



Network of Associations
of Local Authorities
of South-East Europe

REPORT



Fiscal Decentralization Indicators for South-East Europe



Seventh Edition
December 2018

Fiscal Decentralization Indicators for South-East Europe:

2006-2017

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Kelmend Zajazi, Executive Director

Authors/Editors:

Emil Savov, Regional Analyst of Fiscal Decentralization in SEE

Elton Stafa, Regional Analyst of Fiscal Decentralization in SEE, NALAS

Žana Đjukić, Regional Financial Data Expert, Union of Municipalities of Montenegro

Authors/Contributors:

Aida Cacaj, representing the Association of Albanian Municipalities

Gregor Jurišić, representing the Association of Municipalities and Cities of the Federation of Bosnia and Herzegovina (Bosnia and Herzegovina);

Goran Rakić, Association of Municipalities and Towns of Republic of Srpska (Bosnia and Herzegovina)

Emil Savov, representing the National Association of Municipalities in the Republic of Bulgaria

Dario Runtić, representing the Association of Cities in the Republic of Croatia

Osman Sadikaj, representing the Association of Kosovo Municipalities

Sofija Stefanovska, representing the Association of the Units of Local Self-Governments of the Republic of Macedonia

Carolina Furdui and Viorel Girbu, representing the Congress of Local Authorities of Moldova

Žana Đjukić, representing the Union of Municipalities of Montenegro

Radu Comsa, representing the Association of Communes of Romania

Dunja Naić, representing the Standing Conference of Towns and Municipalities of Serbia

Mustafa Kabil, representing the Marmara Municipalities Union, Turkey

Publication Coordinator:

Elton Stafa, NALAS

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Abbreviations

AAM	Association of Albanian Municipalities	NALAS	Network of Associations of Local Authorities in South-East Europe
ACoR	Association of Communes of Romania	NAMRB	National Association of Municipalities in the Republic of Bulgaria
AKM	Association of Kosovo Municipalities	OECD	Organization for Economic Co-operation and Development
AL	Albania	PIT	Personal Income Tax
ALVRS	Association of Towns and Municipalities of Republic of Srpska	RKS	Kosovo
AoCRC	Association of Cities of the Republic of Croatia	RO	Romania
BG	Bulgaria	RS	Serbia
BiH	Bosnia and Herzegovina	RS (BiH)	Republic of Srpska, Bosnia and Herzegovina
CALM	Congress of Local Authorities from Moldova	SDC	Swiss Agency for Development and Cooperation
CIT	Corporate Income Tax	SEE	South-East Europe
COFOG	Classification of the functions of government	SI	Slovenia
EU	European Union	SIDA	Swedish International Development Agency
FBiH (BiH)	Federation of Bosnia and Herzegovina, Bosnia and Herzegovina	SOGFBIH	Association of Municipalities and Cities of the Federation of Bosnia and Herzegovina
GDP	Gross Domestic Product	SOS	Association of Municipalities and Towns of Slovenia
GG	General Government	STCM	Standing Conference of Towns and Municipalities
HR	Croatia	TK	Turkey
IFI	Independent Fiscal Institutions	UNDP	United Nations Development Program
LDF	Land Development Fee	UOM	Union of Municipalities of Montenegro
LG	Local Government	USAID	United States Agency for International Development
LGA	Local Government Association	VAT	Value Added Tax
LUF	Land Use Fee	ZELS	Association of the Units of Local Self-government of Republic of Macedonia
MD	Moldova		
MK	Macedonia		
MMU	Marmara Municipalities Union		
MNE	Montenegro		

THE REPORT IN BRIEF:

The seventh edition of the report captures the development of local finance in South-East Europe (SEE) for the period 2006 - 2017, explores the most recent regulatory changes and compares the different countries and entities' performance related to decentralization. The EU 28 average respective indicators have been unanimously accepted as the benchmark for most of the comparisons. The period covered also reflects the impact of the economic crisis and its aftermaths.

The report has several purposes but the most important one, expressed by the Local Government Associations (LGAs), is to provide guidance to the national counterparts while assessing various policy options in municipal development. All of the countries and entities are in fact very young democracies despite the differences in social and economic development - some of the countries are members of the EU, the others are making steady progress towards membership. At the same time, all of the countries but one, have adopted the European Charter of Local Self-Government of the Council of Europe, which, already part of the national legislations, is to guide the intergovernmental

dialog on local governance development. From this prospective, the report's findings and conclusions might be a powerful tool for informed policy choices and their possible outcomes.

The current edition of report puts more emphasis on service responsibilities of the local governments in order to better describe and explain both their financial positions and the level of decentralization; **and on local governments own revenue raising capacities**, identifying the major developments and challenges faced by local governments as regards the collection of local taxes, fees and charges.

The region remains quite diverse in terms of territorial organization - the number of sub-national levels of governance varies from one to three (*BIH, Moldova and Turkey*) in the different countries. The total number of 1st tier of local governments (the closet to the citizens) is 7,002 but varies greatly - from 23 in Montenegro to 3,181 in Romania. In 2015, Albania, in line with attempts elsewhere in Europe, reorganized its local governments sharply reducing the number of the 1st tier units from 373 to 61. The average population of 1st tier local governments in SEE is over 19,000 and, compared to the EU28 average of 5,100,

seems to be very favorable (*other things being equal*) for decentralization efforts.

The SEE region follows the European trend of concentration of people in the capital and metropolitan cities but for a number of SEE countries (*Albania, Serbia, Macedonia and Montenegro*) this trend is worrisome – over 20% of their population live in the capital cities. The oversized importance of capital cities poses a number of issues outlined in the report and the reader should be aware of capital cities' impact while dealing with national averages and per capita indicators.

The SEE region economy, measured by GDP per capita, grew by 61% between 2006 and 2017, at an annual growth rate of 5.5%, thus outperforming the EU28 average of 22%. At the same time, the country specifics show a very diverse picture due to two main factors: the different starting points and the impact of the economic crisis of 2008-2009. For example, Moldova has the highest cumulative growth of 220% but still the lowest per capita income in both 2006 and 2017. In 2017, RS, Montenegro, Bulgaria and Romania doubled the 2006 level. The two more economically advanced, Slovenia and Croatia, were the hardest hit by the crisis and reached the pre-crisis level of 2008 in 2015 and 2016 respectively, which, to some extent, explains their lowest cumulative growth – 33% and 28%.

By comparing the weight of expenditures according to the functions of government (based on the COFOG¹ classification), **the commonalities and differences across countries become clearly visible** – the share of education of the municipal budgets in Moldova, Slovenia, Kosovo and

Bulgaria is between 40% and 60% - 2-3 times more than the EU28 average. In Albania, Croatia and Turkey, local governments spend on housing one quarter to one third of all expenditures.

SEE local governments' service responsibilities over social sector functions (education, health, social welfare and culture) vary significantly: the municipalities in Kosovo pay for services in all four social functions. In Romania, Macedonia, Bulgaria, Kosovo and Moldova local governments pay the full costs of the secondary education. Similarly, in Romania and Kosovo local governments pay for most of the costs of primary and secondary health care. In Montenegro, they have no responsibilities in either education or health, not even maintaining facilities.

The size of the public sector in the SEE region, as measured by public revenues has stalled at (36%) over the past decade, lagging considerably behind the EU average (45.8% of GDP). However, seven SEE countries and entities have total public sector above 40% of GDP among which Croatia, whose indicator equals the EU average. In Albania and Kosovo, it is below 30%.

In 2017, SEE local governments' revenues decreased by 0.4 pp when compared to 2015, falling from 6.3% of the GDP to 5.9%. Also, SEE local governments' share of total public revenues has decreased from 17.4% in 2015 to 16.9% in 2017. The gap with their counterparts in the EU still remains considerable: SEE local government revenues (compared to the GDP) are only at 61% of the EU average which is 10.7 % of the GDP.

The report reaffirms the previous conclusions that there is no positive correlation between

¹ The **Classification of the functions of government (COFOG)** was developed by the Organization for Economic Cooperation and Development and published by the United Nations Statistical Division as a standard classifying the purposes of government activities.

the size of the total public sector and the share of the local sector within it. For example, despite the small public sector, local governments in Kosovo lead in terms of their share of all public revenues – 25.6%, followed closely by Romania (28.4%) and Moldova (25%) and these three countries most closely resemble those of the EU28. The rest of the countries are further away from the EU average both in terms of local revenues of GDP and of total public revenues. These two indicators in Kosovo, Romania, Moldova, Macedonia, and Bulgaria are close or above the SEE average mainly because their local governments fund expensive social services such as primary and secondary education.

The report reaffirms a negative trend (opposite to the EU experience), i.e. the inverse correlation between the extent of service responsibilities transferred at local level and the size of the public sectors. Among the seven SEE countries with “small states” (*public revenue to GDP less than the EU28 and the SEE levels*), five have devolved the most of the social sector functions to local governments. Despite the slight improvement of some of the countries indicators, no country in SEE is near the EU28 where can be seen both high levels of decentralization and larger public sectors.

The data and the trends observed allow formulating the following main conclusions:

- Maybe most importantly and worryingly, decentralization efforts have stalled and the gap with the EU remains significant;
- A number of countries (most notably Albania and Turkey) have devolved additional service responsibilities to the local governments without expanding the public sector;

- The countries with public sector above 40% also have granted to the local governments additional spending responsibility while keeping the level of tax burden constant;
- Some of the countries with public sectors above 40% continue to expand it but the additional public funds remain at central level;

The only exception to the above is Croatia where the public sector increased significantly without decentralizing service responsibilities.

The level of local fiscal autonomy has decreased: not only SEE local governments’ total revenues have decreased when compared to 2015², but also the share of local revenues over which they can exercise independent decision-making has decreased.

Between 2015, the share of own revenues for the SEE region, on average, remained constant at 34% of total revenues. The share of block grants increased by 50%, constituting 18% of total local revenues in 2017 – mainly at the expense of the shares of shared taxes and general-purpose grants. These figures clearly show that the level of fiscal autonomy has decreased and currently SEE local governments on average can freely decide only on half of their budgets. The nature of the sectoral block grants is the main reason for this negative trend – they arrive at local level with the main spending decisions already taken by the central government. In the countries that have devolved social sector responsibilities to local governments, the central government funds them mainly through conditional grants.

The report provides an adequate analysis and explanation of the intergovernmental finance paradox: “as countries devolve social sector

² Both as a percentage of GDP and overall Public Revenues.

functions to local governments, local governments typically become more financially dependent on their national governments than before". EU local governments provide social services that are similar to those provided by SEE local governments. However, the implementation of the subsidiarity principle, requiring that public services should be delivered by the public bodies that are closest to the citizens, is very different in the EU and SEE. Sectoral block grants – that are overly used in SEE – prohibit the implementation of this principle by centralizing service delivery authority. In addition to limiting local autonomy, as a side effect, micro managing at central level via block grants works against the effective use of the funds and hides the build-in deficiencies such as regional disparities.

As regards the issue of social sector functions, the report finds that it is necessary to: strengthen intergovernmental dialogue and consultation, and eventually introduce Independent Fiscal Institutions as key counterparts in the intergovernmental dialogue; **shift towards costing standards** in the process of overall valuation and allocation among local governments of the sectoral block grants; **and increase accountability** at local level by built-in incentives for achieved performance targets in each of the social sector services.

The composition of local own revenues is a key indicator for fiscal autonomy, regardless of the size of the local public sector. Despite the continuous reduction, Montenegro is still the region's champion with an own-revenues' to total revenues share of 68% in 2017. At the other end of the spectrum is Moldova, which still has the lowest share of sub-national revenues of the total (12%). In term of revenue composition, Bulgaria has the highest share of property tax revenues - 40% of total own revenues. In Romania, the share of the fees tripled since 2006 and reached 60% in

2017 mainly at the expense of the asset revenues and, to a lesser extent, to the tax revenues. In 2017, own revenues in two countries declined in real terms compared to 2016. Transfers from the central government offset most of this decline with the exception of Macedonia.

The share of own revenues from local taxes, fees and charges has decreased in many SEE countries. Compared to 2006, the share of local own-revenues has decreased from 38% to 34%. In seven SEE countries, the share of own revenues to total local revenues has decreased when compared to 2006; in four of these, the share of own revenues in less than in 2009 – while the others that have recovered to the pre-crisis levels the recovery has been slow and with significant fluctuations from year to year; compared 2015, the share of own revenue is smaller in six of the SEE countries.

Local governments powers to set and collect taxes, fees and charges are reduced. In Albania, the Small Business Tax was eliminated between 2014 and 2015, while more recently, the national government has granted tax exemptions to particular categories of businesses, without necessarily compensating local governments for this revenue loss. A similar situation is noticed in Moldova, where local governments powers over taxes on economic activities (income and wage taxes) have been removed and a number of taxpayers were granted tax exemptions and reductions. In Montenegro, while local governments have lost important own revenue sources as a result of legal changes and the aftermath of the global economic crisis, more recently, certain line ministries are in practice limiting the implementation of local government powers over the land development fee and the communal fee. In Serbia, the government eliminated the Land Use Fee, the second most important source of own-revenue.

The revenues from the property tax have increase significantly almost everywhere in the region. In 2006, property tax revenues constituted only 0.34% of the SEE region GDP and 5% of public revenues. In 2017, it constitutes 0.48% of the GDP and 9% of public revenues. Traditionally this report puts a separate accent on property taxation for two reasons: 1) its potential significance for the local governments finance, and 2) promoting more equitable and fair taxation of property of the individuals and the business. Despite the good results, the European history shows that the property tax revenues' importance in SEE will be much smaller than the PIT (sharing or local surcharges) or even asset management revenues.

The major challenges facing most SEE local governments in terms of own revenue generation are: the frequent and continuous amendment of the legal framework; outdated fiscal registers of their tax base (buildings, land, transactions etc..) and tax payers; **weak tax compliance** and **weak tax enforcement** mechanisms. On the other hand, the significant differences in the performance of individual local governments within each of the SEE countries seems to confirm that the **commitment** of national and local policymakers is crucial when it comes to the effective implementation of the local tax legislation.

SEE local governments spend a third of their budgets on labors costs' which is almost equal to the EU. However, in countries with decentralized social sector this percentage goes up to 60. **SEE Local governments, on average, invest twice as much as their counterparts in the EU,** in terms of the share of investments to local budgets. This is true for each of the SEE countries and entities. There are various factors for this phenomenon among which the fact that local

governments in SEE often pay directly for investments when in Europe they are financed mainly through utility tariffs. The greater decentralization of social sector functions within the EU requires higher operating costs, which depress the share of expenditure going to investment. And most importantly, traditionally in the EU, more public investments are made at local than at central level - 55% in 2014.

In SEE countries the state is the ultimate investor in infrastructure; only in Slovenia local governments' share in public investments is higher than the one of the central government. The data shows that public investment in SEE is heavily centralized. In the EU, the state and the municipalities have almost equal shares of the public investments.

The European Maastricht Treaty's thresholds for total public debt and annual budget deficits (less than 60% and 3% of GDP respectively) are the basic macro against which guide the SEE overall framework for public borrowing. **Compared to 2015, the level of public indebtedness goes down by 4pp to below 50% and the budget deficit is cut by half but still negative - 1.2% of GDP.**

The consolidated public debt in Albania, Croatia, Montenegro, Serbia and Slovenia continues to exceed the Maastricht Treaty limit. Serbia, however, improved considerably its budget balance and decreased substantially its debt over the past 2-3 years. A number of countries with low level of debt but with budget balancing problems improved their standings (Macedonia, Kosovo and Moldova) while Turkey and Romania's deficits increased. The only country that has not improved its indicators since 2015 is Montenegro³ - above the two thresholds with staggering budget deficit of -7%.

³ Because of borrowing for the construction of an important highway.

While assessing local governments prospective for investment borrowing a key fact should be taken into account - **the vast majority of public debt is taken by the national government - local governments' share in SEE is merely 1.8% of the total.** RS (BIH) and in Montenegro are the only exceptions with ratios of 4.2% and 3.9% respectively.

For the five SEE countries with public debt to GDP levels above the 60% limit, it is unlikely that the respective central governments will stimulate more local borrowing; at the same time the option for more local borrowing at the expense of the central one (*thus not increasing the overall public debt burden*) is a

viable policy option. For all of the other countries there is plenty of room for prudent local borrowing; which should be encouraged having in mind the needs for adequate infrastructure. This is the case especially in Moldova, Albania, Macedonia and Kosovo where local governments practically do not use debt instruments.

In addition to the previously formulated measures for stimulating the borrowing, this edition presents the **pool-financing** concept, which is widely applied in the advanced economies. In its essence, this is a process of merging the borrowing needs of several local governments and issuing debt as a single entity.

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 seventh edition of an ongoing effort to provide policy-makers and analysts with reliable comparative data on municipal finances and intergovernmental fiscal relations in South-East Europe (SEE).

The first edition was published in March 2011 and covered the years 2006-2010. This edition covers the period 2006-2017 and, compared with the previous one, includes data for both 2016 and 2017. As before, the report tries to both capture regional trends, and major developments in particular countries/entities.

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

Data, Terms, and Methodological Issues

1.

The data used in the report has been provided mainly by NALAS members and comes from their respective Ministries of Finance, Central Banks, 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. For data which is beyond the scope of municipal finance (GDP, national budget surplus/deficit, public debt, population etc.), the primary data source is Eurostat and the World Economic Outlook of the International Monetary Fund and, if missing, - the national official sources.

Comparing intergovernmental finance systems however is never straightforward because of differences in how sub-sovereign governments are organized, what they do, and how they get the money to pay for what they do. In the following, we discuss how the report addresses some of the methodological issues involved in making reasonable comparisons with imperfect data.

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

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

In a number of countries/entities, however, local governments are responsible for delivering important social sector services, particularly in education, but also in some places, healthcare. The degree to which local governments are responsible for social sector services has a profound effect on their "fiscal weight" everywhere. It is thus important when reading the report to remember what social sector services local governments are providing in different places. We discuss these issues in greater detail in the next section.

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

Population: The use of correct and most recent population data is of crucial importance for all per capita indicators. There is a variety of sources which data greatly varies mainly because of the purposes the data is generated and used. The initial focus on the census data had to be reassessed because of increasing time-gaps with the current situation, which cannot reflect the profound demographic changes. We prioritized the data sources for each country and entity in the following way:

- Primary source – EUROSTAT;
- National Statistics - census or most recent data if available, and
- Data used for the transfers systems – from the Local Government Associations’ (LGA) input.

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

Consolidated Public Revenue of the General Government: To compare the relative importance of local governments across settings we have generally used revenues - and not expenditures - as a share of the consolidated finances of the General Government. This is because: 1) data on revenues tends to be more consistent than data on expenditures at the subnational level, and 2) the revenue side has direct impact on the fiscal autonomy. By General Government Revenue, we mean the total revenues of the national government and its agencies, including the revenues of social, pension and health security public funds and those of subnational governments. For local governments we have excluded proceeds from borrowing.

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

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

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

ties the central proceeds from VAT, state-owned agricultural land lease and concession payments.

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

Important note: *The local revenue data might be problematic because different places account for different revenues in different ways, and because in some places accounting classifications have changed over time. The classification of shared taxes is, maybe, the most misleading because of its substantial share of all local revenues. For example, in most places, only shared PIT is considered a Shared Tax, with shared Vehicle Registration and Property Transfer Taxes misclassified as Own-Revenues.*

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

EU members in SEE

Measuring and evaluating the different aspects of decentralization is supposed to reflect exclusively the national efforts in this regard. The appropriate fiscal indicators should not be “contaminated” by external, non-domestic, factors. For countries, that are members of the EU (*Bulgaria, Croatia, Romania and Slovenia*), one such factor are the EU funds which flow primarily to the local level. Ideally, the data we have from member Association would clearly identify these grants flows. But, unfortunately, this is often not the case, and in a num-

ber of countries EU grants are simply not included in the national data we have or, if included, not separated from the domestic revenues. As a result, for the countries that are EU members, there are differences in the data we have on subnational revenues and expenditures and those reported by the EU. In some countries, these differences (especially significant in 2015) amount to between 1 to 3% of GDP when local government revenues or expenditures are calculated as a share of GDP.

2.

Overview of Local Governments in South-East Europe

Number and types of sub-sovereign governments

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

Table 1: Numbers and Types of Sub-Sovereign Governments

	NALAS Member	Levels of Sub-Sovereign Government	Types of Sub-Sovereign Government	Number of 1 st Tier Municipalities	
Albania	AAM	2	Counties (12); Municipalities	61	
Bosnia Herzegovina		3	Entities; Cantons (11); Municipalities	144	
	<i>FBiH</i>	<i>SOGFBiH</i>	2	<i>Cantons (10); Municipalities</i>	80
	<i>RS</i>	<i>ALVRS</i>	1	<i>Municipalities</i>	64
Bulgaria	NAMRB	1	Municipalities	265	
Croatia	UORH	2	Counties (21); Municipalities/Communes	556	
Kosovo	AKM	1	Municipalities	38	
Macedonia	ZELS	1	Municipalities	81	
Moldova	CALM	3	Autonomous Province (1); Regions (32); Municipalities/Communes	898	
Montenegro	UMMo	1	Municipalities	23	
Romania	FALR, ACoR	2	Counties (41); Municipalities/Communes	3,181	
Serbia	STCM	2	Autonomous Provinces (2); Municipalities	145	
Slovenia	SOS	1	Municipalities	212	
Turkey	MMU	3	Provincial Self-Governments (51) Regional Self-Government (793) Municipal and Communal Self-Governments	1,398	

Bosnia and Herzegovina (BiH) is the most complicated and has four-plus levels of government: 1) The state of BiH 2) Two entities: Republic of Srpska (RS of BiH) and the Federation of Bosnia-Herzegovina (FBiH of BiH) - plus the Brcko District; 3) Cantons in FBiH (BiH); and 4) municipalities in both entities, 80 in FBiH and 64 in RS. In FBiH, the entity level government is small and the cantons receive the lion's share of public revenues and provide lion's share of public services, at the cost of both the entity government and local governments. The financial data used in the report for local governments in FBiH does not include the revenues or expenditures of Cantons.

Albania and Croatia both have democratically elected county level governments. In Albania, the *qarks (counties)* play a very limited role while in Croatia the *zupanije* are more important, though both are small compared to the municipal sector.

The situation in **Moldova** is more ambiguous. Moldova has three levels of sub-sovereign government: 1) The autonomous province of Gagauzia 2) *raions* or regions, and 3) communes and municipalities. *Raion* heads are indirectly elected by *raion* councils but operate under strong central influence. They also exercise significant control over the budgets of municipalities and communes. This blurs the distinction between 1st and 2nd-tier governments in Moldova, as well as the

distinction between local governments and the territorial arms of the national government. Because education and other social sector functions are still at the raion level, Moldova appears to be a highly decentralized small state but in fact remains quite centralized.

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

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

Serbia has two levels of sub-sovereign government: 1) provincial and 2) municipal. The financial data in the report is only for municipalities.

Turkey has three levels of sub-sovereign government: 1) Provincial Self-Governments, 2) Regional Self-Government and 3) Municipal and Communal Self-Governments. Only the last one is considered 1st tier local government but the data on subnational finance covers all of them.

The Average Population of Municipal Governments

For the 11-year period since 2007, the SEE countries' population increased by 7.6 million and reached 135 million in total. The increase rate is twice the one in the EU28 (2.8%). Individually, countries, of course, perform differently: the population of only

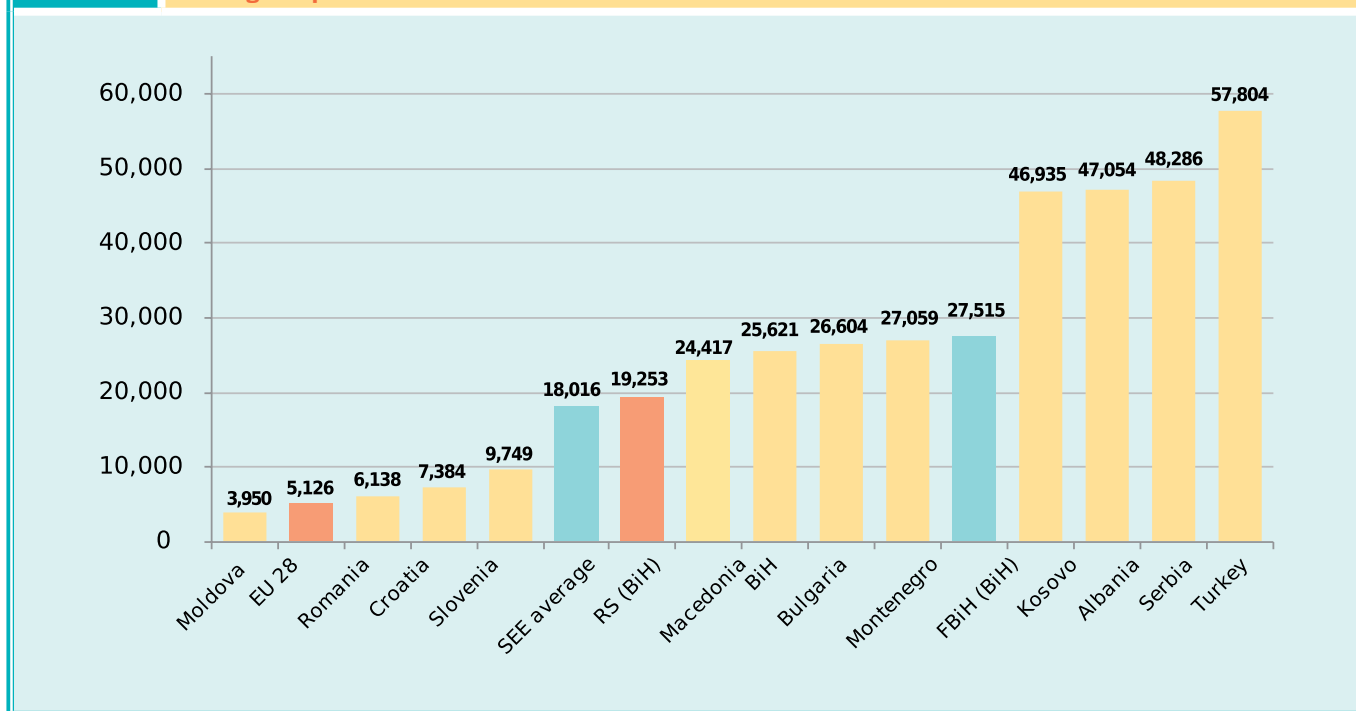
four countries increase - Slovenia, Montenegro, Macedonia and Turkey. Turkey alone adds over 11 million, which explains most of the increase for the region. The biggest nominal declines are registered in Romania (1.6 million), Bulgaria (over 0.5 million)

and Serbia (0.4 million). Relatively to the population in 2007, the sharpest declines are in Kosovo (16%), BiH (8%) and Romania (7.6%).

The average population of 1st tier municipal governments differs significantly across SEE. As can be seen from Chart 1, Moldova has the smallest municipal governments, averaging less than 4,000 inhabitants. Municipalities in Romania, Croatia and Slovenia are also relatively small, averaging

less than 10,000 inhabitants. After the administrative reform in Albania, significantly reducing the number of 1st tier local governments (from 373 to 61), their average size jumped to over 47,000 thus joining Turkey, Kosovo and Serbia which have similar average sizes (above 40,000). Nonetheless, the average size of municipalities in the region (roughly 20,000) is significantly larger than the average for the EU (approximately 5,100).

Chart 1 Average Population of 1st Tier Local Governments



The diversity among SEE countries is no surprising at all - the EU is quite diverse as well - of almost 100,000 municipalities in the 28 Member States, nearly 80% are located in just five countries: 41% in France, 13% in Germany, 9% in Spain and Italy and finally 7% in the Czech Republic. From this prospective, countries such as Austria, Hungary, Cyprus, the Czech Republic, France and Slovakia, are very similar to Moldova and Romania - below 6,000 inhabitants on average per municipality. On the other end of the spectrum Kosovo, Albania, Serbia and Turkey, resemble the United Kingdom, Lithuania, Denmark and the Netherlands with over 40,000 inhabitants per municipality.

In each country the number of sub-national tiers, the number and size of local governments and service provision responsibilities assigned to them, are the result of many factors including historic traditions and the level of democratic development. It is hard to find clear proofs of the notion that jurisdictional fragmentation is an obstacle to decentralization - the experience of countries such as Hungary and the Czech Republic are examples of the opposite. On the other hand, there are attempts throughout Europe, especially after the economic crisis, to optimize the local sector either by municipal mergers or by encouraging various forms of inter-municipal cooperation. This new policy is driven mainly by the need to

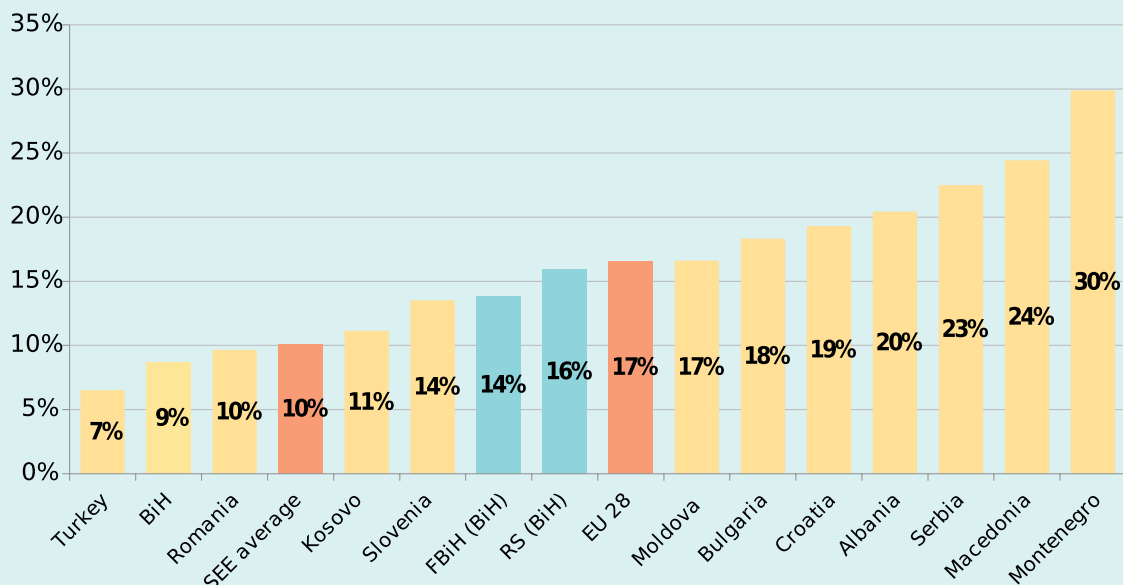
tackle issues such as high administrative costs, weak tax bases and human capital shortages associated with small local governments. This trend can be seen in Greece, Germany, Ireland, Finland, Norway, Albania and other countries.

The increasing concentration of people in the capital and metropolitan cities poses a number of social, economic, administrative and development issues, which, in general, work against decentralization. This trend is not unique for SEE only - during the period 2008 to 2017, the population of the capitals in EU 28 increased by 6.6% - more than twice than the total population increase. Chart 2 shows that the share of EU 28 capital cities' population reaches 17% of total.⁴ The 10% ration for SEE as a region reflects similar trends, ranging from below 10% in Turkey and BiH to above 20% in Albania, Serbia, Macedonia and Montenegro. Almost 20% of the population of Turkey lives in Istanbul metropolitan area and despite not being Turkey's capital, this concentration also should be taken into account.

If we detach the capital cities, the average population of the other local governments will be much lower (and much closer to the real status of the typical municipality). For example, in this case (Belgrade excluded), the average size of the Serbian municipalities would be 37,500 inhabitants - almost 11,000 inhabitants less.

⁴ The data accounts for the population if the metropolitan regions around the capital cities thus not limited to the administrative boundaries of the capital cities.

Chart 2 Percentage of Population Living in Capital Cities



The oversized importance of capital cities in the region skews economic activity towards a single metropolitan area(s)⁵. This creates several challenges to decentralization and the overall local government development:

- For an increasing number of smaller local governments, it is not uncommon that the local administration (including its financially dependent units such as kindergartens and schools or the municipal companies) is the major employer;
- In the countries with negative population growth, the quality of the municipal staff deteriorates due to the competition from the pri-

vate sector i.e. two sectors compete for a decreasing number of skilled labor force;

- As a consequence, major shifts in needs for public services are registered - the pressure for social assistance increases while the own revenue base shrinks;
- Both national and local governments face a growing dilemma:
 - On one hand, capital cities produce the lion's share of GDP and public revenues;
 - On the other, the obvious public need (but not politically obvious) to allocate less transfers to the capital cities while increas-

⁵ Three metropolitan areas in Turkey - Istanbul, Ankara and Izmir.

ing the funding for the rest of the country from which the population is migrating. The typical example is the local infrastructure - maintaining it is not closely related to the population using it.

One of the good, non-partisan, ways to resolve this issue is to adapt and improve periodically the equalizing transfers based on objective and easy-to-measure indicators for both the local needs and the available local revenue base.

The Dynamics of the Gross Domestic Product

Chart 3 presents GDP per capita for all NALAS countries and entities in 2006 and 2017, as well as their cumulative growth rates for the period. The region's growth of over 60% looks like a good achievement - average annual growth of 5.5%. But again, going deeper in the country specifics and international comparisons, there is considerable variation across the group in both relative wealth and GDP growth. Moldova has the lowest per capita income in both 2006 and 2017 despite its considerable (the highest in SEE) cumulative growth of 220%. Starting from a very low base,

even with this remarkable growth, the 2017 level is one third of SEE average and 11% of the group's "champion" - Slovenia. A number of countries doubled the level of 2006 - Montenegro, Bulgaria and Romania, which just overpassed Croatia's level of 2006. The two richest countries, Slovenia and Croatia, have the lowest accumulative growth - 33% and 28% respectively. Turkey's and Serbia's growths are very close to SEE average. Compared to SEE, EU28 grows much slowly, at 2% per year, but only Slovenia's 2017 performance is close to EU's 2006 level and all of the other lag far behind.



Some of the variation in economic performance can be explained by the different ways the countries and entities of the region experienced the economic crisis of 2008-2009. Slovenia, the hardest hit (-7.8% for 2009/2008) reached the pre-crisis level (2008) in 2015 and for the next two years grows at 3.7% and 6.7% respectively. Croatia recovered a year later, in 2016 and grew by 5.4% in 2017. Romania and Turkey, both less severely hit, recovered quickly in 2013 and demonstrate the highest growth in 2017 - 6.9% and 7.4% respectively. Moldova recovered quickly during the

period; in 2015 its GDP was slightly negative but since then it grows steadily - 3.6% in 2017. Serbia, moderately hit, grows a bit faster - 4.3% in 2016 and 6.1% in 2017. The least affected by the crisis countries are Macedonia, Albania and Kosovo. Here, growth was slow immediately after the crisis but accelerated the last two years (3-4% per year).

Various studies⁶ show that the EU membership and the flow of its funds into the national economies of the new members add approximately 1 pp to the GDP. From this prospective, they are important but no decisive for good economic performance.

⁶ Seventh Report on economic, social and territorial cohesion, European Union, 2017; The Future of Cohesion policy, The Council of European Municipalities and Regions position paper, 2017

Basic Indicators of Fiscal Decentralization

3.

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

To make reasonable judgements about the role of local governments in a given country it is important to know 1) what functions they have been assigned, and in particular, 2) whether they are paying the wages of teachers, doctors or other social sector employees.

Table 2: Functional Allocation of Expenditures - share of total in % in 2017⁸

Functions	Countries											
	BG	AL	FBiH	RKS ⁷	HR	SI	TK	MD	RO	RS ⁸	EU28*	
General Public Services	12	19	50	12	23	9	29	9	11	26	14	
Public order and safety	1	0.5	2	2	2	2	4	0.2	1	0,4	3	
Economic affairs	8	25	9	5	19	11	21	10	15	22	12	
Environmental protection	0*	0*	3	0	4	4	11	0.4	4	3	5	
Housing and community amenities	11	29	16	2	25	5	24	9	7	12	4	
Health	3	0.1	0	16	1	12	1	1	17	1	14	
Recreation, culture and religion	6	3	6	2	10	8	6	6	7	8	5	
Education	40	16	5	60	10	38	4	56	23	23	17	
Social protection	7	8	7	2	6	12	1	8	14	5	25	

⁷ Data for 2016

⁸ Data are based on SCTM assessment based on SCTM internal analysis.

Source: Eurostat, National Ministries of Finance, Local Government Associations; *Data for 2016

Some answers to the first question can be found in the following table, presenting the weight of expenditure according to the Classification of the Functions of Government (COFOG)⁹. The variety among countries is clearly visible and is due to various factors, among which could be noted the local traditions and the legal framework, guiding the service responsibilities, and, to some extent, the fact, that for some of the countries¹⁰ the data include all sub-national levels.

Despite the variety and the funding sources, the function, which has the greatest significance for the local governments, is primary and secondary education. In Moldova (all sub-nation levels included) and Kosovo its share is 60%; in Slovenia and Bulgaria – around 40%. The other countries have lower but still significant shares in funding the education. The only exception is Turkey where the state funds directly the education system.

The function of General Public Services generally includes the costs for managing the local authority – municipal officials’ salaries, public building maintenance etc. The costs associated to this function can serve as a proxy of the costs of the local administration within a country. The figures vary between 9% and 50% against the 14% average for the EU28. The costs associated to this function can serve as a proxy of the costs of the local administration within a country although additional factors such as number and composition of the municipal administration, units funded out of this function have to be taken into account also.

The function of Environmental Protection, generally includes the costs of waste management, wastewater management etc., functions which are regularly performed by SEE local governments. On the other hand, the table shows that the share of expenditures dedicated to this function is either below or well below the EU average of 5%, except for Turkey. In Bulgaria, Albania, Kosovo and Moldova, the share seems to be close to zero, although it should be noted that, in the case of Albania and Bulgaria, the costs of waste and wastewater management are ill accounted in the function “Housing and Community Amenities”.

The Housing and Community Amenities function highest shares of 1/3 to ¼ of all expenditures in Albania, Croatia and Turkey. In Kosovo, this activity is insignificant for the local governments, similar to the 4% in EU 28.

Maybe the most important difference between the EU and SEE is the role of the local governments in social protection. In the EU, these form 25% of the expenditures of the EU while in SEE the share is much smaller – up to 14%; in Kosovo and Turkey local governments practically are not involved in this social activity.

If we go back to examine the way the EU countries responded to the economic crisis, one of the lessons learned is that in countries with high level of decentralization, the safety net for the most vulnerable people, managed and funded at local level, was crucial for absorbing the negative financial impacts.

The second question about the wage costs associated with education, health and to a lesser extent,

⁹ The Defense function is omitted because of its insignificance (0% - 0.1%). *In Albania and Bulgaria, the expenditures for Environmental protection are accounted as part of the Housing and Community Amenities function. 3. For some of the countries, this data is not available.

¹⁰ See Table 1 above.

social welfare services has its own importance, because they are so big that they inevitably change the nature of the intergovernmental relations. For example, most OECD countries spend 12 to 20% of all public revenue or 3 to 6% of GDP on pre-tertiary education, of which between 60 and 80% goes to wages¹¹. As a result, assigning important social sector functions to local governments fundamentally alters the nature of intergovernmental fiscal relations.

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

Table 3 summarizes four social sector functions assigned to local governments in the region where the rows with data about the wages are highlighted in grey. Other activities like fire protection, irrigation and forestry are also included

because of their importance for the local governments in some of the countries. It should be noted also that the Social Welfare group contains a wide variety of specific services and nowhere are all of them provided at local level – in most of the cases municipalities fund some of them. The data do not take into account important aspects of the expenditure assignments such as levels of authority to: 1) determine whether a service is required; 2) determine the service policies and standards and 3) organize the service delivery. **It simply shows if local governments pay for these.**

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

¹¹ See Education at Glance, OECD Paris 2013, pp 193, 218, 240-48.

Table 3: Local Government Social Functions

	BG	AL	RKS	HR	FBIH (BiH)	MK	MNE	RS (BiH)	RS	SI	TR	MD	RO
Education													
Maintenance of Pre-school Facilities	X	X	X	X	X	X		X	X	X	X*	X	X
Payment of Pre-school Wages	X	X	X	X	X	X		X	X	X		X	X
Maintenance of Primary School Facilities	X	X	X	X	X	X			X	X	X*	X	X
Payment of Primary School Teachers Wages	X		X			X						X	X
Maintenance of Secondary School Facilities	X	X	X	X		X		X	X*	X	X*	X	X
Payment of Secondary School Teachers Wages	X		X			X						X	X
Maintenance of Special Art or Sport Schools	X	X	X	X				X	X*		X*	X	
Wages in Special Art or Sports School	X		X	X								X	
Health													
Maintenance of Primary Health (Ambulatory) Care Facilities		X	X	X	X			X	X	X	X*		X
Payment of Primary Health Care Wages			X								X*		
Maintenance of Secondary Health Care Facilities (1st tier Hospitals)			X	X	X								X
Payment of Secondary Health Care Wages			X										X
Culture & Sports													
Maintenance of Youth Houses or Houses of Culture		X	X	X	X	X	X*	X	X*	X	X*	X	X
Payment of wages in Youth Houses or Houses of Culture		X	X	X		X	X*	X	X*	X	X*	X	X
Maintenance of Libraries	X	X	X	X	X		X*	X	X*	X	X*	X	X
Payment of Wages in Libraries	X	X	X	X			X*		X*	X	X*	X	X
Maintenance of Museums	X	X	X	X	XC		X*	X	X*	X		X	X
Payment of Wages in Museums	X	X	X	X			X*	X	X*			X	X
Maintenance of Theatres and Cinemas	X	X	X		XC		X*	X	X*	X	X*	X	X

Payment of Wages in Theatres and Cinemas	X	X	X		X		X *	X	X *	X	X *	X	X
Maintenance of Local Sports Facilities	X	X	X	X	X	X	X *	X	X *	X	X *	X	X
Payment of Wages of Local Sports Staff	X	X	X			X	X *	X	X *	X	X *	X	X
Social Welfare													
Maintenance of Orphanages		X	X		XC			X					X
Payment of Wages in Orphanages		X	X					X					X
Maintenance of Homes for the Elderly	X	X	X	X	XC	X	X **				X *	X	X
Payment of Wages in Homes for the Elderly	X	X	X			X	x **				X *	X	X
Maintenance of Homes for People with disabilities	X	X		X	XC		X **	X	X *			X	X
Payment of Wages in Homes for People with disabilities	X	X					X **	X	X *			X	X
Social Welfare Payments made to Individuals or households		X **		X	XC		X **	X	X *	X	X		
Other activities													
Fire Protection		X	X	X	XC	X	X	X	X *	X	X		
Irrigation		X			X					X			
Forestry	X ***	X	X		XC								X ***

X * - These institutions could be formed by the state and by the municipalities. If municipalities formed these institutions, their obligations are maintenance and wages from municipal budgets.

X ** - These are state competences, but very often municipalities provide some logistical support and rooms/buildings for these purposes and pay for their maintenance.

X *** - municipal forests only.

XC - service responsibilities which are shared with the cantons.

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

As a rule, local governments are unlikely to provide the social welfare payments to individuals and households. They usually have more competencies in home caring for the elderly and people with disabilities.

Conversely, local governments in Albania and FBiH pay the wages for the pre-school staff only but the Albanian local governments fully fund the

culture and the social welfare functions. In Montenegro, they have no responsibilities in either education or health, not even maintaining facilities.

Fire protection is often seen as a central government responsibility in Europe but for a number of countries in SEE the local governments are involved to some extent.

Local Governments Revenues in South-East Europe

One of the key indicators for the relative size of the local governments finance is shown in Chart 4, which displays the revenues of the General Government (GG - total public sector revenues) and the Local Government (LG) revenues for each NALAS-member country or entity, as well as the average for SEE and the EU as percentage of GDP.

The previous reports have demonstrated that there is no correlation between the size of the total public sector and the share of the local sector within it. The data for 2017 reaffirms this also. The public sector in SEE continues to lag far behind the EU average - 36.1% vs 45.8% of GDP. Surprisingly, it shrinks by 1.2 pp compared to 2015. The local sector revenue share decreases by close to 0.5 pp to 5.9% compared to 2015, so the difference with the EU (which stands at 10.7%) still remains considerable - almost twice lower. One of the conclusions is that the countries of the EU have both larger public sectors and have decentralized more revenue to local governments than their counterparts in SEE.

Compared with 2015, one more entity joins the group of countries and entities (seven total) with total public sector above 40% of GDP among which Croatia's indicator equals the EU average.

Albania and Kosovo continue to have the smallest public sector - below 30%.

One more group of countries can be identified: Macedonia, Romania, Moldova, Bulgaria, and Turkey, with public sectors between 30% and 40% of GDP. The performance of the last two groups is due to a mix of several factors - problems with tax collection both at central and local level that usually mirrors the share of the so-called "gray" economy, pro-growth tax policies etc. For example, in Bulgaria, Romania and Macedonia, the personal income tax (PIT) rate is 10%¹². The same rate level applies for the corporate income tax in Bulgaria and Macedonia while in Romania it is 16%¹³.

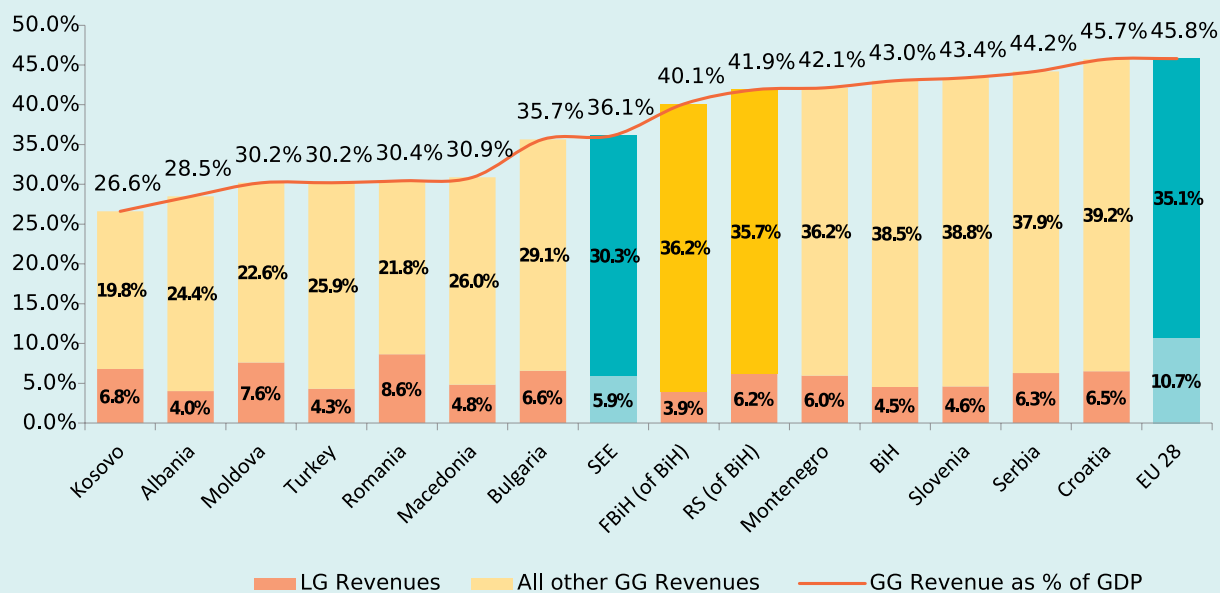
¹² In the EU, the top PIT rate varies very substantially, ranging from a minimum of 10 % in Bulgaria to more than 55% in Sweden, Portugal and Denmark.

¹³ In the EU, the effective average tax rate on corporations is 21%, ranging from 9% in Bulgaria to the highest in France - 38.4 %.



Chart 4

General and Local Government Revenue as a Percentage of GDP in 2017



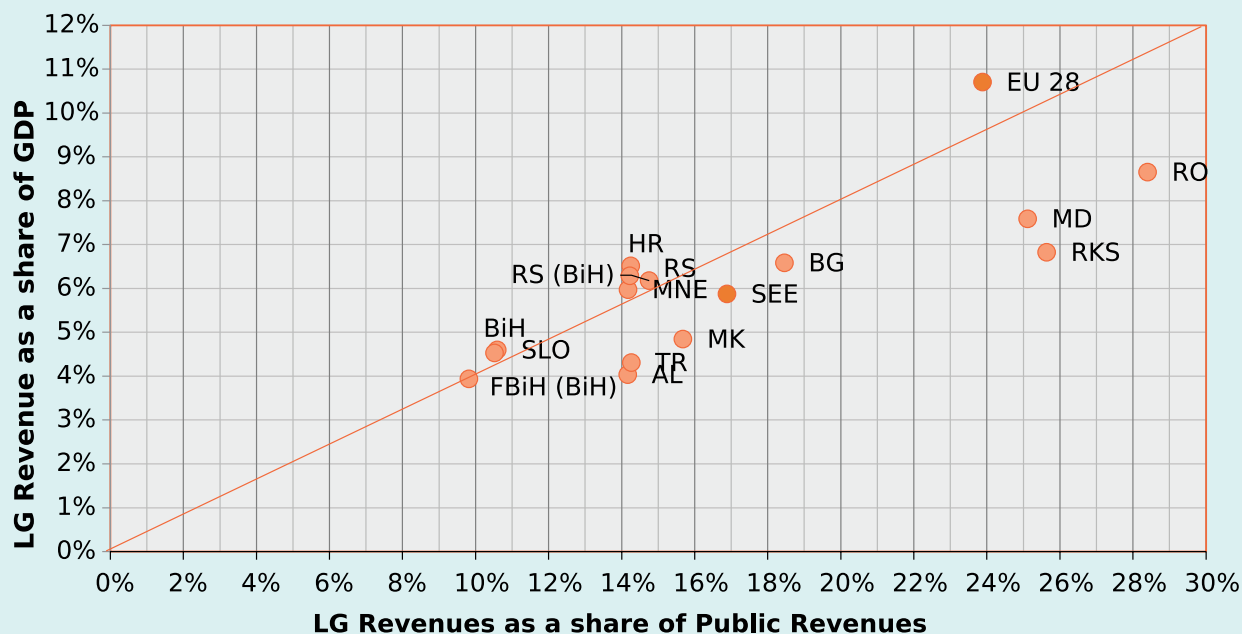
Despite the small public sector, local governments in Romania lead in terms of their share of all public revenues – 30.4%, followed closely by Kosovo (26.6%) and Moldova (30.2%)¹⁴.

Chart 5 further explores the level of fiscal decentralization by plotting the share of local revenue as percentage of total public revenue against local revenue as share of GDP. NALAS members

whose local government sectors most closely resemble those of the EU28 as both percentages of GDP and total public revenue are Moldova, Romania and Kosovo. Bulgaria's performance coincides with the SEE average, closely followed by Macedonia – its two indicators are slightly worse than 2015. The rest of countries are further away from the EU average.

¹⁴ Includes all sub-national levels.

Chart 5 Local Revenues as a share of Total Public Revenues & GDP (2017)



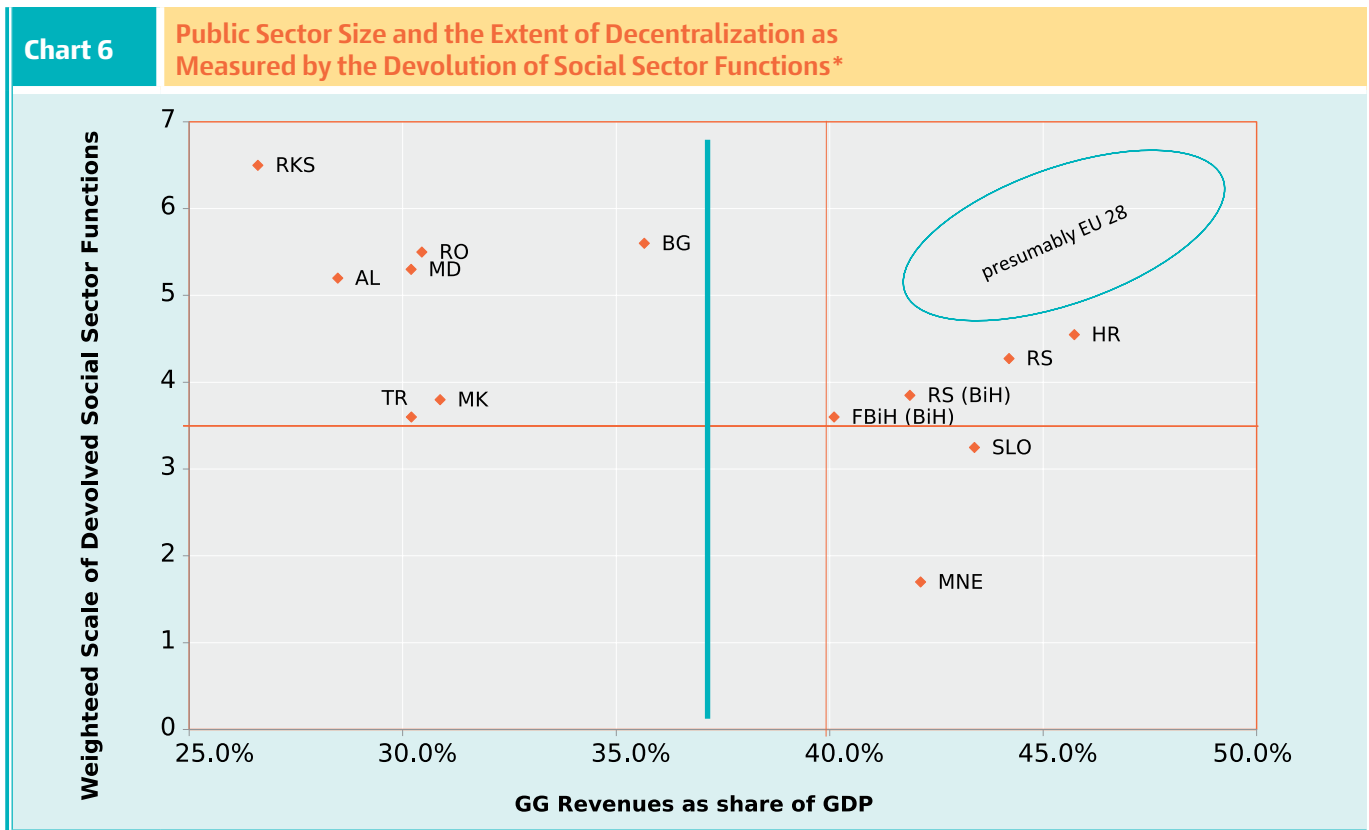
The five countries, mentioned above, with indicators' ratios above the SEE average, differ with the others by the service responsibilities of local governments over expensive social services such as primary and secondary education. As is often the case in the EU, local governments in Kosovo, Romania, Moldova, Macedonia, and Bulgaria are all responsible for these services. In addition to that, in Kosovo and Romania they are also responsible for funding primary and secondary health care. It is thus not surprising that their local governments get larger shares of the total public sector than those of their counterparts elsewhere in the SEE and, respectively, require larger shares of

their GDPs to finance these social sector responsibilities.

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

Chart 6 further explores the **relationship between the size of the public sectors and the extent of service responsibilities decentralized at local level**. As noticed in previous years, **there seems to be a correlation between the extent of decentralization and smaller public sectors**, a trend which is opposite to the EU experience. Additionally, during the last two years, the public sectors in Moldova and Bulgaria shrank and compared to 2015, now there are seven countries' whose size of the

public sector is below the SEE average (*the threshold in red in the chart*). Among the seven countries with "small states" (*public revenue to GDP less than both the 40 % and the SEE thresholds*), five have devolved the most of the social sector functions (*and, especially paying the wages of primary and secondary schools*) to local governments and one, Albania, has done this to a lesser extent. The only exception in the group is Turkey where local governments mainly have maintenance responsibilities.



*The scale is based on Table 3 and has been created by assigning one point for the maintenance of the physical facilities of each type social sector institution that local governments pay for, and 2 points for the wages of each type of social sector function that local governments pay for. An additional adjustment was made measuring the financial weight of the main functions (highest, 50 out of 100), for the three educational functions, etc.

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

Chart 6, especially when compared with its versions in the past reports, indicates, and, to some extent, reaffirms the following findings and trends:

- From a regional perspective, decentralization, unfortunately, seems not to be anymore a priority for the SEE countries, and the gap with the EU remains significant;
- A number of countries (most notably Albania and Turkey) devolved additional service responsibilities to the local governments without expanding the public sector. Five years ago, these two countries were at the bottom of the lower-left quadrant and moved just vertically;
- The countries with larger public sectors (public revenues above 40% of the GDP), also moved mainly vertically i.e., granting to the local governments additional spending responsibility while keeping the overall level of tax burden constant. Croatia is the exemption in this group – its public sector increased significantly without decentralizing service responsibilities.

If we assume that the public needs, both for recurrent services and infrastructure are similar across countries, we can observe three distinct behaviors:

- 1). Countries that collect fewer taxes (and hence have smaller public sectors) may react to these needs by transferring service responsibilities to the local governments thus offloading the public pressure to sub-national levels. The rationale for such a behavior may hardly be economic efficiency but rather political – faced with

lack of adequate public resources, the national governments may prefer to off-load costly social sector functions on local governments thus shifting the political pressure from the national to the local level. A typical example was during the crisis, when the first austerity response of several central governments was to cut transfers to the local governments without reducing their service provision responsibilities.

- 2). Some of the countries with larger public sectors (public revenues above 40% of GDP) continue to expand it but the additional public funds remain at central level.
- 3). FBiH and RS (BiH) are the only entities, which shift towards both expanding the public sector and devolving powers to local governments. It should be noted that their starting base was comparatively low and more time is needed before concluding that this is a sustainable trend. Still, this is a positive case, which needs to be further explored.

What puts the EU local governments in oval in the chart, is the fact that, firstly, preschool, primary and secondary education and the main social services are considered **essential service responsibility of the local governments**, and secondly, these services are funded through a mix of own source revenues, shared taxes and grants. And what is especially important – no matter what the funding mechanism, local governments preserve the decision-making authority to better target the service thus fully implementing the requirements of the **European Charter of Local Self-Government of the Council of Europe**.

From this prospective, the problem in most SEE countries, and especially of the seven below the SEE average (chart 6), is two-fold: a) the small public sector and, b) the conditionality imposed by

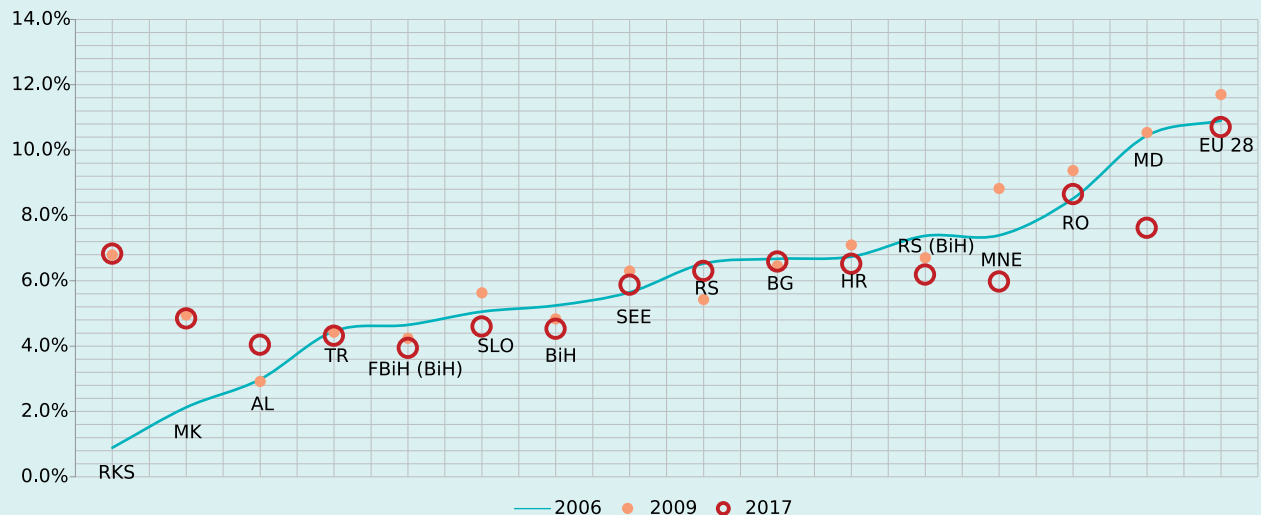
the grants from the central government which to a great extent limit the authority of the local governments to decide. In this case, one could hardly see real local self-governance but more likely paying local agents of the central governments, instead.

Chart 7 shows local government revenue as percentage of a GDP in 2006, 2009 and 2017. The region as a whole slightly improved by 0.3 pp in 12 years. The other way to describe it “no progress at all”. For two countries only, Albania and Serbia, 2017 is better than 2009. Local government revenues

to GDP remained the same between 2009 and 2017 in five countries and entities, Macedonia, Turkey, FBiH, BiH, and Bulgaria while the situation has deteriorated for seven of the countries and entities; Moldova, Montenegro and Slovenia lost the most, respectively 2.9 pp, 2.8 pp and 1 pp compared to 2009. Also, in the EU, local government revenues to GDP in 2017 result to be 1 pp point lower than in 2009. However, the EU 28 average is still 5 pp higher than the SEE average.

Chart 8 shows the per capita revenues of the con-

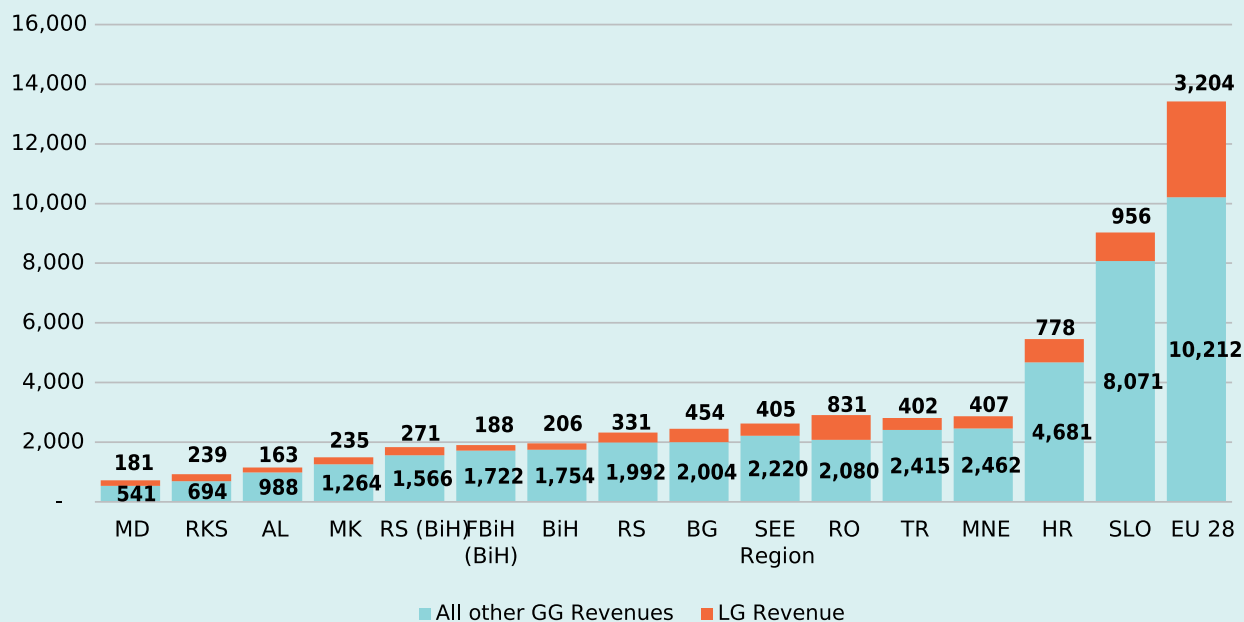
Chart 7 Local Government Revenue as a Share of GDP in 2006, 2009, 2017



solidated public sector and of local governments in EUR in 2017. The Chart is a useful reminder of how little revenue the local governments of most of SEE have to work with, especially when compared with their EU partners. On average, local governments in SEE dispose of eight times less Euro per capita than their European counterparts. Even the richest one, Slovenia, gets 3.3 times less. Across the region the variation is also striking – Slovenian’s local governments are more than 5

times richer than the poorest ones – those in Moldova which get less than 200 Euro per capita. It is also particularly staggering that local governments in Moldova, Kosovo, and Macedonia pay for teachers’ wages on per capita revenues of less than 260 EUR, while Croatian and Slovenian municipalities bear little of these costs and have per capita revenues 3 to 4 times higher.

Chart 8 Consolidated Public and Local Government Revenue (EUR Per Capita-2017)

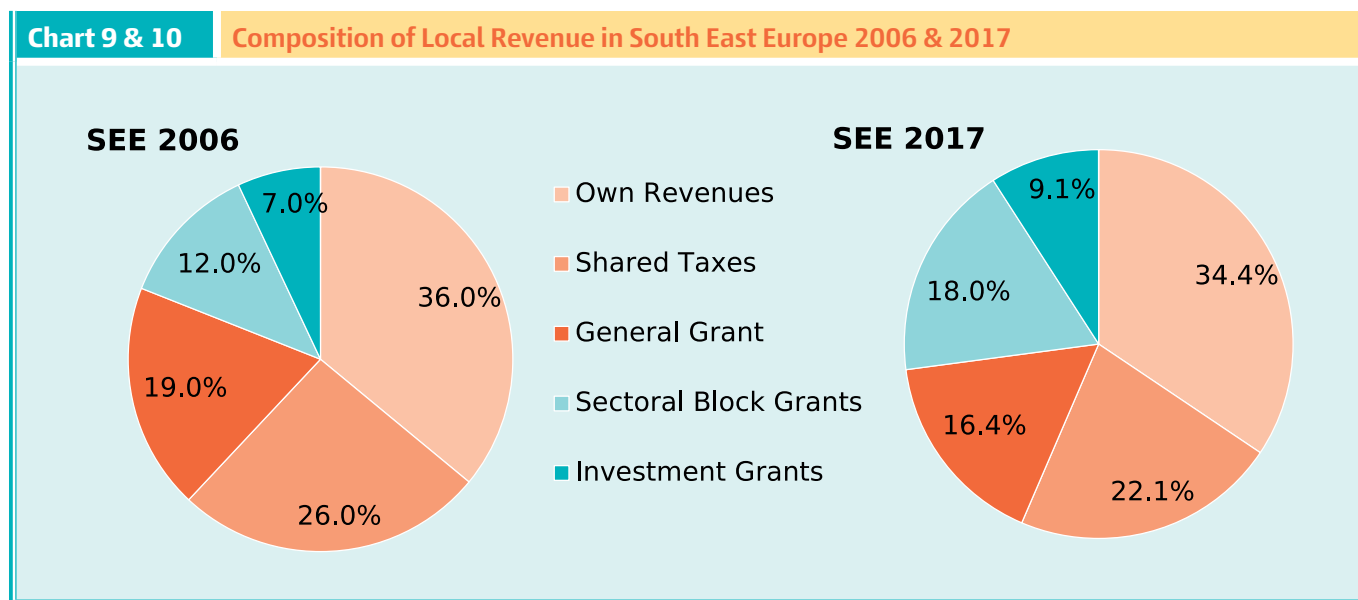


Composition of Local Revenues and Local Fiscal Autonomy

Maybe the key aspect of local fiscal autonomy, besides the total amount and shares of the local budgets in comparison to the GDP or public sector, is the composition of the revenue base. And the main characteristic of the composition is the level of local decision-making authority over its components i.e. the level of the local fiscal autonomy. Although the general revenue categories are clear terminologically, their meaning and composition varies substantially across the region and, on several occasions, one general revenue component might consist of different revenue items¹⁵. The reader should have this in mind because the occa-

sional misclassification may significantly overstate the local fiscal autonomy in some of the countries and entities. Having in mind the differences across the countries, the data is informative of the composition of local revenues and fiscal autonomy.

Chart 9 and 10 show the change in the basic composition of local revenue between 2006 and 2017, as an average for all NALAS members. The shares of own revenues, shared taxes and general grant have dropped by 1-4 pp., and, more worryingly, the share of the block grants increases by 50% and conditional investment grants increase by 30%.



¹⁵ The main differences are explained in Section I - Data, Terms, and Methodological Issues

If we translate these figures from the point of view of local governments' authority to decide how to spend revenues from the different sources, the table below shows an alarming, continuing trend: the share of the revenues, over which local governments have

- full control (*own revenues and general grant*) drops by 4 pp since 2006;
- limited control (*shared taxes and investment grants*) drops by 2 pp since 2006;
- no control (*sectoral block grants*) increases by additional 6 pp since 2006.

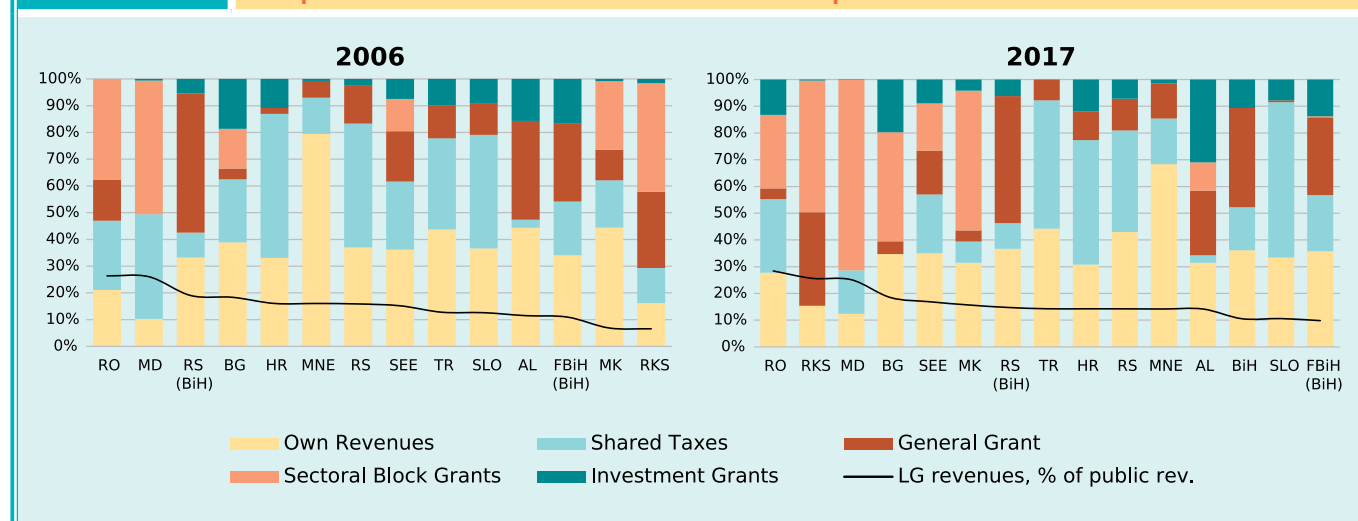
	Full local discretion	Limited local discretion	No local discretion
2006	55%	33%	12%
2015	53%	31%	16%
2017	51%	31%	18%

The table clearly shows that, **on average, local governments in SEE in practice can freely decide on half their budgets, while the other half is preconditioned by the central level via the conditionality of the transfers.**

Charts 11 and 12 present the same information for individual members of the group for year 2017 ordered by local governments' share in total public revenues.

As explained already, Kosovo, Romania, Moldova, Macedonia and Bulgaria are the countries that have devolved the most significant social sector functions to local governments. And not surprisingly, they are the five places where local government revenues are now highest as a share of total public revenues. We can also see that the revenues of all five are dominated by conditional sectoral grants, with much less coming from shared taxes and own-sources.

Chart 11 & 12 Composition of Local Revenue in South East Europe 2006 & 2017



This is very different from the situation in 2006. Kosovo and Macedonia have moved from the far right of the chart to the far left: In fact, between 2006 and 2017 they journeyed from being the least decentralized countries or entities in the region to being the most. In addition, this journey transformed the structure of their revenues, which no longer come mainly from own-revenues and shared taxes but from conditional and unconditional transfers.

Moldova and Bulgaria are also interesting in this respect. In neither country, were major new functions devolved to local governments between 2006 and 2017. Nonetheless, in both countries, Conditional Grants have increased at the expense of shared taxes. This is because early in their decentralization efforts both Bulgaria and Moldova devolved schooling to local governments, but tried to finance it through PIT sharing.

In 2008, Bulgaria completely replaced PIT sharing with sectoral block that, unlike PIT sharing, can be allocated according to objective measure of need, a process that Moldova began in 2014. In fact, Bulgaria is the only country where tax sharing is non-existent.

The shift towards Conditional Grants nicely illustrates again a well-known paradox in intergovernmental finance:

As countries devolve social sector functions to local governments, local governments typically become more financially dependent on their national governments than before¹⁶.

Being financially dependent is not necessarily a bad thing for the local governments – in Europe, almost all municipalities receive some kind of financial support from the state. The real question is if this support reduces the scope of the municipal spending decisions. Further arguments for this fundamental question can be found in the European Charter of Local Self-Government, adopted by all SEE countries¹⁷, which, in article 9 requires:

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

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

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

¹⁶ See Blochlinger and King, “Less than you thought: The Fiscal Autonomy of Sub-Central Governments” OECD, 2006

¹⁷ Except Kosovo

The real question is “Is it decentralization if the process leads to a reduction in municipal discretion on spending decisions or, rather, deconcentration, if local governments’ role is simply to fund the central government’s decisions at local level?” Responding to this paradox is not easy, considering the many contextual variables that drive the policy choices in different countries. Unfortunately, it is not uncommon that such political choices exacerbate this paradox in many contexts: while economies and public sectors’ size increase, it is not uncommon that national governments prefer to utilize sectoral block grants to fund the increase or expansion of services instead of financing instruments over which local governments have more discretion and authority. Ultimately, the decision over the funding mechanism should be pondered having in mind the principles of local self-government and autonomy rather than what is the easiest for the central authorities to control.

The local governments in Kosovo, Romania, Moldova, Macedonia and Bulgaria provide similar social services similar to their counterparts in the EU. The big difference is the extent of implementation of the subsidiarity principle which requires that the public services should be delivered by the public bodies that as closet to the citizens. If we exclude public functions such as defense, diplomacy, intelligence and migration, which, obviously, have nation-wide impact, almost all of the other public services, have local or regional significance. The subsidiarity principle means that the vast majority of these public services should be provided by local or regional authorities no matter what the funding sources are. The sound logic behind this principle is based upon the proven fact that the municipalities possess the best knowledge of local conditions and needs and should have the powers (and being accountable for) to improve the effectiveness of the public money.

In fact, micro managing local governments from the central level via block grants works against the effective use of the funds and hides built-in deficiencies such as the inadequate consideration of regional disparities. Such a system is much less flexible and difficult to modify on a timely basis in order to answer the changes to the public needs.

The broader objective in the region is to constantly promote and nurture the intergovernmental dialogue that allows both central and local governments to seek and reach reasonable compromises over time. Unfortunately, despite the legal obligation in each of the countries, commitment to intergovernmental dialogue is weak across much of the region. One of the ways to overcome this contradiction and build trust could be to agree on a common set of rules regulating the overall size of the pool of the sectoral block grants, and its allocation among municipalities, while local governments preserve a high level of autonomy as regards the utilization of financial resources, within and outside the functions. On the other hand, the national government may use costing standards and service performance standards to measure how the municipalities use the Block Grant. In other words, instead of dictating how much local governments should pay the teachers; the ministries have to set commonly accepted and objectively determined costing standards and service performance indicators such as level of dropouts, exit educational tests, parents’ satisfaction etc. it is important to appreciate that Local autonomy does not mean lack of accountability. On the contrary – the system must contain both incentives for achieved performance targets and financial threats in cases of no compliance such as partial disbursement of the Block Grant

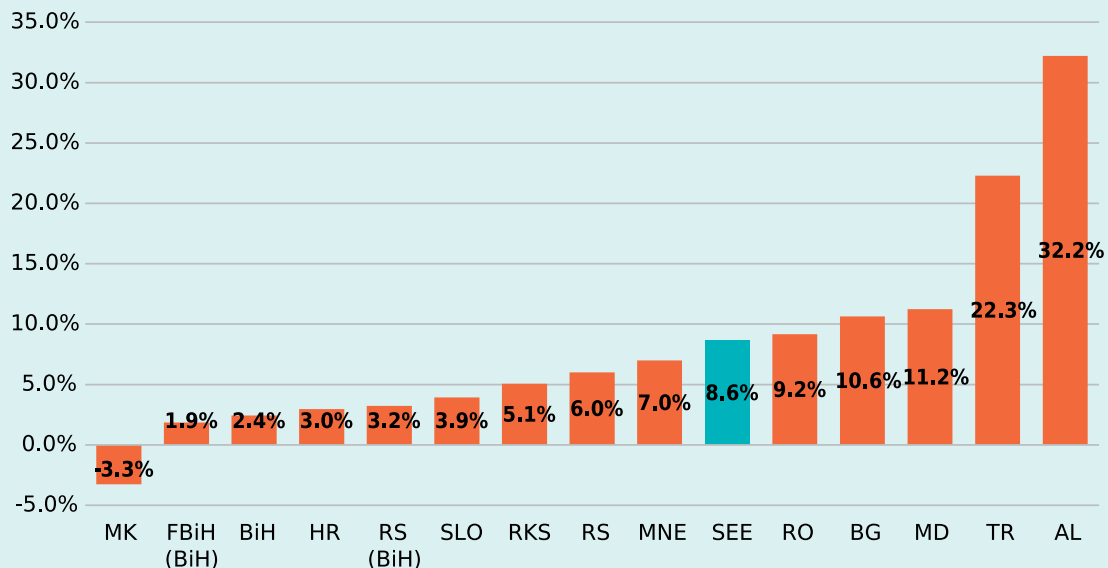
In several countries, there are independent, non-partisan watch-dogs at the Parliaments whose task is to oversee the public money efficiency and to

give advice to all levels of governments to design an enabling environment conducive to good governance. The establishment of such *Independent Fiscal Institutions (IFI)* could help improving the overall intergovernmental finance system and ensuring a better harmonization of strategic objectives and fiscal policies at national and local level.

The next chart shows the dynamic of the revenue position in real terms of the local governments between 2016 and 2017. The SEE growth is 8.6% and can be seen everywhere but in Macedonia is the

only country where local governments have experienced a decline in their overall revenues. The most impressive annual growth is the one in Albania – over 30%, mainly due to an increase in sectoral grants (to fund newly decentralized functions) and an increase in conditional investment grants. Own local revenues have increased as well in Albania, although the growth is mostly concentrated in a number of larger and more urban jurisdictions. Turkey, Moldova, Romania and Bulgaria are the other countries with two-digit annual growth.

Chart 13 Growth/Decline of Total Local Government Revenue in 2016 - 2017



The Composition of Own-Revenues and the Property Tax

The composition of the municipal own revenues is a key indicator for fiscal autonomy no matter what the size of the local public sector is. Its main components comprise the local taxes, service fees and charges, property management revenues and other, smaller revenue categories such as fines and fees. The accounting and reporting of local own-revenues differs substantially across the region. For some of the countries, a detailed breakdown of own-revenues is available whereas for some other countries the data is reported only on two or three categories. These methodological difficulties, hamper the formulation of decisive conclusions for some of the countries. For example, while the “Other” revenue category should have a minor share of the own revenues, in Moldova and Turkey this is the predominant one – over 60%-70%. In other places, tax revenues and some of the fees are reported together – more than 90% of what is recorded as property tax in Slovenia comes from the Land Use Fee.

At a first glance, the shares of own revenue to total revenues are in line with the average for the OECD countries and, to some extent, to the EU average. They also almost certainly overstate the real revenue raising powers of local governments in the region because of the misclassification of many shared taxes and fees as own revenue.

Chart 14 shows the share of own-revenue to total local revenue for NALAS member countries in 2006, 2009, 2015 and 2017. From the regional perspective, on average, own-revenues in 2017 constitute 34% of total local revenues, down from 38% in 2006. Between 2006 and 2017, the share of own revenue to total revenue has increased in half of the NALAS countries, while it has decreased

in the other half. The decrease in the share of own-revenue to total revenue is linked to both the elimination or reduction of local governments’ tax powers and the decentralization of additional social sector functions that are mostly financed by sectoral block grants. This is certainly the case in Kosovo, Albania and Macedonia. It can also be noted that in most of the countries, the share of own-revenue to total revenue has recovered and is higher than the pre-crisis levels, except for Montenegro, Turkey, Albania, Kosovo, Croatia. In Montenegro this is due to the partial elimination of local government tax powers, while in Albania is mostly related to the devolution of block grants for new functions, although also here, local governments have lost relevant tax powers. The chart shows also that while some countries may be better off when compared to 2009, the economic crisis year, still, the recovery remains slow and with substantial ups and downs in the road. In fact, when compared to the more recent past, 2015, it seems that own revenues have lost their importance even in some countries, that have not necessarily transferred social sector functions at the local level.

Charts 15 & 16 present the composition of local government own-revenues in 2006 and 2017 for all NALAS members, ranked by the share of own-revenues to total local revenues. Despite the decrease, Montenegro is still the outlier with own-revenues’ share of 68% of total revenues in 2017. There is a dramatic composition change also – the share of the property tax increased from 8% to 30%. At the other end of the spectrum is Moldova, which still has the lowest share of sub-national revenues to the total public revenues (12%) and where there is a significant decline of the property tax revenues’ share – 30% in 2017 vs. almost 50% in 2006.

Bulgaria has the highest share of property tax revenues, 40%, but it should be noted that this category includes all local taxes – property tax, vehicle tax, property transaction tax and some others will small fiscal impact. The increase in the share since 2006 (12%) is due to two main factors – 1) in 2007 local governments received real taxing powers in setting the rates and 2) in 2006 the local tax administrations have been established¹⁸.

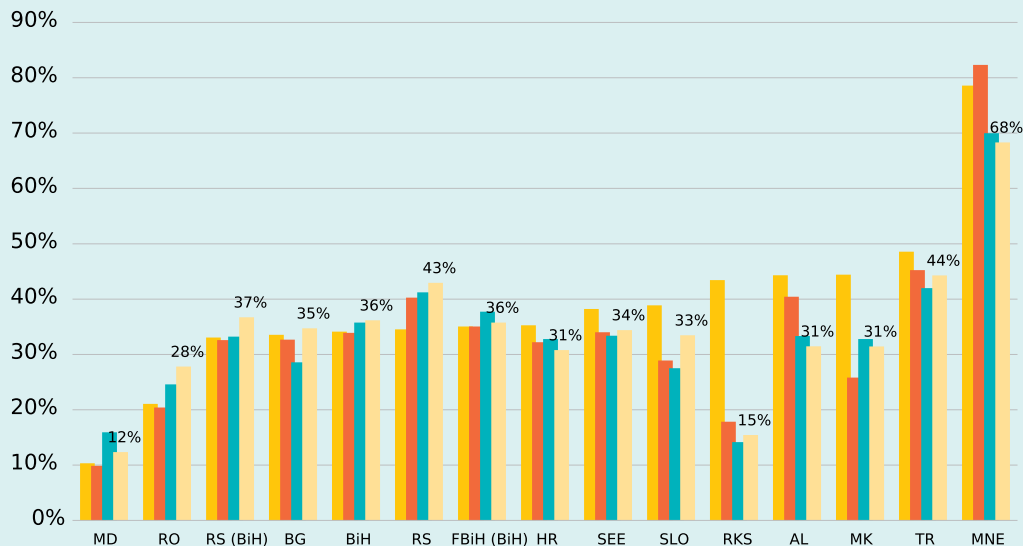
From a regional perspective, compared to 2006, the share of the property tax to total own local revenue has increased in almost all NALAS countries, but in Moldova and in Romania. The share of communal fees also has increased in almost all countries when compared to 2006. It can be noticed also a tendency for the elimination of the

Land Development Fees on new constructions. Only Montenegro, Albania and Kosovo seem to continue granting local governments with taxing powers over new constructions. Asset management revenue also remain important in Bulgaria, Slovenia and Croatia, while its relevance has decreased in Montenegro, Romania and the Republic of Srpska entity of Bosnia and Herzegovina.

Chart 17 shows the annual own revenues growth 2016 and 2017. Two countries register a decline in real terms, which, for Macedonia and Moldova, is considerable – between 4% and 9%. Transfers from the central government offset most of this decline with the exception of Macedonia (reference to chart 13).

Chart 14

Share of own-revenue to total local revenue in 2006, 2009, 2015 and 2017



¹⁸ Until then, a central tax administration was responsible for collecting all taxes and fees.

Chart 15 & 16 Composition of Own-Revenues in 2006 and 2017

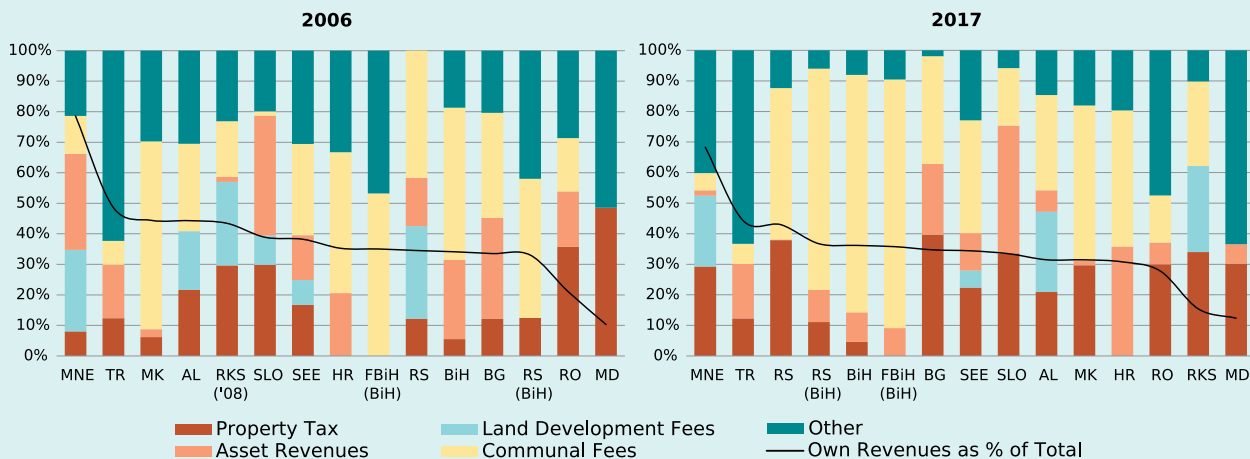


Chart 17 Local Government Own Revenues nominal annual growth 2016-2017 in %

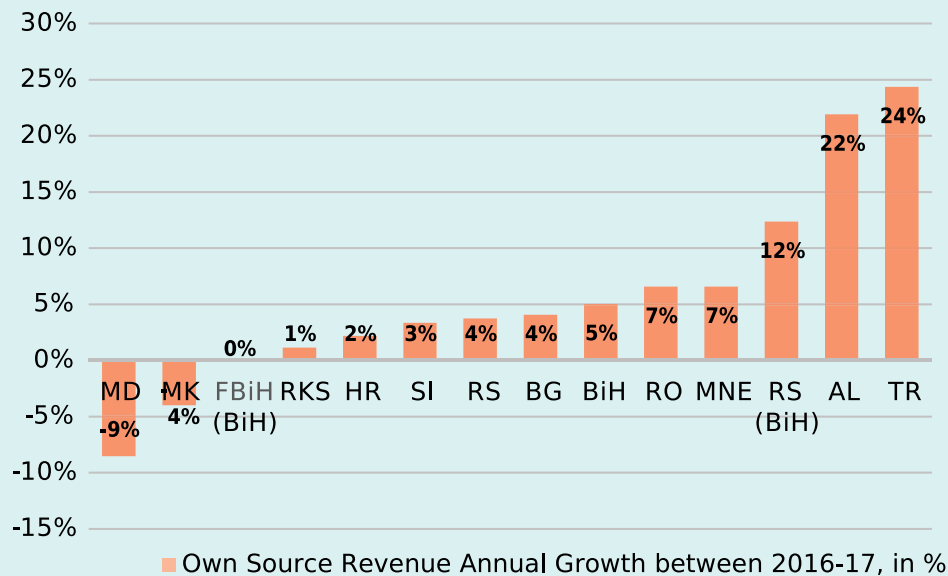


Chart 18 presents the own revenues yield in EUR per capita for three selected years which demonstrates again the variation among the countries and entities. The main conclusion is the fact that compared to 2006 and 2009, this indicator has improved in almost all NALAS member countries, except for Montenegro and to a much lesser extent Kosovo. Romania and Moldova doubled their own revenues per capita since 2009 but Moldova still has the lowest indicator more than twice behind the next one – Kosovo. The most surprising is the performance of Montenegro, which, despite the big share of the local and own revenues, in 2017 lost over 70 EUR per capita compared with 2009. This is due to the legal abolition of several local revenues¹⁹ without proper compensation as well as because of consequences of the economic

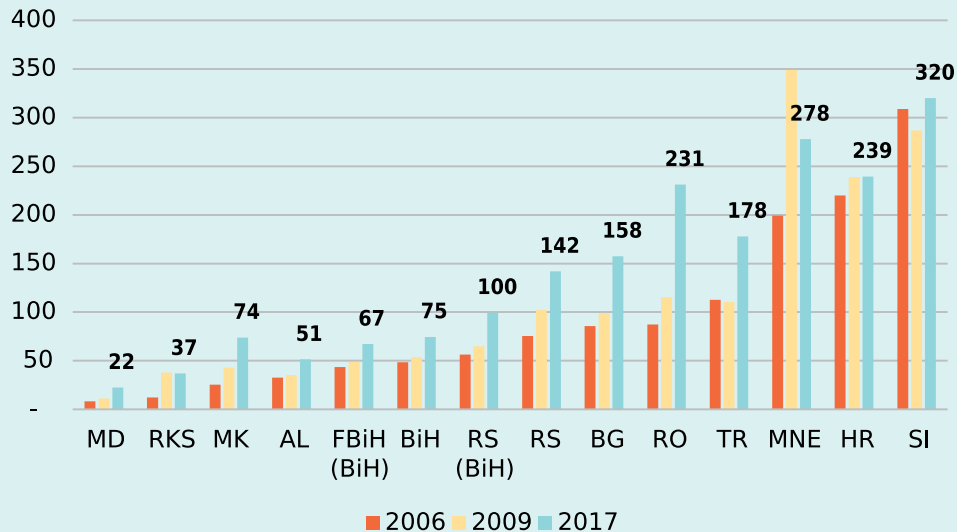
downturn. Croatia's performance in 2017 equals the one in 2009. Slovenia, which suffered one of the highest falls in economic activity during the crisis among EU member states, finally outperformed the pre-crisis level in 2017. Again, the difference among SEE remains considerable- Slovenian local governments generate 14 times more own revenues per capita than their counterparts in Moldova.

Traditionally this report puts a separate accent on property taxation for two reasons:

1. Its potential significance for the local governments finance, and
2. Promoting more equitable and fair taxation of property of the individuals and the business.

Chart 18

Local Government Own Revenues in 2006, 2009 and 2017, in EUR per capita



¹⁹ Land use fee, consumption tax, tax on company title, tax on games of chance and some local charges.

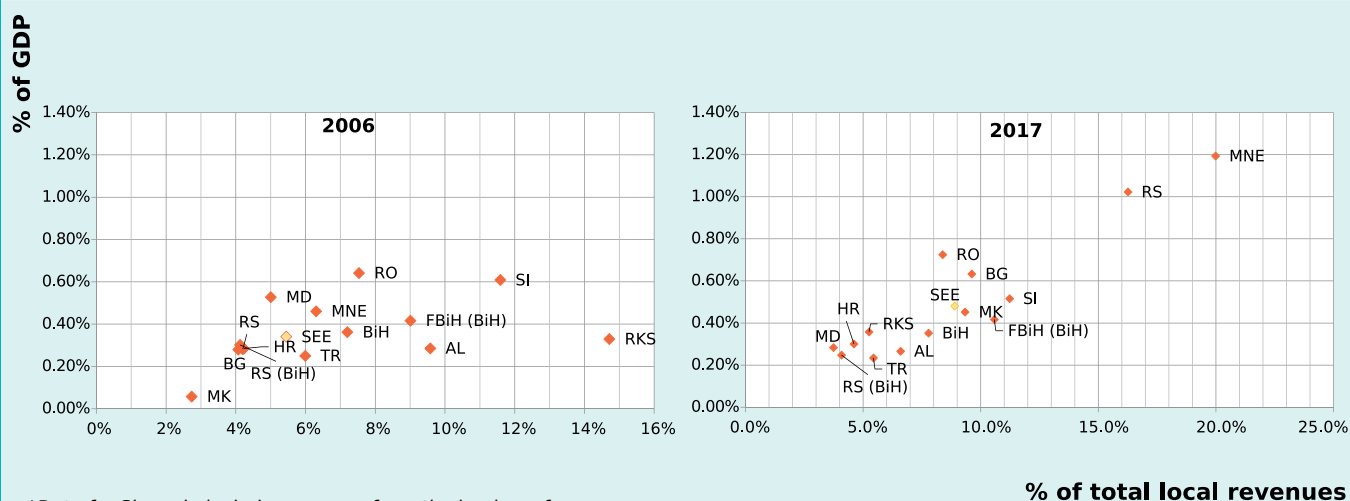
Despite the good results, if we follow the European history and traditions, the property tax revenues' importance in SEE, for the foreseeable future, will be much smaller than the PIT (sharing or local surcharges) or even asset management revenues.

Throughout the region, national and local governments, to a large extent with the support of the donor community have made substantial investments in the technical infrastructure for property taxation. From the regional perspective, between 2006 and 2017, the yield of the property tax almost doubled, increasing from 5% to 9% of local revenues and from 0.3% to 0.5% of the GDP. This tendency is driven by the outstanding performance of Bulgaria, Macedonia, Montenegro and Serbia. Over the same period the share of the property tax revenues to the GDP has fallen significantly in Moldova, Republic of Srpska (of Bosnia and Herzegovina) and Slovenia. Chart 20 also show that Montenegro and Serbia lead considerably above

the rest of the group, which have similar indicators. These two countries' indicators are the closest to the EU average of 1.6% and in line with the countries in Eastern Europe, members of the EU.

The European model suggests that, in a long-term prospective, there is plenty of room for increasing the fiscal significance of the property taxation. The local taxing powers over the property-related taxes are the most common municipal taxing powers. The local option of setting rates within legally set limits (upper, lower or both) should not undermine the tax efforts of the local governments in general. In other words, local governments might be tempted to keep the rates low if they find other ways to attract money from the central governments (usually by more grants). This concept is especially important for the equalizing grants – the intergovernmental system should not “award” municipalities with low property tax rates (significant revenue potential).

Chart 19 & 20 Property Tax as % of GDP and Total Local Revenue in 2006 & 2017*



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

The Composition of Expenditures and Investment Spending

Chart 21 shows the composition of the regional average local government expenditures by economic type for NALAS members in 2006 and 2017 and the EU 28 in 2017. It should be noted that as with revenues, there are inconsistencies in the way expenditure data is reported. For example, some places treat capital transfers to public utilities as investment expenditures while others record them as subsidies, which cannot be distinguished from transfers to individuals or grants to non-governmental organizations. Similarly, in many places, debt repayment is not accounted for separately but included in the category “Other”.

On average, in 2017 local governments in the SEE region spent about a third of their budgets on per-

sonnel expenditures, 23% on goods and services and 21% on capital investments. Compared to 2006, spending for investments has decreased by 8 pp, while spending for staff wages and benefits has increased by 4 pp. Spending for grants and transfers has increased as well by 3 pp, on the back of spending for goods and services which has decreased by 3 pp. Local governments in the EU28 have also spent on average a third of their budgets on wages for the staff and about a fourth on goods and services in 2017. Local government’ share of investment spending is very different between SEE and the EU. Such differences are more clearly shown in Chart 22.

Chart 21 Composition of Local Expenditure in SEE in 2006, 2017 & the EU in 2018

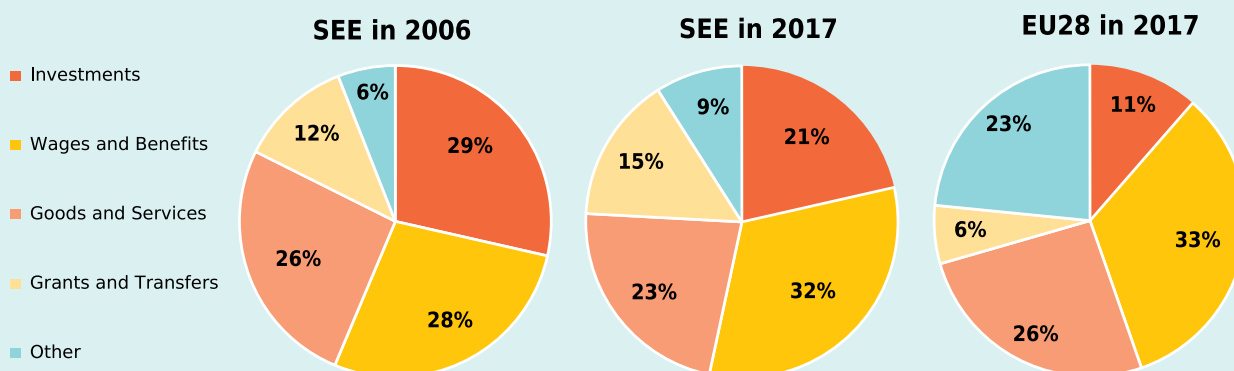


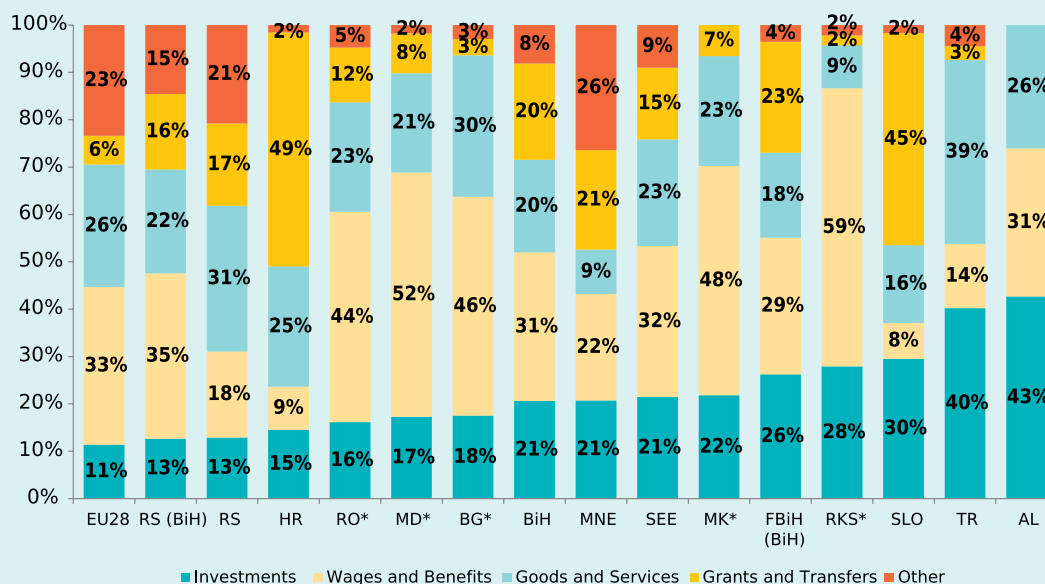
Chart 22 shows the composition of local government expenditures by economic type for each member of the group, as well as the average for the group as a whole (SEE) and the average for the EU (EU28). Again, as explained above already, within SEE, in the countries that have decentralized social sector functions (*) local governments spend a higher percentage of their expenditures on wages (*up to almost 60%*). Countries are ranked on the share of investments to total spending.

More surprising is that local governments in SEE countries spend a larger share on investments than their counterparts in the EU. More notably, in Albania and Turkey, this share is twice the SEE average - above 40%.

A number of reasons can explain this situation:

- Local governments in SEE often pay directly (out of their budgets) for investments that elsewhere in Europe are financed mainly through utility tariffs (water and sewer, waste collection and treatment, public transportation);
- The investment needs of SEE and EU are different - in SEE more money is spent on building new infrastructure and reconstructing the old one while in the EU more is spent on maintaining the existing infrastructure which is treated as operational expense;
- The greater decentralization of social sector functions within the EU requires higher operating costs, which depress the share of expenditure going to investment.

Chart 22 Composition of Local Government Expenditure in 2017



- During the crisis, one of the first responses of the EU countries was to cut the public investments;
- Traditionally in the EU, more public investments are made at local than at central level - 55% in 2014. Among the OECD unitary states, this percentage is the same - The Netherlands and France have the highest share of above 60%²⁰.

Local government investment capacity may be overstated because of centrally controlled investment grants provided to local governments for their own functions, and on which local governments themselves have little discretion or decision-making authority.

The differences within the spending patterns of SEE local governments and their counterparts in the EU can also be analyzed based on the functional allocation of expenditures. Chart 23 shows the composition of local expenditures based on the main functions they perform, for a select number of countries that publish information on expenditures based on the Classification of the Functions of Government Methodology (COFOG). Countries are ranked based on the share of expenditures allocated for “General Public Services” function, covering mainly the functioning of the local administration (wages for the staff and local elected bodies, maintenance of public buildings etc.). Local governments in Slovenia, Moldova, Romania, Bulgaria and Kosovo spend less than their EU counterparts for general public services. Local governments Albania are at the SEE average and those in Croatia, Turkey and the Federation of Bosnia and Herzegovina spend much more than their EU counterparts as regards general public administration services. Not surprisingly, in the countries where local gov-

ernments’ wage bill smaller than the EU average, local governments are responsible for costly social sector functions like education. In fact, in these countries, local governments’ spending for education is much higher than their counterparts in the EU or the rest of SEE.

The infrastructure needs in SEE will require increased spending levels thus higher proportions of municipalities’ income will be invested for infrastructure despite receiving significantly lower shares of public revenue measured either as a percentage of GDP or of total public revenue. Chart 24 clearly illustrates this trend.

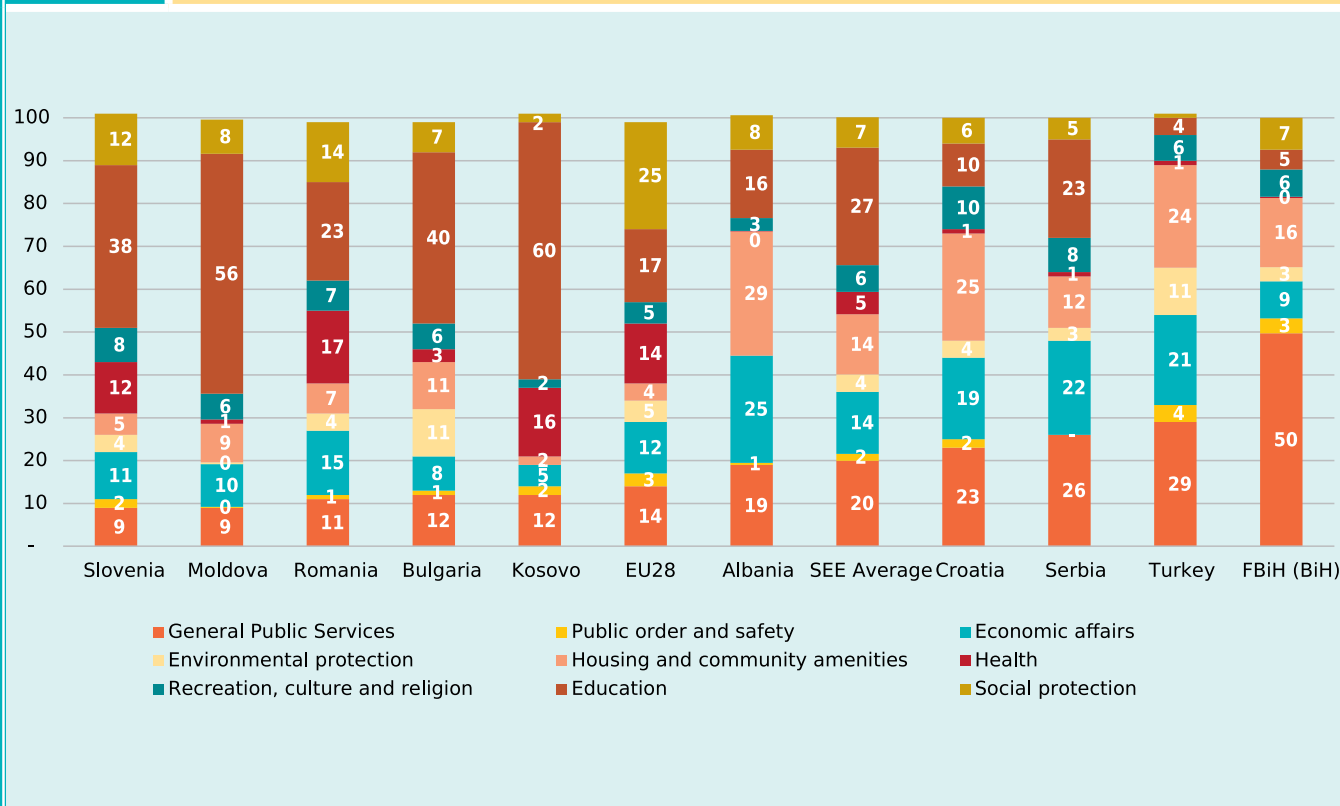
The total public investment in SEE (3.9% of the GDP) is slightly lower than the EU average (4.3% of the GDP) but in Montenegro, Bulgaria, Kosovo and Albania this share is higher. In Turkey and Macedonia, investment spending equals the levels of the EU.

In the EU, the state and local governments have almost equal shares of public investments. The picture in SEE is rather different - the state is the ultimate investor in infrastructure; only in Slovenia and in the Federation of Bosnia and Herzegovina local governments’ share in public investments is higher than the one of the state or entity. Turkey’s indicators match the EU’s. One conclusion may be outlined - SEE in general is heavily centralized in terms of public investment spending when compared to the EU.

Chart 25 presents local government investment spending in EUR per capita in 2006, 2009, 2015 and 2017. In 2017, the region’s indicator falls significantly by 15% compared with 2009 (the regions’ peak) and moves back towards the levels of 2006. This negative trend reaffirms the conclusion above about centralizing public investments.

²⁰ OECD national accounts data.

Chart 23 The Functional Allocation of Expenditures for SEE Countries in 2017, in % of the Total



There are only three countries, Turkey, Albania and Macedonia, where local government’s share over public investment has increased gradually in each of the four years. However, it should be noted that in the case of Albania, about half of the increase is due to centrally controlled investment grants under the Regional Development Fund.

The data includes the local investments funded by the EU and their role can be seen in 2015²¹ - Bulgaria, Romania, and, to a lesser extent Slovenia have historical highs. Despite being volatile, the worrying trend is obvious - municipal investment spending per capita has been falling since 2009 in most of the countries and entities.

²¹ The last year of the Programming period 2007-2013 when the final payments for EU-supported projects had to be made.



Chart 24 Total Public Investment by Level of Government as shares of GDP (2017)

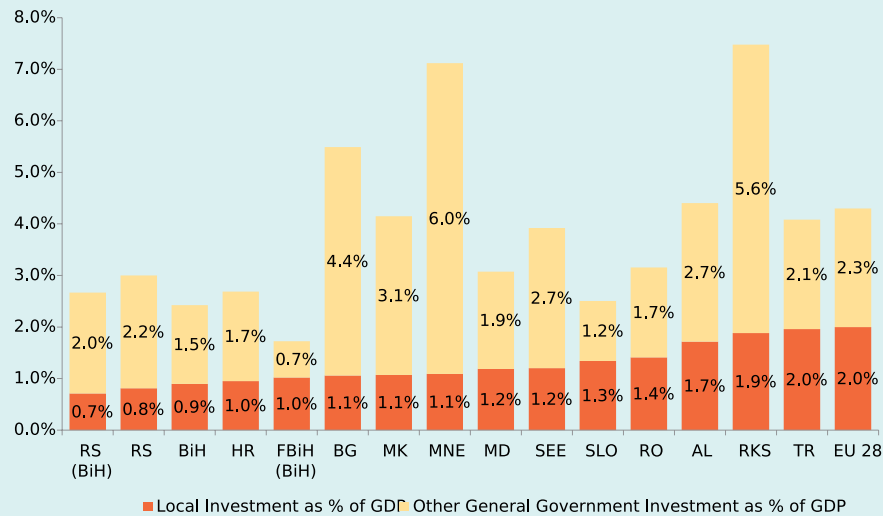
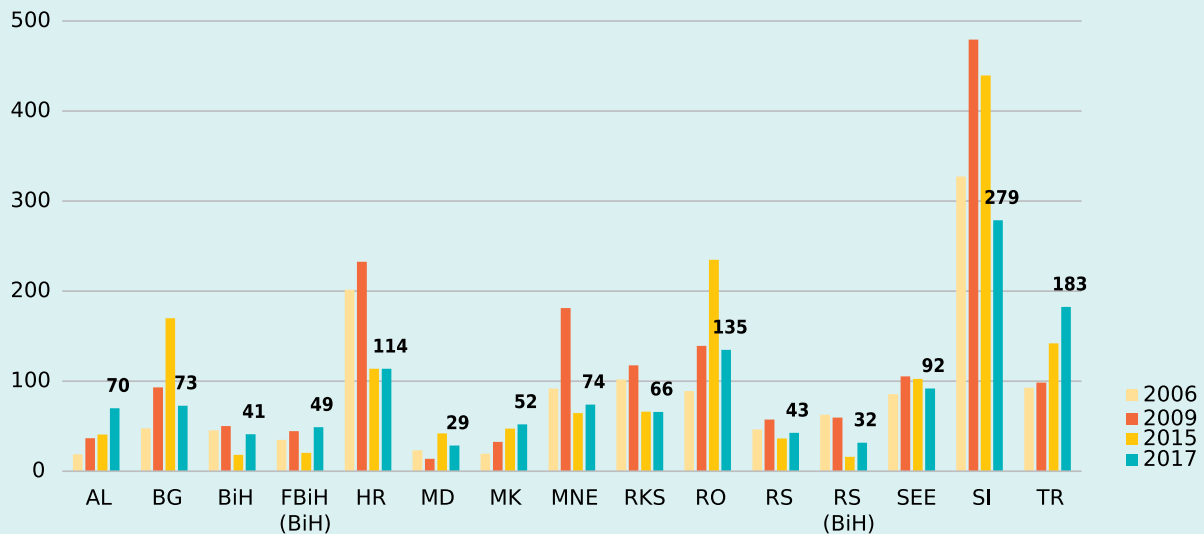


Chart 25 Local Government Investment in 2006, 2009, 2015 & 2017 (EUR per capita)



Continuing the topic of the relative size and wealth, Table 4 shows local government investment in million EUR for all members of the group in 2017. Population and size obviously matter - Turkey's share of the regions' total investments is 74% and, jointly with Romania, they both make up 87% of local governments investment in NALAS member countries. The wealth factor is clearly visible in the cases of Slovenia and Croatia.

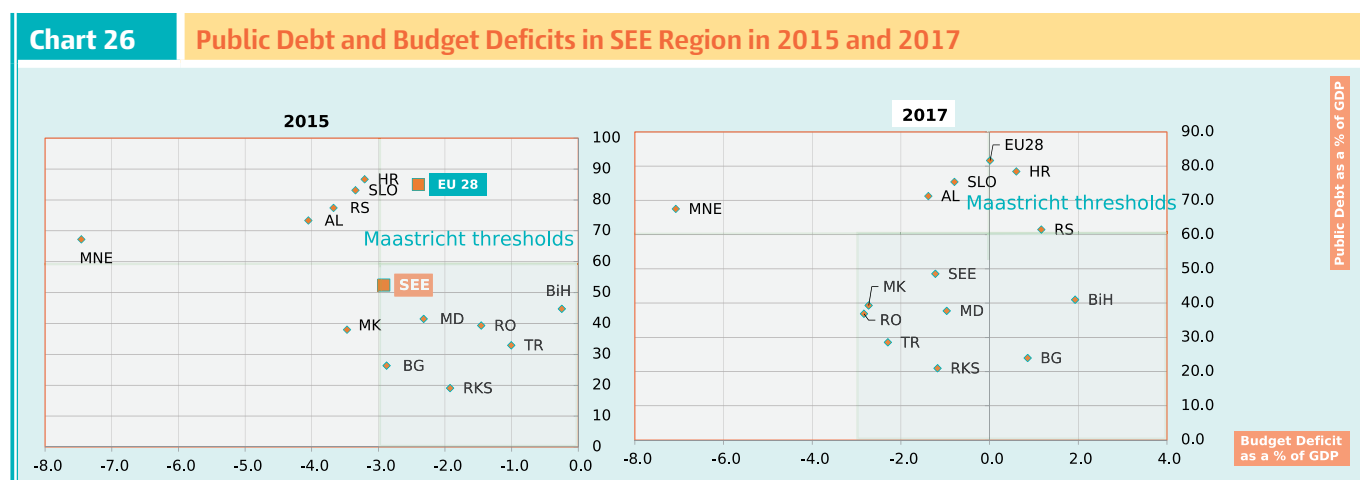
Table 4 Municipal Investment Spending in Million EUR 2017

AL	BG	BiH	FBiH (BiH)	HR	MD	MK	MNE	RKS	RO	RS	RS (BiH)	SI	TR	SEE
199	514	89	53	467	101	108	46	118	2,632	298	37	576	14,758	19,905

Local Government Borrowing

In most of the region, local government borrowing is a new phenomenon. One of the main constrains for this important source of financing, in particular for long term capital investments, (besides other factors like very conservative, rigid and centralized regulatory framework), are high levels of central government debt and the budget deficits. The countries in Europe generally try to meet the Maastricht Treaty's guidelines for total public debt and annual budget deficits (*less than 60% and 3% of GDP respectively*).

From this prospective 2017 is quite different than 2015 as shown by charts, 26 and 26a.



Source: International Monetary Fund, WEO.

On average, region's indicators improve over time: 1) the level of public debt goes down by 4pp and in 2017 is below 50% of the GDP; 2) budget deficit is cut by half but still negative -1.2% of GDP. This trend is similar to the EU but there the European level of the public debt is much higher – 82% of GDP.

In 2015, no country had both budget surplus and public debt below 60% of GDP. In 2017, BiH and Bulgaria accomplished this positive move by improving the budget balances by 2.2 and 3.7 pp respectively. Serbia is perhaps the country that has undergone the most significant adjustments. Between 2015 and 2017, Serbia's public debt has been reduced by 16 pp, from 77% of the GDP to 61.5%, which is very close the Maastricht threshold. At the same time, Serbia improved its budget balance to surplus of 1.2% of the GDP - an improvement of almost 5 pp in total in only three years. A number of countries with low level of debt but with budget balancing problem improved their standings - Macedonia, Kosovo and Moldova while Turkey and Romania's deficits increased. In 2015, five countries were above both Maastricht limits. Two years later, Serbia improved greatly on both indicators. Croatia, Albania and Slovenia maintain high public debt level but improved significantly their budget balances. It should be noted though that both Croatia and Slovenia have reduced their public debt levels by an outstanding 8 pp between 2015 and 2017. The only country that has not improved its indicators is Montenegro²² - above the thresholds but with staggering budget deficit of 7%.

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

Chart 27 shows that the vast majority of public debt is taken by the national government- local governments' share in SEE is merely 1.8% of the total. The municipalities only in RS (BIH) and in Montenegro have ratios above 4% - 4.2% and 3.9% respectively. Among the countries above the Maastricht limit, Albanian local government debt represents a negligible fraction of the total, while in Slovenia, Montenegro, Turkey, Romania and Croatia local borrowing is more substantial. In these countries, it is unlikely that the national governments will look favorably on new subnational borrowing. What is more problematic is that they may even constrain new local borrowing.

Given the infrastructure deficits facing local governments across the region, this is unfortunate, and efforts should be made to ensure that municipalities in these countries have at least some access to debt capital to finance the much-needed capital improvements. In the other members of the group whose total debt remains well below the Maastricht limits, local governments should be encouraged to borrow for infrastructure including by lessening up the regulatory constraints for accessing the capital markets.

²² Because of borrowing for the construction of an important highway.

Chart 27 Public Debt by Level of Government as Share of GDP

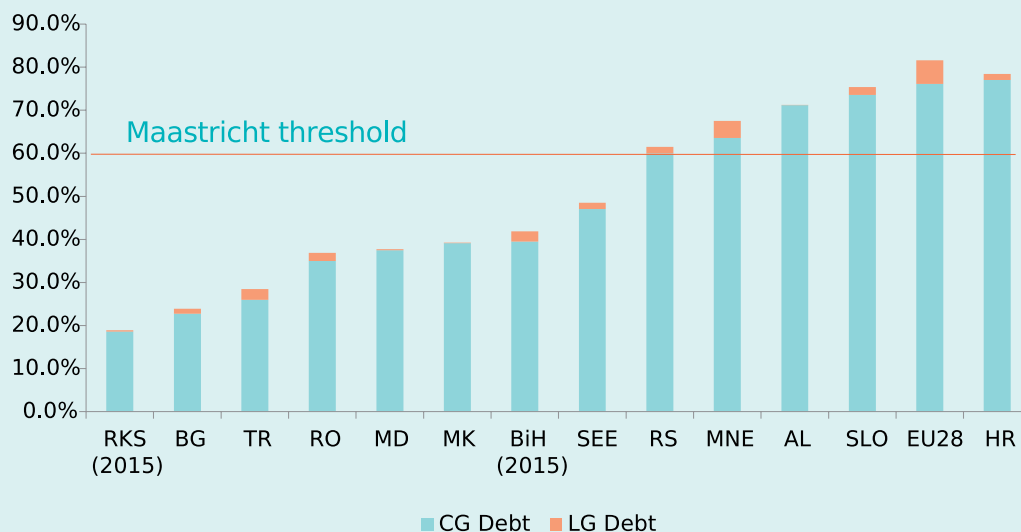


Chart 28 Level of Local Government Debt in 2006, 2015 and 2017 (EUR per capita)



Chart 28 further explains the previous two charts by presenting shows the level of total outstanding local government debt in 2006, 2015 and 2017 in per capita terms. Until 2015, the region's local borrowing has increased substantially – over four times, for almost all countries. Since 2015, local borrowing declined all over the region with one exception – RS (BIH) with 30% increase in 2017. The figures also show that the local governments in Moldova, Albania, Macedonia and Kosovo practically do not use debt instruments.

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

- In most SEE countries, the law requires central government's (*ministry of finance*) approval prior to local debt issuing;
- In more than half of SEE countries, there are legal limitations on both the total outstanding debt and the annual debt service payments;
- Local governments will have to do a better job collecting own-revenues, particularly with respect to setting higher tariffs and then forcing utilities to collect them;

- Local governments will have to radically improve their ability to prepare, plan, and cost-out complex, multiyear investment projects – particularly in the water and solid waste sectors;
- The central governments should systematically promote incentives for investing on a pay-as-you-use basis (*mainly debt-financed*) instead of the currently predominant pay-as-you-build (*paid out of recurrent revenues*).

One of the ways to boost prudential borrowing at local level could be by promoting the pool financing concept, which is widely applied in the advanced economies. In its essence, this is a process of merging the borrowing needs of several local governments and issuing debt as a single entity. Such approach has obvious advantages among which:

- Smaller local governments get market access which would have been much more difficult if issuing debt separately;
- Greater volume of single debt attracts better options (longer maturity) and lowers the borrowing costs;
- The financing institutions have to deal with one single entity issuing debt instead of each of the local governments;
- Pool financing gives access to the international/European market.

4.

Country Reviews of Fiscal Decentralization Trends and Developments

Albania

By Aida Cacaj, Association of Albanian Municipalities

Intergovernmental Finance System

In recent years, Albania has made substantial progress in setting up the policy development framework for decentralization. In July 2014, the Parliament of Albania marked the first step towards Territorial and Administrative Reform (TAR) by enacting Law “On the administrative-territorial divisions of local government units”, which decreased the number of local government units from 373 very fragmented communes and municipalities to just 61 larger municipalities. Having a smaller number of local government units has been widely discussed in political and public fora for a considerable time, making it the most significant change to Albania’s system of local government and providing for the opportunity to strengthen local government capacities.

After the TAR, a series of consequential legal and institutional changes occurred between 2015 and

2017: i) local elections took place in June 2015 and 61 Mayors took office in the newly constituted municipalities; ii), a new National Crosscutting Strategy on Decentralization and Local Governance has been enacted in mid-2015, providing a roadmap to enhance decentralization and strengthening local government and (iii) a new Law on Local Self-Government was approved in December 2015, consolidating the new local governments’ organization and functioning, but also enhancing their responsibilities by decentralizing a number of new and costly functions such as (fire protection, irrigation, the wages of pre-schools teachers and social service centers); iv) a new unconditional grants’ formula was enacted in the 2016 annual Budget Law, allocating grants to local governments in a more transparent, equitable and predictable manner; v) a new Law on Local Self-Government Finance was approved in April 2017, consolidating

local financial autonomy and at the same time enhancing local fiscal discipline; vi) between 2017 and early 2018 a new property tax reform was launched moving from an area based to a market value based system of property taxation.

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

Own revenues are regulated by the Law on the Local Tax System. The most relevant own revenue sources are: the recurrent property tax, the tax on the *infrastructure impact of new construction* (IIT) and local fees and charges for local services. Until recently, the Small Business Tax (SBT) also was a relevant source for local governments. Unfortunately, since 2006, the base of the SBT has been repeatedly reduced and in the period 2013-2015, in practice it was transformed into a shared tax that is now collected by the national government from which the vast majority of small businesses are exempted. The yield of the SBT in 2017 is only 10% of what local governments collected on their own in 2008. The elimination of the SBT coincided with the downward instability of the IIT because of the economic crisis and a centrally imposed moratorium on new construction permits until local governments adopted their General Local Territorial Plans. Local governments responded to fall of the revenues from the SBT and IIT by improv-

ing the administration of the recurrent property tax. In fact, the yield of the property tax increased from 0.18% of GDP in 2013 to 0.27% of the GDP in 2017. The property tax currently represents 21% of own revenues and about 7% of total revenue.

The national government has recently initiated reforms to expand the base of the tax, to establish a nationally-managed cadaster of properties and to move tax assessment closer to a market value (for urban buildings). As a result, in 2018, the base of the property tax on urban buildings was supposed to be the market value of the building, assessed according to some rules set by the national government. The tax rate was set at 0.05% of the assessed value for households and 0.2% of the assessed value of the building for businesses. Due to technical difficulties, most local governments continued to impose lump sum payments for the property tax.

Additional efforts are necessary to make sure that local governments have the systems and capacities in place for an effective administration of the property tax, and thereby for many other local taxes and fees. Currently Albanian local governments suffer from three main strategic weaknesses. First, a poor legal framework that creates confusion over local governments’ real tax and fee powers from base and rate setting to assessment, collection and enforcement. Second, the practice of frequently changing (and reducing) local tax powers, without any form of consultation or effective compensation has depressed tax efforts and discouraged any serious investment from local governments in their collection. Third, because of insufficient investment by both the national and local governments in the technical, regulatory and political infrastructure, the property tax has been underutilized. The main weakness here is the lack of a comprehensive register linking properties to taxpayers and the almost complete lack of cooperation between the central

government agencies responsible for the registration of immovable properties and local governments although the legal framework sanctions that the former should provide LGUs with the information they have on registered properties. The lack of a fiscal cadaster and the inability to cooperate between public institutions has led to the general underperformance in local tax and fee collection.

Shared taxes. Sharing the Personal Income Tax (PIT) revenues has always been promised by the Albanian legal framework, but the actual shares have never been defined, until the approval of the LLGF in April 2017. The LLGF prescribes that 2% PIT revenues should be allocated to the 61 municipalities on an origin basis. Unfortunately, this has not been implemented yet due to the difficulties to identify taxpayers according to their residence. The LLGF increased also the local share of the revenues from the annual tax on vehicle circulation from 18 to 25%. Taken together these are the two most important novelties of the LLGF as regards shared taxes. Albanian municipalities benefit also from 5% of the mineral rent. In recent years, the national government has transformed the Small Business Tax (SBT) in practice into a shared tax also by eliminating all local government powers over its base, rate and by recentralizing its collection. This has led to a fall of more than 75% in the yield of the tax.

The **Unconditional Transfer** was introduced in 2001 and provides local governments with funds to execute their exclusive functions. It is the single most important source of revenue for Albanian local governments, constituting more than 50% of revenues for about 43 of the new 61 larger municipalities at end 2016. The LLGF, for the first time

since 2001, addressed the issue of the annual determination of the total size of the grant by anchoring it at no less than 1% of the projected Gross Domestic Product and no less than the amount allocated the previous year, ensuring both predictability, stability and security of financial resources over time. As a direct result of the LLGF, the unconditional grant in 2018 was 4.2 billion ALL (or 34%) higher than in 2015. The LLGF incorporated also the new formula for the allocation of the unconditional grant, developed in 2015 with USAID's support, reflecting the implications of the territorial and administrative reform and increasing the equity, predictability and transparency in the allocation of resources. The new formula's allocation criteria are: a), 80% according population (based on the concept of Effective Resident Citizens that is the 2011 Census data adjusted by adding 30% of the difference between the Civil Register and the Census²³); b), 15% according to population density, with four different density thresholds where less dense municipalities benefiting from extra-resources; and c), 5% based on the effective number of primary and secondary education pupils. **Fiscal Equalization** is performed within the unconditional grant and is based on shared tax revenues. Once the Unconditional Transfer has been calculated, then a separate set of calculations are made for those local governments whose total per capita revenues from existing shared taxes are below 75% of the national average and 110% above the national average.

The Law on Local Self-Government eliminated the concept of shared functions, and further decentralised several new functions to the local level, such as: preschools, fire protection, forestry, and

²³ Albania is not the only country in the SEE region to use an "adjusted" population data series to allocate grants to local governments. Bulgaria as well uses a different population data series than the Census. Emigration is one of the major causes of the high discrepancies between Census and Civil Register data.

irrigation and drainage. The Law provided that these new functions would be financed through **earmarked specific transfers** for each function and each local government. Transfers are allocated to local governments based on the historical costs previously declared by the respective line ministries. The symmetric decentralization of the functions immediately was faced with the unequal distribution in the territory of the resources that line ministries previously utilized to perform the function. For example, there are 61 municipalities but only 49 fire stations. Between 2016 and 2018, the government has provided additional financial and material support, in particular for preschools, fire protection and irrigation and drainage, although there remain substantial differences in the equipment with resources. The earmarked specific transfers are expected to be transformed into “unconditional grants” at the end of 2018.

Conditional transfers come from two sources. The first is from appropriations from line Ministries that are allocated to local governments for delegated functions or for functions, the responsibilities over which are in practice shared by the two levels of government. The second is from an increasingly large **Regional Development Fund** that allocates investment grants to municipalities on a competitive basis. Indeed, in recent years, the size of conditional transfers from the Regional Development Fund has increased substantially (very close to the size of the unconditional grant itself), leading to concerns that it is crowding out funds that should have been allocated to the unconditional grant. The extensive use of conditional transfers has substantially reduced local fiscal autonomy and has led to allegations that they are being allocated for political purposes, which do not reflect clear local developmental goals.

Main Developments in Municipal Finance and Advocacy Efforts of the Association

The last two years have been particularly important for municipal finances in Albania. As already mentioned, in October 2015, the Government introduced a new formula for the allocation of unconditional grants, developed with the key support of USAID. Throughout 2016, in cooperation with local governments, the Association of Albanian Municipalities (AAM) and other stakeholders, and with the key support of USAID and SDC, the Ministry of Finance developed Albania’s first ever comprehensive Law on Local Government Finance (LLGF). In February 2016, AAM, NALAS and USAID’s Planning and Local Governance Project in Albania (PLGP), organized a regional peer learning and knowledge sharing workshop “*Best practices in Local Government Finance Legisla-*

tion: The South-East Europe experience and the challenges facing Albania”, involving experts and policymakers from six countries of the region that have faced (or continue facing) similar challenges in recent years.

The LLGF was approved by Parliament in April 2017. It constitutes a major milestone in Albania’s progress towards fiscal decentralisation in that, it addresses many of the historical structural weaknesses and introduces a number of internationally recognised best practices in municipal finance. The LLGF addresses the historical underfunding and downward instability of the unconditional grant and increases local governments’ revenues from freely disposable intergovernmental transfers by at least 36 % when compared to their his-

torical average in the past 5-10 years. Further, the draft-LGFL introduces a set of rules that ensure the harmonization of local governments strategic plans with medium term budgets, the uniformity in budgeting and public finance management practices and procedures between the national and local governments including the implementation of the Classifications of the Functions of Government (COFOG) methodology. Finally, the LLGF introduces also for the first time new rules for the management of financial distress and insolvency of local governments. The national government has also committed to developing a new Law on Regional Development although its development status remains unclear.

While recognizing the progress, AAM continues to advocate the further increase of the size of the unconditional transfer as a percentage of the GDP to address the underfunding of a series of local government functions. This is related also to the concern that the RDF is crowding out funds that could more efficiently and effectively be used by local governments themselves that have a better understanding of the real needs and priorities of their constituencies. In fact, the competitive grants - the predecessor of the current RDF - in the mid-2000s, were created by carving out a small portion of the unconditional grant. From this perspective, AAM advocates for the repealing of the RDF and allocating its funds to local governments as part the unconditional grant.

Between 2017 and 2018, the Government of Albania initiated a process of reforming the property tax system, promising the establishment of a national cadaster of properties for property tax purposes and then moving to a market value-based system of taxation for urban buildings. According to the new framework, municipalities have the primary obligation to establish and maintain

a complete register of properties in their territory and implement a market-value based property tax system. To facilitate the process, the legislation included the “self-declaration” mechanism for municipalities. While municipalities started with the preliminary work, also applying the new tax levels, the central government launched the idea of having the electrical distribution company creating the fiscal cadaster and act as a tax collection agent. The electrical distribution company would have been paid 4% of the total yield of the tax while 96% would have been transferred back to municipalities. AAM challenged this proposal on the following grounds: a) the imposition of a tax agent goes against the -principles of local autonomy and decentralization - local governments’ only have the right to regulate local tax administration within their jurisdictions; b) the appointment of a tax agent that is responsible and accountable to the central government alone is problematic for local governments - as shown by the previous experience of the centralization of the collection of the small business tax; c) from local government’s extensive experience, the most problematic aspect remains “the identification of taxpayers and the properties that shall be taxed” and not the collection of the tax per se. In supporting its arguments, AAM made use of the experience of other NALAS member countries and found out that this arrangement is not applied anywhere in the region. Following AAM’s pressure and advocacy the Government withdrew from this proposal and local governments’ themselves would continue to be responsible for the collection of the property tax while the national government would establish the central cadaster over which local governments will be provided access for the purposes of tax assessment. With the support of the Swedish International Development Cooperation Agency, the process for the establishment of the fiscal ca-

daster was launched by the Ministry of Finance in November 2018, including data from GIS system and from the electric distribution company. Municipalities are now in the process of updating their own data. AAM has supported the process with on the job training in many municipalities. Ultimately, it should be recognized that the frequent changes in property tax legislation have brought confusion and significant delays for municipalities.

In late 2018, the Ministry of Finance and the Ministry of Education, with the support of USAID's Planning and Local Governance Project in Albania, moved on with the reformation of the preschool finance system by increasing the overall level of funding for preschool teachers by 9.1% and by

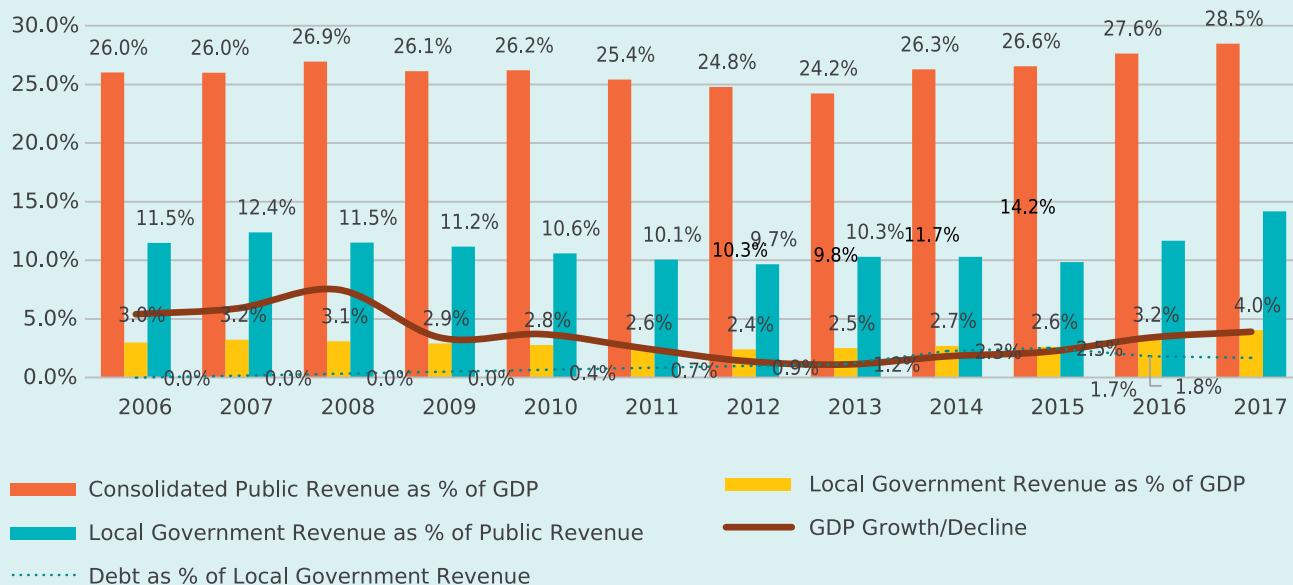
moving primarily to a "per pupil" allocation of funding as opposed to the historical "per teacher" system used in the past. The new system of funding better reflects the social, demographic and infrastructural developments of the past 27 years and helps addressing the problem of overcrowded classes in preschools. As a direct result of this reform, the national average ratio pupils-per-teacher will fall from 18 to 15 and the maximum average will drop from 26 pupils to 18 pupils per teacher. The reform has been discussed in the Consultative Council between the Central and Local Governments, was approved by approved by the Council of Ministers and is currently being discussed in Parliament.

Statistical Overview of Local Government Finance in Albania 2006-2017

Over most of the past decade, Albanian local governments have received less revenue as a share of GDP and of total public revenue than all their counterparts in South East Europe. Worse, this share fell from a high of 3.2% of GDP in pre-crisis 2008 to 2.5% in 2015. Overall, this was due to the frequent amendment of local fiscal powers such as the constraints over the small business tax and the infrastructure impact tax which have had adverse consequences on local government budgets; and to the downward instability of the

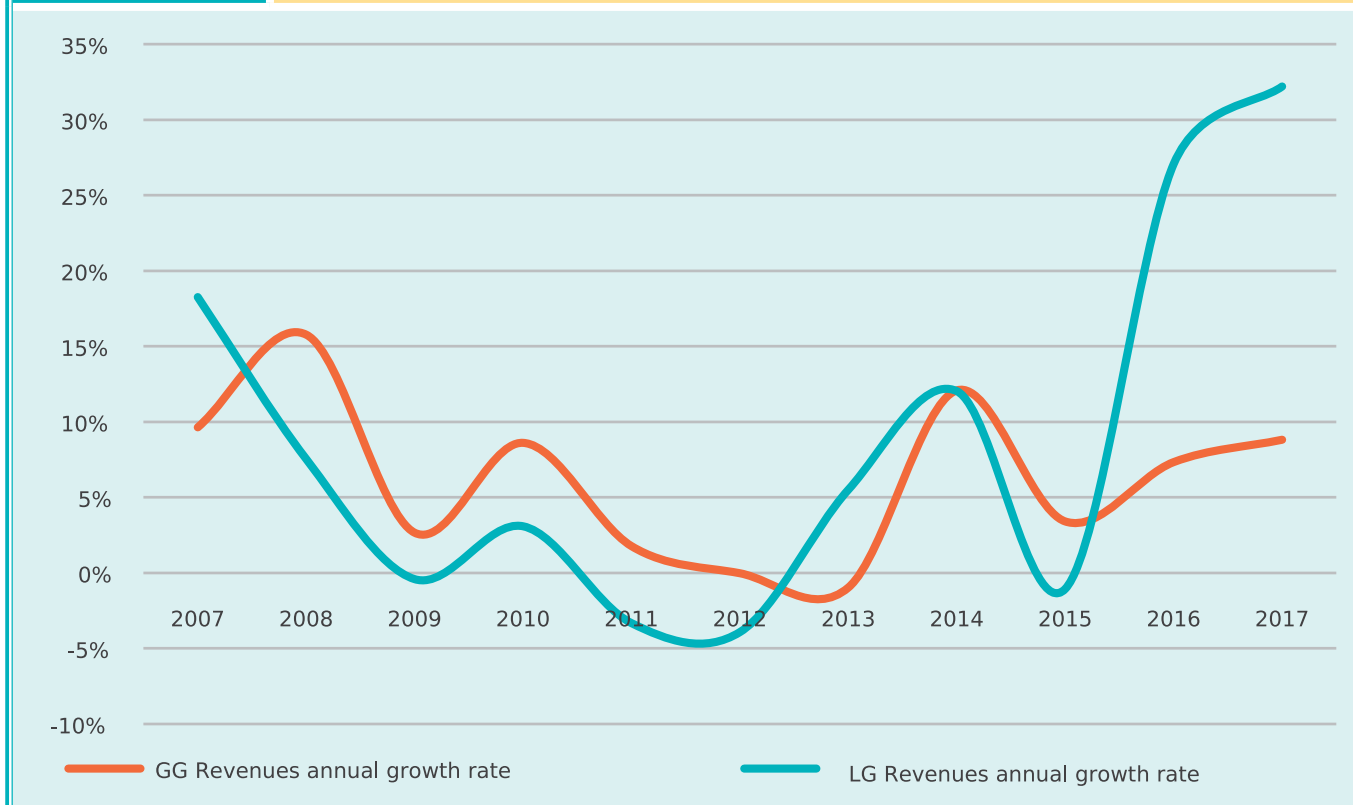
unconditional grant. In 2016, the government transferred at the local level some new and costly responsibilities such as wages of teaching and non-teaching personnel in preschools; non-teaching personnel in primary and secondary schools; the operation of fire protection, the management of forests and pastures, and irrigation and drainage. These new functions were financed with earmarked specific grants (constituting 10% of overall local finances in 2016 and 2017).

Chart 29 Albania: Local Government Revenue as a Share of GDP and Total Public Revenue 2006-2017



The specific transfers and the substantial increase in own revenues by close to 30% and 22% in 2016 and 2017 respectively, have helped in increasing the local government revenue share to public revenue to 14% and the share of local revenues to GDP to 4%. Because of the very conservative legal framework and administrative orders of the Ministry of Finance, municipalities in Albania cannot raise funding from local borrowing. The stock of local debt constitutes 2.4% of local government revenues in 2015, or 0.06% of the GDP.

Between 2007 and 2015, local government revenues fell faster and rose slower than the revenues of the national government. This suggests that the national government was not committed to sharing the benefits and burdens of economic growth with local governments. The steep growth of local government revenues in 2016 is primarily related to the transfer of the new functions at the local level, while the continued increase in local revenues in 2017 is related to the increase in the unconditional and the very positive performance of own source revenues.

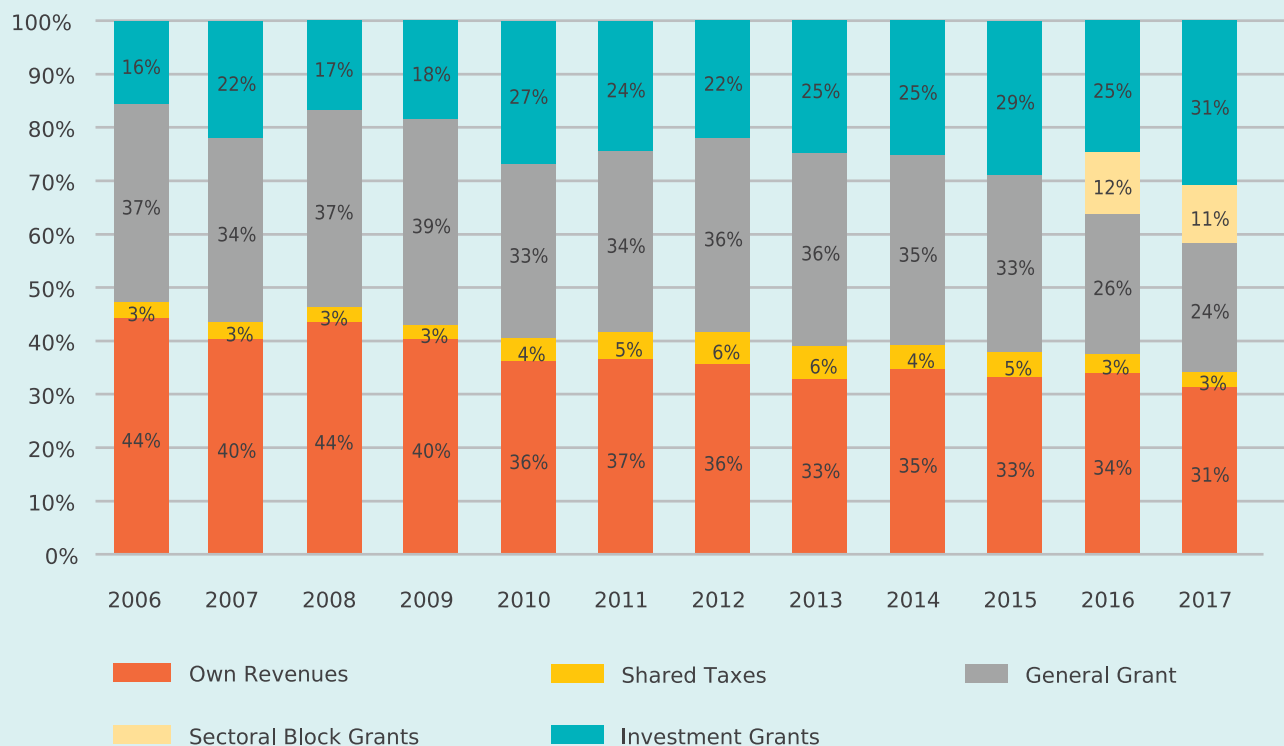
**Chart 30 Albania: Revenue Fluctuations of the General and Local Governments 2006-2017**

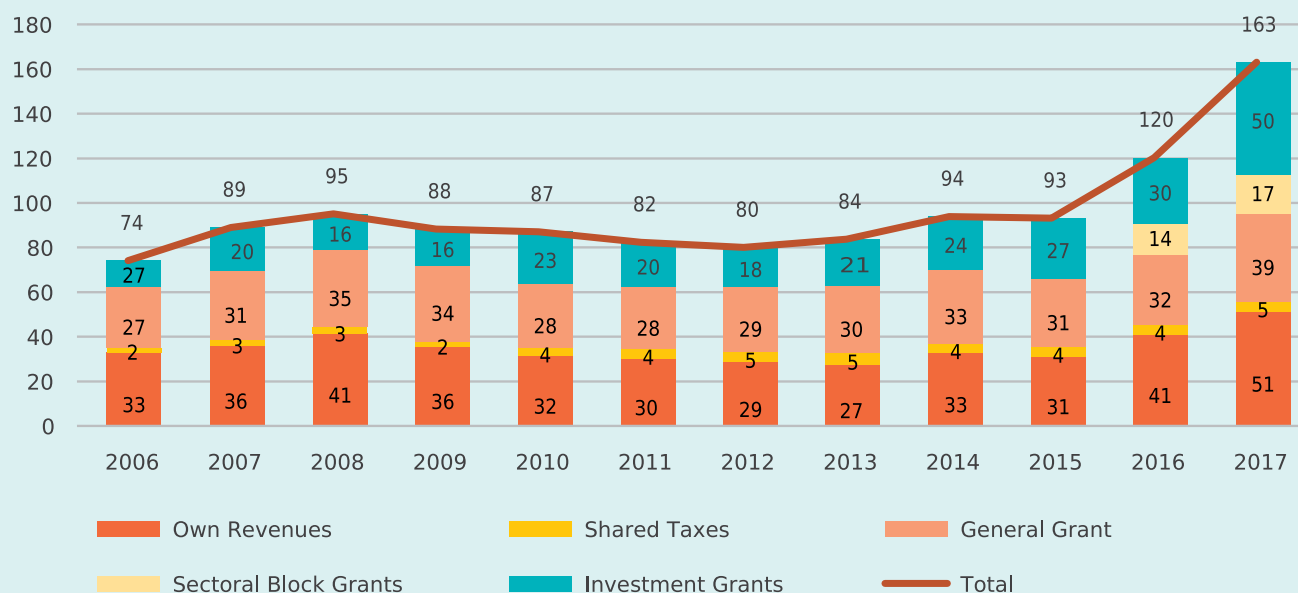
Own source revenues contribute to 31% of total local budgets in 2017, about 10 percentage points below the pre-crisis levels. This is even after the remarkable increase in own revenue over the past two years. The increase in freely disposable revenue from own sources or the unconditional grant (that in 2017 is 22.5% more than in 2015) are offset primarily by the uncontrolled increase in the size of earmarked investment grants that supposedly are allocated to local gov-

ernments on a competitive basis; and to a lesser extent from the introduction of “specific transfers for new functions”. Close to 70% of local finances in 2017 came from intergovernmental transfers, more than half of which are under the direct control of the central government. This subjects local budget planning to large degrees of uncertainty and political patronage. Competitive Investments Grants reached a peak of 31% of the local revenues in 2017.



Chart 31 Albania: Composition of Local Government Revenue 2006-2017



**Chart 32 Albania: Composition of Local Revenue Euro per capita 2006-2017**

Local Government Revenues in Euro per capita peaked in 2008 at 95 Euros per inhabitant (census data) or to 273 million Euro; fell steadily through 2012 with 80 Euros per inhabitant, before increasing in 2014 and 2015 with 94 and 93 Euros per inhabitant. In 2016 and 2017 local government revenue per capita increased to 120 and 163 Euros per inhabitant (or 345 and 468 million Euro in total). This is due to a combination of factors, from the increase in own revenue and the unconditional grant, to the decentralization of the new functions and most importantly to the significant increase in investment grants.

In the composition of own revenues, the Property Tax has been trending upward in the past years as local governments have put more effort into collecting the property tax as a reaction to the elimination of their powers over the small business tax. Over the past few years, Albanian local governments have also improved the administration of local fees and charges. The most important local fees are the waste collection fee, along with greenery and public fees, and fees for the occupation of public space. The revenues from the infrastructure impact tax have increased substantially in 2017, although more than two thirds of the increase are in the capital city of Tirana alone.

Chart 33 Albania: Composition of Local Revenue, in million Euro, 2006-2017

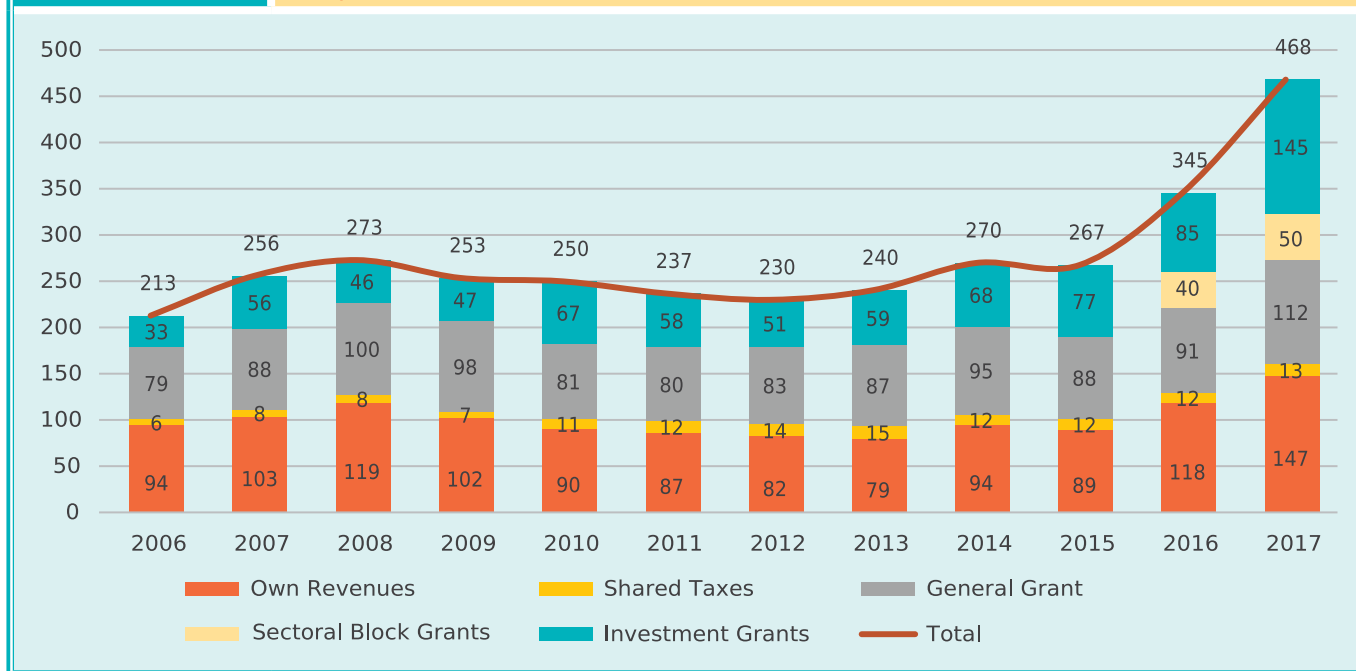




Chart 34 Albania:

Albania Composition of Own Source Revenues 2006-2017

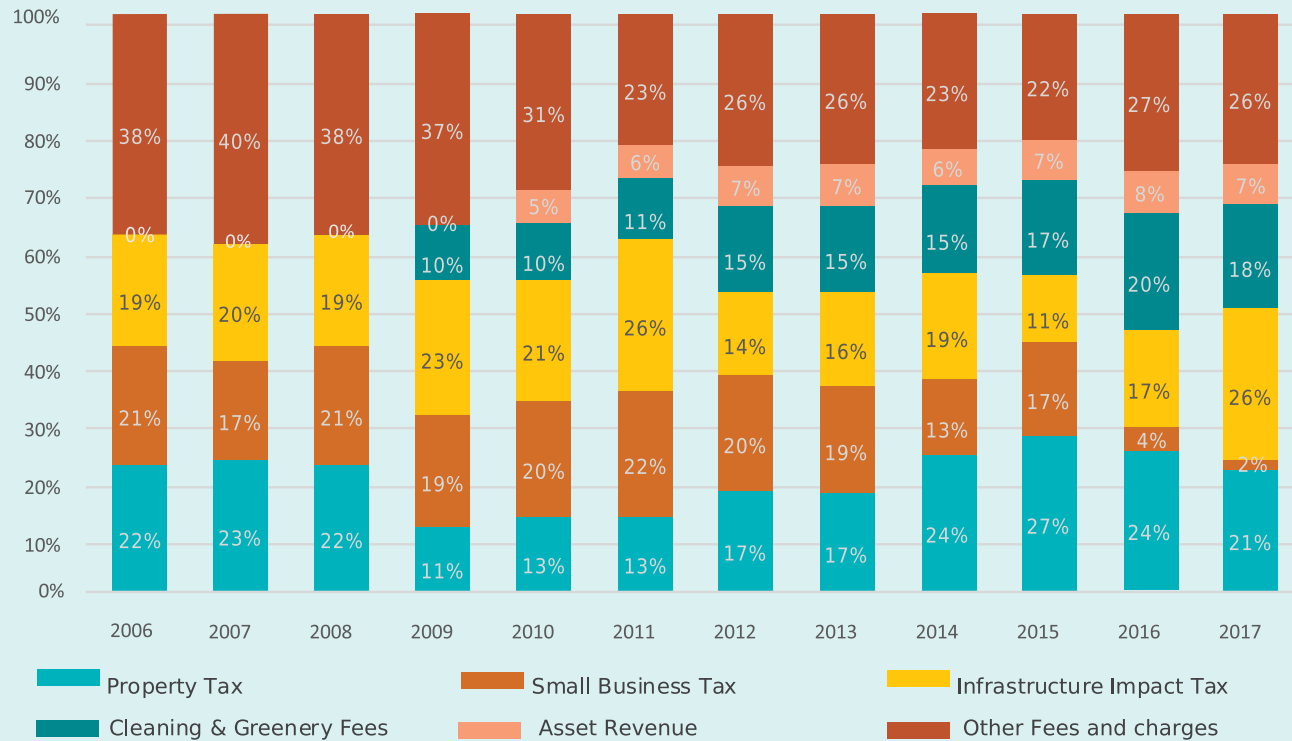


Chart 35 Albania: Composition of Local Government Expenditures 2006-2017, in % of total

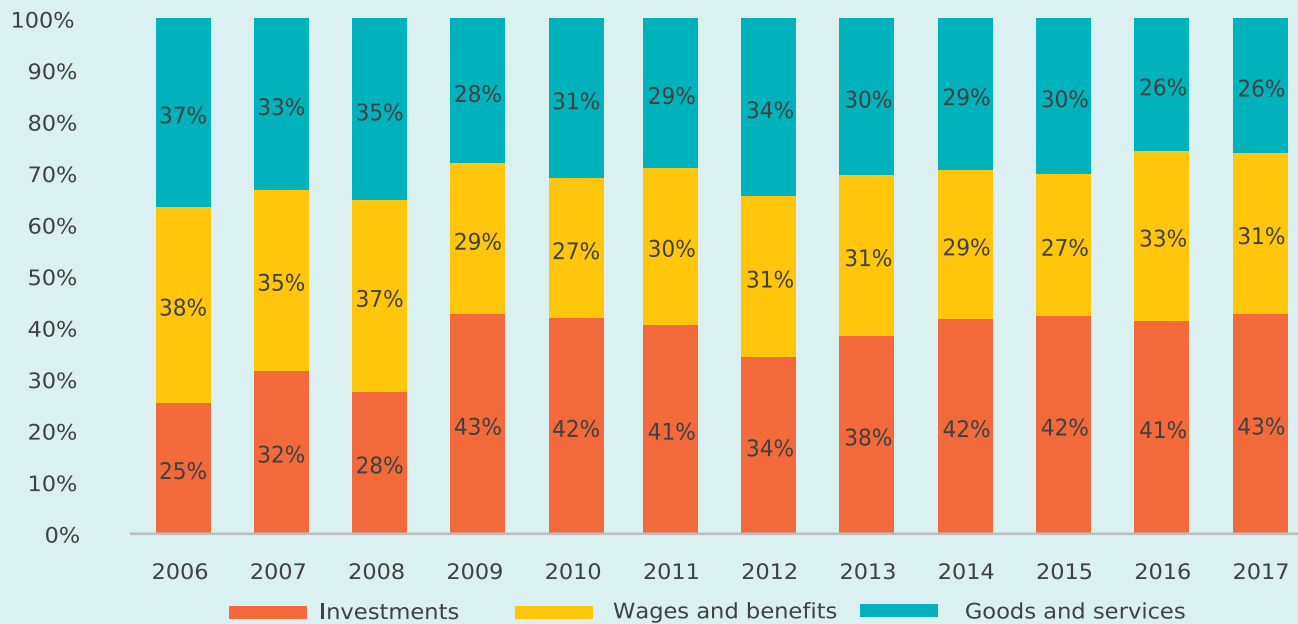




Chart 36 Albania: Composition of Local Government Expenditures 2006-2017, in million Euro

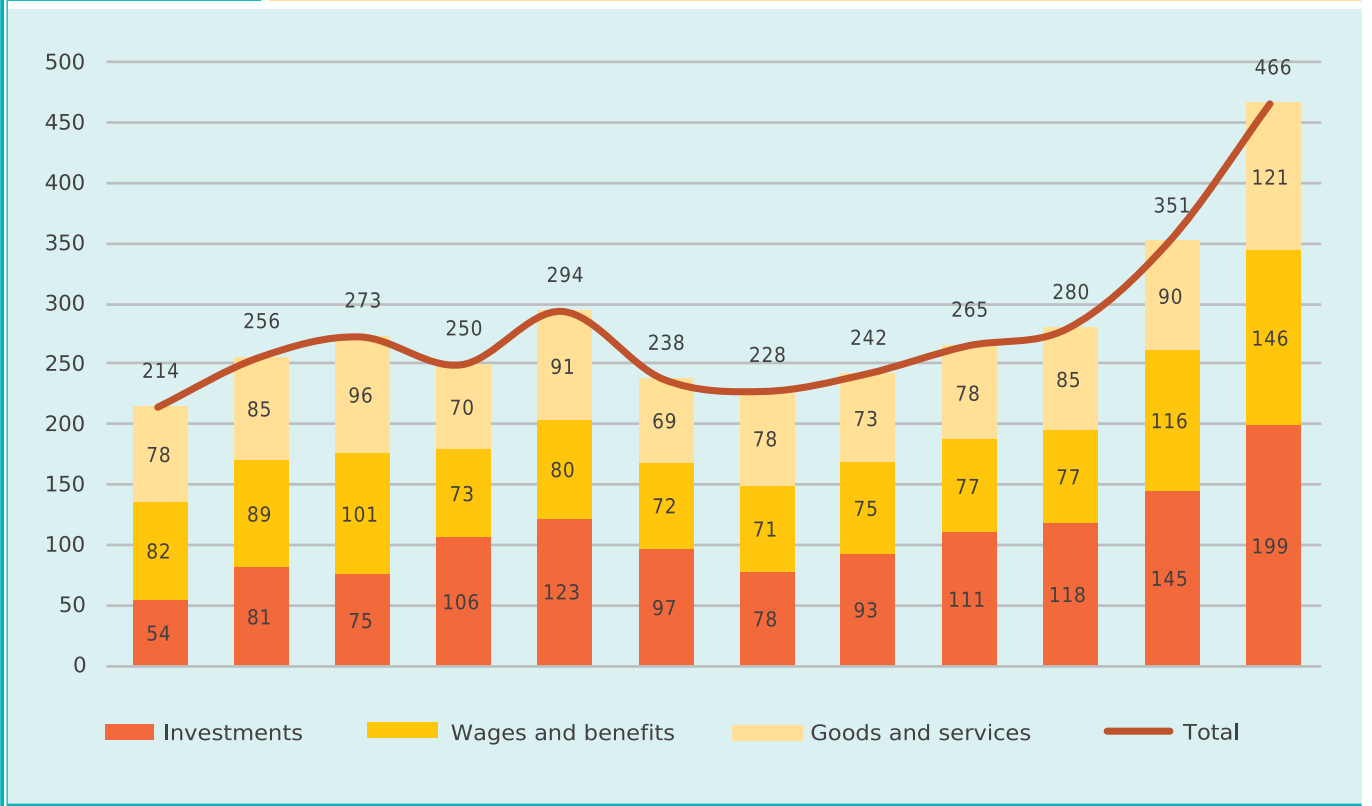


Chart 37 Albania: Investment by Level of Government and as a % GDP 2006-2017

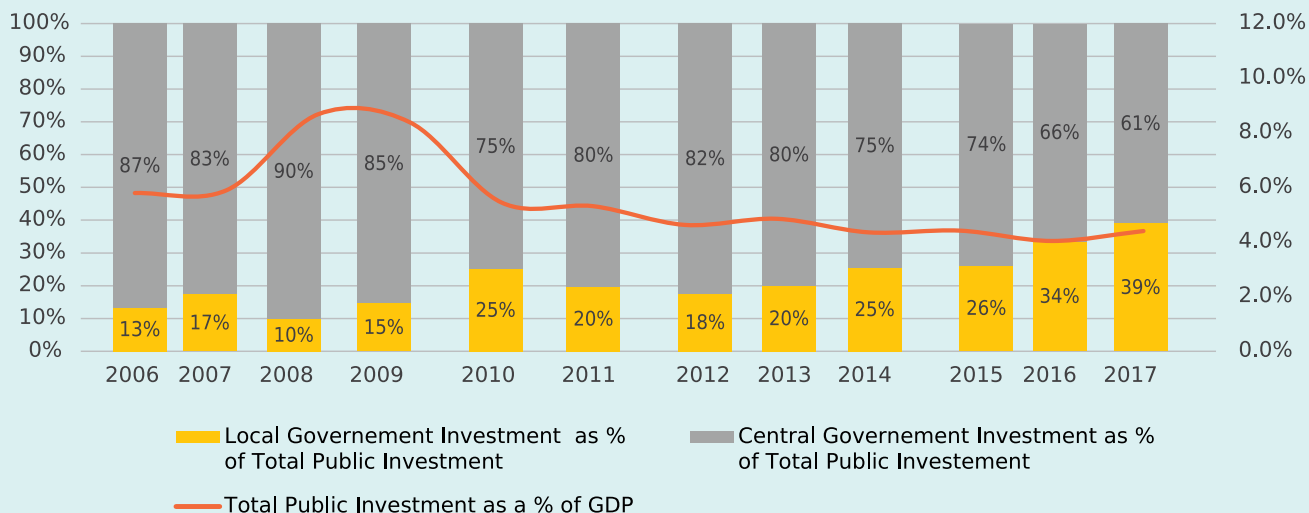
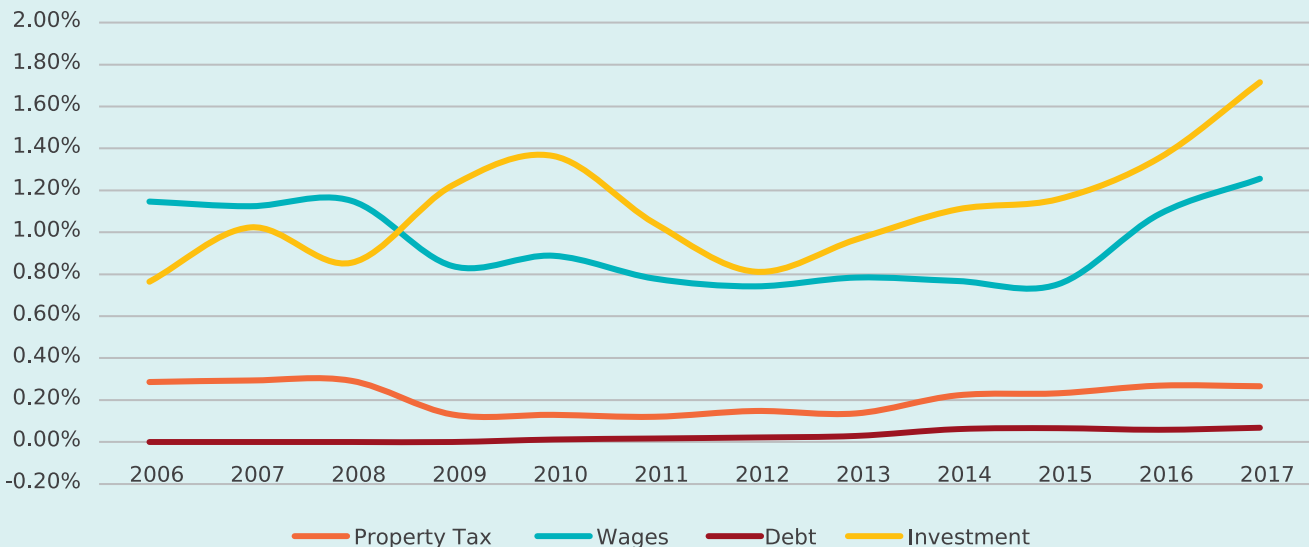


Chart 38 Albania: Investment, Wages, Debt and Property Tax as Share of GDP 2006-2017



Despite the low share of local government revenues in total public revenues, local government investment spending as a share of total local expenditures has been relatively high. In 2017, capital investments made up to 43% of total local expenditures, while personnel costs fell to 29% which their lowest level in the decade. This is due in part to the high and increasing share of conditional investment grants in the system allocated by the national government.

Local government spending for investments has increased from a low of 78 million Euro in 2012 to 199 million Euro in 2017. It is worth mentioning that earmarked investment grants allocated through the national government peaked to 147 million in 2017. Spending for wages and goods and services have also increased over the past two years.

When we compare central vs. local government investments, we see that because of these conditional grant, local investment as a share of total public investment has increased over 2016 and 2017, (34 and 39%) while of total public investments have remained quite stable 4.4% of GDP.

The yield of Property Tax is low as a share of the GDP, when compared to Albania's counterparts in the SEE region. The property tax collection has been stable over much of the analyzed decade, with a slight increase over the past four years. Local government spending on Wages and Investment as shares of GDP have substantially increased in particular over 2016 and 2017 reflecting the decentralization of the new functions and the increase in earmarked grants for investments. Local debt remains low, at 0.06% of the GDP at the end of 2017.

Bosnia and Herzegovina

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

In fiscal terms, the most active level in FBiH (BiH) are the cantons while the entity is not very significant. In RS. (BiH) it is the entity. Each entity has its own Ministry of Finance. On the central level (BiH) the coordinator of fiscal policies is the Fiscal Council. The allocation of indirect taxes within each entity, as well as the regulation of direct and other indirect taxes are regulated by entity legislation. The share of the funds that is controlled by the central state (BiH) is very low at around 10%. Indirect taxes are the most important source of revenue for all levels

of government. They are collected by the central level and then divided between the State, the entities and the Brcko District according to a formula stated in the Law on Indirect Taxation in BiH.

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

The general picture of the municipal finances in Bosnia and Herzegovina has remained stable over the past three years, in terms of the share of local government revenues as a % of GDP and Public Revenue.

Bosnia and Herzegovina - Federation of Bosnia and Herzegovina

By Gregor Jurišić, Association of Municipalities and Cities in the Federation of Bosnia and Herzegovina

The Intergovernmental Finance System

Despite its size, Bosnia and Herzegovina (BiH) has three almost separate fiscal systems: FBiH, RS and the Brcko District. Indirect taxes are the most important source of revenue for all levels of government. They are collected by the State of BiH and then divided between the State of BiH, the two entities – FBiH and RS – and the Brcko District according to a formula stated in the Law on Indirect Taxation in BiH. The allocation of indirect taxes within each entity, as well as the regulation direct and other indirect taxes are regulated by entity legislation.

In FBiH, the entity's share of indirect taxes is allocated to cities, municipalities, cantons and the city of Sarajevo according to fixed percentages. Cantons receive 51.23% of the total, Cities and Municipalities receive 8.42%, the City of Sarajevo receives 0.25% while the budget of the FBiH receives the remaining 36.2%. These shares are given as **Unconditional Transfers** and are allocated by formula. The main criteria for allocating the transfer is population (68%). But there are other coefficients for surface area (5%), school age children (20%) and the municipality's development index (7%) or relative wealth --as measured by the yield of the Personal Income Tax-- that have equalizing effects. In 2017, the Unconditional Transfer constituted 120.17 million € or 29.13% of municipal revenues.

The Unconditional Transfer has fallen because of the rules governing entity debt. These rules re-

quire that debt service payments to foreign creditors be paid directly and immediately from each entities' share of indirect revenues. As a result, the pool of revenues that would otherwise go to cantonal and municipal governments is automatically reduced by the debt service payments of the Federation government. Therefore, municipalities and cities are constantly obligated to participate in debt service, although they don't have any debt arrears. In 2016, the external debt service effectively reduced local government's share of indirect taxes from legally defined 8.42% to 7.1% (with a revenue loss of 40 million KM or 5% local revenues). This procedure means that LGU's revenues depend on external debt servicing, implying significant volatility and instability and lower local government revenues when debt service is high.

According to the Law on the Allocation of Public Revenues, municipalities in FBiH are also entitled to a specified percentage of at least 34.46% of **PIT revenues** collected in their territory. The other 65.54% PIT revenues belong to cantonal governments who are obliged to share a specified percentage of PIT with their municipalities on an origin basis. The minimum amount they should share with municipalities is 34.46%. Municipalities within Sarajevo Canton were given the right to receive a share of only 1.79% of PIT, while Canton itself receives 98.21%. In 2017, about 21% of local government revenue came from shared taxes. Another 14% comes from **conditional**

grants which municipalities receive from either the entity or, more frequently, the cantons. Most are for specific investment projects. **Own Source**

Revenues constitute 36% of total local government revenues in 2017 and are composed primarily by local fees and charges.

Local government tax powers and challenges

Local governments own source revenues are composed primarily of local fees and charges (60%), communal fees and charges (15.8%) and asset revenues (13.3%). Unfortunately, there is no federal level account of local government own revenues and data about the nature, type and composition of these revenues are accounted for differently in each canton.

The recurrent property tax is regulated by the ten cantonal governments and there is no entity-wide legal regulation of the tax. As a result, FBiH (of BiH) has the highest number of property tax laws in the region. In all cantons the tax is a cantonal levy, regulated and administered by cantonal authorities. Municipalities do not play an active role in levying the tax and its revenue potential is not a major concern of authorities at any level of government.

Local governments are also entitled to 100% of the revenues of property transfer tax and property tax, which constitute 10.6% total local government revenues in 2017. Local government powers

over these taxes are significantly limited, as both the base and the rate of the taxes are determined by the cantonal governments.

In FBiH there is no unique system or precise rule regarding the assessment and determination of fees and charges, nor on the way their collection and administration. This fact, along with insufficient revenues to cover the costs of assigned competences, are the two main reasons for the increase in local fees and charges. In the last three years, the Ministry of Finance of FBiH, in collaboration with USAID, gathered and analyzed data regarding fees and charges, establishing a Register of Fees and Charges in November 2017, according to which, there are 350 different fees, with an average of 20 fees per municipality. According to USAID, the number of fees should be rationalized. The increase in local fees and charges is considered a significant obstacle for local development, enterprises and attracting potential investors as they increase the investor's cost of doing business in municipalities.

Main Developments in Local Governance and Municipal Finance and Advocacy Efforts of the Association

Over the past two years, the Association has been constantly advocating and pleading for the adoption of a Law on the Financing of Local Self-Government Units in FBiH to establish a more adequate financing system for local governments' own and delegated competences and responsi-

bilities; an adequate financing system for less-developed municipalities; introducing principles of fiscal autonomy and revenue options in proportion with their legally assigned responsibilities.

The Law on the Principles of Local Self-Governments enables federal and cantonal authorities

to delegate certain competences to local governments. In doing so they have to take into consideration the capability of local authorities and provide them with the necessary funds. Unfortunately, this is not the case, as local governments often execute delegated competences without being provided with sufficient resources because of overlapping and insufficiently defined competences between cantons and municipalities. Only 2 of 10 cantons have coordinated their sectoral laws with the Law on Principles of Local Self-Governments, despite their legal obligation to do so. One of the major activities of the Association of Municipalities and Cities in the FBiH regarding this matter is constantly insisting and pleading at the federal government to incorporate the Association's recommendation that all the competences and responsibilities assigned to municipalities should be precisely defined and encompassed by the new version of the Law on Allocation of Public Revenues. The Association has also recommended that the principle of "finance follows function" is enshrined in legislation.

The Association of Municipalities and Cities in the FBiH continues to advocate for the increase the share of local governments in indirect tax revenues from 8.42% to 12%; increasing the minimum share in PIT revenues from 36.46% to 50%, including municipalities in Canton of Sarajevo; and begin sharing 25% of the cantonal CIT revenues with local governments. The Association is also active in promoting good governance initiatives that prevent corruption at the local level.

A new Law on Treasury in FBiH was passed in 2016, ruling that within one year municipalities should establish a Treasury Single Account that would register and consolidate all financial transactions, including local governments' revenues and expenditures. This is expected to improve financial management, reporting and transparency.

Differently from other cantons, where competences regarding communal services as well as pre-school and primary school are assigned to local governments, the government of the Canton of Sarajevo provides these services instead of municipal governments within the canton. Municipalities in the Canton of Sarajevo have raised their concerns and argued that many of the services provided by the cantonal communal enterprises are simply too inefficient and too expensive. After several appeals, the Constitutional Court of FBiH ruled on several occasions that the rights of municipalities have been harmed. As a consequence, during 2017 there have been 8 modifications to the cantonal constitution, that provides that municipalities in the Canton of Sarajevo should freely decide whether they are willing to give the legal power over these competences to the cantonal government. This process is still in progress.

In 2017, the Federal government planned to amend the Law on Civil Protection and the Protection of Material Goods and eliminate a special charge for the protection from natural and other disasters that represented a significant source of revenue for local governments and for local civil protection systems. After the Association's many efforts and actions, the government of FBiH withdrew the draft-law from the parliamentary procedure. Similarly, after the Association's efforts, the government of FBiH withdrew also from the proposal to amend the Law on Concessions (the local government's share in concession fee's revenue was planned to be extremely low compared to the federal and cantonal share).

In July 2018, the government of FBiH submitted to Parliament a draft-Law that establishes 7 new cities on the territory of FBiH, that currently have the status of municipalities. To legally acquire legal status of a city, a local government unit must fulfill certain criteria concerning population (above 30.000) and in the unit's urban core (at least 10.000).

The Association continues to advocate for the exemption of municipalities and cities from servicing the external debt and has recently filed a lawsuit against the Federation of BiH demanding the return

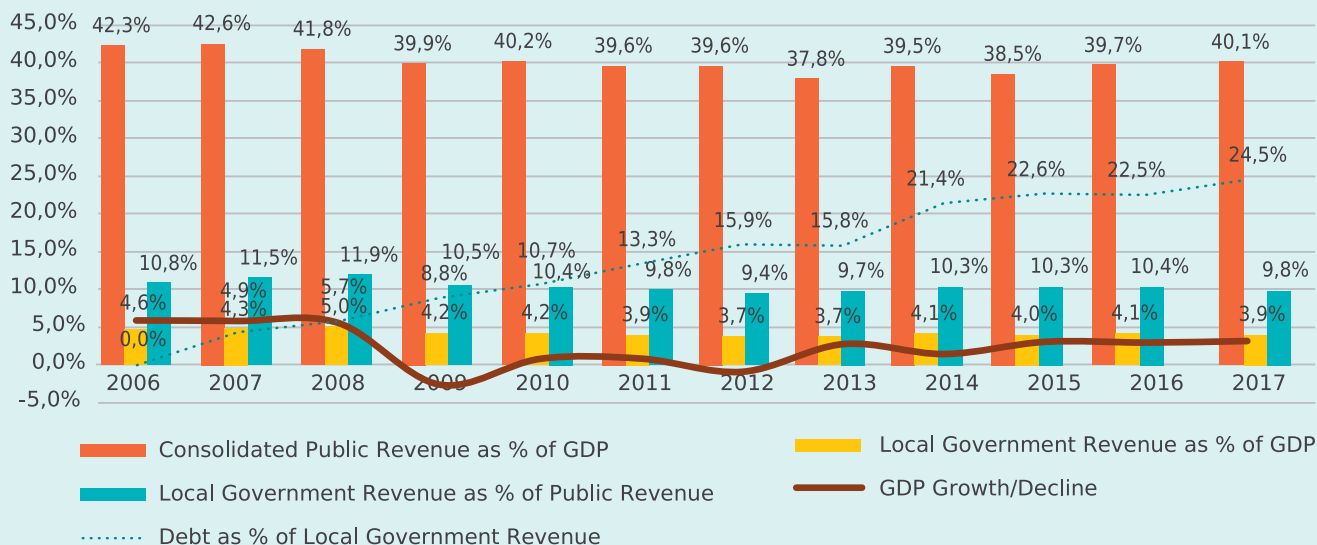
of 43 million KM that represent the reduction of municipalities' share in indirect tax revenues, due to servicing the Federal loan from the IMF in 2010-2014.

Statistical Overview of Local Government Finance in FBiH (of BiH) 2006-2017

Local government revenues in FBiH (of BiH) have not changed significantly in recent years. The upward trend that was evident before the financial crisis never returned. Local government revenues as a share of total public revenues have fallen from 11.9% in 2008 to 9.8% in 2017. The lowest share was recorded in 2012, but between 2013 and 2016 we see this indicator increasing to slightly fall again in 2017.

In 2017, the overall public revenue increased while the share of local revenues to both public revenues and GDP fell to the 2011 levels. The increase in public revenues is due to the measures undertaken under the Memorandum and Reform Agenda signed in 2015, that included an optimization of the control of taxpayers and improved tax collection. It is important also to note that lo-

Chart 39 FBiH (BiH): Local Revenue as Share of GDP and Public Revenue 2006-2017



cal government debt has increased from 4.3% of local government revenue in 2007 when the law on Debt in FBiH was introduced and enabled local governments to borrow and emit municipal bonds to 24.5% of local government revenue in 2017.

Local government revenue fell much faster than that of the general government during the economic crisis of 2008-2009 and throughout 2011-2013. They have also recovered more slowly suggesting that a disproportionate share of the burden of the

downturn was placed on local governments except in 2014 when the local level received support to deal with the flood damages. LG revenues experienced increase in the next 2 years, during 2015 and 2016, mostly because of annual VAT revenues increase. In 2017, the general government revenues increased by 8% whereas local government revenues by only 2% as a result of the lower share of indirect taxes going to local governments because of the increase of the federal debt service outlays.

Chart 40 FBiH (BiH): Annual Fluctuations in the Revenues of the General Government and Local Governments

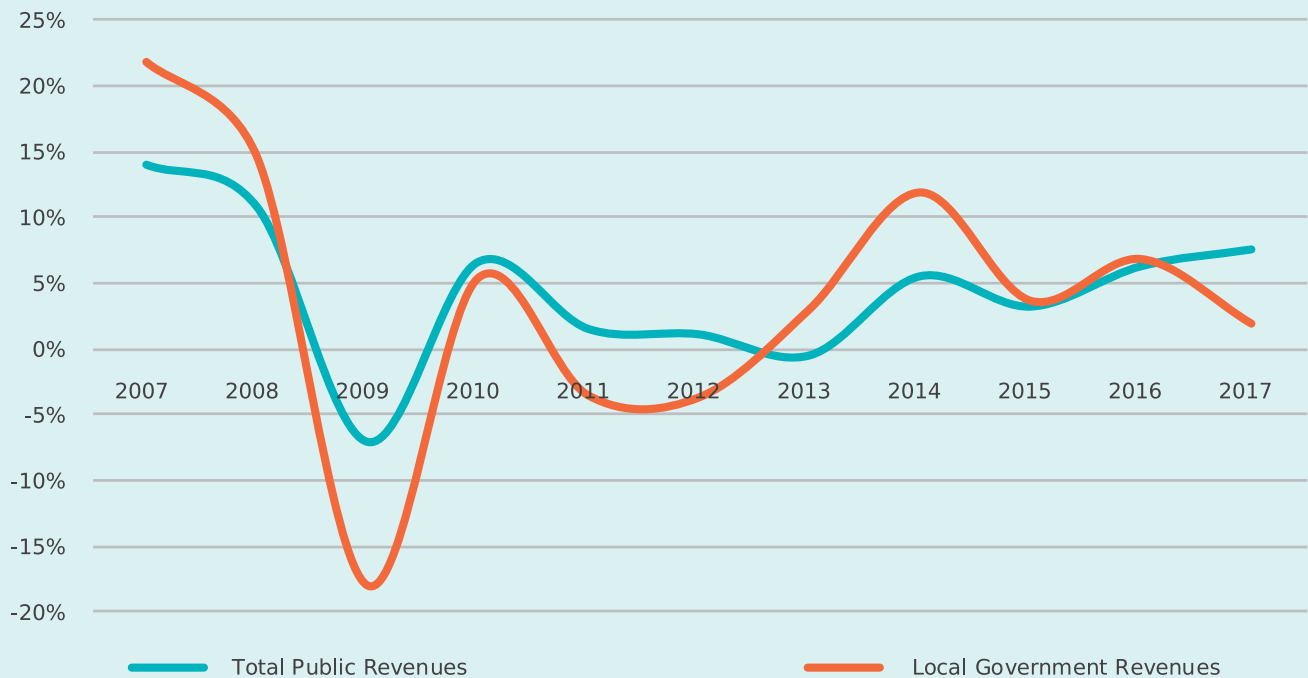
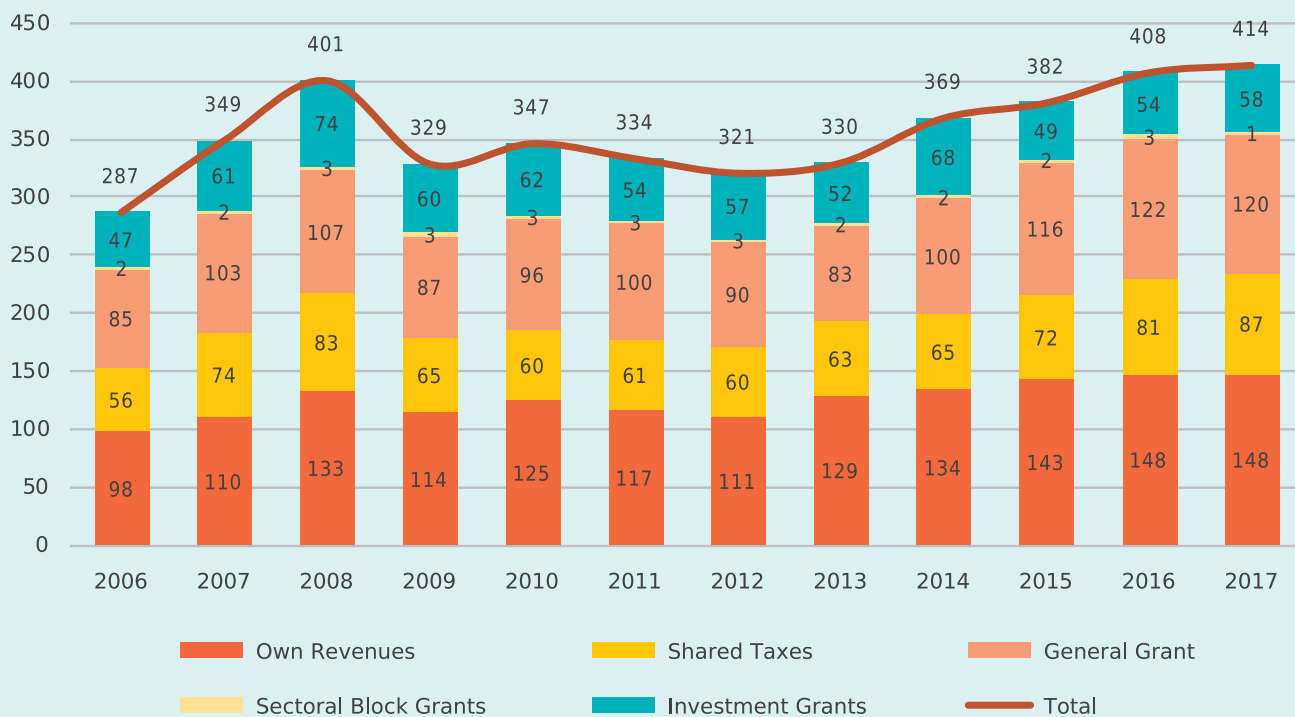


Chart 41 FBiH (BiH): The Composition of Local Government Revenue 2006-2017, in million Euro



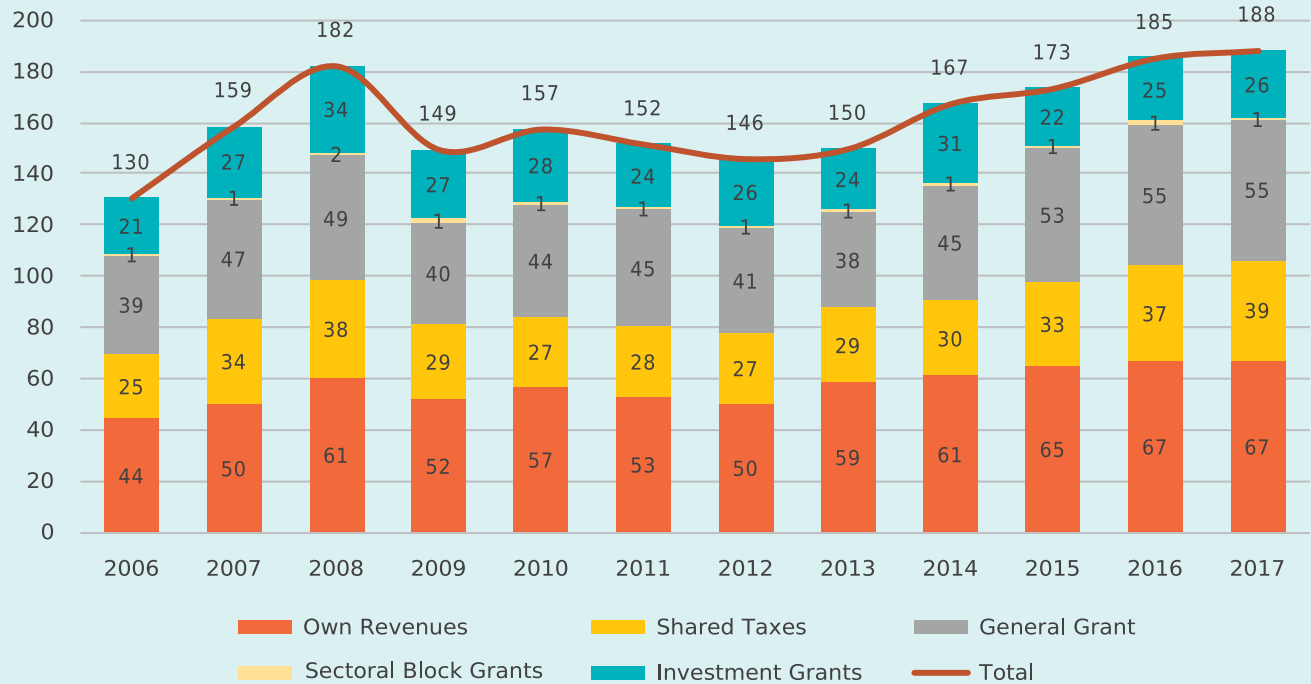
All categories of local government revenue increased since 2013, mostly related to the improved collection of indirect taxes and more efficient control of taxpayers. Own source revenues constitute the single most important source of revenue for local governments (36% of the total in 2017), regardless of the significant level of social welfare functions performed by local governments.

64% of local government revenues are composed of other intergovernmental transfers, in the form of shared taxes and grants. Investment grants have increased over the past two years constituting 14% of local revenues, although they are far from the pre-crisis levels. The share of block grants in revenue composition remained negligible.



Chart 42 FBiH (BiH):

The Composition of Local Government Revenue 2006-2017, in Euro per capita

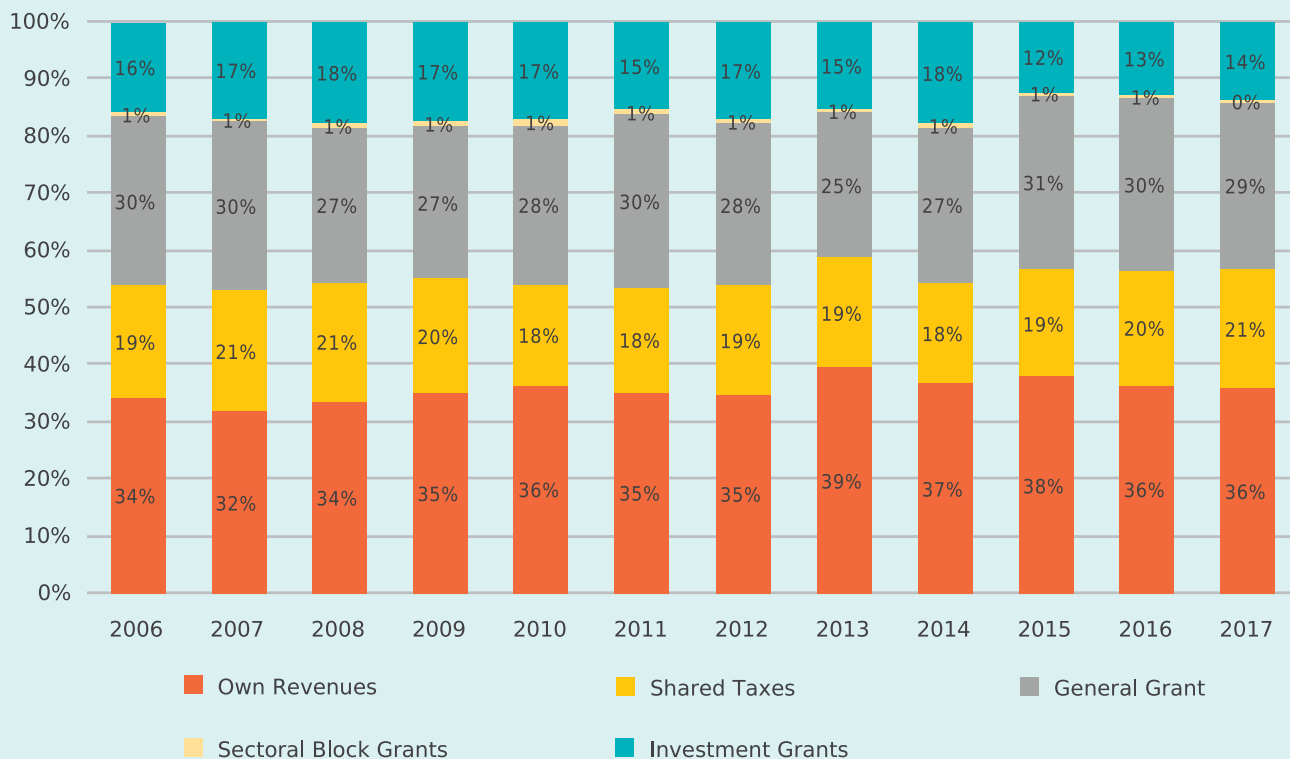


Since 2012, there are no substantial changes regarding structure of LG's own revenues. The composition of own revenues shows a decrease in the yield of the property tax and a stabilization of the revenues derived from municipal assets and communal fees. Other local fees and charges, which include all fees and charges besides administrative and communal ones, still constitute a dominant component of own revenues with 61% in 2017. The main attribute of the category

„Other Local Fees and Charges“ is the heterogeneity of these fees and charges among different municipalities and cities, which derives from the absence of unique system or consistent rules on how these fees are set and collected. Interpretation of this data is difficult because the registry of municipal own revenues across cantons is notoriously inconsistent. It is interesting to note that the revenues from these heterogeneous fees have doubled compared to the pre-crisis levels.



Chart 43 FBiH (BiH): The Composition of Local Government Revenue 2006-2017, in %



Spending for wages and benefits remains the dominant and most stable component of local government expenditure, despite macroeconomic tendencies. Over the past four years it has stabilized close to 29% of local government revenues. Investment, has slowly recovered from its minimum share in 2013 and constitutes 26% of total local expenditures in 2017, yet lower than the pre-crisis level. A high share of expenditure consists of subsidies to utilities, grants to NGOs and transfers to individuals, that constitute 23%. Analyzing the intensity of

expenditure trends from 2006 to 2017, it can be concluded that wages increased by an average of 3.6% per year, while, capital investment have increased by an average annual growth rate of 2.6%.

When local government investments are compared with those of the entire entity we see that the local ones were substantial in the pre-crisis period. Yet, after the crisis this share has dropped significantly, getting to its lowest point in 2013. Local government investments have increased since 2013 and constitute 59% of overall public investment in 2017.



Chart 44 FBiH (BiH):

The Composition of Own Local Government Revenue 2006-2017

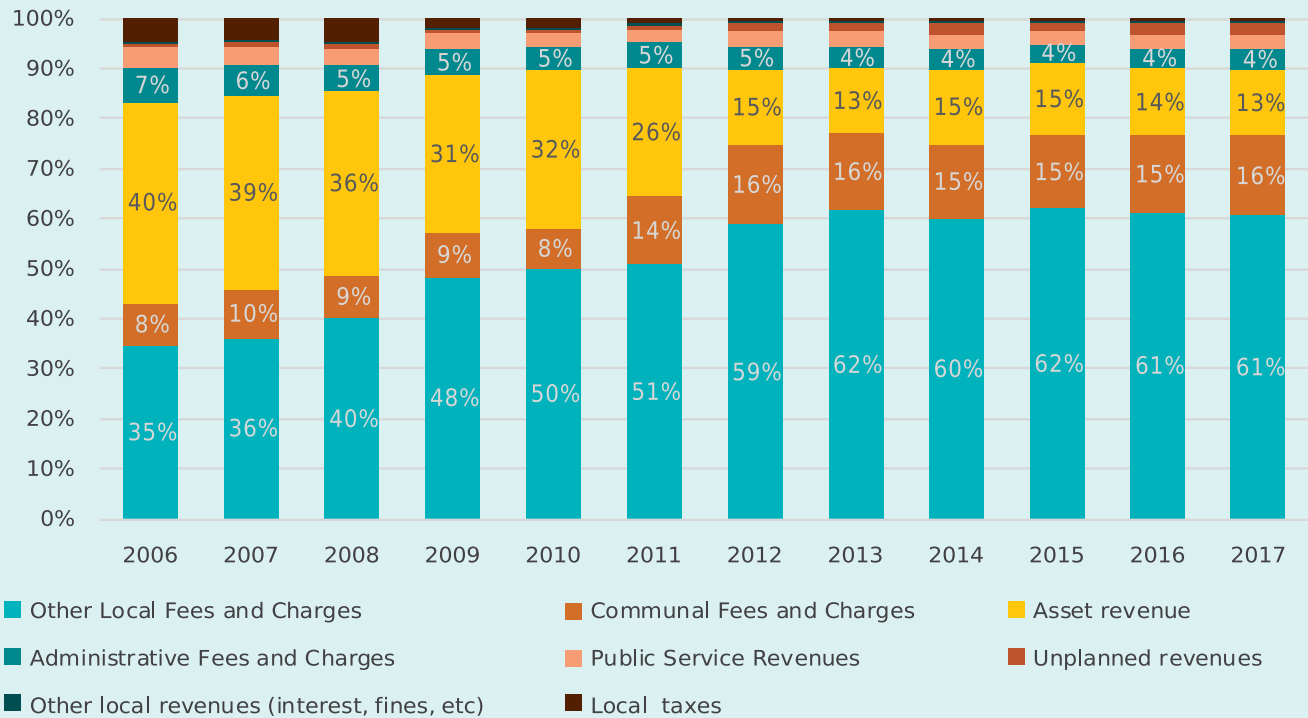
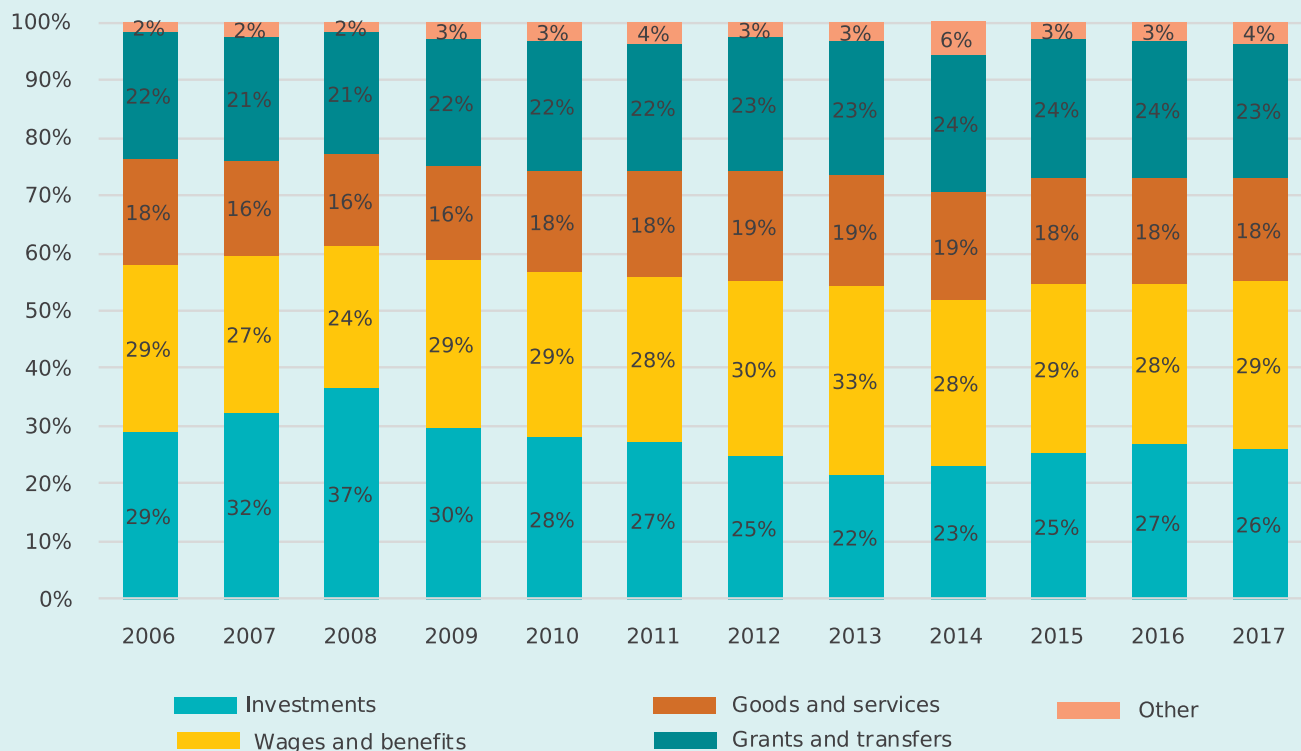


Chart 45 FBiH (BiH):

The Composition of Local Government Expenditure 2006-2017, in %



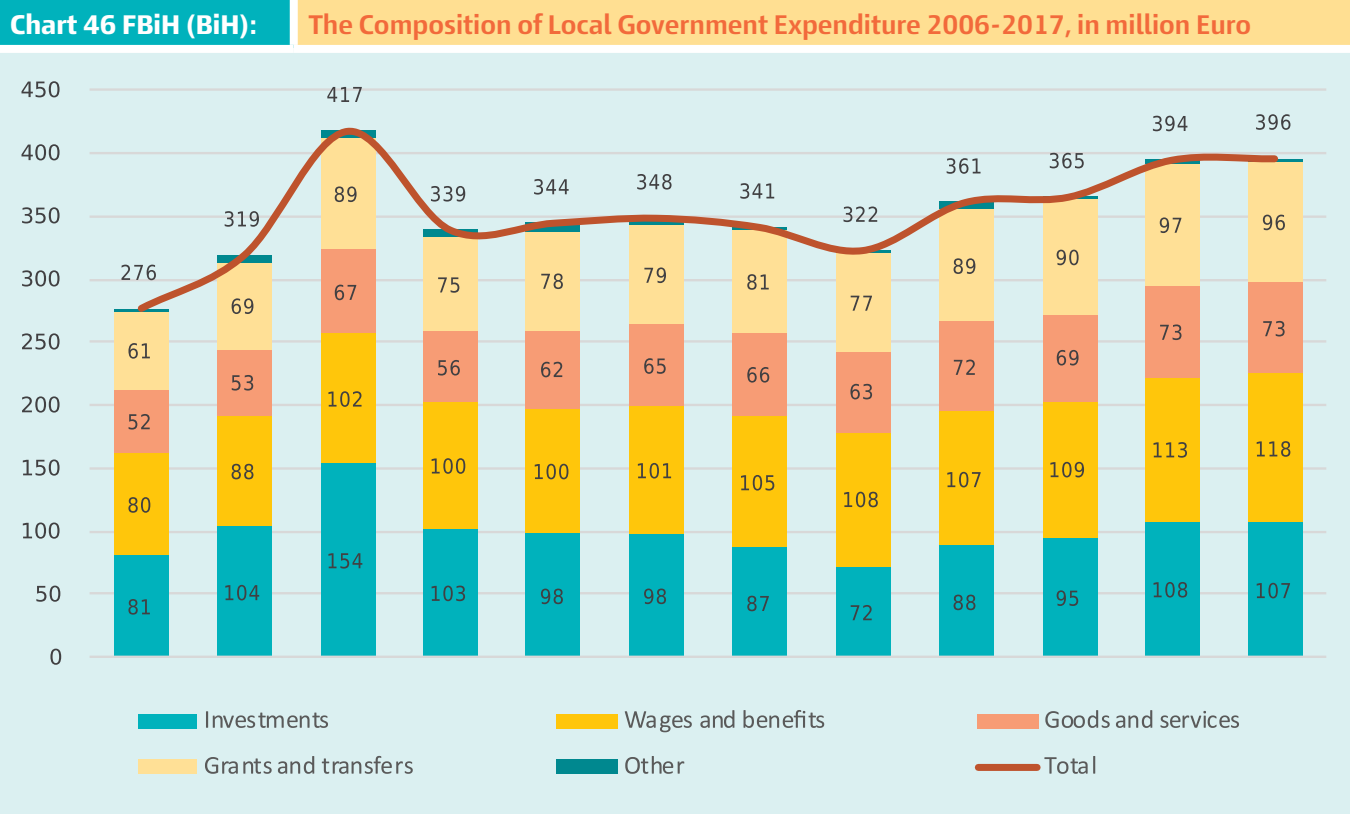
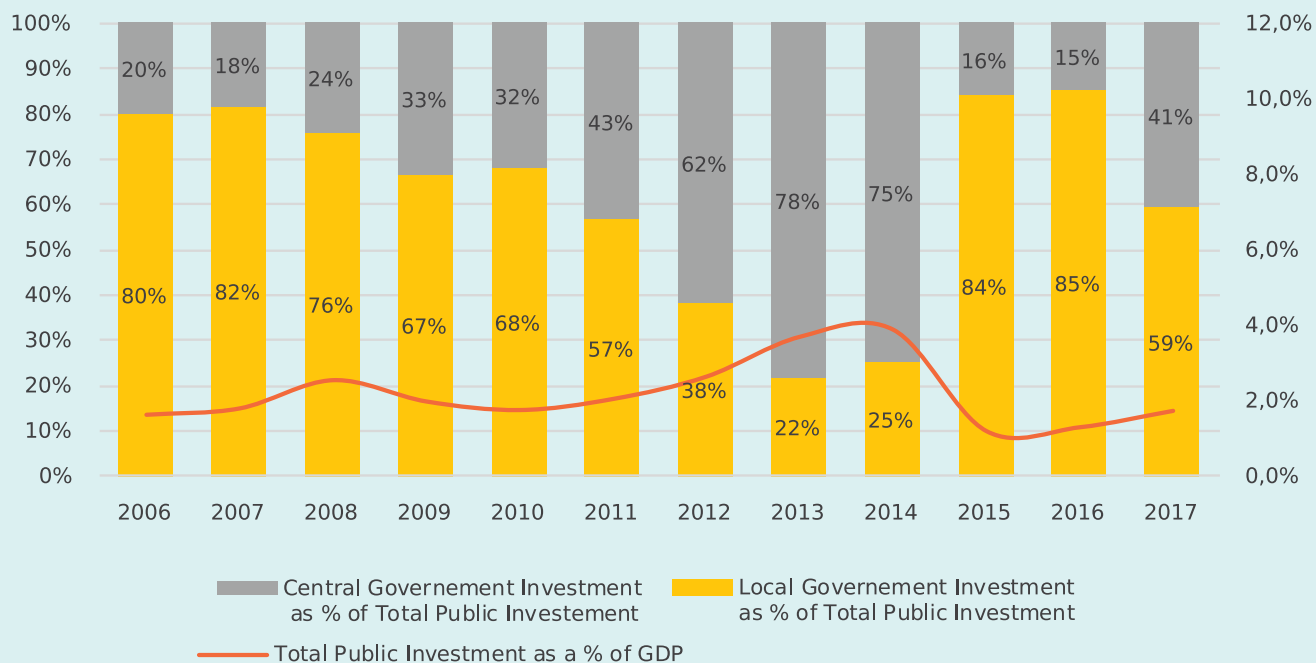
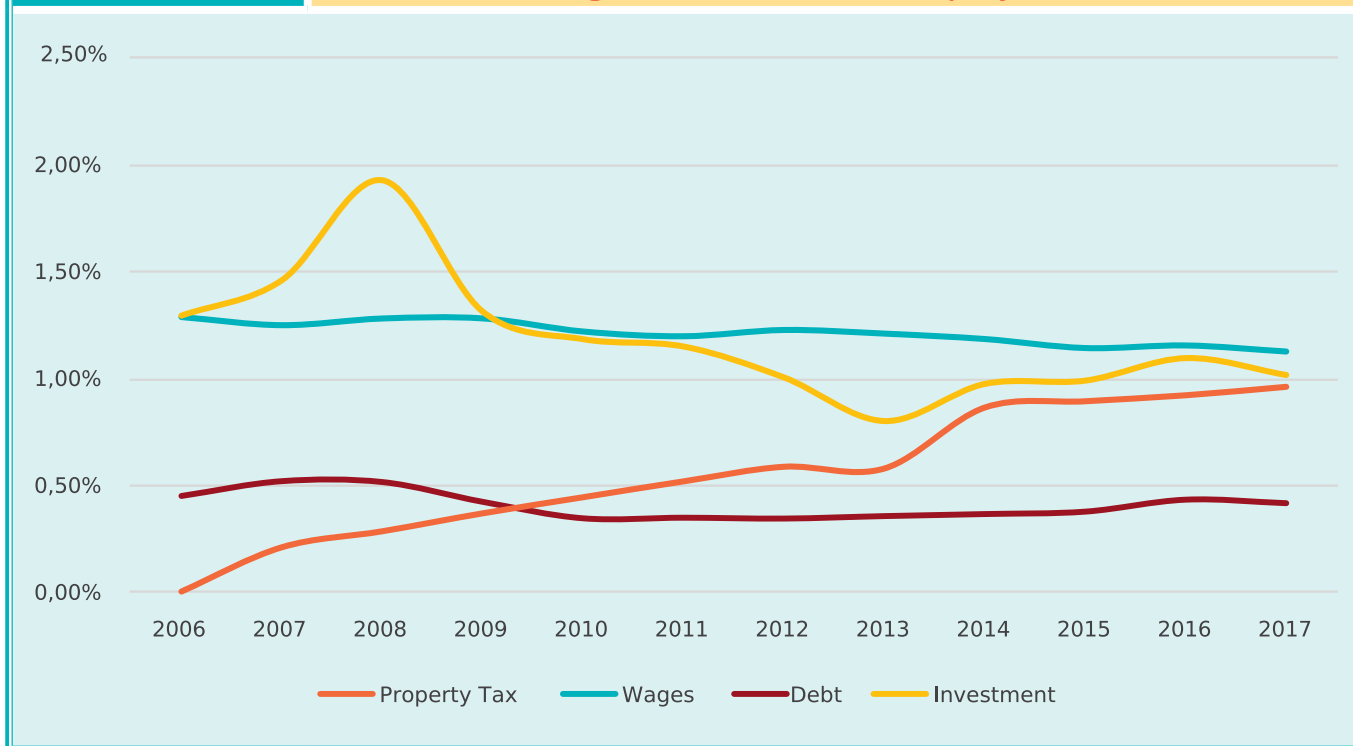


Chart 47 FBiH (BiH):

Public Investment by Level of Government and as a % of GDP 2006-2017



**Chart 48 FBiH (BiH): Local Government Wages, Investment, Debt and Property Taxes as % GDP 2006-2017**

The yield of the property tax – whose base and rate are determined by cantonal governments – is low and has fallen since 2008. The accounting of local government debt remains problematic, but it seems it has increased with a greater jump in 2014 presumably to finance and cover the damages after floods. However it remains under 1%

of GDP. Although increasing in absolute terms, the share of local government spending on wages to GDP, has decreased by 20% when compared to 2006. Between 2008 and 2013, local government investments to GDP have decreased. The downward tendency was reversed over the past four years.



Republic of Srpska (BiH)

By Goran Rakić, Association of Municipalities and Towns of Republic of Srpska

The Intergovernmental Finance System

Local governments in Republic of Srpska (RS of BiH) derive about 85% of their total revenues from an Unconditional Transfers and Own Revenues. Given the RS's extensive responsibilities in social sector functions, including wages of pre-school teachers, and other social and cultural institutions, this is rather peculiar. On the other hand, it may also reflect the fact that all local government competences are defined as "original" or "exclusive" local competences and therefore to be funded through freely disposable revenues.

The definition of local government responsibilities is a subject of discussion in the RS. All local governments, regardless of size and capacity have all the same functional responsibilities. Research shows that this is often accompanied by disparities in access and quality of services provided to citizens. This is which related also to considerations of territorial organization.²⁴

Since 2006, the size of the **Unconditional Transfer** has been set as a percentage of the entity's share of indirect taxes (24%) and allocated by formula. The formula allocates 75% of the pool of funds on a per capita basis, 15% on the basis of the territory of the municipality, and 10% the basis of the students in secondary schools.

While the share of indirect taxes used to fund the transfer has been stable, the formula for allocating it has been repeatedly changed. The Unconditional Transfer accounted for about 50 % of local

revenue between 2006 and 2017. Municipalities also receive 25% of the **Personal Income Tax** (PIT) generated in their jurisdictions. These revenues are freely disposable and have accounted for between 6 and 10% of local budgets since 2006.

There is also a **Transfer for Underdeveloped and Extremely Underdeveloped municipalities**. The amount of this Transfer is set in the annual budget law and allocated according to four criteria: the total per capita revenues of registered businesses (35%); the per capita budgetary revenues of the municipality in the previous year (25%); population density (20%); and the unemployment rate (20%) Finally, municipalities are eligible for **conditional grants from the entity government**, most of which are for investment. Conditional grants accounted for between 5 and 6% of local budgets for most between 2013 and 2017. Overall, local governments in the Republic of Srpska are characterized by a high level of dependence of the revenue transferred from the higher levels of government (63% in 2017).

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

²⁴ Analysis of the status of the local government in BH", Development Agency EDA, 2012

Local Government Tax Powers and Challenges

The financial challenges of the local governments in RS (BiH) in 2017 continued as the competences are underfunded and the majority of funds came from shared revenues and transfers. Local governments still don't actively participate in determining the allocation of the shared revenues and don't have sufficient autonomy in the management of natural and other resources on their territories. Local governments require a higher degree of fiscal decentralization and autonomy, particularly in the area of realization of own source revenue. They have a great interest and motivation for a more efficient tax collection, although in many cases they do not have the competence nor the developed infrastructure. There is a need to review the existing organization of the Tax Administration and the eventual introduction of new local and regional tax authorities, which would be fully dedicated to the collection and implementation of legislation related to the original revenues of local governments.

As many other counterparts in the region, one of the key challenges facing local governments in the RS

is the update of the fiscal register of properties and taxpayers. There have been attempts to regulate this also from a legal perspective. The recent Law on the Property Tax introduces the obligation for the Tax Administration of RS to share and submit data at the request of the city or municipality for properties located in their territories. This is a clear aim to establish better coordination of these bodies for more efficient tax collection. In addition, the Law also introduces the obligation of the Republic Administration for Geodetic and Property Affairs to provide permanent access to the Tax Administration of RS and to local governments on property information. Tax compliance also remains a challenge. To strengthen tax compliance and enforcement, the Law on the Property Tax also introduces a clause that prohibits the sale of those properties for which was not paid property tax. Compliance with this requirement shall be checked when making a notarial document that represents basis for registration of rights on property. The deadlines for the payment of the property tax had been changed as well to improve tax collection and at the same time improve budget sustainability.

Main Developments in Municipal Finance and Advocacy Efforts of the Association

The financial challenges of the local governments in RS (BiH) in 2017 continued as the competences are underfunded and the majority of funds came from shared revenues and transfers. Local governments still don't actively participate in determining the allocation of the shared revenues and don't have sufficient autonomy in the management of natural and other resources on their territories. Local governments require a higher degree of fiscal decentralization and autonomy, particularly in the area of realization of own source revenue. They have a great interest and moti-

vation for a more efficient tax collection, although in many cases they do not have the competence nor the developed infrastructure. There is a need to review the existing organization of the Tax Administration and the eventual introduction of new local and regional tax authorities, which would be fully dedicated to the collection and implementation of legislation related to the original revenues of local governments.

Over the past few years, the National Assembly of the Republic of Srpska has adopted several laws that affect local governments.

The Law on Amendments to the Law on Property Rights

The Law on Amendments to the Law on Property Rights was adopted in July 2015 and it gave additional jurisdiction to the local governments to sell property even below market price (or free of charge), to promote investments of special importance for regional or local economic development. These properties may be used as shares for the establishment of a joint company with the pri-

vate partner, in accordance with the regulations governing public-private partnerships. The rules and procedures should have been defined in by-laws and guidelines adopted by the Local Assembly. While both the Republic and Local Assemblies have been slow in adopting the necessary bylaws that would implement the law, citizens raised the “constitutionality” of some of the articles.

The Law on Amendments to the Law on Income Tax

This law came into force on 1 September 2015, and it aimed to find at reducing the overall tax burden on labor and employment and to reduce the tax burden of companies so that they utilize the freed-up resources for new investments. With this law the incomes from dividends and shares in profit are exempted from the income tax. In this way all taxpayers in BiH are equal and the law prevents

tax competition within BiH. Namely, in the Federation of BiH there was no obligation to pay income tax on dividends, which resulted in the “transfer” of the company`s head offices to the territory where the law was more favorable for the taxpayer. The law had adverse consequences on local government revenues, as 25% of the PIT revenues are allocated to local governments on an origin basis.

The Law on Preschool Education

This Law came into force on September 2015. One of the main changes was the determination of the economic cost of services for preschool institutions which is expected to directly contribute to the increase in children enrollment and reducing waiting lists. The previous law did not define costs,

but only what was financed by the founder of the institution and parents. The criteria that determine the cost of services are based on the structure of the program duration, the analytical structure of the actual costs of services in pre-school institution and the number of children enrolled.

The Law on Fiscal Responsibility

This law has been in force since November 2015 and aims at consolidating public spending, strengthening accountability for the efficient and effective use

of budget resources, and building a stronger system of checks and controls to ensure and maintain fiscal responsibility, transparency and medium and

long-term fiscal sustainability of the Republic of Srpska. This law introduced also the concept of issuing a Statement of Fiscal Responsibility for public officials having office responsibilities for drafting and amending public budgets. Furthermore, the Law es-

tablished also a Fiscal Council, with the authority to request from budget users, local government units and funds adequate economic and fiscal data and information to support assessments and analysis to be performed by Fiscal Council requires.

The Law on Territorial Organization of the Republic of Srpska

Between 2012 and 2016 The Law on Territorial Organization of the Republic of Srpska had changed several times. Firstly, in 2012, 6 cities had the City Status (Banja Luka, Bijeljina, Doboj, Istočno Sarajevo, Prijedor and Trebinje). In 2014 a new municipality, Stanari, was established by separating part of the City of

Doboj. Also, in 2014, the municipality of Zvornik was awarded the status of city. With the amendments to the Law on Territorial Organization of the Republic of Srpska, the number of cities increased from 6 to 7, and therefore the number of municipalities was changed from 58 to 57 municipalities.

The Law on Property Tax

In 2015 the National Assembly of the Republic of Srpska adopted a new Law on Property Taxation to enter into force on 1 January 2016. Since 2012, the Tax Administration of the Republic of Srpska raised issues of inconsistent management of the property tax by certain local governments, in particular as regards untimely decision-making and submission of decisions to the Tax Administration of RS and the “unreasonable” determination of the tax rates at the level of minimum or maximum rates allowed (at the time the interval for the property tax rate was 0.05% - 0.50%). To improve collection the draft-Law proposed a single property tax rate at 0.25% and established a lower tax rate for property used directly for production purposes at 0.20 %. However, in the National Assembly the draft-law was amended and the final rates approved were 0.20% and 0.10% for property which directly carries out productive activity.

Following the new Law on Property Taxation, the tax base is the estimated market value of the property, which is determined on December 31st of the previous year. Municipal and City Assemblies are obliged, no later than January 10th, of the current year, to submit to the Tax Administration of RS decisions on the estimated market value of property by zones on its territory for land (construction, agriculture, forestry, industrial, etc.) and buildings (apartment, house, business, industrial and other facilities). The new Law specifies also properties that are exempted from the tax, including now all public goods, as well as property owned by an institution founded by the Bosnia and Herzegovina, the Republic of Srpska, the Federation of BiH, Brcko District and local government units.

New Law on local self-government

A new Law on Local Self-Government was approved on November 2016 to regulate the system of local self-government, with the major novelties including among others, two additional responsibilities for cities. The law provides now the possibility that a city which consists of no municipalities, in addition to the competencies granted to the municipality, can organize the tasks of legal representation before courts and other bodies in property and legal disputes, disputes on fees and charges and services, and working disputes, as well as the collection, control and enforcement of collection of the original revenue of the city budget. This de facto means that cities are authorized to legal representation, which was previously done by Attorney General of the Republic of Srpska, organize themselves. However, it should be noted that the application of these provisions was postponed for January 1st 2018. The application of the other responsibilities assigned to the city, primarily related to the collection of property tax revenue, have been postponed until further notice, i.e., until 01 January 2019.

The new law prescribes also a threshold for the number of employees in local self-government, including the maximum number of employees for with an indefinite time contract in the city or municipal government, at no more than three employees per 1,000 inhabitants in according to the last census. Notwithstanding Article 67 of this Law, the maximum number of employees with an indefinite period contract (permanent employees) in the municipal administration, according to the latest census is:

- 1) local governments with less than 1.000 residents have 7 employees,
- 2) local governments with 1.001 to 2.000 inhabitants, have 10 employees,

- 3) local governments with 2.001 to 3.000 residents, have 13 employees
- 4) local governments with 3.001 to 4.000 residents, have 15 employees and
- 5) local governments with 4.001 to 5.000 residents have 17 employees.

The mutual cooperation of local governments is regulated in a more comprehensive and detailed manner in relation to the previous legal solutions. Among other things, the law explicitly states that cooperation between local self-government is realized by forming joint working groups, the establishment of a joint public company, a joint company, a joint public institution, public-private partnerships, pooling of financial, material and other resources on the basis of the project, etc.

One of the most important novelties in the new law is the possibility for the National Assembly of the Republic, to dissolve the Local Government Assembly, if the local authority is not constituted within 3 months from the date of confirmation of the election results by the competent authority; if the budget is not adopted within the prescribed deadline; if no Assembly session is held for a period longer than three months, for any reason. In the case of dissolution, the RS government has the authority to appoint an Interim Authority of local government, which shall consist of one representative of the Ministry of Administration and Local Self Government, the Ministry of Finance, and a representative proposed by the mayor. The Interim Authority will perform the assembly affairs until the constitution of Assembly. These rules should prevent blocking the work of local governments.

Finally, it is important to note that along with the entering into force of the Law on Local Self-Government of RS, the Law on Civil Servants and Employees in the bodies of local self-government

of the Republic of Srpska entered also into force, regulating the rights and duties of the public servants in the bodies of local self-government.

Statistical Overview of the Finances of Local Governments in RS (BiH) 2006-2017

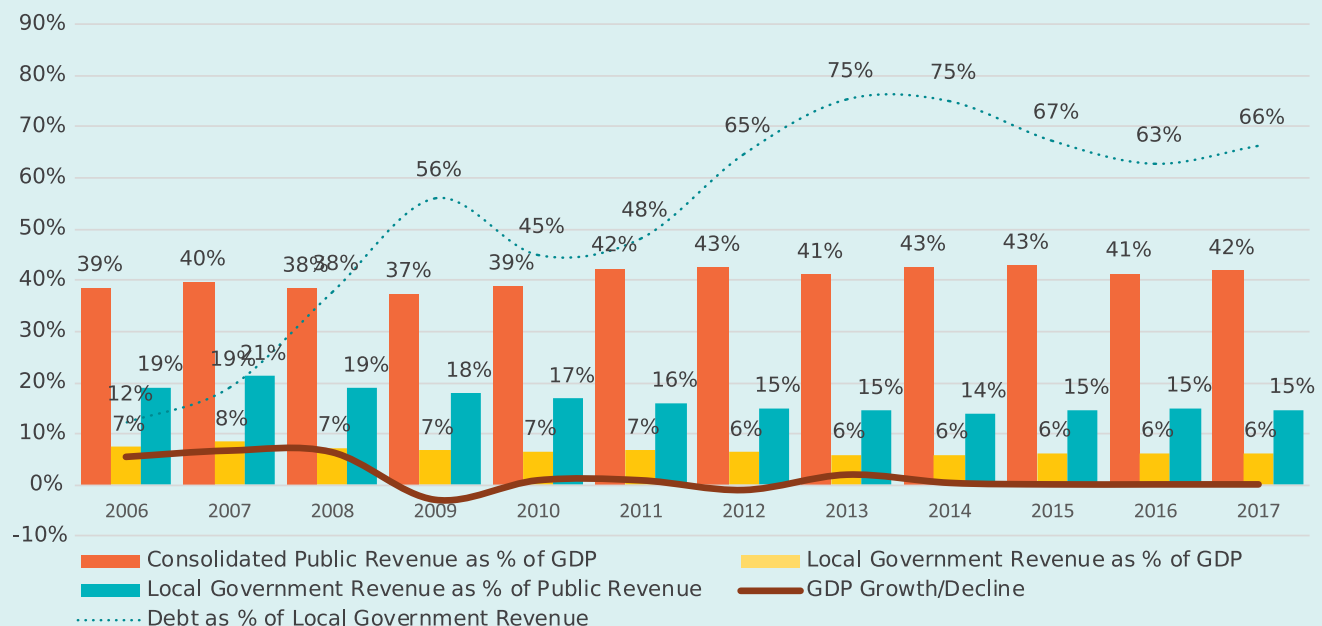
Local government revenue as a share of GDP declined from a peak of 8% in 2007 to 6.2% in 2017. Local revenue as a share of total public revenue fell from 21% in 2007 to 15% in 2017. In short, the financial position of municipalities in RS (of BiH) has deteriorated quite substantially over the past

decade, and has worsened further with the financial consequences of the major floods of 2014.

Local government revenues have declined faster and risen slower than the revenues of the entity government suggesting that the entity government has placed a disproportionate share of the burden

Chart 49 RS (of BiH)

Local Government Revenue as Share of GDP and Total Public Revenue 2006-2017



of economic downturns on local governments, except in 2015 and 2016 when the entity government revenues slightly declined and the local revenues increased. The tendency of slower increase in local government revenues has returned in 2017.

The composition of the revenues of the local governments in RS (BiH) implies they are heavily de-

pendent on the Unconditional Grant, which has fallen to 48% of the total in 2017 from 51% in 2016. Own Revenue has remained relatively stable for the past 7 years to increase at 37% in 2017. The share of shared taxes has also increased to 10% of the total in 2017.

Chart 50 RS (of BiH)

Annual Fluctuations in the Revenues of the General Government and Local Governments

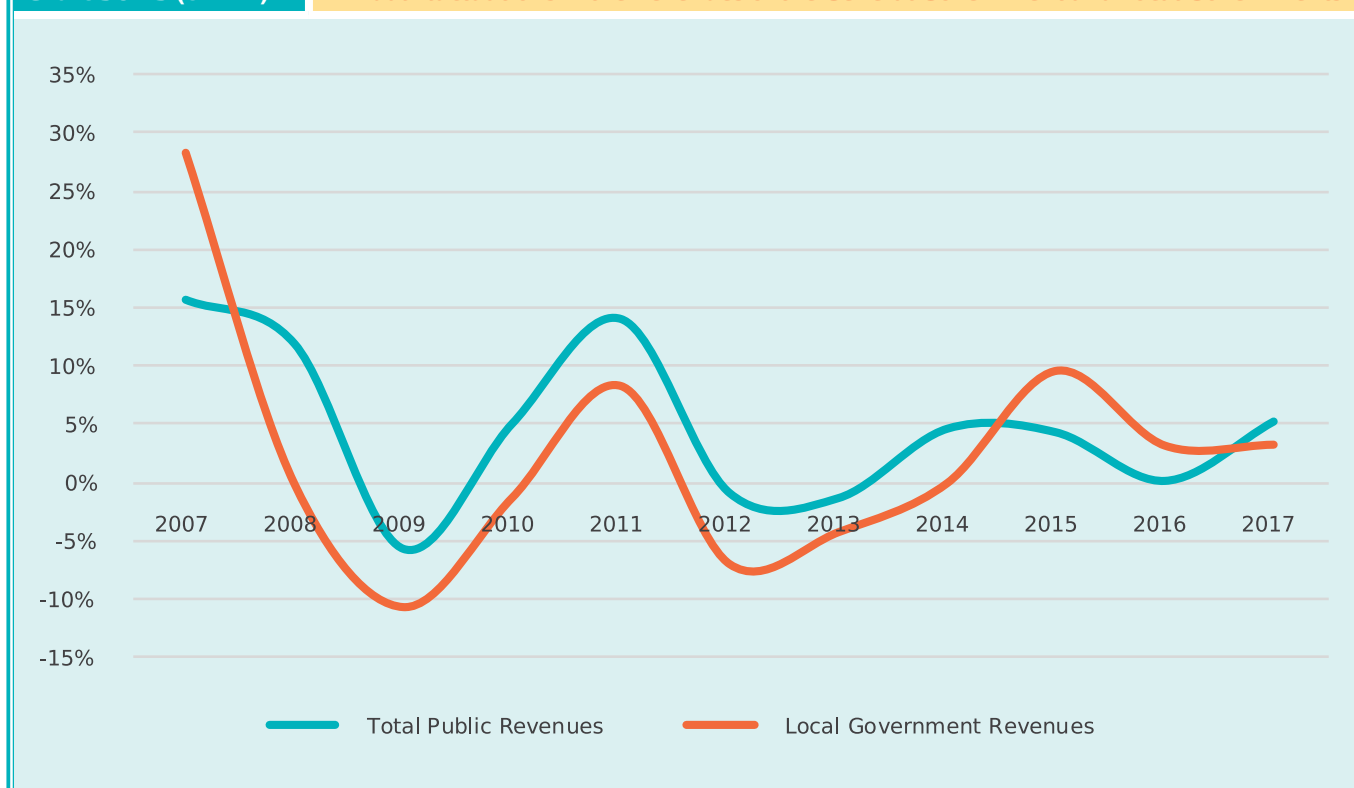




Chart 51 RS (of BiH)

Composition of Local Government Revenues 2006-2017, in % of total

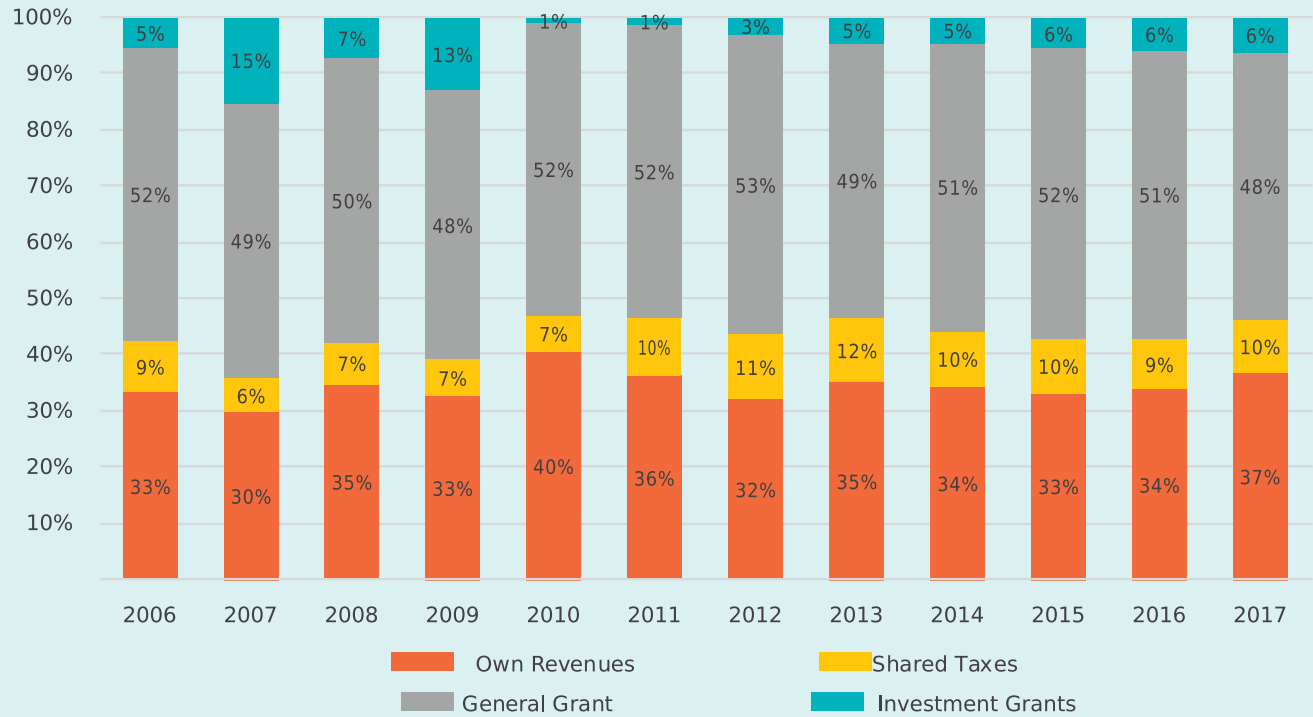
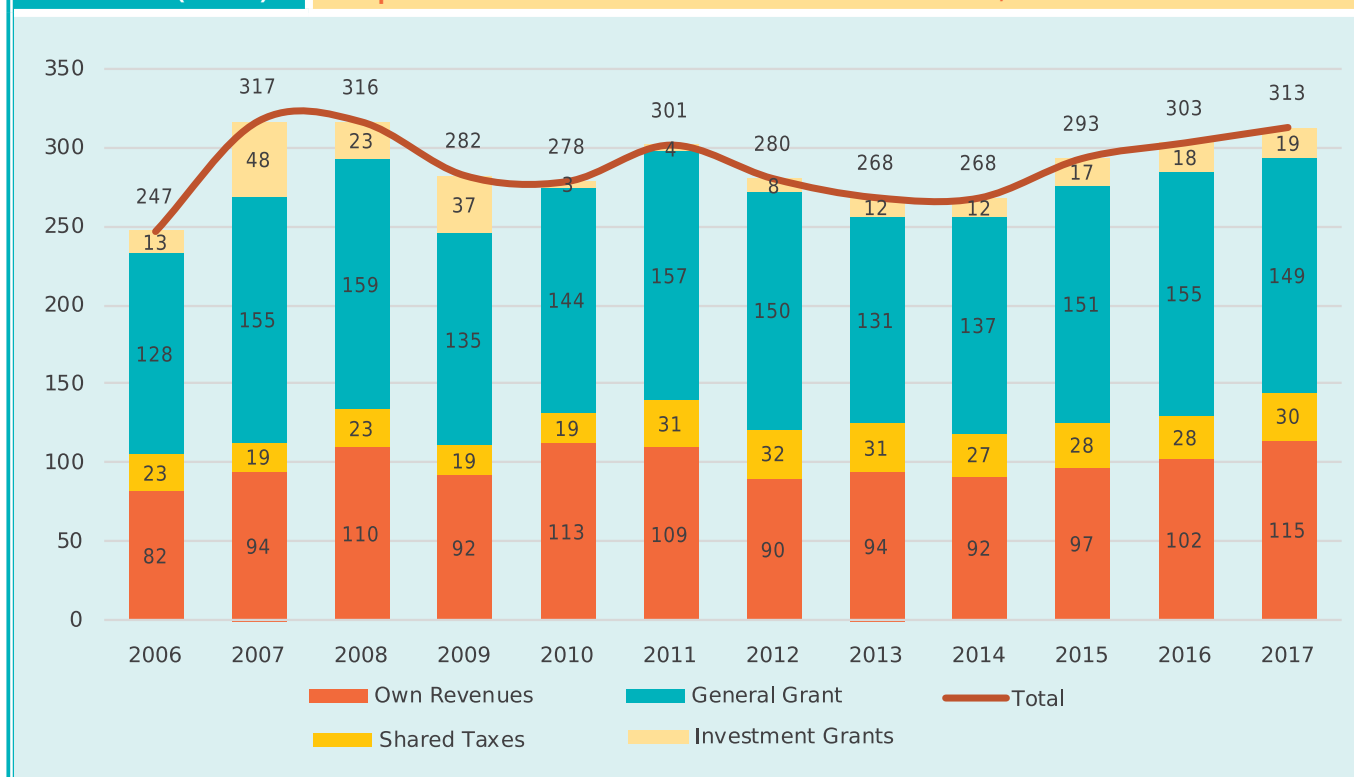


Chart 52 RS (of BiH)

Composition of Local Government Revenues 2006-2017, in mln Euro



The composition of the own revenues shows the domination of communal fees and charges (on advertisement, particular categories of entertainment, use of public space, parking, accommodation in hotels, and construction of buildings) with 72% of the total in 2017. The revenues from property taxation remain very low, just 11% of the own revenues in 2017, and among the lowest in South East Europe.

Over the past two years, investment as share of total expenditure has slightly recovered to 12 and 13% after 8 years of regular decline. On the other hand, spending on wages has increased. Like their coun-

terparts in FBiH (of BiH), RS (of BiH) municipalities spend significantly on subsidies to municipal utilities, grants to NGOs and transfers to individuals. However, the share of grants and transfers has fallen by 10% points between 2016 and 2017. Until recently, Conditional Grants played a marginal role in the system.

The overall deterioration of the financial position of local governments in RS (of BiH) can be seen in the sharp drop in investment spending between 2006-2015. Public investment in general decreased in 2017, but the share of investment of the entity government dominated with 73% of

the total, which has been the case in the past three years. The picture was quite different in the period before the financial crisis.

Wages have also declined as a share of GDP, while property tax revenue has increased as a share but still remains under 0.5% of GDP. The

debt of local governments increased dramatically between 2010 and 2014, which may be due to the need to resolve quickly the damages of the big floods, but decreased again in 2017. Investments as a share of GDP have been declining since 2007.

Chart 53 RS (of BiH)

Composition of Own Local Government Revenues 2006-2017

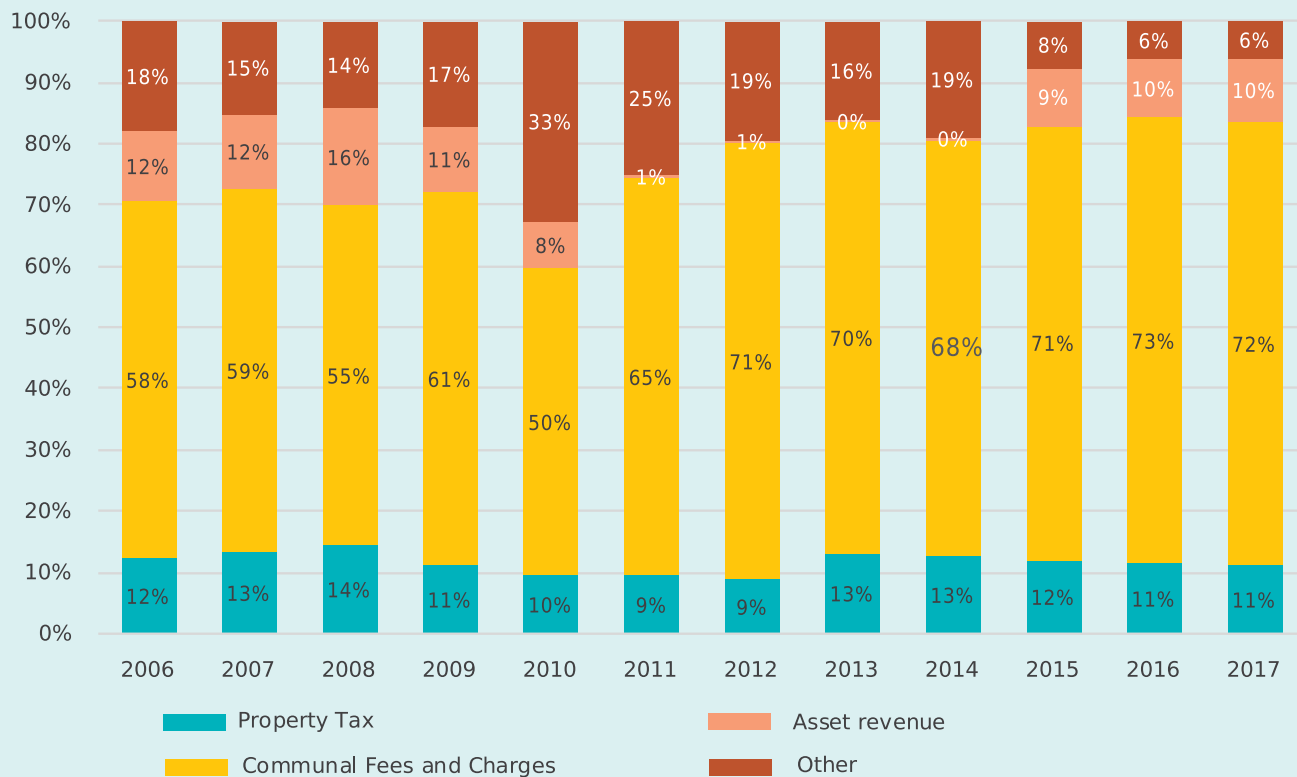


Chart 54 RS (of BiH)

Composition of Expenditures in 2006-2017

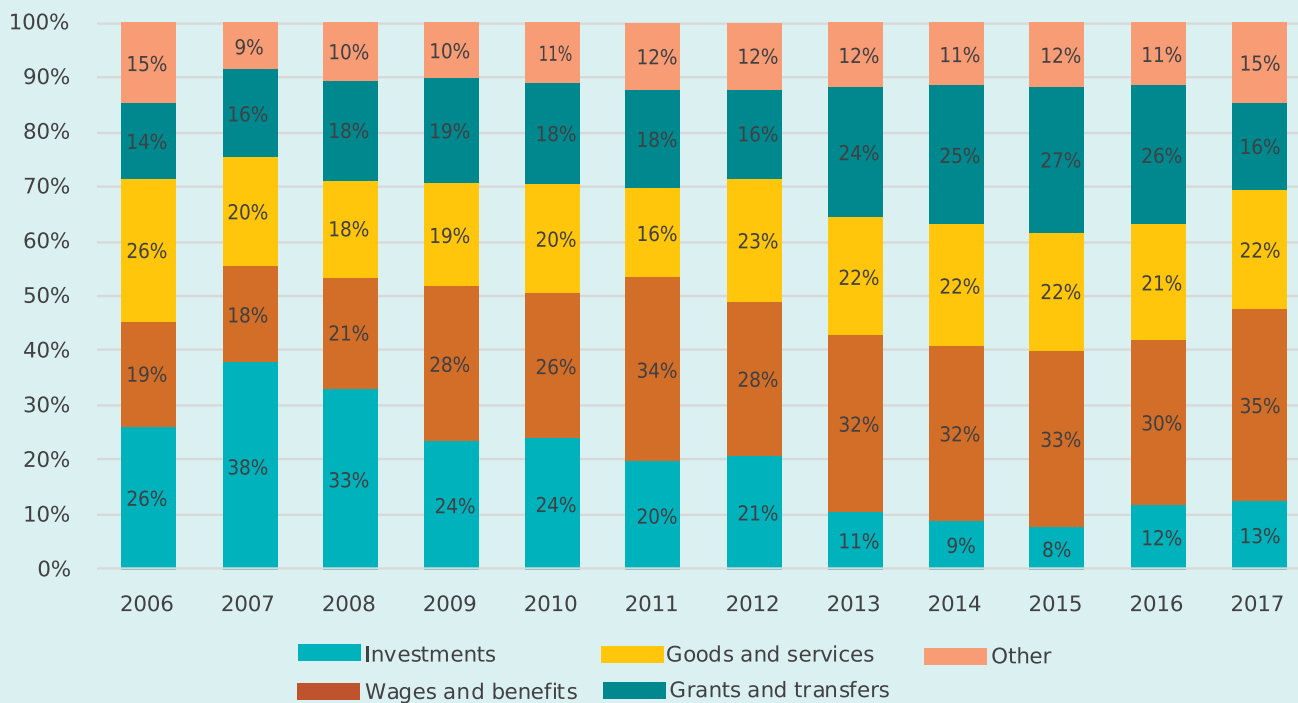




Chart 55 RS (of BiH)

Investment by Level of Government and as a % GDP 2006-2017

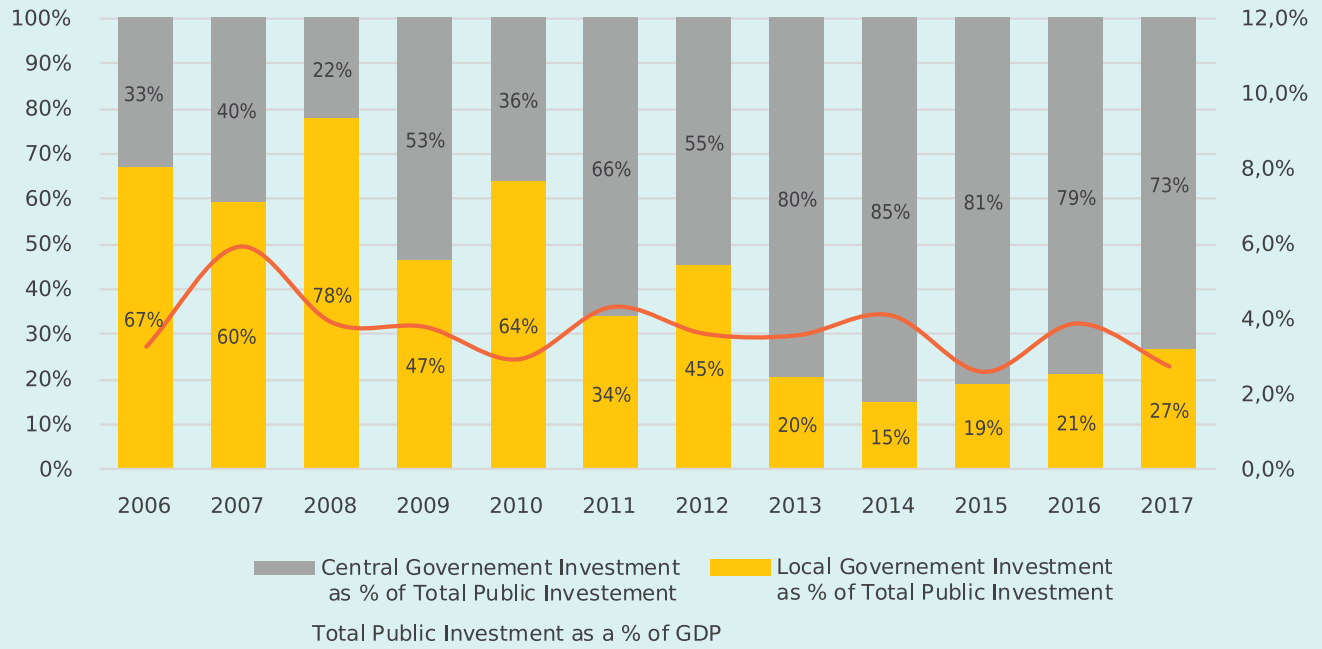
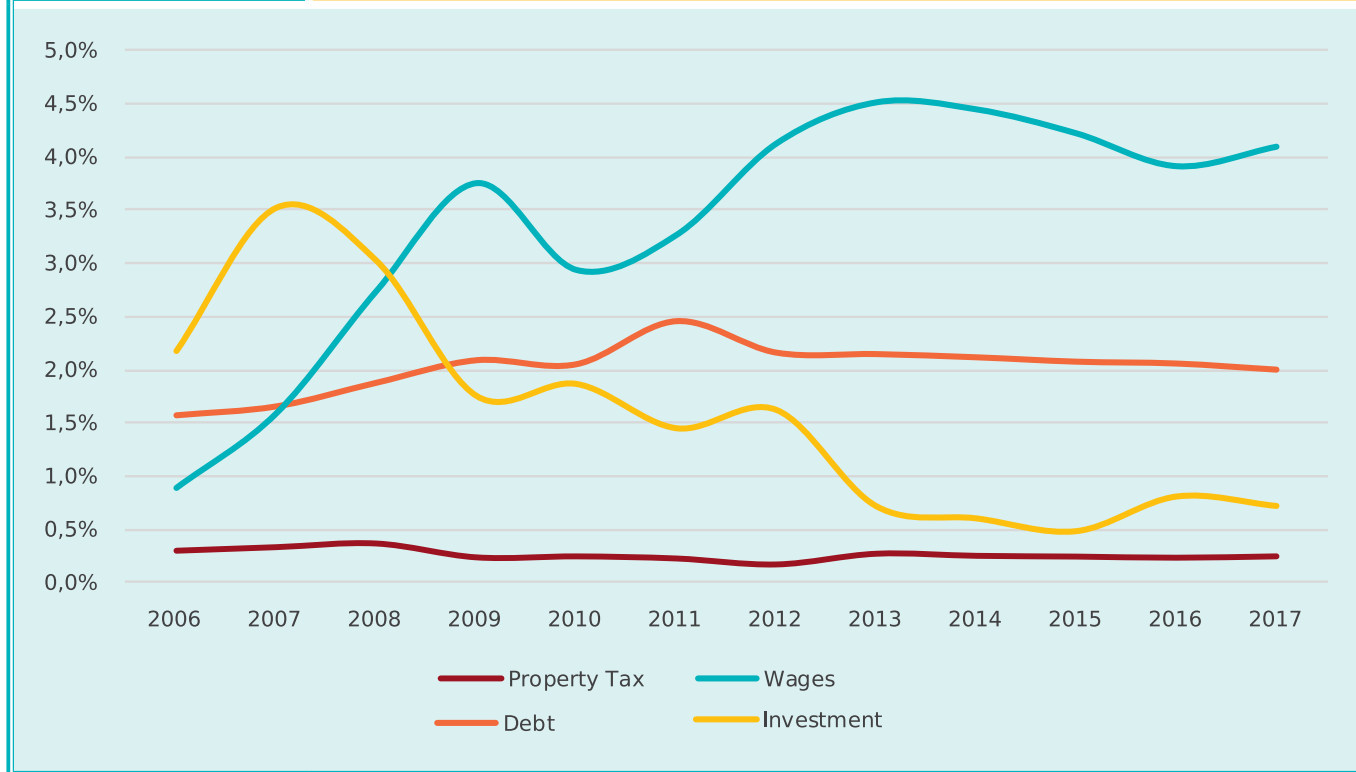


Chart 56 RS (of BiH)

Investment, Wages, Debt and Property Tax as Share of GDP 2006-2017



Bulgaria

Emil Savov, National Association of Municipalities in the Republic of Bulgaria

The Intergovernmental Finance System

The Intergovernmental Finance System (IFS) is regulated mostly in the Public Finance Act (2014) and in the Municipal Debt Act, which defines the borrowing framework. The former represents the legal budget umbrella for all the public sector actors and, with its introduction, the Municipal Budgets Act, which

regulated the local governments' finances between since 1997, has been abolished. In addition to that, the annual state budget laws set the specifics for each of the transfers to the local governments – total amount, allocation among municipalities, timetable for disbursements and other conditionality.

A. Transfers

The Bulgarian municipalities are heavily dependent on transfers from the central budget - in 2017, their share of the total municipal budgets reached 63% (54% in 2015). The following three types of transfers are of greatest fiscal significance at local level:

General subsidy for delegated functions

It amounts to 1.3 billion EUR in 2017 and takes up 82% of the total transfers. Its purpose is to fund public services, which are central government's responsibility but provided by the municipalities. One such service is education (*from kindergartens to secondary school level*), which forms 70% of this subsidy. The other services, funded by this subsidy, are social assistance for elderly people (10%), the salaries of the municipal administration (10%), cultural activities (5%, *museums and libraries*) and healthcare (5%, *nurseries, health services at schools, prevention activities*). The calculation of the total amount of the subsidy is based on service costs. Its allocation among mu-

nicipalities reflects indicators such as number of pupils, classes, libraries' staff etc.

The concept for this subsidy has been developed in 2001-2002 as an attempt to overcome the main deficiency of the IFS at that time (*see the text box below*). Once implemented, it eliminated the municipal budgets' financial gap to great extent but significantly decreased the level of local fiscal autonomy. From this prospective, the term "general" in its name is misleading – in fact, the subsidy "arrives" at local level with almost all service provision decisions already taken by the respective ministries. In Section III of the report, this phenomenon is described as well-known paradox - *as countries devolve social sector functions to local governments, local governments typically become more financially dependent on their national governments than before*. The main reason for this paradox in Bulgaria is the way these functions are being funded – through transfers, micro-managed at the central level.

Prior to 2003, the Bulgarian municipalities have been dependent on sharing (with the central government) proceeds from the personal income tax (PIT) and from the corporate profit tax. Throughout the years this opaque financial arrangement lead to increasing local deficits - municipal governments were expected to cover the full costs of pre-tertiary education from the yield of their PIT share and of a variety of social benefits payments, something that was virtually impossible in all local governments except the capital.

Equalizing subsidy

The purpose of this subsidy is to ensure that each municipality possesses enough money (*both own source and transfers*) to fund a minimum of public services. This is the only transfer, over which local governments have full fiscal autonomy. By law, the annual size of the equalization subsidy cannot be less than 10% of the own revenues of all municipalities in the previous year. Its total amount is 10% of all transfers (*approx. 150 million EUR*).

The allocating criteria among the municipalities are part of the annual state budget laws and have been changed repeatedly. Currently, the allocation formula has two components. The first one (*revenue potential*) allocates to those local governments, whose per capita own-revenues are less than 90% of the national average. This amount can be reduced by up to 25% if a municipality's tax rates are below the national average.

The second component (*service responsibilities*) allocates the remaining funds in the grant pool according to separate calculation of expenditure

needs. These needs are calculated on the basis of costing standards for preschools and homes for the elderly, as well of municipality's surface area. Municipalities whose per capita expenditures on these functions are less than 100% of the national average are entitled to 100% of the difference. Municipalities, whose expenditures are higher than the national average, receive 50% of the difference.

In practice, all local governments are entitled for this subsidy, which contradicts with its general purpose - to help resource-poor local governments only. For a number of years NAMRB's has argued, that despite the efforts for improving it, the current methodology has serious shortcomings mainly because it is not based entirely on criteria that are fully independent of local decisions, and thus can be "gamed".

Earmarked investments transfer

Local Governments receive conditional grants for specific investments and government programs. The total amount is annually set in the state budget laws (*8% of all transfers*) and its allocation is based on objective criteria - number of inhabitants, number of settlements and surface area. During the execution of the state budget, if the central budget operates at a sustainable surplus, the central government provides additional investment transfers to the local governments - mainly for streets and roads reconstruction.

Since joining the European Union in 2007, most investments at local level have been funded by EU monies. Until 2015 (the end of the programming period) municipalities have received nearly 4 billion EUR in EU grant money, mostly for projects to improve their environmental, social, and technical infrastructure. The Bulgarian municipalities receive over 60% of the EU financial support to Bulgaria.

One of the significant traits of the Bulgarian IFS is the lack of central taxes shared with the local governments. From this prospective, Bulgaria is almost unique in the EU.

NAMRB traditionally is heavily involved in the annual state budget cycle during which NAMRB and the Ministry of Finance negotiate on:

- the total amount of each of the transfers,
- the costing standards for each of the services

funded by the subsidy for the delegated functions,

- the allocation criteria of the equalizing subsidy,
- other transfers and changes to the budgeting rules.
- The results of the negotiations become part of the draft budget for further consideration and deliberation by the central government and the Parliament.

B. Own revenues

The own revenues (*1.1 billion EUR in 2017*) form 41% of the municipal budget revenues and consist of three main types – municipal taxes, fees and other (mainly property related) revenues.

Taxes

The local taxes represent 42% of the municipal own revenues in 2017. There are seven local taxes, three of which account for over 90% of all local taxes revenues: property tax (35%), motor vehicle tax (32%) and property transaction tax (28%).

In 2007, the Parliament amended the Constitution thus granting taxing powers to the local governments. The law²⁵ defines the types of the local taxes and, for each of them, the taxpayers, the tax base, the tax rate limits (lowest and highest) and the tax exemptions. The municipal councils determine annually the tax rates and define the zoning for the property tax. The average collection rate for the first two taxes is approximately 70%.

A new local tax has been introduced in 2017, which is paid by the taxi drivers and, in fact, it substitutes their personal income tax. It generated 5.4 million EUR (*1.2% of the local taxes*) mainly in the large municipalities and in local governments with strong tourist business.

Fees

The local fees²⁶ form 35% of the municipal own revenues in 2017. The waste disposal fee, paid by the citizens and the business, has the biggest share of all the fees – over 70%. The parents pay nurseries and kindergartens fees for their kids, which accounts for 9% of the total municipal fees. Local government receive fees also for so-called technical fees – for issuing and/or verifying various documents such as building permits. These fees represent 5% of all fees collected.

²⁵ The Local Taxes and Fees Act

²⁶ According to the Constitution, the types of fees the local governments may collect are to be defined in the law. This law is the Local Taxes and Fees Act.

Other, mainly property management related, own revenues

These revenues' share of own revenues is approx. 20% and their major component are rents from

municipal property (135 million EUR), followed by municipal assets sales (70 million EUR). The other, much smaller, revenue items include fines, concessions rights etc.

Main Developments in Municipal Finance 2017-2018 and Advocacy Efforts of the Association

While the economy and public sector as a whole fully recovered from the effects of the economic downturn. The local government sector in general also overcame the sharp transfers' cut in 2010 but since then the disparities among the local governments' financial situation increased. A number of issues related to the local governments' finances require immediate policy attention and actions:

- The considerable nominal increase of the municipal budget in 2016 and 2017 is the result of short-term state policies (*transfers increase*) funded through the municipal budgets.
- The municipal payment arrears (*payments due to suppliers of goods and services*) maintain an unhealthy level of about 100 million EUR (10% of own-revenue) for a number of years.
- The underfunding of the delegated functions (*via suppressed service costs*) "pumps" 50 million EUR out of the own revenues (*at the expense of the local investments*) in order to maintain the level of the services.
- About 40% of local governments have significant operating deficits and have trouble meeting their co-financing requirements for EU funded projects.
- The local taxes have limited growth potential due mainly to the negative demographic trends. For this reason, the increase of the

collection rate is problematic for most of the local governments and, for the same reason, increasing the tax rates treats unfairly the decreasing number of paying taxpayers.

- The local governments use the debt financing in a prudent and balanced way – mainly for infrastructure and co-funding of EU-supported projects.

NAMRB continues to be proactive in raising these issues and in proposing regulatory changes to address them. Three years ago, the association started to get prepared and to send to the MoF the transfers expectations of the local governments while in advance during the annual budget preparation cycle. This practice proved more fruitful than just reflecting to the ministry's proposals – when the draft state budget is already balanced. This breakthrough can be seen in the considerable increase of some of the transfers, some of which have been "frozen" at the level of 2012.

The most important proposal for substantial change in the municipal **own revenue base is a draft concept for amending the Local Taxes and Fees Act**, developed by NAMRB and adopted by its members in 2015. The concept sets the following areas for improvement: the taxation of agricultural land, introducing municipal PIT, limiting the scope of tax exemptions, increasing the local discretion on tax assessment and adding new fees for street lightning and city-center con-

gestion. The need for changes has been identified by the MOF as well and the first expert groups were established in 2018.

The Concept for amending the Local Taxes and Fees Act in brief

1. Legally banning the state to provide local tax exemptions for state policies. Such policies cost local governments a lot: for example, owners of energy efficient buildings get long-term property tax exemptions, which cost about 2-3 million EUR the budget of a large city (over 100 000 citizens).
2. Adding the agricultural land as taxable asset for the purposes of the Property tax. Currently this land is fully exempt. At the same time, the land is a valuable capital asset, which, among other things, attracts considerable EU grants (*the payments under the Common Agricultural Policy are made based on agricultural land ownerships*). For the majority of the local governments, the agricultural land is the biggest asset (*tax free now*).
3. Establishing tax links between the business and the local governments. Bulgaria ceased to share the corporate income tax with the local governments 15 years ago and NAMRB' does not intent to restore it. The good European examples show successful practices of taxing specific business traits such as number of employees, office space etc. If implemented, a) this tax should be of local choice - each municipality has to decide whether to impose it, and b) the current tourist tax has be abolished.
4. Changes to the methodology for assessing the tax base for the property tax, aiming at:
 - Granting some discretion to the municipal council for applying corrective coefficients according the specificity of the local real estate market - the general goal is to get the assessed value of the property as close as possible to the real (market) values. The same applies to the vehicle tax base.
 - simplification of the methodology and decreasing the "location factor" - currently the size of the settlement, where the property is situated, drives 80% of the assessed value.
5. On-going efforts to link the different public databases (central and local) - couple of years ago the Police shared its vehicle registration databases with both the MOF and the municipalities which lead to a) considerable increase of tax revenues from the vehicle tax and 2) sharp decrease of non-compliance (tax evasion).
6. In the area of the local fees:
 - the current "dog ownership" fee may be transformed into "pet/animal ownership" one. Thus the municipalities will be able to impose fee on the owners of animals creating most of the public concerns - in the cities these are the dogs but in rural settlements - home grown pigs, cows, goats etc. are the origin of additional waste and sanitation problems;
 - new "city congestion" fee is needed in the large municipalities to tackle the traffic problem in downtowns.

NAMRB intends to further propose and insist for advancement in 2018 on the following issues:

- Improving the allocation mechanism of the equalizing subsidy in a way that only financially weak local governments have access to it. The association will face a serious challenge with these of its members which will be denied access to it – currently all 265 local governments are eligible. The trade-off might be progress on the tax reform agenda (see the box above) i.e. losing the subsidy might be compensated with additional own revenue sources;
- Granting local governments with decision-making authority over the services funded by the general subsidy for delegated functions. The good European examples show that focus must shift towards efficiency and result-oriented indicators set by the central governments (*instead of micromanagement*);
- Seeking tangible financial source(s) for maintaining and reconstructing the municipal roads – half of the total road network in the country.

Statistical Overview of Local Government Finance in Bulgaria 2006-2017

Local government revenue as a share of GDP declined from a high of 7.4% in 2008 to a low of 5.8% in 2012, before rebounding to 6.9% in 2014 and 7.9% in 2015 – these two “peaks” reflect the EU money flows. 2014 and 2015 were the last years of the previous EU programming period when most of the payments for implemented municipal EU-backed projects have been made. Without this considerable financial support, in 2016 and 2017 the ration got back to “normal” – 6.2% and 6.6%.

The local share of total public revenue also fell from 20% in 2008 to 17% in 2012. This level was maintained in 2013, rose by 3 p.p. and 4 p.p. in 2014 and in 2015 for the same reasons, explained above. In 2016 and 2017 the ration is back to 17% and 18%. Both shares have to be considered very low given that Bulgarian local governments are fully responsible for financing all pre-tertiary education.

Local and General Government revenues declined in tandem with the economic crisis. But General

Government revenues increased much faster during the recovery. This trend then reversed in 2013, but, as noted already, the EU money is the main growth drive for the municipal revenues since.

In 2006-7, Bulgaria replaced PIT sharing with an expanded set of General Subsidy for social sector functions (education mainly). Since then the composition municipal revenue has been dominated by own-revenue and conditional grants, almost 80% of which are for education. 2014 and 2015 are interesting as they show an increase in investment grants which seem to be slowly returning to their pre-crisis levels but this time the increase is due to EU money. 2016 is the third year of the current programming period (2014-2020) but in fact is the first when EU money poured in. In 2017 a sharp increase of the subsidy for education, reflecting the highest priority of the central government, reversed the negative trend.



Chart 58 Bulgaria

Local Government Revenue as Share of GDP and Total Public Revenue in 2006-2017

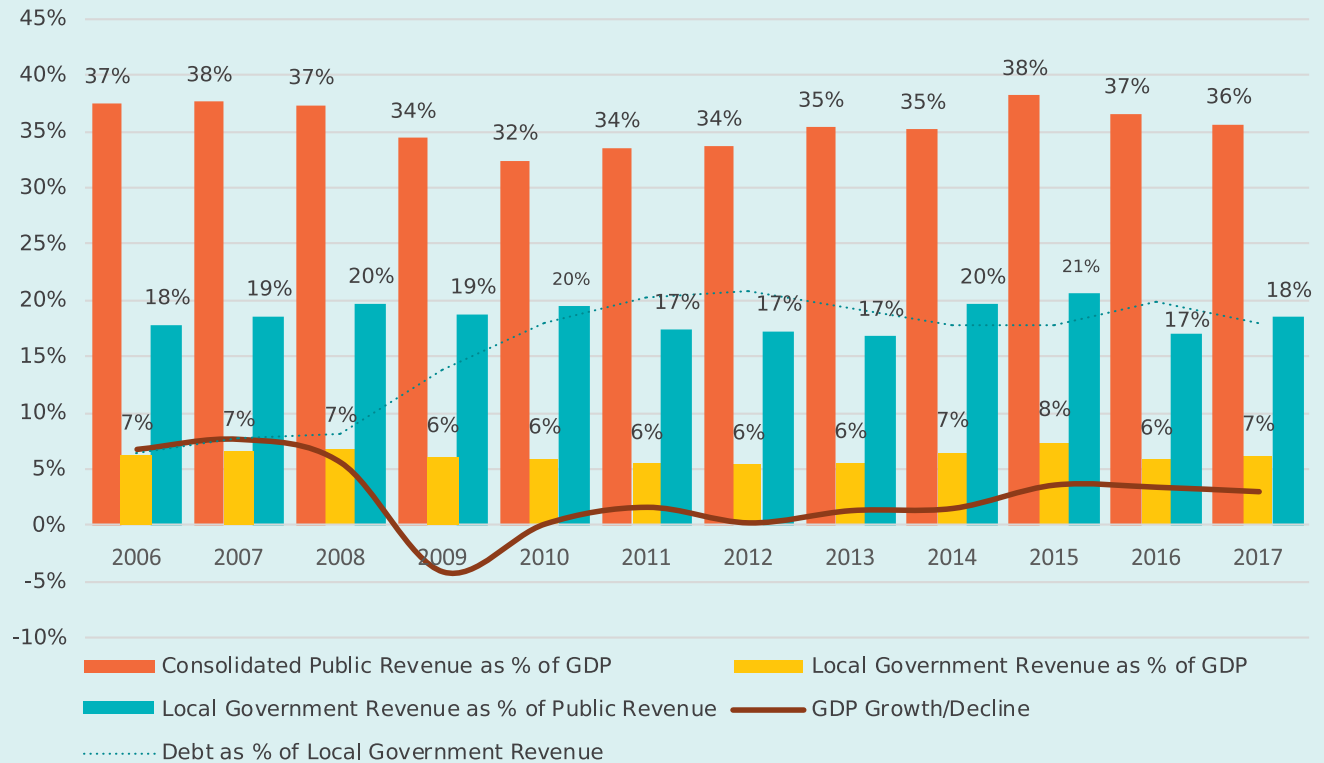


Chart 59 Bulgaria

Fluctuations in the Revenues of the General and Local Governments 2006-201

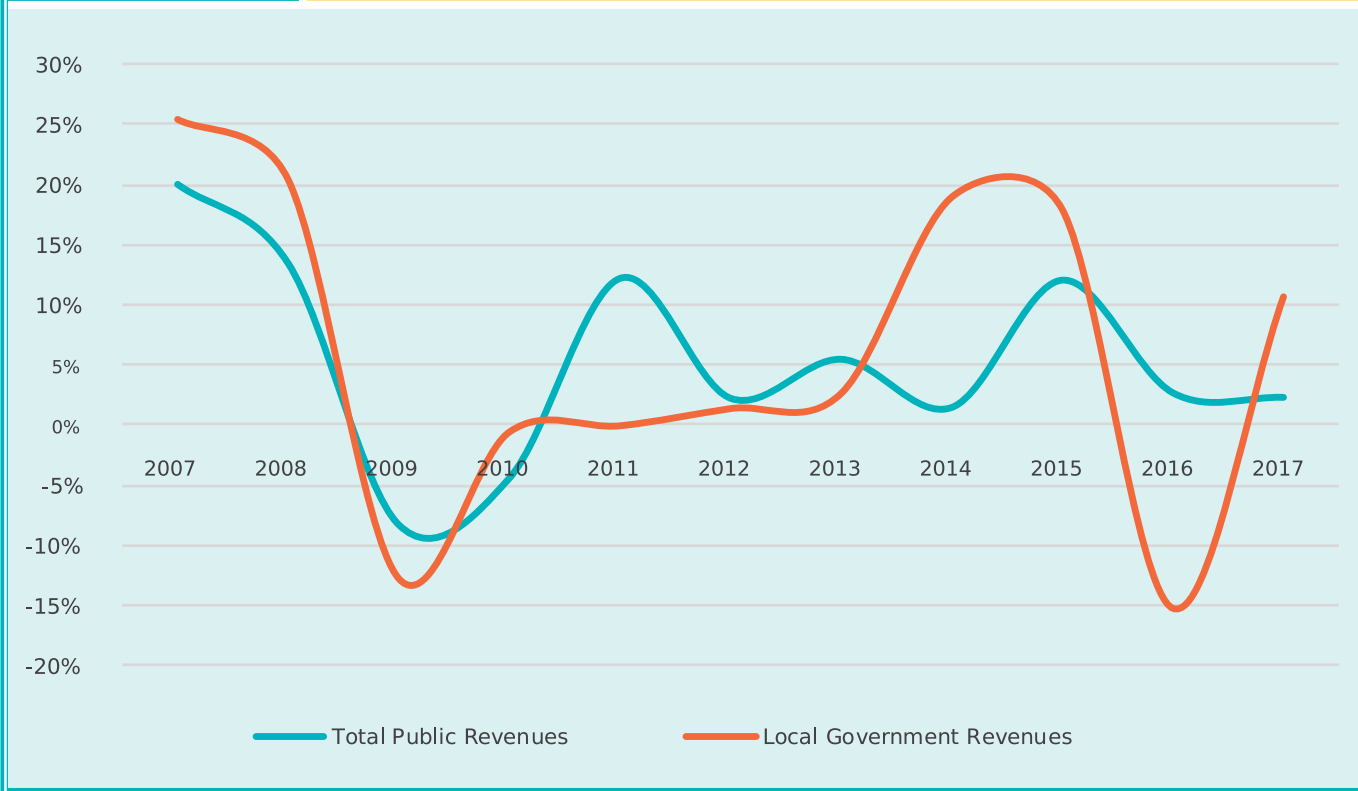




Chart 60 Bulgaria

Composition of Local Government Revenue 2006-2017

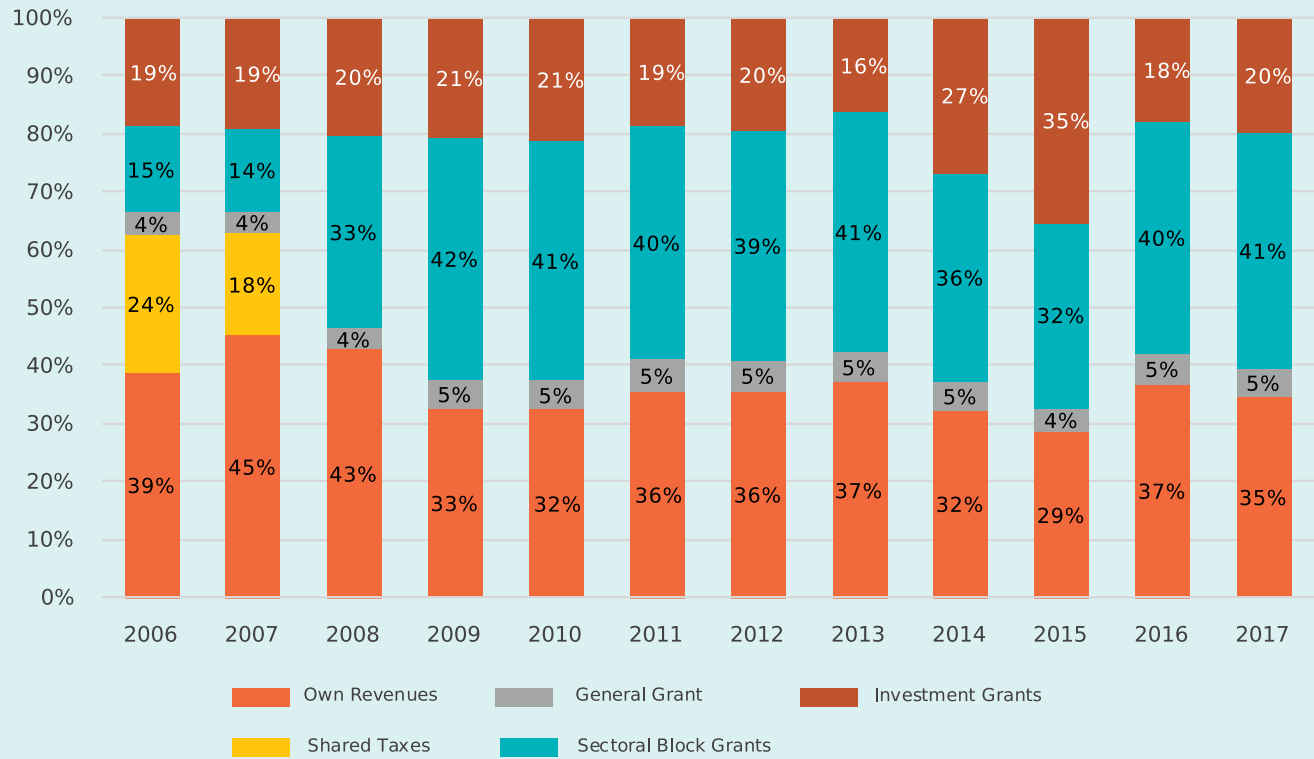


Chart 61 Bulgaria

Composition of Own Source Revenues 2006-2017

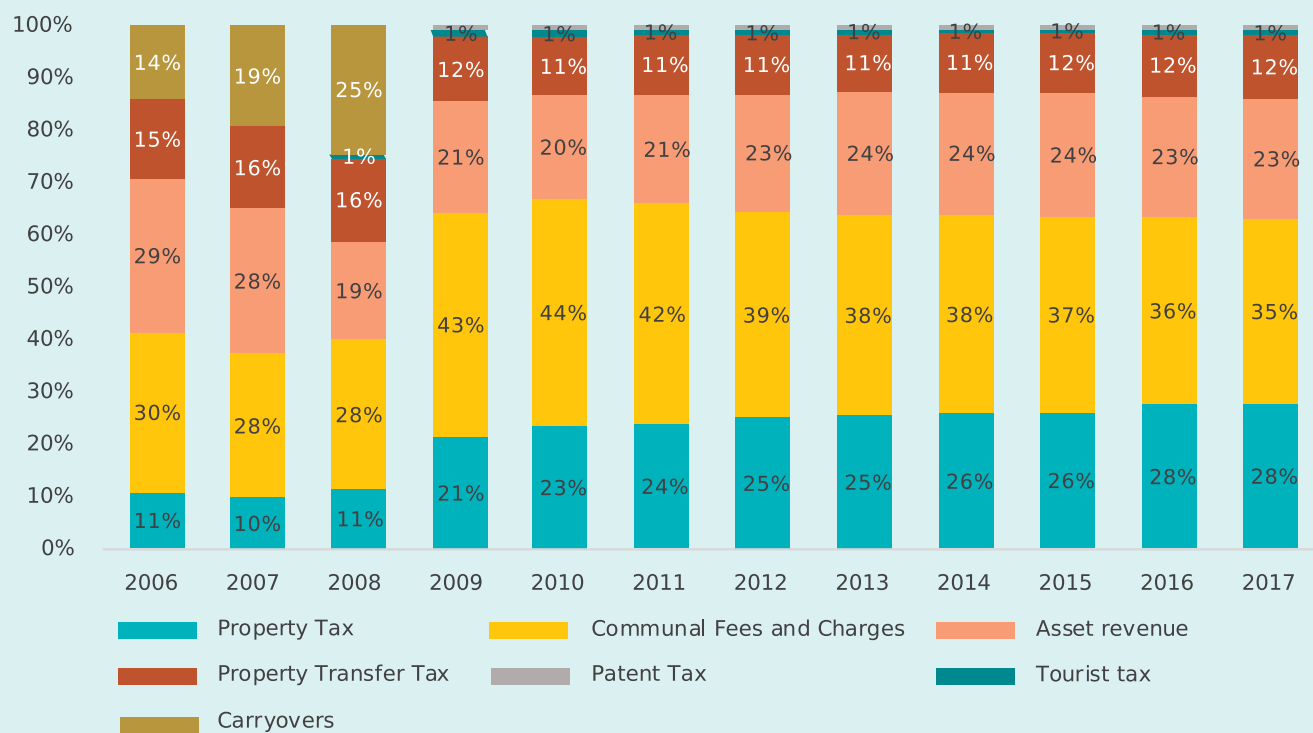




Chart 62 Bulgaria

Composition of Local Government Expenditures 2006-2017

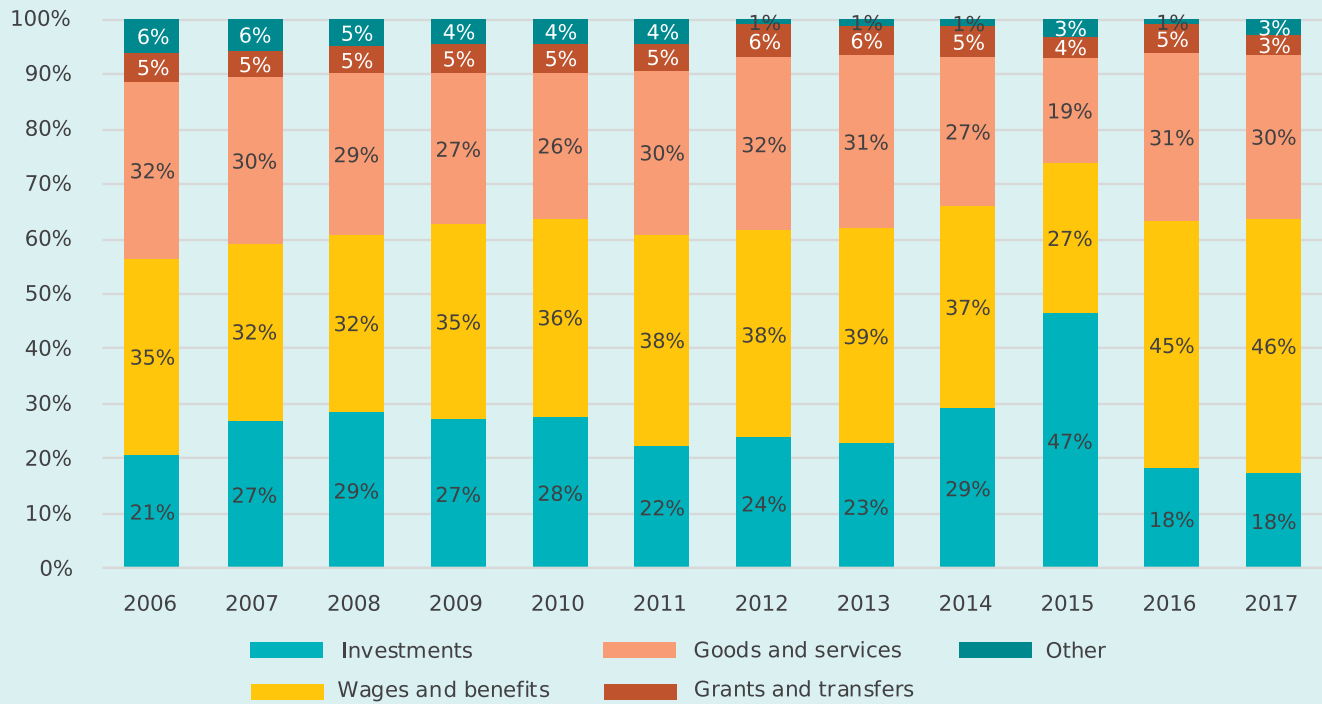
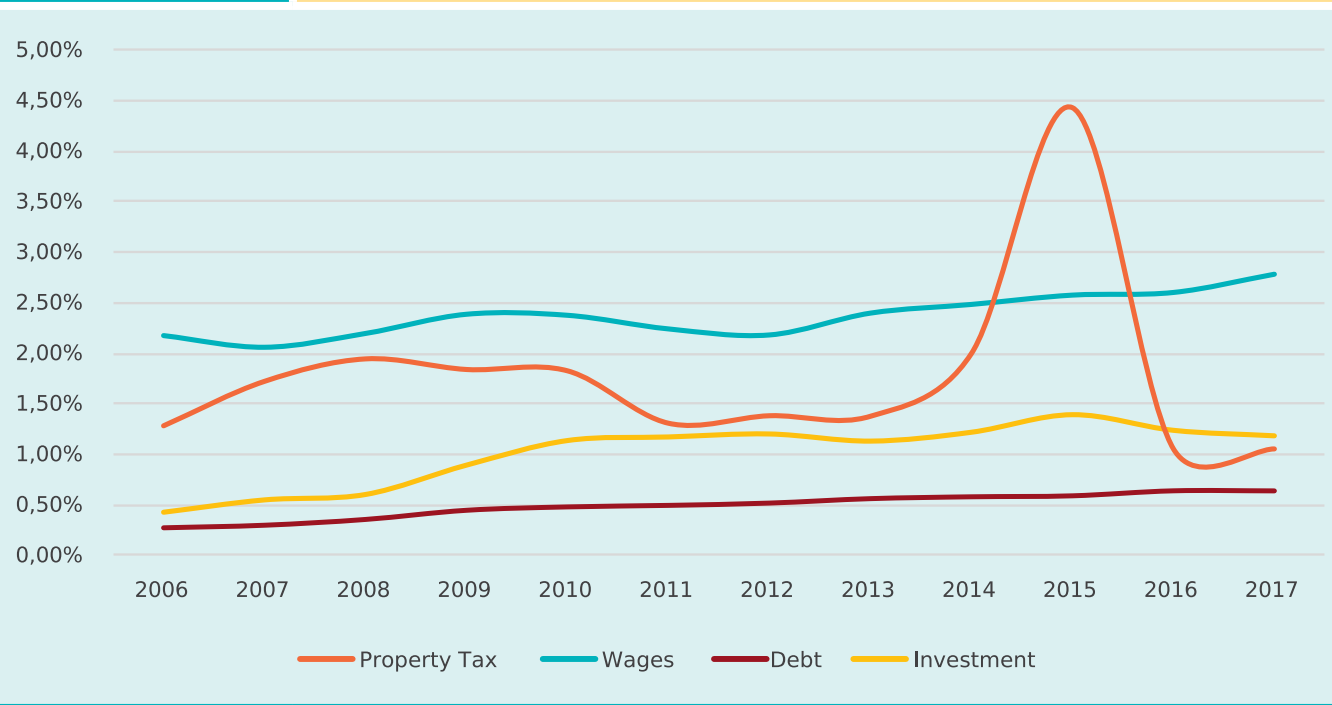


Chart 63 Bulgaria

Local Government Wages, Investment, Property Taxes and Outstanding Debt as % GDP 2006-2017



Croatia

By Dario Runtić, Advisor to the Association of Cities in Croatia

The Intergovernmental Finance System

Croatia's intergovernmental finance system is heavily dependent on the origin-based sharing of **Personal Income Tax (PIT)**. Local governments receive 60% of PIT collected in their jurisdiction; regional governments receive 17% of the PIT revenues; another 6% of PIT revenues are allocated and earmarked to local and regional governments for the decentralized functions they perform and 17% of PIT revenues are paid into Fiscal Equalization Fund. As such, the rules governing PIT sharing also constitute the backbone of Croatia's transfer and equalization system. Local governments are allowed to impose a surcharge of up to 18% on the amount of PIT taxpayers owe to the government. The surcharge currently constitutes 10% of all local PIT revenues. Taken together, PIT revenues generate 43.5% of consolidated local and regional government revenues in 2017.

There are two types of earmarked grants in Croatia and they are both dedicated to financing the specific functions which the national government transferred to regional and local governments in early 2000's, including primary and secondary education, social welfare, healthcare and fire protection). In Croatia, 6% of PIT revenues (approx. 110 million Euro) are earmarked to those regional/local government that carry out the above-mentioned specific functions. Expenditures not covered by the 6% PIT allocation are funded through **the Equalization Fund for Decentralized Functions** (EFDF) that is an earmarked grant funded by the State budget (approx. 200 million

Eur) and legislated annually in the national bylaws of line ministries. Funding from the EFDF depends on function-specific minimal standards determined by national bylaws, (i.e., for primary education – number of pupils, classrooms and school buildings).; While the EFDF provides the majority of the funding for the decentralized functions, it also makes local governments vulnerable to the national budgeting process and economic trends.

The Fiscal Equalization Fund (FEF) is a non-earmarked fund of approx. 270 million Euro established in 2017 with the amendment of the LLGF. It aims at equalizing PIT revenue disparities across local and regional governments. The FEF is funded by 17% of PIT collected and automatically distributed to the recipients daily, according to individual shares which are set in advance of the budget year. Local governments' individual shares are calculated as a difference between the individual *target* per capita PIT revenues and the (5-year average) *actual* per capita PIT revenues. Local governments may address the Constitutional Court at any time on the key elements of the FEF, including total funding, target levels, share calculation formula, automatic distribution etc. The introduction of the FEF is considered a major positive development as it reduces disparities across local governments PIT allocations, increases the transparency and predictability of local government revenues while reducing exposure to national government budgeting process and indi-

vidual bylaws. The major weakness lies in the fact that the overall system is vulnerable to national economic trends.

Own Source Revenues (OSRs) constitute more than 30% of total local revenues in Croatia. Most OSRs come from the *Land Use Fee (LUF)* and *Land Development Fee (LDF)*, with the former known locally as the “Communal Fee”. Revenues from these fees are earmarked for the construction and maintenance of communal infrastructure. Croatian local governments also derive more than 30% of own-revenue from the rental and sale of municipal assets. The regulation of local government powers over asset management are enshrined in national legislation.

The Law on Local Taxes was amended in late 2016 to introduce the *property tax* into the Croatian tax system and local governments were supposed to start collecting property tax as of January 1, 2018.

The property tax was supposed to merge with and replace the Land Development Fee, the Second House Tax and the Monument Fee into a single revenue source. It was supposed to be charged per square meter, depending on a base rate set by local governments and corrected for location, usage (housing, business, leisure), year of construction and quality. Three months before the entry into force, upon the Government’s proposal, in September 2017, Parliament repealed the property tax. The National Taxpayer Association started anti-property tax campaign in April 2017, just in advance of the May local elections in Croatia. Considering that the rate setting powers were in the hands of local governments, rate decisions were due in November 2017, and national associations’ boards were in suspense until end of elections, local units and national associations could not engage in campaigning and Government repealed the tax.

Local government tax powers and challenges

The legal powers granted to local governments to assess, impose and collect taxes and fees from their constituencies vary. The two most important sources of own-revenue, the Land Use Fee (LUF) and Land Development Fee (LDF) are enacted in national legislation and further elaborated in local bylaws approved by local councils. The national law determines the method of calculation, taxpayers, general exemptions and legal remedies. On the other hand, local governments have the power to set the initial values (the LUF rate is capped by law to a max rate of 10% of the average cost of constructing one cubic meter in Croatia) of the fee, zoning regulations and eventual additional factors that affect calculation, tax administration process etc. The collection and en-

forcement of these fees cannot be transferred to the National Tax Administration nor to any other entity under the control of third parties. Except for the LDF and the Tax on Use of Public Space, national legislation defines the tax base and sets or caps the rate of all other local and shared taxes.

As in many other countries in the region and beyond, the main challenge facing Croatian local governments as regards fiscal autonomy and tax administration is the establishment, harmonization and update of fiscal registers of their tax base (buildings, land, transactions etc.) and tax payers. The largest local fiscal register in Croatia is the Land Development Fee Register. This register serves also as a basis for the administration of oth-

er important local taxes and the delivery of public utility services. In a mid-2015 Survey, the Association of Cities in Croatia (AOC) finds that the quality of the LDF register is “fair”, considering that 46% of local governments had performed an extensive review in the previous 12-18 months, while 91% reported performing incremental updates to the register whenever a change occurred or was reported. Nevertheless, there remain significant discrepancies between the LDF register and the State Statistical Offices as regards tax bases (no. of buildings, surface area of buildings etc.). The AOC Survey shows that local governments’ that have smaller discrepancies with the State Statistical Office register have some common characteristics: LDF registers contain the personal unique identifier number for more than 93% of taxpayers’; extensive updates had been performed recently within the last 12 months; taxpayers are more compliant to reporting information changes, as required by law; and the register is updated with data collection in the process of building legalizations.

Along with proactive measures of local government themselves, the regular and automated exchange of information between national and local fiscal registers remains critical. In the framework

of the preparations for the introduction of the property tax, local governments were given access to the Residents Register, the Construction Permits Register, the Cadastre and Real-estate Transactions Register, all in electronic format, to facilitate updating of the LDF and the establishment of the register for the administration of the then-upcoming property tax. While the property tax itself was discontinued, local governments revenues from the LDF increased by 10 million Euro, (3.6%) in annual terms, which is attributed to the updating of the LDF register.

In working with the central government to improve intergovernmental electronic data exchange AOC has identified a number of issues that had a negative impact on local governments ability to update their LDF registers, such as limited usability of the land register and cadastre because of the unresolved property ownership issues; the unique personal identification number not present in every record of key registers; access to data limited or discouraged by bureaucratic procedures; the lack of cross-government integration with basic registers; taxpayers fail to report changes to personal or property information, although required by law.

Main Developments in Municipal Finance and Advocacy Efforts of the Associations

AOC continues to work with the central government institutions to bridge the information exchange gap on the LDF and other local fiscal registers. Nowadays local governments have automated access to the Citizen Registry, Citizen Income Registry, Vehicle Registry; web access to Birth/Marital/Deceased Registry; and electronic delivery of property transaction data for previous years. As a result, bureaucratic procedures

were eliminated, and the access approval process streamlined for many of these registries. In order to further facilitate electronic access to registers AOC is providing a free data-access application and sample access-approval documentation as agreed with the central institutions.

At the policy level, AOC continues to promote the development and implementation of effective fiscal decentralization policies and legislation.

AOC's recommendations to simplify the Personal Income Tax redistribution and to establish a non-earmarked Fiscal Equalization Fund were incorporated in the 2017 amendment of the Law on Local Government Financing. The legal changes provided also for a full compensation of the 2016 reformation of the PIT rate and brackets that led to the reduction of local government revenues.

The Law on Communal Economy was passed by the Parliament in 2018 following a Constitutional Court ruling in favor of AOC and several cities that raised an issue of constitutionality of the Law on State Asset Management which excluded the Republic of Croatia from paying the LDF. Following the Court's decision, the Republic had also to pay LDF arrears to local governments, estimated at 12 million Euros. The Law on Communal Economy changed payment schedule for the LUF to stimulate investments in production and warehousing, and improve Doing Business rating for Croatia.

The Association of Cities of the Republic of Croatia continued its efforts in opening local government data. Following an online visualization on local government financing published in 2016, a new online visualization of projects co-funded by EU funds was released in 2018. The visualization database includes 4.912 projects of public, private and non-profit sector co-funded by the EU with 4.1 billion Euros in the period of 2010-2018. Users can compare number and total values of the projects carried out by individual levels of government and public entities, private companies or non-profit organizations. Furthermore, users can see all projects carried out by a specific entity; compare total EU co-funding provided to all or specific entities within various territorial units. Users can also see a timeline with number of projects contracted weekly in the period of 2010-2018.

Statistical Overview of Local Government Finance in Croatia 2006-2017

The Croatian economy has returned to positive growth after a long period of contraction. Total Public Revenues also increased over 2016 and 2017, in part fueled by an increase in consumption and Value Added Tax revenues as a result of PIT reforms. The increase in total public revenues, unfortunately, is not reflected at the local level. In relative terms, local government revenues as both a share of GDP and Total Public Revenue continue to experience a steady decline, primarily because of the PIT reforms. In 2017, the share of local revenue as a % of the GDP was 6,5%, down from 7% in

2013, the year before the recent PIT reformations.

The revenues of local governments and the General Government declined in tandem during Croatia's long recession. With the exception of 2013, over the past decade, local government revenues have experienced either a stronger decline or a smaller growth rate than total public revenues. In 2013, local revenue increased faster than the revenue of the General Government due to the enforcement of 70 million Euros in PIT arrears, but this trend reversed in 2014 and continued thereafter with the PIT reforms of 2014 and 2016.²⁷

²⁷ For more details please refer to NALAS's fifth edition of the Fiscal Decentralization Indicators in South-East Europe 2006-2014 and sixth edition of the Fiscal Decentralization Indicators in South-East Europe 2006-2015, retrievable at www.nalas.eu.



Chart 64 Croatia

Local Government Revenue as a Share of GDP and Total Public Revenue 2006-2017

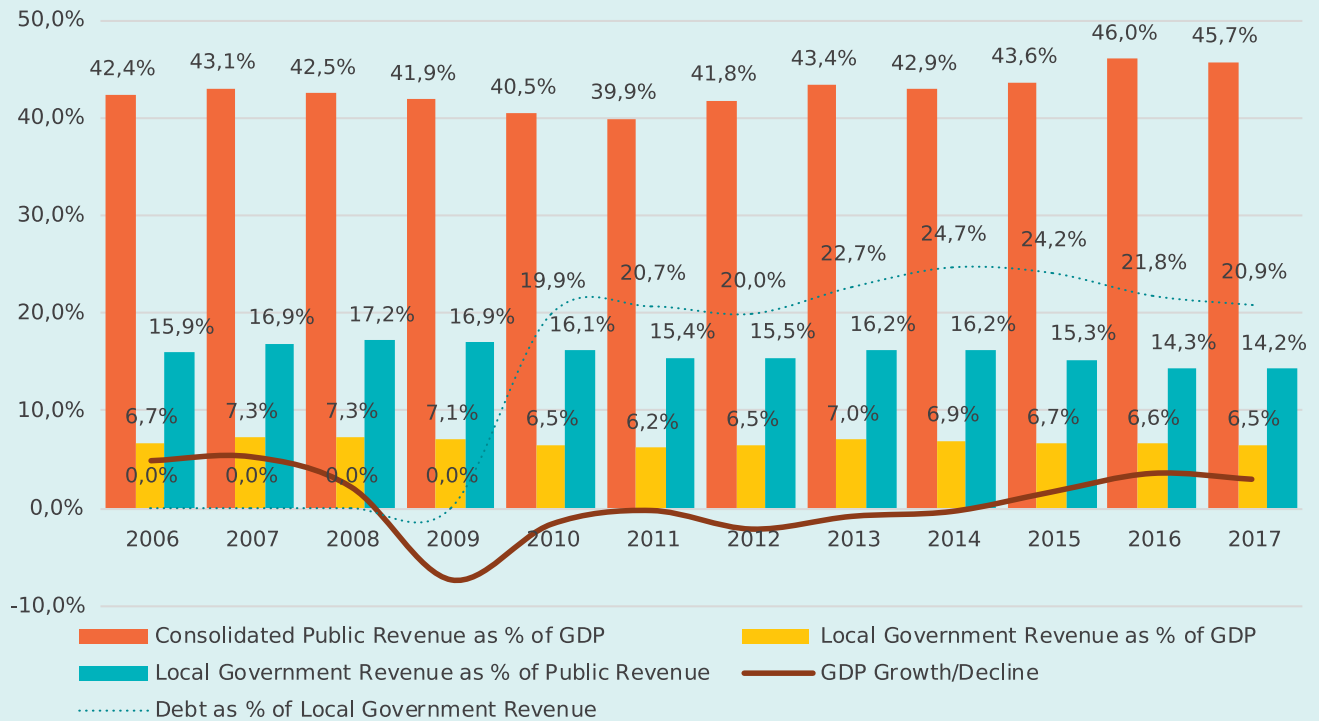
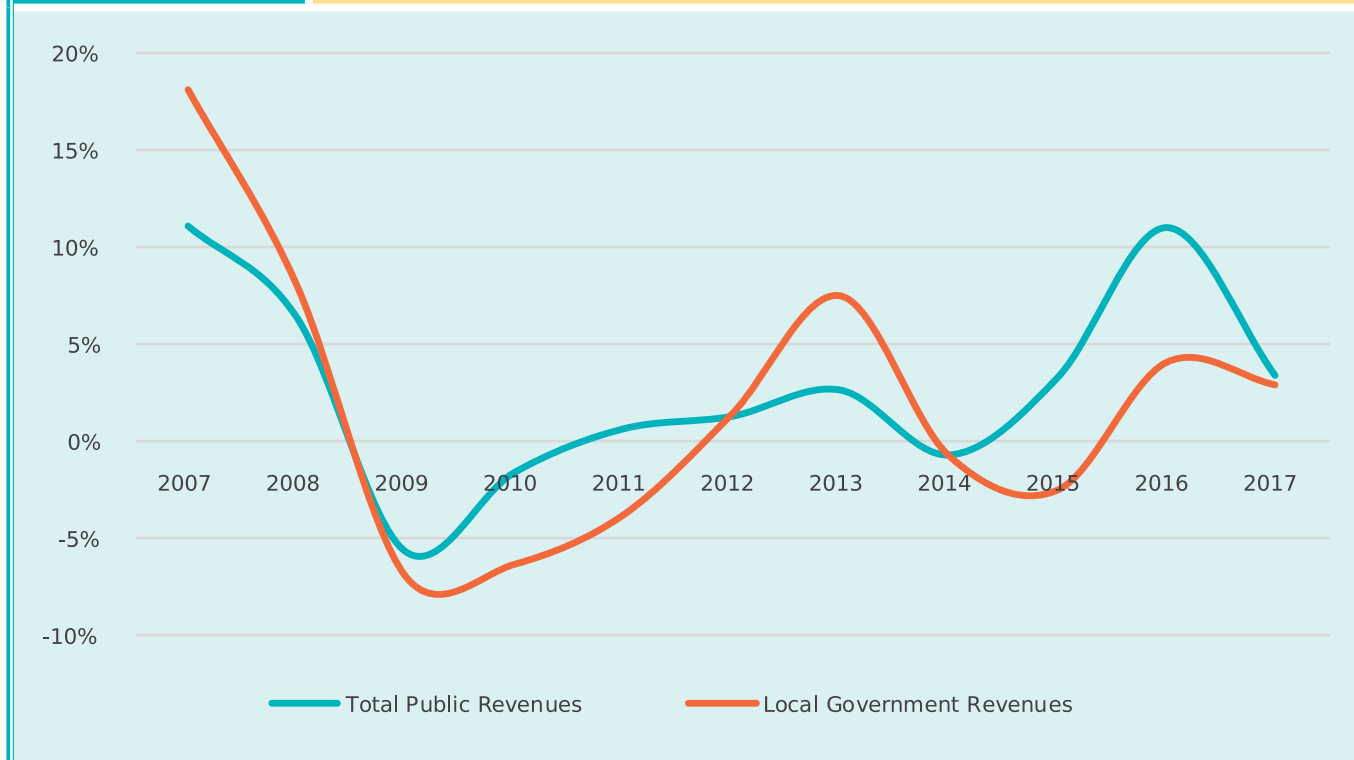


Chart 65 Croatia

Fluctuations in the General and Local Governments Revenue



Local governments' increase in revenues over the past two years have been primarily attributed to the exceptional utilization of the EU funding and an increase in average wages that have slowed the decline in the local share of PIT revenues. These tendencies are reflected also in the charts below, that show local governments revenue in Croatia in billion Euro and in Euro per capita. In 2017, local government revenues were 3.2 billion Euro, with own-revenues constituting 1 billion and shared taxes 1.5 billion Euro.

It is important to note that, investment grants here include also funding for delegated functions and grants from the European Union.

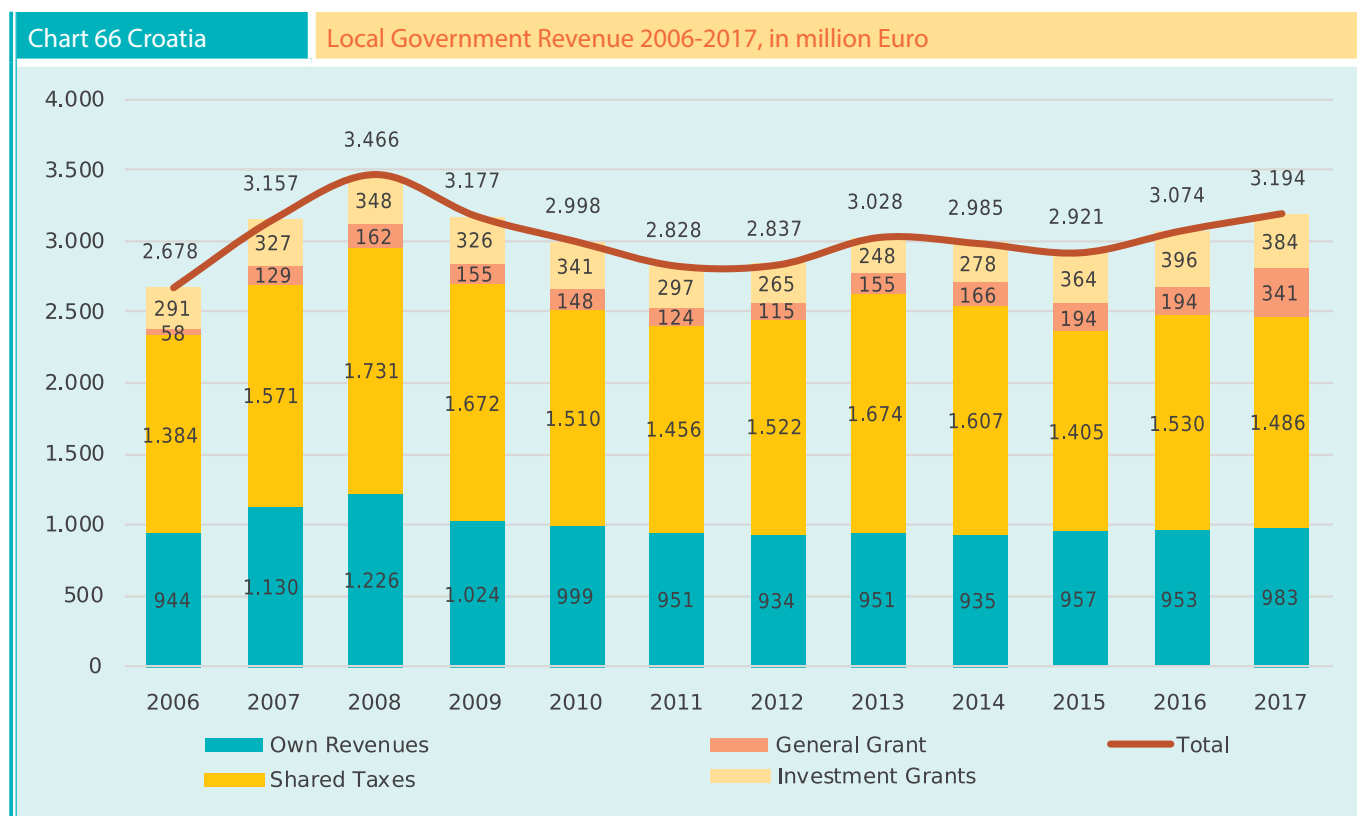
In per capita terms, local government revenues in 2017 were 778 Euro, with 239 per person coming from locally imposed taxes and fees and 362 euros coming from shared PIT revenues.

Between 2006 and 2017, the composition of local revenue changed little and remains dominated by shared taxes despite the PIT reforms in 2014 and

2016 that decreased reliance on shared taxes. The reduction in local governments' revenues from PIT revenues was accompanied by an increase in share of general grants as a compensation for the revenues local governments' lost from PIT reforms. Own revenues make up for 31% of total local revenues in the past two years. Local governments have relatively little control over fees and charges, except for the LDF and the LUF, and unlike in many other countries in the region, local governments in Croatia have not responded to the economic downturn by increasing the collection of own-source revenues. While the introduction of

the local property tax planned to enter into force as of January 2018 was repealed in late December 2017. However, LGUs can impose a PIT surcharge.

The Communal Fees and Charges dominate the composition of own source revenues with 45% of the total and have been steadily increasing. The growth has been fueled mainly because of receipts from the process of legalization of illegally constructed started in 2013 and the increased revenues from the LDF as a response to the PIT reforms, increased efforts to update LDF fiscal registers and the preparatory activities for the introduction of the property tax. The next sig-



nificant groups are asset related revenues (sale and rentals) which jointly account for 35% of local government own source revenues.

On the expenditure side, wages and benefits decreased drastically in 2015 while grants and transfers doubled and maintained such levels until 2017. This is a result of new reporting rules due to which wages and material expenses of budgetary users are no longer reported in the city/municipal budget but are reported as grants to the budgetary users.

Out of 790 million Euros in new grants approximately 50% is allocated for budgetary users' wages and benefits. The share of investment in the composition of the local expenditure has significantly dropped in 2015 but showing signs of recovery along the lines of local government revenue recovery.

Total public investment has fallen dramatically since 2007 to recover during 2015-2017. Local governments' share was quite significant, well above 70% until 2015 when it dropped to 31%.

Chart 67 Croatia

Local Government Revenue 2006-2017, in Euro Per Capita terms

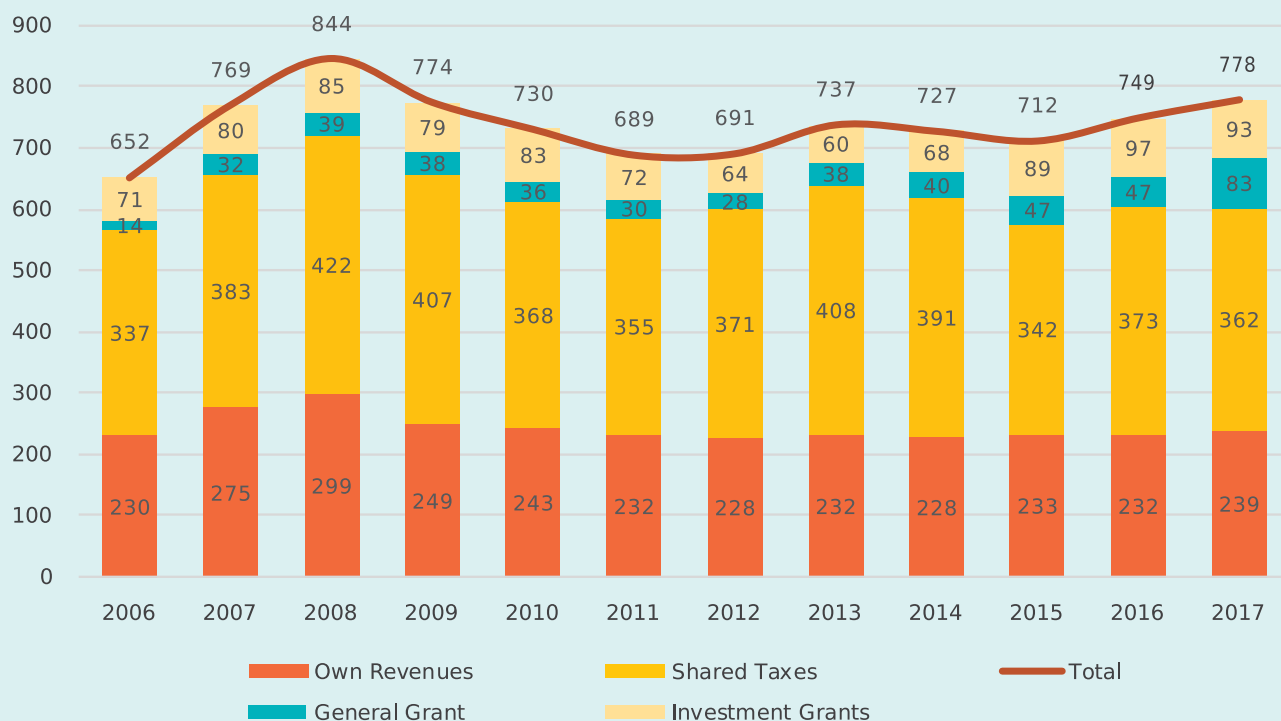




Chart 68 Croatia

Local Government Own Source Revenue 2006-2017

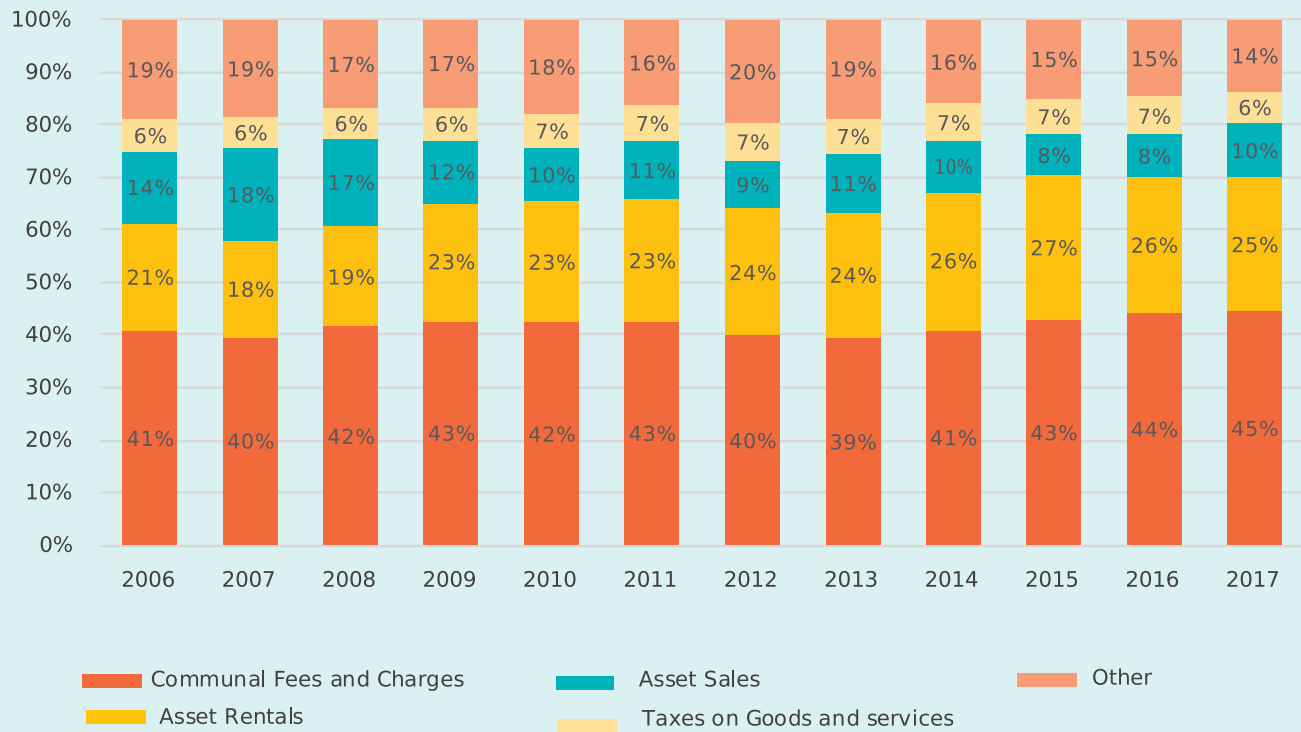
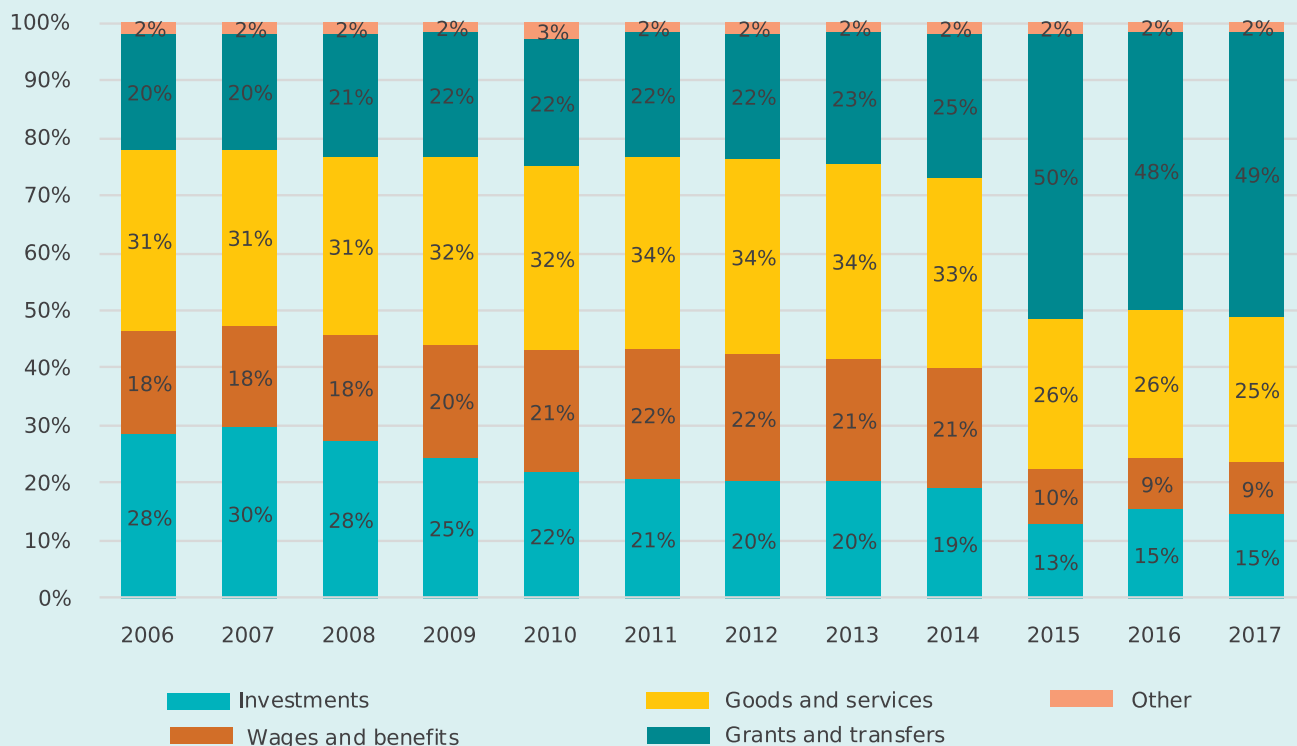


Chart 69 Croatia

Composition of Local Government Expenditure 2006-2017



Local governments cut investments in 2009 and 2010 as a response to diminished funding due to the financial crisis and as a measure not to increase tax rates, utility fees and user charges. It remained stable until 2015 when local governments were hit with a -200 million Euros PIT reform and LGUs responded with investment cuts to maintain budget balance without major increase of taxes and fees. At the same time capital investments of the general government nearly doubled.

As a % of GDP, local investment fell substantially in 2010 and 2015 and has yet to recover. Wage spending dropped in 2015 due to new reporting requirements. Total outstanding debt of local governments in 2017 equaled 1,4% of GDP. Local debt increased in 2010 to fund public investments in time of diminishing local revenues. Debt further expanded in 2013 when borrowing to co-finance EU projects and for Energy Conservation Companies were exempted from borrowing limits. Growing total revenues in 2016 and 2017 enabled deleveraging close to 2010 levels.



Chart 70 Croatia

Shares of Public of Investment by Level of Government and as % GDP 2006-2017

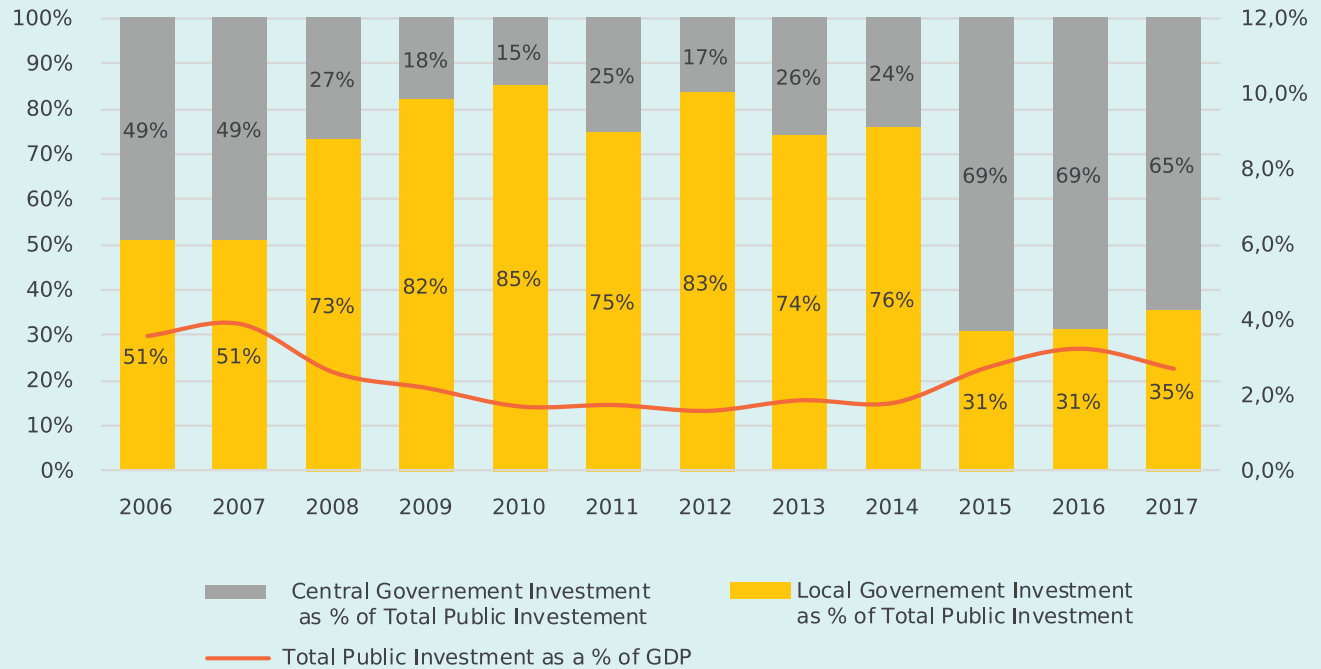
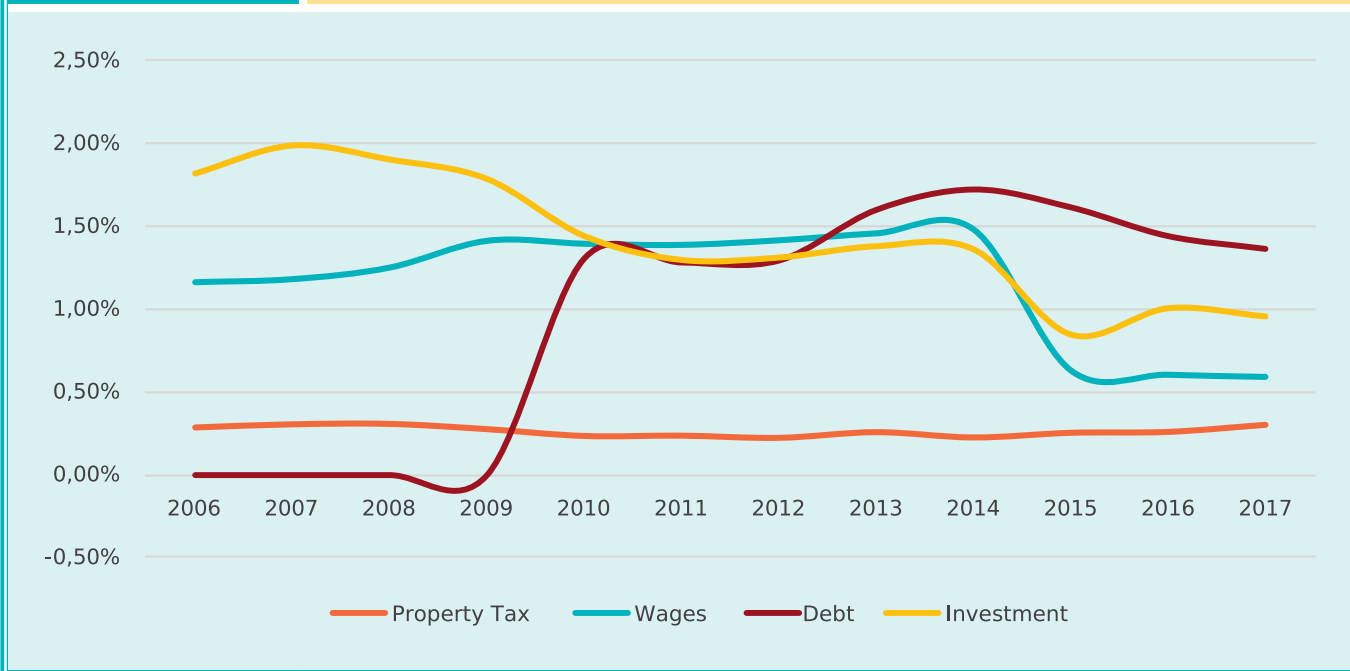


Chart 71 Croatia

Local Government Wages, Investment, Property Taxes and Outstanding Debt as % GDP 2006-2017



Kosovo

By Osman Sadikaj, Association of Kosovo Municipalities

The Intergovernmental Finance System

Kosovo is one of the most decentralized countries or entities in the region because local governments are responsible for all pre-university education as well as primary health care. For these functions, local governments receive block grants that make up to 49% of total local budgets in 2017.

Based on the Law on Local Government Finance, the size of the **General Grant** is defined by law as 10% of the total budgeted revenues of the central government. In 2017 the general grant was at 149.2 million Euro. All local governments receive a lump sum payment of 140,000 euro, minus one EUR per capita for all local governments. Municipalities with populations greater than 140,000 therefore do not receive any lump sum payment. 2.7% of the total pool of the general grant is dedicated to Local governments with less than 22,000 inhabitants, with half of the grant being distributed on a lump-sum basis and the other half on population. The remainder of the general grant pool is then allocated to municipalities by formula: 89% by population, 6% by geographic size (square kilometers); 3% by the number of ethnic minorities; and 2% for municipalities in which the majority population is a national minority.

The size of the **Education and Health Grants** is determined by a National Grant Commission in accordance with a Medium-Term Expenditure Framework. The Education Grant is allocated to local governments on the basis of a formula that takes into account the wages of teachers, administrators and

support staff, goods and services, building maintenance, and specific education policies. Pupil numbers are used to determine the amounts for salaries, goods and services, and building maintenance in accordance with class size norms of: 1 teacher to 22 students in majority communities; 1 teacher to 14 students in minority communities; 1 teacher to 12 preschool pupils; 1 teacher to 17 students in vocational education in majority communities; 1 teacher to 14 students in vocational education in minority communities; 1 teacher to 14 pupils in rural areas. For goods and services, the norms are: 23 € per pupil in majority communities; 17 € per pupil in minority communities; while for capital expenditures (the maintenance of buildings) it is set at 7 € per pupil. The Health Grant is also allocated by formula according to population. The formula assumes that each person visits primary health care facilities 2.5 times year at a cost of 4 euro per visit, and that they receive 3.5 services a year at 3.9 euro per service.

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

In 2013, an agreement was signed between the governments of Kosovo and Serbia to regulate the status of the four Serbian-majority municipalities in the north of Kosovo. Under this agreement, these municipalities have enhanced powers and are now responsible for providing secondary health services and university education. A special development fund was also established to help them. The Fund

will be financed from customs duties from the border with Serbia. Some communities are interested in becoming separate municipalities but there have been no recent changes in the Law on Territorial Division and there are still 38 municipal governments.

A separate law for the Capital City of Pristina has been approved in 2018 with budgetary effects starting in 2019.

Main Developments in Municipal Finance and Advocacy Efforts of the Association

The Association of Kosovo Municipalities (AKM) is very active in advocating for improved policies and legislation, as well as in initiatives that strengthen local government capacities and systems. More recently AKM has lobbied for improvements in **public procurement legislation**. It has also established a **Public Procurement Col- legium** and with the support of USAID has conducted a Training and Certification program from Municipal Public Officials. AKM has also strongly advocated for improvements in the **draft-Law on Salaries of Kosovo Public Administration Employees** providing comments for and from local governments; and has provided recommendations to the Ministry of Finance on the **Public Private Partnership Concept document**; AKM is actively involved in improving the regulation on **Subsidies and Transfers to local govern- ments**, while several capacity building activities

have been conducted to strengthen the capacities of Municipal Officials in property tax management.

As a result of AKM's advocacy efforts, local gov- ernments may now appoint new staff without the previous approval of the Ministry of Finance, while following the recruitment procedures envisaged by Law and the Ministry of Public Administration; and finally, AKM has been successful in securing from the Budget and Finance Committee of the Kosovo Assembly an additional 1.3 million Euro for the treatment of stray dogs in municipalities

Suspension of the decision of the Government to add 500.000 EUR to the Central Government Wage Fund at the expense of Local Transfers:

The advocacy of the Association of Kosovo Municipalities (AKM) prevented the Central Government shifting money out of the local government transfer system and towards its own wage pool in January 2015.

AKM Council of Mayors and Ministry of Finance discuss legislative changes

Minister of Finance and AKM President negotiated over changes in the Law on Property Tax and the Law on Local Government Finance. The changes in property taxation are related to the tax rates

and collection procedures and were designed in close cooperation between the Property Tax Department in the Ministry and the AKM.

Support for the regulation of internal control in Kosovo municipalities

AKM joined the public debate for the draft-law on the Internal Control of Public Finances. The Association reviewed the draft-law and provided recommendations to the Ministry of Finance. Exter-

nal auditor's reports from the past few years in most municipalities in Kosovo show that there is a lack of internal controls.

Inclusion of children in the budgeting/planning processes

AKM, with the support of Save the Children initiated a dialogue between responsible officers and communities (including youth) in relation to issues concerning the allocation of budgetary funds and the quality of services in education and early

childhood care and development in Peja/Pec and Prishtina/Pristina. Inclusion of children in the budgeting/ planning processes will enable budget allocations better suited to meet their needs.

Statistical Overview of the Finances of Local Governments in Kosovo 2006-20177

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

The share of local finances in the GDP between has stopped at 6.8%, down from 7.1% in 2015.

Similarly, the share of local government revenues to overall public revenues has declined from 29% in 2014 to 26% in 2017. The economy continues to grow by 4% for the third consecutive year while total public revenues to GDP have also increased to 27% in 2017.

Unlike in many other places in the region, there has been a consistent pattern in the relationship between local and central government revenues in Kosovo: they have risen and fallen more or less in tandem except for 2016 where we notice a fall in local government revenues as opposed to an increase in overall public revenues. This tendency can be noticed also in 2017.

Chart 72 Kosovo

Local Government Revenue as Share of GDP and Total Public Revenue 2006-2017

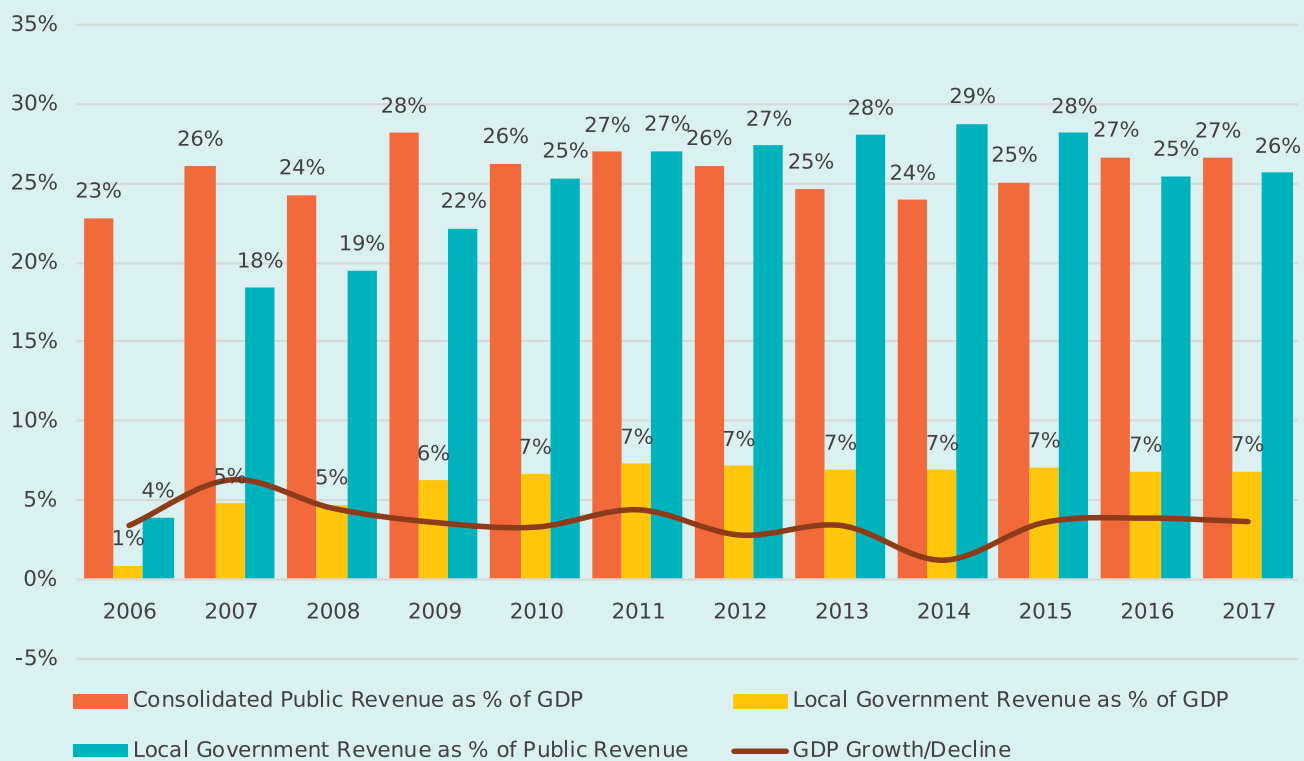
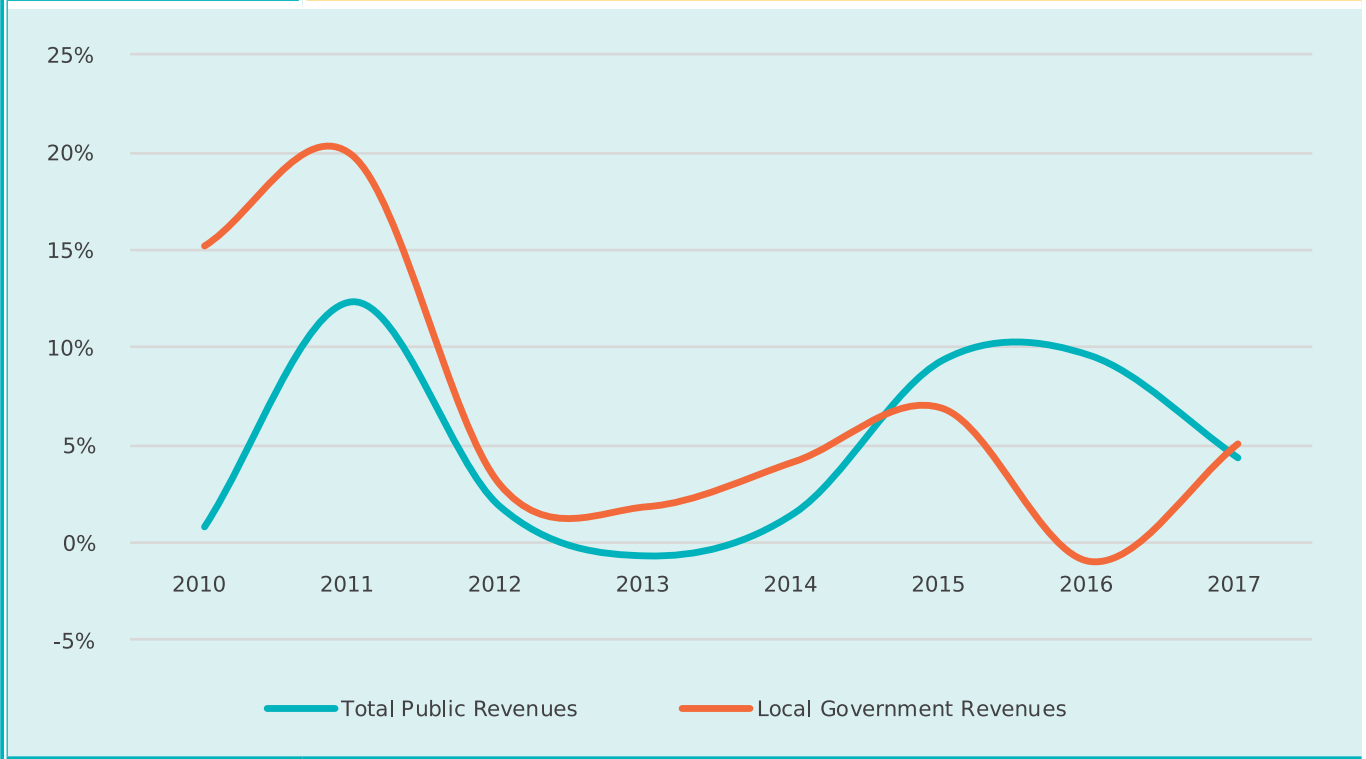




Chart 73 Kosovo

Fluctuations in the Revenue of the General Government and Local Governments 2006-2017



The composition of local government revenues in Kosovo has not changed significantly over the past decade. In 2017, Kosovo local governments derived 49% of their revenues from block grants for Education (38%) and Primary Health Care (11%). They also receive a General Grant, which in 2017 constituted 35% of their revenues. Own-revenues constitute only 15% of the total.

The two most important own-source revenues are the property tax and building permits. In 2011, legislation was passed to eliminate the quasi-

fiscal use of building permits (Land Development Fee). Income reported under this category shows a steady increase over the past four years. In 2014, the central government again tried to tighten up on building permits, but it appears that local governments responded by classifying the revenue under fees and charges.

In 2017, local governments have devoted 28% of their total expenditures to investment and 59% to wages, due to central decisions for alignment of the salaries.

Chart 74 Kosovo

Composition of Local Government Revenues 2006-2017

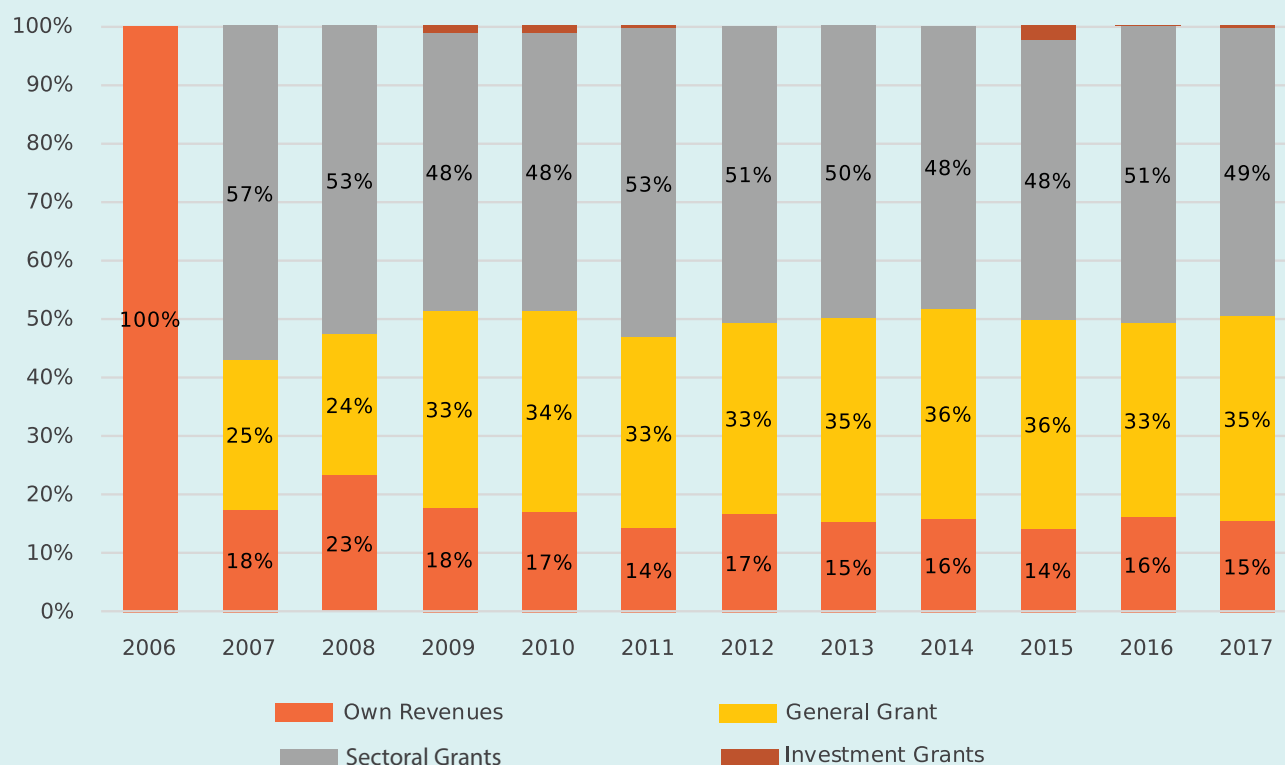




Chart 75 Kosovo

Composition of Own Revenue 2008-2017

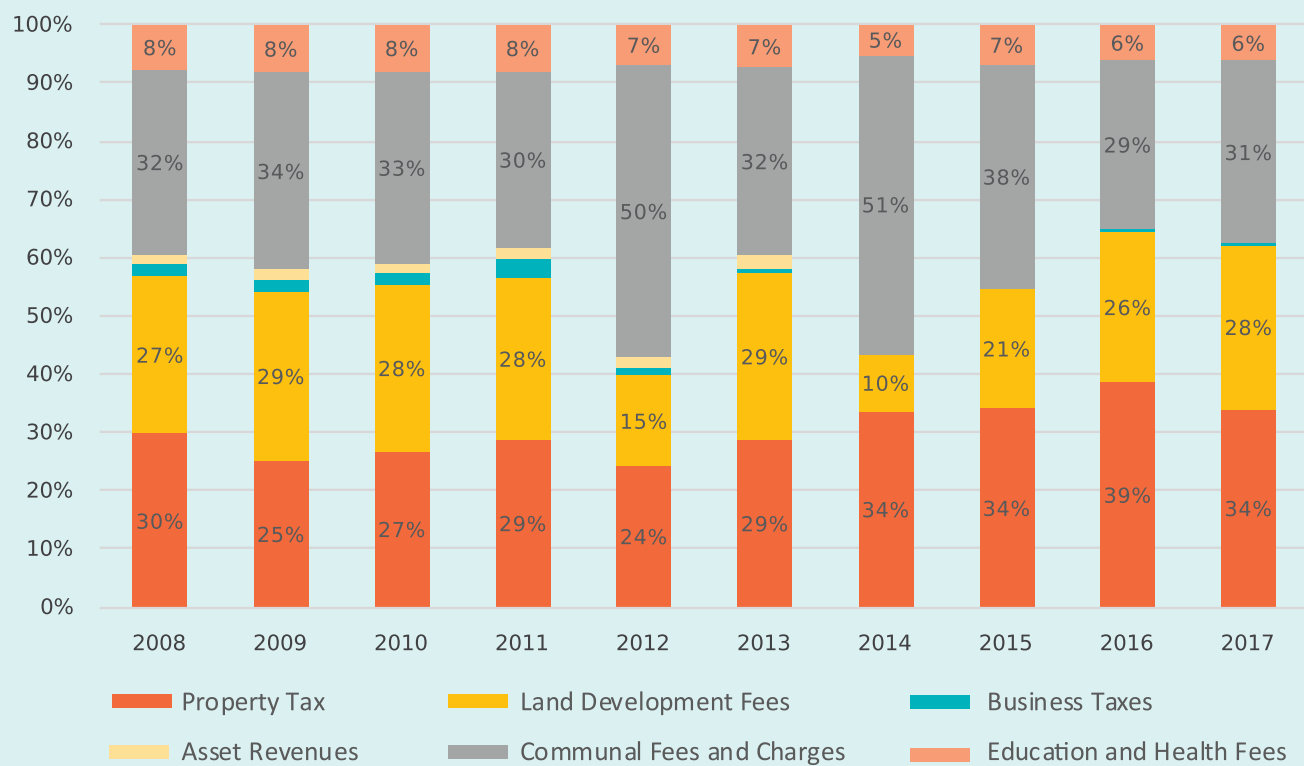


Chart 76 Kosovo Composition of Expenditures in 2008-2017

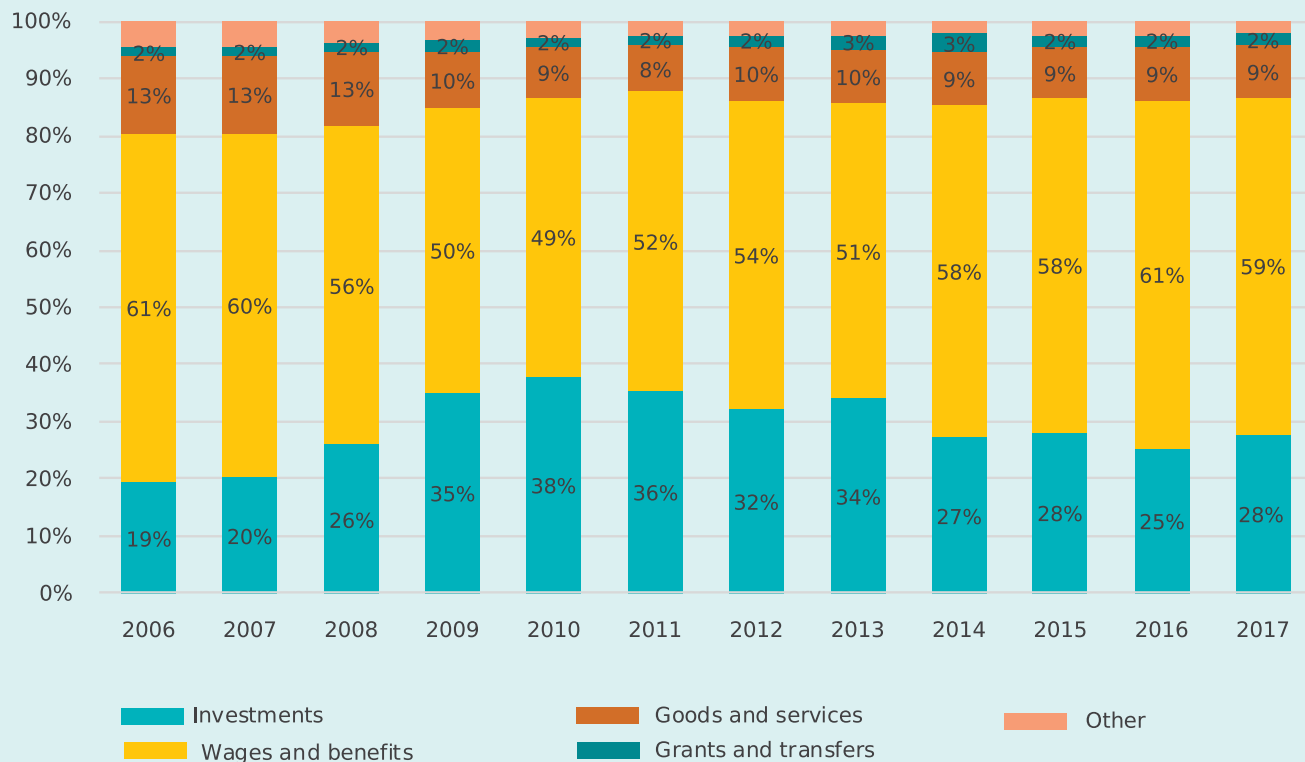
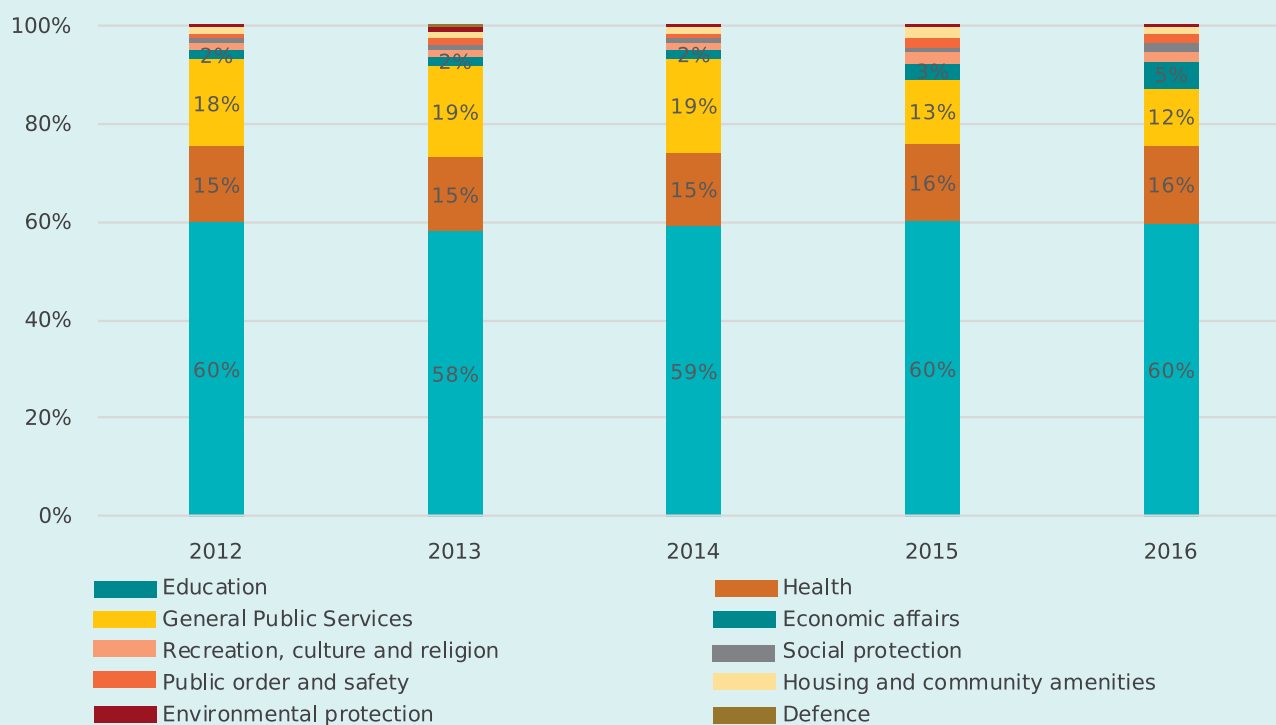




Chart 77 Kosovo

Composition of Expenditures according Classification of the Functions of Government, 2012-2016 (in % of total)



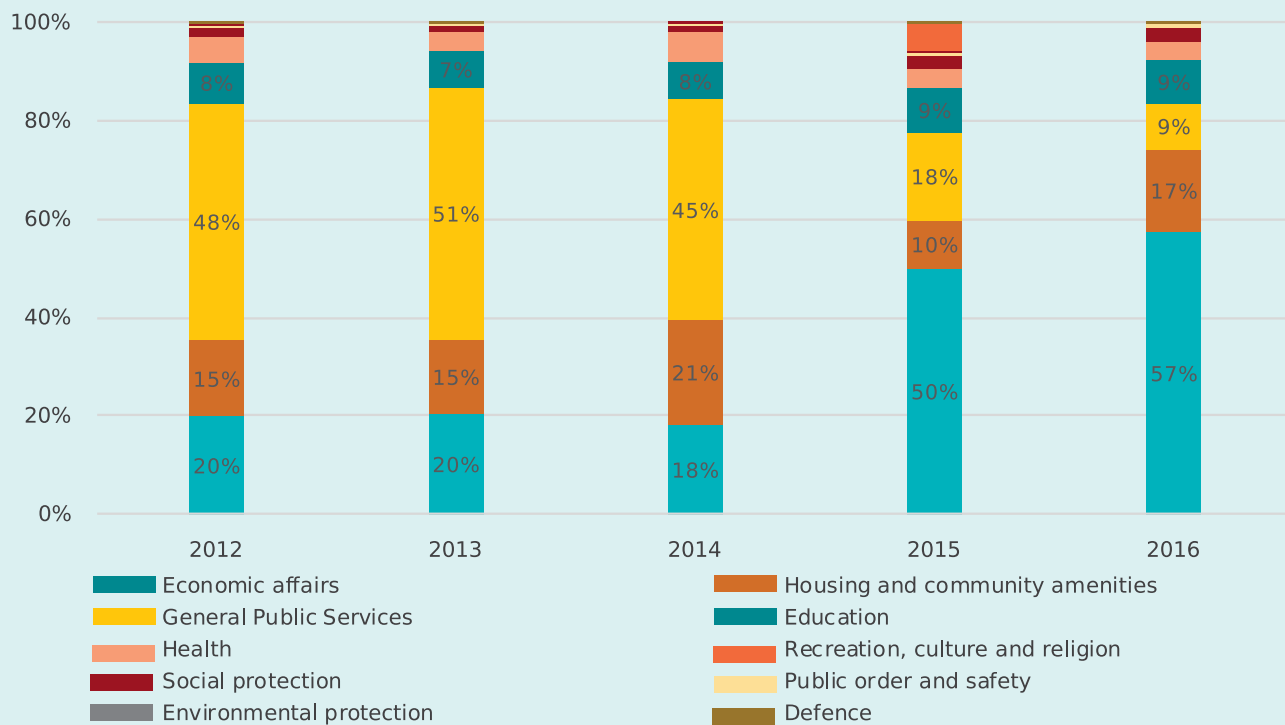
Spending for education and health constitutes about 76% of total local spending in Kosovo, while the general public affairs amount to 12% of the total in 2016. Spending for public infrastructure and general economic affairs has increased over time and in 2016 constitutes 5% of total local spending. Spending for other functions (recreation, culture, social protection etc.) has increased at 7%.

Between 2012 and 2014 about half of local government investments focused on improving general public services. During 2015 and 2016 spending for this function has dramatically declined to create more room for investments in economic affairs (supposedly mostly on road transport infrastructure). Spending for the functions aggregated under the „housing and community amenities”, supposed



Chart 78 Kosovo

Composition of Capital Expenditures according to Classification of the Functions of Government, 2012-2016 (in % of total)



edly financing basic local government services, has increased to 17% of total local investments in 2016 after a significant fall in 2015. Capital investments for the education and health sector have been rather stable during the 5-year time period. Investments in the other functions make up only 4% of total local government capital expenditures.

The total public investment in Kosovo have dropped to 7-7.5% of the GDP in the past four years from 11% in 2012. The share of local level investments in total public investments has slightly increased when compared to 2016 although it remains mostly in line with the historical average.

The wage spending of local governments in Kosovo has increased over time, although in recent years it seems to have stabilized at 4.1% of the GDP. The share of local investments to GDP, on the other hand have dropped from a high of 2.7% in 2011 to a minimum of 1.7% in 2017 and increased to 1.9% in 2017. The yield of the property tax is maintaining a stable trend of 0,4% of the GDP despite the significant investments by the central government into Kosovo Cadaster Agency to improve registration and billing, and substantial increases in the minimum property tax rates imposed by the municipalities.

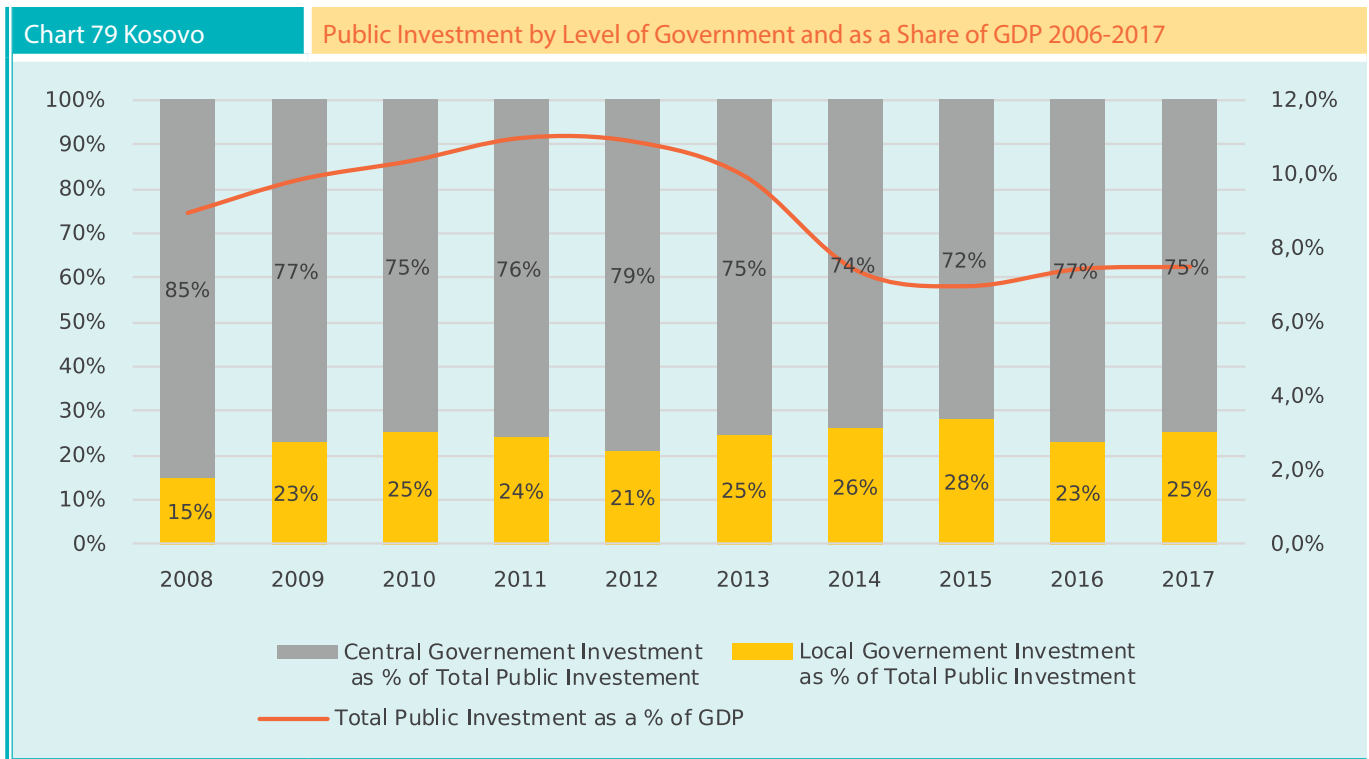
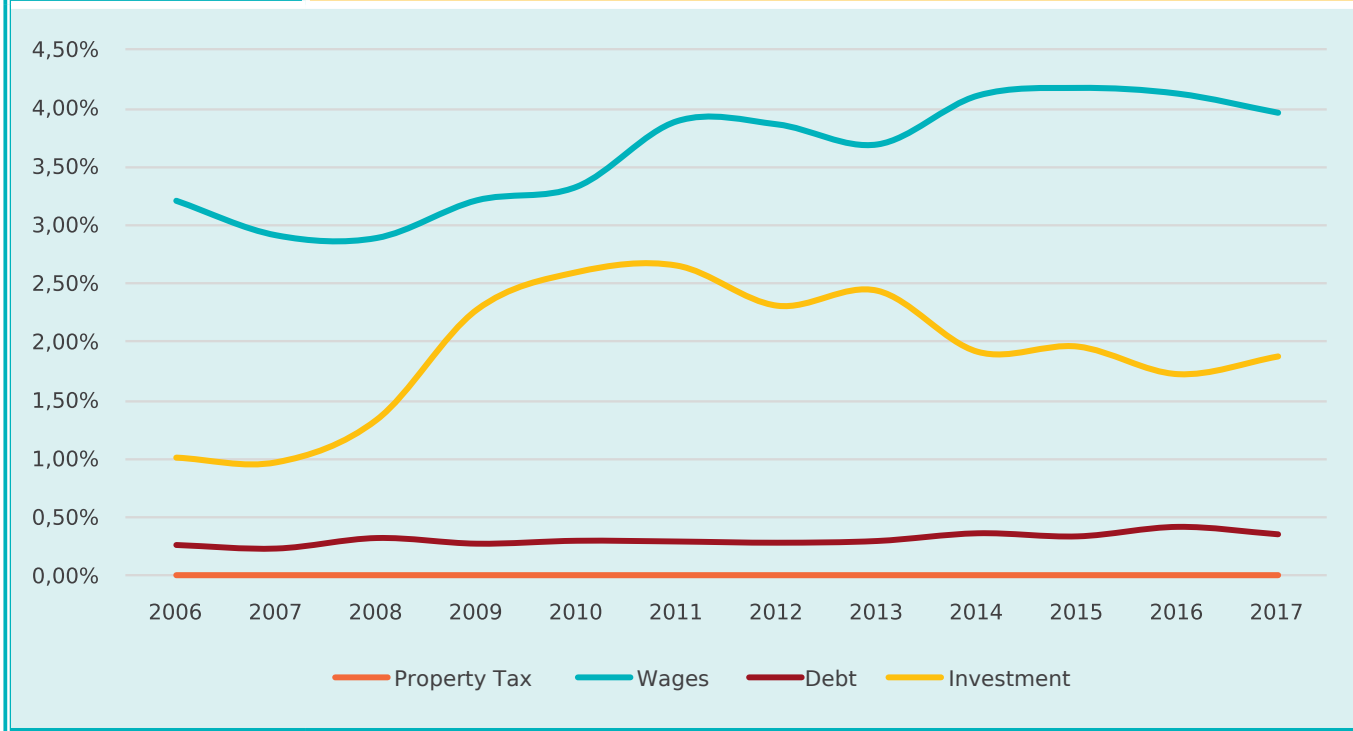


Chart 80 Kosovo

Investment, Wages, Debt & Property Tax as a Share of GDP 2006-2017



Macedonia

By Sofija Stefanovska, Association of the Units of Local Self-Government of the Republic of Macedonia

The Intergovernmental Finance System

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

From a functional perspective, Macedonia has a highly decentralized public sector. Macedonian municipalities are responsible for building and maintaining local public 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. Macedonia is one of the four NALAS member countries that have decentralized the payment of teachers wages in the primary and secondary education system (Bulgaria, Kosovo and Moldova). It is not a surprise that these countries' intergovernmental finance systems are dominated by sectoral block grants.

The Law on Local Government Finance defines sources of municipal revenue as follows:

- Own Revenues, include the Property Tax, other local fees, charges and taxes, asset income and income from fines, penalties and donations;
 - Shared Taxes, in particular Personal Income Tax and 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;
 - Earmarked grant for Fire Protection Unites
 - Debt Finance and donations.
- Since 2006, about a third of local budgets are financed from **Own Source Revenues (OSRs)**. Most own source revenue come from the Communal Taxes and Fees, the Property Taxes and the Communal Tax for Street Lighting, which altogether constitute 107 million Euro or 22% of the overall municipal revenues in 2017.
- The size of the **General Grant** is anchored by law at 4.5% of the collected national yield of VAT. The criteria used to allocate the grant are defined by an annual ordinance. According to the ordinance:
- All jurisdictions receive a lump sum payment of 3 million denars.
 - These payments are then deducted from the grant pool and the residual is divided between the capital city of Skopje and its composite jurisdictions (12%) and all other municipalities (88%).
 - The funds for municipalities are divided by a formula, which allocates 65% of the pool on

the basis of population; 27% on the basis of square kilometers; and 8% on the basis of the number of settlements.

Macedonian local governments receive 3% of the collected yield of the national Personal Income Tax (PIT) collected in their jurisdictions by the national government. In 2017, shared taxes (mostly PIT) generated 39 million Euro, or 8% of total income of local governments.

Block Grants. The allocation of the Block Grant for Education is also determined by an annual ordinance. The main criteria in the formula for allocating the grant are enrollment, employment, and the number of children entitled to free school transport. The formula for determining per pupil payments are publicly available, but the amount of money that municipalities receive through the grant is insufficient and often requires substantial contributions from their general budgets. The allocation of the block grant for preschool education is also governed by an annual ordinance. The formula contains variables for the number of pupils, the type of heating system and the duration of the heating season, the number of teachers in the school, and the utilization rate of the facility. Municipalities that have cultural institutions receive a block grant for culture based

on the number of employees working in the institutions covered by the grant; the total square meters of the buildings; and coefficients for the particular cultural services these institutions provide. The allocation methodologies remained unchanged in 2016 and 2017. The grant for fire protection covers only the salaries of the employees in fire protection units, raising serious concerns of underfunding. In theory, municipalities are autonomous in managing the funds they receive through the block grants. In practice, the situation is much more complicated. Based on criteria approved by their Councils, Municipalities allocate block grants to schools and other institutions on a monthly basis. In total, sectoral block grants constitute 52% (or 255 million Euro) of total municipal finance in 2017.

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

Local Government Tax Powers and Challenges

Local government tax powers are regulated in the Law on Local Government Finance, the Law on the Property Tax, the Law on Communal Taxes, Fees and Charges as well as other sectoral laws that influence local government fees and charges. The Law on Property Tax regulates the three property-related taxes, The Property Transfer Tax, the Inheritance and Gift Tax, and the recurrent Property Tax. The base and rate of the taxes are

provided for in the Law, while municipal councils approve the final rates within the predefined limits. The recurrent property tax is charged on the basis of the market value of the real estate, as determined by an evaluator (employed by the local governments), and a centrally determined - but approved by ZELS - Methodology for estimating the market value of real estate.

Over 2016 and 2017 there has been a substantial improvement in the collection of the property tax whose yield has increased from to 46 million Euro, constituting now about 30% of local Own Source Revenues. However, there remain significant differences in the performance of individual municipalities. Many municipalities have taken proactive measures to regularly evaluate properties, register new properties or changes to existing properties, update fiscal registers of tax bases and taxpayers. Further, certain local governments have taken measures to ensure tax compliance enforcement through the cooperation with the Public Revenue Office to block the accounts of incompliant taxpayers. On the other hand, there are also local governments that have chosen a more passive approach to updating their fiscal registers.

In previous years, the Government of Macedonia has tried to incentivize improvement in tax collection, by ruling that part of the revenues from the agricultural land concessions (according to Law, shared between the central government and municipalities) would be given only to those municipalities that collect at least 80% of the property tax due.

ZELS is actively working at the national level to improve policies and legislation and at the local level to support local governments to improve their systems and capacities for tax administration. ZELS proposes the development and implementation of Information Technology Systems for all local governments for the administration and collection of all types of local taxes. This is expected to help all local governments address a systemic weakness. However, this proposal is constrained by financial resources that have yet to be found.

Main Developments in Municipal Finance and Advocacy Efforts of the Association

The political crisis of the past few years has adversely affected local governance. There have been only few amendments to the legal framework. ZELS prepared a new systematization position, the main tool in our process of negotiating with the central government.

In recent years, ZELS has been successful in lobbying to the government to make amendments to the Local Government Finance Law. As a result:

- The percentage of the national yield of VAT earmarked for the general grant was increased from 3% to 4.5%;
- The municipal share of revenue from other

concessions (e.g. water) was increased from 25% to 50% in 2016;

- Revenue from fees for washing and separating gravel are now split 50/50.
- Revenue from fees for legalizing illegal structures built on agricultural state land are now split 50/50.
- Starting in 2015, 10% municipalities receive 10% of concessions on agricultural land, a share that is increased to 50% in 2018.

ZELS and Ministry of Education and Science discuss School Financing

In 2015, local governments and ZELS have been debating with the Ministry of Education and Science about the “Optimization of the school network and proper planning of the allocation of expenses from block endowments”. This debate was fuelled by the fact that education is underfunded, and local governments are incurring large debts to transport companies for school transport. More

specifically, out of the block grants for education, municipalities use between 67% and 96% for salaries of employees in schools endangering the financing of the other aspects of education, including the transport. Nevertheless, municipalities shall conduct analyses of employment and demographic trends in order to determine how they may further rationalize their school networks.

Agricultural Land and Financing the Rural Development

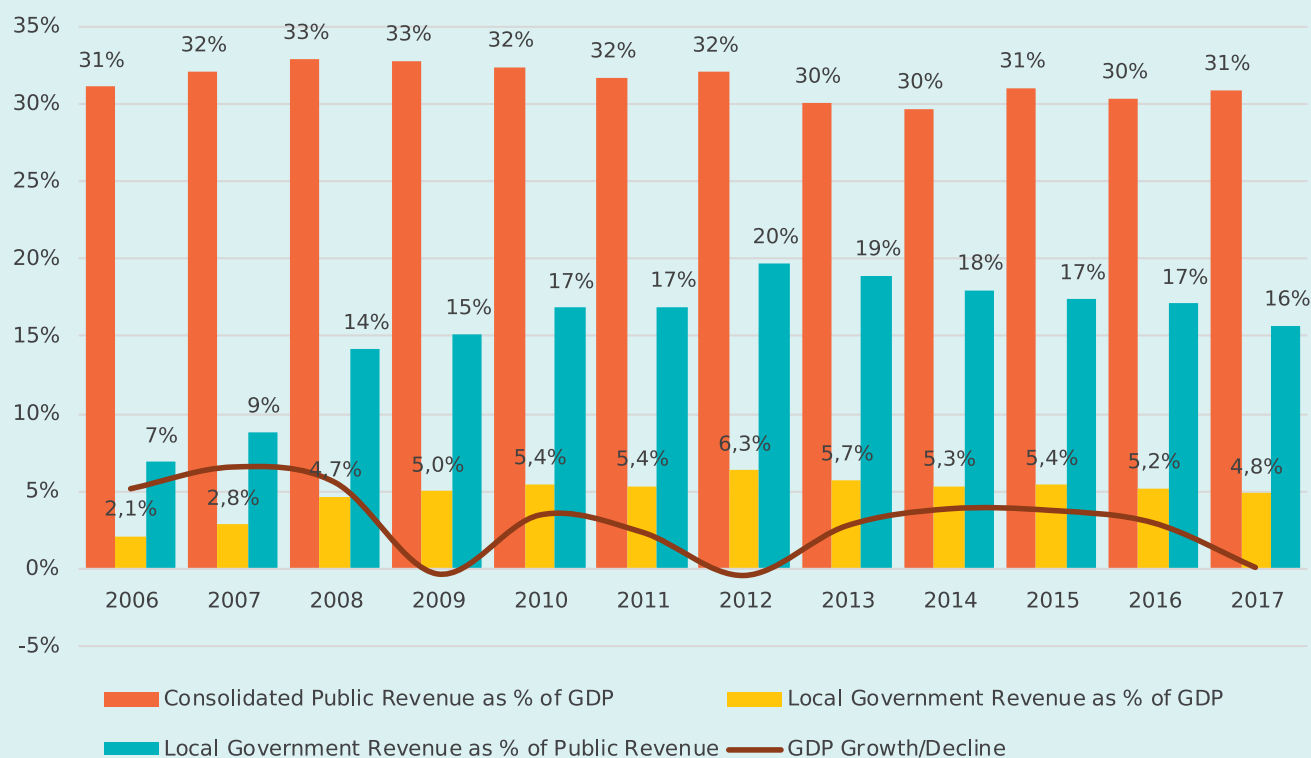
In 2015, the Law on Amending the Law on Agricultural Land entered into force, which may contribute to the improvement of the financial stability of municipalities. By 2018, this law envisions allocation at the ratio of 50 % in favour of the Republic of Macedonia and 50% in favour of municipalities of the funds obtained from the lease of state-owned agricultural land that are collected in the current year. The share of these revenues that municipalities received in 2015 was only 10%. A condition

for obtaining these funds is that the municipality must collect 80% more in property tax revenues over the previous year. Three initiatives of ZELS for amending and supplementing the Programme for Financial Support in Rural Development 2015, the Law on Sale of State-Owned Agricultural Land and the Law on Agricultural Land became part of the national Programme for Financial Support in Rural Development 2015.

Statistical Overview of Local Government Finances in Macedonia 2006-2017

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 6.3% of GDP. It has however been downwardly unstable since then and in 2017 was only at 4.8% of GDP. The local share of overall public revenues has

been declining from 20 in 2012 to 16% in 2017. In the three other countries that are responsible for paying teachers wages in the primary and secondary education system, local government revenues to GDP are between 6.6 to 7.3%. This shows that Macedonian municipalities still face profound financial challenges and are clearly underfunded for the functions they perform.

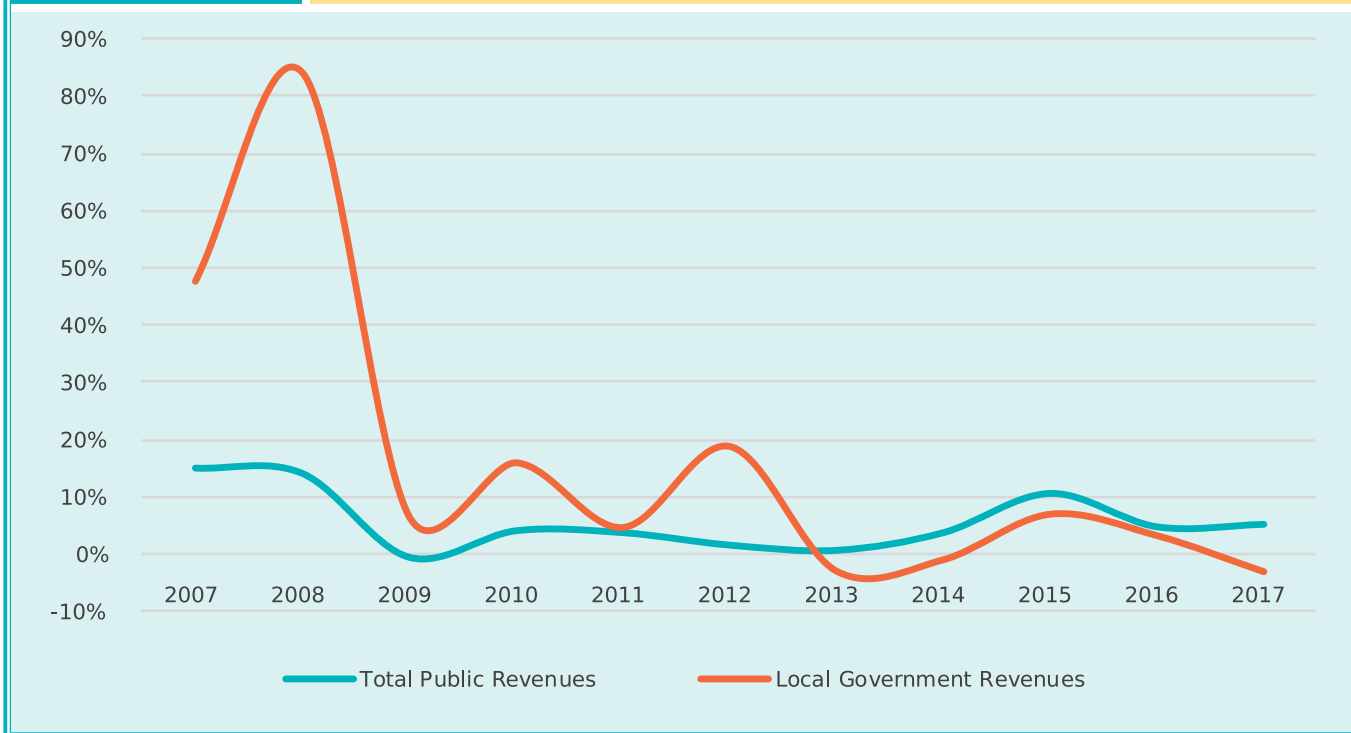
**Chart 81 Macedonia** Local Government Revenue as a Share of GDP and Total Public Revenue in 2006-2017

The general government revenues in Macedonia are much steadier compared to the local governments' revenues. After 2013, for the first time since the beginning of the fiscal decentralization reforms, local governments' revenues declined by -3% when compared to the previous year to slightly recover in 2015 and 2016. In 2017, local revenues fell again by 3% - driven by the decline of the General Grant by 34% and Own Source Revenues by 4%. In 2016 and 2017, general government revenues have increased by 5% annually.

Macedonian local governments derive only modest shares of their revenues from shared taxes and unconditional, general grants (12-13% altogether). Block grants are the largest source of revenue, providing more than half of the funds. Most of these funds are used to finance the pre-university education system including teacher's salaries. Own revenues constitute a third of all local revenues, and investment grants are minimal, c. 1% throughout the decade, yet increasing to 4% over the past two years.



Chart 82 Macedonia Fluctuations in the Revenues of the General and Local Governments 2006-2017



Between 2009 and 2012 , local governments have done an impressive job mobilizing own source revenues, primarily through more aggressively collecting Land Development Fees, Lighting Fees and other communal charges. Though

the overall yield of the property tax remains modest during the overall period, except for 2016 and 2017 when it more than doubled considering its historical pattern.



Chart 83 Macedonia

Composition of Local Government Revenues 2006-2017

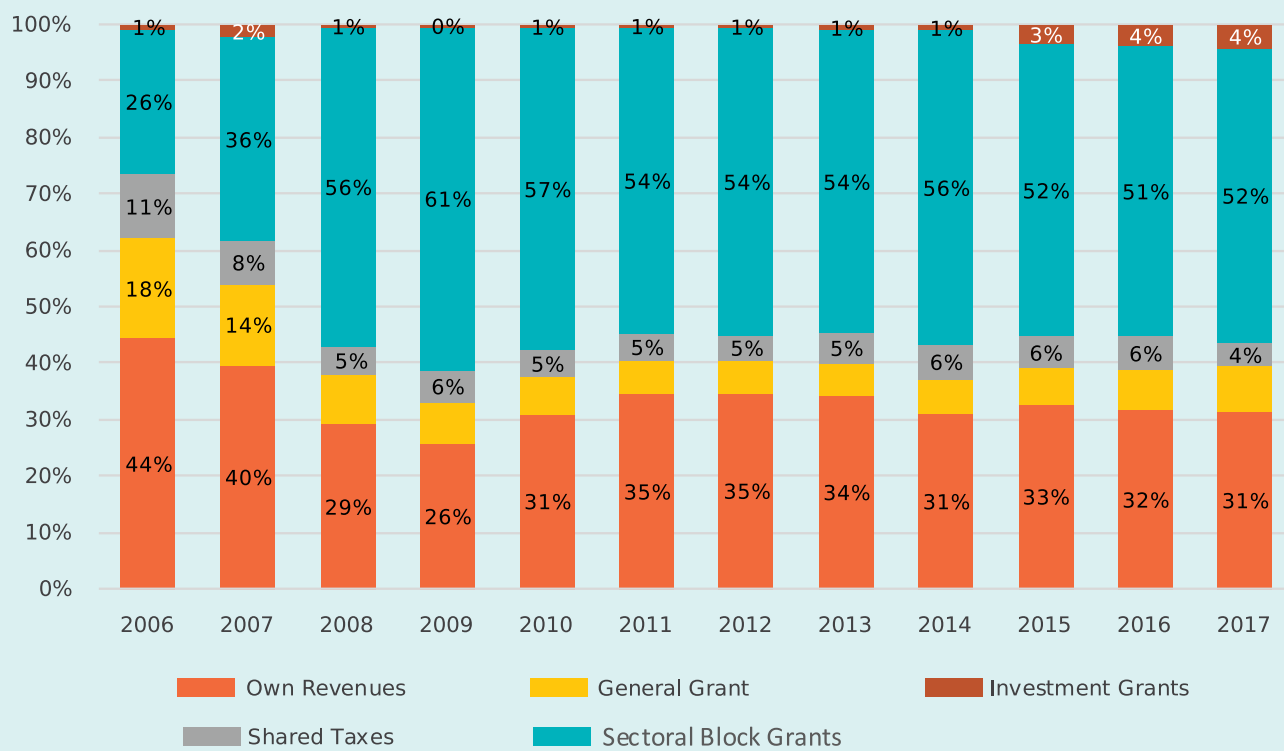


Chart 84 Macedonia

Local Government Own Revenues 2006-2017, in million Euro

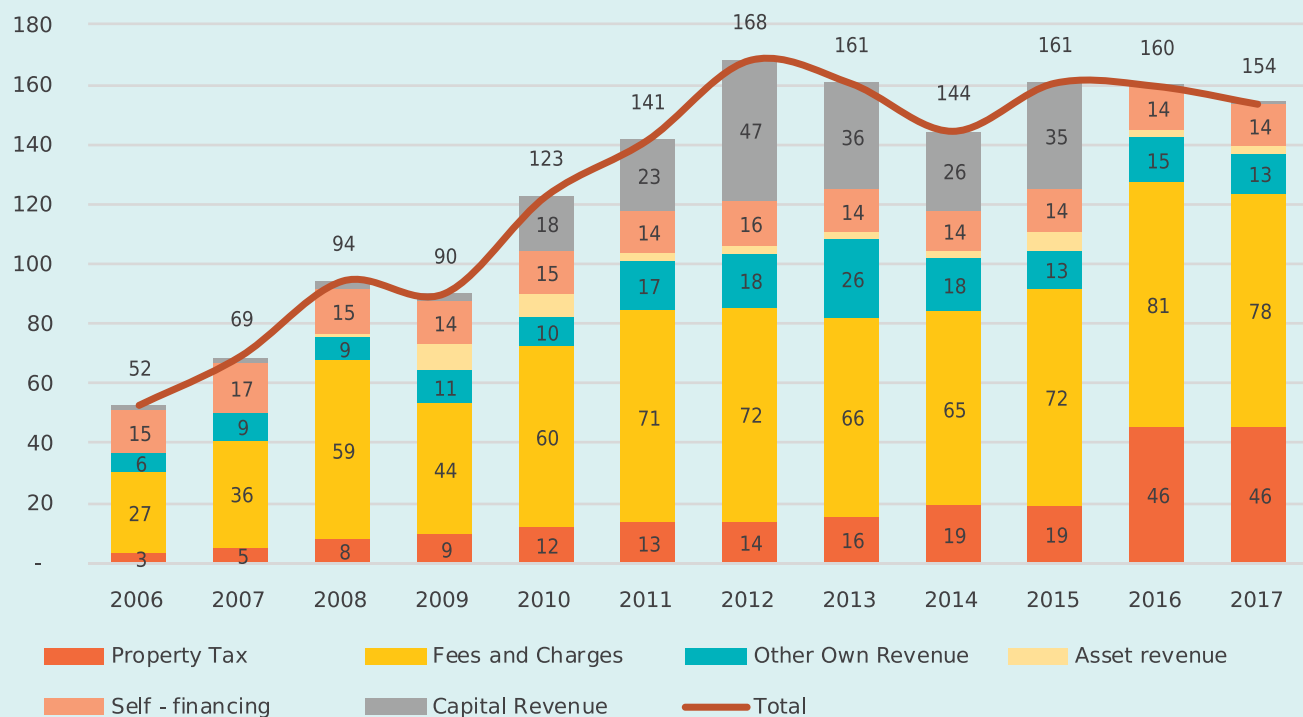
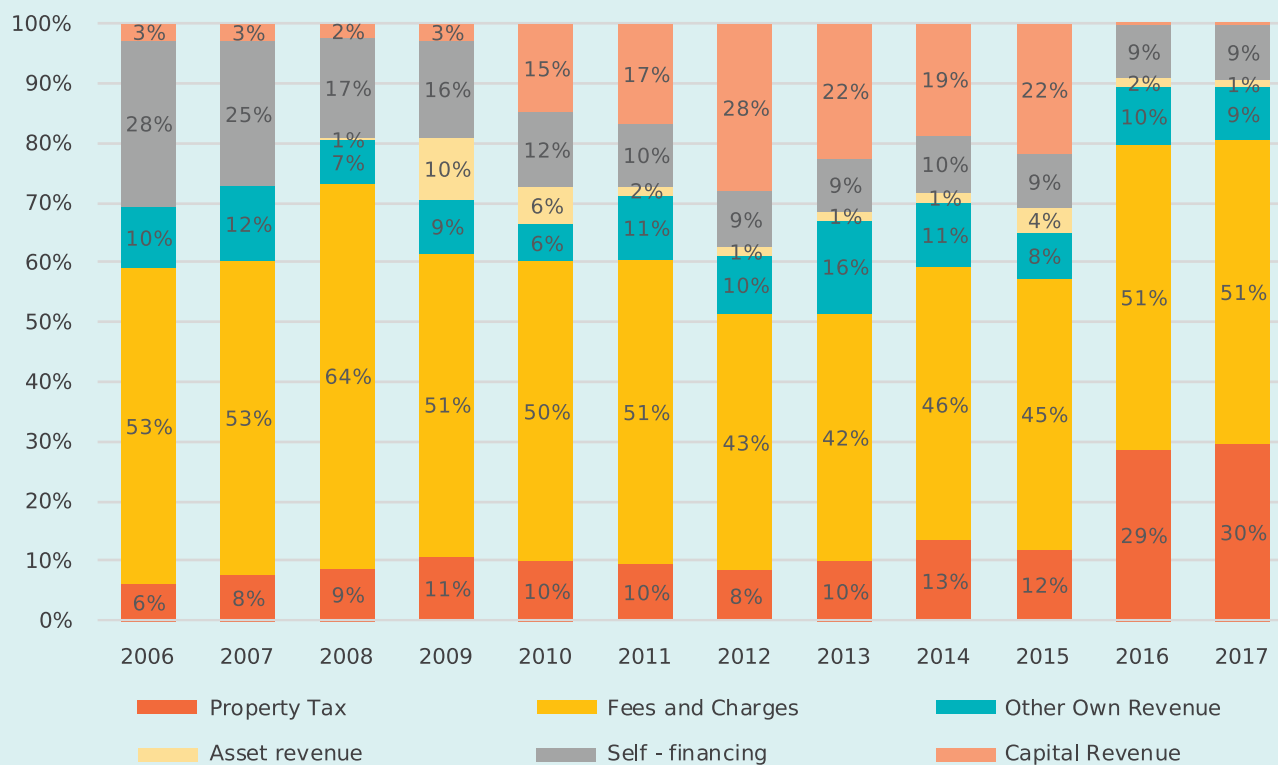




Chart 85 Macedonia

Composition of LG Own Revenues 2006-2017



The share of local expenditures going to wages increased steadily as local governments have assumed responsibility for primary and secondary education until 2011 and 2012 when it began to decrease and accommodate an increase in local investments. Both the share of wages and investments has downwardly unstable thereafter.

Local governments are responsible for about a quarter of total public investment which in 2017

amounted 4.1% of GDP, a slight increase when compared to 2016 when it was 3.8%.

Wage and investment spending as a share of GDP have been declining over the last six years, while the property tax has increased to 0.45% of GDP in 2016 and 2017. Debt is minimal due to the restrictive policies of the Ministry of Finance, but have shown a slight increase between 2012-2015 that has been followed by a decline in the past two years.

Chart 86 Macedonia Composition of Expenditures in 2006-2017

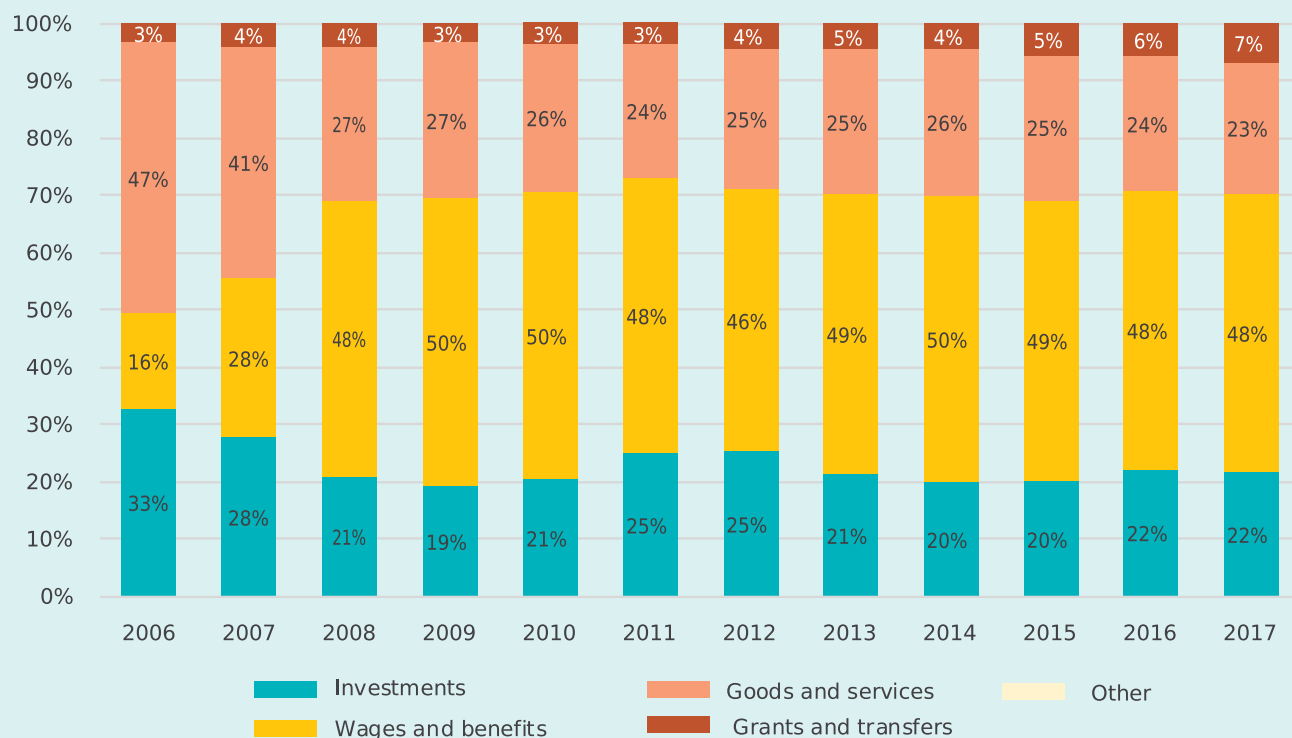




Chart 87 Macedonia

Public Investment by Level of Government and as a share of GDP 2006-2017

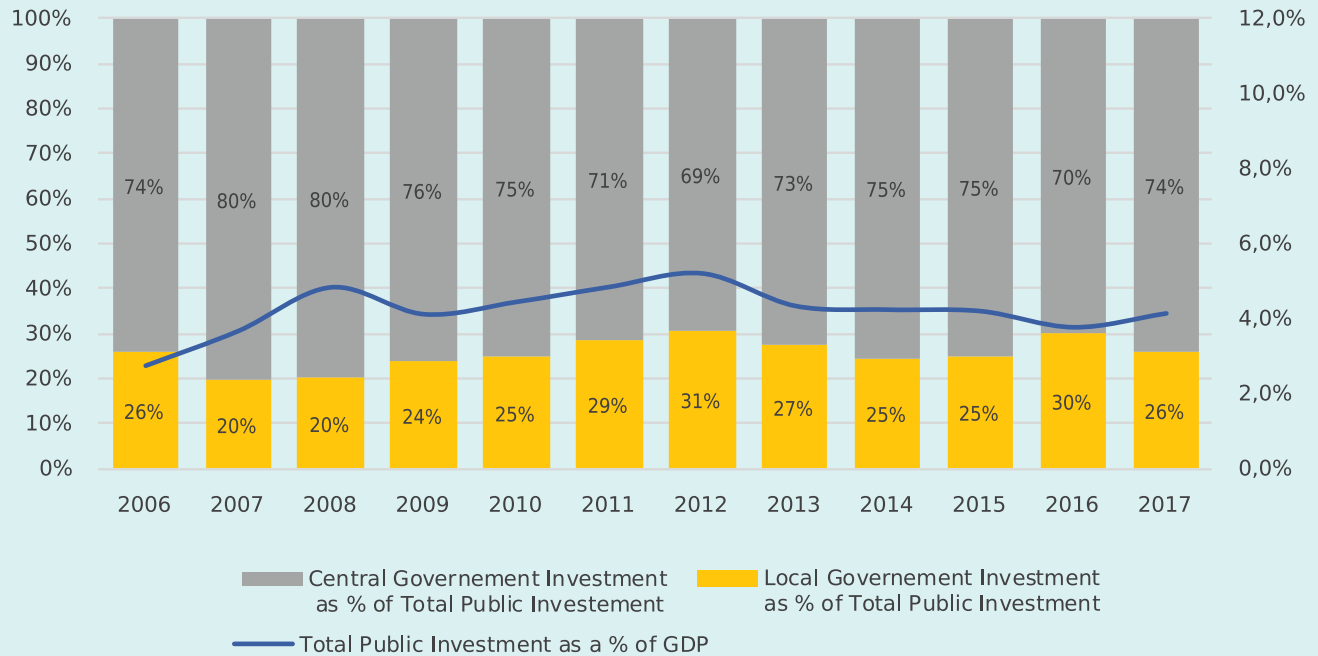
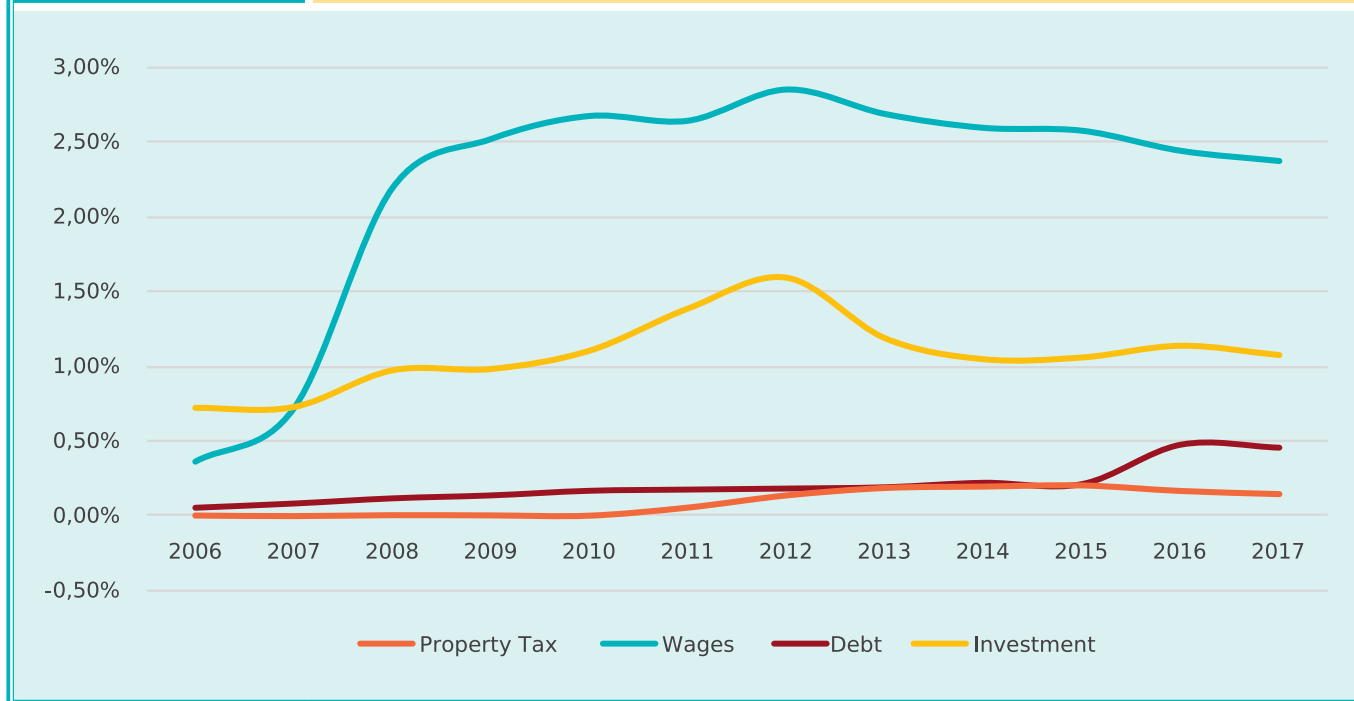


Chart 88 Macedonia

Investment, Wages, Debt & Property Tax as Shares of GDP 2006-2017



Moldova

By Carolina Furdul and Viorel Girbu, Congress of Local Authorities from Moldova

The Intergovernmental Finance System

At first glance Moldova has a highly decentralized public sector with rayon authorities, municipalities and first level local authorities responsible for preschools, primary and secondary education, social assistance etc. Local governments in Moldova are responsible for about a fourth % of total public revenue, the highest levels in South-East Europe. However, this picture may be misleading because in practice, the central government and its decentralized structures continue to hold substantial decision-making powers. Further, due to the lack of progress in fiscal decentralization, most local governments' functions remain de-facto delegated, rather than decentralized.

Limited local financial autonomy hinders the effectiveness of decentralization and public sector reforms in Moldova. The current framework for own local government revenue mobilization remains largely ineffective providing little incentives to local governments for improving revenue collection. Substantial differences remain within local governments in Moldova, with the capital Chisinau and Gagauzia region being most favored. In a context characterized by high functional decentralization of competences with a systemically weak fiscal decentralization, local governments are frequently transformed into a "scapegoat" for unsuccess. Further local governments are subject to regular interferences from the central authorities, mainly for electoral purposes.

In 2012 the Ministry of Finance – with the support of the UNDP — prepared draft legislation designed to improve financial decentralization in Moldova, aiming at addressing systemic weaknesses and major shortcomings. The draft-legislation focused on:

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

Unfortunately, after Parliament approved the draft legislation, the government reversed itself out of fear of losing political, administrative and financial influence over mayors and local officials. 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.

The 2013 amendments of the Law on Local Public Finances introduced changes to the allocation of transfers to local governments and local budget formulation. The principle of balancing local expenditures to a certain minimum level, established nationwide, was replaced with new formula focusing on local fiscal capacity. Local governments powers over taxes on economic activities, (income and wage taxes), have been removed, eliminating local governments' incentives to improve economic environment at the local level. The previous Wage Tax has been transformed into a shared tax, while a part of its yield is transferred to the balancing fund.

According to local public finances legislation, local governments in Moldova benefit from two types of financial transfers: **the General Purpose Transfer**, financed from the balancing fund, and **the Special Purpose Conditional Transfers**, financed from the central budget. Between 2014 and 2017, transfers provided from the state budget increased from 388,2 mil. EUR to 459,4 mil. EUR. Transfers increased from 65% to 71% of total local revenue in 2017. Both, cities and villages (Local Public Administration level 1 (LPA1)) and municipalities and rayons (Local Public Administration level 2 (LPA2)) can benefit from general purpose transfers, which are allocated from the balancing fund, 45% in favor of LPA1 and 55% in favor of LPA2. The balancing fund is funded from the remainder wage tax revenue after a part of them are transferred to local governments' budgets as shared taxes, in the following proportions: 75% for the budgets of villages, cities (excepting capital cities of rayons) and municipalities (excepting Chisinau and Balti); 50% for the budget of

Chisinau municipality; 45% for the budget of Balti municipality; 35% to the budgets of the municipalities - capital cities of a rayon; 25% for rayons; and 20% for capital cities of a rayon.

General purpose transfers are distributed to local governments on the basis of an estimated fiscal capacity per inhabitant, multiplied by a coefficient of 1.3, population and territory of each LPA1. For LPA2, the allocation criteria refer to population and territory (except for the municipalities of Chisinau and Balti). General purpose transfers are limited to the share of funds allocated to LPA1 and LPA2, and to the total amount of the balancing fund created from the revenues generated by the wage tax. Rules for the general purpose transfers distribution could lead to a situation when available funds are lower than the amount needed in order to meet the average fiscal capacity per inhabitant for all LPAs. Special purpose conditional transfers are allocated to local governments to fund expenditure needs of the educational sector, road infrastructure, delegated functions and capital investment. These transfers do not finance rayon level social protection services provided by municipalities and rayons. Additionally, LPA1, have no competences in the distribution of the funds allocated for the development of the road infrastructure, which limits local financial decentralization.

Own revenues of cities and villages are generated by the property tax, the entrepreneurial patent, the transfer tax, asset management revenues and other local taxes. Rayons and municipalities' own revenues are primarily composed of a tax on natural resources and a transfer tax, while in the municipalities of Balti and Chisinau, own resources are composed by all types of own resources of cities and rayon.

The autonomous region of Gagauzia, has a broader resource base, although it cannot benefit from transfers from the balancing fund. Gagauzia's

own revenues are composed of 100% of revenues generated on its territory by tax on wage, tax on income, VAT and excise.

The most important local governments' own revenues in Moldova, after 2014, are the property

tax, the Value Added Tax (VAT) and excises. During this period, the property tax accounts for 20-30% of own revenues, while the share of the VAT and excises varies between 21 and 47%. Overall, own revenues have a high volatility making local budgeting processes very challenging.

Local Government Tax Powers and Challenges

While local governments have no authority to influence the administration of the VAT and excise as it is regulated by the central authorities, the situation for the property tax is different. Local governments assess the property tax, setting the rate within limits prescribed by national legislation.

The property tax is based on the value of intravilan and extravilan land, buildings and constructions. The value of real estate is initially determined by the cadastral authority - during the process of transition to the new rules on property taxation, a process initiated in 2002 but not yet finalized - which is subordinated to the central authorities. According to the law, reevaluation has to be operated every 3 years, with funding from central or local government revenues. Until now, most of the intravilan and extravilan land, buildings and constructions in rural areas did not undergo neither the initial evaluation procedure nor, any further at every 3 years reevaluation, generating huge losses to local budgets, while LPAs do not have the capacity to influence developments in the mentioned domain.

The present system of real estate taxation is tainted by the lack of reliable data on the property's value as evaluation and reevaluation of the

real estate is not done according to the provision of the law. Additionally, local governments cannot perform evaluations on their own, as long as this competence is attributed to a central authority. Although, they may finance the evaluation process, the current poor financial situation of most local governments prevents them doing so. At the same time, there is no differentiation in case of intravilan real estate on land versus constructions/buildings. Looking forward, intravilan land could be taxed using lump sum approach based on its geographic location, avoiding the costly evaluation procedure applied currently in the real estate taxation. Adopting a differentiated approach to taxing intravilan land and intravilan buildings and constructions could partially solve the problems related to the property tax in Moldova.

Finally, the current regulations seem to keep local governments hostages to a system where, central authorities are responsible for the real estate evaluation and ceiling of the tax amount. In a context where real estate value is considerably underestimated (which is the case for most local governments in Moldova), the competence attributed to local governments to establish the tax amount up to a maximum ceiling established by the central authorities, is of a little help.

Main Developments in Municipal Finance 2015-2017 and Advocacy Efforts of the Association

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

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

- Tax discounts and reductions offered to physical persons on local taxes
- Expiration in 2016 of the Compensation Fund introduced earlier;
- Terminating the financing of social centers in municipalities by central government in 2015;
- Terminating the LG share of the corporate income tax in 2012;

- Introduction of 2% quota for channeling part of the personal income tax to NGOs;
- Cash deficit owing to uneven tax collections throughout the months of the year (especially painful for rural LGs);
- Freezing of public investment projects implemented for and by LGs in the aftermath of the financial crisis.

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

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

1. Local taxes shall be at a full discretion of local governments;
2. All currently existing tax ceilings (first of all those on real estate and land taxes) shall be completely removed;

3. Centrally provided tax incentives and tax discounts on that impact on local government revenues shall be strictly prohibited or fully compensated from other sources;
4. The blocking of General Transfers by the national government shall be stopped;
5. The financing of Social Centers by the state budget that was arbitrary stopped in 2015 shall be re-established until these Centers are functional;
6. The Compensation Fund for local finance reform introduced for two consecutive years in 2015 shall be continued since the second stage of local finance reform was not carried out as it was envisaged.
7. Real estate valuations - a main source of local tax revenues -- shall be conducted immediately as per recently approved legislative and normative decisions.
8. An adequate distribution and redistribution of resources and responsibilities between the national and local level: when the national fiscal

system is significantly adjusted (as happened during 2018) a subsequent adjustment of the local public finances should take place as well

- in particular the distribution of incomes as regards the number and amount of shared taxes
- to avoid situations where fiscal reforms are implemented by the national authorities aiming to gain political benefits, while in reality reforms are implemented on the account of LPAs.

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

Despite all the challenges noted above, the only slight improvement reported over the past two years, is related to the partial decentralization of the Road Fund, managed by central authorities, where rayons shall retain competences regarding the distribution of funds allocated for the local roads network development at local level.

Statistical Overview of Local Government Finances in Moldova 2006-2017

From a functional responsibility perspective, Moldova has a highly decentralized system of public administration. Yet, local government are severely underfunded, with great repercussions in service delivery. In relative terms, local governments revenues have fallen from a maximum of 10,5% of GDP in 2009-2010 to 7,6% of GDP in 2017. In the same manner, the share of local government revenues in total public revenues has fallen to the levels previous to 2006. This declining tendency is followed also by Moldova's consolidated public

revenues to GDP have decreased significantly as well during the past decade. On the other hand, it should be noted that the 2017 values of such indicators are significantly impacted by the change in the methodology of estimating the GDP and the recalculation of the GDP estimates for 2017. As a result, the 2017 GDP estimate according to the new methodology is about 10% higher than the previous values. This explains the fall in the indicators related public and local revenues to GDP.

The fluctuations in the growth of the revenues of both the local and general level of government show that the trends are identical for both levels. Following a period of higher or equal level of revenue growth during 2012-2014, and 2016, year 2017 brought much lower rate of growth for local authorities' revenues.

Moldovian local governments derive most of their revenues from conditional sectoral block grants. Unconditional grants, introduced since 2014 in

the system play a insignificant role. The share of shared taxes in the system, likewise the share of own revenues has significantly decreased, specifically with the 2014 reform. Own revenue as a share of total revenue is low. In absolute terms, local revenues increased sharply in 2012-2013 and overturned sharply in 2015. The increase in local revenues returned in 2017, with the increase in the size of sectoral block grants, on which local governments exercise little if any control. Overall, fiscal decentralization in Moldova remains very weak.

Chart 89 Moldova

Local Government Revenue as a Share of GDP and Total Public Revenue 2006-2017

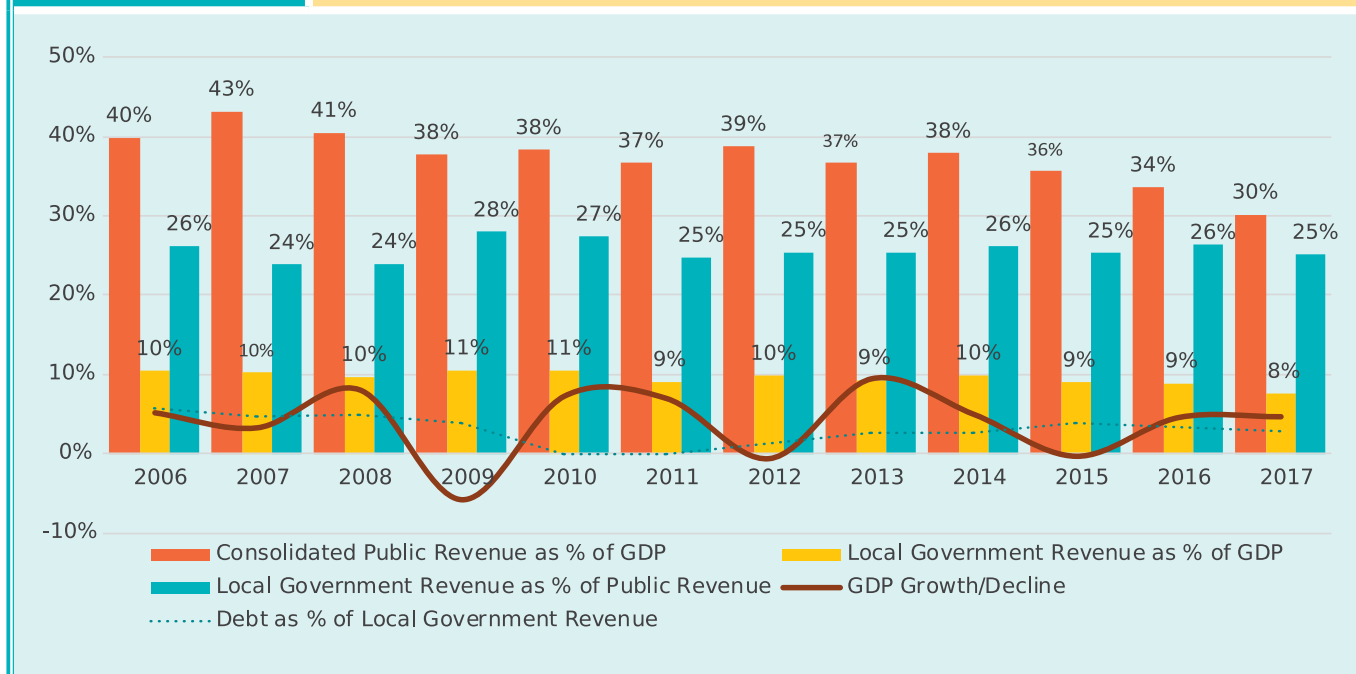




Chart 90 Moldova

Fluctuations in the Revenues of the General Government and Local Governments 2006-2017

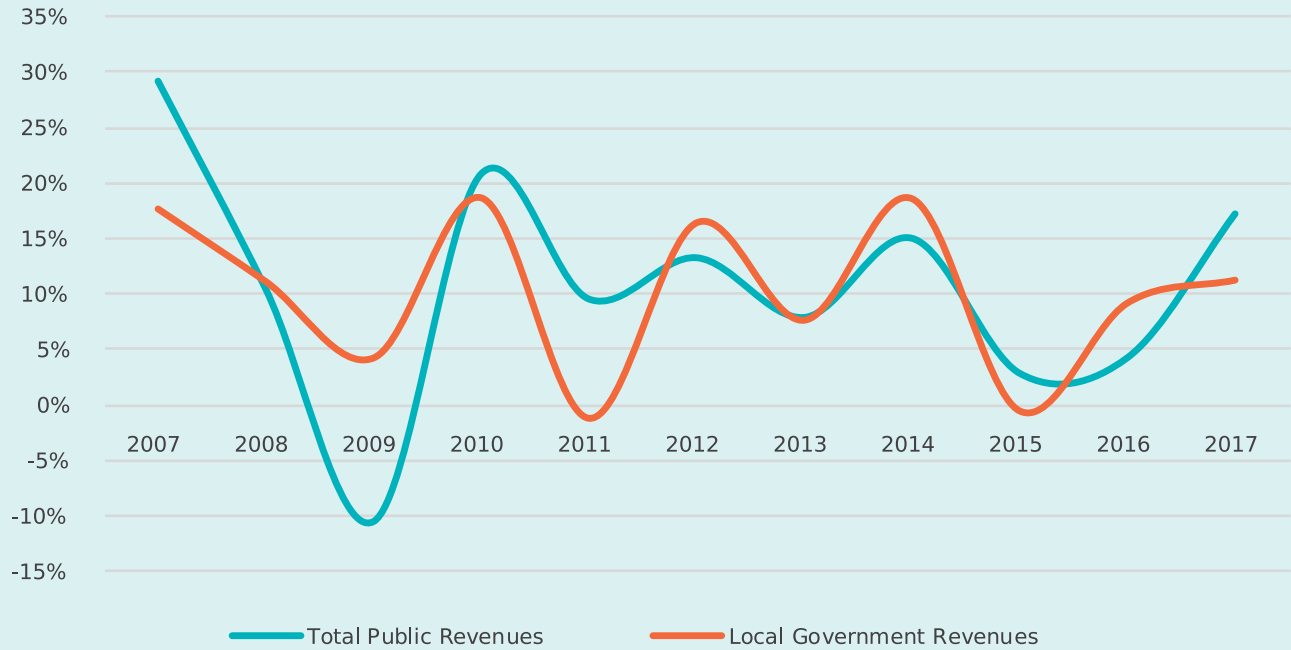
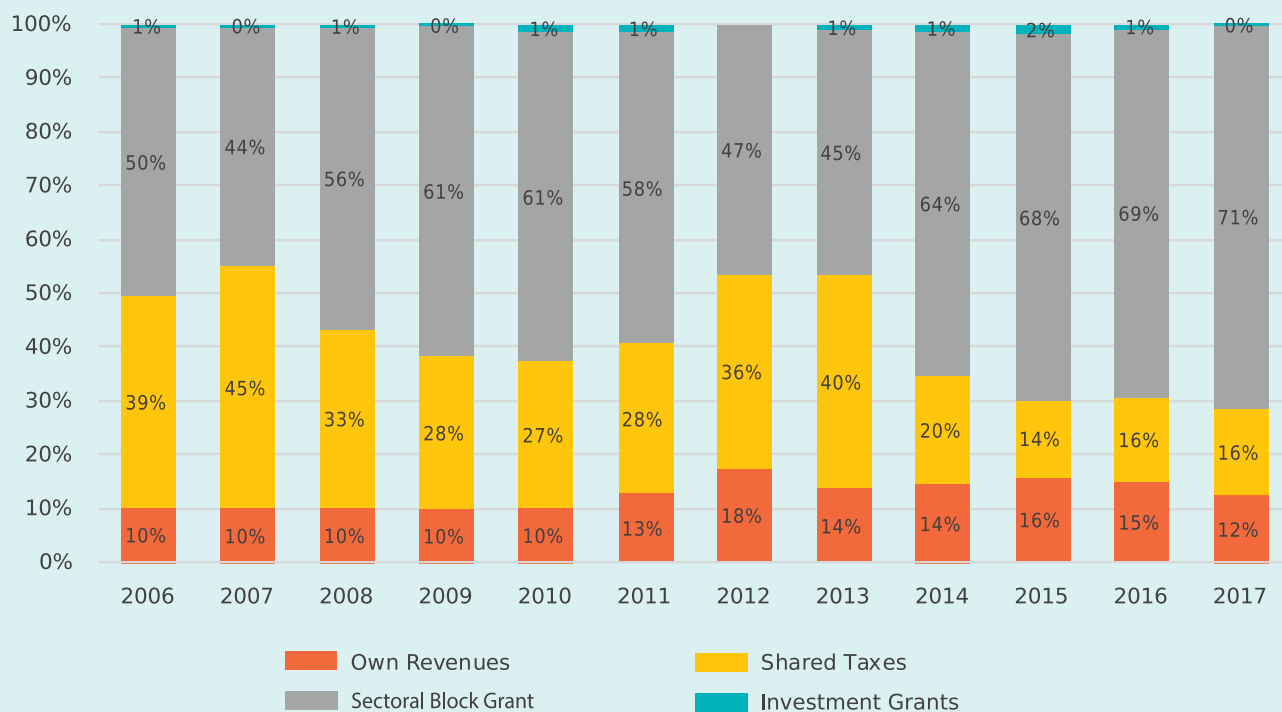


Chart 91 Moldova

Composition of Local Government Revenue 2006-2017



According to the types of own revenues collected at the local level, Moldova has seen a significant shift since the 2014 reform. The share of Taxes on Goods and Services in the total income of local governments increased significantly (yet, it has to be stated that these taxes, in part that is made income to the local governments as described above, are represented only by incomes of the

Gagauzia autonomous region, that is the only region that can benefit from this source of income) subsequently leading to significant disparities in financial autonomy between different types of local governments in Moldova.

Despite the stable stance in local revenue, local government investment spending declined sig-

nificantly between 2006 and 2012, though it rose sharply in 2014, equaling a third of total local expenditure and descended to a less than a fifth in following years. Wage spending jumped in 2009 because of state mandated increases in teachers' salaries but have since fallen as a share of both local budgets and the GDP to increase again in 2016-2017.

The data on total public investment for Moldova shows a drop as a % of GDP from 8,5% in 2014 to 3,1% in 2017.

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

Chart 92 Moldova

Composition of Own Source Revenues 2006-2017

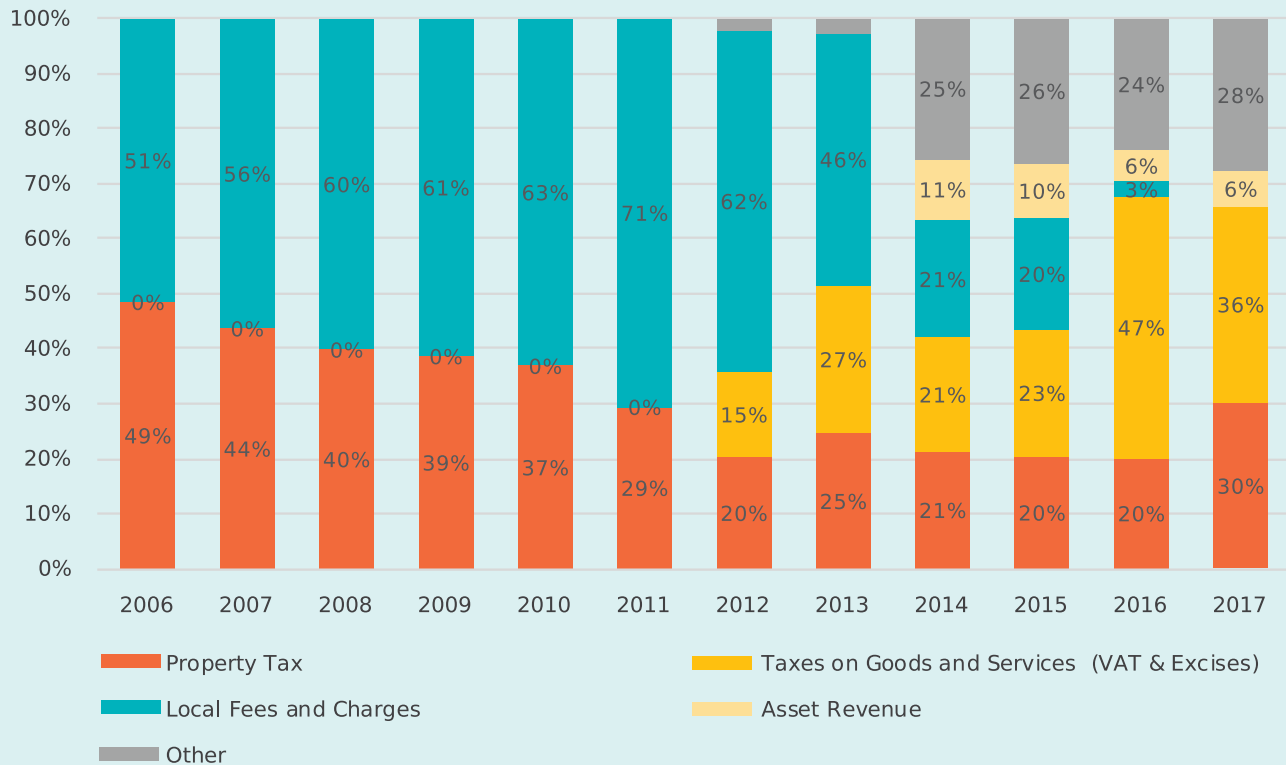


Chart 93 Moldova

Composition of Local Government Expenditures in 2006-2017

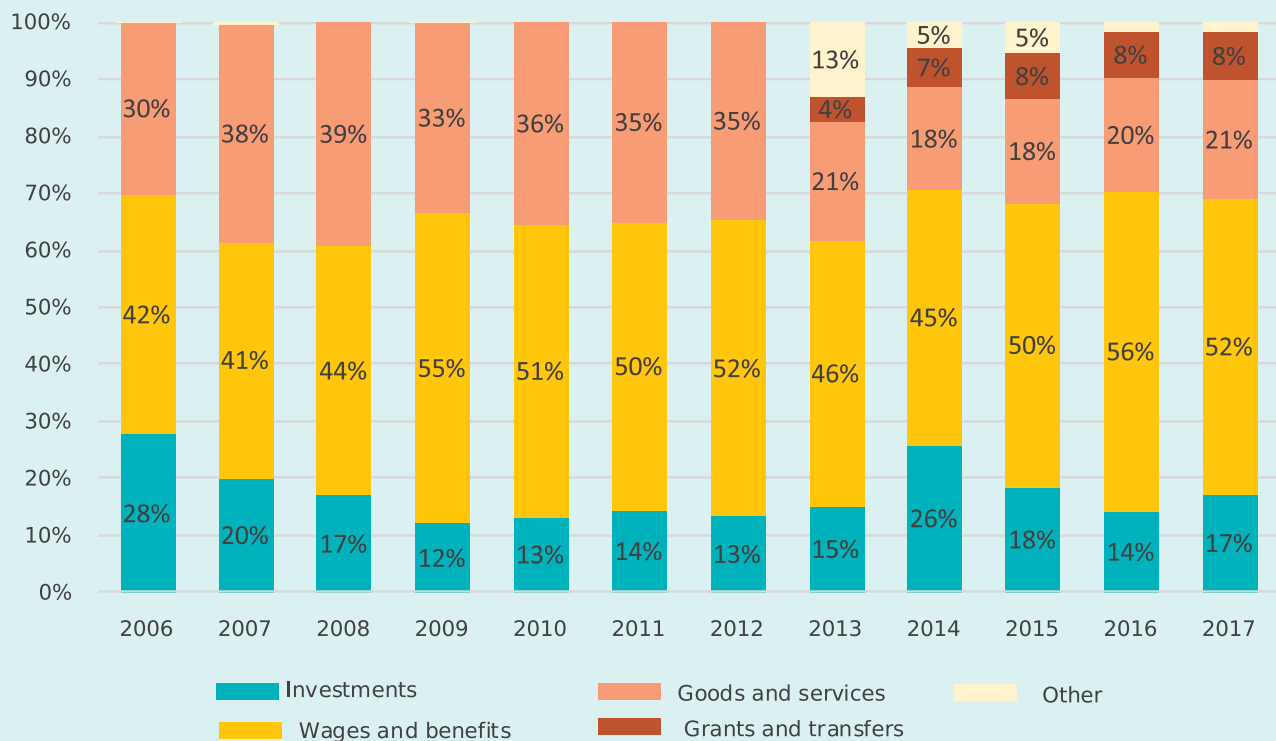




Chart 94 Moldova

Public of Investment by Level of Government and as a % GDP 2006-2017

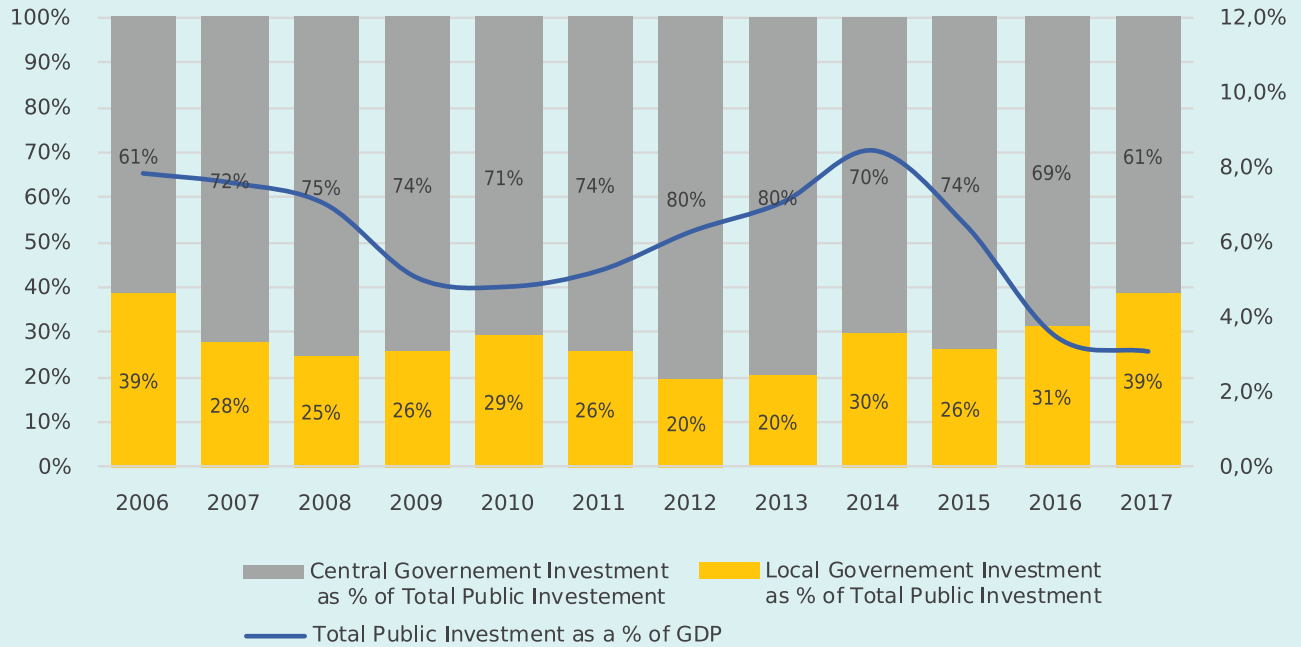
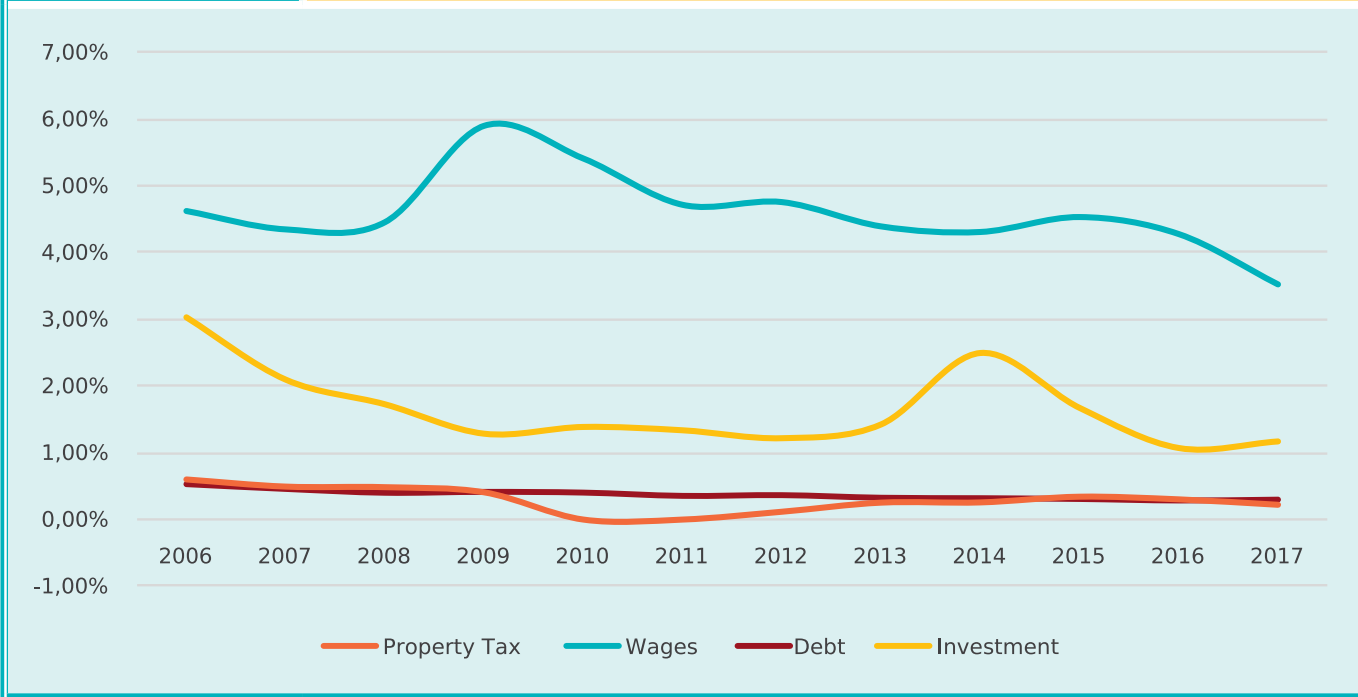


Chart 95 Moldova

Investment, Wages, Outstanding Debt and Property Tax as Shares of GDP 2006-2017



Montenegro

By Žana Đukić, Union of Municipalities of Montenegro

The Intergovernmental Finance System

Montenegro's intergovernmental finance system is unique to the region. Local governments derive almost 70% of their total revenues from true own sources. This is in part because municipalities have only few social sector competencies and therefore are less dependent on intergovernmental grants. And in part it is because Montenegrin local governments control a variety of instruments to tax land and buildings. The character of the land and buildings instruments has changed substantially over the past decade after the bursting of the land bubble of 2005–2007, and the effects of the global economic crisis. The central government has been pushing for a greater use of the property tax and a surcharge on the Personal Income Tax (PIT). At the same time, the role of the land development fee and the fees for the use municipal roads has been reduced, while the land use fee and some local business taxes and charges have been completely abolished between 2008 and 2010, compounding the effects of the crisis.

Own revenues in Montenegro are listed in the Law on Local Government Finance but most of them are regulated by specific laws. The most important own revenues are the property tax; the surtax on PIT; local administrative charges; local communal charges; land development fee; fees for the use of municipal roads; revenues from sale and rent of municipal property; etc. The **property tax** in Montenegro was decentralized in 2003. Since then, the collection of the tax has increased significantly. The

tax rates have changed since 2003 and currently are set between 0,25% and 1,00% of market value (from 0.08% and 0.8% in 2003). Local governments are responsible for tax assessments based on data from the State Statistics Office and/or State Tax Authority on the market value of a square meter of property in each jurisdiction. If these institutions don't have such data, municipalities can engage a court expert to define market value but this solution is very expensive and is used very rarely. The Regulation "On the detailed Criteria and Methodology for the Determination of the Market Value of Properties" defines the nature of the valuation process. Market value is calculated by multiplying a base square meter rate by a number of coefficients that adjust for: the use of the property; its location, its quality size and a number of other elements that could influence its value. According to the Law, the owner of land and building are liable for the tax. However, if the owner of a property is not known the taxpayer is the occupier or user of the property. Local Tax Authorities create and update their Fiscal Registers of taxpayers based on data from the Cadaster Office, although the Cadaster data is often problematic for property tax purposes.

The **land development fee** is regulated by the Law on Spatial Planning and Construction. It is paid by the investor as a precondition for the construction works. This is the most important local capital revenue aimed to build the public infrastructure to serve the new building. It is charged by municipal legal act,

with the prior Government approval. Revenues from the land development fee remain very relevant to municipalities despite their reduction after the economic downturn and the legal limitations introduced in 2009. With the adoption of the General Regulation Plan of Montenegro (it is expected in 2022) the Government plans to abolish this fee and introduce a **fee for development** (paid for undeveloped building land, for building land utility infrastructure and for the preparation of building land for structures). On the other side, the owners of developed building land which was intended for building according to the planning document will pay **city rent**. The government believes that these revenues will, on the right way, compensate revenues from land development fee. The **PIT Surtax** is regulated by the Law on Local Government Finance and the Law on Personal Income Tax. The tax rate is 13%, except for the Capital City and Royal City where it is 15%.

*Montenegrin municipalities have the right to **shared revenues** from 12% of the Personal Income Tax (except for the Capital City where it is 13% and the Royal Capital where it is 16%); 80% of the Property Transfer Tax; 70% of the revenues from concessions and other fees for using natural resources awarded by the State; 50% of the revenues from the fee for use of coastal resources; 100% of the annual fees for the registration of motor vehicles, tractors and trailers. Taken together, these resources provide 17% of total local revenues in 2017.*

Montenegro has as a reasonably robust and evolving **equalization system**, which provides about 13% of local revenue. In recent years, reforms have tried to ensure that equalization monies are allocated not on the basis of what municipalities actually collect in own-revenues but what they could collect given their tax bases. Fiscal equalization is performed through the Equalization Fund, which is formed from 11% of the national

yield of the Personal Income Tax, 10% of the national yield of the Property Transfer Tax, 100% of the national yield of Vehicle Tax and 40% of the yield of concession fees from games of chance. A municipality whose average fiscal capacity per capita for the last three fiscal years preceding the year for which the funds are allocated is lower than the average fiscal capacity per capita of all municipalities for the same period and whose development index is below 100% of the average development index in Montenegro determined by a special regulation, has the right to use the funds of the Fund for that year. Funds are allocated as follows: 60% on the basis of fiscal capacity and 40% on the basis of budgetary needs (where 20% in equal amounts to all municipalities entitled for the equalization and the rest of this amount is allocated based on territory (60%) and the number of inhabitants (40%)). The Local Government Finance Law also requires periodic consultation with the Committee for Monitoring the Development of the System of Municipal Fiscal Equalization. The Committee monitors the implementation of the criteria for fiscal equalization, gives recommendations for improving the system, and issues opinions on documents prepared by the Ministry of Finance related to the allocation of the Fund. Recently the Ministry of Finance has proposed amendments to the equalization procedures to improve the current weaknesses. According to the current legal solution, all local revenues (own and shared) are equalized and equalization money is allocated on the basis on what municipalities actually collect, not on what they could collect given in their tax base. This disincentivizes tax collection process and incentives to provide inaccurate data on own source revenues to get a larger share of the Equalization Fund. With the upcoming expected changes to the Law, it is expected that equalization be performed only on shared tax revenues.

With these changes, most probably the Committee would be abrogated considering that the Ministry of Finance itself provides for all the tasks of the Committee and would be solely responsible for the operation of fiscal equalization.

Municipalities can also receive **conditional grants** from the State Budget for financing investment projects that are of special interest to one or more local governments. These grants can be used to co-finance donor funded projects. In order to receive a conditional grant, municipalities must have adopted a multiyear investment plan. The maximum amount of a conditional grant cannot exceed 50% of the anticipated cost of the project.

The amount of conditional grants that a local government can receive also depends on the level of per capita revenues they generate from the land development fee in relation to the national per capita average in the preceding year. Conditional grants have proved to be very useful instruments for co-financing investment projects that are also being supported by EU funds. Nonetheless, conditional grants represent only 1% of total local government income. Despite their very modest share, and, considering the initiative for establishing the Revolving fund, the Ministry of Finance is proposing their abrogation through the Draft Law amending the Law on Local Government Finance.

Main Developments in Municipal Finance and Advocacy Efforts of the Association

The global economic crisis had a strong impact on Montenegrin municipalities. Like the national government, they borrowed heavily to limit the impact of the crisis. They also accumulated substantial payment arrears to suppliers and contractors. They continue to be on a period of retrenchment struggling to reduce inefficiencies and improve revenue collection. As already mentioned, the effects of the crisis were compounded by a number of policy choices to “improve the business enabling environment”, by cutting or eliminating a number of local taxes and fees. Efforts were made to compensate local governments with higher property tax rates, and very slowly increasing shares from shared revenues. However, the belated amendments were insufficient to compensate for the revenues that municipalities had lost.

Municipal revenues in Montenegro have not yet recovered to the pre-crisis levels. Municipalities and the Union of Municipalities continue to focus on fiscal consolidation measures to ensure sustainabil-

ity and stability of the local government finance system both on the revenue and expenditure sides.

After almost four years of work, a draft law to amend the Law on Local Government Finance has been prepared. Some of Union’s proposals have been accepted and are included in the draft-law, such as: higher percentage from PIT, but not for all municipalities (only for north); improving the allocation criteria for the Equalization Fund (based on the shared taxes); establishing the Revolving Fund, etc. However, the stabilization of local finances will be achieved only if the Law prescribes higher shares from the PIT for all municipalities and higher amounts of the Equalization Fund. The LGFL that is expected to be adopted by the end of this year.

Tax Debt Repayment Rescheduling. The Government of Montenegro, in cooperation with local government units and the Association of Municipalities, approved the **rescheduling of debt repayments for unpaid taxes and contributions**

on salaries in local government bodies as well as in public institutions and companies founded by the municipalities. Contracts on tax debt re-payment rescheduling were signed between the Ministry of Finance and 16 local government units. These contracts are adopted by the municipal assemblies and signed by the mayors and they will be valid for a period of 20 years for all municipalities that are beneficiaries of the Equalization Fund (14), while for the other two municipalities the re-payment period is determined for 5 years. The Ministry of Finance agreed to the request of the Union and local governments themselves to revise re-payment schedules in the first years, in order not to jeopardize local governments normal activity. Besides the repayment of the unpaid tax liabilities, municipalities are obligated to pay current tax obligations, also. While the recent approach was positive, the untimely changes to the legislation as well as the development of local financed did not allow municipalities to fully implement this plan,

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

ties used this instrument to improve their financial situation and signed contract with the State of Montenegro in order to regulate mutual rights and obligations. These measures have contributed to stabilizing local finances in recent years.

Improvement of the legal framework regulating the local self-government finance system. The Law on Communal Services was adopted in 2016, introducing the *communal fee* as a local own source revenue, to be set by municipal councils but that needs to be approved by the Government. This fee was intended to substitute for the elimination of the Land Use Fee in 2008. Unfortunately, the fee is not yet implemented. The responsible line ministries consider that it would adversely affect the business enabling environment. As a result, the Government has not approved the municipal act proposals although the revenue from the fee is intended to cover communal consumption costs starting from January 2017.

In 2017, Montenegro adopted a new Law on Spatial Planning and Constructions which prescribed, among others, the legalization of informal buildings. The process of legalization of informal buildings has started in 2018 and municipalities should collect revenues from legalization (the *land development fee for informal buildings*). On the other hand, the owners of the informal building who didn't file a request for legalization and owners whose requests for legalization have been rejected, shall pay a fee for use of space for informal buildings. To support its members, the Union of Municipalities prepared and shared with all municipalities templates and model Ordinances that would support municipalities preparing their own ordinances for the implementation of the Land Development Fee and the Fee for the Use of Space for Illegal Buildings.

The Union of Municipalities has submitted to the Ministry of Finance a number of proposals and sug-

gestions for the improvement of the Law on Local Government Finance, aiming at defining a model and process that would ensure the compensation of revenues that local governments have lost in previous years due to the central-government policies. Even though Montenegrin municipalities don't have responsibilities in the education and health sector, local government revenues need to increase to compensate the losses they've suffered in previous years, especially for the municipalities from center and south of the country. For other municipalities from north of country (that are less developed economically), the compensation should take place with the higher shares from the Equalization Fund as well as from the improvement of its allocation criteria.

Within the financial perspective 2014-2020 of the European Union, local governments have at their disposal significant funds for the implementation of capital and strategically important projects in the interest of citizens and local communities. When it comes to funds absorption, the main challenge municipalities face is the pre-financing of the EU projects. The Union of Municipalities has proposed amendments to the Law on Local Government Finance to establish a special mechanism/financial instrument, "**Revolving Fund**", designed to allow municipalities to borrow the monies necessary to meet the pre-financing contribution associated with EU projects. As loans are repaid into the Fund, it is re-released for new lending, and thus money permanently circulates in the system, so, with the exception of the initial investment, there is no need to make new investments in this Fund. The Government of Montenegro shows positive will on this UoM initiative. Some moneys are already planned for this purpose in the State Budget Law for 2018. However, the fund cannot be implemented until the criteria for its distribution are not included in the Law on

Local Government Finance. The allocation criteria have been included in the draft-law expected to amend the Law on Local Government Finance.

The Union of Municipalities also submitted to the Ministry of Finance Initiative for changes of the **Law on the Property Tax**, even this law has been changes three years ago. But, its implementation shows that we have to change also this law. Having in mind that the Constitutional Court initiated constitutional review of certain legal provisions last mounts, the Parliament of Montenegro formed Working group for preparing new the Law on the Property Tax. As the UOM representatives are members of the Working group, this is opportunity for including our proposals for improving law (precisely definition of the subject for taxation, secondary housing, delivering of the tax decision, etc.).

Public sector in Montenegro, including local government units, have to **rationalize operating costs and optimize the number of employees**. This is also one of the provisions of the contracts on tax debt repayment rescheduling. In July 2018, the Government adopted the Plan for the Optimization of the Number of Employees in the Public Sector. The goal is to support the development of a public administration that is able to respond to citizens and private sector needs in a better way, and at the same time to generate savings in the state and municipal budgets. In accordance with the Plan, the number of employees at the local level should be reduced by 5% until 2019, and by 10% until 2020.

The Union of Municipalities is taking active measures to improve revenue administration at the local level. Recently the Union decided to initiate activities for the procurement of a unique software for the administration of all local public revenues for all municipalities, to address the problems that local governments faced in accessing Property Administration data for property taxation purposes.

Statistical Overview of Local Government Finance in Montenegro 2006-2017

The impact of the global economic crisis on the Montenegro was particularly strong and dramatic for local authorities. The share of local government revenue as a percentage of GDP in Montenegro was 11% in 2007. This almost equaled the EU average and was the highest in South East Europe. This was fueled by the real estate market expansion, significant public investments and considerable local revenue from asset sales, land development and land use. Since 2007, local government revenues have fallen significantly, and in 2017 their share equaled only 6% of GDP. The effects of the economic crisis were exacerbated by the elimination of a number of local revenue raising sources, in particular fees.

Local government revenues in Montenegro have

fallen faster and recovered slower than the total revenues of the General Government for most of the period 2007-2017. The growth rate shows a better alignment in 2017 where local revenues have increased by 7% while total public revenues have increased by 6% when compared to 2016.

Montenegrin municipalities are unique in the region in that they derive around 70% of their revenues from own sources. Until 2010, own revenues accounted for more than 80% of total revenues. Legislative changes following the crisis cut some types of own revenues. The share of shared taxes and equalization revenues were increased, leading to an increase in the percentage of shared taxes in total revenues from 10% in 2009 to 17% in 2017.

Chart 96 Montenegro

Local Government Revenue as Share of GDP and Total Public Revenue 2006-2017

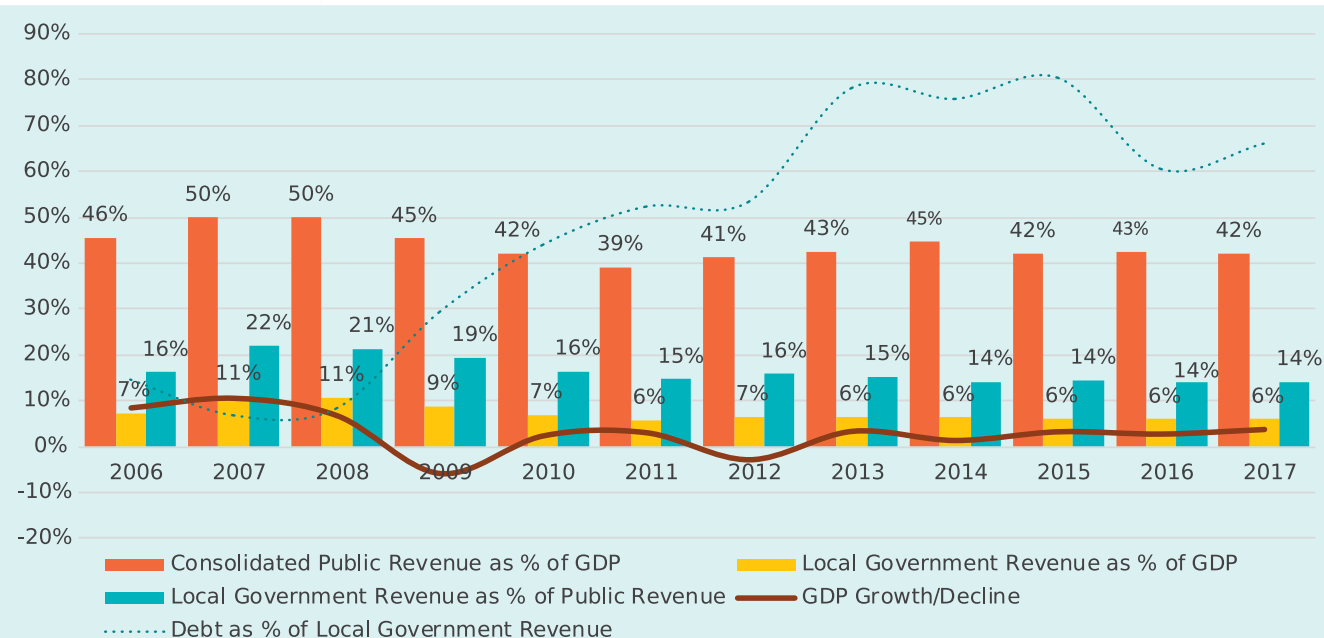




Chart 97 Montenegro

Annual Fluctuations in the Revenues of the General Government and Local Governments

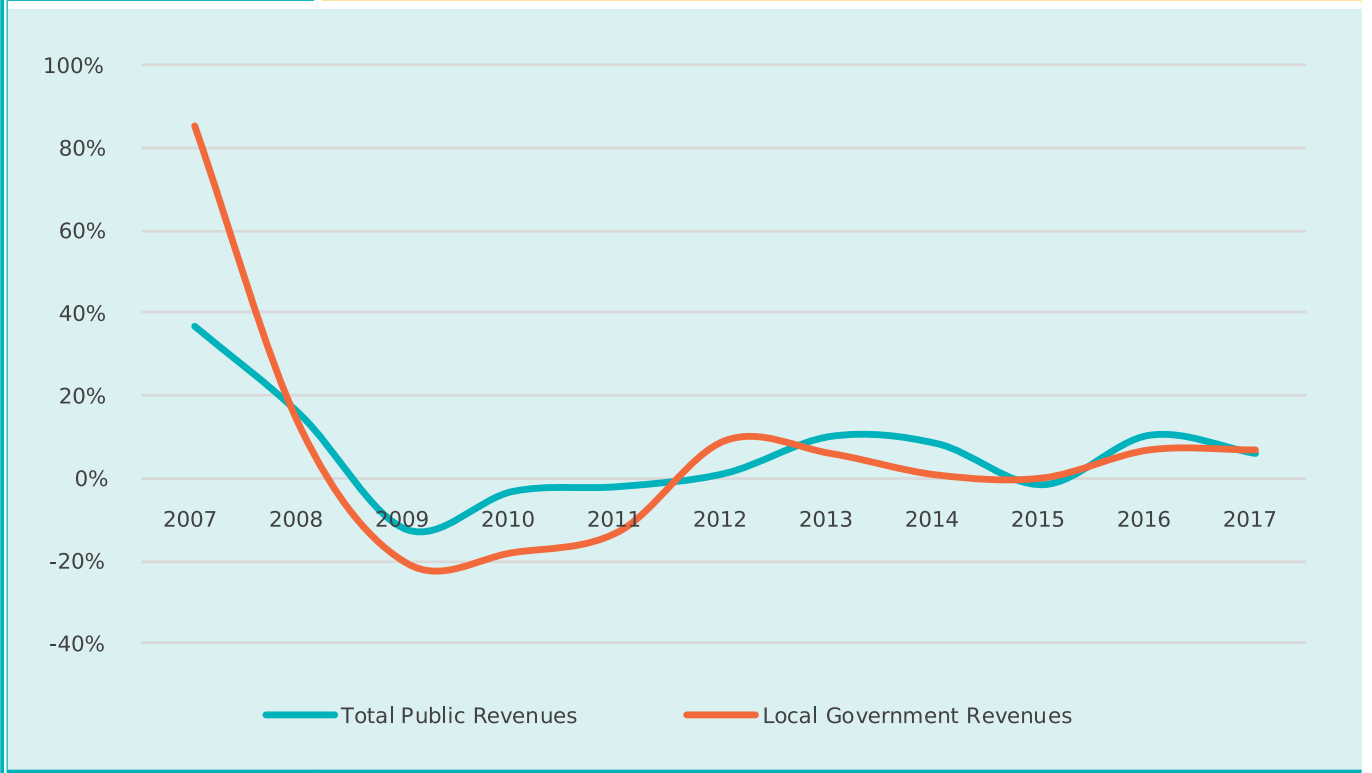
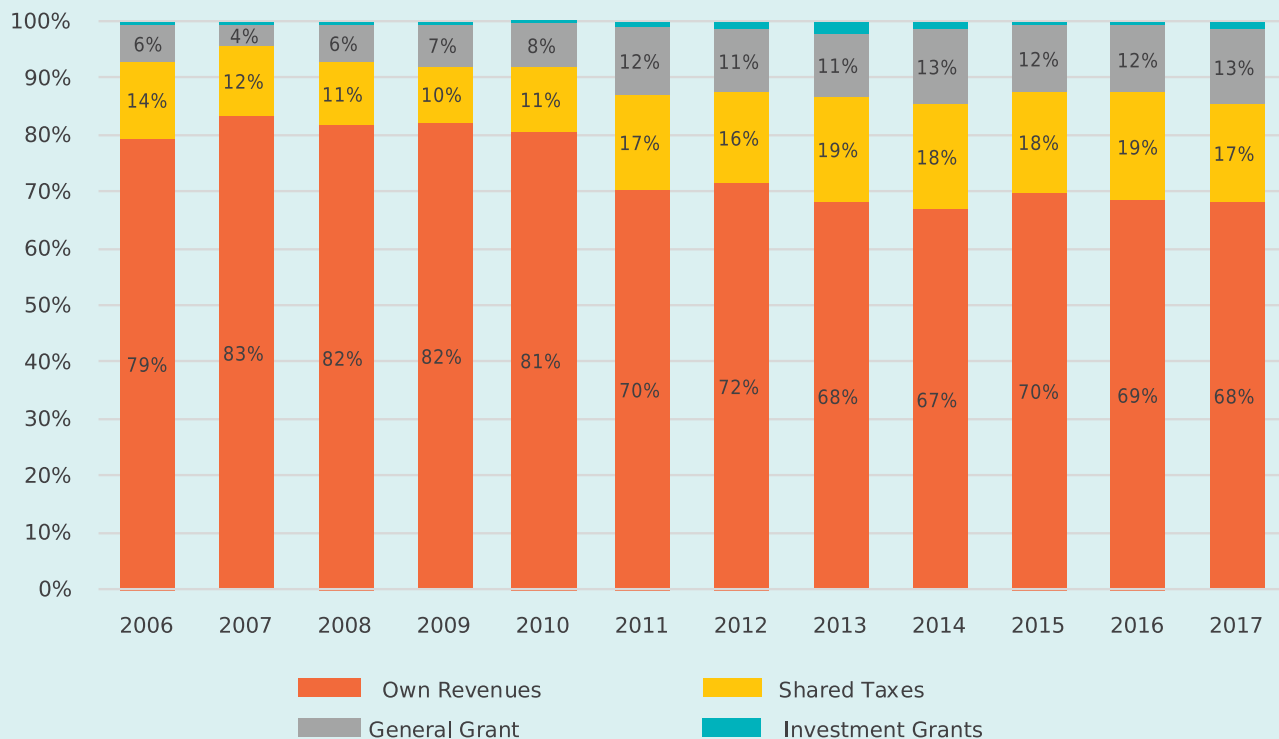


Chart 98 Montenegro

Composition of Local Government revenues 2006-2017, in % of the total



Until recently, the Land Development Fee was the largest source of local own-revenue. But the central government has been imposing constraints that have reduced its role in municipal budgets. Meanwhile, the Land Use Fee was eliminated in 2009. Local governments have tried to replace the lost income by making greater use of the Property

Tax, which went from being a relatively insignificant own revenue back in 2006 (only 8%) to the single most important one in the past five years. Currently it represents a third of all own revenue. In nominal values, the property tax increased from 24,5 mln € in 2010 up to almost 51 mln€ in 2017, or 16€ per capita in 2006 up to 81€ per capita in 2017.

Local government investment's share to total local expenditures has dropped significantly from 2008 from 53% to 21% in 2017. In nominal terms local government investments have decreased from a high of 166.4 mln Euro to a low of 46 mln

Euro in 2017. While operating costs for goods and services have remained relatively stable, spending for wages, transfers and debt repayment have increased substantially.

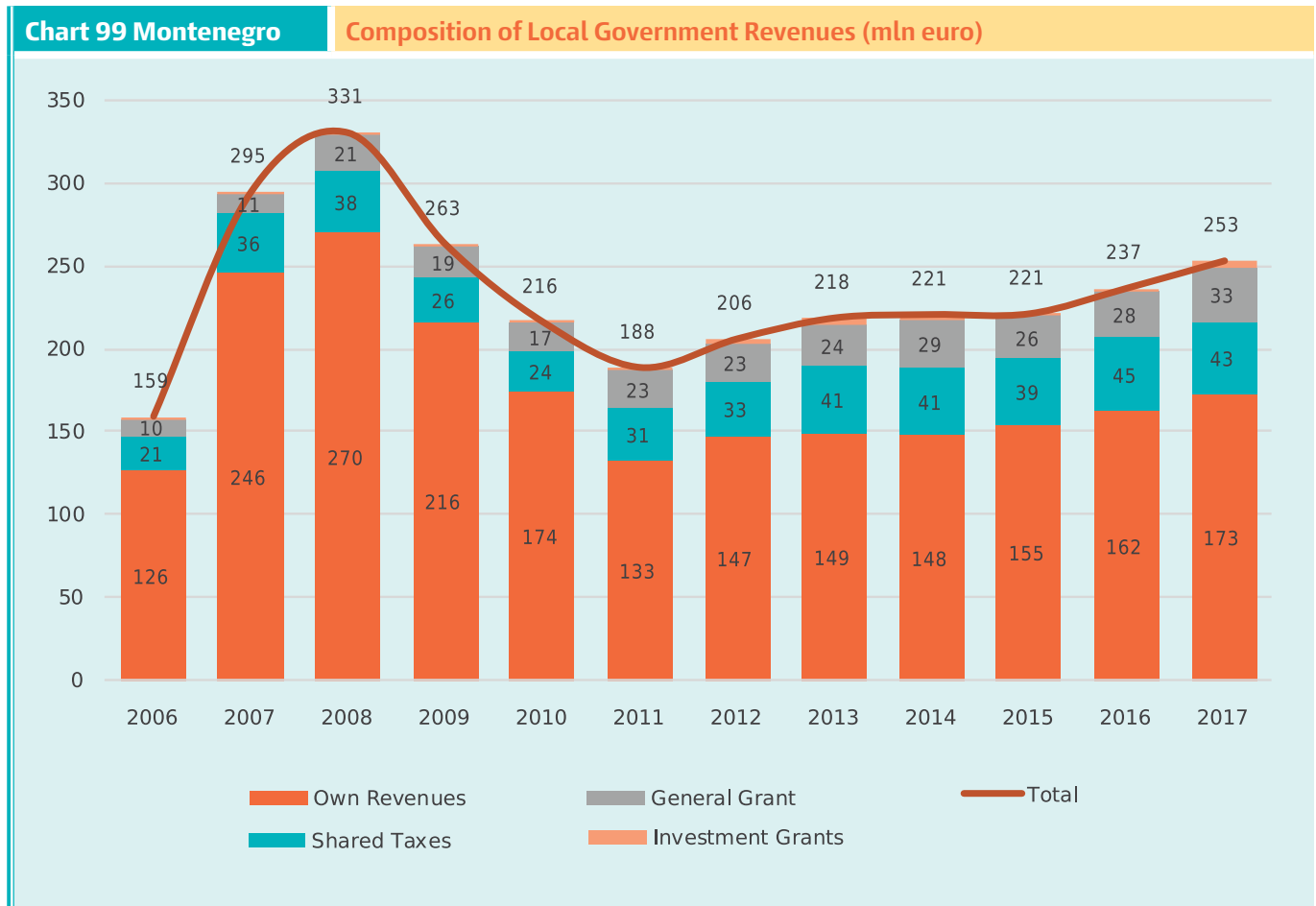


Chart 100 Montenegro

Composition of own revenues 2006-2017, in % of the total

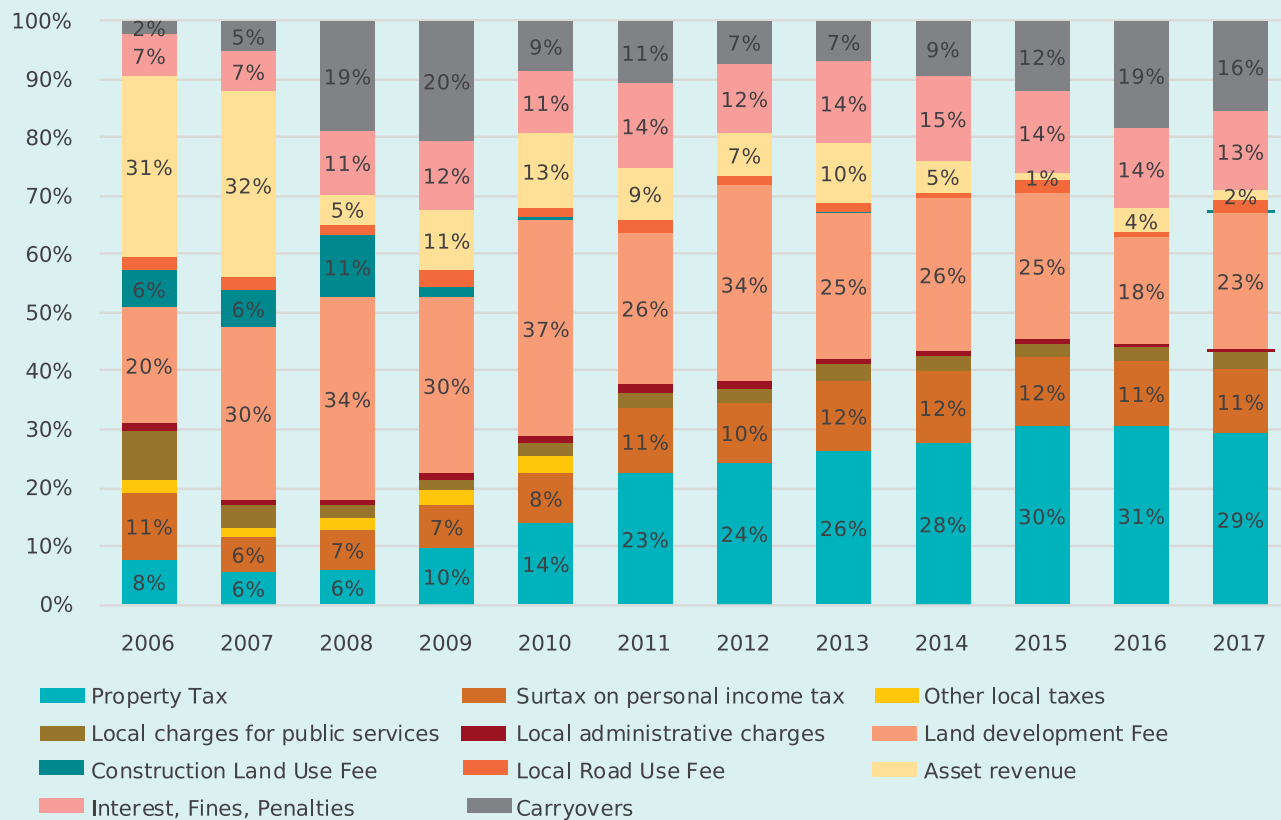
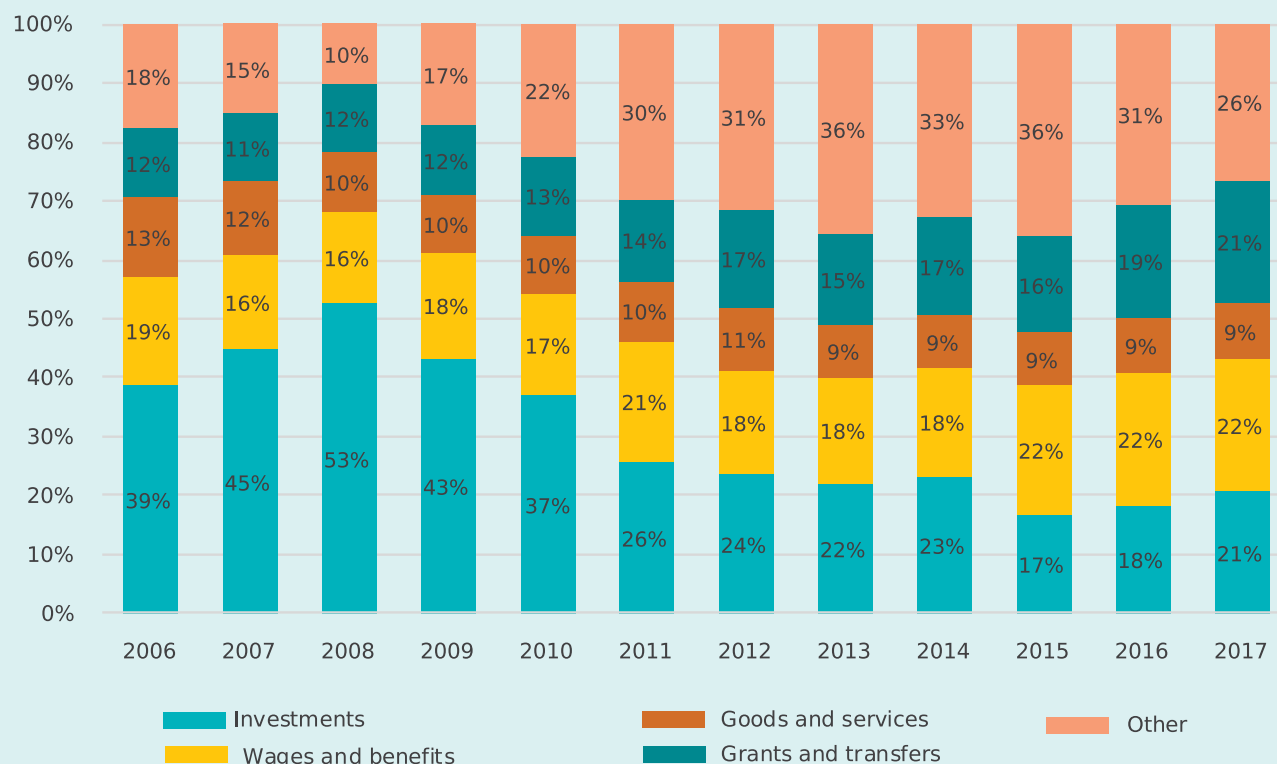




Chart 101 Montenegro

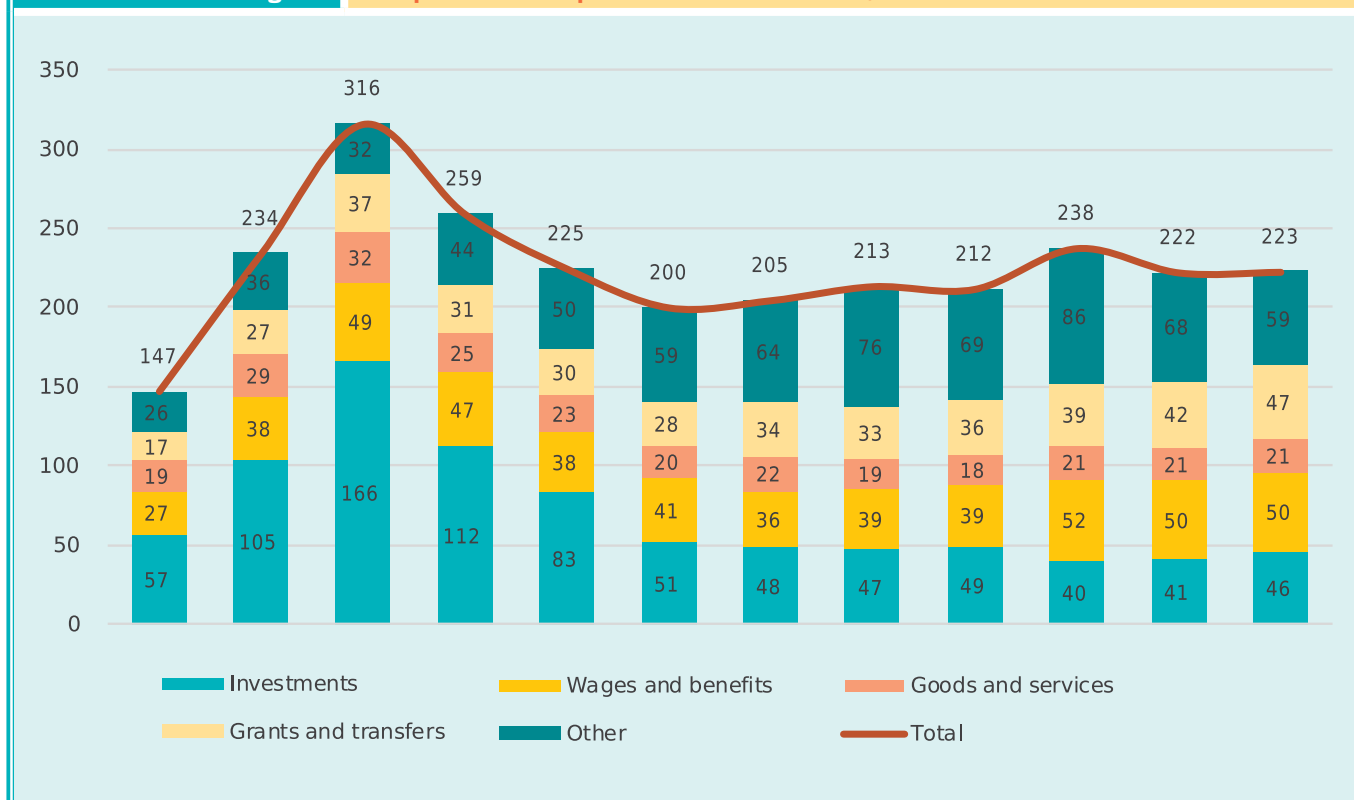
Composition of expenditure in 2006-2017, in % of total



The economic downturn led to a sharp contraction in public sector investment between 2008 and 2013, which again dropped in 2015. But while total public investment recovered somewhat in 2014 and 2015, the share coming from municipalities continued to decline (except in 2016).

Local governments have responded to the economic downturn and the policy changes discussed above by raising the property tax, lowering investment and increasing borrowing. Local debt to GDP increased to above 5% in 2013 creating unsustainable pressures on already weakened local

Chart 102 Montenegro Composition of expenditure in 2006-2017, in mln Euro



finances. Most municipalities simply did not have enough revenue to finance all their obligations to banks, suppliers and the state budget, which required an emergency intervention by the Government of Montenegro, the relevant ministries, municipalities and the UoM. As the result of all measures taken between 2014-2016, the debt service payments were contained and the share of local debt to GDP started to decline although a slight increase can be noted between 2016 and 2017.

Local investment as % of total public investment has fallen from 59% in 2006 to only 15% in 2017. By the same token, local investments to GDP decreased from above 5% in 2008 to 1% in 2017. The share of the local wage bill to GDP has decreased as well when compared to the pre-crisis levels, also because of the inability of some municipalities to pay all taxes and contributions on salaries.



Chart 103 Montenegro

Public Investment by level of Government and as a share of GDP 2006-2017

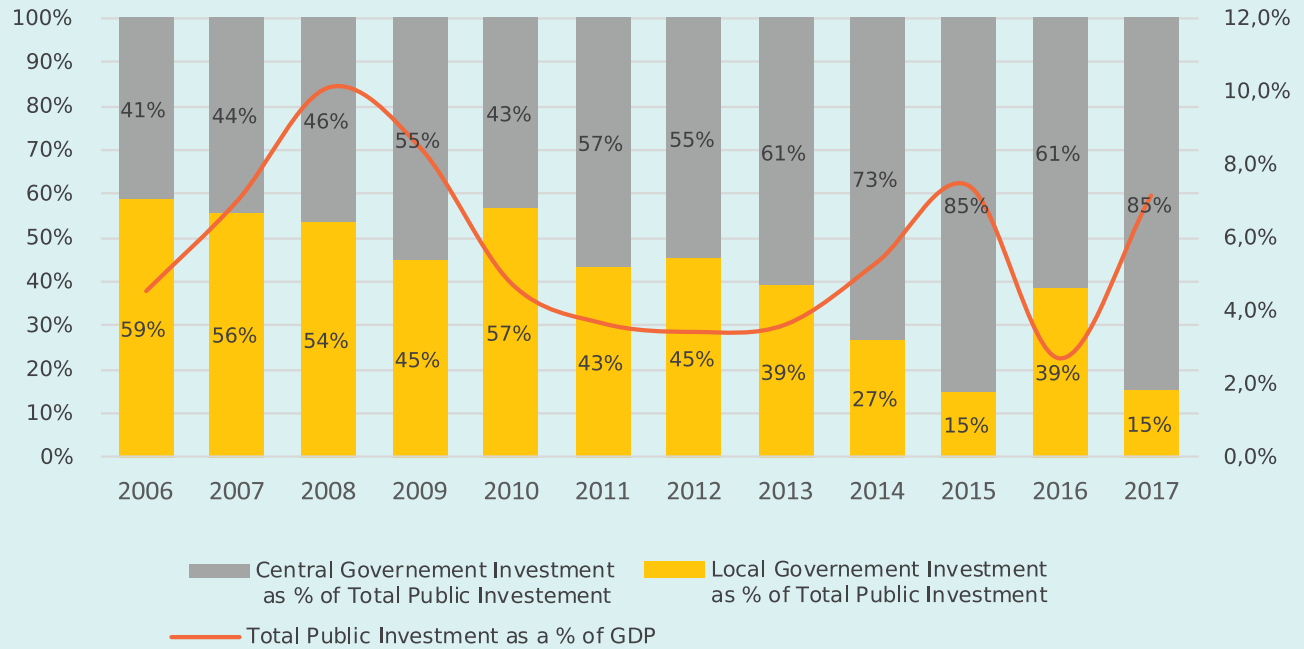
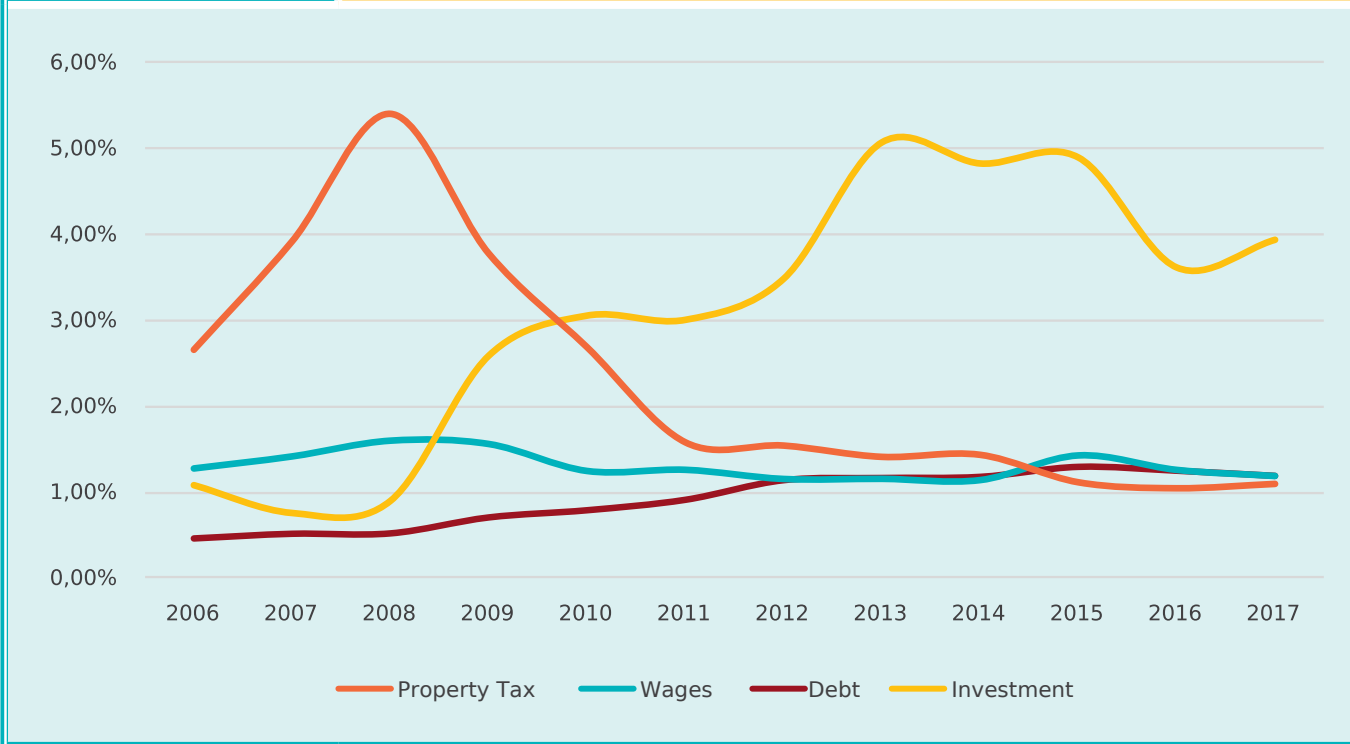


Chart 104 Montenegro

Investment, Wages, Debt Service and Property Tax as a share of GDP 2006-2017



Romania

By Radu Comsa and Adrian Miroiu-Lamba, Association of Communes of Romania

The Intergovernmental Finance System

In Romania, the system of intergovernmental transfers is made of a cluster of financial flows from the state budget to the 3,228 local budgets, which serve several main purposes: (i) vertical equalization (i.e. ensuring resources for the delivery of shared and exclusive responsibilities); (ii) horizontal equalization (i.e. setting a level playing field for all local governments by compensating

poorer ones for their lack of revenue generation capacity); (iii) financing delegated responsibilities (i.e. functions in which local governments act as agents of central government) and (iv) contribution to local governments investment expenditure.

The composition of the intergovernmental transfer system, as of 2017, is illustrated below:

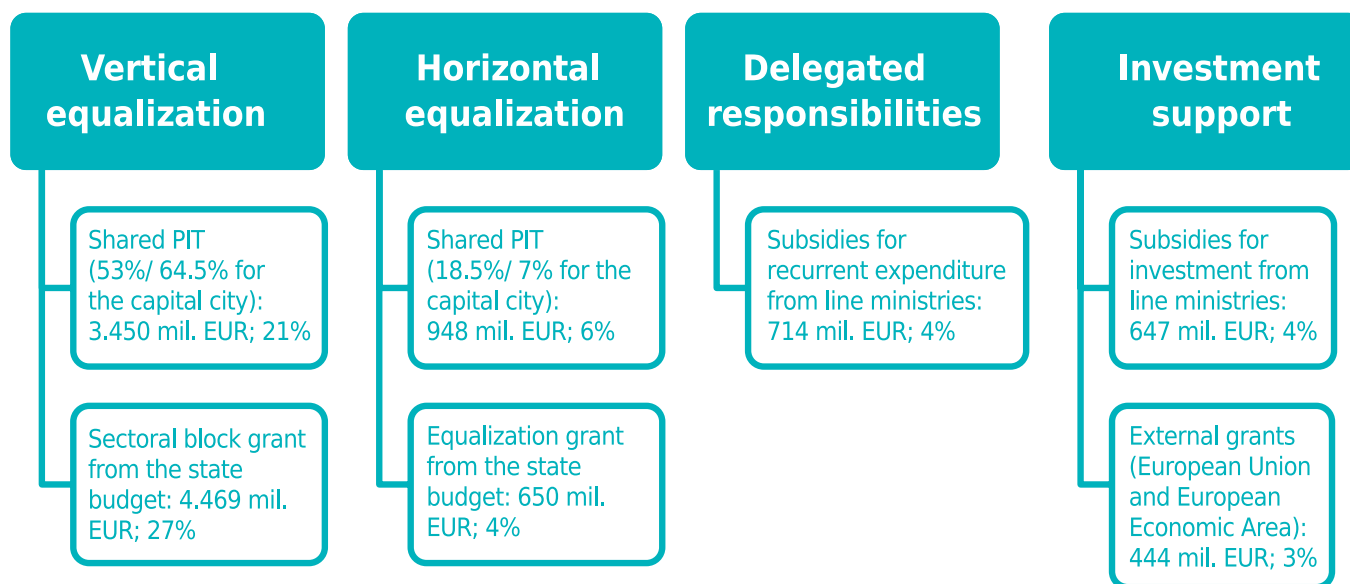


Figure 1 - Intergovernmental transfers to Romanian local governments in 2017 (mil. euro and share of total revenues) (source: MoF)

As of 2017, intergovernmental transfers accounted for 70% of local government revenues, totaling 11.3 bn. euro. The biggest was the sectoral block grant earmarked mainly for expenditure in education and social services (27% of total revenues). The second category was made of shared PIT allocated on derivation basis (21%). The two budget flows aimed at horizontal equalization follow next (10%). In the realm of investment transfers, the flows from the national budget made 4% of total revenues, while EU grants accounted for 3%. The latter is expected to rise in the following years, as new EU co-funded projects enter the implementation phase. In all, intergovernmental transfers equaled 6% of GDP in 2017.

The share of intergovernmental transfers in total local government revenues was stable over the last four years. Throughout, as the EU-grants declined steeply from the 2015 peak, the state budget sector grant and subsidies linked to payroll or social allowances increased rapidly as a result of successive pay rises awarded in the Romanian public sector since 2015.

The annual sizing of intergovernmental transfers in the state budget or the ministries' budgets depends on the calculation method, as shown below:

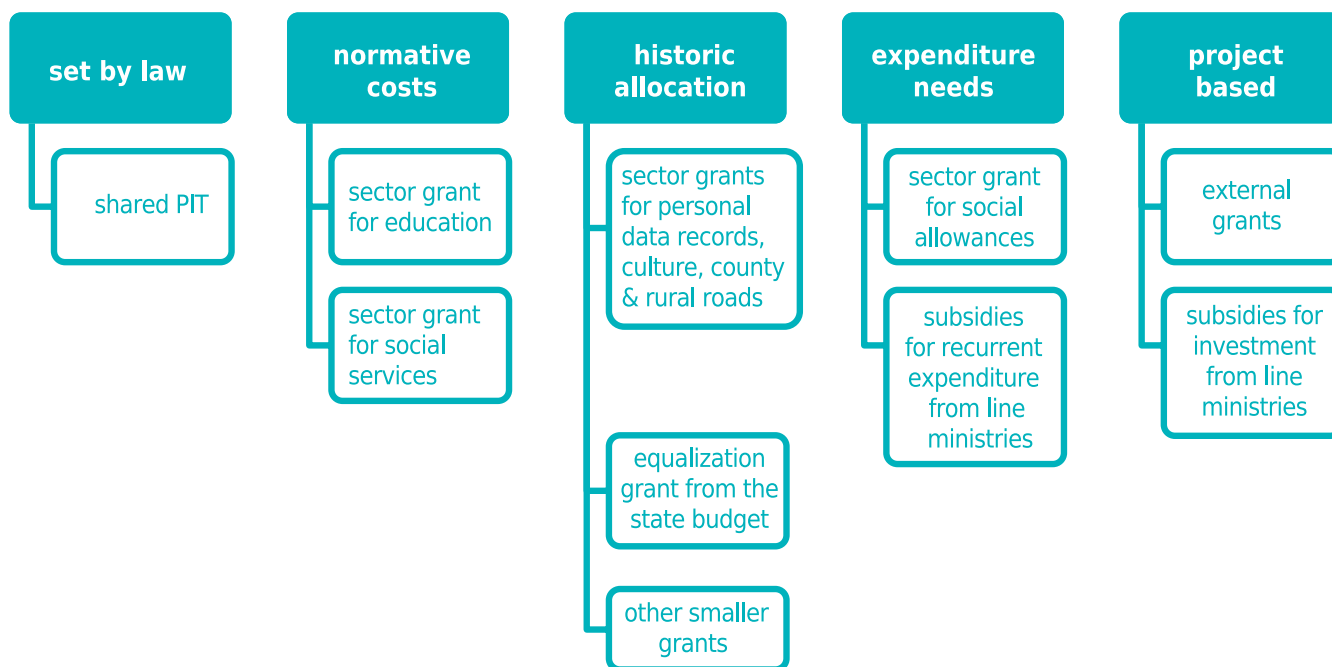


Figure 2 - method of calculation for intergovernmental transfers, as of 2017

As a result of the calculation method, yearly variations of the intergovernmental transfers depend on changes to the underlying legislation, such as wage policy, tax base and rate of PIT or value of social allowances. For example, pay rises in pre-university education in 2016 determined a 12% increase of the education grant in 2017. The allocation of intergovernmental transfers to individual local governments is determined at county level (41 counties plus capital city, Bucharest), for the sector block grant, and central level, for subsidies

and external grants. The calculation is carried out by the Ministry of Finance's deconcentrated services or by line ministries (for subsidies), respectively, employing different criteria. Most resources are allocated to local governments using some sort of quantifiable criteria, either number of beneficiaries or a formula (3/4 of all intergovernmental transfers) (see Figure 3). Investment contracts determine the allocations for investments, while historic allocations are decisive for the remaining transfers.

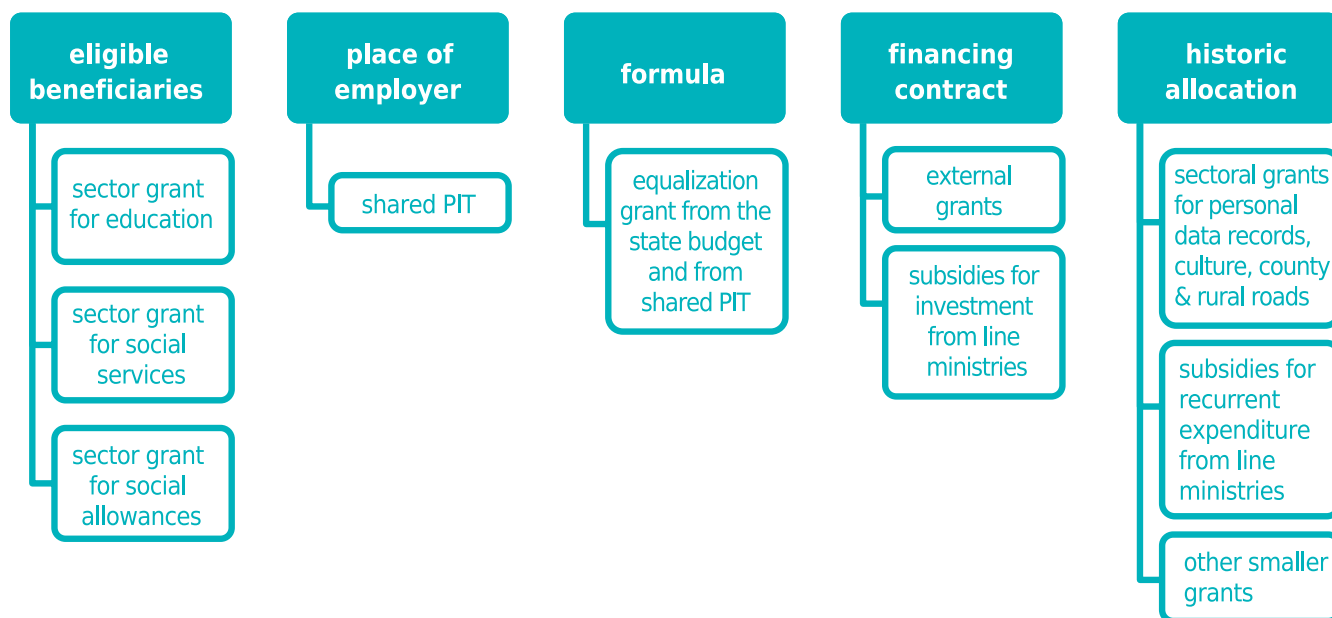


Figure 3 - allocation criteria of intergovernmental transfers, as of 2017

Intergovernmental transfers have been a constant feature of Romania's intergovernmental fiscal relations as the allocation of responsibilities exceeded the own revenue generation capacity of local governments. During the economic crisis of 2009-2012 the central government attempted to rationalize expenditure by setting normative costs as criteria for the calculation of education and social services grants. While this aim was correct, the efficiency gains were precluded by (i) delays in structural reforms (in education, school closure remains complicated, redundancies are impossible, while school heads continue to be appointed by the Ministry of Education), (ii) shortcomings of the allocation flows to individual local governments (in education, schools with funding shortages get additional resources on top of the normative costs allocations by ah-hoc decision of MoF and Ministry of Education deconcentrated services) and (iii) delays in the update of normative costs (in social services, the normative costs do not reflect the pay rises awarded to employees in recent years; as a result, Government puts additional ad-hoc resources to the respective sector grant with each state budget rectification).

In addition to the failure of normative costs, several additional flaws hinder the effectiveness of the

intergovernmental transfers system. The current set-up is too fragmented, especially with regards to subsidies for recurrent and capital expenditure (no less than 37 line-items in 2017). Furthermore, the all the resources allocated within the sector block grant and subsidies are earmarked. Instead of giving local governments allocative autonomy in exchange for performance accountability, the Government and Parliament are micro-managing the utilization of intergovernmental transfers and pay little attention to local preferences. A growing problem in recent years has been the practice of suspending the application of the statutory equalization formula provided by the Law on local public finance. Since 2015, the state budget laws have included provisions which derogated from the Law on local public finance and replaced the formula with other allocation criteria, leaving more room for political interference from county councils. Finally, the issue of unfunded mandates continues to impair the quality and access to local services. For example, each year local governments complain of the insufficiency of sector grants allocated for payroll of assistants to disabled persons; as a result, own revenues are used to complete the respective payroll needs and thus to fulfill a delegated function from central government.

Local Government Own Revenues

Romanian local governments' own revenues consist of local taxes, user charges, fees, asset revenues etc. In 2017, they amounted to 28% of all revenues, i.e. 2.2% of GDP. The high share of own revenues is due primarily to the hospital fees from the National Health Insurance House and the Ministry of Health, which totaled to 2/5 of all own revenues. These are earmarked for use in hospitals.

Local taxes come second among own revenues amounting to 9% of all local government revenues, namely 0.8% of GDP. Property taxes – on buildings, land and motor vehicles – make the biggest part of local taxes (0.75% of GDP in 2017).

All local taxes, including property taxes, are regulated by the Fiscal Code with national application. The current provisions have been in force since

2016. All tax administration duties – from tax setting to collection – are carried out by local governments where taxed item is located.

The tax value of properties is not related to the market value. Instead, for buildings owned by natural persons, the tax value is determined by multiplying area with predefined values and coefficients related to physical characteristics and location. For buildings owned by legal persons the tax value is either the accounting value, the construction value or the transaction value. The tax rate is applied differently for buildings owned by natural and legal persons. The law provides a range from which local governments chose the applicable tax rate, namely 0.08% to 0.2% for natural persons and 0.2% to 1.3% for legal persons. For land, the tax is determined by multiplying area with predefined values and coefficients related to location and land use. For motor vehicles, the tax is determined based on the engine volume: the bigger the engine capacity the higher the tax per unit measure. Local governments are free to increase the property tax due beyond the limits set by the Fiscal Code by up to 50%. In the case of unfarmed land and derelict buildings the tax owned may be increased up to five-fold.

Taxpayers are owners of buildings or land. In the case of publicly owned property which is rented or given to concession, it is the occupier who pays the tax. The legislation provides for numerous exemptions from the property tax. As a rule, public property is not taxed unless used for economic activities. In addition, public infrastructure of any kind, educational, religious and healthcare facilities, as well as residences of disabled and impoverished persons are tax exempt, too. A series of tax reliefs may be granted by the local government (i.e. to historical buildings, buildings occu-

ried by social services providers etc.).

The tax calculation is performed every year by the local government where the property is placed. The local government also sends the tax bills to payers and manages tax collection. An abatement of 10% is provided by law if the tax is paid before due date. Payment methods vary from cash or electronic card at the tax administration desks to online payments or bank transfers. There is a national portal for online payments, www.ghiseul.ro, which has failed to become popular because of complexity and lack of awareness.

In case of non-compliance, the local government sends summons and then begins the forced execution procedure, which consists of garnishment of bank accounts, seizure and eventually sell-off of the respective property. Oversight of tax administration is ensured ex-post by the Court of Accounts. The Ministry of Finance and Ministry of Regional Development and Public Administration provide technical support. Dissatisfied owners may appeal the tax bill at the tax administration or at the Administrative Court.

The biggest challenge faced by local governments in tax administration is collecting tax due from earlier years. They manage satisfactorily the collection of dues arising in the current year, but are very slow to clear historic dues, which account for around 50% of all receivable property tax. One of the major barriers in this respect is the fragmentation of databases. Each local government uses tailor-made fiscal registers which are not interconnected. In addition, connectivity with State Tax Administration, Land Registry, Motor Vehicles Registry and notaries is irregular and depends on local initiatives.

The spread of online payment is still small. While recent data is not available, a study by Expertfo-

rum for VISA Romania in 2013 found that only 1% of taxes had been paid online²⁸. Fragmentation is again a significant hurdle: in addition to a national portal for tax payments, most big municipalities have set proprietary online payment systems. Lack of awareness, the slow distribution of users and back-office complications contribute to the inadequate penetration of online payments.

Finally, property tax valuation is in need for modernization. The current system dates from communist times when transactions and information were scarce. As a result, tax values are significantly below transaction prices and, hence, local governments miss the opportunities provided by the continuous expansion of the housing market.

Against this backdrop, the principal recommendations put forward with regards to property tax administration in Romania are the following:

1. Achieve interconnectivity between all local governments' tax registries, relevant central government registries (State Tax Administration, Land Registry, Motor Vehicles Registry) and notaries.
2. Carry out a national campaign to increase awareness of online tax payments. Simplify procedures for registration and solve back-office difficulties (especially in relationship with the Treasury). The example of creating a single treasury account for fine payments is a good place to start.
3. Change the tax valuation to a market-based system. Current information flows offer enough data on real estate transactions to enable a market-value tax setting mechanism. A gradual implementation and pilot projects could offer practical solutions and anticipate difficulties before the roll-out at national level.

Main Developments in Local Governance and Municipal Finance and Advocacy Efforts of the Association

From January 1st, 2018, two important changes were implemented with significant implications on local government finances. First, the payment of wages to teachers was taken over by the Ministry of Education, following demands of trade unions. Previously, local budgets had been providing schools the necessary budget as part of the normative cost per pupil. The centralization was decided by Government Emergency Ordinance without a due public debate and must be renewed in the coming years. Local governments will continue to receive the education sector grant for overhead expenditures to which they are required

to add from their own revenues. From a budgetary point of view, the change had implications on the size of the education sector grant, which was diminished by 90% as compared to 2017, namely by 1.3% of GDP. As a result, the share of local governments in GDP will drop to around 7.5% in 2018. From a structural point of view, the fragmentation of financial flows will diminish even further the responsibility of local governments for school network rationalization and is likely to bring a complete stop to reforming school capacity, despite the continuous drop of pupil numbers across the country.

²⁸ The study was not published. The underlying data isn't public either.

Secondly, the formula for determining equalization transfers at county level provided by the Law on local public finance was again derogated from and replaced with a mechanism of decision-making by county councils based on loose criteria, which increases political interference in allocations and discourages tax collection performance. The full impact of the new policy is yet to be assessed.

The association has warned publicly against the two measures stating the need for the continuation of school network reform and for fair allocation of equalization funds based on objective and transparent criteria. It pointed that the equalization system would be more effective 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 some wealthy counties.

A third policy change with impact on local budgets was implemented in mid-2017. The new public-sector wage law has provided local governments with more flexibility over setting wages of own employees. The new policy has immediately prompted a series of pay rises in local governments' executive bodies which, alongside similar measures in education, social services and healthcare, resulted in a 30% growth of local government 2017 payroll as compared to 2016. The impact in 2018 will be even more significant. By mid-2018, average wages in city halls and county councils were 80% higher than in mid-2016 (source: Ministry of Finance). The new wages' impact on local budgets is yet to be fully assessed, but they will undoubtedly divert funding away from other expenditure items such as investment, which, on the medium term, may have negative implications on infrastructure and service quality.

Statistical Overview of the Finances of Local Governments in Romania 2006-2017

Throughout 2014-2017, the size of Romania's public sector revenues in GDP contracted from 32% to 30.4%, following a series of tax cuts enacted on VAT, PIT, excises taxes and social contributions. As a result, local governments' relative weight in GDP went down from 9.4% to 8.7%. The trend was reinforced by the phasing out of EU grants pertaining to the 2007-2013 budgetary framework. However, the share of local governments in general government has remained constant to the historical average at 29%, pointing to a general stability of revenue assignment.

Over the last four years, general and local government revenues followed similar paths. The 2016 contraction affected the entire public sector following tax cuts to VAT and excise taxes. The local revenue rebound in 2017 was at the same level as

for the state budget, despite the fact that investment subsidies for local governments decreased by 40% in comparison to the previous year.

The structure of local governments revenues has seen variations in the last four years but did not change structurally. Own revenues, shared taxes and the sector block grants have been the biggest components with 28% each. The high share of own revenues is due to hospital income from the National Health Insurance House and the Ministry of Health, which counts as fees for services. The share of other grants (stat budget subsidies and EU-grants) has fluctuated in line with EU grants availability (from a peak of 22% in 2015 to 13% in 2017). In 2018, it is expected that the share of the sector block grants to drop significantly, following the centralization of education wage payments.

Chart 105 Romania

Local Government Revenue as a Share of GDP and Total Public Revenue 2006-2017

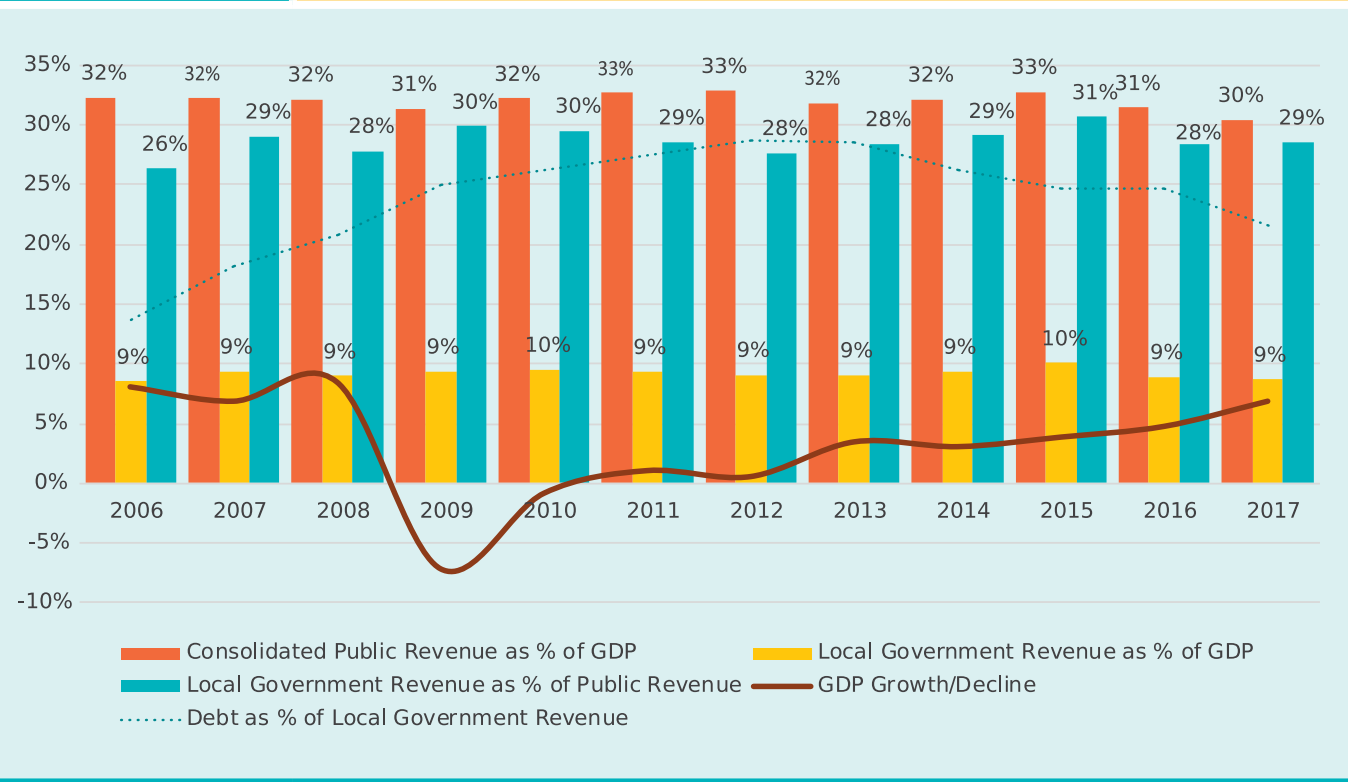
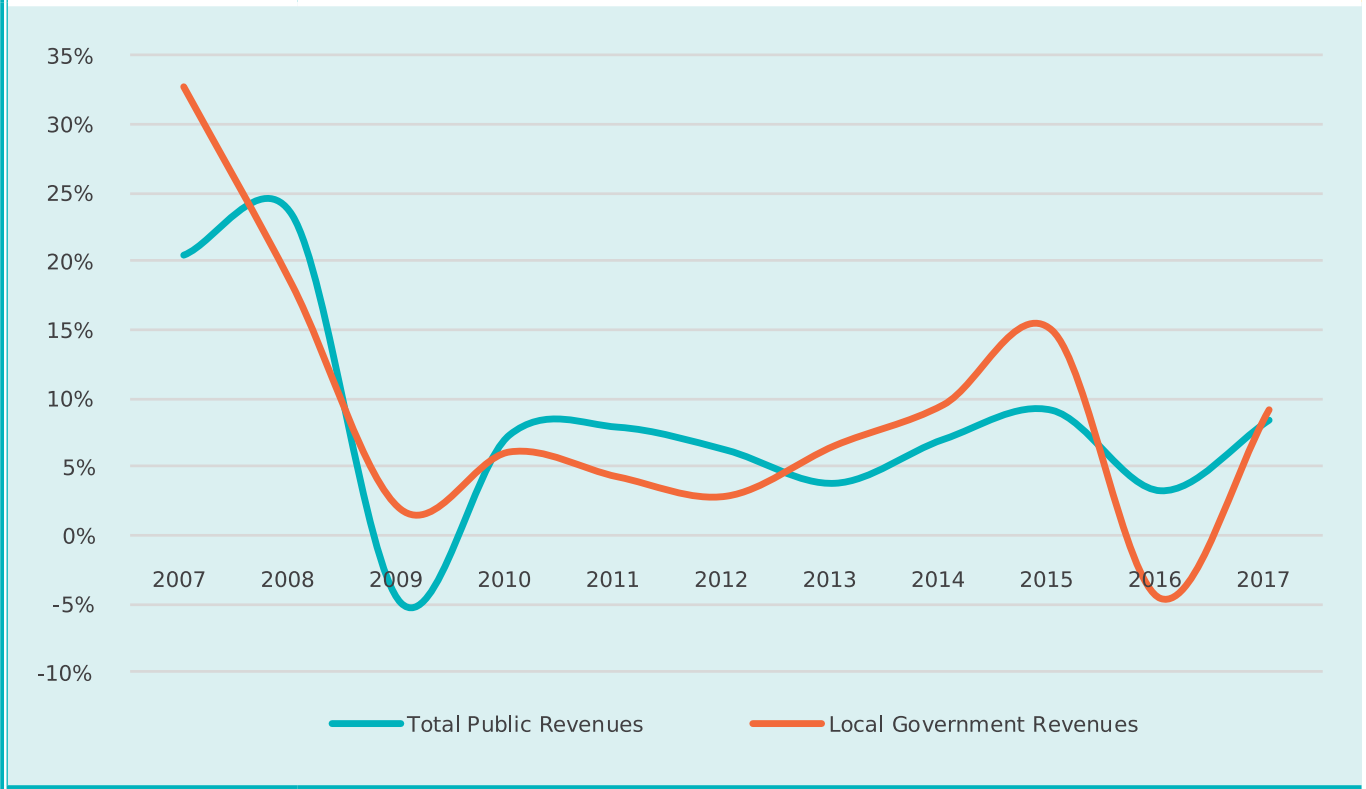




Chart 106 Romania

Annual Fluctuations in the Revenues of the General Government and Local Governments



Overall, local government revenues in 2017 were 16.2 billion Euro, up from 15.2 billion Euro in 2016.

In per capita terms, local government revenues in 2017 were 831 Euro per inhabitant, up from 778 Euro per inhabitant in 2016.

Almost half of local governments' own revenues is made of hospital fees for services. Apart from that, the share of property taxes has been stable while communal fees and charges went upwards following improvements in the collection of fines and the growth of income from municipal property (rents and concessions).

Chart 107 Romania

Composition of Local Government Revenues in percent of total

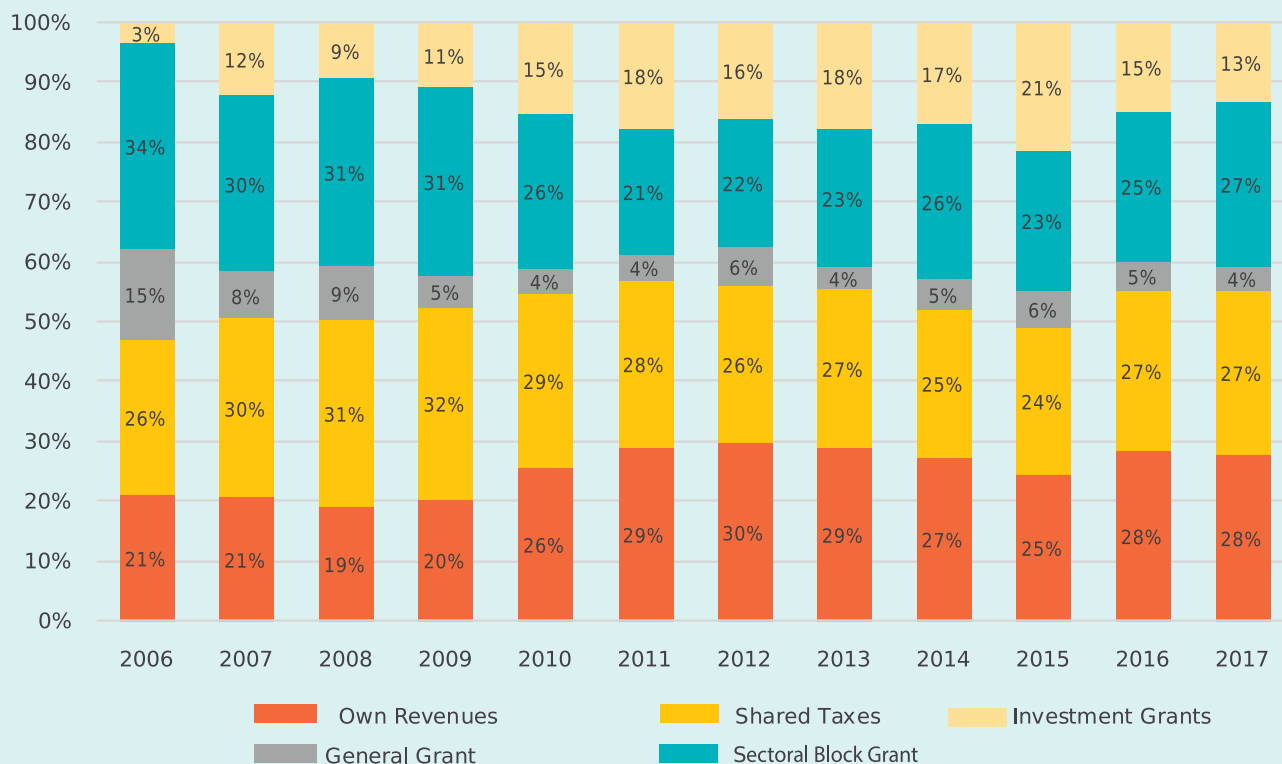




Chart 108 Romania

Composition of Local Government Revenues, in million Euro

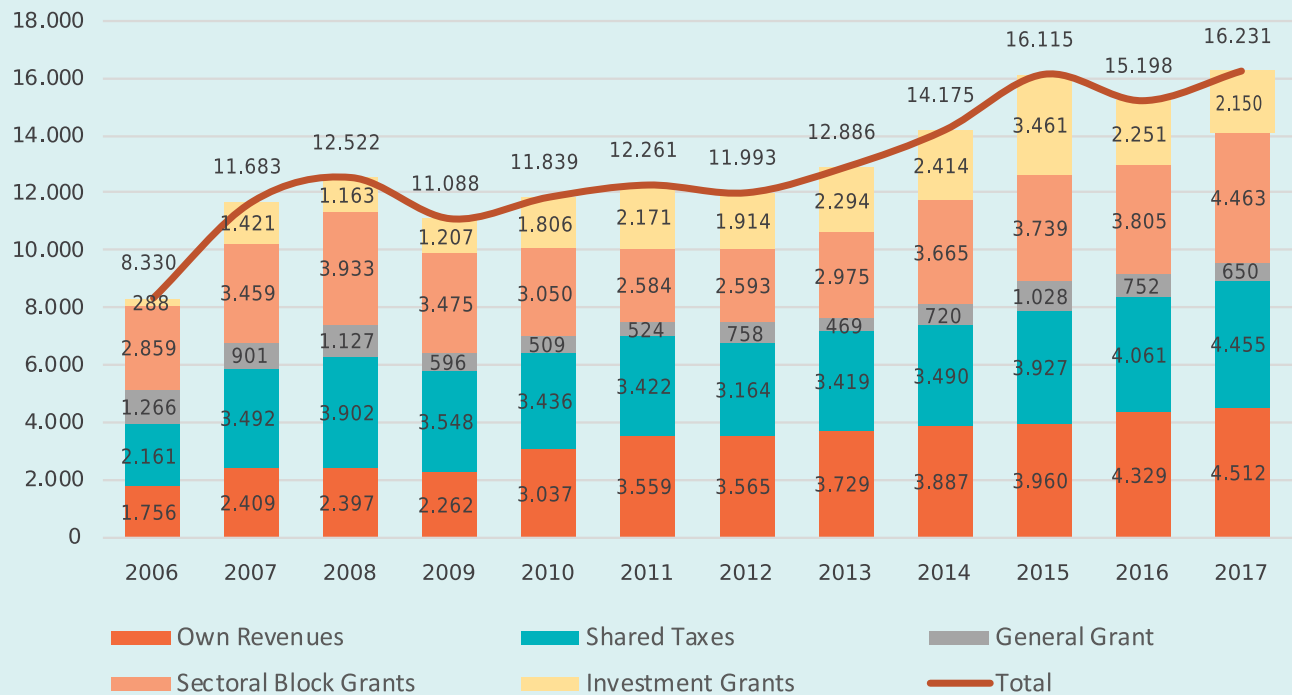
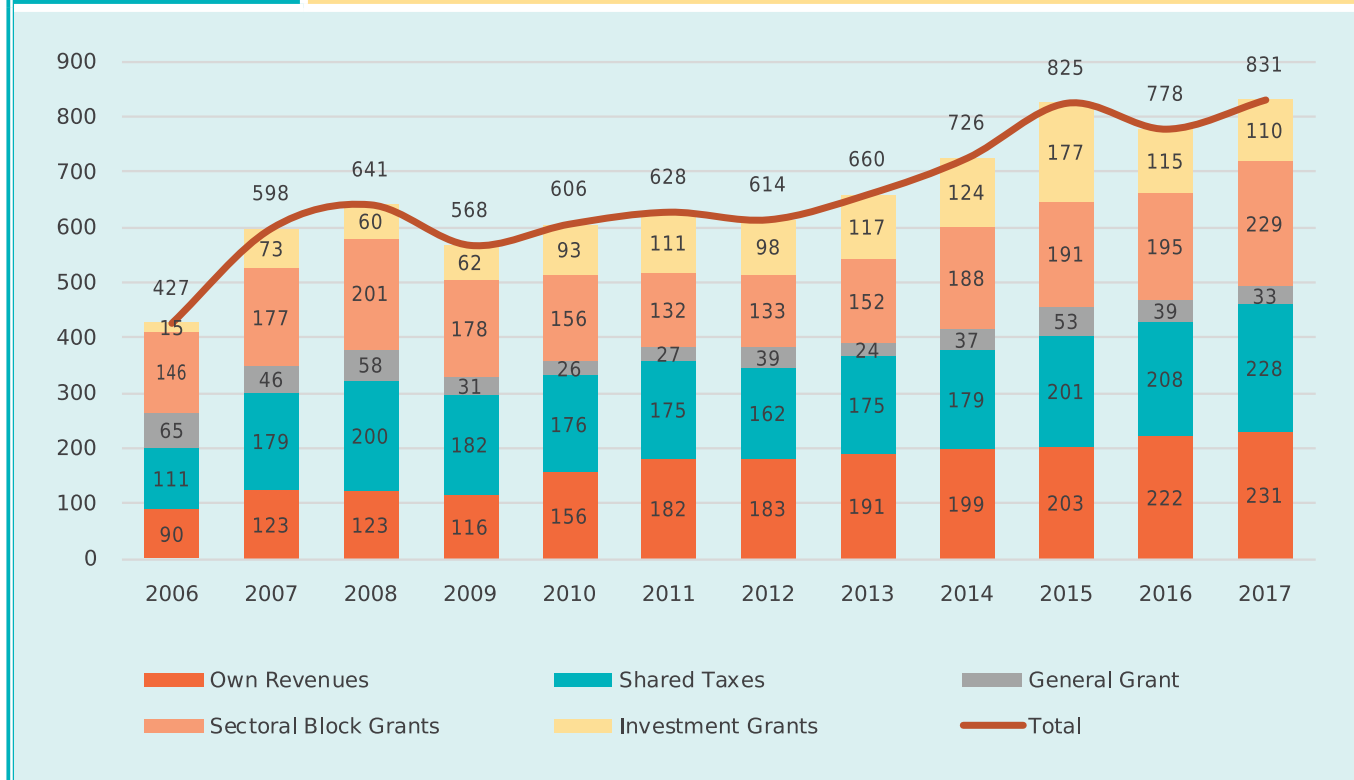


Chart 109 Romania

Composition of Local Government Revenues, in Euro per capita



In terms of expenditure, the most significant change has taken place in the share of spending for wages and benefits (payroll), which has been upwards from 2015, as a result of successive pay rises in education, healthcare and executive bodies. The pay rises have come at the expense of investment, which went down to record levels below 20% of total expenditure.

In nominal terms, the impact of pay rises on payroll has been significant (+40% in 2017 vs. 2015)

and the drop of investment has been important (in 2017 they were below the levels recorded during the economic crisis).

Over the last four years, the property tax revenues as a share of GDP has been constant. It contrasted the expenditure trends, which have seen growth in payroll (to 4% of GDP in 2017) and decline in investment (to 1.2% of GDP). On the positive side, the stock of outstanding local government debt has also been decreasing to below 2% of GDP.



Chart 110 Romania

Composition of Own Revenues, in percent of total

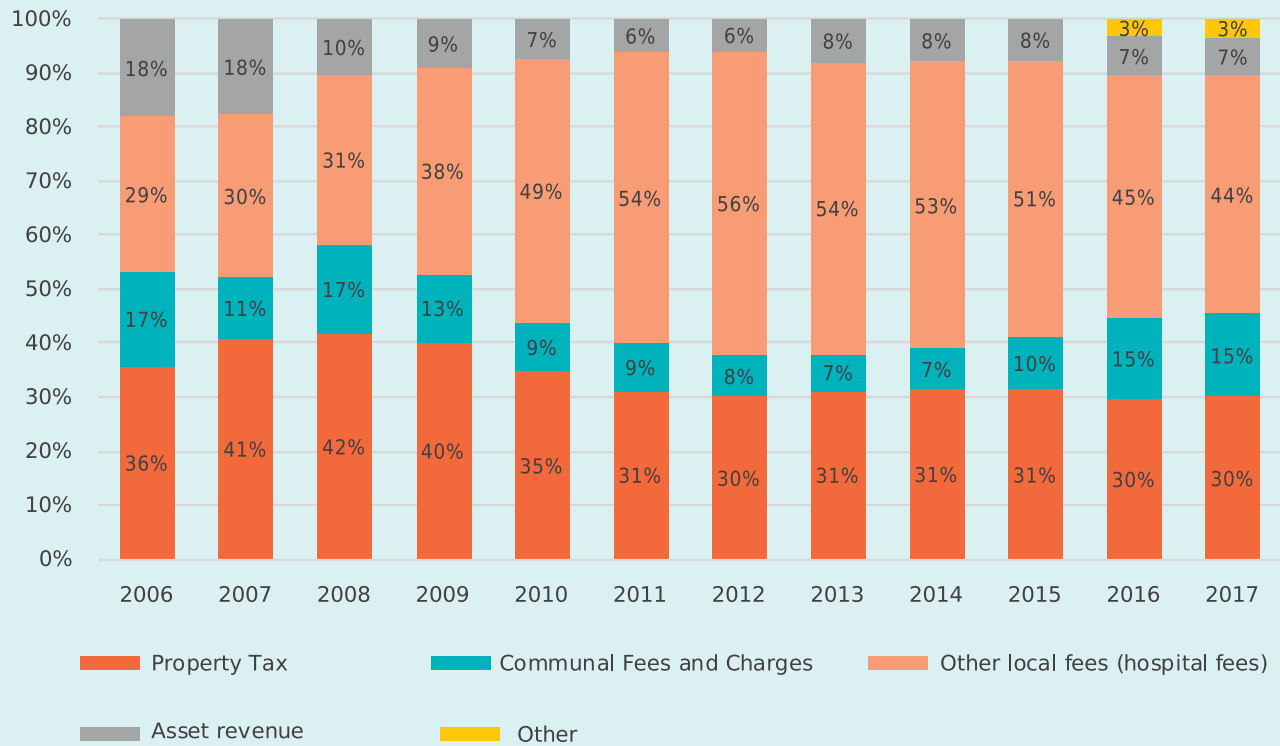


Chart 111 Romania

Composition of local governments' expenditure %

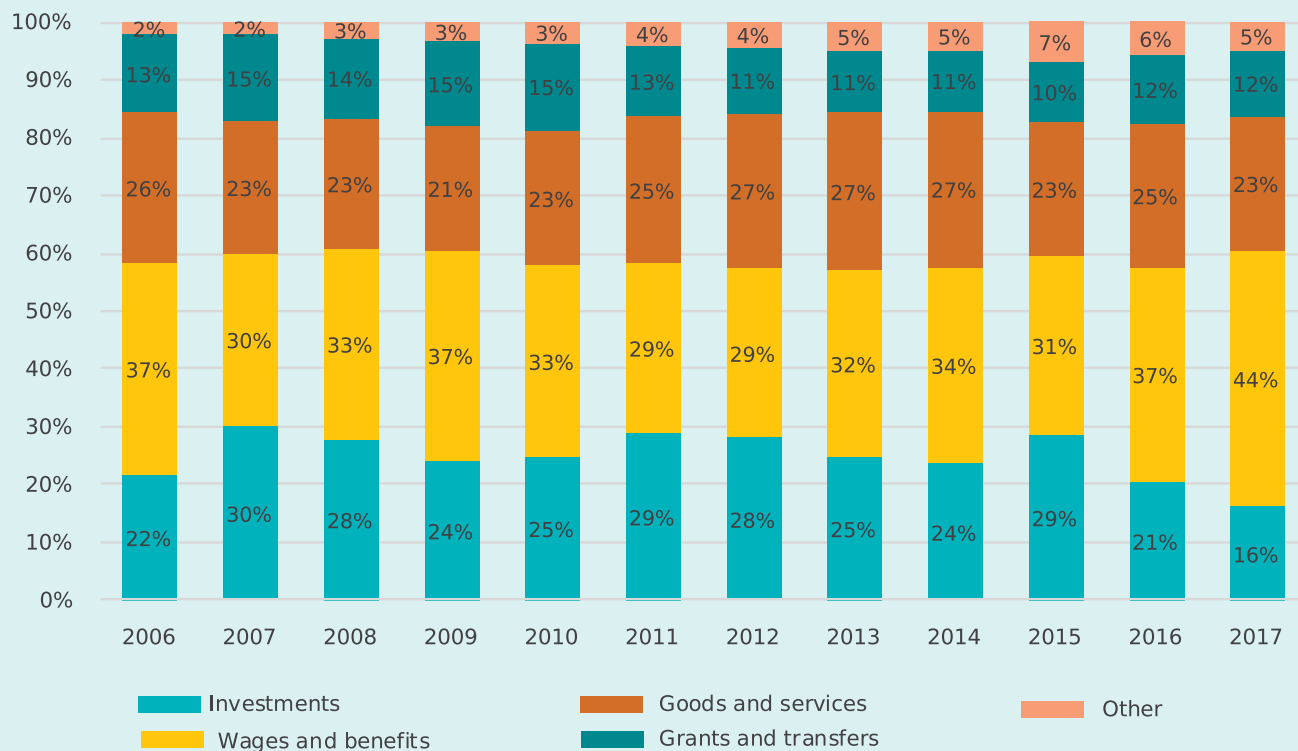
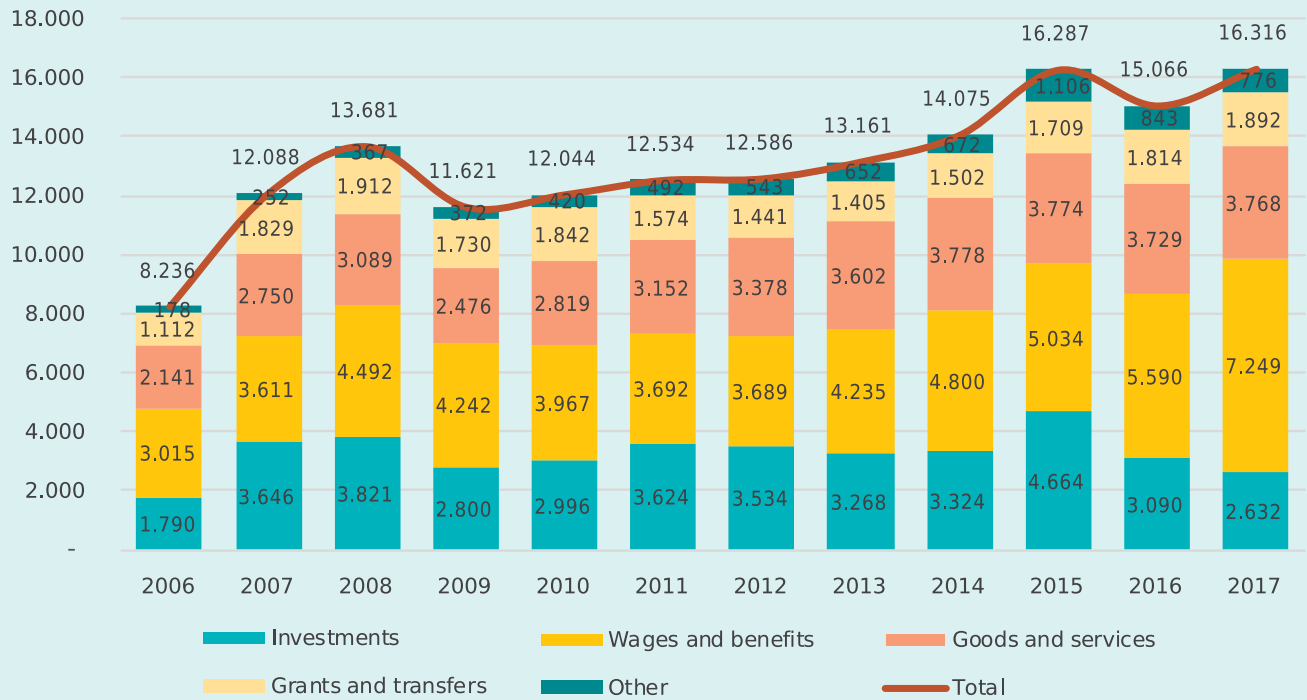


Chart 112 Romania

Composition of Local Expenditure in million Euro



The government's wage policies have led to a growth of social expenditures overall, which has reflected on local governments' spending patterns, too. From 2014 to 2017, the share of education, healthcare and social services in total local gov-

ernments expenditure went up from 49% to 54%. That has come at the expense of investment prone services - transportation, environment, housing and community amenities - which dropped from 34% to 26% as a share in total expenditure.

Chart 113 Romania Composition of Local Expenditure in euro per capita

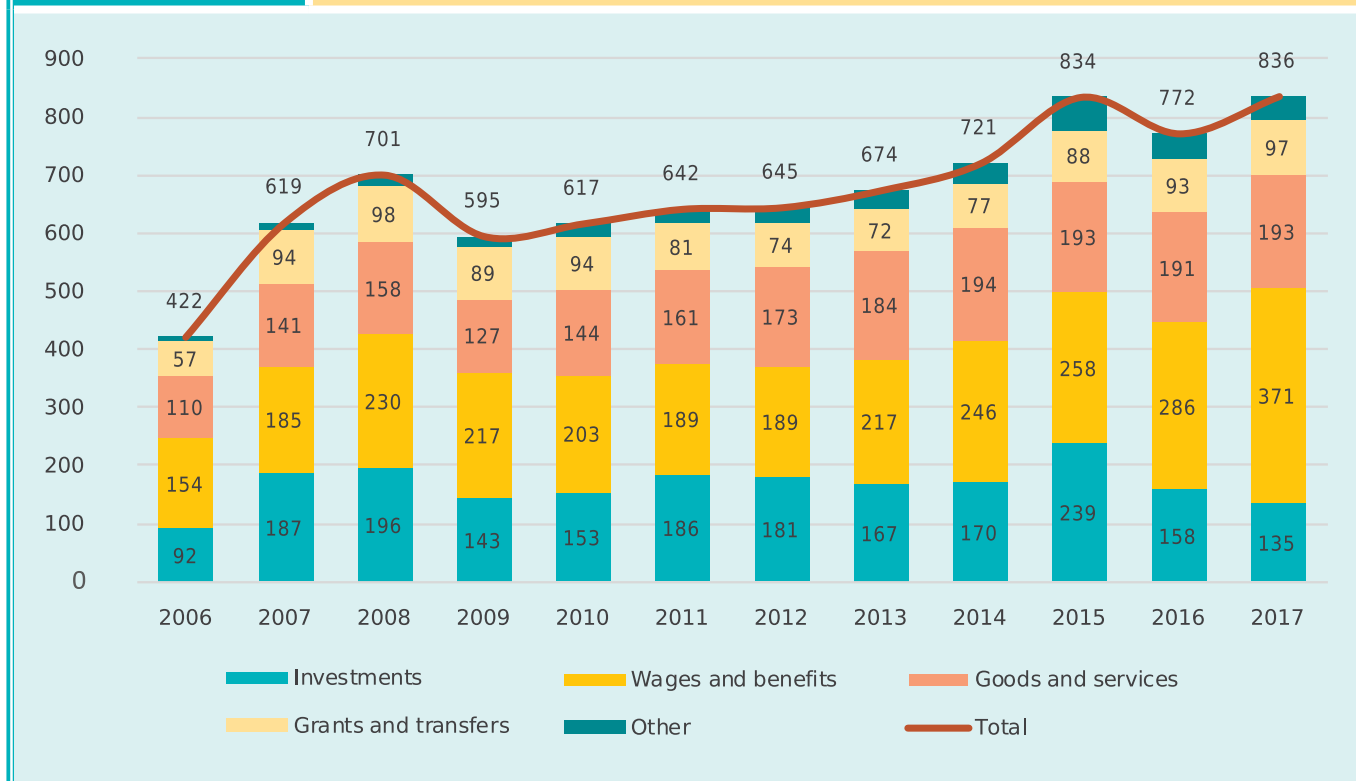




Chart 114 Romania

Trends of selected budgetary indicators as % of GDP

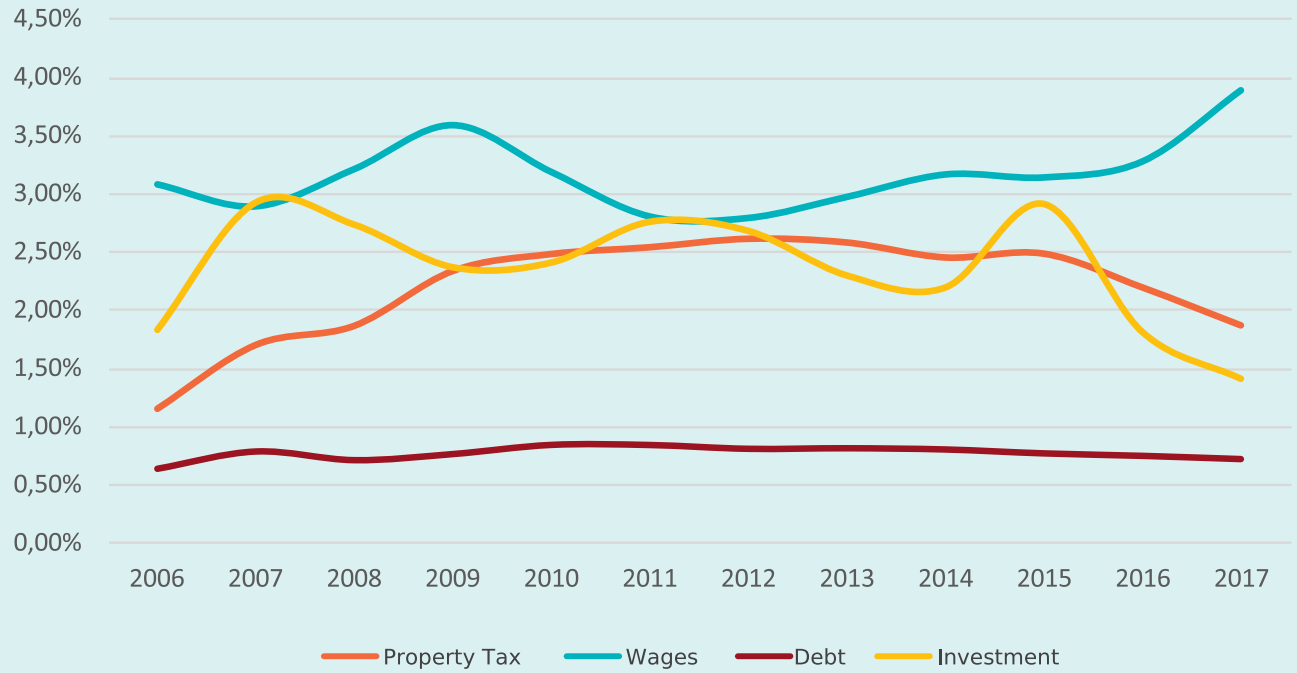
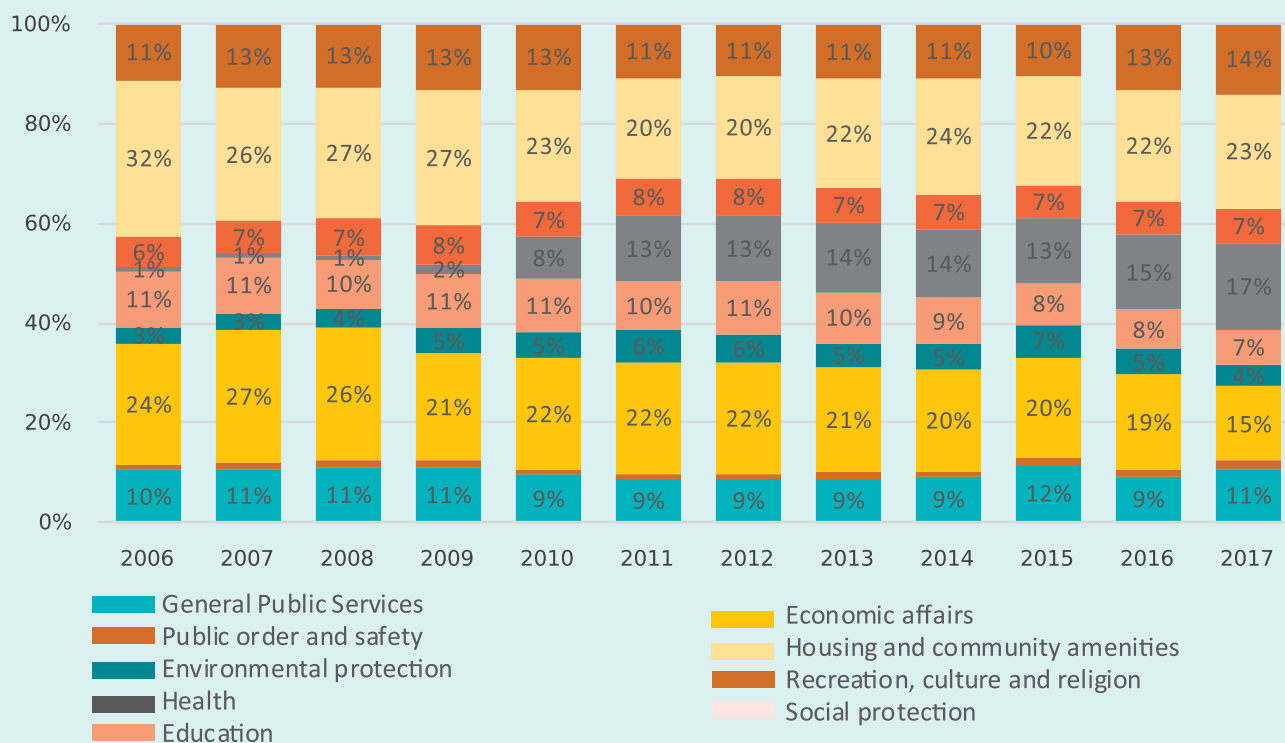


Chart 115 Romania

Functional Allocation of Expenditures (COFOG classification)



Serbia

By Dunja Naić, Standing Conference of Towns and Municipalities

The Intergovernmental Finance System

Serbian local governments are financed according to the Law on Local Government Finance, Law on the Budget of the Republic of Serbia, Law on Budget System, Law on Public Debt, Law on Property Tax, etc. There are attempts, by the Standing Conference of Towns and Municipalities (SCTM) and by the Ministry of Finance to design new solutions for the system. The current Law sets the share of the Wage Personal Income Tax (PIT) local governments receive on an origin basis and regulates the administration and collection of the property tax from local governments, also regulates the determination and allocation of the total pool of funds to be used for both vertical and horizontal equalization across local governments. In 2016, the Law has changed and the percent of the Wage PIT that belongs to the LSGs was slightly reduced.

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

secondary school buildings, number of children attending preschool and number of pre-school buildings. The general transfer thus has an equalizing effect, independent of the equalization grant.

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

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

Own Source Revenues in Serbia are regulated by the Law on the Property Tax, the Law on Tax Procedure and Administration, and the Law on Local Government Finance. Until 2007, the tax was assessed, collected and enforced by the national government, but its yield was returned to local governments on an origin basis. With the passage of the Law on Local Government Finance, local governments were made responsible for administering the tax and were given the right to set tax rates within limits set by law. The Law on Property Tax defines the types of properties subject to taxation, who is liable for the tax, as well as the rules governing exemptions and abatements. The Law on Tax Procedure and Tax Administration regulates the assessment, collection and control of public revenues and regulates rights, responsibilities of taxpayers, their registration, tax offences and sanctions.

In 2012, the legal framework was amended again, this time significantly limiting some local communal fees like the business sign tax and eliminating

others like the local motor vehicle fee. Meanwhile, the national government raised all taxes that accrue to the central budget, including VAT, the capital income tax, excises, and social contributions. In June 2013, the government reduced the rate of the wage tax from 12% to 10% while increasing the threshold for non-taxable income. These changes led to a direct loss of local revenue of about EUR 200 million. At the same time, the government increased the rate of payroll taxes for social contributions from 22% to 24%, basically transferring what it had taken away from local governments to the National Pension Fund. Finally, on January 1, 2014, the government eliminated the Land Use Fee, the second most important source of own-revenue with the idea to integrate it in property tax. The amendments of the Law on Property Taxes brought a significant increase in property tax collection in 2014. On the other hand, Land Development Contribution (the previous Land Development Fee) is still one of the important own-sourced revenues.

Main Developments in Municipal Finance and Advocacy Efforts of the Association

Law on Local Government Finance

The Standing Conference of Towns and Municipalities continues to work towards amending the Law on Local Government Finance in order to return it to its original principles. Efforts began in the first half of 2014 when the Ministry of Finance created a working group and drafted a new law, with solutions that were harmful to local governments, among others, the proposal to cut local governments' share from the Wage Personal Income Tax from 80% to 50%, meaning that only 50% of the revenue would belong to local level and the remaining 50% would go to central level. Repre-

sentatives of cities and municipalities within the association, agreed that the Draft Law is entirely unacceptable and requested from the Ministry to withdraw the document and revise it in cooperation with local representatives and the wider public. The Standing Conference stated that it is not possible to accept a reduction of eight billion dinars (65 million EUR) in local revenue and that such reductions would jeopardize the functioning of local government. The central government stated that this measure is necessary and in line with the recommendations of the Interna-

tional Monetary Fund but the association argued that the local governments in the past year effectively “saved” this amount, from the surpluses in the local budgets in 2014, which occurred due to the decreased wages and salaries, imposed by the central level. SCTM conducted a strong campaign against the negative consequences of the proposals. In the SCTM General Assembly held in December 2015, mayors unanimously decided to request the MoF to withdraw the Draft Law from

any public hearing. SCTM’s advocacy activities continued with the central government against the draft law’s proposals. The draft-law was adopted by the National Assembly in 2016. However, it included only amendments to the share of the Wage Tax in following amounts: from 80% to 77% for cities; from 80% to 74% for municipalities and from 70 to 66% for the city of Belgrade. Although this is rather unfavorable for local governments, yet it is less unfavorable than the initial proposals.

Program Budgeting

The Standing Conference of Towns and Municipalities continues to work with Serbian municipalities to improve program budgeting at local level through a mix of capacity building activities. Local governments are establishing links between the strategic plans and their program budgets, mid-term plans, operational programs, expected results, indicators and resources. A key result of this effort is the establishment of an effective local budget structure which is in line with the objectives of local budget users. The challenges faced in this endeavor revealed that there is still much room for improving central – local government coordination, particularly with respect to the program structure and the budget calendar deadlines set by the Ministry of Finance and the timely publication of the Fiscal Strategy of the country. During 2016 and 2017 SCTM continued work to

improve the Program Budgeting implementation at local level with the support of Exchange 5 Program, implemented by SCTM and funded by EU, and the Institutional Support to SCTM – Second Phase Project implemented by SCTM in cooperation with SDC . The activities included work on the improvement of the program structure for LSGs, the preparation of documentation (guidelines, models, forms, practical examples etc.) as well capacity building events. Annually, SCTM prepares a general overview of local Budget Decisions reviewing the level of application of program budgeting that informs the monitoring of the Public Administration Reform Strategy action plan. and the Public Finance Management Reform Program. A Decree that regulates content, method of preparation, evaluation, monitoring and reporting on the realization of capital projects was in 2017.

Local Government Taxation

During 2014 and 2015, SCTM prepared several analyzes on implementation of **Property Tax Law**, after its amendment in 2013. Also, during that period, numerous comments, and initiatives related

to the most common problems that cities, municipalities, and Local Tax Administrations (LTAs) face during implementation of the Law, have been collected from them via LTA Network (coordinated by

SCTM). On this occasion, SCTM sent the first two initiatives to the Ministry of Finance (in October 2015 and in July 2016), explaining in details why the amendments to the Property Tax Law are necessary, as well as initiatives on changes to Law on Tax Procedure and Tax Administration.

During 2018, in two occasions, the Ministry of Finance formulated amendments to the Property Tax Law. Upon the request of the Ministry, and building on its previous work and a detailed review from the LTAs, the SCTM provided comments and suggestions to improve the draft law in both occasions. The first time in July and the second time in September and October, in cooperation with Municipal Economic Development Programme II – Property Tax Reform, supported by SDC. It is expected that the changes and amendments to the Law will be adopted by the end of 2018.

In 2018, the Government amended the Law on Tax Procedures and Tax Administrations. to enable the networking of more state databases to

improve the efficiency of property tax collection, through the development of a Central Information System of data for Local Tax Administrations (LTAs). Another important change of the Law relates to the introduction of electronic applications on tax for both categories of tax payers.

Updating of the real estate databases at local level is a challenge for Serbian LSGs, indicating also much room for improvement in the collection of the property tax by LTAs. A number of LTAs have been supported in previous years by GIZ and SDC and this support will be continued. Besides the improvement of tax databases, the involvement of citizens in decision making of how funds collected from property tax are being spent, is very important and therefore additional activities would be further implemented in cooperation with the Municipal Economic Development Programme II – Property Tax Reform, supported by SDC. Finally, it should be noted that it is expected that a new Law on Natural Goods Use Fees, regulating a part of own-sourced revenues, will be adopted before the end of 2018.

Improving Public Finance Management and Good Governance by implementing the first Public Budget Portals - PBPs in Serbia

With the support of UNDP and SIDA, the SCTM supported 10 pilot cities and municipalities in increasing transparency of public finances by promoting the best PFM practices and by introducing public budget portals (PBPs) to enable monitoring of the budget formulation and execution process. The PBP is an electronic reporting system for city and municipal assemblies on local budgets, and it

presents an innovative approach to strengthening transparency of local finances and improvement of public finance management at the local level. Members of city/municipal assemblies would have an opportunity to engage in the budget process on time, by regularly following the budget formulation and execution process throughout the year.

Statistical Overview of Local Government Finance in Serbia 2006-2017

Local revenue as shares of total public revenue and GDP fell sharply between 2009 and 2011 as the national government dumped some of its fiscal problems on to municipalities. Between 2012 and 2013 they recovered somewhat only to fall again in 2014. The situation didn't change much in thereafter in terms of the share of local governments revenue to total public revenue, although the latter improved by 1 percentage point per year. The share of local government revenue in the GDP has improved over the past three years, influenced by the slow economic growth. However, in relative terms local governments revenues to GDP are 0.4% less than in 2007. Local Government

Debt decreased by 10% when compared to 2015.

Local revenues have declined faster than those of the general government during the economic crisis. They rose faster than those of the general government immediately before and after the 2011 national elections. A dramatic decline in the local level revenues was seen between 2012 and 2014 due to austerity measures but this seems to have stabilized in 2015. Over the past two years, it seems that local and general government revenue growth follow a much similar pattern. Overall, general government revenues have been much more stable than the local ones.

Chart 116 Serbia

Local Government Revenue as a Share of GDP and Total Public Revenue 2006-2017

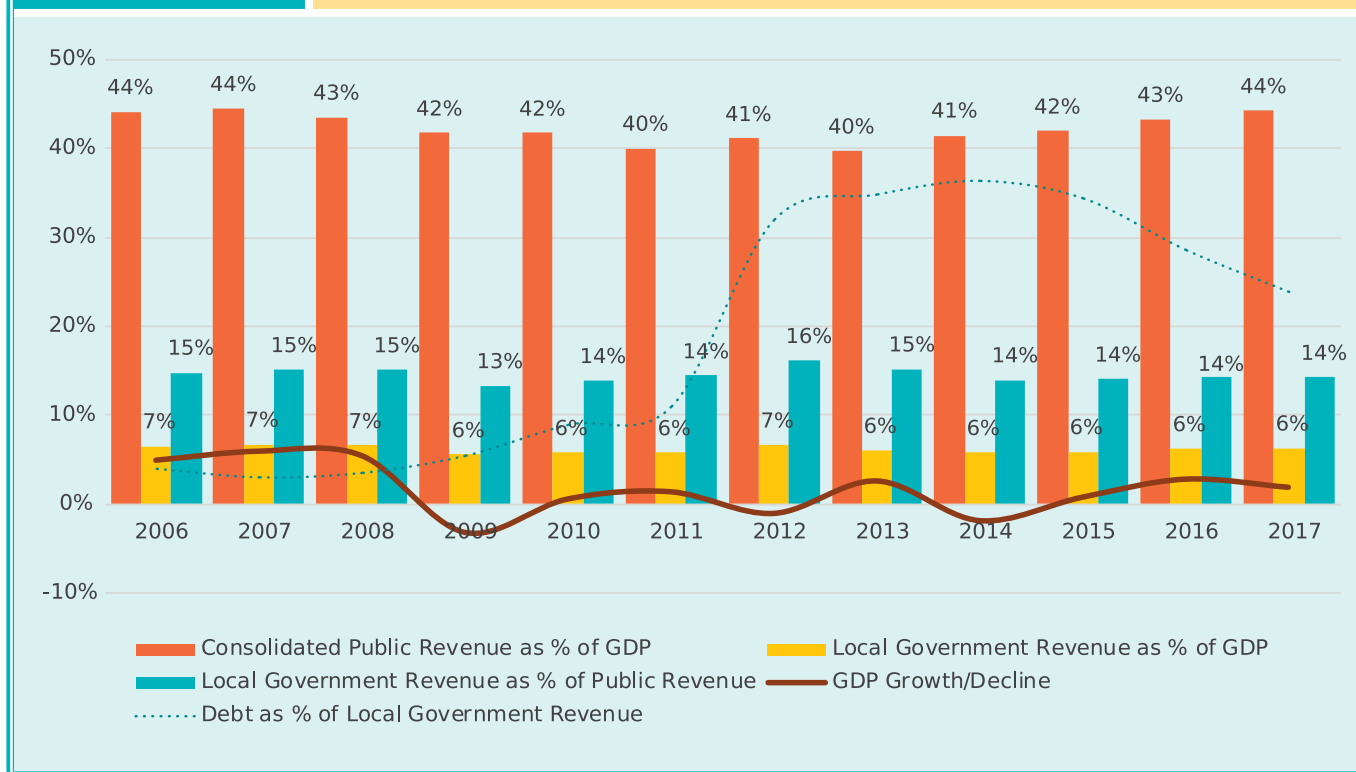




Chart 117 Serbia

Fluctuations in the Revenues of the General Government and Local Governments

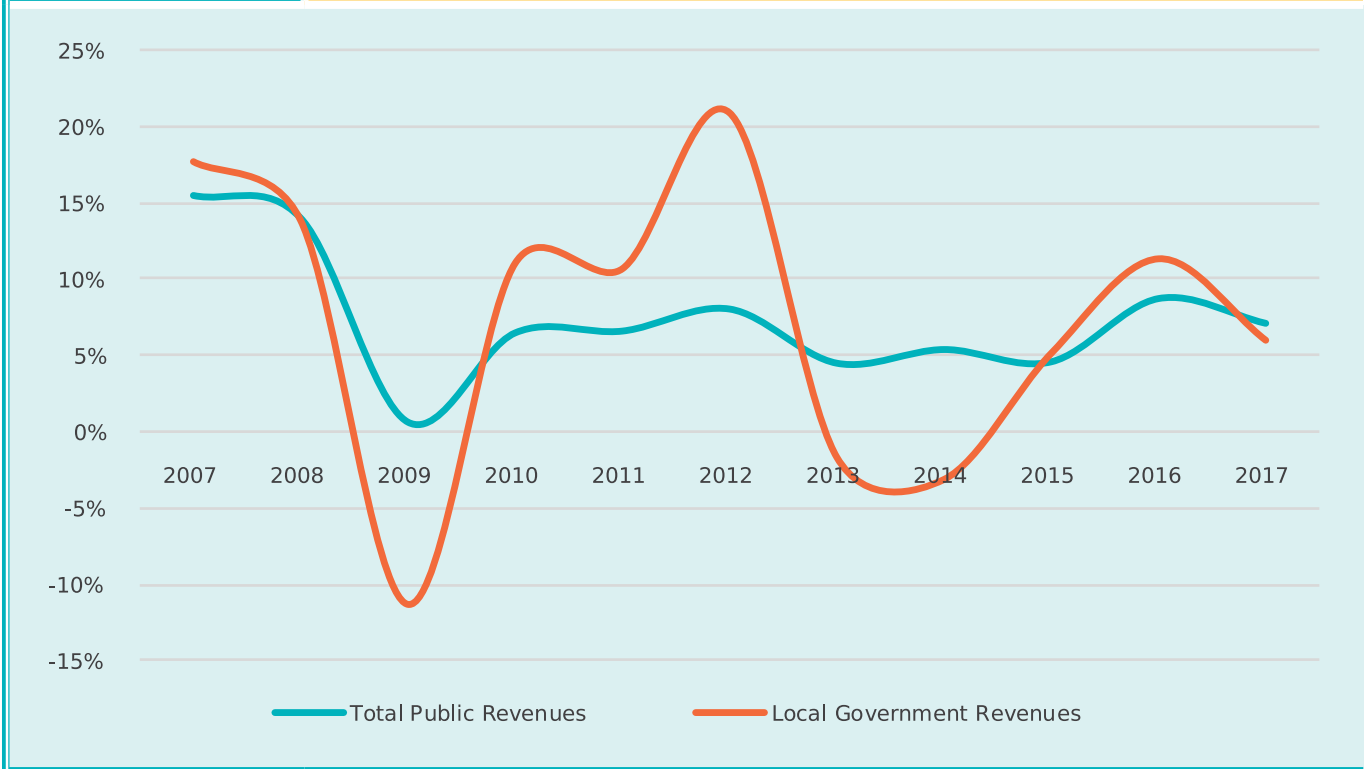
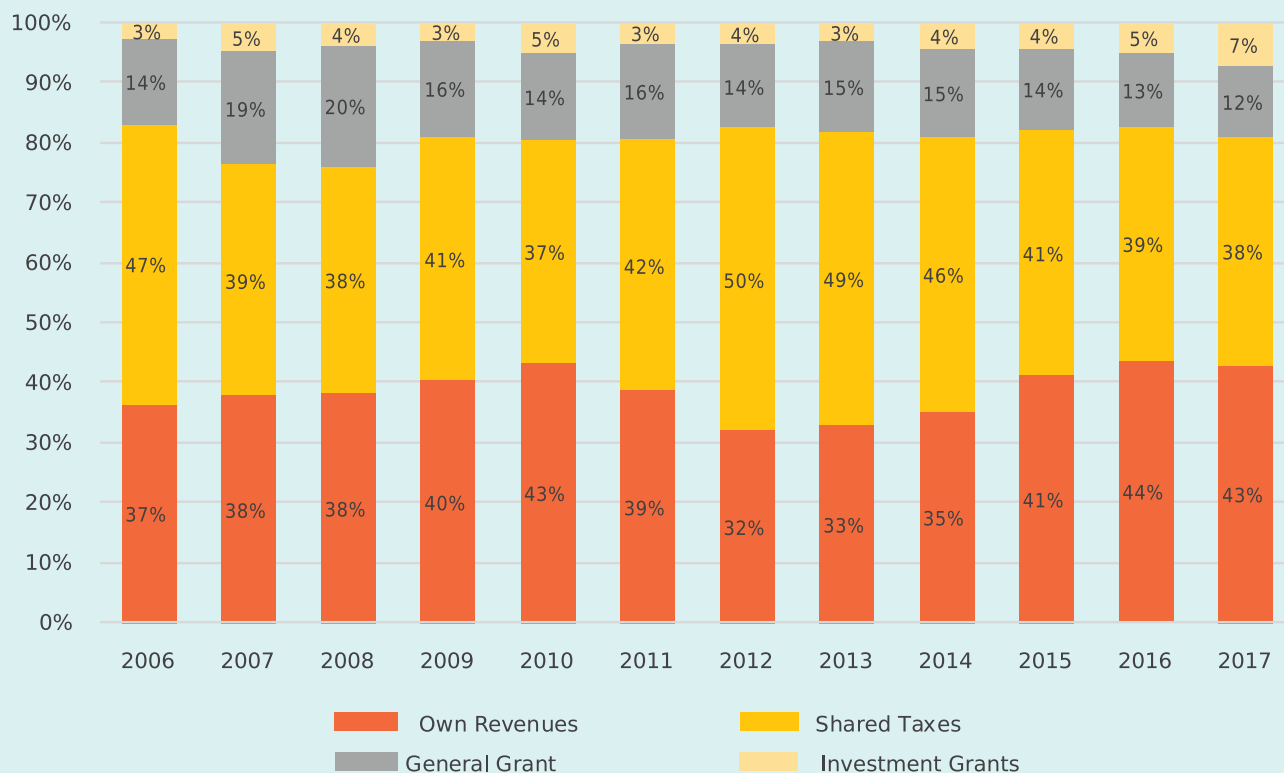


Chart 118 Serbia

Composition of Local Government Revenue 2006-2017, in % of total



On average until 2012, about 40% of local revenue came from own-sources, 40% from shared taxes, 15% from unconditional grants, and about 5% from conditional grants. In 2012, this balance was changed by a sharp increase in the Wage Personal Income Tax share that increased shared taxes weight to 50% of all local revenue. Since 2012, continuous reductions in the base and rate of Wage Personal Income Tax have reduced the yield of the tax for local governments. In 2017, shared taxes generate only

38% of local revenue. Over the past three years, own revenues of local governments have increased as a share of total revenues, despite the several limitations imposed on local government powers to set fees and the elimination of a number of taxes.

Local governments have significantly improved the yield of the property tax since 2006 when it amounted 69 million EUR to 376 in 2017. The trend is especially interesting in the period 2013-

2017 and it is a result of capacity building activities for property tax undertaken at the local level.

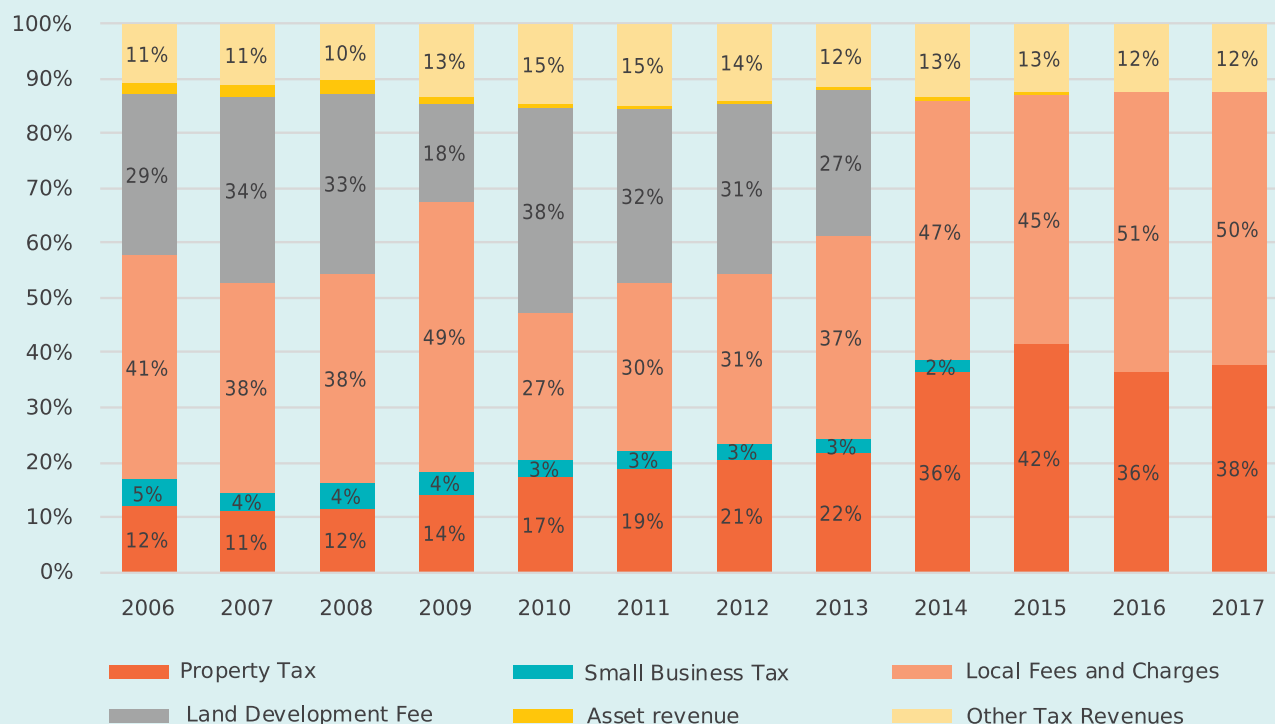
Local government investment as a share of total expenditure remained stable during the worst years of the crisis because of large infrastructure projects in Belgrade. But they have fallen sharply since 2011 and are now under 15% for five years in a row. Serbian local governments also spend a large share of their budgets on subsidies to public

utilities (13%), some of which is for capital investment. Debt service payments now account for about 3.9% of total expenditure.

Despite the financial difficulties of local governments, local wage spending has remained more or less stable over the last eight years and though it started dropping in 2015 due to restrictions imposed by the central level.

Chart 119 Serbia

Composition of Own Revenues 2006-2017, in % of total



Local investment spending has fallen considerably over the past five years. As of 2017, local government investment constitute only 0.8% of the GDP down from about 1.5% in 2011. Between 2011 and 2012 there has been a very sharp increase lo-

cal government debt in Serbia from 0.5 to 2.1% of the GDP. Finally, the property tax constitutes about 1% of the GDP in Serbia up from 0.5% that constituted in 2013. The increase is due in part to a grant program that incentivized collection.

Chart 120 Serbia

Composition of Local Government Expenditure 2006-2017

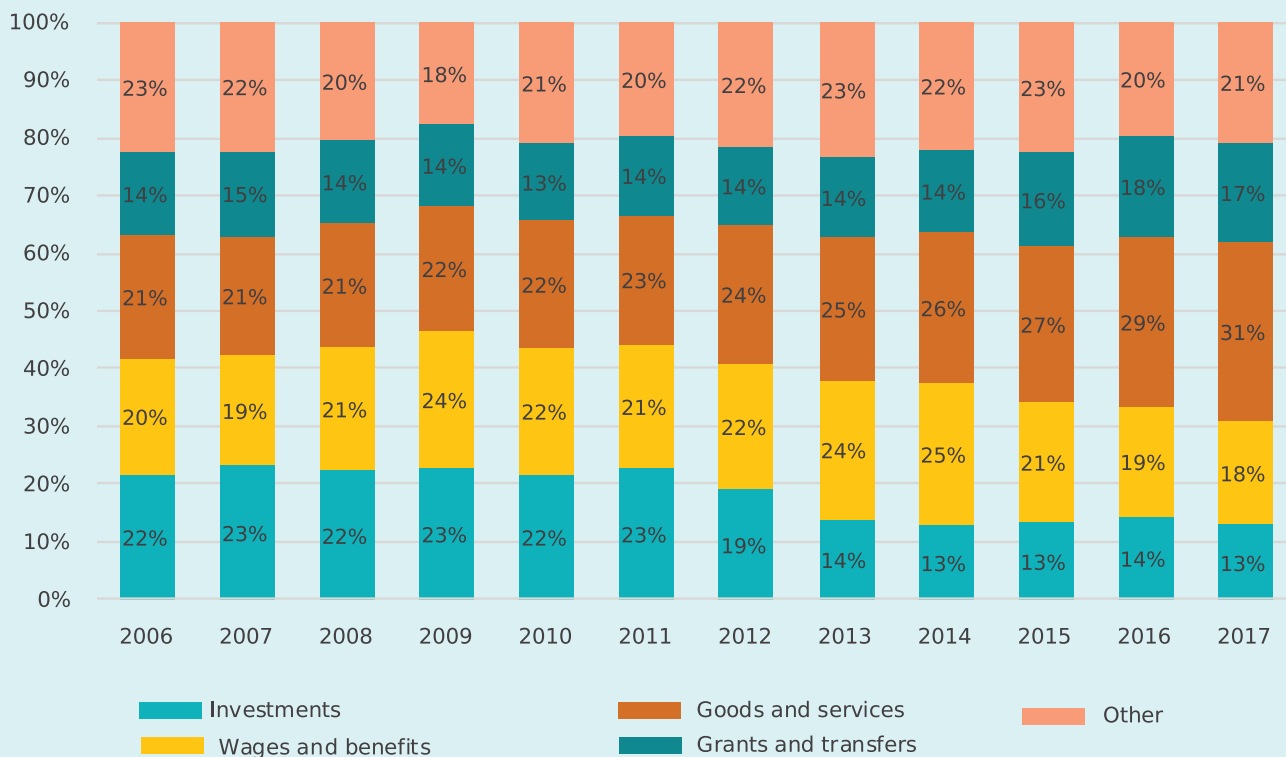




Chart 121 Serbia

Investment by Level of Government and as a % GDP 2006-2017

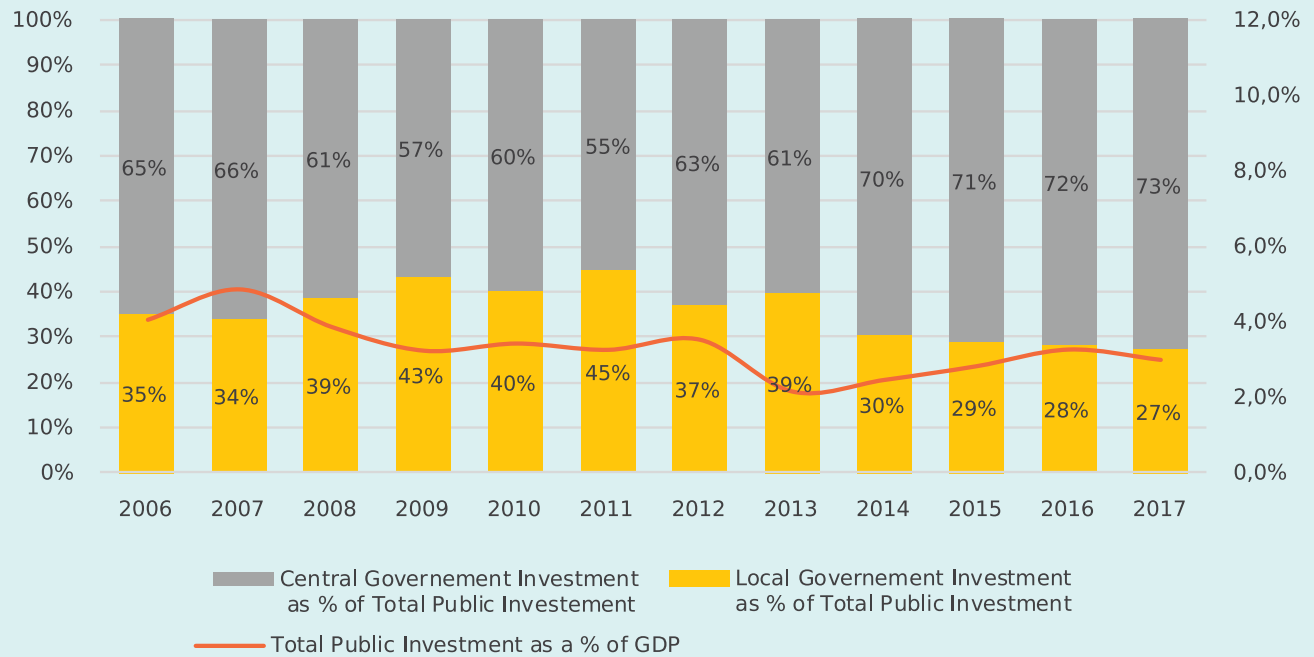
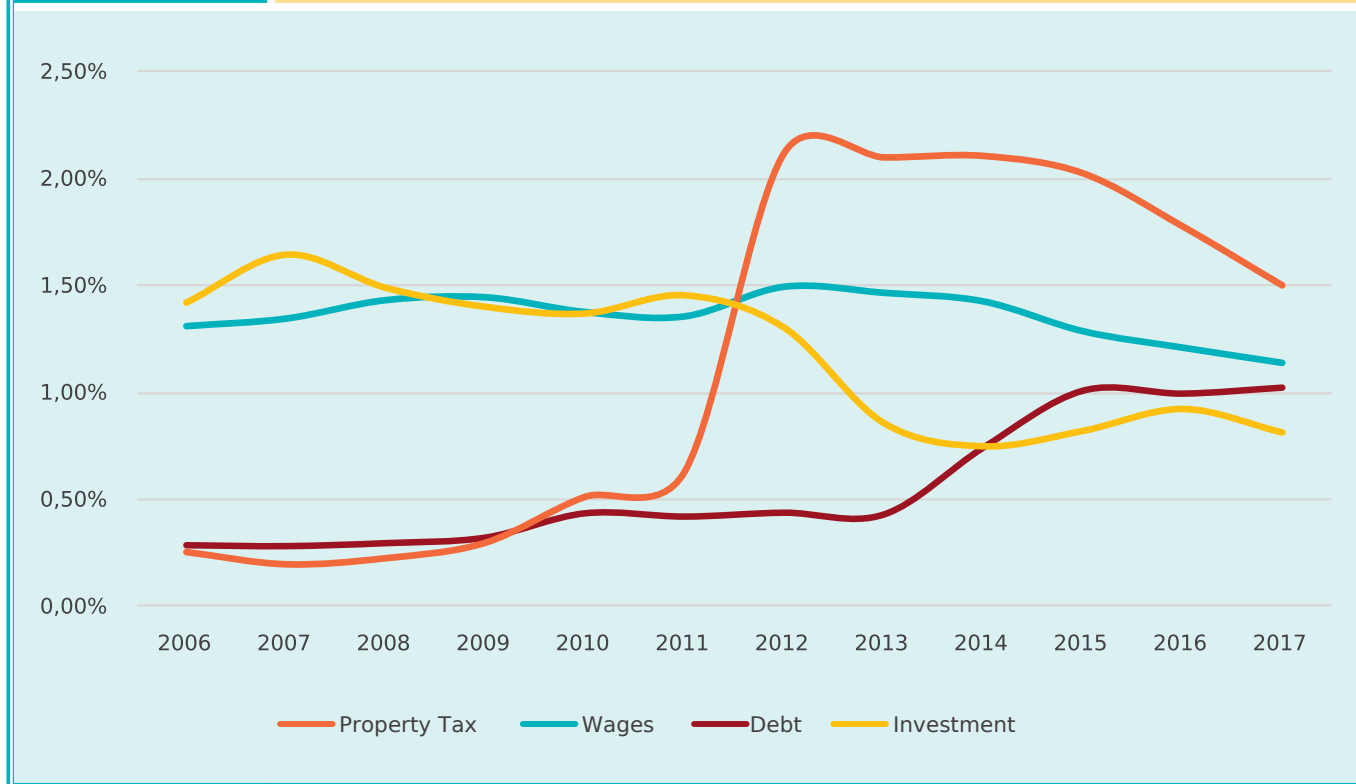


Chart 122 Serbia

Local Government Investment, Wages, Debt and Property Tax as Shares of GDP 2006-2017



Slovenia

The Intergovernmental Finance System

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

Namely, the Slovenian municipalities were hit by the effects of the financial crises in 2011 when municipal revenue declined 5.5% and total expenditure fell 9%. In 2012, because of the persistence of the crisis, Parliament adopted austerity measures, which also affected municipalities. On the revenue side, the national government reduced the lump sum per capita share of PIT for local governments by 3.7% and froze the national government’s share of investment co-financing. On the expenditure side, the austerity measures included a reduction in public sector wages. But

there was also an increase in some social transfers. As a result, municipal current expenditures for statutory tasks decreased by less than 1%.

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

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

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

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

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

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

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

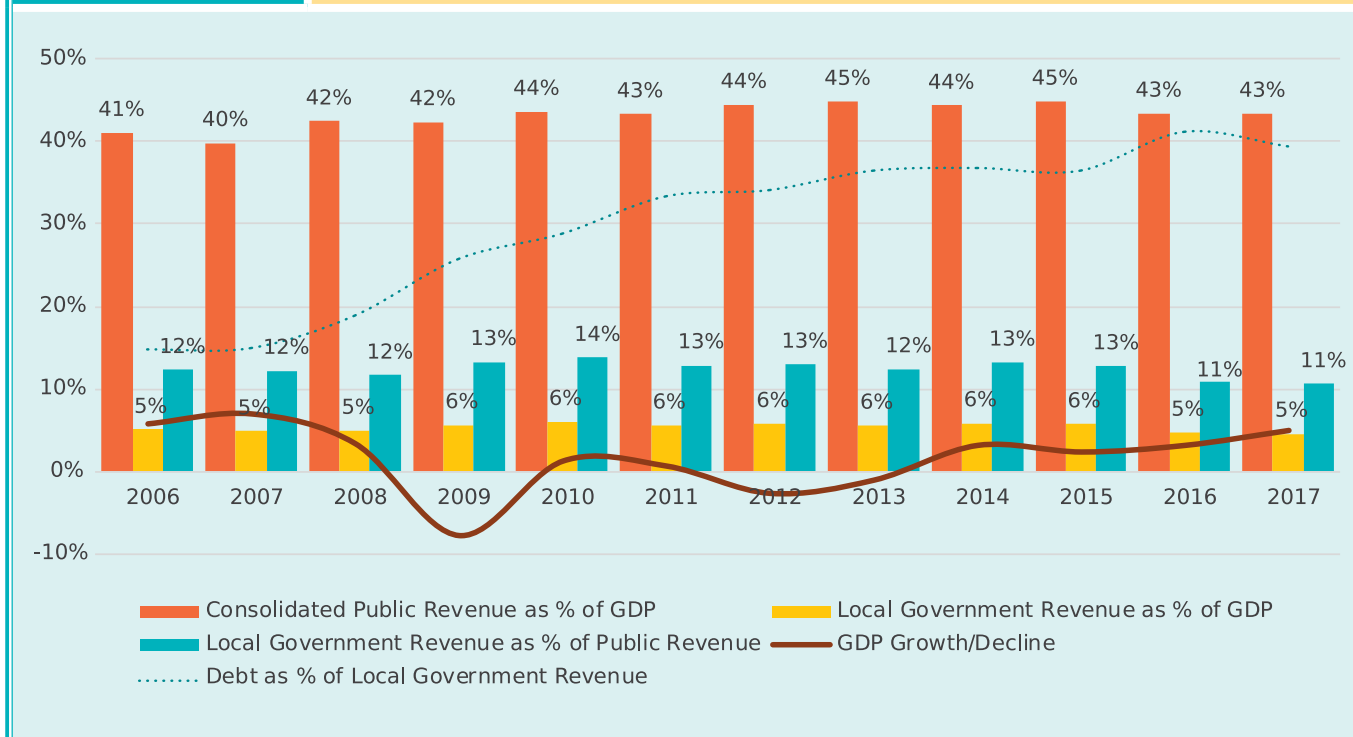
Statistical Overview of Local Government Finance in Slovenia 2006-2017

The overall size of the local government sector in Slovenia increased from 5,7% of the GDP in 2015 to 4.6% in 2017. The impact of the economic crisis

has decreased this share since, with a tendency from the central government to shift a disproportionate burden of fiscal stress to the local level.

Chart 123 Slovenia

Local Government Revenue as a Share of GDP and Total Public Revenue in 2006-2017



Slovenian local governments are heavily dependent on PIT sharing for most of their revenues. Year 2015 brought fiscal equalization in the form of a general grant to the municipalities. The PIT share decreased nonetheless. Over the past two years the share of own revenues and shared taxes has increased, while the tendency of conditional grants, including EU grants, has reversed.

The increase in the share of own-revenues has been accompanied by significant changes in its composition: The Land Use and Land Development Fees have been eliminated. As a result, the

share of own revenues coming from the property tax has increased, though absolute yields have remained stable. Slovenian municipalities also derive a large share of their own revenues from asset sales and rentals, a share that has also increased with the central roll-back of other own-revenues.

Between 2009 and 2013, the investment rate of Slovenian local governments dropped from 45% of total spending to 35% in 2013. In the two following years, the share of investments has increased significantly to fall again in 2016 and 2017.

Chart 124 Slovenia

Composition of Local Government Revenue 2006-2017

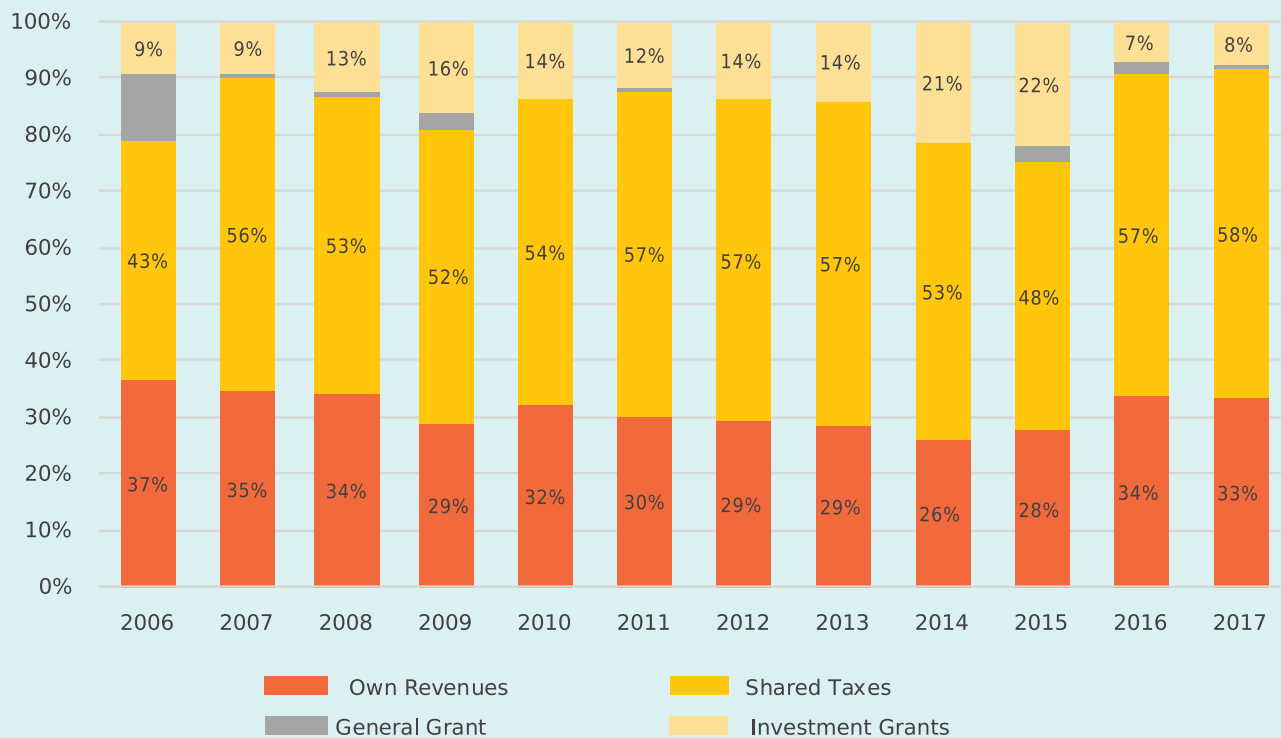




Chart 125 Slovenia

Composition of Own Revenue 2006-2017

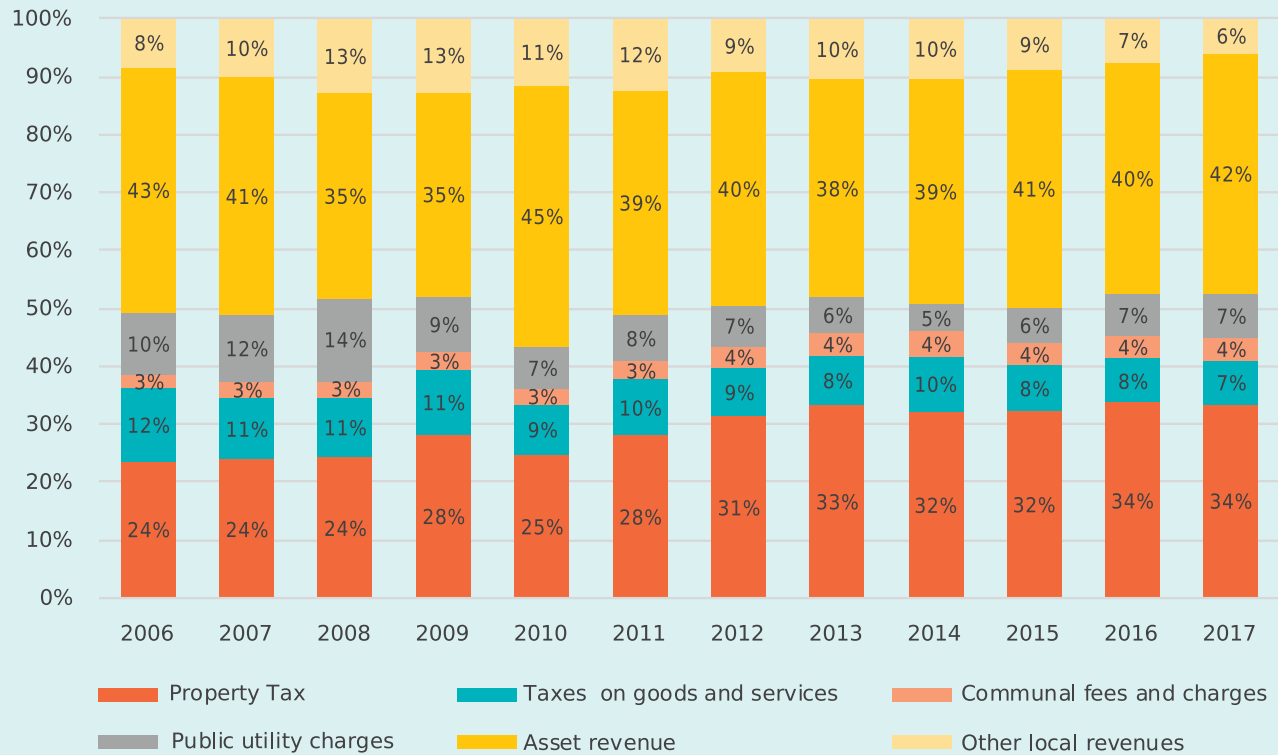
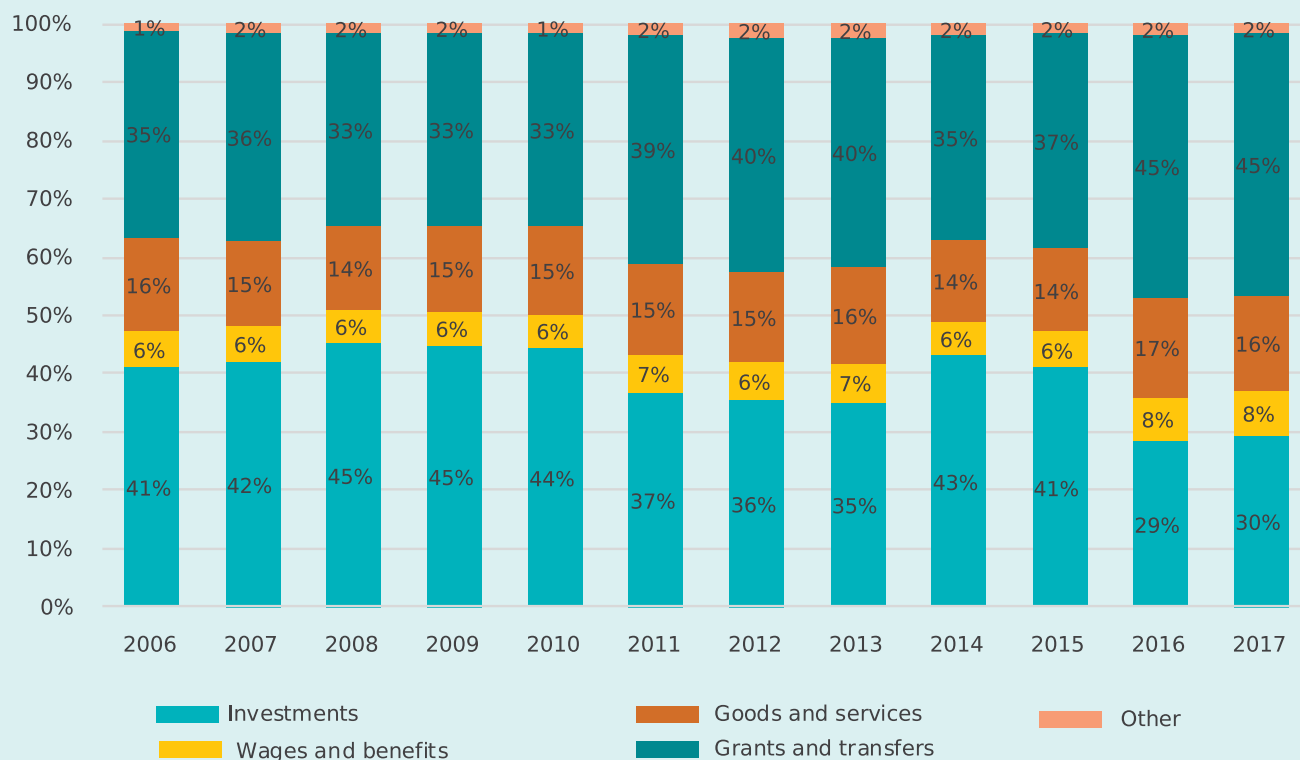


Chart 126 Slovenia

Composition of Expenditure in 2006-2017



Slovenia's has combined robust local investment with low wage spending. Revenue from the Land Use Fee and the Property Tax is better than most countries relying solely on the property tax but still modest. Property tax and wages have been stable, the crisis reflected with fluctuations in investment (that again saw negative drop in 2015)

and increase of debt. Municipalities have been frequently pointed out as debt generators in Slovenia, and the total local debt has indeed increased from 0,75 to 2% of GDP in the years from 2008 to 2015, yet it should be noted that at the local and central government debt have increased with the same dynamics, tripling in the period 2006-2015.



Chart 127 Slovenia

Investment by Level of Government and as a % GDP 2006-2017

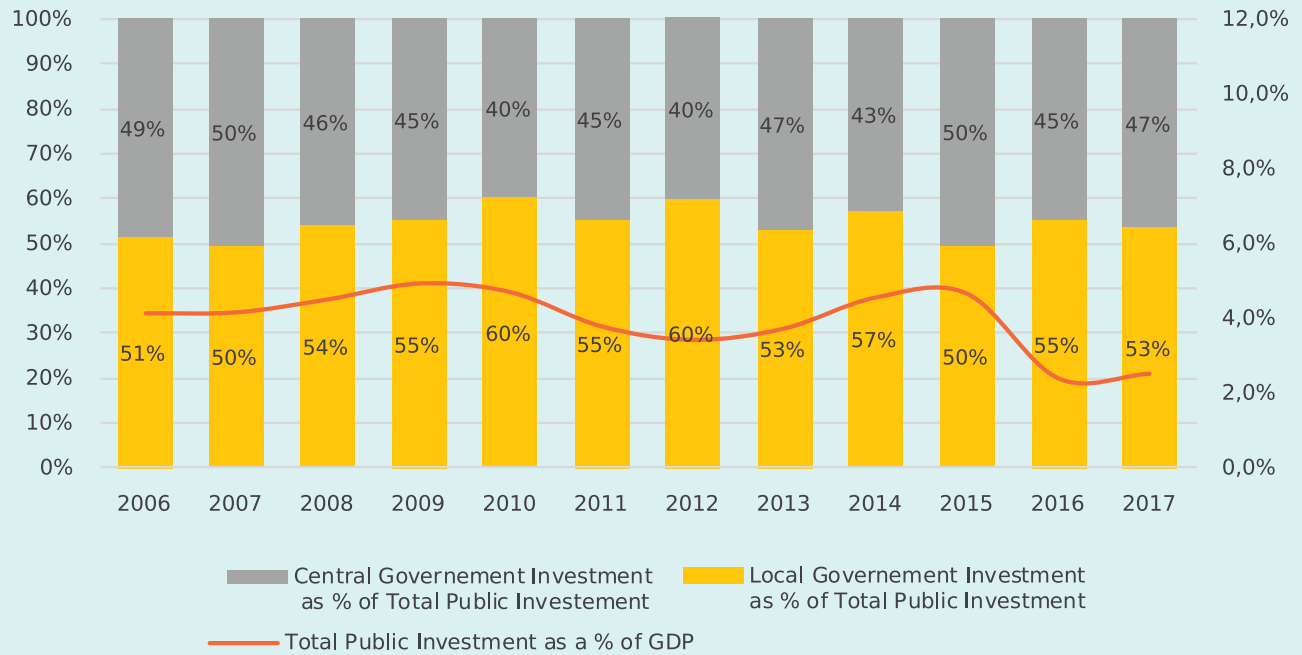
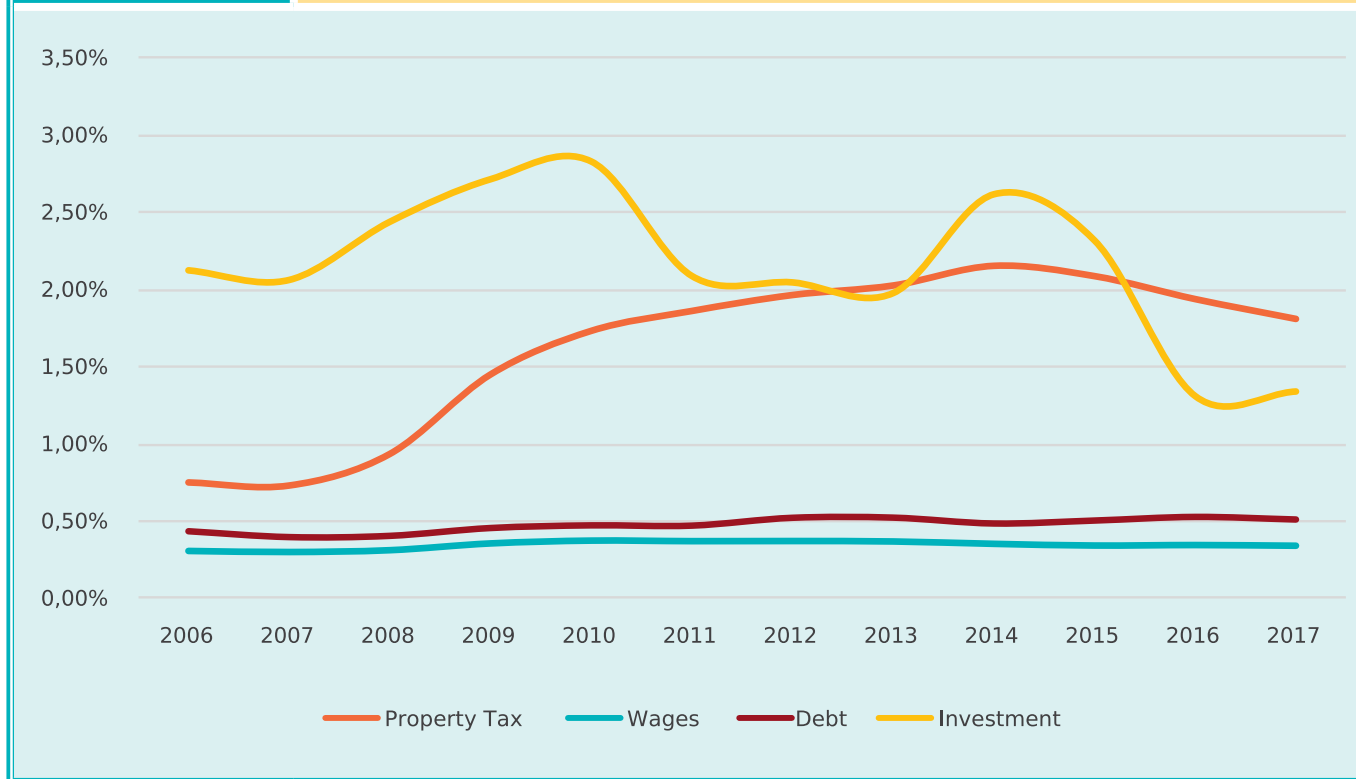


Chart 128 Slovenia

Investment, Wages, Debt, Property Tax as Share of GDP 2006-2015



Turkey

By Mustafa Kabil, Marmara Municipalities Union

The Intergovernmental Finance System

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

The remaining 30-40% are gathered into grant pools specific to each type of local government and redistributed according to two criteria, population and a development index. Eighty percent of these pools are then allocated to local authorities on a per capita basis and 20% according to the development index. This index divides local governments into five groups, with the least developed group getting 23% of the pool and the most developed group gets 17% of the pool. Unfortunately, all of these revenues are classified as shared taxes, instead of being divided into shared taxes and unconditional grants. Together they account for between 45% and 50% of local government revenues, with revenues from own sources accounting for a similar share and other grants making up the difference of less than 10%.

Turkish local governments derive 44% of their revenues from local taxes and fees. There are several local taxes such as the announcement and advertisement tax, entertainment tax, communication tax, electricity consumption tax, environmental tax, with the most important being the property tax. The property tax constitutes 5% of total local revenues and 12% of local own-source revenue in 2017. It is charged on the square meter value of urban buildings and land adjusted by location, use and building quality. Municipalities are legally required to value properties every four years. Tax assessment is done on the basis of a centrally-set methodology and tax rates set by the municipality within limits set by the national government at 0.1-0.3% of the assessed value. These rates are increased by 100% within the frontiers of metropolitan municipality. It is compulsory that a property tax declaration is submitted to the municipality where the building and land is located in case there is a reason for modification of tax value. Both owners and users (if owners cannot be identified) of land and buildings are liable for the property tax. The cadaster of all properties in the country is maintained by the national government and managed by a department within the Ministry responsible for Environment. Local governments may access the cadaster to identify properties and owners within their jurisdictions. Fees constitute an important part of own source revenues. The most important fees are "The building construction fee", charged for the

construction of all kinds of buildings; the “Occupation fee” charged for the temporary occupation territory; “other local fees” are composed mostly of revenues from public services such as water supply and transport.

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

With the 2014 elections, Turkey has two distinct types of local government structures: First, the old system continues in provinces in which there are no cities whose populations are larger than 750,000 inhabitants. In these provinces, there are three basic types of local governments: small cities, special provincial administrations, and villages.

Second, in the 30 provinces where there are cities with populations larger than 750,000, these big cities became metropolitan cities while special provincial administrations and villages were eliminated. As a result, the number of metropolitan cities increased from 16 to 30, and in 30 provinces where they exist there are only two forms of local government, metropolitan cities, and the district cities underneath them. In other words, special provincial administrations still exist in 51 provinces.

From the macroeconomic perspective, Turkey’s longstanding positive economic performance was challenged in 2018, in particular because of the sudden and unexpected depreciation of the Turkish lira and the hikes in interest rates and inflation. The Ministry of Treasury and Finance announced a “New Economy Program” targeting reducing inflation from the current 20.8% to 9.8% in 2020, with a combination of monetary and fiscal policies targeting price stability and fiscal discipline.

Main Developments in Municipal Finance and Advocacy Efforts of the Association

2015 brought a dramatic increase of the influx of people to Turkey, refugees from the Middle East and there were urgent needs for their support. This situation put pressures not only on service delivery at local level but on municipal budgets as well. Marmara Municipalities Union (MMU) published a research report about process management on local governments and refugees from the middle east. The report sets out the activities of municipalities for refugees, process management, problems encountered, limitations due to legislation and proposals. The report raises the issue of additional funding for municipalities as one of the most important problems.

There were important developments for subcontracted public employees. With Decree No. 696 dated 24.12.2017, the personnel working under the “service procurement contracts based on the employment of personnel” were transferred from private companies to the companies belonging to the local governments. Considering the elimination of personnel service procurement tenders, employees have now been secured job stability. The most important financial aspect related to this issue was the reduction of the VAT rate paid by local governments from 18% to 1% for personnel service procurement.

Statistical Overview of Local Government Finances in Turkey

Since 2006, local government revenue as a share of GDP has registered a very small increase of 0.3 percentage points, while it has increased from 13% to 14% of total public revenues. Local government debt, including unpaid liabilities to suppliers, constitutes 58% of total local revenues or about 2.5% of GDP in 2017.

Local governments' revenues have increased by 22% in 2017 as opposed to the 9% increase in

total public revenues, reversing the trend of the past three years.

The composition of local revenues has not changed significantly between 2006 and 2017. Own revenues constitute 44% of the total in 2017. Until 2015 there was an increase in shared taxes to 50% which has slightly fallen to 48% in 2017.

Chart 129 Turkey

Local Government Revenue as a Share of GDP and Total Public Revenue in 2006-2017

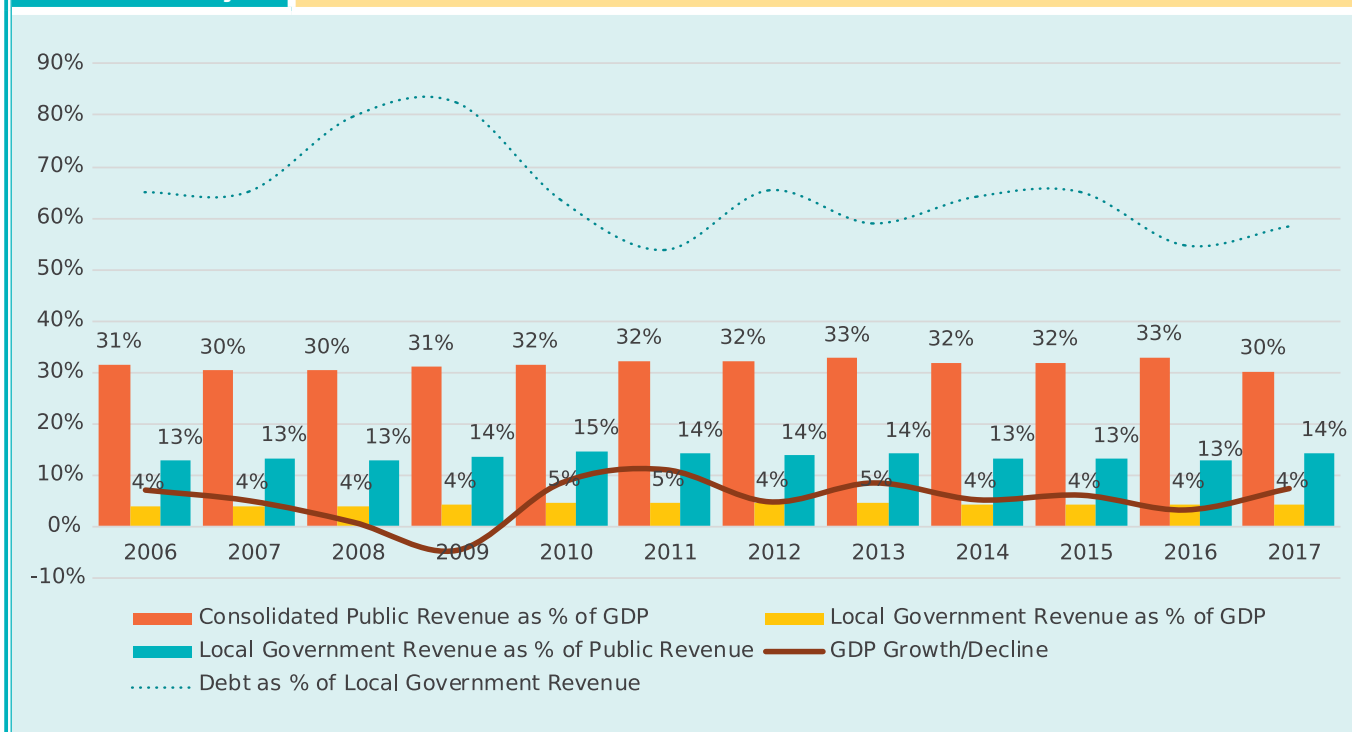
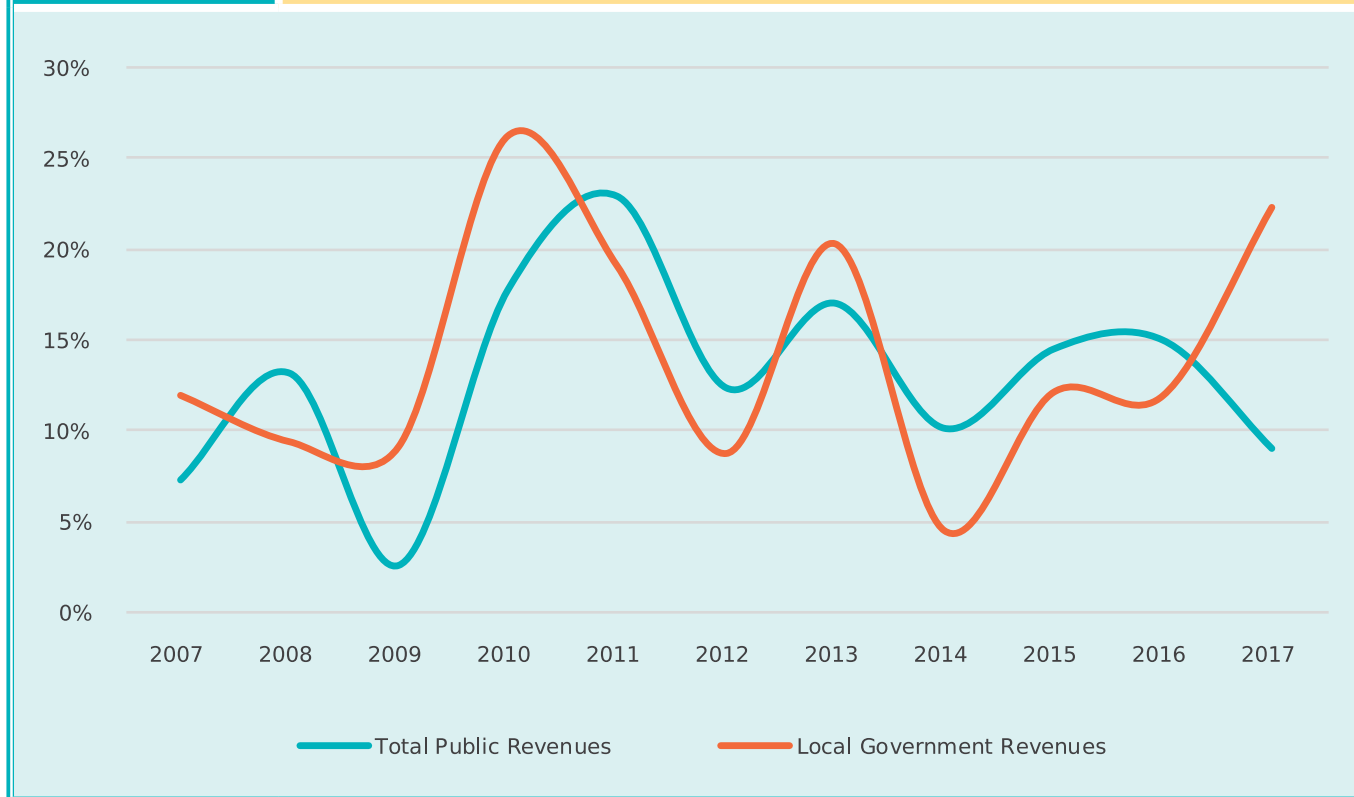


Chart 130 Turkey

Fluctuations in the Revenues of the General Government and Local Governments 2006-2017



Local government revenues have, however, grown consistently by an average of 14% since 2006. In 2017, total local revenues were 22% higher than in 2016. Since 2006, local governments have increased own-revenue collection by 285% and the shared tax revenues increased by about 435%. In relative terms, the composition of Own-Source Revenues has not changed substantially when compared to 2006 or the most recent three years. The share of property tax to own source revenues has further decreased by 3 percentage points in 2017.

In 2017, local investment as a share of total local expenditure increased to 40% up from 36% in 2016. It is the second biggest increase after 2013, compared to the previous year. Wages as a share of total expenditures continue declining and in 2017, they reached the lowest level of 14% since 2006. Expenditures on goods and services started to decline since 2015, where we saw a peak level of 42% of total expenditures.



Chart 131 Turkey

Composition of Local Government Revenue 2006-2017

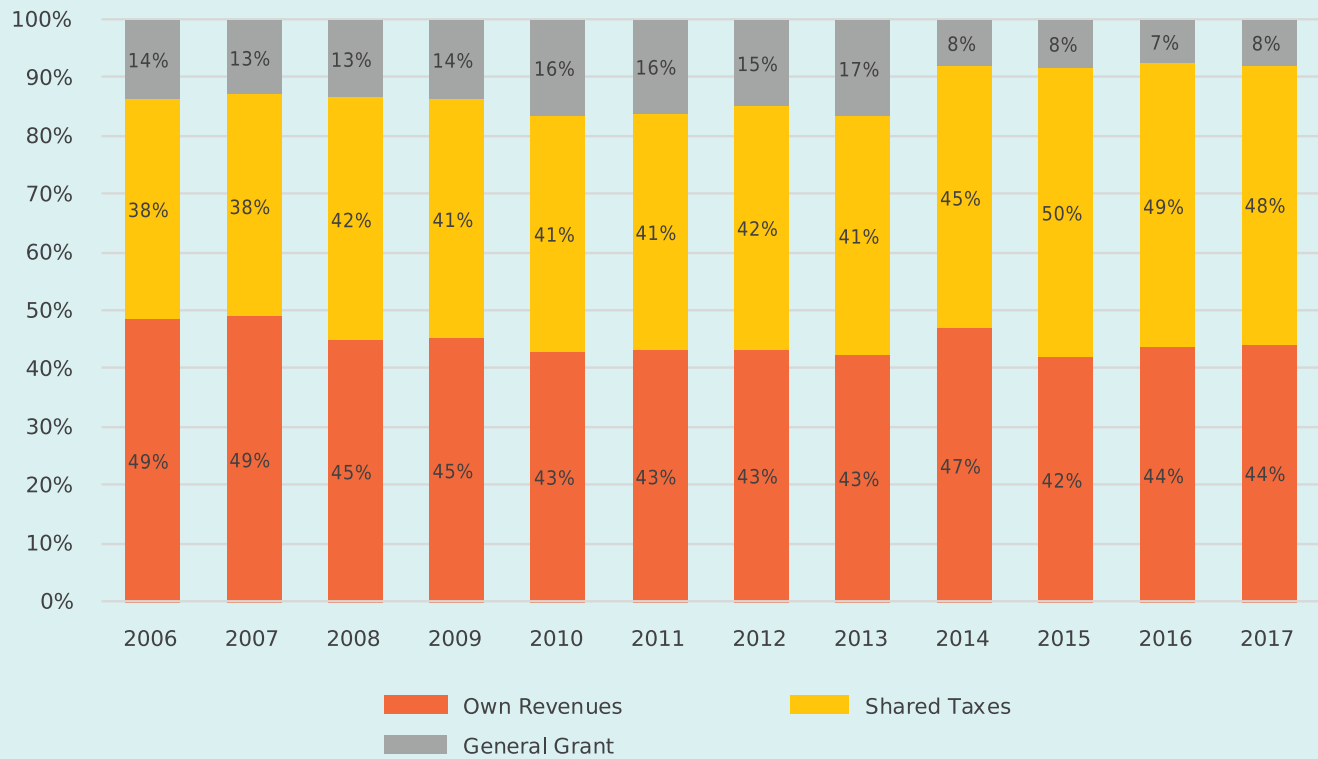
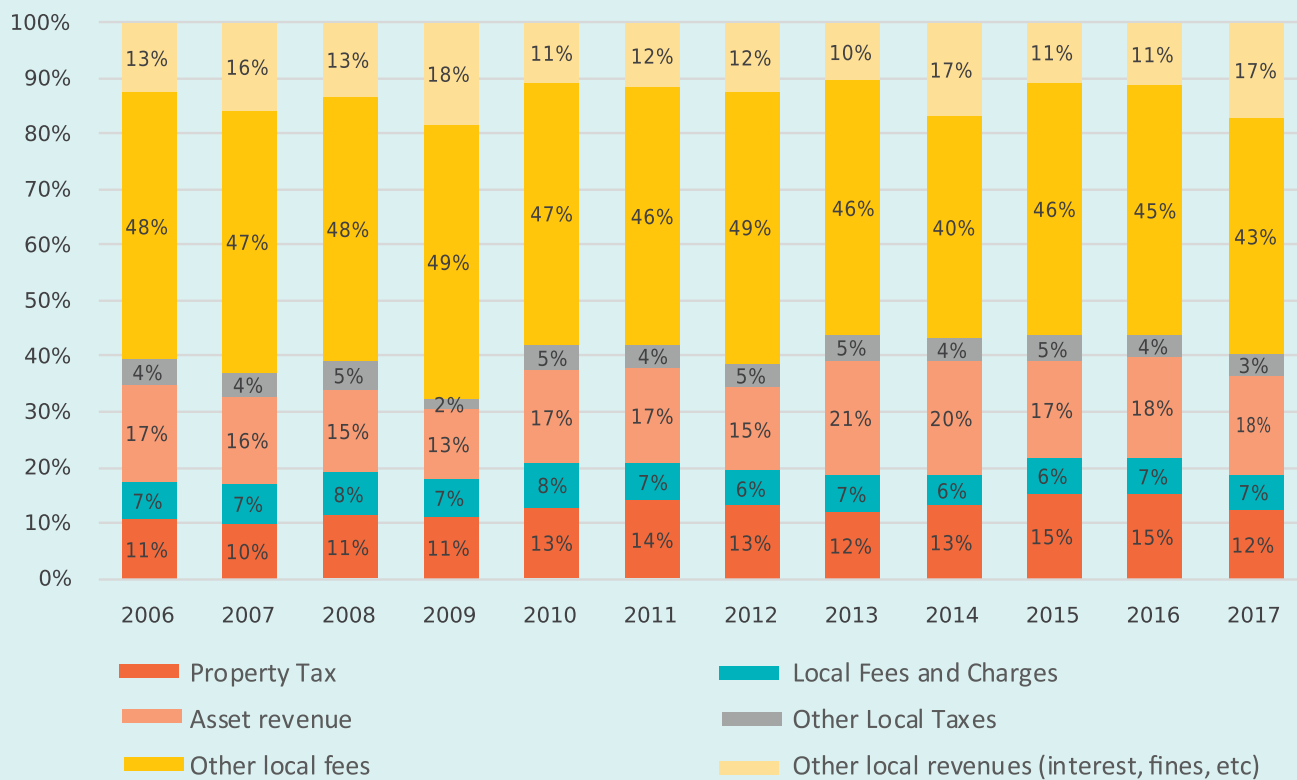


Chart 132 Turkey

Composition of Own Source Revenues 2006-2017



There is a decrease in the cost of local wages as a percentage of GDP since 2006, while property tax remains relatively stable. Local public investment has recently risen to about 2% of GDP, while outstanding

debt is 2,5% of GDP and slightly under the average of last 12 years. This is due more to unpaid liabilities to suppliers and contractors than it is to bank debt.

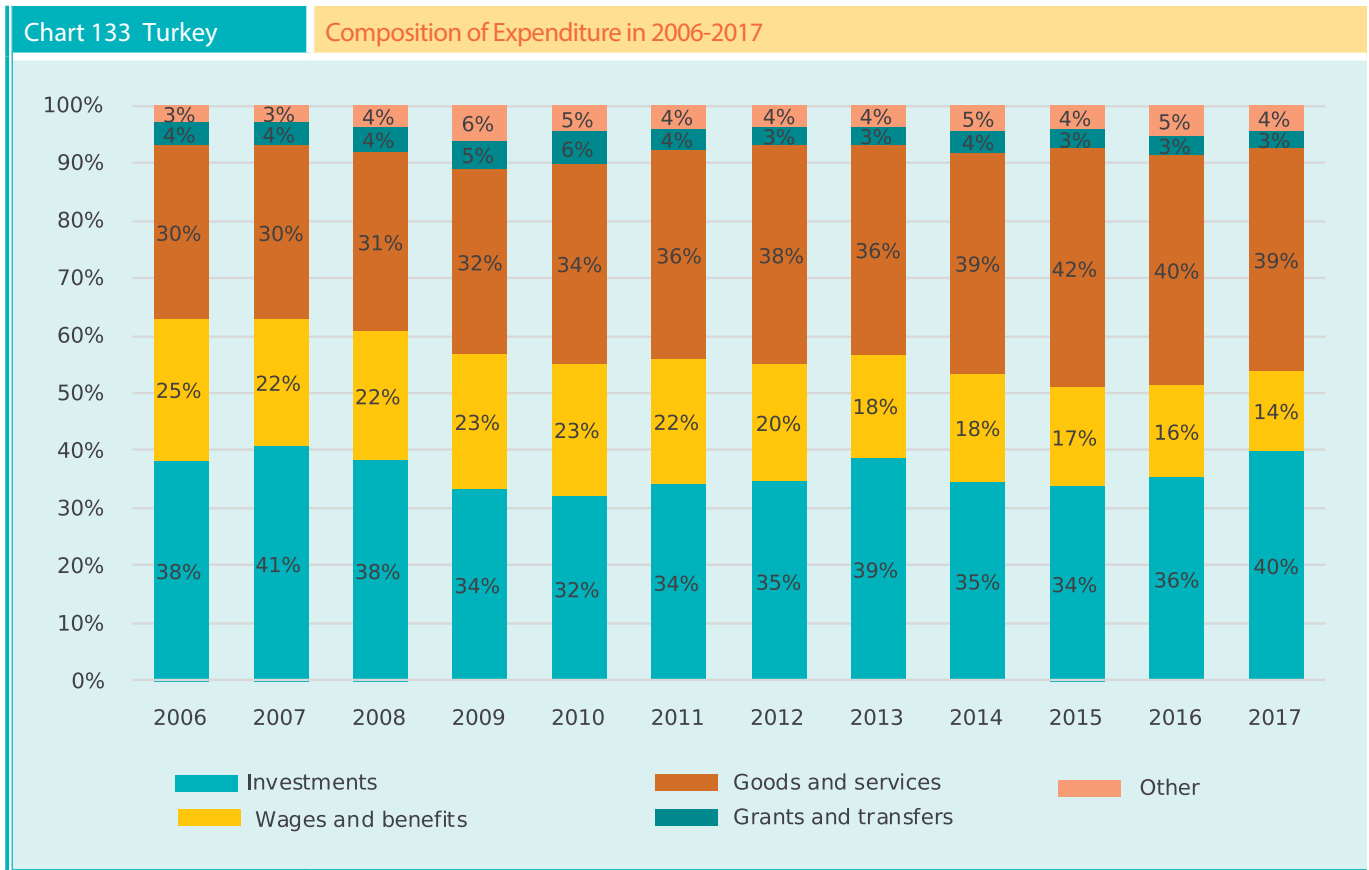


Chart 134 Turkey

Investment, Wages, Outstanding Debt and Property Tax as Shares of GDP 2006-2017

