

# New tax revenue distribution between central government and units of local and regional self-government in Croatia

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**Bajo, Anto; Primorac, Marko**

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# PRESS RELEASES

## New tax revenue distribution between central government and units of local and regional self-government in Croatia

ANTO BAJO, PHD, Institute of Public Finance, Zagreb

MARKO PRIMORAC, PHD, Faculty of Economics and Business, Zagreb

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**The government has submitted for urgent parliamentary procedure a **Proposal for an Act on Amendments to the Act on the Financing of Units of Local and Regional Self-government**. Instead of the current revenue distribution scheme based on the status of areas of special national concern (ASNC) and hill and mountain areas (HMA), the proposed new distribution depends on the development index<sup>1</sup>.**

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**The development index forms a basis for a new personal income tax sharing scheme**, and it has been determined under the Decision on the Classification of Units of Local and Regional Self-government According to the Level of Development (Official Gazette 158/2013). Preferential status in tax revenue distribution is no more given to local government units in the ASNC and HMA, but to the units classified into Groups I and II under the Decision, whose development index values do not exceed 75% of the Republic of Croatia's average (the so-called supported areas). There are only minor changes in the distribution of revenues for these groups of units of local self-government (compared to the distribution ratios applied so far to the units in the ASNC and HMA), i.e. the share of counties in the personal income tax revenues goes up 2% at the expense of the share so far pertaining to municipalities and cities. For all other municipalities and cities, the share of the general (all-purpose) part in personal income tax revenues increases. This increase is due to a cut in the share for decentralised functions from the current 12% to 6%. The share of equalisation grants for decentralised functions (i.e. the funding of capital projects for municipalities and cities on islands) increases from the current 15.5% to 16% (see table 1).

**An impetus to the use of EU funds.** According to the proposed distribution scheme, units of local and regional self-government, including legal entities and institutions in their (co-)ownership, as project holders will receive 1.5% of personal income tax revenues for projects co-financed from the EU structural and investment funds. The Ministry of Regional Development and EU Funds will regulate the use of these funds.

**The consequences of the change of status** of the ASNC, HMA and supported areas with respect to the personal income tax sharing are significant. The share in personal income tax for units in the ASNC and HMA will be reduced from 90% to 60%. However, units in supported areas, but with no preferential financing status, will be in a better fiscal position, as their share in personal income tax goes up from 56.5% to 88%.

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<sup>1</sup> This issue was discussed in the Institute of Public Finance *Press Release, No. 61* that spotlighted the need to amend the Act on the Financing of Units of Local and Regional Self-government.

**Table 1** Distribution of personal income tax revenues (%)

Group	Distribution scheme	Municipality and/or city	County	Decentralised functions	Equalisation grants for decentralised functions	EU project grants	Capital projects	Total
Groups I and II	new	88	12	-	-	-	-	100
ASNC, HMA	old	90	10	-	-	-	-	100
Zagreb	new	-	76.5	6	16	1.5	-	100
	old	-	72.5	12	15.5	0	-	100
Islands	new	60	16.5	6	0	1.5	16	100
	old	56.5	16	12	0	0	15.5	100
Other	new	60	16.5	6	16	1.5	-	100
	old	56.5	16	12	15.5	0	-	100

Note: According to the Proposal, units of local and regional self-government can, by assuming decentralised functions, acquire an additional share in the personal income tax in a maximum amount of 6% (1.9% for primary education, 1.3% for secondary education, 0.8% for social welfare, 1% for health care and 1% for fire-fighting services).

Source: *Proposal for an Act on Amendments to the Act on the Financing of Units of Local and Regional Self-government*

**Changes in the distribution of real estate transfer tax.** The share of municipalities and cities in real estate transfer tax increases from 60% to 80%, while the central government's share decreases from 40% to 20%. As a result, the central government's 2015 budget revenue will shrink by about HRK 232m (the amount by which the revenues of cities and municipalities will increase).

**Grants from tax on income from savings interest.** Revenues from a tax on income from savings interest, to be introduced at a rate of 12%, will belong to the national budget. They are estimated at about HRK 300m, and will be paid during the year in the form of grants to the units of local and regional self-government in supported areas for the personal income tax refunds claimed in citizens' annual tax returns (about HRK 308m).

**The maximum rate of surtax in the City of Zagreb** reduces from the current 30% to 18%. Since further implementation of fiscal decentralisation necessitates a gradual increase in the revenue collection autonomy of units of local and regional self-government, the Government should consider expanding, or removing the limits on, the range within which units of local and regional self-government may set their own tax rates.

It is a good thing that, pursuant to the amendments to the Act, the preferential financing status is given to units of local self-government whose inadequate development has been established on the basis of measurable indicators. Regrettably, tax sharing has become an instrument for redressing economic inequalities and financing capital projects, but also a mechanism to finance decentralised functions. However, the multiple roles of this instrument are hardly desirable. The government should leave personal income tax revenues completely to the municipalities, cities and counties in whose territories these revenues are collected. Tax sharing should be used exclusively for correcting vertical fiscal imbalance, i.e. covering shortfalls in the revenues of units of local and regional self-government necessary for funding transferred (decentralised functions).

The proposed changes deserve commendation, as they will contribute to the new regional development policy announced by compiling the development index. However, introducing a simple and efficient fiscal equalisation system based on high-quality criteria and fiscal instruments remains a challenge for the existing or any future government.