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# Effective Corporate Income Tax Burden in Croatia



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**Abstract**

This paper provides an analysis of corporate income tax (CIT) in Croatia. Given the fact that Croatia implements a consumption-based CIT and a number of tax incentives, the purpose of this paper is to establish the level of effective tax burden on companies in Croatia. In addition to analyzing the basic indicators of the CIT burden, the paper also presents a calculation of the effective tax rate based on the application of the Devereux-Griffith methodology. Apart from the cost of capital, the effective marginal tax rate (EMTR) and the effective average tax rate (EATR), also the EATR will be calculated for cases in which tax holidays are used.

**Keywords**

effective tax rates, corporate income tax, tax holidays, Croatia

**JEL classification**

H25

## 1. Introduction

Croatia, like most transition countries, has chosen to develop a consumption-based concept of personal (PIT) and corporate income tax (CIT). This in fact means that in the case of CIT the tax burden is targeted towards those parts of income intended for consumption, whereas the parts of income intended for investment and savings are in a more favourable tax position or even fully exempt from taxation. According to Rose and Wiswesser (1998), two of the creators of such a taxation concept, the shifting of the tax systems in the direction of a consumption-based PIT and CIT was necessary in transition countries as they suffered from a lack of capital. Such a CIT concept was automatically accompanied by a relatively low tax burden. Although in 2001 by abolishing the „protective interest“<sup>1</sup> Croatia gave up on ACE tax, the practice of a consumption-based CIT was nevertheless retained through deduction of interest payments on debt from the tax base. Together with such a practice also the practice of low tax burden was continued, especially through the application of numerous tax incentives that have been in force since 2001, and most notably of tax holidays.

The basic aim of this paper is to establish the level of effective CIT burden in Croatia. To this effect the methodology first includes the analysis of the basic indicators of the tax burden, such as the statutory tax rate, tax structure and the share of CIT in the GDP. In the scope of the first part of the paper an analysis of tax incentives in case of CIT in Croatia shall be given, with special consideration of tax holidays. The second part of the paper includes a calculation of effective tax rates for domestic investments based on the application of the already standard Devereux-Griffith (1999) methodology, in the scope of which EATR shall be calculated for all types of tax holidays. Induction of the gained results will confirm the hypothesis that Croatia has a low CIT burden and in this aspect represents a favourable investment location.

## 2. Corporate Income Tax in Croatia: basic elements and tax incentives

### 2.1. Basis CIT burden indicators

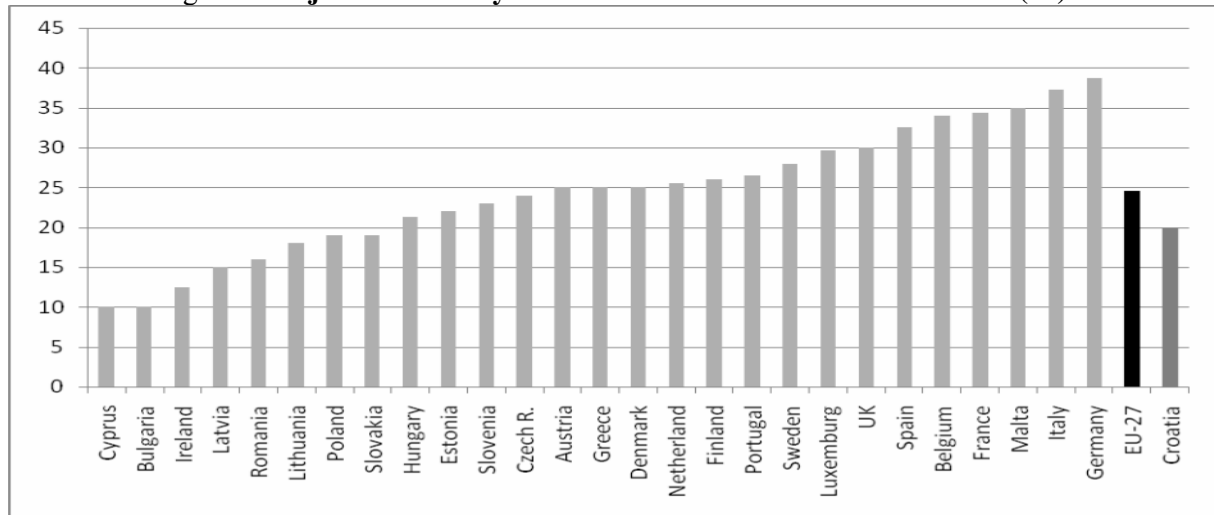
The existing CIT system was introduced in 2005. In order to be able to establish the effective CIT burden within the scope of this paper it is necessary to analyse the basic CIT elements which affect its level. These elements are: the tax base, tax structure and the share of CIT in the GDP, as well as tax incentives within the CIT system.

Although the CIT rate is in its own right neither a relief nor an incentive, it can nevertheless be viewed as such when it is lower with respect to other countries observed. Relevant literature generally sees lower tax rates as the simplest but at the same time also the harshest tax instrument, since the level of incentives does not vary with the level of investment. On the other hand, when compared to other incentives within the CIT system, it is characterised by neutrality, simplicity, transparency and generality (Mintz & Tsiopoulos, 1995). The fact that the level of CIT rate actually does represent a significant incentive instrument is clearly demonstrated by the constant lowering of tax rates among transition countries, i.e. their so called “race to the bottom”. Since acquiring its independence Croatia has modified its CIT rate on three occasions. Up until 1996 the statutory CIT rate of 25% was applied, and until 2000 a CIT rate of 35%. In 2001 the CIT rate was reduced to 20%, and has remained the same ever since.

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<sup>1</sup> “Protective interest” was calculated on equity capital and deducted from CIT base. As a form of equity allowance it served as attempt to approximate the normal return to capital.

Figure 1. Adjusted statutory CIT rates in EU-27 and Croatia in 2007 (%)



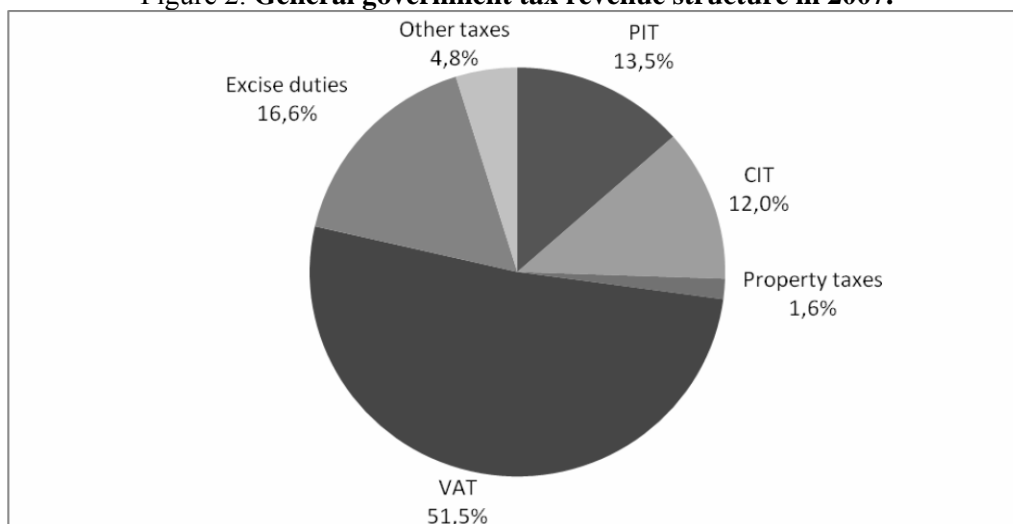
Source: European Communities (2008) & Corporate Income Tax Act.

Figure 1. shows CIT rates applied in EU-27 and Croatia in 2007. According to the figures presented, Croatia has a relatively low tax rate with respect to the EU-27 average. The difference is, expectedly, even greater when only old EU-15 countries are taken into account. New EU-12 countries, on the other hand, in average apply a lower CIT rate than Croatia. Unlike most EU-12 countries, Croatia has not decreased its CIT rate since 2001, and we can therefore talk about a relatively long period of application of a significantly low CIT rate of 20%.

When together with the CIT also the tax structure is observed, and in general the share of CIT in the GDP or in the total revenues, we are talking about a backward-looking approach of observing the effective tax burden.

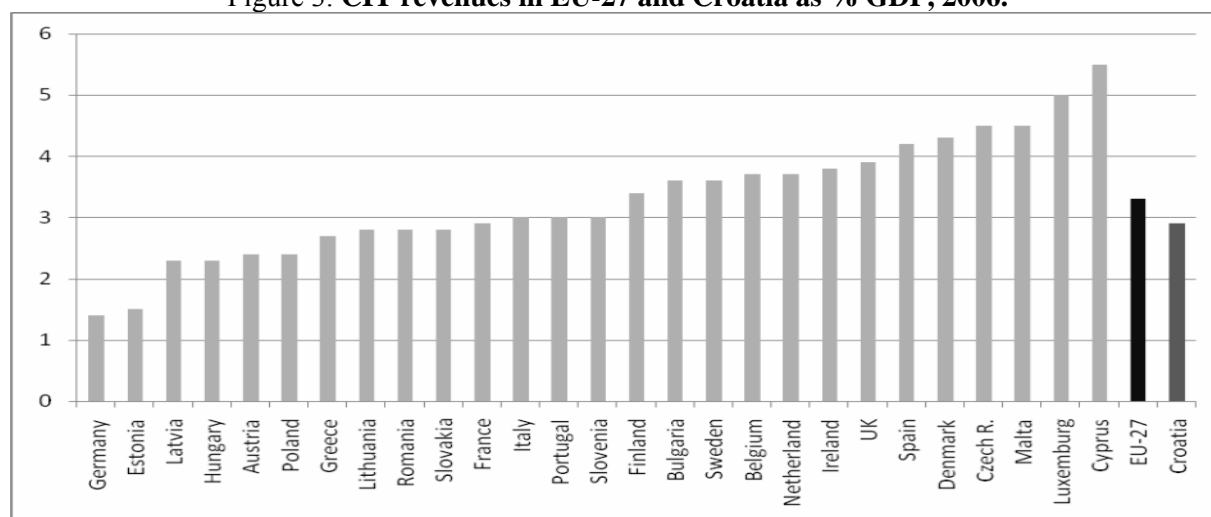
Figure 2. shows the tax structure in Croatia. In the structure of general government tax revenues CIT represents merely 12% of tax revenues, which is the lowest share among the related tax forms such as PIT, VAT and excise duties. The mentioned share would be even smaller if other public revenues, such as social contributions and grants, were taken into account. Apart from demonstrating a rather low CIT burden, the figure also points to a consumption-based tax system in Croatia which is dominated by indirect taxes (VAT, excise duties).

Figure 2. General government tax revenue structure in 2007.



Source: Ministry of Finance (2008).

Figure 3. CIT revenues in EU-27 and Croatia as % GDP, 2006.



Source: European Communities (2008), Ministry of Finance (2008).

Figure 3. shows the share of CIT in the GDP in EU-27 and Croatia. The share of CIT in the GDP is in average lower in Croatia than in EU-27 countries. Similarly as with the CIT rate, among the countries observed Croatia is positioned at the middle of the scale. A lower share of CIT in the GDP is mostly characteristic of other transition countries, which can also be attributed to consumption-based tax systems. The more developed EU-15 countries, on the other hand, demonstrate a larger share of CIT in the GDP, which is also an indication of a higher CIT burden.

## 2.2. Tax incentives

Although tax incentives can be applied in various forms when it comes to CIT, each of these forms, however, includes either a lowering of the CIT rate or a reduction in the tax base which consequently produces a lower effective tax burden. Relevant literature most commonly classifies tax incentives in the case of CIT into the following three basic groups (Zee et al., 2002; Easson, 2004): 1) reduced CIT rates, 2) tax holidays, and various 3) investment incentives in the broader sense.

Apart from implementing the already mentioned relatively low CIT rate, Croatia has also introduced a number of tax holidays. Due to their necessary adjustment to EU regulations, tax holidays are a subject of constant amendments. In this context a difference can be made between general tax holidays applicable on the entire territory of Croatia and regional tax holidays which apply only in certain parts of the country.<sup>2</sup>

Table 1. illustrates the characteristics and conditions of general tax holidays. Such tax holidays are allowed for 10-year periods during which a reduced tax rate (10%, 7%, 3%) or a full tax exemption (0%) is applied, depending on the investment amount and the number of new employees. The stipulated conditions must be met within 3 years from the beginning of investment.

Table 1. General tax holidays

Investment amount (million EUR)	Tax holiday (from beginning of investment)	Reduced CIT rate	Obligation to employ new employees
0 - 1,5	10 years	10%	at least 10
1,5 - 4	10 years	7%	at least 30
4 - 8	10 years	3%	at least 50
Above 8	10 years	0%	at least 75

Source: Investment Promotion Act.

<sup>2</sup> The CIT system is not only regulated by the Corporate Income Tax Act. This is also true of most tax incentives, and especially of tax holidays, which are allowed pursuant to special legislative acts. See more below.

The characteristics and conditions of regional tax holidays are listed in Table 2. The application of such holidays is limited exclusively to four regions in Croatia (the City of Vukovar, areas of special national concern, hill and mountain areas and free zones) and is also regulated by special legislative acts.

Table 2. **Regional tax holidays areas**

<b>Tax holiday area</b>	<b>Reduced CIT rate</b>	<b>Conditions</b>
<b>City of Vukovar</b>		
Until Croatia enters EU	0% (exemption)	- engaged in business activity in the area of the City of Vukovar - obligation to permanently employ at least 5 employees with more than 50% of the employees living in the City of Vukovar area, or a hill and mountain area or an area of special national concern
<b>Areas of special national concern:<sup>a</sup></b>		
<i>1<sup>st</sup> Category:</i>		
2008-2010	0%	<i>For all categories:</i> - engaged in business activity in agriculture and fishery - obligation to permanently employ at least 5 employees with more than 50% of the employees living in the area
2011-2013	5%	
2014-2016	15%	
<i>2<sup>nd</sup> Category:</i>		
2008-2010	5%	
2011-2013	15%	
<i>3<sup>th</sup> Category:</i>		
2008-2010	15%	
2011-2013	17%	
<b>Hill and mountain areas</b>		
2008-2010	15%	- engaged in business activity in the area - obligation to permanently employ at least 5 employees with more than 50% of the employees living in the area
<b>Free zones:</b>		
<i>1. variant:</i>		
2008- (until year incentive is used, max.2016)	0% (exemption, up to the upper allowed limit of incentive) <sup>b</sup>	<i>1. variant:</i> Investment in buildings of more than 1 million HRK
<i>2. variant:</i>		
<i>Northwest Croatia:</i>		
2008-2010	10%	<i>2. variant:</i> engaged in business activity in free zones in the mentioned regions
2011-2013	15%	
<i>Central &amp; East Croatia;</i>		
<i>Adriatic Croatia:</i>		
2008-2013	10%	
2014-2016	15%	
<i>City of Vukovar:</i>		
2008-2010	0%	
2011-2013	5%	
2014-2016	15%	

*Source:* prepared by author according to the Act on Reconstruction and Development of the City of Vukovar, the Act on Areas of Special National Concern, the Act on Hill and Mountain Areas, and the Free Zones Act.

*Note:* <sup>a)</sup> there are 3 categories of areas of special national concern. Their zoning mostly depends on war destructions and development; <sup>b)</sup> Upper allowed limits of incentives depend on the cumulative amount of aid received from all available resources and on the regional aid map. Limits mustn't exceed those allowed by the Investment Promotion Act (general tax holidays).

The third large group of tax incentives are investment incentives in the broader sense, which relevant literature most commonly classifies into following categories (Zee et al., 2002; Easson, 2004): 1) accelerated depreciation, 2) investment allowances and 3) investment tax credits.

Out of the listed standard investment incentives only accelerated depreciation is used in Croatia, which allows for the depreciation rate to be doubled (linear method). In addition to accelerated depreciation, other tax incentives exist which cannot be classified under investment allowances as relevant theory knows them. Such incentives include tax base deductions for certain costs and tax loss relief (Šimović, 2008).

With respect to tax base deductions, additional deductions from the tax base are possible for costs of R&D projects<sup>3</sup>, as well as education and training costs of employees.<sup>4</sup> In case of tax loss relief, on the other hand, tax losses created by the company are carried over and balanced out through a reduction of the tax base over the following 5 years.

### 3. Effective tax rates

#### 3.1. Model

The calculation of the effective CIT burden in Croatia shall be based on the already standard Devereux-Griffith model (Devereux & Griffith, 1999). This forward-looking approach to the calculation of the effective tax burden was first developed by King and Fullerton (1984), and was later extended by Devereux-Griffith (1999). In later years the model was further developed and used in different variants, and the variant to be used in this research takes into consideration the effects of tax policies on local decisions in domestic investments.<sup>5</sup> As in all forward-looking approaches to the calculation of the effective tax burden, three basic indicators of the effective tax burden shall be used here: costs of capital, effective marginal tax rates (EMTR) and effective average tax rates (EATR).

As standard as the Devereux-Griffith model (1999) may be in relevant literature, the assumptions for the calculation of effective tax rates within its framework vary significantly. The first important assumption concerns the inflation rate ( $\pi$ ) and the real rate of return ( $r$ ). Relevant literature most commonly uses the model variant in which the inflation rate is assumed at 2% and the real rate of return at 5% (Commission of the European Communities, 2001; Ernst & Young/ZEW, 2003; Finkenzeller & Spengel, 2004; Overesch, 2005; Elschner & Overesch, 2007). Another frequently used variant assumes an inflation rate of 3.5% and a rate of return of 10% (Devereux et al., 2002; Švaljek, 2006). Other important assumptions to be taken into account are rates of true economic depreciation for certain types of assets, weights for certain types of assets as well as weights for certain types of sources of finance in a particular investment.

Two researches were conducted in Croatia so far using the Devereux-Griffith model (Kukić, 2006; Švaljek, 2006), both of which were based on the assumption of  $\pi=3,5\%$  i  $r=10\%$ , whereas in Švaljek (2006) the model was extended to include the existence of a protective interest rate in the Croatian CIT system until the year 2000. Furthermore, both researches assume investment in two types of assets only (machinery and buildings), while the economic depreciation rates used were taken over from the OECD (1991).

For the purpose of simplicity and the later comparison of results with the EU, the calculations in this paper shall be based on assumptions similar to those regularly used by researchers from the Centre for European Economic Research (ZEW - Zentrum für Europäische Wirtschaftsforschung) in their research projects

<sup>3</sup> Justifiable costs of research and development allow for additional deductions from the tax base by 100%, 125% or 150% of the cost amount, depending on whether development, applied or basic research is concerned. See: Act on Science and High Education and Regulation on State Aid to R&D projects.

<sup>4</sup> The tax base can be additionally decreased by up to 100% of costs of employee education and training. The level of the deduction depends on whether the company concerned is a small or large enterprise, a company involved in maritime transport or other. See: Act on State Aid to Education and Training.

<sup>5</sup> For more information on the methodology of calculation of effective tax rates on domestic investments see Devereux & Griffith (1999 and 2003).



(Overesch, 2005; Elschner & Overesch, 2007). This primarily includes a variant in which  $\pi=2\%$  and  $r=5\%$ , as well as other assumptions which are listed in Table 3. The same methodology is also used for the calculation of effective tax rates in case of tax holidays. EATR shall be calculated for all variants of reduced statutory tax rates which may occur in the above listed cases of tax holidays.

Table 3. **Basic model assumptions**

Inflation rate ( $\pi$ )	2%
Real interest rate ( $r$ )	5%
Pre-tax real rate of return ( $p$ )	20%
Assets (at equal weights)	Buildings, intangibles, machinery, inventories
Sources of finance (at equal weights)	Retained earnings, new equity, debt
Economic depreciation rates	Buildings 3,1%; Intangibles 15,35%; Machinery 17,5%

The new Corporate Income Tax Act which was implemented in 2005 included the last modifications of elements which impact the calculation of effective tax rates (statutory tax rates and depreciation rates); there have been no changes in effective tax rates in Croatia ever since.

The calculation for Croatia is based on the assumption of investment in buildings, intangibles, machinery and inventories. For the types of assets mentioned, a linear method of depreciation is applied in Croatia, and accelerated depreciation is allowed by means of doubling of standard depreciation rates. The presented calculations of effective tax rates were made under the assumption of accelerated depreciation.

According to the model used, investments can be financed from three different sources: retained earnings (RE), new equity (NE) and debt (D). Given the fact that after 2005 dividends are no longer subject to taxation in Croatia, the tax discrimination variable is equal to  $\gamma=1$ .<sup>6</sup> Thus, the element of net present value which refers to new equity financing equals  $F^{NE}=0$ . In other words, the element of net present value in case of financing by new equity is equal to the one in case of financing by retained earnings, i.e.  $F^{RE}=F^{NE}=0$ , meaning that the cost of capital, the EMTR and the EATR are identical for both the financing by retained earnings and the financing by new equity.

### 3.2. Results

Table 4. shows the data obtained for the cost of capital and the EMTR in Croatia. The cost of capital in Croatia is equal to or higher than 5% in case of investments in all types of assets financed by retained earnings or new equity. For investments financed by debt, the cost of capital ranges between 3.6 and 3.8%, which makes for an average of below 5%. The conclusion can therefore be made that the tax system in Croatia subsidizes investments which are financed by debt, since the cost of capital is then lower than 5%, which is the initial assumption of the real rate of return.

<sup>6</sup> The tax discrimination variable equals  $\gamma = (1 - m^d) / (1 - c)(1 - z)$  where  $i$  is the nominal tax rate,  $m^d$  is the personal tax rate on dividend income,  $c$  is the tax credit rate allowed for dividends paid, and  $z$  is the personal tax rate on capital gains. In Croatia  $m^d = c = z = 0$ , hence  $\gamma=1$ . Furthermore, since the personal tax rate on interest income also equals  $m^i=0$ , therefore the shareholders' nominal discount rate (rate of return) is equal to the nominal interest rate, i.e.  $\rho = i$ , given the fact that  $\rho = (1 - m^i) i / (1 - z)$ .

Table 4. **Cost of capital and EMTR in Croatia in 2007.**

<b>Cost of capital EMTR</b>	Buildings	Intangibles	Machinery	Inventories	Mean
Retained earnings	5.51 9.24	5.17 3.26	5.19 3.59	5.00 0.00	5.22 4.02
New equity	5.51 9.24	5.17 3.26	5.19 3.59	5.00 0.00	5.22 4.02
Debt	3.80 -31.46	3.60 -38.79	3.62 -38.11	3.61 -38.59	3.66 -36.74
Mean	4.94 -4.33	4.65 -10.76	4.67 -10.31	4.54 -12.86	4.70 -9.56

*Source:* Author's calculations

The EMTR shows whether and to which extent incentives for new investment were built into the tax system and thus indicates the allocative efficiency of the tax system. In case of investments financed by retained earnings and/or by new equity, positive values were obtained in both periods considered. The EMTR in case of investments financed by debt points to the same conclusion as the figures obtained for the cost of capital. In all the given cases the EMTR<sup>D</sup> takes on negative values, meaning that the cost of capital is lower than the rate of return, i.e. that the existing tax system additionally subsidizes the observed marginal investment in all types of assets. In the situation of a negative EMTR<sup>D</sup> the tax system automatically increases the post-tax rate of return with respect to the pre-tax rate of return, thus making the investment all the more profitable. In average, financing by debt affects the occurrence of a negative EMTR in case of investments in all types of assets, and at the same time influences the average EMTR which is also negative and equals -9,56%.

Table 5. contains the calculated figures for EATR in Croatia. The listed EATR refer to investments with a real rate of return of 20%. The EATR shows to which extent taxation contributes to the decrease of net present value of a profitable (above marginal) investment project, or in other words, indicates the relative share of corporate income being consumed by taxes.

Table 5. **EATR in Croatia in 2007.**

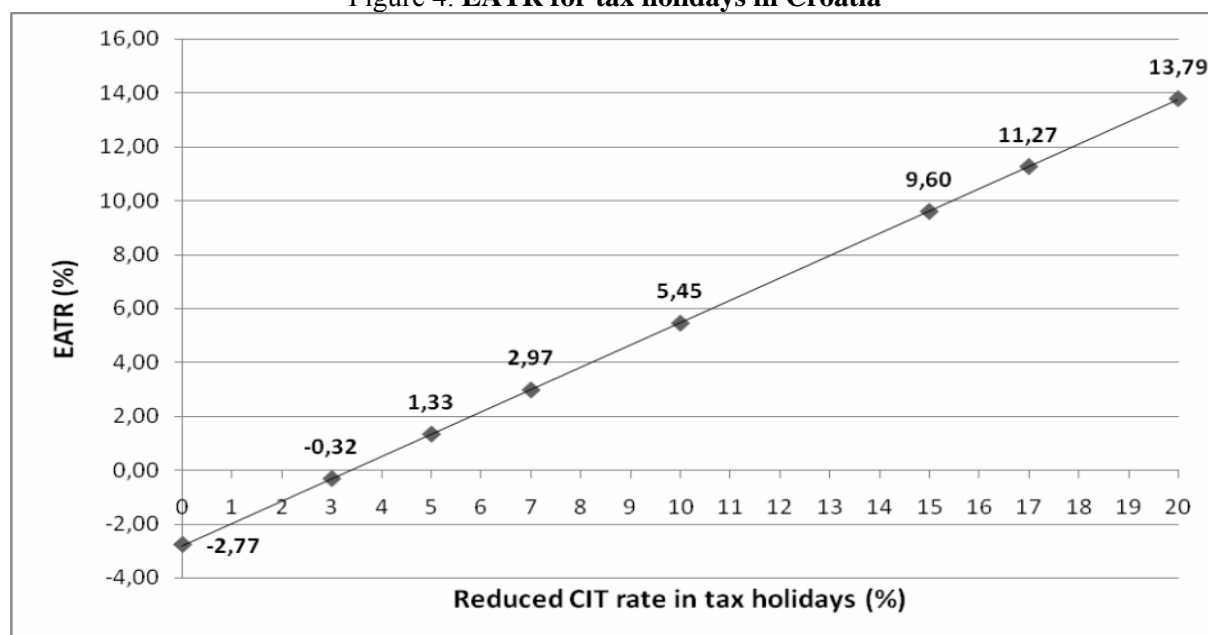
<b>EATR, p=20%</b>	Buildings	Intangibles	Machinery	Inventories	Mean
Retained earnings	17.04	15.67	15.75	15.00	15.87
New equity	17.04	15.67	15.75	15.00	15.87
Debt	10.21	9.41	9.48	9.43	9.63
Mean	14.76	13.58	13.66	13.14	13.79

*Source:* Author's calculations

As in the case of the previous two indicators (cost of capital and EMTR), it can once again be observed that EATRs values are higher for investments financed by retained earnings and/or new equity than for those financed by debt. The highest EATR occurs with investments in buildings financed by retained earnings or new equity, whereas EATR values are lowest in case of investments in intangibles financed by debt. In all cases considered we can, however, talk about a relatively low EATR. The reasons of such a low tax burden are to be found in the simplification of the depreciation scheme after 2005.<sup>7</sup> As already mentioned, after 2005 higher standard depreciation rates were introduced for the types of assets concerned which can be additionally doubled when accelerated depreciation is used. What is more, the statutory CIT rate has not been changed since 2001, whereas the taxation of dividends within the PIT was in the meantime abandoned. In addition to dividends, other forms of capital income are also exempt from taxation in Croatia (interests payments and capital gains), which affects the relatively low EATR values as well.

<sup>7</sup> Prior to 2005 the depreciation scheme used to be more complex. Several different depreciation variants existed for almost each type of assets considered. Buildings, for example, were depreciated differently depending on whether building constructions in reinforced concrete, civil engineering projects (road construction) or wooden constructions were concerned. See: Depreciation Regulation.

Figure 4. EATR for tax holidays in Croatia



Source: Author's calculations

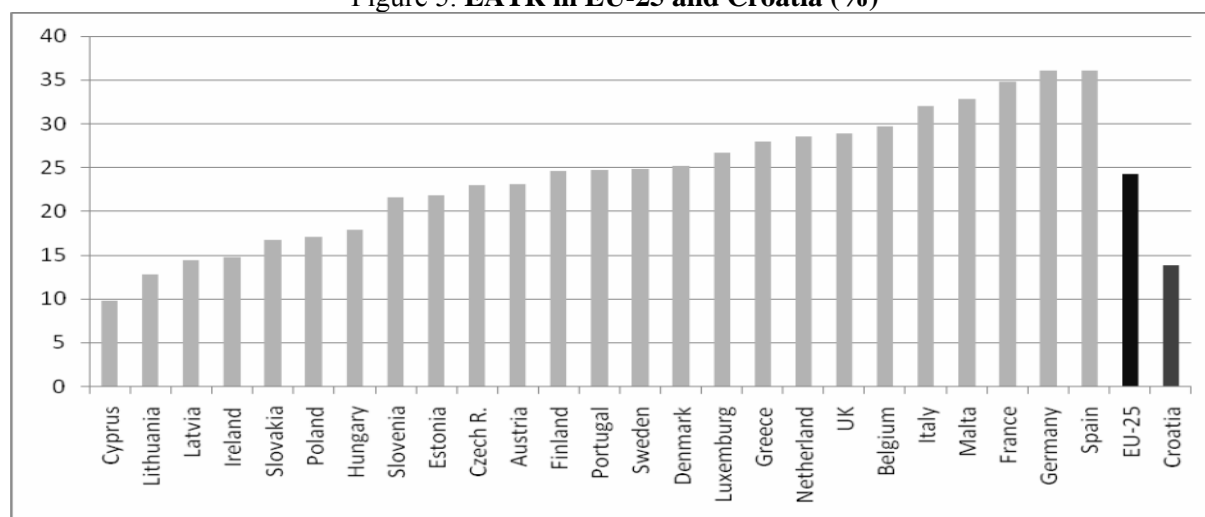
Figure 4. shows the EATR values for tax holidays in Croatia for investments in all types of assets and from all sources of finance. The rates shown refer to all possible variants of reduced CIT rates which can occur in different types of general and regional tax holidays (0%, 3%, 5%, 7%, 10%, 15% and 17%). Regardless of the value of the reduced CIT rate, a linear trend of decrease in EATRs can be observed with the decrease of statutory tax rates.

Given that the basic EATR of 13.79% is already very favourable and low, it is logical that in cases of tax holidays it should be even lower. Even in situations when statutory tax rates amount to 0% (exemption) or 3%, the EATR remains negative, which clearly demonstrates the advantages and tax incentives incorporated into the CIT system. With respect to the high number of tax incentives, and especially the wide variety of existing tax holidays, the conclusion can be drawn that from the aspect of EATR the Croatian CIT system is extremely stimulating and favourable for domestic investment.

### 3.3. Comparison with the EU

The comparison shall be based on the data obtained by the ZEW, who regularly follow fluctuations of effective tax rates using the same methodology which was also used for the calculations of effective tax rates in Croatia (Overesch, 2005; Elschner & Overesch, 2007). As opposed to the EMTR, the EATR is a more adequate indicator when it comes to the effects of taxes on investment location decisions because it shows the relative share of corporate income being consumed by taxes. Therefore, the EATR values shall be compared, since the foreign investment attraction of a particular country primarily depends on the level of its average EATR.

Figure 5. EATR in EU-25 and Croatia (%)



Source: ZEW, Overesch (2005), author's calculations.

Figure 5. shows EATR values in EU-25 and in Croatia. It is easy to conclude that from the aspect of EATR Croatia is a very favourable country for investment as compared to EU-25. Croatia's EATR is lower by more than 10 percent with respect to the EU-25 average (24.2%). Individually speaking, only Cyprus (7.9%) and Lithuania (12.8%) have lower EATR values than Croatia (Overesch, 2005).

Moreover, within the EU new member countries EU-10 expectedly have lower average EATR values than the old member countries EU-15 (see more in Ernst & Young/ZEW, 2003; Finkenzeller & Spengel, 2004). In addition, as compared to a research conducted by the European Commission in 2001, a general trend of decrease of EATR can be observed within the EU with respect to other researches, regardless of the differences in the basic assumptions for the calculation of effective tax rates (Commission of the European Communities, 2001; Devereux et al., 2002; OECD, 2007).

#### 4. Conclusion

The conducted research and calculation of effective tax rates confirmed the existence of a low CIT burden in Croatia, which was the basic aim of this paper. First, an analysis of basic indicators, such as statutory tax rate, tax structure and the share of CIT revenues in the GDP, was provided to indicate that a relatively low CIT burden could be assumed to begin with. In the main part of the paper the previously stated conclusions were additionally confirmed by using the Devereux-Griffith methodology. Based on the research results obtained, the conclusion can be drawn that from the aspect of effective tax rates Croatia offers an extremely favourable treatment for investments, especially if they are for the most part financed by debt. Furthermore, from the aspect of EATR it can be concluded that Croatia represents a very favourable country for investment as compared to the EU.

The obtained research results should not be seen as surprising if one considers the fact that Croatia offers numerous tax incentives, most notably tax holidays. When different variants of tax holidays are included into the calculation of EATR, the obtained EATR values are even lower and in some cases negative. The above stated criteria of the Devereux-Griffith model and the calculation results obtained clearly show that Croatia has a CIT system which is extremely stimulating and favourable for domestic investment.

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