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# NEWSLETTER

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## Lost Personal Income Tax Revenue

Because of reductions of the tax base in the form of deductions and reduction of the tax due the central government budget, out of every 100 kuna that might have been collected as personal income tax, voluntarily relinquished almost 10 kuna in 2001, and 13.5 kuna in 2004<sup>1</sup>. The growth in losses of revenue, which the government has voluntarily relinquished in conditions in which the overall personal income tax revenue is anyway in decline, is bringing the central government

budget into a parlous position. The results are shown in Table 1.

The table shows that personal income tax is increasingly losing significance in terms of filling the government coffers. This claim is backed up by the ever-smaller proportion of personal income tax revenue in total tax revenue in the central government budget. From 2001 to 2004 the proportion reduced from 8.4 to 6.6%. This has all been furthered by the constantly

Table 1 Lost personal income tax revenue

	2001.	2002.	2003.	2004.
A Revenue from personal income tax in the central government budget (in million kuna)	3,404	3,363	3,115	3,128
B Revenue lost to the central government budget because of other allowances (D) and reduction of tax due (C) (in million kuna)	333.0	299.4	408.5	422.5
Lost revenue as a percentage of total revenue of government budget from personal income tax (B/A)	9.8	8.9	13.1	13.5
Personal income tax as a percentage of:				
total tax revenue of central government budget	8.4	7.9	6.9	6.6
GDP	2.1	1.9	1.6	1.5

Source: Ministry of Finance (2004:201, 212; 2006:194, 216). Author's calculation

<sup>1</sup> In Croatia there is a budget of all levels of government (called the general budget), consisting of central government budget, budgets of the extra-budgetary funds and the budgets of local and regional units. The central government budget comprises the budgets of ministries and other spending agencies of central government. Spending agencies of the central government budget are those that the government itself founded, their source of revenue is the central government budget, and the spending agency is stated in the register of budget spending agencies.

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Table 2 Lost revenue in the taxation of personal income system (in million kuna)

	Lost revenue							
	2001.		2002.		2003.		2004.	
	All levels of government	Central government budget (Nx0,53) <sup>2</sup>	All levels of government	Central government budget (Nx0,53)	All levels of government	Central government budget (Nx0,53)	All levels of government	Central government budget (Nx0,53)
<b>I. Reduction of the tax base because of other allowances (D)</b>	616.7	326.9	628.7	295.5	939.3	403.9	1042.2	416.9
<i>Excluded receipts</i>								
D1 untaxed receipts of artists, or exemptions and reliefs to private persons who carry out some artistic or cultural activity	0.0	0.0	0.1	0.1	0.1	0.04	0.0	0.0
D2 the untaxed part of artistic royalty or fee	8.0	4.2	7.1	3.3	6.3	2.7	8.1	3.2
<i>Augmented expenditures</i>								
D3 premiums for life insurance that have characteristics of savings, premiums for supplementary and private health insurance, and voluntary retirement insurance premiums	22.9	12.1	87.4	41.1	123.0	52.9	149.0	59.6
D4 income reduction in the PPDS <sup>3</sup> and the city of Vukovar	16.5	8.7	19.9	9.4	21.7	9.3	44.7	17.9
D5 augmented depreciation costs	62.5	33.1	82.6	38.8	189.5	81.5	133.2	53.3
D6 tax deductible entertainment costs	1.4	0.7	0.5	0.2	1.8	0.8	0.7	0.3
<i>Deducted income</i>								
D7 the salaries paid out for newly hired staff and rewards to pupils doing practical work	7.4	3.9	16.8	7.9	19.7	8.5	18.5	7.4
<i>Enlargement of personal allowances for expenditures made</i>								
D8 expenditures for training and personal development of staff, since 2003	–	–	–	–	1.9	0.8	2.5	1.0
D9 expenditures for R&D (100 percent reduction of tax base for costs of R&D and costs of depreciation for intangible assets acquired), since 2003	–	–	–	–	0.0	0.0	0.2	0.1
<i>Enlargement of personal allowance</i>								
D10 additional personal allowance for persons living in the PPDS (1st, 2nd and 3rd categories) and other areas specially treated for tax purposes (hill and mountain areas and islands – 45 units)	90.0	47.7	117.0	55.0	261.9	112.6	311.3	124.5
D11 contributions for health insurance in the country, from 2003	–	–	–	–	0.1	0.04	0.1	0.04
D12 expenditures for healthcare services, from 2003	–	–	–	–	9.7	4.2	22.9	9.2
D13 expenditures for satisfaction of housing requirements, from 2003	–	–	–	–	67.7	29.1	108.6	43.4
D14 expenditures for donations for culture, art and the similar purposes	1.4	0.7	0.8	0.4	1.4	0.6	0.9	0.4
<i>Lump-sum expenditures</i>								
D15 for taxpayers who have acquired some forms of income from assets	210.8	111.7	87.8	41.3	85.9	36.9	92.5	37.0
D16 for taxpayers who have earned personal income from some other independent activities	195.9	103.8	208.7	98.1	148.7	63.9	149.1	59.6
<b>II. Reduction of tax due (C)</b>								
C1 reduction of the tax due for Croatian Wartime Military Disabled in proportion to degree of disability <sup>4</sup>	11.5	6.1	8.3	3.9	10.7	4.6	14.1	5.6

<sup>2</sup> The ratio of the revenue of the government budget and the revenue of consolidated general government collected from income tax from 2001 to 2004.

<sup>3</sup> In 1996, three groups of areas of special national concern (known in Croatian as PPDS), in which there are 180 local units (50 in the first group, 61 in the second, and 69 in the third). Revenue from the joint taxes on personal and corporate income tax, which are actually shared/divided between central government and local units, were up to 2005 totally ceded to the municipalities and cities in the PPDS. The hill and mountain areas are identical in their tax treatment to the third PPDS category.

<sup>4</sup> Since the beginning of 2005 there has also been an exemption for members of the families of Croatian soldiers of the Homeland War who were killed or who are imprisoned or missing, who do not pay income tax on the income from the survivors' pensions according to the Croatian Defenders' Rights Law.

increasing number and scale of the various reliefs and allowances in the taxation system, introduced since 2000. In the period under analysis lost revenue has increased because of the other allowances granted (D) and reductions of the tax due (C). Between 2001 and 2004, these amounts rose from 333 to almost 423 million kuna.

These other allowances and reduction of tax due are called tax expenditure, and they can be considered as revenue that has been lost to all levels of government – municipalities, cities, counties and central.<sup>5</sup> But in what way do the budgets of all these levels of government in fact relinquish their revenue from the taxation of personal income?

*The personal income tax base is reduced not only by the personal allowance,<sup>6</sup> but by other allowances (D), which include:*

- Excluded receipts (two kinds)
- Augmented expenditures (four kinds)
- Deducted income (one kind)
- Enlargement of personal allowance for given kinds of expenditure (two kinds)
- Enlargement of personal allowance (five kinds)
- Lump-sum expenditures (two kinds).

*Personal income tax can be abated because of:*

- Reduction of the tax due for Croatian Wartime Military Disabled according to the degree of disability ascertained.

Revenue lost in the system of taxation of personal income to all levels of government, per category of other allowances granted and reduction of tax due in the period from 2001 to 2004, are given in Table 2.

The budgets of all levels of government (called the general budget), lost almost 617 million kuna in 2001 because of other allowances (D), while in 2004 this figure rose to the sum of over one billion kuna. The central government budget alone lost 327 million in 2001 and 417 million kuna in 2004.

Particularly prominent for their amount are the additional personal allowances for persons who live in Areas of Special National Concern and in other specially tax treated areas (D10); life insurance premiums that have the characteristics of savings, supplementary and private health insurance premiums and voluntary retirement insurance premiums (D3); lump-sum expenditures for taxpayers who earn their income from some other independent activities (D16); and augmented depreciation costs (D5).

But there are also some reliefs that do not have any important impact in the overall expenditure. This group includes the untaxed receipts of artists (D1), tax deductible entertainment costs (D6), expenditures for research and development (D9) and expenditures donations for culture, art, and similar purposes (D14). Since each relief increases the administration of the tax authorities, and the general trend should be towards as great a simplification of the tax system as possible, consideration should be given to the abolition of these.

Revenue lost because of the reductions of the tax due (C) did not significantly increase in the period under consideration. On average, some 5 million kuna a year were earmarked for the exemptions for Croatian wartime military disabled.

## Conclusion

The total revenue lost to all levels of government in the personal income tax system is obtained by aggregating the amounts of other allowances that reduce the tax base and reductions of the tax due. The results are given in table 3.

Personal income tax revenue lost because of other allowances granted and reductions of tax due to all levels of government came to 628 million kuna in 2001, and rose to 1.06 billion kuna in 2004. Every year the central government budget relinquishes ever-greater sums, mainly because of the other allowances that have been introduced.

Although the practices of contemporary tax systems tend towards the reduction of the number of various tax exemptions and privileges, this is still not the case in Croatia. The domestic system of taxing personal

<sup>5</sup> These are calculations of the Institute of Public Finance, which are slightly different from the official data of the Central Office of the Tax Administration concerning income, reliefs and tax of individual income tax payers (samples of 5% of the population). The total nominal amounts of the reliefs granted and the tax expenditures accruing from them to general government per given relief in the period from 2001 to 2004 as well as the loss to the national central government budget within the context of personal income tax can be seen in the Institute of Public Finance project Tax expenditures in Croatia: individual and corporate income tax, real estate transfer tax and value added tax, Financial Theory and Practice 2/2006.

<sup>6</sup> The personal allowance is the product of the basic allowance amount and the basic personal allowance factor. We distinguish between the basic personal allowance and the dependents' allowance. Basic allowances are not considered a loss to the central government budget in the real sense of the word, because the tax laws of most countries recognise these categories as social variables via which the basic standard of living is respected. For illustration, we can state that the amounts of total personal allowances at the level of general government (the budget of all levels of government) came to from 7.7 billion in 2001 to 9.3 billion in 2004.

Table 3 Total lost revenue in the personal income tax system

	Lost personal income tax revenue							
	2001.		2002.		2003.		2004.	
	All levels of government	Central government budget (Nx0,53)	All levels of government	Central government budget (Nx0,53)	All levels of government	Central government budget (Nx0,53)	All levels of government	Central government budget (Nx0,53)
I. Reduction of tax base because of other allowances (D)	616.7	326.9	628.7	295.5	939.3	403.9	1042.2	416.9
II. Reduction of tax due (C)	11.5	6.1	8.3	3.9	10.7	4.6	14.1	5.6
Total	628.2	333.0	637.0	299.4	950.0	408.5	1.056.3	422.5

income, as well as other forms of tax, is characterised by numerous privileges, of which the many reliefs that reduce the tax base are the most prominent.

It is not the purpose of this paper to say whether these are justified or not. The basic objective is to show what amounts the budgets of all levels of government and the central government budget have renounced because of the existence of these privileges and exemptions. Apart from reducing the tax revenue, all these various exemptions and reliefs make the tax system much more complex, they increase the cost of collecting tax, and throw the door open for tax evasion. At the same time it is exceptionally difficult to show how much the existing tax privileges really tend to improve the position of the privileged categories of tax payers.

We can conclude that, with respect to the total amounts of revenue lost to all levels of government, primarily to the central government budget, certain categories of other allowances do not have a considerable role in the personal income tax system. This would include primarily the untaxed receipts of artists (D1), tax deductible entertainment costs (D6), expenditures for research and development (D9) and expenditures for donations for culture, art and similar purposes (D14). However, since every relief increases the administration of the tax agency, consideration should be given to the abolition of these reliefs. As a substitute, direct subsidies might be given to certain categories of taxpayers, which are at any event more transparent and cheaper instruments of financing.



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