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What to Do with Taxes in Croatia? Tax Burden, Taxation of Income, Profit and Property

Reform priorities are not taxes but public expenditure restructuring

- The tax burden should not be increased by introducing new forms of taxes, given that the tax burden in Croatia is among the heaviest in CEE countries. What is necessary is to reduce it and start disburdening citizens, primarily by lowering social security contributions in order to bring down the cost of labour and to boost competitiveness of the economy.
- The introduction of new capital gains tax, dividend tax and property tax involves a series of problems. Moreover, the resulting revenues would not significantly increase the total tax revenues, whereas such practice would also complicate tax assessment, collection and control. It is also questionable whether it would improve equity, since such taxes can be avoided by the rich.
- As the old saying goes, an "old" tax is a "good" tax. Frequent changes in taxes lead to uncertainty in the decision making by companies and citizens and destabilize the economy. If a new tax is about to be introduced, it should be carefully prepared and announced within clearly defined time limits, in order to provide enough time for all market participants to make the necessary preparations for such a change.
- The crucial problems of the Croatian public finance are not the taxes but huge public spending and its continuous growth. Consequently, instead of redesigning the tax system, which currently performs successfully, Croatia has to restructure its public spending, which is a tough nut to crack. However, given the unfavourable demographic situation, which is likely to exert further pressures on public expenditure, it is difficult to substantially lower the tax burden in the long run.
- Nevertheless, before a general consensus is reached on the necessity of public spending rationalisation, tax reductions can be achieved within the system itself, by gradual abolishment of tax exemptions and relief. This would result in broadening the tax base and lowering rates.
- The tax exemption abolishment should apply to companies and citizens. Instead of promoting economic

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growth by selective taxation of companies, economic sectors and regions, this should be achieved by reducing the overall tax level and providing for a stable business environment. Tax benefits and exemptions for certain social groups should be replaced by targeted social benefits aimed at addressing the actual problems of vulnerable groups of population.

Taxes are a common topic for discussion in the pre-election period. The interest is high among voters, as they are increasingly aware of taxes as the levies to be paid from their own pockets, whose use is beyond their influence. The importance of this issue is emphasized by the public perception that "unjustly" high income of rich individuals can be reduced through taxation. We will therefore address the most frequently discussed issues, i.e. the tax burden in Croatia as compared with that in other countries, personal and corporate income taxation as well as the taxation of dividends, capital gains and property.

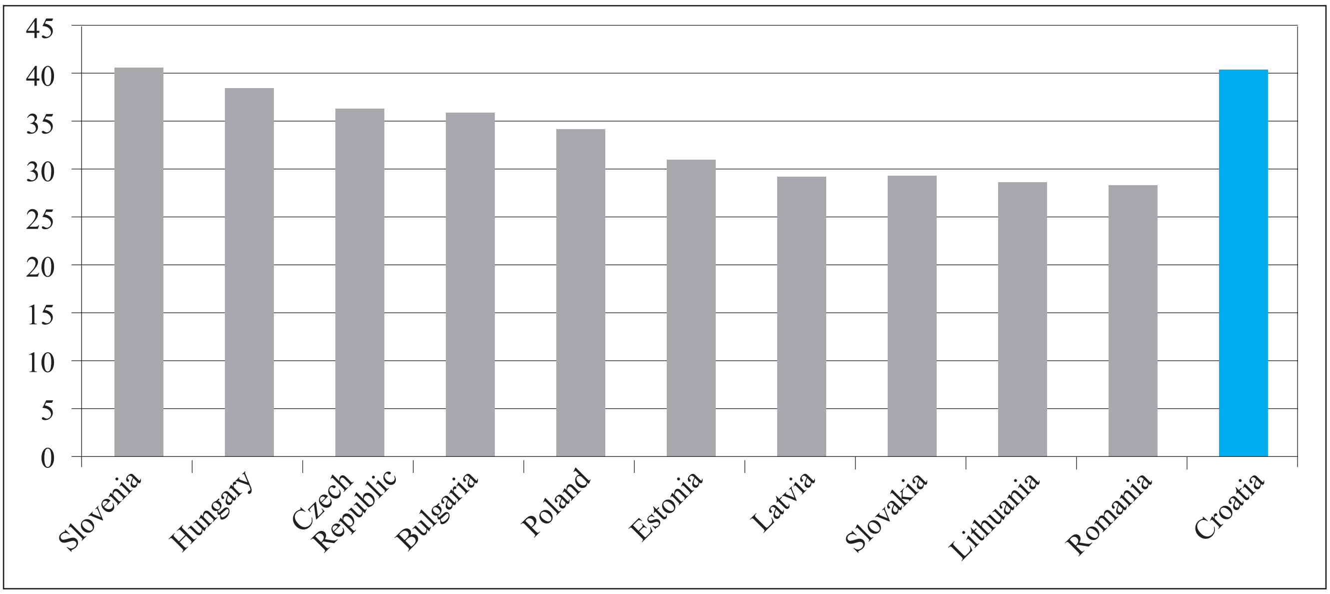
1 Public expenditures and taxes

Public spending is relatively stronger in Croatia compared with similar transition countries. Public spending in Croatia, i.e. the expenditure of the consolidated general government, accounted for about 49% of GDP in 2005, about ten percentage points more than in other Central and Eastern European (CEE) countries. Almost 70% of these funds are used for pensions, health care, various social benefits and public sector salaries. These benefits, which are mostly the consequences of population aging, are likely to continue upwards, thus hindering the reduction of public spending. It is encouraging that, despite similar demographic pressures, other CEE countries still managed to considerably reduce public spending. As a result, all other countries in the region, except Hungary, report significantly lower public spending than Croatia.

Huge public spending inevitably results in a heavy tax burden. In order to finance large government expenditure it is necessary to collect substantial amounts of tax. Like in Slovenia, average tax burden in Croatia, expressed as a share of taxes and social security contributions in GDP, stands at 40%, and represents the heaviest tax burden relative to other CEE countries.

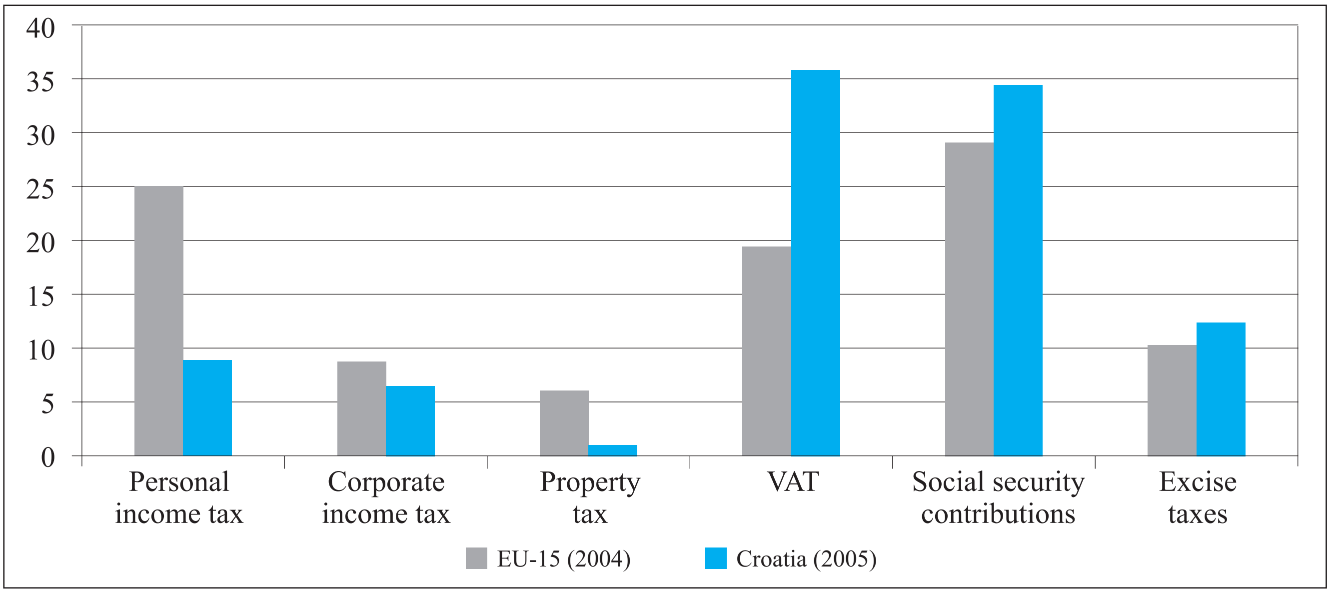
The main taxes in the Croatian tax system are VAT, excise taxes and social security contributions, whereas the personal and corporate income taxes have minor roles in budget revenue formation. The Croatian tax structure is radically different from that in the EU. Compared with Europeans, Croatian citizens are much more burdened by VAT, excise taxes and social security contributions, whereas the personal income tax, corporate income tax and property tax burdens are lower. However, this does not mean that the Croatian tax structure should be adjusted to that in Europe. Heavier reliance on VAT and less on income taxes proved to be an advantage of the Croatian tax system, since VAT is a neutral tax providing equal busi-

Figure 1. Taxes and Social Security Contributions as % of GDP, 2005



Sources: Eurostat and Ministry of Finance.

Figure 2. Tax Structure in EU and Croatia as % of total taxes



Sources: OECD and Ministry of Finance.

ness conditions for all economic activities. VAT is also more successful in dealing with the unofficial economy. As consumption (being the VAT base), is less liable to fluctuations than income, the revenues from VAT are more stable. However, particularly prominent is the large share of social security contributions resulting in high labour costs.

A good tax system is the one which is efficient and equitable, in which consumption taxes prevail and which is implemented by an effective tax administration.

Efficiency. An efficient tax system is the one which least distorts the decisions of economic agents. Such a system relies on a broad tax base, moderate tax rates and a small number of exemptions for individual categories of taxpayers, regions or business sectors.

Equity usually has two aspects: horizontal equity meaning that households with equal or similar income (and living conditions) pay equal or similar taxes, and vertical equity implying higher taxes for better-off households.

Tax structure. Tax structure is considered to be more favourable if it relies more heavily on consumption taxes, such as VAT, which have broadly defined tax bases.

Effective tax administration. The tax administration has to be efficient, prompt, transparent and cost-effective, in order to be able to collect maximum tax revenues. However, the complexity of the tax system, numerous exemptions and deductions and tax relief, increase the cost for both the tax administration and taxpayers.

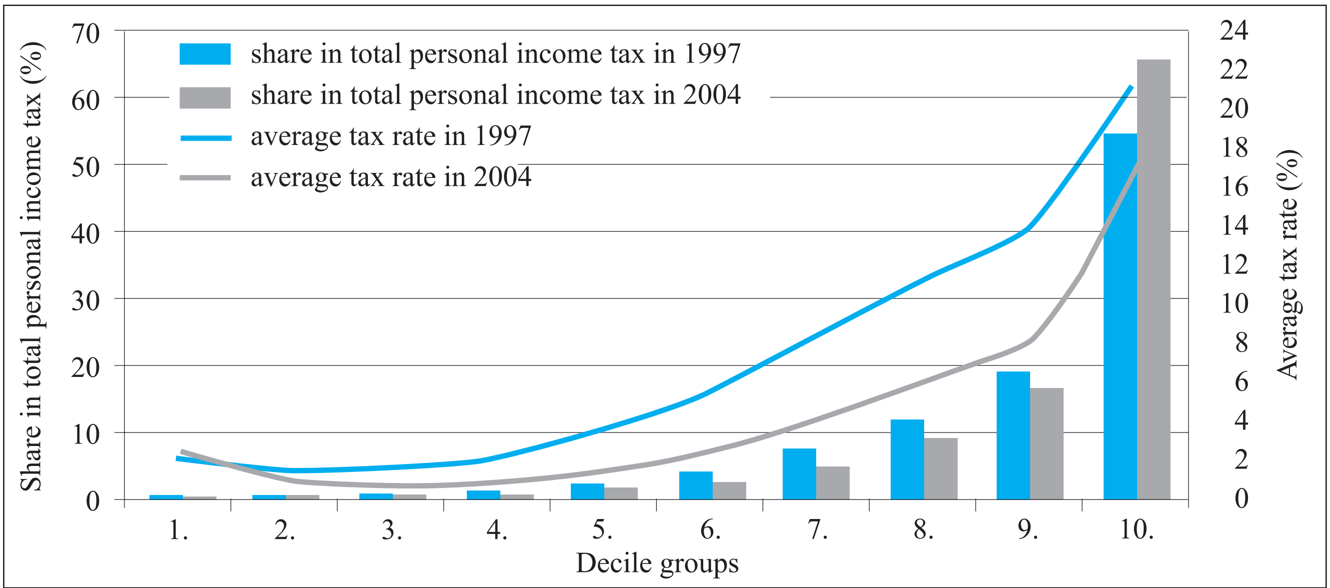
The Croatian tax system generally satisfies the criteria of a "good" tax system. It generates sufficient revenues for the treasury and is largely based on VAT. The tax system in which consumption is taxed more heavily (through an extensive implementation of VAT) than savings and investments (dividends, interest and most capital gains are not subject to tax) certainly has beneficial effects on economic development. However, one has to be aware of some drawbacks of the system, e.g. a large share of social security contributions and numerous tax relief, exemptions and deductions which distort market conditions and complicate the tax collection process.

2 The key features of personal and corporate income taxes

The personal income tax system has been repeatedly distorted. At the time of its launching, in 1994, in accordance with the principle of consumption taxation instead of imposing tax on savings and return on investment, personal income tax was not applied to interest on savings deposits, dividends and certain capital gains. The personal income tax rates were 25%[1] and 35%. A third tax rate of 15% was introduced in 2001, and a fourth one, 45%, two years later. Till 2000, the

[1] In the period 1997-2001, the rate was 20%.

Figure 3. Distribution of Collected Personal Income Tax and Average Tax Rates by Decile Group



Source: IPF calculation based on the Tax Administration data.

personal income tax system included only one tax relief – personal allowance. After that, the number of tax relief picked up to reach 20 in 2003. As tax exemption and tax relief are usually considered as inefficient, non-transparent, expensive and difficult to implement, they will have to be gradually reduced. The simplification of the tax system would also provide a basis for reducing marginal tax rates. In addition, according to some studies, tax exemptions, allowances and relief are mainly benefited by taxpayers with relatively high income, rather than the lower-income citizens for whom they are originally intended.

The average personal income tax is on a decrease, and its heaviest burden is born by better-off citizens. While the statutory rates range from 15% to 45%, the actual personal income tax rates are markedly lower, due to numerous allowances and exemptions, ranging, e.g. in 2004, from 3% to 16%, depending on the decile groups[2]. Moreover, the contributions of nine out of ten decile groups to total personal income tax collected were smaller in 2004 than in 1997. The tenth and highest-income group accounted for 55% of total personal income tax collected in 1997, and as much as 66% in 2004. Accordingly, the government collects about two thirds of its total personal income tax revenues from better-off citizens and their relative tax burden increases.

The levels of personal income tax and social security contributions determine the gross labour cost for employers and affect the competitive strength of the Croatian economy. The tax wedge shows the percentage of employees' gross wages that are calculated and paid into the budget by employers in the form of taxes and social security contributions[3]. A comparison of the tax wedge in Croatia with those in other countries also shows the relative price of labour. In 2005, the tax wedge stood at 39% in Croatia and was below those in the six neighbouring EU countries and below the EU average (only Slovakia reported a slightly lower tax wedge than Croatia). However, the tax burden in Croatia is still above the OECD average, and much higher than that in most prospering OECD countries like Korea, Mexico, New Zealand and Ireland. In order to stimulate competitiveness on the foreign markets (especially the non-EU markets) it is necessary to start reducing the labour price, primarily by cutting social security contributions. The actual problem in Croatia is not the personal income tax, which is relatively low compared with that in other countries, but social security contributions, primarily the contributions payable by employees, which account for one of the heaviest tax burdens worldwide. However, cutting social security contributions is closely linked with health and pen-

[2] Decile groups are obtained in the following manner: taxpayers are arranged in an increasing order of income before tax and then divided into 10 groups with equal numbers of individuals. The first decile group is the ten percent of population with the lowest before-tax incomes and the tenth decile group contains taxpayers with highest before-tax incomes.

[3] The tax wedge is calculated for an average single employed individual without children.

sion insurance reforms, which should ensure restoring the original nature of social security contributions, i.e. making them dependable on the scope and quality of services rendered.

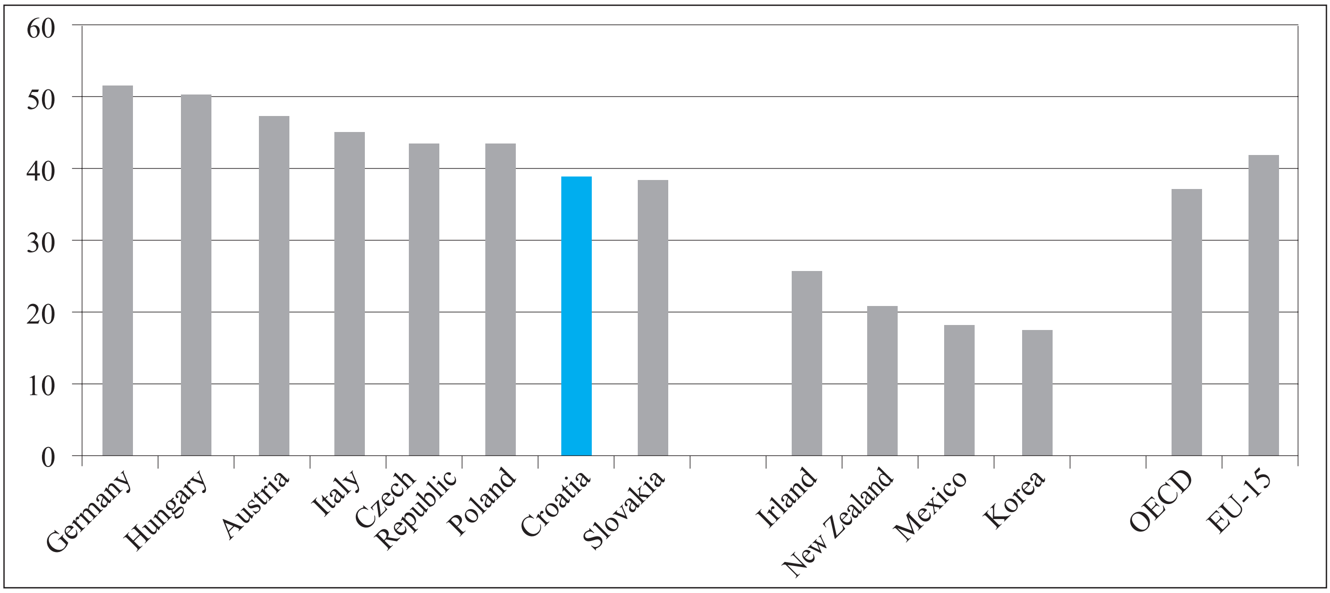
Substantial changes in corporate income tax have been introduced since 2001, by abolishing protective interest, reducing the tax rate and redesigning the tax relief system. At its outset in 1994, the Profit Tax Act regulated the so-called protective interest. Protective interest was a specific type of tax incentive for entrepreneurs, because only the above-average profit and not the 'normal' profit was taxed (hence its name 'protective interest')[4]. Corporate income tax underwent significant changes in 2001, when protective interest was abolished and the tax rate reduced from 35%[5] to 20%. The changes in corporate income taxation continued into 2005, by moving tax incentives for the areas of special state concern, mountain and highland areas, the City of Vukovar and free economic zones from the Profit Tax Act to the acts regulating these areas. This was followed by further changes in 2007, resulting in the abolishment of other tax relief (tax incentives for employment, R&D, occupational training and improvement and occupational rehabilitation of disabled persons). Investment incentives were regulated by the new Investment Promotion Act. Accordingly, while some tax reliefs were abolished, others were just 'moved' to other relevant legislation and their abolishment is yet to come.

Low corporate income tax stimulates investment. Corporate income tax rates in Croatia are below the average for EU Member States, which is certainly a competitive advantage in attracting foreign investors. Moreover, the corporate income tax does not hinder total domestic investment growth, which has strengthened dynamically in recent years: from 4.8% in 2005 to a high 10.9% in 2006. It is worth noting, however, that since the abolishment of protective interest rate in 2001, the corporate income taxation system has given high priority to investment financing by borrowing over the financing by retained earnings. Given the steep growth of borrowing and relatively undeveloped capital market, it is necessary to re-examine the possibilities to redesign the corporate income taxation in order to discourage investment financing by borrowing.

3 Is there a need to introduce the taxation of dividend and capital gains in Croatia?

There is no need to re-introduce the taxation of dividend. Dividend is a part of the profits of a company that is paid to the shareholders. After paying tax, a company

Figure 4. Tax Wedges in Selected Countries and Croatia, 2005 (%)



Sources: OECD and Blažić, H."Comparative Tax Systems – Income and Profit Taxation", Faculty of Economics, University of Rijeka; Rijeka, 2006.

[4] Protective interest was calculated by applying the protective intrest rate of 3% (subsequently 5%) on invested capital and was deductible from the profit tax base.

[5] The rate was 25% in the period 1994-1997.

that realises profit has two options: either to reinvest it in its business operations, or pay it out as dividends to its shareholders. In order to avoid double dividend taxation – once at the company level (in the form of the corporate income tax) and again as the taxation of shareholders' income, various systems of dividend exemption by combining exemptions within the corporate income tax with those granted under the personal income tax scheme were used. As these systems proved to be very complicated, the total exemption of dividends from tax has been increasingly implemented. In Croatia, dividend taxation was in force from 2001 to 2005. Since 2005, by introducing exemption from dividend tax for both legal and natural persons, Croatia has completely followed the described recent trends, so that there is no need to re-introduce dividend taxation.

The potential taxation of financial capital gains should be carefully considered.

Capital gains represent the increased value of real property (mainly land and buildings) or financial assets (shares and bonds.) They are determined as a difference between the selling price and the purchase price of the property or assets. Consequently, the capital gains tax is the tax on the increased value of property. In practice there are various approaches to capital gains taxation. In some countries they are taxed like any other income, whereas in others tax rates on capital gains differ from those applied to income, or only some forms of capital gains are subject to tax. Natural persons in Croatia are not liable to pay tax on receipts from the sale of financial assets, which means that financial capital gains are not taxable. For example, if a person sells Pliva shares the profit derived from such a sale is not taxable. By contrast, in the case of a real property sale, the capital gains tax is payable but only if the property was sold within three years from its purchase. However, if the property is sold after the elapse of a three-year period from its purchase, or if the owner has used the property as his/her residence, the tax is not due.

The taxation of financial capital gains involves a series of practical problems. Recently, the idea of imposing tax on financial capital gains (primarily shares) has been increasingly discussed in Croatia. The most frequent argument in support of that is the fact that without this tax the government gives up substantial tax revenues and that well-off citizens are given the opportunity to become even richer by selling securities. While it is true that numerous countries impose tax on at least a part of financial capital gains, it should be noted that their taxation involves a number of open issues which require careful consideration. They are as follows:

- Despite its accelerated growth, the stock exchange turnovers are still modest. As a result, the revenues from this tax would currently make a relatively small contribution to the budget. Although the revenues from such a tax are very difficult to estimate, the amount is said to be between 200 and 300 million kuna. This is a minor share in total tax revenues that contributed 60 billion kuna to the 2005 general government budget. Consequently, the revenues from this "new" tax would be relatively small.
- The argument that "the equity of the tax system would be improved" is also of little relevance, as all studies show that income taxation in Croatia becomes increasingly progressive from year to year. Moreover, equity should be achieved by introducing targeted social benefits for most vulnerable groups of population rather than by infringing on the neutrality of the tax system.
- The taxation of financial capital gains distorts the market by discouraging the sale of securities and stimulating non-taxable investment. The deferred sale of securities results in deferred tax payment, which is why shareholders are reluctant to sell their shares, despite the fact that there are other types of investment that can produce even larger profits. Such behaviour undermines the flexibility of the market.
- Despite being technically feasible, the taxation of financial capital gains proved to be a very complex procedure. It should be clearly determined who will be subject to taxation, whether the gains from all types of securities or only speculative gains will be taxed, how to define the tax base, etc.
- If the taxation of financial capital gains is introduced, it is necessary to consider the exemption of unexpected capital loss which is particularly likely in the stock market.
- Furthermore, given the globalisation of financial markets and high capital mobility, it is increasingly difficult for tax administrations to capture the profits from capital investment.

4 Does the property tax system need redesigning?

It has been repeatedly proposed to enhance the property tax in Croatia. Property tax revenues are largely collected at the local level and their basic purpose is to ensure proportional contribution of citizens to public utilities financing. In EU-15, property tax accounts for an average of about 5% of total tax compared with only 1% in Croatia. The tax is currently paid on vacation houses, vessels and cars, but not on other real property like houses or apartments, and it is intended to subject these types of property to taxation.

The real property tax has certain drawbacks which should be carefully considered before its possible introduction.

- A common reason for introducing real property tax is the desire to improve the equity of the tax system, primarily by taxing the real property of better-off citizens. However, not only the rich are the owners of apartments and houses in Croatia, as 83% of flats are owned by citizens who have acquired them at considerable financial sacrifice, and imposing this tax would seriously threaten their living standards. Well-off citizens will therefore invest in property "invisible" to the tax-collector, such as paintings, jewellery, or luxury goods rather than in real property. The main purpose of introducing the real property tax – improving the tax system equity - cannot be achieved in this way, because the taxpayers for whom it is originally intended can easily avoid it.
- In order to efficiently implement the property tax, the tax administration must have accurate and complete real property lists, including the data on the size and location of a particular real property item and its owner. As it is expected that some individuals will not provide accurate, up-to-date and complete information on their real property, the government must ensure a well-designed information base for the proper assessment and efficient control of the tax.
- A special challenge is the establishment of the market value of real property. Real property represents heterogeneous goods and it is difficult to find the two items that match by all criteria. The value of real property depends on a number of factors: location, age, the quality of construction and equipment, position within the building, etc. The value of land depends on its location, quality and size, as well as on the quality of its surroundings. Therefore it is difficult to assess the exact value of the real property, so that there are often differences between the value assessed for taxation purposes and the property's market value. The property evaluation is additionally complicated by inflation, which requires annual revaluation of the property in order to maintain its real value.
- The introduction of property tax also implies the need to review the existing system of utility charges, as by introducing property taxation they should be abolished or reduced.

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