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PRESS RELEASES

The Croatian fiscal equalization system is improving

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The agenda of the 58th Croatian Government's session, held on September 28, 2017, included, among other items, a Proposal for an Act on the Financing of Local and Regional Self-government Units. Under the proposed Act, the local government financing system has been changed for the 18th time since 1993, i.e. it changes almost every year. Such frequent revisions of the regulatory framework (accompanied by amendments to income taxation regulations) hamper the long-term financial planning of local government budgets. However, the proposed local government financing act deserves commendation for introducing a new fiscal equalization model.

The issue of fiscal equalization. Despite being formally introduced in Croatia as early as 2001, the fiscal equalization system was based on vague criteria and poorly-defined instruments for the allocation of budget grants and personal income tax sharing between the central and local governments. Instead of being based on differences in fiscal capacity and/or needs, transfers (grants) to local government units (LGUs) have long relied on geographic criteria, i.e. the criterion of being located in an area of special national concern (ASNC) or a hilly and mountainous area (HMA). Such redistribution of funds among LGUs has deepened fiscal inequalities. After replacing the ASNC and HMA concept with the development index calculation in 2010, some improvements were noticeable, as the allocation of grants and income tax distribution were mainly governed by economic criteria. Nevertheless, the fiscal equalization criteria were still not based on differences in LGUs' fiscal capacities and needs, but rather on economic indicators which were more suitable for the implementation of a balanced economic development policy.

The disputable scope of LGUs in the fiscal equalization system until 2016. Due to various lobbying pressures, the number of local government units covered by the preferential financing system has increased unjustifiably over time. An obvious example of that is the personal income tax revenue sharing. The so-called 'general' sharing of these revenues covered only 207 out of a total of 556 LGUs, i.e. only 37% of them were excluded from the preferential income tax sharing scheme. The remaining 349 LGUs (63%) were subject to a specific funding system in which income tax revenues were shared according to various preferential formulas, depending, e.g., on whether the relevant LGU is located in an ASNC or a HMA, whether it is an EU funds beneficiary, whether it is located on an island, or participates in the joint funding of a capital project together with the island's authorities, etc. Moreover, since the privileged status of LGUs located in ASNCs and HMAs had not been annually revised, it was possible for an LGU to retain the privileges for as long as ten years, despite its improved financial position. The term „special status“ has thus been driven to absurdity.

Fiscal equalization improvement through more efficient revenue sharing. The new act proposal offers a simpler, more understandable and more equitable definitions of the personal income tax sharing, fiscal equalization and decentralised functions financing systems. The new revenue sharing scheme enables all LGUs to provide comparable levels of public services at comparable levels of tax burden. Also, the personal income tax sharing model has been simplified. The entire personal income tax revenue is transferred to LGUs and distributed among them according to a general distribution formula, i.e. 60% of the total goes to municipalities and cities, 17% to counties, 6% is spent for decentralised functions and 17% for fiscal equalization. The funds earmarked for fiscal equalization will be used for financing the proposed new fiscal equalization model.

The new system relies on equalization of fiscal potential . Given its goal to eliminate the risks of harmful tax competition, reduced tax effort, etc., the system does not seek to equalize the actual levels of personal income tax and surtax revenues collected by LGUs, but to even up their fiscal potential (the maximum capacity for collecting the relevant tax revenues). This approach is consistent with both the theoretical knowledge and good practices in other countries. The proposed fiscal equalization model reduces disparities in fiscal capacity across LGUs, i.e. differences in their respective revenue collection potential. Given the predominance of personal income tax and surtax in the revenue structure of LGUs, the proposed model will mitigate inequalities arising primarily from different capacities of LGUs to collect personal income tax and surtax.

The clear goal of the new system is to equalize fiscal capacity. So far, the policy and instruments of fiscal equalization were identified with those of balanced regional development. Consequently, the sharing of personal income tax and surtax revenues was used for satisfying fiscal needs for the provision of public services, but also for meeting development, social welfare and other needs. It should therefore be emphasized that *the proposed fiscal equalization model is not aimed at targeting capital investments and promoting regional development, but at equalizing the fiscal capacities of LGUs in order to enable them to provide comparable levels of public services at roughly equal levels of tax burden. Therefore, future equalization grants will exclusively be current general-purpose grants. Regional development and demographic renewal should be stimulated through special-purpose grants governed by other laws, as well as the Regional Development Strategy involving the development index determination.*

Tax on savings interest becomes the revenue of LGUs. Another novelty is that the tax on savings interest which has so far constituted government revenue (standing at about HRK 369m in 2016) becomes the revenue of LGUs.

The equalization of decentralized functions is directly funded from budget transfers. Until 2017, equalization grants for decentralized functions were allocated from the 16% share of the item „equalization grants for decentralized functions“ in the personal income tax revenues. Under the new law, these funds will be allocated as state budget transfers.

The fiscal effects of the new Act. Once the proposed Act is implemented, the Government and the Ministry of Finance will transfer an additional HRK 1.5bn to LGUs. These funds will be allocated by functions under the budget sections of the Ministry of Science and Education, Ministry of Demographics, Family, Youth and Social Policy, Ministry of Health and Ministry of the Interior. The Act also envisages certain compensatory measures for local units suffering revenue losses (due to the implementation of the proposed Act), relative to the revenues collected under the current regulations. Additional amounts of about HRK 100m and HRK 50m in 2018 and 2019 respectively will be provided for such measures in the state budget.

The new Act envisages gradual implementation of measures to improve revenue sharing among LGUs. The Government and the Ministry of Finance deserve commendation for more efficient and transparent revenue sharing among LGUs and should be applauded for the proposed improved fiscal equalization model. Nevertheless, the Government is still faced with the challenge of reform of the country's administrative and territorial organization as a necessary prerequisite for further decentralisation.