CROATIA: FISCAL (DE)CENTRALIZATION AND PUBLIC SERVICE DELIVERY

POLICY NOTE
TABLE OF CONTENTS

1. INTRODUCTION....................................................................................................... 1
2. BACKGROUND AND CONTEXT ........................................................................... 2
3. LOOKING FORWARD.............................................................................................. 3
   Strategic Direction Principles.................................................................................. 5
   The Basic Institutional Set Up ................................................................................ 5
   Policy Reform Options Toward Sustainable Decentralization .............................. 6
      1. Definition of Responsibilities and the Legal and Administrative Frameworks.. 6
      2. Intergovernmental Fiscal Relations and Incentives to Perform ......................... 13
      3. Capacity Building, Accountability, and Fiduciary Management ...................... 20
INTRODUCTION

Since independence in 1991, Croatia has made significant strides toward democracy and a market economy. One important challenge during transition has been to improve efficiency on public service delivery, while maintaining the country’s territorial integrity and macroeconomic stability. In this respect, Croatia has gone a long way, but there still is a long way to go in face of its renewed ambitions to access the European Union (EU) by 2007. This means that a sustainable path toward a more effective and higher public service standard have to be achieved in a relatively short time span. Certainly the stakes are high, but the fact that Croatia has already had its Candidate status confirmed for EU accession augurs well for its near future.

The Croatian authorities’ commitment toward a more participatory and decentralized fiscal system has consistently been evidenced by: (a) ratifying the European Charter of Local Self-Government (1997); (b) becoming a signatory of the Stability Pact (2001); ¹ (c) adopting a Public Sector Reform Program (2004), which explicitly considers decentralization as a priority;² and (d) establishing a “Decentralization Commission” (2004) to design the next steps for decentralization reforms.³

Nevertheless, Croatia still is a highly centralized country in terms of decision making on public service financing and delivery, as compared to most of the new EU members. One indicator for this, is that in Croatia the sub-national Government’s budget still corresponds to five percent of GDP, while in the newly accessed countries this was about eight percent on average in their immediate pre-accession phase (Table D.1, Annex D). The Government of Croatia is conscious about the critical importance of improving citizens’ voice, transparency and accountability on public affairs, especially on matters of local interest, in order to increase efficiency on public service delivery and rapidly converge to EU standards on a sustainable basis.

By the time of the previous local elections (May 2001) decentralization of public functions became an outstanding issue, and the Government started its decentralization reforms in July 2001, although not yet adequately implemented to make the reform process sustainable. As the new election season approached (spring 2005), political pressures built up again, and the Government started preparing a “second-phase” of the decentralization process.⁴

However, while the Central Office of State Administration (COSA) has indicated a desire to proceed with the reforms, it seems that a government clearly coordinated timetable for

¹ And again, in 2004, by signing the “Final Declaration” of the South-Eastern Europe Regional Ministerial Conference on Effective Democratic Governance at Local and Regional Level.
² As expressed at the Varazdin Government Session, in April 2004.
⁴ Donors are trying to assist the Government accordingly. USAID, through the Urban Institute, has been providing substantial support to the Government. Other donors (e.g., EU, World Bank, UNDP, Soros Foundation) have been perceived as prepared to assist on designing a decentralization strategy, as long as coherence among the various Government programs are achieved.
further *functional-cum-fiscal* decentralization is not in place yet. Meanwhile, some donors (including the World Bank) have suggested that transferring *functions* without putting in place the *right institutional arrangements, incentives and commensurate resources* may instead end up disrupting public service delivery. International experience indicates that reform of the intergovernmental fiscal relation system and local governance are complex and lengthy processes, requiring policy prioritization and adequate sequencing. This calls for a carefully thought out strategic plan, which factors in the multiple dimensions of decentralization, and allows for proper completion of implementation of the foundations of the reform process already initiated in 2001. For this reason, the Bank chose, for the time being, to assist the Government of Croatia with this Policy Note on fiscal (de)centralization and public service delivery, which envisages assistance to identify challenges and examine options.

**BACKGROUND AND CONTEXT**

Fiscal autonomy of sub-national governments is granted by the Croatian Constitution and the *Law on Sub-national (Local and County) Self-Governments* (LSG), which broadly follows the EU subsidiarity principle. Since the early 1990s, the Government has taken steps in the direction of fiscal decentralization, but the process has been rather spasmodic, with a major surge in 1997 when the *European Charter on Local Self-Governments* was ratified. Another surge occurred in 2001, when the so-called “first phase” of the decentralization program started; by essentially downloading capital expenditure responsibilities—including maintenance and investment—on education, health care, social assistance and, later, fire fighting to the counties and 32 major cities. Currently, a debate on what has been called a “second phase” of functional decentralization has started with the establishment of the “Decentralization Commission,” headed by COSA’s State Secretary. This Commission was conceived as a technical, consultative body, with representation of the Associations of counties, municipalities, cities, and the Union of the Associations of sub-national governments, besides the concerned line ministries.

Nevertheless, although some delivery responsibilities have already been assigned downwards, the outcomes of the “first phase” of the decentralization reforms have not been as effective as expected, with much of its regulatory framework and the necessary fiscal incentive mechanisms still remaining unsatisfactory or not properly implemented (Annex A, D and E). The reporting, monitoring and the feedback mechanisms have been highly unsatisfactory or non existent (Annex G). *Specific* responsibilities and authorities

---

5 On the subsidiarity principle see Annex A.

6 Since 2001, special laws and amendments on the education, health, and social assistance sectors, and on “financing the sub-national governments” have been adopted. Annually the Government has passed Decrees establishing minimum *financial standard* criteria and methods for the calculation of *equalization assistance* for the jurisdictions assigned with the new “decentralized” functions.

7 Preceding the establishment of the Commission, each line ministry was formally requested to propose a “wish list” of functions to be decentralized. The feedback for such a request was, instead, essentially proposals for more paper work, new forms to be filled in, and an increased bureaucratic burden to be imposed on sub-national governments.
are not yet clearly established, the current intergovernmental fiscal relations system still retains many perverse fiscal incentives, institutional arrangements are still weak, sub-national authorities have not been empowered enough and trained, and technical and financial capacities of the administrative units are quite uneven (Annex B). All in all, although a basic legislative framework on sub-national self-government has been adopted, it has so far been mostly declarative, and Croatia has still to overcome considerable challenges for the consistent implementation of a decentralization process which could be sustainable.

LOOKING FORWARD

Croatia can draw important lessons from its recent decentralization experience, including the following:

a) increasing assignment of non-earned revenues to sub-national governments (SNGs) without an up front clear definition of specific responsibilities and enforceable sanctions tends to weaken local governance;

b) while important decision-making powers on expenditure priorities and revenue mobilization are retained by the center, responsibilities for policy outcomes tends to remain ambivalent, and the accountability framework deteriorates;

c) ex-ante “controls” and micro-managing by central authorities can hardly be a substitute for a predictable, ex-post monitorable intergovernmental fiscal relations system which includes well-regulated incentive and sanctions.

d) policy implementation tends to be ineffective when the legal framework cannot count on strong institutional arrangements for coordination, cooperation, and advocacy.

These lessons are important to the extent that they can help design the next steps toward an autonomous, transparent, efficient and accountable local public service delivery system. They essentially tells us that, in order to reach a sustainable decentralized system of public service delivery, the strengthening of intergovernmental fiscal relations and the deepening of institutional and capacity building dimensions of the system should not be neglected, and should go hand in hand with functional and fiscal decentralization.

---

8 For instance, competences (on policy formulation, planning functions, financing, delivery, reporting, and evaluation) are not sufficiently specified. City mayors and county prefects’ responsibilities are mixed with dual subordination. Legislation on supervisory authority and conflict resolution mechanisms are confusing and not adequate. See Annexes A, B, and C.

9 For example, a “claw back” clause in the SNG finance act (“Law on Financing Local and Regional Self-Government Units”, Art. 45.1(7), Official Gazette …/…/…), and inadequate budgetary autonomy.

10 With local authorities reporting difficulties to uniformly interpret and consistently follow central instructions.

11 For example, national shared-taxes and transfers which do not involve any local tax effort. Local governance is also weakened when local fees, charges and “contributions” are not properly regulated (Annex D).
The Government is conscious that a first phase of the 2001 decentralization reforms has been exhausted, but the decentralization process is not yet sustainable. Therefore, the time has come to deepen decentralization reforms, especially by putting in place adequate policy incentives and fixing the institutional set up. Thus, before continuing with further “decentralization/delegation” of new additional functions to SNGs, at this juncture the focus should be on properly completing the foundation that underpins what has already started with the 2001 reform. This means, first, that implementing effective devolution (which goes beyond the current “delegation”) of well-specified responsibilities on decision-making-cum-improved incentives and enforceable sanctions can empower local authorities to fully perform their competences and be made accountable for results directly to the citizens and the law. Second, a shorter route of accountability at the local level should be strengthened, by building permanent bottom up pressure mechanisms through which the local population can voice their preferences to local authorities directly. This approach would tend to positively affect efficiency of service delivery the way it is normally expected from a truly decentralized functional and fiscal system of public service delivery.

For the successful implementation of decentralization in Croatia, it is sine qua non to promote, simultaneously, a change in the overall policy making paradigm, so that central authorities could shift their attention away from micro-managing day-to-day local businesses, toward a higher level of policy formulation, monitoring, supervision, and evaluation. In this context, central coordination, guidance and support on policy implementation, including assistance for capacity building to facilitate transfer of know-how and tools for local authorities to properly perform their job are essential.

At this juncture, the consultative “Decentralization Commission” can be an important instrument for the Government in consultation with stakeholders to design and adopt a proper “Decentralization and Local Governance Strategy”, to be implemented in phases, and to serve as a guide for the needed reforms. Such a Government strategy, especially if ratified by Parliament, could factor in the essential political support, increasing credibility and effectiveness for the upcoming policy and institutional reforms.

The next sections of this Policy Note discuss the contours of a possible strategic direction, the necessary basic institutional set up for implementation, and key reform policy options to be tackled in order to complete the foundations of the decentralization reform initiated in 2001, before Croatia proceeds with further assignment of new functions to SNG.

---


13 This includes setting adequate standards for service outcome/output, measurement criteria and indicators for monitoring performance, establishing and implementing proper incentive mechanisms and sanctions, designing feasible and reliable reporting systems, evaluating and disseminating data, producing feedback reports for policy adjustments (see below).
STRATEGIC DIRECTION PRINCIPLES

Formal adoption of a Government “Decentralization and Local Governance Strategy” would set the right expectations for successful completion of implementation of functional and fiscal decentralization without disrupting service delivery. Best international practices recommend some fundamental principles to which the design of the Croatian decentralization strategy should adhere, including, essentially, the following: (i) commensurate resources ought to follow functional decentralization (not the other way around), in order to prevent under-provision of essential public services while ensuring macroeconomic stability; (ii) empower sub-national authorities with incentives and enforce sanctions accordingly, so that these authorities can perform decentralized functions autonomously, and be made accountable for the policy results before the law and citizens; and (iii) intergovernmental fiscal relations ought to be predictable, while promoting hard budget constraints and encouraging efficiency.

THE BASIC INSTITUTIONAL SET UP

The establishment of a basic institutional set up for the design and implementation of the decentralization strategy should itself be phased in carefully (Annex H). One possible route is to start by effectively supporting the work being developed by the consultative “Decentralization Commission.” This Commission should have a well-specified mandate, a clear Action Plan for its scheduled tasks, and a sunset clause for it to cease to exist when it delivers the final draft of the “Decentralization and Local Governance Strategy.” Once the Strategy is adopted by the Government and ratified by Parliament, a standing higher level deliberative and coordination “Inter-Ministerial Steering Committee for Decentralization and Local Governance” would be installed. This standing Committee (formed by the concerned Ministers, and chaired by the Prime-Minister) would be advised by a permanent “Technical Secretariat”, with representation of sub-national governments.

Nevertheless, consistent implementation depends on good central coordination and cooperation with and among SNGs. It should be kept in mind that coordination and cooperation is a two-way street, and they will work properly only when SNGs perceive that their voices are heard. In this regard, institutions for coordination and cooperation ought to be encouraged at all government levels. Best practices have shown, for instance, that: (i) strong national associations that advocate SNGs’ views can play an important role mainly by initiating or providing substantive inputs to draft regulations and by leading capacity building efforts; and (ii) strong coordination and cooperation institutions can also serve as an informal first point conflict resolution mechanism, which facilitates implementation. Germany and Austria may be good examples to be examined by the Croatian Government in regard to these institutions.
POLICY AND INSTITUTIONAL REFORM OPTIONS TOWARD SUSTAINABLE DECENTRALIZATION

The strategy to complete implementation of the fundamentals for sustainable decentralized service delivery and fiscal systems in Croatia may address the key policy and institutional challenges (identified in Annexes A to H), which can be grouped in three building blocks of the decentralization process, as follows: (i) definition of responsibilities and the legal and administrative frameworks; (ii) intergovernmental fiscal relations and incentives to perform; and (iii) capacity building, accountability, and fiduciary management. These building blocks of the decentralization process complement each other, and the implementation of many of their specific reform measures should be sequenced.

The most urgent steps to move the decentralization process forward are to put in place the politically supported strategy and the basic institutional set up as envisaged above. The last column of the “Matrix of Challenges and Reform Options” suggests a policy and institutional implementation sequencing for each recommended reform measure. The clear assignment of specific responsibilities and the revision of the existing legal framework should take precedence (immediately or in the short term).

Some measures, although critically important and urgent, could only be implemented in the medium term (about the next two years), because they may require more preparation time; e.g., setting standards and performance indicators, stabilizing the parameters of the intergovernmental fiscal relations, regulating the status of SNG civil service, streamlining the local non-tax revenue regulation, and the adoption of a properly-designed real estate tax as a local tax. It can be foreseen that some necessary reforms could take even more time to implement (long term, as in the “Matrix”), since they depend on certain conditions to be met first—e.g., a satisfactory solution for the fragmented administrative units, which may require political compromises probably of difficult achievement; responsible access of SNGs to borrowing, which may require improved creditworthiness and proper regulation of a domestic municipal capital market.

In what follows, key specific reform measures will be addressed in turn for each of the three above mentioned building blocks of the decentralization agenda. These reform measures are discussed as options to set the contours of a Decentralization and Local Governance Strategy in Croatia’s current context.

1. Definition of Responsibilities and the Legal and Administrative Frameworks

Under this building block Croatian decentralization strategy needs to cover the following areas of policy and institutional reforms: (a) assignment of functional responsibilities/competences; (b) rationalization of the legal framework; and (c) enhancement of the administrative structure.
a. Assigning Functional Responsibilities

Good local governance and accountability on service delivery is possible only when functional responsibilities are well defined and incentives to autonomously perform are in place. In this regard, the current challenges (Annexes A, B, and C) may be overcome by: (i) clarifying specific responsibilities and the authority to perform them for each government level; (ii) establishing adequate incentives to increase efficiency; and (iii) setting up minimum service standards on the basis of policy outcomes/output and measurable performance criteria.

(i) Clarifying specific responsibilities and the authority to perform. Further clarification on specific responsibility/competence and incentives to perform are still necessary, especially on shared/jointly delivered functions (education, health, social assistance, and infrastructure). This is a critically important first step to put on the right track a sound accountability framework and improve public service delivery. Properly specified responsibilities in the law can avoid the confusion of authority and competences, finger-pointing for non-compliance, unfunded mandates, duplication or under-provision of essential public services and accumulation of arrears (Annex C). To this end, the proposed Technical Secretariat for the “Inter-Ministerial Steering Committee for Decentralization and Local Governance” may consider drafting the appropriate secondary legislation specifying in detail, for each shared function, the specific competences (whether regulation, planning, financing, delivery, supervision, evaluation, etc.) that are assigned to each level of government. The regulation should make clear who is responsible for what, while attributing the means for SNGs to perform their respective competences autonomously and fully, in order to make them directly accountable for results before the citizens and the law.

(ii) Establishing proper incentives to increase efficiency. Efficient resource allocation and increased accountability require that budgetary priorities are established according to policy objectives and targets to be achieved. Firstly, local expenditures on specific activities and services to be delivered need to be estimated according to their notional costs. In this regard, Croatia may consider replacing current inefficient budgeting practices, which seem to mainly focus on the maintenance of existing facilities (hospitals, schools etc.). By exposing local idle capacities and specific needs for capital expansion, the notional cost alternative approach builds up pressures on the existing system, thereby promoting changes for increased efficiency on service delivery.

Secondly, the current splitting of capital expenditures responsibilities (maintenance versus investment) among different levels of governments should be avoided. Capital responsibilities of each specific function should, in principle, be kept at the same government level: either central, regional, or local. This criterion would tend to encourage optimum maintenance expenditure allocation, thus minimizing depletion of the

---

14 As a rule of thumb, notional costs may be “proxied” by the average national unitary cost of delivering each specific service, instead (or, at least, by superior indicators, such as per occupied hospital beds, rather than simply by hospital beds or number of doctors and employees in the institution; or by per student in attendance, rather than simply enrolled students, number of teachers or class-rooms in the school). This tends to reduce/eliminate the direct influence of individual local interests in keeping idle capacities.
nation’s capital. The implementation of this principle, if not entirely possible immediately or in the short term, should at least be envisaged as a key strategic direction for the medium-term capital investment and maintenance programs.

Thirdly, allocative efficiency in Croatia would significantly increase if capital grants and transfers could be guided by widely disseminated central master plans (including those for the regions of special concern, mountainous areas, and islands), and awarded on the basis of open competition among regional/local government applicants and more transparent project evaluation technical criteria (see more on this in Section b (ii) below, and Annex E).

(iii) Setting up service standards on the basis of outcomes/output and measurable performance criteria. So far, sub-national self-government policy outcomes/outputs in terms of physical standards (quality and quantity) have not been monitored ex-post through pre-established, agreed measurable indicators, nor have sanctions been clearly prescribed by law or properly enforced. The present systems of setting minimum financial standards for the allocation of block transfers to SNGs, on the basis of “ex-ante controls” are inadequate, since policy results and performance indicators have been disregarded. The current system of setting minimum financial standards simply encourages the SNGs to continue budgeting on the basis of an input approach exclusively, which does not reflect best practices on planning, programming and establishing priorities, since it does not focus on results nor provide indicators for development objectives to be monitored. Budgeting should be encouraged as a policy instrument focusing on results, and achievement of outcomes, or at least outputs, properly pursued, instead of only budget financial inputs (Annex C).

b. Rationalizing the Legal Framework

Given the inadequacies of the current legal framework (see Annex A), the Government may consider reviewing the legal basis which regulates the country’s decentralized service delivery and fiscal systems. This review may be an entry point to motivate the definition of a sounder platform for the implementation of a well-structured and integrated system of intergovernmental fiscal relations and regional/local self-governance in Croatia, based on adequate incentives and enforceable sanctions to increase efficiency and fairness on public services. Essentially, the legal framework may be rationalized by: (i) streamlining and consolidating disperse regulations; (ii) drafting the missing secondary legislation; and (iii) stabilizing the fundamental parameters that regulate intergovernmental fiscal relations and sub-national governance.  

(i) Streamlining and consolidating regulations. Conflicting, incomplete and inappropriate provisions (Annex A) should be identified and rectified accordingly, with a focus on consolidating the legislation. Among the outstanding pending issues (see the respective sections of this Policy Note) that need proper regulation are: (1) the prevention of dual subordination of sub-national executive authorities, to avoid conflict of interest and to make these authorities directly accountable to the tax payers/voters; (2) the regular

---

15 The other sections of this Policy Note address specific policy and institutional reforms in more detail.
use of the *Courts of law as a conflict resolution* mechanism; (3) the elimination of perverse incentives (e.g., “claw back clause” in the SNG finance law) and *clearly defined adequate incentives* for autonomous performance and enforceable sanctions which encourage the law’s implementation or restrict unlawful procedures and behavior;\(^{16}\) and (4) harmonization of cross-sector decentralization and fiscal provisions with the sector legislation, to ensure consistency and effective convergence toward EU standards in the foreseeable future.

**\(\text{(ii) Drafting missing secondary legislation.}\)** The LSG indicates that some critical matters related to sub-national governance will be dealt in detail by *special* laws, but many of these laws have never been drafted. Among the still missing detailed secondary legislation the following are included: the *association* of sub-national governments for *joint delivery* of public services as legal public entities; the proper codification of local taxes, fees and charges; the positions, salary and careers of local *civil servants*; the access to borrowing, debt management and debt work out schemes.

Moreover, there is a need for secondary legislation which clarifies specific competences (such as, policy formulation, standard setting, coordination, financing, service delivery, reporting, monitoring, and evaluation) assigned to each level of government authority. This is particularly important and urgent for the shared/jointly delivered functions, including education, health care, social assistance, urban/physical planning functions, that are now only generically assigned to sub-national governments. *Specific assignment* responsibilities and resource allocations between counties and local governments are still, in practice, mostly left to negotiations.

**\(\text{(iii) Stabilizing intergovernmental fiscal relations.}\)** Important criteria and structural parameters (such as the transfer allocation rules, the reference rates and bandwidth of local taxes, surtax, fees and charges; the tax sharing ratios; the criteria to determine the *size* and *distribution* of equalization grants, etc.) should be established in *organic laws* (such as the LSG, Law on Local Government Finance, or Budget System Law), instead of the current ordinary regulation, such as Decisions, Decrees and annual State budget laws. A more stable and predictable intergovernmental fiscal system, fundamentally regulated by organic laws, would allow both central and sub-national governments to forecast budget revenues and plan medium-term expenditures on a consistent basis.\(^{17}\)

\*c. Enhancing the Administrative Structure*

\(^{16}\) So that commensurate penalties could function as effective deterrents for wrongdoings. In this respect, the Croatia Government may consider examining the New Zealand and/or the Brazilian Fiscal Accountability Acts as examples of best practices.

\(^{17}\) Certainly, this may contribute to a less flexible macroeconomic policy, since in general it is less easy to change an organic law than to change an ordinary regulation. Nevertheless, reduction of the current excessive volatility and uncertainty is the very purpose of the proposed reform. Nevertheless, the structural rules and parameters established in organic laws would still remain changeable. The difference is that in the reformed system any changes would likely be first submitted to ample debate, which may encourage better justification probably substantiated by persuasive technical work.
The Croatian territorial-administrative structure has become fragmented, sub-national authorities are not entirely autonomous, supervision of SNGs and conflict resolution mechanisms between government levels are not yet settled. The most salient pending challenges (Annex B) the Government may consider addressing in this area include: (i) the supervision and conflict resolution mechanisms; (ii) the dual-subordination of sub-national executive authorities; (iii) the legal status of SNG civil servants and employees; and (iv) the fragmentation of SNG units.

(i) **Fixing up supervision and conflict resolution mechanisms.** In order to avoid the current conflict of interest and to build a sound accountability framework: (1) regional/local authorities should not be assigned any supervisory powers over county/local government activities; and (2) the judiciary, not the executive power should preside over the conflict resolution system. In this regard, the Croatian Government may consider:

- reserving supervision of the legality of the local deliberative and executive bodies’ acts and actions exclusively to central government and State institutions, particularly the Ministry of Finance, the supreme audit office and the judicial system (i.e., the Courts of law); and
- reviewing the current process through which central executive authorities can dissolve SNG representative bodies and suspend or nullify their acts and actions. The powers of these executive authorities should be circumscribed to monitoring and supervising the legality of SNGs’ acts and actions, and reporting irregularities back to the Councils; and, in case of disputes, the Court system should be used to resolve the conflict. Therefore, the sequencing of the current administrative procedures for conflict resolution should be reversed: initiated by the central executive authority, by submitting their contention to the Courts, and then, only after a Court decision, suspension or nullification of sub-national representative body’s acts (or dissolution of the representative body itself) should be enforced, if that is the Court mandate. This reform option would intend to: (1) restore the proper role of the Courts of Law for conflict resolution between levels of government in the Republic of Croatia; (2) ensure county/local autonomy and fair enforcement of the law; and (3) improve intergovernmental relations.

(ii) **Eliminating the dual-subordination of local executive authorities.** Sub-national self-governance requires executive authorities to be directly accountable to their respective Councils, tax payers and the citizen who have elected them. This requires that local authorities should not be involved in any monitoring or supervisory roles on behalf of central or State authorities. For a truly decentralized system in Croatia sub-national authorities and managers cannot be made allegiant to the center (Annex B), otherwise SNG budgetary autonomy and accountability will be empty concepts.

In this regard, it seems that draft legislation is now under discussion to institute direct election of mayors and prefects, aimed at making them solely accountable to citizens and respective Councils. This initiative is compatible with a short route of accountability\(^\text{18}\)

---

system of public service delivery, which tends to promote permanent “bottom up” pressures for increased transparency and efficiency, by factoring in people’s voice more effectively. Increased autonomy of sub-national self-government authorities should not, however, prevent collaboration between levels of government and the obligation to report data/information to higher level governments according to the law’s requirement. Moreover, in the case of delegated functions, which are entirely regulated and earmarked financed by the center, sub-national authorities (acting as agents) would certainly continue to be directly accountable to the central authorities, while the latter remains fully accountable to the citizen (a case of long route of accountability).

(iii) Regulating the status of SNG civil servants and employees. Keeping local public civil servants and employees at the current provisional status only tends to aggravate uncertainties, affecting both staff anxieties and the financial difficulties of most administrative units. Sooner than later Croatia will have to address this issue and review the current legislation accordingly, by either drafting a special law or amending the national Law on Civil Servants and Employees, by properly considering the particular circumstances of the county and local civil servants and employees.

The new regulation should create the basis for the development of a stable and well structured career for local/community civil service, by encouraging professional growth prospects. The new regulation should include provisions that aim to attract and retain talented professional staff, to be recruited through tightly regulated open competition. It should also provide local officials with training opportunities, job security, professional career plans based on merit, and adequate pay scale. The new regulation on county/local civil servants and employees should be in line and entirely consistent with the national civil service law, and may ensure mobility both within the local government staff structure and, under certain conditions, might offer the possibility to move from local to county and to national service levels, and vice versa. To ensure effective implementation of the new law, an action plan should be approved and monitored under the guidance of the proposed Inter-ministerial Steering Committee for Decentralization and Local Governance. 19

(iv) Addressing the inefficiencies from fragmented SNG units. Despite difficulties with the current administrative fragmentation of sub-national self-governments units, the Government, for obvious political reasons, has so far avoided initiating any action for compulsory amalgamation of jurisdictions, and has announced that “the present territorial organization of Croatia with the existing number of counties will be preserved …”20 Nevertheless, it has been acknowledged that the current fragmented administrative structure has complicated the implementation of a symmetric decentralization approach, and has called for more innovative solutions. In fact, the current LSG is flexible in this respect, allowing either for further fragmentation or the opposite (joint delivery of

19 Challenges may persist on the implementation of the new regulation to the small units. The use of the county structures or Inter-Municipal Unions-IMU (or other type of association of local governments—see next paragraph) may be an option to deal with these challenges. Piloting or phasing in the implementation of the new regulation on Local Civil Service may also be options to be considered.

services by association of jurisdictions). Moreover, the Law permits for asymmetric assignment of responsibilities by establishing that functions are to be decentralized according to the delivery capacity of the respective administrative unit (Art. 19-21).\textsuperscript{21} Therefore, although more costly than otherwise, the current administrative fragmentation of self-government units should not be seen as a major obstacle to proceed with the completion of implementation of the foundations that underpin decentralization in Croatia. Furthermore, pending adequate regulation, there is also the route of circumventing the fragmentation challenge by outsourcing some public services to private sector providers, probably a more efficient alternative.

In fact, some Croatian municipalities have already started with some type of voluntary arrangements for jointly delivering specific services (particularly water supply, sewerage, garbage collection), either by using more efficient structures of larger neighboring towns (through off-budget public companies, for example, around Rejka, Krk, Split, Osijek, Pula), or by joining contracts outsourced to private sector providers who supply several communities within a contiguous geographic area (e.g., heating, gas). Certain localities, however, because of the regional context, have not been so successful with these types of arrangements (especially the small municipalities in the war affected areas, e.g., Bilije, …) and probably will continue having financial difficulties in the near future. In this regard, most of the small administrative units may also be constrained to access EU funds because of their limited implementation capacity and/or lack of creditworthiness to access capital markets and provide the necessary counterpart funds. Especially for these cases, a solution has to be found soon, otherwise the EU pre-accession funds (and later on the structural funds) tend to be underused or used only by the already most prosperous regions, which would increase horizontal disparities even more, contrary to EU objectives.

\textsuperscript{21} “…if the [self-government] has ensured the conditions for their performance.” In fact, decentralization for certain tasks on education, health and social assistance has already been assigned only to 32 major towns. The remaining local units have to rely on county governments for the provision of these services.
In this respect, one option is to strengthen the current relations to more effectively encourage voluntary union of the smallest contiguous municipalities into Inter-Municipality Unions (IMUs), or their aggregation to a neighboring larger town, in order to increase efficiency on public service delivery. IMUs (or aggregation) could be promoted to form a new public entity, with special fiscal rights and incentives, as opposed to the current loose ad hoc private associations for joint delivery of individual services (i.e., sort of NGOs). The proposed new public entities could be joined for all their fiscal competences. Actually, these IMUs would initially be a transitional arrangement, which could serve as a platform toward a permanent amalgamation after a certain pre-determined number of years, if the respective populations, through a referendum, would finally choose that the IMU would be more beneficial than the previously separated jurisdiction. The initial motivation could be some State incentives to facilitate the formation of new IMUs. Options could include temporary special treatment of these unions both in the formula distribution mechanism for the “Equalization Transfers” and/or the regulations to access the “Regional Development Fund”, which would leverage the IMUs’ counterpart contributions (see below). In any case, in order for these arrangements to be sustainable, citizens have to perceive that the benefits of IMUs are permanent (while they stay in the union), as opposed to a once-and-for-all impact only (or if they split again).

2. Intergovernmental Fiscal Relations and Incentives to Perform

Successful decentralization requires that commensurate resources follow responsibilities in order to avoid unfunded mandates, accumulation of arrears and/or under-provision of public services. Increasing revenue autonomy by shifting own sources of revenue to SNGs has been a way to address potential vertical fiscal imbalances. Nevertheless, owing to the heterogeneous distribution of the economic basis across regions, decentralization tends to expose existing disparities between local needs and local revenue capacities. These horizontal fiscal imbalances can be resolved through systematic fiscal transfer mechanisms from the State to the disadvantageous regions.  

---

22 Shared national taxes have been used both to reduce vertical and horizontal fiscal imbalances. Actually, shared tax can be understood as another form of transfer, and in this case the mechanism through which
Regulated access to capital markets, and now to EU funds, are also potential sources of SNG finance. These intergovernmental fiscal relations have incentive impacts that may affect SNGs’ performance in the delivery of their assigned functions. At the current juncture, the Government of Croatia may consider addressing at least four major challenges under this building block: (a) how to improve local revenue autonomy; (b) how to mitigate fiscal imbalances; (c) how to ensure responsible access by SNGs to capital markets; and (d) how to assist SNGs to absorb EU funds.

a. Improving Local Revenue Autonomy

Croatia has made progress on revenue assignment to SNGs. The PIT sharing allocation scheme according to the tax payers’ place of residence, and the PIT surtax at local government discretion (to an upper limit), are two outstanding positive features of the Croatia revenue assignment system. Nevertheless, inefficiencies still permeate the local revenue system and fiscal autonomy remains inadequate and low (Annex D), so that further reform measures are still necessary in order to remove inefficiencies and improve incentives for better local governance. The Government may consider examining key reform measures in this area, including to: (i) discontinue sharing CIT on a derivation basis; (ii) streamline the local non-tax revenue legislation; and (iii) adopt a well-designed property tax (including land and buildings) as a local tax.

(i) Discontinuing profit tax sharing on a derivation basis. The current sharing of the profit tax (CIT) on a pure derivation basis is an inequitable allocation policy, and alternative routes for this resource transfer should be examined. Actually, the CIT is not a good tax to be directly shared with local governments, since its base tends to be unstable, and the tax yields are easily exportable in favor of more prosperous jurisdictions (Annex D). One reform option would be to re-centralize the CIT and compensate local budgets with a new source of own local revenue, but this could increase the tax burden, and would not ensure better revenue distribution among jurisdictions anyway. A second option could be to apportion the overall shared amount of the CIT among local governments to where the economic activity is actually taking place; according to value added or the use of production factors (labor and/or capital). The apportionment approach, although attractive, would be highly demanding on data (which may not be available) and/or be exposed to excessive bureaucratic interference.

A third option is to keep CIT as a shared tax, but not on a derivation basis. The total SNG share of the CIT could be, instead, brought as one of the resource sources into the general purpose equalization grant pool (see below) to be allocated to all SNGs in accordance with legally pre-established parameters in a distribution formula, which should be immune from bureaucratic manipulations and political influences. This third option of using the shared CIT as a funding for a true equalization transfer mechanism may be a more desirable route to follow at the present juncture in Croatia, given the need to address existing significant horizontal fiscal imbalances.

shared taxes are allocated is of utmost importance, since it can increase disparities (if allocated on a pure derivation basis) or can reduce it (if allocated according to equalization principles).
(ii) **Streamlining local non-tax revenue legislation.** Local non-tax revenue represents the second most important SNG revenue source in Croatia, but its regulation is dispersed, unnecessarily complex, and confusing; an inducing environment for loopholes, inefficiencies and inequities (Annex D). The local non-tax revenue structure needs to be reviewed and streamlined from the myriad of nuisance levies, fees and contributions, and specifically targeted taxation (on cottage, idle land, construction sites, and business buildings), which are difficult to administrate, and some are not always efficient or equitable. The “communal fees” and “communal contribution” should be eliminated altogether and replaced by proper service charges directly collected by the utility service provider on a fully cost recovery basis, as has been intended. The specific taxation on cottage, idle land, idle construction sites, and idle business buildings should also be eliminated and replaced by a properly regulated *general property tax* (where exceptions and special cases should be treated in the very same property tax law consistently). All in all, the Croatian Government may consider overhauling the local non-tax revenue system and properly codify it in one well-structured law.

(iii) **Adopting a well-designed property tax as a local tax.** Instead of the current complexity of communal fee/contribution and taxes on idle real estates, a simpler and well-regulated property tax (including land and buildings) could represent a more justifiable and efficient fiscal instrument through which local authorities could autonomously tap significant resources to be used at local discretion allowed by law. This would boost local autonomy and transparency, which are essential to improve local voice and accountability on public service delivery.

Property tax can be considered one of the most appropriate sources of revenue to be assigned to local governments on a derivation basis, with local authorities having some discretion, at least on a bandwidth of rates, and perhaps on the tax base as well. Besides promoting local tax efforts and efficiency, a general property tax regulation (including land and buildings across the board and only with selected exceptions clearly established in the law) has the advantage of being a non-exportable tax to other jurisdictions and can be a justifiable tax from an equity perspective. Moreover, citizens can more easily and directly associate the tax they are paying with the benefits received from local administration, and if/when the tax liability can be assessed on a market value basis, the property tax will have the advantage of being a buoyant source of local revenue, with tax proceeds evolving in pace with economic development. Also, if properly regulated, a property tax, especially when liabilities can be assessed on a market value basis, will tend to revitalize the capital markets, including real estate markets (land, commercial buildings and housing).

b. **Mitigating Fiscal Imbalances**

Horizontal fiscal imbalances tend to increase with decentralization when there is a mismatch between expanded functional responsibilities and limited local revenue capacities. To a certain extent, Croatia’s 2001 decentralization reform tried to

---

23 The questions of property rights and fiscal cadastres are important separate issues, but Croatia is already quite well-placed to resolve them soon.
circumvent increasing fiscal imbalances by tying resources to assigned decentralized functions, asymmetrically, exclusively to eligible units of SNG. However, the reform did not address the pre-existent horizontal imbalances, nor prevent that these balances would increase (Annex E). Also, ex-ante micromanaging and bureaucratic restrictions built up with the reform, and the fiscal transfer system remained ineffective in terms of improving local governance. Moreover, the allocation mechanisms for earmarked capital investment transfers to SNGs remained non transparent and inefficient. Therefore, before starting with further functional “decentralization,” the Government of Croatia may consider simplifying and completing the intergovernmental fiscal relations reform process initiated in 2001 by: (i) eliminating the excessive bureaucratic rigidities and effectively transferring decision powers to SNGs; (ii) increasing transparency and efficiency on capital grants allocation; and (iii) broadening the scope of the equalization grant mechanism, while eliminating its inefficiencies and inequities.

(i) Eliminating bureaucratic rigidities and empowering SNG authorities. The first requisite to improve local governance and service delivery in Croatia is to remove the existing excessive bureaucratic rigidities in intergovernmental fiscal relations and to effectively transfer decision powers, so that SNGs can properly perform their already legally assigned functions and be perceived by citizens as accountable for policy results. In conjunction with agreed, pre-determined service standards, well-defined performance indicators, systematic ex-post monitoring and feedback mechanisms, and enforceable sanctions, the empowerment of local authorities to their competences would expose them to bottom up pressures, encouraging response in terms of better service delivery accordingly.

The above proposal requires a shift from the current ex-ante controls and endless negotiations (frequently without a satisfactory conclusion) to a more effective, rules-based, ex-post monitoring approach. This shift would mean that the key parameters of the intergovernmental fiscal relations system would, once agreed upon, be established in organic laws. These parameters should include, for example, the tax sharing ratios, the formula for the determination of the equalization grants pool size and distribution, service standards and performance indicators based on measurable objective criteria, capital grants allocation criteria, etc. To ensure proper ex-post monitoring, law enforcement, and satisfactory implementation, central institutions for planning, coordinating, implementing and monitoring the decentralized system should be substantially strengthened (see below).

(ii) Increasing transparency and efficiency on capital grants. Increased transparency on the Croatia system of capital investment grants is essential and urgent at this juncture, especially in face of the EU standards of efficiency and fiduciary requirements. Clear objective criteria for the allocation of conditional capital investment grants should be guided by national master programs, explicitly established ex-ante, and widely disseminated. Eligible administrative units should be assisted and strongly encouraged to apply; and project selection should be based on open competition, minimum bureaucratic requirements, and sound technical appraisal criteria, such as a social cost-benefit analysis. This approach should replace the currently vulnerable “request” basis approach. Allocation of State grants and subsidies awarded through HBOR’s concessional capital
investment financing or those related to EU funds which transit through the “National Development Fund” for regional development should be properly disseminated ex-ante by the MoF, and explicitly highlighted in the State budget.

(iii) Broadening the scope of equalization grants, while eliminating inefficiencies and inequities. In principle, for similar local tax efforts, citizens should have the same opportunity to access equivalent public service standards, regardless where they are living in the country, and whether the fiscal system is less or more decentralized. As distribution of revenue capacity in Croatia is quite skewed, decentralization naturally tends to increase horizontal fiscal imbalances—this has been aggravated by the derivation basis criteria of shared taxes. Therefore, owing to the fragmented territorial-administrative structure, the regional disparities on needs and tax capacities, and the limited creditworthiness of most jurisdictions, fiscal transfers from the State and counties remain a powerful necessary instrument to equalize (or at least reduce disparities on) public service delivery in Croatia.

Although the basic principle introduced by the 2001 reform of assigning responsibilities and resources asymmetrically should be retained, the referred inefficiencies and inequities of the system (Annex D) could be eliminated, by:

- **redefining the “equalization grants pool” by consolidating resources** from: (i) the additional 21 percent PIT that currently goes to the “equalization fund”; (ii) the 10.4 percent that currently goes to the “fund for decentralized functions”; and (iii) discontinuing CIT as a shared tax on a derivation basis, and bringing the corresponding aggregate SNG share from it to integrate the funding of the “equalization grants pool” as well;\(^{24}\)
- **making the overall size of the “equalization pool” predictable** by computing it according to pre-established formula, regulated by organic law. Most importantly, in order to bring stability to the transfer system, Croatia may consider:
  - (1) funding the “equalization grants pool” with diversified sources of resource (say, CIT, PIT, and possibly VAT), and preserving the vertical balance by adjusting the aggregate required ratio/share accordingly; and
  - (2) computing the aggregate SNG share of national taxes that goes into the “equalization grants pool”, on the basis of a three-year moving average of the funding sources (for example, executed values for the last two years and estimated value for the current year);
- **making the distribution of the “equalization grants pool” predictable**, by computing the individual SNG shares also according to pre-established formula, regulated by organic law. In order to provide leeway for autonomy and

---

\(^{24}\) This should not preclude the existence of other separate conditional transfers (for decentralized and/or delegated functions) according to specific sector programs in areas such as education, health, social assistance, transport etc… where clearly national concerns supersede regional/local interests (for instance, hospitals and school building redeployment/restructuring programs, national roads (re)construction/maintenance, contagious disease control programs, vaccination programs, conscription programs, etc.
accountability, the allocation of these grants should be *unconditional*, or at most, *block grants* without strings attached. At the beginning, the distribution formula should be as simple as possible; basically, the resources could be allocated directly according to population size (as a proxy for “needs”), and inversely to revenue capacity (possibly proxied by some measure of local/regional value added);\(^{25}\)

- *defining clearly in the law* how the equalization transfer mechanism will work in practice to resolve the challenges of asymmetric allocation of responsibility in the Croatian hierarchical and bifurcated intergovernmental fiscal relations system. In this respect, to inform the distribution formula, the law should also properly regulate the county-local government fiscal relations explicitly;
- *reviewing whether the differential treatment is still necessary* for each of the “special concern regions”, the “mountainous regions”, and the “island”. If yes, consider establishing a sunset clause/law for their special treatments in regard to tax-sharing, tax exemptions, transfer mechanisms, etc. If not, start a phasing out process to eventually end up treating these regions equally as part of the normal, general distribution formula of the equalization grants and the other transfer instruments;\(^{26}\)
- *removing the “claw-back” clause* of the SNG Finance Act (Annex E),\(^ {27}\) so that the “equalization grants pool” should be *fully* allocated in the same year, in accordance with explicit rule and to what had been planned and expected by the local budgets. This reform would be critically important to help restore efficiency, predictability, and trust in the system of intergovernmental fiscal relations.

c. **Accessing Capital Markets Responsibly**

Municipal capital markets in Croatia are in their infancy, and market failures are numerous. Although central direct control on local credit operation runs contrary to decentralization objectives, has increased bureaucracy and has been ineffective, the sole reliance on market discipline to ensure responsible access of SNGs to capital markets is also risky, is unlikely to prevent financial crises, and thus may not be a feasible alternative for the time being. In the present circumstance, there clearly is a need to enhance regulation under which SNGs could access municipal capital markets, with the necessary safeguards to avoid soft budget constraints, moral hazards, and ensure macroeconomic stability.

\(^{25}\) “The State Bureau of Statistics will finish the job of calculating GDP for 2002 and 2003 in the existing counties until the end of 2005, but also in line with the EU-NUTS2 regional categorization.” See page 91 of the *Pre-Accession Economic Program (PEP)-2005-07*, Government of Republic of Croatia, Zagreb, November 2004.

\(^{26}\) An explicit sunset law, or phasing out process, is a critically important policy in these cases; first, to clearly show that special fiscal treatment is always *transitory* and, second, to keep permanent pressure on the beneficiaries, who have to appear before Parliament periodically with a reasonable justification if they want the special fiscal concessions renovated. If such justifications cease to exist, the special concession period expires automatically according to the sunset clause, and the differential treatment vanishes as desired.

\(^{27}\) Law on Financing Local and Regional Self-Government Units*, Art. 45.1 (7), Official Gazette …/…/…
Box F.1 (Annex F) shows distinct approaches adopted by some similar countries that discipline sub-national government access to borrowing. The main lesson that Croatia can draw from international experience is that of **putting in place an institutional framework and safeguard rules** that ensure fiscally responsible borrowing by sub-national governments, while encouraging competitive behavior and practices of market discipline. In this regard, Croatian regulations and institutions could be substantially enhanced by:

- **establishing basic parameters** for sub-national governments to access capital markets, such as: (i) restricting medium- and long-term loans only to investment projects; (ii) capping SNG debt service ratios to, say, 0.1; and (iii) limiting their debt outstanding to earned revenue ratio to around 0.8 (to be implemented gradually).
- establishing enforceable limits for banks’ portfolio exposure to SNGs (individually) to a certain maximum recommended by best prudential rules.
- **adopting a “bankruptcy law”** that defines debt workout procedures in case SNG units default, while protecting the social assets of SNGs.²⁸
- adopting a **law on fiscal responsibility** to curb excessive deficits, imprudent buildups of public debt, and unlawful budgetary practices, which includes SNGs.²⁹
- **encouraging and disseminating “risk and credit rating analyses,”** aimed at improving transparency and promoting market discipline, if possible by promoting development of domestic rating companies as well.
- enhancing central monitoring institutions (including better coordination and exchange of information among MoF and NBC) to keep a reliable, publicly available, overall track record of SNG debt management, including contingent liabilities, arrears, and guarantees of all sorts (see below).

(d) Improving Conditions for Absorption of EU Funds

The EU pre-accession and structural funds will be implemented on a decentralized basis, and this can be an opportunity to realign the Government decentralization strategy with the EU financial criteria for regional economic development.³⁰ In fact, Croatia may use this opportunity to boost county/local governance by: (i) promoting development of a domestic municipal capital market; and (ii) encouraging rationalization of fragmented administrative units.

(i) Promoting development of a domestic municipal capital market. Proper regulation to enhance financial market conditions can facilitate mobilization of domestic savings by sub-national government units and the placement of municipal (and municipal enterprise) bonds in the domestic capital market. As mentioned above, the adoption of a bankruptcy law (including county and local governments) which regulates municipal debt work out and a law on fiscal responsibilities (which discipline local fiscal management) are, inter

---

²⁸ As a best practice European example, Croatia may consider examining the Hungarian Law on Overhang Municipal Debt Workout, which regulates procedures, intervention, and sanctions (…/…/…).
²⁹ The New Zealand and the Brazilian Fiscal Accountability Acts are among the best international practices.
³⁰ “Pre-Accession Economic Program (PEP)-2005-07”.
alia, important to increase SNG creditworthiness and improve their access to capital markets.\textsuperscript{31} Better access to the domestic capital market will help SNGs to tap the required \textit{counterpart funds} to satisfy the additionality criteria of the EU, thereby leveraging county and local government capacities to finance badly needed investments in infrastructure, agriculture and other regional development projects, and making proper use of EU funds.\textsuperscript{32}

(ii) Encouraging rationalization of fragmented administrative units. The small, fragmented administrative units are unable to access capital markets by themselves for lack of operational scale and counterpart funds. The Government could consider \textit{assistance these units, conditional on their voluntary consolidation} on a more rational basis (which may start by rearranging themselves in associations or aggregation to a larger contiguous jurisdiction, with the intention of permanent amalgamation, if later on approved by the citizens). These consolidations should constitute alternative territorial-administrative arrangements that could entail more efficient operations in terms of economy of scope and scale, as well as externality benefits on services delivery, so that the newly consolidated units could become eligible for EU funds.

Through differential “financial incentives” cum “conditionality”, the “equalization grants mechanism”, for example, could be instrumental in encouraging small units to voluntarily consolidate in order to become eligible to and have enough counterpart funds for the EU financing, which otherwise they could not access individually. This special incentive will be temporarily limited anyway, since it will be once-and-for-all circumscribed to complement the counterpart funds necessary for the newly consolidated unit to access EU financing. These incentives would certainly need to be properly regulated, transparent, and compatible with high-social-rate-of-return projects, in order to make the amalgamation attractive to local inhabitants and permanent in the long term.

3. Capacity Building, Accountability, and Fiduciary Management

Success on completing the foundations of the decentralization process initiated in 2001 very much depends on increasing implementation capacity and improving the accountability framework. Implementation capacity should steadily grow hand-in-hand with more effective divestiture of specific competences and transfer of resources—the latter also includes staff, know how, and proper training. An improved accountability framework requires permanent bottom up pressures to factor in citizens’ voice, and effective top down ex-post monitoring mechanisms to ensure fiduciary management of public resources.

a. Building Capacity

Capacity building should go in tandem with functional and fiscal decentralization, and the best approach is mainly to promote programs that emphasize on-the-job training, instead of isolated, costly training programs that cover functions not yet decentralized or

\textsuperscript{31} In this regard, public property rights of sub-national governments are also to be properly regulated.

\textsuperscript{32} This process might also be assisted by partial credit and partial risk guarantee facilities from international financial institutions.
without the prospect of being decentralized shortly. Initially, donor assistance on capacity building is crucial, including coordination of their technical assistance programs for county/local governments with the Regional Development Fund and the EU criteria and requirements.

Moreover, a uniform national strategy for training SNG staff and authorities should be adopted and led by the Government initially, until sub-national governments can develop capacity (financial and technical) to take on full responsibility of the training strategy themselves (probably through strengthened national associations of sub-national governments). To this end, it could be instrumental for Croatia to create an independent training agency which would be in charge of designing and coordinating uniform SNG training programs, under the adopted national training strategy. Such an agency should initially be entirely financed by donors, conducted by a Board of Directors (with representation of key stakeholders, including central and sub-national governments, and donors), and be managed by a small executive body (formed by only 2 or 3 highly qualified staff). This agency should act exclusively as a broker for the implementation of the approved training programs—by coordinating and facilitating existing donors’ training programs and outsourcing new training, if need be, on a competitive basis—but should not act as a direct provider of training. The latter aims to provide the agency with enough flexibility, so that: (i) it could adjust to changeable needs over time; and (ii) to avoid creating unsustainable recurrent expenditures in SNG budgets.

b. Establishing a Consistent Accountability Framework

Increased local revenue autonomy and authority to perform tend to improve allocative efficiency and horizontal accountability, since citizens would be better placed to associate costs of local taxes with benefits of public services they receive from decisions made locally. In this regard, participatory budgeting may be a highly effective bottom up permanent pressure mechanism to check on local priorities and preferences. In parallel, fiscal transparency (including a clearer relationship between SNG and their off-budget entities), top-down supervision and monitoring should be enhanced, especially by improving the fiscal reporting systems and fiduciary management—including better dissemination and evaluation of local accounts, internal and external audits, with a more systematic auditing of local budgets by the Supreme Audit Commission.

Macroeconomic consistency, while preventing unfunded mandates, can be achieved by ensuring that resources are shifted from line ministries to local authorities, when the latter are required to deliver agreed service standards on decentralized functions. As mentioned before, these resources should include not only the commensurate financial means, but also the human resources (public servants and employees) previously engaged in the respective functions when they used to be centrally delivered. Otherwise, SNGs would have to duplicate employment, and the aggregate public expenditures would increase, jeopardizing macro stability.

33 Particularly USAID/Urban Institute, EU, GTZ and UNDP have been very active in this area in Croatia.
c. Monitoring Implementation of Decentralization

As referred to above, in order to properly monitor the effectiveness of decentralization, central institutional arrangements and capacities have to be developed and strengthened as well. In this respect, the Ministry of Finance and the line ministries have to establish specialized units which would be in charge of systematic collection, analyses and dissemination of relevant data, aiming at closely monitoring and evaluating agreed key performance indicators on service standards. The results of these monitoring efforts should effectively feed back on policy adjustments, and be available publicly.