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Fiscal Autonomy - Opportunity or Limitation for Innovative Local Development in Croatia?

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54th ERSa Congress

Regional Development & Globalisation: Best Practices

26-29 August 2014, Saint Petersburg, Russia

General Themes

G_T Regional finances, investments and capital markets

**Fiscal Autonomy –
Opportunity or Limitation for Innovative Local Development in Croatia?**

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Abstract

This paper explores the role of Croatian large cities in financing local development projects. Croatian cities have limited autonomy in realization of public revenue. There are a small number of fiscal instruments to which cities can fully leverage or at least under the statutory limits can change the rates and thus affect the total amount of revenue collected. However, although they have limited ability to influence, cities insufficiently use fiscal instruments at their disposal for the planning and realization of budget revenue.

Additionally there are several other factors that are recognized as major obstacles to local development financing. Most cities are unprepared to take on increased responsibilities for fund raising for economic development. In order to borrow responsibly, cities must have the ability to understand the impact of borrowing for infrastructure both annual debt service and annual operational and maintenance expenditures; and ability to identify, prioritize and plan capital

investment. The additional problem for local development is structure of expenditures in local budgets. The majority of public expenditures in local budgets have been spent on providing a range of services aimed at ensuring access to education, health care and social protection to every citizen. Jointly these three public functions account for almost two-thirds of total sub-national government spending in Croatia. Contrary, public spending on investment amounts up to only 15 per cent of sub-national budget expenditures.

The key research questions of the paper are the following:

- (i) To what extent is the current structure of local budgets constraint to local development?
- (ii) What role has measurement of local fiscal capacity in providing transparent base for raising revenue at local level?
- (iii) How do large cities develop „joint visions“ that integrate economic and social development? How can the governance system at local level promote better integration of these two objectives in transparent and effective way?
- (iv) What are the opportunities and limitations for financing development projects from various innovative financing sources such as: pooling private and public revenue, new revenue streams (e.g. voluntary contribution scheme) assigned to developmental activities on a multi-year basis, new incentives (financial guarantees, corporate social responsibility or other rewards) to remove market failures or to speed up ongoing developmental activities.

The last section summarizes analysis and offers recommendations that can provide a platform for improvements in the field of financing of innovative local development in Croatia. It also contains a number of political implications for coordinators and decision-makers to encourage local investment in human and social capital and in communications infrastructure that actively promote sustainable economic development and a high quality of life, including the wise management of natural resources through participatory government.

Key words: local development, local public finance, fiscal autonomy, Croatia.

JEL Classification: H71.

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1. Introduction

The aim of this paper is to explore to what extent the current level of fiscal autonomy of Croatian large cities has influence on achieving innovative local development in Croatia. There are various definitions of local government fiscal autonomy. Wolman and Goldsmith (1990) define fiscal autonomy as the local government's ability to have an independent impact on the welfare of the residents of the local jurisdiction. Boyne (1996) describes local government fiscal autonomy as local government powers and ability to innovate, experiment, and develop policies that can vary by jurisdiction. Based on Chapman (1999) fiscal autonomy relates to the ability of the local jurisdiction both to raise enough revenues from the local economy and then to determine how to spend those revenues. General definition of local government fiscal autonomy refers to the ability of the jurisdiction to set tax rates and establish the revenue base without outside influence as well as having the ability to provide the service levels that are demanded by the jurisdiction's citizens. Darby, Muscatelli and Graeme (2002) point out that some degree of fiscal autonomy could improve economic efficiency, but also democratic participation in local government elections.

Fiscal theory examines optimal degree of fiscal autonomy. The theory of fiscal federalism provides arguments for greater fiscal autonomy. Gramlich (1990) gives two main arguments that favour fiscal autonomy of sub-central governments. First, it induces greater responsibility on local politicians because lobbying central governments for grants might lead local politicians to allocation decisions that have little to do with economic efficiency. Second, a dependence on grants would lead local administrations to inefficient public spending.

At the same time, the literature on fiscal federalism also provides clear arguments against fiscal autonomy. Based on Gramlich (1990) there are four arguments. First, the main argument against fiscal autonomy relates to equity. Authorities have different tax resources available and the need to ensure citizens an approximately the same level of public services will indicate some degree of redistribution between sub-central governments. Redistribution can be realized either through transfers financed from general taxation or by implementing tax-sharing arrangements aimed to help poorer authorities. It is needed to find a balance between equity and accountability - if resources are shared equally between sub-central governments, the incentive effects from fiscal autonomy disappear. Second argument against fiscal autonomy relates to the avoidance of tax externalities aiming to achieve economic efficiency. As non-residents benefit from service provision, then a problem of underprovision often arises with large metropolitan areas and satellite towns. This problem can be solved by different types of taxes that should be assigned to different levels of government. Third argument against fiscal autonomy relates to a consequence of the potential migration of production factors because of tax competition. This is reason why most decentralized countries give the majority of redistributive taxes to central government (e.g. corporation taxes) and income taxation, benefit taxes or user charges, property taxes to sub-central governments, which do not cause migration in the tax base. Fourth argument against fiscal autonomy is huge administrative complexity, and because of that many countries decide on a national tax system and financing of sub-central government that is based on grants or tax-sharing arrangements.

The most developed countries have chosen a significant degree of fiscal autonomy and have tended to allow local governments greater control over taxes, user charges and property taxes, limited control on taxes on more mobile factors (income and profit tax) and almost no control over the taxation of the extraction of natural resources (royalties). There are a number of European countries have allowed autonomy to their sub-central governments to set rates of personal income taxation. Croatia belongs to a group of European countries where local governments do not control personal income tax rates or the tax base. In Croatia, income tax surcharges are used but the central government determines the range of tax rates.

The paper is structured as follows. After literature review on fiscal autonomy, the second section describes main facts about fiscal autonomy of Croatian large cities. Structure of local budgets as

constraint to local development is presented in the third section. The fourth section gives explanation of measurement of local fiscal capacity as a base for raising revenue at large cities level. New opportunities for financing development projects are presented in the fifth section. Last section summarizes our analysis and findings, offers recommendations and policy implications.

2. Fiscal autonomy of Croatian large cities

In this section we follow the general definition of fiscal autonomy. Based on general definition, the fiscal autonomy of Croatian large cities expresses the ability of these authorities to set tax rates and establish the revenue base independently, the ability to determine how to spend revenues, as well as the capacity to provide public service to local citizens.

2.1. Definition of large cities in Croatia

Following the definition of the fiscal autonomy of the large cities, we will first define the term “large cities”. Recent changes in Croatian legislation have resulted in the new definition of large cities¹. Large cities are urban settlements with more than 35,000 inhabitants, as well as county centres. They are responsible for all local tasks and services for their citizens. Large cities 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. They have some additional responsibilities concerning the maintenance of public roads, issuance of construction and location permits and other documents related to construction, implementation of physical planning documents and other. There are 24 cities with the status of a large city; 17 cities have more than 35,000 inhabitants; and seven cities are county centres with less than 35,000 inhabitants.

¹ Recently the OECD and the European Commission developed a new definition of a city. Based on the new OECD and EC definition, there are 828 cities with an urban centre of at least 50,000 inhabitants in the EU, Switzerland, Iceland and Norway. For more details in: Dijkstra, L., and Poelman, H., 2012, Cities in Europe, The New OECD-EC Definition. Bruxelles: European Commission, Regional Focus, A series of short papers on regional research and indicators produced by the Directorate-General for Regional and Urban Policy, RF 01/2012, http://ec.europa.eu/regional_policy/sources/docgener/focus/2012_01_city.pdf.

2.2. To what degree Croatian large cities control their revenues?

Second part of the definition of fiscal autonomy specifies the ability of these authorities to introduce taxes and independently generate the revenue. The question is “to what degree Croatian large cities control their revenues?”

2.2.1. Tax revenue

Taxes revenues are divided into two groups - own taxes and shared taxes. Own taxes are taxes for that the sub-national governments can control the tax rate or the tax base. Shared taxes are taxes where the sub-national governments have limited or no control over the rate and the tax base and the state government determines how to share the revenues.

There are five main categories of autonomy using the OECD classification system that shows the percentage of sub-central taxation power (Table 1). These range from type (a) sub-national taxes where the sub-central government can itself set both the tax rate and tax base and means full power over tax rates and bases, (b) the sub-central government has power over tax rates, (c) the sub-central government has power over tax base, (d) tax sharing arrangements between the central and the sub-central government to type (e), where the central government sets both the base and the rate of taxation. Type (f) means non-allocable taxes. Category (d) relates to tax-sharing arrangements, which are divided into four categories: from (d.1) where the sub-central government can determine the revenue split, (d.2) revenue split set by the sub-central government, (d.3) revenue split set by the central government, more times in a year, to (d.4) where the central government can independently decide on the revenue split, once a year. (Kim, Lotz, and Blöchliger, 2013; Blöchliger and Rebesone, 2009)

Table 1 Taxonomy of taxing power of local government units

Sub-central tax revenue		As share of sub-central tax revenues										
As % of GDP	As % of total tax revenue (consolidated GG)	Discretion on rates and reliefs	Discretion on rates		Discretion on reliefs	Tax sharing arrangement				Rates and reliefs set by CG	Other	Total
			Full	Restricted		Revenue split set by SCG	Revenue split set with SCG consent	Revenue split set by CG, more time in a	Revenue split set by CG, annual			

								year				
		(a)	(b.1)	(b.2)	(c)	(d.1)	(d.2)	(d.3)	(d.4)	(e)	(f)	
Weights		1	0.75	0.5	0.75	0.75	0.5	0.05	0.25	0	0	
Index of fiscal control	$FC = 1*(a) + 0.75*(b.1) + 0.5*(b.2) + 0.75*(c) + 0.75*(d.1) + 0.5*(d.2) + 0.05*(d.3) + 0.25*(d.4) + 0*(e) + 0*(f)$											

Note: GG = General government, SCG = Sub-central government, CG = Central government.

Source: Author's systematization based on Kim, Lotz, and Blöchliger (2013).

In this paper the structure of the index of fiscal control is adapted to one that relates to a particular country. The index of fiscal control for local government units contains a weighted average index measuring the tax raising autonomy of sub-central governments, multiplied by the degree of these respective taxation revenues.

Table 2 Level of tax autonomy of local government units

Indicators of tax autonomy	Level of tax autonomy	Weights
Local government is free to set both tax rate and tax base	The highest level of autonomy	1
Local government is free to set tax rate only	Relatively high level of autonomy	0.75
Local government is free to set tax base only	Relatively high level of autonomy	0.75
Local government is able to determine revenue-split in tax sharing arrangement with higher levels of government	Relatively high level of autonomy	0.75
Revenue split in tax sharing arrangement with higher level of government requires consent of local government	Medium level of autonomy	0.5
Revenue split in tax sharing arrangement is fixed, but can be unilaterally altered by higher level of government	Minimum level of autonomy	0.25
Revenue split in tax sharing arrangement is determined by higher level of government in their annual budget	Minimum level of autonomy	0.25
Revenue split in tax sharing arrangement is determined by higher level of government more time in a year	Minimum level of autonomy	0.05
Higher level of government sets both tax rate and base	No autonomy	0

Source: Author's systematization based on Kim, Lotz, and Blöchliger (2013).

Table 3 Taxonomy of taxing power of local government units in Croatia

Type of tax	Description		Category of autonomy by OECD classification system
City or municipal taxes			
Surtax on income tax	Taxpayer	Those liable to pay income tax who have a domicile or a common residence in the area of the municipality that has prescribed the obligation to pay the tax.	(b.2)
	Tax base	The amount of income tax.	
	Tax rate	A municipality at the rate of up to 10%. A city with a population below 30,000 at a rate of up to 12%. A city with a population over 30,000 at a rate of up to 15%. The city of Zagreb at a rate of up to 30%.	
	Tax regulations	The Law on Financing of Local and Regional Self-Government Units (Official Gazette No. 117/93, 33/00, 73/00, 59/01, 107/01, 117/01 – correction, 150/02, 147/03, 132/06, 73/08, 25/12). Croatian Constitutional Court Decision (Official Gazette No. 26/07).	
		A decision of the city or municipality concerning city or municipal taxes.	
Consumption tax	Taxpayer	The natural person or legal entity that provides catering or hospitality services.	(b.2)
	Tax base	The sales price of beverages sold in catering facilities.	
	Tax rate	Up to 3%.	
	Tax regulations	The Law on Financing of Local and Regional Self-Government Units (Official Gazette No. 117/93, 33/00, 73/00, 59/01, 107/01, 117/01 – correction, 150/02, 147/03, 132/06, 73/08, 25/12). Croatian Constitutional Court Decision (Official Gazette No. 26/07).	
		A decision of the city or municipality concerning city or municipal taxes.	
Tax on secondary homes (holiday houses)	Taxpayer	The natural person or legal entity that is the owner of a secondary home (holiday house).	(b.2)
	Tax base	A square meter of useful space in the secondary home (holiday house).	
	Tax rate	From 5 to 15 kuna per square meter of useful area.	
	Tax regulations	The Law on Financing of Local and Regional Self-Government Units (Official Gazette No. 117/93, 33/00, 73/00, 59/01, 107/01, 117/01 – correction, 150/02, 147/03, 132/06, 73/08, 25/12). Croatian Constitutional Court Decision (Official Gazette No. 26/07).	
		A decision of the city or municipality concerning city or municipal taxes.	
Trade name tax	Taxpayer	A natural person or legal entity that is liable to pay corporate income tax or personal income tax and is registered for the performance of an activity.	(b.2)
	Tax base	Trade name.	
	Tax rate	Up to 2,000 kuna for each trade name.	
	Tax regulations	The Law on Financing of Local and Regional Self-Government Units (Official Gazette No. 117/93, 33/00, 73/00, 59/01, 107/01, 117/01 – correction, 150/02, 147/03, 132/06, 73/08, 25/12). Croatian Constitutional Court Decision (Official Gazette No. 26/07).	
		A decision of the city or municipality concerning city or municipal taxes.	
Tax on use of public land	Taxpayer	The legal entity and natural person that makes use of public land.	(a)
	Tax base	The public land that is used by legal entities and natural persons.	

	Tax rate	The amount of the tax is prescribed by the individual municipality or city.					
	Tax regulations	The Law on Financing of Local and Regional Self-Government Units (Official Gazette No. 117/93, 33/00, 73/00, 59/01, 107/01, 117/01 - correction, 150/02, 147/03, 132/06, 73/08, 25/12). Croatian Constitutional Court Decision (Official Gazette No. 26/07).					
		A decision of the city or municipality concerning city or municipal taxes.					
Shared taxes							
	Central government	Counties	Cities/municipalities	Decentralized functions	Equalization fund		
Income tax	0%	15.5%	55%	12%	17.5%	(d.3)	
Real estate transfer tax	40%	-	60%	-	-	(d.2)	

Source: Ministry of Finance –Tax Administration.

Table 4 Tax revenues of local government units in Croatia, in HRK, in %

Classification code	Type of tax	All LGUs	%	Towns and cities	%	Category of autonomy by OECD classification system	Weights	Index of fiscal control of all LGUs	Index of fiscal control of towns and cities
	Sub-central tax revenue as % of GDP		3.63		2.69			53.17	53.61
	Sub-central tax revenue as % of total tax revenue (consolidated general government)		16.11		11.93				
61	Sub-central tax revenue	11.938.587.467	100.00	8.845.310.493	100.00				
6131	Taxes on immovable property	155.105.114	1.30	86.968.832	0.98				
61314	Tax on secondary homes (holiday houses)*	n.a.		n.a.		(b.2)	0.5		
61315	Tax on use of public land*	n.a.		n.a.		(a)	1		
6134	Property taxes	578.192.384	4.84	449.388.543	5.08				
61341	Real estate transfer tax*	n.a.		n.a.		(d.2)	0.5		
6142	Sales taxes	95.687.740	0.80	74.777.048	0.85				
61424	Consumption tax*	n.a.		n.a.		(b.2)	0.5		
6145	Taxes on use of goods	380.293.738	3.19	200.899.104	2.27				
61451	Tax on motor vehicles								
61452	Tax on boats								
61453	Trade name tax*	n.a.		n.a.		(b.2)	0.5		
611	Tax and surtax on income tax					(d.3 + b.2)	(0.05+)		

		10.703.652.915	89.66	8.027.690.818	90.76		0.5)		
	Total tax revenue as % of sub-central tax revenue	11.912.931.891	99.79	8.839.724.345	99.94				

Note: LGUs = Local government units (municipalities, towns and cities, counties). * There are no publicly available data on selected sub-central tax revenue. Publicly are available data on tax revenue on more aggregate level of classification code for type of taxes.

Index of fiscal control (all LGUs) = $1 * (0,33 * 1,30) + 0,5 * (0,66 * 1,30) + 0,5 * (0,95 * 4,84) + 0,5 * (0,95 * 0,80) + 0,5 * (0,2 * 3,19) + (0,05 * 89,66) + (0,5 * 89,66)$

Index of fiscal control (cities) = $1 * (0,33 * 0,98) + 0,5 * (0,66 * 0,98) + 0,5 * (0,95 * 5,08) + 0,5 * (0,95 * 0,85) + 0,5 * (0,2 * 2,27) + (0,05 * 90,76) + (0,5 * 90,76)$

Source: Author's calculation based on the Ministry of Finance –Tax Administration data.

If cities do not actually control the tax base or the tax rates that generate the revenues they share with central government (the shared taxes), this is situation where tax revenue are very similar to a block grant. In this particular case cities have very limited fiscal autonomy.

Data from tables 2, 3 and 4 shows that there are a minor number of fiscal instruments that cities can fully control or at least can control within limits recommended by the central government. Although a limited number of fiscal instruments exist, cities have a statutory ability to influence on the amount of budget revenues collected. The Law on Financing Local and Regional Self-government Units gives cities the possibility for the following types of taxes: surtax on income tax, consumption tax, secondary homes (holiday houses) tax, trade name tax and tax on the use of public land. In the other hand, there are many examples of cities that do not introduce surtax on income tax as local revenue or they introduce a minimum rate of surtax.

Additional example is the opportunity defined by the law that cities are given the choice to determine their own tax decision on rate of tax on the use of public land. In the case of other taxes, cities are given chance to their own decision determine the tax rate in the range prescribed by the law. However, although they have limited ability to influence, cities under-use of fiscal instruments available to them for planning and realising revenue (i.e. they do not introduce surtax on income tax or introduce a minimum rate of surtax, they do not introduce a tax on second homes or introduce minimum tax, etc.).

2.2.2. Non-tax revenue

Cities under special regulations collected more than twenty non-tax revenues, which are mainly earmarked revenues of the local budgets. Non-tax revenues include revenues from business operations, property and administrative fees. The most significant non-tax revenue is communal charges and communal contributions. Since cities have the option of redefining the zone in the city and determining communal utility charges and communal contributions by zones, it is expected that cities will actively and continuously consider the amount of collected communal utility charges and communal contributions.

2.2.3. Shared revenue, intergovernmental transfers and grants

Shared revenue, intergovernmental transfers and grants belong to local government revenues that cities have no autonomy in their determination. These are revenues from personal income tax, which is shared tax revenue between the central government and local government units. The tax rates, tax bases, exemptions and deductions and the allocation of income tax are decided by the central government. The highest level of public authority decides independently of any change of additional income tax that belongs to local government units as additional revenue intended to finance decentralized functions (costs) in the areas of education, health, social welfare and public fire service.

Intergovernmental transfers are provided as block grants and it is not possible to distinguish whether intergovernmental transfers are conditional or general-purpose grants. In addition, it is not possible to make a distinction between transfers that are distributed according to objective criteria in comparison to ones that are based on discretionary measures. Intergovernmental transfers are provided to finance local and regional needs and are usually designed to favour local and regional self-government units with poor fiscal capacity.

The criteria for the allocation grants to local and regional government units in Croatian practice is not discussed among levels of public authorities, but the decision is independently made by the central government.

2.2.4. Borrowing

It is prescribed legal limits on local government borrowing. Local government borrowing requires the approval of the Croatian Government and the Ministry of Finance. There are two key constraints on local government borrowing: (i) debt limit of individual local units and (ii) limit on the borrowing of all local units. The annual limit on borrowing by individual local unit is 20 percent of outturn of operating revenues in the budget in the previous fiscal year. A further limitation of local government borrowing is 2.5 percent of outturn of operating revenues of all local and regional self-government units earned in the previous fiscal year. Regarding borrowing it should be noted that a minor number of local government units are used the legal possibility to fund capital projects by issuing bonds. The reason for that is relatively underdeveloped financial market and especially underdeveloped market of local government debt in Croatia.

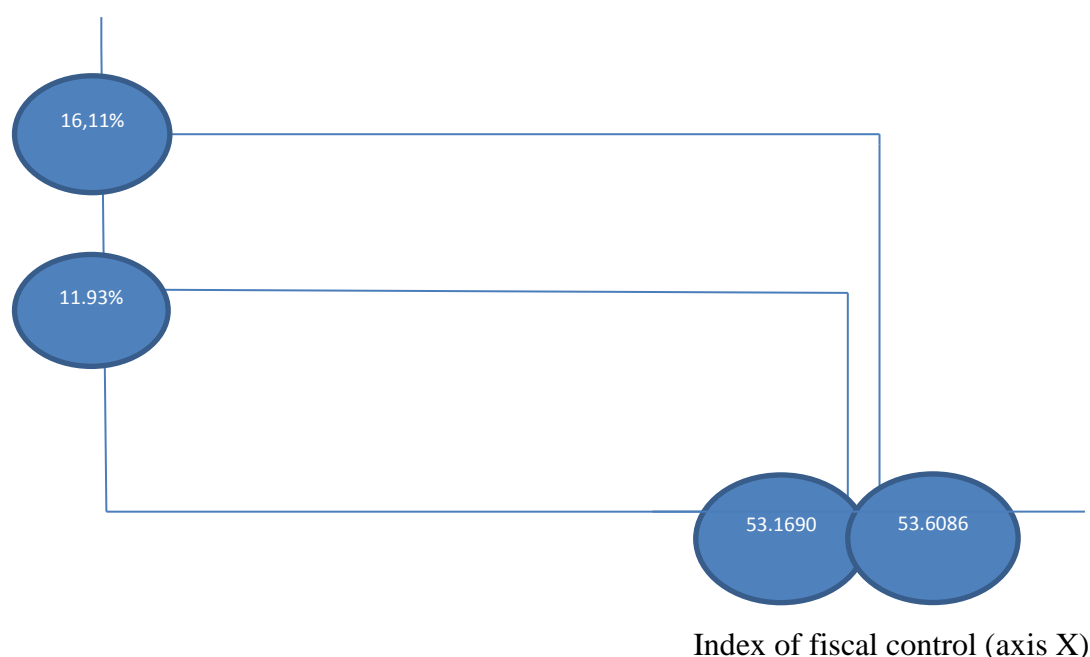
To answer on the question in title of this sub-section “to what degree Croatian large cities control their revenues?”, or in the other words “how to define local autonomy?” we follow OECD classification system of taxing power of local government units in Croatia and Wolman’s (2008) methodological framework for classification of local governments. We define “local autonomy” as a local government which (1) has an important impact on their economy and intergovernmental system, (2) has the decision to participate in fiscal, functional and organizational activities without limitations from central government and (3) has the capacity to achieve their strategic goals and policy preferences.

Based on both classifications we calculate index of fiscal control of all local government units. It suggests that towns and cities has more fiscal control in comparison with all 576 local government units in Croatia (429 municipalities, 126 towns and cities, the City of Zagreb and 20 counties). This conclusion came from the value of index of fiscal control of all local government units - 53.17 in comparison with 53.61 of index of fiscal control of towns and cities (Table 4).

In addition, we summarise available data in Figure 1. The vertical axis plots the percentage of sub-central taxation in total taxation, so provides a measure of the importance of sub-central government in the financing of public services. The horizontal axis plots an overall index of “fiscal control”, which is an overall weighted index of the extent to which sub-central taxation is

controlled locally. Figure 1 shows comparison among towns and cities and all local government units in Croatia. It follows that towns and cities are closest to the north-east corner of the graph which means that this sub-central governments have greater degree of fiscal autonomy and this jurisdictions have control over a large share of total taxation and have greater control on taxation receipts in comparison with all local government units.

Figure 1 Significance of towns and cities and degree of fiscal control
Percentage of sub-central taxation in total taxation (axis Y)

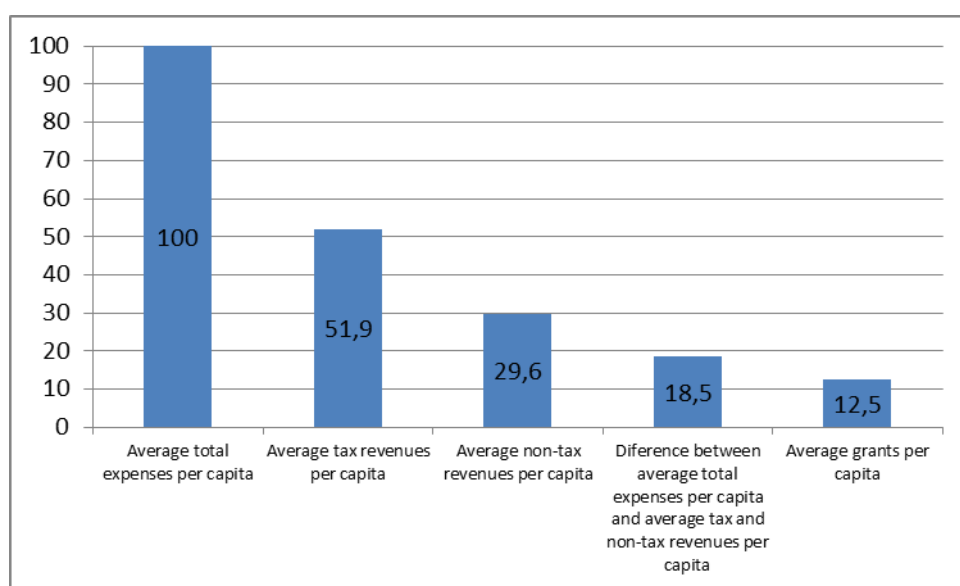


Source: Authors' calculation based on the Ministry of Finance data.

There is the second important indicator of the degree to which local governments have access to their own taxation resources to meet their expenditure commitments. Figure 2 shows the degree of vertical imbalances present in the taxation and expenditure by large cities in Croatia. More precisely, Figure 2 presents the average share of sub-central tax and non-tax revenues excluding grants against the average total expenses in the budget of large cities in Croatia in 2013. The difference between available tax and non-tax revenues and expenditures is a vertical imbalance. This vertical imbalance shows the extent to which large cities are dependent on central government grants. From data on Figure 2 we can conclude that large cities are independent on central government grants.

The ability to determine how to spend owns revenues is the third part of the definition of fiscal autonomy. In other words, here we are talking about division of spending responsibilities between authorities. There is a huge difference between countries in the role played by local government in the provision of public services. The reason for that is the level of (de)centralisation in public services delivery. Economic theory suggests that allocating expenditure decisions close to the citizen will lead to a more efficient outcome, because local authorities are able to determine the allocation of public spending on different services in a way that best suits the local citizens' needs (Wildasin, 1997; Ter-Minassian, 1997).

Figure 2 Fiscal imbalances of large cities in Croatia in 2103



Source: Authors' calculation based on the Ministry of Finance data.

The allocation of responsibilities among level of governments in Croatia is presented in Table 7. There is no clear allocation of responsibilities in the implementation of public functions between the central and sub-national levels of government in Croatia. The provision of any public function is assigned to all levels of government, so their responsibilities often overlap (Jurlina Alibegović, Slijepčević and Kordej-De Villa, 2014).

Table 5 Distribution of responsibilities among level of governments in Croatia

Public functions	Municipalities	Towns	Counties	State
<i>01 General public services</i>				
01.1 Executive and legislative bodies, financial and	✓	✓	✓	✓

fiscal affairs, external affairs				
<i>02 Defense</i>				
02.1 Military defense				✓
02.2 Civil defense	✓	✓		
<i>03 Public order and safety</i>				
03.1 Police services				✓
03.2 Fire-fighting services	✓	✓		
<i>04 Economic affairs</i>				
04.1 General economic, commercial and labor affairs (consumer protection)	✓	✓		
04.5 Transport	✓	✓	✓	✓
<i>05 Environmental protection</i>				
05.1 Waste management			✓	
05.2 Waste water management			✓	
05.3 Pollution abatement	✓	✓		
<i>06 Housing and community amenities</i>				
06.1 Housing planning and development	✓	✓	✓	
06.2 Community planning and development	✓	✓	✓	
06.3 Water supply	✓	✓		
06.4 Street lighting	✓	✓		
<i>07 Health</i>				
07.1 Medical products, appliances and equipment				✓
07.2 Outpatient services			✓	
07.3 Hospital services			✓	✓
07.4 Public health services			✓	
<i>08 Recreation, culture and religion</i>				
08.1 Recreational and sporting services	✓	✓		
08.2 Cultural services	✓	✓		✓
<i>09 Education</i>				
09.1 Pre-school and primary education	✓	✓		
09.2 Secondary education			✓	
09.3 Post-secondary non-tertiary education			✓	✓
09.4 Tertiary education				✓
<i>10 Social protection</i>	✓	✓	✓	✓
10.6 Housing			✓	✓
10.7 Social exclusion n.e.c.			✓	✓

Source: Author's systematization based on the analysis of different laws.

This conclusion may suggest that Croatian local government units do not have adequate spending responsibilities. However, the data do not indicate clearly the level of spending power of local government units by policy area (public functions). Bach, Blöchliger, and Wallau (2009) conducted an analysis of spending power of local government units in OECD countries by policy area and results confirmed the limited discretion of sub-central governments over their own

budget. Federal countries tend to grant more spending power to sub-central governments than unitary countries. Concrete answer on spending power of Croatian sub-central governments by major area and policy arrangements cannot be given without responding on all question regarding policy arrangements relating to major area of autonomy (policy, budget, input, output, monitoring and evaluation). Our general estimation is that Croatian local government units do not have adequate spending responsibilities in all of five categories of spending power, as well as in most of policy arrangements indicated in Table 6.

Table 6 Spending power of sub-central governments

Spending power by:	
(i) category relating to major area of autonomy	(ii) policy arrangements
Policy autonomy	General policy
	Private institutions
Budget autonomy	Public funding
	Capital expenditure/expenditure on infrastructure
	Financing of input for service provision
	Financing of resources of service providers
	Contributions for users
	Financial resources
Input autonomy	General rules for providers
	Management of staff
	Management and provision of input/ infrastructure
Output autonomy	Coverage of service provision
	Quality/ standards for the service in question
Monitoring and evaluation	Conformity with general policy goals
	Monitoring general rules and standards
	Performance of providers and/or staff

Source: Source: Author's systematization based on Bach, Blöchliger, and Wallau (2009).

The capacity to provide public service to local citizens is the fourth part of the definition of fiscal autonomy. The capacity of large cities to provide public service to local citizens depends on many different factors. One of the most important is the number of employees in city administration, as well as the number of employees in public institutions and public bodies that are financed from the large cities budget. Table 7 provides information regarding average numbers of employees in the large city. The data shows that although increasing the total number of employees in the city administration (2.6 per cent) and the total number of employees in public bodies (1.5 per cent) in 2013 compared to 2010, share of employment in administration of

large cities compared to the total number of employees in all 127 Croatian cities during the same period decreased by 1.0 per cent measured by the share of the employed persons in the city's administration of large cities compared to employees in the administration of all cities, and by 1.4 per cent measured by the share of employees in public bodies of large cities in relation to employment in public bodies of all cities. A similar relationship exists when we compare the share of employees in the administration of large cities with the total employed persons in the administration of all LGUs (-2.1 per cent), as well as the share of employees in public bodies of large cities with total employees in public bodies of all LGUs (-3.2 per cent).

Table 7 Average numbers of employees in large cities and in public institutions and public bodies financed from the large cities budget, 2010-2013, %

Employees	2010	2011	2012	2013
Average numbers of employees in:				
- the large cities	5.832	5.853	5.865	5.982
- in public institutions and public bodies financed from the large cities budget	16.605	16.772	16.695	16.851
Average share of employees in:				
- the large cities in relation to total number of employees in all cities	65,8	64,1	65,0	64,9
- in public institutions and public bodies financed from the large cities budget in relation to total number of employees in public institutions and public bodies financed from cities budget	77,2	76,5	76,2	75,8
Average share of employees in:				
- the large cities in relation to total number of employees in all LGUs	39,3	38,5	38,1	37,2
- in public institutions and public bodies financed from the large cities budget in relation to total number of employees in public institutions and public bodies financed from LGUs budget	67,2	65,9	64,8	64,0

Source: Author's calculation based on the Ministry of Finance.

3. Structure of large cities budgets as constraint to local development

The structure of revenues indicates that most of large cities budget revenues derive from shared taxes over which they have little control. The average share of income tax revenues in operating revenues of large cities budget amounted to 48.4 per cent. Own tax revenues have consistently formed a relatively low proportion of total revenues of large cities in Croatia. The average share of own tax revenues amounted to 4.7 per cent of total tax revenues of large cities in 2013 indicating that large cities have very little revenue autonomy or policy control. Overall, the

average share of non-tax revenues amount to 21.1 per cent and grants of 12.1 per cent of the total revenues in large cities budgets.

Within the total expenses, according to economic classification, material expenses are the most important category, with the average share of large cities budget of 32.9 percent. The average share of expenses for compensation of employees represented 21 percent of the total expenses of large cities budget. The average share of current grants in form of cash and capital grants (and mostly issued to companies in the public sector) is 14.8 per cent of the total expenses of large cities budget. Large cities allocated in average 15.8 per cent of their budgets for capital expenses.

According to functional classification, the major categories of expenses in structure of large cities budgets are expenses for housing and community amenity and for education, with 20 percent share in average of each. Expenses for housing and community amenity are spent primarily on the community development, and on improving housing and various communal infrastructure projects. In the same time structure of the large cities budget expenses by functional classification indicates that differences in expense structure reflect differences in capacities of large cities to provide public service to local citizens.

The previous concise analysis of revenues and expenses in the large cities budget indicates that the fiscal autonomy of large cities in collecting their own revenue is relatively low. Surprisingly, large cities in comparison with all cities and towns in Croatia obtain a smaller amount of their own tax revenues (4.7 per cent and 5.6 per cent). From the structure of large cities budget we can conclude that the least amount of revenue is collected from own taxes.

4. Measurement of fiscal capacity as a base for raising revenue at Croatian large cities level

Snah (1997) and Martinez-Vasquez and Boex (1997) defines fiscal capacity of local unit as ability to raise revenues from their own resources in order to pay for a standardized basket of public goods and services. Chernick (1998) and Martinez-Vazquez and Boex (1997) have established two of many available major approaches or concepts to measuring fiscal capacity of local units. 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 local government units. The main measure of the fiscal capacity is the amount of tax and non-tax revenues collected. 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 these services.

There are differences in fiscal capacities of large cities (Table 8). The average tax capacity per capita of large cities is HRK 2.050. Large cities have much lower the average non-tax capacity per capita, and it amounts to HRK 1.170. The highest average tax and non-tax revenues per capita (without grants) are in the City of Zagreb. The average value of total expenses per capita in large cities is HRK 3.320. The average expenses per capita according to functional classification vary substantially among large cities. There is a great difference between the average capacity per capita for performing two public functions for which large cities are spending most of their own budgetary resources, housing and community amenity and education. Average capacity per capita for these public functions is HRK 840 and HRK 765.

A concise analysis of fiscal capacities of large cities indicates great differences for providing public services. Data indicate that there are cities that generate several times higher tax and non-tax revenues per capita comparing to cities with minimum tax and non-tax revenues per capita. The same situation is when we analyze expenses according to economic and functional classification. Analyzing the differences in fiscal capacities among large cities helps us to identify whether cities are actually capable for financing the existing public services and whether their fiscal capacities are adequate for financing innovative local development and ensuring acceptable quality level of public services to their citizens.

Table 8 Fiscal capacities per capita of large cities in 2013, in HRK

	Average	Minimum	Maximum
Tax revenue	2.050	1.130	7.015
Non-tax revenue	1.170	326	3.631
Grant revenue	494	34	2.862
Total revenue	3.956	2.112	9.257
Total expenses	3.953	2.119	8.599

Source: Authors' calculations based on data of the Ministry of Finance and the Croatian Bureau of Statistics.

The analysis clearly shows quite a significant variance in the fiscal capacity among large cities. Conclusions of this as well as the previously conducted research conducted by Jurlina Alibegović, Slijepčević, and Kordej-De Villa (2013) are more or less the same. The financial crisis, which started in Croatia in 2008, had a profound impact on the revenue shrinkage. Large cities as all other local government units exhibit a huge reliance on tax revenues. In Croatia, cities as all other local government units are largely dependent on the income tax imposed at a rate defined by the central government. Tax rate changes may be introduced during the fiscal year, having a direct impact on the level of local revenues despite the actual budget plan. Expenses for financing local public services of each city are large compared to their total revenues and there is not enough financial strength to improve the infrastructure and finance capital projects. Therefore, it is very important to explore other options for finding additional revenue sources and improving the efficiency and quality of public services provided to citizens as well as to finance development at local level.

5. New opportunities for financing development projects

The structure of expenses in cities budgets shows that current expenditures prevail. Cities all over the world face the problem of inadequate revenues for financing development projects. In her research on innovative municipal development financing in three Croatian cities Jurlina Alibegović (2010) pointed that for financing development projects cities and their administration must have different skills and ability. Without the skills and necessary information to budget for the current and coming years (including both operating and capital budgets), the ability to identify, prioritize and plan capital investments, the ability to compare different financing options for capital investments (including budget financing, borrowing, issuing municipal bonds, or using a public-private partnership) and the ability to understand the impact of borrowing on capital investments (both annual debt service and annual operational and maintenance expenditures) cities will never be able to successfully influence on their development projects.

There are several opportunities for financing development projects from various innovative financing sources. Some of them are very well known. Sandor, Scott, and Benn (2009) mentioned the following: pooling private and public revenue, new revenue streams (e.g.

voluntary contribution scheme) assigned to developmental activities on a multi-year basis, new incentives (financial guarantees, corporate social responsibility or other rewards).

A lack of public funds is the predominant reason for the private sector's involvement in local investments and development projects. There are several other reasons for private sector involvement in financing such projects. Jurlina Alibegović (2007) mentioned the following important reasons: increased local public needs, inadequate structure of local revenues in the local budgets, the size of local capital projects and limitations on borrowing at the local level.

Major goal of all of these modes of development financing is to remove market failures or to speed up ongoing developmental activities at local level. Unfortunately, all of these innovative modes of development financing have some limitations and constraints.

6. Recommendations and policy implications

Despite the potential for generating local economic development, the sub-national level of government in Croatia, including large cities, has relatively little fiscal autonomy. Economists have traditionally seen some benefits in fiscal autonomy - it promotes efficiency and accountability of local government. However, the evidence from other countries is that fiscal autonomy is not costless. Any increase in fiscal autonomy will increase the need for some system of horizontal equalisation if we would like to have an equal access to public services all over the country.

Most countries that have granted a greater degree of fiscal autonomy to its regions or cities have done so through a greater delegation of taxes on immobile factors, on personal income, and through non-tax measures (fees and charges to consumers of local services). Devolving income taxation to sub-central government raises the problem of factor mobility in the absence of effective tax competition. However, there is little evidence in the case of Croatia as well as from other OECD countries that small tax differentials have led to major movements in population.

A small number of Croatian cities are capable of financially managing their development needs. Most local government units, including large cities, are dependent on the central government grants to provide mandatory public services. This means that (a) municipal revenues to finance

capital investment are limited; (b) there are, however, many innovative financing instruments for local governments to use; (c) the use of such instruments requires a national regulatory and institutional framework, and a range of skills and municipal capacity; and (d) these instruments can be best utilized when linked with local development strategies, programs and projects.

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