Summary
This paper presents the main results of the Local Self-Government Financing Research that was conducted within the project called Decentralization of Public Administration. The project development was coordinated by the Croatian Law Center.

The main purpose of the project was a reform of the local self-government system in Croatia, in order to satisfy the needs of citizens at the local government level in a more efficient and cost-effective way, and to adjust the local self-government systems to European efficiency standards.

This paper aims to draft a model of local government financing by proposing a change in the current method of financing, and to make a proposal for a dynamic model of decentralized financing based on the results and conclusions of the analysis.

To achieve the main purpose, the current status of the local and regional self-governments is analyzed, a method of analyzing the model of local and regional self-government financing is determined and a comparison is made between the current local self-government system in Croatia and that in other countries.

Two main objectives and a number of sub-objectives are set and the measures for their realization are described.

This paper is an abbreviated version of a document that resulted from a two-year cooperation of a group of experts on the project called Decentralization of Public Administration.

Key Words: local and regional self-governments, local budgets, model of financing, decentralization

Introduction
This paper explores the issue of local self-government financing in Croatia. Although the process of decentralization of authority and financing has already started in the Republic of Croatia, this paper points out the fact that the system of financing is actually centralized. As such a system does not provide municipalities and cities with an appropriate level of authority to provide and finance public services to the local population, a higher level of decentralization in financing the local and regional self-government units is expected in the future.

Given the mainly different levels of development of local and regional self-government units, it is necessary to develop such models of financing that can satisfy the needs of the local population and help to harmonize their standards of living. In other words, it is necessary to reach the highest possible level of fiscal decentralization, which is only possible if local units have enough own sources of financing to provide all public services that come within their fields of activity.

The main goal of this paper is to develop a draft model of financing by proposing a change in the current method of financing local and regional self-government units, and to make a proposal for a dynamic model of decentralized financing based on the results and conclusions of the analysis.

A strong impediment to the research work has been the fact that the Ministry of Finance still has not processed data on the execution of the 2001 budgets of the local and regional self-government units, which is why the impacts of the started decentralization process cannot be analyzed. When the processed data for 2001 and, subsequently, for 2002 are available, it will be possible to draw the relevant conclusions about the progress of the planned decentralization process, its limitations, potential drawbacks and prospects.
The paper consists of several parts. The introduction is followed by a presentation of the concept of decentralization of local self-government financing, and its main advantages. The reasons for starting the decentralization process are explained along with a brief description of the local and regional self-government system in Croatia. In addition, an explanation and definition of the method of analyzing the model of the local and regional self-government financing is provided.

Part three contains the analysis of the current model of the local and regional self-government financing in Croatia. Part four provides a more detailed analysis of local budgets, including the analysis of local budget revenues and the structure of local budget expenditures, the analysis of the local units’ fiscal capacities and a brief analysis of the system of grants.

A separate part of the paper gives an overview of the objectives and sub-objectives together with the measures for their realization. The last part presents the main conclusions and recommendations.

Decentralization of the Local Self-Government Financing

A strong trend towards government decentralization has been perceived all over the world, while decentralization can be simply defined as a transfer of political power and influence from a higher level of government (central government) to lower levels of government (local and regional governments). Despite the differences in the progress of decentralization among countries, what they all have in common is that the need for decentralization results from the need for a more efficient public sector. Various local interests and needs for public goods and services can be best satisfied through decentralized decision-making on the functions and public services provided by individual (especially local) levels of government.

A country may derive a lot of benefits from the decentralization of its government functions. One of the important benefits is improved efficiency in the provision of public services, since the local government has a better insight into the local population’s needs for public services. A decentralized provision of public services satisfies the users of services who have benefited from the services and who, in the end, paid for them.

Decentralization can help in achieving a number of other goals, the most important among them being a reduced share of the public sector in the overall economy, mobilization of public revenue accompanied by a reduction in the cost of public services, linking the responsibilities for local public outlays with the disposable financial resources, increasing the local government’s own revenues and encouraging cooperation between different levels of fiscal government in the provision of public services.

Croatia can be ranked as a highly centralized country on the basis of two indicators: the share of revenue and expenditure of municipalities, cities and counties in the total revenue and grants of the consolidated central government (Table 1); and the share of revenue and expenditure of the local and regional self-government in GDP.

Table 1. Revenues and Expenditures of Municipalities, Cities and Counties as a Share of Total Revenue and Grants of the Consolidated Central Government [%]

<table>
<thead>
<tr>
<th>Year</th>
<th>Revenue</th>
<th>Expenditure</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995</td>
<td>9.20</td>
<td>8.60</td>
</tr>
<tr>
<td>1996</td>
<td>11.30</td>
<td>11.20</td>
</tr>
<tr>
<td>1997</td>
<td>11.60</td>
<td>11.40</td>
</tr>
<tr>
<td>1998</td>
<td>10.80</td>
<td>11.60</td>
</tr>
<tr>
<td>1999</td>
<td>10.32</td>
<td>10.57</td>
</tr>
</tbody>
</table>


The percentage of revenue and expenditure of the local and regional levels of fiscal government in the Republic of Croatia is relatively low, in that the revenue of the local self-government accounted for 9.20% of total revenue and grants of the consolidated central government in 1995, 11.30% in 1996, 11.60% in 1997, 10.80% in 1998 and 10.32% in 1999.

The share of the lower levels of fiscal government’s spending in GDP, which is another indicator of the importance of local government in the overall economy, is also low. Thus, total expenditure of local self-government in the period from 1995 to 1999 ranged from 4.2% to 5.7% of GDP, which suggests that, by international standards, Croatia is a highly centralized country.

One of the main tasks of the government of the Republic of Croatia is to reduce and rationalize the central government budget expenditure as well as the expenditure of the consolidated central government. At the same time, Croatia has embarked on the program of decentralization of certain public functions, which is expected to result in the decentralization of certain administrative and professional operations, i.e. their devolution by the ministries to the local and regional self-government units.

This was the basis for developing a model of decentralization of a part of public services in the area of education, health care and social welfare. According to
the model, outlays for gross wages and contributions on wages in primary and high school education, as well as a part of health care services and social welfare are covered by the state budget; while material costs, investment maintenance costs and capital investment costs are devolved to local and regional self-government units.

The above described activities marked the beginning of the first stage of decentralization of administration and financing of a part of public needs in July 2001, accompanied by revenue sharing between the central government and local and regional levels of government, in order to cover the shortfall in funds to finance these needs. It is expected that a comprehensive reform aimed at decentralization of responsibilities and financing of public needs at the central government level and lower levels of fiscal government will continue in the following fiscal years. Within this framework, the activities, responsibilities and financing for a part of public functions (e.g. primary, high school and, partly, university education, health care and social welfare) will be gradually devolved by the central government to the local and regional self-government, parallel to the transfer of budget revenues.

Local and Regional Self-Government in Croatia

Local and regional self-government in the Republic of Croatia is regulated by a number of statutory provisions. Apart from the Constitution of the Republic of Croatia, these issues are regulated by 23 legal acts, four rulebooks, one decree, five decisions, two enactments and the European Charter of Local Self-Government. According to the stated regulations, as of December 2001, the Republic of Croatia included 424 municipalities, 122 cities, 20 counties and the City of Zagreb, which has the status of both a county and a city.

In order to understand the problems of the local and regional self-government it is worth mentioning that, according to the 2001 census, Croatia had 4,381,352 inhabitants. The City of Zagreb numbered 770,058 inhabitants, or 17.16% of the total Croatian population. This means that 3,611,294 inhabitants or 82.42% of the total population (excluding the inhabitants of Zagreb) live in the remaining Croatian territory. The total number of persons living in cities (including Zagreb) is 3,030,002 or 69.16%. The urban population (excluding Zagreb) accounts for 2,259,944 or 51.58% of the total population. Municipalities account for 1,351,350 or 30.84% of the total population. A considerable number of citizens, i.e. 871,390 or 19.89% of the total Croatian population, live in municipalities and cities in the areas of special government concern.

Given the above mentioned figures on the population in municipalities, cities, the City of Zagreb and the municipalities and cities in the areas of special government concern, it is worth noting that the main task of the local self-government units is to improve the standard of living for all their citizens and to look for necessary sources of financing to ensure regular performance of the functions of local and regional self-government units. Of course, this applies to all local and regional self-government units.

The scope of activity of cities and municipalities includes the following:

- urban development and housing;
- physical and urban planning;
- municipal services;
- child care services;
- social welfare;
- primary health care;
- education and primary education;
- culture and sports;
- consumer protection;
- environmental protection and development;
- firefighting and civil defense.

A county is responsible for performing the operations of regional significance and providing for a balanced development of municipalities and cities within its territory and the county as a whole, particularly operations related to:

- education;
- health care;
- physical and urban planning;
- economic development;
- transport and transport infrastructure;
- planning and development of the network of educational, health care, social and cultural institutions.

Local and Regional Self-Government Financing

The Law on Financing Local and Regional Self-Government Units (N.N., Nos. 117/93, 69/97, 33/00, 73/00, 127/00, 59/01, 107/01 and 117/01) regulates the sources of funds and methods of financing the functions
of municipalities, cities and counties, types of taxes, tax sharing among different levels of government, tax bases, taxpayers, tax rates and the calculation and manner of tax payment.

Units of local and regional self-government derive their revenues from:

- own sources (revenues from own assets, county, city and municipal taxes, fines, fees and charges);
- tax sharing (sharing of income tax, profit tax and real property transaction tax);
- grants from the state and county budgets;
- fiscal equalization grants to finance decentralized functions;
- revenue sharing (revenues from contracted annual charges for concessions to pump mineral and thermal water and to use water for public water supply).

**Changes in the System of Financing**

A series of decisions and decrees enacted in early July 2001 marked the beginning of the first stage of the decentralization process in Croatia aimed at devolving the management and financing a part of public services on municipalities and cities, parallel with the transfer of funds for the financing of these services. Table 2 gives a comparison between the old and the new method of revenue collection in municipalities, cities and counties, showing the effort to increase decentralization of responsibilities and sources of financing for decentralized functions devolved on lower levels of fiscal government.

The change in the sources of revenue of municipalities and cities is seen in the option to introduce new municipal and city taxes, as well as surtax on income tax payable at various rates, depending on the type of local unit (municipality, town, city or the City of Zagreb).

Tax sharing between the state and local government has also undergone changes. Individual levels of government (the central government, counties, municipalities and cities) are entitled to tax sharing in the percentages regulated by law, where tax sharing includes:

- income tax, shared among the government, municipality, city and county;
- profit tax, shared among the government, municipality, city and county;
- real property transaction tax, shared among the state, municipality and city.

The largest changes in the system of local and regional self-government financing were introduced in income tax sharing to the benefit of lower levels of fiscal government. The share of the state in income tax revenue decreased while the share of municipalities, cities and counties went up. A part of the income tax has been allocated for the financing of decentralized functions in primary and secondary education, social welfare and health care. Meanwhile, the local self-government units, which cannot provide enough funds to finance their decentralized functions, are entitled to a share in income tax in the form of equalization grants for decentralized functions.

The sharing of other revenues, i.e. profit tax and real property transaction tax revenues of local self-government units remained unchanged.

The revenues shared among the state, municipalities and cities are revenues from contracted annual charges for concessions to pump mineral and thermal water and to use water for public water supply.

Apart from the above mentioned tax revenues, local self-government units also have numerous other revenues derived pursuant to special laws and/or decisions made by representative bodies, i.e. charges and fees declared in their respective budgets as non-tax revenues.

The purpose of these changes in the system of local and regional self-government financing has been a devolution of authority, an increase in the level of responsibility and enhancing the scope of public services provided at the local level of government, parallel with the allocation of funds for their financing. As the Ministry of Finance currently has no processed data on the execution of local budgets for 2001 and 2002, it is difficult to weigh the impact of the first stage of decentralization in Croatia. This means that it is still unknown to what extent the goals of devolution of authority and decentralization of the financing of public services in education, health care and social welfare have been realized in municipalities, cities and counties together, as well as in each particular city or county that has assumed the decentralized functions in the area of education. Furthermore, it is impossible to establish whether the cities and counties have properly performed all decentralized functions devolved to them and whether the allocated funds for their financing have been sufficient (Table 2).

In light of this, it is necessary to address the question of fiscal equalization. Although each local self-government unit is aimed at providing a satisfactory level of public services to its citizens, one should bear in mind
### Table 2. Comparison Between the Old and New Ways of Revenue Collection in Municipalities, Cities and Counties

<table>
<thead>
<tr>
<th>Old sources of revenue (until July 1, 2001)</th>
<th>New sources of revenue (as of July 1, 2001)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1. Municipal and city taxes</strong></td>
<td></td>
</tr>
<tr>
<td>1.1 Consumption tax</td>
<td>1.1 Consumption tax</td>
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<tr>
<td>1.2 Country cottage tax</td>
<td>1.2 Country cottage tax</td>
</tr>
<tr>
<td>1.3 Advertisement tax</td>
<td>1.3 Public use area tax</td>
</tr>
<tr>
<td>1.4 Firm tax</td>
<td>1.4 Tax on uncultivated farmland</td>
</tr>
<tr>
<td>1.5 Public use area tax</td>
<td>1.5 Tax on unused business immovables</td>
</tr>
<tr>
<td></td>
<td>1.6 Tax on unbuilt building site</td>
</tr>
<tr>
<td></td>
<td>1.7 Firm tax</td>
</tr>
<tr>
<td><strong>2. Surtax on income tax</strong></td>
<td></td>
</tr>
<tr>
<td>Cities with more than 40,000 inhabitants may impose a surtax on income tax up to 30% of their share in income tax (e.g. up to 7.5% of total tax)</td>
<td>Municipalities may impose a surtax up to the rate of 10%</td>
</tr>
<tr>
<td>The City of Zagreb may impose a surtax on income tax up to 60% of its share in income tax (e.g. 27.5% of total tax).</td>
<td>Cities with less than 30,000 inhabitants may impose a surtax up to the rate of 12%</td>
</tr>
<tr>
<td>The City of Zagreb may impose a surtax up to 60% of its share in income tax (e.g. 27.5% of total tax).</td>
<td>Cities with more than 30,000 inhabitants may impose a surtax up to the rate of 15%</td>
</tr>
<tr>
<td></td>
<td>The City of Zagreb may impose a surtax up to the rate of 30%</td>
</tr>
<tr>
<td><strong>3. Tax sharing</strong></td>
<td></td>
</tr>
<tr>
<td>3.1 Income tax (state 70%, city or municipality 25%, county 5%)</td>
<td>3.1 Income tax (state 29.2%, county 8%, city or municipality 32%)</td>
</tr>
<tr>
<td>3.2 Profit tax (state 70%, city or municipality 20%, county 10%)</td>
<td></td>
</tr>
<tr>
<td>3.3 Games of chance tax (state 50%, city or municipality 50%)</td>
<td></td>
</tr>
<tr>
<td>3.4 Real property transaction tax (state 40%, city or municipality 60%)</td>
<td></td>
</tr>
<tr>
<td>3.1.1 Income tax allocation for decentralized functions (9,8%)</td>
<td></td>
</tr>
<tr>
<td>primary education</td>
<td>2.9%</td>
</tr>
<tr>
<td>secondary education</td>
<td>2.0%</td>
</tr>
<tr>
<td>social welfare</td>
<td></td>
</tr>
<tr>
<td>social work centers</td>
<td>0.4%</td>
</tr>
<tr>
<td>retirement homes</td>
<td>1.6%</td>
</tr>
<tr>
<td>health care</td>
<td>2.9%</td>
</tr>
<tr>
<td>investment maintenance of institutions owned by counties—2.5%</td>
<td></td>
</tr>
<tr>
<td>health care for uninsured persons—0,3%</td>
<td></td>
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<tr>
<td>health care for farmers above the age of 65—0,1%</td>
<td></td>
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<tr>
<td>3.1.2 Share of income tax for equalization grants to finance decentralized functions (21%)</td>
<td></td>
</tr>
<tr>
<td>3.2 Profit tax (state 70%, county 10%, city or municipality 20%)</td>
<td></td>
</tr>
<tr>
<td>3.3 Real property transaction tax (state 40%, city or municipality 60%)</td>
<td></td>
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<tr>
<td>3.4 Sharing of revenues from the concessions:</td>
<td></td>
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<tr>
<td>to pump mineral or thermal water (state 50%, city or municipality 50%)</td>
<td></td>
</tr>
<tr>
<td>to use water for public water supply (state 70%, city or municipality 30%)</td>
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</table>

Source: The author’s classification.
that a large number of local units do not have enough own revenue to finance these services. The task of the state is to provide for an appropriate fiscal equalization system to cover the shortfall in funds for public services at the local level.

The problem of fiscal equalization within the system is solved by the allocation of a part of income tax for financing the decentralized functions in primary and secondary education, social welfare and health care, while the local self-government units with insufficient funds for financing their assumed decentralized functions are allocated a part of income tax as equalization grants to finance these functions. The equalization grants for financing the decentralized functions are provided from the state budget for covering public outlays in the areas of primary and secondary education, social welfare and health care, devolved on the local and regional self-government units. The method of calculating the amount of equalization grants is regulated by a decree of the Government of the Republic of Croatia.

The Analysis of the Local Self-Government Financing
A more detailed analysis of the current model of financing local self-government units included a number of activities:

- assessment of the local units’ fiscal capacity and determination of indicators on which the analysis would be based;
- assessment of the local units’ tax burden (by analyzing their own sources of revenue and revenue per capita in order to determine the real possibilities, if any, that municipalities and cities set/introduce tax rates or new taxes as an additional source of revenue provided for by current national legislation);
- establishing and assessing the financial position of local self-government units (by analyzing the spending of their budgets and the structure of budget expenditures of local self-government units based on a separate analysis of the current status and the trends);
- establishing and assessing the financial position of local units in the areas of special national concern;
- establishing and assessing the financial position of local units on islands;
- analysis and assessment of the relationships in the distribution of revenue at the local government level pursuant to the provisions of the current law on local self-government financing (special attention should be given to the system of and criteria for the allocation of grants, supports and subsidies to the local self-government units). In addition, the criteria for the relative amount of revenues, i.e. the deviation from the state and/or county average should be examined;
- analysis of the structure of local units’ budget expenditures and the activities financed by them;
- analysis and assessment of the fiscal equalization system as a part of the state fiscal system. (From its introduction to the present, the fiscal equalization system has been reduced to mainly transferring funds to the areas of special national concern for the reconstruction of areas devastated by war);
- analysis and assessment of the decentralization system within the state fiscal system based on the solutions provided by the current legislation;
- exploring the possibilities of fiscal authority distribution provided by the current law, according to the fiscal government level and the appropriate distribution of funds;
- empirical analysis and assessment of the impact of financing instruments by comparing the solutions provided by law and the situation in local self-government units.

The analysis of the system status and models of financing the local self-government units in Croatia, as well as the available fiscal statistics resulted in the definition of two groups of indicators:

- the basic indicators of financial position, and
- fiscal capacity indicators.

The basic indicators of financial position used for a current status analysis of the system of financing the local self-government units in the Republic of Croatia are the following:

- current revenue;
- current expenditure;
- current revenue/current expenditure;
- total revenue and grants;
- total revenue excluding grants;
- total expenditure;
- total revenue/total expenditure;
Part II.: The Financing of Local Government and Self-Government

Local Self-Government Financing

Table 3. Total Revenues and Grants of Local Government Budgets in Croatia, 1998—plan 2001 [%]

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<tr>
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<tbody>
<tr>
<td>I Total revenues and grants</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
<tr>
<td>I.A) Total revenue</td>
<td>90.3</td>
<td>92.3</td>
<td>93.8</td>
<td>93.9</td>
</tr>
<tr>
<td>I.A) I. Current revenues</td>
<td>85.2</td>
<td>85.7</td>
<td>87.2</td>
<td>85.4</td>
</tr>
<tr>
<td>– Tax revenues</td>
<td>55.9</td>
<td>55.2</td>
<td>55.7</td>
<td>51.1</td>
</tr>
<tr>
<td>– Non-tax revenues</td>
<td>29.3</td>
<td>30.5</td>
<td>31.5</td>
<td>34.2</td>
</tr>
<tr>
<td>I.A) II. Capital revenues</td>
<td>5.1</td>
<td>6.6</td>
<td>6.7</td>
<td>8.6</td>
</tr>
<tr>
<td>I.B) Grants</td>
<td>9.7</td>
<td>7.7</td>
<td>6.1</td>
<td>6.0</td>
</tr>
</tbody>
</table>

budget revenue of the state. The share of revenues of local budgets in the revenue of the consolidated general government budget is relatively small. In 1999, local budgets’ revenues made up 10.32% in the consolidated general government budget revenue and with 5.42% in GDP. In 2000, the share of local budgets’ revenues in the consolidated general government budget revenue and GDP was 11.07% and 5.25%, respectively.

Taken as a whole, current revenues (tax and non-tax revenues) have the largest share in the total revenue of municipalities, cities and counties. Thus, they amounted to 85% in the total structure of revenues in 1999, while in 2000 the share reached 87%. Tax revenues accounted for 55% of total revenue in 1999 and grew slightly in 2000 to reach 56%. The share of capital revenues was 7% in both 1999 and 2000. The share of grants declined from 8% in 1999 to 6% in 2000.

The following table shows the structure of total revenues and grants of local government budgets in accordance with the methodology of the International Monetary Fund (Table 3).

The largest share of local units’ tax revenues stems from tax sharing (sharing of income tax and profit tax), which accounted for about 47% of total revenue in the two observed years (income tax accounted for 35% of the revenue from tax sharing in 1999 and 39% in 2000), while the share of profit tax dropped from 12% in 1999 to 8% in 2000.

The analysis of individual levels of local self-government shows that tax revenues account for the largest share in the structure of budget revenues of cities, representing 60% of their total budget revenues. As concerns county budgets, tax revenues accounted for 57% and 62% of total budget revenues in 1999 and 2000, respectively. However, the share of tax revenues in municipalities exceeded one third of their total budget revenues, amounting to 31% in 1999 and 34% in 2000. Such an increase in the share of tax revenues can be partly accounted for by the impact of the Law on Areas of Special National Concern and the change in the share of municipalities and cities in income tax (this share rose from 25% in 1999 to 32% in 2000), as well as by the tightening of fiscal discipline.

The share of income tax and surtax on income tax in total revenue of municipalities ranged from 20% in 1999 to 23% in 2000. The share of these taxes in cities was 39% in 1999 and 43% in 2000, while in counties it was 29% in 1999 and 39% in 2000. In the City of Zagreb revenues from income tax and surtax on income tax account for about 50% of the total city revenue.

The share of grants in the total realized revenues of all municipalities, cities and counties was 8% in 1999 and 6% in 2000. They represented a significant source of the county budgets’ revenues, accounting for 25% of the total budget revenue in 1999 and 20% in 2000. In municipalities they made up 19% in 1999 and 15% in 2000, while in cities they accounted for as little as 3% of their budget revenue (Table 4).

The studies on local financing use different terms for non-tax revenues. For the purpose of this analysis the term own revenues will be used to cover non-tax revenues and own tax revenues.

Own tax revenues of local budgets. According to international standards, tax on real estate comprises revenues from firm tax, country cottage tax and public use area tax. Domestic taxes on goods and services include advertisement tax, consumption tax, tax on motor vehicles, tax on boats, etc. They mainly represent the local budgets’ own revenues.

Own tax revenues account for as little as 9% of total tax revenues of cities and municipalities and 14% of total tax revenues of counties. If own tax revenues are

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</tr>
</thead>
<tbody>
<tr>
<td>Total revenues and grants</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
</tr>
<tr>
<td>Total revenues</td>
<td>92.31</td>
<td>93.85</td>
<td>80.55</td>
<td>85.43</td>
<td>96.69</td>
<td>97.45</td>
<td>74.59</td>
<td>79.66</td>
</tr>
<tr>
<td>tax revenues</td>
<td>55.19</td>
<td>55.69</td>
<td>31.41</td>
<td>34.09</td>
<td>59.49</td>
<td>59.51</td>
<td>56.86</td>
<td>61.93</td>
</tr>
<tr>
<td>non-tax revenues</td>
<td>30.50</td>
<td>31.48</td>
<td>41.29</td>
<td>41.00</td>
<td>30.27</td>
<td>31.37</td>
<td>25.41</td>
<td>16.38</td>
</tr>
<tr>
<td>capital revenues</td>
<td>6.62</td>
<td>6.68</td>
<td>7.85</td>
<td>10.34</td>
<td>6.92</td>
<td>6.57</td>
<td>2.26</td>
<td>1.35</td>
</tr>
<tr>
<td>Grants</td>
<td>7.69</td>
<td>6.15</td>
<td>19.45</td>
<td>14.57</td>
<td>3.31</td>
<td>2.55</td>
<td>25.41</td>
<td>20.34</td>
</tr>
</tbody>
</table>

added to non-tax revenues, mainly consisting of fees and charges for: municipal services, utilization of maritime resources, extraction of minerals, use of space by power plants, use of public land, lease of hunting ground, as well as local tourist tax, charges, stamp duties, revenues from contracted annual charges for concessions to pump mineral and thermal water, etc., and capital revenues, then their share is much larger—62% of the budget revenues of cities and municipalities, or 46% of budget revenues of municipalities. However, these revenues may only be used for their prescribed purposes. As concerns the municipal and city budget structures, the majority of the above mentioned revenue stems from fees for municipal services and contributions, which account for 16% of total budget revenue, while in some local units this share can even exceed 50%.

In the local units’ financial reports that are prepared in accordance with international standards, non-tax revenues of municipalities, as opposed to other units, account for the largest share in the total budget revenue—41%. Non-tax revenues of cities account for 31% of their total revenue. As concerns counties, the share of non-tax revenues in the total revenue was as low as 15% in 1999 and 16% in 2000.

An analysis of the local units’ budget revenues reveals a number of common characteristics.

Taken separately, the roles of certain tax revenues in the budgets of individual levels of local and regional self-government are different. This is primarily the result of tax sharing and different tax bases. However, it is obvious that the share of local taxes in the total revenue is insignificant at all levels of local and regional self-government.

Looking at the whole, the rate of collection of revenues from fees is not satisfactory, which is not only the result of inefficiency of local government units and the methods of collection, but also of the loopholes in legislation regulating the supervision of revenue collection.

Analysis of the Structure of Local Units’ Budget Expenditures

When discussing the structure of local units’ budget expenditures we should concentrate on their main characteristics. It is worth noting that the structure of total expenditure of local and regional self-government units indicates an upward trend in current expenditures. Current expenditures accounted for 68% of total expenditure in 1999, and 73% in 2000. The largest share in total expenditure was that of expenditures for the purchase of goods and services, capital outlays and outlays for employees.

Outlays and contributions for employees account for an average of 22% of total expenditure at the national level. However, in municipalities and cities, that share ranges from 3% to 100% of current revenues, and sometimes it even exceeds 100% of current revenues.

The analysis of outlays for employees as a share of current budget revenues per municipality in 2000 shows interesting results. Of the total number of municipalities in Croatia, 279 municipalities, or 66%, spend from 3% to 50% of their current revenues on outlays for employees, while 17 municipalities spend more than 100% of their current revenues on outlays for employees.

The analysis of the share of outlays for employees in current revenues per municipality in 2000 shows that of the total number of 122 cities, excluding the City of Zagreb, 108 cities, or 89%, spend from 7% to 50% of their current revenues on outlays for employees.

The average outlays for employees per capita in local self-government units at the national level stood at 148,000.00 HRK. (According to the annual financial statements of local self-government units for 2000, the number of the employed was 25,518 in 2000 and 25,405 in 1999.)

Analysis of the Local Budgets’ Fiscal Capacity

The fiscal capacity analysis of local self-government units in the period 1999–2000 was based on several indicators to provide relevant data on the actual status of the local self-government financing system. For this purpose, indicators of the level of development of local self-government units were established, and municipalities and cities were classified according to three main criteria: 1) current revenues per capita; 2) current expenditures per capita; and 3) current revenues/ current expenditures.

Based on the Central Bureau of Statistics data (the census taken on March 31, 2001, first unofficial data) on the population size of the Republic of Croatia and the revenue of counties, cities (excluding the City of Zagreb) and municipalities raised in 1999 and 2000, a national average revenue per capita and 75% of the average revenue per capita were calculated on the basis of the total realized revenues in 1999 and 2000 (in accordance with the Financing Law).

The largest revenue per capita was recorded in Istria County, 2,685.00 HRK in 1999 and 3,167.00 HRK in 2000. This is double the national average, or 4.5 times the average of Vukovar-Srijem County, which had the
Fiscal Decentralization in Croatia

The smallest revenue per capita of as little as 603.00 HRK in 1999 and 785 HRK in 2000.

The analysis of the local budgets’ fiscal capacity can be summarized as follows:

• In 1999, 12 counties realized the average revenue per capita, while eight counties, out of a total of twenty, recorded below-average revenue per capita. In 2000, the average revenue per capita was recorded in 13 counties, while seven counties had below 75% of the national average revenue per capita.

• Inequality in economic power is an important factor of and/or reason for uneven growth of revenue per capita in counties, and a source of intensifying differences. In addition to inequality in economic power, there are other factors, such as unofficial economy, various legal benefits, exemptions granted to the areas of special national concern, etc.

• According to the index of current revenue/current expenditure in 2000, 33 cities (27%) were unable to cover their current expenditure by current revenue;

• 151 municipalities (35.8%) were unable to cover their current expenditure by current revenue;

• A total of 184 (33.8%) local self-government units were unable to cover their current expenditure by current revenue (Figure 1).

Grants

According to the current legislation, the system of financing public needs is based on grants as an exclusive means to support the units of local self-government with lower fiscal capacities. However, owing to the consequences of the war, grants are mostly targeted at the areas of special national concern, and not at all local self-government units, to finance a certain level of their population’s public needs. More specifically, the law stipulates the following method of fiscal equalization:

• A county whose own per capita revenue and the revenues of municipalities and cities in its territory are below the national average (excluding the city of Zagreb) is entitled to a grant from the state budget up to 75%. However, the grant may not be given to a county in whose territory the rate of surtax on income tax is below 1% and the tax rates an tax amounts are below the legally prescribed rates or amounts.

• A city or municipality whose revenues—assuming an average tax burden per capita are below the county average and excluding cities with more than 40,000 inhabitants—is entitled to a grant from the county budget to the amount of the difference between the raised revenue per capita and 75% of the average county revenue per capita. However, the grant cannot be given to a municipality of city with below-1% surtax on income tax and with local tax rates and tax amounts below the legally prescribed maximum rates and amounts.

In the previous years these regulations could not be applied to all counties, but were only given, within the means of the state budget, to counties (or directly to municipalities and cities) in the areas of special national concern. So, current grants amounted to around 372 million kuna in 1999 and around 270 million kuna in 2000.

In addition to the described system of grants, the new legislation also introduces equalization grants to finance public expenditures for decentralized functions in the areas of primary and secondary education, social welfare and health care that have been devolved on the units of local and regional self-government. The method of calculating the equalization grants for decentralized functions is regulated by a decree of the Government of the Republic of Croatia.

Objectives and Measures to Improve the Local Self-Government Financing

Given the main objective of the system of local self-government reform in Croatia, which is to satisfy the local population’s needs in a more efficient and cost-effective way and to bring it closer to European efficiency standards, a broad analysis was carried out in order to formulate the objectives and the necessary measures to reach them.

In the following text we will formulate two main objectives and a number of sub-objectives, and propose measures to improve and promote local self-government financing.

Objective 1
Changing the Method of Financing Local and Regional Self-Government Units

Sub-objective 1.1 To establish the capacity to finance the basic (obligatory) and additional (optional) expenditures, with a separate consideration of certain areas (e.g. the areas of special national concern and islands).
Figure 1. Municipalities and Cities According to the 2000 Current Revenue/Current Expenditure Index

<table>
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<tr>
<th>Classes</th>
<th>Explanation</th>
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<th>Number of municipalities</th>
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<td>1</td>
</tr>
<tr>
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<td></td>
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<td>3</td>
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<td>10</td>
</tr>
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<td>14</td>
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<td>14</td>
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</tr>
<tr>
<td>TOTAL</td>
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<td>422</td>
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</table>
M. 1.1.1 Compiling a list of basic (minimum) and additional (extended) activities related to the performance of self-government functions of municipalities and cities (cities up to 30,000 inhabitants and those over 30,000 inhabitants).

Once the list of basic (minimum) and additional (extended) activities related to the performance of self-government functions has been compiled, it is necessary to determine the sources of financing the basic (minimum) activities. This will provide for minimum standards of basic self-government functions in each local unit. At the same time, local self-government units are allowed to perform additional activities provided that they find the sources for their financing.

M. 1.1.2 Strengthening of the fiscal capacity of local and regional self-government units, especially by increasing their own revenues; proposing changes in the revenue structure of local and regional self-government units.

The 2000 indicators, obtained by an empirical analysis (the analysis of fiscal capacity) that is the ratio between current revenues (the analysis was based on current revenues as own revenues, where having such revenues is supposed to be the minimum condition for a unit to exist) and current expenditures for the basic functions to be performed by each local self-government unit, suggest that 184 municipalities and cities were unable to cover their current expenditures by current revenues. In addition, it is shown how many local self-government units, which have raised more funds, can use these funds for their own development, i.e. capital construction.

The results of the fiscal capacity analysis by county indicate that total revenues including grants per capita in most local self-government units are below the national average. An additional analysis was carried out excluding grants to provide a more realistic picture, i.e. to establish the actual amount of funds necessary to give grants to counties to the maximum amount of 75% of the national average.

In view of the above, we propose the following:

a) Larger own tax revenue

According to the generally accepted principle, which should be the basis for the financial autonomy of local self-government units, local units are supposed to raise as large revenues as possible from own taxes, with as low tax revenues-to-transfers ratios as possible.

b) The role of user fees (fees for services rendered to citizens and various occasional receipts) and other non-tax revenues.

The amount of revenues raised from user fees depends on the local authorities' initiative, so it is necessary to strengthen the role and efficiency of local authorities in collecting revenues from user fees.

The local self-government units should be allowed to use other non-tax revenues (utility charges, fees for the extraction of minerals, use of public land, contracted annual charges for concessions, etc.) primarily as special-purpose revenues, but also for the financing of other minimum activities related to the performance of self-government functions of municipalities and cities. That would imply a change in the role of a continuously growing share of non-tax revenues in the structure of revenue of local self-government units by changing the current regulations on the purpose of certain revenues.

c) The role of borrowing

The purpose of borrowing should not be to harmonize local budgets but to finance capital investment. The amount of borrowing should depend on the value of a local unit's assets.

d) Grants

The current criteria for giving grants (revenue below 75% of the average) should be changed, and grants should depend on the types of public services (minimum services) to be provided by a particular local unit in the areas of education, health care, social welfare, environmental protection, public utilities, physical planning, transport, public order, protection and improvement of the status of ethnic and national minorities, as well as culture.

Grants (for covering current expenditures) should be given in accordance with the following criteria:

• the size of population adjusted for fiscal capacity;
• age distribution of population;
• social and economic structure of population (the number of the unemployed, children, etc.);
• certain structural characteristics of a local self-government unit (area, total length of roads to be maintained, etc.).
The purpose of grants should not only be fiscal equalization or allocation of funds for financing the basic functions, i.e. provision of general public services, but certain public functions within the field of activity of the local self-government units.

With respect to the criteria for giving grants, the system of grants should include:

- special grants for the coverage of current expenditures;
- operational general-purpose grants;
- operational special-purpose grants;
- special grants for the coverage of capital expenditures;
- capital general-purpose grants;
- capital special-purpose grants.

The system of grants for the coverage of current expenditures should be based on own tax and non-tax revenues (an alternative to that could be a raising of current revenues per capita by the relevant local self-government unit) and on the needs for the basic functions within the field of activity of the local self-government unit.

M.1.1.3 Income tax sharing with the state to finance the functions transferred from the state to the local government level. As an alternative, the system of grants should include special-purpose grants to local self-government units to finance their performance of functions transferred from the higher levels of government (regional self-government or central government).

M.1.1.4 Different approaches to financing the cities and municipalities in the areas of special national concern, including islands and other local self-government units.

M.1.1.5 Regular monitoring of the databases of local and regional self-government units that are relevant for making decisions on the criteria for giving grants:

a) Appointment of a coordinator responsible for making an up-to-date list of available data, collection of the missing data, and creation of a regional and local databases.

b) Development of the methodology for the collection of the necessary regional and local data.

c) Allocation of duties to each participant in the collection of data on regional and local levels.

M.1.1.6 Making a proposal that the structure of expenditures of local and regional self-government include the coverage of basic (minimum) and additional (extended) functions within the field of activity of municipalities and cities (cities up to 30,000 inhabitants and those with more than 30,000 inhabitants).

Sub-Objective 1.2 Definition of Fiscal Criteria for the Establishment of a New Local and/or Regional Self-Government Unit.

M.1.2.1 The minimum criteria for the amount of revenues of local and/or regional self-government units necessary for the coverage of the basic (minimum) functions within their fields of activity should be defined by the Ministry of Finance within the budgetary process for a new fiscal year, and the Government of the Republic of Croatia should submit them, as a part of the so-called “budgetary package,” to the Croatian Parliament for adoption.

Sub-Objective 1.3 Encouraging the interconnection between municipalities, cities and counties in order to achieve common goals and to increase the revenues necessary to finance the basic (obligatory) and additional (optional) functions, as well as to collect more funds for investment in joint capital projects, and through this, to increase their credit rating.

M.1.3.1 A system of grants should be established (like in M.1.1.2 d) as an incentive to form an interconnection of local self-government units in the cases when their individual current revenues (per capita) are insufficient to finance their minimum functions.

M.1.3.2 Greater Importance of Capital Revenues. Capital revenues account for a relatively small share of total revenue of local self-government units. A large part of funds for capital project financing is provided from the state budget, and, in the case of capital projects at the municipality or city level, from the county budgets (in the form of supports and grants). For capital projects that are of common interest to several local self-government units and are financed by capital revenues of several such units, additional special-purpose capital grants should be provided at a several times higher amount than the amount of total capital revenues.

M.1.3.3 The mechanisms of stimulating the cooperation between municipalities, cities and counties in pursuing their common goals should be determined more clearly. In this connection, special emphasis should be placed on the development of international cooperation and integration, particularly cooperation at the regional level.
M. 1.3.4 An optimum number of local self-government units should be established in Croatia.

Objective 2
Proposing a Dynamic Decentralization Model

Sub-Objective 2.1 The financial effects of the regulations governing decentralization should be monitored, so that the initial process of decentralization within a dynamic model could be either adopted, modified or stopped.

M.2.1.1 The drawing up of an annual ranking list of municipalities and cities, and determination of fiscal capacity indicators as the criteria for an evaluation of the economic power of each local self-government unit.

Such a ranking list would reflect the actual status of the revenue structure, capability to perform the self-government functions within the competence of municipalities and cities, as well as the decentralized functions devolved to them. Furthermore, it will show the possibilities of the local units’ economic development, contribute to the growth of responsibility of public services for their own improvement, and encourage democracy.

M.2.1.2 The expenditures for the functions devolved by the state budget to local self-government units should be subject to stricter control, while greater emphasis should be laid on planning, preparation and the drawing up of the budgets of local self-government units as well as on analyzing the execution of the budget at the levels of local and regional self-government.

M.2.1.3 Gradual reduction in the state’s participation in revenue sharing.

M.2.1.4 Permanent monitoring and analysis of the proposed solutions for the decentralization of public functions.

M.2.1.5 Permanent monitoring of the impact of new measures on the realization of revenues at the local and regional self-government levels.

Conclusions and Recommendations

From the point of view of fiscal capacity, the current organization of local and regional self-government is inefficient. This is suggested by the results of the analyses of the local self-government units’ budgets. Depriving the local self-government units of their autonomy or their annexation to the neighboring municipalities and cities, or any other change that affects the existing territorial organization, is hardly a solution that could attract public support at this point in time. Before such a radical change is made, the existing opportunity to interconnect municipalities, cities and counties should be used in order to carry out the projects that they cannot finance individually. The financing of municipalities, cities and counties is a very complex problem that requires continuous monitoring and analysis, continuous adjustment, as well as proposing new/further research.

The decentralization process should be continued and applied in stages. As decentralization means transfer of authority, responsibility and funds from a higher level, i.e. the central government, to the local government levels, for the continuation of this process it is necessary to:

- ensure responsibility and transparency of operations at all government levels, i.e. assign duties according to the level of government;
- safeguard the independence of local self-government units in financing their expenditures and raising revenues, where it is most important “that all units are given relatively equal opportunities to provide services to their citizens”. This can be achieved by a continuous adjustment of equalization grants within the proposed model of fiscal decentralization;
- abandon the current practice of prescribing standards of the local units’ operations by the central government and encourage cooperation between the central government and the local self-government units in setting these standards. This would help to neutralize a direct influence of the central government on the responsibilities and obligations of local self-government units.

The proposed changes in the system of financing the local and regional self-government should only be taken as a provisional model, which requires continued modification based on the monitoring, analysis and evaluation of the fiscal capacity outturns of local self-government units over a minimum period of three fiscal years. During this process, care should be taken that the necessary conditions for the regional development and economic growth of the country are fulfilled.