

# Differentiating VAT rate on food 1/26/22

This article explores key points of “Differentiating the VAT rate on food,” a report the Ministry of Agriculture published on 26 May 2022.

With rising food prices, discussions about reducing the VAT rate on food become increasingly relevant. In response to the “Let’s Cut VAT on Food” initiative signed by more than 19 000 people on the manabalss.lv website and to an initiative coming from industry representatives, the Cabinet of Ministers has been mandated to submit a report on reduced VAT rates on food by 1 July 2022.

We have written before about the reduced-rate amendments of 5 April to the VAT directive. The amendments permit the member states to apply a specially reduced VAT rate of below 5% and a VAT exemption (0% with the right to deduct input tax) on up to seven categories of goods or services that are necessary to meet basic needs, including food (and soft drinks).

Latvia is currently applying a reduced VAT rate of 12% on supplies of specialised food products for infants and a rate of 5% on fresh fruit, berries and vegetables.

2021 saw a rise in food prices in Latvia and globally. According to the UN Food and Agriculture Organisation, prices rose on average by 28% in 2021 to reach a record high for the last decade. The price of meat has increased on average by 12.7% and the price of milk products by 16.9%. All consumer expenses have increased in Latvia this year. The food and soft drinks group saw the highest price rises of 14.7% in April and 17.7% in May. The Central Statistics Office says food prices have been on the increase since mid-2021.

Rising food prices mean that Latvian citizens will find it more difficult to buy foodstuffs needed for a minimum subsistence, because purchasing power goes down as food prices go up. This is confirmed by the Finance Ministry’s data suggesting that both the average inflation and the food inflation rate are rising faster than the average income growth in the country.

On 23 March 2022 the European Commission adopted a communication stating that the member states may introduce lower VAT rates and encourage businesses to cut consumer prices in order to minimise the impact of high food prices on the most vulnerable citizens.

## The scope for applying a reduced VAT rate of 5% on a limited food basket

In line with the objective of its action plan, the government is committed to examining ways to reduce the VAT rate on fresh meat, fresh fish, eggs and milk products, as these foodstuffs are considered to be essential.

According to the Finance Ministry’s estimates, introducing a VAT rate of 5% on this group will have a negative annual fiscal impact of EUR 52 million (0.133% of GDP). A reduced VAT rate on this food group will have a limited impact on the food inflation rate, cutting the annual average inflation rate by 1.2 percentage points. If a reduced VAT rate were introduced for the entire food and soft drinks group, the annual average inflation rate would drop by 4.7 points, which would help cut the inflation rate by 3–4 points. If the VAT rate of 5% were introduced from 1 July 2022, the average inflation rate could even drop to 9.4% and to 1.8% in 2023.

Reducing the VAT rate on food will give agricultural producers and food producers more funds in recoverable input tax, which will increase their working capital in the form of VAT refunds.

Many developed member states are applying reduced VAT rates on food to increase the availability of basic necessities. This is because VAT is essentially a regressive tax, with the needy households paying a larger proportion of their income in VAT than the wealthy ones. Differentiating the VAT rate, with lower rates on basic necessities and higher rates on other products, is a way to minimise VAT's regressivity.

The rate of VAT on food in Latvia is among the highest in the EU, Latvia being grouped with Lithuania, Estonia, and Bulgaria. The main argument against reducing VAT on basic foodstuffs is that it is more useful to collect VAT from basic foodstuffs and redistribute it to the most disadvantaged citizens, thereby closing the social gap. This argument is being used now and was used 15 years ago, when active discussions about the need to reduce VAT began.

It is generally accepted that reducing the VAT rate on food would favourably affect all low-income citizens as a tool that could help keep the food prices down and render foodstuffs needed for a minimum subsistence more available to Latvian citizens in these changing conditions. Discussions about the reduced VAT rate are expected to continue now that EU rules allow the member states to revise it (22-TA-1722).