

## PRINCIPLE OF FAIRNESS IN REGARD TO PERSONAL INCOME TAX

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### Abstract

Any tax that achieves the desired and anticipated economic impact may be considered fair. Croatian positive tax system is justified by the Constitution which states that everyone must participate in the settlement of public expenses in accordance with their capabilities. Accordingly, the tax system is based on the principles of fairness and equality, therefore taxation should be the least property limitation. Tax on personal income is the instrument of tax policy that with its inevitable fiscal objective has a much more important objective of a social nature – alleviate regressivity of VAT. Most financial scholars, lawyers or economists, agree that the principle of fairness is tried to be put into practice just by applying progressive tax rates on income. In some counties of Eastern Europe though, a flat personal income tax system has been introduced, also in order to increase the level of fairness. Thus this paper analyses personal income tax system, by focusing on the different types of income, tax base, tax rates and tax credits. The other issue of taxation that is scrutinized is the formation of an optimal tax burden, which means a continuous balance searching. This procedure and the related arguments are presented in this paper.

**JEL Classification:** D14, K10, K34

**Key words:** personal income tax, fairness, progressive tax rate, flat tax rate, tax burden

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## 1. Introduction

Croatian positive tax system is justified by Article 51 of the Constitution which states that everyone must participate in the settlement of public expenses in accordance with their capabilities and that the tax system is based on the principles of fairness and equality. The notion of fairness is difficult to define due to its abstract nature. History has shown us that the concept of fairness extremely changes with passing of time and that each historical period has its own vision of fairness. Therefore it is impossible to determine the general definition of the term that has been elusive. So to the question whether a tax is fair or unfair we have no correct answer that would be based on some generally accepted principles. Tax practitioners, however, whether they are lawyers or economists, do not attach any special meaning to the concept of fairness.

In fact, any tax that achieves the desired and anticipated economic impact they consider fair. (Lončarić-Horvat, 2010, 182) However, most financial scholars, whether they are lawyers or economists, agree that the principle of fairness is tried to be put into practise just by applying progressive tax rates on income.

One of the most important and most present division of taxes is the one that separates direct and indirect taxes. When it comes to direct taxes redistribution role is possible because the concept of progressivity is not applicable when it comes to indirect taxes. One of the most important direct taxes is personal income tax which is in most developed countries one of the most fiscally abundant tax and the tax by which progressive taxation is introduced in tax systems. Tax on personal income is the instrument of tax policy that with its inevitable fiscal objective has a much more important objective of a social nature-alleviate regressivity of VAT.

## 2. Concept of fairness

Whether a tax regime of a country is fair or effective, depends on the applicability of the principles, proportionality, progressivity, and the exemptions provided. (Deak, 1997, 317) The analysis of the rule of fairness in tax law should begin with the definition of fairness itself. The concept of fairness alludes to the social, legal, political order, which we collate with extant relations, often with a critical aim. That contains such ethical principles and rules, which could accede to form the correct order of human coexistence. In relation to tax law this means that we should locate the tax burdens to the members of society, fairly and in consideration of their tax ability. (Perić, Szilovicz, 2011, 307) Financial theory has concept of fairness in-

terpreted in accordance with two principles: principle of usefulness and principle of tax power. These principles are used by economists in their attempt of justification and realisation of rational tax system. Proportional lay out of tax burden (in accordance with individual tax power) derives from complete tax system. Certainly, the most important role goes to taxation of employment income, which also encloses other types of income, as well as an answer which part of income is to be spent and which part is to be spared.

Contemporary thesis on tax fairness show that the public interest for these type of questions is declining. The classical term of tax fairness is shifted from the sphere of allocation of tax burden to the care of how will tax revenue be spend. The decrease of interest for the principle of fairness is understandable, because citizens perceive tax system as unclear, tax payments are abstract, and awareness of public consumption (how the revenue will be spend) becomes more important area of public interest.

Question of fairness is not related to any specific structural principle that would apply only to taxes. First and primary goal of taxation, that is achieved by actually paying taxes, is to secure the state financial means for coverage of public expenditure. However, it has often been accentuated, that this fiscal goal should cede its place to another, equally important goal- just allocation of tax burden. (Lončarić-Horvat, 2010:187)

Fairness does not mean that income is taken away from the rich and given to the poor; it rather means that it should not create inequalities and additional problems in society. Accordingly, justice and fairness mean at least that the government determines the tax levels with self-restraint and limiting itself to the necessary minimum and distributes them equally to the sections of society, while putting them into an ethical, transparent, and efficient use with the help of the principles public finance. (Wagner, 2007, 200) This would be the full-value definition of fairness-accuracy.

Most financial scholars, lawyers or economists, agree that the principle of fairness is tried to be put into practice just by applying progressive tax rates on income. Recently, however there have been rapid swerve when it comes to progressive taxation of personal income. A great number of countries, primarily countries of Eastern Europe and Central Asia, have implemented flat rate income tax into their tax systems.

Within the flat tax system, all the groups and taxpayers of the society take part the same rate in contributing to public funds irrespectively of their amount of income. Obviously their nominal contribution differs, and the rich pay more, but the same proportion, which might sound fairer than taking more proportion of their income. This could lead to a more balanced and proportionate tax payment system: the taxpayers of higher amount of income pay more anyway, taking part in contributing to public funds according to their ability to pay.

The flat tax provides a stronger motive for the taxpayers to realize higher amount of income, since they can achieve a higher amount after tax in case they work more and make higher revenue. Thus despite their tax due is higher, still a higher amount can be used as per their sole decision.

In the progressive structure it is not worth for the taxpayer to invest more energy in obtaining a higher amount of income, since the amount taken as tax is proportionally higher as well. In other words, it establishes a psychological limit to the activities out of which income is derived. For instance, the taxpayers do not take an additional job, or apply for other grants or subsidies if they get to a higher tax bracket accordingly, and by paying higher amount of tax due to the applicable higher tax rate, and therefore they take less money home. The higher tax rate increases the level of redistribution, but decreases the employment rate. As JOHN STUART MILL stated in 1848: the progressive tax levies a higher rate of tax on the higher income, therefore it definitely punishes the hard working taxpayers.

In modern state every tax and its elements are brought into the system by means of law. Accordingly, fairness of any tax system is determined by legislator.

The most important headquarters of taxation according to economic strenght is income, which taxpayer actualizes on market for certain work or provided services. (Lončarić-Horvat, 2010:188)

Income tax is the type of tax by which we want to achieve fiscal, political, social and economic goals.

Most developed countries consider income tax as most significant and most prominent source of public revenue which implies at its role in realization of fiscal policy.

### 3. Types of personal income in the Republic of Croatia<sup>1</sup>

In the Republic of Croatia there are 6 types of income:

- a) Employment income
- b) Independent personal services income
- c) Income from property and property rights
- d) Investment income,
- e) Income from insurance
- f) Category of other income.

In this paper we are going to elaborate two most important types: employment income and independent personal services income.

Progressive taxation rests on fact, that person who has bigger income should pay bigger tax. On the other hand, person who earns smaller income should pay smaller tax. That means that persons with different economic strenght should pay different amounts of tax,- vertical tax fairnes. (Lončarić-Horvat, 2010:192)

The tax base on income for the taxation of income tax from employment and income from self-employment is divided into three tax brackets.

Income tax is paid at a rate of 12% on taxable income over single of the basic personal deduction.

Income tax is paid at a rate of 25% of the difference between the tax basis of single and quadruple of the basic personal deduction.

Income tax is paid at a rate of 40% on taxable income over four times the amount of the basic personal deduction.

This essentially means that after the decline of the gross salary required to contribute to the basic personal allowance taxable income on a monthly basis is taxed as follows:

- Up to 2.200,00 HRK pay tax at a rate of 12%
- above 2.200,00 HRK to 8.800,00 HRK (ie further 6.600,00 HRK) pay tax at a rate of 25%
- above the total amount of 8.800,00 HRK pay tax at the rate of 40%.

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<sup>1</sup> Personal Income Tax Law, Official Gazette, 177/04, 73/08, 80/10, 114/11, 22/12, 144/12, 43/2013, 120/2013, 125/2013, 148/2013

**Table 1.** Tax rates

<b>Tax rate</b>	<b>Monthly basis (HRK)</b>	<b>Yearly basis (HRK)</b>
12%	- 2.200,00	- 26.400,00
25%	2.200,01-10.800,00	26.400,01-105.600,00
40%	8.800,01 -	105.600,01 -

The essential issue is how business players react on taxes. High and progressive taxes cut back performance and will not stimulate production. (Streissler, 90, 79) Beyond not making the pursuing of activities appealing, high tax rates encourage taxpayers to search for legal and illegal ways of tax evasion (the back door methods, such as the permanent investment account, the calculation of cost invoices for individual entrepreneurs, or when real estate or other property is sold<sup>2</sup>). I believe that tax planning performed by the taxpayer in such ways is by no means harmful, but its wide option much rather promotes that taxpayers accept tax law, because the taxpayer is happy to pay less tax feeling that implicitly he/she received more money or actually more stayed in his/her pocket. This will mean more revenue for the state or eventually in terms of the personal income tax for the budget of local municipalities than as if with regard to the high tax payment obligation or by some tax fraud techniques, no revenue would flow in or the tax base would be significantly lower due to hidden incomes.

When it comes to defining economic strenght, both jurists and economists, although by different means, come to same conclusions. In fact, they both accent that tax basis of income tax must be decreased for expenditure necessary for assurance of minimal existential costs. (Lončarić-Horvat, 2010:189)

Excluded from taxation is part of income that is necessary for taxpayer to fulfill his existential needs. This part of income is usually called existential minimum. Term non-taxable part of income is used in tax terminology, and in Croatia Income Tax Law term personal allowance is used. Article 36. of Income Tax Law says that the full amount of realised income should be reduced for pesonal allowance in the amount of 2.200,00 HRK for each month of taxable period. This amount of personal allowance is enlarged for dependent mamebers of family and children. Income Tax Law presumes that the amount of 2.200,00 HRK is enough for taxpayer to cover his basic extistential needs. (Sindičić, 2010)

<sup>2</sup> The effective regulation has retained taxpayers' opportunity to deduct three types of cost: the amount of income shall be established by deducting the expenditure related to the acquisition, the costs of value-added investments, and the costs in connection with the transfer can be deducted from the revenue.

It should be noted that personal income tax is most fiscally abundant tax form especially when it comes to municipalities and towns. Revenue from income tax is divided between:

- a) municipality/town – 56,5%
- b) county - 16%
- c) part for decentralized functions - 12%
- d) part for position for aid of accommodation for decentralized functions - 15,5%.<sup>3</sup>

Decentralized functions are social care, education, health care and fire department. But it is very important to emphasize that the operational side of these functions is financed through Personal income tax. When it comes to personal income of people employed or taking care of these functions, their income derives from state budget. Operational side includes mostly material costs (buildings, equipment, furniture etc.) in connection to performing these functions.

#### 4. Conclusion

The notion of fairness is difficult to define due to its abstract nature. Therefore it is impossible to determine the general definition of the term that has been elusive. Legal norms can represent some kind of justice, which is a talent, a social and cultural product. History has shown us that the concept of fairness extremely changes with passing of time and that each historical period has its own vision of fairness. However, regarding tax law, fairness is that the tax burdens are located fairly with regard to tax capacity. The most important problem of the perception of fairness is that individuals, in most cases, do not get any direct countervalue in return to their tax payments.

According to P. Bejaković, tax system should be simple, foreseeable and with less changes. In the Republic of Croatia, politicians like to explain these income tax changes as means to introduce elements of fairness into the tax system.

Income tax is one of the basic tax forms which is relatively easy to adjust to economic strength of citizens so that the wealthier ones pay relatively more tax, and poorer ones pay less, and by which it can be influenced on just and fair splitting of

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<sup>3</sup> Law on Financing of Local and Regional Self-Government Units, Official Gazette 117/1993, 92/1994, 69/1997, 33/2000, 73/2000, 127/2000, 59/2001, 107/2001, 117/2001, 150/2002, 147/2003, 132/2006, 26/2007, 73/2008, 25/2012



income so it can be said that income tax has attributes of progression. With income tax we try to fix «injustice» that is brought by consumption tax (VAT and excise duties) that relatively more burden poorer citizens. Also, income tax has distinct and automated ability of adjusting to current economic state of any country (built-in flexibility).

It should be emphasized that there is no optional fairness, and not all of societies have the same concept of fairness. However, moral aspect of taxation should equally apply both to state and taxpayer. That means that duty of every state is to develop fair splitting of tax burden, i.e. taxpayers should pay taxes in accordance to their economic strength and the state should rationally spend collected means. On the other hand, duty of every taxpayer is to bare fair amount of public expenditure in accordance to his or her economic abilities.

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