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FISCAL DECENTRALIZATION IN CROATIA - REFORM PROCESS OR POLITICAL RHETORIC

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Abstract

The paper discusses the issues involved in decentralization process in Croatia. Although it has become the most favoured reform policy priority among the Croatian politicians of all options, the values of indicators of fiscal decentralization confirm the fact that it has been achieved at a very low degree. The paper outlines characteristics of Croatian system of fiscal decentralization and measures that are necessary for successful implementation and realization of the benefits associated with fiscal decentralization. The conclusions in this paper are based on the analysis of the division of functional responsibilities and revenues across levels of government and on calculation of widely used measures for the estimation of the degree of decentralization. The paper concludes with a re-emphasis on the importance of execution of decentralization process in a way that it ensures financial autonomy of local units so that they have sufficient revenues needed for the realization of delegated functions.

Keywords: decentralization, expenditure assignment, revenue assignment, grants, equalization system, indicators of fiscal decentralization

1. INTRODUCTION

In the recent decades, fiscal decentralization has emerged as a trend worldwide. This trend can be seen in the developed as well as in developing countries. There is diversity in degree of decentralization across the world but concern is that there is problem in defining and measuring the degree of fiscal decentralization. In fact, how decentralization is measured depends on how it is defined. Yet, there is no consensus on the precise definition of decentralization and due to complexity of intergovernmental relations that encompass many dimensions there is no single quantitative measure for measuring the degree and evaluating the outcomes of decentralization process.

Decentralization is a complex and multifaceted concept that comprises fiscal, political and administrative dimension. In short, it means distribution of responsibilities and sources of funds. Lower governmental units carry out matters of local importance through which the needs of citizens are met directly. The decentralization process includes the devolution of responsibility for public outlays, revenues and transfers by the central government to lower government levels. Significant increase in the financial capacity and fiscal autonomy of local self-government units is understood.

The process of fiscal decentralization in Croatia started quite recently, in 2001. Having a priority to set up modern state and defend occupied territory, the dominant approach during and after the Croatian War of Independence was centralization of public administration. Political decentralization process started after the war with constitutional and legislative reforms, the development of pluralistic political parties and representative governments that gave citizens and their elected representatives more power in public decision-making. As a candidate country for the accession into EU, Croatia has adjusted legal framework for local self-government to the requirements established in the European Charter of local self-government. However, the question does it succeed to implement decentralization in practice and how successfully still remains.

In 2001 administrative and fiscal decentralization begun, together with the redistribution of authority, responsibility and financial resources for providing public services among different levels of government. After analyzing territorial division, legal and organizational framework, the paper examines the various dimensions in which phenomenon of decentralization has its effect: the assignment of expenditure responsibilities and revenue sources to different government levels, intergovernmental fiscal transfers and sub-national borrowing. The conclusions point out main obstacles for the successful implementation of fiscal decentralization in Croatia, offering some proposals for following steps needed to be taken in decentralization reform process.

2. TERRITORIAL DIVISION OF REGIONAL AND LOCAL GOVERNMENT IN CROATIA

Croatian territory is administratively divided into 577 local and regional self-government units of which 127 are towns/cities and 429 municipalities, which belong to 21 counties. Counties are established as second level units; they are both parts of the system of state administration and local self-government units. The capital of Croatia, Zagreb, has a specific status and is considered both a (capital) town and a county.

One hundred and eighty local units have status of regions of special national concern. Law on regions of special national concern (OG 26/03) distinguishes three groups of regions that enjoy special tax treatment and other privileges, in order to diminish consequences of Croatian War of Independence, encourage uniform demographic and economic development of the entire territory of the Republic of Croatia. One hundred and eleven municipalities/towns that belong to the first and second group are areas that still suffer war consequences. The third group of areas of special national concern consists of 69 municipalities/towns that are classified according to four criteria: economic development, demographic situation, structural difficulties and a special criterion (mined areas and areas that have additional development difficulties). The same privileges enjoy 45 municipalities located in the hill and mountain areas. Special government measures are applied for insular areas as well.

Total number of 577 local government units indicates the fragmentation problem, which has inevitable negative consequences such as higher costs of service provision, due to the non-exploitation of economies of scale and the provision of a smaller range of public services. Further, disparities of social, economic and demographic conditions are noticeable among jurisdictions and they influence their fiscal capacity and ability to deliver services. Such administration has reduced their average size as well as the number of inhabitants. Consequently, such process resulted in their inefficiency because of an increased number of communes whose finances, staff and organization are not capable to provide local public services.

The fact that only 53 (20 counties, the city of Zagreb and 23 municipalities and cities) of total 577 local government units, have assumed the obligation of financing the decentralized functions confirm the thesis of this paper that the decentralization process is not successfully implemented in Croatia and that the need for new reform is priority. It is interesting that these 53 local government units, that assumed the financing of the decentralized functions, participate with 70-80% in total revenues of all local government units.¹

¹ Annual Report for 2007, Ministry of finance, Zagreb, 2008, p. 87. (available on www.mfin.hr)

The large number of local units makes it impossible for the central government to get a realistic picture of their financial capacity. According to the Article 5 of the Law on Local and Regional Self-government, every place that satisfies the formal criterion of a population of 10,000 can become a city so there are cities that are incapable of either of financing their expenditure or of providing the basic services that are statutory stipulated. That is the reason why do they depend on direct transfers from the national Budget.

There is still trend toward the foundation of new local units. Unfortunately, they tend not to be founded on a realistic estimation of their fiscal capacity. Changes in the number of local government units are inevitable. Solutions to fragmentation problem can be: *amalgamation* (merging smaller units into a bigger one), *contracting out services* between government units and *cooperation* through the *creation of specific organizations* (such as associations of municipalities).

3. LEGAL FRAMEWORK FOR DECENTRALIZATION PROCESS IN CROATIA

The process of fiscal decentralization in Croatia has started quite recently, in 2001. After the war and the Constitution it was necessary to undertake significant steps in democratization process through the adoption of legal provisions which were important for establishment of the system of local autonomy and implementation of the first local elections, which gave citizens and their elected representatives more power in public decision making. Further reform was continued with changes in legislation that were introduced during 2001 by the amendments to the Constitution and enactment of the new Law on Local and Regional Self-government (LLRSG) which were adjusted to the provisions of the European Charter of Local Self-government.

As a member state of the Council of Europe, Croatia ratified the European Charter of Local Self-government on September 19th, 1997. The European Charter of Local Self-Government is the first multilateral legal instrument that sets a minimum of basic principles of government that any democratic system of local self-government should include. It provides basic standards for the effective operation of local self-government, as well as standards guaranteeing the political, administrative and financial independence of local authorities. The Charter was created by the Council of Europe at the initiative of the Standing Conference of Local and Regional Authorities of Europe and it was opened for signatures on October 15th, 1985.²

² Mušec, M., Pigey, J., Compliance of the Croatian Legislative Framework with the European Charter of Local Self-government, USAID, The Urban Institute, Zagreb, 2005., p. 9- 10.

Countries that join the Charter have the obligation to apply minimum set of provisions of the Charter in their legislation. Taking into consideration diversity of legal systems, political tradition and local government structures of signatory states, countries are given a degree of choice. According to the Article 12 of the Charter the Parties are required to subscribe to at least 20 of 30 paragraphs of Part I, including at least 10 from a nucleus of 14 basic principles.

Croatian legislation is essentially in compliance with the key requirements and provisions from the Charter but still not with all. Further improvements must be done in provision of legal instruments for improvement in local government's autonomy in exercising delegated powers and raising revenues from own sources.

On 9th December 2004 Croatian government passed Framework Program for Decentralisation of Republic of Croatia from 2004 to 2007. With this Document Croatian Government clearly stated that reform of local and regional self-government ranked among its priorities, and that development of local democracy was one of the key government tasks in next several years. After the last Parliamentary elections, in November 2007, Croatia's new ruling coalition signed a Coalition Agreement after reconciliation of basic objectives in The Program of the Government of the Republic of Croatia for the 2008-2011³. One of the main Government goals and forth chapter of The Program is Policy of Regional Development and Fiscal Decentralization. The Government committed itself to make continuous efforts and propose comprehensive legislative and strategic solutions in order to provide an efficient implementation of the decentralization process and even the development of the entire territory of the Republic of Croatia, as well as the full implementation of the European Local Self-Government Charter.

But still no formal paper has been adopted in the sense of a strategy to define the objectives, principles, effects and procedure of decentralization. All these elements are to some extent contained in the separate laws and in the bylaw regulations. It is necessary to sign single law which should contain clear and specific expenditure assignment, assignment of functional responsibilities and revenue assignment among the different levels of government.

³ New centre right coalition consists of Croatian Democratic Union (HDZ), the Croatian Peasants Party (HSS) and the Social Liberal Party (HSL), the Independent Democratic Serbian Party (SDSS). The new Government is supported in Parliament by other representatives of non-Croatian minorities and by the pensioners' party.

4. MANDATORY RESPONSIBILITIES OF LOCAL AND REGIONAL SELF-GOVERNMENT UNITS

From 2001 through the fiscal decentralization process the central government transferred responsibilities for financing primary and secondary education, health care, social welfare and fire departments to the local government units.

Noticeable is the lack of clear expenditure assignment for counties. They have very few exclusive responsibilities. As result occur functions overlapping between the central government and sub-national governments. Based on provisions of the Law on Local and Regional Self-government, counties, in their self-governing scope of authority, are responsible for functions of a regional character. Exclusive responsibilities of counties enclose secondary, vocational and adult education, maintenance of health and social care facilities and roads in their competence. The most important role of the county is to equalize development of municipalities and cities within its area and to coordinate the interests and views of these units.

The cities and municipalities deliver more public services than do the counties. Within the sphere of competence of their self-government they carry out operations of local importance that directly realize the needs of the citizens, and that have not been assigned by Constitution to the state bodies.⁴ This regulation is in accordance with *the principle of subsidiary*⁵(European Charter, Article 4, Paragraph 3) and is mainly applicable on utility services (drinking water supply; drainage and treatment of sewage; gas and heat supply; public transport; cleaning; deposition of garbage; maintenance of public areas; maintenance of unclassified roads; retail markets; cemetery and crematorium maintenance; chimney sweeping; street lighting (management, maintenance of facilities and devices).

⁴ Law on Local and Regional Self-government (O.G. 33/01 and 60/01)

⁵ *The principle of subsidiary* states that the best results occur when the responsibility for the function of producing public goods are assigned to the lowest level of government capable of performing it.

Table 1.

Division of functions among different levels of government.

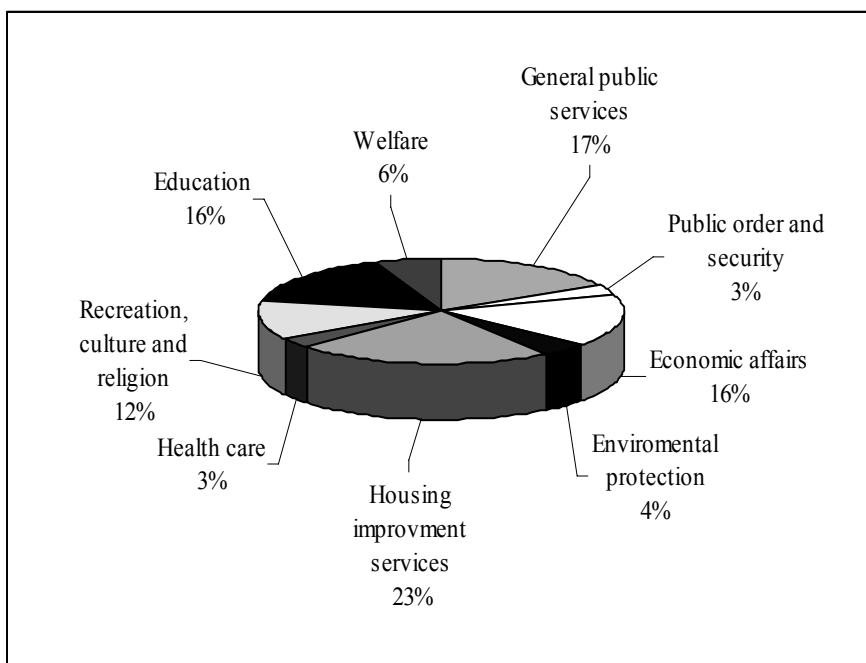
Public service	Central government	Communes	Cities	Counties
1.General public/administrative services	X	X	X	X
2. Defense	X			
3. Law and order	X			
4. Education	X	X	X	X
4.1. Pre-school		X	X	
4.2. Elementary	X	X	X	X
4.3. Secondary	X			X
4.4. Tertiary (university)	X			
5. Health Care	X			X
6. Social security and welfare	X	X	X	X
7. Housing and utilities		X	X	
8. Recreation, culture and religion		X	X	X
9. Agriculture, forestry, hunting and fishing	X			X
10. Mining, industry and construction	X	X	X	X
11. Transport and communications	X	X	X	X
11.1. Road transport	X	X	X	X
11.2. Rail transport	X			
11.3. Air transport	X			
12. Other economic affairs and services	X	X	X	X

Source: Author's systematization

The Law on amendments to the Law on Local and Regional Self-government (O.G. 129/05) distinguished the scope of activities for municipalities and towns, on one side, and large towns and towns that are centers of counties, on the other side. It is important to point out that it is prescribed by law that special particular laws for certain functions of local and regional competences will prescribe activities that large cities and counties are obliged to organize and those that they can carry out. The status of large town has the local unit that is economic, financial, cultural, health, transport and scientific center of development of wider surroundings, that have more than 35.000 inhabitants, and towns that are centers of counties. Besides the functions of local importance since 2005 they carry out some new functions, such as: settlement and environment design, zoning and urban planning, utility services, child care, social care, improvement of natural environment, consumer protection, primary health care, fire-fighting and civil protection. According to the latest regulations large towns

and counties' centers can carry out functions of a county's sphere of competences.

Besides previously determined functions, counties carry out some new functions: maintenance of public roads, issuing building and location permits and other acts related to building and implementation of documents of environment design for the county area out of the area of a large town. Additionally, municipalities, towns and counties carry out functions of government administration that are, in special laws delegated, to them, and that are financed from the state budget. Sub-national expenditure can be analyzed according to the functions of sub-national units and according to the economic classification.



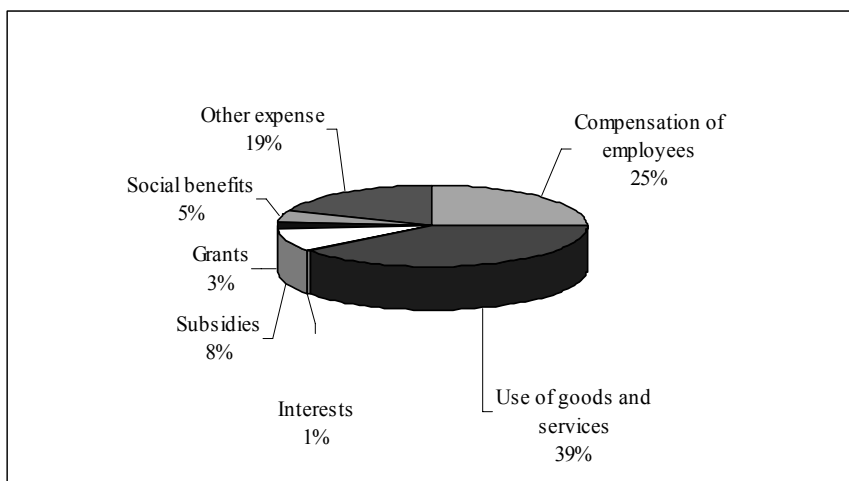
Source: Author's systematization according to Ministry of finance data

Chart 1. Sub-national expenditure according to functional classification, 2007

Chart 1. shows that the most of the expenditure of sub-national units is related to housing improvement services, where is dominant expenditure for communal services, and community development. Expenditure for the general public services is allocated for executive and legislative bodies. Such expenditure pattern is typical for unitary states but such importance of economic affairs is unusual. It includes local government intervention in the economy and is quite substantial, representing 16 percent of total expenditure. It will probably be

gradually reduced since it is incompatible with EU rules about the subsidization of economic activities.

The expenditure values related to decentralized functions correspond with results of decentralization process and match the fact that central government has transferred responsibilities for education, welfare, health care and fire protection) to sub-national units. Expenditure for public order and security refers mainly to the costs of financing the fire departments.



Source: Author's systematization according to Ministry of finance data

Chart 2. Economic classification of local and regional budget expenditures, 2007

The economic classification of local and regional budget expenditures, shown in chart 2., indicates low expenditure autonomy of Croatian LRSGUs. The largest share of total expenditures of local and regional self-government units is accounted for expenditures for the purchase of goods and services and labour expenditures. Compensation for employees refers to the costs for wages of employees in the bodies of local and regional self-government units and for wages of employees in the sub-national budget users (employees in museums, theatres, libraries, kindergartens etc.). The expenditure for the use of goods and services comprise the expenditure necessary for regular functioning of all sub-national budgets users. Resources are spent for material, energy, public lightning, waste disposal and the other services necessary for current maintenance of buildings and equipment.

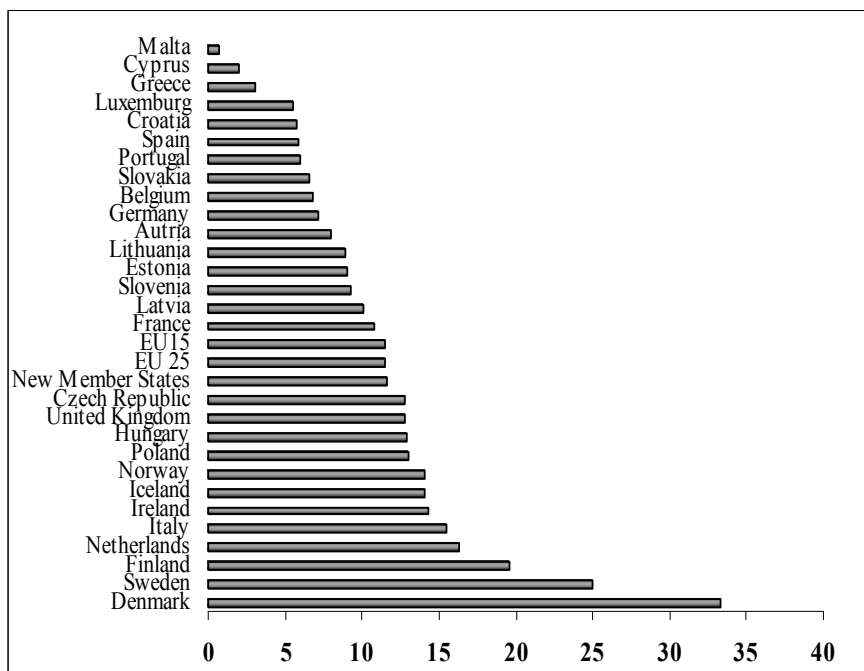
The relative importance of sub-national levels of government in the provision of public goods/services can be measured by the expenditure-GDP ratio or comparing the sub-national spending relative to the general government spending. Table 2. shows that the relative importance of sub-national government has increased since 2001 when

decentralization process started in Croatia. Delegation of public sector functions and spending responsibilities to sub-national governments have increased their share in total government spending and GDP.

Table 2.
Sub-national government expenditure, relative to GDP and Consolidated General Government Expenditure, 2001-2007 (in percent)

LG Expenditures	2001	2002	2003	2004	2005	2006	2007
% General government expenditures	8,4	10,7	11,4	12,5	13,2	13,3	13,7
% GDP	4,3	5,2	5,6	5,7	5,7	5,7	5,9

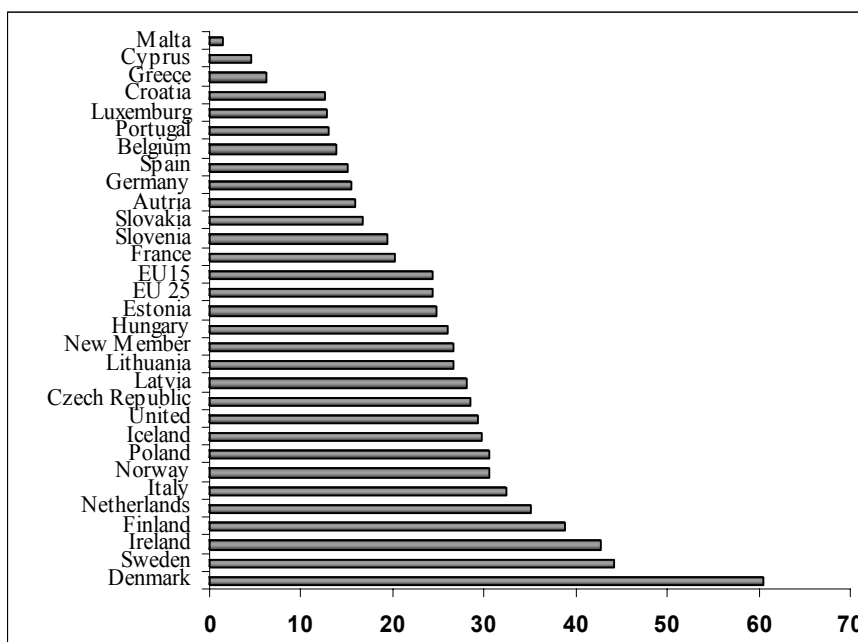
Source: Author's calculation according to Ministry of finance data (Budgets of counties, towns and municipalities in total)



Source: Bauer, H., Rudolf, C., *Local Finance in Europe, An Overview 2000/2005*, Centre for Public Administration Research, Innsbruck, 2006 and Croatian Ministry of Finance

Chart 3. Sub-national expenditure as % of GDP

Comparison of Aggregate Expenditures Measures of Fiscal Decentralization for EU countries and Croatia are shown in charts 3. and 4. Data are available for year 2004. They highlight the differences in sub-national expenditure shares. The degree of sub-national expenditure autonomy varies significantly among analyzed European countries. There are considerable national variations concerning the weight of sub-national expenditure in GDP, which ranges from as low as 0,7% in Malta to as high as 33,4% in Denmark. The ratio largely depends on the size and the nature of responsibilities entrusted to sub-national governments. Values are quite extensive in the Nordic countries. On the contrary, in Malta, Cyprus, Greece and Luxemburg the responsibilities of sub-national governments are limited, and so is the weight of their expenditures. Croatia is situated quite below the EU average (11,5%). In 2004 sub-national expenditure amounted about 5,7% of GDP in Croatia. Those results confirm the thesis that Croatia has unitary and relatively centralized system.



Source: Bauer, H., Rudolf, C., *Local Finance in Europe, An Overview 2000/2005*, Centre for Public Administration Research, Innsbruck, 2006 and Croatian Ministry of Finance

Chart 4. Sub-national expenditure in % of Consolidated General Government

The similar results shown up if sub-national expenditures are compared to General Government. The highest shares are evident for the Nordic countries:

Denmark (60,5%), Sweden (44,2%) and Finland(38,9%) and for the Ireland (42,7%). In Cyprus, Greece and Malta sub-national government is of minor importance comparing sub-national expenditures to General Government expenditures and amounted less than 6%.

5. REVENUE SOURCES OF SUB-NATIONAL UNITS

The core of decentralization process is that sub-national governments need to have revenues that are adequate to finance the expenditures assigned to them. Pre-requisite for achieving adequate fiscal capacity is fiscal autonomy of sub-national governments in raising revenues from own sources.

Table 3.

Croatian sub-national government revenue sources, 2007

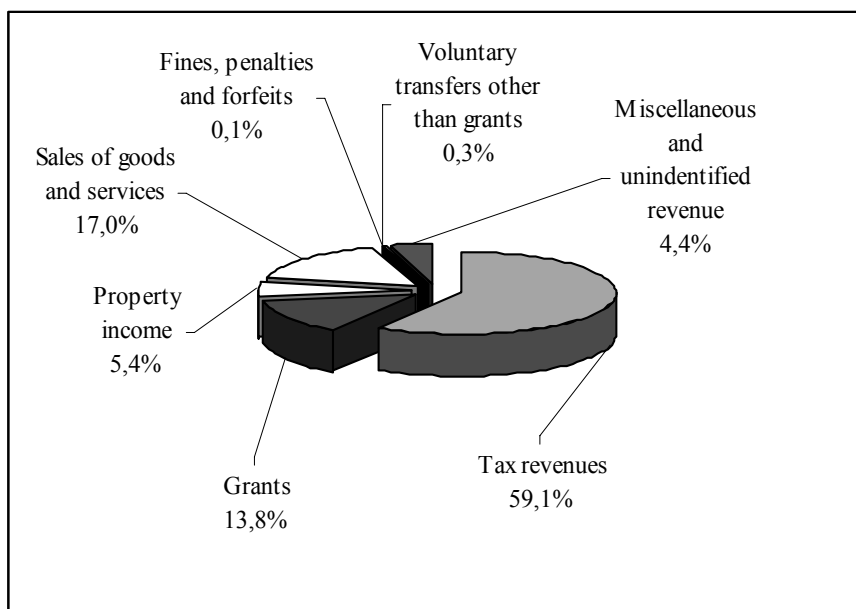
I. Taxes:	A1. Own taxes of Counties <ul style="list-style-type: none"> • Inheritance and gifts tax, • Tax on road motor vehicles, • Tax on vessels, • Levy on coin operated machines for amusement
	A2. Own taxes of Cities or Municipalities <ul style="list-style-type: none"> • Surtax on income tax, • Consumption tax, • Tax on holiday houses, • Tax on trade name, • Tax on the use of public land
	B. Shared revenues (joint taxes) <ul style="list-style-type: none"> • Personal Income tax • Real estate transfer tax
II. Grants	from: foreign governments, international organizations, other general government units
III. Property income	Interests, Dividends, Withdrawals from income of quasi-corporations, Rent
IV. Sales of goods and services	Administrative fees, Incidental sales by non-market establishments
V. Fines, penalties and forfeits	
VI. Voluntary transfers other than grants	
VII. Borrowing	

Source: Author's systematization

Local units' obligation to finance the operations within the sphere of their competence with own financial resources and financial resources transferred

from the central budget has been regulated in the Law on Financing of Local and Regional Self-Government. The Law on Financing of Local and Regional Self-Government has been changed 11 times since it was passed in 1993. According to recent changes in tax revenue sharing, since January 2007, revenues from corporate income tax belong to the central state, additional share of income tax has increased for units that carry out certain decentralized functions and revenues from personal income tax are distributed in a new way.

Chart 5. shows that in the structure of total sub-national revenues realized in 2007 the most important are tax revenues that totaled 59%. The share of non-tax revenues comes mostly from administrative and communal fees that are earmarked for certain expenditures.

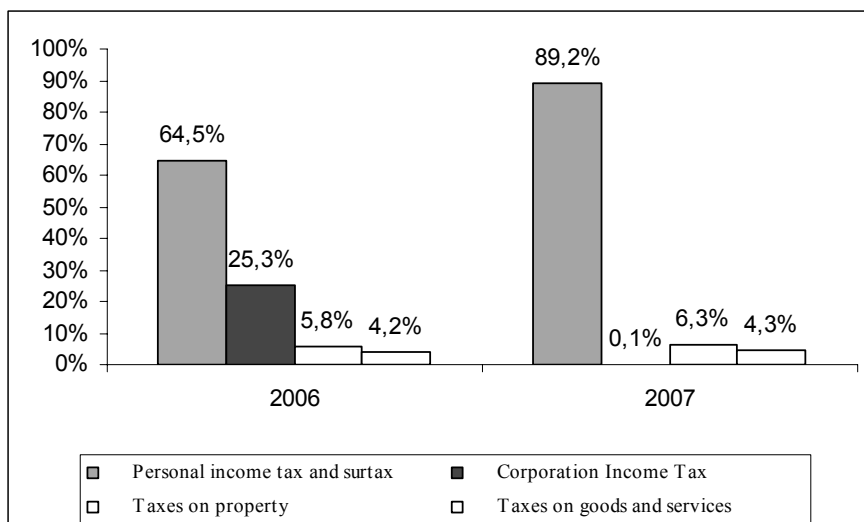


Source: Ministry of finance

Chart 5. Total revenues of 53 sub-national units, in %, 2007

The degree of fiscal autonomy at the sub-national level can be measured as the share of own revenues in total revenues. The share of own local taxes is very low and the largest share (90%) of the tax revenue of sub-national governments in Croatia is collected from the distribution of revenues from shared taxes: personal income tax and corporate income tax until January 2007 (Chart 6). The fact that the rates of shared taxes are completely determined by central government and that there is national determination of the tax base, local determination of the tax rates, within nationally determined brackets, and central government administration of the own taxes of counties, cities and municipalities,

confirm the thesis that there is low fiscal autonomy in Croatia. Only for one kind of municipal/city tax-tax on the use of public land, local government determines the tax rate with complete autonomy.



Source: Author's systematization according to Ministry of Finance data

Chart 6. Structure of the tax revenue of 53 sub-national governments, 2006 and 2007

Such a great reliance on the PIT to finance local government could cause a high degree of regional income disparities and difficulties for equalization between areas of different income levels. Tax sharing is used as vertical and horizontal fiscal equalization instrument. There is a potential risk, if a large share of sub-national spending is financed through transfers, mainly in the form of shared taxes. Sub-national governments may increase sub-national spending and underutilize their own tax base. Reliance on transfers from higher levels of government to finance sub-national spending tends to put strain on intergovernmental fiscal relations, and deepen budget imbalances at the central government level.⁶

For analyzing decentralization from the revenue side commonly used indicators are sub-national government revenues relative to GDP and relative to consolidated general government revenues.

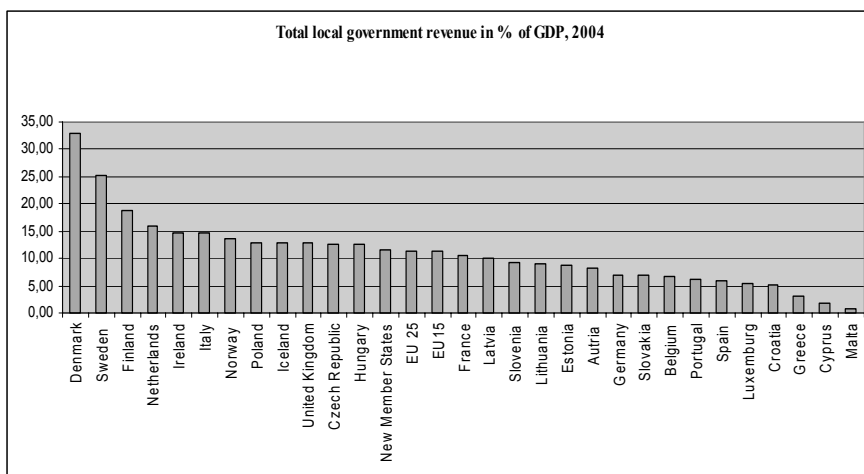
⁶ de Mello, Jr., L. R., Decentralization and Intergovernmental Fiscal Relations: A Cross-Country Analysis, World Development Vol. 28, No. 2, 2000, pp. 376

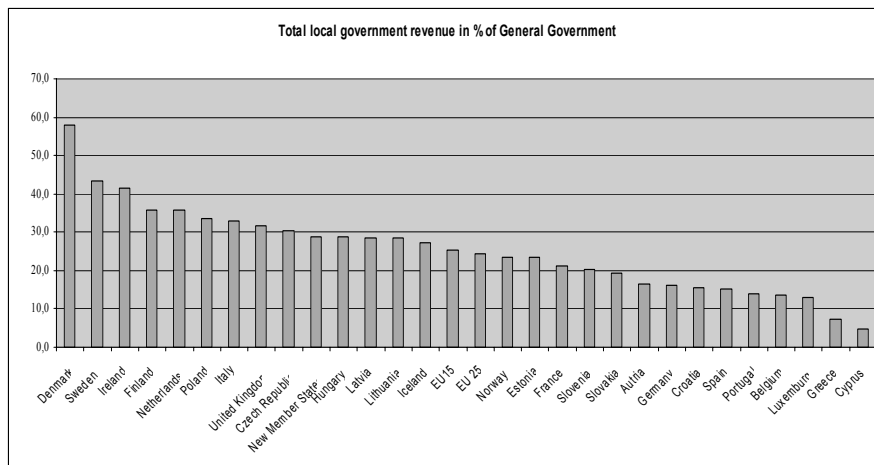
Table 4.
Sub-national government revenues, relative to GDP and Consolidated General Government Revenues in Croatia, 2001-2007 (in percent)

LG Revenues	2001	2002	2003	2004	2005	2006	2007
% General Government Revenues	8,7	14,3	15,3	15,4	16,0	16,6	17,1
% GDP	4,1	6,6	7,1	7,2	7,1	7,5	7,9

Source: Author's calculation according to Ministry of finance data (Budgets of counties, towns and municipalities in total)

The revenues of sub-national governments as a percentage of total revenues have increased in Croatia from 8,7% in 2001 to 17,1% in 2007. Comparing to GDP sub-national revenues have increased from 4,1% in 2001 to 7,9% in 2007. Those are data for all local and regional government units in Croatia. If we take into account only 53 local units that have assumed the obligation of financing the decentralized functions results are even worse. In 2007 their share in GDP was 5,6% and in General Government Revenues 12,2%.





Source: Bauer, H., Rudolf, C., *Local Finance in Europe, An Overview 2000/2005*, Centre for Public Administration Research, Innsbruck, 2006 and Croatian Ministry of Finance

Chart 7. Aggregate Revenues Measures of Fiscal Decentralization, 2004

The conclusion drawn from chart 7. is that the amount of local government revenue in percentage of GDP varies widely among EU countries. European average (25 countries) was 11,3% of GDP in 2004; for the new member states it was 11,6%. Shares above the European average are noticed in many countries such as Hungary, the Czech Republic, Italy, the Netherlands, Poland, Iceland, UK, Norway and Ireland. High quotas ranging from 19% for Finland, 25% for Sweden and to almost 33% are shown for Denmark. Shares of less than 5% are given for Cyprus, Greece and Malta, which are the least decentralized countries. The similar results shown up if sub-national revenues are compared to General Government Revenues. The highest shares are evident for the Nordic countries: Denmark (58%), Sweden (43%) and Finland (35,9%) and for the Czech Republic (30%), Hungary (28,7%), Italy (33%), Poland (33,6%) and the UK(31,5%). In Cyprus, Greece and Malta sub-national government is of minor importance comparing sub-national revenues to General Government revenues and amount less than 7.5%. Results for Croatia bring to the conclusion that it is relatively centralized country. In 2004 the share of sub-national budget revenues in consolidated revenues of the general government budget totalled 11,2% and their share in GDP amounted to 5,2%. Those values increased in 2007: 17,1% of general government revenues and 7,9% of GDP (table 4.).

6. FISCAL EQUALIZATION MODEL

A **vertical fiscal imbalance** occurs when the revenues of different sub-national levels of government do not match their expenditure responsibilities. A **horizontal fiscal imbalance** occurs when different sub-national units have different abilities to provide services due to different abilities to raise funds.

In Croatia evident is the constant increase of the number of towns and municipalities without the sufficient capacity to provide mandatory services to their citizens. More than 35% of local and regional government units have been unable to cover their operating expenses without grants.

The system of fiscal equalization in Croatia is based upon following instruments for :

1. vertical fiscal equalization :

- tax sharing;
- an additional share of income tax for 53 units that carry out certain decentralized functions;
- Equalization fund;

2. horizontal fiscal equalization:

- tax sharing (special treatment of areas of special national concern and islands)
- current and capital grants.

Since tax sharing mechanism is used as vertical and horizontal fiscal equalization instrument all examples for which Croatian government use it, in its attempt to alleviate fiscal imbalances among sub-national units, will be explained hereinafter.

Corporate Income Tax (CIT or profit tax) was shared between different government levels till January 2007 in following percentages: for central government 70%, for counties 10% and 20% for cities and municipalities. Since the corporate income tax had been paid where the headquarters of firms were located, the most of revenues of this tax was collected in Zagreb while the remaining sub-national units had received low share of revenues from CIT.

Sharing rates for **Real Estate Transfer Tax** are: 40% for central government and 60% for cities and municipalities.

The revenue realized through **Personal Income Tax** is distributed in a manner that distinguishes whether local unit finances or not decentralized public services and with respect to the special area that a local government unit belongs to. So we distinguish 4 different types of income tax revenue distribution: standard distribution, distribution in the capital city Zagreb, which has the county

status as well, and distribution in areas of special national concern (ASNC): in war damaged areas, hill and mountain areas and insular regions (table 5).

Since capital city Zagreb has a status of county it gets share of 52% as a city, 15% as county and 12% belongs to it because it has been taken over the financing of decentralized functions. All together is 79%.

Table 5.

Distribution of revenues realized through **Personal Income Tax** in Croatia in 2007

	Standard distribution	Capital city/ county Zagreb	ASNC	Cities and municipalities on islands
County	15%	79%	10%	15%
Municipality/city	52%		90%	73%
Government level that have been taken decentralized functions	12%		/	12%
Equalization fund	21%	21%	/	/

Source: Author's systematization

Cities and municipalities in the areas of special national concern have to finance all decentralized functions from the received revenue (90% of PIT revenues). Counties get only 10% which is usually not sufficient for covering the mandatory obligations transferred for a given decentralized function.

In order to protect the islands from emigration and in order to stimulate rapid demographic and economic development, since 2003 the Government has been giving incentives for the development of insular local government units. These incentives were introduced for the purchase or lease of agricultural land, for water supply capital projects, physical planning and improvement of the traffic and transportation infrastructure. Those municipalities and cities on the islands that make joint agreements about the financing of capital projects in their area are exempt from payment of share of PIT in Equalization Fund (21%). That amount becomes the revenue of stated cities and municipalities (52% +21%= 73%), 15% goes to county and 12% to level of government that took on decentralized functions.

For local government units that took on the financing of the decentralized functions, since 2001 central government has been provided a

larger share of income tax. The size of local units' shares in income tax are determined according to the extent of provision of decentralized functions (primary and secondary education, welfare and health care and fire protection) that given units undertake (table 6).

Table 6.

An additional share of income tax for units that carry out certain decentralized functions

Decentralized function	2006	2007
elementary education	2,9%	3,1%
Secondary education	2,0%	2,2%
Welfare		
Welfare centres	0,4%	0,5%
Homes for the elderly and infirm	1,6%	1,7%
Health care: establishments owned by the county	2,5%	3,2%
Fire fighting	up to 8,0%	1,3%

Source: Author's systematization

Additionally, the sub-national self-government units that took on the financing of the decentralized functions, but are not able to finance them from the revenue obtained from income tax and additional share in income tax, have the right to receive an **equalization grant for decentralized functions** from the state budget, up to the amount of the minimum standards established in the decrees and the decisions of the government on the minimal financial standards for respective decentralized functions that are transferred to them.

The criteria and standards for equalization grants for decentralized functions in selected public services have been set out for the current fiscal year on the basis of expenditures in the previous fiscal year, along with the state budget. The gross grant, thus calculated, is reduced by the amount of PIT collected for that function in each local government unit, to get the net equalization grant for each unit.

“Equalization Fund” is financed with 21% share of Personal Income Tax (PIT) collections. We should mention that in 2006 only 345 local government units took part in filling this Fund. Other 225 local governments that have a special status in financing (areas of special national concern, hill and mountain areas and insular local government) didn't participate.⁷

Because of huge disparities among local units in demographic structure, economic development and fiscal capacity large number of local units is not able

⁷Annual Report for 2006, Ministry of finance, Zagreb, 2007, p. 94. (available on www.mfin.hr)

to raise enough own sources to finance obligations within their sphere of competences. Therefore special laws and programmes define incentive measure for their recovery and development.

Besides for alleviation of vertical fiscal imbalances tax sharing has been used as a horizontal equalization instrument in war-affected areas, areas that are under developed or that have demographic problems (ASNC, mountainous and hilly areas, on islands). The aim is alleviation of disparities in economic and social development among areas and guarantee that minimum needed level of public services will be supplied in all local units.

Horizontal equalization measures are: tax sharing, current/capital general grants, capital grants allocated via competent ministries and allocated via the Regional Development Fund.

Considering that revenues from corporate income tax (CIT) belong to the central state budget since 2007, the Government has decided to give direct incentives from the state budget to the areas of special national concern and hill and mountain areas, equal to the amount of CIT they realize on their area.

Through special treatment of ASNC, hill and mountain areas and insular local units (that made joint agreements about financing capital projects) in sharing PIT revenues the Government ceded 607 million Kuna in 2006 to those areas. That was more than 50% of total collected personal income tax revenue. Additionally, in order to avoid financial problems because of personal income tax refund the central budget has took over that obligation instead of 111 cities and municipalities of I. and II. group of ASNC, 69 municipalities of III. group of ASNC and 45 municipalities in hill and mountain areas.⁸

Grants

Grant system has to introduce more equity into the system by allowing local units to provide uniform levels of service delivery despite the large differences in their fiscal capacity. Local budgets receive grants from: foreign governments, international organizations and other general government units.

Considering that the budgetary funds for a large number of local government units are insufficient, central government uses two types of **grants** trying to equalize fiscal capacity disparities among local units:

1. general current (non- conditional) grants

- for the counties which than allocate grants to the municipalities and cities on their area;

⁸ Annual Report for 2006, Ministry of finance, Zagreb, 2007, p. 92. (available on www.mfin.hr)

- directly for local government units situated in the ASNC, to Mountainous regions, and to the Islands and

2. capital investment grants.

Their total amount is small. In total realized revenues of 53 local and regional self-government units for 2007 the share of grants was 13,8% (chart 5). In accordance with GFS methodology, additional share of income tax for decentralized functions, given as equalization grant from the state budget, has a status of interstate grant. Grants are almost completely realized as intrastate grants (table 7.).

Table 7.

Grants to sub-national units, 2007 (in 000 Kn)

Grants from foreign governments	9.631
Grants from international organizations	4.447
Grants from other general government units	2.123.569
Grants in total	2.137.647

Source: Ministry of finance

Since 2001, total amount and grants allocation criteria are defined annually by the Central Government and the Ministry of Finance, in Budget Execution Law. Grants to counties refer to investments in development programs of counties, municipalities and cities in the area of county. Since 2005 the Central Government has changed their purpose exclusively for capital investment in development programs of counties, towns and municipalities.

The criteria for the calculation of the grants for counties are the following⁹:

- the number of inhabitants according to the 2001 census,
- the average revenues of the county budget in the previous year per capita on national level (national average)
- the revenues of the county budget in the previous year per county inhabitant,
- the number of inhabitants of Republic of Croatia (without Zagreb) per km² territorial area of Republic of Croatia (national average)
- the number of inhabitants of particular county per km² county area.

Counties are obliged to allocate a certain share of those grants to the cities and municipalities that are not direct grant beneficiaries. That share has been changed: in 2003 it was at least 30%, in 2004 at least 50% and since 2005 at least 75%. So, only 25% of specific purpose grants (for capital spending except

⁹ Budget Execution Law, Article 39, (OG 28/08)

for purchase of personal vehicles) remain to the counties. The County assembly stipulates the criteria for the allocation of parts of these grants.

Direct grants to municipalities and cities can be used only for financing material and energy expenditures and investment in capital projects.

The criteria for the calculation of the grants for municipalities and cities in areas of special government concern are the following:

- the number of inhabitants according to the 2001 census,
- the average income of municipality and city per capita on national level (national average) in previous year,
- the average income per capita of the group on the areas of special government concern, (specific municipality or city),
- the number of inhabitants per km² at the level of I. and II. group of ASNC (group average)
- the number of inhabitants per km² of particular municipality and the city
- the share of expenditure for capital programs in previous year as part of the total expenditure,
- rationale of the execution of the system functions (employment numbers, expenditure per employee)
- and the expenditure for the functions of the city (up to 30.000 inhabitants) in previous year.

Apart from direct fund transfer, resources are made available for local and regional self-government units from line ministries and other government agencies, including Croatian Waters and the Regional Development Fund. Mainly, this involves the co-financing of the development programs through current or capital grants or subventions.

7. BORROWING

Sub-national governments in Croatia can borrow only for investments financed from its own budget. The borrowing of lower government tiers is regulated by the Budget Law. They can take on debt to the decision of the representative body of LGU with the prior consent of the Government of Republic of Croatia. Short term borrowing of LGUs is possible for the financing of the regular activities only when the revenue of the budget does not come in evenly all through the year.

In Croatia, according to the article 106 of the Budget Law (OG 96/03), the annual debt service payment limit is 20 percent of local governments' revenues realized in the preceding year. The amount of total borrowing limit includes the amount of the annual loan annuity, liabilities regarding issuing securities, and guarantees from previous years, as well as all unpaid liabilities.

The Government and the Ministry of Finance introduced an additional restriction in 2004 and local governments can now take on debt up to at most 2,3% of the totally realized operating revenue of all local governments (article 12. the Budget Execution Law, OG 137/06 and 28/08). This limit is ineffective because many good investment projects could stay unrealized because of this constraint.

The most typical form of borrowing in Croatia is commercial bank loan, because financial management and personnel are not skilled and they do not know how to use different financing sources. Many small local units are not able to borrow because of the lack of technical capacity and higher fixed costs of borrowing and financial management and personnel in those sub-national units are not skilled.

There is a little initiative for borrowing by the issue of municipal bonds. Only six sub-national governments (Istria County, Opatia, Zadar, Koprivnica, Rijeka and Split) issued bonds, mainly for the financing of infrastructure projects and to meet liabilities to suppliers. Local units choose this type of borrowing when they are, because of the amount of needed money, not capable to take a loan in commercial bank or when they want to expand basis of creditors. The bond issuing lasts longer, because of the Government borrowing restrictions, and is more costly then taking commercial bank loan, so the bond issuing under 5 million € in not remunerative.

CONCLUSIONS

The process of fiscal decentralization in Croatia has started quite recently, in 2001, and has experienced a number of significant changes since than, but the conclusion of this paper, based on the analysis of expenditure and financing dimension of decentralization process, is that Croatia is still highly centralised country.

The values of four important indicators: the share of revenue and expenditure of sub-national governments in GDP and the share of revenues and expenditures of sub-national governments in the total government budget revenues and expenditures, confirms the fact that very low degree of decentralization has been achieved in Croatia in past few years, although it has been emphasized as priority government reform in programmes of all political options.

Still no formal paper has been adopted in the sense of a strategy to define the objectives, principles, effects and the procedure of decentralization. All these elements are to some extent contained in the separate, ambiguous and numerous laws and in the bylaws regulations. Single law should contain clear and specific expenditure and revenue assignment among the different levels of government.

Croatian territorial organization, with total number of 577 local government units, indicates the fragmentation problem which has inevitable negative consequences such as higher costs of service provision and disparities of social, economic and demographic conditions among jurisdictions. Such administration resulted in their inefficiency because of an increased number of local units whose finances, staff and organization are not capable to provide local public services. Changes in the number of local government units are inevitable. This suggests the need of amalgamation and/or of cooperation among local units. It is necessary to establish clear and measurable criteria for local government units to meet preconditions to get status of respective LGU.

Additional problem is vague division of affairs and functions and entangled financial relationships between different levels of government. It is very difficult to say which government level undertakes a given function and the functions of local units are overlapping. Almost all functions are financed from both central and local government levels. Since sub-national expenditure assignments typically exceed revenue assignments, the central government still plays the major role in the system of sub-national financing because the majority of local and regional revenues come from its transfers to sub-national units, mainly in the form of shared taxes. The fact that only 53 (20 counties, the city of Zagreb and 23 municipalities and cities) of total 577 local government units, have assumed the obligation of financing the decentralized functions confirm the thesis of this paper that the decentralization process is not successfully implemented in Croatia and that the need for new reform is priority. These 53 local government units, that assumed the financing of the decentralized functions, participate with 70-80% in total revenues of all local government units.

The fiscal equalization mechanism system, based mainly on tax-sharing mechanism, is not effective enough because it causes the reliance of sub-national units on transfers from higher levels of government to finance their spending instead of being stimulated to improve the efficiency of own revenue collection, especially in 180 local units that have status of regions of special national concern. The criteria for the calculation of grants for local and regional self-government changes every year and that there is no specific consideration of expenditure needs, which causes additional problems in expenditure and development planning process of local units.

Further improvements must be done in encouragement of local government's fiscal autonomy in raising revenues from own sources and autonomy in exercising delegated functions. Central government must create enabling conditions that allow local units to take on more responsibilities. Weak administrative and technical capacity at local levels has resulted in less efficient and effective provision of public services in some areas of the country. Therefore central government should provide sub-national units assistance in the planning, financing and management of decentralized functions.

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**FISKALNA DECENTRALIZACIJA- REFORMSKI PROCES
ILI POLITIČKA RETORIKA*****Sažetak***

U radu se raspravlja o pitanjima vezanim za proces decentralizacije u Hrvatskoj. Iako je postala omiljeni reformski prioritet među hrvatskim političarima svih opcija, vrijednosti pokazatelja ostvarenja fiskalne decentralizacije potvrđuju činjenicu da je njena realizacija na vrlo niskom stupnju. U radu se ističu osnovna obilježja hrvatskog sustava fiskalne decentralizacije i mjere koje je neophodno poduzeti za uspješnu implementaciju i ostvarenje koristi od decentralizacije. Zaključci su zasnovani na analizi odgovornosti za poslove prenesene na djelokrug lokalnih/regionalnih jedinica i prihoda koji se ostvaruju na različitim državnim razinama, te na izračunu nekih najčešće korištenih pokazatelja za procjenu dostignutog stupanja decentralizacije. Zaključak naglašava važnost odvijanja procesa decentralizacije na način koji osigurava financijsku autonomiju jedinica lokalne i područne (regionalne) samouprave, kako bi one mogle preuzeti financiranje decentraliziranih funkcija.

Ključne riječi: decentralizacija, prijenos odgovornosti za pružanje javnih usluga, prijenos financijskih sredstava, pomoći, sustav izravnavanja, pokazatelji fiskalne decentralizacije

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