

# Fiscal Decentralization in Croatia

## Introductory Paper for the Proceedings of the FDI Forum

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### Summary

*This paper serves as the introductory chapter for the Proceedings of the Fiscal Decentralization Forum organized in Zagreb by the Fiscal Decentralization Initiative for Central and Eastern Europe, Budapest and the Institute of Public Finance, Zagreb. It briefly describes the main issues of fiscal decentralization in Croatia, analyzes the recent administrative changes, the way government has tried to tackle the problems, and finishes by giving some conclusions and recommendations.*

**Key words:** fiscal decentralization, Croatia

The intention of this text is to briefly describe fiscal decentralization in Croatia by explaining the recent administrative changes as well as how the government has approached problems, and finally, to offer some conclusions and recommendations. In addition to sharing the views of the authors, this paper tries to reflect on the ideas presented at the Fiscal Decentralization Forum<sup>1</sup> by independent researchers (both from Croatia and neighboring Slovenia), government officials (both

from the central and the local level), representatives of international organizations (World Bank Institute), the organizers (Fiscal Decentralization Initiative and Institute of Public Finance) and the representatives of the media, NGOs and other participants at the Forum.

### Description of the Fiscal Decentralization in Croatia

Citizens of the Republic of Croatia have the constitutional right to local government, which includes the right to take part in decision-making about local needs and issues. For this reason the country is divided into cities, communes (local administration units) and counties (local government and administration units).

Croatia has 20 counties (plus the city of Zagreb), 425 communes and 122 cities. Unfortunately, 29 cities and 82 communes are within the areas of special national concern (areas damaged by the recent war).

Each local unit has its own budget. The revenue of the local unit's budget is recorded in the same way as that of the national budget. All the revenue of the local units is divided into tax revenue, non-tax revenue, capital revenue and grants (Table 1).

*Table 1. Revenue of Local Units in Croatia in % of Budgetary Revenue*

Revenue	1995	1996	1997	1998	1999	2000	Plan 2001
Tax revenue	66.2	55.9	52.7	55.9	51.8	55.7	51.1
Non-tax revenue	22.7	31.4	33.3	29.3	30.9	31.5	34.2
Capital revenue	4.8	4.9	6.3	5.1	7.1	6.7	8.6
Grants	6.3	7.8	7.7	9.7	10.2	6.1	6.0
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: IMF, 2001.

<sup>1</sup> Organized by the Fiscal Decentralization Initiative for Central and Eastern Europe (FDI)–Budapest, Hungary and the Institute of Public Finance (IPF)–Zagreb, Croatia on November 14–15, 2002 in Zagreb.

As seen from Table 1, taxation is the leading item in the budgets of local units, although there is an evident downward trend, from 66 percent in the total revenue in 1995 to 51 percent as planned in 2001. The second most important local government revenue is non-tax revenue, the share of which has been on the increase, from 23 percent in 1995 to 34 percent in 2001<sup>2</sup>. The share of capital revenue has also increased, and in 2001 it represented over 8 percent of all local government revenue. Grants from the central government to local governments were growing from 6 percent in 1995 to their peak of 10 percent in 1999, but they suddenly fell and came to around 6 percent both in 2000 and 2001.

Defining the criteria for transferring grants from central to local government is a constant problem in Croatia. There is an understanding that it is necessary to make transfers to local government units with a below-average fiscal capacity, but we still lack the criteria for evaluating fiscal capacity. As a consequence we have ad hoc grants from the Ministry of Finance and the sharing of taxes, particularly the income tax (Table 2).

The basic source for the financing of local government is the legally defined sharing of common taxes between the central government and the lower levels of government, i.e. the local units. Table 2 shows the common taxes in 2003: personal income and corporate

income tax, and the real estate commerce tax, all of which are divided among central government, county and city or commune.

Unfortunately, reliance on tax sharing and the constant changes in the shares going to particular local government units, without any clear-cut criteria, contributes to the confusion and proves that even for the tax sharing mechanism we need reliable fiscal capacity indicators. We must admit here that there are some positive signs—in the years 2001 and 2002 the Ministry of Finance tried to calculate fiscal capacity using per capita income estimates (Tables 3a and 3b).

Local public expenditure is largely financed by joint taxation, mostly income tax and surtax<sup>3</sup>. This is shown by the extent to which income tax and surtax account for overall taxation: 63 percent in counties, 66 percent in communes, 69 percent in cities and almost 74 percent in the city of Zagreb. Furthermore, the share of income tax and surtax is growing in all local units. Other taxes have varying roles. Profits tax is in second place in the counties, around 23 percent, and in the city of Zagreb is around 16 percent. Real estate commerce tax is in second place in communes, 22 percent, and 16 percent in cities. Other common taxes are less important. It will be very interesting to see the data for 2001 and 2002 where we could expect the effects of the latest changes

Table 2. Common Taxes and Their Division in % Among the Levels of Government (2003)

Kind of tax	Central government	County	Commune or city	Decentralized functions*	Fire brigade**	Equalization fund***
Income tax	24.6	10	34	9.4	2	21
Income tax (Zagreb)	21.6	—	47	9.4	2	21
Profit tax	70	10	20			
Real estate commerce tax	40	—	60			

\* goes to the commune or the city which is financing its decentralized functions, otherwise goes to the county.

\*\* goes to the commune or the city that has established and is financing a regular operation of the public fire-service.

\*\*\* the state-level fund from which transfers are sent to those local units that cannot finance their public functions.

Source: *Local Government and Administration Financing Law, NN 150/02.*

<sup>2</sup> The most important reasons for this growth are the collection of illegal utility fees and the fact that local governments do not have substantial control over the tax bases and tax rates and turn instead towards non-tax revenues. More in Ott and Bajo, 2001.

<sup>3</sup> Surtax is an additional tax levied on top of income tax. The tax base for surtax is the amount of the income tax paid. Surtax is the revenue of the local authorities. From 1994 to 2001 cities with more than 40,000 inhabitants had the right to introduce surtax. The rate of surtax usually ranged between 6 and 7.5%, but in Zagreb it was 18%. Since July 2001 all local units have been allowed to prescribe surtax on the income tax. The rates are determined by the local authorities and may not be higher than: 10% for communes, 12% for a city with a population of less than 30,000, 15% for a city with a population of more than 30,000, and 30% for the city of Zagreb.

Table 3a. The Main Sources of Taxation Revenue of Local Units in Croatia in % of Total Taxation Revenue

Taxes	Counties			Communes		
	1998	1999	2000	1998	1999	2000
Income tax and surtax	54.1	50.6	62.9	54.1	63.5	66.4
Profits tax	32.7	33.8	22.9	32.7	9.4	8.8
Real estate commerce tax	1.3	0.8	0.5	1.3	23.6	21.5
Inland tax on goods and services	11.9	14.2	13.7	11.9	3.3	3.0
Other taxes	0.0	0.6	0.0	0.0	0.2	0.2
Total	100.0	100.0	100.0	100.0	100.0	100.0

Source: Ministry of Finance, 2001.

Table 3b. The Main Sources of Taxation Revenue of Local Units in Croatia in % of Total Taxation Revenue

Taxes	Cities			Zagreb		
	1998	1999	2000	1998	1999	2000
Income tax and surtax	64.8	62.9	69.1	66.6	67.8	73.9
Profits tax	16.0	16.8	11.8	24.6	23.5	16.6
Real estate commerce tax	16.8	17.1	16.3	7.1	6.8	7.4
Inland tax on goods and services	2.5	2.6	2.7	1.6	1.9	2.1
Other taxes	0.0	0.5	0.1	0.0	0.0	0.0
Total	100.0	100.0	100.0	100.0	100.0	100.0

Source: Ministry of Finance, 2001.

Table 4. Expenditure of Local Units, a Functional Classification [%]

Expenditure	1998	1999	2000	Plan 2001
General public services	20.2	21.3	22.4	21.3
Law and order	0.4	0.5	0.8	0.9
Education	11.1	11.3	11.9	10.7
Health care	1.0	1.1	0.8	1.0
Social insurance (welfare)	3.3	3.1	2.9	3.1
Municipal services	25.4	23.5	23.9	26.1
Recreation, culture and religion	13.8	16.2	14.3	12.8
Agriculture, forestry and fisheries	0.6	0.7	0.7	0.8
Mining, trades and construction	4.5	3.7	2.6	3.1
Transport and communications	13.5	13.2	13.3	12.8
Other economic affairs	4.8	3.5	3.9	4.8
Miscellaneous expenditure	1.1	1.7	2.1	2.0
Total expenditure	100.0	100.0	100.0	100.0

Source: IMF, 2001.

in the percentages in which the common taxes are shared (Table 4).

Table 4 shows what local units used their resources for. The biggest item was municipal services (utilities), accounting for 25 percent on average, followed by general public services (21%). After that came expenditure on recreation, culture and religion, as well as transport and communications, both averaging around 13 percent.

If we look at the consolidated general government (according to Ministry of Finance and Government Statistics Office data), we can see that the share of the local government revenues and grants in GDP was on the increase from 4.4 percent in 1995 to 5.4 percent in 1999. The share of expenditures was on the increase, from 4.2 percent in 1995 to 5.8 percent in 1999. Unfortunately, we do not have any newer data, but the changes were not substantial anyway and we can only conclude that Croatia is, despite all efforts to the contrary, quite a centralized country.

### Recent Administrative Changes

During the year 2001, Croatia undertook a reform of the financing of local units. The functions of education, health care and welfare have been partially decentralized. After the reform, these expenditures began to be financed from the budgets of the local units, but also from the equalization fund and from the increased share in income tax going to the local unit.

The legal status of all local units is now the same, and all can carry out administrative functions. In spite of the wish to reduce the numbers and to unite some small local units, there is still a trend towards the foundation of new units. Unfortunately, they tend not to be founded on a realistic estimate of their fiscal capacity.

It is as yet too early to estimate the real effects of the reform measures. Nevertheless, it is obvious that the additional income tax sharing and the equalization grants are now the basic instruments for financing the decentralized functions of education, health care and welfare. Unfortunately, no account has been taken of the state of the fiscal capacity of individual local units. Zagreb, the capital, for example, did not need to have an increased share in income tax because in all categories of revenue Zagreb is capable of financing decentralized functions. Interestingly, not a single commune has taken on the decentralized functions, although a considerable number of communes introduced surtax. Proper fiscal capacity indicators would show us if these communes are really in a poor financial position, i.e. incapable of financing the decentralized functions.

In principle, the reform provided the conditions for the consolidation of local units' budgets. Local units can now draw up numerous performance indicators concerning the execution of their jobs. There is now no reason for local units or for the Ministry of Finance not to publish complete information about local unit budgets. Nevertheless the consolidation of the local unit's budgets will depend on the definition of the budgetary beneficiary. Unfortunately, the lack of any clear definition could make the consolidation questionable.

Formally, control of borrowing and the issue of guarantees has been strengthened, and it is now possible to obtain a picture of borrowing and of the structure and size of guarantees. However, we cannot expect any major change at the local level until the central government proves it is capable of controlling the spending of its own budgetary beneficiaries at the national level.

So, we can stress that the government should decide upon one of two possibilities—first, decentralization of both authorities and finances, or second, decentralization of authorities and centralization of finances.

If the government wants decentralization of both authorities and finances, then it must to a greater extent leave some of the taxes within the jurisdiction of the local units. If the government wants the decentralization of authorities and the centralization of finances, then it should say so clearly, and work on the improvement of the existing model of fiscal equalization. In this case, fiscal capacity indicators should be calculated for all levels of government as well as all categories of revenue and expenditure.

Further progress of the reform will to a great extent depend on the capacity and knowledge of individuals at all government levels. Every mistake could be a step backward with respect to the main objective the government should have in mind—providing a simple, user-friendly and responsible system for the financing of local units.

### Tackling the Problems

The main problems of fiscal decentralization in Croatia are related to the number and size of the local units, the budget itself and the budgetary process.

Croatia is a small country, in which there are too many local government units. This situation causes an oversized administration at several tiers of government as well as inadequate division of functions and responsibilities. Unfortunately, the situation has been aggravated by the foundation of the areas of special national concern after the war.

A change in the number and shape of local government units is more a political than an economic problem, and as such it is something we cannot influence. Thus, the attitude of the Institute of Public Finance has been to concentrate on budget and budgetary process-related problems like classification, consolidation, methodology, transparency, revenue and expenditure analysis.

In line with this reasoning, in one of the previous texts (Ott and Bajo, 2002), we enumerated the most important problems and gave particular suggestions for improvements. Comparing our suggestions with recent trends we can now make some conclusions

There have been *no substantial positive changes* regarding:

- territorial organization;
- oversized administration at several tiers of government;
- areas of special national concern;
- public investment planning;
- revenue structure;
- insufficient shared taxation;
- the central government's control of the local government units' utility contributions and charges;
- frequent founding of new local government units without secured funds;
- classification by program and subprogram;
- the position of utility companies;
- evaluations and rewards for the work of employees;
- internal controls;
- audits of joint stock companies owned by local units;
- guidelines of the Ministry of Finance.

We witnessed *partial changes for the better* regarding:

- inadequate division of functions and responsibilities;
- classification of budgets;
- fiscal capacity indicators;
- financial equalization and allocation of grants;
- consolidation of local government units' budgets;
- complicated accounting;

- plans and estimates of the budget;
- national treasury system;
- reporting on the local government units' own tax revenue;
- participation of citizens;
- long-term capital project planning;
- financial control of the local government units' borrowing;
- recording potential obligations (guarantees).

Despite many problems, in some aspects, the situation is slightly improving. Positive changes are particularly visible in budget-related problems generally (regarding classification, consolidation, accounting, the national treasury system), and also, to a slightly lesser degree, with respect to expenditure side problems, (regarding long-term capital project planning, controlling borrowing, recording liabilities). Almost no improvements could be noted regarding the problems connected with the number and size of the local government units (territorial organization, oversized administration on several tiers of government, areas of special national concern) and the problems connected with the budgetary process (internal controls, audits, guidelines of the Ministry of Finance). Only slight improvements could be seen in connection with revenue side problems (reporting on the local government units' own tax revenue, control of the local government units' utility contributions and charges).

The explanation probably lies in the political sphere—in the decision to change the territorial organization of the country and the related hesitations about engaging in problems regarding the budgetary process and the assignment of revenues. General problems like classification, consolidation, accounting, the treasury, or expenditures are problems that could seriously obstruct the functioning of the country, so it comes as no surprise that the Ministry of Finance and other relevant agencies are keen to make some improvements.

## Conclusions

In several of our previous texts<sup>4</sup> we drew various conclusions stemming from the experience of our own research and we will not repeat them here. Let us rather

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<sup>4</sup> Op. cit for example.

see what we can conclude from the experience of the Fiscal Decentralization Forum.

An increase in the interest in fiscal decentralization issues in Croatia is more than obvious. More and more people are writing about and discussing this issue, as well as attending various fiscal decentralization issue gatherings, including this Forum.

The diversity among the participants is also obvious. They come not just from the ministries and other central government agencies, but more and more from the local level, and from the wider academic community, the media and NGOs. This mixture of participants shows a great inclination towards extremely constructive discussion.

We should also stress the importance of the participation and collaboration between participants from Slovenia. Croatia and Slovenia shared the same history for so many years that even today as separate countries they have a lot of issues and problems in common, and it is very useful to share experiences, disseminate knowledge and try to implement the best possible practices.

Although it might seem that we are stuck in the same position—the same people, the same approaches—the step forward is visible. Issues are more expertly addressed in writing, while more and more people outside of the government and the academic community are showing an interest in the field.

It seems that the majority of participants have drawn attention to the problem of the high number of local government units and the consequently ensuing inefficiencies. Changes in the number of local government units are inevitable, but they necessarily involve changes in the political sphere, and so it is impossible to predict when they might occur.

What can we do in the meantime?

We can try to improve that which can be improved.

We should probably narrow our field of interest and research and deal only with the few most important issues. This could, for example, mean concentrating on developing high quality databases, improving the calculation of the fiscal capacities of local government units, educating all participants in the process, including the citizens, improving the transparency of the process, government accountability, and participation of the citizens.

In her discussion at the Fiscal Decentralization Forum, Dubravka Jurlina-Alibegović emphasized the importance of the regulated minimum criteria for local government units. Although we are in complete

agreement, we also want to bear in mind the growing differences between local government units. More developed units will be able to produce citizens' budget guides, organize public debates, and issue charters; their politicians will try to win the next elections, and they—the more developed, richer units—will be able to implement new ideas and new public management. At the same time, the less developed units will be more and more dependent on transfers from the central government. Perhaps some of the poorest units will in time cease to exist.

Ivica Maletistinić stressed in that context that local government units are not supposed to expect everything to be prescribed by the central government but could go a step further and show possible new approaches (e.g. fire brigade financing or public debates) through their own examples.

Gábor Péteri summarized the Forum by suggesting that at this stage of fiscal decentralization development in Croatia we should probably establish a kind of task force consisting of persons and institutions representing different interests and concentrate on policy design improvements. Priorities could evolve around (1) developing a grant allocation formula, which also requires fiscal capacity indicators and fiscal data improvements, (2) improving fiscal transparency both at the national and at the local level, and (3) the importance of local taxes within the framework of tax policy, of course having in mind that they are not supposed to increase the total tax burden.

We conclude that both the researchers and the policy makers should consequently concentrate on:

- developing and calculating fiscal capacity indicators;
- developing the system of transfers and grants;
- vertical, but also horizontal equalizations;
- indebtedness problems—pertaining to the regulation and role of the central government;
- analyses of revenue and expenditure, but also of the efficiency of revenue and expenditure, administrative and compliance costs of revenue collection and benefits arising from the expenditure made;<sup>5</sup>

<sup>5</sup> In this context we could mention the project “Administrative and compliance costs of taxation in Croatia” run by the Institute of Public Finance and co-funded by the CERGE, Prague, Czech Republic.

- costs of the government (both central and local) per capita, per types of costs, per local government units, etc.;
- education of government employees but also of all participants in the decision-making process (national Parliament and local assemblies) and all the citizens;
- improving transparency, accountability and participation in budgetary process at all levels of government.

And finally, although it is questionable when Croatia will become eligible to join the European Union, we should continue at all times to bear in mind the requirements of the Union regarding taxation, the scale of the public sector and particular regional development policies.

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