

Issues paper: Towards sustainable financial mechanisms for regional development



Key highlights

- Mobilising funding and financing for regional development requires ensuring a mix of stable sources, creating an adequate institutional structure for RDAs without un- or under-funded mandates, and promoting effective inter-regional co-operation mechanisms.
- Enabling conditions for financing regional development are not always in place. Governments are often faced with complex and fragmented regulatory frameworks, the absence of an investment strategy, and a lack of administrative capacity or deficient co-ordination and collaboration.
- Financial sources for regional development priorities are sometimes limited and insufficiently diversified, often due to competing priorities or budgetary constraints, higher perceived risks, or an uncertain regulatory environment. An over-reliance on a single source of financing may also pose a threat to the sustainability of regional development initiatives.

Towards better financing for regional development

- Regional development policies can be financed through a variety of sources, be they public or private. These include EU funds, central government grants (including National Funds for Regional Development), tax instruments, external financing from international financial institutions or loans and bonds from the private capital market, and public-private partnerships.
- A deep dive into Croatia's financing arrangements for regional development reveals that EU funds are the leading financing source, followed by county-level taxes. Linked to this, one of the challenges in accessing EU funding is the co-financing requirement, especially for smaller regions.

Towards the sustainability of regional development agencies

- RDAs in OECD countries employ various funding models ranging from government grants, EU funds, commercial activities offered to the public, and membership fees, among others.
- A focus on Croatia's RDAs shows that they rely heavily (70-85% of their resources) on EU technical assistance funds to fund their own staff and operational costs. Although they most claim to be sufficiently well-staffed for the time being, the phasing out of EU funding raises questions regarding the financial sustainability of these agencies, which will need to find alternative funding models to sustain their operations.

Fostering inter-regional co-operation and joint projects for regional development

- Inter-regional co-operation mechanisms are a solution to address regional development challenges at the right geographic scale and range widely across the OECD, from joint investment strategies to the establishment of joint authorities or even the introduction of a new level of governance merging smaller regions.
- A closer look at the Croatian example shows that Croatian RDAs operate more locally than many of their EU equivalents, which risks leading to fragmentation. Croatia has supported inter-regional co-operation through a different mechanisms, including two inter-regional co-operation agreements, and programmes such as "Dalmatinska Zagora" and "Gorski Kotar". There may be

an opportunity for Croatia to learn from other OECD and EU country experiences on how to further bolster inter-regional co-operation.

Introduction

Mobilising “diversified, balanced, and sustainable financial resources to adequately fund regional development policy at the national and subnational levels” is one of the 10 key principles of the new Recommendation on Regional Development Policy adopted on 8 June by the OECD Council (OECD, forthcoming^[1]). This principle invites national and subnational governments to secure sufficient and adequate financial resources to reduce territorial disparities and promote balanced regional development. It confirms that the adequacy and the sustainability of financial mechanisms to implement regional development policies are critical factors for success. Stable and robust financial frameworks enable regions to invest in “hard” (e.g. roads and bridges) and “soft” infrastructure (e.g. skills, innovation, research and development) necessary for balanced regional development (OECD, 2009^[2]; OECD, 2020^[3]).

However, funding and financing regional development is a complex task. OECD countries encounter a series of challenges when seeking to finance their regional development priorities. These challenges can be broadly categorised into two main groups: those pertaining to enabling conditions for regional development, and those that are specifically related to financial resources.

Enabling conditions for financing regional development priorities are not always in place

- **Regulatory frameworks governing regional development projects can often be complex and fragmented.** This often results in time-consuming and resource-intensive processes (e.g. for public procurement) that can potentially delay project implementation or cause a duplication of project funding (OECD, 2019^[4]). Complex regulatory and legal frameworks can be particularly burdensome for smaller subnational entities. Moreover, the lack of clarity in funding regulations (e.g. co-funding requirements or the selection criteria when applying for calls) may hamper the effective use of available resources, thereby impeding regional development stakeholder ability to access funding and/or financing or plan projects effectively. Additional challenges may arise from lengthy approval processes, legal barriers, and compliance and monitoring requirements.
- **The absence of an investment strategy or regional development policy can lead to fragmented decision-making and suboptimal use of resources.** Without a clear vision of how and where investments should be made to support regional development, it may be challenging to identify and prioritise key investment areas and projects and allocate resources efficiently and strategically. The absence of an investment strategy can also create uncertainty among investors, including public and private entities, who tend to seek stability, predictability, and clarity when considering funding opportunities. Designing and implementing an investment strategy or regional development policy can help guide funding priorities and avoid suboptimal use of funding for regional development.
- **A lack of administrative capacity may hinder the efficient utilisation and management of funds.** Should this capacity be lacking, negative consequences may include delays, inefficiencies, and diminished regional development outcomes (OECD, 2018^[5]). Obtaining financing to implement

regional development initiatives requires strong administrative capacity at all levels of government, as well as among beneficiaries of regional development funding, be they from the public, private or third sectors. The workforce should be proficient in project management, finance and economic analysis, as well as policy design, implementation, monitoring and evaluation. In turn, the providers of financing for regional development should support the development of these essential skills by encouraging and financing targeted training and capacity building programmes, which may be too costly for funding recipients to cover themselves. Furthermore, allocating sufficient resources, both human and financial, is vital to ensure the necessary personnel, infrastructure, and tools for effective performance. However, attracting and retaining public sector employees at subnational entities may pose challenges, as they may identify more appealing opportunities in the central government or the private sector (OECD, 2022^[6]; OECD, 2023^[7]).

- **Deficient co-ordination and collaboration can impede the efficient allocation of funds.** Navigating the complexities of co-ordination among multiple national, regional, and local actors—including public authorities, private entities, and non-governmental bodies—can be challenging and can affect the efficient allocation and utilisation of funds. To address this, regular communication and information sharing, and establishing platforms for dialogue, such as inter-governmental councils or task forces, can catalyse co-ordination and collaboration, and help ensure that strategies and funding align with regional or local needs and priorities.

Financial sources for regional development priorities may be limited and insufficiently diversified

- **Public financial resources may be limited.** Adequate funding for regional development may be constrained due to limited public financial resources at the national or subnational level (OECD, 2019^[8]). Competing priorities, budgetary constraints (such as budget deficits or high levels of public debt), and economic downturns resulting in spending increases and revenue decreases can restrict the resources available for regional development initiatives. At the subnational level, a low level of resources for regional development can be related to the low level of fiscal decentralisation and/or the lack of competences in areas particularly relevant for regional development (OECD, 2019^[8]).
- **Private sector investment may also be restricted.** While the private sector can drive regional economic growth by injecting capital into a region (Alfaro et al., 2004^[9]; OECD, 2012^[10]), less-developed regions may be limited in their ability to gather additional financial resources. In fact, they are often confronted with higher perceived risks, lower market potential or uncertain regulatory environments that may deter private capital to reach these areas.
- **The over-reliance on a single source of financing may pose challenges for the sustainability of regional development initiatives.** Regional development financing can sometimes be dependent on one or two primary sources (e.g. EU funding or central government grants). As long as these sources are stable, the funding and implementation of regional development projects may unfold seamlessly. Nevertheless, external shocks (e.g. an international macroeconomic crisis) or internal changes (e.g. decentralisation framework reforms) can disrupt the stability and the sustainability of these primary sources of financing, thereby impeding financing for regional development policies. For instance, central government grants, which frequently account for a significant share of funding for regional development, tend to fluctuate in size and stability due to changes in fiscal capacity and changes in national priorities, in particular the willingness of higher tiers of government to allocate sufficient resources to support regional development. Therefore, it is crucial to diversify funding and financing sources and establish resilient mechanisms to mitigate the risks associated with relying solely on a single financing stream (OECD/UCLG, 2022^[11]).

1. Towards better financing for regional development

Across OECD countries, regional development policies can be financed through a variety of sources, be they public or private. Their size and stability differ from one country to another depending on the multi-level governance and finance frameworks in place.

European Union funds

European Union Member States typically receive EU funding for regional development policies that address infrastructure gaps, stimulate economic growth, and reduce economic and social disparities (OECD, 2020^[12]). The EU funds its regional policy directly through various funding mechanisms, including the European Regional Development Fund (ERDF), the EU Cohesion Fund, the European Social Fund Plus (ESF+), and the Just Transition Fund, among others. In response to the COVID-19 pandemic, the EU has introduced new initiatives such as the Recovery and Resilience Facility (RRF), as part of the NextGenerationEU programme (NGEU), which plays a crucial role in financing cohesion policy by providing grants and loans to Member States. While the RRF does not explicitly target regional disparities unlike the EU Cohesion Fund, it contributes to overall economic recovery and can indirectly benefit regional development initiatives (ECA, 2023^[13]). Finally, other EU sectoral programmes under direct or indirect management, such as Horizon+ and Erasmus+, can also contribute to the attainment of regional development objectives.

Several key principles govern access to EU funds for regional development. They include, among others, the principles of partnership, co-financing and additionality (EU Parliament and Council of the EU, 2021^[14]). The principle of partnership is a key feature in the implementation of the funds, building on the multi-level governance approach and ensuring the involvement of regional, local, urban, and other public authorities, civil society, economic and social partners and, where appropriate, research organisations and universities. Regarding the co-financing principle, projects receiving funding from EU structural funds must be supported by funds from the country involved, whether such funding (public or private) be sourced at the national or at the subnational level. Linked to co-financing, the principle of additionality establishes that EU funds should supplement, not substitute, funding provided by individual Member States. Concretely, EU funding must always be provided in addition to funding provided by the Member States themselves. Co-financing can increase the commitment of different stakeholders to the success of a project and encourage resource pooling across subnational governments. It can also pose challenges, especially for smaller regions or localities, which often struggle to generate the necessary domestic funds to apply for an EU funding call. In addition, ensuring the capacity of subnational governments to adequately manage and absorb these funds requires appropriate administrative and institutional resources, as well as continuous co-ordination among the different levels of government to align project strategies and implementation (Rodríguez-Pose and Garcilazo, 2015^[15]).

One risk of relying strictly on EU funding for regional development is that of becoming overly dependent on it. Some EU Member States, such as Poland, Bulgaria or Romania, have relied heavily on EU funding, which has discouraged the diversification of funding sources (Reichardt, 2011^[16]; OECD, 2021^[17]). This can have two important implications. First, it subjects regional development to fluctuations in EU budgetary cycles and priorities—which might not necessarily align with local priorities—and second, when other financing mechanisms are available (which is not always the case), relying on EU funding may reduce the incentives or the willingness to utilise these alternative financing instruments, such as inter-governmental transfers, equalisation mechanisms, tax incentives, loans, etc. Moreover, not all relevant actors possess the same capacity to effectively compete for EU funding. This tendency can lead to an imbalance in the utilisation of EU support, favouring larger municipalities or regions over smaller ones, subsequently contradicting the fundamental regional development principle of reducing inequalities and fostering equitable growth. In addition, EU funds do not cover all costs, such as the costs of land acquisitions, which are not eligible for EU funding and can have an impact on project selection (OECD, 2021^[18]).

Central government grants

Across the OECD, regional development policies are sometimes financed, to a greater or smaller extent, through budgetary allocations from various levels of government, including national, regional, and local governments, targeted at a variety of beneficiaries, including local authorities, firms, non-governmental organisations, and households, thereby contributing to the support of regional development projects. National governments play a crucial role by providing earmarked grants for regional development projects. These grants may serve several purposes, such as:

- Internalising externalities, which means encouraging subnational governments to consider the benefits that certain activities or investments could have for others (e.g. gains from improving transport infrastructure within a region)
- Promoting national policy goals at the subnational level
- Facilitating risk-sharing and co-operation among different tiers of government
- Strengthening the administrative capacities of subnational governments to devise and implement regional development strategies (Bergvall et al., 2006^[19]; Spahn, 2012^[20]; OECD, 2020^[3]).

Moreover, national governments can also offer non-earmarked grants to subnational governments or regional development agencies, giving them greater flexibility to tailor policies according to regional or local preferences and priorities. However, some challenges can arise with central government grants, especially when such funds are earmarked and discretionary. Political factors, including electoral considerations, can affect the distribution of resources, potentially favouring specific regions or localities based on political interests rather than development needs. Additionally, disputes may arise regarding the size of transfers and the criteria used for their distribution, leading to difficulties in reaching consensus among different levels of government.

Equalisation transfers, whose main goal is to provide a minimum acceptable level of public goods and services at a comparable tax rate across regions, can also contribute to achieving regional development objectives (Blöchliger et al., 2007^[21]). Equalisation transfers can help regions operate on an equal footing and harness their resources to implement targeted regional development policies (OECD, 2021^[22]; Moisió and Vidal-Bover, forthcoming^[23]). Yet, there is some debate regarding the extent to which fiscal equalisation might actually hinder long-term development incentives in an attempt to correct short-run disparities in fiscal capacity (Bartolini, Stossberg and Blöchliger, 2016^[24]).

Box 1. National funds for regional development

In some countries, national funds for regional development (NFRDs) serve as a specific type of earmarked transfers from the central government. They are established by governments to allocate resources towards supporting regional development. These funds may gather funding from various sources, including budget allocations, inter-governmental transfers, or specific revenue streams, such as royalties from natural resources (e.g. Norway¹) (Clark and Monk, 2010_[25]). The allocation of funds is based on specific criteria, such as population size, unemployment rates, or specific development needs identified through planning processes at the subnational level. Subnational authorities identify and propose regional development projects, which are then evaluated and selected based on their alignment with regional development goals and priorities. Upon approval, funds are disbursed to the regions either through direct transfers to local authorities or project-specific grants to eligible entities like RDAs. Governments typically monitor the utilisation of funds, ensuring accountability and effective implementation.

NFRDs offer important advantages, including targeted financial assistance to regions with specific development needs and fostering collaboration among different levels of government to achieve regional development objectives. However, just like with EU funds, it is essential to design NFRDs in a way that prevents regional actors from becoming over-reliant on national funds. Over-dependence can discourage and hinder long-term self-sustainability, especially when fiscal frameworks limit local capacity to raise resources independently.

The cases of France, Moldova, and the United States

NFRDs can vary in design and size. For instance, in France, the National Fund for Planning and Territorial Development (*Fonds national d'aménagement et de développement du territoire*, FNADT) receives funding from the French central government, regional authorities, and the EU's Structural Funds, particularly the ERDF. Eligible projects under FNADT encompass various areas, such as local economic development, urban and rural planning, transportation, cultural heritage preservation, social inclusion, and environmental protection (Besse, 2003_[26]).

In Moldova, the NFRD primarily consists of annual allocations from the state budget, representing 1% of the approved revenues of the state budget for a given year (excluding special purpose revenues provided by legislation) and focuses on sectors such as agriculture, tourism, and SMEs (EURADA, 2016_[27]).

In the United States, the Community Development Block Grant (CDBG) programme, which receives annual appropriations from the federal government, allocates funds to states and local governments for a wide range of community development activities such as housing, infrastructure, and job training. State and local governments often distribute the funds to eligible entities within their jurisdictions, such as non-profit organisations or community development agencies (US Department of Housing and Urban Development, 2022_[28]).

¹ Norway established the Government Pension Fund Global in 1990, also known as the Norwegian Oil Fund or Sovereign Wealth Fund, to manage the country's surplus revenues from oil and gas production in the North Sea. A significant portion of the fund's capital comes from the taxation of oil and gas activities and the collection of petroleum-related revenues, including royalties. While the fund's primary purpose is not regional development specifically, it indirectly contributes to regional development in Norway through its investment activities, which can have positive spillover effects on the national and regional economy (Clark and Monk, 2010_[25]).

Tax instruments for regional development

Most countries use fiscal tools to encourage regional development in specific areas. Apart from central government grants as noted above, fiscal tools may include tax incentives, special economic zones (SEZs), development funds or revolving loan funds (see below), among others. These fiscal tools and measures provide governments with mechanisms to encourage investment, attract businesses, and direct financial resources towards regional development.

Tax incentives are sometimes used to attract firms and investment to specific regions. These incentives can include tax breaks, reductions in corporate income tax rates, or tax exemptions. SEZs aim for the same goal by offering economic regulations and policies that differ from the rest of the country and that, in principle offer a more favourable business environment, streamlined administrative procedures, or tax benefits. The rationale behind these incentives is that the revenue no longer collected through taxes because of tax incentives will *de facto* act as an investment that furthers regional development goals. However, empirical evidence has yielded mixed results. It indicates that these tools need to be used in a balanced manner to ensure that the benefits of increased investment, job creation, and infrastructure development outweigh the drawbacks of reducing tax incentives or unintentionally promoting rent-seeking behaviour (Brussevich, 2020^[29]; World Bank, 2017^[30]).

France, Italy, Portugal, Spain, and the United States are among the countries that have implemented tax incentives as part of their efforts to finance and promote regional development. In France, the *Zones Franches Urbaines* (Urban Free Zones) provide tax incentives, including exemptions from local business taxes and reductions in social security contributions, to attract businesses and foster economic revitalisation in economically deprived urban areas (Ministère de l'Économie et des Finances, 2023^[31]). Similarly, in Italy, the 2019 Super-Depreciation measure offered additional tax deductions for investments in new tangible assets (e.g. machinery and equipment, renewable energy infrastructure, industrial plants, etc.), stimulating investment and technological modernisation, particularly in the country's southern regional (Ministry of Economy and Finance of Italy, 2019^[32]). Lastly, in the United States, the Opportunity Zones programme, first created in 2017, provides a framework whereby investors can defer and potentially reduce capital gains taxes by investing in distressed areas designated as Opportunity Zones.

External financing

International financial institutions

Apart from national development banks, countries may also seek financing from international financial institutions such as the World Bank, the International Monetary Fund, the European Investment Bank as well as the European Bank for Reconstruction and Development. These institutions mobilise funds through member contributions, borrowing from capital markets, and other financial instruments. These international financial institutions (IFIs) offer loans and grants to support regional development projects, providing national and subnational governments with the necessary capital to invest in infrastructure, human and institutional capacity building programmes. Loans from IFIs generally have concessional terms, including lower interest rates and longer repayment periods, which help reduce the financial burden on recipient countries. IFIs also usually accompany their financial contributions with technical knowledge and expertise in project design, implementation strategies, policy reforms, and institutional strengthening.

Loans and bonds

Governments can raise funds for regional development by issuing bonds or obtaining loans from domestic or international financial markets. However, accessing capital markets can be challenging for subnational governments seeking to finance regional development. First, regulatory and legal frameworks can create

burdensome requirements for subnational governments and can restrict or even forbid subnational governments to borrow or issue bonds. Moreover, subnational governments often have limited financial resources and borrowing capacity given their constrained budgets and revenue sources, and low tax-raising powers. This can hinder their ability to meet the requirements and financial thresholds set by capital market participants, making it difficult to access favourable lending terms or issue bonds at competitive rates. Related to this, the smaller market size and investor demand of regional and local governments may also prove challenging as capital markets tend to be more active and liquid at the national level, with larger issuances and a broader investor base. Finally, subnational governments may face challenges in demonstrating creditworthiness, as credit rating agencies primarily focus on that of national governments, which may push investors to perceive them as riskier, resulting in increased borrowing costs.

There are several ways in which access to capital markets can be facilitated for subnational governments. Subnational governments can improve their financial management practices and reporting standards to enhance transparency and demonstrate their creditworthiness with tools such as the Municipal Financial Information Return in Ontario (Canada). They can also collaborate with national governments or development banks, who may provide guarantees or co-sign loans to support regional initiatives. In some countries credit rating agencies focusing on subnational governments have been established. These agencies evaluate and assign credit ratings to subnational issuers, enhancing transparency and investor confidence. Germany has the Creditreform Rating AG, which specialises in assessing the creditworthiness of municipalities and local government entities.

Moreover, some OECD countries have established regional bond issuance platforms to facilitate access to capital markets for regional and local governments. These platforms pool the borrowing needs of multiple regions, reducing costs and administrative burden. The Local Government Funding Agency (LGFA) in New Zealand is a joint venture by New Zealand's local government sector and serves as a central borrowing agency for local authorities, enabling them to issue bonds collectively. Similarly, pooled finance mechanisms such as revolving loan funds can be established to fund common infrastructure projects, address shared challenges, and reach common regional development objectives. In a revolving loan fund, each participating government contributes to the fund, and the repayments from previous loans replenish the fund, allowing it to provide loans to subsequent projects. These funds offer flexibility and sustainability, as the capital is recycled and used to support multiple projects over time.

Public-private partnerships

Public-private partnerships (PPPs) are long-term contracts between government entities and private parties, whereby the private party assumes significant risk and management responsibilities to deliver public assets or services. This encompasses public service contracts and concessions (World Bank et al., 2017^[33]; OECD, 2018^[34]).

Governments, including subnational ones, which embrace PPPs can reap numerous benefits, such as enhanced project selection through private sector analysis and innovation, improved access to private sector expertise, and better lifecycle management driven by long-term incentives, among others. Furthermore, their stronger incentive to minimise whole-of-life costs can result in higher-quality up-front investments, leading to reduced ongoing operational and maintenance expenses. In certain cases, PPPs can also facilitate access to alternative funding sources and financing instruments, especially when private providers are better equipped to implement user charges compared to subnational governments.

Nevertheless, as the OECD Principles for Public Governance of PPPs state, it is critical to compare benefits, costs, and risks of PPPs against other funding and financing models, and to carefully assess the "value for money," key risk factors, and characteristics of specific projects before opting for a PPP. For instance, improper use of PPPs to bypass financial management controls can create long-term fiscal risks for both national and subnational governments. Using PPPs solely as a means to circumvent fiscal

constraints is not a valid justification for their use, and it can compromise project preparation and value for money, creating a misleading “affordability illusion.”

In addition, subnational governments face risks related to institutional capacity and fiscal and regulatory frameworks when engaging in PPPs. Successful implementation of PPP projects requires substantial institutional expertise, including the ability to assess benefits, costs, and risks, manage project development, procurement, awarding, and contract management, all while ensuring transparency. Therefore, PPPs should primarily be utilised by larger cities and regional jurisdictions that possess the necessary fiscal and institutional capacities, under specific conditions and stringent control mechanisms. (OECD, 2022^[35]).

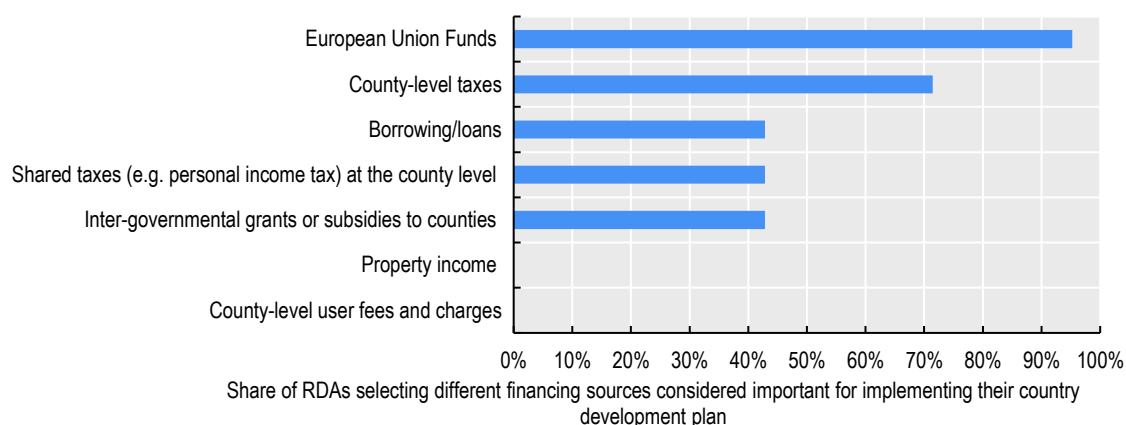
Several countries have established PPP agencies or units to provide targeted technical assistance to subnational governments. This is the case for six provinces in Canada (e.g. *Société Québécoise des Infrastructures*), where these agencies oversee PPP implementation within their respective jurisdictions and assist municipalities in developing their own PPPs. Similarly, in 2012, in the Netherlands, the Ministry of Housing, Spatial Planning and Environment established a PPP support unit, in order to make the national government’s knowledge and experience of PPPs available to subnational governments and semi-public institutions (OECD/UCLG, 2022^[11]).

Croatia’s funding and financing landscape for regional development

Croatia finances its regional development strategies and initiatives through various means. However, EU funds are particularly important. During the 2014-2020 funding period, Croatia received over EUR 12.1 billion of EU funding, of which EUR 9 billion came from Cohesion Policy funds (as of October 2022). Most fund allocations are through ERDF (39.8%), followed by EAFRD (23.1%), the Cohesion Fund (17.7%), and ESF (15.5%). For the current period 2021-2027, over EUR 10 billion has been budgeted, with ERDF being the primary source of EU funding (62.1%), followed by ESF+ (22.2%), the Cohesion Fund (13.6%) and the Just Transition Fund (2.1%) (European Commission, 2023^[36]). It must be underlined that these amounts include EU financing and national co-financing (see below). Croatia has also received EUR 6.3 billion of funding for sustainable investment projects from the EU’s Recovery and Resilience Plan as well as EUR 7.29 billion from the EIB since its start of operations in 1977 (EIB, 2023^[37]).

In a survey carried out by the OECD in 2022, Croatia’s RDAs were asked to select three main financing sources to implement their county’s development plan (OECD, 2022^[38]). Almost all counties (20) selected EU funds as a main financing source, followed by county-level taxes (15), which also serve as a way to finance, at least in part, specific regional development projects (Figure 1). Nine counties selected financing sources such as borrowing, shared taxes, and inter-governmental grants to counties. It is important to note that RDAs do not view property income and county-level user fees and charges as important financing sources for regional development. This clearly indicates that EU funds represent a substantial portion of financing for regional development in Croatia. This may be supported by the fact that tax revenue in Croatia accounts for 34.2% of total subnational revenue and borrowing at subnational level is limited as it can only be used to finance capital investment and is subject to prior approval by the national government (OECD/UCLG, 2022^[39]).

Figure 1. Main financing sources to implement counties' development plans

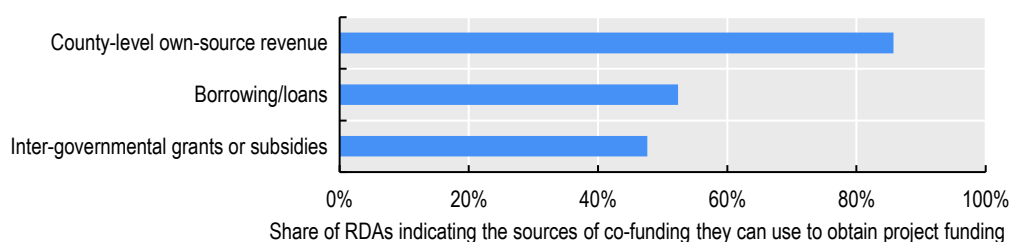


Note: Survey question: Please select the three main funding sources for implementing your county's development plan. Response options: County-level user fees and charges; Property income; Inter-governmental grants or subsidies to counties; Shared taxes (e.g. personal income tax) at the county level; Borrowing/loans; County-level taxes; European Union Funds.

Source: Author's elaboration, based on the 2022 OECD online survey (OECD, 2022^[38]).

As mentioned above, one of the challenges in accessing EU funding is related to the co-financing requirement, as smaller regions may struggle to gather the needed additional funds to apply for a specific EU funding call. As a result, national co-financing amounted to over EUR 2 billion during the 2014-2020 funding period and EUR 1.5 billion during the current period, both of which represents just under 15% of the total EU budget adopted (European Commission, 2023^[40]). In light of the answers from RDAs to the OECD survey, most of them (18) use county-level own-source revenues to provide the necessary co-financing, while about half of them also cite loans and inter-governmental grants (Figure 2) (OECD, 2022^[38]).

Figure 2. Sources of co-financing

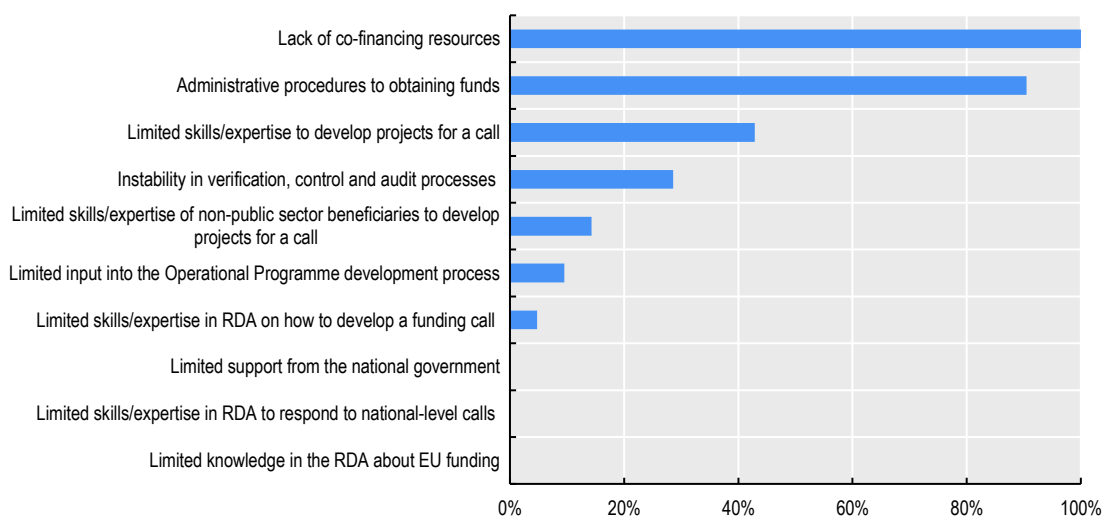


Note: Survey question: Please specify the sources of co-funding that the RDA can provide to obtain project funding when co-financing is required (for example to obtain certain EU funds). Response options: Inter-governmental grants or subsidies; Borrowing/loans; County-level own-source revenue.

Source: Author's elaboration, based on the 2022 OECD online survey (OECD, 2022^[38]).

Nevertheless, Figure 2 does not imply that co-financing sources are sufficient across all counties, or that they are accessed without any challenges. In this regard, all 21 RDAs in Croatia indicate a general lack of co-financing resources as the main challenge to accessing and managing EU funding (Figure 3) (OECD, 2022^[38]). Smaller counties may find it more difficult to access and repay loans, and poorer counties may not be able to raise as many own-source tax revenues as wealthier ones. Ensuring that counties—and local self-governments—are able to access and provide the needed co-financing should be a priority in order to provide counties and local self-governments with equitable access to funding.

Figure 3. EU funding challenges



Note: Survey question: What does your RDA perceive to be the 3 main challenges to managing EU funding? Response options: Limited knowledge in the RDA about EU funding (including guidelines and procedures); Limited skills/expertise in your RDA on responding to national-level project calls; Limited support from the national government (e.g. training, guidelines, templates, etc.); Limited skills/expertise in your RDA on how to develop a funding call; Limited input into the Operational Programme development process; Limited skills/expertise of non-public sector beneficiaries (e.g. private sector, civil society, academia) to develop projects in response to a call; Instability in verification, control and audit processes; Limited skills/expertise in local self-government beneficiaries to develop projects in response to a call; Administrative procedures and documentation required for obtaining and managing funds (administrative burden); Lack of co-financing resources for beneficiaries

Source: Author's elaboration, based on the 2022 OECD online survey (OECD, 2022^[38]).

As can be seen in Figure 3, RDAs also face other challenges in managing EU funding. For example, RDAs indicate that administrative procedures and documentation required for obtaining and managing funds is cumbersome and time-consuming. This is especially challenging for RDAs with fewer staff (OECD, 2023^[41]). Accessing EU funds also requires specific technical skills to develop projects in response to an EU call, which represents a challenge in nine RDAs. Croatian RDAs do consider themselves well-equipped in terms of sufficient expertise to respond to national-level project calls and believe that the support from national government is sufficient and does not constitute a challenge (OECD, 2022^[38]).

RDAs also consider that the national government could support funding for regional development initiatives in different ways. Over half of RDAs (15) would welcome more training on how to mobilise public funding for regional development initiatives. Furthermore, RDAs consider it desirable to establish and maintain a national fund to help co-finance EU projects. Only two RDAs consider that the mandate of counties to borrow from national and international financial organisations should be expanded (OECD, 2022^[38]).

One-third of RDAs (7) consider that the national government should better support them in establishing PPPs, which are currently underutilised in Croatia (OECD, 2022^[38]). In fact, only one RDA reports having established PPPs, covering the energy, environment, healthcare, and housing sectors. Despite some interest from RDAs in employing these instruments, the underutilisation of PPPs may be explained by the high level of public distrust in PPPs and/or in any sort of co-operation between the public and private sectors, more generally—indeed, 17 out of 21 RDAs consider this to be one of the largest obstacles to establishing PPPs. According to RDAs, other hurdles are the lack of support and guidance from the national government to establish PPPs as well as the regulatory uncertainty around them (OECD, 2022^[38]).

Despite the critical role of EU funds in supporting Croatia's regional development initiatives, lack of co-funding resources emerges as a significant hurdle for accessing and managing these funds among all 21

RDAs, especially the smaller and/or poorer ones. As the country moves forward with the implementation of its regional development policy, exploiting other funding sources (such as county-level taxes, inter-governmental grants, borrowing and, under the right circumstances, PPPs) and closer co-ordination with the national government in setting its regional development priorities will be crucial to ensure the sustainability of regional development initiatives.

2. Towards the sustainability of RDAs

RDA funding varies across OECD countries

RDAs in OECD countries employ various funding models to sustain their operations and support regional development initiatives. These funding models can differ based on the specific country and the structure of their RDAs.

Many RDAs, such as those in Austria, Italy, and Spain, receive most of their funding through government transfers or grants. National and/or regional governments allocate budgets to RDAs to finance their activities. These grants can cover a range of expenses, including staff costs, infrastructure development, research, and project implementation. Government grants ensure a stable and reliable source of funding for RDAs, allowing them to carry out their mandate of promoting regional development.

In some EU Member States (e.g. Poland, Romania), RDAs can access funding through EU programmes. The EU usually provides in its funding schemes for regional development several allocations related to technical assistance which can serve to cover, at least for a set period of time, the operational costs of RDAs, build their capacity in order to guarantee the absorption of funds, and thus support projects that align with their priorities.

Some RDAs, especially those established as limited liability companies, generate a part of their revenue through commercial activities or services they provide. For example, an RDA may operate business incubators, offer training programmes, or provide consultancy services, charging fees to participants or clients. Revenue generated from these activities can be reinvested into the RDA's operations and used to fund other regional development initiatives. This is the case of Navarre Development Society (SODENA) in Spain and that of Invest in Bavaria, in Germany, both of which provide tailored investment support, business advisory services, technology transfer support, and financial assistance programmes to regional companies. The fees and revenues earned contribute to their operational budget.

Albeit less frequent in the OECD, some RDAs have a membership-based funding model. In this approach, businesses, organisations, and individuals become members of the RDA by paying annual membership fees. These fees contribute to the RDA's budget and provide a sense of ownership and engagement for the members. The funds raised through membership fees can be used to finance various activities, such as advocacy, networking events, business support services, and capacity-building programmes. For example, Romania's RDAs are partly funded through a contribution of their members (e.g. councils) (West RDA, 2022^[42])

An analysis of RDAs across OECD countries points to an important conclusion. Despite the existence of several models, most funding for RDAs comes from government grants, in particular from the national government. Securing the national government's commitment to properly fund RDAs to enable them to devise and implement regional development policies is key, particularly in cases where RDAs are

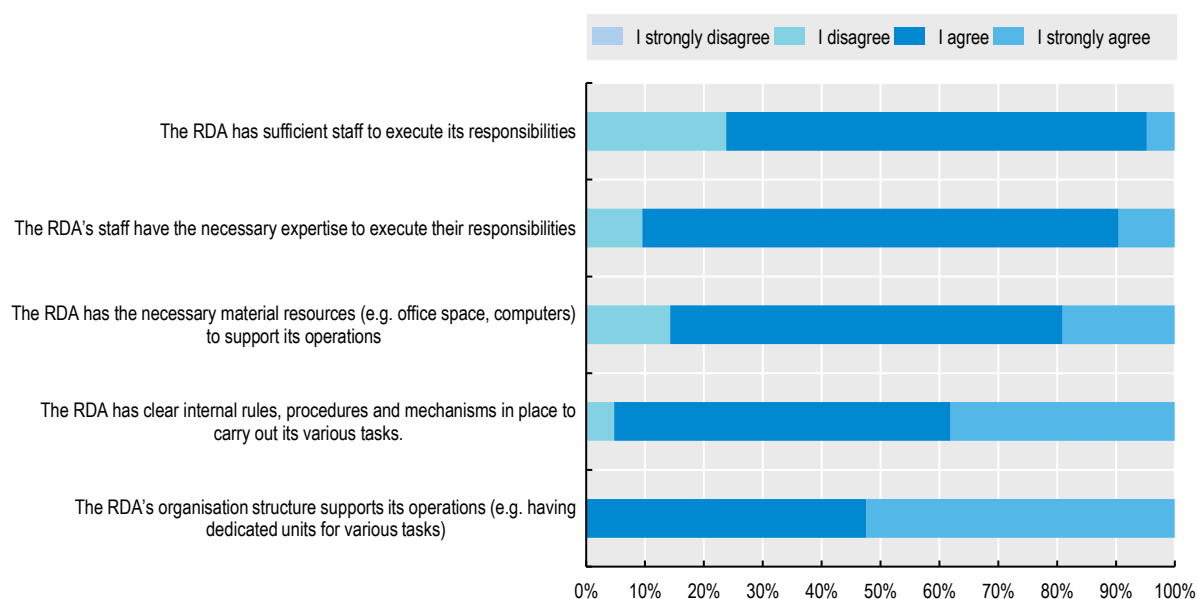
responsible for a wide range of tasks, from strategic planning, to supporting innovation, or managing stakeholder networks, for example.

Focusing on RDA funding in Croatia

Croatian RDAs are funded through various sources of financing to support the design and the implementation of their regional development strategies. Croatian RDAs rely heavily on EU technical assistance funds that have so far been used to fund their own staff and other operational costs: EU technical assistance funding generally represents from 70% to 85% of total funding for RDAs, the rest of it coming from county budget allocations (OECD, 2023^[41]; OECD, 2022^[38]). As this source of EU funding will be significantly reduced by the end of 2023, the financial sustainability of RDAs and their strategies and activities may be endangered unless alternative sources of funding can be found. Conversations on how, and to what extent, the government can support the RDAs financially in the short-term are ongoing.

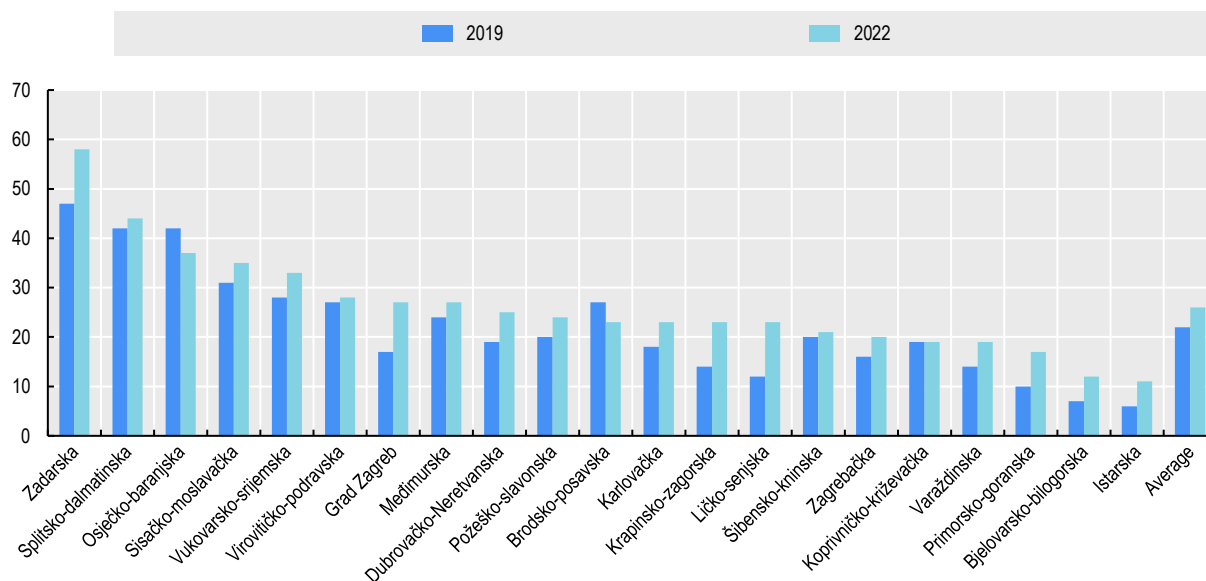
For the time being, according to the results of the OECD survey, 16 RDAs consider that they have sufficient staff to execute their responsibilities (Figure 4) (OECD, 2022^[38]). Indeed, the average number of staff increased from 22 to 26 between 2019 and 2022 (Figure 5). Nonetheless, several RDAs still believe that they are understaffed, including three whose operational budget is among the highest and two which are among the lowest operational budgets. Although material resources and human skills could be improved according to some RDAs, in general RDAs currently appear to work with an adequate level of resources.

Figure 4. Current resources of Croatia's RDAs



Source: Author's elaboration, based on the 2022 OECD online survey (OECD, 2022^[38]).

Figure 5. Total staff per Croatian RDA



Note: Only Osječko-baranjska and Brodsko-posavska reported a decline in the number of staff between 2019 and 2022.

Source: Author's elaboration, based on the 2022 OECD online survey (OECD, 2022^[38]).

As Croatia moves forward with the implementation of its regional development policy, there is a need to address the dependence of RDAs on EU funds to cover their operational costs, especially considering the considering proposed changes in EU technical assistance funding for RDAs post-2023. Exploring alternative funding sources for RDAs becomes crucial in this context. While RDAs currently have sufficient resources to fulfil their tasks, concerns arise regarding their future staffing and material capacities once EU funding diminishes. To mitigate this, potential funding options may include increased inter-governmental grants from the national government to the counties, granting RDAs the status of limited liability companies to offer paid services, and introducing a membership-based model where RDAs can generate revenue through annual fees. Securing EU projects that have the capacity to fund the salaries of staff members can also potentially help cover operational costs. However, it is important to note that the presence of staff members would be contingent upon successfully obtaining such EU projects. This approach may offer an incentive to accumulate projects for the operational sustainability of the RDA and could shift the focus more towards securing projects rather than effectively addressing the specific regional development priorities of each RDA.

3. Fostering inter-regional co-operation and joint projects for regional development

Mobilising funding and financing and delivering effective public investment for regional development is not easy. It requires understanding development priorities and investment needs and aligning investment delivery among levels of government. It also involves ensuring that governments at all levels have adequate financial and human capacities, for example to design project proposals and manage procurement processes. In addition, it requires co-operating and investing at the right scale (OECD, 2022^[1]; OECD, 2014^[2]). In fact, functional areas rather than administrative boundaries are often most important for effective regional development policy and investment (OECD, 2019^[1]). For example, different regional or local governments may face similar development challenges (e.g. population shrinkage, flooding) requiring common solutions. Similarly, individual regional or local governments may not have the human or financial capacity or scale to provide cost-efficient public services (e.g. waste or water management, public transportation). In such instances, working together on a regional level can help ensure that quality public services can be delivered, including in remote areas. Finally, enhanced co-ordination across subnational governments can generate synergies among policies of neighbouring (or otherwise linked) regional or local governments. This is typically the case for physical infrastructure investment, where the most efficient scale often exceeds the administrative boundaries of individual regions of local governments (OECD, 2019^[43]).

Inter-regional co-operation mechanisms vary across OECD member countries

A range of mechanisms has been adopted across OECD countries to support inter-regional co-operation. One mechanism relates to the design of joint investment strategies among regions (or counties, in the case of Croatia). This is the case for Canada's Atlantic Growth Strategy, which brings together the provinces of Nova Scotia, New Brunswick, Prince Edward Island, and Newfoundland and Labrador to collaborate on initiatives such as infrastructure development, innovation, and skills training (Government of Canada, 2022^[44]). Another example comes from Germany where the federal states of Rhineland-Palatinate, Saarland, and the Lorraine region of France have established the Future Region Westpfalz (*Zukunftsregion Westpfalz*). This body, which groups over 300 representatives from regional governments as well as non-governmental actors, serves as a platform to collaborate on various investment projects, including research and innovation, infrastructure, and cross-border co-operation to promote economic development in the region (ZukunftsRegion Westpfalz, n.d.^[45]).

Another mechanism to foster inter-regional co-operation is through the establishment of joint authorities. These entities, which can be public and non-governmental actors, typically bring together representatives

of regional and/or local governments that are involved in the specific areas where the joint authorities will be allowed to legislate. For instance, the West Midlands Combined Authority is a joint authority established in the UK, comprising 17 local councils and three local enterprise partnerships in the West Midlands region (West Midlands Combined Authority, n.d.^[46]). The Combined Authority is responsible for strategic planning, economic development, and investment co-ordination throughout the region. It brings together local government leaders and promotes collaboration (OECD/UCLG, 2019^[47]; OECD/UCLG, 2022^[39]). Other examples of public and non-governmental actors established to support inter-regional co-operation in the field of regional development come from Romania and Wales, United Kingdom (Box 2).

Box 2. Examples of mechanisms for improved inter-regional co-operation

Romania's regional development agencies

In 1999, Romania established eight development regions that align with the country's NUTS 2 regions. In addition, it formed a regional development council and agencies in each region, along with a framework for the elaboration, implementation, and assessment of regional development policies. The RDAs, which operate as non-governmental organisations, are responsible for encouraging territorial development and boosting regional attractiveness. They are charged with drafting and implementing territorial development strategies, plans and programmes (including smart specialisation strategies). They also support the implementation of regional development projects financed by the European Union. In addition, RDAs contribute to attracting foreign investments, offer business support services and promote innovation. The oversight of each RDA falls under a regional development council, composed of counties and local self-governments, and can include representatives of non-governmental organisations such as business chambers and academic institutions. The councils are responsible for reviewing and approving the RDAs' regional development planning documents.

Between 2007 and 2020, Romania's regional development agencies operated as intermediary bodies for the implementation of EU cohesion funds. However, in 2021, the RDAs became regional managing authorities. As such, the eight agencies are now entrusted with the task of designing and implementing the EU-funded Regional Operational Programmes 2021-2027. In practical terms, this shift in responsibility translates to the agencies being responsible for the management of EU funds exceeding EUR 1 billion per development region.

Wales's Corporate Joint Committees

In order to deal more effectively with regional cross-boundary issues (e.g. housing and transport), and provide a strategic approach to planning at a greater scale than local development plans, Wales created four Corporate Joint Committees (CJCs) in 2021, one in each of four development regions. The CJCs are regional corporate bodies, on which sit representatives of local self-governments. Their primary responsibilities encompass spatial planning, regional economic development planning, and regional transport planning. The goal is to generate more effective planning outcomes for communities by ensuring that key development needs and associated development projects and infrastructure are planned in an integrated and comprehensive way across a broader geographical area.

Source: Romania: (ROREG, 2022^[48]; EURADA, n.d.^[49]); Wales (OECD, 2020^[3]; Welsh Parliament, 2022^[50]).

Lastly, enhancing inter-regional co-operation can also be achieved by introducing a new level of governance or by modifying the existing institutional framework governing the responsibilities and resources of subnational entities. This approach might involve merging smaller regions or local governments. Indeed, such changes to the institutional framework would subsequently affect the allocation of responsibilities and resources within the country, paving the way for improved inter-regional

collaboration. For example, in 2015, France passed a reform that reduced the number of regions from 27 to 18. The reasons for this were numerous but included a desire to reinforce strategic planning capacities and support economic development. Another example comes from Greece, which, in 2010-11, created a new level of regional government consisting of 13 full self-governing regions. These regions were granted new responsibilities in the fields of regional planning and development. An additional example comes from Poland. In 1999, it reduced the number of top-tier administrative regions (*voivodeships*) from 49 to 16 and provided them with new responsibilities, including regional development planning, higher education, regional infrastructure development and the management of EU funds (OECD/UCLG, 2022^[51]) (OECD, 2022^[52]; OECD/UCLG, 2022^[53]).

A closer look at inter-regional co-operation in Croatia

Croatia's 21 RDAs are central actors in the country's regional development ecosystem. They are responsible for encouraging development at the county level, for example by designing and implementing territorial development strategies that are aligned with the National Development Strategy 2030. They can also support county and local self-government strategic planning efforts and help them mobilise and implement EU funding. As explained below, since 2017, there have been several initiatives to increase co-operation among Croatia's RDAs—which operate at the NUTS 3 level—in order to strengthen regional development outcomes.

Croatia's regional development agencies operate more locally than many of their EU peers

Compared to many other EU and OECD countries, the Croatian RDAs act on a very local level (Table 1). In 2021, the average population of a Croatian county—the level at which the RDAs operate—was almost 185 000. This is similar to that of Slovenian RDAs (175 584), which also operate at the NUTS 3 level. In comparison, the average population of the areas covered by RDAs in the Netherlands, Portugal, Romania, Spain, and the Republic of Türkiye ranges between 1.1 and 3.2 million inhabitants. In these countries, almost all RDAs operate at the NUTS 2 level.

Table 1. RDAs and similar bodies in different EU and OECD countries

Country	Population 2021	Number of RDAs (or similar entity)	Average population per RDA (or similar entity)	NUTS or TL level at which RDAs (or similar entity) operate
Croatia	3 878 981	21	184 713	TL3
Slovenia	2 107 007	12	175 584	TL3
Costa Rica	5 163 038	6	860 506	TL2
Scotland (United Kingdom)	5 480 000	3	1 826 667	NUTS 2 and above
Portugal	10 297 876	5	2 059 575	NUTS 2
Netherlands	17 533 406	9	1 948 156	7 RDAs overlap with one NUTS2 area. 2 RDAs cover 2 NUTS areas
Romania	19 124 061	8	2 390 508	NUTS 2
Spain	47 331 545	19	2 491 134	NUTS 2
Turkey	84 147 326	26	3 236 436	NUTS 2

Note: *Lithuania's regional development councils are collegial bodies, composed of municipalities' mayors. They are responsible for development planning, not for encouraging regional investment. **Finland's Centres for Economic Development, Transport and the Environment promote regional development by managing the central government's implementation and development tasks in the areas coming under them.

Source: Population data, except for Scotland: (OECD, 2022^[54]); Costa Rica: (OECD/UCLG, 2022^[53]); Lithuania: (OECD/UCLG, 2022^[53]); Netherlands: (Netherlands' Regionale Ontwikkelingsmaatschappijen, n.d.^[55]); Portugal: (EURADA, n.d.^[56]); Romania: (ROREG, 2022^[48]; EURADA, n.d.^[49]); Scotland (United Kingdom): (Office for National Statistics, 2022^[57]; Scottish Hub for Regional Economic Development, n.d.^[58]); Slovenia: (Republic of Slovenia, 2023^[59]); Spain: (Foro ARD, n.d.^[60]; EURADA, n.d.^[61]); Turkey (OECD, 2019^[62]).

There can be benefits to organising regional development planning and investment at the NUTS 3 level. For example, the proximity of the RDAs in Croatia and Slovenia to local self-governments, civil society organisations, local businesses and citizens can help them design development plans and investment strategies that closely match local development needs, priorities and capacities.

Operating at the NUTS 3 rather than the NUTS 2 level, however, can also present a series of challenges. First, it can lead to a suboptimal use or fragmentation of investment funds, as many small projects implemented at the county level might tackle similar issues that could benefit from inter-regional intervention (OECD, 2022^[63]). In fact, small scale development projects can result in lower returns on public investment. Small scale projects may even have an insufficient minimum scale for the investment to be viable at all (OECD, 2019^[43]). Second, not all RDAs operating at the NUTS 3 level might have the necessary technical skills and expertise available to design, implement, and monitor robust development strategies and investment projects. Third, the availability of data on a wide range of indicators (e.g. economic, labour, productivity) is often greater at the NUTS 2 level than at the NUTS 3 level. The higher data availability at the NUTS 2 level can facilitate the design of regional or inter-regional development and investment strategies that closely match current development trends (OECD, 2019^[43]).

Croatia's experience with inter-regional co-operation mechanisms

In recent years, Croatia has set up different regional co-operation mechanisms to address development challenges shared by counties and achieve economies of scale. For example, in 2017, the Council for Slavonia, Baranja and Srijem, which groups five counties located in eastern Croatia, was established as an advisory body to support the management and absorption of EU and national funding. By 2022, this initiative, which was supported financially by the EU, had resulted in EUR 2.6 billion worth of contracted projects, some of them implemented at the macro-regional (inter-county) level, while others were implemented in specific counties. Examples of projects include the construction of a fruit and vegetable distribution centre, waste management centres, the rehabilitation of railways, and the refurbishment of monuments (Government of the Republic of Croatia, 2022^[64]; Croatian Ministry for Regional Development and EU Funds, n.d.^[65]).

Based on the success of the Slavonia, Baranja and Srijem development agreement, five counties located in northern Croatia requested a similar co-operation agreement, which was signed by the county prefects and the national government in 2021. Its objective is to increase the macro-region's competitiveness and enhance citizen well-being by mobilising funding for projects in areas such as transport, mobility, education, and tourism (Government of the Republic of Croatia, 2021^[66]). As part of this agreement, 36 projects worth over EUR 2 billion should be implemented. As this initiative still in its early stage of implementation, there is still some uncertainty about how the co-operation agreement of the northern counties will be fully funded.

In addition, Croatia also recently launched the "Dalmatinska Zagora" and "Gorski Kotar" regional development programmes. These initiatives focus on the economic and social revitalisation of the Dalmatian hinterland and north-western mountainous areas, respectively. Croatia aims to fund these programmes, which will include investment in social and economic infrastructure and be implemented in co-ordination with local self-governments, through a combination of EU and national-level funding (Croatian Ministry of Regional Development and EU Funds, n.d.^[67]; Croatian Ministry of Regional Development and EU Funds, 2023^[68]). Croatia's regional development agencies consider there is much value in regional co-operation and exchange. Yet, the uncertainty over how the northern development agreement, which is still in its early stages of implementation, will be funded has generated doubt among the agencies regarding the benefits of entering into similar co-operation agreements (OECD, 2023^[41]). This raises the question of how Croatia can further encourage inter-regional co-operation to improve territorial development outcomes. In this regard, experiences from other EU and OECD member countries, including Romania, can serve as examples.

Conclusion

Funding and financing regional development is not straight-forward. Many regional and local governments in OECD countries face similar challenges to fund and finance their regional development priorities, strategies, and projects. These challenges can be classified into three main groups:

1. **Ensuring a mix of funding and financing sources for regional development** strategies and projects. This includes leveraging EU funds, inter-governmental transfers, national funds for regional development, own-source revenue, international financial institutions, public-private partnerships, and private finance. This diverse range of sources can be used by national and subnational governments to reduce territorial disparities, finance regional development projects as well as to finance bodies in charge of the effective implementation of regional development policies.
2. **Establishing robust institutional structures for RDAs that avoid un- or underfunded mandates.** Adequate funding should be allocated to cover operational expenses, including staff costs, to enable RDAs to effectively pursue regional development goals. Uncertainty or instability in funding can hinder the achievement of these objectives.
3. **Enhancing inter-regional co-operation mechanisms** to benefit from economies of scale, improve co-ordination, enhance efficiency, and achieve higher returns on investment. By implementing projects at the appropriate geographic scale and establishing mechanisms that facilitate co-operation between regions, the benefits of funding can be maximised, and operational efficiency can be enhanced.

Croatia, similar to several OECD member countries, faces challenges in funding and financing regional development projects, the sustainable funding of RDAs, and the promotion of inter-regional co-operation mechanisms. These are among the topics that will be explored in detail with Croatian and international policy makers during the forum “Towards Sustainable Financial Mechanisms for Regional Development in Croatia”. This forum, taking place on 15 and 16 June 2023, is organised by the OECD and the Croatian Ministry of Regional Development and EU Funds as part of the “Enhanced Strategic Planning at Regional and Local Levels in Croatia” project. The project is funded by EEA and Norway Grants.

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