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NEWSLETTER



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

Between June 2001 and June 2002 the corporate sector in Croatia spent more than 2 billion kuna on taxation compliance activities, which amounts to about 1.2% of GDP.

The Institute of Public Finance tried to assess the total costs of taxing companies, defined as entities liable to pay profit tax². The total compliance costs of the taxation of companies are the part of the costs that a corporate entity has to bear to comply with the demands set by the law and the revenue authorities, and that surpasses the actual amount of tax that is paid. According to kind of tax, all the taxes apart from customs duty and excise duty were analysed – profit tax (or corporate income tax), VAT, wage taxes, contributions for social insurance and other taxes. According to kind of cost, an analysis was made of the costs of labour charged with tax matters within the company, costs inside the company that do not relate to labour (additional software and hardware, forms and office materials, postage,

telephones, professional literature, seminars, travel and court costs) and external costs (independent accounting, tax advisers and the like).

The total annual compliance costs of companies that pay profit tax in Croatia from June 2001 to June 2002 came to a sum equivalent to 1.2% of GDP. Of this amount, a third of all costs were borne by companies with two employees at the most, including the owner of the company. It is significant that with the increasing size of the company, the compliance costs of profit tax fall, the costs of VAT compliance rise, while the proportion represented by wages tax is constant. As far as the effectiveness of tax is concerned, defined as the percentage of the tax compliance costs in the relevant tax revenue, profit tax is the least effective (11.8%), while VAT and wage tax, which amount to 4.5% and 2.9% of the relevant revenues respectively, are relatively effective. The 11.8% proportion of profit tax means that a company that pays one kuna of profit tax also pays an additional 11.8 lipa in the sheer act of com-

¹ This Newsletter was written according to the article Blažić, H., 2004. "Compliance Costs of Business Taxes: Business Units that Pay Corporate Income Tax", *Financijska teorija i praksa* 3/04, Institute of Public Finance, available at the URL: <http://www.ijf.hr/eng/finpraksa/2004/3-04.html#2>. The author thanks 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.

Table 1. Average costs of tax compliance in companies (in kuna)

| Number of employees, excluding proprietors | Average total costs | Average costs per employee, excluding proprietors | Average costs per unit of profit* | Average costs per unit of revenue |
|--|---------------------|---|-----------------------------------|-----------------------------------|
| up to 2 | 19,824 | 16,641 | 0.7421 | 0.0402 |
| 3-5 | 30,217 | 8,033 | 0.4159 | 0.0283 |
| 6-20 | 45,063 | 4,715 | 0.1844 | 0.0105 |
| 21-250 | 80,686 | 1,168 | 0.1198 | 0.0047 |
| more than 250 | 120,130 | 267 | 0.0183 | 0.0009 |
| total | 27,112 | 9,988 | 0.5861 | 0.0321 |

* Only for companies that do make a profit.

pliance with this tax liability (some of this is the time spent by the owner of the company). Similar comments can be made about the other proportions.

The average of overall and unit costs of the taxation of companies according to number of employees is displayed in Table 1.

From Table 1 it can be seen that the average costs rise with an increase in the size of the company. The overall costs, measured per employee, units of profit and units of revenue, are regressive. The regressive effect of the costs of corporate taxation is also seen, visible in the fact that these costs lie relatively more heavily upon small companies. The costs of taxation compliance per employee in the smallest companies are 62 times as great as in the largest companies that have 250 employees or more. Taxation compliance costs per unit of profit are 40 times greater for small companies, and the costs per unit of revenue are 45 times greater.

Taxation compliance costs according to kind of cost

The proportion of proprietors or managers of companies that deals with taxes reduces in all size classes, except in the last. The larger the company, the more proprietors and managers take an active part with other persons inside and outside the companies. On the other hand, though, with a rise in the size of the company, the proportion of unpaid assistance tends to drop. As far as the proportion of proprietor's time costs are concerned, they tend to fall with the rising size of the company. The trend is

completely opposite for costs related to other employees who deal with tax matters, with their proportion constantly rising.

The proportion of independent costs at first rises rapidly because many proprietors in the second size class outsource their tax and accountancy matters. After that, the proportion falls, because an increasing number of accountants are employed in-house, to deal with numerous daily accountancy and tax matters. This is the main reason why the share of these costs is very low in companies with more than 250 employees. In such companies the whole matter of accountancy and taxation is done in-house, while independent sources are mainly used for the specialised services of tax advising.

Table 2 displays costs of tax compliance at the macro-level and the effectiveness of the tax.

As mentioned, the smallest companies with up to two employees bear a third of all the compliance costs of taxation. These companies, constitute 60% of all corporate entities. Furthermore, more than a half of the overall costs of taxation are borne by companies with five employees at the most. Such companies amount to almost 80% of the corporate sector. The largest companies, with more than 250 employees, account for a very small proportion of the compliance costs, only 2.4%, which primarily reflects the fact that there are so few of them. Of the companies that were analysed in this research, there were only 419 large ones, or 0.5%.

VAT is the most expensive tax. It is followed by wage tax, wage contributions and profit tax. The proportion of the compliance costs of profit tax decreases (with growing size of the company)

Table 2. Compliance costs of taxation borne by companies from June 2001 to June 2002 according to kind of tax and size of entity (in millions of kuna and in %)

| Number of employees | Compliance costs for all taxes (in million kuna) | Structure of all the tax compliance costs under review (%) | Compliance costs of profit tax (%) | VAT compliance costs (%) | Compliance costs of wage taxes and wage contributions* (%) | Compliance costs of other taxes (%) |
|--------------------------|--|--|------------------------------------|--------------------------|--|-------------------------------------|
| up to 2 | 760,39 | 37.30 | 24.15 | 42.43 | 23.67 | 9.75 |
| 3-5 | 431,69 | 21.18 | 18.85 | 46.75 | 28.35 | 6.05 |
| 6-20 | 472,85 | 23.19 | 20.40 | 46.86 | 24.14 | 8.60 |
| 21-250 | 324,92 | 15.94 | 10.59 | 55.96 | 27.88 | 5.59 |
| >250 | 48,75 | 2.39 | 10.49 | 65.01 | 22.00 | 2.50 |
| total (in %) | – | 100.00 | 19.31 | 47.49 | 25.34 | 7.86 |
| (in million kuna) | 2.038,60 | – | 393,65 | 968,13 | 516,58 | 160,23 |

* Tax on income on the pay of employees, not including the proprietors of the companies, local surtax and contributions for social insurance.

because of the important fixed element of this tax. On the other hand, the proportion of VAT compliance costs increases because of the rise in turnover and the delivery of goods and services. The proportion of the costs of wage taxes and contributions for social insurance remains more or less a constant.

Effectiveness of taxes

The effectiveness of a tax is usually measured by their costs expressed as a percentage of the relevant tax revenues. For companies that are liable to pay profit tax this percentage amounts to 11.8%, which is higher than relative compliance costs of other taxes. Reasons for this include the constant rise of the proportion, the introduction of numerous tax incentives, the relatively low rate of tax on profit and the fact that almost half of the companies operate at a loss.

The compliance costs for VAT borne by VAT registered entities expressed as a percentage of VAT revenue come to about 4.5%. This is strong evidence of the relative effectiveness of this tax at the

corporate level. In spite of this, it is worth pointing out that this relatively low proportion is affected by the relatively high standard rate of VAT, 22%, without any reduced rates and with a very limited (rare) implementation of the zero rate.

On the basis of the number of employees in the sector analysed, a rough estimate of the profit paying entities' compliance costs of wage taxes and social security contributions as a percentage of the total revenue of these taxes (resulting in the effectiveness of wage taxes) was made, and it amounted to 2.4%.

Finally, it may be said that the overall taxation compliance costs of entities liable to pay profit tax expressed as a percentage of GDP is, at 1.2%, not particularly high. Neither are the proportions of the costs of the different taxes in the relevant tax revenues (taking into consideration corresponding researches in other countries). In other words, this means that the effectiveness of different kinds of tax analysed is relatively reasonable. But it would certainly be necessary, among other improvements of the tax system, to work on the simplification of the taxation system and harmonise the taxation and accounting systems more effectively.

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