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PRESS RELEASES

Croatia among the leaders in the level of VAT rates

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Along with its Economic and Fiscal Policy Guidelines for the 2014-2016 period, the Government on September 26 presented 37 reform measures to reduce budget deficit which include a proposal for an increase in the intermediate VAT rate.

One of the deficit control measures to become effective on January 1, 2014, which attracts great public attention, is raising the intermediate VAT rate from 10% to 13%. Accordingly, as early as three months from now, higher VAT rates should be applied to: edible oils and fats, white sugar, food for infants, water supply, catering and tourism services, some newspapers and magazines, tickets for concerts and cultural and artistic magazines.[1] While this three-percentage-points increase does not seem to be a big change, its implications are far-reaching: Croatian VAT rates are going to be among the highest in the EU; this will prompt additional unrest in the economy; and it will send a message of an unstable tax environment.

Now, let us first see how Croatia ranks against other EU member states with respect to VAT rates, particularly the proposed higher intermediate rate.

Table 1. *VAT rates in EU28, %*

MS	Standard rate	Intermediate rate	Reduced rate
Hungary	27	18	5
Croatia	**25**	**13***	**5**
Sweden	25	12	6
Demark	25	none	none
Finland	24	14	10
Romania	24	9	5
Greece	23	13	6.5
Portugal	23	13	6
Ireland	23	9 and 13.5	4.8
Poland	23	8	5
Slovenia	22	none	9.5
Belgium	21	12	6
Czech Republic	21	none	15
Italy	22	10	4
Latvia	21	none	12

[1] Article 38, paragraph (3) of the Value Added Tax Act (Croatian version: OG 73/13).

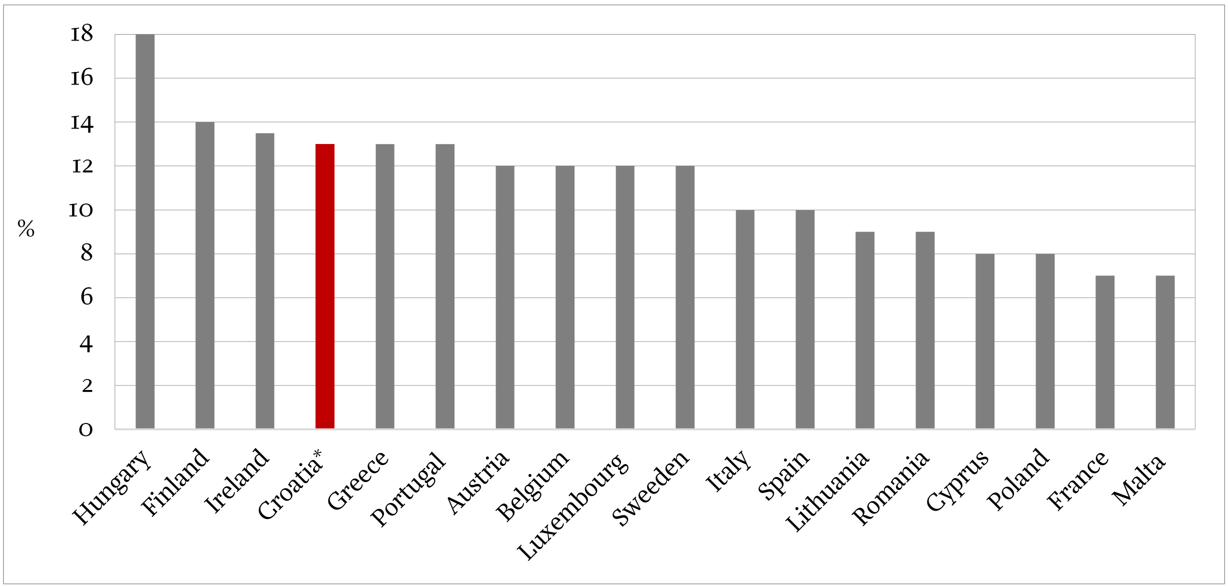
MS	Standard rate	Intermediate rate	Reduced rate
Lithuania	21	9	5
Netherlands	21	none	6
Spain	21	10	4
Austria	20	12	10
Bulgaria	20	none	9
Estonia	20	none	9
Slovakia	20	none	10
United Kingdom	20	none	5
France	19.6	5.5 and 7	2.1
Germany	19	none	7
Cyprus	18	8	5
Malta	18	7	5
Luxembourg	15	6 and 12	3
EU28 average	**21.5**	**10.4****	**6.7**

** Proposed rate.*
*** The calculation of the average included all intermediate rates.*
Source: International Bureau of Fiscal Documentation.

Even a brief look at the above table reveals the following: both the standard rate and the proposed intermediate rate in Croatia are higher than the EU28 averages (25% vs. 21.5% and 13% vs. 10.4% respectively), whereas the reduced rate (5%) is lower than the EU28 average rate (6.7%). Although a sizeable number of EU member states increased their standard VAT rates during the economic crisis, Croatia is at the very top in Europe with a standard VAT rate of 25% (equal to those in Sweden and Denmark). The only country with a higher rate (27%) is Hungary.

What is the situation on the application of intermediate rates in EU member states? A large number of the member states (eighteen of them) apply intermediate VAT rates, while the other ten countries do not, having only two rates (the standard rate and the reduced rate) instead. Denmark is an exception, with no reduced rates, but only one flat rate of VAT (25%) applied to all goods and services. Chart 1 shows that, after raising the intermediate rate to 13%, Croatia will again join the leaders in the EU, with the fourth highest intermediate rate, following Hungary (18%), Finland (14%) and Ireland (13.5%). Countries in the environment also apply lower intermediate rates: 12% (Austria) and 10% (Italy). Slovenia does not have any intermediate rates, but it only applies a reduced rate of 9.5%.

Chart 1. Intermediate VAT rates in the EU



** Proposed rate.*
Source: International Bureau of Fiscal Documentation.

The problem is not only that we will be among the EU leaders in the level of VAT rates, but also that the Croatian VAT rates are so frequently changed. Let us only recall how the application of intermediate rates has evolved. The rate was first introduced in 2006, when it was only applied to accommodation and food services in hotels (the former rate of 22% was cut to 10%). As early as 2007, however, its application was extended to news papers and magazines. During the following five years, the rate remained unchanged, but from March 1, 2012 to date, pursuant to three amendments to the VAT Act, the scope of the rate was continuously expanded. Consequently, the number of goods and services taxed at an intermediate rate rose from only one in 2006 to ten in 2013, with another change expected in 2014 – the said increase in the intermediate rate from 10% to 13%.

Table 2. *The application of the 10% intermediate VAT rate in Croatia*

Effective date	Goods and services covered by the 10% rate
January 1, 2006 (OG 90/05)	The rate was first applied to accommodation (and accommodation with meals) in hotels, including the related agency commission services
August 1, 2007 (OG 76/07)	Extended to include newspapers and magazines
March 1, 2012 (OG 22/12)	Further extended to: oils and fats food for infants water (except bottled water), and white sugar
January 1, 2013 (OG 22/12)	Further extended to: food preparation and serving of drinks in catering establishments
July 1, 2013 (OG 73/13)	Further extended to: tickets for concerts cultural and artistic magazines accommodation on board of nautical tourism vessels, and camp rental services Repealed on: agency commission services

Source: Value Added Tax Act, OG, various issues.

Even the late professor Hanžeković used to teach his public finance students that „an old" tax system was a good one, or, to put it more simply, that it was dangerous to change taxes frequently as this causes uncertainty in the business environment. And uncertainty is the enemy of investment. Indeed, there is hardly a foreign investor who would be interested in doing business in a country in which the government imposes new VAT rates only a few months after a brand new VAT law was enacted in July 2013. How can business entities plan their future operations and investments if taxes (in this case, VAT) change so frequently? What they must do now is to rearrange their balance sheets for 2014 and decide whether they will absorb the proposed increase in the intermediate VAT rate and reduce their profits, or simply increase their prices. Hence, it remains to be seen what will be the ultimate effect of the three percentage points increase in VAT on inflation in Croatia. In a market economy, this issue is determined by the supply and demand law and not by state administration.

It should be noted, however, that perhaps there is not much point in discussing the reduced VAT rates now that Croatia has joined the EU and that its intermediate rate depends on changes in the EU VAT system. The EU is currently reviewing its VAT system with a view to making it simpler and more efficient, with fewer exemptions and reduced rates.[2] In this context, the Commission advocates a restricted use of reduced rates and plans to make some proposals by the end of 2013, after consultations with the member states, regarding their future destiny. These proposals will also determine the application of reduced rates in Croatia as the 28th member state of the EU.

[2] For more information, see European Commission (2011). *Communication on the future of VAT. COM(2011) 851 final.*