ISSN: 2787-7639 DOI: 10.3326/in.2023.131

IPF NOTES

#131
21 June 2023

Changes to tax legislation in 2023

Ivica Urban, Slavko Bezeredi, Vjekoslav Bratić

On 24 May 2023, the Croatian Government presented changes to tax legislation affecting various forms of taxation. The key changes pertain to the introduction of a relief for calculating contributions to Pillar I of pension insurance, the abolition of surtax and autonomy of local government units (cities and municipalities) to freely define the personal income tax (PIT) rate and the increase of personal allowances in the income tax system. This Note analyses the effects of the proposed measures to the tax burden of a hypothetical employee, discusses their advantages and potential threats to autonomous definition of tax rates and suggests potential alternatives to the proposed contribution relief.

Key changes

The Croatian Government has highlighted the following as primary objectives of the tax reform: “increasing the real purchasing power of lowest-income households and reducing inequalities", "maintaining economic growth" and "enhancing fiscal autonomy of municipalities and cities". Even though the reform has been announced to affect various forms of taxation, the following three changes have been highlighted:

(1) A relief in the calculation of contribution for pension insurance Pillar I is being introduced, whereby this contribution is reduced for employees whose monthly gross salary is below EUR 1,300. The relief amounts to EUR 300 if the gross salary is EUR 700 or lower. For each EUR 1 of gross salary above this threshold, the relief amount shall be reduced by EUR 0.50, leading to a zero relief for gross salaries of EUR 1,300.

(2) The surtax to the PIT is being abandoned, while cities and municipalities are free to define "floating" rates of PIT within pre-defined ranges. The current annual personal income taxation system includes two rates: 20% ("lower rate") and 30% ("higher rate"). In order to make up for the potential budget deficit caused by the abolition of surtax, the new system will enable cities and municipalities to increase these rates by a certain percentage, depending on their category.[1] In addition, they will also be able to reduce the lower rate to as low as 15% and the higher rate to as low as 25%.

---

[1] This increase percentage shall be as follows: (a) 18% for the City of Zagreb, (b) 15% for cities with a population above 30,000, (c) 12% for cities with a population below 30,000 and (d) 10% for municipalities.

(3) Monetary parameters in the PIT system are being amended. The following parameters will be increased: basic personal allowance (from EUR 530.90 to EUR 560, i.e., by 5.5%) and parts of personal allowance for dependant family members and children and disability (for instance, for first dependent child from EUR 232.27 to EUR 280, i.e., by 20.5%), while the threshold for the application of the higher rate is also being raised (from EUR 3,981.69 to EUR 4,200 per month, i.e., by 5.5%).

Effects of the proposed changes

Parameters in the personal income tax system

The average tax rate increases if, over the years, personal allowances and other monetary parameters of the PIT system are not aligned with income growth. In order to constrain excessive growth of the average tax burden, personal allowance amounts and other monetary parameters in the PIT system need to be increased from time to time. The Croatian system does not make use of a regular mechanism of aligning personal allowances with the growth of personal income and living costs (as is the case, for instance, with pension actual value alignment); instead, ad hoc changes, such as the ones discussed herein, are more common. The proposed changes will result in a tax burden relief in the amount of around EUR 108 million[2], which should be perceived as the normal consequence of adjusting the PIT system with increasing income in

[2] The reduction would have been even greater if, in parallel to the proposed changes, a relief for calculating pension insurance contributions was not being introduced, which, in turn, increases the PIT base.

order to retain the average tax rate at the same or similar level rather than the "loss of local government revenue".[3]

Abolition of surtax and greater autonomy of local government

Simultaneous introduction of several distinct tax reforms from 2024 will result in manifold changes in local government units' revenues from PIT. To explain these changes and their effects in a simple manner, we use the example of a hypothetical City of G with a population of 25,000 and a surtax rate of 12% in 2023.

We assume that, prior to the announced tax reforms, the City of G was expecting revenues from PIT and surtax in the amount of EUR 11.7 million in 2024. However, due to an increase of personal allowances in 2024, the City of G's expected revenue is reduced to EUR 11.2 million, i.e., by EUR 0.5 million. Therefore, if no other legislative changes occurred, the City of G would be able to plan its 2024 budget with the expected revenue in the amount of EUR 11.2 million.

However, with surtax being abolished, the City of G's expected revenue from PIT drops to only EUR 10.0 million, which constitutes a loss of revenue in the amount of EUR 1.2 million. In order to compensate for the drop in tax revenues due to surtax abolition, the City of G can increase the PIT rate to 22.4% and 33.6% respectively,

---

[3] Namely, despite substantial growth of the average salary and pension, basic personal allowance has been held constant since 2020, while other personal allowances have not changed since 2017. On the other hand, PIT rates have been substantially reduced in 2021, from 24% and 36% to 20% and 30% respectively.

which are the maximum permissible rates for a city of its size. With such rates, the City of G would collect revenues from PIT in the amount of around EUR 11.2 million, thus neutralising the loss of revenue due to surtax abolition.

However, the City of G can also choose a completely different direction, i.e., it could introduce lower rates than the maximum, but not lower than 15% for the lower or 25% for the higher rate, thus collecting substantially lower PIT revenues, depending on the selected rates.

Each local government unit will have to decide for itself how to adapt to these changes and balance their budgets. If the local government estimates that raising PIT rates would be an unpopular decision, they might opt for other scenarios, such as adjusting their expenditures and/or increasing existing local taxes. In any case, this major decision has been transferred to the level of local government units, who will have to decide on the path they will pursue. Heads of cities and municipalities need to be very cautious when defining new PIT rates. Reducing rates to the lowest possible levels may sound as a politically very attractive option, but any future planning must consider the potential vast reduction of tax revenues. For instance, in the example of the City of G introducing 15% and 25% rates can lead to revenues being reduced to EUR 7.5 million, which is almost one-third of the maximum potential revenue.[4]

---

[4] The baseline threshold for applying the higher rate is quite high (EUR 4,200 per month), so the higher PIT rate is applied to a relatively small number of taxpayers. Hence the key role for setting the overall PIT revenues will be played by the lower rate.

In addition, the general public would expect from cities and municipalities to reduce their tax rates in order to stimulate the increase of living standard of citizens living on their territory. However, the living standard of citizens is not observed only through their net salaries but also through the services financed by the local units, with PIT being the most substantial source of funding for these services.

Furthermore, cities and municipalities have been granted greater autonomy in defining PIT rates, but many other important parameters are still under the central state's authority. In the context of the most recent changes to the PIT system, additional reforms that would establish mid-term planning of important system parameters (to a period of 5 to 10 years) are also advisable, such as changes to the personal allowance amount and the baseline threshold for applying the higher tax rate, which enable local units to plan their budget revenues in an easier and more efficient manner.

New relief in the system of pension insurance contributions

Personal allowances in the PIT system are relatively high, especially considering relatively generous allowances for children and dependent family members. For this reason, employees receiving the lowest salaries pay no PIT or pay very low amounts. Increasing allowances in the PIT system is not an efficient measure for raising net income of such persons, just like reducing the rates themselves can also make no difference.

So how can the tax burden of employees with lowest salaries be reduced? The difference between gross and net salaries is produced by the pension insurance contributions (Pillars I and II), PIT and surtax. Since there is no efficient method for affecting PIT and surtax, the Croatian Government decided to introduce a relief reducing the Pillar I contribution amount, with Pillar II contribution remaining intact. The measure applies to all employees whose monthly gross salary is below EUR 1,300. Employees whose monthly gross salary is EUR 700 shall be entitled to a relief of EUR 300, which in effect represents a EUR 45 reduction of benefits paid. However, this amount now becomes taxable income, so if we apply only the basic personal allowance (with no dependants and no disabilities), the PIT baseline now increases by EUR 45, while the PIT increases by EUR 9. This means that the effect of the relief has partially been annulled.

The greatest debate regarding the present measure revolved around the issue of intervening into the system of contributions, which are used for financing the pension system, as the system is presently not collecting sufficient funds to finance existing pensions. This relief shall result in an annual contribution revenue deficit in the amount of EUR 329 million, which will be covered by transferring the funds from the central state budget and/or borrowing, as is the case with the pension system's present deficit. Was such a measure possible without affecting the pension system?

In comparison, many European countries introduced so-called refundable tax credits into their national fiscal systems.[5] In such a

[5] "Tax credit" is applied after the tax base has been calculated and tax rates have been applied and should not be identified with personal allowances, which represent "tax base reductions" and are calculated before the tax

system, the final or "net" PIT payable by an employee is calculated as the difference between the "gross" PIT and the amount of the tax credit. If the tax credit exceeds the gross tax burden, the employee is entitled to "negative tax" payable in the form of tax refund. The tax credit amount can be modelled in numerous ways. One way would be to award maximum credit to employees with the lowest gross salaries, after which the credit amount would decrease in a linear manner as the salaries increase – a similar idea is behind the proposed contribution relief.

Therefore, one alternative to the contribution relief may be the tax credit referred to above, whereby the negative tax refund would be paid from the central state budget. Employees' contributions would be payable in full, as was the case until now, but their net salary would increase due to negative tax. In addition, this measure could be further adjusted to specific categories of employees, for instance more "vulnerable" groups, so that the relief amount increases for persons with children, single parents etc.

Another alternative to the contribution relief as presented herein could be in the form of a separate social benefit (i.e., monetary compensation) that would be calculated using the same formula as the tax credit above and paid in full together with the net salary. Advantages of a social benefit as opposed to tax relief are easier and cheaper administration and greater transparency.

---

rates are applied. The Croatian PIT system recognises several types of tax credits (for instance, for young employees), but they can never lead to negative tax amounts.

Many countries that introduced such measures did so in order to not only increase the net income of persons with low salaries but also to "make work pay" for such groups, i.e., to motivate working-age individuals with low employability to enter the labour market and remain there, instead of staying home and receiving social welfare.

In order to illustrate the effects of individual changes in the taxation system, below we present calculations for a hypothetical individual with various levels of monthly gross salary.

Effects of the proposed changes

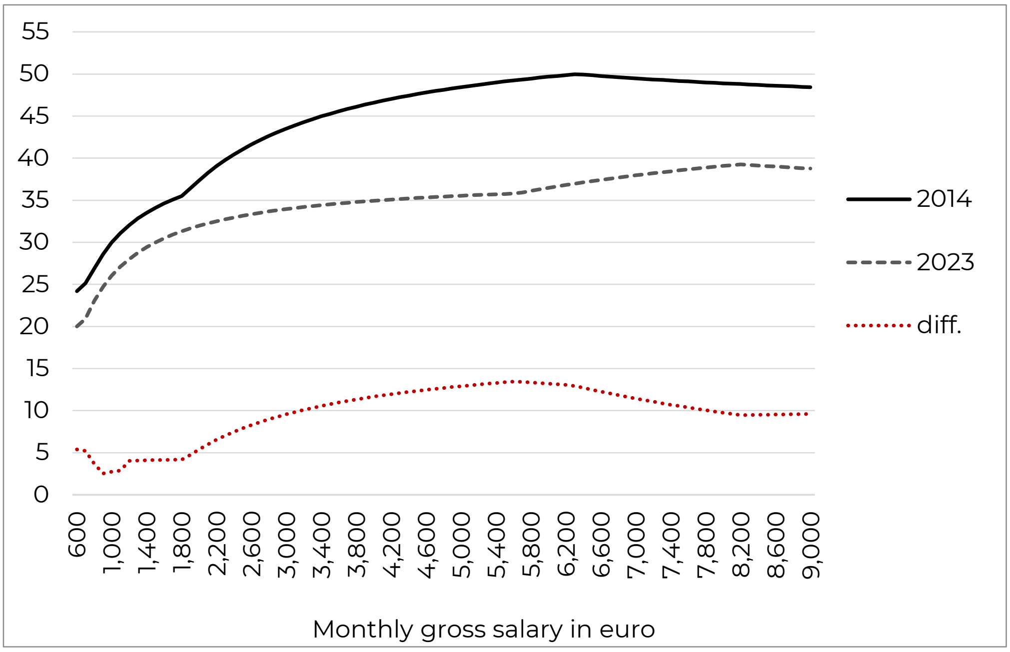
The hypothetical individual is assumed to be 40 years old, with no dependants, living in a city with a 12% surtax rate, working all 12 months in a year, 40 hours a week and receiving no non-taxable receipts.

We analyse pension insurance contributions (Pillars I and II), PIT and surtax. These charges account for the difference between gross and net salary and shall hereinafter be referred to as "mandatory salary contributions".

Graph 1 presents the share of mandatory salary contributions in gross salary for 2014 and 2023 for gross salary ranging between EUR 600 and 9,000. We also present the difference in percentage points ("diff."), which reveals the reduction of relative tax burden for each individual gross salary amount. For monthly gross salary of up to EUR 2,000, this difference amounts to around 5%, while for gross salaries between EUR 3,000 and 8,000, it exceeds 10%.

Since there have been no reforms to the pension insurance contribution system between 2014 and 2023, all the differences above can be attributed to the changes to the PIT. It is clear that the higher salaries recorded higher tax burden reductions, both in a relative and absolute sense.

Graph 1. Share of mandatory salary contributions in gross salary, for a hypothetical taxpayer in 2014 and 2023 (%)



The following analysis compares the mandatory contributions in 2023 with the proposed changes to the mandatory contributions, PIT and surtax systems as of 2024. These changes include the following:

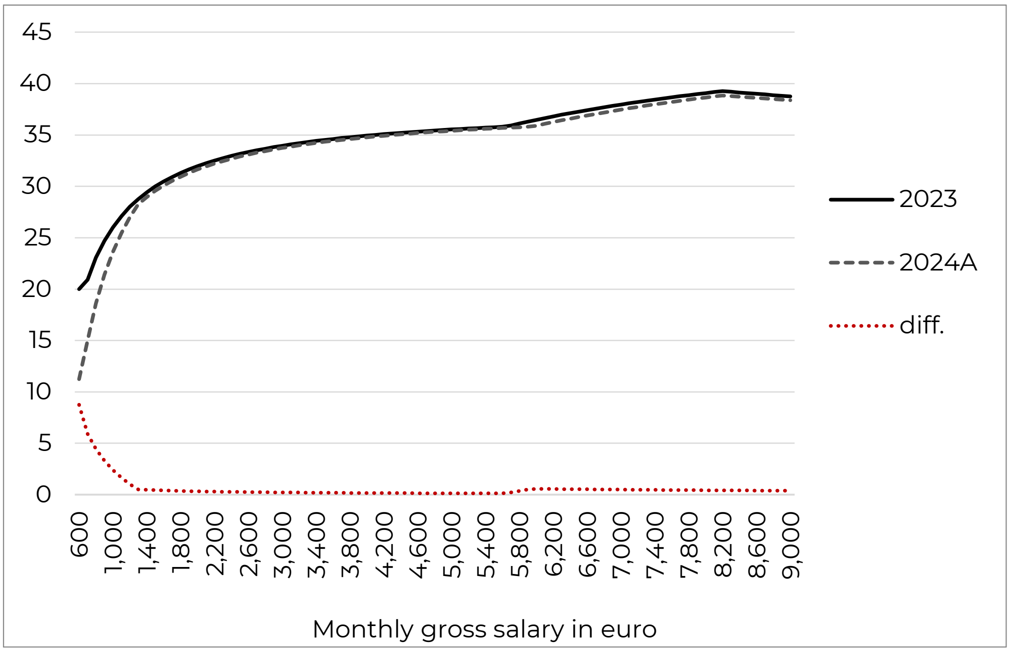
- introduction of a relief for social insurance Pillar I contribution,
- increase of personal allowances,
- abolition of surtax.

Depending on which PIT rate the city will opt for, we distinguish two scenarios:

- 2024A. The city of the hypothetical employee increases the PIT rates to 22.4% and 33.6% respectively in 2024.
- 2024B. The city of the hypothetical employee decreases the PIT rates to 15% and 25% respectively in 2024.

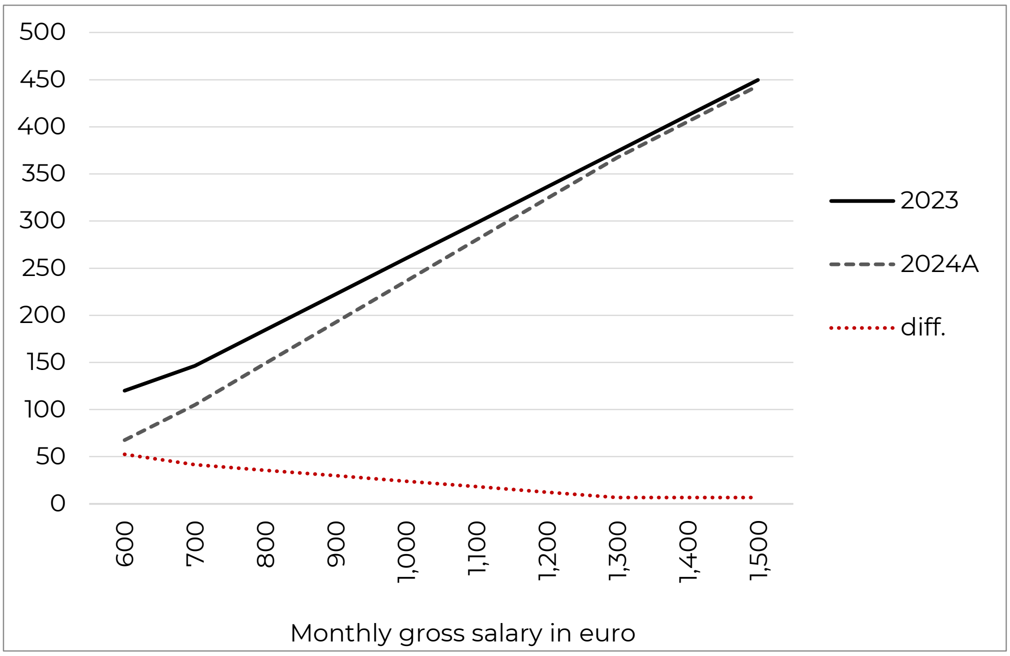
Graph 2 compares the system in force in 2023 and scenario 2024A. The share of mandatory salary contributions in gross salary is lower in scenario 2024A than in 2023. The difference is particularly evident with lowest salary levels, where this share drops to below 20% in scenario 2024A, amounting to around 11% for a gross salary of EUR 600 and to around 15% for a gross salary of EUR 700.

Graph 2. Share of mandatory salary contributions in gross salary, for a hypothetical taxpayer in 2023 and scenario 2024A (%)



Further useful information is provided in Graph 3, which shows mandatory salary contributions in EUR for gross salaries of up to EUR 1,500. Based on this information, we can directly calculate the amount by which net salary in scenario 2024A would rise in comparison to the current 2023 salary. For instance, for a person with a EUR 600 gross salary, net salary in 2024A would increase by around EUR 50, with higher gross salaries accompanied by smaller increases. In sum, in scenario 2024A the reduction of the tax burden is strongest for employees with the lowest salaries, while as salaries increase, this reduction eventually reaches zero.

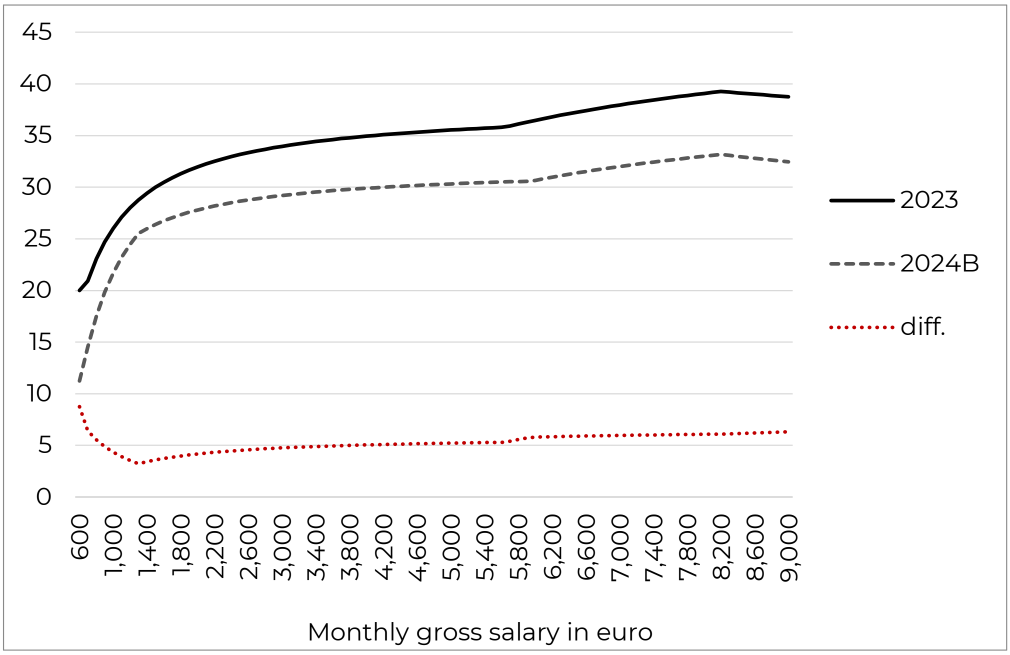
Graph 3. Total amount of mandatory salary contributions in gross salary, for a hypothetical taxpayer in 2023 and scenario 2024A (in euro)



On the other hand, as shown in Graph 4, in scenario 2024B, all salary levels, not only employees with the lowest salaries, would experience a substantial reduction of the tax burden. As shown in

Graph 1, these other salaries have already been relieved of the tax burden several times in the past 10 years.

Graph 4. Share of mandatory salary contributions in gross salary, for a hypothetical taxpayer in 2023 and scenario 2024B (%)



Conclusion

The PIT system underwent numerous reforms in the past ten years, all of them aimed at reducing the tax burden, which primarily benefited persons with above-average income. Having employees with lowest salary levels in mind, the Croatian Government proposed a relief in the pension insurance Pillar I contribution, starting in 2024, which stirred up quite a reaction from the experts in public, primarily because this would lead to a reduction of funds collected for financing pensions, which are insufficient as it is. The present Note describes how the same objective could be achieved by redesigning the tax system through refundable tax credits, which would be paid from the central state budget, instead of intervening into the pension system. An alternative solution would be to design a monetary compensation which would be disbursed together with the net salary but would be administratively simpler and cheaper and more transparent than the contribution and tax reliefs referred to above. Such measures should be designed taking into account the aspect of "make work pay", i.e., they should contain elements which would motivate individuals with low employability to enter the labour market and remain there.

In sum, the new measure – Pillar I relief – benefits the group of employees with lower incomes, which were unable to profit from the increase of personal allowances and reduction of tax rates in the present PIT system. However, giving the cities and municipalities full autonomy to decide on reducing the PIT rate from 20 to 15% and from 30 to 25%, opens the possibility of further reduction of the tax burden; however, this reduction would, once again, benefit those with above-average salaries. This is not necessarily a bad thing, but heads of cities and municipalities should also keep in mind that revenue from PIT could drop substantially, and for many local units this is the main source of financing for public services. Therefore, in the following, relatively short period, local authorities would need to make a key strategic decision as to which direction to follow and how to adjust to the new circumstances.