

# The impact of changes in the Personal Income Tax Act on the average tax rate

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*Source / Izvornik:* **Press releases, 2014, 7, 1 - 3**

**Journal article, Published version**

**Rad u časopisu, Objavljena verzija rada (izdavačev PDF)**

<https://doi.org/10.3326/pr.2014.71>

*Permanent link / Trajna poveznica:* <https://urn.nsk.hr/urn:nbn:hr:242:510116>

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*Download date / Datum preuzimanja:* **2025-02-05**



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# PRESS RELEASES

## The impact of changes in the Personal Income Tax Act on the average tax rate

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**The Government of the RC, at its session on October 30, adopted a **proposal** for amendments to the Personal Income Tax Act, which had been announced for some time.<sup>1</sup> In this article, we comment on changes to the amount of the basic personal allowance and the size of tax brackets.<sup>2</sup> After the changes, the personal income tax system will continue to be progressive, while the average tax rate will decline for all taxable persons whose tax liability under the current scheme is greater than zero kuna.<sup>3</sup>**

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This is the third such change in the personal income tax since the onset of the economic stagnation in 2009. Specifically, on July 1, 2010, the number of rates fell from four (15, 25, 35 and 45%) to three (12, 25 and 40%). Then, on March 1, 2012, the amount of the basic personal allowance went up from HRK 1,800 to HRK 2,200 and the tax bracket sizes changed insofar as the 40% rate was applied to the portion of the tax base exceeding HRK 8,800 (instead of the previous cut-off amount of HRK 10,800).

The current three-rate tax schedule, which can be called a *general tax rate schedule*, is applied in the taxation of income from salaries and pensions and of the total income reported in annual tax returns. Besides the general tax rate schedule, there are also *individual tax rate schedules* for the taxation of other income, capital income, income from rentals, etc.<sup>4</sup>

Table 1 shows differences in the levels of the basic personal allowance, marginal tax rates and tax brackets between the current and the proposed new income taxation scheme. We can observe two changes: (a) an increase in the basic personal allowance by HRK 400, and (b) the expansion of the 25% tax bracket by HRK 4,400.

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<sup>1</sup> A proposal for an Act on Amendments to the Personal Income Tax Act, together with the final Act Proposal, the 189<sup>th</sup> government session, October 30, 2014.

<sup>2</sup> This analysis does not include changes in the personal allowances of pensioners and persons living in supported areas, or changes in the taxation of interest on savings and capital gains. The issue of compensating for reduced revenues from personal income tax and surtax is also not addressed.

<sup>3</sup> Note that taxable persons whose personal income tax liability under the current scheme is equal to zero kuna cannot benefit from the said changes, because the tax liability cannot be negative, i. e. go below zero kuna.

<sup>4</sup> For more information, see the article by Marija Zuber „Prijedlozi za porezne promjene“, *Banka Magazine*, July 10, 2014.

**Table 1** Tax brackets and the basic personal allowance under the current and the proposed new rules

	Current scheme	Proposed new scheme
Basic personal allowance (in HRK)	2,200	2,600
Marginal rates (%) and tax rate brackets (in HRK)	12 25 40	0 – 2,200 2,200 – 8,800 > 8,800
		0 – 2,200 2,200 – 13,200 > 13,200

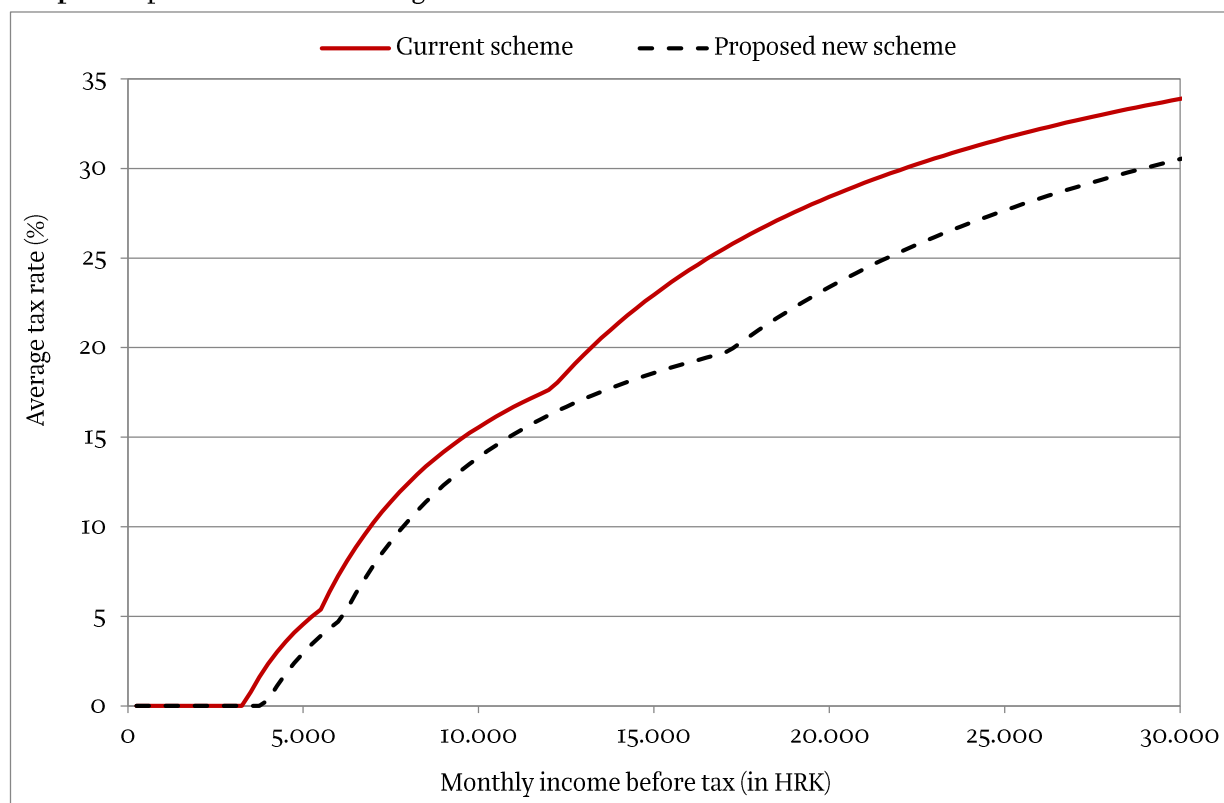
Source: Personal Income Tax Act, and Government of the RC, 2014.

Below we will show the amounts of tax reduction for taxpayers with different levels of income and will find out whether the personal income tax has remained progressive, i. e. whether taxpayers with higher income continue to shoulder heavier average tax burdens.

*Income before tax* is the income subject to personal income tax. In the case of income from salary, the income before tax is equal to the gross wage minus contributions 'out of wage' (pension insurance contributions).<sup>5</sup> *The tax* is the sum of the personal income tax and the related surtax. *The average tax rate* is equal to the ratio between the tax and income before tax.

Graph 1 shows the relationship between the average tax rate (ATR) and income before tax under the current and the new proposed schemes. The calculation applies to hypothetical taxpayers with one dependent family member (a child or an adult), who are subject to surtax at a rate of 12%.<sup>6</sup>

**Graph 1** Dependence of the average tax rate on income before tax



Source: Authors' calculation.

<sup>5</sup> The person liable to pay contributions 'out of wage' is the employee. There are also contributions 'upon wage', payable by the employer (health insurance and employment contributions). The contribution base for all contributions is the gross wage. For more information, see the booklet *Doprinosi za obvezna osiguranja* (Compulsory Insurance Contributions), Ministry of Finance, 2014.

<sup>6</sup> The surtax rate of 12% roughly corresponds to the average surtax rate in Croatia.

Let us first look at the shape of the ATR curve under the current scheme. Taxable persons with income below HRK 3,300 are not subject to tax, because their income is lower than the total personal allowance.<sup>7</sup> After that amount, the ATR curve rises steeply. A taxpayer with an income of HRK 5,250 pays 5% of his/her income for tax and surtax. A taxpayer with earnings of HRK 13,200 pays tax at an ATR of 20%. For taxpayers with even higher income, ATR goes up to a maximum of 44.8% in the case of very high income levels.<sup>8</sup>

Given that the ATR grows in the entire area of income before tax, we say that the personal income tax is progressive. In other words, persons on higher income pay more tax in both absolute and relative terms.

Now, what happens to the ATR if the proposed new scheme is adopted? This is shown by the second curve in Graph 1. This curve lies under the one representing the current scheme, which means that the average rate falls for all taxpayers (except those whose tax liabilities under the current scheme have been zero kuna). The reduction in ATR for taxpayers with an income between HRK 3,500 and HRK 12,500 amounts to about 2 percentage points on average, and is primarily due to an increase in the personal allowance. For taxpayers with an income between HRK 12,500 and HRK 30,000, ATR falls by an average of about 4 percentage points, due to the combined effect of the increase in personal allowance and expansion of the 25% tax bracket.

The finance minister Boris Lalovac has advocated a different proposal, namely the abolition of the 40% rate<sup>9</sup>. Such a scheme would include only two rates, 12% and 25%, but its effects would be equal to those of the „flat rate“ schemes applied across the New Europe, characterised by only one relatively low tax rate. This proposal has been abandoned for now, probably because it would lead to a further loss of the general government's tax revenues, estimated at HRK 2 billion under the proposed scheme.

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<sup>7</sup> Under the current scheme, the personal allowance consists of the basic personal allowance in the amount of HRK 2,200 and the personal allowance for a dependent family member (HRK 1,100), which totals HRK 3,300. Under the proposed new scheme, the personal allowance amounts to HRK 2,600 and the allowance for a dependent family member HRK 1,300 (i. e. half the amount of the basic allowance), which is HRK 3,900 in total.

<sup>8</sup> The highest marginal rate is equal to the rate of 40%, increased by surtax at a rate of 12% ( $40 \cdot (1 + 0.12) = 44.8\%$ ).

<sup>9</sup> Korda, Z., 2014. *Lalovac reže u svom ministarstvu: Učite od mene!* tportal.hr, October 27, 2014.