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PRESS RELEASES

Package of legislative amendments for a better Croatian regional policy

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On November 14, 2013 the Government sent to parliamentary procedure for amendments under an emergency procedure **five laws which specifically govern the allocation of tax reliefs and grants from the government budget to underdeveloped local government units. For a more comprehensive solution to the distribution of grants, preferential tax status and in particular the distribution of tax revenue the Government should change the existing Proposal of the Act on Execution of the State Budget for 2014 and the Law on Financing of Local and Regional Self-Government.**

Classification of local government units according to development index

In Croatia, the specific laws established Areas of Special State Concern (ASSC), Hill and Mountain areas (HMA) and the City of Vukovar as areas whose development is particularly supported by the state. However, the criteria for receiving the ASSC and HMA status were generally not associated with the actual socio-economic indicators. Therefore, the preferential status was also given to economically more developed (above average) local government units. The Law on Regional Development (Official Gazette 159/2009) introduced the assessment and classification of local government units according to development index. Thus, the Government abandoned the concept of ASSC and HMA in 2009 and classified all local government units according to the value of development index into five groups presented in table 1. Supported areas are those classified into groups I and II according to development index. These are also the areas that deserve special attention in assigning tax reliefs, allocating grants from the state budget and tax sharing.

Changes in regulations and the development index

Four years after the enactment of the Law on Regional Development and the calculation of the first development indexes the Government is changing Corporate Income Tax and Personal Income Tax Acts, the Law on Areas of Special State Concern, the Law on Hill and Mountain areas and the Law on Reconstruction and Development of the City of Vukovar. Through these amendments the Government strives to harmonize tax reliefs and distribution of grants to local government units with their level of development measured by the development index. Proposed legislative changes directly affect the need for changes in the distribution of the personal income tax revenue as well as changes in the criteria for allocation of grants from the state budget.

The main changes are:

Grants to local government units in the ASSC and HMA. Existing grants from the state budget allocated to local government units in the ASSC and HMA in the amount of corporate income tax generated in their area will be redirected to local government units according to the development index. Thus, the local

government units in groups I and II (supported areas) will obtain the right to the entire income tax revenue, in group III to aid in the amount of 75%, in group IV 60% and in group V 40% of income tax revenue (see table 1) collected in their area.

Table 1 Areas according to development index and the amount of grant based on the share of corporate income tax revenue collected

| Group | Development index in relation to the Croatian average (%) | Amount of grant in % of revenue collected from corporate income tax |
|-------|---|---|
| I | less than 50 | 100 |
| II | 50-75 | 100 |
| III | 75-100 | 75 |
| IV | 100-125 | 60 |
| V | more than 125 | 40 |

Changes in the basic personal allowance. The amendments to the Personal Income Tax Act propose to repeal the right to an increased basic personal allowance for taxpayers in the ASSC and HMA (except for the City of Vukovar). In parallel with the abolition of the increased basic personal allowance for ASSC and HMA, it is introduced for supported areas and the City of Vukovar. Taxpayers who have a permanent residence and live in the local units classified into the first group by the level of development and in the Vukovar area could use the personal allowance in the amount of HRK 3,200 per month and those in the area of local units classified into the second group in the amount of HRK 2,700 per month.¹ An increase of the basic personal allowance in these areas will have a negative impact on their budgets as it will lead to a reduction of income tax collected. So far the state has regularly taken on an income tax return (used by taxpayers to claim the right to an increased basic personal allowance) in the ASSC and HMA. Therefore, the amount of the basic personal allowance has not had a direct impact on the local governments' budgets. The state should take on an income tax return for the supported areas in future Acts on Execution of the State Budget.

Additional amendments required

Besides amendments to the Act on the Execution of the State Budget, in order to more clearly implement the provisions of the proposed legislative amendments and mitigate fiscal inequalities between local government units, the Government should also amend the Law on Financing of Local and Regional Self-Government.

It is necessary to modify the provisions of the *Law on the Execution of the State Budget for 2014* which prescribe the allocation of grants to local and regional governments in the section 025 - the Ministry of Finance according to the status of the ASSC I and II. The distribution of these grants does not necessarily have to rely on the development index used for the regional development policy. On the contrary, it might be used for mitigation of local fiscal inequalities arising because of different fiscal capacities and decentralized liabilities assumed at the lower levels government.

Amendments to the *Law on Financing of Local and Regional Self-Government* are necessary because the Government has neglected the current tax sharing arrangements. Current Law provides for an increased share of personal income tax revenue for local government units in the ASSC and HMA, and liberation of local government units on the islands with an agreement on joint financing of capital projects for the development of the island from filling the equalisation fund for the decentralized functions with the share of the personal income tax revenue. Now is the right time to introduce a uniform tax sharing scheme for all local government units (regardless of the level of development). According to the proposed tax sharing system all local government units (now even those that were in the ASSC and HMA) would transfer part of their personal income tax revenue into the equalization fund for decentralized functions. In line with the existing provisions of the Law, local government units in the AGCS and HMA, as well as those on the islands with an agreement on joint financing of capital projects for the development of the island do not currently finance the equalization fund for decentralized functions. Counties would also benefit from the new tax sharing arrangement through a larger share of the personal income tax revenue.

¹ So far, the increased basic personal allowance was determined according to the status in the certain group of ASSC or HMA. Taxpayers in the ASSC group I have used an increased basic personal allowance of 3,840, group II 3,200 and group III and HMA HRK 2,400 per month.

The proposed package of five laws more precisely regulates the allocation of grants and preferential treatment of local government units based on differences in the level of economic development according to development index. This is a significant improvement for the implementation of regional policy which has so far often been conducted within the scope of the fiscal equalisation policy and vice versa. Therefore, the instruments and the objectives of these policies often clashed, and the effects neutralized at a high cost to the state budget. The introduction of a simple and transparent system of fiscal equalization based on appropriate criteria and fiscal instruments remains a challenge for the Government.