

## ENTREPRENEURIAL ACTIVITIES IN ECONOMICALLY UNDERDEVELOPED AREAS OF CROATIA

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### Abstract

Entrepreneurship activities are crucial for regional development. Croatian legislative supports regional development almost fifteen years. Acts from the late 90s are directed to separated, economically stagnated regions (areas special state concern, hill and mountain areas, islands etc.). Acts are still lawfully and still encourage entrepreneurship activity through the tax exemptions. Regional development Act and subordinate acts from 2009, defined regions with developmental disabilities, so called assisted areas. Their status is determined by development degree. Development degree is connected indirectly with entrepreneurship activity progress. Earlier regulated and economically weaker areas differ territorially with regard to assisted areas.

Considering the above, authors of this paper will analyze entrepreneurship activity indicators (entrepreneurship number, number of employees and financial results). Indicators will be compared for two groups of areas:

Areas special state concern (1<sup>st</sup>, 2<sup>nd</sup> and 3<sup>rd</sup> group) and hill and mountain area

Assisted areas at local self-government level

Research results should indicate on correlation between areas development degree and entrepreneurship success. The paper will provide the overview of entrepreneur activity indicators for areas which are not include in Croatian system of incentive measures and it will never be.

JEL Classification: O12, R11

**Keywords:** underdeveloped areas, indicators of entrepreneurial activity, government incentives

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## 1. Introduction

Due to a non-existent and undeveloped regional development strategy, the Republic of Croatia has been undertaking measures for development promotion during the period of twenty years, mostly in the form of individual regional acts. Such measures have been aimed at economic and demographic development promotion, extending the capability of exploitation of existing natural resources and at the development of competitive regional values. For the purpose of solving the accumulated economic development problems, the Act on Areas of Special State Concern (OG 86/08 and 57/11) was adopted in 1996, while the Act on Hill and Mountainous Areas was passed several years later, i.e. in 2002 (OG 12/02, 32/02, 117/03, 42/05, 90/05 and 80/08). The aforementioned areas<sup>1</sup> take up a large portion of the territory of the Republic of Croatia, which implies that the aforementioned areas should, via more significant economic development indicators, participate in large part in the overall economic development of the country. The aforementioned acts are still in force in the Republic of Croatia. Almost 20 years after the emancipation of the Republic of Croatia, legislative authorities have passed the Act on Regional Development of the Republic of Croatia (OG 153/09), and soon the Strategy for Regional Development of the Republic of Croatia for the period of 2011-2013 was passed. In the Act on Regional Development, a special category was introduced – assisted areas. Assisted areas represent the areas of the Republic of Croatia that lack behind the national average regarding the development level and whose development is to be promoted additionally (Act on the Regional Development of the Republic of Croatia, (OG 153/09, Article 3, paragraph 4). The development level is based on the development index.<sup>2</sup> The status of assisted areas is given to regional self-governing units that are in group I (development index under 75% of the national average). On local self-government level (municipalities and cities) the assisted areas are divided into group I (development index under 50% of the national average) and group II (development index between 50 and 75% of the

<sup>1</sup> For the purposes of this paper, the areas of special state concern (ASSC I., ASSC II and ASSC III groups) and hill and mountainous areas (HMA) shall be encompassed with the term: the areas of special state status

<sup>2</sup> The development index is calculated, pursuant to Article 2 of the Regulation on Development Index (Official Gazette 63/10), on the basis of the following indicators: unemployment rate, per capita income, per capita budgetary income for local, i.e. regional, self-government, overall population trends and education rate

national average). For the purposes of this paper, the assisted areas will be observed on local self-government level.

Developed entrepreneurship is a significant factor in the economic development of every country, the same goes for the Republic of Croatia. The activities of entrepreneurs in the areas of special state status are encouraged by authorities via tax relieves on income tax. Entrepreneurs who have their enterprises registered in the assisted areas, and are not simultaneously a part of the areas of special state status, neither had such relieves, nor have them at present. The activity indicators of those entrepreneurs that are subject to income tax<sup>3</sup> and that have their enterprises registered in the areas of special state status and assisted areas for the period between 2007 and 2010 will be observed further in this paper. These indicators are related to the number of entrepreneurs; the number of people employed and net financial results of their business activities.

## **2. Territorial determinants of the areas of special state status and assisted areas**

The areas of special state status are defined according to criteria linked to war circumstances during the aggression on the Republic of Croatia, economic development, structural and demographic difficulties and natural and geographical characteristics that represent aggravated life conditions. Table 1 presents an overview of basic determinants for the areas of special state status. In the area of special state status, 66 local self-government units of the total number of 220 units were not determined as assisted areas. This means that their development index exceeds 75% of the national average. However, it is necessary to emphasize that those local self-government units have used, and are still using, certain privileges via which the government is promoting their development. Such rights are guaranteed to those local self-government units by legal regulations that are still in force and which regulate the area of special state status.

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<sup>3</sup> Income tax payers, banks and insurance companies not included

Table 1: Basic determinants of the areas of special state status

Area	Classification criteria <sup>1</sup>	Number of encompassed cities/ municipalities	Territory (in % of total territory of the Republic of Croatia) <sup>2</sup>	Population (in % of total population of the Republic of Croatia) <sup>3</sup>
The area of special state concern group I (ASSC I)	Circumstances occurred based on war aggression on the Republic of Croatia	6 cities, 42 municipalities and 5 settlements in 2 cities**	45.6	15.15
The area of special state concern group II (ASSC II)	Circumstances occurred based on war aggression on the Republic of Croatia	13 cities, 40 municipalities and 75 settlements in 8 cities***		
The area of special state concern group III (ASSC III)	Economic development, structural difficulties, demographic criteria	1 city and 73 municipalities		
Hill and mountainous areas (HMA)	Natural and geographical characteristics that represent aggravated life conditions	12 cities and 33 municipalities	10.5	4.71

Source: Act on Areas of Special State Concern (OG 86/08 and 57/11), Articles 3-6 and 24

Act on Hill and Mountainous Areas (OG 12/02, 32/02, 117/03, 42/05, 90/05 and 80/08), Articles 7b and 7d

<sup>2</sup> Đulabić, V., Manojlović, R., 2011, pp. 1041-1074

<sup>3</sup> National Bureau of Statistics, 2011, pp. 14-160, data processed by the authors

\*\* Osijek (10% of city area) and Vinkovci (25% of city area)

\*\*\* Daruvar (25% of city area), Dubrovnik (50% of city area), Karlovac (10% of city area), Sisak (10% of city area), Slatina (10% of city area), Virovitica (10% of city area), Vodice (25% of city area) and Zadar (10% of city area)

The assisted areas in groups I and II encompass cities and municipalities with the development index under 50%, i.e. between 50% and 75%, of the national average. The data listed in Table 2 refers to basic determinants for the assisted areas in the Republic of Croatia. From the table it is visible that a total of 256 local self-government units have the status of assisted areas. It is especially important to emphasize the fact that in group II of assisted areas there are 21 cities. To conclude, as much as 16.5% of the total number of cities in the Republic of Croatia<sup>4</sup> has the status of assisted area. 54.8% of the total number of municipalities in the Republic of Croatia<sup>5</sup> have the status of assisted area.

Table 2: basic determinants of the assisted areas in the Republic of Croatia

Area	Classification criteria <sup>1</sup>	Number of encompassed cities/municipalities	Territory (in % of total territory of the Republic of Croatia) <sup>2</sup>	Population (in % of total population of the Republic of Croatia) <sup>3</sup>
Group I	Development index under 50% of the national average	35 municipalities	35.08	11.29
Group II	Development index between 50% and 75% of the national average	21 city and 200 municipalities		

Source:<sup>1</sup> Act on Regional Development of the Republic of Croatia (OG 153/09), Article 2, paragraph 1

<sup>2</sup> Decision on the classification of local (regional) self-government according to development level (Official Gazette, 89/10)

<sup>3</sup> [http://www.hgk.hr/wp-content/files\\_mf/potpomognuta%20podru%C4%8Dja.pdf](http://www.hgk.hr/wp-content/files_mf/potpomognuta%20podru%C4%8Dja.pdf), visited on February 15<sup>th</sup> 2013, data processed by the authors

Areas marked as those of special state status and assisted areas slightly differ. Local self-government units, 139 municipalities and 15 cities, have a dual status: the status of area of special state status and the status of assisted area. Assisted areas outside the areas that have special state status encompass 102 local self-government units, i.e. 96 municipalities and 6 cities. The aforementioned local self-government units did not have certain governmental privileges that were granted to local self-government units in the areas of special state status so far.

<sup>4</sup> The Republic of Croatia is administratively divided into 127 cities

<sup>5</sup> The Republic of Croatia is administratively divided into 429 municipalities

### 3. Entrepreneurial activity indicators in the areas of special state status and assisted areas

The entrepreneurship activity is indirectly linked to the development index. At the end of the 80s of the past century, the preconditions for the development of entrepreneurship were created in the Republic of Croatia (Company Act, OG of SFRY 77/88 and 40/89). The development of entrepreneurship activities was followed by changes in regard to creation of a large number of small and middle companies, i.e. there was a significant decrease in the number of large companies in comparison to the period of socialistic system. The information that in 2010 (according to Financial Agency, 2008 and 2011), 99.6% of the total number of the entrepreneurs that were tax payers were small or medium entrepreneurs and only 0.40% were large entrepreneurs, speaks in the favor of the previous statement. In the Republic of Croatia in 1983, small and medium entrepreneurs accounted for 79% of the total number of entrepreneurs, while 21% were large entrepreneurs (Bogović, T.; 2006, p. 38). Today Croatian entrepreneurship is faced with problems of inefficient government bureaucracy, corruption, political instability, tax burdens, expensive financing sources etc. (Centre for Global Competitiveness and Performance, 2012, p. 146).

Taking into account the prolonged period of not implementing regional policy, i.e. inadequate implementation of the same, it is important to analyze the entrepreneurial activity indicators that are active in the areas of special state status and assisted areas. The entrepreneurial activity is promoted in the areas of special state status by the government with income tax exemptions.<sup>6</sup> The exemption in the areas of special state status accounted for almost 700 million HRK during the period of 2007-2010 (Tax Administration, 2012). Furthermore, it is important to emphasize that a part of government's tax income (a part of tax liability from which entrepreneurs are not exempted) is returned by the government into the budgets of cities and municipalities that are in the area of special state status. During the period of 2007-2010, governmental authorities have returned 1.2 million HRK of the aforementioned amount (Ministry of Finances, 2010 and 2011, pp. 76 and 67). A majority of such funds were earmarked for the development of entrepreneurship,

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<sup>6</sup> The exemptions are defined in Articles 23 and 24 of the Act on Areas of Special State Concern (Official Gazette 86/05 and 57/11) and Articles 7b and 7d of the Act on Hill and Mountainous Areas (Official Gazette 12/02, 32/02, 117/03, 42/05, 90/05 and **80/08**)

but such funds were often used for financing other budgetary expenditures in local self-government units.

An overview of entrepreneurial activity indicators for the whole Republic of Croatia, the areas of special state status and the assisted areas is presented further in this paper. These indicators are related to the number of entrepreneurs; the number of people employed and net financial results of their business activities (Financial Agency, 2008, 2009, 2010, 2011, pp. 11, 12, 14 and 14).

**Table 3:** Entrepreneurial activity indicators of Croatian entrepreneurs for the period of 2007-2010

No.	Indicator	2007.	2008.	2009.	2010.	2010/2007
1.	Number of entrepreneurs	83.532	89.656	91.320	96.758	15,83%
2.	Number of people employed	869.013	933.958	889.396	859.808	-1,06%
3.	Net financial result* (000 HRK)	24,763,709	17,229,532	4,396,868	-1,663,070	-106.72%

Source: Financial Agency, 2008, 2009, 2010, 2011, pp. 11, 12, 14 and 14, data processed by the authors

\* Net financial result represents the difference between gain after taxation and loses after taxation of all entrepreneurs

Although the number of entrepreneurs has increased on the national level during the observed period, the number of people employed is in decline. The decline of the number of people employed is especially outlined if we look at the number of people employed in 2010 in comparison with 2008. During that period, there was a 7.94% decline in the number of people employed. The net financial result was, during the observed period, reduced for as much as 106.72%.

From the data listed in Table 4 it is visible that 28.92% less entrepreneurs have registered enterprises in the assisted areas when compared to the areas of special state status. At the same time, 36 more local self-government units are included into the assisted areas than in the areas of special state status (consult Table 1 and Table 2). The number of entrepreneurs in 2010 in the assisted areas accounted for only 8.5% of the total number of entrepreneurs in the Republic of Croatia. Only 6.05% of the total number of entrepreneurs in the Republic of Croatia conducts business activities in the assisted areas. Net financial results of all entrepreneurs in the areas of special state status in 2010 represented 25.25% of the total net financial results of all entrepreneurs in the Republic of Croatia. Entrepreneurs that conduct

business activities in the assisted areas participated in the overall financial results of the Republic of Croatia with a share amounting to 17.24%. Therefore, it is visible that entrepreneurs generate highly negative net financial results in these areas.

**Table 4:** Entrepreneurial activity indicators of all entrepreneurs in the areas of special state status and assisted areas for the period of 2007-2010

No.	Indicator	2007	2008	2009	2010	2010/2007
<b>I. Areas of special state status</b>						
1.	Number of entrepreneurs	6,683	7,297	7,813	8,234	23.21%
2.	Number of people employed	64,649	70,755	68,536	62,834	-2.81%
3.	Net financial results (000 HRK)	1,069,120	848,239	-424,305	-419,887	-139.27%
<b>II. Assisted areas</b>						
1.	Number of entrepreneurs	4,610	5,097	5,503	5,853	26.96%
2.	Number of people employed	47,907	53,447	52,039	49,526	3.38%
3.	Net financial results (000 HRK)	522,196	275,323	52,436	-286,646	-154.89%

Source: Financial Agency, 2008, 2009, 2010, 2011, pp. 11, 12, 14 and 14, data processed by the authors

Furthermore, it is important to emphasize that 58.72% of entrepreneurs in the areas of special state status were outside of the assisted areas in 2010. The same entrepreneurs employed 57.16% of the total number of people employed in 2010 and participated with high 64.27% in the achieved losses of the areas of special state status. In the areas of special state status, outside the assisted area, there are 24 local self-government units that have achieved their status solely because of the consequences of war destruction. In the area of such local self-government units in 2010 there were 26.62% of the total number of entrepreneurs that operate in the areas of special state status. Entrepreneurs in the same local self-government units employed 29.81% of the total number of people employed in the areas of special state status.

Assisted areas outside the areas of special state status have not been, in the past, included into areas in which governmental incentives in the form of income tax exemption were given. The assumption is that a certain level of development existed in such areas. However, low values of the development index and adverse entrepreneurial activity indicators suggest otherwise.



**Table 5:** The entrepreneurial activity indicators of all entrepreneurs in the areas of special state status outside the assisted areas and assisted areas outside the areas of special state status for the period of 2007-2010

No.	Indicator	2007	2008	2009	2010	2010/2007
<b>I. areas of special state status outside the assisted areas</b>						
1.	Number of entrepreneurs	4,046	4,354	4,598	4,835	19.5%
2.	Number of people employed	38,695	40,739	39,157	35,916	-7.18%
3.	Net financial results (000 HRK)	665,800	500,006	-541,585	-269,873	-140.53%
<b>II. assisted areas outside the areas of special state status</b>						
1.	Number of entrepreneurs	1,937	2,154	2,288	2,454	26.69%
2.	Number of people employed	21,953	23,431	22,660	22,608	2.98%
3.	Net financial results (000 HRK)	118,876	-72,909	-64,844	-136,632	-214.94%

Source: Financial Agency, 2008, 2009, 2010, 2011, pp. 11, 12, 14 and 14, data processed by the authors

#### 4. Conclusion

Local self-government units included into the assisted areas, according to the development index, are undeveloped in the entrepreneurial sense. In those areas, encompassing over one third of the entire territory of the Republic of Croatia, there is a small number of entrepreneurs. In the same areas, a trend of employment growth and loss generation is also evident. In the areas of special state status, despite governmental incentives in the form of income tax exemptions, entrepreneurs have, during the observed period, reduced net financial result and generated losses. Furthermore, entrepreneurs in the areas of special state status outside assisted areas do not exhibit success in their business activities. That is why entrepreneurial activity indicators should be taken into account when assessing the development level. That would mean that almost the entire territory of the Republic of Croatia should be classified as an assisted area. All observed entrepreneurial activity indicators point at the existing adverse situation, but also at the situation which does not promise better results in the near future.

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