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### **The Impact of Proposed Changes in Personal Income Tax on the Living Standards of Citizens in Croatia**

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The Ministry of Finance has proposed economic policy measures to mitigate the consequences of the growth in food and energy product prices on the living standards of the population. One of these measures should be the provision of subsidies to individuals and companies and the other is aimed at changing the tax system, specifically, at increasing personal allowances and income tax brackets of the personal income tax (PIT). The goal of this paper is to answer the following question: To what extent will the announced measures increase the disposable income of citizens?

*Should the government introduce measures to compensate the entire population for a potential increase in the prices of certain products?* The author's view of this is negative. The growth in food and energy prices is a consequence of imbalance in the global market, which is beyond our influence. Most citizens adapt themselves to the growing prices of "indispensable" products by reducing their spending on other "less indispensable" goods. The most vulnerable groups, i.e. those who could barely afford the "indispensable" goods even before their prices went up, can be additionally supported by the government through its existing targeted welfare measures, because, as suggested by the analysis below, these citizens cannot be helped by means of the PIT system.

*Then how can the government help, given the growing food and energy product prices?* Simply, by continuing the already launched privatisation and liberalisation processes, by abolishment of subsidies and state-given monopolies, reducing taxes and expenditures and, generally, by withdrawing from the economy. All these activities will improve market competition and, consequently, increase investment and production, which will in turn lead to lower prices of goods and services. Stronger private initiative will also improve the flexibility of the economy and facilitate its adjustment to changes in the global environment.

*Should the government cut taxes?* The government should relieve the overall tax burden, but this should be accompanied by corresponding cuts in expenditures. Reducing taxes and expenditures as a share of GDP should be a gradual and ongoing process, independent of daily politics and precipitate decisions.

In 2005, we provided a detailed description of the impact of the then new Personal Income Tax Act on the living standards of various income groups.<sup>1</sup> Some of the conclusions of this paper were the following:

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<sup>1</sup> The analysis was presented in the [Newsletter No 18](#) of the Institute of Public Finance.

- The PIT in Croatia is pronouncedly progressive, which is also supported by the fact that 10% of the highest-income taxpayers contributed two thirds of total income tax revenues.
- An increase in personal allowance can hardly be a measure to improve the living standards of individuals having no taxable income and those with low incomes (whose income is lower than the current personal allowance).

Here we offer a similar analysis based on the Household budget survey (HBS) for 2006.<sup>2</sup> Households in the sample are first ordered according to the annual disposable income per household member and then divided into five groups with equal number of individuals in each group (quintile groups). Table 1 shows average values of various items per household member. *Non-taxable income* (column 1) represents all income that is not subject to PIT (pensions from abroad, social benefits, income from saving, self-sufficiency farming, and transfers from other persons). *Taxable income* (column 2) represents the income subject to PIT. Column 3 shows the average annual amount of tax and surtax payable by a household member pursuant to current regulations.<sup>3</sup> *Disposable income* (column 4) is the sum of non-taxable and taxable income reduced by PIT and surtax. Column 5 shows the amounts of tax and surtax obtained by a simulation based on future parameters, i.e. the basic personal allowance of 1,800 kuna monthly (3,200 kuna for pensioners).<sup>4</sup> The last column in Table 1 shows the difference between the current and future amounts of tax and surtax.

*Table 1 Average annual amounts of income and tax per household member, in kuna, 2006*

Quintile group	Non-taxable income	Taxable income	PIT and surtax (current regulation)	Disposable income	PIT and surtax (new regulation)	Tax liability reduction
	1	2	3	4=1+2-3	5	6=3-5
1	2,975	7,485	21	10,439	15	6
2	2,817	14,217	186	16,848	131	55
3	3,190	19,840	642	22,388	509	133
4	3,530	27,123	1,455	29,198	1,244	211
5	5,191	46,782	5,747	46,226	5,221	526

*Source: The author's calculations based on the 2006 Household budget survey, made by using the micro-simulation model.*

Quintile group 1 represents one fifth of the population with the lowest disposable income. Owing to the current personal allowance, this group pays almost no PIT and surtax, i.e. it pays as little as 21 kuna on average per household member annually (column 3). In the case of the new (increased) basic personal allowance, the average amount of PIT and surtax would be 15 kuna per household member (column 5), i.e. 6 kuna less (column 6). However, the annual decrease in tax and surtax would be mild or insignificant for other quintile groups as well, ranging from 55 kuna per household member for quintile group 2 to 526 kuna for quintile group 5.

<sup>2</sup> The Institute of Public Finance is developing a micro-simulation model which uses the available data from the HBS (carried out by the Central Bureau of Statistics) and selected parameters to calculate the amount of PIT and surtax for every individual from the Survey sample. Here, the model is used to calculate tax liabilities under two systems, the current system and the proposed new one (available at: [www.vlada.hr](http://www.vlada.hr))

<sup>3</sup> Given a monthly personal allowance up to 3,000 kuna for pensioners and the basic personal allowance of 1,600 kuna for other taxpayers.

<sup>4</sup> Personal allowances for children and supported family members are increased proportionally, because the personal allowance factors are now multiplied by the increased amount of basic personal allowance (1,800 kuna). The tax brackets are also increased proportionally.

Table 2 shows the average annual amounts of total personal consumption per household member (column 2), and, separately, the expenses for food and fuel (columns 3 and 4). Let us assume a 10% one-time increase in food and fuel prices, with the quantities of purchased goods remaining the same. Column 5 shows an increase in annual expenses for food and fuel resulting from such price increase. Now we may set a question, to what extent will the government compensate for higher expenses for food and fuel by reducing the tax burden?

*Table 2 Average annual amounts of income and consumption per household member, in kuna, 2006*

Quintile group	Disposable income	Total personal consumption	Expenses for food	Expenses for fuel	Increase in expenses for food and fuel due to a 10% price increase	Tax liability reduction	Compensation (%)
	1	2	3	4	$5 = (3+4) \times 10\%$	6	$7 = 6/5 \times 100\%$
1	10,439	14,369	5,532	571	610	6	1
2	16,848	18,584	6,538	837	737	55	7
3	22,389	21,908	7,022	1,115	814	133	16
4	29,198	26,746	7,837	1,466	930	211	23
5	46,226	36,441	8,693	1,858	1,055	526	50

*Source: The author's calculations based on the 2006 Household budget survey, made by using the micro-simulation model.*

The average annual expenses for quintile group 1 would rise by 610 kuna; owing to a PIT reduction, their compensation would amount to 6 kuna, i.e. as little as 1% of increased expenses (column 7). Relatively low compensations (from 7% to 23% of increased expenses) would also be made to the next three quintile groups. In case of a 10% price increase, annual expenses for food and fuel for quintile group 5 would rise by 1,055 kuna on average, whereas the tax liability would be reduced by 526 kuna. Consequently, this quintile group would receive a 50% compensation for the loss caused by the 10% price increase. The level of compensation rises according to the growth of income (column 7), but it is relatively modest for most of the population.

## Conclusion

Relieving the income tax burden by reducing tax base has no impact on the incomes of lowest-income taxpayers and can bring about almost no improvement in their standards of living. However, the government can provide special help to this group of population through its targeted social welfare measures.

Although the proposed reduction in personal income tax will slightly increase the disposable incomes of most citizens and alleviate the consequences of the price shock, further efforts are needed to relieve the tax burden, also by cutting the PIT and other tax rates and reducing public expenditures. Tax reductions should not only be made in response to boosts in "indispensable" products' prices, but as part of an independent and well-designed process of long-term fiscal system adjustment.