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DECENTRALIZATION IN CROATIA: PROBLEMS AND POSSIBLE SOLUTIONS

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Abstract

In 2001 Croatian Government launched the initiative aimed at loosening a high degree of centralization by extending the mandates of local units and changing the sources of financing public functions. However, initial steps in the process of decentralisation have not been followed by additional measures of fiscal decentralization, and consequently its level has stayed broadly unchanged. We elaborate main problems and obstacles in relation with actual implementation of the decentralization process and give three groups of proposals for decentralisation: (i) division of mandatory authorities among different local units, (ii) change in funding and (iii) modified territorial division of the country.

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1. INTRODUCTION

The legislative framework of local and regional self-government in Croatia was formed with the passing of the Constitution of the Republic of Croatia in 1990. Croatia has today a *two-tier system of sub-national government*. *Municipalities, towns and cities* represent the local level of government and *counties* represent the regional level of government. *The City of Zagreb* has status of a local and regional level of government. Today the territory of Croatia consists of *429 municipalities and 126 towns (cities)* at the local level, the City of Zagreb and of *20 counties* at the regional level, which makes a total of 576 sub-national units.

Decentralization can be generally described as a process in which selected functions are assigned to sub-national units and fiscal decentralisation is described as the assignment of revenue sources and expenditure functions to sub-national levels of government. The theoretical and empirical literature shows that higher level of decentralisation of administrative power and responsibilities is expected to result in increase of public sector efficiency, in strengthening of local governance, as well as in increase of local development.

Process of decentralisation in Croatia started in mid 2001. However, initial steps in the process of decentralisation have not been followed by additional measures of fiscal decentralization, and consequently its level has stayed broadly unchanged in recent years¹. In the paper we show that fiscal capacities of local government units significantly differ. Also, we show that additional measures need to be undertaken to achieve efficient provision of public functions in Croatia.

In the paper we analyse the process of decentralisation in Croatia and elaborate main problems and obstacles in relation with local government units and in the actual implementation of the decentralization process. In the third chapter we show that fiscal capacities of local government units significantly differ and that are, therefore, local government units faced with many problems in providing public functions. Problems with the conducted decentralisation of public functions and proposals for further decentralisation of local government units are given in the fourth chapter. The paper ends with final conclusions.

¹ Based on Jurlina Alibegović (2007a).

2. DECENTRALIZATION PROCESS IN CROATIA AND DIVISION OF AUTHORITIES AMONG DIFFERENT GOVERNMENT LEVELS

Based on provisions of the Law on Local and Regional Self-Government Units, in Croatia exists clear division of authorities among different government levels. Municipalities and towns perform tasks of local significance, which directly address the needs of citizens and which are not assigned to state bodies by the Constitution or by the law. Big cities (cities with more than 35,000 inhabitants) and county centres are responsible for all local tasks and services for their citizens, including newly introduced tasks regarding public roads maintenance and issuing of building and location permits. Counties in their self-governing scope of authority are responsible for the functions of regional character (see Table 1). Towns with more than 35,000 inhabitants may be also responsible for functions which otherwise fall within the competence of counties, as long as they ensure the necessary conditions for performance of these services.

Table 1: Mandatory authority of local and regional government units

| Municipalities and towns | Big cities and county centres | Counties |
|--|--|--|
| <ul style="list-style-type: none"> - community and housing planning - physical planning and zoning - utility services - child-care - social welfare - primary health care - primary school education - culture, physical culture, and sports - consumer protection - protection and improvement of the natural environment - fire protection and civil defense - local transport | <ul style="list-style-type: none"> - community and housing planning - physical planning and zoning - utility services - child-care - social welfare - primary health care - primary school education - culture, physical culture, and sports - consumer protection - protection and improvement of the natural environment - fire protection and civil defense - local transport - public roads maintenance - issuing of building and location permits | <ul style="list-style-type: none"> - education - health care - physical planning and zoning - economic development - traffic and transport infrastructure - planning and development of the network of educational, medical, social and cultural institutions - issuing of building and location permits and other document in relation to construction in the county area excluding the area of the big city |

Source: Authors' systematisation.

Special administration departments in cities and counties are responsible for state administration affairs that are transferred to the level of local and regional government.

In July 2001 Croatia launched partial decentralization of its public functions². The decentralization reforms have been directed in two areas of decentralization:

- delegation of administrative and professional tasks from central government (ministries) to local and regional government units, and
- fiscal decentralization where part of financing public needs was transferred from the state government budget to regional and local government budgets.

In the first phase of fiscal decentralization, 32³ financially stronger cities, the City of Zagreb and all of 20 counties⁴ in Croatia have been assigned additional responsibilities to provide some of public functions locally. Adopted model of decentralization implied that expenditures for material expenses and capital investments in primary education are transferred to 32 big and/or financially stronger cities and counties budgets, as well as expenditures for material expenses and capital investments in secondary education, health care and social welfare sector are transferred to the counties budgets. Financing of fire protection was transferred to local government (municipalities and cities) (see Table 2).

Table 2: Financing of public expenditures for decentralized responsibilities

| Decentralized responsibilities | Counties, the City of Zagreb and cities (32) | State budget |
|--------------------------------|--|--|
| Primary education | <ul style="list-style-type: none"> – material and financial expenses – maintenance and investment expenses – fixed assets expenses – investment on nonfinancial fixed assets | <ul style="list-style-type: none"> – wages and salaries – local transport expenses for employees – employer contributions – training – school IT equipment – library supply and equipment |
| Secondary education | <ul style="list-style-type: none"> – material expenses – local transport expenses for employees – co-financing of expenses for housing and organized meals for students in dormitories – maintenance and investment expenses – school equipment expenses – investment on nonfinancial fixed assets based on standards and benchmarks set up by the Minister decision | <ul style="list-style-type: none"> – wages and salaries – local transport expenses for employees – training of teachers – expenses for teaching pupils in national minority language – expenses for teaching pupils with developmental difficulties – expenses for programmes for talented pupils – school IT equipment – library supply and equipment |

² Based on Program of Fiscal Decentralisation (2002). Croatian Government described this process as the first phase of fiscal decentralisation.

³ During the last nine years, only one more financially stronger city has taken new responsibilities in financing primary education.

⁴ Total number of 53 selected local and regional government units that have been assigned decentralised functions represents only 9 percent of total number of local and regional government units in Croatia.

| | | |
|----------------|--|--|
| | | – co-financing of private schools programmes |
| Social welfare | <ul style="list-style-type: none"> – wages and salaries for employees in elderly persons centres – material and financial expenses of elderly persons centres – investment on nonfinancial fixed assets in elderly persons centres – material and financial expenses of social welfare centres – expense for grants to cover heating costs of social benefits users | <ul style="list-style-type: none"> – employee expenses in social welfare institutions – nonfinancial fixed assets in social welfare institutions |
| Healthcare | <ul style="list-style-type: none"> – structure and equipment maintenance of the health institutions owned by the municipalities and the City of Zagreb – informatization of health institutions | <ul style="list-style-type: none"> – wages and salaries – training – non-financial fixed assets |
| Fire fighting | <ul style="list-style-type: none"> – employee expenses in public fire brigades – material and energy expenses – financial expenses for public fire brigades | – |

Source: Authors' systematisation.

3. INTERGOVERNAMENTAL FISCAL RELATIONS

3.1. Revenue sources of sub-national government units

The Law on Local and Regional Self-Government Financing is main legal framework of local government finance system. This law defines sources for financing of the operations of municipalities, towns (cities) and counties, various types of taxation, distribution of funds among the different levels, tax base, taxpayers, rates, as well as calculations and forms of tax payment.⁵ Table 3 contains short review of main revenue sources for financing local and regional self-government units in Croatia.

⁵ There are many other special laws that regulate other revenue sources for financing public tasks of sub-national governments.

Table 3: Review of revenue sources of local and regional self-government units

| | |
|------------------|---|
| Tax revenues | <p>Municipal, town and city taxes: Surtax on income tax Consumption tax Tax on vacation homes Tax on firm or name Tax on the use of public surfaces</p> <p>County taxes: Tax on inheritance and gifts Tax on motor vehicles Tax on boats and vessels Tax on gambling machines</p> |
| Nontax revenues | Local government units' revenues for which the purpose is set in advance (20 sorts of the local government units' special purposes revenues out of 245 nontax revenues which are in Ministry of Finance (2010) Register of Non-tax Revenues). |
| Capital revenues | Revenues from financial asset (profit revenues of municipal owned company) Revenues from non-financial asset (rental revenues) |
| Shared taxes | <p>Personal income tax: Central state – 0 percent Counties – 15.5 percent Municipalities and towns – 55 percent City of Zagreb – 70.5 percent Decentralized functions – 12 percent (primary education 3.1 percent; secondary education 2,2 percent; social care 2.2 percent; health care 3.2 percent; fire fighting – 1.3 percent) Equalisation fund (line-item in the state budget) – 17.5 percent</p> <p>Tax on real estate: Central state – 40 percent Municipalities and towns – 60 percent</p> |
| Grant revenues | <p>Grant revenues from the state budget allocated to the counties, cities and municipalities which belongs to the first and second category of special state concern.</p> <p>Grant revenues from the state budget allocated to the cities and municipalities for the personal income tax returns in the area of special state concern and in the hill and mountain areas.</p> <p>Grant revenues from the state budget allocated to the cities and municipalities for the profit tax returns in the area of special state concern and in the hill and mountain regions.</p> <p>Grant revenues from the state budget of other public bodies allocated to the cities and municipalities for the local development projects.</p> <p>Grant revenues from the state budget as equalisation fund allocated to the cities, municipalities and counties for financing decentralized functions.</p> |
| Borrowing | <p>Previous approval by the Government of the Republic of Croatia for sub-national government borrowing.</p> <p>Total borrowing limit of local and regional self-government unit for fiscal year: up to 20 percent of outturn of current revenues in previous fiscal year.</p> <p>Additional borrowing limit for local and regional self-government unit: up to 2.3 percent of outturn of current revenues in previous fiscal year of all sub-national government units</p> |

Source: Authors' systematization.

Local and regional self-government unit realise revenue through: *own sources, shared taxes, grants from the state and county budget, equalisation grants for decentralised functions, shared revenues and borrowings.*

Local governments' *own sources* include income from local governments' own property, from county, city, town or municipal taxes, from fines, fees and charges.

Croatian law outlines the *distribution of shared revenues* between the state and local authorities. Local government units are entitled to the revenue from *shared taxes* and fees collected within their area, at a percentage stipulated by the law. Shared taxes are income tax and tax on real estate transactions.

Sub-national government in Croatia is not autonomous in the determination of base and rates of tax revenue. The rates of shared taxes and of county taxes are completely prescribed by the state government. The rates of municipal, town and city taxes are on the whole determined by the municipal or city authority, but within the framework of the limits set by central government. The tax rate on the use of public surface is determined independently by the local government⁶.

Local government units autonomously determine the rates of surtax on income tax within the limits (the maximum possible rate of surtax) set by the central government. From 2001 all local self-government units could introduce surtax. The current maximum rates of surtax are: 10 percent for municipalities, 12 percent for towns up to the 30,000 citizens and 15 percent for cities with more than 30,000 citizens, and up to 30 percent for the City of Zagreb.

The income realised through *income tax* is distributed in a manner that it distinguishes whether municipality, city or county finances or not decentralised functions in selected public services including education, health care, social welfare and fire fighting and with respect to the supported area⁷ that a local government unit belongs to. A distinct distribution of income tax is provided for the City of Zagreb. Within the area of local

⁶ Fiscal autonomy means the capacity of local government units to fix the bases and tax rates as well as non-taxation revenue independently.

⁷ Four special legal documents regulate supported areas in Croatia: Law on Areas of Special State Concern, Law on Hilly and Mountainous Areas, Law on Islands, and Law on Reconstruction and Development of the City of Vukovar. 275 municipalities and towns belongs to supported areas. There are municipalities and cities in the area of special state concern (180 local government units); municipalities and towns in hilly and mountainous areas (45 local government units) and municipalities and towns on islands (50 local government units). Total surface area of supported area is 64.3 percent of Croatian territory. 23 percent of Croatian population live in municipalities and towns in the area of special state concern. Based on current legal framework aiming to remove identified development problems in supported area, this area has been receiving different types of state aid assigned to local inhabitants, firms and local budgets (grants, fiscal subsidies, development financing etc.). Identified developmental problems comprise the following: social-economic underdevelopment, underdevelopment caused by geographic location (islands and hilly and mountainous areas) and area damaged by the war. Income tax revenue sharing in municipalities and towns in area of special state concern and in hilly and mountainous areas is different and these municipalities and towns receive higher share of income tax revenue (90 percent and the share of counties is 10 percent).

government units which have founded public fire brigades and which finance the regular work of the employees therein, the share of a municipality and town in income tax increases as a percentage of income tax (see Table 4).

A share in the distribution of revenue from *tax on real estate transactions* for municipalities and cities is 60 percent and for the state 40 percent.

Regarding *grants*, a system of financing community needs has been designed in such a way that grants are used solely as funds to support local government units with poor fiscal capacity⁸.

Equalisation grants for decentralised functions are ensured from the state budget to cover public expenses in the area of primary and secondary education, social welfare and health care, which are transferred to local and regional government units in the case if they do not have enough revenues from additional share of income tax for financing of decentralised functions.

Shared revenues of the state, municipality, town and city is the revenue from agreed annual concession fees for pumping mineral and thermal water, and for the use of water for the public water supply.

Apart from the a fore mentioned taxes and grants, local government units have numerous other revenues introduced on the basis of special acts and/or decisions of representative bodies, such as *charges and fees*, which are contained and stated in the *non-tax revenues* of their budget. Non-tax revenue is the autonomous revenue of sub-national government. Sub-national government units independently set the rates of non-tax revenue and independently carry out the collection of this revenue. The main non-tax revenue consists of municipal utility charges and contributions. These funds are used for the construction and maintenance of the utility infrastructure.

Local and regional self-government units may incur debt in two ways: *borrowing* by taking a loan or issuing securities (municipal bonds).

The Ministry of Finance has settled general principle on local and regional government borrowing.

⁸ Every year Law on the Execution of the State Budget prescribes criteria for allocating grants to the local government units.

Municipalities, cities and counties can borrow resources for the purpose of capital investment financed from their budget, with previous approval by the Government of the Republic of Croatia. Counties can issue guarantees to the municipalities and cities with previous approval from the Croatian Government. Municipality, city and county can issue guarantees to the public institution or company that it owns or is a majority owner.

All borrowing, guarantees and obligations cannot exceed maximal rate prescribed by the Law on the State budget. Total borrowing limit of local and regional self-government unit for fiscal year can be up to 20 percent of outturn of current revenues in previous fiscal year. The amount of total borrowing limit includes the amount of annual loan annuity, liabilities regarding issuing securities and guarantees in previous year, as well as all unpaid liabilities. Additional borrowing limit for local and regional self-government unit is up to 2.3 percent of outturn of current revenues in previous fiscal year of all sub-national government units.

Since 2001, the revenue of sub-national government units has been increased substantially. It coincides with the beginning of the process of fiscal decentralisation and the increased share of sub-national government units in income tax.

Table 4: Additional share of income tax for financing of decentralised functions

| | The beginning of the decentralization process - July 1 st , 2001 | Current situation |
|---|---|-------------------|
| Cities/municipalities | | |
| share of income tax | 32.0 | 55.0 |
| share of income tax for decentralised functions: | 3.9 | 4.4 |
| primary education | 2.9 | 3.1 |
| public fire brigades | 1.0* | 1.3 |
| The City of Zagreb | | |
| share of income tax | 45.0 | 70.5 |
| share of income tax for decentralised functions: | 9.4 | 12.0 |
| primary education | 2.9 | 3.1 |
| secondary education | 2.0 | 2.2 |
| social welfare | 2.0 | 2.2 |
| health care | 2.5 | 3.2 |
| public fire brigades | 1.0* | 1.3 |
| Countries | | |
| share of income tax | 8.0 | 15.5 |
| share of income tax for decentralised functions: | 9.4 | 10.7 |
| primary education | 2.9 | 3.1 |
| secondary education | 2.0 | 2.2 |
| social welfare | 2.0 | 2.2 |

| | | |
|--|-------------|-------------|
| health care | 2.5 | 3.2 |
| Share of income tax for equalization grants (line item in the state budget) | 21 | 17.5 |
| Share of income tax for state government | 29.6 | 0.0 |

Note: *Since 2003 additional share of income tax for financing decentralized expenses of public fire brigades went to municipalities and towns that are establishers of public fire brigades. Income tax revenue sharing in municipalities and towns in area of special state concern and in hilly and mountainous areas is different and these municipalities and towns have received higher share of income tax revenue (90 percent and the share of counties is 10 percent).

Source: Ministry of Finance.

Implemented model of decentralization includes several changes in revenue sources. The first one is the possibility of introducing different levels of surtax on income tax depending on the size of the municipality. Distribution of revenues usually shared between the state and sub-national government has also been changed. The major change was in the distribution of income tax revenues⁹, with a larger part of revenues now being allocated to the local governments (55 percent), as well as to the regional government units (15.5 percent). Additional part of income tax revenue (12 percent) was reserved for covering expenditures regarding decentralized functions in primary (3.1 percent) and secondary education (2.2 percent), health care (3.2 percent), social welfare (2.2 percent) and fire fighting (1.3 percent) (see Table 4). There have been established equalization grants for decentralized functions (17.5 percent of income tax) for local and regional government units that do not have enough resources (from additional share of income tax revenues) for financing decentralized functions.

The decentralized functions are financed from the local budgets (from additional share of income tax), and additionally supported through the equalization grants to meet the required minimum service standards. The most of the health care and social welfare responsibilities are still the financial responsibility of the central government (see Table 2).

⁹ Additional share of income tax for decentralised functions has been changed during period of last nine years. Table 4 contains review of additional share of income tax for financing of decentralized functions for the year 2001 and 2010.

3.2. Analysis of sub-national government units' budgets

Revenues outturn in local government units in Croatia is harmonised with IMF (2001) methodology¹⁰. Data in table 5 shows the structure of local government revenues in 2009.

Total revenues of all local government units in Croatia totalled HRK 23.3 billion¹¹ in 2009. Within the structure of total revenues of municipalities, towns and counties the most important category is *tax* revenues, with the share of 61.1 percent. The largest part of tax revenues is generated through taxes from income (55.1 percent of total revenues). *Taxes on property* are the second most important source of tax revenues, with the share of 3.9 percent in the total local government units' revenues. Revenues from *taxes on goods and services* make 2.1 percent of total revenues of all local government units.

The second most important source of total local government units revenues are *revenues from grants*. Grant revenues have a share of 8.7 percent in total local government units' revenues.

The administrative fee revenue is an important revenue source for local government units, and it generated 18.4 percent of the total revenues. Local government units generate most of their administrative fee revenues from public utilities. The counties, unlike municipalities and towns, do not generate any revenues from public utilities, and the public utilities revenue is exclusively municipal, town, and city revenue. For better comparison of the significance of the public utility revenue, it is important to observe that in 2009 the municipalities, towns and City of Zagreb realised HRK 3.2 billion revenue from the public utilities, while the total fiscal revenue of all the counties was HRK 3.6 billion.

The property income holds a significant portion of the total municipality, town, and county revenue, equalling 7.3 percent. This revenue is largely visible in the town (and City of Zagreb) budgets, and in somewhat lesser extent in the municipality budgets, while it represents a less significant part of the county revenues.

¹⁰ Since 2002 methodology of compiling fiscal statistics, as well as data about local government units' revenues and expenditures in Croatia changed and became harmonised with International Monetary Fund (2001; IMF, 2001) methodology. This international guidelines for statistical methodology of compiling public finance statistic is harmonised with System of national accounts 1993 (SNA 1993). The new revised methodology brought some changes in fiscal statistic with the goal of improving transparency. Therefore, classification of revenues and expenditures changed and now it includes next classification of public functions: 01 General public services, 02 Defence, 03 Public order and safety, 04 Economic affairs, 05 Environmental protection, 06 Housing and community amenities, 07 Health, 08 Recreation, culture and religion, 09 Education and 10 Social protection.

¹¹ For comparison, exchange rate for one EUR is 7,375773 HRK.

There is a prominent difference in the fiscal revenue structure between counties, towns, and municipalities, when considering the levels of local and regional governments.

In 2009 the total fiscal expenditure of municipalities, towns, and counties was HRK 25.3 billion. Within the structure of total expenditures the most important category, with the share of 30.5 percent, related to *material expenditure*. The expenditure for services, specifically for current and investment maintenance, and material and energy expenditure were prevalent in the structure of the material expenditure. All the local units have high material expenditures.

The local government units also spent a lot on *purchasing non-financial assets*. These expenditures made 23.2 percent of the total expenditure of the local units. These expenditures mostly regard acquisition of the tangible fixed assets, that is, purchase of buildings. Also, the towns and municipalities spend significantly more for these purposes than the counties.

The third largest item of the expenditure was *the expenditures for compensation of employees*, which in 2009 represented 18.4 percent of the total expenditure. These expenditures relates to salary and wages in local government units, as well as taxes and contributions.

The current grants in form of cash and capital grants (and mostly issued to companies in the public sector) are the main reason for high *other expenditures* of municipalities, towns, and counties. The other expenditures represented as much as 14.9 percent of the total expenditures.

For *subsidies* local units allocated 5.6 percent of their budgets in 2009. The largest part of subsidies local government units gave to the companies in the public sector. In this regard, the largest part of those subsidies was issued by the City of Zagreb.

From the functional classification point of view, the expenditure structure of municipalities, towns and counties is predominated by *the expenditures for housing and community amenity* with 19.4 percent share in the total expenditure of the local government units. These resources are spent primarily on the community development, and on improving housing and various communal infrastructure projects. The

second largest part of expenditures was the *expenditures for education* with 18.2 percent share in the total expenditure, and these expenditures are mostly used to finance preschool and primary education. For *general public services* the local units allocated 18.1 percent of their budgets, and most of these resources were used to finance executive and legislative bodies. For *economic affairs* the local units allocated 15.9 percent of their budgets. The expenditures for road traffic were the most important part of the expenditures for the economic affairs. The expenditures for *recreation, culture, and religion* made 12.7 percent of total local units' expenditures. The remaining expenditures, according to the functional classification, had less than 10 percent share in the total local units' expenditure.

Detailed structure of the local budget expenditures by economic and functional classifications is shown in the tables 6 and 7.

The major characteristics of the Croatian intergovernmental fiscal system are the following: tax revenues are the most important revenue source in the budget of sub-national units; the second most important revenue of sub-national government units is non-tax revenue; grants from the state government to local governments are the third revenues sources for sub-national government units.

The previous short analysis of revenues and expenditures of local government units in Croatia leads to conclusion that local government units in Croatia are largely dependent on financing public functions from tax on income and from grants from state budget. The fiscal autonomy of sub-national government units in collecting their own revenue is relatively low. The sub-national government units obtain the least amount of revenue from their own taxes.

Budgetary capacity of counties, towns and municipalities largely differ. 429 municipalities generate 15.8 percent, 126 towns 39.9 percent, the City of Zagreb 28.9 percent and 20 counties 15.4 percent of total revenues of all local government units in Croatia. This data clearly show that when considering the future process of decentralization in Croatia, special attention has to be put on those local government units which largely contribute to the total budgetary revenues of sub-national government units, meaning on towns. In the same time, this means that change of mandatory authorities has to go in the direction of changing authorities and functions for municipalities. Municipalities have the lowest fiscal capacities for performing public functions. In the same time, they are largely dependent on grants from state budget.

If we stick to the view that regional self-government is the public government level which should be, in the greatest measure¹², responsible for setting direction of regional development on the territory of Croatia, then also fundamental reform in this sector are necessary and should be expected. These changes should be undertaken towards creation of new regional authorities, which would then have adequate capacities (organisational, administrative, human resources, financial, and others) to carry out all the responsibilities in performing public functions and in strengthening the coordinating role of that level of public authority¹³.

Table 5: Total revenues in local budgets in 2009, in percentage

| | Municipalities (429) | Towns and cities (126) | The City of Zagreb | Counties (20) | Total local budgets (576) |
|---|-------------------------|---------------------------|-----------------------|------------------|------------------------------|
| OPERATING REVENUES | 93.06 | 94.13 | 99.03 | 99.64 | 96.22 |
| Tax revenues | 43.40 | 52.37 | 72.22 | 81.19 | 61.14 |
| Taxes on income and surtax on income tax | 36.05 | 45.89 | 67.00 | 76.36 | 55.13 |
| Taxes on profits | 0.11 | 0.00 | 0.00 | 0.00 | 0.02 |
| Taxes on property | 6.11 | 5.09 | 3.03 | 0.07 | 3.88 |
| Taxes on goods and services | 1.12 | 1.39 | 2.19 | 4.76 | 2.10 |
| Other taxes | 0.02 | 0.00 | 0.00 | 0.00 | 0.00 |
| Grants from foreign governments and from other general government units | 20.53 | 8.64 | 0.82 | 11.75 | 8.74 |
| Property income | 8.44 | 8.23 | 7.52 | 3.00 | 7.25 |
| Administrative fees | 19.62 | 23.77 | 18.36 | 3.38 | 18.41 |
| Revenues of nonfinancial assets sales | 6.94 | 5.87 | 0.97 | 0.36 | 3.78 |
| TOTAL REVENUES | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 |

Source: Ministry of Finance.

¹² Regional self-government should set directions of regional development in coordination with the central state, other local units and with all the important actors.

¹³ Problem of insufficient financing and inadequate structure of expenditures in regional budgets are two of the most important obstacles at regional level in financing development projects of local and regional importance (Jurlina Alibegović, 2007b).

Table 6: Total expenses in local budgets in 2009 in percentage economic classification

| | Municipalities (429) | Towns and cities (126) | The City of Zagreb | Counties (20) | Total local budgets (576) |
|--|-------------------------|---------------------------|-----------------------|------------------|------------------------------|
| OPERATING EXPENSES | 66.43 | 76.54 | 79.42 | 83.91 | 76.82 |
| Compensation of employees | 11.86 | 21.48 | 19.87 | 14.21 | 18.39 |
| Use of goods and services | 29.67 | 29.38 | 28.18 | 39.24 | 30.50 |
| Interests | 0.80 | 1.31 | 0.76 | 0.98 | 1.02 |
| Subsidies | 1.80 | 2.42 | 12.70 | 3.74 | 5.56 |
| Grants to foreign governments and to other general government units | 1.97 | 0.62 | 0.79 | 6.73 | 1.78 |
| Social benefits | 5.31 | 4.42 | 3.81 | 6.24 | 4.64 |
| Other expenses | 15.02 | 16.90 | 13.32 | 12.77 | 14.94 |
| Expenses for nonfinancial assets | 33.57 | 23.46 | 20.58 | 16.09 | 23.18 |
| TOTAL EXPENSES | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 |

Source: Ministry of Finance.

Table 7: Total expenses in local budgets in 2009, in percentage functional classification

| | Municipalities (429) | Towns and cities (126) | The City of Zagreb | Counties (20) | Total local budgets (576) |
|----------------------------------|-------------------------|---------------------------|--------------------|---------------|------------------------------|
| General public services | 25.28 | 17.06 | 15.30 | 18.33 | 18.05 |
| Defence | 0.01 | 0.02 | 0.00 | 0.01 | 0.01 |
| Public order and safety | 2.51 | 4.54 | 1.23 | 0.76 | 2.68 |
| Economic affairs | 21.16 | 14.67 | 17.56 | 10.10 | 15.92 |
| Environmental protection | 5.65 | 6.92 | 0.85 | 2.29 | 4.25 |
| Housing and community amenities | 24.93 | 19.36 | 24.58 | 2.74 | 19.41 |
| Health | 0.36 | 0.74 | 2.05 | 12.02 | 2.70 |
| Recreation, culture and religion | 7.39 | 16.20 | 14.76 | 4.84 | 12.70 |
| Education | 8.35 | 14.80 | 18.06 | 38.98 | 18.22 |
| Social protection | 4.36 | 5.68 | 5.62 | 9.93 | 6.06 |
| TOTAL EXPENSES | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 |

Source: Ministry of Finance.

3.3. Fiscal capacity of sub-national government units

Fiscal capacity of regional or local government unit can be defined as the potential ability of the government in the region or in the city (municipality) to raise revenues from their own resources in order to pay for a standardised basket of public goods and services (Snah, 1997; Martinez-Vasquez and Boex, 1997). Fiscal

capacity can be also defined as the ability of governmental jurisdiction to translate economic activity within its geographic borders into public spending (Chernick, 1998).

Table 8 shows the development in total fiscal capacity in countries, towns and municipalities in Croatia in 2009.¹⁴ Results of measurement of the fiscal capacity with different indicators¹⁵ imply that there are large differences in the level of budget per capita between local government units in different counties. *Total revenues* per capita of counties, towns and municipalities in Croatia were between HRK 2,789 and HRK 8,655. However, it has to be noticed that fiscal capacity of counties, towns and municipalities was significantly lower when we observe data about total revenues without grant revenues and share of income tax revenue for financing decentralized functions (revenues without grants). Average revenues are also significantly lower when exclude from the analysis City of Zagreb¹⁶. Thus, average revenues without grants (City of Zagreb excluded) decrease to 3,044 HRK per capita.

Indicators of fiscal strength of counties, towns and municipalities also imply that there are large differences in outturn of different categories of revenues per capita. Some local government units have 20 times larger revenues from some sources than the others.¹⁷

Differences in *total expenditures* per capita are even more pronounced. Total average expenditures per capita in counties, towns and municipalities were HRK 4,841 in 2009. Local government units in nine counties had expenditures above average.¹⁸ When we analyse data according to the functional classification of the budget, the highest differences can be seen in the level of expenditures for financing housing and community amenities, and for general public services. The lowest differences were in the expenditures for defence. This is not surprising having in mind expenditures for defence have low share in total local government units' expenditures.¹⁹

¹⁴ Data in table 8 shows aggregated data for municipalities, towns and counties divided according to the county in which in local government unit. Data about fiscal capacity in counties, towns and municipalities separately could be found in Annex.

¹⁵ More about result of measuring fiscal capacity in Croatia in the period before 2009, with different indicators see in Jurlina Alibegović (2005).

¹⁶ City of Zagreb does not have revenues from share of income tax revenue for financing decentralized functions and has very low revenues from grants.

¹⁷ Examples are grants. City of Zagreb receives HRK 74 per capita from grants, while local government units in Lika-Senj County receive HRK 1,511 per capita from grants.

¹⁸ Those are: City of Zagreb, Primorje-Gorski Kotar, Lika-Senj, Zadar, Šibenik-Knin, Split-Dalmatia, Istria, Dubrovnik-Neretva and Zagreb County.

¹⁹ Only local government units in Lika-Senj County have extremely high expenditures for defence per capita (HRK 18 per capita).

Expenditures for compensation of employees are also very important indicator of the fiscal capacity of local government units. Average expenditures for compensation of employees in local government units in Croatia were HRK 874 per capita in 2009. Local government units from seven counties had above average expenditures for employees. Data about the share of expenditures for compensation of employees in total revenues, as well as in the revenues without grants shows capability of municipalities, towns and counties to pay wages and salaries of their employees in their own administration using only total revenues or their own revenues. Average share of expenditures for employees in total revenues of local government units in Croatia amounted 19.9 percent in 2009. Expenditures for compensation of employees above that average had local government units in nine counties. Similar, the share of expenditures for compensation of employees in total expenditures amounted 18.4 percent. Eight counties had expenditures for that purposes above that average.

In addition, there are large differences between local government units in counties in subsidies, material expenditures and grants per capita (table 8).

Table 8: Financial capacity of all local government units in Croatia, per capita, in HRK

| Year 2009 | Average | Minimum | Maximum |
|---|---------|---------|---------|
| According to the economic classification of the budget | | | |
| OPERATING EXPENSES | 4,290.4 | 2,672.3 | 8,571.4 |
| Tax revenues | 2,597.5 | 1,580.9 | 6,250.6 |
| Share of income tax revenue from equalization grants for financing decentralized functions | 406.9 | 0.0 | 617.8 |
| Grant revenues | 578.9 | 71.2 | 1,511.4 |
| Property income | 308.6 | 78.2 | 921.3 |
| Administrative fees | 770.2 | 312.3 | 1,762.7 |
| Total revenues without grant revenues and share of income tax revenue for financing decentralized functions | 3,304.7 | 1,677.7 | 8,500.1 |
| OPERATING EXPENSES | 3,662.2 | 2,192.2 | 7,633.0 |
| Expenditures for compensation of employees | 874.2 | 479.2 | 1,909.6 |
| Use of goods and services | 1,519.4 | 808.8 | 2,708.1 |
| Subsidies | 164.0 | 29.6 | 1,220.5 |
| Grants | 94.0 | 12.4 | 201.2 |
| TOTAL REVENUES | 4,486.4 | 2,788.9 | 8,655.3 |
| TOTAL EXPENDITURES | 4,840.6 | 3,021.2 | 9,610.6 |
| According to the functional classification of the budget | | | |
| Expenditures for general government services | 973.9 | 576.9 | 2,048.8 |
| Expenditures for defense | 1.4 | 0.0 | 18.1 |

| | | | |
|---|-------|-------|---------|
| Expenditures for public order and safety | 159.3 | 71.6 | 337.4 |
| Expenditures for economic affairs | 713.7 | 370.2 | 1,687.7 |
| Expenditures for environment protection | 231.9 | 56.4 | 648.9 |
| Expenditures for housing and community amenity | 873.9 | 347.7 | 2,362.0 |
| Expenditures for health | 144.6 | 60.4 | 284.9 |
| Expenditures for recreation, culture and religion | 552.7 | 216.8 | 1,419.0 |
| Expenditures for education | 900.7 | 629.8 | 1,735.3 |
| Expenditures for social protection | 288.6 | 127.1 | 539.8 |

Note: Item total revenues without grants means total revenues without grant revenues and share of income tax revenue for financing decentralized functions.

Source: Authors calculations based on data from Ministry of Finance and Croatian Bureau of Statistic.

4. RECOMMENDATIONS FOR FURTHER DECENTRALIZATION

4.1. Critical view on the process of decentralisation in Croatia

The first set of our conclusions concerns realisation of local budgets and their fiscal capacities which are the result of the existing legal framework which stipulates the ways in which municipalities, towns, and counties can generate their fiscal revenues and spend them in an optimum manner. The number of revenue sources on which local government units can autonomously influence (on their base and/or rate) is small. Local government units have only influence on the tax on the use of public surfaces and partly on the nontax revenues that the local government units stipulate as special purpose revenues through special regulations. Municipalities, towns, and counties can independently control the rate level for certain types of revenues, but within the limits stipulated by the central state. The result is that more than half of the total revenue in the local government units' budgets consists of revenues on which amount local government units cannot influence (revenues from the income tax which is shared tax revenue, and grants). The administrative fees and special regulation revenues form almost one fifth of the total revenue, and these are the revenues on which local government units have only partial influence.

Respecting the existing legal solutions resulted in the existing level and structure of the total expenditures of municipalities, towns, and counties. Approximately half of the total expenditures of municipalities, towns, and counties are related to the current expenditures for financing the functioning of the local government (expenditures for goods and services and expenditures for compensations of the employees). The local budgets use a little bit less than one quarter of the total expenditure to finance development, i.e. capital

expenditures. According to the functional classification of the budget, it can be observed that the local government is mostly concerned about (and finances) public functions of housing and community amenity, preschool and primary school education, general public services, and road traffic (within the economic affairs).

There is a significant difference between fiscal strengths of different municipalities, towns, and counties in Croatia, and there is a significant difference in the level of realisation of certain revenue items per capita. The amount of revenues generated by the counties is significantly lower than the one generated by towns, but also than the one generated by the most municipalities. Such data confirms poor fiscal capabilities of counties to provide quality public services. The fiscal capacities of towns in Croatia significantly differ, because as many as 77 out of 127 towns have total revenue per capita below average. As far as the municipalities are concerned, their fiscal capability of financing their own requirements differs extremely, and approximately 70 percent of municipalities have revenues (grants excluded) below average. However, the municipality revenues are in no correlation with the amount of grants received from the state budget.

Apart from that, there are a large number of municipalities and towns that have special financing status.²⁰ The special financing status consists of various forms of reliefs, benefits, supports and grants for population, economic subjects, and local budgets which in various ways have impact on the decrease (through uncollected revenues from reliefs and benefits) and/or increase (through grant revenues) of the revenue side of the local budgets.

Municipality, town or county should generate such amount of revenues that ensure that local government units can cover all necessary public expenditures stipulated by the law. The real question is whether the revenue structure described, and, even more, expenditure structure, as well as indicators of the fiscal strength of municipalities, towns, and counties, allow the increase of local government units responsibilities to provide public services to their citizens, as well as the increase of awareness of local government units of the need to rely on their own fiscal capacities in order to execute public tasks.

In this part of the paper we additionally analyse the data about realisation the local budgets in revenues and expenditures of the consolidated general government and in GDP in order to evaluate how much local

²⁰ Areas of special state concern, hill and mountain regions, islands, City of Vukovar and local government units which finance decentralised functions.

government units truly contribute to the realisation of revenues and expenditures of the consolidated general government and to GDP, once all the mutual transactions between different levels of government cancel each other.

Table 9: Revenues and expenditures of sub-national government in revenues and expenditures of the consolidated general government and in GDP, in percentage

| Year | Revenues of sub-national government units | | | Expenditures of sub-national government units | | |
|------|---|--|-------------|---|--|-------------|
| | Outturn in 000 HRK | In % of consolidated general government revenues | In % of GDP | Outturn in 000 HRK | In % of consolidated general government expenditures | In % of GDP |
| 2000 | 8,155,966 | 10.93 | 5.35 | 8,263,723 | 10.04 | 5.42 |
| 2001 | 6,953,953 | 8.82 | 4.12 | 7,321,974 | 8.71 | 4.28 |
| 2002 | 8,332,799 | 10.05 | 4.00 | 8,335,141 | 10.25 | 4.00 |
| 2003 | 8,456,146 | 9.47 | 3.72 | 9,239,693 | 10.58 | 4.07 |
| 2004 | 9,407,683 | 9.76 | 3.83 | 8,599,052 | 9.12 | 3.50 |
| 2005 | 10,458,468 | 10.14 | 3.96 | 9,713,927 | 9.66 | 3.67 |
| 2006 | 11,901,172 | 10.60 | 4.16 | 10,469,573 | 9.72 | 3.66 |
| 2007 | 13,379,019 | 10.56 | 4.26 | 11,819,047 | 9.95 | 3.76 |
| 2008 | 14,747,477 | 10.95 | 4.31 | 13,650,745 | 10.48 | 3.99 |
| 2009 | 14,615,102 | 10.86 | 4.39 | 13,460,196 | 10.12 | 4.04 |

Note: Due to a change in the way of collecting data about sub-national government outturn in fiscal year 2001 and later, Ministry of Finance publishes only data from 53 local government units (20 counties, City of Zagreb and 32 big cities which cover decentralisation function in education).

Source: Ministry of Finance.

The share of revenues and expenditures of sub-national government in the total government budget revenues and expenditures, as well as share of these revenues in GDP - before and after 2001 – could indicate size of undertaken fiscal decentralization. In 2001 the process of decentralization started. Unfortunately, the Ministry of Finance does not have a whole data base on outturn of local government budgets. The reason is change in methods for collecting and distributing data (change in programme of collecting data on local budgets). Consequently, the Ministry of Finance disposes with 70 percent of local budgets²¹. On the basis of available data, the share of local budget revenues in consolidated general government budget revenues totalled 8.8 percent and 4.1 percent in GDP (Table 9). Data for 2002, the first

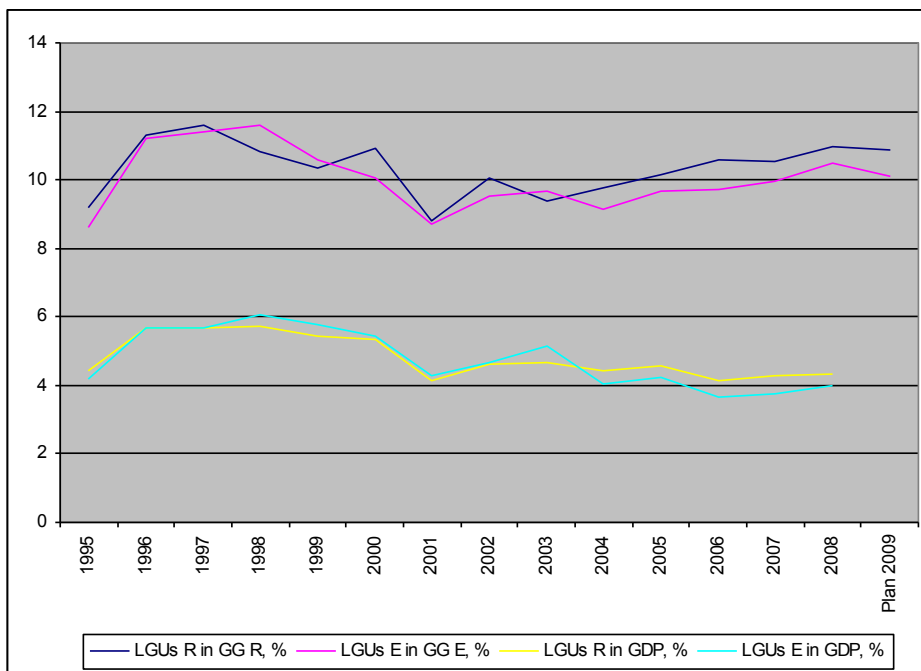
²¹ This 70 percent of local budgets covers 53 local government units (21 counties and 32 big cities) out of 576 as total number of local government units that, by law and government decree, cover decentralized functions in primary and secondary education, social welfare and health care.

year after the launch of decentralization, indicates that the share of local budget revenues in consolidated revenues of the general government budget totalled 10.1 percent, and their share in GDP amounted to 4 percent.

Data for 2009 shows that level of decentralisation only slightly changed compared to the 2001. The share of local budget revenues in consolidated revenues of the general government budget increased to 10.9 percent, while share of local budget expenditures in consolidated general government expenditures decreased to 10.1 percent in 2009. This is the clear sign that the goal of achieving higher participation of local budgets in consolidated general government budget is still not achieved.

All this data clearly show that Croatia is a highly centralised country based on two important indicators: the share of revenues and expenditures of sub-national government in GDP and the share of revenues and expenditures of sub-national government in the total government budget revenues and expenditures (see Figure 1).

Figure 1: Revenues and expenditures of sub-national governments in revenues and expenditures of consolidated general government and in GDP, in percentage



Source: Ministry of Finance.

The analysis of the current financing of decentralised functions in Croatia for the 2001-2009 period leads to a series of conclusion about the past process of decentralisation in Croatia.

The most of the existing ten public functions are still under jurisdiction of the central state. This is also the case with four public functions that are partially decentralised (education, health, social protection, and fire protection), since responsibilities and expenditures for their financing are still divided between the central, and local and regional levels of government.

Financing decentralised functions is still realised from two sources, to the lesser extent from local budget revenues (from additional part of the income tax), and to the more significant extent from the central budget revenues (from the grant equalisation fund for financing decentralised functions).

The existing decentralisation of the competencies and of financing part of public functions did not strengthen the responsibility of municipalities, towns, and counties, nor has it enhanced their autonomy in providing decentralised public function. Also, it has not increase local government units responsibility in securing other public services that are the nearest to the citizens or the degree of their responsibility in performing other public functions from their competence. The responsibility and resources to perform decentralised public functions are still divided between the central state and local levels of government, where the local level of government very limitedly participate in decision making on dividing that responsibility and finances.

Only one quarter of Croatian towns took over the obligation of decentralised financing of the part of the primary school expenditures²², while the existing legal possibility for financing part of the school expenditures has not yet been exploited by further sixty local units, each with more than 8,000 citizens, which did not took over the responsibility for decentralised financing of the part of the primary school expenditures.

In Croatia there are significant differences in budget capacities between counties, towns, and municipalities. 429 municipalities generate 15.8 percent, 126 towns 39.9 percent, the City of Zagreb 28.9 percent, and 20 counties 15.4 percent of the total local budget revenue in Croatia. The authorities of all the municipalities

²² In total, 33 towns and City of Zagreb.

and towns (with the exception of large towns) in performing public affairs are the same, no matter what their development level, fiscal capacity or size is. Large towns, that is, those towns that have over 35,000 inhabitants or that are county seats are exception. They can also conduct tasks from the authorities of the counties. Such a defined system of municipality and town authorities has numerous shortcomings. One of the more important shortcomings is that municipalities and towns can not perform public functions with the same level of quality because they have different degree of development, fiscal capacity, and the size. Small municipalities and towns with low fiscal capacity cannot fully comply with the requirement to provide the same kind and same quality of public service to their citizens as large towns which have higher fiscal capacity.²³

Local government units have a small number of financing instruments on which they can influence or on which they can at least sufficiently influence (by changing the rates within law stipulated limits) to collect needed resources to finance their authorities and tasks.

Despite the fact that the total number of fiscal instruments on which they can influence is small, municipalities and towns still have legally defined potential possibilities to influence the level of the collected fiscal resources. Municipalities and towns can set the tax rate of one tax revenue by their own decision, and they can set the tax rate of other tax revenues by their own decision within a legally stipulated range. However, although they do have limited possibility of influence, municipalities and counties use insufficiently these fiscal instruments.²⁴ Unlike municipalities and towns, the counties are almost completely denied by law the possibility to autonomously prescribe county taxes.²⁵

²³ The reasons behind this situation are twofold: lack of their own capacities and financial resources, and economics of scale, that make providing public service to a small number of users more expensive.

²⁴ Out of 213 municipalities (50 percent of the total number of municipalities) and 75 towns (59 percent of the total number of towns) that introduced surtax on the income, only 41 municipalities and 9 towns introduced the maximum legally allowed rate of surtax. City of Dubrovnik is the only town with the status of a large city that introduced the maximum legally allowed rate of surtax. That means that only 9 percent of all the units of local self-government in Croatia (9.6 percent of municipalities and 7 percent of towns) introduced the maximum legally allowed rate of surtax on the income. Introducing the maximum surtax rate would generate 5.9 percent higher revenues to all the towns (City of Zagreb excluded) compared to the current revenues from the income tax and surtax (without the equalization grant and income tax returns), and municipalities would generate 6.7 percent higher revenues compared to their current revenues from the income tax and surtax. That would also mean that if the municipalities and towns had introduced the highest possible rates of surtax and thus made additional tax burden on their inhabitants, their total debt would have been less by half than the existing level of debt.

²⁵ Since county taxes are stipulated by law in such a way that the county authorities do not have any freedom to prescribe any changes in the base or the rate.

The criteria for assigning grants to the local government units in Croatian practice are not based on the calculation of fiscal capacity, but they change every year. In the same manner, every year bring new or changed criteria for assigning current grants from the state budget to the counties. Counties then these grants assign to municipalities and towns in their region. Due to insufficiently transparent criteria for assigning the grants defined in the *Budget Execution Act*, and also because these criteria are subject to annual changes, municipalities, towns, and counties have reduced ability to plan their resources.

Since those are mostly capital grants, which mean that these resources are mostly used for financing development projects, it is clear that in the future the grant criteria should be defined at least in the three year fiscal period. That way, local government units could plan their development priorities and expenditures in the longer term.

The level of the total borrowing of the local government units in Croatia is defined by the central state through annual enactment of the measures to limit borrowing of local units, compliant with the *Budget Act*, *Budget Execution Act* and *Regulations on Borrowing Procedure for Local Units and on Issuing Guarantees to Local Units*. There are two key limitations on local units borrowing. The first limitation puts limits on borrowing of all the local units, and the second limitation concerns borrowing of an individual local unit. The problem which should be pointed out here concerns lack of transparency in the criteria for getting the approval from the Government of the Republic of Croatia for borrowing of municipalities, towns, and counties within the boundaries of the maximum allowed level of borrowing of all the local government units.²⁶

The real decentralisation also carries clear responsibilities for local government units. Local budgets have to depend as little as possible on the state budget to finance their obligations (current activities and development projects). If a local unit with its local budget revenues is incapable of financing even its current, legally stipulated affairs, then it cannot justify execution of its basic reason of existence - efficient meeting of public needs of its citizens. In case when a local unit cannot finance a development project important to its citizens from its own budget, prior to allocating the resources from the state budget, there is a possibility of increasing fiscal capacity by joining/merging with a neighbouring local government unit in providing this

²⁶ Namely, there are no clear criteria (with the exception that the requests are to be solved in the order in which they were received) which would enable local government units to use the possibility of the total borrowing capacity regulated in the annual Budget Execution Act.

project/activity. If the local units are not able to realise this in practice, then the attempt to organise distribution of public functions so that those public functions that are closer to the local community are also decentralised actually does not have a lot of sense.

Local and regional self-government units in Croatia are highly dependent on tax revenue sharing (income tax) and grants from the central government. The fiscal capacities of local government units differ significantly, while all municipalities and all cities (except big cities and cities that are county centres) have equal authorities. Consequently, it is not possible to ensure the comparable quality of public services. In order to address these imbalances, in the next part of paper we consider possible solutions for decentralisation in Croatia²⁷.

4.2. Possible solutions for decentralisation in Croatia

In this part of the paper we are giving only short guidelines and proposals for further fiscal decentralization in Croatia, aimed at ensuring more equal and more efficient provision of public services. Our proposals for decentralization can be grouped in three main areas:

- (i) a clear division of mandatory authorities among different local units,
- (ii) a change in funding of the local units, and
- (iii) a modified territorial division of the country.

A *division of mandatory authorities* among municipalities, towns, big cities, county centres and regions in Croatia are seen as fundamental requirement for future efficient decentralization. In the next table we propose division of mandatory authorities among local government units in Croatia.

²⁷ The same conclusions are given at recently organized Roundtable on regional and local self-government in Croatia organized by HAZU (Barbić, 2010).

Table 10: A clear divisions of mandatory authorities among municipalities, cities, big cities, and regions

| | |
|-------------------------------|--|
| Municipalities | <ul style="list-style-type: none"> – financing children’s day-care – financing municipal waste transport and management – financing the maintenance of public areas – financing public fire fighting brigades – financing unclassified roads and public lighting |
| Towns | Mandatory authorities of municipalities and <ul style="list-style-type: none"> – financing public libraries – financing public utility services – financing water supply and drainage – financing primary and secondary education – financing social welfare centres |
| Big cities/ County centres | Mandatory authorities of cities and <ul style="list-style-type: none"> – management of primary healthcare – financing of cultural institutions – financing of public roads |
| Regions | <ul style="list-style-type: none"> – handling the networks of agencies and institutions providing public services (establishing a network of primary and secondary healthcare, pre-school educational institutions, primary and secondary education, social protection institutions, and cultural institutions) – financing secondary healthcare and financing primary and secondary education in municipalities and cities of the region which do not support the costs of primary and secondary education – funding some of the public services which had previously been provided by state administration offices in the county, as well as physical planning and environmental protection |

Source: Authors' systematization.

A *change in funding of the local units* is related to their mandatory authorities and should provide stable, adequate and foreseeable revenue. The first set of proposals refers to modification of the existing mode of financing and includes changing the income tax surtax rates and using surtax revenues in determining the amount of central government grants extended to local self-government units; modifying the purpose of communal contribution, and measures focused on the management of property owned by local and regional self-governments. The second set consists of *reform proposals* - they ask for the new role of property tax which would replace communal fees, the application of formulas to share total revenues with the central government, the definition of criteria for the allotment of grants to local units, and introduction of incentives for the joint provision of public functions and/or financing of development projects by several local self-government units.

A *modified territorial division of the country* is result of application of fiscal autonomy principles for local units aimed at efficient provision of mandatory authorities. The division should be based on three main criteria: i)

population size; ii) fiscal capacity and iii) economic structure.²⁸ The first criterion proposes a minimal number of 2,000 inhabitants for a municipality, 10,000 inhabitants for a city, and 35,000 inhabitants for a big city. The second criterion defines standard expenditure for mandatory authorities and standard revenues for municipalities and cities. Based on the factor and cluster analysis²⁹ and taking into account the efficiency of providing public services, it is proposed that Croatia is divided into seven larger regions that consist of several counties.

5. CONCLUSIONS

The initiated decentralization process in Croatia should be continued. Given that decentralization is a delegation of authority, responsibility, and resources from a higher government level to the local and regional level, it is necessary to ensure that provision of responsibility is transparent at all administration levels.

The future implementation of the decentralization process enquires for independence of local self-government units, both in performing the tasks and in the collection of revenues. In doing so, it is crucial to “provide approximately equal possibilities for the provision of services to their citizens”, which is possible only through the transparent and constant re-defining of equalisation grants in the proposed fiscal decentralisation model.

Implementation of decentralization process should involve active participation of all key stakeholders at the central, regional and local level of government with expert help of scientific institutions, NGOs, civil society and all other interested institutions and individuals in the transparent decentralization process.

Together with the existence of the political will, the most important prerequisite for successful decentralisation is to set clear goals of decentralisation (administrative, fiscal, and territorial), activities and measures for its realisation, identify entities responsible for execution of activities and measures, define the

²⁸ In addition to these criteria some other factors should be taken into consideration when deciding about new territorial division of the country, such as: historical factors.

²⁹ Details about factor and cluster analysis conducted, main assumptions and statistical data used in the analysis to propose new territorial division of the country can be found in Institute of Economics, Zagreb (2010).

expected results and effects (outcomes), and create a political consensus among all the important participants regarding the need to reform public administration with special focus on the reform of the system of local and regional self-government. In conclusion of this paper we are stating only the most important goals of decentralisation. Cogitating on realisation of other important pre-requirements for successful decentralisation is not the object of consideration in this paper and we leave them to the exponents of the public policy.

Among the most important goals of decentralisation, there is more efficient provision of public services in order to fulfil the needs of local inhabitants in the best manner possible.

Clear division of authorities between the central state and lower levels of government should enable more efficient provision of public services. Responsibilities for performing public functions should be harmonised with the financial resources.

Efficient administrative and territorial organisation of the state should come as a result of transparent functional and fiscal decentralisation. That is also the reason why the important goal of decentralisation is to minimise municipality, town, and county dependence on the central state grants and to promote financial independence of local government units in financing compulsory authorities.

The goal of decentralisation is also to encourage cooperation between local government units in joint provision of public services and in financing development projects of mutual interest to more than one local unit.

The modern approach to local development has increasing tendency towards participation of a broader range of subjects interested in individual development programmes and projects. Cooperation of public and private sector, combined with letting part of public services to the care of non-government sector and privatisation of public services, is one of the goals in providing public services efficiently.

There are new responsibilities for the local authorities that come with the decentralisation process, and these responsibilities require significantly different knowledge and skills necessary for their execution. One of the more important goals of decentralisation is that the new public administration should be founded on

the approach to provide public services and their financing, since the citizens of local government units expect far greater responsibilities and orientation towards outputs and outcomes with savings of public resources in execution of public functions.

Also, it is necessary to build a system of clear criteria. Building is among the most important goals of decentralisation. There are numerous areas in which the effort should be made to establish clear criteria. Measurement of fiscal capacity has to be specifically point out as a basis for establishing required level of assistance form the central state, and establishment of the structure and the number of local units.

Establishing the appropriate administrative and territorial organisation is the final goal of decentralisation. Decentralisation should be such to support and allow efficient provision of public services, and the system itself should be based on compulsory authorities in execution of public functions and on transparent financing.

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ANNEXES

ANNEX 1: Indicators of fiscal capacity for counties, per citizen, in HRK

| Number of counties: 20 | Average | Minimum | Maximum |
|---|---------|---------|---------|
| OPERATING EXPENSES | 974.6 | 787.2 | 1,208.5 |
| Tax revenues | 757.3 | 243.3 | 1,018.1 |
| Share of income tax revenue from equalization grants for financing decentralized functions | 314.2 | 14.7 | 447.9 |
| Grant revenues | 155.8 | 49.2 | 869.7 |
| Property income | 29.8 | 6.0 | 55.7 |
| Administrative fees | 28.3 | 15.1 | 90.8 |
| Total revenues without grant revenues and share of income tax revenue for financing decentralized functions | 504.6 | 286.6 | 843.0 |
| OPERATING EXPENSES | 841.6 | 685.2 | 1,086.5 |
| Expenditures for compensation of employees | 140.2 | 90.5 | 272.2 |
| Use of goods and services | 400.1 | 211.5 | 573.9 |
| Subsidies | 34.8 | 10.4 | 59.6 |
| Grants | 59.1 | 6.3 | 111.1 |
| TOTAL REVENUES | 978.4 | 796.3 | 1,208.5 |
| TOTAL EXPENDITURES | 1,009.0 | 819.0 | 1,276.4 |
| Expenditures for general government services | 194.5 | 115.1 | 360.9 |
| Expenditures for defense | 0.1 | 0.0 | 1.1 |
| Expenditures for public order and safety | 7.3 | 0.0 | 11.6 |
| Expenditures for economic affairs | 94.3 | 34.0 | 185.9 |
| Expenditures for environment protection | 18.7 | 1.1 | 44.2 |
| Expenditures for housing and community amenity | 24.3 | 0.0 | 67.2 |
| Expenditures for health | 122.1 | 54.6 | 196.1 |
| Expenditures for recreation, culture and religion | 44.8 | 9.9 | 98.2 |
| Expenditures for education | 401.1 | 270.2 | 669.5 |
| Expenditures for social protection | 101.8 | 28.9 | 253.3 |

Note: item total revenues without grants means total revenues without grant revenues and share of income tax revenue for financing decentralized functions.

Source: author's calculation based on data from Ministry of Finance (2010a) and Central Bureau of Statistics (2002).

ANNEX 2: Indicators of fiscal capacity for cities, per citizen, in HRK

| Number of cities and towns: 127 (City of Zagreb included) | Average | Minimum | Maximum |
|---|---------|---------|----------|
| OPERATING EXPENSES | 3,734.5 | 948.2 | 10,533.3 |
| Tax revenues | 1,969.0 | 464.9 | 6,250.6 |
| Share of income tax revenue from equalization grants for financing decentralized functions | 120.5 | 0.0 | 997.3 |
| Grant revenues | 531.8 | 20.2 | 3,563.3 |
| Property income | 281.1 | 14.5 | 1,785.4 |
| Administrative fees | 904.4 | 89.5 | 4,258.6 |
| Total revenues without grant revenues and share of income tax revenue for financing decentralized functions | 3,082.2 | 683.1 | 9,735.3 |
| OPERATING EXPENSES | 3,211.5 | 886.9 | 8,968.1 |
| Expenditures for compensation of employees | 885.4 | 99.0 | 2,618.1 |
| Use of goods and services | 1,274.7 | 278.2 | 4,178.5 |
| Subsidies | 74.0 | 0.0 | 1,220.5 |
| Grants | 28.9 | 0.0 | 471.6 |
| TOTAL REVENUES | 4,023.0 | 968.2 | 11,594.3 |
| TOTAL EXPENDITURES | 4,360.0 | 1,324.8 | 13,486.3 |
| Expenditures for general government services | 842.1 | 168.4 | 2,368.6 |
| Expenditures for defense | 3.2 | 0.0 | 256.7 |
| Expenditures for public order and safety | 198.5 | 0.0 | 957.5 |
| Expenditures for economic affairs | 717.2 | 0.0 | 4,667.6 |
| Expenditures for environment protection | 307.5 | 0.0 | 4,861.3 |
| Expenditures for housing and community amenity | 906.4 | 0.0 | 4,239.1 |
| Expenditures for health | 34.3 | 0.0 | 1,078.2 |
| Expenditures for recreation, culture and religion | 573.1 | 93.5 | 3,794.3 |
| Expenditures for education | 571.7 | 15.0 | 3,415.2 |
| Expenditures for social protection | 206.1 | 0.0 | 1,026.0 |

Note: item total revenues without grants means total revenues without grant revenues and share of income tax revenue for financing decentralized functions.

Source: author calculation based on data from Ministry of Finance (2010a) and Central Bureau of Statistics (2002).

Annex 3: Indicators of fiscal capacity for municipalities, per citizen, in HRK

| Number of municipalities: 429 | Average | Minimum | Maximum |
|---|---------|---------|----------|
| OPERATING EXPENSES | 3,010.0 | 506.7 | 16,993.6 |
| Tax revenues | 1,253.5 | 185.7 | 7,882.5 |
| Share of income tax revenue from equalization grants for financing decentralized functions | 19.3 | 0.0 | 1,874.8 |
| Grant revenues | 812.1 | 0.0 | 15,727.9 |
| Property income | 263.0 | 0.0 | 6,741.9 |
| Administrative fees | 639.9 | 12.0 | 9,059.0 |
| Total revenues without grant revenues and share of income tax revenue for financing decentralized functions | 2,178.6 | 288.1 | 15,252.5 |
| OPERATING EXPENSES | 2,350.1 | 352.9 | 13,330.0 |
| Expenditures for compensation of employees | 425.9 | 43.4 | 4,211.3 |
| Use of goods and services | 1,079.5 | 180.7 | 7,671.4 |
| Subsidies | 51.4 | 0.0 | 1,584.1 |
| Grants | 74.3 | 0.0 | 1,744.1 |
| TOTAL REVENUES | 3,227.4 | 507.4 | 18,335.4 |
| TOTAL EXPENDITURES | 3,617.8 | 646.5 | 34,828.2 |
| Expenditures for general government services | 976.9 | 0.0 | 13,034.3 |
| Expenditures for defense | 0.4 | 0.0 | 29.2 |
| Expenditures for public order and safety | 88.4 | 0.0 | 1,691.5 |
| Expenditures for economic affairs | 819.2 | 0.0 | 26,389.2 |
| Expenditures for environment protection | 211.7 | 0.0 | 8,231.8 |
| Expenditures for housing and community amenity | 856.1 | 0.0 | 9,211.4 |
| Expenditures for health | 11.4 | 0.0 | 908.3 |
| Expenditures for recreation, culture and religion | 250.6 | 0.0 | 3,729.4 |
| Expenditures for education | 259.4 | 0.0 | 4,840.9 |
| Expenditures for social protection | 143.5 | 0.0 | 4,271.1 |

Note: item total revenues without grants means total revenues without grant revenues and share of income tax revenue for financing decentralized functions.

Source: author calculation based on data from Ministry of Finance (2010a) and Central Bureau of Statistics (2002).