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Abstract
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Keywords
value added tax, Croatia, VAT, GST, tax

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VALUE ADDED TAX IN CROATIA - AN (ALMOST) PERFECT TAX IN AN IMPERFECT ENVIRONMENT

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This article considers value added tax issues in Croatia. Generally, Croatian VAT is in accordance with the Sixth Directive of EU. This Directive was the model on which the Croatian VAT was designed. It raises design issues for other countries implementing a VAT/GST. In Croatia, the tax treatment of financial services is different from the solution in the Directive, giving unjustified advantage (tax exemption) to certain financial institutions. Originally there was only one tax rate, but later, dictated by political need, a zero rate was introduced. The author considers other issues of implementation including the length of accounting periods.

1 INTRODUCTION

Value added tax ("VAT"; Croatian "PDV") was introduced into the Croatian legal system in 1995. The Value Added Tax Act ("VAT Act") was published in "Narodne novine" (official gazette) No 47 on 12 July 1995. According to the Transitional Provisions, Art 35, of that Act, it should have applied from 1 January 1997, but according to Art 1 of the Value Added Tax Postponement Act, published in "Narodne novine" No 106 on 17 December 1996, its implementation was postponed until 1 January 1998. Value Added Tax Act came into effect on 1 January 1998.

In the period preceding the introduction of the VAT, a single stage retail tax applied in Croatia as a general consumption tax. Introduction of the VAT was one of the key features of general tax reform in Croatia, after the democratic changes and the beginning of the process of transition. There were several reasons for the introduction of the VAT; one of the most important was that the vast majority of European countries that trade with Croatia introduced the VAT. Its introduction in the Croatian tax system makes it transparent and comparable with the systems of its trading partners. In line with this, the process of joining with European Union (EU) imposes an imperative on every future member state to introduce VAT as a general consumption tax. It

is part of the tax harmonisation efforts that continue in the EU. As the Republic of Croatia plans to join the EU, the introduction of the VAT was an inevitable step on the way.[1] In any event, the old single stage retail tax proved to have a cascading effect, with all the negative consequences stemming from it. It produced a complicated and therefore untransparent, biased system that gave some taxpayers privileges that were not intended by the policy-makers.

2 THE STRUCTURE OF VAT IN CROATIA

Taxpayers

Generally, all business undertakings are subject to VAT, whether conducted through legal persons or by individuals, regardless of whether they are foreign or domestic. However, "small" entrepreneurs with a value of goods delivered and services performed of not more than 85.000 kunas (around A$17.800) in the preceding calendar year can opt in to the VAT system. If they do so, they have to remain VAT taxpayers for another five years. The calculation and payment of the VAT is based on a system of self-assessment, ie, the taxpayers have to determine their own value added tax liability for the given accounting period and state it in their tax return.

Object of taxation

VAT is levied on deliveries of goods of all kinds (products, commodities, real estate, equipment etc) and on all services performed in Croatia for a consideration, other than exempt transactions such as financial services rendered by certain legal persons (see below under 6), transactions subject to real estate transfer tax, export of goods, renting of housing premises etc.

Tax base

The tax base is the consideration received for goods delivered and services performed. Consideration includes anything that the recipient of goods or services is required to give or pay for the goods delivered or services

[1] It should be said, however, that Croatia's joining the EU is currently very distant. It is estimated that it will take 10 years for Croatia to become a full EU member state.

performed, excluding the amount of the VAT.[2] Input tax related to VAT-exempt transactions is irrecoverable, except for exported goods.

Tax rate

The standard rate is 22%. For some food, books of certain kinds, medicines and surgical implants the rate is 0%.

3 THE MAIN CHARACTERISTICS OF THE VAT IN CROATIA

Croatian VAT is, with some exceptions, in accordance with the Sixth Directive of EU.[3]

The main characteristics of VAT in Croatia are the:[4]

1 Consumption type of VAT;
2 Credit method of the collection of tax;
3 Destination principle;
4 Broad range of taxable transactions;
5 Two rate system (standard and zero rate); and
6 Principle of limited application of the special tax procedures.

3-1 Consumption type of VAT

Macroeconomically, the consumption type of VAT means that the amounts spent for the purchase of the capital goods are excluded from the tax base. VAT tax base is, therefore, equal to personal consumption. Along with the expenses made for raw materials, gross investments, (ie, the whole amount spent on the purchase of fixed assets) are also excluded from taxation.[5] The main advantage of this VAT type is that it causes the least distortions when the choice between capital and other inputs is in question, and is therefore considered the most neutral VAT type. Its disadvantage is that it, of all VAT

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2 This amount constitutes so-called "tax prepayment" (germ: Vorsteuer) and its deduction from the entrepreneur's VAT liability is the key feature of the VAT, ie, it is the technical solution that eliminates the cascade effect.

3 Bubaš Z, Dalić M, "Hrvatski zakon o porezu na dodanu vrijednost u kontekstu zahtjeva Europske unije" (No 2/96) Financijska praksa 151; see Directive 77/388 (OJ 1977 L145/1) (Sixth VAT Directive).

4 Amidžić-Peročević K et al, "Hrvatski zakon o porezu na dodanu vrijednost" in Spajić F I, Šimović J (eds) (1997) at 39.

5 Kesner-Škreb M, "Obuhvat poreza na dodanu vrijednost" (No 2/96) Financijska praksa 157.

types, mostly narrows the tax base, so that the highest tax rate has to be implemented.[6]

3-2 Credit method of tax collection

Under the credit method, the taxpayer subtracts the value of the VAT in input invoices from the VAT presented in output invoices issued to the purchasers of goods or services. The advantages of this method are simplicity and efficient control of the collection of tax. This control enables the tax administration to combat tax evasion; For example, taxpayers can subtract the VAT paid to suppliers only if they issue VAT invoices to the purchasers of their goods.

3-3 Destination principle

All the countries applying the consumption type of VAT also apply the principle of destination, and Croatia is no exception. This means that imports are taxed, and exports are exempt. The main advantage of this principle is the equal treatment of domestic and imported products in the domestic market. In Croatia, the export of goods and services is taxed at zero rate, with entrepreneurs exporting goods and services having the right to subtract the VAT paid.

3-4 Broad range of taxable transactions

On the definition of taxable transactions, the Croatian VAT Act is in accordance with the EU's Sixth Directive. Based on theoretical arguments, both documents include the broadest possible range of goods and services in order to accomplish some important goals: the broadest possible tax base, the lowest possible tax rate and neutrality of the tax.

3-5 Two rate system (standard and zero rate)

There are now two rates in the Croatian VAT system: a standard, generally applicable 22% rate, and a zero rate, which is applied to some basic goods, defined as basic needs.[7]

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6 Ibid.

7 See below under "4" for more on the problem of VAT tax rate(s) in Croatia.

3-6 Principle of limited application of the special tax procedures

While the Sixth Directive regulates special procedures in the system of the VAT, there is only one such situation built into Croatia's VAT Act. According to Article 22 of that Act, entrepreneurs whose turnover of goods delivered and services performed does not exceed 85.000 kunas in the previous calendar year are not be liable to pay VAT, but also do not have the right to declare tax on invoices issued, and cannot deduct tax calculated by other entrepreneurs.

The criterion expressed in this amount of money (85.000 kunas), separates entrepreneurs who are taxpayers from those who are not. The intention was to exclude small entrepreneurs from the VAT system, to make the system more transparent. However, as this can be a disadvantage for small entrepreneurs (being excluded from the VAT system, they cannot deduct input VAT) they were left the possibility to opt in for the VAT system.

The VAT is the most significant revenue source in Croatia. The share of VAT in the total income from taxation was 49.61% in 1998 and 52.93% in 1999, compared with the second most important item of taxation, personal income tax and surtax, whose share was 11.54% in 1998 and 10.82% in 1999.[8] These facts, together with the share of excise taxes, illustrate why the Croatian tax system is described as a "consumer oriented tax system".

The importance of the VAT is stressed by the procedural rule[9] that:

> (A)gencies responsible for domestic payment operations shall process the taxpayer's payment orders relating to value added tax payments and any effective orders passed by bodies responsible for tax supervision before the taxpayer meets any other payment obligation.

4 THE PROBLEM OF TAX RATES

Introduction of the VAT induced an extensive discussion, but most of that discussion referred to the topic of tax rates, ie, to the problem of the uniform tax rate introduced in Croatian VAT.

Croatia started with a uniform 22% rate of VAT, regulated in the VAT Act. "(S)ome tax experts, politicians, media and the citizenry" challenged that solution; they "hold that the system of VAT with a single rate is regressive, ie, it tends to hit the poor relatively hard, since they spend more of their

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8 Ott K and Bajo A, "The Croatian Budget for 1999" (January 1999) Newsletter, Institute of Public Finance, Zagreb 2.

9 VAT Act, Art 19, para 4.

income and save less".[10] Defenders of that approach point to the well known argument, that VAT, as a type of general consumption tax, has a regressive effect; and that effect should be alleviated through the application of selective taxation by means of more tax rates. There should be zero rate and, possibly, at least one lower rate; those privileged rates should apply to certain socially (and therefore also politically) important goods and services. Another line of argument stated that Croatia is one of very few countries that applies one-rate of VAT; it puts her, therefore, in an exotic group of tax countries.[11]

Those defending the one rate concept argue that it is grounded in theoretical and empirical arguments, stemming from the fact that the one rate VAT system with a broad tax base and a few exemptions provides abundant tax and is neutral.[12] Their main point is that:[13]

> (T)he goal to be accomplished through the introduction of the VAT is not the solution of certain social and political problems, but the creation of abundant tax revenue which does not introduce further distortions in the economic system.

The dispute over the problem of the rates of VAT was the main issue accompanying the introduction of VAT in the Croatian tax system. Introduction of the new tax, however, agitated not only experts but also Croatian public opinion as no one tax or even public finance problem had before. There were two assertions:

1 VAT as such will cause a rise in retail prices;
2 One relatively high rate[14] will cause living conditions for the poor to worsen.

It follows that the main concern was the impact of the new tax on the living standards of the wider population. Croatia faced two serious difficulties: firstly, the war for independence caused great loss of life, material damage and economic stagnation and even decline; and secondly, the process of transition, carried out through numerous bad solutions (a great deal of them stemming from political pressures that favoured "politically correct" individuals and groups, with market rules being deliberately neglected)

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10 Kesner-Škreb M, "Ten reasons in favour of a uniform rate of Value Added Tax" (September 1999) Newsletter No 2, Institute of Public Finance, Zagreb 1; also available at <http://ijf.hr/eng/newsletter/2.htm>.

11 See, eg: Jelčić B, "Ocjena hrvatskog sustava oporezivanja" Vol VI, No 1/99 Ekonomija/Economics 45-60; Jelčić B, "Novi režim poreza na dodanu vrijednost u Hrvatskoj" No 1/99 Pravo i porezi 7-13.

12 Kesner-Škreb M, "Stope poreza na dodanu vrijednost", No 2/96 Financijska praksa 168.

13 Ibid.

14 At the time of introduction the rate was (and still is) 22%, compared with, eg, 17% in FR Germany; and the difference between Croatia and Germany in terms of living standards is enormous.

contributed further to the deterioration of the Croatian economy. The consequence was the near disappearance of the middle class, which emerged to some extent during the existence of the system of so-called self-governmental socialism, and the rise in the number of the poor. Such an unstable socio-political environment, and the threat of a further worsening of living standards, induced by the new tax, caused the whole project to be questioned and, furthermore, numerous criticisms to be raised against it.

On an anecdotal level, it is, I think, worth describing the trouble with the timing of the introduction of VAT, in the general socio-political context. The VAT Act was officially published on 12 July 1995,[15] and it should have been applied beginning 1 January 1997. However, local elections were to take place in April 1997. The then right wing nationalist government concluded that due to the massive publicly expressed dissatisfaction, the introduction of the VAT and probable retail price raise could have politically harmful effects. The coming into effect of the VAT Act, and the implementation of the VAT consequently, was therefore postponed for another year[16] (ie, until 1 January 1998); such a long *vacatio legis* was then justified on the grounds of the need, expressed by practitioners, to get better acquainted with the new tax.

It seems that the VAT rate attracts ill-advised moves from every government, no matter what its political orientation. For example, the present Government, left centred and far less nationalist than the former, announced in April 2000 the lowering of the general VAT rate to 19%. This was in the context of the 100 day anniversary since it took office and in accordance with some promises hastily given during the election campaign. Only a few days later, this announcement was reversed. Furthermore, the Government announced higher excise duties on mineral oils, claiming, of course, that this would not cause price rises. It all left an impression of a lack of caution and seriousness when the most important tax(es) are in question.

5 FISCAL PERIOD AND ACCOUNTING PERIODS

At a first glance, the fiscal period and accounting periods are strictly technical matters, with no influence on the very material core of a VAT concept. This, of course, is completely wrong, especially in an economy burdened with problems of cash flow, as the Croatian economy now is.

According to the VAT Act,[17] the fiscal period is a calendar year, and where an entrepreneur has operated his business only during a part of the calendar

15 "Narodne novine" No 47/95.

16 See Value Added Tax Postponement Act, "Narodne Novine" No 106/96 (17 December 1996).

17 Art 16, para 1.

year, the fiscal period is the period in which he has conducted business operations. According to the first version of the VAT Act, the accounting periods were from 1st to 15th day of each month and from 16th to the last day of each month.[18] This meant that every taxpayer (except the specific group whose situation is explained below) had to calculate and pay his VAT twice monthly. This concept later changed. The change was due to numerous taxpayers' objections. For example, the great number of taxpayers had to calculate VAT on the basis of invoices or receipts issued for goods delivered and services performed in the accounting period.[19] In other words, the taxpayer had to calculate and pay VAT to the state on an invoiced (and not received) basis. A great many taxpayers had to pay VAT before they collected the cash for the goods they delivered and services they performed.

This is a usual approach, and it causes no problems in stable economies with established rules concerning payment periods. However, in Croatia, almost every entrepreneur faces serious problems when it comes to the collection of cash for his deliveries. The collection periods are uncertain and always rather long. This causes the temporary insolvency of many entrepreneurs, although they are solvent according to their books. On the general level, this phenomenon is called "internal debt" and it is one of the key characteristics of the crisis the Croatian economy is facing.

Consequently, and paradoxically, entrepreneurs found (and still find) themselves in the situation that although they conduct their businesses successfully, measured only by invoices accepted and issued, after they pay VAT they have cash flow problems. They pay their tax debt to the state, but then do not have enough cash to pay their debts to their business partners. Rather a long time ago, the domino effect caused this phenomenon to spread throughout the whole economy.

One specific group of taxpayers escaped this kind of problem. Entrepreneurs liable to personal income tax (attorneys, doctors, craftsmen, etc) have to calculate VAT on the basis of consideration received.[20] Often (but not so often as other entrepreneurs) they too face problems of non-payment. But, as they pay VAT only after they have received consideration in cash for their goods and services, the VAT is not the cause of their insolvency.

Even generally speaking, without reference to the Croatian situation, the accounting periods described above were too short, designed only with the interests of the state budget in the legislator's mind. They were especially short considering the reality of the Croatian economy. The pressures to make changes were therefore constant and strong, together with the surprise some foreign experts expressed when considering this solution. Politicians had to take these into consideration.

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18 VAT Act, Art 16, para 2.
19 VAT Act, Art 17, para 1.
20 Ibid at para 3.

The first changes and amendments of the VAT Act, contained in the Act on Amendments and Additions to the Value Added Tax Act,[21] that came into force a year after the VAT Act had come into force (ie, on 1 January 1999), made considerable changes to the article on accounting periods. According to new rules, accounting periods are from the first to the last day in the month, ie, the taxpayer now has to calculate and pay VAT once a month. Furthermore, the criterion dividing taxpayers into two categories (those who pay VAT according to consideration invoiced and those who pay VAT according to consideration received) is no longer whether the taxpayer is a personal income taxpayer. Instead the criterion is the value of goods delivered and services performed in the previous calendar year. If that value is less than 300,000 kunas (around A$61,500),[22] the accounting periods are from the first to the last day in a quarter, and the tax return has to be submitted to the competent unit of the Tax Administration according to the registered location of his office or residence within the period of ten days following the expiry of the accounting period.

This last point has changed since the new Government took office. As from 1 June 2000, according to Art 6 of the Act on Amendments and Additions to the Value Added Tax Act,[23] a taxpayer does not have to submit a tax return until the last day of the month following the accounting period. This prolongation is the result of further efforts aimed at alleviating entrepreneurs' insolvency problems. It allows, for example, the taxpayer to defer the payment of tax for another 20 days, compared with the previous solution.

6 TAX TREATMENT OF FINANCIAL SERVICES

Due to the difficulties in applying VAT to financial services,[24] it is a common practice to exempt those services from VAT. Insurance and reinsurance services are also exempt. Such an approach is present in Art 13 of the EC Sixth VAT Directive. Financial services include "dealings in money, shares, bonds, lending money, advancing credit, and operating bank accounts"[25] ("core" financial services).

Croatian VAT contains a somewhat different approach. Article 11 of the VAT Act (para 1, Item 2) provides for exemption of "services of banks, savings institutions, savings and loans institutions, insurance and reinsurance companies". When compared with the Sixth Directive, it is obvious that Croatian VAT exempts only the services performed by certain institutions,

21 "Narodne Novine" No 164/98 (18 December 1998).

22 This criterion aims to separate the so-called small entrepreneurs as VAT taxpayers from the rest.

23 "Narodne Novine" No 54/00 (31 May 2000).

24 See, eg, OECD Consumption Tax Trends (1995 OECD) at 27.

25 Ibid at 28.

while the Sixth Directive exempts the same services, but regardless of the institution that renders such services. In Croatian theory, this difference is known as the difference between the functional (that in the Sixth Directive) and institutional (that in Croatian VAT law) approach.[26]

The Croatian approach is different from the Sixth Directive, and is still challenged by scholars and practitioners. The main argument is that it breaks the principle of neutrality, privileging one category of lenders and deprivileging the other. For example, any bank should not calculate and pay VAT on the services it renders. This makes its "products" more competitive. On the other hand, the Croatian Pension and Disability Fund, while it legally could act as a lender, has to calculate VAT on the interest on its loans. The Croatian VAT Act contains in itself substantial, unfounded inequality of persons performing the same services. On the contrary, the solution contained in the Sixth Directive is in accordance with the principle of neutrality, because it makes no difference which kind of persons render exempt services.[27]

The situation described above refers only to the loans. But the banks, savings institutions, savings and loans institutions, and insurance and reinsurance companies enjoy exemptions relative to all goods they deliver or services they perform (Regulation on Value Added Tax, Art 66)[28] no matter whether they are financial or non-financial. This means that if, for example, the bank sells its used cars, or rents business premises, it will be exempt from VAT on these transactions.[29] This exemption aims at simplification of the taxation procedure. To illustrate, as privileged taxpayers perform services other than financial service, and deliver some goods, theoretically they should divide VAT inputs on the taxable part from VAT inputs on the non-taxable goods and services, if there were differentiation between the financial and non-financial services and delivery of goods. However, tax exemption of all deliveries of goods and of all services means that there is no need for such division.[30] This concept of tax exemption lowers the compliance costs for taxpayers and the cost of taxation for the Government, but the cost, ie, the breaking of the principle of neutrality and discrimination connected therewith, far exceeds the described relatively modest benefit.

As far as tax exemptions are concerned, there are some other differences from the Sixth Directive. For example, according to the Directive, services in the fields of education, science, sport, medical and social care are exempt from VAT, no matter whether they are performed "by bodies governed by

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26 Jelčić B, Lončarić-Horvat O, Šimović J, Arbutina H, "Hrvatski fiskalni sustav (1)" Birotehnika, Zagreb at 91.

27 Ibid at 94.

28 "Narodne novine" No 60/96, 113/97, 7/99, 112/99.

29 Javor L, "Financijske usluge u sustavu poreza na dodanu vrijednost" No 4/2000 Računovodstvo, revizija i financije 104.

30 Ibid.

public law or ... other duly recognised establishments of a similar nature".[31] In Croatia, however, again because of the so-called institutional approach, the exemption of these services is rather restricted. They will enjoy the tax exemptions, but only provided they are performed by the institutions and communities that perform their activities in accordance with special regulations.[32] In other words, these legal persons are exempt from VAT only if they are founded according to the Act on Institutions.[33] That means that if their founder (and owner) is the state, this implies that they do not perform their activities to make a profit. This excludes bodies performing these services that are founded by individuals and legal persons according to some other acts (for example, according to the Company Act), from the privilege of tax exemption. It once again breaks the principle of neutrality of the VAT. This disadvantage is of special importance in Croatia, where private undertakings are still weak in the field of these services. The private sector should not be privileged, but it should be in an equal position, in the context of VAT among other things, with the public sector.

7 CONCLUSION

Value added tax has been applied for rather a short period of time in Croatia, but at the moment it is the cornerstone of the state revenue. This is not entirely new or surprising, because it replaced the former single-stage retail tax, which had the same role. Comparatively, VAT proved to be the best solution, compared with the other forms of consumption taxation, and arguments in favour of it prevailed in Croatia over the difficulties of its implementation.

Croatian VAT was modelled against the Sixth Directive of the EEC. As such, it has all the main characteristics of a standard VAT form - with a few, but, unfortunately, important exceptions. Those exceptions mean that some persons enjoy potentially significant tax privileges, while others are put in an unequal position on the market. The discrimination is so obvious and so narrowly aimed at only certain "winners" that this makes it hard to believe that it is the result of lobbying. However, another possible explanation, that of negligence in legislative process seems to be rather naive, bearing in mind the interests involved. Furthermore, this reason could have been removed by now, since there have already been some changes in the VAT Act For example, accounting periods have been changed in order to conform to the real conditions in the Croatian economy.

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31 Directive 77/388 (OJ 1977 L145/1) (Sixth VAT Directive).

32 VAT Act, Art 11, para 2.

33 Published in "Narodne novine" No 76/93; the syntagm "special regulations" refers to this Act.

Speaking of those conditions, VAT is still too heavy a burden for Croatian entrepreneurs. The main reason is not the VAT as such, but the general economic situation in Croatia. Lack of capital, the high rate of unemployment and some other more specific problems of transition, errors in privatisation not being the least, led to the position that every tax is hardly bearable for most businesses. Those conditions make even very good taxes bad. VAT is probably the best form of general sales tax, but it cannot improve the general economic environment. Reduction of the VAT rate would be of help in Croatia, but the real solution is far more general and lies outside the field of taxation.