

Local Government Budgeting in Croatia¹

—One Year Later—

Katarina Ott and Anto Bajo

Institute of Public Finance, Zagreb

Summary

This paper aims to briefly describe the main problems of local government budgeting in Croatia a year ago and today. The problems are divided into those connected with the number and size of the local government units (LGUs), the budget itself and the budgetary process. For each problem, first the situation a year ago is analyzed, followed by the suggestions put forward at that time and, finally, the changes within one year are described. The basic conclusion is that it is less important where the budgeting functions are performed than how this is done. Therefore, we suggest further strengthening of the budget, budgetary techniques and budgetary process at all levels of government, a more powerful financial control mechanism at the central government level accompanied by an appropriate education of public officials and the general public.

Key words: local government budgeting, Croatia

Introduction

A lot of time and energy has been expended on fiscal decentralization issues. However, all our research has so far supported the approach that it is not important where but how the budgeting functions are performed.

This paper derives from a research project and a paper that we wrote in 2001. We then concentrated on some of the problems in the Croatian local government budgeting connected with the number and the size of the local government units (LGUs), the budget itself and the budgetary process. In this new version of the paper we

mainly repeat what we did a year ago—a description of the situation and suggestions for policymakers, but we also include the changes that occurred in the meantime. We think it would be interesting to see what these changes are and what conclusions we could draw from them.

Problems Connected with the Number and Size of the LGUs

Croatia has three tiers of government: (1) central government, (2) counties, and (3) municipalities and cities. Counties are units of local administration and local self-government, while cities and municipalities are units of local self-government only. The counties, cities and municipalities regulate their own internal organization and structure and the way they operate by their statutes. An overabundance of LGUs has resulted in an accumulation of oversized administrative machinery at several tiers of government and an inadequate distribution of functions and responsibilities. The situation has been aggravated by the establishment of areas of special national concern in response to the damage caused by the war.

The situation one year later. Since 2001, the central government has been able to devolve some administrative affairs not only to counties but also to local units (municipalities and cities). The authorities of prefects, mayors and heads are the same. Where the national administration affairs have been transferred to the competence of the county, city or municipality, there the prefect, mayor or head of a local unit is equally responsible to the administrative bodies of the central government.

Territorial Organization

Croatia is a small country (4.4 million people, 56.5 thousand square kilometers) with a large number of LGUs: 422 municipalities, 122 cities and 20 counties (plus the capital, Zagreb, which has the dual status of

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city and county). The large number of local units makes it impossible for the central government to get a realistic picture of their finances.

Every place that satisfies the formal criterion of a population of 10,000 can become a city. This means that there are cities that cannot justify the title either by their revenues or by the functions that are statutorily stipulated. The situation is similar with municipalities. The fashionable trend toward municipality establishment that took Croatia by storm in 1993, allowed any petty rural area to establish a municipality of its own. The main problem is illustrated by the amassing of administrative bodies and employees in these municipalities. Such LGUs are simply incapable of either financing their current expenditure or providing basic services in their areas. And so they depend on direct transfers from the government budget. In practice, this leads to a centralization of government, in spite of a theoretical territorial decentralization.

Suggestion. An optimum number of local units should be determined. A detailed analysis of the financial situation in local units and their ability to finance themselves and provide public services should be carried out. After that, a decision should be made as to a reduction in the number of existing municipalities and counties, which is unsustainable, and imposes a heavy burden upon the government budget.

The situation one year later. The trend towards the establishment of new local units has continued. Since 2001, three new municipalities have been established. It should be emphasized that the decisions on the establishment or the approval of the establishment of local units lies within the competence of the Ministry of Justice, Administration and Local Self-Government (hereafter: MPULS). It adopts its decision according to the opinions from the line ministries (e.g. the Ministry of Finance), counties, and other local units and competent institutions. There are cases in which decisions to establish new local units are taken in spite of a negative opinion of the competent body.

Oversized Administration at Several Tiers of Government

Administrative functions at the local level are performed by counties. The administrative functions performed by the administrative bodies of the counties are financed from the government budget, while the functions within the sphere of local self-government are financed from the county budgets. This duality is observable in the function of the prefect, who carries out the functions of

both the central government and local self-government. New laws envisage these functions being split between two officials. But before this is done, the National Administration System Law will have to be changed—something no one seems to have thought about.

The question has arisen about the accretion of administrative machinery at the county level. Given the widespread criticism aroused by cities and municipalities about the operation of counties and county bodies, it is essential to settle on the number of administrative bodies and the people employed within them. The existing administration at the county level is inefficient. Another problem is the level of salaries in the administrative services of local units, which exceeds that of the central government bodies. There are no evaluation criteria for the performance of the administrative services of local units; in most cases the system of rewarding good work and penalizing the bad is based on the internal regulations of the local units. The central government has practically no control over these regulations, or knowledge of their content.

Suggestion. In all local units (counties, municipalities and cities), the number of administrative units and their employees should be determined.

The situation one year later. Since 2001, all local units have been able to perform the operations related to self-government provided that they find the sources of financing. To make use of this possibility, it is still necessary to work out the transfer procedure. It is possible to establish a common administrative body for several local units². The MPULS can give the local communities the authority to manage administrative affairs, but it can also take it away. The question is whether local units will manage their administrative affairs through common administrative bodies or whether each of them will set up their own departments. The increase or reduction in the size of the administrative apparatus depends on this option. The MPULS endeavors to carry out the recommendations of the government to reduce the number of employees in the administrative bodies of the local units.

² The Local and Regional Self-Government Law (NN 33/01 and 60/01).

Table 1. Distribution of Authority Among the Levels of Government

Title	Central gov.	Municipalities	Cities	Counties
1. General public (administrative) services	X	X	X	X
2. Defense	X			
3. Law and order	X			
4. Education	X	X	X	X
4.1. Preschool		X	X	
4.2. Elementary	X	X	X	X
4.3. Secondary (high)	X			X
4.4. Tertiary (university)	X			
5. Health Care	X			X
6. Social security and welfare	X	X	X	X
7. Housing and utilities		X	X	
8. Recreation, culture and religion		X	X	X
9. Agriculture, forestry, hunting and fishing	X			X
10. Mining, industry and construction	X	X	X	X
11. Transport and communications	X	X	X	X
11.1. Road transport	X	X	X	X
11.2. Rail transport	X			
11.3. Air transport	X			
12. Other economic affairs and services	X	X	X	X

Inadequate Distribution of Functions and Responsibilities

Despite the many laws³, there is no clear delimitation of functions between the levels of government. As shown in Table 1, almost all functions are financed from both central and local government levels. Local governments do finance certain functions, such as welfare and secondary education, although they have no legal obligation to do so. Some healthcare functions have been devolved to the counties, although they are incapable of financing them (Table 1).

³ The principal laws regulating local self-government and administration are: The Local Self-Government and Administration Law (1992), The Local Self-Government and Administration Units Financing Law (1993), The Areas of the Counties, Cities and Municipalities Law (1993, 1997), The Budget Law (1994) and The City of Zagreb Law (1997). In 1997 Croatia ratified the European Charter about local self-government, accepting the principles laid down in the Charter.

Suggestions. It is necessary to distinguish between the functions of the central and local governments. The authority and responsibilities for the financing of functions, and the provision of public services at the local level, should be regulated by a single law.

Also, a clear distinction should be made between the rights and obligations of local units and those of the central government. This will motivate the individual local units to meet their obligations, and should these obligations be neglected, it will be easy to establish individual responsibility for mistakes and oversights.

The efficiency of financing the public expenditure of local units from the central government budget should be reassessed, particularly as concerns the financing of elementary and secondary education, health care, welfare, fire protection, and road maintenance and construction. Along with the decentralization of expenditure, a gradual decentralization of the local units' revenue should also be provided for.

The situation one year later: Quite important changes have taken place since July 2001, when the right to found secondary and elementary schools was devolved on local units. The government provides for a part of funds for financing the elementary education (in 32 cities) and secondary education by giving grants. The same applies to healthcare and welfare establishments. Besides the grants from the government budget, local units are allocated a larger share in common taxes (income tax) and can realize their own receipts.

It should be emphasized that the local units have not been given full authority to carry out decentralized functions, because the central government is still there as the founder and financier of both welfare and healthcare institutions. Through the system of sharing taxes and equalization grants the central government still exercises the central control of financing these functions. Thus, only partial (formal) decentralization of responsibility and financing has been provided. The state has retained financial control through the mechanism of fiscal grants.

Areas of Special National Concern

The situation has been aggravated by the creation of areas of special national concern in response to the damage caused by the war. These areas were set up for the purpose of a more rapid development, and they have a privileged status in financing. Through many tax exemptions, the government is attempting to jump-start the economic development of these regions.⁴ However, these development measures have never relied on any serious analysis, and there are no tested economic indicators of the development of the regions. Moreover, there are no accurate data on the number of employees in the administrative services, or employees in industry and business. The government currently provides grants from the central budget. However, the criteria are very questionable, as are the amounts of funds sent to these areas year after year.

⁴ In 2000, new tax incentives in the areas of special national concern were introduced. When it comes to the revenue shared between the central government and the local units in the next five years, the local units in the areas of special national concern will have the right to 92% of all revenue from personal income tax and 90% of profit tax revenue (compare with Table 4). This redistribution, or cession, in favor of the areas that were occupied and directly damaged in the war will last until the end of 2005. Apart from these tax benefits, local units in the areas of special national concern also receive subsidies and grants from the government budget, and receive other types of revenue in accordance with special laws and decisions of the local government representative bodies.

Suggestion. Realistic conditions and indicators of development in the areas of special national concern should be determined, and the efficiency of the government incentives aimed at improving the functions of the public sector in these regions should be assessed.

The situation one year later: The number of units in the areas of special national concern (PPDS) has not changed (there are still 111 such areas). However, the population of the PPDS has increased. Up to 2001, not all settlements of the cities and municipalities within the PPDS were necessarily part of the PPDS. Since 2001, however, all the settlements that are in the territory of the PPDS are involved in the PPDS. As a result, the number of inhabitants in the PPDS has increased from 364 to 482,000, i.e., by 117,000.

A model for the calculation of grants to local units in the PPDS has been worked out. It involves several criteria, and was first used in drawing up the plan of the Government budget for 2002. Since the criteria have a lifespan of only one year, they should be included in the Local and Regional Self-Government Financing Law.

Local units can only use grants for financing the obligatory expenditures laid down by law. Although this is not expressly stated, these are special-purpose grants.

Budget Related Problems

Budget related problems include inadequate classification of budgets, lack of budgetary classification, lack of fiscal capacity indicators, the absence of consolidation of LGU budgets, complicated accounting, non-uniformity in budget plans, lack of estimates and methodology, and the lack of a developed national treasury system.

A General View of the Budget Related Problems

Classification of Budgets

Classification of budgets does not support the separation of functions according to the level of government. Planning of the budget is carried out according to the account plan, which cannot be applied at the LGU level, because of the particular types of revenue and expenditure.

It is impossible to present the data on current and capital expenditure, and the data on utility charges, according to the economic and functional classifications. Thus, for example, some local units include the salaries and material expenses of employees in grants and current and capital transfers, although they should be

expressed as employee expenditure. The problem lies in the account plan of the budget(s), which does not provide the information about overall expenditure by a purely functional or economic structure (since economic, functional and institutional classifications are all mixed up). In order to obtain data by functions and economic categories, the data from financial reports and other sources have to be constantly adjusted, and this does not give a very realistic picture of the situation.

Suggestion. The obligation should be prescribed to separately keep detailed functional, administrative and economic classifications of all budgets of all government units.

The situation one year later. A new accounts chart has been adopted that makes possible the planning of the budgets of local units (counties, cities and municipalities) according to an economic, functional and organizational classification. All revenue/receipts and expenditures/outlays of the budget (clearly structured) are planned, but this time including the budget beneficiaries (their own revenues and revenues pursuant to special regulations).

In 2002, the plans of the local units' budgets included individual expenditures of each spending agency, but only for the part financed from the local budget. In drawing up the budget plan for 2003, a further step was taken, i.e. the budget plan shall also include the revenues derived by budgetary beneficiaries on the market from performing their basic and other operations, according to the definition of their activities, revenues from donations, and the revenues pursuant to special regulations, as well as the expenditures that are financed by the budgetary beneficiary's own funds.

Previously, the budgetary plan consisted of a general and a specific section. The novelty inheres in the general part of the budget being planned according to the organizational, economic and functional classifications. The budgetary plans of local units also contain the plans of their budgetary beneficiaries. This provides for a consolidation of the budgets of local units.

Fiscal Capacity Indicators

It is hard to measure the fiscal capacity⁵ of local units because there are no exact figures on the population

involved.⁶ It is also hard to get a realistic account of the revenues and expenditures of the LGUs. An additional problem inheres in the tax bases and the rates of local taxes⁷, which are not systematically controlled at the central government level. In addition, there are no figures on the GDP in given areas (counties). The government has established, in general terms according to per capita revenue, the criteria for the allocation of grants used for fiscal equalization. However, the criteria and equalization of fiscal capacity on the basis of income are not applied, and the fiscal capacity of most counties is below the average.

Suggestion. On the basis of the 2001 Census data, regional statistics (the regional GDP figures) should be improved as soon as possible. The collection of data on local revenues should also be improved. The purpose of these measures is to calculate fiscal capacity indicators.

The situation one year later. In 2001, the results of a new Census were published. Thus the government obtained some of the input required for a more realistic calculation of grants. Unfortunately, there is still no calculation of regional GDP. Apart from that, the ground has been cleared for a comparison of local units, which are all obliged to inform the Tax Administration about the introduction of new tax rates and tax bases.

While making up a model for the calculation of grants to local units in the PPDS from the government budget, the Ministry of Finance makes use of an estimate of fiscal capacity. For 2002, counties were given grants according to the following criteria: the population size as per the 2001 Census, the average per capita revenue at the county level (state average) for the county budget for 2000 and the county budget revenue for 2000. Since 2001, criteria for the allocation of grants to the PPDS have been applied that are based on the calculation of revenue per capita as compared with the regional or state average. Categories of expenditure (for employees) based on the results for the previous year are included into the calculation of the grant.

⁵ By fiscal capacity we mean an indicator of a local unit's ability to collect revenue and finance expenditure. For a definition of fiscal capacity it is essential to determine the parameters on which the calculation will be based.

⁶ The most recent data available derive from the 1991 Census. In the meantime, Croatia had a war and great migrations of inhabitants to and from the country. The data from the 2001 Census are not yet available.

⁷ However, local taxes have little influence on the fiscal capacity of local units as they only account for 4% of total budgetary revenues.

Consolidation of LGU Budgets

The local units' budgets are still not consolidated, just like there is no consolidation at the same level of government (county, municipality and city). In outline, a summary balance sheet is drawn up for all local units. One of the main problems is the classification of the budget(s), which makes a consolidation of budgets at the local unit level impossible, something which is only further aggravated by the absence of instructions about how to carry out consolidation.

Suggestion. A new account planning of the budget for the country as a whole and for local units should be introduced, and a review of public expenditure in terms of functions and economic categories should be provided for.

The situation one year later. The adoption of a new accounts chart, the decree concerning financial reporting, and the new decree concerning budgetary accounting have created the possibility for consolidation of the budgets of local units. The budget plans of local units for 2002 also contain the plans of their budgetary beneficiaries, which makes it possible to consolidate the budgets of local units (together with the budgetary beneficiaries' own revenues). The consolidated budget of the local units is to be drawn up quarterly and annually. There is still no official report or information on the first consolidations, because the regulations governing financial reporting were adopted only at the beginning of 2002. The first results concerning the consolidated budgets of local units are not expected until 2003, when the realization of the budget for the previous year (2002) will be announced.

It should be noted that the scope and quality of consolidation might be dubious because it has not been decided which budgetary beneficiaries will be included in the consolidation. This is caused by the absence of a clear definition of "budgetary beneficiary."

Complicated Accounting

Budgetary accounting is complicated and governed by numerous regulations that overlap, while remaining unclear conceptually and in terms of content. For example, budget accounting underrates obligations, overrates assets and makes consolidation impossible.

There is no single model or methodology for showing revenue and expenditure for all budgets. The lack of a unified methodology makes it impossible to keep up with and consolidate local unit budgets.

Suggestions. The Ministry of Finance should clearly inform all local units about the prescribed form or model

of financial reporting.

A review of the entire budgetary accounting and reporting system is necessary, which should be regulated by a single law. Various regulations should be terminologically unified, because local units interpret and apply them in different ways.

The Ministry of Finance should impose the obligation to adopt annual accounts of the budgets of local units as financial reports. Changes should start from classifying revenue and expenditure into a certain number of modified categories. This would make the collected financial data analyzable in various ways and for various purposes.

The situation one year later. A series of new regulations has been enacted⁸ which has fundamentally changed the system of accounting at the level of central and local government. A new Budget Law and an Accounting Law are currently being drafted, which should unite all the provisions contained in by-laws.

The new system of accounting has set up a new framework for financial reporting, uniform for the central government, local units and their budgetary beneficiaries. Instead of the accounting on a cash basis, the receipts and revenues, as well as expenditures and outlays, are registered according to the so-called modified accrual accounting basis.

The content of financial reports of the budget and of budgetary beneficiaries has been defined and prescribed in detail. All local units consolidate the financial reports of their budgetary beneficiaries and the financial report of the budget. The overall—consolidated financial report is submitted to the Ministry of Finance within 20 days from the expiry of the reporting period. Financial reports are drawn up quarterly and annually.

The legal obligation has been stipulated to adopt the annual execution of the budget. The annual execution of the budget is adopted by the representative body at the proposal of the relevant authorities, but only after the end of the year for which the budget was adopted. The local authority is obliged to submit the proposal for the annual calculation of the budget to the body competent for the control of the utilization of resources by April 15.

Along with the annual calculation of the budget, the following shall be submitted to the representative body for the adoption of the annual execution of the budget:

⁸ The Decree on budget accounting, Regulations concerning financial reporting, Regulations concerning budgetary accounting and the accounts chart, Amendments to the Local and Regional Self-Government Financing Law.

the profit and loss accounts of public corporations, public institutions, and the permanent reserves of the local units, and the balance sheet. A part of the annual execution of the budget (the general part) is published in the same manner as the budget itself.

Planning and Estimation of the Budget

The basic elements for planning and estimation of the budget are not always uniform or worked out in detail. They depend on the size of the budget, the structure of public expenditure and revenue, and the type of public functions financed from the budget. Methods and quality of estimating LGU budgetary revenue and expenditure do not depend on the size of a budgetary unit or its economic power, but on the interest of the executive bodies, and the expertise and personnel of the finance departments responsible for planning and preparing the budget.

Suggestion. Local units should base the planning of their budgets upon their own indicators. Local units that receive transfers from the government budget have to keep to the guidelines for salaries and expenditure movements. They also have to keep up with expenditure in terms of items.

The situation one year later. In planning and estimating their budgets, local units start from the guidelines (budget circular) of the Ministry of Finance for the preparation and drawing up of budgets for the following three-year period. The guidelines are based on the estimate of the macroeconomic indicators that the MF has to draw up and submit to the local units every year.

The MF submits its guidelines to the counties, which use them to draw up the guidelines for the county budget, as well as for the municipalities and cities in their respective areas. The MF also delivers its guidelines to all municipalities and cities, so that they can start preparing their budgets even before the county has drawn up its own guidelines. The problem here is that the counties do not stick to this schedule.

Guidelines for drawing up the budgets for the 2003–2005 period contain recommendations for the preparation and planning of the budget, separately for revenue/receipts and expenditure/outlays. The planned revenues of the budgets and budgetary beneficiaries of local units are based on an estimate of trends in economic indicators and the size and structure of public and local revenues.

Of course, planning of the local budget depends on the qualifications and knowledge of the local unit's

experts (the head and the finance department). The frequent rebalancing of local unit budgets during the year (two or three times) indicates that many local units have not yet mastered the principle of realistic budgetary planning.

Public Investment Planning

So far, the government has not dealt in any serious way with the planning of public investment, nor has any overall approach to the financing of capital projects at the local unit level been set up. A list of capital investment per sector first appeared as late as the beginning of 2000, for the 1996–1999 period. The strange thing is that this list cannot even be found in the Ministry of Finance, whose decision-makers know nothing about its existence. It was compiled and signed by the Government. Owing to this news blackout, the competent institutions, above all the Ministry of Finance, find it difficult to control the degree to which the local government capital investments are financed and carried out. Besides, capital projects are not included in public investment programs.

Suggestions. A complete and detailed record of capital projects financed at the local level should be kept at the central government level, in order to control the transfer of capital grants to local units.

It is necessary that the procedure of capital investment planning should include feasibility studies giving consideration to the potential sources of financing. As this relates to projects that are of great importance to the society as a whole, the obligation to make a social justifiability study of each such investment should be imposed.

Local administration should be equipped and trained to use modern methods of capital project planning. This, of course, goes for the administration at the national level as well.

All local units should be obliged to measure the costs and benefits of capital projects, and to plan capital projects over a longer period of time.

The situation one year later. There have been no significant changes. A novelty is that local units must work out in detail the capital part of their budget for 2003, in order to plan capital programs and borrowing for a number of years. The capital part of the budget encompasses all expenditure for the procurement of non-financial assets, with the exception of current non-financial assets. During the planning of capital programs, projects under way and reconstruction projects are given priority. This is a recommendation of the MF to local units contained in the guidelines for the preparation and

drawing up of the budgets of local units in the period from 2003 to 2005.

National Treasury System

The treasury system does not operate at the national level, and there is no national financial information system. There are no long-term plans for the structuring of treasuries at the level of LGUs. At the central government level, the function of cash management is not separated from debt management. Both functions are organizationally linked in a single administration or agency of the Ministry of Finance. The basic problem is that there is no developed national treasury system at the central government level.

Although there is a single treasury, at the Croatian National Bank, most transactions and payments from the budget are done across the many accounts of the budget kept with commercial banks. The problem is aggravated by the above stated absence of an efficient national financial information system.

The same applies to cash management at the level of local units. They too have no treasury system, but make their payments and manage their cash through the many accounts with commercial banks and the Institute for Payment Transactions⁹.

Suggestion. The Ministry of Finance should draw up a plan for organizing a treasury at the local government level, and, of course, get the treasury going at the national level as well. The Ministry of Finance should also determine the method of cash management, and oblige local units to keep their funds in a single budgetary account.

The situation one year later. Considerable progress in the development of the governmental financial

information system has been made. Payments have been ensured from the Single Treasury Account (JRR) for a large number of budgetary beneficiaries via branch treasuries mainly set up at the level of the competent ministries.

At the local unit level there are no major changes. The provisions of the National Payment System Act still apply (NN 117/01), as well as the provisions of the Budget Law (NN 92/94), pursuant to which local units can open only one bank account for regular operations, and can have a foreign currency account, and make time deposits. An account of the local self-government (which is also an independent legal entity) is opened with the same bank with which the account of the budget is opened.

A problem can lie in the so-called exceptions, according to which the budget of a local unit (county, municipality or city) can also have an account with another bank, to which it transfers budgetary resources for the implementation of programs adopted by the representative body of a local unit¹⁰.

There is an additional exception related to local units, which entered into agreements with the Ministry of Agriculture (for priority financing in agriculture) and the Ministry of Trades, Small and Medium-Sized Enterprises (for encouraging development of small businesses) before the new National Payment System Act came into force. These local units can keep budgetary resources with commercial banks with which they have no account for regular budgetary operations. The funds are used from the accounts of the bank until the end of the program for the development of small businesses and for priority financing in agriculture. However, these local units are obliged to submit to the MF and the competent ministries the data on the balances of time deposits. It is also worth noting that in 2003, the new resources for these purposes can be used for extending loans, but only through the bank with which the local unit has its account for the regular budgetary operations.

The problem with the number of accounts continues, because local units may have accounts with several other banks, apart from their budget account for regular operations.

⁹ The Institute for Payment Transactions—IPT (since 2002—Financial Agency, FINA) is a public institution that keeps the accounts of the central government, local governments, companies and citizens. The data of the Ministry of Finance are supplemented by data from IPT; alternatively, these data are used to establish the dynamics of the flow of budgetary resources. IPT has prescribed accounts for the payment of public revenue, the manner of paying this revenue, and reporting to its customers. It provides the Tax Administration with the data on the revenue collected by the central government, as well as the county, municipality and city budgets. Revenue is allocated from the IPT accounts, in statutorily determined percentages, to budgetary and extra-budgetary beneficiaries. The allocation key for the revenue is set by the Tax Administration. IPT collects fees for its services related to the payment of revenue in accordance with the contract concluded with the Ministry of Finance.

¹⁰ Decree on the amendments to the Decree on the manner of paying in budgetary revenue, mandatory contributions and revenue for the financing of other public needs in 2002 (NN 92/02).

Table 2. Revenue of Local Units as % of Total Budgetary Revenue

Revenue	1995	1996	1997	1998	1999	2000
Tax revenue	66.24	55.89	52.73	55.94	55.19	55.69
Non-tax revenue	22.69	31.41	33.32	29.25	30.50	31.48
Capital revenue	4.80	4.93	6.25	5.12	6.62	6.68
Grants	6.27	7.77	7.70	9.70	7.69	6.15
Total	100.00	100.00	100.00	100.00	100.00	100.00

Table 3. Total Revenue Realization Structure by Type of Unit in 2000 [%]

Title of revenue	Total	Municipalities	Cities	Counties
I+II total revenue and grants	100.00	100.00	100.00	100.00
I. Total revenues (1+2+3)	93.85	85.42	97.45	79.71
1. Tax revenue	55.69	34.08	59.51	61.97
2. Non-tax revenue	31.48	40.97	31.37	16.40
3. Capital revenue	6.68	10.37	6.57	1.34
II. Grants	6.15	14.58	2.55	20.29

Problems Related to Revenues

Among the main problems on the revenue side is an inadequate system of financial equalization and allocation of grants, too many new local units without secured funding, insufficient shared tax revenues, small own tax revenue and heavy reliance on non-tax revenue such as utility charges and contributions.

Revenue Structure

In order to perform the operations that lie within the competence of self-government, the local units provide resources for their budgets. In addition to their own resources (revenue from assets, local taxes, fines, fees and charges), they raise revenue from taxes (income, profit, real estate sale, and gambling tax) that are shared with the state government, and grants (from the government or county budget). In this paper we deal with another possible structure of revenues, i.e. the division of the revenue of local units into tax, non-tax, capital and grant revenue (Table 2).

Taxes are the leading item in the budgets of local units, although they are trending downwards. The second most important item is non-tax revenues, the proportion of which is constantly growing. The total capital revenue accounts for about 6.68% of the revenue of local units. Grants from the central government in 2000 stand at 6.15% of the revenue of the LGUs. A more detailed survey of revenues in 2000 for various local governments is given in Table 3.

Tax revenues are dominant in cities, where they account for 60%, and in counties for 62% of their total budgetary revenue. In municipalities they account for a little less than a third of the total revenue (34%).

However, all levels of local government rely on shared taxes. Local taxes account for only 4%, which shows that their influence on the fiscal capacity of local units is insignificant.

In municipalities, the most important is the non-tax revenue, with a 41% share in the total budgetary revenue. Non-tax revenue represents a third of budgetary revenue of cities and 16% of the total budgetary revenue of counties.

In the total realization structure of revenues of all LGUs in 2000 grants came to almost 6%. Grants are an important source of revenue for county budgets, accounting for a quarter of their total budgets. Grants represent 15% of the revenue of municipalities and 3% of the revenues of cities.

The situation one year later. In 2001, new local taxes were introduced in addition to the existing ones: tax on uncultivated but cultivable agricultural land, unused enterprise real estate, undeveloped building land, and the use of public areas. Moreover, the local and county tax rates were changed. The name of the Tax on the Organization of Sporting and Entertainment Events was changed to the Tax on Automatic Machines for Games of Entertainment. It is too early for an assessment of the first effects of these taxes on the size and structure of the revenue and expenditure of local units. The data

Table 4. Joint Taxes and their Distribution among Authorities [%]

Tax on	Central government	County	Municipality or city	Decentralised functions*	Fire brigades**	Equalisation fund***
Income	24.6	10	34	9.4	1	21
Income (including city of Zagreb)	21.6	—	47	9.4	1	21
Corporate income/profit	70	10	20	—	—	—
Real estate transfers	40	—	60	—	—	—

* goes to the municipality or city that finances its own decentralised functions, otherwise goes to the county

** goes to the municipality or city that has founded and finances regular work of public fire brigades

*** the government fund from which resources are transferred to those LGU that cannot finance their own public functions

Source: Law concerning the Financing of Units of Local Self-Government and Administration; OG 150/02 (the old laws are found in OG 117/93 and OG 33/2000.)

on the realization of local budgets for 2001 are still not publicly available.

Insufficient Shared Taxation

The central government has stipulated the sharing of the main types of taxes with the local units. The main taxes like income tax and profit tax are thus shared in percentages among all levels of government (see Table 4). A special problem, however, is value-added tax, which goes only to the central government. Many local units have a consumption tax, and they set the rate of that tax autonomously. There is also the problem of double taxation of the same product—alcoholic and non-alcoholic beverages, for example. Has the central government appropriately determined the amount that remains at the LGU level? An analysis of revenue shows that the main revenue of individual local units (especially municipalities) is not taxes but non-tax revenue. The small percentage allocated to the local units in shared taxes needs increasing.

Suggestion. The share of local units (in the tax revenue sharing arrangement, primarily the personal income tax and profit tax) should be increased (i.e. the share of the central government should be reduced).

The situation one year later. On July 1, 2001, the process of decentralization of elementary and secondary education, welfare and health care was started, which resulted in changes in the distribution of income tax. The financing of all decentralized functions was taken over by all the counties and the city of Zagreb. 32 cities took over the financing of elementary education only. The cities and counties that took over the decentralized functions have the right to an additional share in income tax, apart from the one they already have (Table 5).

An important role in the distribution of income tax is played by the so-called Equalization Fund (actually

a position or account within the government budget) to which funds for the financing of decentralized functions are transferred (21%).

Table 5. Additional Share of Local Units
(which took over the obligation to finance
the decentralized functions) in Income Tax [%]

Functions	Counties	Municipalities and cities
1. Education		
Primary	2,9	2,9
Secondary	2	2
2. Welfare	2	2
Senior citizens' homes	1,6	1,6
Welfare centers	0,4	0,4
3. Health care	2,5	
4. Fire protection	2	2

Local units that have taken over the financing of the decentralized functions derive a part of their revenue from an additional share in income tax, and obtain the difference in the funds necessary for financing the functions from the Equalization Fund.

If a given local unit gets more revenue (from its share in the income tax) than necessary according to the calculation of the government and the MF, the amount of grants is reduced by the amount provided by the local unit for the financing of decentralized functions. Revenue from equalization grants that has not been spent during the year remains in the account of the budget and is used for the payment of grants in the following year.

The share of municipalities and cities that have not taken over the decentralized functions remains the same. The share of the state in income tax is reduced by 21%, to

the benefit of the Equalization Fund, which is supervised by the MF (central government).

The share of island municipalities and cities in income tax has increased to 29.2%, provided that they conclude an agreement on the joint financing of some capital project that is important for the development of the island.

In the period from 2003 to 2005, the central government will approve an additional share in income tax to local units (from the part that belongs to the government budget that is derived in their area) for the financing of firefighting units. Since 2002, the government has ceded 2% of its share in income tax to local units for the financing of the regular activities of regular firefighting units. In 2003, the rate will be 4%; in 2004, 6%; and in 2005, 8%. Since many local units establish, finance or co-finance the firefighting units, and are therefore interested in getting an additional share in income tax, the Ministry of the Interior (the firefighting units are within its competence) has laid down the criteria that local units must meet to obtain the approval of the Ministry. FINA determines the quotas for the redistribution of the taxes (including income tax) in co-operation with the TA.

Despite being competent for public firefighting units at the level of local units, the Ministry of the Interior must not interfere with the fiscal equalization system (tax sharing), which has to remain in the exclusive competence of the MF.

Low Level of Own Tax Revenue

In practice to date, the central government has not supervised the rate of local taxes that can be set autonomously by local units. The introduction of new local taxes is envisaged, as well as the possibility for all local units to prescribe rates of surtax on personal income tax¹¹. It is questionable what the effects of the new local taxes will be on tax revenue growth, for in current practice, local taxes do not have an important role in the budgets of local units.

Suggestion. The central government should oblige local units to submit information about the size of the base for local taxes, and the tax rate set by each unit.

The situation one year later. Since July 2001, all local units that have introduced a tax are obliged to

notify the Central Office of the TA¹² about it. Every local unit is obliged to explain in the budget proposal the reasons for the introduction of a new tax, to provide an estimate of the revenue from the tax, as well as the administrative costs of the tax (assessment, collection, inspection, execution and record-keeping).

Subject to certain fixed criteria, municipalities and cities can prescribe surtax on income tax, provided that they publish their decision in the official gazette. During 2001 and 2002, over a hundred local units introduced surtax, at rates ranging from 1% to 18% of the amount of income tax paid. Unfortunately, we have not been able to estimate the effects of the introduction of the new taxes and surtax because of a lack of official information.

Heavy Reliance on Non-Tax Revenue (Utility Charges and Contributions)

Owing to the small fiscal capacity and the low level of revenue from local (own) taxes, many LGUs rely on non-tax revenue as their main source of revenue.¹³ Utility charges and contributions stipulated by law participate with the largest share in the local budgets, especially those of cities and municipalities. The problem is that many local units autonomously prescribe high rates of utility charges and contributions. 80% of cities (or their utilities) illegally impose charges for connections to the infrastructure, which result in high utility prices and contributions. To avoid this, some people resort to illegal connections. There is a whole series of charges and fees that the local units levy, while the central government does not have any control over their rates, or their accounting records (Table 6).

Suggestion. The central government should control the rate of utility contributions and charges that are set autonomously by local units.

The situation one year later. The sharing of the revenue from charges for concessions to pumping mineral and thermal water by municipalities and cities was introduced (50% goes to the local units, 50% to the central government), and the charge for the concession

¹¹ Surtax is an addition to income tax that is assessed on the basis of the tax already paid. Cities with more than 40,000 inhabitants have the right to impose surtax. The rate ranges between 6% and 7.5%, but in Zagreb (the capital) it is 18%.

¹² Amendments to the Local and Regional Units of Self-Government Financing Law (NN 59/01).

¹³ For example, in the municipality of Kostrena, which has the highest per capita revenue in Croatia (around US\$ 1,000), non-tax revenue accounts for 85% of total revenue. Revenue from utility charges comes to 58% of the total revenue. In the city of Zagreb (the biggest center), non-tax revenue accounts for 21%. Utility charges represent 6% of the total budgetary revenue.

Table 6. Revenues from User Charges and Administrative Fees in 1999 [%]

	Municipalities	Cities	Counties	Total
National stamp duty revenue	0.44	6.41	76.64	7.81
Road tolls	0.26	4.98	0.00	4.09
Administrative fees	0.95	0.73	18.19	1.34
Other charges	11.34	3.41	0.96	4.54
Other fees	2.15	0.34	4.22	0.75
Entertainment and gambling fees	0.01	0.01	0.00	0.01
Utility charges	61.65	61.10	0.00	59.17
Utility contributions	20.19	21.86	0.00	20.89
Tourist tax	3.00	1.16	0.00	1.40
Total	100.00	100.00	100.00	100.00

for pumping water for the public water supply (30% goes to the local units, 70% to the central government). Amendments to the Public Utility Services Law were also passed. We were not able to establish the changes in the size and structure of non-tax revenue because there is no information available about the realization of the budgets of local units in 2001 and the first half of 2002.

Citizen Participation

Despite the principle saying that citizens have the right to elect, and encourage the election of, representatives in the representative and executive government bodies, there is no way in which citizens can participate in the provision or financing of public services. Members of the public do appear as the initiators of the financing of individual programs and projects, but their participation is not regulated by statute. However, non-tax revenues can include income from self-contributions. These are self-imposed levies of citizens introduced for the financing of items within the utility infrastructure—water mains, local roads and the like. However, self-contributions are not regulated by statute, even though the local units do introduce them and use them as a result of grassroots initiatives.

Suggestion. A more active role of citizens in providing and financing public services should be ensured. The self-contribution system should be regulated by statute.

The situation one year later. The first steps have been taken to ensure a more active participation of the local population in budgetary debates. Some cities have organized public debates on the budget, and some have issued first guides to the local budget, in order to explain

the situation in city coffers, as well as the intent of the city authorities in spending budgetary resources. The Urban Institute, MPULS, the MF and the Croatian Law Center (HPC) have provided a strong institutional and expert support.

Financial Equalization and Allocation of Grants

The central government provides numerous grants from the government budget—current, capital, specific and general—to local units. The grants are transferred to the counties, which distribute the funds among the local units whose fiscal capacities are below the average, in accordance with the size of their revenues. However, this does not apply to areas of special national concern, to which the government gives grants directly. The government has no clearly defined criteria for the awarding of grants. A complete confusion arises when an attempt is made to establish the total amount of funds that the state gives to local units. This is impossible because numerous grants are given through various ministries. The Ministry of Finance has no way of checking whether these funds are used, to what extent and for what purposes. Local units have no obligation (except for areas of special national concern) to report to the Ministry of Finance on the amount of funds used. It is questionable to what extent the grants are used for fiscal equalization, because most of them are spent for financing current expenditure.

Suggestion. Fiscal equalization criteria must be fixed. Funds for fiscal equalization should be allocated not only by the central government, but also by the richer counties and more developed cities and municipalities.

The situation one year later. There were no significant changes, except for the introduction of criteria for

the calculation of grants to all counties, including the municipalities and cities within the PPDS. The criteria were first applied for the calculation of grants within the framework of the government budget plan for 2002, and were built into the Law on the Execution of the 2002 Budget. Unfortunately, fixed criteria for the allocation of grants between the local units—richer to poorer (the so-called horizontal fiscal equalization) are still missing.

Too Many New Local Units Without Secured Funds

In spite of an excessive number of local units, new units are still being founded by splitting up the existing units. The problem of founding a new unit is closely related to the distribution of assets. More specifically, many local units do not have any inventories of their assets (asset balance sheets), nor do they know the value of the assets they have. Many units are faced with legal proceedings for the distribution of assets. The management of assets belonging to local units is an additional problem, since there are no departments or individuals with the expertise required for these issues. Even in the central ministries, asset management is not institutionally organized.

Suggestion. Once and for all, the value of the assets of local units and the responsibility for managing these assets should be determined.

The situation one year later. No changes.

Problems Related to Expenditure

The main problems related to expenditure lie in the lack of long-term capital project planning and the non-separation of current budgets from capital budgets. Furthermore, the principle of balancing budgets and borrowing is not observed, capital expenditures are financed without proper studies, and there is no appropriate recording of potential obligations (guarantees).

Long-term Capital Project Planning

Decision making about capital investment and the financing of capital projects at the local level is one of the weaker links in the finances of local units. No analysis of the structure of capital expenditure is made, the execution of capital projects is not monitored and the current and capital budgets are not clearly separated. This is not even stipulated by the laws regarding local government financing.

When making decisions on capital financing, local units neither conduct investment studies nor social justifiability studies. Such a method gives then impression of a lack of seriousness, which discourages

potential domestic or foreign investors. The financing of capital projects by borrowing is practically impossible because of the low fiscal capacities of local units. The problem of the asset balance sheets in some of the units is still unresolved.

Local units do not undertake any long-term planning of capital projects, and most such projects are financed in line with the capacities of the local budget at any given moment in time. The reasons can be seen in the poor or non-existent registers of capital projects. Even at the central government level there is no programmatic classification of public expenditure.

Furthermore, local governments do not estimate the effects of making decisions about financing (current investment maintenance and the construction of facilities) on the execution and financing of projects in the years to come. For this reason, most projects are financed from the central government budget, which, again, does not have a complete oversight of the use of budgetary resources at the local level. No program of capital financing or sectoral analysis of programs exists, either at the local or central government level.

Suggestions. The budgets of local units should be divided into current and capital parts and all local units should be obliged to keep a financing account. Keeping registers of capital projects at the local and central government levels should be legally prescribed.

The situation one year later. The new account plan of the budget makes it possible for the capital part of the budget to be separated from the current part, and the execution of capital projects can be monitored. Local units can borrow for the financing of capital projects subject to the approval of their representative body and the Government of the Republic of Croatia. One of the basic conditions for this is that the total yearly annuity does not exceed 20% of the revenue realized in the preceding year.

Another novelty is the obligation to publish invitations to bid (Public Procurement Law) for selecting financial institutions or contractors.

A budget consists of a general and a specific section. The general part of the budget has to be planned according to an economic classification, and among other things it has to contain a financing account. In the financing account, the size and structure of debt and the debt repayment have to be shown.¹⁴

¹⁴ The Local and Regional Self Government Financing Law, Article 61.

Classification by Program and Subprogram

There is no classification of expenditure by program or subprogram. For this reason many LGUs do not program expenditure for more than a year ahead. If expenditure were programmed for several years ahead (with a realistic estimate of revenue), even in the first year it would become clear that the funds would be insufficient for the completion of many capital projects in the year(s) to come. In this way any unnecessary expenditure that arises when projects are incomplete would be avoided.

Suggestion. A program and subprogram classification of public, especially capital, expenditure should be introduced and applied at both national and local levels.

The situation one year later. There is no change, except with respect to capital expenditure. The guidelines that are sent to local units contain macroeconomic indicators for the next three years (specifically, the last guidelines contained indicators for 2003, 2004 and 2005). The new guidelines recommend that the plan of capital programs for 2003 (which is an integral part of the special part of the budget) be worked out in detail, for the purpose of long-term planning of capital programs and borrowing. Capital programs for 2004 and 2005 have to be planned according to the economic classification.

Principle of Balancing Budgets and Borrowing

According to the budgetary principle, local budgets have to be balanced. Every year the local units are encouraged to observe the “golden rule” that borrowing should only be used for the financing of capital expenditure. However, in many cases the balancing principle is not observed, and local units rely on borrowing from commercial banks for the financing of current expenditure as well, although this is expressly forbidden. There are many examples in which local units do not have a clearly separated part of the budget for the financing account, in which borrowing and repayment of debt are presented. Many transactions, such as the issue of government guarantees for utility companies, are simply not registered, and there is no unified or single register of local government-issued guarantees. Guarantees are often recorded in the financing accounts of the LGUs, even if they have not become a real obligation of the unit.

Suggestion. Financial control of the local units’ borrowing should be introduced and the volume of loans and potential obligations of local units should be reduced.

The situation one year later. The new Budget account chart has made it possible to record outlays for

extended loans and for financial assets in special outlay accounts. The limit up to which units may borrow or give guarantees has been set. The total yearly annuity can reach a maximum of 20% of the revenue realized in the previous year. Realized budgetary revenue is the total revenue reduced by receipts from domestic and foreign grants, subsidies and transfers from the government budget and the budgets of other local units, receipts derived pursuant to special contracts (local self-contributions, co-financing by citizens) and domestic and foreign borrowing.

Recording of Potential Obligations (Guarantees)

Local units apply various methods of recording and booking the extended loans and issued guarantees. Some units record the issued guarantees as the loans extended. While planning the budget, many local units deliberately overrepresent their revenues and expenditures, which gives them better chances of borrowing than if they assessed their budgetary expenditure and revenue more realistically.

Suggestions. The obligation for all units to keep registers (off-balance sheet) of issued guarantees should be introduced.

Special auxiliary records of the issued guarantees should be kept. Pursuant to central government instructions, local units should plan a guarantee reserve. However, the instructions should specify the amount, i.e. percentage, of the guarantees that should be set aside as the guarantee reserve.

The situation one year later. At the beginning of 2002, the MF worked out in greater detail the procedure of borrowing and issuing guarantees by local budgets by virtue of the Law on the Execution of the Government Budget, and the Instruction for Borrowing and Giving Guarantees (NN 32/02).

Counties may now issue guarantees to the municipalities and cities within their territory area with the prior approval of the government of the Republic of Croatia. Counties, cities and municipalities may issue performance guarantees for firms or public institutions, which they founded or whose majority owners they are, even without the consent of the state government. However, in this case they are obliged to inform the MF of the size of the guarantees issued. Guarantees are included in the volume of a local unit’s potential borrowing. The total annual annuity of a local unit can amount to a maximum of 20% of the revenue realized in the preceding year. All payments due in the current year for loans and guarantees from previous years, as

well as outstanding due obligations, are included in the total annual annuity.

The realized budgetary revenue includes the realized revenue of the unit that is contracting the debt, reduced by the receipts from domestic and foreign grants, subsidies and transfers from the government budget and the budgets of other local units, and reduced by the receipts related to special contracts (co-financing by citizens, local self-contributions or voluntary levies) as well as domestic and foreign debt.

It is worth mentioning that local units are required to submit a report to the MF on given approvals and issued guarantees twice a year (in July and December).

The Instruction and the decrees issued by the MF are a step forward in establishing the level of debt and guarantees in the local units. Finally, the implementation of the Instruction should give the MF a clear insight into the financial condition of local units and their abilities to finance capital projects.

Position of Utility Companies

Little is known about the privatization and ownership of utility companies. Many local units do not provide a realistic assessment of the value of their assets, and their responsibility for the management of these assets is not institutionally regulated. Moreover, the value of utility companies is not known. Another problem is the connection between the local budget and the utility companies. These companies operate as commercial, i.e. profit-making firms.

However, the losses of these companies are covered from the budgets of the LGUs, which pay their debts.

Suggestion. The ownership of utility companies should be established and the possibility of privatizing individual functions at the local government level should be created.

The situation one year later. No change.

The Budgetary Process

The budgetary process lacks internal controls, evaluation of activities, evaluation and remuneration for the work of employees, treasury system audits of joint-stock companies and firms owned by local units, and collaboration between the LGUs and the Ministry of Finance. Furthermore, budget-planning guidelines are too general.

Evaluation of Activities (Performance Indicators)

The system of performance in local units comes down to a comparison between plan and realization. There are

individual examples of progress in programs. However, the performance of programs is still not monitored in the sense of creating some general good or providing satisfaction for citizens.

The performance data are not supposed to be, and usually are not, part of the documentation of the annual budget. The most important issue is the monitoring of the level of revenue and expenditure, and budgetary balance, as well as control of the local units' borrowing. Local units do not keep a record of expenditure in terms of individual activities; they do not measure the effectiveness and the costs of activities by means of a cost benefit analysis, nor do they insist on quality, efficiency and management. Performance is not an imperative, either at the central government level, or at the local level.

Suggestion. Every budgetary financial transaction should be able to identify the budget and cost center, its purpose or the service it provides, the source of funds and the kind of revenue or expenditure.

The situation one year later. The local unit budget classification system has been improved. Local units classified the plan of the budget for 2003–2005 according to organizational, functional and economic principles. This gave insight into the place of expenditure, the purpose, the source of funds and the type of receipts/revenues and expenditures/outlays. This means that receipts/revenues and expenditures/outlays are planned and distributed according to an economic and functional classification with a clear organizational structure and budgetary beneficiaries. The introduction of a clearer classification of the budget provided a good basis for drawing up performance indicators of the execution of the functions and tasks of local units. The provision of these indicators depends heavily on the initiative and desire of individual local units to establish the quality, quantity, and costs of the provision of public goods and services to the public in their respective areas.

Evaluations and Rewards for the Work of Employees

The work of employees in local units is not evaluated. There is no system for monitoring success and quality of work, or a system of incentives for better performance. Performance is not evaluated at all. Discussions continue within the statutory framework, while a concrete shift towards change and improvement is expected from outside, i.e., from the central government. The model of initiative and independent, active and creative work has not been internalized. Owing to lack of incentive

measures or criteria for providing incentives, individuals cannot be expected to carry out creative, high-quality work. Ideas interest nobody, and the final result, in which there is no systematic effort to raise the quality of the work of employees, is inertia and red tape.

Suggestion. The government and the local units should be able to prescribe a system of incentives for good work, and penalties for inefficient work.

The situation one year later. No change.

Internal Control

Internal control is not organized, neither in ministries or at the local unit level.

Suggestion. Set up internal control in larger local units and ensure that internal control is carried out in the counties on behalf of smaller units that are incapable of doing this themselves.

The situation one year later. No change.

Audits of Joint Stock Enterprises and Firms Owned by Local Units

Like privately owned companies, joint stock enterprises and firms owned by local units are subject to state audit and commercial audit. It is not clear why both types of auditing are required.

Suggestion. It should not be necessary to carry out external commercial auditing of the utility companies, only the national auditing. For this reason the Accounting Law needs amending. This would reduce the costs of auditing, and the national audit system would then carry out the audits of these firms within the required time limits.

The situation one year later. No change.

Guidelines of the Ministry of Finance

A problem that occurs in the early phases of the LGU budget planning is the implementation of the Ministry of Finance guidelines, which are too general for the purposes of most local units.¹⁵ For this reason the Ministry of Finance has to pay more attention to the specific needs of each of them and adapt the guidelines to the units (municipalities, cities, counties). The problem lies with the MF, which gives priority to the counties and the city of Zagreb in requesting the budget preparation and submitting the guidelines. In line with these guidelines, the counties are required to make estimates of their own budgets, and draw up guidelines for the cities and municipalities in their respective territories. However, the counties do not fulfill their obligations, nor do they draw up guidelines with indicators for the cities

and municipalities in their regions. This is the basic reason why most of these units consider the guidelines too general and partially inapplicable. In addition, the municipalities, cities and counties are obliged to draw up their budgets by December 15 for the next year. Very often, budgets are passed at the very end of December. Many units make at least one or two revisions of the budget during the year—some of them even three or four.

Suggestion. The Ministry of Finance guidelines should be adapted to the levels of local units, and the local units should be obliged to draw up their own indicators. A unified model of budgetary planning for all local units should be prescribed.

The situation one year later. There are no significant changes, except for the insistence on timely submission of guidelines to local units, so as to leave them enough time for more realistic planning of the budget and the provision of their own guidelines. In 2002, the guidelines were sent to the local units in June. Still, there have been problems, because the counties are often late in making their own guidelines and sending them to the cities and municipalities. Therefore they receive the guidelines from the MF before they get those from the county. From a technical point of view, the guidelines for the preparation and drafting the budgets of local units for 2002 and 2003 were more detailed than those in previous years.

¹⁵ The Ministry of Finance sends out a circular for the preparation of the three-year plan of the LGUs budget, which includes the following items: (1) Basic indicators of macroeconomic policy for the coming three-year period (growth rates of both nominal and real GDP, inflation rate, wage growth rates, trends in employment, cost of living and so on) and an estimate of trends in joint taxation at the national level. (2) Recommendations for realistic estimation of the growth of revenue and receipts, and shared taxation in the revenue of the local budget. (3) Estimates of local tax and non-tax revenue and receipts, with financial control of their assessment and collection. (4) Determination of the amount of current and capital expenditures, and definition of priority expenditure that has to be adjusted with the planned rate of growth in joint and own revenue. (5) Local units should adhere to the real dynamics of realization of revenue through the year as the basis for planning and execution of tasks. (6) Adjustment, i.e., reduction of public expenditure, in case of lower realization of public revenue owing to a drop in economic activity. (7) Attention should be paid to the balancing of local budgets. (8) Local units that are provided with resources (current grants, transfers) from the government budget should observe the prescribed limits related to the growth of wages and material costs.

Conclusion

After recognizing the main problem related to the fiscal structure, i.e. the absence of an efficient budgetary system and clearly separated functions and competencies both on the revenue and expenditure sides, the basic recommendations may be provided to the government and to economic policymakers. In accordance with the numerous suggestions given above, a reform of the budgetary system of LGUs in Croatia should be carried out in several phases. For this purpose, a further research into the financial position of the LGUs still needs to be carried out. The main problem about the reform is its excessive politicization that might discourage any new initiative. For this reason it would be better to concentrate on possible improvements in the present system of LGUs, with the emphasis on strengthening the budget, budgetary techniques and the budgetary process at all levels of government and activating a more powerful financial control mechanism at the level of the central government. All the main participants in the budgetary process—Parliament, Government, ministries, budget beneficiaries and citizens—should be educated to understand the aims and purposes of the measures proposed for the future.

The situation one year later. A year after the beginning of the reform of the local unit financing, it became clear which steps have actually been taken and what would be the direction of the reform in the future. The functions of education, health care and welfare have been partially decentralized. However, as these functions are financed from the budgets of local units, the Equalization Fund, and from a larger share of local units in income tax, we may conclude that this is not really fiscal decentralization, but rather a partial transfer of authority for the financing of partially decentralized functions.

The legal status of all local units has been equalized, so that they can all carry out administrative functions. In spite of the wish to unite some small local units and to reduce their number, a trend towards the foundation of new units continues. Unfortunately, they are usually not founded on the basis of a realistic estimation of their ability to provide independent financing.

Without the available and accessible data, it is not possible to estimate the real effects of the reform measures and compare the reformed state with the pre-reform situation. Nevertheless, it can be concluded that income tax has become the basic instrument for financing decentralized functions, and that a model of fiscal equalization founded on tax sharing is being tested. While using this model, no account has been

taken of the fiscal capacity of individual local units (Zagreb, for example, did not need a larger share in income tax because its revenue, in all its categories, is sufficient to finance the decentralized functions). It is interesting that not a single municipality has assumed the decentralized functions, although a considerable number of municipalities introduced surtax. An assessment of their fiscal capacity would show if these municipalities were really in a bad financial position, that is, incapable of financing the decentralized functions.

After the implementation of reforms, the budget should improve and become a better source of reliable information. Information from financial reports must finally be used in the planning and adoption of budgets. In principle, the consolidation of the budgets of local units has been secured. Local units can provide numerous performance indicators concerning the execution of their jobs. Neither the local units nor the MF have any reason or excuse for not publishing exhaustive information about the budget realization of local units.

However, consolidation of the budgets of local units will heavily depend on the definition of “budgetary beneficiary.” Owing to a lack of such clear definitions (particularly of property, and the balance of revenue, expenditure and debt), the quality of consolidation carried out at the level of local units is questionable.

Formally, control of borrowing and the issue of guarantees have been strengthened, and it is possible to establish the balance of borrowing as well as the structure and size of guarantees. However, no major changes are expected until the central government proves its capability of implementing the same thing with respect to its own budgetary beneficiaries.

The main task of the government is to decide what it really wants: 1) decentralization of authority and finances; or 2) decentralization of authority and centralization of financial resources.

If it wants to decentralize both the authority and revenue, then it must leave a larger part of the taxes within the competence of the local units. That, again, would result in a problem of too many small tax systems, i.e. a parallel tax system at the local unit level, where the existing tax system is already difficult to control.

If it wants decentralization of authority and centralization of revenue, then it should say this clearly, and work on the improvement of the model. In this case, the central government should provide for calculations of fiscal capacity for all categories of revenue, expenditure, and tax and non-tax revenues. To achieve this goal an appropriate institutional structure should be developed.

A public advisory institution for making estimates of fiscal capacity for lower levels of government should be established based on the U.S. model (in the U.S.A. this is the Advisory Commission for Intergovernmental Relations—ACIR).

Only the MF can make estimates of fiscal capacity, lay down the criteria for the calculation of fiscal capacity and fiscal equalization, and change the share of local units in joint taxes. No other ministry (the Ministry of the Interior, for example) should be involved in these affairs of the MF.

During 2002, the MF provided education to the local units for the purpose of their better understanding and implementation of the reform of budgetary and local unit financing. Although the dynamics of the changes are well coordinated, the application of the financial management model is behind schedule. This model should provide for the unification of all types of information in the system of financial and fiscal reporting.

However, further progress in the reform will heavily depend on the capacities and knowledge of individuals at the central government level, but also in the local units, who have to implement the ideas of the initiators of the reform on the spot. Every wrong central government decision with respect to the assignment of authority and resources can be a step backward from the main objective of providing a simple, user-friendly and reliable system of financing in the local units.

The implementation of reform measures lies within the competence of those employed in the local units. For this reason, each local unit has to determine the criteria for setting the wage levels and designing the remuneration systems for their workers based on their performance. After all, this is also the task of the government ministries.