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## **A QUALITATIVE ANALYSIS OF THE COSTS OF TAX COMPLIANCE IN THE REPUBLIC OF CROATIA \***

### ***Abstract***

*On the foundations of research into business operators in Croatia in 2002, the results are given of a qualitative analysis of the costs of tax compliance for business entities that pay personal income tax and business entities that pay corporate income tax<sup>1</sup>. The analysis is focused on attitudes concerning the procedures of tax compliance, certain tax regulations, relationships with and attitudes towards the tax authorities, and possibilities for improving the equitableness and effectiveness of the tax system. It was carried out in terms of certain forms of taxation: value added tax, corporate income tax, personal income tax, and the taxation of employees' wages.*

*The attitudes of taxpayers can signal to the tax authorities the desired directions of future tax changes, and show that most of the criticisms of respondents relate to the taxation of wages and salaries.*

*The proposals of business entities that pay corporate income tax for a simplification of the tax system, a reduction of costs and an increase in the equitability and effectiveness are directed towards a reduction of tax rates, a greater tax differentiation according to the activities and sizes of corporations, a simplification of taxation procedures and an improvement of communications with the tax authorities and two-way communications between departments in the tax system.*

*The proposals of business entities that pay personal income tax are directed towards a reduction of the tax burden in all segments, the introduction of lump sum taxation, the increase of equitableness and social sensitiveness of income tax and a reduction in the administrative work to do with tax compliance.*

*Key words: costs of tax compliance, business entities paying personal income tax, business entities paying corporate income tax, Croatia*

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\* This research was financed with a grant of money from the CERGE-EI Foundation within the Global Development Network programme. Additional resources for recipients of monetary grants from the Balkan countries were given by the Austrian government via WIIW, Vienna. All the views stated are exclusively the opinion of the author and not of CERGE-EI, WIIW or GDN. Additional funds provided by the Institute of Public Finance, Zagreb, the institute that led the project: Costs of Taxation in Croatia: administrative costs of taxation and taxation compliance costs, of which this paper is a part. The interviews (questionnaires) were administered according to the instructions of the project leader and the author and statistical processing was organised by PULS, a market research agency. The authors and the Institute for Public Finance would like to take this opportunity to thank the Tax Administration of the Republic of Croatia.

<sup>1</sup> Tradesmen and people engaged in freelance occupations in the sample include natural persons who are liable to pay personal income tax on self-employed activities. As well as tradesmen and freelance occupations, there are also natural persons that deal with farming and forestry, if they are VAT registered. Firms in the sample include those liable to pay corporate income tax, companies and other legal entities that make a profit, as well as business operators, natural entities that at their own request pay corporate income tax, or profit tax, instead of personal income tax.

## Introduction

In the last decade, transitional countries have implemented and run in tax reforms that have put the problems of the costs of tax collection into the background<sup>2</sup>. Only in more recent times has the cost of tax collection as it relates to the taxpayer become a subject of interest for investigations in the transitional countries.

The first part of the paper gives the basic elements of the investigation carried out: the size and structure of the sample, the persons who answered the questions, the questions put to the respondents. In the next four parts the results per individual tax are analysed: VAT, personal income tax, corporate income tax, and taxation of the wages of employees<sup>3</sup>. In part six of the paper, the attitudes of taxpayers to the tax administration are analysed.

The paper analyses the most frequent criticisms of the respondents to the tax system, as well as proposals for making it simpler, reducing the cost and increasing equitableness and effectiveness.

## The basic elements of the investigation

A qualitative analysis of the cost of tax compliance covers the testing of the subjective standpoints of taxpayers about their tax compliance, and contributes to the creation of a qualitative evaluation of the tax system.

The statistical sample of respondents is adjusted to the real structure of entrepreneurs weighted according to number of employees. The questions put were answered: in small business operators by the owner and (or) manager, or by the external accountant that kept the business books; in the major business operators most often by the head of the accounting department.

The questions posed related to the overall tax system and to individual forms of taxation: personal income tax, corporate income tax, VAT and the taxation of wages. They were designed to elicit: the expression of a feeling of satisfaction or dissatisfaction on the part of taxpayers, their evaluation of the psychological costs of the system; an evaluation of the procedures for tax compliance; an evaluation of individual tax regulations; an evaluation of relations with tax authorities and an evaluation of and proposals for any possible improvements in the equitableness and effectiveness of the taxation system.

## Value added tax

VAT provides the government is most important tax revenue, accounting for about 50% of the total revenue from taxation<sup>4</sup>. It was brought into the Croatian tax system instead of the hitherto gross tax on turnover. At the beginning it had a single rate of 22%, and then a zero

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<sup>2</sup> Ott, K. - Bajo, A., 2000 *Troškovi oporezivanja u tranzicijskim zemljama: iskustvo Hrvatske*. Financijska teorija i praksa, 24 (2), pp.170-171.

<sup>3</sup> Tax on income from self-employed work is looked at separately from the wages of employed person, which is income from employed work, because they require separate tax records and matters, and because it is a question of the income of different persons. Income from independent work is the income of a given concrete business operator, a tradesman, while wages, the income from employed work, are the incomes of his employees, and his costs.

<sup>4</sup> 49/6%; 1999, 51.8%; 2000, 54.6%; 2001, 48.1%; Statistical Annuals and Monthly Statistical Reviews of the Ministry of Finance of the Republic of Croatia, various years and numbers.

rating was brought in for given products and services, and VAT exemptions because of exports, in certain activities and for financial institutions.

Business operators who make an annual net income, or whose net receipts are lower than 85,000 kuna are not liable to pay VAT unless they want to. The base for the calculation of the VAT of companies and other entities liable to pay corporate income tax is invoices received and rendered, with precisely prescribed contents. Input invoices received from entities liable to pay personal income tax must for the needs of deduction of prepayment of tax be paid. This is an exception from the principle of invoiced sale that is otherwise enforced for the calculation of company VAT. Business entities liable to pay personal income tax and those engaged in freelance occupations determine their tax liability according to invoices collected, and the right to show prepayment of tax according to invoices paid, that is according to the cash principle.

VAT is calculated monthly, but business operators with net annual earnings or receipts of less than 300,000 kuna can employ a quarterly calculation.

To the question of how much the two tax rates and the special recording of non-taxable revenues complicated their calculation and took additional time, about a half of the tradesmen and a third of the companies replied that this did not create any difficulties, and only about 10% of the entities considered that their calculations were very complicated because of this and took up a lot of additional time.

<b><i>Question: What do you consider the most complicated thing in the VAT system, that is, what takes up most of your time in tax compliance (in order of frequency of answer)</i></b>
<b><i>Companies and tradesmen</i></b>
• Updating the necessary documentation
• The calculation of VAT on prescribed expenditure
• The payment of VAT on import, and then acknowledgement as tax prepayment
• The book of input and output invoices and their parallel registration
• The obligation to make one's own calculation of VAT on some import services
• The special treatment of input invoices issued by income tax payers

The updating of the necessary documentation is stated to be a problem because of the delay in receiving the input invoices. Although at the beginning of the introduction of VAT the deadline for the calculation and payment of VAT was shorter, it is clear that the deadline of a month is too short for a significant number (10%) of respondents.

Expenses on which VAT is paid, the calculation of which the respondents said was complicated, are the 70% on entertainments and the 30% on the expenses of a company owned or hired car. These are also expenses that are not acknowledged for the purposes of corporate income tax or personal income tax. Taxpayers are discontented with the intention of the tax regulations to put advertising expenses in the same class as taxable entertainment. The VAT Regulations<sup>5</sup> provide for the taxability of the expenses of a rented car. This includes the provision concerning financial leases, which is in contravention of IAS 17. According to this standard, the expenditure of a financial lease is the interest contained in the rental fee and the amortisation on the leased item. As distinct from this, according to the tax regulation cited<sup>6</sup> it would appear that the expense of a financial lease can be the total leasing fee, but

<sup>5</sup> OG 60/96, 113/97, 7/99, 112/99, 44/00, 63/00, 80/00, 109/00, 54/01.

<sup>6</sup> To the tax base, 30% of all expenditures for vehicles born by the leaser are added. "If an entity liable to VAT agrees on a financial lease and for the instalments does not burden the expenditure but transfers the value of assets acquired in this way to the costs via write-off, the entity is obliged to add 30% write off to the tax base (Article 26, Paragraph 5, Regulations concerning VAT)

only if it is not, then it is necessary to calculate and pay VAT on 30% of the depreciation of the item leased.

The next most common reason quoted for the complications is the payment of VAT on import, which is then acknowledged as a tax prepayment. As well as there being a number of tax exemptions on import, an additional difficulty is constituted by the fact that on some import services, for example in the tourist industry, the taxpayer itself is bound to calculate the VAT, not the customs house, which would be a more usual procedure.

Parallel record keeping refers to the Input-Output Accounts book, in which the input and output invoices are kept, which are recorded in parallel in the main book that is kept according to the accounting regulations in the firms, that is in the book of receipts and expenses that are kept by tradesmen. Accounting software allows for the automatic entry of figures into both books as well, but for some taxpayers (for example, budgetary beneficiaries) that keep their main books according to specific rules, there is no specialised software adapted to them, and so they have to keep the Input-Output book by hand, which they consider extremely complicated. This criticism is justified also for those operators that do not keep their business books on the computer or who do not have contemporary accountancy software.

Firms calculate VAT according to accounts rendered or received, according to the principle of invoiced sale, with the exception of invoices received from natural entities that are liable to pay income tax. VAT according to these invoices is acknowledged in prepayment of tax according to the cash principle, that is, when the invoices are paid. The recording and monitoring of these accounts is an additional difficulty for firms. Several respondents mentioned their own responsibility to the tax authorities during the calculation of tax prepayment according to input invoices rendered by entities that are not VAT registered and yet state VAT.

As compared with corporate income tax and the taxation of wages, there are relatively few complaints concerning the complications of the VAT system. Almost half of the firms and a third of the tradesmen stated that they do not consider anything particularly complex.

<b><i>Question: What would you propose for the simplification of VAT, or for the reduction of time spent and the costs of tax compliance, as well as for the improvement of its equitableness and effectiveness? (in order of frequency of answer)</i></b>
<b><i>Firms</i></b>
• Cutting the 22% rate
• Bringing in tax differentiation according to activity
• Application of the cash principle (standardisation of the input invoices of firms and tradesmen)
• Stabilise the tax regulations
• Reduce the complicated tax supervision on the refund of excess VAT paid
• Abolish VAT on import
• Abolish VAT on uncollected exports receivable
• Extension of the period for the calculation and payment of VAT
• Abolish VAT on advance payments
• Reduce VAT for producers, especially those with a long production cycle
• Abolish VAT on own use as it is called
<b><i>Tradesmen</i></b>
• Cutting the 22% rate
• Unify the position of tradesmen and companies in the manner of calculating VAT according to the invoiced sale principle (standardise the output invoices of tradesmen with the output invoices of firms).

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| <ul style="list-style-type: none"> <li>• Abolish the Book of Input and Output Invoices and do the calculation according to the Book of Receipts and Expenditures</li> </ul> |
| <ul style="list-style-type: none"> <li>• Extend the period for the calculation and payment of VAT</li> </ul>  |

These criticisms are directed of course not only to the simplification of the VAT system and a saving of time, but also to the possibility of improving equitableness and effectiveness.

Cutting the tax rate is in first place according to the frequency with which it is suggested in both categories of business operator. A rate of 22% in comparison with other transitional countries is a medium rate<sup>7</sup>, and it is not very high even in comparison with the rates of the turnover tax that preceded the introduction of VAT<sup>8</sup>, which was confirmed by research of the time<sup>9</sup>. Those that fared worst from the introduction of VAT were the service activities, with a high labour proportion of the inputs and relatively high profit rates.

The proposal of firms that the cash principle should be introduced, that is, that the calculation of VAT should be done only on invoices that have been collected on and paid in and the diametrically opposite proposal of the tradesmen that the invoiced sale principle should be applied to them are particularly interesting as being contradictory proposals. The cash principle in the context of VAT is more equitable and in essence acceptable than the invoiced sale principle. It does not put either the operators or their creditors in an unfavourable position vis-à-vis tax, or net debtors into a favourable position vis-à-vis taxation<sup>10</sup>. The standpoint of the tradesmen wishing to have the cash system replaced by the invoice system can only be explained by this being related to net debtors, who in this way would save on VAT.

The remaining proposals analysed below were given in any substantial numbers only by the firms.

The introduction of tax differentiation according to activities is a proposal about a principle that would produce very uneven viewpoints if it were put into practice. It can be understood more as a supplement to the reduction of the tax rate, because VAT is not a tax form in which tax differentiation according to activities can be carried out successfully. That is why Croatia decided at the outset for just one rate. The later introduction of the zero rate and the series of exemptions are already at the margins of acceptability of tax differentiation from the

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<sup>7</sup> The standard rate of VAT in Hungary is 25%, in Slovakia 23%, Czech R and Poland 22%, Slovenia, Bulgaria and Russia 20%, Latvia and Estonia 18%. *European Tax Handbook 2002*. International Bureau of Fiscal Documentation.

<sup>8</sup> The rate of turnover tax that was applied to the total sales value in the general tariff class of tax on the sale of products, which covered the most products, came to 15%, and the tariff of the tax on the sale of services was 10%. Considering the deduction of prepayments of tax in VAT, a rate of 22% does not on average mean a greater tax burden than before.

<sup>9</sup> See for example Spajić, F., 1999. *Ekonomski i financijski učinci prijelaza na sustav poreza na dodanu vrijednost*. Hrvatski zakon o porezu na dodanu vrijednost. Zagreb. Hrvatska zajednica računovođa i financijskih djelatnika, pp. 19-36.

<sup>10</sup> When claims are greater than liabilities, the company is in the position of net creditor, unfavourable from the tax point of view. This position is determined by there being an excess of outstanding claims over unmet liabilities. In the reverse vase, when the liabilities according to invoices received are greater than claims on the basis of invoices rendered, the company is in the position of net debtor, which is favourable in tax terms. This is to do with the relationship between calculated VAT in claims and calculated prepayment of tax in liabilities that reduce the final tax obligation.

standpoint of the positive features of VAT: productiveness, neutrality, simplicity and effectiveness<sup>11</sup>.

The stabilisation of tax regulations is an intelligible demand. The VAT law in force since the beginning of 1998 has been amended five times, and the VAT Regulations that determine the application of the law in more detail have been changed as many as nine times.

Tax supervision during the refunding of overpaid VAT is not a prescribed procedure, but it is a regular practice of the tax authorities, particularly when the return of quite a large sum is sought. This kind of procedure is usually experienced by the taxpayers as an additional difficulty in tax compliance, because apart from constituting a stressful situation, it requires additional time for attending to the representatives of the tax authorities during the supervision.

The demand for the abolition of VAT on imports is very justified, because this kind of VAT is anyway later calculated as prepayment of tax. Through this kind of procedure the tax authorities involve the taxpayer in additional tax administration to make sure they are paid as soon as possible.

Also visible in this light is the provision about the payment of VAT on uncollected exports receivable. Exports are actually exempted from VAT, unless in a given period the exports are still outstanding, because the tax authority starts from the assumption that the taxpayers might be avoiding bringing money into the country.

VAT on advance payments is a departure from the invoiced sale principle, because advance payments are not earnings admitted in accounting. In this case, the tax authority is showing a willingness to put the taxpayer in a potentially unfavourable position and thus accelerate the filling of the state's coffers.

The demand for the reduction of VAT for producers is motivated by the view that this would encourage production as a whole, and is the consequence of a tradition in which in the one time gross system of turnover tax production was exempt from such a tax.

The threshold for entry into the VAT system is considered an important element in VAT policy. If it is too low, it brings about high compliance costs, but if it is too high, along with loss of tax revenue to the state, it occasions unfair competition among the business operators<sup>12</sup>. In some countries, such as Ireland, there are two thresholds, one for service industries, with a low share of tax burdened inputs, and the other for other activities. In Croatia, there are divided opinions about the justification of the 85,000 kuna threshold, among companies and among tradesmen<sup>13</sup>, which means that it should certainly be reinvestigated.

In the firms, there is a statistically significant correlation between the attitudes to this issue and viewpoints about the threshold of 300,000 kuna annual revenue for the obligation of calculating VAT monthly<sup>14</sup>. Those respondents who think that the threshold of 85,000 a year revenue is too low for entering the VAT system also think that the 300,000 kuna threshold for obligatory monthly calculation of VAT is too low, and vice versa.

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<sup>11</sup> Most of the EU and CEE countries that are candidates for entry into the EU have, for social reasons, a lowered rate on essential and some meritorious goods, and so Croatia is not an exception.

<sup>12</sup> See, for example, Sandford, C., 1998. *Minimising the Compliance Costs of a GST*. Australian Tax Forum, 14, pp. 134,135.

<sup>13</sup> 40% of tradesmen and 40% of firms thought the threshold of 85,000 kuna for mandatory joining of the VAT system too low.

<sup>14</sup> For statistical correlation of the view about the threshold of 300,000 kuna and the viewpoint about the 85,000 kuna threshold, gamma=0,536; p=0,000.

In the tradesmen's sample there is a statistically significant correlation between the views about this question and the amount of annual receipts and annual income. Respondents with lower receipts and income to a greater extent considered the threshold too low, which means that they preferred to be or remain outside the VAT system<sup>15</sup>. Since it is precisely the service industries that are most common in the small trades, and since in them input VAT is less represented than activities that are not labour intensive, this kind of view is completely logical. To be outside the VAT system gives an increased ability to compete on the market by being able to set lower prices. On the other hand, the fact that in this case input VAT is paid has no very pronounced negative effect because of the high proportion of labour in the structure of inputs.

With the tradesmen, there is also a significant negative correlation between the view about the 85,000 kuna threshold and the seasonal nature of the trade<sup>16</sup>. Trades that are not of a seasonal nature consider the 85,000 kuna threshold too low to a greater extent. This suggests that seasonal trades are in a better profit position. They are active at a time that favours the generation of earnings, that is, an optimal relation of inputs and outputs, in which VAT does not constitute any important burden.

Most of the respondents are in agreement about the threshold of 300,000 kuna for the obligatory monthly calculation of VAT, to which the optional nature of the quarterly calculation for taxpayers with lower annual net earnings, or receipts of 300,000 kuna contributes.

## **Income tax**

After VAT and excise, income tax is the most important source of government tax revenue. It is paid by natural persons that have an income. An income from a self-employed activity is made in a trade, a freelance profession, in agriculture and forestry and other self-employed activities.

The questions were designed to elicit evaluations of and suggestions for the improvement of the equitableness and effectiveness of the tax system.

To the question of what they would change in connection with income tax, as many as 86% of the respondents said that they would make it lower and more equitable. This kind of respondent viewpoint is interesting in the light of the development of tax reform in Croatia. The reforms of 1994 brought in an alternative consumption tax model, according to which consumption was taxed, as well as savings their originating phase, that is income from work was taxed, while income from capital – interest and dividends – were excepted from taxation. There were two tax rates, of 20% and 35%, and for this reason the system was evaluated as being insufficiently progressive as well as socially insensitive. It was claimed that the richer classes, that is those who made their income from capital and assets, were given tax breaks, while the others, who on the whole made their income from their work, with personal allowances that were under the minimum standard of living, had to bear a high tax burden.

In the new regulations of 2000, a shift towards an earning tax model was made, because tax was brought in for dividends, interest on loans made, and a third, and lowest, tax rate of 15% was introduced. Personal allowances were increased a little, meaning the untaxed part of

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<sup>15</sup> For statistical correlation of receipts and views about the 85,000 kuna threshold –  $\gamma=-0,267;p=0,030$ .  
For the statistical correlation of income and the view about the 85,000 kuna threshold –  $\gamma=0,484;p=0,008$ .

<sup>16</sup> For the statistical correlation of the seasonal nature of a trade and the standpoint about the 85,000 kuna threshold –  $\gamma=-0,710;p=0,000$ .

income. These measures were aimed at palliating the social insensitivity of the system, but from the point of view of equitability did not do very much. The highest tax rate of 35% continued to be among the lowest in the transitional countries<sup>17</sup>, and it was applied to relatively the lowest amounts of the highest tax bracket<sup>18</sup>. This meant that taxpayers with the highest incomes were still tax privileged.

These reforms resulted in a fall in the share of income tax in the total tax revenues of the government, which was not compensated for by greater tax burdens on the richest. From this point of view the opinion of the respondents that income tax should be more equitable could be considered understandable, while the opinion that in comparison with other countries it was too high is not well founded, unless one looks from the aspect of social sensitivity, that is of the taxpayers from the lower income brackets, who in spite of the improvements are still subject to a high tax burden<sup>19</sup>.

In answer to the questions of whether some incomes should be exempted from taxation, or whether individual incomes that are now not taxed should be taxed or should be taxed higher than now, a greater inclination to exempt some incomes from taxation can be observed than to the taxation of some incomes hitherto untaxed or to a taxation that is higher than the current level.

<b><i>Question: If you think that some incomes should be exempted from taxation, which incomes are these? (%)</i></b>	
• Low incomes, people with minimum wages, incomes below 60,000 kuna pa	22
• Author's royalties, piece work or extra work contract income	11
• Students' and schoolchildren's incomes	8
• Incomes in science, the arts and charitable work, and donations	9
• Incomes from capital	6
• All incomes	6

The other respondents opted, in low percentages (1% each) for various kinds of income, for example, in tourism, forestry, from insurance and so on, or did not give a specific answer.

<b><i>Question: If you think that some incomes should be taxed higher than hitherto, which are these incomes? (%)</i></b>	
• High incomes	27
• Retirees' incomes	12
• Incomes from catering, trade in luxury items, porn and trashy literature	12
• Incomes of freelance artists	5
• Incomes from capital	5
• Incomes from gambling	3
• Incomes of government officials	2

The other respondents either offered no concrete answer or opted in very low percentages for various kinds of earnings. The answers, apart from confirming the views of respondents about the insufficient equitableness in income tax, show that the respondents think that some incomes are in a certain sense unjustified, and need to be burdened with increased taxes.

<sup>17</sup> For example, Slovenia has an upper border tax rate of 50%, Bulgaria, Hungary, Poland, Slovakia and Romania 40%-45%. See: Kesner-Škreb, M., Kuliš, D., Madžarević-Šujster, S., Arbutina, H., 2001. *Progresivnost poreza na dohodak u Hrvatskoj u razdoblju od 1995. do 1999. godine*. Financijska teorija i praksa, 25 (2), str. 245-253.

<sup>18</sup> On an average monthly income of over 6,250 kuna, or 830 euros.

<sup>19</sup> In the most recent amendments to the Income Tax Law, of 1 January 2003, a tax rate of 45% on income over 21,000 kuna a month, or 2,800 euros, was introduced, the criticism of the lack of adequate progressiveness in income tax being thus significantly silenced.



Particularly interesting is the high proportion of respondents thinking that the earnings of retirees should be taxed more than it is to date. Because of the very bad social position of Croatian pensioners, whose average pension is 1,542 kuna or 39% of the average wage, 74%<sup>20</sup> of them receiving pensions below this amount, a considerable number of retirees make money on the side, mainly from work on the black. On the other hand, according to the tax regulations, retirees are tax privileged, because they are allowed a personal allowance, that is, the untaxed income from pensions in the amount of their pension, and at most up to an amount of twice the personal allowance that other taxpayers have (2,500 kuna). Alongside their pensions, retirees are allowed to make other earnings, apart from their extra earnings from employment and income from a trade or freelance profession (that is, they can make these earnings only if they put their pensions on hold, that is, halt them for the interim). Perhaps this attitude to retirees is justified by the conviction that retirees work a lot in the grey economy and thus, with the other negative effects, exacerbate the unemployment situation in Croatia. The view can also be partially explained by the negative attitude to the disability pensions of those who took part in the Homeland War.

It is interesting that catering should have got onto the list of very profitable activities; this can be ascribed more to tradition than the real state of affairs. Today, the objective situation of the person in the catering trade, because of the increased competition, is not at all as favourable as it was in the pre-transition period, which has as yet not been reflected in the subjective perception of the average respondent<sup>21</sup>.

The earnings of artists is controversial, because it is put forward as something that should be both more taxed and something that should be exempted from taxation. The tax treatment of royalties, the most common kind of receipt of the freelance artist, is privileged as compared with wages from employment. In their case, tax by withholding at a rate of 35% is levied, but only on a base that is reduced by 40% for the estimated allowed expenditures, which ultimately means a 21% income tax. Up to the end of 2002, this kind of income was exempt from contributions too, which has been abolished by the most recent Obligatory Contributions Law<sup>22</sup>, and now pensions and health contributions have to be calculated and paid on all kinds of payment.

Earnings from capital are also stated as those that should be exempted, and yet also more taxed. This is not surprising since tradesmen do have capital and would like to exempt it from taxation and yet at the same time tax on income from capital is one of the elements of the equitableness of a tax system, and it is necessary to tax such an income more.

Income from agriculture also has a special tax status, through which the state provides development incentives to it. Income tax is paid only if the taxpayer is, pursuant to this activity, also a VAT payer. This means that the income of farmers whose turnover is below 85,000 kuna a year, is exempt from income tax, because such people are not obliged to be in the VAT system either.

A certain number of questions were designed to elicit the opinions of respondents about certain legal solutions from the area of taxation. What positively speaks on behalf of the interest of taxpayers in favourable taxation is the fact that two thirds of the respondents considered the one-time write off of equipment a good measure, but it is concerning that as

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<sup>20</sup> According to data of the Croatian Institute for Retirement Insurance on December 31 2002; <<http://www.mirovinsko.hr>> and <<http://ppdiv.hr/statistika>> (15.02.2003.)

<sup>21</sup> From interviews with caterers who have been in business for over twenty years, it can be concluded that their position and ability to earn was much better in the pre-transition period than it is today.

<sup>22</sup> OG 147/02.

many as a fifth have no opinion about it. A large number of respondents cannot even make use of this measure since they have low investments in their trade and/or have too low an income to be able to reduce their tax base by a one-time write-off.

The interest contained in collected and paid annuities on loans that are used for the purpose of performing an activity are in tax terms counted as receipts or expenditures, which leaves the problem of determining that part of the annuity that relates to interest. Because of the different accountancy policies that the financial institutions can apply in the calculation and allowance of interest, the question arises as to which part of the annuity a tradesman that has taken out a loan can count as expenditure. Although the inclusion of interest in receipts and expenditures is a favourable measure, because it allows for the statement of higher expenditures allowable for tax purposes, that is, for lower tax liabilities, only 37% of the respondents considered it correct. This is the more surprising in that tradesmen in Croatia are very considerably financed from loans, that is, the degree of self-financing is too low to make them indifferent to such a tax measure. It seems, however, that the problems attending the application of this kind of measure outweigh the benefits that the respondents consider it can bring them.

The keeping of the business books of tradesmen is regulated only by tax laws, and not by the Accountancy Law, as with companies. It is interesting that over half of the respondents would anyway keep all the regulation books in order to keep up with their operations, irrespective of tax laws.

Because of the frequent changes and amendments to the Income Tax Regulations, the actual form of the tax return is also often changed. Over half the respondents thought that the new form for the tax return was more complex than the old one, and for them, the reasons that lay behind this attitude were analysed.

Most of the respondents went on record that the main cause of the complexity of the new tax return form, as compared with the previous one, is the special part of the tax return and the new reliefs. The special part of the tax return contains data about the amounts of the prescribed and used reliefs and exemptions. For reliefs to be made use of, it is necessary to make an income that is high enough, which is often not the case. They do not affect the creation of a tax loss which can be carried over into and covered in the future periods, when the income made will permit of this. Probably this is the reason why taxpayers did not greet them with any particular delight.

<b><i>Question: What do you consider the most complicated thing in income tax compliance, or, what takes you the most time? (in order of frequency of response)</i></b>
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| • Collecting receipts about income, or documents related to the tax return |
| • The many forms   |
| • Filling in the return  |
| • Keeping up with the changes  |

In line with the criticisms voiced, these proposals were suggested for the simplification of income tax.

<b><i>Question: What would you propose for the simplification of income tax, or the reduction of the time and costs of tax compliance? (in order of frequency of answer)</i></b>
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| • Reduction of the number of forms and the amount of necessary accompanying documentation |
| • Simplification of the tax return form   |
| • Introduction of lump-sum taxation for small tradesmen                                   |
| • Introduction of just a single tax rate  |
| • Reduction of income tax for the sake of incentives to hiring and development            |

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| <ul style="list-style-type: none"> <li>• Simplification of records of input and output invoices</li> </ul> |
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Among these proposals, special attention should be given to the proposal to introduce just a single tax rate, which is in contradiction to the previously analysed viewpoints concerning the insufficient progressiveness and social sensitivity of income tax.

The proposal to introduce lump-sum taxation for small tradesmen is also aimed at the simplification of the tax system, and is actually provided for in the Income Tax Law<sup>23</sup> for small taxpayers who are not VAT registered. But this does not mean that the business books need not be kept, the way some taxpayers have understood this opportunity. The Tax Administration, that is, pursuant to supervision of operations, could always scrap the lump-sum taxation, if it was determined that the taxpayer generated earnings above those prescribed in the estimated tax. No detailed regulations for lump-sum tax have yet been brought into Croatian taxation practice.

The procedures concerning income tax, the main one being the filling in of the tax return, were not however too great a psychological burden for 58% of the respondents, since they felt indifferent or satisfied after submitting their returns. Twenty six percent of respondents felt relieved, and 16% disturbed.

### Corporate income tax

In the total structure of the revenue of the national Budget, corporate income tax provides a very modest 3-6%<sup>24</sup>. It is paid by legal and natural entities that make a profit. Among them are the most important corporations or firms. At the moment, the second Corporation Tax Law is in force, since the beginning of the tax system reform<sup>25</sup>. This has introduced considerable changes into the calculation and taxation of profit, or corporate income, as against the preceding model, which relate to: the manner of determining the tax base, the abolition of protective interest, the change in the tax rate and the introduction of new reliefs, exemptions and incentives.

Below, questions designed to elicit the evaluation of the proceedings in corporation tax compliance are analysed.

<b><i>Question: What do you consider the most complicated things in corporate income tax compliance, that is, what takes up the most time? (in order of frequency of answer)</i></b>
• The discrepancies between displaying earnings and expenses for accounting and tax purposes
• Complications in monitoring and recording earnings and expenses not allowable for tax purposes
• The complicatedness of the form – Corporate Income Tax return – overgeneralisation and the items for increasing or reducing profit (loss).
• The necessity for filling in the Tax return form by hand
• The tax system does not recognise IAS (International Accounting Standards)
• Frequent changes in and different interpretations of the regulations
• Complicated records in value adjustments
• Complicated recording of long-life assets that are written off one-time
• Complicated calculation and carrying forward of losses

<sup>23</sup> OG 127/00, Article 32.

<sup>24</sup> 1998, 6.1%; 1999, 6.2%, 2000, 4.2%; 2001, 4.2% - Statistical Annuals and Monthly Statistical Reviews of the Ministry of Finance of the Republic of Croatia, various years and numbers.

<sup>25</sup> OG 127/00.

One of the main complaints about the current Corporate Income Tax Law was the total separation of the taxation and the accounting calculation. A tax profit or loss is determined as the difference between earnings and expenses, and according to the demands of the tax return, these are recorded in 40 sub-kinds. Their values can be obtained by reworking the accounts of the main book in the accountancy, but not by being taken directly from the book keeping. Taxpayers should actually keep two kinds of accounts: one according to IAS, which is mandatory on them according to the Accountancy Law<sup>26</sup> and another special tax accountancy, which should have, at any given moment, data about the tax results (the profit or loss).

The difference between the accountancy and the tax statement of earnings and expenses is not only in the classification and systematisation, but also in the recognition of their values. For each item, the tax regulations determine the manner and conditions for allowance, and do not in a single case refer to the IAS. The failure to acknowledge IAS is particularly evident in the calculation of amortization (depreciation). According to tax regulations in Croatia, accountancy amortisation may not be lower than tax amortisation, for which reason the methods provided for in the accountancy standards may not be employed, or rather, their application would have a negative effect on the taxpayer. On the other hand, for this reason the accountancy balance sheet also may not display the real value of long-life assets. If a one-time write off for tax purpose is resorted to, then the long-life assets item will also be written off in accounting.

The corporate income tax return form is large because of the separate statement of individual items of income and expenditure, and also enlarged is the number of items for increasing and reducing profit for permanent and temporary differences in tax allowance, as is the number of reliefs, exemptions and incentives. For taxpayers who run their tax and accounting books by computer, the computer handling of the tax return forms is nevertheless not possible, because it requires the adjustment of individual items, the subsequent calculation of permanent and temporary differences and the entry of reliefs, exemptions and incentives. That is why, along with the complications of the tax return form, the necessity for it to be filled in manually is also stated as one of the difficulties in tax compliance.

Value adjustment relates to the allowance of expenses on long-life and short-life assets, but under precisely defined conditions with respect to the age of outstanding claims. Those outstanding claims that have not been sued for must once again be turned into income for the purpose of the calculation of the tax basis. Losses from value adjustments of long-life assets are allowed only if they are realised, which is also not in line with IAS. Value adjustments of shares and equity, when they are recorded in the accounting according to the share method, are also not allowed for tax purposes.

The possibility of carrying a tax loss five years forward is built into corporate income tax, and this was considered complicated by a considerable number of respondents. Since this is an exceptionally favour tax measure, it is hard to explain such a view, except in the case of those taxpayers who have tax losses over a longer period of time and thus cannot make use of the losses from previous periods.

***Question: What would you propose for the simplification of corporate income tax, that is the reduction of time spent and the costs of tax compliance, and also for increasing its equitableness and effectiveness? (in order of frequency of response)***

- Bringing protective interest back into the tax system
- Tax should not be paid in advance, only after the final calculations
- Periodic quarterly calculations should be abolished

<sup>26</sup> OG 90/92, Article 15.

• The deadlines for handing in forms with the same kind of data should be harmonised
• Reduction of corporate income tax at the beginning of the work of the corporation (for example, for the first three years)
• Reduction of tax on the payout of profit
• Introduction of new tax reliefs

Of these proposals, particular attention should be devoted to the proposal to bring protective interest back into the tax system. Although this was one of the most controversial elements of the Croatian tax system before the most recent reforms, it is clear that the taxpayers experienced it as a considerable tax relief. The tax base, in the system of protective interest, was reduced by 5% of the value of the capital at the beginning of the period, augmented by the rate of inflation. This relief had one other specific featured, because it augmented the tax loss and could be carried over with interest into the next period. Taxpayers who made less than 10% profit on the capital they put in (depending on the rate of inflation) were ensured practically permanent exemption from the payment of corporate income tax or profit tax. Protective interest, among other reasons, practically marginalized government tax revenue from corporate income tax, and, irrespective of all the reasons and justifications for its introduction, was nevertheless replaced by classical tax reliefs. Its restoration, as important tax relief, would be appropriate without the involvement of the rate of inflation.<sup>27</sup>

The calculation of income tax of 15% on the payout of profit, with a tax rate of on corporate income tax of 20% is not an additional tax burden as compared with the earlier rate of corporate income tax of 35% and the payment of corporate income tax in advance, but does represent a burden for those taxpayers who at the end of the period do not make a profit that they have paid in advance for all through the year. This profit should be refunded, or should be treated as a loan of the firm to the owner, and on it interest and VAT on interest should be calculated.

The quarterly calculations, the abolition of which is proposed for the sake of simplifying the tax system, are drawn up for the purposes of and according to the regulations of the national statistics services, and are optional from the point of view of taxation.

Among the proposals for the improvement of the tax system is the abolition of monthly advance payments of corporation tax. In ordinary circumstances it would perhaps suit taxpayers to be able to use the tax advances during the year for other purposes, but then the amount that they would have to pay at the end might jeopardise their solvency.

The lack of harmonisation in the deadlines for the submission of forms relates to the periods for the submission of statistical reports and the corporate income tax return. But the data of the statistical reports are accounting figures, mainly currently updated figures, and this to some extent palliates this problem.

The demand for more reliefs or new reliefs, and in particular the demand for exemption from corporation tax in the first years of the firm's operations (3-5 years) reflects the normal desire of the taxpayer to pay as little tax as possible. This particular demand for a relief can be classified as a tax holiday<sup>28</sup>, and is much more attended with drawbacks than advantages, because it tends to encourage short-term investment and the foundation of new firms, and not

<sup>27</sup> It was never explained why the protective rate of 5% was increased by the rate of inflation, as if all entrepreneurs made inflationary losses. In the total system, some made inflationary losses at the expense of others, depending on the relative movement of prices of inputs and outputs of a given firm.

<sup>28</sup> For the kinds of tax incentive see: Blažić, H – Pečarić, M., 2001. *Oporezivanje i investicije u tranzicijskim ekonomijama: primjer Hrvatske*. In the collection: *Ekonomska globalizacija i razvoj u malim zemljama Europe*. Pula: Dr. Mijo Mirković Faculty of Economics and Tourism

new productive investment. In Croatia there are tax reliefs and incentives in the form of reduced tax rates<sup>29</sup> and in the form of deductions from the tax base<sup>30</sup>. Among them there is a considerable difference from the point of view of usability, because with deductions from the tax base alone it is possible to produce a tax loss that will be carried over to the next tax period. From this point of view the value of such tax reliefs is much greater from the point of view of the taxpayer.

To the question of whether they think the corporate income tax return form more complex than the previous form, a small share of respondents (16%) stated that they thought it very or somewhat more complicated. Of these, more than a half stated that the main cause of the complexity was the involvement of revenue and expenditure that might be different from those that are shown in accountancy terms in the profit and loss account. This is completely in accordance with the previously analysed reasons for the complicatedness of corporation tax, and with the proposals for the simplification of it.

Tending to confirm the interest of taxpayers in favourable tax regulations is the fact that almost 80% of respondents considered the newly introduced possibility for the one-time write-off of long-life assets an exceptionally good or a good measure. However, it causes concern that as many as 40% think there is no benefit in such a measure. A large number of respondents cannot make use of this measure, because they have low investments or have to show a small profit to be able to soften the tax blow with this measure.

There is a correlation between the viewpoint about the one-time write off of long-life assets and amount of income, or expenditure of the firm. The one-time write-off is evaluated more often an exceptionally good measure by respondents with higher earnings and expenses<sup>31</sup>. In addition more respondents with lower earnings considering the measure good, but say that they cannot make use of it because of their low investments or that they would not want to show a loss<sup>32</sup>.

## **The taxation of wages**

The most recent changes in the taxation of wages of employees lay down the obligation of all payers of wages and other employee receipts, during each payment on which they pay contributions and income tax, to supply the data to Central Register of Insurants (known as REGOS) on a specially prescribed form – specification per insured concerning calculated and paid obligatory contributions, income tax and surtax (R-S). Apart from being rendered at least

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<sup>29</sup> According to current tax regulations there are reliefs to taxpayers from the areas of special national concern and the city of Vukovar who employ more than five employees full time and those who do business in the free zones (Articles 13-15, Corporate Income Tax Law). For newly founded firms and firms already existing in tourism, there are investment incentives in the form of considerable reductions of the tax rate in a period of ten years on profit made from investments in the regulation amounts and with the employment of the prescribed number of new employees, as well as the employment of persons with some disability (Article 16 and 19 of the Corporate Income Tax Law).

<sup>30</sup> These are employment incentives on the basis of which the tax base is reduced by the pay and contributions of new employees taken on in the tax calculation period, which can be used for one year from the employment of the new employees (Article 17, Corporate Income Tax Law).

<sup>31</sup> Over 30% of respondents with revenue or expenditure above 3.5 million kuna think it a very good measure, while the same thing is considered by about 20% of respondents with revenues or expenses lower than 1 million kuna.

<sup>32</sup> 58% of respondents with earnings lower than 1 million kuna think the measure is good but that they cannot make use of it because of their low investments or else that they would not show a loss, while the same thing is thought only by 32% of respondents who have earnings or expenses over 3.5 million kuna.

once a month with data for each individual employee, the form is also rendered separately for each kind of payment, and in the event of any monthly payment to the employees not being made, for the sake of the forcible collection of the regulation contributions on the lowest prescribed base. Accountants considered the filling in of this form and communications with REGOS, the agreement of which is necessary for the final payment of wages, a very strenuous and highly bureaucratic job. Although it was claimed that the form will replace as many as eleven forms used to date connected with the calculation and payment of wages which were supplied to various organs and offices, this has not happened, and most of the forms and reports are still filled in and supplied to the taxation organs.

Only a quarter of the companies and a fifth of the tradesmen do not have any problem with filling in the forms, although the investigation was carried out almost a year after the introduction of it. Adjustment to the changes in the recording of the pay of employees must be evaluated as being very slow.

<b><i>What do you think is the most complicated thing in calculating wages, that is, what takes you the most time? (in order of frequency of answer).</i></b>
<b><i>Companies</i></b>
• Too many forms with overlapping data
• Frequent change of regulations, e.g. the pensions law, which affects the calculation of pay
• Large number of paying in accounts and rates for calculation, which are often changed
• Complicated recording of sick leave of employees
• Filling in the R-S form <sup>33</sup>
• Complicated recording of orders for business trips
<b><i>Tradesmen</i></b>
• The employment of a large number of calculation rates and paying in accounts
• Frequent changes of regulations, e.g., of the pensions law, which affects the calculation of pay
• A large number of forms filled in with the same data
• Filling in the R-S form
• Overlapping of the R-S and the ID <sup>34</sup> forms

In connection with the calculation of wages there are obligatory forms according to the labour regulations, then forms according to the demands of the tax authorities, the retirement and health institutes, then forms that are demanded by the Statistics Bureau. The problem of the overlap of data on the regulation forms is still to be felt, in spite of arguments that the R-S form will pull all the red-tape about the calculation of wages together.

As for complaints at the large number of calculation rates and paying in accounts, in recent times this part of the calculation has been significantly simplified, because each contribution is no longer split up into an employer's and an employee's part, but is calculated as a single payment, and the payment is sent to the single account of the national treasury. The problem of the change of regulations is particularly related to retirement reform, which led to the introduction of three pillars for paying in, which constitutes for the employer an additional job in the calculation of this contribution.

The calculation and recording of sick leave is complicated by the fact that sick leave of over 42 days that is charged to the Croatian Health Insurance Institute (known as HZZO) is paid by the employer, and then, pursuant to a request for a refund of the payment, with the appending of documents about the sick leave, payment of the sick leave payment, wages and hours of

<sup>33</sup> Specification per insured about calculated and paid in obligatory contributions, income tax and surtax.

<sup>34</sup> Report about receipts from employed work, the tax on wages calculated, surtax and contributins.

work of the employee and proof of the health contribution having been paid, the funds paid out can be claimed from HZZO. This protects employees on sick leave in the sense of getting their wages paid regularly, but the administrative and financial burden of such a protection is transferred from the institute to the employer. This manner of calculating sick leave can have very opposite results for the employees, if the employer is insolvent and unconscionable. The obligation of health insurance is upon the employer, and not on the employee, and if the employer falls down in this part of his obligations, the employee has no ability to claim directly from the health insurance.

Business trip orders up to the regulation amounts are not burdened by taxation, but there are strict forms for their recording, and for each part of the costs of a business trip it is necessary to append the appropriate proof.

The most common proposals of the respondents derive from these criticisms, for the simplification of the taxation and calculation of wages, and the shortening of the time needed for compliance with this tax.

<b><i>Question: What do you suggest for the simplification of the calculation of wages, that is the reduction of time spent and the costs of tax compliance? (in order of frequency of answer)</i></b>
<b><i>Companies and tradesmen</i></b>
<ul style="list-style-type: none"> <li>• Abolish all forms apart from the R-S, or abolish the R-S form, if all the others are really necessary</li> <li>• Reduce the number of paying in accounts and join employer's and employee's contributions</li> <li>• Pay in only the aggregate rate of tax and contribution</li> <li>• Simplify form RS, in the part of the individual data for individual employees that should not be sent every month but for example just once a year</li> <li>• Better connections between REGOS, the Tax Administration and the Statistics Bureau, so that they should coordinate with each other, the taxpayers not having to give each one of them data</li> <li>• Bring some order into the changes of the rates for calculating contributions, taxes and surtaxes – so that they are allowed to be changed only at the beginning of the year, for example, and not at just any time.</li> </ul>

Over 90% of respondents who calculate wages, that is, that have employees, stated what they thought the most complicated things and what they suggested for the simplification of the calculation of wages. This shows a high degree of interest in taxpayers in this segment of tax compliance and the fact that it is actually in PAYE that they have the greatest difficulties.

### **Attitude of taxpayers to the tax authorities**

The attitude of taxpayers to the tax authorities was analysed according to questions about the evaluation of the degree of satisfaction with their relations, and of the most important criticisms of the tax authorities.

Over a half of the taxpayers were satisfied with the work of the Tax Administration, and only a smaller number, about a tenth, gave this work the lowest possible grade.

<b><i>Question: If you rated your satisfaction with the work of the Tax Administration with the lowest scores, what is the reason for your dissatisfaction? (in order of frequency of answer)</i></b>
<b><i>Companies</i></b>
<ul style="list-style-type: none"> <li>• Inadequate familiarity of tax officials with the changes in the regulations and the way they have to be implemented</li> </ul>



<ul style="list-style-type: none"> <li>• The demand that the necessary documents are to be taken in person (although this is nowhere prescribed) and the lack of development of electronic means of communication with the taxpayers.</li> </ul>
<ul style="list-style-type: none"> <li>• Enslavement to the computer system and poor contact with taxpayers</li> </ul>
<ul style="list-style-type: none"> <li>• Morning only working hours</li> </ul>
<ul style="list-style-type: none"> <li>• Inability to get the right information from tax officials and the necessity to contact directly with the Finance Ministry and the advisers of accountancy associations</li> </ul>
<ul style="list-style-type: none"> <li>• Difficulty in showing tax that has been overpaid, orientation only to the debts of the taxpayers</li> </ul>
<ul style="list-style-type: none"> <li>• Failure to keep up to date, slowness, arrogance, lack of attention to the opinions of the taxpayers, superficiality</li> </ul>
<ul style="list-style-type: none"> <li>• Charging for receipts concerning taxes paid</li> </ul>
<ul style="list-style-type: none"> <li>• Frequent changes of personnel in some jobs</li> </ul>
<ul style="list-style-type: none"> <li>• Knowing the law only with control and penalisation, not in the solution of concrete problems. Controls are in some places too frequent and superficial – only for the purpose of penalising.</li> </ul>
<ul style="list-style-type: none"> <li>• Lack of coordination between the work of the Customs and the Tax Administration</li> </ul>
<ul style="list-style-type: none"> <li>• Long wait for refund of tax</li> </ul>
<b><i>Tradesmen</i></b>
<ul style="list-style-type: none"> <li>• Tax officials are poorly informed, too young and have no experience in business practice</li> </ul>
<ul style="list-style-type: none"> <li>• They are polite, but without expertise, since they are mainly lawyers and not economists and do not understand the essential problems of taxpayers</li> </ul>
<ul style="list-style-type: none"> <li>• They are arrogant, interested only in collecting as much tax as possible</li> </ul>
<ul style="list-style-type: none"> <li>• They are slowing in giving refunds, but insist on promptness in payment</li> </ul>
<ul style="list-style-type: none"> <li>• They are often changed around in given jobs, which makes communications difficult</li> </ul>
<ul style="list-style-type: none"> <li>• They do not allow certain expenses, and it is necessary to appeal against rulings concerning tax liabilities</li> </ul>

Though very sporadically, the companies did also state positive views on the increased kindness and helpfulness shown in the settlement of the problems of taxpayers in more recent times.

It can be concluded that in general there was a prevailing higher grading of the kindness of the officials than of their expertise and competence. Taxpayers who negatively grade the work of the Tax Administration are mostly from commerce and the services industries. The size of a taxpayer did not affect the degree of satisfaction with the work of the tax authorities.

## **Conclusion**

This paper has analysed the standpoints of taxpayers concerning the procedures for tax compliance, the tax regulations, relations with the tax authorities and possibilities for increasing the equitableness and effectiveness of the tax system. Through a comparison of the views of taxpayers that are liable to pay corporate and those that are liable to pay personal income tax, the following most important conclusions can be drawn:

- The tax burden is too high in all segments; all the tax rates should be reduced; and for small tradesmen, lump-sum taxation should be introduced.
- The tax system is burdened with too much administration and by too frequent changes of the regulations, and the number of forms should be reduced, particularly in the taxation of wages, and changes in taxation should be reduced.
- The attitude of the tax authorities to the taxpayers is not satisfactory, and it is necessary to improve mutual communication as well as the quality of personnel in the Tax

Administration, and in particular to link the Tax Administration better with other departments in the tax system, so that the taxpayers themselves do not have to provide them with the same or similar information.

- In the opinion of the respondents, income tax should be more progressive and more socially sensitive, and the calculation of taxation should be better adjusted with the accounting system, and in addition it would be useful to bring protective interest back into the tax system.

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