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# NEWSLETTER

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## Lost Tax Revenue: How Much Corporate Income Tax the Government Relinquishes?

The existence of various incentives, reliefs and exemptions in the system of corporate income tax in effect means that in 2001 the central government budget voluntarily relinquished 3 kuna out of every 100 kuna of potential collected revenue, while in 2004 it relinquished 11 kuna. The results are shown in table 1.<sup>1</sup>

The table shows that the amounts of tax revenue that the central government budget could have collected, but chose not to, are increasing. Revenue lost from corporate income tax as a percentage of the total central government budget tax revenue increased from 0.15% in 2001 to 0.7% in 2004. In the light of the existence of

a deficit in the central government budget, as well as the local and regional unit budgets, and the ever increasing financial needs, these losses could be looked at as important sources of revenue.

In order to provide more detailed information on reliefs and incentives, we analysed corporate income tax in the 2001 to 2004 period. The final results of the analysis were greatly affected by the fact that from 2000 on new reliefs and incentives (in addition to those already existing) were introduced into the corporate income tax. The rationale behind their introduction was the idea that they would stimulate greater investment in

Table 1. Lost corporate income tax revenue

|   | 2001   | 2002   | 2003   | 2004   |
|---|--------|--------|--------|--------|
| A Central government budget revenue from corporate income tax (in millions of kuna)                     | 1,987  | 2,659  | 3,074  | 3,131  |
| B Total central government budget tax revenue (in millions of kuna)                                     | 40,493 | 42,810 | 45,281 | 47,150 |
| C Revenue from corporate income tax lost to the central government budget (in millions of kuna)         | 60.3   | 86.0   | 261.7  | 336.9  |
| C/A Lost tax revenue as percentage of total central government budget corporate income tax revenue in % | 3.0    | 3.2    | 8.5    | 10.8   |
| C/B Lost tax revenue as share of total central government budget tax revenue in %                       | 0.15   | 0.2    | 0.58   | 0.7    |

<sup>1</sup> For more details, see the journal *Financijska teorija i praksa* 2/06, Institute of Public Finance, Zagreb. Available from: <http://www.ijf.hr/index.php?ime=37>.

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Table 2. Lost revenue because of reductions in the corporate income tax base (in millions of kuna)\*

|  | Lost Revenue             |                             |                          |                           |                          |                           |                          |                           |
|--|--------------------------|-----------------------------|--------------------------|---------------------------|--------------------------|---------------------------|--------------------------|---------------------------|
|  | 2001.                    |                             | 2002.                    |                           | 2003.                    |                           | 2004.                    |                           |
|  | All levels of government | Central government budget** | All levels of government | Central government budget | All levels of government | Central government budget | All levels of government | Central government budget |
| Employment incentives  | 35.7                     | 25.0                        | 59.6                     | 41.7                      | 76.9                     | 53.8                      | 74.0                     | 51.8                      |
| Incentives for research and development                                  | 0                        | 0                           | 0                        | 0                         | 111.5                    | 78.1                      | 124.0                    | 86.8                      |
| Incentives for education, training and personal professional development | 0                        | 0                           | 0                        | 0                         | 62.6                     | 43.8                      | 130.4                    | 91.3                      |
| Total  | 35.7                     | 25.0                        | 59.6                     | 41.7                      | 251.0                    | 175.7                     | 328.4                    | 229.9                     |

\* Calculated by multiplying the tax base by the current rate of 20%.

\*\* Seventy per cent is due to the central government budget.

research and development (R&D) and encourage taxpayers to invest in the ongoing training and education of their employees or to concentrate their businesses in the areas of special national concern. These reliefs and incentives are known as tax expenditures. They can be divided into deductions from the tax base, i.e., taxable corporate income, and deductions from the tax amount due. More specifically, there are three kinds of incentives that are first deducted from the taxable base, and then, there exist five more kinds of reliefs, exemptions and incentives that can be deducted from the tax amount due, resulting in the final corporate income tax liability.

The taxable income of corporate income tax can be diminished with the following incentives:

- for employment (from 2000)
- for research and development (R&D) (from 2003)
- for education, training and personal professional development (from 2003).

The amount of corporate income tax due is diminished for the following reasons:

- reliefs and exemptions for areas of special national concern (ASNC, for Groups 1, 2 and 3, since 2000) and the hill and alpine areas (since 2003)
- reliefs and exemptions for the area of the city of Vukovar (since 2000)
- reliefs and exemptions for users of free zones (from 2000)
- investment incentives (from 2000)
- incentives for occupational rehabilitation and the employment of disabled persons (from 2000).

Tax expenditures, which is another way of referring to revenue lost to all levels of government – municipalities, cities, counties and central government budget – are the consequence of the existence of the numerous reliefs and incentives in the corporate income tax system. These are shown in the following tables.<sup>2</sup> First of all, let us consider the items that reduce the taxable base of corporate income tax.<sup>3</sup>

Total revenue from corporate income tax lost to all levels of government increased practically tenfold in the period under consideration. The central government budget alone, because of incentives given for employment, research and development, and education, training and personal professional development relinquished 25 million kuna in 2001, but 230 million kuna in 2004. In 2001 and 2002 incentives for employment were still under the threshold of pain, but in 2003, when new research and development and education, training and personal professional development incentives were introduced, there was a veritable explosion in loss of tax revenues.

Table 3 shows the items that reduce corporate income tax due.

The amounts of reliefs, exemptions and incentives that reduced corporate income tax due have also increased (from 51 million kuna in 2001 to 153 million kuna in 2004). In line with this, the revenue that the central government budget consciously and knowingly relinquished also grew. The reliefs and exemptions for free zone users stand out for their amount.

## Conclusion

By finally aggregating the amounts of the reduced taxable base and the reduction in the amount of the tax due,

<sup>2</sup> Data concerning reliefs, exemptions and incentives to corporate income tax payers from the Corporate Income Tax Return Forms from 2001 to 2004 were obtained from the Central Office, Tax Agency, Ministry of Finance, January 31, 2006.

<sup>3</sup> For simplicity and readability, the nominal amounts of the reliefs allowed are not displayed here, rather the real lost revenue in the taxation of corporate income tax at all levels of government and of the central government budget was at once calculated, by applying the rate of 20% to the nominal amounts of the reliefs, exemptions and incentives.

*Table 3. Lost revenue because of reduced corporate income tax (in millions of kuna)*

|  | Lost Revenue             |                            |                          |                           |                          |                           |                          |                           |
|--|--------------------------|----------------------------|--------------------------|---------------------------|--------------------------|---------------------------|--------------------------|---------------------------|
|  | 2001.                    |                            | 2002.                    |                           | 2003.                    |                           | 2004.                    |                           |
|  | All levels of government | Central government budget* | All levels of government | Central government budget | All levels of government | Central government budget | All levels of government | Central government budget |
| Reliefs & exemptions in ASNC**                     | 14.2                     | 9.9                        | 18.4                     | 12.9                      | 34.6                     | 24.2                      | 34.6                     | 24.2                      |
| Reliefs & exemptions for Vukovar                   | 5.5                      | 3.9                        | 6.5                      | 4.6                       | 10.0                     | 7.0                       | 13.0                     | 9.1                       |
| Reliefs & exemptions for free zone users           | 30.7                     | 21.5                       | 36.8                     | 25.8                      | 57.5                     | 40.3                      | 63.5                     | 44.5                      |
| Incentives for investment                          | 0.2                      | 0                          | 1.3                      | 0.9                       | 19.8                     | 13.9                      | 41.1                     | 28.8                      |
| Incentives for employing persons with disabilities | 0                        | 0                          | 0.3                      | 0.2                       | 0.9                      | 0.6                       | 0.8                      | 0.6                       |
| Total  | 50.6                     | 35.3                       | 63.3                     | 44.4                      | 122.8                    | 86.0                      | 153.0                    | 107.2                     |

\* Seventy percent is due to the central government budget

\*\* Areas of special national concern

we can get a picture of the total loss of tax revenue in the corporate income tax system. From what has been stated above, it is clear that the total amounts of revenue that could have been collected, but actually were not collected, have been growing multiplicatively.

porate income tax. It should be pointed out that apart from the basic problem that these reliefs and incentives give rise to – i.e., the reduction of budgetary revenue – they cause other problems as well. All these reliefs and incentives in the corporate income tax system also

*Table 4. Total lost revenue in the corporate income tax system (in millions of kuna)*

|  | Lost Revenue             |                            |                          |                           |                          |                           |                          |                           |
|--|--------------------------|----------------------------|--------------------------|---------------------------|--------------------------|---------------------------|--------------------------|---------------------------|
|  | 2001.                    |                            | 2002.                    |                           | 2003.                    |                           | 2004.                    |                           |
|  | All levels of government | Central government budget* | All levels of government | Central government budget | All levels of government | Central government budget | All levels of government | Central government budget |
| Reductions in taxable income                         | 35.7                     | 25.0                       | 59.6                     | 41.7                      | 251.0                    | 175.7                     | 328.4                    | 229.9                     |
| Reductions of the amount of corporate income tax due | 50.6                     | 35.3                       | 63.3                     | 44.3                      | 122.9                    | 86.0                      | 152.9                    | 107.0                     |
| Total  | 86.3                     | 60.3                       | 122.9                    | 86.0                      | 373.9                    | 261.7                     | 481.3                    | 336.9                     |

\* Seventy per cent is due to the central government budget.

While in 2001 the tax revenue in the corporate income tax system lost to all levels of government came to only 86 million kuna, in 2004 it had risen to almost half a billion kuna. Year by year, the central government budget voluntarily relinquishes increasing resources that are devoted to the various incentives, reliefs and exemptions in the corporate income tax system. Thus in 2004 alone the central government budget “spent” 337 million kuna for these purposes.

At the opening of this paper we stated that in 2001 the central government budget gave up 3 kuna out of 100 kuna that it could have collected, and in 2004 it gave up 11 kuna. This figure is derived from the comparison of the total central government budget lost revenue with the actual central government budget revenue from cor-

porate income tax. It should be pointed out that apart from the basic problem that these reliefs and incentives give rise to – i.e., the reduction of budgetary revenue – they cause other problems as well. All these reliefs and incentives in the corporate income tax system also

increase the administrative costs of taxation, which also should not be ignored. But the real question is whether these incentives and reliefs have achieved the aim for which they were intended, for example, have they reduced unemployment and underdevelopment in the areas of special tax treatment, have they had a positive effect on the economic and social trends in the areas to which they refer? Yet the closer Croatia is to the final moment of acceding to the European Union, the stronger is the need to harmonise the Croatian tax legislation with that in Europe, which means that some of these reliefs will necessarily have to be abolished; these, however, are open questions that will have to be left for some future investigations.

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