



Одјелjenje за макроекономску анализу – Одјелjenje за макроекономску анализу

## IMPLICATIONS OF INTRODUCING THE DIFFERENTIATED VAT RATE IN BOSNIA AND HERZEGOVINA

### SUMMARY

- 1. Introduction of differentiated VAT rates is a complex operation with a wide range of implications.** Besides the fiscal impacts, the analysis should include both microeconomic and macroeconomic effects, which will ultimately reflect on economic growth, social status of the citizens, and retrospectively, on the fiscal position of the country. The initiatives should be analysed both in terms of harmonization of VAT regulations in B&H with European directives and best practices, and in the context of reform and strategic objectives of the EU as well, bearing in mind that the time horizon for B&H to adjust the obligations of the *acquis* from the time of obtaining candidate status coincide with the period of implementation the new EU tax strategy until 2020.
- 2. Evolutionary time of the policy of VAT rates in the EU shows continuous activities of the European Commission and the Council with the ultimate goal of elimination of reduced VAT rates in Member States.** The appearance of distortions in the EU market with the loss of VAT revenues, which escalated after opening the EC single market (1992) and the process of expansion of the Community, endangered the achieved level of harmonization of VAT at the EC level. In order to achieve a higher degree of convergence in the field of VAT rates over the past twenty years at the EU level, the measures were adopted which include the following: abolishing the VAT zero rates, prescribing a maximum of two reduced rates, determining the minimum reduced rate of VAT in the amount 5%, prescribing the list of goods and services on which reduced rates could be applied, abolition of derogations or maximum rationalization of previously acquired privileges, with the introduction of time limits of duration of zero or reduced rates application.
- 3. Although the vast majority of member states in their tax systems still use differential VAT rates, usage of reduced and especially zero VAT rates is, in principle, limited because each year the scope of eligible goods and services increasingly narrows.** Except from Denmark, which has a single rate system, reduced rate is applicable in 11 Member States, two rates in 13 States, while two (Luxembourg and Ireland) States have three reduced rates. Zero rates are still applicable in the systems of 7 Member States. However, zero rates are applicable to strictly limited range of goods in four States, mainly to newspapers and periodicals, while only three States (Ireland, Malta and UK) apply zero rates on a wider range of goods / services from the approved list of goods / services. The mentioned three countries are islands, which reduces the mobility of goods, so the application of zero VAT rates have a

negligible distorting effect on the common market of the Union, as well as on the formation of the chain cross-border frauds.

4. **With the appearance of global economic crisis, rationalization of number, level and scope of reduced rates becomes the most important measure of anti-crisis national policies of the huge number of EU Member States.** Opting for the stronger taxing of consumption, in order to close or at least reduce fiscal deficits, 15 Member States have increased the reduced rates, abolished zero rates or narrowed the scope of goods to which those rates refer, while 13 Member States increased standard VAT rate. Given the planned increase of the rates in the following two years, the average standard rate in EU will increase from 19.5% in 2008 to 21% in 2013.
5. **The new VAT strategy, as an integral part of the new EU tax strategy until 2020, puts VAT policy in the function of two goals: (i) the short-term - fiscal consolidation and faster economic recovery, and (ii) long-term – economic growth and strengthening the competitiveness.** According to Commission estimates, Member States are able to collect only 55% of potential VAT revenue due to reduced rates and exemptions. The concept of an ideal VAT system, currently advocated by EU, OECD and IMF, is based on a single VAT rate, the wider tax base and minimum extent of exemptions. VAT system with these characteristics can provide the maximum possible tax neutrality and increase the efficiency of VAT collection without the increase of fiscal burden. Significant part of the informal economy would be included in regular flows through the widening of tax base and reducing the standard VAT base, because the “costs“ of tax evasion and black economy business would become higher than VAT liability. Finally, the lower single rates have weaker regressive influence on low income households than the one that current high standard VAT rates have on the costs of energy, utilities, communications and others that make up the bulk of the costs of most households.
6. **The implementation of the flat rate system in B&H is a logical continuation of the development trend of VAT systems in the world in the past two decades.** Based on the IMF recommendations and bad experiences of EC countries and other countries with “mature” VAT systems that use differential rates, the most countries in the world, who have introduced VAT in the past twenty years, chose flat VAT rate. After negative experiences with differential rates, in recent years several countries have announced the return to a flat rate (the Czech Republic from 2013, Switzerland from 2017), and some have carried out serious researches on the effects of the rate unification (Great Britain).
7. **The comparative analysis of the efficiency of VAT system in B&H and EU Member States indicates that the VAT system B&H is far more efficient.** The most important factor of the VAT system efficiency in B&H is precisely the existence of a single rate, which is of a moderate amount (currently only two EU Member States have lower standard VAT rate than in B&H), and which leaves less room for VAT frauds.
8. **Previous experiences of EU Member States and analysis of European Commission and IMF indicate that differentiated VAT rates produce a series of universal implications, which could also be expected in the case of B&H:**

- the existence of two or more VAT rates threatens the choice of consumers, and thus the choice of the manufacturer;
- manufacturers are always trying to adjust the price policy to the “threshold of consumer resistance”, and will strive to maximally transfer the costs of higher rate on consumers, which would nullify any reduction of prices on the items that are in the regime of lower rates;
- benefits from reduced rates will not only have low income households, but the high income households as well;
- preferential tax treatment is discriminatory for the producers of substitutes;
- more VAT rates makes room for tax frauds, mostly because of the problem of defining the goods and services which are in the preferential regime, regarding a wide range of products and “gray zones” which exist in such a product line, and also because of the increase of standard rate;
- higher VAT rate will not bring the expected revenue growth, while the administrative costs will significantly increase at the same time.

9. **Introducing the differential VAT rates in B&H will produce the following implications:**

- **fiscal,**
- **microeconomic,**
- **macroeconomic.**

*Fiscal implications*

10. **Fiscal implications include (i) loss of VAT revenues related to goods / services which are under preferential tax regime and (ii) increase in expenditures of the budget of B&H for the ITA, due to greater complexity of administration and control of the taxpayers.** In case of introducing zero or reduced rate of 5% or 8% on basic food, medicines, medical supplies and orthopaedic support devices, agricultural inputs, paper for the printing industry, books and newspapers various models for calculation of VAT revenue losses indicate the following range of VAT revenue losses:

	mil BAM		
	<b>0%</b>	<b>5%</b>	<b>8%</b>
<b>MIN</b>	548	387	290
<b>MAX</b>	1,348	852	714

The maximum amounts of losses relates to the situation of applying zero or reduced rate to all goods that were tax free or taxed at reduced rate in the sales tax system.

11. **If the same level of revenue is to be sustained after introducing the differential rates, standard rate should be increased on the all other goods and services.** Standard rate should also be increased for the amount of estimated revenue loss due to tax evasion. Level of the new standard rate in case of applying zero or reduced rates of 5% and 8% in B&H is estimated in the following ranges:

	<b>0%</b>	<b>5%</b>	<b>8%</b>
<b>MIN</b>	20.81%	19.68%	19.02%
<b>MAX</b>	30.91%	26.82%	24.36%

12. **Introducing the differentiated VAT rate in B&H is a complex technical operation which implies the existence of a dynamic elaborate plan for the implementation and timely insuring of legal, operational, IT, material-technical and financial assumptions.** According to the ITA estimates, it takes minimally two years to finalize all preparations. Furthermore, the ITA estimates that additional 110 employees in Tax sector and minimally 10 additional IT experts should be hired in the case of applying two rates, because of complexity of administration and control of VAT. In order to manage the project the maximum engagement of many institutions on B&H level and in entities is needed in the complex process of making the changes in VAT legislation.

#### *Microeconomic implications*

13. **Dealing with two VAT rates leads to the increased costs of obeying VAT regulations by taxpayers.** Those costs include the costs of adapting IT systems and records, the costs of continuous maintenance of data on products which also include the VAT rate, the additional costs of hiring accountants and other administrative staff who keep the records necessary for the calculation of VAT and filing of VAT return, the costs related to the additional communication with the ITA. Besides that, VAT taxpayers in B&H will have the additional costs of adapting fiscal systems and cash registers.
14. **Increasing the standard VAT rate, as an inevitable consequence of the introduction of reduced rate, worsens the position of small companies which are not in the VAT system.** Entities which are outside the VAT system and purchase their inputs from VAT taxpayers will be affected by higher costs of procurement, since they can not deduct input VAT from their purchases. The possibilities of shifting the higher costs of purchases at the consumer are limited, and it can be expected that a large number of small companies will be faced with the problem of sale of goods, which may further worsen their position in the market, threaten their survival and lead to the closure of shops and trades and losing jobs.
15. **Increasing the standard VAT rate can lead to the increase of the prices of services which are exempted in the VAT system (financial services, insurance and postal services).** The mentioned sectors procure their inputs from the VAT taxpayers and they can not deduct the most of the input VAT from the possible liability for the residual of the taxable turnover, so they transfer it on their clients through the higher prices, which will ultimately threaten the liquidity, increase financing expenses and reduce profit of the users of services.

#### *Macroeconomic implications*

16. **Increase in standard VAT rate will lead to the growth of the prices and fiscal burden of citizens and contraction in consumption and economic activities, which will postpone the coming out of the crisis and slowdown the expected dynamics of the economic growth in B&H.** Previous experiences of traders in the world, but also in B&H in similar situations when the tax rates have been changed, confirmed the existence of two models of the behaviour of traders:
- **increase in the VAT rate leads to a higher sales price increase than a mere level of rate increase**, as traders often use the opportunity to increase their profits under the cover of rate increase;
  - **reduction in the VAT rate often does not lead to a reduction in sales price by the amount of taxes abolished**, in a way that one part of reduction goes to the benefit of

consumers in the form of lower prices than it was before the rate cuts, and the other goes to the benefit of taxpayers in the form of higher margin. If it is a monopolistic good, local good or inelastic demand good, then the merchants can keep the same price regardless of the reduction or elimination of the VAT, because the buyers don't have other choice or the purchase of goods outside the place of residence is unprofitable in relation to the possible savings on VAT.

17. **Increase in standard VAT rate will lead to the growth in expenditures of public sector institutions.** The consequences will be felt by the social and health sector, because it can be assumed that the costs of other inputs such as energy, medical and other equipment, material costs and costs of services will exceed the positive effects of introducing a lower rate of VAT to certain food, medicines and medical supplies.
18. **At the macroeconomic level the rise in prices of financial services affects the overall price level.** The rise in prices of these services have an adverse impact on both small companies which are not in the VAT system, and on citizens, regarding the increase in lending rates and the costs that they have in transactions with banks. Increases in prices in the financial sector, postal and insurance sector have the negative impact on the financing of business activities and investment, employment and economic growth, while in the case of citizens, there is an adverse effect on private consumptions, which is already severely affected by the economic crisis, and whose growth is necessary to stimulate the economic growth. Finally, the public sector is also affected by cascading VAT, which regularly borrows from commercial banks in order to overcome the financial problems of adjustment of income inflows and expenditure outflows.
19. **The introduction of differentiated VAT rates will affect adversely the competitiveness of B&H and investments.** Administrative and tax complexity of B&H in that case would be further increased, which would have a negative impact on competitiveness indexes B&H, B&H attractiveness for investment and the perception of investors, creditors and the business community about the business environment in B&H.
20. **Inevitable increase of the standard rate of VAT will reduce the fiscal competitiveness of B&H,** regarding the use of all the benefits that moderate standard rate of VAT on excise and other goods have for the carriers of goods, the consumption of people in transit and touristic consumption.
21. **Analyses and studies have shown that the differentiated rates are the most ineffective way to provide help for poor households.** Studies of the EU, IMF and OECD have confirmed that the differentiated VAT rates can not significantly improve the social status of the population, and that the ultimate net effect of this measure, which also takes into account the budgetary effects of the tax administration, taxpayers and citizens, is negative. Furthermore, the reduction of VAT rates is a waste of limited budget resources, which can be used in much more efficient manner through use of transfers and subsidies targeted at the socially endangered categories of the population.

Banjaluka, August 22, 2011.

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