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FLAT TAX REFORMS IN ESTONIA AND SLOVAKIA AS PERSPECTIVES FOR CROATIAN TAX REFORM

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CONTENT

ABSTRACT

The article examines main features of the flat tax system, with additional research analysis of flat tax reforms in Estonia and Slovakia, focusing on tax revenue and growth effects. The author puts up a hypothesis that the flat tax reform has had positive effects on tax revenues and GDP growth in Estonia and Slovakia, as a part of comprehensive package of various structural liberalisation reforms, which should give a perspective for Croatian tax reform as well. Therefore, the article also presents additional fiscal policy perspectives for Croatia. Research results show that flat tax can produce positive economic effects in combination with other structural liberalisation reforms, which should be taken into account by Croatian policy makers as well. Moreover, it can be concluded that the rising tax competition from Eastern European may influence tax policy decisions in Western European countries and enhance flat tax reforms.

KEY WORDS

Flat tax reform, tax revenues, economic growth, tax burden, budgetary expenditures, tax competition, Estonia, Slovakia, Croatia

JEL CLASSIFICATION

H20, H21, H24, H25, H26

INTRODUCTION

The article examines main features of the flat tax system, with additional research analysis of flat tax reforms in Estonia and Slovakia, focusing on tax revenue and growth effects. The author puts up a hypothesis that the flat tax reform has had positive effects on tax revenues and GDP growth in Estonia and Slovakia, as a part of comprehensive package of various structural liberalisation reforms, which should give a perspective for Croatian tax reform as well. Therefore, the article also presents additional fiscal policy perspectives for Croatia. Research results show that flat tax can have produce positive economic effects in combination with other structural liberalisation reforms, which should be taken into account by Croatian policy makers as well. Moreover, it can be concluded that the rising tax competition from Eastern European may influence tax policy decisions in Western European countries and enhance flat tax reforms.

Tax reforms can be seen as one of important aspects of free-market structural reforms needed for sound public finances and open investment climate. Estonian and Slovak cases show that the introduction of the flat tax, in combination with other structural liberalisation reforms, has increased opportunities for economic growth, due to dynamic economic effects. Flat tax policies have already been enacted in majority of Eastern European countries. In the meantime, Hungary and Poland have flat tax policy plans, which gives a significant signal that almost the whole Eastern European area shall have flat tax systems soon, with even stronger challenges for Western European countries.

Flat tax reforms aim to create more simple, fair and neutral tax systems, through a single tax rate on personal and/or corporate income and/or VAT, and broadening the tax base through abolishment of all exemptions, except personal allowance. Countries aim to achieve higher tax revenues and economic growth through increased investment incentives in their fiscal policies. This research aims to provide a proposal for the tax reform in Croatia, through case analyses of tax policies in Estonia and Slovakia.

1. FLAT TAX – MAIN FEATURES

1.1. Proportional taxation of personal income

The flat tax has also been called „proportional tax". It means a constant marginal tax rate for all personal and/or corporate incomes, and/or VAT (Kesner-Škreb, 2005). Therefore, a proper term would rather be "flat taxes". The flat has mostly been related to personal income taxation, which replaces progressive marginal tax rates with the proportional, equally treating all incomes through the single rate. In fact, the single rate system is not necessarily the flat tax in its pure form. Emes and Clemens (2001) argue that flat tax means the single rate, including personal allowance, and excludes any tax deductions and exemptions.

In the 19th century most countries had the flat tax, while in the 20th century many countries converged towards progressive taxation (Baturo and Gray, 2007). Therefore, the flat tax has not been a new fiscal policy instrument, while progressive personal income taxation was proposed by Karl Marx (Basham and Mitchell, 2008), as one of socialist policy proposals for the income redistribution, in order to achieve "social justice". In fact, as this term cannot have a precise meaning, social justice could also be defined in other ways. Therefore, the flat tax idea has been based upon the principle that the tax system needs to be just, which could be achieved only if all personal income shall be treated with equal marginal tax rate and without exceptions. This brings a new perspective on the idea of social justice and equality.

The flat-tax idea was put on the policy agenda after the World War II, with prominent thinkers of liberalism such as August von Hayek and Milton Friedman. In 1962 Friedman proposed a 23.5% federal income tax for USA and maximum 20% in 1980 (Socol and Marius, 2009). The flat tax idea has been one of main features of liberalism, as a part of comprehensive tax reform model which would create open investment environment for economic growth. Although the flat tax proposals originally come from the United States, countries that have enacted this model are mainly Eastern European transition countries, as well as other non-European countries, such as Hong Kong. In Western Europe, only Iceland has the flat tax, while there are discussions related to that topic in many other countries.

Hall-Rabushka flat tax proposal holds its progressivity through the amount of basic personal allowance and low marginal income tax rate. Deductions and exemptions are not allowed, which means that it is applicable to a broad tax base. The flat tax decreases the tax burden and the possibility of tax evasion. Its simplicity reduces administrative costs of taxation (Kesner-Škreb, 2005). In 1983 Hall and Rabushka proposed 19% flat income tax for companies and individuals in the United States, including personal allowance, while other income exemptions were not allowed (Rosen, 1999). The flat tax is based on a consumption tax principle. Therefore, people are taxed on what they take out of the economy, not on what they put into it. The flat tax gives work incentives, increases take-home wages and stimulates capital formation (Hall and Rabushka, 1995), switching the tax burden from income towards consumption. Hall and Rabushka (1996) argue that income tax with an exemption for saving is a consumption tax, as a difference between income and saving. Expensing investments eliminates double taxation of saving. Efremidze (2007) adds that consumption taxation discourages consumption and stimulates saving.

The aim of the flat tax is to stimulate income savings and capital accumulation in order to increase private investment opportunities. Therefore, uniform top marginal income rate results in more disposable income. Those personal incomes could then be saved for investments or consumption as well. Furthermore, tax administration can get even more revenues. The tax base becomes broader with more economic activities, through higher investments and employment, and new taxpayers, who were exempted from the tax duty or foreign investors. Also, reduced tax rates can stimulate economic activities by shifting them from informal into formal economy, which bring even more tax revenues.

1.2. Progressivity inside proportionality

The flat tax produces a comprehensive tax base which results in fairer distribution of tax liabilities among those with equal incomes. Therefore, taxpayers could not be able to shift a proportion of their incomes into untaxed forms. Moreover, the flat tax system includes personal allowance which means that the amount of non-taxable income can even be increased, so lower incomes could benefit (Browning, 1985).

The majority of progressivity inside Croatian tax system has been achieved through personal allowances and very little by progressive tax rates. Therefore, flat tax rate for individual incomes, including personal allowance and abolishment of all tax reliefs should be proposed. Tax revenues would be the same, with around 90% of progressivity as in the current progressive system. The goal of the tax policy is to collect sufficient tax revenues, with larger simplicity and transparency, less costs and less harmful effects on efficiency (Urban, 2006).

The flat tax can include (horizontal) progressivity with higher personal allowance, instead of vertical progressivity through higher marginal tax rates on individual income (Emes and Clemens, 2001). Therefore, the flat tax is progressive, because the poor would pay no tax (Hall and Rabushka, 1995), different from regressive character of VAT (Hall and Rabushka, 1985). Moreover, the central principle of the tax reform is limiting the tax burden on the poor, which does not require graduated tax rates (Hall and Rabushka, 1996). The flat tax indirectly keeps progressivity. While the marginal tax rates remains constant, average personal income tax rate[1] keeps its progressivity (Blažić, 2006).

Therefore, two concepts of taxation progressivity can be distinguished. Traditional (direct) concept understands taxation progressivity as the amount of personal income tax through gradual marginal tax rates which depend on the income level. The system includes the personal allowance. The second (indirect) concept keeps progressivity through average personal income tax rate, despite the elimination of gradual marginal tax rates. Therefore, individuals would still need to pay different amounts, which depend on the income. Also, increased personal allowance mostly affects lower incomes because of higher non-taxable income. Therefore, flat tax system keeps indirect progressivity inside its proportionality.

Progressive tax systems aim to combine tax policy with social policy goals, which requires the introduction of various exemptions and deductions, including different marginal tax rates. On the other side, the flat tax system, or at least more simple tax system, aims to be neutral and reduces costs of tax administration. In this case, social policy would be a consequence of efficient tax revenue collection, in order to cover the needs for welfare expenditures. Therefore, even with the flat tax, governments could perform different social policies through direct social transfers, while the tax system would remain neutral.

1.3. Simple, fair, neutral and efficient taxation

Tax reforms usually aim to simplify the system, while at the same time tax administration increases efficiency in tax revenues collection. First, the flat tax reduces administrative and calculation costs, because several tax rates are displaced by a single one, while deductions and

[1] Average personal income tax rate means the amount of personal income tax divided by the tax base (taxable and non-taxable income).

exemptions are abolished. Therefore, this reform process also simplifies tax forms into a form of a postcard, instead of having several papers.

The central feature of the flat tax is simplicity. Complicated tax systems require expensive tax advisers and audits. Both income taxes would be equal, having tax forms of a postcard. Income should be taxed only once, as close to its source. The firm would pay tax on sales revenues, except income paid to its workers (taxed as personal income), and all purchases of inputs from other firms, as well as purchases of capital equipment, buildings and plants, which represents an investment inventive. Furthermore, the business tax would not have deductions for any type of payment to business owners. As a result, all income would be taxed, including capital gains, dividends and interests. Concerning the individual income, pension contributions would not be counted as a part of wages and taxed. In other words, pension income would be taxed when the retired worker receives the pension (Hall and Rabushka, 1996). The idea of the business tax is to collect tax revenues from business income of its owners (Hall and Rabushka, 1995).

Simple, neutral and efficient taxation is favourable, with broader tax base, and abolishment of all deductions and exemptions, including better tax administration. However, tax system is not the most important for attracting investments and growth, but the reduction of overall tax burden and government's role in economy. Investors mostly value political and institutional stability, and they also invest in countries with higher tax burden (Ott, 2005). Therefore, the tax reform which aims to reduce the tax burden and simplify the tax system is important, especially for countries with high burden and complexity of its tax system. However, other institutional factors need to be improved through structural reforms in order to create a sound investment climate. Although the flat tax can influence higher growth rates, a country may have other (non-fiscal) advantages which could attract investors, such as technological innovations and highly educated labour force. This may not be understood as the argument against the flat tax, but rather as a clear perspective that the flat tax can be considered only as one of several competitive advantages that could contribute to the economic growth.

The flat tax includes a single flat rate, which reduces penalties against productive behaviour, such as hard work and entrepreneurship. Moreover, the flat tax means the elimination of special preferences, reducing deductions and exemptions. Furthermore, the flat tax does not tolerate double taxation of dividends, capital gain, wealth, saving and/or death. The flat tax system requires only territorial taxation, when a government can tax only incomes earned inside national borders (Mitchell, 2008). The advantages of the flat tax are its simplicity and transparency, cost efficiency of tax administration, fairness and non-discrimination through equal treatment of taxpayers, without the existence of tax privileges, which ends political partiality (Srdoč and Anand Samy, 2005). The tax reform needs to include simplicity, incentives for capital formation and and economic efficiency (Hall, 2004).

Any serious income tax reform must broaden the tax base and reduce high top marginal rates, making evasion uneconomic and undesirable (Hall and Rabushka, 1985). Supply-side tax policy stands for lower marginal tax rates because they stimulate economic growth and increase of tax revenues (Dorn, 1985). The main advantage of flat tax is stimulation of productive activities through hard work and entrepreneurship, which brings more income to individuals and companies. Therefore, accumulation of capital can be invested in new economic activities, including job creation. Higher business income and employment increase the amount of taxable money, so tax revenues can rise.

Seeing from the perspective of neoclassical theory, tax policy is highly effective in changing the level of timing of investment expenditures. Firms behave as to maximize profits. The marginal capital product should equal the rental value of capital input, which depends on the tax policy. The change in capital stock influences investment (Hall and Jorgenson, 1967).

1.4. Flat value added tax

Consumption taxes are related to consumption, not to annual income savings, so rich and poor people both need to pay it equally. This means that the VAT does not have any kind of progressivity in comparison with the personal income tax. Moreover, Reduced VAT rates on certain products do not guarantee lower prices, because prices depend on demand. Reduced VAT rates on certain products benefit not only poor but also rich people. Moreover, reduced VAT rates result in less tax revenues, so governments can increase the standard rate which results in dissatisfaction because it is related to the majority of products (Kesner-Škreb, 1999). VAT is a consumption tax which highly contributes overall tax revenues. Therefore, its administrative collection is very important for sound public finances and the tax base should be as broader as possible. The flat VAT rate would equally treat consumptions of all products and services, ending all special treatments.

2. FLAT TAX – TAX REFORMS IN ESTONIA AND SLOVAKIA

2.1. Estonian Tax Reform

After a long period of Soviet-style communist system which led to massive repression organized against all spheres of human liberty, Estonia did not have any other chance than changing the whole society, including political and economic system. Prime Minister Mart Laar was aware of serious and deep reform challenges. Estonia expressed its strong decisiveness for the implementation of free-market policies, including the tax reform. In 1994 Estonia became the first country in Eastern Europe that introduced the flat tax system. In the meantime, the majority European countries soon followed its example. Estonia replaced progressive personal income tax rates (16, 24 and 33%, and 50% for a short period) with a proportional 26% rate, which was further reduced to 21% in 2008.

Vanasaun (2006) argues that the new system introduced broader tax base, easier tax administration and transparency, but it kept several tax incentives. Although the reform has been considered as flat tax, it is not precisely in its pure form (Saavedra, 2007), because tax exemptions in Estonia still apply on certain types of personal income such as capital gains, scholarships, fringe benefits, accommodation reimbursements for business trips, compensation for the use of private vehicles, child allowances, inheritance and gifts. Foreign diplomatic and consular representatives, representatives of international or intergovernmental organisations who are not citizens or permanent inhabitants of Estonia are not subject to personal income taxation (Ministry of Finance of the Republic of Estonia, 2009). The amount of basic personal allowance increased (Estonian Tax and Customs Board, 2009). Despite these exemptions, the tax system remained simple. Pre-filled by the tax administration, many tax returns in Estonia are submitted via internet (Vanasaun, 2006), which was a part of overall introduction of e-government services.

Government figures show that flat tax reform in Estonia had positive effects on tax revenues. Table 1 shows that tax revenue collection of both personal and corporate income tax increased almost each year, including VAT revenues. Corporate income tax revenues decreased in 1996 and then in 2000-2002, because reinvested profits became tax free. Personal income tax revenues increased each year except in 2005 and 2008, while VAT revenues decrease only in 1998 and 2008. Table 2 shows that tax revenues in 1996-2007 increased.

Table 1 – Estonia: State budget tax revenues (1995-1997); in thousands EEK

Budgetary year	Personal income tax	Corporate income tax	Value added tax
1995	1,721,700	1,049,700	4,164,300
1996	1,949,500	891,000	5,333,700
1997	2,315,730	1,228,400	6,729,300
1998	2,761,600	1,914,100	6,382,300
1999	2,882,700	1,635,100	6,505,800
2000	2,923,244	854,488	8,158,590
2001	3,157,014	748,256	8,671,910
2002	3,457,775	748,256	10,171,966
2003	3,910,225	2,156,446	11,186,728
2004	3,969,956	2,522,063	11,307,696
2005	3,370,883	2,496,434	14,677,349
2006	3,846,390	3,123,407	18,645,059
2007	4,786,701	4,083,706	22,303,880
2008	4,328,700	4,166,022	20,547,960

Source: Ministry of Finance of the Republic of Estonia (2010)

Table 2 – Estonia: Overall general government tax revenues (1996–2007)

Budgetary year	Overall tax revenues (in millions EEK)
1996	20,332
1997	28,902
1998	28,138
1999	27,830
2000	32,786
2001	36,666
2002	42,786
2003	48,413
2004	55,123
2005	64,407
2006	79,184
2007	94,714

Source: Bank of Estonia (2010)

In 2000 Estonia enacted an innovative corporate tax reform. While redistributed profits were kept taxable, reinvested profits became tax free. Capital gains remained untaxed if the receiver is an incorporated Estonian firm, while natural persons needed to pay 26% on their capital gains. In the following period, corporate income tax rates were cut from 26% to 24% in 2005, 23% in 2006 and 20% in 2007. Dynamic effect of the Laffer curve has been shown in Estonian case because tax cuts resulted in higher tax revenues due to more investments, production and taxable income (Arrak, 2008). Angelov adds that Estonian corporate income tax rates have been applied to all redistributed profit, irrespective of dividends, gifts, donations, representations, non-business expenses and payments, or fringe benefits.

After hard annual economic downturns in first years of transition followed by the collapse of Soviet-style communist system, in 1995 Estonia started to grow continuously each year, except in 1999. Table 3 shows that the Estonian economy already in 1997 reached high 11.7% real GDP growth rate, followed by annual growth rates at least or even higher than 7.5% since 2000. In 2000 the unemployment rate reached record 13.6%, with annual decreased to 4.7% in 2007. In 1999-2004, FDI inflow almost tripled, including net investments. While in 1995-2000 average annual real GDP growth rate was 5.3%, Estonian GDP rapidly increased reaching its average increase of 8.4 % in 2000-2007 (Bank of Estonia, 2010). Angelov adds that within the same period, reinvested profits increased more than 12 times, from 46.1 to 573 million euro.

Table 3 – Estonia: Annual real GDP growth rates (1995–2007)

Year	Real GDP growth rates (%)
1995	2.8
1996	5.7
1997	11.7
1998	6.7
1999	-0.3
2000	10.0
2001	7.5
2002	7.9
2003	7.6
2004	7.2
2005	9.4
2006	10.0
2007	7.2

Source: Bank of Estonia (2010)

Rapid privatisations and organisational restructuring, flexible labour market policies, balanced budgetary policies, flat tax system, with no taxation of reinvested profits, e-government public services and other free-market reforms have contributed to these Estonian successes, beside other factors. Estonian economic model attracted confidence of foreign investors through massive capital inflow. There cannot be a simple conclusion that the flat tax itself has attracted foreign investments and economic growth in Estonia. Estonia tax reform and tax cuts have contributed these economic policy achievements, together with other important structural free-market reforms.

2.2. Slovak Tax reform

Flat tax reform in Slovakia was introduced in 2004 by a centre-right government, led by Prime Minister Mikulaš Dzurinda and Deputy Prime Minister Ivan Mikloš[2]. Slovakia decided to implement a set of free-market reforms in order to stimulate investments and growth, after years of lagging behind other countries of Central Eastern Europe. Structural reforms were adopted in the field of the labour market, fiscal system, pensions, health care, education and business environment.

Taxes started to be understood as an economic burden rather than active tools of economic policy. Therefore, tax reform was one of the most important initiatives for competitive and non-distortive market environment. Its goal was to transform the Slovak tax system and increase its competitiveness through efficiency and transparency. Simplification of the tax code improved business environment. Also, the Slovak tax reform was followed by two important projects: e-DP (Internet input of tax declarations) and e-TAX (Ministry of Finance of the Slovak Republic, 2005).

Mikloš (2005)[3] argues that the power of Slovakian tax system derives from its efficiency and transparency. Like in other countries, previous tax code was complex with various taxes, rates, deductions and exemptions. So the tax system produced administrative costs and difficulties to small and medium enterprises, while others, especially big and influential businesses, were able to find legal ways to evade taxation (Srdoč and Anand Samy, 2005).

Three main goals of Slovak tax reform were suitable business and investment climate for individuals and companies, removing the existing weaknesses and distortions and fair reform focused on equal taxation of all sorts and amounts of income. The tax reform goals were achieved by shifting the tax burden from direct towards indirect taxes, because high direct taxes were distortive to fiscal competitiveness. Furthermore, all exceptions, exemptions and special regimes were eliminated, while the flat personal income tax rate was introduced in order to increase labour productivity. Moreover, tax instruments aimed at achieving non-fiscal goals were eliminated, as well as double taxation of income (Goliaš, 2005).

[2] Richard Sulík was a special adviser of Finance Minister Ivan Mikloš, who worked on the flat tax reform.

The aim of the tax reform was to tax all types of income at the same manner, regardless of the economic activity, in order to increase potential economic product. Tax reform introduced a uniform 19% flat tax rate on personal and corporate income and VAT, which removed multiple tax rates[4] that existed before. Personal allowance was increased. Personal income deductions were kept for taxpayers with non-working spouses (Krajčir and Odor, 2005), pensions and charitable contributions (Basham and Mitchell, 2008). Therefore, it is precisely not a flat tax in its pure form (Saavedra, 2007). Taxation of dividends, inheritance, gifts and real estate was abolished (Oravec, 2008).

The aim of the tax reform was to shift the tax burden from income (direct taxes) towards consumption (indirect taxation). This way the system penalizes consumption which reduces savings needed for capital accumulation rather than income which is a result of productive business activities. Second, a single rate makes the system neutral, fair, transparent and more attractive for investments and job creation. Third, the new system manifests the need that taxes must affect everybody, including groups targeted by social policy tax exemptions.

Slovakia also reduced its social security contributions from 51 to 48% (Gallagher and Babić, 2006). Various sorts of contributions put 13.4% burden on employees and 35.2% on employers (KPMG, 2009). It is important to notice that social security rates have been high in Slovakia, which represents the main source of fiscal burden on labour competitiveness. It can be concluded that the introduction of flat taxes may not be sufficient without taking into account the whole perspective of fiscal burden on labour. As in other continental European countries, social security contributions represent important budgetary revenues need for financing health care and pension expenditures. Therefore, cuts on that fiscal field directly depend on health care and pension system restructuring, especially rationalisation of costs and increased organisational efficiency.

Government figures show that the flat tax reform in 2004 had positive effects on all tax revenues, which were increased each year. This may be a result of broader tax base due to increased economic activities through higher investments and employment and decreased grey economy.

[4] Before the tax reform in 2004, Slovak income tax rates were 10, 20, 28, 35 and 38 % for individuals, 25, 15 and 18% for businesses. Standard VAT rate was 20% and a reduced rate was 14%. In 1993 Slovakia had six progressive personal income tax rates between 15and 47%.

Table 3 – Slovak tax revenues (2000–2007), in thousands EUR

Budgetary year	All taxes	Personal income tax	Corporate income tax	Value added tax
2000	6,286,617	1,056,692	874,681	2,332,833
2001	6,023,627	1,149,047	719,586	2,432,996
2002	6,871,208	1,231,738	987,661	2,723,243
2003	7,259,030	1,310,086	1,014,437	2,764,827
2004	7,649,105	1,112,129	1,055,774	3,290,946
2005	9,087,235	1,325,215	1,393,055	4,051,948
2006	9,604,771	1,355,680	1,564,807	4,245,448
2007	10,523,104	1,538,858	1,736,710	4,494,765
2008	11,245,493	1,819,293	2,115,673	4,614,313

Source: Ministry of Finance of the Slovak Republic (2009)

Flat tax reform had positive effects on economic growth. Two years before the reform real GDP growth rates were 4.8%, while they increase after to 5.2% in 2004, 6.6 to 2005, 8.5% in 2006 and record high 10.4% in 2007. At the same time, unemployment rates were decreased from 18.2% in 2004 to 11.1% in 2007 (Oravec, 2008).

3. FLAT TAX – PERSPECTIVES FOR CROATIAN TAX REFORM

3.1. Conditions for tax reform

The importance of structural liberalisation reforms has been put on policy agenda in Croatia, although many recipients of budgetary expenditures remain opposed to any serious fiscal change, which would mean organisational restructuring in order to increase cost efficiency. High level of irrational and inefficient public spending, which takes around one half of annual GDP, seriously distorts opportunities for increased economic competitiveness and GDP growth rates in Croatia.

Various non-tax levies (Ministry of Finance, 2010) represent additional fiscal burden on the current tax burden[5] needed to cover high level of public expenditures. Therefore, the tax reform directly depends on deep cuts of budgetary expenditures in order to reduce high fiscal burden which distorts Croatian fiscal competitiveness, raising costs of labour and production. Together with various institutional and legal factors, including labour market rigidities and uncompetitive educational system, high fiscal burden represents one of main factors which have seriously distorted economic competitiveness in Croatia, causing structural weaknesses due to the lack of liberalisation reforms.

Budgetary cuts should be focused several key aspects. All privileged[6] and/or early retirement schemes should be abolished, as well as programmes of pro-natal policy[7]. Various health care costs should be reduced through strict control[8]. State aid schemes[9] need to be gradually

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[5] In Croatia, social security contributions are not considered as taxes in a general sense, because they are charged to cover specific budgetary expenditures, primarily related to health care and retirement insurance. However, they also represent the tax burden for individuals and/or businesses.

[6] Every fifth pension in Croatia has been under favourable condition, which includes members of military forces, police, former political prisoners, parliamentary representatives and members of Croatian Academy of Sciences and Arts.

[7] Programmes of pro-natal policy include child support, maternity leave and others. Birth rate could be a result of increasing personal income of households, instead of government programmes.

[8] Increasing costs of health care system represent a huge fiscal burden, which includes procurement of medicines and equipment, sick leaves and various treatment costs. In addition to this, individual responsibility through preventive activities could minimise these costs. Furthermore, Croatia has the network of 64 hospitals which has been a high density comparing with other countries. Reduced network should partially shift services towards primary health care, while hospital transport system could be improved.

reduced, followed by privatisation schemes for all corporate entities where public sector participates in their assets, including unused real estate. State aid to agriculture needs to be reduced[10] and shifted towards EU grant schemes, while all state owned agricultural lands should be privatised. Social benefit programmes should be strictly targeted on providing adequate income security for the unemployed citizens[11], active labour market[12] policies and social care for citizens below the poverty line[13]. All privileged benefit schemes or cheating practices should be stopped by strict revision[14]. Furthermore, various inefficient costs of public administration[15] need to be reduced with efficient public management and e-government services[16]. Financing big infrastructural, environmental and energy development projects should be shifted towards EU grant schemes and public private partnership model. At the end, combating corruption and grey economy is crucially important for the rule of law, the whole institutional and fiscal stability, especially for property rights protection.

The purpose of these cuts is to reduce the ratio of public spending in GDP, which mean that the public sector would need less taxpayers' money to cover its expenditures. Croatia needs a serious budgetary rebalance which would decrease the 2010 expenditures for at least a quarter in order to reach sustainable fiscal capacity, including reduced tax burden and reduced deficit. Therefore, reduced tax burden would increase economic activities, and switch at least part of them from informal to formal sector. The result would be much broader tax base needed for increased tax revenues as well.

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[9] Limited state aid programmes should remain for small and medium enterprises, while all public enterprises should be privatised. State aid schemes have been primarily focused on shipbuilding and railways.
[10] Domestic agricultural subsidies need to be based upon productivity, instead of maintaining small and uncompetitive agricultural landowners which receive state aid support for uncompetitive survival.

[11] Income security though adequate unemployment benefits and active labour market policies, combined with flexible labour market conditions, has been known as a flexicurity model, as a part of EU's strategic goals.

[12] Government should create educational programmes for the unemployed citizens in order to improve and match their skills with competitive labour market needs and increase employability.

[13] Social care should be connected with active policies in order to increase employability, instead of creating long-term dependency on government provided welfare. Social policy should not be a permanent purpose, but rather a temporary and transitional aid instrument, connected with active employment policies.

[14] This problem has been primarily related to one part of war veterans. Each government's revision attempts were hardly criticised.

[15] Public administration costs should be reduced in the field of administrative structures and territorial division, expenditures and compensations for employees, expenditures for the purchase of fixed assets, material and energy, services, assistance within the general government and various unspecified expenses.

[16] Administrative procedures should be based electronic communication and documents, which could simplify and accelerate these processes and increase quality of public services.

3.2. Tax burden

High social security contributions[17] seriously reduce opportunities of employers to hire more workers, making labour force expensive and uncompetitive, with reduced net wages. Reduced tax rates require serious restructurings and cuts of budgetary expenditures. More reliance would be put on financing health care and retirement insurance systems from general taxes, although at least partial privatisation of health care and pension system could also be considered as an option.

The size of labour supply, influenced by government's tax policy, determines the labour force competitiveness. Reduced labour supply increases business costs and decreases productivity. Concerning the tax wedge, Croatia is not significantly different from other EU Member States and there are even countries with even higher tax wedge. However, the tax wedge[18] in very high and long-term development will depend on its reductions and other reforms (Urban, 2009). If contributions are focused on employers, it can have negative impacts on labour demand because of high labour costs. If the tax burden (through contributions) is focused on employees, it has negative effects on net wages (and labour supply). In fact, Croatian has high social security contributions on employees (Blažić, 2006) collected for two pillars of the retirement insurance.

Tax burden must to conform to the economic development, when slow tax increase can have positive effect on GDP. High tax burden can be justified in cases of high level of technology and labour efficiency and tax payment culture (Vasiliauskaite and Stankevicius, 2009). Therefore, Croatian case of tax burden should be seen from the perspective of a transitional country, as other Eastern European countries, which have aimed to reduce their tax rates and stimulate GDP growth through decreased public spending. Despite higher taxes and public spending ration in GDP, the most developed countries, such as Scandinavian ones, remain competitiveness due to sound institutional factors, flexible labour markets, as well as high level labour productivity, skills and innovation.

[17] The rates of social security contributions are 37,2% in total (employees pay 15+5% for two pillars of the retirement insurance, while employers pay 17.2% in total, or 15% for health care insurance, 1.7% for employment insurance and 0.5% injuries at work).

[18] The tax wedge is calculated as a ratio of labour taxation (personal income tax, surtax and social security contributions) in gross labour costs. The average tax wedge rate in Croatia is around 40%.

The reason for a high unemployment rate and low labour market participation in Croatia, including widespread informal economic activities, can be found in high tax wedge. This correlation is strong, although not necessarily in each case, because there are countries with high tax wedge and low unemployment rate. Therefore, additional institutional factors need to be included, particularly the level of labour market flexibility, measured by the employment protection level. Croatia belongs to the group of countries with high tax wedge, employment protection and unemployment rate. The safety net forward would be reducing budgetary expenditures before cutting the tax wedge (Grdović Gnip and Tomić, 2009).

Higher employers' contributions can result in lower net wages, because business costs increase. The marginal labour cost equals marginal productivity. Therefore, firms will employ additional employees if cost of the marginal worker is lower than the value productivity. High taxation is one of the reasons why labour in Croatia is expensive in comparison with other countries (Urban, 2009).

3.3. Flat tax rates

Facing rising tax competition from Eastern Europe, where majority of countries have enacted flat tax reforms, Croatia may introduce 20% flat tax for personal income, the same as the current corporate income tax rate. Current standard VAT rate could be gradually reduced to 20% in long-term[19]. Instead of current progressive personal income tax rates[20], which put burden on higher incomes, without real progressive incentives for lower incomes, the last could benefit from higher and flat amount of non-taxable income[21]. Therefore, progressivity would even increase despite the introduction of proportional personal income taxation. Current 20% corporate income tax rate should be kept for redistributed profits, while reinvested profits should be tax free, which would represent an investment incentive. In order to make the tax system as flat as possible, with simplicity and neutrality, including broader tax base, it is essential to abolish all tax deductions and exemptions, except in VAT for exports

[19] VAT has been the main source of budgetary revenues and fiscal burden should be primarily decreased in the context of social security contributions and progressive personal income tax rates. Although not a priority, VAT rate could be reduced only gradually, depending on fiscal reforms in budgetary expenditures and revenues.

[20] Personal income in Croatia is taxable according to 3 progressive tax brackets (12, 25 and 40%).

[21] Different monthly amounts of personal allowances (non-taxable incomes) should be replaced by a flat amount increased to 4000 HRK. This measure would reduce tax burden for lower personal incomes and therefore keep the system progressive, despite the proportional personal income tax rate. Flat amount should replace progressive amounts of personal allowance, designed to stimulate births in an inefficient way.

and free zones and in corporate income taxation for reinvested profits. Furthermore, property tax should be enacted for all extra properties. Various non-tax levies need complete abolishment because they represent extra fiscal burden in Croatia.

Adriatic Institute for Public Policy from Croatia proposes the introduction of the flat tax for Croatia, beside other structural free-market reforms[22]. Tax policy should aim to achieve the most sustainable growth with equal treatment of all tax payers. Flat tax would encourage entrepreneurial risks, investments and employment (Srdoč and Anand Samy, 2005).

3.4. Tax competition for investments

Tax reform would certainly decrease fiscal burden for individuals and businesses in Croatia. Rising tax competition which comes mainly from countries of Eastern European countries can be an incentive for the tax reform focused on simplifying the system and reducing the tax burden, mainly non-tax levies and social security contributions, but also personal income taxation. Almost all Eastern European countries will soon have flat tax systems, as Hungary and Poland also consider its enactment by 2011. It will be a challenge to Western European countries as well, because businesses tend to transfer a least part of their activities to Eastern Europe, because of lower top marginal personal income rate as well as lower overall costs of labour and production.

Tax reforms focused on making the system simple, neutral and efficient, with lower and flat tax, can certainly be positive signals to investors. Investors make decisions upon various factors, such as institutional and macroeconomic stability and security, rule of law and protection of property rights, labour productivity, educational skills and innovation, level of labour market regulations and flexibility, total labour costs, overall fiscal burden and many other factors. Businesses and individuals prefer lower fiscal burden resulting in higher net income which could be accumulated and invested.

[22] The Adriatic Institute for Public Policy is Croatian think-tank which proposes free-market reforms such as rule of law, judicial reform and protection of property rights; public sector reforms, through decreased public spending and limited government, including full privatisations of all state-ownership ratios in enterprises and real estate; flat tax reform; labour market reform.

4. CONCLUSION

It can be concluded that the enactment of flat tax reforms in Estonia and Slovakia have created simple, fair and neutral tax systems, with positive effects on tax revenues, inflow of foreign investments and economic growth. However, this contribution needs to be seen only in combination with effects of other free-market reforms.

Flax tax systems could soon become the reality of almost all Eastern European countries and even enhance flat tax reforms in Western European countries, due to rising tax competition. Looking from economic growth perspectives, tax burden represents the important factor which can slow economic growth, although other factors need to be taken into account as well. In this context, flat tax reforms are necessary, although in many countries social security contributions represent even higher ration in overall tax burden. Although tax burden influence economic performance, the key fiscal policy challenge has been in public spending cuts in order to reduce fiscal burden and budgetary deficit.

Croatia faces serious structural and fiscal challenges which could be met only by decisive free-market reforms. Tax reform perspectives could be seen in cases of Estonia and Slovakia, while conditions for any tax reform need to be satisfied through deep cuts of budgetary expenditures, independent of their unpopularity. Tax reform in Croatia should aim for creating simple tax systems, with low tax burden which would increase labour competitiveness. Furthermore, tax systems need to be neutral towards taxpayers and treat them equally. It is also important to emphasize its efficiency which improves tax administration. Tax base needs to be as broader as possible in order to increase tax revenues and particular efforts need to be focused on combating the grey economy. The tax system needs to provide open and transparent environment for potential taxpayers as well, primarily investors who expect more net income savings needed for larger amounts of investments and employments. Therefore, both public and private sector can benefit with the flat tax reform.

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