

Impact Of Value Added Tax On Tourism

Renata Dombrovski, University of Rijeka, Croatia
Sabina Hodžić, University of Rijeka, Croatia

ABSTRACT

The Republic of Croatia is currently carrying out preparatory measures for accession to the European Union. One of them is the harmonization of value added tax (VAT) with the requirements of Directive 2006/112/EC. Strong taxation affects tourism negatively. Hoteliers in Croatia set aside large funds for facility investments, which include partly high VAT rate of 23%, in order to achieve the market standards. Tourists face higher bid prices which puts the country in an unenviable position among Mediterranean competitors. It is important to find an optimal solution within the VAT system to encourage tourism development. Budget funds collected from tourism need to be refunded to the tourism industry.

Keywords: value added tax (VAT), tax rates, tourism, competitiveness, Republic of Croatia

INTRODUCTION

Quick development of tourism affected higher taxation of that industry. Tourism is sensitive to taxes, but it cannot be exempt from them since it is a significant source of revenue for the budget. Value added tax (VAT) most strongly affects the tourist competitiveness of the country. In Republic of Croatia it is paid at the standard rate of 23%, zero rate and reduced rate of 10% for certain goods and services. EU Directive prescribes that the standard rate in member states may not be lower than 15% and that there may be up to two reduced rates for products and services which may not be lower than 5%. After its accession to EU, Republic of Croatia shall cancel the zero rate of VAT. The state considers the cancellation of zero rate with maintaining or even increasing of general rate of 23% as an excellent way of filling the budget. On the other hand, high rates of taxes are disastrous for realization of competitiveness and wanted revenue from tourism. Decisions on the level of tax rates should be the result of implemented research of their impact on tourism and the budget. After an optimal solution is found, frequent changes should not be done because even a smallest correction of tax rate significantly affects the decrease of demand of tourist services.

ELEMENTS OF VALUE ADDED TAX IN REPUBLIC OF CROATIA

Elements of value added tax in Republic of Croatia have been determined pursuant to the Law on Value added Tax and Rulebook on Value Added Tax. Value added tax is abundant revenue for state budget. The entrepreneur that delivers goods or renders services pays value added tax. The entrepreneurs that had not had taxable deliveries over 85.000.00 HRK in the previous calendar year are exempt from this obligation. The value added tax is paid according to the location where goods were delivered or services rendered, in which domestic market is considered as one location where goods are delivered or services rendered. Fee for delivered goods or rendered services, except VAT, represents the tax basis. Value added tax in Republic of Croatia is paid at a standard rate of 23% for majority of goods in all phases of turnover, at 0% rate and at 10% rate for some goods and services. The law prescribes some tax exemptions: at domestic market, at export and import. The tax payer is obligated to issue an invoice for delivered goods or rendered services on which the value added tax must be clearly and separately stated. The expressed value added tax is a precondition for deduction of pre-tax. The invoice for delivered goods and rendered services which are exempt from payment of value added tax should clearly state that the value added tax is not calculated. The tax payer calculates the tax according to its invoices or collected fees.

VALUE ADDED TAX RATES IN REPUBLIC OF CROATIA

The regulations on value added tax in Republic of Croatia have been largely amended since its introduction on 1 January 1998. The element of that tax which most significantly affects tourism is its rates at which the traffic of goods and services is calculated and paid. Republic of Croatia first introduced a single rate of 22% and 0% for export of goods. On 1 November 1999 the 0% rate was introduced for bread, milk, books, medicines and orthopaedic aids. On 1 January 2001 the manner in which the tax on services of accommodation of foreign tourists was calculated was changed. Instead of 22% rate, 0% rate was introduced for organized stay paid from abroad by bank transfers and relating to services of bed and breakfast, half board or full board in all types of commercial tourist objects, commission for agency services, tours, coach transfers and vessel transfers. The zero rate tax was possible to apply only when the organizer charged those services directly to foreign agencies and other foreign legal entities. Domestic and foreign guests were not in equal position because the services rendered to domestic guests were taxed at 22%. Zero rate for organized stay of foreign tourists was cancelled on 31 December 2005. Since 1 January 2006 all services of accommodation rendered to foreign or domestic guests, directly or through tourist agencies are taxed at 10%. Introduction of that rate resulted in dissatisfaction of tourist workers because higher rate of VAT corresponded to higher prices, lower competitiveness and lower revenue from tourism. VAT rate of 22% was raised to 23% on 1 August 2008, by which the state planned to collect additional amount in the budget.

Value added tax in Republic of Croatia is today paid at the rate of 0% on the following:¹ all types of bread; all types of milk (cow's, sheep's, goat's) which is marketed under the same name in liquid state, fresh, pasteurized, homogenized (except butter milk, yoghurt, kefir, chocolate milk and other dairy products) and food for infants serving as complete replacement for mother's milk in line with special regulations; books of expert, scientific, artistic, cultural and educational content, school books for pedagogical education for primary, secondary and university education, printed on paper or other media such as papyrus, leather, canvas or cloth, CD-ROM, video and audio cassettes and diskettes; medicines identified by the Decision on Determination of List of Medicines of Croatian Institute for Health Insurance; products that are surgically implanted in human body- implants, according to the List of Medicines that are Surgically Implanted in Human Body; other medical products for compensation of bodily disability or insufficiency from the Rulebook on Terms and Conditions for Realization of the Right to Orthopaedic and Other Aids of Croatian Institute for Health Insurance, except dentures when delivered by dental technicians and dentists from Article 11, paragraph 1 of the Law; scientific magazines and services of public projection of films.

Value added tax in Republic of Croatia is today paid at 10% on the following:² services of accommodation or bed and breakfast, half board and full board in all types of commercial objects and agency commission for stated services; newspapers and magazines printed on paper and issued daily and periodically, except those that mainly contain advertisements or have advertising purpose.

Value added tax for all other goods and services is paid at the rate of 23% on tax basis (fee).

Upon accession to European Union, Republic of Croatia shall cancel the zero VAT rate. In line with Directive 2006/112/EC standard rate in member states cannot be lower than 15%. There can be two reduced rates at the most, for products and services anticipated in the Directive and they may not be lower than 5%. Fiscal policy carriers must calculate the impact of the rate change to the budget revenue and to the citizens' standard of living. Cancellation of zero rate could be compensated by introduction of lower standard rate which is preferred from the aspect of the population, but not from the aspect of the state. The cancellation of zero rate with preservation of general rate of 23% or even a possible increase of that rate for several percents is regarded by the state as an opportunity for compensation of the deficit in the budget. The experts claim that the period of recession which has hit Croatia is a favourable time for cancellation of zero rate. The commercial sector shall find it hard to raise the prices in accordance with the raise of VAT in times when demand is low because they have found themselves in the situation to fight for survival on the market. The budget will grow but the cancellation of zero rate will negatively impact the standard of living.

¹ Narodne Novine, br.149/09

² Ibid.

IMPACT OF CHANGE OF RATE OF VALUE ADDED TAX ON ARRIVAL OF FOREIGN TOURISTS

According to the information from Central Bureau of Statistics of Republic of Croatia³, travel agencies organized trips for 2.083.956 foreign tourists in 2006. They realized 14.696.256 overnight stays. Tourists stayed for seven nights on average. The number of foreign tourists that came to Croatia through travel agencies in 2006 is at the level of 2005 while the number of overnight stays is by 2.2% down in relation to 2005. This is partly due to the increase of reduced VAT rate from 0% to 10% on 1 January 2006, to all accommodation services rendered to foreign or domestic guests, directly or through travel agencies. Higher prices that accompanied the increase of VAT rate led some tourists to competitive countries with lower VAT rates and also lower prices for the same services. Domestic tourist workers fight to reduce the VAT rates from 10% to 6% in order to be able to survive on the turbulent tourist market.

In 2007 travel agencies organized trips for 2.039.677 foreign tourists in Croatia and they realized 14.341.881 overnight stays. Tourists spent seven days on average in Croatia. The number of foreign tourists that came to Croatia through travel agencies in 2007 is by 2.1% lower than in 2006 while the number of overnight stays is by 2.4% lower than in 2006. This information points to the higher rate of decrease of overnight stays and arrivals of foreign tourists through travel agencies if compared with the previous year.

In 2008 travel agencies organized trips for 2.013.661 foreign tourists in Croatia and they realized 14.063.780 overnight stays. Tourists spent seven days on average in Croatia. The number of foreign tourists that came to Croatia through travel agencies in 2008 is by 1.3% lower than in 2007 while the number of overnight stays is by 1.9% lower than in 2007. The information shows that arrivals and overnight stays through travel agencies still have a falling trend.

In 2009 travel agencies organized trips for 1.738.901 foreign tourists in Croatia and they realized 11.606.178 overnight stays. Tourists spent seven days on average in Croatia. The number of foreign tourists that came to Croatia through travel agencies in 2009 is by 13.6% lower than in 2008 while the number of overnight stays is by 17.5% lower than in 2008. Besides the change of reduced VAT rate from 0% to 10% and very high standard VAT rate of 23%, recession was an additional factor that affected these figures. In times of crisis and saving offers are meticulously studied and even a small difference in price has great significance. Solutions should be looked for in VAT system in order to have effect on the prices and incite positive percents relating to arrivals and overnight stays of foreign tourists in Croatia. VAT is the most important but not the only source of the budget. An optimal way for filling the budget which should not be an obstacle for development of tourism and life of citizens should be found. With one of the highest rates of value added tax, Republic of Croatia may realize short - term expected revenue. However, if necessary introduction of competitive rates will not be carefully contemplated, a long - term fall of demand will occur. It will be followed by a drop of tourists' expenditure and insufficient money in the budget. On the contrary, lower rates shall enable decrease of prices, higher demand with higher expenditure and filling of the budget. Well contemplated decisions regarding the VAT system are the key for development of tourism and collection of necessary financial assets. It is very important to direct the collected budget funds correctly and to use them properly.

Below is the SWOT analysis that shows the impact of VAT on tourism.

³CROSTAT, Central Bureau of Statistics of Republic of Croatia, First release, No. 4.4.4./2, Zagreb, 2007.-2010.

Table: Croatia Tourism VAT SWOT

<p>Strengths</p> <ul style="list-style-type: none"> - realization of higher revenue for state budget due to the increase of the standard rate from 22% to 23% and from increase of the reduced VAT rate from 0% to 10% (for services of accommodation or bed and breakfast, half board or full board in all types of commercial tourist objects) 	<p>Weaknesses</p> <ul style="list-style-type: none"> - negative impact of high VAT rate of 23% calculated for most goods and services on standard of citizens (particularly the poorest ones) - reduced competitiveness of tourism due to increase of reduced VAT rate from 0% to 10% - small number of tax benefits and allowances
<p>Opportunities</p> <ul style="list-style-type: none"> - introduction of more tax benefits and exemptions in VAT system, primarily for food and other mass consumption products - granting benefits in VAT system for investments in hotel facilities - higher employment opportunities, seasonal work in tourism - possibility to deduct VAT as pre-tax calculated in output invoices for rendered tourist services - introduction of privileged rates in line with Directive 2008/8/EC 	<p>Threats</p> <ul style="list-style-type: none"> - neighbouring countries with lower VAT rate - decrease of competitiveness of tourist services, fall of demand and loss of revenue from tourism due to high VAT rates in Republic of Croatia - lower input cost of material and services of hotel enterprises in competitive countries - significant increase of prices within the tourist sector in the heart of tourist season - increase of prices of tourist products caused by weakening of the currency in tourist season

Source: Authors

Strengths, weaknesses, opportunities and threats for tourism of Republic of Croatia under the impact of VAT rates in force were analysed. An optimal solution that would satisfy both the state and the population and incite competitiveness should be found.

COMPARISON OF VALUE ADDED TAX RATES

According to the provisions of Directive 2006/112/EC, the standard rate in European Union countries may not be lower than 15%. States may implement either one or two reduced rates for products and services anticipated by the Directive and they may not be lower than 5%. The decision on the level of standard VAT rate and implementation of one or two reduced rates and percentage of those rates is passed by the member state. Besides the reduced and standard rates, in some EU countries super reduced rates, parking rate and zero rate are applied. Super reduced rates are rates that are lower than 5%, parking rates are lower than 15% and higher than 5%. These are certain deviations from the provisions of Directive that certain countries agreed during their accession processes.

Information from the table show the trend of standard rates of value added tax in EU countries from 15% in Cyprus and Luxembourg to the highest 25% in Denmark, Hungary and Sweden. The average standard rate of VAT within 27 member states is approximately 20% (19.96). For Republic of Croatia with its high standard rate of VAT of 23% it is very difficult to win in the competitive tourist environment.

Reduced rate within EU mainly relates to food products (except alcoholic drinks), water supply, supply of firewood, electricity and ground gas, pharmaceutical products, some medical aids, medical devices for disabled persons, public transport of persons, books, newspapers and magazines, tickets for cultural events, tickets for amusement parks, services of cable televisions, writer's fees and composer's fees, some services of social building of housing complexes, agricultural goods, hotel accommodation, tickets for sports events, use of sports facilities, funeral services, medical and dental services, waste disposal and street cleaning. Hungary applies two reduced rates. One is 18%, which is also the highest reduced rate in EU, the other is 5%, which is the lowest reduced rate within the member states. Denmark is the only EU member state that does not apply a reduced rate. If lowest reduced rates are considered, the average one is 7.48%. Value added tax in Republic of Croatia is paid at reduced rate of 10% for accommodation or bed and breakfast, half board and full board in all types of commercial tourist objects. From 1 January 2001 to 31 December 2005 zero rate was applied for the services of accommodation of foreign tourists. This brought domestic guests into an unfavourable position. The rate of 10% actually equalizes the status of domestic and foreign guest but puts Republic of Croatia into an awkward position when compared with Mediterranean competitors with a lower rate of that tax.

Table 1: List Of VAT Rates Applied In Croatia And In EU-27 As Of 1st January 2010

States	Code	Zero rate	Super Reduced Rate	Reduced Rate	Standard Rate	Parking Rate
Croatia	HR	+	-	10	23	-
Belgium	BE	+	-	6 / 12	21	12
Bulgaria	BG	-	-	7	20	-
Czech Republic	CZ	-	-	10	20	-
Denmark	DK	+	-	-	25	-
Germany	DE	-	-	7	19	-
Estonia	EE	-	-	9	20	-
Greece	EL	-	4,5	9	19	-
Spain	ES	-	4	7	16	-
France	FR	-	2,1	5,5	19,6	-
Ireland	IE	+	4,8	13,5	21	13,5
Italy	IT	+	4	10	20	-
Cyprus	CY	+	-	5 / 8	15	-
Latvia	LV	-	-	10	21	-
Lithuania	LT	-	-	5 / 9	21	-
Luxembourg	LU	-	3	6 / 12	15	12
Hungary	HU	-	-	5 / 18	25	-
Malta	MT	+	-	5	18	-
Netherlands	NL	-	-	6	19	-
Austria	AT	-	-	10	20	12
Poland	PL	+	3	7	22	-
Portugal	PT	-	-	5 / 12	20	12
Romania	RO	-	-	9	19	-
Slovenia	SI	-	-	8,5	20	-
Slovakia	SK	-	-	10	19	-
Finland	FI	+	-	8 / 12	22	-
Sweden	SE	+	-	6 / 12	25	-
United Kingdom	UK	+	-	5	17,5	-

Source: According to

http://ec.europa.eu/taxation_customs/resources/documents/taxation/vat/how_vat_works/rates/vat_rates_en.pdf

Out of 27 EU members, seven countries apply super reduced rates for certain products and services which is 3.62% on average. The lowest super reduced rate of 2.1% is applied in France for certain pharmaceutical products, some books, newspapers and magazines and radio fees. The highest super reduced rate of 4.8% is in Ireland for certain food products. Republic of Croatia has not introduced the super reduced rate.

Five member states apply parking rate which is 12.3% on average. In Belgium, Luxembourg, Austria and Portugal it is 12% and only in Ireland it is 13.5%. Republic of Croatia does not apply parking rates.

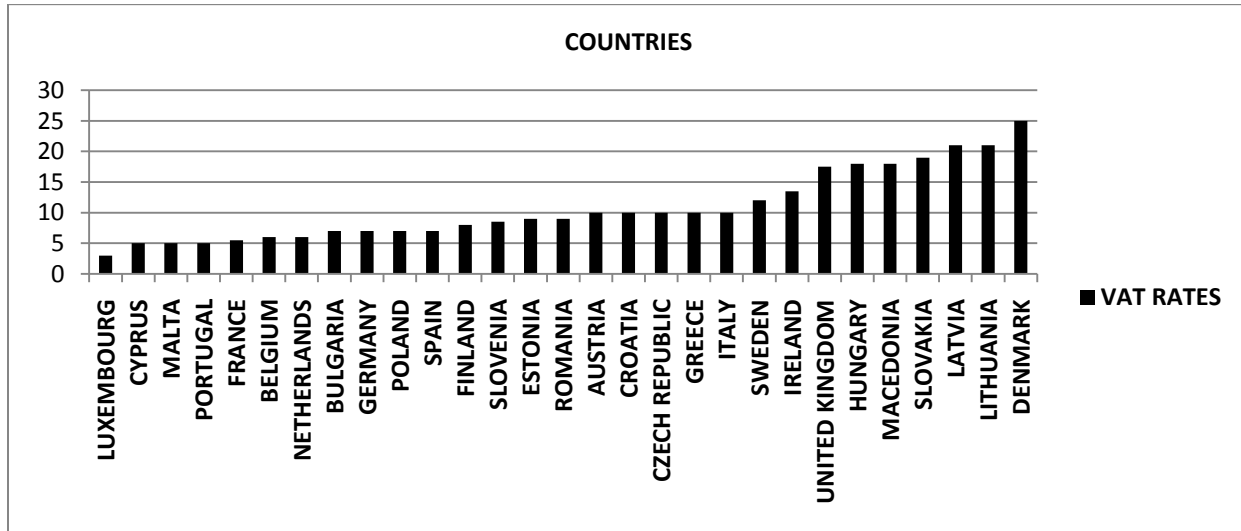
Application of zero rate enables stimulation. It means that tax payers may demand return of previously paid VAT expressed in the invoice. Recommendation of EU guidelines is for the zero rate to be cancelled, except for export. Despite that recommendation, ten countries kept the zero rate. Once Republic of Croatia becomes member of EU it will also have to cancel that rate.

VAT RATES FOR HOTELS AND RESTAURANTS

In line with Supplement III of Directive 2006/112/EC, member states may prescribe a reduced rate to restaurant and catering services, in which delivery of alcoholic and/or soft beverages may be excluded from that reduced rate. Republic of Croatia applies a reduced rate of 10% only for accommodation services or bed and breakfast, half board and full board in all types of commercial tourist objects. Restaurant and catering services rendered outside of the bed and breakfast, half board and full board are taxed with 23% rate. In this way the tax

payers are put in an unequal position together with the end users of those services. A reduced rate of 10% should be introduced to restaurant and catering services rendered outside the bed and breakfast, half board and full board and in this way the tax position of tax payers and end users would be equalized. Seventeen EU member states (Austria, Cyprus, Denmark, France, Greece, Ireland, Italy, Latvia, Lithuania, Luxembourg, Macedonia, Netherlands, Poland, Slovakia, Slovenia, Spain and United Kingdom) use equal tax rates for hotels and restaurants.

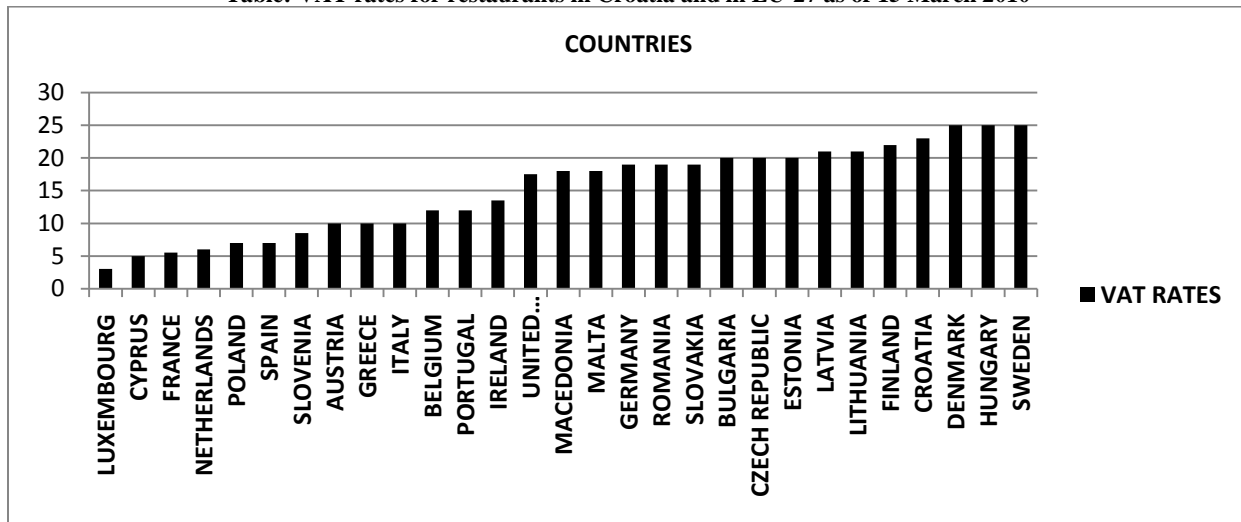
Table: VAT rates for hotels in Croatia and in EU-27 as of 15 March 2010



Source: According to: Hotels, Restaurants & Cafés in Europe, http://www.hotrec.org/files/view/1252-d-1209-496-dm-vat_table_as_of_january_2010_with_graphs.pdf

The table shows value added tax rates applied for hotels in Republic of Croatia and the European Union. It is interesting that only 5 countries (Denmark, Latvia, Lithuania, Slovakia, United Kingdom) out of 27 member states apply the standard instead of reduced rate for tourist accommodation. Luxembourg applies the lowest rate of 3%, while Denmark applies the highest rate of 25%. Republic of Croatia with 10% rate is somewhere in the middle of the list. Tourist sector is very sensitive to prices. Application of lower tax rates provides higher compatibility for the countries on the dynamic tourist market.

Table: VAT rates for restaurants in Croatia and in EU-27 as of 15 March 2010



Source: According to: Hotels, Restaurants & Cafés in Europe, http://www.hotrec.org/files/view/1252-d-1209-496-dm-vat_table_as_of_january_2010_with_graphs.pdf

The table shows the rates of value added tax applied for restaurants in Republic of Croatia and in European Union. Currently, 11 of 27 member states apply the reduced rate to restaurant services. The lowest rate of value added tax is applied in Luxembourg, the highest in Denmark, Hungary and Sweden. Luxembourg has introduced the super reduced rate of 3% applied to restaurants while Denmark, Hungary and Sweden do not have the reduced rate for restaurants but apply the standard rate of 25%. Republic of Croatia also does not have a reduced rate for restaurants but applies the high standard rate of 23% which reduces the competitiveness of the offer. The reduced rate of 10% is applied only within the service of bed and breakfast, half board and full board in all types of commercial objects.

COMPARISON OF IMPACT OF VAT RATES FOR HOTELS AND RESTAURANTS ON TOURISM

An important factor in selection of the tourist destination, beside the natural beauty and abundance of facilities is also the price of overnight stay and food. Tourists tend to choose a country with more convenient prices. Rate of value added tax affects the prices and subsequently also the competitiveness of each country. Below is the presentation of the impact of VAT to the level of the price for overnight stay and lunch in Republic in Croatia, Luxembourg and Denmark. For example, a selling price without VAT used for overnight stay in a single hotel room is 100 Euro and that of lunch in a restaurant without VAT is 10 Euro.

So the price of overnight stay in a single hotel room with VAT is then 103 Euro in **Luxembourg** and lunch costs 10.3 Euro. In **Denmark**, the overnight stay in a single hotel room with VAT costs 125 Euro, lunch is 12.5 Euro. In **Croatia**, overnight stay in a single hotel room is 110 Euro, lunch is 12.3 Euro, VAT included.

The calculations above point out that Luxembourg and Denmark according to their regulations apply the same rate of VAT for hotels and restaurants. Republic of Croatia applies 10% to accommodation services and 23% to restaurant services because the reduced rate is not applied in that case. Luxembourg introduced the super reduced rate of 3% for hotels and restaurants, while Denmark applies standard rate of 25% to both services. It is clearly seen that the VAT rate strongly affects the price of the service. Tourism is sensitive to taxation and the best idea would be to make it exempt from payment of VAT. Since that is impossible, solution should be looked for in application of reduced rates within the framework prescribed by the EU Directive. Luxembourg is most competitive with 3% rate for overnight stays and lunch. Price of overnight stay in Denmark is by 22 Euro higher than in Luxembourg due to the high tax rate of 25%. The price of lunch, taxed with the same rate is by 2.2 Euro higher. Overnight stay in Croatia is by 7 Euro higher than in Luxembourg due to the 10% rate. It is by 15 Euro lower than in Denmark. Cost of lunch in a restaurant in Croatia is by 2 Euro higher than in Luxembourg and only by 0.2 Euro lower than in Denmark.

Assuming that $E_{y,x} = -1.5$, where y is the quantity of demand for overnight stays in hotels and lunch in restaurant and x is rate of value added tax for the stated services, the elasticity coefficient value is interpreted:

Quantity of demand for overnight stays in a hotel and lunch in a restaurant in **Luxembourg** will fall by 4.5% if the VAT rate for those services is 3%, provided the other variables remain unchanged.

Quantity of demand for overnight stays in a hotel and lunch in a restaurant in **Denmark** will fall by 37.5% if the VAT rate for those services is 25%, provided the other variables remain unchanged.

Quantity of demand for overnight stays in a hotel in **Republic of Croatia** will fall by 15% if the VAT rate for those services is 10%, provided the other variables remain unchanged. Quantity of demand for services of lunch in a restaurant in Republic of Croatia will fall by 34.5 % if VAT rate for stated services is 23%, provided the other variables remain unchanged.

Tourism is sensitive to taxes. Product of elasticity coefficient and tax rate implies that a significant fall of demand occurs if a high tax rate is applied, i.e. there is a small fall of demand if the state introduces a lower VAT rate.

CONCLUSION

Tourism is very sensitive to prices, and also to taxes that affect the formation of prices. Value added tax has the strongest impact on tourism and prices. High rates of that tax disturb the competitiveness of a certain state that applies the taxes. Solutions should be sought in VAT system in forms of benefits, exemptions and lower tax rates for a wider range of products and services in line with EU Directive so that possibility for reduction of prices is created. Lower prices would result in higher demand, production, consumption and filling of budget. Such manner of filling of budget through already realized taxes from extended range of business would not be an obstacle to tourism. Well thought decisions in the VAT system are essential for survival of tourist and hotel industry on a turbulent market. It is very important to utilize the collected budget funds.

AUTHOR INFORMATION

Renata Dombrowski is currently working as a teaching assistant on tax and financial courses at the Faculty of Tourism and Hospitality Management in the Republic of Croatia. In 2007 I graduated among the ten percent most successful students of my generation and in 2010 I enrolled in the PhD programme entitled Business Economics in Tourism and Hospitality. My continuous research is based on developing innovative tax strategies for positive economic impact.

Sabina Hodžić was born on April 27th, 1984 in Rijeka. With excellent grades I applied to the Faculty of Tourism and Hospitality Management in Opatija, where I graduated among the top 10% of students. I remained at the Faculty where I started my first job as an Assistant at the Department for Finance. Right now I am PhD student at my Faculty and the area in which I would like to pursue further research is Taxes and Finance.

REFERENCES

1. Croatia Tourism Report, January 2010
2. CROSTAT, Central Bureau of Statistics of Republic of Croatia, First release, No. 4.4.4./2, Zagreb, 2007.-2010.
3. Cutvarić, M. et.al., *Porezi u praksi turističkih agencija*, Hrvatska zajednica računovođa i financijskih djelatnika; Udruga hrvatskih putničkih agencija, Zagreb, 2007.
4. Markota, Lj. et.al., *Porez na dodanu vrijednost (IV. izmijenjeno izdanje)*, RRiF Plus, Zagreb, 2010.
5. Mijatović, N., "Stope poreza na dodanu vrijednost u EU", RRiF, br. 4., Zagreb, 2009.
6. Mijatović, N., "Usklađivanje poreza pod okriljem EU", RRiF, br. 4., Zagreb, 2010.
7. Roller, D., *Fiskalni sustavi i oporezivanje poduzeća*, RRiF Plus, Zagreb, 2009.
8. VAT indicators, Taxation papers, European Commission, Brussels, WP 2/2004.
9. www.hotrec.org, Hotels, Restaurants & Cafés in Europe,
10. www.ibfd.org, International Bureau of Fiscal Documentation
11. www.nn.hr, Narodne Novine, Službeni list Republike Hrvatske