

## A Critique of Proposed Changes to Croatia's Personal Income Tax

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# VIEWPOINTS

## A Critique of Proposed Changes to Croatia's Personal Income Tax

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Ivica Urban is a researcher with the Institute of Public Finance in Zagreb.

Croatia's Ministry of Finance has proposed economic measures to mitigate the effects of rising food and energy prices on Croatians' living standards. One measure would provide subsidies to individuals and companies; another would increase personal allowances and broaden the brackets of the personal income tax (PIT).

Should the government introduce measures to compensate the entire population for an increase in the prices of some products? I believe it should not. The growth in food and energy prices on the global market is beyond our control. Most citizens adapt to rising prices of essential products by reducing spending on nonessential goods. The most vulnerable, who are unaffected by the PIT, can receive added support from the government through existing welfare measures.

The government can help by continuing the privatization of government-owned enterprises and price liberalization, abolishing subsidies and state-supported monopolies, reducing taxes and expenditures, and, generally, withdrawing from the economy. Those actions would improve market competition and increase investment and production, which would in turn lead to lower prices of goods and services. Stronger private initiatives will also increase the flexibility of the economy and help it adjust to changes in the global environment.

The government should relieve the overall tax burden, but only with corresponding cuts in expenditures. Reducing taxes and expenditures as a share of GDP should be done gradually.

In 2005 I provided a detailed description of the impact of the Personal Income Tax Act on the living standards of various income groups.<sup>1</sup> Among my conclusions were:

- the PIT in Croatia is progressive, and 10 percent of the highest-income taxpayers contributed two-thirds of total income tax revenue; and
- an increase in the personal allowance cannot improve the living standards of individuals who have no taxable income and whose income is lower than the current personal allowance.

Here is a similar analysis based on the household budget survey for 2006.<sup>2</sup> Households in the sample are first ordered according to annual disposable income per household member, and then divided into five groups with an equal number of individuals in each group (quintile groups). Table 1 shows the average values of various items per household member. Nontaxable 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 under current regulations.<sup>3</sup> Disposable income (column 4) is the sum of nontaxable and taxable income reduced by PIT and surtax. Column 5 shows the amounts of tax and surtax obtained by a simulation based on projected changes, that is, the basic personal allowance of HRK 1,800

<sup>2</sup>The Institute of Public Finance is developing a micro-simulation model that uses available data from the household budget survey, which was 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 one. See <http://www.vlada.hr>.

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

<sup>1</sup>Institute of Public Finance, Newsletter 18.

**Table 1. Average Annual Amounts of Income and Tax per Household Member (in HRK), 2006**

Quintile Group	Nontaxable 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 microsimulation model.

**Table 2. Average Annual Amounts of Income and Consumption per Household Member (in HRK), 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)x10%	6	7=6/5x100%
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 microsimulation model.

monthly (HRK 3,200 for pensioners).<sup>4</sup> The last column in Table 1 shows the difference between the current and future amounts of tax and surtax.

Quintile group 1 represents the poorest 20 percent of the population. Because of the current personal allowance, this group pays almost no PIT and surtax, or as little as HRK 21 on average per household member annually (column 3). Under the new (increased) basic personal allowance, the average amount of PIT and surtax would be HRK 15 per household member (column 5), that is, HRK 6 less (column 6). However, the annual decrease in tax and surtax would be slight or

insignificant for other quintile groups as well, ranging from HRK 55 per household member for quintile group 2 to HRK 526 for quintile group 5.

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). Assume a 10 percent 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 price increases. To what extent would the government compensate for higher expenses for food and fuel by reducing the tax burden?

The average annual expenses for quintile group 1 would rise by HRK 610; because of a PIT reduction, their compensation would amount to HRK 6, that is, as little as 1 percent of increased expenses (column 7). Relatively low compensation (from 7 percent to 23 percent of increased expenses) would also be made for the

<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 (HRK 1,800). The tax brackets are also increased proportionally.

next three quintile groups. With a 10 percent price increase, annual expenses for food and fuel for quintile group 5 would rise by HRK 1,055 on average, and tax liability would be reduced by HRK 526. This quintile group would receive a 50 percent compensation for the loss caused by the 10 percent 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 the tax base has no impact on the incomes of the lowest-

income taxpayers and can bring about almost no improvement in their standard of living. However, the government can aid this group through targeted social welfare measures.

Although the proposed PIT reduction will slightly increase the disposable incomes of most citizens and help offset rising prices, further efforts are needed to relieve the tax burden, including further cutting the PIT and other tax rates and reducing public expenditures. ♦