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NEWSLETTER



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What Are the Compliance Costs of Taxation in Croatia for Small Businesses?¹

In Croatia, between June 2001 and June 2002, small businesses, defined as business units that pay personal income tax, spent 1.4 billion kuna on tax compliance costs, the equivalent of 0.8% of GDP.

The tax compliance costs of small businesses, defined as business units that pay personal income tax, referred to below as tradesmen (including women) are constituted by that part of the costs that tradesmen have to bear in order to comply with the demands made on them by the law and the tax authorities, and that surpasses the amount of tax actually paid. These costs of taxation consist of the time of the tradesman, unpaid assistance, the costs of labour employed in the small business, etc (see Table 3). The total annual compliance costs of tradesmen (who pay income tax) in Croatia from June 2001 to June 2002 amounted to the equivalent of 0.8% of GDP. During this period the tradesmen spent about 1.4 billion kuna in order to meet their tax liabilities. Apart from the high costs paid by the

tradesmen, the greatest reason for concern was the fact that more than three quarters of all costs were borne by the smallest small businesses, those with two to three employees, not including the registered tradesman or proprietor.

Effectiveness of the tax. Effectiveness is usually measured as the percentage of tax costs in the relevant tax revenues. The compliance costs of tradesmen's income tax expressed as a percentage in the total revenue collected from tradesmen (the effectiveness of income tax) is exceptionally high, which means that the tax is very ineffective. In order to pay one kuna of income tax, a tradesman has to spend between 65 lipa and one kuna on his compliance costs. By way of explanation, the average yearly revenue from tradesmen's income tax comes to 437 million, which is only slightly higher than the compliance costs incurred by the tradesmen (which add up to almost 98% of that amount). This means that the tradesmen spent practically the same amount to meet the costs of complying with their

¹ This Newsletter is written according to an article by Blažić, H., 2004. "Costs of Taxation of Business that Are Liable to Pay Income Tax", *Financijska teorija i praksa* 3/04, Institute of Public Finance, Zagreb. <http://www.ijf.hr/eng/finpraksa/2004/3-04.html#2>. The present author would like to thank Helena Blazic for permission to use this article.² Companies here are taken to include both companies and establishments that are liable to pay profit tax.

The Institute of Public Finance deals with economic research and analysis related to various forms of public finances such as the budget, taxation and customs duties. Its orientation is thus to the various economic, legal and institutional topics that are important for the sound long-term economic development of the Republic of Croatia. So that the public should be able to have a better insight into certain issues, the Institute of Public Finance is launching its Newsletter, in which it will from time to time publish informed and independent analysis of economic questions. The views expressed in the articles published in the Newsletter will reflect the opinions of the authors, which do not necessarily coincide with those of the Institute as institution. Full text of Newsletter is also available on Institute's Web site: <http://www.ijf.hr/newsletter>.

Table 1. Total annual costs of tax compliance incurred by tradesmen from June 2001 to June 2002 according to kind of tax and size of the business.

| Number of employees | Compliance costs of all taxes (in million kuna) | Structure of all compliance costs under consideration (%) | Income tax compliance costs* (%) | VAT compliance costs (%) | Wages tax and contributions compliance costs** (%) | Compliance costs of other taxes (%) |
|--------------------------|---|---|----------------------------------|--------------------------|--|-------------------------------------|
| 0 | 503.68 | 36.79 | 40.44 | 29.94 | 8.87 | 20.75 |
| 1-2 | 550.84 | 40.24 | 27.00 | 26.88 | 31.81 | 14.31 |
| 3-5 | 176.25 | 12.87 | 21.77 | 43.64 | 27.24 | 7.35 |
| ≥6 | 138.24 | 10.10 | 23.35 | 38.49 | 26.94 | 11.22 |
| total (in %) | – | 100.00 | 31.39 | 31.02 | 21.86 | 15.73 |
| (in million kuna) | 1,369.00 | – | 429.73 | 424.66 | 299.26 | 215.34 |

* Tax on the tradesman's income.

** Tax on the incomes of employees, excluding the proprietor's income, local surtaxes and social security contributions.

tax liabilities, as the whole revenue generated from small businesses' income tax that flowed into the government's coffers in the same period. However, one should also bear in mind the fact that a large part of the costs of tax compliance for tradesmen consists of time spent (according to their own estimation). The gross costs of VAT compliance expressed as a percentage of revenue brought in by VAT are smaller, coming to about 24.3% (from 16 to 25%). This means that VAT effectiveness is greater than that of small business income tax.

Furthermore, the compliance costs paid by tradesmen in Croatia have proved to be regressive, which means that proportionally greater costs during taxation compliance are paid by those who are least capable of paying, that is the smallest small businesses or trades. The structure of compliance costs of tradesmen is dominated by the cost of the time, particularly the time of the proprietor of the trade. All these facts are the outcome of the research into the compliance costs of small business that pay income tax carried out by the Institute of Public Finance. The analysis covered not only tradesmen but also freelance professions and others that are treated in the same way as tradesmen. But in order to obtain a complete picture, the following table should be consulted.

More than three quarters of all tradesmen's compliance costs are borne by the smallest trades with two employees at the most first two classes. In the

structure of costs according to kind of tax, VAT is dominant, and then comes income tax (about 31%). If the costs structure of only those tradesmen that are VAT-registered (36% are outside the system) is taken into consideration then VAT is the most important, at 36.9%. After VAT come income tax (28.6%), and taxes on wages and social security contributions (22%). It is notable that in the third size class (3 to 5 employees) in which there are almost no exceptions to VAT payment, the proportion of VAT related compliance costs rises considerably.

The percentage of income tax compliance costs incurred by tradesmen is high (31%), particularly for the smallest trades, which are rarely in the VAT system and have few or no employees. For the same

Table 2. Average costs of employment per employee (in thousand kuna)

| Number of employees* (excluding the proprietor) | Average costs per employee (excluding the proprietor) | Average costs per employee (including the proprietor) |
|---|---|---|
| 1-2 | 12.9 | 10.0 |
| 3-5 | 6.0 | 4.8 |
| 6 and over | 4.6 | 2.7 |
| total | 10.3 | 7.7 |

* Small businesses with no employees excluded.

Table 3. A full picture of the structure of total compliance costs of the taxation of tradesmen according to kind of cost

| Number of employees not including proprietor | Proprietor | Unpaid assistance | In-house accountant | Other internal costs (not relating to labour) | Outsourced accountancy | Total |
|--|--------------|-------------------|---------------------|---|------------------------|-------|
| 0 | 61.54 | 8.12 | 1.62 | 19.59 | 9.13 | 100 |
| 1-2 | 66.20 | 6.08 | 9.74 | 10.51 | 7.48 | 100 |
| 3-5 | 47.51 | 4.83 | 27.50 | 9.84 | 10.31 | 100 |
| ≥ 6 | 48.55 | 6.37 | 17.70 | 15.55 | 11.88 | 100 |
| total (u %) | 60.52 | 6.94 | 8.34 | 15.28 | 8.89 | 100 |

reason the costs of compliance with wage taxes and social insurance contributions are, as could be expected, small.

The compliance costs of tradesmen are regressive when measured as the costs of compliance per employee, per total size of the labour force including the proprietor and cost per employee.

The table shows that higher costs per employee (including or excluding the proprietor) are indeed borne by the smallest tradesmen, and that the compliance costs are smaller the larger the business. As the smallest tradesmen bear a proportionally larger share of the costs, the compliance costs of the tax are clearly regressive in their effect. The costs per employee in small businesses with one or two employees are three times greater than in businesses with six or more employees.

Internal labour costs are the most important part of the costs borne by tradesmen while complying with their tax liabilities, particularly for the smallest trades. Small business proprietors (particularly sole traders) consider taxation a very interesting issue. The proprietors almost always deal with the problem of taxation and carry out a certain part if not

the entire part of the taxation business, working closely with in-house and independent professionals. Many small trades make use of unpaid assistance, but that percentage falls with the rising size of the trade. On the other hand, the percentage of small businesses that hire tax accountants rises with an increase in the size of the trade.

The research resulted in the following recommendations, aimed at reducing the total tax compliance costs for tradesmen, mainly connected with the effectiveness of the tax:

- The introduction of estimated taxation of the income of tradesmen (this option has in the meantime been put into practice) because the costs of compliance incurred by tradesmen are exceptionally high expressed as a percentage of the relevant tax revenue, that is, the low effectiveness of tradesmen's income tax.
- The introduction of a higher threshold for exception (registration threshold) if the tradesmen pay VAT. The reasons for this are high compliance costs expressed as a percentage of tax revenue and VAT's inefficiency and burden to the small business.

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