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Local Innovations for Growth in Central and Eastern Europe

Chapter 12

Tackling the Problem of Inadequate Financing for Local Development: The Case of Croatia

by
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Local and regional governments everywhere share the problem of inadequate financing. The main revenue source for financing local and regional development projects is the local and regional budget. The revenue sources for capital projects are limited. The solution for local and regional government is to find additional revenue sources for development projects. Most sub-national authorities are unprepared or unable to take on increased responsibilities for fund raising directed to economic development. In order to tackle this challenge, municipalities and cities must gain the skills and information needed to budget for the current and future years; the ability to understand the impact of borrowing on infrastructure – both annual debt service and annual operational and maintenance expenditures – and the ability to identify, prioritise and plan capital investment. Municipalities and cities facing a shortage of investment capital must be able to identify and analyse technical and financial options and show investors that they have adequate and reliable revenues to meet their debt service obligations.

This chapter explores the role of the local level of government in financing local development projects in Croatia. It explains the present model of financing of local self-government units and, the basic composition of local government revenues and expenditures, and makes an assessment of the strengths and weaknesses of local governments' systems of financing. The chapter then details the potential sources of finance for local development projects. It highlights limitations at the local level of government in financing local development projects. The last section summarises our analysis and offers several recommendations that would lead to improved financing of local development in Croatia.

Present model of financing of local self-government units

Structure of local government revenues and expenditures

Croatia has today a two-tier system of sub-national government. Municipalities, towns and cities represent the local level of government and counties represent the regional level of government. The City of Zagreb has the status of a local and regional level of government.

Following the latest amendments, the territory of Croatia consists of 426 municipalities and 123 towns (cities) at local level, the City of Zagreb and 20 counties at regional level, which makes a total of 570 sub-national units.

Several important laws are the legal basis of the local government financing system.[1] The Law on Local and Regional Self-Government Financing defines sources for financing the operations of municipalities, towns (cities) and counties, various types of taxation, the distribution of funds among the different levels, the tax base, taxpayers, rates, as well as the calculations and forms of tax payment.

Local and regional self-government unit secures revenue through:

- own sources,
- shared taxes,
- grants from the state and county budgets,
- equalisation transfers for decentralised functions, and
- shared revenues,

  in addition to
- borrowing.

Local governments' own sources include income from local governments' own property, from county, city or municipal taxes (see Table 12.1), fines, fees, and charges.

Croatian law outlines the distribution of shared revenues between the state and local authorities. Local self-government units are entitled to the revenue from shared taxes and fees collected within their area, at a percentage stipulated by the law. Shared taxes are income tax, profit tax, and tax on real estate transactions (see Table 12.2 and Table 12.3).

The income realised through income tax is distributed in such a manner as to distinguish between municipality and city finances and between decentralised functions in selected public services including education, health care, social welfare and fire-protection, with respect to the special area that a local government unit is part of. A distinct allocation of income tax is provided for the City of Zagreb (47%).

A new distribution of income tax among the state, municipalities, cities and counties was introduced at the end of 2002. It left the share of other shared tax revenues (profit tax and tax on real estate transactions) the same as in the previous year. The share of income tax for municipalities and cities amounted to 34%, increased by the allowance for activities taken over by the units (2.9% share for primary education and 1% for public fire brigades). The share of the state budget in income tax after changes amounted to 25.6%, while the state ceded in full its share of income tax to areas of special state concern, mountainous areas and islands that finance capital projects. The state cedes its share of income tax (25.6%) to municipalities and cities on islands that concluded an agreement on the financing of capital projects of joint interest for the development of islands. Those were mainly water supply and physical planning projects, and the upgrading of transport infrastructure.

Table 12.1. **Local and regional self-governments' taxes**

Municipal, town and city taxes	County taxes
Surtax on income tax	Tax on inheritance and gifts
Consumption tax	Tax on motor vehicles
Tax on vacation homes	Tax on boats and vessels
Tax on idle lands	Tax on gambling machines
Tax on unused commercial real estate	
Tax on unused building plots	
Tax on firm or name	
Tax on the use of public surfaces	

Source: Author's compilation.

The major change in revenue sources for municipalities and counties is the authority to introduce new municipal and city taxes, as well as the possibility of introducing different levels of surtax on income tax[2] depending on the size of the municipality.

The distribution of shared revenue sources between the state and sub-national government has changed. The most significant change is in the distribution of income tax revenues, with a larger part of income tax revenue going to local government units. A special part of income tax revenue is reserved for covering expenditures regarding decentralised functions in primary and secondary education, health care, social welfare and fire protection (see Table 12.2). Local government units that do not have enough resources to finance decentralised functions can draw on equalisation grants for these functions.

The changes described in the financing of the system of local and regional government have focused on one major objective – the transfer of responsibilities in providing part of public services to the local and regional level and at the same time securing revenues to finance the responsibilities transferred.

The amendments to the Law on Local and Regional Self-Government Financing resulted in an increase of the share of public revenues ceded to the municipalities, cities and counties. The share of unconsolidated revenues of local and regional self-government units in GDP increased from 5.6% in 2000 to 7.4% in 2003.

On the basis of available data for fiscal 2003, the respective shares of local and regional budget revenues in consolidated general government budget revenues amounted to 9.40% and 4.67% of GDP. The data show that two major goals of the decentralisation process, greater participation of local and regional self-government in the consolidated general government budget and a more efficient public sector, have not yet been achieved.[3]

The share in the distribution of revenue from profit tax for municipalities, towns and cities is 20%, for counties 10%, and for the state 70%.

Table 12.2. **Distribution of shared taxes**

Shared taxes	Central government budget	Counties	Municipalities, towns and cities
Income tax	25.6% share of income tax for equalisation fund 21%	10% + additional share of income tax for decentralised functions 9.4%	34% + additional share of income tax for decentralised functions 2.9%
Profit tax	70%	10%	20%
Tax on real estate transactions	40%	–	60%

Source: Author's compilation.

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Table 12.3. **Additional share of income tax for decentralised functions**

Function	Additional share of income tax, %
Education	
Primary	2.9
Secondary	2.0
Health care	
Health care institutions	2.5
Social welfare	
Social welfare centres	0.4
Old age homes	1.6
Fire protection	
Public fire brigades	1.0

Source: K. Davey, "Report on Fiscal Decentralisation in South Eastern Europe", SEE Ministerial Conference on "Effective Democratic Governance at the Local and Regional Level", Zagreb, 26 October 2004, p. 4.

The share in the distribution of revenue from tax on real estate transactions for municipalities, towns and cities is 60%, and for the state 40%.

Regarding grants, transfers or subsidies, a system of financing community needs has been designed in such a way that grants are used solely as funds to support local self-government units with poor fiscal capacity.[4]

Equalisation grants for decentralised functions are drawn from the state budget to cover public expenses in the area of primary and secondary education, social welfare, and health care and fire protection, which are transferred to local and regional self-government units.

Shared revenues of the state, municipality and city is the revenue from agreed annual concession fees for pumping mineral and thermal water, and for the use of water for the public water supply.

Apart from the aforementioned taxes and grants, local self-government units have numerous other revenues in application of special acts or decisions of representative bodies, such as charges and fees, which are contained in the non-tax revenues of their budget and set forth there.

Viewed as a whole, current revenue accounts for the major share of the total revenues of municipalities, cities and counties. The share of capital revenues amounted to 4.6% in 2003. The share of grants amounted to 14.6% in 2003. The share of tax revenues in total revenues was 56% (see Table 12.4).

The largest share of the tax income of sub-national government units is collected from their share in the distribution of revenues from shared taxes (income tax and surtax on income tax[5] and profit tax). Altogether, it accounts for approximately 50.5% of total revenue in 2003.

Own tax revenues of sub-national budgets amount to only 2.5% of the total tax revenues of towns, municipalities and counties.

Table 12.4. **Total revenues and grants of sub-national budgets, in 000 HRK and %**

Revenues	2002		2003	
I. Total revenues and grants	9 595 090	100.0	10 554 899	100.0
I.A. Total revenues	8 328 336	86.8	9 008 108	85.4
I.A.I. Current revenues	7 830 809	81.6	8 527 776	80.8
– Tax revenues	5 477 139	57.1	5 906 130	56.0
Income tax and surtax	3 863 377	40.3	4 083 336	38.7
Profit tax	1 055 017	11.0	1 244 040	11.8
Property tax	329 418	3.4	315 914	3.0
Sales tax and other taxes	229 326	2.4	262 839	2.5
– Non-tax revenues	2 353 671	24.5	2 621 646	24.8
I.A.II. Capital revenues	497 527	5.2	480 332	4.6
I.B. Grants	1 266 754	13.2	1 546 792	14.6

Note: Data refers to 53 local government units (20 counties, the City of Zagreb and 32 big cities).

Source: Ministry of Finance, 2004. Annual Report of the Ministry of Finance for 2002-2003 Year. Zagreb: Ministry of Finance. Available from *www.mfin.hr/godisnjak*.

Non-tax revenues of all sub-national budgets amount to 24.8% of total revenues and grants. If non-tax revenues are added to the own tax revenues and capital revenues, the share is considerably higher, rising to 31.9% of total sub-national budget.

In the structure of total expenditures of local and regional self-government units, current expenditures amounted to 72.8%. The largest share of total expenditures is accounted for by expenditures for the purchase of goods and services, transfers and labour expenditures (see Table 12.5).

Table 12.5. **Sub-national budget expenditures, by economic classification, in %**

Expenditures	2002		2003	
I. Total expenditure and lending minus Repayments	8 770 288	100.0	10 458 376	100.0
II. Total expenditures	8 680 768	99.0	10 296 246	98.5
III. Current expenditures	6 863 830	78.3	7 617 598	72.8
1. Wages and employer contributions	1 900 678	21.7	2 001 555	19.1
2. Material expenditures	3 270 658	37.3	3 551 369	34.0
3. Financial expenditures	111 620	1.3	75 639	0.7
4. Subsidies and other current transfers	1 580 874	18.0	1 989 036	19.0
IV. Capital expenditures	1 816 938	20.7	2 678 648	25.6
V. Lending minus repayments	89 520	1.0	162 130	1.6
Overall deficit/surplus	824 802	9.4	96 523	0.9

Note: Data refers to 53 local government units (20 counties, the City of Zagreb and 32 big cities).

Source: Ministry of Finance, 2004. Annual Report of the Ministry of Finance for 2002-2003 Year. Zagreb: Ministry of Finance. Available from *www.mfin.hr/godisnjak*.

The strengths and weaknesses of local government finance

The problems of financing municipalities, towns, and counties are complex and call for continual monitoring and analysis, constant adjustment, and proposals for further research.

Two major issues that affect intergovernmental finance need to be pointed out: first, changes in administrative and territorial organisation and second, frequent changes of laws.

Constant changes in administrative and the territorial setup of Croatian territory at local and regional level have made it impossible to evaluate the new approach to the overall intergovernmental finance system.

The existing organisation of local and regional self-government is not efficient in terms of fiscal capacity; this is indicated by the data obtained from budget analyses. Abolishing the autonomy of local self-government units and merging them with neighbouring municipalities and towns, or any other change which would affect the present territorial organisation, is not an approach which should be supported at this time. Before making such a radical change, the existing possibility of connecting municipalities, towns and counties should be drawn on to implement development projects which cannot be financed individually.

The laws that determine various aspects of intergovernmental finance have been modified quite frequently and these frequent changes have also affected local and regional financing in many areas. Such practices create much uncertainty regarding the ability to forecast long-run revenues and expenditures at local and regional level.

Few local government units are able to manage the financial aspects of their development needs using advanced techniques, such as project budget planning methods or the conduct of long-term benefit studies of the local financing strategies. About one third of local government units in Croatia cannot cover current expenditures with current revenues, yet the basic responsibilities to be financed are equal for all local government units. This raises the local and regional government units' dependence on central government transfers to provide the mandatory services: indeed, even the mandatory services may not be provided assuming no sanctions will apply. This means that the financing of local development projects in future will depend on available revenues from the state budget.

Sources for financing local development projects

Local governments everywhere share the problem of inadequate financing. The structure of expenditures in local budgets shows that current expenditures tend to exceed the availability of resources. For reasons of economic development the structure of expenditures needs to be completely different.

The lack of public funds is the predominant reason for the involvement of the private financial sector in providing local and regional investment and development projects. Apart from the lack of public funds, there are several other reasons for involvement of the private sector in the financing of development projects:

- increasing local and regional needs,
- inadequate structure of local and regional revenues,
- the size of local and regional development projects, and
- limitations regarding borrowing at local and regional level.

Several potential sources for financing local development projects could be tapped. They are reviewed in the following section.

Local and regional budget

The Law on Local Self-Government Financing and the Law on the State Budget govern the drafting, adoption, execution, balance and reporting of local and regional budgets and transfers between sub-national and central government.

Total revenues and grants to municipalities, cities and counties in 2003 amounted to HRK 10.6 billion. In the structure of total revenues, the outturn of current revenues accounted for the largest share. In 2003 capital revenues amounted to HRK 480 million, but their share in total revenues was only 5%. Since capital revenues are derived from the sale of assets that are mostly in the ownership of cities and municipalities, and to a lesser extent in the ownership of counties, their share in budgets of cities and municipalities was higher as well.

Capital expenditures in 2003 were financed not only out of capital revenues, but also from the outturn of current revenues, unutilised funds carried forward from the previous year, and the proceeds of borrowing.

The largest share in total capital expenditures (78% for 2002 and 75% for 2003) was accounted for by expenditures for acquisition of fixed material assets (communal infrastructure, school and health institutions, cultural objects, pre-school institutions, business zones, business buildings, reconstruction and construction of roads, sports and recreation centres, etc.).

Capital transfers accounted for 19% of transfers in total capital expenditures for 2003, 4% up on 2002. They were mainly earmarked for non-profit organisations for non-economy investment, procurement of equipment and procurement of material assets by companies owned by local units.

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Local borrowing for capital purposes

There are two methods of local borrowing for capital purposes:

- through loans from financial institutions and other credit institutions, and
- through the capital market (issuance of securities and municipal bonds).

Loans

The most revolutionary change put into effect by the relatively new legislation in transition countries was to give local and regional government power to contract medium or long-term loans for public investment of local interest or to refinance the local public debt. Previously, such investments were financed solely from their own revenues plus central budget transfers, which created difficulties due to delays in approving and transferring funds from the central budget to local budgets. All loans contracted by local and regional authorities are part of total public debt in a country. However, such loans are not the responsibility of the central government, and they must be repaid out of the incomes with which they were guaranteed by local and regional authorities.

Local and regional authorities can contract internal loans with a government guarantee and with the approval of the Ministry of Finance.

The situation in Croatia is more or less the same as in most transition countries. In the absence of capital revenues, and with a view to meeting the needs for financing capital projects, local and regional self-government units were given the opportunity to borrow in line with the provisions of the Budget Law on the Execution of the State Budget and the Instructions of the Minister of Finance.

The Law on the Execution of the State Budget for 2002 and 2003, stipulates that counties, cities, and municipalities may borrow only in the domestic money and capital markets, and that contractors undertaking capital projects are to be financed from their budgets. This is confirmed by the representative body with the preliminary approval of the government.

For the first time in 2003 restrictions were imposed by the decisions on the execution of the budget which stipulate that the operating revenues and revenues from sale of material assets are should equal or exceed the operating expenditures and expenditures for acquisition of material assets, and that the Croatian Government may issue approvals for borrowing of local and regional self-government units not exceeding 2% of total planned expenditures of all local and regional self-government units covered in the financial report.

In addition, the municipalities, cities, and counties may guarantees borrowing by a public institution or company of which they are the founder and majority owner. The guarantee mentioned above is included in the annual borrowing of the respective unit. The annual liability for loans, guarantees, and other outstanding commitments (arrears) may account for no more than 20% of the own properties of units, and is subject to the approval of the State Audit Office and the Ministry of Finance.

Local borrowing is authorised by budget legislation. Short-term borrowing has aimed to cover cash flow irregularity and must be repaid within the same fiscal year. Long-term borrowing has aimed to finance capital investment expenditures in accordance with criteria to be specified and debt can be incurred domestically.

Local borrowing limits are defined annually in the State Budget Act, which leads to the risk that the framework for borrowing will evolve in an unpredictable manner.

Municipal bonds

Municipal bonds are securities issued by a state, city, or local government. Municipalities issue bonds to raise capital for their day-to-day activities and for specific projects that they may be undertaking (usually pertaining to development of local infrastructure such as roads, sewerage, hospitals etc). Interest on municipal bonds is generally exempt from federal, state and local taxes.

Capital gains however are taxable. Given the tax-savings they offer, municipal bonds are often bought by people who have high tax liabilities. The yields on municipal bonds are often lower than on corporate or treasury bonds with comparable maturities, because of the considerable advantage of exemption from federal tax. In general, municipal bonds are considered safer than corporate bonds, since a municipality is far less likely to go bankrupt than a company.

Some municipal bonds can also be insured by outside agencies. These companies will promise to pay the interest and principal if the issuer defaults. Both issuers and bondholders can carry this insurance, though a bondholder would need to have a large stake to obtain coverage.

There are two common types of municipal bonds: General obligation and Revenue. General obligation bonds are unsecured municipal bonds that are backed simply by the faith and credit of the municipality. Generally, these bonds have maturities of at least 10 years and are paid off with funds from taxes or other fees. Revenue bonds are used to fund projects that will eventually create revenue directly, such as a toll road or lease payments for a new building. The revenues from the projects are used to pay off the bonds. In some cases the issuer is not obligated to pay interest unless a certain amount of revenue is generated.

In the United States, municipal bonds usually come in USD 5 000 par values and require a minimum investment of USD 25 000 in order to get the best price. (*www.investorwords.com /3162/municipal_bond.html*)

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There are only a few examples of municipal bonds being issued to raise capital for local development project in Croatia.[6]

Privatisation

Privatisation means the repurchase of all of a company's outstanding stock (the shares of a corporation that have been issued and are in the hands of the public) by employees or a private investor. As a result, the company is no longer publicly traded. Sometimes the company may have to take on significant debt to finance the change in ownership structure. A company might want to go private in order to restructure its businesses (when it feels that the process might affect its share price adversely in the short run). It might also want to go private to avoid the expense and regulations associated with remaining listed on a stock exchange.

Privatisation also means the process of moving from a government-controlled system to a privately-run for-profit system.

The aim of introducing the private sector into the provision of public services is to provide additional resources for financing public programmes for different public services. The concept of privatisation includes participation of the private sector in the construction, ownership, organisation and supply of public services. The concept can be applied to different kinds of infrastructure projects (for example, water supply, wastewater and solid waste, public transportation, etc.).

The private sector has several advantages over the public sector in the provision of public services. The most important is that it may secure resources for the social, economic and developmental needs of a local community without additional financial effort by the community. This means that the local government, with the help of the private sector, will receive additional revenues for public services, supplementing limited local revenues for financing other public needs.

In Croatia the privatisation of companies whose majority owner or founder is a sub-national government unit has now started.[7]

Public-private partnership

A public-private partnership (PPP) is a partnership between the public and private sectors for the purpose of delivering a project or service traditionally provided by the public sector. PPP recognises that the public sector and the private sector have each certain advantages relative to the other in the performance of specific tasks. By allowing each sector to do what it does best, public services and infrastructure can be provided in the most economically efficient manner.

There are several models of PPP, with variations and combinations, that the local authority may turn to for undertaking infrastructure projects:

Build-and-Transfer (BT): A contractual arrangement whereby the developer undertakes the financing and construction of a given infrastructure or development facility and after its completion hands it over to the government, government agency or the local authority. The government, government agency or the local authority will reimburse the total project investment, on the basis of an agreed schedule. This arrangement may be employed in the construction of any infrastructure or development projects, including critical facilities which for security or strategic reasons must be operated directly by the government or government agency or the local authority.

Build-Lease-and-Transfer (BLT): A contractual arrangement whereby a developer undertakes to finance and construct an infrastructure project and upon its completion hands it over to the government or government agency or the local authority concerned on a lease arrangement for a fixed period, after which ownership of the facility is automatically vested in the government or government agency or the local authority concerned.

Build-Operate-and-Transfer (BOT): A contractual arrangement whereby the developer undertakes the construction, including the financing, of a given infrastructure facility, and the operation and maintenance thereof. The developer operates the facility over a fixed term during which he is allowed to charge facility users appropriate tolls, fees, rentals and charges not exceeding those proposed in the bid, or as negotiated and incorporated in the contract, to enable the recovery of the investment in the project. The developer transfers the facility to the government or government agency or the local authority concerned at the end of the fixed term specified in the concession agreement. This includes a supply-and-operate arrangement, which is a contract whereby the supplier of equipment and machinery for a given infrastructure facility, if the interest of the government, government agency or the local authority so requires, operates the facility providing in the process technology transfer and training to persons nominated by the government, government agency or the local authority s.

Build-Transfer-and-Operate (BTO): A contractual arrangement whereby the government or government agency or the local authority contracts out an infrastructure facility to a developer to construct the facility on a turnkey basis, assuming cost overruns, delays and specified performance risks. Once the facility is commissioned satisfactorily, the developer is given the right to operate the facility and collect user levies under a concession agreement. The title of the facilities always vests in the government, government agency or the local authority.

Contract-Add-and-Operate (CAO): A contractual arrangement whereby the developer adds to an existing infrastructure facility which it rents from the government, government agency or the local authority, operates the expanded project and collects user levies to recover the investment over an agreed franchise period. There may or may not be a transfer arrangement with regard to the added facility provided by the developer.

Develop-Operate-and-Transfer (DOT): A contractual arrangement whereby favourable conditions external to a new infrastructure project which is to be built by a developer are integrated into the BOT arrangement by giving that entity the right to develop adjoining property and thus enjoy some of the benefits flowing from the investment such as higher property or rent values.

Rehabilitate-Operate-and-Transfer (ROT): A contractual arrangement whereby an existing facility is handed over to the private sector to refurbish, operate (collecting user levies in the operating period to recover the investment) and maintain for a franchise period, at the expiry of which the facility is turned over to the government or government agency or the local authority. The term is also used to describe the purchase of an existing facility from abroad, importing, refurbishing, erecting and consuming it within the host country.

Rehabilitate-Own-and-Operate (ROO): A contractual arrangement whereby an existing facility is handed over to the operator to refurbish and operate with no time limitation imposed on ownership. As long as the operator is not in violation of its franchise, it can continue to operate the facility and collect user levies in perpetuity.

Design-Build (DB): The private sector designs and builds infrastructure to meet public sector performance specifications, often for a fixed price. Here, the risk of cost overruns is transferred to the private sector. (Many do not consider DBs to be within the spectrum of PPPs).

Operation & Maintenance Contract (O & M): A private operator, under contract, operates a publicly owned asset for a specified term. Ownership of the asset remains with the public entity.

Design-Build-Finance-Operate (DBFO): The private sector designs, finances and constructs a new facility under a long-term lease, and operates the facility during the term of the lease. The private partner transfers the new facility to the public sector at the end of the term.

Build-Own-Operate (BOO): The private sector finances, builds, owns and operates a facility or service in perpetuity. The public constraints are stated in the original agreement and through on-going regulatory authority.

Build-Own-Operate-Transfer (BOOT): A private entity receives a franchise to finance, design, build and operate a facility (and to charge user fees) for a specified period, after which ownership is transferred back to the public sector.

Buy-Build-Operate (BBO): Transfer of a public asset to a private or quasi-public entity, usually stipulating under contract that the assets are to be upgraded and operated for a specified period of time. Public control is exercised through the contract at the time of transfer.

Operation License: A private operator receives a license or rights to operate a public service, usually for a specified term. This is often used in IT projects.

Finance Only: A private entity, usually a financial services company, funds a project directly or resorts to various mechanisms such as a long-term lease or a bond issue.

There are several interested partners in PPP. These are: public (especially consumers), building contractors, operators, maintenance services, suppliers, loan capital providers, investors and insurance companies.

Public-private partnership holds the promise of increasing the supply of infrastructure projects and other services without overburdening a country's public finances. An inflow of private capital and management can ease fiscal constraints on infrastructure investment and boost efficiency.

But PPP should be treated with great care. It is by no means certain that PPPs will be more efficient than traditional public investment. PPP can be used to move investment off budget and transfer debt off the government balance sheet, but the government still carries most of the risk and faces potentially large costs that will eventually be borne by taxpayers.

If PPPs are to deliver high-quality and cost-effective services to consumers and the government, there must be adequate risk transfer from the government to the private sector. The quality of services has to be contractually specified so that payments to service providers can be linked to performance and the risk of costly contract regeneration minimised. There has to be either competition or incentive-based regulations (Hemming and Ter-Minassian, 2005).

In Croatia there exist only a few examples of PPP. The majority of them are concession agreements for usage of some infrastructure projects.

External support and aid

An important source for financing of local and regional development projects in Croatia is the proceeds of loans and grants received from the international financial institutions – the International Bank for Reconstruction and Development (IBRD), the European Bank for Reconstruction and Development (EBRD), the Council of Europe Development Bank (CEB), and the European Investment Bank (EIB).

The IBRD has provided grants for the social and economic recovery project from funds received from the foundation set up by the government of Japan. The aim is to increase social cohesion in the area of special state concern (war damaged areas, undeveloped areas and the islands).

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The plan of activities of EBRD in Croatia involves some infrastructure financing, including encouraging the marketing, liberalisation and privatisation of infrastructure services.

The CEB is to finance infrastructure in the areas of special state concern by new loans currently under preparation.

The EIB has a mandate to finance infrastructure projects and private sector development projects in Croatia.

Extra budgetary resources

There are two major sources of extra budgetary funds[8] for financing local and regional capital projects. These are:

- the Fund for Regional Development, and
- the Fund for Development and Employment.

The major activity of the Fund for Regional Development is the stimulation of uniform regional development in the country at large. Revenue sources include the proceeds of: privatisations, the state budget, long-term bonds, loans from financial institutions, bilateral loans, donations, and other revenue sources.

In 2003 a total of approximately HRK 112 million was disbursed by the Fund for Regional Development for capital projects to the areas of local and regional self-government units. Incentives for the development of municipalities, cities and counties are planned within the funds of several ministries. This is mainly for co-financing of development programmes in the area of crafts, agriculture, small and medium-sized enterprises, etc.

The major activity of the Fund for Development and Employment as regards local and regional development is support to county programs that invest own-revenues for employment programs, development of enterpreneurship and construction of infrastructure facilities, as well as help and support in the establishment of business centres, development centres, industrial zones, incubators and technological parks. Revenue sources come from the proceeds of sales of state real estate, privatisation, state budget transfers, and other revenue sources.

Limitations at local level in financing local development projects

There are limitations at local level of government in financing local development projects. Several factors are recognised as major obstacles to local development financing.

The majority of small local authorities in Croatia are unprepared or unable to take on increased responsibilities for fund raising for economic development. This is because these authorities do not employ appropriately trained administrative staff. In most such small local self-government units, the staff members are responsible for different tasks (financial, legal, technical and other) and they do not have a chance to try to specialise in one business area. Local government officials and professionals lack know-how for assessing real and financial needs and accordingly lack the necessary communication and networking skills. This reflects into the many miscalculations observed in the current activities and planning of development projects. The result is a series of important obstacles to raising funds, especially for undertaking local borrowing for capital purposes.

In order to borrow responsibly, municipalities and cities must have:

- the skills and information to budget for the current year and future years (including both operating and capital budgets);
- the ability to understand the impact of borrowing on infrastructure (both annual debt service and annual operational and maintenance expenditures); and
- the ability to identify, prioritise and plan capital investment.

Municipalities and cities must be able to identify and analyse technical and financial options and show investors that they have adequate and reliable revenues to meet their debt service obligations (Kandeva, 2001).

Sometimes the difficulties stem from a lack of investment capital. The problem lies in the structure of expenditures in local government budgets whereas sub-national government is responsible for covering a wide range of public services.

Recommendations for improving the financing of local development

Local and regional governments everywhere share the problem of inadequate financing. The main revenue source for financing local and regional development projects is the local and regional budget. The revenue sources for capital projects are limited. The solution for local and regional government is to find additional revenue sources for development projects.

Most sub-national authorities are unprepared or unable to take on increased responsibilities for fund raising directed to economic development. One major problem is a lack of investment capital. Several other problems arise because of inadequate knowledge of regional and local administration regarding a need for implementing a clear strategy of regional and local development. The strategy has a major duty to render explicit the roles of the major actors involved in regional and local development.

Capital projects and programs hold considerable promise as ways to mobilise resources to provide results at local level. A clear strategy of regional and local development is one of the modern approaches aiming to create conditions for testable and balanced development of particular regions of a country, to reduce inter-territorial differences in employment and income and to realise regional and cross-national co-operation and integration. Financial resources for regional and local development should come from the budget but in the near future major financial resources should come predominantly from other sources.

Partnership between central, regional and local government, non-governmental organisations, private sector and all other major actors involved in regional and local development will create useful forms of efficient interaction, such as the participation of representatives of different institutions in the activities, initiatives, and procedural rules for consultations on drafting budgets or planning major capital projects in local areas. The existence of an active network of different actors is indicative of the awareness of the need for joint action and inter-institutional co-operation in revenue raising for local and regional development.

Finding money to invest in infrastructure and other public projects without jeopardising fiscal stability has become a hot topic in many countries seeking to boost economic growth. While looking for innovative ways to expand the private sector's role in providing infrastructure and other services, many countries are also focusing on how to make more room for public spending. The limitations are generated by two fiscal constraints: the overall fiscal balance and gross public debt, which are key fiscal indicators used by the IMF. These two indicators establish links between short-term macroeconomic stability and longer-term public debt sustainability.

The theoretical literature suggests that the poorer regions and local areas spend a larger proportion of their budgets on social expenditures, while their lower revenue base means that their per capita spending on such items remains significantly below that of the richer regions and local areas. There is evidence that the shares of spending on social items and on capital items are inversely related. Richer regions and local areas use their higher revenue capacities to finance more capital spending. Such conclusions have several important implications:

- lower capital spending may influence slower growth in poorer regions and local areas;
- lower economic growth means that the revenue capacities of poorer regions and local areas will continue to lag behind those of richer regions and local areas;
- in the absence of an adequate equalisation system, lower revenue capacities would doom poorer regions and local areas to inadequate social spending and

poor development of human capital, reinforcing the lower growth prospects in the future (Ter-Minassian, 1997).

To perform their major role in co-ordination and promotion of regional and local development, regional and local governments faces three main challenges.

The first is to improve the quality and operational efficiency of local and regional governments at the lowest cost. This implies raising local administration productivity, reducing public costs (central state, regional, municipal and city and other), rendering transparency in local government activities, and actively involving the community and citizens in local government.

The second challenge concentrates on restructuring the relationship between local governments and citizens and acknowledging that citizens are the customers of the local administration. The shift of focus to citizens as clients in the public sector depends upon two principal considerations. First, citizens are users of public services provided by local authorities for which they pay either directly or indirectly through the collection of fees and taxes. Second, any particular public service has a value, price and quality that have to correspond to the needs and requirements of citizens in their capacity as taxpayers and users of these services. Since citizens are clients in the public sector, they have to be protected against possible discrepancies in the "price-quality" correlation.

The third challenge is adjustment of local governments and local administration to the requirements and conditions of economic development of local and regional areas. Thus, it also includes the search for a reasonable balance between the public and private sectors at the local level and the use of private sector methods and approaches in local public management. Public procurement and other forms of contracting are tools of modern local government.

The growing trend to liberalisation, the shortage of funds in practically all budgets and the process of internationalisation are creating new market conditions in the infrastructure of transport, energy, environment and communal services. This means that public-private partnership is the keyword for development at state, as well as local and regional level. The state's control function is coupled to the operational efficiency of the private economy. Practice shows that PPP represent a viable and actively used project financing alternative in cases where the project is of sufficient size and has a high degree of self-financing secured by cash flow and in cases where efficiency improvements can be successfully realised.

The government of Croatia has started the process of decentralisation, moreover retaining it as the principle of its future work in many areas. The

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government has continued to express confirmation of its political will to pursue decentralisation. However, no documents presenting a detailed, implementation-level programme have been approved that set forth the objectives, work out the methods, impose concrete tasks, define who would be responsible, propose deadlines and provide yardsticks for performance measurement for the achievement of the aims of decentralisation (Jurlina Alibegović, 2004).

Finally, counties, towns and municipalities in Croatia should take advantage of the opportunities to co-operate, particularly having in mind the joint realisation of development projects for which individual local self-government units do not have adequate financial resources, but may benefit mutually from the project results. There is much benefit to be expected from enhanced co-operation between municipalities, cities and counties in order to achieve common goals and to increase the revenues necessary to finance local functions, as well as to collect more funds for investment in joint capital projects, and as a result, to improve their credit standing.

Notes

1. The Law on State Budget, the Law on Local and Regional Self-Government Financing, the Law on Execution of the State Budget, the Decree on the Mode of Calculation of Equalisation Grants for Decentralised Functions, the Decree on Budget Accounting, the Rules on Budget Accounting and Chart of Accounts, the Rules on Financial Reporting in Budget Accounting. In addition, the local units also have to abide by other special regulations relating to various areas of public spending.
2. The rate of surtax on income tax: municipalities may levy up to 10%, towns with a population below 30 000 inhabitants may levy a surtax of up to 12%, cities with over 30 000 inhabitants may levy a surtax of up to 15%, and the City of Zagreb may levy surtax of up to 30%.
3. The share of revenues of local and regional government in the total revenue of the consolidated general government in Croatia is much lower than in other transition countries. While in Croatia the share in total revenues of local government is 9.40%, this share in other countries is: 20.8% in the Czech Republic, 26.7% in Hungary, 28.8% in Poland, 22.1% in Estonia, 25.0% in Latvia and 22.8% in Lithuania (Ebel and Yilmaz, 2002).
4. For more details on grant system and equalisation grants in Croatia see Jurlina Alibegović (2004).
5. After the amendments to Law on Local and Regional Self-Government Financing in 2001 extended the possibility of the introduction of surtax on income tax to all municipalities and cities until the end of 2003, the number of local self-government units which introduced of surtax on income tax rose to 198 municipalities and cities.
6. The county of Istria was the first example of a local bond issuer in Croatia. Recently the City of Zadar has begun to issue municipal bonds to raise funds for specific development projects.

7. Debate on the process of privatisation of communal and other companies owned by the City of Zagreb started several years ago. But the City of Zagreb is owner or founder of more than 20 companies.
8. Revenues and expenditures of both Funds are now the part of the State Budget.

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ANNEX

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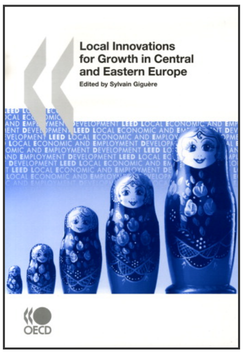

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