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Regional Development and Decentralization - Two Options to Overcome Lack of Funding

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Regional Development and Decentralization – Two Options to Overcome Lack of Funding

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Abstract

Abstract

Decentralization can be generally described as a process in which selected functions are assigned to sub-national units. The literature identifies number of positive consequences of decentralization which all lead to better satisfaction of citizens' needs for public services. Although decentralization process in Croatia started more than 10 years ago, it still has not been finished. It led to new division of authorities and responsibilities to the local government units, but the level of fiscal decentralization remained lower than in the EU countries.

The efficient decentralization should incorporate delegation of authorities, responsibilities and resources to local government units based on the clear criteria, but also should ensure better coordination and cooperation of all entities in providing public functions. In the paper we analyze fiscal capacity of local government units to provide an insight into the main problems of decentralization in Croatia. We show that the most of local government units have very low fiscal capacity and cannot finance basic public functions from their own resources. The paper also presents result of the performed survey about decentralization process among local councilors at the regional level in Croatia. We explore how local councilors at regional level in Croatia evaluate different goals of decentralization. Having in mind the lack of fiscal capacity, we identify two possible solutions for an optimal provision of public functions. The first one is level of political will for the joint provision of public functions between different local units, and the second one is change in territorial division of the country. We measure the difference in the attitudes toward these questions across counties.

Key words: decentralization, fiscal capacity, regional development, Croatia.

JEL classification: H7, R58

General theme: E. Private and public finance for regional development

1. INTRODUCTION

Theory suggests that decentralized decision-making related to fiscal issues for each level of government best meet local public interests (Dillinger, 1994). The fundamental reason for the existence of multiple levels of government is to allow a certain level of government to provide selected category of public service and to allow their level varies across different local units according to their preferences. In addition, multiple levels of government also mean that voters have more choices to express their preferences. Tanzi (1995) considered that fiscal decentralization exists when sub-national levels of government, on the basis of the constitution or the law, have the autonomy of introducing taxes, and that tax revenues can be spent for the provision of public services according to clearly defined criteria.

Theory and empirical research have suggested that underdeveloped countries are more centralized than the developed ones. Therefore, the question is whether fiscal decentralization is a cause or a consequence of economic development. Opinions differ, Bahl and Linn (1992) and Bailey (1999, 2002, 2004) suggest that decentralization comes with a higher level of economic development. In transition economies, decentralization is an essential element of the process of transition and the development of democracy, which necessarily leads to economic development (Horvath, 2000). Therefore the main argument for promotion of decentralization is that it directly encourages and contributes to economic growth, enhancing the development of the regions in heterogeneous countries, using limited resources more efficiently to encourage the development of less developed areas (regions). Therefore, decentralization becomes an important part of development strategy not only in underdeveloped, but also developed countries.

Fiscal decentralization has been associated with efficient fulfillment of development goals, bigger competitiveness within the sub-national levels of government in providing public services and with boosting economic growth (Bahl and Linn, 1992; Bird and Wallich, 1994). Dillinger (1994) considers that decentralization began in a number of developing countries, countries in South Eastern Europe, and even in those states that have always been centralized. Decentralization is an effective strategy for improving the delivery of public services.

Although a large body of literature analyzes reasons for greater decentralization, there is a less discussion of its positive effects on economic growth and development. Also, there are no

many empirical researches to support these conclusions. Davoodi and Zou (1998) conducted an empirical study using panel data from 46 countries in order to investigate the relationship between fiscal decentralization and economic growth.¹ They found a negative relationship between fiscal decentralization and growth in developing countries. In developed countries, this link is positive. A similar view has Lijeron (1996), who suggests the positive relationship between the level of income per capita and the degree of decentralization, because of the fact that the most developed countries have a higher rate of decentralization in comparison to underdeveloped countries. Recent research on relationship between federalism and decentralization in developed countries has shown that federalism makes positive push to sub-national stakeholders. In addition it has positive influence on the quality of local public services as well as on efficiency (Biela, Hennel, and Kaiser, 2012). Recent empirical analysis in Croatia identifies a positive relationship between the extent of fiscal decentralization and economic development, suggesting that higher level of decentralization would be beneficial for the Croatian economy (Jurlina Alibegović, 2013).

The rest of the paper is structured as follows. The second section describes main features of fiscal decentralization reform in Croatia. The third section elaborates in details fiscal capacity of municipalities, towns and counties in Croatia as potential sources for financing decentralized public functions as well as local development projects. Basic findings of performed survey among regional councilors are presented in the fifth section. The last section summarizes our analysis and offers conclusions regarding possible options to overcome lack of funding to promote decentralization and regional development in Croatia.

2. FISCAL DECENTRALIZATION REFORM IN CROATIA

2.1 Sub-national governments' responsibilities in providing public services

According to the theory of public finance, responsibility of sub-national levels of government in providing public goods and services resulting from established intergovernmental fiscal relations between the central and sub-national fiscal authorities. For efficient decentralization transparent distribution of responsibilities between the central and sub-national levels of

¹ The paper gives a brief review of the theoretical literature and empirical framework linking fiscal decentralization and growth, and describes the parameters that measure the effects of fiscal decentralization on economic growth.

government in provision of public functions is needed. In addition, adequate revenue sources for financing public goods and locally provided services are of great importance. Efficient decentralization should also ensure better coordination and cooperation of all public entities in providing public functions.

In this section we focus on the distribution of expenses and revenue sources among levels of government in Croatia, aiming to compare fiscal data and Croatian practice with theoretical explanations regarding advantages of decentralization.

The Republic of Croatia has a two-tier system of sub-national government, towns and municipalities comprise the level of local self-government, while counties represent the regional self-government level. The City of Zagreb has status of a local and regional level of government. Today the territory of Croatia consists of 429 municipalities and 126 towns (cities) at the local level, the City of Zagreb and of 20 counties at the regional level, which makes a total of 576 sub-national units.

In July 2001 Croatia started decentralization reform. This reform initiative has been described as the first phase of decentralization process². The decentralization reform has been directed both to administrative and fiscal areas. A result of the new division of responsibilities among different government levels is based on provisions of specific laws³. These laws define public functions that are transferred from the state to the county, city and municipality level. Municipalities and towns perform tasks of local significance, which directly address the needs of citizens and which are not assigned to state bodies by the Constitution or by the law. Big cities (cities with more than 35,000 inhabitants) and county centers are responsible for all local tasks and services for their citizens, including tasks regarding public roads maintenance and issuing of building and location permits. Counties in their self-governing scope of authority are responsible for the functions of regional character. Cities with more than 35,000 inhabitants may be also responsible for functions which otherwise fall within the competence of counties, as long as they ensure the necessary conditions for performance of these services. All municipalities and all cities (except big cities and cities that are county centers) have equal authorities. Consequently, it is not possible to ensure a comparable quality of public services.

² Based on Program of Fiscal Decentralization (2002).

³ Law on Primary Education, Law on Secondary Education, Law on Social Welfare, Law on Health Insurance, Law on Fire Protection, and Law on Local and Regional Self-Government Unit. Koprić (2003) elaborates legislative framework for decentralization in more details.

In Croatia is not made a clear division of responsibilities in the implementation of public functions between the central and sub-national levels of government. Providing of any public function is assigned to all levels of government and their responsibilities in the implementation of public functions often overlap (Table 1). Defense is the only one public function for which is responsible the state government. Responsibility for civil protection as part of a public defense function is on local levels of government. Even in the situation that the component/segment of public affairs had been transferred to regional and/or local levels of government, current situation shows that operating with this segment of public affairs is not entirely under jurisdiction of sub-national governments. The reason for that is because of overlapping responsibilities with higher level of government.

In the first phase of decentralization, 32 financially stronger cities, the City of Zagreb and all of 20 counties in Croatia have been assigned additional responsibilities to provide some of public functions locally. Assignment of new responsibilities in providing public services and new revenue sources did not included all, but only marginal number of local and regional government units⁴. Adopted model of decentralization implied that expenses for material costs and capital investments in primary education are transferred to 32 big and/or financially stronger cities and counties budgets, as well as expenses for material costs and capital investments in secondary education are transferred to the counties budgets. In health care and social welfare expenses for material costs are transferred to county budgets, but financing of capital investments is responsibility of the state budget. Financing of total expenses for fire protection was transferred to local government budgets (municipalities and cities). The only one public function, fire protection, is entirely transferred from the state to municipal level. Financing of other public functions is as a shared responsibility between the state and city or county level.

Table 1 Distribution of responsibilities

	Municipalities	Towns	Cities	Counties	State
01 General public services					
01.1 Executive and legislative organs, financial and fiscal affairs, external affairs					
02 Defense					

⁴ Total number of 53 selected local and regional government units that have been assigned decentralized functions represents only 9 percent of total number of local and regional government units in Croatia. Refer to Jurlina Alibegović (2007) and Jurlina Alibegović (2013).

02.1 Military defense					
02.2 Civil defense					
03 Public order and safety					
03.1 Police services					
03.2 Fire-protection services					
04 Economic affairs					
04.1 General economic, commercial and labor affairs (consumer protection)					
04.5 Transport					
05 Environmental protection					
05.1 Waste management					
05.2 Waste water management					
05.3 Pollution abatement					
06 Housing and community amenities					
06.1 Housing planning and development					
06.2 Community planning and development					
06.3 Water supply					
06.4 Street lighting					
07 Health					
07.1 Medical products, appliances and equipment					
07.2 Outpatient services					
07.3 Hospital services					
07.4 Public health services					
08 Recreation, culture and religion					
08.1 Recreational and sporting services					
08.2 Cultural services					
09 Education					
09.1 Pre-primary and primary education					
09.2 Secondary education					
09.3 Post-secondary non-tertiary education					
09.4 Tertiary education					
10 Social protection					
10.6 Housing					
10.7 Social exclusion n.e.c.					

Implemented model of decentralization includes several changes in revenue sources. The first one is the possibility of introducing new municipal and city taxes, as well as the possibility of introducing different levels of surtax on income tax depending on the size of the municipality. Distribution of revenues usually shared between the state and sub-national government has also been changed. The major change was in the distribution of income tax revenues, with a larger part of revenues now being attributed to the local governments (34 percent). Additional share of income tax revenue (10.4 percent) is reserved for covering expenditures regarding

decentralized functions in primary (2.9 percent) and secondary education (2.0 percent), health care (2.5 percent), social welfare (2.0 percent) and fire protection (1.0 percent). There have been established equalization grants for decentralized functions (21 percent of income tax) for local government units that do not have sufficient resources for financing decentralized functions. During the next years additional share of income tax for financing decentralized functions has been gradually increased (Table 2).

Table 2 Additional share of income tax for financing decentralized functions

	July 1 st , 2001	2013
Towns/municipalities		
share of income tax	32.0	55.0
share of income tax for decentralized functions:	3.9	4.4
primary education	2.9	3.1
public fire brigades	1.0*	1.3
The City of Zagreb		
share of income tax	45.0	70.5
share of income tax for decentralized functions:	9.4	12.0
primary education	2.9	3.1
secondary education	2.0	2.2
social welfare	2.0	2.2
health care	2.5	3.2
public fire brigades*	1.0	1.3
Countries		
share of income tax	8.0	15.5
share of income tax for decentralized functions:	9.4	10.7
primary education	2.9	3.1
secondary education	2.0	2.2
social welfare	2.0	2.2
health care	2.5	3.2
Share of income tax for equalization grants (line item in the state budget)	21.0	17.5
Share of income tax for state government	29.6	0.0

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

Source: Ministry of Finance.

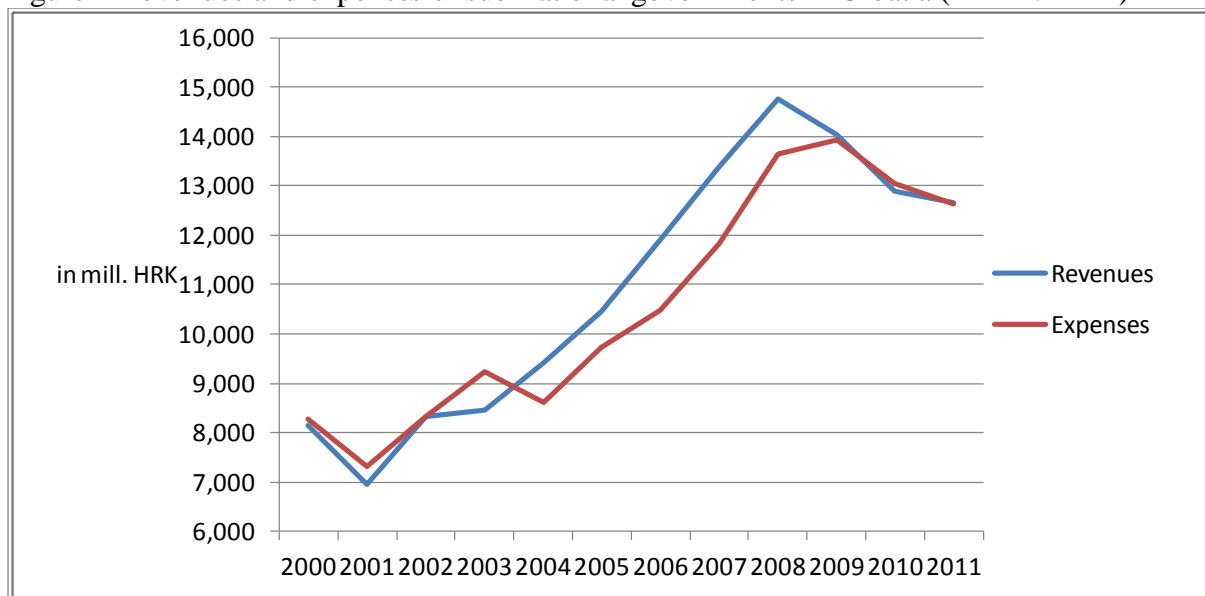
2.2 Key facts about decentralization process

The share of revenues and expenses of sub-national government in the total government budget revenues and expenses, as well as share of these revenues in GDP (before and after 2001) could indicate size of undertaken fiscal decentralization. In 2000, the year before the

launch of decentralization process in Croatia, the share of local budget revenues in consolidated revenues of the general government budget totaled 10.9 percent while their share in GDP amounted to 5.4 percent. In 2001 respective shares amounted to 8.8 and 4.1 percent.

Although total revenues and expenses of local government units have been nominally increased (Figure 1), all data clearly show that Croatia is a highly centralized country measured by two important indicators: the share of revenues and expenses of sub-national government in GDP and the share of revenues and expenses of sub-national government in total government budget revenues and expenses (Figure 2). The share of local budget revenues and expenses in the consolidated general government budget has remained around 10 percent while their share in GDP has been 4 percent. Consequently, Croatia has continued to be among the least decentralized countries, not only compared to the EU-27 countries⁵. Comparison with other SEE countries shows that Croatia is rather similar to those countries. The degree of decentralization in SEE countries is still very low. The average share of unconsolidated local government revenues is 5-6 percent of GDP, or 14-17 percent of total government revenues (Figure 3).

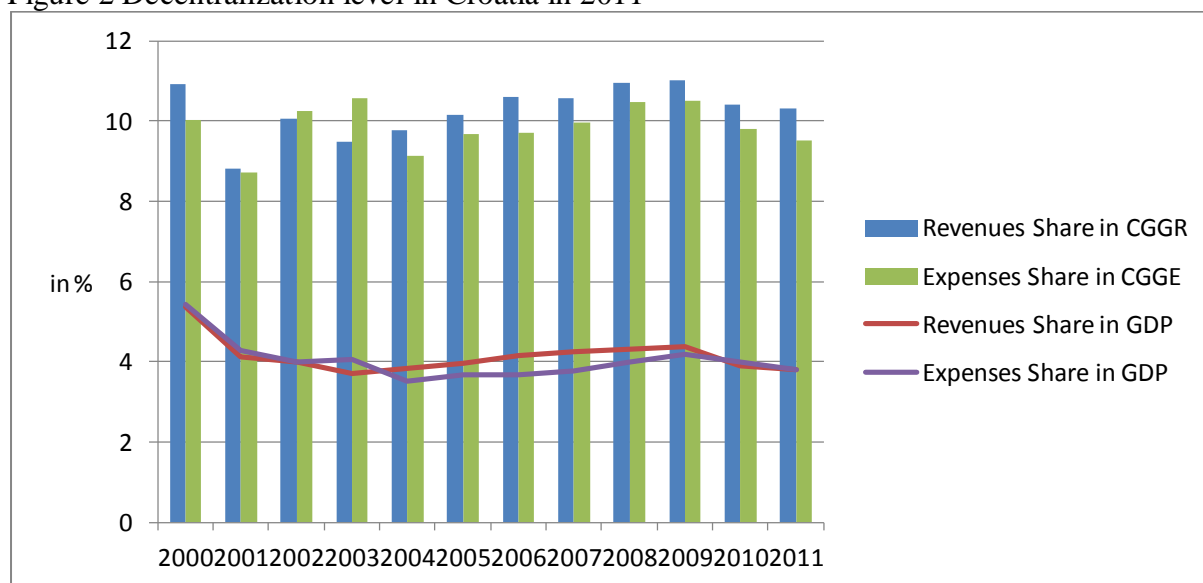
Figure 1 Revenues and expenses of sub-national governments in Croatia (in mill. HRK)



Source: Ministry of Finance.

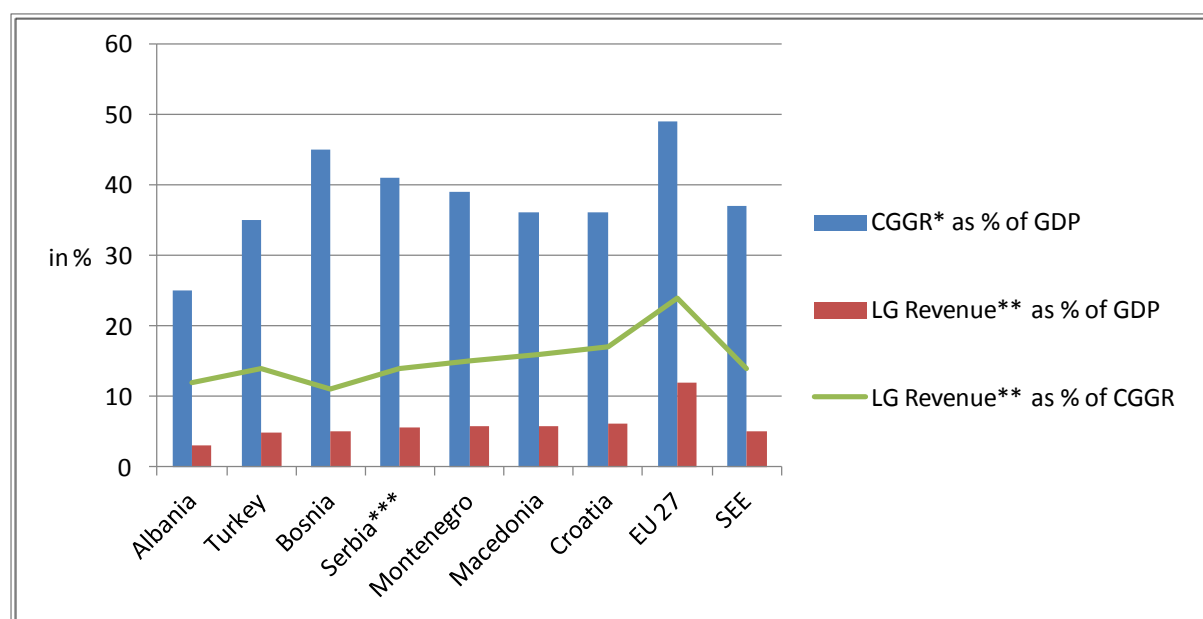
⁵ For thorough description of local government reform in EU refer to Kuhlmann (2010). Brezovnik and Oplotnik (2012) elaborate optimal system of municipalities' financing in Slovenia. Koprić (2010) offers recommendations for local and regional reform in the context of Croatia's EU accession.

Figure 2 Decentralization level in Croatia in 2011



Source: Ministry of Finance.

Figure 3 Decentralization level in selected countries in 2011



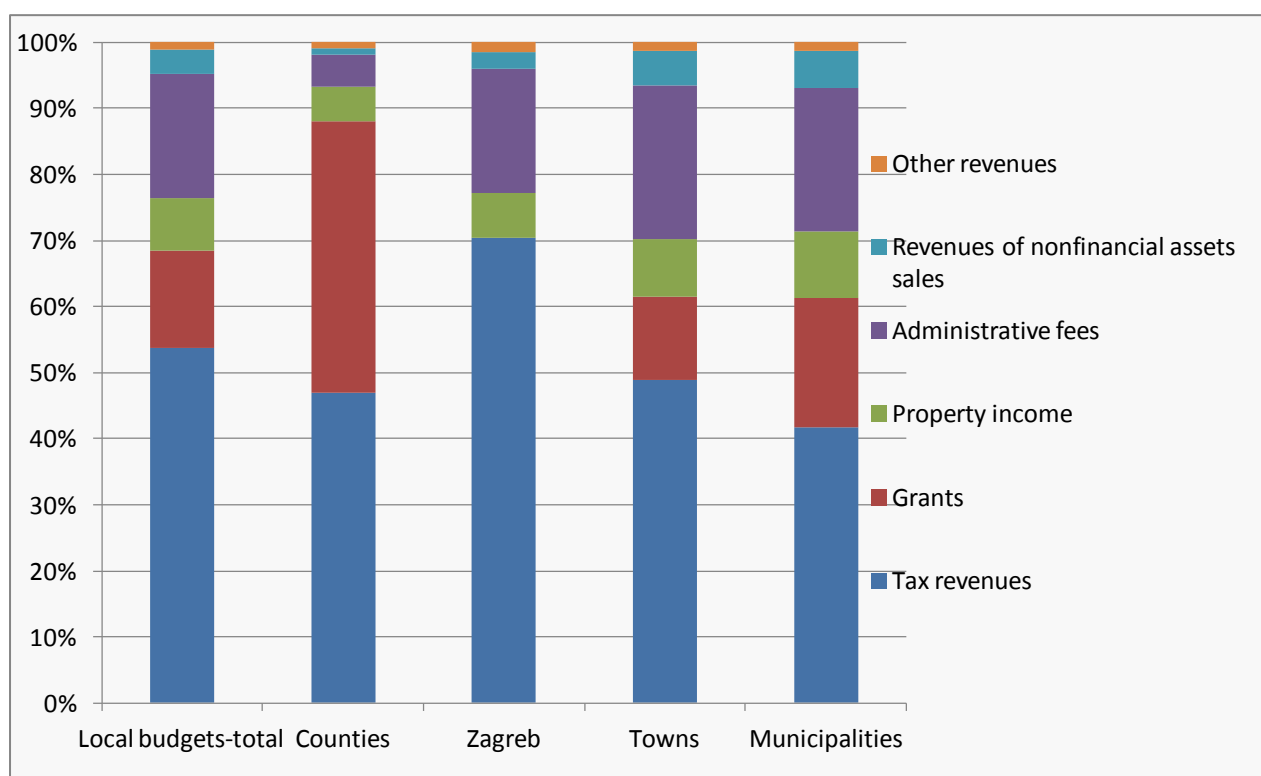
Notes: * Consolidated general government revenue; ** Local government; *** for 2009.
Source: NALAS (2012).

3. FISCAL CAPACITY OF SUB-NATIONAL GOVERNMENT UNITS

Since 2001, the revenue of local units has been increased substantially. It coincides with the beginning of the process of fiscal decentralization. Implemented model of decentralization includes several changes in revenue sources. The first one is the possibility of introducing different levels of surtax on income tax depending on the size of the municipality. Distribution of revenues that has been shared between the state and sub-national government has also been changed. The major change was in the distribution of income tax revenues, with a larger part of revenues now being allocated to the local governments (55 percent), as well as to the regional government units (16 percent).

Revenues outturn in local government units in Croatia is harmonized with IMF (2001) methodology. Data in Figure 4 show the structure of local government revenues in 2011.

Figure 4 Structure of local budgets revenues in 2011



Source: Ministry of Finance.

Total revenues of all local government units in Croatia totaled HRK 20.2 billion⁶ in 2011. Within the structure of total revenues of municipalities, towns and counties the most important category is *tax* revenues, with the share of 52 percent. The largest part of tax revenues is generated through taxes from income and surtax on income tax (46 percent of total revenues).

The second most important source of total local government units revenues are *grants*. In the period 2009-2011 there has been an obvious increase in grants share in total local revenues (from 9 to 14 percent of total local revenues). The major part of grants received in 2011 are in the form of current and capital grants, as well as equalization transfers for decentralized functions. This means that revenue from additional share of income tax is not sufficient to cover costs of decentralized functions.

The administrative fee revenue is an important revenue source for local government units, and it generated 18 percent of the total revenues. Local government units generate most of their administrative fee revenues from public utilities. The counties, unlike municipalities and towns, do not generate any revenues from public utilities, and the public utilities revenue is exclusively municipal, town, and city revenue.

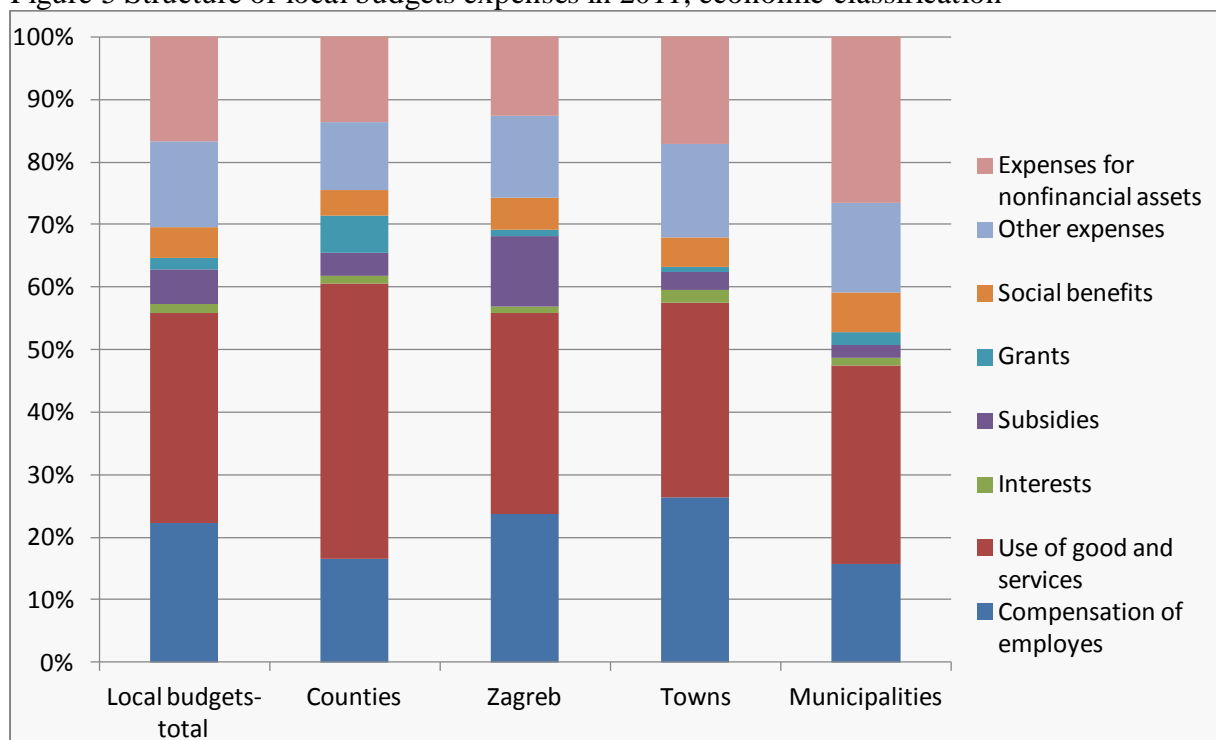
There is a prominent difference in the amount of fiscal revenue, as well as in their structure between counties, towns and municipalities. Participation in total local revenues of the City of Zagreb, towns⁷ and municipalities were 30, 38 and 16 percent respectively.

In 2011 the total expenses of municipalities, towns, and counties was HRK 21.2 billion. In the Figure 5 detailed structure of expenses is presented. Within the total expenses, according to economic classification, *material expenses* were the most important category, with the share of 32 percent.

⁶ For comparison, exchange rate on February 25th, 2013 for one EUR is 7.585314 HRK.

⁷ Without the budget of the city of Zagreb.

Figure 5 Structure of local budgets expenses in 2011, economic classification



Source: Ministry of Finance.

The local government units also spent a lot on *purchasing non-financial assets* (predominantly acquisition of the tangible fixed assets). These expenses made 16 percent of the total expenses of the local units. The towns and municipalities spent significantly more for these purposes than the counties.

Expenses for compensation of employees, in 2011 represented 21 percent of the total expenses. These expenses include salary and wages in local government units, as well as taxes and contributions.

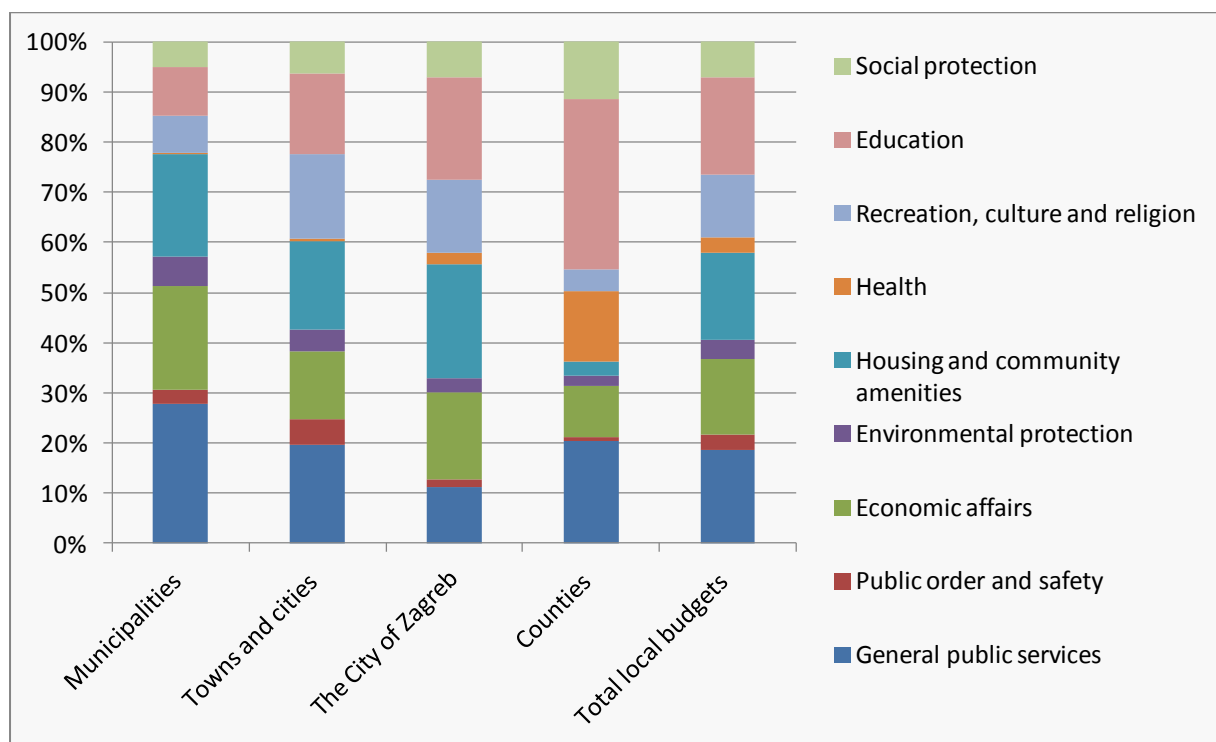
The current grants in form of cash and capital grants (and mostly issued to companies in the public sector) are the main reason for high *other expenses* of municipalities, towns, and counties. The other expenses represented as much as 13 percent of the total expenses.

Local units allocated 5 percent of their budgets in 2011 for *subsidies*. The largest part of subsidies is transferred to the companies in the public sector.

There are pronounced differences on the expenses side of the local budgets – related to amounts, as well as to the structure. Analysis shows that more than 37 percent of total local expenses are generated by towns, 27 percent by municipalities, 24 percent by the city of Zagreb, and 12 percent by counties. For the purpose of this paper it is important to stress out that the major difference between counties and other local budget is the amount of grant. Out of HRK 394 million allocated for total local grants, 52 percent are grants transferred by counties to towns and municipalities. Analyzing economic classification of budget data one can see that majority of funds was used for regular activities and that very small amount is available for funding local development projects.

According to functional classification, presented in Figure 6, the major categories of expenses in structure of local budgets are *expenses for education* and expenses for general public services, with 18 percent share each. *Expenses for housing and community amenity* attract 17 percent of their budgets. These resources are spent primarily on the community development, and on improving housing and various communal infrastructure projects.

Figure 6 Total expenses in local budgets in 2011, functional classification



Source: Ministry of Finance.

Analysis of local budget expenses by functional classification indicates that differences in expense structure reflect differences in allocation of responsibilities for providing public services among different local levels.

From the previous short analysis of local revenues and expenses it can be concluded that local government units are largely dependent on financing public functions from income tax and grants from the state budget. Municipalities and towns can not affect the amount of these revenues. The fiscal autonomy of sub-national government units in collecting their own revenue is relatively low. The sub-national government units obtain the least amount of revenue from their own taxes.

Fiscal capacity of regional or local government unit can be defined as the ability of the local unit to raise revenues from their own sources in order to pay for a standardized basket of public goods and services (Snah, 1997; Martinez-Vasquez and Boex, 1997). Fiscal capacity can also be defined as the ability of governmental jurisdiction to translate economic activity within its geographic borders into public spending (Chernick, 1998). There are several major approaches or concepts to measuring fiscal capacity of local units (Chernick, 1998; Martinez-Vasquez and Boex, 1997).⁸

A measurement of fiscal capacity should be an important factor in determining the allocation of intergovernmental grants in order to equalize the amount of resources available to each of the regions or cities. A measurement of fiscal capacity should be an important factor in determining the allocation of intergovernmental grants in order to equalize the amount of resources available to each of the regions or cities.⁹

A measurement of fiscal capacity in Croatia is the base for determining the allocation of intergovernmental transfers and grants in order to equalize the amount of resources available to each of the regions or cities. There are two major kinds of transfers and grants in Croatia: (1) grants and transfers from the state and county budget to local units and (2) equalization grants for decentralized functions from the state budget to regional and local government in

⁸ The representative tax system, the representative tax system using regression analysis, the income with exporting, the maximum amount of revenue, per capita personal income, gross regional product, and the level of total taxable resources. For detailed elaboration refer to Jurlina Alibegović (2005).

⁹ Refer to Bajo (1999) and Jurlina Alibegović (2005).

order to cover major public services expenditure (education, health care, social welfare and fire-protection).

Grants for local and regional government are realized in line with the capabilities of the state budget, in a way to secure grants for the local units without fiscal capacity for financing mandatory functions. The criteria for the calculation of the grants for local units change every year. Equalization grants for decentralized functions are provided from the state budget to cover public expenses in the area of primary and secondary education, social welfare and health care, which are transferred to local units.

One of the main measures of the fiscal capacity is the amount of income tax revenues collected. The equalization grant volume, for the finance of the decentralized functions is calculated as the difference between the minimal required expenditure for the public services finance (determined on the basis of the minimal financial standard) and the amount of the corresponding income taxation. The equalization grant system requires constant monitoring and improvements. One of the key areas for which a better solution is required is the definition of the minimal financial standard.

Selected measures for fiscal capacity of counties, towns and municipalities in 2011 are presented in the tables 3-5 according to economic and functional classification.

Analyzing differences in fiscal capacities across different local levels helps us to identify whether local units are actually capable for financing existing public services and whether their fiscal capacities are adequate for taking new responsibilities in providing public services.

Table 3 Fiscal capacity of **counties** (without Zagreb) in Croatia, per capita, in HRK

Year 2011	Average	Minimum	Maximum
According to the economic classification of the budget			
OPERATING REVENUES	993.52	809.00	1,169.13
Tax revenues	412.04	217.88	692.18
Share of income tax revenue from equalization grants for financing decentralized functions	77.67	0.00	207.27
Grant revenues	471.98	120.57	801.08
Property income	53.10	19.68	159.60
Administrative fees	46.56	18.67	138.27
Total revenues without grant revenues and share of income tax revenue for financing decentralized functions	455.10	246.12	884.38
OPERATING EXPANSES	844.33	682.70	1,051.80

Expenditures for compensation of employees	159.17	75.21	291.68
Use of goods and services	439.03	230.94	685.57
Subsidies	30.67	8.69	67.12
Grants	52.62	6.91	86.95
TOTAL REVENUES	1,004.74	814.70	1,180.00
TOTAL EXPENDITURES	992.21	803.33	1,236.21
According to the functional classification of the budget			
Expenditures for general government services	212.17	140.00	429.21
Expenditures for defense	0.09	0.00	1.50
Expenditures for public order and safety	6.53	0.00	11.70
Expenditures for economic affairs	91.15	15.69	209.19
Expenditures for environment protection	17.43	1.01	34.35
Expenditures for housing and community amenity	23.03	0.00	55.66
Expenditures for health	143.76	77.17	226.58
Expenditures for recreation, culture and religion	38.55	6.79	97.33
Expenditures for education	345.50	231.85	617.91
Expenditures for social protection	114.00	28.95	242.92

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

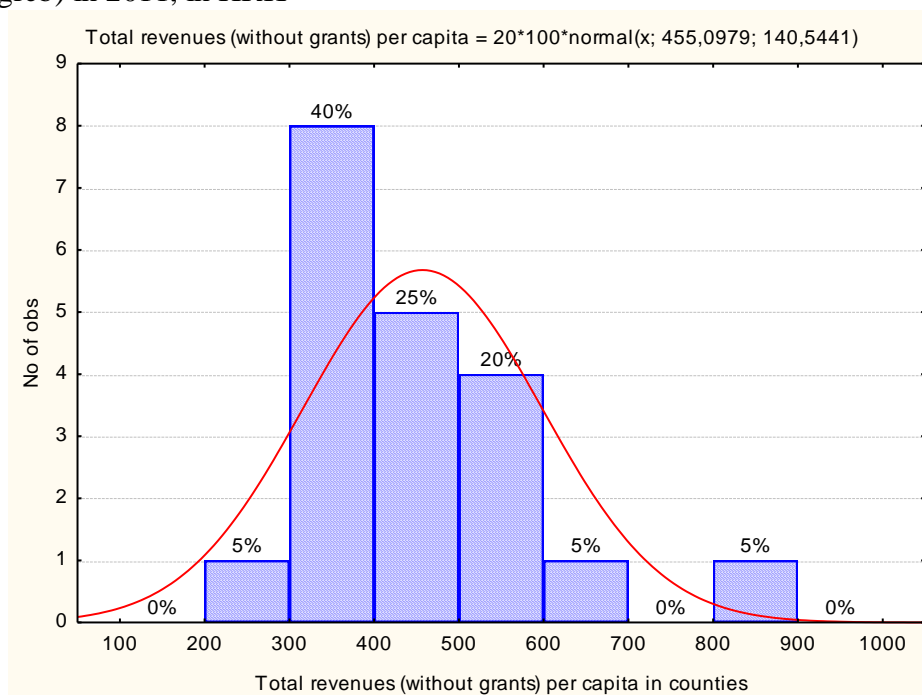
Source: Authors calculations based on data from Ministry of Finance and Croatian Bureau of Statistic.

As seen in table 3 total average revenue per capita of counties in 2011 was HRK 1,005. Results of measurement of the fiscal capacity with different indicators¹⁰ imply that there are large differences in the level of budget per capita between different counties. Therefore some counties generate operating revenues per capita that are 17 percent higher than in some other counties.

Differences in fiscal capacities of counties according to economic classification are especially evident when analyzing total revenues data without grants and share of income tax revenue for financing decentralized functions (Figures 7, 8 and 9). The highest revenues per capita (without grants) are in the City of Zagreb. When excluding the City of Zagreb from analysis, fifty percent of counties generate below-average revenues without grants per capita. Forty percent of counties generate between HRK 300 and HRK 400 revenues per capita.

¹⁰ For measuring fiscal capacity in Croatia with different indicators prior to 2009 see in Jurlina Alibegović (2005).

Figure 7 Differences in total revenues (without grants) per capita across counties (without the City of Zagreb) in 2011, in HRK



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

** The City of Zagreb is not included in the analysis of fiscal capacity.

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

Disparities in different categories of expenditure per capita according to economic classification are pronounced, too. Average value of total expenditures per capita in counties is HRK 990. As shown in table 3 expenditure per capita according to functional classification varies substantially across counties.

Table 4 Fiscal capacity of towns (without Zagreb) in Croatia, per capita, in HRK

Year 2011	Average	Minimum	Maximum
According to the economic classification of the budget			
OPERATING REVENUES	3,471.05	1,087.79	9,411.02
Tax revenues	1,632.78	459.91	3,892.57
Share of income tax revenue from equalization grants for financing decentralized functions	16.69	0.00	152.92
Grant revenues	630.91	0.00	5,848.22
Property income	295.33	3.36	1,503.61
Administrative fees	853.88	120.84	3,296.19
Total revenues without grant revenues and share of income tax revenue for financing decentralized functions	3,049.17	706.92	13,762.20
OPERATING EXPENSES	2,976.48	999.92	7,776.82
Expenditures for compensation of employees	927.80	126.29	2,787.87

Use of goods and services	1,153.15	252.53	3,322.48
Subsidies	66.33	0.00	451.49
Grants	29.06	0.00	479.78
TOTAL REVENUES	3,696.77	1,128.96	14,408.46
TOTAL EXPENDITURES	3,657.44	1,129.05	13,100.06
According to the functional classification of the budget			
Expenditures for general government services	852.69	135.46	2,927.89
Expenditures for defense	1.70	0.00	78.35
Expenditures for public order and safety	195.29	0.00	934.80
Expenditures for economic affairs	470.35	0.00	3,525.70
Expenditures for environment protection	216.74	0.00	2,169.17
Expenditures for housing and community amenity	678.86	0.00	4,190.48
Expenditures for health	18.41	0.00	203.06
Expenditures for recreation, culture and religion	509.56	51.53	3,382.36
Expenditures for education	514.69	60.28	2,008.30
Expenditures for social protection	199.15	0.00	1,063.95

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

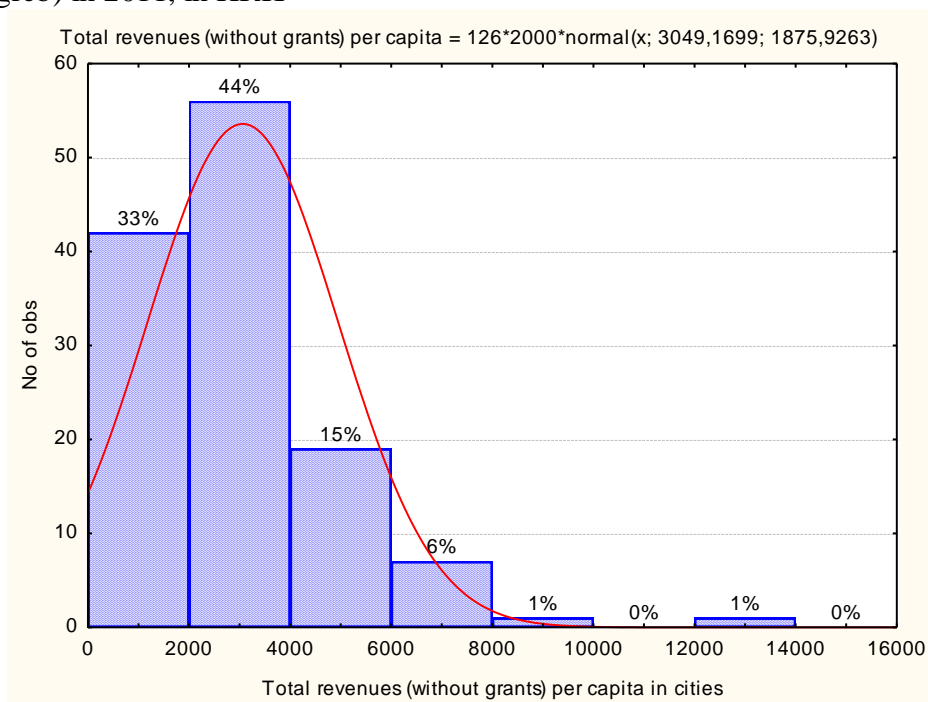
Source: Authors calculations based on data from Ministry of Finance and Croatian Bureau of Statistic.

Analysis shows large differences in fiscal capacities of towns for providing public services. Data in table 4 indicate that there are towns that generate nine times higher operating revenues per capita comparing to towns with minimum operating revenues per capita.

Income tax revenues from equalization grants for financing decentralized functions are not sufficient for financing mandatory public services (on average HRK 17 per capita). Therefore towns exhibit huge dependence on received grants (on average HRK 630 per capita). Disparities relating to grants revenue are very high. The highest grant revenue per capita is HRK 5,848. On the other side there is a town without any grant revenue. Out of 126 towns, 38 towns (which represent 30 percent of total number of towns) generate grant revenues per capita below average (HRK 630).

Figure 8 shows the structure of total revenues without grants, per capita, by towns. On average towns generate HRK 3,050 revenues without grants per capita. The lowest amount of revenues without grants is HRK 707 per capita while the highest amount is HRK 13,762 so the substantial disparities in towns' capacities for financing mandatory services without grants are evident. The majority of towns generate revenues without grants that are below HRK 4,000 per capita. Due to the lack of available data, analysis of towns' abilities in generating own revenues cannot be performed. This kind of analysis would better reveal actual financial independence and capacity of towns to finance expenditure by own revenues.

Figure 8 Differences in total revenues (without grants) per capita across towns (without the City of Zagreb) in 2011, in HRK



Notes: * Item total revenue without grants is equal total revenues without grant revenues and share of income tax revenue for financing decentralized functions.

** The City of Zagreb is not included in the analysis of fiscal capacity.

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

Situation is similar when analyzing expenditures according to economic and functional classification. In 2011, total expenditures ranged from HRK 1,130 to 13,100 per capita. In the same year, average expenditures for compensation of employees in towns were HRK 928 per capita.

Table 5 Fiscal capacity of municipalities in Croatia, per capita, in HRK

Year 2011	Average	Minimum	Maximum
According to the economic classification of the budget			
OPERATING REVENUES	2,816.06	518.15	13,406.32
Tax revenues	1,124.03	130.55	5,516.02
Share of income tax revenue from equalization grants for financing decentralized functions	1.26	0.00	186.10
Grant revenues	676.79	0.00	10,285.78
Property income	308.78	0.01	9,893.44
Administrative fees	661.59	0.00	8,070.31
Total revenues without grant revenues and share of income tax revenue for financing decentralized functions	2,323.09	215.35	12,285.32
OPERATING EXPENSES	2,161.67	447.34	8,502.30
Expenditures for compensation of employees	476.13	49.01	2,642.73
Use of goods and services	966.40	135.20	4,359.86

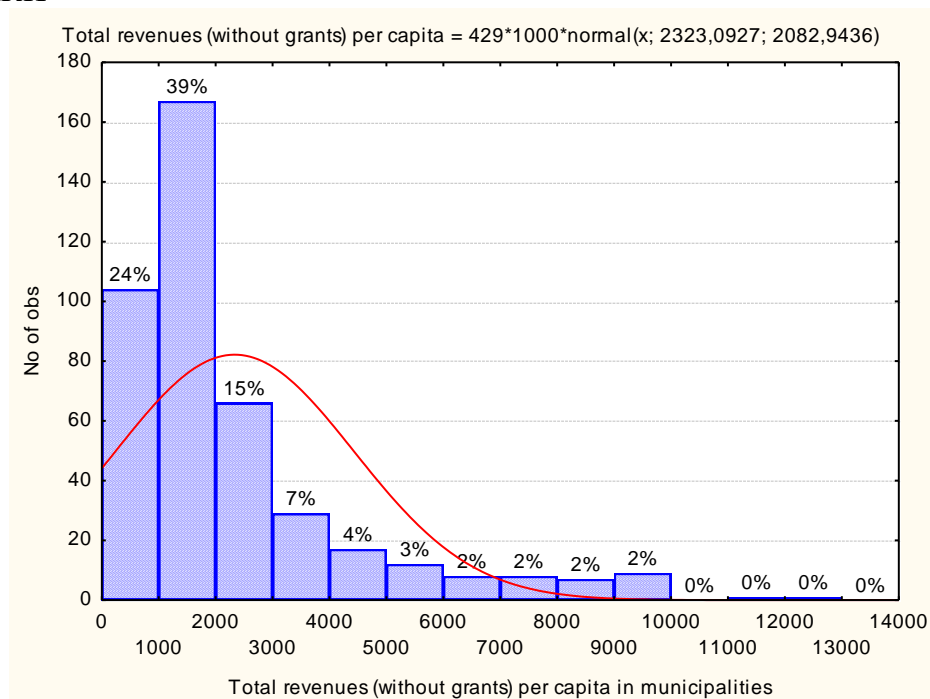
Subsidies	47.71	0.00	1,021.46
Grants	70.56	0.00	1,570.53
TOTAL REVENUES	3,001.14	518.15	14,070.90
TOTAL EXPENDITURES	3,007.45	449.53	29,200.96
According to the functional classification of the budget			
Expenditures for general government services	910.15	0.00	8,954.46
Expenditures for defense	0.79	0.00	90.83
Expenditures for public order and safety	92.86	0.00	2,142.43
Expenditures for economic affairs	632.67	0.00	21,910.36
Expenditures for environment protection	175.88	0.00	3,173.48
Expenditures for housing and community amenity	595.63	0.00	6,830.38
Expenditures for health	11.23	0.00	987.71
Expenditures for recreation, culture and religion	202.05	0.00	2,993.20
Expenditures for education	246.55	0.00	3,114.54
Expenditures for social protection	140.99	0.00	1,115.01

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

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

Fiscal capacity of municipality for providing public services is smaller than in towns. Figure 9 shows that 24 percent of total numbers of municipalities generate revenues without grants below HRK 1,000 per capita. In addition 39 percent of municipalities generate revenues without grants between HRK 1,000 and 2,000 per capita. The major part of grants is allocated from budget.

Figure 9 Differences in total revenues (without grants) per capita across municipalities in 2011, in HRK



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

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

From fiscal capacity analysis it can be concluded that there are substantial differences on the revenue, as well as on the expense side of the budget. Measured by average revenues per capita, and average expenses per capita, counties have the smallest capacity (comparing to towns and municipalities). All local units exhibit big dependence on received grants. On average, counties, towns and municipalities generate HRK 455; HRK 3,050 and HRK 2,320 revenues without grants per capita, respectively. In 2011, such revenues were sufficient to finance 46 percent of total expenses generated by counties, 83 percent of total expenses generated by towns and 77 percent of total expense generated in municipalities.

4. SURVEY RESULTS

Decentralization should result in increasing responsibility of local government in providing public functions and consequently with more efficiently provided public services to the citizens. However, previous analysis of fiscal capacity of local government units clearly shows that the most of counties, cities and municipalities in Croatia do not have enough financial resources to provide basic public functions to their citizens. Financial crises make the situation even more difficult¹¹. It is not easy to diminish or avoid the consequences of the current financial crisis. Thus the projections for the state and local budgets are not very bright and it will be very difficult to accumulate enough funds to ensure the proper functioning of public services at the local level. Therefore in this part of the paper we investigate different modes which could ensure sustainable decentralization of authorities and responsibilities to the local government units and at the same time would not give such a large additional pressures on the state or local government finance. Analysis is based on the result of the survey conducted among local councilors at the regional level in Croatia in 2013.

Our analysis is based on the result of survey among 265 local councilors from 14 Croatian countries¹² in 2013. In the following table short overview of sample characteristics are given.

¹¹ Higher unemployment, social needs of citizens and lower investments are only few examples of negative effects of financial crisis on state and local finances.

¹² Analysed counties are: Krapina-Zagorje, Karlovac, Varaždin, Koprivnica-Križevci, Bjelovar-Bilogora, Primorje-Gorski Kotar, Lika-Senj, Zadar, Osijek-Baranja, Vukovar-Srijem, Split-Dalmatia, Istria, Dubrovnik-Neretva and Međimurje County.

Table 6 Sample characteristics

	Sample characteristics
Number of examined local councilors analyzed	265
Share of councilors – respondents in the total number of local councilors at regional level	30.0 %
Share of analyzed counties in total number of counties in Croatia	70.0 %

Source: authors' analysis

Our analysis consists of several steps. As the first step, we evaluate average local councilor attitudes about decentralization to investigate the existence of political support for this reform. Existence of political support at the central and local level to continue decentralization process is important precondition for its successful implementation. The result of the conducted survey confirms that there is generally accepted opinion among local councilors at the regional level that the decentralization process is desirable reform. Over 90 percent of the analyzed local councilors find that decentralization should be continued by assigning additional authorities, responsibilities and financial resources to the local government (table 7).

Table 7 Overall local councilors' attitude toward decentralization

Question	Positive answer	Negative answer	Without answer
Decentralization process should be continued with additional authorities, responsibilities and financial resources transferred from central state to local government units.	90.2 %	7.5 %	2.2 %

Source: Authors' analysis.

Table 8 presents the local councilors opinion about importance of six different goals of decentralization. It could be noticed that local councilors find that two most important goals are to improve the quality of public services and ensuring the more efficient provision of public functions to citizens and to obtain financial independence of local government units. This shows that local councilors are much more worried about fiscal decentralization than about the division of authorities and responsibilities and rate this problem very high in their views about priorities that should be solved.

Table 8 Average score of different goals of decentralization (1-unimportant, 5-very important)

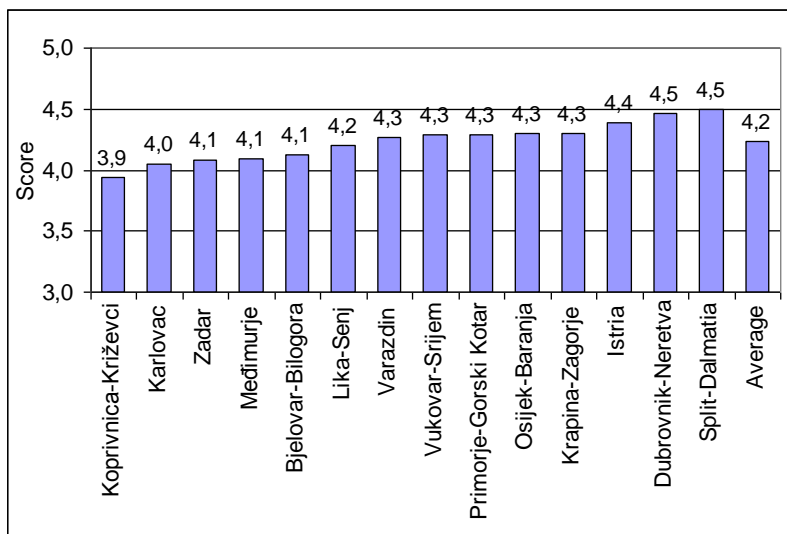
	Goals of decentralization
Ensuring the equal development of all municipalities and cities in county	4,25
Transferring the authorities, responsibilities and financial resources to local government units	4,15
Strengthening the role of counties in achieving local and regional development	4,08
Improving the quality of public services and ensuring the more efficient provision of public functions to citizens	4,39
To achieve financial independence of local government units	4,36
Joint provision of public services and financing of development projects	4,23

Source: Authors' analysis.

After confirming the existence of political support to the decentralization process, further we analyze two different options how to decentralize authorities and responsibilities and provide proper functioning of public services with such a low fiscal capacity of local units. First, we explore the local councilors' views about possibilities that two or more local government units jointly provide public functions to the citizens if they do not have enough resources to provide it separately. As a second solution, we explore the local councilors' opinion about the acceptability to change the territorial division of the country. Croatia has today a two-tier system of sub-national government. Existing territorial structure is such that there is large number of local government units, and many of them are very small and with no capacity to ensure sustainable financial resources from own resources without grants received from central state. Therefore, we analyze two channels which can help to overcome lack of funding and still enables to fulfill the main goals of the decentralization process efficiently.

First channel is the joint provision of public functions to citizens. Therefore we explore the local councilors' opinion whether joint provision and financing of public functions between two or more local government units which have not financial strength to finance it alone more efficient, or not? In other words, we are trying to find councilors' opinion what is efficient way to provide and finance public services. Local government have to rate this goal of decentralization with rate between 1 (not important) and 5 (very important). The result is presented on the figure 10.

Figure 10 Local councilors' opinion about joint provision of public functions and joint financing of development projects as the goal of decentralization

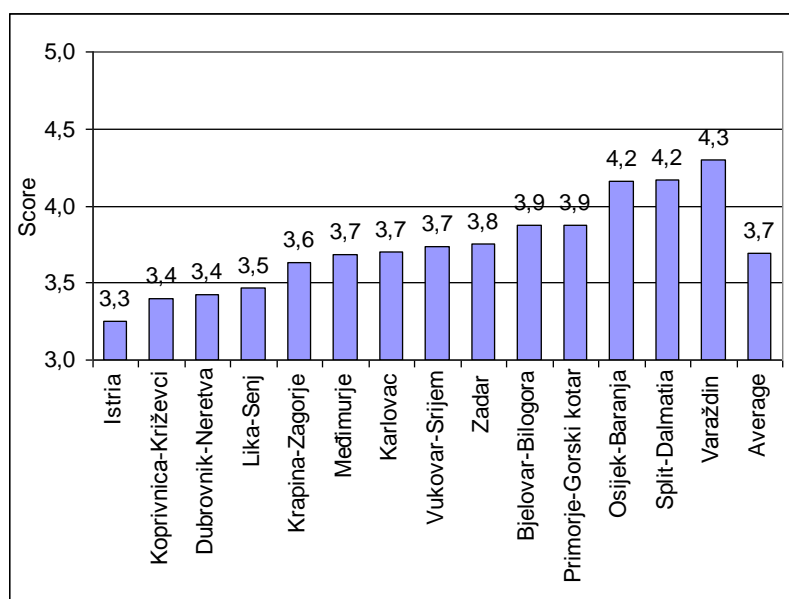


Source: Authors' analysis.

Results show that local councilors expect from decentralization to enable the joint provision of public functions and joint financing of development projects. Local councillors rate this goal very high, with average score 4.2. Also, there is no county which rate this goal as unimportant.

Second channel for improving provision of public functions at local level is to change territorial division of country. We ask the local councilors to give their opinion about the mergers of municipalities and cities and about mergers two or more counties. Results are presented on Figure 11 and 12.

Figure 11 Local councilors' opinion about mergers of two or more municipalities or cities

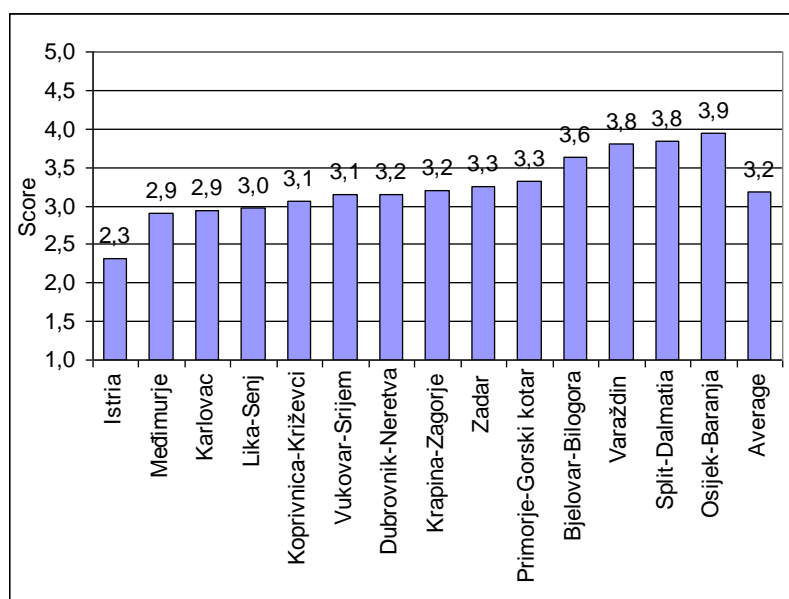


Source: Authors' analysis.

The results of the survey show that the all counties find that reforms in territorial division of countries are desirable. Average rating for this reform is 3.7. It can be noticed that there is no large difference between local councilors' views about this issue and that local councilors are generally aware that there is too many very small municipalities and cities.

However, there is no consensus about local councilor's opinion about conducting reform which would result in merging of two or more counties (figure 12). Local councilors from three counties find that change in territorial division of the country which would result in merging of two or more counties is undesirable. On the other side, four counties find this reform desirable with the average score above 3.5. So the average result shows that local councilors at regional level do not deny the possibility to conduct this reform.

Figure 12 Local councilors' opinion about mergers of two or more counties



Source: Authors' analysis.

A modified territorial division of the country should be result of application of fiscal autonomy principles for local units aimed at efficient provision of mandatory authorities. The division should be based on several different criteria, such as population size, fiscal capacity and economic structure. In addition to these criteria some other specific factors should be taken into consideration when deciding about new territorial division, such as historical factors and others.

5. CONCLUSIONS

There are numerous reasons for decentralization. One of the most important is that decentralization supports local economic development and contributes to public sector competitiveness. Decentralization may also strengthen local governance bringing government closer to citizens' preferences in providing public services.

The literature and the experience from a large number of developed countries confirm that decentralization has many positive effects and therefore many countries transferred public functions to local government units. In the Croatia the level of decentralization is still low and this process has been still in its beginning phase. The main problem to further decentralization of authorities and responsibilities is how to find adequate measures to conduct fiscal

decentralization. The financial crisis made the problem even larger. The result of conducted survey among local councilors at the regional level in 2013 shows that local level of government gives strong political support to the decentralization process. However, the analysis of the fiscal capacity prove that the majority of municipalities, cities and counties have revenues below average and that the most of them cannot provide even basic public functions to the citizens. This problem could be mostly notices in the counties and municipalities which have very low budget. The total revenues of 20 counties make only 16 percent of total local government units' budget. The total revenues of 429 municipalities make 16 percent of the budget of all local government units. In addition, small level of financial independence of local government units could be noticed. They are highly dependent on grants received from state budget. The results of the survey conducted among local councilors show that local councilors have great expectations from decentralization and especially from its goal to achieve lower reliance on the grants and to achieve higher financial independence.

It is very hard to increase the revenue side of the budget. Especially in the situation of financial crises, while economy achieves negative rates of gross domestic product and when the economic projections for the next two years are not very bright. Therefore, in this paper we analyze two channels to conduct decentralization efficiently. In addition these channels are supposed to help to overcome lack of funding and difficulties in fiscal decentralization process on one side and should result in the desired outcomes - satisfactory level of providing public functions and improving regional development on the other side. First channel is the possibility that two or more local government units jointly provide public functions. The result of the survey confirms the support from local councilors for this option. Second option is to modify territorial division of the country by merging some municipalities, cities and counties. On average, 50 percent of local councilors support this reform at all levels. However, to propose the entirely new territorial division it is necessary to make separate analysis taking into account the specific characteristics (historical, demographic structure, economic situation etc.) of each municipality, city and county.

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