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# Governance Structures for Local Economic Development in Croatia

- Abstract -

*Who should take care of local economic development in Croatia? This question seems trivial; however, there are still some open questions. According to current legislation, local economic development is an administrative task of the 21 counties, the current units of regional self-government. On the other hand, the cities and municipalities as units of local self-government regularly get involved in economic development activities, though this is not directly defined in the legislation. There is a contradiction concerning development capacity of cities and counties. Cities attract population and economic activity and are usually stronger than counties in terms of financial and human resources that are necessary for economic development activities.*

*This research questions if the existing administrative-territorial setup and functions of counties in Croatia correspond to the needs of economic growth and development on local level. It is also intended to get some insights from concepts that derive from trade theory, location theory and economic geography. Governance relations between bigger cities and counties in fostering local economic development in Croatia will be examined. For this purpose, local and regional data will be analyzed and through the discussion on existing governance structures, qualitative insights on the appropriateness of the current situation will be presented. The main goal of this research paper is to find quantitative and qualitative justification for an appropriate governance structure for fostering local economic development in Croatia.* [1]

**Key words:** Local governance, local economic development, development capacity

**JEL:** O 18, R 11, R 12

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[1] An earlier version of this paper has been presented at the OECD international conference on «Local Development and Governance in Central, East and South-East Europe», OECD LEED Trento Centre for Local Development, Trento, Italy, June 2005.

## Introduction

The thesis of this paper rests on the assumption that the existing administrative-territorial setup and functions that derive from the related legislation in Croatia are not in accordance with the needs of economic growth and development on local level. The main goal of this research paper is to find quantitative and qualitative justification for an appropriate governance structure for fostering local economic development in Croatia. With the aim to investigate current local governance problems in Croatia, the focus of this research is on relations between bigger cities and counties in promoting and fostering local economic development.

Croatian counties are responsible for fostering and promoting economic development on local level. At the same time, even though not formally stated in any of the fundamental legal documents, most of the cities (towns) and many municipalities are very active in promoting local economic development. Naturally, the stronger cities and towns are the driving forces in local economic development in Croatia, whereby the competence of the counties in this domain can be questioned. In practice, governance problems are visible and can be seen through conflicts, competitive behaviour based on local politics, lacking communication and cooperation, causing waste of scarce resources, inadequate support, duplication and neglect of those who really need support. Regional development theories such as trade theory, location theory and new economic geography can give some insight into spatial aspects of economic activities, as well as more contemporary approaches to polycentric development that are currently discussed among experts and academics in the European Union (EC, 2004). Besides the economic focus on development such as promoting growth and competitiveness, the adequacy of the institutional structures and modes of governance as a crucial development aspect is now widely recognized.

The theoretical overview is presented in the first chapter of this paper. The second chapter is devoted to the institutional analysis of the existing administrative-territorial setup, functions and competences of the local governments in Croatia. This is the basis for identifying shortcomings of the current governance structures for local economic development. The analysis of economic activity on local level is presented in the third chapter of this paper. Whereby, due to lack of data on the level of local self-governments, the analysis is based on data for counties. According to theory as well as practice, some units of local self-government, particularly bigger cities, attract population and economic activity and have therefore more strength and capacity in supporting economic development activities than

counties. This is mostly evident through fiscal data, which exists for all local governments. Therefore, the fourth chapter is devoted to the analysis of fiscal capacity for local economic development. The fiscal analysis is focused on the case of three counties and their respective county centers (economic and/or administrative), namely Sisak-Moslavina County (central Croatia); Šibenik-Knin County (southern Croatia); and Virovitica-Podravina County (eastern Croatia). The fifth chapter is devoted to the concluding discussion on the local economic governance structures in Croatian counties and their internal economic development relations with the county centers, whereby the insights gained from the analytical part on the appropriateness of the current situation are presented.

## 1. Some theoretical insights for local and regional economic development

### *1.1 Specificities of locations in regional development theory*

In theory, development relations between economic centers and its regions are the central consideration of the very broad spectrum of local and regional economic theories. These theories evolved primarily during the 20th century embedded in trade theory, location theory and economic geography. Even though these theories were criticized and even considered as not adequate in certain periods towards the end of the past century, a certain revival of the basic concepts is occurring again, particularly in Europe. They are viewed now through a new lens in the context of spatially oriented economic development policy that focuses on competitiveness, networking and collaboration. In addition, these developments can also be recognized in the concepts of territorial cohesion and polycentric development which are put forward by European planning and regional development experts and scientists.

Some of the old theories still provide arguments for development strategies and many strategies target sectoral or regional poles. According to Myrdal's (1957) cumulative causation theory, some markets and places or nodes attract capital and skilled labour force accumulating competitive advantages compared to other locations. He also stressed that less developed regions can have advantages from growth in developed regions due to spread effects that derive from diffusion of innovations in lagging regions and rise in export markets for products from these lagging regions. However, there is a tendency that the benefits will be set off by backwash effects that occur because of movement of capital and labour from the lagging regions towards the more prosperous regions. Dawkins (2003) explained that the results of free trade among regions actually reinforce the process of cumulative causation, whereby growth is further catalyzed in the more developed regions on expense of the lagging regions. Another famous theory is Perroux's (1950) growth pole theory based on his

perception of firms and industries viewed in space as a web being linked by centripetal forces. According to growth pole theory, economic development strategies should focus on investments in a certain growth pole or sector, in order to initiate development. He also suggested that through adequate policies urban centers in a multi-regional context can become growth poles. Growth pole theory was also criticized because of unbalanced benefits that derive from implementation of such strategies as benefits initially flow into the growth pole, but at the relative expense of other parts of the economy. Consequently, groups in other sectors or parts of the region or national economy become impatient, since benefits trickle down into sectors or regions with a certain time lag. Dawkins however stressed that the application of growth pole strategies was abandoned during the 1980's because of implementation failures of such policies which were supposed to initiate new growth in lagging regions. The emphasis on the process of structural change within growth poles through time was missing.

A further significant contribution came from Hirschman (1958) who focused on backward and forward linkages between firms, and made his research on how polarized development could benefit a growing region and its environment. He also put forward the view that growth in a developed region produces favourable trickle-down effects in lagging regions because developed regions buy their products and employ their labour force. A further often mentioned model is Friedmann's (1966) center-periphery model. He referred to the traditional export base theory of economic growth and stressed the important role of local politics, economy and leadership as well as the impact of the development history of the region. According to Friedmann, big urban areas have actually an initial advantage in competing for new growth because of the advantages of lower urbanization costs of such economies. According to this theory, all factors are in favour of central regions, and regions outside the center differ according to their relative autonomy of their economy.

Location theory, which was initially introduced by Alfred Weber in 1929 and later developed in the 1960s by Walter Isard, questions primarily through mathematical models why economic activity is not equally spatially distributed and looks at factors that firms consider when selecting a certain geographic location. According to this theory firms locate in the way as to minimize costs, maximize opportunities to reach markets in order to maximize profits. Stimson, Stough and Roberts (2002) added that significant attention was given to transport costs, labour costs and other production costs, scale of operation and agglomeration economies. Besides these factors that are still important, over time, attractiveness and

business climate, as well as networking possibilities became also important for firms in their decisions on where to locate. A further important theory is agglomeration theory or external economies of scale. Armstrong and Taylor (2000) explained that agglomeration economies emerge on the basis of economic association of a big number of economic activities that do not necessarily need to be within the same industry. Concentrations of a big number of firms are created that together serve various industries, including for example urban transport and communication, well organized labour markets, social and public services, cultural and recreational activities, firms organized in clusters and geographic concentration of innovative activities. All this contributes to the attractiveness of existing centers or growth poles creating a cumulative process of growth. They recognized also that this can have negative impacts on the less developed regions through backwash effects (e.g. skilled labour migrating to more prosperous regions), causing negative cumulative causation effects. In addition, polarization and fast growth can also result in external diseconomies (or negative externalities) such as congestion, pollution, rising factor costs and living expenses.

An older often quoted theory is Christaller's central place theory published in 1933, which rests on the notion that centralization is a natural principle of order and that human settlements follow it. He suggested that there are laws determining the number, size and distribution of towns. This theory relied on two concepts, i.e. every good or service will have a range (maximum distance consumers are prepared to travel to acquire goods) and a threshold (minimum market needed to bring about the selling of a particular good or service). According to Christaller, urban settlements are ordered according to a hierarchical structure of central places of various sizes and functional complexity, and in every larger region exists a systematic spatial order of central places (urban settlements). The various functions, which these central places offer, reflect the variety of economic activity that serves the surrounding population. The main criticism of this theory is that it was based on the assumption of isotropic places in which density, purchasing power and consumer preferences are homogenous. In reality, density and socio-economic characteristics of consumers significantly differ through space.

One of the newer models is Krugman's (1991) core-periphery model embedded in new economic geography which is linked also to newer trade theories. He stressed that the regional clustering of economic activities occur due to a combination of centrifugal (immobile factors, land rent/commuting, congestion and other pure diseconomies) and centripetal forces (linkages, thick markets, knowledge spillovers and other pure external economies). The

pattern of core and periphery is defined in the way that the total manufacturing industry will be located in the core, while the total agricultural production will be located at the periphery. This is sustainable with big internal economies of scale, low transport costs, and with a large share of regional population which is employed in the manufacturing industry.

The briefly presented theoretical overview represents the fundaments of contemporary regional development theory, though the focus has shifted more towards the complex relations of competitiveness, cohesion and sustainability. For the purpose of this paper the main theoretical points such as concentration and agglomeration, as well as the importance of institutions and structural considerations are mentioned. Further, the economic importance of certain locations (regions) and their developmental effects (positive as well as negative) on the surrounding territory are recognized. The next section is devoted to the second but crucial aspect of local and regional economic development, namely the theoretical background of the popular concept of governance.

*1.2 The levels of governance*

Though there are numerous definitions of governance today, depending also on the context, one of the often quoted definitions is the one put forward by UNDP. Accordingly, governance can be defined as "the exercise of political, economic and administrative authority to manage a society's affairs" (UNDP, 1997). While the economic, political and administrative aspects of governance are often the focus, recognition of the need for a more holistic concept is growing. Therefore, governance comprises mechanisms, processes and institutions through which collective decisions are made and implemented, citizens, groups and communities pursue their visions, articulate their interests, exercise their legal rights, meet their obligations and mediate their differences. As defined in this manner, it emphasizes the nature and quality of interactions among social actors and between social actors and the state.

Scientific and professional discussions on the issue of multi-level governance have intensified during the 1990's that can be linked to the integration and expansion processes of the European Union. With the formulation of common policies on EU level, more complex interrelations and requirements for the implementation of development policies between different levels of government are occurring. Carmichael (2002) stressed that "government" became more variegated within different levels of government (i.e. horizontally differentiated or provided by multiple agencies). In addition, government is also geographically more diverse (i.e. vertically differentiated or conducted on multiple levels). Therefore, multi-level governance stresses the complexity of policy making, implementation and responsibilities

among different governmental and societal actors in their activities on supranational, national, regional, local as well as quasi-governmental institutions. While government activities go more in the direction of regulating public activities and to a lesser extent the redistribution of funds. Changes in governing towards multi-level governance are primarily the result of changes in the modes and nature of public sector activities. Multi-level governance has changed the relation between policies and service delivery, and the emergence of different tiers of government complicated the process of policy making. Therefore, the coordination of services through several functional areas and levels of government is becoming more problematic. Tensions are also growing between the static territorial space and dynamic functional space creating also difficulties in governing. Hooghe and Marks (2003) pointed out that the dispersion of governance throughout several jurisdictions actually stimulates flexibility. They also stressed that centralised government can not answer all needs that derive from variety. While through multi-level governance decision makers can adjust the levels of governance and provide better for requirements that derive from heterogeneity.

Local and regional economic development (LED), as defined by the World Bank (2001) is a process in which local and regional governments co-operate with the public and business sector as well as with the civil society with the aim to facilitate better conditions for the economic growth and the creation of employment. It offers local and regional government, the private sector, the non-profit sectors and the local community the opportunity to mutually co-operate in order to improve the local economy. LED encompasses many different disciplines, such as planning, economics, and marketing. It also encompasses many local and regional government and private sector functions including planning, infrastructure provision, real estate development and finance. Good governance on the local level as defined by Romeo (2002) is an institutional system for managing local public affairs, characterized by three critical dimensions:

- *Performance* of the local authorities (fiscal effort and discipline, allocative and operational efficiency) in managing public resources and discharging their responsibilities for delivery of economic and social services, protection of the environment and management of natural resources, and promotion of economic development;
- *Participation* of organized and individual citizens in local public sector decision-making, through mechanisms that supplement and enhance, rather than replace or contradict, the functioning of the institutions of democratic representation; and

- *Partnership* between local authorities, civil society organizations and private sector units for the provision and production of local collective goods and services.

He stressed also that the adoption of good local governance practices depends upon changes in the policy, legal and regulatory framework governing political, administrative and fiscal decentralization of public sector powers, responsibilities and resources, and the role and status of civil society and private sector associations and organizations; as well as the build up of local governments' capacity along three dimensions: individual, institutional and systemic capacity. Importantly, the build up of local government capacity is understood as a demand-driven process. Crucial aspects of this process are the creation of financial and other incentives for local governments to invest in the building of their own capacity, and the establishment of clear local government accountability both "upward" to the national level and "downward" to their constituencies with related systems for administrative and social monitoring and auditing. As it is expected that good local governance has impacts on improved services delivery and local economic development, it is evident that it is complementary to and not in conflict with the local self-government functioning. Having a good legislative framework in place for local self-governments is, although fundamental, only one precondition for local development. Another dimension to be considered is how do local self-governments work with this legislation, how do they practically implement all the rights and responsibilities they have. The next part is hence devoted to the institutional structures for governance in Croatia.

## 2. The Croatian institutional framework for local economic governance

### *2.1 The administrative-territorial structure*

Formed in the early 1990s Croatia is a relatively new state and is consequently in the process of local and regional reformation. This includes not only changes in administrative and territorial arrangements, but also reforms connected with the decentralisation and concentration-reduction issues. Furthermore, Croatia's application to the European Union has also initiated numerous other adjusting activities.

The legislative framework of the local and regional self-government in Croatia was established in 1992 with the introduction of the local government system. In the following years, different reforms of the territorial and institutional framework occurred. Consequently, in 2001 a new Law of Local and Regional Self-Government (LLRSG) was adopted, where counties were clearly defined as the units of regional self-government, while cities and

municipalities remained units of local self-government. Today, the Republic of Croatia is a unitary state with 20 counties referred to as regions, and the capital city of Zagreb, which has a County and City status. Sumpor (2004) stressed that until 2001 counties had dual functions and were primarily responsible for performing delegated tasks from the national level, while neglecting to a certain extent their own self-government role. The existence of basically two kinds of public administrations on county level, i.e. the devolved RSGs and the deconcentrated national government offices on county level, created a somewhat unclear institutional structure on this level of government. Even though counties are referred to as regional governments in Croatian legislation, they are actually too small to be considered as regions in European terms, and belong in fact to the local government level (NUTS III level). As Croatia is in the preparatory process for accession to the European Union, the Croatian Central Bureau of Statistics (CBS) initiated a consultation process on possible scenarios for dividing Croatia into NUTS II regions. Scenarios ranging from one, four or five regions are still discussed in Croatia. Statistical regions would be comprised of a number of administrative regional units, i.e. counties. But, a national consensus and decision on the most adequate division can only be achieved through the national political process.

The Local Self-Government (LSG) level is comprised of 124 cities or towns and 426 municipalities, while the precise number of LSGs increases frequently (CBS, 2004). Besides the major cities in Croatia such as Zagreb, Split, Rijeka, Osijek, or Varaždin most of the cities are actually towns. However, the terminology in the Croatian legislation does not make a distinction between these two terms. The city or town is a unit of local self-government with more than 10,000 inhabitants, constituting a unitary urban, historical, natural, economic and social space. The vast majority of towns have less than the minimal number of inhabitants, since the Law prescribes a list of exemptions under which a municipality can gain a town status. The municipality is a unit of local self-government, consisting of the territories of several inhabited places representing a natural, economic and social entity, and which is connected by the common interests of its inhabitants.

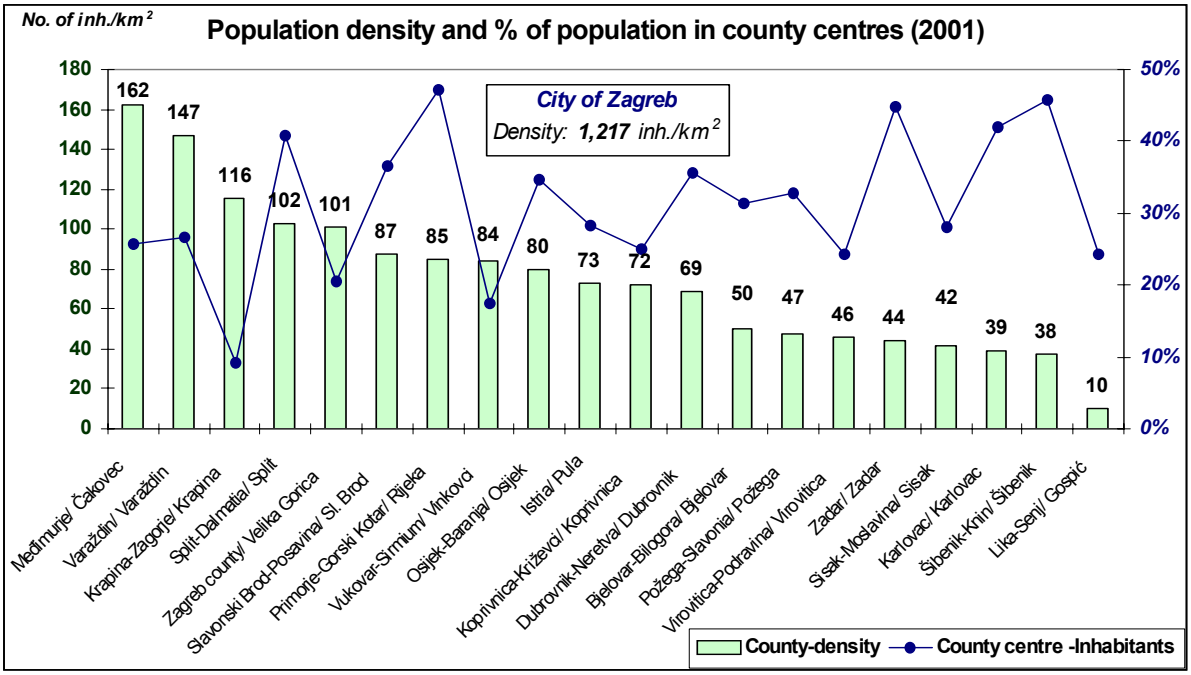
Decentralisation is based on three core principles of local government: autonomy (or liberty); democracy (or participation); and, effectiveness. The structure of territorial organisation that can be observed across different countries may be viewed as a reflection of the national focus on one of these values over the others. Thus, a large number of smaller local units can be viewed as a preference for autonomy or democracy, while fewer, larger local units would tend to express the value of effectiveness. (Pigey et al., 2002)

*2.2 The size and population of units on different levels of government*

The Republic of Croatia covers 56.5 thousand km$^2$ of continental surface and has a population of 4.4 million inhabitants (Census, 2001). The total number of 571 local and regional government units in comparison with the population of 4.4 million does not say much. But knowing that from 1990 the number of LSGs increased five times and that it constantly increases regardless of the fact that many of the existing LSGs are unable to fulfil their functions (many being highly dependent on central government grants, it can be stated that this is not sustainable in the long run.

The internal structure of distribution of local governments by population size is an important factor to consider. The Croatian population density average is 78 inhabitants per square kilometre. The analysis of the county organization further reveals significant differences between them (see Figure 1):

***Figure 1***




*Source: Republic of Croatia, Census 2001.*

The most densely populated county is the Croatian capital city of Zagreb (779,145 inhabitants), then followed by the County of Međimurje (118,426 inhabitants). The lowest population density has County of Lika-Senj (53,677 inhabitants). The population size of units of local self-government also varies widely, whereby approximately 70% live in cities or towns (urban) and 30% in municipalities (rural). Further, according to the Census 2001 data only four cities have more than 100,000 inhabitants. There are also 28 municipalities that

have less than 1,000 inhabitants. But regardless of the actual size, LSGs have the same responsibilities and accomplish the same functions.

The percentage of population living in county centres indicates concentration of urban population. Five out of 20 counties (except City of Zagreb) have more than 40% of population concentrated in county's centre. The regional gross domestic product (RGDP) estimates by counties show great differences between counties. For example, 53.1% of the national GDP was produced in only 4 counties: City of Zagreb (30.1%), County of Primorje-Gorski Kotar (8.1%) and County of Split-Dalmatia (7.9%) and County of Istria (6.3%).

*2.3 Functions of local and county governments in Croatia*

According to the LLRSG, units of *local self-government* should perform tasks of local importance, which directly address the needs of citizens, and which are not assigned to state bodies by the Constitution or by law. It is interesting to note that economic development, as a task is not explicitly mentioned as a task of local government, but as a task of counties. However, LED can be considered as a task of local importance. Croatia has a significant number of municipalities that are actually far too weak to perform legally required functions and tasks on their own. Such municipalities regularly rely on support and transfers from higher levels of government. The regional self-governments, i.e. counties should perform tasks of regional importance, especially tasks that relate to: education; health care; spatial planning; economic development; transit and transport infrastructure; development of educational, medical, social and cultural institutions. In addition, cities that have more than 30.000 inhabitants can take over some of the county services, if they have sufficient resources for their provision. In 2001, as a part of the ongoing decentralization process, 32 of the stronger local and all regional self-governments gained greater responsibilities in education, health and social care, for which they receive also fiscal support through an equalisation fund.

The LLRSG only lists general mandatory functions of local and regional governments. While detailed responsibilities are defined in a broad number of special laws and by-laws. However, due to the vast number of such laws, by-laws and regulations, frequent changes, amendments as well as new regulations, difficulties occur in the implementation on local level. Many of these regulations are conflicting, contradictory, lacking of transparent financial flows and are often neglected by the responsible levels of government, leading to poor or even no provision of specific public services. The reason for this derives primarily from the fact that the many shared responsibilities between the various levels of government, from national to local, are not clearly defined. Therefore, it is useful to gain a better understanding on the nature of

various functions. According to Sumpor (2004), functions of local self-governments can be categorised into three main groups, which can be:

- the sole responsibility of local governments, e.g. pre-school, housing and utilities – the delivery of such services depends entirely on own fiscal and human resources of the local government;
- shared responsibility with regional governments, e.g. recreation, culture and religion – the delivery of such services depends on the capacities of the local as well as the regional governments, particularly their cooperation and communication;
- shared responsibility with the regional as well as central government, e.g. general public services, elementary education, social security and welfare, mining, industry and construction, roads, other economic affairs and services – the delivery of such services depends very much on bottom-up and top-down relations.

All three groups show specific needs and problems of local governments in providing public services according to their functional responsibility. Major problems arise when local governments depend on other levels of government. If the problem of fragmentation is taken into account as well as unclear legislation, significant efficiency problems occur. Also, the still quite centralized Croatian Government, it is impossible to target all needs through standard top-down decisions. While communication on real needs from below is difficult due to inexisting mechanisms. On the other hand, counties, as an intermediary level between the local and the national level, are administratively as well as fiscally still too weak to be the balancing level in the provision of public services. The mentioned problems are less pressing in the more developed, administratively and economically stronger local governments (i.e. cities/towns), which are also more eager to take over new responsibilities.

## 3. Analysis of the local economies and economic governance in Croatia

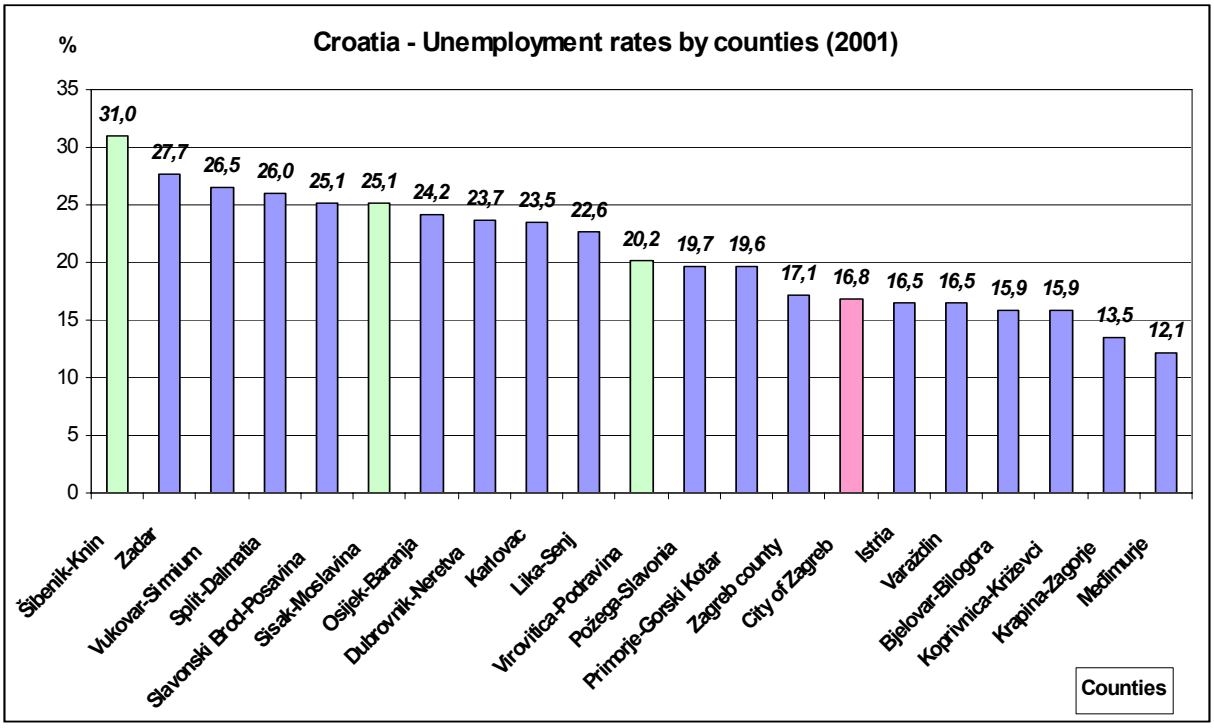
### *3.1 Employment and active companies across sectors and counties*

First of all, economic data on county level has to be treated carefully and the results are only indications, as most of the data is based on estimates. Also, data on the level of local self-governments is not collected by the Croatian central bureau of statistics. The lack of local data is a serious problem faced in Croatia and is an obstacle for performance measurement on any level of government. However, in this chapter the available economic data on county level is presented, while in the next chapter some indications on the relations between counties and cities will be presented based on fiscal results available for all local government units.

The structure of employed persons by groups of activity shows that in 2001 most employed persons or 43.1% of total employment by sectors were in services (incl. construction, wholesale and retail trade, hotels, restaurants, transport and communications, financial and real estate services), and another 24.2% were employed in the public sector. While, 29.4% worked in the secondary sector (manufacturing) and only 3.3% in the primary sector (agriculture). When analyzing the employment structure across counties, significant deviations from the national averages can be seen in the least developed counties like Vukovar-Sirmium, Virovitica-Podravina and Lika-Senj, which show also higher shares of employment in the primary sector (above 11%).

The unemployment rate in the Republic of Croatia, i.e. the ratio of unemployed persons to the total economically active population, was 20.4 % in 2001. At counties' level there were marked deviations from this average figure as show in Figure 2.

***Figure 2***




*Source: Republic of Croatia, Central Bureau of Statistics, Statistical Yearbook 2002.*

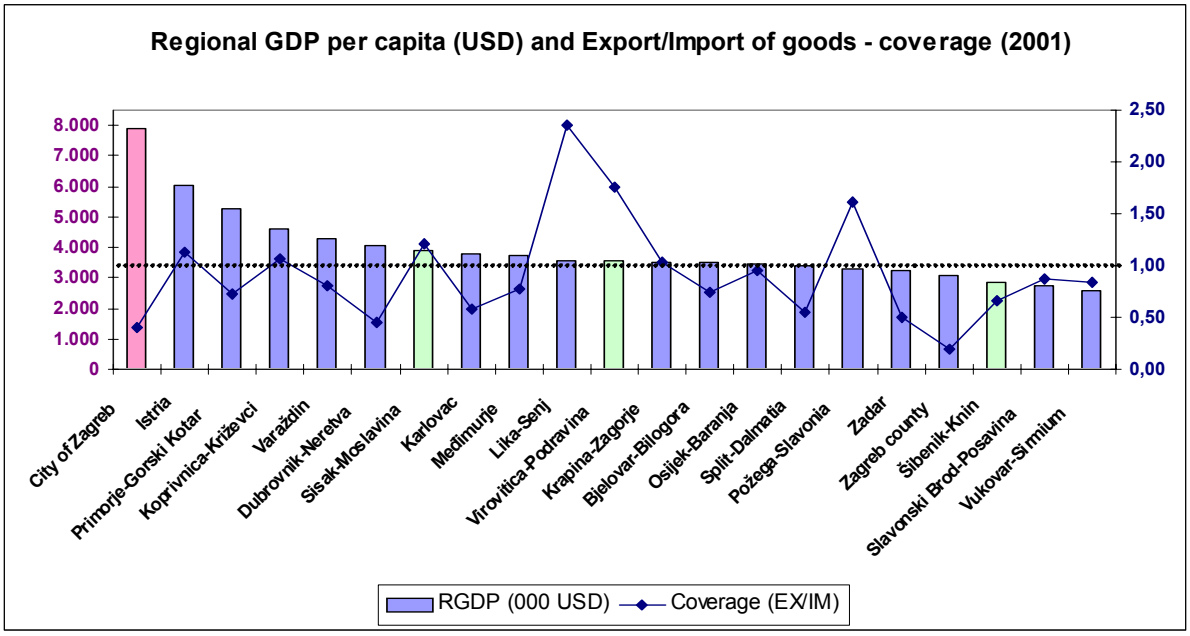
An unemployment rate above national level was arrived at by ten counties; it varied between 22.6% in County of Lika-Senj and 31.1% in County of Šibenik-Knin. The lowest unemployment rate was reached in the County of Međimurje (12.1%) and County of Krapina-Zagorje (13.5%).

In 2001 there were more than 175 thousand active legal entities registered in Croatia (companies, crafts, trades and free-lance), wherefrom more than 51% were registered as crafts and free lance. When analyzing the number of active legal entities across counties, most companies were concentrated in the City of Zagreb (27%), followed by the County of Split-Dalmatia (11%), the County of Primorje-Gorski Kotar (9%), and the County of Istria (8%). The lowest number of active legal entities in 2001 was registered in the County of Lika-Senj (1,579), and the County of Požega-Slavonia (2,038). According to sectors, more than 70% of active legal entities were registered in the service sector.

*3.2 Economic performance on county level*

In 2001 Croatia's GDP amounted to USD 19.9 billion or USD 4,486 in per capita terms (at current exchange rate). Based on estimates of the regional gross domestic product (RGDP) by counties, significant differences in GDP per capita between counties occurred (see Figure 3).

***Figure 3***



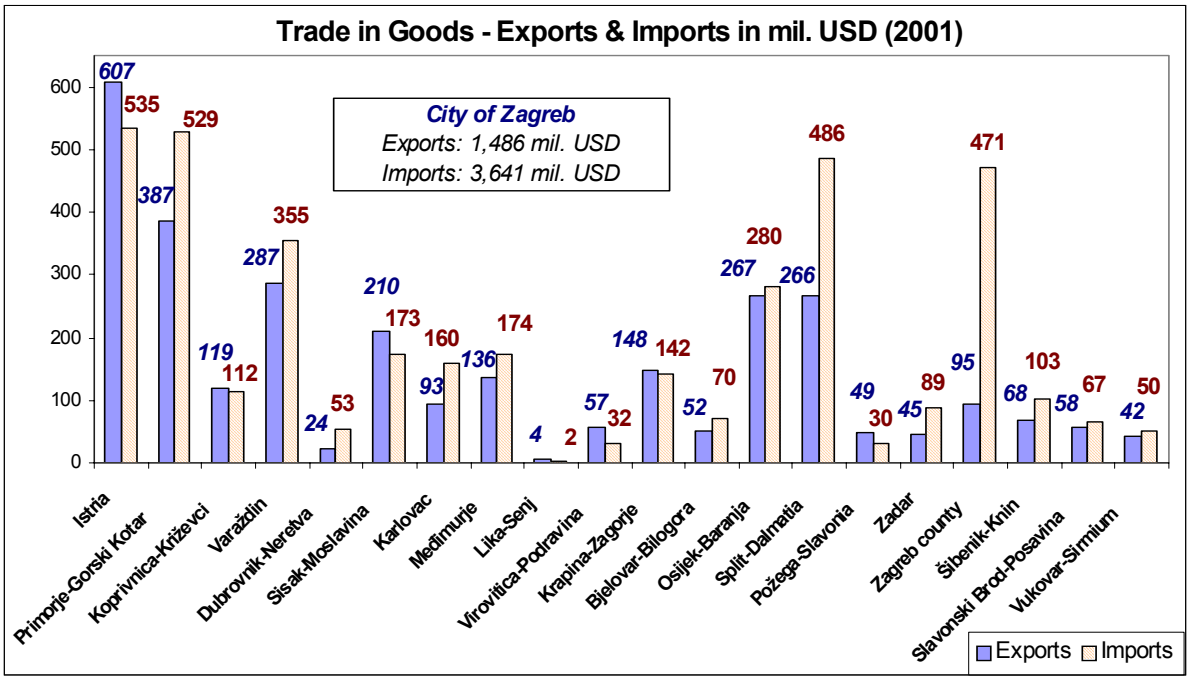

*Source: Lovrinčević, Ž. et al (2004); CRORPI data base, Institute of Economics, Zagreb.*

The RGDP varied between USD 0.2 billion in the County of Lika–Senj and 6.1 billion in the City of Zagreb. According to that estimation, RGDP per capita of the Croatian capital city Zagreb was 76.3 percentages above the national level in 2001. GDP per capita above the national level has also been reached in County of Istria (34.6 percentages above) as well as the County of Primorje-Gorski Kotar (17.5 percentages above), which are both in northern coastland of Croatia. While in 17 out of 21 counties, GDP per capita was actually below national average. The county results reflect also that those counties, mainly in the north-

western part of the country, with the most advanced and economically developed urban centers (Zagreb, Rijeka, and Pula) have the highest RGDP per capita. This supports the thesis that the concentration of infrastructure, business services, skilled labour, and higher housing standards are located within the major urban centers.

Total exports of goods in the Republic of Croatia amounted to USD 4.5 billion. At the same time, imports of goods were USD 7.6 billion. This resulted in the quite problematic foreign trade deficit amounting to USD 3 billion, which was more than 15% of GDP. The coverage of imports by exports was at 60% only. On county level, only seven counties reached a positive export/import coverage (see previous Figure 3) or trade surplus (see Figure 4).

***Figure 4***




*Source: Lovrinčević, Ž. et al (2004); CRORPI data base, Institute of Economics, Zagreb.*

Interestingly, among those only Istria is one of the more developed counties, while the other 6 counties with a trade surplus were among the least developed counties (Sisak-Moslavina, Virovitica-Podravina, Požega-Slavonia, Koprivnica-Križevci, Krapina-Zagorje and Lika-Senj). At the other end is the city of Zagreb with the highest trade deficit of USD 2.2 billion (or more than 70% of the total national trade deficit). Zagreb's share of imports in total Croatian imports was 33% and the share of exports was 48.2%. The smallest contribution to the national foreign trade made the County of Lika-Senj with exports being only 0.1% of national exports and imports that were only 0.02% of total national imports. These trade results show also an interesting development, as significant trade deficits are generated in the more populated and economically more developed counties with strong urban centers.

*3.3 Local economic governance in Croatia*

Based on a recently conducted study on local economic development policy in Croatia, important insights were gained on the current state of affairs. Generally, Croatian legislation referring to sectors of the economy is prepared, adopted and managed on national level. Whereas, measures and regulations are implemented either directly top-down, through deconcentrated national institutions and government offices, or through delegation of tasks to local and regional self-governments. Laws and regulations with strong spatial economic effects are broadly defined on the national level. Their implementation is managed across levels of government which are supposed to cooperate. Local and regional self-governments are commonly viewed as promoters and supporters of small and medium-sized enterprises (SMEs) on their territory. While, big industry is commonly in the domain of the national government and regulated through the national institutional and legal framework.

Croatian LSGs are active in local economic development in two ways varying according to fiscal strengths, available human resources and political stability: through promotion of economic development based on proactive approaches; and through various measures for economic development. In addition, local and regional self-governments can either design and offer their own programs and measures, or obtain information on programs offered by others. Since 2001, a significant number of local and regional economic development initiatives in Croatia were promoted and financially supported by the former Ministry of Crafts, Small and Medium Enterprises (merged with the Ministry of Economy in 2004). In addition, communication and interaction between the existing and emerging domestic and foreign business related institutions is of crucial importance and recent developments demonstrate vivid and lively activities in SME development. Recent LED initiatives in Croatia include local government incentives (lower surtax on income tax, tax on unused land, utility charges and contributions), financing local economic entities (annual credit lines), business support initiatives (over 30 public and private entrepreneurial centers and nine business incubators established), provision of business related infrastructure (business zones), establishment of networks and associations, and promotion of human resources development (certified educational programs, trainings and seminars).

LSG administrations can levy taxes, use part of the national tax which is shared with local budgets, levy charges and take loans. Quite a few underdeveloped municipalities can also count on external financing, which may be obtained from the national budget or from various international sources. The funds collected in this way can be used for a number of economic

development incentives. Acting directly, the LSGs can decrease certain local taxes or defer charges. They can also give exemptions of fees for a limited period of time. Through national fiscal legislation, tax incentives (exemptions) have been defined for businesses which establish themselves in LSGs or communes included in areas of special state concern (affected by war and underdeveloped areas), in mountain areas or on islands. Here, LSGs cannot act directly, but have the possibility to inform entrepreneurs and businesses who wish to set up operations. Tax incentives are usually combined with the development of industrial and commercial or mixed zones. The main promoter, the Ministry of Economy launches loan programs in cooperation with selected banks and offers them to municipalities/towns rather than to entrepreneurs. This requires that the LSG has a high level of fiscal capacity as well as a capable administration, which is able to assist in the implementation and monitoring of a well elaborated project or program. However, there are very few LSGs in Croatia that can actually meet these requirements.

Directly and/or indirectly, LED is managed by all three levels of government. Larger municipalities/towns and all 21 counties have departments that deal with the economic issues. Ministries that are in charge of administering various aspects of overall development (environmental protection, spatial planning, reconstruction, finances etc.), have their offices at the county level and in some 100 LSGs. There are also the state owned enterprises which implement their plans mainly at the local level. Finally there are municipal courts and municipal cadastre departments, which are unavoidable steps in every local economic venture. The institutions that approach and assist potential entrepreneurs are, besides the Croatian Chamber of Economy and Croatian Chamber of Crafts, with their regional and local offices, also some associations of LSGs and emerging local development agencies.

## 4. Analysis of the fiscal capacities for local economic development

### *4.1 Fiscal analysis based on the consolidated general government data*

As mentioned before, fiscal data provides the only and somewhat more reliable quantitative information source for the analysis of the relations between counties and cities/towns. Based on demographic and economic data, primarily collected and presented on county level, it can only be assumed that the main economic poles in Croatia remain the bigger urban county centers across the country such as Zagreb, Split, Rijeka, Osijek, or Varaždin. It can be stated that local governments, which are more developed and have economic advantages due to concentration of businesses, are therefore in a better position to collect more own revenues as

well as revenues from shared taxes. These are in Croatia, like in other countries, naturally mainly larger urban areas.

The economic and administrative strength of the major urban centers was also considered with the first phase of decentralization, which was initiated in 2001. An analysis of the fiscal capacity of local self-government and administration units in the period 1999 – 2000 was conducted for that purpose by using a number of indicators with a view to obtaining relevant indicators of the real state of affairs in the local self-government financing system. The 2000 indicators, obtained by an empirical analysis of fiscal capacity and the ratio between current revenues and current expenditures for the basic functions to be performed by each local self-government unit, suggest that 184 municipalities and cities (or more than 30%) were unable to cover their current expenditures by current revenues. (Perko-Šeparović et al., 2003) However, the study does not address in detail the sizes of local governments nor whether the local governments actually provide all legally foreseen services. The weaker LSGs therefore either rely on central government transfers or simply do not provide the mandatory services.

For the initiation of the decentralization process, 32 cities/towns (out of a total of 546 units of local self-government in 2001) and 21 counties were selected to take over new responsibilities. Due to the initiated reform process and difficulties with implementing new procedures and information technology systems in most of the local governments, fiscal data for all local governments is still not publicly available. However, the Croatian Ministry of Finance managed at least to publish aggregated data on the consolidated general government budget outturn for 2001-2003. These data refer to the central government and extra-budgetary funds outturn, and local data for 53 units that entered the first phase of decentralization in 2001. The consolidated general government total revenues were between 46-47% of GDP in 2001-2003, while expenditures and lending minus repayments exceeded total revenues resulting in an overall deficit of around 3% of GDP every year in the period. Some policy changes occurred during that period. The central government revenues increased from 32% in 2001 to almost 39% of GDP in 2003, while central government expenditures show an even more significant change from 26% in 2001 to 38% of GDP in 2003. These changes are the result of a change in fiscal policy in 2001 regarding extra-budgetary funds, when the central budget took over expenditures as well as revenues for pension insurance contributions. An additional policy change occurred in 2002, when the revenues and expenditures for health insurance and employment contributions were integrated into the State Treasury system.

As mentioned before, Croatia is a highly centralised country, which can be confirmed on the basis of two important indicators: the share of revenues of local self-governments in GDP and the share in the total government budget revenues. In 1999, the share of local budget revenues in consolidated revenues of the general government budget was 10.3% (or 5.4% GDP). In 2000, the year before the launch of the first phase of decentralisation, the share of local budget revenues in consolidated revenues of the general government budget was 10.9% (5.2% GDP). The 2001-2003 fiscal data for the local level (based on local 53 units) does not show any significant change during that period, where revenues rose only from 4.1% and 4.7% of GDP, and expenditures rose from 4.3% to 5.2% of GDP in the period 2001-2003. The deficit of local governments increased slightly from 0.2% to 0.5% of GDP in the same period. These results show that, even though, the decentralization process was initiated, no significant changes in the local fiscal data occurred.

In Croatia, as in the most other countries, local and regional economic development is not an obligatory function of local and regional government. Although local and regional economic development is a duty of many institutions at national, regional and local level, the majority of activities regarding development of municipalities, cities and counties refer to the fiscal capacity of sub-national government to promote their own development. Sub-national government units do not have enough capital revenues to finance capital expenditures. This means that financial sources for the majority of development activities at local and regional level come from grants, donations and borrowing (domestic financing). If we take into account the Croatian statistics (budget, GDP, and unemployment) and achieved level of LED in Croatia, the current status of LED in Croatia is, to a great extent, faced with financial constraints for local and regional units in the promotion of local economic development.

*4.2 Fiscal capacity of the local government in Croatia*

The analysis of the fiscal capacity of the local level in Croatia has still some real limitations, as the last complete fiscal data publicly available is for the year 2001. Based on such data, only indications on possible trends can be made (see Appendix Table 1). On aggregate level for all local governments, the share of cities or towns in total revenues was 73%, while counties had only a share of 13%. With regard to capital revenues as well as capital expenditures, the most significant share is generated by the cities or towns. At the same time, counties received 49% of the total grants for all local governments, which confirms that they have a significant need for additional financing. Also, contrary to the counties, the LSGs managed to reach a coverage indicator above 1. Concerning the administrative capacity, from

the data on employed persons in local government administration, it is clear that cities or towns dominate as well with 66% of public officials working in the city or town administrations (in counties only 10%).

When comparing the indicators for the counties of Virovitica-Podravina, Šibenik-Knin and Sisak-Moslavina and the respective county centers, the findings that derived from the aggregates further confirm the assumption that the counties are weak compared to cities. In all three counties, the total revenues of the cities or towns significantly exceed the total revenues of the respective county self-governments. While the city of Šibenik and city of Sisak managed to collect alone more revenues than their county. The somewhat lower revenues collected in the city of Virovitica can be explained by their weaker economic structure. All three cities show that they manage to cover their current expenditures with current revenues, while all three counties show significant difficulties in that part of their budget management. The share of capital revenues in the total of the cities of Šibenik and Sisak show, that more than 70% was collected in the county centers alone. Virovitica shows again a significantly lower share (39%). At the same time, the counties collected very low or even zero income (Šibenik-Knin) from capital revenues. The expenditure side shows similar relations between the counties and their centers. Concerning employment in the public administrations, all three cities have more staff than their counties. The most significant share of public administration staff on the territory of the county is in Šibenik (57% of the total).

## 5. Concluding remarks on local economic governance structures in Croatia

The thesis of this paper was that the existing administrative-territorial setup and functions that derive from the related legislation in Croatia do not comply with the needs of economic growth and development on local level. With regard to the theoretical overview and based on the quantitative analyses as well as qualitative comments presented in the preceding chapters, the cities or towns that keep the position of the county economic center are clearly stronger and more able to take care of local economic development than the county administrations.

The main points highlighted by old as well as newer theories such as cumulative causation, agglomeration and economy of scale effects are relevant and can be seen in Croatia. The cities frequently mentioned as the strongest like Zagreb, Rijeka, Split, Osijek, or Pula are in fact regional growth poles and have the respective function and role in relation to the surrounding regions (as recognized in the central place or core-periphery models). To a lesser extent, but still valid, this applies also to the second range cities analyzed in this paper like Virovitica, Sisak or Šibenik. Their strength in comparison to counties was confirmed by the fiscal data.

However, due to the missing institutional links (formal and informal), political instability and low level of collaboration, all the negative development effects recognized in theory like the backwash effects, drain of skilled labour or the time lag in trickling-down are visible throughout Croatia. By ignoring the importance of the development role of the urban centers and relying entirely and only on the competence of institutionally weak counties (without administrative history), it is not surprising that local economic governance structures are not adequately set up to foster and promote development throughout the country.

In general, many local economic governance problems today are related to certain legislative omissions in the past, when counties were introduced into the system of local governance without more serious analyses and preparations, which is also true for the Law on local and regional self-government. The definition of responsibility for local economic development in the legislation refers only to counties, while at the same time the role of counties remains unclear. This can be also related to the territorial division which is still strongly influenced by politics, whereas expert analyses and warnings on the current system of local governance are ignored. In addition, counties are considered to be too small and too weak to be considered as regions in EU terms (NUTS II), while discussions on the introduction of a new (NUTS II) regional level are heating up. At the same time, the significance and strengths of the urban centers was completely neglected in the past 15 years. An additional severe problem for better local economic governance derives from inadequate official and uneven individual regional and local statistics seriously needed for monitoring local government performance.

In governance terms, interrelations and interdependencies between the counties and county centers were neglected by policy throughout the entire period. Furthermore, political as well as personal animosities and certain competition between these two governance levels contributed further to the difficulties faced by many local self-governments and counties. Unbalanced development throughout the Croatian regions is mostly visible, when comparing the data for Zagreb and the remaining part of the country. This has definitely negative impacts on economic development of the whole country. It should be mentioned that there are good experiences and examples in local economic governance in Croatia, but they are visible in the mentioned stronger LSG, and the success is to a large extent based on individual efforts. Some of the LSGs in Croatia have had the opportunity to gain more experience in building partnerships, networking as well as broader citizen participation in the public sector, primarily through foreign technical assistance projects. Such experiences should serve Croatia further on its way towards improving local economic governance structures.

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**Appendix: Table 1 - Fiscal capacity of Local Government in Croatia and three selected counties - status 2001 (in Croatian Kuna)**

| | Total revenues | Current revenues | Capital revenues | Grants | Total expenditures | Current expenditures | Capital expenditures | Lending minus repayments | Coverage *(cur.rev./ cur.exp.)* | Employed *RSG+LSG pub. admin.* |
|---|---|---|---|---|---|---|---|---|---|---|
| ***I. TOTAL LOCAL GOVERNMENT - REPUBLIC OF CROATIA*** | ***9.961.437.514*** | *8.317.120.358* | *683.608.397* | *960.708.759* | ***9.900.758.113*** | *7.122.067.422* | *2.602.804.761* | *175.885.930* | *1,17* | *10.446* |
| **COUNTIES - TOTAL (RSG)** | **1.271.078.943** | 792.644.952 | 8.848.965 | 469.585.026 | **1.220.840.423** | 833.740.718 | 276.307.803 | 110.791.902 | 0,95 | 1.042 |
| *- % in total local government* | *13%* | *10%* | *1%* | *49%* | *12%* | *12%* | *11%* | *63%* | | *10%* |
| **CITIES/TOWNS -TOTAL (LSG 1)** | **7.262.862.300** | 6.468.451.951 | 557.636.872 | 236.773.477 | **7.245.360.849** | 5.369.995.999 | 1.831.373.298 | 43.991.552 | 1,20 | 6.868 |
| *- % in total local government* | *73%* | *78%* | *82%* | *25%* | *73%* | *75%* | *70%* | *25%* | | *66%* |
| **MUNICIPALITIES - TOTAL (LSG 2)** | **1.427.496.271** | 1.056.023.455 | 117.122.560 | 254.350.256 | **1.434.556.841** | 918.330.705 | 495.123.660 | 21.102.476 | 1,15 | 2.536 |
| *- % in total local government* | *14%* | *13%* | *17%* | *26%* | *14%* | *13%* | *19%* | *12%* | | *24%* |
| ***II. VIROVITICA-PODRAVINA COUNTY - TOTAL (RSG + LSG 1 + LSG 2)*** | ***114.674.410*** | *76.977.801* | *4.089.596* | *33.607.013* | ***110.698.570*** | *73.640.399* | *26.259.843* | *10.798.328* | *1,05* | *144* |
| **COUNTY - TOTAL (RSG)** | **35.862.882** | 14.488.903 | 18.053 | 21.355.926 | **35.038.818** | 17.070.453 | 8.482.411 | 9.485.954 | 0,85 | 23 |
| *- % in county total* | *31%* | *19%* | *0%* | *64%* | *32%* | *23%* | *32%* | *88%* | | *16%* |
| **CITIES/TOWNS -TOTAL (LSG 1)** | **50.028.130** | 39.190.152 | 3.626.736 | 7.211.242 | **49.194.897** | 37.280.541 | 10.914.356 | 1.000.000 | 1,05 | 52 |
| *- % in county total* | *44%* | *51%* | *89%* | *21%* | *44%* | *51%* | *42%* | *9%* | | *36%* |
| **MUNICIPALITIES - TOTAL (LSG 2)** | **28.783.398** | 23.298.746 | 444.807 | 5.039.845 | **26.464.855** | 19.289.405 | 6.863.076 | 312.374 | 1,21 | 69 |
| *- % in county total* | *25%* | *30%* | *11%* | *15%* | *24%* | *26%* | *26%* | *3%* | | 48% |
| **City of Virovitica** | **28.286.272** | 23.108.096 | 1.590.017 | 3.588.159 | **27.790.052** | 21.055.945 | 5.734.107 | 1.000.000 | 1,10 | 28 |
| *- % in county total* | *25%* | *30%* | *39%* | *11%* | *25%* | *29%* | *22%* | *9%* | | *19%* |
| ***III. ŠIBENIK-KNIN COUNTY - TOTAL (RSG + LSG 1 + LSG 2)*** | ***184.078.370*** | *128.498.342* | *5.687.524* | *49.892.504* | ***179.583.783*** | *133.198.171* | *40.722.631* | *5.662.981* | *0,96* | *477* |
| **COUNTY - TOTAL (RSG)** | **43.141.663** | 21.703.515 | 0 | 21.438.148 | **41.307.326** | 33.712.606 | 2.357.974 | 5.236.746 | 0,64 | 45 |
| *- % in county total* | *23%* | *17%* | *0%* | *43%* | *23%* | *25%* | *6%* | *92%* | | *9%* |
| **CITIES/TOWNS -TOTAL (LSG 1)** | **105.741.720** | 84.284.547 | 4.642.579 | 16.814.594 | **104.786.309** | 78.050.181 | 26.312.293 | 423.835 | 1,08 | 342 |
| *- % in county total* | *57%* | *66%* | *82%* | *34%* | *58%* | *59%* | *65%* | *7%* | | *72%* |
| **MUNICIPALITIES - TOTAL (LSG 2)** | **35.194.987** | 22.510.280 | 1.044.945 | 11.639.762 | **33.490.148** | 21.435.384 | 12.052.364 | 2.400 | 1,05 | 90 |
| *- % in county total* | *19%* | *18%* | *18%* | *23%* | *19%* | *16%* | *30%* | *0%* | | *19%* |
| **City of Šibenik** | **62.209.476** | 53.406.447 | 4.053.075 | 4.749.954 | **62.209.476** | 45.330.195 | 16.475.446 | 403.835 | 1,18 | 270 |
| *- % in county total* | *34%* | *42%* | *71%* | *10%* | *35%* | *34%* | *40%* | *7%* | | *57%* |
| ***IV. SISAK-MOSLAVINA COUNTY - TOTAL (RSG + LSG 1 + LSG 2)*** | ***340.018.838*** | *254.283.070* | *15.065.391* | *70.670.377* | ***322.238.919*** | *259.598.791* | *61.744.016* | *896.112* | *0,98* | *404* |
| **COUNTY - TOTAL (RSG)** | **59.193.343** | 29.493.617 | 1.009.806 | 28.689.920 | **57.367.960** | 55.196.564 | 490.612 | 1.680.784 | 0,53 | 42 |
| *- % in county total* | *17%* | *12%* | *7%* | *41%* | *18%* | *21%* | *1%* | *188%* | | *10%* |
| **CITIES/TOWNS -TOTAL (LSG 1)** | **214.329.336** | 180.684.987 | 13.152.481 | 20.491.868 | **202.618.796** | 164.147.473 | 39.859.695 | -1.388.372 | 1,10 | 234 |
| *- % in county total* | *63%* | *71%* | *87%* | *29%* | *63%* | *63%* | *65%* | *-155%* | | *58%* |
| **MUNICIPALITIES - TOTAL (LSG 2)** | **66.496.159** | 44.104.466 | 903.104 | 21.488.589 | **62.252.163** | 40.254.754 | 21.393.709 | 603.700 | 1,10 | 128 |
| *- % in county total* | *20%* | *17%* | *6%* | *30%* | *19%* | *16%* | *35%* | *67%* | | *32%* |
| **City of Sisak** | **108.609.495** | 94.555.737 | 11.502.634 | 2.551.124 | **102.954.421** | 79.744.893 | 22.909.528 | 300.000 | 1,19 | 82 |
| *- % in county total* | *32%* | *37%* | *76%* | *4%* | *32%* | *31%* | *37%* | *33%* | | *20%* |

*Source: Republic of Croatia, Ministry of Finance, on-line publication* [*www.mfin.hr* ]; authors calculations.