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**INTERGOVERNMENTAL FISCAL RELATIONS:  
POTENTIALS AND LIMITATIONS FOR FINANCING OF LOCAL  
DEVELOPMENT IN CROATIA<sup>1</sup>**

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**ABSTRACT**

*The major goal of this paper is to give an overview on the most important issues regarding intergovernmental fiscal relations, potentials and limitations for financing of local development in Croatia.*

*The first section will give a general background for analysis of intergovernmental fiscal relations. In order to achieve this, the present model of financing of the local and regional self-government units, the number and size of local and regional governments and distribution of functions and revenue sources among levels of government in Croatia will be presented.*

*The second part of the paper consists of a detailed explanation of potential sources for financing local development projects (local budget; local borrowing for capital purposes through loans from financial institutions and other credit institutions or through capital market; public-private partnerships; external support and aid; extrabudgetary resources; transfers from the state budget for the implementation of state policy to promote local development and national and regional programs and projects; and other sources.*

*The third part of the paper gives explanations of limitations at local level of government in financing local development projects. There are several factors that are recognized as major obstacles to local development financing.*

*The last section summarizes our analysis and offers several recommendations that will lead to improvement of financing local development.*

**Key words:** intergovernmental finance, local development, Croatia.  
**JEL Classification:** H7, H2

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<sup>11</sup>This paper is mainly based on Jurlina Alibegović, D., 2005. Financing of Local Development Projects in Croatia: Potentials and Limitations at Local Level. Paper presented at the *OECD LEED Programme, International Conference on Local Development and Governance in Central, East and South-East Europe*, OECD LEED Trento Centre for Local Development, 1-2 June, 2005, Trento, Italy, pp. 21.

## **1. Introduction**

This paper gives an overview on the most important issues regarding intergovernmental fiscal relations and explores the role of local level of government in financing local development in Croatia.

Local governments everywhere share the problem of inadequate financing. The structure of expenditures in local budgets everywhere shows that current expenditures tend to prevail. For economic development reasons the structure of expenditures need to be completely different. Most local authorities are unprepared or unable to take on increased responsibilities for fund raising for economic development. On major problem is a lack of investment capital.

The second section of this paper gives explanations of present model of financing of local self-government units, basic composition of local government revenues and expenditures and an assessment of the strengths and weaknesses of local governments' system of finances. The third part of the paper consists of a detailed explanation of potential sources for financing local development projects. The fourth part of the paper gives explanations of limitations at local level of government in financing local development projects. The last section summarizes our analysis and offers several recommendations that will lead to improvement of financing local development in Croatia.

## **2. Present model of financing of the local self-government units**

### **2.1 Structure of local government revenues and expenditures**

Croatia has today a *two-tier system of sub-national government*. *Municipalities, towns and cities* represent the local level of government and *counties* represent the regional level of government. *The City of Zagreb* has status of a local and regional level of government.

Following the latest amendments, the territory of Croatia consists of *426 municipalities and 123 towns (cities)* at local level, the City of Zagreb and of *20 counties* at regional level, which makes a total of 570 sub-national units.

There are several important laws that are the legal basis of local government finance system<sup>2</sup>. The Law on Local and Regional Self-Government Financing defines sources for financing of the operations of municipalities, towns (cities) and counties, various types of taxation, distribution of funds among the different levels, tax base, taxpayers, rates, as well as calculations and forms of tax payment.

Local and regional self-government unit realises revenue through:

- *own sources*,
- *shared taxes*,
- *grants from the state and county budget*,
- *equalisation transfers for decentralised functions*, and
- *shared revenues*, and
- *borrowing*.

Local governments' *own sources* include income from local governments' own property, from county, city or municipal taxes (see Table 1), from fines, fees, and charges.

Croatian law outlines the *distribution of shared revenues* between the state and local authorities. Local self-government units are entitled to the revenue from *shared taxes* and fees collected within their area, at a percentage stipulated by the law. Shared taxes are income tax, profit tax, and tax on real estate transactions (see Table 2 and 3).

The income realised through *income tax* is distributed in a manner that it distinguishes whether municipality or city finances or not decentralised functions in selected public services including education, health care, social welfare and fire-protection and with respect to the special area that a local government unit belongs to. A distinct distribution of income tax is provided for the City of Zagreb (47%).

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<sup>2</sup>The Law on State Budget, the Law on Local and Regional Self-Government Financing, the Law on Execution of the State Budget, the Decree on the Mode of Calculation of Equalization Grants for Decentralized Functions, the Decree on Budget Accounting, the Rules on Budget Accounting and Chart of Accounts, the Rules on Financial Reporting in Budget Accounting. In addition, the local units also have to abide by other special regulations that regulate various areas of public spending.

**Table 1          Local and regional self-governments' taxes**

Municipal, town and city taxes	County taxes
surtax on income tax consumption tax tax on vacation homes tax on idle lands tax on unused commercial real estate tax on unused building plots tax on firm or name tax on the use of public surfaces	tax on inheritance and gifts tax on motor vehicles tax on boats and vessels tax on gambling machines

Source: Author's systematisation

A new distribution of income tax among the state, municipalities, cities and counties was made at the end of 2002, whereby the share of other shared tax revenues (profit tax and tax on real estate transactions) remained the same as in the previous year. The share of income tax for municipalities and cities amounted to 34% increased by the scope of activities taken over by the units (2.9% share for primary education and 1% for public fire brigades). The share of the state budget in income tax after changes amounted 25.6%, whereas the state has fully ceded its share of income tax to areas of special state concern, mountainous areas and islands that finance capital projects. The state cedes its share of income tax (25.6%) to municipalities and cities on islands, that concluded an agreement on the financing capital projects of joint interest for the development of islands. Those were mainly water supply and physical planning projects, and upgrading of transport infrastructure.

The major change in revenue sources for municipalities and counties is the possibility of introducing new municipal and city taxes, as well as the possibility of introducing different levels of surtax on tax on income tax<sup>3</sup> depending on the size of the municipality.

Distribution of shared revenue sources between the state and sub-national government has changed. The most significant change is in the distribution of income tax revenues, with a larger part of income tax revenue going to local government units. A special part of income tax revenue is reserved for covering expenditures regarding

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<sup>3</sup>The rate of surtax on income tax: municipalities may levy up to 10%, towns with a population below 30,000 inhabitants may levy a surtax of up to 12%, cities with over 30,000 inhabitants may levy a surtax of up to 15%, and the City of Zagreb may levy surtax of up to 30%.

decentralised functions in primarily and secondary education, health care, social welfare and fire protection (see Table 2). For local government units that do not have enough resources for financing decentralised functions there has been established equalisation grants for decentralised functions.

Described changes in financing the system of local and regional government have focused on one major objective – the transfer of responsibilities in providing part of public services to the local and regional level and at the same time securing revenues for financing the transferred responsibilities.

All amendments to the Law on Local and Regional Self-Government Financing resulted in increase of share of public revenues ceded to the municipalities, cities and counties. The share of unconsolidated revenues of local and regional self-government units in GDP increased from 5.6% in 2000 to 7.4% in 2003.

On the basis of available data for the fiscal year 2003, the share of local and regional budget revenues in consolidated general government budget revenues totalled 9.40% and 4.67% of the GDP. Data shows that higher participation of local and regional self-government in consolidated general government budget and more efficient public sector as two major goals of the decentralization process have not been achieved yet<sup>4</sup>.

A share in the distribution of revenue from *profit tax* for municipalities, towns and cities is 20%, for counties 10%, and for the state 70%.

A share in the distribution of revenue from *tax on real estate transactions* for municipalities, towns and cities is 60%, and for the state 40%.

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<sup>4</sup>The share of revenues of local and regional government in the total amount of revenues of the consolidated general government in Croatia in comparison with other transition countries is much lower. While in Croatia the share of total revenues by local government is 9.40%, the share of revenues in other countries is: 20.8% in the Czech Republic, 26.7% in Hungary, 28.8% in Poland, 22.1% in Estonia, 25.0% in Latvia and 22.8% in Lithuania (Ebel and Yilmaz, 2002).

Regarding *grants, transfers or subventions*, a system of financing community needs has been designed in such a way that grants are used solely as funds to support local self-government units with poor fiscal capacity<sup>5</sup>.

*Equalisation grants for decentralised functions* are ensured from the state budget to cover public expenses in the area of primary and secondary education, social welfare, and health care and fire protection, which are transferred to local and regional self-government units.

**Table 2**      **Distribution of shared taxes**

Shared taxes	Central government budget	Counties	Municipalities, towns and cities
Income tax	25.6% share of income tax for equalisation fund 21%	10% + additional share of income tax for decentralised functions 9.4%	34% + additional share of income tax for decentralised functions 2.9%
Profit tax	70%	10%	20%
Tax on real estate transactions	40%	-	60%

Source: Author's systematisation

**Table 3**      **Additional share of income tax for decentralised functions**

Function	Additional share of income tax, %
Education	
primary	2.9
secondary	2.0
Health care	
health care institutions	2.5
Social welfare	
social welfare centres	0.4
home for elderly people	1.6
Fire protection	
public fire brigades	1.0

Source: Author's systematisation

*Shared revenues* of the state, municipality and city is the revenue from agreed annual concession fees for pumping mineral and thermal water, and for the use of water for the public water supply.

Apart from the a fore mentioned taxes and grants, local self-government units have numerous other revenues introduced on the basis of special acts and/or decisions of

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<sup>5</sup>See more details on grant system and equalization grants in Croatia in Jurlina Alibegović (2004).

representative bodies, such as *charges and fees*, which are contained and stated in the *non-tax revenues* of their budget.

Viewed as a whole, *current revenue* account for the major share in total revenues of municipalities, cities and counties. The share of *capital revenues* amounted to 4.6% in 2003. The share of *grants* amounted to 14.6% in 2003. The share of *tax revenues* in total revenues was 56% (see Table 4). The largest share of the tax income of sub-national government units is collected from the share in the *distribution of revenues from shared taxes* (income tax and surtax on income tax<sup>6</sup> and profit tax). It together account for approximately 50.5% of total revenue in 2003.

*Own tax revenues of sub-national budgets* amount to only 2.5% of the total tax revenues of towns, municipalities and counties.

**Table 4 Total revenues and grants of sub-national budgets, in 000 HRK and %**

Revenues	2002		2003	
I. Total revenues and grants	9.595.090	100.0	10.554.899	100.0
I.A. Total revenues	8.328.336	86.8	9.008.108	85.4
I.A.I Current revenues	7.830.809	81.6	8.527.776	80.8
- Tax revenues	5.477.139	57.1	5.906.130	56.0
Income tax and surtax	3.863.377	40.3	4.083.336	38.7
Profit tax	1.055.017	11.0	1.244.040	11.8
Property tax	329.418	3.4	315.914	3.0
Sales tax and other taxes	229.326	2.4	262.839	2.5
- Non-tax revenues	2.353.671	24.5	2.621.646	24.8
I.A.II Capital revenues	497.527	5.2	480.332	4.6
I.B. Grants	1.266.754	13.2	1.546.792	14.6

Source: Ministry of Finance, 2004. Annual Report of the Ministry of Finance for 2002-2003 Year.

Zagreb: Ministry of Finance. Available from:

[<http://www.mfin.hr/godisnjak>]

Note: Data refers on 53 local government units (20 counties, the City of Zagreb and 32 big cities).

*Non-tax revenues* of all sub-national budgets amount to 24.8% of the total revenues and grants. If non-tax revenues are added to the own tax revenues and capital

<sup>6</sup>Since the amendments to Law on Local and Regional Self-Government Financing in 2001 extended the possibility of the introduction of surtax on income tax to all municipalities and cities, until the end of 2003, the number of local self-government units which introduced of surtax on income tax increased to 198 municipalities and cities.

revenues, the share is considerably higher and accounts for 31.9% of total sub-national budget.

In the structure of total expenditures of local and regional self-government units, *current expenditures* amounted 72.8%. The largest share of total expenditures is accounted for expenditures for the purchase of goods and services, transfers and labor expenditures. (see Table 5)

**Table 5 Sub-national budget expenditures, by economic classification, in %**

Expenditures	2002		2003	
I. Total expenditure and lending minus repayment	8.770.288	100.0	10.458.376	100.0
II. Total expenditures	8.680.768	99.0	10.296.246	98.5
III. Current expenditures	6.863.830	78.3	7.617.598	72.8
1. Wages and employer contributions	1.900.678	21.7	2.001.555	19.1
2. Material expenditures	3.270.658	37.3	3.551.369	34.0
3. Financial expenditures	111.620	1.3	75.639	0.7
4. Subsidies and other current transfers	1.580.874	18.0	1.989.036	19.0
IV. Capital expenditures	1.816.938	20.7	2.678.648	25.6
V. Lending minus repayments	89.520	1.0	162.130	1.6
Overall deficit/surplus	824.802	9.4	96.523	0.9

Source: Ministry of Finance, 2004. Annual Report of the Ministry of Finance for 2002-2003 Year.

Zagreb: Ministry of Finance. Available from:

[<http://www.mfin.hr/godisnjak>]

Note: Data refers on 53 local government units (20 counties, the City of Zagreb and 32 big cities).

## 2.2. The strengths and weaknesses of local government finance

The problems of financing municipalities, towns, and counties are complex and call for continual monitoring and analysis, constant adjustment, and proposals for further research.

Two major issues that affected the overall intergovernmental finance need to be point out. First, changes in administrative and territorial organization and second, frequent changes of laws.

Constant changes in administrative and territorial set-up of Croatian territory on local and regional level have led to the impossibility in evaluation of the new solutions of the overall intergovernmental finance system.



The existing organization of local and regional self-government is not efficient in terms of fiscal capacity, which is indicated by the data obtained from budget analyses. Abolishing the autonomy of local self-government units and merging them with neighboring municipalities and towns, or any other change, which would affect the present territorial organization, is not a solution which would be currently supported. Before such a radical change is carried out, the existing possibility of connecting municipalities, towns, and counties should be used in order to implement development projects, which cannot be financed individually.

Laws that determine various aspects of intergovernmental finance have been modified quite frequently and such frequent changes have also affected many areas regarding local and regional financing. Such practices create much uncertainty regarding possibilities to forecast in long-run revenues and expenditures at local and regional level.

Few local government units are capable to manage financially their development needs in the advanced manner, using the project budget planning methods and elaborating long-term benefit studies on the local financing strategies. About one third of local government units in Croatia can not cover current expenditures with current revenues, while basic responsibilities to be financed are equal for all local government units. That increases the local and regional government units' dependence on the central government transfers to provide the mandatory services, or even results in not fulfilling the mandatory services at all assuming no sanctions will apply. This means that financing of local development projects in future will depend on available revenues from the state budget.

### **3. Sources for financing local development projects**

Local governments everywhere share the problem of inadequate financing. The structure of expenditures in local budgets everywhere shows that current expenditures tend to prevail. For economic development reasons the structure of expenditures need to be completely different.

The lack of public funds is the predominant reason for involvement private financial sector in provision local and regional investment and development projects. Besides the lack of public funds, there are several other reasons for involvement private sector in financing development project:

- increasing local and regional needs,
- inadequate structure of local and regional revenues,
- size of local and regional development projects, and
- limitations regarding borrowing at local and regional level.

There are several potential sources for financing local development projects. In the following section they are explained.

### **3.1 Local and regional budget**

The Law on Local Self-Government Financing and the Law on State Budget governs the drafting, adoption, execution, balancing and reporting of local and regional budgets, transfers between sub-national and central government.

The total revenues and grants to municipalities, cities and counties in 2003 amounted to HRK 10.6 billion. In the structure of total revenues, the outturn of current revenues accounted for the biggest share. In 2003 capital revenues were collected at HRK 480 million, but their share in total revenues accounted for only 5%. Since capital revenues are collected from the sale of assets that are mostly in the ownership of cities and municipalities and to a lesser extent in the ownership of counties, their share in budgets of cities and municipalities was higher as well.

Capital expenditures in 2003 were financed not only from capital revenues, but also from the outturn of current revenues, transferred unutilized funds from the previous year, and receipts from borrowing.

The biggest share in total capital expenditures (78% for 2002 and 75% for 2003) accounted for expenditures for acquisition of fixed material assets (communal infrastructure, school and health institutions, cultural objects, pre-school institutions,

business zones, business buildings, reconstruction and construction of roads, sports and recreation centers, etc.).

Capital transfers accounted for 19% of transfers in total capital expenditures for 2003 and grew by 4% in comparison with 2002. They were mainly earmarked for non-profit organizations for non-economy investment and procurement of equipment and companies owned by local units for procurement of material assets.

### **3.2 Local borrowing for capital purposes**

There are two ways of local borrowing for capital purposes:

- through loans from financial institutions and other credit institutions, and
- through capital market (issuing of securities and municipal bonds).

#### **3.2.1. Loans**

The most revolutionary change effected by relatively new legislation in transition countries was to give local and regional governments power to contract medium or long-term loans for public investment of local interest or to refinance the local public debt. Previously, such investments were financed solely from own revenues and central budget transfers, which created difficulties due to delays in approving and transferring funds from the central budget to local budgets. All loans contracted by local and regional authorities are part of total public debt in a country. However, such loans are not the responsibility of the central government, and they must be paid from the incomes with which they were guaranteed by local and regional authorities.

Local and regional authorities can contract internal loans with government guarantee and with the approval of the Ministry of Finance.

The situation in Croatia is more and less the same as in the most transition countries. In the absence of capital revenues, and with a view to meet the needs financing a capital projects, local and regional self-government units were given the opportunity to borrow in line with the provisions of the Budget Law on the Execution of the State Budget and the Instructions of the Minister of Finance.

According to the Law on the Execution of the State Budget for 2002 and 2003, the counties, cities, and municipalities may borrow only in the domestic money and capital market and contractors performing capital projects that are financed from their budget. This is confirmed by the representative body with the preliminary approval of the Government.

For the first time for 2003 restrictive measures were prescribed by the decisions on the execution of the budget which ensure that the operating revenues and revenues from sale of material assets are the same or higher than the operating expenditures and expenditures for acquisition of material assets, and that the Croatian Government may issue approvals for borrowing of local and regional self-government units, no more than 2% of total planned expenditures of all local and regional self-government units reported in the financial report.

In addition, the municipalities, cities, and counties may issue guarantees for borrowing to a public institution or company whose founder and majority owner they are. The guarantee mentioned above is included into the annual borrowing of the respective unit. The annual liability for loans, guarantees, and other outstanding commitments (arrears) may account for no more than 20% of the own properties of units with approval of the State Audit Office and the Ministry of Finance.

Local borrowing is authorized by budget legislation. Short-term borrowing has aimed to cover cash flow irregularities and must be repaid within the same fiscal year. Long-term borrowing has aimed to finance capital investment expenditures in accordance with criteria to be specified and debt can be incurred domestically.

Local borrowing limits are defined annually in the State Budget Act, which leads to the risk that the framework for borrowing will evolve in an unpredictable manner.

### 3.2.2. Municipal bonds

Municipal bonds are securities issued by a state, city, or local government. Municipalities issue bonds to raise capital for their day-to-day activities and for

specific projects that they might be undertaking (usually pertaining to development of local infrastructure such as roads, sewerage, hospitals etc). Interests on municipal bonds are generally exempt from federal, state and local taxes.

Capital gains however are taxable. Given the tax-savings they offer, municipal bonds are often bought by people who have large tax burdens. Yields on municipal bonds are often lower than corporate or treasury bonds with comparable maturities, because of the important advantage of not being taxed at the federal level. In general, municipal bonds are considered safer than corporate bonds, since a municipality is far less likely to go bankrupt than a company.

Some municipal bonds can also be insured by outside agencies. These companies will promise to pay the interest and principal if the issuer defaults. Both issuers and bondholders can carry this insurance, though a bondholder would need to have a large stake to get the coverage.

There are two common types of municipal bonds: general obligation and revenue. *General obligation bonds* are unsecured municipal bonds that are simply backed by the full faith and credit of the municipality. Generally, these bonds have maturities of at least 10 years and are paid off with funds from taxes or other fees. *Revenue bonds* are used to fund projects that will eventually create revenue directly, such as a toll road or lease payments for a new building. The revenues from the projects are used to pay off the bonds. In some cases the issuer is not obligated to pay interest unless a certain amount of revenue is generated.

In the US municipal bonds usually come in USD 5,000 par values and usually require a minimum investment of USD 25,000 in order to get the best price. ([http://www.investorwords.com/3162/municipal\\_bond.html](http://www.investorwords.com/3162/municipal_bond.html))

There are only several examples of issuing municipal bonds to raise capital for local development project in Croatia<sup>7</sup>.

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<sup>7</sup>The Istria county was the first example of local bond issuer in Croatia. Recently the City of Zadar issues municipal bonds to raise funds for specific development projects.

### **3.3. Privatization**

Privatization means the repurchasing of all of a company's outstanding stock (the shares of a corporation's that have been issued and are in the hands of the public) by employees or a private investor. As a result of such an initiative, the company stops being publicly traded. Sometimes, the company might have to take on significant debt to finance the change in ownership structure. Companies might want to go private in order to restructure their businesses (when they feel that the process might affect their stock prices poorly in the short run). They might also want to go private to avoid the expense and regulations associated with remaining listed on a stock exchange.

Privatization means also the process of moving from a government-controlled system to a privately run, for-profit system.

The aim of introducing of private sector in providing public services is to provide additional revenues for financing public programs for different public services. The concept of privatization includes participation of private sector in construction, ownership, organization and supplying of public services. The concept of privatization can be applied to different kinds of infrastructural projects (for example, water supply, wastewater and solid waste, public transportation, etc.).

The private sector has several advantages in providing public services into comparison with the public sector. The most important is that it may ensure resources for social, economic and developmental needs of local community without additional financial effort for the local community. This means that the local government with the help of the private sector will receive additional revenues for public services, and use of limited local revenues for financing other public needs.

In Croatia the privatization process of companies whose majority owner or founder is sub-national government unit has been started recently<sup>8</sup>.

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<sup>8</sup>Debate on the process of privatization of communal and other companies owned by the City of Zagreb has started several years ago. But the City of Zagreb is owner or founder more than 20 companies.

### **3.4. Public-private partnership**

A public-private partnership (PPP) is a partnership between the public and private sector for the purpose of delivering a project or service traditionally provided by the public sector. PPP recognizes that both the public sector and the private sector have certain advantages relative to the other in the performance of specific tasks. By allowing each sector to do what it does best, public services and infrastructure can be provided in the most economically efficient manner.

There are several models of PPP with their variations and combinations may be arrived at the local authority for undertaking infrastructure projects:

*Build-and-Transfer (BT):* A contractual arrangement whereby the developer undertakes the financing and construction of a given infrastructure or development facility and after its completion hands it over to the government, government agency or the local authority. The government, government agency or the local authority would reimburse the total project investment, on the basis of an agreed schedule. This arrangement may be employed in the construction of any infrastructure or development projects, including critical facilities, which for security or strategic reasons, must be operated directly by the government or government agency or the local authority.

*Build-Lease-and-Transfer (BLT):* A contractual arrangement whereby a developer undertakes to finance and construct infrastructure project and upon its completion hands it over to the government or government agency or the local authority concerned on a lease arrangement for a fixed period, after which ownership of the facility is automatically transferred to the government or government agency or the local authority concerned.

*Build-Operate-and-Transfer (BOT):* A contractual arrangement whereby the Developer undertakes the construction, including financing, of a given infrastructure facility, and the operation and maintenance thereof. The developer operates the facility over a fixed term during which he is allowed to charge facility users

appropriate tolls, fees, rentals and charges not exceeding those proposed in the bid or as negotiated and incorporated in the contract to enable the recovery of investment in the project. The developer transfers the facility to the government or government agency or the local authority concerned at the end of the fixed term that shall be specified in the concession agreement. This shall include a supply-and-operate situation which is a contractual arrangement whereby the supplier of equipment and machinery for a given infrastructure facility, if the interest of the government, government agency or the local authority so requires, operates the facility providing in the process technology transfer and training to government, government agency or the local authority nominated individuals.

*Build-Transfer-and-Operate (BTO):* A contractual arrangement whereby the government or government agency or the local authority contracts out an infrastructure facility to a developer to construct the facility on a turn-key basis, assuming cost overruns, delays and specified performance risks. Once the facility is commissioned satisfactorily, the developer is given the right to operate the facility and collect user levies under a concession agreement. The title of the facilities always vests with the government, government agency or the local authority in this arrangement.

*Contract-Add-and-Operate (CAO :* A contractual arrangement whereby the developer adds to an existing infrastructure facility which it rents from the government, government agency or the local authority and operates the expanded project and collects user levies, to recover the investment over an agreed franchise period. There may or may not be a transfer arrangement with regard to the added facility provided by the developer.

*Develop-Operate-and-Transfer (DOT):* A contractual arrangement whereby favorable conditions external to a new infrastructure project which is to be built by a developer are integrated into the BOT arrangement by giving that entity the right to develop adjoining property and thus, enjoy some of the benefits the investment creates such as higher property or rent values.



*Rehabilitate-Operate-and-Transfer (ROT):* A contractual arrangement whereby an existing facility is handed over to the private sector to refurbish, operate (collect user levies in operation period to recover the investment) and maintain for a franchise period, at the expiry of which the facility is turned over to the government or government agency or the local authority. The term is also used to describe the purchase of an existing facility from abroad, importing, refurbishing, erecting and consuming it within the host country.

*Rehabilitate-Own-and-Operate (ROO):* A contractual arrangement whereby an existing facility is handed over to the operator to refurbish and operate with no time limitation imposed on ownership. As long as the operator is not in violation of its franchise, it can continue to operate the facility and collect user levies in perpetuity.

*Design-Build (DB):* The private sector designs and builds infrastructure to meet public sector performance specifications, often for a fixed price, so the risk of cost overruns is transferred to the private sector. (Many do not consider DB's to be within the spectrum of PPP's).

*Operation & Maintenance Contract (O & M):* A private operator, under contract, operates a publicly owned asset for a specified term. Ownership of the asset remains with the public entity.

*Design-Build-Finance-Operate (DBFO):* The private sector designs, finances and constructs a new facility under a long-term lease, and operates the facility during the term of the lease. The private partner transfers the new facility to the public sector at the end of the lease term.

*Build-Own-Operate (BOO):* The private sector finances, builds, owns and operates a facility or service in perpetuity. The public constraints are stated in the original agreement and through on-going regulatory authority.

*Build-Own-Operate-Transfer (BOOT):* A private entity receives a franchise to finance, design, build and operate a facility (and to charge user fees) for a specified period, after which ownership is transferred back to the public sector.

*Buy-Build-Operate (BBO):* Transfer of a public asset to a private or quasi-public entity usually under contract that the assets are to be upgraded and operated for a specified period of time. Public control is exercised through the contract at the time of transfer.

*Operation License:* A private operator receives a license or rights to operate a public service, usually for a specified term. This is often used in IT projects.

*Finance Only:* A private entity, usually a financial services company, funds a project directly or uses various mechanisms such as a long-term lease or bond issue.

There are several interested partners in PPP. These are: public (especially consumers), building contractors, operators, maintenance services, and suppliers, loan capital providers, investors and insurances.

Public-private partnership holds the promise of increasing the supply of infrastructure projects and other services without overburdening a country's public finances. An inflow of private capital and management can ease fiscal constraints on infrastructure investment and boost efficiency.

But PPP should be treated with great care. It is by no means certain that they will be more efficient than traditional public investment. PPP can be used to move investment off budget and debt off the government balance sheet, while the government still bears most of the risk and faces potentially large costs that will eventually be borne by taxpayers.

If PPPs are to deliver high-quality and cost-effective services to consumers and the government, there must be adequate risk transfer from the government to the private sector. The quality of services has to be contractible so that payments to service providers can be linked to performance and the risk of costly contract regeneration can be minimized. There has to be either competition or incentive-based regulations. (Hemming and Ter-Minassian, 2005)

In Croatia exist only several examples of PPP. Majority of these examples relates to concession agreement for usage of some infrastructural projects.

### **3.5. External support and aid**

Important source for financing of local and regional development projects in Croatia are revenues from loans and grants received from the international financial institutions - International Bank for Reconstruction and Development (IBRD), European Bank for Reconstruction and Development (EBRD), Council of Europe Development Bank (CEB), and European Investment Bank (EIB).

The IBRD provided grant for the social and economic recovery project from the funds of the foundation of the Government of Japan. The aim is to increase social cohesion in the area of special state concern (war damaged areas, undeveloped areas and the islands).

The plan of activities of EBRD in Croatia involves some activities regarding financing infrastructure, including encouraging commercialization, liberalization and privatization of infrastructure services.

The CEB is going to finance infrastructure in the areas of special state concern by new loans that are under preparation.

The EIB has mandate to finance infrastructure projects and private sector development projects in Croatia.

### **3.6. Extrabudgetary resources**

There are two major extrabudgetary resources<sup>9</sup> for financing local and regional capital projects. These are:

- the Fund for Regional Development, and
- the Fund for Development and Employment.

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<sup>9</sup>Revenues and expenditures of both Funds are now the part of the State Budget.

The major activity of *the Fund for Regional Development* is stimulating uniform regional development in whole country. Revenue sources come from: privatization revenues, state budget, long-term bonds, loan from financial institutions, bilateral loans, donations and other revenue sources.

In 2003 a total of approximately HRK 112 million was remitted from the Fund for Regional Development for capital projects to the areas of local and regional self-government units. Incentives for the development of municipalities, cities and counties are planned within the funds of several ministries. This is mainly co-financing of development programs in the area of crafts, agriculture, small and medium sized enterprises, etc.

The major activity of *the Fund for Development and Employment* regarding local and regional development is support to county programs that invest own revenues for realization of employment programs, development of entrepreneurship and construction of infrastructural objects, as well as help and support in establishment of business centers, development centers, industrial zones, incubators and technological parks. Revenue sources come from: revenue received from sale of state estate, privatization revenues, state budget, and other revenue sources.

#### **4. Limitations at local level in financing local development projects**

There are limitations at local level of government in financing local development projects. There are several factors that are recognized as major obstacles to local development financing.

The majority of small local authorities in Croatia are unprepared or unable to take on increased responsibilities for fund raising for economic development. This is because that authorities do not employed administration (staff) properly educated. In most of that small local self-government units employed personnel are responsible for different tasks (financial, legal, technical and other) and they do not have a chance to make an effort for specialization in one business area. Local government officials and professionals lack know-how for assessing real and financial needs and therefore, the

necessary communication and networking skills, which reflected many miscalculations in the current activities and planning of development projects.

The results of that are several important obstacles to raise revenues, especially for taking local borrowing, for capital purposes.

In order to borrow responsibly, municipalities and cities must have:

- the skills and information to budget for the current year and future years (including both operating and capital budgets);
- the ability to understand the impact of borrowing for infrastructure both annual debt service and annual operational and maintenance expenditures; and
- ability to identify, prioritizes and plan capital investment.

Municipalities and cities must be able to identify and analyze technical and financial options and show investors that they have adequate and reliable revenues to meet their debt service obligations. (Kandeva, 2001)

Sometimes the problem is a lack of investment capital. The problem is structure of expenditures in local government budgets and the need that sub-national government is responsible for covering a lot of public services.

## **5. Recommendations for improvement of financing local development**

Local and regional governments everywhere share *the problem of inadequate financing*. The main revenue source for financing local and regional development projects is local and regional budget. The revenue sources for capital projects are limited. The solution for local and regional government is to find additional revenue sources for development projects.

Most sub-national authorities are unprepared or unable to take on increased responsibilities for fund raising directed to economic development. One major problem is a lack of investment capital. Several other problems arise because of inadequate knowledge of regional and local administration regarding a need for

implementation *a clear strategy of regional and local development*. The strategy has a major duty to explain the roles of major actors involved in regional and local development.

Capital projects and programs hold considerable promise as ways to mobilize resources to provide results at local level. Clear strategy of regional and local development is one of the modern approaches aiming to create conditions for testable and balanced development of particular regions of a country, to reduce interterritorial differences in employment and income and to realize regional and cross-national cooperation and integration. Financial resources for regional and local development should come from the budget but in the near future major financial resources should come predominantly from other sources.

*Partnership* between central, regional and local government, nongovernmental organizations, private sector and all other major actors involved in regional and local development will create useful forms of efficient interaction, such as participation of representatives of different institutions in the activities, initiatives, and procedural rules for consultations on budget drafting or planning major capital projects in local areas. The existence of active network of different actors is indicative of the awareness of the need for joint action and interinstitutional cooperation in revenue rising for local and regional development.

Finding money to invest in infrastructure and other public projects without jeopardizing fiscal stability has become a hot topic in many countries seeking to boost economic growth. While looking for innovative ways to boost the private sector's role in providing infrastructure and other services, many countries are also focusing on how to make more room for public spending. The limitations are occurred because of two fiscal constraints: the overall fiscal balance and gross public debt as key fiscal indicators used by the IMF. These two indicators establish links with short-term macroeconomic stability and longer-term public debt sustainability.

Theoretical literature suggests that the poorer regions and local areas spend a larger proportion of their budgets on social expenditures, their lower revenue base means their per capita spending on such items remains significantly below that of the richer

regions and local areas. There is evidence that the shares of spending on social items and on capital items are inversely related. Richer regions and local areas use their higher revenue capacities to finance more capital spending. Such conclusions have several important implications:

- lower capital spending may influence slower growth in poorer regions and local areas,
- lower economic growth means that revenues capacities of poorer regions and local areas will continue to lag behind those of richer regions and local areas,
- in the absence of an adequate equalization system, lower revenue capacities would doom poorer regions and local areas to inadequate social spending and poor development of human capital, reinforcing the lower growth prospects in the future. (Ter-Minassian, 1997)

To do their major role in coordination and promotion of regional and local development, regional and local governments faces three main challenges.

The first involves improving the quality and operational efficiency of local and regional governments at the lowest cost. This implies raising local administration productivity, reducing public costs (central state, regional, municipal and city and other), rendering transparency in local government activities, and actively involving the community and citizens in local government.

The second trend concentrates on restructuring the relationship between local governments and citizens and acknowledgement of the fact that citizens are the customers of the local administration. The shift of focus on citizens as clients in the public sector depends upon two principal considerations. First, citizens are users of public services provided by local authorities for which they pay either directly or indirectly through the collection of fees and taxes. Second, any particular public service has a value, price and quality that has to correspond to the needs and requirements of citizens in their capacity as taxpayers and users of these services. Since citizens are clients in the public sector, they have to be protected against possible discrepancies in the "price-quality" correlation.

The third trend is adjustment of local governments and local administration to the requirements and conditions of economic development of local and regional areas. Thus, it also includes the search for a reasonable balance between the public and private sectors on the local level and the use of private sector methods and approaches in local public management. Public procurement and other forms of contracting are tools of modern local government.

Increasing tendencies towards liberalization, the shortage of funds in practically all budgets and the process of internationalization are creating new market conditions in the infrastructure sector of transport, energy, environment and communal services. This means that public-private partnership is the keyword for development at state, as well as local and regional level. The state's control function is coupled to the operational efficiency of the private economy. Practice shows that PPP represent a viable and actively used project financing alternatives in cases where the project is of sufficient size and has a high degree of self-financing induced by cash flow and in cases where efficiency improvements can be successfully realized.

The Government of the Republic of Croatia started with the process of decentralization determining decentralization as the principle of its future work in many areas. The Government continued to express its undoubted political will for decentralization. However, no documents of a detailed, implementation-level nature were adopted to determine the objectives, work out the methods, impose concrete tasks, define who would be responsible, propose deadlines and provide the yardsticks for performance measurement for the achievement of the aims of decentralization (Jurlina Alibegović, 2004).

Finally, counties, towns and municipalities in Croatia should take advantage of the opportunities to cooperate, particularly having in mind the joint realization of development projects for which individual local self-government units does not have enough financial resources, but may benefit mutually from the project results. There are so many expected benefit of encouraging the cooperation between municipalities, cities and counties in order to achieve common goals and to increase the revenues necessary to finance local functions, as well as to collect more funds for investment in joint capital projects, and through this, to increase their credit rating.



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