NALAS
Network of Associations of
Local Authorities of South-East Europe

Fiscal Decentralization Indicators for South-East Europe: 2006–2015

REPORT

May 2017

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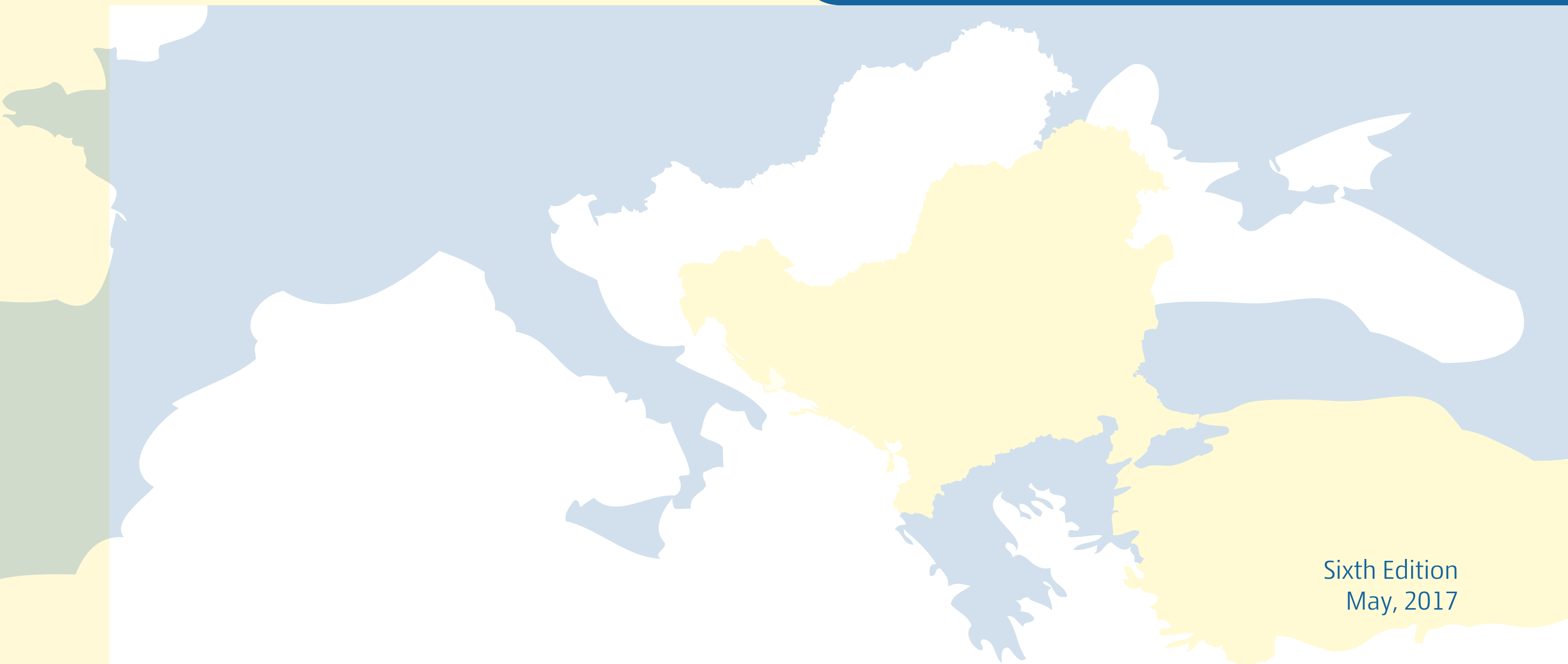
2006-2015



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THE REPORT IN BRIEF:

Over the last 20 years, efforts to decentralize public services to democratically–elected local governments has been a common theme across South–East Europe. Progress however has been uneven, and there are few places in the region where local government revenues or expenditures approach EU averages, either as percentages of GDP or of total public revenue.

The region is quite diverse in terms of territorial organization – the number of sub–national levels of governance varies from one to three in the different countries. The number of 1st tier of local governments (the closet to the citizens) varies greatly – from 23 in Montenegro to 3,181 in Romania. In 2015, Albania, in line with attempts elsewhere Europe, optimized its local governments sharply reducing the number of the 1st tier units from 373 to 61. The average population of 1st tier local governments in SEE is over 19,000. This compares to the EU28 average of 5,600) and thus seems to be very favorable –other things being equal– for decentralization efforts.

At the same time, however, in many places in SEE, economic activity and political power is concentrated in capital cities, which contain disproportionate shares of the total national population (10% on average, compared to 7% in EU28). In Albania, Serbia, Macedonia and Montenegro over 20% of citizens live in capital cities. This trend widens the revenue potential gap between the capital city and the others.

The global downturn of 2008–2009 hit much of the region very hard. Slovenia and Croatia were hit hardest by the crisis and recovery took the longest. For Croatia and Serbia, 2015, is the first year of growth. Macedonia, Albania and Kosovo[1] have been least affected by the crisis. For the region, GDP grew about 40% in per capita terms since 2006. This is a good achievement, but there is considerable variation across the group in both relative wealth and GDP growth. Moldova has the lowest per capita income in both 2006 and 2015, and is ten times poorer than Slovenia, itself 35% poorer than the EU average.

Central governments often responded to the fiscal pressures of the crisis by making ad hoc adjustments in transfer systems that compounded the negative effects of the recession on municipal budgets. In some places, however, the fall in global economic activity had relatively little impact on the domestic economies of the region or this impact was delayed.

While it is always difficult to judge the adequacy of local government revenues relative to their expenditure needs, there seems little question that in many places in the region municipalities are underfunded, and that central governments are not giving them a fair share of the overall fiscal pie. On average, SEE local government revenue as a share of GDP stood at 6.3%, almost half EU28 average of 11.3%. Similarly, local government revenue as a percentage of total public revenue in the region is low when compared to the EU28 (17% vs. 25%).

This report continues to explore the relations between 1) levels of decentralization, 2) the scope of the social functions devolved to the local governments and 3) the size of the public sector. Previous trends and conclusions have been reconfirmed again in 2015.

1 "This designation is without prejudice to positions on status, and is in line with UNSC 1244 and the ICJ Opinion on the Kosovo declaration of independence."

Underfunding is particularly obvious in Albania and the Federation of Bosnia and Herzegovina (BiH) despite the fact that in both, municipalities have few social sector responsibilities. Municipalities in Macedonia and Bulgaria also appear to be significantly under–resourced, though here the underfunding of basic municipal services is intertwined with the underfunding of primary and secondary education, which in both countries has been devolved to local governments.

Romania and Kosovo are at the other end of the spectrum. Here, local governments pay for all pre–university schooling, as well as for much of primary healthcare. But their revenues, both as a share of total public revenues and of GDP are closer to the average for the EU. On paper, the situation is similar in Moldova, but central and regional control over municipal budgets makes these indicators highly misleading.

With two exceptions, all countries with public sectors equal to less than 40% of GDP, have devolved responsibility for paying the wages of primary and secondary school teachers to local governments. Even more striking is the fact that all four countries that have very small public sectors (less than 35% of GDP) have devolved primary and secondary education to local governments.

Surprisingly then, decentralization has gone furthest in places where higher–level governments have trouble collecting taxes and the overall public sector is relatively small. The correlation between small public sectors and the decentralization of social sector functions to local governments –particularly primary and secondary education— suggests that in some places national governments have sought to relieve themselves of the burden of administering services they feel they can't afford to adequately finance themselves.

In order to assess more objectively the quality of decentralization in terms of local autonomy over the spending decisions, it is important to analyze the local revenues sources. With the notable exception of Montenegro, municipalities in SEE derive only about 35% of their revenue from sources over which they have some control. The rest comes from some combination of Unconditional Grants, Conditional Grants, and Shared Taxes, particularly shared personal income tax.

This level of dependency on central government transfers is, however not unusual. Indeed, it is in line with the average for OECD member–states. Moreover, "transfer dependency" in the region increases as social sector functions are devolved to municipalities, a trend that is also in line with experiences elsewhere. Despite this similarity in the overall trend, the main difference lies elsewhere: in local governments' limited decision–making authority to better target the service. From this prospective, the problem in most SEE countries can be defined as:

1) Small public sector and

2) Conditionality, imposed by the grants from the central government, which transform local governments into paying agents thus limiting the local self–governance.

The reason for this is relatively simple and easy to explain politically: Central governments that have difficulties with revenue collection, devolve social sector functions to the local governments while at the same time making them more dependent on conditional grants. This has important policy implications: by limiting the municipal spending decisions, central government create strong local disincentives for efficient service delivery in the social sector. This report advocates for shifting the focus of the intergovernmental dialogue towards the spirit and the requirements of article 9 of the European Charter of Local Self–Government (adopted by all SEE countries).

In much of SEE, municipalities derive significant amounts of own–revenue from quasi–fiscal instruments imposed on real–estate transactions, new investment, and business operations. Central governments in a number of places have started to constrain these practices in order to improve the "business enabling environment". As legitimate as these efforts may be, they are compounding the financial problems of local governments in a number of places and should be accompanied by efforts to replace the lost revenue.

With the exception of Croatia and the Federation of Bosnia Herzegovina, the Property Tax has been decentralized throughout the region. In most places, municipalities have substantially improved the yield of the tax – in ten years it has increased considerably – from 5.5% of total local government revenue in 2006 to 8% in 2015. With the exception of Montenegro, the region still generates revenue less than 0.5% GDP; in the EU, the recurrent taxes on immovable property account for 1.6% of GDP (2014). While achieving EU norms is certainly desirable, it alone will neither solve the region's problem with underfunding nor radically increase the "fiscal autonomy" of the region's municipalities.

Instead, efforts to enhance the revenue raising capacities of local governments in many places should focus on transforming the Personal Income Tax from a Shared Tax into a tax over which local governments have some rate–setting powers. This can be done by giving them the right to impose a surcharge on the rate set by the central government, as is already practiced in Montenegro and Croatia. Or "PIT space" can be divided between the national government and local governments, as is currently being considered in Bulgaria.

In most of the region, local governments are spending higher shares of expenditure on investment than their counterparts in the EU, despite receiving significantly lower shares of total public revenue. This suggests that municipalities in South–East Europe are working hard to make–up for the infrastructure deficits they inherited from the past. Since 2009, however, investment rates have fallen significantly in most of the region, and in a number of places are holding their own only because of the influx of EU structural funds.

Scarce investment funds also tend to be spent on pay–as–you–build road projects and not on pay–as–you–use environmental facilities. This is because planning roads is simpler; construction can be delayed if money runs out; tangible benefits can be delivered within a single election cycle; and because in much of the region municipal borrowing remains a marginal phenomenon.

In Albania, Croatia, Montenegro, Serbia and Slovenia, the consolidated debt of the General Government now exceeds the limits set by the Maastricht Treaty. Here, Ministries of Finance are likely to restrict the access of local governments to credit in order to reduce the consolidated public debt and/or to preserve borrowing space for their central governments. In these countries, efforts should be made to reserve some debt space for municipalities and to ease the access of the municipalities to the credit market (*in most SEE countries, the law requires central government's approval prior to local debt issuing*) without undermining the guiding principles for prudent borrowing.

More generally, however, the adequacy and predictability of local government revenues will have to be improved, if municipalities are to have the resources against which to prudently incur debt. Part of the answer here is to increase the own–revenue raising powers of municipalities by strengthening property taxation and/or by introducing local PIT surcharges. And part of the answer lies in enhancing and stabilizing transfer systems, efforts that almost everywhere pay particular attention to questions of horizontal equity.

Finally, and perhaps most importantly, national and local government officials need to recognize that decentralization actually intensifies the need for continuous, informed and substantive intergovernmental dialogue, and that like it or not, the fate of national and local governments are linked together at the hip.

INTRODUCTION

This report has been prepared by the Fiscal Decentralization Task Force of the Network of Associations of Local Authorities of South–East Europe (NALAS). It is the sixth edition of an ongoing effort to provide policy–makers and analysts with reliable comparative data on municipal finances and intergovernmental fiscal relations in South–East Europe.

The first edition was published in March 2011 and covered the years 2006–2010. This edition covers the period 2006–2015. As before, the report tries to both capture regional trends, and major developments in particular countries/entities.

The report consists of four sections. The first reviews the data used in the report and discusses some basic methodological issues. The second begins with a presentation of the structure and functions of municipal governments in the region. The third section examines selected indicators of macro–economic performance and fiscal decentralization. The fourth section focuses on the evolution of intergovernmental finances in each NALAS' member country or entity.

I. Data, Terms, and Methodological Issues

The data used in the report has been provided by NALAS members and comes from their respective Ministries of Finance, Central Banks and Statistical Agencies. The data was checked for consistency and compared, where possible, with similar data from Eurostat –the statistical agency of the European Union– and other sources.

Comparing intergovernmental finance systems, however is never straightforward because of differences in how sub–sovereign governments are organized, what they do, and how they get (or don't get) the money to pay for what they do. In the following, we discuss how the report addresses some of the methodological issues involved in making reasonable comparisons with imperfect data.

Levels of Government: The report's primary object of analysis are first–tier local governments, meaning democratically elected municipal or communal authorities. They constitute the most important level of sub–sovereign government in the region and in the report are collectively referred to as municipalities.

What Municipal Governments Do: Throughout South–East Europe, municipalities and communes bear primary responsibility for maintaining and improving local public infrastructure. This includes local roads, bridges, and parks, as well as water supply and sewage treatment, garbage collection and disposal, public lighting, local public transport, and district heating.

In a number of countries/entities, however, local governments are responsible for delivering important social sector services, particularly in education, but also in some places, healthcare. The degree to which local governments are responsible for social sector services has a profound effect on their "fiscal weight" everywhere. It is thus important when reading the report to remember what social sector services local governments are providing in different places. We discuss these issues in greater detail in the next section. But in many of the report's Charts and Tables, places in which local governments are responsible for paying teachers' wages – the single weightiest function devolved to them— are indicated with an asterisk (*).

The Eurostat data for the sub-national level in Croatia include the wages of schoolteachers and some others employed in local institutions even though the national government pays these wages. The data, provided by the LGAs, excludes them, which should be taken into account throughout the various financial data, ratios, charts and comparisons in the report.

Population: In general, the population numbers used in the report are from the most recently conducted censuses. In Albania, Bosnia and Herzegovina, Kosovo and Macedonia however, the results of recently conducted censuses have been abandoned or remain unofficial for political reasons. In these places, we have used either older census data or the data, which the Ministry of Finance is using for grants and transfers calculations. Since there has been a profound demographic decline in most of the region, the use of older census figures significantly inflates the actual number of citizens residing in a given country or entity and distorts the per capita indicators.

GDP: We have used the GDP figures calculated by the respective Ministries of Finance of each country or entity according to the production method. Where we converted GDP into EUR figures for comparative purposes, we have used the average annual exchange rates provided by the relevant Central Banks.

Consolidated Public Revenue of the General Government: To compare the relative importance of local governments across settings we have generally used revenues – and not expenditures – as a share of the consolidated finances of the General Government. This is because data on revenues data tends to be more consistent than data on expenditures at the subnational level. By General Government Revenue we mean the total revenues of the national government and its agencies, including the revenues of off–budget (social security) funds and those of subnational governments. For local governments we have excluded proceeds from borrowing, but included income from asset sales and carry–overs from previous years.

General Grants: In most of South–East Europe, local governments receive freely disposable (unconditional) General Grants from their central governments. In some places, the size of the relevant grant pools are defined by law as percentages of national taxes. Because these funds are allocated by formula, we consider them Grants, despite the fact that in some places they are popularly referred to as shared taxes. Unless otherwise indicated, we use the term Shared Taxes only for national taxes that are shared with local governments on an origin basis.

Conditional and Block Grants: Throughout South–East Europe, local governments receive grants from higher level governments which they can only be use for particular purposes. We refer to grants that must be spent on specific projects or programs as Conditional Grants. Grants that are designed to help local governments fund a particular function (such as primary education), but which they are free to spend across that function as they see fit, we refer to as Block Grants. In many places however, the “block” function of Block Grants is limited due to other centrally imposed constraints on local spending. In the extreme, some “Block Grants” (particularly for primary and secondary education) make local governments little more than the payroll agents of the national government.

Shared Taxes: In most of the region, local governments are entitled to shares of national taxes generated in their jurisdictions (origin–based tax sharing). The most important shared tax is usually the Personal Income Tax (PIT), which is also usually accounted for officially as a Shared Tax. The Property Transfer Tax is also often shared (100%) with local governments but is usually misclassified as an own–revenue. In a few places, the recurrent property tax is shared between levels of government and in Romania, a small fraction of the Corporate Income Tax is shared with regional governments.

Own–Source Revenues: As in much of the world, data on local own–revenue is often poorly maintained and classified. Own–revenues include locally imposed taxes; income from the sale or rental of municipal assets; fines, penalties, and interest; local user fees and charges; and fees for permits, licenses, and the issuance of official documents. Typically, the most important local tax is the Property Tax, though it is often not the single–largest source of own–revenue. Importantly, Montenegrin and Croatian municipalities can impose local surcharges on personal income tax, powers that are being considered in other countries/entities. In many places, the regulation of local fees and charges is weak, allowing local governments to use them as quasi–taxes. Particularly important in this respect are three fees inherited from the (Yugoslavian) past: the Land Development Fee, the Land Use Fee, and the Business Registration Fee (or Sign Tax). In most of the region however, the Land Development and Business Registration fees are being phased–out in the name of improving the local "business enabling environment", while the Land Use Fee is being eliminated or constrained with the introduction or expansion of the Property Tax[2].

EU members in SEE

Measuring and evaluating the different aspects of decentralization is supposed to reflect exclusively the national efforts in this regard. The appropriate fiscal indicators should not be "contaminated" by external, non–domestic, factors. For countries, that are members of the EU (*Bulgaria, Croatia, Romania and Slovenia*), one such factor are the EU funds which flow primarily to the local level. Ideally, the data we have from member Association would clearly identify these grants flows. But, unfortunately, this is often not the case, and in a number of countries EU grants are simply not included in the national data we have. As a result, for the countries that are EU members, there are differences in the data we have on subnational revenues and expenditures and those reported by the EU. In some countries, these difference amount to between 1 to 3% of GDP when local government revenues or expenditures are calculated as a share of GDP.

[2] These fees go under different names in different inheritor states of the former Yugoslavia.

II. Overview of Local Governments in South–East Europe

Number and types of sub–sovereign governments

Table 1 presents the numbers and types of sub–sovereign governments in NALAS– member countries or entities. For the sub–sovereign levels marked in red in the table, no financial data are available so the respective country indicators do not include them.

Table 1: Numbers and Types of Sub–Sovereign Governments[3]

	NALAS Member	Levels of Sub–Sovereign Government	Types of Sub–Sovereign Government	Number of 1st Tier Municipalities
Albania	AAM	2	Counties; Municipalities	61
Bosnia Herzegovina		3	Entities; Cantons; Municipalities	144
FBiH	*SOGFBIH*	*2*	*Cantons; Municipalities*	*80*
RS	*ALVRS*	*1*	*Municipalities*	*64*
Bulgaria	NAMRB	1	Municipalities	265
Croatia	UORH	2	Counties; Municipalities/Communes	556
Kosovo	AKM	1	Municipalities	38
Macedonia	ZELS	1	Municipalities	81
Moldova	CALM	3	Autonomous Province; /Regions; Municipalities/Communes	898
Montenegro	UMMo	1	Municipalities	23
Romania	FALR, ACoR	2	Counties; Municipalities/Communes	3,181
Serbia	STCM	2	Autonomous Provinces; Municipalities	145
Slovenia	SOS	1	Municipalities	212
Turkey	MMU	3	Provincial Self–Governments Regional Self–Government Municipal and Communal Self–Governments	1,397

[3] In 2015, a new municipality was established in Bulgaria after people of several villages voted to dissociate from the existing municipality.

Bosnia and Herzegovina (BiH) is the most complicated and has four–plus levels of government: 1) The state of BiH 2) Two entities: Republic of Srpska (RS of BIH) and the Federation of Bosnia–Herzegovina (FBiH of BiH) – plus the Brcko District; 3) Cantons in FBiH (BiH); and 4) municipalities in both entities, 80 in FBiH and 63 in RS. In FBiH, the entity level government is small and the cantons receive the lion's share of public revenues and provide lion's share of public services, at the cost of both the entity government and local governments. The financial data used in the report for local governments in FBiH does not include the revenues or expenditures of Cantons.

Albania and Croatia both have democratically elected county level governments. In Albania, the *qarks* play a very limited role while in Croatia *zupanije* are more important, though both are small compared to the municipal sector. The situation in **Moldova** is more ambiguous. Moldova has three levels of sub–sovereign government: 1) The autonomous province of Gaugazia 2) *raions* or regions, and 3) communes and municipalities. *Raion* heads are indirectly elected by *raion* councils but operate under strong central influence. They also exercise significant control over the budgets of municipalities and communes. This blurs the distinction between 1st and 2nd–tier governments in Moldova, as well as the distinction between local governments and the territorial arms of the national government. Because education and other social sector functions are still at the raion level, Moldova appears to be a highly decentralized small state but in fact remains quite centralized.

Romania has two levels of sub–sovereign government, communes and municipalities on the one hand and counties or *judets* on the other. *Judets* play a more important than their counterparts in Albania or Croatia, particularly because of their role in healthcare. Nonetheless, communes and municipalities are the fiscally weightier level of government.

In the report, the local revenue and expenditure data for Albania, Croatia, Romania, and Moldova includes both communes and municipalities, and 2nd-tier local governments at the county or regional level.

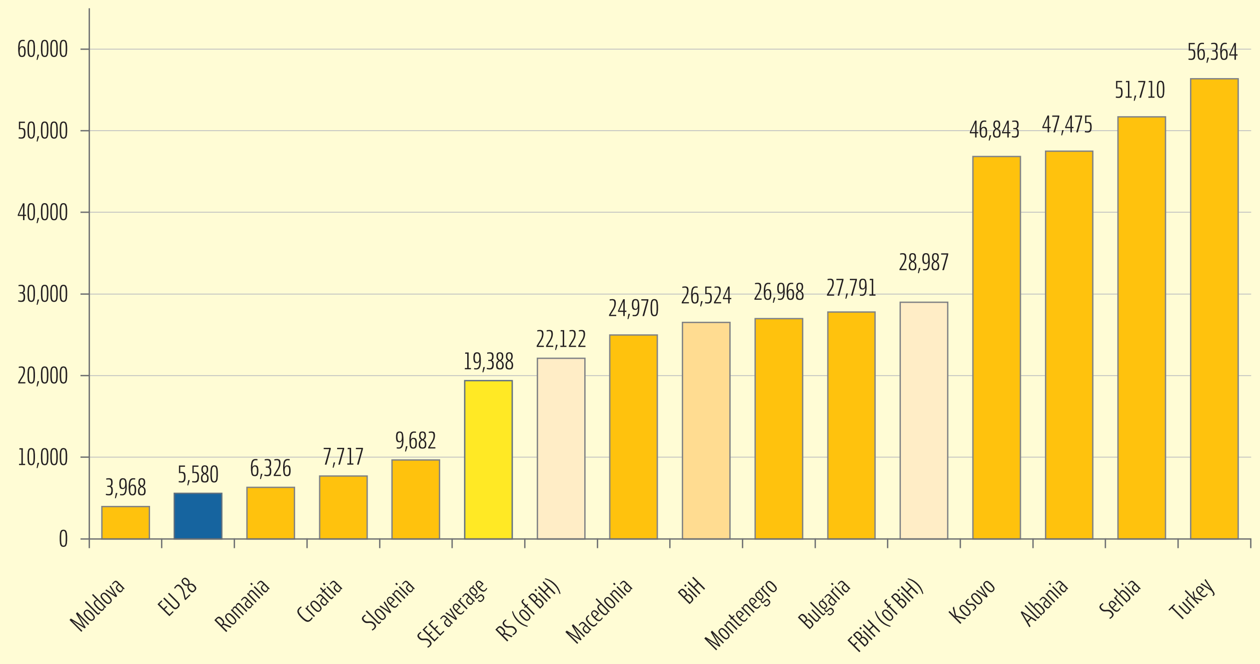
Serbia has two levels of sub–sovereign government: 1) provincial and 2) municipal. The financial data in the report is only for municipalities. **Turkey** has three levels of sub–sovereign government: 1) Provincial Self–Governments, 2) Regional Self–Government and 3) Municipal and Communal Self–Governments. The last one only is considered 1st tier local government but the data on subnational finance covers all of them.

The Average Population of Municipal Governments

The average population of municipal governments differs significantly across South–East Europe. As can be seen from Chart I, Moldova has the smallest municipal governments, averaging less than 4,000 inhabitants. Municipalities in Romania, Croatia, Albania and Slovenia are also relatively small, averaging less than 10,000 inhabitants. Nonetheless, the average size of municipalities in the region (roughly 20,000) is significantly larger than the average for the EU (approximately 5,600).

The EU is quite diverse as well – of almost 91,000 municipalities in the 28 Member States, nearly 80% are located in just five countries: 41% in France, 13% in Germany, 9% in Spain and Italy and finally 7% in the Czech Republic. From this prospective countries such as Austria, Hungary, Cyprus, the Czech Republic, France and Slovakia, are very similar to Moldova and Romania – below 6,000 inhabitants on average per municipality. On the other end of the spectrum Kosovo, Albania, Serbia and Turkey, resemble the UK, Lithuania, Denmark and the Netherlands with over 40,000 inhabitants per municipality.

Chart 1 Average Population of 1st Tier Local Governments

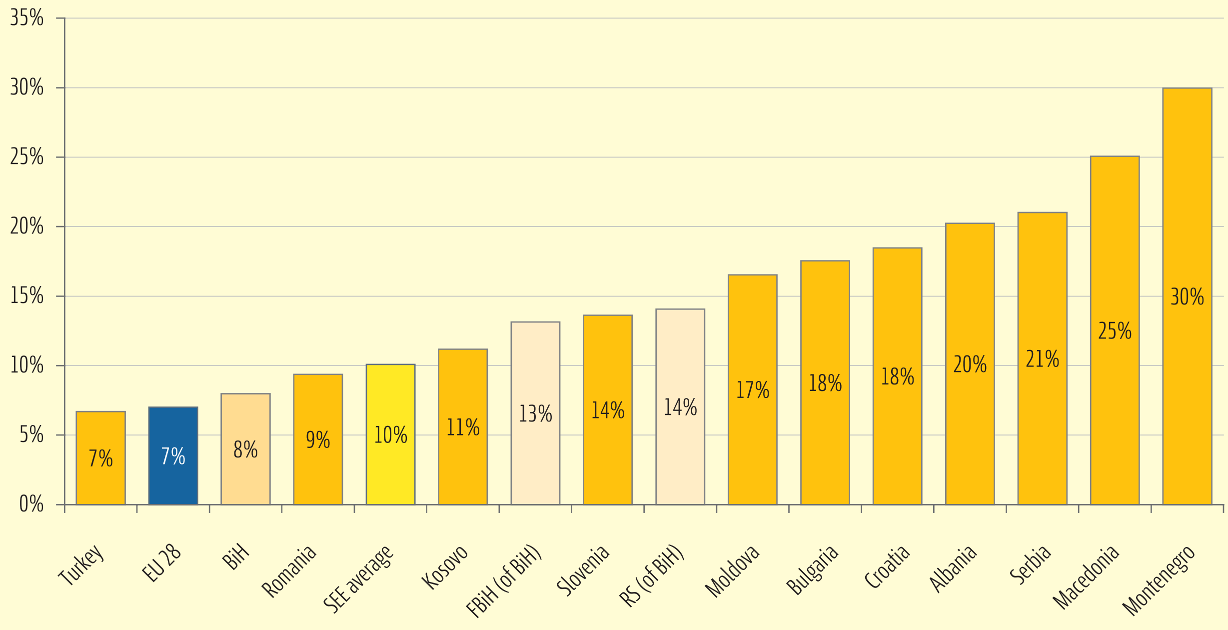


In each country the number of sub-national tiers, the number and size of local governments and service provision responsibilities assigned to them, are the result of many factors including historic traditions and the level of democratic development. It is hard to find clear proofs of the notion that jurisdictional fragmentation is an obstacle to decentralization – the experience of countries such as Hungary and the Czech Republic are examples of the opposite. On the other hand, there are attempts throughout Europe, especially after the economic crises, to optimize the local sector either by municipal mergers or by encouraging various forms of inter-municipal cooperation. This new policy is driven mainly by the need to tackle issues such as high administrative costs, weak tax bases, and human capital shortages associated with small local governments. This trend can be seen in Greece, Germany, Ireland, Finland, Norway, Albania and other countries.

A more plausible causal force working against decentralization is the relatively high percentage of the total population living in capital cities. As can be seen from Chart 2, in most NALAS-member countries/entities much higher shares of the population reside in capital cities than is the norm for the EU.

The oversized importance of capital cities in the region skews economic activity towards a single metropolitan area. This creates several challenges to decentralization and the overall local government development:

Chart 2 Percentage of Population Living in Capital Cities



- Major shifts in needs for public services – the deprived areas suffer labor skills both for business and for public institution. At the same time, the pressure for social assistance increases while the own revenue base shrinks;

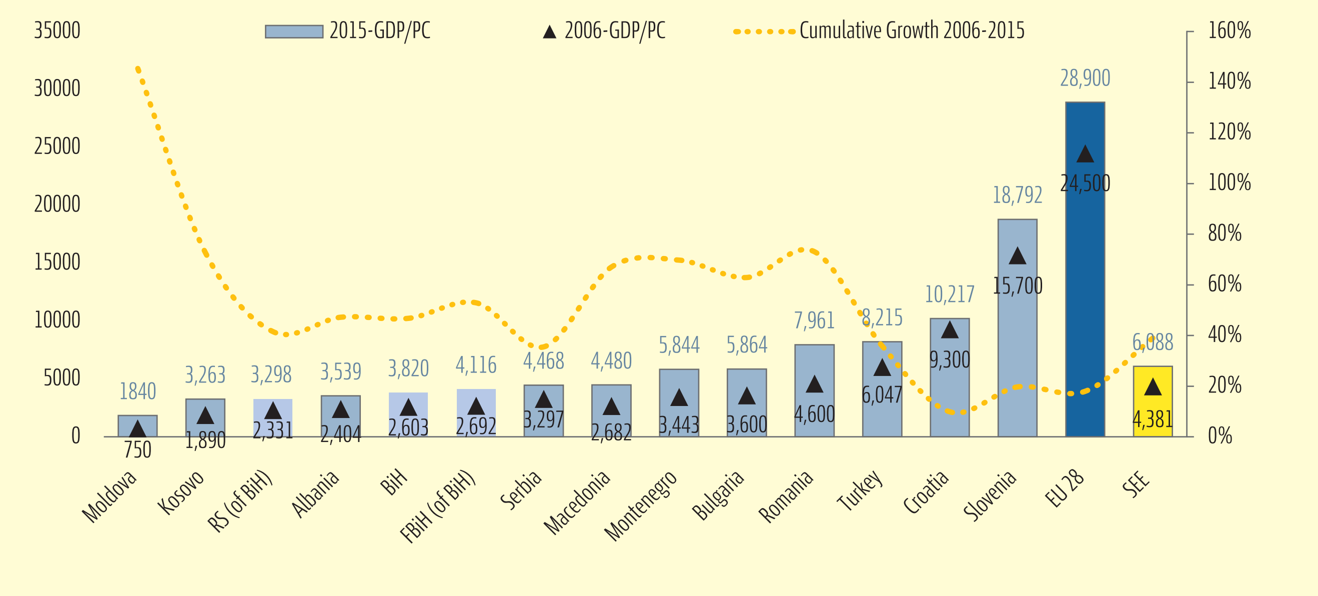
- National governments face a growing dilemma – how to allocate less transfers to the capital cities while increasing the funding for the rest of the country from which the population is often migrating. The typical example is the local infrastructure – maintaining it is not closely related to the population served.

Politically, the struggle of ruling parties to control both the national government and the capital city often complicates efforts to redistribute public revenues to poorer local governments. One of the good, non–partisan, ways to resolve this issue is to periodically adapt the equalizing transfers based on objective and easy–to–measure indicators for the local needs.

The Dynamics of the Gross Domestic Product

Chart 3 presents GDP per capita for all NALAS countries and entities in 2006 and 2015, as well as their cumulative growth rates for the period. The region's growth of 40% is good achievement but might be misleading – there is considerable variation across the group in both relative wealth and GDP growth. Moldova has the lowest per capita income in both 2006 and 2015, and is ten times poorer than Slovenia, itself 35% poorer than the EU average. Nonetheless, Moldova grew the fastest over the period (145%) while Slovenia and Croatia –the wealthiest of the group—have grown slowest.

Chart 3 GDP Per Capita in 2006 & 2015 and GDP Growth 2006–15*

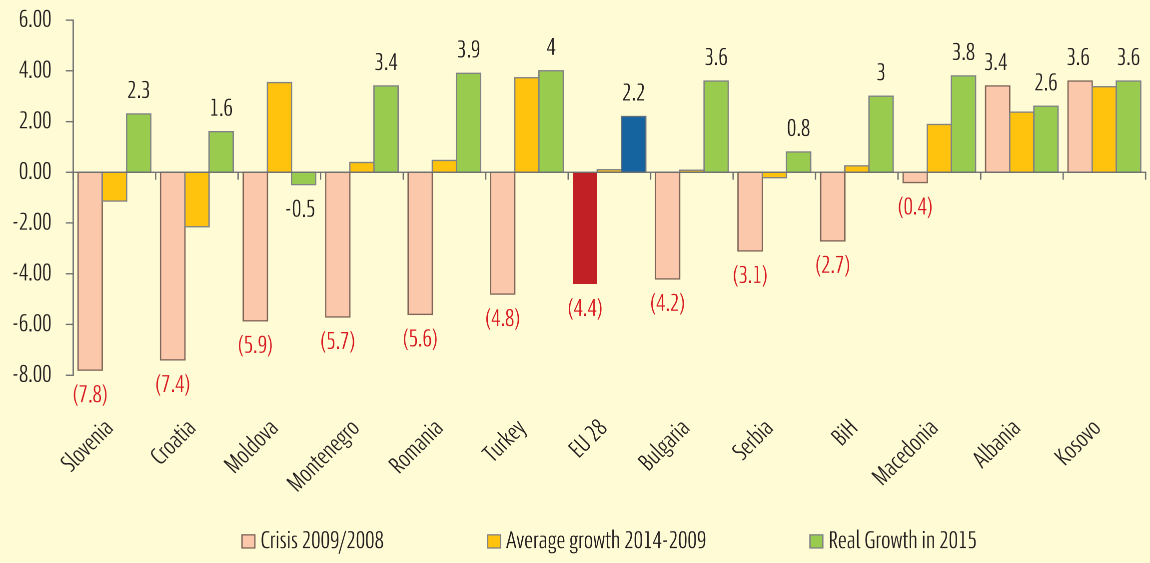


* Eurostat

Some of the variation in economic performance can be explained by the different ways the countries and entities of the region experienced the economic crisis of 2008–2009. As can be seen from Chart 4, Slovenia and Croatia were hit hardest by the crisis and have taken the longest to recover. In 2015, Slovenia records the second consecutive year of growth while for Croatia and Serbia this is the first year of growth, even though a modest one.

The crisis hit Moldova, Romania, Montenegro, Turkey and Bulgaria hard. Turkey grows steadily after the crisis. Moldova recovered quickly during the period by in 2015 its GDP was slightly negative. The recovery in Montenegro, Romania and Bulgaria has been slower but accelerated considerably in 2005 – almost twice compared to 2014. The three least affected (if at all) by the crisis countries are Macedonia, Albania and Kosovo. Here, growth was slow but essentially positive for the entire period, suggesting their limited integration with the world economy and its shocks might be the main reason.

Chart 4 **GDP Growth in the Crisis of 2008–9; between 2009 and 2014; and in 2015**



III. Basic Indicators of Fiscal Decentralization

The most straightforward indicators of the relative importance of local governments in a country's governance structure are local expenditures and revenues as shares of total public expenditures and revenues, and as a percentage of GDP. Their significance, however, depends on both the functions that local governments are responsible for and what revenue sources are assigned to them.

To make reasonable judgements about the role of local governments in a given country it is important to know what functions they have been assigned, and in particular, whether they are paying the wages of teachers, doctors or other social sector employees. This is because the wage costs associated with education, health and to a lesser extent, social welfare services are so big that they inevitably change the nature of the intergovernmental relations. For example, most OECD countries spend 12 to 20% of all public revenue or 3 to 6% of GDP on pre–tertiary education, of which between 60 and 80% goes to wages[4]. As a result, assigning important social sector functions to local governments fundamentally alters the nature of intergovernmental fiscal relations.

In short, if the full costs of running schools or hospitals are devolved to local governments, then they must be given large grants by the national government because there is no way that these services can be financed by locally raised revenues. Equally important, they cannot reasonably be financed by shared taxes. This is because the proceeds from robust taxes such as the Personal and Corporate Income Tax are highly skewed towards a limited number of jurisdictions, but the services that need to be financed are everywhere. Worse, the costs of providing many of those services actually go up in the poorest places (*think small schools in rural setting or elderly people needing personal assistance at home*), just the opposite to the tax revenues generation potential.

Table 2 summarizes the main social sector functions assigned to local governments in the region. Other functions like housing, public transportation and public safety are not reflected despite the fact that they have great importance on the way intergovernmental relations are set. It should be noted also that the Social Welfare group contains a wide variety of specific services and nowhere are all of them provided at local level – in most of the cases municipalities fund three to four of them. The data do not take into account important aspects of the expenditure assignments such as levels of authority to: 1) determine whether a service is required; 2) determine the service policies and standards and 3) organize the service delivery. **It simply shows if local governments pay for these.**

The municipalities in Kosovo pay for services in all six groups. In **Romania, Macedonia, Bulgaria and Moldova local governments pay the full costs or pre–tertiary education.** Similarly, in Romania local governments pay for most of the costs of primary and secondary health care. Other things equal, local governments in these countries should have higher revenues and expenditures as shares of both GDP, and of total public revenues and expenditures. Local governments should also be receiving very large shares of their revenue from Conditional Transfers because without them they cannot pay for the schools, hospitals, and other social sector institutions that they have been tasked with managing.

[4] See Education at Glance, OECD Paris 2013, pp 193, 218, 240–48.

Table 2: Local Government Social Sector Functions*

	Preschools		Primary Schools		Secondary Schools		Primary and Secondary Health		Social Welfare		Culture	Sports
	Buildings	Wages	Buildings	Wages	Buildings	Wages	Buildings	Wages	Buildings	Wages	Buildings	Wages
Kosovo	XX	XX	XX	XX	XX	XX	XX	XX	XX	XX	XX	XX
Romania	XX	XX	XX	XX	XX	XX	XX	XX				
Macedonia	XX	XX	XX	XX	XX	XX			XX	XX	XX	XX
Bulgaria	XX	XX	XX	XX	XX	XX			XX	XX	XX	XX
Moldova	XX	XX	XX	XX	XX	XX						
Serbia	XX	XX	XX		XX		XX					
Slovenia	XX	XX	XX				XX				XX	XX
Croatia	XX	XX	XX		XX							
Albania	XX		XX		XX		XX		XX	XX	XX	XX
FBIH (BIH)	XX		XX									
RS (BIH)	XX				XX		XX		XX	XX	XX	XX
Montenegro									X**	X **	XX	XX

* In some places some social sector functions are provided by 2nd tier local governments but they are included here for those members of the group for which our financial data covers both levels.

** Only small % of total social welfare services are provided by local government units as their own competence.

Conversely, local governments in Albania, FBiH (of BiH) and Montenegro do not pay the wages of any social sector employees. Indeed, local governments in Montenegro have no responsibilities in either education or health, not even maintaining facilities. Here, local government revenues as shares of both GDP and of total public revenues should be lower, as should the share of conditional transfers in their budgets.

Local Governments Revenues in South–East Europe

Chart 5 shows the revenues of the General Government (GG) – total public revenues– for each NALAS–member country or entity, as well as the average for the EU and the region (SEE) as percentage of GDP. Local revenue is distinguished from other General Government revenue to indicate the relative size of the local sector in the total public sector.

As can be seen from Chart 5, the public sector (GG) of the region continues to lag far behind the EU average – 37.3% vs 45% of GDP. The difference in local government revenue is even bigger – 6.3% of GDP in SEE vs 11.3% in the EU. On average, the countries of the EU have both larger public sectors and have decentralized more revenue to local governments than their counterparts in SEE.

In 2015, Croatia's indicators moved closer to the EU average. Albania and Kosovo have the smallest public sector – below 30%. The EU28 is at the other end of the spectrum, with both General and Local Government revenue highest as shares of GDP.

Besides Albania and Kosovo, two other groups of countries can be identified: Macedonia, Romania, Moldova, Bulgaria, Turkey and FBiH, with public sectors between 30% and 40% of GDP, and for the rest – above 40%. The most probable explanation for the performance of the first two groups is problems with tax collection both at central and local level. These problems usually mirror the share of the so–called gray economy.

Despite the small public sector, local governments in Kosovo receive 30% of all public revenues. Only Romania has a slightly better indicator – 31%. All the others' performance is below the EU28 average of 25%.

Chart 5 General and Local Government Revenue as a Percentage of GDP in 2015

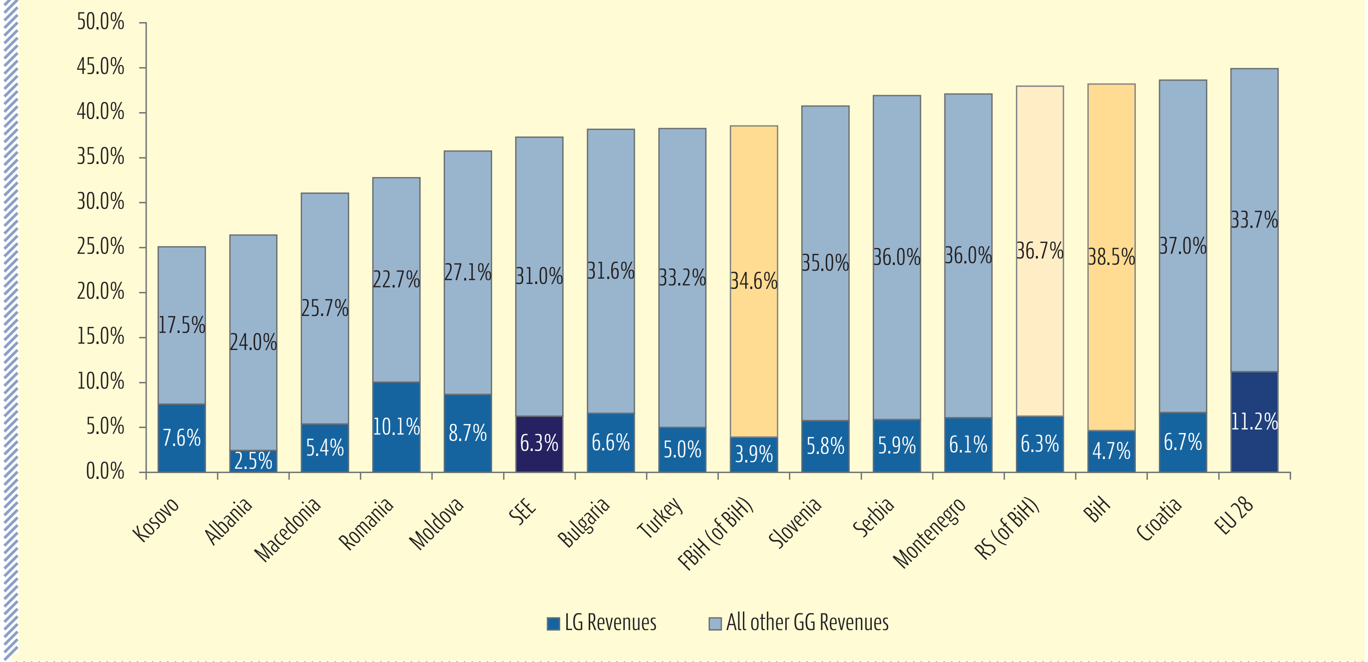
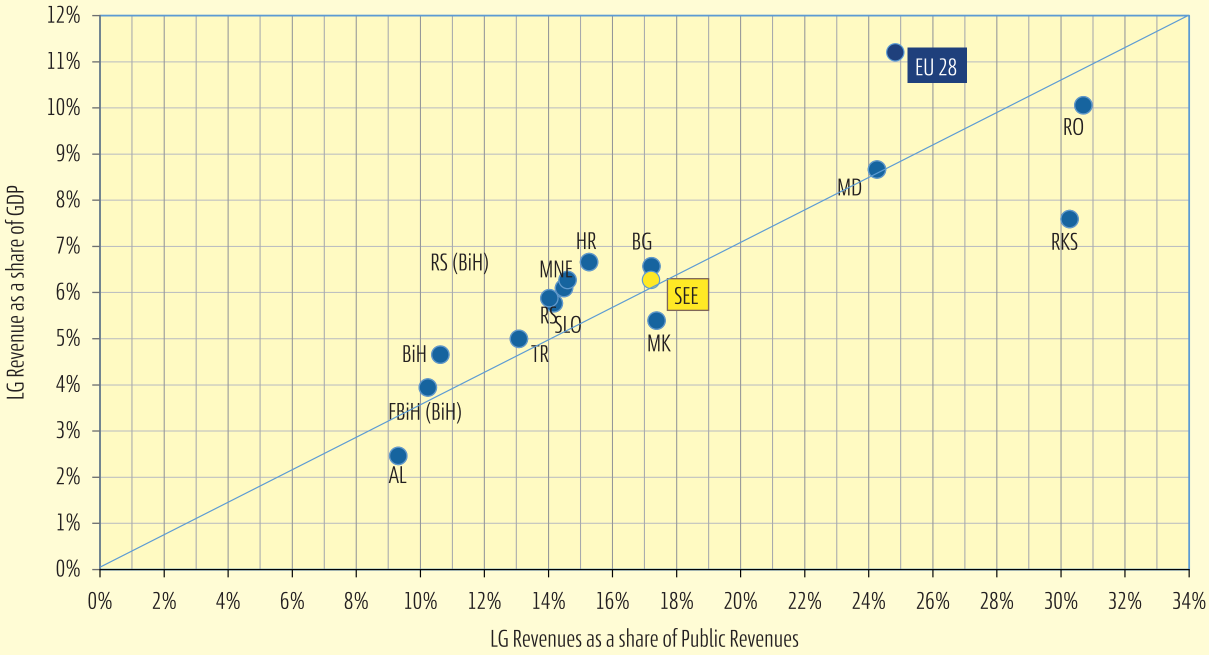


Chart 6 further explores the level of fiscal decentralization by plotting the share of local revenue as percentage of total public revenue against local revenue as share of GDP. As we can see from the Chart, the NALAS members whose local government sectors most closely resemble those of the EU28 as both percentages of GDP and total public revenue are Moldova, Romania and Kosovo. Bulgaria and Macedonia follow; this is also where lies the SEE average. The rest of countries are further away from the EU average.

A considerable part of the reason for these rankings lies in Table 2, where the local governments' financial responsibilities for the social sector services are shown. As is often the case in the EU, local governments in Kosovo, Romania, Moldova, Macedonia, and Bulgaria are all responsible for these services, especially primary and secondary education –one of the most expensive public services. It is thus not surprising that their local governments represent larger shares of the total public sector than those of their counterparts elsewhere in the SEE, or that their local governments require larger shares of their respective GDPs to finance these social sector responsibilities.

At the same time, one might expect that the share of LG revenues of all public revenues in the EU member countries in SEE should be considerably higher thanks to the EU grants (*which flow mainly to the local governments*). The reality is different – what mainly drives these ratios is the scope of the service provision responsibilities at local level. For example, the main reason for Romania's place in the chart is the fact that local governments pay for teachers, nurses and doctors salaries. For the same reason Bulgaria is slightly ahead of the two other EU member states – Croatia and Slovenia.

Chart 6 **Local Revenues as a share of Total Public Revenues & GDP (2015)**



The data on Chart 7 further explores a **correlation, noticed in previous editions, between the extent of decentralization and the size of the public sectors**; again it illustrates a trend, which is opposite to the EU experience. The Chart clearly illustrates that the countries with "small states" (*public revenue of GDP less than 35%*) have devolved the most of the social sector functions to local governments.

As can be seen from the Chart, all countries or entities with a public sector less than 35% of GDP, have devolved responsibility for paying the wages of primary and secondary school teachers to local governments.

Another group of countries position themselves between the two thresholds, 35% and 40% – three of them have devolved little social functions to local governments, which is not the case in Bulgaria.

Finally, and perhaps, most importantly, no member of the group is in the oval reserved for both high levels of decentralization and larger public sectors, the quadrant where most of the EU's decentralized unitary states would be found.

Chart 7 **Public Sector Size and the Extent of Decentralization as Measured by the Devolution of Social Sector Functions***

* The scale is based on Table 2 and has been created by assigning one point for the maintenance of the physical facilities of each type social sector institution that local governments pay for, and 2 points for the wages of each type of social sector function that local governments pay for. An additional adjustment was made measuring the financial weight of the main functions (highest, 50 out of 100), for the three educational functions, etc.

One way to interpret this finding is that in the region countries that collect fewer taxes (and hence have smaller public sectors) are more inclined to decentralize social sector functions. The rationale for such a behavior is hardly economic efficiency but rather political – faced with lack of adequate public resources, the national governments off–load social sector functions on local governments thus shifting the political pressure into the wrong direction. A typical example was during the crisis, when the first austerity response of several central governments' was to cut transfers to the local governments without reducing their service provision responsibilities.

It should be noted, that throughout the EU, preschool, primary and secondary education and the main social services (*but not the welfare payments*) are considered **essential service responsibility of the local governments**. Usually these services are funded through a mix of own source revenues and grants but what is more important – no matter what the funding mechanism, local governments preserve the decision–making authority to better target the service. From this prospective the problem in most SEE countries is 1) the small public sector and 2) the conditionality imposed by the grants from the central government which to a great extent limit the authority of the local governments to decide. Some experts describe these local governments functions simply as paying agents at local level i.e. the local self–governance is quite limited.

Let us return to the five countries, which have fully devolved very costly education functions to local governments (Table 2). As can be seen in Chart 6, the local share of total public revenues in Kosovo, Romania and Moldova is line with EU norms in 2015, despite the fact that their public sectors are comparatively very small (Chart 5). This suggests that despite their small public sectors, central governments here are treating their local governments reasonably fairly –call it "well–balanced dumping".

But the situation in Macedonia and Bulgaria is a little different. Here, local governments receive a substantially smaller share of total public revenues in comparison to both their highly decentralized counterparts in the SEE and the EU. As such, the central governments of Bulgaria and Macedonia seem to be underfunding local governments in general and their social sector functions in particular *relative to the size of their public sectors*. Indeed, they seem to be cases of what might called "unbalanced off–loading."[5]

Unfortunately, however, "unbalanced off–loading" need not be limited to places where local governments have been assigned significant social sector functions. It can also be a feature of places where local governments remain responsible for "only" basic urban services. Here, Albania, with the smallest local government sector in terms of both GDP and total public revenues (2.5 & 9.3% respectively) stands out, followed closely by FBiH (of BiH) (3.9 & 10.2% respectively).

A more precise picture at country/entity level about "balanced and unbalanced" off–loading should take into account the allocation of revenues across the local governments – data which is not collected for the production of the this report. In some places, local revenues are skewed toward large municipalities in general and capital cities in particular. As a result, the relatively comforting macro–picture suggested by high local revenue in comparison to total public revenue may be misleading at the micro–level because of the overfunding of the few against the interests of the many.

[5] It should be noted that in Moldova, Romania, and Macedonia local governments have very little control over the wage components of their education subventions and in many ways have just assumed the payroll function of the national government for these services.

Chart 8 shows local government revenue as percentage of a GDP in 2006, 2009 and 2015. The region as a whole slightly improved by 0.5pp in 10 years. Turkey and Romania improve this indicator both in 2009 and in 2015. Several countries' position in 2015 deteriorates even below the 2009 levels – Albania, FbIH, BiH, Serbia, Montenegro, RS (BiH) and Moldova. The other's performance does not change significantly. The EU 28 slightly stagnated in 2015 but its average is still above the SEE by **5 pp**. **While local revenues increased in Turkey without the devolution of new responsibilities, in both Kosovo and Macedonia they have risen significantly because over the period local governments became responsible for paying the wages of social sector workers.**

They have fallen most in Montenegro, RS (of BiH), Serbia and Moldova. In Montenegro, a real–estate boom pushed–up local revenues before 2006. But their fall has been made harder by national government restrictions on municipalities' right to tax businesses (in the name of improving economic "enabling environment"). Similar things could be said about RS (of BiH), Croatia, and Serbia where national governments also made some cuts in grants in response to the economic crisis.

Chart 8 **Local Government Revenue as a Share of GDP in 2006, 2009, 2015**

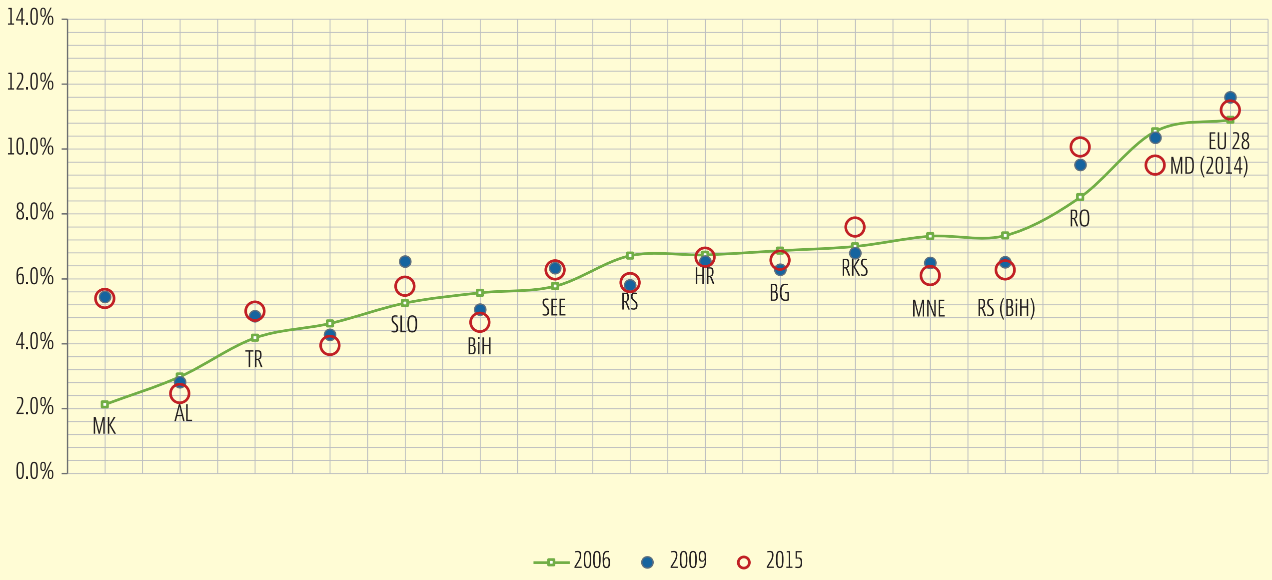
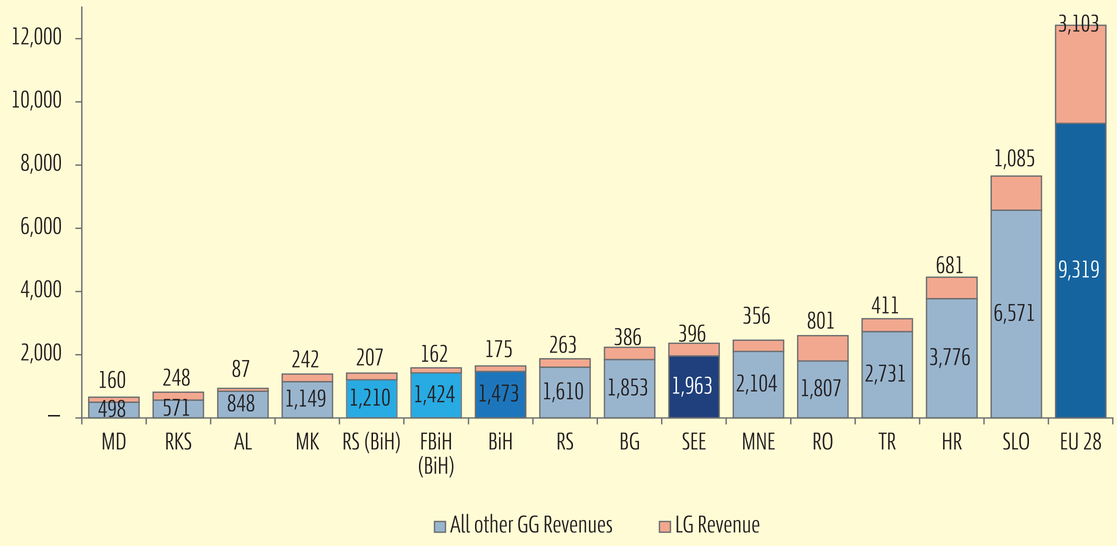


Chart 9 shows the per capita revenues of the consolidated public sector and of local governments in EUR in 2015. The Chart is a useful reminder of how little revenue the governments of most of South–East Europe have to work with. It also shows how much variation there is across the region in the "relative weights" of the local public sector. It is particularly striking that local governments in Moldova, Kosovo, and Macedonia pay for teachers' wages on per capita revenues of less than 250 EUR, while Croatian and Slovenian municipalities bear little of these costs and have per capita revenues 3 to 4 times higher. In the same time, the richest one – Slovenia, lags almost three times behind the EU average.

Chart 9 Consolidated Public and Local Government Revenue (EUR Per Capita–2015)



The Local Fiscal Autonomy and the Basic Composition of Local Revenues

Our data on the composition of local public revenue is problematic because different places account for different revenues in different ways, and because in some places accounting classifications have changed over time. The classification of shared taxes is particularly problematic. In most places, only shared PIT is considered a Shared Tax, with shared Vehicle Registration and Property Transfer Taxes misclassified as Own–Revenues. Because these are important sources of revenue in many places, this misclassification significantly overstates the fiscal autonomy of local governments.

In Turkey, some shared PIT revenues are accounted for as Unconditional Transfers while in Slovenia some Unconditional Transfers are accounted for as shared PIT. Meanwhile in Croatia, some of what is accounted for as shared PIT should be recorded as an own–source revenue because it comes from locally imposed surcharges on personal income and not just from the centrally set shares. Finally, in most places we cannot separate Conditional Grants for specific investments or programs from Block Grants for social sector functions. Despite these shortcomings, however, the data is still informative.

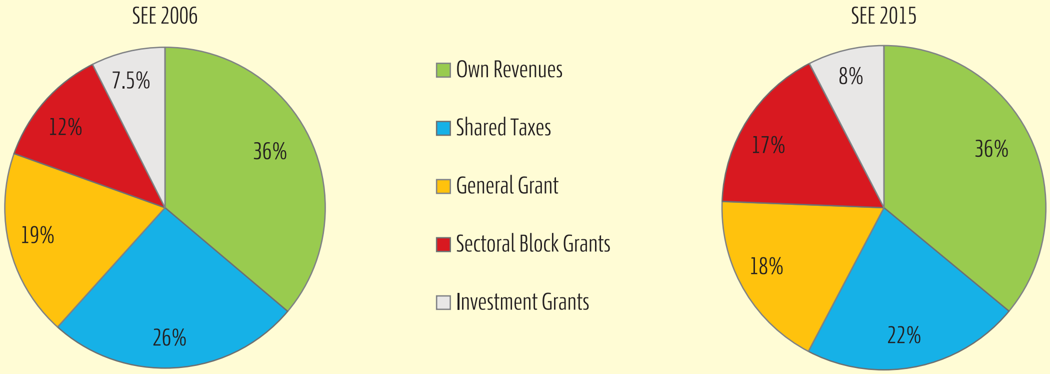
Chart 10 and 11 show the change in the basic composition of local revenue between 2006 and 2015 as an average for all NALAS members. The shares of both Own Revenues and General Grants (*unconditional*) as a percentage of total revenue have remained stable over the period. Shared Taxes have declined, while Sectoral Block Grants (*conditional*) have increased as from 12 to 17% of the total.

From the point of view of local governments' authority do decide how to spend the different revenues sources, the table below shows a slight deterioration i.e. the share of the revenues, over which local governments have

- full control (*own revenues and general grant*) remains the same – 55%;
- limited control (*shared taxes and investment grants*) decreases by 3 pp;
- no control (*sectoral block grants*) increases by 5 pp.

	Full local discretion	Limited local discretion	No local discretion
2006	55%	33%	12%
2015	55%	30%	17%

Charts 10&11 **Composition of Local Revenue in 2006 & 2015**



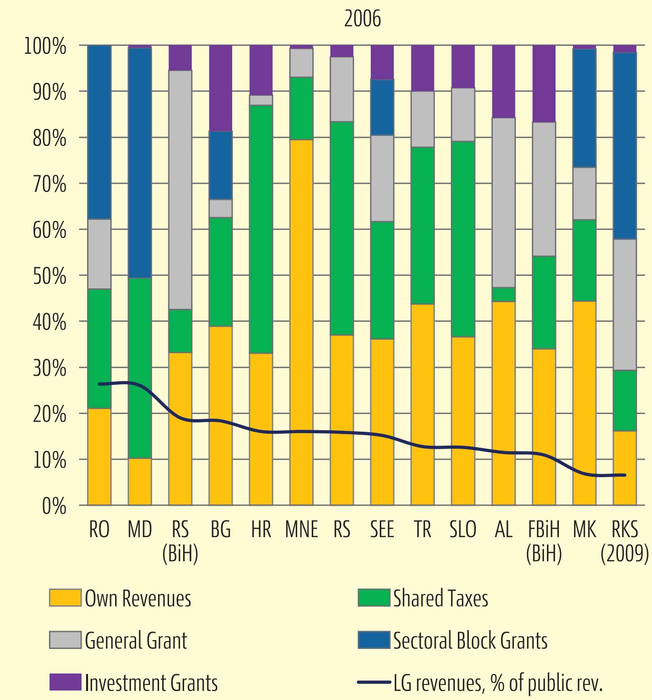
Charts 12 and 13 present the same information for individual members of the group ordered by local governments' share in total public revenues. They help explain what is driving this increase in Conditional Grants.

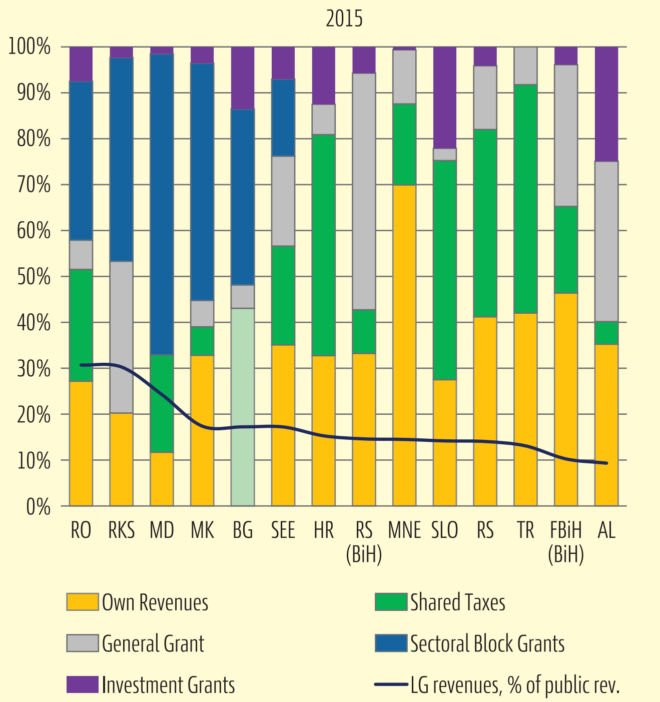
Reading from left of Chart 13 (for 2015), we find Kosovo, Romania, Moldova, Macedonia and Bulgaria. They are already familiar to us as the five places that have devolved the most significant social sector functions to local governments. And not surprisingly, they are the five places where local government revenues are now highest as a share of total public revenues. We can also see that the revenues of all five are dominated by Conditional Grants, with much less coming from shared taxes and own–sources.

This is very different from the situation in 2006. Kosovo and Macedonia have moved from the far right of the chart to the far left: In fact, between 2006 and 2015 they journeyed from being the least decentralized countries or entities in the region to being the most. In addition, this journey transformed the structure of their revenues, which no longer come mainly from own–revenues and shared taxes but from conditional and unconditional transfers.

Moldova and Bulgaria are also interesting in this respect. In neither country, were major new functions devolved to local governments between 2006 and 2015. Nonetheless, in both, Conditional Grants have increased at the expense of shared taxes. This is because early in their decentralization efforts both Bulgaria and Moldova devolved schooling to local governments, but tried to finance it through PIT sharing.

Charts 12 & 13 **Composition of Local Government Revenue 2006 & 2015**





This proved disastrous for rural areas that had weak tax bases and hence low PIT revenues, but high education costs because of lots of small schools with small classes. Indeed, in both Bulgaria and Moldova these imbalances distorted their intergovernmental finance systems for many years. In 2008, Bulgaria completely replaced PIT sharing with sectoral block that, unlike PIT sharing, can be allocated according to objective measure of need, a process that Moldova began in 2014.

The shift towards Conditional Grants in Bulgaria, Moldova, Kosovo, and Macedonia explains the change in the composition of local revenues that we saw for the region as whole in Charts 10 & 11. It also nicely illustrates a well–known paradox in intergovernmental finance:

As countries devolve social sector functions to local governments, local governments typically become more financially dependent on their national governments than before[6].

Being financially dependent is not necessarily a bad thing for the local governments – in Europe, almost all municipalities receive some kind of financial support from the state. The real question is if this support reduces the scope of the municipal spending decisions. Further arguments for this fundamental question can be found in the European Charter of Local Self–Government, adopted by all SEE countries, which, in article, 9 requires:

"5. The protection of financially weaker local authorities calls for the institution of financial equalization procedures or equivalent measures which are designed to correct the effects of the unequal distribution of potential sources of finance and of the financial burden they must support. Such procedures or measures ***shall not diminish the discretion local authorities*** *may exercise within their own sphere of responsibility.*

6. Local authorities ***shall be consulted****, in an appropriate manner, on the way in which redistributed resources are to be allocated to them.*

7. As far as possible, grants to local authorities ***shall not be earmarked*** *for the financing of specific projects. The provision of grants* ***shall not remove the basic freedom of local authorities to exercise policy discretion*** *within their own jurisdiction."*

Put more bluntly, if decentralization leads to a reduction in municipal discretion on spending decisions then in reality the real term should be deconcentration – local governments'' role is simply to fund the central government's decisions at local level. This paradox is important to appreciate because too often advocates of decentralization see the principle measure of success in terms of how big local governments budgets are. This is wrong–headed – if the devolution of social or any other functions to local level means more revenues but reduced municipal spending decisions, can we talk about real fiscal decentralization?

While many countries have recognized that the financing of major social sector functions is best achieved through the use of Block Grants and not shared taxes or own–revenues, it is also true that in many places central control over these Block Grants remains excessive. It is one thing for national governments to want to make sure that monies earmarked for health and education are actually spent on them and quite another for them to control exactly how local governments use these funds within a sector. After all, the entire logic of devolving these functions is defeated if central regulations make it impossible for municipalities to use their knowledge of local conditions and needs to improve the effectiveness of how these monies are spent.

The goal should be to civilize the struggle through informed intergovernmental dialogue that allows both sides to reach reasonable and dynamic compromises over time. Unfortunately, despite the legal obligation in each of the countries for such, this commitment to intergovernmental dialogue is weak across much of the region. One of the ways to overcome this contradiction, which constantly arises in the intergovernmental dialogs, is two–fold:

[6] See Blochlinger and King, "Less than you thought: The Fiscal Autonomy of Sub-Central Governments" OECD, 2006

1. The central governments may use costing standards for determining the pool of the Block Grant (*incl. allocation among the municipalities*) but should not impose these standards as payment obligations at local level. Instead, they should impose service performance standards in order to measure how the municipalities use the Block Grant. In other words, instead of dictating how much local governments should pay the teachers; the ministries have to set commonly accepted indicators such as level of drop-outs, exit educational tests, parents' satisfaction etc.

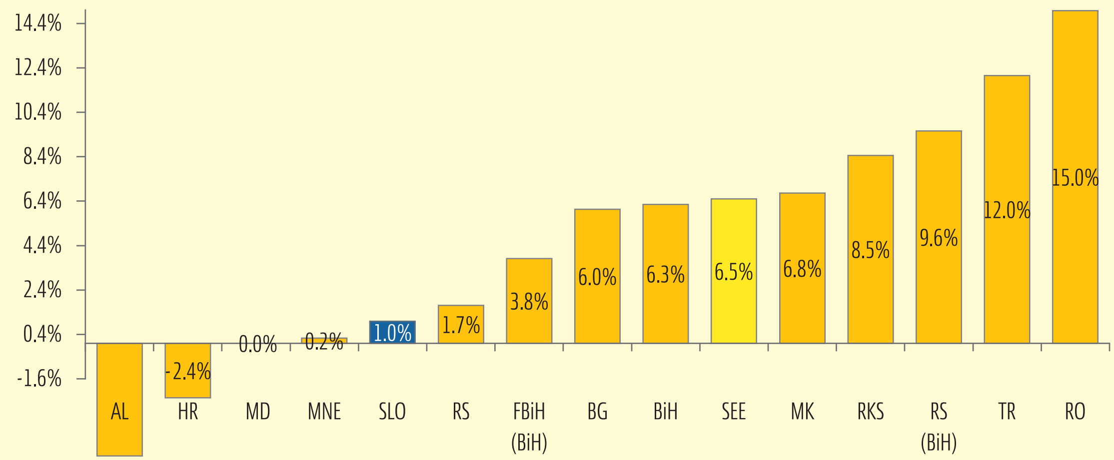
2. Local autonomy does not mean lack of accountability. On the contrary – the system must contain both incentives for achieved performance targets and financial threats in cases of no compliance such as partial disbursement of the Block Grant.

Montenegro has the highest share (70%) of own–revenues in total revenues. On the one hand, Montenegrin municipalities have only few social sector responsibilities. On the other hand, they have a particularly broad palette of own–revenues that includes not just the property tax, asset sales and rentals and development fees, but most interestingly, local PIT surcharges. Nonetheless, between 2006 and 2015, Montenegro moved from being a country in which local governments received a fairly large pie of the fiscal pay, to one whose share is now relatively modest.

It is also worth noting that local governments in Turkey, Slovenia, and Moldova receive tiny or no income from Unconditional Transfers. This absence raises questions about the equity of these countries' intergovernmental finance systems because it is generally through such transfers that central governments provide additional money to poorer jurisdictions. Nonetheless, equalizing funds can be provided in many ways and the absence of unconditional transfers does not mean that no equalization is taking place. But again, we lack the data to systematically address this question.

Finally, between 2014 and 2015 the revenue position in real terms of many local governments in the regions changed quite significantly. The region's healthy revenue growth of 6% is allocated unequally among the countries. The municipalities' revenues in Moldova and Montenegro remained the same. In Kosovo and Albania, the revenues went down by 5%. At the other end of the spectrum Romania, Turkey and RS (BiH) grew, respectively, by 15%, 12% and 10%. All the other grew also, but more modestly, from 1% (Slovenia) to 7% (Macedonia).

Chart 14 Growth/Decline of Local Government Revenue between 2014 and 2015

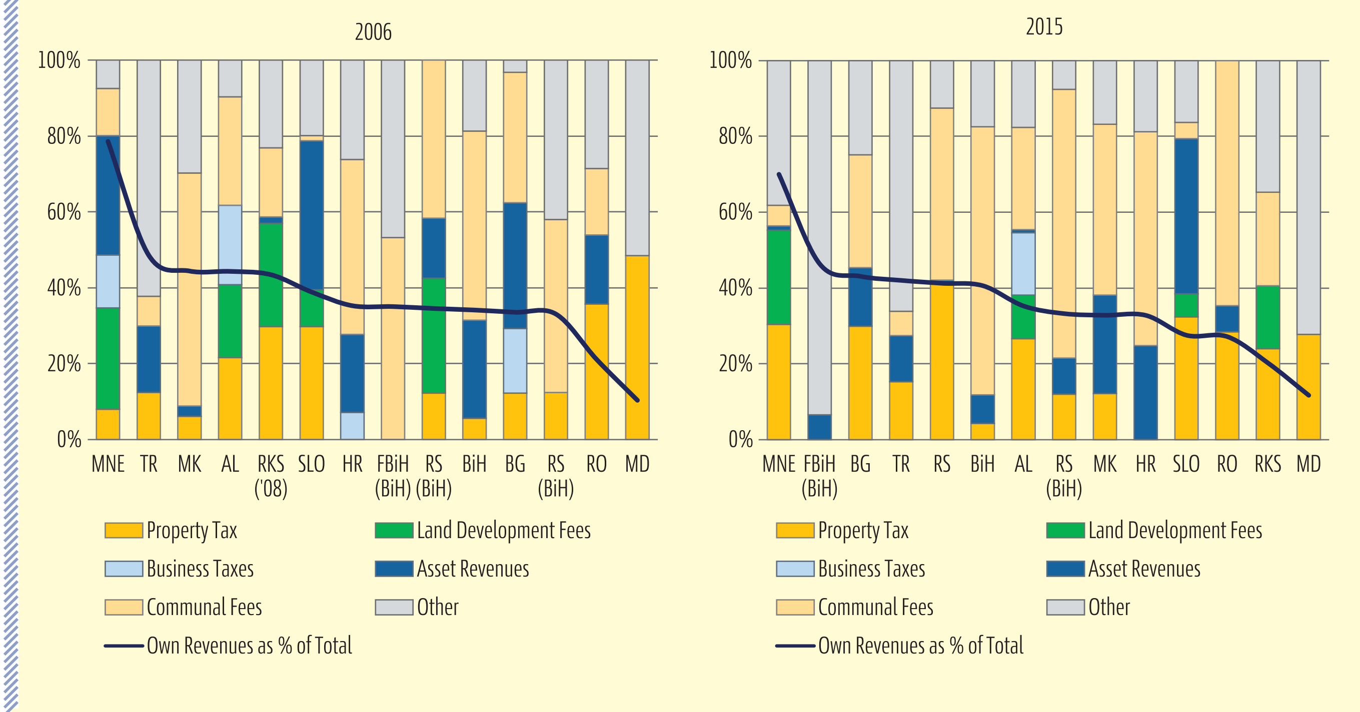


The Composition of Own–Revenues and the Property Tax

Unfortunately, the accounting of own–revenues differs substantially across the region. In some places it is quite detailed and contains more categories than are presented in our charts. Others use only two or three categories and it is difficult to say what they contain. For example, local governments in Croatia, Turkey, FBiH (of BiH) and RS (of BiH) derive significant revenue from Land Development Fees and quasi–fiscal Construction Permits, but record them as Communal Fees. Revenues from asset sales and rentals, fees for the use of public space, and fines and penalties are also lumped into this category. Meanwhile, Slovenia records revenue from the Property Tax and the Land Use Fee together. The data for Moldova is very murky too – both in 20016 and in 2015 it contains two categories only – Property tax and Other own revenues.

These accounting issues make it hard to come to any general conclusions about the nature of own revenue in the group. However, a few observations are worth making. Charts 15 & 16 present the composition of local government own–revenues in 2006 and 2015 for all members of the group, ranked by the share of own–revenues in total revenues. Montenegro is the outlier with own–revenues equal to about 80% of total revenues in 2006 and 70% in 2015. Over the ten–year period, without Montenegro, the average share of own–revenues of total revenues fell from about 35% in 2006 to 32% in 2015.

Charts 15 & 16 **Composition of Own–Revenues in 2006 and 2015**



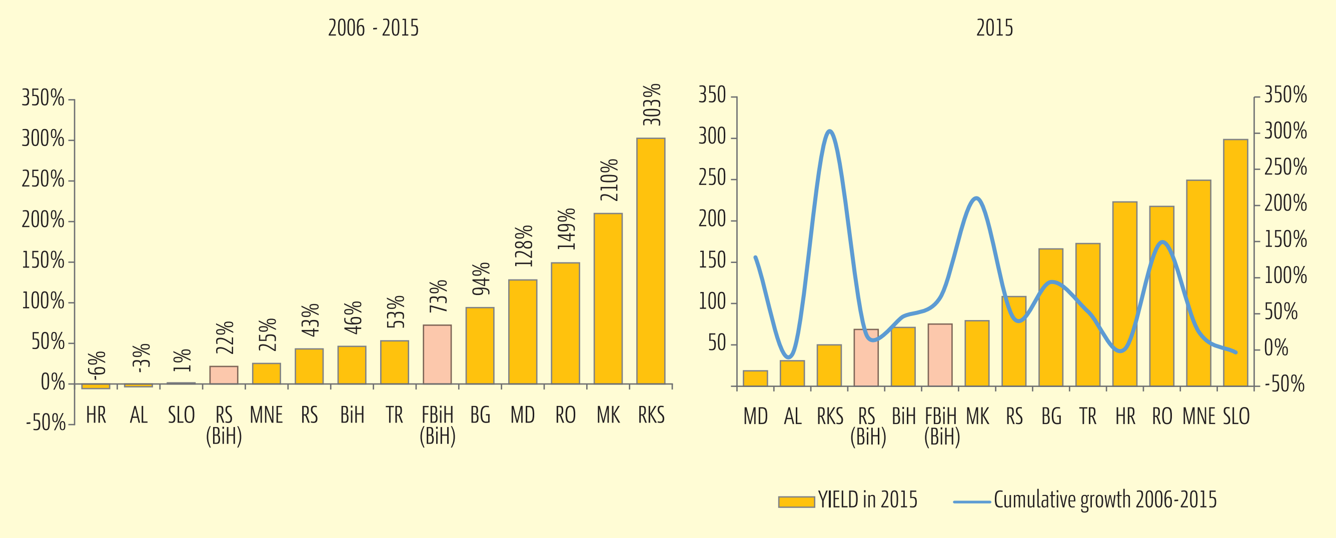
* More than 90% of what is recorded as property tax in Slovenia comes from the Land Use Fee.

Surprisingly, these shares of own revenue to total revenues are in line with the average for the OECD and, to some extent, to the EU average. They also almost certainly overstate the real revenue raising powers of local governments in the region because of the misclassification of many shared taxes and fees as own revenue. **But again, the point is that *almost everywhere* own–revenues are much lower than the literature suggests is optimal because of the grants and transfers that local governments receive –particularly, for social sector functions.**

Across the group there is much variation in both the growth of own revenues over the period, and their yield in EUR per capita as can be seen in Charts 17 and 18. There are three countries, which still are not able to reach the pre–crisis levels. Slovenia suffered one of the highest falls in economic activity among EU member states, which resulted, among other things, into heavy debt crisis – the public debt rose from 20% of GDP in 2008 to over 80% in 2014. The sharp decline in own–revenues was the result of slow economic growth combined with 2014 elimination of the Land Development Fee. Croatia also experiences a GDP drop of 6% between 2008 and 2010. The impact of the crisis on Albania was mild but the economic ties with Greece, maybe the hardest hit in Europe, caused sharp decline of remittances from Albanians working there. In addition to that, the stagnation of own–revenues in Albania is the result also of the progressive restriction and ultimate elimination of a local tax on small businesses, as well as a moratorium on new construction that has reduced the yield of the Infrastructure Impact Tax.

The restriction or elimination of this fee also had a strong impact in Serbia and Montenegro. However, in both sharp increases in property tax collection have softened the blow. More generally, national governments throughout the region have been reducing local governments' ability to tax businesses – a policy frequently supported by the World Bank and USAID.

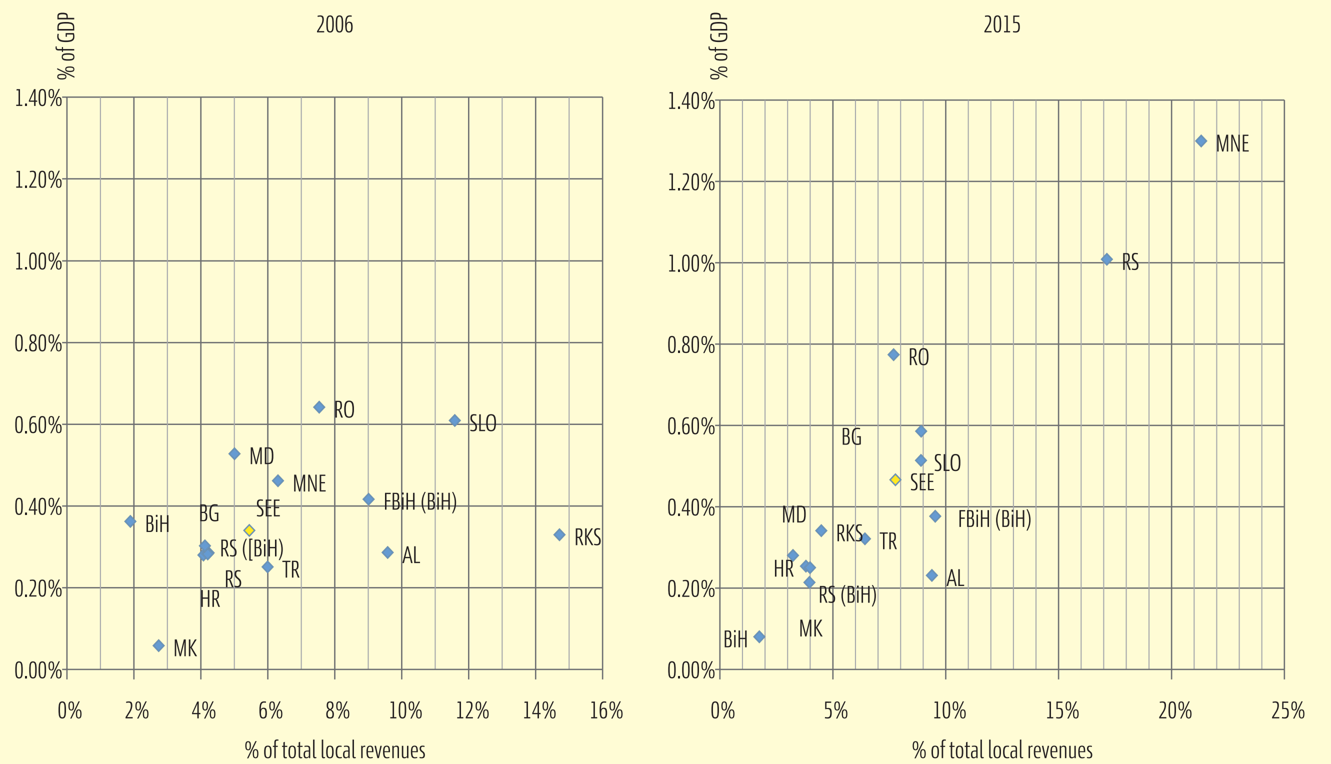
Charts 17 & 18 **Absolute Growth of Own Revenues 2006–2015 and their yield in EUR 2015 per capita**



Five countries record an impressive growth during this period, between 90 % and almost 300%, mainly driven by better tax collection and improved own revenues management. In Macedonia, the sharp increase in own–revenues –from a very low base– has come largely from a 600% improvement in property tax collection. Growth in Turkey has also been driven by the almost doubling of property tax revenues and by the substantial growth of revenue from asset sales and rental, an important and often underappreciated source of local revenue. Improved property tax collection has also helped in Kosovo, Moldova and Romania. Nonetheless, the lion's share of growth in all three places has come from "Other" sources.

The yield of own revenue per capita varies greatly; Slovenia, despite having a negative 10–year growth of the own revenues, leads the group with E 300 per capita. Montenegro follows with E 250 and Croatia is not far behind with E 205. Eight countries and entities lie below the group's average E 130 (not shown in the chart); Moldova and Albania are even below one third of the group's average.

Charts 19 & 20 **Property Tax as % of GDP and Total Local Revenue in 2006 & 2015***



* Data for Slovenia include revenues from the land use fee.

Throughout the region, national and local governments have made substantial investments in the technical infrastructure for property taxation. The international donor and other assistance programs (USAID, World Bank etc.) have strongly supported these efforts, usually backed by recommendations from the International Monetary Fund. However, the results in terms of better taxation and improved collection cannot and are not supposed to eliminate the difference between North America and Europe. While in the US the property tax is considered the single most appropriate tax to devolve to local governments, the European history and development shows that local governments rely much more on PIT sharing or local surcharges and asset management.

Despite the impressive growth, there are limits to how much the property tax alone can be used to bring local government revenues in line with their service responsibilities. This ten–year trend can be seen from Charts 19 and 20, which shows that the yield of the tax has increased considerably – from 5.5% of total local government revenue in 2006 to 8% in 2015. The respective shares of GDP are 0.34% and 0.46%: in the EU[7], the recurrent taxes on immovable property account for 1.6% of GDP (2014) with the highest share in France – 3.2% and the lowest – in the countries of Eastern Europe – *below 1.2% (Poland's)*. From this prospective Montenegro (1.3%) and RS (BiH)' (1.01%) performance is the closest to the EU average. In most of the countries, a disproportionately high percentage of the tax comes from businesses (*often over 70%*). Despite the ambiguity of the property tax data in SEE (*land development fees, construction permits, the Property Transfer Tax etc.*) the European model suggest, that, in a long–term prospective, there is plenty of room for increasing the fiscal significance of the property taxation.

[7] Taxation trends in the European Union, 2002-2014, The European Commission

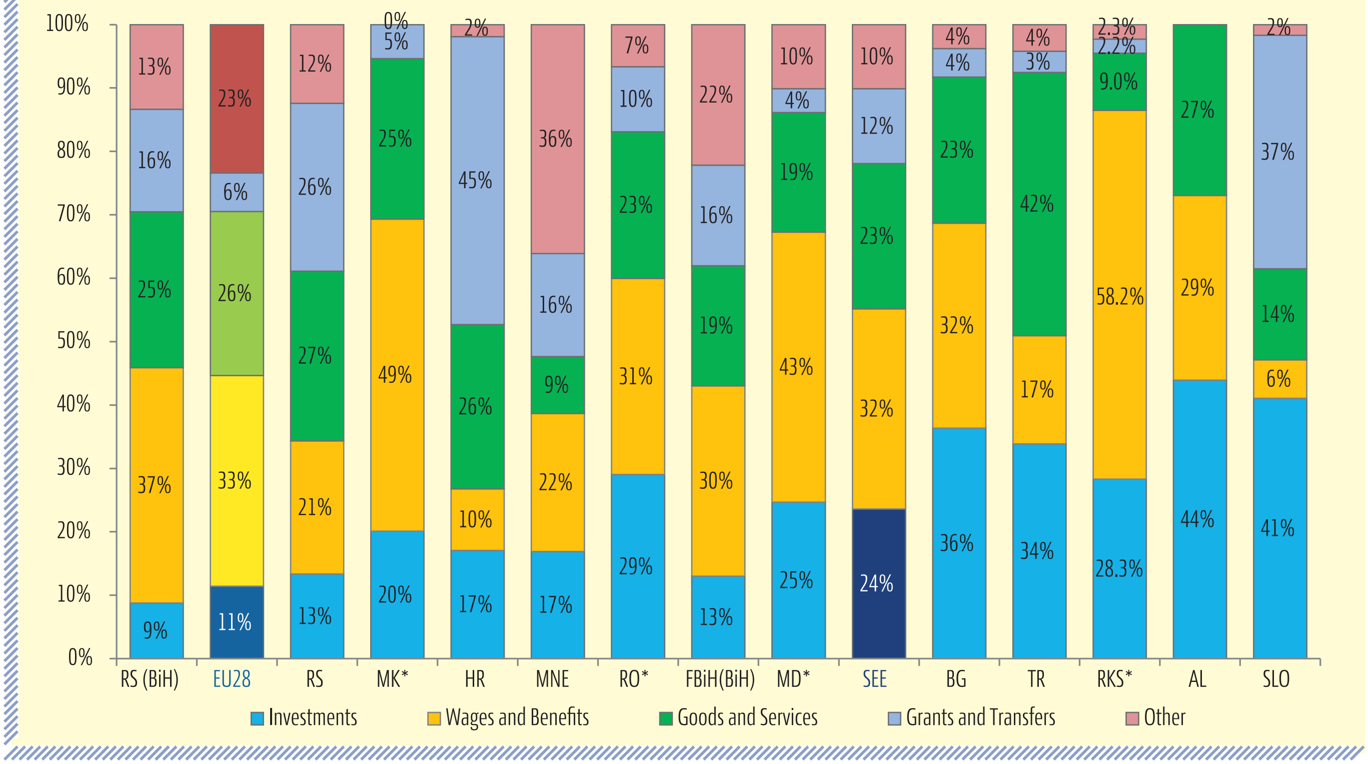
The Composition of Expenditures and Investment Spending

Chart 21 shows the composition of local government expenditures by economic type for each member of the group, as well as the average for the group as a whole (SEE) and the average for the EU (EU28). As with revenues, there are inconsistencies in the way expenditure data is reported. For example, some places treat capital transfers to public utilities as investment expenditures while others record them as subsidies, which cannot be distinguished from transfers to individuals or grants to non-governmental organizations. Similarly, in many places debt repayment is not accounted for separately but included in the category "Other".

Local governments in the five members of the group that have decentralized social sector functions (*) spend a higher percentage of their expenditures on wages (*up to almost 60%*). But surprisingly, local governments in most of South-East Europe spend a larger share of their budgets on investment than their counterparts within the EU. A mix of a number of reasons can explain this situation:

- Local governments in South-East Europe often pay for investments that elsewhere in Europe are financed through utility tariffs;
- The investment needs of SEE and EU are different – in SEE more money is spent on building new infrastructure and reconstructing the old-one while in the EU more is spent on maintaining the existing infrastructure which is treated as operational expense;

Chart 21 Composition of Local Government Expenditure in 2015



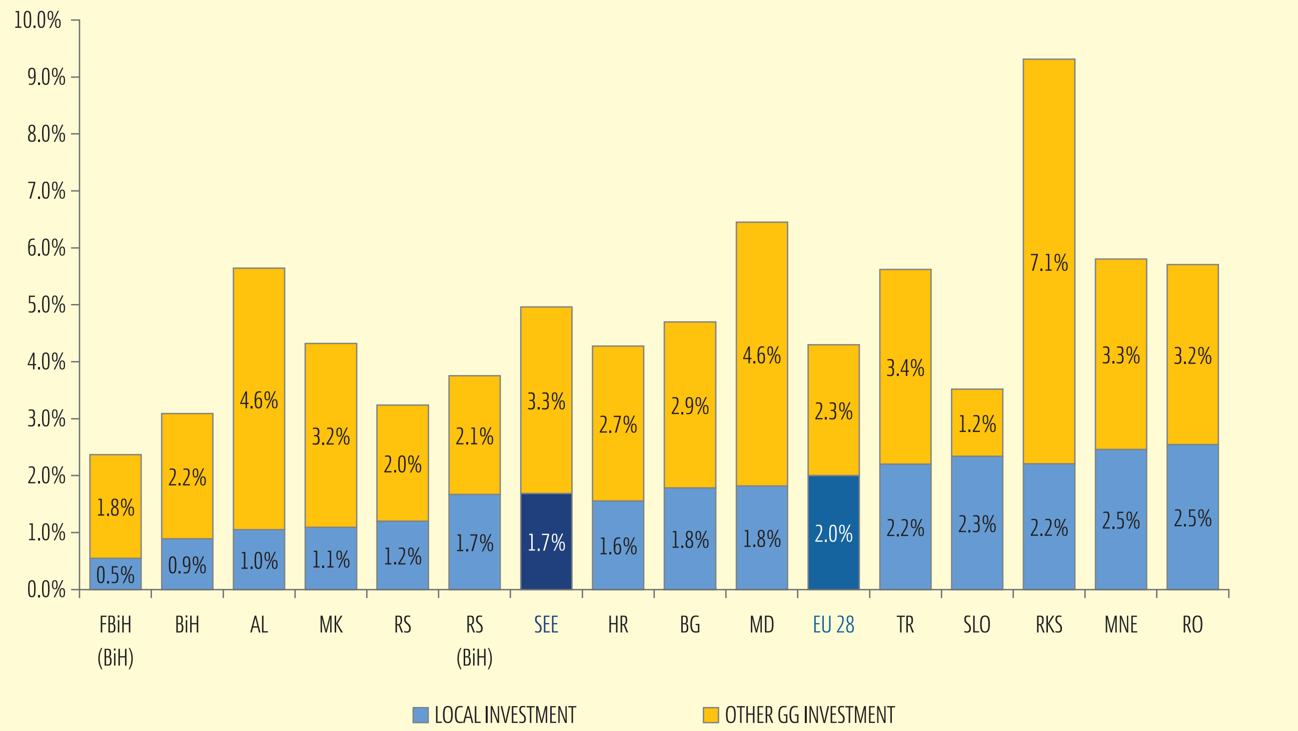
- The greater decentralization of social sector functions within the EU requires higher operating costs whish depress the share of expenditure going to investment;

- During the crisis, one of the first responses of the EU countries was to cut the public investments. It should also be noted that traditionally more public investments are made at local than at central level. Thus, while the average total public investments in the EU remained at around 7% of all public expenditures; half of the countries' public investments are still below the pre-crisis levels. The other half, mostly the new member countries from Eastern Europe, outpaced considerably the crisis drops. What is more important, in both cases the investment cut has been made mainly at central level i.e. preserving local governments fiscal ability to invest.

It is fair to say, that local governments in South-East Europe are playing a successful game of catch-up, spending as much they can to modernize the run-down infrastructure they have inherited. They are spending higher proportions of their income on investment despite receiving significantly lower shares of public revenue measured either as a percentage of GDP or of total public revenue (Chart 6).

Chart 22 shows the average public investment by level of government as shares of GDP for the period 2005-2015. The total public investment spending of the SEE region as a group (5%) is higher than the EU 28 average (4.3%) but six SEE countries are below, some considerably, the both averages. SEE and the EU28 have another similarity – in both regions central government expenditure accounts for the lion's share of total public investment – the notable excep-

Chart 22 Total Public Investment by Level of Government as shares of GDP (average 2006-2015)



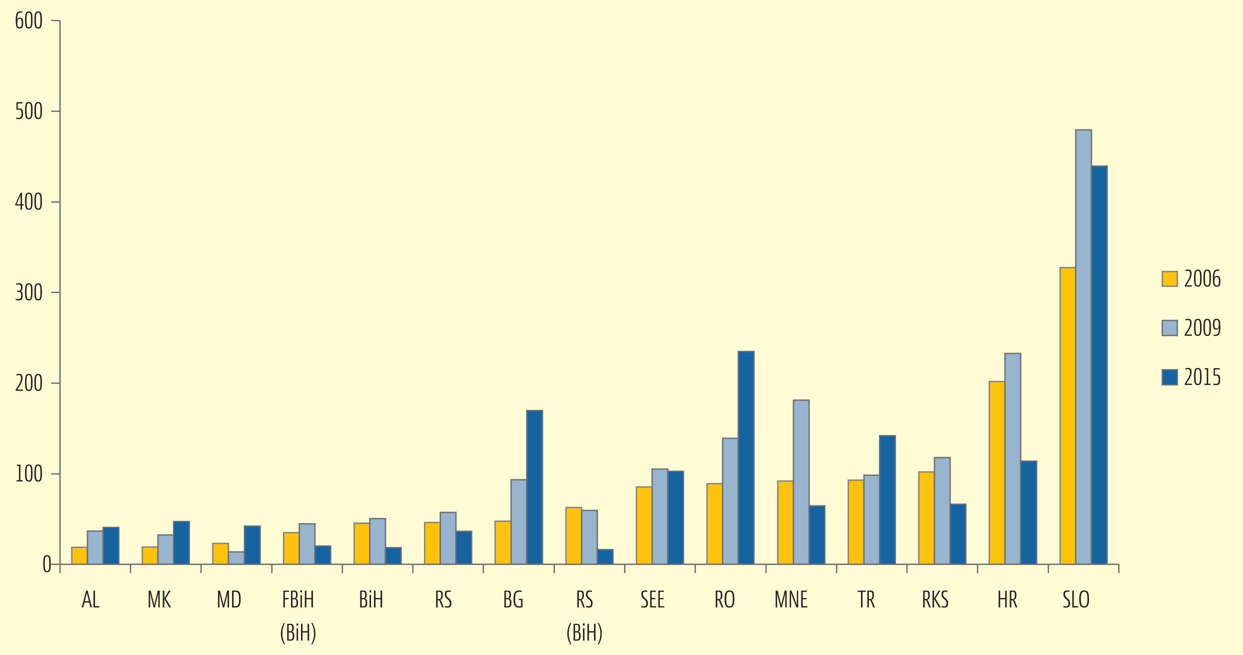
tion here is Slovenia, where 60% of the public investments are made at local level[8]. The local investments' share in SEE varies widely between 0.5% (BiH) and 2.5% (Montenegro and Romania) of GDP. It is extremely low in both Albania and FBiH (of BiH) and is not much higher in Macedonia and Serbia. The picture is better in Romania, Bulgaria, Slovenia, Moldova, and Turkey. In five countries, the share of local investments exceeds the EU28 average.

For the region as a whole, this picture seems lower than what might be reasonably expected, given the fact local governments in South–East Europe have huge deficits in basic urban infrastructure that can only be overcome through high levels of sustained investment.

Chart 23 presents local government investment spending in EUR per capita in 2006, 2009, and 2014. Seen from this angle, the region's indicator falls by 15% (E 17 per capita) – for the first time since 2011, when NALAS started the monitoring. Despite being volatile, municipal investment spending per capita has been falling in a greater number of countries than in 2014 – Slovenia and Kosovo joined Montenegro, RS (of BiH), FBiH, BiH, Serbia and Croatia.

Some national trends are hard to understand – in 2014 Kosovo marked a record of E 174 per capita; in 2015, it dropped to E 66. Meanwhile, Albania, despite relative high shares of investment spending in total expenditure (44%) and positive investment rates since 2006, can hardly exceed 40 EUR

Chart 23 **Local Government Investment in 2006, 2009, 2015 (EUR per capita)***



* Domestically financed

[8] This ratio moves Slovenia closer to the so-called benchmark of a decentralized state – Denmark, where most of the public investments are local.

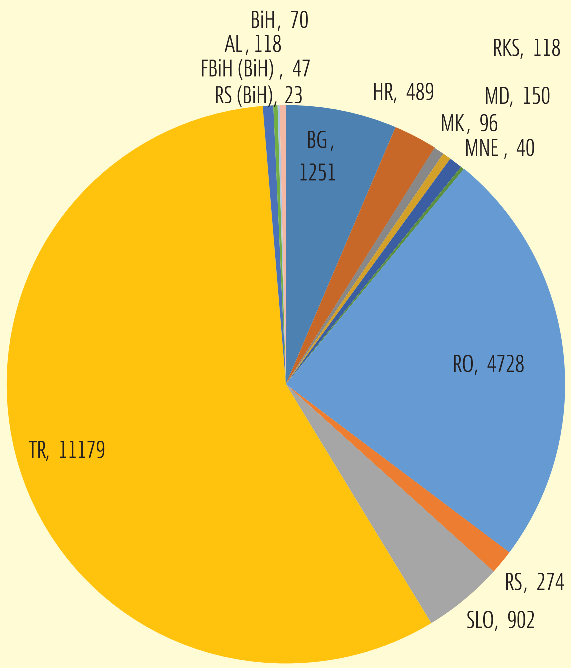
per capita on local infrastructure but again, the total public sector there is very small.

Finally, it is worth stating what different influence the EU Structural Funds might have on the national investment policies. Local governments in Bulgaria and Romania spent 40% more on infrastructure than in 2014 (*EU money excluded*) meaning that the central governments even increased the capital transfers to the municipalities. There is a simple logic for this – the EU funds do not cover all of the projects' activities. Having in mind that these are costly projects, especially the environmental ones, the state adds up additional national funding for the successful completion of the projects.

In Croatia and Slovenia, much wealthier than Bulgaria and Romania, the use of EU money maybe substitutes for the investment of own revenues for infrastructure thus the decrease by 10% to 40%.

Continuing the topic of the relative wealth, Chart 24 shows local government investment in million EUR for all members of the group in 2015. Again, it is a useful reminder of how much variation there is across the group in both wealth and in local revenue and expenditure patterns.

Chart 24 Investment Spending in Million EUR 2015

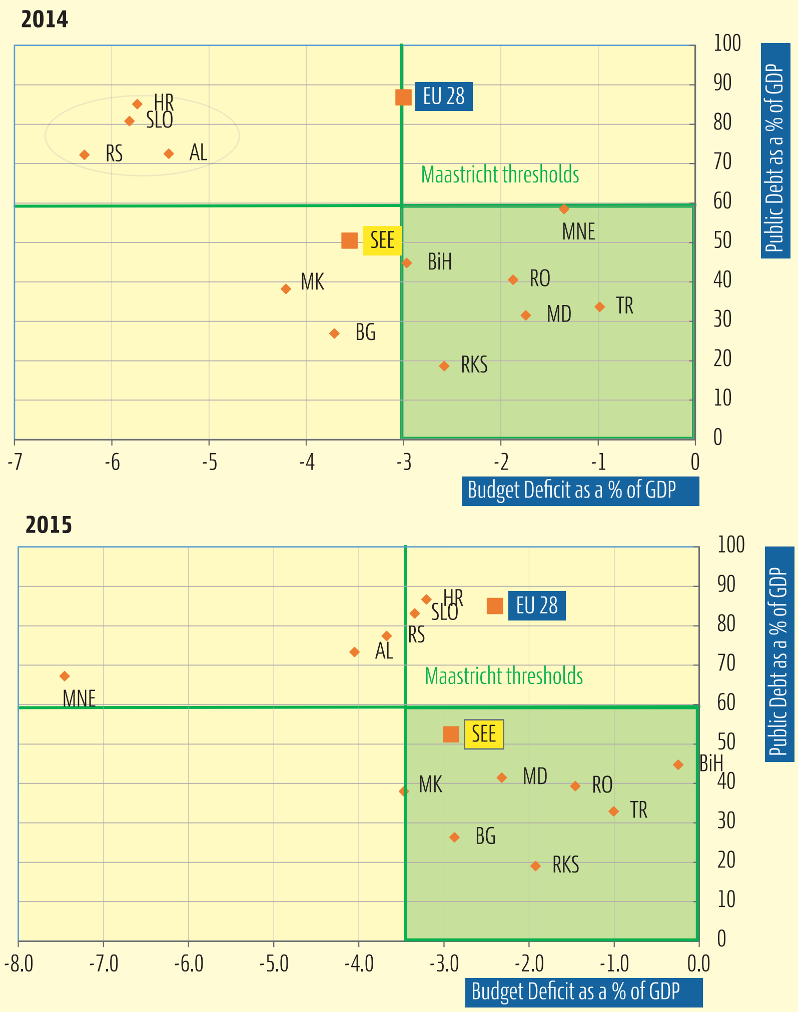


Local Government Borrowing

In most of the region, local government borrowing is a new phenomenon. One of the main constrains for its development, besides other factor like too centralized regulatory framework, is by high levels of central government debt and the budget deficits. The countries in Europe generally try to meet the Maastricht Treaty's guidelines for total public debt and annual budget deficits (*less than 60% and 3% of GDP respectively*).

From this prospective 2015 is quite different than 2014 so the two charts, 25 and 25a, show the pictures for the respective years.

Chart 25&25a Public Debt and Budget Deficits in SEE Region in 2014 and 2015



The region as a whole is still close to the debt level threshold (criteria) – 52%, but the groups' budget deficit has improved – slightly below the 3% criteria. In 2014, six members of the group had total public debt and deficit levels below the Maastricht limits. In 2015, one of them, Montenegro, deteriorated the two indicators, which are now above the thresholds (*67% and −7.5%*). Bulgaria decreased its deficit below the criteria and Macedonia is close to do so.

In 2014 Croatia, Slovenia, Albania and Serbia have exceeded the 60% limit for total public debt (*within this group: the lowest in Albania – 73% and the highest in Croatia – 87%*). These high levels remained in 2015 though their budget deficits decreased.

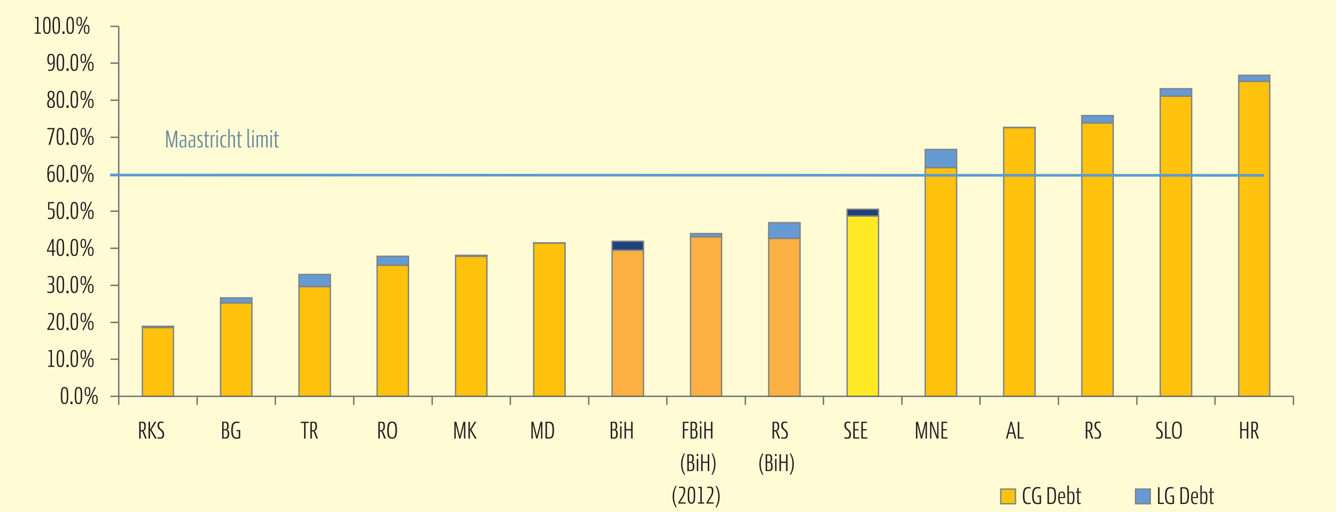
Under Maastricht, total public debt includes the debt of both national and subnational governments (*though not the debt of publically–owned but commercialized utilities. Their debt is considered a corporate one.*). As a result, when total public debt is close to or above Maastricht limits, not only is there pressure to reduce overall borrowing but local governments compete with their national governments for "debt space".

Chart 26 shows that the vast majority of this debt space is already taken up by the national government. Albania and Serbia are already above the Maastricht limits despite the fact that local government debt represents a negligible fraction of total public debt. Meanwhile, in Slovenia, Montenegro and Croatia, they too above the limits, local government borrowing has been more substantial. In these five countries, it is unlikely that the national governments will look favorably on new subnational borrowing. What is more, they even may constrain new local borrowing.

Given the infrastructure deficits, facing local governments across the region, this is unfortunate and efforts should be made to ensure that municipalities in these five countries have at least some access to debt capital.

In other members of the group, debt remains well below the Maastricht limits and local governments should confront fewer policy obstacles in borrowing.

Chart 26 **Public Debt by Level of Government as Share of GDP***



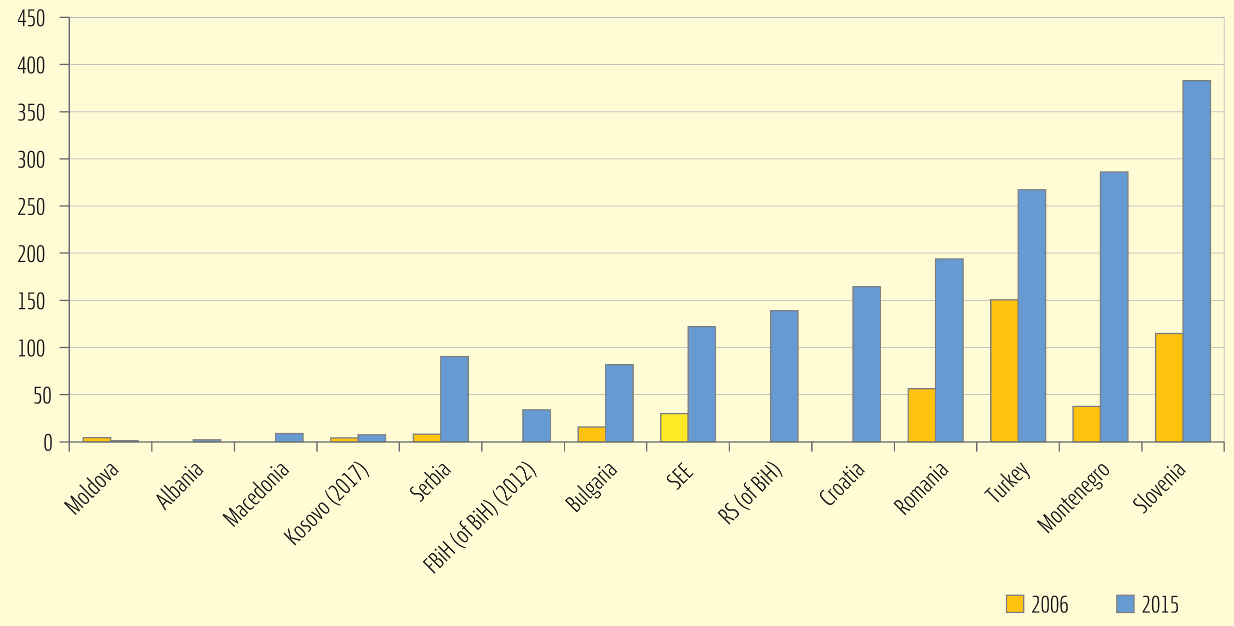
* Data for Turkey includes unpaid liabilities to private contractors or government agencies. These equal at least half of the total.

Chart 27 shows the increase in total outstanding local government debt between 2006 and 2015 in per capita terms. The region's local borrowing has increased substantially – over four times. Growth has been particularly striking in Croatia, Montenegro, Serbia and the RS (of BiH). Not all of this growth has been prudent, however and it seems that during the recession some local governments, at least in Montenegro and the RS, borrowed less to build new infrastructure than to avoid making painful cuts in operating costs. In any case, some municipalities in these countries are having trouble meeting their debt service payments. The local governments in Moldova, Albania, Macedonia and Kosovo practically do not use debt instruments.

In many places, the overall adequacy and predictability of local government revenues will have to be increased if municipalities are to prudently incur debt. Given the dependency of local governments on transfers, the rules regulating intergovernmental finances and borrowing need to be clear and stable if borrowers and lenders are to be confident that municipal governments will be able to pay off their debts. Other NALAS's studies have identified the following obstacles to local borrowing for infrastructure:

- In most SEE countries, the law requires central government's (*ministry of finance*) approval prior to local debt issuing;
- In more than half of SEE countries there are legal limitations on both the total outstanding debt and the annual debt service payments;
- Local governments will have to do a better job collecting own–revenues, particularly with respect to setting higher tariffs and then forcing utilities to collect them;
- Local governments will have to radically improve their ability to prepare, plan, and cost–out complex, multi-year investment projects – particularly in the water and solid waste sectors;
- The central governments should systematically promote incentives for investing on a pay–as–you–use basis (*mainly debt–financed*) instead of the currently predominant pay–as–you–build (*paid out of recurrent revenues*).

Chart 27 Increase in Local Government Debt 2006–2015 (EUR per capita)



IV. Country Reviews of Fiscal Decentralization Trends and Developments

Albania

Intergovernmental Finance System

In recent years, the government of Albania has made substantial progress in setting up the policy development framework for decentralization. In July 2014, the Parliament of Albania enacted the Territorial and Administrative Reform (TAR), decreasing the number of local government units in Albania from 373 very fragmented communes and municipalities to just 61 consolidated and larger municipalities. It is generally agreed that this was the greatest change to Albania's system of local government and it provides an unprecedented opportunity to strengthen local government capacities.

After the TAR, a series of consequential legal and institutional changes occurred in 2015: i) local elections took place in June and 61 Mayors took office in the newly constituted municipalities; ii), a new National Crosscutting Strategy on Decentralization and Local Governance has been enacted, providing a roadmap to enhance decentralization and strengthening local government and (iii) a new Law on Local Self–Governance was approved in December, consolidating local governments' rights while enhancing their responsibilities by decentralizing a number of new and costly functions such as (fire protection, irrigation, the wages of pre–schools teachers and social service centers).

Intergovernmental finances in Albania are regulated by a wide array of laws and bylaws, with the most important ones being the new Law "On Local Self–Government", the Law "On the management of the Budgetary System in the Republic of Albania" and the Annual Budget Laws. The legal framework defines four types of transfers: shared taxes, unconditional transfers, conditional transfers for delegated functions and conditional competitive–based investment grants from the Regional Development Fund (RDF).

Sharing the Personal Income Tax or the Corporate Income Tax have always been promised by the Albanian legal framework but the actual shares have never been defined. On the other hand the national government has been sharing with local governments 18% of the annual tax on vehicle circulation and 5% of mineral rents.

The Unconditional Transfer was introduced in 2001 and provides local governments with funds to execute their exclusive functions. The unconditional grant is the single most important source of revenue Albanian local governments, constituting more than 50% of revenues for about 43 of the 61 larger municipalities at end 2016. Unfortunately, despite its importance the legal framework had never addressed the issue of the annual determination of the total size of the grant. However, with the new LGFL, expected to be adopted by Parliament in 2017, the annual size of the unconditional transfers to local governments will be anchored at 1% of the Gross Domestic Product, ensuring both predictability and stability of financial resources over time.

In 2015, with USAID's support, a new formula for the allocation of the unconditional grant was introduced, reflecting the implications of the territorial and administrative reform and increase equity, predictability and transparency in the allocation of resources. The new formula's allocation criteria are: a), 80% of the total pool is allocated to the 61 jurisdictions on the basis of the concept of Effective Resident Citizens that is the 2011 Census data adjusted by adding 30% of the difference between the Civil Register and the Census; b), 15% of the total pool is allocated to jurisdictions with a population density lower than 110% of the national average; there are four different density thresholds, with less dense municipalities benefiting from extra-resources; In total 39 municipalities receive additional resources through this mechanism; and c), 5% of the total pool is allocated to the 61 municipalities based on the effective number of pupils enrolled in the primary and secondary education system. Once the Unconditional Transfer has been calculated, then a separate set of calculations are made for those local governments whose total per capita revenues from existing shared taxes are below 75% of the national average and 110% above the national average. In 2015, Local governments whose total per capita income is less than 75% of the national average and whose grant is less than 85% of the of last year's grant are then compensated for the difference. Conversely, local governments whose total per capita income is 10% greater than the national average and whose grant is more than 15% of last year's grant must give up the difference to help pay for the compensation of the others.

Conditional transfers come from two sources. The first is from appropriations from line Ministries that are allocated to local governments for delegated functions or for functions, the responsibilities over which are in practice shared by the two levels of government. The second is from an increasingly large Regional Development Fund that allocates investment grants to municipalities on a competitive basis. Indeed, since 2009 conditional transfers have constituted the single largest source of local government revenue. The extensive use of conditional transfers has substantially reduced the fiscal autonomy of local governments and has led to allegations that they are being allocated for political purposes, which do not reflect clear developmental goals.

Main Developments in Municipal Finance 2015–2016 and Advocacy Efforts of the Association

The last two years have been particularly important for municipal finances in Albania. As already mentioned, in October 2015, the Government introduced a new formula for the allocation of unconditional grants to all local self-government units, changing also the allocation and equalization criteria. Throughout 2016, in cooperation with local governments, their associations and other stakeholders, and with the support of USAID and the donor community, the Ministry of Finance has been working on a draft-Law on Local Government Finance (LGFL). After many months of discussions and consultations, the draft-LGFL has been approved by the Council of Ministers of the Republic of Albania and is expected to be adopted by Parliament within the first half of 2017 enabling thus local governments to budget for 2018 and onward within the new legislative framework for local finances.

While providing more stringent budgeting procedures, the LGFL is expected to increase local governments' revenues from freely disposable intergovernmental transfers by at least 30% over 2016. Further, the draft-LGFL introduces a set of rules that ensure the uniformity in budgeting and public finance management practices and procedures between the national and local governments, as well as new rules for the management of financial distress and insolvency of local governments. The national government has also committed to developing a new Law on Property Taxation that would reform the current area-based tax into a value-based system and a new law on Regional Development. However, their development status remains unclear despite commitment made.

The Albanian Association of Municipalities (AAM) and the Albanian Association of Local Autonomy (AALA) have had a seat in the Intergovernmental Working Group set up by the Ministry of Finance of Albania for the development and consultation of the draft-LGFL. AAM and AALA have discussed the various drafts with their members, collecting important feedback from their experts and practitioners, on how to improve the intergovernmental finance system and remove constraints on revenue raising options. Such comments and recommendations have been continuously shared with the Ministry of Finance. However, while recommendations on the size of the unconditional (general grant) have been taken into consideration, recommendations for the improvement of the conditional/competitive based investment grants from the Regional Development Fund still needs to be addressed. AAM will continue to advocate to increase local government funding to about 5% of the GDP and reforming the Regional Development Fund, so that investment funding can be allocated more transparently and equitably to all 61 municipalities.

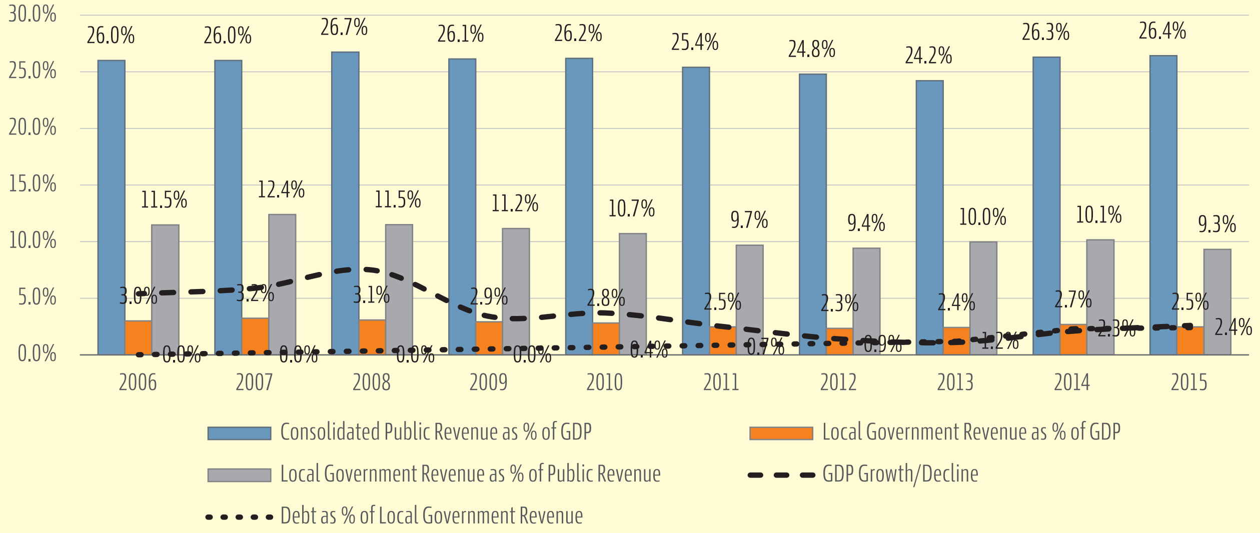
NALAS joined the advocacy efforts of the Association of Albanian Municipalities by bringing the regional best practices in the analyses and discussions. In February 2016, AAM and NALAS, supported by USAID's Planning and Local Governance Project (PLGP), organized a peer learning and knowledge sharing workshop *"Best practices in Local Government Finance Legislation: the South-East Europe experience and the challenges facing Albania"*, involving experts and policymakers from six countries of the region that have faced (or continue facing) similar challenges in recent years. The event reinforced evidences that Albania was the only country in the region that still left the size of the unconditional grant entirely up to an annual decision by parliament, did not use PIT sharing and implements a system where local governments are asked to compete for investment financing for exclusive local functions. Indeed, among the most important achievements of the draft-LGFL, is the anchoring of the size of the general (unconditional) grant to a macroeconomic variable and the introduction of Personal Income Tax sharing, both of which are very common in the region.

www.financatvendore.al is the information platform on fiscal and financial performance of the Albanian local government units brought by Co-Plan Institute for Habitat and supported by Open Society Foundation. This platform aims at Open Governance as responsible government. The platform is the result of a work supported by the Ministry of Finance, Ministry of Local Government and the Association of Albanian Communes. The platform, an innovative one for Albania, provides for distribution and division of the financial and fiscal data of the local government units for 2008 – 2014, and for comparative analysis of such data. Thus, it is becoming an important instrument of monitoring the financial and fiscal performance of the LGUs but also of increasing the transparency of the government and improving the inclusive decision-making.

Statistical Overview of Local Government Finance in Albania 2006–2015

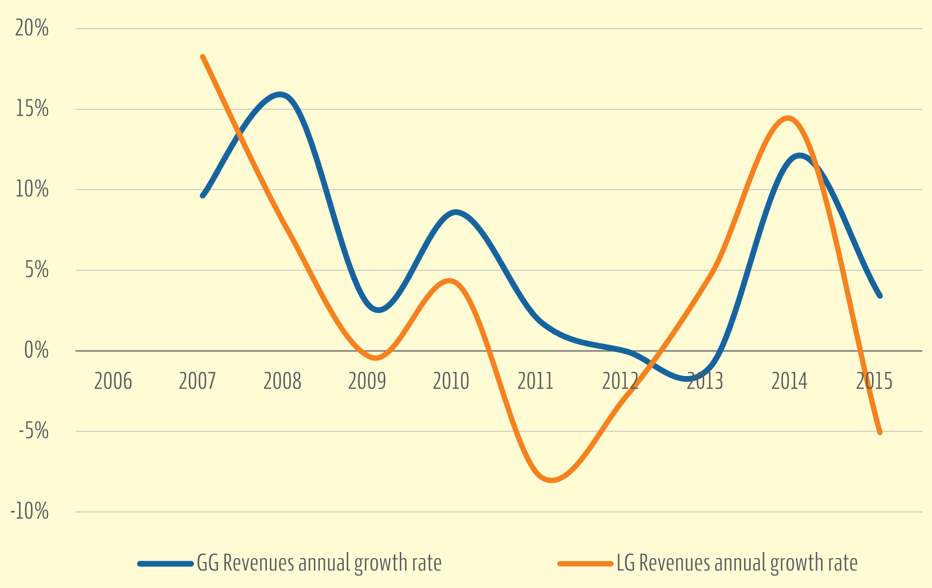
Over the past decade, Albanian local governments have received less revenue as a share of GDP and of total public revenue than all their counterparts in South East Europe. Worse, this share fell from a high of 3.2% of GDP in pre–crisis 2008 to 2.5% in 2015, and is still well below the level in 2006. They also receive the lowest share of total public revenues in the region, which in 2015 fell to a record low of 9.3%. Overall, the national policies on the small business tax and the infrastructure impact tax have had adverse consequences on local government budgets. Because of the very conservative legal framework and administrative orders of the Ministry of Finance, municipalities in Albania cannot raise funding from local borrowing. The stock of local debt constitutes 2.4% of local government revenues in 2015, or 0.06% of the GDP.

Albania: **Local Government Revenue as a Share of GDP and Total Public Revenue 2006–2015**



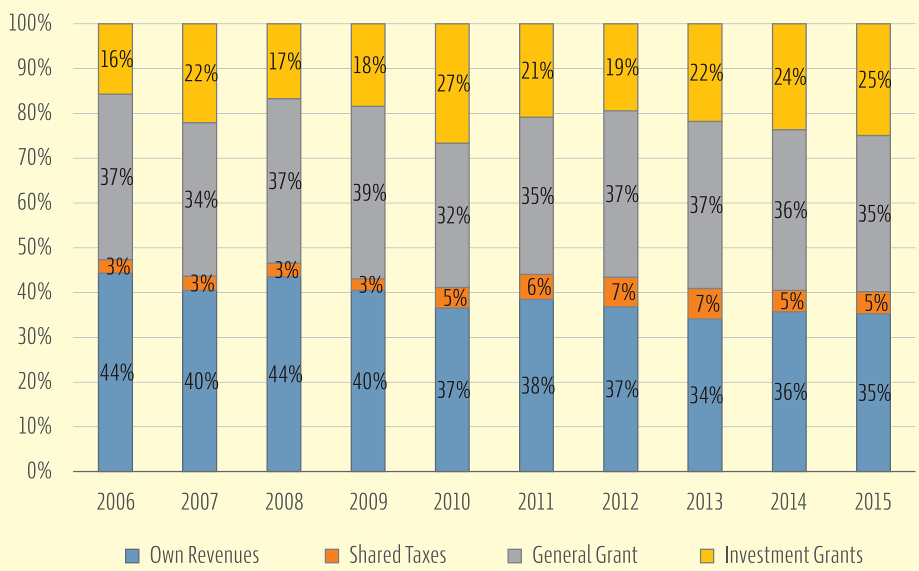
Between 2007 and 2015, local government revenues fell faster and rose slower than the revenues of the national government. This suggests that the national government is not committed to sharing the benefits and burdens of economic growth with local governments. In 2015, a steep decline in the growth of the local governments of –5% was registered coming right after the rather dynamic 2014. The main reasons behind the fall in local government revenues in 2015 is the reduction of the unconditional grant by 7% y–o–y and the reduction in the yield of the infrastructure impact tax on new buildings by 41% y–o–y.

Albania: **Revenue Fluctuations of the General Government and Local Governments 2006–2015**



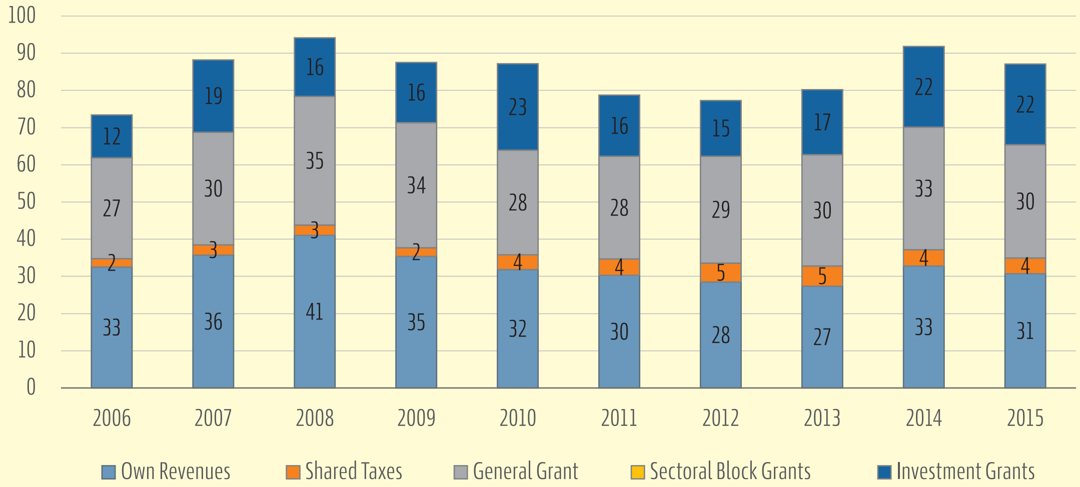
Own source revenues contribute to 35% of local government finances, with the remaining 65% being directly or indirectly controlled by the national government. While it is expected that the anchoring of the general (unconditional) grant to a % of the GDP and the introduction of a PIT sharing will improve local government finances and with it their financial independence, a very high and unstable share of local financing in still comes from Competitive Investment Grants from the national government. This subjects local budget planning to large degrees of uncertainty and political patronage. Competitive Investments Grants reached 25% of the local revenues in 2015.

Albania: Composition of Local Government Revenue 2006–2015



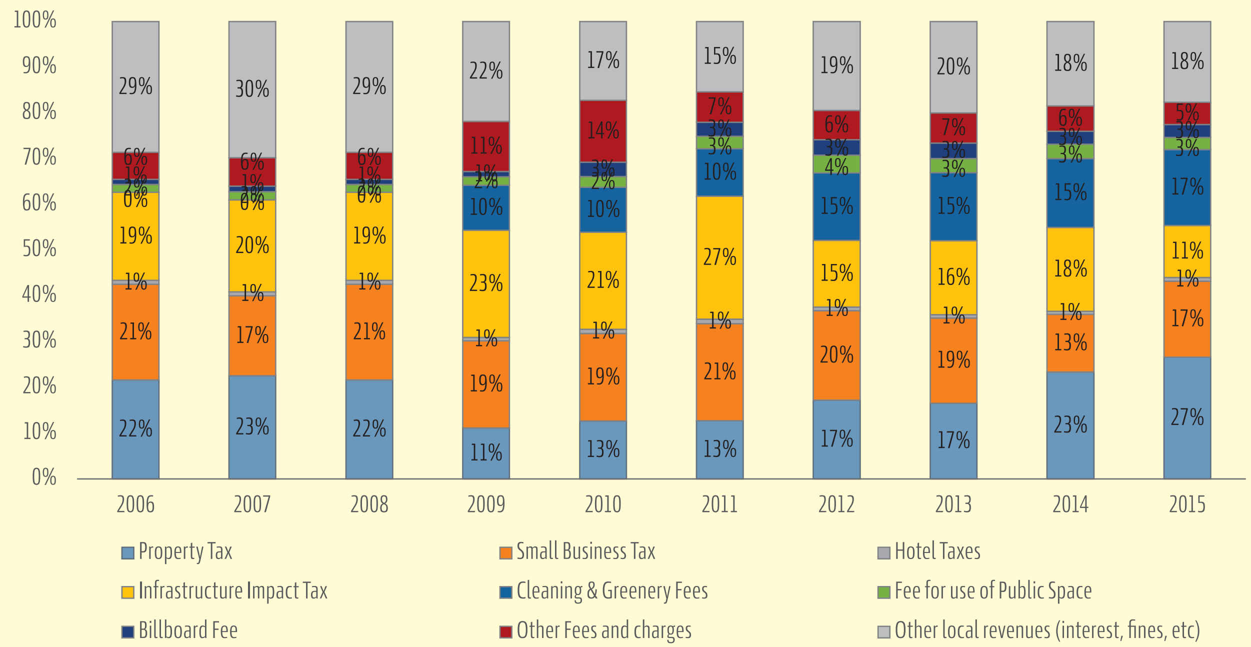
Local Government Revenues in EUR per capita peaked in 2008 at 94 Euros per inhabitant (census data); fell steadily through 2012 with 77 Euros per inhabitant, before increasing in 2014 with 92 Euros per inhabitant. As already mentioned earlier, in 2015, with the fall in the unconditional grant and the decline of the infrastructure impact tax, per capita revenues fell again at 87 Euros per inhabitant.

Albania: Compostion of Local Revenue Euro per capita 2006–2015



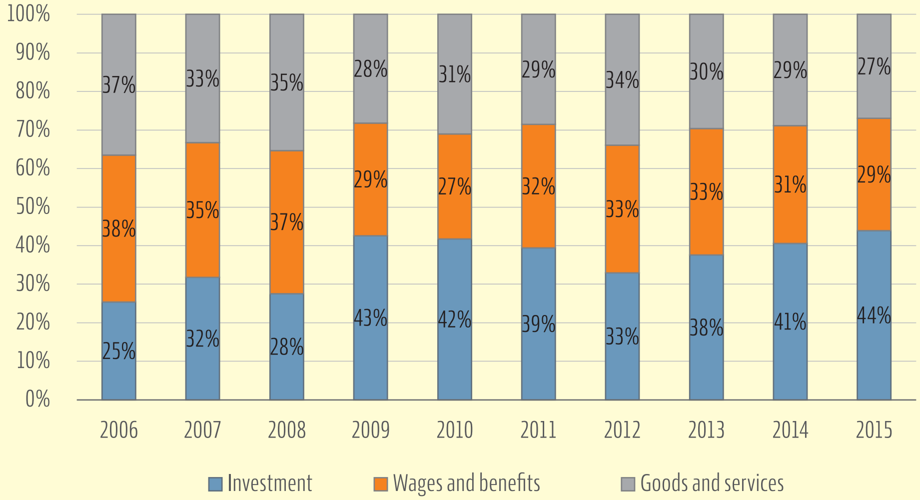
In the composition of own revenues, the Property tax has been trending upward in the past years, and in 2015 it represented 27% –its highest level in the analyzed period. In recent years the national government has eliminated all local government powers over the base, rate and collection of Small Business Tax (SBT). This has led to a substantial fall in the yield of the tax. Local governments have put more effort into collecting the property tax as their powers over the small business tax and the infrastructure impact tax have been eroded. Over the past few years, Albanian local governments have also improved the administration of local fees and charges. The most important local fees are the waste collection fee, along with greenery and public fees, and fees for the occupation of public space.

Albania: Composition of Own Source Revenues 2006–2015



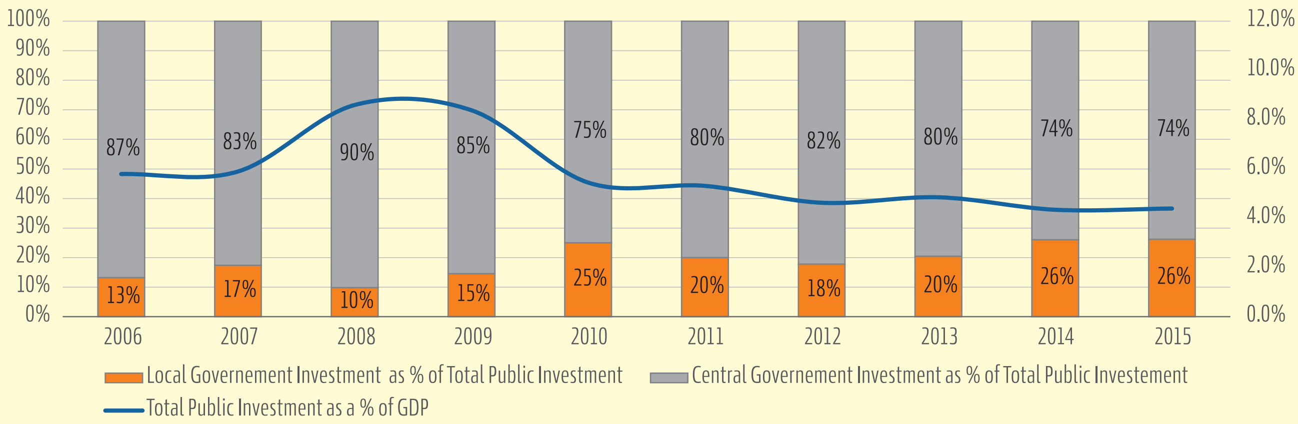
Despite the low share of local government revenues in total public revenues, investment spending as a share of total local expenditures has been relatively high. In 2015, capital investments made up to 44% of total local expenditures, which is the highest share in the past decade, while personnel costs fell to 29% which their lowest level in the decade. This is due in part to the high share of Conditional Investment Transfers in the system.

Albania: **Composition of Local Government Expenditures 2006–2015**



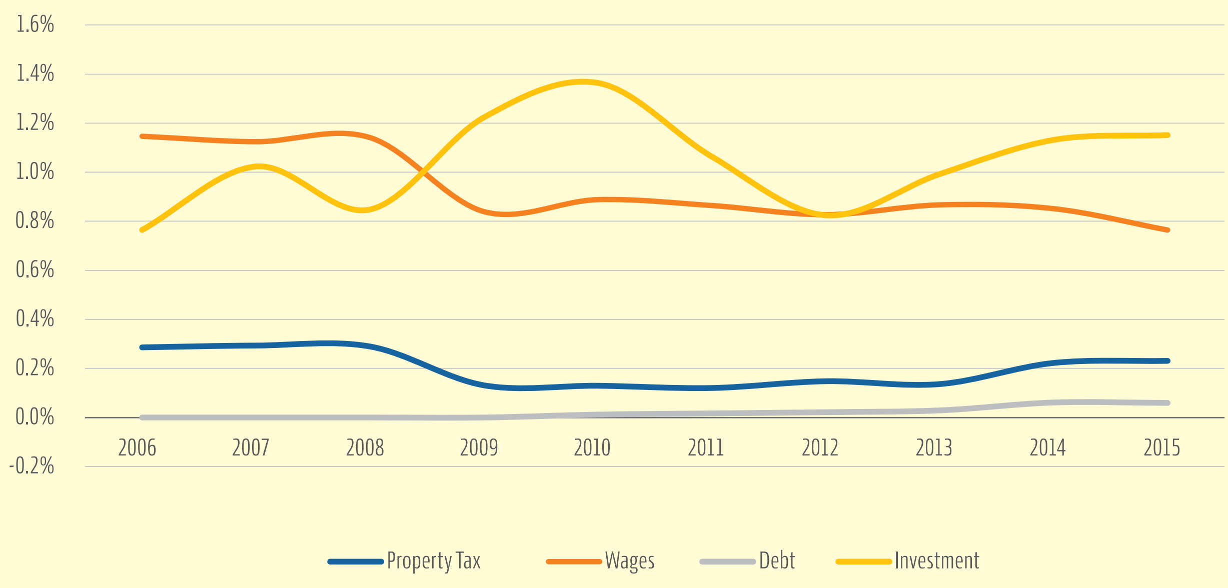
Yet, when we compare central vs. local government investments, we see that despite these conditional transfer, local investment remains low as a share of total public investment, (26%) while of total public investments have remained quite stable 4% of GDP since 2010.

Albania: Investment by Level of Government and as a % GDP 2006–2015



Local government spending on Wages and Investment, as well as the yield of Property Tax revenues are all low as shares of the GDP, when compared to Albania's counterparts in the SEE region. The property tax collection has been stable in the analyzed decade, with a slight increase in 2014 and 2015. Local debt is also low, at 0.06% of the GDP at the end of 2015. While spending for personnel salaries shows a stable downward tendency, spending on investments has been fluctuating following much more the competitive conditional transfers allocation rather than the performance of own revenue collection.

Albania: **Investment, Wages, Debt and Property Tax as Share of GDP 2006–2015**



Bosnia and Herzegovina

The complex administrative system of Bosnia and Herzegovina (BiH), consists of the state of BiH which is the central level of government, the two entities: Republic of Srpska (RS of BIH) and the Federation of Bosnia–Herzegovina (FBiH of BiH), and the District of Brcko. In FBiH (BiH), the next level of government are the cantons and within them cities and municipalities. In RS (BiH there are only cities and municipalities below the entity level.

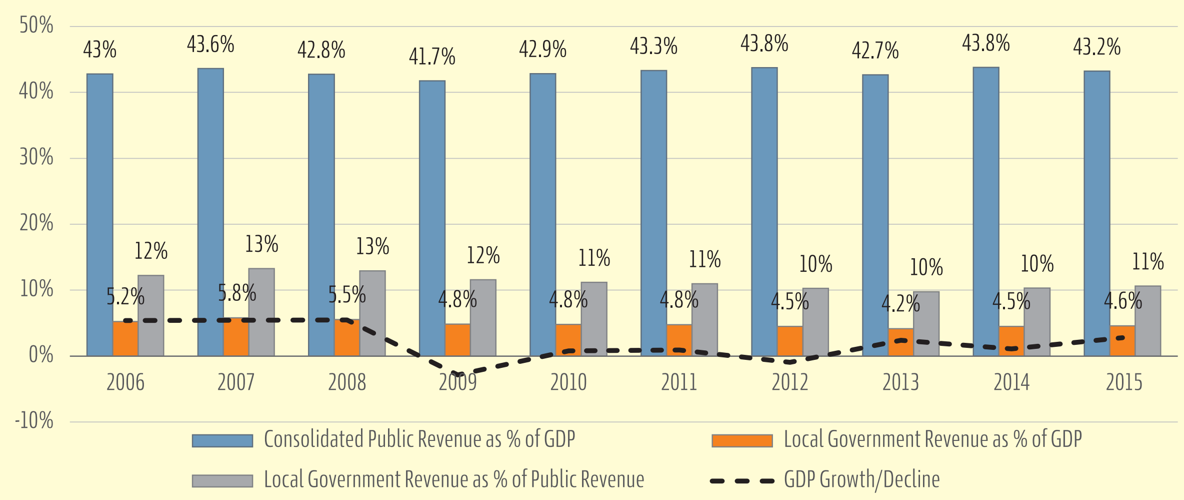
In fiscal terms, the most active level in FBiH (BiH) are the cantons while the entity is not very significant. In RS. (BiH) it is the entity. Each entity has its own Ministry of Finance. On the central level (BiH) the coordinator of fiscal policies is the Fiscal Council. The allocation of indirect taxes within each entity, as well as the regulation of direct and other indirect taxes are regulated by entity legislation. The share of the funds that is controlled by the central state (BiH) is very low at around 10%. Indirect taxes are the most important source of revenue for all levels of government. They are collected by the central level and then divided between the State, the entities and the Brcko District according to a formula stated in the Law on Indirect Taxation in BiH.

In 2009, in order to alleviate the effects of the crisis, the central government took a loan from the IMF and used it for financing current expenditures. Although the local governments did not participate in the decision related to this loan, they were forced to participate in paying it back. This has significantly weakened the position of the local governments in both entities since 2012. The associations of local authorities in BiH addressed this issue and put serious efforts into advocating for exempting local governments from servicing the foreign debt of higher level of government.

The general picture of the municipal finances in Bosnia and Herzegovina shows a gradual decline in the share of local government revenues as a % of GDP from 5,8% in 2007 to 4,6% in 2015.

As the systems of municipal financing in the two largest entities are quite different and as NALAS has two members from BiH, one from each entity, we continue the analysis for the Federation of Bosnia and Herzegovina and for the Republic of Srpska separately.

Bosnia and Herzegovina: **Local Government Revenue as a Share of GDP and Total Public Revenue 2006–2015**



Bosnia and Herzegovina – Federation of Bosnia and Herzegovina

The Intergovernmental Finance System

In FBiH, the entity's share of indirect taxes is allocated to municipalities and cantons according to fixed percentages. These shares are given to municipalities and cantons as Unconditional Transfers and are allocated by formula. The main criteria for allocating the transfer is population (70%). But there are other coefficients for surface area, school age children and relative wealth –as measured by the yield of the Personal Income Tax– that have equalizing effects. In 2014, the Unconditional Transfer constituted about 27% of municipal revenues.

The Unconditional Transfer has fallen because of the rules governing entity debt. These rules require that debt service payments to foreign creditors be paid directly and immediately from each entities' share of indirect revenues. As a result, the pool of revenues that would otherwise go to cantonal and municipal governments is automatically reduced by the debt service payments of the Federation government. Because 60% of all indirect taxes are earmarked for cantons and municipalities they are effectively paying 60% of all debt incurred by the Federation.

During the economic crisis of 2009, FBiH took a loan from the IMF for over 250 million EUR to finance current expenditures. Now the entity government must pay back the loan. But because much of the debt–service cost is being born by cantons and municipalities, they have seen their revenues from indirect taxes fall substantially, despite an overall improvement in the economy. To address this problem, the FBiH Parliament created a Fiscal Coordination Body in 2014. This new institution is responsible for determining the status of the entity's debt obligations and for taking measures to ensure that debt service payments can be met in fair and equitable way. The Fiscal Coordination Body includes the Federal Minister of Finance, all cantonal Ministers of Finance and a representative of the Association of Municipalities and Cities of the Federation of BIH.

The Law on the Allocation of Public Revenues also requires cantonal governments to share a specified percentage of PIT with their municipalities on an origin basis. In 2012 the FBiH Parliament increased the share of PIT that cantons must share with municipalities from 34.46% to 41% in all cantons except Sarajevo Canton. Municipalities within Sarajevo Canton were also give the right to receive their share of indirect taxes directly from the entity government, and on the same basis as municipalities in other cantons. In 2014, about 17% of local government revenue came from shared taxes. Another other 17% comes from conditional grants which municipalities receive from either the entity or, more frequently, the cantons. Most are for specific investment projects

Main Developments in Municipal Finance 2015–2016 and Advocacy Efforts of the Association

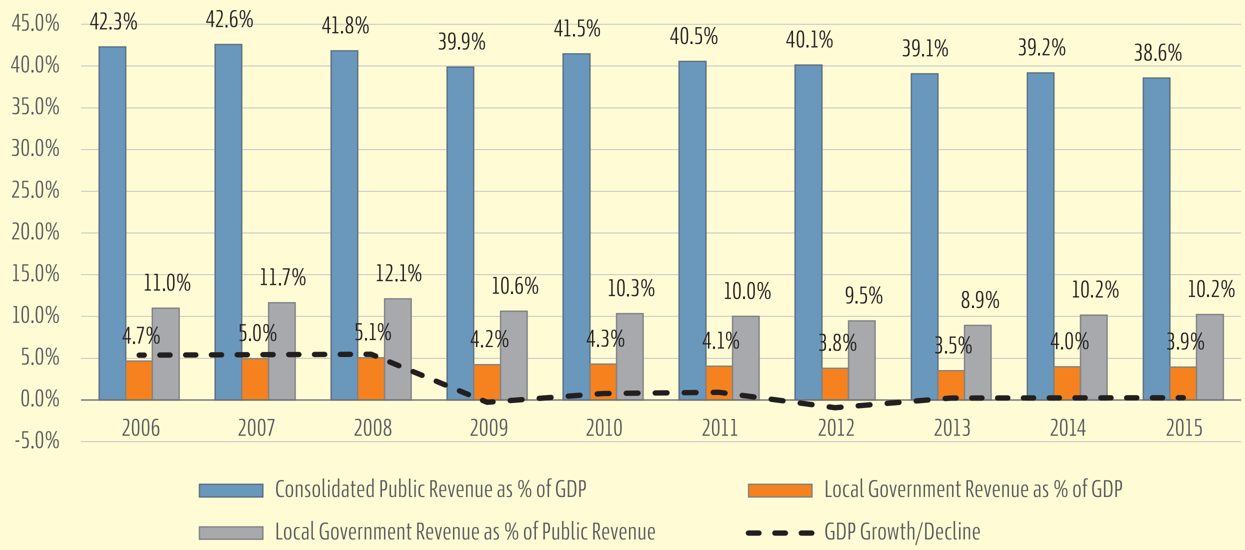
The Association initiated a series of efforts in exempt the local governments from servicing the debt of the IMF loan about which they were never consulted and from which they received no direct proceeds. The Association is asking the federation government to return over 18 million KM for 2013 alone.

Amendments to the Law on the Allocation of Public Revenues in FBiH gave back to the City of Sarajevo the right to be financed directly from the central account of the federation, thus integrating its financing into the more general transfer system after 18 months of legal battles.. These amendments follow the decision of the Constitution Court of FBiH that ruled that the taking of revenues from the city has was prohibited by the constitution of Bosnia and Herzegovina, the Law on the principles of local government and the European Charter of Local Self Governance.

Statistical Overview of Local Government Finance in FBiH (of BiH) 2006–2015

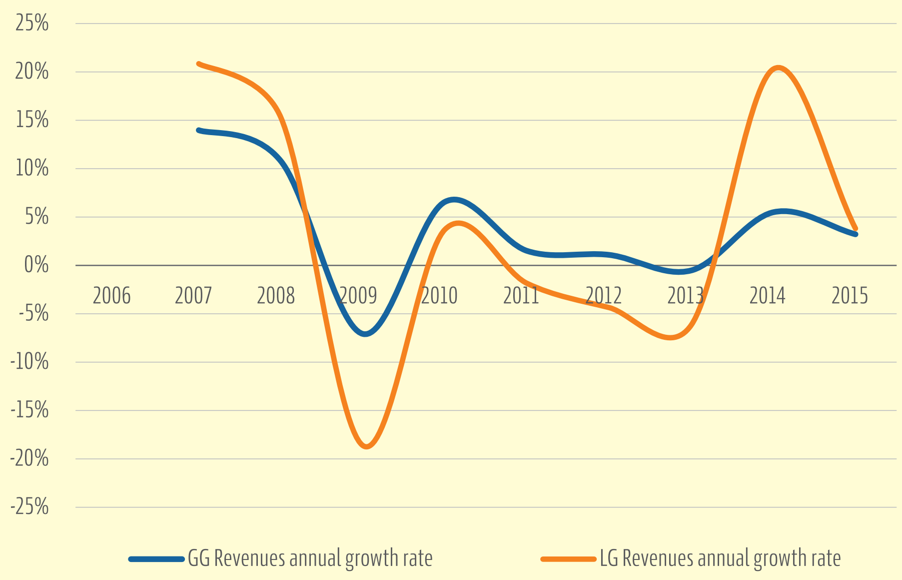
Local government revenues in FBiH (of BiH) have not changed significantly in the past decade yet. The upward trend that was evident before the financial crisis never returned. Local government revenues as a share of total public revenues have fallen from 13% to under 9% since 2008. The lowest share was recorded in 2012 –2013, but in 2015 we see this indicator returning to levels of around 10% of total public revenues. In 2015, overall public revenue dropped and the share of local revenues as a share of the GDP was very low, at only 3,9%.

FBiH (of BiH): Local Government Revenue as Share of GDP and Total Public Revenue 2006–2015



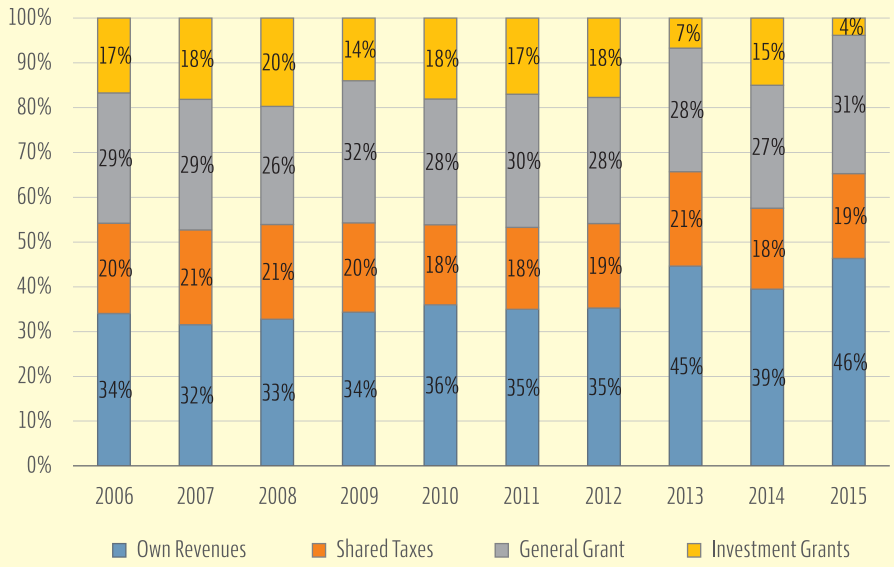
Local government revenue fell much faster than that of the general government during the economic crisis of 2008–2009 and again in 2012–2013. They have also recovered more slowly suggesting that a disproportionate share of the burden of the downturn was placed on local governments except in 2014 when the local level received support to deal with the flood damages.

FBiH (of BiH): Annual Fluctuations in the Revenues of the General Government and Local Governments



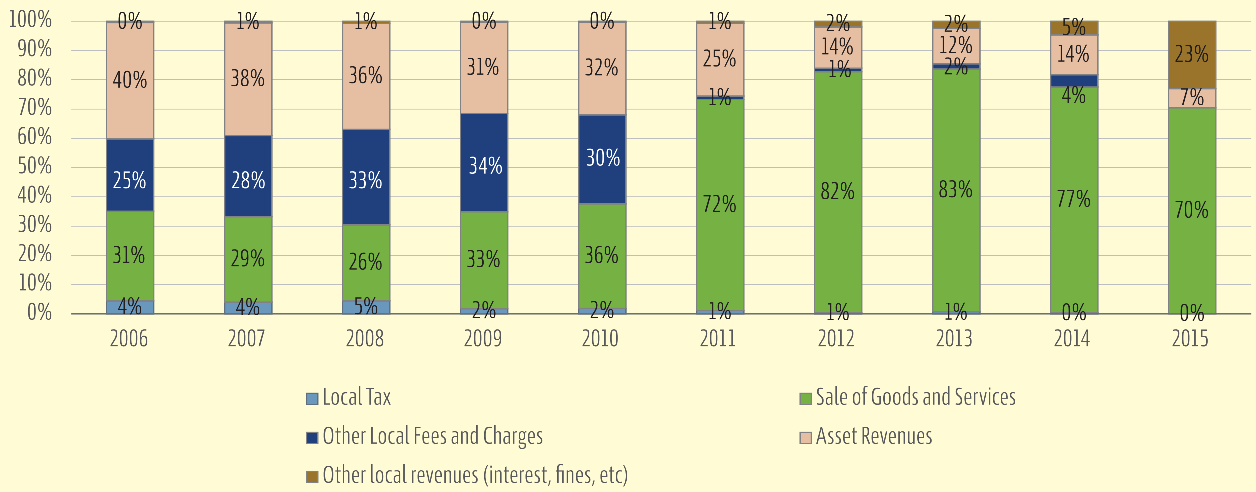
All categories of local government revenue declined in 2009 in the face of the global downturn and –with the exception of own revenues– have yet to return to pre–crisis levels, despite an improvement in the overall financial picture of local governments in 2015. Investment grants have seen a major decrease in 2015 and are the least improtant element of the local revenues (only 4%) since 2006.

FBiH (of BiH): The Composition of Local Govrnment Revenue 2006–2015



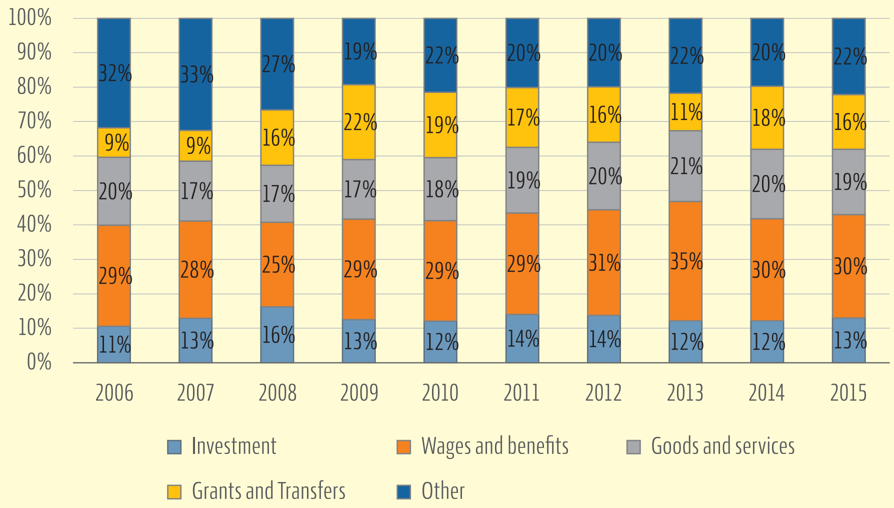
The composition of own revenues shows a major increas in income from municipal assets and services since 2011, as well as a decrease in the yield of the property tax. Interpretation of this data is difficulty because the registry of municipal own revenues across cantons is notoriously inconsistent.

FBiH (of BiH): **The Composition of Own Local Govrnment Revenue 2006–2015**



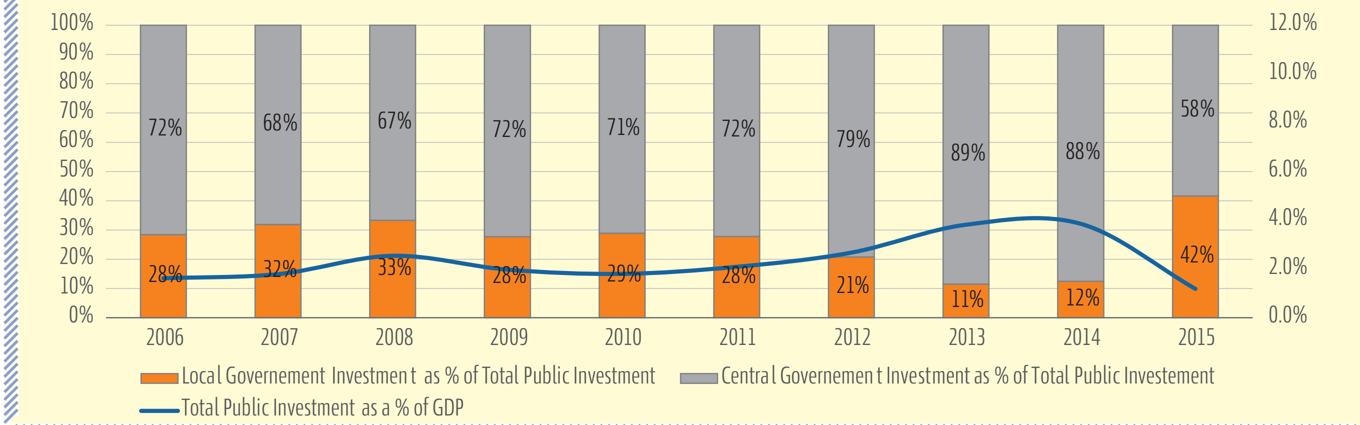
Wage spending remained stable despite the economic downturn. Investment, however, fell to 13% of total expenditure in 2015. A high share of expenditure consists of subsidies to utilities, grants to NGOs and transfers to individuals.

FBiH (of BiH): The Composition of Local Government Expenditure 2006–2015



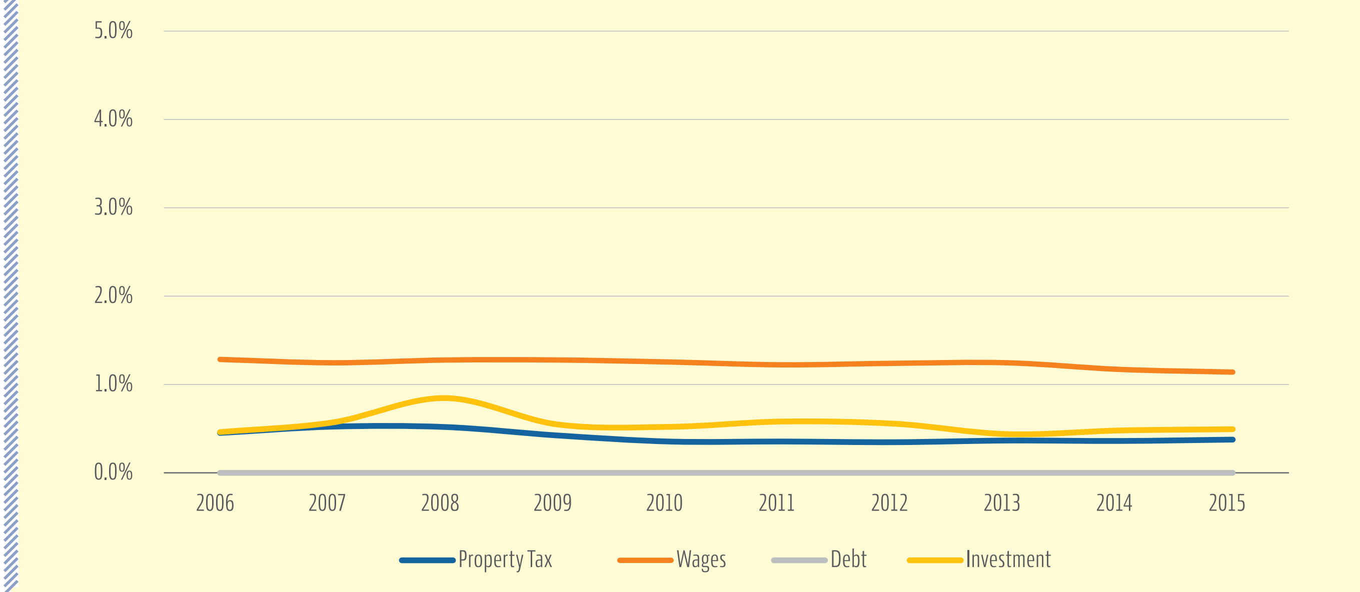
When compared local government investments are compared with those of the entire entity we see that the local ones were more substantial in the pre–crisis period, representing about a third of all public investments. Yet, after the crisis this share has dropped significantly, getting to its lowest point in 2013 and 2014 when they constituted only a tenth of the total public investment In 2015 the situation changed dramatically and the local government investment increased to 42% of the total ones.

FBiH (of BiH):



The yield of the property tax –which in some cantons is a local tax but in most remains controled by cantonal governments—is low and has fallen since 2008. The accounting of local government debt remains problematic, but it remains under 1% of GDP.

FBiH (of BiH): **Local Government Wages, Investment, Debt and Property Taxes as % GDP 2006–2015**



Republic of Srpska (BiH)

The Intergovernmental Finance System

Local governments in Republic of Srpska (RS of BiH) derive their revenue from an Unconditional Transfers, Shared Taxes, Conditional Grants and Own Revenues. Since 2006, the size of the Unconditional Transfer has been set as a percentage of the entity's share of indirect taxes (24%) and allocated by formula. 75% of the formula is allocated on a per capita basis, 15% on the basis of the territory of the municipality, and 10% the basis of the students in secondary schools.

While the share of indirect taxes used to fund the transfer has been stable, the formula for allocating it has been repeatedly changed. The Unconditional Transfer accounted for between 50 and 60% of local revenue between 2006 and 2014. Municipalities also receive 25% of the Personal Income Tax (PIT) generated in their jurisdictions. These revenues are freely disposable and have accounted for between 6 and 12% of local budgets since 2006.

There is also a Transfer for Underdeveloped and Extremely Underdeveloped municipalities. The amount of this Transfer is set in the annual budget law and allocated according to four criteria: the total per capita revenues of registered businesses (35%); the per capita budgetary revenues of the municipality in the previous year (25%); population density (20%); and the unemployment rate (20%) Finally, municipalities are eligible for conditional grants from the entity government, most of which are for investment. Conditional grants accounted for between 5 and 10% of local budgets for most of the 2006–2014 period.

Municipalities derive own revenue from property taxes, a local business registration tax, a hotel tax, land use and land development charges, other communal fees, asset sales and rentals, fees for the issuing of official documents, and interest, fines and penalties. Unfortunately, the available data for own–revenue is poor and most of it is accounted for under the title "Communal Fees and Charges".

Main Developments in Municipal Finance 2015–2016 and Advocacy Efforts of the Association

The financial challenges of the local governments in RS (BiH) in 2015 continued as the competences are underfunded and the majority of funds came from shared revenues and transfers. Local governments still don't actively participate in determining the allocation of the shared revenues and don't have sufficient autonomy in the management of natural and other resources on their territories.

The Association developed an "Analysis of participation of local authorities of RS in indirect taxation". This analysis examined the influence of the growth of external debt service on local government budgets, the current allocation of shared revenues, the simulation of few other models, as well as policy recommendations for improvement of the system.

The association cooperated with the Ministry of Finance and the Solidarity Fund for the Units of Local Governments for Recovery of the Consequences of the Floods in 2014, and developed criteria for the allocation of financial support from the fund.

The Association of Municipalities and Cities of Republic of Srpska prepared "Policy Proposals for the Economic Policy of RS in 2016" which was presented at meetings with the Government. As a result of advocacy in 2015, the Government agreed to work on amending the Law on the Budget System, so that all municipalities be required to to develop municipal investment programs and that the rules for public–private partnerships be defined at the local level.

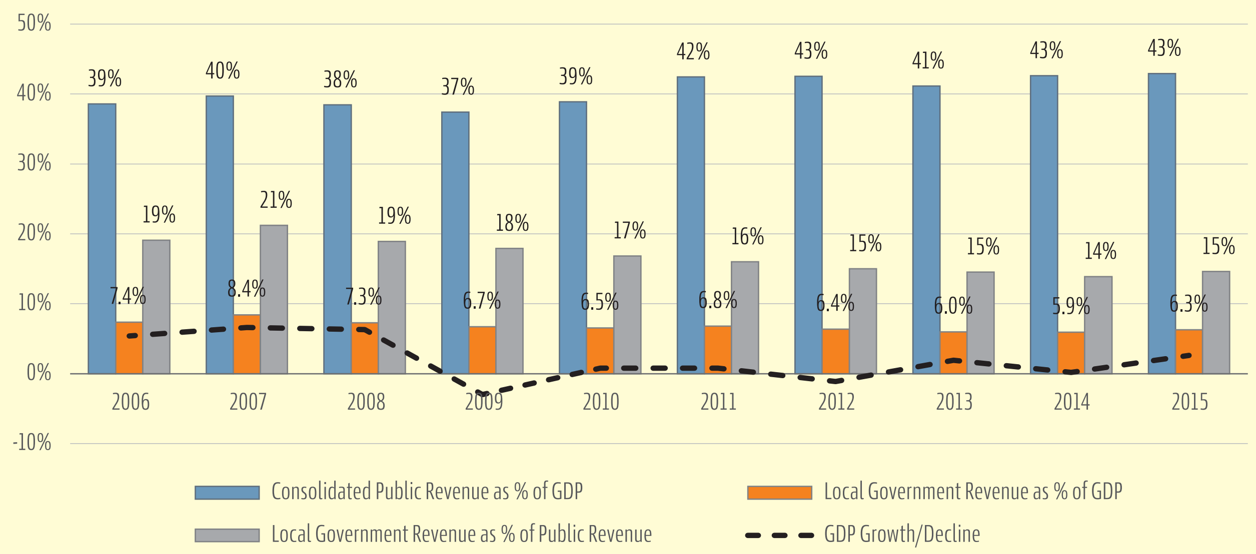
An initiative for the exemption of local governments from the servicing of the external debt of RS (BiH) was submitted, considering that this is a key negative factor on the financial condition of the local governments in BiH.

In 2016 the Association of Municipalities and Cities of Republic of Srpska initiated a number of activities for amending the Law on the Budget System of RS (BiH) in an attempt to change the criteria for allocation of the funds for the local governments thus enabling a fairer share of the budgets between the entity and the municipalities and cities. The association also submitted an initiative to the Ministry of Finance for drafting a Law on Local Government Finance in RS (BiH).

Statistical Overview of the Finances of Local Governments in RS (BiH) 2006–2015

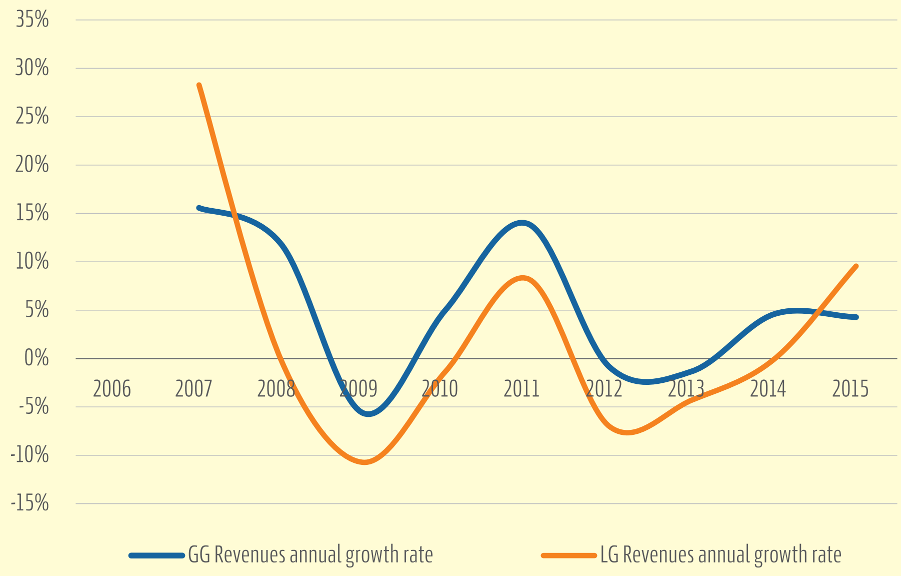
Local government revenue as a share of GDP declined from a peak of 8% in 2007 to 5.9% in 2014, but increased again in 2015 to 6,3%. Local revenue as a share of total public revenue fell from 20% in 2007 to 15% in 2015. In short, the financial positon of municipalities in RS (of BiH) has deteriorated quite substantially over the past decade, and has worsened further with the financial consequences of the major floods of 2014.

RS (of BiH): Local Government Revenue as Share of GDP and Total Public Revenue 2006–2015



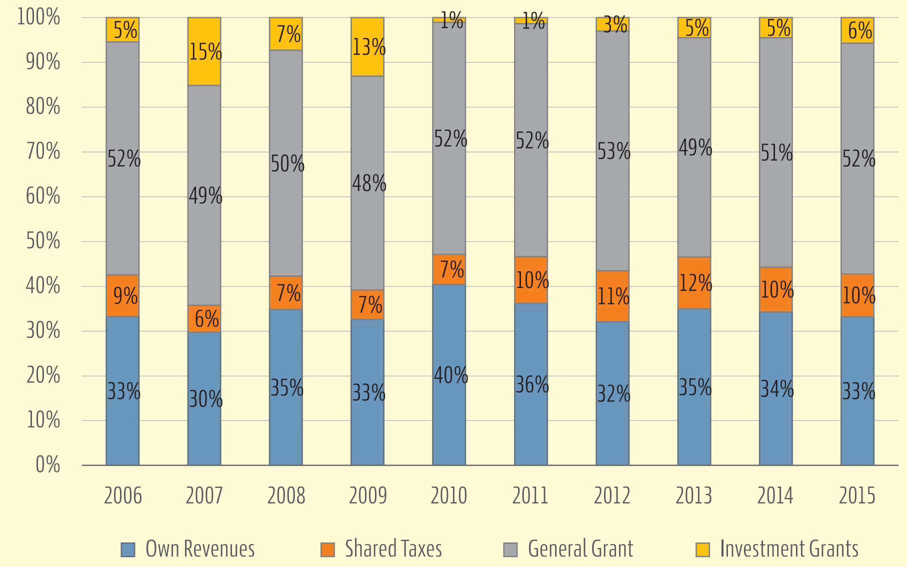
Local government revenues have declined faster and risen slower than the revenues of the entity government suggesting that the entity government has placed a disproportionate share of the burden of economic downturns on local governments, except in 2015 when the entity government revenues slightly declined and the local revenues increased.

RS (of BiH): **Annual Fluctuations in the Revenues of the General Government and Local Governments**



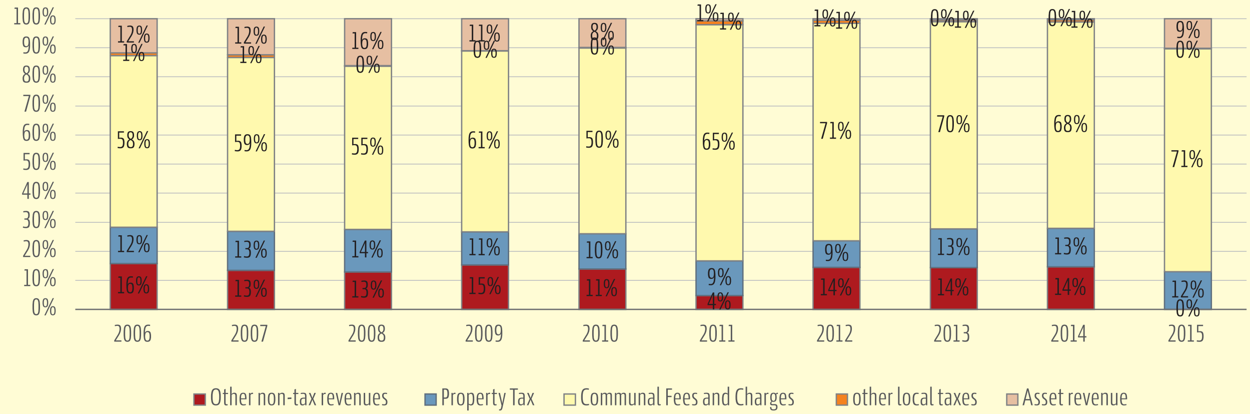
The composition of the revenues of the local governments in RS (BiH) implies they are heavily dependent on the Unconditional Grant, which constitutes over 50% of their revenues. Own Revenue declined as a share of total revenue between 2006 and 2012, but has since recovered to pre-crisis levels. In part, this is due to changes in property taxation – in 2012, one single property tax was introduced at the expense of three old types of property taxes. Between 2006 and 2015, own revenues have constituted between 30 and 40% of total local government revenues and in 2015, they were 33%.

RS (of BiH): **Composition of Local Government Revenues 2006–2015**



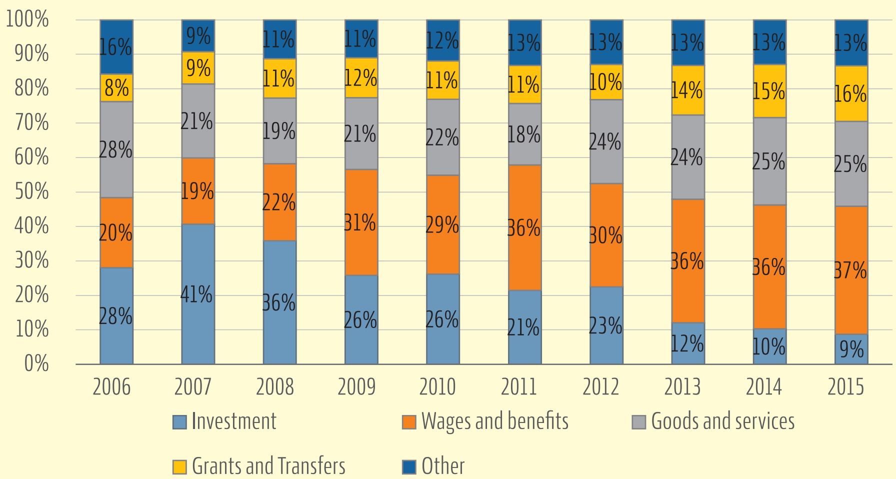
The composition of the own revenues shows the domination of communal fees and charges, which is not a desirable position. The revenues from property taxation are very low, just 12% of the own revenues in 2015, and among the lowest in South East Europe.

RS (of BiH): Composition of Own Local Government Revenues 2006–2015



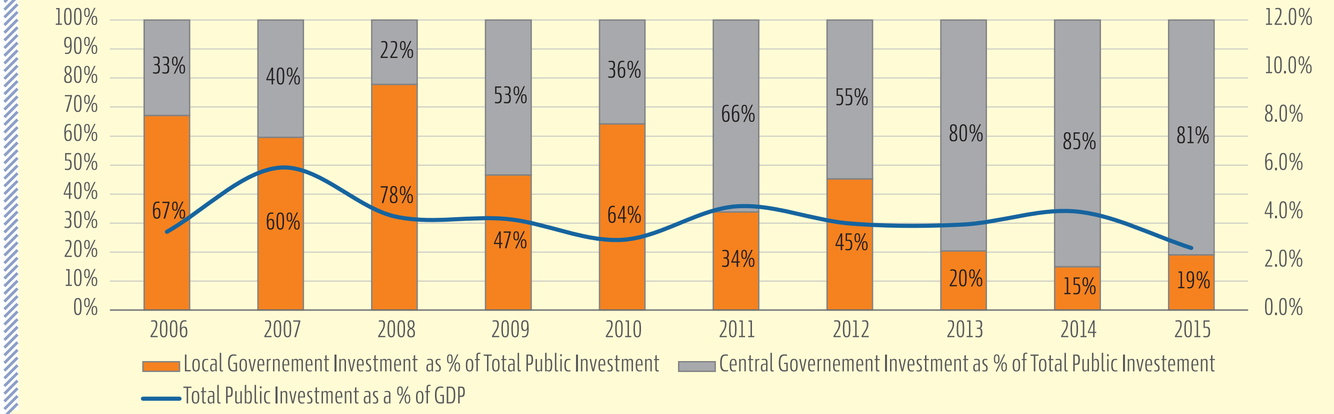
Over the last few years, investment as share of total expenditure has fallen while spending on wages has increased. Like their counterparts in FBiH (of BiH), RS (of BiH) municipalities spend significantly on subsidies to municipal utilities, grants to NGOs and transfers to individuals. Until recently, Conditional Grants played a marginal role in the system. The situation remained similar in 2015, with 1% drop in investments, but increases in wages and benefits, and a 1% increase in transfers to the third parties at local level.

RS (of BiH): Composition of Expenditures in 2006–2015



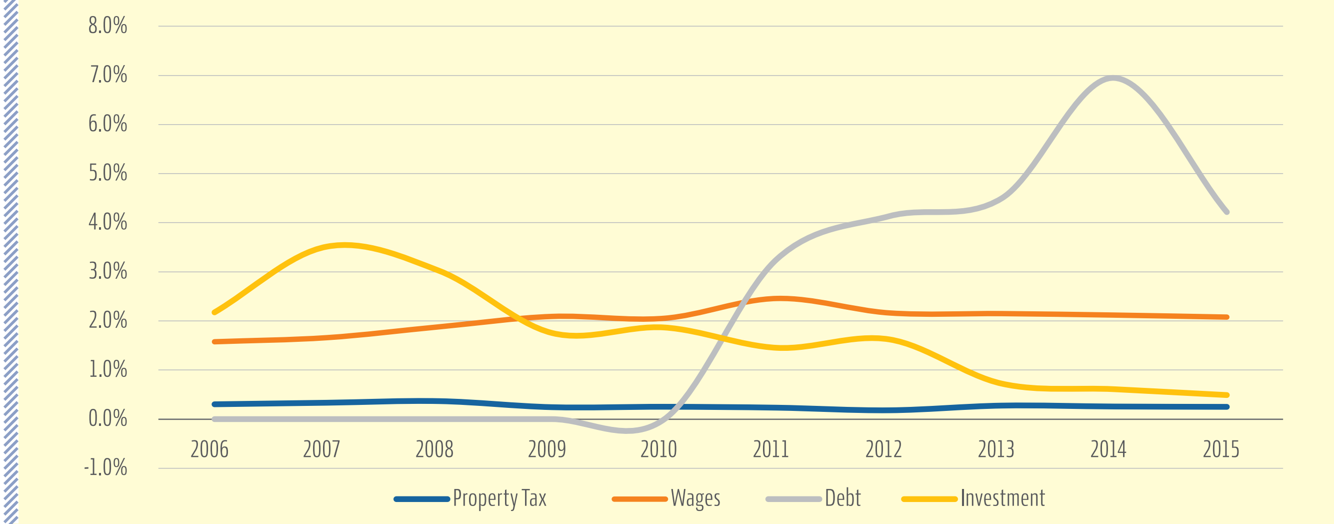
The overall deterioration of the financial position of local governments in RS (of BiH) can be seen in the sharp drop in investment spending between 2006–2015. Public investment in general decreased in 2015, but the share of investment of the entity government dominated with 81% of the total, which has been the case in the past three years. The picture was quite different in the period before the financial crisis.

RS (of BiH): Investment by Level of Government and as a % GDP 2006–2015



Wages have also declined as a share of GDP while property tax revenue has increased as a share but still remains under 0.5% of GDP. The debt of local governments increased dramatically in 2014, which may be due to the need to resolve quickly the damages of the big floods, but decreased again in 2015. Investment have been declining since 2012.

RS (of BiH): Investment, Wages, Debt and Property Tax as Share of GDP 2006–2015



Bulgaria

The Intergovernmental Finance System

Prior to 2003, the Bulgarian intergovernmental finance system was heavily dependent on sharing personal income tax. This was problematic because municipal governments were expected to cover the full costs of pre–tertiary education from the yield of their PIT share, something that was virtually impossible in all local governments except the capital.

In 2003, amendments to the Municipal Budgets Act (MBA) introduced a clearer division of the responsibilities for financing local government own and delegated functions and a set of block grants were introduced for delegated functions –principally education—based on centrally determined service costs. At the same time, PIT sharing was phased out, and the Education Block Grant became the largest single source of local government revenue. Between 2006 and 2015 it has accounted for about 45% of total local revenue.

Block Grants for social sector services are supplemented by a freely disposable transfer for equalization. The size of the equalization grant pool cannot be less than 10% of the own–revenues of all municipalities in the previous year. It is allocated by criteria determined jointly by the Ministry of Finance and the National Association of the Municipalities of Bulgaria (NAMRB). These criteria should reflect the objective disparities among municipalities due to external factors and should not act as a disincentive for local revenue mobilization.

The criteria for allocating the equalization subsidy have been changed repeatedly. Currently, the allocation formula has two components. The first provides local governments whose per capita own–revenues are less than the national average with 90% of the difference between their per capita revenues and the per capita national average. Since 2008, this amount of the grant can be reduced by up to 25% if a municipality's tax rates are below the national average.

The second component allocates the remaining funds in the grant pool according to a separate calculation of expenditure needs. These needs are calculated on the basis of costing standards for preschools and homes for the elderly, as well as a municipality's surface area. Municipalities whose per capita expenditures on these functions are less than 100% of the national average are entitled to 100% of the difference. Municipalities whose expenditures are higher than the national average, receive 50% of the difference. NAMRB's has argued that despite efforts to improve equalization, the current methodology has serious shortcomings because it is not based entirely on criteria that are fully independent of local decisions, and thus can be "gamed". Since its introduction, the Equalization Grant has accounted for about 5% of local revenue.

Local Governments can also receive Conditional Grants for specific investments and government programs. Since joining the European Union in 2007, most Conditional Grants have been for investments and have been funded by EU monies. In total they have received over 5 billion EUR in EU grant money, mostly for projects to improve their environmental, social, and technical infrastructure. Municipalities receive over 60% of all EU financial support to Bulgaria and almost all of their investments come from this source.

Within the public sector, the effects of the economic downturn were felt most profoundly by local governments. In 2010 – the worst year of the crisis in Bulgaria– the national government severely cut most transfers to local governments. The yield of the Property Transfer Tax –a major local revenue– also declined significantly because of the sharp decline in private investment.

As a result, local revenue fell sharply between 2010 and 2013, leaving municipalities with 25% less revenue than they had in 2008. Municipalities accumulated payment arrears of about 100 million EUR (10% of own–revenue) while trying to cover the costs of underfunded (delegated) social sector functions. These account for 60% of local expenditure and should be fully covered by state transfers. About 40% of local governments had significant operating deficits and had trouble meeting their co–financing requirements for EU funded projects.

In 2013, NAMRB signed an agreement with the newly elected national government to correct some of these problems. This agreement created a new public investment program called "Growth and Sustainable Development of Regions". As result, and for the first time, local governments and ministries competed for investment resources according to publicly defined selection criteria. The application process started in 2014, and 70% of municipalities have been granted 145 million EUR for nearly 400 investment projects.

Equally important, the agreement called for restarting the decentralization process in accordance with a two–year roadmap that the government adopted in February 2014. The roadmap outlined the following reform measures: transferring a portion of the personal income tax (PIT) to the local level (citizens would pay a 7% PIT rate to the national government plus up to a 2–3% rate to their local governments), facultative municipal sales tax on the consumption of luxury goods and services, introducing a local tax on agricultural land, a new way to calculate the waste disposal fee so that it reflects not property values but the actual generation of waste and reshaping the equalization subsidy. This was a strategic point for Bulgarian municipalities and this agenda is being perused in the several years ahead.

Main Developments in Municipal Finance 2015–2016 and Advocacy Efforts of the Association

2015

2015 was the last year, during which payments for EU–funded projects were possible (N+2 rule) and this fact heavily influenced the co–funding and the use of debt instruments by the local governments.

The state budget law restrained the overall level of transfers to municipalities to that of 2012. However, the government continued its opaque policy to award selectively certain local governments with additional transfers for local investments – less than 60 local governments received 60 million EUR on top of the budget framework.

Proactive efforts for a new Local Taxes and Fees Act

In 2015, the Program for Decentralization was signed between the government and NAMRB. As part of this agreement, NAMRB prepared a concept for a new Local Taxes and Fees Act which was presented to MoF in July 2015. The concept set the following areas for improvement: the taxation of agricultural land, introducing municipal PIT, limiting the scope of tax exemptions, increasing local discretion on tax assessment, and adding new fees for street lightning and city–center congestion.

Contrary to the proposals made in the Program and without consulting local governments, the Ministry of Finance (MoF) has put up for public discussion amendments to the Law on PIT, which allows municipal councils to impose additional income tax between 0 and 2 per cent in addition to the flat tax of 10 per cent which is now charged on individual incomes. The new tax is supposed to be collected by the National Revenue Agency (NRA) and will be transferred to the respective municipal budgets, according to the number of inhabitants with permanent address in the respective municipalities. The idea of the Ministry of Finance differs substantially from the original idea of NAMRB and the municipalities for financial decentralization, namely that the municipalities should receive 2% of the now existing 10% flat tax, without an additional tax burden. Due to negative social outcry, the MoF withdrew the proposal.

In 2016 transfers from the central to the local level were again modest and far below the expectations and the needs of municipalities. Local governments received a small increase in the overall amount of transfers. But MoF unilaterally modified the allocation criteria without preliminary consultations with the local authorities, as stipulated by the legislation. The small increase of the subsidies was concentrated in 15–20 municipalities (of 265). The rate of increase of the total amount of the transfers is well below the increase in the rate for the whole public sector and far from enough for covering the additional expenditures required by recent legal amendments – the increase of the minimal salary and the substantial increase of the heating fuel price (due to excise tax increase).

Financial recovery procedures for municipalities

In January, MoF published for discussion draft amendments to the Public Finance Law, introducing a special recovery procedure for municipalities in financial distress. The draft procedure consists of:

- A set of indicators with benchmark values above which municipalities shall be deemed to be in financial difficulties.
- If and when a combination of the benchmark values is abused, then the Mayor shall inform the Municipal Council and propose the launch of a financial recovery procedure.
- The Municipal Council is to take a decision for opening of the procedure and to entrust the Mayor with the task both to prepare a recovery plan and to conduct public consultations with the local population.
- Following the public consultations, the municipal Council shall determine the length of the financial recovery procedure (from one to three years) and adopt the financial recovery plan.
- The recovery plan may contain assistance from the Ministry of Finance. In this case, the plan shall be agreed in advance with the Minister and endorsed by the municipal Council upon Minister's opinion.
- Provisional interest–free loans may be granted to municipalities under the terms and conditions of the Minister of Finance, with a period of recovery that may not exceed the period of the financial recovery procedure.
- In case of sustainable financial stabilization, the additional grants may be provided to the local governments.
- Other proposals introduce sanctions for the municipal Councilors if the Council does not approve the annual municipal budget in the timeframe prescribed by law – their remunerations shall be suspended.

NAMRB strongly opposed the proposed regulation on the following main grounds:

- The overcentralized environments cannot provide the basis for objective judgments of municipal financial performance
- The proposed procedure lack firm commitments on behalf of the MoF. The law mostly uses the word "may".

Instead, NAMRB proposed a comprehensive outline of a warning system with three layers of austerity measures depending on the gravity of the financial problems. None of the proposals has been accepted and the MoF proposal entered into force in June. Soon after that, 36 municipalities were declared in financial distress and by the end of 2016, none of them received financial support despite the recovery plans.

New Instrument for Support of Municipal Investments

The General Assembly of NAMRB in 2016 gave the green light for the establishment of a Municipal Investment Fund, which, through the use of advanced tools of pooled financing, shall facilitate the access of small municipalities to investment funding. NAMRB shall lead the efforts in this area as well, employing the proved models and long–time experience of Scandinavian countries.

Policy dialog on 2017 budget framework – A Breakthrough Advocacy Success

In October 2016 NAMRB and the MoF met as part of the legal budget preparation procedure, and discussed the draft national budget for 2017. The outcome of these consultations is positive – there is an increase in all state budget transfers to municipalities:

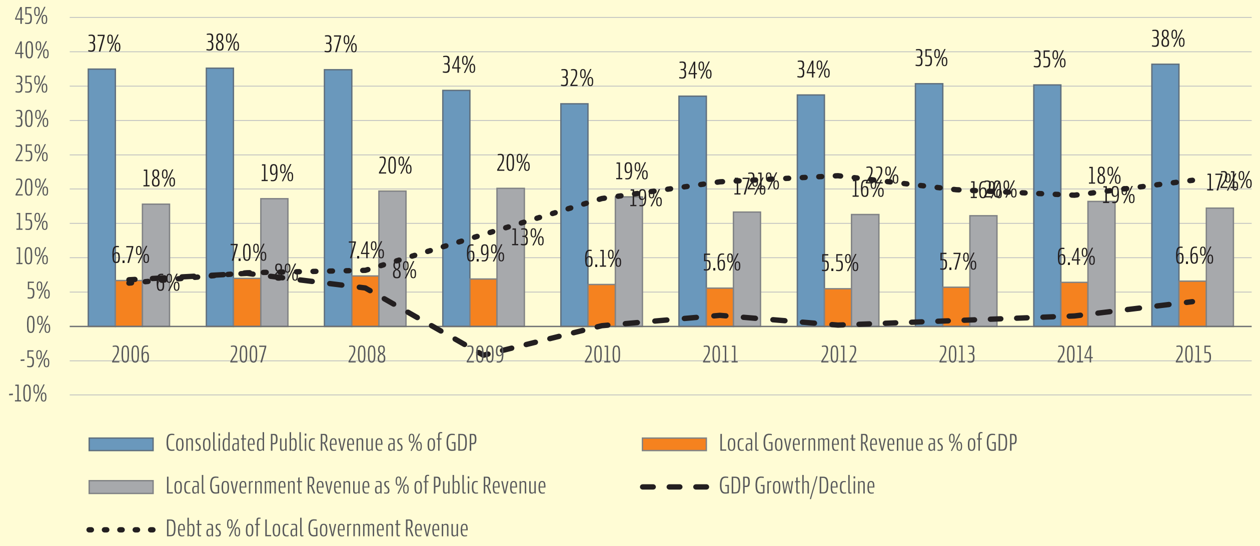
- The overall subsidy for delegated activities is increased by 100 million EUR (8%);
- The overall equalizing subsidy is increased by 2.5 million EUR (2%);
- The transfer for wintertime maintenance and snow cleaning for municipal roads is increased by 1 million EUR (7.5%);
- The capital investment subsidy is upped with 6 million EUR (8.4%);
- The state subsidy for the salaries of municipal officers is increased for 9 million EUR (8%).
- A mechanism for compensation of financial corrections levied on EU funded municipal projects was introduced – an option is provided so that 80% of financial corrections are covered by the state.

It is important to note that, for the first time, NAMRB sent to the MoF the expectations of the local governments a month earlier in order to avoid the last–minute disputes on already balanced draft budget. This breakthrough was achieved after six long years of constant efforts of the association.

Statistical Overview of Local Government Finance in Bulgaria 2006–2015

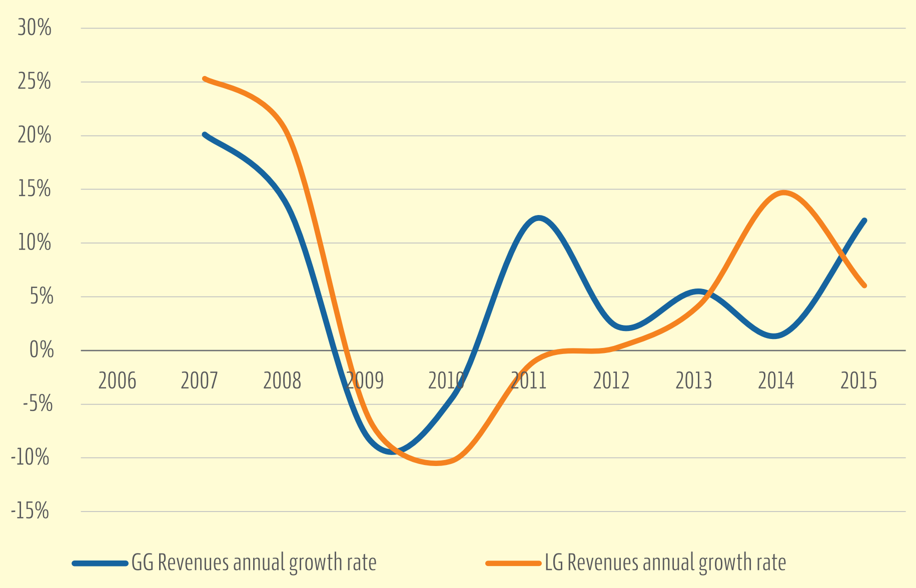
Local government revenue as a share of GDP declined from a high of 7.8% in 2008 to a low of 5.8% in 2012, before rebounding to 6.4% in 2014 and 6.5% in 2015. The local share of total public revenue also fell from 21% in 2008 to 16% in 2012.This level was maintained in 2013 rose 2% in 2014 but fell back to 17% in 2015. Both shares have to be considered very low given that Bulgarian local governments are fully responsible for financing all pre–tertiary education.

Bulgaria: Local Government Revenue as Share of GDP and Total Public Revenue in 2006–2015



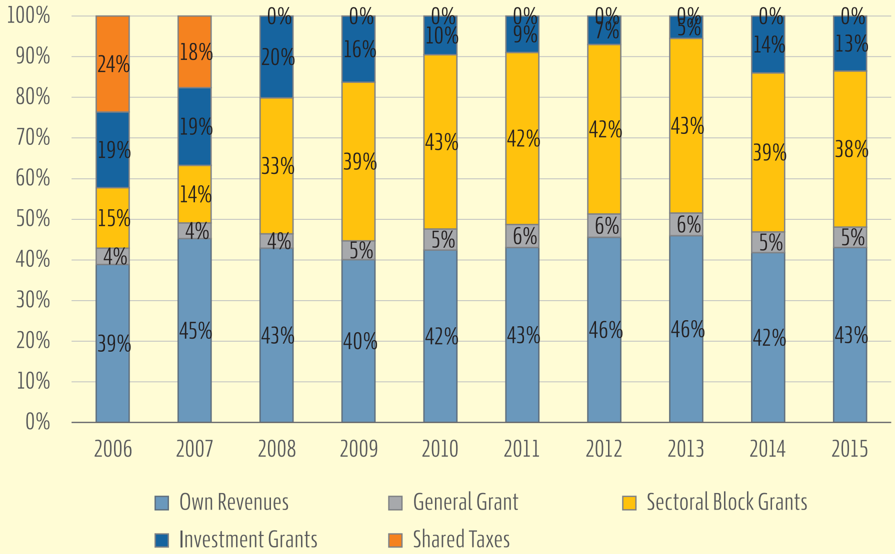
Local and General Government revenues declined in tandem with the economic crisis. But General Government revenues increased much faster during the recovery. This trend then reversed in 2013, but 2015 brought another drop for the local revenues, while the general government revenues continued to increase.

Bulgaria: Fluctuations in the Revenues of the General Government and Local Governments 2006–2015

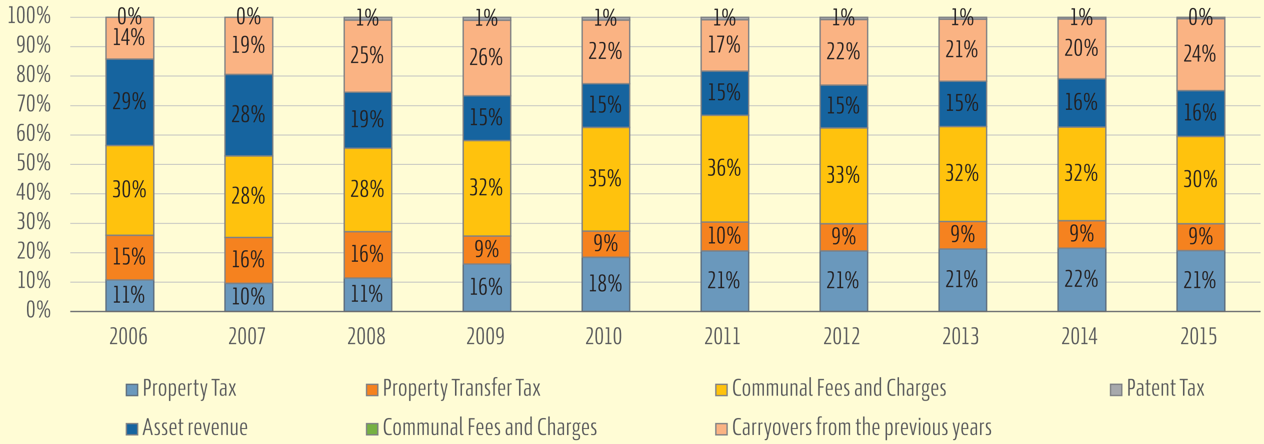


In 2006–7, Bulgaria replaced PIT sharing with an expanded set of Block Grants for social sector functions. Since then the composition municipal revenue has been dominated by own–revenue and conditional grants, almost 80% of which are for education. 2014 and 2015 are interesting as they show an increase in investment grants which seem to be slowly returning to their pre–crises levels.

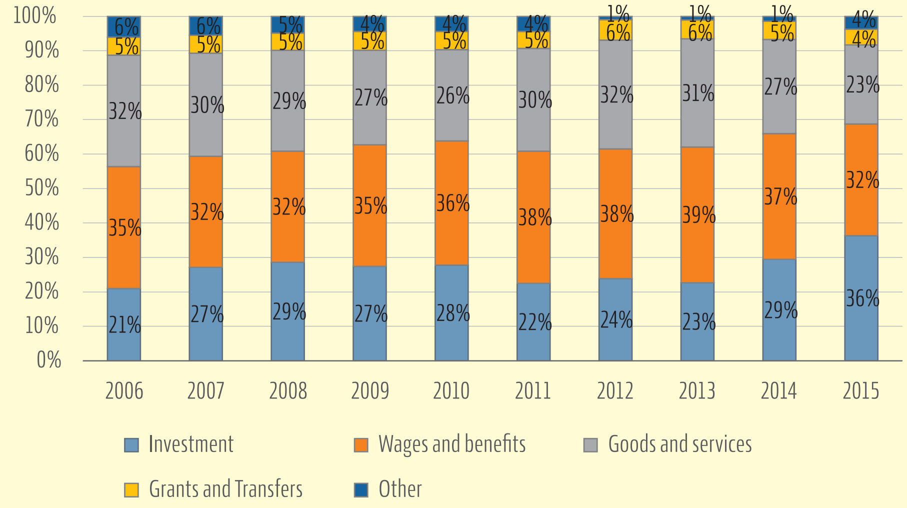
Bulgaria: **Composition of Local Government Revenue 2006–2015**



Bulgaria: **Composition of Own Source Revenues 2006–2015**

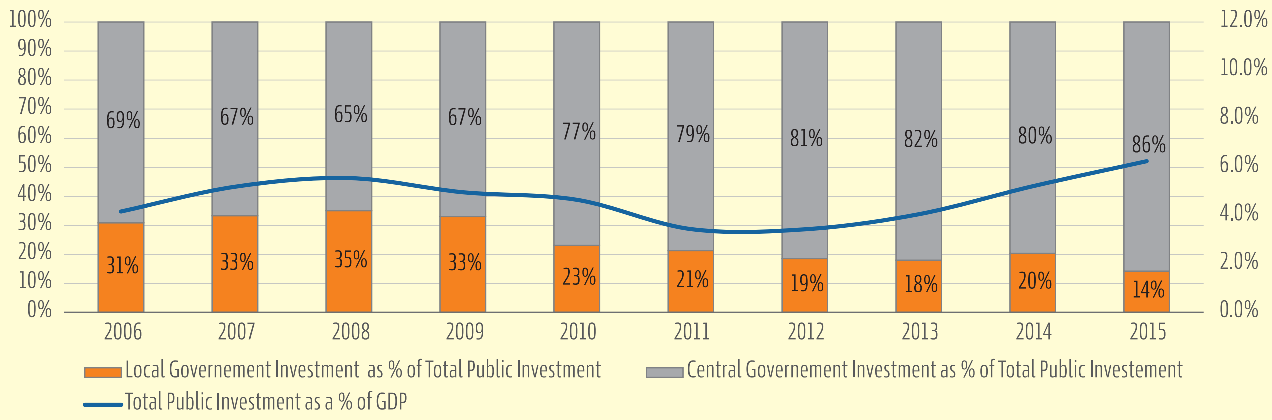


Bulgaria: Composition of Local Government Expenditures 2006–2015



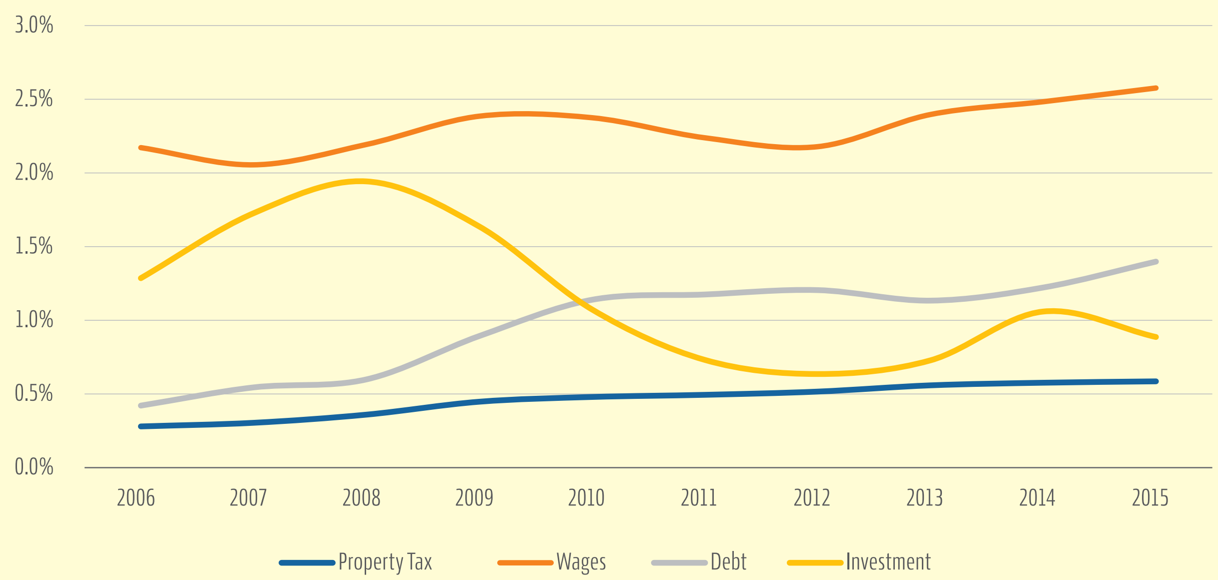
Until 2009, the share of local public investment in total public investment was above 30%. In 2010 the government cut significantly the investment transfers for the local governments and the share fell to 14% in 2015. The actual share is higher if the influx of EU funds is taken into account.

Bulgaria: Investment by Level of Government and as a % GDP 2006–2015



Since 2006, local governments have doubled the yield of the property tax as a percentage of GDP. Investment dropped sharply with the economic crisis of 2010 and has yet to fully recover. Wage spending fell less sharply and in 2013 returned to pre–crisis levels. The outstanding debt of municipalities has risen and is now above 1% of GDP – due largely to local governments borrowing to cofinance EU–funded investments.

Bulgaria: Local Government Wages, Investment, Property Taxes and Outstanding Debt as % GDP 2006–2015



Croatia

The Intergovernmental Finance System

Croatia's intergovernmental finance system is heavily dependent on the origin–based sharing of Personal Income Tax. Local Governments receive from 60 to 88% of the PIT generated in their jurisdictions, depending on their development index and the functions they perform. As such, the rules governing PIT sharing also constitute the backbone of Croatia's equalization system. Local governments are also allowed to impose a surcharge of up to 18% on the amount of PIT taxpayers owe to the national government. The surcharge currently constitutes 10% of all local PIT revenues. Taken together, PIT revenues have constituted more than 50% of total local government revenues since 2006.

In 2016, the rules regulating the Personal Income Tax were changed. The number of tax brackets was reduced from 3 to 2 and the base rate was increased from 12% to 24% and top rate was lowered from 40% to 36%. Since the income tax is jointly shared between municipalities, cities, counties and the national government the reduction of these rates had a significant negative effect on local budgets, but Croatian LGAs negotiated compensation funds from the State Budget, which will offset almost all funds lost in 2017. The Government legislated mandatory changes in the Law on Financing Local Governments in 2017 to simplify PIT redistribution and introduced a non–earmarked Fiscal Equalization Fund. About 10% of local government revenues come from Conditional Grants for specific programs or investment projects.

Since 2006, about 30% of local budgets come from own–sources. Most own–source revenue comes from Land Use and Land Development Fees, with the former known locally as the "Communal Fee". Croatian local governments also derive a significant amount of own–revenue from the sale and rental of municipal assets. A new Law on Local Taxes introduced property taxation into the Croatian tax system and local governments will start collecting property tax as of January 1, 2018. The Property Tax will be merged with the Communal Fee, the Second Home Tax and the Monument Fee into a single revenue. It will be charged per m2, depending on a base rate set by local government and corrected for location, usage (housing, business, leisure), year of construction and quality

The new Law on Local Taxes also terminated Business Tax, which will decrease local government revenue by 16 million Euro. No compensation for the loss of revenue is anticipated. The Property Transfer Tax rate was reduced from 5% to 4% but is now returned 100% to local governments on an origin basis. The tax exemption for purchase of a first property was discontinued.

The economic crisis reduced local government revenues, expenditures and investments significantly. Many of the 555 local governments (without Zagreb) increased their budget deficits and turned to borrowing. In 2010, measures aimed at improving the efficiency of the use of public revenues were implemented. One of these is the Fiscal Responsibility Act, which sets limits on national and local government spending, strengthens the legal and functional accountability of budgetary resources, and introduces stronger controls for financial reporting.

Measures to improve tax compliance were also introduced. In late 2012, the Fiscalization Act for Real Cash was adopted. Its main objective is to monitor cash transactions and to increase tax collection. The Tax Administration now has internet access to the accounts of all taxpayers who are dealing in cash and is in a much stronger position to reduce evasion. This has contributed to an increased awareness of the need to pay taxes and to an improved balance in public finances.

In 2012, a fee was also introduced for the legalization of illegal buildings. Building owners are now required to pay a fee for the legalization of structures built without proper permits. 50% of the fee goes to the national government, 20% to the competent body issuing the permit, and 30% to the local government in which the illegal construction is located. Also, in 2013 and as result of changes in EU regulations, a Law on Sustainable Waste Management was introduced. Local governments are now obliged to finance the recycling and sorting of solid waste from their own sources and through the tenders of the Fund for Environmental Protection and Energy Efficiency.

Main Developments in Municipal Finance 2015–2016 and Advocacy Efforts of the Associations

Both NALAS–member Associations from Croatia committed to actively participate in the local government reforms taking place in 2015–2016.

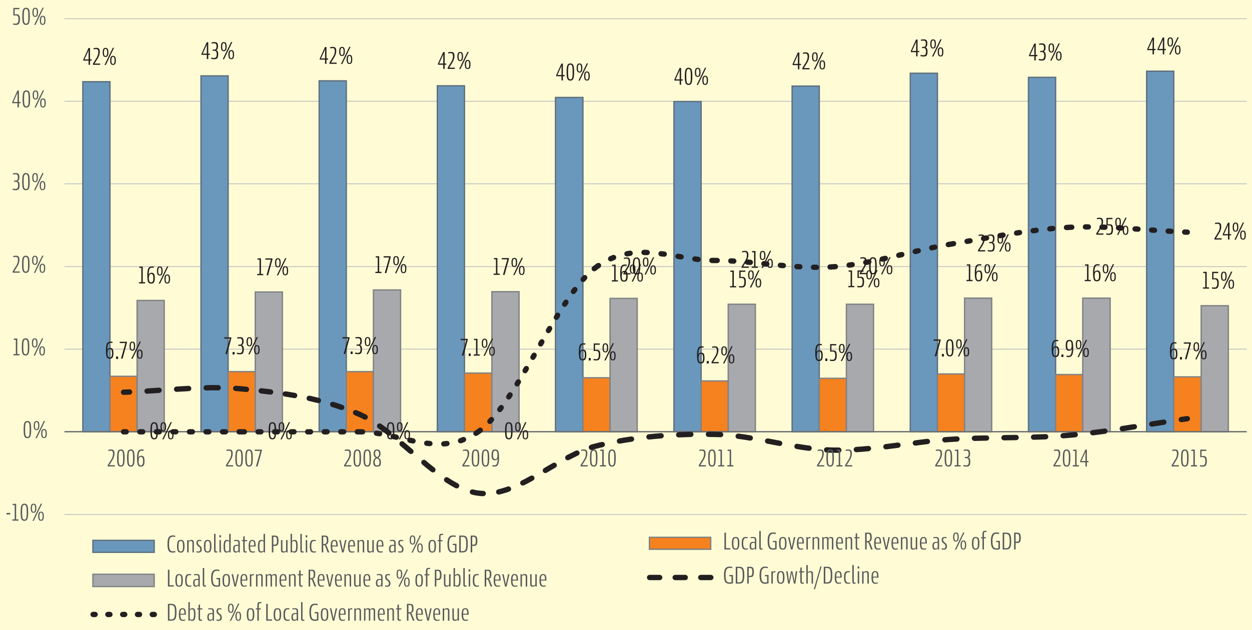
The Association of Cities of the Republic of Croatia designed an online visualization on local government financing offering public information on various aspects of municipal and city budgets including the possibility of comparing and benchmarking different revenues and expenditures across cities and time for the period 2010–2015. One of the most interesting aspects of the visualization is the functional analysis of local government expenditures. The database and visualization is available at: http://www.udruga–gradova.hr/proracuni/

The Croatian Institute of Public Finance published the results of a comprehensive research on budget transparency for 576 local units – counties, cities and municipalities – for the period from November 2015 to March 2016. The main ranking criteria was the public declaration of five basic budget documents (usually on their web–sites) and citizens' opportunity to participate in budget planning. The transparency is improving over time – from an average score of 1.75 in the previous cycle to 2.35 in this research cycle– but the situation is still unsatisfactory. It is interesting that among the most transparent local units are those with extremely low total revenues and a small population, while the counties, cities and municipalities with the highest income are among the least transparent, many without any published documents. All stakeholders agree that transparency serves to increase the credibility of policies and to monitor the fulfilment of political promises.

Statistical Overview of Local Government Finance in Croatia 2006–2015

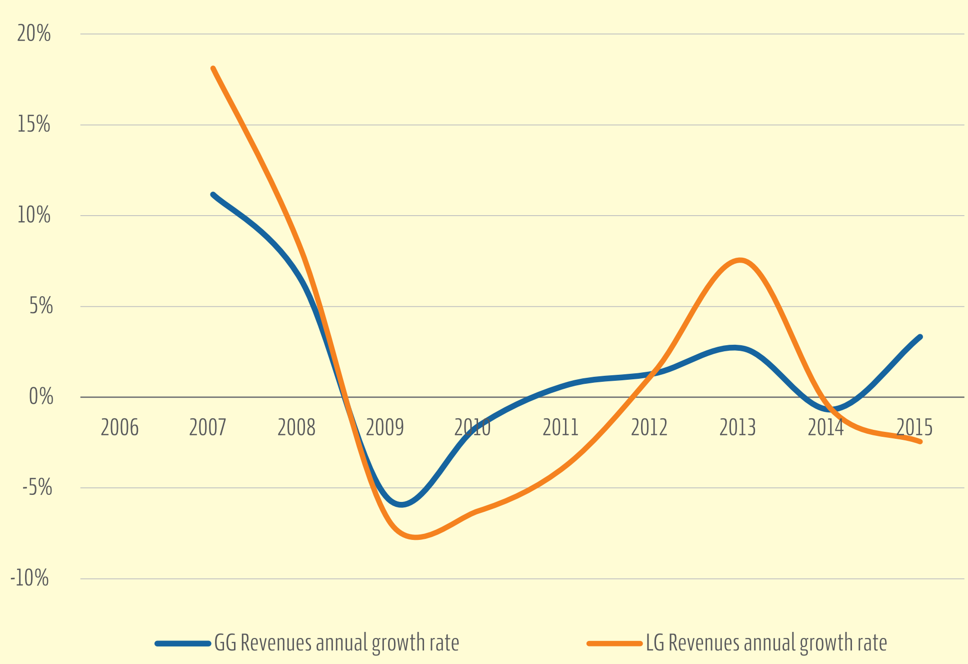
Local government revenues as a share of GDP were mainly stable in Croatia in the past decade although the effect of the financial and economic crisis lowered this share, especially between 2010–2012. In 2015, the share of local revenue as a % of the GDP was 6,7% which is a small decrease compared to 2014 when it was 6.9%. The local share of total public revenue was also reasonably stable, suggesting that the national government did not try to push the costs of the recession onto local governments. However, this indicator decreased in 2015 from 16 to 15% as a result of 2014 PIT tax reform which reduced PIT revenues by 200 million Euro.

Croatia: Local Government Revenue as a Share of GDP and Total Public Revenue 2006–2015



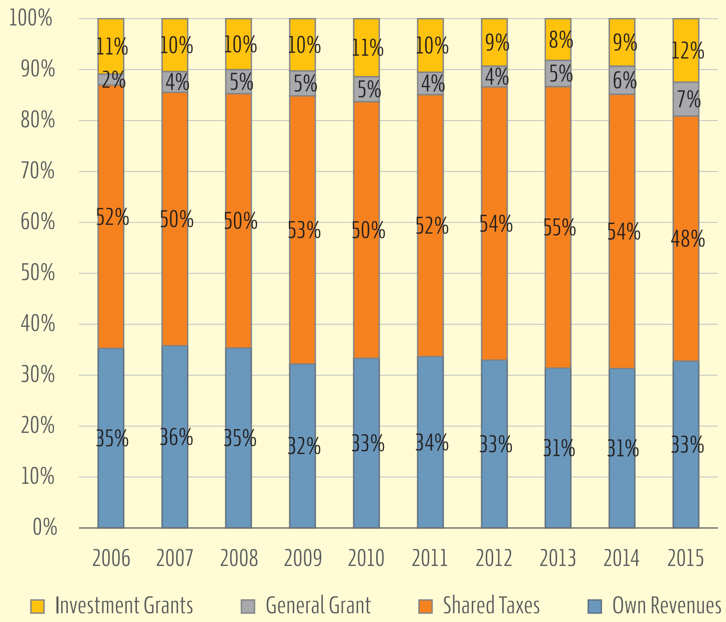
The revenues of local governments and the General Government declined in tandem during Croatia's long recession. In 2013, local revenue increased faster than the revenue of the General Government due to the forced collection of 70 million Euro in PIT arrears, but this trend reversed in 2014 and continued in 2015. Local government revenues saw a decrease in 2015 due to the tax reform.

Croatia: Fluctuations in the Revenue of the General Government and Local Governments



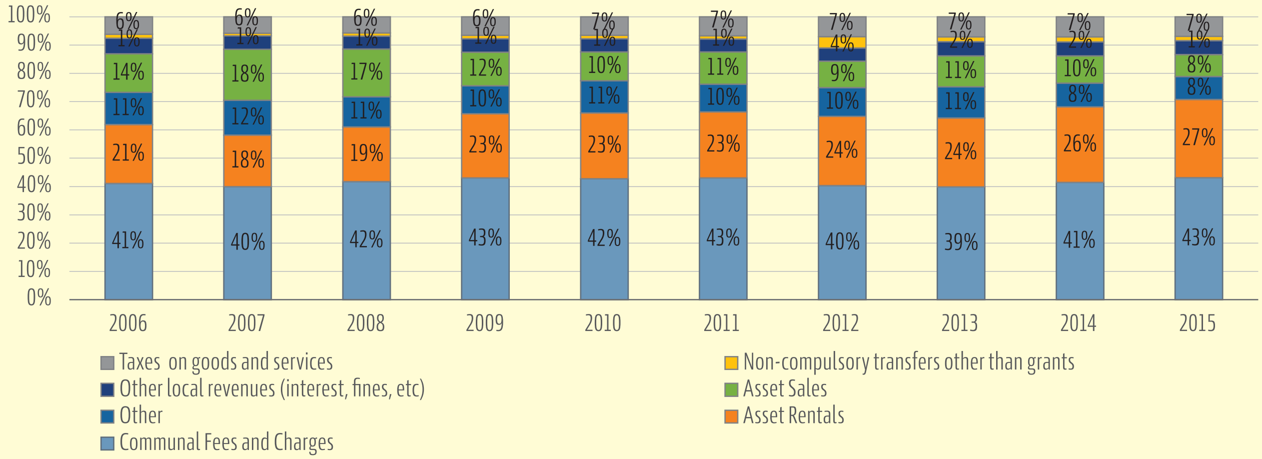
Between 2006 and 2015, the composition of local revenue changed little and remains dominated by shared taxes. Croatia legislated a local property tax in 2016 which will come into effect as of January 2018, and local governments have relatively little control over other fees and charges. They can however impose PIT surcharges. The general grant share increased a bit in 2015 as a measure of financial compensation for tax reform revenue loss. Unlike in many other places in the region local governments in Croatia have not responded to the economic downturn by increasing the collection of own–source revenues.

Croatia: **Composition of Local Government Revenue 2006–2015**



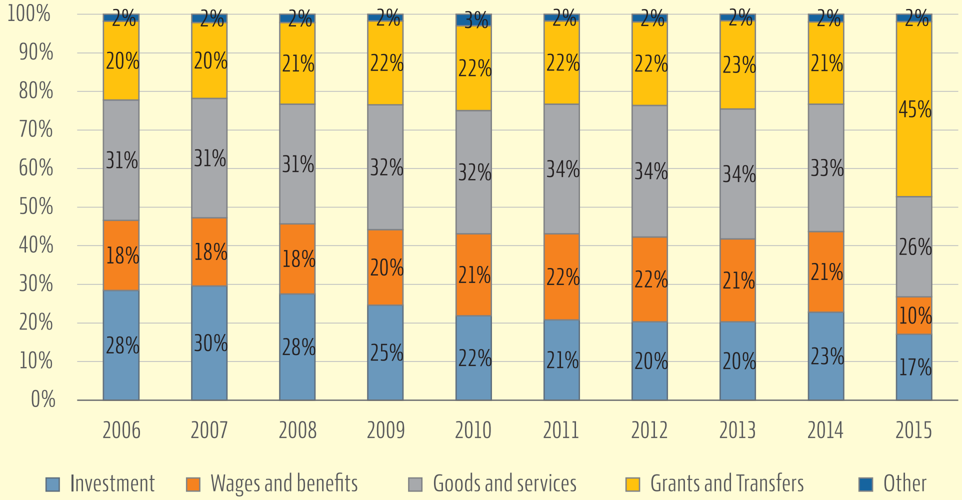
The Communal Fees and Charges dominate the composition of own source revenues with 43% of the total. The next significant group are asset related revenues.

Croatia: **Local Government Own Source Revenue 2006–2015**



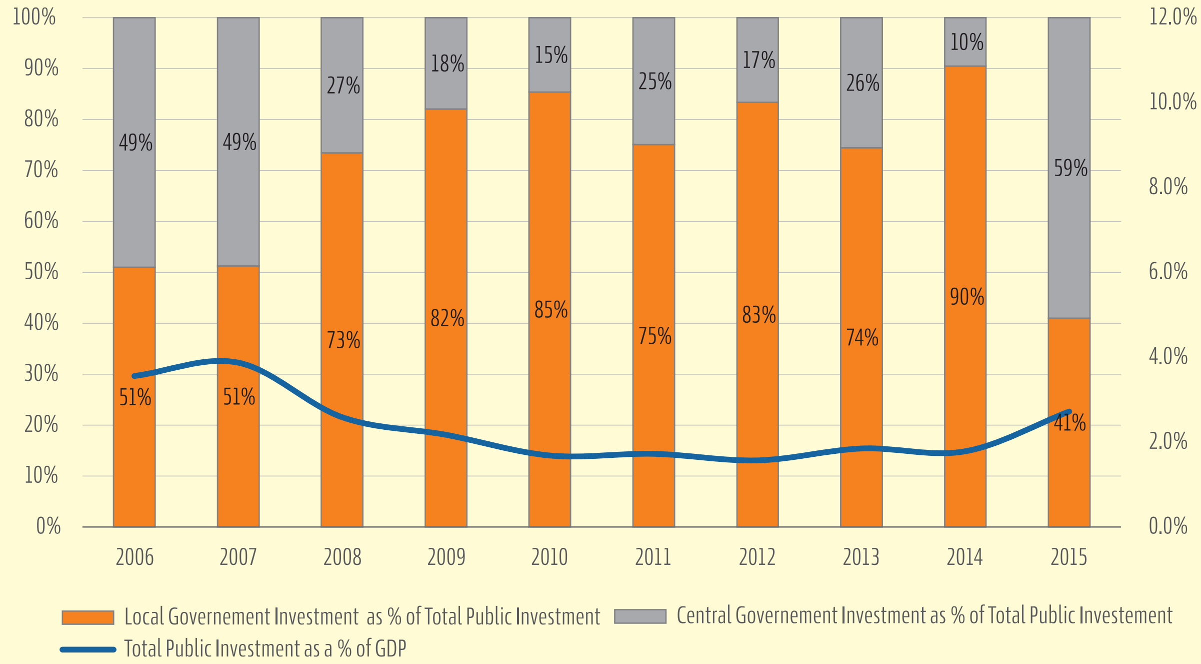
On the expenditure side, wages and benefits decreased drastically in 2015 while grants and transfers doubled, compared to previous years. This is a result of new reporting rules due to which wages and material expenses of budgetary users are no longer reported in the city/municipal budget, but are reported as grants to the budgetary users. Out of 710 million Euro in new grants approximately 50% is allocated for budgetary users' wages and benefits. The share of investment in the composition of the local expenditure has significantly dropped in 2015 as part of the general trend of decreasing of the investment in Croatia.

Croatia: **Composition of Local Government Expenditure 2006–2015**



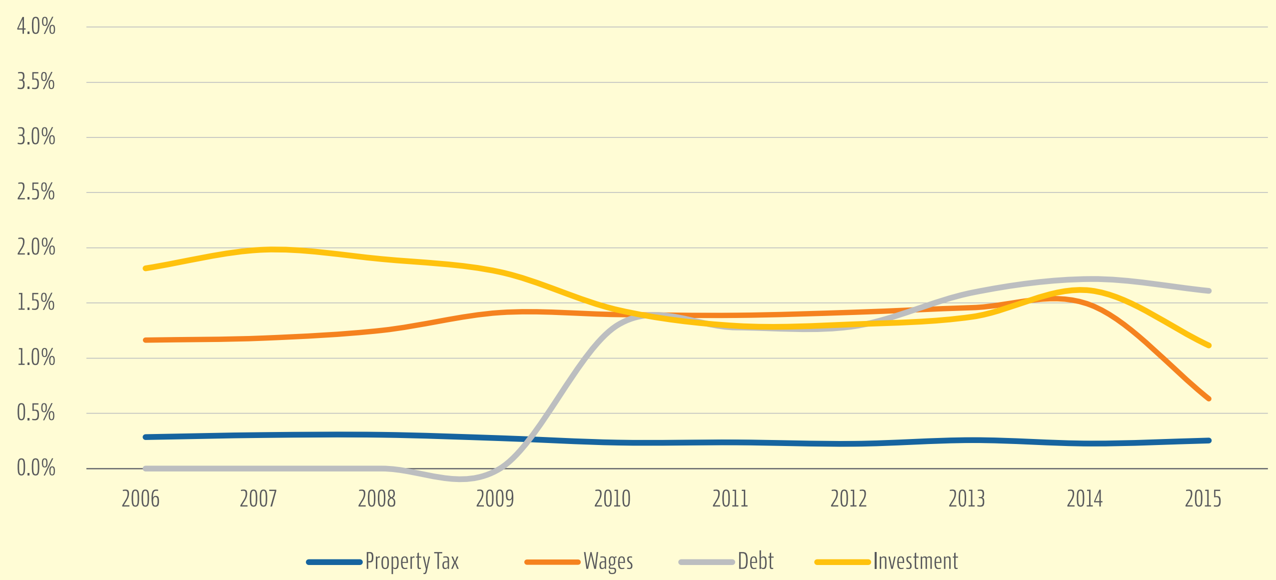
Total public investment has fallen dramatically since 2007. But the local government share of it has remained a quite significant part of it, well above 70% until 2015 when it dropped to 41% of the total investments. Local governments cut investments in 2009 and 2010 as a response to diminished funding due to the financial crisis and as a measure not to increase tax rates, utility fees and user charges. It remained stable until 2014, when it increased because of capital investments related to the operations of the City of Zagreb worth 1 billion kuna. In 2015, Zagreb operations were discontinued and LGs were hit with −1.6 billion kuna tax reform. Zagreb discontinuation accounts for 1 bln kuna drop in investment and tax reform for another half billion when 2015 is compared to 2014. At the same time capital investments of general government nearly doubled.

Croatia: **Shares of Public of Investment by Level of Government and as % GDP 2006–2015**



As a % of GDP, local investment fell substantially in 2010 and has yet to recover. Wage spending has dropped in 2015, along with the investments and also wages. The total outstanding debt of local govenrments in 2015 equaled 2,7% of GDP. Through 2009 there were strict limits on local government borrowing because total public debt had exceeded the Maastricht limit. In 2010, debt space was created for local governments, and the space was quickly used. This space was expanded in 2013 when borrowing to cofinance EU projects and for Energy Conservation Companies (ESCOs) were exempted from the limits.

Croatia: **Local Government Wages, Investment, Property Taxes and Outstanding Debt as % GDP 2006–2015**



Kosovo

The Intergovernmental Finance System

Kosovo is one of the most decentralized countries or entities in the region because local governments are responsible for all pre-university education as well as primary health care. For these functions, local governments receives block grants.

The size of the General Grant is defined by law as 10% of the total operating revenues of the central government. All local governments receive a lump sum payment of 140,000 euro, minus one EUR per capita for all local governments with populations greater than 40,000. Municipalities with populations greater than 140,000 therefore do not receive any lump sum payment. The remainder of the grant pool is then allocated to municipalities by formula: 89% by population, 6% by square kilometers; 3% by the number of ethnic minorities; and 2% for municipalities in which the majority population is a national minority.

The size of the Education and Health Grants is determined by a National Grant Commission in accordance with a Medium Term Expenditure Framework (MTEF). The Education Grant is allocated to local governments on the basis of a formula that takes into account the wages of teachers, administrators and support staff, goods and services, building maintenance, and specific education policies.

Pupil numbers are used to determine the amounts for salaries, goods and services, and building maintenance in accordance with class size norms of 1 teacher to 23 students in majority communities and 1 teacher to 14 students in minority communities. The Health Grant is also allocated by formula according to population. The formula is based on the assumption that each person visits primary health care facilities 2.5 times year at a cost 4 euro per visit, and that they receive 3.5 services a year at 3.9 euro per service.

The most important own-revenues are the Property Tax and revenues from Construction Permits. Municipalities have been using Construction Permits as quasi-fiscal infrastructure impact fees, a practice that the national government has been trying to stop –with mixed success—in order to improve the "business enabling environment." They are also allowed to collect fees for health and education services. Municipalities receive 100% of the national government's property transfer tax.

The global financial crisis of 2009 did not precipitate a recession and while growth has been slow, it remains positive. It also has not affected intergovernmental fiscal relations: Transfers to local governments have increased, as has the collection of own source revenue.

In 2013, an agreement was signed between the governments of Kosovo and Serbia to regulate the status of the four Serbian-majority municipalities in the north of Kosovo. Under this agreement, these municipalities have enhanced powers and are now responsible for providing secondary health services and university education. A special fund was also established to help them. The Fund will be financed from customs duties from the border with Serbia. To date 400,000 EUR have been placed in the fund. Some communities are interested in becoming separate municipalities but there have been no recent changes in the Law on Territorial Division and there are still 38 municipal governments. A separate law for the Capital City of Pristina is however, being considered.

Main Developments in Municipal Finance 2015–2016 and Advocacy Efforts of the Association

In 2015, Kosovo local governments derived 44% of their revenues from block grants for Education (34%) and Primary Health Care (9,5%). They also receive a General Grant, which in 2015 constituted 33% of their revenues. Of the rest, about 20% comes from own–revenue.

Suspension of the decision of the Government to add 500.000 EUR to the Central Government Wage Fund at the expense of Local Transfers: The advocacy of the AKM prevented the Central Government for shifting money out of the local government transfer system and towards its own wage pool in January 2015.

AKM Council of Mayors and Ministry of Finance discuss legislative changes:

Minister of Finance and AKM President negotiated over changes in the Law on Property Tax and the Law on Local Government Finance. The changes in property taxation are related to the tax tares and collection procedures and were designed in close cooperation between the Property Tax Department in the Ministry and the AKM. The minister stressed that these adjustments to the property taxation will enable the adoption of legislation in line with European Union directives, simplify some procedures and is expected to increase the yield of the tax on land and other immovable property.

Support for the regulation of internal control in Kosovo municipalities:

The AKM joined the public debate for the draft–law on the Internal Control of Public Finances. The Association reviewed the draft–law, and provided recommendations to the Ministry of Finance. External auditor's reports from the past few years in most municipalities in Kosovo show that there is a lack of internal controls.

Inclusion of children in the budgeting/planning processes

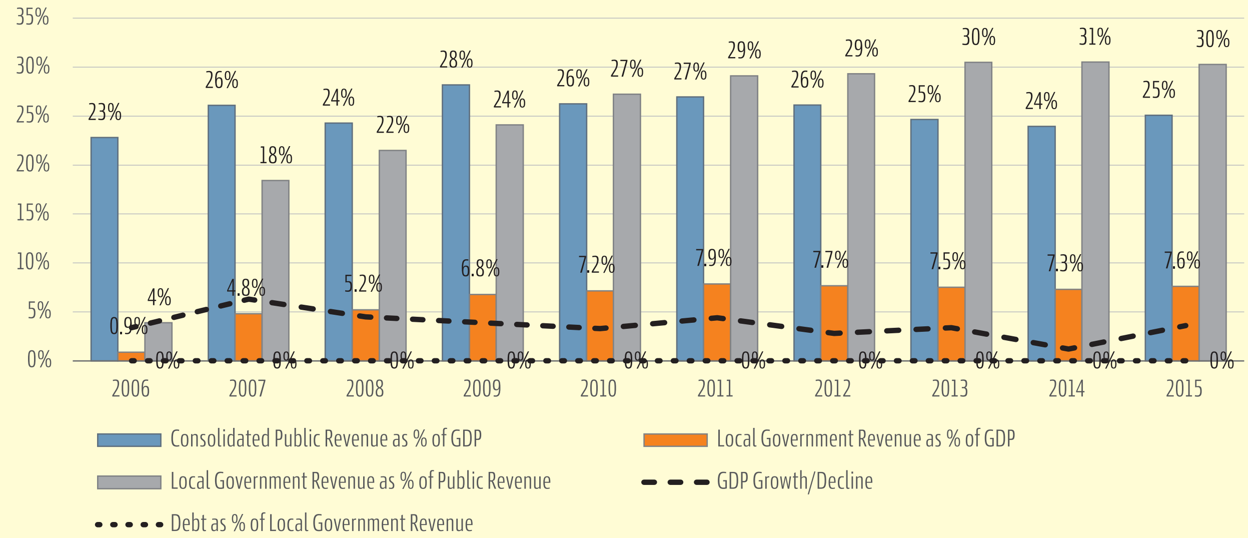
AKM, with the support of Save the Children has initiated a dialogue between responsible officers and communities (including youth) in relation to the issues concerning the allocation of budgetary funds and the quality of services in comprehensive education and early childhood care and development in Peja/Pec and Prishtina/Pristina. Inclusion of children in the budgeting/planning processes will enable budget allocations better suited to meet their needs.

Statistical Overview of the Finances of Local Governments in Kosovo 2006–2015

In 2009, schools and healthcare clinics were decentralized to local governments. As a result, local revenue as both a share of GDP and total public revenue increased sharply making Kosovo one of the most decentralized governments in the region. Municipalities receive almost a third of all public revenues and are getting a remarkably fair share of the overall fiscal pie in comparison to many of their counterparts in the region. This share has also increased since 2009. Local spending on education and healthcare however remains heavily controlled by the central government and municipalities have yet to be allowed to borrow.

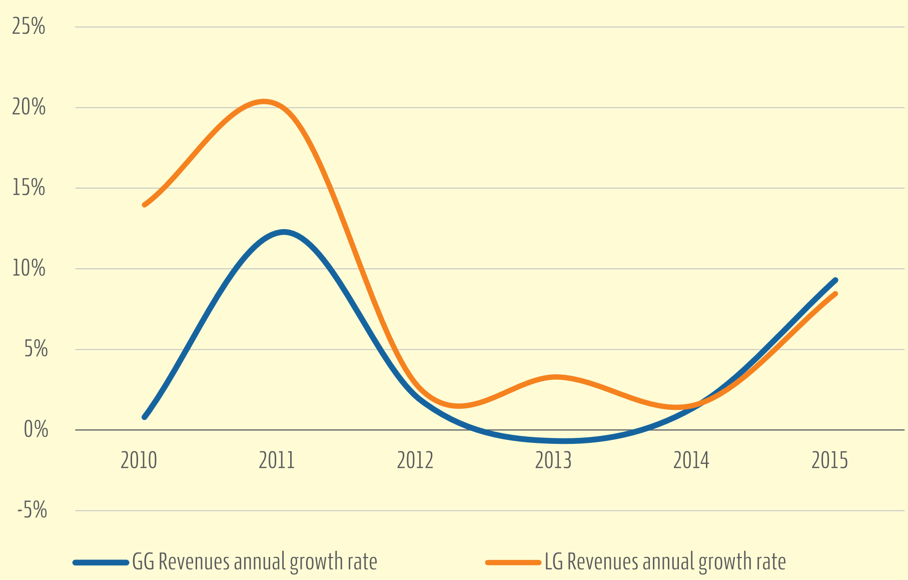
The share of local finances in the GDP between 2010 and 2015 has been stable, maintaining the level of around 7%. In 2015, the Kosovar economy grew by 4%. Consolidated public revenues as a share of GDP were at 25,3% (24% in 2014) and the local government revenue as a share of the consolidated public revenues was 30%, practically maintaining the same level for four years in a row.

Kosovo: **Local Government Revenue as Share of GDP and Total Public Revenue 2006–2015**



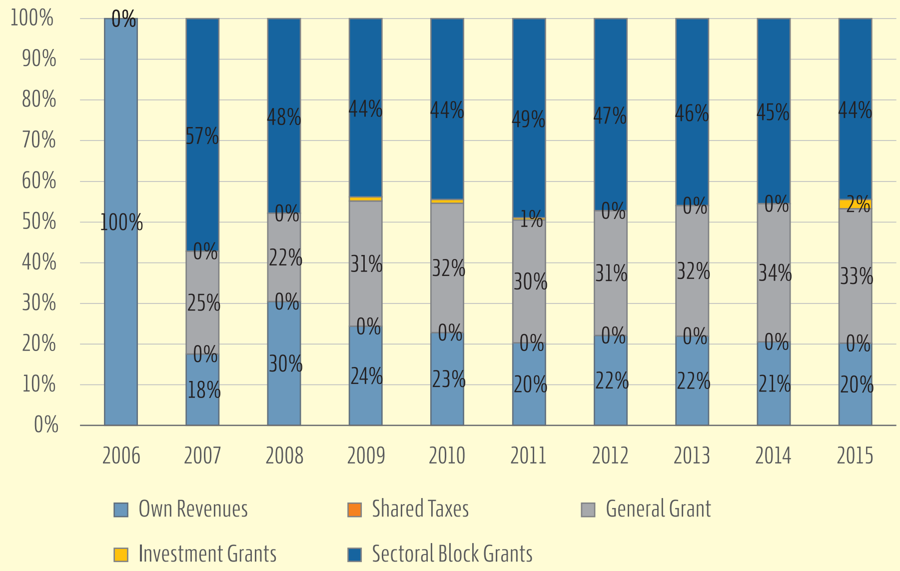
Unlike in many other places in the region, there has been a consistent pattern in the relationship between local and central government revenues in Kosovo: they have risen and fallen more less in tandem for the last five years.

Kosovo: **Fluctuations in the Revenue of the General Government and Local Governments 2006–2015**



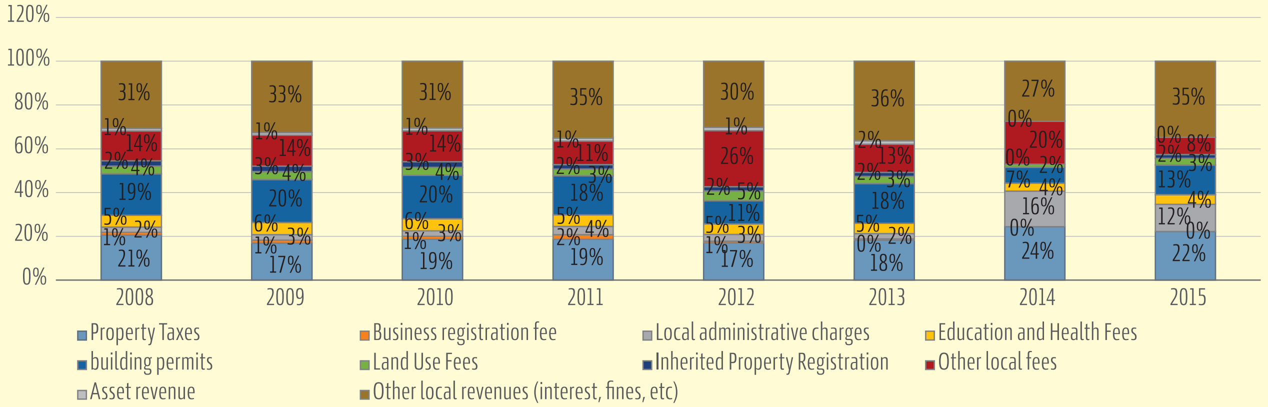
Since 2009, the size of the Unconditional Grant has increased in line with national budget revenues. Own revenues collection have risen , and after four years we again see the allocation of invetsment grants. In 2015, they constituted2% of municipal revenue.

Kosovo: Composition of Local Government Revenues 2006–2015



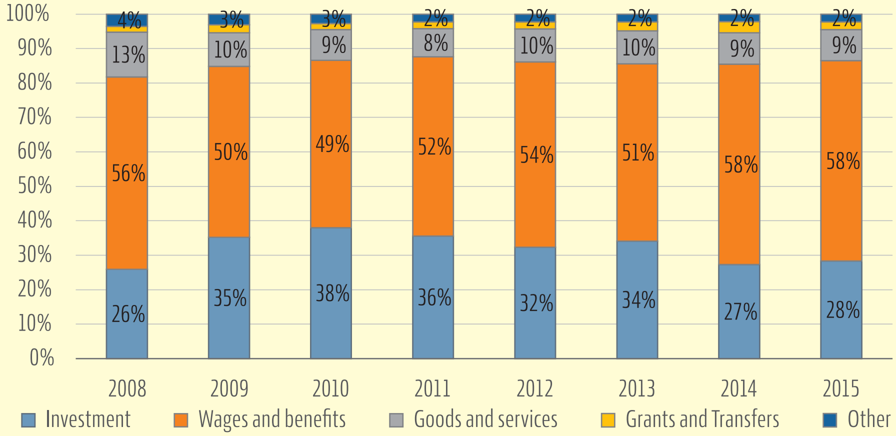
The two most important own–source revenues are the property tax and building permits. In 2011, legislation was passed to eliminate the quasi–fiscal use of building permits. Income reported under this category declined in 2012, but in fact local governments simply classified it as other revenue. In 2013, the restrictions on the pricing of building permits were loosened and revenue in the category increased. In 2014, the central government again tried to tighten up on building permits, but it appears that local governments responded by classifing the revenue under fees and charges.

Kosovo: Composition of Own Revenue 2008–2015



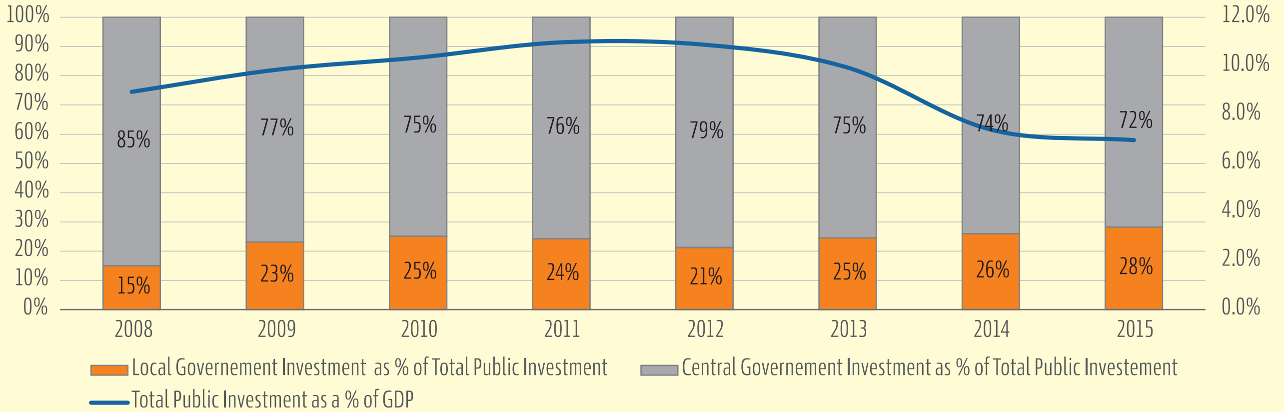
In 2015, local governments have devoted 28% of their total expenditures to investment and 58% (same as 2014) to wages, due to central decesions for allignment of the salaries.

Kosovo: Composition of Expenditures in 2008–2015 (mln EUR)



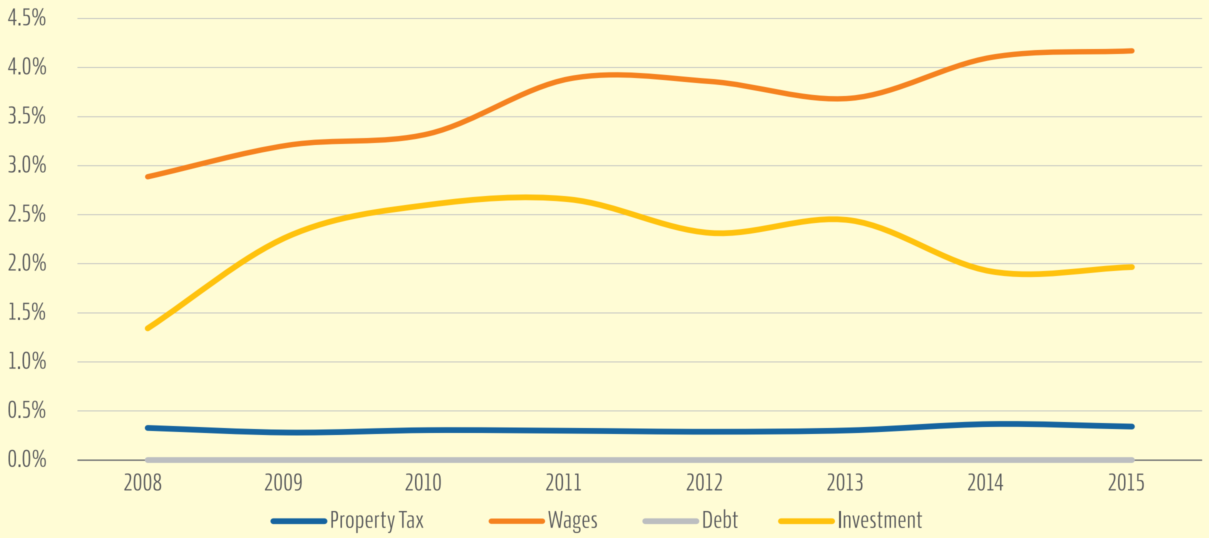
The total public investment in Kosovo have dropped in 2014–2015 to 7% of the GDP. Yet, the share of the local level investments in the total public investmets has increased and in 2015 reached a historical high of 28%.

Kosovo: Public Investment by Level of Government and as a Share of GDP 2006–2015



In recent years, the wage spending of local governments in Kosovo has increased but not significantly and is now 4.2% of the GDP. Investments, on the other hand dropped in 2014 but increased again in 2015. The yield of the property tax is maintaining a stable trend of 0,3% of the GDP despite the significant investments by the central government into Kosovo Cadaster Agency to improve registration and billing, and substantial increases in the minimum property tax rates imposed by the municipalities. After a small increase in 2014, the local government debt came back to zero level again in 2015.

Kosovo: Investment, Wages, Debt & Property Tax as a Share of GDP 2006–2015



Macedonia

The Intergovernmental Finance System

The fiscal decentralization process in the Republic of Macedonia commenced in 2005 by transferring the competencies and earmarked funds for their execution from the central to the local level. In 2007, those municipalities that had cleared their payment arrears and met other criteria for good financial management became responsible for financing and managing all schools, as well as a number of other cultural and social welfare institutions. They were given Block Grants to finance these new functions.

Currently, municipalities are responsible for building and maintenance, improvement of local infrastructure, water and wastewater treatment, public hygiene, public lighting, local public transport, fire protection, pre–school, primary and secondary education, local cultural institutions (Cultural Houses, libraries, and museums) and care of the elderly. Since 2011, they have also assumed responsibility for managing state land.

In accordance with the Law on Local Government Finance, municipal revenue consists of:

- Own Revenues, include the Property Tax, other local fees, charges and taxes, asset income and income from fines, penalties and donations;
- Shared Taxes, in particular Personal Income Tax;
- A General Grant defined as a percentage of the national yield of the Value Added Tax and allocated by formula;
- Block Grants from the national budget for primary and secondary education, culture and social welfare;
- Earmarked grants for special programs or specific investments;
- Debt Finance and donations.

The size of the Grant is anchored by law at 4.5% of the national yield of VAT. The criteria used to allocate the grant are defined by an annual ordinance. According to the ordinance:

- All jurisdictions receive a lump sum payment of 3 million denars.
- These payments are then deducted from the grant pool and the residual is divided between the capital city of Skopje and its composite jurisdictions (12%) and all other municipalities (88%).
- The funds for municipalities are divided by a formula, which allocates 65% of the pool on the basis of population; 27% on the basis of square kilometers; and 8% on the basis of the number of settlements.

The allocation of the Block Grant for Education is also determined by an annual ordinance. The main criteria in the formula for allocating the grant are enrollment, employment, and –since 2009– the number of children entitled to free school transport. The formula for determining per pupil payments are publicly available, but the amount of money that municipalities receive through the grant is insufficient and often requires substantial contributions from their general budgets. The allocation of the block grant for preschool education is also governed by an annual ordinance. The formula contains variables for the number of pupils, the type of heating system and the duration of the heating season, the number of teachers in the school, and the utilization rate of the facility. Municipalities that have cultural institutions receive a block grant for culture based on the number of employees working in the institutions covered by the grant; the total square meters of the buildings; and coefficients for the particular cultural services these institutions provide. The allocation methodologies remained unchanged in 2015.

The fiscal decentralization process can best be seen through the expansion of local government revenue as percentage of GDP between 2005 and 2012. In 2005, it equaled only 1.9% of the GDP while by 2012 the share had more than tripled to 6.5% of GDP. It has however fallen significantly since then and in 2014 was only at 5.4% of GDP. Thus, despite the radical increase in their revenues, Macedonian municipalities still face profound financial challenges and are clearly underfunded for the functions they perform.

There is also a fund for balanced regional development which allocates money to regions according to a formula contained in the Law on Regional Development. By law this fund should be equal to 1% of the GDP, but so far this has not been the case, though the national government claims that the total amount of money allocated by Ministries for development purposes is greater than 1% of the GDP.

Main Developments in Municipal Finance 2015–2016 and Advocacy Efforts of the Association

Total revenues of the local self–government of the Republic of Macedonia in 2015 marked a rise by 6.7 % – compared to the previous year. Within total revenues, own revenues are higher by 12.5% unlike in 2014. Such a positive trend rests on the success of municipal administrations in managing their own revenues; better record of taxpayers and revaluation of the property value; a rise of financial resources based on concessions and sale of state–owned construction land. The share of local self–government revenues as a % of the GDP in 2015 (MKD 560,148 million)[9] was 5.7%, a mild increase over to 2014.

In order to strengthen their financial position, the municipal association, ZELS has lobbied the government to make amendments to the Local Government Finance Law. This has resulted in the following recent changes.

- The percentage of the national yield of VAT earmarked for the general grant was increased from 3% to 4.5%;
- The municipal share of revenue from other concessions (e.g. water) was increased from 25% to 50% in 2016;
- Revenue from fees for washing and separating gravel are now split 50/50.
- Revenue from fees for legalizing illegal structures built on agricultural state land are now split 50/50.
- Starting in 2015, 10% municipalities receive 10% of concessions on agricultural land, a share that will be increased to 50% by 2018.

ZELS and Ministry of Education and Science debate school financing

In 2015, local governments and their association ZELS have been debating with the Ministry of Education and Science about the "Optimization of the school network and proper planning of the allocation of expenses from block endowments". This debate was feuled by the fact that education is underfunded and local governments are incurring large debts to transport companies for school transport. More specifically, out of the block grants for education, municipalities use between 67% and 96% for salaries of employees in schools endangering the financing of the other aspects of the education, including the transport. Nevertheless, municipalities shall conduct analyses of employment and demographic trends in order to determine how they may further rationalize there school networks.

Agricultural Land and Financing the Rural Development

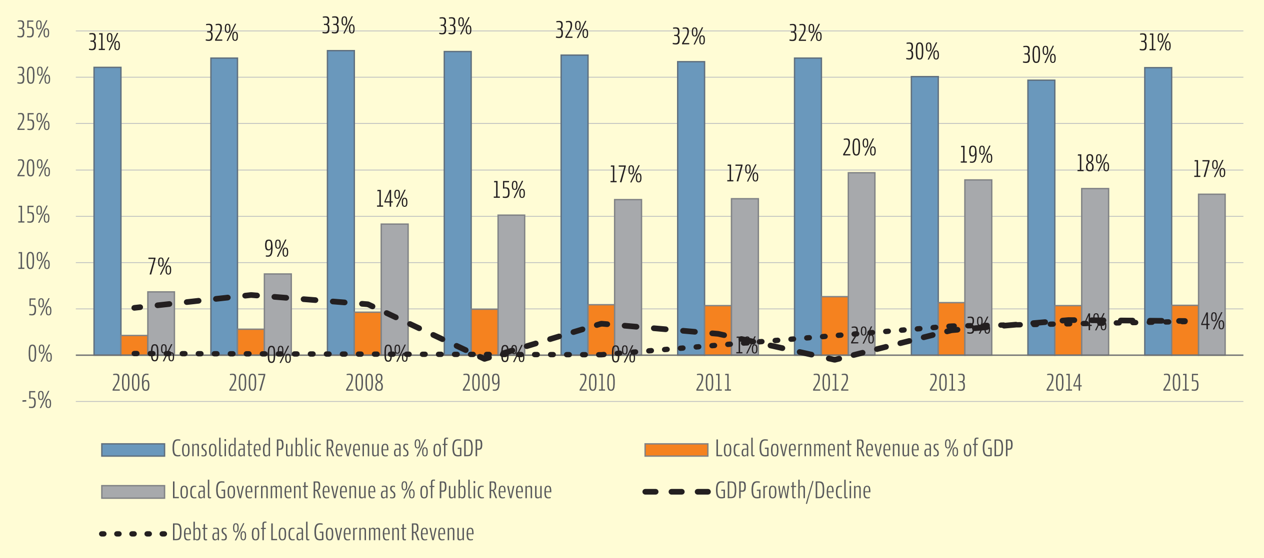
In 2015, the Law on Amending the Law on Agricultural Land entered into force, which may contribute to the improvement of the financial stability of municipalities. By 2018, this law envisions allocation at the ratio of 50 % in favour of the Republic of Macedonia and 50% in favour of municipalities of the funds obtained from the lease of state–owned agricultural land that are collected in the current year. The share of these revenues that municipalities received in 2015 was only 10%. A condition for obtaining these funds is that the municipality must collect 80% more in property tax revenues over the previous year. Three initiatives of ZELS for amending and supplementing the Programme for Financial Support in Rural Development 2015, the Law on Sale of State–Owned Agricultural Land and the Law on Agricultural Land became part of the national Programme for Financial Support in Rural Development 2015.

[9] Resource: Ministry of Finance of RM, Bulletin Nr. 6, 2016

Statistical Overview of Local Government Finances in Macedonia 2006–2015

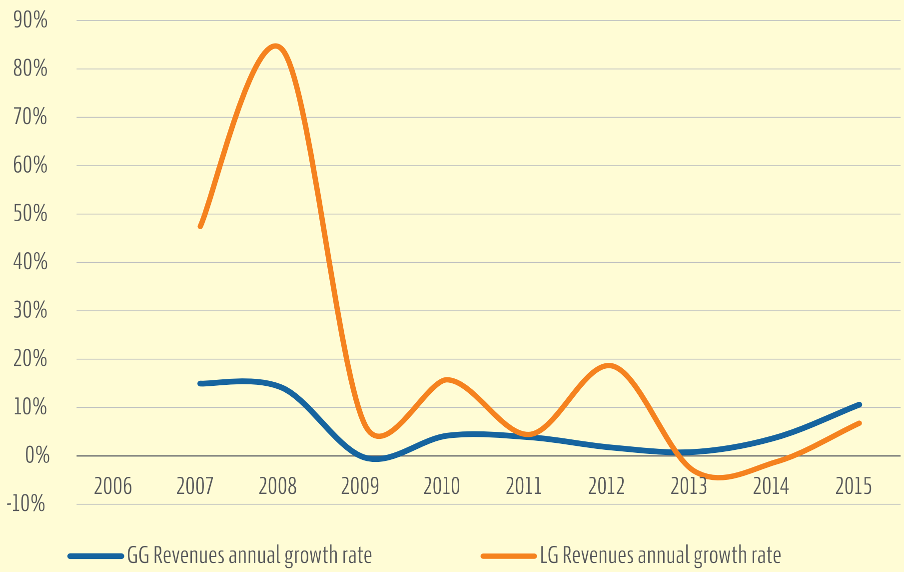
Since 2007, Macedonia has progressively devolved major social services to local governments. This has substantially increased local revenue as a share of both GDP and of total public revenue. Even in 2012, however, when local government revenue peaked at 20% of total public revenue and 6.3% of GDP, Macedonian local governments appear to be underfunded given their responsibilities. Moreover, in 2013 through 2015 the positive trend in local revenue growth stopped. . Local Government revenue was equal to 17 % of total public revenue and 5,4% of GDP, which is similar to the performance in 2014.

Macedonia: **Local Government Revenue as a Share of GDP and Total Public Revenue in 2006–2015**



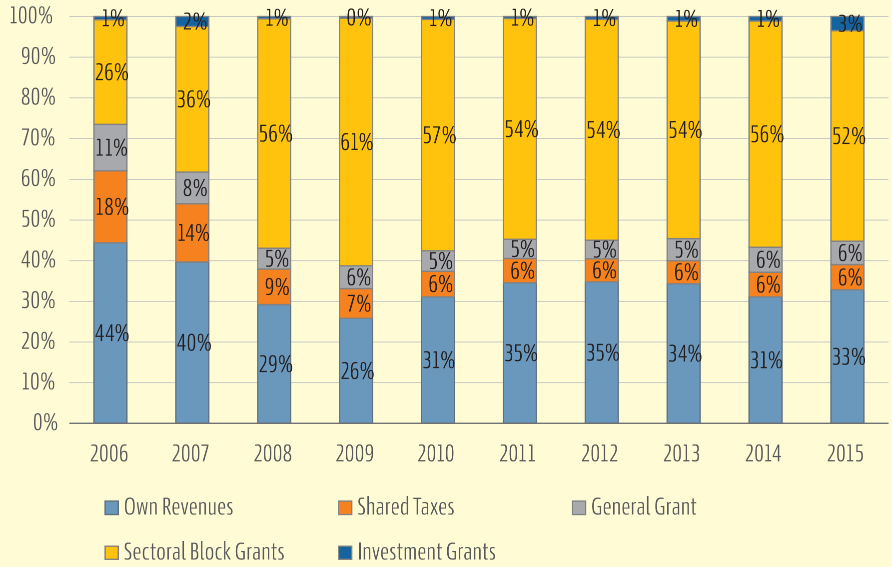
The general government revenues in Macedonia were much steadier compared to the local governments' ones, especially until 2013 when they start mirroring each other. The fluctuations of local government curve reflect the phases and main developments of the fiscal decentralization.

Macedonia: **Fluctuations in the Revenues of the General Government and Local Governments 2006–2015**



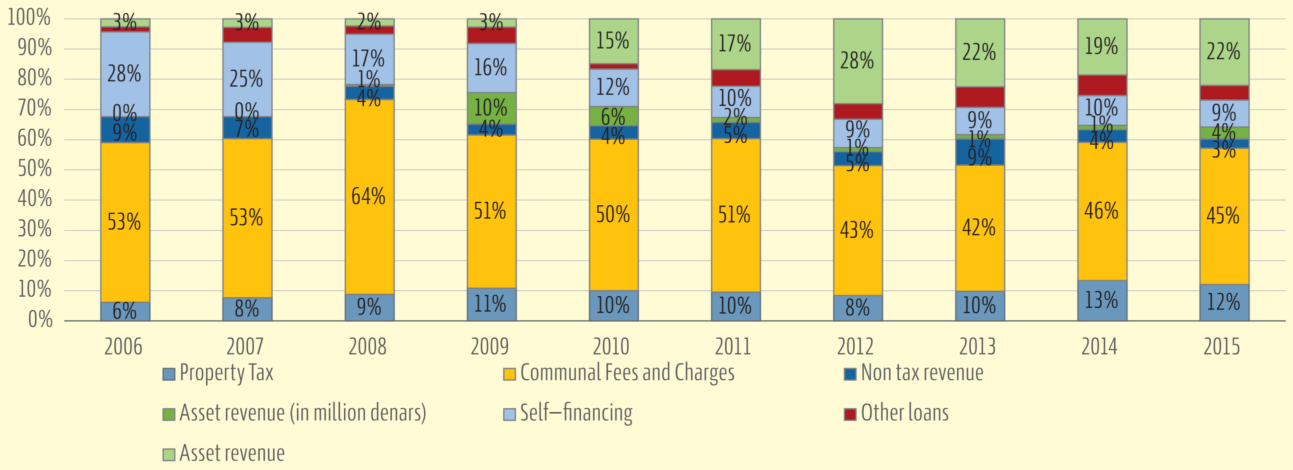
Macedonian local governments derive only modest shares of their revenues from shared taxes and unconditional, general grants. These have have been a small but component of local revenue (5–6%). Block grants are their largest source of revenue, providing more than half of the funds. Most of these funds are used to finance the pre–university education including teacher's salaries. Own revenues constitute a third of all local revenues, and investment grants are minimal, c. 1% throughout the decade, yet increasing to 3% in 2015.

Macedonia: **Composition of Local Government Revenues 2006–2015**



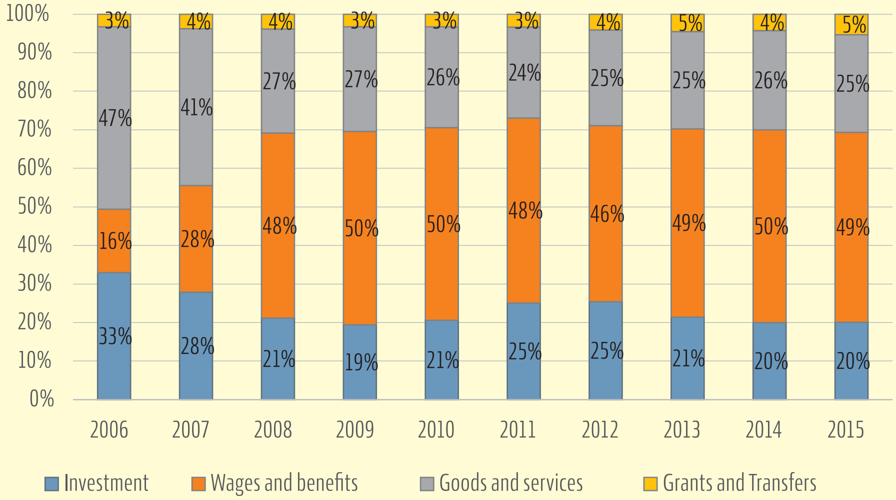
Since 2009, local governments have done an impressive job mobilizing own source revenues. Though the overall yield of the property tax remains modest they have increased collection five times. They are also more argresssively collecting Land Development Fees, Lighting Fees and other communal charges.

Macedonia: Composition of LG Own Revenues 2006–2015



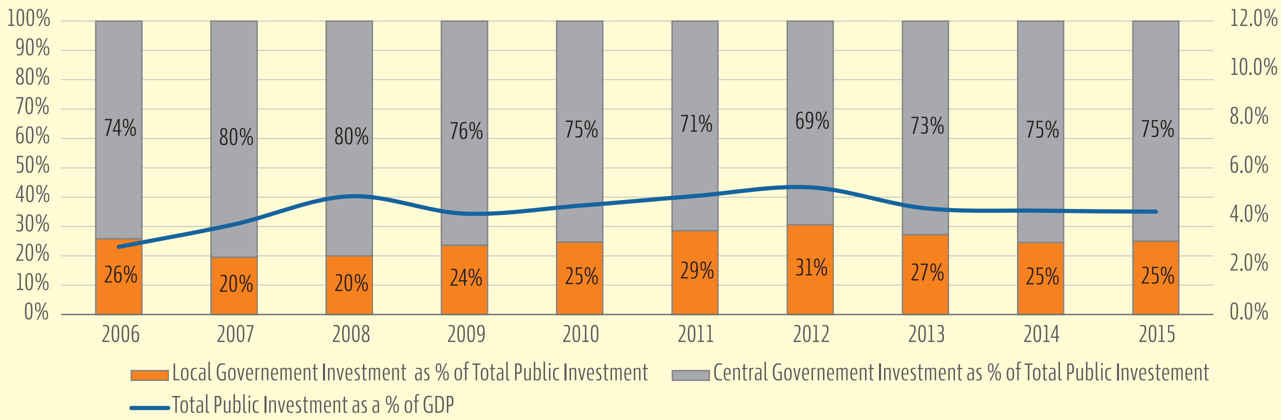
The share of local expenditures going to wages has increased steadily as local governments have assumed responsibility for primary and secondary education. The investment rate is modest, with a large share of it probably coming from the capital city.

Macedonia: **Composition of Expenditures in 2006–2015**



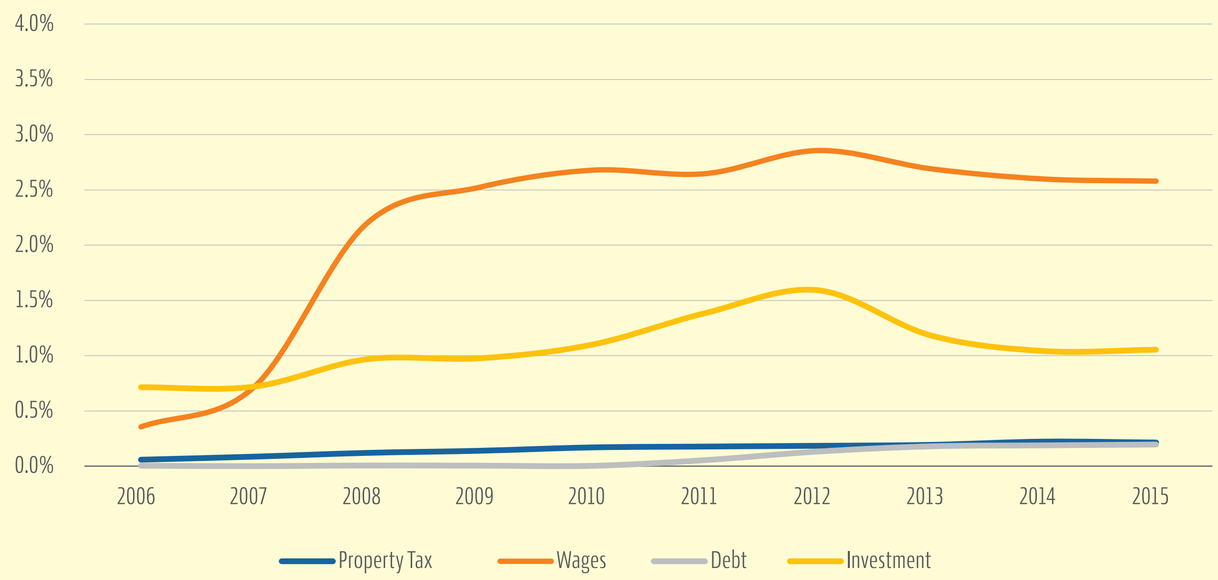
Local governments are responsible for about 25% of total public investment which in 2015 amounted 2,6% of GDP, a decrease compared to 2014 when it was 4%.

Macedonia: **Public Investment by Level of Government and as a share of GDP 2006–2015**



Wage and investment spending as a share of GDP have expanded over the last eight years, while the property tax has increased more modestly and still only yields revenue equal to 0.2% of GDP. Debt is minimal due to the restrictive policies of the Minstry of Finance, but have shown a slight increase since 2012.

Macedonia: Investment, Wages, Debt & Property Tax as Shares of GDP 2006–2015



Moldova

The Intergovernmental Finance System

On paper, Moldova has a highly decentralized public sector with raions and municipalities responsible for all pre-tertiary education and 25% of all public expenditures. This picture, however, is misleading because of the subordination of municipal governments to raion authorities, and the subordination of raions to the national government.

In 2012 the Ministry of Finance –with the support of the UNDP– prepared draft legislation designed to eliminate the financial subordination of lower-level local governments to higher ones. The legislation:

- Preserves the existing division of total public revenue between levels of government and is broadly speaking fiscal neutrality;
- Requires the national government to fully finance delegated functions.
- Requires the national government to provide raions and municipalities with separate transfers, ending the financial dependency of municipalities on raions.
- Requires the separation of Conditional Grants from the General Grant;
- Defines local governments' right to specific percentages of shared taxes.
- Eliminates disincentives for local revenue mobilization by basing the equalization system on shared taxes and not on locally collected taxes and fees.

Unfortunately, after Parliament approved the draft legislation the government reversed itself out of fear of losing political, administrative and financial influence overs mayors and local officials postponed the implementation of the law until after the 2014 elections. Making matters worse, the government has continued to politicize the already non-transparent allocation of national funds for local infrastructure investments while capping all local taxes. The attempt to cap local taxes however was contested and declared unconstitutional by the Constitutional Court.

Main Developments in Municipal Finance 2015–2016 and Advocacy Efforts of the Association

In 2015 and 2016 Moldovan local governments have been pushed to the edge of bankruptcy. The political and financial crisis due to fraud and corruption is directly affecting the condition of local governments. In August 2016 the Ministry of Finance blocked transfers to LGs explaining this by the complicated financial situation. The same approach was used earlier when all public investment projects for LGs were stopped. The local governments, which enjoy the highest trust of the population, are now burdened with paying the price for this difficult situation.

Throughout 2016, the Ministry of Finance has manifested a reluctance to implement both national and international commitments assumed by the Republic of Moldova in the field of local finance and financial decentralization. All started in June 2016, when all statements calling for the consolidation of local revenues were excluded from the draft of the government's 2016 Fiscal and Budgetary Policy. More specifically, Parliament has excluded all provisions related to the increase of the land tax and the introduction of the road tax, leaving local governments in a disastrous financial position. These problems were compounded by other arbitrary measures, such as:

- Tax discounts and reductions offered to physical persons on local taxes
- Expiration in 2016 of the Compensation Fund introduced earlier.;
- Terminating the financing of the social centers in municipalities by central government in 2015;

- Terminating the LG share of the corporate income tax in 2012;
- Introduction of 2% quota for channeling part of the personal income tax to NGOs;
- Cash deficit owing to uneven tax collections throughout the months of the year (especially painful for rural LGs);
- Constantly diminishing currency exchange rate and high inflation;
- Freezing of public investment projects implemented for and by LGs in the aftermath of the financial crisis.

In July 2016, a new roadmap for local government and decentralization reform in Moldova was agreed on by the Congress of Local and Regional Authorities (CLRA) of the Council of Europe, the Government of Moldova and the Congress of Local Authorities from Moldova (CALM). The roadmap defines the steps that central authorities have to take to eliminate the enormous policy failings concerning decentralization and local democracy in Moldova. Its implementation will be monitored by Council of Europe experts.

The Congress of Local Authorities of Moldova, representing about 700 of the 898 communities and local governments, in the spirit of the European Charter of Local Self–Government, in the spirit of the Moldovan national and international commitments, in the spirit of the highest national representation on behalf of the most trusted by the people layer of public administration, advocates the following simple but fundamentally important positions related to fiscal decentralization:

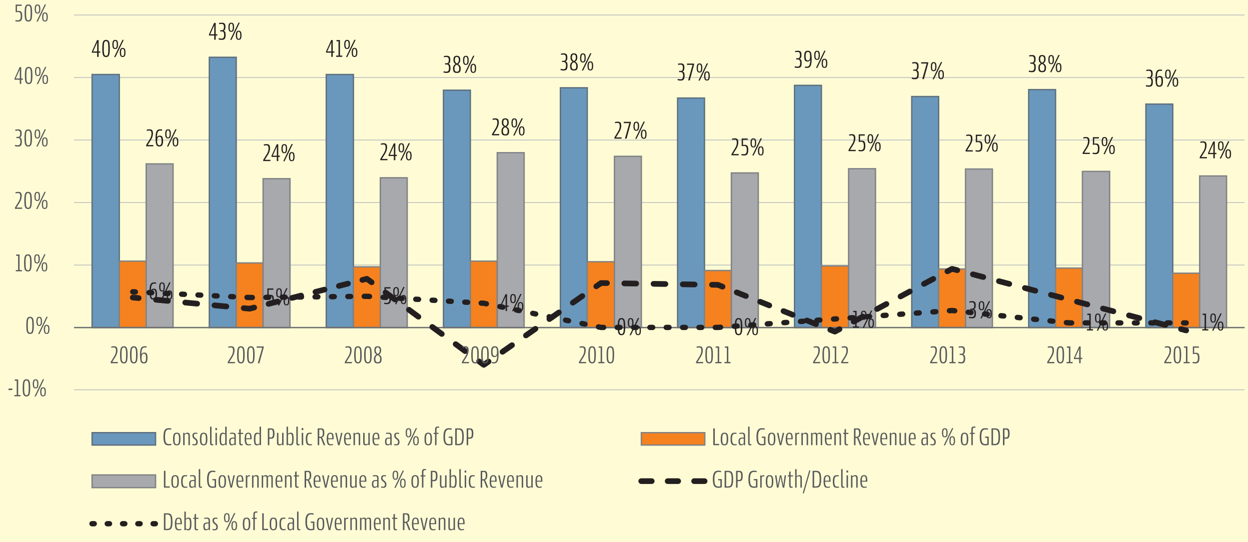
1. Local taxes shall be at a full discretion of local governments;
2. All currently existing tax ceilings (first of all those on real estate and land taxes) shall be completely removed;
3. Centrally provided tax incentives and tax discounts on that impact on local government revenues shall be strictly prohibited or fully compensated from other sources;
4. The blocking of General Transfers by the national government shall be stopped;
5. The financing of Social Centers by the state budget that was arbitrary stopped in 2015 shall be re–established until these Centers are functional;
6. The Compensation Fund for local finance reform introduced for two consecutive years in 2015 shall be continued since the second stage of local finance reform was not carried out as it was envisaged.
7. Real estate valuations –a main source of local tax revenues– shall be conducted immediately as per recently approved legislative and normative decisions.

Above all, CALM's main postulate related to local and national finance, and which, at the end of the day, all relations, discussions and negotiations shall be grounded, is that the central government should not exercise a monopoly of power, but instead, relations between all levels of public administration and the distribution of resources across them be guided by principles of trust and efficiency.

Statistical Overview of Local Government Finances in Moldova 2006–2015

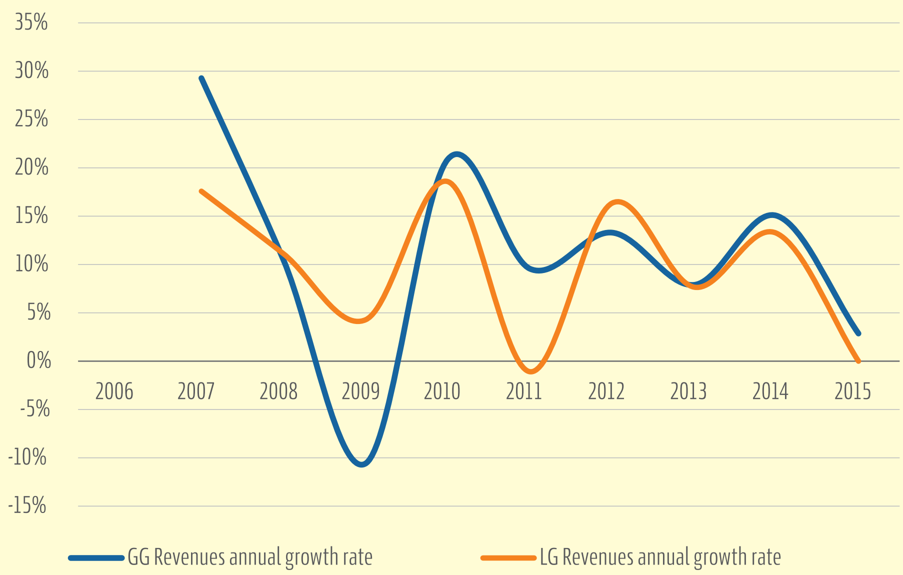
On paper, Moldova has a highly decentralized system of public administration. Local government revenues equal about 8,7% of GDP and 24% of total public revenues –levels close to the EU average. In reality, however, the situation is quite different because of the political and economic subordination of municipal governments to raion governments and to the line ministries of the national government. In 2015, Moldova saw stagnation in its growth and a decrease in total public revenues of 2%. At the local level, revenues dropped 1% as a share of total public revenues and almost 1% as a share of the GDP. 2015 in fact is one of the worst years for Moldova in the past decade, comparable only to the crisis 2009. The level of debt of local governments was 1% of their revenues.

Moldova: **Local Government Revenue as a Share of GDP and Total Public Revenue 2006–2015**



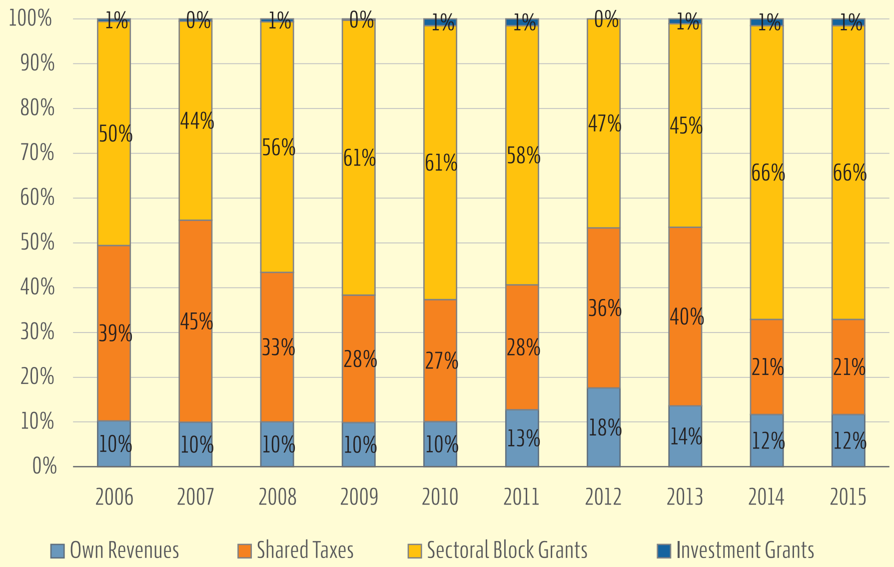
The fluctuations in the growth of the revenues of both the local and general level of government show that the trends are identical for both levels, except for during the crisis in 2009 when the GDP declined for 6%. The crisis impacted more strongly on general government revenues than on then on local governments. The second wave of the crisis –though in 2011—hit local government budgets harder.

Moldova: Fluctuations in the Revenues of the General Government and Local Governments 2006–2015



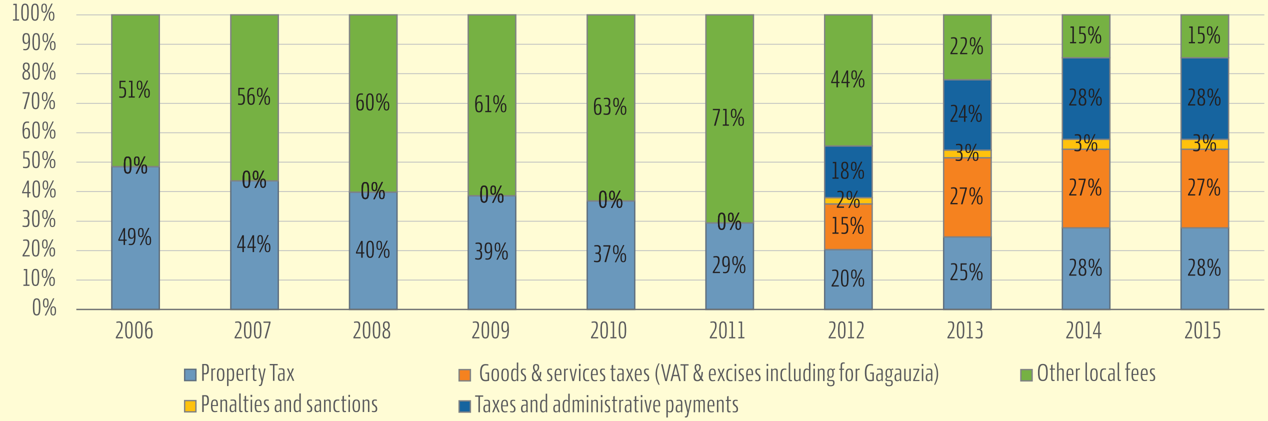
Moldovian local governments derive most of their revenues from conditional grants. There are no general, unconditional grants in the system and thus no clear mechanism for horizontal equalization. The share of shared taxes in the system has decreased, as Moldova, like Bulgaria , is trying to back out funding social sector functions with shared taxes ––whose distribution is highly–skewed. Own revenue as a share of total revenue is low. In EUR per capita terms, local revenue increased sharply in 2012 and have held more or less steady since. Own–revenues, which showed substantial growth between 2006 and 2012, have fallen over the last three years.

Moldova: **Composition of Local Government Revenue 2006–2014**



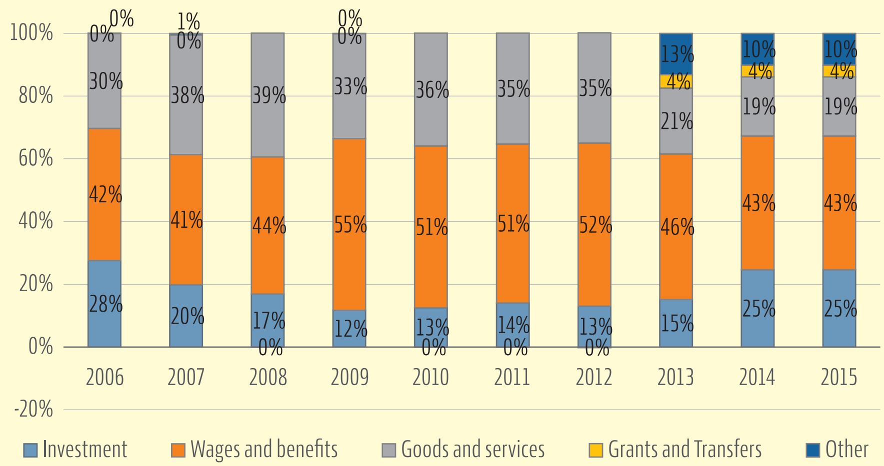
According to the types of own revenues collected at the local level, Moldova has seen diversification in the past four years. Various kinds of taxes and administrative fees have grown in importance, while the significance of the property tax has decreased. Nonetheless it remains the single most important own revenue (28% of total).

Moldova: Composition of Own Source Revenues 2006–2014



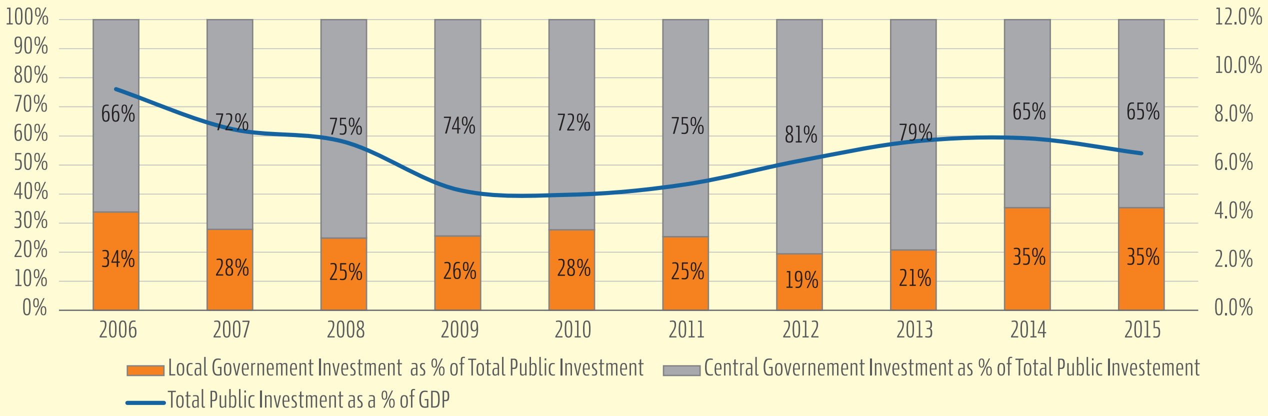
Despite the growth in local revenue, local government investment spending declined significantly between 2006 and 2012, though it rose sharply in 2014, equaling a quarter of total local expenditure. Wage spending jumped in 2009 because of state mandated increases in teachers' salaries but have since fallen as a share of both local budgets and the GDP.

Moldova: Composition of Local Government Expenditures in 2006–2014



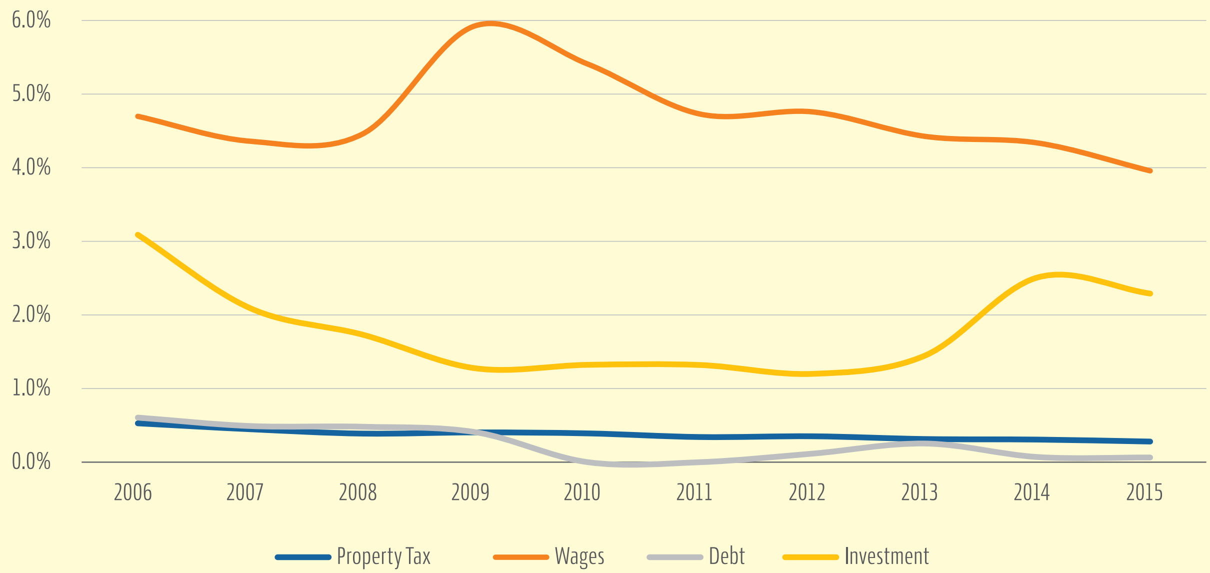
The available data for Moldova for 2015 shows a drop in the total public investment as a % of GDP from 7.1% in 2014 to 6.5% in 2015.

Moldova: **Public of Investment by Level of Government and as a % GDP 2006–2015**



The yield of the property tax has slowly declined as a share of GDP and is now well 0.3%. Local wages as a share of GDP remain high, though they have fallen since 2009. Investment is low, but rose in 2014. Debt financing is near zero.

Moldova: **Investment, Wages, Outstanding Debt and Property Tax as Shares of GDP 2006–2015**



Montenegro

The Intergovernmental Finance System

The unique feature of Montenegro's intergovernmental finance system is that so far the local governments have derived more than 70% of their total revenues from true own sources. This is possible because municipalities have only few social sector competencies and at the same time control a variety of instruments to tax land and buildings. Nonetheless the character of these instruments has changed substantially over the past decade: The problems caused by the bursting of the land bubble of 2005–2007 has been compounded by central government policies that push for the greater use of the property tax, while, at the same time, abolishing the land use fee, and the local business tax and reducing the development fees.

Montenegro has as a reasonably robust and evolving equalization system, which provides about 13% of local revenue. In recent years, reforms have tried to ensure that equalization monies are allocated not on the basis of what municipalities actually collect in own–revenues but what they could collect given their tax bases. The fiscal equalization is performed through the Equalization Fund, which is formed from 11% of the national yield of the Personal Income Tax, 10% of the national yield of the Property Transfer Tax, 100% of the national yield of Vehicle Tax and 40% of the yield of concession fees from games of chance. The Law on Local Government Finance also requires periodic consultation with the Committee for Monitoring the Development of the System of Municipal Fiscal Equalization. The Committee monitors the implementation of the criteria for fiscal equalization, gives recommendations for improving the system, and issues opinons on documents prepared by the Ministry of Finance related to the allocation of the Fund.

Municipalities can also receive conditional grants from the State Budget for financing investment projects that are of special interest to one or more local govenrments. These grants can be used to co–finance donor funded projects. In order to receive a conditional grant, municipalities must have adopted a multiyear investment plan. The maximum amount of a conditional grant cannot exceed 50% of the anticipated cost of the project. The amount of conditional grants that a local government can receive also depends on the level of per capita revenues they generate from the land development fee in relation to the national per capita average in the proceeding year. Conditional grants have proved to be very useful instruments for co–financing investment projects that are also being supported by EU funds. Nonetheless, conditional grants represented only 1% of total local government income in 2015.

Main Developments in Municipal Finance 2015–2016 and Advocacy Efforts of the Association

2015 was mainly focused on continued efforts to mitigate the severe effects of the “great recession” of 2009 on Montenegro's public finances. In the years since 2009, there were many efforts to limit the effects of the crisis through countercyclical spending. These led to a sharp increase in the level of the public debt, including at the local level (through both heavy borrowing and accumulates payment arrears). Various efforts were made to adjust local revenues (replacing fees with increased shares of PIT, the Property Transfer Tax, and concessions; reshaping equalization), but the amendments came too late and the crisis produced a sharp increase in local government debt and payment arrears. As a result, local government budgets have not recovered to pre–crises levels.

Most local government units in Montenegro during 2015 have been focused on overcoming their financial problems, strengthening functional abilities and creating sustainable local government budgets. Achievement of these most important goals means the adoption and implementation of a lot of measures by the Government of Montenegro, competent ministries, local government units and the association of municipalities, and requires their intense cooperation in creating a stable and sustainable intergovernmental finance system.

The Union of Municipalities of Montenegro undertaken a number of activities to help consolidate local public finances. In particular, the Executive Board of the Union of Municipalities prepared and adopted the **Proposal of Measures to Overcome the Difficult Financial Situation in Local Self–Government Units**, which was sent to all competent state authorities/government bodies. It deserves to be noted that the Government of Montenegro is ready to help municipalities that demonstrate a willingness and determination to solve their increased financial burdens. Most of these measures have been partly or completely implemented during 2015 and 2016 and, as a result, the local financial situation is now improving.ad now.

In order to facilitate long–term local financial sustainability following measures were taken:

- ***Tax Debt Repayment Rescheduling***: The Government of Montenegro ***approved the rescheduling of debt repayments for unpaid taxes and contributions on salaries*** in local government bodies as well as in public institutions and companies founded by the municipalities. Contracts on tax debt repayment rescheduling were signed between the Ministry of Finance and 16 out of 23 local government units. These contracts are adopted by the municipal assemblies and signed by the mayors and they will be valid for a period of 20 years for all municipalities that are beneficiaries of the Equalization Fund (14), while for the other two municipalities the re–payment period is determined for 5 years. While determining the schedules of payment, the starting point of the Ministry of Finance was the request of the Union of Municipalities and local governments that the amount of the monthly installments in the first years of repayment should be lower, in order not to jeopardize the ongoing liquidity of local governments and the normal mode of functioning. Besides the repayment of the unpaid tax liabilities, municipalities are obligated to pay current tax obligations, also. The Union will work towards achieving such agreements for all local governments in Montenegro.

- ***Refinancing of municipal unpaid liabilities:*** In order to create a long–term local financial sustainability, it is particularly important to ***create a sustainable model of refinancing of unpaid liabilities*** of local self–government units towards financial institutions, other suppliers, employees, etc., and to finance a social programme in order to optimize the number of employees at local level. According to information that local self–government units provided to the Ministry of Finance, the total unsettled liabilities of municipalities are increasing, requiring urgent measures, while at the same time, efforts must be made to lower debt service expenditures (i.e. ensure refinancing of existing debt due to high interest rates and short repayment periods). Having this in mind, the Parliament of Montenegro ***amended the Law on State Budget for 2015 thus increasing the amount of State Guarantees (107 mil €) in order to ensure favorable conditions for*** refinancing unpaid municipal liabilities. Several municipalities used this instrument to improve their financial situation and signed contract with the State of Montenegro in order to regulate mutual rights and obligations.

- ***Improvement of the Legal Framework related to Local Self–Government Financing and the utilization of EU Funds***: Sustainability and stabilization of public finances at the local level requires improvement of the legal framework regulating the system of local self–government. In this regard, the Union of Municipalities in launched a number of legislative initiatives. As a result of these initiatives, the Parliament of Montenegro in 2015 ***amended the Law on Property Tax, the Law on Communal Services and the Law on Legalization of Informal Buildings*** in 2016. The Law on Property tax prescribed higher tax rates and an expanded base for taxation starting from 01.01.2016. The Law on Communal Services and the Law on Legalization of Informal Building introduced new sources of own revenues: utility fee; legalization fee; fee for utility equipment of construction land and fee for construction of regional water supply system in territories of municipalities on the Montenegrin coast, which is expected to significantly increase local government revenues.

With regard to the Law on Local Government Financing, the Union of Municipalities through the Commission for Local Government Finance and with the Ministry of Finance pushed for ***a model which would ensure compensation of revenues that are abolished to local self–governments by numerous changes to the law***. The Union proposed that new legal provisions should: establish a higher percentage of shared revenues for municipalities; to determine accurately the particular legal provisions whose practical implementation have been deficient; to enact by–laws whose adoption is a necessary condition for the introduction of certain local government revenues (fees for the protection and improvement of the environment, the tax on uncultivated agricultural land, etc.); the need to adjust the equalization fund to meet the needs of newly created municipalities that do not have sufficient fiscal capacity.

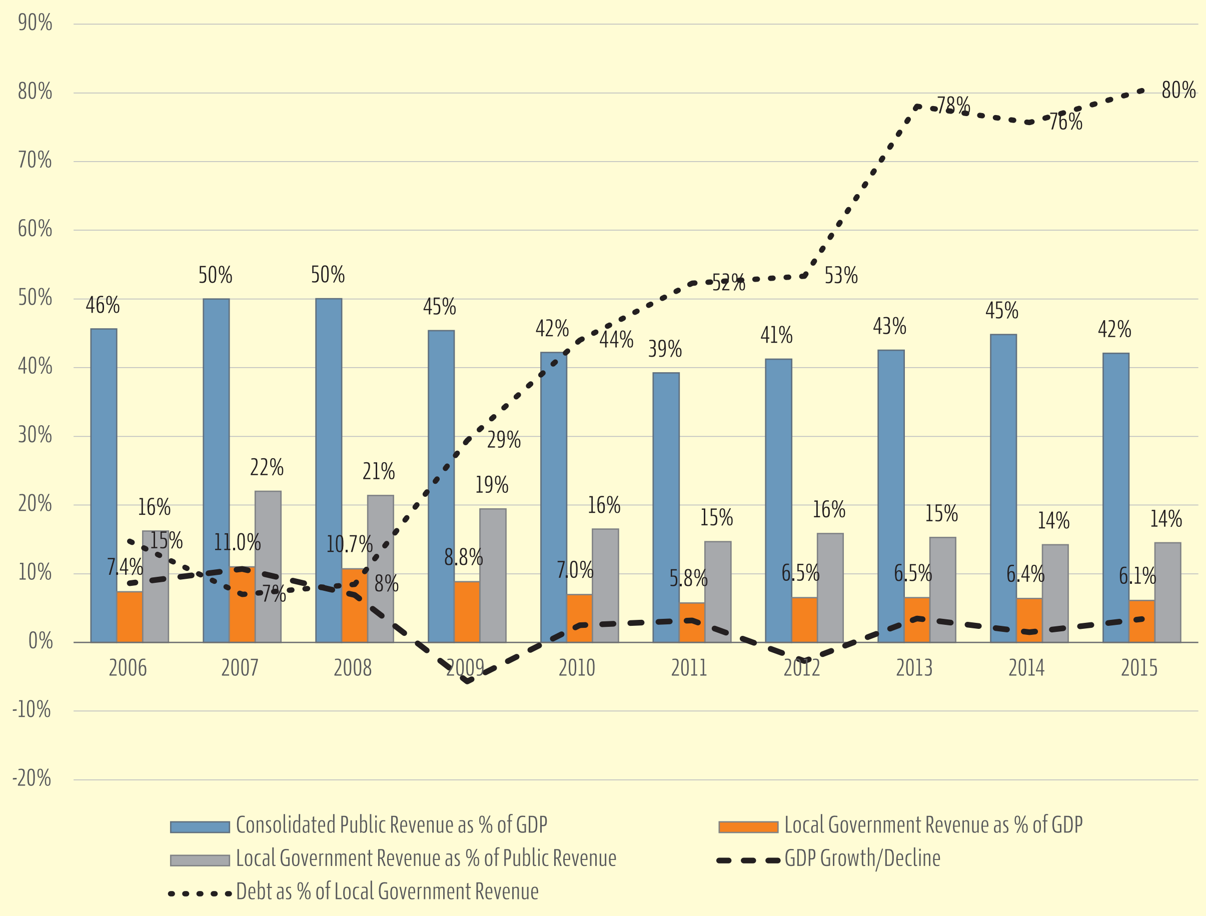
The Union of Municipalities particularly focused on the problems that local governments encounter when providing funds for the pre–financing of the implementation of EU financed projects. It proposed an amendment to the Law on Local Self–Government Financing which would allow for the introduction of a "***Revolving Fund***" designed to allow municipalities to borrow the monies necessary to meet the 10% pre–financing contribution associated with EU projects.

▸▸ ***Optimizing the number of employees on the local level:*** Local self–government units play key role in the stabilization of local public finances, in line with the *Plan of the internal reorganization of the public sector* adopted by the Government of Montenegro. Therefore, they are undertaking measures for the ***rationalization of operating costs and optimization of the number of employees in local governments,*** which is one of the provisions of the signed contracts on tax debt repayment rescheduling.

Statistical Overview of Local Government Finance in Montenegro 2006–2015

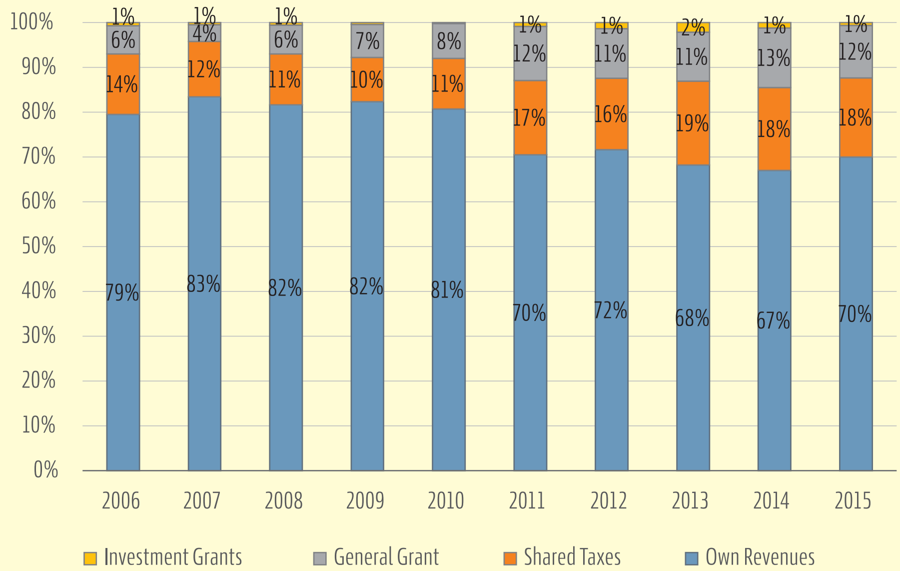
The impact of the global economic crisis on the Montenegro was particularly strong and dramatic for local authorities. The highest share of local government revenue as a percentage of GDP in Montenegro was 11% in 2007.This almost equaled the EU average and was the highest in South East Europe. Since 2007, local government revenues have fallen significantly, and in 2015 their share equaled only 6.1% of GDP and 14% of total public revenues.

Montenegro: Local Government Revenue as Share of GDP and Total Public Revenue 2006–2015



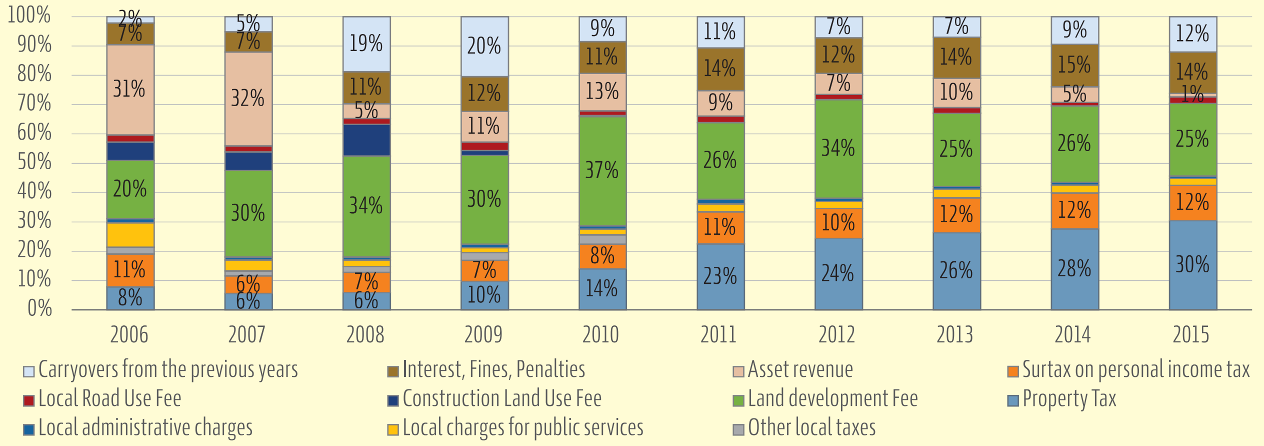
Montenegrin municipalities are unique in the region in that they derive around 70% of their revenues from own sources, even in these hared times. Indeed, in the middle of the decade, own revenues accounted for more that than 80% of total revenues, and were being driven up by a real estate boom that increased income from asset sales, land development fees and other property related fees and charges. Legislative changes following the crisis cut some types of own revenues. The share of shared taxes was increased and the equalizaation system improved, leading to an increase in the percentage of shared taxes in total revenues from 12% in 2007 to 18% in 2014 and 2015.

Montenegro: **Composition of Local Government Revenues 2006–2015**



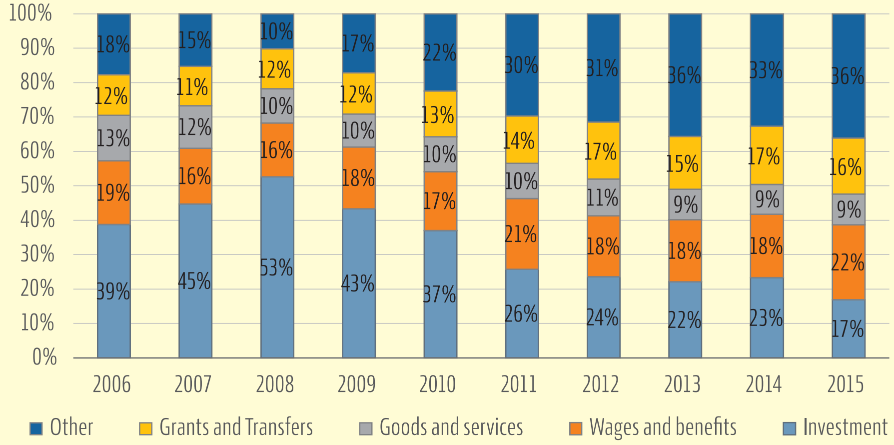
Until recently, the Land Development Fee was the largest source of local own–revenue. But the central government has been imposing constraints on it, and the Fee is scheduled for elimination in 2020. If so, this will have a serious impact on municipal finances. Meanwhile, the Land Use Fee was eliminated in 2009. Local governments have tried to replace the lost income by makinig greater use of the Property Tax, which went from being a relatively insignificant own revenue back in 2006 (only 8%) to the single most important one in 2015, and it now represents a third of all own revenue.

Montenegro: Composition of Own Revenues 2006–2015



Local government investment has dropped from 268 EUR per capita in 2008 to 65 EUR per capita in 2015, while debt service payments have more than doubled from 54 EUR per capita to 119 EUR in 2015.

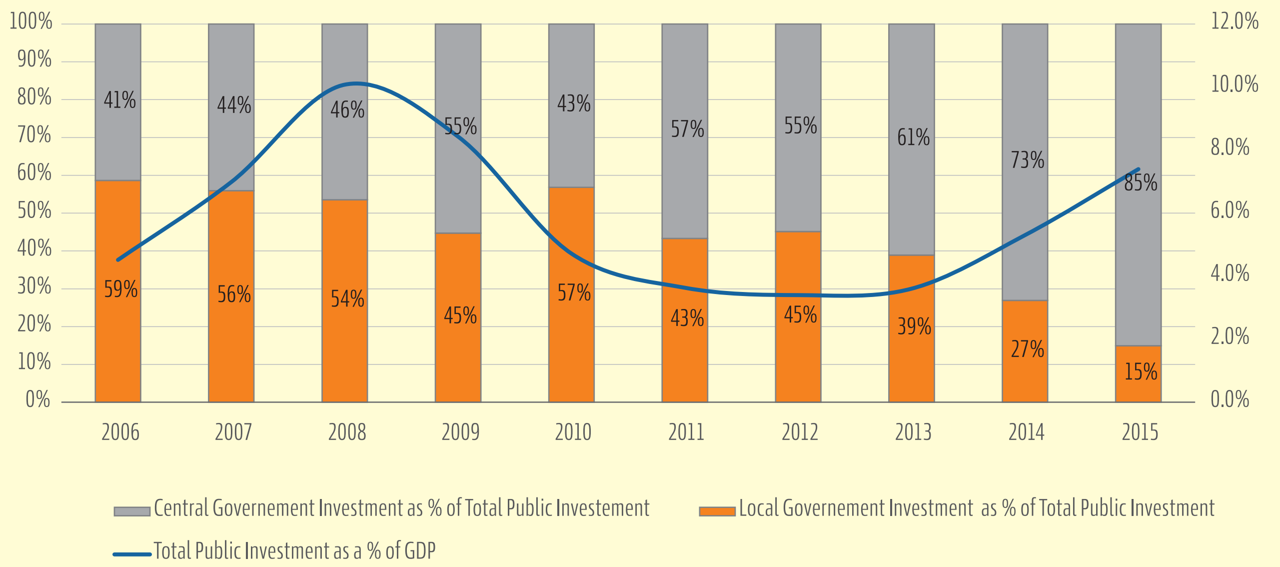
Montenegro: Composition of Expenditures in 2006–2015



The economic downturn led to a sharp contraction in public sector investment between 2008 and 2013, which again dropped in 2015. But while total public investment recovered somewhat in 2014 and 2015, the share coming from municipalities continued to decline.

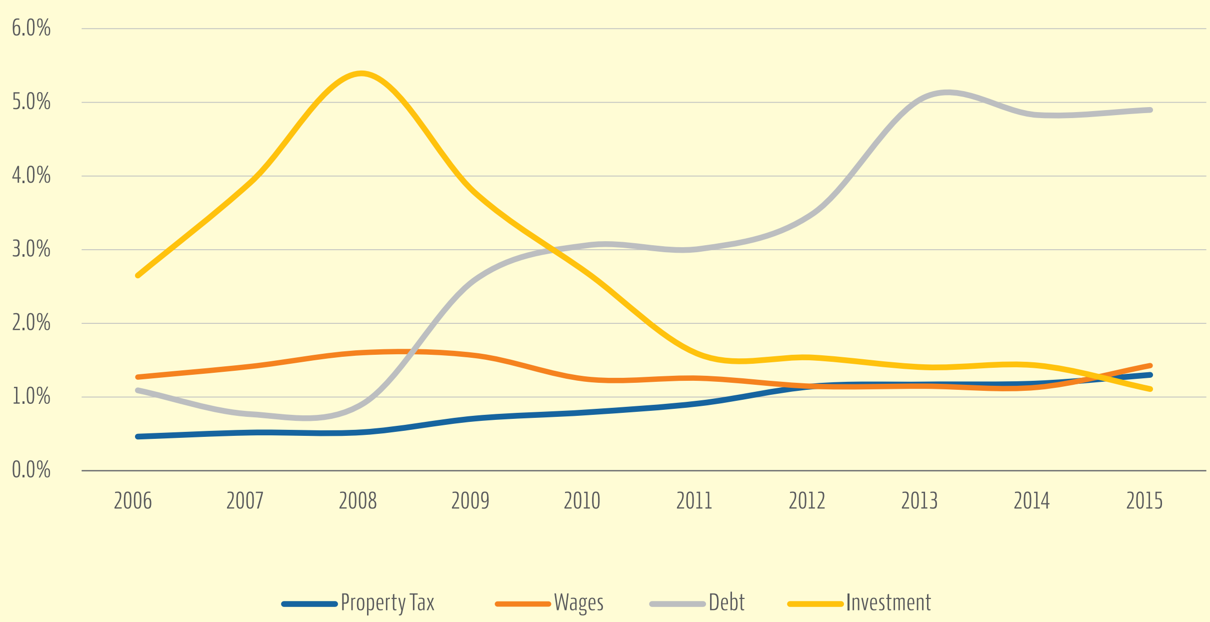
Most municipalities have reached their legal debt limits and many do not have enough revenue to finance all their obligations to banks, suppliers and the state budget. The debt service payments accounted for 48% of total local expenditures in 2015. Local investment as % of Total Public Investment has fallen from 59% in 2006 to 27% in 2014, whit another fall in 2015 to only 15%.

Montenegro: Public Investment by Level of Government and as a Share of GDP 2006–2015



Local governments have responded to the economic downturn and the policy changes discussed above by reducing wages, raising the property tax, lowering investment and increasing borrowing.

Montenegro: **Investment, Wages, Debt Service and Property Tax as Share of GDP 2006–2015**



Romania

The Intergovernmental Finance System

In Romania, public sector revenues account for only 33% of GDP. This is low by EU standards. In terms of expenditure, they are below 35% the lowest in the EU. Nonetheless, local governments play a very important role in the country's public sector. Their revenue as a share of GDP is above 9%, which is high for comparable European countries. As a result, local governments have been targeted for many of the fiscal adjustment measures taken in the wake of the financial crisis of 2009. These included a reduction in their share of the personal income tax, a reduction in grants for social sector functions, wage cuts, layoffs and a tightening of debt limits.

By the end of 2013, 56% of all public employees were paid for by local governments. This includes almost 300,000 teachers, over 100,000 social service employees and since 2010, health workers. Indeed, over the last six years local governments at once added 120,000 hospital employees to their payrolls while shedding 140,000 employees from other local services – a net reduction of about 20,000 people.

Local governments have full expenditure control of about 50% of their revenues that come mostly from shared income tax and property taxes which they collect on their own. Grants from the national budget account for another 30%, and grants from the EU for 7%. The fiscal adjustment program has led to 4% reduction in state transfer for social sector functions. It also led to a reduction of the local share of personal income tax from 82% in 2010 to 71.5% in 2012.

Most local government expenditure is for education (c. 20%), health (13%) and social welfare (10%) and most is for recurrent expenditures (c. 65%). Nonetheless investment spending is high by European standards, especially if one adds EU grants, which are generally for investment (14% + 10%). Expenditures on debt service however remain low –though rising—and account for only 4% of total spending. In 2009 and 2010, new limits were set for local debt and both borrowing and investment spending declined. There are however, exceptions for loans incurred to co–finance EU funded projects.

Romania's intergovernmental finance system tries to equalize local government revenues both vertically and horizontally. Vertical equalization is achieved by sharing Personal Income Tax (PIT) on an origin basis. The shares vary according to the type of local government: municipalities get 41.75%, counties 11.25%, the city of Bucharest 44.5% and its six districts 20%. Horizontal equalization is carried out at the county level from funds created by 18.5% of the PIT collected in a given county plus an equalization grant from the state budget.

Since 2006 horizontal equalization has been managed mainly through a mathematical formula. Until then discretionary allocations by county councils and central government were prevalent; since the adoption of the formula, discretionary transfers have been drastically reduced, but still continue to be a feature of the system.

Figure 1 below shows the formation of the horizontal equalization pool at the county level. The pool is created by a share of the income tax collected within the county (18.5%) and an equalization grant from the state budget (so–called "VAT sums for equalization"). The latter arrives by formula to each county. The county pool is split between the county council (27%) and the municipalities (73%). In the latter case, most is distributed by a two–step formula.

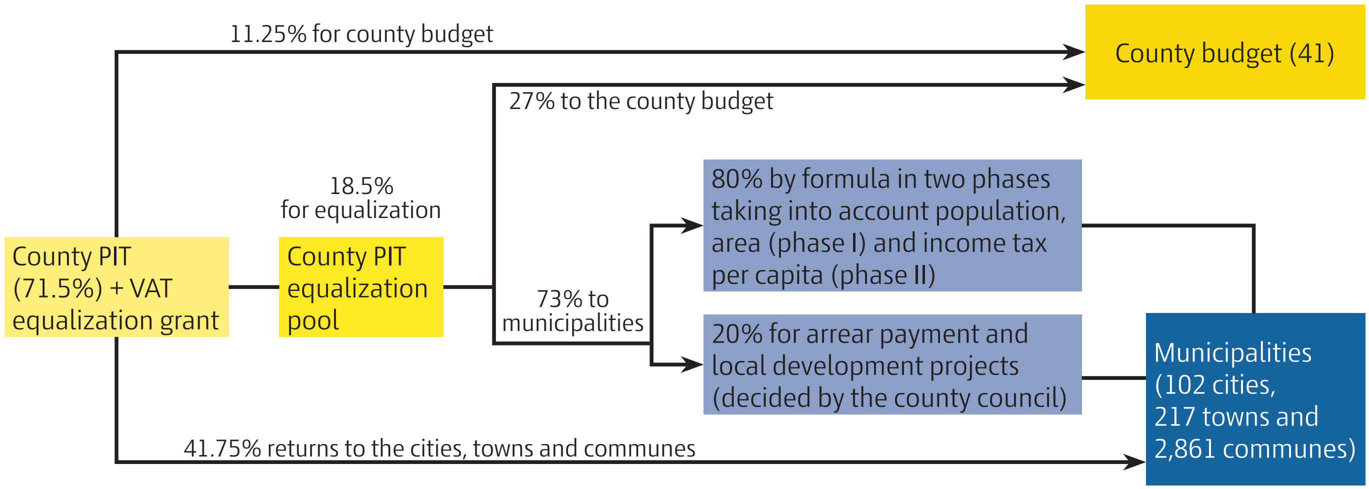


Figure 1 – Financial flows of the Romanian equalization system

The variables of all formulas in the equalization system are based on income tax, population, county area and urbanized area. No weight is given to any indicators of expenditure need like population density, geographical position or development level. Income tax per capita is used in most formulas as a proxy for economic development. The indicator is designed to allocate more funding to poorer municipalities whose per capita revenue from shared PIT is below the county average. In contrast, population and area are employed as proxies for expenditure needs providing more money to local governments with large populations or which service large territories. Overall, the most important indicator in all formulas is income tax per capita.

The system does not contain any "Robin Hood" mechanism whereby richer municipalities are taxed to help cover the costs of equalization. The formula allocations are uniform and unbiased. But the discretionary allocations on top of the formulas provide county councils with significant leverage over poor municipalities. The current equalization system has a series of drawbacks, which should be corrected. The most important of these are:

- It is unclear how well vertical equalization performs because local government expenditure needs have not been thoroughly measured;
- Income tax is shared on the basis of the tax payers' place of work, not their place of residence. Because many people work in big cities this increases fiscal inequalities;
- The significant weight of discretionary transfers from the national government and county councils make the system unnecessarily unpredictable, non–transparency and subject to political bias;
- The formation of 41 separate county pools exacerbates the differences in per capita revenues between similar local governments from different counties;

Despite its flaws Romania's equalization system manages to reduce the wealth gap between local governments even in the current setup. Some scenarios were tested with a view to improving current resource allocation and achieve better outcomes. The best results were obtained with the formation of a unique national equalization pool. Such a solution would be technically feasible, but politically difficult to sell to would–be losers: county councils, Bucharest districts and wealthy counties.

Against this backdrop, changes to Romania's equalization system were recently enacted through the 2015 state budget law. Without any prior notice to local governments, the Parliament adopted provisions, which in effect suspend the application of the statutory equalization system in 2015. Instead, a different system is being used. It is based on revenue thresholds calculated for each category of local governments – communes, towns, cities and counties. These thresholds include own revenues, shared PIT and equalization, and the new provisions of the budget law guarantee all local governments the attainment of the respective thresholds, regardless of their population, through equalization allocations to cover the deficit. Once these equalization allocations are made, whatever remains in the pool of funds earmarked for equalization is then distributed to all local governments based on a number of criteria, of which population is the most important. An impact analysis carried out by the Association of Communes reveals major drawbacks in the new system:

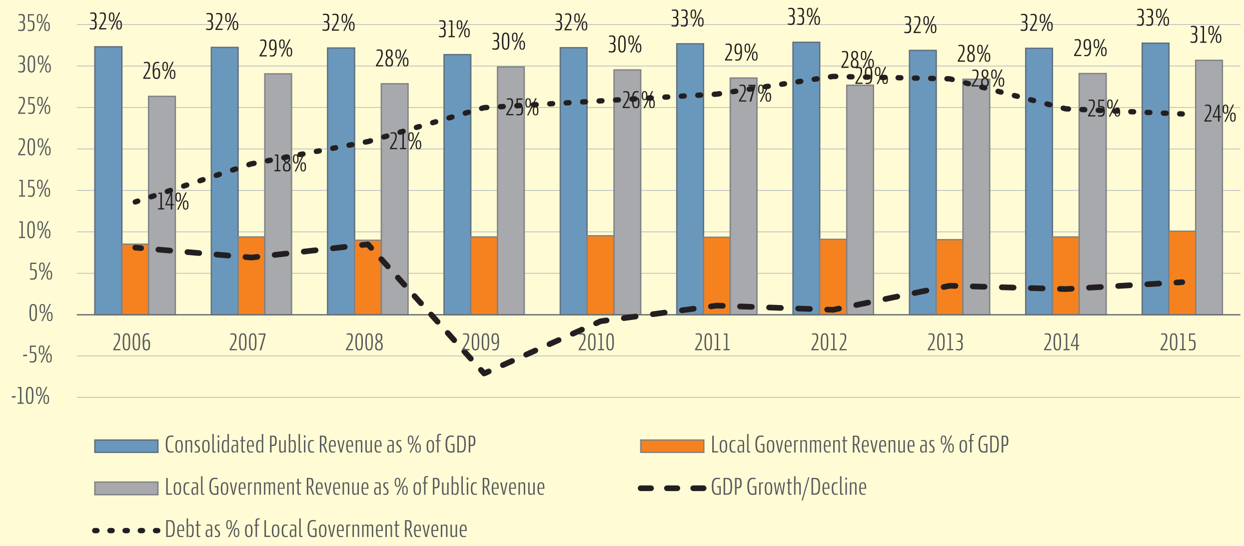
- Half of local governments are losing money compared to 2013 and half are gaining;
- On the losing side, are over 500 local governments in the poorest two quintiles of local governments –mostly heavily populated but poor communes and towns;
- Winning are almost 500 well–off local governments in the richest two quintiles;
- Over 1,800 local governments are subject to a major variation (+/– 50%) in their equalization revenues as compared to 2013, half of them on the negative side
- The coefficient of variation of local governments' per capita discretionary revenues after equalization has deteriorated when compared to 2013, which means the 2015 system equalizes less than the statutory one.

This is an example of opaque and hasty policy decision that was not proceeded by an impact analysis and has had unforeseen consequences. Hopefully, the system will not be implemented beyond 2015, otherwise we fear a significant change in local governments' behavior (e.g. reduction of tax collection efforts, break–up into smaller units).

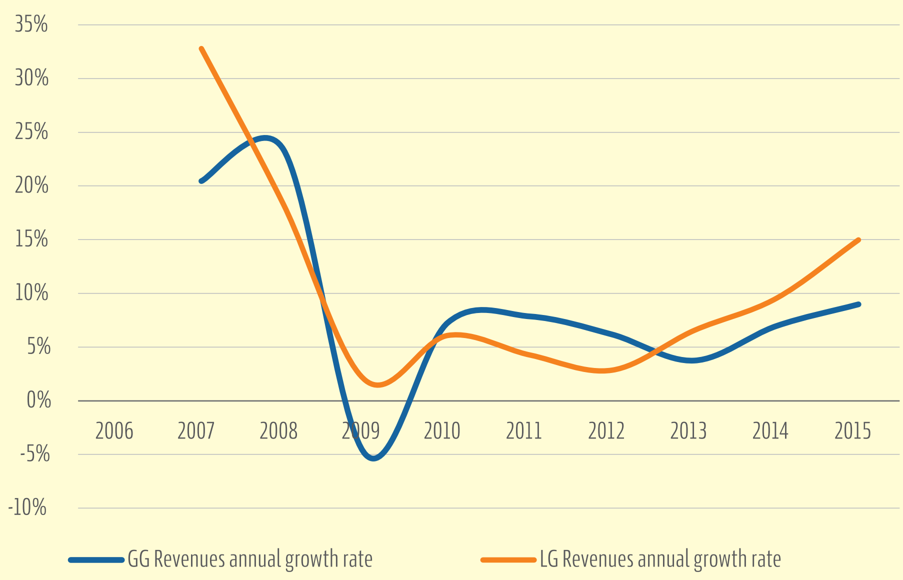
Statistical Overview of Local Government Finance in Romania 2006–2015

Local government revenues in Romania have been both high and stable over the entire period and given the overall modest size of the total public sector, this suggests that the national government has been treating local governments reasonably fairly and predictably. Yet in 2015, the consolidated public revenue was 36% of GDP which is lowest point in the analyzed decade, as is local government revenue as a share of GDP (8.7%). The local share of total public revenues is more in line with the past years and equals 24%.

Romania: **Local Government Revenue as a Share of GDP and Total Public Revenue 2006–2015**

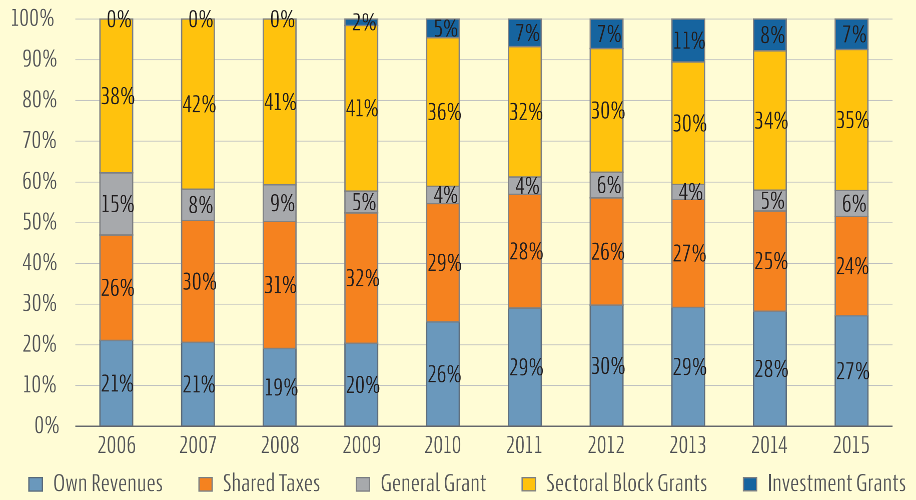


Romania: **Fluctuations in the Revenues of the General Government and Local Governments 2006–2015**



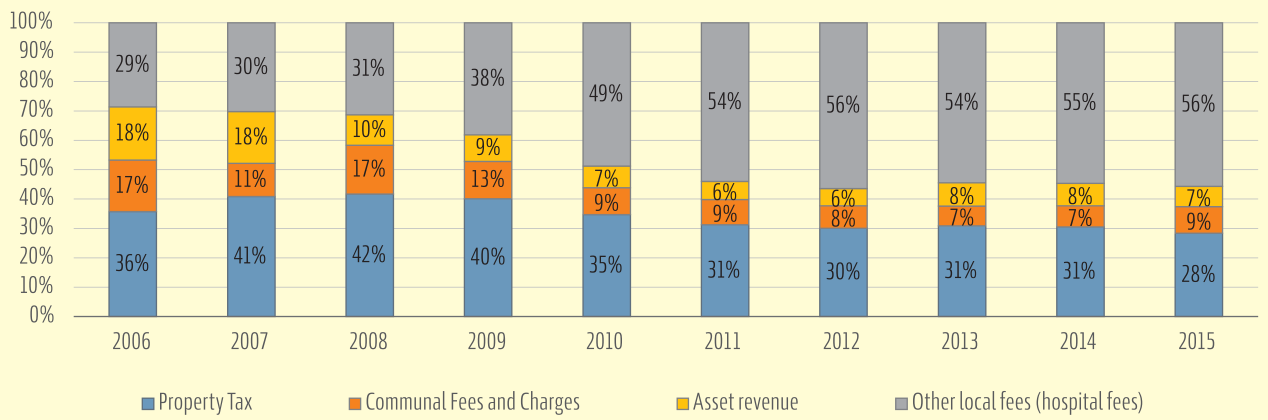
Since 2006, the share of own revenues in local budgets has increased from 20 to 30%. Part of this increase has been due to a doubling of property tax revenues whose yield is now equal to 0.8% of GDP, one of the highest in the region. The composition of revenues has generally been very stable after overcoming the effects of the financial crisis.

Romania: **Composition of Local Government Revenues %**



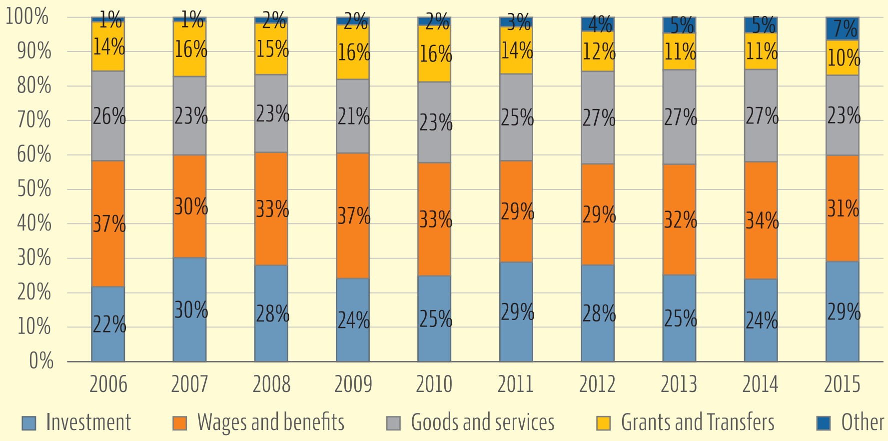
With the decentralization of hospitals in 2010, hospital fees have also become an important source of own-revenue. But these revenues must be spent in the health sector.

Romania: **Composition of Own Revenues 2006–2015**



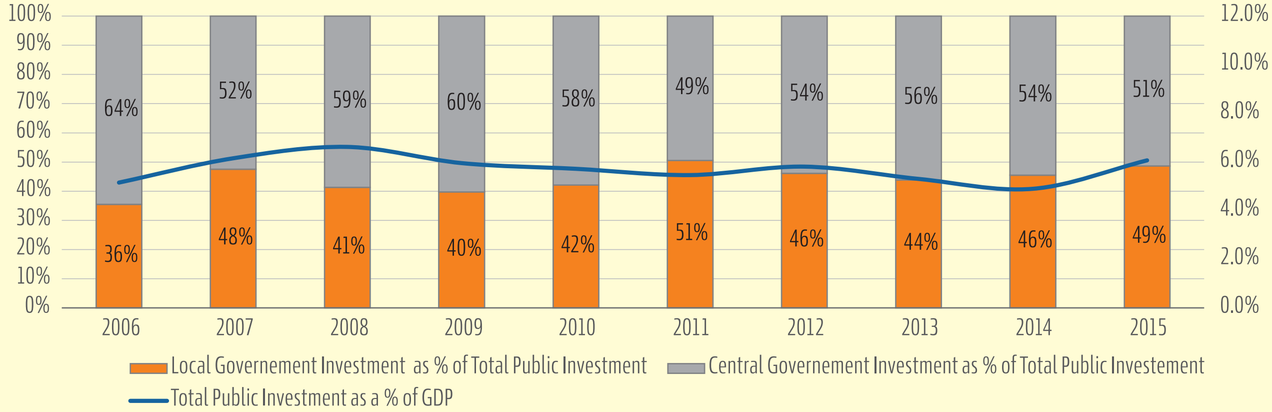
Local governments' initial response to the economic crisis was to slash expenditure on investments and on goods and services, and to reduce – though to a lesser degree—wage spending. By 2011, however, investment spending as well as spending on goods and services increased while wage spending declined through before rising in 2013 and 2014 as investment expenditure fell. Yet, 2015 was a good year as investmets increased for over 40%.

Romania: Composition of Local Expenditure 2006–2015



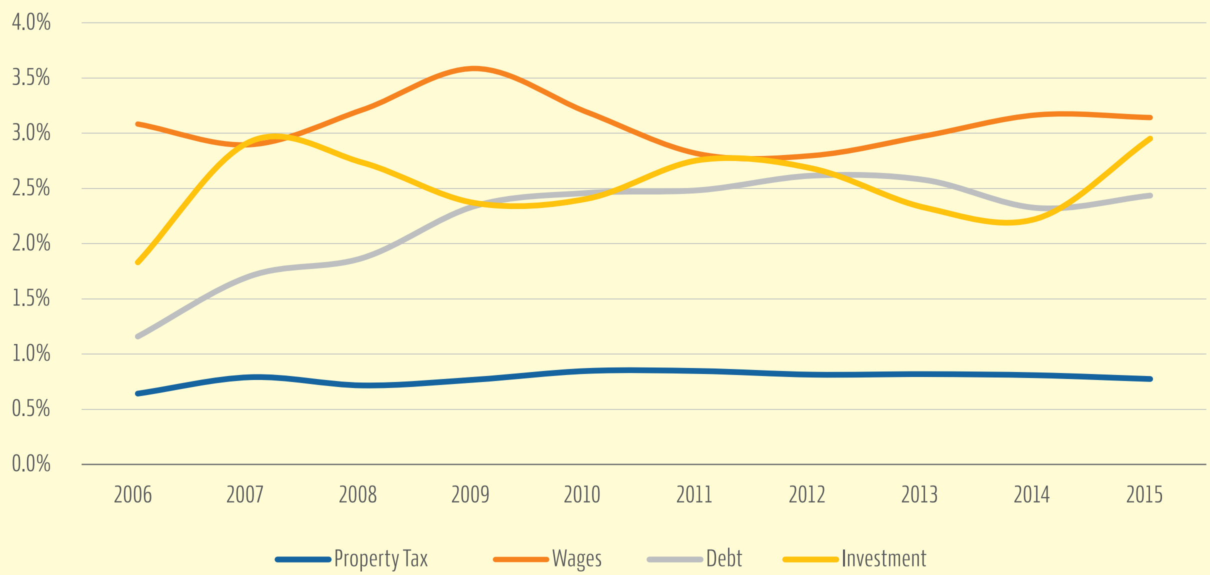
Since 2010, local governments have accounted for over 50% of all public investment. As in Bulgaria and Slovenia, much of the Romanian investment is being facilitated by EU grants.

Romania: Investment by Level of Government and as a % GDP 2006–2015



The property tax collection has been stable in the analyzed decade, unlike the other three trends on the expenditure side of the budget. The debt was rising in the years before the crisis, and continued to do so, but with decreased intensity over the years 2010–2013. The debt dropped in 2014 but increased again in 2015.

Romania: **Local Government Wages, Investment, Property Taxes and Outstanding Debt as % GDP 2006–2015**



Serbia

The Intergovernmental Finance System

Serbian local governments are being financed according to the Law on Local Government Finance from 2006, but the past two years there are attempts, by the Association and by the Ministry of Finance to design new solutions for the system.

The current Law set the share of the personal income tax local governments receive on an origin basis and decentralized the administration and collection of the property tax to local governments, also set the total pool of funds to be used for both vertical and horizontal equalization.

The first call on this pool of funds is for horizontal equalization. Local governments whose per capita revenues from shared taxes are less than the national average –calculated are entitled to an equalization grant. Their grants are equal to a percentage of the difference between their per capita revenue from shared taxes and a percentage of the national average multiplied by their populations. The remainder of the pool is allocated by formula to all local governments as an Unconditional Transfer. The allocation of the transfer to individual local governments is determined in accordance with uniform criteria set: metrics for population, territory, number of classes in elementary and secondary schools, number of elementary and secondary school buildings, number of children attending preschool and number of pre–school buildings. The general transfer thus has an equalizing effect, independent of the equalization grant.

The economic crisis of 2008–9 had extremely negative consequences for the Serbian economy in general, and local government budgets in particular. In 2009 the GDP declined 3.5%, and the real–estate market collapsed, leading to a sharp decline in shared taxes and own–revenues associated with property transactions. But the situation was made much worse by the government's suspension of the Law on Local Government Finance between 2009 and 2011 which led to a dramatic fall in the unconditional transfer.

In 2011, amendments were introduced into the law that radically changed its character. The share of the Personal Income Tax that local governments retain (on an origin basis) was increased from 40% to 80% for all municipalities except Belgrade, whose share was raised to 70%. But at the same time, the amount of unconditional transfers was reduced, and a smaller pool of grant funds was allocated to municipalities in accordance with a complicated development index that divided them into four groups. Municipalities in the fourth group continued to receive 100% of the transfers they received before, while those in the third group got 10% less, in the second group 30% less and in the first group received 50% less.

In 2012, the Law was amended again, this time significantly limiting some local communal fees like the business sign tax and eliminating others like the local motor vehicle fee. Meanwhile, the national government raised all taxes that accrue to the central budget, including VAT, the capital income tax, excises, and social contributions. In June 2013, the government reduced the rate of the wage tax from 12% to 10% while increasing the threshold for non–taxable income. These changes led to a direct loss of local revenue of about EUR 200 million. At the same time, the government increased the rate of payroll taxes for social contributions from 22% to 24%, basically transferring what it had taken away from local governments to the National Pension Fund. Finally, on January 1, 2014, the government eliminated the Land Use Fee, the second most important source of own–revenue. The amendments of the Law on Property Taxes caused significant increase in property tax collection in 2014, but even that wasn't enough to compensate the construction land use fee which was abolished.

The 2011 amendments also created a new transfer called the Solidarity Transfer which all municipalities are entitled to except the City of Belgrade. The size of the Solidarity Transfer is equal to 10% of the wage taxes of the City of Belgrade. It is allocated to local governments through the use of the complicated coefficients for development that now divide municipalities into four groups. Unfortunately, since the introduction of the Solidarity Fund, and the adjustment of all transfers by the development index have rendered the Serbian intergovernmental finance system in general, and its equalization mechanism in particular extremely non–transparent.

Main Developments in Municipal Finance 2015–2016 and Advocacy Efforts of the Association

Law on Local Government Finance

The Standing Conference of Towns and Municipalities worked toward amending the Law on Local Government Finance in order to return it to its original principles. Efforts began in the first half of 2014 when the Ministry of Finance created a working group and drafted a new law, with solutions that were harmful to local governments. Representatives of cities and municipalities within the association, agreed that the Draft Law is entirely unacceptable and requested from the Ministry to withdraw the document and revise it in cooperation with local representatives and the wider public. The Standing Conference stated that it is not possible to accept a reduction of eight billion dinars (65 million EUR) in local revenue and that such a reductions would jeopardize the functioning of local government. The central government stated that this measure is necessary and in line with the recommendations of the International Monetary Fund but the association argued that the local governments in the past year effectively "saved" this amount, from the surpluses in the local budgets in 2014, which occurred due to the decreased wages and salaries, imposed by the central level.

Program Budgeting

The Standing Conference of Towns and Municipalities headed Serbian municipalities towards the effective introduction of program budgeting at local level through a mix of capacity building activities. Local governments are establishing links between the strategic plans and their program budgets, mid–term plans, operational programs, expected results, indicators and resources. A key result of this effort is the establishment of an effective local budget structure which is in line with the objectives of local budget users. The challenges faced in this endeavor revealed that there is still much room for improving central – local government coordination, particularly with respect to the budget calendar deadlines set by the Ministry of Finance and the timely publication of the Fiscal Strategy of the country. Program Budgeting as an approach is still new in Serbia and it needs further work to be mainstreamed.

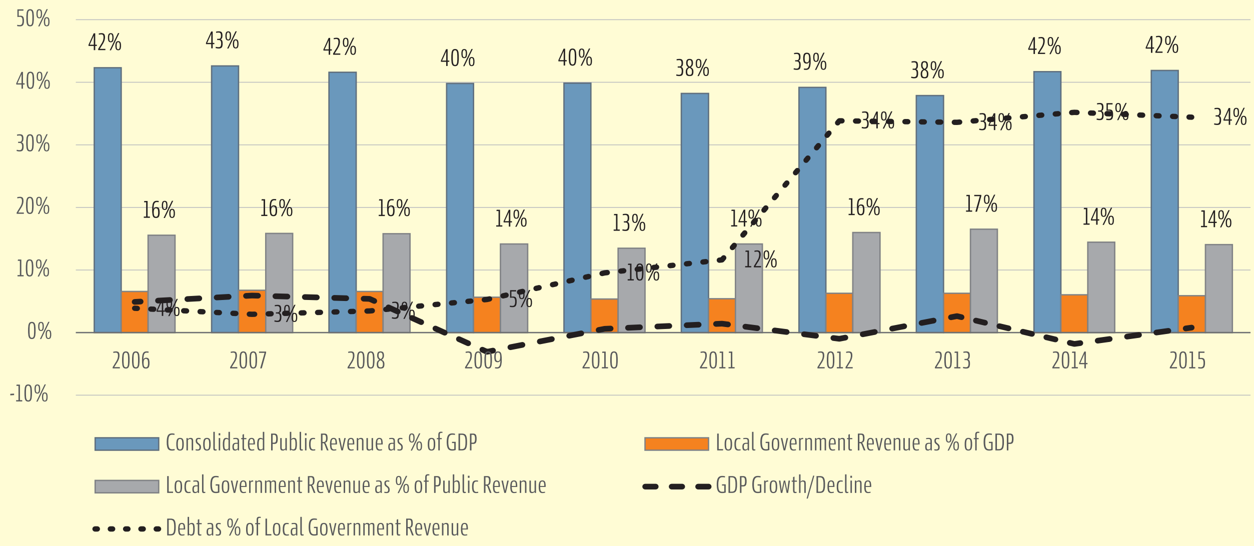
Supporting investment prospects of the City of Belgrade

In 2016, the Standing Conference of Towns and Municipalities supported the process of getting a credit rating for the City of Belgrade. Later in the year, Belgrade received a B1 issuer rating assigned by Moody's Public Sector Europe (MPSE), with a positive outlook. This is the first time that the City of Belgrade received a rating. The support by the Standing Conference of Towns and Municipalities is an attempt to contribute to positive investor trends for Serbian local governments and to signal to all interested partners, investors and financiers that investment activities and development projects in Serbia are credit worthy.

Statistical Overview of Local Government Finance in Serbia 2006–2015

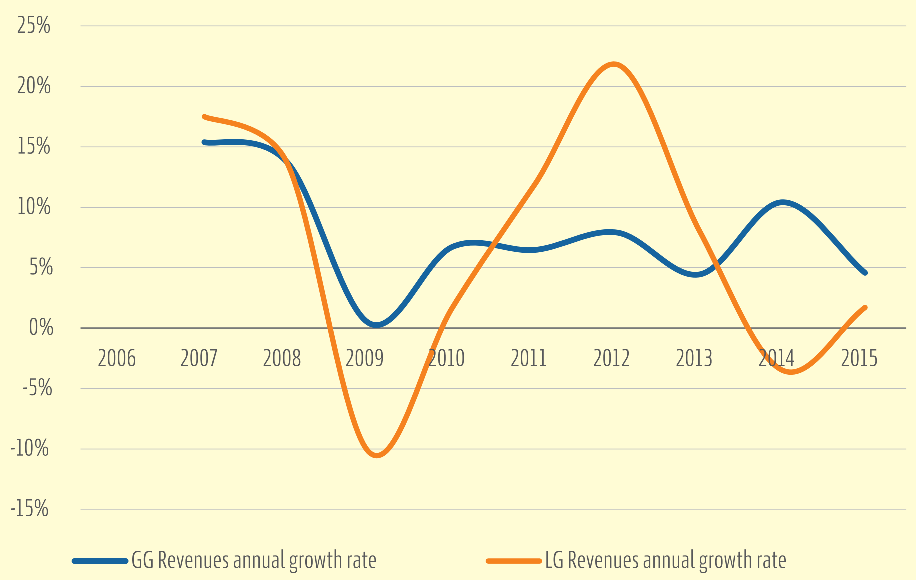
Local revenue as shares of total public revenue and GDP fell sharply between 2009 and 2011 as the national government dumped some of its fiscal problems on to municipalities. Between 2012 and 2013 they recovered somewhat only to fall again in 2014. The situation didn't change much in 2015: the share of local government revenue in the GDP stayed the same while, local government revenue as a share of public revenue stayed dropped 1%. Debts decreased by 1%.

Serbia: **Local Government Revenue as a Share of GDP and Total Public Revenue 2006–2015**



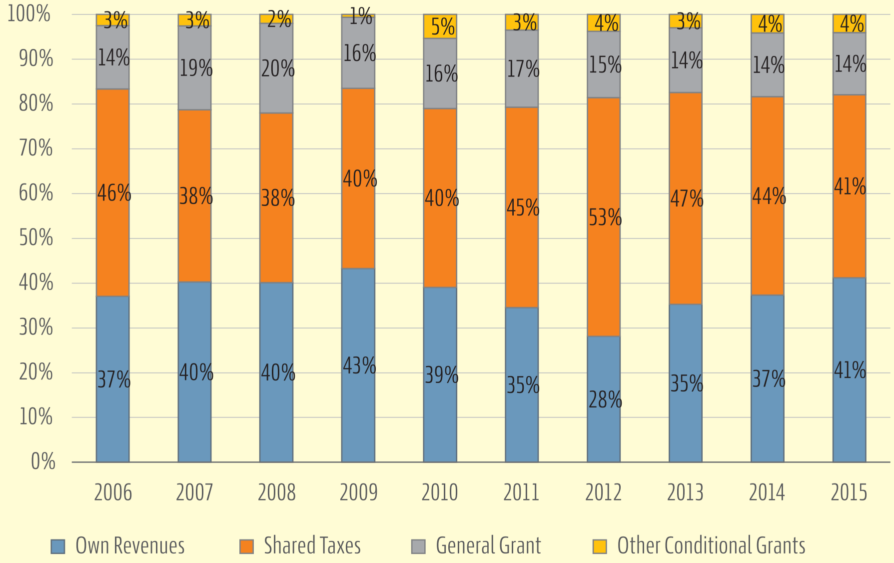
Local revenues have declined faster than those of the general government during the economic crisis. They rose faster than those of the general government immediately before and after the 2011 national elections. A dramatic decline in the local level revenues was seen between 2012 and 2014 due to austerity measures but this seems to have stabilized in 2015. In general, general government revenues have been much more stable than the local ones.

Serbia: **Fluctuations in the Revenues of the General Government and Local Governments**



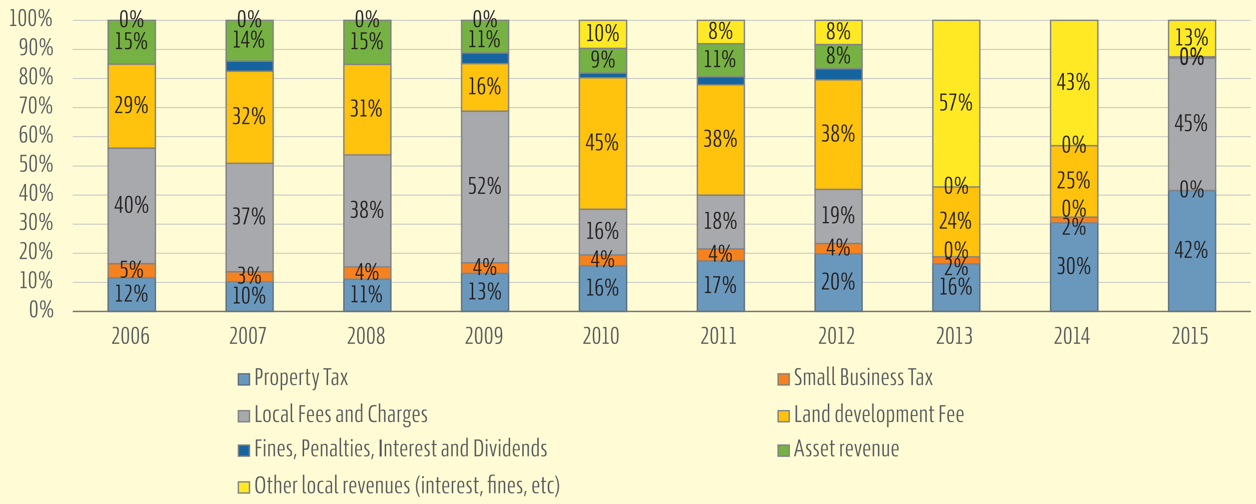
Until 2012, about 40% of local revenue came from own–sources, 40% from shared taxes, 15% from unconditional grants, and about 5% from conditional grants. In 2012, this balance was changed by a sharp increase in the local PIT share. Since 2012, reductions in the base and rate of PIT have reduced the yield of the tax for local governments and pushed the system back towards its earlier composition. In 2015 the own revenues of local governments increased as a share of total revenues, compared to 2014.

Serbia: **Composition of Local Government Revenue 2006–2015**



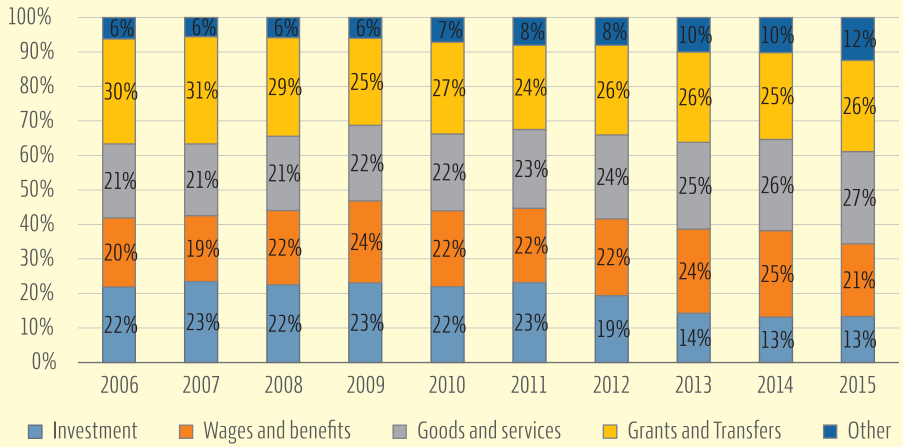
Own–revenue from Communal Fees and Charges has declined sharply since 2009 because the rate of the Property Transfer Tax was cut in half and caps were put on the Business Sign Tax and the Land Use Fee before the latter was eliminated in 2012. The financial situation of local governments will worsen if plans to eliminate the Land Development Fee go forward. Local governments have significantly improved the yield of the property tax since 2006 when it amounted 69 million EUR to 338 in 2015. The trend is especially interesting in the period 2013–2015 and it is a result of capacity building activities for property tax undertaken at the local level.

Serbia: Composition of Own Revenues 2006–2015



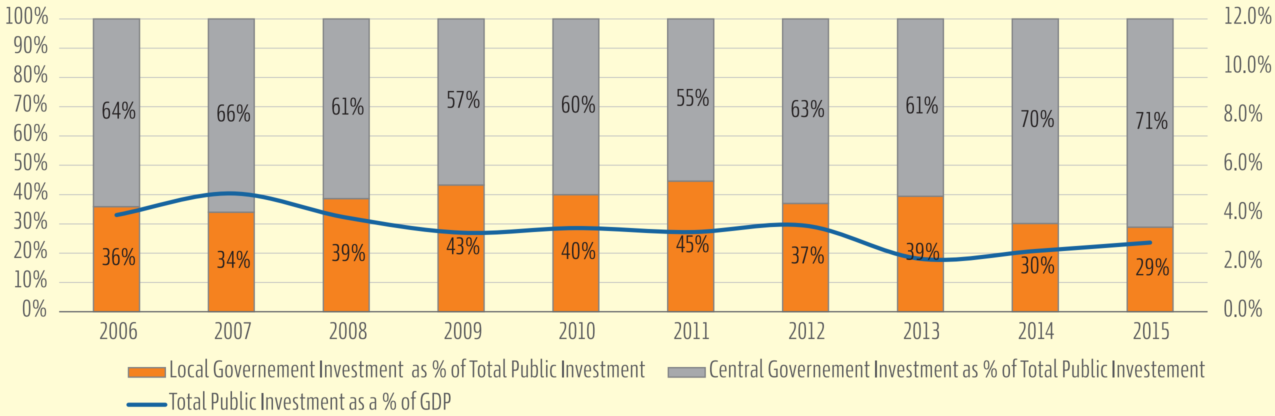
Local government investment as a share of total expenditure remained stable during the worst years of the crisis because of large infrastructure projects in Belgrade. But they have fallen sharply since 2011 and are now under 15% for three years in a row, low for the region. Serbian local governments also spend a large share of their budgets on transfers to individuals and organizations (14%) and subsidies to public utilities (12%), some of which is for capital investment. Debt service payments now account for about 5% of total expenditure.

Serbia: **Composition of Local Government Expenditure 2006–2015**

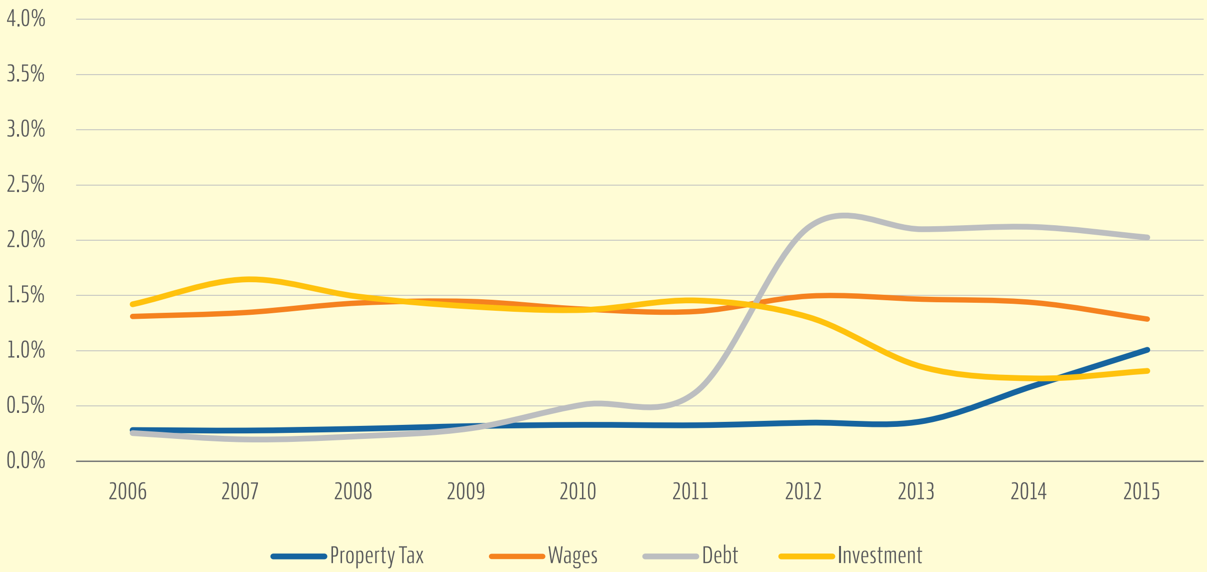


Despite the financial difficulties of local governments, local wage spending has remained more or lessconstant over the last eight years and though itdropped in 2015 due to restrictions imposed by the central level. Investment spending has fallen considerably since 2012. 2013 – 2015 saw a very sharp increase in property tax collection, due in part to a grant program that incentivized collection.

Serbia: Investment by Level of Government and as a % GDP 2006–2015



Serbia: Investment, Wages, Debt and Property Tax as Shares of GDP 2006–2015



Slovenia

The Intergovernmental Finance System

Municipal finances in Slovenia are based on the share of the origin–based allocation of the personal income tax, which historically has provided more than 50% of the revenues for the local level. There are no unconditional grants from the central government, but there is a mechanism for equalization that works by computing for every local government a "lump sum" per capita expenditure need that is supposed to represent the costs of its statutory tasks. Those local governments whose PIT share is insufficient to fund this measure of need are given additional increments of PIT. These allocations have been the major preoccupation of the Slovene stakeholders in the past three years, as the saving mode of the Slovenian public sector is perceived to have felt on the backs of the municipalities.

Namely, the Slovenian municipalities were hit by the effects of the financial crises in 2011 when municipal revenue declined 5.5% and total expenditure fell 9%. In 2012, because of the persistence of the crisis, Parliament adopted austerity measures, which also affected municipalities. On the revenue side, the national government reduced the lump sum per capita share of PIT for local governments by 3.7% and froze the national government's share of investment co–financing. On the expenditure side, the austerity measures included a reduction in public sector wages. But there was also an increase in some social transfers. As a result, municipal current expenditures for statutory tasks decreased by less than 1%.

As agreed between the associations and the government, in 2013 and 2014 the lump sum per capita needs indicator used to calculate the revenue from the shared income tax was additionally reduced, forcing municipalities to lower expenditures. Additional fiscal consolidation measures included an increase in the VAT rate, a rise in social transfers, and a further reduction in the co–financing by the national government of local investments. At the end of 2013, the associations managed to prevent potentially legal changes in the real estate taxation and with the decision of the Constitutional Court the law was never put in force and the previous Land Use Fee still remains valid.

In addition to these pressures, in 2013 the Ministry of the Interior, the competent authority for local governments, proposed a territorial reform that would have reduced the number of municipalities from 212 to 122. After protests by mayors and criticism of the proposal by municipalities, the associations, independent experts the proposal was withdrawn. Instead, the Ministry promised to develop a more strategic approach to territorial reform that would include objective analysis, wide discussion, and consultation. This strategic approach is expected to be completed by 2018.

Main Developments in Municipal Finance 2015–2016 and Advocacy Efforts of the Association

2015 and 2016 saw dynamic discussions over: the transition from the current system of compensation for the use of building land to a system of based on real estate taxation , new developments in the law on public finances, as well as digital transformation, the reorganization of existing business processes, the introduction of new, innovative management, procurement proccedures and the implementation of new monitoring technique. Not a lot of this has been adopted: only the strategy on local–self–government was adopted by the Government in September 2016 and the amended Law on Public Procurement entered into force in 2015.

In 2015, more than 120 Mayors from three associations of Municipalities in Slovenia protested at the National Parliament against the arbitrary dispossession of municipal funds by the state, their transfer into the state budget and the consequences citizens will have to bear as a result.. They argued that municipalities and their local residents have already contributed to the stabilization of the national budget by introducing more than 260 million € in saving measures. And yet, the proposed changes in the financing schemes were even more rigorous – creating a yearly gap of

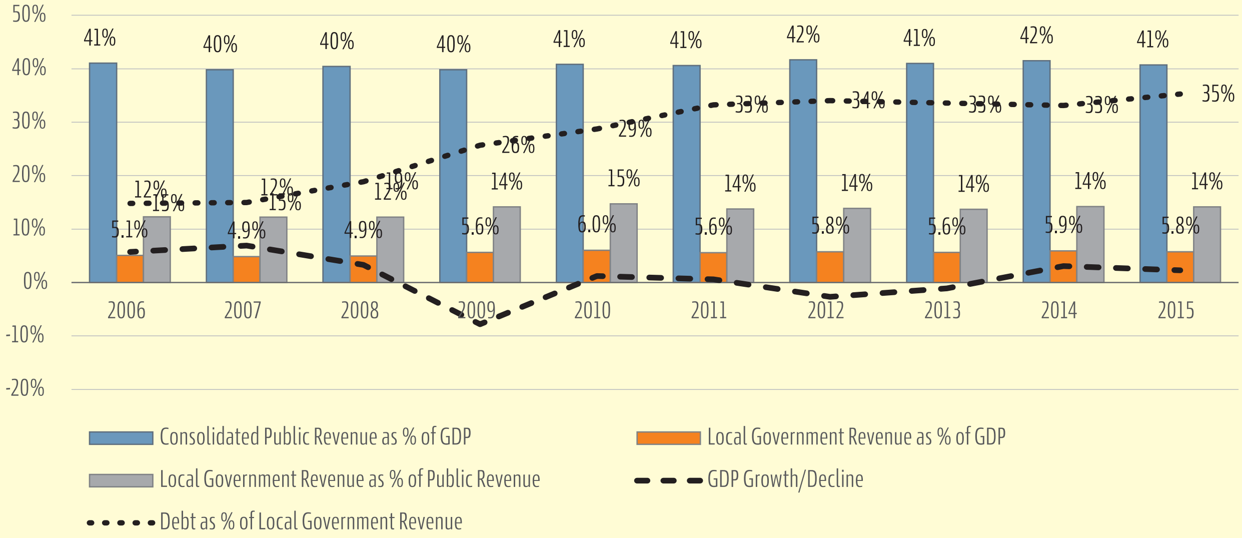
€ 132 per capita and 4% non–refundable investment funds, effectively underfunding the performance of competencies and endangering the coherent development of local communities in all regions. The Mayors also gathered in front of the Central Government headquarters in Ljubljana, to hand over their collected statements requesting the dismissal of the Minister of Finance. SOS and its member municipalities publicly emphasized that the Minister of Finance violates the existing laws with big consequences for the municipalities and their inhabitants. The advocacy efforts continued in 2016, especially related to the proposal on the Public Finance Act, as the Association considered that the ultimate effect of the draft would be to centralize public finances. Finally, after all this activities the agreement on the per capita expenditure for the year 2015 was signed in January 2015.

The Association of Municipalities of Slovenia (SOS), together with the project partners Peace Institute, Faculty of Arts and the Women's Lobby of Slovenia, carried out a set of activities related to mainstreaming gender sensitive budgeting at local level.

Statistical Overview of Local Government Finance in Slovenia 2006–2015

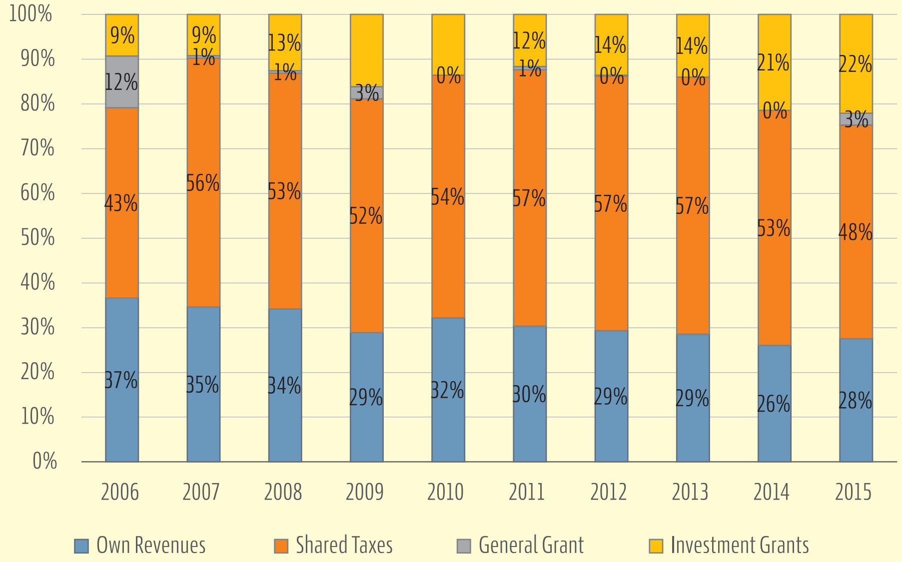
Cumulative GDP growth in Slovenia for 2006–2015 is 20%. The overall size of the local government sector in Slovenia increased from 5,1% of the GDP in 2006 to the maximum 6% of the GDP in 2009. The crisis has decreased this share since, with a tendency from the central government to shift a disproportionate burden of fiscal stress to the local level. With huge and organized resistance from the local level, local government revenues managed to stay relatively stable, accounting for 5,8% of GDP in 2015.

Slovenia: Local Government Revenue as a Share of GDP and Total Public Revenue in 2006–2015



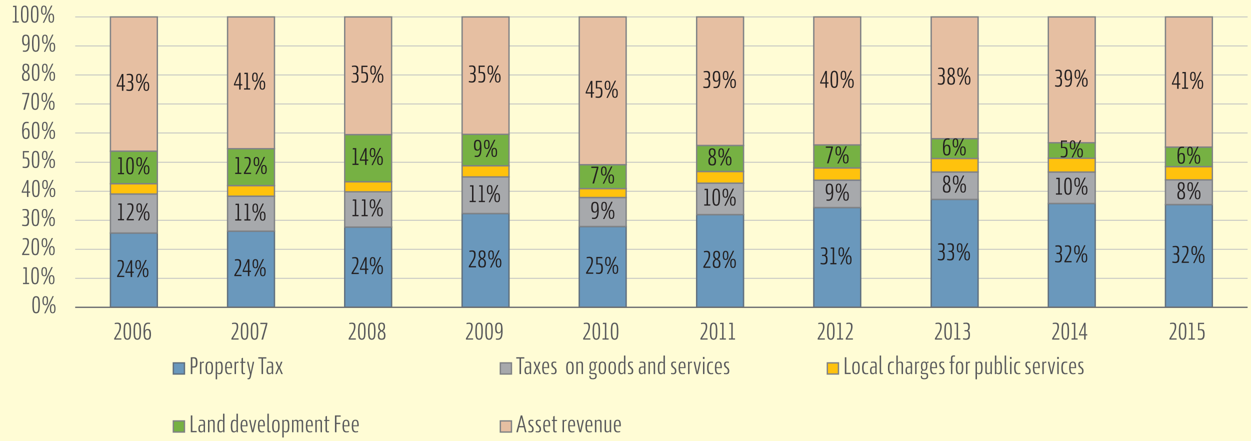
Slovenian local governments are heavily dependent on PIT sharing for most of their revenues. 2015 brought fiscal equalization in the form of general grant to the municipalities, yet the PIT shared decreased. From today's perspective, it seems like the actual formula reduced the horizontal inequities quite a lot. Recently the share of conditional grants in the system have increased due to the use of EU grants. The share of own–revenuefrom non – tax sources has also increased

Slovenia: **Composition of Local Government Revenue 2006–2015**



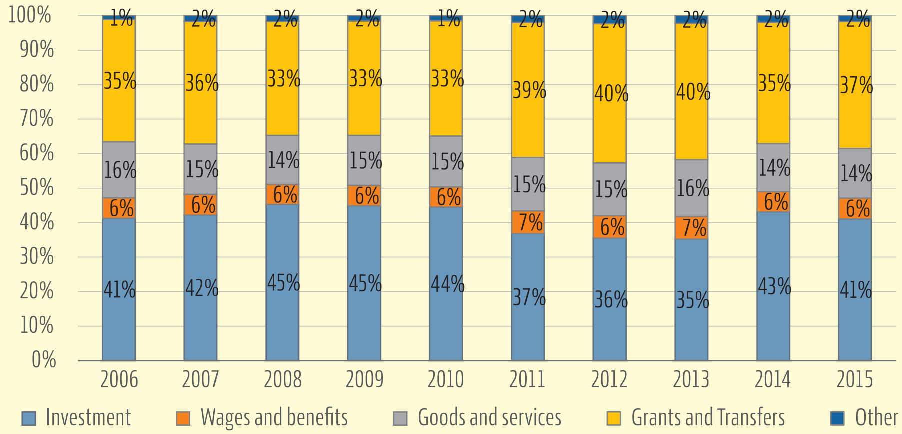
The fall in the share of local own–revenues has been accompanied by significant changes in its composition: The Land Use and Land Development Fees have been eliminated. As a result, the share of own revenues coming from the property tax has increased, though absolute yields have remained stable. Slovenian municipalities also derive a large share of their own revenues from asset sales and rentals, a share that has also increased with the central roll–back of other own–revenues.

Slovenia: Composition of Own Revenue 2006–2015

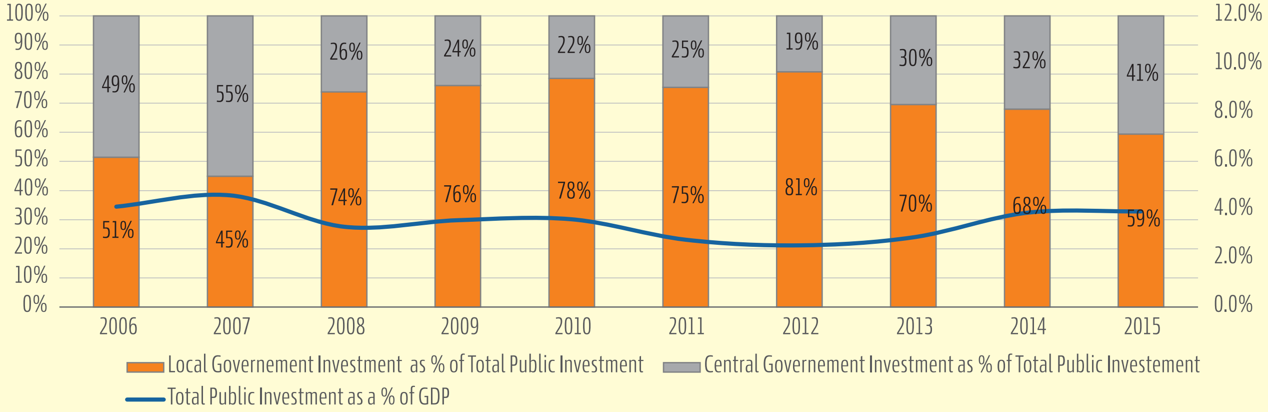


Between 2009 and 2013, the investment rate of Slovenian local governments dropped from 45% of total spending to 35% before rising to early levels in 2014 which was unfortunately not maintained in 2015 and saw a drop of 2%.

Slovenia: **Composition of Expenditure in 2006–2015**

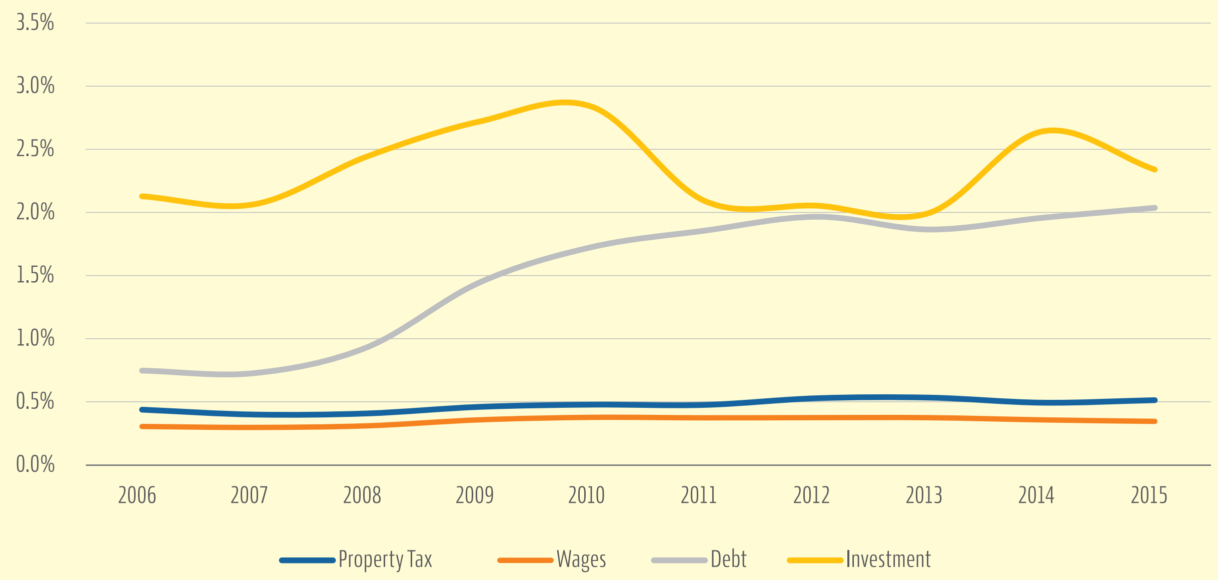


Slovenia: **Investment by Level of Government and as a % GDP 2006–2015**



Slovenia's has combined robust local investment with low wage spending. Revenue from the Land Use Fee and the Property Tax is better than most countries relying solely on the property tax but still modest. Property tax and wages have been stable, the crisis reflected with fluctuations in investment (that again saw negative drop in 2015) and increase of debt. Municipalities have been frequently pointed out as debt generators in Slovenia, and the total local debt has indeed increased from 0,75 to 2% of GDP in the years from 2008 to 2015, yet it should be noted that at the local and central government debt have increased with the same dynamics, tripling in the period 2006–2015.

Slovenia: Investment, Wages, Debt, Property Tax as Share of GDP 2006–2015



Turkey

The Intergovernmental Finance System

The revenue entitlements of provincial administrations and municipalities from the national budget are defined by Law number 5779, passed in 2008. According to this law, different types of local governments are entitled to different percentages of national taxes. Thus, 6% of national taxes are earmarked for metropolitan municipalities, 4.5% for district municipalities, 1.5% for other municipalities and 0.5% for special provincial administrations. Depending on the type of local government between 60 and 70% of these shares are returned to them on an origin basis.

The remaining 30–40% are gathered into grant pools specific to each type of local government and redistributed according to two criteria, population and a development index. Eighty percent of these pools are then allocated to local authorities on a per capita basis and 20% according to the development index. This index divides local governments into five groups, with the least developed group getting 23% of the pool and the most developed group gets 17% of the pool. Unfortunately, all of these revenues are classified as shared taxes, instead of being divided into shared taxes and unconditional grants. Together they account for between 40% and 45% of local government revenues, with revenues from own sources accounting for a similar share and conditional grants making up the difference of about 15%.

Conditional grants are generally used to help poorer jurisdictions. For example, the Koy–des Program provides additional support for villages and the Bel–des Program provides support for small districts. These Programs help villages and districts complete investment projects that they cannot complete themselves. They typically focus on water–supply, sanitation and roads to urban centers.

Turkey's macroeconomic journey over the past decade can be divided into three phases. The first came after the currency and banking crisis of February 2001 and lasted until the global crisis of 2007–08. Most macroeconomic indicators improved during this period. The public debt–to–GDP ratio was halved from a post–crisis peak of 75%, while inflation dropped from around 70% to single digits. Major reforms of the banking sector affected all sectors and credit flowed back into the economy. GDP per capita rose from about $4,000 to almost $11,000 (in current U.S. dollars) in 2013.

The second phase began with the global financial crisis of 2008, during which Turkey's economy contracted by 5%. But recovery came remarkably quickly. Significant policy easing and an exceptionally low interest rate environment at home and abroad allowed for growth to average 9% over the next two years.

Now the country has entered a third phase. Growth has visibly slowed and the economy seems driven by the ups and down of the Eurozone crisis and the decisions about quantitative easing taken by the United States Federal Reserve. Public spending has quickened while private investment remains lethargic, suggesting that the private sector–led growth that Turkey's government once liked to boast about is losing momentum. Also, in 2016, due to the weakened growth and institutional strength, Turkey's credit rating saw a downgrade, reflecting on the credit rating of its metropolitan cities.

With the 2014 election, Turkey has two distinct types of local government structures: First, the old system continues in provinces in which there are no cities whose populations are larger than 750,000 inhabitants. In these provinces, there are three basic types of local governments: small cities, special provincial administrations, and villages. Second, in the 30 provinces where there are cities with populations larger than 750,000, these big cities became metropolitan cities while special provincial administrations and villages were eliminated. As a result, the number of metropolitan cities increased from 16 to 30, and in 30 provinces where they exist there are only two forms of local government, metropolitan cities, and the district cities underneath them.

Main Developments in Municipal Finance 2015–2016 and Advocacy Efforts of the Association

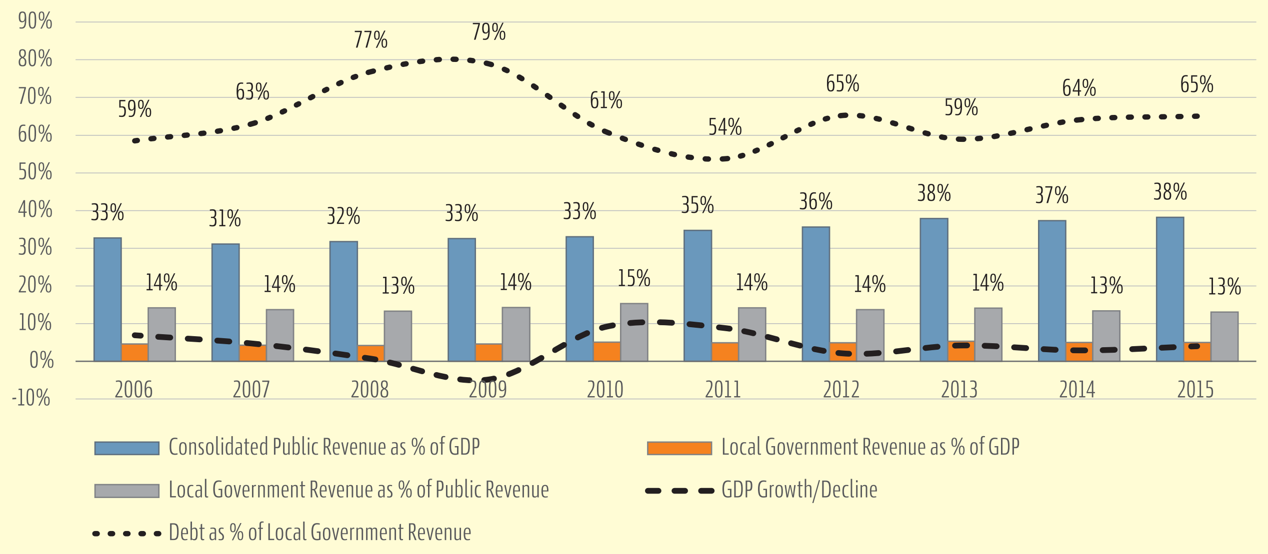
2015 brought a dramatic increase of the influx of people to Turkey, refugees from the Middle East and there were urgent needs for their support. This situation put pressures not only on service delivery at local level but on municipal budgets as well.

Marmara Municipalities Union (MMU) organized the Local Authorities Finance Summit in May 2016 in Istanbul, discussing the development challenges at metropolitan and local level and use of adequate forms of local government financing, alternative financing instruments for capital investments, access to capital markets, etc. The preferred direction for going forward in financing local growth are sophisticated financial solutions, such as municipal bonds and public–private partnerships. The Summit was the first event ever addressing financial issues at the local level in Turkey and therefore raised the interest of local authorities, banks, central authorities and other stakeholders in the financial world. Prestigious speakers representing various stakeholders in the financial world, including the European Bank for Reconstruction and Development (EBRD), the European Investment Bank (EIB), Moody's, Fitch Ratings, ECO Bank, the Turkish Ministry of Development, and the Turkish Ministry of Environment and Urbanization contributed to the discussions.

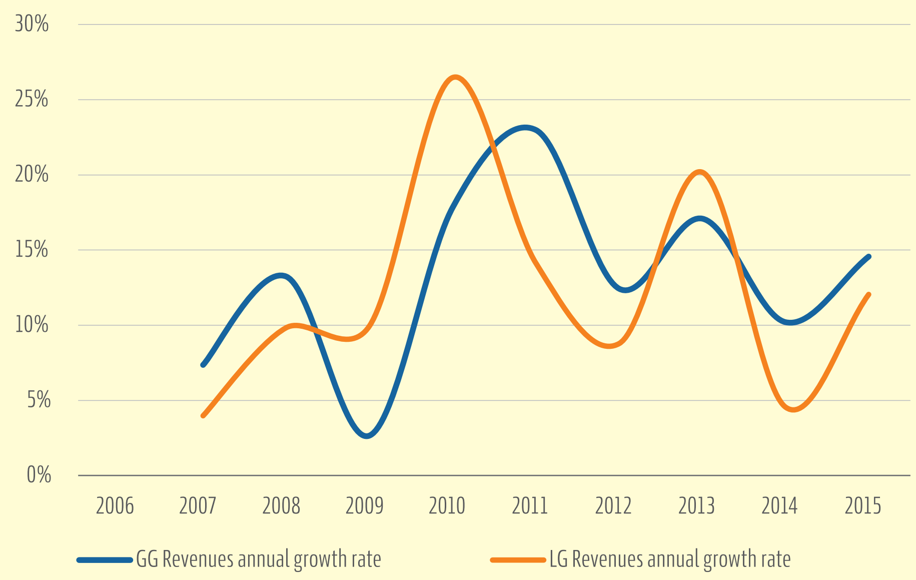
Statistical Overview of Local Government Finances in Turkey

Since 2005, local government revenue as a share of GDP has increased by about 1%, while it has remained more or less stable as a share of total public revenues. This growth was not affected by the economic downturn of 2009. Local government debt, including unpaid liabilities to suppliers, has also been stable at about 3% of GDP.

Turkey: Local Government Revenue as a Share of GDP and Total Public Revenue in 2006–2015

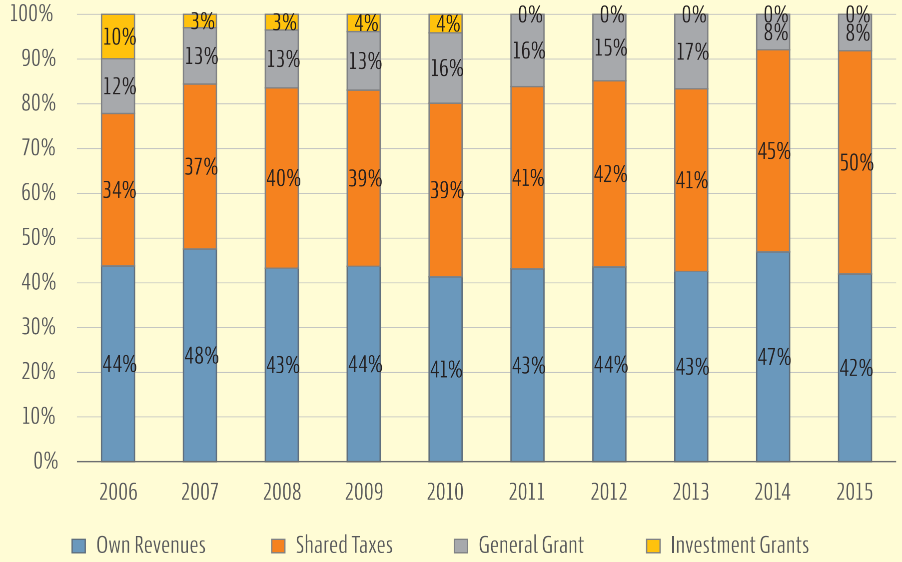


Turkey: Fluctuations in the Revenues of the General Government and Local Governments 2006–2015



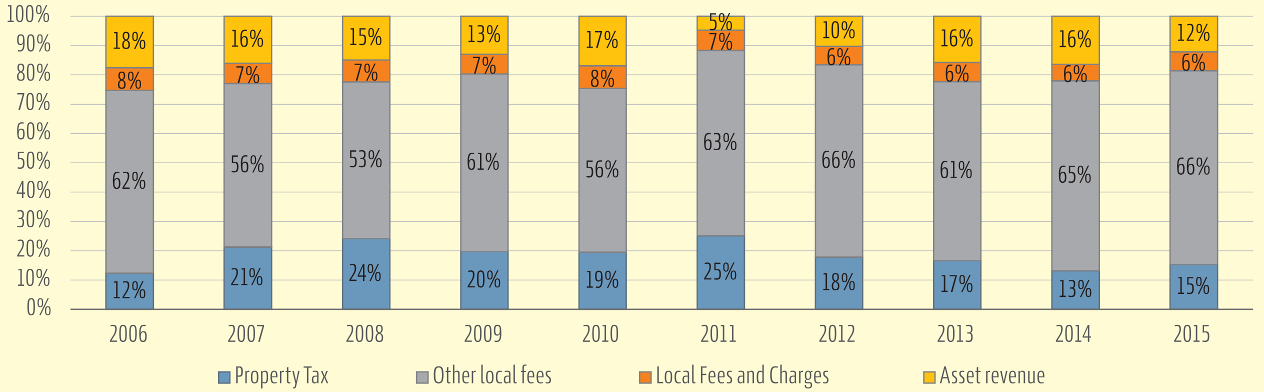
The composition of local revenues has changed little between 2006 and 2015 except for a very recent fall in the amount of conditional grants they receive for investment purposes. The own revenues have seen a drop of 5% in 2015 compared to 2014, due to the increase of shared taxes which now make half of all municipal revenues.

Turkey: Composition of Local Government Revenue 2006–2015



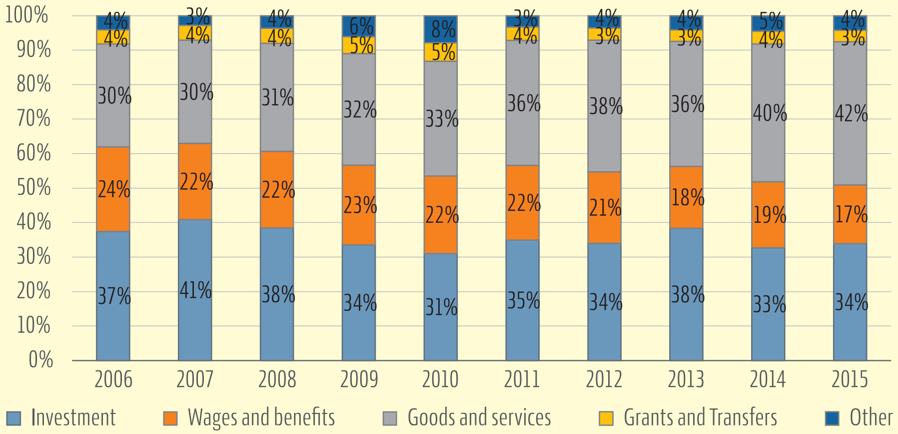
Local governmnet revenues have, however, grown sharply in EUR terms since 2010. Since 2006, local governments have increased own–revenue collection by 60% and the shared revenues increased two and a half times.

Turkey: Composition of Own Source Revenues 2006–2015



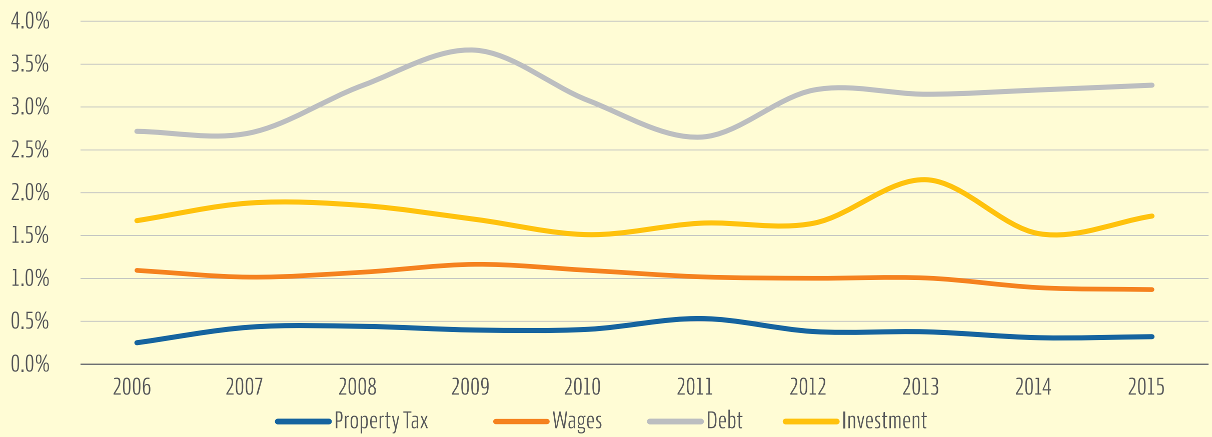
Local investment as a share of total expenditure declined slightly in 2010 but rose again in 2013 when it reached the level of the 2008 taking 38% of the total expenditures. Yet, in the last two years we again see a drop, taking investment to 33–34% which practically equals a level during the crisis years of 2009–2011. Wages as a share of total expenditures see constant declining while expenditures on good and services are continually increasing since 2006 and are in 2015 are on a record level of 42% of total expenditures. This suggests that many local governments are outsourcing the provision public goods to commercialized providers.

Turkey: **Composition of Expenditure in 2006–2015**



Neither wages nor the yield of the property tax have increased as a percentage of GDP. Local public investment has recently risen to about 2% of GDP, while outstanding debt has again risen to over 3% of GDP. But this is due more to unpaid liabilities to suppliers and contractors than it is to bank debt.

Turkey: **Investment, Wages, Outstanding Debt and Property Tax as Shares of GDP 2006–2015**



PARTNER ORGANISATIONS

Organizations, institutions and companies that have given significant support to NALAS and its Member Associations are recognized as NALAS Partners. Their support may include, but is not limited to lobbying for NALAS and its members, expertise support and financial support. In addition, NALAS proved to be a valued asset for many of these partners, by providing regional experience, guidelines or coordination of activities conducted in the member countries

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