# Fiscal Decentralization Indicators for South-East Europe: 2006-2013

REPORT

NALAS

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

NALAS

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**This report is a collaborative effort of the NALAS Task Force on Fiscal Decentralization (TF FD)**

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# THE REPORT IN BRIEF:

- **Decentralizing public services to democratically elected local governments has been a common theme across South-East Europe for the last 20 years. Nonetheless, there are few places in the region where local government revenues or expenditures approach the EU average as either a percentage of GDP or of total public revenues**.

- **The global economic crisis of 2009 hit many countries in region very hard, often producing ad hoc adjustments in intergovernmental financial arrangements that compounded the negative effects of the downturn for municipalities.** In other countries, however, the global crisis had little effect and/or its impact was delayed. With a few exceptions, economic growth since 2009 has been slow, though in most countries, local government finances improved in 2010 and 2011. A few countries went into recession again in 2012 and 2013, eroding whatever modest gains municipalities achieved in the interim.

- **In many countries, intergovernmental finance reform has been on the political agenda for a number of years. In most however, comprehensive reforms remain on the horizon.** This suggests that the policies designed to transfer power and money to local governments that began in the late 1990s have lost momentum. While it is always difficult to make judgments about the adequacy of local government revenues relative to their expenditure responsibilities, there seems little question that in many countries of the region municipalities remain underfunded.

- Local governments in South-East Europe derive the majority of their revenues from general grants, conditional grants, and shared taxes. **In most countries, own-source revenues account for between 30% and 40% of total revenues, a level similar to that of most OECD member states.**

- **In a few countries, local governments derive a very high share of their revenues from conditional grants, limiting their financial independence. In many countries, unconditional grants are underutilized. This raises questions about the overall equity of their intergovernmental finance systems because it is through unconditional grants that equalization funding is usually provided to poorer jurisdictions**.

- **In much of South East Europe, local governments derive significant amounts of own-revenue from quasi-fiscal instruments imposed on real-estate transactions, new investment, and business operations.** In a number of countries, national governments 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 that local governments currently face and ways should be found to replace the lost revenue.

- **In most countries of South East Europe, the Property Tax has been decentralized to local governments, and in most they have increased the yield of the tax. But with the exception of Montenegro, it still produces revenues equal to less 1% of GDP, the average for the EU.** It is unrealistic to expect the Property Tax to yield anything like the revenue it does in North America (2-3% of GDP) and achieving EU norms will not radically improve the fiscal autonomy of the region's local governments. **Own-source revenues are disproportionally concentrated in capital cities and very strongly linked to the real-estate market –through land development fees, construction permits, and the Property Transfer Tax.**

- **Efforts to increase the fiscal autonomy of local governments 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 above the rate set by the national government, as is already practiced in Montenegro and Croatia, or by dividing the PIT "space" between the national government and local governments, as is currently being considered in Bulgaria.

- In most of South-East Europe, local governments have not been assigned significant social sector functions. **But in Romania, Bulgaria, Moldova, Macedonia, and Kosovo[1], local governments are fully responsible for financing pre-tertiary education, including paying teachers' wages. In most of them, there is evidence that local governments and/or schools are underfunded.** In most countries, the "block" grants that local governments receive for pre-tertiary education remain highly earmarked and do not function as block grants which give local governments real discretion over how money is spent in the sector.

- **In most of the region, local governments are spending higher proportions of their income on investment than their counterparts in the EU, despite receiving significantly lower shares of total public revenue.** Indeed, local government investment spending has been higher as a percentage of GDP over the last six years than in the EU itself. This means that municipalities in South-East Europe are working hard to make-up for the massive infrastructure deficits they inherited from the past. **But while investment rates are generally high, it is likely that in many countries these rates are being driven-up by a few wealthier jurisdictions. Investment rates have also fallen over the last few years.**

- **In a few countries, investment spending is well below the average for the EU, and still further below the average for the eight formerly communist countries that joined the EU in 2004.** This is troubling given the neglected and underdeveloped state of network (environmental) infrastructure in the region.

[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."

- Scarce investment funds tend to be spent on pay-as-you-build road projects and not on debt-financed, pay-as-you-use environmental facilities like waste water treatment plants because planning roads is simpler; construction can be delayed if money runs out; and because visible benefits can be delivered within a single election cycle. **Local governments need to radically improve their ability to prepare, plan, and cost-out complex multiyear investments - particularly in water, sewage and solid waste.**

- **EU funds are playing an important role in the modernization of local public infrastructure in new member states.** In some countries, however, national policy makers seem to be using them as substitutes for transfers funded through domestic sources.

- In most countries in the region, municipal borrowing remains a marginal phenomenon, though in a few some local governments are now having problems meeting liabilities incurred during the crisis. In a number of countries, the consolidated debt of the General Government has grown rapidly over the last few years and now exceeds the limits set by the Maastricht Treaty. Over the coming years, Ministries of Finance in these countries are likely to restrict the access of local governments to credit in order to preserve debt space for their national governments. This will undermine the ability of credit worthy local governments to use debt capital to finance major investments.

- **In many countries, the adequacy and predictability of local government revenues will have to be increased if municipalities are to have the resources against which to prudently incur debt.** Albanian, Serbian, Croatian and Montenegrin local governments my find it harder to access credit in the immediate future not because of their lack of fundamental credit worthiness, but because of the reluctance of their national governments to exceed the Maastricht limits.

- **New censuses are producing technical and political problems because there are differences between the population numbers currently used to allocate intergovernmental grants and the ones revealed by the new censuses.**

# 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 fourth edition of an ongoing effort to provide national and local 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 2006-2013. As before, we present a comparative picture of what has been happening in the region as a whole, but with increasing focus on monitoring the intergovernmental finances of individual countries.

The reliability of the data used in the report continues to improve and we have tried to update basic indicators in accordance with changes in population and the number of local governments in a given place. But the report, like its object of analysis, remains a work in progress which NALAS hopes to expand, improve and deepen over time. In particular, we still do not have good data on the distribution of revenues and expenditures across local governments of different sizes and types. This is problematic because in many countries revenues and expenditures are heavily skewed toward wealthier jurisdictions, particularly capital cities. In this edition, however, we take a first step towards filling this gap by presenting narrative descriptions of each entity's equalization system.

The report provides a reasonably clear picture of the structure, functions, and financing of local governments in South-East Europe today, as well as an overview of how intergovernmental financial relations have evolved over the economically turbulent period 2006-2013. The report has been used by member associations to argue for policy changes at home. It has also provided input for the design of the monitoring system of the regional strategy South East Europe 2020[2].

The report is divided into three sections. The first, discusses the data used in the report and some basic methodological issues. The second begins with a review of the structure and functions of municipal governments in South-East Europe, as well as a few important macro-economic indicators. It then presents comparative indicators of fiscal decentralization for the region as whole. The third section focuses on the changes in intergovernmental fiscal relations that have occurred within individual NALAS' member countries/entities. Each review begins with a description of every entity's intergovernmental finance system with a particular emphasis on fiscal equalization. We then present data on how these systems evolved between 2006-2013.

[2] http://rcc.int/pages/62/south-east-europe-2020-strategy

# I Data, Terms, and Methodological Issues

The data used in this report has been provided by NALAS's members. It 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 is never straight forward because what sub-sovereign governments do, and how they pay for it, varies substantially from one country to another.

**What sub-sovereign governments do, and how they pay for it, varies substantially from country to country.**

**Levels of Government:** The report concentrates on the democratically-elected municipal or communal governments, as a first tier governments. Throughout the report we refer to them local or municipal governments. Municipal governments constitute the most important level of democratically elected sub-sovereign governance in the region when measured in fiscal terms. Democratically-elected regional governments however are important in the Federation of Bosnia Hercegovina, Moldova, Turkey and Romania.

**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 most of the region, network infrastructure has been neglected or underfunded for decades and modern, environmentally sustainable facilities are only now being built.

**Local governments must pay for the costs of building new (network) infrastructure, infrastructure that almost everywhere has been neglected or underfunded for decades. Indeed, in many places it has never existed.**

The most important differences in what municipal governments do concerns the degree to which they are responsible for social sector services, particularly education. In Bulgaria, Kosovo, Macedonia, Moldova, and Romania local governments are responsible for financing and managing primary and secondary education, including the payment of teachers' wages. In Serbia, they are fully responsible for all the costs associated with preschools, while in the most other countries local governments are responsible for maintaining and improving school facilities.

**Population:** The population numbers used in this report are based on the last official census or where lacking an official census, the numbers used by the relevant statistical agencies in each entity or country. In Albania, Bosnia and Herzegovina, Kosovo and Macedonia censuses have recently been conducted (or abandoned), but their results --mainly for political reasons-- remain unofficial. In these countries, the population numbers currently used to allocate intergovernmental grants and transfers are significantly higher than the ones yielded by the recent censuses.

**Recently conducted censuses are producing technical and political problems because the population figures currently used to allocate intergovernmental grants are higher than those generated by the new censuses.**

**GDP:** The GDP numbers used in this report have been calculated by their respective Ministries of Finance according to the production method. Where they have been converted into EUR for comparative purposes we have used the average annual exchange rates provided by the relevant Central Banks. In the four countries that are EU members - Bulgaria, Croatia, Slovenia, and Romania - we have used data from Eurostat for many of the comparative tables, data that is not always fully consistent with the data provided by the associations.

**Consolidated Public Revenue of the General Government**: To compare the relative importance of local governments across settings we have 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, these grants are defined by law as percentages of national taxes. Yet, as long as the funds are allocated by formula we consider them to be grants and not shared taxes. 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 that cannot be spent as freely as the general ones. They may be conditional grants which are tightly limited in the spending to a specific action (e.g. maintenance of school buildings), or block grants which can be freely managed and spent by the municipalities but only within one specific competence or function (e.g. primary education). In practice, however, we find the “block” function of block grants is often limited, due to other constraints imposed on spending (e.g. collective agreements between teachers’ unions and higher level governments which mayors must follow). This often limits local governments’ ability to spend these funds even within the functions they are intended for.

**The “block” function of block grants often remains very limited.**

**Shared Taxes**: In most of the region, local governments are entitled to shares of national taxes generated in their jurisdictions. The most important shared tax is usually the Personal Income Tax (PIT). The Property Transfer Tax is also often shared with local governments but is usually misclassified as an own-revenue. In a few places, the recurrent Property Tax is also a shared tax.

> **The most important tax shared with local governments on an origin-basis is the Personal Income Tax (PIT).**

**Own-Source Revenues**: As in many parts of the world, data on local own-revenues in the region is often poorly maintained and classified. Own-revenues include: locally imposed taxes; the sale or rental of municipal assets; fines, penalties, and interest; local user fees and charges; fees for permits, licenses and the issuance of civil registration documents. In some places, local user fees and taxes --though collected locally-- are defined by higher level governments and sometimes shared with them. As such, they should really be considered shared revenues.

In others, the regulation of local fees and charges is weak, allowing local governments to use them as quasi-taxes. Particularly, important in this respect are two fees inherited from the past: the Land Development Fee[3] and the Business Registration Fee (or Sign Tax). In most of the region however, these fees are being reformed or phased-out. The most important local tax is typically the Property Tax, though it is often not the single-largest source of local own-revenue. Local governments in Montenegro and Croatia can also impose local surcharges on the PIT.

[3] This fee goes under different names in different inheritor states of the former Yugoslavia.

# II General Overview of Local Governments in South-East Europe

## Number and type of sub-sovereign levels of governance

Table 1 presents the number and type of sub-sovereign governments where NALAS members operate. Bosnia and Herzegovina (BiH) has four levels of government. The state of BiH; two entities, Republika Srpska (RS of BIH) and the Federation of Bosnia-Herzegovina (FBiH of BiH) as well as the District of Brcko; cantons in FBiH (BiH); and 4) municipalities in both entities. In FBiH (BiH), the cantons provide most public services and the entity government is relatively small. In this report, however, we do not consider cantons as local governments and their finances are not included with those of municipalities.

**Table 1:** Levels, Type and Numbers of Sub-Sovereign Governments

| | NALAS Member | Levels of Sub-Sovereign Government | Types of Sub-Sovereign Government | # of 1st Tier |
|---|---|---|---|---|
| **Albania** | AAM/AAC | 2 | Counties; Municipalities/Communes | 373 |
| **Bosnia Herzegovina** | | 3 | Entities; Cantons; Municipalities | 143 |
| **FBiH** | SOGFBIH | 2 | Cantons; Municipalities (Neighborhood Units) | 80 |
| **RS** | ALVRS | 1 | Municipalities (Neighborhood Units) | 63 |
| **Bulgaria** | NAMRB | 1 | Municipalities/Communes(Neighborhood Units) | 264 |
| **Croatia** | UORH | 2 | Counties; Municipalities/Communes | 556 |
| **Kosovo** | AKM | 1 | Municipalities (Neighborhood Units) | 38 |
| **Macedonia** | ZELS | 1 | Municipalities (Neighborhood Units) | 81 |
| **Moldova** | CALM | 2 | Autonomous province Raions/Regions; Municipalities/Communes | 898 |
| **Montenegro** | UMMo | 1 | Municipalities | 21 |
| **Romania** | FALR, ACoR | 2 | Counties; Municipalities/ Communes | 3181 |
| **Serbia** | STCM | 2 | Autonomous Provinces; Municipalities (Neighborhood Units) | 145 |
| **Slovenia** | SOG | 1 | Municipalities | 212 |
| **Turkey** | UMMa | 4 | Special Provincial Administrations; Metropolitan municipalities; District municipalities; Communes | 1395 |

Albania and Croatia both have county levels of government. In Albania, the *qarks* play a very limited role while in Croatia *zupanije* are somewhat more important. Moldova has two levels of sub-sovereign government, raions/regions and communes/municipalities (as well as the autonomous province of Gaugazia). Raion heads are indirectly elected by raion councils and 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.

Romania has two levels of sub-sovereign government, communes and cities on the hand and *judets* on the other. *Judets* play a more important than their counterparts in Albania or Croatia and have been made responsible for maintaining general hospitals. Nonetheless, the 1st tier is more important fiscally.

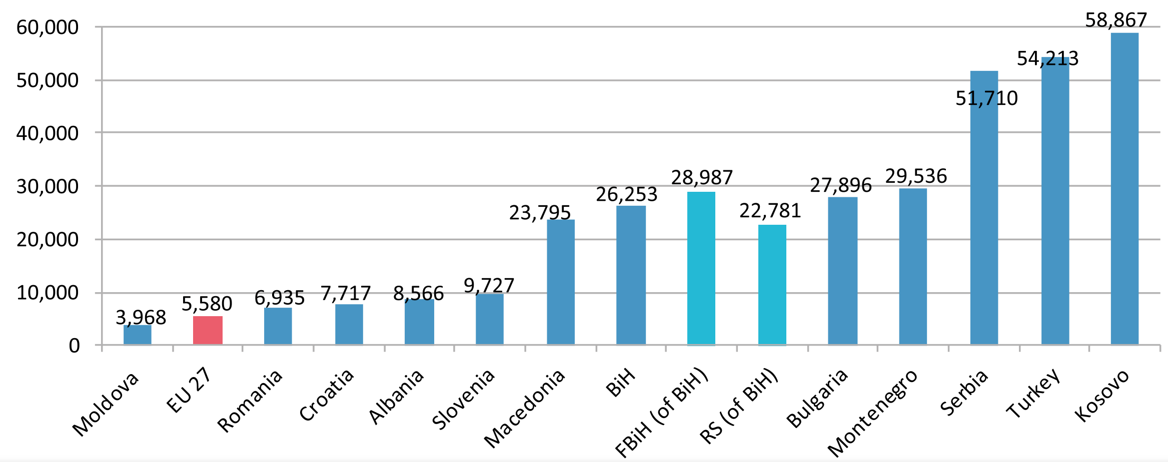
**In this report, the financial data for Albania, Croatia, Romania, and Moldova includes both 1st and 2nd-tier of local governments.**

Serbia has two levels of sub-sovereign governance, the autonomous province of Vojivodina and municipalities. The data in the report however is only for municipalities. Turkey has four levels of sub-sovereign government. Three of them – communes, district municipalities, and metropolitan municipalities - can be considered 1st tier local governments. But they have different rights and responsibilities. Turkey also has 51 democratically-elected Special Provincial Administrations (SPAs). They function alongside the territorial arms of the national government in most of Turkey's regions and deliver some public services, particularly in rural areas. The data in the report for includes the revenue and expenditures of SPAs.

There is considerable variation in the average size of 1st tier local governments across South-East Europe. As can be seen from Chart I, Moldova has the smallest 1st tier local governments. They average less than 4,000 inhabitants. Municipalities in Romania, Croatia, Albania and Slovenia are also relatively small, averaging less than 10,000 inhabitants. The small size of first tier local governments in these places presents obstacles to decentralization because small jurisdictions often have weak tax bases and lack the human capital necessary to reasonably support major public services.

Average Population of 1st Tier Local Governments

Chart 1



But on the whole, the average size of local governments in the region is larger than the average for the EU as a whole. BiH, Bulgaria, Macedonia, Montenegro, Kosovo, Serbia and Turkey all have municipalities with average populations of greater than 20,000.

One reason for the relatively large size of municipalities in South-East Europe is the high percentage of people living in capital cities. As can be seen from Chart 2 most NALAS members have significantly higher shares of their populations living in their capitals than is the average for the EU.

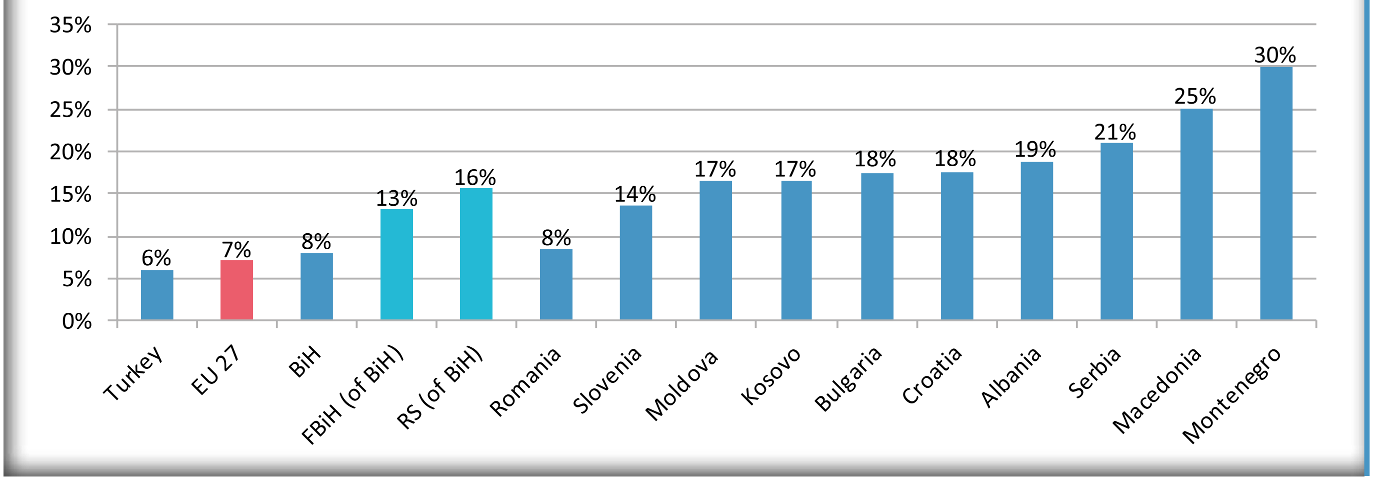
## Population Distribution and Density

One consequence of the oversized importance of capital cities in the region is that tax yields tend to be skewed towards one metropolitan area. This creates technical and political obstacles to decentralization. Technically, it is difficult to assign local governments robust own-revenues or to create efficient equalization mechanisms when a disproportionate share of the economy is concentrated in a single city. Politically, it can make equalization difficult by setting the interests of all other jurisdictions against the capital.

**The relatively large size of capital cities in the region means that tax yields tend to be skewed towards one metropolitan area. This can create technical and political impediments to decentralization.**

Percentage of Population Living in Capital City

Chart 2



## The Dynamics of the Gross Domestic Product

Chart 3 presents the GDP per capita for all members of the group in 2006 and 2013. Not surprisingly, there are very significant variations in relative wealth across the group. Slovenia is by far the richest, with GDP per capita of 17,186 EUR, followed by Croatia (10,435), Turkey (8,161) and Romania (7,200). Moldova is the poorest with a per capita GDP under 2000 EUR followed by Kosovo whose GDP per capita is now 2170 EUR. GDP growth in Croatia (12%) and Slovenia (14%) was slowest over the period, though slightly higher than the average for the EU (9%). Moldova's GDP more than doubled while all the rest grew by between 30% and 60%.

Table 2 presents annual changes in the GDP for all countries in the group between 2006 and 2013. There is considerable variation in economic performance across the group for the period. Prior to the Great Recession of 2009, most were growing robustly and --with the exception of Kosovo and Albania—all were hit hard by the crisis. Since 2009, growth has been uneven and generally sluggish. Indeed, most of the region fell back into recession in 2012, though the Serbian, Moldovan, Montenegrin and Turkish economies showed some life in 2013. Slovenia and Croatia, and to a lesser extent Albania and Bulgaria are still in the doldrums.

GDP Per Capita 2006 vs. 2013

Chart 3

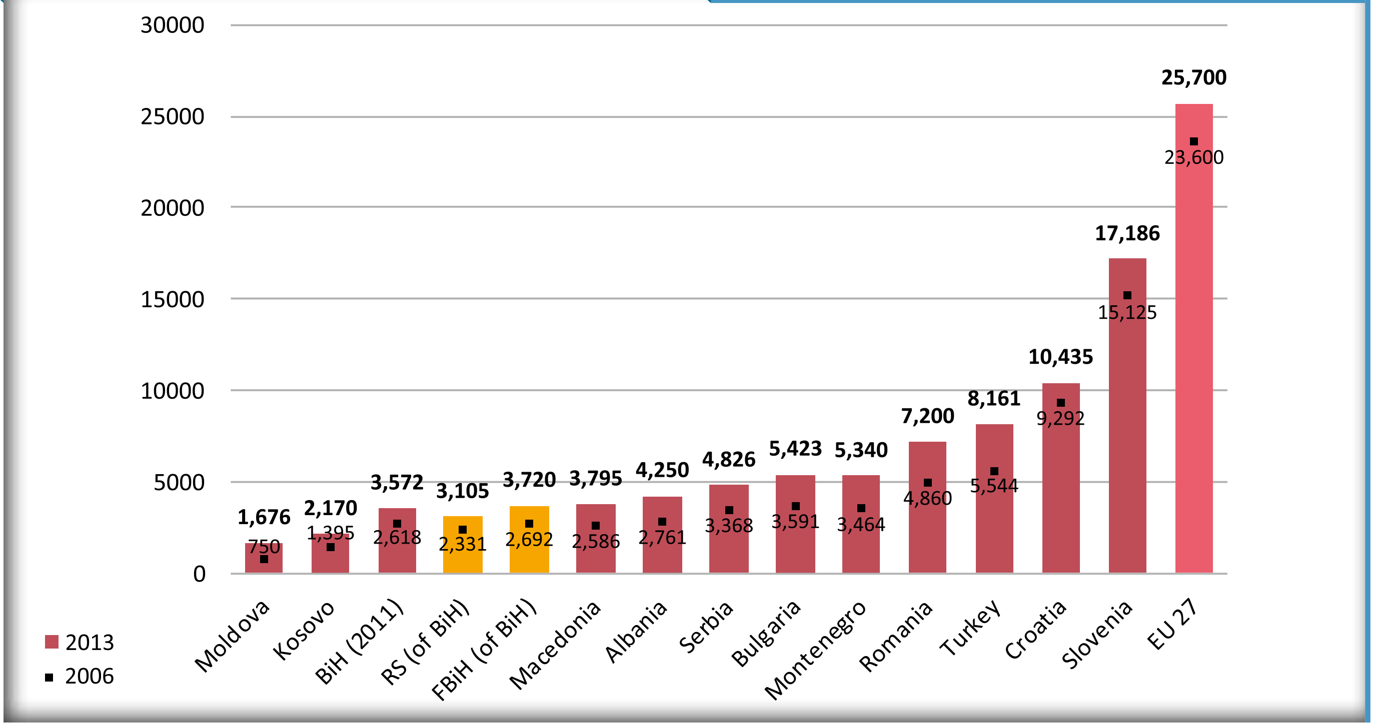


**Table 2** Annual GDP Growth and Decline 2006-2012

| | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 |
|---|---|---|---|---|---|---|---|---|
| Slovenia | 5.8 | 6.9 | 3.6 | -8.0 | 1.4 | 0.7 | -2.5 | -0.1% |
| Croatia | 4.9 | 5.1 | 2.1 | -6.9 | -1.4 | -0.9 | -2.0 | -1.0% |
| Serbia | 3.6 | 5.4 | 3.8 | -3.5 | 1.0 | 1.6 | -1.7 | 8.0% |
| Moldova | 4.8 | 3.1 | 7.8 | -6.0 | 7.1 | 6.4 | -0.8 | 5.4% |
| Bosnia and Herzegovina | 6.2 | 6.8 | 5.4 | -2.9 | 0.7 | 1.3 | -0.7 | 2.2% |
| Montenegro | 8.6 | 10.7 | 6.9 | -5.7 | 2.5 | 3.2 | -0.5 | 5.1% |
| Macedonia | 5.0 | 6.1 | 5.0 | -0.9 | 2.9 | 2.8 | -0.3 | 3.1% |
| Romania | 7.9 | 6.3 | 7.3 | -7.1 | -1.1 | 2.3 | 0.6 | 3.5% |
| Bulgaria | 6.5 | 6.4 | 6.2 | -5.5 | 0.4 | 1.8 | 0.8 | 0.7% |
| Albania | 5.0 | 5.9 | 7.7 | 3.3 | 3.5 | 3.0 | 1.6 | 1.7% |
| Kosovo | 3.4 | 8.3 | 7.2 | 3.0 | 3.2 | 4.5 | 2.7 | 3.2% |
| Turkey | 6.9 | 4.7 | 0.7 | -4.8 | 9.2 | 8.8 | 2.2 | 4.0% |

## Basic Indicators of Fiscal Decentralization

**The two best indicators of the relative importance of local governments in a country's overall governance structure are local public revenues (or expenditures) in relationship to GDP and in relationship to total public revenues (or expenditures).** To interpret their significance, however, we also need to know how large the total public sector is in relation to the GDP, and what public services have been assigned to local governments. If a country's public sector is small, it is unlikely that local government revenues will represent a significant share of GDP. They may, however, represent a substantial share of total public revenues. Such a situation would suggest that all levels of government have trouble collecting taxes, but that the national government is treating local governments relatively fairly. In contrast, if a country's public sector is large, but local government revenues are low as both a share of GDP and total public revenues, then this suggests that the national government is not taking local government seriously.

It is also important to know whether local governments are responsible for delivering significant services in the areas of education, health and social welfare. This is because these functions are so costly that assigning them to local governments really changes the nature of intergovernmental fiscal relations. For example, in most OECD countries the full costs of pre-university education usually equal between 3 and 6% of GDP (12 and 20% of total public expenditure) of which between 60 to 80% goes for teachers' wages[4].

Table 3 summarizes the social sector functions that have been assigned to local governments in the region. In Bulgaria, Kosovo, Macedonia, Moldova, and Romania local governments are fully responsible for pre-tertiary education, including paying teachers' wages. In Kosovo, local governments also maintain primary health care clinics and pay the wages of doctors and nurses. Similarly in Romania, local governments pay for most of the wage and non-wage costs of primary and secondary health care. By all rights, local governments in these countries should have higher revenues both as a share of GDP and of total public revenues than other members of the group.

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

**Table 3:** Social Sector Functions of 1st Tier Local Governments

| | Preschools | | Primary Schools | | Secondary Schools | | Primary Health | | Secondary Health | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Buildings | Wages | Buildings | Wages | Buildings | Wages | Buildings | Wages | Buildings | Wages |
| Kosovo | XX | XX | XX | XX | XX | XX | XX | XX | | |
| Romania | XX | XX | XX | XX | XX | XX | XX | XX | XX | XX |
| Macedonia | XX | XX | XX | XX | XX | XX | | | | |
| Bulgaria | XX | XX | XX | XX | XX | XX | | | | |
| Moldova | XX | XX | XX | XX | XX | XX | | | | |
| Serbia | XX | XX | XX | | XX | | XX | | | |
| Slovenia | XX | XX | XX | | | | XX | | | |
| Croatia | XX | XX | XX | | XX | | | | | |
| Albania | XX | | XX | | XX | | XX | | | |
| FBIH (BIH) | XX | | XX | | | | | | | |
| RS (BIH) | | | | | XX | | XX | | | |
| Montenegro | | | | | | | | | | |
| Turkey | | | | | | | | | | |

At the other end of the spectrum, local governments in Albania, FBiH (of BiH), RS (of BiH), Montenegro and Turkey do not pay the wage costs of any social sector employees. Indeed, in Montenegro and Turkey they have no responsibilities in either health or education. So by all rights, local government revenues as both a share of GDP and of total public revenues should be lower here than elsewhere.

## Local Governments Revenues in South-East Europe

Chart 4 shows local government revenue as a share of total public revenue and of GDP for all members of the group, as well as the average for the EU. As can be seen from the Chart, local governments in the EU play --on average-- a substantially larger role than counterparts among NALAS members.

**In most of South-East Europe local governments play a much smaller role in delivering public services than their counterparts in the EU.**

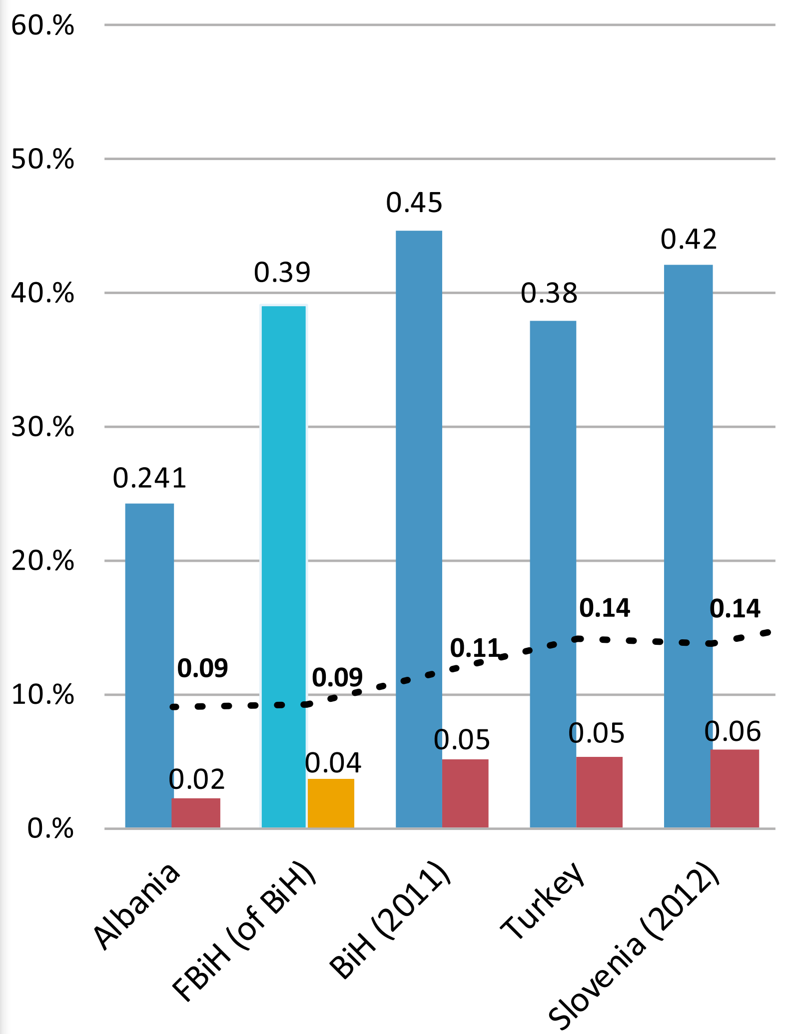
All countries where NALAS members operate have public sectors that are smaller than the EU average. In Albania, Kosovo, and Romania total public revenues are well under 40% of GDP, suggesting particular problems with tax collection. Yet, while local governments in Albania receive very little of the total fiscal pie, their counterparts in Romania and Kosovo receive shares of public revenue that are close to EU norms. As such, it is reasonable to say that despite their problems with taxation, the governments of Kosovo and Romania are treating their local governments as serious partners while Albania is not.  The situation in FBiH (of BiH) is also troubling from this perspective. Here, local governments are receiving only 3.6% of GDP and 9% of total public revenue, despite the fact that the size of FBiH's public sector is closer to the EU average.

As in Romania and Kosovo, local governments in Bulgaria, Macedonia, and Moldova are fully responsible for financing and managing pre-tertiary education, including paying teachers' wages. In Romania, Kosovo and Moldova, however, between 20 and 25% of all public revenue goes to local governments (or 7.6 to 9.5% of GDP) --shares closer to the EU average-- while local governments in Bulgaria and Macedonia are only receiving about 15% of all public revenues (or 6% of GDP). This strongly suggests that the national governments of Bulgaria and Macedonia are underfunding local governments in general, and pre-tertiary education in particular, and thus failing to meet their obligations under the European Charter of Local Self-Governments.

The situation in the rest of the region is harder to assess. Local governments in Turkey, Slovenia, RS (of BiH), Serbia, Montenegro and Croatia all have revenues equal to between 5.3 and 7.0% of GDP (14-18% of public revenues). This is low by EU standards. At the same time, local governments in Turkey, RS and Montenegro have almost no social sector responsibilities, while those in Serbia, Slovenia and Croatia maintain preschools and pay the wages of preschool teachers, a significant expense particularly in urban jurisdictions with high enrollment rates.

Finally, it is important to note that while the Chart provides much useful information about the overall importance of local governments within the group, it does not provide information about how these revenues are distributed across local governments, or about how much autonomy local governments have in actually spending them. Thus in some members of the group, funding that at the macro-level might appear reasonable may at the micro level be undermined by the concentration of revenues in a few jurisdictions. Similarly, regulatory or political constraints on the ability of local governments to actually control their revenues, as for example is clearly the case in Moldova, may render this picture misleading.

## Chart 4




* indicates that local governments pay teachers wages.

Local Government Revenue as Share of GDP and Total Public Revenue in 2013

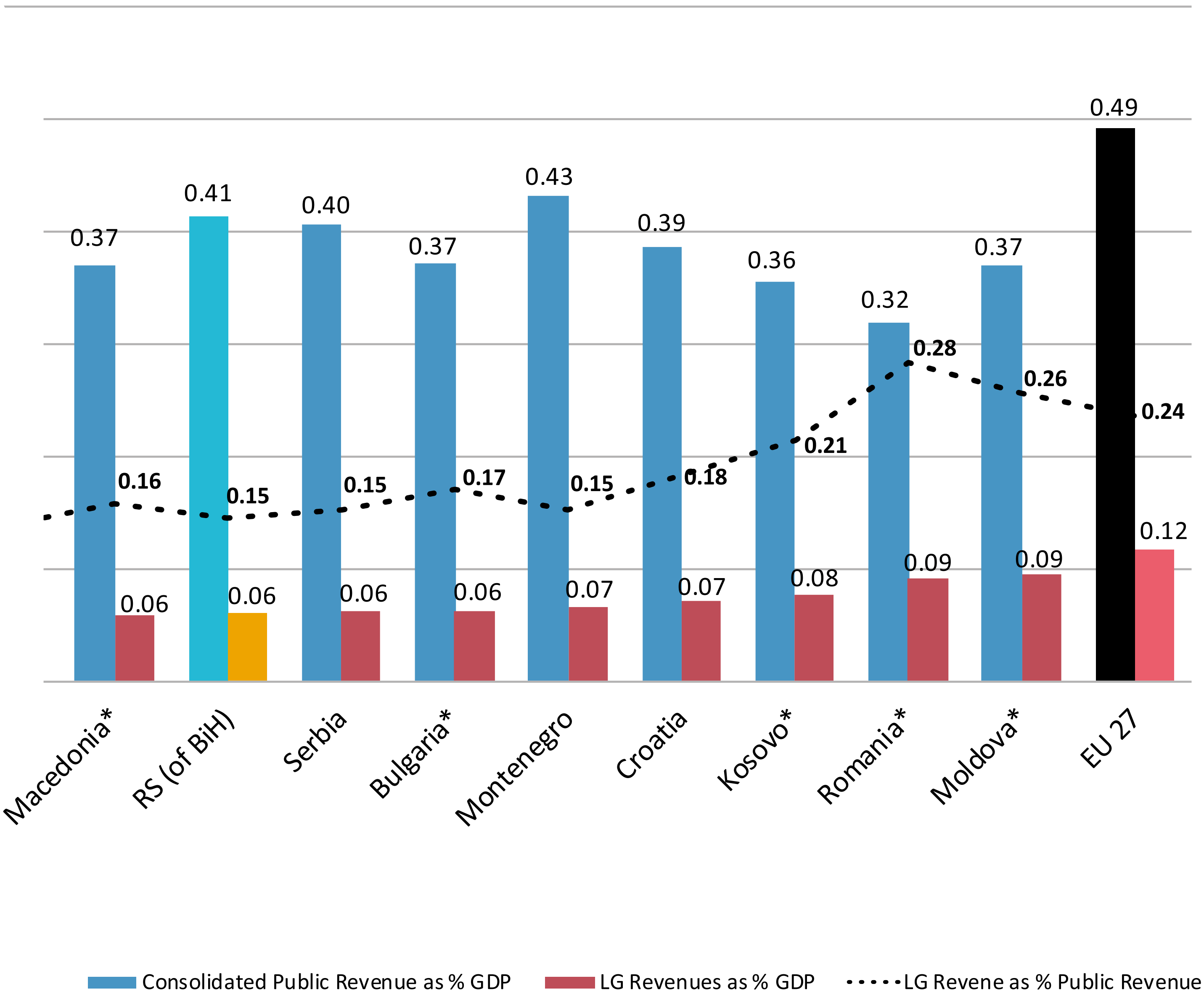
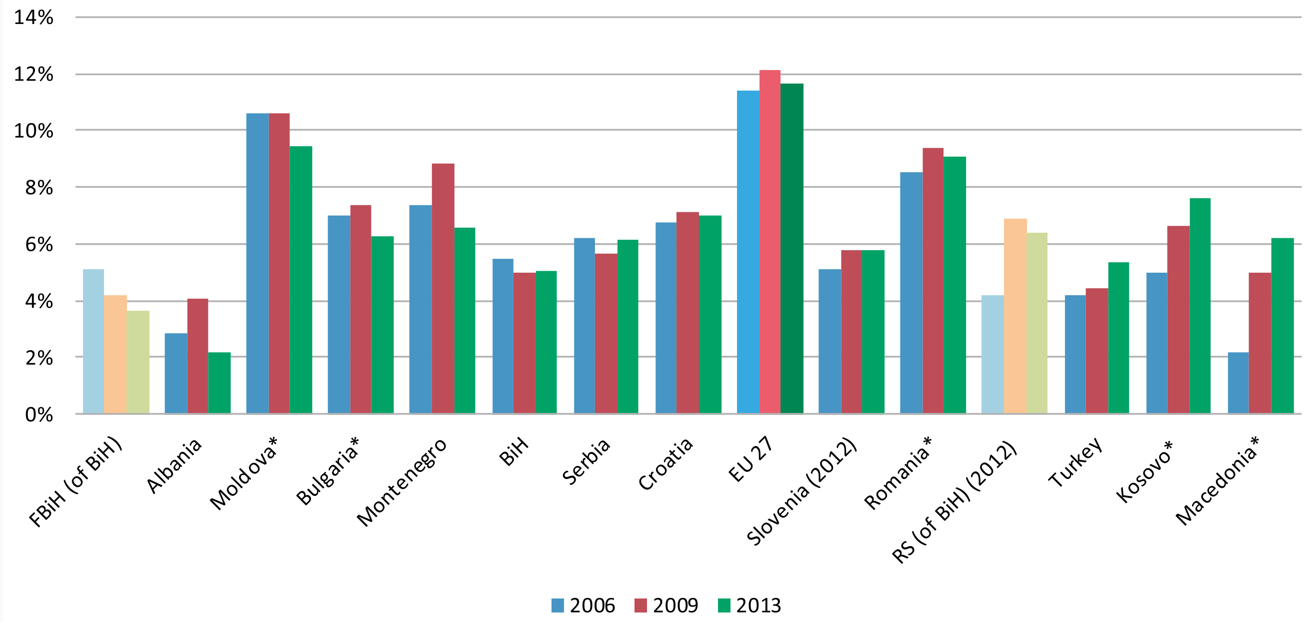


Chart 5 shows local government revenue as percentage of GDP in 2006, 2009 and 2013. In FBiH, local government revenues have declined as a share of GDP since 2006. In Albania Moldova, Bulgaria and Montenegro they increased between 2006 and 2009, but by 2013, fell to levels significantly below those in 2006. In Serbia, Slovenia, Croatia, and Romania local government revenue has been more stable, rising or falling marginally over the entire period. Only in the RS (of BiH), Turkey, Kosovo, and Macedonia, has the revenue position of local governments significantly improved over the entire period.

Chart 6 shows the per capita revenues of the consolidated public sector and of local governments in EUR in 2010. The Chart is a useful reminder of how much poorer the governments of most of South-East Europe are when compared to those of the EU, as well as how much variation there is across the region. It is particularly striking that local governments in Moldova, Kosovo, and Macedonia -three of the poorest in the group-- are paying for both basic services and teachers' wages with per capita revenues of less than 250 EUR.

Local Government Revenue as a Share of GDP in 2006, 2009, 2013

Chart 5

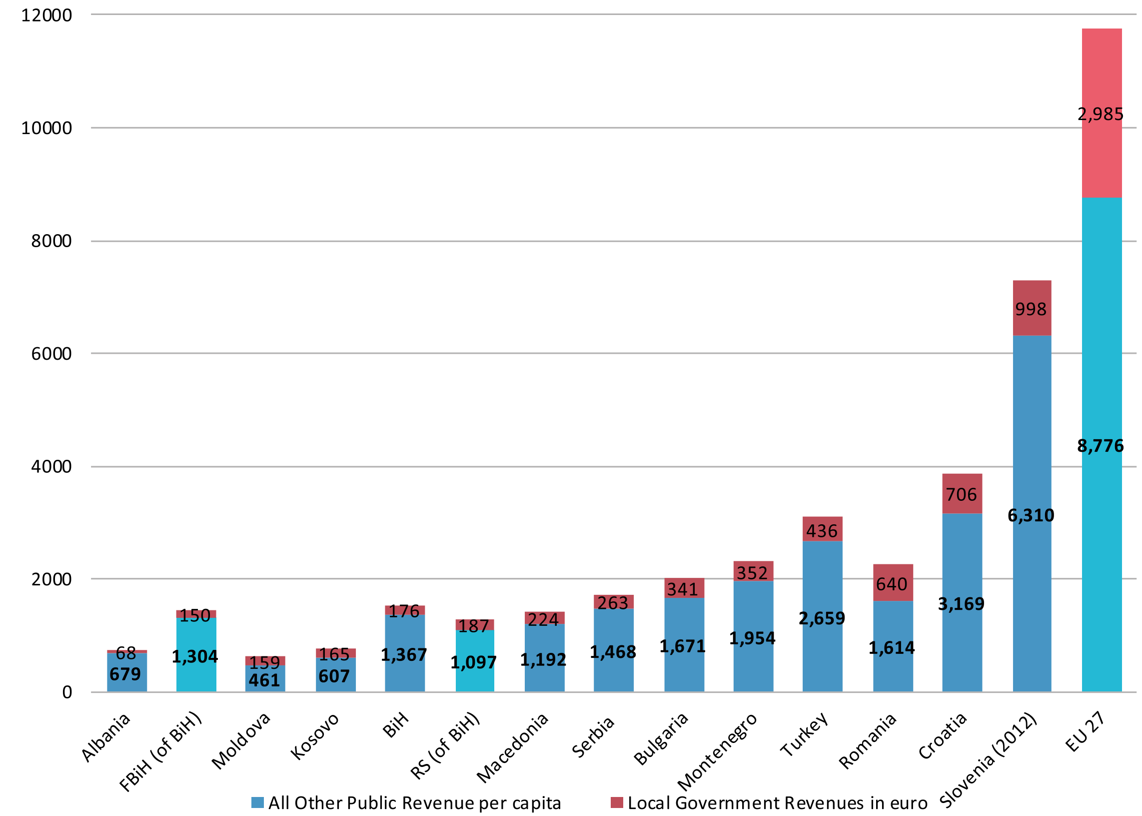


Indeed, it seems that decentralization has been pushed farther among the poorer members of the group, than among the more wealthy, suggesting that at least in some cases, it has been driven less by a desire to empower local governments than by the desire of central governments to relieve themselves of the responsibility for reasonably financing public services.

> **If decentralization has not progressed very far among the relatively wealthy, it has been pushed farthest among the poorest. This suggests that at least in some cases decentralization has been driven less by a desire to empower local governments to deliver public services, than by the desire of central governments to relieve themselves of the responsibility to reasonably finance them.**

Consolidated Public Revenue and Local Government Revenue in Per Capita EUR in 2013

**Chart 6**



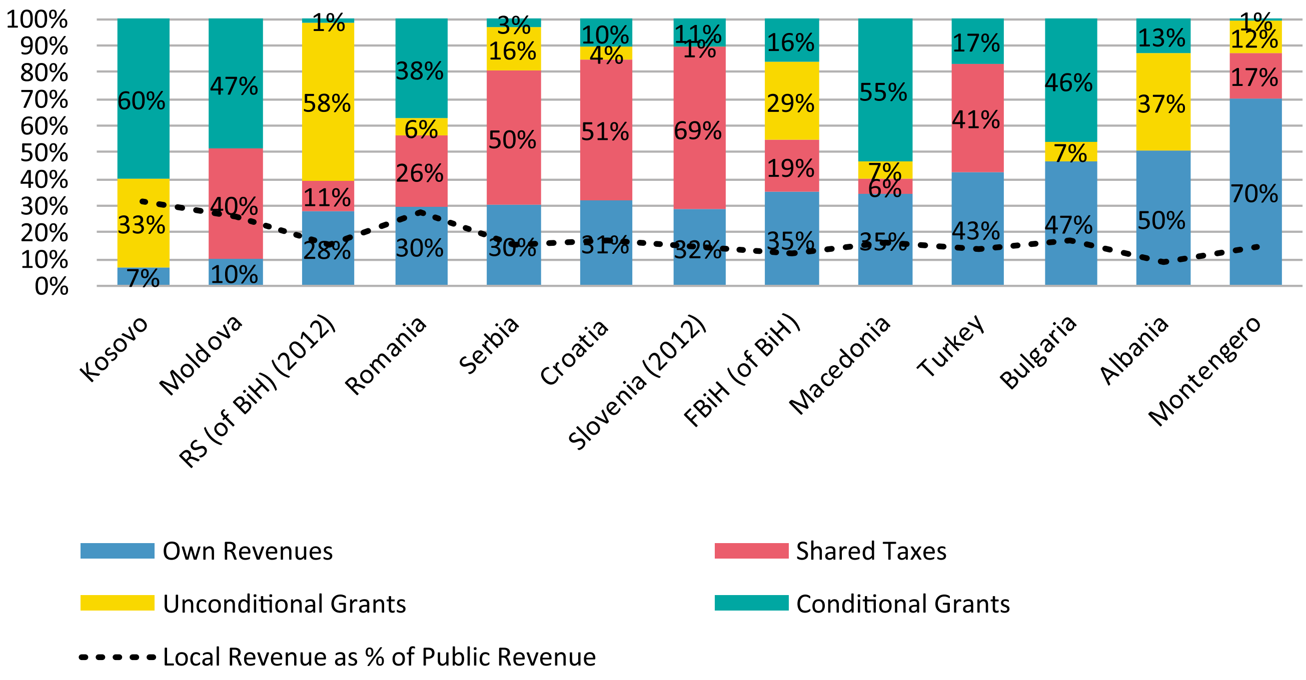
The Chart is also useful when read in conjunction with Chart 5. For example, Bulgarian local governments have per capita revenues similar to those of their Montenegrin counterparts. But they pay teachers' wages while the Montenegrins do not. Meanwhile, municipalities in the RS (of BIH) have higher per capita revenues than their counterparts in FBiH (of BiH) despite the fact that both groups of local governments have the same functions and total per capita public revenues are higher in FBiH (of BiH) than in RS (of BIH).

## Basic Composition of Local Government Revenues

Chart 7 shows the basic composition of local government revenues in 2013. Unfortunately, this data is less comparable then it should be because of differences in the classification schemes used by members of the group: In some places, shared taxes are presented as own-revenues or grants while in others, own revenues (from PIT surcharges) are presented as shared taxes.

Composition of Local Government Revenue in 2013

Chart 7




In Bulgaria, Kosovo, Macedonia, Moldova a large share of conditional grants are block grants for education, and sometimes health.

For example, in Turkey "shared taxes" are returned to local governments in part on an origin basis, and in part as an unconditional grant that is allocated by formula. But it is impossible to distinguish the unconditional grant from shared taxes in our data. Similarly, the equalization system in Slovenia gives additional increments of PIT to poorer jurisdictions. These additional PIT increments function like equalization "grants", but again cannot be distinguished from shared taxes. Meanwhile, Croatian local governments are allowed to impose local surcharges on PIT. But these revenues are shown in the Chart as shared taxes when they should be classified as own revenues –as they are in Montenegro. Finally, many of the revenues that are classified as own-revenues are in fact fees and charges set by higher-level governments (and sometimes collected by them) but whose yields go entirely to local governments. These revenues should be considered shared taxes but are often incorrectly classified as own-revenues. As such, the Table overstates –like much of the data for other countries- the real share of own-source revenues at the local level.

## Financial Independence of Local Governments

Nonetheless, Chart 7 does provide some basic information about the financial independence of local governments. In Bulgaria, Kosovo, Moldova, and Macedonia local governments have limited financial autonomy because more than 50% of their revenues come from conditional grants for health and education functions. Here, national governments have a legitimate interest in making sure that money intended for these functions actually gets spent on them. But, 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. And in most places it is probably fair to say that social sector block grants are over regulated.

Conversely, local governments in Montenegro receive insignificant conditional grants and have very high levels of own-revenue. Indeed, the share of own-revenue in Montenegro is about double what the average for EU countries would probably look like if we had reliable data. This is possible in Montenegro because local governments derive significant revenue from asset sales and rentals, land development fees, and PIT surcharges.

**Albania, Kosovo, and Bulgaria make no use of PIT sharing, while Macedonia makes extremely limited use of it. This is surprising since the origin based sharing of PIT is not only clearly popular in the region, but has formed a critical pillar of the intergovernmental finance systems of many of the post-communist countries that joined the EU in 2004**.

It is also interesting that local governments in Turkey, Slovenia, Croatia, and Moldova receive no income from unconditional grants, while in Macedonia, Montenegro, Bulgaria, and Romania unconditional grants accounted for less than 10% of total revenue. The absence or relative insignificance of unconditional grants raises questions about the equity of these countries' intergovernmental finances systems. This is because it is generally through unconditional grants that central governments provide additional revenues to poorer jurisdictions. Nonetheless, unconditional grants can be allocated in many ways and their simple existence should not be taken to mean that they effectively redistributing national income. Moreover, and as we have already mentioned both Turkey and Slovenia do at least some equalization through other mechanisms.

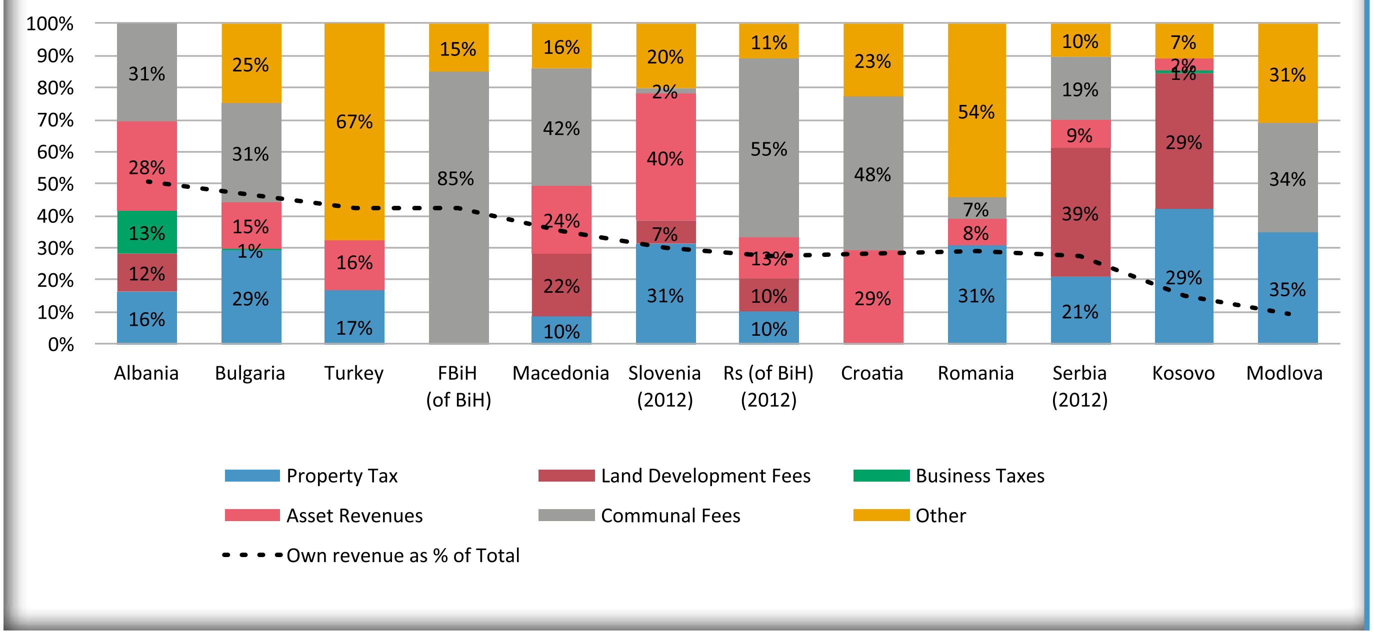
**The low share of unconditional grants in total revenue raises questions about the equity of these intergovernmental finance systems because it is generally through unconditional grants that central governments provide additional revenues to poorer jurisdictions.**

Chart 8 presents the composition of own-revenues for local governments in the region, ranked by the share of these revenues in total revenues. Unfortunately, the way own-revenues are accounted for differs from place to place. In some cases, the reporting is quite detailed and contains more categories than are presented in the Chart. In others, only two or three categories are used and it is difficult to say what these categories contain. For example, local governments in Croatia, Turkey, FBiH (of BiH) and RS (of BiH) all derive significant revenues from Land Development Fees and quasi-fiscal Construction permits, but they are recorded only as Communal Fees. Similarly, revenues from the sale or rental of municipal assets are frequently presented as Communal Fees.

Because of this it is hard to come to any general conclusions about the composition of own-revenues in the group. What can be said is that in most places the data on own-revenues is poor and that there does not seem to be a strong relationship between the composition of own-revenues and their share in total revenues. But it is worth noting that revenue from the rental and sale of assets is surprisingly important in many places, as is revenue from quasi-fiscal charges imposed on new development, charges that national governments throughout the region are trying to roll back. It is also worth adding –though the Chart does not show it-- that throughout the region own-source revenues are disproportionally concentrated in capital cities and typically tied very strongly to the real-estate market through asset sales, land development fees, construction permits, the Property Transfer Tax and the Property Tax.

Composition of Own-Revenue 2013

Chart 8



**Throughout the region own-source revenues are disproportionally concentrated in capital cities and typically tied very strongly to the real-estate market through asset sales, land development fees, construction permits, the Property Transfer Tax and the Property Tax.**

Table 4 shows the per capita yield of the property tax in EUR in 2006 and 2013 for all NALAS members. It also shows the data for 2012, so comparisons between the two consecutive years can also be made. As can be seen from the Table, there are very significant differences across the group in both the yield of the tax and its growth over the last seven years. In the RS (of BiH) the tax's yield is low and has decreased in recent years. In Croatia, where the tax has yet to be decentralized, the yield remains relatively high but there has been no growth. In Slovenia, control over the tax has recently been recentralized, and though yields are relatively high, they have not increased since 2006. In Albania, FBiH (of BiH), Kosovo, and Moldova there have been modest gains but off a very low base. In Macedonia the yield of the tax has increased almost fourfold, but still amounts to only 8 EUR per capita. Growth in Serbia, Turkey and Bulgaria has also been substantial. But the real highflyer in the group is Montenegro.

Table 5 presents the same basic information but expresses the yield of the tax as a percentage of GDP and includes the average for the EU. What the Table shows is that in Croatia, Slovenia, FBiH (of BiH), RS (BiH), Albania, and Moldova the expansion of the property tax did not keep up with GDP growth while it exceeded it in Macedonia, Montenegro, Bulgaria, Turkey, Serbia, Romania, and (marginally) Kosovo.

**Table 4:** Change in Per Capita Yield of the Property Tax in EUR 2006 vs. 2013

| | 2006 | 2012 | 2013 | % + or – 2006-2013 |
|---|---|---|---|---|
| RS (of BiH) | 7.0 | 6.0 | 5.5 | -21% |
| Croatia | 26.0 | 23.0 | 25.9 | 0% |
| Slovenia (2012) | 92.0 | 92.0 | 92.0 | 0% |
| FBiH (of BiH) | 11.2 | 13.4 | 12.6 | 12% |
| Albania | 4.4 | 2.7 | 5.6 | 26% |
| Moldova | 4.0 | 5.6 | 5.3 | 32% |
| Kosovo (2008) | 5.0 | 6.5 | 7.2 | 44% |
| Romania | 31.2 | 53.0 | 57.8 | 85% |
| Serbia (2012) | 7.7 | 16.7 | 16.7 | 117% |
| Turkey | 14.0 | 31.0 | 31.0 | 121% |
| Bulgaria | 10.0 | 29.0 | 31.8 | 218% |
| Montenegro | 16.0 | 58.0 | 63.4 | 296% |
| Macedonia | 1.6 | 6.9 | 7.8 | 385% |

**Table 5** Change in Property Tax as a Percentage of GDP 2006 vs. 2013

| | 2006 | 2013 | % + or - |
|---|---|---|---|
| Macedonia | 0.06% | 0.21% | 253% |
| Montenegro | 0.46% | 1.19% | 157% |
| Bulgaria | 0.29% | 0.59% | 103% |
| Turkey | 0.25% | 0.38% | 51% |
| Serbia (2012) | 0.27% | 0.37% | 37% |
| EU 27 | 1.00% | 1.10% | 10% |
| Romania | 0.75% | 0.82% | 9% |
| Kosovo | 0.33% | 0.33% | 1% |
| Croatia | 0.29% | 0.26% | -10% |
| Slovenia (2012) | 0.61% | 0.54% | -12% |
| FBiH (of BiH) | 0.42% | 0.34% | -19% |
| Albania | 0.29% | 0.18% | -37% |
| RS (of BiH) (2012) | 0.30% | 0.18% | -40% |
| Moldova | 0.53% | 0.31% | -40% |

This suggests that there is a division within the group between countries/entities where local governments are more aggressively using the property tax and those where they aren't. Property tax collection as a share of GDP has declined substantially in Albania, Moldova and RS (of BiH). And it has grown only marginally in Kosovo, despite significant investment by the national government (and the international community) in improved fiscal cadasters and billing systems. The yield of the tax exceeds the EU average of 1.1% of GDP only in Montenegro, though Romania is close. (And the EU average is low when compared to North America, Australia, France, and some of the Nordic countries where the tax accounts for between 2 and 3% of GDP.)

Given the difficulties across the region - and much of the EU - in making the property tax a robust revenue source, it is probably unrealistic to expect it to serve as the foundation for the financial independence of local governments in South-East Europe. But there is clearly also room for improvement.

## Local Government Investment Spending

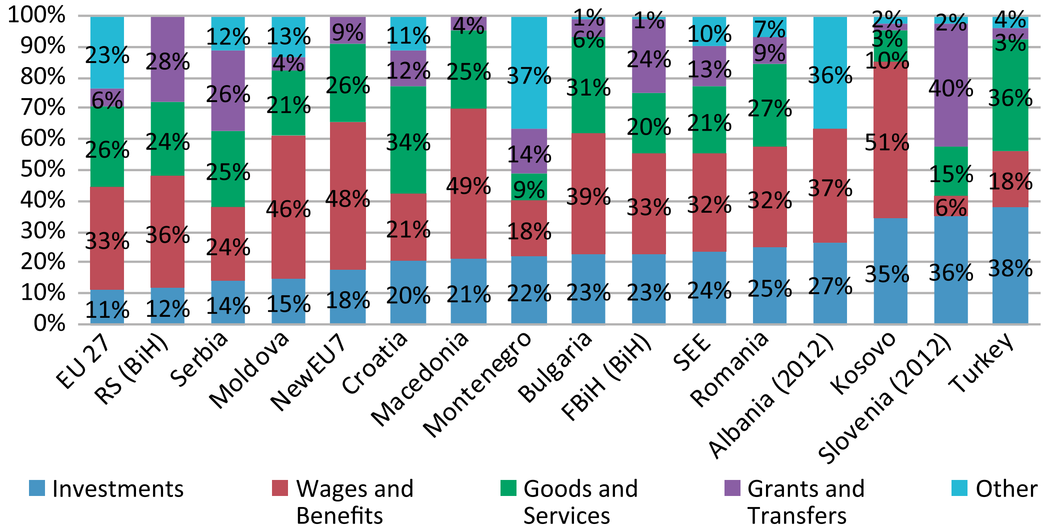
Chart 9 shows the composition of local government expenditures by economic type for each member of the group, as well as the average for the group as a whole (SEE); the average for the EU (EU28); and the average for the seven post-communist countries that joined the EU in 2004 (NEWEU7)[5].

The data should be treated cautiously because there are differences in the way countries report expenditures, as well as problems with extracting fully comparable data from Eurostat. For example, some places treat capital transfers to public utilities as investment expenditures while others record them as subsidies. There also seems to be a tendency to record wage spending as a purchase of goods and services.

[5] Czech, Estonia, Hungary, Latvia, Lithuania, Poland and Slovakia.

Composition of Local Government Expenditure in 2013

Chart 9



For the RS (of BIH) transfers to individuals and to firms are not distinguished. For Serbia, investment includes capital subsidies to public companies and "neighborhood units". For Montenegro "other" includes substantial amounts of debt service payments, for EU28 and NEW-EU7 transfers include only operating subsidies to public utilities.

Nonetheless, the most striking feature of the Chart is that local governments in most of South-East Europe spend a larger share of their budgets on investment than their counterparts within the EU - even those of the seven EU members that joined in 2004. Indeed, in some places investment rates would be substantially higher (e.g. Serbia) if the data on local government transfers to public utilities distinguished between operating and capital subsidies.

Explaining the high share of investment spending in the municipal budgets of local government is more difficult, given their generally poor financial position. Some of it may be due to the fact that across the region local governments often pay for investments in public utilities that elsewhere utilities finance themselves through tariffs. And part of the reason may be that within the EU, the decentralization of social sector functions with very high operating costs means that the share of total spending on investment will always be relatively small.

But for whatever reason, the differences in the average investment rates for the three groups (SEE, EU28, and EU7) have been remarkably consistent over the last 8 years. This suggests that local governments in South-East Europe, like those of the EU7 are playing an extraordinary game of catch-up, spending as much they can to modernize the run-down infrastructure they have inherited. Or to put the matter another way, local governments in South-East Europe are working harder than their counterparts in most of the EU to build new infrastructure because 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 7).

**Local governments in South-East Europe are working harder than their counterparts in most of the EU to build new infrastructure because 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 revenues (Chart 4).**

But while investment rates in the region have been comparatively robust, it is again important to remember that we don't know how much these rates have been driven-up by a few wealthier jurisdictions and by the (likely) imbalances in the region's intergovernmental finance systems. Moreover, since 2009, they have been falling in most countries (see country reports) and in the new EU member states, would have fallen faster if not for the influx of EU funds. In Bulgaria, for example, EU grants have accounted for almost all of local government investment spending in recent years (see country report for Bulgaria). So EU funds are undoubtedly playing an important role in the modernization of local public infrastructure in new member states. In some cases, they have also made it possible for national policy makers to slash domestically funded grants to local governments.

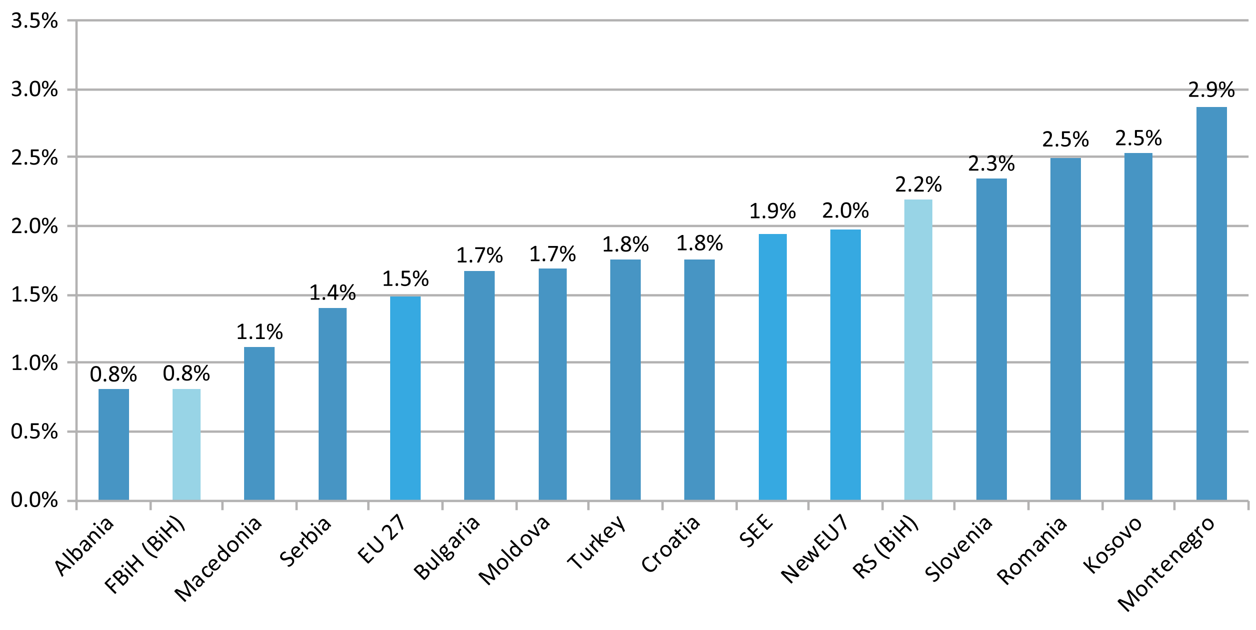
**But while investment rates in the region are generally high, what we don't know is how much these rates are being driven-up by a few wealthier jurisdictions and by the (likely) imbalances in the region's intergovernmental finance systems. They have also been falling in recent years.**

**EU funds are undoubtedly playing an important role in the modernization of local public infrastructure in new member states. In some cases, they have also allowed national policy makers to substitute transfers from the EU for transfers generated from domestic sources.**

Chart 10 presents local government investment as a percentage of GDP for the last eight years for all members of the group, the average for the group as a whole (SEE) as well as for the EU28 and the EU7. Chart 11 presents local government investment in EUR per capita for 2013 as well as the average for 2006-2013. These Charts demonstrate that the relatively high investment rates that we saw in Chart 9 do not necessarily translate into high levels of investment when looked at as a share of GDP or in EUR per capita. Local governments in Albania, for example, have been devoting more than 30% of their expenditures to investments (Chart 9), but this is still the lowest level of investment spending both as a percentage of GDP or in per capita EUR. Meanwhile, Moldova has a low municipal investment rate, and the lowest spending in per capita EUR, but nonetheless exceeds the average for the EU28 with respect to local government investment as share of GDP.

Local Government Investment as a share of GDP (average 2006-2013)

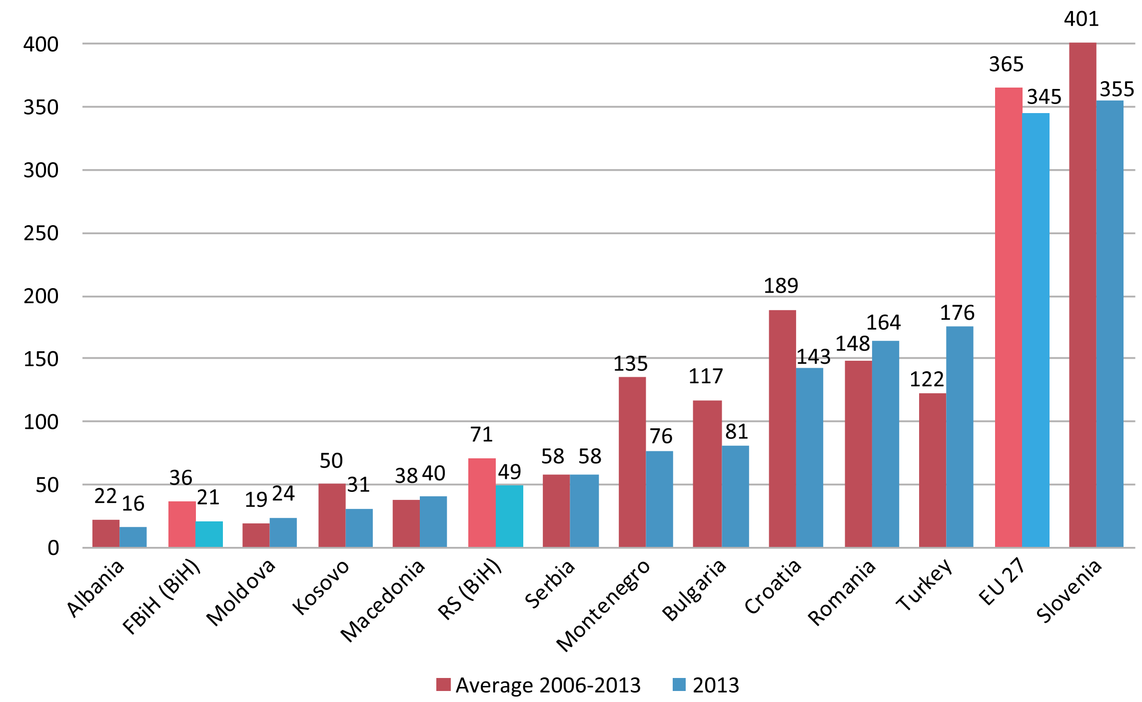
Chart 10




Average for Kosovo 2008-2012

Local Investment in EUR Per Capita (2013 & Average 2006-2013)

Chart 11




Nonetheless, the higher investment rates that we saw in Chart 9 have generally been accompanied by higher levels of municipal investment as a share of GDP when compared to the average for the EU. Indeed, local government investment as a share of GDP has exceeded both the average for the EU28 and the EU7 in RS (of BiH), Slovenia, Romania, Kosovo, and Montenegro. Hopefully, these gains will continue.

**Local government investment has exceeded the EU average in the Republika Srpska (of BiH), Slovenia, Romania, Kosovo, and Montenegro.**

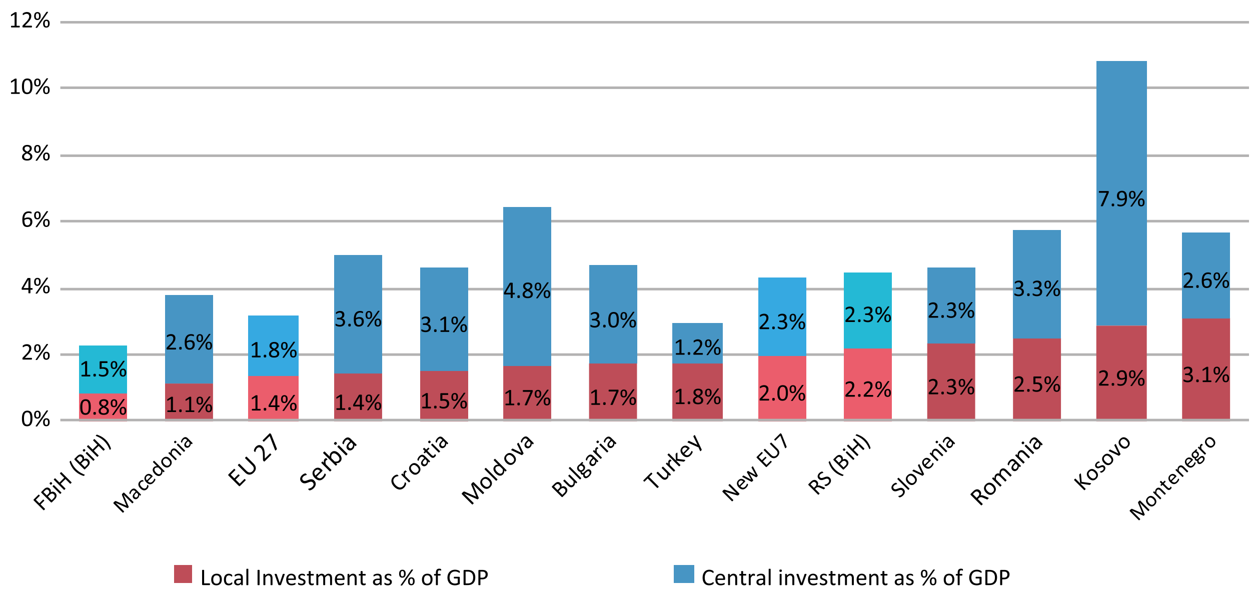
**But the situation elsewhere in the region is not so positive. Local government investment spending as a percentage of GDP is extremely low in both Albania and FBiH (of BiH) and is not much higher in Macedonia and Serbia. The picture is better in Bulgaria, Croatia, Moldova, and Turkey but local government investment as a share of GDP remains lower than the average of the new EU7. This 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.** It is also worth noting that with the exception of Turkey, Slovenia, Serbia and Macedonia, per capita investment in 2013 was lower than the average for the period 2006-2013 in all members of the group.

Finally, it is worth looking briefly at the composition of public investment by level of government. Chart 12 shows total public investment as a share of GDP divided by level of governments for the years 2006-2013. There is significant variation in both total public investment and its composition across levels of government. In general, total public investment in the NALAS group tends to be higher than for the more established member states of the EU. This is not surprising given that all of the states are in the process of modernizing their public infrastructure.

Similarly, a larger share of this public investment comes from central governments in most of South-East Europe than it does in either the EU28 or the new EU7. This is not surprising. But it is striking that in most of the region, local public investment as a share of GDP remains lower than in the EU 7, whose members faced similar deficits in costly environmental and network infrastructure. Nonetheless, in at least some members of the group, local government account for a healthy share of total public investment, both in relationship to the GDP as a whole, and to the central government (Slovenia, Montenegro, RS (of BiH), and to a lesser extent Kosovo.)

Public Investment as a Percentage of GDP by Level of Government (average 2006-2013)

Chart 12



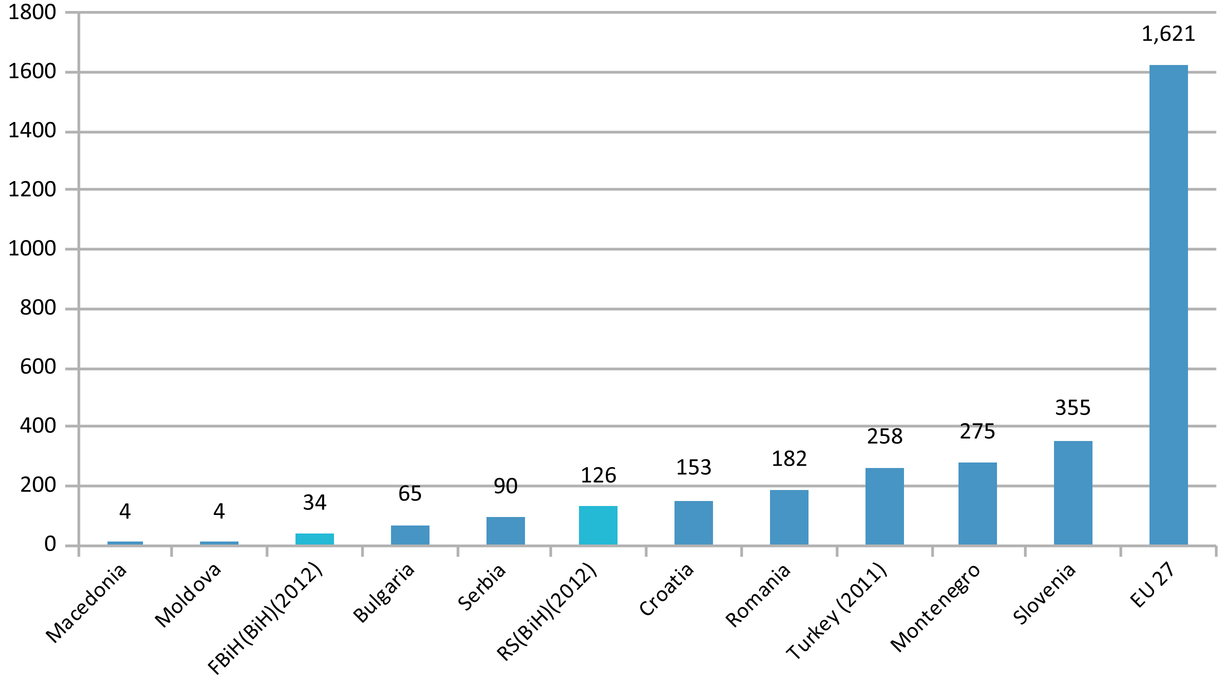

Kosovo 2008-2012, Turkey, 2006-2011

## Local Government Borrowing

In most of South-East Europe, local government borrowing is still a new phenomenon. Chart 13 shows that the outstanding per capita debt of local governments in the EU is close to five times greater than that of Slovenia, the country with the highest level of local debt in the group. Meanwhile, local government borrowing in Albania, Macedonia, Moldova, and FBiH (of BiH) is clearly in its infancy while elsewhere in the region it is underdeveloped. Given the infrastructure deficits facing local governments in the region, it is important that they have better access to debt capital.

Outstanding Local Government Debt in 2013 (EUR Per Capita)

Chart 13




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

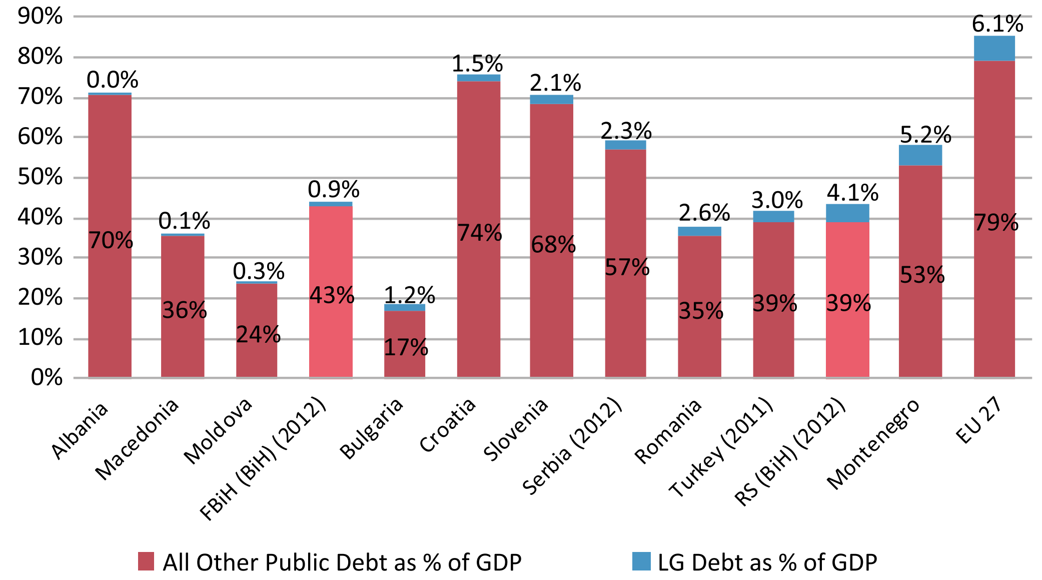
In many places, increasing local government borrowing will prove difficult because of the (de facto and de jure) limits on borrowing created by the Maastricht Treaty. According to the Treaty, the consolidated public debt of EU members should not exceed 60% of their GDP. Chart 14 presents data on the consolidated public debt of NALAS members and of the EU28 by level of government. As can be seen from the Chart, Albania, Croatia, Slovenia and the EU28 are now all above the debt limits set by Maastricht, while Montenegro and Serbia are extremely close.

As efforts are made to bring total public debt closer to Maastricht norms, local governments in these countries (as in the EU itself) will find themselves competing for "debt space" with their national governments. This is a competition they will have a hard time winning even if in most of them local borrowing still represents a small share of total public debt and the basic creditworthiness of many municipalities is good. (The exception here is Montenegro, where debt repayment now constitutes a very large share of local expenditure --see country report).

In other members of the NALAS group, total public debt remains well below the Maastricht limits, and local government in these places should confront fewer policy obstacles to incurring debt. Indeed, local government borrowing in Romania, Bulgaria, RS (of BiH) and Turkey has increased significantly over the last few years. The situation in Macedonia, Moldova, and FBiH however, is more problematic and municipal borrowing clearly remains in the early stages of development.

General Government and Local Government Debt as % of GDP in 2013

Chart 14



In many places, the overall adequacy and predictability of local government revenues will have to be increased if municipalities are to be able to prudently incur debt. The rules regulating intergovernmental finances 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. Local governments will also 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 also have to radically improve their ability to prepare, plan, and cost-out complex, multiyear investment projects - particularly in the water and solid waste sectors.**

**In many places, the overall adequacy and predictability of local government revenues will have to be increased if municipalities are to be able to prudently incur debt.**

Local governments will also have to radically improve their ability to prepare, plan, and cost-out complex, multiyear investment projects - particularly in the water and solid waste sectors. This sort of planning, however, requires money and time that many local governments in the region do not feel they have. Scarce investment funds tend to be spent on pay-as-you-build road projects and not on debt-financed, pay-as-you-use environmental facilities like waste water treatment plants because planning roads is simpler; construction can be delayed if money runs out; and because the benefits are more likely to be visible to voters before the next election.

**Scarce investment funds tend to be spent on pay-as-you-build road projects and not on debt-financed, pay-as-you-use environmental facilities like waste water treatment plants.**

# III Country Reviews of Fiscal Decentralization Trends and Developments

## Albania

### Intergovernmental Transfer System

Albanian Law No. 8652 of July 2000, "On the Organization and Functioning of Local Governments", defines three types of transfers, shared-taxes (which have never been created), unconditional transfers and conditional transfers. The law does not define how the size of unconditional transfers to local governments should be determined. Nor does is specify the formula that should be used to allocate them. It does however clearly state that fiscal equalization should be the primary objective of unconditional transfers.

The legal regulation of the transfer system is based on the following rationales: (i) provision of adequate revenues to local budgets, in addition to local taxes; (ii) assistance to lower levels of government; and (iii) financial equalization to compensate for inequalities between central and local governments (vertical) and among local government units (horizontal).

The size of the unconditional transfer is determined in the national government's annual budget process and allocated by a formula set in the budget law. Conditional transfers are appropriations of line Ministries that are then allocated to local governments through decisions taken by the Committee of Regions.

### The Unconditional Transfer

The unconditional or general transfer provides local governments with funds to execute their exclusive (own) functions. It was introduced in 2001. Since 2002, the size of the transfer and the formula used to allocate it has been defined in the national government's Annual Budget Law. The size of the transfer is based on the historic cost of the services that were transferred, delegated, or mandated to local governments and are not based on standardized measure of service costs. The formula used to allocate the transfer is designed to equalize the revenues of local governments.

The unconditional transfer is divided between the first and second levels of local government. The first level –municipalities and communes—gets 91% of the grant pool; the second level -regions or qarqe— get 9%. The following factors are used to allocate the grant to municipalities and communes : (i) an *equal share (lump sum payment)* for all communes and municipalities to ensure that even the smallest jurisdictions can pay their administrative staff; (ii) a share distributed based on the number of inhabitants in each jurisdiction (70% of the transfer pool after lump sum payments are made); (iii) a share for communes distributed on the basis of the *surface area* of each commune (15% of the pool); (iv) a *share for municipalities* other than Tirana distributed on the basis of the number inhabitants of those municipalities (15% coefficient).

Once the general grant has been calculated for each municipality then a separate set of calculations are made for those local governments whose total per capita revenues are more than 25% below or above the national average. If a local government's whose total per capita income is less than 75% of the national average and its grant is less than 91% of the grant it received in the previous year, then it is compensated for the difference. Conversely, if a local government's total per capita income is 25% greater than the national average and its general grant is more than 93% of what it received the in the previous year then it must give up the difference to help pay for the compensation of the others. Finally, the law ensures that final value of the grant should be no less the 2000 lek/capita for communes and 2960 lek/capita for municipalities.

## Conditional Transfers

Albania has also made extensive use of conditional transfers and between 2009 and 2011 they constituted over 40% of total local government revenues. The extensive use of conditional grants to fund local governments led to allegations that the grants were being allocated for political purposes and did not reflect either clear developmental goals or the objective needs of local governments.

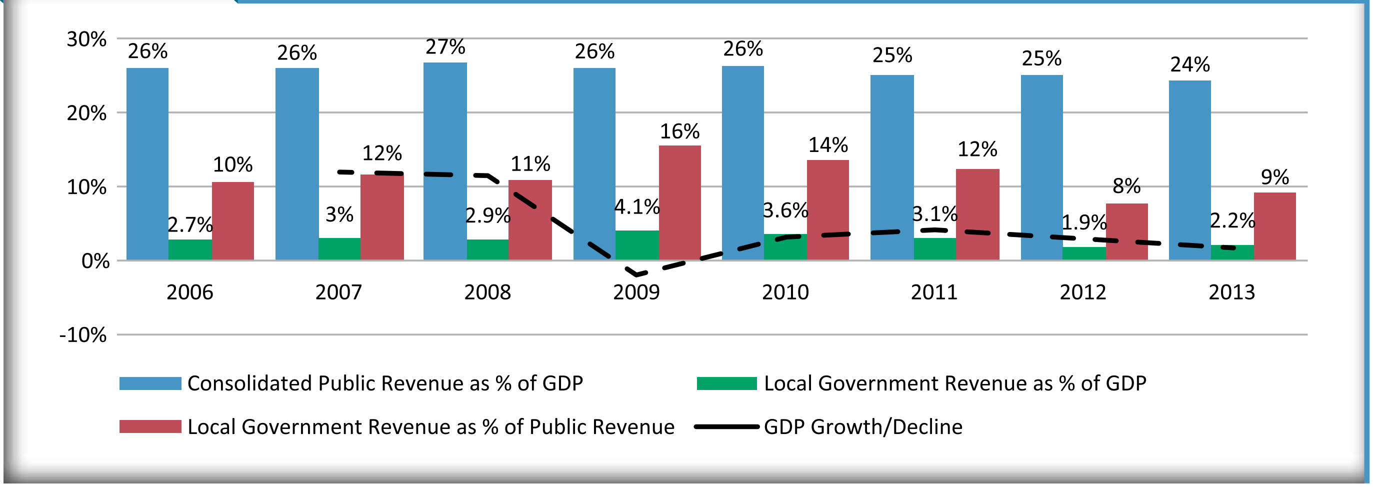
In 2014, the government of Albania passed legislation that will reduce the number of local governments in the country from 373 jurisdictions to 61. These new jurisdictions will come into effect with the local government elections scheduled for the fall of 2015 and will require the intergovernmental finance to be reconfigured for 2016. Hopefully, this will lead to an overall improvement of the financial position of local governments in Albania, a position that has deteriorated over the last ten years.

# Statistical Overview of Local Government Finance in Albania 2006-13

Albanian local governments receive less revenue as both a share of GDP and of total public revenue than all their counterparts in the region. Worse, this share fell from a high of 4.1% of GDP in 2009 to 2.2% in 2013.

## Chart 1 Albania

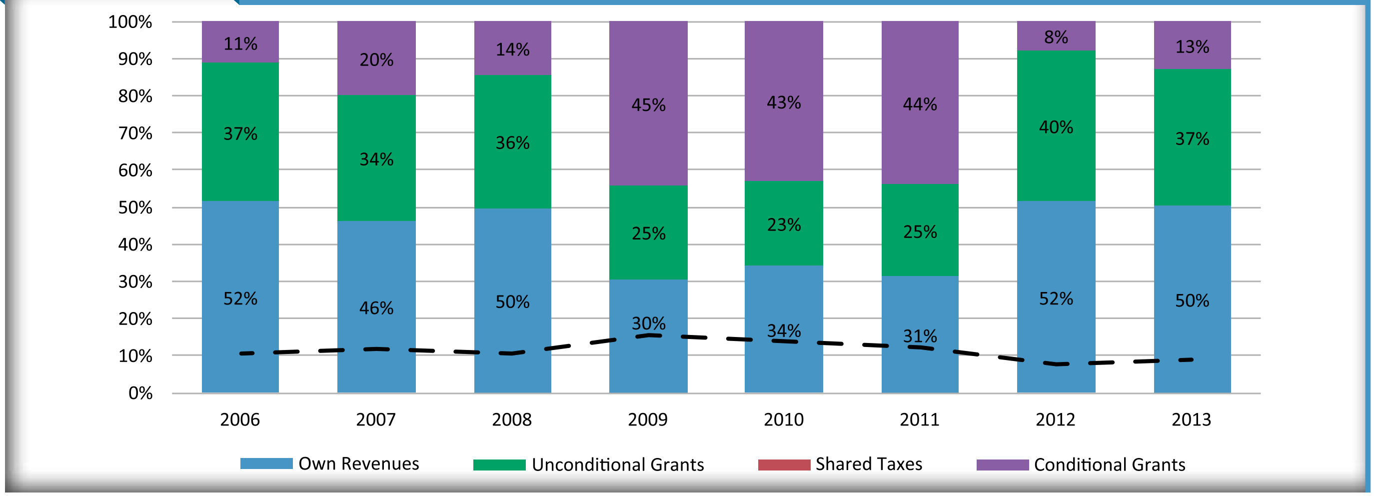
Local Government Revenue as a Share of GDP and Total Public Revenue 2006-2013




Between 2009 and 2011, an extraordinarily high share of local revenue came from Conditional Grants, suggesting that the intergovernmental finance system was highly politicized in these years.

## Chart 2 Albania

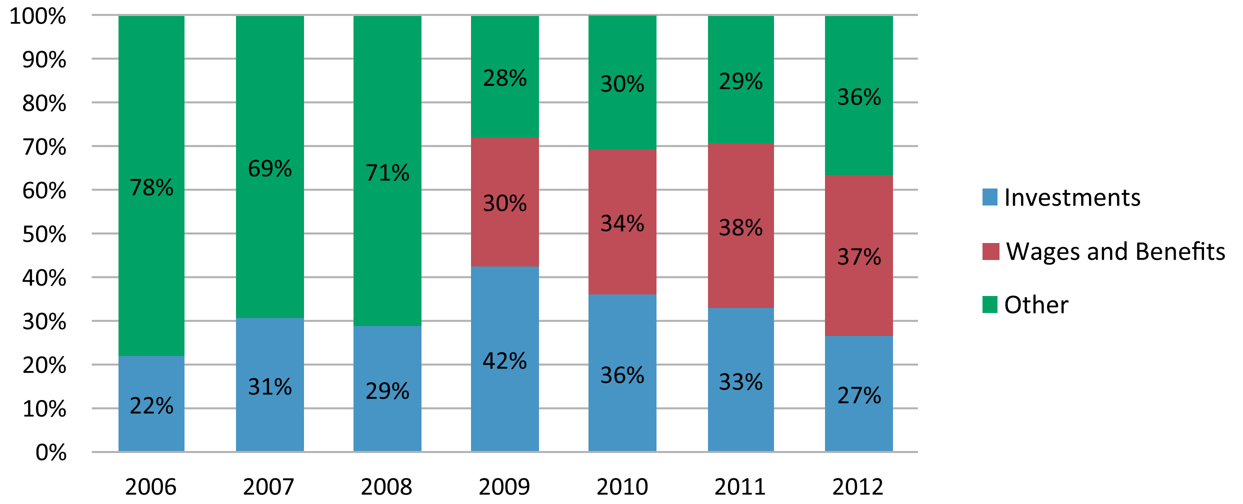
Composition of Local Government Revenues 2006-2013



Investments as a share of total local expenditures have fallen in recent years. The growth in the share of wages is only because total expenditures are falling.

**Chart 3 Albania**

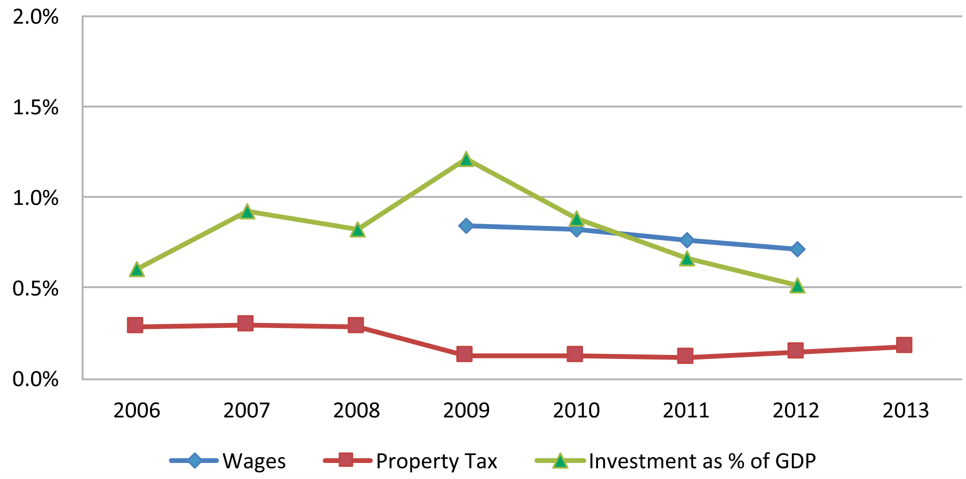
**Composition of Local Government Expenditures 2006-2012**




Wages, Investment, and Property tax collection are all extremely low as shares of the GDP and all have fallen since 2006.

**Chart 4 Albania**

**Investment, Wages, and Property Tax as Share of GDP 2006-2012**



# Bosnia and Herzegovina - Federation of Bosnia and Herzegovina

Bosnia and Herzegovina (BiH) continues to make very limited progress in political, economic as well as legislative reforms necessary for future EU membership. *Bosnia and Herzegovina 2013 Progress Report* by the European Commission clearly states that there is an absence of clear political vision for the country s future. The Report states also that very limited progress was made towards meeting the economic and legislative EU criteria. The quality of public finances and fiscal reporting continues to be an issue over the years.

There were few major developments concerning public finances in the Federation of Bosnia and Herzegovina:

A new Law on Budgets in the Federation of Bosnia and Herzegovina was adopted in 2013. The adoption of this law was a precondition for continuation of the Stand-by arrangement with the IMF and a step forward to improving fiscal reporting in the Federation. Besides its good merit, the law has a major flaw regarding the local self-government level. Namely, it was written with the Federal level of government in the main focus and as a result its implementation on the local level is not well regulated.

Indirect taxes continue to be the most important source of revenue for all levels of government. The allocation of these taxes is regulated on the entity level. In FBiH, the Law on the Allocation of Public Revenues allocates ca. 60% of the Federation's indirect revenues to cantons and municipalities according to a formula. The recent changes to this law, that are already being implemented, increase the transparency in the allocation of the indirect taxes in the Canton of Sarajevo. Previously, the local self-government units in this Canton did not get their share of indirect taxes according to the formula but according to an estimation of the Canton's Ministry of Finance. This change resulted in a major increase of this revenue in some municipalities (with high population numbers) and a slight decrease of revenue in other municipalities.

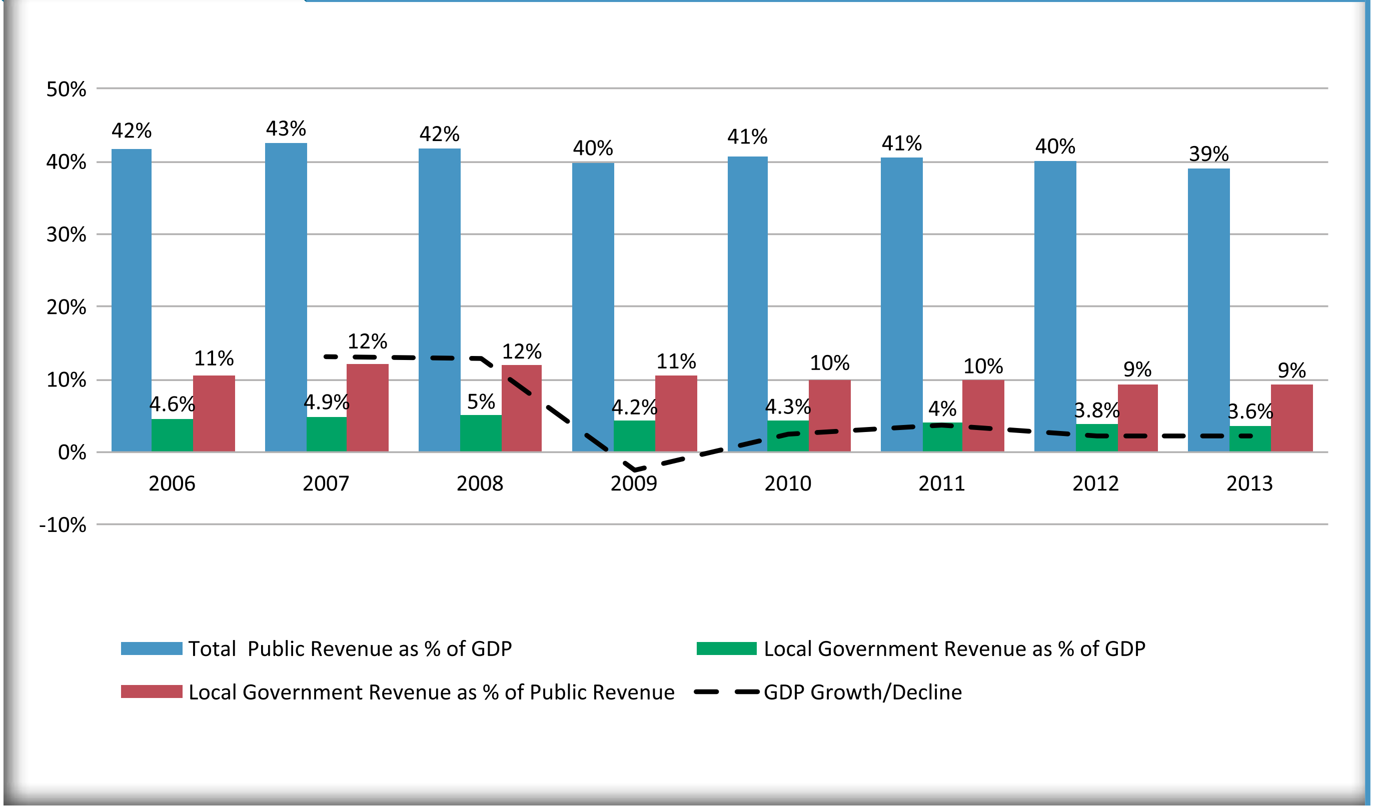
A major problem was created for the City of Sarajevo. The Canton of Sarajevo used to redirect a share of revenues belonging to municipalities for financing the City of Sarajevo, but since the revenues are now directly forwarded to municipalities, the Canton of Sarajevo refuses to continue financing the City of Sarajevo. The City of Sarajevo is therefore left without the most important revenue and is facing bankruptcy. The City plans to sue the Canton to get some of the lost revenues back.

The problems with debt service payment to foreign creditors in the Federation continue to be a major issue concerning local self-government units in the Federation (for every EUR that the Federation government decides to borrow, 60% of the costs of paying off the debt comes out of the budgets of cantons and municipalities). The problems with this system have become particularly apparent in recent years. During the global 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 some of these debt service costs are being born by the budgets of cantons and municipalities, they have seen their revenues from indirect taxes fall substantially, despite an overall improvement in the economy.The Association of Municipalities and Cities of the Federation of Bosnia and Herzegovina took a number of measures to try to discuss this issue with the Federal level. The next step of the Association will be to take the issue before the court.

## Statistical Overview of Local Government Finance in FBiH (of BiH) 2006-13

Local government revenues in FBiH (of BiH) peaked as a share of both the GDP and public revenues in 2008. Since then, they have declined substantially despite the fact that the economy has slowly recovered and total public revenues as a share of GDP have increased. Local government revenues as a share of total public revenues have fallen by more than 25% since 2008 (from 13% to 9%).

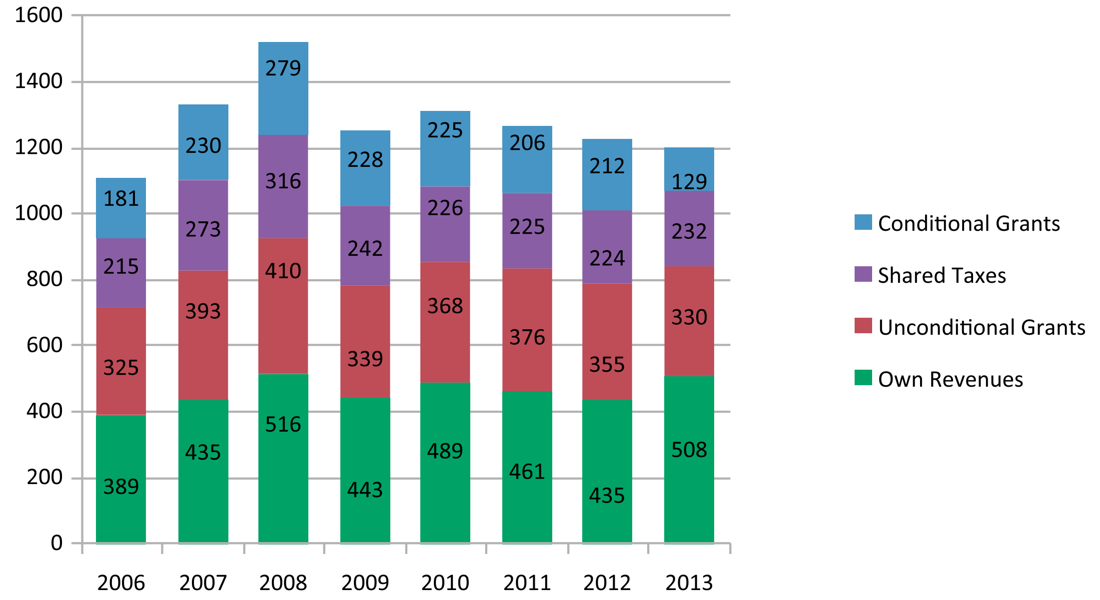
**Chart 1 FBiH (of BiH)** Local Government Revenue as Share of GDP and Total Public Revenue in 2006-2013




All categories of local government revenue declined significantly in 2009 in response to the contraction of the economy. In 2010, local governments intensified the collection of own revenues, and there was as increase in revenues from unconditional grants as the entity's share of indirect taxes went up. But there was no recovery in either conditional grants or more importantly in revenue from shared PIT, presumably because of higher levels of unemployment. Worse, in 2010-11, the yield of the general grant fell –in part because of the costs of servicing the entity's debt as discussed above.

## Chart 2 FBiH (of BiH)

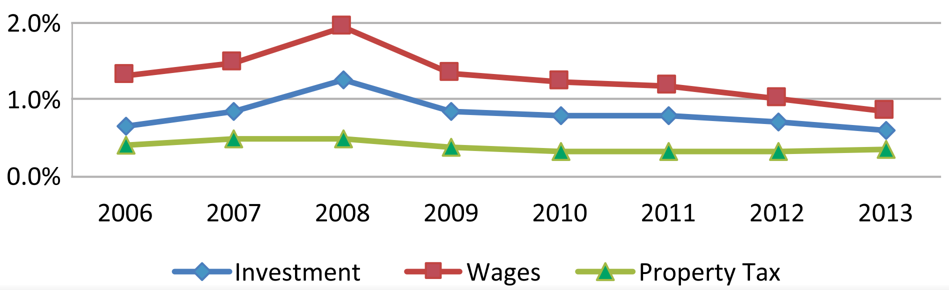
The Composition of Local Govrnment Revenue (mln EUR)




Local government spending on investment and wages has been declining since 2008. Indeed, wage spending is well below what it was at the begining of the period, and local government investment as a share of GDP is well under 1% of GDP. 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 declining. The accounting of local government debt remains problematic, but 2011 data suggest that it is under 1% of GDP. None of this bodes particularly well for the future, though the expected increase in the PIT share, and the current discussions about more fairly distributing the costs of servicing FBiH's external debt hold at least some promise for relief.

## Chart 3 FBiH (of BiH)

Local Government Wages, Investment, Property Taxes as % GDP 2006-2013



# Bosnia and Herzegovina – Republic of Srpska

As elsewhere in the region, Republic Srpska (RS of BiH) felt the economic crisis of 2008-2009. It experienced a recession in 2009, weak growth in 2010 and 2011, a second downturn in 2012, and the resumption of modest growth in 2013. The poor performance of the economy has negatively impacted local finances. Most importantly, the recession sharply reduced the size of the General Grant which is tied to the national yield of VAT. The national government has also reduced earmarked grants by 50% since 2008.

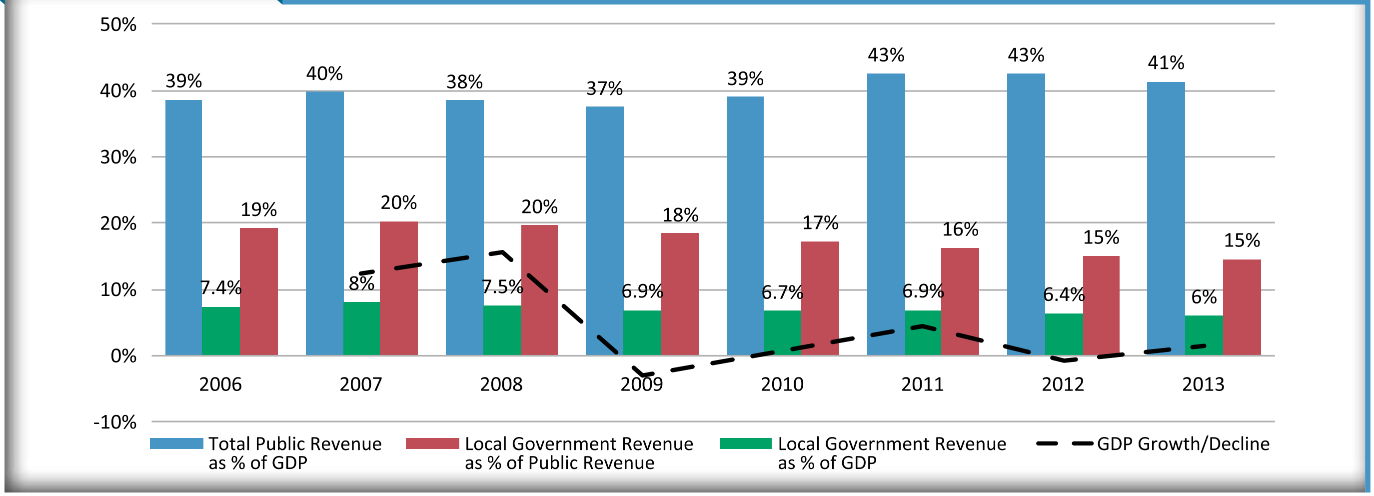
Further complicating the situation is the new Property Tax Law, passed in late 2009, but implemented only in January 2012. The Law created a centralized fiscal cadaster and transferred responsibility for billing and collection – though not rate setting—from local governments to the entity. But this has not led to an improvement in collection. Instead, it has declined because of the self-registration of citizens, complicated forms, and a payment system that allows people to pay their taxes in the following year.

In 2011, the entity finally transferred ownership rights of public utilities to local governments. Now local governments can more effectively influence the policies of local utility companies. However, most of these companies need much new investment and many were transferred with significant debts. As a result, a large number of local governments have had to borrow to pay off these debts and some of them have now reached their borrowing limits under the law. Local government revenues have also been reduced by amendments to the Law on Business Registration which reduced the annual Business Registration Fee (Sign Tax) from 400 to 500 EUR a year to 70-100.

## Statistical Overview of the Finances of Local Governments in RS (BiH)

Local government revenues as a share of GDP have declined from a peak of 7.5% in 2008 to 6.0% in 2013. Over the same period, local government revenues as a share of total public revenues declined 25%, suggesting that the entity government has placed a disproportionate share of the burden of fiscal adjustment on local governments.

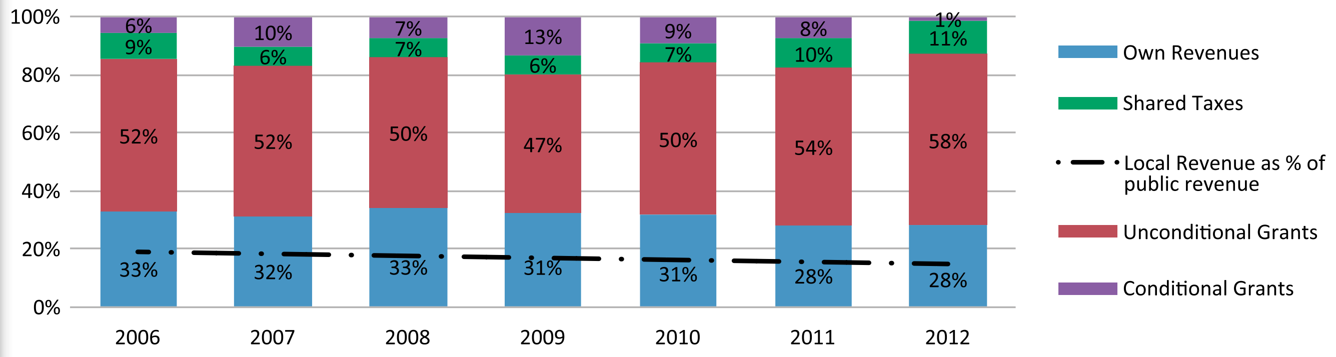
**Chart 1 RS (of BiH)** Local Government Revenue as Share of GDP and Total Public Revenue 2006-2013



Local governments are heavily dependent on the unconditional grant they receive from the entity government and which now constitutes 60% of their revenues. Between 2006 and 2013, own-revenues have declined as a share of local budgets.

Chart 2 RS (of BiH)

Composition of Local Government Revenue 2006-2012




Over the last few years, investment spending as share expenditure has fallen while spending on wages has increased.

Chart 3 RS (of BiH)

Composition of Expenditures in 2006-2013

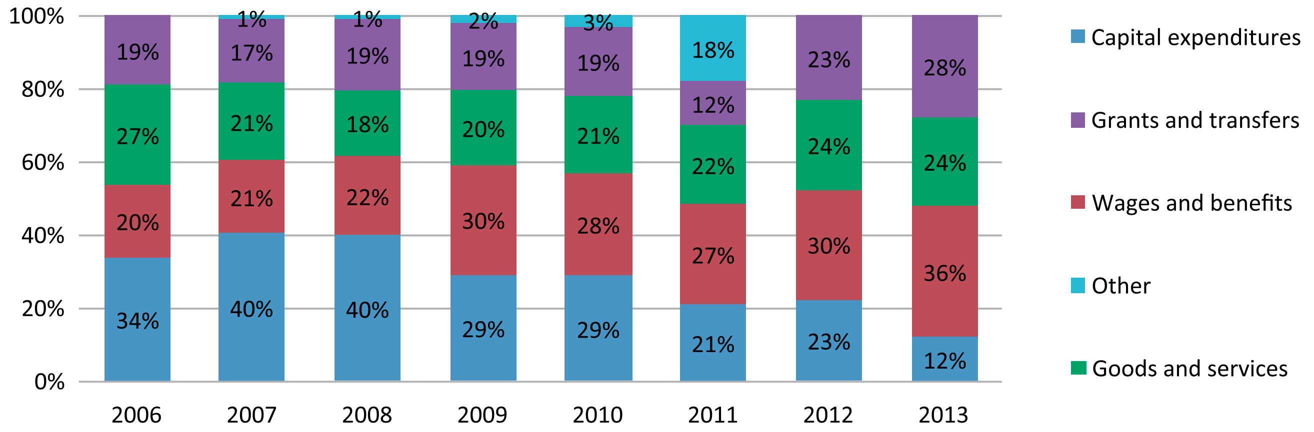
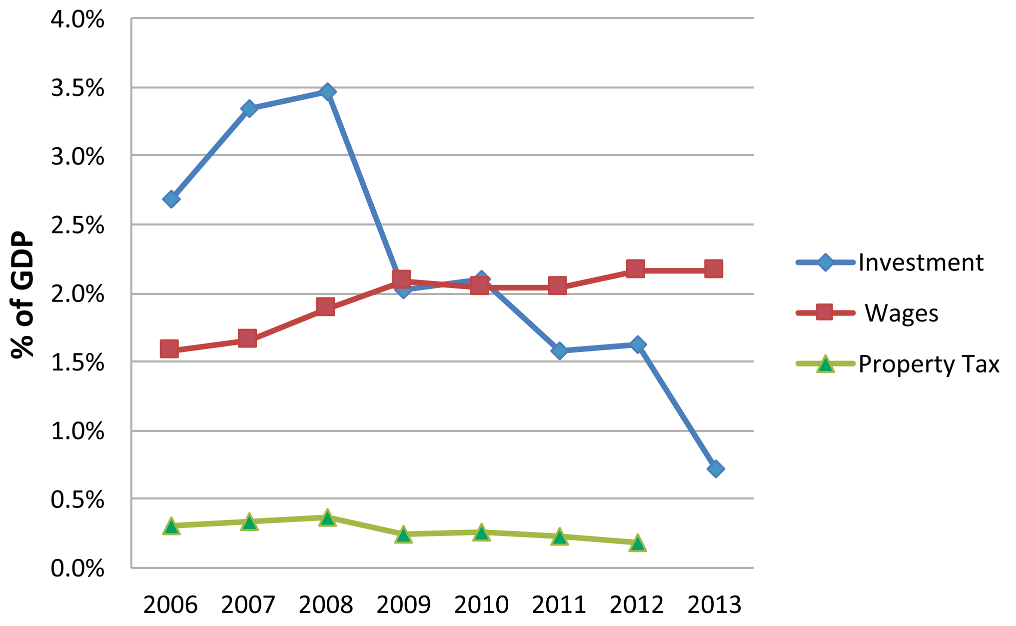


Chart 4 RS (of BiH)

Investment, Wages, and Property Tax as Share of GDP 2006-2013



# Bulgaria

## The effects of the economic crisis

Within the public sector, the effects of the economic downturn have been 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. Since then, and despite a modest increase in economic activity, the financial situation of municipalities has been "frozen" at 2010 levels.

As a result, in 2013 local governments disposed of nearly 25% less revenue than in 2008. This has resulted in:

- Overdue liabilities at around 100 million EUR (10% of municipal own revenues).

- Underfunding of delegated social welfare functions, which account for 60% of municipal expenditures and should be 100% funded by state transfers.

- 40% of local governments face a permanent shortfall of local revenues vis-à-vis their mandatory expenditures of about 100 million EUR;

These shortfalls are in turn putting pressure on the ability of local governments' to meet their co-financing requirements for EU funded projects, which currently stand at around 140 million EUR.

## The effects of the EU membership at local level

Bulgaria joined the EU in 2007 and by the end of 2013 local governments had signed 3,800 EU-funded contracts worth almost 5 billion EUR (of which grants account for 4.7 billion EUR). These contracts are mostly for environmental, social, and technical infrastructure. Municipalities are the beneficiaries of over 60% of all EU financial support and almost all of their investments come from this source.

In October 2013, the National Association of the Municipalities of the Republic of Bulgaria (NAMRB) signed its traditional agreement with the government that had been elected in June. This agreement calls for restarting the decentralization process in accordance with a two-year roadmap that the government adopted in February 2014. The roadmap outlines the following reform measures:

- Transferring a portion of the personal income tax (PIT) to the local level. As a result, citizens would pay a 7% PIT rate to the national government plus up to a 3% rate to their local governments based on their tax policies. This change should go into effect in 2015 and should double local government tax revenues while keeping the overall fiscal burden on citizens the same.

- Introducing a facultative municipal sales tax on the consumption of luxury goods and services (similar to the American sales tax).

- Introducing a local tax on agricultural land (currently non-taxable).

- Reshaping the equalization subsidy.

## Equalization

In 2003, amendments to the Municipal Budgets Act (MBA) introduced a clearer division of the responsibilities for financing local government own and delegated function. For delegated functions, costing standards were introduced. These are used to calculate the block grants that local governments receive from the national government. Own revenues are funded by own source revenues, but are supplemented by an equalization grant. 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 NAMRB. These criteria should reflect the objective disparities among municipalities due to external factors, and should act as a disincentive for local revenue mobilization.

Over the years the criteria for allocating the equalization subsidy have been changed repeatedly. Currently the allocation formula has two distinct components. The first component 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 the amount of the grant each municipality is entitled to receive can be reduced by up to 25% depending on how its local tax rates compare to the national average.

The second component allocates the amount of funds that remain in the grant pool after the first component has been paid out 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 local government's area in square kilometers. 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' position is that despite efforts to improve equalization, the methodology being used has serious shortcomings in as much as that it is still not based entirely on criteria that are fully independent of local government decisions, and thus can be "gamed".

## New public investment program (PIP)

The 2014 state budget created a new public investment program called "Growth and Sustainable Development of Regions". For the first time, local governments and ministries will compete for investments resources according to publicly defined selection criteria. The application process started in February, 2014, and 70% of municipalities were granted 145 million EUR for nearly 400 investment projects.

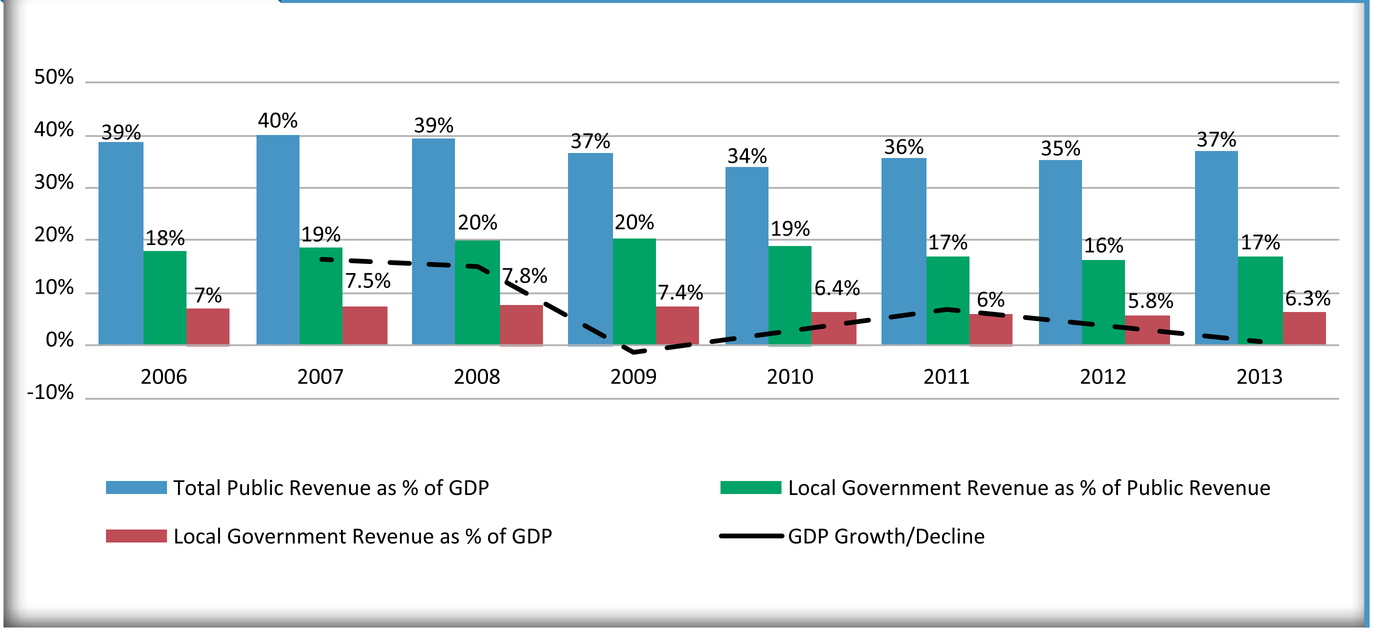
## New waste disposal fee base

By the end of March 2015, a new way of setting the waste disposal fee should be developed by NAMRB and proposed to Parliament. The idea is to eliminate the use of property values as the base for setting the fee and to promote a system that better reflects the linkage between generated garbage and the individual polluter.

# Statistical Overview of Local Government Finance in Bulgaria 2006-2013

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 6.3% in 2013. The local share of total public revenue also fell from 20% to 16% during the same period. This is low given that Bulgarian local governments are responsible for all aspects of pre-tertiary education, functions which usually account for between 2.5 and 4.0% of GDP and 12 to 20% of public expenditure. It also suggests that the national government is not living up to its obligations under the European Charter to provide local governments with revenues commensurate with their responsibilities.

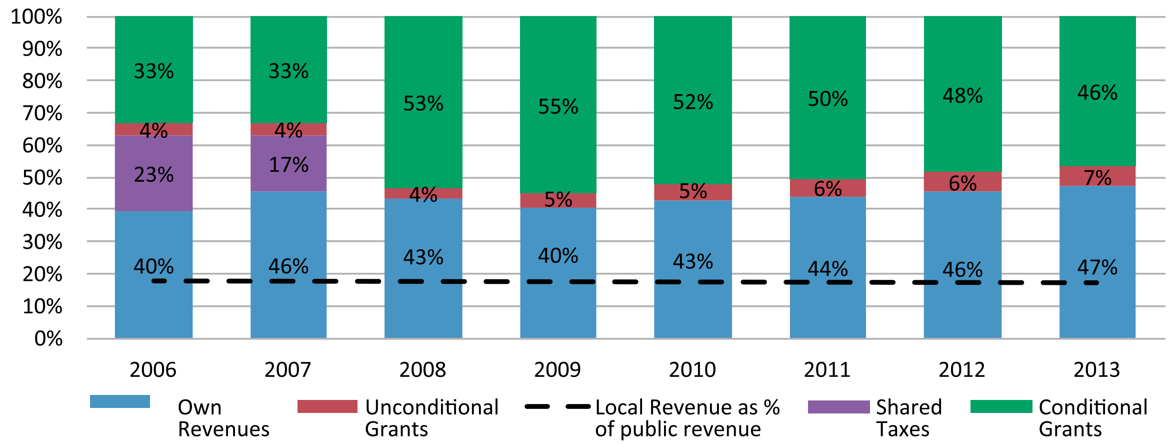
**Chart 1 Bulgaria** Local Government Revenue as Share of GDP and Total Public Revenue in 2006-2013




In 2008, Bulgaria replaced PIT sharing with a much larger set of conditional grants for social sector responsibilities. Since then the composition of local government revenues has been dominated by own revenues and conditional grants, almost 80% of which are for education.

## Chart 2 Bulgaria

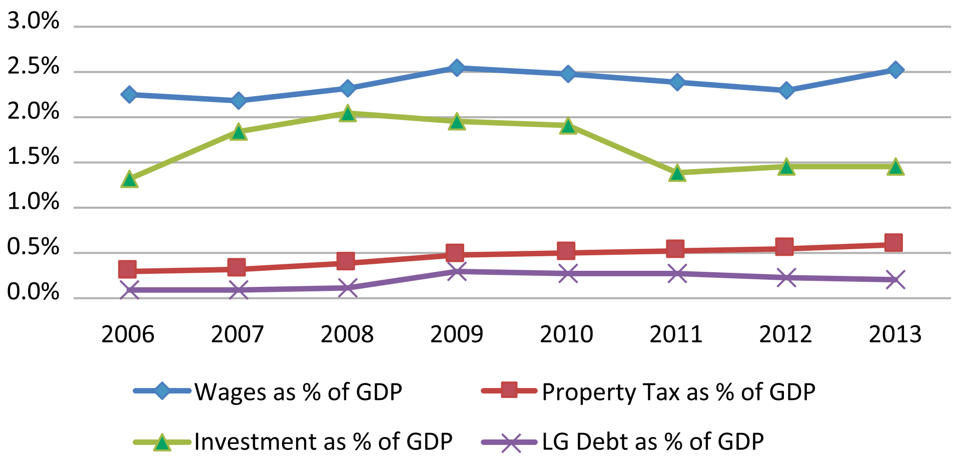
Composition of Local Government Revenue 2006-2013




Since 2006, Bulgarian local governments have doubled the yield of the property tax as a percentage of GDP. Investment dropped sharply with economic crisis of 2010 and has yet to recover. Wage spending fell less sharply and in 2013 returned to pre-crisis levels. The total outstanding debt of local governments has risen, but remains well under 1% of GDP.

## Chart 3 Bulgaria

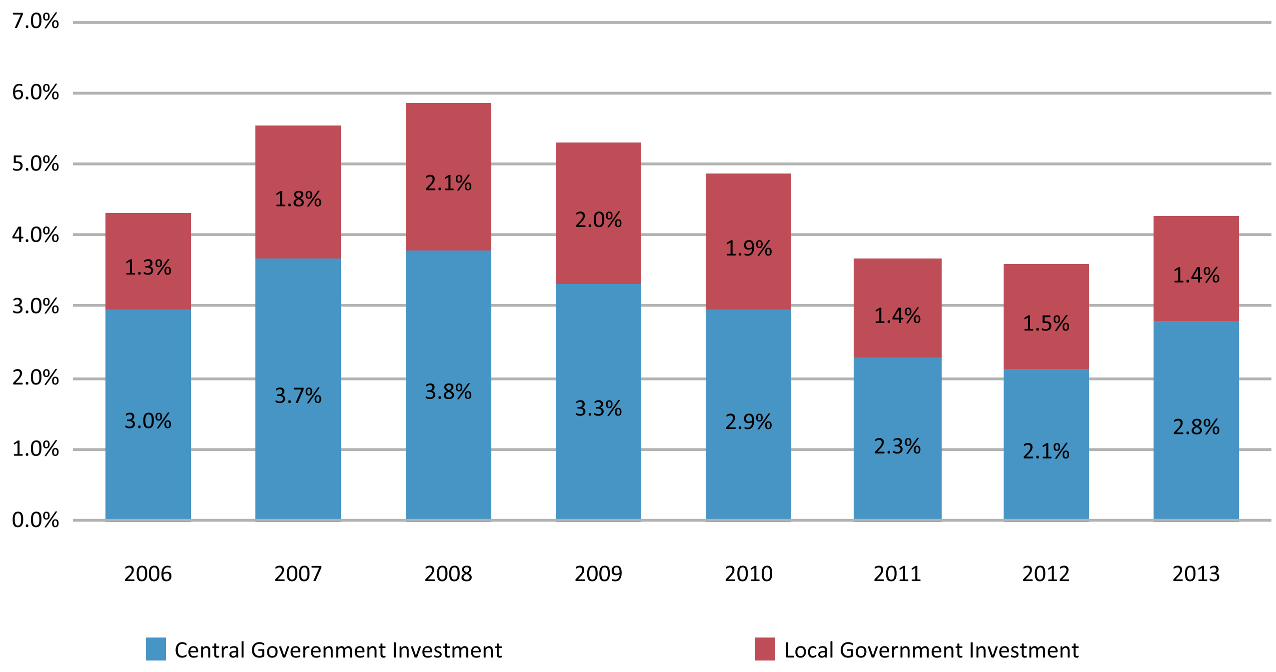
Local Government Wages, Investment, Property Taxes and Outstanding Debt as % GDP 2006-2013




Since 2008, local governments have accounted for between 30 and 40% of all public investment since 2008.

**Chart 4 Bulgaria**

Public Investment as a Share of GDP by Level of Government, 2006-2013



# Croatia

As a result of the economic crisis, local government revenues, expenditures and investments in Croatia have decreased. Many of the 555 local governments (without Zagreb) increased their budget deficits and borrowing. In 2010, measures aimed at improving the efficiency of the use of public revenues began to be 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 the use 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.

Between 2006 and 2013, there were no major changes in the territorial boundaries or service responsibilities of local governments. There have however been some important changes in the tax system. The basic rate for VAT was increased from 23% to 25%, though a lower rate of 10% was introduced for some foods. Of more importance to local governments were changes in the Personal Income Tax. The number of tax brackets was reduced from 4 to 3 and the base rate was lowered from 15% to 12%. 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.

Croatia has been considering the introduction of a local property tax for many years, but this has still not happened. If a local property tax is implemented the so-called local utility charge will be eliminated (elsewhere in the region, the land use charge).

In 2012, a fee for the legalization of illegal buildings was introduced. Building owners are now required to pay a fee for the legalization 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.

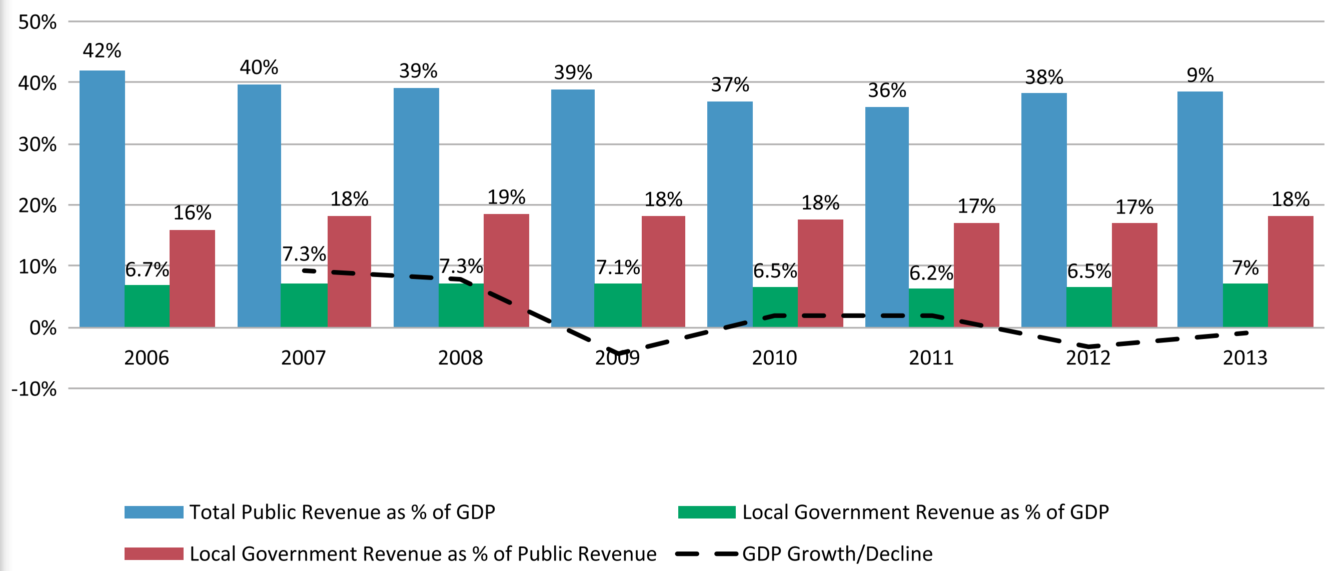
Due to changes in EU regulations, a Law on Sustainable Waste Management was introduced in 2013. Local governments are now obliged to finance the recycling and sorting of solid waste from their own sources and through the tenders of the Fund for Environmental Protection and Energy Efficiency.

# Statistical Overview of Local Government Finance in Croatia 2006-2013

Local government revenue as a share of GDP contracted significantly in the years immediately after the economic crisis of 2009. Their share of total public revenue however remained reasonably stable, suggesting that the national government did not try to disproportionately push the costs of onto local governments.

## Chart 1 Croatia

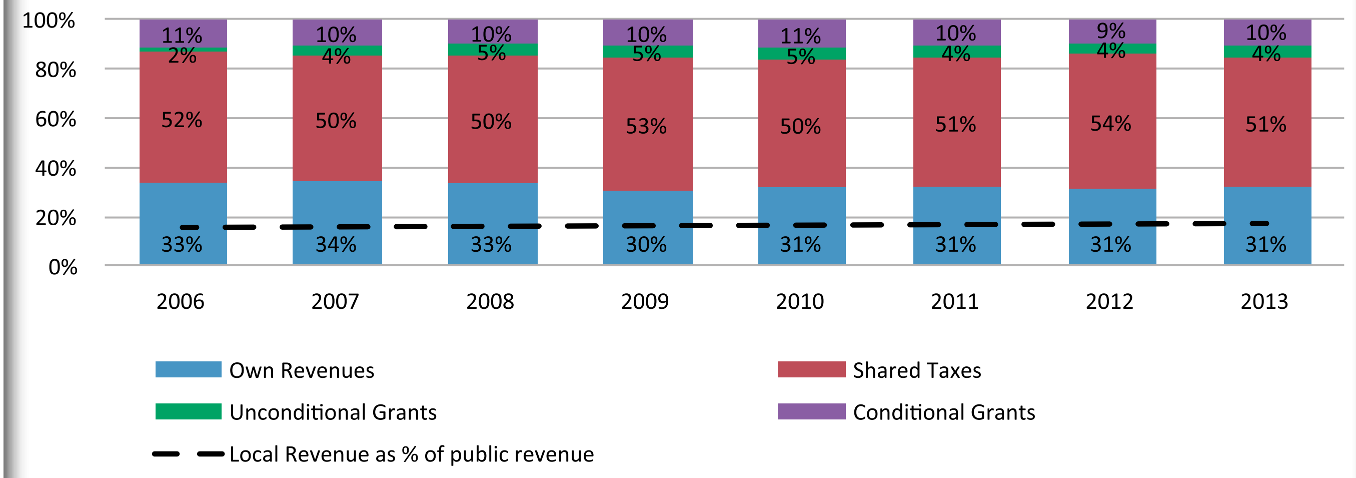
Local Government Revenue as Share of GDP and Total Public Revenue in 2006-2013




Between 2006 and 2013 there has been little change in the composition of local revenue, which remains dominated by shared taxes. Croatia has yet to introduce a local property tax, and local governments have relatively little control over other fees and charges. They can however impose PIT surcharges. This revenue is freely disposable and legally considered an own revenue, but is still accounted for as shared-tax in Croatia's public accounts.

## Chart 2 Croatia

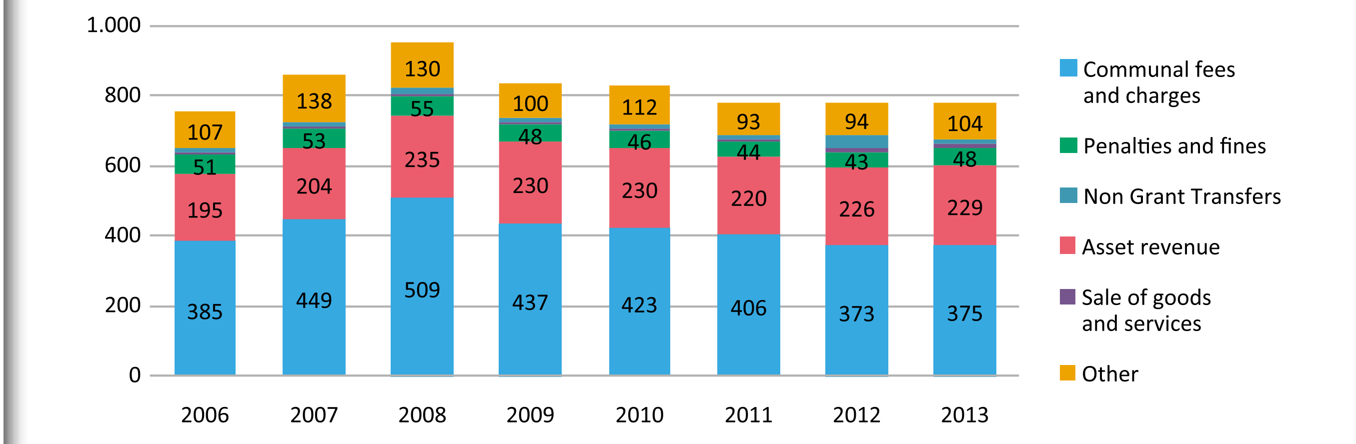
### Composition of Local Government Revenue 2006-2013




Local own-revenues in have declined since 2008 and there is little evidence that the economic downturn has led to greater local revenue collection.

## Chart 3 Croatia

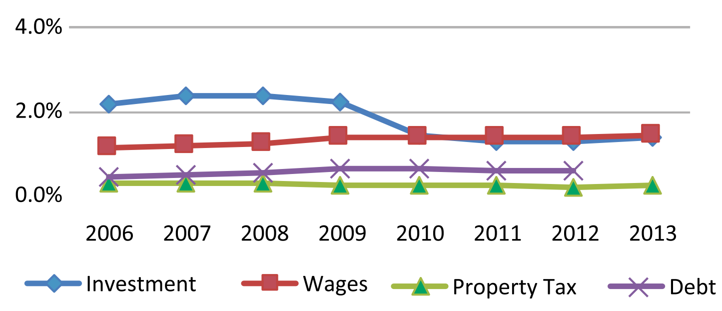
### Local Government Own-Revenue 2006-2013 in mln EUR




Local investment fell substantially in 2010 and has yet to recover. Wage spending has increased slightly but remains low. Local borrowing remains low.

## Chart 4 Croatia

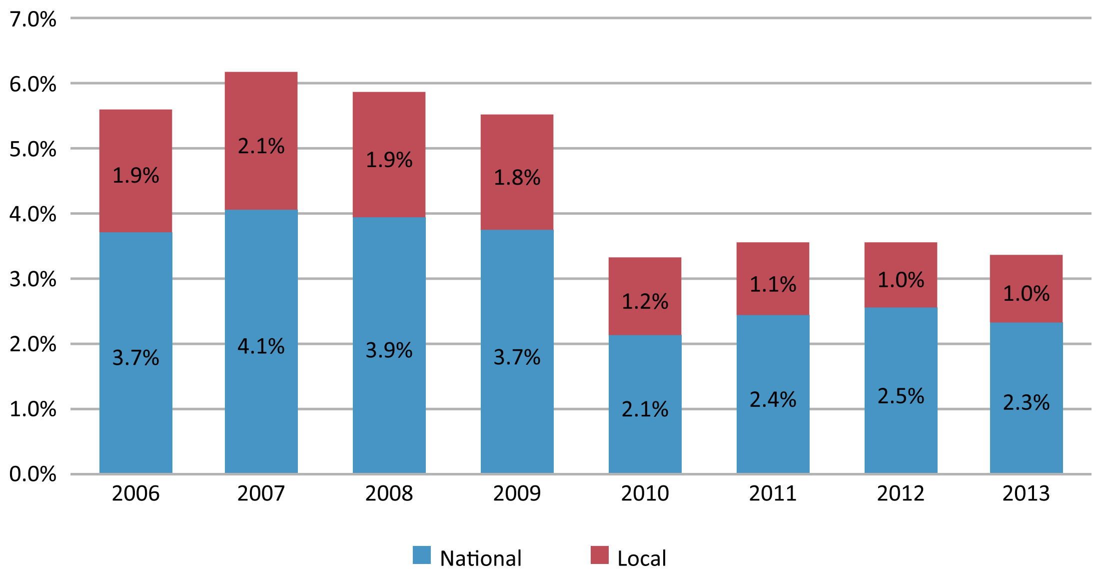
Local Government Wages, Investment, Property Taxes and Outstanding Debt as % GDP 2006-2013




Total public investment has fallen by almost half since 2009 at both the national and local government levels. But the share of total public investment made by local governments has remained reasonably stable at between 30 and 35%.

## Chart 5 Croatia

Public Investment as a Share of GDP by Level of Government, 2006-2013



# Kosovo

The global financial crisis of 2009 did not precipitate a recession in Kosovo and while growth has slowed 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 April of 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. This Fund will be financed from customs duties from the border with Serbia. To date 400,000 EUR have been placed in this 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 in Kosovo. A separate law for the Capital City of Pristina is however, being considered.

Local governments in Kosovo derive their revenues from four basic sources: Own-revenues (c.17% of total revenues); a General Grant (c. 34%), an Education Grant (c. 38%) and a Health Care Grant (c. 10%). All of these grants have an equalizing effect on local government revenues, though only a few of their provisions are specifically designed for this purpose.

The size of the General Grant is defined by law as 10% of the total operating revenues of the national government. All local governments receive a lump sum payment of 140,000 euro minus one EUR per capita for all local governments with populations of less than 140,000, and zero EUR per capita for all local governments with populations of greater the 140,000. What is left of the grant pool is then divided to municipalities in accordance with a formula: 89% by population, 6% by square kilometers; 3% by number of ethnic minorities; and 2% for municipalities in which the majority population is a national minority.

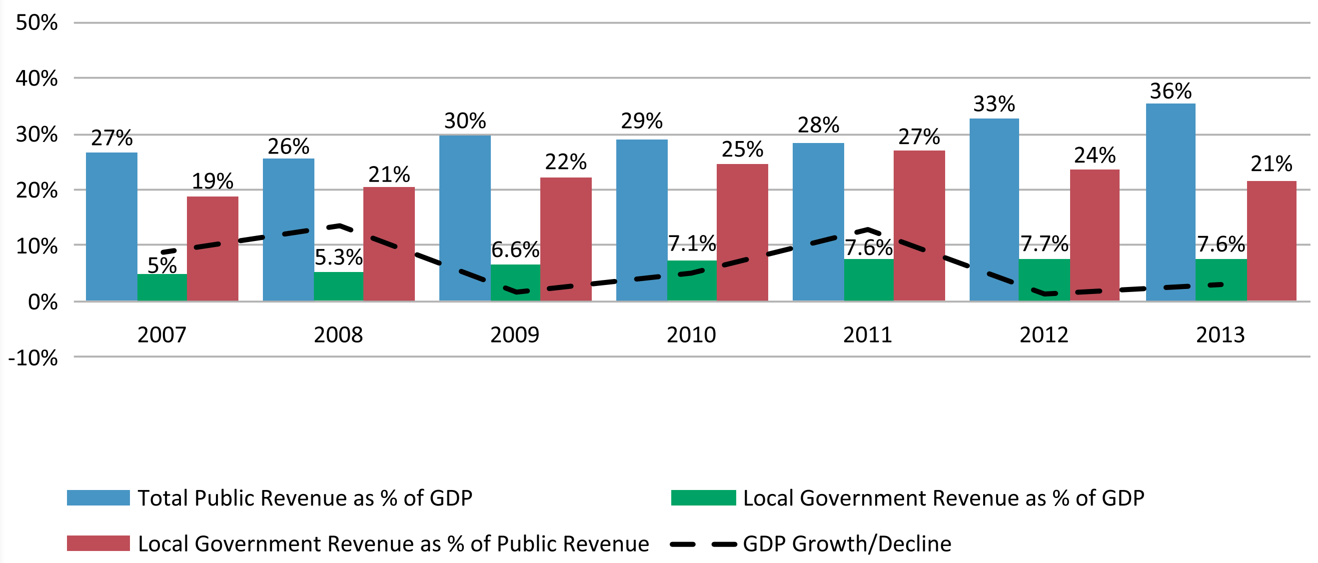
The size of the Education and Health Grants is determined by a national Grants Commission in accordance with a Medium Term Expenditure Framework (MTEF). The education grant is allocated to local governments on the basis of a formula that takes into account the wages of teachers and administrative and 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 the number of a local government's inhabitants. 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.

# Statistical Overview of the Finances of Local Governments in Kosovo

Local revenue as both a share of GDP and total public revenues increased steadily between 2007 and 2011 and has since leveled-off. This growth has been driven by both increased transfers for newly devolved responsibilities in health and education as well as by increases in the collection of own revenue. Given the relatively small size of the overall public sector, it is particularly striking that such a high share of total public revenues has been allocated to municipalities. Local governments in Kosovo however have yet to be able to access debt capital.

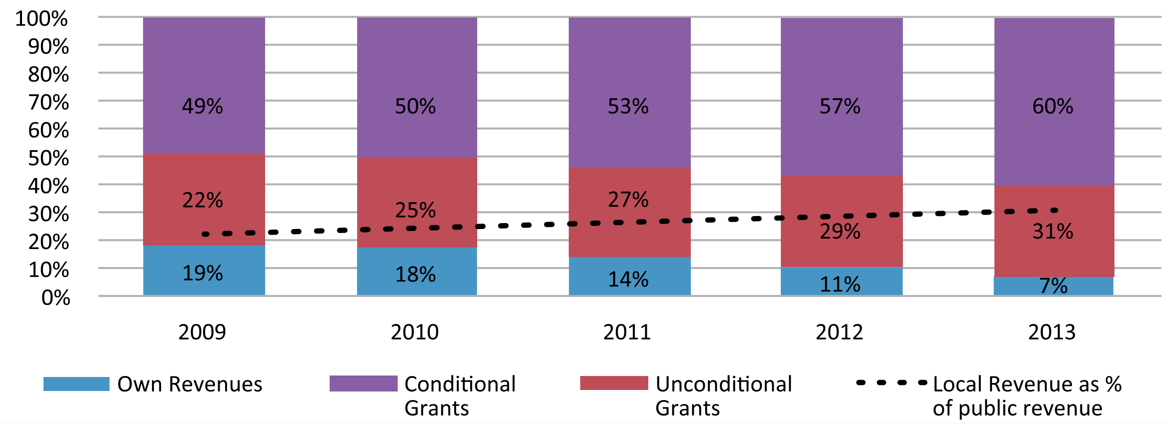
**Chart 1 Kosovo** Local Government Revenue as Share of GDP and Total Public Revenue 2007-2013




Close to two-thirds of local revenue in Kosovo comes from conditional grants for health and education. The national government has increased the size of these grants as new responsibilities have been devolved to local governments. But the amount of control that local governments have over these funds even within their respected sectors remains limited.

## Chart 2 Kosovo

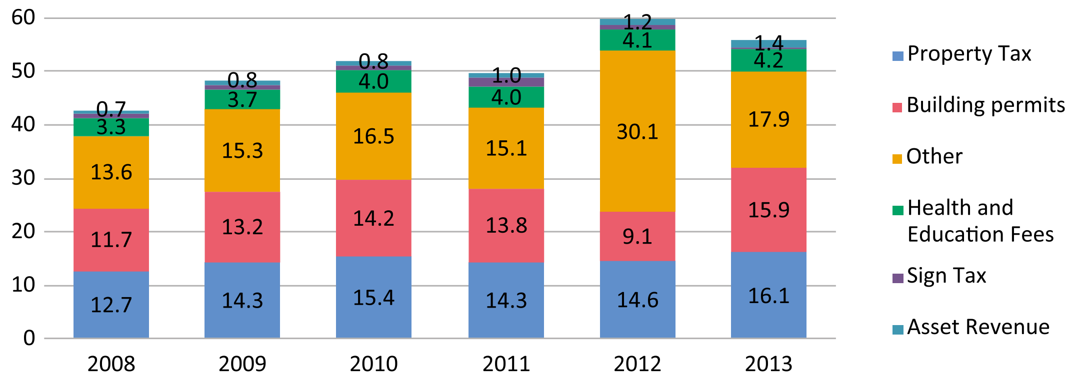
Composition of Revenue 2009-2013




Own-source revenue increased by c. 30% between 2008 and 2013. The two most important own revenues are the property tax and building permits. The yield of the property tax has increased modestly, but not as a share of GDP. Building permits in Kosovo function much like the Land Development Fees in of the rest of the region. In 2011, legislation was passed to eliminate the quasi-fiscal use of building permits by putting them on strictly reimbursment basis. Income reported under this category declined in 2012, but in fact local governments simply classified it as other revenue. In 2013 the restriction on the pricing of building permits were loosened and revenue in the category increased.

## Chart 3 Kosovo

Composition of Own-Revenue 2008-2013 (mln EUR)




Rather remarkably Kosovar local governments have devoted almost 35% of their total expenditure to investments, despite spending more than 50% of their budgets on wages.

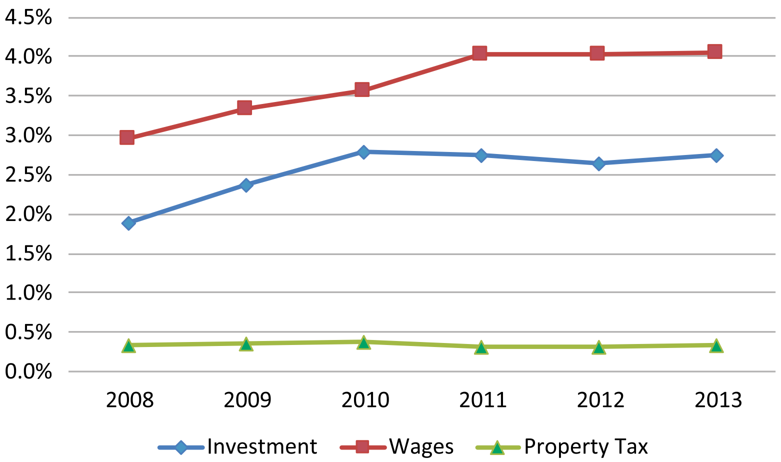
## Chart 4 Kosovo

Composition of Expenditures in 2008-2013 (mln EUR)


In recent years, wage spending has grown faster than investment as a percentage of GDP. The yield of the property tax has not improved despite very serious efforts of the national government to build a national fiscal cadaster and to improve billing.

## Chart 5 Kosovo

Investment, Wages, and Property Tax as a Share of GDP 2006-2013



# Macedonia

As a result of the Ohrid Agreements of 2001, and as part of the country's effort to accede to the European Union, Macedonia introduced changes in the laws governing local governments. The number of local governments was reduced from 124 to 85 in 2005, and then to 81 in 2013 as a result of changes in the Law on Territorial Organization. Beginning in 2007, local governments that had cleared all outstanding arrears and met other criteria for good financial management were allowed to enter the so-called Second Phase of Decentralization. At this point, they began to receive block grants from the national government to cover their radically expanded responsibilities with respect to primary and secondary education, as well as for some cultural and social welfare institutions. As of today, only one municipality has not entered into the Second Phase of Decentralization.

As a result, Macedonian municipalities have progressively assumed responsibility for the maintenance and 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, local governments derive revenues from:

- Own Revenues, including the Property Tax, other local fees, charges and taxes, asset income and income from fines, penalties and donations;
- Shared Taxes, in particular a share of the income tax coming from artisans;
- 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 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, though it fell back to 5.9% in 2013. Despite this radical increase in revenues, Macedonian municipalities still face profound financial challenges. 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 has been increased from 3% to 4.5%, and will be progressively increased to 6% in accordance with the agreement reached with ZELS;
- The share of income from the sale of state-owned land going to municipalities has been increased to 80%;
- The share of income from minerals concessions going to municipalities was increased to 78%;
- The municipal share of revenue from other concessions (e.g. water) will be increased from 25% to 50% in 2016;
- Revenue from fees for washing and separating gravel are now split 50%/50%;
- Revenues from fees for legalizing illegal structures built on agricultural state land are now split 50%/50%;

- Revenues from fees for legalization will now go entirely to municipalities;

- Starting in 2015, 10% municipalities will receive 10% of concessions on agricultural land, a share that will be increased to 50% by 2018.

Municipalities receive block grants for primary and secondary education, kindergatens, and culture. For these competencies they receive monthly transfers designed to cover the salaries of employees and other operating costs. The transfers depend on dynamics agreed upon by the Ministry of Education, Ministry of Labor and Social policy, Ministry of Culture with the Ministry of Finance.

Municipalities are notified about the total amount of their block grants through the Budget Circular, a document defined by the Law on the Financing of LSG, and submitted to municipalities every year by the Ministry of Finance. Municipalities are autonomous in managing the funds they receive through the block grants. Based on the criteria determined by municipalities and approved by their City Councils, they allocate these funds to schools and other institutions on a monthly basis.

For schools, the main criteria is enrollment, the number students registered in a school, (or other criteria which are determined by the City Council) the number of employees and the number of children who use free transportation in accordance with amendments for free transportation determined in the changes in the Law's for education in the Republic for Macedonia in 2009.

## Equalization Instruments

The criteria used to allocate the General Grant have an equalizing effect. The size of the General Grant is anchored by law at 4.5% of the national yield of VAT. The criteria to allocate the grant are defined by an annual ordinance of the government according to the following rules:

- All jurisdictions receive a lump sum payment of 3 million denars;

- The costs of these payments are deducted from the grant pool and the residual is then divided between the capital city of Skopje and its composite jurisdictions (12%) and all other municipalities (88%);

- The funds for municipalities outside of Skopje 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 block grants also has implications for equalization. The allocation of the education grant is governed by an annual ordinance which determines the amount of funds each local government will get for pupils enrolled in primary and secondary school and for pupils with special needs. The formula for determining these per pupil payments are publicly available, but the amount of money that municipalities receive through the grant is insufficient and to be increased by the national government.

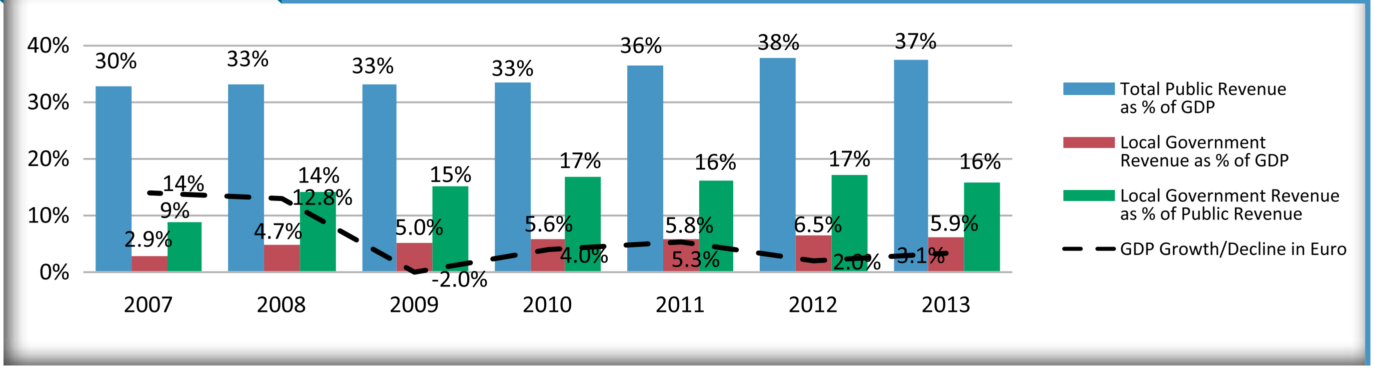
The allocation of the block grant for preschool education is also governed by an annual ordinance. The formula in this ordinance contains variables for the number of pupils in the school, for the type of heating in the school and the duration of the heating system, the number of teachers in the school, 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. As with the other block grants, the rules governing the allocation of the grant for culture are determined by an annual ordinance of the national government.

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.

# Overview of Local Government Finances in Macedonia

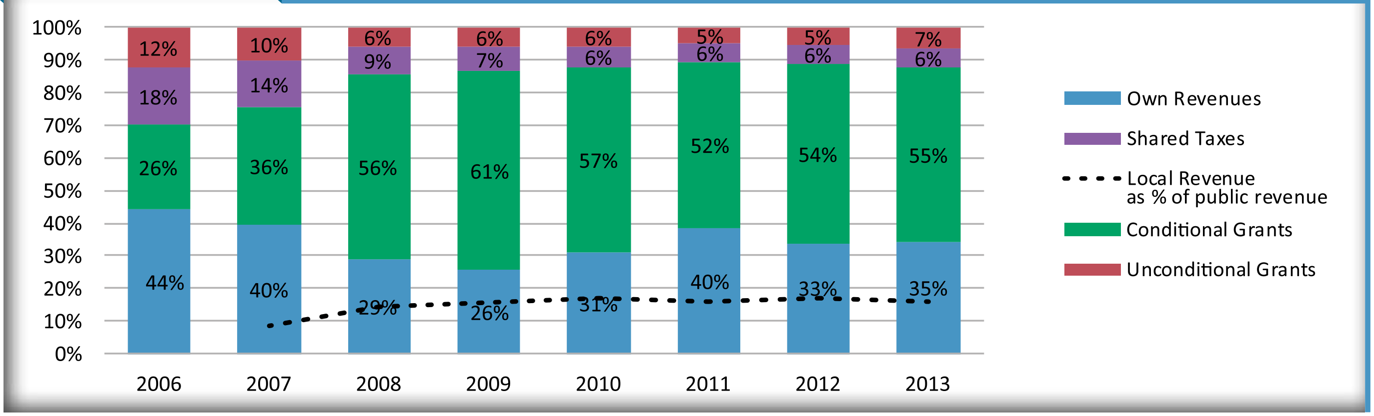
Of all the countries in the region, Macedonia has undergone the most structural change over the last eight years. This change has been driven by the progressive decentralization of major social sector functions to local governments ---particularly primary and secondary schools. This process has significantly increased local revenue as a share of both GDP and of total public revenue.

**Chart 1 Macedonia** Local Government Revenue as a Share of GDP and Total Public Revenue in 2006-2013




Macedonian local governments derive modest shares of their revenues from shared taxes and unconditional grants. Their most important revenue is the block grant for block grant.

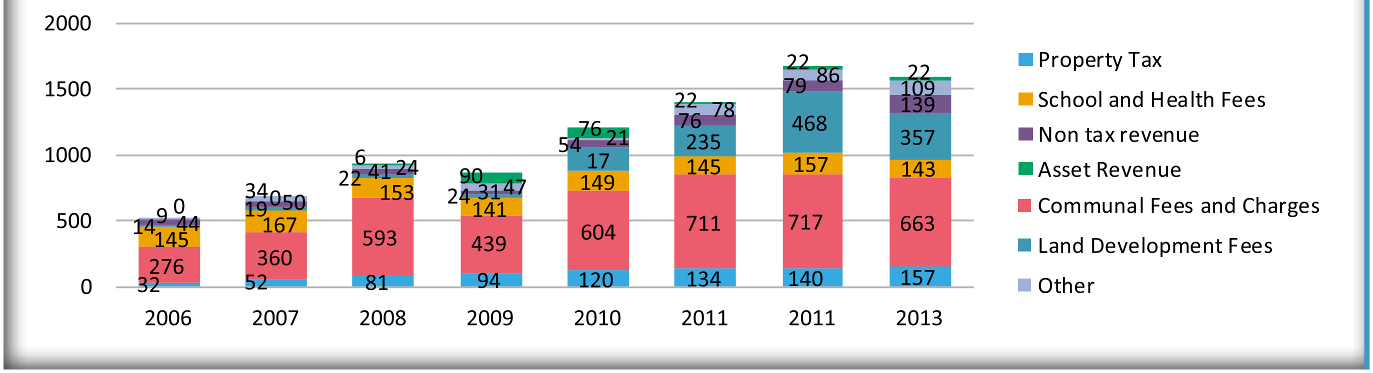
**Chart 2 Macedonia** Macedonia Composition of Local Government Revenues 2006-2013




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 argressively collecting Land Development Fees, Lighting Fees and other communal charges.

## Chart 3 Macedonia

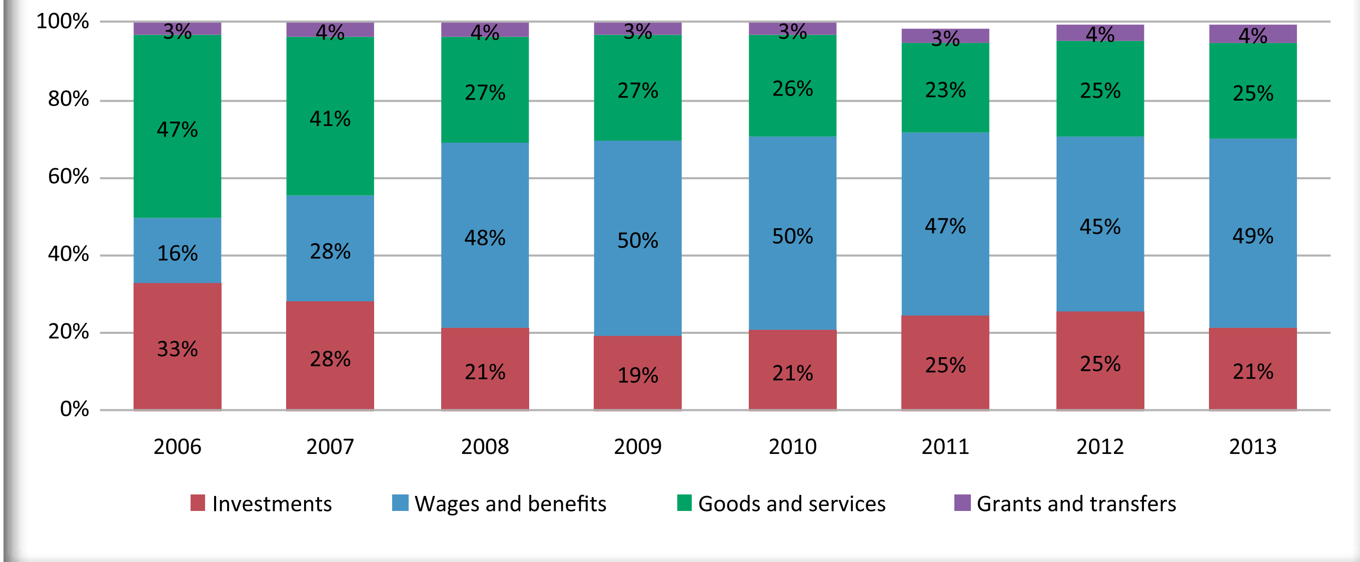
Composition of Own-Revenue 2006-2013 (mln EUR)




The share of local expenditures going to wages has increased steadily as local governments have assumed responsibility for primary and secondary education. Despite this wage growth, local governments have maintained respectable investment rates.

## Chart 4 Macedonia

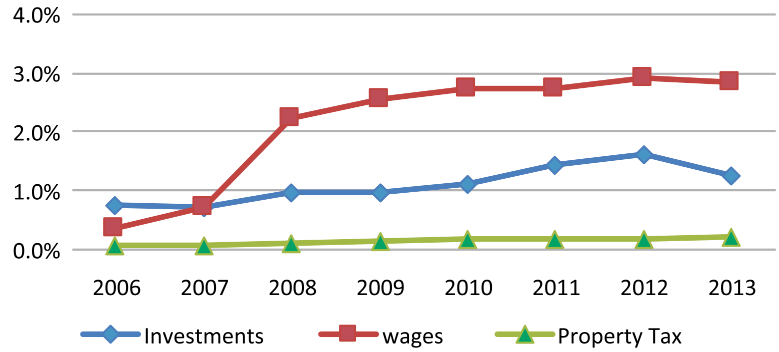
Composition of Expenditures in 2006-2012




Wage and investment spending as a share of GDP have expanded significiantly over the last eight years, while the property tax has increased more modestly and still only yields revenue equal to 0.2% of GDP.

## Chart 5 Macedonia

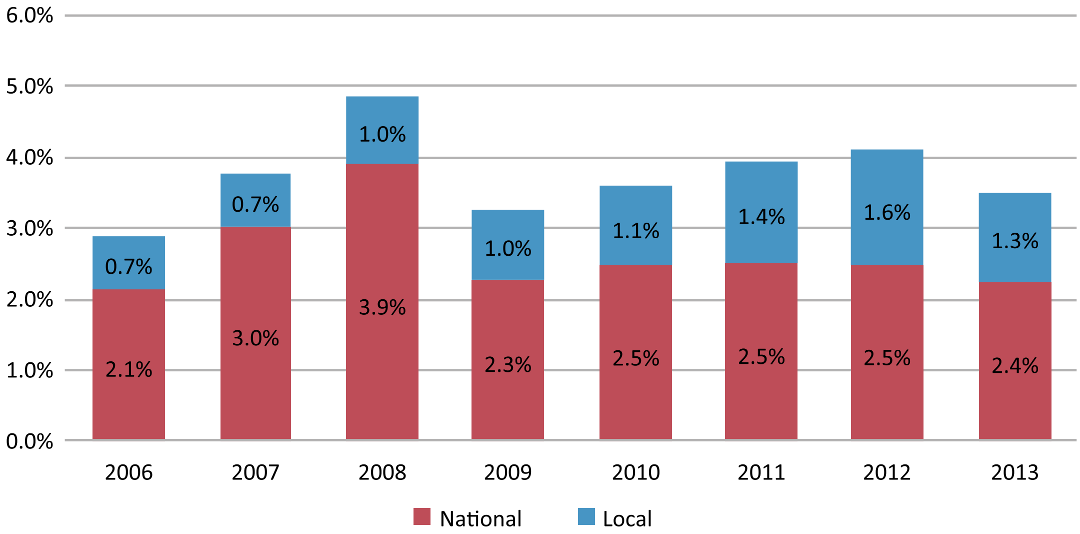
Investment, Wages, and Property Tax as Shares of GDP 2006-2013




The share of local public investment in total public investment as increased from about 20% between 2006 and 2009 to about 40% between 2010 and 2013

## Chart 6 Macedonia

Public Investment as a Share of GDP by Level of Government, 2006-2013



# Moldova

Moldova was not significantly influenced by the world crisis. In fact, through most of the period there has been impressive economic growth (5-7% yearly basis). But this does not mean that financial situation of local governments situation has improved. On the contrary, instead of moving forward with long-planned decentralization reforms, the Government reversed gears and has recentralized power in areas as diverse as local finance, public procurement, education and the police. In 2013, it also imposed new ceilings on almost all local taxes. Thus the rules of the game for local governments have become more restrictive against a background of unconstrained political patronage, non-transparency, and corruption.

The one bright spot is that in the spring of 2012 the Ministry of Finance –with the support of UNDP experts— submitted for discussion a "Concept for the Reform of Local Finances". Then, in September 2012, the Ministry prepared draft legislation based on a modified version of the Concept. This draft eliminates the financial subordination of lower-level local governments to higher ones, and with it hierarchical relations between 1st tier local governments, 2nd tier local governments and the national government. This reform is crucial for the country's democratization because local governments remain one of the few strongholds against authoritarian trends in society. It is also important for fighting corruption and improving the juridial system.

The suggested reform is based upon the following ideas:

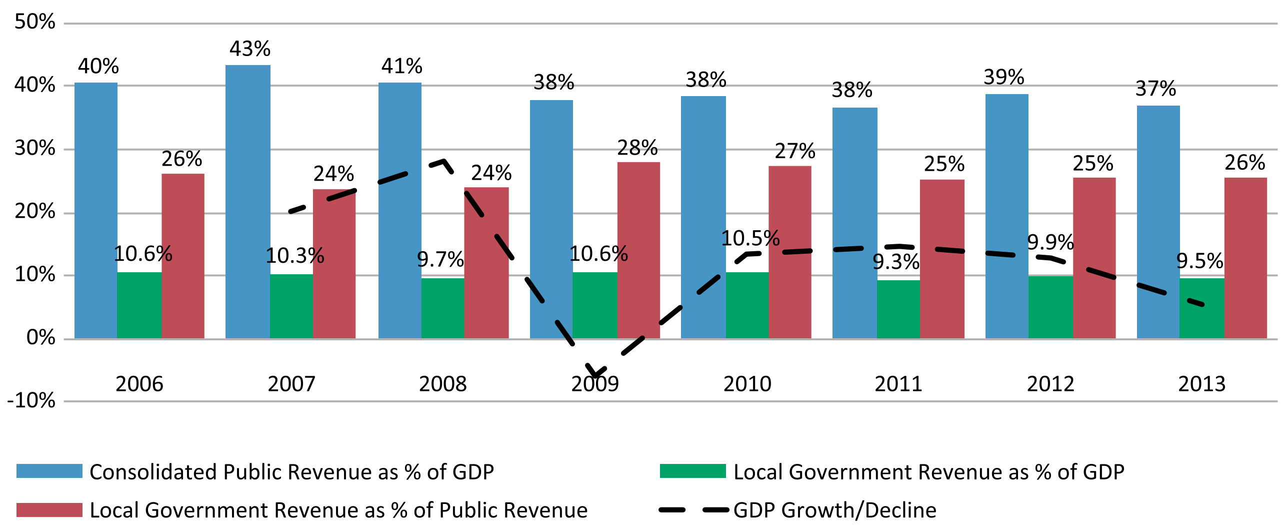
- It generally preserves the existing division of total public revenue between levels of government and is broadly speaking fiscal neutrality;
- In accordance with international standards, including the European Charter of Local Self-Government, the national government is expected to fully finance delegated functions and eliminate as much as possible unfunded mandates;
- 1st tier and 2nd tier local governments will each receive transfers directly from the national government, eliminating the financial dependency of former on the latter;
- Separation of freely disposable general grants from earmarked grants;
- Legally defining local governments' right to specific percentages of shared taxes;
- Eliminating disincentives for local revenue mobilization by tying basing the equalization system on shared taxes and not on locally collected taxes and fees.

Unfortunately, after the Moldavian Parliament approved the draft legislation, Moldovan politicians reversed their position because they were afraid of losing political, administrative and financial influence overs mayors and local officials on the eve of the 2014 national elections. Thus, the implementation of this legislation has been postponed will be left to the new government. 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.

# Statistical Overview of Local Government Finances in Moldova

On paper, Moldova has a highly decentralized system of public administration. Local government revenues equal about 10% of GDP and 25% of total public revenues –level close to the EU average. In reality, however, the situation is quite different because of the political and economic subordination of local 1st tier local governments to 2nd tier local governments and to the line ministries of the national government.

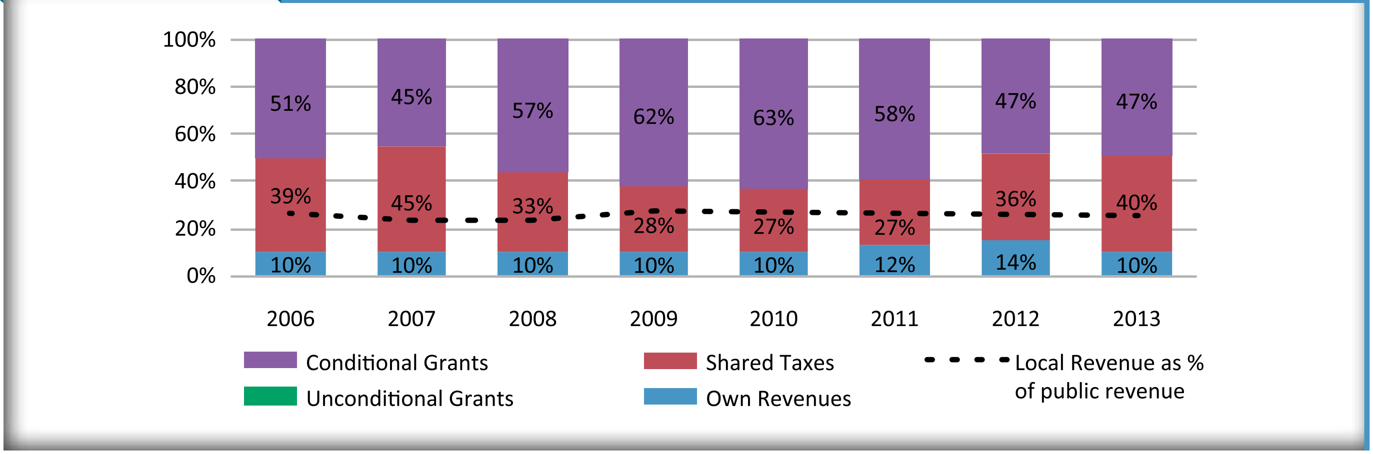
**Chart 1 Moldova** Local Government Revenue as Share of GDP and Total Public Revenue in 2006-2013




Moldovian local governments derive most of their revenues from conditional grants. Indeed, at the moment there are no unconditional grants in the system and no clear mechanism for horizontal equalization.

## Chart 2 Moldova

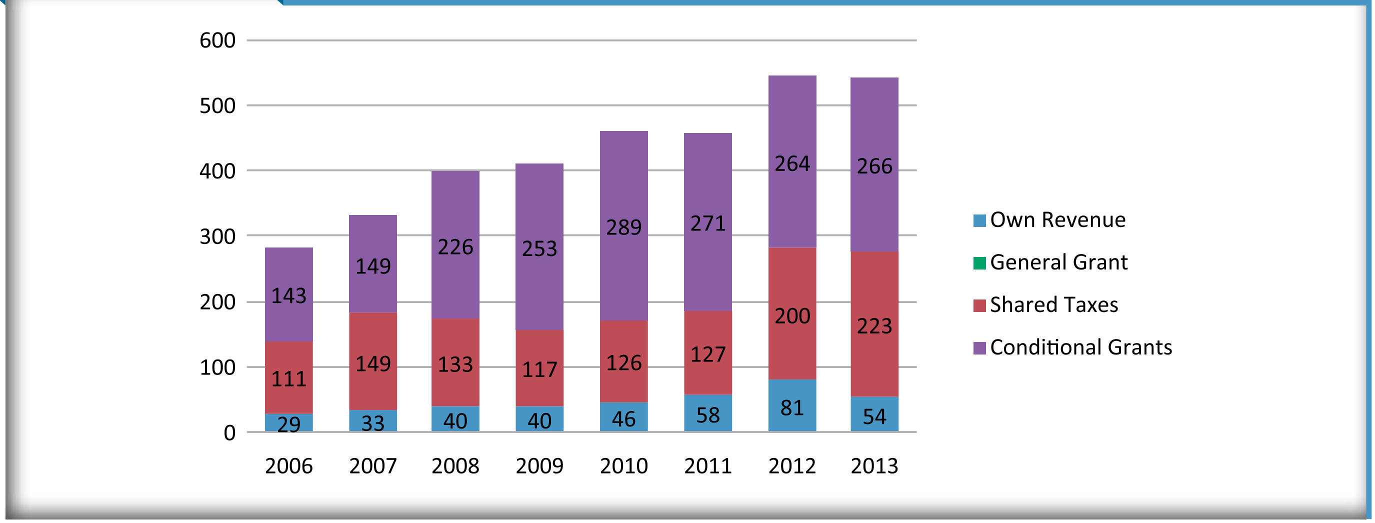
### Composition of Local Government Revenue 2006-2013




Local revenues increased steadily between 2006 and 2013. Between 2006 and 2011 the growth was driven primarily by increases in conditional grants. Since 2012 it has been driven by an increase in the rates at which PIT and CIT are shared with local governments. Own revenues have increased modestly but steadily over most of the last eight years.

## Chart 3 Moldova

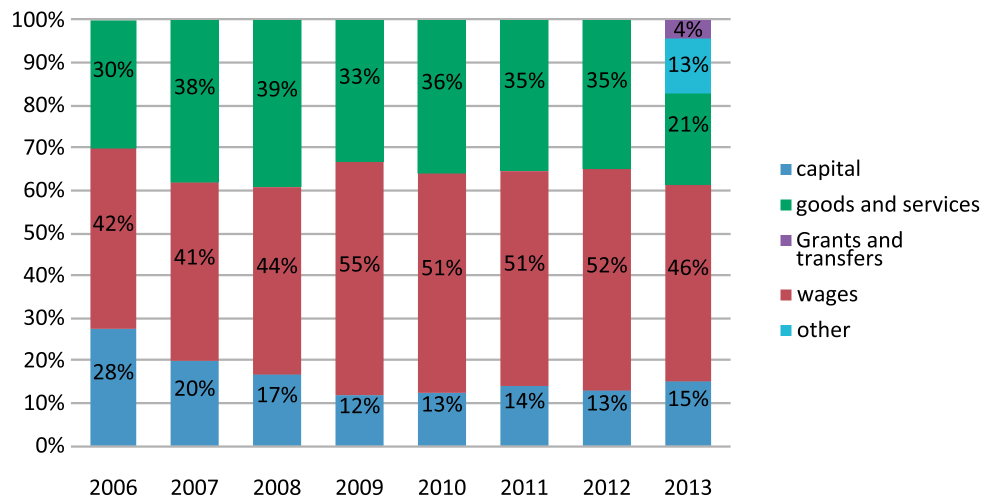
### Composition of Local Government Revenue 2006-2013 (mln EUR)




Despite the growth in local revenues, local government investment spending has declined significantly since 2006. This should be a serious concern for policy makers. Wage spending shot up in 2009 because of state mandated increases in teacher but have since fallen as a share of both local budgets and the GDP.

**Chart 4 Moldova**

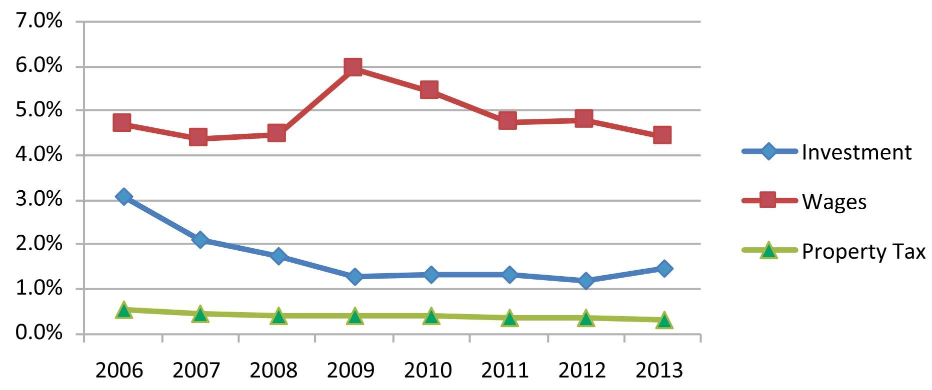
**Composition of Local Government Expenditures in 2006-2012**




The yield of the property tax has declined as a share of GDP. Local wages as a share of GDP are extraordinarily high.

**Chart 5 Moldova**

**Investment, Wages, and Property Tax as Shares of GDP 2006-2013**



# Montenegro

The “great recession” of 2009 had a strong impact on Montenegro’s public finances. Efforts to limit the effects of the crisis through countercyclical spending led to a sharp increase in the level of the public debt. The economic crisis also effected local governments. Like the national government, they borrowed heavily to limit the impact of the crisis. They also accumulated payment arrears to suppliers and contractors. So they too are now in a period of retrenchment, struggling to reduce overstaffing, collect revenues and decrease inefficiencies.

Since 2008, a number of local own-revenues have been reduced or eliminated. These include fees for: electrical transmission towers, telecom facilities, TV and radio receivers, land use and land development as well as the business sign and gambling taxes. In 2011, to compensate local governments for the loss, amendments were introduced into Law on Local Government Finance. These amendments increased the municipal share of PIT from 10% to 12%; the share of the Property Transfer Tax from 50% to 80%; and the share of concessions and other fees from 30% to 70%. They also increased the size of the Equalization Fund and changed the criteria for allocating it.

But the amendments came too late and the loss of own-revenues compounded the effects of the crisis. Indeed, it is one of the reasons that crisis produced such a sharp increase in local government debt and payment arrears. Moreover, they did not fully compensate local governments for the own revenues that had been lost, revenues, which were both more stable and robust than shared taxes. As a result, local government budgets have not recovered to pre-crises levels and the investment of boom the early years of the millennium are clearly over.

Most municipalities have reached their legal limits for incurring debt and many do not have enough revenue to finance all their obligations to banks, suppliers and the state budget. Indeed, payment arrears have risen 27.9 million EUR in 2008 to 170 million in 2013. Investment spending has fallen from 52,6% in 2008 to 22% in 2013, while debt service payment have increased from 6,3% of local government expenditures in 2008 to 31% in 2013.

## Fiscal Equalization

In accordance with the Law on Local Government Finance, fiscal equalization is performed through the Equalization Fund. The Fund 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. In 2013, the Fund equalled about 24 million euro and amounted to 10.5% total local government revenues.

Municipalities whose per capita revenues from own sources –excluding the land development fee-- and shared taxes for the last three years are lower than the national per capita average from these same sources are entitled to receive grants from the Fund. The Fund is allocated in two phases. In the first phase, 60% of the Fund is allocated on the basis of the difference between an individual municipality's per capita revenue from own-revenues and shared taxes and the national average over the last three years (estimated fiscal capacities). These per capita differences are then multiplied by the number of inhabitants and a set of coefficents based on the population of the municipality. The coefficient for municipalities with less than 3,000 inhabitants is 2; for municipalities with populations between 3 and 6,000, 1.5; and for the Historical Capital 2.5. For all others, it is 1.

In the second phase, the remaining 40% of the Equalization Fund is allocated to local governments based on estimated budgetary needs, according to the following procedure: 20% of the funds are allocated equally to all local governments entitled to equalization; 60% of the remainder is then allocated on basis of municipality's area in relationship to the area of other municipalities entitled to equalization and 40% on the basis of its in relationship to total population of municipalities entitled to equalization.

The 2011 amendments to the Local Government Finance Law changed the way in which fiscal capacity is calculated. Earlier, fiscal capacity was determined on the basis of the own-revenues that local governments actually collected, effectively rewarding municipalities for not trying to mobilize local fees, charges and taxes. Since 2011, the Ministry calucalates an "estimated amount" of own-revenues revenues for each municipality and uses this both to determine who is entitled to receive equalization funds and how the Fund is allocated.

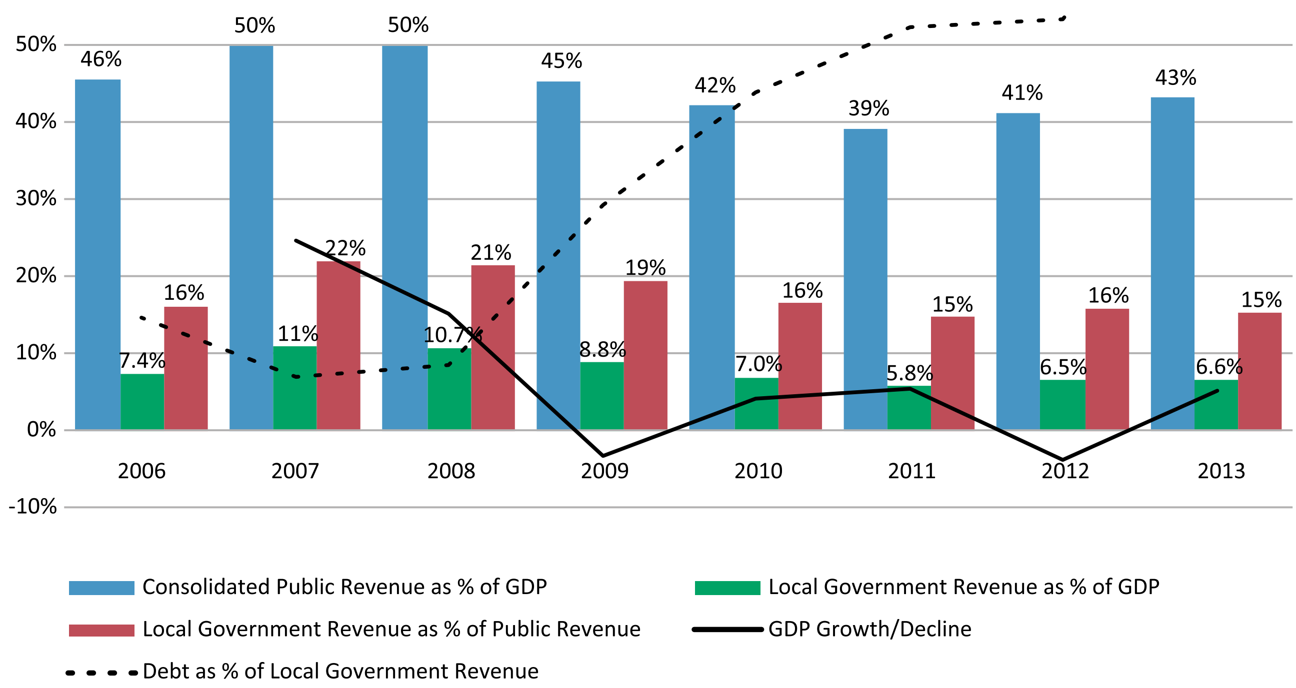
The Committee for Monitoring the Development of the System of Municipal Fiscal Equalization was established in accordance with the Law on Local Government Finance It monitors the implementation of the criteria for fiscal equalization, gives recommendations for improving the system and issues opinons on documents prepared by the Ministry of Finance related to the allocation of the Fund. Indeed, the Ministry of Finance is currently preparing amendments to the Local Government Finance Law that will introduce new changes into the equalization system.

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 size of a conditional grants that a local government can receive also depends on the level of per capita revenues they receive from the land development fee in relation to the national per capita average in the proceeding year. These conditional grants are very useful instruments for co-financing investment projects that are also being supported by EU funds. Nonetheless, conditional grants represented only 2% of total local government income in 2013.

# Statistical Overview of Local Government Finance in Montenegro 2006-2012

The impact of the global economic crises on the Montenegro has been particularly strong. In 2007, local government revenue as a share of GDP was extraordinarily high –11%-- given that Montenegrin municipalities have no major social sector responsibilities. In 2011, it bottomed out at 5.8% of GDP and then recovered to 6.6% in 2013. Local government borrowing also expanded rapidly after 2008 as municipalities borrowed to maintain spending levels in the face of the recession.

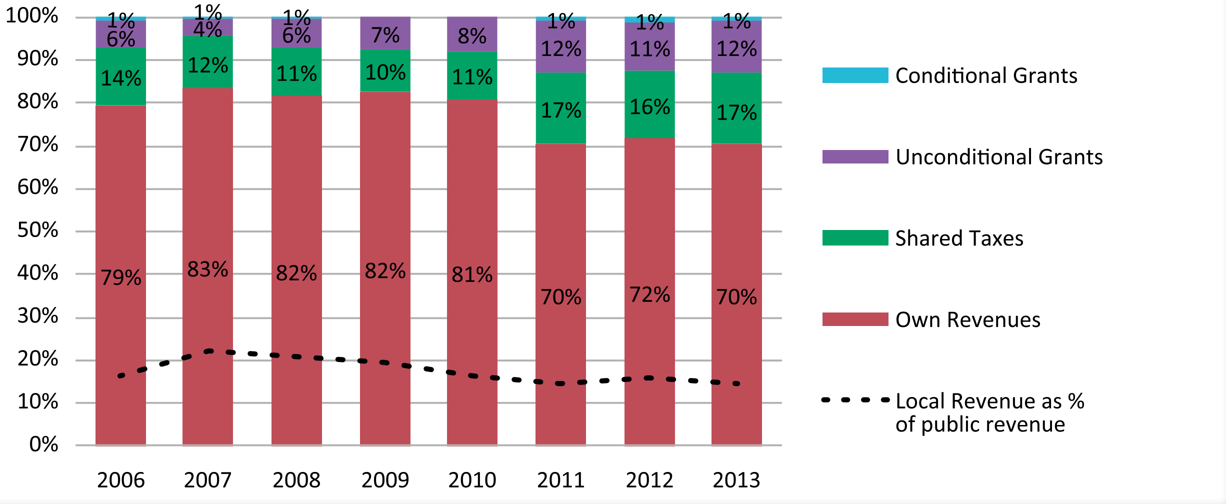
**Chart 1 Montenegro** Local Government Revenue as Share of GDP and Total Public Revenue in 2006-2013




Local governments in Montenegro are unique in the region in that they derive well over 50% of their total revenues from own sources. 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.

## Chart 2 Montenegro

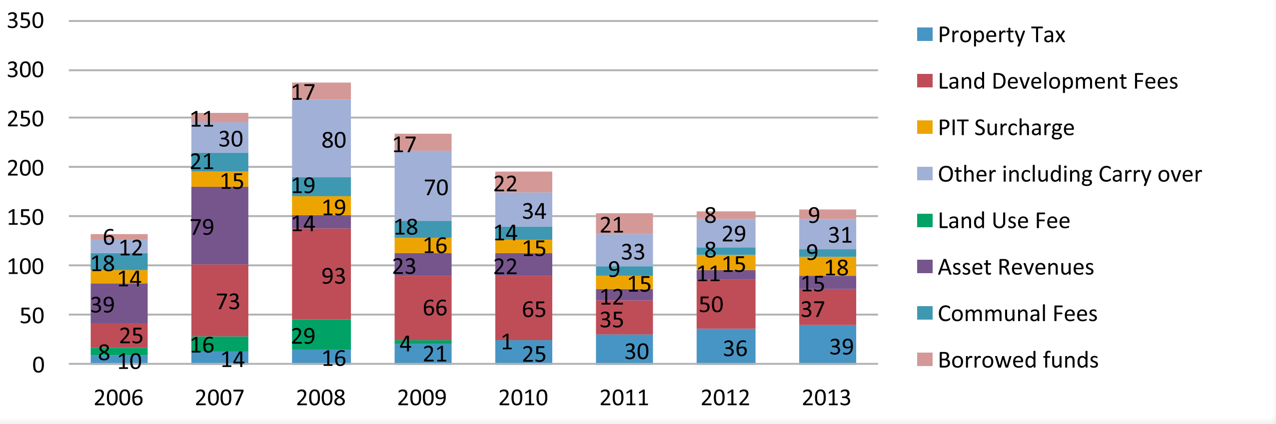
Composition of Local Government Revenues 2006-2013




The Land Development Fee has been the largest source of local own-revenue. But it is scheduled for elimination in 2016. If so, this will have a serious impact on municipal finances. Local governments have largely succeeded in replacing the revenues the lost when the Land Use Fee was eliminated in 2009 by increasing the yield of the property tax, which is now the highest in the region.

## Chart 3 Montenegro

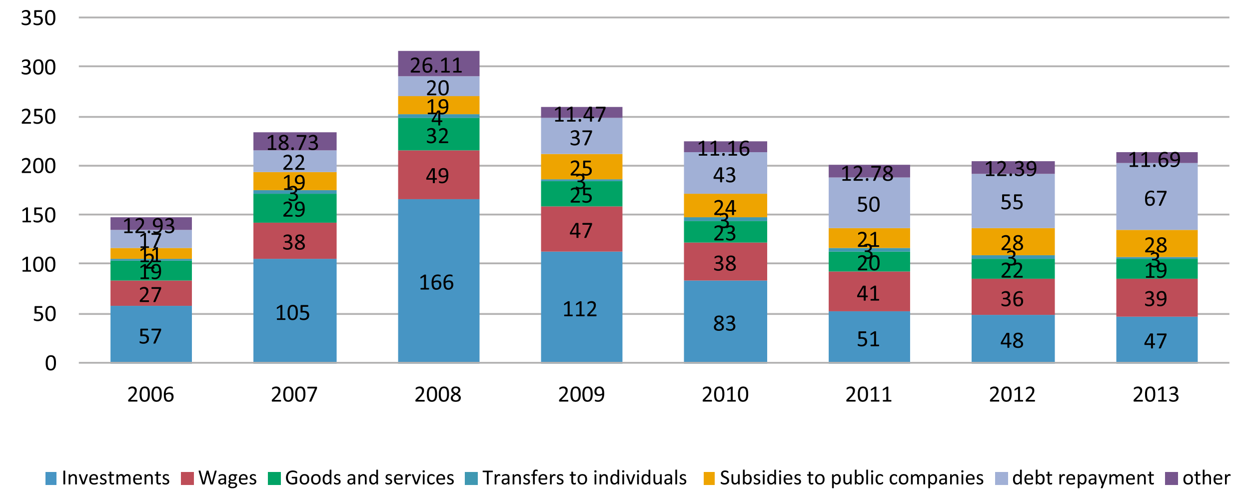
Composition of Own Revenues (with borrowed funds) 2006-2013 (mln EUR)




Local government expenditures on invesment have droped from 166 million EUR in 2008 to 47 million in 2013 while debt service payments have risen from 20 million EUR to 67 million an increase of over 300%.

## Chart 4 Montenegro

Composition of Expenditures in 2006-2013 (million EUR)




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

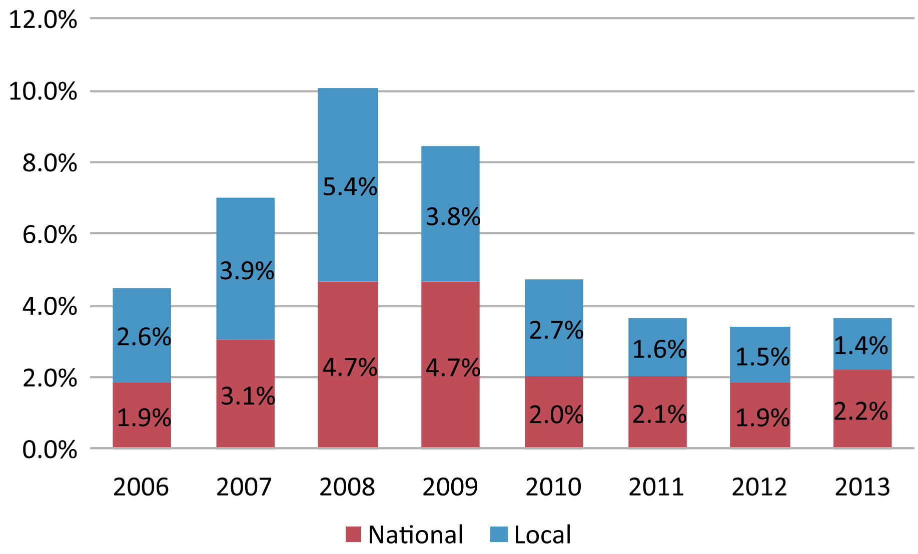
## Chart 5 Montenegro

Investment, Wages, Debt Service and Property Tax as Shares of GDP 2006-2013


The economic downturn has led to a dramatic contraction of public sector investment. But Montenegrin municipalities still account for almost 40% of it, down from 60% in 2006.

**Chart 6 Montenegro**

Public Investment as a Share of GDP by Level of Government, 2006-2013



# Romania

In Romania, public sector revenues account for only 33% of GDP. This is very 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 four year 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 which 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.

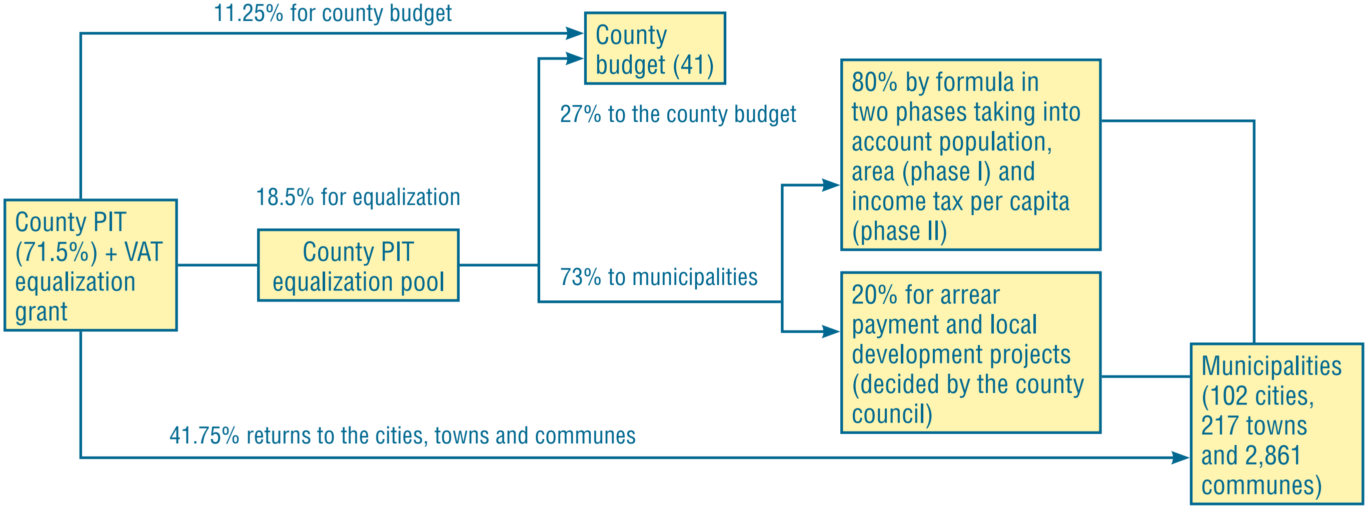
## Fiscal Equalization

Romania's intergovernmental finance system aims to equalize local government revenues both vertically and horizontally. The 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 through 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 probably 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:

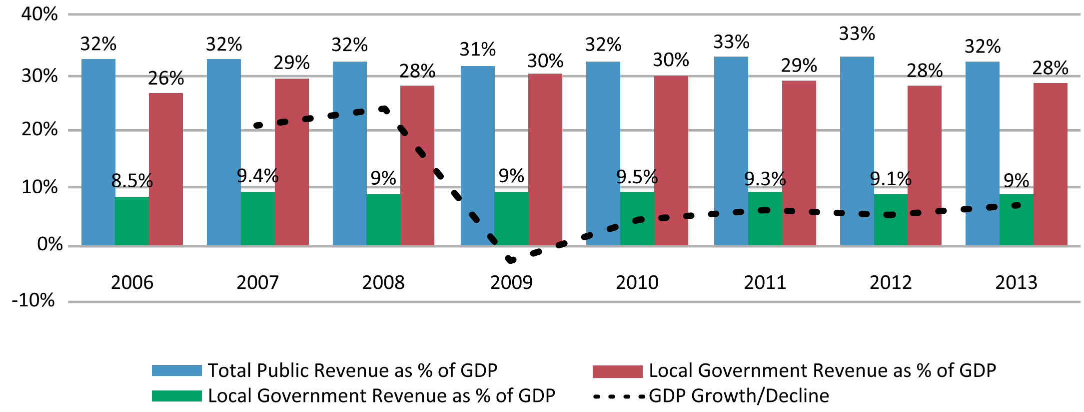
- Half of local governments are losing money when compared to 2013 and half are gaining;
- On the losing side there are over 500 local governments in the poorest two quintiles of per capita own revenues (mostly heavily populated but poor communes and towns);
- On the winning side, there are almost 500 well-off local governments, i.e. placed in the richest two quintiles of per capita own revenues; they include small local governments, but also some large cities in well-off counties;
- 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 (165 of the big losers are from the poorest two quintiles of local governments);
- 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

## Chart 1 Romania

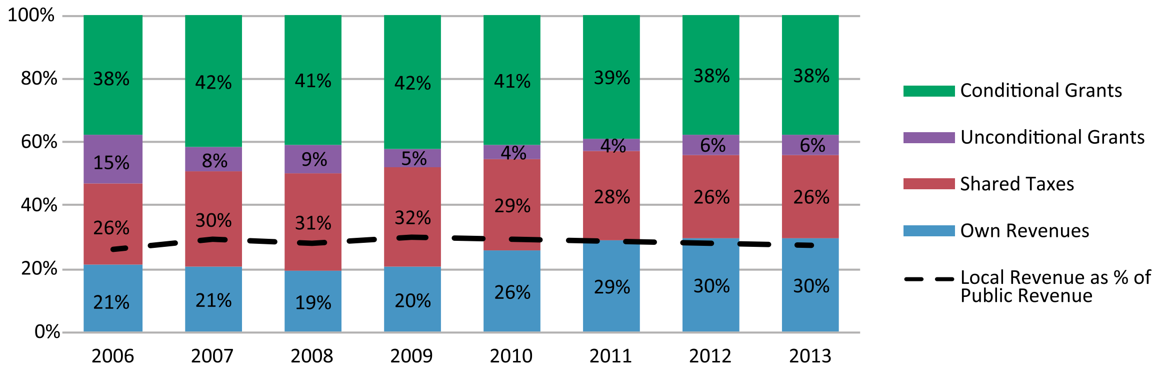
Local Government Revenue as Share of GDP and Total Public Revenue in 2006-2013




Since 2006, the share of own revenues in local budgets has increase from 20 to 30%. Part of this increase has been due to a doubling of revenues from the property tax whose yield is now equal to 0.8% of GDP. This is close to the EU average and one of the highest in the region.

## Chart 2 Romania

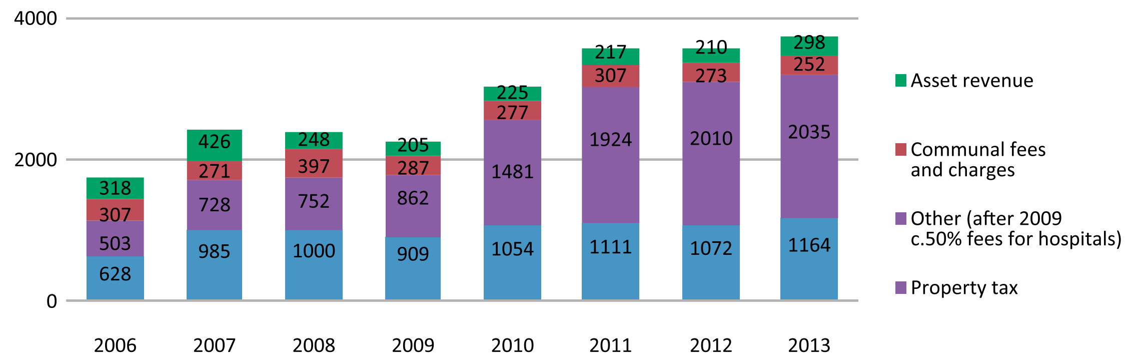
Composition of Revenue 2006-2013




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

## Chart 3 Romania

Composition of Local Government Own Revenues 2006-2013 (mln EUR)




Local governments' initial response to the economic crisis was to slash expenditure on investments and on goods and services, and to reduce –though to lesser degree—wage spending. By 2010, however, investment spending as well as spending on goods and services increased while wage spending continued to decline (in 2010 a 25% cut was enforced on all public sector wages). By 2012, wage and investment spending had recovered to levels close to those achieved in 2007 in both EUR and per capita terms.

## Chart 4 Romania

Composition of Local Government Expenditures in 2006-2013 (mln EUR)

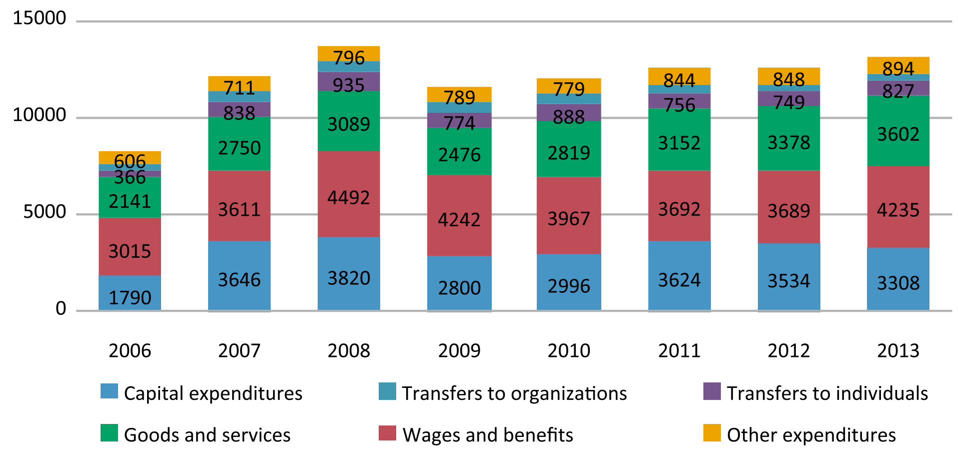
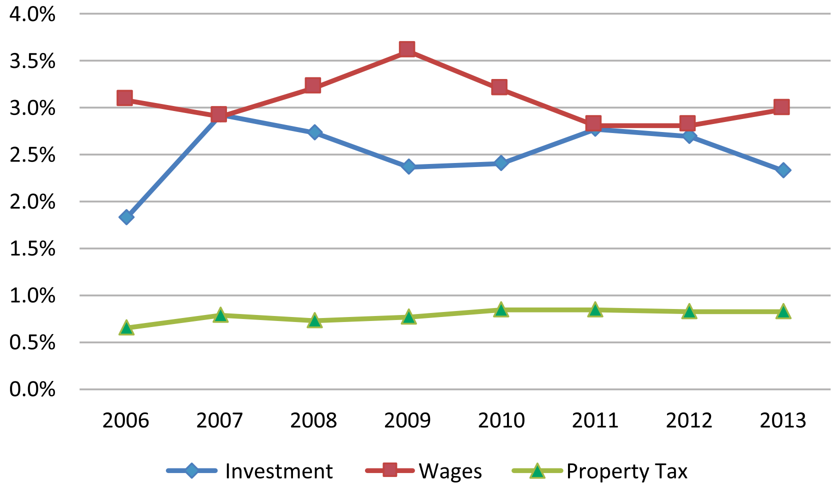


**Chart 5 Romania**

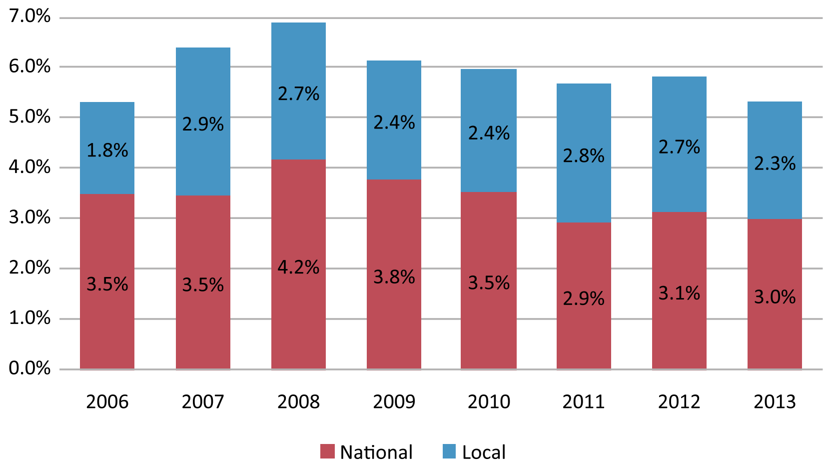
Investment, Wages, and Property Tax as Shares of GDP 2006-2013




Since 2010, local governments have accounted for close to 45% of all public investment. As in Bulgaria and Slovenia much of this investment is being facilitated by EU grants.

**Chart 6 Romania**

Public Investment as a Share of GDP by Level of Government, 2006-2013



# Serbia

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 seized up, 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, a suspension that led to a dramatic cut in the unconditional grant.

In 2011, amendments were introduced into the law that radically changed its character. The share of the wage 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 grants was reduced, and a smaller pool of grant funds was allocated to municipalities in accordance with a development index that created four groups of local governments. Local governments in the fourth group continued to receive 100% of the transfers the 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 from 8.776 RSD to more than 11.000. These changes in the tax code 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 they took away from local government to the National Pension Fund. Finally, on January 1, 2014, the government eliminated the fee for the use of construction land, the second most important source of municipal own revenue in Serbia, while putting a new Property Tax Law is place. This Law will go into full effect in 2015.

Given all these changes, the best way to improve the situation would be to return to the principles contained in the original Law on Local Government Finance. Efforts to do this began in the first half of 2014 when the Ministry of Finance created a working group to redraft the law. These efforts however collapsed when the Ministry of Finance resigned.

## Equalization Instruments

According to the Local Government Finance Law the total pool of funds used to finance non-categorical transfers should be equal to 1.7% of the GDP. The first call on this pool of funds is for equalization. Local governments whose per capita revenues from shared taxes are less than 90% of the national average –calculated without the 4 largest cities—are entitled to an equalization grant. Their grants are equal to 90% of the difference between their per capita revenue from shared taxes and 90% of the national average multiplied by their populations.

All local government units in Serbia also have the right to a general transfer. The size of the general transfer is equal to the amount of funds for non-categorical transfers once the equalization grant and two other smaller transfers have been paid for. (These smaller transfers compensate local governments for revenue lost when the 2006 legislation was put in place). The allocation of the general transfer to individual local governments is determined in accordance with uniform criteria set in the Local Government Finance Law. These criteria include metrics like population, the number of pre-school age children, and the number of schools. The general transfer thus has an equalizing effect, independent of the equalization grant.

Since the introduction of the 2011 amendments, the total amount of money that local governments are entitled to from the equalization, compensation, transition and general transfers are then multiplied by the development coefficients discussed above. As a result, local governments in the fourth group receive the full value of their calculated transfers while those in group three get 90%, those in group two 70% and those in group one 50%.

The 2011 amendments also introduced 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 shared taxes of the City of Belgrade. It is allocated by population according to a local governments' level of development. Municipalities in the fourth group are entitled to 50% of the Solidarity Fund; those in the third group 30%, and those in first and second groups, 10%.

The 2011 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. As a result, the Standing Conference of Serbian Towns and Municipalities is trying to once again amend the Law on Local Government finance in order to return to its original principles.

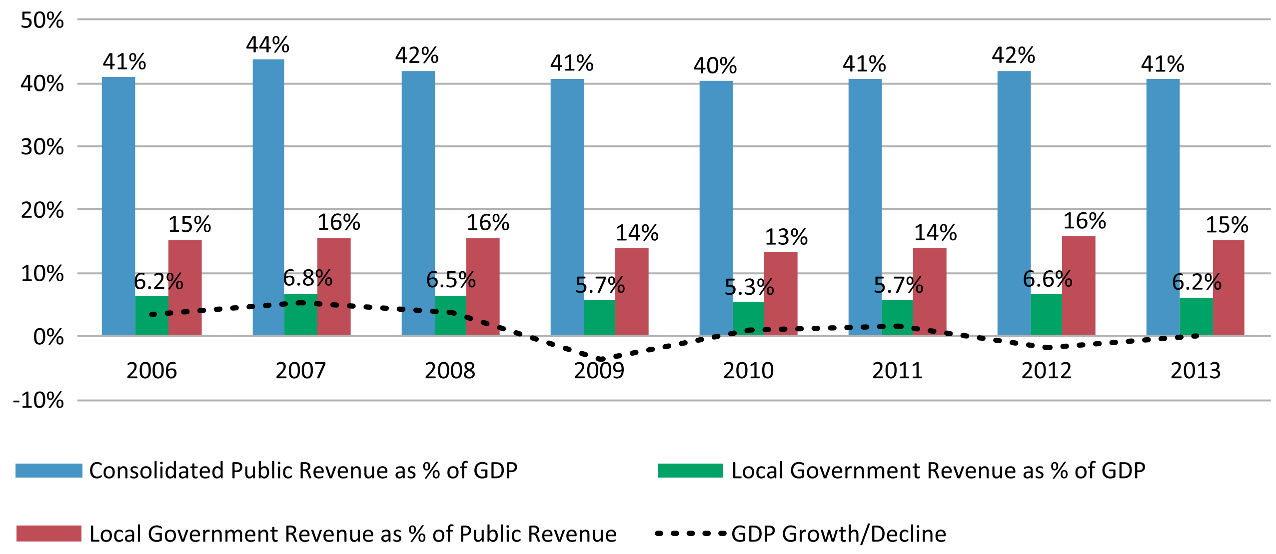
Finally, the national government may allocate categorical transfers to local governments for performing particular own and delegated functions. Line ministries or other agencies of the national government determine the amount of categorical transfers as well as the criteria for their allocation to individual local government units.

## Statistical Overview of Local Government Finance in Serbia 2006-2012

The global economic crisis led to a deep contraction of local government revenues between 2009 and 2011. In part, this was caused by the economic downturn itself, and in part by the policy decisions of the national government. In 2012, local government revenues returned to earlier levels because in the run up to the elections of that year, the government raised the PIT share from 46 to 80%. Policy changes introduced immediately after the elections clawed back most of these gains by 2013 (see above).

Chart 1 Serbia

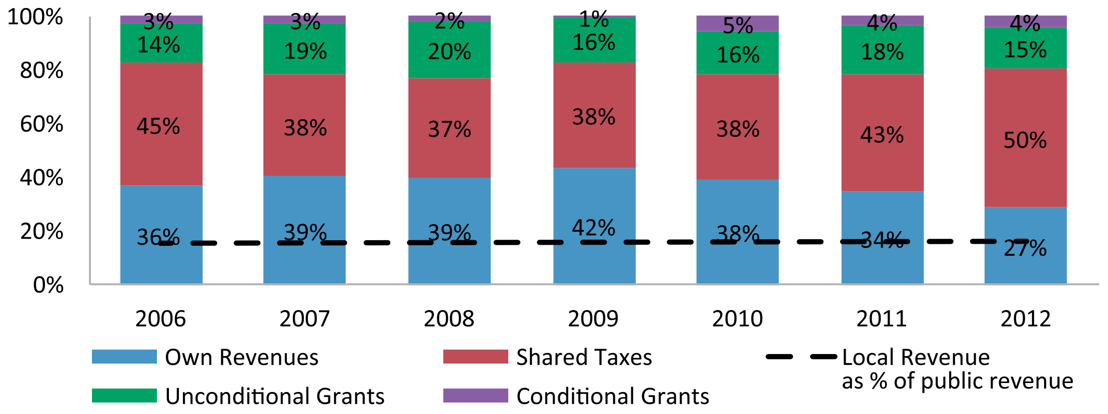
Local Government Revenue as a Share of GDP and Total Public Revenue in 2006-2013




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 the sharp increase in the local PIT share and now shared taxes account for 50% of municipal revenue.

## Chart 2 Serbia

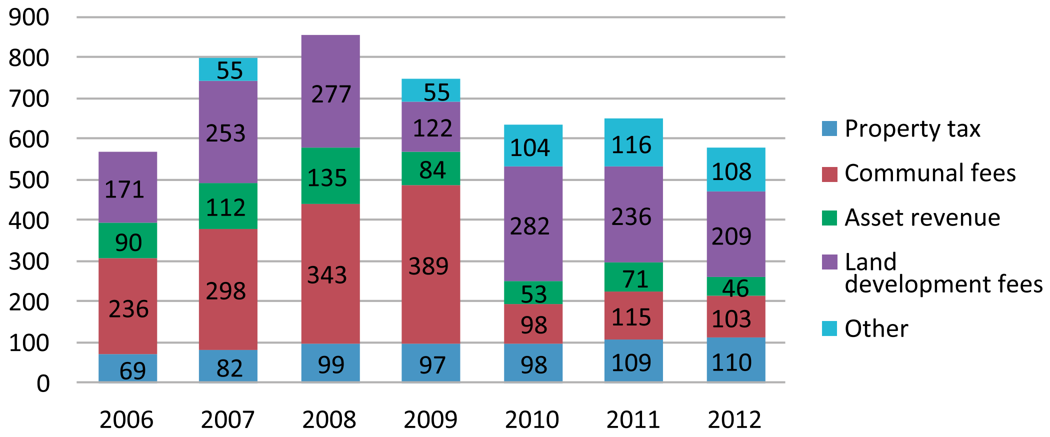
Composition of Local Government Revenue 2006-2013




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 almost doubled the yield of the property tax since 2006.

## Chart 3 Serbia

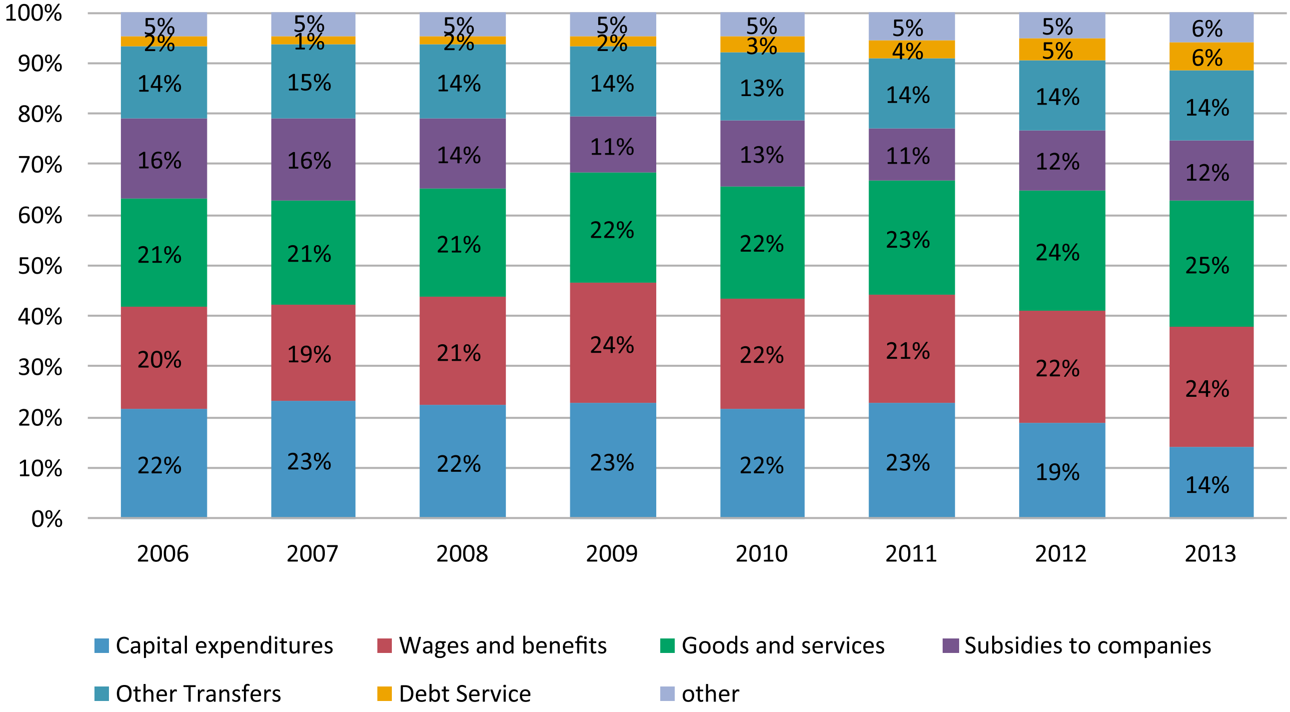
Composition of Own Revenues 2006-2013 (mln EUR)




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 and are now under 15%. 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.

## Chart 4 Serbia

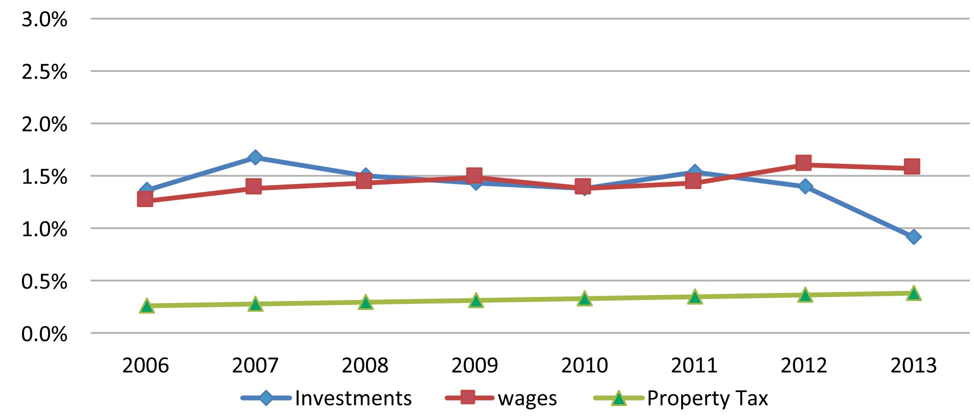
Composition of Local Government Expenditure 2006-2013




Despite the financial difficulties of local governments, local wage spending has remained remarkably constant over the last eight year.

## Chart 5 Serbia

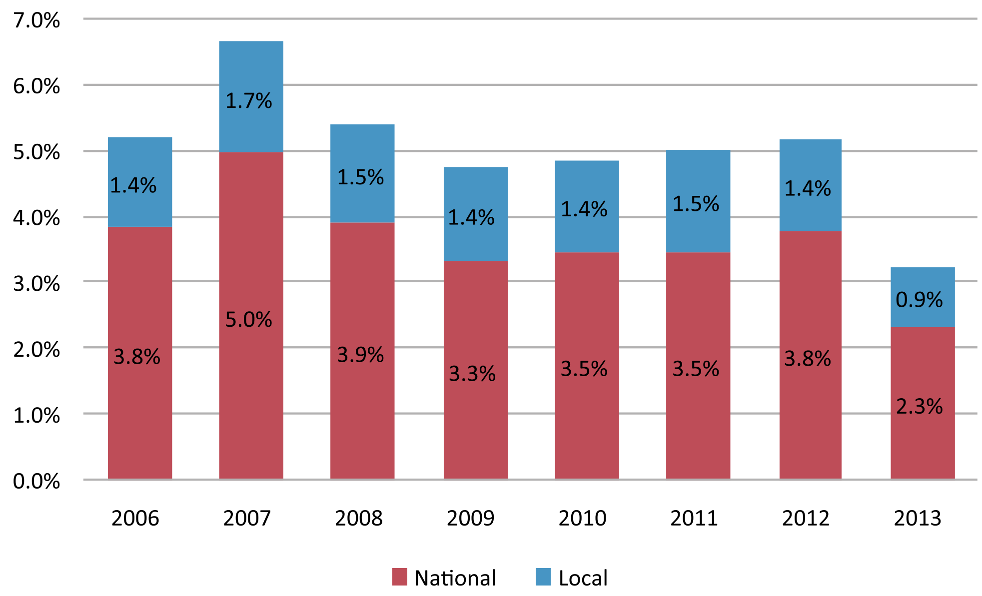
Investment, Wages, and Property Tax as Shares of GDP 2006-2013




Local investment as a share of total public investment in Serbia has consistently been below 30%, low for the region.

## Chart 6 Serbia

Serbia Public Investment as a Share of GDP by Level of Government, 2006-2013



# Slovenia

In the first years of the financial crisis Slovenian municipalities didn't suffer from the overall downturn. But In 2011, 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 needs calculation for determining the amount of shared taxes going to local governments by 3.7%. It also froze the national government's share of investment co-financing to the already reduced levels of the previous year. On the expenditure side, the austerity measures included a reduction in the wages of public servants. But there was also an increase in some social transfers. As a result, municipal expenditures decreased by less than 1%.

In 2012, the Government and the municipal associations signed an agreement to further reduce the needs indicator use to calculate shared taxes in 2013 and 2014, essentially forcing municipalities to lower expenditures. In 2013, additional fiscal consolidation efforts placed new expenditure burdens on municipalities. These included an increase in the VAT rate, a rise in social transfers and a further reduction in the co-financing of local government investment by the national government. Only the state-mandated reduction of public sector wages worked in the opposite direction.

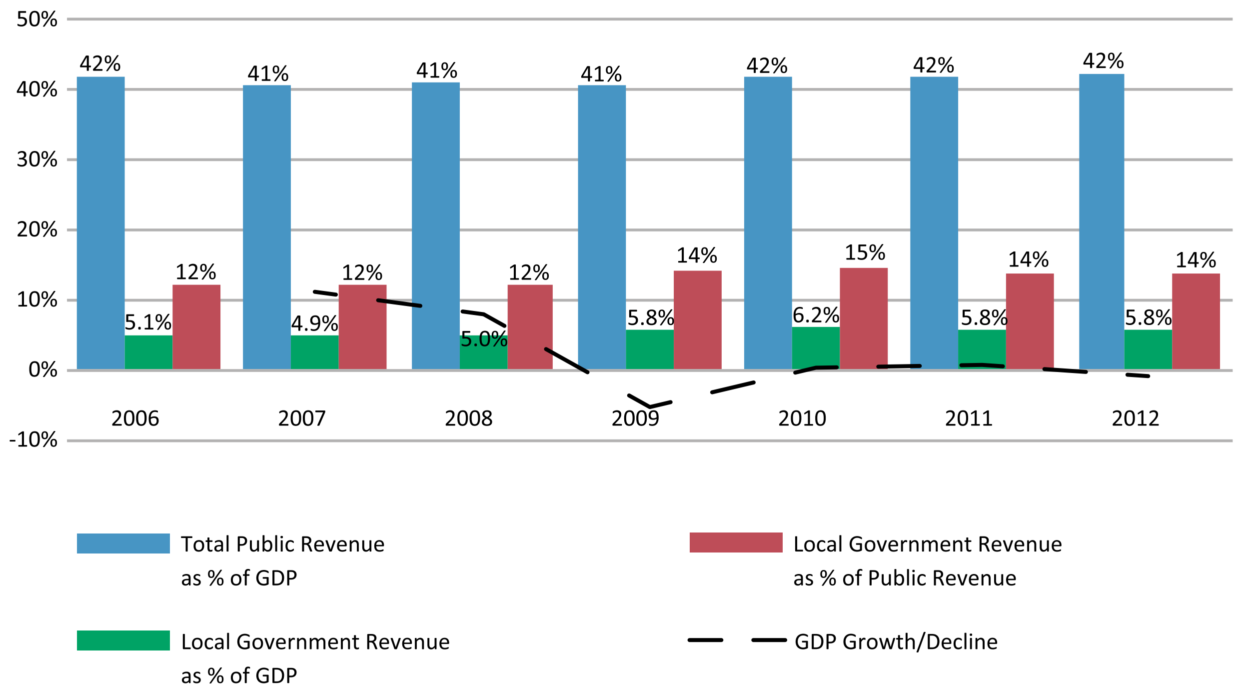
At the end of 2013, the national government adopted a new Law on Real Estate Taxation. The Law eliminates the Land Use Fee, a charge that formerly was completely under municipal control and which generated 9% of local revenue. The Law also transformed the Property Tax into a shared tax that will be fully administered by the national government, and whose yield will be divided 50/50 between local governments and the state. Municipalities would no longer have the right to determine the base of the tax or to make exemptions, though they will retain the right to set the rate within centrally set norms. Such a new Law on Real-Estate Taxation would significantly reduce the fiscal autonomy of municipalities. But the law was not put into force due to the annulation/ abolishment by the Institutional Court, and as a consequence the previous Land Use Fee still remains valid.

The fiscal pressures generated by the financial crisis have also led to proposals to consolidate local governments in order to improve the economic efficiency of the public sector. The Ministry of the Interior, the competent authority for local governments, has stated that there are too many small municipalities with limited governance capacities. In the summer of 2013, the Ministry proposed a territorial reform that would have eliminated all municipalities with fewer than 5,000 inhabitants in 2014, reducing 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.

## Statistical Overview of Local Government Finance in Slovenia 2006-2012

The overall size of the local government sector in Slovenia increased from about 5% of the GDP in 2006 to close to 6% of the GDP in 2009 and has remained at about this level since then. This suggests that the national government has been distributing the costs of the economic adjustment reasonably fairly between levels of government.

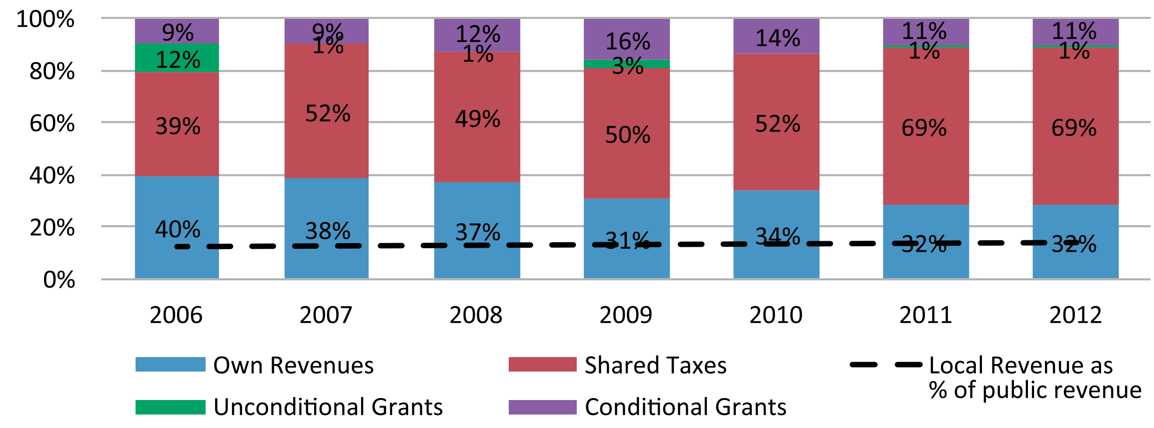
**Chart 1 Slovenia** Local Government Revenue as a Share of GDP and Total Public Revenue in 2006-2012




Slovenian local governments are heavily dependent on PIT sharing for most of their revenues, and since 2007 freely disposable equalization grants that provide additional revenues to poorer local governments have been reduced. Instead, weaker local governments are given additional increments of PIT.

## Chart 2 Slovenia

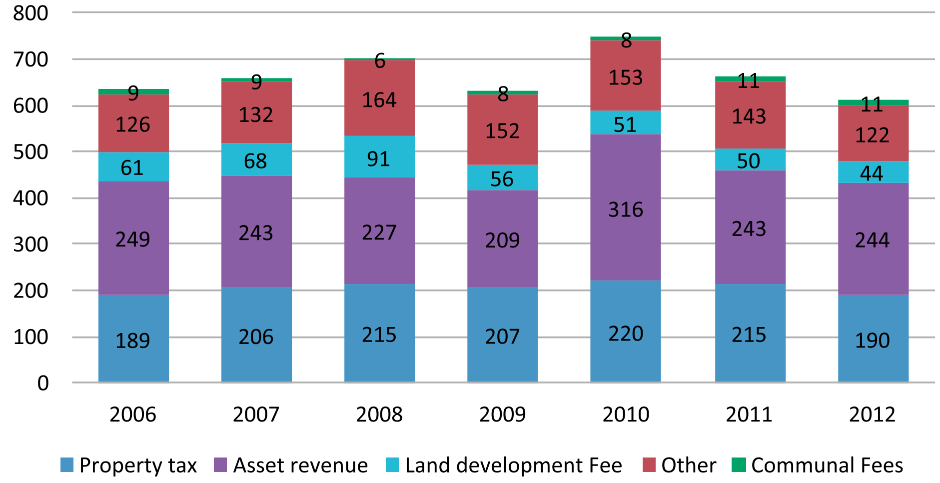
Slovenia Composition of Local Government Revenue 2006-2012




Local own-revenues have performed roughly in line with the economy as a whole. Slovenian municipalities derive an unusually large share of their revenues from asset sales and rentals. The yield of the Property Tax has been significant but with no clear upward trend.

## Chart 3 Slovenia

Composition of Own-Revenue 2006-2012 (mln EUR)




In 2011 and 2012, the investment rate of Slovenian local governments dropped from about 45% of total spending to about 36%, still high for the region. Wage spending is remarkably low, though in part this is because local government have no social sector services.

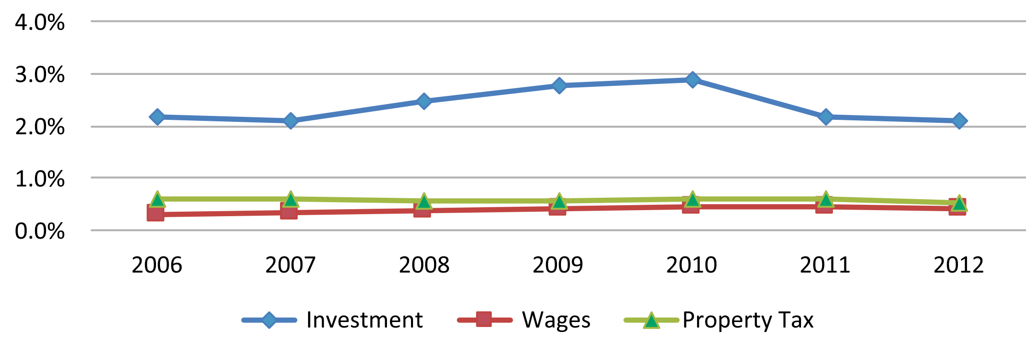
## Chart 4 Slovenia

Composition of Expenditure in 2006-2012


Slovenia's has combined robust local investment with low wage spending and modest property tax yields. The yield of the property tax as a share of GDP has declined from 0.64% of GDP to 0.5%.

## Chart 5 Slovenia

Investment, Wages, Property Tax as Share of GDP 2006-2012



# Turkey

## Macroeconomic Overview

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 sluggish, suggesting that the private sector-led growth that Turkey's government once liked to boast about is losing momentum.

## Local Government's Outlook

On March 30, 2014, Turkey held local elections for metropolitan and district mayors, as well as for municipal councils in cities, and muhtars (village leaders) and "elderly councils" in rural areas. The governing Justice and Development Party (AKP) took 43% of the vote, winning 818 of 1395 municipalities and 11,309 council seats. The opposition Republican People's Party (CHP) came in second with 26% of the vote, winning 232 municipalities and 4,320 council seats.

With this election, Turkey now 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.

## Equalization Instruments

Law number 5779 defines the revenue entitlements of provincial administrations and municipalities from the national budget, including for equalization. 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 pools for 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.

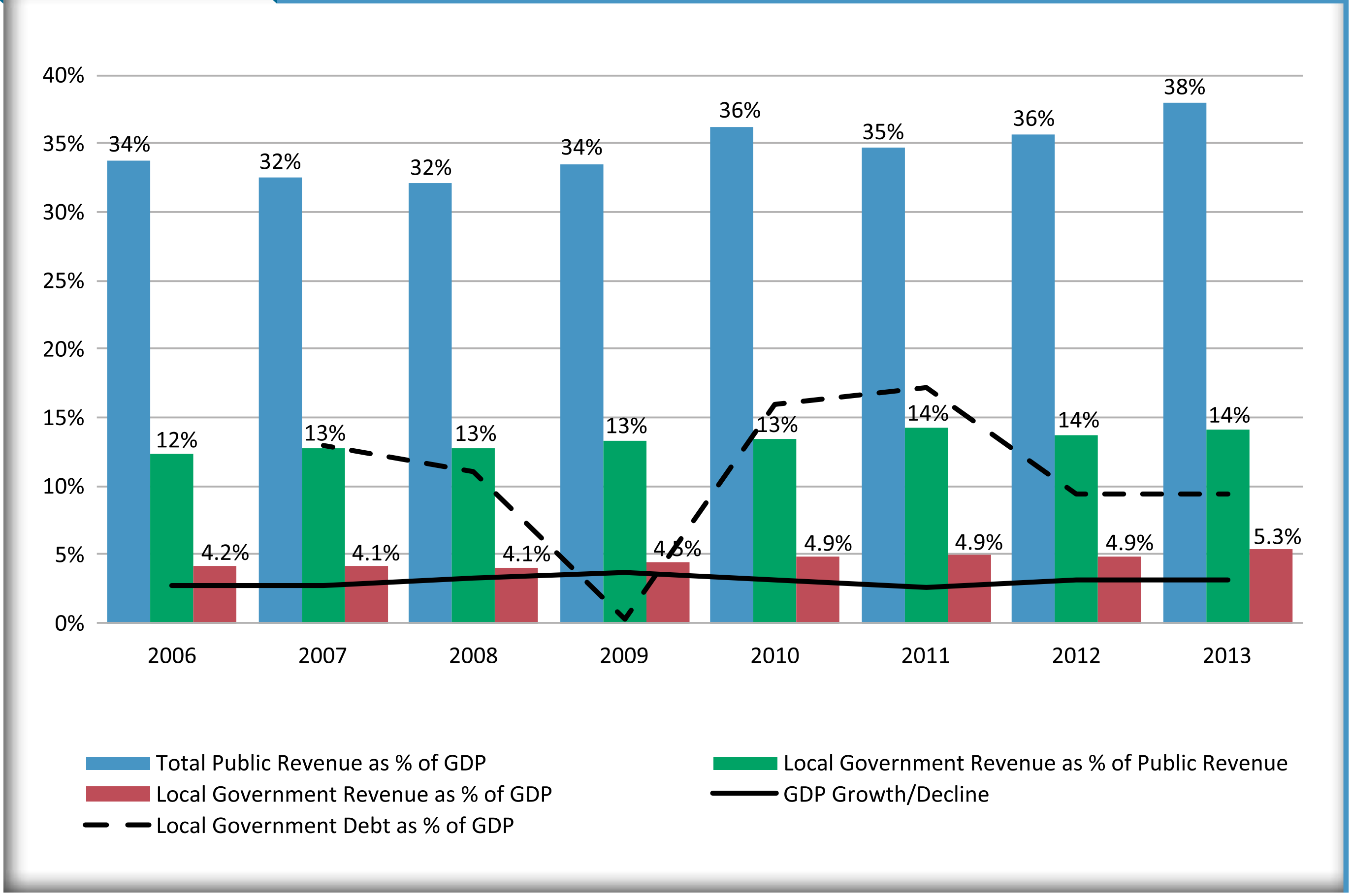
Turkey also makes use of other instruments to help poorer jurisdictions. For example the Koy-des Program provides additional support for villages and the Bel-des Program provides support for small districts. These Programs help villages and districts complete investment projects that they cannot complete themselves. They typically focus on water-supply, sanitation and roads to urban centers.

# Statistical Overview of Local Government Finances in Turkey

Local government revenue as a share of GDP has increased steadily over the last seven years, as has local government revenue 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.

## Chart 1 Turkey

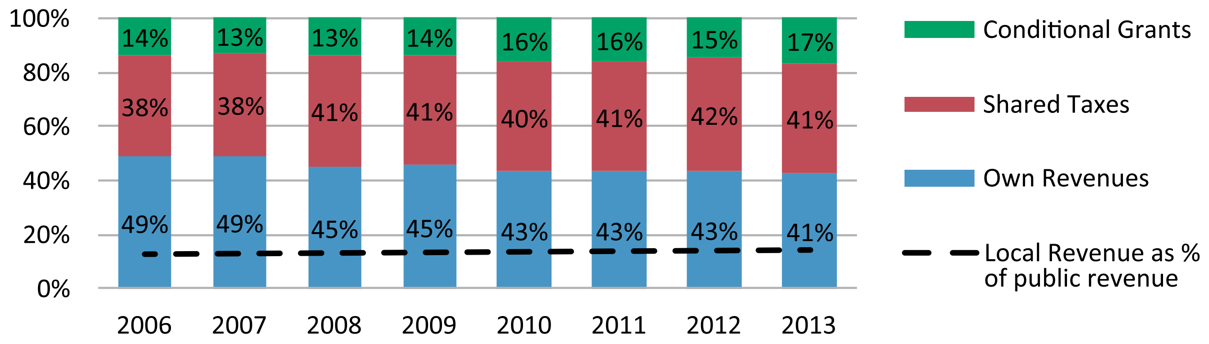
Local Government Revenue as a Share of GDP and Total Public Revenue in 2006-2013




The composition of local revenues has changed little between 2006 and 2013, though the share of own revenue has decreased slightly while shared taxes have increased.

**Chart 2: Turkey**

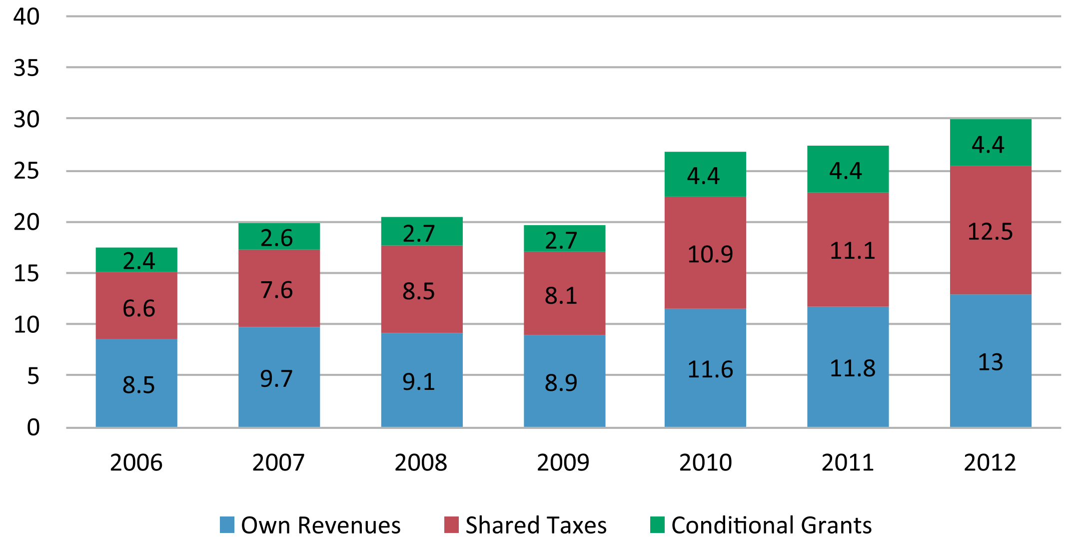
Composition of Local Government Revenue 2006-2013




Local governmnet revenues have grown particularly sharply in EUR terms since 2010. Since 2006, local governments have increased own-revenue collection by 65%.

**Chart 3: Turkey**

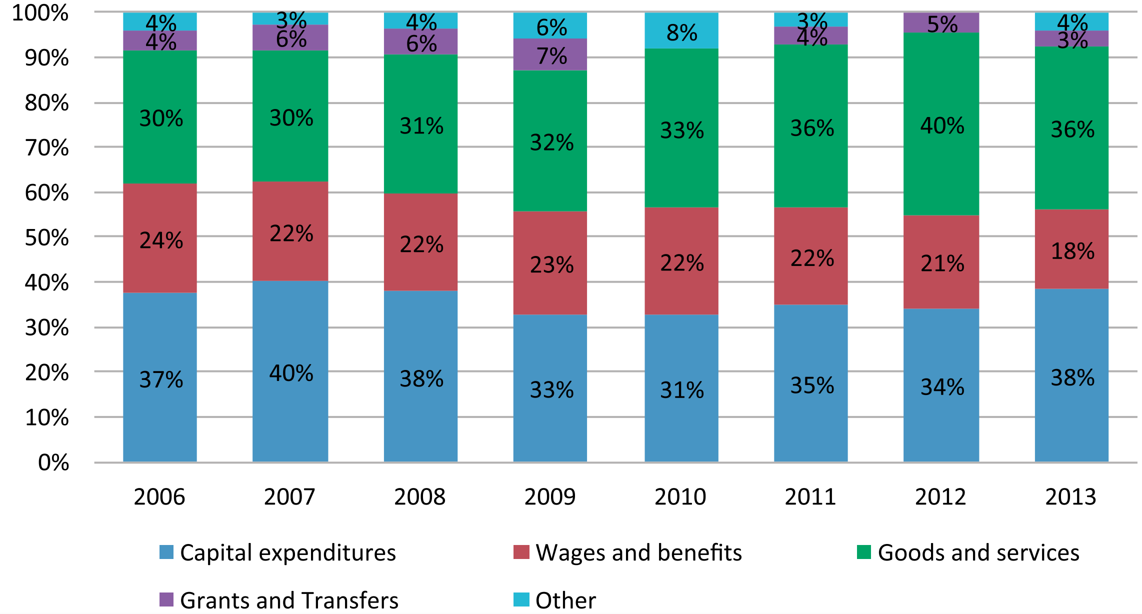
Composition of Local Government Revenue 2006-2013 (bln EUR)




Local investment as a share of total expenditure declined slightly in 2009-10 rose again in the last two years and is again above 35%. Wages as a share of total expenditures have also declined while expenditures on good and services have increased. This suggests that many local governments are outsourcing the provision public goods to commercialized providers.

## Chart 4: Turkey

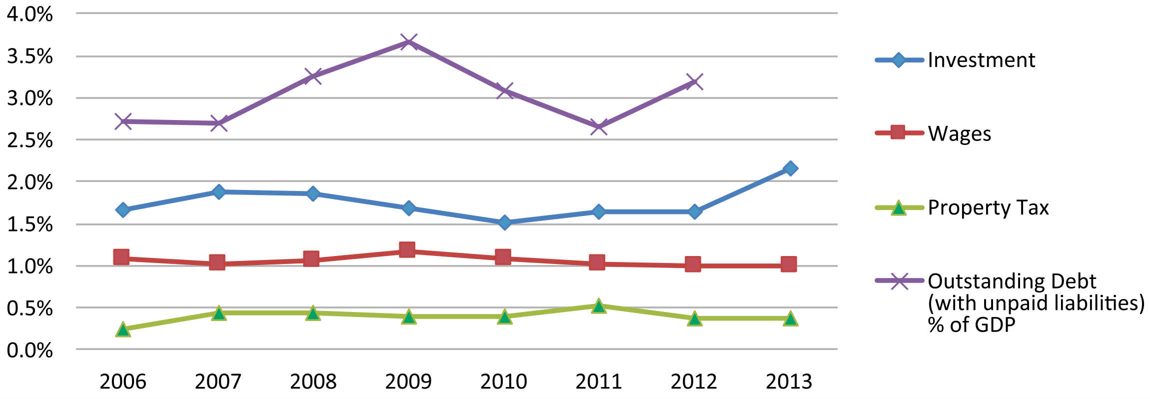
Composition of Expenditure in 2006-2012




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.

## Chart 5: Turkey

Investment, Wages, Outstanding Debt and Property Tax as Shares of GDP 2006-2013



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