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TAX FRAMEWORK OF THE CROATIAN FINANCIAL SYSTEM[1]

POREZNI OKVIR HRVATSKOG FINANCIJSKOG SUSTAVA

ABSTRACT

The responsibility of the financial sector for the global financial crisis spurred the interest of the public to assess the 'fair and substantial contribution' of the financial industry that would level the costs associated with government interventions. In addition to various and comprehensive changes in the regulatory regime, most countries focused its efforts towards reforms of the tax systems.

Therefore, it seemed reasonable to investigate the existing tax treatment of different categories of capital income in Croatia, i.e. interest income on savings deposits and bonds, dividends and capital gains. These additional taxes have been introduced recently with the primary objective of growth of budget revenues as well as additional contributions to the stability of the financial system. However, the paper raises the question of the justification of this decision with respect to the relative underdevelopment of the domestic financial system, and particularly illiquid and shallow capital markets. For this reason, the authors will analyze the structure and determinants of Croatian financial institutions and financial markets, and the importance of financial services in the national economy.

The aim of this paper is to point out the importance of developing appropriate tax framework for all segments of the financial system in the Republic of Croatia. Authors will provide insight into the nature and key features of capital income taxes as well as the basic elements of the state taxes on financial institutions. Furthermore, in line with trends in European legislation, the introduction of tax on financial transactions (FTT) will also be taken into account.

Key words: *taxation, financial institutions, financial markets, capital income, Croatia*

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SAŽETAK

Odgovornost financijskog sektora za globalnu financijsku krizu potaknula je interes javnosti za procjenu odgovarajućeg doprinosa financijske industrije koji bi nivelirao troškove povezane s vladinim intervencijama. Osim raznih i sveobuhvatnih promjena regulatornog režima, većina zemalja usmjerila je svoje napore ka poreznim reformama.

Stoga se činilo opravdanim istražiti postojeći porezni tretman različitih dohodaka od kapitala u Hrvatskoj odnosno prihod od kamata na štedne depozite i obveznice, dividende i kapitalne dobitke. Navedeni porezi uvedeni su u novije vrijeme s primarnim ciljem rasta proračunskih prihoda, kao i doprinosa dodatnoj stabilnosti financijskog sustava. Međutim, u radu se postavlja pitanje opravdanosti ove odluke s obzirom na relativnu nerazvijenost domaćeg financijskog sustava, a posebno nelikvidnog i plitkog tržišta kapitala. Iz tog razloga autori će analizirati strukturu i determinante financijskih institucija i financijskih tržišta, kao i važnost financijskih usluga u nacionalnom gospodarstvu.

Cilj ovog rada je ukazati na važnost razvijanja odgovarajućeg poreznog okvira za sve segmente financijskog sustava u Republici Hrvatskoj. Autori će istražiti prirodu i bitne značajke oporezivanja dohotka od kapitala, kao i osnovne elemente državnih poreza na financijske institucije. Nadalje, u skladu s trendovima u europskom zakonodavstvu, sagledati će se i mogućnost uvođenja poreza na financijske transakcije (FTT).

Ključne riječi: *Porezi, financijske institucije, financijska tržišta, prihod od kapitala, Hrvatska*

1. Introduction

Well developed and efficient financial system can offer great advantages to national economies. Despite the important contributions of financial sector, there is a growing concern that the sector suffers from structural problems, with the result being a misallocation of resources and undue risk imposed to the economy (Burman, 2016, 185). The financial market collapse of 2007 illustrated painfully how financial sector can impose significant costs on the broader economy. Many countries in Europe introduced financial sector levies immediately after the crisis.

The issue of taxation of financial institutions and financial transactions is a matter of high-importance. Taxation could supplement regulation of financial institutions because it can be focused on risks to the overall financial system rather than just on individual financial institutions (Keen, 2011, 2).

In 2014, when the consolidation of Croatian public finances was needed as was the settling of disputes over the amendments regarding the Croatian taxation system, a new feature was being introduced, namely, the capital income tax by means of the Income Tax Act. Until 2014 Croatia was one of the few countries where taxation of interests on savings and capital income from financial assets did not exist. Although the foundations of the present taxation system were laid more than two decades ago, the stance pursued by the legislator has been mainly oriented toward consumption taxation, rather than the taxation of savings and investments. In time, the tax system has grown in complexity, becoming more centralized and burdened by a variety of tax reliefs and tax exemptions. At the end of the global financial crisis there was the need for rethinking the fiscal system, a system which did not focused on assets, interests and dividends taxation. The economic downturn and the failure to fill-in the state budget have confirmed the general conviction that a wider consumption taxation, rather than taxing savings and investments, would have a favorable impact on economic development. In 2012 the first shift in the investment income taxation took place, which saw the introduction of both dividend and profit-sharing taxation. Such shift proved to be less favorable for investment income than for other income types, thus highlighting the need for a fair partition of the fiscal burden.

In 2014, Croatia extended the tax base on investment income, following an approach present in the other EU Member States. Furthermore, information exchange concerning Croatian residents' interests abroad between Croatia and the rest of the Member States encouraged a more equitable taxation, but also an insight of the extent of foreign savings, which were likely to reduce tax evasion and tax avoidance (Cipek & Uljanić, 2015, p. 111). At the same time with such change, the taxation system was being harmonized to meet the European Commission's recommendations, in the way to shunt anomalies from the taxation systems of the EU Member States and to create a taxation system based on labour taxation.

These introductory remarks are followed by the in-depth analysis of the progress made by the Croatian financial system. The paper than addresses latest trends and the impact of changes in the financial system on financial organizations and services. Prior to the conclusions, we examine whether it was justified the need for the introduction of the tax on financial transactions as a form of indirect taxation, recommended by the European Commission.

2. Financial system in the Republic of Croatia

Croatian financial system is underdeveloped as compared with financial systems in developed market economies. Banks are the most important financial institutions, despite slower growth rates comparing to other financial intermediaries. Moreover, Croatian economy is still mostly financed by conventional bank loans or in larger amounts, syndicated loans. The non-deposit financial intermediaries comprises over a quarter of the domestic market due to rapidly growing pension funds, turbulent development of open-end investment funds and stable insurance market.

Banks face greater competition from other financial institutions with important remark about significant ownership relationship between banks or their parent companies with a majority of other financial institutions. The three largest banking groups dominate pension and investment funds market, infiltrate in the area of insurance market and capital market and thus creating a problem of formal or informal financial groups. This implies increased responsibility of regulatory and supervisory institutions and also the need for harmonization of legislative and revision of all regulations that should protect service users.

Concerning general common features of all financial institutions, it can be concluded that they are predominantly foreign-owned, highly concentrated and profitable. Capital market is underdeveloped and illiquid, especially after the global financial crises. One of the specific problems is low investor risk tolerance enhanced with the lack of tradition and culture of investment in capital market and saving via non-deposit financial intermediaries.

Global financial crises slowed down the process of rapid growth in the non-banking sector and reinvigorating of bank-based system. Trend alleviates the pension funds due to allocations momentum of mandatory monthly contribution of resources. All other financial institutions have been faced with increased investors caution and shattered confidence because of the recession and the ongoing financial crises. These negative influences were especially referred to the open-end funds, which reduced their importance in financial system by the highest extent. Hence, long-standing domination of the banks has been slightly threatened only in the years prior the financial crises which accent the necessity for further encouraging the development of long-term voluntary savings through non-bank institutional investors as shown in Table 1.

Table 1 *Financial Market Structure in Croatia in 2007 and 2013*

Financial institution	**Assets** (in mill.of HRK)		**% of total assets**		**Number of institutions**	
	2007	**2013**	**2007**	**2013**	**2007**	**2013**
Banks	345.1	397.9	72.7	73.3	33	33
Open-end investment funds	30.1	13.2	6.3	2.4	100	108
Closed-end investment funds	3.7	1.4	0.8	0.3	9	4
Insurance companies	23.2	34.5	4.8	6.4	25	27
Housing savings banks	6.4	7.6	1.3	1.4	5	5
Mandatory pension funds	21	58.2	4.4	10.7	4	4
Voluntary pension funds	0.8	2.7	0.2	0.5	18	22
Savings and loan associations	1.3	-	0.3	-	104	-
Credit unions[1]	-		-		-	4
Leasing companies	30.3	19.7	6.4	3.6	25	23
Factoring companies	4.2	7.9	0.9	1.5	12	14
Total	**466.1**	**543.1**	**100.0**	**100.00**	**335**	**244**

Notes: 1 – estimated assets < 0,1 bill. kn

Source: author's calculation (www.hanfa.hr; www.hnb.hr)

The structure of financial markets can be seen from Table 2, presenting the relative relevance of different types of financial instruments. It can be seen that the bank loans are prevalent, however not to the extent in which the banks' assets dominate the total assets of the financial system. The reason for that is that the banks in their equity portfolios also have large portfolios of shares and bonds.

Table 2 *Financial Market Structure (in millions of HRK)*

Financing in the Republic of Croatia		**Amount**			**% of total amount**		
		2002	**2009**	**2015**	**2002**	**2009**	**2015**
Bank loans (cons.)		92,292.9.1	252,428.3	253,132.3	71	60	55
Market capitalization	**Shares**	28,325.6	135,368.2	128,137.1	22	32	28
	Bonds	8,996.4	36,255.8	78,993.8	7	9	17
	Structured products	-	-	1,724.2	-	-	
Total		**129,614.9**	**424,052.3**	**460,263.2**	**100**	**100**	**100**

Source: www.cnb.hr, www.zse.hr

Although the Croatian stock market has existed for more than twenty years and has developed a solid infrastructure as well as modern legal framework, the very low liquidity still places it in the emerging market category. By the 2007, Croatian companies, financial institutions and government were increasingly financed by issuing securities which resulted with the improvement of institutional investor's development and strong growth of domestic capital market. However, almost decade later one can tell that activities in domestic capital market are significantly reduced and in addition, traditional banking financing become even more significant. Although pension system reform created a great demand for shares and debt securities, the ongoing problem is lack of high quality financial instruments and their low liquidity. One of the possibilities for improving the domestic capital market in the near future is in strategic alliances with exchanges in the region[2] (Olgić Draženović, Prohaska, Suljić, 2014, 213).

[2] Together with Bulgarian and Macedonian stock exchanges, Zagreb Stock Exchange(ZSE) has established the SEE LINK company in 2104 with the objective of creating a regional infrastructure for trading securities listed on those three markets and the system is about to be operational in the first quarter of 2016. At the end of 2015 ZSE acquired the Ljubljana Stock Exchange by taking over 100% of its shares from the CEE Stock Exchange Group (ZSE).

3. The taxation on financial institutions, markets and services in Croatia

The Croatian tax system is compatible with those of EU member countries, and is based around a set of direct and indirect taxes. The current Croatian tax system is a hybrid system, where both the elements of income-based and consumption-based taxation concept are present and where the domination of the particular concept depends mostly on the current ruling party (Šimović, Blažić, Štambuk 2014, 408).

3.1. Corporate taxation

In Croatia corporate financial taxpayers (financial institutions) are subject to a national profits tax (20%), social security contributions, value added tax, excise taxes and county and municipal/city surtaxes as local self-governing units' revenues.

Financial institutions in the Republic of Croatia are liable to corporate income tax at a rate of 20%. The tax base is the accounting gain which increases or decreases according to the Law on Profit Tax and regulations are established by various exemptions and incentives.

Although these state and other taxes are by sufficiency and importance for tax authorities and tax payers more prominent than others, considering the development of the financial system it is of major importance to analyze the taxation of capital income which will be further explained below.

3.2. Tax on capital income

Personal income tax is the centerpiece of the modern tax systems, and not only because of its extremely high financial yields, but also because of the extensive capability to be used as a suitable instrument for the realization of some non-fiscal objectives of taxation (Jelčić, Jelčić, 1998, 173).

The amendments to the Income Tax Act (Official Gazette 143/14) passed in November 2014, concerned a mini tax reform in the field of income taxation from interest on savings deposits, dividends and capital gains. Most of the provisions came into force in early 2015, while the taxation of capital gains was announced to start of one year later, from January 2016.

Capital income is, according to the Law on Personal Income Tax (Official Gazette 143/14), considered as receipts from interest, seizure of property and the use of services at the expense of profit for a specific period, capital gains and profit shares generated through the assignment or the optional purchase of one's own shares, which have been accrued in the tax period. The taxpayer is a natural person who derives income.

3.2.1. Taxation of interest

In 2015 certain measures associated with the taxation of interest on domestic and foreign deposits of natural persons in the banking institutions came into effect. Interest on savings paid out after 1 January 2015 are subject to taxation at the tax rate of 12% plus city surtax. Tax liability will be withheld at the moment of payment of interest and considered as final. In accordance with the provisions of the Capital Income Tax Act (Official Gazette 136/15) all receipts from interest rates are taxable unless they exceed the 0,5% per annum paid out to natural persons. Tax prepayments on capital income are calculated, withheld and paid by the payer of interest as withholding tax, without personal tax allowance.

Taxable interests are considered to be receipts of claims of every kind, and in particular:

- receipts from interest on domestic and foreign currency savings (current account savings, term or annuity savings, including the yield, reward, premium and any other compensation earned over the amount of invested resources)
- receipts from interest on securities
- receipts from interest on loans
- receipts based on revenue-sharing investment fund in the form of interest (if they are not taxed share of profit on the basis of profit-sharing or income of the investment fund).

The Law prescribes certain exemptions from taxation of interest, such as interest on arrears, charged interest on court rulings, current and foreign exchange account interest if it does not exceed the lowest interest rate on savings deposits and does not exceed 0,5% per year, interest on bonds, receipts based on assets on life insurance with a savings component and return on voluntary pension contributions.

3.2.2. Taxation of dividends

Dividends and share in profit are subject to tax in Croatia. They have to be paid by the tax rate of 12%, after deduction. Tax prepayments on capital income are calculated, withheld and paid by the payer of interest as withholding tax, without personal tax allowance. Non-taxable part of dividends and share in profit on income up to HRK 12,000 per year is no longer valid. Taxpayers were able to make use of such tax relief through the annual tax return in 2013 and 2014.

Exemptions from taxation are prescribed for dividend payments from the program ESOP (Employee Stock Ownership Plan). Reinvested earnings and the use of income from capital to increase the company's share capital are also deducted from taxation. This applies under the condition that there are no subsequent reductions of the share capital nor payments to company members, nor reductions in the number of jobs in the following two years.

Dividends paid to non-residents are subject to a 12% withholding tax. This does not apply if the rate is reduced or exempt due to an existing tax treaty or the dividends qualify for an exemption under the EU parent-subsidiary directive.

3.2.3. Taxation of capital gains

One of the novelties in the Law on Personal Income Tax is the introduction of a special tax treatment of capital gains upon sale and disposal of financial instruments and structured products acquired from 01 January 2016 and alienated within three years.

Investment income arising from capital gains is defined as the difference between the agreed sale price (receipts determined in accordance with the market value of financial assets that are alienated) and the purchase of financial assets that are alienated. Under the alienation of financial assets the law does not specify only sales but also exchange, donation and other transmissions, and disposal of property and property rights. The taxpayer is the owner of a financial asset under the obligation to calculate, withhold and pay the tax on capital gains at the rate of 12% without any personal allowance. For a natural person as a tax payer, the obligation can be performed by the management company or by the person who manages the financial assets.

Under the law, capital gains taxation is applied to instruments that are usually traded on the Zagreb Stock Exchange, such as shares and bonds (transferable securities), certificates and structured products. In addition, the tax is calculated on the profit deriving from receipts from alienation of shares in the capital of companies, shares in investment undertakings, money market instruments (treasury bills and commercial papers) and derivatives.

The law provides certain exceptions, in particular for:

- The transfer of shares between pension funds,
- The replacement of securities with the same kind of securities of the same issuer,
- The distribution of shares of the same issuer if there is no change in the share capital and cash flow,
- The replacement of shares among investment funds managed by the same management company, with the fulfillment of the condition that the sequence of financial assets acquisition is secured,
- The redemption of shares in the Fund of the Croatian Homeland War Veterans and their families.

In addition, the following types of income are not taxed:

- The alienation between the spouses and relatives in first line and other close family members and between divorced spouses when the alienation was in close conjunction with divorce,
- Alienation in close connection with the inheritance of financial assets,
- Alienation after three years from the purchase of financial assets.

It is one of the most complex type of income taxation in Croatia, which has raised numerous concerns and was the subject of disputes among experts and market participants. These remarks are reflected in the Amendments to the Personal Income Tax Act related to capital gains (Official Gazette 136/15). Such amendments have changed the deadline for the payment of the capital gains tax. Before the Amendments were enacted, taxpayers were required to calculate and pay tax within 8 days from the income receipt date, or on income receipt date in the case that the tax calculation and payment obligation were taken over by the security fund manager. The Amendments change the filing deadline to a single date, which is 31 January of the current year for the previous tax year. In other words, capital gains tax will be paid on an annual basis, and the tax base will be the difference between capital gain and capital loss.

The main disadvantage of introducing a new fiscal burden is the lack of quality analysis and expertise concerning the impact it might have on the Croatian economy, especially on fragile and illiquid capital markets. This measure was adopted ad-hoc with the sole purpose of filling the state budget. This tax will discourage primarily small investors who have been a significant generator of domestic liquidity. Small investors probably will turn to other forms of investing capital due to higher costs. The investment activity will be largely slowed down owing to the economically inefficient calculation, where investors' earnings will shrink even more than the amount of tax they are required to pay and it will be difficult to take the decision about investing in securities.

4. Reflections on the possibilities of introducing tax on financial transactions in Croatia

Global economic and financial crisis, which was triggered by financial market failures, has prompted a public debate about the possible solutions to the fiscal burden of the financial sector of certain national economies on the single European market. With the aim of stabilizing the EU financial system and ensuring a fair contribution of the financial sector to public finances, in 2011 the European Commission proposed a harmonized financial transactions tax (FTT) for the EU.[3]

[3] Because of not reaching an agreement, a new proposal was tabled in February 2013 (EC, 2013) but again implementation was repeatedly postponed. Meanwhile, some EU states have maintained their existing taxes while others including France and Italy, independently introduced new ones. In January 2017, 10 EU states will adopt a FTT. The parties include Austria, Belgium, France, Germany, Greece, Italy, Portugal, Slovakia, Slovenia, and Spain. Some observers believe delays in implementation are likely (Burman et. al., 2016, 178).

European FTT is based on a so called "AAA approach" (*all institutions, all markets, all instruments).* It refers to a broad fiscal framework, proposing a unique tax burden on trading of all financial instruments of all financial institutions within the EU, which takes place on organized financial markets (exchange and OTC markets). Tax rates for basic financial instruments are 0.1% of the value of buying and selling transaction (except the primary market for shares and bonds), whereas the tax rates of 0.01% of nominal contract value are defined for derivative products.

FTT is aimed at financial transactions made by financial institutions on their own behalf or on behalf of their clients. Financial institutions are all entities that make more than 50% of their annual turnover through financial transactions, namely: investment companies, regulated markets, credit institutions, insurance and reinsurance companies, collective investment companies, financial leasing companies, with the exception of transactions carried out by central securities depositories and central banks. This implies that the scope of FTT is primarily limited to financial industry, while it excludes the impact on daily citizens' and small and medium enterprises transactions.

The tax combines a residence principle with an issuance principle, according to which all transactions by financial institutions based in the EU as well as by those based outside the EU are to be taxed as long as the transaction takes place in the FTT region.

The proposal of the single European FTT leaves out of its scope traditional bank lending and deposit taking as well as currency trading. Taxing gross transactions on secondary financial markets at relatively low rates would prevent disruptions, ensure system stability and generate substantial public revenues.

Preliminary analysis of the possibilities of FTT in Croatia, according to this proposal, leads to a conclusion that Croatian capital market is not developed enough to generate substantial tax revenues. On the other hand, non-taxation of financial transactions in Croatia would impose a fiscal burden for domestic financial institutions when transactions take place in Member States of the FTT jurisdiction or when trading in financial instruments issued in these countries. Such a provision would cause an outflow of tax revenue outside Croatian borders (Milevoj, 2012, 34).

5. Conclusion

The latest amendments of the personal income tax in the Republic of Croatia have further extended the tax base for capital gains, which regulates the taxation of dividends, interests and capital taxation. Hence, from the beginning of 2015 interests were subject to taxation like revenue from any receipts, and, after one year deferral, also capital gains were liable to taxation in the form of personal investment income during the alienation of financial instruments and structured products acquired after 1st January 2016.

The impact of the new fiscal framework shall be visible in the future. Yet, taxation of trade earnings from capital trade are likely to have a negative impact on small investors due to the unfavorable calculation, income tax return and tax payment. Apart from individual investors, who are the driving force providing liquidity on the domestic market, the negative effects may also discourage foreign investment, since the afore mentioned amendments destabilize the fiscal system and hamper long-term planning. The impression is that the damage on the financial markets caused by the introduction of these new measures shall exceed by far the benefits to the state budget.

In fact, the baseline for an effective fiscal system are durability, foreseeability and simplicity. On the one hand, uncertain fiscal planning shall certainly have a negative impact on investors on financial markets, but, on the other, the taxation of financial transactions imposed by financial organizations may contribute to a more equal distribution of the burden generated by the financial crisis.

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