Developments in the Croatian Tax System

Kuliš, Danijela

AN OCCASIONAL PUBLICATION OF THE INSTITUTE OF PUBLIC FINANCE

NEWSLETTER

INSTITUT ZA JAVNE FINANCIJE

Institute of Public Finance, HR-10000 Zagreb, Katančićeva 5 Croatia

P.O.Box 320, Phone: (385 1) 4819 363; Fax: 4819 365; e-mail: office@ijf.hr; www.ijf.hr

No. 14, December 2003

Danijela Kuliš

Developments in the Croatian Tax System

The main principles on which the Croatian tax system was established by introducing a tax reform ten years ago are still broadly observed, despite the deviations caused by current economic and political changes. While some of the changes represent a move in the right direction (e.g. decreasing of the tax burden, giving priority to consumption taxation over taxation of income and savings, reducing tax evasion, improving the efficiency of tax administration), other changes that have already been effected or announced should be reconsidered carefully while making realistic estimates of the fiscal consequences resulting from their implementation. This relates to the introduction of new forms of tax allowances and exemptions, additional tax rates, e.g. the income tax or VAT rate, reduction of the VAT rate and introduction of new taxes.

Decreasing the overall tax burden

The tax burden expressed as a share of taxes and social security contributions in GDP at the consolidated general government level (Table 1) has gradually decreased and was almost equal (40.8%) to that in EU Member States (41.0%) in 2001. However, this burden is still 5 percentage points higher than in the observed EU Accession Countries.

Table 1 Taxes and Social Security Contributions as a % of GDP, 2001

	Taxes and contributions	Taxes	Contributions
EU Member States			
Sweden	51.4	36.1	15.3
Denmark	49.8	47.6	2.2
Finland	46.1	33.8	12.3
Belgium	45.8	31.4	14.4
Austria	45.4	30.6	14.8
France	45.0	28.6	16.4
Italy	42.0	29.9	12.1
Luxembourg	40.7	29.6	11.1
The Netherlands	39.5	25.3	14.2
United Kingdom	37.3	31.0	6.3
Greece	36.9	25.5	11.4
Germany	36.8	22.2	14.6
Spain	35.2	22.6	12.6
Portugal	33.5	24.5	9.0
Ireland	29.9	25.6	4.3
EU Member States Average	**41.0**	**29.6**	**11.4**
Selected EU Accession Countries			
Hungary	39.0	27.5	11.5
Czech Republic	38.4	21.3	17.1
Poland	33.6	23.5	10.1
Slovakia	32.3	17.9	14.4
EU Accession Countries Average	**35.8**	**22.6**	**13.3**
Croatia (1995)	**44.4**	**30.2**	**14.2**
Croatia (2000)	**42.6**	**29.3**	**13.3**
Croatia (2001)	**40.8**	**27.6**	**13.2**
Croatia (2002)	**41.1**	**28.6**	**12.5**

Sources: Revenue Statistics 1965-2002, OECD, 2003; Ministry of Finance of the Republic of Croatia, 2003.

Reducing social security contribution rates

The share of total social security contributions in the Croatian GDP has also decreased (Table 1) and is approximately 1 percentage point higher than in EU Member States. This favourable trend resulted from reducing the total rates of social security contributions from wages and on wages from 43.4% in 1995 to 37.2% in 2003. This change was by all means beneficial as it led to a reduction in labour costs and improved the competitiveness of Croatian export products. However, it is open to question whether the reduced contributions will be sufficient to cover the existing, but also the growing future needs of the pension and health care systems.

The tax revenue structure

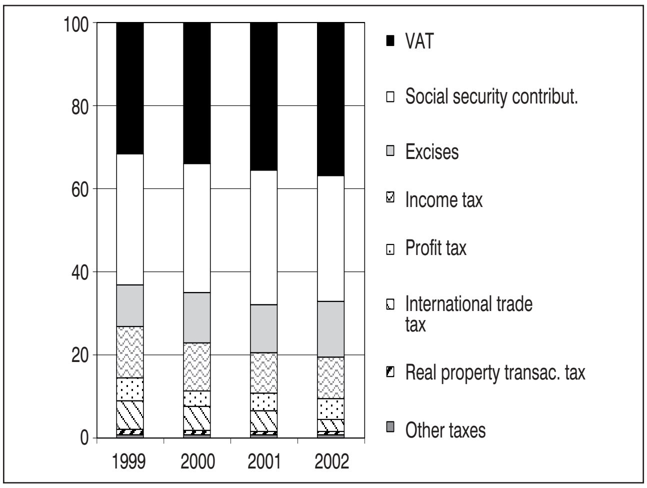
The share of income tax collected in total tax revenues (Table 2) is on the decrease, while the share of turnover tax collected goes up. VAT and excise taxes represent the most significant tax revenues and account for almost one half of the total tax revenues. It is advisable to continue to follow the principle of consumption taxation rather than the taxation of income, savings or investment.

Table 2 Tax Revenues of the Consolidated General Government

(million kuna)	**1999**	**2000**	**2001**	**2002**
Total tax revenue	**62,395**	**65,049**	**66,406**	**72,598**
Income tax	7,538	7,486	6,445	7,227
Profit tax	3,341	2,387	2,789	3,714
Social Security Contributions	19,453	20,282	21,550	21,984
Real property transaction tax	760	804	661	624
Turnover taxes on goods and services	26,537	29,827	31,262	36,527
VAT	19,830	21,979	23,562	26,691
Excise taxes	6,161	7,730	7,699	9,835
Other taxes	546	118	0,0	0,0
International trade tax	4,288	3,795	3,215	2,051
Other taxes	478	468	484	472
Tax revenue structure	**100**	**100**	**100**	**100**
Income tax	12.1	11.5	9.7	10.0
Profit tax	5.4	3.7	4.2	5.1
Social Security Contributions	31.2	31.2	32.5	30.3
Real property transaction tax	1.2	1.2	1.0	0.9
Turnover taxes on goods and services	42.5	45.9	47.1	50.3
VAT	31.8	33.8	35.5	36.8
Excise taxes	9.9	11.9	11.6	13.5
Other taxes	0.9	0.2	0.0	0.0
International trade tax	6.9	5.8	4.8	2.8
Other taxes	0.8	0.7	0.7	0.7
GDP (at current prices)	**141,579**	**152,519**	**162,909**	**176,429**
Share of tax revenue in GDP	**44.1**	**42.6**	**40.8**	**41.1**
Share of social security contributions in GDP	**13.7**	**13.3**	**13.2**	**12.5**

Source: Ministry of Finance of the Republic of Croatia, 2003.

Figure 1 Revenue Structure of the Consolidated General Government (%)



Tax benefits, tax relieves and tax allowances

The often invoked principle that no new tax relief, allowance or exemption should be introduced into the tax system irrespective of the type of tax, has frequently been violated in the last few years.

In *income tax and profit tax,* the already existing benefits (for war veterans, artists, the areas of special state concern and free trade zones) were supplemented by new benefits for highland and mountain regions (reduced tax base, tax exemptions or allowances). As these benefits are regulated by the Highland and Mountain Areas Act (official gazette *Narodne novine,* No. 12/02) the question arises why tax matters are not primarily governed by tax regulations rather than by special legislation*. More specifically, up to 2001 the provisions on tax benefits were incorporated into special acts and have later become part of the tax legislation.

Apart from investment and employment incentives, in late 2003 additional incentives to research and development were introduced into the profit tax and income tax acts. They included a 100%-reduction in the tax base by the costs of research and development and depreciation charges for the acquired intangible assets, as well as the allowance of education and professional improvement costs.

* The Act on the Amendments to the Income Tax Act of 20 October 2003 (official gazette Narodne novine, No. 163/03) includes the provision on tax relief for highland and mountain areas.

As of 1 January 2003, a new income tax allowance was introduced for health care costs and for satisfying certain housing needs, along with a reduction in the tax base for the wages paid to new employees and the amount of awards paid to pupils during their practical work and apprenticeship. This was paralleled with an increase in the basic personal allowance (from 1,250.00 kuna to 1,500.00 kuna), the introduction of an additional 45% tax rate and a change in tax brackets.

At end-2003, the non-taxable amount of special bonuses was increased from 1,000.00 to 1,600.00 kuna.

All these changes in income tax were aimed at relieving the tax burden on income and improving the financial status of lower-income population. Nevertheless, this will certainly result in reduced income tax revenues in the future.

In *real property transaction tax,* a new exemption for the first time property purchase has been introduced. Unfortunately, the exemptions that followed were not regulated by the Act on Real Property Transaction Tax but by other regulations, which resulted in the lack of transparency and impossibility to get full information on a particular tax from the act that regulates it.

The Act on Government Incentive to Housing Construction regulates the tax relief, which allows the Agency for Legal Transactions and Mediation in Real Estate to be exempt from paying tax on the acquisition of land. By virtue of the Act on the Legal Position of Religious Communities from 2002, religious communities are also exempt from tax on the acquisition of religious facilities and the sites for their construction.

A tax allowance for real property transactions has also been introduced in highland and mountain areas.

Reducing the standard VAT rate instead of introducing new rates

Value added tax was introduced on 1 January 1998 with a uniform rate of 22% and was based on the principle of efficiency (as few as possible tax rates and exemptions). As a result of strong pressures from various interest groups that lasted for almost two years, a zero rate was introduced for particular products (bread, milk, books and some medicines). Since mid-2000, the list of products and services to which the zero rate applies has been extended (by including books on CD-ROM, showing movies, delivery of goods by free-lance artists and artistic organisations, in some cases of imports, as well as some tourist services).

During the pre-election campaign, promises were made to reduce the current and/or introduce an additional lower VAT rate. The Croatian VAT rate is definitely higher compared with EU Member States (excluding Denmark and Sweden, which apply the 25% rate), but it remains within the limits of the rates applied in transition countries (19%-25%).

A reduction in the standard rate would be preferable to introducing another rate, but the question is how to make up for reduced budget revenues and how this problem can be solved. There are several options. The first and the best one would be to reduce government expenditure, while the other two (less favourable) options include raising other taxes or introducing new ones.

Some arguments in favour of a uniform VAT rate

- *The introduction of multiple VAT rates requires detailed definition of taxable products.* If foodstuffs are taxed at lower rates in order to support the lower-income groups, should the same rate apply to both cabbage and broccoli? While both vegetables belong to the same group, broccoli is more expensive and thus more frequently eaten by the rich. This dilemma should be resolved by a competent tax administration, which should be able to determine clearly and with valid arguments, which products should be subject to a lower VAT rate.
- *Unclear definition of products opens the way to tax evasion.* This particularly concerns products, which are not unambiguously classified as subject to a lower tax rate. However, the application of multiple rates may lead to bribery and lobbyism, since many wish that precisely their products would be included in the lower-rate taxation category.
- *Multiple rates increase tax collection costs.* A government that applies multiple VAT rates needs more employees to define taxable and non-taxable products and to process more sophisticated tax returns. This also increases the costs of VAT calculation and payment by companies. A famous tax expert and long-time Director of the IMF's Fiscal Affairs Department Vito Tanzi points out that switching from one to two VAT rates doubles the VAT administration costs, while choosing three rates results in ten times higher costs.
- *Lower VAT rates are no guarantee against price growth.* A lower VAT rate on medicines of foodstuffs does not necessarily mean lower prices of these products. Consequently, lower VAT rates cannot guarantee that the poor will be able to buy these products at lower prices. Neither in tourism can a lower VAT rate provide any magic solution to all the problems with which this industry is faced.

- *Lower VAT rates on certain products also help the rich.* It is often stated that lower VAT rates should be introduced to support the low-income population. However, why should the rich, too, be supported by lower VAT rates on food? The poor would be more efficiently helped through direct budget transfers, while food should be taxed at the standard VAT rate.
- *Lower VAT rates result in reduced budget revenues.* In 2002, revenues from VAT accounted for as much as 38% of the total tax revenues of the government budget. Therefore, even a small reduction in the VAT rate could effect significant changes in the level of revenues. By lowering the VAT rate on certain products tax revenues would additionally decrease, which could lead to a rise in some other taxes or a serious re-examination of government expenditure.
- *European Union favours reducing the number of rates.* EU recommends the use of two or three rates for its Member States: a standard rate of minimum15% and two or three lower rates but not below 5% each. The number of rates has been reduced in most EU Member States. For example, Italy, France and Ireland, which used to apply 10, 8 and 6 different rates respectively in 1980s, reduced those numbers to 3, 3 and 4 rates respectively in 2002. Modern theory of taxation mainly supports a single VAT rate with a small number of exemptions and a wide tax base, so further reductions in the number of VAT rates can be expected in the EU.

See more in: Marina Kesner-Škreb: "Ten Reasons in Favour of a Uniform Rate of a Value Added Tax", *Newsletter No. 2*, September 1999.

Table 3 VAT Rates in 2001

	Reduced	Standard
Denmark		25
Sweden	12; 6	25
Finland	17; 8	22
Italy	10; 4	20
Austria	10	20
Belgium	12; 6; 1	21
Ireland	12.5; 4.3	21
France	5.5; 2; 1	19.6
The Netherlands	6	19
Greece	8; 4	18
United Kingdom	5	17.5
Portugal	12; 5	17
Germany	7	16
Spain	7; 4	16
Luxembourg	12; 6; 3	15
Average standard rate in EU Member State		**19.5**
Selected EU Accession Countries		
Hungary	12	25
Slovakia	10	23
Czech Republic	5	22
Poland	7; 3; 0	22
Slovenia	8.5	20
Average standard rate in EU Accession Countries		**24.4**

Source: European Tax Handbook, IBFD, 2002.

Excise taxes

Since 2002, the excise tax system has included the tax on insurance premiums for automobile responsibility, which was supplemented by the tax on premiums for comprehensive motor (automobile) insurance in early 2003. Even though this is not a typical excise tax it has been classified as such in all IMF reports, which is why we do the same. While the taxpayers are insurance companies, they shift the financial burden to the owners of vehicles, who are generally have to pay 10-15% higher insurance premiums due to the introduction of this tax. As the justifiability of excise taxes on non-alcoholic beverages is still disputable (taxable products are discriminated in favour of other food products; they are usually not taxable in the EU; the tax collection procedure is complicated and the share of this tax in budget revenues is relatively small), the tax on insurance premiums for cars was probably introduced in order to compensate (to a certain degree) for the revenue loss that may arise from lifting the tax on non-alcoholic drinks.

Since the beginning of 2002, the implementation and supervision of excise tax collection has been transferred from the Tax Administration to Customs Administration, which is a common practice in other European countries.

Reducing tax evasion

A survey on the unofficial economy in Croatia in the period 1990-2000, conducted by the Institute of Public Finance in 2001, demonstrates that the unofficial economy, measured by using the method of discrepancies in national accounts, declined from some 25% in the period 1990 -1995 to 10% of GDP in the period 1996-2000. One of the factors that influenced this slowdown was the tax system, particularly the introduction of VAT, which resulted in improved tax collection and tax controls and might have also been a sign of a more efficient operation of the Tax Administration.

Conclusions and recommendations

The major breakthroughs in the Croatian tax system include the degreasing of the tax burden expressed as a share of total taxes and social security contributions in GDP, reducing tax evasion and improving the efficiency of the tax administration, as well as relieving the tax burden on income.

The introduction of the new tax exemptions and tax benefits threatens the consistency, transparency and stability of the tax system. The tax collection and controlling procedures become more complicated, thus increasing the costs and reducing the efficiency of the system. Frequent changes, which often include *ad hoc* measures, have adverse effects on taxpayers' economic decision-making. The tax policy should not be used for the implementation of social, economic or development policy measures. Its main goal and purpose should rather be to collect in a most simple, efficient and equitable way, the tax revenues that will be used to cover public expenditures.

Indeed, it is the expenditure side of the budget that represents a problem in Croatia, and no change on the revenue side can improve the status of public finance in Croatia unless a radical expenditure reform is carried out.

Institut za javne financije
Katančićeva 5
Zagreb, Hrvatska
p.p. 320

INSTITUT ZA JAVNE FINANCIJE

Institute of Public Finance
Katančićeva 5
Zagreb, Croatia
PO Box 320

**Poštarina plaćena
u poštanskom uredu 10000
ZAGREB**

TISKANICA