lifetime, then, and not just as annual income, the concept of regressiveness is questionable. In such conditions, VAT is a proportional burden on the income that an individual can earn over the whole of his life.

Irrespective of this relativisation of the concept of regressiveness, it nevertheless has to be admitted that the concept of the regressiveness is habitually linked with annual income, and it is then accurate to say that a single rate of VAT burdens the poor more. In their income, consumption forms a far greater part than it does in the income of the wealthy. As against this, in poorer members of the society, savings are regularly much smaller. However, proposals that this regressiveness be palliated by the introduction of a multi-rate VAT should be resisted. For a VAT system with several rates has a large number of drawbacks.

2. In Croatia, it is impossible precisely to define the extent of the regressiveness.

When VAT with a single rate of 22% was introduced to replace turnover tax with five rates in which the standard rate came to 26.5% (15% plus 10% retail sales service tax) there was certainly a shift in relative prices. What the final effect of such changes in relative prices on various categories of the population was is quite difficult to determine unambiguously. There is as yet no research of the distribution of income and of the tax burden in Croatia, and it is impossible to comprehend the regressive effects of VAT. Lack of information about the real size of VAT regressiveness makes it more difficult to make conclusions, and creates a fertile ground for the work of demagogues.

Apart from this, when there is discussion of the regressive effects of VAT, one should not forget that there are other forms of tax that also apply differently to the incomes of individuals. Unlike

VAT, some of these forms of tax, for example income tax or excise taxes, have progressive features, and they have to be taken into consideration when the effects of taxation on individual income groups of the population are considered. Also to be considered is the effect of “negative taxes”, i.e., subsidies (various forms of welfare) that are received by the poorest members of the population. Thus VAT should not be considered in isolation when discussing the impact of taxation on the population; rather, one should take into consideration all forms of taxation, including their negative components, i.e., all forms of welfare.

3. Empirical research about the regressiveness of VAT largely bears out the thesis that it cannot be used to reduce differences. In Ireland, for example, it has been ascertained that in absolute terms the rich spend twice as much on food as the poor, although the poor spend relatively more of their income than the rich on food. Accordingly, the zero rating of food in Ireland provides twice as much a tax break for the rich as it does for the poor. A Swedish study showed that the abolition of the zero rating for food would mostly benefit single people in the high income groups, because they usually buy more expensive food. In addition, the demand for books, newspapers and magazines is very income elastic. In other words, the rich buy more books and other forms of printed matter, and a cut in the rate for publications would make VAT still more regressive.

4. The introduction of several rates requires a detailed definition of taxable products. If vegetables are taxed at a reduced rate, does this mean that fresh, canned and frozen vegetables are taxed at a single rate or different rates? Should there be a same rate of VAT for lettuce and for artichokes? Nor are all kinds of lettuce the same, and it is then necessary to define whether there is a need to embark on a further distinction of products. The process of defining the products for different rates gets very complex and gives rise to further discussion, most often about borderline products that in their nature can be taxable in terms of two different rates. The definition of products requires a professional and intelligent tax administration capable of giving clear, convincing and well-supported explanations of its decisions in public discussions about rates that tend to become very heated. Thus the introduction of several rates complicates a tax administration and

makes it more expensive than a system with a single rate.

5. Unclear definition of products opens up the door to tax evasion. This relates to all products that are not unequivocally defined. Taxpayers will attempt to put them in lower rate categories. The use of several rates will open the door to corruption and lobbying, for many will wish to persuade the state to put their product in the lower rate category. Thus powerful lobbies will get into the VAT system.

6. Increasing the number of rates will lead to an increase in the administrative costs of collecting the tax. A state that uses several rates of VAT will have to have more civil servants for the processing of complex tax returns than a state with a single rate VAT. In addition, the costs of calculating and paying VAT in the companies will also rise. The well known taxation expert and long-term director of the Fiscal Department of the IMF, Vito Tanzi, said in 1993 that with a transition from one to two rates, the costs of VAT administration went up five times, and with a change to three rates, ten times. The increased costs of the tax administration and of the compliance costs of the corporate sector in the collection of VAT with multiple rates should certainly not be neglected in discussion of introducing a lower rate of VAT.

7. Lower VAT rates are no guarantee of lower prices. Lower rates of VAT in tourism, for drugs and food do not automatically mean a lowering of prices for these products. In a free market, prices are formed according to supply and demand. Traders set their prices according to the elasticity of demand, that is, according to what the market will bear, irrespective of the rate of taxation. Accordingly, a lower rate of VAT is no guarantee that the poor will pay lower prices, nor is a lower VAT in tourism a panacea for all the problems in this branch of the economy. It would be very nice indeed if all the problems in the Croatian tourist industry could be solved through the introduction of a lower rate of VAT.

8. Various rates of VAT distort consumer preferences. It is usually said that lower rates for food should be introduced because the poor spend more on food in their household budgets than the rich. But the rich spend also on milk, meat and oil. Why should such products be taxed at a lower rate, the rich thus being helped just like the poor? The introduction of lower taxes for food will indirectly subsidise the rich.

As against this, taxing luxury products at higher rates will discourage the poor from occasionally upgrading their consumption with the more expensive product. Do the poor have no right to buy luxury products? Is the purchase of luxury products considered the exclusive right of the rich, with enough money to pay high taxes on such products as well? Why introduce such discrimination into consumption? The poor can be helped much more effectively with the aid of direct transfers from the budget or by a progressive income tax. Total income formed in this way (earned income plus welfare payments) will help the poor, in a single rate VAT system, to adjust their consumption to their own preferences, and not to the rates of taxation.

9. Lower rates of VAT mean less revenue to the national budget. In such a situation, the state would very likely be forced to increase the standard rate of VAT in order to obtain revenue adequate for its own inelastic expenses. An increase in the standard rate would lead to a still greater wave of discontent, for it would be applied to the greatest number of products and services.

Apart from this, today about 50% of budgetary revenue is derived from VAT (Table 1), and a small shift in the rates would bring about great changes in the level of tax revenues. For this reason the Croatian Finance Ministry has to be extremely cautious when making any decision about the number and the amount of rates. Reducing the rates for some products would mean a reduction of taxation revenue or would lead to the standard rate being put up from 22% to some higher level, or would lead to an increase in other types of taxes, or would result in a serious reduction in budgetary expenditures.

10. The EU is tending towards a smaller number of rates of VAT. Many say that in the area surrounding the Croatian economy, mainly implying the EU, a system of VAT with several rates is employed. This is indeed true. Of the EU countries, only Denmark has a single rate system, and of OECD countries, only Japan and New Zealand have a single rate system (Table 2). But the EU is a community of fifteen states with different tax systems. Coordination of their tax systems is underway, and comprises a painful and long-term process in which each country feels that interference with its taxation system is an attack on its sovereignty. However, the EU recommends its members the reduction of numbers of rates of VAT

so that there are only two: a standard one of 15% and a reduced one, of not lower than 5%. The EU too, then, is tending towards a single rate, and the end result of this long lasting process is certain to be a single rate. This is possible to state with a great amount of certainty because contemporary taxation theory has on the whole unambiguously and unanimously opted for the adoption of single-rate VAT with a small number of exemptions and zero ratings and a broad tax base. EU countries introduced VAT in the sixties and seventies, when the attitude towards a single rate was not so explicit. Their aim was that the tax burden should be as similar as possible to that with the sales tax in order to facilitate acceptance of a completely new form of taxation of consumption, a form that until then had never been implemented. In Croatia a taxation system founded on the experience of EU countries should be retained, and VAT in its best form be continued, which certainly means a system with a single rate.

Convinced that the regressiveness of VAT can be palliated with the application of a number of rates, the transition countries, guided primarily by political motives, have largely introduced multi-rate VAT systems (Table 3). Unfortunately, they have not paid attention to foreign experience about the drawbacks of multi-rate systems, and they are now burdened with a number of problems, of the kind entailed by such systems on the countries that were the first to introduce VAT.

Finally, it should be said that the comparison of a tax in several different countries does not have a great deal of point. A correct approach would involve a comparison of the entire taxation system, and also of the welfare system.

### **Conclusion**

Although we are aware of the regressive effect of a single-rate VAT, at the same time we are

convinced that VAT should not be used to attain objectives that it cannot address in the most satisfactory manner. The aim of the tax is to gather revenue by taxing consumption, not to carry out measures of welfare or industrial policy. Its regressive effects must be corrected by other instruments of the fiscal system, such as direct transfers from the budget in the form of welfare aid to the poor, and progressive income tax and other forms of taxation. Economic theory and practice show that the application of target measures that are aimed at a clearly selected group of citizens is much more effective and cheaper for the budget than general, unselective measures that, intended to help just some, also assist those who do not need help. The introduction of several rates of VAT will not do away with its regressive effect, but will also obliquely subsidise the rich. A several-rate system is a clumsy way of palliating the regressive effects of a single-rate VAT system. The good features of a single-rate VAT, such as neutrality and collection efficiency should not be sacrificed to introduce a much more complicated form with several rates that will introduce new distortions in to the market and additionally exacerbate the problem of the optimal allocation of resources. The aim of reducing the overall tax burden, which came in 1997 to as high as 50% of GDP (expenditures of general government as a percentage of GDP) and which is still rising can be achieved by a change in other taxes: reduction of the standard rate of VAT from 22% to a lower rate or by reducing the contributions rate, which greatly increases the costs of labour. But a precondition for a permanent reduction in taxation pressure is a reduction in budgetary expenditure. This relates in particularly to the great, accumulated problems in the retirement pension and health-care insurance funds. Beginning to make reforms in these areas will have a crucial importance for a reduction in national expenditure, which will in turn allow a reduction in the tax burden.

**Table 1. BUDGETARY CENTRAL GOVERNMENT TAX REVENUE**

Current prices, 000 000 kuna

|                                    | 1994      | 1995      | 1996       | 1997       | 1998       |
|------------------------------------|-----------|-----------|------------|------------|------------|
| Tax revenue                        | 22.377,48 | 26.505,35 | 28.530,43  | 31.338,17  | 40.327,49  |
| Income tax                         | 3.211,61  | 3.497,59  | 4.216,93   | 4.102,23   | 4.915,10   |
| Profits tax                        | 591,59    | 1.009,07  | 1.271,18   | 1.785,26   | 2.461,15   |
| Real estate sales tax              | 117,67    | 141,76    | 171,78     | 242,70     | 270,92     |
| Tax on sales of goods and services | 14.920,74 | 17.762,70 | 18.895,16  | 20.538,00  | 27.968,26  |
| VAT                                | 0,00      | 0,00      | 0,00       | 0,00       | 20.228,23  |
| Turnover tax                       | 13.107,16 | 12.802,26 | 13.504,37  | 15.133,17  | 1.972,05   |
| Excise                             | 1.813,58  | 4.960,44  | 5.390,79   | 5.404,83   | 5.767,98   |
| International trade tax            | 3.486,77  | 3.922,48  | 3.942,44   | 4.639,99   | 4.256,33   |
| Other taxes                        | 49,11     | 171,76    | 32,94      | 29,99      | 455,74     |
| Structure of tax revenue           |           |           |            |            |            |
|                                    | 1994      | 1995      | 1996       | 1997       | 1998       |
| Tax revenue                        | 100,0     | 100,0     | 100,0      | 100,00     | 100,00     |
| Income tax                         | 14,4      | 13,2      | 14,8       | 13,09      | 12,19      |
| Profits tax                        | 2,6       | 3,8       | 4,5        | 5,70       | 6,10       |
| Real estate sales tax              | 0,5       | 0,5       | 0,6        | 0,77       | 0,67       |
| Tax on sales of goods and services | 66,7      | 67,0      | 66,2       | 65,54      | 69,35      |
| VAT                                | 0,0       | 0,0       | 0,0        | 0,0        | 50,16      |
| Turnover tax                       | 58,6      | 48,3      | 47,3       | 48,29      | 4,89       |
| Excise                             | 8,1       | 18,7      | 18,9       | 17,25      | 14,30      |
| International trade tax            | 15,6      | 14,8      | 13,8       | 14,81      | 10,55      |
| Other taxes                        | 0,2       | 0,6       | 0,1        | 0,10       | 1,13       |
| As percentage of GDP               |           |           |            |            |            |
|                                    | 1994      | 1995      | 1996       | 1997       | 1998       |
| Tax revenue                        | 25,6      | 26,9      | 26,4       | 25,5       | 29,7       |
| Income tax                         | 3,7       | 3,6       | 3,9        | 3,3        | 3,6        |
| Profits tax                        | 0,7       | 1,0       | 1,2        | 1,5        | 1,8        |
| Real estate sales tax              | 0,1       | 0,1       | 0,2        | 0,2        | 0,2        |
| Tax on sales of goods and services | 17,1      | 18,1      | 17,5       | 16,7       | 20,6       |
| VAT                                | 0,0       | 0,0       | 0,0        | 0,0        | 14,9       |
| Turnover tax                       | 15,0      | 13,0      | 12,5       | 12,3       | 1,5        |
| Excise                             | 2,1       | 5,0       | 5,0        | 4,4        | 4,3        |
| International trade tax            | 4,0       | 4,0       | 3,7        | 3,8        | 3,1        |
| Other taxes                        | 0,1       | 0,2       | 0,0        | 0,0        | 0,3        |
| GDP                                | 87.441,20 | 98.382,00 | 107.980,60 | 122.904,50 | 135.645,20 |

Source: Ministry of Finance, Republic of Croatia

**Table 2. Current VAT rates in OECD countries**

| Country                  | Reduced rate  | Standard | Higher rate |
|--------------------------|---------------|----------|-------------|
| Austria <sup>1</sup>     | 10:12         | 20       |             |
| Belgium                  | 0:1:6:12      | 21       |             |
| Canada                   | 0             | 7        |             |
| Denmark                  | -             | 25       |             |
| Finland                  | 0:6:12:17     | 22       |             |
| France                   | 2.1:5.5       | 20.6     |             |
| Germany                  | 7             | 15       |             |
| Greece <sup>2</sup>      | 4:8           | 18       |             |
| Iceland                  | 14            | 24.5     |             |
| Ireland                  | 0:2.5:10:12.5 | 21       |             |
| Italy                    | 4:10:16       | 19       |             |
| Japan <sup>3</sup>       | -             | 3        |             |
| Luxembourg               | 3:6:12        | 15       |             |
| Mexico                   | 0:10          | 15       |             |
| Holland                  | 6             | 17.5     |             |
| New Zealand <sup>4</sup> | -             | 12.5     |             |
| Norway                   | 0             | 23       |             |
| Portugal <sup>5</sup>    | 5:12          | 17       |             |
| Spain                    | 4:7           | 16       |             |
| Sweden                   | 6:12          | 25       |             |
| Switzerland              | 2             | 6.5      |             |
| Turkey                   | 1:8           | 15       | 23:40       |
| United                   | 0:2.5:8       | 17.5     |             |

Source: "Consumption Tax Trends", OECD, Paris, 1997.

- 1) A rate of 16% is applied in the Austrian tax enclaves Mittelberg and Junghollen
- 2) In some outlying parts of the country the taxation rate is reduced by 30%.
- 3) 3% up to March 1997; 5% from April 1, 1997
- 4) For long-term lease of commercial property, standard rate VAT is collected on 60% of the value of the property.
- 5) From July 1996 the reduced rate of 12% has been applied to restaurant services and for some food products (and from October 1 expanded to cover other food products).
- 6) Standard rate applied at a reduced value of some artworks, ancient and collectors' objects, which makes the effective rate 2.5%.

**Table 3. VAT rates in Central and Eastern Europe**

| Country   | Reduced rate | Standard rate |
|-----------|--------------|---------------|
| Bulgaria  | -            | 22            |
| Czech R.  | 5            | 22            |
| Estonia   | 0            | 18            |
| Hungary   | 0:12         | 25            |
| Latvia    | -            | 18            |
| Lithuania | -            | 18            |
| Poland    | 0:7:17       | 22            |
| Romania   | 0:9          | 18            |
| Slovakia  | 6            | 23            |
| Slovenia  | 8            | 19            |

Source: Cnosen, Siibren (1999) in Rose, "Reform for Countries in Transition to nomies", Lucius & Lucius, Stuttgart. For Slovenia: "Denar", vol .IX. 15.