

Regulation of Public Finances in Croatia in Light of Financial Constitutionality

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ABSTRACT

This chapter describes the basic features of financial law and financial regulation in the Republic of Croatia. With the aim of defining financial law in Croatia, the authors provide the setting thereof in the Croatian legal system and address the main areas which it encompasses. The introductory part describes the development of Croatian financial law and sets the boundaries by identifying the areas it includes. Beginning in the early 1990s, marked by the transition to market economy, the introduction of new tax forms as well as the development of tax procedure and tax administration are explained. Simultaneously, budgetary law, social contributions law, law on financing local and regional units, fees law and customs law were created to eventually assume their present form. Starting from the constitutional provisions, this chapter sets all those areas in the framework of financial law regulation and provides basic information for each of them. The descriptions include the concepts and instruments of financial law in Croatia, starting with the budget law of the state and of local self-government, followed by tax and fee law, customs law, and social insurance law. The overview is supplemented by the most important aspects of tax procedure and tax administration. The conclusion reflects on the present state of Croatian financial law, the challenges that influenced its development, and the prospects for the future.

KEYWORDS

Financial law, budget, tax, customs, social security contributions, Croatia.

1. Financial law in Croatia

Unlike in Western European countries, but similar to the other Central and Eastern European countries, financial law in Croatia is viewed conceptually and researched very broadly, trying to comprise a ‘complete’ financial dimension of the public sector. However, over time, certain areas are no longer considered as a part of financial law (e.g., financial markets, banks). Due to the Socialist system in use until 1990, it is a relatively new area of law, especially tax law as one of its main and the most important subdisciplines (but still a subdiscipline). The creation of the new, modern tax system began in 1994 when the first tax laws were adopted, e.g., the Personal Income Tax Act

and the Corporate Income Tax Act. A new system of local and regional taxes was also established. The main aim of the reform¹ was to establish a tax system suitable for the needs of the market economy. Moreover, the reform envisaged a tax system oriented almost exclusively toward taxing consumption,² which was a unique example in the world at that time.³ However, tax procedure and tax administration⁴ were overlooked until the year 2000 when the General Tax Act was adopted. It is a systemic regulation that regulates the fundamental concepts and rules of a variety of processes in the implementation of taxation for all types of taxes, and by its nature had an exceptionally important influence on the relationship between the tax authorities and taxpayers. It might be concluded that the other subareas of financial law in Croatia (e.g., budgetary law, social contributions law, law on financing local and regional units, etc.) followed a resembling ‘phasing –pattern’—since 1990s several of them saw substantial changes and reforms within the framework of modernization.

Financial law in Croatia is perceived as a branch of law but also as a branch of science. The main difference lies in its scope and role—the scope and role of financial law as a science is considerably wider. While the term ‘financial law’ primarily indicates legal norms that regulate a variety of financial relationships, financial law as a science examines socioeconomic relationships that stem from state’s financial activity; explains legal justification of the financial relationships; determines the main principles on which legal regulation of the financial relationships is based; examines the process of implementation of financial laws; systematizes substance that is subject of financial law regulation, etc. However, it should be noted that the course taught at Croatian universities⁵ is called ‘financial law and financial science’ mainly to emphasise this broad and dual character of the discipline.

2. Theoretical issues of financial law

Financial law may be defined as a set of legal rules that regulate the financial relationships arising with the collection, management, distribution, and use of public funds designated for financing public expenditures.⁶

However, despite this comprehensive approach taken, the general and special parts of financial law are distinguished. This classification is of theoretical as well as of practical significance. The general part of financial law encompasses legal norms whose aim is to ensure the unity of the financial system, i.e., general principles on

1 The leading role in the design of tax reform was conferred to Prof. Manfred Rose and his assistants.

2 Known as KNS—*Konsumorientierte Neuordnung des Steuersystems*.

3 Gadzo, 2017, p. 178.

4 However, the Tax Administration, as an independent administrative organization within the Ministry of Finance, was also established in 1994.

5 In Croatia there are four faculties of law: in Zagreb, Rijeka, Split, and Osijek.

6 For an extensive description of financial law, see Jelčić et al., 2008.

which financial relationships are essentially based. The special part of financial law encompasses those norms whose main aim is to regulate a particular group of financial relationships. Therefore, tax law, budgetary law, and public debt law form the special part of financial law. The distinction is made to facilitate the research and study of particular financial relationships that arise in the course of applying certain financial instruments, and that contribute to better regulation in the field of public finances. In accordance with that, financial law is partly codified.

In previous paragraphs, the term ‘financial relationship’ is a rather generic term covering all socioeconomic relations that occur in the area of the state’s financial activity, and are regulated by the provisions of competent authorities. The main subject of a financial relationship is monetary obligation, whereas the state as well as natural and legal entities are the main parties in that relationship. However, the parties have very different and unequal positions because financial relationships are primarily incurred by the will and power of the state, and that state position is privileged compared to the other subject of the relationship. This feature attracts attention especially in the tax-law relationship. For example, recent studies show that it is seen as an authoritarian relationship dominated by a marked division between the superior (tax authority) and the subordinate (taxpayer).

Traditionally, in Croatia, financial law is a branch of law that could be classified as public law. The main reasons for that are twofold. First, it regulates all legal relationships between the state (and other public authorities), on the one side, and natural and legal entities, on the other.. The second reason relates to the mandatory nature of the provisions. It is also recognized as an independent, separate branch of law. The recognition of its autonomous status is especially important in relation to the administrative law.⁷ Tax administration and procedure, for instance, leans heavily on general administrative law.⁸ This reflects a shadow of the ‘old Austrian tradition, i.e., the ideas of classical, Weberian public administration’.⁹

Beside strong interference with administrative law, it is common knowledge that financial law interferes with many other branches of law, especially constitutional, European, international, civil, employment, criminal, and commercial law. When it comes to the constitution, as the highest legal source in Croatia, it encompasses only a few provisions regarding public finances: provisions that refer to the state budget and its legal nature; those proclaiming the principles of legality, equality, and equity as a basis of the tax system; those that position the State Audit Office as the highest, independent audit institution in Croatia; and provisions that guarantee social security to Croatian citizens. The constitution also regulates the status and legal force of international treaties—it stipulates a monistic approach, and international treaties constitute part of Croatian internal legal order, whereas its legal force is below the

7 Historically, financial law was perceived as a branch of administrative law.

8 Arbutina and Bogovac, 2014, pp. 481-503.

9 This is partly due to historical reasons—primarily the fact that that largest part of present-day Croatia has been part of the Austrian empire for several centuries. See Gadzo, 2017, p. 180.

constitution but above the laws. The European law primarily tackles field of indirect taxation and budgetary system. As for the international law, double taxation treaties must be mentioned. Croatia has so far concluded, as an independent state or assumed from the former Socialist Federal Republic of Yugoslavia (SFRY), over sixty double taxation agreements (DTA). When negotiating DTAs, Croatia has been sticking to the OECD model with a few exceptions.¹⁰

3. Croatian financial regulation

As we see from the previous section, Croatian financial law¹¹ is a very broad and complex branch of law. The highest legal source is the constitution, but the relevant financial provisions are rather scattered throughout the document. When it comes to the financial law, the constitution offers basic principles (as in the case of the principle of equality) or guarantees (as in the case of social security).

For clear organization of this chapter, the following basic areas will be considered as the subject of financial regulation: budget law of the state and of local self-government, tax and fee law, customs law, and social security law.

3.1. Budget law

When it comes to the state budget, the constitution is not voluminous. The main article is Article 91(2) proclaiming the legal nature of the state budget is an organic law, as it should be voted by the majority of all representatives of the Croatian Parliament (*Sabor*). It is *sui generis* law—'law in numbers'. It also declares that the state's revenues and expenditures are laid down by the budget. The last part of Article 91 tackles sound financial management—if the implementation of the particular law needs additional financial means, its sources should be provided. However, the exact meaning of the provision is not quite clear, especially in terms of its further development in the relevant laws. Among the constitutional bases of budgetary law, we must also mention Article 54, inaugurating the State Audit Office as the highest audit institution, especially emphasising its independency and autonomy. This feature is underlined with provision regulating the accountability—the State Audit Office is governed by the main state auditor whose obligation is to regularly report to Croatian Parliament.

As to the budget of local and regional self-government, the constitution is almost silent. It could be concluded that the constitutional foundation in question could be best described as indirect, and expressed through the financial autonomy concept.¹² The starting point of financial autonomy of sub-national units is the citizens' right to local and regional self-government (Article 128). Financial autonomy itself is referred

10 Arbutina and Bogovac, 2014, p. 482.

11 The most comprehensive of the Croatian financial law is provided by Šimović et al., 2010.

12 Constitutional provisions on the citizens' right to the local and regional self-government and the financial autonomy concept are introduced as a part of legislative changes caused by the process of decentralization which started in 2001.

to in Article 131. It emphasizes the right of subnational units to its own revenues over whom they freely dispose. The revenues should be proportionate to the competencies transferred and prescribed by the relevant laws (i.e., to the expenditures). Finally, there is an obligation of the central state to support financially weaker local and regional units.

The constitutional regulation of the budget is further developed in several laws which could be divided in subjective and objective budgetary law. The most important provision of subjective budgetary law (which is absolute subjective budgetary law in Croatia) is the Act on Budget¹³ (also called systemic regulation). The Act on Executing the Budget¹⁴ (which is a one-year law, adopted annually together with the budget) is the provision of objective budgetary law. Then there is the state budget ('law in numbers'). *Largo sensu*, the Act on Budgetary Responsibility,¹⁵ the Act on Financing of Local and Regional Self-Government,¹⁶ and the State Audit Office Act¹⁷ must also be mentioned.

The central instrument of the budgetary system is the budget of the general state, consolidated statistical statement of the planning data on revenues and expenditures, receipts and outlays¹⁸ of all subjects included in the general state, i.e., the central state, the local state, and social security funds.

The state budget and financial plans of extrabudgetary users are included in the so-called central state budget. Extrabudgetary users function as a special fund budget funded by specific mostly earmarked revenues.

According to the law, the state budget is defined as an act estimating revenues/receipts and determining expenditures/outlays, enacted by the Croatian Parliament. Although the principle of annuality is a rule, it is supplemented by the principle of multi-year planning. In that framework, the budget and financial plans are enacted for a three-year period, that is, a plan for the budget year and projections for the next two years (n+2 system). The projections are not binding except in the case of the budgetary deficit/surplus limitations. The main functions of the budget are following: it has important strategical and management role in the public finance policy domain;¹⁹ it serves as the main instrument of state intervention;²⁰ it is the most important financial instrument.²¹ Budgeting is geared to a cycle consisting of four usual phases: (1) preparation and design; (2) adoption and approval; (3) execution; (4) evaluation. The average duration of the cycle is 27 months. For the first and third phases, executive

13 The Act on Budget, OG 144/21.

14 The Act on Executing the Budget, OG 140/21.

15 Act on Budgetary Responsibility, OG 111/18.

16 Act on Financing of Local and Regional Self-Government, OG 127/17, 138/20.

17 State Audit Office Act, OG 25/19.

18 The difference between the terms derives from the structure of the budget in Croatia, namely the existence of two accounts.

19 As it shows the most important country's aims in a fiscal year.

20 As an instrument with which the country influences its economic condition.

21 It serves as a control system of collecting and spending budget means.

authorities are responsible, while in the second and fourth phases, the government has the main role.

As stated above, the state budget is *sui generis* law, and it differs from ‘standard’ laws in formal and substantive aspects. In a formal aspect, first and foremost it is the law in numbers. The formal difference also tackles a special (legislative) procedure visible in, for instance, the existence of budgetary calendar (a concise schedule of activities, activity holders, and statutory deadlines for preparing and submitting the draft of state budget); the special meaning of the parliamentary debate and approval (the principle of prior approval); or the possibility of introduction of a temporary financing (in the case of non-approval of the budget). In the substantive aspect, budget norms are temporary limited (they are in force only during a budgetary year) and individualized (especially in the special part where the addressee of the norm is known).

Structurally, the state budget consists of two main parts: a general and a special part. In the general part, two accounts are differentiated: (i) the account of revenues and expenditures, and (ii) the account of receipts and outlays. The first account contains revenues and expenditures that are classified according to *economic* classification. The second one contains all transactions (receipts and outlays) related to the financial assets and borrowing. A special part is a plan of expenditures and outlays of the state budget and its budgetary users, presented according to *organizational* classification.²² Budgetary revenues/recipes and expenditures/outlays in all budgetary documents are presented pursuant to *budgetary* classifications. There are six of them: economic (being the most common and important), organizational, functional, programming, locational, and source of financing classification. Revenues should be classified following economic and source of financing classification, whereas expenditures should be classified under all mentioned classifications.

The state budget revenues and receipts include taxes, social contributions, revenues from assets, revenues from administrative fees, charges, fines, other revenues, and revenues from financial assets. According to the latest data, the total state budget revenues for 2020 amount to EUR 17.474 billion. The tax revenues amount to EUR 9.715 billion, i.e., about 55% of the total state budget revenues, which include value added tax in the amount of EUR 6.270 billion (36%), and excise duties in the amount of EUR 1.931 billion (11%), corporate income tax in the amount 1.236 EUR billion (7%). The social contributions amount to EUR 3.023 (17%).

The total state budget expenditures for 2020 amount to EUR 20.390 billion, which brought the state budget in a deficit of EUR 2.919 billion. Two disasters had a significant impact on the financial result in question—the COVID-19 pandemic, and two earthquakes that heavily hit Zagreb and the central part of Croatia. For illustration, the costs of the measures and activities related to the pandemic were EUR 2.124 billion (including health costs), while the earthquake resolution actions cost the state budget

22 One of the budgetary classifications, primarily based on a link between budgetary data and budgetary users.

EUR 30 million. The most important expenditures are operational expenditures, which include expenditures for employees, material and financial expenditures, subventions, social expenditures, etc.

The budget of local and regional units is defined in a similar way as described above—as an act enacted by the representative body of local and regional self-government unit that entails a plan for a budgetary year and projections for next two years estimating revenues/receipts and expenditures/outlays of local and regional units and its budgetary users. However, the Act on Local and Regional Self-Government²³ defines it as the basic and most important financial act. The act also emphasizes the constitutional principles (mentioned above) on which financial autonomy of sub-national units is established. The revenues of the budgets of sub-national units include their own taxes, shares in the personal income tax,²⁴ grants, and non-tax and assigned revenues in accordance with special provisions. Own taxes are regulated by a special Local Taxes Act.²⁵ Local taxes are defined as taxes whose revenues belongs to the sub-national units²⁶ and could be further labelled as county or municipal taxes. Hence, inheritance and gift tax, tax on road motor vehicles, tax on vessels, and tax on gambling machines are county taxes. Surtax (on the personal PIT), and tax on local consumption, holiday houses, the use of public surfaces, and real estate transfers are municipal taxes. PIT is a shared tax. Non-tax revenues include a variety of revenues, among which the most significant (financially) are the communal fee²⁷ and communal contribution.²⁸ Despite the decentralization process in force for the last twenty years (since 2001), the importance of ‘local state’ (measured by share of local expenditures in GDP) is growing very slowly—it remains mainly stable comprising around 15%.

In 2011, Croatia adopted the Act on Fiscal Responsibility. This act was adopted to achieve and maintain fiscal responsibility, as well as to promote and strengthen the transparency and medium-term and long-term sustainability of public finances. In that context, the Act introduced the fiscal rules concept—two groups of them. The first one tackles certain fiscal goals and limits in relation to the structural balance, the annual growth of budgetary expenditures, and the public debt level. The second one deals with the concept of fiscal responsibility of the head of the budgetary (and extrabudgetary) users of the state budget and of the budgets of local and regional self-government. The crucial instrument is a statement on fiscal responsibility by which the head confirms that they have ensured the legal, earmarked, and purposeful use

23 Act on Local and Regional Self-Government, OG 33/01, 60/01, 129/05, 109/07, 125/08, 36/09, 36/09, 150/11, 144/12, 19/13, 137/15, 123/17, 98/19, 144/20.

24 According to the current legal situation, personal income tax revenues are divided between municipalities and counties in the proportion of 74% (municipalities) to 20% (counties). The remaining 6% is for decentralized functions (those units who finance decentralized functions have an additional share in PIT).

25 Local Taxes Act, OG 115/16, 101/17.

26 Although it is not precisely defined, it could be concluded that tax autonomy is assessed through its formal and material dimension.

27 For more details on communal fee, see Žunić Kovačević and Gadžo, 2014.

28 S. Act on Communal Management, OG 68/18, 110/18, 32/20.

of funds; the efficient and effective functioning of the internal control system within the framework of the funds determined in the budget; and the financial plan, respectively. The obligation also includes companies owned by the Republic of Croatia or local and regional units as well as legal entities founded by the Republic of Croatia or subnational units. The act also provides for the establishment and competences of the Fiscal Policy Commission. The commission is an independent expert body established to envisage and evaluate the implementation of the fiscal rules. During the performance of its tasks, the commission takes the ‘positions’ that are posted on the website of the commission. A special procedure is prescribed in the case of serious fiscal risks. If the commission assess that there is such a risk, it prepares a special report for the government, which must give an opinion within 45 days, or as necessary to undertake additional measures.

As previously mentioned, the State Audit Office is essentially the supreme audit institution in Croatia. The entities subject to audit are numerous: state sector units; subnational units (including the Croatian National Bank); legal entities financed from the state budget; legal entities financed from the state budget; legal entities founded by the Republic of Croatia or local and regional self-government units and legal entities owned by the Republic of Croatia or local and regional self-government units; companies and other legal entities in which the Republic of Croatia or local and regional self-government units hold a majority block of shares or stakes and/or exercise a decisive influence on management; legal entities (subsidiaries) established by legal entities of which the founder is the Republic of Croatia or local and regional self-government units; legal entities which secure their operating funds from mandatory contributions, membership fees or other revenues regulated by law; political parties, independent members of the parliament and members of the representative bodies of local and regional self-government units as stipulated by legislation governing the financing of political activities and election campaign promotion; legal entities in the Republic of Croatia that utilize funds from the European Union, international financial mechanisms, and other international organizations or institutions to finance public needs.

The object of the audit are revenues and expenditures, assets and liabilities, financial statements, transactions and the programmes, projects, and activities of the audited entities. The audits are conducted in accordance to the Annual Programme and Plan of Work. The Croatian Parliament may also request the audit. The audit of the Execution of the State Budget is conducted every year.

3.2. Tax and fee law

The Croatian tax system is the most important source of public revenues, accounting to 55.6% of budget revenues in 2020.²⁹ In Croatia, taxes are introduced by the state parliament and mostly regulated at the state level. In some cases, the local units are

29 More information may be found on the website of the Ministry of Finance, available at <https://mfin.gov.hr/proracun-86/drzavni-proracun-2020-godina/2981>.

entitled to regulate tax rates within the set framework, while all other elements are set out in tax acts. The tax revenues may be allocated to the central government level, local, or regional governments or they may be joint revenues of the central and local budgets.

The universal obligation to pay taxes stems from the Croatian Constitution,³⁰ which prescribes that everyone should participate in the defrayment of public expenses, in accordance with their economic capacity, and hence introduces the ability to pay principle in Croatian tax system. The constitution also sets out that the tax system must be based on the principles of equality and equity, without elaborating the notions in more details.

The normative framework of taxation includes the General Tax Act,³¹ the *lex generalis* to all other tax acts, which sets out provisions on tax procedure applicable to all taxes. The general Tax Act, as stated in Article 1, ‘regulates the relationship between taxpayers and tax authorities applying the regulations on taxation and other public dues, if not regulated otherwise by special acts on certain types of taxes and other public charges, and represents the joint tax system basis.’ Besides this so-called ‘systemic regulation’, there are numerous acts which regulate specific taxes, i.e., *leges speciales*. All the tax acts are accompanied by one or more ordinances.

The General Tax Act, as set out in Article 2, relates to ‘taxes and other public dues’, whereas taxes are financial dues and are a budget revenue used for settling public expenditures determined in the budget. Excise duties are considered taxes, while ‘other public dues are customs duties, fees, contributions, concession fees, monetary fines for tax violations and all dues the establishment and/or payment and/or audit of which is made according to special regulations within the competence of a tax authority’.

A general overview of special acts on certain types of taxes and other public charges includes: (a) income taxes: Personal Income Tax Act, Corporate Income Tax Act; (b) property taxes: Local Taxes Act; (c) consumption taxes: Value Added Tax Act, Real Estate Transfer Tax Act, Excise Duties Act, special excise duties acts (Special Tax on Motor Vehicles Act, Special Tax on Coffee and Non-alcoholic Beverages Act and Tax on Liability and Comprehensive Road Vehicle Insurance Premiums Act)

Another possible approach of presenting the Croatian tax system is according to the attribution of tax revenues: (a) state taxes are value added tax, profit tax (corporate income tax) and special taxes and excise duties; (b) county taxes are inheritance and gifts tax, road motor vehicles tax, vessels tax and tax on slot machine games; (c) municipal taxes are surtax on income tax, the consumption tax, tax on holiday homes, tax on the use of public land and real estate transfer tax; (d) joint state and local units’ tax is personal income tax.

30 The Constitution of the Republic of Croatia, Consolidated text, OG 56/90, 135/97, 113/00, 28/01, 76/10, 5/14. English translation available at https://www.usud.hr/sites/default/files/dokumenti/The_consolidated_text_of_the_Constitution_of_the_Republic_of_Croatia_as_of_15_January_2014.pdf.

31 General Tax Act, OG 115/16, 106/18, 121/19, 32/20, 42/20.

Finally, the tax system may be analysed from the viewpoint of direct taxation (personal income tax, corporate income tax, some local taxes such as surtax on personal income tax or inheritance and gifts tax) and indirect taxation (VAT, excise duties, and some local taxes such as real estate transfer tax and the consumption tax).

3.2.1. *Income tax*

In the Croatian tax system, the income tax is applied to natural persons (personal income tax) and legal entities (corporate income tax).

Personal income tax is regulated by the Personal Income Tax Act.³² Personal income tax was introduced in Croatian legislation in 1994³³ and has experienced many amendments since. The taxpayer is a natural person who generates an income. If several natural persons generate an income together, the taxpayer is each natural person separately (whereby the Croatian legislature chose to adhere to transparent approach to partnerships). Resident taxpayers have unlimited tax liability, i.e., they are liable to pay personal income tax in Croatia in accordance with the worldwide principle, while non-residents have limited tax liability, i.e., in Croatia they are only liable for taxes on income earned in Croatia (the source principle). Croatia has a network of 66 international bilateral tax treaties, and their provisions should be considered when determining international tax liability.

Natural persons are subject to personal income tax from five taxable sources of income: income from employment, income from self-employment, income from property and property rights, income from capital and/or other income.

Personal income tax liability is increased by surtax on personal income tax, introduced by the local self-government units (see Section 3.2.3, subsection 'Local taxes'). Personal income tax is determined and paid for the taxation period of one calendar year.

Personal income is defined by Article 12 of the Personal Income Tax Act as the difference between receipts inflowing in the taxation period and expenses arising over the same period. The receipts represent all goods (money, things, substantive rights, services, and other) that a taxpayer has acquired within a taxation period, and the expenses are all the outflows of goods with a monetary value made for the purpose of realizing or ensuring the receipts. Personal income may be determined as annual income or as final income.

Annual personal income comprises total income from employment, income from self-employment, and other income which is not deemed final, received over the taxation period. It is determined and calculated based on the annual tax return. The taxpayers are entitled to a personal allowance, parts of personal allowance for supported members of immediate family and children as well as for disability or physical handicap. The annual personal income tax base is the total amount of income from employment, self-employment activity and other income which is not deemed final,

32 Personal Income Tax Act, OG 115/16, 106/18, 121/19, 32/20, 138/20.

33 Šimović, 2012.

reduced by personal allowance. The annual personal income tax is paid at a rate of 20% on a tax base of up to HRK 360,000 (EUR 48,000) and at the rate of 30% on a part of the tax base exceeding the amount of HRK 360,000, which represents the use of a slice system of progression.

Personal income from employment represents the difference between (1) the receipts realized over the taxation period and (2) the expenses incurred over the same period. Receipts arising from employment (salaries) are all receipts, which the employer pays out in cash or in kind or gives to the worker based on employment, entrepreneurial salary, receipts (salary) of natural persons posted to work in the Republic of Croatia upon the order of a foreign employer to domestic companies to work in those companies, receipts (salary) of the members of representative and executive bodies of the government and local and regional self-government units for work in those bodies and units and/or salary compensations to persons providing care and assistance to Croatian military disabled persons of the Homeland War. Expenses, which are deducted from the receipts, are paid contributions for compulsory insurances from receipts or contributions for pension insurances.

Personal income from self-employment is income from trade crafts, from professions (self-employed health workers, veterinarians, attorneys, notary publics, auditors, engineers, architects, tax advisors, interpreters, translators, tourist workers, self-employed scientists, writers, inventors, self-employment lecturing activity, self-employed journalists, artists and sportsmen), and from agriculture and forestry. Income from a self-employment activity is that the difference between business receipts and business expenses that occurred over a taxation period. Taxpayers performing a self-employment activity must be included in the register of income taxpayers, and must determine their income based on the information from financial records and registries.

Other income that is not deemed final is the difference between receipts and expenses, though the receipts relate to activities of the members of assemblies and supervisory committees of companies and management boards, royalties, receipts of athletes, travelling salespersons, agents, sports referees, interpreters, translators, tourist workers, and consultants. It also includes receipts in kind (use of buildings, means of transport, favourable interest, and other benefits) that are provided to natural persons who are not employed by payers, awards to pupils during work practice and apprenticeships, receipts of pupils and students for work via pupil and student associations, scholarships, awards for sports achievements, and other receipts not specifically stated that are paid or given to natural persons by legal and natural persons (payers of profit tax and payers of income tax performing self-employment activities). The expenses deductible in determining other income consists of contributions paid for compulsory insurance from receipts. Exceptionally, in determining other income, the expenses are deductible at a flat rate of 30% of realized receipts for royalties, the professional activities of journalists, artists, and athletes and receipts of non-residents for the performance of art, artistic, entertainment, sports, literary, or visual arts activities and activities in connection with the press, radio, and television and entertainment shows.

The final personal income consists of income from property and property rights, income from capital and final other income. Taxpayers are not allowed to submit tax returns for those categories of income and no personal allowance is applied.

Income from property and property rights is the difference between (1) receipts accruing from leases, rentals, renting of flats, rooms, and beds to travellers and tourists and organizing camps, (2) receipts from a temporally limited cession of copyright, industrial property rights, and other property rights, (3) receipts from alienation real estate and property rights, and the expenses that the taxpayer has incurred in a taxation period in connection with these receipts. When calculating the income from property based on the rental or lease of movable and immovable property, the taxpayers are allowed to deduct expenses at the flat rate of 30% of the realized rental or lease. The taxpayer who earns income from renting of flats, rooms, and beds to travellers and tourists and organizing camps pays tax on income (lump sum set out by the local unit). In earning income from property rights, expenses are actually incurred expenditures, for which the taxpayer provides authentic documents. With income from property realized from rentals and leases, the income tax is paid monthly at a rate of 10%. Tax on income from property rights must be calculated, withheld, and paid by payers of receipts as withholding tax, simultaneously when paying the receipt from the total remuneration, by applying a rate of 20%. Tax on income from the alienation of real estate and property rights is paid by taxpayers on a one-time basis at the rate of 20%. Tax on income from the alienation of more than three pieces of real estate of the same type, or more than three property rights of the same type, over a period of five years from the day of acquiring them, is paid on a one-time basis after the alienation of the fourth piece of real estate of the same type, or the fourth property right of the same type, at the rate of 20%.

Income from capital represents the receipts based on interest, withdrawals of assets and the utilization of services at the expense of current-period profits, capital gains, shares in profits realized by award of or optional purchase of own shares, dividends, and shares in profit according to the share of the capital, which were realized in a taxation period. No expenses are considered when determining the tax base. Tax rates for this category of personal income vary between 10% and 30% and are paid in the form of withholding tax upon payments of the income.

Final other income includes other income based on the reimbursement of contributions (paid at a rate of 30%), other income, based on the difference between the value of the assets and the amount of funding with which they were acquired (paid at a rate of 30% and increased by 100%), and other income based on temporary or occasional jobs in agriculture (paid at a rate of 10%).

Corporate income tax, as set out by the Corporate Income Tax Act,³⁴ is paid by a company or another legal or natural person, a resident of the Republic of Croatia, performing its economic activity independently, permanently, and with the purpose

34 Corporate Income Tax Act, OG 177/04, 90/05, 57/06, 146/08, 80/10, 22/12, 148/13, 143/14, 50/16, 115/16, 106/18, 121/19, 32/20, 138/20.

of achieving profit. The taxpayer is also a domestic permanent establishment of a foreign entrepreneur (non-resident). Self-employed natural persons who declare that they will pay corporate income tax instead of income tax are categorized voluntary taxpayers, while natural persons are obligatory taxpayers if they generated a total receipt greater than HRK 7,500,000 (EUR 1,000,000) in the previous taxation period. State administration bodies, regional and local self-government authorities, and the Croatian National Bank are not corporate income tax payers. A list of non-taxpayers also includes state institutions, institutions of units of regional self-government, institutions of units of local self-government, state institutes, religious communities, political parties, trade unions, chambers, associations, artistic associations, voluntary firefighters' associations, tourist boards, sports clubs, societies and associations, trust funds and foundations. However, if the exempt persons perform a certain economic activity whose non-taxation would result in unjustified privileges on the market, they are required to determine the corporate income tax liabilities for those activities.

The tax base is the corporate income, i.e., the difference between revenue and expenditures before the corporate income tax calculation, increased and reduced under the Corporate Income Tax Act. The tax base of a resident taxpayer consists of corporate income generated domestically and abroad (universal tax liability), while the tax base of a non-resident consists only of corporate income generated domestically (limited tax liability). The corporate income tax base is set out at a tax rate of 10% if, during the taxation period, the revenue amounts to up to HRK 7,500,000 (EUR 1,000,000) or 18% if, during the taxation period, revenue has been generated equal or higher than HRK 7,500,000 (which represents an uncommon case of slab system of progression). For the corporate income generated by a non-resident in the Republic of Croatia, withholding tax is applied and paid at a rate of 15% except for dividends and shares in profit for which the withholding tax is paid at a rate of 10%. The Corporate Income Tax Act contains some provisions directed to prevent tax avoidance, such as transfer pricing rules and thin capitalization³⁵ rules. The corporate income tax legislation has been amended under the influence of EU legislation over the past decade, particularly on taxation of interest and royalty payments made between associated companies of different Member States, on taxation of mergers, divisions, partial divisions, transfers of assets and exchanges of shares concerning companies of different Member States, on taxation of parent companies and subsidiaries of different Member States, as well as on rules against tax avoidance practices, encouraged by the OECD's BEPS (controlled foreign company (CFC) rule, exit taxation,³⁶ interest limitation, General anti-abuse rule (GAAR)³⁷ and the rule on hybrid mismatches).

35 More details on thin capitalization in Arbutina, 2011.

36 For a detailed overview on exit taxation, see Klemenčić, 2016.

37 Analysis of GAAR in the Croatian tax law in Gadžo and Klemenčić, 2014.

3.2.2. *Consumption taxes*

Value added tax (VAT) was introduced in Croatian tax system in 1998. The Croatian VAT legislation was amended significantly during the Croatian accession to the EU and is now regulated by the Value Added Tax Act,³⁸ As the field of indirect taxation is highly harmonized at the EU level, Croatia incorporated the EU legislation into its tax system. VAT is the most important source of tax revenues in Croatia. In 2020, it accounted for 36% of total tax revenues.

Under the VAT directive, the following transactions are subject to VAT: (a) the supply of goods for consideration within the Croatian territory by a taxable person acting as such, (b) the intra-community acquisition of goods for consideration within the Croatian territory, (c) the supply of services for consideration within the Croatian territory by a taxable person acting as such, and (d) the importation of goods.

The VAT legislation defines the taxable person as a person who independently performs any economic activity, regardless of the purpose or result of that activity performance. The taxable person is also any person who occasionally supplies a new means of transport. Taxable persons are not state government bodies,³⁹ the bodies and units of local and regional self-government, chambers and other bodies governed by public law or when they collect charges, fees or other payments within their scope or authority. If their status of non-taxable persons would cause considerable detriment to the market competition principle, those bodies are taxable persons in relation to those activities or transactions.

Each person must report the start of their activity as taxable person to the Tax Administration, i.e., they must register in the VAT taxable person registry if the value of their supply exceeded the amount HRK 300,000 (EUR 40,000) in the previous year. Upon registration, the taxable person is issued a VAT ID number. Each taxable person must issue an invoice for the supply of goods and services performed for another taxable person or non-taxable legal person.

The taxable amount for the supply of goods and services refers to the full amount the supplier receives from the buyer or another person for those supplies, including the amount of subsidies directly related to the price of supplied goods or services. The taxable amount includes the amounts of taxes, customs duties, fees and similar charges, except for VAT, and ancillary costs such as commissions, the costs of packaging, transport and insurance which the goods or services supplier charges to the buyer or recipient. The taxable amount does not include price reductions or rebates granted to the customer at the time of supply, nor the amounts which the taxable person charges to or receives from the buyer as a refund for the expenses paid on their behalf and for their account and which are entered into the records as transitory items.

38 Value Added Tax Act, OG 73/13, 99/13, 148/13, 153/13, 143/14, 115/16, 106/18, 121/19, 138/20.

39 For more information on the tax regime of public law bodies in the Croatian system of value added tax, see Gadžo, 2015.

VAT is calculated and paid at the standard rate of 25%. In Croatia, two reduced VAT rates are applied. The reduced rate of 5% is charged on the supply of bread, milk, books, medicines, medical equipment, daily newspapers, and cinema tickets. The reduced VAT rate of 13% is charged on the supply of accommodation services, newspaper journals, edible oils and fats of plant and animal origin, child car seats, baby diapers, baby food, supply of water (other than water in bottles) through public water supply and public drainage, concert tickets, supply of electricity to another supplier or end user, public service of collection of mixed municipal waste, etc. Before joining the EU, Croatia also had a 0% tax rate in the VAT system. However, that rate is not envisaged by the VAT directive.

VAT exemptions relate to certain activities of public interest, some cases of goods supply within the European Union, goods acquisition within the European Union, certain transport services, importation, exportation, the supply of services on movable property, international transport, certain supplies equated to export, mediation services and transactions relating to international trade.

The taxable person may deduct from VAT the amount of VAT (input tax) that he paid on the home territory for the supply of goods or services performed by other taxable person for their taxable transactions. The taxation period spans from the first to the last day of the month. A taxable person must pay calculated and reported VAT for a taxation period until the last day of the month following the end of the taxation period.

Excise duties in Croatia are partly regulated by the Excise duties Act,⁴⁰ which encompasses excise duties harmonized on the EU level: excise duties on alcohol, alcoholic beverages, tobacco products, energy products and electricity. There are additional special taxes on coffee and non-alcoholic beverages,⁴¹ special taxes on motor vehicles⁴² and the tax on liability and comprehensive road vehicle insurance premiums.⁴³

3.2.3. *Other taxes*

Local taxes. The government in Croatia operates on three levels. Besides the central government on the state level, there is a regional self-government which includes 20 counties and the capital city of Zagreb. The local self-government is at the lowest level, and it comprises cities and municipalities, counting 555 local units in total. A part of lower government levels revenues comes from the personal income tax. Another important source of revenues are regional and local taxes. Local taxes are introduced and regulated on the state level, while some elements (e.g., tax rates) are left to the local units to prescribe, within the boundaries set out by the state level act. Introducing some taxes on a local level is optional, and the local units may decide on

40 Excise Duties Act, OG 106/18, 121/19, 144/21.

41 Special Tax on Coffee and Non-alcoholic Beverages Act, OG 72/13, 121/19, 22/20.

42 Special Tax on Motor Vehicles Act, OG 15/13, 108/13, 115/16, 127/17, 121/19.

43 Tax on Liability and Comprehensive Road Vehicle Insurance Premiums Act, OG 150/02.

it. Under the Local Taxes Act,⁴⁴ local taxes are divided between regional government taxes and local government taxes, whose revenues are allocated to counties or cities and municipalities, respectively. Regional self-government taxes are inheritance and gifts tax, road motor vehicles tax, vessels tax and the tax on coin-operated machines for games for amusement. Local self-government taxes are surtax on income tax, consumption tax, tax on holiday homes and tax on the use of public land. Additionally, real estate transfer tax is a tax allocated to local units of the place where the real state is located, as set out by the special Real Estate Transfer Tax Act.⁴⁵

Other taxes in Croatia include taxes on winnings from games of chance and fees for organising games of chance, as set out by the Games of Chance Act.⁴⁶ Per the act, games of chance may be organized as lottery games, casino games, betting games and slot machines games. Taxes are applied for the winnings in lottery games and betting games at progressive tax rates of 10%, 15%, 20% and 30% applied on winnings in four tax brackets. Taxpayer of the tax on winnings in lottery games is a natural person who won the lottery game, while for betting game the taxpayer is a natural person who won the betting game. Besides taxes, the Games of Chance Act also prescribes the obligation for the games of chance organizers to pay monthly and annual fees.

Another type of public dues, as set out by the General Tax Act, are fees, i.e., monetary dues paid for a certain performance or use of a certain public good. In theory, fees may be divided into three groups: administrative fees, court fees and notary public fees.

Administrative fees are paid for filing written requests or requesting actions performed by state administration, diplomatic missions, consular offices, local and regional units' bodies and bodies with public authorities, under the Administrative Fees Act⁴⁷ and accompanying tariff. The person liable to pay a fee is the person who filed a request for proceedings or administrative action. Court fees are paid for court proceedings, under the tariff, which is a part of the Court Fees Act.⁴⁸ The fee is paid by the party upon whose request or in whose interest the action is undertaken. Notary public fees are paid for issued documents and actions performed by the notary public. Tariff on notary public fees is contained in the annex to the Notary Public Fees Act.⁴⁹ The person liable to pay fees is the persons upon whose request or in whose interest the notary public actions are performed.

3.2.4. *Customs law*

Customs law is an important part of Croatian financial law. As set out in Article 2 of the General Tax Act (a systemic regulation for the entire field of public dues), customs

44 Local Taxes Act, OG 115/16, 101/17.

45 Real Estate Transfer Tax Act, OG 115/16, 106/18.

46 Games of Chance Act, OG 87/09, 35/13, 158/13, 41/14, 143/14.

47 Administrative Fees Act, OG 115/16.

48 Court Fees Act, OG 118/18.

49 Notary Public Fees Act, OG 72/94, 74/95, 87/96, 112/12, 110/15.

duties are a form of ‘other public dues’, besides taxes, excise duties and other dues. Customs duties are monetary dues paid on import or export.

As a part of Croatian accession to the European Union in 2013, Croatia became a part of the EU customs union and has therefore incorporated the Union Customs code and accompanying EU legislation in its legal system. The Union Customs code⁵⁰ is the central source of EU customs law, which provides a comprehensive framework for customs rules and procedures in the EU customs territory. It was enacted as a regulation and is therefore directly applicable in the EU Member States. It covers missions of customs, rights, and obligations of persons regarding the customs legislation, application of import and export duties, customs debt, goods brought into the EU customs territory, rules on customs status, customs procedure. It is supplemented by Croatian legislation—the Act on Implementation of the EU Customs Legislation⁵¹ and corresponding national bylaws, which determine the implementation of the EU legislation in Croatia. The Act on Customs Services⁵² provides for an organizational framework of Croatian customs authorities, their structure, authorities, competencies, and supervisory provisions.

3.2.5. Social security contributions

The General Tax Act classifies contributions as ‘other public dues’⁵³ and defines contributions as ‘monetary dues paid for using certain services or exercising rights’, i.e., they are earmarked revenues. The Croatian system of social security contributions covers pension and health insurance. Certain family benefits and social aid programs complement the system. Unlike in some other systems, there are no special rules for public servants. Generally, it covers main social risks—old age, decease and invalidity, risk of temporary incapacity of work because of sickness and maternity. In Croatia, contributions represent an important budget revenue, accounting for 17.3% of total budget revenues in 2020, which makes it the second largest group of public revenues. Tax authorities within tax collection system collect social contributions as well.

Under the Contributions Act,⁵⁴ there are three types of compulsory insurance systems: compulsory pension insurance based on inter-generational solidarity (first pillar), compulsory pension insurance based on individual capitalised savings (second pillar) and mandatory health insurance contribution. For each of the insurance systems, the Contributions Act sets out the obligation to pay contributions: (a)

50 Regulation (EU) no 952/2013 of the European Parliament and of the Council of 9 October 2013 laying down the Union Customs Code (OJ L 269 10.10.2013, p. 1) Amended by: Regulation (EU) 2016/2339 of the European Parliament and of the Council of 14 December 2016, OJ L 354 of 23.12.2016 p. 32, Regulation (EU) 2019/474 of the European Parliament and of the Council of 19 March 2019, OJ L 83 of 25.3.2019, p. 38 and Regulation (EU) 2019/632 of the European Parliament and of the Council of 17 April 2019, OJ L 111 of 25.4.2019, p. 54.

51 Act on Implementation of EU Customs Legislation, OG NN 40/16.

52 Customs Service Act, OG 68/13, 30/14, 115/16, 39/19, 98/19.

53 General Tax Act, Article 2, paragraph 3, OG 115/16, 106/18, 121/19, 32/20, 42/20.

54 Contributions Act, OG 84/08, 152/08, 94/09, 18/11, 22/12, 144/12, 148/13, 41/14, 143/14, 115/16, 106/18.

compulsory pension contribution based on inter-generational solidarity (15%), (b) compulsory pension insurance based on individual capitalised savings (5%), and (c) compulsory health insurance and health insurance for work injury and occupational disease (16.5%).

Compulsory pension contributions are contributions ‘*from the basis*’ (meaning due by the insurer or employee) and compulsory health contributions are contributions ‘*on the basis*’ (due by the insurer or employer).

All insured persons have so-called insurance base determining their ‘status’—rights, contributions they are subject to, and rates. There are three insurance bases: work/social status; special and particular circumstances; health protection of the foreigners. ‘Insurance holders’ (i.e., the Croatian Pension Insurance Fund and Croatian Health Insurance Fund) determine the insurance base.

The basis of the social contributions is (taxable) income, or it is calculated by the formula (for self-employed insured persons). Besides the standard base, there is also a minimum and a maximum base.

3.2.6. *Tax procedure and tax administration*

Tax procedure in Croatia⁵⁵ is regulated by the General Tax Act,⁵⁶ which is in fact a tax procedure act. The act is *lex generalis* in relation to specific tax legislation; however, it is also a *lex specialis* in relation to General Administrative Procedure Act,⁵⁷ which is applied in case when some issues have not been regulated by the General Tax Act. Under the *lex specialis derogat legi generali* principle, the General Tax Act has the advantage in application.

As set out in Article 1 of the General Tax Act, it ‘regulates the relationship between taxpayers and tax authorities applying the regulations on taxation and other public dues, if not regulated otherwise by special acts on certain types of taxes and other public charges, and represents the joint tax system basis.’ Therefore, it is often concluded that the General Tax Act is a systemic act, regulating the field of taxation, and applied to all public dues, along with the special tax acts.

The General Tax Act introduces the concepts of taxes and other public dues (as explained previously in this chapter) as well as the tax authority, as ‘a body of the state administration, an administrative body of a regional self-government unit or an administrative body of a local self-government unit the competences of which encompass the tasks of assessing and/or auditing and/or collecting taxes’. The act continues with the elaboration of basic principles of tax procedure (such as the principles of non-retroactivity, legality, material truth, certainty, and language), the right to be heard; the principles of tax secrecy and good faith, the economic approach principle and the anti-abuse principle regarding fraud). The act sets out provision on taxpayers’ rights, competencies, representations, and obligations. The procedural

55 For a detailed description of tax procedure in Croatia, see Arbutina and Rogić Lugarić, 2017.

56 General Tax Act, OG 115/16, 106/18, 121/19, 32/20, 42/20.

57 General Administrative Procedure Act, OG 47/09, 110/21.

provisions provide rules on jurisdiction, documents used and filed in tax procedure, the establishing of facts essential for taxation, filing tax returns, and tax assessment. The act continues with the rules of tax supervision and enforcement procedure. The final part of the Act addresses legal remedies and provides rules on tax violations.

The Tax Administration⁵⁸ is an administrative body of the Ministry of Finance.⁵⁹ Its organizational structure reflects the administrative organization of the state—it consists of the Central Office in Zagreb, branch offices operating in counties and local branch offices set up in cities and municipalities. Their main competence is to implement tax regulations and regulations concerning the payment of obligatory contributions. The main duties of the Tax Administration are normative activities, keeping the tax registers and issuing documents, exchange of information with other public authorities and international information exchange, assessment and collection of taxes and obligatory contributions, tax audit, enforced collection of taxes and contributions, taxpayers' services, and misdemeanour procedure. The competencies and the organization of the Tax Administration are stipulated by the Tax Administration Act.⁶⁰

3.3. Summary and current regulatory challenges

As a relatively new legal discipline, financial law in Croatia has seen substantial changes and reforms. One could observe two main periods. The first period, 1990–2000, could be called the formative period in which the modern tax and budgetary system is established and the main taxes are introduced. The second period has been a period of 'upgrading' with an emphasis on (tax) procedure, improving the relationship between tax authorities and taxpayers, improving budgetary principles and procedures, including control of the use of public funds, etc. These efforts are especially visible in the second part of the period (after the economic and financial crisis). Under the different nature of the periods, two main influences could be identified. While German legal tradition was dominant in the formative period, accession to the EU and the need for the harmonization of tax law (and public finances regulations) profoundly affected the 'upgrading period', which is still ongoing.

As previously mentioned, Croatia has taken a comprehensive approach to the financial law. In that context, the importance of the constitutional foundation of financial law lies mainly in the constitutional principles and guarantees. However, it is well illustrated that the result is a very broad and dynamic area and the division on the sub-disciplines, theoretically, practically, and regulatory, is eminent. Nevertheless, integral parts are closely linked and interrelated. This interrelation is increasingly acknowledged in financial management and during times of crisis. For instance, the entire public finance system is faced with two recent 'disasters'—an

58 More information on Croatian Tax Administration is available at https://www.porezna-uprava.hr/en/EN_o_nama/Pages/default.aspx

59 For more information on the challenges of adjusting the Croatian Tax Administration to the EU requirements, see Žunić Kovačević, 2020.

60 Tax Administration Act, OG 115/16, 98/19.

earthquake and the pandemic—and their final consequences are yet to be seen. One of them, accidentally or not, might be raised awareness of the importance of the financial management. It is interesting that recent regulatory changes in budgetary law concern predominantly financial management, and likewise indicate future tendencies.

As to the future regulatory challenges, three might be emphasised. The first challenge is tax law, especially the improvement of tax procedure and the (continuation of) modernization of the relationship between tax authorities and tax administration. Undoubtedly, the time has come for a new strategy and vision of the relationship between the main parties and changes in the current, mostly traditional approach to forming that relationship. As to the new taxes, one of the crucial questions relates to the introduction of real estate tax and digital taxes.

The second challenge is related to the (continuation of) the consolidation of public finances. Croatia experienced a period of stable economic growth and even realised a budgetary surplus and consequently reduced public debt. Unfortunately, the pandemic disrupted and postponed positive trends.

The third challenge is the process of decentralization, which has been progressing for the last twenty years. The importance of local state is, despite the effort, growing very slowly. However, the process will depend on taxation reforms and presumably wait for better times.

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