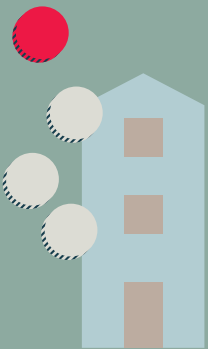
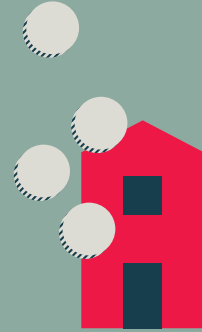


# Fiscal Decentralization in Croatia



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1818 H Street NW  
Washington DC 20433  
Telephone: 202-473-1000  
Internet: [www.worldbank.org](http://www.worldbank.org)

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# List of Acronyms

<b>ASNC</b>	Areas of Special National Concern	<b>MCPP</b>	Ministry of Construction and Physical Planning
<b>CAMA</b>	Computer Assisted Mass Appraisal	<b>MDF</b>	Municipal Development Fund
<b>CES</b>	Croatian Employment Service	<b>MDI</b>	Municipal Development Intermediaries
<b>CIT</b>	Corporate Income Tax	<b>MOA</b>	Ministry of Agriculture
<b>CNT</b>	Company or Title Tax	<b>MOC</b>	Ministry of Culture
<b>COFOG</b>	Classification of Functions of Government	<b>MODFYSP</b>	Ministry of Demography, Family, Youth and Social Policy
<b>CSOS</b>	Central State Office of Sports	<b>MOF</b>	Ministry of Finance
<b>DEF</b>	Defense	<b>MOJPA</b>	Ministry of Justice and Public Administration
<b>DEX</b>	Decentralization of Expenditure	<b>MOT</b>	Ministry of Tourism
<b>DRE</b>	Decentralization of Revenue	<b>MRDEUF</b>	Ministry of Regional Development and EU Funds
<b>DTA</b>	Decentralization of Taxes	<b>MSE</b>	Ministry of Science and Education
<b>EA</b>	Economic Affairs	<b>NALAS</b>	Network of Associations of Local Authorities of South-East Europe
<b>EDU</b>	Education	<b>NRRP</b>	National Recovery and Resilience Plan
<b>ENV</b>	Environment	<b>OECD</b>	Organisation for Economic Co-Operation and Development
<b>ESA</b>	European System of Accounts	<b>OG</b>	Official Gazette
<b>EU</b>	European Union	<b>PBGS</b>	Performance-Based Grant System
<b>FRDV</b>	Fund for Reconstruction and Development of The City of Vukovar	<b>PIT</b>	Personal Income Tax
<b>GDP</b>	Gross Domestic Product	<b>POS</b>	Public Order and Safety
<b>GFS</b>	Government Finance Statistics	<b>PPP</b>	Public-Private Partnership
<b>GPS</b>	General Public Services	<b>RCR</b>	Recreation Culture and Religion
<b>HC</b>	Housing and Community	<b>RETT</b>	Real Estate Transfer Tax
<b>HC</b>	Hunter's Coefficient	<b>RMVT</b>	Road Motor Vehicle Tax
<b>HDZ</b>	Hrvatska Demokratska Zajednica (Croatian Democratic Union)	<b>SDP</b>	Socijaldemokratska Partija Hrvatske (Social-Democrat Party)
<b>HFI</b>	Horizontal Fiscal Inequalities	<b>SEE</b>	South East Europe
<b>HLT</b>	Health	<b>SOE</b>	State-Owned Enterprise
<b>HMA</b>	Hilly and Mountainous Area	<b>SP</b>	Social Protection
<b>HRK</b>	Hrvatska Kuna (Croatian Kuna)	<b>USAID</b>	United States Agency for International Development
<b>IGT</b>	Inheritance and Gift Tax	<b>VAT</b>	Value Added Tax
<b>IMF</b>	International Monetary Fund	<b>VFI</b>	Vertical Fiscal Imbalance
<b>IPSAS</b>	International Public Sector Accounting Standards		
<b>ISOEF</b>	Integrated State-Owned Enterprises Framework		
<b>IT</b>	Information Technologies		
<b>KW</b>	Kilowatt		
<b>LGU</b>	Local Government Unit		
<b>LRGU</b>	Local and Regional Government Unit		

**NOTE:**

The decimal form used throughout the report uses a decimal point (.) instead of a decimal comma (,).

# Executive Summary

The problems in Croatia's fiscal decentralization system have long been recognized. The fragmented territorial-administrative structure, fiscal decentralization efforts with insufficient fiscal autonomy, inconsistent public service standards, unbalanced sources of revenue, and doubts about the introduction of real estate taxes are just some of the concerns. However, there is often no consensus on the possible ways to address them. Compounding the problem is the fact that the recent and still ongoing tax reform, due to its tax relief element, has created the need to compensate subnational governments for the losses of revenues.

The COVID-19 pandemic has increased the significance of these issues as the lockdown measures have had a strong negative impact on the existing revenue sources, such as personal income taxes (PITs), of many local and regional government units (LRGUs). At the same time, it may be that the current crisis has created the preconditions and opportunity needed for the government to finally implement reforms in support of fiscal decentralization and more effective financing of subnational governments, reforms that have long been postponed due to political reasons and a lack of popular support. These reforms include addressing the fragmentation of local governments, providing a clearer and more appropriate assignment of functional responsibilities, improving the fiscal equalization system by including the fiscal expenditure needs component, and introducing a working property tax. All of these ideas have long been debated, but there are many reasons to believe that the time is right for at least some of them to be implemented.

This report provides a comprehensive overview of the major challenges and options for reform in several critical areas of Croatia's fiscal decentralization system, including: (i) the vertical structure of government, (ii) expenditure responsibilities, (iii) taxation and revenue autonomy, (iv) intergovernmental transfers, (v) borrowing and debt, and (vi) asset management.

## **I. THE VERTICAL STRUCTURE OF GOVERNMENT**

Subnational government fragmentation is one of the more significant policy issues in Croatia's system of intergovernmental fiscal relations. This fragmentation, together with the current vertical structure of government, has had negative consequences not only for the financing system but also for the efficient delivery of local public goods and services, that is, the quality and quantity of service provision for the assigned local public functions. Despite these significant issues with scale and capacity, currently there is no legislation in Croatia that incentivizes, much less mandates, the association of local governments to gain in scale and administrative capacity for the improved delivery of local public services.

Decentralization trends since 2001 reveal important issues concerning the role and position of LRGUs in the consolidated public finances of Croatia. In particular, the continued efforts to balance the consolidated general government's fiscal position and the increasing need for local public goods and services have developed into a continued strain on the subnational government sector. Although the scope of assigned public functions to subnational governments

has been expanding and their standard of service provision increasing, their own revenue collection space has been narrowing. These imbalances have particularly affected the less-developed LRGUs, which has likely contributed to significant negative long-term socioeconomic outcomes. These problems have been compounded by an insufficient differentiation of the functions assigned to the different levels of government. In spite of the many laws, there is still no clear division of function between the various government tiers, and almost all functions are concurrent at both the central and LRGU levels. In some ways, this has contributed to the fundamental problem that the large number of overly fragmented local governments have been unable to carry out basic local public functions.

Cyclicalities is another problem, specifically the fact that fiscal transfers to LRGUs have increased in times of economic prosperity but decreased in times of crisis, due to significant declines in revenues, especially at the central government level. In addition to the cyclicalities, and to the asymmetry in the collection of tax revenues between the central government and LRGUs, the lack of institutional stability—frequent top-down changes to the rules—also impedes the ability of LRGUs to adequately plan and efficiently provide the public services with which they have been charged. Amendments to the tax rates and personal allowance tax brackets of the PIT and other tax instruments have been carried out regularly, creating negative vertical fiscal externalities (of central government actions on LRGUs) and largely ignoring the repercussions on lower levels of government. All of this has produced additional burdens on the entire local and regional public sector.

#### Options for reform:

- **Develop a policy strategy with new legislation for a centrally designed program** to incentivize or mandate the merger and/or association of local governments for joint service delivery, accompanied by a capacity support program (national and subnational) and financial incentive instruments.
- Include, in the new policy strategy and legislation, **a medium-term period during which institutions and rules are to be fixed.**
- **Consider forming a task force** or commission to carry out this reform with representation from the Ministry of Finance (MOF), Ministry of Regional Development and EU Funds (MRDEUF), and Ministry of Justice and Public Administration (MOJPA), and from LRGUs.
- In the short term, the task force could carry out a combination of actions:
  - **Develop a program** to incentivize and support the association of local governments for joint service delivery.
  - **Delegate selected local public services** to the intermediate level of government as needed in such areas as investment planning, tax administration, and property valuation.
  - **Develop a tool to assess municipal capacities**, particularly for small and medium municipalities (e.g., those with fewer than 10,000 inhabitants), to analyze whether they have the capacity to deliver the minimum public services. This would include the development of an inventory of the municipal services to be provided (accountability).
  - **Develop a centrally driven technical assistance program** to enable the identified local governments to improve their administrative capacity.
  - **Strengthen the county/regional government level** and create some sort of regional coordination body to anchor this program and provide support.

## II. EXPENDITURE RESPONSIBILITIES

Despite numerous efforts in the past, a clear framework for the provision, standard setting, and funding of public services has not yet been established in Croatia. There are very few exclusive assignments, and for the many responsibilities that are concurrent or shared, the formal arrangements are still unclear. In particular, no effort has been made thus far on the clear assignment and understanding of what level of government is responsible for regulation or service norms and standards, for financing, and for implementation. Despite the fact that the general responsibilities and jurisdiction of local government units (LGUs) are laid out in the Law on Local and Regional Self-Government, similar provisions on the financing side are still missing.

There are other political economy issues with expenditure assignments in Croatia that must be addressed. The current process for delegating functions—the process whereby local governments assume decentralized functions—needs to be revised. Currently, there are some barriers to the transfer of those responsibilities. For example, some county assemblies have declined to allow the transfer of public services to LGUs because they would lose the significant funds attached to financing those functions. Instability is a factor here also, a noticeably unfavorable feature of the current system of expenditure assignments. Even though some of the frequent changes can be understood in the context of “learning by doing” in a fairly recently decentralized country, others could have been avoided if expenditure assignments had been better shielded from the similarly numerous adjustments to revenue assignments.

### Options for reform:

- **Clarify the functions** (in new legislation and regulations) between the levels of government and **revise the process for delegating those functions** (the assumption of decentralized functions by local governments).
- **Enhance and promote horizontal cooperation** by creating government associations at the municipality, county, and city levels to provide public services and to prepare joint supra-municipal investment projects.
- **Set minimum public service standards** to be maintained by all local and regional units with the same or similar conditions.
- **Increase the transparency** of the process of setting minimum financial standards.
- **Promote the creation of permanent bodies to facilitate dialogue and cooperation** between the different levels of government that are charged with concurrent responsibilities.

## III. TAXATION AND REVENUE AUTONOMY

Subnational governments in Croatia, particularly at the county and regional levels, lack sufficient tax revenue autonomy, which means that the decentralized system underperforms in terms of spending efficiency, accountability, and overall fiscal responsibility. A significant contributing factor is that, unlike most countries in the world, Croatia does not have an annual real estate property tax. Although there have been several attempts in the past to introduce this tax, none were successful. As one of its possible reform paths, Croatia could again consider introducing a real estate property tax in the medium term, which, to be successful, would require the development of a more comprehensive strategy and phase-in plan. Although the subnational piggyback PIT is one of the best features of Croatia’s current revenue assignments, it still presents several issues that need to be addressed, including whether it should be assigned to the city/municipal or regional level.

### Options for reform:

The most urgent revenue assignment reform is the need to raise own source revenues by **increasing revenue autonomy, especially at the regional level, and gradually introducing an annual real estate property tax** in line with European Union (EU) practice. Specifically:

- **Provide regional governments with more revenue autonomy**, which can be accomplished by replicating the common practice in revenue assignments where there are two levels of subnational government: reassigning the piggyback PIT from the city-municipality level to the regional level and introducing an annual real estate property tax at the city-municipal level.
- **Develop a phased plan for introducing the property tax at the local level** that includes updating fiscal cadasters, implementing fair and efficient valuation or appraisal methods, and carrying out fair and transparent administration procedures, including efficient appeals, all under a predictable implementation calendar. The property tax should be introduced in addition to, and not instead of, utility fees. However, the total tax burden could remain at the level of current utility fees for the time being.
- **Develop a technical assistance program to strengthen local capacity in tax administration**, particularly by setting up an effective information exchange process between the central Tax Administration unit and LRGUs.
- **Explore the further expansion of subnational tax autonomy by assigning to regional and local governments several “green taxes”** that will report the double dividend of not only generating revenues but also engaging the subnational governments in helping to combat climate change.

## IV. INTERGOVERNMENTAL TRANSFERS

One main issue with the transfer system has been the lack of stability of some of its components, in particular, revenue sharing and the equalization grants. This lack of stability has reduced the system’s predictability and thus impeded subnational governments’ ability to do adequate budget planning. Although the central government is currently working on the determination of minimum financial standards for decentralized public services, the equalization of expenditure needs still remains a challenge within the formula and allocation of equalization grants. In addition, a more complete measurement of fiscal capacity in the equalization grant formula would be useful, one that would include all revenue potential, from own taxes (which are not accounted for at present) side by side with the fiscal capacity arising from revenue sharing (which is accounted for in the current formula). The inclusion of expenditure needs and the full measure of LRGU fiscal capacity would bring the current equalization system closer to best international practices and deliver a fairer and more equitable allocation of equalization transfers, making it possible for citizens to have consistent access to basic public services regardless of where they live in Croatia.

The lack of clarity and transparency of subnational fiscal accounts is another important issue. Methodological changes related to the recording of various intergovernmental transactions have hampered the interpretation and analysis of longer-term fiscal data for LRGUs. Moreover, the analytical breakdown of the structure of LRGU grants in publicly available reports is too broad and general, mostly differentiating only between current and capital grants and then basic types of grant providers. It is almost impossible to understand the differences between certain grant schemes. A modern, more conventional classification of grants, one that reports

the different types of conditional grants utilized, from specific grants to block grants, their main purpose, and whether they are for recurrent or capital purposes, would greatly help clarify the structure of the transfer system. Moreover, in the typology and functions of grants, central government authorities should consider the introduction of ex post performance-based grants.

The fuller, more effective exploitation of EU grants is another important pending issue in this area. The two main obstacles to the more successful use of EU funds by lower government tiers are insufficient administrative capacity and poor co-financing ability. Excessive fragmentation also hinders many small LGUs from securing the needed financial and administrative capacities to prepare and execute significant capital investment projects.

#### Options for reform:

**Adopt sequenced reform and guidance on equalization grants** so that they evolve and mature in line with EU/OECD best practices. The initial phase could include the following actions:

- **Develop a white paper** analyzing the potential disparities across regional and local governments in expenditure needs caused by demographic composition, geographic remoteness, or other factors.
- If significant disparities in expenditure needs are found, study a reform of the equalization grants to include expenditure needs equalization side by side with revenue capacity equalization by **adopting either the fiscal gap approach or the fiscal capacity per adjusted population approach** (where the adjusted population reflects differences in expenditure needs).
- **Reform the overall structure of conditional grants** in line with international practice, **particularly by:** simplifying the complex systems of specific purpose grants; consolidating similar conditional grants; increasing the use of block grants; introducing performance-based grants; using capital grants to build public capital infrastructure (regional projects); integrating capital transfers into the budget and planning process (MOF) as opposed to the current discrete arrangements for capital grants managed by other agencies; and introducing formal periodic evaluations of all transfers and programs and making them public.
- **Create a single database** for all the different grants allocated to LRGUs that includes the criteria for allocation and the level of allotment per annum.
- **Create a development management system at the regional level** to promote capital investments at lower government levels (e-catalogue of investment projects and capital investments at the county level).
- **Introduce stronger governance of the transfer system** by consolidating and assigning the central coordinating role to the MOF for all types of transfers.
- **Publish grant data** in a more transparent, detailed, and centralized way to make longer-term datasets comparable.

## V. BORROWING AND DEBT

Reporting on borrowing activities in Croatia is still incomplete in that the existing legislative framework does not provide for the preparation of consolidated financial statements of counties, cities, and municipalities and their utilities. The reporting of consolidated accounts would be useful for a comprehensive assessment of the exposure of LRGUs to direct but also indirect liabilities arising from the financial operations of their utility companies. Borrowing procedures should also be improved. Given the expected increased borrowing needs to overcome the consequences of the COVID-19 crisis (in the short run) and to finance EU projects (in the long



run), and the currently favorable borrowing conditions that allow the refinancing of existing debts with lower total costs, borrowing procedures could be, to some extent, administratively relaxed, although keeping with standard prudential measures. The currently restrictive nature of the fiscal rules for LRGU borrowing became especially evident during the pandemic when borrowing needs increased. To overcome this problem, the government made a one-off relaxation of the cumulative borrowing limit, which doubled in 2020.

In addition, weak administrative capacities, including financial management knowledge and skills, hamper the ability of LRGUs to effectively borrow and manage debt. Borrowing conditions differ significantly among LRGUs, some of which reflect imprudent debt and risk management policies. Weak administrative capacities are also one of the reasons for the limited scope of borrowing instruments in use—mostly boiled down to loans with commercial banks. There have only been a few examples of borrowing through municipal bonds to finance long-term projects, even though borrowing on the financial markets would be beneficial because it increases transparency and usually reduces borrowing costs.

#### Options for reform:

- **Consider eliminating central government guarantees**, in accordance with best international practices, with the exception of some joint development projects.
- **Consider increasing individual entity borrowing limits.** However, the limit should be related to current revenue (or more precisely, to own source revenue) and not total revenue.
- **Introduce explicit, transparent rules** for how the central government may apportion overall borrowing limits among different tiers of government and then also among jurisdictions in each tier (level of government). In this respect, a separate and specific apportionment limit should be devoted to Zagreb alone to avoid the potential of unfairly crowding out other LGUs.
- **Consider improving the legislative framework for LRGU borrowing** by introducing a single public debt act.
- **Encourage the financing of capital investments** by issuing revenue bonds whenever appropriate and feasible. In general, the borrowing system should be redesigned to encourage the expansion of marketable local government debt.
- **Consider the creation of a subnational financial intermediary** that can work at arm's length, using strict financial institution criteria, and lend to subnational governments at lower costs, building on the experience of other European countries in this matter.
- **Consider the introduction of bankruptcy procedures for LRGUs** to ensure prudent and sustainable public financial management at the subnational level.

## VI. ASSET MANAGEMENT

The structure of financial assets owned by LRGUs is dominated by shares and equity stakes in the capital of public sector companies—in other words, the ownership of LRGU enterprises. When evaluating financial assets, it should be noted that most of the shares and stakes are probably not expressed at market value, because the shares of companies in which LRGUs have stakes are not actively traded on the stock exchange. But even if some publicly owned companies are rightfully ensuring public service delivery in some sectors, in reality, the coverage and types of activities in which LRGU-owned companies currently engage clearly exceed the international norm, and many generally belong in the private sector.

Although LRGUs are de facto players in the real estate market, this role needs to be re-examined—if not questioned. The primary purpose of real estate owned by LRGUs should be to facilitate public service provision, or even perhaps to help address unemployment, lodging, and economic activity in targeted areas. The role of locally owned real estate partially serving as an instrument to regulate the rental market and generate operating income should be minimized, if not eliminated altogether. Currently, a significant number of vacant business premises remain unused because of disputes between the state and LRGUs involving claims on the right to return of confiscated property. Inadequate property inventories (at the local, regional, and state levels) have delayed resolutions to these questions of legal ownership.

The poor asset management practices are manifested in the currently large number of vacant and unused assets for which LRGUs nevertheless bear maintenance costs. Local assets, when they should not be privatized, could be used more efficiently and, with better management, could generate additional revenues for LRGUs. Many LRGUs do not have property inventories due to the unresolved property disputes, inconsistencies in land registers and cadasters, and outstanding litigation related to property rights. From a financial perspective, a significant problem is the lack of financial and accounting data: the market value of real estate units is often unknown to LRGUs, as are the revenues and expenditures incurred in relation to a unit of fixed property.

#### Options for reform:

- **Publishing data:** It would be useful for the MOF to publish a unique and up-to-date online database with balance sheets and revenue and expenditure accounts of LRGUs' enterprises (as well as lists of addresses and contacts). LRGUs should be responsible for providing this data to the MOF, which, in its role as "regulator," should set reporting standards, dates, scope, and templates.
- **Control:** The State Audit Office should incrementally conduct a detailed financial and performance analysis of all companies owned by LRGUs.
- **Financial reporting:** LRGUs should issue consolidated financial reports that include their utility enterprises. The financial planning and operations of those enterprises should come under the purview of local representative bodies.
- **Inventory of assets:** An Action Plan could be adopted to perform an inventory of assets, including activities, deadlines, methods, and competences, that also outlines the manner in which they should be reported.
- **Gradual divesting:** The first policy priority for LRGUs should be to gradually divest by selling stakes in companies and to scale down their holdings by selling assets that are not central to their role as public service providers. The MOF could facilitate and support the disinvestment if needed but should respect local autonomy to decide on ownership.

**Table ES1.** Summary of Country Challenges, International Trends, and Policy Options

## Territorial-administrative structure

### CHALLENGE

1. Subnational government **fragmentation**
2. **Cyclicality of subnational funding**, compounded by an asymmetric effect
3. Lack of **institutional stability**

### INTERNATIONAL TRENDS

- Promoting, through incentives, a voluntary amalgamation or merger
- Forcing a merger by law of suboptimal-sized subnational governments
- Promoting and incentivizing the voluntary association of local governments into commonwealths or consortia to jointly provide certain services that require minimum efficiency scales
- Forcing the association of contiguous local governments for the joint provision of certain services
- Creating special districts or the common contracting of services
- Adopting an asymmetric allocation of spending functions, contingent upon the size and capacities of each level of government
- Allowing and facilitating the (temporary) upward delegation of some local public services to the intermediate level of government
- Developing a legally binding definition of a medium-term period for the divisible pool of funds, which provides stability/predictability to subnational government finances and also hard budget constraints and incentives for own revenue collection

### POLICY OPTIONS

- **Develop a policy strategy with new legislation for a centrally designed program** to incentivize or mandate the merger and/or association of local governments for joint service delivery, accompanied by a capacity support program (national and subnational) and financial incentive instruments.
- Include, in the new policy strategy and legislation, **a medium-term period during which institutions and rules are to be fixed.**
- **Consider forming a task force** or commission to carry out this reform with representation from the MOF, MRDEUF, and MOJPA, and from LRGUs. In the short term, the task force could carry out a combination of actions:
  - **Develop a program** to incentivize and support the associations of local governments for joint service delivery.
  - **Delegate selected local public services** to the intermediate level of government as needed in such areas as investment planning, tax administration, and property valuation.
  - **Develop a tool to assess municipal capacities**, particularly for small and medium municipalities (e.g., < 10,000 inhabitants), to analyze whether they have the capacity to deliver the minimum public services. This would include the development of an inventory of the municipal services to be provided (accountability).
  - **Develop a centrally driven technical assistance program** to enable the identified local governments to improve their administrative capacity.
  - **Strengthen the county/regional government level** and create some sort of regional coordination body to anchor this program and provide support.

## Expenditure assignment framework

### CHALLENGE

#### 4. **Strain** on subnational government and **incomplete expenditure assignment** framework

### INTERNATIONAL TRENDS

- Defining the overall governance of the system (clear definition of the rules of the game, which level does what), including an explicit coordination and cooperation mechanism across different levels of government for dealing with concurrent responsibilities
- Defining expenditure assignments and minimizing concurrent or shared functions, and for concurrent responsibilities, clearly defining responsibilities for the attributes of regulation, financing, and implementation
- Assigning functions based on affordability and capacity, using the “correspondence” and “subsidiarity” principles
- Assigning the level of government responsible for each attribute of each service (regulation, financing, and implementation)
- Assigning both recurrent and investment responsibilities for any expenditure function to the same level of government

### POLICY OPTIONS

- **Clarify the functions** (in new legislation and regulations) between the levels of government and **revise the process for delegating those functions** (the assumption of decentralized functions by local governments).
- **Enhance and promote horizontal cooperation** by creating government associations at the municipality, county, and city levels to provide public services and to prepare joint supra-municipal investment projects.
- **Set minimum public service standards** to be maintained by all local and regional units with the same or similar conditions.
- **Increase the transparency** of the process of setting minimum financial standards.
- **Promote the creation of permanent bodies to facilitate dialogue and cooperation** between the different levels of governments that are charged with concurrent responsibilities.

## Revenue assignment framework

### CHALLENGE

#### 5. **Revenue measures** to tackle vertical imbalances

### INTERNATIONAL TRENDS

- Increasing revenue autonomy to regional governments
- Developing tax administration support programs and coordination of national and regional agencies

- Promoting property tax as the key revenue source for local governments
- Increasing the delegation of taxing power to LRGUs
- Promoting accountability, efficient spending, and fiscal responsibility by providing each level of government with some sort of taxing power and revenue autonomy

## POLICY OPTIONS

- The most urgent revenue assignment reform is to raise own source revenues by **increasing revenue autonomy, especially at the regional level, and gradually introducing an annual real estate property tax** in line with EU practice. Specifically:
  - **Provide regional governments with more revenue autonomy**, which can be accomplished by replicating the common practice in revenue assignments where there are two levels of subnational government: reassigning the piggyback PIT from the city-municipality level to the regional level and introducing an annual real estate property tax at the city-municipal level.
  - **Develop a phased plan for introducing the property tax at the local level** that includes updating fiscal cadasters, implementing fair and efficient valuation or appraisal methods, and carrying out fair and transparent administration procedures, including efficient appeals, all under a predictable implementation calendar. The property tax should be introduced in addition to, and not instead of, utility fees. However, the total tax burden could remain at the level of current utility fees for the time being.
  - **Develop a technical assistance program to strengthen local capacity in tax administration**, particularly by setting up an effective information exchange process between the central Tax Administration unit and LRGUs.
  - **Explore the further expansion of subnational tax autonomy by assigning to regional and local governments several "green taxes"** that will report the double dividend of not only generating revenues but also engaging the subnational governments in helping to combat climate change.

## Intergovernmental transfer system features

## CHALLENGE

6. Lack of clarity in the **design and effects of the fiscal needs equalization**/distribution formula (calculating minimum financial standards, etc.)
7. **Grants mechanism:** proliferation and fragmentation of grants, regular rule changes, weak execution, and fragmented information
8. Lack of clarity and coordination of **system governance**

## INTERNATIONAL TRENDS

- Differentiating between the devolution objective of transfers (revenue sharing on a derivation basis) and redistribution (equalization transfer)
- Designing equalization transfers by using the "fiscal gap" approach, defined as the difference between separate estimates of the expenditure needs and the fiscal capacity of subnational governments
- Simplifying the complex systems of specific purpose grants
- Consolidating conditional grants
- Increasing the use of block grants

- Introducing performance-based grants
- Using capital grants to build public capital infrastructure (regional projects)
- Integrating capital transfers into the budget and planning process (MOF) as opposed to discrete arrangements for capital grants managed by other agencies
- Introducing formal evaluations for transfers and programs (center of government systems, evaluation agenda)
- Strengthening the system for generating fiscal data at the subnational level, promoting its rational use, and developing transparency portals with clear data standards
- Developing a reporting framework with enforcement features and simplifying municipal reporting (single reporting, IT tools)
- Clarifying and consolidating the central coordinating role of the center of government, usually at the MOF

#### POLICY OPTIONS

- **Adopt sequenced reform and guidance on equalization grants** so that they evolve and mature in line with EU/OECD best practices. The initial phase could include the following actions:
  - Develop a white paper analyzing the potential disparities across regional and local governments in expenditure needs caused by demographic composition, geographic remoteness, or other factors.
  - If significant disparities in expenditure needs are found, study a reform of the equalization grants to include expenditure needs equalization side by side with revenue capacity equalization by adopting either the fiscal gap approach or the fiscal capacity per adjusted population approach (where the adjusted population reflects differences in expenditure needs).
  - Reform the overall structure of conditional grants in line with international practice, **particularly by:** simplifying the complex systems of specific purpose grants; consolidating similar conditional grants; increasing the use of block grants; introducing performance-based grants; using capital grants to build public capital infrastructure (regional projects); integrating capital transfers in the budget and planning process (MOF) as opposed to the current discrete arrangements for capital grants managed by other agencies; and introducing formal periodic evaluations of all transfers and programs and making them public.
- **Create a single database for all the different grants** allocated to LRGUs that includes the criteria for allocation and the level of allotment per annum.
- **Create a development management system at the regional level** to promote capital investments at lower government levels (e-catalogue of investment projects and capital investments at the county level).
- **Introduce stronger governance of the transfer system** by consolidating and assigning the central coordinating role to the MOF for all types of transfers.
- **Publish grant data** in a more transparent, detailed, and centralized way to make longer-term datasets comparable.

## Borrowing and debt framework

### CHALLENGE

9. **Incomplete reporting** on debt and fiscal risks
10. **Restrictive borrowing (fiscal) rules**
11. **Limited scope of borrowing instruments** in use (primarily loans with commercial banks)
12. **Weak administrative capacities**, including knowledge and skills in financial management

### INTERNATIONAL TRENDS

- International experience in setting up a subnational borrowing and debt framework is very diverse, but several effective features have been widely adopted across countries:
- Good decentralization design and explicit rules, monitoring, and oversight regarding subnational debt have proved useful.
- Experiences range from: no central government controls, leaving market conditions to limit borrowing, to a multiplicity of rules and controls and the outright prohibition of borrowing by subnational governments. Most existing borrowing and fiscal rules systems fall into five general categories.
- The rule-based approach (centrally imposed rules) appears to be a popular and well-functioning system that combines transparency with strong, indirect central government control.
- Another option involves ex post controls and the vertical apportionment of aggregate debt limits.
- Beyond fiscal rules, some countries have used other supporting institutions to monitor spending and borrowing behavior and maintain fiscal discipline by creating “fiscal councils” and/or building a safety net to cushion the impact of sudden drops in budget revenues through the use of “rainy day funds.”
- An alternative to bond issues that has been used effectively in EU countries is the creation of a financial intermediary or a financial intermediation program that allows all local governments, especially those with no direct access to capital markets, to borrow based on selective banking criteria.
- A complete system of borrowing and fiscal rules requires that ex post control rules define an insolvency framework for subnational governments and vertical apportionment of aggregate debt limits across tiers of government.

### POLICY OPTIONS

- **Consider eliminating central government guarantees**, in accordance with best international practices, with the exception of some joint development projects.
- Consider increasing **individual entity borrowing limits**. However, the limit should be related to current revenue (or more precisely, to own source revenue) and not total revenue.
- **Introduce explicit, transparent rules** for how the central government may apportion overall borrowing limits among different tiers of government and then also among jurisdictions in each tier (level of government). In this respect, a separate and specific limit apportionment should be devoted to Zagreb alone to avoid the potential of unfairly crowding out other LGUs.
- **Consider improving the legislative framework for LRGU borrowing** by introducing a single public debt act.

- **Encourage the financing of capital investments** by issuing revenue bonds whenever appropriate and feasible. In general, the borrowing system should be redesigned to encourage the expansion of marketable local government debt.
- **Consider the creation of a subnational financial intermediary** that can work at arm's length, using strict financial institution criteria, and lend to subnational governments at lower costs, building on the experience of other European countries in this matter.
- **Consider the introduction of bankruptcy procedures for LRGUs** to ensure prudent and sustainable public financial management at the subnational level.

## Asset management framework

### CHALLENGE

13. **Incomplete reporting** on local utility enterprises
14. The absence of **property inventories among many LRGUs** due to unresolved property disputes, inconsistencies in land registers and cadaster, and litigation related to property rights
15. Substantial **LRGU assets that are inactive** (unused)
16. **Poor asset management** practices

### INTERNATIONAL TRENDS

- Overall international trends:
- A centralized system for collecting, analyzing, and disclosing information on state-owned enterprises in general and LRGU-owned enterprises in particular would be beneficial to achieving a satisfactory level of transparency and creating the foundations for effective management. The Lithuanian Governance Coordination Centre is a good example of how such a system could be introduced.
- Although the existing legislative framework does not provide for the preparation of consolidated financial statements of counties, cities, and municipalities and their companies, consolidation is indeed required by the International Public Sector Accounting Standards (IPSAS).
- Good practices regarding the establishment of an effective real estate management system at the LRGU level include:
  - introduction of a reliable database/inventory system with the classification of assets
  - real estate valuation
  - accounting and financial planning for assets
  - development of well-functioning rental procedures
  - quantification and monitoring of direct and indirect subsidies related to real estate
  - timely reporting and development of a comprehensive asset management plan



## POLICY OPTIONS

- **Publishing data:** It would be useful for the MOF to publish a unique and up-to-date online database with balance sheets and revenue and expenditure accounts of LRGUs' enterprises (as well as lists of addresses and contacts). LRGUs should be responsible for providing this data to the MOF, which, in its role as "regulator," should set reporting standards, dates, scope, and templates.
- **Control:** The State Audit Office should incrementally conduct a detailed financial and performance analysis of all companies owned by LRGUs.
- **Financial reporting:** LRGUs should issue consolidated financial reports that include their utility enterprises. The financial planning and operations of those enterprises should come under the purview of local representative bodies.
- **Inventory of assets:** An Action Plan could be adopted to perform an inventory of assets, including activities, deadlines, methods, and competences, that also outlines the manner in which they should be reported.
- **Gradual divesting:** The first policy priority for LRGUs should be to gradually divest by selling stakes in companies and to scale down their holding by selling assets that are not central to their role as public service providers. The MOF could facilitate and support the disinvestment if needed but should respect local autonomy to decide on ownership.

# 01 Introduction

The challenges to the effective functioning of Croatia's fiscal decentralization system have been recurrently diagnosed in recent years. The most prominent issues include its fragmented territorial-administrative structure, the insufficient fiscal autonomy provided to subnational governments and the unbalanced sources of revenue, the ongoing reluctance to introduce a property tax at the local level, and inconsistent public service standards. However, the same voices that have repeatedly raised these concerns themselves disagree on how to set up a clear policy reform program to address them. The purpose of this report is to systematically carry out an in-depth review of Croatia's intergovernmental fiscal framework, area by area, and benchmark its current practices to the way in which Organisation for Economic Co-operation and Development (OECD) and other European Union (EU) countries have been addressing similar or related issues. Based on that analysis and taking into account the local economic, social, and political context, the report proposes some meaningful and feasible reform options for the government's consideration.

More recently, the challenge of reforming the intergovernmental fiscal framework has been compounded by two factors: ongoing tax reform and the COVID-19 pandemic. The recent, and still ongoing, tax reform, which includes a tax relief element, has created the need to compensate subnational governments for the associated loss of revenues. The COVID-19 pandemic has increased the significance of these issues as the lockdown measures have had a strong impact on the revenue sources, such as personal income taxes (PITs), of many local and regional government units (LRGUs). On the other hand, the current crisis has likely created the preconditions necessary for the government to finally implement reforms in support of fiscal decentralization and more effective financing of subnational governments, reforms that have long been postponed due to political reasons and an apparent lack of popular support. These reforms include addressing the fragmentation of local governments, providing a clearer and more appropriate assignment of functions, potentially improving the fiscal equalization system by including the expenditure needs component, and possibly introducing a property tax. These ideas have long been debated, but again, there are reasons to believe that the time is now right for them to be fully explored and for at least some of them to be implemented.

The Croatian government is aware of the challenges to the system's efficient operation. In fact, in its *Government Programme for the Mandate 2020–2024* (Croatia 2020b), it has proposed specific reform measures to tackle those challenges and ensures that public administration reform will be systematically carried out. In the first phase, the current number of local officials will be cut in half and the number of elected representatives will be reduced by a fifth. By the end of 2021, the LRGU system will be restructured. In the first half of the mandate, a database on the financial and administrative capacities of local government units (LGUs), as well as the tasks they carry out, will be established; in addition, cooperation mechanisms will be defined in order to connect them to functional government units, and the digitalization of public services will be increased. The government will also work on expanding fiscal and functional decentralization. Transparency will be ensured at all levels of state and public administration, especially in the preparation of budgets and the use of all county, city, and municipal funds, as well as the funds of any companies or institutions founded by the local government entities.

The *National Reform Programme 2020* (Croatia 2020a) recognized these recommendations and has planned follow-up actions. According to this document, in order to establish an adequate division of competences between the central and local levels of government, their existing capacities must be identified to acquire a clear picture of their ability to adequately provide public

services. In addition to their competences, the report states, the quality of their performance of existing tasks, as well as the possibilities and preconditions for assuming new ones, should be reviewed and analyzed. One known obstacle to further decentralization, a key reform priority, is the insufficient capacity of LRGUs, which creates discrepancies in the number and quality of public services that they provide. Clearly, LRGUs should have adequate administrative and financial capacities within their legally prescribed scope to perform decentralized tasks and take over new ones. The ultimate goal is to increase the efficiency with which LRGUs perform the required functions, ensuring a uniform and even provision of services to all citizens.

The *National Development Strategy of the Republic of Croatia 2030 (NN 13/2021)* (Croatia 2021a) also recognizes these pressing issues and calls for action in several priority areas. The Strategy points to the fragmentation of public administration in Croatia, which frequently impedes coordination and cooperation among the various public bodies and institutions. In addition, the Strategy notes, local administrations are often lacking sufficient capacity, which is reflected in the low level of decentralization and the difficulties in using European funds to finance large investments. The government will therefore cooperate with LRGUs to increase their efficiency and effectiveness, taking into account the principle of subsidiarity and the right of citizens to decide independently on the regulation of their specific local problems. Mutual cooperation, stronger institutional links, and voluntary mergers among LGUs will be encouraged by providing support in the form of much-needed data on government units, their tasks within their self-governing scope, how these tasks are currently performed, and the organizations that perform them.

The need for reform has also been acknowledged by the European Commission. The details were first outlined in the 2019 *Country Specific Recommendation for Croatia*, which stated that Croatia should take action to “reinforce the budgetary framework and monitoring of contingent liabilities at central and local level. Reduce the territorial fragmentation of the public administration and streamline the functional distribution of competencies” (EC 2019). Significant deficiencies in the local government system in Croatia were identified again in the 2020 report (EC 2020), which revealed that the efficiency of public administration ranks below the EU average. Low capacity to design and implement policies and projects hampers effectiveness and speed, something that became particularly apparent during the pandemic in the implementation of Structural and Investment Funds. Moreover, the report stated, there is high territorial fragmentation of public administration and an imbalance between responsibilities and resources at the local level. This contributes to the uneven quality of public services provided across the country and raises administrative costs.

Finally, the *National Recovery and Resilience Plan (NRRP)* (Croatia 2021b) underscores the challenges and proposes changes. More specifically, it points to the unsatisfactory quality of service provision by LRGUs, mainly as a result of weak administrative and fiscal capacity and lack of transparency. To address these deficiencies, further decentralization will be carried out, and the state will encourage the functional merging of individual LRGUs to promote the more sustainable planning of local budgets and projects and raise the quality of public life. This includes optimizing the LRGU system through the operational integration of certain business processes and generally modernizing public administration at the LRGU level through digitalization, better interoperability, employee reductions, salary regulation, and human resource management. The functional merger of LRGUs will also seek to mitigate the negative effects of territorial fragmentation on the provision of public services at the local level. One of the

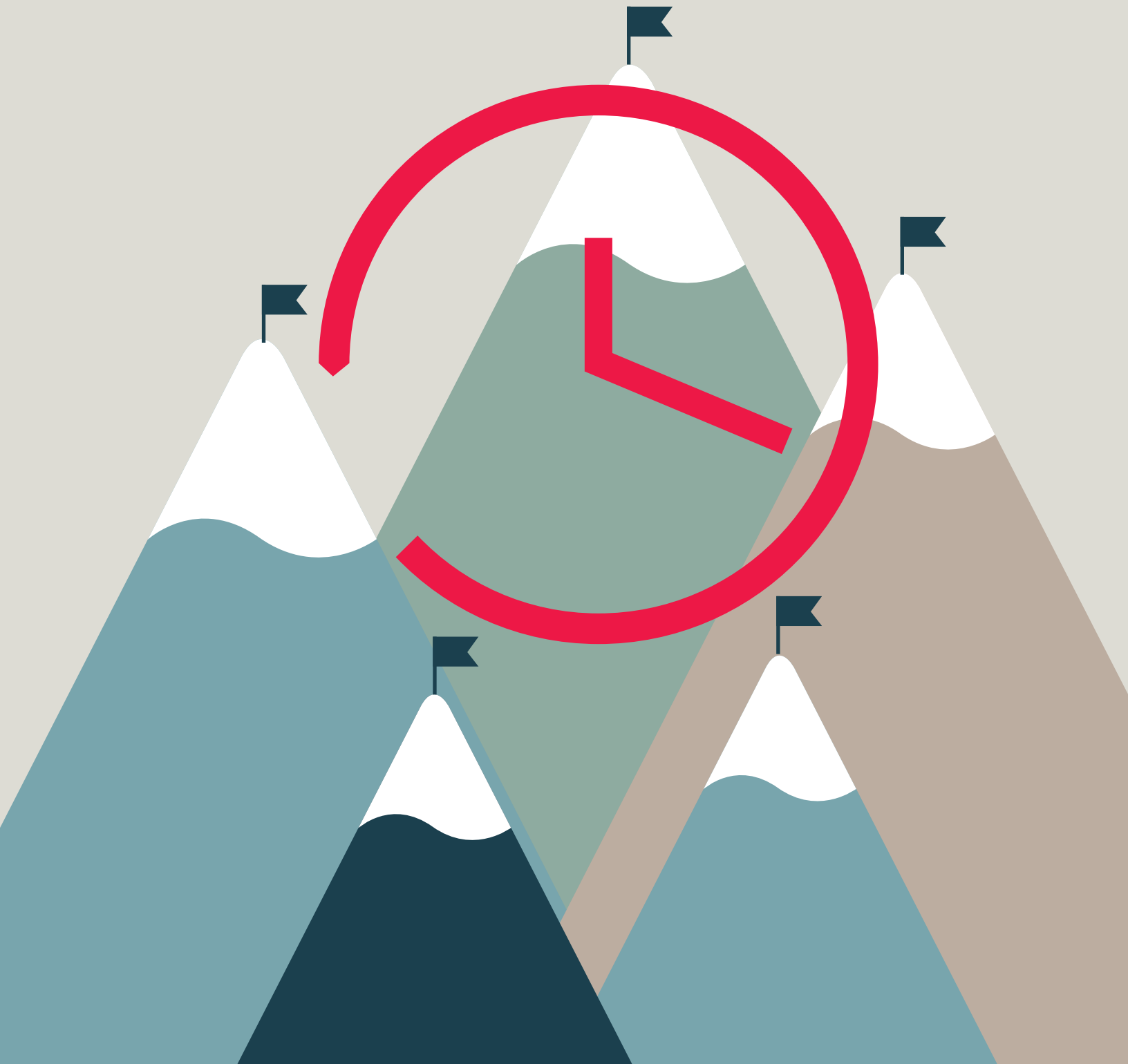
main imperatives will be to continue the privatization of majority LRGU-owned companies and to enhance corporate governance in companies that remain under LRGU ownership, in line with best practices, with the goal of improving allocative efficiency in the economy and supporting higher overall growth rates. The NRRP program, organized by the Croatian government and financed by the European Commission, is an excellent opportunity to identify the main priorities, reforms, and investments needed, using it as a platform to tackle many of the current system's shortcomings.

This report is organized as follows. This introduction is preceded by an executive summary, together with a table that summarizes the key messages across themes on current country practice in Croatia and the challenges to be addressed, international practice and emerging trends, and useful policy options. Section 2 contains an overview of the main historical challenges. Section 3 reviews the vertical structure of government, and section 4 the functional expenditure responsibilities and actual expenditure patterns. Section 5 analyzes subnational taxation and revenue autonomy, and section 6 the intergovernmental transfer system. Section 6 reviews the subnational borrowing and debt framework, and section 8 examines asset management at the local level. All sections include a review of the most pressing concerns, references to international practice, and emerging trends to which Croatia's practices are benchmarked. The final section contains proposed policy reform options.

02

# Overview of the Main Historical Challenges

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Croatia has a territory of roughly 56,000 square kilometers and a population of 4.2 million. It is administratively divided into 21 counties (in Croatian, *županija*) as units of regional self-government and 556 local government units (LGUs): cities (*grad*) and municipalities (*općina*). Croatia's capital, the city of Zagreb, is counted twice here due to its formal dual status: it performs the tasks of both a city and a county.

The process of fiscal decentralization in Croatia began in 2001, when a number of LRGUs<sup>1</sup> assumed responsibility for certain decentralized functions. The preconditions for the fiscal decentralization process had begun to emerge in 1994 and were realized gradually through the processes of political and administrative decentralization. Effective fiscal decentralization and fiscal equalization have evolved directly with the development of local government financing systems.

Given the changes in the financing system that have taken place since 1994, four distinctive phases in the development of the fiscal decentralization and fiscal equalization systems can be identified:

- Administrative and Political Decentralization (1994–2001)
- Fiscal Decentralization (2001–07)
- Reform of the Fiscal Decentralization System (2007–15)
- Reform of the Fiscal Equalization System (2015–the present)

#### **PHASE I. ADMINISTRATIVE AND POLITICAL DECENTRALIZATION (1994–2001)**

Decentralization in Croatia began with the gradual implementation of political and administrative devolution from 1994 to 2001. The Law on Local Self-Government and Government (OG 90/1992)<sup>2</sup> defined the self-governing scope of LRGUs. LGUs (municipalities and cities) were responsible for providing for the local needs of residents in the areas of child care; education and upbringing (kindergartens and primary education); some public health services (pharmacies, health clinics); culture, physical recreation, and sports centers; planning of settlements; and housing and communal facilities.<sup>3</sup> Among other functions, the counties were responsible for coordinating the development of educational, cultural, health, social, communal, and other institutions as well as facilities and infrastructure of importance for the county as a whole (roads, tram-railways, and port facilities), and also performing tasks that municipalities and cities transferred upward to the county level.

Formal preconditions for decentralization were created by the adoption of the Law on Financing of Local Self-Government and Government Units (OG, 117/1993), which determined

<sup>1</sup> For the sake of simplicity, the term LGU will be used for cities and municipalities at the local level and LRGU to include also the county (regional) government.

<sup>2</sup> At that time (until 2001), municipalities and cities were referred to as units of local self-government and counties as units of local self-government and government. In 2001, by passing the Law on Local and Regional Self-Government (OG 33/2001), municipalities and cities were recognized as local and counties as regional self-government units.

<sup>3</sup> Although the provision of these services by LGUs is stipulated in the Law on Local Self-Government and Government (OG 90/1992), the Law on Determining Tasks from the Self-Governing Scope of Local Self-Government and Government Units (OG 75/1993) does not prescribe specific tasks related to certain services, such as education or social welfare, whereas concrete tasks for some other services, for example, housing and communal services, are prescribed down to the last detail.

the revenues of LRGUs. Financing of LGUs during this period was largely centralized, and they had limited autonomy in raising revenue and determining the purpose and final use of the funds raised. Due to the unobtainability at that time of reliable data about the fiscal capacity of LGUs, it was impossible for them to propose their own revenue sources. LGUs were therefore exclusively financed through the intermediary role of counties, which distributed central government funds. The first LRGU elections were held in February 1993, after which a legislative framework was set up that allocated fiscal and administrative powers between the central government and LRGUs.

PIT was a central government tax, but its revenue was shared between the central government and LRGUs. This was also the case with corporate income tax (CIT), which was, as are all other shared taxes, distributed on a derivation basis, that is, LRGUs retained a particular share of the tax revenue where the tax was collected. At that time, 70 percent of CIT revenue was directed to the central government budget, and the cities and municipalities where the tax was collected retained 20 and 10 percent, respectively. Real estate transfer tax (RETT) revenue was shared at a ratio of 40:60, with the larger share going to local units. The central government and local units also shared gambling tax revenue (50:50), but since July 1, 2001, revenues from this tax have been fully retained by the central government. All tax revenues shared between the different tiers of government were central government taxes, meaning that the central government had exclusive authority for determining the tax base, tax rate, and other important elements of the tax structure.

In terms of equalization, during this phase, counties where LGU revenues per capita, not including the city of Zagreb, were less than 75 percent of the average per capita income at the national level were allocated unconditional (non-earmarked) grants from the central government budget in the amount of the difference in their revenue per capita and the 75 percent national average. The new local government financing model, accompanied by tax reform, was introduced at a time when the search for the optimal fiscal decentralization model was hampered by the destruction brought by the homeland war in the 1990s. The consequences of the war were distributed asymmetrically, which called for an equally asymmetric national intervention in order to reconstruct the severely damaged areas. At that time, it was possible only to speculate on the level of fiscal inequalities. During this period, areas of special national concern (ASNCs)<sup>4</sup> were defined, which created the preconditions for the eventual implementation of balanced local and regional development policies. Three groups of ASNCs, introduced in 1996, consisted of a total of 180 local units, 50 of which were in the first group, 61 in the second, and 69 in the third (Bajo and Bronić 2004).

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<sup>4</sup> ASNCs were created to achieve more even development in Croatia, encourage demographic and economic progress, complete the reconstruction program, return the areas to their pre-war population levels, and promote the development of permanent housing. ASNCs are divided into three groups: the first (ASNC I) and the second (ASNC II) group according to circumstances that existed as a consequence of the aggression on Croatia (primarily during what is called the homeland war in the 1990s), and the third (ASNC III) group according to three criteria: economic development, structural problems, and demographics.



## PHASE II. FISCAL DECENTRALIZATION (2001–07)

Fiscal decentralization in Croatia began in earnest in 2001, when the functions and authority to provide certain services in the areas of health care, education, welfare, and fire-fighting services were transferred to the counties and major cities. These subnational government units were supposed to finance non-personnel recurrent costs and a portion of capital infrastructure investment, while employee expenditures remained within the competence of the central government (ministries). Responsibility for these decentralized functions was taken over by counties and by those cities with the highest fiscal and administrative capacities. Local units hoping to take on the newly decentralized functions were required to prove that they had sufficient fiscal capacity to carry them out, and the number of subnational units capable of doing so increased over time.

After 2001, LGUs were also provided with additional funding through a “piggyback” or surtax on the central government PIT, whereby the maximum rate of the surtax was made dependent on both the administrative status of the local unit (city or municipality) and the population (number of inhabitants). All municipalities and cities were able to introduce the surtax: municipalities at a rate of up to 10 percent, cities with fewer than 30,000 inhabitants at up to 12 percent, cities with more than 30,000 inhabitants at up to 15 percent, and the city of Zagreb at up to 18 percent. During this period, the central government’s share of PIT revenue gradually decreased in favor of LRGUs. Part of this revenue was aimed at financing decentralized functions (9.4 percent), and part (21 percent) was paid into an equalization fund for financing the decentralized functions of less well-off local units. The funds were distributed to LGUs in need according to their negative deviations from the minimum financial standards set for each decentralized function.

In addition, financial support for some local units was expanded, specifically in a preferential financing system for hilly and mountainous areas (HMAs),<sup>5</sup> which, after 2002, included 45 LGUs. The preferential treatment of these LGUs was in the form of an increased share of PIT and the additional allocation of several types of grants from the central government.

## PHASE III. REFORM OF THE FISCAL DECENTRALIZATION SYSTEM (2007–15)

Although the coefficients of the distribution of tax revenues (especially PIT) were changed frequently, LRGU financing became increasingly reliant on PIT after 2007, when the central government completely ceded its share of PIT in favor of LRGUs. At the same time, the CIT, which was always a much harder tax to share on a derivation basis with subnational governments, became fully a central government tax. The number of local units in the preferential financing system (with the higher sharing rates introduced in the previous period) was also expanded to include local units on the islands off Croatia’s coast. This move also involved a multilevel agreement on the joint financing of capital projects of interest to island development.

<sup>5</sup> HMAs are determined as areas of interest and under special protection in order to encourage demographic renewal, settlement, and the creation of preconditions for the efficient use of natural and economic resources for economic development. The HMAs are areas whose elevation, slope, vertical field stratification, conditioned soil, climate, and other natural characteristics represent difficult conditions for the life and work of the residents.

In addition, municipalities and cities in ASNCs and HMAs were provided with additional grants in compensation for the CIT revenues that had been fully centralized. As Croatia moved closer to the EU, more attention was paid to the goal of more balanced regional development. This included reforming the fiscal equalization system to address problems in financing local public services and also the regional development program to better identify areas with economic difficulties through the introduction of a newly calculated regional development index.

#### **PHASE IV. REFORM OF THE FISCAL EQUALIZATION SYSTEM (2015–THE PRESENT)**

Beginning in 2015, the preferential treatment of local units in ASNCs and HMAs in the distribution of PIT revenue was abandoned. At that time, preferential treatment was introduced for LRGUs that, under special regulations, had the status of “supported area” according to the development index. Thus, for certain local units, qualification for the preferential financing arrangement was no longer based on geographic or historical criteria but rather strictly on the basis of economic measures. In addition, the general allocation scheme for PIT revenue (as well as the allocation scheme applicable to the islands) was changed to introduce a share (1.5 percent) for projects co-financed by European Structural and Investment Funds. Since 2018, all preferential arrangements in the PIT revenue sharing system (for islands, supported areas, and the city of Zagreb) have been abandoned and a single allocation scheme introduced in their place. Considering that tax sharing on a derivation basis could not be an effective instrument of fiscal equalization, a much more appropriate system, based on mitigating the disparities or inequalities in the fiscal capacities of local units, was introduced. The new equalization system is financed at the central government level.

The gains from the different reform phases, and more recently the reform of the fiscal equalization system started in 2015 and carried forward in 2018, will continue to strengthen the decentralization system in the short to medium term. However, the still unfinished agenda of reforms calls for a thoughtful and well-planned reform implementation roadmap. This report provides a background analysis and a number of reform options to tackle the pending issues with the broad objective of assisting Croatia’s government in designing a comprehensive reform program.



# 03 Vertical Structure of Government and Trends in Fiscal Decentralization



### 3.1. Vertical structure

Croatia is a unitary country, administratively divided into 21 regional (county level) and 556 LGUs (table 3.1). The 21 counties (including the 780,000-inhabitant city of Zagreb, which has county status) constitute the second, or intermediate, level of subnational government, that is, *regional self-government*. Cities (127, mainly urban, altogether comprising 3 million people) and municipalities (428, mainly rural, comprising 1.3 million people) represent the first level of subnational government, that is, *local self-government*.

**Table 3.1.** The Vertical Structure of the Croatian Public Sector

TIER	UNITS (1992)	UNITS (2011)	TIER	POPULATION (IN MILLION)	UNITS PER MIL.CITIZENS	UNITS PER 1,000 KM <sup>2</sup>
Central government	1	1		4.3	-	-
Counties	21	21	II	4.3	4.9	0.4
Cities	70	127	I	3.0	42.3	2.2
Municipalities	419	429		1.3	330.0	7.6
Cities and municipalities	489	556	I	4.3	129.3	9.8

Note: In 2013, the municipality of Popovača was transformed into a city; the data for 2011 show 429 (instead of 428) municipalities and 127 (instead of 128) cities.

Source: Authors calculations, based Croatian Bureau of Statistics (2012).

Municipalities are established along the territory of more populated places that represent a natural economic and social entity and are linked by the common interests of the population. A city may be an LGU with the county seat or any town with more than 10,000 inhabitants, representing an urban, historic, natural, economic, or social entity. A county is a unit of regional self-government whose territory represents a natural, historic, transport, economic, or social self-governing entity.

The counties, cities, and municipalities regulate their internal organization, structure, and operations through their own statutes. LRGUs have a representative and executive body. The representative body is the municipal council, city council, and county assembly. In Zagreb, as a special status unit—a city with county status—the representative body is the City Assembly. Members of the representative bodies are elected in local elections by secret ballot. Local elections with a proportional electoral system are held every four years,<sup>6</sup> whereby the candidates have to pass a threshold of 5 percent to qualify. Although there is a strong domination of two political parties, HDZ (*Hrvatska demokratska zajednica* (in English, the Croatian Democratic Union) and SDP (*Socijaldemokratska Partija Hrvatske*, the Social-Democrat Party), local elections are pluralistic, with many small regional parties and independent local candidates running for county, city, or municipal offices. The executive body is the municipal chief, the city mayor, and the county prefect, which, since 2009, have been directly elected by secret ballot.

<sup>6</sup> The first local elections in Croatia were held in February 1993.

The chairperson recommends members of the executive authority of the LRGU to the representative body, which selects them by a majority vote. Sessions of the LRGUs' representative bodies are open to the public.

### ADMINISTRATION OF LRGUS

Administrative departments and services (administrative bodies) are organized to perform tasks within the self-governing scope of the LRGU as well as the entrusted tasks of the state administration. In municipalities and cities with up to 3,000 inhabitants, a single administrative department is set up to carry out all tasks within the scope of self-government, and in larger municipalities and cities, a single administrative department can be established. The organization of administrative bodies is regulated by a general act of the LRGUs in accordance with statute and law. The administrative bodies are governed by heads appointed by the municipal chief, city mayor, or county prefect based on public competition (Law on Local and Regional Self-Government, OG 33/01, 60/01, 129/05, 109/07, 125/08, 36/09, 36/09, 150/11, 144/12, 19/13, 137/15, 123/17, 98/19).

The Law on Local and Regional Self-Government (OG 33/01, 60/01, 129/05, 109/07, 125/08, 36/09, 150/11, 144/12, 19/13, 137/15, 123/17, and 89/19) defines the city of Zagreb, the capital of Croatia, as a separate territorial and administrative unit with a governing structure determined by the Law on the City of Zagreb (OG 62/01, 125/08, 36/09, 119/14, and 98/19). As such, Zagreb has a special status to perform tasks within the self-governing scope of a city and a county. Zagreb is also responsible for the affairs of state administration within the scope of the state administration offices, performed by the city's administrative bodies. When performing these tasks, Zagreb's administrative units have the authority and obligations of state administration bodies in accordance with the law governing the state administration system. Administrative bodies (city offices, institutes, and services) have been established to carry out activities within Zagreb's jurisdiction. Local self-government in Zagreb is organized into 17 city districts represented by city district councils. Residents of the districts elect the council members. There are no other metropolitan areas with this specific status in Croatia.

Since 1993, there have been no significant territorial reforms at the regional level of government, and the number of counties has not changed. Jobs in regional and local administrative bodies (administrative departments and services) are performed by civil servants and state employees. Civil servants perform general, administrative, financial planning, material financial, accounting, IT, and other professional tasks, and state employees do auxiliary technical and other related tasks. Rights, obligations, and responsibilities, as well as other issues important to the work of civil servants and state employees in the administrative bodies of LRGUs, are regulated by the Law on Civil Servants and State Employees in Local and Regional Self-Government (OG 86/08).

Civil servants and state employees are recruited and assigned to the vacancies established by the Ordinance on Internal Organization. The ordinance must be adopted by the municipal chief, city mayor, or county prefect upon the proposal of the heads of administrative bodies separately or in accordance with a joint rulebook for several such bodies. The ordinance determines the internal structure of LRGU administrative bodies, the names and job descriptions of posts, professional and other conditions for post assignments, the number of executors,

and other issues relevant to their work. The admission process can be carried out only in accordance with the established admission plan. The admission plan determines the actual occupancy of posts in the administrative bodies of LRGUs, the required number of civil servants and state employees for the period for which the plan is enacted, and the number of persons for the relevant professional training (Law on Civil Servants and State Employees in the Local and Regional Self-Government, OG 86/08, 61/11, 04/18, 112/19).

### TERRITORIAL FRAGMENTATION

Croatia's administrative-territorial structure is characterized by high levels of fragmentation, with the existence of numerous relatively small local governments that generally have weak fiscal and administrative capacities. Among other issues, this poses a significant lack of economies of scales in the delivery of many public services. Almost two-thirds of municipalities have fewer than 3,000 inhabitants; roughly 9 percent have fewer than 1,000. In 2011, 46 municipalities had a slightly larger population (between 5,000 and 10,000), while only seven had over 10,000 inhabitants (see table 3.2).

**Table 3.2.** Population of Municipalities in 2011

	MUNICIPALITIES	POPULATION	% MUNICIPALITIES	CUMUL. % MUNICIPALITIES	% POPULATION	CUMUL. % POPULATION
< 1,001	37	27,321	8.6	8.6	2.2	2.2
1,001 – 1,500	49	62,122	11.4	20.0	4.9	7.1
1,501 – 2,000	71	125,659	16.6	36.6	9.9	17.0
2,001 – 2,500	63	139,421	14.7	51.3	11.0	28.0
2,501 – 3,000	56	155,295	13.1	64.4	12.2	40.2
3,001 – 3,500	29	95,459	6.8	71.2	7.5	47.7
3,501 – 4,000	35	131,194	8.2	79.4	10.3	58.0
4,001 – 4,500	15	63,341	3.5	82.9	5.0	63.0
4,501 – 5,000	21	98,803	4.9	87.8	7.8	70.8
5,001 – 6,000	24	130,497	5.6	93.4	10.3	81.1
6,001 – 7,000	13	85,702	3.0	96.4	6.8	87.9
7,001 – 15,000	16	153,938	3.6	100.0	12.1	100.0
Total	429	1,268,752	100.0		100.0	

Source: Authors, based on the Croatian Bureau of Statistics (2012).

As noted above, city status requires that the LGU be located in the county seat or that it have more than 10,000 inhabitants and represent an urban, historic, natural, economic, and/or social entity. However, cities in Croatia are relatively small, and almost half have fewer than 10,000 inhabitants. In 2011, when the last census was taken, 71 percent of cities had populations under 15,000 inhabitants, and 18 had fewer than 5,000. However, nine cities had more than 50,000 inhabitants, and four had more than 100,000 (see table 3.3).

**Table 3.3.** Population of Cities in 2011

	CITIES	POPULATION	% CITIES	CUMULATIVE % CITIES	% POPULATION	CUMULATIVE % POPULATION
< 5,001	18	59,681	14.1	14.10	2.0	2.00
5,001 – 10,000	42	296,726	33.1	47.20	9.8	11.80
10,001 – 15,000	30	372,587	23.6	70.80	12.4	24.20
15,001 – 20,000	8	132,465	6.3	77.10	4.4	28.60
20,001 – 30,000	11	272,599	8.7	85.80	9.0	37.60
30,001 – 40,000	4	142,466	3.1	88.90	4.7	42.30
40,001 – 50,000	5	223,937	3.9	92.80	7.4	49.70
50,001 – 60,000	3	172,306	2.4	95.20	5.7	55.40
60,001 – 70,000	1	63,517	0.8	96.00	2.1	57.50
70,001 – 80,000	1	75,062	0.8	96.80	2.5	60.00
100,001 – 200,000	3	414,774	2.4	99.20	13.8	73.80
> 200,000	1	790,017	0.8	100.00	26.2	100.00
Total	127	3,016,137	100.0		100.0	

Source: Authors, based on Croatian Bureau of Statistics (2012).

The vertical structure of government in the majority of EU countries consists of several tiers (table 3.4).<sup>7</sup> However, countries with smaller territories, such as Bulgaria, Cyprus, Estonia, Ireland, Latvia, Lithuania, Luxembourg, Malta, and Slovenia, have only one subnational level. Several countries, including Belgium, Germany, Spain, France, Poland, and the United Kingdom, have three subnational tiers of government. The majority of (13) EU countries, including Croatia, have two subnational tiers (local and regional).

<sup>7</sup> For details and country specifics (notes) see Annex 1.



**Table 3.4.** Number of Subnational Governments (2018–19)

	LOCAL LEVEL	INTERMEDIARY LEVEL	REGIONAL OR STATE LEVEL	TOTAL
<b>FEDERATIONS AND QUASI FEDERATIONS</b>				
<b>Austria</b>	2,096		9	2,105
<b>Belgium</b>	581	10	6	597
<b>Germany</b>	11,014	401	16	11,431
<b>Spain</b>	8,131	50	17	8,198
<b>UNITARY COUNTRIES</b>				
<b>Bulgaria</b>	265			265
<b>Croatia</b>	556		21	577
<b>Cyprus</b>	380			380
<b>Czech Republic</b>	6,258		14	6,272
<b>Denmark</b>	98		5	103
<b>Estonia</b>	79			79
<b>Finland</b>	311		1	312
<b>France</b>	34,970	101	18	35,089
<b>Greece</b>	325		13	338
<b>Hungary</b>	3,178		19	3,197
<b>Ireland</b>	31			31
<b>Italy</b>	7,926		20	7,946
<b>Latvia</b>	119			119
<b>Lithuania</b>	60			60
<b>Luxembourg</b>	102			102
<b>Malta</b>	68			68
<b>Netherlands</b>	355		12	367
<b>Poland</b>	2,477	380	16	2,873
<b>Portugal</b>	308		2	310
<b>Romania</b>	3,181		42	3,223
<b>Slovak Republic</b>	2,929		8	2,937
<b>Slovenia</b>	212			212
<b>Sweden</b>	290		21	311
<b>United Kingdom</b>	382	35	3	420
<b>EU 28</b>	86,682	977	263	87,922

Source: OECD and EC (2018).

Although Croatia is considered to be a very fragmented country, there are many EU countries with more LGUs, both in relation to the number of inhabitants and the area (table 3.5). In terms of the number of LGUs per 100,000 inhabitants, Croatia compares to Germany and Italy, whereas Austria, Spain, Cyprus, the Czech Republic, France, Hungary, Luxembourg, Malta, Romania, and Slovakia have a greater number than Croatia. Croatia's number of 13.5 is also lower than the EU28 average, which is 16.9. When it comes to the average LGU area (land in square kilometers over the number of LGUs), Croatia does even better. With an average LGU area of 102 square kilometers, larger LGUs (on average) exist only in Bulgaria, Denmark, Estonia, Finland, Greece, Ireland, Latvia, Lithuania, Netherlands, Poland, Portugal, Sweden, and the United Kingdom.<sup>8</sup> The EU28 average is 52 square kilometers per LGU.

**Table 3.5.** Fragmentation in EU Countries (2018–19)

	AREA (KM <sup>2</sup> )*	INHABITANTS (THOUSANDS)**	AVERAGE LGU SIZE (NUMBER OF INHABITANTS)	AVERAGE NUMBER OF LGUS PER 100,000 INHABITANTS	AVERAGE LGU AREA (KM <sup>2</sup> )
<b>FEDERATIONS AND QUASI FEDERATIONS</b>					
<b>Austria</b>	83,878	8,822	4,209	23.8	40
<b>Belgium</b>	30,666	11,399	19,620	5.1	53
<b>Germany</b>	357,569	82,792	7,517	13.3	32
<b>Spain</b>	505,983	46,658	5,738	17.4	62
<b>UNITARY COUNTRIES</b>					
<b>Bulgaria</b>	110,996	7,050	26,604	3.8	419
<b>Croatia</b>	56,594	4,105	7,383	13.5	102
<b>Cyprus</b>	5,695	864	2,274	44.0	15
<b>Czechia</b>	78,871	10,610	1,695	59.0	13
<b>Denmark</b>	42,925	5,781	58,990	1.7	438
<b>Estonia</b>	45,336	1,319	16,696	6.0	574
<b>Finland</b>	338,411	5,513	17,727	5.6	1,088
<b>France<sup>1</sup></b>	638,475	66,926	1,914	52.3	18
<b>Greece</b>	131,694	10,741	33,049	3.0	405
<b>Hungary</b>	93,012	9,778	3,077	32.5	29
<b>Ireland</b>	69,947	4,830	155,806	0.6	2,256
<b>Italy</b>	302,073	60,484	7,631	13.1	38
<b>Latvia</b>	64,586	1,934	16,252	6.2	543
<b>Lithuania</b>	65,284	2,809	46,817	2.1	1,088
<b>Luxembourg</b>	2,595	602	5,902	16.9	25

<sup>8</sup> Data are presented for the years 2018–19 when the United Kingdom was still part of the EU.

	AREA (KM <sup>2</sup> )*	INHABITANTS (THOUSANDS)**	AVERAGE LGU SIZE (NUMBER OF INHABITANTS)	AVERAGE NUMBER OF LGUS PER 100,000 INHABITANTS	AVERAGE LGU AREA (KM <sup>2</sup> )
<b>Malta</b>	316	476	7,000	14.3	5
<b>Netherlands</b>	37,378	17,181	48,397	2.1	105
<b>Poland</b>	311,928	37,977	15,332	6.5	126
<b>Portugal</b>	92,227	10,291	33,412	3.0	299
<b>Romania</b>	238,398	19,531	6,140	16.3	75
<b>Slovakia</b>	49,035	5,443	1,858	53.8	17
<b>Slovenia</b>	20,273	2,067	9,750	10.3	96
<b>Sweden</b>	447,424	10,120	34,897	2.9	1.543
<b>United Kingdom</b>	244,424	66,274	173,492	0.6	640
<b>EU 28</b>	4,465,993	512,379	5,911	16.9	52

Notes: \*Total surface area, including land area and inland waters (lakes, rivers, etc.). Eurostat data as of 2016. \*\*OECD and EU national accounts database (main aggregates). Total area and population include the five French outermost regions.

Source: Authors' calculations, based on OECD and EC (2018) and Eurostat data.

These findings are also reflected in the structure of municipalities by population size (table 3.6). The majority (more than 50 percent) of municipalities in Austria, Germany, Spain, Cyprus, the Czech Republic, France, Hungary, and Slovakia have fewer than 2,000 inhabitants, whereas this applies to only 29 percent of Croatian municipalities. However, there are countries, such as Denmark, Ireland, Lithuania, Netherlands, and the United Kingdom, in which more than half of the municipalities have more than 20,000 inhabitants.

**Table 3.6.** Structure of Municipalities by Population Size (% of all municipalities)

	FEWER THAN 2,000 INHABITANTS	2,000–4,999 INHABITANTS	5,000–19,999 INHABITANTS	20,000 OR MORE INHABITANTS
<b>FEDERATIONS AND QUASI-FEDERATIONS</b>				
<b>Austria</b>	55	33	11	1
<b>Belgium</b>	1	11	62	26
<b>Germany</b>	54	20	20	6
<b>Spain</b>	72	12	11	5
<b>UNITARY COUNTRIES</b>				
<b>Bulgaria</b>	3	17	54	26
<b>Croatia</b>	29	42	24	5

	FEWER THAN 2,000 INHABITANTS	2,000–4,999 INHABITANTS	5,000–19,999 INHABITANTS	20,000 OR MORE INHABITANTS
<b>Cyprus</b>	83	9	6	2
<b>Czech Republic</b>	89	7	3	1
<b>Denmark</b>	1	2	5	92
<b>Estonia</b>	5	16	70	9
<b>Finland</b>	15	30	38	18
<b>France</b>	85	9	5	1
<b>Greece</b>	8	7	35	50
<b>Hungary</b>	77	15	7	2
<b>Ireland</b>	0	0	0	100
<b>Italy</b>	44	26	24	7
<b>Latvia</b>	5	35	40	19
<b>Lithuania</b>	0	3	27	70
<b>Luxembourg</b>	26	44	25	4
<b>Malta</b>	15	40	40	6
<b>Netherlands</b>	1	1	21	77
<b>Poland</b>	1	25	60	14
<b>Portugal</b>	1	14	46	40
<b>Romania</b>	23	53	21	3
<b>Slovak Republic</b>	84	11	4	2
<b>Slovenia</b>	13	39	40	8
<b>Sweden</b>	0	5	52	42
<b>United Kingdom</b>	0	0	2	98
<b>EU28</b>	28	19	27	26

Source: OECD and EC (2018).

It is also interesting to see how Croatia compares, in terms of fragmentation, with countries from the South East Europe (SEE) region. In table 3.7, it can be seen that SEE countries are, in general, less fragmented. Only Moldova and Romania have smaller LGUs than Croatia in terms of population size (number of inhabitants), whereas average LGU size by area (in square kilometers) is lower in Slovenia.

**Table 3.7.** Subnational Governments in SEE Countries in 2019

COUNTRY	NO. OF LGUS	AVERAGE LGU SIZE, NO. OF INHABITANTS	AVERAGE LGU SIZE, IN SQ. KM	% OF POPUL. LIVING IN CAPITAL CITIES	LEVELS OF GOV.	NO. OF SECOND-TIER UNITS
<b>Albania</b>	61	47,054	471	20.5	2	12
<b>B&amp;H</b>	144	24,417	356	13.9	3	11
<b>Bulgaria</b>	265	26,038	416	19.1	1	
<b>Croatia</b>	556	7,383	102	19.3	2	20
<b>Kosovo</b>	38	46,935	287	11.2	1	
<b>North Macedonia</b>	81	25,621	317	24.4	1	
<b>Moldova</b>	898	3,950	38	16.6	3	32
<b>Montenegro</b>	25	24,894	552	29.9	1	
<b>Romania</b>	3,181	6,103	75	9.4	2	42
<b>Serbia</b>	145	48,286	609	22.5	2	24
<b>Slovenia</b>	212	9,749	95	13.3	1	
<b>Turkey</b>	1,398	59,481	583	6.8	3	793

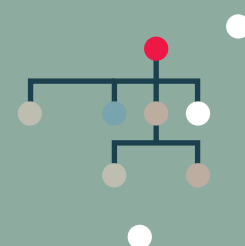
Source: NALAS (2020).

### Box 3.1.

## Models of Hierarchical Relations among Subnational Governments

In international experience (including developed and developing countries, with constitutional federal and unitary regimes), there are two main models of fiscal interrelationships among the different levels or tiers of government: (i) the hierarchical model and (ii) the bifurcated model. Many countries use a combination of both designs, but most often with the predominance of one of the models over the other.

In the case of the *hierarchical model*, the central or federal government interacts exclusively with the intermediate level of government (provinces, regions, or states) and never or almost never does so directly with the lower levels (local, municipal, or district governments). In the hierarchical model, only the regional governments interact directly with the local governments located within their boundaries. Most if not all policies of the central authorities that may ultimately have a local impact go through the intermediate level of government. These hierarchical flows extend to most or all aspects of intergovernmental fiscal relations, from functional coordination to revenue sharing or the design of equalization grants and conditional grant programs.



It should be noted here that the brief overview of different indicators of fragmentation presented in the tables above could be misleading, so these figures should be interpreted with caution. Although the ratios of the number of LGUs per capita or per unit of area can be revealing, the question of fragmentation, in essence, is really a financial/fiscal one. Regardless of how big or small LGUs are in terms of population or area, if they have enough capacity to provide public services and promote local development and growth, their size does not really matter. However, in Croatia, many small LGUs do not have such capacities, and a significant share of their current expenditure goes to employee salaries. These units do not appear to have sufficient capacity to perform basic public service delivery, and their growth and development potential is severely lacking. More specifically, their administrative capacities are weak and cannot support local development (through, for example, strategic planning, capital investments and development of infrastructure, digitalization, absorption of EU funds, use of advanced financing models, etc.).

Currently there is no legislation in Croatia that promotes the association of several LGUs to enable them to reach a minimum scale and thereby provide services more efficiently. However, two or more LGUs may organize the performance of individual tasks within their self-governing scope jointly, especially for the purpose of preparing EU-funded projects. To do this, LGUs may establish a joint body, administrative department or service, or company, or they may jointly organize their operations in accordance with special laws. The mutual relations of LGUs in the joint organization of tasks within the scope of their self-government are regulated by a special agreement in accordance with the law and their statutes and general acts.

More generally, subnational administrative units are also free to organize themselves and participate in general government associations, which exist in Croatia at all levels of government: the Croatian Association of Municipalities, the Association of Cities, and the Croatian County Association (see box 3.2).

In contrast, in the *bifurcated model*, there is no direct hierarchical relationship between the intermediate or regional level of government and the lower tiers of government. In this case, the central government implements separate systems of relations with the regional and local governments. All these bifurcated flows extend to most if not all aspects of intergovernmental fiscal relations, from functional coordination to revenue sharing, the design of equalization grants, conditional grant programs, and so on.

The presence of the hierarchical model is common in federal countries, because most federal constitutions explicitly recognize the powers emanating from the states and federal government, while local governments are either not explicitly mentioned or are simply considered to be dependent on the states. The hierarchical system is also frequently found in unitary countries, sometimes with past histories of strong centralization. Thus, decentralization systems as diverse as those in the United States and China can be considered hierarchical. Bifurcated systems are most common in loosely defined unitary countries, with varied examples, such as Poland, Spain, and the United Kingdom in the EU and Ukraine in Eastern Europe.

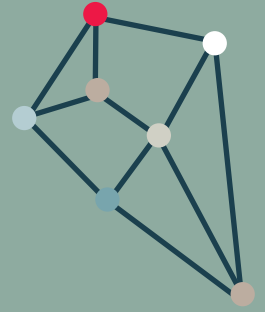
## Box 3.2. LRGU Associations

The Croatian Association (or Community) of Municipalities is a nonprofit, nongovernmental, and nonpartisan organization, based on the principle of voluntary association, established by Croatian municipalities with the aim of promoting and protecting their interests. It was established in 2002 in Zagreb, according to the provisions of the Law on Associations and the Law on Local and Regional Self-Government, which enables LGUs to establish associations to promote and pursue common interests. In 2020, the Croatian Association of Municipalities included 328 municipalities from all 20 counties. The community encourages cooperation and the exchange of experiences; promotes interesting features in the economic, cultural, and other aspects of the life and work of municipalities; monitors legislation related to local self-government; conducts trainings for the professional development of officials and employees in municipal bodies; organizes meetings to consider issues of interest to municipalities; promotes and represents the interests of municipalities before central government bodies and other institutions; provides assistance to members in establishing and implementing cooperation with municipalities outside the country; cooperates with related domestic and international organizations; and disseminates relevant publications.

The Association of Cities is a national, nonpartisan association of cities founded in 2002 with the aim of encouraging cooperation among LGUs and promoting the common interests of cities in Croatia. The association has 126 members and finances its activities from membership fees, EU funds, international grants, registration fees from professional meetings, donations, and so forth. Each member city is represented by the mayor. The key goals of the association are the decentralization of power and finances from the central government to cities, the public promotion of LGU interests, and the encouragement of cooperation among LGUs.

The Croatian Community of Counties is an association established to promote regional self-government and to encourage and support the social and economic development of regional self-government units in Croatia. The aim is to promote cooperation among counties and LGUs in their area, as well as to harmonize the views and actions of members in relation to government and administration on issues important for the development of regional self-government.

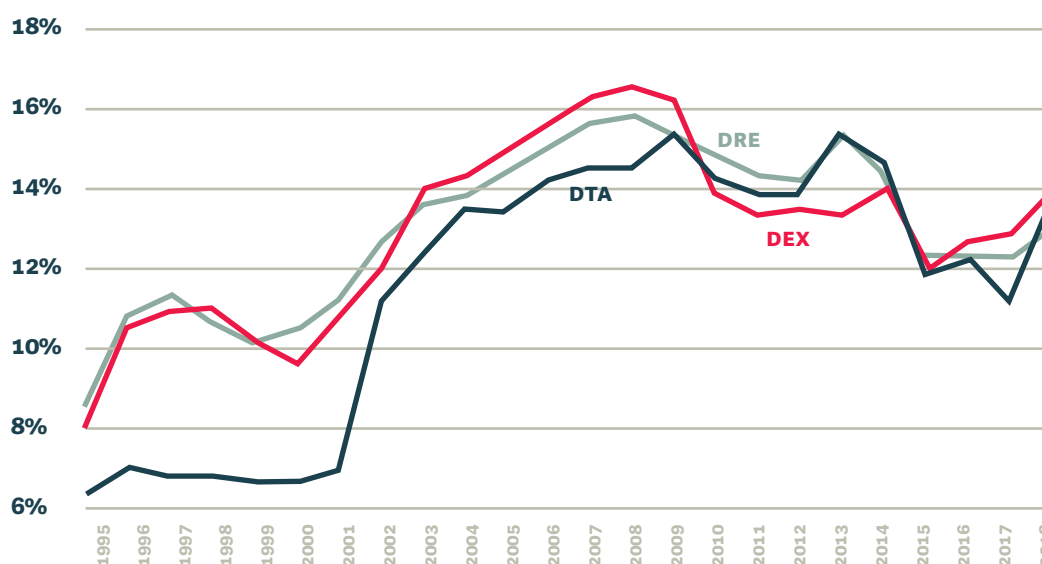
The activities that all of these associations generally perform to achieve their goals include: monitoring the work of the Croatian Parliament, the government, and relevant ministries; studying, analyzing, and researching issues of importance to LRGUs; drafting new laws or amending laws at the suggestion of members; assessing the effects of laws and regulations on LRGUs; providing opinions and proposals on laws and other social relations of local and regional significance; lobbying for amendments to laws; organizing meetings to discuss common problems among municipalities, cities, and counties; and advising their members.



### 3.2. Overall level of fiscal decentralization

The process of fiscal decentralization in Croatia has been underway since 2001. The evolution of this process can be monitored by examining some of the conventional indicators of fiscal decentralization: the ratio of revenues and expenditures of counties, cities, and municipalities in total general government revenues and expenditures or as a percent of GDP. As shown in figure 3.1, a sharp increase in the decentralization of tax revenue was recorded in 2002, when this measure increased to 11.3 percent from 7 percent the previous year. This was followed by a much milder, but mostly continuous upward trend to the peak level of 15.4 percent in 2009 and 2013. The indicators for expenditure and tax decentralization have followed similar patterns.

**Figure 3.1.** Fiscal Decentralization Coefficients in Croatia from 1995 to 2018



Note: DRE: the ratio of total revenue of subnational to general government; DEX: the ratio of total expenditure of subnational to general government; DTA: the ratio of total tax revenue of subnational to general government.

Source: Authors' calculations, based on data from the Report on Revenues and Expenditures, Receipts and Expenses (Form PR-RAS) for the years 1995–2018.

At the end of the observed period, all decentralization indicators declined. This was first due to the asymmetric effects of the 2008 international financial crisis and then to the asymmetry in the collection of tax revenues between the central government and LRGUs, which increased in line with the subsequent economic recovery. With a view to exercising greater control over the collection and spending of financial resources, the central government has slightly centralized revenues and expenditures through several fiscal policy measures. This could be seen as justified because macroeconomic stabilization is one of the basic functions of the central government, which can be very difficult to decentralize (much like the redistribution function).

As a result of the financial crisis, public sector revenues have generally declined, and the government has offset some of the tax revenue decreases through interventions on the revenue

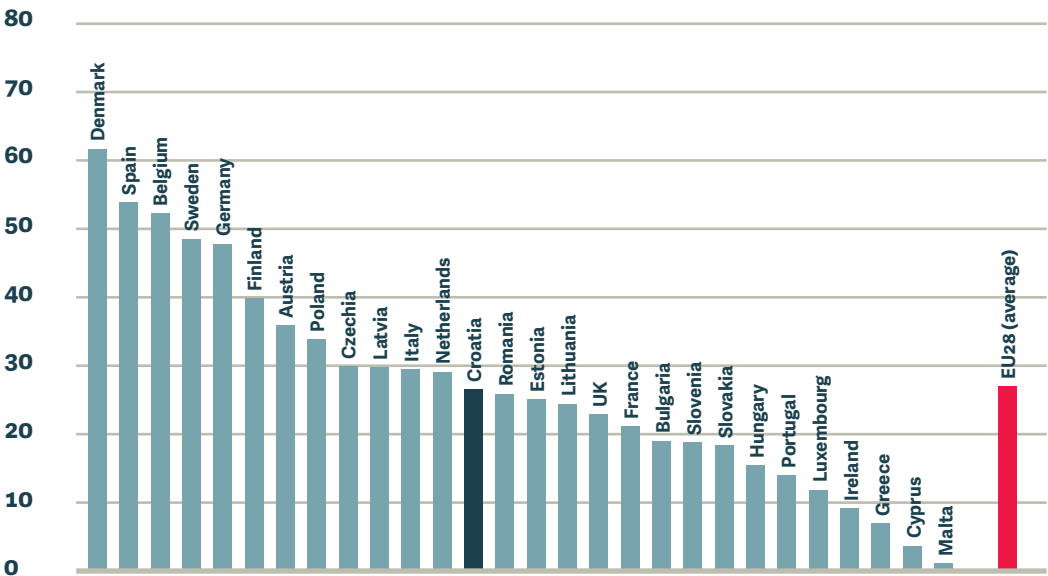


side of the budget (for example, by increasing the value added tax (VAT) rate), which was not the case at the local level. Compared to the relatively smaller decrease in central tax revenues, the decline in local government tax revenues has decreased the share of local government tax and total revenues in general government revenues, that is, decreased the degree of decentralization of tax and total revenues. The same holds for the expenditure side. Since 2014, frequent central government reforms to reduce the burden of PIT, which is the most important source of revenue for LRGUs, have also had a negative impact on LRGU budgets.

However, since the beginning of 2018, with the new Law on Financing Local and Regional Self-Government Units (OG 127/17), significant changes have been made to the system of LRGU financing, leading to an inversion of the negative trends in the share of local revenues in total general government revenue. Particularly significant changes included the complete transfer of the PIT (and all its fractions) to the LRGUs and a shift in the financing of equalization grants for decentralized functions, which were until then secured from the central government share of the PIT, to a share of the central government general budget revenues. Such measures resulted in raising LRGU revenue by roughly HRK 2 billion. In addition, it is important to note that the new financing system has significantly reduced horizontal fiscal disparities among LRGUs.

In order to gain relative insight into the intensity of fiscal decentralization in Croatia, it is helpful to look at the decentralization coefficients compared to those in other European countries. The position of Croatia within other EU member states is presented in figure 3.2 in the share of subnational revenues in general government revenues in 2019. By this measure, Croatia appears to be slightly less decentralized (revenue decentralization coefficient of 26.5) than the EU average (27). The most decentralized countries in this respect are Denmark, Spain, and Belgium, whereas the least decentralized are Malta, Cyprus, and Greece.

**Figure 3.2.** Decentralization of Revenue in EU Countries in 2019 (in %)

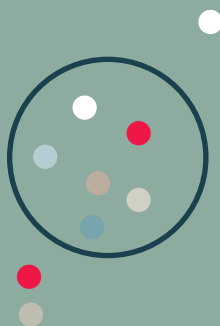


Note: Decentralization of revenue is calculated as a ratio of subnational government revenue and total general government revenue.

Source: Authors, based on Eurostat data.

However, it should be noted that Eurostat's methodology for defining subnational government revenue is different from the methodology applied at the national level in Croatia and is based on a broader scope (see box 3.3). Therefore, the indicators of the level of decentralization are slightly higher than those of the Croatian Ministry of Finance (MOF) presented in figure 3.1. Nevertheless, despite the methodological differences, it can be argued that the level of decentralization measured by the share of subnational revenues in total general government revenues in Croatia is below the average for EU countries.

### Box 3.3. Methodological Scope of the Subnational Sector



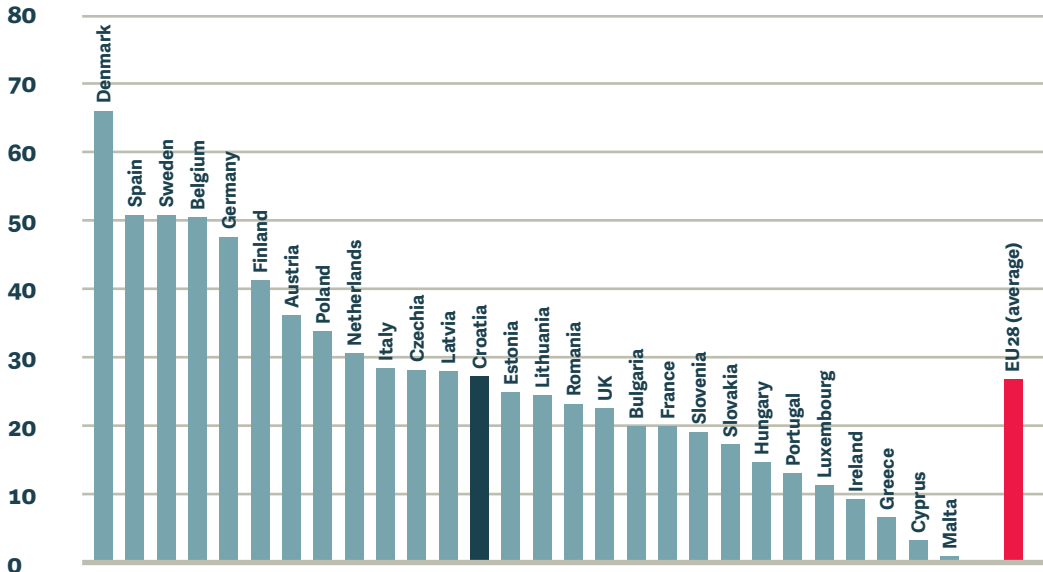
According to the European System of Accounts (ESA) 2010, paragraph 20.65, local government is defined as follows. The local government (excluding social security) subsector (S.1313) consists of government units having a local sphere of competence (with the possible exception of social security units). Local governments typically provide a wide range of services to local residents, some of which may be financed out of grants from higher levels of government. Statistics for local government cover a wide variety of governmental units, such as counties, municipalities, cities, towns, townships, boroughs, school districts, and water or sanitation districts. Often, LGUs with different functional responsibilities have authority over the same geographic areas. For example, separate government units representing a town, a county, and a school district have authority over the same area. In addition, two or more contiguous local governments may organize a government unit with regional authority that is accountable to local governments. Such units are classified to the local government subsector.

In Croatia, the local government subsector includes the total coverage of budgets of local units (city of Zagreb, 20 counties, 428 municipalities, and 127 cities) and their budgetary users (e.g., hospitals, schools, kindergartens) and extra-budgetary users, like county road authorities. There are some units that were reclassified into S.1313 according to qualitative aspects, due to which a 50 percent test was done (i.e., units in liquidation and utility services companies).

Similar patterns are shown for the degree of fiscal decentralization in Croatia compared to EU countries when measured by the share of subnational expenditures in general government expenditures in 2019 (figure 3.3). However, according to the expenditure decentralization coefficient, Croatia is a bit more decentralized (coefficient of 27.4) than the EU average (27). The most decentralized country in this respect is Denmark, followed by Spain, Sweden, and Belgium, whereas the least decentralized are again Malta, Cyprus, and Greece.<sup>9</sup>

<sup>9</sup> The decentralization coefficient can also be calculated for each public function according to the Classification of Functions of Government (COFOG) to show whether the provision is decentralized (see Annex 2 for EU countries).

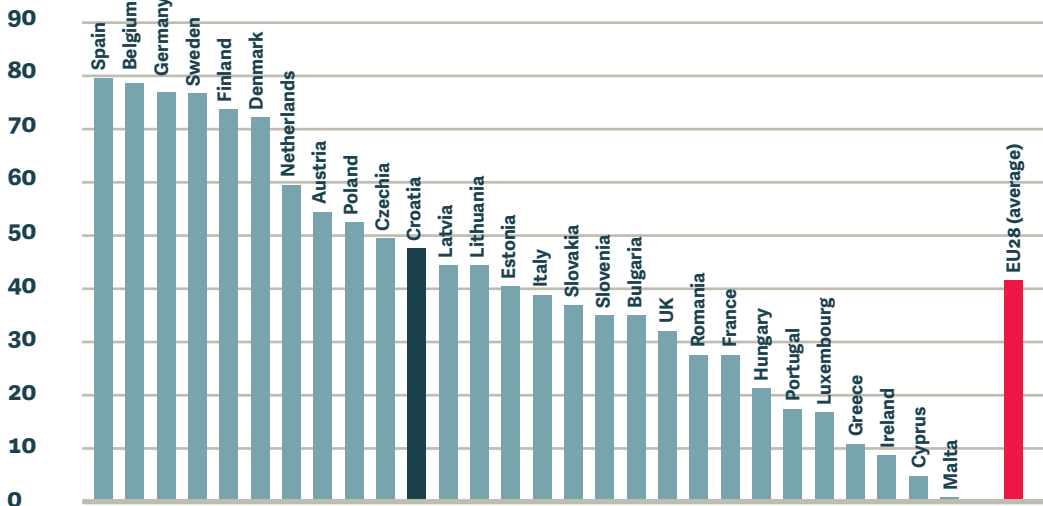
**Figure 3.3.** Decentralization of Expenditure in EU Countries in 2019 (in %)



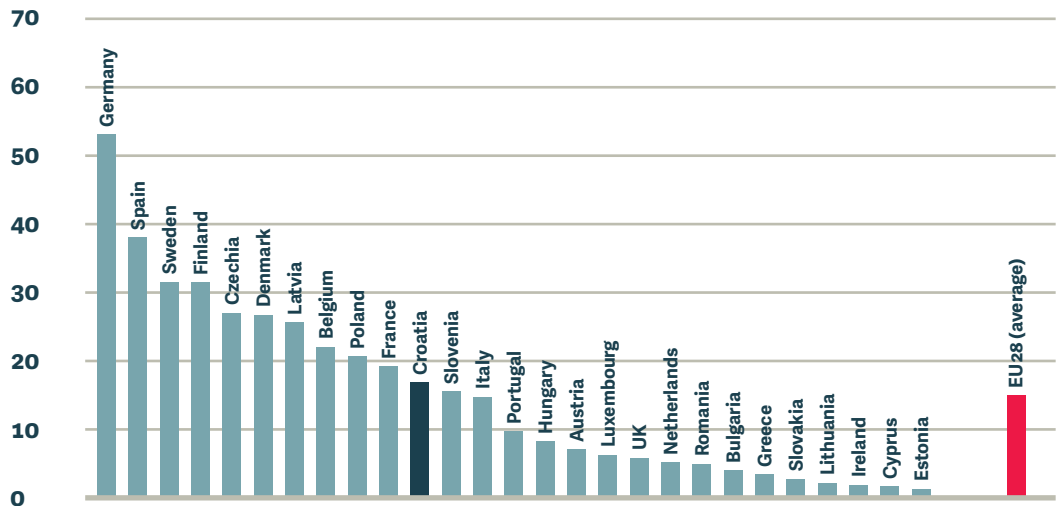
Note: Decentralization of expenditure is calculated as a ratio of subnational government expenditure and total general government expenditure.  
 Source: Authors, based on Eurostat data.

Croatia, however, turned out to be above the EU average in terms of the share of subnational and total general government expenditure for employees in 2019 (figure 3.4). This means that the intensity of employment on the subnational level in Croatia is (on average) greater than in other EU countries. The most decentralized EU countries by this measure are Spain and Belgium (Denmark comes only sixth, after Germany, Sweden, and Finland), whereas the least decentralized are Malta, Cyprus, Ireland, and Greece.

**Figure 3.4.** Decentralization of Employees in EU Countries in 2019 (in %)



Note: Decentralization of employees is calculated as a ratio of subnational government expenditure for employees and total general government expenditure for employees.  
 Source: Authors, based on Eurostat data.

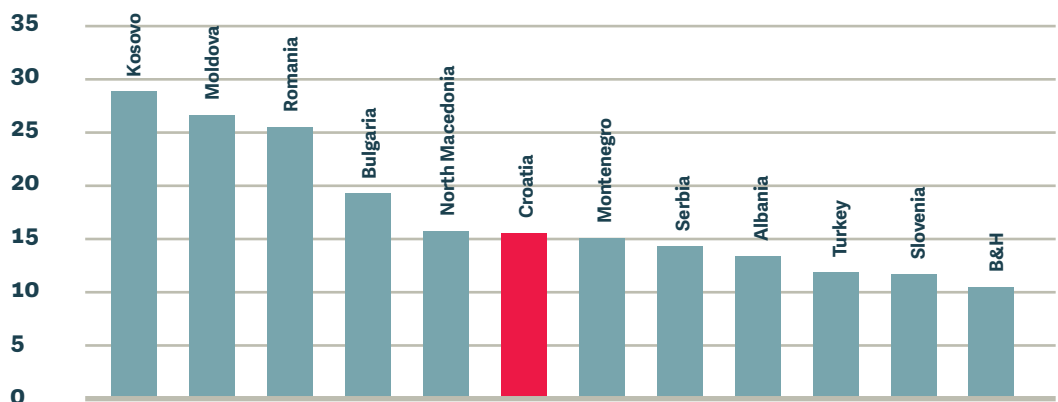
**Figure 3.5.** Decentralization of Taxes in EU Countries in 2018 (in %)

Note: Decentralization of taxes is calculated as a ratio of subnational government tax revenue and total general government tax revenue. Data for local government total tax receipts for Malta not available.

Source: Authors, based on Eurostat data.

The level of the decentralization of taxes measured as a ratio of subnational and total general government tax revenue in Croatia is also slightly higher than the EU average (figure 3.5). The most decentralized country in this context is Germany, and the least decentralized is Estonia. Considering all the presented ratios of decentralization, it can be said that the level of fiscal decentralization in Croatia more or less reflects the EU average.

The revenue decentralization level in Croatia is medium in comparison also to the SEE countries (figure 3.6). The most decentralized are Kosovo and Moldova, and most centralized Bosnia and Herzegovina and Slovenia.

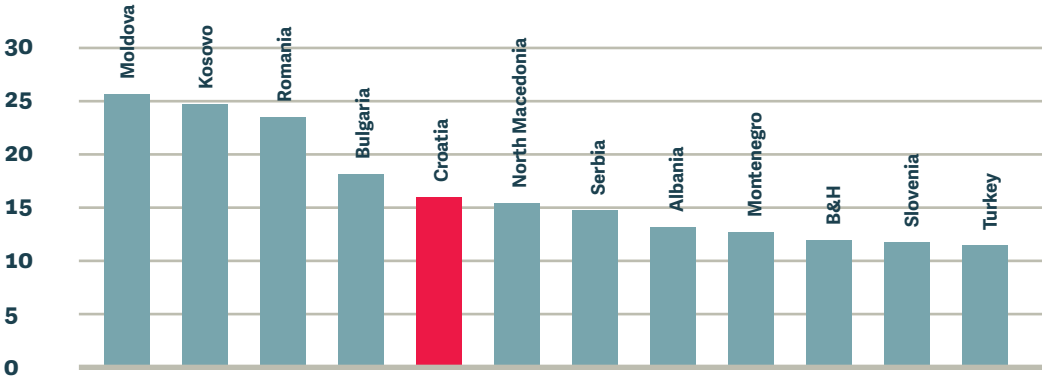
**Figure 3.6.** Decentralization of Revenue in SEE Countries in 2019 (in %)

Note: Decentralization of revenue is calculated as a ratio of subnational government revenue and total general government revenue.

Source: NALAS (2020).

When it comes to expenditure, the most decentralized is Moldova and most centralized is Turkey (figure 3.7). Croatia is again somewhere in the middle of all the observed countries.

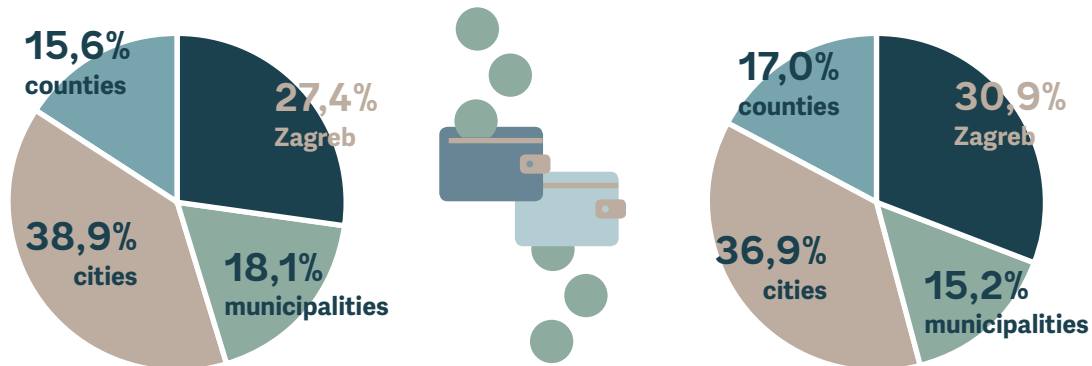
**Figure 3.7.** Decentralization of Expenditure in SEE Countries in 2019 (in %)



Note: Decentralization of expenditure is calculated as a ratio of subnational government expenditure and total general government expenditure.  
 Source: NALAS (2020).

In terms of the vertical composition of budgets, figure 3.8 shows the structure of current revenues and expenditures by level of public authority (counties, municipalities, and cities, as well as Zagreb) for 2018. It shows that cities carry the most fiscal activity in Croatia. Over 66 percent of revenues and 67 percent of expenditures of LRGUs are generated at the city level when Zagreb is included as a city. This is logical, since most of the population lives in cities. In addition, cities have a greater self-government coverage of functions than counties. However, what is particularly important to note is that of the total current revenues of LRGUs, Zagreb captures almost 28 percent. Thus, more than one quarter of all current LRGU revenue is related to the capital city. All municipalities and counties combined together in 2018 generated only slightly more current revenue than Zagreb alone.

**Figure 3.8.** The Structure of Current Revenue (left) and Expenditure (right) by Level of Government in 2018



Source: Authors' calculation, based on data from the 2018 Statement of Revenue and Expenditure, Income and Expense (PR-RAS Form).

### 3.3. Significant policy issues

Subnational government fragmentation is one of the more significant policy issues in Croatia's system of intergovernmental fiscal relations. This, together with the current vertical structure of government, has had negative consequences not only for the financing system but also for the efficiency of supply of local public goods and services, that is, the quality and quantity of provision for the assigned local public functions. A good share of cities and most municipalities would appear not to have the managerial, human, fiscal, technical, and organizational capacity to successfully perform all entrusted functions. For local governments, fiscal revenues often cover only the cost of operating the basic administration. Many counties are in a similar position. Although constitutionally defined as regions, many counties have never been able to perform a true regional function because of the lack of economies of scale and other similar problems with administrative capacity. (See Annex 3 for details on administrative capacities, with recommendations for improvement through enhanced governance, capacity building, and IT.)

Despite these significant issues with scale and capacity, as is seen above, currently there is no legislation in Croatia that incentivizes, much less mandates, the association of local governments to gain in scale and administrative capacity to better provide public services. On the other hand, as has also been seen, current legislation does enable LGUs to associate in the provision of public services, though this has been especially promoted only for the purpose of preparing EU-funded projects. In the subsection below, international experience on addressing the problems presented by fragmentation is reviewed.

Concerning the overall levels of decentralization, there is no right or wrong system. Croatia is slightly more decentralized than the average EU country. The basic features of intergovernmental fiscal relations in Croatia, as in all countries, are determined by the assignment of expenditure responsibilities for public functions, the sources of funding or assignment of revenue sources for the performance of those functions, and the system of transfers and borrowing rules. Every country tends to make different choices, for better or worse, on the design of each of the pillars of fiscal decentralization, and those for Croatia are reviewed and analyzed in greater detail in the remaining sections of this report.

Nevertheless, decentralization trends since 2001 do reveal important issues concerning the role and position of LRGUs in the consolidated public finances of Croatia. In particular, the continued efforts to balance the consolidated general government's fiscal position and the increasing need for local public goods and services have developed into a continued strain on the subnational government sector. Although the scope of assigned public functions to subnational governments has been expanding and their standard of service provision increasing, their own revenue collection space has been narrowing. These imbalances have particularly affected the less-developed LRGUs, which has likely led to markedly negative long-term socioeconomic outcomes.

These problems have been compounded by an insufficient differentiation of the functions assigned to the different levels of government. This has been only partially mitigated by the decision authorizing large cities to take over some of the functions entrusted to the counties. In spite of the many laws, however, there is still no clear division of function between the levels of government, and almost all functions are financed from both central and LRGU levels.

Moreover, the basic problem remains that many local governments are unable to carry out basic local public functions. It is therefore important to facilitate cooperation and the creation of associations and joint projects at the municipality level, among counties, and between cities and municipalities, thereby allowing for a greater concentration of funds and expertise.

Another problem that has become apparent over the past two decades is the cyclical nature of overall LRGU funding. Fiscal transfers to LRGUs have increased in times of economic prosperity, while in times of crisis, due to significant declines in revenues, especially at the central government level, transfers have declined markedly. These shifts have particularly affected less-developed areas, that is, those that were first defined as ASNCs and then transformed into supported areas and to a certain extent HMAs.

In addition to the asymmetry and pro-cyclicality of the funding system, there has been a lack of institutional stability, which again has hurt the ability of LRGUs to plan adequately and efficiently provide the public services with which they have been charged. Frequent changes to the tax rates and personal allowance tax brackets of the PIT and other tax forms have been carried out often, largely ignoring any repercussions on LRGUs, producing additional burdens on the entire local and regional public sector and creating what are known as negative vertical fiscal externalities (of central government actions on LRGUs). Clearly, some of these changes were necessary and, in some cases, adequate remedial actions were taken. Such was the case in 2007, when the CIT was removed from the list of shared revenues and the loss was offset by an increased LRGU share in the PIT. However, in contrast, a change to the PIT in 2014, which reduced the revenues of all LRGUs, was never redressed. The objective of balancing fiscal horizontal inequalities should not be attained by reducing the revenue autonomy of all LRGUs, which was the case with more recent changes in tax legislation that caused significant reductions in the fiscal potential of some local governments, especially Zagreb's. The horizontal disparities caused by desirably high levels of subnational revenue autonomy can be addressed by strengthening the system of equalization transfers.

### **3.4. International experience and practice in addressing subnational fragmentation**

Although the existence of a large number of relatively small municipalities in some countries, such as France, Italy, Spain, or Switzerland, has historical roots, in other countries, the problem is more recent. For example, the 1992 Law on the Territories of Counties, Cities and Municipalities divided Croatia into 21 counties, including the city of Zagreb, 69 cities, and 421 municipalities and abolished the existing 114 municipalities of the former state. The number of LRGUs in Croatia increased to a total of 556 LGUs (cities and municipalities) by 2020, while the number of counties did not change. Similarly, Hungary's more than 3,000 municipalities were created during the 1990s. Other Eastern European countries, however, such as Bulgaria and Romania, did not experience similar increases during the transition period. In countries outside Europe, such as Indonesia and Peru, the fast increase in the number of municipalities can be traced to significant incentives for municipal fragmentation hidden in the system of transfers, granting minimum equal amounts to all municipalities.

The various empirical studies carried out in many countries show that the vast majority of public services provided at the local level require on average a minimum optimal scale of 10,000 inhabitants, though that varies depending on the type of service.<sup>10</sup> For a small number of public services (e.g., urban transport and brownfields), the optimal minimum population can reach up to 100,000 inhabitants, but for others (e.g., elementary education), it can be as low as 5,000. The problem of municipal fragmentation in many countries typically does not lie so much in the average size of local governments, but in the fact that in many cases, as in Croatia, this average value obscures the fact that there is a significant percentage of suboptimal-sized municipalities.

International experience indicates that other countries that have found themselves in a similar situation have resorted to several types of policy options:

1. introducing or strengthening incentives for the association of small municipalities for more efficient provision of public services (Some countries, like France, have gone further and required the compulsory association of smaller municipalities.)
2. promoting, through incentives, a voluntary amalgamation or merger of small municipalities
3. forcing a merger by law of the municipalities considered to be of suboptimal size
4. relying on the creation of special districts for the inter-municipal provision of large-scale services, or alternatively, enabling some services that require a large minimum size to contract between small and larger contiguous municipalities or to contract those services with a privatized company<sup>11</sup>
5. adopting an asymmetric allocation of spending functions, contingent upon the size and capacities of each level of government
6. allowing and facilitating the (temporary) upward delegation of some local public services to the intermediate level of government

With regard to the first option, the creation of inter-municipal associations or commonwealths of local governments,<sup>12</sup> the appeal is that through this type of cooperation, smaller local governments are allowed access to specialized technologies, equipment, and personnel. However, inefficiencies, such as creating duplication, can also arise to the extent that local governments might continue to provide services in the same competitive area. This could occur, for example, when participating municipalities do not reduce their employee staffing due to legal restrictions or bureaucratic inertia.

Typically, the law on municipalities or some other legislation introduces the possibility of creating commonwealths as an inter-municipal associative form.<sup>13</sup> In Croatia, cooperation between local and regional units is proving to be one of the foundations for improving the state of local self-government. Cooperation is achieved through the joint ownership of utility

<sup>10</sup> See, for example, Martínez-Vázquez and Lago-Peñas (2013).

<sup>11</sup> For example, in the United States, small towns often hire larger local governments or create "special districts" for certain services.

<sup>12</sup> These receive different names around the world. For example, in Spain and Latin America, they are called "*mancomunidades*."

<sup>13</sup> In a broader sense, municipal cooperation could include not only the joint provision of public services by several local governments but also the possible recruitment of one subnational government by another to provide a public service in their territory in exchange for a pre-established payment. The presence of this form of legislation is not a guarantee of success, however. For example, in Latin America, in countries such as Argentina, Guatemala, and Peru, commonwealths are recognized but have not flourished; Bolivia is an exception, where there are about 100 commonwealths that receive financial support and preferential treatment in public planning and investment systems by the central government.



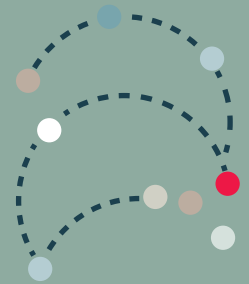
companies (e.g., garbage collection or water supply companies, etc.) or simply in an ad hoc manner, without any written agreement, meaning that there is no mechanism for monitoring and recording it. Thus, cooperation mechanisms already exist but are very often informal or based on unreliable political agreements. It is therefore necessary for Croatia to *establish a solid institutional foundation to strengthen existing cooperation efforts*.

One of the obstacles to fully establishing formal inter-municipal cooperation is the weak capacity of LRGUs to take the initiative, and the fact that the central government has never really insisted on the unification of local or regional public services across subnational units. The legal requirements can sometimes also be demanding, for example, requiring popular consultation. Another major drawback to the formation of commonwealths is the lack of guarantees of the stability and continuity of the new institutional arrangement. It may also be that the institutional framework is inflexible and unclear, or that the costs of reaching agreements are very high (for reasons of communication, negotiation, coordination, or monitoring and evaluation). International experience in the use of commonwealths as a solution to local fragmentation is varied, with important lessons to be learned (see box 3.4).

### Box 3.4. International Experience in Inter-Municipal Cooperation

The most common form of cooperation is for the provision of services whose production is capital intensive—those that require heavy investment, such as waste collection and treatment and water supply and channeling. Regional economic development is another frequent goal.

In Europe, there is a wide variety of experience, including in Portugal, France, and Spain, which all promote the formation of commonwealths by means of very precise and developed national legislation. In France, financial incentives to promote cooperation have long been provided, but a law was introduced in 2008 that required all municipalities of a certain size to find contiguous border partners with which to associate. In Spain, there are no substantial financial incentives or mandates, but there is a flexible legal framework that allows municipalities to adapt to new formats and objectives with ease.



Among these lessons, the various incentives and rules for the creation and proper functioning of commonwealths can be highlighted (box 3.5).

### Box 3.5.

## Basic Rules and Incentives for the Creation and Proper Functioning of Municipal Commonwealths



First, *establish, through national legislation, simple and flexible channels* for the creation of incentives. Second, since small municipalities have fewer financial, human, and technical resources, require that the central government and municipal associations provide these municipalities with the necessary *support and technical advice*. In this regard, it would be desirable to ensure that local governments have the required training on the various possibilities for collaboration, such as through the establishment of a specialized center for advice on local cooperation within the orbit of the central government.

Third, introduce ways to *reduce communication and transaction costs to reach agreements and to monitor their proper execution*. This can be achieved, for example, with the provision of standardized model agreements. Fourth, consider the introduction of *positive financial incentives*, for example, (i) providing priority financial treatment to investment projects and/or public services that come from commonwealths; (ii) creating a line of subsidies (or subsidized credits) specifically aimed at financing projects proposed by commonwealth governments, or (iii) creating a system of conditional transfers whose “coverage rate” is higher for projects from commonwealths. Fifth, when private providers are considered, look for ways to *promote competition between the concessionaires* used by the commonwealths.

A second option to solving the problem of municipal fragmentation is to promote, through incentives, the voluntary merger or amalgamation of the smaller municipalities into larger ones. International experience indicates that this approach has generally enjoyed little success, however. European countries, such as France, Spain, or Italy, that have historically experienced high levels of local fragmentation have for many years tested this path with minimal results, even when significant tax advantages were offered. One reason is the political economy of this process. Locally elected officials tend to be extremely reluctant to lose their jobs and positions, while residents, often for very good reasons, fear the loss of representation and accountability associated with becoming part of a larger municipality that may be based in distant places. In short, the lesson that can be drawn from international experience is that the voluntary merger of municipalities is not usually an effective solution.

A third solution is to legally force the municipalities of suboptimal scale to merge. In reality, there are a number of countries that have implemented this measure in recent decades, including the United Kingdom and most of the Nordic countries, such as Denmark, Sweden, and Finland, and more recently, in the wake of the economic crisis, countries such as Greece and Italy. These measures are sometimes implemented at once or in two stages, first through a voluntary merger or fusion period, followed by a final forced unification. Although these forced mergers have been accepted in many of these countries as a solution to historical problems, in many cases the results have not always positive. In some countries, the formation of larger jurisdictions raised the management costs of the new entities, partly due to the lack of job

consolidation and partly to the adoption of higher wages and standards than before consolidation. Forced merger can also limit the use of the advantages of decentralization, not only the greater degree of representation and accountability that decentralization often provides but also the better orientation of public services to the various preferences in the different jurisdictions, thus generally improving social welfare. In short, even if politically feasible, forced mergers must be weighed from an individualized cost-benefit perspective to ensure that savings actually take place in the management of public services.

### Box 3.6.

## Vertical Fragmentation: A Review of the Different Options<sup>14</sup>

Local government fragmentation is quite pervasive across decentralized countries around the world. It is characterized by the presence of a relatively large number of local governments with populations too small to take advantage of economies of scale in the delivery of public services, a lack of administrative capacity and specialized resources, and/or very low tax bases and own revenue potential. Although this phenomenon has long historical roots in some countries, such as France, Italy, Spain, and Switzerland, in other countries the problem is more current, which is the case in Croatia, Hungary, Indonesia, Peru, and South Africa, where it is an outcome of the relatively recent process of decentralization.

International experience shows that while some countries have opted for mergers, others have maintained high levels of fragmentation and chosen other remedies. In the first group, the United Kingdom and most Nordic countries, such as Denmark, Sweden and Finland, and more recently, in the wake of the 2008–09 economic crisis, countries such as Greece, Italy, and Turkey have gone through forced merger or amalgamation programs for local governments. Many of these reforms have successfully addressed the issue of fragmentation, although in some cases, the cost savings have not been too pronounced because of the lack of job reductions or the adoption of higher wages and standards than before consolidation. The main issue to consider with forced mergers is the potential losses in representation and accountability. Other countries, like France, Italy, and Spain, have promoted and incentivized the voluntary merger of local governments, but generally without much success.

There are various other policy options. The most popular and effective is the facilitation and promotion of voluntary associations of small municipalities for the more efficient provision of public services, such as in Italy, Peru, and Spain. In some other cases, as in France, the association of small municipalities has been forced or compulsory. Less frequent measures include creating special districts for the inter-municipal provision of large-scale services or, alternatively, contracting for such services between small and larger contiguous municipalities or with a privatized company, as is the case in Australia, Canada, and the United States. Another solution has been the adoption of an asymmetric allocation of spending functions contingent upon the size and capacities of each level of government, used in such countries as Croatia, Peru, South Africa, and Spain.

<sup>14</sup> For further reading see: Martinez-Vazquez and Lago-Peñas (2013).



The fourth option, the creation of special districts for the inter-municipal provision of large-scale services, can be considered a specialized version of the more general commonwealth solution, one that is commonly used in some regions of North America, such as with the creation of special water and sewage districts.<sup>15</sup> It is also more common for smaller local governments to contract with a larger contiguous one for the provision of certain services that may benefit from a large scale, or for several local governments to do so with a privatized provider.

Fifth, some countries have addressed the issue by creating several tiers of local governments that are assigned, at least in principle, expenditure responsibilities that are affine and congruent with their size and administrative capabilities. Adopting an asymmetric allocation of spending functions contingent upon the size and capacities of each level of government is far from an ideal solution to the issue of local government fragmentation, however. In reality, this approach has already been implemented in part in Croatia with the distinction between cities and municipalities at the local level.

Finally, an alternative option is to allow the upward delegation of certain local functions to a higher level of government. For example, in some parts of Spain, small municipalities delegate some of their functions to the provincial subregional “*diputaciones*.”<sup>16</sup> In other cases, the delegation of functional responsibility is horizontal, from a smaller jurisdiction to an adjoining larger one. For example, in the United States, small municipalities may contract for refuse collection or fire protections services with larger neighboring jurisdictions.

It is obvious that there is no “one size fits all” solution to the problem of vertical fragmentation. Countries have taken various approaches to this issue with more or less successful outcomes. Box 3.6 above provides a synopsis of the various international examples.

### 3.5 Summary and options for reform

Fragmentation is identified as one of the main obstacles to well-functioning subnational government in Croatia. To cope with this problem, the government could consider developing a strategy with a centrally designed program to incentivize (or mandate) the merger or association of local governments for the provision of services, including a capacity support program and financing instruments. The capacity strengthening efforts should be focused mainly on the subnational governments but should also support the central government teams leading these efforts. This reform could be carried out by a task force/commission with representation from relevant ministries like the MOF, Ministry of Regional Development and EU Funds (MRDEUF), and Ministry of Justice and Public Administration (MOJPA). In the short term, the task force could carry out a combination of actions:

- A. Develop a program to incentivize and support associations.
- B. Delegate selected local public services upward to the intermediate level of government (such as investment planning, tax administration, property valuation).

<sup>15</sup> There are also some special districts, such as school districts, that are created to enhance accountability and purpose and as such are not so much the product of optimal size decisions.

<sup>16</sup> *Diputaciones*, or provincial councils, are the administrator and governing body of a province of Spain, an intermediate institution between the municipal and regional governments (*Comunidades Autónomas*), and part of the local government system there.

- C. Develop a tool to assess municipal capacities, particularly for small and medium municipalities (e.g., those with fewer than 10,000 inhabitants), to ascertain their capacity to adequately deliver the minimum public services, as well as to guide a centrally driven technical assistance program. This would include the development of an inventory of the municipal services that are not being adequately provided.

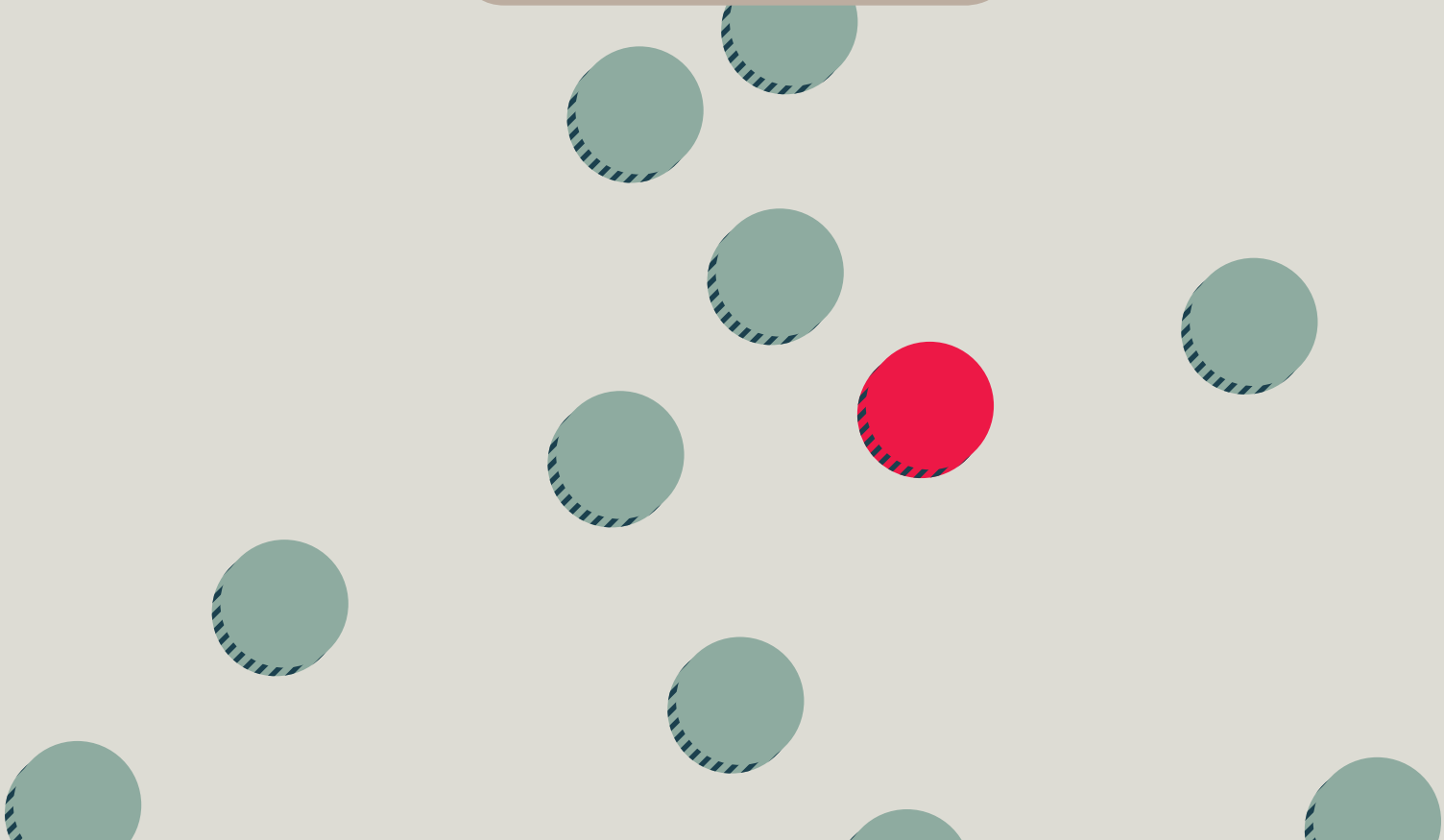
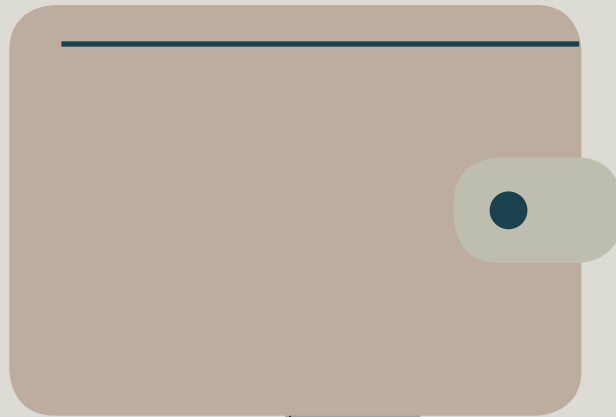
Enhancing cooperation among LGUs, and also between counties and LGUs, is a precondition to more balanced LGU development. Horizontal (inter-municipal) cooperation between LGUs in performing certain tasks together is not sufficiently widespread in Croatia. Joint administrative departments could also be encouraged through the finalization of a legal framework for the horizontal cooperation of LGUs, the preparation of typical cooperation agreements, and the promotion of good practices.

Regarding the potential relationship between counties and municipalities, there are basically two models of vertical organization: (1) hierarchical, where the counties have power over municipalities; or (2) bifurcated, where municipalities do not depend at all on the counties and report to differently identified authorities, and where the MOF and the rest of the central government deal directly with the municipalities, without counties' intermediation. Although older, well-established federal systems and centralized systems have a hierarchical structure, many newly decentralized countries have been adopting bifurcated systems. Given all the characteristics of subnational government in Croatia, as well as the country's historical experiences, the bifurcated system might prove to be the right choice. The efficiency and cost-effectiveness of conducting tasks of local importance could be directed toward forms of inter-city or inter-municipal cooperation, such as joint administrative departments, shared development of utility companies, and other formal forms of collaboration.

Currently, counties in Croatia have too little authority and responsibility. Going forward, counties' authority over municipalities could be better defined through strategies and the integration of certain subregional tasks that municipalities have but are currently performing separately. Although the bifurcated system could be suitable for Croatia, the county/regional level should still be strengthened and play the role of regional coordination body to anchor subnational reform program and support. This would be a good step toward the greater accountability of counties and better functional coordination between the state and LRGUs. Counties need to be capable of becoming fundamental factors in regional development, especially for certain underdeveloped areas within their territory.

One of the ongoing problems regarding the vertical interaction of administrative units relates to the cyclicity of subnational funding, compounded by an asymmetric effect. As noted, fiscal transfers to LRGUs have increased in times of economic prosperity but decreased in times of crisis. In addition, the lack of institutional stability (frequent/regular changes to the rules, including to the taxation and tax sharing schemes) does not help ensure LGUs' long-term fiscal sustainability. To avoid such adverse effects, any new legislation should strive for more permanent rules and institutional frameworks in the medium term. To cope with the problem of vertical fiscal externalities, the government should always compensate LRGUs for decisions made at the central level, but the main priority should be to keep the legislative and institutional framework stable for longer periods of time.

# 04 Functional Expenditure Responsibilities and Actual Expenditure Patterns



## 4.1. Assignment of functions

After the constitutional changes in 2000, the self-governing scope of Croatia's municipalities, cities, and counties was determined by the method of the general clause for residual powers in expenditure assignments. Contrary to the concept of administrative decentralization adopted in the previous period, the constitutional changes recognized the legal personality and autonomy of subnational authorities in decision making and management of their affairs of immediate importance. State control over LRGUs became limited to verifying the constitutionality and legality of their actions. By introducing the method of the general clause, according to which the presumption of authority over local affairs is on the side of subnational units, the range of tasks over which LRGUs have jurisdiction is widely defined. Moreover, LRGUs independently dispose of their own income, are authorized to adopt general acts for their independent internal organization and that of their administrative bodies, and are given the opportunity to cooperate at the national and international levels. Municipalities and cities perform tasks of local importance, and counties perform tasks of regional significance that otherwise are not assigned to state (central government) bodies. This potentially provides a very wide scope of responsibilities.

*The counties* carry out matters of regional consequence, particularly those related to: education, health care, physical and town planning, economic development, traffic and the transportation infrastructure, and the planning and development of the network of educational, health care, welfare, and cultural establishments.

*Cities and municipalities*, in their self-governing area of competence, administer matters of local significance through which the needs of citizens are met directly and that are not by the constitution or law assigned to state bodies. Specifically, they are responsible for carrying out the following assignments: housing, physical and town planning, communal economy matters, child care, welfare, primary health care, preschool and elementary school education, culture, physical recreation and sports, protection and improvement of the environment, and civilian and fire protection. Solely from comparing the functions of cities and municipalities stipulated in the law to those of counties, it is clear there is an overlap as certain functions are managed at both the local and the regional levels. All municipalities and cities may also administer matters delegated from their own county's self-government jurisdiction if the county government provides the necessary funds.

The process of fiscal decentralization (since 2001) has enabled LRGUs to take on authority for the provision and financing of significant decentralized functions, including health care, education, social welfare, and fire protection services, from the central government. The assignment of newly decentralized functions (responsibilities) to LGUs has not been mandatory but rather voluntary. This has led to an asymmetric assignment, with different cities and municipalities in charge of different services and some regional government (counties) still in charge of providing many services that in other areas or counties have been effectively decentralized. Only a minority of cities (around one quarter) with higher fiscal capacities have taken on all of these optional functions. A significantly higher number of cities and municipalities (roughly half of all LGUs) have assumed responsibility for firefighting services, while other decentralized functions have largely remained under the jurisdiction of the 20 counties. LRGUs that took over the decentralized functions were provided with funding through an additional share in

the PIT and through equalization grants specifically for this purpose (further discussed below). Where the LGUS have not taken over the newly (optional) decentralized functions, the tasks are performed by their respective counties, which also receive an additional share of PIT for each function they provide in each LGU. Thus, there has been a de facto upward delegation by cities and municipalities that decided not to take on certain types of services. Perhaps the most important policy implication of this asymmetric assignment is that Croatia has indeed found a very effective way (if not the most correct one) of dealing with the lack of administrative capacity of fragmented local governments as discussed in the previous chapter.

**Table 4.1.** Distribution of Functions by Level of Government

	CENTRAL GOV.	COUNTIES	MUNICIPALITIES	CITIES
1. General public services	✓	✓	✓	✓
2. Defense	✓			
3. Public order and security	✓		✓	✓
4. Education	✓	✓	✓	✓
4.1. Preschool			✓	✓
4.2. Elementary	✓	✓	✓	✓
4.3. Secondary	✓	✓		
4.4. Tertiary	✓			
5. Health care	✓	✓		
6. Social security and welfare	✓	✓	✓	✓
7. Housing and communal economy matters and services*			✓	✓
8. Recreation, culture, and religion			✓	✓
9. Agriculture, forestry, hunting, fishing	✓	✓		
10. Mining, industry, construction	✓	✓	✓	✓
11. Traffic and communications	✓	✓	✓	✓
11.1. Road transport	✓	✓	✓	✓
11.2. Rail transport	✓			
11.3. Air transport	✓			
12. Other economic matters and services	✓	✓	✓	✓

Note: \*Housing and communal economy matters and services include housing development, implementation of the law on spatial planning and land use, supervision and regulation of drinking water supply, management of public lighting, and so on. Source: Ott and Bajo (2001).



The summary information in table 4.1 shows the exclusive assignment of functions to one level of government, as in the case of air and rail transport at the central level and housing and communal services at the city and municipal level. However, the overall impression from the table is the existence of a substantial number of shared or concurrent responsibilities. In the case of the latter, it is always difficult to summarize the roles of the different levels of government. One way is to look at the actual expenditures of each government tiers on each concurrent function. That is the approach taken later in this section.

Qualitatively, however, environmental concerns, housing and community improvement services, and recreation, culture, and religion have been transferred to LRGUs to a greater extent. General public services, economic affairs, and education are less decentralized, while public order and security, health and social protection, and especially defense are mainly the responsibility of the central government.

Other functions, such as health care, have been assigned to counties, which are typically not able to finance those functions in full. Three tasks that are often assigned to local governments and that in Croatia can be considered rather centralized are: provision of health services, energy supply, and business development support. Greater LGU autonomy can, nevertheless, be found in connection with housing and public utilities, preschool education, and cultural, sports, and religious activities. LGUs often entrust the provision of a certain segment of public services (utilities) to special legal entities (utility companies) that they mainly control through ownership. Utility services include the supply of drinking water, drainage and wastewater treatment, gas supply, heat supply, public transport, trash pickup, disposal of municipal waste, maintenance of public areas, upkeep of unclassified roads, retail markets, maintenance of cemeteries and crematoria, funeral services, chimney sweeping, and public lighting.

These services may be provided by a company, public institution, or service department established by an LGU, as well as a legal and natural person on the basis of a concession contract or a contract on the entrustment of utility services. Funds for performing utility services are provided from the price of services, utility fees, the budget of the LGU, and other sources according to special regulations. Local utility companies provide most municipal services in Croatia (including water, sewerage, irrigation, infrastructure, energy, and sanitation). Housing and public utilities are, in addition to recreation, culture, and religion, exclusive functions of LGUs at the lowest tier of government.

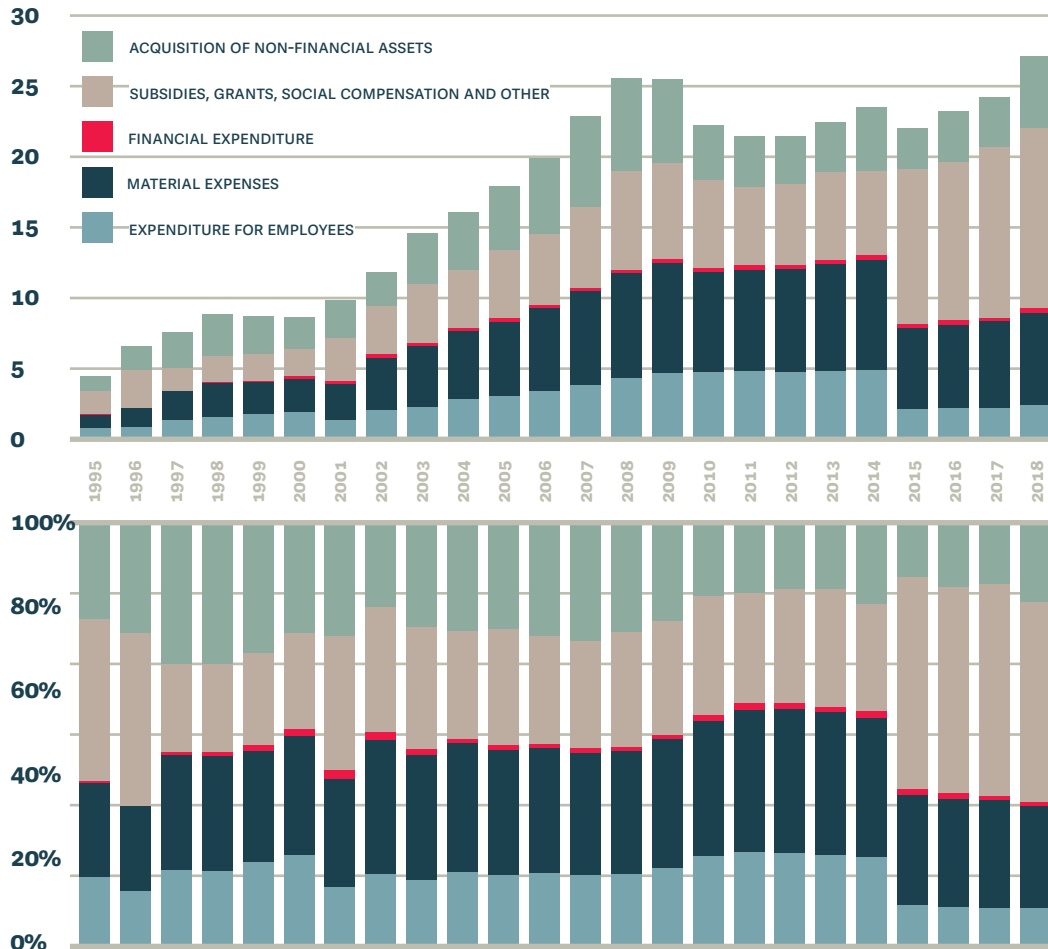
## 4.2. LRGU expenditure levels and composition

The review of LRGU expenditures begins by focusing first on the economic classification. The expenditure budget of LRGUs is comprised of current or operating expenditures and capital expenditures, that is, the acquisition of non-financial assets. Operating expenditures account for about 80 percent of total local government expenditures, while the remaining 20 percent relate to the acquisition of non-financial assets (figure 4.1).

Subsidies and operating expenditures (other than personnel), also called “material expenses,” are the largest components of current expenditures. The subsidies and grants are transfers to individuals and households. Since 2015, this latter category has also included transfers to

budgetary users<sup>17</sup> for the financing of their regular activities. At the same time, the expenditure on personnel or public employees has decreased significantly in recent years because since 2015, spending on employees of budgetary users is no longer recorded in LRGUs' budgets as such but rather as subsidies and grants to budgetary users (see box 4.1 below).

**Figure 4.1.** Expenditure of LRGUs by Economic Classification from 1995 to 2018 (HRK billion - above and in % - below)



Source: Authors' calculation, based on the data from the Report on Revenues and Expenditures, Receipts, and Expenses (Form PR-RAS) for the years 1995–2018.

<sup>17</sup> According to the Ordinance on the Determination of Budgetary and Extra-Budgetary Users of the State Budget and Budgetary and Extra-Budgetary Users of the Budgets of LRGUs and on the Method of Keeping a Register of Budgetary and Extra-Budgetary Users (OG, 128/09, 142/14, and 23/19), budgetary users are state bodies, institutions, councils of minority self-government, budgetary funds, and sub-local self-governments whose expenditures for employees and/or material expenditures are secured from the LRGU's budget. LRGU budgetary users are those founded by LRGUs, predominantly (more than 50 percent) financed from the LRGU's budget and listed in the Register of Budgetary Users. These may be, for example, museums, theaters, kindergartens, schools, social care institutions, and/or health institutions founded and majority-owned by LRGUs. Extra-budgetary users of LRGU budgets are extra-budgetary funds, companies and other legal entities in which LRGUs have a decisive influence on management, and contributions and/or earmarked revenue from one of the financing sources that are listed in the Register. According to the current information from the Register, extra-budgetary beneficiaries of LRGUs are only county road administrations.

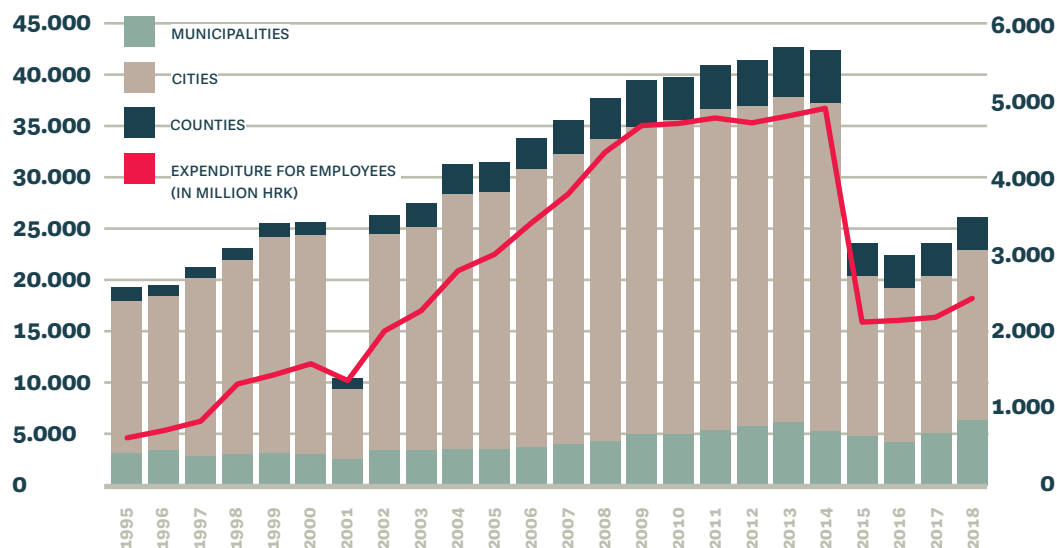
Although since 2002 separate categories have been reported for subsidies, grants (given), compensation to citizens and households, and other expenditure, before that time, most of these categories were aggregated and presented as subsidies and other current transfers. This change in budget classification starting in 2002, though desirable for greater transparency, represents an inconsistency or break in the long-term data series and naturally hampers the analysis of long-term spending patterns (see Annex 4 for a detailed discussion on data and transparency issues). In order to maintain the consistency of long-term data, other expenditures are shown in figure 4.1, together with the subsidies, grants, and social compensation. Note that the category of “other expenditures” (representing HRK 2.9 billion in 2018) is a significant share of current spending, which is even higher than spending on employee wages and salaries (which was HRK 2.4 billion in 2018). Other expenditures consist predominantly of current donations but include also capital donations, capital assistance, and penalties and indemnities. Higher shares of the catch-all category of “other expenditures” are associated with less transparent budgets.

Total expenditures of LRGUs in the observed period range from the lowest, at HRK 3.4 billion in 1995, to the highest at HRK 26.9 billion in 2018. Total LRGU expenditure has significantly increased since 2001 through the fiscal decentralization process, reaching HRK 25.3 billion in 2008 and 2009 when total expenditure shrank because of the effects of the global financial crisis. The temporal profile of expenditure levels is to a very large extent a mirror reflection of the ups and downs in the LRGUs’ sources of financing. To offset the decrease in tax revenue (primarily the PIT and surtax due to increased unemployment), LRGUs had to significantly cut their capital expenditures from HRK 6.5 billion in 2008 to HRK 3.8 billion in 2010.

LRGU budgets have gradually recovered since 2014, when they were strained again, this time due to tax reform that was primarily focused on the reduction of the PIT burden. The decrease in PIT revenue in 2015 translated into significant reductions in expenditures on employees, materials, and operations, as well as on capital investments. Due to the recovery in economic activities, including local budget revenues, expenditures increased in the succeeding years and, with the EU grants received, total expenditures in 2017 exceeded 2014 levels. The introduction of the fiscal equalization system and complete transfer of PIT to LRGUs in 2018 created additional fiscal space for increasing the expenditure side of LRGU budgets.

Total expenditure for employees increased from HRK 527 million in 1995 to HRK 4.9 billion in 2014 (figure 4.2). For municipalities, the total amount increased 4.9 times (HRK 108 to 527 million), for cities 7.8 times (HRK 476 million to 3.7 billion), and for counties 18.1 times (from HRK 33 to 603 million). The increasing trend has significantly intensified since 2001 with the fiscal decentralization process. The sharp decline in 2015 onwards, beyond the decrease in PIT revenues that same year, can be attributed to the methodological changes in accounting for the number of employees in local bodies (box 4.1).

**Figure 4.2.** Total Number of Employees in Local Bodies and with Users (left axis) and Expenditure on Wages and Salaries of Employees (right axis) from 1995 to 2018



Note: Data for the number of employees with users in 2001 are not available.

Source: Authors' calculation, based on the data from the Report on Revenues and Expenditures, Receipts and Expenses (Form PR-RAS) for the years 1995–2018.

## Box 4.1. Methodological Changes in Subnational Budget Classification in 2015

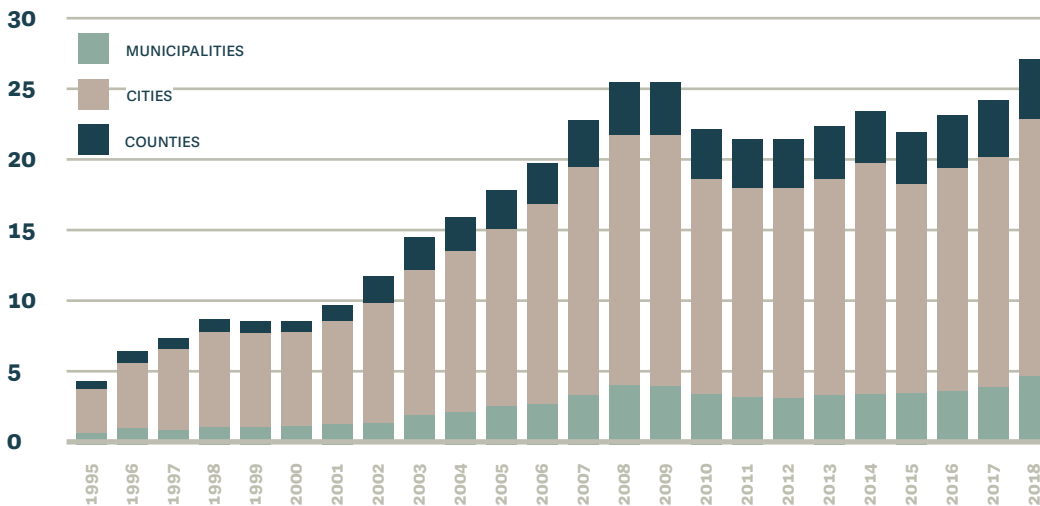
Beginning in 2015, transfers of funds to budgetary users for salaries were no longer recorded in the accounts of subcategory 311 Salaries (gross), but in subcategory 367 *Transfers to budgetary users from the competent budget for financing of regular activities*. Accordingly, the manner of presenting data on the average number of employees of LRGUs in Form: PR-RAS (Level 22 reports) also changed. In their financial statement (level 22), LRGUs are required to fill in the data on the average number of employees in their governmental bodies (based on the balance at the beginning and end of the reporting period and based on hours worked) but not fill in the data on the average number of employees among their budgetary users. This is the main reason why the number of employees suddenly decreased in 2015.

However, some LRGUs still report the latter number, although they received a circular from the MOF with detailed instructions on how the reporting should be performed. A more detailed analysis of the reported data reveals that 446 out of a total of 576 LRGUs did not report the number of employees among budgetary users in 2018, whereas as many as 130 LRGUs did. In contrast to the reporting on financial data, which is controlled to ensure accuracy, information on the number of employees is entered into the analytical (statistical) data without controls, enabling LRGUs to fill in the data according to their own rough understanding and interpretation of the instructions. This is an additional sign that the administrative capacity in LRGUs in Croatia is weak and needs to be strengthened. Moreover, the MOF needs to implement additional controls on the reporting process and make the circulars more user friendly and easier to understand, with no space for discretionary and subjective interpretations by local officials.

LRGUs are autonomous in determining the number of administrative departments and the number of employees as long as they comply with the rules determining the maximum value of the wage bill. According to the Law on Salaries in Local and Regional Self-Government (OG 28/2010), the mass of funds for salaries (i.e., the wage bill) of employees in LRGUs may not be more than 20 percent of the current revenue of the unit generated in the previous year, minus revenue from: (i) domestic and foreign grants and donations, except for grants for civil servants taken over under a special law, (ii) special contracts: co-financing of citizens for sub-local self-government; and (iii) the additional share of PIT and equalization grants for decentralized functions. The number of employees in LRGUs therefore depends solely on the fiscal capacities and political will of the representative body. The Law on Local and Regional Self-Government determines the deputies and the number of members of the representative bodies according to the number of citizens, and all other personnel decisions are made autonomously by LRGUs.

Despite the significant changes in LRGU expenditure since 1995, the structural composition of spending by tier of subnational government has remained relatively constant (figure 4.3). Not even the significant fiscal decentralization process that has taken place, when counties and fiscally stronger cities assumed many decentralized functions, has brought about any significant changes in the shares of municipalities, cities, and counties in total LRGU expenditure. On average, throughout the period from 1995 to 2018, municipalities accounted for 15.5 percent, cities 70.5 percent, and counties 14 percent of total LRGU expenditure.

**Figure 4.3.** Total Expenditure of LRGUs by Tier of Government from 1995 to 2018 (HRK billion)



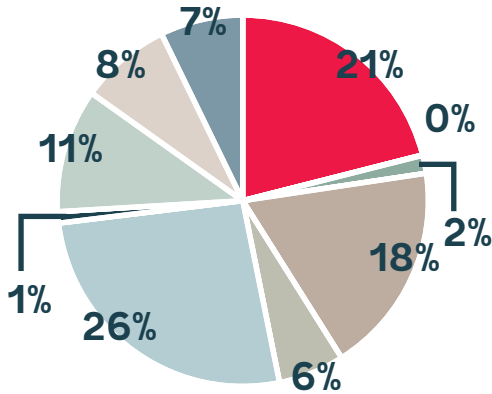
Source: Authors' calculation, based on the data from the Report on Revenues and Expenditures, Receipts and Expenses (Form PR-RAS) for the years 1995–2018.

The structure of LRGU expenditure by functional budget classification reveals the intensity of performing various functions and service delivery at the subnational level. This is especially helpful in understanding the respective roles of the different tiers of government in the provision of services where there are concurrent or overlapping responsibilities. The largest share of LRGU expenditures, with regard to functions, is for housing and communal amenities and general public (administrative) services (figure 4.4). Since 2001, the budget items for decentralized functions have increased considerably, as financing of the major part of education,

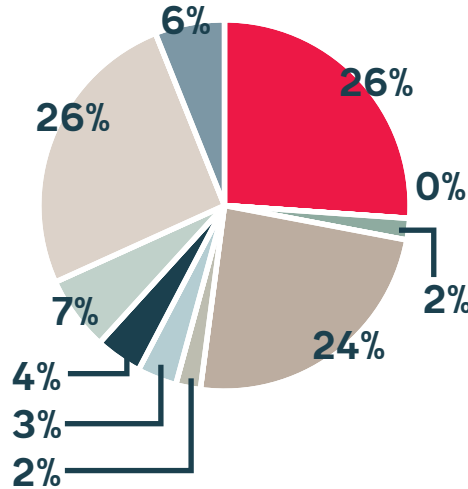


**THE STRUCTURE OF LRGU EXPENDITURE BY FUNCTIONAL CLASSIFICATION IN 2018 (IN %)**

**Local Government**  
(cities and municipalities)



**Regional Government**  
(counties)



Note: GPS: general public services, DEF: defense, POS: public order and safety, EA: economic affairs, ENV: environment, HC: housing and community, HLT: health, RCR: recreation, culture, and religion, EDU: education, SP: social protection.  
Source: Authors' calculation, based on the data from the Report on Revenues and Expenditures, Receipts and Expenses (Form PR-RAS) for the years 1995–2018.

### 4.3. The ups and downs of expenditures on decentralized functions

The temporal evolution of LRGUs with regard to decentralized functions also reflects the policy changes in assignments and the corresponding sources of financing. As noted, amendments to the Law on Financing of Local and Regional Self-Government Units in 2001 and 2003 and amendments to special laws created the legal preconditions for the decentralization of primary and secondary education, social welfare, health, and firefighting functions (public fire departments) to LRGUs. These (optional) newly decentralized functions are financed through the increased share of PIT revenue allotted to LRGUs (assigned for each function assumed) and also through equalization grants for decentralized functions (in the event that LRGUs cannot meet the minimum financial standards).

Thus, within the framework of meeting the needs of primary education, it is stipulated that the budgets of LRGUs provide funds for material expenditures of primary schools, investment maintenance of school premises, equipment and teaching aids, supplies of school equipment, teaching aids and resources, transportation of students, capital construction of school premises, and equipment according to standards and norms established by the line ministry. Similarly, for secondary education, it is stipulated that the budgets of LRGUs provide funds

for: material expenditure of secondary schools, transportation of employees, the co-financing of accommodation and meals for students in dormitories, investment maintenance of school premises, teaching aids and resources, the purchase of school equipment, and the capital construction of school buildings.

Moreover, in the budgets of LRGUs, funds are secured for the investment maintenance of the premises and equipment of health institutions<sup>18</sup> owned by the counties or the city of Zagreb. They also provide funds for financing social welfare centers, including for materials, energy, utilities and other services, current maintenance, financial other non-mentioned expenditures, and heating. In addition, the counties, to which the funding responsibility for nursing homes has been transferred, must provide funds for the continuation of this service by ensuring the difference between the total expenditures and nursing homes' own revenues (from fees charged for the care provided and other services).

Some of the functions of and expenditures for education, health, and social care were transferred to the 55 largest units, namely to 20 counties, 34 cities, and the city of Zagreb, and the regular activities of public fire departments are funded by 160 municipalities and cities. As compensation, these subnational governments have been given an additional share in the PIT on a derivation basis (that is, where the PIT is collected) for each transferred function. For elementary education, it is 1.9 percent; secondary education, 1.3 percent; social care, 0.8 percent (centers for social care 0.2 percent, nursing homes 0.6 percent); health care, 1.0 percent; and firefighting, 1.0 percent (public fire departments).

With those additional shares in PIT revenues, LRGUs are required to meet the minimum financial standards according to the criteria regulated by government's annual decisions in the respective areas. However, LRGUs that do not receive sufficient funds from the additional share of the PIT to cover the minimum financial standards are entitled to equalization grants for decentralized functions financed from the central government budget.

There are significant disparities in the distribution of expenditure per capita, especially on the LGU level. The total expenditure per capita in 2018 ranged from HRK 1.495 to 29.477, with a coefficient of variation exceeding 62 percent (table 4.2). The disparities are even greater for certain components, especially capital (acquisition of non-financial assets) and financial expenditures. The distribution of expenditure among counties is more even: total expenditure per capita ranges from HRK 1.049 to 2.757. The coefficient of variation for total expenditure is 27.3 percent, whereas certain categories of expenditures, such as capital and financial expenditures, again show greater variation.

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<sup>18</sup> The counties own health centers, home health care institutions, polyclinics, general hospitals, special hospitals, spas, and emergency medical facilities.



**Table 4.2.** Summary Statistics of LRGU Expenditure Components per Capita in 2018 (HRK)

	MAX	MIN	AVERAGE	MEDIAN	STAND. DEVIATION	COEF. OF VARIATION
<b>LOCAL GOVERNMENT UNITS (CITIES AND MUNICIPALITIES)</b>						
Expenditure for employees	4,933.3	106.0	592.2	476.6	437.2	73.8%
Material expenses	10,350.6	351.2	1,467.5	1,165.2	1,036.1	70.6%
Financial expenditure	6,484.4	1.8	61.5	23.6	296.1	481.6%
Subsidies, grants, social compensation, and other	6,171.1	161.9	1,220.1	969.1	821.5	67.3%
Acquisition of non-financial assets	23,383.5	44.6	1,532.2	1,093.7	1,713.4	111.8%
<b>Total expenditure</b>	<b>29,477.4</b>	<b>1,495.4</b>	<b>4,873.4</b>	<b>4,041.1</b>	<b>3,035.2</b>	<b>62.3%</b>
<b>REGIONAL GOVERNMENT UNITS (COUNTIES)</b>						
Expenditure for employees	217.5	88.5	113.0	105.7	29.4	26.0%
Material expenses	311.1	52.6	159.0	128.3	74.9	47.1%
Financial expenditure	115.1	0.4	10.2	2.3	25.3	248.8%
Subsidies, grants, social compensation, and other	2,317.6	740.1	936.0	863.3	335.1	35.8%
Acquisition of non-financial assets	822.6	34.2	164.0	101.0	178.0	108.6%
<b>Total expenditure</b>	<b>2,757.0</b>	<b>1,049.4</b>	<b>1,382.2</b>	<b>1,288.2</b>	<b>376.9</b>	<b>27.3%</b>

Source: Authors' calculation, based on the data from the Report on Revenues and Expenditures, Receipts and Expenses (Form PR-RAS) for 2018.

The functional dimension of expenditures reveals even more evident disparities among LGUs (table 4.3). It is surprising that the minimum value for all functional expenditure components is zero, though this is usual for certain naturally centralized functions (such as defense). However, it is difficult to believe that in some LGUs, there is no expenditure for such functions as general public services, economic affairs, or housing and community affairs. It is possible that there are problems in recording these values (functional classification of expenditures) in certain LGUs with weaker administrative capacities. Functional expenditure distribution disparities are less pronounced on the regional (county) level.

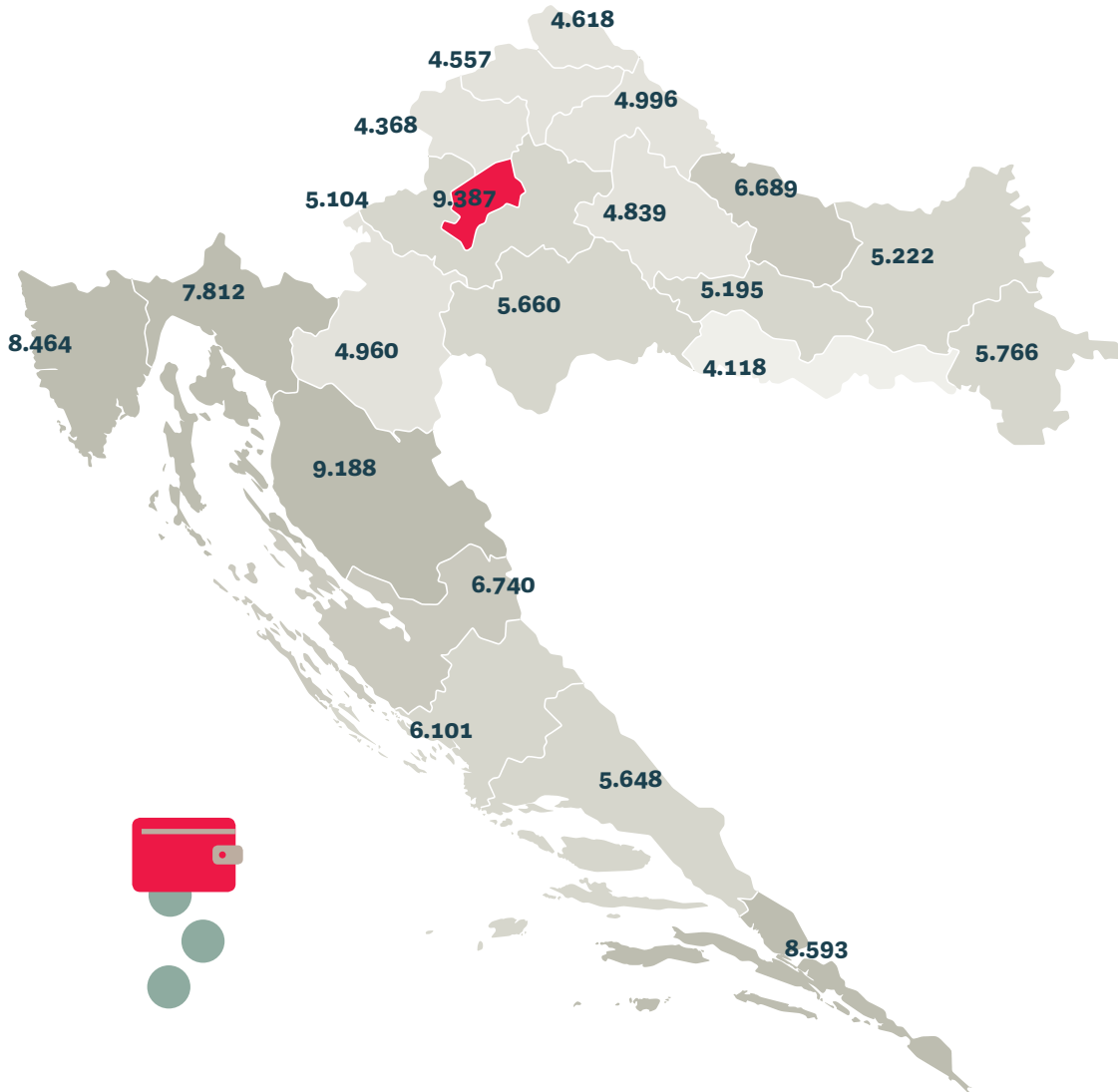
**Table 4.3.** Summary Statistics of LRGUs' Functional Expenditure Components per Capita in 2018 (HRK)

	MAX	MIN	AVERAGE	MEDIAN	STAN. DEVIATION	COEF. OF VARIATION
<b>LOCAL GOVERNMENT UNITS (CITIES AND MUNICIPALITIES)</b>						
GPS	15,242.7	0.0	1,180.8	935.8	1,066.2	90.3%
DEF	211.5	0.0	2.5	0.0	12.9	507.9%
POS	2,056.4	0.0	125.6	90.5	140.7	112.0%
EA	28,563.0	0.0	936.0	615.1	1,551.9	165.8%
ENV	4,575.0	0.0	234.1	85.1	447.5	191.2%
HC	9,449.6	0.0	1,184.4	885.2	1,172.9	99.0%
HLT	408.4	0.0	18.4	2.5	36.0	195.0%
RCR	6,007.4	0.0	381.3	246.3	529.4	138.8%
EDU	6,431.5	0.0	281.4	184.8	425.0	151.0%
SP	10,840.2	0.0	221.1	134.8	500.0	226.1%
<b>Total</b>	<b>29,477.4</b>	<b>1,465.9</b>	<b>4,565.6</b>	<b>3,699.2</b>	<b>2,944.1</b>	<b>64.5%</b>
<b>REGIONAL GOVERNMENT UNITS (COUNTIES)</b>						
GPS	353.7	125.7	207.9	186.4	65.6	31.6%
DEF	1.0	0.0	0.1	0.0	0.3	261.9%
POS	147.0	3.5	17.5	9.4	30.9	176.1%
EA	1,503.5	61.4	238.7	127.8	339.9	142.4%
ENV	41.5	0.0	13.5	12.4	11.4	84.4%
HC	105.7	0.0	22.9	13.1	29.0	126.7%
HLT	145.1	5.5	39.9	30.8	36.3	90.9%
RCR	122.5	8.7	47.0	38.3	30.3	64.4%
EDU	397.9	32.6	197.6	204.2	99.7	50.4%
SP	74.5	29.2	47.5	43.7	13.9	29.3%
<b>Total</b>	<b>2,061.2</b>	<b>511.1</b>	<b>832.6</b>	<b>793.3</b>	<b>337.4</b>	<b>40.5%</b>

Note: GPS: general public services, DEF: defense, POS: public order and safety, EA: economic affairs, ENV: environment, HC: housing and community, HLT: health, RCR: recreation, culture and religion, EDU: education, and SP: social protection.  
Source: Authors' calculation, based on the data from the Report on Revenues and Expenditures, Receipts and Expenses (Form PR-RAS) for 2018.

The territorial distribution of total LRGU expenditure per capita (figure 4.5) reveals that, with the exception of Zagreb, it is higher in the coastal (Adriatic) than in the continental part of Croatia. Figure 4.5 presents a total of all LRGU expenditures per capita (a cumulative of total municipal, city, and county expenditures divided by the number of inhabitants for each county). In 2018, the city of Zagreb had the highest per capita expenditure of HRK 9.387. See Annex 5 for a territorial distribution of specific expenditure components and Annex 6 for a territorial distribution of per capita LRGU expenditures for particular functions (according to the Classifications of the Function of Government [COFOG]).

**Figure 4.5.** Territorial Distribution of LRGUs' Total Expenditure per Capita by County in 2018 (HRK)



Source: Authors' calculation, based on the data from the Report on Revenues and Expenditures, Receipts and Expenses (Form PR-RAS) for 2018.

#### 4.4. Significant policy issues in expenditure assignments

Despite numerous efforts by various governments, working groups, and research institutions, and also the support of international donor institutions (including the U.S. Agency for International Development, the Council of Europe, and the governments of Sweden and Norway), a clear framework for the provision, standard setting, and funding of public services in Croatia has not yet been established. As has been shown, there are very few exclusive assignments, and many of the responsibilities are concurrent or shared, and for the latter, the formal arrangements are still unclear. In particular, no effort has been made thus far on the clear assignment and understanding of what level of government is responsible for regulation or service norms and standards, for financing, and for implementation.

Although the issue of LRGU revenue and financing sources is more fully addressed in the section below on revenue assignments, it is worth pointing out here that expenditure assignments to LRGUs do not correspond well with the sufficiency or adequacy of their financing sources. Despite the fact that the general responsibilities and jurisdictions of LGUs are laid out in the Law on Local and Regional Self-Government, they do not have total fiscal autonomy in the financing of all their expenditures. This is likely the case for a number of reasons. First, as already stated above, despite the many efforts, there has been no agreement on or certainty about the standards for local service provision. This is always a difficult—and not at all uncommon—issue in other decentralized countries. But the upshot is that because there are no clearly and transparently defined (minimum) standards for services, it is not possible to quantify the expenditure needs of subnational governments and there is therefore no way of knowing the adequacy level of the current financing sources. Moreover, in practice, revenue sharing and central government grants are earmarked to finance certain decentralized functions and capital investment, leaving LRGUs with what appears to be insufficient revenues. To cope with these problems, LGUs could be encouraged to enter into territorial, functional, and financial cooperation, but unless there are significant economies of scale in doing so—and the chances are unlikely given what is empirically known in other countries—it is doubtful that cooperation alone will suffice.

There are other political economy issues with expenditure assignments in Croatia that must be addressed. The current practice of delegating functions, that is, of local governments assuming decentralized functions, needs to be revised. Currently there are some barriers to the transfer of those responsibilities. Among other obstacles, some county assemblies have declined to allow the transfer of public services to LGUs. Negative incentives are at play here. This may be one reason to reconsider the hierarchical vertical structure of government and to explore the advantages of the bifurcated system. By authorizing the transfer of power from the county to the city level, counties would lose the significant funds attached to financing those functions. In practice, such transfers should be encouraged, subject to adequate criteria (minimum fiscal capacity per capita for each function) that local units must fulfill as a prerequisite. Another obstacle in practice is that there are insufficient regulations enabling local units to demonstrate that they have secured the funding needed to finance these functions. Local units wishing to take on certain decentralized functions are required to prove that they have secured their own funds to carry them out, although for this purpose they also have access to additional shares of the PIT and receive equalization grants.

Another noticeably negative feature of the system of expenditure assignments is its instability over time. Even though the frequent changes can be understood in the context of “learning by doing” in a fairly recently decentralized country, some could have been avoided if expenditure assignments had been a bit more insulated from the adjustments to revenue assignments. It is the assignment of expenditure responsibilities that must be the first step in the design of a decentralization system, and the financing arrangements, including revenue assignments and transfers, must follow. In Croatia, the reverse has been taking place: the changes in funding have determined the changes in the allocation of responsibilities. The frequent amendments to the tax system in particular have often translated into changes to LRGU financing and a mismatch between the allocation of functions and sources of funding.

## 4.5. International experience and practice in expenditure assignments

The first fundamental step in the design of a system of intergovernmental fiscal relations should be the clear assignment of functional responsibilities among the different levels of government. Allowing other important aspects of a decentralized finance system, such as revenue assignments and transfers, to take precedence or worse, dictate the expenditure assignments, would be equivalent to putting the proverbial cart before the horse and lead to instability, controversy, and ultimately to inefficiency in public service delivery.

Expenditure assignments should be broadly aligned with the “correspondence” and “subsidiarity” principles. The former requires that the geographic dimension of the benefits from a particular service should match the geographic dimension of the level of government responsible for its provision. The latter states that the responsibility for any service that can be provided at a different level should be assigned to the lowest possible level of government compatible with the size of the “benefit area” associated with that service. A good expenditure assignment requires that affordability and capacity also be considered, that is, the extent to which subnational expenditure needs can be covered with the resources that will be made available to them and whether subnational governments are administratively capable of delivering those services.

The assignment of responsibility for investment in capital infrastructure requires special attention. Subnational governments play a key role in public investment in many countries. As recently reported in OECD (2019), subnational governments represent over 40 percent of total public investment in high-income economies. A common problem is that the assignment of responsibility to fund a particular service on a recurrent basis and the responsibility to build the infrastructure needed for its provision may be assigned to two different levels of government.

Splitting the responsibilities for a recurrent service and the capital infrastructure investment needed for that same service has proven problematic across countries. The level of government responsible for funding a service (typically a local or regional government) should also be in charge of, logically, operating the infrastructure facility and its maintenance. Otherwise, what may follow is a significant lack of expenditures for infrastructure maintenance or the generally unsustainable use of the infrastructure facilities. This would be aggravated by the fact that infrastructure maintenance is one of the areas that governments tend to postpone when

facing financing problems. Therefore, best practice is to *assign both recurrent and investment responsibilities for any particular expenditure function to the same level of government*. If that assignment is at the subnational level, the financing will generally require some combination of capital transfers and borrowing.

Coordination mechanisms for ensuring concurrent responsibilities has also proven to be critical across countries. This lesson is very relevant for Croatia, which needs to institutionalize *explicit coordination, cooperation, and dialogue among the different levels of government in those cases where there are concurrent responsibilities*. This should involve regular and transparent exchanges of information and dialogue, with regular periodic meetings at the political and technical levels.

Lastly, there is the important issue of minimum standards of service. The central government could determine the *minimum public services to be provided by all local and regional units with the same or similar conditions and the same service quality*. Currently, the level of quality standards is significantly uneven among municipalities, cities, and counties. *Minimum standards* for all public services to which all citizens are entitled should be established so that there is sufficiently adequate coverage from all LRGUs, despite different staffing and financial capacities. Implementing a fiscal needs equalization system would certainly help mitigate inequalities in the quality of public services among LRGUs, and the expenditure needs recognized in the equalization system could be generally based on the centrally determined minimum standards. At the same time, minimum financial standards for decentralized functions would need to be revised periodically to ensure that they reflect the realistic needs of LRGUs.

See box 4.2. below for a look at international practice and country examples in setting minimum financial standards.

### Box 4.2. Setting Minimum Public Service Standards: Conceptual Issues and International Practice<sup>19</sup>



Minimum service standards, sometimes called “budgetary norms,” are typically used in budget formulation (how much funding is needed) and also in the computation of expenditure needs for equalization grants or for conditionality purposes in the case of other grants. In other words, service standards may be used as notional amounts for computational purposes only to address existing vertical and horizontal gaps or as compulsory benchmarks for budget units to ensure that certain national expenditure priorities are reserved for the subnational level.

There are several desirable properties for service standards. They should be transparent and as simple as possible; carry low computational intensity so they can actually be used; be

<sup>19</sup> For further reading see Alm and Martinez-Vazquez (2002) and Martinez-Vazquez, Boex, and Ferrazzi (2004).

affordable within the existing expenditure budget envelopes (otherwise they become simply aspirational and ultimately rendered ineffective); be flexible and responsive to changes in policy priorities; strive for accuracy of information and use data and other information sources that are independent and cannot be manipulated by implementing units; and be demand driven and client-based rather than based on existing capacity related to public employees or physical infrastructure (to avoid the perverse incentive to accumulate idle or excess capacity).

Not all countries use explicit minimum service standards or budgetary norms in formulating their budgets or structuring their systems of intergovernmental fiscal relations, although all such procedures and funding levels almost always imply some implicit norms or standards of service. For those countries that do explicitly use them, there are a variety of methodological approaches, all of which can be justified on some basis.

First, some countries have used lagged or historical values of actual expenditures to define service standards or norms. This was the approach followed, for example, in Russia and Spain at the beginning of their decentralization reforms. It imposes low information demands but can also set in motion perverse incentives for budget agents to inflate spending, and historical values may not reflect current priorities and needs.

Other countries have used norms to indicate absolute equality of needs per jurisdiction. This was the case in Nepal, where at the time there was no reliable information on the population of different jurisdictions. Clearly, this approach can be justified only in extreme situations. A more sophisticated version of this method is to assume an equal per capita expenditure norm. This is a fallback approach used, for example, in Mexico and other countries, including those that, like Canada or Croatia at present, only equalize revenue capacity and ignore differences in expenditure needs across jurisdictions.

Many countries around the world continue to use weighted index formulas with several variables to approximate expenditure needs or minimum service standards. The variables included are generally proxies for expenditure needs, such as the share of population, the share of land area, geographic conditions, and so on. This approach is very common in Latin American countries, but it is also used in many others, including Bosnia, France, India, and Indonesia. The weighted index approach generally does not properly set a service standard or budget norm, since no specific expenditure category may be identified; it can perhaps be interpreted as a substitute for a system of norms that uses a single composite proxy norm for all expenditure categories. The main drawback lies in the arbitrariness of the variables and the relative weight given to each, which can expose the process to political pressures.

A more sophisticated approach is the traditional bottom-up costing of a basket of physical service standards. In this approach, “needs” are equated to the actual costs of providing levels of physical service standards, which can be more or less detailed. This system has been successfully applied in a number of developed countries with long decentralization histories, including Australia, Japan, South Korea, and the Netherlands. But despite the many years available to advance and perfect it, this approach presents multiple implementation obstacles. In addition to the difficulty in agreeing on the numerous physical standards designed by sector specialists, the bigger risk is arriving at service standard norms that are entirely unaffordable, rendering them useless or merely aspirational (as was the case in the former Soviet Union).

Another, and perhaps even more sophisticated, approach to quantifying expenditure needs is the so-called representative expenditure system (RES), which is based on the statistical relationship between actual expenditure observed and variables driving those expenditures, such as population, prices, and so on. Countries like Canada (for the territories), Denmark, England and Wales, and Sweden have used this approach. The basic premise is to view actual observed expenditure patterns across jurisdictions as demand-driven by freely choosing local governments, reflecting, on the one hand, the preferences of their residents and on the other, their needs and supply constraints. The statistical estimates are in turn used to predict or calculate the expenditure needs of each jurisdiction, taking into account its population, prices, and so on. Clearly, this is a computationally complex approach that assumes that observed actual expenditures are a reflection of true need.

A good compromise between accuracy and simplicity are the per client (top-down) financial expenditure standards or norms for the different categories of public services. This is used in a variety of countries, including the United States, China, Vietnam, and Ukraine. In this approach, expenditure needs are associated with affordable goals for service standard provision and driven by the number of beneficiaries or clients on the demand side, also accounting for the different costs of provision on the supply side. The basic structure of each expenditure norm is:  $Expenditure\ Need\ i = c_i * Norm * p_i$ , where  $p_i$  is the size of the client population in jurisdiction  $i$ ,  $Norm$  is the (standard) affordable and desired expenditure per client, reflecting not only basic costs but also policy priorities regarding the desirability of the particular service, and  $c_i$  is the parameter measuring the higher or lower costs of service provision in the jurisdiction relative to the average cost in other jurisdictions. The attraction of this last approach is that it tends to better fulfill all the desirable properties of budget expenditure norms listed above.

## 4.6. Policy options for reform

The three most common problems in international practice with the assignment of expenditure responsibilities are the lack of a formal assignment process, the presence of inappropriate or inefficient assignments, and the extensive use of concurrent responsibilities (those assigned simultaneously to two or more levels of government) without clarifying the level of government responsible for the different “attributes” of the service: regulation, financing, and implementation.

Croatia is not affected by the first two problems, but does suffer from the third, which has led to confusion, friction, and inefficiencies in public service delivery. At present, there is no clear division of functions between levels of government. These could be clarified through new legislation/policy, and the practice of delegating those functions (local governments assuming decentralized functions) could be revised. For concurrent services to become less of a problem, further regulations are needed to clearly assign financing, regulation, and implementation to the different levels of government (central government, counties, cities, and municipalities).



The government should consider setting the minimum level of public services to be provided by all local and regional units with the same or similar conditions and the same service quality. Currently the minimum financial standards are set only for the newly decentralized functions. Still, though the criteria for determining these standards are known, the explicit formula for calculating them is not publicly available. In order to increase the transparency in setting the minimum financial standards, the government could publish the procedure for how exactly they are set/calculated for each decentralized function.

Existing public services assigned to counties, cities, and municipalities would benefit from a redesign, possibly by means of a single law, for example, the Law on Local and Regional Public Services. The need for the redesign stems from the dynamic and cost-effective solutions that can be seen in some new concepts like “smart cities.” Cities, municipalities, and counties need to evolve in how they provide services to the local population, especially in the context of public lighting and the use of energy sources; minimum and basic environmental standards; the harmonization of waste management issues; per pupil funding for preschool, primary, and secondary schools; the uneven financing and rehabilitation of communal infrastructure; erratic water quality; and other local and regional public services.

The government could also consider strengthening the role of county development agencies to make counties the leaders of regional development, ensuring that they take over (at least as coordinators) the more technically and financially demanding jobs—such as spatial planning, local community development, the use of EU funds, and other development activities—that the smallest municipalities and cities are unable to perform due to a lack of human and organizational capacity. In addition, as already highlighted above, cooperation could be promoted by creating subnational associations (at the level of cities, municipalities, and counties) to provide public services and to prepare joint supra-municipal investment projects.

# 05 Subnational Taxation and Revenue Autonomy



## 5.1. Tax revenues

LRGUs generate tax revenue from several sources. These are county taxes, city or municipal taxes, and shared taxes (PIT, which is basically a central government tax with shared revenues distributed to LRGUs based on a defined tax sharing schedule). Most local taxes can be categorized as taxes on property ownership (although actually there is no a conventional annual property tax in Croatia), and a few other taxes related to goods and services, such as a local consumption tax.

LRGU taxes and other types of own revenues are defined by the Law on Local Taxes (OG 115/16, 101/17). County taxes include inheritance and gift taxes (IGTs) as well as the tax on road motor vehicles, vessels, and gambling machines. Municipal or city taxes include the surtax on the PIT and the tax on local consumption, holiday houses, the use of public land, and real estate transfers.

IGTs are payable at the rate of 4 percent on the market value of the property at the time of acquisition and on inherited and donated cash, monetary claims, securities, and movable property with an individual market value that exceeds HRK 50,000. Taxpayers are natural and legal persons who inherit or receive a gift on the territory of Croatia or acquire taxable property on another basis but without compensation. The tax base is the amount of cash and the market value of the financial and other assets at the date when the tax liability is determined, but after the deduction of debts and expenses related to the taxable property.

Taxes on road motor vehicles are paid by legal and natural persons who own registered cars, motorcycles, and four-wheelers. The tax is paid annually according to the engine power (expressed in kW) and the age of the vehicle, ranging from HRK 200–1,500 for cars, HRK 50–1,200 for motorcycles, and HRK 30–140 for light four-wheelers and four-wheelers.

The tax on vessels is paid annually according to the length of the vessel (in meters) and the power of the engine (in kW) and depending on whether the vessel is with or without a cabin. Taxpayers are the legal and natural persons who own the vessel. A vessel is a yacht or a boat or an inland navigation boat for leisure, sports, or recreation. The tax is not payable on vessels engaged in certain registered activities and on boats owned by the native population on the islands who manage the life and maintenance of the estates there. Taxes are payable in the amount of HRK 0–600 for vessels without a cabin, HRK 0–5,000 for motor driven vessels with a cabin, and HRK 0–4,000 for vessels with a cabin and propulsion on the sails.

The tax on gambling machines is paid monthly in the amount of HRK 100 per machine. Subject to taxation are machines used in entertainment clubs, restaurants, public facilities, and other public spaces. These are divided into two groups: group A includes video games, simulators, and other electronic machines and group B includes pinball machines, billiards, table hockey, table football, darts, and other mechanical machines. The taxpayer is a legal and natural person who puts the machines into use.

The local consumption tax is an excise tax payable on the consumption of alcoholic beverages (wine, brandy, and spirits), beer, and nonalcoholic beverages in catering establishments. The tax is declared (and paid) according to the taxpayer's residence or headquarters, and the taxpayer

is a legal and natural person providing catering services. The tax base is the selling price of beverages, which does not include VAT. The tax rate is prescribed by the city or municipality but cannot exceed 3 percent.

The tax on holiday houses is paid by legal and natural persons who own holiday houses. The tax can be set in a range from HRK 5 to 15 per square meter of usable surface of the house. The amount of the tax is set by municipalities or cities depending on the location of the house, its age, the state of the infrastructure, and other circumstances relevant to its use.

The tax on the use of public lands is paid by legal and natural persons who are users of public lands. The municipality/city prescribes what is considered public land. The amount of the tax and the manner and conditions of payment are determined by the municipality or city.

The RETT is paid by the acquirer of real estate in Croatia. The tax base is the market value of the property at the time the tax liability arises. The market value of a property is the price of the property that is reached or can be achieved on the market at the time the tax liability arises. The subjects of taxation are real estate transactions. The real estate sales tax is payable at the rate of 3 percent.

A surtax to the PIT is a local piggyback tax payable on top of the (central government) PIT. Its tax base is the PIT base within the central tax, and the amount of the surtax is determined by LGUs. The surtax is the revenue of the LGU in which the taxpayer resides (and not the place of work). All municipalities and cities can introduce the surtax: municipalities at a rate of up to 10 percent, cities with fewer than 30,000 inhabitants up to 12 percent, cities with more than 30,000 inhabitants up to 15 percent, and the city of Zagreb up to 18 percent.

Although the Tax Administration is under the authority of the central government, its territorial organization is highly decentralized. The Tax Administration consists of the central office, 22 regional offices, and 96 branch offices and is managed by a director who also manages the work of the central office. The director is appointed and dismissed by the government on the advice of the Minister of Finance. The central office is located in Zagreb, and regional offices are usually established on the territory of each county as well as Zagreb. The tasks of the central office are those common to the Tax Administration head office.<sup>20</sup> Regional offices are set up to coordinate and supervise the work of branch offices and also to carry out the registration, enforcement, and collection of taxes.<sup>21</sup> The regional office has competent authority over taxpayers with headquarters or residence in the territory of the respective county or the city of Zagreb. The activities of branch offices include registering taxpayers and maintaining the

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**20** Among others, these are: proposing improvements to the tax system and tax policy, drafting bills, implementing tax policy, informing and educating taxpayers, drafting binding opinions and expert opinions and explanations, drafting methodologies and instructions for work, conducting and coordinating collection and enforcement procedures, coordinating and supervising the work of regional offices, providing professional assistance and monitoring the legality and regularity of the application of tax regulations, issuing misdemeanor orders, filing indictments and criminal charges, and coordinating organizational units of regional offices for misdemeanor procedures.

**21** In more detail, these tasks include determining taxes, contributions, and other public benefits; supervising taxes, contributions, fiscalization, and other public levies and concluding tax settlements; combating tax fraud; coordinating the procedure of verification and indirect supervision in branch offices; issuing misdemeanor warrants, file indictments, and criminal charges; conducting misdemeanor proceedings in the first instance for violation of tax and contribution regulation; and determining the disproportion between earned income and property and abuse of rights and other related activities.

taxpayer register.<sup>22</sup> Branch offices are also set up to carry out certain tasks of regional offices for the taxpayers with their headquarters or residence in the branch area.

The territorial organization of the Tax Administration is hierarchical, with superior administrative units coordinating the work of subordinates. It more or less follows the territorial and administrative division of the country, with branch offices usually responsible for several LGUs. In essence, the Tax Administration is responsible for collecting central government taxes in all LRGUs, but it also collects local and regional taxes for LRGUs that have voluntarily transferred the tax revenue collection authority to the central Tax Administration. In general, LRGUs are responsible for collecting local and regional taxes, except the surtax, the tax on gambling machines, and the motor vehicles tax. The collection of the surtax and the tax on gambling machines is performed exclusively by the Tax Administration, whereas the collection of the motor vehicles tax is performed annually, as part of the registration process, by the technical inspection stations. LGUs (cities and municipalities) can voluntarily transfer tax revenue collection authority for all other subnational taxes to other LRGUs, but all LRGUs can also transfer tax revenue collection authority to the central Tax Administration, which is what they usually do.

## 5.2. Non-tax revenues

LRGUs generate a significant amount of non-tax revenue. Non-tax revenue is income from: property and property rights; companies and other legal entities owned by LRGUs (in full or in part); concession fees, fines, and forfeited property benefits for misdemeanors that are prescribed in accordance with the law; and other revenues determined by law.

The most significant non-tax revenues are certainly utility fees and betterment levies whose role is related to financing an operation and constructing and maintaining utilities. These are activities that provide utilities of interest to natural and legal persons and that finance the construction and maintenance of facilities and devices of utility infrastructure in municipalities, cities, and counties. Utilities functions are carried out by: companies, public institutions, and LRGUs' own establishments, as well as by legal and natural persons on the basis of concession contracts or contracts on entrusting utilities. Utilities (communal activities) can be jointly organized by several LRGUs.

The amount of the utility fee (*komunalna naknada*) is a form of monetary public payment for the maintenance of communal infrastructure. It is the LGU revenue used to finance the maintenance and construction of communal infrastructure. Funds collected from the utility fee can be used, on a decision of the LGU, for other public functions, such as financing the construction and maintenance of preschool, school, health, and social facilities and public buildings for sports and cultural purposes and improving the energy efficiency of buildings owned by LGUs. The utility fee depends on the location (zone) and the type of property. The

<sup>22</sup> Other activities of branch offices include receiving tax returns; determining the timeliness, legality, and regularity of submitted tax returns and processing tax returns; determining the basis of taxes, contributions, and other public levies; determining tax liabilities and contributions; recording tax liabilities and contribution obligations in tax records, tax refunds and transfers, and contributions; conducting indirect supervision and verification procedures; monitoring collection; issuing misdemeanor warrants and filing indictments; and issuing certificates of facts about which the Tax Administration keeps official records.

fee for residential, commercial, and garage space is calculated per square meter of usable area, and for construction, land per unit of actual area in square meters. The amount of the utility fee per square meter of real estate is a product of the value of the calculation unit point expressed in HRK per square meter, zone coefficient, and purpose coefficient.

Betterment levies (*komunalni doprinos*) are public financial contributions paid as one-time levies for the construction and use of public infrastructure facilities.<sup>23</sup> A betterment levy is the LGU revenue paid by the owner of the construction plot where the building is built, that is, the investor. The representative body of the LGU decides on the levy, a decision that determines: the area of the zone in the city or municipality; the unit contribution value in HRK per cubic meter of construction; the manner of and deadline for payment of the betterment levy; general conditions and reasons why partial or total exemption may be granted in individual cases; and the sources of funds from which the exemption amount will be settled. For outdoor swimming pools, playgrounds, and other buildings, the levy is calculated per square meter of the space (area). The betterment levy is earmarked revenue spent in accordance with the Utility Infrastructure Maintenance Program and the Program for the Construction of Utility Infrastructure Facilities.

**Table 5.1.** LRGUs' Non-Tax Revenues

	FUNCTIONS	NON-TAX REVENUE
1.	<b>General public services</b>	administrative fees
2.	<b>Economic affairs</b>	agricultural land use concession fees, mineral exploitation fees, solid waste collection fee, hunting rents, tourist (accommodation) tax, tourist board membership fees, parking fees, concessions on public roads, forestry contributions, concessions for the economic use of maritime domain
3.	<b>Environmental protection</b>	compensation for the exploitation of mineral resources, oil, and gas
4.	<b>Housing and community</b>	utility fees, utility contributions, utility connection fees, water use fees, utility concessions, mineral and thermal water extraction concessions
5.	<b>Recreation, culture, and religion</b>	rents on monuments

Source: Law on Financing Local and Regional Self-Government Units (OG 127/17), Law on Administrative Fees (OG 115/16), Law on Concessions (OG 69/17), Law on Forests (OG 68/18, 115/18, 98/19), Mining Act (OG 56/13, 14/14, 52/18, 115/18, 98/19), Hydrocarbon Exploration and Exploitation Act (OG 52/18, 52/19), Law on Maritime Property and Seaports (OG 158/03, 100/04, 141/06, 38/09, 123/11, 56/16, 98/19), Utilities Act (OG 68/18, 110/18, 32/20), Law on the Protection and Preservation of Cultural Property (OG 69/99, 151/03, 157/03, 100/04, 87/09, 88/10, 61/11, 25/12, 136/12, 157/13, 152/14, 98/15, 44/17, 90/18, 32/20).

Significant LRGU revenues are generated by property income, most of which relates to concessions. The use and disposal of property and other local and regional resources are essential to ensuring the autonomy of LRGUs. Croatia is rich in many natural resources, such as forests,

<sup>23</sup> Public areas, unclassified roads, cemeteries and crematoriums, and public lighting.

gravel, water, and other raw materials, that can contribute to the sustainability of LRGUs. According to Art. 3 of the Law on Financing of Local and Regional Self-Government Units, shared revenues are also those from the contracted annual concession fees. According to the Law on Concessions, concession fees for the extraction of mineral, geothermal, and natural spring waters, and for the abstraction of water for the public water supply, are shared between the central government and LGUs in the territory on which the right is exercised (table 5.2).

**Table 5.2.** Concession Fee Revenue Sharing Scheme from 2018 (in %)

CONCESSION FEES FOR THE:	CENTRAL GOVERNMENT	CITY OR MUNICIPALITY
Extraction of mineral, geothermal, and natural spring waters	50	50
Extraction of water for public water supply	70	30

Source: Law on Financing of Local and Regional Self-Government Units (OG 127/17).

Maritime domain concession fees are divided in thirds between the central government, regional governments (counties), and local governments (cities or municipalities).<sup>24</sup> Certain LGUs also generate income within the scope of hunting activities. According to the Hunting Act (OG 99/18, 32/19, 32/20), the fees for hunting rights are also shared between the central government and LRGUs, whereby the lion's share of these fees are captured by the central government. The Mining Act (OG 56/13, 14/14, 52/18, 115/18, 98/19) defines the exploitation of mineral resources and allows for the granting of concessions for their exploitation. For other ore minerals whose exploitation is not prescribed by the Mining Act, the provisions of the Concessions Act apply. The Decree on the Concession Fee for Exploitation of Mineral Resources (Official Gazette 31/14) defines the distribution of revenue from concession fees, of which 30 percent belongs to the LGU in the area from which the mineral resources are extracted, 20 percent to the counties in the same area, and 50 percent to the central government budget.

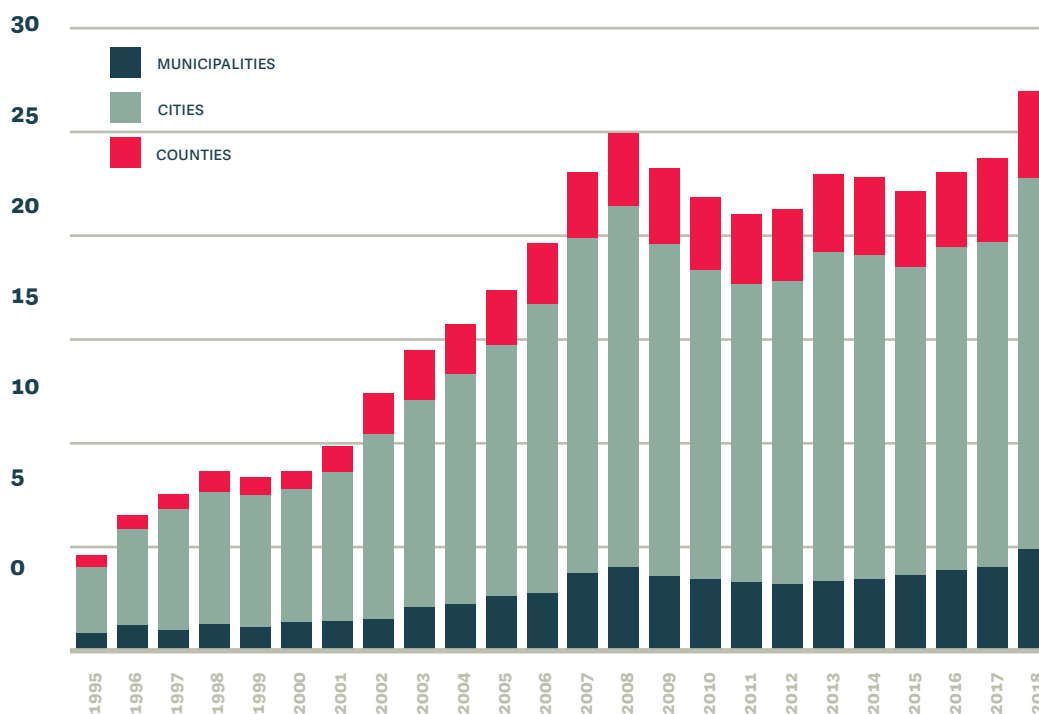
Capital revenues relate mainly to the sale of immovable property and the privatization of utility companies. Nevertheless, information on the proceeds from the latter is scarce. The process of privatization of these companies has remained in the shadows of the general privatization of large state-owned enterprises (SOEs), which, due to their size and the controversy surrounding the process itself, has received considerable attention from the media and general public. Although there is also little information on the privatization of local utility companies, it is noticeable that in many cases, the passenger transport companies have been privatized. However, the balance sheets of LRGUs are still not transparent on this subject. One complication is that the new territorial reorganization and the establishment of a number of new local units in the 1990s necessitated the redistribution of assets among local units. Since 2000, a large number of local units have put together their property balance sheets, but the issue of how these properties (assets) are managed remains largely unknown.

<sup>24</sup> Concession fees for the economic use of maritime property are covered by the Law on Maritime Domain and Seaports (OG 158/03, 100/04, 141/06, 38/09, 123/11, 56/16, 98/19).

### 5.3. Trends and composition of LRGU revenue

The fragmented institutional arrangement between larger and smaller units and relatively richer or poorer areas in terms of tax bases is largely reflected in the LRGUs' financing systems. And unsurprisingly, the adequacy of current revenue assignments differs significantly across units. Fiscal revenue in some LRGUs covers only the cost of operating the basic administration. Figure 5.1 shows the composition of LRGU revenue by levels of public authority (counties, municipalities, and cities). As described above, with approximately 70 percent of total LRGU revenues, cities have the largest fiscal capacity. Municipalities and counties have significantly smaller and similar shares. It is, however, notable and worth repeating that 27.4 percent of total LRGU revenue refers to the city of Zagreb (see also figure 3.8) and that all municipalities and counties together in 2018 generated only slightly more revenue than Zagreb alone.

**Figure 5.1.** Structure of LRGU Revenue by Level of Government from 1995 to 2018 (in billion HRK)



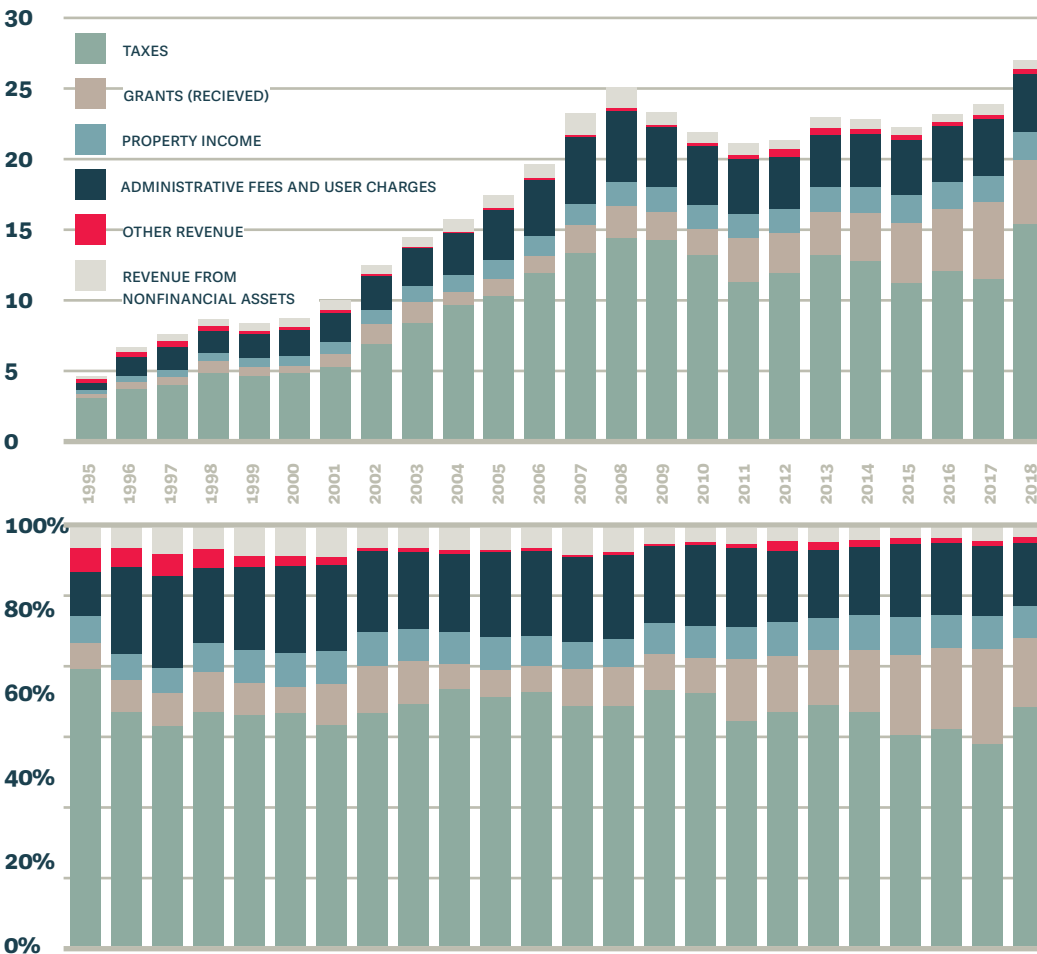
Source: Authors' calculation, based on the data from the Report on Revenues and Expenditures, Receipts and Expenses (Form PR-RAS) for the years 1995–2018.

Revenues of LRGUs increased in nominal terms from HRK 4.6 billion in 1995 to HRK 27 billion in 2018 (figures 5.1 and 5.2). Current revenues mainly dominate the structure of total LRGU revenue, with the share of capital revenues from sales of non-financial assets almost negligible. Given the dominant role of taxes in the structure of LRGU revenues, the increase in total revenues has been due mainly to the increase in tax proceeds. The revenue structure of local units has generally been stable. As shown in figure 5.2, by far the most significant source of



LRGU revenue is from taxes (accounting for almost 60 percent of total LRGU revenue), followed by administrative fees and user charges (over 15 percent) that relate primarily to utility fees and contributions. Grants or transfers (received) also have a significant share in LRGU revenues (over 15 percent). Other categories of income are less significant (which, together with revenues from the sale of non-financial assets, amount to about 10 percent of total LRGU revenue). The revenue of LRGUs has significantly increased since 2001, thanks to the beginnings of the fiscal decentralization process. This is mainly reflected in the revenue from LRGUs' increased share of the PIT.

**Figure 5.2.** Revenue Sources of LRGUs from 1995 to 2018 (in HRK billion - above and in % - below)



Source: Authors' calculation, based on the data from the Report on Revenues and Expenditures, Receipts and Expenses (Form PR-RAS) for the years 1995–2018.

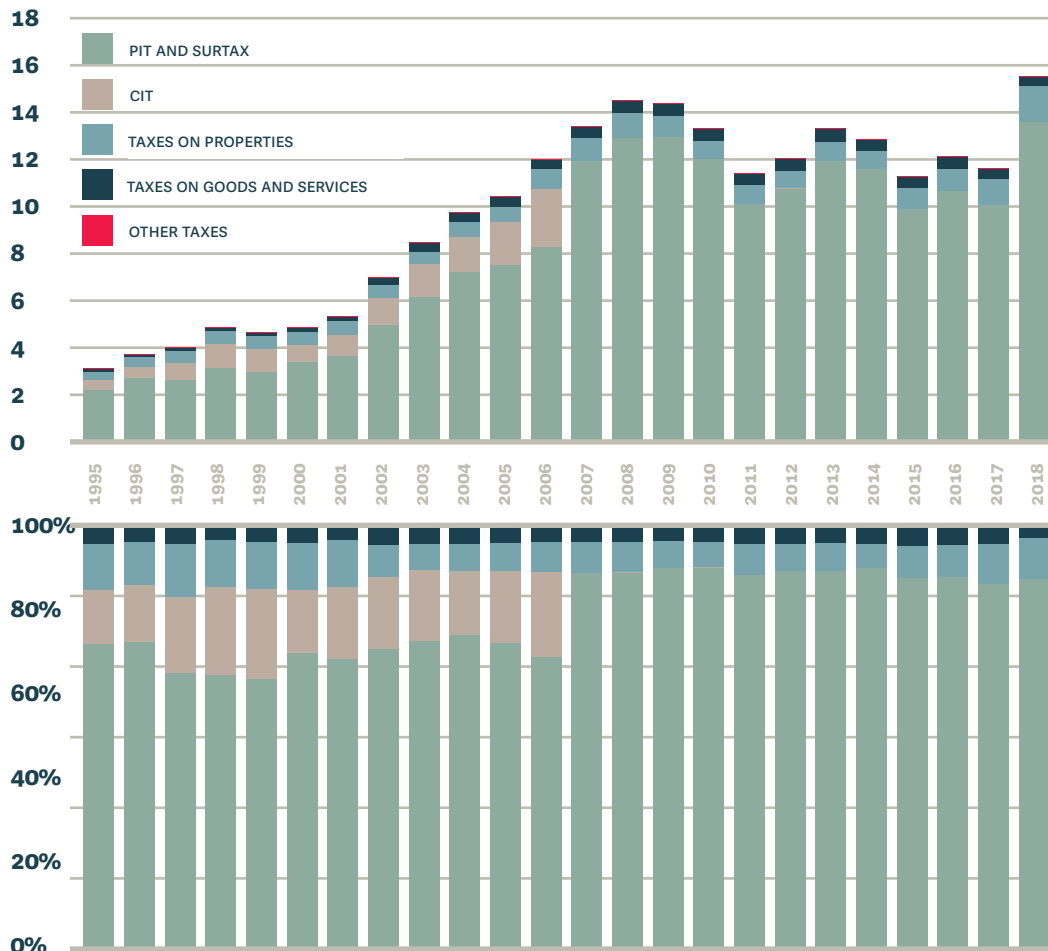
Although the variety of non-tax revenue sources (described in the previous chapter) suggests that LRGUs generate a significant amount of non-tax revenues, in reality, they appear to represent a small share of total LRGU income. The two largest revenue sources are taxes and grants. However, non-tax revenue is an important and often under-tapped source of public revenue in many countries. Given the nature of expenditure assignments, in the sense that LRGUs are mostly delivering urban services as outlined above, such as utility services (water, drainage and wastewater treatment, gas supply, heat supply), urban transportation, disposal

of municipal waste, maintenance of public areas, maintenance of unclassified roads, retail markets, maintenance of cemeteries and crematoria, funeral services, chimney sweeping and public lighting, there would seem to be a significant potential for raising additional revenue from these sources in user charges and fees.

With a combined share of almost 90 percent, PIT and the surtax are the main sources of LRGUs' tax revenues (figure 5.3). PIT became a particularly important source of LRGU financing from 2007 onward. Since then, the central government has entirely renounced its share of any revenue from the PIT, but at the same time, it completely centralized the revenue from the CIT, which had previously been shared among the state, counties, cities, and municipalities.

After the surtax and PIT, another important category is taxes on different types of properties. This segment is dominated by the RETT, while taxes on other types of property are relatively negligible (and it should be recalled that Croatia does not have a recurrent property tax). All local taxes are collected by local communities in an arrangement with the Tax Administration, according to regulations issued by the central government (Law on Local Taxes, OG 115/16 and 101/17; Real Estate Transfer Tax Act, OG 115/16 and 106/18).

**Figure 5.3.** Tax Revenue of LRGUs from 1995 to 2018 (in HRK billion above and in % below)



Source: Authors' calculation, based on the data from the Report on Revenues and Expenditures, Receipts and Expenses (Form PR-RAS) for the years 1995–2018.

The share of taxes collected at the LRGU level alone does not provide enough information to make a judgement on the real fiscal decentralization and autonomy of LRGUs. To fill the gap, table 5.3 presents the level of autonomy of LRGUs in setting the rates for the various tax instruments. As the most important source of revenue, the PIT is shared, though the central government determines the tax base and the rates. LRGUs' weak autonomy with regard to aspects of the PIT raises questions about the true nature of decentralization, because LRGUs do not have the power to alter any element of the PIT in order to raise additional revenues if so desired or to compete with other LRGUs. In other words, it is highly questionable the extent to which shared revenue from the PIT can be treated as decentralized revenue rather than as just another form of transfer, as stated in all fiscal decentralization theories and the official classifications of international organizations, such as OECD or the International Monetary Fund (IMF).

**Table 5.3.** Autonomy in Determining the Tax Rates

	CENTRAL GOVERNMENT DETERMINED	LOCAL UNITS' AUTONOMY TO SET RATES	LOCAL UNITS' AUTONOMY TO SET RATES WITHIN A RANGE
<b>SHARED TAXES</b>			
Personal income tax	✓		
<b>COUNTY TAXES</b>			
Inheritance and gift tax	✓		
Tax on motor vehicles	✓		
Tax on vessels	✓		
Tax on gambling machines	✓		
<b>MUNICIPAL AND CITY TAXES</b>			
Local consumption tax			✓
Tax on holiday houses			✓
Tax on the use of public land		✓	
Real estate transfer tax	✓		
Surtax (to the personal income tax)			✓

Source: Authors, based on the Local Taxes Act (OG 115/16, 101/17) and the Law on Financing Local and Regional Self-Government Units (OG 127/17).

The disparities among LGUs in the values of total per capita revenue are substantial and ranged between HRK 1,726 and 26,750 per capita in 2018 (table 5.4). Inequalities in the collection of certain revenue components are less visible, for example, the coefficient of variation of taxes

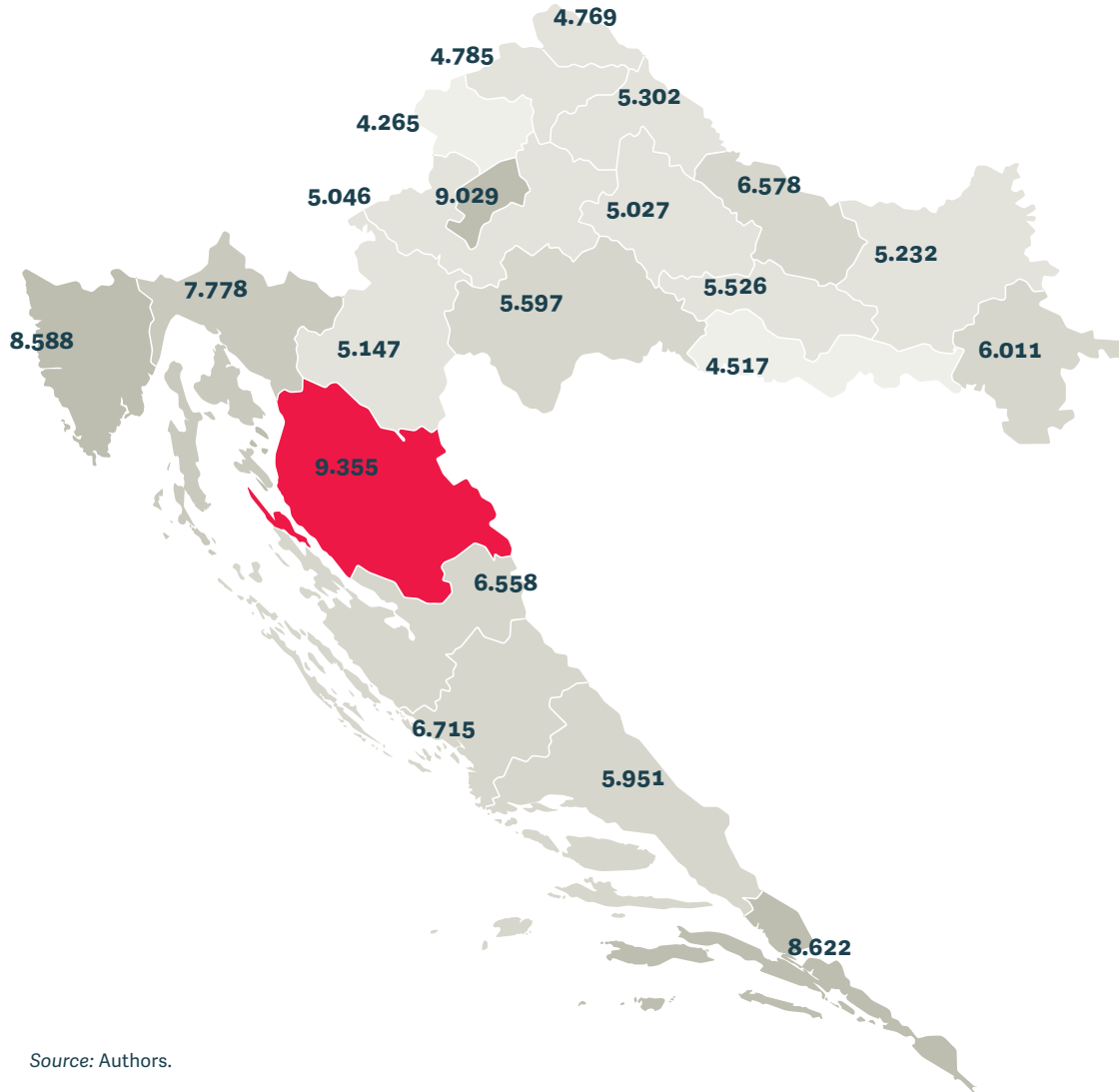
per capita of 38.8 percent is lower than the coefficient of variation for total per capita revenue of 57.2 percent. On the other hand, other revenue components, such as grants, revenue from non-financial assets, and especially other revenue, seem to be much more unevenly distributed across LGUs. Disparities in per capita revenue for counties is less pronounced, following a similar pattern in cities and municipalities, as taxes are more evenly distributed than total revenue.

**Table 5.4.** Summary Statistics of LRGUs' Revenue Components per Capita in 2018 (in HRK)

	MAX	MIN	AVERAGE	MEDIAN	STANDARD DEVIATION	COEF. OF VARIATION
<b>LOCAL GOVERNMENT UNITS (CITIES AND MUNICIPALITIES)</b>						
Taxes	8,418.9	343.1	2,354.8	2,124.4	913.6	38.8%
Grants (received)	23,794.8	0.0	1,076.1	645.5	1,625.1	151.0%
Property income	4,173.6	0.4	426.4	235.4	549.3	128.8%
Administrative fees and user charges	9,873.6	9.6	846.6	432.8	1,049.2	123.9%
Other revenue	3,674.6	0.0	70.3	15.1	238.7	339.4%
Revenue from non-financial assets	5,963.5	0.0	194.9	37.0	545.9	280.1%
Total revenue	26,749.9	1,726.0	4,969.2	4,119.0	2,842.6	57.2%
<b>REGIONAL GOVERNMENT UNITS (COUNTIES)</b>						
Taxes	772.7	443.6	540.3	511.1	101.1	18.7%
Grants (received)	2,248.8	183.1	732.6	627.4	437.3	59.7%
Property income	199.9	22.6	78.3	74.5	40.9	52.3%
Administrative fees and user charges	70.2	13.6	26.2	21.1	14.4	54.8%
Other revenue	119.8	0.0	11.0	3.0	26.6	242.2%
Revenue from non-financial assets	39.6	0.0	4.4	1.7	8.8	199.6%
Total revenue	2,941.7	999.8	1,392.8	1,275.6	421.4	30.3%

Source: Authors.

Per capita revenue tends to be higher in coastal counties. Figure 5.4 shows the territorial distribution of per capita total revenue (see Annex 7 for a territorial distribution of specific revenue components). Counties in the coastal part of Croatia generally collect more revenue than counties in the continental part (with the exception of the city of Zagreb). The total per capita revenue of Zagreb in 2018 amounted to HRK 9,029.

**Figure 5.4.** Territorial Distribution of Total LRGU Revenue per Capita by County in 2018

Source: Authors.

Counties' per capita revenue includes total aggregate revenue of all subnational units (counties, cities, and municipalities) in the area of a particular county divided by the total number of inhabitants (population) of that county.

## 5.4. Vertical fiscal imbalances

Vertical fiscal imbalances are important. The transfer of responsibility for certain public functions from the central government to lower levels of government should always be accompanied by an equivalent decentralization of funding sources sufficient to finance the resulting expenditure needs. However, this does not usually happen, that is, the expenditure needs are often larger than the devolved fiscal capacities of LRGUs. This results in the emergence of

vertical fiscal imbalances (VFIs). Large VFIs are undesirable because there is ample empirical evidence that they lead to less accountability to residents on the part of subnational officials, lower efficiency in spending, lower tax effort in raising own revenues, and less fiscal discipline and responsibility in budgeting and borrowing practices.

VFIs can be measured in different ways. In a purely theoretical sense, a VFI can be defined as the ratio of fiscal capacity (from own assigned revenues) to expenditure needs (from functional assignment). This statutory measure of a VFI, which is the one that corresponds to the laws as originally designed by policy makers, is typically not easy to quantify, and in practice, other measures are utilized. For example, one practical measure of a VFI is to look at the deficits (surpluses) after all available revenues are considered. Thus, in this case, the VFI of a particular government level can be defined as the budgetary deficit (or surplus) of each consolidated level of government before borrowing but after all revenue sharing and transfers have been implemented.

**Table 5.5.** Hunter's Coefficients

COEFFICIENT	FORMULA
HC#1	$1 - \left( \frac{\text{revenue sharing+untied (equalizing) and other transfers}}{\text{total expenditure}} \right)$
HC#2	$1 - \left( \frac{\text{untied (equalizing) and other transfers}}{\text{total expenditure}} \right)$
HC#3	$1 - \left( \frac{\text{other transfers}}{\text{total expenditure}} \right)$

Source: Authors, based on Hunter (1977).

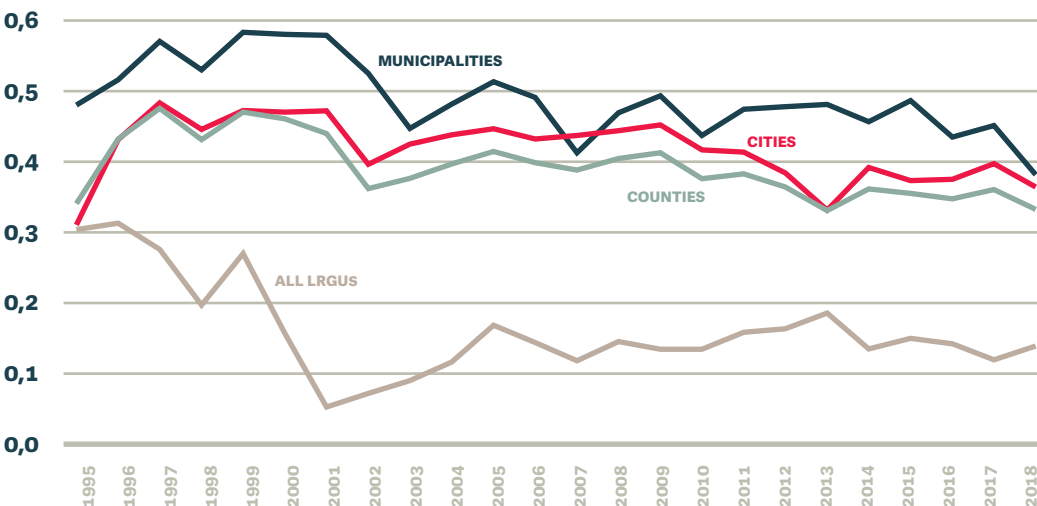
A more sophisticated way of measuring a fiscal imbalance involves identifying expenditures that LRGUs finance with autonomous revenues (the revenues they control). Given that the actual extent of autonomy of LRGU revenues is often open to debate, there are several standard indicators (coefficients) of fiscal imbalance (table 5.5), and the scientific and professional literature continually proposes new types of these indicators. It must be noted that all of these measurements using actual data on collected own revenues and expenditures fail to capture or adjust for the actual behavior of local governments. For example, actual own revenues may be less—due to a lower tax effort—than the capacity local governments have to generate own revenues.

Commonly, VFI coefficients (also known as Hunter's coefficients, for their initial developer) are calculated by determining the portion of expenditures financed by revenues controlled by LRGUs. What is understood by local "control" is interpreted in three increasingly laxer stages: first, only own revenues are included; second, shared revenues are added to own revenues; and third, other unconditional transfers, such as equalization grants, are finally added. In calculating the first coefficient (HC#1), non-autonomous LRGU revenues (that is, the opposite of own revenues) are considered to be revenue sharing, untied, or non-earmarked transfers

(which include equalization) and other transfers, mostly conditional or tied transfers; in the second (HC#2), only non-earmarked transfers and other transfers; and in the third (HC #3), only other transfers. Hunter’s fiscal imbalance coefficients assume values in the interval [0,1], with higher coefficient values indicating a smaller fiscal imbalance. The calculation of all three Hunter’s coefficients should show an ordered hierarchy, such that  $HC\#1 < HC\#2 < HC\#3$ . The coefficient HC#1 treats the proceeds from the tax revenue sharing and all other grants or transfers (which includes untied or unconditional grants and conditional or tied transfers) as non-autonomous LRGU revenue. In Croatia, shared taxes currently include the PIT and historically also the CIT. One complication is that the PIT includes also the surtax because in the publicly available data, it was not possible to isolate it. And properly speaking, the surtax should indeed be considered own revenue. Because the distinction between the PIT and the surtax is very important, it would also be important to be able to separate the shared PIT as a transfer and the surtax (piggyback ) as own revenue.

Although the scope of revenue sources treated as non-autonomous here is not precise (due to data limitations), relative comparisons of coefficients for various tiers of government in different points in time provide at least a sense of the VFIs that exist at the different subnational levels of government. Even though the values are somewhat volatile, it is interesting to see how HC#1 coefficients for cities and counties have moved almost axially symmetrically in the past decade (figure 5.5). Regional governments turn out to be facing huge VFIs (measured by HC#1, which fluctuates for counties between 0.1 and 0.2 most of the time). Cities and municipalities are in a much better position (with HC#1 in 2018 of 0.36 and 0.38, respectively). This means that cities and municipalities finance almost 40 percent of total expenditure with their autonomus revenue. It is also worth mentioning here that the position of LRGUs has deteriorated over time with the fiscal decentralization process, at least when it comes to VFIs, proving that more spending needs have been transferred to LRGUs than revenue sources to finance them.

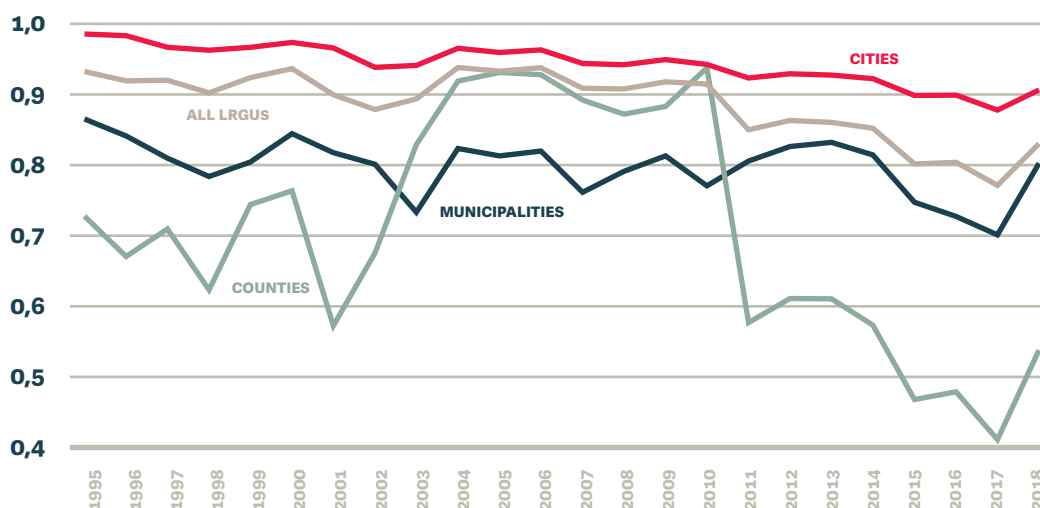
**Figure 5.5.** Hunter’s Coefficient #1 by Level of Government from 1995 to 2018



Source: Authors’ calculation, based on the data from the Report on Revenues and Expenditures, Receipts and Expenses (Form PR-RAS) for the years 1995–2018.

An alternative view, which adapts more realistically to how revenue sharing is interpreted in Croatia and therefore to how fiscal imbalances may actually be viewed, is presented in figure 5.6. In calculating the HC#2 coefficient, only grants (other than revenue sharing) are treated as non-autonomous revenue of LRGUs. According to this measure, cities have the lowest VFI (with HC#2 of 0.91 in 2018), followed by municipalities (HC#2 of 0.81) and counties (HC#2 of as low as 0.54). Trends point to a similar conclusion about the impact of the fiscal decentralization process on VFIs as described above for HC#1. Although it seems that counties experienced a significant change in the HC#2 coefficient in 2011, this is merely a reflection of the methodological changes in recording the equalization grants for the decentralized functions. Since these grants were financed from a share of the PIT, they were recorded under revenue from that and the surtax. However, since 2011, equalization grants for decentralized functions have been recorded as grants (received), which has had a huge impact on the accounting of the total value of grants and consequently the HC#2 coefficient.

**Figure 5.6.** Hunter's Coefficient #2 by Level of Government from 1995 to 2018



Source: Authors' calculation, based on the data from the Report on Revenues and Expenditures, Receipts and Expenses (Form PR-RAS) for the years 1995–2018.

## 5.5. Significant policy issues and international experience and practice in revenue assignments

It has been established that subnational governments in Croatia, particularly at the county and regional levels, lack sufficient tax revenue autonomy. This section explores the different ways in which subnational tax revenue autonomy can be increased. But because there are many avenues for doing this and some are more desirable than others, it is necessary to first address the question: What type of revenue autonomy is most desirable and what is the best way to achieve it? The list of tax assignments at the regional and local levels is also examined to determine whether it is complete and appropriate. Here the most fundamental concerns



are that regional governments lack a significant source of revenue and that, unlike most countries in the world, Croatia does not have an annual real estate property tax. Thus, there is the additional question of the type and form of real estate property tax that is best suitable to Croatia. Although the subnational piggyback PIT is one of the best features of the current revenue assignments, it raises several issues that need to be examined. In particular, is the assignment of this tax to the city-municipal level the correct one, or should it be the regional level? How can the fiscal vertical externalities continuously inflicted on subnational governments by changes in national legislation be minimized? Clearly, there are several issues in tax administration that need to be addressed.

### **INCREASING SUBNATIONAL TAX REVENUE AUTONOMY**

Increasing subnational revenue autonomy and reducing dependence on central government transfers make regional and local government officials more accountable and responsive to their constituencies' needs.<sup>25</sup> But if effective fiscal decentralization requires meaningful revenue autonomy at the regional and local levels of government, what kind of autonomy is best and what taxes should be assigned to the subnational levels to achieve it?

Even if subnational tax autonomy is needed, not all forms of tax autonomy are equally desirable. Subnational government may be given the authority to introduce new taxes at will, to define and change tax bases through exemptions and so on, or to change tax rates and the authority to administer those new taxes. Nevertheless, there are good reasons not to provide subnational governments with the autonomy to choose the taxes that they can impose. The general choice is between (i) an open list of taxes to be determined by the subnational governments themselves within some general limits and restrictions, or (ii) a closed list of allowed taxes that is determined at the national level and from which subnational governments can choose. Overall, the latter is arguably preferable because it avoids the introduction of nuisance taxes in some cases or higher and inefficient distortionary taxes that can impede local economic development, domestic trade, and growth. In practice, however, where subnational governments are given more constitutional discretion, as in some federal systems, open lists with some general restrictions are common, and closed lists are used more frequently in unitary systems of government. Overall, therefore, the current practice in Croatia is well justified.

An additional decision to be made is whether a specific tax base should be used exclusively by one tier of government or whether a base can be used simultaneously (co-habited) by several government levels. In practice, the choice between exclusive or shared tax bases among tiers of government comes down to the advantages and disadvantages of each. The most important disadvantage of the exclusive base is that typically, subnational governments will be shut out of any opportunity to use significant (either in size or, over time, buoyancy) tax bases, thus drastically reducing any meaningful possibility of subnational tax autonomy. The main disadvantage of cohabitation is the potential presence of negative vertical externalities (tax decisions at one level of government that affect the tax bases and revenues of other levels). This latter is evident in the case of the PIT revenue sharing and the piggyback PIT in Croatia.

<sup>25</sup> The simple but powerful logic is that subnational authorities will spend resources differently when they need to incur the political costs of taxing their constituents, in comparison to what they would do if the money comes to them, practically cost free, from the central government.

All things considered, the preferred approach may be a choice of a closed list that allows for the co-habitation of tax bases by different levels of government. The aim should be to reduce vertical externalities by minimizing changes in national legislation, and when those have to be made, to use intergovernmental transfers or other adjustments to correct for their revenue effects.<sup>26</sup> From this perspective, the main problem in Croatia has been the frequent changes in national legislation, and the obvious solution lies in changing that process.

The most common dimensions of tax autonomy relate to: (i) which level of government can legislate over the structure of the tax bases; and (ii) which level has the discretion to set the tax rates. Variations in the definition of the tax base, either through special exclusions from the tax, deductions from the tax base, and credits against the tax liabilities, can more easily lead to complexity and a lack of harmonization across jurisdictions. The most important unwanted consequence is the higher tax administration costs for all the jurisdictions involved, as well as the higher compliance costs for taxpayers who have tax obligations in several jurisdictions. Tax harmonization is easiest when the structure for subnational taxes, including the definition of tax bases, is nationally legislated. When tax structures are separately legislated by subnational governments, harmonization can prove to be quite difficult.

On the other hand, autonomy to define the tax rate generally tends to be more desirable because it is simpler to deal with across jurisdictions for both tax administrators and taxpayers. Focusing on autonomy in setting the tax rate has the additional important advantage of enhancing the visibility of the tax, which tends to generate greater political accountability. Both households and businesses can more easily determine the fiscal exchange or net benefits provided by different jurisdictions in their tax-public service packages when the differences in tax burdens are expressed in terms of (highly visible) differences in tax rates. Note also that by setting minimum rates that subnational governments must apply in national legislation works effectively as a preventer of negative tax competition, the so-called “race to the bottom.” Maximum legislated rates may also be desirable if there are concerns about overall tax burdens. In any case, negative tax competition is much harder to avoid when subnational governments have discretion over the structure of tax bases. Thus, overall, current practices for granting tax autonomy in Croatia have been on the right track, but clearly there is room for granting the discretion to set tax rates within certain parameters, which currently is not allowed.

#### **COMPLETING SUBNATIONAL REVENUE ASSIGNMENTS: INTRODUCING THE PROPERTY TAX AND REASSIGNING THE PIGGYBACK PIT**

The currently marked lack of revenue autonomy at the regional level in Croatia can be best addressed by replicating the revenue assignments in many EU and other countries with two levels of subnational government. This would imply reassigning the piggyback PIT from the city-municipality level to the regional level and introducing an annual real estate property tax

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<sup>26</sup> The PIT has become a very powerful and often utilized political tool in Croatia. In order to gain popularity, politicians at the central government level have often decreased the tax burden or altered the distribution (tax sharing with subnational governments) schedule, causing minor effects at the central level but producing serious consequences at lower levels of government. Since PIT is often perceived as “almighty” (aiming at securing financing for LGUs, interregional redistribution, interpersonal redistribution due to its progressive tax schedule, etc.), the PIT law in Croatia is changed or amended very frequently (on average more than once a year). This makes the financing environment for LGUs unstable, which directly affects other aspects of their operations (investments, etc.).

at the city-municipal level. Although the PIT piggyback can also be used at the local level, its progressive nature and geographic dispersion make it more generally fit as a regional-based tax. In contrast, all cities and municipalities have a tax base presence with the real estate property tax.

There is ample consensus in the public finance literature identifying the property tax as one of the best mainstays at the subnational level. Local governments have a comparative advantage in identifying and valuing properties because they are familiar with the housing and land available in their areas. Almost without exception in international practice, property tax revenues are assigned to local governments as opposed to intermediate level or regional governments. Revenues from property taxes in OECD member countries represent up to 2 percent of GDP, although in developing and transition countries, this share is less than 0.7 percent but with an upward trend.<sup>27</sup> For the sake of comparison, the revenue from the PIT surtax in Croatia amounts to about 0.5 percent of GDP.

Why would the introduction of the annual real estate property tax be a good reform for local financing in Croatia? Several features make a property tax especially attractive at the local level. It is a visible tax and thus conducive to political accountability, and for the most part, it falls on an unmovable base. Generally, it can act as a quasi-benefit charge because property and land values will respond to the level and quality of the public services provided. The more homogeneous the property and population, the closer the property tax comes to being a benefit tax.

Other advantages of property taxes are their revenue potential and stability. The potential revenues of the property tax are large because it has a revenue-income elasticity and rapidly growing base (property values). The property tax can be made more progressive by ensuring that low-value structures are exempt or taxed more lightly or by introducing “circuit breakers” that allow a lower tax bill for the elderly or low-income families who are temporarily “income poor but house rich.” The property tax also has the advantage of imposing a relatively low compliance cost on taxpayers because taxpayer intervention in the determination of tax liability is minimal. Lastly, property taxes can generate improved land-use practices.

The disadvantages of introducing a property tax include the initial cost of the valuation of properties and their periodic revaluation. Moreover, because of its visibility, it can be unpopular among taxpayers and consequently, also with public officials. When property values are not regularly updated, however, even though they are stable over business fluctuations they will lack little automatic revenue growth.

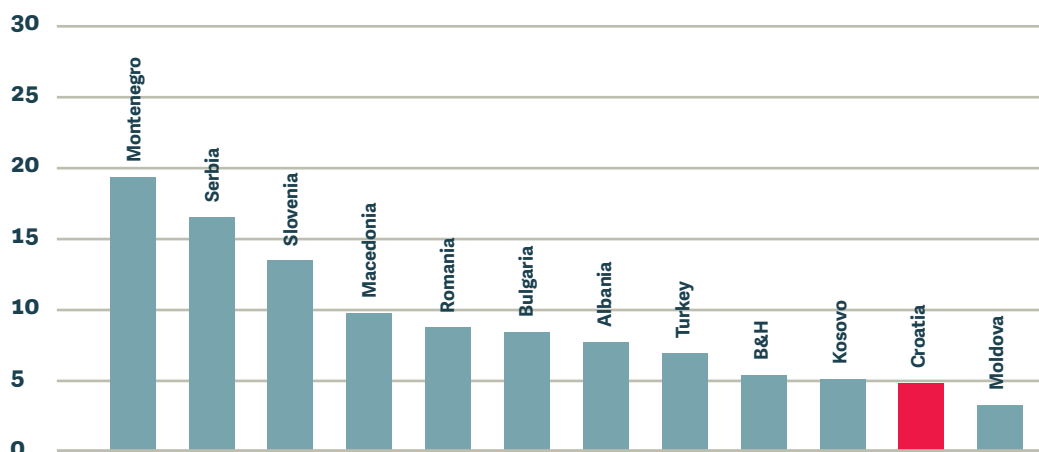
Although the taxation of properties can be quite sophisticated, it is not reserved exclusively to developed western economies. In fact, some SEE countries collect a significant share of LGU revenue in property taxes, for example, Montenegro, where the share of taxes on properties reaches almost 20 percent of total tax revenue (figure 5.7). Although the classical property tax, in the narrow sense, does not exist in Croatia, there are various other taxes that tax properties. However, their share in total tax revenue is below 5 percent. In fact, among SEE countries, Croatia has one of the lowest shares of property taxes in total tax revenue (a smaller share exists only in Moldova).

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<sup>27</sup> See, for example, Bahl and Martinez-Vazquez (2008).

In practice, there are several forms of the property tax. The most common by far is the annual real estate tax that depends on the market value, or an otherwise assessed value, of land and improvements or structures.<sup>28</sup> This is the tax that Croatia currently lacks, except for that tax on second home properties. Of course, with the introduction of a general property tax, this special tax on second homes could be absorbed into the new tax.

**Figure 5.7.** Share of Taxes on Properties in LRGUs' Revenue in 2019 (in %)



Source: NALAS (2020).

A second form of property tax is the betterment levy. In this context, these are lump-sum payments exacted up front by subnational governments from land and housing developers and also from homeowners as a charge for public service improvements, such as road paving, drain infrastructure, sidewalks, street lights, and so on, that have a visible benefit on property values. Betterment levies can be useful in providing subnational governments with liquidity to invest in needed infrastructure; they also have the advantage of being more directly contractual than property taxes and therefore reinforcing the benefit principle feature in subnational government financing.<sup>29</sup> Croatia already has this type of tax under the name of utility fees, as discussed above. Since betterment levies are complementary to ordinary property taxes, it would be appropriate to maintain utility fees side by side with the new annual property tax.

A last form of property taxation is the property transfer tax, which is paid at the time of the sales transaction. This can be a relatively high revenue-yielding tax, but the high rates have the negative effect of locking in land and property sales, which could lead to efficiency losses. This form of property taxation is also likely to be more volatile in its revenue flows than the regular property tax and can be subject to the significant underreporting of sales prices. This form of property taxation already exists in Croatia and is assigned to local governments.<sup>30</sup>

<sup>28</sup> In a few cases, the tax may fall only land values. Although a tax on land tends to be more efficient, it also has less revenue potential and is generally more difficult to administer in terms of valuation or assessment of properties.

<sup>29</sup> A different modality of betterment levies is what is known as a land value increment tax (as in Taiwan) or land value capture levy (as in Brazil). This is more of a form of capital gains tax on land values associated with infrastructure improvements and also changes in regulations regarding, for example, the height at which structures can be built.

<sup>30</sup> In some European countries, the property transfer tax is assigned to the regional level. This is an option that could also be considered in Croatia, depending on the revenue balances between the local and regional levels once the annual property tax is introduced.

## ISSUES IN TAX ADMINISTRATION

One last important dimension of revenue assignment and tax autonomy refers to the level of government that is put in charge of administering the various taxes. That a particular tax has been assigned to the local or regional level does not necessarily mean that it should be administered at that level; under some circumstances, it may be more advantageous to have that tax centrally administered, but with the subnational government still able to set the tax rate. International experience shows a variety of approaches to the organization and degree of decentralization in tax administration. Countries with considerably decentralized revenue authority may have a highly centralized tax administration (e.g., Scandinavian countries), and countries with little decentralized tax autonomy may have highly decentralized tax administration (e.g., Germany). More typically, one can find systems with separate tax administrations (each level of government administers its own taxes) or mixed models (the central government administers some local taxes, and much less frequently, local governments may administer some central taxes.)

From a technical side, several factors favor a more centralized administration, including economies of scale and scope, informational externalities, and compliance costs with the uniformity of tax procedures. There are overwhelming reasons to have the piggyback subnational PIT administered centrally, as is the case in Croatia. From the view point of visibility and accountability to residents, there is a premium to having local or regional tax administration and enforcement when there are no powerful technical reasons against it. Also, it is generally desirable to consider asymmetric solutions. Some subnational jurisdictions may have better knowledge of local circumstances, be large enough to realize at least some of the advantages related to economies of scale, and/or be small enough to allow more experimentation to take place. Moreover, new developments in hardware and software have reduced the previous advantage of centralized information and processing systems.

Taxpayer compliance costs generally may be reduced through a centralized tax administration because of fewer offices to visit, less information to process, and so on. However, decentralization may provide more proximity to subnational offices when the central tax administration does not have a localized presence, which seems generally to be the case in Croatia. But a central administration that enforces subnational taxes must also have incentives to do so. Some degree of incentive compatibility may be gained through appropriate contracting whereby the central tax administration gets monetarily compensated for the collection of subnational taxes, as in the case of Croatia, where the central Tax Administration gets 5 percent of subnational tax collections.

The model of (de)centralized tax administration that fits better is likely to depend on the specific tax assignment in a country. However, it would generally be undesirable to decentralize the administration of taxes shared between the central and local governments or subnational taxes that piggyback on national taxes, which again, is the case with piggyback taxes in Croatia. In the case of exclusively subnational taxes, their administration can be assigned to the central tax administration, but this needs to be accompanied by incentive-compatible contracts, as is already the practice in Croatia. Subnational tax administrations are more desirable for exclusive subnational taxes for which there are information and enforcement advantages at the local level, such as, it is often argued, with the property tax.

Whatever model is adopted, best practice requires coordination and information sharing about taxes and taxpayers among the different levels of tax administration. As was outlined above, that cooperation and information sharing is currently lacking in Croatia.

But because the property tax would be a new local tax in Croatia, it would be important to review the different possible modalities in property tax administration. A key realization is that in many countries, including Croatia, the ability of local governments to properly administer the property tax varies significantly. Although large cities are likely to have the capacity to develop a cadaster of properties with valuations for each property, that capacity is likely to be lacking in small municipalities. This calls for an asymmetric approach, whereby some local governments take on all aspects of property tax administration, while the development of the cadaster and property valuation is left to a central or regional government office for smaller local governments. Once administrative capacity is in place at the local level, the control of the tax can be shifted to those local governments.<sup>31</sup>

The biggest operational challenge to the property tax is the difficulty in assessing the market values. The valuation of property has increasingly been based on computer-assisted mass appraisal (CAMA) methods using information from reported sales values, individual property characteristics, and property location.<sup>32</sup> The key element is the availability and quality of data on property transactions. Where those data do not exist or are too costly to develop, several alternative methods are used. One is the area-based approach to valuation, which involves two steps. First, properties are assigned a value zone based on such factors as quality and size of the structure, location, and service availability. Second, the taxable area of the property is multiplied by a notionally determined value per square area, which may be more or less related to market sales information, to arrive at the property tax base. A less common approach is to use the rental value system, whereby the tax base is rental payments, though true rental values may be harder to obtain than property market values.

## 5.6. Options for reform

For Croatia, the two most promising revenue assignment reforms would be increasing overall revenue autonomy and introducing the property tax. These two reforms could be coordinated so that as the annual real estate property tax is introduced at the city-municipality level, the piggyback PIT surtax now assigned to that level can be reassigned to the regional/county level. In addition, the introduction of the annual real estate property tax would make it possible to simplify and rationalize a number of other local taxes. In particular, rents on monument sites and taxes on holiday houses could be amalgamated into the new real estate property tax.

The new property tax would allow the adequate taxation of non-permanent residential properties, including cottages, occasional rentals, and unused properties. If the government decides

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<sup>31</sup> It should be noted that tax autonomy is largely preserved as long as subnational authorities are given some discretion over rate setting. For international experience with the property tax, see Bird and Slack (2004) and Bahl and Martinez-Vazquez (2008).

<sup>32</sup> A different approach to property assessment is to tax only land and leave out improvements (structures) from the tax base. But data on comparative land sales tend to be considerably scarcer. See Franzsen and McCluskey (2008) on experience with site value taxation in developed and developing countries.

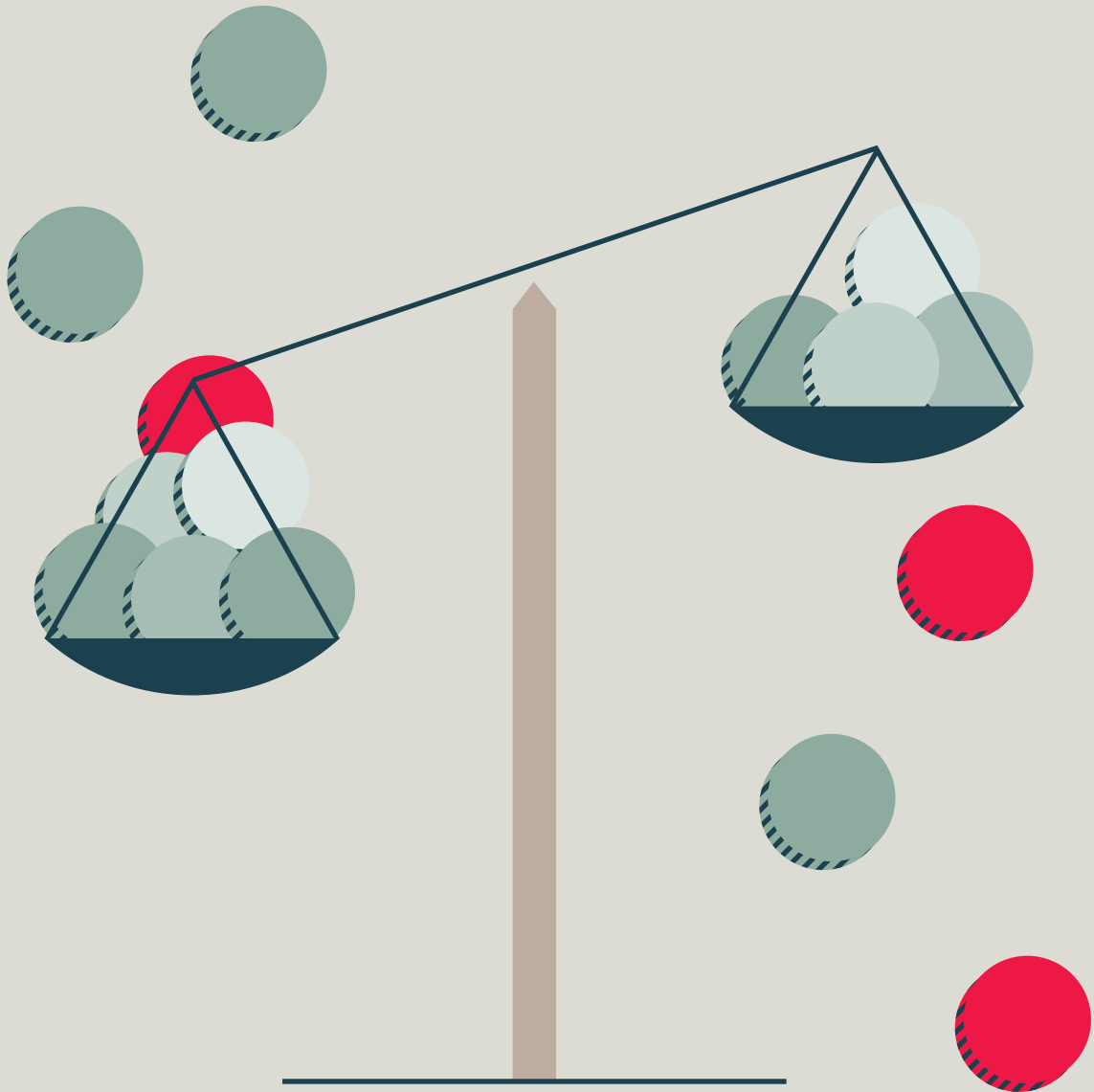
to introduce the property tax at the local level, a phased plan for its introduction should be developed that involves updating fiscal cadasters, implementing fair and efficient valuation or appraisal methods, and carrying out fair and transparent administrative procedures, including efficient appeals, all under a predictable implementation calendar. Moreover, a property tax should be introduced in addition to and not instead of utility fees. However, the total burden should remain at the level of current utility fees, at least for a while, until it is determined that raising tax burdens for improved services is a desirable next step. The introduction of a property tax will not be an easy task; on the one hand, it would change the logic of local taxation for the better and bring greater autonomy to LGUs, but on the other, it would create an additional tax burden for citizens. In order to avoid the adverse effects and ensure that its introduction remains fiscally neutral, this reform should be put in the context of the overall tax structure in the country and the different capacities of LGUs.

The government could also explore assigning some “green taxes” to regional and local governments, thereby gaining a double dividend of generating revenues and also engaging the subnational governments in combating climate change. These could include fees and charges for the preservation of the environment, involving construction, transportation, forestry, and so on. Examples of these levies in international practice include green fees for vehicle tire and battery disposal, the use of landfills, and disposable plastic bag usage; taxes on motor vehicles; road taxes; water supply, sewage, and household and industrial waste charges; surtaxes on electrical energy consumption; charges for bush and tree removal; or fees for any environmental damage caused by large commercial establishments. Other green levies can be assigned to subnational governments to deter certain decisions and behaviors that tend to increase the costs of adaptation to the effects of climate change, such as fees imposed on home builders in flood plains, and taxes and fees can be used to partially capture the value created by installing green infrastructure, such as storm water management.

A technical assistance program could be developed to strengthen local tax administration capacities, particularly for setting up an effective information exchange between the central tax administration unit and the LRGUs. The effectiveness of tax administration for the collection and enforcement of LRGU taxes is currently impeded by the lack of information exchange between the various authorities. Most LRGUs have voluntarily transferred tax revenue collection authority to the Tax Administration (which charges a commission of 5 percent of collected revenue). Due to the provision on tax secrecy (Article 8 of the General Tax Law), most LRGUs do not have accurate information on debtors and debt status. Particularly problematic is the collection of taxes and non-tax revenues related to property, such as taxes on holiday houses (because owners do not provide information on ownership and status of real estate) and IGTs (the Tax Administration has no obligation to report to LRGUs on its decisions). These problems could be tackled through interventions in the collection process itself and through legislation, which currently hampers the exchange of information between the Tax Administration and LRGUs. Since LRGUs now receive payments based on revenue collected by the Tax Administration but without information on who the primary payer is, an important pending issue is the creation of preconditions for LRGUs to obtain accurate information on taxpayers and to have detailed insight into the structure of claims in real time.



# 06 Toward More Efficient, Equitable, and Stable Intergovernmental Transfers





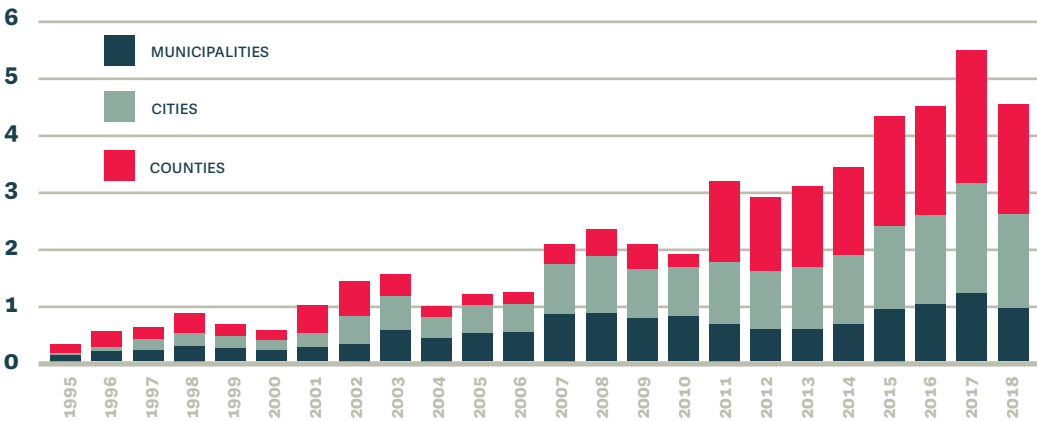
Transfers and grants are an important component of the financing architecture for subnational governments in decentralized systems that help complement revenue assignments. Transfers are necessary (i) to help close vertical imbalances stemming from either insufficient revenue decentralization (through revenue sharing) or the unequal distribution of own resources (through equalization transfers), or (ii) to finance certain expenditure programs that complement central government objectives and specific investment programs (through conditional grants). Croatia, like most other decentralized countries, has a full range of transfers and grants. The most prominent ones, including revenue sharing (from the PIT), equalization grants for decentralized functions and fiscal (capacity) equalization transfers, conditional grants, and EU grants, are described in this chapter.

### 6.1. The structure of LRGU grants

The total level of grants to LRGUs increased from HRK 0.3 billion in 1995 to HRK 4.5 billion in 2018. Although the grant amount sometimes increased as a result of methodological changes in recording certain intergovernmental transactions, it is interesting to observe a pattern of a sudden increase in total grants approximately every four years. Given that Croatia held parliamentary elections in 1992, 1995, 2000, 2003, 2007, 2011, and 2015, it seems that the total amount of grants to LRGUs increases with the electoral cycle.

The distribution of grants between the different tiers of government reveals that counties are more recently the most significant beneficiaries of LRGU grants (43 percent of the total), followed by cities (36 percent) and municipalities (21 percent) (figure 6.1). The share of the different tiers of government in total grants fluctuates throughout the observed period, depending on the macro-fiscal environment and also on the scope of transactions treated as grants and the changes in recording them. For example, a huge increase in grants from 2011 is a “technical” increase caused by changes in recording the equalization grants for decentralized functions, which until 2011 were recorded as the revenue from the PIT and surtax.

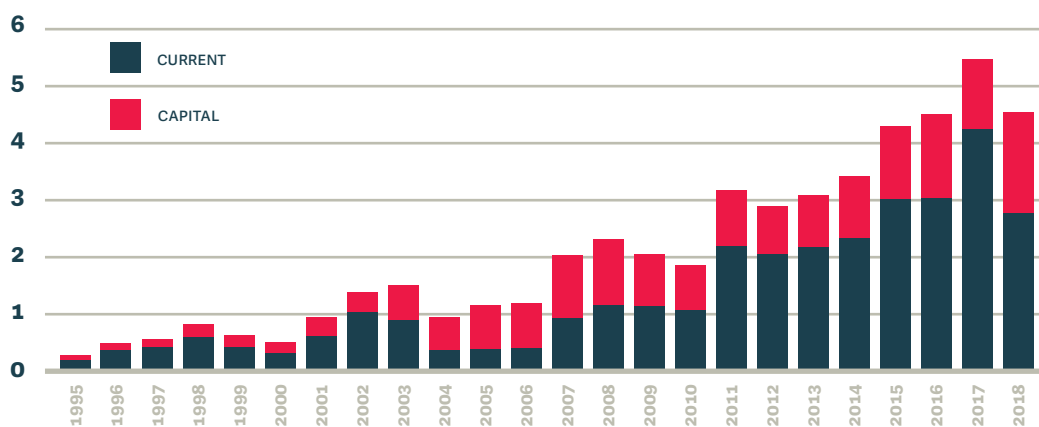
**Figure 6.1.** Grants Received by Level of Government from 1995 to 2018 (in HRK billion)



Source: Authors’ calculation, based on the data from the Report on Revenues and Expenditures, Receipts and Expenses (Form PR-RAS) for the years 1995–2018.

Current grants dominate the structure of total LRGU grants (figure 6.2). The share of capital grants increased gradually to account for 64 percent in the period before the global financial crisis and then slowly decreased to its lowest level of 22 percent in 2017. Current grants to LRGUs had previously included those from the MOF to counties, current MOF grants to cities in ASNCs I and II, current grants as a substitute for the CIT, and other types of grants (Primorac 2015). With the introduction of the new system in 2018 all of these different types of grants initially meant for fiscal equalization merged into a single fiscal equalization grant. However, fiscal equalization funds are now recorded as non-earmarked revenue from the PIT and not shown in the statistics of LRGU grants.

**Figure 6.2.** Current vs. Capital Grants from 1995 to 2018 (in HRK billion)



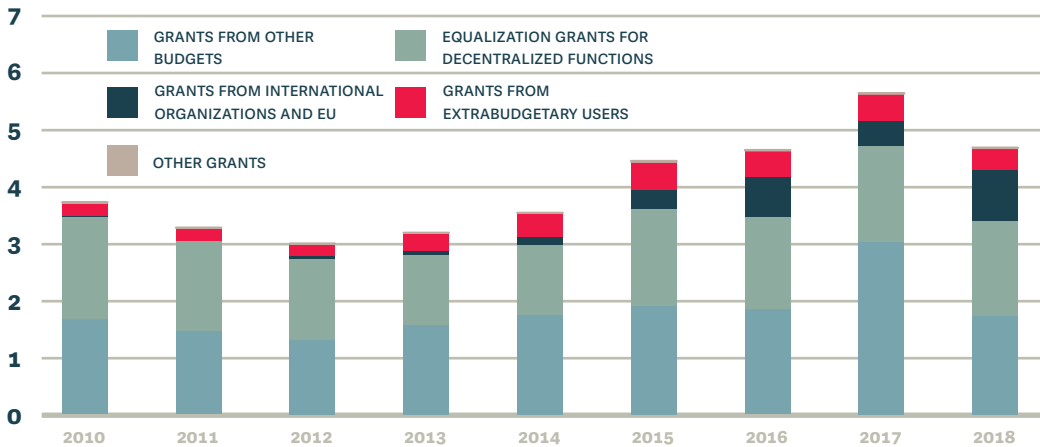
Source: Authors' calculation, based on the data from the Report on Revenues and Expenditures, Receipts and Expenses (Form PR-RAS) for the years 1995–2018.

LRGUs in Croatia receive various types of other grants from foreign governments, international organizations, and EU institutions and from extra-budgetary users, as well as from other budgets, mainly the central government in the form of conditional transfers (figure 6.3). Note that since 2011, equalization grants for decentralized functions have also been included in the grants (received). Before 2011, they were recorded under the revenue from the PIT and surtax because they were financed from a share of the PIT.

Grants from other budgets are predominantly conditional grants from different ministries for various programs, but they include also other types of grants, for example, central government grants distributed to LRGUs as compensation for the loss of revenue due to legislative changes related to LRGU financing and tax reform. Since in several “rounds” of tax reform the tax burden on labor, and thus LRGU revenues, has been significantly reduced, since 2017, the central government has provided grants to LRGUs as a compensatory measure. The value of these grants reached HRK 643.8 million in 2017 and HRK 134.4 million in 2018. Funds for the payment of damages from natural disasters are also part of the current grants from the central government. Until 2018, grants from other budgets had also included grants for equalization purposes, but since then, these transfers have been recorded as unconditional revenues from the PIT. Grants from other budgets include funds for co-financing the work of public fire brigades by other municipalities; grants from the county budgets for capital investments,

kindergartens, libraries, and the like; and other grants from counties, various ministries, and so on. These grants also include current and capital grants from the state budget to co-finance the participation of LRGUs in the implementation of EU projects.

**Figure 6.3.** Structure of LRGU Grants from 2010 to 2018 (in HRK billion)



Note: Adjustments are made here for 2010 (equalization funds for decentralized functions that were recorded under the PIT are shown here as equalization grants for decentralized functions to preserve consistency).

Source: Authors' calculation, based on the data from the Report on Revenues and Expenditures, Receipts and Expenses (Form PR-RAS) for the years 2010–2018.

Grants from extra-budgetary users are those from the Croatian Pension Insurance Institute, Croatian Health Insurance Institute, Croatian Employment Service, Environmental Protection and Energy Efficiency Fund, Croatian Waters, Croatian Roads, and other extra-budgetary users of the state budget. Grants from international and EU organizations primarily refer to financial resources withdrawn from various EU funds. Others refer to grants from foreign governments, grants to budgetary users, and transfers between budgetary users.

All of these different types of grants, as well as other important transfers that are not considered grants and are not shown in figure 6.3, such as revenue sharing and equalization transfers, will be discussed in more detail in the following sections.

## 6.2. Revenue sharing

Revenue sharing has been used quite extensively, especially in the context of certain central taxes. The most significant shared revenue sources used to mitigate VFIs have been the PIT, CIT, and RETT. However, as noted above, the CIT was fully assumed by the central government in 2007, and the RETT was completely ceded to local governments in 2017. Since then, the PIT, with a distribution scheme subject to frequent changes, has become the only shared tax in Croatia. Currently, PIT revenue is distributed in such a way that 74 percent belongs to the municipality or city on a derivation basis (or where the tax is collected), 20 percent to the county

in which the local government is located, and 6 percent to LRGUs that have taken over the financing of newly decentralized functions (elementary and secondary education, social welfare, health care, and firefighting). Beginning in 2001, when the decentralization process began, LRGUs have been able to take over the provision and financing of decentralized functions. If they do so decide, they receive an additional share of the PIT to finance them. The historical evolution of sharing the PIT is summarized in table 6.1.

**Table 6.1.** General PIT Distribution Scheme (in %)

PERIOD	CENTRAL GOVERNMENT	COUNTY	CITY/ MUNICIPALITY	DECENTRALIZED FUNCTIONS	EQUALIZATION FUND FOR DECENTRALIZED FUNCTIONS	EU PROJECTS
1.1.1994–1.4.2000	70	5	25			
1.4.2000–1.7.2001	60	8	32			
1.7.2001–1.1.2002	29.2	8	32	9.8	21	
1.1.2002–1.1.2003	29.6	8	32	9.4	21	
1.1.2003–1.1.2007	25.6	10	34	9.4	21	
1.1.2007–1.7.2008		15	52	12	21	
1.7.2008–1.3.2012		15.5	55	12	17.5	
1.3.2012–1.1.2015		16.0	56.5	12	15.5	
1.1.2015–1.1.2018		16.5	60	6	16	*1.5
1.1.2018–1.1.2021		17	60	6	**17	
1.1.2021–		20	74	6		

Notes: \*Share for projects co-financed by European Structural and Investment Funds led by municipalities, cities, and counties, legal entities under their majority ownership or co-ownership and institutions they founded.

\*\*Share for financing the fiscal equalization system. Until 2018, funds within this category were used to finance equalization grants for decentralized functions. However, in 2018, the central government took over the equalization funding for decentralized functions, leaving this share of the PIT for funding the newly established fiscal equalization scheme.

Source: Law on Financing of Local and Regional Self-Government Units (OG 117/93, 33/00, 59/01, 107/01, 117/01, 150/02, 147/03, 132/06, 73/08, 25/12, 147/14, 100/15, 115/16, and 127/17).

The municipality, city, or county that takes over the financing of newly (optional) decentralized functions retains an additional share of the PIT as follows: for elementary education, it is 1.9 percent; for secondary education, 1.3 percent; for social welfare, 0.8 percent (0.2 percent for social welfare centers and 0.6 percent for nursing homes); for health care, 1.0 percent; and for firefighting (public fire departments), 1.0 percent. Also, 1 percent of the total PIT revenue collected is charged by the Tax Administration for the costs of performing the activities of determining, recording, collecting, supervising, and enforcing the tax. Counties have, in practice, taken over responsibility for financing newly decentralized functions. So, in essence, LGUs that want to do this have to prove that they have the capacity to do so and also must have the consent of the county assembly. This is why only cities with the highest fiscal capacities have

taken over all newly decentralized functions, whereas the majority of other LGUs have taken over only certain functions, mostly firefighting. Those LGUs that have taken on responsibility for financing a newly decentralized function receive an additional share of the PIT for each function assumed, whereas the rest of the available PIT share (for functions not assumed by LGUs) goes to counties.

Note that the city of Zagreb, since it also has the status of a county and performs activities within the scope of both entities, accrues the sum of the shares belonging to a city and a county, plus the share intended for the financing of newly decentralized functions. In other words, as of 2018, Zagreb keeps 94 percent of the income tax revenue collected within its area.

Through the latest amendments to the Law on Financing Local and Regional Self-Government Units, a simpler, more understandable, and generally fairer system of distribution of PIT has been established. All PIT revenue is left to the LRGUs, and its distribution is simplified by applying a uniform allocation scheme for all of them. There are no exceptions, and all units are covered with the same (uniform) tax schedule, including those in the supported areas that had previously enjoyed preferential treatment in the PIT revenue sharing system.<sup>33</sup> Of course, it must be noted that even though the shares are uniform, the bases or the amounts shared on a derivation basis are very different depending on the level or economic activity and the income earned by residents. In this sense, PIT sharing with uniform shares and on a derivation basis, although among the most desirable types of revenue sharing that can be used, also adds to the burden or need for an equalization system that takes into account these different levels of fiscal capacity across LGRUs.

In the new distribution of PIT, the share for financing both equalization grants for decentralized functions and the newly established fiscal (capacities) equalization scheme ceased to exist. The fiscal equalization system is now completely financed from the state budget: equalization grants for decentralized functions since 2018 and the fiscal (capacities) equalization system since 2021. The appropriation of 1.5 percent of PIT for EU projects, as well as the shares intended for capital projects for the development of municipalities and cities in HMAs and on the islands, have been abolished. Since 2018, the funds for these purposes have been provided in the state budget from the general budget revenues.

### 6.3. Equalization grants for decentralized functions

According to the Decree on the Method of Financing Decentralized Functions and Calculating the Amount of Equalization Grants for Decentralized Functions of Local and Regional Self-government Units for 2020 (OG 128/2019), decentralized functions are expenditures that have been transferred to LRGUs by special laws for primary and secondary education, social welfare, health care, and firefighting. In its decisions on financial standards, the government determines the minimum amount of funds to be provided to cover expenditure on these decentralized functions. If less money than the amount determined by the government is

<sup>33</sup> Annex 7 describes the development of the PIT sharing arrangements in the HMAs, ASNCs, islands, and supported areas.

obtained from the designated share of PIT for decentralized functions, LRGUs are entitled to equalization grants in the amount they require to reach the minimum financial standards for every decentralized function assumed.

Although all LRGUs have the right to assume the financing of newly (optional) decentralized functions, practice reveals that the majority of these functions are taken over by counties and the city of Zagreb (table 6.2). They include secondary education, social care/social welfare centers, nursing homes, and health care. Primary education has been decentralized to the 35 cities with the strongest fiscal capacities, and fire protection has also experienced widespread decentralization. Public fire departments are usually co-owned by LGUs (cities and municipalities) in different proportions and with different numbers of co-founders (e.g., Zagorje's public fire department is co-owned by 23 LGUs: six cities and 17 municipalities).

**Table 6.2.** Decentralization of Particular Public Functions in 2020

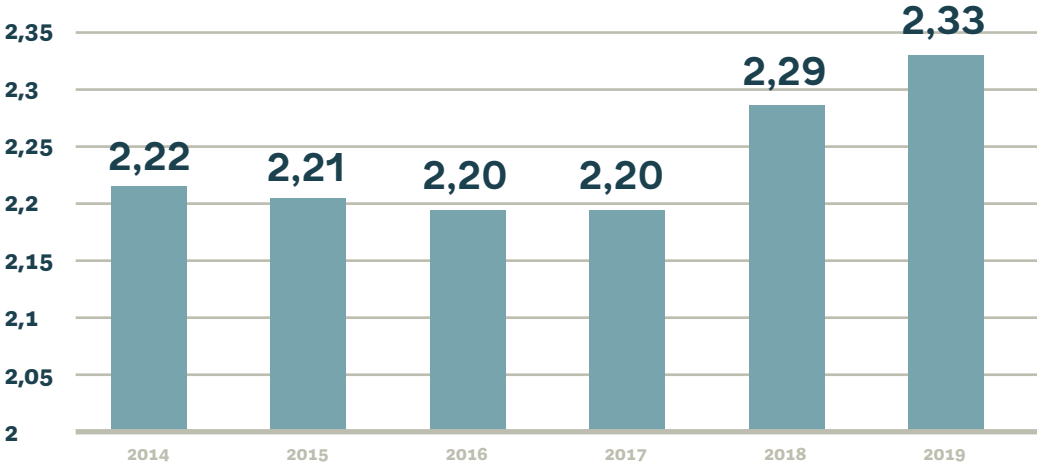
FUNCTION	DECENTRALIZED TO
<b>Primary education</b>	20 counties and the city of Zagreb, as well as 35 other cities with stronger fiscal capacities
<b>Secondary education</b>	20 counties and the city of Zagreb
<b>Social care—social welfare centers</b>	20 counties and the city of Zagreb
<b>Nursing homes</b>	*17 counties and the city of Zagreb
<b>Health care</b>	20 counties and the city of Zagreb
<b>Firefighting—public fire departments</b>	76 public fire departments co-owned by LGUs

Note: \*In three counties (Virovitičko-podravska, Zagrebačka, and Krapinsko-zagorska), there are no nursing homes founded by the state or the LRGUs.

Source: Decisions on minimum financial standards for individual public functions (NN 128/2019).

As noted, equalization grants for decentralized functions are transfers of funds from the state budget to LRGUs for financing when revenues from the additional share of PIT are not sufficient according to decisions on minimum financial standards. (For a detailed elaboration of the criteria for determining the minimum financial standards for each decentralized function, see Annex 9.) The government determines the manner of financing the decentralized functions and the method of calculating the equalization grants for each year by decree. The grants are provided in the central government budget on the accounts of the ministries responsible for the four areas. The overall amount of the planned pooled funds for all decentralized functions is shown in figure 6.4.

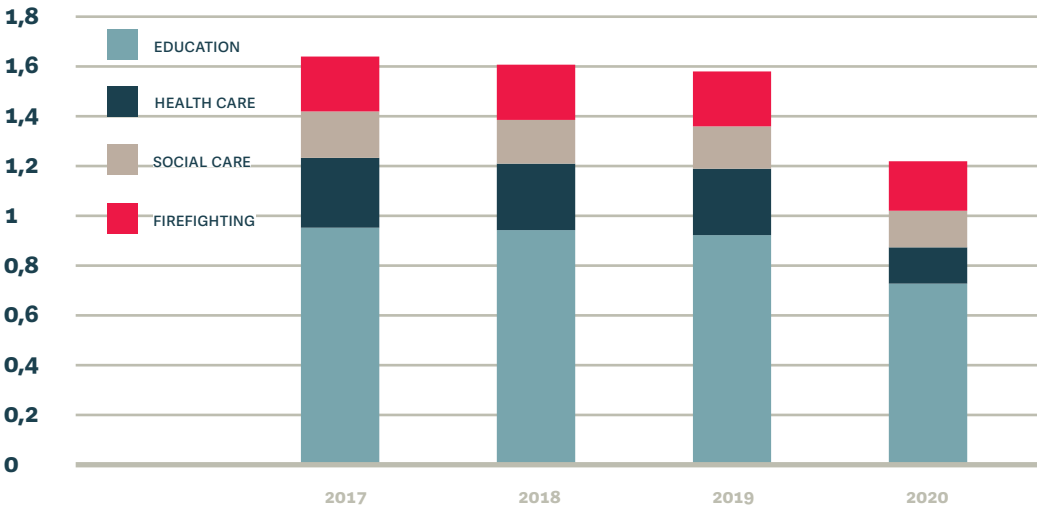
**Figure 6.4.** Expected Expenditure for Decentralized Functions from 2014 to 2019 (in billion HRK)



Source: Annual Regulations on the Financing of Decentralized Functions and the Calculation of the Amount of Equalization Grants for Decentralized Functions of LRGUs from 2014 to 2019.

The equalization grants, which until 2018 were funded from a share of PIT revenue, since then have been financed from the central government budget. Their total value has decreased over time from HRK 1.64 billion in 2017 to HRK 1.22 billion in 2020 (figure 6.5). The majority of equalization grants for decentralized functions are devoted to education (almost 60 percent of the total in 2020), whereas shares for other decentralized functions are more or less equal and amount to slightly above 10 percent.

**Figure 6.5.** Equalization Grants for Decentralized Functions from 2017 to 2020 (in billion HRK)



Source: Ministry of Finance, "Analytical Report of the Budget from 2017 to 2020."

In practice, there is an asymmetry on how the two sources of financing (PIT shares and specialized equalization grants) actually work. Any “excess” PIT shares are retained. This means that if LRGUs that finance decentralized functions generate more revenue from the PIT share for those functions than the minimum financial standards set, they can use the excess funds to finance other decentralized functions taken over in the amount above the minimum financial standards. However, any “excess” specialized equalization grants have to be returned. That is, if LRGUs that finance the decentralized functions receive equalization grants for those functions in excess of the amount established by the minimum financial standards, they have to pay the excess funds to the state budget within the deadline set by the government. This surplus of funds is the revenue of the state budget.

## 6.4. Fiscal (capacity) equalization

Due to the different conditions in which individual areas have developed, LRGUs differ in their degree of economic development and their tax bases and therefore in their ability to raise revenues from the taxes that have been assigned to them. In other words, not all LRGUs are able to independently (without central government assistance) provide adequate public services to all their citizens (exercising a comparable level of tax collection effort). The fiscal equalization system is currently used to mitigate these disparities. In addition, as noted, LRGUs receive different amounts per capita in revenue sharing from the PIT, and that shared revenue is generally considered part of the fiscal capacity of subnational governments. Finally, even with the same fiscal capacity from own revenues and revenue sharing, LRGUs are likely to differ in their expenditure needs because of their different demographic composition, socioeconomic conditions, or costs of service delivery. This fact is more or less ignored in the current equalization system, although the calculation of minimum financial standards and the distribution of equalization grants for decentralized functions only very indirectly address this problem—and with questionable effect. More specifically, both the determination of minimum financial standards and the effects of the equalization grants have not been made explicit and are unknown to the general public and probably even to policy makers.

The LRGU financing system has undergone significant changes in this regard as a result of an amendment to the Law on Financing of Local and Regional Self-Government Units (OG 127/17). This created a completely new model of fiscal equalization that allowed for greater levels of fiscal equalization, especially among cities and municipalities.

According to the new law, municipalities, cities, and counties whose capacity of generated tax revenue is less than the reference value become eligible to receive fiscal equalization funds. To allocate these funds, three separate equalization systems were introduced, each for one group (level) of units: counties, cities, and municipalities. It is important to point out here that for simplicity reasons, that is, to avoid the difficulty of estimating the fiscal capacity from own revenues, the equalization system focuses exclusively on PIT sharing and the surtax. Despite omitting own revenue capacity, this approach provides satisfactory results because PIT sharing and the surtax account for roughly 90 percent of LRGU revenue. However, since the (omitted) fiscal capacity from own revenues is much more important proportionally for relatively richer jurisdictions, this approach tends to “punish” relatively poorer jurisdictions with lower tax bases.



The estimated (partial) fiscal capacity of LRGUs is based on the five-year average of the collected PIT and surtax per capita that would be achieved if the highest surtax rate were applied. The benchmark (i.e., the reference value of the capacity of generated tax revenue) is selected as the average fiscal capacity per capita of all government units of a same level. In other words, a separate benchmark has been determined for each group of units: counties, cities, and municipalities. The city of Zagreb, due to its disproportionately high fiscal capacity,<sup>34</sup> is excluded from the calculation. In addition, the benchmark for municipalities is adjusted (the average fiscal capacity is increased) by 50 percent to equalize the substantial difference in reference values between cities and municipalities in general.

The fiscal equalization model incorporated into the new LRGU financing system is based on several important variables. The funds distributed to LRGUs through the fiscal equalization system are unconditional, or non-earmarked revenues (grants from the central government budget), which is a conventional feature of equalization grants in the vast majority of countries.

The distribution formula is based on two criteria:

- the capacity of the generated tax revenue (based on PIT sharing and the surtax only)
- the reference value of the capacity of generated tax revenues

More specifically, the measure of fiscal capacity is calculated for each LRGU as follows:

- The capacity of generated tax revenues of a municipality or city is a five-year moving average of revenue from the PIT generated in the territory of a municipality or city, as well as from the surtax that a municipality or city would achieve by introducing the highest allowed rate of surtax per capita of each municipality or city:

$$cgtr_{mu,ci} = \frac{1}{5} \sum_{t=1}^5 pit_{mu,ci,t} \times (1 + \hat{st}_{mu,ci,t})$$

where  $cgtr_{mu,ci}$  denotes the capacity of generated tax revenue of a municipality or city per capita,  $pit_{mu,ci,t}$  per capita revenue from the PIT of a municipality or city in the period  $t$ , and  $\hat{st}_{mu,ci,t}$  potential (estimated) surtax that a municipality or city would achieve by introducing the highest allowed rate of surtax per capita in the period  $t$ .

- The capacity of generated tax revenues of a county is a five-year moving average of revenue from the PIT generated in the individual county, multiplied by the proportion (currently 20 percent) that belongs to counties based on the distribution of PIT revenue per capita in that county:

$$cgtr_{co} = \frac{0.20}{5} \sum_{t=1}^5 pit_{co,t}$$

<sup>34</sup> As stated above, more than one quarter of all LRGU current revenue in 2018 is related to Zagreb. All municipalities and counties combined together generated in the same year only slightly more current revenue than Zagreb alone. The divergence of Zagreb's fiscal capacity (in relation to other LRGUs) is significant also in per capita terms. The unique possibility of introducing a surtax of up to 18 percent (the maximum rate for other cities is 15 percent) makes Zagreb an outlier in every sense. If Zagreb were included in the calculation of the reference value, it would skew the average upwards such that most of cities would turn out to be below average.

where  $ctgr_{co}$  denotes the capacity of generated tax revenue of a county per capita and  $pit_{co,t}$  the per capita revenue from the PIT of a county in the period  $t$ .

The reference value of the capacity of generated tax revenues is calculated separately for all municipalities, cities, and counties as follows:

- The reference value of the capacity of generated tax revenues for municipalities is a five-year average of the revenue from the PIT generated in all municipalities and revenues possible to achieve using the highest statutory surtax rate per capita of all municipalities, which is increased by 50 percent of the value thus obtained:

$$rv(cgtr)_{mu} = \frac{1.5}{428} \sum_{i=1}^{428} cgtr_i$$

where  $rv(cgtr)_{mu}$  denotes the reference value of the capacity of generated tax revenues for municipalities and  $cgtr_i$  the capacity of generated tax revenue of a municipality  $i$ .

- The reference value of the capacity of generated tax revenues for cities is a five-year average of the revenue from the PIT generated in all cities and revenues possible to achieve using the highest statutory surtax rate per capita of all cities,

$$rv(cgtr)_{ci} = \frac{1}{127} \sum_{i=1}^{127} cgtr_i$$

where  $rv(cgtr)_{ci}$  denotes the reference value of the capacity of generated tax revenues for cities and  $cgtr_i$  the capacity of generated tax revenue of a city  $i$ .

- The reference value of the capacity of generated tax revenues for counties is the five-year average of the revenue from the PIT generated in all counties, multiplied by the county share of PIT revenue per capita of all counties:

$$rv(cgtr)_{co} = \frac{0.17}{20} \sum_{i=1}^{20} cgtr_i$$

where  $rv(cgtr)_{co}$  denotes the reference value of the capacity of generated tax revenues for counties and  $cgtr_i$  the capacity of generated tax revenue of a county  $i$ .

Municipalities, cities, and counties whose capacity of generated tax revenues is lower than the reference value of the capacity of generated tax revenues are entitled to fiscal equalization funds.

The amount of per capita funds needed by each unit for its full fiscal equalization can be obtained by comparing the capacity of generated tax revenues of each LRGU with the corresponding reference value of the capacity of generated tax revenues. The full fiscal equalization funds for a particular municipality, city, or county represent the difference between the reference value of the capacity of generated tax revenues for municipalities, cities, or counties and the capacity of generated tax revenues of each municipality, city, or county multiplied by the total

population of that municipality, city, or county. Again, if the capacity of generated tax revenues of a particular LRGU is greater than the corresponding reference value of the capacity of generated tax revenues, the unit is not entitled to fiscal equalization funds.<sup>35</sup>

$$\widehat{FFE}_{mu} = f(x) = \begin{cases} \sum_{i=1}^{428} [rv(cgtr)_{mu} - cgtr_i] \times pop_i, & cgtr_i < rv(cgtr)_{mu} \\ 0, & cgtr_i \geq rv(cgtr)_{mu} \end{cases}$$

$$\widehat{FFE}_{ci} = f(x) = \begin{cases} \sum_{i=1}^{127} [rv(cgtr)_{ci} - cgtr_i] \times pop_i, & cgtr_i < rv(cgtr)_{ci} \\ 0, & cgtr_i \geq rv(cgtr)_{ci} \end{cases}$$

$$\widehat{FFE}_{co} = f(x) = \begin{cases} \sum_{i=1}^{20} [rv(cgtr)_{co} - cgtr_i] \times pop_i, & cgtr_i < rv(cgtr)_{co} \\ 0, & cgtr_i \geq rv(cgtr)_{co} \end{cases}$$

$\widehat{FFE}_{mu}$ ,  $\widehat{FFE}_{ci}$ , and  $\widehat{FFE}_{co}$  denote estimates of full fiscal equalization funds for municipalities, cities, and counties, respectively;  $rv(cgtr)_{mu}$ ,  $rv(cgtr)_{ci}$ , and  $rv(cgtr)_{co}$  reference values of the capacity of generated tax revenues for municipalities, cities, and counties per capita;  $cgtr_i$  per capita capacity of generated tax revenue of a municipality, city, or county  $i$ ; and population of a municipality, city, or county  $i$ .

The actual amount of fiscal equalization funds that each LRGU will receive depends on the total pool of funds for fiscal equalization determined annually by a decision of the Minister of Finance. The total amount of funds needed for full fiscal equalization is equal to the sum of funds needed for fiscal equalization in the full amount of all LRGUs:

$$\widehat{FFE} = \widehat{FFE}_{mu} + \widehat{FFE}_{ci} + \widehat{FFE}_{co}$$

where  $\widehat{FFE}$  denotes the total estimated funds required for the full fiscal equalization of municipalities, cities, and counties and  $\widehat{FFE}_{mu}$ ,  $\widehat{FFE}_{ci}$ , and  $\widehat{FFE}_{co}$  estimates of full fiscal equalization funds for municipalities, cities, and counties, respectively.

The share of funds needed for the fiscal equalization of each LRGU in the total sum of the funds needed for the fiscal equalization of all LRGUs represents the share of each unit on the basis of which it will receive the funds from the fiscal equalization fund determined annually by a decision of the Minister of Finance. That is:

<sup>35</sup> Importantly, there is no Robin Hood element in the fiscal equalization system. LRGUs that are not eligible to receive equalization transfers do not have to contribute any of the surplus to the pool of equalization funds.

$$FEG_i = FEC \times S_i; \quad S_i = \frac{\widehat{FFE}_i}{\overline{FFE}_i}$$

where  $FEG_i$  denotes the value of the fiscal equalization grant for an LRGU  $i$ , the actual capacity of the fiscal equalization fund, and  $S_i$  the share of LRGU  $i$  in the fiscal equalization fund.

The funds to be distributed to each LRGU depend, therefore, on the amount of the share calculated for each LRGU and on the funds available for fiscal equalization, determined each year by a decision of the Minister of Finance (HRK 2 billion in 2021). In other words, when the total pool of equalization funds is not sufficient to cover all the gaps relative to particular reference levels, the available funds are distributed proportionally to the size of the gaps across the levels of government (groups of units) and within each level, also proportionally to the gap for each jurisdiction. The share of funds required for the full fiscal equalization of a municipality, city, or county in the total required fiscal equalization funds for all municipalities, cities, and counties, as well as the capacity of generated tax revenues and the reference value of the capacity of generated tax revenues, shall be determined for each fiscal year. The share of full fiscal equalization funds for each municipality, city, and county in the total fiscal equalization funds is determined by a decision of the Minister of Finance.

LRGUs that are entitled to fiscal equalization funds are allocated a monthly payment (before the 15th day in the current month). As noted above, the equalization transfers are non-earmarked grants from the central government budget. Thus, LRGUs have the freedom to direct the funds received for the purposes they have identified as most needed.

Interestingly, for 2020, according to the MOF's calculations, there were only 82 municipalities, 40 cities, and five counties outside the fiscal equalization system.<sup>36</sup> This confirms a significant asymmetry or large disparities in fiscal capacity between Croatia's local and regional governments with regard to the ability to provide comparable public services with a comparable tax burden across all LRGUs.

The effectiveness of the new fiscal equalization system is presented by Gini coefficients (figure 6.6). The Gini coefficient is a common measure used to represent (fiscal) inequalities. It ranges from 0 to 1, with 0 indicating complete equality and 1 total inequality. The Gini coefficients compared in the figure below are computed for cities, municipalities, and counties on the basis of the PIT and surtax, compensatory grants, and grants established by the State Budget Execution Law for 2017 (under the old system) and 2018 (under the new system). With the implementation of the new fiscal equalization system, inequalities in terms of fiscal capacity (defined as currently in the law) have been almost halved at all levels of local and regional public authority.

<sup>36</sup> This information is from the Table of LRGUs' share of fiscal equalization in 2020, which can be found at: <https://mfin.gov.hr/istaknute-teme/lokalna-samouprava/fiskalno-izravnaje/2020>.

**Figure 6.6.** Gini Coefficients of the Distribution of PIT, Surtaxes, and Fiscal Equalization Funds in 2017 and 2018



Source: Authors' calculation, based on the data from the Report on Revenues and Expenditures, Receipts and Expenses (Form PR-RAS) for the years 2017 and 2018.

Although the comparison of Gini coefficients for the revenue from the PIT and surtax, compensatory grants, and grants established by the State Budget Execution Law for 2017 (old system) and 2018 (new system) gives a sense of the efficiency of the new equalization system, it is not completely credible, because there might also be other factors influencing the different revenue components and consequently influencing the Gini coefficients. To deal with this potential issue, table 6.3 shows various dispersion measures for certain components of LRGU revenues and expenditures. The table makes it possible to get a better look at the disparities in own and shared revenues and the extent to which equalization transfers can reduce them, as well as how these disparities are then maintained or made worse by other transfers.

**Table 6.3.** Comparative Effects on per Capita Fiscal Disparities for LRGUs in 2018

	OWN REVENUES	(1) + SHARED REVENUES	(2) + EQUALIZATION TRANSFERS	(3) + OTHER TRANSFERS	EXPENDITURES
	(1)	(2)	(3)	(4)	(5)
<b>COUNTIES</b>					
Min, HRK	156.8	352.5	503.5	999.8	1,049.4
Max, HRK	489.2	956.2	956.2	2,941.7	2,757.0
Range (max-min), HRK	332.4	603.7	452.7	1,941.8	1,707.6
Average, HRK	323.4	595.6	660.2	1,392.8	1,382.2
Median, HRK	329.2	569.5	628.2	1,275.6	1,288.2

	OWN REVENUES	(1) + SHARED REVENUES	(2) + EQUALIZATION TRANSFERS	(3) + OTHER TRANSFERS	EXPENDITURES
	(1)	(2)	(3)	(4)	(5)
<b>Standard deviation, HRK</b>	83.8	156.9	113.3	421.4	376.9
<b>Coefficient of variation</b>	25.9%	26.3%	17.2%	30.3%	27.3%
<b>Gini coefficient</b>	0.142	0.138	0.088	0.126	0.114
<b>CITIES</b>					
<b>Min, HRK</b>	469.5	972.0	2,364.8	2,405.4	2,029.9
<b>Max, HRK</b>	9,538.8	10,912.2	11,042.2	12,031.3	14,053.9
<b>Range (max-min), HRK</b>	9,069.3	9,940.2	8,677.4	9,625.9	12,023.9
<b>Average, HRK</b>	2,440.0	3,803.1	4,571.0	5,401.4	5,316.2
<b>Median, HRK</b>	1,584.4	2,887.4	3,817.9	4,821.5	4,695.0
<b>Standard deviation, HRK</b>	2096.6	2469.5	2115.6	2213.5	2502.8
<b>Coefficient of variation</b>	85.9%	64.9%	46.3%	41.0%	47.1%
<b>Gini coefficient</b>	0.429	0.336	0.233	0.218	0.247
<b>MUNICIPALITIES</b>					
<b>Min, HRK</b>	104.5	464.5	1,543.7	1,726.0	1,495.4
<b>Max, HRK</b>	13,934.2	15,855.1	15,855.1	26,749.9	29,477.4
<b>Range (max-min), HRK</b>	13,829.7	15,390.6	14,311.4	25,023.9	27,981.9
<b>Average, HRK</b>	1,955.0	2,815.3	3,738.7	4,839.9	4,741.0
<b>Median, HRK</b>	991.5	1,792.0	2,872.4	3,847.6	3,758.1
<b>Standard deviation, HRK</b>	2313.3	2616.7	2310.6	2995.4	3167.8
<b>Coefficient of variation</b>	118.3%	92.9%	61.8%	61.9%	66.8%
<b>Gini coefficient</b>	0.523	0.425	0.277	0.281	0.303

Source: Authors.

The data reveal that Gini coefficients for all categories of LRGUs (counties, cities, and municipalities) significantly decrease with the distribution of the equalization transfers: for counties from 0.138 to 0.088, for cities from 0.336 to 0.233, and for municipalities from 0.425 to 0.277. This

shows that, despite its shortcomings (such as ignoring fiscal capacity from own revenues and expenditure needs disparities), the current fiscal equalization system effectively performs a redistributive function. However, other transfers significantly increase disparities for counties, whereas for cities and municipalities disparities are more or less maintained. The efficiency of the equalization transfers can also be presented graphically with Lorenz curves. Figure 6.7 shows how the distribution of revenues gets closer to the (diagonal) equal distribution line after the disbursement of equalization transfers.

**Figure 6.7.** Lorenz Curves of Fiscal Disparities among LRGUs in 2018



This is certainly not a surprise, given the expected negative correlation between equalization transfers and PIT revenue. Figure 6.8 depicts the correlation between equalization transfers (basic regression) and subnational income per capita. The correlation is negative, as desired.

**Figure 6.8.** Relation between LRGU Income and Equalization Transfers per Capita in 2018 (in HRK)



Source: Authors.



## 6.5. Conditional grants for capital and recurrent purposes

Conditional grants are characterized by earmarking the funds to specific activities that the central government agencies want subnational governments to undertake because of their social merit, because they address externalities across subnational government boundaries, or because of some other objective. Conditional grants can be for recurrent or capital purposes and can be matching or not matching depending on whether the contribution of a share of funds is required from the subnational governments.<sup>37</sup>

Unfortunately, the LRGUs' reporting system in Croatia does not follow an ordered scheme of the conventional typology of transfers. Therefore, it is not easy to elaborate on the structure of conditional grants, because this category is not directly reported in the LRGU budgets. The structure of grants is reported according to their source, irrespective of their nature. The reports distinguish only between current and capital grants in each category (for each source/grant provider). As shown in figure 6.3 above on the structure of LRGU grants, categories reported in standard (publicly available) reports include: grants from other budgets (central government, county, etc.), equalization funds for decentralized functions, grants from international organizations and the EU, grants from extra-budgetary users, and others.

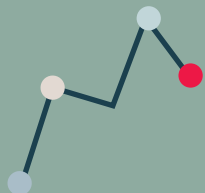
As discussed above, grants from extra-budgetary users refer to those from the Croatian Pension Insurance Institute, Croatian Health Insurance Institute, Croatian Employment Service, Environmental Protection and Energy Efficiency Fund, Croatian Waters, Croatian Roads, and other extra-budgetary users of the state budget. These grants are mainly conditional in nature. Capital grants from extra-budgetary users may include, for example, the co-financing of landslide remediation documentation by Croatian Waters. Grants from the Croatian Employment Service may include funds for active employment policy measures, for example, public work programs, and so forth. Grants from Croatian Roads may include grants for co-financing the winter service on unclassified roads.

The Fund for Environmental Protection and Energy Efficiency is used to co-finance projects that implement the concept of "smart cities and municipalities," providing modern and effective approaches to city management and ensuring innovative implementation of city or municipality affairs. Eligible areas for project implementation in the city or municipality are: (i) the economy, (ii) the security of citizens and property, (iii) sustainable transport, (iv) energy management, environmental protection, and climate change, (v) city or municipality management and service management, and (vi) education and quality of life. One of the key criteria for determining the amount of the grants (in terms of the matching rate or percent of co-financing of eligible project costs) is the "development index" ranking (see box above).<sup>38</sup>

<sup>37</sup> Further, conditional grants can be closed or open-ended, depending on whether the total availability of funds in the program is fixed or left open. Typically, the "conditions" demanded in conditional grants are ex ante, meaning that the requirements must be met from the start of the program. However, some conditionality may also be ex post, based on the performance of subnational governments. In this case, the grants are known as performance-based grants. Some of these issues are further discussed in the next section.

<sup>38</sup> This index has been determined by the Decision on the Classification of Local and Regional Self-Government Units according to the Level of Development (OG 132/17). See Box 6.1 for a description of how the index is calculated.

## Box 6.1. The Development Index



The development index is a composite indicator that is calculated as an adjusted average of standardized values of socioeconomic indicators in order to measure the degree of development of LRGUs in a certain period. The index is calculated on the basis of: (i) the unemployment rate, (ii) per capita income, (iii) budget revenues of LRGUs per capita, (iv) general population trends, (v) the education rate, and (vi) the aging index (Ordinance on the Development Index, OG 131/2017).

According to the index, counties are classified into four development groups, and cities and municipalities into eight groups on the basis of the deviations from the average development threshold. All jurisdictions below the development average of the Republic of Croatia, (i.e., groups I–IV of LGUs, and groups I–II of regional self-government units) are categorized as supported areas. The evaluation process is carried out every three years. The management of development in supported areas is regulated by a special Law on Supported Areas (OG 118/18). Given that the calculation of the development index and the identification of supported areas fall primarily within the domain of a regional development policy and not fiscal decentralization in a pure sense, the calculation of the development index, as well as the instruments and effects of regional policies, will not be further discussed here.

Grants from other budgets, for example, central government or county budgets, are also more or less conditional in nature. However, the classification of these grants according to standard typology does not exist, so in order to determine the more detailed structure of this category, analytical reports of the budgets had to be analyzed item by item. Table 6.4 shows the most significant categories covering three quarters of the total value of grants from other budgets in 2018. As the complete list includes more than 1,000 items, it could not be shown here in full, so all other grants not included specifically in the table are added together and shown as “other grants.” Before delving deeper into the structure of these grants, it has to be noted that not all are conditional. For example, the compensatory measure to LRGUs, amounting to HRK 134.4 million, does not belong in this category. A compensatory measure to LRGUs refers to unconditional central government grants distributed to LRGUs as compensation for a loss of revenue caused by legislative changes to LRGU financing and tax reform. There is also the possibility that some of the grants in the category of “other grants” are also not conditional. However, the majority of the grants listed in the table can be considered conditional.

**Table 6.4.** The Structure of Grants from Other Budgets to LRGUs in 2018 (in million HRK)

PROVIDER	ACTIVITY/PURPOSE OF THE GRANT	VALUE
MOF	Compensatory measure to LRGUs	134.4
CSOS	City sports halls in Zagreb, Split, and Varaždin	42.8
MOC	Cultural heritage protection and preservation programs	31.1
MOC	European Capital of Culture 2020	22.8
MOC	Programs for cultural infrastructure	21.5
MOA	Development projects for Slavonia, Baranja, and Srijem	60.2
MOA	Common agricultural policy - rural development measures	55.4
MRDEUF	Development of islands	25.0
MRDEUF	Development of supported areas	80.2
MRDEUF	Co-financing of EU projects	147.9
MRDEUF	Regional development fund	49.3
MRDEUF	Fund for capital projects of interest to island development	35.5
FRDV	Development projects of Vukovar	39.2
MCPP	Improvement of housing and communal services	46.6
MSE	Public inter-city transportation for students	281.8
MSE	Capital investments in primary and secondary education	62.7
MSE	Center for education Virovitica	37.5
MOT	Tourism fund	22.2
MODFYSP	Implementation of demographic and migration policy measures	35.8
	Other grants	420.8
	<b>Total</b>	<b>1,652.7</b>

Note: MOF: Ministry of Finance, CSOS: Central State Office of Sports, MOC: Ministry of Culture, MOA: Ministry of Agriculture, MRDEUF: Ministry of Regional Development and EU Funds, FRDV: Fund for Reconstruction and Development of the City of Vukovar, MCPP: Ministry of Construction and Physical Planning, MSE: Ministry of Science and Education, CES: Croatian Employment Service, MOT: Ministry of Tourism, and MODFYSP: Ministry of Demography, Family, Youth and Social Policy.  
Source: Ministry of Finance, "Analytical Report of the Budget from 2017 to 2020."

Grants for sports halls in Zagreb, Split, and Varaždin are from the Central State Office of Sports to city budgets for financing (subsidizing) the halls' annual rent. Grants for development projects in Slavonia, Baranja, and Srijem are capital grants from the Ministry of Agriculture (MOA) disbursed to counties according to the development agreement for those areas. Grants for the common agricultural policy and other rural development measures are mostly capital grants from the MOA to LRGUs. Grants for the development of supported areas are capital grants from the MRDEUF to LRGUs classified as supported areas according to their development index ranking. Grants for co-financing EU projects are both current and capital grants from

the MRDEUF according to the program of co-financing EU projects at the regional and local levels. The program's funds are nonrefundable, earmarked, and aimed at beneficiaries that have concluded a grant agreement for EU funds for the current programming period.

One of the most prominent conditional grants for capital purposes is the Ministry of Construction and Physical Planning's (MCP) grant to cities and municipalities to encourage the development of a communal economy and harmonized communal standard. This grant is recorded within the MOF's (budgetary) evidence (and in table 6.4) as part of the "improvement of housing and communal services." In order to encourage this in LGUs, the Minister of Construction and Physical Planning annually issues a public call for co-financing city and municipality projects that contribute to improving the performance of communal activities and to raising the level of public services and the quality of life of residents. Thus, in the conventional typology, this is a conditional capital grant with a matching arrangement.

Under this "communal development grant," eligible applicants are LGUs, while the matching grant rates they receive depend on their development index ranking. Eligible activities for the grant include:

- Project preparation and other technical documentation for the construction of facilities and devices of communal infrastructure and the execution of major interventions in the investment maintenance of communal infrastructure
- Execution of works and installation of communal infrastructure devices, execution of works on investment maintenance of communal infrastructure and arrangement of public areas, unclassified roads, public lighting, and other public spaces, as well as other facilities that contribute to raising the level of public services and improving the quality of life in local government settlements
- Costs of professional supervision over the execution of works
- Procurement of equipment and machinery that will significantly improve the delivery quality of communal services and communal standards, such as the performance of certain communal activities and the procurement of other communal equipment for community public areas

The highest amount of co-financing by the MCP per beneficiary cannot exceed HRK 400,000, including VAT. The matching rate, that is, the ministry's share in the co-financing of the project, as just indicated above, depends on the development index of the eligible applicant and can be up to:

- 80 percent of the total eligible project costs for applicants from Group I
- 70 percent of the total eligible project costs for applicants from Group II
- 60 percent of the total eligible project costs for applicants from Group III
- 50 percent of the total eligible project costs for applicants from Group IV
- 40 percent of the total eligible project costs for applicants from Group V
- 30 percent of the total eligible project costs for applicants from Group VI

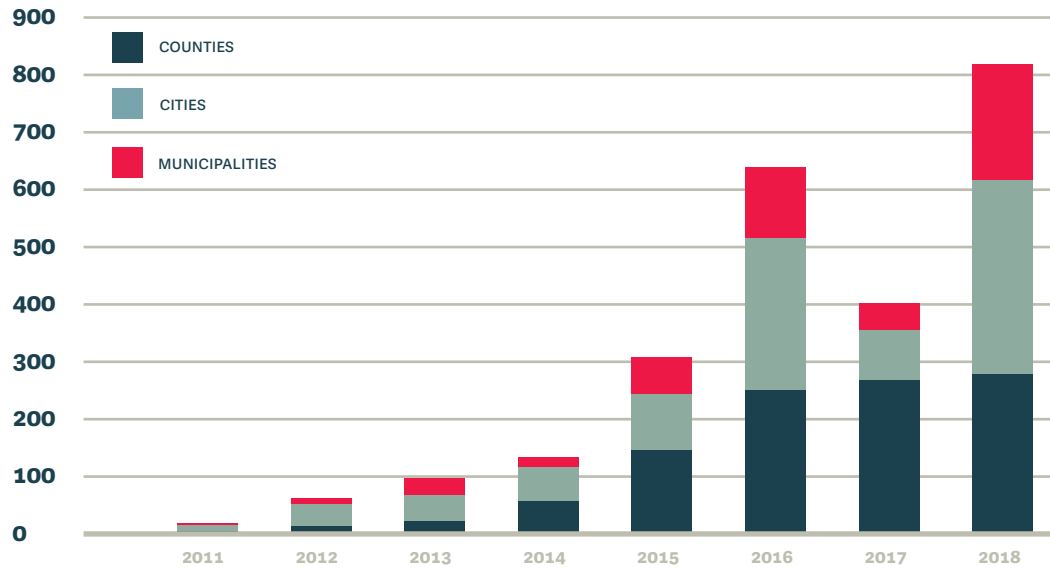
The applicant may submit a maximum of one application for co-financing eligible projects in a particular year. Importantly, the quality of each individual project is assessed by the Project Selection Committee established by the Minister of Construction and Physical Planning. After the evaluation procedure, at the proposal of the Committee, the minister makes a decision on the selection of projects for co-financing in each year. The ministry publishes the list of selected projects on its website and signs a co-financing agreement with the selected beneficiaries.

The Ministry of Science and Education (MSE) provides current grants to cities and counties for financing/co-financing transportation for high school students. These grants represent almost 20 percent of total grants from other budgets (presented in table 6.4). The right to co-financing of 75 percent of the costs of inter-city public transport is exercised by students who are enrolled and regularly attend high school, who buy a monthly ticket for the use of regular public transport (bus and train), and whose distance from their place of residence to the school is more than five kilometers. The right to finance 100 percent of the price of a monthly student ticket for local and long-distance public transport is exercised by students who are enrolled and regularly attend secondary school if they are members of a household that is a beneficiary of the guaranteed minimum allowance or maintenance allowance in accordance with the regulations governing social welfare. Students whose dormitory is located outside their school are entitled to co-financed or financed transport from the location of their dormitory to their school, according to government criteria. Grants for capital investments in primary and secondary education are capital grants from the MSE to cities and counties to improve the infrastructure as well as the material and technical working conditions of students and teaching staff.

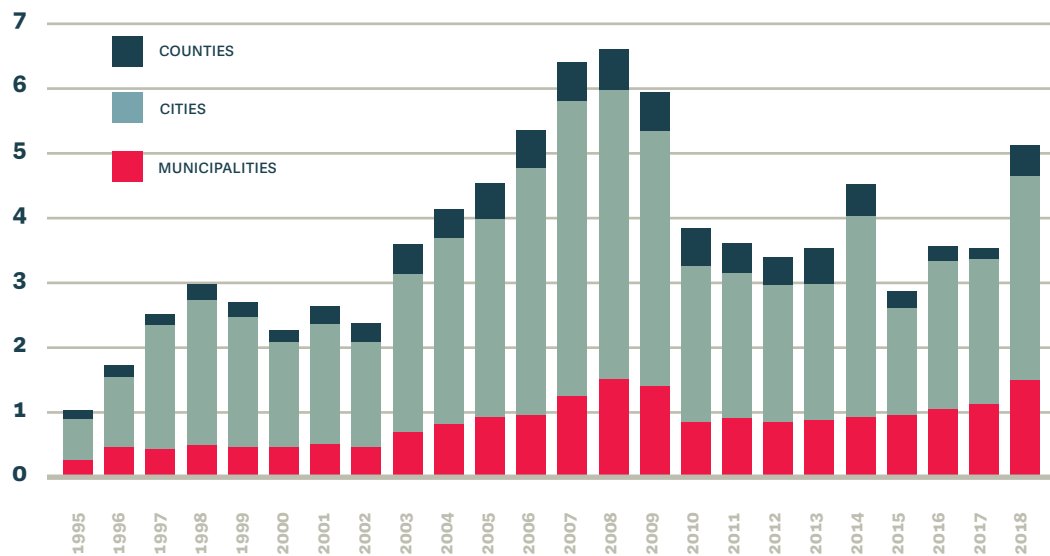
## 6.6. EU grants and capital expenditure

With its accession to the EU, Croatia started to utilize new financial programs directly linked to the EU budget through multiannual financial frameworks. The financing within the 2014–20 framework was directed mostly to environmental protection, agriculture, transport infrastructure, promotion of entrepreneurship, and the education system, with a special emphasis on the development of less developed regions. The amount of the EU grants increased almost 50 times in a seven-year period from HRK 17 million in 2011 to HRK 831 million in 2018 (figure 6.9). These grants have been utilized primarily by counties and cities, with municipalities in general lagging behind. More significant values of EU grants to municipalities were recorded only in 2018, when they began to make better use of EU funds.

The main obstacles to a more intensive use of EU funds by the lower government tiers are insufficient administrative capacities and poor co-financing potential, which is likely to be additionally strained in the short term due to the consequences of the COVID-19 crisis. Further efforts to increase the absorption capacity should make LRGUs the main drivers of capital investments financed through EU funds and similar programs. Currently, LRGU operating expenditures account for more than four-fifths of their budgets, and capital expenditures less than one-fifth. After 2008, capital expenditures (expenditures for the acquisition of non-financial assets) declined due to the decrease in revenues caused by the financial crisis, indicating prudent financial management and liquidity constraints by lower tiers of government (figure 6.10). In this period, investments were largely put on hold in order to ensure the financing of core LRGU functions. Although the financial position of LRGUs has since stabilized, capital investments have still not reached their pre-financial crisis level. As shown in figure 6.10, cities have always performed the majority of capital investments, whereas municipalities, due to their size, have had very limited potential in this regard.

**Figure 6.9.** EU Grants from 2011 to 2018 (in HRK million)

Source: Authors' calculation, based on the data from the Report on Revenues and Expenditures, Receipts and Expenses (Form PR-RAS) for the years 2010–2015.

**Figure 6.10.** Expenditure for the Acquisition of Non-Financial Assets by Level of Government from 1995 to 2018 (in HRK billion)

Source: Authors' calculation, based on the data from the Report on Revenues and Expenditures, Receipts and Expenses (Form PR-RAS) for the years 1995–2018.

## Box 6.2. Register of Capital Projects

Pursuant to the Strategic Planning and Development Management System of the Republic of Croatia Act (OG 123/17), the Information System for Strategic Planning and Development Management (containing the Register of Projects), managed by the MRDEUF, was established. This became a tool for drafting and mutually harmonizing strategic planning acts, enabling the connection of strategic planning acts to budgetary and other sources of financing and to development projects prepared by public bodies in Croatia, and reporting on the implementation of strategic planning acts, achieved results, outcomes, and the effects of public policy implementation. The register will define the stock of projects, which will, among other outcomes, be the basis for negotiations with the European Commission on financial allocations for sectoral policies and territorial development in the new EU Financial Perspective post-2020.



## 6.7. Main challenges related to the intergovernmental fiscal transfers

One main issue with the transfer system has been the lack of stability of some of its components, in particular, revenue sharing and the equalization grants. This lack of stability has reduced the system's predictability and thus subnational governments' ability to do adequate budget planning. The main obstacle to efficient long-term strategic and financial planning is the frequent changes to the revenue sharing and fiscal equalization arrangements. More specifically, the Law on Financing Local and Regional Self-Government Units and the Personal Income Tax Act have changed six times since 2006. This means that in 12 years between 2006 and 2018, there were 12 changes to the laws regulating this source of income. Frequent changes to the regulations governing the financing of LRGUs are not desirable, as they prevent long-term strategic planning and make the entire budgetary process, as well as investment planning, long-term borrowing, and repayment projections, difficult. To avoid these adverse effects, regulations regarding LRGU funding should be as stable as possible and remain in place for a period of three or more years; if they are amended, the changes should be planned as far in advance as possible and preferably be set out in transparent, clear, and publicly available formulas. Very few of these prerequisites have been adhered to in recent years.

However, the most recent amendments to the law were desirable because they established a simpler, more understandable, and fairer PIT distribution system, which became more transparent and less complicated by applying a uniform allocation scheme for all LRGUs. In addition, an equalization system was recently introduced that significantly reduces fiscal inequalities among LRGUs by equalizing (a significant share of) their fiscal capacities. Although an effort

is being made to determine the minimum financial standards for decentralized public services and the allocation of equalization grants for decentralized functions, the equalization of expenditure needs still remains a challenge. A more complete measurement of fiscal capacity that would include all revenue potential, from own taxes side by side with the capacity arising from revenue sharing, would also be desirable. The inclusion of expenditure needs and the full measure of LRGU fiscal capacity would bring the current equalization system closer to best international practices.

There is also an important issue with the clarity and transparency of subnational fiscal accounts. Methodological changes related to the recording of various intergovernmental transactions hamper the analysis of longer-term fiscal data for LRGUs. This is particularly reflected in the reported structure of grants (received), where the nature of the grants and their financial effects are hard to observe. This problem can be avoided by reducing the frequency of such changes but also by more transparently publishing additional data that would make longer-term datasets comparable. In this regard, there is the need to explicitly categorize and report on the different types of conditional grants utilized, from specific grants to block grants, and whether they are for recurrent or capital purposes. Moreover, central government authorities should consider the introduction of ex post performance-based grants.

Although the criteria for the allocation of certain types of grants are determined and transparently publicized, longer-term data analysis is difficult to perform. Moreover, the analytical breakdown of the structure of LRGU grants in publicly available reports (i.e., the Report on Revenues and Expenditures, Receipts and Expenses: Form PR-RAS) is quite general, differentiating mostly between current and capital grants and basic types of grant providers. However, it is almost impossible to differentiate between certain grant schemes. For example, grants from other budgets include current and capital grants to LRGUs from the central government, counties, cities, and municipalities. These grants are distributed to LRGUs from various sources and with different purposes. Nevertheless, the detailed structure of this category of grants is not publicly available, but the aggregate level is provided instead.

This is mainly because the government finance reporting system is to a large extent harmonized with economic classification according to IMF methodology (Government Finance Statistics [GFS] 2001). The problem in using GFS for subnational financial infrastructure and intergovernmental fiscal relations is not new. Ebel and Yilmaz (2002, 21–22) describe several drawbacks. First, local expenditures that are mandated by, or spent on behalf of, the central government appear as subnational expenditure because GFS does not identify the degree of local expenditure autonomy. Second, GFS does not distinguish the sources of tax and non-tax revenues, intergovernmental transfers, and other grants. Hence, there is no information on whether revenues are collected through shared taxes, piggybacked taxes, or locally determined “own-source” revenues. Third, GFS does not disclose what proportion of intergovernmental transfers is conditional as opposed to general purpose, and whether transfers are distributed according to objective criteria or discretionary measure. These aggregation problems limit the use of subnational statistics in the GFS dataset.

The fuller, more effective exploitation of EU grants is another important pending issue. EU grants are of particular importance to the development of LRGUs. In this sense, the main obstacles to the more intensive use of EU funds at lower government tiers are insufficient administrative



capacities and poor co-financing potential. Excessive fragmentation also hinders many small LGUs from securing the needed financial and administrative capacities to prepare and execute significant investment projects.

The financing system of LRGUs has been markedly pro-cyclical, and the transfer system has played a major role. Fiscal transfers to local governments have increased during times of economic prosperity but declined significantly in times of crisis. These trends have particularly affected economically lagging areas of the country, which had been first defined as ASNCs and then transformed into assisted (supported) areas and partly classified as HMAs.

Subnational governments in Croatia have also been subject to negative vertical fiscal externalities caused by changes in legislation at the central level, desirable or not, often without adequate long-term compensation. More specifically, frequent changes in PIT rates, tax brackets (classes), and other taxes, largely ignoring their repercussions at the local government level, have created an additional burden on the entire local public sector. Thus, in 2007, the CIT came out of the system of shared revenues, an otherwise positive measure, but without adequate compensation for the revenues of some economically developed local governments (such as the capital Zagreb). Likewise, a similarly significant problem for all local governments was created with the PIT change in 2014, which reduced, again without proper compensation, the revenues of all local governments. Finally, the most recent tax changes, though contributing to the mitigation of fiscal inequalities, caused significant reductions in the fiscal potential of fiscally stronger local governments. Even if these local governments cannot enjoy the benefits of fiscal equalization, their financing potential could be enhanced via greater local tax autonomy.

## 6.8. International trends in intergovernmental fiscal relations

### FISCAL EQUALIZATION DESIGN

Because the levels of economic activity and wealth, as well as expenditure needs and cost of services, tend to show marked differences across regions and localities, most countries address these horizontal fiscal imbalances with equalization grants. The architecture of these grants requires explicit decisions about objectives, funding, and allocation mechanisms.

The first step is always to have a clear vision of the objective pursued with an equalization grant. The most commonly accepted objective is to allow regional governments to provide their residents with a similar level of access to a standard package of public services when they exercise an average level of tax effort. However, the objective of equalization grants is not to equalize income per capita or the level of economic development across regions, which are much more complex outcomes.

For the pool of equalization funds, two main approaches are followed: ad hoc every year in the national budget or a fixed rule or formula. The latter provides for more stable funding, more predictable budgeting, and more certain determination of the pool of funds. This second approach also eliminates an implicit soft budget constraint faced by the subnational

governments—fighting for higher funding and doing less to increase their own tax efforts. More subnational budget predictability can be introduced by using, for example, a moving three-year average of a certain share of central government revenues.

The allocation or distribution formula is generally the most complicated step. The state of the art in the design of equalization transfers in international practice is the “fiscal gap” approach, defined as the difference between separate estimates of expenditure needs and a state’s fiscal capacity. An increasing number of countries have adopted this methodology, including, among developed OECD countries: Australia, Canada for the Northern Territories, Italy, Japan, Korea, Sweden, United Kingdom, and many U.S. states; among countries in transition: China, Latvia, Russia, Ukraine, and Vietnam; and among developing countries: Indonesia, Peru, and Uganda. Closely related, Canada implements equalization for its provinces (as opposed to the territories) only on the basis of fiscal capacity per capita. And Germany, Poland, and Spain use yet another variation of the methodology by equalizing fiscal capacity per adjusted population (instead of simply per capita), where adjustments to the actual population are made to reflect differences in expenditure needs.

The main design features of the fiscal gap approach include quantifying expenditure needs and fiscal capacity and then selecting a rule for the distribution of available funds. There are different methodologies that are used to compute expenditure needs and fiscal capacity across subnational governments, just as there are also different ways to apply that difference—the fiscal gap—to implementing the actual distribution of the available equalization funds among subnational governments.

Several methodologies are used to estimate tax capacity across subnational governments. The preferred, more sophisticated ones do a good job of estimating the potential revenues that can be obtained from the tax bases assigned to the subnational government (when they exercise an average or maximum level of collection effort). The most credible methodologies for estimating tax capacity include: (i) the representative revenue system, which uses information on tax bases and average collection efforts; (ii) the stochastic frontier estimation of potential maximum revenues, which assumes subnational governments deviate from the optimal collection levels because of lower administration collection efforts; and (iii) the use of basic proxies for the local ability to tax, such as the per capita level of personal income.

Regarding expenditure needs, the exercise is to quantify the funding that would be necessary to cover all expenditure responsibilities assigned to the subnational government at a common standard level of service provision. International practice shows several methodologies: (i) the “per client (top-down) financial expenditure norms,” which specify per client expenditure standards, either from a normative or a historical and affordability viewpoint (for example, derived by dividing the aggregate level of expenditure across all subnational governments in each functional area by the number of clients or users of that function at a national level); (ii) the “bottom-up costing of baskets of standardized inputs” methodology, which costs standardized baskets of state government services by functional area; and (iii) the “regression-based representative expenditure system,” which uses data on expenditure per function and drivers of those expenditures, and the results can be interpreted as the amount of money that a subnational government would have spent in a particular service function in order to provide a standard level of service.

### CONDITIONAL GRANTS DESIGN

In practice there are different types of conditional grants used: block grants and specific grants, which can be matching or not, and conditionalities, which can be ex ante and ex post, as in the case of performance-based grants.

Conditional grants design should always start with the fundamental question of what type of instrument (that is, conditional grant) would best achieve the goal or purpose that is being sought. From this perspective, it is important to recognize that there is no absolute dominance of one type of conditional grant over another (see box 6.3. below).

Internationally over several decades, central governments in many countries have overused specific grants to address a multiplicity of issues, many of them too small, costly to administer, and imposing, with high compliance and reporting costs and often overlapping targeted roles with contradictory objectives. In response, over the past several decades there has been an international trend toward the simplification of transfer systems with the introduction of general purpose block grants. Even though conditional, general purpose block grants provide subnational governments with more autonomy in the use of transferred funds in a particular area, though they may also be accompanied by more central regulations external to the grant. In all cases, conflict over priorities in the use of funds is generally addressed by using conditional matching arrangements, allowing the central government to preserve its priorities and leaving subnational governments free to exercise their own budget decisions.

### Box 6.3. International Trends on Transfer/Grant System Design: Simple is Better<sup>39</sup>

Over the past several decades, many national governments have overused specific grants to address a multiplicity of issues in ways that were not always warranted, as many of the grants were too small, were expensive to manage, imposed high compliance and reporting costs on subnational governments, and often overlapped in targeted roles with conflicting goals.

As a consequence, there has been a tendency toward simplifying transfer systems by introducing a few block grants in the place of many specific earmarked grants. The objectives here include lowering monitoring and compliance costs, providing subnational governments with more autonomy in the use of the transferred funds, and establishing a clearer set of national priorities in the overall use of grant funds. Significant grant simplification reforms have been implemented in Austria, Italy, Denmark, the Netherlands, Norway, Sweden, Switzerland, the United Kingdom, and the United States.

<sup>39</sup> For further reading see, for example, Martinez-Vazquez (2020).



Despite the general advantage of block grants in providing more autonomy, specific earmarked grants may work better when the central government has incomplete information on differences in costs and expenditure needs. Specific grants may also better contribute to intergovernmental cooperation and be more conducive to developing more horizontal accountability (given the higher visibility of the expenditure-revenue link). Specific grants may also be less likely to lead to a soft budget problem, as in the case of discretionary changes to block grants.

In addition, international practice is generally to use distinctive separate capital grants or transfers in support of subnational governments' needs to build public capital infrastructure. Because of their "lumpiness" and non-recurrent nature, the needs for capital infrastructure cannot be adequately taken into account in the recurrent equalization transfer or in ordinary conditional grants. In terms of design, capital grants vary by the degree of flexibility in the use of the funds. They can either be specific project-based grants, which tend to be closely administered and monitored by line ministries, or categorical or block grants, which can be designed with strong equalization features and which give much more discretion to subnational governments for whose projects the funds can be used. These two approaches can exist side by side, depending on the objectives of the central government and the nature of the projects. In terms of their allocation, funds are distributed by using pre-established formulas and competition processes with defined application procedures; using ad hoc decisions and negotiations is not desirable.

Last, performance-based grants, or "performance-based grant systems" (PBGs), have been increasingly used in some countries as an alternative to specific earmarked and block conditional

However, no one type of conditional grant is favored over another, for example, block grants over specific grants or performance-based grants over ex ante conditional grants. The design of conditional grants should always start with the basic question of the type of instrument (that is, conditional grant) that would best realize the anticipated goal. From this perspective, even specific purpose grants (with ex ante conditionality or ex post performance-oriented conditionality) may be what is needed, depending on government objectives. In this case, there would be an accepted tradeoff between less subnational autonomy but more efficacy in outcomes.

grants. Their advantage is to incentivize improvements in subnational government performance and service delivery by linking performance in pre-determined areas to access to funding and to the amount of funding. The basic idea is to move away from the ex ante controls intrinsic to most conditional grants (whether specific or block grants). The most delicate design area in PBGS lies in the specification of the performance measures.

## 6.9. Options for reform

There have been advances in subnational fiscal equalization, but these reforms need to go further. Although a solid system for mitigating disparities among LRGUs' fiscal capacity was introduced in 2018, further steps toward greater fiscal equalization could be taken, in particular by incorporating the (potential) existing disparities in expenditure needs in the equalization system, but also by accounting fully for disparities in fiscal capacity by incorporating measures for potential own revenues.

In terms of expenditure needs, if the central government determines what public services should be provided by all LRGUs and at what quantity and quality, the equalization system could guarantee access to an equal or similar level of services to all citizens regardless of where they live in the country. Currently, by comparing the level and quality standards of services, it is evident that there are significant disparities among municipalities, cities, and counties. Moving forward, a minimum standard of public services to which all Croatian citizens are entitled could be determined, at least in the form of minimum financial norms per client (main service users), so that there is no unequal coverage or access to public services in different LRGUs with different staffing and financial opportunities.

In summary, currently, despite the equalization in fiscal capacity, there is still a substantial difference in the quality of public services in Croatia, indicating that fiscal expenditure needs should be introduced into the equalization system side by side with fiscal capacity equalization and also that disparities in fiscal capacity should be addressed through strategies for potential own revenues. This will not be an easy task. The minimum financial standards should be affordable within existing overall budget constraints—that is, they should correspond to the fiscal reality of the country and only revised over time as the overall financing and budget constraints allow. There is a wealth of methodologies and experiences at the international level to quantify expenditure needs from which Croatian authorities could draw to implement these reforms. There is also a variety of methodologies that can be used to measure potential own revenues.

The current fiscal equalization system has a lack of clarity in the design and the effects of the fiscal needs equalization/distribution formula (calculating minimum financial standards, etc.). The government could consider a sequenced reform in order for the system to evolve and mature in line with EU/OECD standards. The initial phase could include the following actions: (i) prepare a white paper analyzing the potential disparities across regional and local governments in expenditure needs caused by demographic composition, geographic remoteness, or other factors; and (ii) if significant disparities in expenditure needs are found, study a reform of the equalization grants to include expenditure needs equalization with revenue capacity equalization by adopting either the fiscal gap approach or the fiscal capacity per adjusted population approach (where the adjusted population reflects differences in expenditure needs).

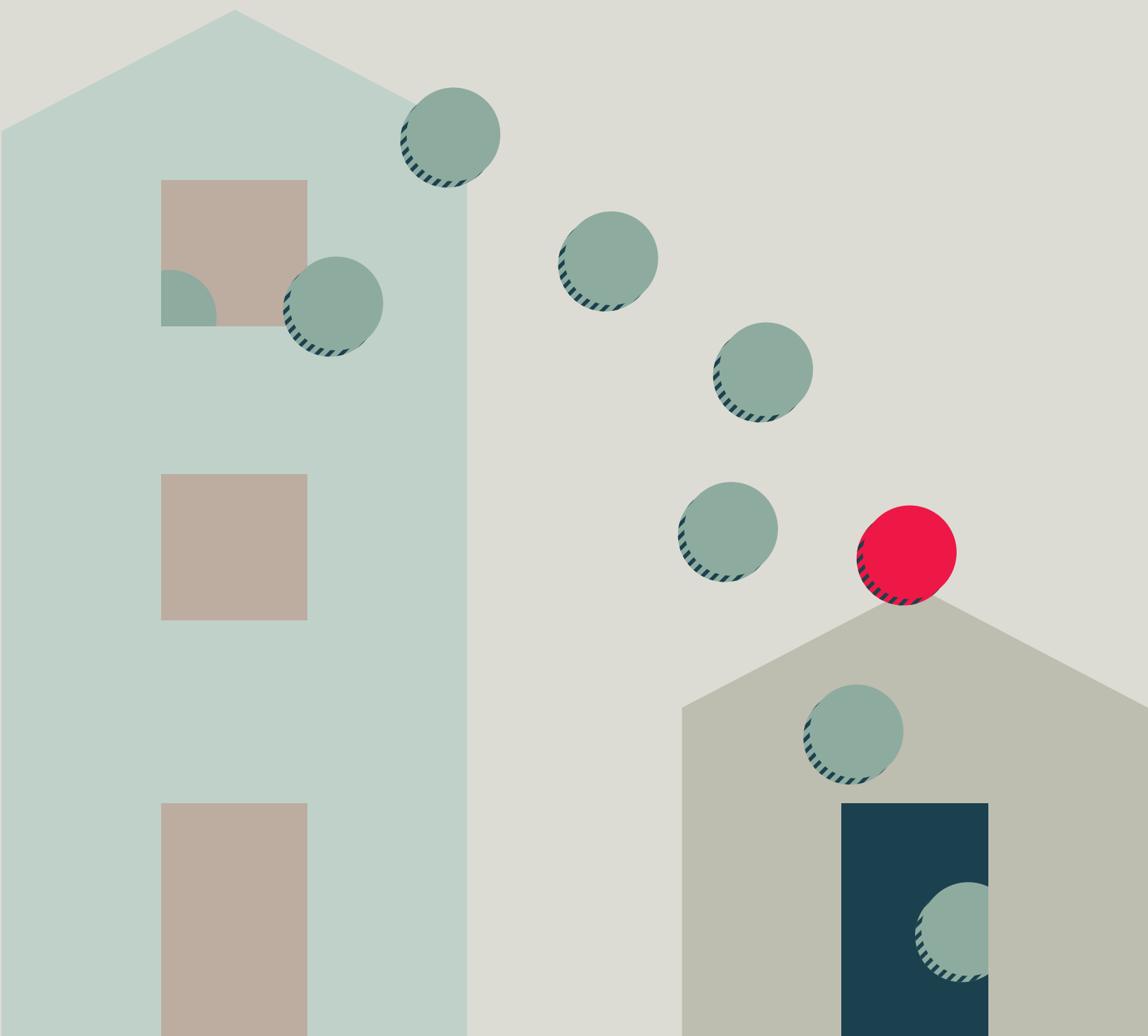
Conditional grants to LRGUs are distributed from various sources and with different purposes. Nevertheless, the detailed structure of this category of grants is not publicly available, as only the aggregate level is provided. This is one of the main obstacles to analyzing this aspect of LRGU revenue and also to fully understanding and evaluating the effects of these different grants. The general criteria for the allocation of a majority of these grants are publicly available. However, the documents are scattered across various ministries, institutions, and competent bodies, usually without details on the total financial amount allocated, let alone the distribution according to individual LRGU. In order to remove concerns about the lack of transparency or even political interference in the allocation process, there could be a single database for all the different grants distributed to LRGUs, including the criteria for allocation and the level of allotment per annum. The intergovernmental transfer system in general is hampered by the proliferation and fragmentation of the grants, frequent rule changes, weak execution, and erratic information. To cope with these problems, data on grants should be published in a more transparent, detailed, and centralized fashion to make longer-term datasets comparable. Moreover, the MOF could consider introducing evaluations of the transfers and transparently publish the results. The rules for disbursement should be clarified and kept unchanged for a period of time to increase the revenue predictability and budgetary certainty of LRGUs, and the governance of the whole system should be strengthened by consolidating the central coordinating role and assigning it to the MOF.

One of the most pressing problems for LRGU development is the weak absorption (administrative) capacity to attract EU funds. One potential solution is for counties to assume several of the tasks currently assigned to LGUs, especially those that do not have the necessary capacity (personnel and professional) to demonstrate quality performance in the use of EU funds. County prefects, city mayors, and municipal heads, as well as other employees, should be encouraged to regularly engage in professional training, and LGUs, particularly less-developed LGUs, should be provided with additional professional financial support. Some city and county finance managers have relevant knowledge and experience, but their activities are limited. The role of county development agencies as regional coordinators could be strengthened so they can better prepare and implement projects and monitor all beneficiaries in their counties in the central electronic register of development projects. Given that regional coordinators have the proverbial “big picture,” they could help in prioritizing projects and abandoning the current “spontaneous approach” to development management in counties.

In order to promote capital investments at lower government levels, a development management system could be established at the county level. In addition to the existing national development management system, a link to both the regional and local levels could be made so that counties or regional coordinators (county development agencies) can establish an e-catalogue of investment projects and capital investments at the regional self-government level. This would enable a proactive approach to attracting direct (foreign) investments and provide insight into investment projects and capital investments in the county that will contribute to growth and development and strengthen regional competitiveness.



# 07 Subnational Borrowing and Debt





## 7.1. LRGU borrowing and fiscal rules

LRGUs can borrow by taking loans and issuing securities. The central government regulates borrowing and the issuing of guarantees by LRGUs and sets limits (fiscal rules) on LRGU borrowing through the Budget Act (OG 87/08, 136/12, and 15/15) and the annual Acts on the Execution of the State Budget of the Republic of Croatia.<sup>40</sup> LRGU borrowing can be short and long term. Short-term borrowing (up to 12 months) can be utilized exclusively to bridge the gap caused by the different dynamics of revenue collection, expenditure flows, and maturity of liabilities. However, LRGUs can borrow long-term only for capital infrastructure investment purposes financed from its budget, which must be confirmed by its representative body,<sup>41</sup> recommended by the MOF, and approved by the central government.

The borrowing agreement is concluded by the municipal head, city mayor, or county prefect on the basis of the adopted budget. Official government consent is a mandatory annex to the borrowing agreement. The government must decide whether to give consent to the borrowing request within 40 days after the submission of a complete application. The LRGU informs the MOF of the borrowing agreement within eight days of its conclusion and is required to report quarterly to the ministry by the 10th of the month for the previous reporting period on the repayment of the loan. Within the same deadline, LRGUs are obligated to report to the MOF when they give consent to the borrowing and issuance of guarantees to legal entities in which they have a majority ownership or to institutions they founded, as well as to the borrowing and issuance of guarantees for their extra-budgetary users.

The total annual debt service payment of the LRGU may not exceed 20 percent of realized total revenues in the year preceding the borrowing year. The total annual debt service payment includes the average annual annuity (interest and repayment of principal) for loans, debts, or liabilities based on issued securities, guarantees, consents, and any overdue outstanding liabilities from previous years. Realized budget revenues related to this fiscal rule are total revenues minus any revenues from: a) domestic and foreign aid and donations; b) special contracts involving the co-financing of citizens for local self-government, and c) the basis of additional shares in PIT and equalization grants for decentralized functions. This fiscal rule does not generally apply to projects co-financed by EU programs and funds or to energy-efficiency projects in which LRGUs participate.

The total annual debt repayment obligation includes consents for: a) the borrowing of legal entities that are majority owned or co-owned by the LRGU and that have shown a loss in their annual financial statements for the year preceding the borrowing year; b) the borrowing of these legal entities that do so within a period of two years from the date of entry of their establishment in the court register; or c) the borrowing of institutions whose founder is the LRGU. A legal entity in majority ownership or co-ownership of an LRGU and an institution founded by an LRGU can borrow long term only for investment purposes with the consent of the LRGU.

<sup>40</sup> Bajo (2004) and Bajo and Primorac (2010) provide a comprehensive overview of LRGU borrowing in Croatia.

<sup>41</sup> The representative bodies are the municipal council, city council, and county assembly. In Zagreb, as a special status unit—a city with a county status—the representative body is the City Assembly. Members of the representative bodies are elected in direct elections by secret ballot.

An LRGU's extra-budgetary users can also borrow and provide guarantees only for investments with the consent of the LRGU. Borrowing and guarantees given with the consent of the LRGU are also included in the scope of (deducted from) the LRGU's borrowing capacity. The total amount of borrowing and guarantees given is determined by an LRGU's budget decision for a particular year.

The county government may provide a loan guarantee to a city or municipality in its area with the consent of the central government. The given guarantee is then included in the scope of possible indebtedness of the county government. The LRGU may provide a guarantee to a legal entity in direct or indirect majority ownership and an institution it founded. The guarantee given is included in the scope of possible borrowing, and the LRGU has the obligation to obtain the consent of the Minister of Finance before issuing the guarantee. All of these different possibilities and contingencies are summarized in table 7.1.

**Table 7.1.** LRGU Borrowing Options

ITEM	OF (SUBJECT)	TO (SUBJECT)	FOR (PURPOSE)	CONSENT OF THE GOVERNMENT OR THE MINISTER OF FINANCE
Short-term borrowing	LRGU		Bridging the financing gap	Not needed
Long-term borrowing	LRGU		Acquisition of non-financial assets	Government
Issuing of guarantees	county	City/municipality	Acquisition of non-financial assets	Government
	LRGU	Legal entity/institution	Acquisition of non-financial assets	Minister of Finance
Giving consent	county	Extra-budgetary users (county road administration)	Borrowing for the acquisition of non-financial assets and issuing guarantees	Minister of Finance
	LRGU	Legal entity/institution	Acquisition of non-financial assets	Not needed
Issuing guarantees/consents	LRGU	Legal entity/institution	Borrowing for the acquisition of non-financial assets	Minister of Finance
Debt refinancing	LRGU		For the remainder of the debt	Government

Source: The Budget Act (OG 87/08, 136/12 and 15/15).

LRGUs and their institutions and companies may, as public partners, enter into public-private partnership (PPP) agreements if the total annual amount of all fees paid by the public partner to the private partners under all PPP contracts does not exceed 25 percent of the previous year's respective budget revenue, reduced by capital revenue. This is in addition to the 20 percent limit for general debt service. As with the fiscal rule for the total annual debt repayment obligation, the above-mentioned categories of revenues are excluded from the realized budget

revenues, as are the capital revenues, including those from the sale of non-financial assets, receipts from the sale of securities, and receipts from the sale of shares and equity.

According to the Act on the Execution of the State Budget of the Republic of Croatia for 2020 (OG 117/19, 32/20, 42/20), the central government may give consent to an LRGU to borrowing up to 3 percent of the total current revenues of all LRGUs realized in the year preceding the year of borrowing. This restriction does not apply to: a) LRGUs that received the government's consent in the previous year but did not use it in that year; b) LGUs (cities and municipalities) in supported areas; c) LRGUs that borrow for projects co-financed by EU funds up to the amount of eligible costs; and d) energy-efficiency improvement projects in which LRGUs participate. Although the limits (fiscal rules) are currently well defined, it should be noted that there are no explicit rules on how the central government may apportion those limits among the different tiers of government and then also among jurisdictions in each tier (level of government). Therefore, the borrowing consents are given essentially on a first-come, first-served basis until the funds (limits) are exhausted.

Table 7.2 summarizes the changes in fiscal rules for LRGU borrowing since 1996. The individual borrowing limit is set out to preserve the liquidity and indebtedness of LRGUs as well as to maintain their creditworthiness and control their credit risk. On the other hand, the aggregate borrowing limit is set to preserve the financial health of the sector in general and to control for the associated fiscal risks to the general government. It is worth mentioning here that in 2020, there was a significant one-off increase in this borrowing limit (to 6 percent). This relaxation was to enable LRGUs to cover the financing gap that emerged as a consequence of the COVID-19 pandemic (loss of revenue due to reduced economic activity). Moreover, since taxpayers were not obligated to pay the PIT during the lockdown period and the PIT is one of the main revenue sources for LRGUs, the MOF provided interest-free loans to LRGUs in the amount of the PIT and surtax that they did not collect due to legislative changes that enabled exemptions or deferrals during the pandemic. In addition, LRGUs that faced a revenue decline in 2020 compared to 2019 also had access to interest-free loans provided by the MOF, with a maturity of three years.

**Table 7.2.** Fiscal Rules for LRGU Borrowing

YEAR	PURPOSE OF THE BORROWING	INDIVIDUAL LRGU RULE: TOTAL ANNUAL DEBT SERVICE PAYMENT MAY NOT EXCEED	AGGREGATE ANNUAL BORROWING LIMIT (% OF ALL LRGUS' CURRENT REVENUE)
1996–1997		30% of budgetary expenditures	n/a
1998–2002			
2003–2004			3
2005–2006	Financing of capital projects	20% of revenue realized in the year preceding the year of borrowing	2
2007–2010			2.3
2011–2014			2.5
2015–2019			3
2020			6
2021			3

Sources: The Budget Act (OG 87/08, 136/12, and 15/15) and Act on the Execution of the State Budget of the Republic of Croatia for the Years from 1996 to 2020.

Despite the aggregate cap increases over time (from 2005 onward), overall fiscal rules for LRGU borrowing in Croatia can be considered restrictive. This might be positive for the financial position and sustainability of the sector as a whole, but at the same time it hampers the level of capital investments at the LRGU level in the face of the significant subnational capital infrastructure development needs. A relaxation in the fiscal rules for LRGUs is therefore advisable. However, this should be gradually implemented, because of many LRGUS' fragmentation and weak administrative capacities, which could lead to excessive borrowing and the possible reliance on soft budget constraints and central government bailouts.

Table 7.3 depicts fiscal (debt) rules for subnational governments in several EU countries in 2018. Most of those rules apply to LGUs in Croatia, whereby the target/constraint is tied to different indicators of indebtedness, including the debt service ratio, net debt, debt-to-revenue ratio, and so on. However, the ceiling is usually set as a ratio of debt to (current) revenue and at 60 percent (and in some countries even more, for example, in Portugal, where the limit is set to 1.5 times or 150 percent). Relating this to Croatia—even with the assumption of constant LRGU revenue and an average debt maturity of 20 years—it is not possible that LRGU debt ever comes close to 60 percent of revenue.

**Table 7.3.** Fiscal (Debt) Rules for Subnational Governments of EU Countries in 2018

COUNTRY	SECTOR	TARGET/CONSTRAINT	DESCRIPTION	NON-COMPLIANCE ACTIONS
<b>BULGARIA</b>	LG	Debt service ratio	The annual amount of municipal debt payments for each municipality may not exceed 15% of the annual average amount of own revenue and the total balancing subsidy for the previous three years.	No pre-defined actions
<b>CZECHIA</b>	LG	Nominal debt as % of total revenues	The local government units are obligated to keep their debt at a maximum level of 60% of their 4-year average of revenues.	Correction mechanism is triggered automatically
<b>ESTONIA</b>	LG	Net debt	Local governments are not allowed to increase their debt over 60% of their budget revenue, of which the allocations from the state budget for a specific purpose have been deducted.	Correction mechanism is triggered automatically
<b>POLAND</b>	LG	Debt service ratio	The ratio of installments of loans and interest payable in this fiscal year, redemption of securities and interest payable on them, and potential payments resulting from sureties and guarantees granted to the planned revenues cannot exceed in a given fiscal year the arithmetic mean from the ratio of its current revenues augmented by revenues from the sales of assets and reduced by current expenditures computed for the previous three years to budget revenues in total.	Correction mechanism is triggered automatically
<b>PORTUGAL</b>	LG	Debt ceiling in nominal terms	The debt at the end of the year cannot exceed 1.5 times on average the current net revenue collected in the previous 3 years. Additionally, the total debt can only increase each year by 20% of the margin available at the beginning of each financial year.	Correction mechanism is triggered automatically

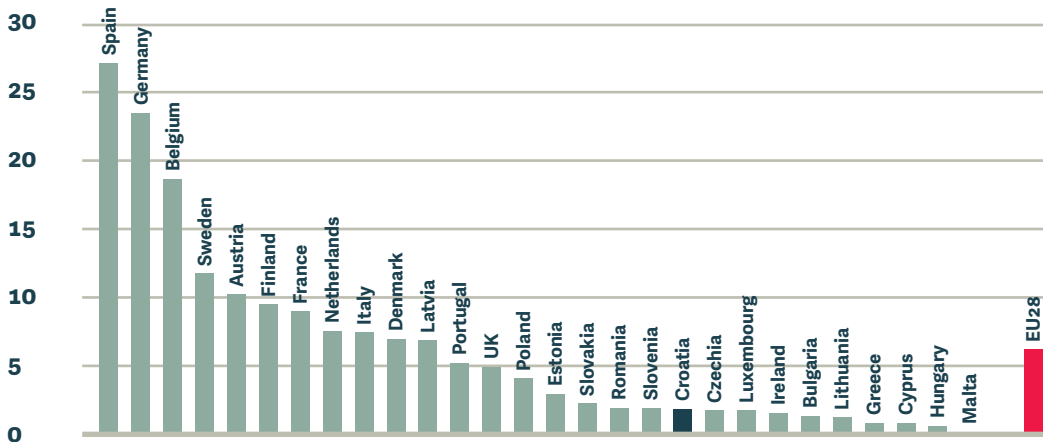
COUNTRY	SECTOR	TARGET/CONSTRAINT	DESCRIPTION	NON-COMPLIANCE ACTIONS
<b>PORTUGAL</b>	RG	Nominal debt in absolute terms	End of year liabilities <=1.5 times the average of the current net revenue collected in the previous three years.	Correction mechanism is triggered automatically
<b>ROMANIA</b>	LG	Debt ceiling as % of current revenue	Local governments cannot contract or guarantee loans if their annual public debt service (principal payment, interest, commissions), including the loan they want to contract, is higher than 30% of their own revenue.	No pre-defined actions
<b>SLOVAKIA</b>	LG	Debt ceiling and limit on repayment as % of current revenue in previous budget year in nominal terms	Borrowing limits for regional and local governments: 1) total debt cannot exceed 60% of current revenue in the previous budget year in nominal terms (i.e., capital revenues and revenues from financial transactions are excluded); 2) annual installments to reimburse debt cannot exceed 25% of revenue in the previous budget year in nominal terms.	Correction mechanism is triggered automatically

Source: European Commission, "Fiscal Rules Database," available at [https://ec.europa.eu/info/publications/fiscal-rules-database\\_en](https://ec.europa.eu/info/publications/fiscal-rules-database_en).

## 7.2. The size and the structure of LRGUs' debt stock

Due to quite restrictive borrowing requirements (fiscal rules), Croatia's subnational sector is only modestly indebted. Countries with the highest percentage of subnational debt (as a percent of GDP) are Spain (26.5 percent), Germany (22.9 percent), and Belgium (18.2 percent). Croatia's subnational debt reached 1.7 percent of GDP in 2018, which is significantly below the EU28 average of 6 percent (figure 7.1).

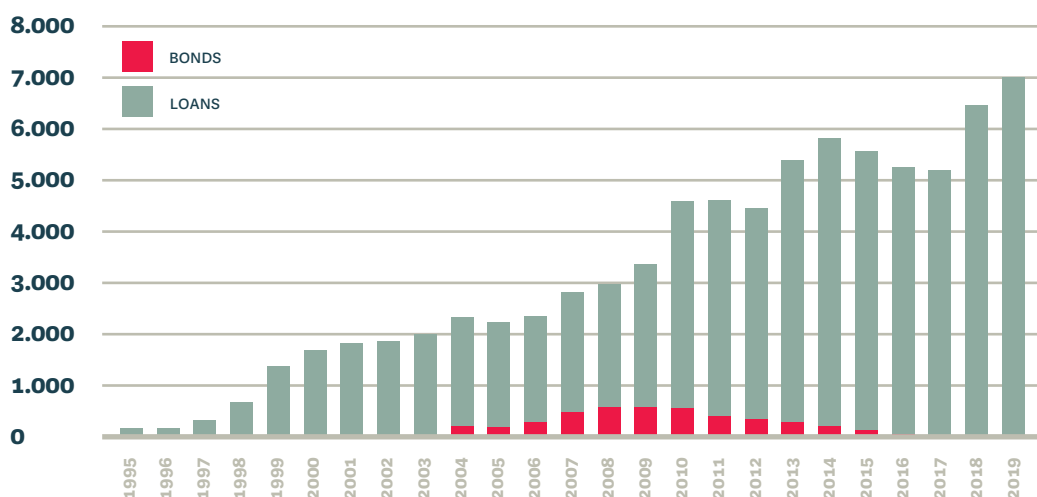
**Figure 7.1.** Subnational Government Consolidated Gross Debt in 2018 (% of GDP)



Source: Eurostat, 2020, available at <https://ec.europa.eu/eurostat/data/database>.

The direct debt (financial liabilities) of LRGUs, consisting of loans and bonds, increased from HRK 144 million in 1995 to HRK 7 billion in 2019. LRGUs in Croatia rely almost exclusively on loans, while the share of the marketable debt is negligible (figure 7.2). The cities of Opatija, Koprivnica, Zadar, Rijeka, Split, and Vinkovci, as well as the county of Istarska, are the only LRGUs in Croatia ever to issue municipal bonds. The last one was issued by the city of Split in 2008 with a 10-year maturity; currently there are no LRGU bonds traded on the stock exchange. It might be strange, or at least interesting, at first sight that Zagreb is not among the LRGUs that have issued municipal bonds. However, it should be noted that Zagreb is indirectly participating in the municipal bond market through its utility company (Zagrebački Holding), which issued a corporate bond in 2007 to circumvent the borrowing limits imposed on LRGUs.

**Figure 7.2.** The Structure of LRGU Debt by Type of Debt Instrument from 1995 to 2019 (in HRK million)



Source: Croatian National Bank, 2020, available at <https://www.hnb.hr/statistika/statisticki-podaci/opca-drzava/dug-opce-drzave>.

Zagreb's utility company (Zagrebački Holding Ltd.) later issued an additional corporate bond in 2016, with a reopening in 2017. The operations of the city and Zagrebački Holding are an example of how fiscal rules can actually be circumvented through utility firms. Financial operations of the two are interwoven so that the financial position of Zagreb cannot be observed independently of its utility firm. Moreover, the strained financial position of the holding company would definitely be negatively reflected in Zagreb's credit risk/rating and vice versa. Table 7.4, which shows the main characteristics of LRGU bonds, reveals an interesting fact: that LRGUs were issuing bonds denominated in foreign currencies though they generate revenues in HRK. Since the central government backs them up in the event of financial difficulties, it is not clear why LRGUs agreed to such unfavorable terms, as they should have a much stronger negotiating position than their creditors.

**Table 7.4.** Main Characteristics of LRGU Bonds

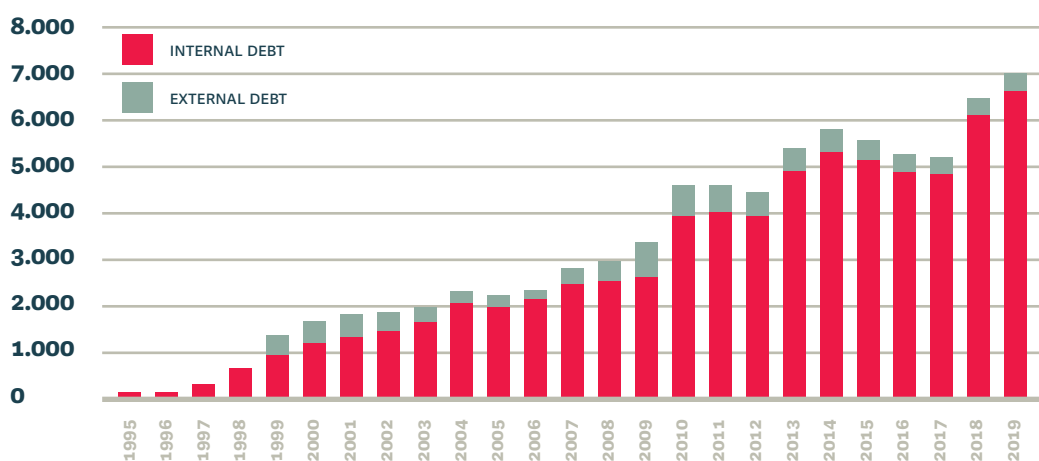
	LRGU	ISSUED IN	MATURITY (YEARS)	MIL. DEM	MIL. EUR	MIL. HRK	INTEREST (%)
1	Istarska county	1995	2.5	2			11
2	Istarska county	1996	2	4		4.3	
2.1.	Istarska county	1996	3			5.7	7
3.	Opatija	1998	4			14	8.5
4.	Koprivnica	2004	7			60	6.5
5.	Zadar	2004	7		18.5		5.5
6.	Rijeka	2006	10		8.2		4.13
7.	Split	2006	7		4		4.56
8.	Vinkovci	2007	10			42	5.5
9.	Zagrebački Holding	2007	10		500		5.6
10.	Rijeka	2007	10		8.2		4.125
11.	Split	2008	10		8.2		6
12.	Zagrebački Holding	2016	7			1,800	3.875
12.1.	Zagrebački Holding	2017	6			500	3.875

Source: Zagreb Stock Exchange.

One reason for such imprudent public financial management is their weak administrative capacities, including a lack of the needed knowledge and skills in this area. LRGUs thus predominantly rely on loans provided by commercial banks because this type of borrowing is less transparent and often hidden from the public, as opposed to bonds traded on the stock exchange for which all the borrowing conditions are published in the prospectus.

The smaller-scale borrowing is often done with local banks on discretionary (subjective) terms, without proper evaluation of the LRGU's creditworthiness. This is reflected in the structure of the debt by the residence of the creditors, as 95 percent of debt is internal (figure 7.3). It is not clear why the central government does not take a more active role when approving LRGU borrowing by evaluating the terms in more detail and advising the subnational governments on acceptable terms and conditions. The advantage of such extensive administrative supervision is not fully exploited if it is used only to control the level of borrowing. LRGUs' domestic borrowing very likely does not crowd out private investments due to its limited scale (and the stock of debt in general). Nevertheless, LRGUs should be incentivized to rely more intensively on marketable debt (municipal bonds) and alternative financing models in order to promote transparency and competition and to participate in the development of the domestic capital market.

**Figure 7.3.** The Structure of LRGU Debt by Residence of Creditors from 1995 to 2019 (in HRK million)



Source: Croatian National Bank, 2020, available at <https://www.hnb.hr/statistika/statisticki-podaci/opca-drzava/dug-opce-drzave>.

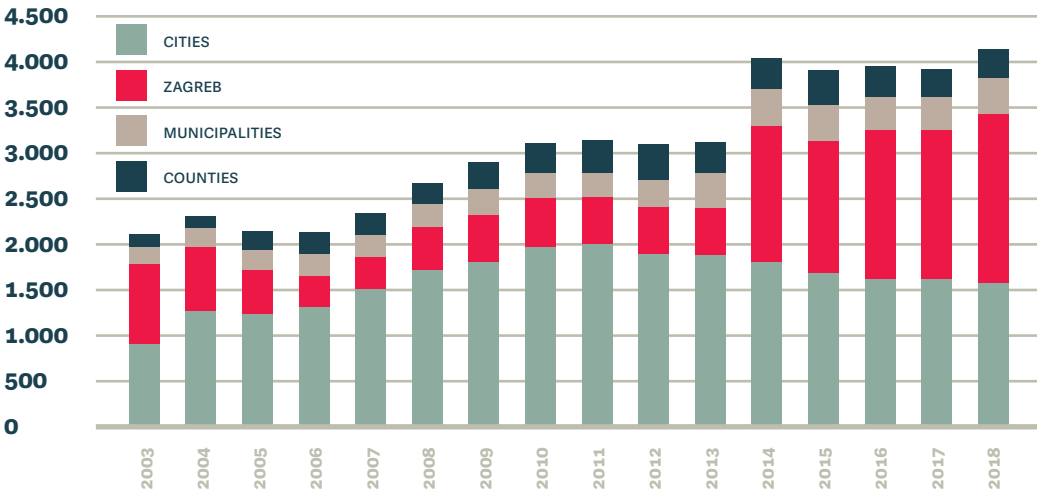
Figure 7.4 shows the structure of LRGU debt by the type of subnational administrative unit, revealing that cities generate the lion's share of subnational debt (more than 80 percent). More surprisingly, Zagreb alone generates almost a majority of the debt (45 percent of total LRGU debt and 54 percent of all city debt). This additionally supports the thesis that the financial operations of LRGUs and their utility firms (especially in the case of Zagreb and Zagrebački Holding) should be closely monitored, and fiscal risks from their operations should be constantly evaluated and adequately managed.<sup>42</sup> After all, since a large number of LRGU companies benefit from subsidies that sometimes account for over 90 percent of their total revenue, it would be reasonable to include some of these companies within the LRGUs' budgets.<sup>43</sup>

<sup>42</sup> For a detailed discussion on fiscal risks from LRGUs' companies, see Bajo and Primorac (2014).

<sup>43</sup> See Primorac (2011) for a discussion of these issues.



**Figure 7.4.** The Structure of LRGU Debt by Administrative Units from 2003 to 2018 (in HRK million)



Source: LRGU balance sheets in the period from 2003 to 2018.

It should be noted that the total amount of debt in figures 7.2 and 7.3 differs from the amount presented in figure 7.4. That is because the Croatian National Bank (the source for figures 7.2 and 7.3) uses the European System of Accounts (ESA) 2010 methodology, and the MOF, which is the source for figure 7.4, uses the IMF's GFS 2001 system. In accordance with the ESA 2010 methodology, loans in figures 7.2 and 7.3 include those received from resident and non-resident creditors as well as loans taken on from institutional units covered by government guarantees, called on within three years (the so-called "third-party call" criterion). Loans that have been transferred from the original debtor to the central government are also counted here, and the statistical treatment of PPP agreements and concessions was harmonized with ESA 2010. The debt stock of a single general government subsector is consolidated within a subsector, and the general government internal debt is consolidated also between subsectors.

### 7.3. Main issues with subnational borrowing

Reporting on borrowing activities should be comprehensive, but in Croatia it is still incomplete. Although the existing legislative framework does not provide for the preparation of consolidated financial statements of counties, cities, and municipalities and their utilities, consolidation is required by the International Public Sector Accounting Standards (IPSAS).<sup>44</sup> The application of these regulations would be useful for a comprehensive view of the exposure of LRGUs to direct but also indirect liabilities arising from the financial operations of their utility companies. In addition, despite the rather strict fiscal rules, LRGUs are still able to bypass the controls on their surrogate units. This means that in practice, LRGUs have sometimes borrowed through utility companies to finance their capital projects. Even though currently this is an issue relevant

<sup>44</sup> IPSAS are a set of accounting standards issued by the IPSAS Board for use by public sector entities around the world in the preparation of financial statements.

mainly to the city of Zagreb, the problem could potentially expand to other local governments, especially given the consequences of the COVID crisis and the likely shrinking of PIT revenue. The risks to the financial operations of LRGUs' companies are significantly wider than the guarantees, because the latter are granted only for a portion of what they have borrowed.

There are fiscal risks because reporting is incomplete. The financial performance of LRGUs and their companies should be considered together (especially in the context of borrowing) to obtain a complete picture of the financial "health" of the local and regional public sector. It is therefore a necessity and an obligation to increase transparency in the publication of the data, decisions, and activities of LRGUs. The MOF publishes the budgets and balance sheets of counties, cities, and municipalities on its website. However, for more complete information on the overall and actual financial situation, a unique and up-to-date online database (with addresses and contacts) should also be published for all legal entities owned and co-owned by LRGUs (regardless of the percentage of co-ownership) and for their institutions, including the balance sheets and profit and loss accounts. In order for the data to be usable, it should be published in appropriate formats; for example, financial data should be published in Excel.

Borrowing procedures themselves should also be improved. Given the expected increased borrowing needs to overcome the consequences of the COVID-19 crisis (in the short run) and to finance EU projects (in the long run), and the currently favorable borrowing conditions that allow the refinancing of existing debts with lower total costs, borrowing procedures should be administratively relaxed. To start with, the deadline (40 days) in which the government is obligated to issue consent should be significantly reduced. Currently, the same procedure applies to both the refinancing of existing loans and regular borrowing, which is why counties, cities, and municipalities do not more frequently refinance on more favorable terms. The restrictive nature of the fiscal rules for LRGU borrowing became evident especially during the pandemic when LRGU borrowing needs increased. To overcome this problem, the government made a one-off relaxation of the cumulative borrowing limit, which doubled in 2020.

In sum, in addition to incomplete reporting on debt and financial risks and restrictive borrowing rules, weak administrative capacities, including financial management knowledge and skills, hamper the ability of LRGUs to effectively borrow and manage debt. Borrowing conditions differ significantly among LRGUs, some of which reflect imprudent debt and risk management policies—borrowing in euros, for example, when their revenues are in HRK, a practice that should certainly be avoided. Weak administrative capacities are also one of the reasons for the limited scope of borrowing instruments in use—mostly boiled down to loans with commercial banks. Due to the underdeveloped financial market and the weak capacities of LRGUs, there were only a few examples of borrowing through municipal bonds to finance long-term projects. Borrowing on the financial markets would be beneficial because it increases transparency and usually reduces borrowing costs. In addition, these instruments would be very attractive to institutional investors (most notably pension funds) that are always seeking low risk investments. Despite its many benefits, this instrument has largely been neglected, especially since the 2008 financial crisis, and should be promoted and maybe even incentivized.

## 7.4. International experience and practice with subnational borrowing and fiscal rules

### JUSTIFICATION AND TYPES OF BORROWING

Subnational borrowing is well justified as an instrument for financing subnational governments' investments in capital infrastructure. All decentralized systems need to address the issue of long-term financing for the capital infrastructure expenditure needs of subnational governments, not least because typically, a considerable share of capital investment responsibilities has to be assigned to the subnational level. On the other hand, most subnational governments are not able to finance these responsibilities out of their current savings. The same is also true for public utilities, when (and if) they are decentralized. These companies also often lack the necessary funds for the rehabilitation, maintenance, and expansion of their capital stock. Beyond the supporting use of capital transfers, the practical solution to this financing problem is for subnational governments (and their public utilities) to borrow the necessary funds for new capital infrastructure investments or for the rehabilitation of existing infrastructure if that is the case.

On the other hand, subnational borrowing is often seen as full of risks and thus not always desirable. Despite those concerns, there is wide consensus that subnational government borrowing for much-needed infrastructure is generally both efficient and equitable. Borrowing is efficient because it allows subnational governments to make large lump-sum payments in order to acquire the necessary infrastructure and capital equipment for the provision of public services. That is, borrowing solves the problem of liquidity or the fact that current savings are inadequate for financing occasional capital investment needs. Borrowing is also efficient and equitable because it allows local governments to match the timing of the consumption of services with the payment. Having one generation of taxpayers pay for capital equipment and subsequent generations to freely consume the services would not be fair.

Two forms of credit-based financing are generally available. The first is direct access to capital markets for subnational governments by issuing bonds. The second is borrowing from financial institutions. Bond issuing as the main means of financing long-term capital investments often faces the handicap of weak or nonexistent capital markets. Furthermore, bond issuing is more difficult for smaller local governments. An alternative to issuing a bond that has been used effectively in EU countries is the creation of a financial intermediary or intermediation program that allows all local governments, especially those with no direct access to capital markets, to borrow based on selective banking criteria.

An important advantage of this approach is that these financial intermediaries can reduce the cost of borrowing for smaller governments by spreading the risks among several LGUs. It is also easier for a larger borrower to acquire a good reputation as a debtor and therefore be able to borrow funds in the capital market at lower costs, savings that can then be passed on to local governments. Other advantages of this approach include the ability to combine technical development assistance with lending activities and also to facilitate central government intervention through the supply of funds.

However, the creation of a financial intermediation program also carries risks, such as political biases and abuses, that need to be assessed carefully. Experience with this type of financial intermediary in some developing countries has often been disappointing because of direct involvement by a central government that has mixed soft loans and political objectives with the strict lending banking criteria of financial intermediaries. There are lessons to be learned from international experience both for errors to be avoided and successful features to be imitated (see box 7.1).

There is no intrinsic superiority to any particular approach to financing subnational governments' long-term capital investment needs. Direct borrowing from private commercial banks and other financial institutions, international lending programs, bond issues, and the creation of local government development funds are all desirable alternatives that need to be considered.

To provide safety to investors, bond issues need to conform to standard specifications, and subnational governments need to comply with the borrowing rules imposed by the central government. For that, the MOF or other designated agency needs to act as a register. To facilitate bond issuance by subnational governments, it may be desirable to support the establishment of an insurance scheme. However, it is generally not desirable that the central government act as guarantor of the bonds because serious moral hazards would emerge, both from borrowers and lenders.

Public utilities, or local governments responsible for public utilities, should be allowed to issue a variety of bonds known as "revenue bonds." This refers to non-guaranteed or limited liability debt to be paid from the proceeds associated with the public project that the bond issue is to finance.<sup>45</sup> The funds needed to repay the bond are mobilized from setting public utility tariffs at full-cost recovery levels. To guarantee payment these funds can be put in special escrow as they accrue.



### Box 7.1. Municipal Development Funds and Intermediaries

A Municipal Development Fund (MDF) is defined as a pool of money operated at a level above the individual local government primarily for investment in infrastructure. MDFs are managed by different institutions, such as banks or government agencies, which are the "municipal development intermediaries" (MDIs).

With very few exceptions, Western European countries as well as Japan have for decades had well-established MDIs that channel investment credit to local governments. In many European

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<sup>45</sup> Revenue bonds are different from ordinary subnational government bonds because the latter are considered "full faith and credit" debt, meaning that they carry an unlimited claim on the taxes and other revenues of the subnational government issuing the bonds.

countries, these institutions were established also to provide a reliable outlet for private savings. Over the past several decades, MDFs have spread rapidly through Asia, Latin America, and Africa, where the financing of capital infrastructure has often been combined with longer-term institutional development goals.

**Objectives:** The main objective of development funds is to mobilize resources from private lenders, the central government, donor agencies, and local governments themselves and make them available for investment in urban infrastructure. A second objective is to strengthen the operational capacity and efficiency of local governments by assisting them in the design, appraisal, and execution of investment programs; the rationalization of their programs, moving away from ad hoc investment practices; and the use of rational criteria in the geographic and sectoral distribution of funds. Development funds are best suited to addressing the needs of smaller cities that tend to lack skilled administrators and access to capital markets. Development funds also have the attraction of offering a mechanism for “wholesaling” extensive programs for capital investment in infrastructure as opposed to micro-managing a myriad of small-scale projects.

**Management:** The most common approach has been to introduce an autonomous institution with a legal and financial identity separate from the central government. However, there is great variance in the real degree of autonomy and the precise nature of the institution. Examples include:

- Municipal development banks that are primarily concerned with financing municipal investment. These include the Belgian and Danish Municipal Credit Associations, Bank for the Netherlands Municipalities, and the Municipal Bank of Norway. In all these cases, municipal government representatives control the management board.
- Municipal or local government windows within institutions established to manage state-controlled pensions and insurance funds. This is the case in France, Italy, and Spain, where management is appointed by the central government, but municipal governments are represented in the decisions. The British Public Works Loan Board is 100 percent controlled by the central government, but half of the board draws membership from local governments.
- Municipal “windows” of banks with a wider scope, including mortgages and public works. This is the case of BANOBRAS in Mexico.

**Direct administration by the central government:** This is the mode adopted by many developing countries. The central agency is the Ministry of Local Development or the Interior or, in some cases, the MOF. Problems with some of these new funds have included a lack of capacity for sustained assistance, under-capitalization, and poor loan repayment discipline.

**Funding:** In Western Europe and Japan, most of the activities of MDFs are funded by direct access to financial markets. However, the initial subscription of shared capital by either central or local governments, though not representing any significant resources for lending, has been important in establishing credibility and control. Additional resources are tapped by competing for private savings deposits. Other financial institutions (banks, insurance companies, and pension funds) have been major sources of funds, either through the purchase of bond issues or through directly negotiated deposits. In contrast, developing country MDIs have been largely financed with public funds. Even though most of these institutions have the power to issue bonds, most of them do not.

**Loans and conditions:** MDFs lend money to local governments for long-term investment at preferential rates that cover interest and administration costs. In some cases, there are elements of a grant or subsidized interest. These take different forms, such as matching grants attached to loans that vary with the repayment capacity of the local government or with the type of project. Most often eligibility is unrestricted, in which case the allocation of funds depends on the bids of individual authorities. In some cases, local governments, especially large units, are given a maximum quota.

**Security and Debt Service:** Assessing the debt service capacity of local governments is one of the most difficult aspects of managing an MDF. In most cases the policy is to rely on the statutory limitations established in the law, stating a maximum ratio of debt or debt service for local government revenues. However, in the case of self-liquidating investment, as for public utilities, the limitation depends on the internal financing viability of the enterprise and not the local government per se. There are exceptions to this rule, however. For example, the French Caisse de Depots bases its lending to local governments on financial forecasts, not on debt service ratios.

*Source:* Based on Davey (1988).

## **BORROWING RULES AND OTHER FISCAL RULES<sup>46</sup>**

Given the risks, many countries have introduced rules limiting subnational government borrowing. Undisciplined use of subnational borrowing can lead to disruptions in public service delivery and, more significantly, have important negative effects on the macroeconomic stability of the entire country.

There are two fundamental reasons why subnational governments may be undisciplined regarding borrowing. First, the design of the fiscal decentralization system may be—and often is—faulty. Although most fiscal decentralization reforms have devolved significant expenditure authority, they have much less frequently devolved revenue authority. This form of asymmetric decentralization leads to large vertical imbalances that are routinely closed, with high degrees of local government dependence on central transfers. This, in turn, through the common pool problem, leads to excessive local spending and lower tax effort, since transfers represent little political cost to subnational authorities, and also to moral hazard and expectations of bailouts for excessive borrowing. Second, even when no such defects are present in the fiscal decentralization design, there are basic political economy issues at work that must be recognized. In simple terms, borrowing often allows huge increases in local spending—the cutting of ribbons for infrastructure projects by subnational officials—while it postpones most of the payments to the future. Subnational officials seeking votes may see additional borrowing and spending as an expedited way to gain political support, while the (political) costs are shifted to someone else. Thus, ensuring disciplined and responsible subnational borrowing behavior

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<sup>46</sup> Parts of this section are based on Martinez-Vazquez and Vulovic (2017) and Martinez-Vazquez and Civelek (2019).

generally requires both *good decentralization design and explicit rules, monitoring, and oversight regarding subnational debt.*

The question is how to provide a legal framework that allows subnational governments the flexibility to pursue optimal service delivery and at the same time prevents undisciplined or irresponsible behavior. The main types of borrowing and fiscal rules used in international practice are described below. But beyond those fiscal rules, some countries have used other supporting institutions to monitor spending and borrowing: maintaining fiscal discipline with the creation of “fiscal councils” (box 7.2) and building a safety net to cushion the impact of sudden drops in budget revenues with the creation of “rainy day funds” (box 7.3).

## Box 7.2. Fiscal Councils

The most recent innovation in fiscal governance over the past decade has been the introduction of fiscal councils. In some cases, as in Hungary and Nigeria, fiscal councils have been established as part of a fiscal rules package. In all cases, developed and developing countries, fiscal councils have been adopted as a more or less independent authority to monitor and help enforce fiscal rules. The original idea had been whether a truly independent authority—similar to the role played by central banks and monetary policy—should be formed to control government debt and deficits, given that most governments are inconsistent about their short-run fiscal policy objectives and long-term fiscal stability performance. Many existing fiscal councils were created to focus on central government performance but more recently, the scope of has been extended to the subnational level also.

What is the effectiveness level of fiscal councils? This institutional innovation is fairly new, but the preponderant evidence is that they can play a significant role in improving fiscal discipline and overall performance, especially when they have more independence and authority. The evidence regarding the impact on subnational borrowing and fiscal discipline is still limited, but the combination of the public reports and high media impact of fiscal councils clearly has good potential to lead to better fiscal outcomes at the subnational government level.

Nevertheless, even though most existing councils make some form of ex ante and ex post policy assessment and fiscal sustainability analysis, practically none go beyond the evaluation of current policies and forecasts. In particular, they lack any legal authority to determine national debt or deficit levels, which are still reserved—unlike independent central banks—for elected authorities.

Source: Martinez-Vazquez and Civelek (2019).



### Box 7.3.

## Rainy Day Funds



The “rainy day fund” is a subnational fiscal institution that has long been around but gained special attention in the aftermath of the Great Recession. Nearly all states in the United States have adopted “rainy day funds” to protect their budgets and spending against unexpected economic shocks and uncertainties and to minimize the disruptions caused by economic fluctuations and sharp declines in revenues. Their effectiveness in the past has depended on the size of the shock and the type of expenditures protected. There is no consensus on the optimal amount for a rainy day fund, but following the 2008 crisis, it was recommended that they be increased to 15 percent of annual revenues against the suggested rates of 3–5 percent in the 1980s.

*Source:* Martinez-Vazquez and Civelek (2019).

International experience in setting up subnational borrowing frameworks and fiscal rules is very diverse (see box 7.4.). Experiences range from no central government controls, a multiplicity of rules and controls, and the outright prohibition of borrowing by subnational governments. Most existing borrowing and fiscal rules systems fall into five general categories, described in figure 7.5. But even though some countries fall neatly into one of those categories, many have what could be called mixed systems that combine elements of the different categories to customize and build their own system. In addition, some countries also have changed their subnational borrowing regime over time, which is logical as decentralized systems mature and external conditions change, such as the development of domestic capital markets.

### Box 7.4.

## Borrowing and Debt Management: Diverse Practices, Same Principles



All decentralized systems need to address the issue of long-term financing for the capital infrastructure expenditure needs of subnational governments. In addition to the use of capital transfers, the other reasonable solution to this financing problem is for subnational governments (and their public utilities) to prudentially borrow the funds for new investments or for the rehabilitation of infrastructure, using the two general forms of credit-based financing generally available: bond issuance and financial intermediation (from private banks or official local development funds).

Because of the risks involved, decentralized countries around the world utilize borrowing and fiscal rules to guide and constrain subnational government decisions on borrowing and the



use of credit. Ensuring disciplined and responsible subnational borrowing behavior generally requires more than good decentralization design; it also requires unambiguous rules, monitoring, and oversight regarding subnational debt.

Different systems have been adopted that allow subnational governments the flexibility to pursue optimal service delivery and at the same time prevent undisciplined or irresponsible behavior. Some countries have also introduced fiscal councils as a more or less independent authority to monitor and help enforce fiscal rule, as for example in Hungary, Nigeria, and Spain.

The main types of borrowing and fiscal rules used internationally fall into four general categories, even though many countries combine elements of each of them, relying on some common fiscal rules: administrative approach, cooperative approach, rule-based approach, and market-based approach. (There is also a fifth approach, in which subnational governments are not allowed to borrow at all.) Each encompasses multiple dimensions, and clearly none a priori dominates all of them.

Moreover, successful fiscal discipline at the subnational level requires moving past subnational borrowing and fiscal rules and focusing on preventive measures (such as the streetlight system introduced in Colombia and Mexico), institutionalizing monitoring (via fiscal councils), introducing enforcement measures (for example, by using the intercept of other subnational funds, such as transfers, to ensure compliance with repayment terms), and if needed, applying sanctions (including bankruptcy proceedings and administrative interventions). The consistency with which the rules are applied, encompassing the monitoring and enforcement mechanisms, ultimately could be more critical than the rules themselves.

These are the most common types of subnational fiscal rules per category and type of rule:

- Category: **Numerical**; Type: **Debt rule**. A limit is established on total outstanding debt or debt service in relation to local revenues. Examples of countries include Argentina, Brazil, Italy, Japan, Spain, Lithuania, Romania, Poland, Colombia, Peru, Colombia, Korea, Canada, Czech Republic, the Netherlands, Portugal, and Turkey.
- Category: **Numerical**; Type: **Budget balance rule**. Specific targets are set for subnational balance. Sometimes the rule takes a form of the “golden rule,” when borrowing is only permitted for capital expenditure (current balance rule). Examples of countries include, for current budget balance: Germany, Japan, Netherlands, Italy, France, New Zealand, Sweden, Switzerland, Canada, Finland, and Norway; and for overall budget balance: Canada, Czech Republic, Denmark, France, Korea, Portugal, Turkey, Spain, Poland, and Peru.
- Category: **Numerical**; Type: **Expenditure rule**. Expenditures may not grow faster than some determined rate. Examples of countries include Germany, Spain, Portugal, Korea, and Turkey.
- Category: **Numerical**; Type: **Revenue rule**. Floors or ceilings are set on government revenue. This rule is not used frequently at the subnational level, though sometimes in relation to natural resource revenue in the context of stabilization funds.
- Category: **Procedural**; Type: **Legal approval**. Local councils are required to approve borrowing for individual projects. Examples of countries include Canada, Switzerland, and the United States.

Source: Martinez-Vazquez and Civelek (2019) and Sutherland, Price, and Joumard (2015).

**Market-based approach and self-imposed rules.** Under this approach, the central government does not regulate subnational government debt limits but rather, the entire system relies on financial markets to regulate and restrict subnational borrowing. Subnational governments are free to decide on the source of the debt, its terms and conditions, and the amount that they want to borrow, as long as the financial market institutions allow it. This system presumes the availability of accurate information and indicators on the subnational governments' ability to repay the debt, and there is a clear understanding that there will be no bailouts by the central government. All of these requirements mean that this approach is used in only a few highly developed countries, prominently in the United States and Canada. An alternative similar approach is to rely on self-imposed rules among subnational governments, as in the case of Switzerland.

**Cooperative approach (among different levels of government).** In this case, neither the law nor higher-level governments determine subnational borrowing and debt regulations. Instead, they are determined through negotiations and dialogue between the central and subnational governments regarding deficit targets and debt ceilings. Dialogue raises general awareness at all levels, but negotiations can break down, with negative consequences for budgetary discipline. South Africa is a prominent example of this approach.

**Rule-based approach (national imposed rules).** Rather than resting on central discretion or voluntary agreements, this approach relies on compliance with clearly stated ex ante rules that subnational governments must follow when they borrow. To restrict subnational borrowing, fiscal rules are specified in a legal framework that lists the different combinations: debt ceilings or limits on total borrowing; ceilings on debt service expenditure (for principal and interest); the "golden rule" in which funds can be used only to finance investment on infrastructure; rules on who can be a lender; whether or not lenders can be foreign entities; and so on. A clear goal is to relate the level of borrowing to the repayment capacity of the borrower entity.

A second goal is to make subnational fiscal outcomes predictable. Because most often the rules are specified in the national legal framework, they are known as centrally imposed rules. However, it is possible for subnational governments to have additional self-imposed rules. Although it may seem relatively straightforward to monitor the legal limits of total debt or the limits on debt service expenditures, these rules are not always effective because subnational governments may use different procedures to go around them (box 7.4). The rule-based approach has the clear advantages of transparency and freedom from unnecessary bureaucracy or long negotiations; on the other hand, it can be inflexible in financial crises. In practice, this has been the most frequently adopted approach in recent years and it is by far the most commonly used, for example, in such countries as Brazil, Mexico, Argentina, Bulgaria, Colombia, Czech Republic, Hungary, Poland, Romania, and many others.

**Administrative approach (direct control).** This approach gives power to the central authorities to directly control subnational borrowing and debt through different instruments, including debt ceilings, prohibitions on external borrowing, and prior approval of conditions for any new debt. Direct central government control on subnational government borrowing is more frequently seen in unitary countries—and in those at the early stages of decentralization, which is perhaps where Croatia is at the present time. This approach provides tight macroeconomic stability tools but weakens fiscal decentralization.

**Figure 7.5. Subnational Fiscal Rules**

### Types of subnational fiscal rules (more detail)

	No central controls	Center-SNG Agreement	Centrally-imposed
<b>DEFINITION</b>	Market discipline (and no bailout)	Rules imposed at local levels ("Self imposed")	Borrowing controls (fiscal targets & debt ceiling) result of negotiation between center states
<b>COUNTRY EXAMPLES</b>	<ul style="list-style-type: none"> <li>- Canada (province)</li> <li>- Japan (local; up to a limit)</li> <li>- US states and LGs</li> <li>- Argentina province (domestic)</li> <li>- Czech Republic (local)</li> </ul>	<ul style="list-style-type: none"> <li>- Switzerland cantons</li> <li>- US states</li> <li>- Canadian provinces</li> </ul>	<ul style="list-style-type: none"> <li>- Australia (province)</li> <li>- Austria (local)</li> <li>- Belgium (local)</li> <li>- Germany (region)</li> <li>- Spain (region)</li> </ul>

Source: based on Martines-Vazquez & Vulović (2015)

INCREASING CENTRAL CONTROL

Indirect rules

Direct control

Borrowing prohibited



Constraints on the fiscal balance of expenditures

Constraints on new borrowing, level of debt or service

SNG borrowing requires prior approval from the center (or upper level of gov't)

Exception is usually on lending from the center

- Germany local
- Italy state and local
- France local
- Brazil local
- Colombia local
- Peru local
- Lithuania local
- Russia local
- Indonesia local

- Germany local
- Spain local
- Brazil local
- Peru local
- Estonia local
- Hungary local
- Lithuania local
- Latvia local
- Poland local
- Russia local
- Serbia local
- Slovakia local
- Philippines local
- Thailand local
- Nigeria state

- Japan local (above a certain limit)
- Korea local
- Germany local
- Turkey local
- UK local (external)
- Argentina province (external)
- Brazil local (external)
- Colombia local (bond issuance)
- Peru local (external)
- Serbia local
- Slovakia local (above certain limit)
- India state (domestic)
- Indonesia local (domestic)
- Thailand local

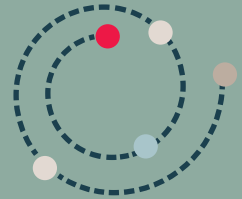
- Mexico state (external)
- Armenia local (external)
- Kazakhstan local (external)
- Russia local (external)
- India state (external)
- Indonesia local (external)
- Nigeria state (external)
- Vietnam local
- Denmark

**Prohibition approach.** This approach simply does not recognize that subnational governments can borrow. Many countries started here and later evolved to more permissive systems. But it is still utilized in countries as diverse as Denmark and Chile.

## Box 7.5. Circumventing the Borrowing Rules

Subnational governments can be resourceful and creative in circumventing legislated borrowing rules. Some of these common practices include:

- Subnational governments can label current expenditure as capital expenditure.
- They can use subnational government financial vehicles that have extra-budgetary status, such as government-owned enterprises. Subnational governments may borrow through these entities, which are often outside of debt ceilings determined by fiscal rules.
- Using local government financial vehicles, the subnational government may borrow to fund projects that should be funded by its own budget.
- The rule-based approach may lead to an accumulation of short-term debt, and it is often not clear whether it is included in debt ceilings.
- Subnational governments can accumulate considerable payment arrears to providers, central government agencies, and even employees; these may not be readily apparent when cash-based accounting is used as opposed to accrual.



Source: Based on Ter-Minassian and Craig (1997).

### ARE THERE BETTER PERFORMING OR PREFERABLE BORROWING AND FISCAL RULES?

The rule-based approach, with rules imposed by the central government, appears to be the best option. The majority of countries have adopted this approach. Its main attraction is that it combines transparency with strong, though indirect, central government control. However, each approach encompasses multiple dimensions, and clearly none a priori dominates. In addition, statistical analyses in the economics literature show that no particular borrowing regime dominates in terms of effectiveness and overall fiscal discipline results.

Nevertheless, the more general rules (see table 7.5), including the “golden rule,” put limits on total debt and debt service. Spending rules also appear to be quite effective in guaranteeing subnational fiscal discipline. On the whole, successful fiscal discipline at the subnational level requires going beyond subnational borrowing and fiscal rules to focus on early warning and preventive measures (such as the streetlight system introduced in Colombia and Mexico), institutionalize monitoring (via fiscal councils, for example), introduce enforcement measures (for example, by using the intercept of other subnational funds, such as transfers, to ensure compliance with repayment terms), and if needed, apply sanctions, including the possible

application of bankruptcy proceedings and administrative interventions. The strength with which the rules are applied, including the monitoring and enforcement mechanisms, ultimately would appear to be more important than the rules structure itself.

**Table 7.5.** Types of Subnational Fiscal Rules

TYPE OF RESTRICTION	DESCRIPTION	COUNTRY EXAMPLES
<b>Affordability/Limits Formulae</b>	Ceilings on (i) debt service/local revenues; (ii) debt service/local current saving	Argentina, Brazil, Italy, Japan, Spain, Lithuania, Romania, Poland, Colombia
<b>Indebtedness Formulae</b>	Limit on total outstanding debt/net revenues	Brazil, Colombia, Italy, EU
<b>"Golden Rule" Provision</b>	Borrowing for capital expenditures only	Brazil, Canada, United States, Austria, South Africa, Switzerland, India
<b>Balanced Budget</b>	Councils are required to pass balanced budgets. OR Budget bill needs to identify the financing sources of a deficit.	Germany, Netherlands, United States Brazil, Canada
<b>Spending Limits Rule</b>	Expenditures may not grow faster than some determined rate.	Most EU countries
<b>Local Approval</b>	Local councils are required to approve borrowing for individual projects.	Canada, Switzerland, United States

Source: Martinez-Vazquez and Civelek (2019).

A complete system of borrowing and fiscal rules requires setting ex post control rules that define an insolvency framework for subnational governments and the vertical apportionment of aggregate debt limits. The first relates to the need to *explicitly state ex post rules that define an insolvency framework for subnational governments*. If the ex ante borrowing and fiscal rules analyzed above fail to work effectively and subnational governments become unable to service and repay their debt, a bailout by the central government should be avoided at all costs because of the precedent and the moral hazard it creates regarding future borrowing behavior and fiscal discipline. Exclusive reliance on only ex ante rules and controls gives both borrowers and lenders room for irresponsible behavior, since the latter will bear no consequences in the absence of ex post regulations and sanctions. Ex post regulations for an insolvency framework that rely either on judicial or administrative-based approaches must also be accompanied by sanctions for noncompliance with the rules or for imprudent behavior.

The second issue relates to the *vertical division of debt limits between different levels of government*. Given that there is an optimal debt-to-GDP ratio for general government (for example, in the EU it is 60 percent of GDP), can the decomposition of this limit into shares between the central and subnational governments be related to their expenditure assignments? There is no solid guidance from international practice. Countries that use market-based borrowing and fiscal rules do not coordinate the apportionment of debt accumulation at different levels

(for example, Canada, the United States, and more recently, Germany). On the other hand, countries with cooperative systems coordinate and negotiate, as do those with rule-based systems, for example, in Australia; in most other systems, the issue is centrally decided in a more or less fair way. Based on these principles, expenditure assignments should matter, especially for assignments related to capital infrastructure and also for netting out capital grants. Still, based on principles, responsibility for the macroeconomic stabilization function, which is a central government responsibility, should also weigh significantly on the allocation of the debt-to-GDP ratio. Some rules of thumb are used, such as apportioning the total debt limits according to the subnational governments' share of the GDP. However, GDP shares can be unfair to relatively poorer subnational governments, especially because with equalization grants, they can spend above their GDP shares. This calls for also taking into account subnational governments' shares in total subnational revenues (including transfers).

## 7.5. Options for reform

The government could explore relaxing the fiscal rules for LRGUs over time. Croatia could move from the direct controls model to the rule-based model, which relies more on ex ante rules than on administrative discretion. However, there needs to be sufficient reporting and monitoring by the MOF instead of direct control. Moreover, the government should consider gradually increasing the individual borrowing limit, though the limit should be related to current revenue and not total revenue. Tying the borrowing constraint to total revenue is questionable because it also includes revenues from the sale of non-financial assets that are occasional, and LRGUs can easily become over-indebted. Actually, the borrowing constraint should be even more restrictive in this sense and tied only to current revenues of free disposition (i.e., excluding earmarked or conditional grants).

Regarding the aggregate borrowing limit, the city of Zagreb can significantly reduce the space for financing smaller local units, because it can capture most of the cumulative debt limit. To avoid this, explicit and transparent rules for how the central government may apportion overall borrowing limits (consents) among different tiers of government and also among jurisdictions in each tier (level of government) could be introduced. The lack of explicit rules results in allocations on a first-come, first-served basis, which could be replaced with a more fair, transparent, and efficient system.

In this respect, a specific limit apportionment could be devoted to Zagreb alone to avoid the unfair potential of crowding out other LGUs. One possibility for dividing the borrowing limits is to apportion them according to the share in total subnational expenditures. Although the actual borrowing will depend on many other factors, the distribution of total borrowing according to the share in total subnational expenditure would reflect potential needs. The legislative fiscal framework for LRGUs could be improved by introducing a single public debt act that would encompass all provisions related to LRGU borrowing and debt in one place. These provisions are currently scattered in several different acts.

The financing of capital investments could be encouraged by issuing revenue bonds whenever appropriate and feasible. In general, the borrowing system could be redesigned to encourage the expansion of marketable debt. Project (revenue) bonds could be of particular interest to

pension funds, insurance companies, and other institutional investors, which, in an environment of declining yields, are seeking quality investment opportunities. Certainly, this way of financing requires further capital market development and training for everyone involved.

Despite the many benefits of borrowing on the capital market, it is obvious that issuing municipal bonds faces many obstacles, especially for smaller LGUs that will never take this action because it is too expensive and cumbersome. This does not necessarily mean that borrowing with commercial banks should be their only alternative. One of the options could include the creation of an official (government-sponsored) subnational financial intermediary that could work at arm's length, using strict financial institution criteria, and lend to subnational governments at lower costs. Croatia would not be unique in this case, because similar arrangements exist in other countries, such as France, Italy, Spain, and many others.

Introducing a bankruptcy procedure for LRGUs is also worth exploring to ensure prudent and sustainable public financial management at the subnational level. Currently in Croatia there is no bankruptcy for LRGUs as there is in some countries (Hungary, for example). Exposing LRGUs to the risk of bankruptcy in the event of financial misbehavior would certainly help eliminate moral hazard issues and encourage responsible financial management. This should be a prerequisite to liberalizing the fiscal rules.





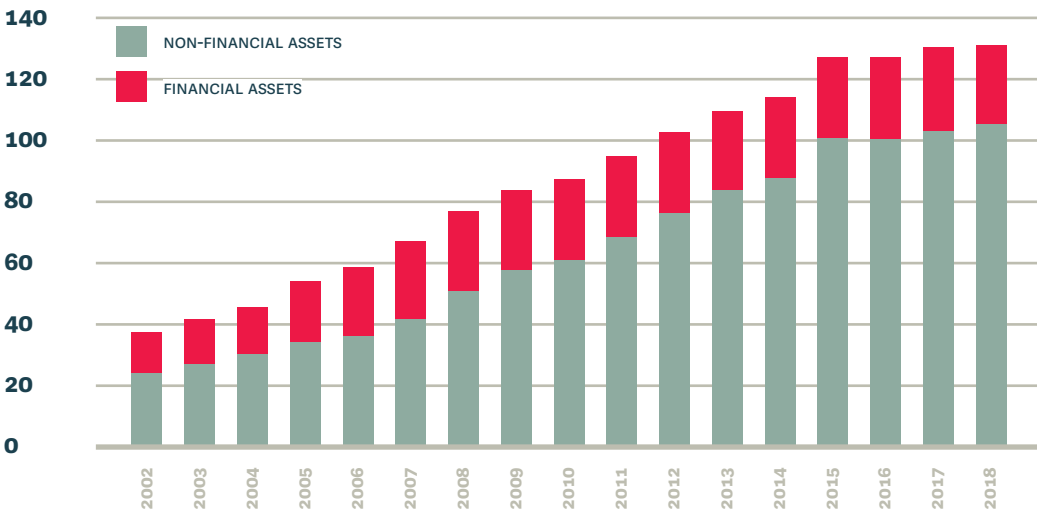
# 08 Asset Management



## 8.1. Structure and value of LRGUs' total assets

In 2018, LRGUs in Croatia had slightly less than HRK 130 billion in total assets. This amount is almost five times higher than the total aggregate LRGU revenue reached in that year. Of that, HRK 103.6 billion refers to non-financial and HRK 25.5 billion to financial assets (see figure 8.1). The financial assets consist of cash, deposits, loans, securities, shares, and equity in institutions within or outside the public sector, as well as claims for uncollected revenues (the breakdowns are further quantified below). The non-financial assets are far higher in value than the financial assets. The structure of the non-financial assets is dominated by produced fixed assets, which include construction, residential buildings, business offices, roads, and railways and other transport facilities (HRK 50.6 billion). It is followed by non-produced fixed assets, consisting mainly of natural resources and intangible assets (HRK 40.9 billion), as well as long-term non-financial assets under construction, consisting of buildings, plant and equipment, transport vehicles, perennial crops, and basic livestock (HRK 12 billion).

**Figure 8.1.** Structure of Total Assets of LRGUs from 2002 to 2018 (in billion HRK)



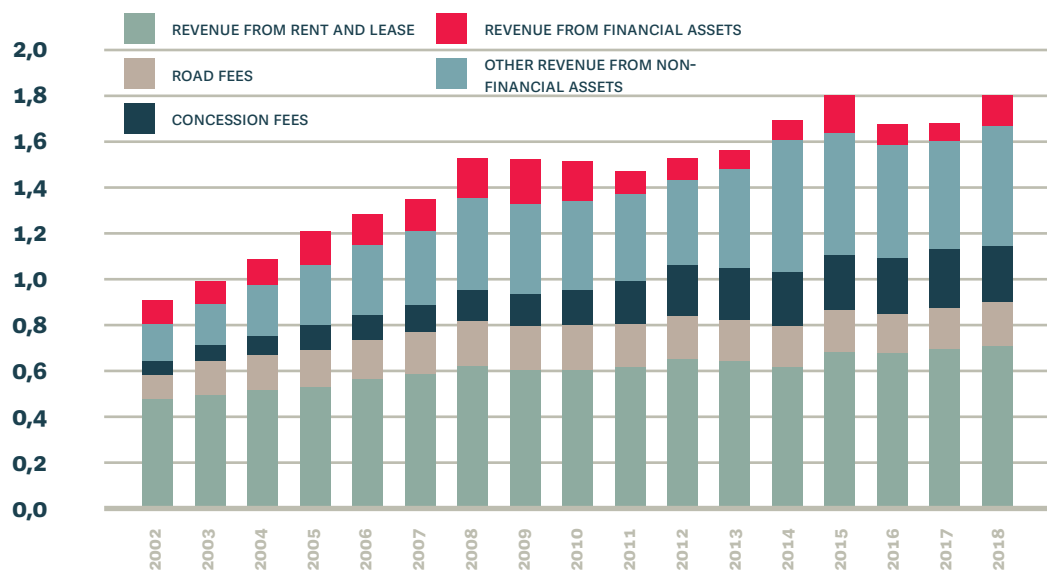
Source: Financial reports of LRGUs (form BIL) for the years from 2002 to 2018.

LRGUs can freely use these different types of property for their own needs, and by effectively engaging the property, they can also generate significant ongoing revenues. These are mainly from non-financial assets (from rents and leases, road fees, concession fees, and other sources). All of the above revenue categories, including from financial assets, in turn can be classified as current revenue from assets. Figure 8.2 shows the value and structure of current revenues from LRGU assets.

Current revenues from assets (property income) have grown from about HRK 1 billion per year in 2002 to roughly HRK 2 billion in 2018, when they reached almost 8 percent of LRGUs' total current revenue. In 2018, LRGUs' taxes amounted to HRK 15.4 billion, grants (received) HRK 4.5

billion, administrative fees and user charges HRK 4.1 billion, revenue from non-financial assets HRK 0.6 billion, and other revenue HRK 0.3 billion. Current revenues from assets (property income) mainly refer to revenues from rents and leases, as well as road and concession fees, which experienced the highest relative growth in the observed period. Despite the increasingly efficient exploitation of assets yielding increasing proceeds, these revenues are still at a suboptimal level and could be significantly increased by implementing a more effective asset management system.

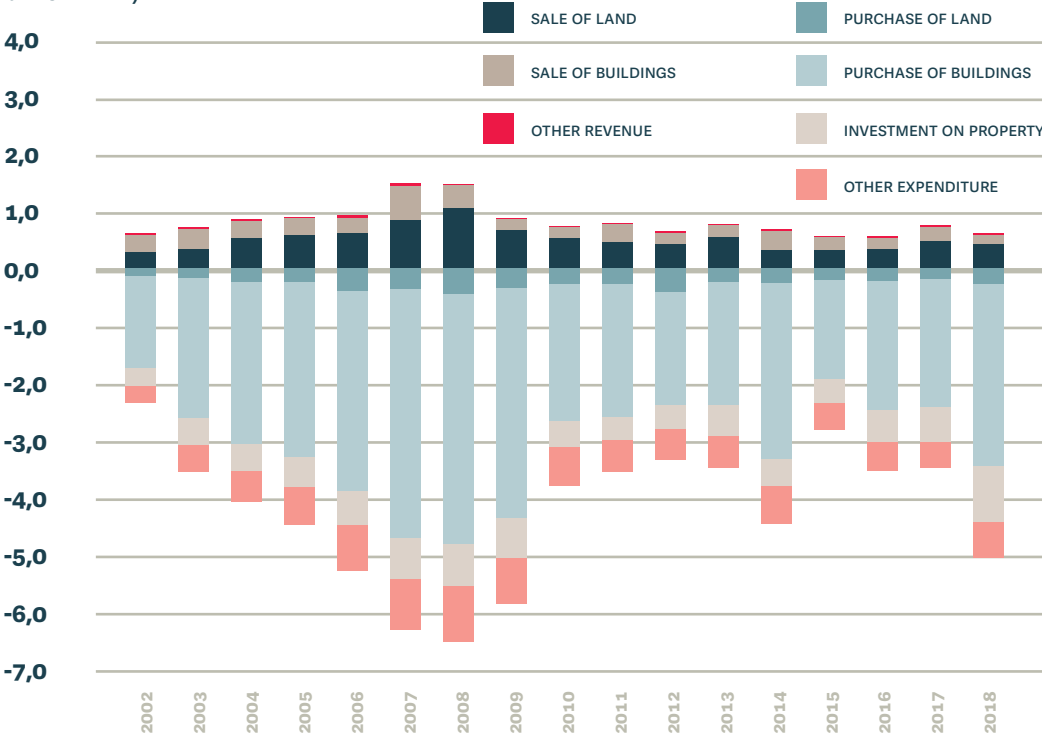
**Figure 8.2.** Structure of Current Revenues from LRGU Assets from 2002 to 2018 (in billion HRK)



Source: Financial reports of LRGUs (form BIL) for the years from 2002 to 2018.

In addition to current revenues arising from the business exploitation of assets, LRGUs may also generate capital revenues from the sale of assets. These revenues are mainly generated by the sale of land and buildings and have amounted to up to HRK 1 billion per year (figure 8.3). At the same time, expenditures for the acquisition of non-financial assets (capital investment expenditures) have been many times higher, ranging from HRK 2.3 billion in 2002 to HRK 5.1 billion in 2018. The highest values of capital revenues and expenditures were realized in 2008, with the former amounting to HRK 1.5 billion and the latter to HRK 6.5 billion. It is interesting to note that these extremes were realized on the eve of the financial crisis and were followed by drastic reductions, especially on the expenditure side of the capital budget. The structure of capital expenditures is dominated by spending for the purchase of buildings, which includes business offices, roads and railways, and other transport facilities. It has to be noted that part of the spending on other capital infrastructure at the local and regional level (e.g., water, sewage, etc.) is managed by public utilities and therefore not addressed here.

**Figure 8.3.** Structure of LRGUs’ Capital Revenues and Expenditures from 2002 to 2018 (in billion HRK)



Source: Financial reports of LRGUs (form BIL) for the years from 2002 to 2018.

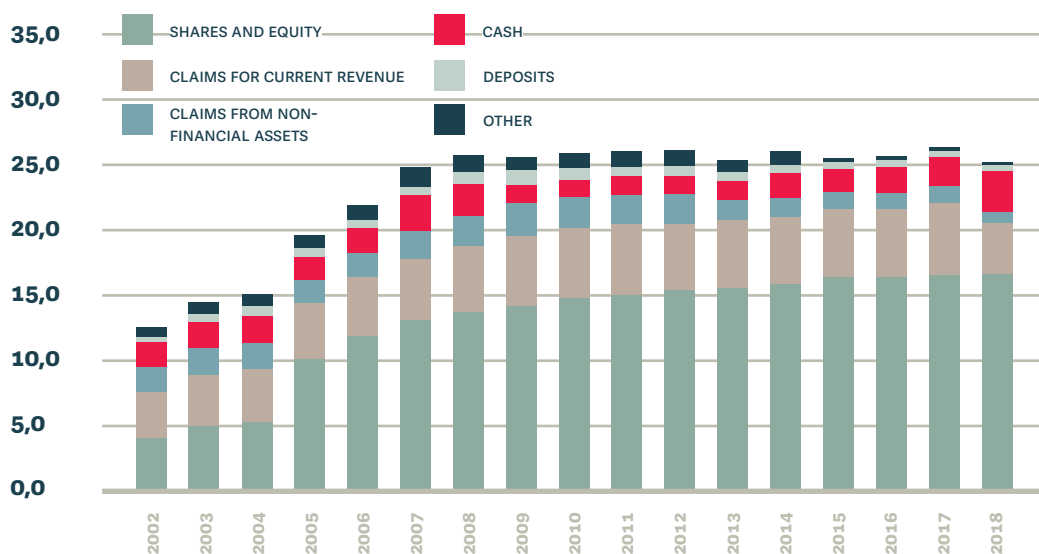
Improved real estate management is likely to lead to significant savings in capital expenditures, especially in the acquisition of business facilities. These buildings are often located in prestigious and attractive locations, a feature that is generally not needed for the basic service and business functions of LRGUs. In addition, given the already high value of the real estate portfolio LGRUs have at their disposal, and with many premises standing empty (unused), it is unclear why LRGUs in Croatia still invest so heavily in the acquisition of new business facilities.

## 8.2. Financial assets

As discussed above, LRGU financial assets include cash at bank accounts and in hand, deposits, guaranteed deposits, claims, securities, and shares and equity interests. Although they have no significant share in the structure of total assets, financial assets—and financial asset management—are extremely important to LRGU operations. The liquid share of financial assets, which relates mainly to cash and cash equivalents, plays an indispensable role in managing the treasury function in terms of cash and budget liquidity. Good planning and management of cash and liquidity aims to generate as much income from financial assets as possible while ensuring enough liquidity to meet liabilities that become due. This aspect of financial management in the subnational public sector is closely related to borrowing and debt management policy, discussed in more detail in chapter 6.

The value of LRGUs' financial assets ranged from HRK 12.9 billion in 2002 to HRK 25.5 billion in 2018, when overall aggregate subnational budgets reached HRK 27 billion (figure 8.4). The structure of financial assets is dominated by shares and equity stakes, the value of which increased sharply (almost doubled) in 2005. These are mainly shares and stakes in the capital of companies in the public sector, that is, ownership of LRGU companies. The substantial increase in 2005 was mainly because Zagreb recorded the value of its companies on the balance sheet that year. On December 20, 2005, the Zagreb City Assembly made a decision to transfer the founding rights and business shares of 22 companies from the city to *Gradsko stambeno-komunalno gospodarstvo d.o.o.*, which takes over the function of holding. When evaluating financial assets, it should be noted that most of the shares and stakes are probably not expressed at market value, because the shares of companies in which LRGUs have stakes are not actively traded on the stock exchange (Bajo and Primorac 2014).

**Figure 8.4.** Structure of LRGUs' Financial Assets from 2002 to 2018 (in HRK billion)



Source: Financial reports of LRGUs (form BIL) for the years from 2002 to 2018.

Besides utility firms, LRGUs own companies that deal with promoting regional development, managing business zones, and attracting private investments and project development. There are also companies engaged in trade intermediation, waste management, physical culture, asset management, unified utility billing, production and broadcasting of radio programs, and publishing and printing. In fact, the coverage and types of activities of companies owned by LRGUs, which are generally more typical of the private sector, are unexpectedly large. Many do not ever fulfill the purpose for which they were established (Bajo and Primorac 2015). More importantly, a list of, or detailed information on, LRGU-owned companies does not exist.

The largest amount of financial assets by tier of subnational government is accumulated by cities (HRK 18.5 billion in 2018), to a lesser extent by municipalities, and the least by counties (table 8.1). This reflects the fact that most of the public utility companies are owned by LGUs

(especially cities). Thus, the value of shares and equity stakes in cities accounts for over half of the total value of financial assets of all LRGUs together. This is probably even higher because it is recorded according to the accounting value (purchasing value at the time of acquisition) and not by the market value.

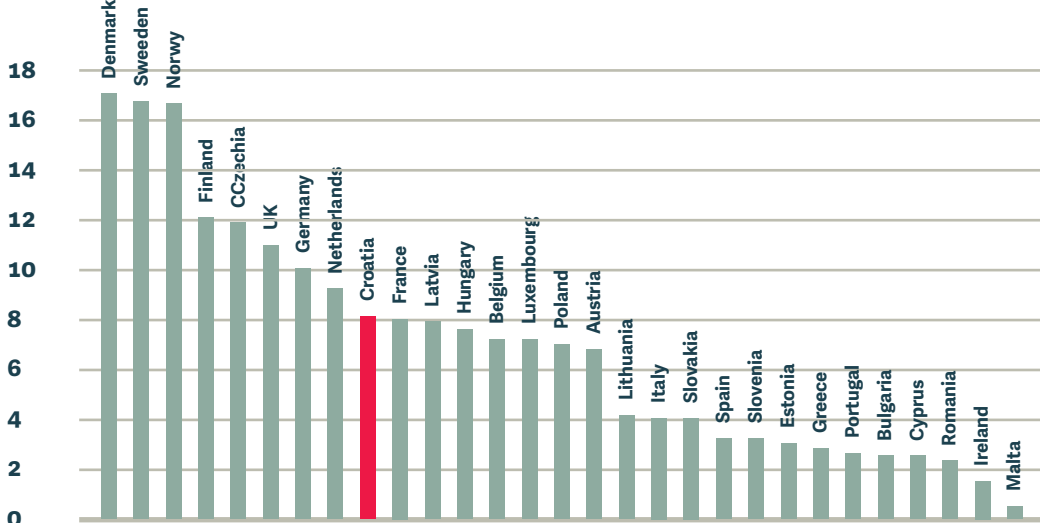
**Table 8.1.** Structure of Financial Assets of LRGUs in 2018 (in million HRK)

	MUNICIPALITIES	CITIES	COUNTIES	TOTAL
Financial assets	5,230	18,477	1,816	25,522
Shares and equity	2,670	13,220	798	16,688
Claims for current revenue	1,055	2,650	182	3,887
Cash	952	1,562	566	3,080
Claims from non-financial assets	307	539	0	846
Deposits and other	158	238	74	469
Loans (given)	45	129	168	342
Deferred expenditure and outstanding revenue collection	41	120	27	188
Securities	3	19	0	22

Source: Financial reports of LRGUs (form BIL) for 2018.

Despite this methodological (recording) limitation, the value of LRGUs' financial assets is also significant compared to other EU member states. Namely, according to Eurostat data (figure 8.5), the value of financial assets of lower levels of government in Croatia represents 8 per cent of GDP, while the EU average is 6.8 per cent. This once again confirms the importance of financial assets for LRGUs in Croatia and signals the significance and urgency of planning and programming the optimization of their structure and seeking a more efficient management of these assets.

**Figure 8.5.** Value of Financial Assets of the Local Sector of EU Member States in 2019 (in % of GDP)



Note: Data for Denmark are for 2018.

Source: Eurostat, available at <https://ec.europa.eu/eurostat/data/database>.

### 8.3. LRGU-owned enterprises

LRGUs in Croatia often delegate the supply of a certain segment of public services (utilities) to separate legal entities (utility enterprises) that they typically wholly control by means of their equity ownership. Utilities include services for drinking water supply, wastewater drainage and treatment, gas supply, thermal energy supply, mass transit, hygiene and cleaning, disposal of household waste, maintenance of public areas, maintenance of unclassified roads, retail markets, maintenance of cemeteries and crematoria, performance of funeral services, chimney sweeping services, and street lighting. Funding for utility service delivery comes from service charges, the LRGU budget, and “holding other sources” according to current regulations.

Utility firms can issue corporate bonds or borrow from banks to finance capital investments. This can be done with or without the LRGU’s guarantee but only with its consent (i.e., the founder or majority owner). The most prominent example is certainly the corporate bond of Zagrebački Holding (Zagreb’s utility), described in the previous chapter. Although the operations of LRGUs and utility enterprises are formally distinct, the former often support the financial operations of the latter directly with subsidies and capital aid and indirectly by providing guarantees. The water supply sector receives the majority of subsidies on a sectoral level. Most enterprises are local companies that provide drinking water services—testing the health of drinking water, delivering water connections, and other activities related to the local sewerage system. On an individual basis, Zagrebački Holding has been a leading consumer of subsidies, mainly due to subsidies directed at ZET (Zagreb Electric Tram), which was removed from Zagrebački Holding in 2017. For this reason, the financial operations of LRGUs and utility enterprises must be looked at together in order to obtain an integral image of the financial health of the local public sector. Croatian legislation does not prescribe the consolidation of the reports of LRGUs and the utility enterprises they own, but there is a good basis for such a procedure in IPSAS (Primorac 2011).

According to data from Croatia’s Financial Agency (FINA),<sup>47</sup> there are 1,010 SOEs in the country, referring to enterprises that delivered their annual financial statements to FINA for 2016 or 2017. By comparison, the number of private non-financial companies exceeds 120,000. A total of 208 enterprises are central government owned, and the remaining 802 are owned by LRGUs (these predominantly include utility companies, local tourism authorities, local development agencies, etc.). LRGU-owned enterprises are majority-owned by LRGUs or by another LRGU-owned enterprise. Although centrally owned SOEs make up only around one-fifth of the total number of SOEs, they represented 80 percent of assets and 76 percent of turnover of all SOEs in 2017. In 2020, the World Bank conducted an assessment of the SOEs in Croatia under the standard Integrated State-Owned Enterprises Framework (iSOEF). The main recommendations from the report are presented in the box below.<sup>48</sup>

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<sup>47</sup> The Financial Agency (FINA) is a leading Croatian company (state-owned) in the field of providing financial and electronic services. FINA maintains the Register of Annual Financial Statements of all companies registered in Croatia.

<sup>48</sup> World Bank (forthcoming).



**Box 8.1.****Recommendations from the Croatia iSOEF Assessment**

The Croatia Integrated State-Owned Enterprises Framework (iSOEF) Assessment carried out in 2020 highlighted the following recommendations:

**1. Assessment of Fiscal Costs and Risks from the SOE Sector:**

- Carry out an efficiency analysis of government-subsidized SOEs. An in-depth analysis is needed to evaluate the efficiency of subsidized SOEs in providing their services and achieving appropriate value for money. The decision on whether the company should indeed remain owned by the state can be made only with high-quality data and clear criteria for state ownership.
- Develop an SOE fiscal risk management framework. This framework—prepared and disclosed by the MOF—should identify the major risks to the budget emanating from SOEs; assess their size and probability of occurrence; identify any policy or other measures to mitigate these risks; and disclose the fiscal risks to enhance awareness of fiscal policy trade-offs and bring transparency to the entire budgeting process. The framework should take into consideration both direct and contingent liabilities, as well as explicit and implicit obligations.

**2. Privatization Plan:**

- After defining a state ownership rationale with clear criteria, prepare a privatization plan for the remaining companies in the government portfolio. Intensify activities related to privatization.

**3. Corporate Governance and Accountability Mechanisms:**

- Develop a coherent and binding regulatory SOE framework in line with OECD standards. This is a necessary condition to improving the performance of the enterprises where state ownership is warranted and to reducing their fiscal impact. The framework should include an ownership policy and a reinforced SOE corporate governance structure, including strengthening the Boards, ensuring consistent public disclosure of SOE financial information, and strengthening the external audit practice.

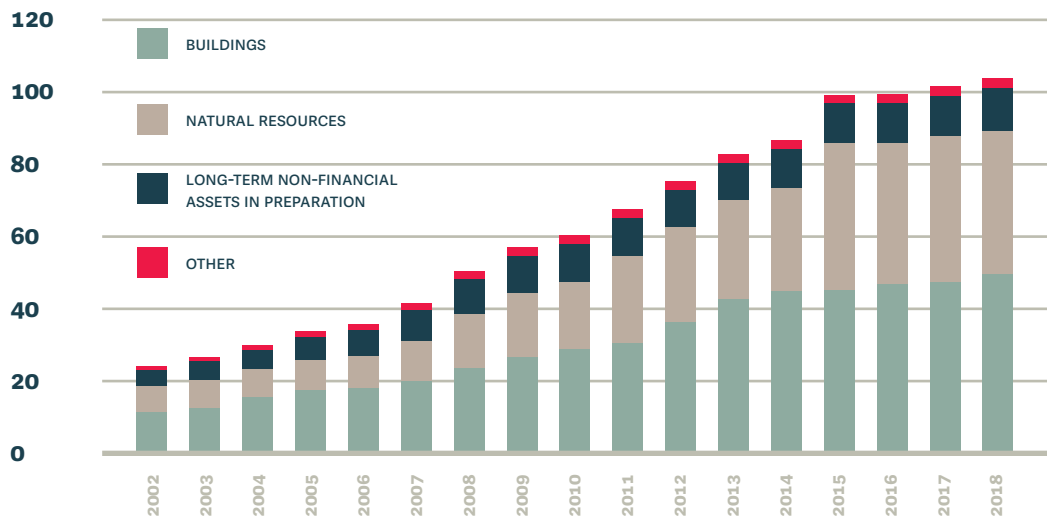
Source: World Bank (forthcoming).

The sectors that are dominated by state ownership vary substantially by their structure and type of public ownership (central relative to local). As pointed out, the MOF currently provides information on county, city, and municipal budgets on its website, but for more complete information on the overall and actual financial situation, this should also be done for all legal entities owned and co-owned by LRGUs (regardless of the percentage of co-ownership) as well as institutions established by them.

## 8.4. Non-financial assets

LRGUs own and have many different forms of non-financial assets at their disposal. However, currently these assets represent a mediocre source of funding and revenue generation. This is despite the fact that the value of non-financial assets of LRGUs has been growing significantly, from HRK 23.4 billion in 2002 to HRK 103.6 billion in 2018 (see figure 8.6). Many of these assets were purchased or built by LRGUs, and some were allocated to them by the transfer of ownership, primarily by the central government.<sup>49</sup>

**Figure 8.6.** Structure of LRGUs' Non-Financial Assets from 2002 to 2018 (in HRK billion)



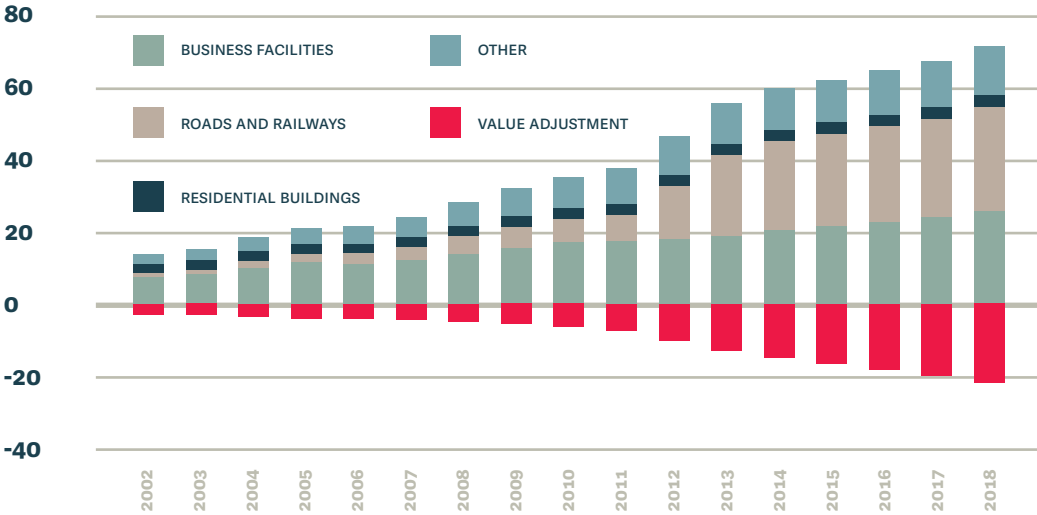
Source: Financial reports of LRGUs (form BIL) for the years from 2002 to 2018.

Regarding the composition of non-financial assets, the most significant are buildings and, on a lesser scale, natural resources, while other forms of assets are less represented. The non-financial assets managed and disposed of by the LRGUs are extremely large and in fact represent the largest resource managed by elected representatives, through executive and representative government, on behalf of the citizens of the local community.

Transitional changes over the past two decades have led to significant innovations in the approach to asset management, but progress has been slow on meeting its basic requirements, which include complete and orderly records of type, purpose, number, and value, as well as the income and expenses of non-financial assets. Given that the structure of non-financial assets is dominated by buildings, figure 8.7 shows the value and structure of this segment.

<sup>49</sup> Real estate donations to LRGUs are possible for the construction of entrepreneurial infrastructure, investment projects, projects of general public, social, or cultural interest, schools, kindergartens, hospitals, health centers, social welfare institutions, cemeteries, sports facilities, museums, memorial centers, and other similar projects that increase the quality of life of citizens, and also for the implementation of housing programs and socially supported housing, programs for the integration of persons with disabilities into society, demographic renewal programs, waste management programs, and operational programs for national minorities.

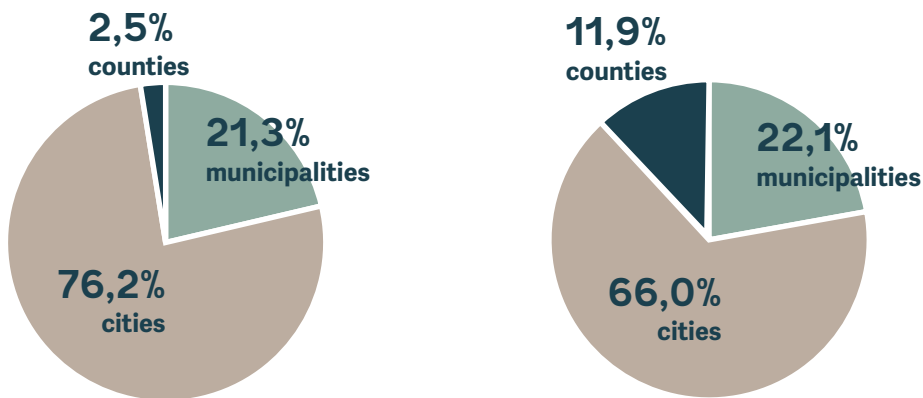
**Figure 8.7.** Structure of Value of LRGUs' Buildings from 2002 to 2018 (in billion HRK)



Source: Financial reports of LRGUs (form BIL) for the years from 2002 to 2018.

In the portfolio of construction facilities, the value of business offices stands out (increasing from HRK 7.5 billion in 2002 to HRK 25.4 billion in 2018), as does roads and railways, which also achieved the highest absolute and relative growth (from HRK 1.1 billion in 2002 to HRK 28.8 billion in 2018). Residential and other types of buildings have a less significant share.

**Figure 8.8.** Structure of Non-Financial Assets (left) and Revenue from Non-Financial Assets (right) of LRGUs by Levels of Government in 2018



Source: Financial reports of LRGUs (forms PR-RAS and BIL) for 2018.

Among LRGUs, cities have the largest share of non-financial assets as well as revenues from those assets (figure 8.8 above). Over three quarters of the total non-financial assets of LRGUs are concentrated in cities, with which they generate about two-thirds of the total revenue from

all LRGU non-financial assets. This is followed by the share of municipalities and then counties. It is interesting to note that counties, with only 2.5 percent of the value of non-financial assets of all LRGUs, together generate almost 12 percent of total revenues.<sup>50</sup>

## 8.5. Real estate holdings

LRGUs own many different types of properties, some of which appear to fulfill their economic and social purpose and others that do not. Although there is no complete register or generally available data on real estate owned by LRGUs, in 2016, the State Audit Office conducted an efficiency audit of LRGU real estate management and disposal, which included, among other figures, data on the number and area of business offices and apartments and the area of LRGU land by levels of government for 2014 (table 8.2). In 2014, LRGUs had over 40,000 business premises and apartments with a total area of 4.5 million and 338 million square meters of land, respectively. By presenting the data in this way, one gets an even more realistic impression of the great potential that is available to LRGUs, which could be generating significant revenues through more efficient management. By describing a real estate portfolio in terms of the value of its assets, it is usually difficult to represent the actual size of the portfolio. In addition, property value is often a rather abstract category.

**Table 8.2.** Number and Area of Business Premises and Apartments and the Land Area of LRGUs, as of December 31, 2014, by level of government

TIER	NUMBER OF UNITS	BUSINESS PREMISES		APARTMENTS		LAND SURFACE IN M <sup>2</sup>
		UNITS	SURFACE IN M <sup>2</sup>	UNITS	SURFACE IN M <sup>2</sup>	
Counties	20	300	225,484	29	1,708	1,587,038
Zagreb	1	4,170	610,337	7,504	397,273	24,900,202
Cities	127	11,734	1,664,664	9,478	463,155	150,730,426
Municipalities	428	6,221	1,113,481	1,360	71,626	160,956,792
<b>Total</b>	<b>576</b>	<b>22,425</b>	<b>3,613,966</b>	<b>18,371</b>	<b>933,762</b>	<b>338,174,458</b>

Source: State Audit Office (2016).

Table 8.3 shows the number and area of business premises and apartments and the area of LRGU-owned land in 2014 by county. Business premises managed and disposed of by cities and municipalities refer to business offices, LGUs' administrative offices, fire houses, business areas, and, in Zagreb, to garages. On the other hand, business premises managed and disposed of by counties mostly refer to the business offices in which the county administrative departments are located and the business premises given for use to companies, budgetary users, or state administration bodies.

<sup>50</sup> With the limited data on disposal, the reasons for this are not obvious. In general, it could be that counties are more active in terms of activating their properties, that is, renting, or that they have more properties available for renting (not needed for the provision of services) in relation to cities. Detailed information on types of properties rented, purposes, rents, and so on would certainly make it possible to reach a relevant conclusion.

**Table 8.3.** Number and Area of Business Premises and Apartments and the Land Area of LRGUs as of December 31, 2014, by county

COUNTY	BUSINESS PREMISES		APARTMENTS		LAND SURFACE IN M <sup>2</sup>
	UNITS	SURFACE IN M <sup>2</sup>	UNITS	SURFACE IN M <sup>2</sup>	
Zagrebačka	883	155,759	278	13,013	7,749,416
Krapinsko-zagorska	462	65,790	68	3,452	3,040,561
Sisačko-moslavačka	782	196,497	525	24,383	16,750,568
Karlovačka	538	64,513	659	28,442	6,169,750
Varaždinska	507	90,687	397	20,763	5,626,725
Koprivničko-križevačka	618	212,661	131	6,526	7,164,726
Bjelovarsko-bilogorska	562	100,928	198	9,514	4,105,173
Primorsko-goranska	3,542	639,847	2,591	129,635	41,643,047
Ličko-senjska	230	49,336	135	6,462	3,391,927
Virovitičko-podravska	233	38,895	212	10,277	4,511,277
Požeško-slavonska	260	79,833	183	11,779	2,297,359
Brodsko-posavska	712	143,552	294	14,306	12,020,697
Zadarska	870	80,637	396	20,160	66,490,494
Osječko-baranjska	1,121	183,537	1,701	74,482	7,105,897
Šibensko-kninska	549	54,627	167	8,587	1,499,080
Vukovarsko-srijemska	616	113,254	231	12,136	20,169,803
Splitsko-dalmatinska	1,930	336,627	814	45,522	59,205,351
Istarska	2,512	215,678	1,355	71,412	30,364,748
Dubrovačko-neretvanska	701	104,206	403	19,910	10,859,134
Međimurska	627	76,765	129	5,728	3,108,523
Grad Zagreb	4,170	610,337	7,504	397,273	24,900,202
<b>Total</b>	<b>22,425</b>	<b>3,613,966</b>	<b>18,371</b>	<b>933,762</b>	<b>338,174,458</b>

Source: State Audit Office (2016).

An important issue is the function that all these forms of real estate ownership perform at the local and regional levels and whether some should be privatized. The use of real estate in the local and regional community should be focused on local needs (communal infrastructure, roads, etc.), as well as all legally defined obligations (cemeteries, preschool education, local and regional government, etc.) and support to socially useful sports, cultural, nongovernmental, political, and other entities. Assets that do not have any of these functions should be mobilized for revenue generation according to market conditions, that is, rented or (even better) privatized.

Comprehensive records of all forms of real estate are necessary for the effective management and disposal of LRGU land holdings. These records are a tool to help leaders in decision making, and without them, it is impossible to manage the assets effectively. Furthermore, organizing records effectively and conducting all procedures related to management and disposal publicly (leases, exchanges, sales, use with a valid legal basis, etc.) are also extremely important to transparent management.

Over time, the central government in Croatia has donated real estate to LRGUs for the purpose of building infrastructure and other facilities to raise educational, cultural, or other service standards. More specifically, the real estate was transferred on the basis of the Decree on the Donation of Real Estate Owned by the Republic of Croatia (OG 123/11 and 129/11, 95/18), the State Asset Management Act (OG 52/18), and the Act on the Regulation of Property Relations for the Construction of Infrastructure Buildings (OG 123/11 and 129/11, 95/18). Thus, more than 40 million square meters of state-owned land have been allocated for the construction of business zones. However, only a small portion of that land is currently in operation.

## 8.6. A diagnostic of the main problems and issues

The structure of financial assets is dominated by shares and equity stakes in the capital of public sector companies—in other words, the ownership of LRGU companies. When evaluating financial assets, it should be noted that most of the shares and stakes are probably not expressed at market value, because the shares of companies in which LRGUs have stakes are not actively traded on the stock exchange. But even if some publicly owned companies are rightfully ensuring public service delivery in some sector, in reality, the coverage and types of activities in which LRGU-owned companies engage clearly exceed the norm, and many generally belong in the private sector. And again, a large number of companies have not fulfilled their planned purpose. The lack of transparent information on asset ownership and management is still highly problematic; no list of all LRGU-owned companies exists, and reporting on local utility companies in terms of their financial interactions with LRGUs remains incomplete.

Although LRGUs are de facto players in the real estate market, this role needs to be re-examined—if not questioned. The primary purpose of real estate owned by LRGUs should be to facilitate public service provision, or even perhaps to help address unemployment and economic activity in targeted areas. The role of partially serving as an instrument to regulate the rental market and generate operating income should be minimized, if not eliminated altogether.

Importantly, LRGUs should not enter into open market competition with the private sector but should primarily meet the public service needs of the wider community. Currently, a significant number of vacant business premises remain unused because of disputes between the state and LRGUs involving claims on the right to return of confiscated property. However, not all LRGUs have professional departments and trained asset management officers. Inadequate property inventories (at the local, regional, and state levels) have delayed resolutions to these questions of legal ownership. The poor asset management practices are manifested in the currently large number of vacant and unused assets for which LRGUs bear maintenance costs. Local assets, when they should not be privatized, could be used more efficiently and, with more adequate management, generate additional revenues for LRGUs.

One of the main challenges in real estate administration is the demanding normative framework that includes over 30 laws and other regulations governing the area of property and real estate management. An inadequate legislation framework is generally a limiting factor. The key difficulties are that LRGUs own more and more real estate assets, but they often do not know what they own or what to do with them, and in some cases those assets have been real burdens, financially and otherwise. Many LRGUs do not have property inventories due to

unresolved property disputes, inconsistencies in land registers and cadasters, and outstanding litigation related to property rights.

From a financial perspective, a significant problem is the lack of financial and accounting data. This primarily refers to the market value of real estate units, which is often unknown to LRGUs, and the revenues and expenditures incurred in relation to a unit of fixed property. Without data on the value and financial result of an individual piece of property, there are no grounds for effective decision making on its optimal disposal, although ultimately, some of the property could be auctioned on the private market.

The central government has further complicated LRGU real estate management with a conscious desire and effort to maintain control over certain resources. Part of the responsibility lies with the judiciary for its sluggishness, lack of interest, and inefficiency in resolving cases involving real estate management. This primarily refers to property restitution issues, which are resolved only after years, during which time local units suffer financial losses instead of being put to proper use.

Donations or transfers of real estate from the central government to LRGUs in the past were made without actual supervision, and there has been no follow-up to determine whether the transferred properties were put into operation or whether the current function is in accordance with the purpose of the donation. Therefore, the central government should determine whether the assets allocated to LRGUs are being used for the specified purposes, with the implication that real estate that is not so used could be repurposed at the subnational level, sold, or even returned to the central government.

## 8.7. Good practices in urban property management

Almost everywhere in the world subnational units own and manage various properties. Their scope of responsibility and competence over these properties differs and is usually prescribed by central government regulations. However, international experience shows that in many countries, these regulations are not mandatory but rather based on positive fiscal incentives. The Canadian province of Ontario, for example, uses such “soft policies” to disburse provincial funding for capital investment by requiring municipalities to prepare an asset management plan and show how the requested capital investment fits into this plan prior to obtaining the funds. Irrespective of the ways in which good practices will be promoted, there is a unique set of these practices used internationally that are relevant also for LRGUs in Croatia.

Bertović, Kaganova, and Rutledge (2004) published a *Handbook on LRGU Asset Management* that is a synthesis of theoretical and practical knowledge and a concrete guide to the best international practices. Developed by experts from the Urban Institute at the request of the World Bank, the guide has been utilized by projects in emerging markets in Europe and Asia, as well as pilot cities in Croatia. The authors list 11 key actions needed to effectively manage assets at the LGU level:

1. introduction of a database/inventory system for each unit of property separately
2. repossession of property

3. classification of assets and formulation of financial policy in accordance with the classification
4. real estate appraisal
5. accounting and financial planning for assets (operational reports for asset or portfolio units)
6. intensive financial analysis of projects, assets, and portfolios
7. deregulation of business leases and improvement of rental procedures
8. quantification and monitoring of direct and indirect subsidies related to real estate enjoyed by tenants and users of real estate owned by local self-government
9. asset reporting
10. consolidation of management
11. development of a comprehensive asset management plan

**Introduction of a new data processing system for each asset unit separately.** Establishing a database with a complete and correct asset inventory is an extremely important foundation for building an efficient asset management system. Supervising and analyzing one's own real estate is not possible without a detailed database. Based on such data, it is possible to apply a strategic plan for the management of different types of assets. A quality asset inventory contains two categories of information: a realistic inventory of assets and data on accounting and finances.

**Transition issues.** In Croatia, there are still ongoing processes that are related to the country's transition from a centrally planned to a market-based economy. There are a significant number of former property unit owners who are in the process of regaining property rights lost in the past through confiscation or nationalization. When it comes to property restitution, it is necessary to be pragmatic. If the property does not generate income, measures should be taken to accelerate the restitution process. The most important question is whether and to what extent the LGU is willing to invest in a particular property and in repairs and maintenance of property that will most likely be returned to its previous owners.

**Classification of assets.** Different functions of local self-government are determined by the Law on Local and Regional Self-Government. That is why in Croatia portfolios are often diverse and can contain many of the following categories: land, apartments and houses, business premises for administration, business premises for rent, sports facilities (such as stadiums, halls, etc.), kindergartens, cultural institutions, facilities for markets and fair maintenance, public lighting, industrial and storage facilities, utilities, cemeteries, landscaping and cleaning services, and others.

All LRGU assets can be divided into three groups: a) mandatory assets; b) discretionary assets; and c) income-generating or surplus assets. The effect of mandatory tasks can be optimally determined by increasing the efficiency of property units, setting up a system that requires local government departments to justify their demand for those specific spaces, reducing current costs to an optimal extent, and selecting office locations where local government services may be provided in functional, more modest facilities in less sought-after areas. Furthermore, it is highly desirable to conduct cost-benefit analyses that can justify the purpose of a particular unit of property to meet the needs of the local government.



**Real Estate Appraisal.** The sale of local government property must be preceded by an independent appraisal. Systemic change begins by first estimating the value of several units of property. These units should be either potentially the most lucrative or the most problematic. In today's practice, there are three common methods or approaches to assessing market value:

1. Cost approach: value = land market value + construction cost estimate
2. Sales comparison approach: a comparison of similar units of property whose sale was realized on the market
3. Income capitalization approach: value = cash flow / expected rate of return

Of course, an assessment based on multiple approaches is always more relevant and credible. However, it should be emphasized that the valuation is only an estimate, as the actual value will be determined on the market in the buying and selling process.

**Operational reports for assets and portfolios.** This activity puts the main focus on the systematic use of operational reports for all assets, including real estate. It is necessary to include all revenues and expenditures for each unit of assets and to emphasize the management costs. For each unit, an annual budget or financial plan should be prepared and the related activities carried out, such as an analysis of the actual and planned effects of the assets.

**Intensive financial analysis of portfolios, assets, and projects.** If the LGU wants to consolidate the basic data on revenues and expenditures for each unit of property, accounting at the asset level should be introduced. This way it will benefit significantly from knowing the net income or cash flow from the property. For assets that are exposed to expenses but do not generate income, reports will show details of the losses it suffers. For example, the use of a building used as a town hall has a negative cash flow because it does not generate the revenue needed to pay for its operating costs. Ultimately, the LGU is exposed to financing the cost of operating that building, which would be visible on the asset financial report as the only expense. Details of the functioning of the building in this case can be seen in the operational report for the property. This allows for both a detailed report and a concrete analysis of all the costs of operating the city hall.

**Deregulation of business leases and improvement of lease prices.** Real estate management in local governments in Croatia seems to be over-regulated in several ways. Local governments define the type property use in too much detail (too narrowly). In cities with developed market economies, these decisions are left to private entrepreneurs. Urban plans place general restrictions on use, but within these limits there is fairly wide flexibility. When the self-government decides how a unit of real estate should be used, it creates artificial spatial frameworks that reduce potential income and thus the value of the property.

**Quantification and monitoring of direct and indirect subsidies related to real estate received by tenants and users of real estate owned by LGUs.** The best purpose of the property provides the highest rent and value to the owner. This can be achieved when the LGU leases the property for the most desirable purpose according to market demand. Frequently in Croatia, the heads of LGUs fail to generate higher income for local budgets because a property is rented below the market price, which realistically represents indirect subsidies to the property. If there is no system of accurate monitoring and reporting, it is impossible to estimate the total amount of lost income. Nonprofit organizations are an example of indirect subsidies. These organizations often rent out spaces for a symbolic amount that are sometimes located in the most attractive

and expensive zones or historic or business centers. These are always exclusively political decisions. Decision makers should be well informed about the costs of such indirect subsidies.

**Property Reporting.** Complete and concise information on the property that the LGU owns and/or supports is needed not only by the local government but also by local residents. Mayors, councilors, and residents do not necessarily need detailed information about each unit of property, but they should have a summary that includes the main asset portfolios and the revenues and expenditures of the main institutions involved in them. A satisfactory level of information needs to be available so that it can be concretely shown to the public how these assets are managed. Such reporting removes suspicions of corruption in the distribution of property and raises the transparency of the LGU.

**Consolidating management.** The function of asset management is almost always divided among several administrative bodies, none of which has the complete picture. There are two ways of improving this problem in Croatia. First, it is necessary to set up a unified office with responsibility for developing and implementing an asset management strategy and program. One of its basic tasks would be to organize the collection of the information needed for this goal. Furthermore, the same office should be in charge of plans to improve the financial condition of individual assets and portfolios on which it should regularly report. Another way is to engage external suppliers, which may involve complete tasks, such as managing and maintaining a specific property or managing the entire portfolio.

## 8.8. Options for reform

The MOF could consider publishing a unique and up-to-date online database with balance sheets and profit and loss accounts of LRGU enterprises (as well as lists of their addresses and contacts). LRGUs should be responsible for providing this data to the MOF, and the ministry, in its role as “regulator,” should set reporting standards, dates, scope, and templates. To ensure usability, the data should be published in the appropriate formats, for example, Excel for financial data. A centralized system for collecting, analyzing, and disclosing information on SOEs in general and LRGU-owned enterprises would be beneficial to achieving a satisfactory level of transparency and creating the foundation for the effective management of LRGU-owned enterprise portfolios.

The Lithuanian Governance Coordination Centre is one of the best institutional examples of how this kind of system could be introduced. Implementation of the system would be a gradual process, from the adoption of transparency guidelines to the introduction of aggregate SOE portfolio reporting, board nomination rules, letters of expectations, and SOE portfolio optimization and corporatization. Importantly, all of these steps together could significantly improve locally provided public services at lower costs and have a beneficial impact on LRGU budgets by reducing subsidies, mitigating fiscal risks, and generating additional revenue from the sale of shares and equity in enterprises of no strategic interest to LRGUs. Local economic growth could also get a boost from the more efficient and productive management of those assets.

The State Audit Office could incrementally conduct a detailed financial and performance analysis of all companies owned by LRGUs. Since many companies receive grants that are

so generous as to represent over 90 percent of total revenues, the question arises as to why these companies do not operate within local and regional budgets. In many cases it may become obvious that some of these companies should be privatized, some should be included in LRGU budgets, and some (mainly utility companies) should be maintained as an LRGU-owned company. After a review of purpose, LRGUs could be encouraged to gradually divest, primarily selling stakes in companies in which they have a minority interest and that are not central to their role as public service providers. The MOF could facilitate and support the disinvestment if needed but maintain the local autonomy/freedom to decide on ownership.

Although LRGUs have no input in the utility companies' financial plans, in view of the interweaving of LRGU operations with those companies, a more consolidated financial picture could be considered. LRGUs could be mandated to merge their financial reports with those of their utility enterprises and to submit the financial planning and operations of those enterprises to the purview of local representative bodies. Although the existing legislative framework does not provide for these kinds of consolidated financial statements, IPSAS does. The application of these regulations would also help to produce a comprehensive view of the exposure of LRGUs to any direct and indirect liabilities arising from the financial operations of their companies and to capture information on their long-term fiscal sustainability.

As noted, many LRGUs do not have property inventories due to unresolved property rights disputes and inconsistencies in land registers and cadaster. Given that the analytical records of all fixed assets have not been established, an Action Plan could be adopted to perform an inventory of assets, including activities, deadlines, methods, and competences, as well as the manner in which they should be reported. This would make it possible to harmonize the financial statements with the inventory of assets. In particular, all assets and liabilities should be included in the annual inventory, in accordance with the provisions of the Ordinance on Budget Accounting and the Chart of Accounts. This would provide a strong foundation for the development of a clear and comprehensive LRGU asset management strategy. It should be reiterated, however, that a prerequisite for achieving these goals is strong administrative capacity and highly qualified professional staff trained in asset management at the LRGU level.

Some LRGUs do not have professional departments and trained individuals to manage their property. It is therefore necessary to resolve the property disputes (with preferential treatment in relation to other court procedures) as soon as possible to determine ownership rights over LRGUs' real estate and to register this information in the cadaster. LRGU operations and real estate management would certainly be facilitated by the application of positive experiences and norms from the private sector, with a key emphasis on market principles and an understanding of the real estate market. However, the fact that there is no long-standing tradition of operating according to those principles could be an impediment. LRGU employees are often just becoming familiar with modern methods of real estate management, and many lack the motivation to become better trained, since property management is often perceived as an additional burden on the operational level. Although these practices have to be improved among LRGUs, it should be their first policy priority to scale down their holdings by selling the assets that are not necessary or not related to their public service functions.

# Annexes



## Annex 1. Country Notes on the Vertical Structure of Government in EU Member States

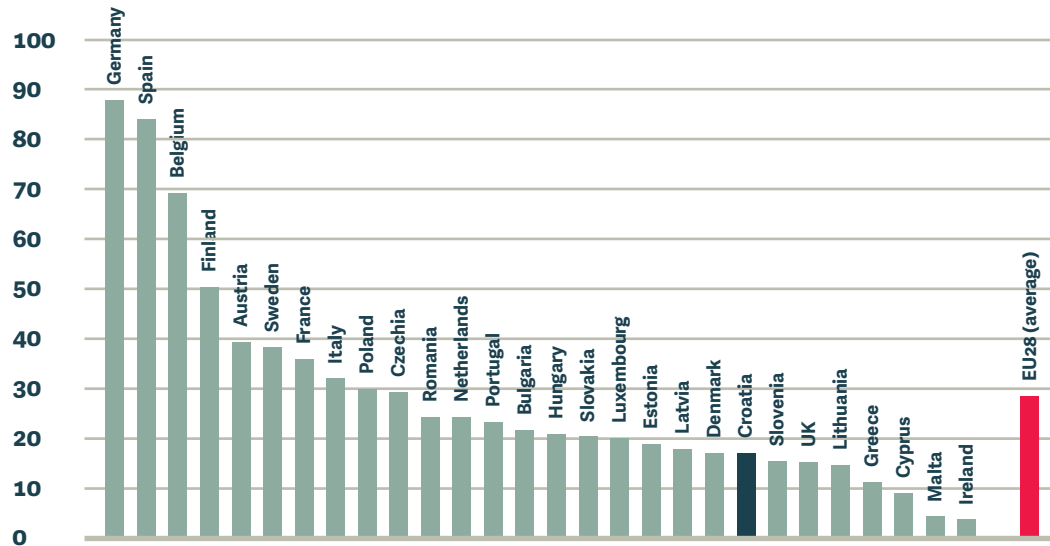
**Table A1.1.** Country Notes on the Vertical Structure of Government in EU Member States

COUNTRY	DESCRIPTION
<b>FEDERATIONS AND QUASI-FEDERATIONS</b>	
<b>Austria</b>	The municipal level comprises statutory cities, towns, markets, and villages. The nine Bundesländer include Vienna.
<b>Belgium</b>	The upper level consists of six federated entities (three language communities and three regions). In Flanders, 15 municipalities merged on January 1, 2019, reducing the total number of municipalities from 589 to 581.
<b>Germany</b>	The intermediary level comprises 294 rural districts and 107 district-free cities.
<b>Spain</b>	The two “foral” autonomous communities (Basque Country and Navarra) retain more autonomy than the other regions. Local subdivisions vary according to the autonomous communities. The two autonomous cities of Ceuta and Melilla are included in the number of municipalities but not in the number of provinces.
<b>UNITARY COUNTRIES</b>	
<b>Bulgaria</b>	Municipalities are subdivided into smaller towns and villages, totaling 4,995 as of December 31, 2017.
<b>Croatia</b>	The number of regions includes the city of Zagreb, which has the status of both a county and a city. The municipal level comprises 128 towns and 428 municipalities.
<b>Cyprus</b>	The municipal level includes municipalities and communities.
<b>Czech Republic</b>	The municipal level includes municipalities, towns, and statutory cities. The number of regions includes Prague.
<b>Denmark</b>	The number of municipalities does not include Christiansø, which has a special status.
<b>Estonia</b>	The number of municipalities decreased from 213 to 79 (14 of which are urban and 65 rural) following administrative reform completed in October 2017.
<b>Finland</b>	There are 19 regional councils but only one has an autonomous administration (the island region of Åland); the other 18 regional entities are statutory joint municipal boards.
<b>France</b>	The total number of subnational governments in each level includes those of Corsica and the outermost regions. With the 2015 regional reform, there are 13 regions instead of 22 in mainland France and 5 outermost regions (Martinique, Guadeloupe, Guyane, La Réunion, and Mayotte). Municipalities are undergoing continuous consolidation since the creation of the status of “new municipality” (commune nouvelle) in 2010. Between 2010 and 2019, 2,508 municipalities joined together to create 774 new municipalities. Since 2010, the number of municipalities has decreased by 5%.
<b>Greece</b>	Since the 2010–11 Kallikratis reform, municipalities have been divided into sub-municipal localities (local and municipal communities). The reform also created 13 self-governing regions from the previous 54 prefectures.
<b>Hungary</b>	Hungarian “settlements” include the capital city of Budapest and its 23 districts, towns of county rank, other towns, and villages. The number of counties excludes Budapest.

COUNTRY	DESCRIPTION
<b>Ireland</b>	The new municipal level established with the 2014 Local Government Act includes 31 county and city councils. The 2014 reform also created a nationally representative system of sub-county governance, the municipal districts.
<b>Italy</b>	Since the introduction of Law n° 56/2014, effective January 2015, the intermediate level is no longer composed of directly elected governments, but rather of 14 metropolitan cities and 84 provinces, to which are added the Free Municipal Consortia of Agrigento, Caltanissetta, Enna, Ragusa, Syracuse, and Trapani. Their representatives are now elected by mayors and municipal councilors. Among the 20 regions, 15 have an ordinary status and 5 have a special status (i.e., Sardinia, Sicily, Trentino-Alto Adige/Südtirol, Aosta Valley, and Friuli-Venezia Giulia).
<b>Latvia</b>	With the 2011 municipal amalgamation reform, Latvia has 119 local governments, including 110 municipalities (novads) and 9 “republican cities.” Municipalities are divided into sub-municipal divisions, including 76 towns and 497 civil parishes. In 2019, the government initiated a new territorial reform aiming at reducing the number of local governments from 119 to 35.
<b>Luxembourg</b>	Since January 1, 2018, the date of entry into force of the last three amalgamation laws, the number of municipalities has decreased from 105 to 102.
<b>Malta</b>	The municipal level is composed of local councils.
<b>Netherlands</b>	The gradual decrease in the number of municipalities has continued, from 389 in January 2018 to 355 in January 2019 (there were 443 municipalities in 2007). District Water Boards, which are considered to be decentralized local governments in national legislation, are excluded from the count reported in the table.
<b>Poland</b>	The total number of counties (powiats) includes 314 counties and 66 cities with county status.
<b>Portugal</b>	Municipalities are subdivided into 3,091 sub-municipal localities (freguesias). The regional level comprises the two autonomous regions of the Azores and Madeira.
<b>Romania</b>	The number of regions includes the municipality of Bucharest, which also has county status. The municipal level comprises 320 towns and municipalities and 2,861 communes. Romania also has a sub-municipal level composed of 12,957 villages.
<b>Slovak Republic</b>	The municipal level includes cities, rural municipalities, city districts in Bratislava (17) and Košice (22), and three military districts.
<b>Slovenia</b>	Among the municipalities, there are 11 urban municipalities with a special status. There is also a structured sub-municipal level (6,035 settlements).
<b>Sweden</b>	As of January 2019, all counties have been formally transformed into regions, including the municipality of the island of Gotland. Until that date, Sweden’s regional governance structure had been asymmetric.
<b>United Kingdom</b>	The three devolved administrations at the regional level are Northern Ireland, Scotland, and Wales. England has 35 local governments at the intermediary level (upper tier), comprising 26 county councils, the Greater London Authority (GLA), and 8 combined authorities. The municipal level consists of 317 local authorities in England, 22 in Wales, 32 in Scotland, and, since April 1, 2015, 11 local councils in Northern Ireland (formerly 26). In addition, there is a structured sub-municipal level of approximately 9,500 parish councils in England, 735 community councils in Wales, and 1,200 councils in Scotland.

## Annex 2. Decentralization of Expenditure Responsibilities in EU Countries

**Figure A2.1.** Decentralization of Expenditure for General Public Services in 2018

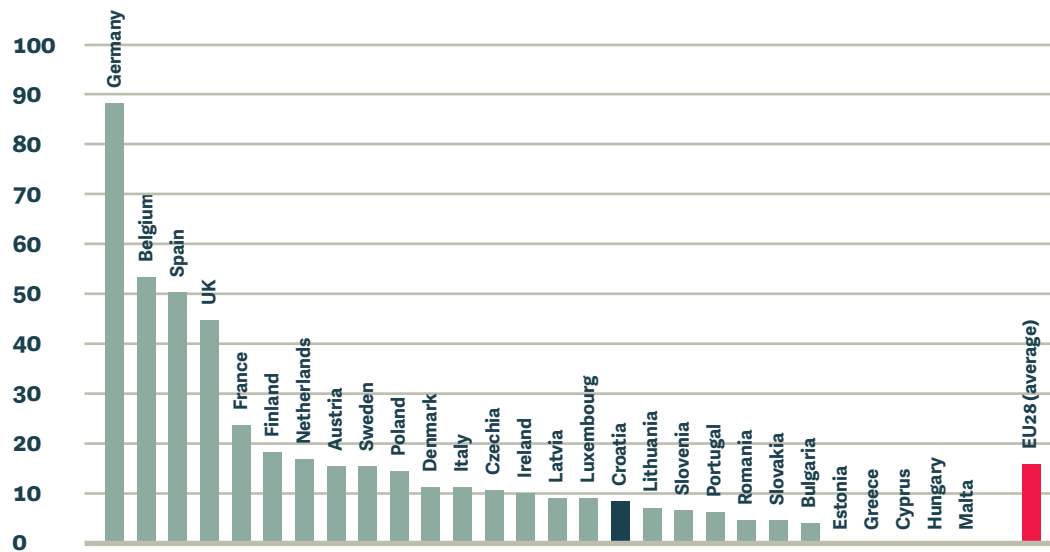


Note: Decentralization of expenditure for general public services is calculated as a ratio of subnational government expenditure for general public services and total general government expenditure for general public services.

Source: Authors, based on Eurostat, available at <https://ec.europa.eu/eurostat/data/database>.

Decentralization of expenditure for defense in 2018 was 0 because this service is customarily provided exclusively at the central government level.

**Figure A2.2.** Decentralization of Expenditure for Public Order and Safety in 2018

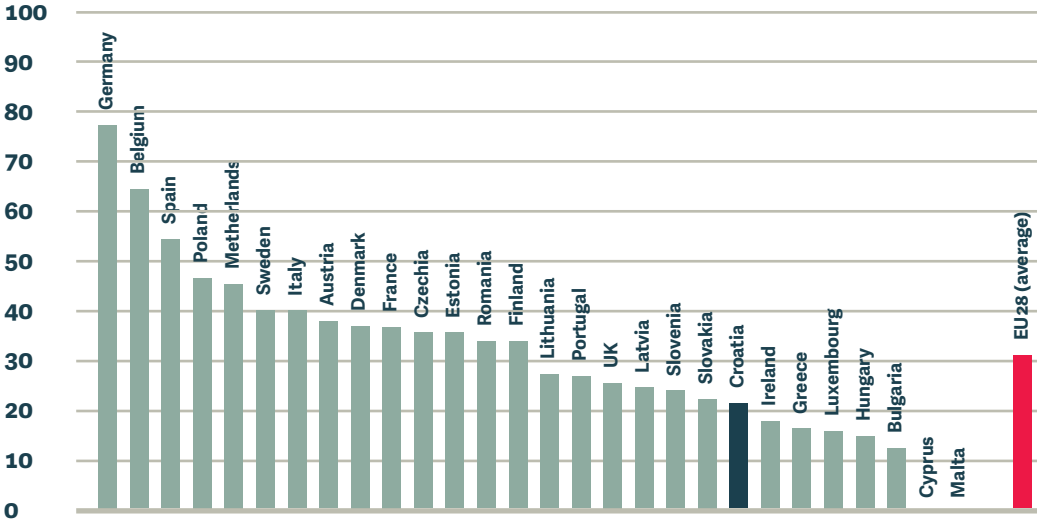


Note: Decentralization of expenditure for public order and safety is calculated as a ratio of subnational government expenditure for public order and safety and total general government expenditure for public order and safety.

Source: Authors, based on Eurostat, available at <https://ec.europa.eu/eurostat/data/database>.

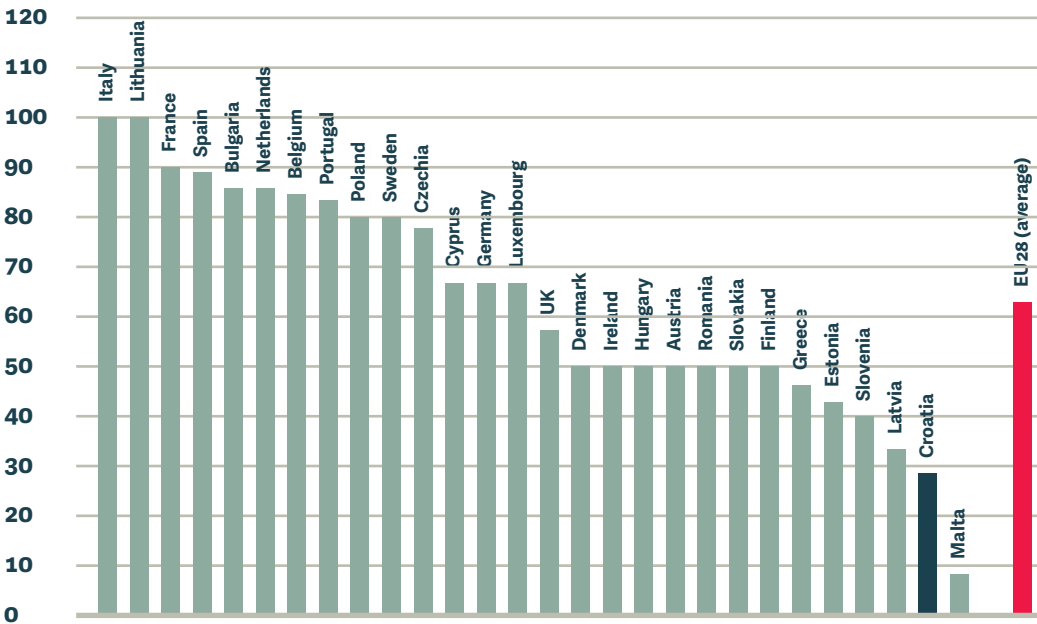


**Figure A2.3.** Decentralization of Expenditure for Economic Affairs in 2018



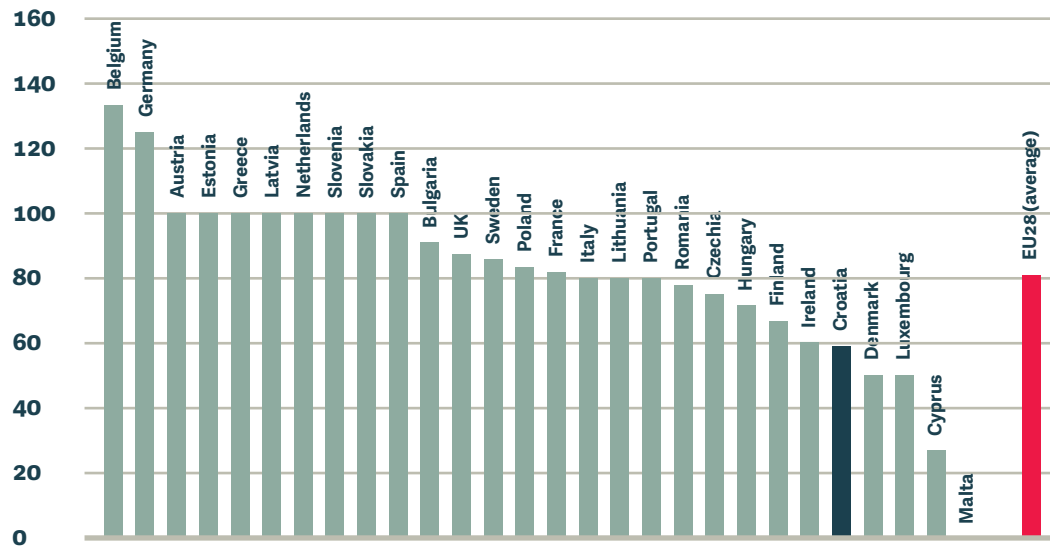
Note: Decentralization of expenditure for economic affairs is calculated as a ratio of subnational government expenditure for economic affairs and total general government expenditure for economic affairs.  
 Source: Authors, based on Eurostat, available at <https://ec.europa.eu/eurostat/data/database>.

**Figure A2.4.** Decentralization of Expenditure for Environmental Protection in 2018



Note: Decentralization of expenditure for environmental protection is calculated as a ratio of subnational government expenditure for environmental protection and total general government expenditure for environmental protection.  
 Source: Authors, based on Eurostat, available at <https://ec.europa.eu/eurostat/data/database>.

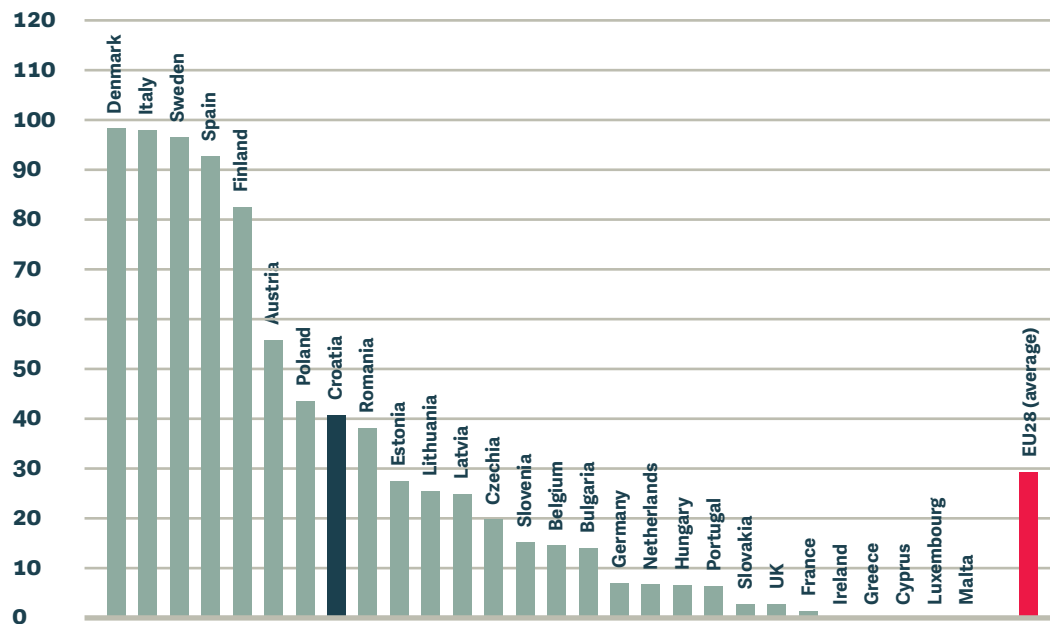
**Figure A2.5.** Decentralization of Expenditure for Housing and Community Amenities in 2018



Note: Decentralization of expenditure for housing and community amenities is calculated as a ratio of subnational government expenditure for housing and community amenities and total general government expenditure for housing and community amenities. Belgium and Germany have coefficients larger than 100 percent, which should not be the case and indicates probable errors in reporting or data processing.

Source: Authors, based on Eurostat, available at <https://ec.europa.eu/eurostat/data/database>.

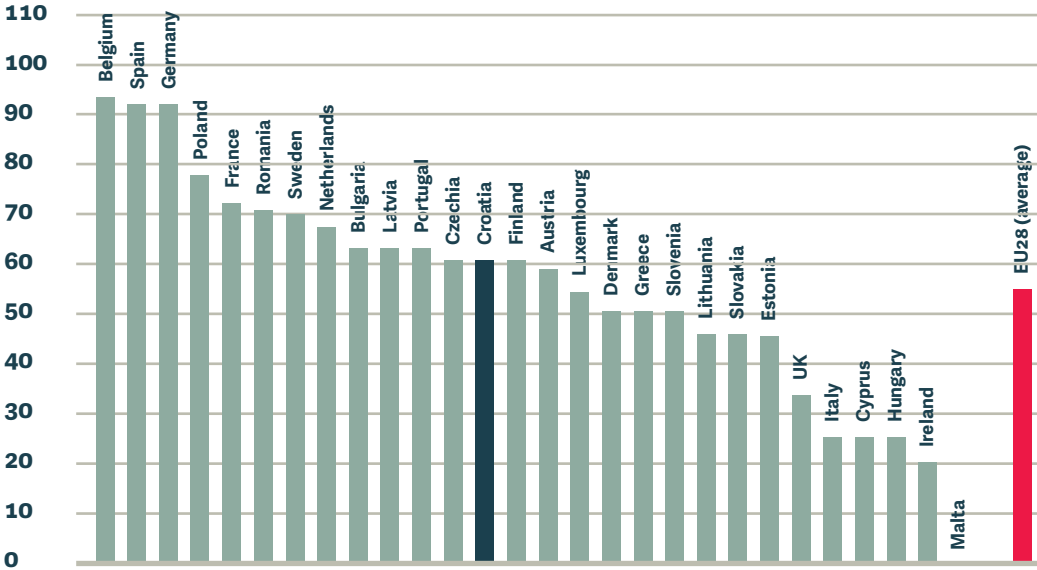
**Figure A2.6.** Decentralization of Expenditure for Health in 2018



Note: Decentralization of expenditure for health is calculated as a ratio of subnational government expenditure for health and total general government expenditure for health.

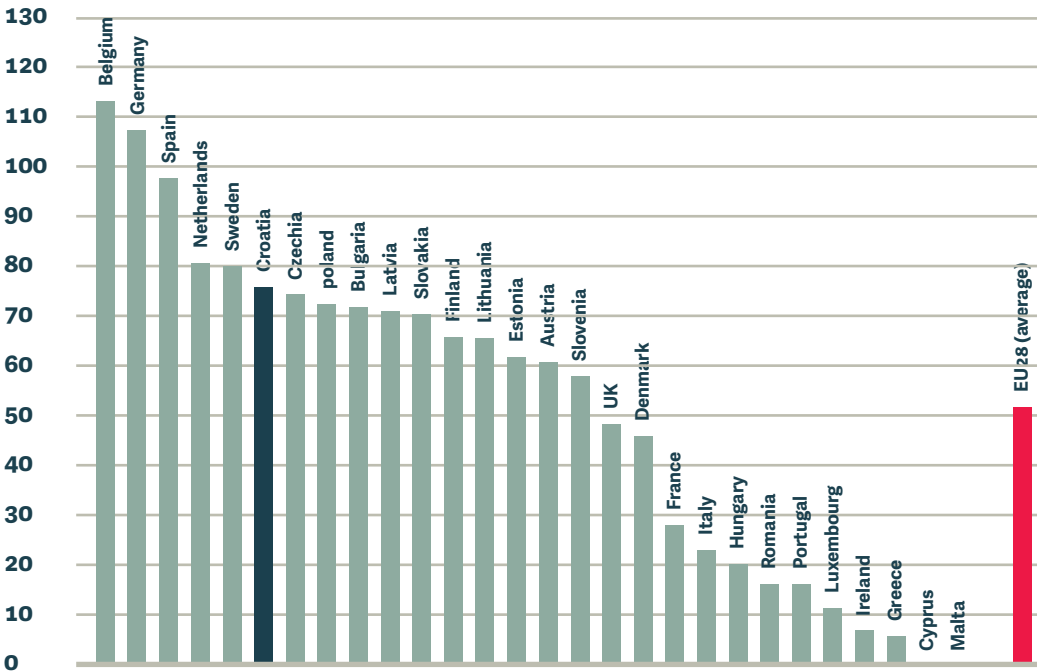
Source: Authors, based on Eurostat, available at <https://ec.europa.eu/eurostat/data/database>.

**Figure A2.7.** Decentralization of Expenditure for Recreation, Culture, and Religion in 2018

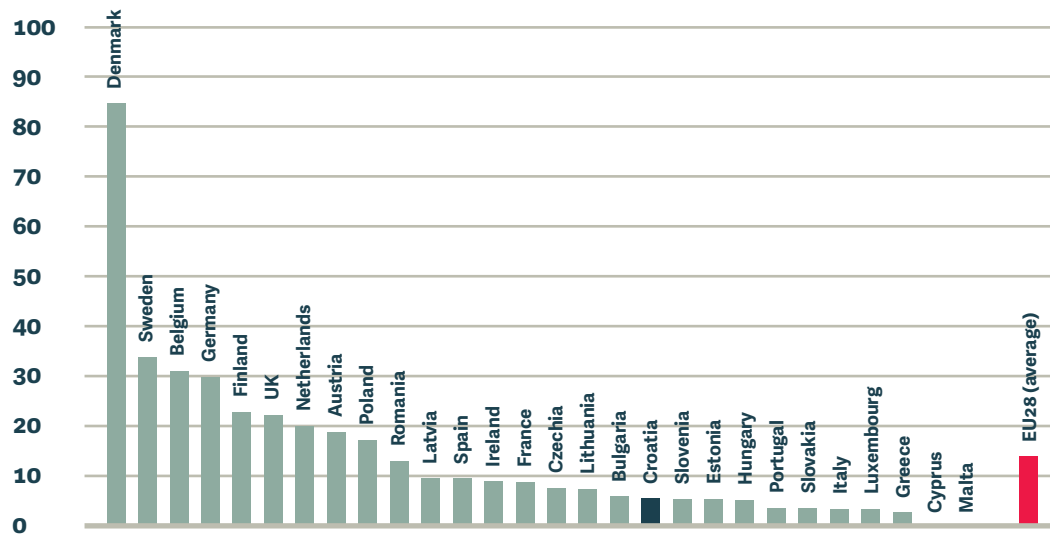


Note: Decentralization of expenditure for recreation, culture, and religion is calculated as a ratio of subnational government expenditure for recreation, culture and religion and total general government expenditure for recreation, culture, and religion. Source: Authors, based on Eurostat, available at <https://ec.europa.eu/eurostat/data/database>.

**Figure A2.8.** Decentralization of Expenditure for Education in 2018



Note: Decentralization of expenditure for education is calculated as a ratio of subnational government expenditure for education and total general government expenditure for education. Belgium and Germany have coefficients larger than 100 percent, which should not be the case and indicates probable errors in reporting or data processing. Source: Authors, based on Eurostat, available at <https://ec.europa.eu/eurostat/data/database>.

**Figure A2.9.** Decentralization of Expenditure for Social Protection in 2018

Note: Decentralization of expenditure for social protection is calculated as a ratio of subnational government expenditure for social protection and total general government expenditure for social protection.

Source: Authors, based on Eurostat, available at <https://ec.europa.eu/eurostat/data/database>.

### **Annex 3. Governance, Capacity Building, and IT**

Quality of governance. In order to increase the absorption capacity and take advantage of EU-financed projects, it will be necessary to provide additional professional and financial support to LRGUs, which at present lack sufficient administrative competence and have significant disparities in their human, financial, organizational, and infrastructural capacities that complicate regional convergence and access to EU funds. This is due in large part to the long-term neglect of regional policy and to the considerable regional economic imbalances. The quality of public administration at the national, regional, and local levels is the foundation of Croatia's absorption capacity. Given that the problem of unequal development among LRGUs is also associated with disparities in administrative capacities, addressing this issue is also key to achieving the goals of regional development policies. Even when some city and county finance managers have the relevant knowledge and experience, their activities are limited. The central government should put together a national program to assist counties, cities, and municipalities in strengthening their human, professional, and technical capacity, and prefects, mayors, municipal heads, councilors, and all LRGU employees should be encouraged to routinely undergo professional training.

Regional coordinators. The role of county development agencies as regional coordinators should be strengthened to enable them to perform activities of general public interest. This will yield more effective implementation of regional policy at the county level and also better cooperation between the central government and LRGUs, which should help support regional development. The Act on the System of Strategic Planning and Development Management of the Republic of Croatia (OG 123/17) and the Act on Regional Development of the Republic of Croatia (OG 147/14, 123/17, 118/18) identified regional coordinators as an important mechanism in the implementation of regional development policy. The work of the regional coordinators includes, among other tasks, the coordination of the activities of LGUs within their county. In addition, since the Act requires them to participate in the preparation and implementation of projects of public bodies in their county, as well as to monitor the status of all projects in the central electronic registry, regional coordinators have special insight into the development needs and potential of their county and the readiness of priority projects for implementation and financing. It would therefore be desirable to strengthen the capacity of regional coordinators to prepare, implement, monitor, and evaluate strategic regional development projects (i.e., ensuring value for money) in order to better manage the available public funds at the regional and local levels. Strengthening the regional coordinators should involve also a stronger role for other stakeholders in strategic planning and development management at the regional level.

Local and regional development. In addition to the existing development management system at the national level, a link to both the regional and local levels should be made so that counties or regional coordinators (county development agencies) will be able to establish an e-catalog of investment projects and capital investments at the regional self-government level. This would enable a proactive approach to attracting direct (foreign) investments and provide insight into ongoing investment projects and other capital investment possibilities in the county. This will also contribute to growth and development throughout the entire country and strengthen regional competitiveness.

Cash management. LRGUs should establish local treasuries to improve financial management and link them to the state treasury, so that the central government has information on (if not control or direct supervision over, which may or may not be desirable) local finances in real time. Currently, LRGUs pay little attention to cash management and budget liquidity, and they generally do not have established treasuries but rather operate through accounts in commercial banks. Commercial banks charge fees for the services provided, so LRGUs are often considered among their best clients. Nevertheless, LRGUs usually do not enjoy a privileged position due to the volume of transactions or (non) risk in borrowing from these banks and are generally treated like other business entities.

In a related issue, all monthly and quarterly financial reports of local units to the MOF and line ministries should be eliminated and only the semi-annual and annual reports retained, because there is currently an abundance of reports that no one reads or uses. The budget process and the application of appropriate financial management instruments greatly affect the financial stability of the LRGU. Quality analytical data, records of cash flows, and information on planned investments and borrowing needs are all essential to effective LRGU financial management. The regular use of recognized diagnostic tools, such as Public Expenditure and Financial Accountability (PEFA) and Municipal Finances Self-Assessment (MFSA), can help identify segments of financial management where further progress can be made.

Public services and IT. The quality of public services should be improved by the more generalized use of IT through computerization/digitization. In addition, the mechanisms for evaluating the transparency of local and regional authorities should be strengthened, including by increasing administrative efficiency through the use of a comprehensive document management system to provide services to citizens electronically. The role of IT (involving an internet connection, the availability of chargers, citizen training, investment in the IT economy, etc.) is inevitable and should be seen as an integral part of future local and regional public services.

## Annex 4. Data and Transparency

Methodological issues. Frequent methodological changes have hampered this analysis because long-term series were hard to obtain and required modifications of inputs and data recorded in LRGUs' financial statements over several years. Of course, many of the methodological changes have had a logical purpose and represented improvements in the transparency of public accounts. For example, since 2015 transfers of funds to budgetary users for salaries have not been recorded as salaries (gross) but rather as transfers to budgetary users from the competent budget for financing regular activities. Accordingly, the manner of presenting data on average number of employees has changed. In addition, the scope of transactions treated as grants and the methodology for recording them have also changed over the years. For example, the substantial increase in the number of grants starting in 2011 is actually only a "technical" increase caused by methodological changes in recording equalization grants for decentralized functions, which were before then recorded as revenue from the PIT and surtax. These problems can be resolved by re-examining the changes and reforms that are necessary and implementing them as soon as possible, thus reducing the frequency of methodological alterations. The goal should be the more transparent publication of additional data, which would also help make longer-term datasets comparable (providing parallel data series several years before and after such changes).

At the same time, it would be useful to publish explanations of the methodology utilized and any changes that are made to it. The methodological notes should also list the data coverage and what variations have been made. Among other benefits, these changes would make it easier to follow trends at the most general level, such as in terms of intensity (degree of decentralization), and would also represent improvements in the context of other data and indicators. For example, employee expenditures and the number of employees and beneficiaries are constantly increasing relative to what is reported in LRGU financial statements. However, existing reports do not transparently show the movement of employees but only the number of civil servants, other employees, and temporarily engaged workers in special programs, all within the same category (item). This makes long-term monitoring of the system more difficult and creates unnecessary confusion. A simple methodological change, such as introducing a new category or item called "temporary employees" or "employees under special programs," would significantly help to clarify what is actually happening. Similarly, other data records should be edited, including data on guarantees and other sources of fiscal risks for the LRGU, as well as other relevant indicators.

Compliance. It is sometimes the case that the lack of transparency in the data is due to the failure of the LRGU to comply with current norms. Since 2015, LRGUs have been required to enter the data in their financial statements on the average number of employees (working in LRGU bodies) but not the data on the number of employees among their budgetary users. This appears to be one of the reasons why the number of public employees suddenly decreased that year. However, some LRGUs still report the incomplete number, despite the fact that they have received a circular from the MOF with detailed instructions on how the reporting should be performed. It could be an issue of how some LRGUs understand the current reporting rules, but the situation makes adequate reporting difficult and sometimes less reliable. These issues again point to the weak administrative capacity among LRGUs in Croatia and of the need to take active measures to improve it. On the other hand, it does appear that the MOF

could implement additional controls on the LRGU reporting process. It would also help if the circulars were more user friendly and easier to understand, with less room for discretionary and subjective interpretations by local officials.

**Data sources.** These at times are not compatible, which represents an additional obstacle to analyzing long-term series for LRGUs. For example, data on LRGU debt provided by the Croatian National Bank and the MOF are not comparable because the National Bank uses the ESA 2010 methodology and the MOF the GFS 2001.

The fact that the data are overly general and poorly aggregated also has a negative impact on the clarity and transparency of subnational fiscal accounts. Although the data quality has been improving, in certain cases the data published are still too imprecise. For example, the analytical breakdown of the structure of LRGU grants in publicly available reports (i.e., the Report on Revenues and Expenditures, Receipts and Expenses: Form PR-RAS) differentiates only between current and capital grants and basic types of grant providers, making it almost impossible to differentiate between the different types of grant schemes. Grants from other budgets include current and capital grants from the central government, counties, cities, and municipalities that are distributed to LRGUs from various sources and with different purposes. Unfortunately, the more disaggregated and detailed structure of these grants is not publicly available, and only the combined figure is provided.

**Accounting rules.** The reliability of the data is sometimes in question because the system of accounting rules has not been updated. For example, the value of LRGU shares and equity stakes is recorded according to the accounting value (purchase value at the time of acquisition) and not the market value. This rule makes the data less relevant, because LRGU liabilities are recorded according to the real (market or close to market) value, while the value of assets (especially certain categories of assets) is often far from reality (market value).

**Incomplete records and data evidences.** Many LRGUs do not have inventories of assets due to unresolved property disputes, inconsistencies in land registers and cadasters, and numerous lawsuits related to property rights. Some units do not have professional departments and trained individuals to manage the jurisdiction's assets. These issues should be resolved—and given priority over other court procedures—as soon as possible to determine the ownership of LRGU real estate and to register it in the cadaster. The annual inventory should include all assets and liabilities, in accordance with the provisions of the Ordinance on Budget Accounting and the Chart of Accounts. This would create the much-needed foundation for the development of a clear and comprehensive LRGU asset management strategy. It should also be noted that a prerequisite to achieving these goals is a strong administrative capacity and highly qualified professional staff trained in asset management at the LRGU level.

**Lack of territorial dimension in the state budget.** The state budget can be presented according to economic, functional, program, and location classification. Each of the classifications provides different and useful information for more efficient financial management and budget planning. However, the budget of the Republic of Croatia currently is not presented according to location, making it impossible to monitor the country's fiscal position according to the spatial dimension of LRGUs. In particular, at the present time it is not possible to analyze the impact of certain central government policies and reforms or assess their impact on regional development and the overall fiscal position of individual regions.



Clear accounting of fiscal risks. The financial performance of LRGUs and their companies should be viewed together (especially in the context of borrowing) in order to get a complete picture of the financial “health” of the local and regional public sector. This is a fundamental aspect of the need to increase the transparency of the published data, as well as the decisions and activities of LRGUs. The MOF offers the budgets of counties, cities, and municipalities on its website. However, for more complete information on the overall actual financial situation of each jurisdiction, all LRGUs should publish an up-to-date online database (list of addresses and contacts) as well as their balance sheets and profit and loss accounts for all legal entities owned and co-owned by them (regardless of the percentage of co-ownership) and their institutions. For the data to be more usable, it should be published in appropriate formats; for example, financial data should be published in Excel.

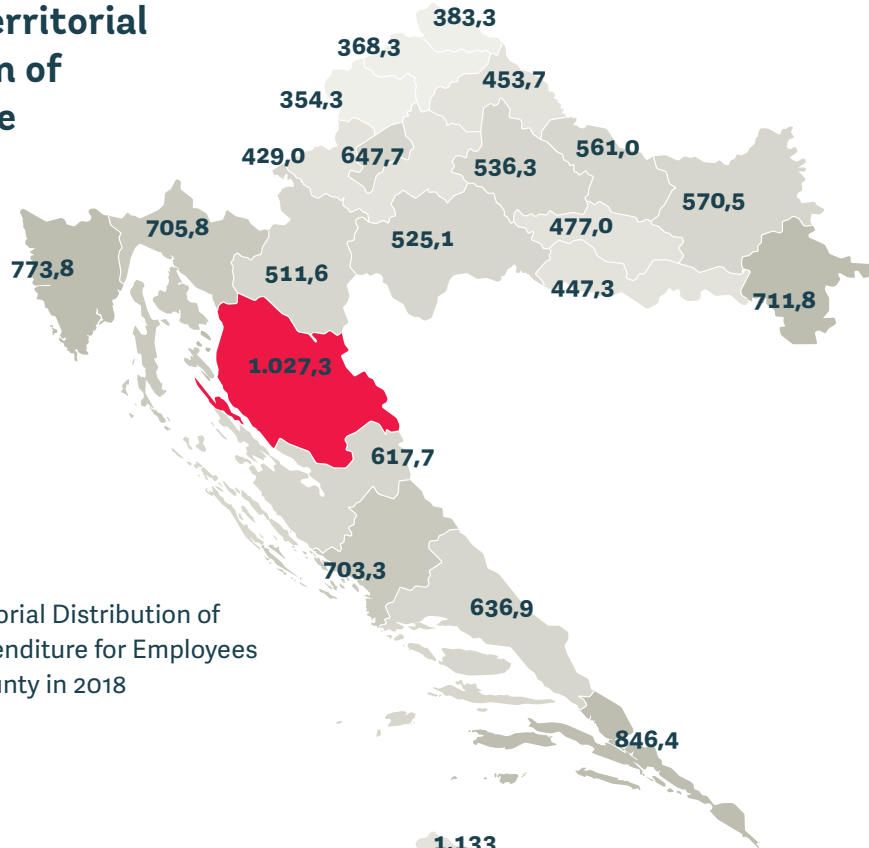
Although Croatia’s existing legislative framework does not provide for the preparation of these consolidated financial statements, they are required by IPSAS. The application of these regulations would be useful for a comprehensive view of the exposure of the LRGU to direct and indirect liabilities arising from the financial operations of their utility companies. LRGUs currently do not perform credit risk assessments of LRGUs and their companies. The development of a tool to assess the credit rating of LRGUs and the companies owned by them could be performed by the Association of Cities, which could publish an annual map of each LRGU according to its credit risk and present an annual evaluation. These results could help the MOF to improve the decision-making process regarding the approval of borrowing and the provision of guarantees to LRGUs and their companies. The information could also encourage a healthy positive competition among them.

Fiscal transparency. Croatia has made progress in providing more transparent and accountable local financial management, as well as citizen involvement in the budgetary process. Although until recently these topics were discussed only in principle, concrete mechanisms to increase transparency and improve the quality of governance are gradually being implemented at the LRGU level. For example, LRGUs are increasingly creating and publishing budget guides for citizens and business information on their websites. However, this practice is often as uneven as the presentation format for publishing data. Therefore, a more detailed framework for publishing data should be prescribed for target groups of users. The Institute of Public Finance has been analyzing the budget transparency of all Croatian counties, cities, and municipalities for many years. Budget transparency implies insight into complete, accurate, timely, and understandable budget information. Based on this information, citizens can engage and, among other things, influence the efficiency of collecting and spending budget funds, increase the accountability and responsibility of local officials, and help minimize the occurrence of corrupt practices.

On the other hand, the aim is not simply to increase the number of budget documents published on the websites of local units but also to facilitate a more detailed analysis of their content. Clearly, the mere publication of these budget documents does not mean that LRGUs are absolutely budgetary transparent, or that their leadership is necessarily accountable and responsible; rather, it is only a confirmation that they complied with the Budget Law, the Law on Access to Information, and the MOF’s recommendations. This level of budget transparency should be seen only as the first necessary step toward more complete budget openness—in other words, a basic precondition for educating citizens about local budgets. Again, only budget-educated citizens can be effectively involved in local budget processes, that is, in helping decide on the collection and spending of local funds and holding local authorities accountable.

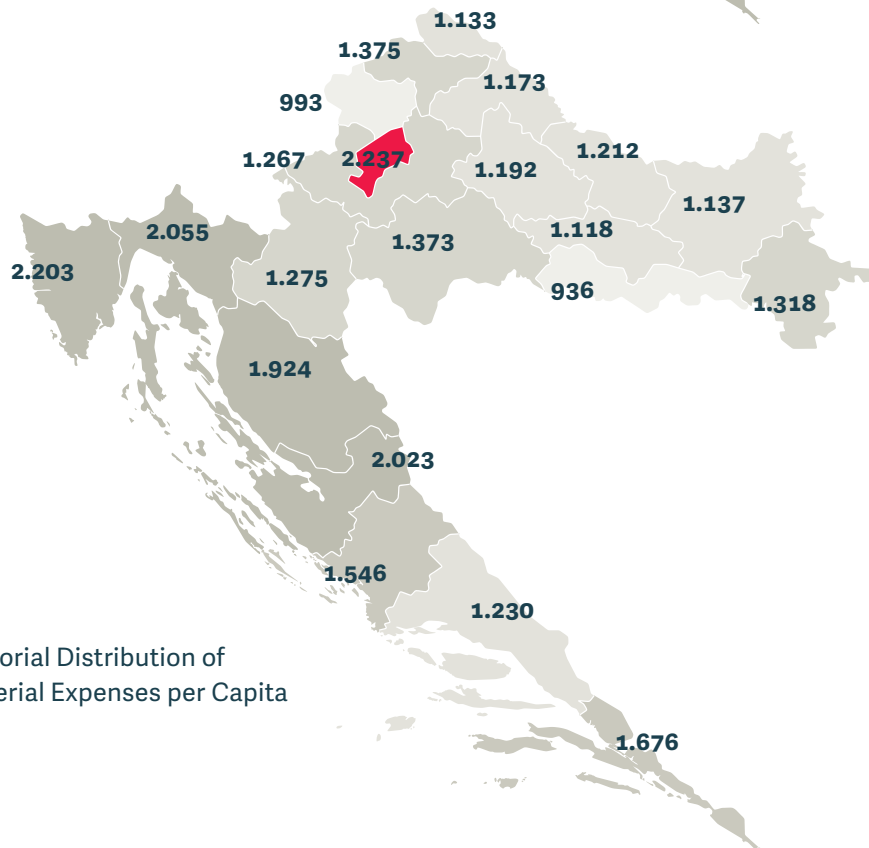
Further engaging civil society and promoting citizen participation. Local self-government should be developed further through joint activities and cooperation among city/municipal administration departments, civil associations, and economic actors to promote citizen participation in decision making on local affairs on the basis of a partnership between leaders and citizens. All interested stakeholders should be motivated to productively use the available information, particularly since much of what is already published is not used. Thus, there is a need to raise awareness and promote citizen involvement through participatory budgeting with the development of a "small budget" or a "citizen guide." Some LRGUs have already developed budget guides for citizens, but often these have not been updated, which should lead officials to consider exactly for whom the information is intended and the best way to present it. In recent years, several cities (Pula, Mali Lošinj, Karlovac, Pazin, Rijeka, Trogir, Dubrovnik, Sisak, Bjelovar) have taken the first steps in improving communication and involving citizens in participatory budget decision making. And some public administration leaders are trying to create a partnership among public authorities, the private sector, civil society, and citizens. The popularization of participatory budgeting leads to the strengthening of links between local government and citizens, raises trust in decision-making processes and government institutions and their representatives, and finally, ensures the more efficient provision of public services in accordance with the real preferences of residents.

### Annex 5. Territorial Distribution of Expenditure



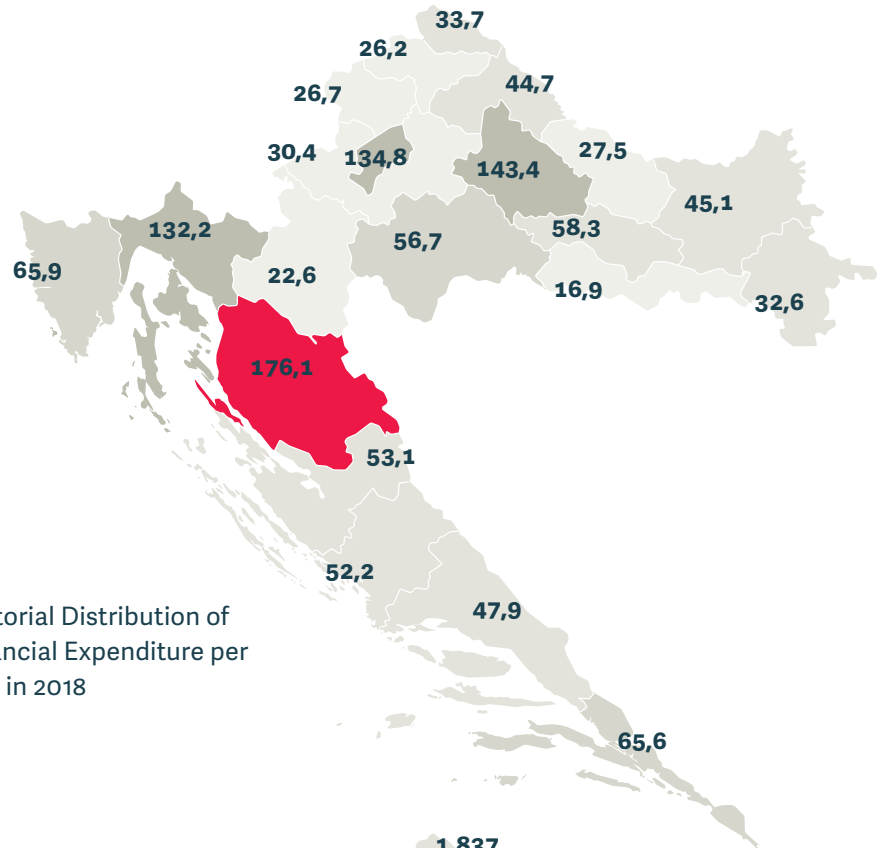
**Figure A5.1.** Territorial Distribution of LRGUs' Total Expenditure for Employees per Capita by County in 2018

Source: Authors.



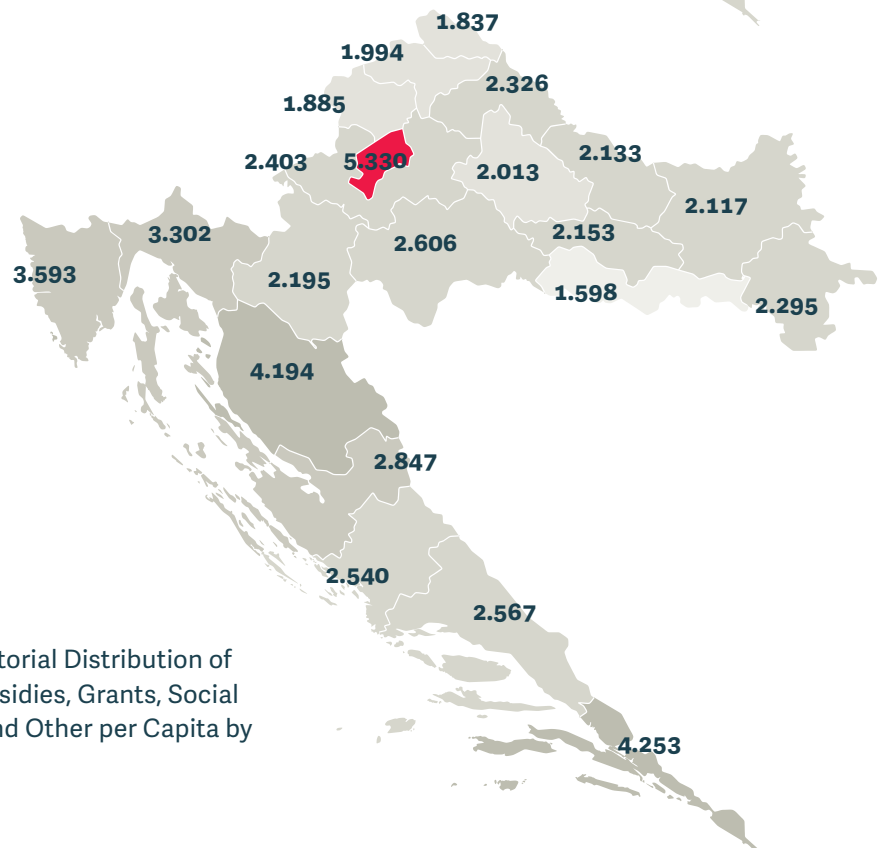
**Figure A5.2.** Territorial Distribution of LRGUs' Total Material Expenses per Capita by County in 2018

Source: Authors.



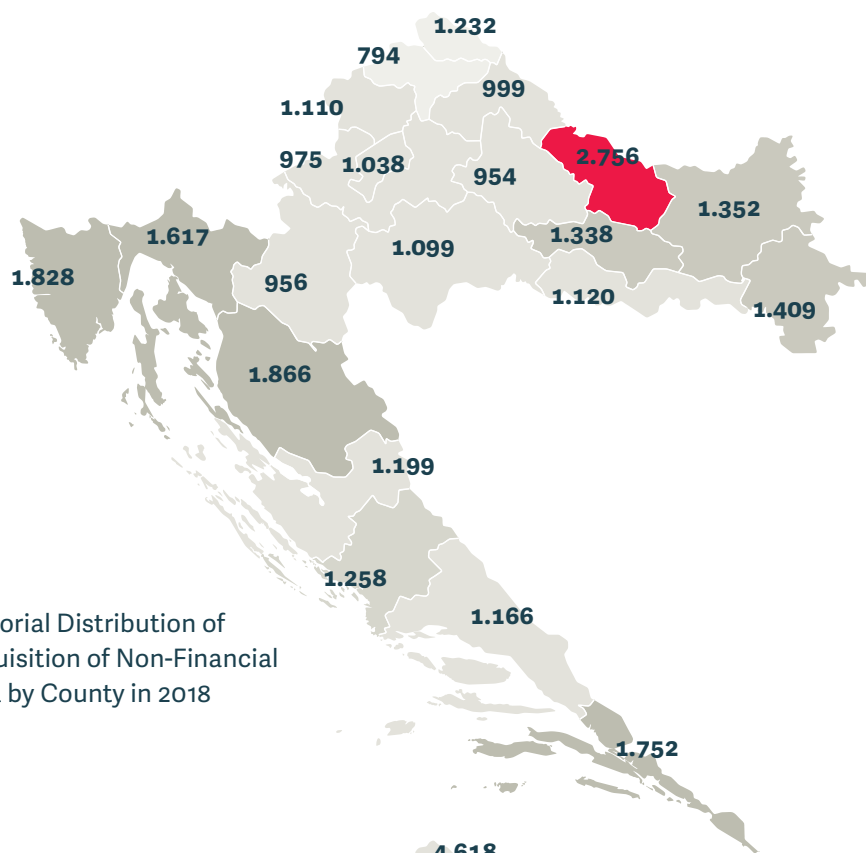
**Figure A5.3.** Territorial Distribution of LRGUs' Total Financial Expenditure per Capita by County in 2018

Source: Authors.



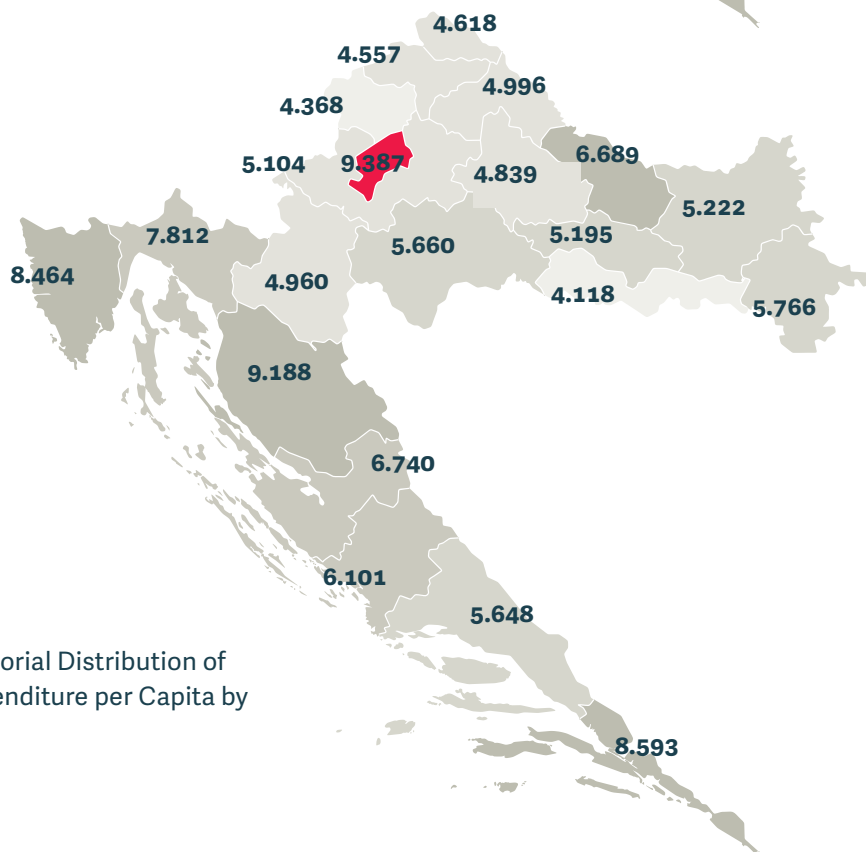
**Figure A5.4.** Territorial Distribution of LRGUs' Total Subsidies, Grants, Social Contributions, and Other per Capita by County in 2018

Source: Authors.



**Figure A5.5.** Territorial Distribution of LRGUs' Total Acquisition of Non-Financial Assets per Capita by County in 2018

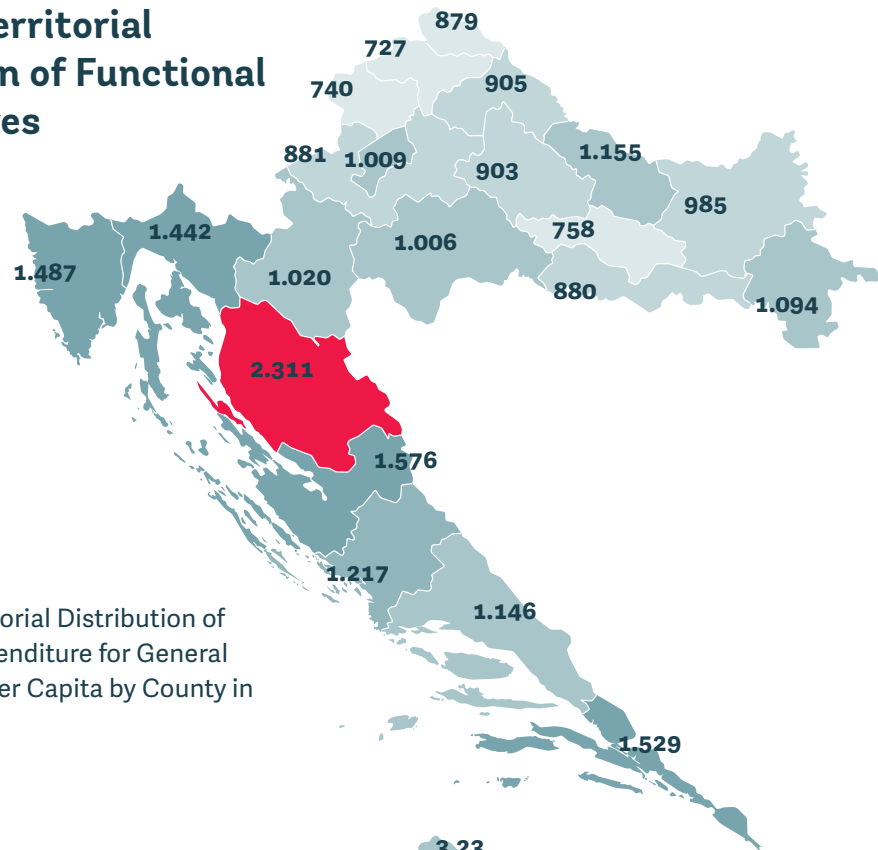
Source: Authors.



**Figure A5.6.** Territorial Distribution of LRGUs' Total Expenditure per Capita by County in 2018

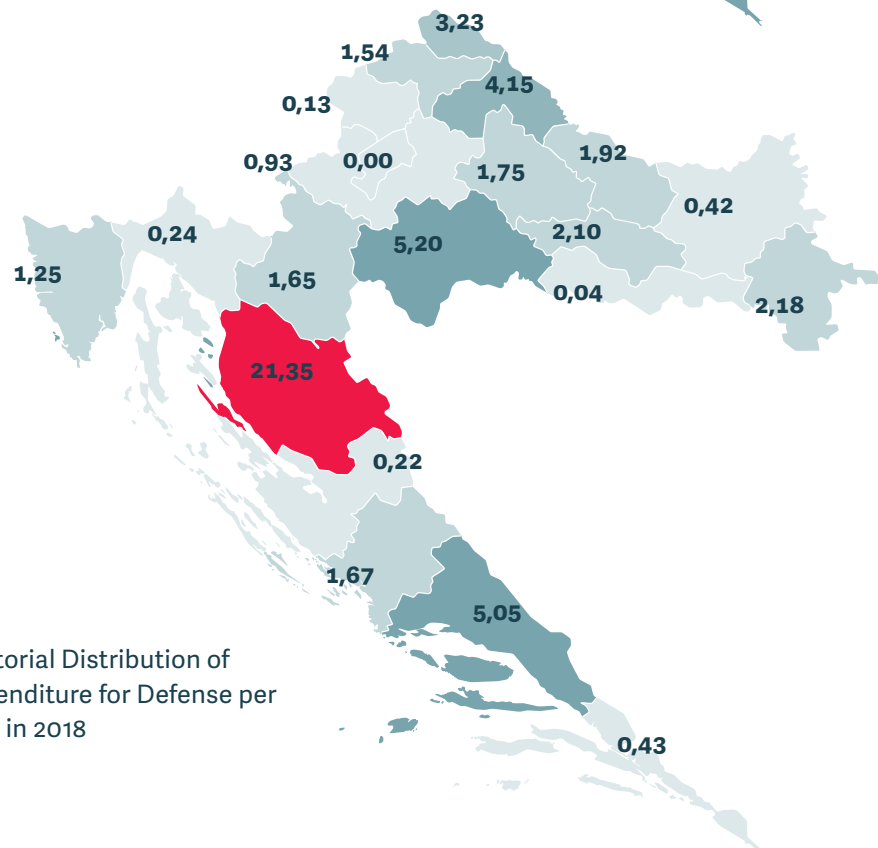
Source: Authors.

## Annex 6. Territorial Distribution of Functional Expenditures



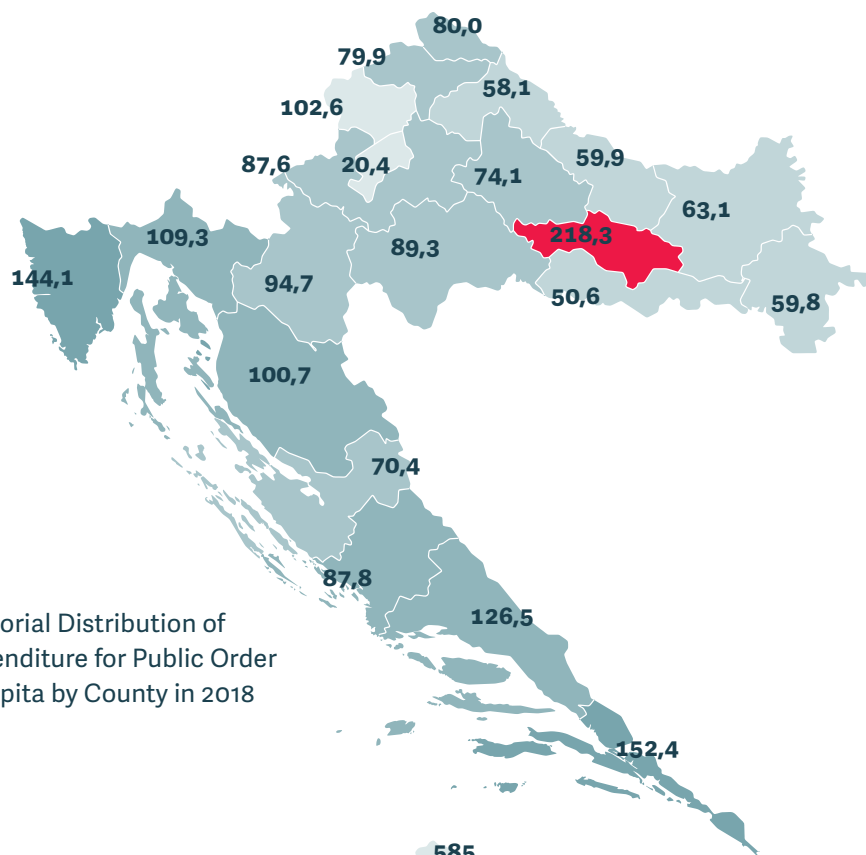
**Figure A6.1.** Territorial Distribution of LRGUs' Total Expenditure for General Public Services per Capita by County in 2018

Source: Authors.



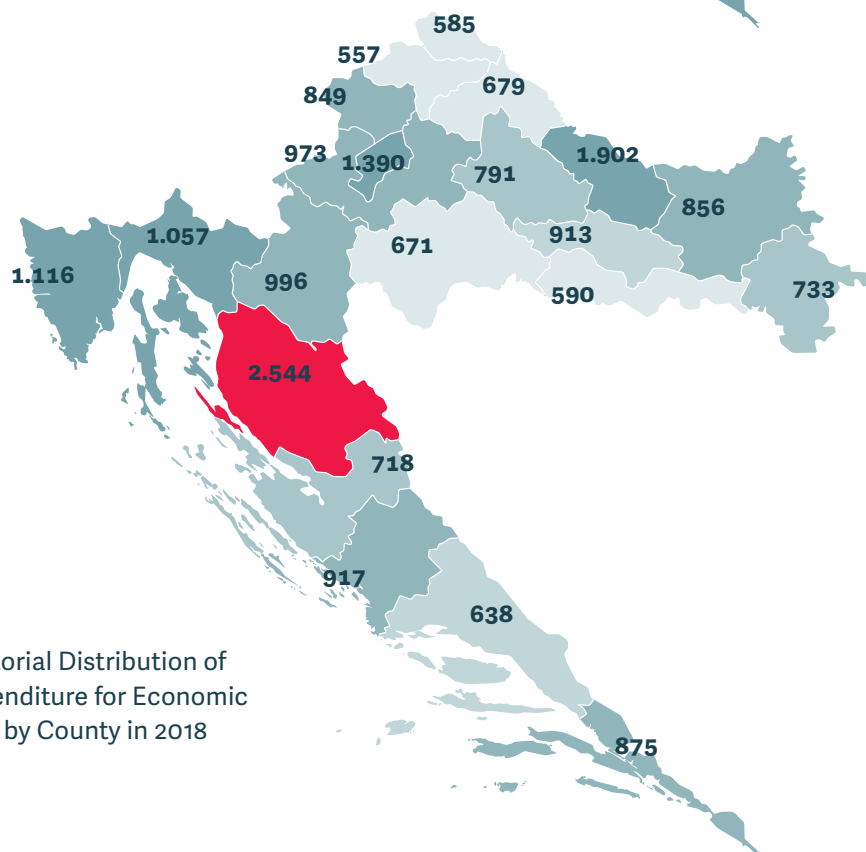
**Figure A6.2.** Territorial Distribution of LRGUs' Total Expenditure for Defense per Capita by County in 2018

Source: Authors.



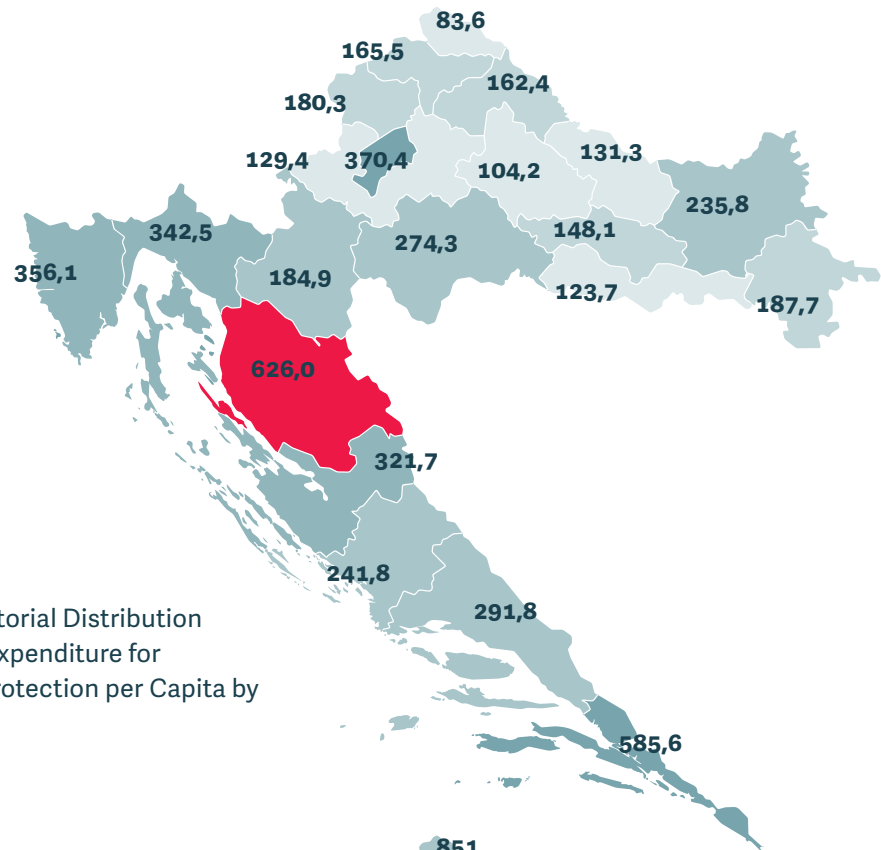
**Figure A6.3.** Territorial Distribution of LRGUs' Total Expenditure for Public Order and Safety per Capita by County in 2018

Source: Authors.



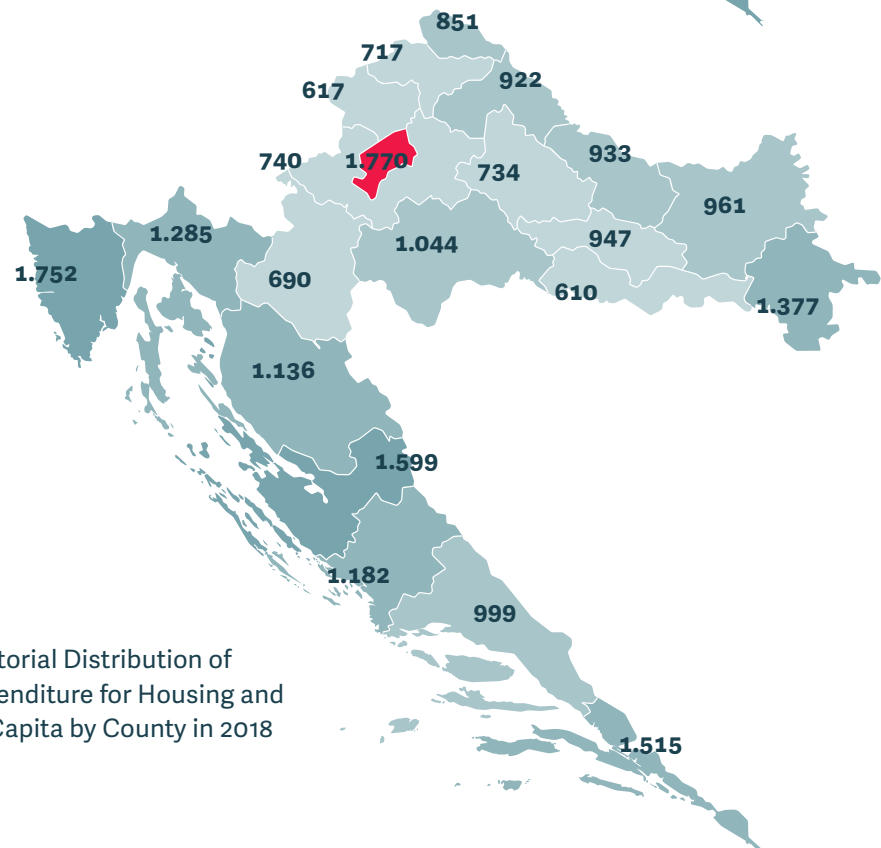
**Figure A6.4.** Territorial Distribution of LRGUs' Total Expenditure for Economic Affairs per Capita by County in 2018

Source: Authors.



**Figure A6.5.** Territorial Distribution of LRGUs' Total Expenditure for Environmental Protection per Capita by County in 2018

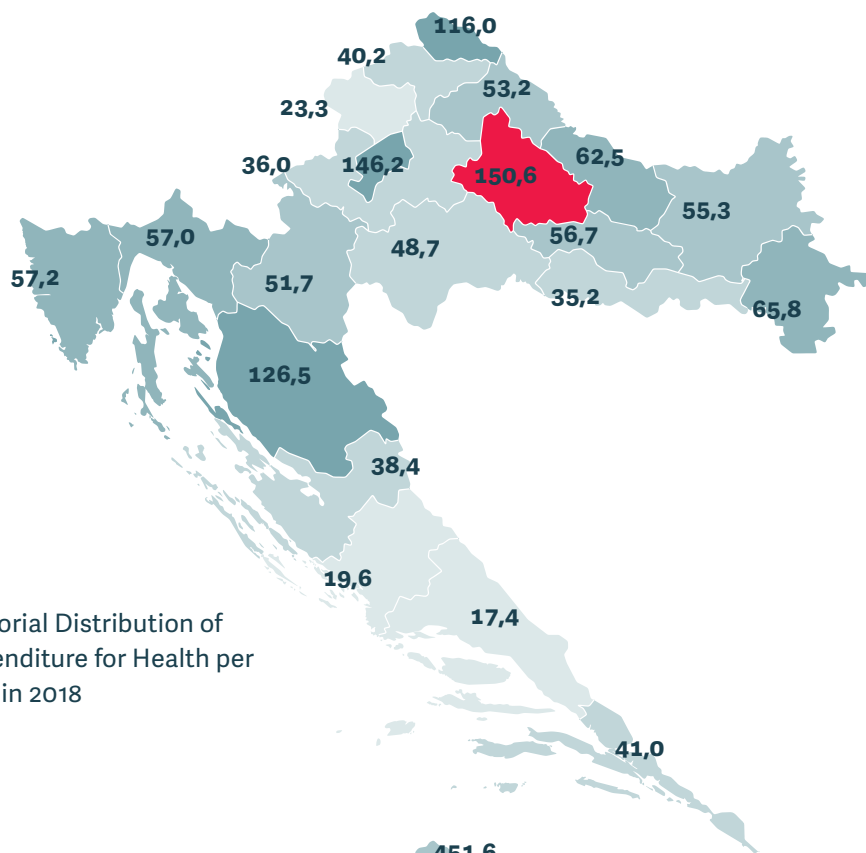
Source: Authors.



**Figure A6.6.** Territorial Distribution of LRGUs' Total Expenditure for Housing and Community per Capita by County in 2018

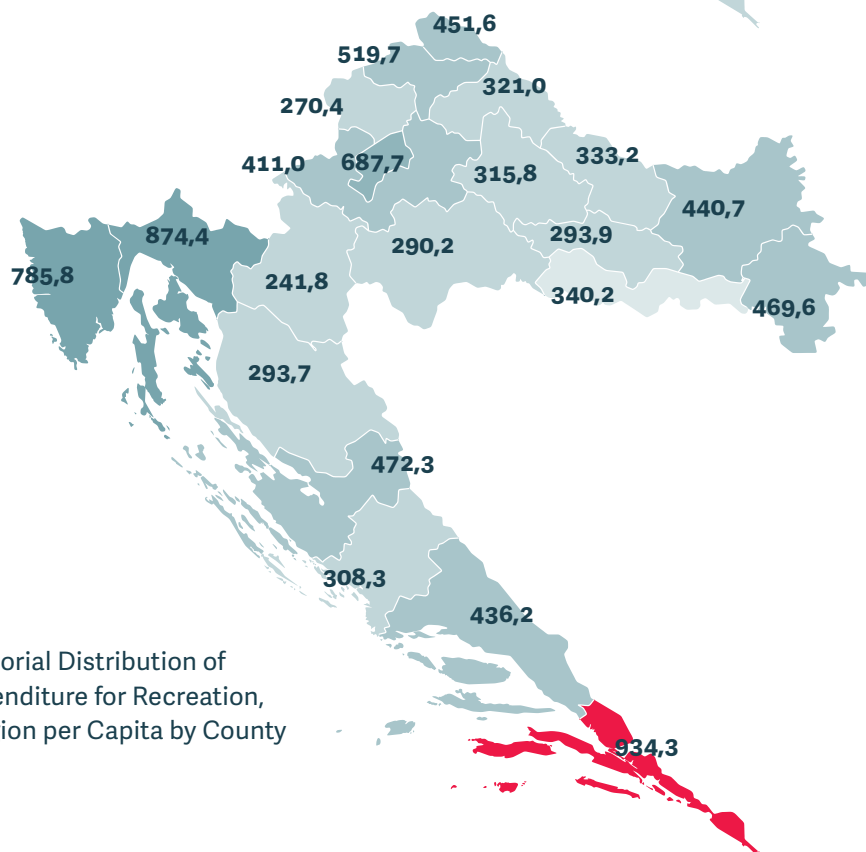
Source: Authors.





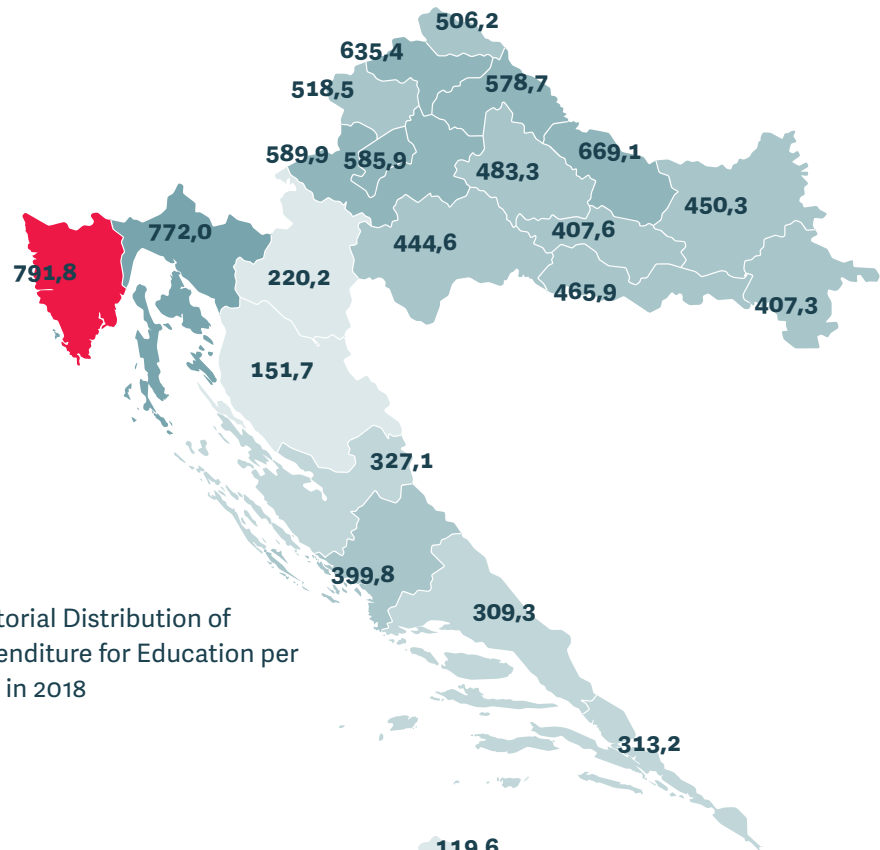
**Figure A6.7.** Territorial Distribution of LRGUs' Total Expenditure for Health per Capita by County in 2018

Source: Authors.



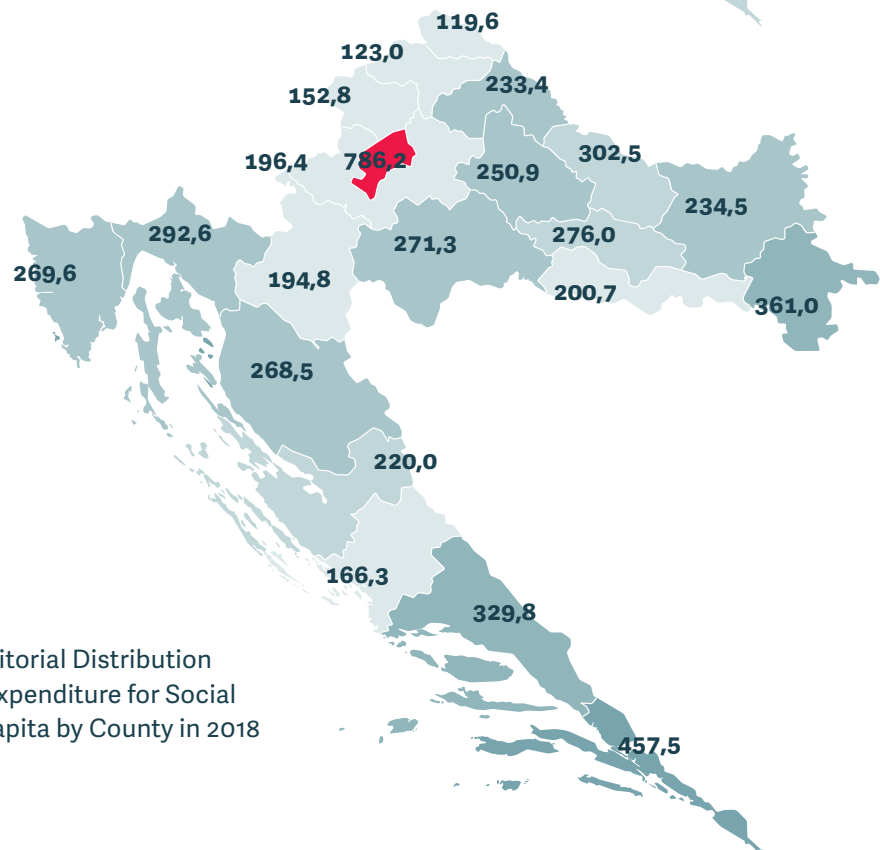
**Figure A6.8.** Territorial Distribution of LRGUs' Total Expenditure for Recreation, Culture, and Religion per Capita by County in 2018

Source: Authors.



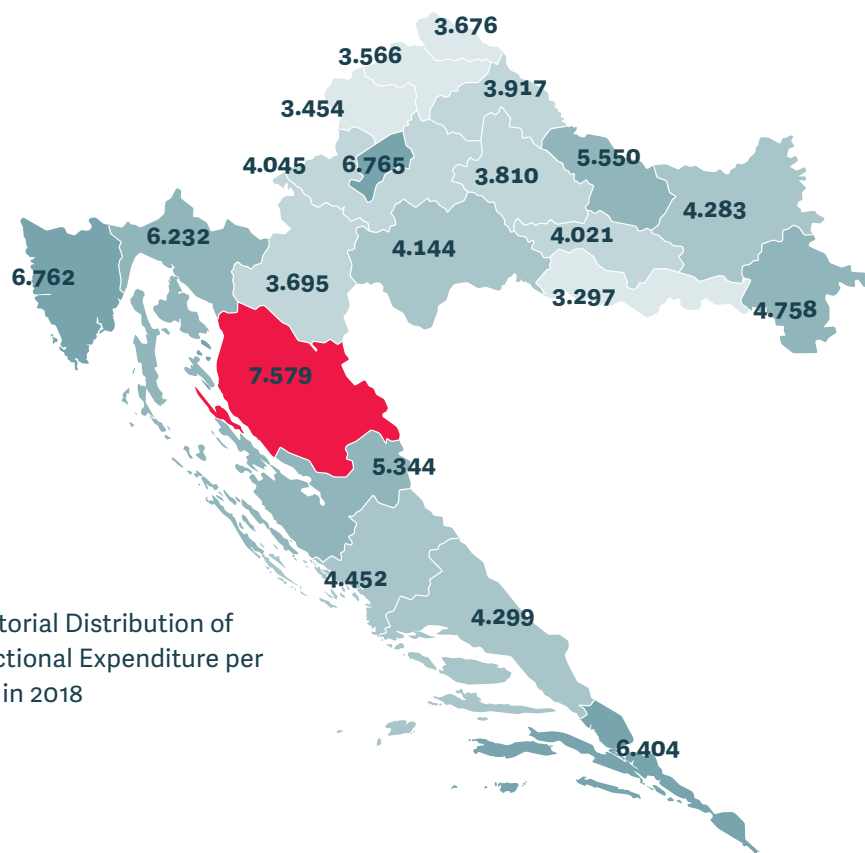
**Figure A6.9.** Territorial Distribution of LRGUs' Total Expenditure for Education per Capita by County in 2018

Source: Authors.



**Figure A6.10.** Territorial Distribution of LRGUs' Total Expenditure for Social Protection per Capita by County in 2018

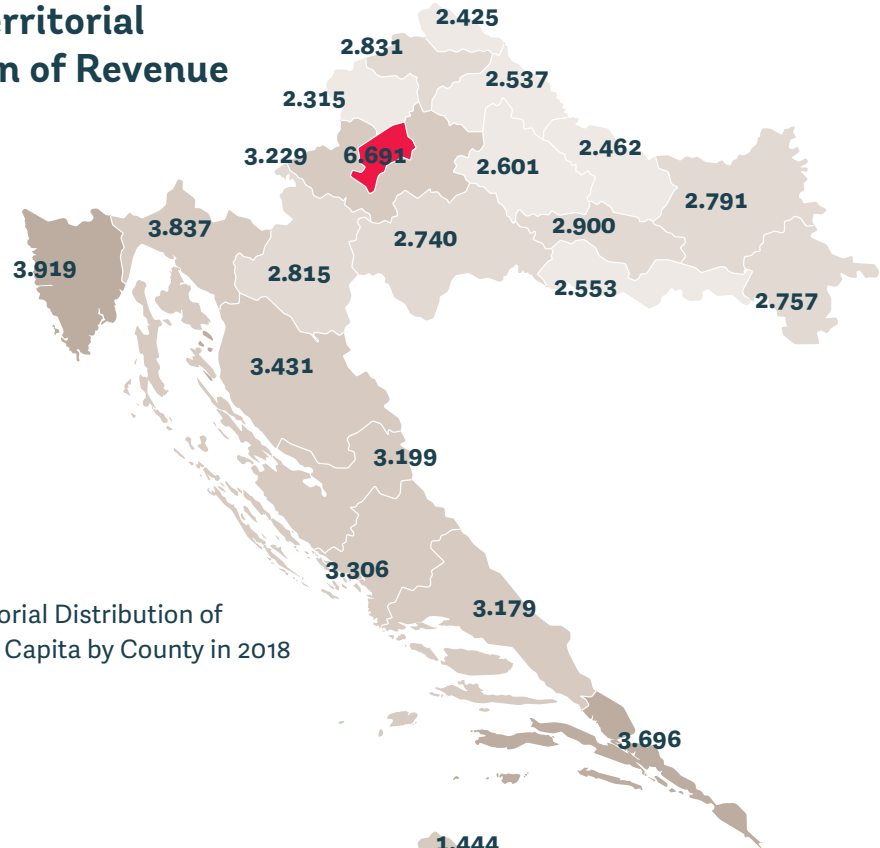
Source: Authors.



**Figure A6.11.** Territorial Distribution of LRGUs' Total Functional Expenditure per Capita by County in 2018

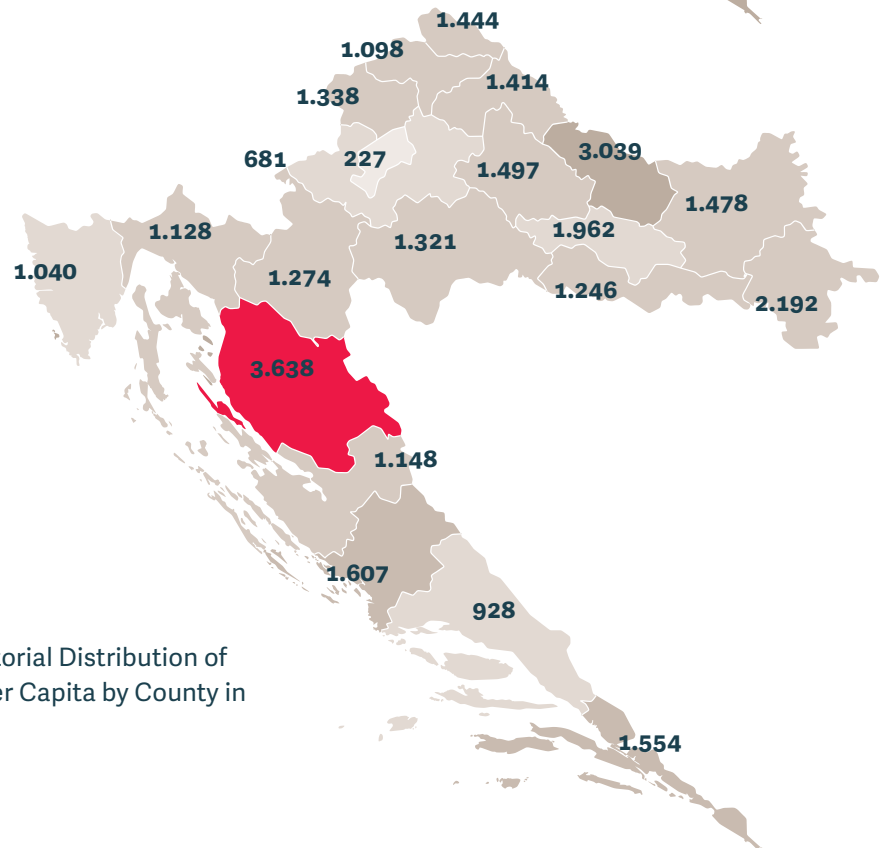
Source: Authors.

## Annex 7. Territorial Distribution of Revenue



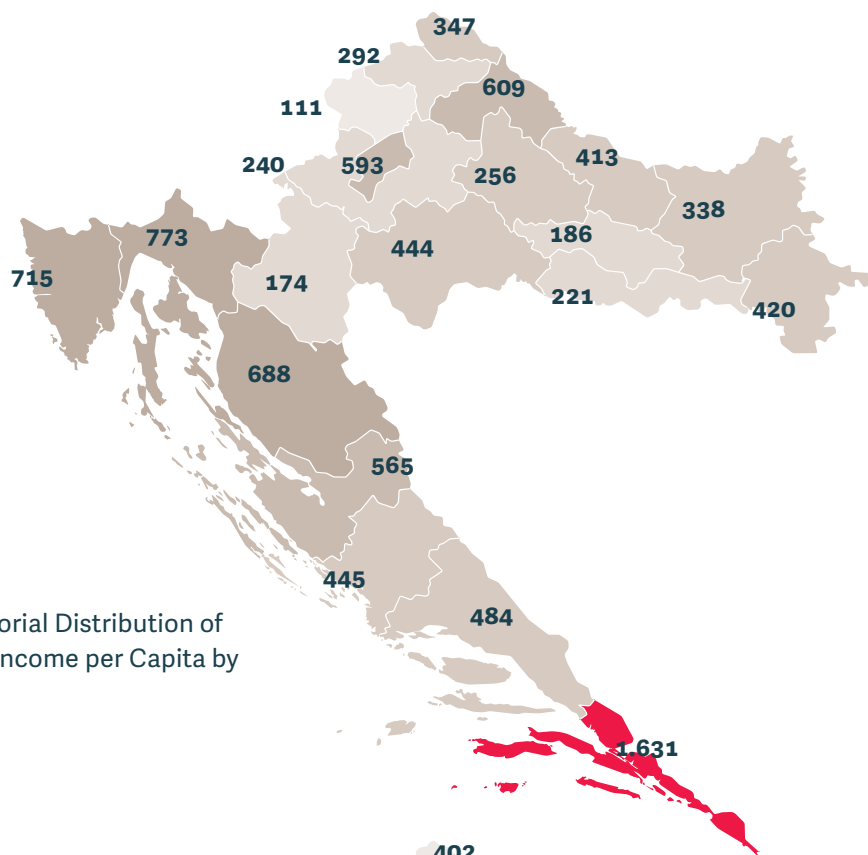
**Figure A7.1.** Territorial Distribution of LRGUs' Taxes Per Capita by County in 2018

Source: Authors.



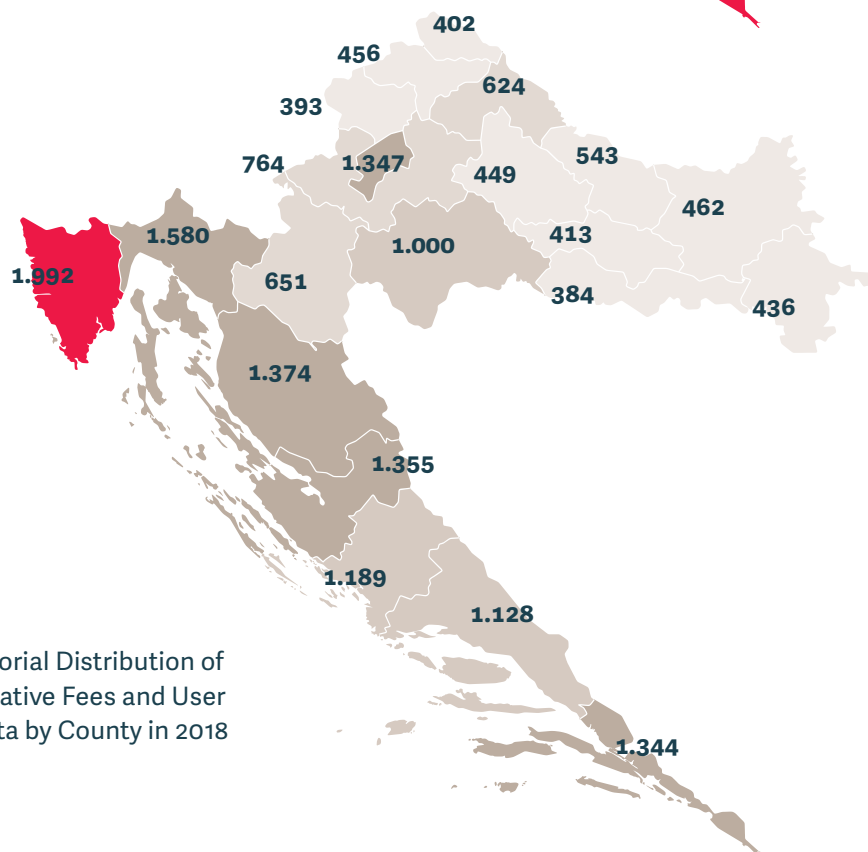
**Figure A7.2.** Territorial Distribution of LRGUs' Grants Per Capita by County in 2018

Source: Authors.



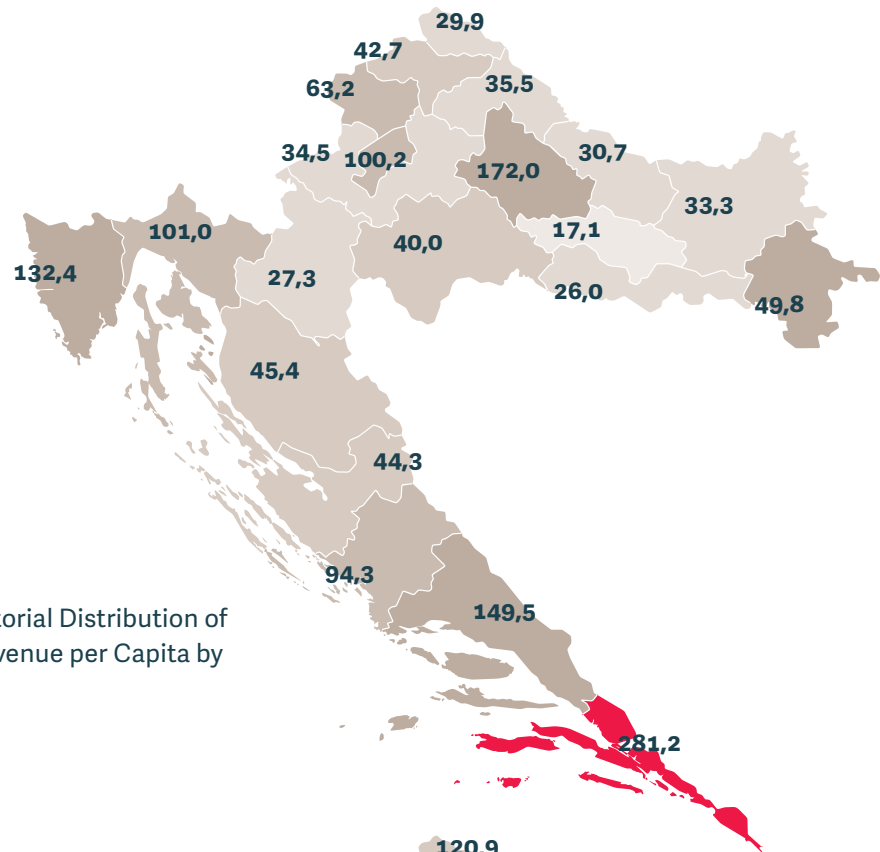
**Figure A7.3.** Territorial Distribution of LRGUs' Property Income per Capita by County in 2018

Source: Authors.



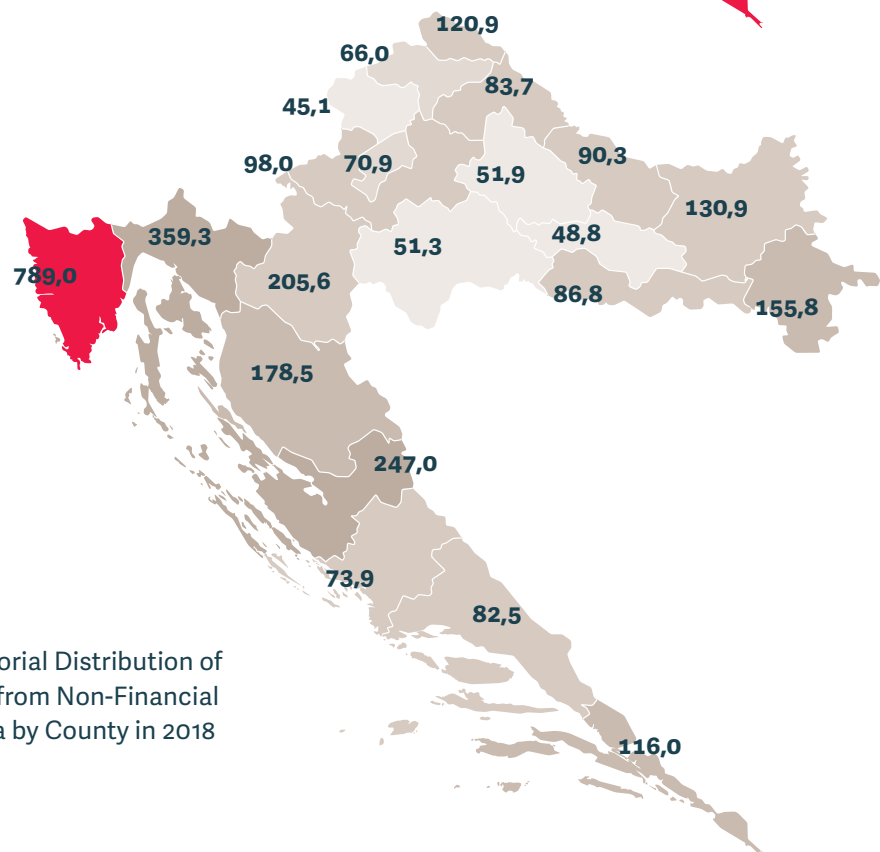
**Figure A7.4.** Territorial Distribution of LRGUs' Administrative Fees and User Charges per Capita by County in 2018

Source: Authors.



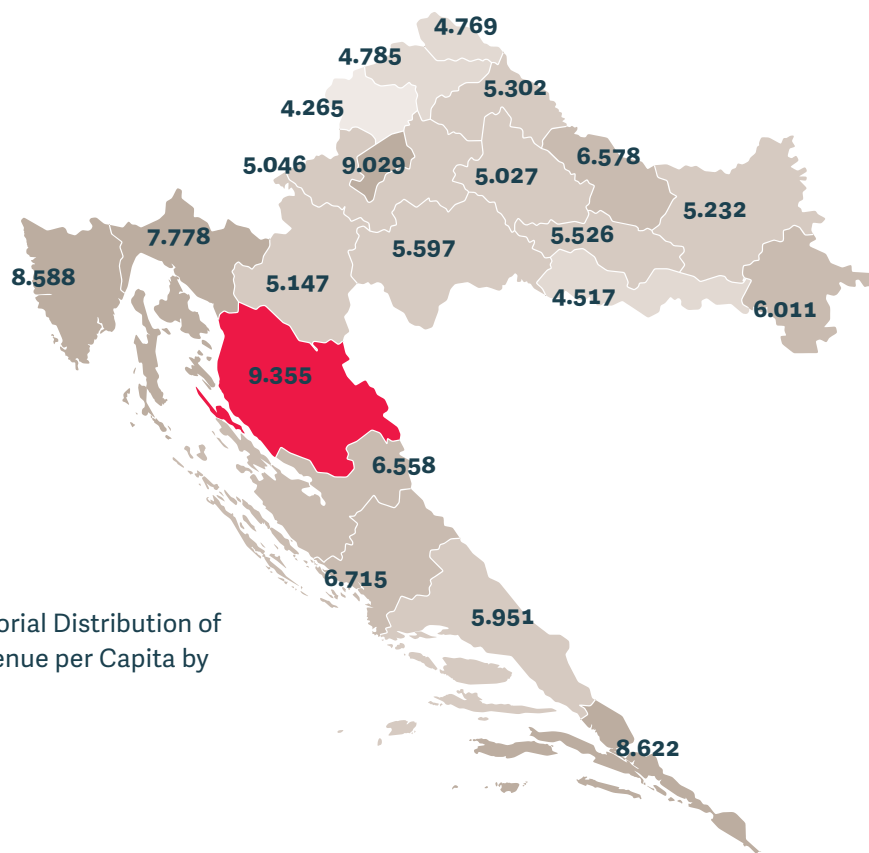
**Figure A7.5.** Territorial Distribution of LRGUs' Other Revenue per Capita by County in 2018

Source: Authors.



**Figure A7.1.** Territorial Distribution of LRGUs' Revenue from Non-Financial Assets per Capita by County in 2018

Source: Authors.



**Figure A7.7.** Territorial Distribution of LRGUs' Total Revenue per Capita by County in 2018

Source: Authors.

## Annex 8. Fiscal Equalization and PIT Revenue Sharing

Until 2018, PIT revenues were shared in different proportions between counties, cities, and municipalities, with the allocation coefficients depending on the status of the local unit: city of Zagreb, ASNCs, HMAs, local units on islands with a joint financing agreement on capital projects of interest to island development, LGUs in supported areas, and LGUs without special status. Most significantly, this allocation of PIT revenue was aimed partly at mitigating horizontal fiscal disparities (fiscal equalization).

**Table A8.1.** PIT Distribution Scheme for ASNCs and HMAs (in %)

PERIOD	CENTRAL GOVERNMENT	COUNTY	CITY/ MUNICIPALITY	DECENTRALIZED FUNCTIONS	EQUALIZATION FUND FOR DECENTRALIZED FUNCTIONS
1.1.1994–1.4.2000	70	5	25		
1.4.2000–1.7.2001	60	8	32		
1.7.2001–1.1.2003	-	8	92		
1.1.2003–	-	10	90		
1.1.2015–	SPECIFIC STATUS FOR HMA AND ASNC ABOLISHED*				

Note: \*In 2016 and 2017, LGUs in HMAs with a development index between 75 and 125 percent on average (classified in groups III and IV) had a preferential distribution scheme, whereby the LGUs' share was 70.5 percent, the county retained 12 percent, the share for decentralized functions was 6 percent, the share for EU projects was 1.5 percent, and the share for financing capital projects of interest to the development of LGUs in HMAs was 10 percent.

Source: Law on Financing of Local and Regional Self-Government Units (OG 117/93, 33/00, 59/01, 107/01, 117/01, 150/02, 147/03, 132/06, 73/08, 25/12, 147/14, 100/15, 115/16, and 127/17).

Local units in ASNCs and HMAs enjoyed a privileged position in the tax revenue allocation system (table A8.1). They were entitled to 90 percent of the PIT collected in their area, while the counties they belonged to received only 10 percent of the funds. Moreover, local units in ASNCs did not participate in the replenishment of the equalization fund for decentralized functions. When the preferential tax sharing arrangement for ASNCs and HMAs was abolished in 2015, it was introduced in the same year for so-called supported areas (table A8.2), determined according to the development index as areas that are lagging behind in relation to the national average.

**Table A8.2.** PIT Distribution Scheme for Supported Areas (in %)

PERIOD	CENTRAL GOVERNMENT	COUNTY	CITY/ MUNICIPALITY	DECENTRALIZED FUNCTIONS	EQUALIZATION FUND FOR DECENTRALIZED FUNCTIONS
1.1.2015–1.1.2018		12	88		
1.1.2018–	SPECIFIC STATUS FOR LGUS IN SUPPORTED AREAS ABOLISHED				

Source: Law on Financing of Local and Regional Self-Government Units (OG 117/93, 33/00, 59/01, 107/01, 117/01, 150/02, 147/03, 132/06, 73/08, 25/12, 147/14, 100/15, 115/16, and 127/17).



The preferential position of local units on islands with joint financing agreements was reflected in their exemption from the obligation to finance the equalization fund for decentralized functions starting in 2007. The share of 16 percent of the PIT revenue collected in those LGUs was designated for their own capital project financing (table A8.3).

**Table A8.3.** PIT Distribution Scheme for Islands (in %)

PERIOD	CENTRAL GOVERNMENT	COUNTY	CITY/MUNICIPALITY	DE-CENTRALIZED FUNCTIONS	EQUALIZATION FUND FOR DECENTRALIZED FUNCTIONS	JOINT FINANCING OF CAPITAL PROJECTS	EU PROJECTS
1.1.1994–1.4.2000	70	5	25				
1.4.2000–1.7.2001	60	8	32				
1.7.2001–1.1.2002		8	61.2	9.8	21		
1.1.2002–1.1.2003		8	61.6	9.4	21		
1.1.2003–1.1.2007		10	59.6	9.4	21		
1.1.2007–1.7.2008		15.0	52	12		21	
1.7.2008–1.3.2012		15.5	55	12		17.5	
1.3.2012–1.1.2015		16	56.5	12		15.5	
1.1.2015–1.1.2018		16.5	60	6		16	1.5
1.1.2018–	SPECIFIC STATUS FOR LGUS ON ISLANDS ABOLISHED						

Source: Law on Financing of Local and Regional Self-Government Units (OG 117/93, 33/00, 59/01, 107/01, 117/01, 150/02, 147/03, 132/06, 73/08, 25/12, 147/14, 100/15, 115/16, and 127/17).

## **Annex 9. Criteria for Determining the Minimum Financial Standards for Decentralized Functions**

### **FIREFIGHTING**

LGUs, which are the founders and co-founders of public fire departments, provide funding for employees and for material and financial expenditures. According to the Decision on Minimum Financial Standards for Performing the Activities of Public Fire Brigades in 2020 (OG 128/2019), the minimum financial standard for 2020 is set at a total of HRK 341,484,990. The criteria and benchmarks for setting minimum financial standards as a basis for planning grants for the decentralized function of firefighting to the founders and co-founders of public fire brigades in 2020 are:

- fixed assets - fixed allowance (20 percent of the total amount)
- classification of the unit according to vulnerability, capability, and resilience (20 percent)
- number of inhabitants in the area of the founder and co-founder that the fire brigade can reach in 15 minutes (25 percent)
- the area of the founder and co-founder that the fire brigade can reach in 15 minutes (5 percent)
- current average of financing from 2003 to 2019 (25 percent)
- other risks, additional activities on command, and correction for personal protective equipment (5 percent)

### **HEALTH CARE**

The Decision on Minimum Financial Standards for Decentralized Functions for Health Care Institutions in 2020 (OG 128/2019) sets minimum financial standards for:

- investment of health care institutions in space, medical and non-medical equipment, and means of transport
- investment and current maintenance of health care institutions: premises, medical and non-medical equipment, and means of transport
- informatization of health care

The minimum financial standard for 2020 is set at a total of HRK 407,549,130. The amount of funds allocated to an individual county, plus the city of Zagreb, is determined by applying the following criteria:

- the share of the number of insured persons in each county, plus the city of Zagreb, in relation to the total number of insured persons with the Croatian Health Insurance Institute (75 percent of the total amount)
- the share of the number of locations where health care activities take place in each county (and Zagreb) in relation to the total number of locations in Croatia (10 percent)
- the share of the number of health care institutions in each county (and Zagreb) in relation to the total number of health care institutions that have a contract with the Croatian Health Insurance Institute (5 percent)
- the share of the number of contracted beds in each county (and Zagreb) in relation to the total number of contracted beds with the Croatian Health Insurance Institute in Croatia (5 percent)

- Corrective criterion: the inclusion of projects of priority importance to raising the availability of health care or completing the started investments, taking into account the share of investments in the health care institutions (space, medical and non-medical equipment, and means of transport) of counties from the state budget in previous years (5 percent)

### PRIMARY EDUCATION

The Decision on the Criteria for Determining Balance Sheet Rights<sup>51</sup> for Financing the Minimum Financial Standard for Public Needs of Primary Education in 2020 (OG 128/2019) determines total balance sheet rights of LRGUs for:

- material and financial expenditures
- expenses for materials and parts for current and investment maintenance, current and investment maintenance services
- expenditures for the acquisition of produced fixed assets and additional investments in non-financial assets

The amount of funds allocated to an individual county, plus the city of Zagreb, is determined by applying the following criteria:

- For material and financial expenditures: the amount of these expenditures determined in 2019 (OG, 2/19), in accordance with the Economic and Fiscal Policy Guidelines for the period 2020–22 and the Budget Guidelines for LRGUs for the period 2020–22.
- For expenditures for current and investment maintenance: the number of students, classrooms, and school buildings in the school year 2019/20, based on average calculation prices as follows: per student HRK 62.00 per year, per class department HRK 1,032.77 per year, and per school building HRK 7,564.08 per year.
- For expenditures for the acquisition of produced fixed assets and additional investments in non-financial assets: the number of students, classrooms, and school buildings in the school year 2019/20, based on average calculation prices as follows: per student HRK 189.65 per year, per class department HRK 3,158.95 per year, and per school building HRK 4,990.19 per year.

### SECONDARY EDUCATION

The Decision on Criteria for Determining Balance Sheet Rights for Financing the Minimum Financial Standard of Public Needs of Secondary Schools and Student Dormitories in 2020 (OG 128/2019) determines total balance sheet rights for counties and the city of Zagreb for:

- material and financial expenditures
- expenditures for materials and parts for current and investment maintenance and current and investment maintenance services
- expenditures for the acquisition of produced fixed assets and additional investments in non-financial assets

<sup>51</sup> Balance sheet rights are the funds required to ensure minimum financial standards in a particular decentralized function according to decisions on minimum financial standards for a particular function.

The amount of funds allocated to an individual county, plus the City of Zagreb, is determined by applying the following criteria:

- For material and financial expenditures: amount of these expenditures determined in 2019 (OG, 2/19), in accordance with the Economic and Fiscal Policy Guidelines for the period 2020–22 and the Budget Guidelines for LRGUs for the period 2020–22
- For expenditures for current and investment maintenance: the number of students, classrooms, and school buildings in the school year 2019/20, based on average calculation prices as follows: per student HRK 64.74 per year, per class department HRK 1,246.62 per year, and per school building HRK 11,553.76 per year for secondary schools and HRK 492.23 per year per student for dormitories.
- For expenditures for the acquisition of produced fixed assets and additional investments in non-financial assets: the number of students, classrooms, and school buildings in the school year 2019/20, based on average calculation prices as follows: per student HRK 177.91 per year, per class department HRK 3,425.65 per year, and per school building HRK 6,847.83 per year.

The criterion for determining the balance sheet rights for co-financing in student dormitories in counties and the city of Zagreb is the number of students enrolled in the school year 2019/20. The measure is the average price of HRK 6,300 per student for I–IV class.

#### **SOCIAL CARE – SOCIAL WELFARE CENTERS**

The Decision on Minimum Financial Standards and Criteria for Financing Material and Financial Expenditures of Social Welfare Centers and Firewood Costs for Users Heated with Wood in 2020 (OG 128/2019) sets minimum financial standards for counties and the city of Zagreb for material and financial expenditures of social welfare centers headquartered in their area. The criterion for material and financial expenditures is the number of employees in the social welfare center. The measure is the average monthly amount of funds per worker. Counties and the city of Zagreb provide funds for firewood costs to users heated with wood. The criterion for the expenditure of heating costs is the number of users planned in 2019. The measure is the amount of HRK 1,050 per user.

#### **HOMES FOR THE ELDERLY AND INFIRM (NURSING HOMES)**

The Decision on Minimum Financial Standards and Criteria for Decentralized Financing of Homes for the Elderly and the Infirm in 2020 (OG 128/2019) sets minimum financial standards for counties and the city of Zagreb for expenditures for employees, material and financial expenditures, and expenditures for the acquisition of non-financial assets and emergency interventions.

Criteria for financing expenditures for employees are determined by the number of employees, that is, per beneficiary (of permanent accommodation, adjusted coefficient of 20 percent for beneficiaries of home help and delivery and preparation of meals for external beneficiaries), according to:

- a regulation determining the minimum conditions for the provision of social services

- the law that regulates salaries in public services and, according to the regulation, that determines job titles and coefficients of complexity of jobs in public services
- the basis for calculating the salary of employees in public services determined by a collective agreement or a decision of the Government of the Republic of Croatia
- the provisions of the Basic Collective Agreement for Civil Servants and Employees in Public Services and the Collective Agreement for Social Welfare Activities, which apply as legal rules

**THE MEASURE FOR SETTLING MATERIAL AND FINANCIAL EXPENDITURES IS THE NUMBER OF BENEFICIARIES.**

Criteria for financing the expenditure of non-financial assets are determined per beneficiary according to:

- a regulation laying down minimum conditions for the provision of social services
- the condition of the space and equipment according to the intensity of investment in previous years and investment per beneficiary

The counties and the city of Zagreb secure, per home for the elderly and infirm, HRK 150,000 per year for emergency interventions (investment maintenance, equipment and procurement of non-financial assets).

## Annex 10. Legal Framework for Subnational Government

- Budget Act (OG 87/2008, 136/2012, 15/2015)
- Decision on Minimum Financial Standards for Performing the Activities of Public Fire Brigades in 2020 (OG 128/2019)
- Decision on Minimum Financial Standards for Decentralized Functions for Health Care Institutions in 2020 (OG 128/2019)
- Decision on Criteria for Determining Balance Sheet Rights for Financing the Minimum Financial Standard for Public Needs of Primary Education in 2020 (OG 128/2019)
- Decision on Criteria for Determining Balance Sheet Rights for Financing the Minimum Financial Standard of Public Needs of Secondary Schools and Student Dormitories in 2020 (OG 128/2019)
- Decision on Minimum Financial Standards and Criteria for Financing Material and Financial Expenditures of Social Welfare Centers and Firewood Costs for Users Heated with Wood in 2020 (OG 128/2019)
- Decision on Minimum Financial Standards and Criteria for Decentralized Financing of Homes for the Elderly and the Infirm in 2020 (OG 128/2019)
- Decision on the Classification of Local and Regional Self-Government Units according to the Level of Development (OG 132/17)
- Decree on the Donation of Real Estate Owned by the Republic of Croatia (OG 123/11, 129/11, 95/18)
- Hunting Act (OG 99/18, 32/19, 32/20)
- Hydrocarbon Exploration and Exploitation Act (OG 52/18, 52/19)
- Law on Administrative Fees (OG 115/16)
- Law on City of Zagreb (OG 62/01, 125/08, 36/09, 119/14, 98/19)
- Law on Civil Servants and State Employees in the Local and Regional Self-Government (OG 86/08, 61/11, 04/18, 112/19)
- Law on Concessions (OG 69/17)
- Law on Determining Tasks from the Self-Governing Scope of Local Self-Government and Government Units (OG 75/1993)
- Law on Execution of the State Budget of the Republic of Croatia for 2020 (OG 117/19, 32/20, 42/20)
- Law on Financing Local and Regional Self-Government Units (OG 127/17, 138/20)
- Law on Financing of Local Self-Government and Government Units (OG 117/93, 33/00, 59/01, 107/01, 117/01, 150/02, 147/03, 132/06, 73/08, 25/12, 147/14, 100/15, 115/16)
- Law on Forests (OG 68/18, 115/18, 98/19)
- Law on Local and Regional Self-Government (OG 33/01, 60/01, 129/05, 109/07, 125/08, 36/09, 150/11, 144/12, 19/13, 137/15, 123/17, 89/19)
- Law on Local Self-Government and Government (OG 90/1992)
- Law on Local Taxes (OG 115/16, 101/17)
- Law on Maritime Property and Seaports (OG 158/03, 100/04, 141/06, 38/09, 123/11, 56/16, 98/19)
- Law on Protection and Preservation of Cultural Property (OG 69/99, 151/03, 157/03, 100/04, 87/09, 88/10, 61/11, 25/12, 136/12, 157/13, 152/14, 98/15, 44/17, 90/18, 32/20)
- Law on Regional Development of the Republic of Croatia (OG 147/14, 123/17, 118/18)
- Law on Regulation of Property Relations for the Construction of Infrastructure Buildings (OG 123/11 and 129/11, 95/18)
- Law on Right of Access to Information (OG 25/2013, 85/2015)
- Law on Salaries in Local and Regional Self-Government (OG 28/2010)
- Law on State Administration System (OG 66/19)
- Law on Supported Areas (OG 118/18)

Law on System of Strategic Planning and  
Development Management of the  
Republic of Croatia (OG 123/17)

Mining Act (OG 56/13, 14/14, 52/18, 115/18,  
98/19)

Ordinance on Budget Accounting and  
Accounts Plan (Official Gazette 124/14)

Personal Income Tax Act (OG  
115/16, 106/18, 121/19, 32/20, 138/20)

Real Estate Transfer Tax Act (OG 115/16,  
106/18)

Regulation determining the manner of  
calculating equalization grants for the  
decentralized functions of local and  
regional self-government units for 2020  
(OG 128/2019)

State Asset Management Act (OG 52/18)

Utilities Act (OG 68/18, 110/18, 32/20)

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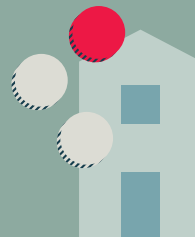
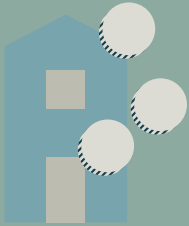
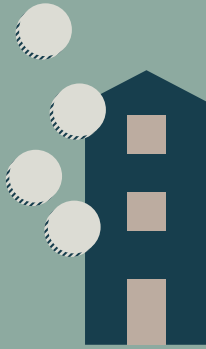
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Croatia Country Office  
Radnička cesta 80/IX, Zagreb  
Tel: +385 (0)1 2357 222  
[www.worldbank.org/croatia](http://www.worldbank.org/croatia)  
f WorldBankCroatia