# Tax Competitiveness of Croatia and Slovenia as Tourist Destinations

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## Abstract

The increasing competition in the tourism sector forces tourist destination countries to search for ways to improve their competitiveness. One way is cutting non-cost element of prices such as taxes. The paper examines and analyses the most relevant types of taxes in the tourism sector and presents the corresponding tax rates for Croatia, Slovenia and their rivals in the Mediterranean region. The most significant tax on tourist consumption is value added tax (VAT), which is considered in great detail. Within a certain country different VAT rates apply to different goods and services consumed by tourists. The overall level of direct taxation of tourists' consumption is computed as the weighted average VAT rates for each European Mediterranean country and the results are compared. Businesses engaged in labor intensive hospitality industry face large share of labor costs and thus considerable payroll taxes. Since a part of taxes can be passed on to tourists through higher prices, we briefly present also overall tax rates on labor incomes and tax rates applied to business earnings.

Key words: tourism, taxation, value added tax, Mediterranean

## Introduction

International tourism is often in more favorable position regarding taxation than the commodity trade, which is subject to tariffs, quotas and generally higher taxes (Yarcan, 2007, p. 5). Nevertheless, due to relatively high importance of tourism sector for the Mediterranean countries and due to price sensitive demand for tourist services (see De Mello *et al.*, 2004, p. 517; Copenhagen Economics, 2007, p. 43), taxes can be an important tool of enhancing international price competitiveness. Namely, due to increasing living standard the importance of the tourism sector is rising in Europe and the rest of the world. Since living standard is rising faster in less developed European countries than in the old European Union (EU) member states, the demand for tourist services is expected to grow faster in the former (Leidner, 2007, p. 1–3). Croatia and Slovenia could gain prosperous developments from this trend. The traditional Mediterranean tourist destinations (Spain, France, Italy, Greece, and Turkey) are challenged by the emerging Mediterranean countries, especially Croatia, Tunisia, Egypt, Romania, and Morocco. Especially Egypt with its Mediterranean and Red Sea coastline has excellent price competitiveness and chartered flights directly from Europe (see Blanke and Chiesa, 2007, p. xx–xxiv). One of the measures that can help to improve other country's price competitiveness is cutting non-cost element of prices such as taxes. Contrary, high taxation lowers international price competitiveness of a tourist destination and can negatively affect tourist demand. The latter is likely to happen especially if neighboring countries improve their competitive position. That is argued by De Mello, Pack and Sinclair (2002), who have analyzed UK demand for tourism in the neighboring destinations, France, Spain and Portugal. During the period under consideration Spain and Portugal had a similar position as Croatia has today, experiencing a process of transition from "developing" to "developed" status (considering World Bank's classification). Their estimates of cross-price elasticities indicate substitutability of tourist services between the immediate neighbors. They also suggest that tourists could be more price-sensitive when they demand for tourist services in less developed tourist destinations but that is not necessarily the rule.

The paper examines and analyses most relevant types of taxes in the tourism sector and represents the corresponding tax rates in Croatia, Slovenia and their rivals in the Mediterranean region. The aim of the paper is to provide ranking of European Mediterranean countries due to tax burden directly levied on tourist consumption and estimate relative tax competitiveness of Croatia and Slovenia as tourist destinations.

## Tourism taxation

The main taxes affecting tourism sector can be classified into two groups. The first group consists of general taxes that apply not only to tourism but to different industries generally. The second group consists of specific taxes, which are related explicitly to the tourism industry. The majorities of taxes that affect the tourism industry fall into the first category and are not a source of discrimination among sectors and are thus justified (NTA, 2003, p. 4). In the following table we summarize the main general and specific taxes levied on tourism activities. There are also taxes, which are according to upper definition general but are levied on tourism activities at special rates (usually more favorable). These types of taxes are classified as a subgroup of general taxes.

The most significant tax on tourism activities is *value added tax* (VAT). The role of this type of tax is to capture revenue from the final consumption of certain goods and services in the home market what means that the VAT is designed to be borne by the end consumer. It is collected partly at every stage of production and distribution chain, since it would be technically infeasible to collect it from the end consumer. Nevertheless, the tax is after all at least partly passed on to consumer by its inclusion in the price charged for the goods or services at every stage. The fact that VAT is a tax on domestic consumption raises a question whether international tourists, who consume goods and services on the spot in foreign country, should be liable to pay VAT to this foreign country (NTA, 2003, p. 5). Considering

**Table 1:** *Main types of tourism (direct and indirect) taxes*

| **General taxes** | | **Specific taxes** |
|---|---|---|
| *Fall on residents and tourists; apply to tourism on the same basis as applies to other industries.* | | *Fall mainly on tourists; apply specifically to tourism industry.* |
| **Standard tax rates** | **Special tax rates for tourism activities** | |
| Standard VAT on goods and services | VAT on tour packages | International transport taxes (air travel taxes and duties, airports/seaports/road borders taxes) |
| Transportation taxes (fuel tax, car rental taxes and duties) | VAT on (hotel) accommodation | Visitor attractions taxes |
| Corporate income tax | VAT on services in restaurants and bars | Entry/exit taxes and permits (visa fees and arrival and departure taxes) |
| Labor income taxes (personal income tax, social security contributions, payroll taxes) | Other taxes (*e.g.* local taxes on consumption of drinks *etc.*) | Bed taxes / Lodging taxes (local) |
| Import duties | | Taxes on games of chance (*e.g.* gambling) |
| Land and property taxes | | |
| Other taxes | | |

*Note:*
*Similar classifications are provided by World Tourism Organization (WTO, 1998), Australian National Tourism Alliance (NTA, 2003, p. 4–7), Gooroochurn and Sinclair (2003, p. 4–7), and Durbarry and Sinclair (2001).*
*Source: Own compilation.*

consumption of international tourists we could draw some parallels to export of goods, which is VAT free, but it would in fact be discriminatory to treat domestic tourist differently from international tourists (though Croatia did for some time). Therefore, also international tourists pay prices higher due to the collection of VAT in the tourist destination country. In this subsection we represent a short analysis of VAT imposed on the consumption of tourists in Mediterranean Europe.

Under current arrangements, the EU Member States apply a standard VAT rate on goods and services of at least 15 percent and have the option of applying reduced rates (which may not be less than 5 percent) to certain goods or services of a cultural or social nature and temporarily or exceptionally also zero or super reduce rates (might be below 5 percent). Several EU countries apply reduced VAT rates also to some tourism sector activities. Namely, Directive 2006/112/EC[1] (hereinafter referred to as the EU VAT Directive), gives the EU Member States the choice of applying a reduced rate to accommodation provided in hotels and similar establishments, including the provision of holiday accommodation and the letting of places on camping or caravan sites. Other goods and services commonly consumed by tourists that are in several countries entitled to the reduced VAT rate are (see Annex X of the EU VAT Directive) the following:

- transport of passengers and their accompanying luggage;
- foodstuffs (including beverages but excluding alcoholic beverages) for consumption;
- admission to shows, theatres, circuses, fairs, amusement parks, concerts, museums, zoos, cinemas, exhibitions and similar cultural events and facilities;
- the use of sporting facilities and admission to sporting events.

According to the EU VAT Directive neither restaurants, holiday packages nor car rental companies are eligible for a reduced VAT rate as neither is

1 Council Directive 2006/112/EC is a recast of the 6th VAT Directive (77/388/ECC) on the common system of value added tax.

specified in Annex III of the Directive. However, the EU member states, which were applying a reduced rate to restaurants and bars in January 1991, have the option of continuing to apply such a rate to these supplies. There are also temporary or exceptionally derogations allowed for some new EU member states. Bulgaria, for example, retains preferential VAT rate only for accommodation provided by the hotelier as part of a tourist package tour (Vatahov, 2006a).

Croatia, a non-EU Mediterranean country, applies reduced VAT rate not only on hotel accommodation, but also on travel agent's admission on supply of such services (the second paragraph of Article 10a of Croatian VAT Act, known as ZPDV for short). Turkey, on the other hand, retains mostly a uniform VAT rate for hotel and hospitality services.

## Taxes and excise duties on transport

Most of foreign tourists come to the Mediterranean tourist destination from other parts of Europe, mostly from northern and western countries. Especially in long haul destinations international transport occupies a major part in the total cost of holiday packages (except for low cost air travel carriers) and hence taxing this sector is in principle very important from tourist's perspective. Tax on transport, which is directly calculated to a tourist as a consumer, is VAT on plane/rail/bus ticket or ticket for sea transport. As international transport is mostly exempt from VAT, is not an element of international tax competitiveness of tourist destinations. Namely, international air travel and sea transport are VAT exempt in all EU countries. In most considered countries the same is valid also for international rail transport, while some countries (France, Spain, and Slovenia) apply a reduced VAT rate on international bus transport. In Slovenia international air, sea and rail transport of passengers are VAT exempt, while international road transport is liable to VAT. In Croatia international passenger transport is VAT exempt only in part that refers to foreign country. Part of all kinds of trips taking place in the territory of Croatia is liable to VAT payment. VAT rates for different means of domestic and international transport in European Mediterranean countries are shown in Appendix 1.

Inland or domestic transport is, contrary, taxed in great majority of countries. Many different VAT rates apply to inland passenger transport across the EU with some member states offering VAT exemptions or applying zero VAT rates. Among considered countries, the inland transport taxed by zero VAT rate only in Malta. Half of the considered countries apply reduced VAT rates (Portugal 5 percent, Spain 7 percent, Slovenia 8.5 percent, Greece 9 percent, and Italy mostly 10 percent), while the rest, including Croatia, apply standard VAT rates (see Appendix 1). Croatia with 22-percent VAT rate on tickets imposes the heaviest direct tax burden on tickets for inland transport.

Tourists also face several types of entry and exit taxes. These include taxes and charges on airport departure, which are fixed amounts that have to be paid when leaving the country, taxes on airport embarkation, which is paid on entering the country, and possible the visa fee. These taxes are usually levied at a flat rate or in nominal terms and are relatively small in amount (Gooroochurn and Sinclair, 2003).

Aviation is currently exempt also from fuel taxes; while in the EU taxes on road fuel amount on average about 0.65 euros per litre (T & E, 2006, p. 12). Road fuel excise duties adopted by Croatia are much lower than in EU countries. Petrol and diesel excise duties in Slovenia are above the minimum amounts prescribed by the EU and are close to the average levels for considered Mediterranean countries (see Appendix 2).

## Taxation of hotel and hospitality services

Beside transport costs most of tourists' expenditures represent costs of accommodation and hospitality services. VAT rates for *hotel accommodation services* in considered countries vary between 5 and 18 percent, with Malta, Portugal and France having the lowest VAT rates (5 and 5.5 percent, respectively) and Turkey imposing the highest VAT rate for accommodation services (18 percent). VAT rate for hotel accommodation in Slovenia is on the average level of analyzed countries. In Croatia it is 1.5 percentage points above the average rate. With an exception of Slovenia all countries apply the same VAT rate to *food in* *restaurants and non-alcoholic beverages in bars and cafes*. This VAT rate is the highest in Croatia (22 percent)[2] and the lowest in the Aegean Sea area (6 percent) and Spain (7 percent). Slovenia applies 8.5 percent VAT rate to food in restaurants and 20 percent VAT rate to all kind of beverages in restaurants, bars and cafes. In all countries, except in Cyprus and Greece, where higher VAT rates apply to alcoholic drinks, VAT rates for *alcoholic beverages* do not differ from VAT rates for non-alcoholic beverages in bars and cafes. Only Italy, Portugal and Spain apply reduced VAT rates to alcoholic drinks supplied in restaurants, bars and cafes. *Night club services* are mostly subject to standard VAT rates – where exceptions are Spain (applying 7 percent VAT rate) and Portugal (applying 12 percent VAT rate).

Beside government VAT on tourist accommodation tourists also face *local tourist taxes* related to overnight stay of nonresidents. First type of these taxes is a tourist tax/fee, which is set at fixed, usually smaller amount (*e.g.* 1 Euro per person per night). Revenue acquired by this type of tax is mostly allocated to local tourism development. In some countries/cities tourists are beside VAT on tourist accommodation subject to local tax that is set in percent of a lodging selling price. Here we refer to it as a bed tax or local lodging tax. Rates of this tax are usually beside VAT applied to the net price of a hotel accommodation (*e.g.* in hotels in Athens a tourist pays 6 percent community tax for the overnight stay).[3]

## Value added tax on other tourist goods and services

Tourists also spend some income on clothes and alcoholic and soft drinks in stores, artisan products and souvenirs. Some of them also engage in sport activities, visit museums, concerts and other cultural activities. Most of these goods and services are standard-rated but to some of them reduced VAT rate applies. Among the latter, they are often different cultural, sport or social activities, newspapers and magazines and food bought in stores.

Among all considered Mediterranean countries (see Table 1) Croatia has the *highest standard* VAT *rate* (22 percent). Slovenia's standard VAT rate of 20 percent is ranked (as the VAT rate in Bulgaria and Italy) at third place after the VAT rates in Croatia and Portugal. The lowest standard VAT rates are levied in the Aegean Sea area (13 percent), Cyprus (15 percent) and Spain (16 percent).

VAT rates for *food sold in shops* vary from 0 percent in Malta to 22 percent in Croatia (except on all types of bread and milk). VAT rates for *soft drinks sold in shops* vary from 5.5 percent in France to 22 percent in Croatia. The VAT rate for food and soft drinks sold in shops in Slovenia is 8.5 percent. Thus, it is below the average VAT rate for considered countries.

Table 2 shows that the category of products facing the largest VAT rate variation among the analyzed countries is food and soft drinks sold in shops. Though services supplied by restaurants, bars, cafes and night clubs also face significant variation. However, range is a bit lower but still considerable in the case of hotel services, where only Turkey persists with standard VAT rate. All other 11 analyzed countries have adopted the option of applying reduced VAT rate on hotel services. According to WTTC (2007), there is a widespread agreement that economies benefit from a reduced VAT rate for the hospitality sector.

## Value added tax on holiday packages

Significant share of international tourists come to the Mediterranean tourist destinations through tour operators/travel agencies. This share varies from country to country. In Bulgaria[4] and Antalya[5] (Turkey), for example, it reaches around 80 percent, while the share was only 38 percent in Spain[6] , around 35 percent in Croatia[7] , and 32 percent in Slovenia[8].

2 Beside government VAT Croatia also implies local tax on consumption of alcoholic and non-alcoholic drinks, which is up to 3 percent (Kesner-Škreb in Kuliš, 2008, 58).
3 Butler, 2007

4 Data is for 2006 (Vatahov, 2006a)
5 Data is for 2000 (Anadolu Agency, 2000).
6 Data is for 2005 (Galdiano, 2005).
7 Data is for 2006 (UHPA, 2008).
8 Data is for 2003 (Arnež *et al.*, 2004, p. 23).

**Table 2:** *VAT rates in chosen Mediterranean European countries as of 1st January 2007*

| Country | Standard VAT rate | Reduced VAT rate | Super reduced or zero VAT rate | HOTEL room*** | Restaurant (food) | Bars and cafes (beverages) | | Night clubs | Sold in shops: | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | Non-alcoholic | Alcoholic | | Food | Soft drinks |
| Bulgaria | 20 | 7 | | 7,0[1] / 20 (9.6) | 20 | 20 | 20 | 20 | 20 | 20 |
| Cyprus | 15 | 5/8 | / | 8 | 8 | 8 | 15 | 15 | 0/5/15 | 15 |
| France | 19.6 | 5.5 | 2.1 | 5.5 | 19.6 | 19.6 | 19.6 | 19.6 | 5.5 | 5.5 |
| Greece** | 19/13 | 9/6 | 4.5/3 | 9/6 | 9/6 | 9/6 | 19/13 | 19/13 | 9/6 | 9/6 |
| Italy | 20 | 10 | 4 | 10 | 10 | 10 | 10 | 20 | 4/10 | 4/20 |
| Malta | 18 | 5 | / | 5 | 18 | 18 | 18 | 18 | 0 | 18 |
| Portugal | 21 | 5/12 | / | 5 | 12 | 12 | 12 | 12 | 5/12/21 1 | 5/12 |
| Romania | 19 | 9 | / | 9 | 19 | 19 | 19 | 19 | 19 | 19 |
| **Slovenia** | **20** | **8.5** | / | **8.5** | **8.5[2]** | **20** | **20** | **20** | **8.5** | **8.5** |
| Spain | 16 | 7 | 4 | 7 | 7 | 7 | 7 | 7 | 4/7 | 7 |
| Turkey | 18 | / | / | 18 | 18 | 18 | 18 | 18 | 0[3]/18 | 18 |
| Croatia | **22** | / | 0 | **10** | **22** | **22** | **22** | **22** | **0[4]/22** | **22** |
| Average* | **18.5** | **7.5** | **2.6** | **8.6** | **14** | **15** | **16.1** | **17** | **10.7** | **13.3** |
| Range | 9 | 5 | 4 | 13 | 16 | 16 | 15 | 15 | 22 | 16.5 |
| Standard Deviation | 2.6 | 1.6 | 1.7 | 3.4 | 5.9 | 5.9 | 4.7 | 4.4 | 7.3 | 6 |

*Notes:*
*1 When organized by tour operators (just on hotel accommodation services provided as part of an organized trip).*
*2 The date until Slovenia may apply 8.5 percent VAT rate to the preparation of meals was after the negotiations in December 2007 prolonged to the end of 2010.*
*3 Only for basic food items like milk, macaroni, oil, and similar (Revenue Administration of Turkey, 2006).*
*4 Only for all types of bread and milk.*
** We calculate the average hotel VAT rate using the weighted average VAT rate for the hotel services in Bulgaria. Thus, the average VAT rate for the hotel services in Bulgaria amounts 9.6 (0.8*7+0.2*20), since about 80 percent of foreign tourists come to Bulgaria through foreign tour operators/travel agencies, which are taxed at only seven percent VAT rate (Vatahov, 2006a). When we have different tax rates for the same category of goods/services, we usually calculate the average VAT rates by taking simple average, unless this is not appropriate (e. g. for food VAT rate sold in shops in Croatia, where we take just 22 percent, since the zero rate is applied only to bread and milk). For Greece, we use data for the islands of Aegean Sea and some other islands (lower VAT rates).*
*** Greece: All tax rates are 30 percent lower for the islands in the Aegean Sea and certain other islands (the second rate).*
****Some counties/cities also charge special bed taxes, which are not included here, e. g., 6 percent tax on overnight stays at hotels and motels in Oconee county – Athens (Butler, 2007).*
*Similar classifications are provided by World Tourism Organization (WTO, 1998), Australian National Tourism Alliance (NTA, 2003, p. 4–7), Gooroochurn and Sinclair (2003, p. 4–7), and Durbarry and Sinclair (2001).*

*Source: HOTREC, 2007; for Croatia: VAT Act (ZPDV) and IJF, 2007.*

The EU member states tax tour operators' (travel agencies')[9] services in accordance with the EU VAT Directive, which contains a special margin scheme for tour operators (so called tour operators' margin scheme – TOMS). Tour operators that buy in a hotel accommodation, passenger transport, organize trips, excursions or other activities in their own name to provide these services in a package to a customer are regarded as making a single supply of services for VAT

9 Tours operator and travel agencies are here regarded as businesses that buy-in and resell travel, accommodation and certain other services as a principal or undisclosed agent, which is acting in their own name (Pooley, 2005).

purposes. Tour operators do not pay VAT on the whole selling price of a holiday package, but only on the margin on resale of this bunch of services. To the relevant margin standard VAT rate should apply. Tour operators are taxed only in the country where their business is established and therefore do not have to register for VAT in other countries. Since VAT is charged only on the margin of transactions, tour operators cannot deduct input VAT on the corresponding costs of sale (Pooley, 2005; Articles 306–311 of the EU VAT Directive). For example, a tour operator established in Slovenia, selling a holiday package (*e.g.* accommodation) in Italy, registers for VAT only in Slovenia. It is liable to pay 20-percent VAT rate on the difference between the total amount (exclusive of VAT) to be paid by the traveler and its actual cost of accommodation provided by a certain hotel in Italy. It cannot deduct VAT on hotel accommodation paid in Italy to lower its corporate income tax base and therefore its tax liability to the Slovenian Tax Authority.

**Table 3:** *VAT rates generally applied to travel agencies in considered Mediterranean countries, situation as at 1st May 2007*

| | Bulgaria | Cyprus | France | Greece | Italy | Malta | Portugal | Romania | Slovenia | Spain | Croatia |
|---|---|---|---|---|---|---|---|---|---|---|---|
| VAT rate | 20 | 15 | 19.6 | 19 | 20 | 18 | 21 | 19 | 20 | 16 | 10/22* |
| TOMS | | [m] | [m] | [m] | [m] | [m] | [m] | [m] | [m] | [m] | |

*Notes:*
*[m] = taxation on the margin; TOMS = tour operators' margin scheme.*

*Source: European Commission, 2007b; Slovenian VAT Act (ZDDV-1, Article 98).*

The EU VAT Directive appoints standard VAT rate on tourist packages. Even if an EU country could exceptionally apply a reduced VAT rate on holiday packages, the VAT rate is an element of competition between tourist destinations only if a tourist buy a package directly in the country, which is his/her final tourist destination. From the perspective of foreign tourist agencies (and in the final instance also tourists) not only VAT rate on margin is important, but also a non-refundable VAT on accommodation and other services bought in order to provide holiday packages to tourists. After the EU accession, Bulgaria was not allowed to retain lower VAT rate on accommodation for all taxable persons. Nevertheless, it has made every effort to negotiate at least for reduced VAT rate for hotel accommodation services provided as part of an organized trip (Vatahov, 2006b). It was successful and Bulgaria can regarding VAT rate for accommodation compete with Greece and Spain (that holds only for tourists with holiday package).

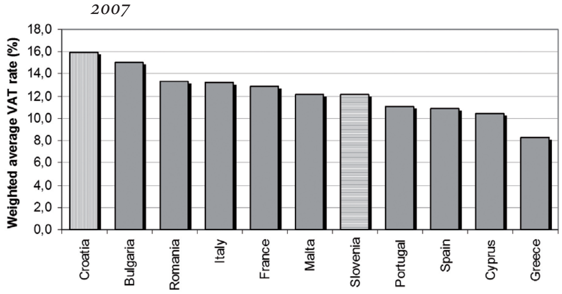
The only among considered Mediterranean countries that offers preferential tax treatment of tour operator's margin is Croatia. Since January 2006 Croatia applies 10-percent VAT not only on accommodation with or without breakfast, and half-board and full-board in hotels and similar establishments, but also on tour operator's margin on these services (Porezna uprava Republike Hrvatske, 2006). Since reduced VAT rate on tour operator's margin and hospitality services for guests staying in hotels are not in compliance with the EU VAT Directive, Croatia will probably try to negotiate for certain exceptions on its way to the EU. It should also have to introduce the necessary legislative provisions for tour operators into its domestic legislation.

## Weighted average VAT rate levied on tourist consumption

We have examined VAT rates for different groups of goods and services. Generally, if we would like to get a quick picture of how a particular country performs in comparison to others in a certain area, we rank countries up to suitable index. Though rankings are often being criticized that they oversimplify the picture, they are very convenient for the use and give quick information about country's relative position in certain area. Due to lack of internationally comparable data on consumption patterns of tourists, we calculate weighted average VAT rate levied on tourist goods and services. A weight attached to each category of tourist consumption determines the impact of its VAT rate on the average VAT rate. Since it is difficult to obtain comparable international data on the breakdown of tourist expenditures by main item groups, we will assign weights to the components of a so called tourist's market basket arbitrarily (although taking into the consideration data for some countries, *e. g.* Arnež et al. 2004, Srivastava, 2000, Durbarry and Sinclair, 2001, Dunlop, 2003). Primary groups of tourism expenditures proposed by WTO and the corresponding, arbitrarily assigned weights are: package travel/holidays/tours (0.10); accommodation (0.45); food and drinks (0.15 and 0.05, respectively), inland transport (0.05), recreation, culture and sporting activities (0.06), shopping and miscellaneous (0.14). International transport is not included here, since it partly refers to the country of origin.

Figure below shows weighted average VAT rate faced by a hypothetical tourist in the European Mediterranean countries. It clearly shows that a tourist visiting Croatia face higher average VAT rate than those visiting the competing tourist destinations. Greece, Cyprus and Spain are the most competitive regarding VAT on tourist consumption. Slovenia's average VAT rate for tourists is in comparison to other destinations quite favorable. Since in reality tourist's market basket differs among tourist destinations, our indicator of average VAT rate is not reliable. But also by changing weights assigned to groups of expenditures, ranks mostly do not change (if they do, a country mostly switches the place with the closest neighbor).

**Figure 1:** *Weighted average VAT on tourist consumption (in %), 2007*




*Note:*
*For item groups of tourist expenditures, tbier VAT rates and the corresponding weights, see Appendix 3.*

*Source: Own compilation.*

There future of preferential tax treatment of the hospitality sector and other tourist services depends on the ongoing political debate on VAT rate structures, which should be closed by the end of 2008. Then the European Commission should put forward concrete legislative proposals for a revision of the reduced rates. The starting point of the debate is the Commission's assessment report on the impact of reduced rates applied to locally supplied services (including restaurant services), notably in terms of job creation, economic growth and the proper functioning of the internal market (Copenhagen Economics, 2007, p. 9). The report concludes that from economic perspective a uniform VAT rate per member state is the best policy choice. Nevertheless, there may be specific economic benefits from operating a reduced rate in carefully targeted sectors. The report suggest that it might be justified to apply reduced VAT rates to locally supplied services and some parts of the hospitality sector, respectively hotels and restaurants (Copenhagen Economics, 2007, p. 4). But there is no explicit argument to extend reduced VAT rate to tour operator's services. On the other hand the report warns that the option to apply reduced VAT rates to part of hospitality industry may affect distribution of tourism between EU member states and may have a non-negligible impact in border regions (Copenhagen Economics, 2007, p. 89). Since reduced VAT rates serve as a tool for promoting international price competitiveness of certain sectors, different interest groups are still seeking reduced VAT rates for their sectors or products.

## Business taxation

No matter on which side of the market taxes are legally levied, part of taxes can be passed on to tourists through higher prices. How much of a particular tax is actually paid by business and how much by the end consumer depends according to economic theory on the price elasticity of demand and supply (Musgrave and Musgrave, 1989, p. 251–253). Since surveys show that tourism demand is relatively price sensitive (see De Mello *et al.*, 2004, p. 517; Copenhagen Economics, 2007, p. 43), businesses have limited possibilities to shift tax burden to consumers through higher prices.

We briefly present overall tax rates on income from employment and tax rates applied to business earnings.

The hospitality sector is a labor intensive service sector that has, after the business service sector, second highest share of personnel costs in total operating costs (European Commission, 2007c, p. 19–21). Thus, heavy taxation of labor income can impose considerable costs to this sector. Organization for Economic Cooperation and Development (OECD) has established a micro indicator of total tax burden on labor income, called tax wedge[10]. It can be calculated for various examples of households' types and representative wage levels. Since wages in the hospitality sector are usually lower than average wages in the economy (see European Commission, 2007c, p. 21; ILO, 2001, p. 53), we will use tax wedge on low paid workers[11] as a proxy for tax wedge in the hospitality sector. As can be seen from Appendix 4, tax wedge is among all considered Mediterranean countries the lowest in Malta and Cyprus and the highest France, Romania, Turkey, Italy and Slovenia. In the last five countries it exceeds 40 percents, what simply means that an amount that worker receives on personal bank account is less than 60 percent of an amount paid for his/her work by the employer. The calculated tax wedge for low paid worker in Croatia was in 2006 about 38.4 percent, what places Croatia right behind the leading group of five countries with the highest tax burden on labor (see Appendix 4). Tax wedge on labor income is significant in most of the EU member states and in Turkey and can harm the price competitiveness of these countries relative to non-European tourist destination.

The tourism sector is characterized by a large number of small businesses (European Commission, 2007c, p. 324). They can choose between different legal forms in which to operate what affects their liability to tax. Depending on the legal form, their profits are taxed either under the personal income tax or the corporation tax system. Since effective tax rates on corporate income are not available for the tourism sector, we compare adjusted top statutory corporate income tax rates. It is up to individual company to optimize its effective tax burden and carry out possible tax credits, deductions and other tax relieves. Among the considered Mediterranean countries the corporate income tax (CIT) rates are most favorable in Bulgaria and Cyprus (10 percent on corporate earnings), while they are the highest in France (34.4 percent), Malta (35 percent), and Italy (37.3 percent). Slovenia and Croatia have the CIT rates below the average CIT rate for the considered countries (see Appendix 5).

Many small businesses (mostly sole proprietors) are taxed within the personal income tax (PIT) scheme. At the moment Romania is the only amongst the European Mediterranean countries having flat-rate PIT. Bulgaria has announced flat PIT rate for 2008 (Beekman, 2007). All other countries levy taxes according to tax brackets, though the number of brackets is reducing in the last years. Top statutory PIT rates differ substantially between the Mediterranean countries, ranging from 16 percent in Romania to 45 percent in Croatia. The top statutory PIT rate in Slovenia is above the average in the Mediterranean Europe (see Appendix 6).

## Conclusion

During their stay in a foreign country tourists face several general and specific taxes, which make traveling more expensive. Losing price competitiveness due to high taxes under fierce competition can motivate potential guests to move to rivalry tourist destinations with more favorable prices. The most important tax levied directly on tourists is value added tax (VAT). The most competitive European Mediterranean tourist destinations according to VAT are Spain, Cyprus, and Greece. VAT rates in Croatia are the highest amongst considered countries and several of these countries are better ranked than Croatia according to price competitiveness. The main VAT derogations in the Croatian tax system concerning tourism are reduced VAT rate for accommodation that includes different meals and reduced VAT for tour operator's margin on

10 Total tax wedge considering OECD methodology is calculated as the sum of personal income tax, employee plus employer social contributions and any payroll tax, expressed as a percentage of labor costs. Labor costs are defined as gross wage earnings plus employers` social security contributions and payroll taxes (OECD, 2004).

11 Tax wedge on low paid worker represents tax wedge for single individuals without children at the income level (gross earnings) of two thirds of an average worker (AW).

these services. Since the latter is not in compliance with the EU VAT Directive, Croatia should try to negotiate for certain exceptions on its way to the EU.

Slovenia is quite competitive according to VAT rates but is on disadvantage especially regarding taxation of labor. In Slovenia as well as in Croatia labor income is taxed heavily relative to several competing tourist destinations (Bulgaria, Cyprus, Malta, Greece and Spain). While Croatia sticks to high top personal income tax rate, Slovenia makes rather small steps in reducing marginal income tax rates. Their close rivals, Bulgaria and Romania, are making quick steps towards extremely tax friendly environment. By simplifying their tax regimes they attract foreign investors that modernize their capacities and attract tourist from abroad. Beside that we should be aware that Europe is at the time being of a strong Euro a relatively expensive tourist destination and is gradually loosing its market share in the world. As non-European Mediterranean and Middle Eastern countries have relatively low unit cost base compared to their European counterparts and thus low price levels, labor taxes could be an appropriate element to target when removing price level as competitive disadvantage in tourism.

## Appendices

**Appendix 1:** *VAT rates generally applied in the considered Mediterranean countries to passenger transport, situation at 1st May 2007*

| | Bulgaria | Cyprus | France | Greece | Italy | Malta | Portugal | Romania | Slovenia | Spain | Croatia |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **Domestic transport:** | | | | | | | | | | | |
| **Air** | 20 | 15 | 5.5 | 9 | 10 | 0 | 5 | 19 | 8.5 | 7 | 22 |
| **Sea** | 20 | 8 | 5.5 | 9 | 10 | 0 | 5 | 19 | 8.5 | 7 | 22 |
| **Inland waterway** | 20 | 15 | 5.5 | 9 | 10 | n/a | 5 | 19 | 8.5 | 7 | 22 |
| **Rail** | 20 | n/a | 5.5 | 9 | 10 [ex] | n/a | 5 | 19 | 8.5 | 7 | 22 |
| **Road** | 20 | 5/15 | 5.5 | 9 | 20 [ex] | n/a | 5 | 19 | 8.5 | 7 | 22 |
| **Intra-community and international transport:** | | | | | | | | | | | |
| **Air** | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 * |
| **Sea** | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 * |
| **Inland waterway** | n/a | n/a | 5.5 | 0 | 0 | n/a | 0 | 0 | 0 | 7 | 0 * |
| **Rail** | n/a | n/a | 0 | 0 | 0 | n/a | 0 | 0 | 0 | 7 | 0 * |
| **Road** | n/a | 0 | 5.5 [ex] | 9 | 0 | n/a | 0 | 0 | 8.5 | 7 | 0 * |

*Notes:*
*0 = zero rate (exemption with refund of tax paid at preceding stage); [ex] = exemption; N/A = not applicable; [ex] = exemption.*
*Croatia: Standard VAT rate applies on part of a trip taking place in the territory of Croatia.*

*Source: European Commission, (2007b); VAT Act for Croatia and information from Tax Administration of Republic of Croatia.*

**Appendix 2:** *Excise duties imposed on unleaded petrol and diesel fuel in the considered Mediterranean countries (in euros), situation as at 1st July 2007*

| | Unleaded Petrol | Diesel fuel |
|---|---|---|
| *Minimum excise duty adopted by the Council on 27–10–2003 (Dir. 2003/96/EEC)* | *359 EUR per 1000 litres* | *302 EUR per 1000 litres* |
| **Bulgaria** | 322.12 | 273.55 |
| **Greece** | 331.00 | 276.00 |
| **Spain** | 395.69 | 302.00 |
| **France** | 606.90 | 428.400 |
| **Italy** | 564.00 | 423.00 |
| **Cyprus** | 303.10 | 247.96 |
| **Malta** | 474.26 | 332.40 |
| **Portugal** | 582.95 | 364.41 |
| **Romania** | 327.29 | 259.91 |
| **Slovenia** | 400.03 | 323.30 |
| **Croatia** | 227.59 | 137.93 |
| **Average** | 412.27 | 306.26 |

*Source: European Commission, 2007a; for Croatia IJF, 2008.*

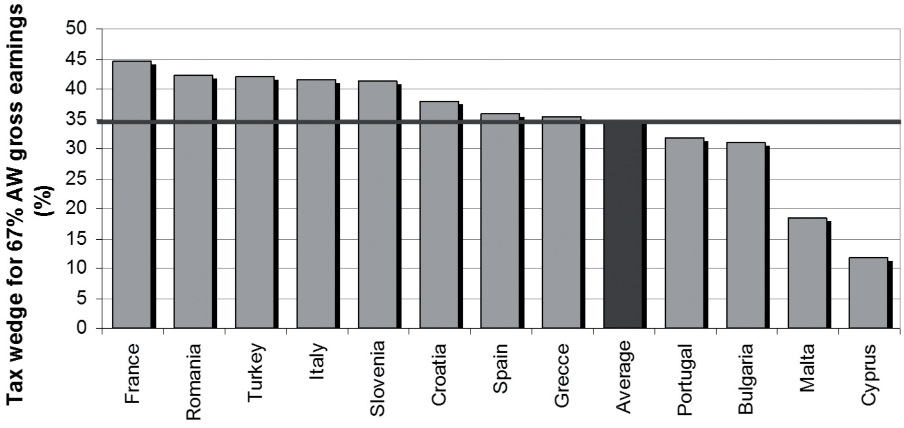
**Appendix 3:** *VAT rates by item groups of tourist expenditures and weighted average VAT rate on tourist consumption (in %), 2007*

| Item group and corresponding weight | Bulgaria | Cyprus | France | Greece | Italy | Malta | Portugal | Romania | Slovenia | Spain | Croatia |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Package tours 0.15 | 20 | 15 | 19.6 | 13 | 20 | 18 | 21 | 16 | 19 | 20 | 22 |
| Accommo-dation 0.45 | 9.6 | 8 | 5.5 | 6 | 10 | 5 | 5 | 9 | 8.5 | 7 | 10 |
| Food 0.15 | 20 | 8 | 19.6 | 6 | 10 | 18 | 12 | 19 | 8.5 | 7 | 22 |
| Drinks 0.05 | 20 | 11.5 | 19.6 | 9.5 | 10 | 18 | 12 | 19 | 20 | 7 | 22 |
| Inland transport 0.05 | 20 | 15 | 19.6 | 13 | 20 | 18 | 21 | 16 | 19 | 20 | 22 |
| Cultural events 0.03 | 9.6 | 7.5 | 5.5 | 4.5 | 10 | 18 | 5 | 9 | 8.5 | 7 | 0 |
| Recreation and sporting activities 0.03 | 20 | 15 | 19.6 | 9 | 20 | 18 | 5 | 19 | 8.5 | 11.5 | 22 |
| Shopping and miscellaneous 0.09 | 20 | 15 | 19.6 | 13 | 20 | 18 | 21 | 16 | 19 | 20 | 22 |
| **Weighted average VAT** | 14.8 | 10.3 | 12.6 | 8.1 | 13.0 | 12.0 | 10.8 | 13.2 | 11.9 | 10.7 | 15.7 |

*Note:*
*VAT rates for cultural events and sport activities are obtained from European Commission, 2007b and VAT Act for Croatia. When different rates apply for different kinds of cultural events or sport activities, simple an average rate is used.*

*Source: Own compilation*

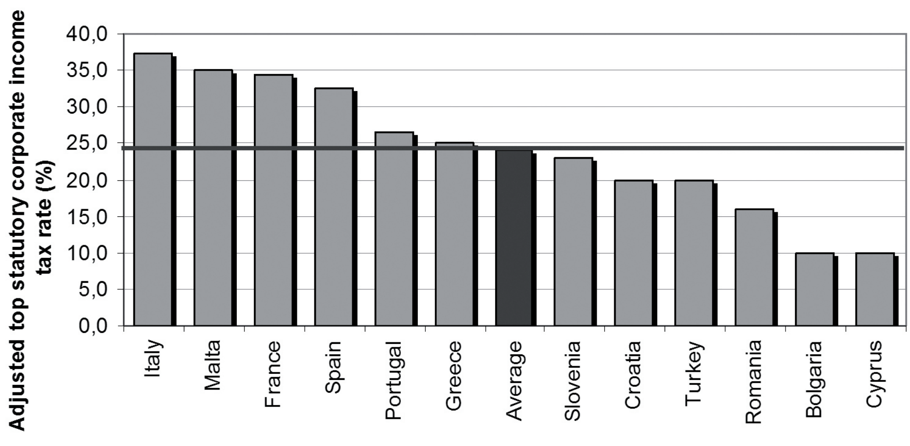
**Appendix 4:** *Tax wedge at income level of two thirds of average worker's (AW) gross earnings, 2006*




*Notes:*
*The tax wedge for Croatia is calculated on the basis of tax legislation in force for a single worker from Zagreb without children with gross wage of 2/3 of average earnings in Croatia in 2006. Data on average monthly gross earnings (6.634 Kuna in 2006) have been obtained from Statistical Yearbook 2007, Republic of Croatia (2007, p. 150). Important source of information for wage taxation: Porezna uprava Republike Hrvatske (2005, p. 34).*

*Source: Eurostat, 2007; own calculation for Croatia.*

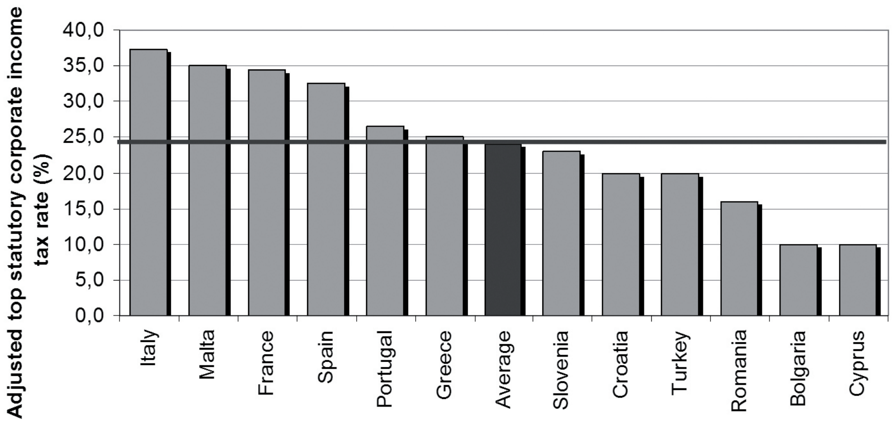
**Appendix 5:** *Adjusted top statutory tax rate on corporate income (in %), 2007*




*Notes:*
*Only the "basic" (non-targeted) top rate is presented here. Existing surcharges and averages of local taxes are included. Some countries also apply small profits rates or special rates, e. g., in case the investment is financed through issuing new equity, or alternative rates for different sectors. Such targeted tax rates can be substantially lower than the effective top rate.*
***France:** Medium and small enterprises are taxed at a reduced rate of 15 percent on the first 38.120 euros of the profits.*
***Italy:** Rates for Italy include IRAP (rate 4.25 percent), a local tax levied on a tax base broader than corporate income. The rate may vary up to 1 percentage point.*
***Portugal:** For small companies taxed under the simplified scheme a reduced rate of 20 percent applies. As from 2007 the rate for Portugal includes the maximum 1.5 percent rate of a municipal surcharge, which municipalities may levy at a non deductible rate of the taxable profit. The municipal surcharge base corresponds to the taxable profit before the deduction of tax losses and tax benefits.*
***Romania:** Micro-enterprises may opt for taxation at a rate of 2 percent of the turnover instead of the general corporate income tax (the rate will be 2.5 percent in 2008 and 3 percent as of 2009).*
***Spain:** For small companies, a 25 percent tax rate applies.*

*Source: European Commission, 2007d, p. 319–359; for Croatia IJF, 2007.*

**Appendix 6:** *Top statutory personal income tax rate (in %), 2007*




*Source: European Commission, 2007d, p. 319–359; for Croatia: IJF, 2007, for Turkey: HLB International, 2007, p. 30.*

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