

## Lower VAT might not bring lower prices

TAXES were one of the most commonly discussed topics before the recent elections in Slovakia. The markets carefully watched the lips of Slovak politicians whenever they commented on the country's much-praised flat tax or on the issue of payroll taxes that in the opinion of some international organisations are in urgent need of a trimming cure.

Tax experts Todd Bradshaw, tax leader and partner at **PricewaterhouseCoopers**, Koen Dewilde, tax director at Deloitte, and Bart Waterloos, country manager at VGD, shared their opinions on the possibility of a lower value added tax (VAT) for selected goods as well as the prospect of lower payroll taxes. They also touched on a recent discussion about possible income tax harmonisation within the EU.

**The Slovak Spectator (TSS): The future government has already declared their intention to lower the VAT rate for selected food stuffs, medicines and health aids. This move would in fact mean the cancellation of the flat VAT rate. The government claims that the move will result in lower prices for selected goods. How do you evaluate this move? Will it have any decisive impact on the state budget deficit?**

**Todd Bradshaw (TB):** Introducing a lower VAT rate should result in lower prices on the selected goods, however it is unlikely that the full VAT reduction will be passed on by retailers. If the Slovak crown weakens as a result of the new government's legislative changes, the price of goods purchased from abroad are likely to increase which would also reduce any price reduction benefit connected to a lower VAT rate.

A lower VAT rate on selected goods is likely to have a significant negative impact on the state budget. The loss of tax revenue will need to be replaced if the government wishes to stay within the budgetary limits necessary to adopt the euro in 2009. If the budget deficit increases, this is likely to result in a devaluation of the Slovak crown similar to what has happened in Hungary. This will in turn push up the prices of goods acquired with foreign currency, e.g., petrol.

In summary, the lost tax revenue will need to be replaced and/or significant cuts in government spending will be required to avoid a large budget deficit. If this is not achieved, the price savings for consumers as a result of a lower VAT rate on selected goods would be eroded by higher prices on other goods.

**Koen Dewilde (KD):** A lower VAT rate for services and goods with a social character is in place in most EU countries. From a social point of view, such initiatives should be welcomed. On the other hand, the risk exists that this reduced rate will not necessarily result in cheaper prices for the end consumer, but could be "consumed" in the preceding stages. Therefore, such a reduced VAT rate should be implemented in combination with other measures (price regulation), in order to assure that the initial goal will be reached.

**Bart Waterloos (BW):** Certainly this will impact the state budget. A lot of products would end up in the lower bracket, thus a huge fall in VAT revenues is to be expected. It also remains to be seen whether the final sales prices will indeed decrease.

And it will create a lot of chaos and confusion: which rate is to be applied on the products you are selling? In other EU countries this very often is a large source of disputes with the tax administration. Will there exist an institution that can issue binding decisions?

**TSS: On one hand, the government promises more generous social policies but on the other hand there is a permanent call within the business community for lower payroll taxes. Can these two objectives be harmonised? Is the expectation of lower payroll taxes realistic?**

**TB:** The expectation of significant reductions in payroll taxes is not realistic because this is not at the top of the new government's agenda. This would be more like an unexpected 'bonus' if it happens.

**BW:** It might be a difficult exercise to balance the two, but maybe the government might find other ways where it can save valuable taxpayers' money.

**TSS:** Several European countries called for the unification of taxes for EU countries along with

more control over the new members who tend to push down their tax rates. Slovakia has sent out several signals that it wants to maintain sovereignty over tax issues. What are the possible developments?

**TB:** It is unlikely that corporate tax will be harmonised within the EU in the near future. The harmonisation of the tax base calculation method across the EU is based on the assumption that companies report under International Financial Reporting Standards (IFRS). In practice, most companies still do not report under IFRS, but under their local accounting rules. This means that even if agreement is reached on the tax base calculation under IFRS by each member state, it would be limited to companies working cross border that report under IFRS in each country. Even reaching this stage would be difficult because of the range of accounting treatments available under IFRS, the differences in interpretation of IFRS in each country and the reluctance to create dual tax calculation systems for those reporting under IFRS and those who are not.

Harmonisation of tax rates by member states is highly unlikely as most member states refuse to give up their fiscal sovereignty.

**KD:** Slovakia is not the only country that would like to maintain sovereignty over its tax issues. There is a large resistance from almost every EU-member state to give up their sovereignty on fiscal matters. For this reason, decisions at the level of the European Council should be taken by unanimity for fiscal matters. As a consequence, every EU-member state has a veto and can block new EU legislation if it disagrees with it. So far, every attempt to introduce the principle of majority voting in this area has failed, and it is expected that this will not happen in the near future.

**BW:** The actual tax rate is only one aspect of the taxes that have to be paid. No word is being said about the tax-free sums that are being awarded in other countries or the expenses that can be claimed there as tax expense. We might see developments in the harmonisation of the tax base.

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