



Combating tax evasion and tax avoidance: tax reform in Croatia

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Tax evasion and avoidance constitute a severe problem for any process of sustainable development and are especially detrimental to good financial governance. When designing an effective, efficient and transparent system of taxation it is therefore essential to address these issues explicitly. A successful and sustainable strategy has to take into account the interests and aims of all parties involved as well as the specific situation in which the reform process is placed. Against this background, tax evasion and avoidance can be curbed by a comprehensive reform of the tax law combined with a capacity development process that guarantees effective and efficient tax administration.

Reform of the Croatian tax system

On behalf of the German Federal Ministry for Economic Cooperation and Development (BMZ) the GTZ adopted a comprehensive approach embracing a joint tax system and administration reform when supporting the Croatian tax reform process from 1993 to 1999. Prior to the reform, taxation in the Republic of Croatia was characterised by a multiplicity of different commodity taxes and exemptions as well as by tax reductions in the field of personal income and profit taxation. In the absence of a systemic approach,

widespread tax evasion and avoidance were inevitable. To enhance revenue-raising capacities and prevent abuse of the many existing special regulations, a comprehensive reform of the entire tax system was initiated. In cooperation with the Croatian government, the GTZ successfully established a simple, transparent and user-friendly tax law. More importantly, the reform process included a profound reorganisation of the entire tax administration thus guaranteeing effective, efficient and transparent execution of the law.

The GTZ approach to tax reform in the Republic of Croatia

To improve domestic resource mobilisation capacities, the GTZ approach relied on a systemic two-pillar approach simultaneously targeting tax law and tax administration. This close interconnection ensured that a new tax law was introduced which would be executed effectively by a newly established and well-trained administration. Tax regulations were kept as simple and clear as possible in order to ensure a user-friendly tax regime and to keep both administrative necessities of the state as well as compliance costs of the taxpayers low. The main achievement of the reform process was the implementation in 1994 of a comprehensive tax system characterised by the following features:



Tax law reform

- Replacement of the complex system of different commodity tax rates by a value-added tax (VAT) in line with international good practice
- Implementation of redistributive, pro-poor components of fiscal policy, e.g. by guaranteeing a tax-free subsistence income
- Avoidance of double taxation of income: 40 double-taxation treaties based on a newly developed Croatian double-tax convention were negotiated with other countries



Capacity development in tax administration

- Reorganisation of the existing multiplicity of different agencies, each targeting specific taxes, to a modern comprehensive system of tax administration
- Implementation of more effective modes of tax enforcement and revenue-raising
- Linking all tax agencies in the country via a data processing system
- Establishment of a training centre

Main results and impacts

In only five years the GTZ project succeeded in completely reforming the Croatian system of tax law and tax administration. The legislative tax system was founded on transparent regulations and avoided excessive use of exemptions and tax reductions. Combined with enhancement of the effectiveness of tax administration with respect to enforcement and control, and a potential rise in voluntary tax compliance as a response to the explicit pro-poor focus of the new fiscal policy, such a reform has a direct and lasting effect on tax evasion and avoidance. The improved revenue-raising capacity of the Croatian system stabilised the legitimacy of the newly formed independent Republic of Croatia.



Tax reform preventing tax evasion and avoidance

Experience with the Croatian reform project has shown that policies aiming at fighting tax evasion and avoidance must not remain mere theoretical commitments, but have to be implemented in practice. Future projects should, therefore, interconnect a systemic approach to fiscal policy reform with capacity development in tax administration. Furthermore, civil society's interests should also be taken into account. While the specific situation of the partner country is a crucial factor guiding any fiscal reform, designing simple and clear tax regulations proved vital in supporting the effectiveness and efficiency of tax enforcement procedures in the Republic of Croatia. Moreover, such a system not only eases compliance for taxpayers but is also perceived as fair and legitimate and thereby contributes to both voluntary tax compliance and the legitimacy of the state.



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