

# Are All the Municipalities and Cities in Croatia Able to Provide Adequate Public Services?

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# NEWSLETTER

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## Are All the Municipalities and Cities in Croatia Able to Provide Adequate Public Services?<sup>1</sup>

**Croatia is made of central government and local units** [the 21 counties (including the city of Zagreb), 429 municipalities and 126 cities].

**Every level of government has to perform certain public activities, and for this reason it is allocated certain revenues.** Process of fiscal decentralisation devolved responsibilities for certain revenues and expenditures from central government to the counties, municipalities and cities. Thus a question logically arises: are the local units (the counties, municipalities and cities) capable of providing adequate public services themselves?<sup>2</sup> Current per capita expenditures are a good indicator of the quantity of public services, and thus it is useful to consider the differences between municipalities and cities.

**The differences in current per capita expenditures in 2005 – as indicator of the adequacy of public services – among the municipalities and cities in Croatia are significant (see Table 1).** The lowest current per capita expenditures were found in the municipality of Darda in Osječko-baranjska County (123 kuna) and the highest in the municipality of Povljana in Zadarska County (over

17,000 kuna). The per capita average current expenditure for all municipalities and cities was about 1,700 kuna.

**Central government should provide at least the minimum or standard public services in all municipalities and cities.** Since in the municipality of Darda current expenditures are much smaller than the average, it is obvious that central government should help it to achieve at least some minimum current expenditures (for example, 75% of the Croatian average). In practice, it is difficult to provide the same level public services in all local units, but central governments usually do their best to see that all local units provide at least the minimum or standard public services, which depends on policies and vary from country to country.

### 1. How to help municipalities and cities that cannot provide adequate public services?

**In order to help municipalities and cities that do not have sufficient revenue to provide adequate public services, it is needful to know what their fiscal capac-**

<sup>1</sup> This Newsletter draws on the paper of Bajo and Bronić, 2007. Assessments of the Effectiveness of the Croatian Fiscal Equalisation Model. Financial Theory and Practice, 31, (1), 2007, 1-24. Available at <http://www.ijf.hr/eng/FTP/2007/1/bajo-bronic.pdf>

<sup>2</sup> The paper analyses the level of cities and municipalities. The same kind of analysis could be carried out for the county level.

**Table 1. Current per capita expenditures at the municipality and city level in 2005 (in kuna)**

County	Municipality or city		Ratio of max/min
	minimum	maximum	
Bjelovarsko-bilogorska	335	1,721	5
Brodsko-posavska	276	1,410	5
Dubrovačko-neretvanska	390	6,235	16
Istarska	1,127	11,232	10
Karlovačka	553	2,889	5
Koprivničko-križevačka	381	4,377	11
Krapinsko-zagorska	440	1,725	4
Ličko-senjska	1,117	6,586	6
Međimurska	339	1,986	6
Osječko-baranjska	123	7,568	61
Požeško-slavonska	410	1,647	4
Primorsko-goranska	1,656	9,968	6
Sisačko-moslavačka	523	2,881	6
Splitsko-dalmatinska	386	7,832	20
Šibensko-kninska	616	2,924	5
Varaždinska	252	6,965	28
Virovitičko-podravaska	349	1,675	5
Vukovarsko-srijemska	424	1,857	4
Zadarska	726	17,121	24
Zagrebačka	412	3,461	8
City of Zagreb	5,300		

Source: calculation on the basis of Finance Ministry figures.

ities are (what capacity they have to gather revenue from their own sources) and what their needs for expenditures are. It is obvious that the ability to provide public services depends to a large extent on the funding capacities, that is, on the revenue that the given municipality or city can raise. A good indicator of the capacities of municipalities and cities to collect revenue from their own sources is per capita gross personal income.<sup>3</sup> In 2004 there were considerable differences in the distribution of per capita gross personal incomes<sup>4</sup> in the municipalities and cities (see Table 2).

**Very clearly, there are great differences in the capacities of municipalities and cities in the collection of revenue.** One of the largest per capita gross personal income on the level of cities and municipalities was recorded in the city of Varaždin (30,000 kuna) and the smallest in the municipality of Zrinski Topolovac (1,500 kuna). Thirty per cent of cities and municipalities had a per capita gross personal income of less than 75% of the average. These were the main candidates that the Government and the Finance Ministry should support more substantially by tax sharing and current grants.

**The aim behind tax sharing and grants from central government is at least partially to achieve an equality of public services in the richer and the poorer local units.** Tax sharing is a system in which one level of government (most often central govern-

**Table 2. The distribution of per capita gross personal income in the cities and municipalities in 2004, in kuna**

	Cities and municipalities, total	%	Cities and municipalities with the special financing status	%	Other cities and municipalities	%
above 20,000	141	26	63	23	78	29
16,000 - 20,000	106	19	54	20	52	19
12,000 - 16,000	135	25	60	22	75	28
8,000 - 12,000	117	21	66	24	51	19
Up to 8,000	47	9	31	11	16	6
Total	546	100	274	100	272	100
average = 16,000						
above average	247	45	117	43	130	48
below average	299	55	157	57	142	52
below 75% of the average	164	30	97	35	67	25

Cities and municipalities with the special financing status = cities and municipalities in the areas of special national concern, hill and mountain areas and cities and municipalities on islands that have entered into agreements to jointly finance capital projects.

Source: calculated from Finance Ministry figures.

<sup>3</sup> Figures concerning per capita gross personal incomes were obtained from the Tax Administration on the basis of a sample covering 5% of the population of cities and municipalities that earned income subject to taxation according to the provisions of the Personal Income Tax Law (about 120,000 people).

<sup>4</sup> Personal income including personal income tax.

ment) collects revenue from one or more taxes and then divides the revenue subsequently with lower levels of government. In Croatia, personal income tax and the real estate transfer tax are shared.

Grants are resources from one government unit to another, which has no obligation either to return them or give any kind of compensation. Most often, higher levels of government allocate grants to lower levels, but it is possible that, for example, a city might give a grant to another city or a municipality.

The financing of municipalities, cities and counties in Croatia is founded to a large extent on the sharing of taxes, particularly of personal income tax, and on grants from the central government budget. According to Finance Ministry figures in the 1995-2005 period, revenues from shared taxes and current grants comprised about 60% of total revenue of municipalities, cities and counties.

However, there are very many problems related to personal income tax sharing and the allocation of current grants.

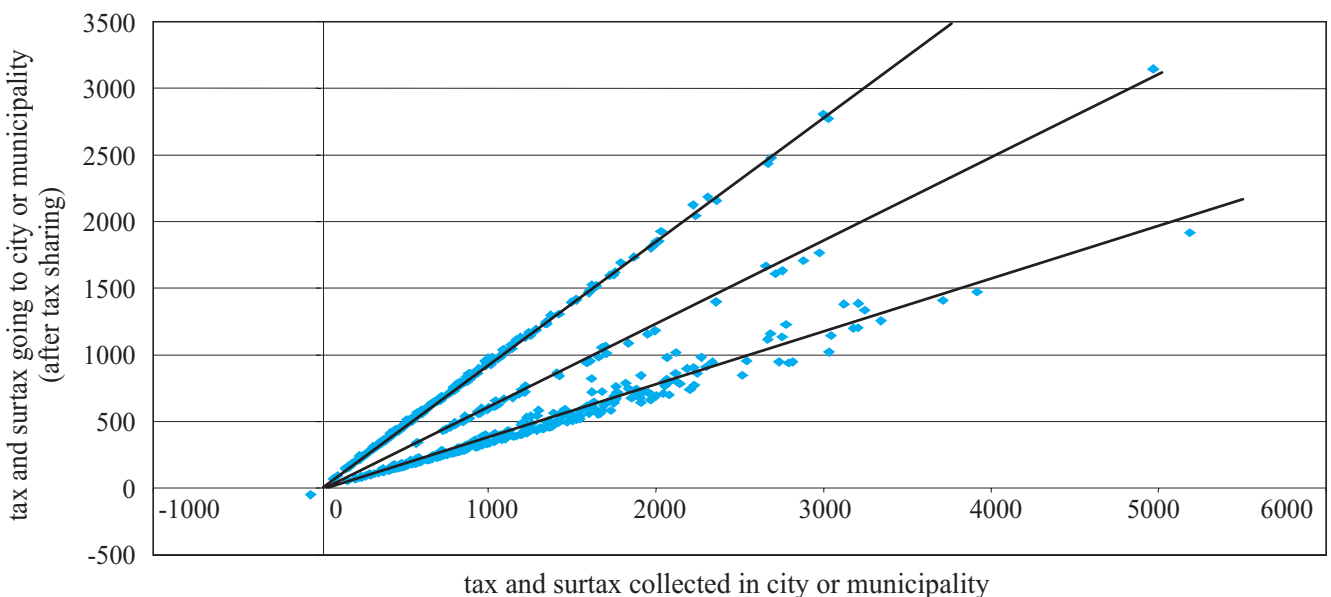
## 2. Personal income tax sharing in Croatia

**Since 1993, central government has shared certain tax revenues with the counties, municipalities and**

**cities, while the manner of the sharing has changed a number of times.** Personal income tax sharing, which produces the greatest tax revenue for cities and municipalities, is highly complicated<sup>5</sup>, but the most important characteristics at the level of municipalities and cities can be shown in the following graph.

**The sharing of personal income tax and surtax mostly helps the cities and municipalities with the special financing status (areas of special national concern, the hill and mountain areas and the local units on the islands that have entered into agreements to jointly finance capital projects).** Every point on Graph 1 shows how much per capita revenue from personal income tax was collected in a given municipality or city and how much accrued to them after tax sharing. On the line closest to the y-axis (vertical) are the cities and municipalities in the areas of special national concern, the hill and mountain areas. In the centre are the cities and municipalities on the islands that had made agreements with each other to finance capital projects. On the line closest to the x-axis (horizontal) are the cities and municipalities without any special position in the financing system. For example, Marija Bistrica, a municipality (which is not with the special financing status), the city of Vis (an island local unit that has entered into a capital financing agreement) and the city Hrvatska Kostajnica (with the special financing status) each collected about 1,000 kuna personal income tax

Graph 1. Sharing personal income tax and surtax on personal income tax between central government and cities and municipalities per capita in 2004, in kuna.



<sup>5</sup> For more on the personal income tax sharing see Bronic, M. 2007. Personal Income Tax and Surtax Sharing in Croatia. Newsletter, no. 27, 2007. Available at <http://www.ijf.hr/eng/newsletter/27.pdf>

and surtax per capita. After the redistribution Marija Bistrica (on the line closest to the x-axis) received 300, Vis (on the central line) 600, and Hrvatska Kostajnica (on the lines closest to the y-axis) about 1,000 kuna of income tax and surtax per capita.

**However, the personal income tax sharing should not depend upon the area in which some municipality or city lies, rather on its fiscal capacity (its capacity to raise revenue from its own sources).** For all the cities and municipalities with the special financing status do not have small fiscal capacities. Table 2 shows that of the 274 cities and municipalities that are with some special financing status, 117 of them, or 43%, have above-average per capita gross personal income. These cities and municipalities have above-average abilities to collect revenue, and the central government should not help them more than other cities and municipalities, outside special financing status, that yet have equal fiscal capacities. On the other hand, there are numerous cities and municipalities with lower average per capita gross personal incomes that really need assistance, and which the central government does not help, because they are not located in any of these specially treated areas. Table 2 shows that of the 272 cities and municipalities not included in any special financing system as many as 67 of them should be candidates for greater assistance from the central government budget, since they have a per capita gross personal income lower than 75% of the average at the level of cities and municipalities.

### 3. Lack of clarity in the allocation of current grants

Central government also helps local units with current grants,<sup>6</sup> but because of the unclear and unpredictable allocation criteria, these grants are not effective.

In Croatia, there are six types of current grants to counties, cities and municipalities:

1. Grants from equalisation fund for decentralised functions,
2. Current grants of the Finance Ministry to cities and municipalities belonging to 1<sup>st</sup> and 2<sup>nd</sup> group areas of special national concern,
3. Current grants of the Finance Ministry to counties which then according to their own criteria send part of these grants to cities and municipalities in

their territory that are not in the 1<sup>st</sup> and 2<sup>nd</sup> groups of the areas of special national concern,

4. Current grants from other ministries and institutions of central government,
5. Budgetary reserves and compensation for damage brought about by natural disasters and
6. Current grants as substitute for corporate income tax revenue.

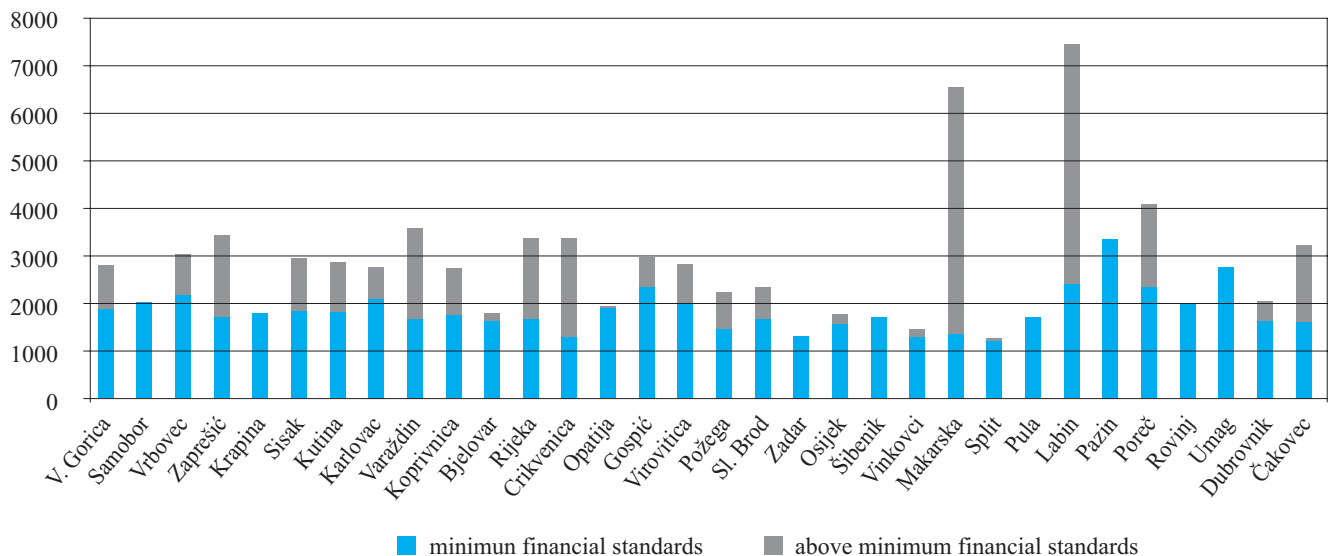
**1. Grants from equalisation fund for decentralised functions.** Since 2001, for the 53 local units (cities, municipalities and counties) that have taken on the obligation to finance decentralised functions (elementary and secondary education, health care, welfare) and for the 126 cities and municipalities that have founded and finance fire services, the government has provided an extra share in the personal income tax. For units that have assumed the decentralised functions and from the extra share in personal income tax have not obtained enough resources to bring them up to the minimum financial standard level government provides grants. The government, at the recommendation of the relevant ministries (of health, science, education and sport, welfare) sets the minimum financial standards every year, meaning the costs of carrying out some activity. In defining these standards, the ministries have to take into account the different needs of local units for public expenditures. For example, the criterion for the allocation of resources to cover material and financial expenditures in secondary schools and pupil hostels is the number of pupils enrolled multiplied with the average annual cost per pupil. The average annual cost is determined annually for each individual local unit.

**However, it is not clear how these financial standards for the decentralised functions are calculated, nor is it clear on what figures they are based.** For example figures on which the calculation of the average cost per pupil in given local units is based are not published. Graph 2 shows that there are important differences in the cities in the minimum financial standard per pupil and that this calculation need to be reconsidered or explained to the public.

**2. Current grants of the Finance Ministry to cities and municipalities belonging to 1<sup>st</sup> and 2<sup>nd</sup> group areas of special national concern.** These are allocated to local units with below-average abilities to collect revenue from their own sources. **But there are many**

<sup>6</sup> The paper analyses only current grants, although the issue of capital grants is just as important, wide and interesting a theme.

Graph 2. Expenditures up to and above the minimum financial standards of elementary schools per pupil in 2005 (distribution among cities in kuna)



Source: Model for introduction of compulsory secondary education, 2007. Zagreb: Ivo Pilar Social Sciences Institute and Institute of Public Finance.

criteria, they change frequently, and are far from clear (see Table 3). Nowhere, for example, is the public told what is meant by the criterion stated as “expenditures for the functions of a city (below population of 30,000)”, or how this is used in a formula. No formula for the allocation of these grants has ever been published. What does this all look like?

### 3. The current grants that the Finance Ministry allocates to counties, which then according to their own

criteria send part of these grants to their own cities and municipalities that are not in the 1<sup>st</sup> and 2<sup>nd</sup> areas of special national concern. These are meant for local units that have below-average abilities to collect revenue from their own sources. The counties can use part of the grant for their own needs, and part, according to criteria they establish themselves, is sent on to their own cities and municipalities that are not in 1<sup>st</sup> and 2<sup>nd</sup> areas of special national concern. **The criteria for the**

Table 3. Criteria for the allocation of current grants from central government to cities and municipalities in the areas of special national concern from 2002 to 2007

	2002.	2003.	2004.	2005.	2006.	2007.
1. Population according to 2001 census	+	+	+	+	+	+
2. Average per capita revenue of cities and municipalities at national level	+	+	+	+	+	+
3. Average per capita revenue of the areas of special national concern group (individual cities or municipalities)	+	+	+	+	+	+
4. Expenditure for capital programmes expressed as share of total expenditure	+	+	+	+	+	+
5. Rationality of performance of the functions of the system (number of employees, expenditure per employee)	+	+	+	+	+	+
6. Expenditure for the functions of a city (below population of 30,000)	+	+	+	+	+	+
7. Adjustment factor for gradual transition to new model of calculating grants	+	+	+	-	-	-
8. Balancing material expenditures (population size and per capita expenditure)	-	+	+	-	-	-
9. Population density (per km <sup>2</sup> ) at 1 <sup>st</sup> and 2 <sup>nd</sup> group areas of special national concern level (collective average)	-	-	-	+	+	+
10. Population density (per km <sup>2</sup> ) of a given municipality or city	-	-	-	+	+	+

+ the criterion is employed, - the criterion is not employed.

Source: Laws concerning the Execution of the Central Government Budget. Zagreb: Official Gazette.

**allocation of these grants are not clear.** The public has never been shown the formula according to which the Finance Ministry allocates these grants to the counties, nor has it seen how the counties decide to redistribute the grants to their own cities and municipalities.<sup>7</sup>

**4. Current grants of other ministries and institutions of central government also have no clear criteria.**

Neither the size nor the structure of current grants from, for example, the Ministry of Culture or the Ministry of the Sea, Tourism, Transportation and Development to a given county, municipality or city, is known to the public. In the national budget, all that can be determined is that a certain amount of these current grant was earmarked for a given project. But to what municipality, city or county it was paid is not shown.

5. In the central government budget, there is no specification of exactly how **budgetary reserves and compensation for damage caused by natural disasters are spent, and it is not clear where this money went, and why.** For example, in the draft of the central government budget for 2007 it says that in 2005, 315 million kuna were spent for budgetary reserves, but there is no indication of how much was paid to whom, or why.<sup>8</sup>

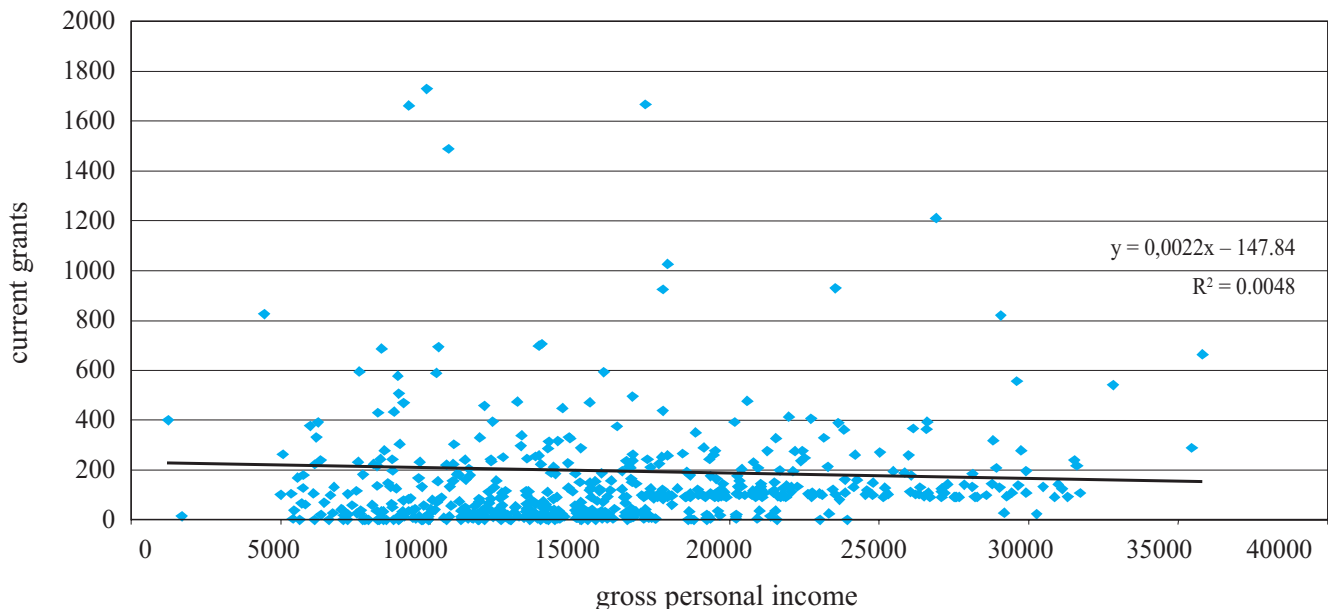
6. Since from 2007 corporate income tax is no longer shared with the local units, the Government decided to pay **current grants from the central government budget equivalent to the corporate income tax** that should have been paid in municipalities and cities in the areas of special national concern and the hill and mountain areas. In the central government budget for 2007, 287 million kuna was earmarked for this purpose, but the local units that were to receive it were not specified.

**4. Has the central government managed with its current grants to help the cities and municipalities?**

Graph 2 shows the distribution of annual gross personal income and current grants<sup>9</sup> per capita of cities and municipalities in 2004.

**Central government did not manage, via its current grants, to palliate to any significant extent the inequalities in gross personal income of cities and municipalities.** Every dot on Graph 2 shows gross personal income and the total amount of current grants per capita of a given city or municipality. It would be logical for

Graph 2. Gross personal income and current grants per capita of cities and municipalities in 2004, in kuna



<sup>7</sup> Additional confusion brought into the definition of criteria for these current grants is the provision of the Execution of the Central Government Budget Law (Official Gazette 31/04) according to which these current grants are provided for units in the areas of special national concern and the hill and mountain areas in the amount of the difference of the estimated refund of personal income tax according to the annual return for the previous year (which a given local unit in the areas of special national concern or the hill and mountain areas should refund) and the amount of these current grant calculated on the basis of criteria from the Execution of the Central Government Budget Law for each year. For this tax refund to personal income tax payers in the areas of special national concern and the hill and mountain areas is actually made by the central government budget and not the local unit, and then the amount of these current grant to the local unit is reduced by the same amount.

<sup>8</sup> Figures do exist in the Finance Ministry but they are not made public.

<sup>9</sup> Amounts of grants from equalisation fund for decentralised functions are not included.

the poorer cities and municipalities (those with smaller gross personal incomes per capita) to get larger current grants from the central government budget. But there is almost no correlation between the amounts of total current grants and the level of gross personal income, which means that the allocation of current grants does not depend on whether a given city or municipality has revenues sufficient for adequate public services.

## 5. The problems and possible solutions

**Because of the unclear and territorially-oriented fiscal decentralisation strategy, there has been no decent solution for the financing of the cities and municipalities.** Some cities and municipalities still do not have enough resources for adequate public services. The problem inheres in the poor tax sharing and allocation of current grants.

The laws that regulate local and regional self-government are often modified; they are complicated; there are no calculations of the fiscal capacities and fiscal capacities of the local units; the quality and consequences of the sharing of tax between central and local government are often questionable; grants from the central government budget are often wrongly targeted; refunds of personal income tax are poorly directed, and which cities and municipalities should belong to the areas of special national concern and the hill and mountain areas is not properly determined.

The Government and the Finance Ministry should:

- lay down the objectives and a proper timetable of fiscal decentralisation,
- the reasons why a given current grant is allocated (the objectives) need to be defined simply and clearly, as do the criteria for the allocation of grants. How much which county, city or municipality obtained, from which source, and for which purposes should be published. The public has the right to know what money from the central government budget is spent on,
- there is no need to use tax sharing and current grants to additionally help cities and municipalities just because they are in the areas of special national concern or the hill and mountain areas; rather, on the basis of measurements of fiscal capacities and needs, there is a need for extra help to be given to those units that really do not have sufficient revenue for adequate public services. There are no perfect measures, but for a beginning it is necessary to measure simply, transparently and clearly the fiscal capacities and needs of the municipalities and cities.

In addition, the following are necessary:

- the provisions of the laws concerning the distribution of tax sharing and the allocation of current grants

should not be changed frequently, particularly not without consideration of the financial consequences,

- the personal income tax sharing should be simplified, and there should be only one or two kinds of simpler tax sharing for all areas; and the area of special national concern and the hill and mountain areas, if necessary, should additionally be helped with special-purpose grants,
- personal income tax sharing should not be used for the financing of capital projects on islands, rather a good system of special-purpose capital grants should be developed (with or without the participation of the local units), paying attention to the economic capabilities of the cities and municipalities; the approach of the local government units to the capital market should be regulated as well as possible so that they should be able to borrow for their own needs responsibly,
- figures should be published about how much revenue from personal income tax and surtax was realised in each city and municipality, and about how much after tax sharing went where,
- the current grants that the Finance Ministry allocates to the cities and municipalities not in 1<sup>st</sup> and 2<sup>nd</sup> area of special national concern need not be allocated via the counties, but directly to these cities and municipalities themselves. The counties should not be allowed to create their own criteria for the allocation of these grants to their cities and municipalities, which are never even publicly announced,
- for the grants from the equalisation fund for the decentralised functions, objectives – performance indicators – should be clearly defined (for education, for example, the aim might be to reduce the number of schoolchildren's absences, to achieve a better level of pupil knowledge), follow up the fulfilment of these objectives, and implement sanctions if they are not met,
- exactly where in the budgets grants from equalisation fund for decentralised functions are recorded has to be supervised. Some local units book it in with tax revenues, others with grants,
- consolidated figures of the budgets of all local units should be published, so that we would know how much, for example, all the cities and municipalities and counties have spent in all,
- thought should be given to the modification of the organisation of the treasury. The budget is planned in one sector, executed in another, without their being good connections between them. Either the budget should be planned and executed in a single sector, or the links between these two parts of the government treasury have to be improved.



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