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## The Croatian Ministry of Finance's Current Grants to Municipalities and Cities in the Areas of Special National Concern

In this paper we will use the example of Hrvatska Kostajnica to demonstrate how the Croatian Ministry of Finance allocates current grants to municipalities and cities in the Areas of Special National Concern, Groups I and II<sup>1</sup>. These are areas in which special incentive measures for reconstruction and development are applied, with a view to alleviating the consequences of war, facilitating the return of displaced population, encouraging demographic and economic growth and ensuring a balanced development of all regions in Croatia.

Two groups of the Areas of Special National Concern (ASNCs) were established in 1996, and a third one in 2002 (Official Gazette, No. 26/2003). Group I comprises 180, Group II 61 and Group III 69 municipalities and cities. Groups I and II were constituted according to the level of economic damage caused by the ravages of war. The third group areas are considered as underdeveloped according to four criteria: economic development, structural difficulties, demographic criterion and a special criterion.

While, since 2001, the central government has allocated almost all of its personal income tax and corporate income

tax revenues to municipalities and cities in the ASNCs, not all the municipalities and cities in these areas have had enough resources to provide adequate public services<sup>2</sup>. In order to, at least partially, achieve equality in providing public services between richer and poorer areas, the Ministry of Finance introduced current grants to municipalities and cities in the ASNCs.

**Purpose.** In the period from 2002 to 2007, current grants from the Ministry of Finance to municipalities and cities in the ASNCs were used to finance both *current and capital expenditures*. Table 1 shows the changes in the purpose of these grants.

**Criteria.** From 2002 on, the grant beneficiaries have only been municipalities and cities in the ASNCs Groups I and II, because the ASNCs Group III at that time did not yet exist. Table 2 shows the changes in alloca-

<sup>1</sup> Zakon o područjima posebne državne skrbi (Act on Areas of Special National Concern), Official Gazette (Narodne novine), Nos. 26/2003, 42/2005 and 90/2005.

<sup>2</sup> The government has also introduced various kinds of real estate transfer tax relief, lower corporate income tax rates for certain categories of taxpayers and other privileges to natural and legal persons.

**Table 1. The purpose of current grants from the Ministry of Finance to municipalities and cities in the ASNCs**

| Period    | Purpose of grants  |
|-----------|--|
| 2002-2004 | Adjusting fiscal capacities (possibilities/capabilities of municipality/city to raise revenues for public spending in the own territory), encouraging investment in capital programmes and promoting rationality |
| 2005-2008 | Financing material and energy expenditures and expenditures for capital programme investment   |

Sources: Annual State Budget Execution Acts.

tion criteria for these grants pursuant to the State Budget Execution Act.

There are many criteria, they are not clearly defined and are subject to frequent changes. Additional confusion is produced by a provision of the State Budget Execution Act for 2004 (Official Gazette 31/2004) stipulating that the grants should be provided in the amount of the dif-

ference between the estimated personal income tax refund based on the annual tax returns, paid from the central government budget on behalf of the municipalities and cities concerned, and the amount of grants calculated pursuant to the criteria defined in the annual State Budget Execution Acts (Table 2). Consequently, since a part of the personal income tax refund to taxpayers in the ASNCs is paid from the government budget instead from the respective budgets of municipalities or cities, the amount of the grant to a municipality/city is reduced by the amount of that refund.

As the allocation formula for the Ministry of Finance's current grants to municipalities and cities in the ASNCs has not to date been publicly explained, we will now offer a detailed explanation of the formula for 2008, by using the example of Hrvatska Kostajnica. The explanation can be summarized in six steps<sup>3</sup>. The calculation is always based on the data from two years before. In this case, the data have been taken from the PR-RAS (revenue/expenditure) forms for 2006<sup>4</sup>.

**Table 2. Criteria for the allocation of the Ministry of Finance's current grants to municipalities and cities in the ASNCs Groups I and II**

|     |   | 2002 | 2003 | 2004* | 2005-2008 |
|-----|---|------|------|-------|-----------|
| 1.  | Population according to the 2001 census   | +    | +    | +     | +         |
| 2.  | Average per capita revenue of municipalities and cities at the national level (national average) realised two years before                  | +    | +    | +     | +         |
| 3.  | Average per capita revenue of an ASNCs group and average per capita revenue of an individual municipality or city realised two years before | +    | +    | +     | +         |
| 4.  | Share of expenditures for capital programmes in total expenditure realised two years before   | +    | +    | +     | +         |
| 5.  | Rationality of the performance of the system's functions (number of employees, expenditures per employee), two years before                 | +    | +    | +     | +         |
| 6.  | Expenditures for the functions of the city (below 30,000 inhabitants)   | +    | +    | +     | +         |
| 7.  | Adjustment factor for a gradual transition to a new grant calculation model   | +    | +    | +     | -         |
| 8.  | Balancing out of material expenditures (population size and per capita expenditure) realised two years before                               | -    | +    | +     | -         |
| 9.  | Population density (per km <sup>2</sup> ) at the level of ASNCs Groups I and II (collective average)  | -    | -    | -     | +         |
| 10. | Population density (per km <sup>2</sup> ) of an individual municipality and city  | -    | -    | -     | +         |

(+) – the criterion is employed; (-) – the criterion is not employed.

\*Since 2004, these grants have been provided in the amount equal to the difference between the estimated personal income tax refunds based on the annual tax returns, which are paid from the central government budget on behalf of the municipalities and cities concerned, and the amount of grants calculated pursuant to the criteria defined in annual State Budget Execution Acts (Table 2).

Sources: Annual State Budget Execution Acts.

<sup>3</sup> The example of Hrvatska Kostajnica is used because this is one of the cities where all the allocation criteria for this type of grant are employed. Specifically, the criterion of funds for financing public utility and social services of a city with a population below 30,000 is only used for current grant calculation for 5 cities.

<sup>4</sup> Statement of revenues/expenditures and receipts/outlays; available at: <http://www.mfin.hr/str/55/>.

## Formula Explanation

### Step 1: Calculation of funds for fiscal capacity adjustment

The first step includes the identification of municipalities and cities with insufficient fiscal capacities and calculation of the amounts which they should receive on that account. Fiscal capacity can be defined as the ability of a municipality or a city to raise revenues for public spending in its own territory. According to the formula, the Ministry of Finance allocates additional funds to municipalities or cities with inadequate fiscal capacities. The formula for the calculation of the funds for fiscal capacity adjustment is as follows:

$$SKFK = \frac{FKS}{100} * \frac{FKD}{FK} * STPPDS * M * PMF1 \quad (1)$$

where:

- SKFK = funds for fiscal capacity adjustment
- FKS = average fiscal capacity per capita of a group of ASNCs<sup>5</sup>
- FKD = average fiscal capacity per capita of all municipalities and cities<sup>6</sup>
- FK = fiscal capacity per capita of the observed municipality or city<sup>7</sup>
- STPPDS = population of the observed municipality or city<sup>8</sup> in an ASNC
- M = group multiplier<sup>9</sup>
- PMF1 = Ministry of Finance's weight<sup>10</sup>.

The funds necessary for the fiscal adjustment of Hrvatska Kostajnica (which belongs to ASNC Group I) in 2008 are calculated as follows:

$$SKFK = \frac{1897.11}{100} * \frac{3134.78}{2148.07} * 2746 * 1.65 * 4.5 =$$

$$18.97 * 1.459 * 2746 * 1.65 * 4.5 = 564,312 \text{ kuna.}$$

It follows that in 2008, Hrvatska Kostajnica should receive a current grant for fiscal capacity adjustment in the amount of about 565 thousand kuna.

<sup>5</sup> This can be an ASNC of Group I or II. The average fiscal capacity per capita of an ASNC group = [current revenues of municipalities and cities from the observed group of ASNCs (Chart of Accounts 6 + 7) – grants of municipalities and cities covered by the observed ASNC group (Chart of Accounts 63)]/total population of municipalities and cities covered by the observed ASNC group.

<sup>6</sup> This indicator is calculated in the same manner as the FKS, only for a different area (i.e. all municipalities and cities).

<sup>7</sup> This indicator is calculated in the same manner as the FKS, only for a different area (i.e. the observed municipality or city).

<sup>8</sup> In the case of an ASNC Group I – total population, and in the case of an ASNC Group II – the population in the communities belonging to an ASNC. According to the Central Bureau of Statistics data, the data from the 2001 census are used.

<sup>9</sup> M = FKD/FKS.

<sup>10</sup> For 2008, it is 4.5. It changes depending on the volume of funds disposable for this type of grant. For the three previous years, the weight was 3.

### Step 2: Capital investment promotion funds

In the second step, we identify the municipalities and cities in an ASNC which made major capital investments (two years before) and we determine the amounts to be allocated to these units by the Ministry of Finance as aid for financing part of these investments. The calculation formula for capital investment promotion funds is as follows:

$$SPKU = \frac{FKD}{FKS} * STPPDS * KIUI * PMF2 * \frac{FKD}{FK} * X * PMF3 \quad (2)$$

where:

- SPKU = capital investment promotion funds
- FKD = average fiscal capacity per capita of all municipalities and cities
- FKS = average fiscal capacity per capita of an ASNC group (I or II)
- STPPDS = population of the observed municipality or city in an ASNC
- KIUI = share of capital expenditures in total expenditures of a municipality or city<sup>11</sup>
- FK = fiscal capacity per capita of the observed municipality and city
- PMF2 = Ministry of Finance's weight<sup>12</sup>
- PMF3 = Ministry of Finance's weight<sup>13</sup>
- X = if the share of capital outlays in grants received<sup>14</sup> ≤ 1, then x = share of capital outlays in grants received; if the share of capital outlays in grants received > 1, then x = 1.1.

The funds needed for promoting capital investments in Hrvatska Kostajnica are calculated as follows:

$$SPKU = \frac{3134.78}{1897.11} * 2746 * 0.07 * 10 * \frac{3134.78}{2148.07} *$$

$$0.26 * 15.5 = 1.65 * 2746 * 0.07 * 10 * 1.459 * 0.26 * 15.5 = 18,648.45 \text{ kuna.}$$

<sup>11</sup> The share of capital expenditures in total expenditures = [capital grants to foreign governments (Chart of Accounts 3612) + capital grants to international organisations (Chart of Accounts 3622) + capital grants within the general government (Chart of Accounts 3632) + capital donations (Chart of Accounts 382) + capital grants (Chart of Accounts 386) + expenditures for the purchase of non-financial assets (Chart of Accounts 4)] / total expenditure (Chart of Accounts 3 + 4).

<sup>12</sup> The Ministry of Finance's weight that is not subject to changes; its value is 10.

<sup>13</sup> For 2008, it is 15.5. It changes depending on the volume of funds disposable for this type of grant. For the three previous years, the weight was 10.

<sup>14</sup> The share of capital outlays in grants received = [capital grants to foreign governments (Chart of Accounts 3612) + capital grants to international organisations (Chart of Accounts 3622) + capital grants within the general government (Chart of Accounts 3632) + capital donations (Chart of Accounts 382) + capital grants (Chart of Accounts 386) + expenditures for the purchase of non-financial assets (Chart of Accounts 4)]/grants from abroad (deeds of donation) and from entities within the general government (Chart of Accounts 63).

It follows that in 2008, Hrvatska Kostajnica should receive a current grant for capital investment promotion in the amount of about 19 thousand kuna.

### Step 3: Funds for the rationalisation of outlays for employees

The third step includes the identification of municipalities and cities with low outlays for employees and determination of the amounts to be allocated to these units by the Ministry of Finance for financing part of these outlays. The aim is to provide assistance to the municipalities and cities whose outlays for employees are below 75% of the national average (of all municipalities and cities). The formula for the calculation of funds for the rationalisation of outlays for employees is as follows:

$$SRIZ = (0.75 * DIZ) * MBZ * K * PMF4 \quad (3)$$

where:

SRIZ = funds for the rationalisation of outlays for employees

DIZ = average outlays per employee of all municipalities and cities<sup>15</sup>

MBZ = potential number of employees<sup>16</sup>

K = adjustment factor<sup>17</sup>

PMF4 = Ministry of Finance's weight<sup>18</sup>

The funds needed for the rationalisation of outlays for employees in Hrvatska Kostajnica are calculated as follows:

$$SRIZ = (0,75 * 112,196.91) * 3 * \frac{0.75 * 112,196.91}{54,981.50} *$$

$$0.25 = 84.147.68 * 3 * 1.53 * 0.25 = 96,559.46 \text{ kuna.}$$

In 2008, Hrvatska Kostajnica should receive a current grant for the rationalisation of outlays for employees in the amount of about 96 thousand kuna.

### Step 4: Funds for financing public utility and social services in cities with a population below 30,000

Although the law does not provide for separate treatment of the functions of cities and municipalities in the Ministry of Finance analyses, the fact is that cities have more functions and also some additional ones. Therefore, a special criterion of facilitating the provision of public

<sup>15</sup> Average outlays per employee = outlays for employees in the financed bodies (additional data – Chart of Accounts 31)/average number of employees in the financed bodies, as at the end of the reporting period (additional data – whole number).

<sup>16</sup> The potential number of employees is 1 per 970 inhabitants. A municipality or city with less than 970 inhabitants is entitled to a minimum of 3 employees.

<sup>17</sup> Adjustment factor =  $(0.75 * DIZ) / \text{outlays per employee in the observed municipality or city}$ .

<sup>18</sup> The Ministry of Finance's weight not subject to changes; its value is 0.25.

utility and social services is only applied to cities with a population below 30,000. The formula for the calculation of funds for financing public utility and social services in cities with a population below 30,000 is as follows:

$$SPFG = \left( \frac{IFG}{DIFG} * KVG * PMF5 * STPPDS * \frac{STPPDS}{ST} \right) * PMF6 \quad (4)$$

where:

SPFG = funds for financing the functions of a city

IFG = per capita outlays for financing the functions of a city<sup>19</sup>

DIFG = average per capita outlays for financing the functions of all municipalities and cities

KVG = city size coefficient<sup>20</sup>

PMF5 = Ministry of Finance's weight<sup>21</sup>

STPPDS = population of the observed municipality or city in an ASNC

ST = total population of the observed municipality or city

PMF6 = Ministry of Finance's weight<sup>22</sup>.

The funds needed for financing the public utility and social services of Hrvatska Kostajnica are calculated as follows:

$$SPFG = \left( \frac{510.02}{504.83} * \left[ \left( \frac{30,884}{5} \right) / 2746 \right] * 100 * 2746 * \right.$$

$$\left. \frac{2746}{2746} \right) * 2 = (1.01 * 2.25 * 100 * 2746 * 1) * 2 =$$

$$1,248,057 \text{ kuna.}$$

In 2008, Hrvatska Kostajnica should receive a current grant for the financing of its public utility and social services in the amount of about 1.2 million kuna.

### Step 5: Funds for underpopulation

The application of this criterion should ensure the allocation of larger amounts of current grants to underpopulated municipalities and cities in the ASNCs, Groups I and II. The following calculation formula is applied:

<sup>19</sup> Per capita outlays for the functions of a city = [subsidies (Chart of Accounts 35) + grants provided to foreign countries and within the general government (Chart of Accounts 36) - capital grants to foreign governments (Chart of Accounts 3612) - capital grants to international organisations (Chart of Accounts 3622) + insurance-based compensation to individuals and households and other compensation (Chart of Accounts 37) + current donations (Chart of Accounts 381)]/total population of a city.

<sup>20</sup> City size coefficient = (total population of all the cities in the observed group/ number of cities in the group)/population of the city living in the ASNCs.

<sup>21</sup> The Ministry of Finance's weight not subject to changes. Its value is 100.

<sup>22</sup> For 2008, its value is 2. The weight was introduced in 2005, when it stood at 1.5. In 2006, its value was 2.5 and in 2007 it was 2.

$$SGN = \frac{GNS - GNPPDS}{GNS} * PMF7 \quad (5)$$

where:

- SGN = funds for grants for underpopulation
- GNS = average population per km<sup>2</sup> of the observed group of municipalities and cities<sup>23</sup>
- GNPPDS = population per km<sup>2</sup> of the observed municipality or city<sup>24</sup> in an ASNC
- PMF7 = Ministry of Finance's weight<sup>25</sup>

This criterion is only applied to the units in which the population per km<sup>2</sup> of a municipality/city is lower than the average population per km<sup>2</sup> of the observed ASNC group of the municipalities or cities. Hrvatska Kostajnica should not receive a current grant from the Ministry of Finance based on the population density criterion, because its population density of 59.5 inhabitants/km<sup>2</sup> exceeds the average for the observed ASNC Group I (23.4 inhabitants/km<sup>2</sup>).

### Step 6: Final amount assessment

In the last step, the funds that should be allocated to a municipality/city based on the five specified criteria are added together and then the sum is reduced by the estimated personal income tax refund.

According to the five criteria, Hrvatska Kostajnica is entitled to the amount of 1.9 million kuna<sup>26</sup>. According to the Ministry of Finance estimate, it will receive 1.7 million kuna on account of a personal income tax refund<sup>27</sup> for 2008. It follows that the final amount of the current grant to be provided by the Ministry of Finance to Hrvatska Kostajnica in 2008 will be about 216 thousand kuna.

### Conclusion

The allocation formula for current grants to municipalities and cities in ASNCs, Groups I and II is rather complicated and, we could say, non-transparent. The allocation criteria are changed by annual State Budget Execution Acts, which makes it difficult to prepare triennial budget plans for local government units in an ASNC and, consequently, for Hrvatska Kostajnica. Therefore, it is impossible for any local government unit in an ASNC, including Hrvatska Kostajnica, to foresee

the amount of the current grant for the next fiscal year. Even if all the variables in the formula were known, it would be impossible for municipalities and cities to estimate the amount of personal income tax refund.

The Ministry of Finance should ensure clear-cut and stable criteria and a simple allocation formula for current grants. In particular, it should regularly publish any changes in the formula (notably the changes in weights and the estimated personal income tax refund). On the basis of this analysis it is difficult to say whether Hrvatska Kostajnica received a sufficient amount of the current grant to provide adequate public services. This would necessitate more profound analyses of fiscal capacities and needs of all municipalities and cities (and not only those in the ASNCs Groups I and II). Only after the fiscal capacities and needs of all municipalities are estimated would it be possible to assess the adequacy of the calculated amount of the grant to Hrvatska Kostajnica and the justifiability of its privileged financing (or even its status as part of an Area of Special National Concern).

### Appendix: Grants in Croatia

*Grants* are defined as funds received by one government unit from another government unit or an international institution that are not supposed to be repaid or compensated for. In most cases, higher-level units of government provide grants to lower-level units of government. However, grants can also be provided between the units of the same level, e.g. between cities.

*Current grants* are funds that should be spent for current outlays/expenditures. In Croatia, there are six types of current grants to counties, municipalities and cities:

1. equalisation grants for decentralised functions;
2. current grants provided by the Ministry of Finance to municipalities and cities in the Areas of Special National Concern, Groups I and II;
3. current grants provided by the Ministry of Finance to counties;
4. current grants provided by other ministries and central government institutions;
5. budgetary reserves and compensation for damage caused by natural disasters; and
6. current grant as a substitute for revenues from corporate income tax.

*Capital grants* are generally intended for the purchase of fixed assets. The classification of grants into current and capital grants is not enough precise, because current grants are sometimes used in practice for capital purposes. For more details about grants, see *Newsletter No. 30* of the Institute of Public Finance (available at: <http://www.ijf.hr/eng/newsletter/30.pdf>).

<sup>23</sup> The average population per km<sup>2</sup> of the observed ASNC group (I or II) of municipalities and cities = population of the observed group/area in km<sup>2</sup> of the observed municipalities and cities.

<sup>24</sup> Population per km<sup>2</sup> of the observed municipality or city in a ASNC = population of the relevant municipality or city (for Group I: total population; for Group II: population of the units belonging to an ASNC)/area in km<sup>2</sup> of the observed municipality/city.

<sup>25</sup> The Ministry of Finance's weight not subject to changes. Its value is 1,000,000.

<sup>26</sup> 1,927,577 = 564,312 + 18,648.45 + 96,559.46 + 1,248,057 + 0.

<sup>27</sup> 1,712,049.

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