

# REGIONAL DEVELOPMENT AND DECENTRALIZATION – TWO OPTIONS TO OVERCOME LACK OF FUNDING

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## Abstract

Decentralization can be generally described as a process in which selected functions are assigned to sub-national units. The literature identifies a number of positive consequences of decentralization which all lead to a better satisfaction of citizens' needs for public services. Although the decentralization process in Croatia started more than ten years ago, it has not yet been completed. While leading to a new allocation of authorities and responsibilities to local government units, the level of fiscal decentralization remained lower than in the EU countries.

In this paper we analyze the fiscal capacity of local government units to provide an insight into the main problems of decentralization in Croatia. We show that most local government units have very low fiscal capacity, which is insufficient for financing basic public functions with their own resources. The paper presents the results of a survey relating to the decentralization process conducted among local councilors at the regional level in Croatia. We explore how local councilors at the regional level evaluate different goals of decentralization. With the lack of fiscal capacity in mind, we identify two possible solutions for an optimal provision of public functions. The first one is the level of political will for a joint provision of public functions by different local units, and the second one is a change in the territorial organization of the country. We measure the difference in the attitudes toward these questions across counties.

**Keywords:** decentralization, fiscal capacity, regional development, local units, Croatia.

## 1. Introduction

The devolution of power from central to local levels of governments is a complex and multidimensional process which involves political, administrative and fiscal decentralization (Martínez-Vázquez and McNab, 2003; Schneider, 2003). The main argument for promoting decentralization is that it directly encourages and contributes to economic growth, while also enhancing the development of regions in heterogeneous countries by using limited resources more efficiently. Theory and empirical research suggested that underdeveloped countries are more centralized than developed ones. Therefore, the question is whether fiscal decentralization is a cause or a consequence of economic development. Opinions differ. Bahl and Linn (1992) and Bailey (1999, 2002, 2004) suggest that decentralization comes with a higher level of economic development. Therefore, decentralization becomes an important part of the development strategy not only in underdeveloped, but also in developed countries.

The major focus of this article is on fiscal decentralization. Theory suggests that a decentralized decision-making related to fiscal issues best meets local public interests (Dillinger, 1994). The main reason for the existence of multiple levels of government is to allow a certain level of government to provide a selected category of public service and to allow that their level varies across different local units according to their preferences (Biela, Hennel and Kaiser, 2012). In addition, multiple levels of government also imply that voters have more choices to express their preferences. Tanzi (1995) believed that fiscal decentralization exists when sub-national levels of government, on the basis of the constitution or the law, have the autonomy to introduce taxes, and that tax revenues can be spent for the provision of public services according to clearly defined criteria.

Increased scientific efforts have been devoted to understanding the consequences of fiscal decentralization, but far less effort has been invested into analyzing the causes of fiscal decentralization. Causes of the difference in the level of decentralization among countries still represent an enigma. Oates (1972), Panizza (1999) and Treisman (2006) argue that the origins of fiscal federalism stem from diverse factors: history, culture, politics, and even physical geography.

Fiscal decentralization has been associated with an efficient fulfillment of development goals, greater competitiveness among the sub-national levels of government in providing public services and with boosting economic growth (Bahl and Linn, 1992; Bird and Wallich, 1994). Dillinger (1994) considers decentralization to have begun in a number of developing countries, including those in South Eastern Europe (SEE) and even in the countries that have always been centralized<sup>1</sup>. Decentralization is an effective strategy to improve the delivery of public services.

Similarly to a number of other transition countries, local reforms in Croatia were understood as the vehicle to achieve autonomy of a larger number of local govern-

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1 In transition economies, decentralization is an essential element of the process of transition and the development of democracy, which necessarily leads to economic development.

ment units<sup>2</sup>, instead of focusing on a better provision of public functions to citizens. Swianiewicz (2000) stresses that the territorial fragmentation in Eastern European countries became a large barrier to decentralization. Croatia is not an exception. The territorial fragmentation resulted in a large number of local government units with a small number of inhabitants and inadequate fiscal capacity to provide even the basic public functions to their residents. Only 16% of local government units in Croatia have more than 10,000 residents and 6% of them have fewer than 1,000 residents.

Although the relationship between decentralization and economic growth is still inconclusive, recent empirical analysis for Croatia identified a positive relationship between the level of fiscal decentralization and economic development, suggesting that a higher level of decentralization would be beneficial for the Croatian economy (Jurlina Alibegović, 2013).

The main goal of this paper is to investigate and discuss the solutions to increase the quality of public functions provided to citizens at the local level in the circumstances of low fiscal capacity of local government units. We examine the existence of local support for the decentralization process and territorial reforms. In addition, many European countries recognized the lack of inter-municipal cooperation in the provision of public functions and the necessity to increase the level of that cooperation. As the inter-municipal cooperation could be a solution to solving the mismatch between scarce resources and public functions requirements at the local level, we investigate the existence of political will at the local level for a joint provision of public functions regardless of different political orientation of local authorities.

The rest of the paper is structured as follows. Section two describes the main features of the decentralization reform in Croatia. Section three elaborates on the fiscal capacity of municipalities, towns and counties in Croatia as potential sources of financing decentralized public functions, as well as local development projects. Methodology and basic findings of the survey conducted among regional councilors are presented in section four. The last section summarizes our analysis and offers conclusions regarding possible solutions which may help overcome a lack of funding for promoting decentralization and regional development in Croatia.

## **2. Decentralization reform in Croatia**

According to the theory of public finance, the responsibility of sub-national levels of government in providing public goods and services results from established inter-governmental fiscal relations between the central and sub-national fiscal authorities. Transparent allocation of responsibilities between the central and sub-national levels is essential for efficient decentralization. In addition, adequate revenue sources to finance public goods and locally provided services are of great importance. Efficient decentralization should also ensure a better coordination and cooperation of all public entities in providing public functions.

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2 In the majority of SEE countries legislation has allowed settlements of any size to claim the status of an autonomous municipality, resulting in a very fragmented territorial structure.

In this section we focus on the distribution of expenditures and revenue sources among different levels of government. The Republic of Croatia has a two-tier system of sub-national government – the local level (126 towns and 429 municipalities) and the regional self-government level (20 counties and the city of Zagreb). Today, the territory of Croatia consists of 576 sub-national units.

For almost 15 years, there has been an increasing interest in the vertical organization of government in Croatia. As in many other countries, the main question asked is whether it is advantageous to give sub-national governments more authority and autonomy in revenue and expenditure decisions, or whether it is better to make those decisions at the central level of government. A number of research projects produced in Croatia since 1999 have focused on decentralization. Even though they have dealt with different issues of decentralization, the major focus has been on fiscal issues. Such projects have been financed by domestic and international agencies and implemented by Croatian experts and scholars. Several working groups and commissions have been formed with the main task of proposing a framework for decentralization. The results of projects serve for policy recommendations and formulation of the guidelines and principles for a functional decentralization and territorial reorganization in Croatia. In spite of all these activities there is still no comprehensive decentralization strategy (Zakošek, 2012).

The first phase of the decentralization reform in Croatia began in July 2001<sup>3</sup>. The decentralization reform has been directed both at administrative and fiscal areas. A new division of responsibilities among different governmental levels is based on the provisions of specific laws<sup>4</sup>. These laws define the public functions to have been transferred from the national or state level to the county, town and municipal level. The allocation of responsibilities is presented in Table 1.

As Table 1 shows, all municipalities and all towns have equal authorities. Consequently, it is impossible to ensure a comparable quality of public services. There has been no clear allocation of responsibilities in the implementation of public functions between the central and sub-national levels of government in Croatia. The provision of any public function is assigned to all levels of government, so their responsibilities often overlap.

As Rodríguez-Pose and Gill (2003) noted, it is often the case in different countries that two local units with very similar political powers may have different resources at their disposal, so units with similar fiscal capacities may have different levels of authority. In the case of asymmetric decentralization this situation is feasible within a single country (Ezcurra and Rodríguez-Pose, 2013, p. 390).

In the first phase of decentralization, 32 financially stronger towns, the city of Zagreb and all of 20 counties in Croatia were assigned additional responsibilities for

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3 Based on the Program of Fiscal Decentralization (2002)

4 Primary Education Act, Secondary Education Act, Social Welfare Act, Health Insurance Act, Fire Protection Act, and Local and Regional Self-Government Units Act

**Table 1:** Distribution of responsibilities

	Municipalities	Towns	Counties	State
01 General public services				
01.1 Executive and legislative bodies, financial and fiscal affairs, external affairs	√	√	√	√
02 Defense				
02.1 Military defense				√
02.2 Civil defense	√	√		
03 Public order and safety				
03.1 Police services				√
03.2 Fire-fighting services	√	√		
04 Economic affairs				
04.1 General economic, commercial and labor affairs (consumer protection)	√	√		
04.5 Transport	√	√	√	√
05 Environmental protection				
05.1 Waste management			√	
05.2 Waste water management			√	
05.3 Pollution abatement	√	√		
06 Housing and community amenities				
06.1 Housing planning and development	√	√	√	
06.2 Community planning and development	√	√	√	
06.3 Water supply	√	√		
06.4 Street lighting	√	√		
07 Health				
07.1 Medical products, appliances and equipment				√
07.2 Outpatient services			√	
07.3 Hospital services			√	√
07.4 Public health services			√	
08 Recreation, culture and religion				
08.1 Recreational and sporting services	√	√		
08.2 Cultural services	√	√		√
09 Education				
09.1 Pre-school and primary education	√	√		
09.2 Secondary education			√	
09.3 Post-secondary non-tertiary education			√	√
09.4 Tertiary education				√
10 Social protection	√	√	√	√
10.6 Housing			√	√
10.7 Social exclusion n.e.c.			√	√

**Source:** Authors' systematization based on the analysis of different laws

providing some of the public functions locally (Jurlina Alibegović, 2007; Jurlina Alibegović, 2013)<sup>5</sup>. According to the adopted model of decentralization, the expenditures for material costs and capital investments in primary education were transferred to the budgets of 32 large and/or financially stronger towns and counties, as well as the

5 A total of 53 selected local and regional government units that have been assigned decentralized functions represent only 9% of the total number of local and regional government units in Croatia.

expenditures for material costs and capital investments in secondary education that were transferred to county budgets. When it comes to health care and social welfare, the expenditures for material costs were transferred to county budgets, but the financing of capital investments remained within the scope of the state budget. Firefighting was the only public function transferred entirely from the state to the municipal level. Financing of other public functions is a shared responsibility between the state and lower levels.

The implemented model of decentralization introduced several profound changes in revenue sources. The first one was the possibility of introducing new municipal and town taxes, as well as the possibility of introducing different levels of surtax on the income tax, depending on the size of the municipality. The usual distribution of revenues between the state and local levels also changed. The most important change was in the allocation of income tax revenues, with a larger part of revenues now being assigned to the local governments (55%). An additional portion of income tax revenue (10%) is reserved for covering the expenditures regarding decentralized functions in primary (3%) and secondary education (2%), health care (3%), social welfare (2%) and firefighting (1%). Equalization grants for decentralized functions (21% of the income tax) were established for the local government units which do not have sufficient resources for financing decentralized functions. Over the following years, the additional portion of income tax allocated for financing decentralized functions also increased gradually (Jurliina Alibegović, Slijepčević and Kordej-De Villa, 2013).

Although total revenues and expenditures of local government units were raised in nominal terms, all data clearly show that Croatia is a highly centralized country measured by two important indicators: the share of revenues and expenditures of the sub-national government in the country's GDP, and the share of revenues and expenditures of the sub-national government in total government budget revenues and expenditures (see Table 2).

**Table 2:** Decentralization level in Croatia in 2011

	Local government revenues		Local government expenditures	
	Share in consolidated general government revenues (%)	Share in GDP (%)	Share in consolidated general government expenditures (%)	Share in GDP (%)
2000	10.93	5.35	10.04	5.42
2001	8.82	4.12	8.71	4.28
2002	10.05	4.00	10.25	4.00
2003	9.47	3.72	10.58	4.07
2004	9.76	3.83	9.12	3.50
2005	10.14	3.96	9.66	3.67
2006	10.60	4.16	9.72	3.66
2007	10.56	4.26	9.95	3.76
2008	10.95	4.31	10.48	3.99
2009	11.00	4.39	10.5	4.20
2010	10.40	3.90	9.80	4.00
2011	10.30	3.80	9.50	3.80

**Source:** State and local budgets. Ministry of Finance, different years

The share of local budget revenues and expenditures in the consolidated general government budget has remained around 11% while their share in the GDP has been 4%. Consequently, Croatia has continued to be among the least decentralized countries, and not only compared to the EU-27 countries. A comparison with other SEE countries shows that Croatia is rather similar to those countries. The degree of decentralization in SEE countries is still very low. The average share of unconsolidated local government revenues is 5-6% of GDP, or 14-17% of total government revenues (see Table 3).

**Table 3:** Decentralization level in selected countries in 2011

	Consolidated general government revenues, as % of GDP	Local government revenues, as % of GDP	Local government revenues, as % of consolidated general government revenues
Albania	25	3.1	12
Turkey	35	4.9	14
Bosnia	45	5.1	11
Serbia*	41	5.6	14
Montenegro	39	5.8	15
Macedonia	36	5.8	16
Croatia	36	6.2	17
EU 27	49	11.9	24
SEE	37	5	14

Notes: \* for 2009

**Source:** NALAS (2012)

To investigate the decentralization issues in Croatia more thoroughly, in 2009, the Institute of Economics, Zagreb (2010) conducted interviews with the representatives of local and regional government units as part of a project to explore which public functions of the central government could be transferred to local government units, and what the prerequisites for increasing the local government units' responsibilities in providing public functions would be. The interviewed representatives of local government units agreed that it was necessary to make a clear division of tasks and responsibilities among different government levels and to receive additional resources to finance it. Also, the representatives of local government units stressed as a very important prerequisite that politicians and bureaucrats support these reforms. The literature also recognizes this issue. As pointed out by Eaton, Kaiser and Smoke (2010), due to the fact that decentralization changes the institutional rules dividing the resources and responsibilities among different levels of government, politicians and bureaucrats are worried that their power and authority are at stake<sup>6</sup>. They observed

6 This statement is true regardless of: whether there is full or partial decentralization of responsibilities to the local level; the substantive target(s) of reform (administrative, political, fiscal); whether the reforms are broad-based or activity/sector-specific; and the type of transformation involved (creating new sub-national administrations or governments where none existed, transforming existing local administrative units into elected governments, or strengthening elected local governments that have powers but function poorly).

that the lack of correspondence between official public policy goals and the goals of political and bureaucratic actors commonly result in a failure to fully achieve the stated objectives of decentralization.

In 2010, the Government of the Republic of Croatia adopted the Guidelines and Principles for a Functional Decentralization and Territorial Reorganization, in which it planned to press on with the process of decentralization in 2013, showing that it supports the idea of further decentralization. Its designated counties are the entities which should be responsible for coordinating local development.

### **3. Fiscal capacity of sub-national government units**

Since 2001, the revenue of local units has increased substantially. It coincides with the beginning of the process of fiscal decentralization. As reported in the previous section, the decentralization model implemented in Croatia included several profound changes in revenue sources. The major change was in the distribution of income tax revenues, with a larger portion of revenues now being allocated to local governments, as well as to regional government units.

The revenue outturn in local government units in Croatia is harmonized with the IMF (2001) methodology.

In 2009, total revenues of all local government units in Croatia stood at EUR 3.05 billion while in 2011 they amounted to EUR 2.72 billion<sup>7</sup>. A comprehensive analysis of local budgets is presented in Jurlina Alibegović, Slijepčević and Kordej-De Villa (2013). Here is a short summary of some of the most important findings.

Within the structure of total revenues of municipalities, towns and counties, *tax* revenues are the most important category, with a 52% share. The second most important source of total local government units revenues are grants. In the 2009-2011 period, there was an obvious increase in the share of grants, from 9 to 14% of total local revenues<sup>8</sup>. It is important to note that the majority of grants received in 2011 were in the form of current and capital grants, as well as equalization transfers for decentralized functions. This, in turn, means that the revenues from an additional share of income tax are insufficient for covering the costs of decentralized functions. The administrative fee revenue is an important revenue source for local government units, and it generated 18% of the total revenues<sup>9</sup>. There is a prominent difference in the amount of fiscal revenue, as well as in their structure among counties, towns and

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7 For comparison, the average annual exchange rate of the EUR was HRK 7.34 in 2009, and in 2011 it was HRK 7.43.

8 In 2009, total grants to local governments amounted to HRK 2.0 billion while in 2011 grants totaled HRK 3 billion. One can notice a substantial increase in the local dependency on state budgets (in the form of grants) during the economic crisis.

9 Administrative fee revenue is predominantly revenue from public utilities and it is exclusively municipal, town revenue.

municipalities. The participation of the city of Zagreb, towns<sup>10</sup> and municipalities in total local revenues stood at 30, 38 and 16%, respectively.

In 2011, the total expenditures of municipalities, towns, and counties were HRK 21.2 billion. Of the total expenditures, according to the economic classification, material expenditures were the most important category, with a 32% share. Expenditures for the purchase of non-financial assets accounted for 16% of the total expenditures of local units. The towns and municipalities spent significantly more for these purposes than did the counties. The counties should be responsible for coordinating the regional development. Compared to the budgets of other local units, county budgets are sufficient for the coverage of compensation of employees and material expenditures only. Due to financial limitations their role of promoters of the regional development could not be performed successfully.

In 2011, expenditures for compensation of employees represented 21% of the total expenditures. Other expenditures of municipalities, towns and counties represented as much as 13% of the total expenditures. The main reason for that is the amount of current grants, mostly issued to public sector companies. In addition, local units allocated 5% of their 2011 budgets for subsidies. The largest part of subsidies was transferred to public sector companies.

There are pronounced differences – related to both the amounts and the structure – on the expenditure side of the local budgets. The analysis shows that more than 37% of total local expenditures are generated by towns, 27% by municipalities, 24% by the city of Zagreb and 12% by counties. As Jurlina Alibegović, Slijepčević and Kordej-De Villa (2013) show, the major difference between county and other local budgets is the amount of grants. Out of the HRK 394 million allocated for total local grants, 52% are the grants transferred by counties to towns and municipalities.

According to the functional classification, the major categories of expenditures in the structure of local budgets are the expenditures for education and those for general public services, with a 18% share each. The expenditures for housing and community amenities consume 17% of local budgets. The analysis of local budget expenditures according to the functional classification indicates that the expenditure structure reflects differences in the allocation of responsibilities for providing public services among different governmental levels.

From the previous overview of local revenues and expenditures it can be concluded that the financing of local public functions is largely dependent on the revenues from income tax and state budget grants. Municipalities and towns cannot raise sufficient amounts of these revenues and, therefore, the fiscal autonomy of sub-national government units in collecting their own revenue is relatively low. The sub-national government units obtain the least amount of revenues from their own taxes.

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10 Without the city of Zagreb budget.

**Table 4:** Composition of local government revenues in 2011 (in %)

	Own revenues	Shared taxes	Grants
Albania	31	0	69
Turkey	43	41	16
Bosnia	35	12	53
Serbia**	41	40	19
Montenegro	70	17	13
Macedonia	37	6	57
Croatia	32	53	15
SEE	42	24	34

Note: \*\* for 2009

Source: NALAS (2012)

Aristovnik (2012) assessed the degree of fiscal decentralization in the SEE region by using three different measures of fiscal decentralization<sup>11</sup>. Croatia 'has the highest fiscal autonomy which means that local governments in Croatia have been provided with 'real' fiscal resources and have the potential to realize real responsibilities on fiscal autonomy and on the fiscal importance of sub-national governments' (Aristovnik, 2012, p. 13). But it is important to emphasize that this is an average measure of fiscal autonomy. An analysis of the distribution of financial strength across different local units shows a considerable deviation from the average. Our analysis shows that the majority of local government units do not have sufficient revenues to cover their own expenditures. The situation is clearly much worse in the countries with a lower fiscal autonomy index.

Fiscal capacity of a regional or a local government unit can be defined as the ability of the local unit to raise revenues from its own sources in order to pay for a standardized basket of public goods and services (Snah, 1997; Martínez-Vázquez and Boex, 1997). Fiscal capacity can also be defined as the ability of governmental jurisdiction to translate economic activity within its geographic borders into public spending (Chernick, 1998). There are several major approaches or concepts to measuring the fiscal capacity of local units (Chernick, 1998; Martínez-Vázquez and Boex, 1997)<sup>12</sup>.

A measurement of fiscal capacity should be an important factor in determining the allocation of intergovernmental grants in order to equalize the amount of resources available to each of the regions or towns (Bajo, 1999; Jurlina Alibegović *et al.*, 2005).

In Croatia there are two major kinds of transfers and grants. There are grants and transfers from the state and county budgets to local units<sup>13</sup>, and equalization grants

11 These are the fiscal autonomy, the fiscal importance of sub-national governments and the fiscal decentralization index.

12 These are: the representative tax system, the representative tax system using regression analysis, the income with exporting, the maximum amount of revenue, per capita personal income, gross regional product, and the level of total taxable resources.

13 These grants are paid in accordance with the capabilities of the state budget. They are allocated to the local units without fiscal capacity for financing mandatory functions. The criteria for the calculation of the grants for local units change every year.

for decentralized functions from the state budget to the regional/local government in order to cover major public services expenditures (education, health care, social welfare and fire-fighting).

The equalization grant volume for the finance of the decentralized functions is calculated as the difference between the minimum required expenditure for the public services finance (determined on the basis of the minimum financial standard) and the amount of the corresponding income taxation. The equalization grant system requires constant monitoring and improvements. One of the key areas for which a better solution is required is the definition of the minimum financial standard.

Selected measures for the fiscal capacity of counties, towns and municipalities in 2011 are presented in Table 5. Results of the measurement of the fiscal capacity with different indicators imply that there are large differences in the level of budget per capita across different counties, towns and municipalities. Differences in fiscal capacities are especially evident when analyzing total revenues data without grants and the share of the income tax revenue for financing decentralized functions. Analyzing the differences in fiscal capacities across different local levels helps us to identify whether local units are actually capable of financing the existing public services and whether their fiscal capacities are adequate for taking on new responsibilities in providing public services.

**Table 5:** Fiscal capacities per capita, in EUR

Year 2011	Average	Minimum	Maximum
<b>Tax revenues</b>			
- counties	55.42	29.31	93.11
- towns	219.63	61.86	523.60
- municipalities	151.20	17.56	741.98
<b>Share of the income tax revenue from equalization grants for financing decentralized functions</b>			
- counties	10.45	0.00	27.88
- towns	2.25	0.00	20.57
- municipalities	0.17	0.00	25.03
<b>Grant revenues</b>			
- counties	63.49	16.22	107.76
- towns	84.87	0.00	786.66
- municipalities	91.04	0.00	1,383.58
<b>Total revenues without grant revenues and the share of the income tax revenue for financing decentralized functions</b>			
- counties	61.22	33.11	118.96
- towns	410.15	95.09	1,851.20
- municipalities	312.49	28.97	1,652.54
<b>TOTAL REVENUES</b>			
- counties	135.15	109.59	158.73
- towns	497.27	151.86	1,938.13
- municipalities	403.69	69.70	1,892.72
<b>TOTAL EXPENSES</b>			
- counties	133.47	108.06	166.29
- towns	491.97	151.87	1,762.13
- municipalities	404.54	60.47	3,927.92

Note: the total revenues without grants item means total revenues without grant revenues and the share of the income tax revenue for financing decentralized functions.

**Source:** Authors' calculations based on data of the Ministry of Finance and the Croatian Bureau of Statistics

**Table 6:** Differences in total revenues (without grants) per capita across local government units in 2011

Total revenues* without grants per capita (in EUR)	Counties** that generate actual level of total revenues (in %)	Towns** that generate actual level of total revenues (in %)	Municipalities that generate actual level of total revenues (in %)
0-270	100	33	63
270-540	0	44	22
540-810	0	15	7
810-1080	0	6	4
1080-1350	0	1	4
1350-1620	0	0	0
1620-1890	0	1	0

Notes: \* The total revenue without grants item means total revenues without grant revenues and the share of the income tax revenue for financing decentralized functions. \*\* The city of Zagreb is not included in the analysis of the fiscal capacity.

**Source:** Authors' calculations based on data of the Ministry of Finance and the Croatian Bureau of Statistics

Table 6 shows the distribution of total revenues without grants per capita, across local government units in 2011. On average, towns generate EUR 410 in revenues without grants per capita. The lowest amount of revenues without grants is EUR 95 per capita while the highest amount is EUR 1,850, so substantial disparities in the towns' capacities for financing mandatory services without grants are evident. The majority of towns generate revenues without grants of less than EUR 540 per capita<sup>14</sup>. Due to the lack of available data, the ability of towns to generate their own revenues cannot be analyzed. But if such analysis were possible, it would shed a better light on the actual financial independence and the capacity of towns to finance their expenditures with their own revenues.

It can be concluded from the fiscal capacity analysis that there are substantial differences on the revenue, as well as on the expenditure side of the budget. Measured by the average revenues per capita and the average expenditures per capita, counties have the smallest capacity (compared to towns and municipalities). All local units exhibit a major dependence on the grants they receive. On average, counties, towns and municipalities generate EUR 60, EUR 410 and EUR 312 in revenues without grants per capita, respectively. In 2011, such revenues were sufficient to finance 46% of the total expenditures generated by counties, 83% of the total expenditures generated by towns and 77% of the total expenditures generated by municipalities.

The analysis clearly shows quite a significant variance in the fiscal capacity between different, as well as within the same group of local government levels. The financial crisis, which started in Croatia in 2008, had a profound impact on the revenue shrinkage, and even exacerbated many other problems that are similar to those in other Eastern European countries. Local government units exhibit a huge reliance on tax revenues. In Croatia, local government units are largely dependent on the

<sup>14</sup> For comparison, the fiscal capacity of counties, measured by their revenues without grants per capita is lower than EUR 135.

income tax imposed at a rate defined by the central government. Tax rate changes may be introduced during the fiscal year, having a direct impact on the level of local revenues despite the actual budget plan. Second, the number of local government units, specifically towns and municipalities, has increased since the process of decentralization started. There is a large number of very small municipalities and towns, which cannot provide basic functions to their residents. The fiscal strength of counties is very low. Fixed costs of each local government unit (for example, operating costs of running the mayor's office) are large compared to their total revenues and there is no financial strength to improve the infrastructure and finance capital projects. Therefore, it is very important to explore other options for bridging the resulting fiscal gap and improving the efficiency and quality of public services provided to citizens.

#### **4. Methodology and survey results**

##### **4.1. Methodology**

Decentralization should result in a greater responsibility of the local government in providing public functions and, consequently, in a more efficient provision of public services to its citizens. However, a previous analysis of the fiscal capacity of local government units clearly shows that most counties, towns and municipalities in Croatia do not have sufficient financial resources to provide basic public functions to their citizens. Financial crises make the situation even more difficult.<sup>15</sup> It is not easy to diminish or avoid the consequences of the current financial crisis. Thus, the projections for the state and local budgets are not very optimistic and it will be very difficult to accumulate sufficient funds to ensure the proper provision of public services at the local level.

Having in mind the poor budgetary conditions of local government units and the previously discussed issues arising from the interviews with the representatives of local government units conducted within research project of the Institute of Economics, Zagreb (2010), in this part of the paper we investigate different modes which could ensure a sustainable decentralization of authority and responsibilities to the local government units while at the same time not exerting excessive additional pressure on the state or local government finance.

We focus our research on the members of county assemblies for several important reasons. County assemblies have a large scope of responsibilities affecting the local development. They make decisions and adopt other general acts regulating the issues in the self-governmental scope of activities of the county, as well as decisions on the county tax rates and other county-bound revenues under the law, decisions concerning the contracts on cooperation with local self-government and administration units. In addition, county assemblies address the issues to secure an even economic and

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<sup>15</sup> Higher unemployment, social needs of citizens and lower investments are only a few examples of negative effects of the financial crisis on state and local finances.

social development of towns and municipalities encompassed by the county and of the county as a whole, as well as other issues of common interest to the towns, municipalities and the county as a whole; they establish public institutions, companies and other legal persons to conduct economic, social and other operations of interest to the county, etc.

This part of research is based on the quantitative survey specifically designed to analyze the county councilors' attitudes toward administrative and territorial reforms. The questionnaire was developed in two steps. In the first step the larger international questionnaire for councilors at regional level was developed by the group of researchers as the part of the project 'Policy Making at the Second Tier of Local Government in Europe: What is happening in Provinces, Counties, Départements and Landkreise in the on-going re-scaling of statehood?'<sup>16</sup>. This questionnaire was translated to Croatian. In the second step, based on relevant researches and insights (The Institute of Economics, Zagreb, 2010; Rašić Bakarić, 2012), additional questions for this topic were formulated.

After developing the whole questionnaire, the printed version was distributed to all counties. Data were collected in the way that questionnaire was sent by e-mail to the Secretary of each county assembly with a request to distribute the printed version of the questionnaire at the meeting of county assembly. The Secretary of county assemblies at the meeting of local councilors in each county then collected the fulfilled questionnaires and sent them back by mail to the authors.

The survey covered the whole territory of Croatia and 100% of councilors at the county level. The analysis is based on the results of the survey in 2013 among 265 councilors from 14 Croatian counties which represent 70% of counties which answered the questionnaire.<sup>17</sup> A short overview of sample characteristics is given in Table 7.

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16 A group of scholars, including also the authors of this paper, has developed a comprehensive survey consisting of around 270 questions, aimed at enabling the researchers involved in the survey to analyze the position of the second tier of local government in European countries from a comparative perspective. The survey has been conducted in Belgium, Croatia, the Czech Republic, England, France, Germany, Greece, Hungary, Italy, Norway, Poland, Romania, Spain and Sweden since 2012 and has not yet been completed. Such a survey should fulfill the knowledge gap about the attitudes of councilors, political executives and leading bureaucrats at the second level of local government about a number of different questions, such as their notion of democracy, attitudes toward public participation, different administrative reforms, local councilors' social background and political career etc. The original international survey has been expanded by further questions added only to the Croatian survey in order to more deeply analyze councilors' attitudes toward a recent decentralization process in Croatia.

17 The analyzed counties are: the Krapina-Zagorje, Karlovac, Varaždin, Koprivnica-Križevci, Bjelovar-Bilogora, Primorje-Gorski Kotar, Lika-Senj, Zadar, Osijek-Baranja, Vukovar-Srijem, Split-Dalmatia, Istria, Dubrovnik-Neretva and the Međimurje County.

**Table 7:** Sample characteristics

	Sample characteristics
Share of analyzed counties in the total number of counties in Croatia	70.0 %
Share of councilors – respondents in the total number of local councilors at the regional level	30.0 %
Gender structure of local councilors – respondents	Female: 4.1 % Male: 91.4 % Not answered: 4.5%
Structure of local councilors – respondents according to the education level	Elementary school: 1.3% Secondary school: 35.5 % University or higher education: 60.7 % Not answered: 2.6 %

**Source:** Authors' analysis

The goal of the conducted survey is to investigate councilors' attitudes towards administrative and territorial reforms, with a special focus on the recent decentralization process and political will at the local level to support decentralization. Analysis encompasses questions from the survey relating to overall councilors' opinion about decentralization process, goals of decentralization and different solutions for the improved provision of public functions chosen on the basis of the theory review. Each item in the questionnaire was measured by a five-point Likert-scale, from 1 (unimportant/strongly disagree) to 5 (important/strongly agree).

#### 4.2. Survey results

Taking into account the roles of county assemblies and the fact that their decisions provide additional support to a successful provision of decentralized public functions, we investigated whether local councilors support the decentralization process in Croatia and what, from their perspective, the most important goal of further decentralization should be. Our analysis consists of several steps. As the first step, we evaluate the average local councilors' attitudes toward decentralization to investigate the existence of political support for this reform, as political support is an important precondition of its successful implementation. According to Aristovnik (2012) the level of fiscal decentralization in Eastern European countries was primarily influenced by political realities. Over 90% of the local councilors that participated in the survey find that decentralization should be implemented further by assigning additional powers, responsibilities and financial resources to the local government (Table 8).

**Table 8:** Overall local councilors' attitude toward decentralization

Question	Positive answer	Negative answer	Without answer
Decentralization process should continue with additional authorities, responsibilities and financial resources transferred from the central government to local government units.	90.2 %	7.5 %	2.2 %

**Source:** Authors' own analysis

Table 9 presents the local councilors' opinion on the importance of six different goals of decentralization. Local councilors find that two most important goals are to

improve the quality of public services and to achieve financial autonomy of local government units. This indicates that local councilors are much more concerned about fiscal decentralization than decentralization in general. It is important to note several facts here. First, such results imply that councilors suppose that comparing to the central state, local units can provide public functions of higher quality to their citizens. Second, the actual situation in Croatia shows that the councilors are not sufficiently aware that higher quality of public functions, in general, requires additional source for their financing. Third, according to survey results, the local councilors expect that the decentralization process will bring them greater autonomy for allocation of resources which is currently limited by regulations. So far, the dominant role of local government is only in transferring financial resources from the central government to certain institutions. Furthermore, according to actual legislation, local government is powerless to determine the purpose and optimal allocation of available funds. On the other side, local government units exhibit a passive attitude toward revenue collection. Although actual legislation enables introduction of new revenue sources, the large number of local government units did not exercise this opportunity for introducing additional surtax on tax on income, while relying on grants from the central government. This situation is additionally exacerbated by the absence of clear criteria for allocating grants to local government units. The role of the central state should be to secure minimum resources, but the local government units should acquire additional resources in order to provide higher standards and attract population to their local unit.

**Table 9:** Average score of different goals of decentralization (1 – unimportant, 5 – very important)

	Goals of decentralization
Ensuring equal development of all municipalities and towns in the county	4.25
Transferring the authority, responsibilities and financial resources to local government units	4.15
Strengthening the role of counties in achieving local and regional development	4.08
Improving the quality of public services and ensuring a more efficient provision of public functions to citizens	4.39
Achieving financial independence of local government units	4.36
Joint provision of public services and financing of development projects	4.23

**Source:** Authors' own analysis

After confirming the existence of political support to the decentralization process, we further analyze two different options for a decentralization of authority and responsibilities, as well as for a proper provision of public services in the circumstances of low fiscal capacity of local units. First, we explore the local councilors' views on the possibilities of a joint provision of public functions<sup>18</sup> to citizens if there is a lack of resources to provide these functions separately.

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18 It is important to point out here that Croatian Guidelines and Principles for a Functional Decentralization and Territorial Reorganization introduced in 2010 emphasize cooperation among neighbouring local and regional governments as a possible way to improve the quality and efficiency in providing public functions.

Cooperation among local governments has a long and successful tradition in EU countries. The forms of public service provision went through significant change in the past 20 years. There is an obvious shift towards cooperation in providing local public services. The most frequent forms are consortia cooperation among local units, as well as concessions and contracting with outsourcing. It can be noticed that in CEE countries there are no legal obstacles to cooperation among different local units in the provision of public services. The forms of cooperation depend on the legal form and administrative organization, sources of funding and voluntary or mandatory nature of such cooperation. The same is true of the situation in Croatia. One of the first successful examples of cooperation among local governments in Croatia is the cooperation of seven island municipalities. There are also examples of cooperation between municipalities and towns. New opportunities for local/regional cooperation were introduced by the Regional Operational Program at the county level. It is necessary to point out that a joint provision of public services is still rather rare, primarily due to political issues. However, the results presented in Table 9 show that local councilors find the joint provision and financing of public functions to be an efficient way to provide and finance public services. Results show that local councilors expect decentralization to enable the joint provision of public functions and joint financing of development projects. Local councilors rate this goal very highly, with an average score of 4.2. Also, there is no county which rates this goal as unimportant. The government should encourage the cooperation of local units and joint provision of public functions. One way to do so is to allocate additional financing of certain public function in the case of joint provision.

The second channel for improving the provision of public functions at the local level is to change the territorial division of the country. The number of local government units has increased since 1990. The current territorial structure in Croatia is such that there is a large number of a very small local government unit, with no capacity to ensure sufficient funds from their own sources, i.e. without grants received from the central government.

In order to examine the local councilors' attitude toward changes in the territorial organization of the country, we asked them to give their opinion about the mergers of municipalities and towns, and about the mergers of two or more counties.

The results of the survey show that all the counties believe that territorial reforms of the counties are desirable. The average rating for this reform is 3.7. No large difference among local councilors' views about this issue has been observed, and local councilors are generally aware that there are too many very small municipalities and towns.

However, there is no consensus among local councilors about conducting a reform which would result in the amalgamation of two or more counties. Local councilors from three counties find a change which would result in merging of two or more counties to be undesirable. On the other hand, four counties believe that such a reform is desirable, rating it with the average score above 3.5. So, the average result shows that local councilors at the regional level do not deny the possibility of this reform

**Table 10:** Analysis of local councilors' attitudes towards different solutions for a better provision of public functions

County	Joint provision of public functions	Merger of municipalities and towns	Merger of counties
Bjelovar-Bilogora	4.13	3.88	3.63
Dubrovnik-Neretva	4.46	3.42	3.15
Istria	4.38	3.25	2.31
Karlovac	4.05	3.70	2.95
Koprivnica-Križevci	3.94	3.40	3.07
Krapina-Zagorje	4.30	3.64	3.19
Lika-Senj	4.20	3.47	2.97
Međimurje	4.09	3.68	2.91
Osijek-Baranja	4.30	4.16	3.94
Primorje-Gorski Kotar	4.29	3.88	3.31
Split-Dalmatia	4.50	4.17	3.83
Varaždin	4.27	4.30	3.80
Vukovar-Srijem	4.29	3.74	3.15
Zadar	4.08	3.75	3.25
<b>Average</b>	<b>4.23</b>	<b>3.69</b>	<b>3.17</b>

**Source:** Authors' own research

being conducted. Despite that local councilors are obviously aware of the fact that existing territorial division of the country is unsustainable from economic perspective, it could be expected that the problem will arise when the government should make the decision about the actual merger of two or more local government units.

A modified territorial structure of the country should be a result of implemented fiscal autonomy principles for local units aimed at an efficient provision of services which fall within the scope of their mandatory functions. The division should be based on several different criteria, such as population size, fiscal capacity and economic structure. In addition to these criteria, some other specific factors should be taken into consideration when deciding about a new territorial division, such as historical factors and others (Illner, 1997; Wollmann, 2004; Wollmann and Bouckaert, 2006; Kuhlmann and Wollmann, 2011).

## 5. Conclusions

There are numerous reasons for decentralization. One of the most important is that decentralization supports local economic development and contributes to public sector competitiveness. Decentralization may also strengthen local governance by bringing the government closer to citizens' preferences in providing public services.

The literature and the experience from a large number of developed countries confirm that decentralization has numerous positive effects and, therefore, many countries have transferred public functions to local government units. In Croatia, the level of decentralization is still low and this process is still at the beginning. A further decentralization of authorities and responsibilities requires adequate measures to conduct fiscal decentralization. The financial crisis has exacerbated the problem

even more. The results of the survey conducted among local councilors at the regional level in 2013 show that the local level of government gives strong political support to the decentralization process. However, the analysis of the fiscal capacity proves that the majority of municipalities, towns and counties have revenues below average and that most of them cannot provide even basic public functions to their citizens. This problem could be mostly observed in the counties and municipalities with small budgets. Total revenues of 20 counties represent only 16% of the total local government units' budget. Total revenues of 429 municipalities account for 16% of the budget of all local government units. In addition, a small degree of financial autonomy of local government units has been observed. These units are highly dependent on the grants received from the state budget. The survey results show that local councilors have great expectations from decentralization, especially from its goal of achieving a lower degree of reliance on the grants and greater financial independence.

Increasing the revenue side of the budget is a very demanding task. This is especially so in the situation of financial crises, when the economy records negative GDP growth rates and the economic projections for the next two years are not very promising. Therefore, in this paper we analyze two possible channels of conducting decentralization efficiently. In addition, these channels are supposed to help overcome the lack of funding and difficulties of the fiscal decentralization process on the one hand while also resulting in desired outcomes, i.e. a satisfactory level of providing public functions, and improving regional development on the other hand. The first channel involves the possibility that two or more local government units jointly provide public functions. The result of the survey confirms the support by local councilors for this option. The second option is to modify the territorial division of the country by merging some municipalities, towns and counties. On average, 50% of local councilors support this reform at all levels. However, in order to propose an entirely new territorial division, it is necessary to conduct an additional analysis, taking into account the specific characteristics (historical, demographic structure, economic situation etc.) of each municipality, town and county.

As it is shown in the paper, similar to Croatia, the level of decentralization in most of the other SEE countries is very low, with large portion of shared taxes and grants. Even more, some researches showed higher level of fiscal autonomy in Croatia than in other SEE countries which would imply that the fiscal stance at the local level could be even better than in some other countries. Therefore, solutions and propositions analyzed for Croatia should be analyzed for other SEE countries as well.

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