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Consumption Taxation: Value Added Tax and Excise Taxes

In 2005, Croatia allocated almost half of its GDP for financing public needs. Such heavy public consumption requires the provision of sufficient revenues whose main sources are taxes. Tax burden in Croatia, including social contributions (40% of GDP in 2005) has not deviated significantly from the European average (39.6%), although it has been a few percentage points higher than those in other Central and Eastern European countries, except Slovenia.

For example, tax burdens in the USA and Japan are almost 13% below the EU level. Similarly, the citizens of other OECD countries which are not EU Member States also pay lower taxes. The tax burden is heavier in the old than in the new EU Member States.

There are three main groups of taxes: indirect taxes (VAT and excise taxes), direct taxes (income tax, profit tax and property tax) and compulsory social security contributions. Their shares in GDP are roughly equal across the EU, standing at about 13% per tax group. However, the tax structure in Croatia is rather different. In 2005, indirect taxes accounted for about 20% of GDP, primarily due to substantial revenues from VAT and excise taxes. The share of social contributions revenues approximated the European average (13.7%), whereas the revenues from income and profit taxes were relatively

low compared with the European average (6.1%). Economic theory generally supports the model based on a heavier reliance on consumption tax revenues, which is especially suitable for transition countries. Consumption taxation is considered to be simpler and more efficient and is less sensitive to inflationary effects. Therefore, the Croatian taxation model which is based on heavier taxation of consumption should not be changed. There is no ideal universal tax structure, but it depends on the local economic, political, social and historical environment, as well as on the needs for sufficient revenues to appropriately fund public expenditures.

I. Value Added Tax – the Most Abundant Source of Budget Revenue

Owing primarily to VAT and also excise taxes, the Croatian tax system is predominantly based on consumption taxation. This is the most abundant source of tax revenues covering the largest number of taxpayers. No wonder therefore that each, even the smallest change in the VAT system always attracts strong public attention.

The importance of VAT is best illustrated by the fact that it accounts for 60% of total tax revenues of the government budget and 14% of GDP.

The Institute of Public Finance deals with economic research and analysis related to various forms of public finances such as the budget, taxation and customs duties. Its orientation is thus to the various economic, legal and institutional topics that are important for the sound long-term economic development of the Republic of Croatia. So that the public should be able to have a better insight into certain issues, the Institute of Public Finance is launching its Newsletter, in which it will from time to time publish informed and independent analysis of economic questions. The views expressed in the articles published in the Newsletter will reflect the opinions of the authors, which do not necessarily coincide with those of the Institute as institution. Full text of Newsletter is also available on Institute's Web site: <http://www.ijf.hr/newsletter>.

VAT has undergone several changes, and further changes can be expected in future, particularly those related to EU adjustment. However, regardless of whether such changes are required within the current fiscal policy measures or by the EU, fiscal policy-makers must be extremely cautious in taking their decisions, as even small changes in the tax system can strongly impact on budget revenues.

1. General Characteristics of Value Added Tax

Neutrality and abundance of revenues are the main characteristics of VAT. Neutrality ensures optimum allocation of resources, and abundance is the result of a broad tax base, tax rate level and a limited number of exemptions. Despite the almost ten-year history of VAT, the number and level of VAT rates is still an unavoidable subject for debate and confrontation between fiscal experts, politicians and the public. Experts have recommended the implementation of a VAT which, in its ideal form, would involve a broad tax base, a small number of rates (ideally, a single rate) and exemptions, the application of a zero tax rate to exports only, and an optimum threshold for VAT registration in order to minimize taxation costs.

2. Value Added Tax in Croatia

The Croatian VAT, introduced in 1998 with a single tax rate, a broad tax base and a small number of standard exemptions was very close to the theoretical ideal of VAT.

Almost equally important was the high level of its harmonization with the EU recommendations. However, despite the well-argued opposition of experts, the Croatian VAT model increasingly deviated from its original form. Owing to strong pressures from interest groups accounted for by social reasons, and those coming from certain business sectors, e.g. tourism, and as a result of political (often election) promises, a zero rate and a reduced 10% rate were introduced. In the period 1999-2001, the list of products eligible for the zero rate (e.g. bread, milk, books, certain pharmaceuticals, medical aids, scientific magazines and public showing of films) was expanded. Since 2006, a new reduced 10% rate has been applied to certain tourist services. The last measure to this effect was the “Government’s contribution to reducing the cost of living and improving the living standards of Croatian citizens”, by cutting the VAT rate on newspapers and magazines from 22% to 10%. The beneficiaries of these tax cuts were newspaper publishers and the loser was the state budget, losing about 300 million kuna. However, the prices of newspapers remained unchanged.

Was it justified to disrupt the originally established VAT system? Tax experts still have different views about the number of necessary tax rates. Those in favour of a multiple-rate VAT system emphasize the advantages of multiple rates, whereas the supporters of a smaller number of rates try to prove the theoretical and practical groundlessness of a multiple-rate VAT system. Let us consider some of these views.

Arguments in favour of the multiple-rate system

The regressive nature of the single-rate system produces adverse social effects. Basic food products account for a much larger share in the income of low-income citizens, whose tax burden is much heavier than that of higher-income citizens.

In order to promote economic growth and boost competitiveness, **certain key business sectors** find it acceptable to apply **lower rates** to certain products or services.

The multiple-rate scheme is also applied in EU Member States, so why not implement it in the Croatian tax system, too?

Arguments in favour of the single-rate system

VAT does have certain regressivity features but regressivity should be corrected either by social transfers or by enhancing the effects of other progressive taxes.

Multiple rates distort the decisions of consumers and producers, thus violating the tax neutrality. Growing pressures from individual business sectors, as well as from social, development, demographic and similar policies open the door to corruption and lobbying, in order to obtain preferential tax treatment for certain products.

The EU tends to reduce the number of rates recommending a standard rate and a maximum of two reduced rates. Certain progress has been made towards reducing the number of tax rates since 1970s. Despite the numerous disagreements, particularly among the old EU Member States, the complex harmonisation process is still going on pending the establishment of a future “final system”.

Taxation costs do not solely depend on the number of rates, so this technical aspect should not influence the choice of the number of rates or tax policy. The implementation of multiple rates in itself will not have any significant effect on **tax evasion**.

Numerous research works have proved that the larger the number of rates the higher the taxation costs. A clear-cut definition of products subject to different tax rates, as well as the control of tax application and collection of revenues require more work from the tax administration. This also provides more opportunities for tax evasion.

Revenue losses arising from the introduction of reduced or zero rates could be alleviated by boosting consumption or increasing other taxes (e.g. excise taxes).

The introduction of lower VAT rates reduces budget revenues. Therefore, fiscal policy-makers should either clearly identify other sources of revenue to cover the losses or examine the options to reduce public spending.

Lower VAT rates do not necessarily mean lower prices or heavier consumption of lower-taxed goods.

Table 1. State Budget Revenues from VAT and Excise Taxes in Croatia (in billion kuna)

| State budget | 2002 | 2003 | 2004 | 2005 | 2006 | plan 2007 |
|--------------------|------|------|------|------|------|-----------|
| Total revenues | 69.7 | 76.7 | 80.5 | 85.7 | 95.2 | 103.5 |
| Total tax revenues | 42.8 | 45.3 | 47.1 | 50.7 | 58.5 | 62.3 |
| VAT | 26.0 | 28.1 | 29.9 | 32.2 | 34.9 | 37.6 |
| Excise taxes | 7.5 | 7.9 | 7.9 | 8.2 | 11.6 | 12.1 |

Source: Ministry of Finance of the RC.

VAT revenues have grown continuously, from 20.2 billion kuna in 1998 to 34.9 billion in 2006, exceeding the amount of total social contributions.

The importance of VAT is best illustrated by its share in total budget revenues, standing at about 37% in the last five years, and its even larger share in total tax revenues (almost 60%). VAT revenues accounted for about 14% of GDP in this period.

3. Value Added Tax in the EU

Compared with Croatia, the VAT revenues-to-GDP ratios are lower in EU countries (Table 3), standing at 8% on average. They range from 6% (in Italy, Spain and Luxembourg) to 10% or more (in Denmark and Bulgaria).

ia). The shares of VAT revenues in total tax revenues in these countries are also much lower than in Croatia.

The current EU VAT system prescribes the application of a minimum standard rate of 15% and a maximum of two reduced rates, which cannot be lower than 5%, to products and services as provided by an EU VAT Directive. As the Directive was only a framework for setting up national VAT schemes over the last three decades, the system has been continually undermined by numerous derogations. The Directive permitted certain exemptions for some old Member States at the time of its adoption, and for new Member States during their EU accession processes. These exemptions could be applied during specified transition periods. The exemptions usually included the application of lower tax rates

Table 2. VAT Revenue Structure in the State Budget (in %)

| Share | 2002 | 2003 | 2004 | 2005 | 2006 | plan 2007 |
|-----------------------|------|------|------|------|------|-----------|
| in total revenues | 37.3 | 37.7 | 37.1 | 37.6 | 36.7 | 36.3 |
| in total tax revenues | 60.6 | 62.1 | 63.3 | 59.2 | 61.4 | 60.2 |
| in GDP | 14.3 | 14.2 | 14.0 | 13.9 | 13.9 | |

Source: Ministry of Finance of the RC.

Table 3. Revenues from VAT and Excise Taxes as Percentages of GDP and Total Tax Revenues in EU Member States, 2005

| Country | VAT | | Excise Taxes | |
|----------------------------|-------------------|----------------------------|-------------------|----------------------------|
| | Percentage of GDP | Percentage of tax revenues | Percentage of GDP | Percentage of tax revenues |
| AUSTRIA | 7.9 | 18.8 | 2.8 | 6.6 |
| BELGIUM | 7.2 | 15.7 | 2.4 | 5.4 |
| BULGARIA | 12.4 | 34.5 | 5.0 | 13.8 |
| CYPRUS | 9.8 | 27.4 | 4.1 | 11.4 |
| CZECH REPUBLIC | 7.2 | 20.0 | 3.7 | 10.3 |
| DENMARK | 10.0 | 19.9 | 3.5 | 7.0 |
| ESTONIA | 8.8 | 28.3 | 3.8 | 12.2 |
| FINLAND | 7.4 | 24.5 | 3.8 | 8.6 |
| FRANCE | 7.4 | 16.7 | 2.4 | 5.4 |
| GREECE | 7.4 | 21.5 | 2.8 | 8.2 |
| IRELAND | 7.7 | 24.9 | 3.2 | 10.5 |
| ITALY | 6.0 | 14.8 | 2.3 | 5.6 |
| LATVIA | 7.9 | 26.8 | 3.7 | 12.4 |
| LITHUANIA | 7.2 | 25.0 | 3.0 | 10.3 |
| LUXEMBOURG | 5.9 | 15.5 | 4.3 | 11.4 |
| MALTA | 8.2 | 23.3 | 3.2 | 9.2 |
| HUNGARY | 8.4 | 21.9 | 3.2 | 8.4 |
| NETHERLANDS | 7.3 | 19.1 | 2.5 | 6.6 |
| GERMANY | 6.2 | 16.1 | 2.9 | 7.5 |
| POLAND | 7.7 | 22.6 | 4.2 | 12.3 |
| PORTUGAL* | 8.1 | 23.6 | 3.2 | 9.3 |
| ROMANIA | 8.1 | 29.0 | 3.3 | 11.8 |
| SLOVAKIA | 8.0 | 27.3 | 3.7 | 12.7 |
| SLOVENIA | 9.0 | 22.1 | 3.5 | 8.6 |
| SPAIN | 6.3 | 17.8 | 2.4 | 6.6 |
| SWEDEN | 9.3 | 18.2 | 3.1 | 6.1 |
| UK | 6.8 | 18.4 | 3.2 | 8.7 |
| NORWAY | 8.0 | 18.2 | 1.4 | 3.3 |
| EU-27 (arithmetic average) | 8.0 | 21.8 | 3.3 | 9.1 |
| CROATIA | 13.9 | 35.1** | 3.5 | 8.9** |

* Data for 2004.

** Of total tax revenues of the consolidated general government.

Source: Eurostat and Ministry of Finance of the RC.

(e.g. a zero rate, a specially reduced rate or a parking rate) than those provided for by the Directive, derogations in the application of a reduced rate and, in some cases, a combination of these two types of exemptions.

Some countries also used the opportunity to apply reduced rates to labour-intensive services.

In this way, the system has been continually distorted and complicated by introducing numerous derogations from the general model. This resulted in huge differences, in both the number and level of rates, among business sectors, both at the national level and the internal market level.

VAT rates (Table 4) differ sharply from country to country, particularly as concerns the old and new Member States. The standard rate ranges from 15% in Cyprus and Luxembourg to 25% in Denmark and Sweden. In addition to reduced rates between 5% and 17%, a super reduced rate between 2.1% and 4.5% is applied. In spite of some theoretical arguments pointing to unquestionable advantages of implementing as **few as possible rates**, or, ideally a single rate, there is currently no single-rate VAT system in any EU Member states whatsoever. The only country applying a uniform VAT rate was Slovakia, but, after the almost three-year implementation of the single-rate system, this country also introduced a reduced 10% rate on pharmaceuticals and medical aids.

While the number of rates dropped sharply in most EU countries over the last twenty years, especially in France and Italy which halved the number of rates (from 8 to 4), there are still many countries applying more than two reduced rates on top of the standard rate. A leading country in the number of VAT rates is Ireland, applying a standard rate (21%), two reduced rates (4.4% and 13.5%), a parking rate (13.5%) and a zero rate (on certain foodstuff, books and medical aids for disabled persons).

About one-third of consumption in the EU is taxed at one of reduced rates (9% on average) and the remaining two thirds are subject to a standard rate (19% on average). Compared with 2000, some progress has been made towards expanding the coverage of standard VAT rates. However, the stated average value has also been influenced by EU enlargement, where new Member States are not permitted to apply reduced rates, or are only permitted to apply them during a transition period (until 2012).

However, **zero rates** still represent the most serious problem. While being intended only for exports, zero rate is applied to domestic deliveries of goods and services in as many as 12 EU Member States (Table 4). This benefit is mainly used (for an indefinite period of time “pending the introduction of a final VAT system”) by old Member States, which applied zero rates at the time of adopting the Directive. For new Member States, zero rate is only permitted during a specified transition period.

Table 4. VAT Rates in the EU

| | Standard rate | Reduced rate | Super reduced rate | Parking rate | Zero rate |
|-------------|---------------|--------------|--------------------|--------------|-----------|
| AUSTRIA | 20 | 10 | | 12 | |
| BELGIUM | 21 | 6 | | 12 | yes |
| BULGARIA | 20 | 7 | | | |
| CYPRUS | 15 | 5/8 | | | yes |
| CZECH REP. | 19 | 5 | | | yes |
| DENMARK | 25 | 7 | | | yes |
| ESTONIA | 18 | 5 | | | yes |
| FINLAND | 22 | 8/17 | | | yes |
| FRANCE | 19.6 | 5.5 | 2.1 | | |
| GREECE | 19 | 9 | 4.5 | | |
| IRELAND | 21 | 13.5 | 4.8 | 13.5 | yes |
| ITALY | 20 | 10 | 4 | | yes |
| LATVIA | 18 | 5 | | | |
| LITHUANIA | 18 | 5/9 | | | |
| LUXEMBOURG | 15 | 6 | 3 | 12 | |
| MALTA | 18 | 5 | | | yes |
| HUNGARY | 20 | 5 | | | |
| NETHERLANDS | 19 | 6 | | | |
| GERMANY | 19 | 7 | | | |
| POLAND | 22 | 7 | 3 | | yes |
| PORTUGAL | 21 | 5/12 | | 12 | |
| ROMANIA | 19 | 9 | | | |
| SLOVAKIA | 19 | 10 | | | |
| SLOVENIA | 20 | 8.5 | | | |
| SPAIN | 16 | 7 | 4 | | |
| SWEDEN | 25 | 6/12 | | | yes |
| UK | 17.5 | 5 | | | yes |
| CROATIA | 22 | 10 | | | yes |

Source: European Commission, 2007.

Study on the Impact of Reduced VAT Rate Application in the EU

The EU VAT system is far from its theoretical perfect form, as shown by the efforts of the European Commission to carefully review the reduced rates that have been gradually included into the system. A comprehensive survey conducted by the Copenhagen Economics Institute and published at end-July 2007, examined the impact of the application of reduced rates on income distribution, unofficial economy and taxation costs, both in terms of the national economies of Member States and the entire internal market.

The survey was based on two key questions:

How intensively must VAT rates be unified in order to promote economic efficiency and the functioning of the common market? And

What were the economic effects of broadening the scope of reduced rates (e.g. on employment growth or reducing tax inequality)?

The survey confirmed the well-known theory of the unquestionable advantages of uniform rates as instruments for enhancing economic efficiency and reducing taxation costs, as well as removing the obstacles to successful functioning of the internal market.

It was, however, recognized, that there were also those who disapproved of this rule, and considered as acceptable the application of reduced rates in certain business sectors (e. g. to some locally supplied services) or in certain Member States with specific economic structures. A successful application of reduced VAT rates consists primarily in minimizing budget revenue losses, which requires a careful choice of a financial model to ensure a budget balance.

Despite the complex and politically delicate situation with reduced rates, it is necessary to simplify and rationalize both the levels and the scope of reduced VAT rates. However, solutions must be sought that will fully support the basic principles of the internal market functioning, taking account of the national interests of each Member State concerning such a delicate matter as fiscal sovereignty.

Given that Croatia is in the process of integration into the EU, it is necessary to determine what has to be adjusted or changed in order to comply with EU conditions and criteria. The harmonization rules do not mean the alignment of tax rates and procedures but, above all, the harmonization and minimization of differences in the tax systems of the Member States, with the view to promoting the efficient functioning of the single internal market.

Despite the high level of harmonization of the Croatian VAT system with that of the EU, certain arrangements still deviate from the recommendations provided in the Directive. The Croatia's 2006 Progress Report made by the European Commission clearly points to discrepancies, the most delicate among them for Croatia being the discrepancies in the level and number of rates, scope of exemptions, level of the threshold for VAT registration and restrictions on tax refund to foreign businesses. The socially and politically most difficult issue will certainly be the application of the **zero rate** on domestic de-

liveries. All products subject to zero VAT rate pursuant to the Croatian law can be taxed at a reduced rate according to the EU legislation. The abolition of the zero rate will be inevitable, and this can be done according to two scenarios, depending on the negotiation results: 1) the abolition of the zero rate and moving to a reduced rate in the pre-accession period; and 2) the prolonged application of the zero rate during a specified transition period, which has been permitted to some countries of the last accession wave.

Changes are also called for in the implementation of **tax exemptions**. The Croatian system is based on an 'institutional model', i.e. tax exemptions are granted to specific institutions. However, the European Commission recommends the so-called functional model providing exemptions for certain goods and services.

A less demanding issue for both negotiations and implementation will be the harmonization of the threshold for VAT registration in Croatia with that in the European Union (5,000 euros), as well as the issue of restrictions on VAT refund to foreign entrepreneurs. The level of threshold under the Croatian legislation (85,000 kuna or about 11,600 euros) is higher than in the EU, but it does not exceed the amount permitted to all Member States pursuant to their accession agreements.

The restrictions on tax refund to foreign businesses is an issue whose resolving is also in the interest of Croatian taxpayers who are currently unable to obtain tax refund abroad for lack of reciprocity. For both of these issues, the tax administration has more room for manoeuvre in proposing better solutions that will be in the interest of the Croatian tax policy.

II. Excise Taxes

Excise taxes are applied in almost all modern tax systems and they usually comprise taxes on energy products, alcoholic beverages and tobacco products. However, some countries impose excise taxes on a much larger number of products (up to twenty), e.g. ice-cream, TV sets, video equipment, household appliances, matches, lighters, salmon, sugar, tea, cosmetic products, light

bulbs, insecticides, herbicides, playing cards, bananas, cacao, etc.). The advantages of excise taxes are a simple collection procedure, relatively small number of taxpayers (producers or importers), relatively low taxation costs, and, as the greatest advantage, abundant tax revenues. Owing to the increasing importance of social, medical and environmental reasons for excise taxes, these revenues have grown continuously.

Excise Taxes in Croatia

In Croatia, excise taxes are paid on tobacco products, alcoholic beverages, coffee, oil derivatives, beer, non-alcoholic beverages, cars, other motor vehicles, vessels and airplanes and luxury goods. The number of excise taxes in Croatia is much smaller than in most EU Member States. Despite the growth in revenues from these taxes, in nominal terms, (Table 1), their share in total government budget revenues and in GDP declined over the 2003-2005 period (Table 5) mainly owing to unofficial economy. In its fight against the unofficial economy, which is most prevalent in the sale of tobacco products, Croatia has implemented new revenue stamps since 2005, and intensified the Customs Administration's supervision of the production, imports and sales of cigarettes. The increase in excise taxes on tobacco products in mid-2004 failed to produce the expected effect in 2005, and it was not until 2006 that revenues went up. Due to a rise in the sales of new cars, excise tax on cars was the main generator of revenue growth in that year.

The main contributors to total excise tax revenues are oil derivatives and tobacco products. Unlike in the case of VAT, the shares of revenues from excise taxes in both GDP and total tax revenues of the consolidated general government are almost equal to those in EU countries (Table 3).

Excise Taxes in the EU

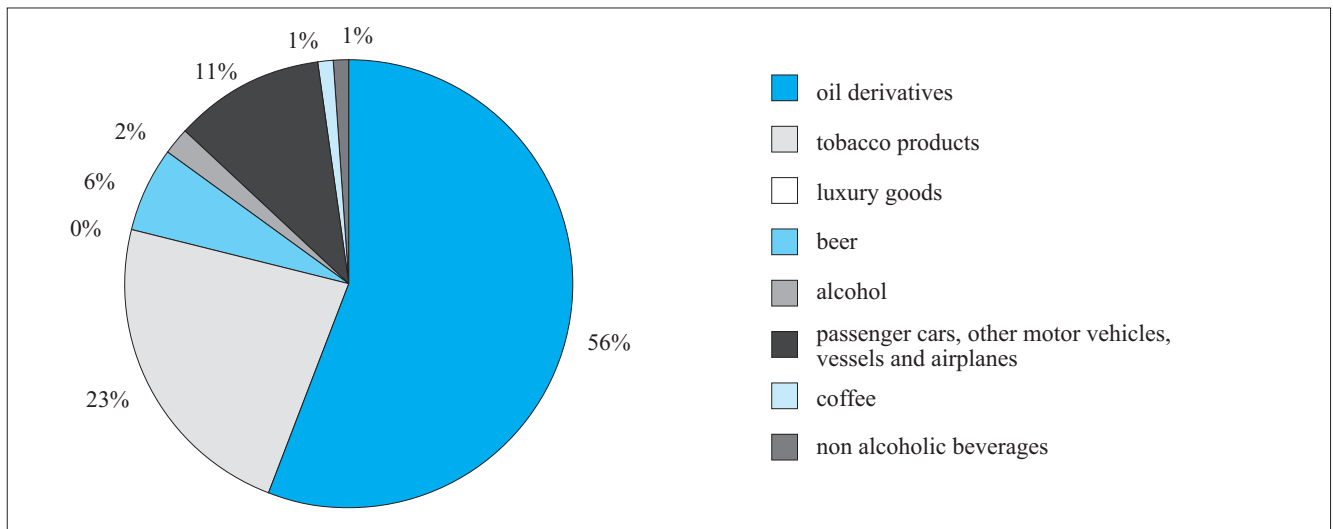
In the EU Member States, excise taxes are payable on a wide variety of products, but there are common regulations on the taxation of alcoholic beverages and beer,

Table 5. Excise Tax Revenues as a Percentage of the State Budget

| | 2002 | 2003 | 2004 | 2005 | 2006 | plan 2007 |
|-----------------------------|------|------|------|------|------|-----------|
| Share in total revenues | 10.7 | 10.5 | 9.9 | 9.5 | 12.1 | 11.7 |
| Share in total tax revenues | 17.5 | 17.3 | 16.8 | 16.1 | 19.8 | 19.4 |
| Share in GDP | 4.1 | 4.0 | 3.7 | 3.6 | 4.6 | |

Source: Statistical Survey of the Ministry of Finance of the RC.

Graph 1. Excise tax revenues in 2006



Source: Statistical Survey of the Ministry of Finance of the RC.

tobacco products and mineral oils, and, since 2004, on the taxation of energy products (natural gas, coke and electricity).

Apart from the basic Directive 92/12/EEC on the harmonization of excise tax systems, there are special directives for each group of taxable products defining the excise tax structure (taxable products, tax bases, exemptions and transition periods), as well as directives determining tax rates.

According to the general principle, goods manufactured in the country or imported from another country or from a non-EU territory are taxed at the rates applicable in this country.

The directives also determine minimum rates and possible relief and exemptions necessary due to economic differences between and priorities of individual countries. This results in sharp differences in tax rates and tax structures among Member States. Huge differences in rates lead to tax fraud, smuggling and cross-border trading in cheaper, lower-taxed goods with neighbouring countries. Late in 2004, a system of a closer co-operation between the customs and tax collection services was established, and special co-operation offices were set up with a view to exchanging data on taxpayers and their business turnovers through an IT-system.

Besides the considerable differences in tax rates, there are still discrepancies in tax structures (relating to the scope of taxation, definition of taxable products and tax bases, tax collection methods, tax exemptions and relief and tax payment deadlines). Therefore, great efforts are being made in order to minimize these differences.

As excise taxation is not only a fiscal policy issue, the EU has been increasingly focused on the implementation of a common environmental, health-care, agricultural and traffic policies. Whereas the health-care and environmental policies support higher excise taxes, the agricultural and traffic policy-makers favour a more flexible system, which requires a close examination of the level of rates and their increase as it might adversely affect the competitive ability and sales of taxable goods on the common market.

However, a consensus has been reached on the introduction of a more efficient taxation system capable of addressing the problems of tax fraud, illicit trade and smuggling.

EU Compliance of Croatian Excise Tax Regulations

The Croatian excise tax system is only partly harmonized with EU legislation. Consequently, major adjustments will be necessary regarding the tax base and structure, as well as the definition of most products subject to excise tax. Special effort will have to be made to adjust the level of rates, most of them being considerably lower than the EU-prescribed minimum rates.

The oil derivatives taxation scheme needs largest adjustments including the adjustment of the scope of taxable products, which has to be enhanced to include other energy products subject to tax in the EU, harmonization of taxation criteria for certain products, etc. The possible introduction of new excise taxes on coal, natural gas and electricity is a matter of foremost public concern in Croatia.

Table 6. Minimum EU Rates of Excise Tax on Energy Products

| Energy product | Used as motor fuel | Industrial and commercial use | Heating – for business purposes | Heating – for non-business purposes |
|--------------------------------------|--------------------|-------------------------------|---------------------------------|-------------------------------------|
| gasoline (EUR/1000 l) | 421 | | | |
| lead-free gasoline (EUR/1000 l) | 359 | | | |
| diesel (EUR/1000 l) | 302 | 21 | 21 | 21 |
| aviation gasoline (EUR/1000 l) | 302 | 21 | 0 | 0 |
| liquefied petroleum gas (EUR/1000 l) | 125 | 41 | 0 | 0 |
| natural gas (EUR/gigajoule) | 2.6 | 0.3 | 0.15 | 0.3 |
| coal and coke (EUR/gigajoule) | | | 0.15 | 0.3 |
| electricity (EUR/MWH) | | | 0.5 | 1.0 |

Source: Eurostat 2007.

The EU implements a wide variety of excise tax rates, exemptions and derogations. Denmark and Sweden have the highest excise taxes on energy products. Most new Member States have been permitted transition periods (not later than 2012) to harmonise their energy product taxation arrangements with those in the EU, so the same can be expected for Croatia as well.

The organisation and operations of the Customs Service will also need certain changes in terms of staff and professional competencies in order to join the EU system and to become part of the IT- network of EU customs and tax services.

Like the EU, Croatia is also faced with the problems of tax fraud and tax revenue loss. Tax fraud, smuggling and illicit trade are most prevalent in the sales of tobacco products and alcoholic beverages.

III. Conclusions and Recommendations

Tax burden should not be increased. The tax burden is heavy in Croatia, and what should be considered is the possibility of its lowering, which can only be achieved by reducing excessive public spending. Under the current circumstances, there is no real possibility to reduce certain taxes.

The main tax policy objective is to ensure **as simple, efficient and equitable as possible collection of tax revenues** necessary to cover public expenses. Tax policy should not be used as an instrument for implementing the social, economic or development policy measures.

The tax system and tax policy should be stable. Frequent changes, mostly in the form of ad hoc measures, impact negatively on taxpayers' economic decision-making. The tax collection and control procedures are

becoming more complicated, thus leading to a more expensive but less efficient tax system.

The EU accession requires great effort. Especially important are the professional skills and competencies of the negotiation team which will also have to protect the national interests while complying with the EU requirements. Each country's tax system is the result of its tradition, experience and economic and political environments, but also of the balance of power among various interest groups.

Certain changes are still inevitable. Despite the high level of compliance with EU recommendations, the Croatian VAT system still needs considerable changes. **The most delicate and controversial issue will be the abolition of the zero VAT rate.** Fiscal policy-makers are required to closely examine the economic and social effects of this measure, e.g. the change in the amount of revenues, potential price growth and the impact on the standards of living. The zero rate abolition effects will further depend on the choice between the following two options: 1) the replacement of the zero rate by a reduced rate; and 2) return to the single-rate tax system. It is beyond dispute that the zero rate abolition must be carefully reviewed and prepared step by step, and the time of the abolition will depend on the progress of negotiations.

Changes are also likely in the excise tax system, the most challenging among them being the harmonization of the rate levels. It is necessary to consider a gradual raising of certain rates (e.g. on tobacco products or some oil derivatives), which was done in Hungary where excise tax on alcohol gradually rose over several years prior to the EU accession. This could help avoiding the one-off effect of a price boom.

The introduction of excise tax on energy products is expected to be the most delicate measure whose implementation is likely to be either postponed until EU membership, or an attempt will be made to obtain a transition period, which was the case in some countries of the last accession wave. In such a way Croatia could gradually prepare itself for a higher tax burden.

A better and more effective control and functioning of the tax and customs services and their inclusion in the European system for the supervision of the sales of

goods subject to excise tax should provide for reducing the tax revenue losses arising from illegal activities. For Croatia, this would certainly represent a positive move towards improving budget revenues.

However, despite the potential growth in budget revenues as a result of raising certain excise taxes, it is necessary to examine the justifiability of imposing tax on non-alcoholic beverages and non-alcoholic beer, as well as the excise tax rate on beer, which is considerably above the EU level.

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