

## ROLE AND RESPONSIBILITIES OF LOCAL MANAGEMENT FOR GOVERNING AND DISPOSAL OF FUNDS FOR FINANCING OF DECENTRALIZED FUNCTIONS

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### Abstract

Decentralisation and devolution in conducting of public affairs from higher to lower level of government was implemented in Croatia in 2001 in elementary and secondary education, health care, social welfare and firefighting. It was not true decentralization, with the expansion of the local authority, responsibility and financial capabilities, rather mere administrative decentralization, without spreading the autonomy of the local community. Legal decentralization was not accompanied by fiscal decentralization, which involves financial aspects of transfer of public affairs to regional and local government. The degree of fiscal decentralization of certain government is estimated by the proportion of local government involvement in total revenues and expenditures of the general government and the local government share in GDP. None of these indicators in Croatia are reaching the EU average.

Financing of decentralized functions from income tax in the past five years indicates enormous problems in financing due to total dependence of local communities on the central government, especially in the area of primary and secondary education. In such circumstances, the local management, responsible for the efficient and economical operation of the management and disposal of funds for decentralization, is facing organizational challenges.

**JEL Classification:** H72

**Keywords:** decentralization, fiscal decentralization, decentralized functions, local management

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## 1. Introduction

Decentralization in Croatia is an unfinished process. During the establishment of the system of decentralization, especially in the last five years, there have been no significant changes in funding or in the transfer of authority to local government. One of the major reasons for the delay in this process are large differences in the size of the fiscal capacity of local government units. Local management which manages budgetary resources (fiscal capacity) should be more and more focused on increasing effects in the managing of limited resources and achieving of the set goals with a reduction in costs. The paper will be exploring issues of fiscal decentralization with an emphasis on elementary and secondary education. One of the key problems is the fact that regional government funds for financing primary and secondary education are continuously being reduced, with a steady increase in costs. The amount of decentralized funds allocated to regional government for the monitored features is only 77% of funds allocated in 2010. In such conditions, local management is put in a very difficult position of making unpopular decisions that need to have a long-term positive effect. It is very difficult for the managers in the regional government to maintain the achieved standard with the available financial capacity .

„What is the actual fiscal power and how much of the responsibilities are allocated to regional and local authorities greatly depends on: (1) which public services local and regional governments are funding, (2) whether their revenues are proportionate and consistent with the responsibilities in providing of public services, (3) level of rights regional and local authorities have to vote in the actual allocation of their budget for the financing of certain public services, (4) whether the regional and local authorities determine their own tax rates and benefits by allowing the level of public spending (public expenditure) to vary in order to adjust the level of quality of the public services to the users who are also the taxpayers.“<sup>1</sup>

We will try to find the answers to these questions in the following chapters.

## 2. Decentralization and fiscal decentralization in Croatia

Decentralized functions are expenses that are by special laws for primary and secondary education, welfare, health and fire services transferred to the local and regional self-government, and financed from additional share of income tax and equalization grants for decentralized functions.

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<sup>1</sup> Jurlina Alibegović, D.: Fiskalna decentralizacija u Hrvatskoj: između želja i mogućnosti, Ekonomski institut, Zagreb, 2012, str. 35

Balance sheet rights are funds necessary to ensure minimum financial standards in a given decentralized function according to the Article 4 of this Regulation.

Equalization grants are transfers of funds from the state budget to local and regional self-government for financing of decentralized functions when revenues generated from the additional share of income tax are not sufficient to finance the minimum financial standards.

Fiscal decentralization involves the division of public expenditure (public affairs) and revenues for financing of public affairs between levels of public authority and discretion to decide of regional and local public authorities. It is, in fact, the relationship between central and local levels of government in which part of operations were transferred to lower levels, as well as given a certain, limited autonomy in financing expenses. Simply put, we can say that this is a kind of transfer of "power and money" from the central government level to a lower one-local.

The decentralization process in Croatia is characterized by unclear division of competence in the implementation of public functions between central, regional and local government, so that all the levels of government are charged with the enforcement of public functions and their responsibilities often overlap. In addition, a large number of laws that regulate this area (Constitution, more than 20 laws, regulations, decisions) make the system even more complicated in practice.

Various authors have studied the process of decentralization and given their assessment of the effectiveness of the process, some of them being "Decentralization of primary and secondary education, health, social welfare and public fire service conducted in 2001 was not conducted so as to strengthen local autonomy, but so as to some lesser extent include the local government and the counties in the organization and financing of these services. At the same time fiscal decentralization was not implemented, but the funds for these services are transferred from the state budget. There is no decentralization of decision-making and then virtually no accountability. Line ministries are still the power centres in regard to services concerned."<sup>2</sup>

The degree of fiscal responsibility in Croatia is characterized by a very small proportion of local government in total revenue (11.9%) and expenditure (10.0%)

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<sup>2</sup> Koprić, I.: *Lokalna samouprava u Hrvatskoj: pokvarena igračka u rukama politike*, 1. Forum o javnoj upravi, 2012. str.13.

of the consolidated general government, as well as a share of income (4.5%) and expenditure (4.0%) of local government in GDP in the year 2012.

All subsequent changes after 2001, the so-called decentralization of government functions, the concept of major cities (2005), direct election of local officials (2009) were only cosmetic changes of the same, centralized model of governance. The mentioned indicators of the degree of fiscal decentralization indicate that Croatia is still an unchanged and strictly centralized state, one of the few severely centralized in Europe, which divides the infamous position at the rear with Greece and Slovenia.

### 3. Characteristics and problems of financing decentralized functions

The system of financing local and territorial (regional) self-JLP (R) S in Croatia is characterized by a large number of local units in a special status (275), of which 180 local government units (LGUs) in the status of special state concern, 45 local governments in the hilly mountainous areas, and 50 on the islands. Special status also belongs to 54 local units (34 cities and 20 counties) that finance decentralized functions (DEC). Thus, more than a half of the local government, or a total of 328 local governments is in a special financing status, while only 248 are out of the special status of funding. Particularly complicated is the system of public financing of decentralized functions of the so-called shared taxes - income taxes.

Income tax is a shared tax, which means that the revenues from this tax are shared between the municipality or the city in which the taxpayer has a domicile or habitual residence, the county in which is located the city or municipality and the central government. There is a general and two types of special allocation of revenues from income tax (Table 1). For the sake of simplicity this article explains only the general allocation of income tax.

Method of allocation of income tax is defined by:

- The Law on Financing of the Local and Regional self-government<sup>3</sup>
- Regulations on the method of calculating the amount of equalization grants for decentralized functions of the local self-government and the decisions of

<sup>3</sup> NN br. 117/93, 33/00, 73/00, 59/01, 107/01, 117/01-ispravak, 150/02, 147/03, 132/06, 73/08, 25/12 Odluka Ustavnog suda Republike Hrvatske NN br. 26/07

the minimum financial standards for each decentralized function. These regulations and decisions are published separately for each year.

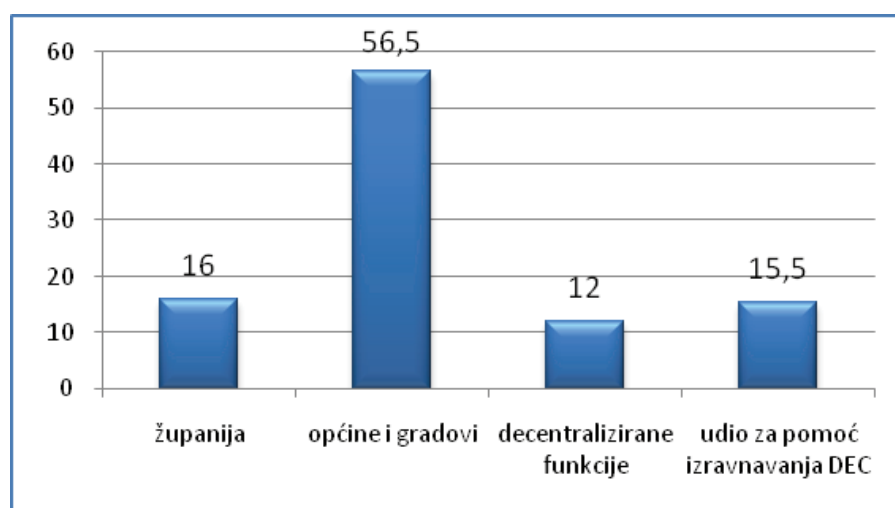
**Table 1:** Distribution of income tax from 1 March 2012 according to the Law on Amendments to the Law on Financing of Local and Regional self-government (in%)

Type of distribution	County – main part	Municipality or city- main part	Fire services (decentralized functions)	Other decentralized functions	Equalization fund for decentralized functions
General	16,0	56,5	1,3	10,7	15,5
General – for the City of Zagreb	-	72,5	1,3	10,7	15,5

Source: Author's calculations based on the Law on Amendments to the Law on Financing of Local and Regional self-government

Method of allocation of revenues from income tax changed over time, and amendments to the Law on the 1st March 2012, 16% belongs to the county and 56.5% to cities/municipalities. Since the City of Zagreb performs within the scope of the city and the county, the City of Zagreb's share in the revenue from income tax is 72.5% (16%+56.5%). These revenues can be used by municipalities/cities/counties to finance any expenditure.

**Graph 1** Allocation of income tax (%)



Source: Author's calculations based on the Law on Amendments to the Law on Financing of Local and Regional self-government

Part of municipalities/cities/counties has since 2001. assumed the obligation to finance one or more decentralized functions (education, welfare, health and/or fire service) from the revenue collected from income tax. This is a public service that was previously financed by the central government. Each year the Government prescribes minimum financial standards, or how much an individual municipality/city/county should spend for each assumed decentralized function.

To fund these decentralized functions central government leaves up to 12% income tax to municipalities/cities/counties (1.3% for fire fighting and 10.7% for the other decentralized functions: 3.1% for the financing of primary education, 2.2% for the secondary education, 2.2% for social welfare and 3.2% for health). If municipalities/cities have not taken the decentralized functions those are funded by the central government. In this case, additional share in income tax intended for these functions belongs to the central government.

The remaining 15.5% of the income tax collected in their area the municipalities / cities pay to the Fund for decentralized functions. Resources from this fund are awarded only to those municipalities/cities/counties that have taken the decentralized functions, and an additional share in income tax that accrues in their area is not sufficient to finance the minimum financial standards.

Municipalities/cities/counties which obtain more funds from additional share in income tax for funding decentralized functions and assistance from the Fund for decentralized functions than was prescribed by minimum financial standards must return the excess to the state budget.

This model of distribution of the income tax has led to significant fiscal imbalances and to large differences in fiscal capacity of local units, as can be seen from the table of the gross domestic product in Croatia for the year 2012 (Table 2)

**Table 2:** Gross domestic product of the Republic of Croatia

	GDP in thousands €	Compared to 2008. %	GDP per capita €
REPUBLIC OF CROATIA	44,219.521	-7	10.235
CONTINENTAL CROATIA	30,184.405	-6,7	10.514
City of Zagreb	14,633.846	-3	18.503
Zagreb County	2,474.201	-5,4	7.786
Krapina-Zagorje County	836.265	-16	6.300

Varazdin County	1,457.024	-13	8.285
Koprivnica-Križevci County	984.443	-13	8.524
Međimurje County	962.715	-7	8.459
Bjelovar-Bilogora County	884.007	-15	7.062
Virovitica-Podravina County	536.188	-15	6.333
Pozega-Slavonija County	488.743	-10	6.281
Brod-Posavina County	931.277	-12	5.882
Osijek-Baranja County	2,520.085	-10	8.271
Vukovar-Srijem County	1,113.215	-13	6.217
Karlovac County	991.103	-12	7.709
Sisak-Moslavina County	1,411.293	-2,2	8.214
MEDITERRNIAN CROATIA	14,035.115	-7,7	9.941
Primorje-Gorski Kotar County	3,768.380	-3,3	12.724
Lika-Senj County	409.920	-15	8.081
Zadar County	1,413.905	-12	8.302
Sibenik-Knin County	865.431	-15	7.930
Split-Dalmatia County	3,672.051	-11	8.072
Istria County	2,703.901	-4	12.991
Dubrovnik-Neretva County	1,201.527	-11,4	9.807

Source: National Bureau of Statistics, 2014.

From the data presented are visible large differences in average GDP per capita between individual counties and regions. For example, the poorest Brod-Posavina County has only 57.5% of the Croatian average GDP per inhabitant, and the City of Zagreb even 180.8% of Croatian average. Only two counties (Istria and Primorje-Gorski Kotar) exceed Croatian average, and 90% of Croatian counties is below the average of € 10,235.

Total revenues and receipts of all local government units in Croatia in 2012 amounted to HRK 21,993,030,187, out of which 3,535,587,768 kuna applies to counties (16.1%), cities 8,659,608,812 kuna (39.4%), City of Zagreb (29.1%) and municipalities (15.4 %).

In the period from 2010 to 2013 the total funds for financing of decentralized functions are reduced from 2.85 billion to 2.21 billion, a decrease of 640.89 million kuna, or only 77.5% of the amount from 2010.



**Table 3:** Financing of decentralized functions (DEC) in the year 2012

No.	DEC function carrier	Additional share in income tax for DEC (without the City of Zagreb)	Additional share in income tax for DEC	Equalisation fund	Total DEC	Participation of additional shares in DEC%
1.	Counties	504.375.066	504.375.066	1.022.148.515	1.526.523.581,00	33,04
2.	Cities	167.292.640	167.292.640	252.506.805	419.799.445,00	39,85
3.	City of Zagreb		531.196.893		349.141.001,00	0,00
4.	Municipalities				31.597.000,00	152,14
<b>TOTAL:</b>		671.667.706	1.202.864.599	1.274.655.320	2.327.061.027	<b>28,86</b>
5.	Republic of Croatia (for cities that have not taken DEC)	250.827.973			250.827.973	100,00
<b>GRAND TOTAL:</b>		922.495.679	1.202.864.599	1.274.655.320	2.577.889.000	35,78

Source: Authors calculation based on data from the Ministry of Finance

Analytics in the table above confirm the stated claims of inadequate funding model of decentralized functions in Croatia. To obtain more objective data from the analytics it is necessary to exclude the City of Zagreb, which is an obvious example of unsustainable financing model of DEC.

Three counties with additional share in finance of DEC participate with more than 50%, 14 with less than 30%. City of Zagreb with realization of 152% DEC or 182 million more than the necessary funds for funding of decentralized functions confirms the specified argument.

For financing of DEC in 2012 a total of about 2.6 billion kuna was spent of which the local units (not including the city of Zagreb) with additional share in income tax participated with only 28.86%. This means that the transfer of some public functions and resources needed for their implementation from the state to the local level has not achieved the desired goal nor caused a higher autonomy of local governments.

In the conditions of strong (financial and political) dependence and increasing paternalistic attitude of the central government and its “power centers” local management can hardly manage public resources more efficiently, increase their effectiveness, monitor the results of their own decisions and thus lead to increased accountability for the results achieved .



#### **4. The role and responsibility of local management to manage and dispose of the funds for funding of decentralized functions on the example of elementary and high school education**

By the Decree on the method of calculating the amount of equalization grants for decentralized functions of regional self-government and the Decisions on the criteria and standards for financing of minimum financial standards of elementary and secondary education for each year, the Croatian Government determines the amounts of funds for counties, the City of Zagreb and 34 cities that took over the obligation to fund primary and secondary education (cities finance DEC primary schools in their area only). From the thus established balance rights are funded material and financial expenditures, current and investment maintenance and expenditures for the acquisition of fixed assets and additional investments in nonfinancial assets.

It should be emphasized that, except for the first year of decentralized funding of some public functions in 2001, formulas for the method of calculation of equalization funds and the minimum financial standards were not publicly disclosed. The Decree is issued by the Government, and the amount of funds for each year is determined by the line ministry. In this way, local management is led into great temptations. The amount of funding is determined by the power centers (relevant ministries) and the responsibility for the management and disposal is transferred to the local level. It is important to note that the county management cannot in any way independently exert influence on the amount of the shared revenue and help because it has no role in their determination. The rates, bases and deductions as well as the distribution of income tax and the change of the additional share in income tax are decided by the central government without consultation with the local community. In this way, local management is placed in the gap between legally defined duties and responsibilities and actual possibilities. This is best illustrated by the following table (Table 4)

The data shows that for a very important function in the primary and secondary education local management in 2013 had at their disposal only 77 or 78% of funds in relation to 2010, that is over 247 million Kuna less on the level of Croatia. At the same time, an important segment of material expenditure - energy (fuel oil) can be used as an example. Compared to the year 2009 it recorded a price increase of a staggering 200% and in relation to the year 2010 132% (6 Jan 2009 price fuel oil/lit = HRK 3.58, 14 Dec 2010 price was HRK 5.44 / l and on 3 April 2013 even HRK 7.19 / l). If we consider the most important goals of the local management:

improving the effectiveness and efficiency, strengthening of responsibility, increase in efficiency and effectiveness while reducing public expenditure, the question remains open how to minimize already minimized costs with a strong and steady rise in prices? The solution is to further reduce student standards, since the existing fiscal capacity cannot meet even the minimum. At the same time students in other communities enjoy 152% of the standard ...

**Table 4:** Financing DEC primary and secondary education in the period from 2010 to 2013

[illegible]

## 5. Instead of conclusion: further steps in fiscal decentralization and local management

The current decentralization process in Croatia has been implemented from administrative but not enough from the fiscal point of view. Funding DEC is achieved at much lesser extent from the revenues of local budgets (additional share in income tax), the most significant part comes from the revenues of the central budget (grants for funding DEC) and the Equalisation Fund. The only public function that is almost completely decentralized is public fire service, while in other functions jurisdiction overlaps, which, together with the lack of own resources to finance local management presents great temptations.

In the governance and management of funds for the financing of decentralized functions, local management under the definitions of management is tasked to plan, organize, lead and control the operation of primary and secondary education, fire service, health and social welfare<sup>4</sup>. Regional governments and managers on that level have a much more complex role. Management must take into account the economic as well as social, political and many other aspects, because those are the most important segments of the local community.

Public management must apply fundamental “principles of public life”, namely: integrity, objectivity, accountability, openness, honesty and leadership<sup>5</sup>.

In particular, there is a big problem in financing DEC of primary education, which is divided by the founding rights between counties and cities. Only a quarter (34 cities) of the total number of Croatian cities has assumed the obligation to finance part of the expenses of primary education, while more than sixty cities with more than 8000 inhabitants have not benefited from the existing legal possibility so far. Due to the large differences in fiscal capacities between counties, cities and municipalities, local management is not able to provide the same level of public services to taxpayers in all communities.

Based on previous research and our own experiences in decentralization in the Brod-Posavina County the following measures and activities are proposed:

- Define the jurisdiction of state and local government
- Reassign taxes and provide greater share to units of regional self-government

<sup>4</sup> Kaštelan-Mrak, M., Vašiček, D.: „Menadžment u javnom sektoru“, Zbornik radova, Savjetovanje pročelnika jedinica lokalne i područne (regionalne) samouprave, Zagreb, 2013, str.121.

<sup>5</sup> IFAC: „Governance in the Public Sector-a governing body perspective“ Research Report, [www.ifac.org](http://www.ifac.org)

- Build systems and criteria for the allocation of government assistance
- Connect neighboring local and regional governments to strengthen the fiscal capacities
- Create financially independent local and regional self-government

For the implementation of the decentralization process, it is necessary to empower the management of regional and local self-government in all its components: top managers, middle managers and operational managers through education. Operational managers must become a link that perceives needs of the citizens, operationalizes them through projects and presents to medium and top managers, the County Prefect and the heads of regional administrations.

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16. Odluka o kriterijima i mjerilima za utvrđivanje bilančnih prava za financiranje minimalnog financijskog standarda javnih potreba osnovnog školstva u 2010.,2011.,2012. i 2013. godini (NN br. 19/10, 29/11, 52/12 i 29/13)
17. Odluka o kriterijima i mjerilima za utvrđivanje bilančnih prava za financiranje minimalnog financijskog standarda javnih potreba srednjih škola i učeničkih domova u 2010.,2011.,2012. i 2013. godini (NN br. 19/10, 29/11, 52/12 i 29/13)
18. Odluka o minimalnim standardima, kriterijima i mjerilima za financiranje materijalnih i financijskih rashoda centara za socijalnu skrb i troškova ogrjeva korisnicima koji se griju na drva u 2010.,2011.,2012. i 2013. godini (NN br. 19/10, 29/11, 52/12 i 29/13)
19. Odluka o minimalnim standardima, kriterijima i mjerilima za decentralizirano financiranje domova za starije i nemoćne osobe u 2010.,2011.,2012. i 2013. godini (NN br. 19/10, 29/11, 52/12 i 29/13)
20. Odluka o minimalnim financijskim standardima za decentralizirane funkcije za zdravstvene ustanove u 2010.,2011.,2012. i 2013. godini (NN br. 19/10, 29/11, 52/12 i 29/13)
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