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Marković, Branimir and Matić, Branko

J. J. Strossmayer University of Osijek, Faculty of Economics

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# PROBLEMS OF FINANCING LOCAL AND REGIONAL SELF-GOVERNMENT

**Branimir Marković, Branko Matic**

Faculty of Economics

Gajev trg 7, 31 000 Osijek, Croatia

## INTRODUCTION

The Republic of Croatia, as a small country with a surface of 56,500 km<sup>2</sup> has according to the last Census from 2001 had 4.4 million inhabitants. Following the provisions of the Local and Regional Self-Government Act, the country has been territorially organized into 21 counties, 126 towns and 429 municipalities (these data relate to the year 2004). The same Law also regulates the internal structure, modes of operation, scope of autonomy, bodies and organs, forms of the communication of citizens, organization of referenda, as well as other questions of importance for the realization of rights and duties. A special area of functioning of the local and regional units of self-government is their financing, in other words, sources of income that create the basis for settling public needs in their jurisdiction. Because of various problems, it very often happens that local and regional units of self-government have insufficient income for executing their daily businesses, which, eventually, makes such system of financing rather inefficient, so that the consequences are felt in the uneven development of particular territorial units in the Republic of Croatia. Although the central state finds additional solutions for this problem through financial compensations and similar actions, units of local and regional self-government must alone, autonomously, find new models of financing of their activities, whereby they directly contribute to the improvement of their citizens' standard of living.

## 1. SCOPE OF AUTONOMY OF THE UNITS OF LOCAL AND REGIONAL SELF-GOVERNMENT

The Constitution of the Republic of Croatia from 1990, and Constitutional changes from the year 2000 have determined the scope of autonomy for municipalities, towns and counties as units of local and regional self-government. Thus Article 19 of the Local and Regional Self-Government Act stipulates that units of local self-government engage in activities relating to organization of settlements and living in them, spatial and urban planning, utility services, child care, social care, primary health protection, upbringing and elementary education, culture, physical culture and sport, consumer protection, protection and improvement of natural environment, fire-prevention and civil protection, traffic and other activities as laid down by special laws. Special regulations define the work in large towns (towns with more than 35,000 inhabitants) that function as centers of economic, financial, cultural, health, traffic and scientific development in a wider sense.

Counties as the units of regional importance engage in operations relating to education, health care, economic development, traffic and road infrastructure, maintenance of public roads, planning and development of a network of educational, scientific, social and cultural institutions, issuing of building and location permits and other activities as regulated by special laws (Article 20 of the Local and Regional Self-Government Act).

As an example, here are some of the activities regulated by the Law on Utility Services, relating to the drinking water supply, drainage and cleansing of effluents, drainage of atmospheric waters, gathering and removal of municipal waste, cemetery maintenance service and crematory, public lighting, maintenance of public surfaces and a number of other activities.

All these activities in the domain of the units of local and regional self-government that are performed in counties, towns and municipalities must have their funding sources because the efficiency and quality of their work depend on that.

## 2. INSTITUTIONAL FRAMEWORK OF FINANCING UNITS OF LOCAL AND REGIONAL SELF-GOVERNMENT

We can conclude that financing of the units of local and regional self-government is one of the most important issues, as well as problems in all democratic countries. The organization and financing of counties, towns and municipalities in the Republic of Croatia enables citizens to decide about satisfying their needs and interests on the local and regional levels on the one hand and to decide about the financing of most important needs, on the other.

The established institutional framework of financing the local and regional self-government is based on two declarations. In its directives, the Declaration about the Local Self-Government promulgated in Rio de Janeiro in 1985 gives local authorities a certain level of autonomy in disposing with their own means, in the collection of their own incomes through local taxes, contributions and allowances, in forming regulations about the redistribution of means, in financial settlement and in securing general designated subsidies.

The European Charter of the Local Self-Government considers units of local self-government as the basic values of democratic society, and in the provisions of its Art. 9, the Charters regulates the system of financing which has been adopted by the Republic of Croatia.

## 3. SOURCES OF INCOME OF THE UNITS OF LOCAL AND REGIONAL SELF-GOVERNMENT

Pursuant to Art. 68 of the Local and Regional Self-Government Act, public revenues for the financing of public expenditures within the autonomous scope of municipalities, towns and counties, which the local units have at their disposal for free and independent usage, come from the following sources:

- municipal, town or county taxes, surtax, allowances, contributions and fees;
- income from objects owned by counties, towns and municipalities and from property rights;
- income from companies and other legal persons in their ownership, or in which they hold stocks or shares;
- income from allowances for concessions issued by their representative bodies;
- fines and seized material gain from offenders for offences prescribed according to the law;
- common taxes shared with the state;
- means allotted as aid or subsidies of the Republic of Croatia, as planned in the state budget;
- other incomes determined by law.

Theoretically, income of the local and regional self-government can be divided into:

1. income from their own sources,
2. income from common taxes,
3. income from supports and subsidies.

On the other hand, depending on the sources of incomes, they can be fiscal incomes, non-fiscal incomes, incomes from supports and subsidies and receipts from debt accumulation.

### 3.1. Fiscal Revenues

Local and regional self-government units' tax yields are realized through common taxes and through their own, local/regional taxes. Common tax yields come from income tax, corporation tax and real property transfer tax. These incomes are divided among individual levels of powers as presented in Table 1.

Table 1. Division of common taxes between individual levels of government (%)

	<b>Income tax</b>	<b>Profit tax</b>	<b>Tax on the sales of real estates</b>
State	25.6	70	40
City	34.0	20	60
County	10.0	10	-
The City of Zagreb	47.0	30	-
Settlement aids from the state budget for decentralized functions	21.0	-	-

As a specific kind of common tax yields, there are also concessions for the exploitation of mineral and thermal waters that are distributed in 50 % shares between the towns/municipalities and the state, and concessions for utilization of water for public water supply, which are distributed in a 30 % share for towns/municipalities and 70 % for the state.

In the following sections of this paper, we wish to present an analysis of common tax revenues and their share in total incomes on the example of several counties. Data for all following analyses are based on relative indicators (in %) calculated in our own research on the basis of absolute monetary indicators for the period from 2002 to 2005. Data sources can be found on [www.revizija.hr](http://www.revizija.hr) and on the web-pages of the Croatian Bureau of Statistics.

Table 2. Tax yields of local self-government units in the Republic of Croatia (%)

<b>County</b>	<b>Share of common tax revenues</b>	<b>Share of their own tax revenues</b>
Osijek-Baranya	91.0	9.0
Vukovar-Syrmia	90.5	9.5
Primorje and Gorski Kotar	83.4	16.6
Zadar	79.4	20.6
Istria	80.9	19.1

Source: [www.revizija.hr](http://www.revizija.hr)

Average share on the level of the Republic of Croatia for common tax revenues is 86.9 %, and own tax yields is 13.1 %. Table 2 shows that there is diversity in the share of tax yields among counties in the structure of total tax yields of counties, towns and municipalities. Table 3 presents the shares of common tax yields in total incomes of the same counties.

Table 3. Common tax revenues in total incomes of the counties (%)

<b>County</b>	<b>Income tax and surtax</b>	<b>Profit tax</b>	<b>Share of common taxes in total revenues</b>
Osijek-Baranya	42.9	4.1	47
Vukovar-Syrmia	21.8	3.5	33.3
Primorje and Gorski Kotar	32.6	3.9	36.5
Zadar	31.1	2.9	34.0
Istria	29.5	9.2	38.7

Analysis of the obtained data leads to the conclusion that the share of common taxes is different in the five counties that were used as the example. Economically and industrially more developed counties have a lesser participation of common tax yields in their budget structures than the less developed counties. (Table 3) With the counties' own tax revenues, the situation is reversed. The share of their own tax revenues is higher in more developed counties than in the less developed ones. (Table 2)

In the structure of county taxes for all counties the most abundant tax revenue comes from the tax on road motor vehicles, followed by taxes and allowances from games of chance and prize games, vessels taxes, and finally taxes on inheritances and gifts.

In town and municipal taxes, there is a wide variety in the structure of taxes. Broadly speaking, in all towns and municipalities the most yielding are the consumption tax, tax on holiday houses, company or brand tax, and the tax on the use of public surfaces. Generally, we can say that the share of county, town and municipal taxes in total incomes is relatively low. On the average, the share of these taxes in all local units on the level of the Republic of Croatia is 6.3 %, and within this structure, 16.9 % refers to county taxes and 83.1 % to town and municipal taxes.

### 3.2. Non-Fiscal Revenues

According to the principle of abundance, beside tax revenues, non-fiscal revenues are the most important sources of income, and together they make around 80 % of the total incomes of local and regional self-government units. In this function are various kinds of non-fiscal incomes that make either the common income of local and regional self-government units, or their own incomes. Common non-fiscal incomes include, for example:

- incomes from fees realized through the sale of revenue stamps, which are divided as follows: 33 % into the state budget, 33 % to the counties and 33 % to the town/municipality on whose territory the revenue stamps were sold;
- income from the lease of farmland owned by the state, which is distributed thus: 25 % to the county budget, 50 % to the budget of town/municipality and 25 % to the state budget;
- income from the sales of the state-owned farmland, 25 % of which go into the county budget, 50 % into the budget of the town/municipality and 25 % into the state budget;
- fees for the concession on maritime domain, 33 % of which belong to the county budget, 33% to the budget of the town/municipality and 33 % to the state budget;
- allowance for the utilization of mineral raw materials, 50 % of which go to the county budget and 50 % to the town/municipality budget on whose territory the raw material is exploited.

Far more interesting are the local and regional self-government units' own non-fiscal incomes which they realize in different ways and with different shares in the structure of non-fiscal income within the total income. Table 4 presents the share of non-fiscal income for the same counties that have been analyzed earlier.

The average share of the local and regional self-government units' own non-fiscal income in the total income for the Republic of Croatia is 31.2 %.

On the level of the local units, most important are the incomes from utility service payments and communal contributions (Croatian average is 41.5 % of the total income). Utility service charges are paid by the owners of housing, business and garage space and owners of construction ground used for business activities, as well as the owners of unbuilt construction grounds. Utility service charges provide means for the performance of communal activities and services, such as public lighting, drainages of atmospheric waters, cleaning and disposal of waste from public surfaces, maintenance of non-classified roads and the like. Communal contributions are monetary public duties paid by owners of construction grounds on which buildings are being constructed, and they relate to construction and use of objects and arranging of communal infrastructure (public lighting, supplying drinking water, municipal waste disposal, retail markets, cemeteries, etc.).

Incomes from the non-financial property (the average for the Republic of Croatia is 20.8 % of the total incomes) include fees for concessions of different kinds, for the lease and hiring of property, for roads, for the use of power plants spaces, hunting fees and the like.

Incomes from financial assets (the average for the Republic of Croatia is about 1.5 % of the total incomes) include incomes from interests, currency exchange rate gains and losses, dividends and profit shares in companies owned by local and regional self-government units.

Incomes from administrative fees and sojourn fees are determined diversely through town and municipal decisions (the average for the Republic of Croatia is 6.7 % of the total incomes).

Incomes from debt accumulation relate to incurring debts by the local and regional self-government units for capital projects of reconstruction and development on the money and capital market and with the investment contractors. Average indebtedness of the local and regional self-government units on the level of the Republic of Croatia is about 14.6 % of the total income, of which 97 % of the incurred debts are inland debts.

Table 4. Structure of non-fiscal incomes in %

Kind of income	COUNTIES					
	Osijek - Baranya	Vukovar - Syrmia	Primorje and Gorski Kotar	Zadar	Istria	Average for Croatia in %
utility service payments and communal contributions	34.3	31.2	42.0	34.7	41.5	41.5
Incomes from non-financial property	39.2	29.6	20.2	19.3	21.3	20.8
Incomes from financial property	0.9	1.2	2.1	1.7	2.2	1.5
Incomes from fees	5.7	10.6	4.7	6.0	8.5	6.7
Incomes from debt accumulation	11.7	14.1	19.5	8.3	14.9	14.6
Incomes according to special regulations	5.8	6.6	10.8	8.6	11.0	10.6
Other regulations (fines, etc.)	2.4	6.5	0.7	21.4	0.5	4.3

Source: www.revizija.hr

The difference in the share of non-fiscal income, which can be observed in the analyzed counties, results from a number of factors that could be defined as: geopolitical, geographical, social, economical, developmental, cultural, personnel and so on. Nevertheless these differences in non-fiscal incomes allow the bodies of local and regional self-government to take higher quality and more efficient measures and actions to either introduce or make better use of the said sources of income.

### 3.3. Settlement Aids for Decentralized Functions

For the purpose of decentralization, in July 2001 the Republic of Croatia has introduced the institute of settlement aid from the means acquired through income tax. Decentralization refers to a part of civil services in the sphere of schooling, health care, social services and firefighting, and it concerns the transfer of some administrative and professional work and services from ministries to the bodies of local and regional self-government. Concretely, means for salaries and contributions on salaries in these activities are provided in the state budget, and material costs, investment maintenance expenses and investments are transferred to local and regional self-government, whereby the state provides a part of the income which the local units lack for the financing of these needs. These means are taken from the settlement aid assets, which are accumulated from the rate of 21 % from the income tax and expressed in the state budget.

The shares of the income tax rate for decentralized functions according to particular functions are the following:

- for the basic education system 2.9 %
- for secondary education system 2.0 %
- for social care centers 0.4 %
- for homes for old and disabled persons 1.6 %
- for health care 2.5 %
- for public firefighting units 1.0 %.

Settlement aids are allotted to those municipalities, towns and counties which - from the additional share in the income tax for decentralized functions – do not realize assets in the amount determined by minimal financial standards in particular activities.

Criteria, scales and the amounts of minimal financial standards are prescribed by the Government of the Republic of Croatia for every calendar year and for each of the decentralized functions individually.

Although settlement aids for decentralized functions present a significant source of income for the budgets of many local and regional self-government units, these means are mainly insufficient for the financing of all functions transferred to these units. This is why another instrument of financing has been added to the financing system – the settlement fund on which the units of local and regional self-government have no direct influence, which leads to the weakening of their autonomy. The settlement fund disrupts the

principle of even incomes and the principle of democratic publicity and independence in determining the budget.

### **3.4. Subsidies (Pork Barrels)**

One of the important sources of income of local and regional units of self-government are the pork barrels or subsidies that represent horizontal equalization, compensating for the differences in fiscal power and for the lack of individual local and regional units' own fiscal capacity to finance planned activities.

Most significant are the subsidies from the state budget although aid may also come from foreign governments and from other subjects within the state as a whole. Aids from the state budget are assigned through programs, financial plans depending upon the requirements of individual ministries, i.e., depending on the purpose (of the current and capital aids), character of the aids and the subjects to which aids are directed. Aids are given to local and regional budgets, but not to the user himself, and they are remitted through the Fund for Regional Development and through the Ministries authorized for specific areas. Criteria, indicators and standards for the determination of the aid (under the legislation about the execution of the budget) are determined separately for each year on the basis of the financial sovereignty of the counties and the density of the population (the demographic criterion).

Thus, for the year 2005, counties were obliged to distribute at least 75 % of the amount of obtained aid to municipalities and towns on their territories, which are not direct users of subsidies and aids from the state budget.

The average share of aid in the structure of total incomes of all counties on the level of the Republic of Croatia (without the City of Zagreb) is about 15 %. The shares of aid vary among the counties, and for those included in this analysis they are as follows: (Source [www.revizija.hr](http://www.revizija.hr))

- for Osijek – Baranya County	17.2 %
- for Vukovar – Sylvania County	37.1 %
- for the Primorje and Gorski Kotar County	4.6 %
- for Zadar County	12.3 %
- for the County of Istria	7.7 %.

## **4. PROBLEMS OF FINANCING LOCAL AND REGIONAL SELF-GOVERNMENT UNITS**

In the previous chapter, we have analyzed the sources of income that the local and regional self-government units use to finance activities and tasks in their jurisdiction. From relative indicators for five selected counties, one can observe a wide variety of particular incomes in the structure of total incomes which directly affects the quality of providing services on local and regional level. In other words, the lack of income for regular financing of all functions creates problems in the functioning of the local and regional self-government units.

This primarily refers to the territorial structure of the Republic of Croatia. Croatia has three levels of government: 1. the central state; 2. counties and 3. municipalities and towns which on a relatively small territory (56,500 km<sup>2</sup>) make more than 570 organizational self-government units. The too big number of local and regional units makes it impossible for the bodies of central government to get a realistic financial picture, bureaucracy is piling up at all levels of government with an inadequate division of functions and responsibilities. There are places in the Republic of Croatia which, although they satisfy formal criteria and become towns or municipalities, do not justify this status neither with their level of income nor with the functions which are assigned to them by the law. The piling up of administrative bodies and of staff employed in them makes it impossible for such local units to finance current expenditures or to provide basic services on their territories, so that their income rates depend more and more on direct transfers from the state budget. The state provides local units with permanent subventions (current, capital, appropriated and general) from the state budget which are through counties remitted to local units below the average fiscal capacity. Although there are fixed fiscal equalization criteria for the financing of decentralized functions on the local level, a part of these means is intended for the financing of current expenditures. Part of the territorial structure of the Republic of Croatia consists of areas under special state care that have been established to stimulate their faster development because of the damages caused by war. These areas, which

constitute 111 units of local self-government, have a privileged financing position with numerous tax relieves and privileges and with current subventions from the state budget.

The performed reform of the local units' budget system has lifted the problems of inappropriate classification of budgets, complicated accounting, heterogeneousness in the creation of budget plans, and non-consolidation of the budgets of local units. Budget has become a quality source of information. Planning of the local units' budgets follows the economic, functional and organizational classification, where the general part of the budget is planned according to economic classification, and the special part is planned according to organizational and functional classification.

Local units' budget plans also contain plans of their users, which creates the conditions for the consolidation of the local units' budgets. Planned incomes of the local units' budgets and budget users are based on the evaluation of trends in macroeconomic indicators, which are elaborated by the Ministry of Finance, and on the volume and structure of the public and local incomes. Local units must make a detailed capital part of their budget plan for the purpose of the years-long planning of capital programs and debt accumulation, whereby the debt accumulation for the financing of capital projects must not exceed 20 % of the income realized in the previous year. All activities connected with budget planning, planning of capital investments through elaboration of investment studies and the analysis of social justification of every investment, depend on the training level and competences of the employees in local units. These problems must be solved through continuous informing and training of administration staff and through the adoption of modern ways of budget calculation.

One special problem that we would like to emphasize is the lack of internal control which should be organized on the level of the counties for internal control of smaller local units which are unable to do so themselves. It is possible to observe a high degree of politicization which makes it impossible to create stronger mechanisms of financial control of the central state.

## **5. CONCLUSION**

The aim of every unit of local and regional self-government is to provide their citizens the most satisfactory level of public services possible. Their task is to improve their own efficiency in providing public services, because precisely the local units, and that also includes regional units, have better insight into the needs of the citizens on their territory than the state.

It is a fact that the efficiency of providing public services grows if accompanied by more rational and more quality tracking of costs and operating expenses (which has not been discussed in this paper) and if there are adequate and sufficient incomes. The sources of income for the financing of the local and regional self-government units are diverse and numerous, some more and some less efficient, some more, and some less frequently used in particular self-government units.

But, nevertheless, the common conclusion is that, due to the very large number of local units in the Republic of Croatia, the system of collecting income is mainly insufficient for quality and functional financing of public needs on the local and regional levels.

It is therefore necessary to continue the search for new models of regulating financial relations between the state and local units. The executed decentralization of the financing of local and regional self-government is not sufficient. Because of the new work and activities that have fallen into the jurisdiction of counties (as regulated by Amendments to the Act from 2005), it is necessary to increase the state's allocation of funds from common taxes for the units of the local and regional self-government, to increase the autonomy of the local and regional units in the introduction of their own incomes, especially taxes, to take care about the implementation of functional decentralization, and to stimulate local and regional governments in the realization of a larger non-fiscal income of their own.

It is a fact that some countries in the European Union have begun with the reorganization and reduction of their local self-government precisely because of too high financial payments for the needs of the local self-government. However, so long as the Republic of Croatia retains the existing organization of local governments, it should also provide for its financing. The local or regional self-government units' own sources of income should be their principal sources of financing.

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