

# LUMP SUM TAX FOR SMALL BUSINESS: THE CASE OF CROATIA

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## *Abstract*

The objective of the paper is to explore the reasons pro and contra for lump sum taxation for smallest of small businesses in Croatia, to analyse causes of its failure and to propose its future changes to make it effective.

The research methodology includes comparative analysis, face to face interviews – field research and quantitative desk research using applicable calculations.

The efficiency arguments speak in favour of that tax, but the equity arguments not. However, both are mitigated when this tax is optional, as it is mostly the case in other CEE countries implementing that tax. It is usually restricted to the smallest of small businesses. The compliance costs measurement for Croatia showed extremely high and regressive income tax compliance costs of small business owners, that gives a strong argument in favour of introduction of lump sum tax for smallest of small businesses.

Our research results indicate that the biggest problem of the Croatian lump sum tax was its assessment base – average wage, since this estimation base is too high. The other problem was the upper limitation (ceiling) for the lump sum taxation – annual turnover below the VAT threshold, which is too low in comparison with the former. So, not only that the lump-sum tax did not pay for the most taxpayers, but it was also in effect not possible to be implemented in businesses where it was beneficial, because their turnover was already above the VAT threshold. Even the saving in compliance costs was not enough attractive to taxpayers to opt for a lump sum tax. That is caused by the high proportion of owner's time costs, but also implies high proportion of these costs as tax planning costs and also the fact that they are at the expense of leisure. It could also imply the use of tax planning for tax evasion opportunities.

Our proposal is based on the lump sum taxation instead of lump sum income (corrected average wage). The basis for the lump sum assessment could be around 80% of average income of each small business activity. Upper limit for lump sum taxation (VAT threshold) should be reconsidered also.

## **1. Introduction**

Lump sum tax is often advocated from the taxation literature as the ideal tax from the efficiency point of view. On the other hand – the traditional efficiency-equity trade-off is presented here again, since this tax has nothing to do with the ability to pay. That is why this tax form is very rare.

The third, relatively newly emphasized criteria – tax compliance costs speaks also in favour of the lump sum tax. Relating alternative “tax efficiency” (ratio of tax compliance costs in tax revenues) of the existing taxes, which could be used as the argument in favour of lump sum, is the result of demanding empirical survey. The experience of these measurements in developed countries suggests tax compliance cost being especially burdensome for the small business. The tax compliance costs measurement (interview survey) for Croatia – one of the first of that kind in “transition” countries, reveals that the income tax for small business (business units that pay personal income tax) is completely inefficient tax and should be replaced by the lump sum tax. We came to that conclusion two months before it was optionally introduced in the Croatian tax system for smallest of small businesses (business units that pay personal income tax).

Nevertheless, the estimation technique and parameters for the lump sum tax (estimated tax) seem to be unfavourable for the taxpayers and they hesitate to opt for that kind of taxation. We will try to explore the reasons for that.<sup>2</sup>

First part of the paper briefly discusses equity and efficiency aspects of the lump sum tax instead of “normal” income tax. The second part gives an overview of the lump sum (estimated) taxation of business and professional income of individuals (“small business”). The main part of paper is devoted to the case of Croatia. First, quantitative and qualitative data from the income tax compliance costs survey for small business in Croatia are analysed. As already pointed out, the term small business in this paper will refer to the business units that pay

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<sup>2</sup> It is important to point out that the topic of this paper explicitly excludes the other form of lump sum tax – the one that comprises part of income from property – income from renting of flats, rooms and beds to travelers and tourists and organizing camps (VAT exemption, income is not derived as income from small business). It was introduced into Croatian tax law in 2004 and came into effect in 2005.

personal (individual) income tax and the tax analysed will be personal (individual) income tax of their owners. After briefly presenting the main elements of the lump sum tax legislation in Croatia, the paper further explores the reasons for the inadequate implementation of this tax in Croatia, suggesting some measures for its improvement.

## **2. Advantages of lump sum tax**

All taxes, including income taxes, influence economic behaviour. They have substitution effect and income effect. The former makes taxpayers work less (disincentive effect of income tax, since higher income means absolutely and even relatively higher tax). This substitution effect is so called “distortionary” effect, since it distorts work/leisure choice. The income effect means that individuals are worse off after tax, and it induces them to work more.

A lump sum tax is the only non-distortionary tax. That means that there is nothing the taxpayer can do to alter his tax liability (distortions are associated with the taxpayer’s attempt to lower the tax liability). So, there is no change in behaviour or the reallocation of resources, other than the income effect of reduced after-tax income. So, the same tax burden (and tax revenue for the government) leads to no distortion and only incentive to work more.

Of course, this advantage is accompanied by the total equity disadvantage. The concept of vertical equity (taxes paid by the ability to pay principle, with higher incomes paying higher taxes) is completely ignored here and the horizontal equity loses its sense completely. That is the reason why lump sum taxes, despite their efficiency advantages, seem to be relatively unpopular.

## **3. Implementation of a lump sum tax in CEE**

Although, of course, not applicable for the corporate income tax, some CEE countries implement lump sum tax for some business units that pay income tax - the smallest businesses mostly (IBFD 2005). These regimes are very often optional and conditional upon some criteria defining small business (VAT exemption, no employees, turnover/income under certain ceiling) or type of activity. The tax amount is estimated according to some “second best” criteria, such as business location, type of activity, specific factors of business activity...

The local tax on small businesses in Albania is calculated as an annual lump sum amount, depending on the type of business activity and the location of the business. It is paid by individuals that are not registered for VAT.<sup>3</sup>

In Bulgaria, a final lump sum tax is applicable for individuals engaged in certain activities, provided their previous year's turnover was less than BGN 50,000. The lump sum depends on factors specific to the business activity, e.g. the number of rooms (for hotel accommodation), or volume of warehouses (for a wholesaler). In determining the tax, the place where the activity is performed is also taken into consideration.

In Czech Republic a taxpayer deriving income from agriculture and business (not exempt or taxed at separate rate) may request for an estimated assessment, provided that:

- he does not engage any employees or other collaborating persons;
- his annual income in the three immediately preceding taxable periods did not exceed CZK 1 million;
- he is not a participator in any association without legal personality; and
- he is not a taxable person for VAT purposes.

The tax authority estimates the taxable base and the tax due according to the progressive rates. The taxable base may not be less than it would be when applying the optional lump sum deduction and the tax due may not be lower than CZK 600 per taxable period.

In Lithuania, a taxpayer may obtain a «business certificate» for certain types of independent activities, such as private accommodation services, barber and beauty shop activities, handicraft works and translation work. The business income earned by a taxpayer is subject to a lump sum tax, the amount of which depends upon the type of activity.

In Macedonia, taxpayers who satisfy certain conditions may pay tax on a lump sum basis, depending on factors such as the extent and location of activities, market conditions and volume of net profits of similar taxpayers (the same and similar conditions and the same and similar activities).

In Romania, individuals pursuing independent activities listed by the Ministry of Finance through a fixed base are taxed on deemed income (optional). The tax payable is calculated by applying the tax rate on the deemed income, defined by the Ministry of Finance.

In Ukraine, an individual entrepreneur may opt for a «unified tax» if his gross entrepreneurial income does not exceed UAH 500,000 and he has less than 11 employees. The unified tax is levied as a lump sum between UAH 20 and 200 per month, as fixed by the municipalities depending on the type of activity.

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<sup>3</sup> Besides the local income tax, small businesses not registered for VAT pay also the simplified income tax. It is generally levied at 3% on the annual turnover of the business. Individuals with a turnover below ALL 3 million are exempt from the simplified income tax.

In addition, a number of CEE countries (Czech Republic, Hungary, Poland, Russia, Slovakia, Slovenia) as well as some EU 15 countries (Belgium, Austria, Spain, Portugal) apply simplified income taxation, where tax is based on a turnover/gross income with a lump sum expenses (in percentage terms)<sup>4</sup> or even gross income alone (Lithuania, Hungary, Poland). Of course, these regimes could not be regarded as lump sum tax, rather as some elements of it, caused mostly by simplicity reasons and relating tax compliance costs.

#### 4. Lump sum (estimated) tax in Croatia

##### 4.1. Tax compliance costs measurement

The research in tax compliance costs of small business in Croatia was part of the broader research of tax compliance costs in Croatia. It was based on research experience on similar research in other countries and was conducted by face to face interviews. Tax compliance costs for small business in our research entail labour costs (owner, unpaid help, internal bookkeeper/accountant or other employee who handles taxes), external costs (bookkeeping/accounting office) as well as some other internal non-labour costs (software and hardware (additional), forms and stationary, postage and telephone, instructional literature and seminars, travelling costs, court costs). Tax planning is included as an inherent part of tax compliance costs.<sup>5</sup>

As usual for this type of research, the study confirmed strong regressivity of tax compliance costs not only for small business (business units that pay personal income tax) in comparison with companies (business units that pay profit – corporate income tax), but also inside the business units that pay personal income tax (small business). This regressive effect is expressed for the entire amount of all small business taxes (personal income tax of the owner, VAT, wage tax and social security contributions, other taxes) and measured in terms of number of employees, turnover as well as income.

The efficiency measurement (expressed here as ratio of tax compliance costs in tax revenues) pointed out to the personal income tax of the small business (their owners) as being the most inefficient one (Table 1)<sup>6</sup>.

**Table 1: Efficiency of taxes in Croatia (2001/2002)<sup>\*7</sup>**

Tax	Ratio	Tax compliance costs as proportion of tax revenues (%)
VAT (companies)		4
VAT (small business)		24
Customs		31
Wage taxes (personal income, tax, social security contributions, local surcharge)		4
Income tax (small business)		98
Profit tax (companies)		12
Excise duties		0.3
Income tax (persons-individuals-non business)		0.9

\* Taxes collected from public sector and non profit sector excluded

It is astonishing that personal income tax of business units (income tax of small business) turns out to be a totally inefficient tax. Its revenues equal its tax compliance costs. This means that adding an adequate part of administrative costs (costs of tax administration) would surely make its entire cost higher than revenues.

The fact that tax compliance costs of personal income tax of business units are as high as the revenues from this tax is not completely surprising. The first reason may be tax planning, which is especially important for personal income tax. Owners of business units that pay personal income tax in Croatia are known to be very astute towards this aspect of taxation.

<sup>4</sup> Alternatively, the income tax base could be expressed as percentage of turnover/gross income (Portugal)

<sup>5</sup> For more detailed information about methodology and research results concerning other taxes levied on small business see: Blažić 2004 and Blažić 2005.

<sup>6</sup> The terms for taxes are taken from the Croatian tax law. Corporate income tax (company tax, corporation tax) is called «profit tax» in Croatia and as a result of that – personal (individual) income tax, only «income tax».

<sup>7</sup> H. Blažić. "Compliance Costs of Taxation in a Transition Country: the Example of Croatia." In the National Tax Association Proceedings of the 97<sup>th</sup> Annual Conference on Taxation, Kalambokidis, Laura (ed.), 2005.

Second one is that there might be a certain accounting/taxation overlap made by some taxpayers, but this is hardly possible<sup>8</sup>. Third is already mentioned probability that taxpayers overestimate the value of their hour.<sup>9</sup> Finally, it is well known from the tax compliance literature that this share can be misleading and that the other side of the picture should be taken into account – the amount of revenues. Here, this amount is underrepresented, i.e. underreported. This is a well known fact in Croatia. Unofficially, taxpayers as well as their accounting offices admit that the income statement should be fine tuned so as to show some positive though small income (in order to avoid an audit).<sup>10</sup> The major part of the shadow economy in Croatia is in the sphere of small business. It is connected with a tax evasion of personal income tax of the owners, but also wage tax and social security contributions of employees<sup>11</sup> (Madžarević 2002). This is a strong argument speaking in favour of introducing lump sum tax (estimated tax) for business units that pay personal income tax. It is interesting to point out, that the results of the qualitative research of tax compliance costs (what they claim to be more complicated and time spending, what would they suggest in order to simplify tax system and ease tax compliance...) led to the similar conclusion (Dimitrić 2003). The taxpayers pointed out collecting of receipts about income or documents related to the tax return as well as too many forms as their biggest problem. They also suggested reduction of the number of forms and the amount of necessary accompanying documentation (nr. 1 ranking), simplification of the tax return (nr. 2 ranking) and also introduction of lump sum (estimated) taxation for smallest of them. These suggestion answers (proposals) were not suggested to them in advance in any way. As already pointed out, we came to the conclusion that suggests introducing a lump sum tax a short time before it was effectively introduced in Croatia.

#### **4.1. Legislative solutions**

To be completely precise, the proposal for lump sum (estimated) tax for small business (business units that pay personal income tax) that is not registered for VAT has already existed in the Croatian Income Tax Act (Official Gazette of the Republic of Croatia “Narodne novine”, No.127/00, Article 32) at the time our research was conducted.<sup>12</sup> But, it did not come into force until then (the law announced that the Ministry of finance will further regulate this topic, but these further regulations have not occurred yet, so the new rules were in effect not existing). Still, people could have expected for it to come into force and that, of course, could partly explain the relative high frequency of that proposal among the interviewers.

On the other hand, the taxpayers were probably not aware of the fact that on the basis of inspection carried out and data about turnover gathered the Tax Administration can repeal such a tax and force the taxpayer to pay “regular” income tax, if it assesses that the taxpayer has realised an income above the amount that through the application of the prescribed tax rate exceeds the assessed estimated amount of the lump sum tax. This implied that business books should still be kept (or at least some of them) and that the lump sum (estimated) tax could be abolished for the certain taxpayer based on the discretionary measures. In this way, both simplicity and efficiency (from the neutrality point of view) arguments in favour of a lump sum tax were neutralized.

Later legislative solution, which in effect introduced lump sum tax in Croatia (Official Gazette of the Republic of Croatia “Narodne novine”, No. 90/2003, March, 2003<sup>13</sup>) was improved in a way that was more transparent and justified, but the lump sum assessment turned out to be very unfavourable for the small business. Lump sum option was restricted not only to small businesses (until then personal income taxpayers) that do not pay VAT, but also to those that neither have employees or co-entrepreneurs (partners). The other prerequisite is that small business does not have any additional form of separate establishment or production units.<sup>14</sup> Commercial activities and bar and restaurant services are explicitly excluded. The tax assessment was based on: average wage

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<sup>8</sup> In order to avoid this, tax compliance activities were itemized in our questionnaire.

Furthermore, the possibility of this overlap was tested, too. Taxpayers were asked how they would behave if there were no taxes. 55% of them answered that they would go on keeping all the same books of accounts as they do at present (of course except tax evidence and statements), 31% said they would continue keeping some record, but simplified than before and only 9% said they would not keep books of accounts at all. So, there is no considerable taxation/accounting overlap and there is no relationship between these results and the size of the business units.

<sup>9</sup> An alternative calculation based on a halved hourly value of owner (the average wage) still yields a high percentage - 65% in relevant tax revenues.

<sup>10</sup> Of course, it should not be forgotten, that business units that are really in loss additionally contribute to the small amount of revenues from that tax.

<sup>11</sup> Unfortunately, their efficiency could not be estimated for the small business and companies separately.

<sup>12</sup> The research was conducted in 2002 and the new Income Tax Act was for 2001 on.

<sup>13</sup> Pravilnik o samostalnim djelatnostima koje se mogu paušalno oporezivati te načinu utvrđivanja i oporezivanja paušalnog dohotka

<sup>14</sup> The list of labor intensive, small scale and locally restricted activities is added, which can apply lump sum, even if they have employees.

in Croatia, activity and situs (rural, urban, county capital, state capital). Further deductions from the amount of tax could be allowed depending on the location of activity (in relation to the centre of the town - place), number of other small businesses performing that activity in the same place - town, how well the business is technically equipped and other characteristics of business. Furthermore, additional deductions were available for special areas-regions (war affected areas and mountain areas, islands). The local tax administration is responsible for establishing the scope of the deductions. Taxpayers do not have to keep any books, except the turnover records (they are important to establish whether the taxpayer is liable for VAT<sup>15</sup>).

As one can see, Croatian solution is very close to the pattern presented in comparative analysis of other CEE countries. To be completely precise and consistent with theory, the lump sum explained here (as well in other CEEs) can not be regarded "pure" lump-sum, since it is estimated according to some not fixed elements (location, business activity). So, they can eventually influence the behaviour of the taxpayers in some way. In addition to that, in Croatia, for instance, it could adversely influence the rise of its turnover (not above the VAT exemption limit). Furthermore, since lump sum taxation is mostly optional (as it is the case for Croatia too), its non-distortionary and incentive potentials could not be completely exhausted. On the other hand, abolishing this option seems to be completely unfair and could lead to the closing down of some of the smallest businesses.

But, the biggest problem of Croatian lump sum tax was the base of its assessment – the average wage. The average wage in Croatia is calculated for the legal entities only, so the physical entities – small businesses that pay personal income tax are not covered. The average wage in that sector is definitely deep below the average wage in sector of legal entities. All the owners of small business put that forward as the major disadvantage of the lump sum tax assessment. To be completely honest, the average wage of the employees working for physical entities (small business) is very often lower due to the underreporting of the real wage. The reason is high tax burden (not income tax on wages, but high burden of social security contributions)<sup>16</sup>. So, most employees are officially paid under the minimum wage rate, with additional amounts of cash given to them "off the record". The resulting tax evasion is not the biggest problem – moonlighting in the small business is even bigger problem. Only a negligible amount of taxpayers in Croatia opted for a lump sum tax. The new Croatian Income Tax Act (Official Gazette of the Republic of Croatia "Narodne novine", No.177/04, Article 44) still contains the possibility to introduce the lump sum tax for the small business exempt from VAT, but further detailed legislative solutions are in the process of transformation.

#### **4.2. Quantitative illustrations**

In order to illuminate why the lump sum taxation has not been accepted among Croatian entrepreneurs, three questions are to be answered:

- what is the highest level of monthly income that an entrepreneur in small business may earn to still have an option to switch to lump sum taxation;
- what is the lowest level of monthly income that an entrepreneur in small business must earn in order to opt for lump sum taxation, i.e. to benefit from it;
- what is the income span that a potential lump sum taxpayer in Croatia can have.

**First question:** What is the highest level of monthly income that an entrepreneur in small business may earn to still have an option to switch to lump sum taxation?

Taking into consideration that the starting limitation is the VAT exemption threshold (annual taxable turnover of 85.000 kn), the highest hypothetic monthly income is 7.083 kn (85.000 / 12), with an unreal prerequisite that an entrepreneur in small business does not have any expenses (i.e. that receipts equal income).

According to the last data processed from annual tax reports of business entities that pay personal income tax in period from 1999 to 2003, stated entities had receipts and expenses as shown below:

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<sup>15</sup> In the case the turnover exceeds the yearly ceiling.

<sup>16</sup> Social security contributions of employees (20% from gross wage) are relatively high in comparison with the EU and CEE; from the CEE countries only Poland, Slovenia and Serbia and Montenegro (Montenegro) have such a high rates (OECD 2006, IBFD 2005).

**Table 2: Receipts and expenses of Croatian business entities that pay personal income tax (small business)<sup>17</sup>**

Year	Receipts	Expenses	Expenses as percentage of receipts
1999	20.232.592.707	17.364.935.738	85,83%
2000	21.818.302.481	18.689.342.113	85,66%
2001	26.217.040.634	22.632.064.662	86,33%
2002	29.759.296.768	25.912.074.464	87,07%
2003	34.561.458.383	30.345.940.422	87,80%
Average	26.517.738.195	22.988.871.480	86,54%

If the average percentage of expenses in receipts is 87%, then the potential lump sum taxpayer could not have had a monthly income higher than 920,83 kn ( $85.000 / 12 * 13\%$ ), except in case he has lower than average percentage of expenses in receipts.

**Second question:** What is the lowest level of monthly income that an entrepreneur in small business must earn in order to opt for lump sum taxation, i.e. to benefit from it?

The lump sum income estimation is based on an average monthly wage per employee in legal entities in Republic of Croatia in previous year, reduced for the amount of compulsory social security contributions. That means that the lowest monthly lump sum income was 4.293 kn (5.366 kn - average wages reduced for 20% of compulsory social security contributions).

The starting lump sum income is thereafter adjusted according to the type of activity (coefficients ranging from 0,8 to 1,5) and location (0,8 – 1,2). Adjusted lump sum income could then be lowered up to 25% by the local tax authorities and their estimation. If the most beneficial scenario is taken from the taxpayer's point of view (i.e. the lowest starting lump sum income, lowest type-of-activity and location coefficients, and 25% reduction of income by the tax authorities' estimation) it turns out that the lowest possible monthly lump sum income in 2003 would be 2.061 kn ( $4.293 * 0,8 * 0,8 * 75\%$ ).

In order to opt for lump sum taxation, the potential lump sum taxpayer with the lowest possible monthly lump sum income in 2003 had to have a percentage of expenses in receipts not higher than 71% ( $(7.083 - 2.061) / 7.083$ ), had to engage in activities of agriculture, hunting, forestry or manufacturing (coefficient 0,8), had to be located within a municipality or a city (coefficient 0,8), and had to have an approved maximal (25%) income reduction by the tax authority. Even then the lowest possible monthly lump sum income was higher than the highest permitted if one considers that the average percentage of expenses in receipts was 86,54%. It is more than obvious that enforcement regulation in Croatia was not meant to make lump sum taxation possible. Therefore, the fact that a negligible number of entrepreneurs switched to lump sum taxation does not come as a surprise.

If we base the calculation only on the lowest starting monthly lump sum income (and neglect the previously implemented reduction/rise coefficients), then the potential lump sum taxpayer had to have a percentage of expenses in receipts lower than 39% ( $(7.083 - 4.293) / 7.083$ ).

**Third question:** What is the income span that a potential lump sum taxpayer in Croatia can have?

In order to answer this question it is necessary to forego the assumption of the average percentage of expenses in receipts, as well as the assumption of application of lump sum income reduction coefficients. As it can be noted from previous calculations, if these assumptions would not be abandoned, no income span would exist. Namely, the lower limit of remunerative income for lump sum tax option would be higher than the upper allowed limit, i.e. VAT threshold, which excludes the possibility of lump sum taxation. In such case (i.e. without the above mentioned assumptions), lump sum tax option would be remunerative for a small business entrepreneur in Croatia only if he had monthly income in 2003 higher than 4.293 kn and lower than 7.083 ( $85.000 / 12$ ). At the same time his percentage of expenses in receipts had to be lower than 39% and diminish to 0% with the income rising up to the highest possible level of 7.083 kn. It can be assessed without hesitation that such tax-payer in reality existed extremely rarely.

If it is presumed that a percentage of expenses in receipts cannot be lower than 20%, then the potential lump sum taxpayer would have a possible income span between 4.293 kn and 5.666 kn ( $7.083 * 80\%$ ). Lower span limit in 2005 would be 4.788 kn, which is the amount of an average monthly wage per employee in legal entities in

<sup>17</sup> Croatian Ministry of Finance (2005). "Statistical report of processed annual income tax reports for business entities that pay personal income tax" and calculations of authors

2004, reduced by 20% (compulsory contributions). That means that the income span of the potential lump sum taxpayer would fall to only 878 kn per month (5.666 – 4.788), i.e. if he had an income lower than 4.788 kn, lump sum taxation would not pay for him, and if he had an income higher than 5.666 kn, he had no right to opt for lump sum taxation.

Yearly income span for potential lump sum taxpayer in 2003 was from 51.516 kn (4.293\*12) to 67.992 kn (5.666\*12), which is considerably higher than the actual average income for small business in Croatia in 2003 in amount of 46.887 kn. In order for remunerative and permitted income span of potential lump sum taxpayer to be in acceptable relation to the actual average of income, it should be lower than average. Namely, it is customary that the smallest of small businesses opt for lump sum taxation, them being the reason why this kind of taxation came into existence.

According to the data on average income of small business entities (business entities that pay personal income tax) in 2003, only the following activities had an average of actual income above or within the stated remunerative and permitted (possible) income:

**Table 3. Activities with income above and within remunerative and permitted income span of potential lump-sum taxpayers<sup>18</sup>**

Type of activity	Average income	Number of entrepreneurs
Croatia	46.887	94807
<i>Average income <b>above</b> the remunerative and permitted income span of a potential lump sum taxpayer</i>		
Bread and pasta products manufacturing	111.948	911
Legal, public administration, defence and social security services	100.737	2430
Water management and distribution	97.003	2
Extraction of other minerals and stone	82.560	50
Food and beverages manufacturing	77.040	1830
Health care, social care and dental services	73.339	8983
Medical, optical instruments, watches manufacturing	72.427	262
Total:		14468
Share in total number of small business entities		15,26%
<i>Average income <b>within</b> the remunerative and permitted income span of a potential lump sum taxpayer</i>		
Manufacture of metal products, machinery and equipment	66.562	2808
Forestry and forestry services	65.969	279
Other business activities	62.860	6941
Postal and telecommunication services	62.832	34
Real estate services	61.698	957
Manufacture of chemicals, rubber and plastic	61.243	84
Construction	59.582	8800
Manufacture of other transport equipment	57.187	77
Road transport of goods	55.839	6324
Manufacture of paper and paperboard	55.236	244
House-painting and glassworks	55.197	847
Meat manufacturing, processing and canning	53.537	210
Research and development	51.537	27
Total:		27632
Share in total number of small business entities		29,15%

The data show that small business entrepreneurs engaged only in seven activities had an actual income average above the set income span of potential lump sum taxpayers. It would have been expected that relatively significant number of entities engaged in those activities would have opted for lump sum taxation (had they been allowed to). Even if these expectations were met, the purpose of lump sum taxation would not have been accomplished since they make only 15% of the total number of small business entities.

<sup>18</sup> Croatian Ministry of Finance (2005). "Statistical report of processed annual income tax reports for business entities that pay personal income tax" and calculations of authors

From everything previously said, the conclusion can be drawn that reasons that the lump sum taxation has not been accepted in Croatia are twofold:

- (1) Lump sum income defined by enforcement regulation was too high for an entrepreneur to pay to opt for lump sum taxation. Most of small business entrepreneurs that do not pay VAT and have no employees have lower income. Also, the average small business income in Croatia is lower than the lump sum income.
- (2) VAT threshold defined by law, which also excludes the possibility of lump sum taxation, is too low. For that reason then the upper limit of possible income for lump sum taxation in relation to the lower limit, is also too low.

Small business entrepreneur in Croatia reaches relatively easy the yearly turnover above VAT threshold. Yet on the other hand, even if he does have lower turnover, then his income is lower than by regulations defined lump sum income. There are only few exceptions, such as some highly profitable service activities with low expenses/receipts ratio.

#### **4.4. Proposals for lump-sum tax actualization in Croatia**

The latest Income Tax Law further considers lump sum taxation for those entrepreneurs that are exempt from VAT. That being the case, everything previously said about the upper limit of the remunerative and permitted income span is still valid. Even though there is no new enforcement regulation that would indicate a real intention of lump sum tax implementation in Croatia, proposals can be given that could make such intention credible. As already pointed out, the work on enforcement regulation is in progress.

Authors are of the opinion that the lump sum taxation should be determined through definition of a lump sum tax, and not lump sum income. So far the concept of lump sum income served as starting point and base for determining the amount of lump sum tax in the same way the actual income is used as starting point and base in determining the income tax. Such regulation enabled an entrepreneur to compare the lump sum income with the income he actually earns or expects to earn. As being the case in Croatia, he came to the conclusion that the lump sum income is set too high.

Regulation that would set the amount of a lump sum tax, on the other hand, would make this kind of taxation acceptable to a considerably larger number of taxpayers, including those that have an actual income below the lump sum tax base, and even those that in some periods have tax loss. Namely, in that case the amount of tax in question would be acceptable for the taxpayer, and he would calculate with it in advance, anyway.

Lump sum tax and (or) lump sum income should be regulated at the lowest income tax bracket (15%), based on 80% of an actual average income of a specific activity. That way the lower limit of remunerability of lump sum taxation would be at an acceptable level.

Example:

In order to make an illustration we can take as an example a small business entrepreneur engaged in meat manufacturing, processing and canning that earns an average income from that activity in 2003 (53.537 kn – see Table 3).

His lump sum tax would be regulated on a yearly basis (as the authors suggest) at level of 6.424 kn ( $53.537 * 80% * 15%$ ) or monthly at 535 kn ( $6.424 / 12$ ).

Within income tax system, which demands keeping different books and records (as regulated), his final tax calculation is as follows:

**Table 4: The example of income tax calculation for the hypothetical taxpayer (who earns average income from an activity)<sup>19</sup>**

Actual income	53.537
Personal allowance (1.600 * 12)	19.200
Tax base (53.537 – 19.200)	34.337
Income tax (up to 38.400 = 15%) 34.337 * 15%	5.150
Monthly tax (5.150 / 12)	429

From this example one can notice that it would not pay for a hypothetical taxpayer to opt for lump sum taxation, considering the amount of tax. This is even more the case for those taxpayers that have dependant family members, which would make their tax base even lower. Nevertheless, the difference between the lump sum tax (535 kn) and the calculated income tax (429 kn) would compensate for all the compliance costs related to

<sup>19</sup> The authors



keeping different books and records necessary when operating within income tax system<sup>20</sup>. In that case one could expect opting for lump sum taxation.

This example shows that the framework suggested for implementation of lump sum taxation could be acceptable to taxpayers. There remains a necessity to reevaluate VAT threshold, which limits the possibility of a lump sum tax option.

## 5. Conclusion

Although advocated by the public finance theory (efficiency aspects) and some recent research results about tax compliance costs in Croatia as well as relatively widely used in CEE countries, lump sum taxation for small business in Croatia did not turn out to be successful.

The reasons should be sought primarily in its legislative design and enforcement, but maybe also in tax planning activities, including tax evasion.

The lump sum tax design in Croatia was formally based on some mutual characteristics of lump sum taxation in other CEE countries. These regimes are very often optional and conditional upon some criteria defining small business (VAT exemption, no employees, turnover/income under certain ceiling) or type of activity. The tax amount is estimated according to some "second best" criteria, such as business location, type of activity, specific factors of business activity... The Croatian lump sum tax option was restricted to small businesses that neither pay VAT nor have employees or co-entrepreneurs (partners). The tax assessment was based on average wage in Croatia, activity and situs (rural, urban, county capital, state capital) with further possible deductions from the amount of tax (depending on location of activity, number of other small businesses performing that activity in the same place - town, how business is technically equipped and other characteristics of business and possible underdeveloped region).

The biggest problem was the main assessment base – average wage, since the official statistics calculates it for legal entities only and it is higher than the average small business income (assuming that it is reported correctly). So, this estimation base is too high. The other problem is the upper limitation (ceiling) for the lump sum taxation – annual turnover below the VAT threshold, which is too low in comparison with the former.

Therefore, not only that the lump sum tax did not pay for the most taxpayers (i.e. was not lower than income tax), but it was also in effect not possible to be implemented where it was beneficial (i.e. lower than income tax), because such entities' turnover was already above the VAT threshold.

Even the saving in compliance costs was not enough attractive to taxpayers to opt for a lump sum tax. That is caused by the high proportion of owner's time costs, but also implies high proportion of these costs as tax planning costs as well the fact that they are at the expense of leisure. It could also imply the use of tax planning for tax evasion opportunities.

Our proposal is based on the lump sum taxation instead of lump sum income (corrected average wage). The basis for its assessment could be around 80% of average income of each small business activity. Upper limit for lump sum taxation (VAT threshold) should also be reconsidered.

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<sup>20</sup> Despite compliance costs being as high as income tax, taxpayers have not opted for a lump sum tax. Although generally higher than income tax, as explained above, it would result in saving of the compliance costs (income tax compliance costs are saved completely, but some turnover record must still be kept). This deserves further analysis. More than 60% of tax compliance costs structure comprises costs of the time of the owner. It is normal that big part of these costs is devoted to the tax planning. If the owner has no business opportunity cost of that time (he does not sacrifice his regular business work, but his leisure only), than the compliance costs of that time are in effect much lower, even negligible when compared to the gain (taxes saved). It seems that this is the case for the bulk or our small business owners. Furthermore, the fact that they did not opt for the lump sum tax could imply the use of tax planning not only for tax avoidance, but also tax evasion opportunities, as already pointed out.

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