

## JUSTIFICATION OF TAXATION WITH FLAT-RATE INCOME TAX ON REAL ESTATE RENTING FOR TOURIST PURPOSES IN THE REPUBLIC OF CROATIA

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**Abstract** Income from renting apartments, rooms, and beds to travelers and tourists and organizing camps in the Republic of Croatia is taxed at a flat rate. The question is whether the taxation of this type of activity is justified if it generates more income than from renting/leasing real estate under a lease or rental agreement when these activities are taxed with a higher amount of tax from renting real estate for tourism purposes. Therefore, it is necessary to analyze why the flat-rate taxation regime for the activity of renting apartments, rooms, and beds to travelers and tourists and the organization of camps is prescribed in the Republic of Croatia and whether it is justified.

**Keywords**

taxation,  
income tax,  
flat-rate income tax,  
tourism,  
Republic of Croatia

## 1 Introduction

In modern states, the tax system is typically a complex system consisting of different taxes. As a rule, the design of the tax system seeks to achieve a larger number of goals that can be classified into different groups. The three most general groups that are characteristic of all relevant modern countries are fiscal-political, economic-political, and socio-political. Consequently, the different taxes that are part of a tax system are to varying degrees appropriate to achieve these objectives. Thus, the general sales tax seeks to effectively collect public revenues, although this tax is inappropriate as an instrument of social action in society. By applying some other taxes, all groups of the stated goals are sought to be achieved. The most prominent is the income tax (Jelčić *et al.*, 2008: 298-299).

In most developed industrialized countries, members of the Organization for Economic Co-operation and Development (OECD), income tax is the most important source of public revenue, whereas, in other countries that have introduced it, it is not in the first place. Nevertheless, it is certainly not insignificant, which points to its essential role in the implementation of fiscal policy. With regard to income tax as an instrument of economic policy, prescribing tax exemptions and expenditures, it is possible to direct investments in certain areas and activities. In the field of social policy, income tax appears as one of the means of implementing social policy due to its particular characteristics, the most important of which is the taxation of income at progressive rates and due to the tax exemptions and expenditures associated with the taxpayer (Jelčić *et al.*, 2008: 299).

In the Republic of Croatia, the income tax is an important tax form because the tax revenue from the income tax is used to finance municipalities, cities, and counties. Considering the characteristics of income tax as a tax form and taking into account the fact that this tax finances local levels of government in the Republic of Croatia, this paper will outline the basis of income tax as a tax form and the basis of unavoidable tax expenditures, as a part of income taxation (and flat-rate taxation can be classified in the category of tax benefits in income taxation), and financing of local and regional self-government units with income tax and flat-rate income taxation of real estate renting for tourist purposes in the Republic of Croatia. Finally, due to the above characteristics of income tax, an attempt will be made to conclude whether the income of a natural person from renting apartments, rooms, and beds

to travelers and tourists and organizing camps in the Republic of Croatia should be taxed as a lump sum with respect to income from these activities to be taxed in the same way as other rental or leasing activities are generally taxed.

## **2 Income tax and tax expenditures**

The first income tax was introduced in 1798 in Great Britain and has been applied since 1799. It was introduced by Minister of Finance (*Chancellor of Exchequer*) William Pitt to raise additional revenue to fund the war against Napoleon. The income tax introduced at that time contained a tax liability for certain types of income (cedular income tax), regulations on the calculation of income, as well as provisions that take into account the subjective economic power of taxpayers (deduction of living expenses by a non-taxable amount). It was levied on the global income of British taxpayers, as well as the income earned by foreign taxpayers in Great Britain. Since there were some technical problems during its implementation, it was abolished two years later (the reason for this was the cessation of the war with Napoleon), and in 1803 it was reintroduced for the second time, this time successfully. It was introduced by Henry Addington, Pitt's successor as Minister of Finance, this time as an amended law based on different sources of revenue. The 1803 Act still forms the basic structure of British income tax law (Birk *et al.*, 2015: 7). In Germany, it took longer to introduce an appropriate income tax. Although, as early as 1812 in Prussia, following the example of the English model, an appropriate income tax was introduced, and the same tax form was abolished two years later. Shortly afterwards, in 1820, in addition to the then existing direct taxes (taxes on real estate and crafts), a special tax with tax classes (*ger. Klassensteuer*) was introduced. It divided the population into tax brackets to avoid encroachment on income and property relations. The idea of creating an income tax that would exist independently of social classes had not been sustained. Namely, in 1851 a law came into force in Prussia which concerned the introduction of a classified income tax divided by tax brackets as a precursor to the current system of income taxation in Germany. The impression that the income tax caused at the time of its introduction is sufficiently illustrated by the fact that in the financial science of the time, it was discussed as a suitable form of taxation following economic power and a suitable redistribution instrument (Birk *et al.*, 2015: 7-8).

The basic characteristics of income tax are: a) Income tax is a tax form whose source, subject of taxation and tax base (total) is the income of a natural person. b) Income tax is linked to the income and taxes the income earned by a natural person, regardless of the type of use of income - the principle of tax irrelevance of the use of income and the inability to deduct the cost of living; income tax refers in principle to the total income of the taxpayer and not to individual parts of the income. In other words, income tax in most countries is determined by the total income of the so-called synthetic income tax (ger. *Synthetische Steuer*), to which a single tax rate applies, and there is no differentiation of the tax burden according to the type of income. The opposite of the synthetic tax that taxes the taxpayer's total income (the individual amounts of income are added up) is the analytical income tax (the so-called cedular or individual tax; ger. *Schedulen-System*). Within the analytical tax, different and special tax rates are paid on certain types of income (e.g. on income from agriculture and forestry or income from work). c) Income tax for the base is realized income (ger. *Ist-Einkommen*) and not potential income, i.e. income that could be realized in optimal conditions (ger: *Soll-Einkommen*). Taxation of potential income as required by the theory of optimal taxation would lead to unsolvable problems, especially when distinguishing between earned and potentially earned income and the evaluation of free time. Nevertheless, a partial violation of the principle of taxation of actually earned income is allowed in practice. It is a matter of determining income and taxing it by applying average rates (especially for agriculture), i.e. trying to determine the lump sum of income and consequently determining the flat tax. d) Income tax shall be levied on the total net income obtained after deducting the costs of earning that same income. In other words, the tax base is the net size. It is obtained by reducing the realized income by expenses, i.e. expenses on behalf of the realization of income (objective net principle). In doing so, the personal circumstances of the taxpayer are taken into account, indicating their reduced individual economic strength in relation to other persons earning an income of the same size (subjective net principle) (Mijatović, 2007: 292-294).

The principles of income taxation will also be briefly presented and explained additionally to the characteristics of income tax, as these principles are also important for the topic of this paper. The principles of income taxation are as follows: a) The most important principle and essence of the income tax system is the principle of taking into account personal economic strength (ger. *Prinzip der Berücksichtigung der persönlichen Leistungsfähigkeit*). Income, financially and legally, is

considered to be a particularly appropriate indicator of personal economic strength. Taking into account the personal economic strength belongs to the essential features of income tax. The very principle of economic power is not the invention of lawyers but economic or financial scientists who have elaborated this principle more concretely. The main attempts of economists consist in trying to create a rational tax system. For this purpose, traditional financial science has been formulated, in addition to the principle of equivalence, another normative principle of taxation, the application of which should lead to a time-adequate and factually justly regulated unit of taxation, and the principle of ability-to-pay approach. The ability-to-pay approach as a maxim of fair distribution of the tax burden between natural persons in developed countries requires that individuals with the same economic power be treated equally in tax, and individuals with unequal economic power should be treated unequally for tax purposes. Following this principle, in the collection of tax revenues, everyone should contribute following their economic strength. Individuals in the same position should be taxed equally, and individuals in a better economic starting position should be taxed more (Mijatović, 2007: 294). Here we can talk about the vertical fairness of the tax system, which states that the tax burden should be distributed fairly among people who have different payment options (Rosen, Gayer, 2010: 401). American humorist Will Rogers once said that "people want fair rather than low taxes and that they would like each individual to pay a portion commensurate with their wealth." This criterion for assessing the tax system is contained in the economic view of horizontal fairness. According to the criterion of horizontal fairness, persons in equal positions should be treated in the same way. For horizontal justice to become a feasible idea, the term "equal position" needs to be defined. Rogers recommends wealth as the measure of paying ability, whereas the income or expenditure for consumption can be used for this. However, all these measures are the result of people's decisions and are not entirely suitable for measuring equality of position. Feldstein proposes defining horizontal justice with the help of utility. Thus, the definition of horizontal equity with the help of utility would read: 1. if two individuals are equally well off (if they have the same level of utility) when there are no taxes, they should be in the same position with taxation, and 2. taxes should not change the utility if before taxing person A was better off than person B, it should remain the same after taxation (Rosen, Gayer, 2010: 411). Article 51 of the Constitution of the Republic of Croatia, as the only provision that states the principles of tax system regulation, requires the universality of tax liability (according to which everyone is obliged to participate in covering public costs) and

the respect for the principle of economic power, equality and fairness in taxation. The principle of tax fairness (Article 51, paragraph 2 of the Constitution of the Republic of Croatia) results in the declaratory commitment of the constitution-maker to social goals, while its content is determined by other provisions of the same article as a requirement for achieving vertical and horizontal fairness in taxation. The above provisions on the design of the tax system should be interpreted in the context of the entire constitutional text, taking into account the fundamental commitment of the Republic of Croatia to the concept of the welfare state and the principle of social justice. In the context of the modern Republic of Croatia, it is only possible to accept the concept of the so-called social equality as a principle derived from the constitutional vision of a society striving for equality through a fair redistribution of resources. This principle is strengthened by enabling (constitutional) judicial intervention in tax legislation with the aim of monitoring state activity in the direction of achieving a more socially just order (Miloš, Kuzelj, 2021: 1110-1111).

Furthermore, the principle of economic power requires that only disposable income is subject to tax. Therefore, the appropriate tax base for the purposes of paying taxes is not the income earned but disposable income. This means that the income incurred on the market should be deducted from the expenses that were incurred to generate income. This is a matter of taxation according to the objective net principle. Also, on the other hand, expenses incurred to ensure one's existence and the existence of the taxpayer's family, *i.e.* taxation according to the subjective net principle, should be deducted. It is also important to emphasize the principle of income tax progression. To generate higher incomes, economic capacity expressed through growing income must not be taxed proportionally but above-proportionally. To achieve a proportional tax burden in terms of generating higher tax revenues, the income tax rate must be progressively regulated. Also, achieving income distribution requires a progressive tax burden. However, newer aspirations in science and pragmatic thinking speak against the excessive progression of the income tax rate. In addition to these principles, there is also the principle of personal universality, the principle of actual universality, and the principle of periodic taxation (Mijatović, 2007: 294-299). After a brief overview of income tax as a tax form, this chapter will briefly explain tax expenditures.

The notion of tax expenditures can be related to the notion of fiscal interventionism or fiscal incentives as one of the fiscal policies aimed at regulating the economy. The very notion of tax expenditures originated in the United States in the late 1960s. More precisely, the term was first used by Stanley Surrey in 1967 (Rogić Lugarić, Bogovac, 2012: 175). A part of a country's overall fiscal activity may go unreported because it is hidden in the form of revenue that is not intentionally or unintentionally collected and is not shown as public spending. In the broadest sense of the word, such activities are tax expenditures or tax allowances. These activities can take many forms, from tax exemptions, allowances, exemptions, or reductions to the tax base or tax due (Bratić, 2006: 113). One of the controversial points for tax expenditures is the definition of the term tax expenditures, which may lead to problems in the comparative analysis of tax expenditures, but also the data on the number of tax expenditures in individual countries (Rogić Lugarić, Bogovac, 2012: 176). The tax regulations of different countries, especially in the systems of personal and corporate income taxation, contain several tax reliefs, sometimes called tax aid, incentives, or subsidies, which deviate from the usual tax structure (Bratić, 2006: 115). The term tax expenditure refers to the provisions of tax laws that provide favorable tax treatment for a particular business, industry, or group of taxpayers.<sup>1</sup>

From the above, it can be concluded that the flat-rate taxation of renting apartments, rooms, and beds to travelers and tourists in the Republic of Croatia should be considered as one type of tax expenditure prescribed for these activities. In the continuation of this paper, an attempt will be made to answer the question of whether this tax expenditure was prescribed by the Republic of Croatia due to an economic, social, or some third goal.

### **3 Financing local units with income tax revenues**

Modern states are characterized by the existence of at least two, and often more, usually three, levels of territorial organization. Such a structure is conditioned by the need to solve various tasks that life in human societies has long posed to the state. Today, we have adopted the view that the existence of multiple levels of the territorial organization is imperative for state organization because such an organization is necessary for the state to satisfactorily respond to the demand of

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<sup>1</sup> Tax Expenditures in the Nordic Countries 2009, str. 6.

meeting the various needs that arise in modern societies. For this way of functioning to work successfully, certain problems need to be solved. One of the most important problems is the issue of the individual level scope, *i.e.* individual territorial units, and the issue of regulating their mutual financial relations. The level of competence of local or regional self-government units depends on the actual degree of decentralization of a particular state in the political and administrative sense (Jelčić *et al.*, 2008: 639). How much power local levels of government have solely depends on the range of public services financed by the lower levels of government, adequacy of revenues to finance public services, the extent of the powers that local authorities have in allocating budgetary resources, and the extent of authority in determining local tax rates and user fees (Kesner-Škreb, 2009: 237).

Therefore, the need for lower levels of government is indisputable, and supporters and opponents of decentralization will agree on this. The least they have in common, in the many ways opposing views, is the administrative usefulness of such levels. After this, their harmonization ceases, and the conflict between the supporters of deconcentration and the supporters of decentralization begins. Deconcentration is, therefore, a relationship between the central and local levels of government in which a certain set of powers under the control of the central government is transferred to the lower levels of government. Lower levels of government only execute decisions, while decision-making in general, and thus the financing of lower levels of government, is normatively regulated at the level of the central government (Jelčić *et al.*, 2008: 640). On the other hand, in the case of deconcentration, the lower levels of government are only the executors of decisions and instructions that come from the central level of government. Systems characterized by deconcentration stop at interpreting only the administrative necessity of the lower levels of government. In the case of decentralization, the opposite is true because "regional and local authorities are perceived as independent bodies elected by the inhabitants of their areas to perform certain services following the wishes of that population". The application of these opposing approaches is different in different countries and at different times. However, the standard economic division of the public sector functions into stabilization, redistribution, and allocation functions, applied to the decentralization model, provides an orientation overview of the division of individual functions at different levels of government (Jelčić *et al.*, 2008: 640-641). Therefore, a decentralized state would be the one in which most local authorities have a greater, sometimes even greater, degree of autonomy. This means that in



matters within their scope, they are free to decide as they see fit (purposefully) for the service they perform, but within the framework of constitutional, legal, and other general norms that bind them. Local authorities must comply with the general norms of higher authorities but do not receive orders from them on how to apply those norms to each case (Visković, 2006: 77). According to the usual approach, the stabilization function should be performed by the central government because it is in charge of macroeconomic stability; which is reflected, for example, in the formulation and conduct of monetary policy; the redistribution function should also be performed by the central government, while the decentralized level, and primarily the local level, is the most suitable for performing the allocation function (Jelčić *et al.*, 2008: 641).

The fundamental feature of financing the public needs of local units certainly stems from the realization that the expansion of public functions of modern states was not limited to its central levels but was also reflected at the local level (Jelčić *et al.*, 2004: 308). Accordingly, one of the most significant trends in today's local finance is marked by fiscal decentralization; the process of redistribution of financial powers, expenditure, and revenue, in favor of the lower levels of government. Thus, local units become holders of many public functions and include several public services, most often transport, utilities, housing, primary health care, recreation, culture, education, social protection, *etc.* In any case, it is a process that has had an impact on increasing the share of local and regional government expenditures in total public expenditures. However, giving responsibility for public expenditures without simultaneously providing sufficient sources of public revenues greatly limits the ability and autonomy of local and regional units in providing public services. This, in turn, requires special attention to the choice and source of funding for local public services and especially infrastructure, which in modern conditions at the same time implies new budget functions for local and regional units (Šimović *et al.*, 2010: 404).

Public expenditures of local and regional levels of government are financed by local taxes, non-tax revenues, and financial transfers between different levels of government. Also, local and regional authorities can borrow from the financial market (Kesner-Škreb, 2009: 237-238). Tax revenues are one of the most important sources of financing at all levels of government, including the decentralized, *i.e.* local levels. As decentralization is largely a consequence of the political balance of power in this context, there is often a demand for as much fiscal autonomy as possible from

the lower levels of government, especially the lowest ones. One of the factors in achieving this autonomy is autonomy in the field of taxation because taxes are an important source of funding, and these tasks are the responsibility of the lower levels of government. Thus, an indicator of the general autonomy of the lower levels of government is, to a significant extent, though not entirely, their tax autonomy (Jelčić *et al.*, 2008: 649). The criteria for determining or assessing the degree of tax autonomy are formal and material. The formal criterion is the degree of independence in regulating the powers related to taxation, *i.e.* the introduction of taxes and the standardization of their elements. At the same time, the material criteria are the generosity of taxes placed under the jurisdiction of the lower levels of government and the distribution of tax revenues between the central government and decentralized levels (Jelčić *et al.*, 2008: 649-653). Taking into account the degree of autonomy of regional and local levels of government in regulating the elements of individual taxes, taxes can be classified into two categories, namely: exclusive taxes where all tax elements, such as taxpayer, tax base, *etc.*, are prescribed exclusively by central or local authorities, and mixed taxes where the taxpayer, tax base and tax benefits are defined at the central government level but the rates are controlled by local governments (Jelčić *et al.*, 2008: 653).

The most important for the mean of this paper is the way how local and regional authorities finance their needs with local taxes. Local tax revenues can be collected from two sources. The first source is from the distribution of tax revenues among different levels of government (joint taxes), while the second source is autonomous, which means that each local or regional government decides on the amount of local taxes in a way that can determine the tax base, tax rate or tax exemptions. Local taxes are divided into three categories, namely: property tax, income and corporate income tax, and sales tax (Kesner-Škreb, 2009: 238).

Of these taxes, the most important one for this paper is the income tax which is the most generous local tax. Local income tax rates are usually determined as surtax rates on state income tax. In some countries, local governments also participate in corporate tax funds. However, the importance of income taxes in the local budgets of European countries has recently begun to decline. Namely, the corporate tax base is very mobile, so it is difficult to determine which part of that tax belongs to the local government (Kesner-Škreb, 2009: 238).

### **3.1 Financing of local and regional self-government units with income tax revenues in the Republic of Croatia**

In the period from 1990 to 1995, Croatia proclaimed the Constitution, gained independence and was affected by the war in which a third of its territory was occupied. Despite the devastation of the war, the Republic of Croatia in that period established the constitutional and legislative framework for the development of local self-government. Counties were established, which perform administrative and self-governing functions, municipalities and cities with self-governing functions, and a new model of local unit financing was introduced. After the war, areas of special state concern were identified, for which the state aimed to help in the development and reconstruction and return of reallocated people. The period was marked by the establishment of the basic legislative framework, the new territorial structure, and the adjustments of the newly elected authorities assigned to administrative and self-governing functions. From 1995 to 2001, Croatia was a largely centralized state in which, despite local self-government, central government bodies played a leading role. In parallel with the establishment of local units, the process of determining their ownership and property value took place. However, law enforcement practice has highlighted several problems in the organization and distribution of powers, as well as in the financing of local units. Also, the system of financing local units was not based on transparent procedures for calculating fiscal capacities that would take into account the differences in the economic development of local units when allocating grants and tax revenues. Since 2001, the state has been transferring part of the authority to finance education, health, and social care to local units. In parallel with the transfer of powers, the state provides local units with a larger share in the distribution of taxes and increases grants from the state budget. Thanks to this process, questions about the efficiency of local unit services and the organization of the financing system began to arise. The enactment of the Constitution in 1990 and the declaration of independence in 1991 defined local self-government units. In addition to the Law on the Financing of Local Units, one of the key laws affecting the financing of local units is the Law on the Budget and the annual laws on the execution of the state budget (Bajo, 2007: 53-54).<sup>2</sup>

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<sup>2</sup> Available at: <http://www.ijf.hr/rosen/rosenic/decentralizacija.pdf>. accessed 15.11.2021.

Fiscal autonomy means the ability of local units to independently determine the bases and rates of tax and non-tax revenues. Local units in the Republic of Croatia are not completely autonomous in determining the base and rate of tax revenues. Local units determine local tax rates to a relatively small extent. Municipal and city tax rates are mostly set by the local government but with restrictions set by the central government (Bajo, 2007: 57-58). According to the Law on Local Taxes, local self-government units independently determine only the amount of tax on the use of public areas.<sup>3</sup> Since 2001, the central government has also provided a higher share of income tax for local units that take over the financing of decentralized functions (Bajo, 2007: 58).

The Law on Financing of Local and Regional Self-Government Units in the Republic of Croatia (hereinafter: ZFJLPS)<sup>4</sup> regulates the sources of funds and financing of activities from the self-governing scope of local and regional self-government units, distribution of income tax revenues, fiscal equalization of units local and regional self-government and financing of decentralized functions.

According to Article 3, paragraph 1 of the ZFJLPS, local and regional self-government units are financed by revenues from taxes, assistance, and from own and earmarked revenues following special regulations. Taxes that finance local and regional self-government units are common tax and local taxes.<sup>5</sup> Income tax is a common tax whose revenue is shared between municipalities, cities, and counties. Income tax revenue is distributed to the share of the municipality or city in the amount of 74%, the share of the county in the amount of 20%, while the amount of the share for decentralized functions is 6%. The municipality, city, county, and the City of Zagreb, which according to special regulations, finance decentralized functions, distribute the share for decentralized functions in such a way that 1.9% is allocated for primary education, 1.3% for secondary education, 0.8% for social welfare (0.2% for social care centers and 0.6% for homes for the elderly and infirm), 1.0% for health care and 1.0% for fire brigades - public fire brigades. The Ministry of Finance is entitled to a fee of 1% of the total collected revenues for the costs of

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<sup>3</sup> Article 29, paragraph 2 of the Local Taxes Act, Narodne novine br. 115/16, 101/17.

<sup>4</sup> Narodne novine br. 127/17, 138/20.

<sup>5</sup> Article 3, paragraph 3 of the ZFJLPS.

performing the tasks of determining, recording, collecting, supervising and enforcing income tax.<sup>6</sup>

#### **4 Flat-rate taxation of renting apartments, rooms, and beds for travelers and tourists and organizing camps in the Republic of Croatia**

According to Article 56 of the Croatian Income Tax Act (hereinafter: ZPDoh),<sup>7</sup> income from property and property rights is considered to be the difference between receipts based on rent, lease, renting apartments, rooms, and beds to travelers and tourists and organizing camps, receipts from the time-limited assignment of copyright, industrial property rights, and other property rights following special regulations, receipts from the alienation of real estate and property rights and expenses incurred by the taxpayer in connection with these receipts. In the case of income from property based on the lease and rental of movable and immovable property, expenditures in the amount of 30% of the realized rent or lease are recognized. However, a taxpayer who earns income from renting apartments, rooms, and beds to travelers and tourists and organizing camps pays a flat-rate income tax for performing these activities.<sup>8</sup> The amount of the flat tax per bed or per accommodation unit in the camp must be determined by the body of the local self-government unit, and the amount of tax cannot be lower than 150.00 HRK or higher than 1,500.00 HRK (Vranar, 2021: 167). Thus, it can be said that it is a mixed tax because the taxpayer, tax base, and tax benefits are defined at the central government level, but the rates, *i.e.* the amount of the annual flat tax, are under the control of local authorities, although the central government prescribes the lowest and highest amount.

Until the end of 2004, in the Republic of Croatia, income from the property from renting apartments, rooms, and beds to travelers and tourists was determined as the difference between business revenues and business expenses that were realized by performing this activity in the tax period, which, as a rule, was a calendar year. Expenditures necessary for the realization of income from renting apartments, rooms, and beds to passengers and tourists for which the sojourn tax was paid were determined in the amount of 50% of the realized rent. Thus, the tax base was the

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<sup>6</sup> Article 5 of the ZFJLSP.

<sup>7</sup> Narodne novine br. 115/16, 106/18, 121/19, 32/20 i 138/20.

<sup>8</sup> see Article 57, paragraphs 1 and 2 of the ZPDoh.

difference between the realized receipts and 50% of the expenditures. Income tax was calculated on the tax base, which was increased by a surtax on income tax if the surtax was prescribed by a decision of the municipality or city in which the lessor had a permanent or usual residence (Vuraić, Lelas, 2005: 114). According to the data of the then Ministry of the Sea, Tourism, Transport and Development of the Republic of Croatia, in 2004, there were almost 50,000 registered private renters who had a total accommodation capacity of 340,000 beds, which was approximately 40% of the accommodation capacity, while according to tourist boards 10-30% of renters did not register their guests but rented out rooms and apartments "under the counter". For this reason, the Income Tax Act of 2004, which entered into force on January 1st 2005, stipulates that a person who earns income from renting apartments, rooms, and beds to travellers and tourists and organizing camps and is not a taxpayer of value-added tax according to the Value Added Tax Act and if it does not determine the income in the manner prescribed for self-employment, *i.e.* based on business books, the tax is paid in a lump sum. Furthermore, they could rent out rooms, apartments, and holiday homes, owning up to a maximum of 10 rooms or 20 beds, or if they established a camp on their land, a maximum of 10 accommodation units or 30 guests at a time. To implement the legal provisions, the Ordinance on the activities of renting apartments, rooms, and beds to passengers and tourists and organizing camps to be taxed at a flat rate, on the amount of the flat tax and the method of paying flat tax (Narodne novine br. 48/05) was adopted and entered into force on April 13th 2005 (Vuraić, Lelas, 2005: 114-115).

The annual flat income tax and surtax on income tax were determined by a decision issued by the competent tax administration according to the residence or usual residence of the landlord. The annual flat income tax was determined as the product of the number of beds or the number of accommodation units in the camp, the amount of the flat tax per bed or accommodation unit in the camp, and the corresponding coefficient of the area where the service is performed. The number of beds, *i.e.* the number of accommodation units in the camp, was determined based on the approval of the competent tourism office, which authorized the person to perform household services. Only the number of permanent beds was taken into account in the number of beds, and not the number of additional beds. The amount of the flat tax per bed was 300.00 HRK, and per accommodation unit in the camp 350.00 HRK. The coefficient of the area in which the service is performed was taken as the corresponding coefficient of the settlement in which the service is performed.

Therefore, the settlements classified in class A have a coefficient of 1.00, the settlements classified in class B have a coefficient of 0.85, settlements classified in class C have a coefficient of 0.70, settlements classified in class D have a coefficient of 0.50, and settlements that have not been declared a tourist place or have not been classified in a class have the coefficient of the area where the service is performed of 0.50 or the coefficient of class D. The annual flat income tax and surtax on income tax are paid quarterly (until the end of each quarter), for each quarter in the amount of  $\frac{1}{4}$  of the annual flat income tax, in proportion to the number of quarters for which the tax liability was determined (Mijatović, 2016: 18-19). If citizens received a decision from the authorized office on approval for the provision of household services during the year, in the opinion of the Central Office of the Tax Administration, the annual flat tax would be determined in proportion to the number of quarters in which the taxpayer had the approval to provide services.<sup>9</sup> Since the ZPDoh entered into force on January 1st 2017, Article 82 prescribes for which taxpayers and under what conditions the flat-rate income and flat-rate income tax are determined. As real estate renters for tourist purposes are also covered by this provision, a new Ordinance on renting apartments, rooms, and beds for travellers and tourists and organizing camps that will be taxed at a flat rate, on the amount of flat tax and the method of paying flat tax (hereinafter: Ordinance/17) which entered into force on January 3rd 2017,<sup>10</sup> the entry into force of which supra the said Ordinance ceased to be valid. Article 2 of Ordinance/17 defines the taxpayer as in the previous Ordinance. The annual flat income tax was determined in the same way as under the previous Ordinance. Even the amount of the flat tax per bed or per accommodation unit in the camp and the coefficient of the area where the service is provided have remained unchanged. According to Article 5, paragraph 1 of the Ordinance/17, the annual lump-sum income, the annual flat income tax, and surtax on income tax were determined by the tax administration by a decision. With the Law on Amendments to the ZPDoh entering into force on January 1st, 2019,<sup>11</sup> Article 17 stipulates that the representative body of the unit must make a decision prescribing the amount of flat tax per bed or accommodation unit in the camp and per accommodation unit for Robinson tourism, which cannot be less than 150.00 HRK or more than 1500.00 HRK. If the representative body of the local self-

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<sup>9</sup> Central Office of the Tax Administration, October 25th 2005 Klasa: 410-01/05-01/207, Urbroj: 513-07-21-01/05-8.

<sup>10</sup> Narodne novine br. 1/17.

<sup>11</sup> Narodne novine br. 106/18.

government unit does not decide within the prescribed period, the amount of the flat tax per bed or per accommodation unit in the camp is determined at 750.00 HRK (Markota, 2020: 143). Due to the mentioned amendments to the ZPDoh, a new Ordinance on flat-rate taxation of rental and organization of accommodation in tourism was adopted (hereinafter: Ordinance/19).<sup>12</sup> Pursuant to Article 7 of Ordinance/19, a taxpayer is a taxpayer of income tax, referred to in Article 82, paragraph 2 of the ZPDoh, whose annual income tax is determined in a flat-rate, is a natural person - a citizen, a renter to whom based on the decision on approval the competent office approved the provision of catering services in the household in accordance with the provisions of the law governing the catering business, and is not subject to value added tax under that law according to the law governing value added tax and income is not determined on the basis of business books, provided organizes accommodation in a room, apartment and holiday home, up to a maximum of 10 rooms or 20 beds, and/or; to organize accommodation in a camp and/or camp-rest area, organized on the land, with a total of a maximum of 10 accommodation units or for 30 guests at a time, and/or; to organize accommodation in a Robinson accommodation facility in which services are provided in the premises or on the premises, the capacity of which is determined by the number of guests who can safely stay in it, but up to a maximum of 10 accommodation units or 30 guests at a time. The annual flat income tax is determined as the product of the number of beds or the number of accommodation units in the camp and/or campsite or the number of accommodation units in the Robinson accommodation facility and the amount of the flat tax per bed or per accommodation unit in the campsite and/or campsite that is, per accommodation unit in a Robinson accommodation facility. The number of beds or the number of accommodation units in the camp and/or camp-rest area or the number of accommodation units in the Robinson accommodation facility is determined based on the decision of the competent office on approval for the provision of catering services in the household. The amount of the annual flat income tax is increased by the surtax on income tax, which was introduced by the decision of the local self-government unit according to the place where the real estate or accommodation unit is located, and for which a decision of the competent office on approval for providing catering services.<sup>13</sup> According to Article 12 of the Ordinance/19, the annual flat-rate income tax and

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<sup>12</sup> Narodne novine br. 1/19, 1/20, 1/21.

<sup>13</sup> Article 8, paragraphs 1-3 Ordinance/19.



surtax on income tax shall be paid quarterly, until the end of each quarter, in the amount of 1/4 of the annual flat-rate income tax and surtax on income tax, *i.e.* in proportion to the number of quarters the obligation determines.

#### **4.1 Financial relationship between rental income in general and rental for tourism purposes in the Republic of Croatia**

As in the Republic of Croatia, there is a difference in the taxation of income from rent or lease and rental of real estate for tourism purposes; although both incomes come from property income and property rights, the relationship between income and tax payments will be shown when income is generated by "classic" rent or lease and when the income is generated from renting apartments, rooms and beds to travellers and tourists and organizing camps. Five cities will be taken into account, namely: Dubrovnik, Poreč, Rovinj, Split, and Zagreb, and it will be taken into account that the taxpayer will have been approved four beds by the competent tourism office. Also, it will be taken for comparison that the given apartment is rented to a family of four. Of course, this is a situation when the taxpayer's income does not exceed 300,000.00 HRK, *i.e.* when they become a value-added taxpayer by force of law.

In Dubrovnik, the amount of the flat tax is prescribed by Article 2 of the Decision on the amount of the flat tax per bed, accommodation unit in the camp, and accommodation unit in a Robinson accommodation facility<sup>14</sup> and amounts to 750.00 HRK. The amount of surtax on income tax in Dubrovnik is 10%.<sup>15</sup> Following Article 8 of the Ordinance/19, the annual flat income tax will amount to 3,000.00 HRK (4 x 750.00) plus a surtax of 10%, which amounts to 300.00 HRK. Therefore, the total annual liability of the flat-rate income tax and surtax on income tax amounts to 3,300.00 HRK. Therefore, the monthly liability for the flat-rate income tax and surtax on income tax would amount to 275.00 HRK (3,300.00/12). If the taxpayer rents an apartment to a family of four according to the lease agreement and for non-tourist purposes for the total rent of 3,500.00 HRK per month, the taxpayer would pay monthly income tax and surtax on income tax of 269.50 HRK (3,500.00 x 30% of expenses = 2,450.00 x 10% tax = 245.00 + 10% surtax = 24.50) which means

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<sup>14</sup> Službeni glasnik Grada Dubrovnika br. 1/19.

<sup>15</sup> Retrieved from: Ministarstvo financija, Porezna uprava, [https://www.porezna-uprava.hr/HR\\_porezni\\_sustav/Stranice/Popisi/Stope.aspx](https://www.porezna-uprava.hr/HR_porezni_sustav/Stranice/Popisi/Stope.aspx), accessed 15.11.2021.

6.50 HRK less than the landlord for tourist purposes. So, they are roughly equally taxed. Therefore, it can be concluded that if both landlords earn a total income of 3,500.00 HRK per month or 42,000.00 HRK per year, they will be taxed approximately equally. However, if the landlord raises the rent for non-tourist purposes, the amount of income tax and surtax on income tax will increase, while the landlord's property for tourist purposes remains the same. Therefore, it can be concluded that in Dubrovnik, fair taxation would be realized from the same source, *i.e.* from property income, if the annual income of both landlords was around 42,000.00 HRK.

In Poreč for zone I, the amount of the flat tax is prescribed by Article 3 of the Decision on the amount of the flat tax for rental and accommodation activities in tourism and amounts to 300.00 HRK, which is the highest amount in the area of Poreč.<sup>16</sup> There is no surtax on income tax in Poreč. The annual flat income tax will amount, following Article 8 of the Ordinance/19, to 1,200.00 HRK (4 x 300.00 HRK). This means that the monthly flat-rate income tax liability would amount to 100.00 HRK (1,200.00/12). If the taxpayer rented out an apartment to a family of four according to the lease agreement and for non-tourist purposes for the total rent of 1,500.00 HRK per month, the taxpayer would pay monthly income tax and a surtax on income tax of 105.00 HRK (1,500.00 x 30% of expenses = 1,050.00 x 10% of taxes = 105.00) which means 5.00 HRK more than the landlord for tourist purposes. So, they are roughly equally taxed. Therefore, it can be concluded that if both landlords earn a total income of 1,500.00 HRK per month or 18,000.00 HRK per year, they will be taxed approximately equally. However, if the landlord raises the rent for non-tourist purposes, the amount of income tax and surtax on income tax will increase, while the landlord's property for tourist purposes remains the same. Therefore, it can be concluded that in Poreč in zone I, fair taxation would be realized from the same source, *i.e.* from income from property, if the annual income of both landlords was around 18,000.00 HRK.

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<sup>16</sup> Službeni glasnik Grada Poreča-Parenzo 1/19.

In Rovinj, the amount of the flat tax is prescribed by Article 2, paragraph 1 of the Decision on the amount of the flat tax for rental and accommodation activities in tourism<sup>17</sup> and amounts to 300.00 HRK per bed and per accommodation unit in the camp and/or camping rest area or per accommodation unit in the facility for Robinson accommodation of 350.00 HRK, which is paid in the area of the City of Rovinj-Rovigno, for the class of tourist place A (settlement Rovinj). The amount of surtax on income tax in Rovinj is 6%.<sup>18</sup> The annual flat income tax will amount, following Article 8 of the Ordinance/19, 1,200.00 (4 x 300.00), plus a surtax on income tax of 6%, to 72.00 HRK. Therefore, the total annual liability of the flat-rate income tax and surtax on income tax amounts to 1,272.00 HRK. Therefore, the monthly liability for the flat-rate income tax and surtax on income tax would amount to HRK 106.00 (1,272.00/12). If the taxpayer rents out an apartment to a family of four according to the lease agreement and for non-tourist purposes for the total rent of 1,500.00 HRK per month, the taxpayer would pay monthly income tax and a surtax on income tax of 111.30 HRK (1,500, 00 x 30% of expenses = 1,050.00 x 10% of taxes = 105.00 + 6% surtax = 6.30) which means 5.30 HRK more than the landlord for tourist purposes. So, they are roughly equally taxed. Therefore, it can be concluded that if both landlords earn a total income of 1,500.00 HRK per month or 18,000.00 HRK per year, they will be taxed approximately equally. However, if the landlord raises the rent for non-tourist purposes, the amount of income tax and surtax on income tax will increase, while the landlord's property for tourist purposes remains the same. Therefore, it can be concluded that in the City of Rovinj, fair taxation would be realized from the same source, *i.e.* from property income, if the annual income of both landlords was around 18,000.00 HRK.

In the City of Split, the amount of the annual flat tax is prescribed by Article 4 of the Decision on determining the amount of the flat tax per bed or per accommodation unit in the camp<sup>19</sup> and amounts to 300.00 HRK per bed for all city districts of the City of Split or 350.00 HRK per accommodation unit in camp. The amount of surtax on income tax in the City of Split is 15%.<sup>20</sup> The annual flat income tax will amount, following Article 8 of the Ordinance/19, to 1,200.00 HRK (4 x

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<sup>17</sup> Službeni glasnik Grada Rovinja-Rovingo br. 1/19.

<sup>18</sup> Retrieved from: Ministarstvo financija, Porezna uprava, [https://www.porezna-uprava.hr/HR\\_porezni\\_sustav/Stranice/Popisi/Stope.aspx](https://www.porezna-uprava.hr/HR_porezni_sustav/Stranice/Popisi/Stope.aspx), accessed 15.11.2021.

<sup>19</sup> Službeni glasnik Grada Splita br. 3/19.

<sup>20</sup> Retrieved from: Ministarstvo financija, Porezna uprava, [https://www.porezna-uprava.hr/HR\\_porezni\\_sustav/Stranice/Popisi/Stope.aspx](https://www.porezna-uprava.hr/HR_porezni_sustav/Stranice/Popisi/Stope.aspx), accessed 15.11.2021.

300.00) plus a surtax of 15% income tax, which amounts to 180.00 HRK. Therefore, the total annual liability of the flat-rate income tax and surtax on income tax amounts to 1,380.00 HRK. Therefore, the monthly liability for the flat-rate income tax and surtax on income tax would amount to 115.00 HRK (1,380.00/12). If the taxpayer rents an apartment to a family of four according to the lease agreement and for non-tourist purposes for the total rent of 1,500.00 HRK per month, the taxpayer would pay monthly income tax and a surtax on income tax of HRK 120.75 (HRK 1,500, 00 x 30% of expenses = 1,050.00 x 10% of taxes = 105.00 + 15% surtax = 15.75) which means 5.75 HRK more than the landlord for tourist purposes. So, they are roughly equally taxed. However, if the landlord raises the rent for non-tourist purposes, the amount of income tax and surtax on income tax will increase, while the landlord's property for tourist purposes remains the same. Therefore, it can be concluded that in Split, fair taxation would be realized from the same source, *i.e.* from property income, if the annual income of both landlords was around 18,000.00 HRK.

In the City of Zagreb, the amount of the annual flat tax is prescribed by Article 2 of the Decision on the amount of the flat tax for rental and accommodation activities in tourism (City of Zagreb)<sup>21</sup> and amounts to 300.00 HRK per bed, accommodation unit in a camp and/or camping resort and accommodation unit in a Robinson accommodation facility. The surtax rate on personal income tax in the City of Zagreb is 18%.<sup>22</sup> The annual flat income tax will amount, following Article 8 of the Ordinance/19, 1,200.00 (HRK 4 x 300.00) plus a surtax on income tax of 18%, which amounts to 216.00 HRK. Therefore, the total annual liability of the flat-rate income tax and surtax on income tax amounts to 1,416.00 HRK. Therefore, the monthly liability for the flat-rate income tax and surtax on income tax would amount to 118.00 HRK (1,416.00/12). If the taxpayer rents an apartment to a family of four according to the lease agreement and for non-tourist purposes for the total rent of 1,500.00 HRK per month, the taxpayer would pay monthly income tax and surtax on income tax of 123.90 HRK (1,500.00 HRK). 00 x 30% of expenses = 1,050.00 x 10% tax = 105.00 + 18% surtax = 18.90) which means 5.90 HRK more than the landlord for tourist purposes. So, they are roughly equally taxed. However, if the landlord raises the rent for non-tourist purposes, the amount of income tax and

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<sup>21</sup> Službeni glasnik Grada Zagreba br. 24/19.

<sup>22</sup> Retrieved from: Ministarstvo financija, Porezna uprava, [https://www.porezna-uprava.hr/HR\\_porezni\\_sustav/Stranice/Popisi/Stope.aspx](https://www.porezna-uprava.hr/HR_porezni_sustav/Stranice/Popisi/Stope.aspx), accessed 15.11.2021.

surtax on income tax will increase, while the landlord's property for tourist purposes remains the same. Therefore, it can be concluded that in Zagreb, fair taxation would be realized from the same source, *i.e.* from property income, if the annual income of both landlords was around 18,000.00 HRK.

## **5 Conclusion**

Traditional analysis of tax systems has singled out several principles of tax formation. Namely, taxes must be horizontally and vertically fair, they must be neutral with respect to economic incentives, and they must be easy to implement (Rosen, Gayer, 2010: 422). The requirement to achieve fairness in taxation is an unavoidable normative requirement placed on tax policymakers. It is one of the "four canons of taxation" of the father of political economy, Adam Smith, as well as one of the nine principles of taxation of the classical theorist of public finance, Adolf Wagner. However, the problem that has always existed and still exists today is how to apply this principle in conducting tax policy. This is certainly the result of theoretical disputes over the content of concepts and justice, which have their roots in the philosophy of morality. Namely, the principle of justice can be marked by a bridge between two systems of social norms: law and morality. In the words of the famous German professor of tax law Klaus Vogel, "The meaning of justice, unlike efficiency, cannot be defined, it can only be explained, paraphrased. In addition, justice is an interpretive concept. In other words, discovering what justice requires in a particular situation implies an element of creativity." (Gadžo, 2015: 134). In addition to achieving the fiscal goal, the income tax entrusts the achievement of numerous other goals, primarily social goals. Its social line, that is, taxation in proportion to its economic strength, contributed to the fact that income tax is now referred to as a relatively fair tax (Mijatović, 2007: 308).

Flat-rate taxation of renting apartments, rooms, and beds for travelers and tourists and organizing camps in the Republic of Croatia can be viewed from three angles. 1. The state seeks to reduce the possibility of tax evasion by prescribing lower amounts of income tax from the rental of real estate for tourism purposes and consequently increase tax revenues; 2. The state's tax policy wants to encourage entrepreneurial activity in tourism by prescribing lower taxation, which would mean that it is a tax expense to encourage economic activity in tourism; 3. flat-rate taxation of renting real estate for tourist purposes is a social criterion by which the state, by

prescribing tax benefits, enables its citizens to improve their financial situation by generating income from renting real estate to tourists.

The argument that the state seeks to avoid tax evasion by prescribing flat-rate taxation in a modern EU Member State cannot be justified. State bodies and inspections should do the work within their competence using all the advantages of modern technology. Prescribing more favorable taxation to encourage entrepreneurial activity in tourism by renting real estate is also a weak argument because even when the coronavirus pandemic in the Republic of Croatia was rampant, notable tourist results were achieved.<sup>23</sup> The argument that renting real estate is a social criterion by which the state prescribing tax benefits allows its citizens to improve their property is debatable. It is necessary to answer the question of whether someone who owns expensive real estate at the seaside (*i.e.* cities stated above, Dubrovnik, Poreč, Rovinj, and Split) or in Zagreb is a social case.<sup>24</sup> If it is determined that they are, the question should be asked why they are given tax benefits only in the case of renting out real estate for tourist purposes.

As stated in the text, everyone should participate in the payment of public costs in the Republic of Croatia according to their economic strength, equality, and fairness in taxation, which is the social goal of the tax system. Also, the demand for the realization of vertical and horizontal fairness in taxation is visible. This means that citizens with higher incomes need to contribute more to meeting public costs and that individuals with equal economic power are treated equally, and that individuals with unequal economic power are treated unequally. In the above-stated examples of five Croatian cities, we can see the amount of annual income from property and property rights from rent for housing and for tourist purposes, which would be approximately equally taxed, regardless of the form of rent. Given that both incomes come from the same source of income (income from property and property rights), they should always be taxed approximately equally, given the amount of income (provided that no taxpayer exceeds the limit of 300,000.00 HRK when by force of

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<sup>23</sup> Hrvatska turistička zajednica, <https://www.htz.hr/hr-HR/press/objave-za-medije/u-2020-godini-ostvareno-50-posto-nocenja-od-rekordne-2019>, accessed 16.11.2021, Crnjak M., Poslovni.hr, <https://www.poslovni.hr/hrvatska/turizam-u-kolovozu-utrzio-petinu-vise-nego-prije-korone-4303724>, accessed 16.11.2021.

<sup>24</sup> Jutarnji list, <https://novac.jutarnji.hr/novac/aktualno/rastu-cijene-nekretnina-na-moru-gradani-upozoravaju-pitanje-je-gdje-ce-to-sve-završiti-15095199>, accessed 16.11.2021, Vukić Z., Dnevnik.hr, <https://dnevnik.hr/vijesti/hrvatska/informer-rast-cijena-nekretnina-u-zagrebu--676632.html>, accessed 16.11.2021.

law one becomes a taxpayer of value-added tax). If a taxpayer who pays an annual flat income tax in a lump sum earns a higher amount of income than the amount up to which he pays approximately the same amount of tax as a taxpayer who rents real estate for residential purposes, then the taxation and principles according to which income is taxed justification and existence of flat-rate taxation of the activity of renting apartments, rooms and beds to travelers and tourists and organizing camps in the Republic of Croatia should be questioned with regard to the principle of fairness.

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