In this paper authors argue that the increase in VAT for restaurant/catering services will have negative influence on the tourism sector and consequently slow Croatian economy which is heavily dependent on tourism.

This increase will negatively influence the price competitiveness and the overall competitiveness of the tourism sector. According to the latest Travel and Tourism Competitiveness Report 2015, Croatia has been ranked 33\textsuperscript{rd} out of 141 countries (scoring 4.3 of 7). Looking at the price competitiveness pillar which measures how costly it is to travel and invest in the country, Croatia has been placed on 101\textsuperscript{st} place. Claiming that business operating in the catering industry did not take advantage of the preferential (lower) VAT rate of 10\% (01/01/2013) and 13\% (01/01/2014) to increase its competitiveness cannot be accepted.

The employment cycle in the tourism sector began with the targeted VAT relief on catering services in 2013. The research results have shown the existence of strong correlation between accommodation and catering services, particularly when it comes to the creation of new jobs and protection of existing ones. Delving into the relationship between taxation and the profit margin, authors conclude that Croatian businesses operating in the restaurant and catering industry do not have space to amortize shocks derived from the increase of VAT tax to 25\%. The only way to amortize shocks would be the price increase or the decrease of product/services quality. This can only result in the loss of the competitiveness of the tourism sector.

**Index Terms**—Economic impacts, tax reform, tourism and hospitality sector, the Republic of Croatia.

**I. INTRODUCTION**

Tourism has a strong potential in boosting economic development, economic growth (measures of GDP) and employment. Tourism impacts on the economy can be categorized into: direct, indirect and induced. In calculating overall impacts of tourism sector the World Travel and Tourism Council summarizes the following impacts [1]:

1. Direct contribution of Travel & Tourism to GDP which reflects the “internal spending” on Travel and Tourism total spending within a particular country by residents and non-residents for business and leisure purposes, followed by the government “individual” spending on Travel and Tourism services directly linked to visitors, such as cultural or recreational visitors;

2. Indirect contribution includes the GDP and jobs supported by investments in tourism, government “collective” spending (i.e. tourism marketing, promotion etc. on the national level) and domestic purchases of goods and services by the sectors dealing directly with tourists; induced contribution measures the GDP and jobs supported by the spending of those who are directly and indirectly employed by the Travel & Tourism sector.

Tourism is a major component of Croatian economy. The number of arrivals and nights spent in tourist accommodation establishments is showing an upward trend. In 2016 the number of nights spent in tourist accommodation establishments in Croatia reached a peak of 78.04 million nights. In 2016 the number of arrivals reached 15.5 million [2].

According to the World Travel and Tourism’s calculations and projections, direct contribution of Travel and Tourism to Croatian GDP in 2015 was HRK 33,896.7mn (10.1\% of GDP). This is forecast to rise by 2.6\% to HRK34, 775.3mn in 2016. The direct contribution of Travel & Tourism to GDP is expected to grow by 4.4\% pa to HRK53, 697.3mn (13.2\% of GDP) by 2026. The total contribution of Travel & Tourism to GDP was HRK77, 918.4mn in 2015 (23.2\% of GDP) and is expected to grow by 1.9\% to HRK79, 429.1mn (23.3\% of GDP) in 2016. It is forecast to rise by 4.2\% pa to HRK120, 329.0mn by 2026 (29.7\% of GDP). Travel and Tourism generated 130,500 jobs directly in 2015 (9.8\% of total employment) and this is forecast to grow by 1.0\% in 2016 to 132,000 (9.8\% of total employment). By 2026, Travel and Tourism will account for 155,000 jobs directly, an increase of 1.6\% over the next ten years [3].
Vellas points that tourism, as an economic stimulant, should be central to measures designed to revive economic growth for the trade flows generated by a strong tourism industry have a major effect on business and consumer confidence. This has been proved in the research where the scale of the indirect economic effects of tourism in the T20 countries was measured [4]. There is an evident positive impact of tourism on incomes (monetary and non-monetary terms), livelihoods and poverty (especially for rural households that participate in the sector) [5]. The taxation system strongly influences destination’s competitiveness. The value added tax rate in Croatia is higher than in most of the Mediterranean countries. In the table below (see Table I), authors highlight the VAT rates in the EU countries. [6]

13 out of 28 countries (UK included) benefit the reduced VAT rate on catering service, amongst which Luxembourg has the lowest VAT rate of only 3%. Denmark levies the highest rate of 25%. As of 1st of January 2017 Croatia has introduced a standard VAT rate for catering services of 25%, thus abolishing the reduced rate of 13%. Croatia will no longer take advantage of the reduced rate in catering sector. The tax reform that Croatian government introduced has attracted a great attention particularly in the catering services and tourism (hospitality) sector. Significant changes to the tax law always create “winners and losers” but also can have strong economic repercussions and alter the competitive landscape [7]. This is particularly true for the Croatian economy where tourism constitutes a major component of the economy. Therefore, catering sector will be strongly hit by the tax reform, but tourism in general will bear consequences of such reform. Apart the above mentioned, the Croatian fiscal system includes an extensive list of hidden fees, and neither the number of these different fees nor the way in which they are calculated is fully known [8]. Bearing in mind the contribution of tourism to Croatian GDP, it is therefore, reasonable to conclude that such abolition of the reduced rate on catering services will strongly impact the Croatian economy, employment and GDP growth in the years to come. Dombrovski and Hodžić explained the reasons behind the negative influence of strong taxation on tourism in Croatia particularly emphasizing the impact of taxation on price competitiveness of the country [9]. VAT increase in catering sector is expected to have a negative impact on inbound tourism whilst it will impact the general price levels of the “tourism product”. Reducing the VAT rate in catering sector would lower the prices, but also allow businesses to increase investment in tourism sector because most of the catering services are strongly connected with tourism (hospitality sector).

For example, in Ireland reduced VAT rate has contributed significantly to strong growth in tourism over the past few years marked by lower prices, enhanced competitiveness, growth of employment in the sector, increased investments in maintenance, refurbishment, renovation and innovation [10]. Gago, Labandeira, Picos and Rodrigues analysed the effects of tourism taxation in Spain - both economic and environmental reasons for taxation – and concluded that the increase of VAT rates on tourism-related sectors could be mostly done at the costs of greater negative impact for Spain’s economy [11].

In this paper authors argument that the increase in VAT for catering services will have negative influence on the tourism sector and consequently will possibly slow Croatian economy which is heavily dependent on tourism. This paper can serve as a context for the stronger debate about taxation and its implications on the overall competitiveness of tourism destination and economic development of the country.

II. EMPIRICAL ANALYSIS

Since the reduced VAT rate of 10% for food preparation and services was applied on 1/1/2013, the number of full-time employees in hospitality and food and beverages services has increased from 41,862 in 2012 to 47,246 in 2013, then to 51,304 in 2014, all the way to 56,170 in 2015.

In the period from 2006 to 2012 when the lowered rate of VAT was applied only for accommodation services, the number of employees remained mostly unchanged. The movement of the employee’s figures indicates a strong connection between accommodation and hospitality because of the investment cycle. Thus, also the cycle of increased employment in the tourism sector has started with the very reduction in VAT for hospitality in 2013. The number of full-time employees in 2013 increased by as much as 11.3 %, while the growth in 2014 and 2015, when the VAT rate for accommodation and hospitality increased from 10% to 13%, was of a reduced intensity and came up to between 8% and 8.7%.

The fact stated above clearly indicates the strong significance of the restaurant/catering sector in the context of increasing the competitiveness of the entire tourism sector. We conclude that the accommodation and hospitality sectors behave according to the “Siamese twins” principle; because, looking through the contexts of investment impact, level of service quality and employment, they work best when “together”, i.e., when they are afforded the condition of a privileged and equal tax treatment. In the following Fig. 1 authors present the data on the full-time employment in tourism sector from 2007 to 2015 [12].

![Fig. 1. Full-time employment in tourism sector 2007-2015 (accommodation + restaurants/catering).](image)

The Tourism Development Strategy of the Republic of Croatia until 2020 that the government adopted in February 2013 assumes that the investment cycle will last until about 2025. It should be noted that this investment cycle assumed a further reduction in the VAT for accommodation and hospitality services to the level of 5%, which the former government led by Mr Tihomir Oreskovic announced, and numerous investors probably included in their business plans. The interruption of the afore-mentioned investment cycle by
raising the VAT for the restaurants/catering sector will cause very negative impacts on the tourism sector and thus the entire Croatian economy through related sectors (agriculture, construction, transport and communications, retail, etc.).

Considering that the estimated height of investment in the hospitality and catering (restaurants) sector until 2020 is over 35 billion Kunas (see: Table II), any shocks in this segment would reduce the mentioned investment potential and threaten faster economic growth and the development of the Republic of Croatia. Besides, according to the Eurostat data, the number of employees in the hospitality and catering (restaurants) sector in 2015 was more than 115,000, which is 20,000 more than the estimated by the Tourism Development Strategy. The table 2 shows that planned investments and employment by 2020 in the tourism sector (hotels and restaurants) [13].

**TABLE II: PLANNED INVESTMENTS AND EMPLOYMENT BY 2020 IN TOURISM SECTOR IN CROATIA**

<table>
<thead>
<tr>
<th>Year</th>
<th>Investment projections (u 000 kn)</th>
<th>Number of employees (projections)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2015</td>
<td>3.542.354</td>
<td>95,000 (&gt; 115,000)*</td>
</tr>
<tr>
<td>2016</td>
<td>4.250.825</td>
<td>98,800</td>
</tr>
<tr>
<td>2017</td>
<td>5.100.990</td>
<td>102,752</td>
</tr>
<tr>
<td>2018</td>
<td>6.121.188</td>
<td>106,862</td>
</tr>
<tr>
<td>2019</td>
<td>7.345.426</td>
<td>111,137</td>
</tr>
<tr>
<td>2020</td>
<td>8.814.511</td>
<td>115,582</td>
</tr>
<tr>
<td><strong>TOTAL 2015-2020</strong></td>
<td><strong>35,175,296</strong></td>
<td><strong>Increase 20,582</strong></td>
</tr>
</tbody>
</table>

Analysis of the restaurant/catering sector shows that reduction of VAT rate resulted in high growth rates of all the key indicators (see Table III) [14].

**TABLE III: ECONOMIC AND FINANCIAL ASPECTS OF RESTAURANT/CATERING SECTOR IN CROATIA, 2011-2015**

<table>
<thead>
<tr>
<th></th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. entrepreneurs</td>
<td>4.128</td>
<td>4.278</td>
<td>5.053</td>
<td>5.910</td>
<td>6.324</td>
</tr>
<tr>
<td>Total revenues</td>
<td>4.279.49</td>
<td>4.469.75</td>
<td>6.311.55</td>
<td>7.301.67</td>
<td>8.124.49</td>
</tr>
<tr>
<td>Wage costs</td>
<td>1.091.52</td>
<td>1.113.73</td>
<td>1.379.12</td>
<td>1.730.36</td>
<td>1.846.42</td>
</tr>
<tr>
<td>EBIT</td>
<td>-198.85</td>
<td>-167.76</td>
<td>363.716</td>
<td>180.645</td>
<td>286.301</td>
</tr>
<tr>
<td>earnings/revenues</td>
<td>-4.6%</td>
<td>-3.8%</td>
<td>5.8%</td>
<td>2.5%</td>
<td>3.5%</td>
</tr>
</tbody>
</table>

The restaurants/catering sector grew particularly well in all aspects (number of businesses, number of employees, revenues, expenses and revenue profit shares) just after 2013, when the VAT rate was reduced from 25% to 10%. In the period between 2006 and 2013 it operated with a loss while the number of employees did not change significantly, and this trend was reversed precisely by introducing reduced VAT rate. Similar indicators are visible in the consolidated balance sheets of both accommodation and restaurant/catering sectors.

In the period from 2013 to 2015 the number of employees in the hospitality sector grew from 24,346 to 31,247 which implies growth of 28.3%, more than entire period between 2006 and 2013, i.e., in the period when the lowered rate of VAT applied only on the accommodation sector. Furthermore, in the period from 2013 to 2015, revenues of businesses in the hospitality sector increased by 28%, while wages costs grew to as much as 33%, which implies that the hospitality business owners used the benefits of a differentiated VAT rate for new employment and partial wages increase.

Looking at the expenditure side, where a parallel increase of fixed assets is noticeable, it is clear that during the afore-mentioned period, hospitality business owners chose to redirect the benefits of a lowered VAT rate to invest in the new infrastructure and, consequently, to raise the quality of the existing ones. In other words, increased profits as a result of reduced VAT rate were not used for payments of dividends or asset stripping but for investment in infrastructure (quality) and new employment.

Profit margins were relatively low in the years when the restaurant/catering sector operated positively. After several years operating with a loss and upon the introduction of the reduced VAT rate, in 2013 profit margin spiked to 5.8%, while in 2014 and 2015 they amounted 2.5% and 3.5% respectively. Such movements clearly illustrate that the restaurant/catering sector have very limited space to cushion the blows of an increased VAT rate of 25%. Therefore, it has to either raise prices or reduce quality of its service. This scenario will result in a reduced competitiveness of the restaurant/catering services and entire tourism sector in the moment when the investment cycle is having its full swing.

Furthermore, an increase in employment, revenue and profit in the restaurant/catering sector implies higher tax revenues for the state and local government budgets via taxes and surtaxes on higher income and profit. Finally, there is the significant influence of the tourism development on linked sectors (construction, agriculture, transport and communications, and retail) which further strengthens the side of state and local budgets.

### III. CONCLUSION

Tourism has been the main driver of employment and GDP growth in the Republic of Croatia with planed estimates of over 35 billion kn of investments in tourism sector by 2020. Huge spike in investments and employment in tourism has been encountered since 2013 when reduced VAT rate has been imposed on both segments of tourism industry; accommodation and restaurants/catering.

In a period from 2006-2013 reduced VAT rate of 13% was imposed only to accommodation while restaurants where charged standard rate ranging from 23 to 25%. During this period employment and investment in tourism sector mostly stagnated. Reduced VAT rate on restaurants/catering in 2013 initiated investment cycle in tourism resulting in increase of employment in tourism sector of 34%, revenues of restaurants/catering businesses by 28%, number of entrepreneurs in restaurant segment of 25% and nominal wage increase in hospitality industry by 33%. Finally, since 2013 profit margins of restaurants/catering businesses finally turned slightly positive, yet with margins still less than 6%. The only viable option for hospitality sector to amortize shocks of VAT rate increase is either to increase prices or decrease delivered service quality. Such findings clearly
reflect that growth and higher competitiveness of the tourism sector in Croatia will only be achievable under reduced VAT rate for both accommodation and restaurant/catering services. This implies that accommodation and restaurants/catering services behave according to the principles of the Siamese twins, i.e. they best behave when they are provided with the same (tax) treatment.

Croatian economy is highly dependent on tourism sector, perhaps more than any other Mediterranean country. With highly inefficient agriculture sector and industry that has been mostly devastated through the process of economic transition, tourism has been the most propulsive segment of the economy that generated increase in investments and new employment. Moreover, tourism development provided enormous support for related sectors such as construction, communication, retail and agriculture. Therefore, government decision to raise VAT rate on restaurants/catering services will have deleterious impact not only for restaurant business and tourism sector but also for entire economy. Investment and employment cycles that began in 2013 have been put in enormous jeopardy.

REFERENCES


