

THE TAX ALIGNMENT PROCESS IN THE NEW EUROPEAN UNION MEMBER STATES: HOW MIGHT CROATIA FARE?

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ABSTRACT

This article discusses the process of alignment with taxation *acquis* in 12 new European Union (EU) member states (Bulgaria, Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Romania, Slovakia and Slovenia) and Croatia. It analyses problems faced at the beginning of the process, developments along the road and the situation at the time these countries joined the EU. Since the administrative capacities of all these states were identified as their main problems, this article assesses the capacities of the administration in Croatia and, in particular, the tax administration. One of the conclusions is that at the beginning of its relationship with candidate countries, the European Commission was rather optimistic, while alignment proceeded slowly in all the countries. Notwithstanding the various deficiencies, the outcomes of all negotiations were ultimately successful. However, Croatia's alignment with taxation *acquis* has not only been slow, but has also lagged behind that of other countries at the same stage of negotiations. As the EU might be less forthcoming in its approach to Croatia than it was to the countries from the last accession wave, the Croatian government and tax administration should make much stronger efforts not only to speed up, but also to deepen, the necessary reforms.

KEYWORDS

EU taxation *acquis*, *acquis* alignment, new EU member states, administrative capacity, tax administration capacity, Croatia.

I. INTRODUCTION

Most of the ex-communist countries that either joined or intended to join the European Union (EU) in the last decade had to make strenuous efforts to align their tax systems with the taxation *acquis*. As Croatia is about to join the EU, the goal of this article is to acquaint the reader with the process of the alignment of 12 new member states with the taxation *acquis*.¹ This article identifies problems encountered at the beginning of the process of the alignment of direct and indirect taxation, developments during the process and the situation at the time of accession. Finally, this article tries to put Croatia in that context.

Part II briefly explains the EU *acquis* on taxation and the goal of the alignment. Part III describes the main issues in the alignment of Croatian taxation with the *acquis*. Part IV elaborates on the process of alignment with the taxation *acquis* in the new member states and Croatia. Part V briefly assesses administrative capacity and the capacity of the tax administration in Croatia. The paper ends with some brief conclusions and recommendations. It is outside the scope of this article to look at the effects of the implementation of the *acquis*, a task that may well be left to the teams of researchers engaged by the European Commission.

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1 Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia joined the EU in 2004, whereas Bulgaria and Romania became members of the EU in 2007. This paper will not deal with Turkey and FYR Macedonia, which have been EU candidates since 1999 and 2005 respectively.

II. THE *ACQUIS* ON TAXATION AND THE GOAL OF THE ALIGNMENT

One of the key prerequisites for membership of the EU is the adoption of the *acquis communautaire* or Community *acquis*, i.e. the body of rights and obligations that binds and links together all member states in the EU. The *acquis* does not only cover laws in the narrow sense, but also the common objectives laid down in the founding treaties. The *acquis* is actually a set of principles to be incorporated in member countries' legislations. The *acquis* has evolved over time and today it comprises 33 chapters that candidate countries negotiate with the EU, taxation being only one of them.²

Chapter 16 of the *acquis* on taxation covers essentially indirect taxation, namely Value Added Tax (VAT) and excise duties.³ Chapter 16 lays down the definitions and principles of VAT. Excise duties on mineral oils, tobacco products and alcoholic beverages are regulated by Community directives as regards the structure of the duty, the level of minimum rates and the holding and movement of excisable goods. Concerning direct taxation, the *acquis* covers some aspects of corporate taxes and aims mainly to remove obstacles to enterprises' cross-border activities. Finally, Community legislation on administrative cooperation and mutual assistance provides instruments for tackling intra-Community tax evasion and fraud for both direct and indirect taxation.

The EU is particularly interested in VAT as its own source of revenue, and in excise duties because of possible illegal cross-border trade.⁴ What it actually insists upon in the process of taxation alignment is that tax administrations in future member countries should be able to cooperate and provide mutual assistance. The European Commission has so far refrained from getting involved in the issue of tax competition within the Union, particularly between the old and new member states. The Commission would like to have more harmonised tax systems, but does not plan to introduce a common corporate income tax base until some time after 2010. For the time being, there are no plans for a common corporate income tax rate. Old member states with higher tax rates like Germany and France are in favour of harmonisation, while Ireland and all new member states with lower tax rates are against it.

Harmonising the taxes of a wide range of countries with different tax systems and different levels of traditional public services would be an extremely difficult task. This is the reason why the Commission only insists on the alignment of member states with the *acquis*, which is also not an easy task.

III. THE ALIGNMENT OF CROATIAN TAXATION

A VAT system replacing the multistage turnover tax was introduced in Croatia in 1998. The initial design of the VAT system fairly closely followed the recommendations of tax theory and EU practice. The VAT had a uniform rate, a broad tax base, the minimum number of standard exemptions, and zero rates only on exports. Unfortunately, with the introduction of zero rates on certain goods and services, new exemptions, changes in the

2 The *acquis* chapters are: (1) Free movement of goods, (2) Freedom of movement for workers, (3) Right of establishment and freedom to provide services, (4) Free movement of capital, (5) Public procurement, (6) Company law, (7) Intellectual property law, (8) Competition policy, (9) Financial services, (10) Information society and media, (11) Agriculture and rural development, (12) Food safety, veterinary and phytosanitary policy, (13) Fisheries, (14) Transport policy, (15) Energy, (16) Taxation, (17) Economic and monetary policy, (18) Statistics, (19) Social policy and employment, (20) Enterprise and industrial policy, (21) Trans-European networks, (22) Regional policy and coordination of structural instruments, (23) Judiciary and fundamental rights, (24) Justice, freedom and security, (25) Science and research, (26) Education and culture, (27) Environment, (28) Consumer and health protection, (29) Customs union, (30) External relations, (31) Foreign, security and defense policy, (32) Financial control, and (33) Financial and budgetary provisions.

3 European Union, *Summaries of Legislation: Taxation*, Europa — SCADplus <<http://europa.eu/scadplus/leg/en/s10000.htm>> at 9 January 2009.

4 The EU budget revenue consists of the revenues from: customs duties, agricultural duties and VAT, revenue transfers based on the percentages of the member states' gross national income, and revenues from other sources. VAT is the second-largest source of EU revenue after the transfers based on gross national income. For more details, see Marina Kesner-Škreb, 'The Budget of the European Union' (2007) 31 *Financial Theory and Practice* 203; Hrvoje Šimović, 'The European Union Budget' (2005) 29 *Financial Theory and Practice* 245.

registration threshold and the taxation of land for construction, the Croatian system has started to deviate increasingly from theoretical precepts and EU practices.⁵

According to the European Commission, the most important discrepancies to be dealt with in the alignment process will be in the level and number of rates, the scope of exemptions, the level of the registration threshold, and VAT refunds to foreign businesses.⁶ According to Danijela Kuliš,⁷ the most difficult issue will be the inevitable abolition of zero rates on domestic deliveries of certain products like bread, milk, books and drugs. Depending on the negotiation results, zero rates could be abolished and reduced rates introduced in the pre-accession period, or a transition period obtained.

The two other EU requirements will be easier to satisfy. The first is the change in the definition of tax exemptions - Croatia uses an institutional model (exemptions granted to institutions), while the EU recommends a more logical functional model (exemptions granted to goods and services). The second is the harmonisation of the registration threshold, which is higher in Croatia than in the EU (€11 600 as opposed to €5000).

Excise taxes in Croatia are currently paid on a smaller number of products than in the EU, i.e. on tobacco products, alcoholic beverages, coffee, oil derivatives, beer, non-alcoholic beverages, cars, other motor vehicles, vessels and airplanes, and luxury goods. The rates in Croatia are lower than the EU minimum rates and the system is only partly harmonised with the *acquis*. Adjustments will be necessary regarding the tax base, rates, structure and definitions of products. The largest adjustments will relate to the requirement to tax additional energy products like coal, natural gas and electricity, and in raising the rates on certain oil derivatives and tobacco products. The introduction of excise tax on additional energy products could be a shock to the economy and the citizens, so its implementation could be postponed and a transition period negotiated. Alternatively, changes in the rates could be introduced gradually.

IV. THE PROCESS OF TAX ALIGNMENT IN THE NEW MEMBER STATES

The literature about the alignment process mostly comprises European Commission documents, and it seems that the process has not attracted much attention from academic circles. This is why the work on this article started by analysing the summaries of the adoption of the Community *acquis* by the new member states at the moment of their accession (based on the 2003 Commission reports on the 10 countries that joined the EU in 2004, and on the 2005 Commission reports on Bulgaria and Romania, which joined the EU in 2007)⁸ and the 2007 Commission report on Croatia.⁹ These documents contained references to a large number of mostly legal and institutional documents. However, surprisingly, they provided few analyses of the economic aspects and effects of the alignment. A rare exception is the Copenhagen Economics,¹⁰ and some works on the effects of tax harmonisation that include the new member states.¹¹

It is interesting that the Bureau of European Policy Advisers and the Directorate General for Economic and Financial Affairs carried out an economic evaluation of differences in the tax systems of the new member states (tax structure; tax burden, imposed particularly by corporate taxation, and its effects on attracting foreign investment) only two

5 For detailed analyses of VAT and excise taxes in Croatia, see Marina Kesner-Škreb and Danijela Medak Fell, 'Value Added Tax in Croatia vs EU: Tax Threshold, Zero Rate, Building Land Taxation and Exemptions' (2008) 36 *Newsletter*, Institute of Public Finance, Croatia ; and Danijela Kuliš, 'Consumption Taxation: Value Added Tax and Excise Taxes' (2007) 33 *Newsletter*, Institute of Public Finance, Croatia.

6 Commission of the European Communities, *Croatia 2006 Progress Report* (2006).

7 Kuliš, above n 5.

8 European Union, above n 3.

9 Commission of the European Communities, *Croatia 2007 Progress Report* (2007).

10 Copenhagen Economics, *Economic Effects of Tax Cooperation in an Enlarged European Union: Simulations of Corporate Tax Harmonisation and Savings Tax Coordination* (2004).

11 Michael Kohlhaas et al, 'Economic, Environmental and International Trade effect of the EU Directive on Energy Tax Harmonization' (Discussion Paper No 462, DIW Berlin, German Institute for Economic Research, 2004); Jens Bröchner et al, 'The Dilemmas of Tax Co-ordination in the Enlarged European Union' (Working Paper No 2006-11, Institute for Federalism and Intergovernmental Relations, 2006).

years after the enlargement.¹² However, nothing was said about the issues that were important in the alignment process, such as tax administration capacity, information technology interconnectivity and so on. One could just wonder what the alignment process was then for and why it was not important for these economic evaluations. If the alignment process has not been considered important in these economic evaluations, the purpose of the process might very well be called into question.

A. The Situation in the 10 New Member States on the Eve of Accession

This part outlines the general situation on the eve of accession i.e. in the year 2003.¹³ The questions addressed are: How were the 10 new member states fulfilling their commitments and meeting the set requirements? Were they in a position to fulfill them? What transitional periods and derogations did they get and what were they required to improve urgently?

On the eve of accession in 2003, only Cyprus was assessed as fulfilling the commitments it had made and meeting the taxation requirements set during negotiations. The nine other countries were evaluated as fulfilling the commitments and meeting the requirements ‘essentially’ or ‘mostly’. There were also some exceptions. The Czech Republic was evaluated as ‘essentially’ meeting the requirements, except for duty-free shops at land borders, Malta as fully meeting the requirements regarding direct taxation, but only partly regarding indirect taxation, and Poland as ‘essentially’ meeting the requirements regarding direct taxation, but only partly regarding VAT and excise taxation. Slovenia was assessed as ‘essentially’ meeting the requirements regarding VAT and excise taxation, but only partly regarding direct taxation.

Table A-4 below shows that all the new candidates obtained various transitional periods for the alignment and some derogations from the *acquis*. All the countries were granted derogations regarding VAT — exemption and registration threshold for small and medium-sized enterprises and exemption on international passenger transport. Two countries obtained additional derogations regarding some specific VAT exemptions, and five regarding reduced excise duties rates for some spirits produced in small quantities. The majority of countries obtained various transitional periods, most of them until the end of 2007, but some until 2011, regarding VAT rates and procedures, as well as exemptions from, and rates of, excise duties. Only two countries were granted transitional periods for profit tax alignment.

The new member states’ abilities to implement the *acquis* upon accession were assessed as ‘should be able to implement’ (Cyprus, Estonia, Latvia), ‘should be able to be in a position to implement’ (Lithuania), ‘expected to be in a position to implement’ (the Czech Republic, Hungary, Malta, Poland, Slovakia), and ‘should be expected to be in a position to implement’ (Slovenia).

What conclusions could be drawn from these assessments? The countries were allowed to join the Union, although the majority of them neither completely fulfilled their commitments nor met the accession requirements. Moreover, even upon accession, they were not completely in a position to implement the *acquis*. This article will try to elaborate on whether Croatia could also count on such a generous approach on the part of the EU.

That was the situation at the end of the accession process. It is instructive to go back to the start of the whole process and see how different countries have aligned their tax systems over time.

12 European Commission Bureau of European Policy Advisers and the Directorate-General for Economic and Financial Affairs, ‘Enlargement, Two Years After: An Economic Evaluation’ (Occasional Paper No 24, European Commission, 2006).

13 This section is based on Commission of the European Communities, *Towards the Enlarged Union: Strategy Paper and Report of the European Commission on the Progress Towards Accession by Each of the Candidate Countries* (2002) EUR-Lex ; *Treaty of Accession 2003* [2003] OJ L 236/17; European Union, above n 3.

B. Developments between 1997 and the Accession

Table A-1 below shows that the progress of transposing the *acquis* and making the necessary alignments was slow and that the problems were similar in all new member states. The EC complained about the possibilities for administrative cooperation and mutual assistance in all the countries. The Commission used formulations such as ‘alignment partial’, ‘no progress’, ‘no significant developments’, and ‘needs further improvements’. Nonetheless, at the start of the alignment in 1997, the EC was optimistic and claimed that several countries (eg, Latvia, Slovakia and Slovenia) should be able to comply with the *acquis* and to participate in the mutual assistance arrangements, provided their tax administrations developed the required expertise.

On the eve of the accession, however, the situation was not too promising: almost all countries, except Poland and Slovakia, had central liaison offices, but just three of them had excise liaison offices (Malta, Slovenia and the Czech Republic). Some were in the process of establishing excise liaison offices (Poland, Cyprus, Hungary), while others had no such offices (Latvia, Estonia) and some did not even have plans to establish them (Slovakia). The situation was even worse with the VAT information exchange system and the system for the exchange of excise data. Only Slovenia had both systems in place, while all other countries were at various stages of preparation for the establishment of these systems. Nevertheless, all the 10 countries joined the EU on 1 May 2004.

Interestingly, in 1997, the Commission thought that the alignment of direct taxation should not cause major difficulties for Slovenia, but the compliance with indirect taxation requirements might pose serious challenges, given the absence of a VAT or an excise system in Slovenia at the time. On the eve of accession in 2003, Slovenia was essentially meeting the VAT and excise duties requirements but only partially those on direct taxation. It was therefore required to accelerate the transposition of almost the entire *acquis* regarding direct taxation. This example shows that countries cannot rely on the assessments of the Commission and that they must have full control over their alignment processes. Moreover, the pace of reforms could be surprising.

C. Developments in Bulgaria and Romania

Table A-2 below shows that developments in Bulgaria and Romania in the period 1997-2002 were very similar to those in the 10 countries that joined the EU in 2004. Although Bulgaria and Romania did not join the EU with the 10 other countries in 2003, they both essentially fulfilled their commitments and met the taxation requirements. The negotiations on the taxation chapter were closed provisionally and both countries got some transitional periods and derogations (see Table A-4 below). It is obvious that taxation alignment was not an obstacle to their joining the EU.

On 25 April 2005, both countries signed the accession treaties as they were deemed to be in a position to implement the *acquis*, although they both still had to consolidate their administrative capacities. Bulgaria had to put in place the national revenue collection office, reinforce tax collection and inspection, intensify its efforts in the fields of excise duties and taxation, as well as administrative cooperation and mutual assistance, while Romania had to complete legislative alignment in several areas, such as the modernisation of its tax administration. Nevertheless, on 1 January 2007, both countries joined the EU.

It can be concluded that, like the 10 new member states that joined the EU in 2004, Bulgaria and Romania showed various deficiencies in alignment when they joined the EU in 2007.

D. Developments in Croatia

Here it should be explained why this article deals with Croatia from the year 2004. Due to the war in Croatia in the early 1990s and its political, institutional and economic consequences in the following years, the country lagged behind other Central and Eastern European countries in developing a relationship with the EU. The Stabilisation and

Association Agreement¹⁴ was signed in 2001. Croatia applied for EU membership in 2003 and, after numerous ups and downs in the relationship, mostly caused by its clumsy cooperation with the International Criminal Tribunal for the former Yugoslavia, the screening stage of the accession negotiations started in October 2005.

Table A-3 shows that Croatia has constantly showed slow progress, and that from year to year the main problems lay in administrative capacity and information technology interconnectivity. If one expects the accession to take place in a couple of years (2010 or 2011), one should bear in mind the Commission's present awareness of the importance of the alignment in the specified fields, which it will certainly insist upon in its negotiations with Croatia.

E. Croatia and Ex-candidate Countries Three Years before the Accession

If the year 2010 is considered as the target date for Croatia's joining the EU, the situation in Croatia as reported by the Commission in 2007 should be compared with the situations in the 10 countries as reported in 2001 and the two countries as reported in 2004.

In 2001, almost all the 10 countries that joined EU in 2004 were further aligning indirect taxation, particularly regarding excise duties. Some of the countries made no progress in the area of VAT, but most of them made no progress in direct tax alignment, although they all continued improving their administrative capacities.

The two countries that joined the EU in 2007 continued their alignment processes during 2004, although one of them made unsatisfactory progress in the field of direct taxation, and both still had to improve their administrative capacities. But the fact is that the two countries essentially fulfilled their commitments and met the taxation requirements as early as 2003, and that the negotiations on the taxation chapter were provisionally closed in that year.

It is obvious that Croatia is lagging behind these countries three years before the accession, as, according to the Commission of the European Communities, it made a very limited progress, its alignment is far from complete and substantial efforts are required to strengthen the country's administrative capacity.¹⁵ According to the latest available data provided in the Mission of Croatia to the EU, the negotiations on the taxation chapter are lagging behind those on other chapters. Croatia presented its negotiating position on the taxation chapter to the EU in April 2008 and, at the time of writing this article (June 2008), the Commission was preparing a draft common position. At the same time, 21 chapters are in more advanced stages, whereas the negotiations on only eight chapters are lagging behind the taxation negotiations. As the taxation chapter is not deemed particularly difficult, the delay in the negotiations on this chapter can be considered another proof of the weakness of Croatia's tax administration.¹⁶

V. ADMINISTRATIVE CAPACITY IN CROATIA

As administrative capacity might be considered Croatia's crucial weakness in its EU accession process, this article particularly concentrates on this issue with regard to both the general and tax administrations.

14 *Stabilisation and Association Agreement between the European Communities and their Member States, of the one part, and the Republic of Croatia, of the other part* (2005) OJ L 26. The Stabilisation and Association Agreement (SAA) represents a new generation of Europe agreements offered to the countries of south-eastern Europe in the framework of the stabilisation and association process. The SAA governs the general principles, political dialogue, regional collaboration, free movement of goods, movement of labour, foundation of legal entities, provision of services and capital, harmonisation of laws, implementation of legislation and rules governing market competition, justice and internal relations, and political and financial collaboration. It gives a signatory country the status as a potential applicant for EU membership.

15 Commission of European Communities, above n 9, 41.

16 The progress of the EU-Croatia accession negotiations by chapter, including the negotiation process for each particular chapter, is regularly presented in Mission of Croatia to the EU, *Progress in EU-Croatia Accession Negotiations at a Glance* (2008).

A. The General Administration Capacity

As suggested by the EU Monitoring Project, in the last few years Croatia showed limited progress in the implementation of its public administration reforms, which continue to be made partially, without any strategy and under a strong political influence.¹⁷ While in 2004 the Commission said that only initial steps should be taken,¹⁸ in 2005 it required strict enforcement of the reform measures.¹⁹ Although the results of administrative capacity development cannot be seen in the short run, the changes in the legislation on government administration and changes in the number and scope of ministries and various government offices and agencies tend to suggest that it has not been driven by rationalisations, but has rather been aimed at combining the available human resources in the most effective and politically rewarding ways. The way in which the public administration is organised, the transparency of its work and accessibility of information are crucial, particularly in the fight against corruption.

However, Croatia is still in want of a clear definition of the structure of public administration and its bodies and of a list of government officials, information that has to be accessible to the public. A reform strategy is still in preparation, which to some extent accounts for the partiality of reforms. The adopted *Strategic Development Framework for 2006-13*²⁰ defines some of the goals of public administration reform and proposes various new measures. However, it is difficult to secure the necessary political will to implement them under the circumstances of coalition governments constantly striving to satisfy numerous interest groups. This is why the establishment of a public administration capable of first reforming itself and then the entire public sector, and aiming at introducing and enforcing EU-aligned legislation, will depend on depoliticisation, political commitment, competence and the will to instigate substantial reforms and changes.²¹

Despite many improvements, the ability of Croatian institutions to comply with EU requirements remains the weakest point. Reform progress has been limited and marked by partiality, lack of strategy and strong political influences. The key actions missing are implementation, enforcement and action plans. The Government is, on paper, dedicated to reforms. However, unfortunately, changes are often made without analysing the needs and estimating the effects, which results in superficial reforms without real content, new laws whose implementation and enforcement is not ensured, and a lack of long-term strategies and the necessary coordination.

For example, the *Strategic Development Framework for 2006-13* medium-term development strategy defined the situation and goals and offered the necessary instruments and actions for achieving these goals. However, the pattern was not of equal quality for all the fields, i.e. the instruments and actions for some of them were rather vague and the circumstances and goals were not appropriately defined. Even more importantly, such an unbalanced strategy was not elaborated in the documents needed to regulate the necessary 'tactics' and to correct flaws in the strategy. Three years after publication of the strategy document, no concrete actions have been taken and no resources or possibilities defined. The leading persons involved moved from the government to the private sector and it seems as though the strong effort put into preparing the document was of no avail.

17 For more details about the EU Monitoring Project see Katarina Ott, 'Croatian Accession to the European Union: The Challenges of Participation' in Katarina Ott (ed), *Croatian Accession to the European Union: The Challenges of Participation* (2006) vol 4, 4.

18 Commission of the European Communities, *Opinion on Croatia's Application for Membership of the European Union* (2004).

19 Commission of the European Communities, *Croatia: 2005 Progress Report* (2005).

20 Government of the Republic of Croatia, *Strategic Development Framework for 2006-13* (2006).

21 For more details about the administrative capacity weaknesses of Croatia, see Katarina Ott, above n 17; Katarina Ott, 'Croatia and the European Union: Accession as Transformation' in Katarina Ott (ed), *Croatian Accession to the European Union: Facing the Challenges of Negotiations* (2005) vol 3; Katarina Ott, 'Croatian Accession to the European Union: Institutional Challenges' in Katarina Ott (ed), *Croatian Accession to the European Union: Institutional Challenges* (2004) vol 2; Katarina Ott, 'Croatian Accession to the European Union' in Katarina Ott (ed), *Croatian Accession to the European Union: Economic and Legal Challenges* (2003) vol 1.

There is another minor but more dramatic example. Despite its many controversies, the government, hurriedly and without proper preparations, passed a new trade law²² that shortened retailers' working hours. However, due to the protests of local communities (particularly those from tourist regions) it had to be put out of force less than 20 days after it became effective. The government is now struggling with prolonged negotiations with trade unions, the employers' association, chamber of trade and local communities.

Everything said above refers to the tax administration as well. The tax administration cannot be viewed separately from the whole of the public administration and cannot be improved without an improvement of the whole. However, this article focuses on the tax administration.

B. The Tax Administration Capacity

One could start optimistically. According to the World Bank report *Doing Business 2008*, Croatia is the top reformer in Europe and second-best worldwide, ranking 97th among 178 countries. One of the key breakthroughs was made in the 'paying taxes' category (up 12 places from last year): Croatia is the third top country in terms of paying taxes among 28 countries of Eastern Europe and Central Asia; and Croatia has lower total tax rates for enterprises than any new member state (32.5 per cent as opposed to the new member states' average of 44.5 per cent).²³ However, looking in greater detail, the report shows that the number of tax-related procedures, duration of the process and costs did not change in the last three years. As suggested by more detailed findings of the Institute of Public Finance's *Identification of Strategic Priorities and Formulation of the Development Strategy of the Croatian Tax Administration*,²⁴ there are some concrete problems which constrain the improvements.

Some of the problems lie in inadequate systems of rewarding and promoting employees, lack of consistent mentoring of young and inexperienced employees and limited possibilities and lack of encouragement for employees to report evasion and corruption and to suggest improvements in their activities. This is why employees often leave the tax administration, and those who stay are not motivated for continuous education and improvements. One of the ways to improve this situation would be to exclude the tax administration from the general public administration nomenclature, as in the case of central bank employees, and to change the rules governing the salaries and rewards of tax administration employees.

Owing to their poor education, tax administration employees are not sufficiently acquainted with constant changes in economic circumstances, eg, in information technology (IT) services, cross-border activities of companies or new products and services. The tax administration cannot recognise the problems of taxpayers who are willing to abide by tax rules or distinguish them from those who try to avoid or evade their tax obligations. This is why honest and decent taxpayers are not in the same competitive position as those who avoid or evade taxes (tradesmen and small traders in the informal economy, those who rent apartments or holiday apartments). The tax administration should urgently ensure equal tax treatment for all taxpayers of a particular category and change the decades-long routines to control the renting of apartments, and small craftsmen and traders.

It is also a pity that the tax administration abolished the very successful and well-accepted campaigns to popularise the citizens' tax responsibilities conducted during the 1990s. It

22 *Act on Trade and Commerce of the Republic of Croatia*, NN 87/08

23 World Bank. *Doing Business 2008* (2008). This report looks into 10 categories, from starting to closing a business, one of them being taxation. Under taxation, it looks into the number of tax payments, time spent on fulfilling tax obligations and the rates of profit tax, labor tax and contributions and other taxes, as well as the total tax rate as a percentage of profit.

24 Institute of Public Finance, Croatia, *Identification of Strategic Priorities and Formulation of the Development Strategy of the Croatian Tax Administration* (2008).

would be good to renew these actions, introduce new campaigns and try to regain the confidence of citizens.

The European Union's *Summaries of Legislation: Taxation* emphasises the problems of coordination and organisation.²⁵ For example, direct taxes and VAT fall under the responsibility of the tax administration, whereas excise duties are the responsibility of the customs administration. The independent Department for Tax Crimes Investigation is not yet well organised. Serious delays have resulted from the lack of cooperation between the tax administration, the police and the judiciary. The excise duty service does not yet exist as a real functioning body, since it employs only two people, and considerable efforts will be required to develop IT systems for the exchange of information.

In 2005, as part of its improved interoperability, Croatia set up a team responsible for the VAT information exchange system project. Limited strengthening of the excise duty service took place, and a Financial Police Department was set up in 2004. The collection and control functions of the tax and customs administrations remained insufficient.

In 2006, some progress was made: for example, an International Cooperation Department was set up and the Financial Police Department became operational in January 2006.

In 2007, progress in administrative cooperation was limited, with Croatia starting to participate in the *Fiscalis 2007* program.²⁶ There was some progress with regard to operational capacity and computerisation; the tax administration adopted an IT strategy and efforts were made to increase operational capacity.

As stated in the World Bank Independent Evaluation Group's report *Public Sector Reform: What Works and Why?*, the main incentives for recent tax administration reforms around the world were the need for additional government revenue, preparation for accession to the European Union, adapting tax administration to a free-market economy and increasing transparency and efficiency in order to improve the image of tax administration among voters and businesses.²⁷ Although preparing for EU accession currently seems to be the most important incentive for Croatia, the other incentives mentioned, particularly those aimed at improving the image of tax administration, are also essential for the country. Croatia has followed the main reform trends, like partial reorganisation along functional lines, making efforts to introduce a taxpayer identification number, computerisation and the establishment of some large taxpayer units. However, mostly thanks to the complacency resulting from ever-rising revenues derived primarily from growth in consumption, the tax administration has not worked enough on the simplification of procedures, improvement of collection systems, increasing the effectiveness of audit and appeal mechanisms, and human resources policies (salaries in tax administration and public administration deserve a separate article). According to the same report, all this is necessary to increase effectiveness and reduce opportunities for corruption.

VI. CONCLUSIONS

The following conclusions can be drawn. The Commission was rather optimistic at the beginning of its relationship with candidate countries. The alignment in the field of taxation was slow in all countries, with numerous ups and downs, but the countries were allowed to join the EU, despite various deficiencies in the alignment with the taxation *acquis*. Their tax administrations were generally poorly prepared for administrative cooperation and mutual assistance.

Recent developments within the extended EU, particularly very harsh recent statements on Bulgaria and Romania, have shown that the Commission has become painfully aware of

25 European Union, above n 3.

26 *Fiscalis 2007* is a European Community programme to improve the operation of taxation systems in the internal market. See European Commission, Taxation and Customs Union, *Fiscalis 2007* <http://ec.europa.eu/taxation_customs/taxation/tax_cooperation/fiscalis_programme/fiscalis_2007/index_en.htm> 10 February 2009.

27 World Bank Independent Evaluation Group, *Public Sector Reform: What Works and Why? An IEG Evaluation of World Bank Support* (2008) 57.

the consequences of the acceptance of all new member states even without them all being equally prepared at the moment of the accession.²⁸ When it comes to taxation, even in its last reports published on the eve of the accession, the Commission pointed to various deficiencies regarding the administrative weaknesses of new member states. The EU would like to have good administrative cooperation and mutual assistance, particularly regarding VAT, which is of great importance to it as a source of revenue, and also regarding excises, given the risk of illegal cross-border trade.

Croatia is also slow in its alignment. However, it should be aware that the now more experienced EU might be less enthusiastic about Croatian membership and might insist on better alignment than in previous accession cases. As explained above, the EU became aware of the problems that persisted in the new member states, and of the obstacles these problems are posing to the smooth functioning of the common market. Croatia is not joining the EU as part of a group, but individually, and it will therefore be much easier to monitor it closely than if it were one in a group of countries. Compared to the group of Central and East European countries, or big individual countries like Poland, Croatia as a small country is not a particular asset to the common market. Finally, the attitudes, moods and even institutional circumstances in the EU regarding further enlargements are less favourable today than before the last enlargement. This means that the Croatian government and the tax administration should intensify their efforts not only to speed up but, more importantly, to deepen, the reforms necessary for the alignment.

Unfortunately, Croatia is not only slow, but only three years before its hypothetical EU accession, it is also lagging behind the achievements of other ex-candidates three years before they acceded to the EU. Moreover, the negotiations between Croatia and the EU on the taxation chapter are lagging behind those on other chapters, although the taxation chapter does not count among the most difficult negotiation chapters. As the negotiating team for the taxation chapter consists mostly of tax administration representatives, it is obvious that the tax administration suffers from a serious lack of capacities for successful negotiations. Although some external experts have been included in the preparation of the negotiations, the government and, consequently, the tax administration, have been very secretive, and both experts and the general public are poorly informed about the topics, problems, developments and stance of the negotiations.

One can probably hope that at least the EU-dictated partial reforms and initiatives regarding the consolidation and modernisation of tax administration operations in the capital city, the strengthening and consolidation of the administration and control of large taxpayers, establishment of model branch offices for small taxpayers in the counties, improvement of VAT collection, introduction of tax identification numbers for companies and citizens and modernisation of the organisational structure and management will be implemented. Some changes and amendments to the laws governing: public administration and civil servants, the depoliticisation of public administration, staff recruitment, selection, promotion and training policies, and the resolution of potential conflicts of interest, were adopted in 2007. However, substantial changes in these fields are not visible yet.

Irrespective of the demanding but rather technical requirements of the EU, more efforts should obviously be made to work out consistent and successful strategies and reforms and to implement these reforms. It will also be necessary to lessen the strong political influences (i.e. lobbyists), and to insist on expert rather than political appointments in the tax administration, the transparency of its work and better access to more reliable information and data. Only a professionally competent and dedicated tax administration can make good analyses and assessments of the current needs and insist on the implementation, enforcement and coordination of reform measures. This, of course

28 Commission of the European Communities, *Report from the Commission to the European Parliament and the Council on Progress in Romania under the Co-operation and Verification Mechanism* (2008); Commission of the European Communities, *Report from the Commission to the European Parliament and the Council on Progress in Bulgaria under the Co-operation and Verification Mechanism* (2008).

requires strong political commitment, depoliticisation, competence and will, which Croatia is, unfortunately, lacking for the time being.

Even if the EU had an equally generous approach to Croatia as it had to the 12 new member states, without the fulfillment of the above recommendations, the Croatian tax administration might end up ill-prepared for achieving the basic goals of the taxation *acquis*, like controlling enterprises' cross-border activities and combating tax evasion and fraud.

Appendix: Table A-1 – The European Commission Opinions on Developments Since 1997 in the 10 then Candidate Countries

		1997	1998	1999	2000	2001	2002
General	General	The transposition of the <i>acquis</i> should not pose significant or major difficulties	All countries were urged to strengthen their administrative structures involved in the <i>acquis</i>	Uneven developments and only gradual improvements.	Almost all countries speeded up their progress.	Progress continues in the majority of countries, particularly in indirect taxation and administrative capacity.	Progress continues in all the fields in some countries (eg, Cyprus, Lithuania, Poland, Slovakia, and Slovenia).
	Country examples				Eg, no new elements observed in Slovenia; no specific advancements in Cyprus, but positive changes in the Czech Republic and Estonia.	No progress in the majority of countries.	Some countries moving too slowly or making no progress at all.
Direct taxation	Country examples				Eg, no progress in Cyprus, Czech Republic, Estonia, Malta, Slovakia and Slovenia.	Eg, no progress in Cyprus, Czech Republic, Estonia, Malta, Slovakia and Slovenia.	Eg, Czech Republic, Estonia, Hungary, Latvia and Malta.
	General	Uneven evaluation of countries	Slow progress in all 10 countries.	Gradual improvements in the majority of countries, both in VAT and excises, but more in VAT.	Gradual improvements.	Further alignment in almost all countries, particularly regarding excise duties.	Progress in almost all countries.
Indirect taxation	Country examples	No significant difficulties, provided that the country made a considerable effort (Czech Republic); should be able to, provided that it kept up its efforts (Hungary, Slovakia); considerable efforts needed (Estonia, Latvia, Lithuania), not convinced that it could comply in the absence of a VAT or excise duty system (Slovenia).	Eg, Slovenia again post-poned the introduction of the VAT and excise duty systems. Considerable efforts needed in all other countries.	The Czech Republic adopted VAT legislation similar to that of the EU, but excise duties were still not in conformity with the <i>acquis</i> ; Estonia made progress in excises, but not in VAT; Slovakia made progress both in VAT and excises, but targeted efforts were still required.	Particular progress with VAT in Malta; some progress with excises in Slovakia; only partial alignments in Estonia; limited but genuine progress in Hungary; however, only minor adjustments still needed in Slovenia.	However, some countries (Czech Republic, Slovakia, Slovenia) made no progress regarding VAT.	Eg, Cyprus completed the reform; Estonia, Latvia and Malta made progress; however no legislative progress in the Czech Republic.
	Administrative capacities	General	Further preparations and expertise development needed in almost all the countries.	Further efforts and improvements needed.	Uneven developments in individual countries.	Improvements in almost all countries.	Continued improvements in all countries, eg, in computerisation, inspection, transparency, reporting, anti-fraud measures, penalties and collection.
	Country examples	Eg, the tax administration of Lithuania should complete its technical preparations, and those of Latvia, Slovakia and Slovenia should develop their expertise.	Arrangements for administrative cooperation and mutual assistance in Hungary need to be improved. Further efforts are necessary to strengthen administrative structures in Poland.	Poland had to improve administrative cooperation and speed up computerisation; Latvia had to continue restructuring and strengthening its administrative structures. However, Slovenia took measures to restructure its tax administration.	Eg, Slovenia — implementing new legislation, department reorganisation, data collection; Hungary — introduction of new control measures, simplification of rules, inspections, anti-fraud and training centres and divisions; Latvia — tax services reorganisation, modernisation of global fiscal administration, setting up of internal audit division and arbitration body for complaints and disputes, and computerisation.	Eg, Lithuania — improvements in the central taxpayers register, now containing a large database and a new unit responsible for the administration of excises; improvements in the fiscal control procedures, imposition of penalties, settlement of disputes and the recovery and carry-over of debt.	Progress in Lithuania, Poland, Slovakia, Slovenia, Czech Republic and Hungary; however, no progress in administrative cooperation and mutual assistance in Malta, Latvia and Estonia.

Source: Prepared by the author based on European Union, *Summaries of Legislation: Taxation* (2008)

Appendix: Table A-2: The European Commission Opinions on Developments Since 1997 in Bulgaria and Romania

Year	General	Bulgaria	Romania
1997	The transposition of the direct taxation <i>acquis</i> should not pose major difficulties. However, regarding indirect taxation, both countries need to make sustained efforts.	Particular efforts needed in the fields of VAT and excise.	Also problems with VAT and excises.
1998	Poor progress in both countries, plus the necessity to strengthen tax administration.	Continuing difficulties in indirect taxation.	Some progress made in VAT, but further efforts needed in the fields of both VAT and excises.
1999	Progress, but continuing efforts needed.	Considerable progress, but no special focus on implementation.	Country had to continue its efforts in the alignment process, tax administration restructuring, capacity improvement and IT reform.
2000	Both countries made further progress in indirect taxation but poor or no progress in direct taxation, and both made some efforts to modernise their tax administrations.	Progress only in VAT.	Progress both in VAT and excise duties.
2001	Both countries continued aligning excise duties; none made any progress regarding direct taxation; both continued strengthening their administrative capacities.	Continuing progress in VAT; setting up an internet site and an anti-fraud unit.	No improvements in VAT, establishing training programs and introducing IT systems.
2002	Further progress and substantial alignments, but not in all fields.	Further progress in harmonising legislation, but poor progress in tax administration reform.	Substantial alignment of the legislation on VAT and excise duties; continued modernisation of tax administration and improvement of revenue collection.
2003	Both countries essentially fulfilled the commitments and requirements.	Although alignment was satisfactory, further progress in direct taxation, and a significant improvement in administrative capacity were needed.	Despite some progress achieved in the alignment process and administration reform, it was required to continue with the transposition, and particularly to reform and modernise its tax administration.
2004	Both countries continued the alignment process and both needed the reinforcement of administrative capacities.	The progress in direct taxation was still inadequate.	Consolidation of tax laws, but continued alignment needed.

Source: Prepared by the author based on *European Union, Summaries of Legislation: Taxation* (2008).

Appendix: Table A-3 – The European Commission Opinion on Developments in Croatia Since 2004

Year	Progress evaluation	Requirements
2004		Considerable efforts needed in legislative alignment, particularly regarding interconnectivity of IT systems; sales taxes existing besides VAT and direct taxes, and excise discrepancies which had to be removed; serious efforts required to strengthen the tax administration (which was ineffective at tax collection and control) and to simplify legal and prosecution procedures.
2005	Very little progress seen.	Major efforts needed; priorities insisted upon were modernising tax administration and improving IT interconnectivity.
2006	Limited progress made. Despite similarities in the overall structure of tax legislation with the <i>acquis</i> , the tax legislation was at an early stage of alignment.	Intensive efforts needed to accelerate the alignment process and strengthen the tax administration; regarding IT interconnectivity, the country should be in a position to implement and enforce the <i>acquis</i> .
2007	Very limited progress. The overall structure of the tax legislation similar to the <i>acquis</i> , but the alignment far from complete.	The problem of excise duty on cigarettes needed to be resolved, substantial efforts needed to strengthen the administrative capacity and improve IT interconnectivity.

Source: Prepared by the author based on Commission of the European Communities, *Croatia 2006 Progress Report* (2006); Commission of the European Communities, *Croatia 2007 Progress Report* (2007); Commission of the European Communities, *Opinion on Croatia's Application for Membership of the European Union* (2004).

Appendix: Table A-4 – Transitional periods and derogations for new member states

Country	Transitional periods up to 31/12/07			Derogations			
	VAT (rates/procedures)	Excise duties (exemptions/rates)	Profit tax	Exemption and registration thresholds for SMEs of euro	VAT Exemption on international passenger transport	Other exemptions	Reduced rates of excise duties on some spirits in small quantities
CYPRUS	Yes	Yes	No	15 600	Yes	No	No
CZECH REPUBLIC	Yes	Yes, some up to 31/12/06	No	35 000	Yes	No	Yes
ESTONIA	Yes, some up to 30/6/07	Yes, some up to 31/12/09	Yes, up to 31/12/08	16 000	Yes	No	No
HUNGARY	Yes, some up to 31/12/04	No	No	35 000	Yes	No	Yes
LATVIA	Yes, some up to 31/12/04	No	No	17 200	Yes	Services by authors, artists, interpreters	No
LITHUANIA	No	No	No	29 000	Yes	No	No
MALTA	Yes, some up to 1/1/10	No	No	By categories 14 600, 24 300, 37 000	Yes	Inland passenger transport and domestic inter-island sea passenger transport, water supplied by public authorities and buildings and building land	No
POLAND	Yes, some up to 30/4/08	Yes, some up to 30/4/05	No	10 000	Yes	No	No
SLOVAKIA	Yes, some up to 31/12/08	No	No	35 000	Yes	No	Yes
SLOVENIA	Yes	Yes	No	25 000	Yes	No	No
BULGARIA	No	Yes, some up to 31/12/09	No	25 000	Yes	No	Yes
ROMANIA	No	Yes, some up to 31/12/09	Yes, for taxation of interest and royalty payments, up to 1/1/11	Yes, but no amount specified	Yes	No	Yes

Source: Prepared by the author based on data from the Commission of the European Communities, *Enlargement Archives: Reports 2003* (2003) and *Treaty of Accession 2003* [2003] OJ L 236/17.

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