DISCUSSIONS
ON CHANGED CONTEXT AND TRENDS IN FISCAL DECENTRALIZATION IN SOUTH-EAST EUROPE

NALAS

Discussions

on Changed Context and Trends in Fiscal Decentralization in South-East Europe

Skopje, March 2013

This publication represents a collection of policy papers developed by associations of local authorities of South East Europe in preparation for the international conference "The Future of Fiscal Decentralisation in South Eastern Europe" organized by NALAS in Budva, Montenegro on 1-2 November 2012. It also contains the speech of the President of NALAS as well as the "Budva Declaration for the Future of Fiscal Decentralisation in South East Europe" adopted at this Conference. More information on the conference are available at http://www.nalas.eu/fd/index.aspx

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Speech of the NALAS President at the Inernational Conference "The Future of the Fiscal Decentralisation in South Eastern Eurpe", Budva 1 November 2012

Dear Ambassadors, Dear Ministers, Dear colleagues, Dear guests,
Ladies and Gentlemen,

As a President of The Network of Associations of Local Government Authorities of South-East Europe (NALAS), I wish you a warm welcome and hope for an open and fruitful discussions at this important conference where we will develop a better understanding and view of the future of decentralization in SEE.

I am certain that there is no doubt among us, present in this room, that local government has a key role in exercising participative democracy. Being closest to the citizens, local governments represent citizens' interests, provide them with the services they need and take care for their wellbeing and the wellbeing of many generations to come.

Therefore today I'd like to firstly thank all levels of governments in South Eastern Europe for the efforts made in strengthening local government in the past decade. All countries in South East Europe undertook profound structural reforms and transferred numerous competencies to the local level, following and respecting the principle of subsidiarity. Throughout the region, municipal governments are responsible for maintaining and improving local public infrastructure, including local streets, roads, bridges, and parks. The vast majority of countries in the region finance and manage

water supply and sewage treatment, garbage collection and disposal, public lighting, local public transport, and district heating. Moreover, in 10 (ten) countries local governments are in charge of preschool and primary school education.

Yet, the NALAS analysis revealed that the decentralization in South-East Europe is still a work in progress: in no country in the region do local government revenues or expenditures reach the average for the EU, either as a percentage of GDP or of total public revenues. We have a lot of work ahead of us to fulfill our mission.

Imagine what is possible when all conditions are right: that the local governments have the legal responsibility to organize services (achieved) but also the funds and capacities to build new local roads, to create healthy urban environment, protect the green urban spaces, build new schools, introduce energy efficient municipal operations. It means raising the quality of life of all our citizens.

Raising the quality of life of citizens means we need more investments, and more investments at the local level.

Yet, NALAS analysis present the fact that local government investment spending in a number of countries in the region is well below the average of the EU, and still further below the average of the eight formerly communist countries that joined the EU in 2004. This is particularly concerning if we know the neglected and underdeveloped state of the environmental and network infrastructure that local governments have inherited.

Therefore several questions arise at this point: What is the best strategy for the countries in South-East Europe to face the financial challenges and to reinforce investments in local communities? What are the open issues related to this process throughout the Region? Where and how should countries direct the future actions? Is the fiscal decentralization the question, or in fact – it is the answer?

We are all well aware of our current and old systems. But is it only the old system that we have on hand? Maybe in the new world we need new partners and inclusion of all available forms of financing service delivery: public private partnerships, international finance funds, national financing, local innovation in finance, increasing the locally generated municipal incomes or local borrowing? These forms can all be utilized, but only if local governments establish trustful relations with all partners: citizens, national governments, private investors, international financiers, etc.

As a President of NALAS, I deeply believe that in these times of crisis cooperation and consolidation of all levels and partners is crucial. We jointly need to work towards local governments that are innovative, trustworthy and capable to carry out innovations, improvements and learning. In that light - I see the fiscal decentralization as the answer and the method to go for more local actions and to realize the joint mission.

That is why fiscal decentralization (FD) has been in NALAS' focus since its creation, as a natural response to the members local sectors' needs. NALAS Task Force on Fiscal Decentralization constantly promotes the principles of the fiscal decentralization and has already produced valuable products in the areas of Budget Negotiations, Cost Estimation of Municipal Services, Improvement of Local Property Tax Administration and Local Borrowing. NALAS has also raised numerous political calls for fiscal decentralization and autonomy: Tirana Declaration in 2008, a year later the Dubrovnik Declaration focusing on the immediate impact of the crisis and earlier this year the Pristine Declaration adopted by the General Assembly of NALAS.

Following the best international practices, NALAS commissioned a comparative analysis: Fiscal Decentralization Indicators in South East Europe 2006 – 2011. At this Conference, you have the chance to be the first to get the latest, second edition of the report.

While assessing the trends in the fiscal decentralization it is important to take into account the following general guiding aspects:

1. Implementation of the national fiscal decentralization reform agenda
2. Level of the intergovernmental dialog
3. Financial indicators

1. Regarding the first point, NALAS analyses conclude that there is no continued progress in fiscal decentralization throughout the whole region during the last 2-3 years. In Moldova and Romania there is even a trend towards recentralization.

   Part of the explanation for this loss of momentum may be structural, coming from the low population density of local governments in most of South-East Europe which makes delivering public services to dispersed settlements difficult and costly. On the other hand, the disproportionate concentration of people, wealth, and power in the region's capital cities has impeded the development of effective equalization systems. It has also made it harder to assign local governments robust sources of own revenues.

   One more important trend is visible - the fiscal discipline has improved in the three EU member states, Slovenia, Romania and Bulgaria, because of the austerity measures implemented through the Fiscal Stability Pact.

2. Regarding the level of intergovernmental dialogue: in most of the countries there ARE formal agreements with the central government regarding further development of fiscal decentralization. Almost everywhere the dialog with the ministries of finance is good but with modest results. As a general rule the Ministry of Finance is acquainted with the municipal financial problems but does not consider them a priority and the responses should be more proactive, before the problems' implications become severe.

3. Speaking of the indicators - the latest edition of the NALAS report Fiscal Decentralization Indicators for South-East Europe outline some more key trends for the period 2006-2011:

   - Considering the share of local government revenues of GDP , local government revenues have risen significantly in the Republic of Srpska of the B&H, Macedonia, and Kosovo which is due mainly to conditional grants increases.

   Yet, the local governments in Croatia, FBiH, Serbia, Bulgaria, Montenegro and Moldova have all weakened over the period due to the combined effect of a) sharp decrease of revenues associated with the real-estate market i.e. property transfer taxes and building permits fees, and b) cutting the transfers from the central government.

   - When it comes to the financial independence of local governments, if we consider that it is best measured by the ratio between own source revenues and the total revenues, the conclusion is that all local governments in the region are heavily (more than half) dependant on transfers.

   The most positive example is Montenegro where municipal own revenues make 70% of the total municipal revenues (double the average for EU countries). In addition to that local governments in Montenegro receive no conditional grants from the central government.

   But in Bulgaria, Kosovo, Macedonia, Moldova and Romania the financial autonomy of local governments is further limited because they receive more than 50% of their revenues as conditional grants.

It's important to acknowledge that local governments in Montenegro and Croatia have the right to impose a local surcharge on the Personal Income Tax (PIT).

   - In most of SEE, local government borrowing is still a very new phenomenon.

Some local governments have been affected by liquidity stress and face higher costs of funding. Others have seen their access to the market restricted by central government policy; for example in Albania, where the public debt is limited 60% of GDP, the central government administratively prohibits municipal borrowing; the central government in Bulgaria restricted legally the municipal annual debt service limit by 60% in 2011.

The outstanding per capita debt of local governments in the EU is close to five times greater than that of Slovenia, the country with the highest level of outstanding debt in the group. Meanwhile, at the other end of the spectrum, local government borrowing in Moldova, Albania, and Macedonia is clearly in its infancy while elsewhere in the region it remains underdeveloped.

- As municipal investments are concerned, there is a noticeable decline after 2009 due to the economic crisis. In the same time, current local infrastructure needs are huge, and become even bigger with the EU requirements. Local governments are facing low budget financial possibilities for funding capital public investment and underdeveloped capital market.

The municipal investments mark a steady decline in most of the SEE countries with the following exceptions and particularities:

- There is a moderate growth of up to 15% in the Republic of Srpska. The same trend is seen in Moldova, but the sources of the growth are either from international or national central government funds - practically no investments at all come from municipal own sources.
- Slovenia, Romania and Bulgaria have access to the EU Cohesion, Structural and Agricultural funds which are used mostly for infrastructure. For a vast number of local governments, having weak own revenue base, these funds are the only source for investments.
- In my country, Turkey, where the impact of the crisis is mild compared with the other SEE countries, municipal investments grow despite that on a per capita basis their level is three times lower than the average for the EU27.

Despite these trends that reveal the challenges and the fiscal pressure to both central and local governments throughout the Region, my deep belief is that we need to jointly focus on several key policy issues which are also proposed in the joint Declaration that we propose for this Conference and they include:

1. Improving the results of the dialog between the Ministries of finance and the national associations

2. Expanding the municipal investment capacity in order to overcome the continuing underfunding of the municipal infrastructure

3. Facilitating the access of the local government to the EU Pre-accession and Structural/Agricultural funds

4. Facilitating the access to the credit market

5. Stabilizing the local revenue base

6. Developing long-term partnerships, and

7. Increasing the efficiency of the municipal services

As I mentioned earlier, there are long-term national programs or strategies for fiscal decentralization in most of the SEE countries. It is very important to monitor objectively the implementation of these programs via joint teams of experts from the associations and the Ministries of Finance.

Our common message is that one can always justify reasons for postponing or not implementing important FD measures - the economic crisis or other national priorities. Our objective is to find ways to diminish the negative impact of these reasons. Delays in implementing FD measures could naturally happen but freezing the process or worse, recentralization of authority and resources, is not acceptable. We strongly believe that today, at this conference, together with our partners from the central governments and the financial institutions, we will design at least a portion of the possible good solutions.

Maybe the best way to act jointly, the national and local governments, on the above issues, is to support and implement the "Europe in 3D" approach, adopted in September at the General Assembly of the Council of European Municipalities and Regions. "Europe in 3D" means the emergence of a Europe that believes that collaboration among political, economic and social actors is the key to recovery. Decentralization, Democracy and Development are the three dimensions on which a renewed and strengthened common voice must be expressed.

II. Budva Declaration on the Future of the Fiscal Decentralisation in South Eastern Europe

We, the participants at the conference "The Future of Fiscal Decentralisation in South Eastern Europe" held in Budva, Montenegro on 1-2 November 2012,

We, mayors, representatives of the ministries of finance, representatives of the local governments associations, representatives of the international financial institutions, experts in municipal and intergovernmental finances, leaders of South Eastern Europe,

Recognizing the importance of the local governments in representing citizens' interests, in providing the services needed and caring for citizen's wellbeing and the wellbeing of many generations to come,

Acknowledging the progress in the fiscal decentralisation achieved with the efforts of all levels of governments,

Conscious of the strong need for renewed and new infrastructure in our communities,

Aware of the responsibility for local investments at the local level,

Taking in consideration the lower fiscal power of the local governments in South Eastern Europe compared with the EU,

All taking full account of the European standards, namely the Council of Europe acquis including the European Charter of Local Self-Government,

Declare to join our efforts for:

1. **Expanding the scope of the dialog between the Ministries of finance and the national associations and improving its results**

   The topics for discussion, besides the regular/typical one on the annual intergovernmental transfers, should include other important issues such as review of the municipal revenue base, local governments' borrowing capacity, improvement of the regulatory framework for PPPs, policy options for mitigating the impact of the economic crisis etc.
   The dialog should become results-oriented, based on preliminary objective assessment of the policy options, instead of a formal one. In parallel both the central and the local governments should establish stable mechanisms for monitoring and evaluation of the results. The problems of the FD should be constant part of the dialog. The dialog could be facilitated by donor programs, international financial institutions, partner research institutions which can provide in-depth rationale and justification about the national specifics.
   The economic crisis is often used as an excuse/reason for undermining and postponement of important FD measures. We need to look and the impact of crisis as an opportunity to intensify and institutionalize the dialogue.

2. **Increasing the municipal investment capacity in order to overcome the continuing underfunding of the municipal infrastructure**

   Municipal investments are universally among the worst affected by the crisis. In centering the focus on protecting the social safety net, local governments' investment capability sharply deteriorated; the municipal infrastructure in the countries from SEE is in a poor shape and needs long-term solutions. Focused efforts are needed in at least three key impact areas: building the administrative capacity at local level for long-term capital investment planning, facilitating the use of various funding sources (own revenues, grants, debt financing and PPPs) and implementation of tangible local policies for greater transparency and accountability towards the citizens.

3. **Facilitating the access of the local government to the EU Pre-accession. Structural/Agricultural funds and other EU national funds**

   For an increasing number of local governments the EU funds are the only source for investments. The national policies should encourage the use of these funds by removing the regulatory obstacles and by assisting local governments in stabilizing their revenue base , capacity building support and other implementing innovative credit mechanisms/intermediaries. The co-funding requirements should take into account the revenue generation capabilities of the local authorities.

4. **Facilitating the access to the credit market**
   In many cases the good and widespread practices for local borrowing work well only for large and financially stable local governments. A right combination of regulatory changes and the implementation of innovative pooling mechanisms can facilitate the smaller local authorities to access the local and international credit markets.

NALAS, the national associations and their members commit to:

1. Meet growing need to increase the capacity to develop, implement and disseminate good local practices; to become resource centers of advanced knowledge

2. Focus on increasing the efficiency of the municipal services - benchmarking methodologies for proper costing, comparative studies for specific service etc. which can lead to substantial efficiency gains

3. Support the least performing local governments and regions; develop analytical tools for objective assessment of the economic, financial and social situation and design of targeted measures for poor and/or badly hit by the crisis.

4. Increase transparency and efficiency in local financial management. The difficult decisions require more transparency and accountability in all areas of local governance - procurement, expansion/reduction of the scope of services, analyses of full costs before setting the fee and user charges, detailed justification and impact assessment of tax reliefs etc. A special emphasis should be given to efforts for improving the revenue collection systems thus achieving greater collection rates.

5. Prepare and propose improved intergovernmental mechanisms
   Development of a system of transfers aimed at increasing the volume and share of the unconditional grants and, at the same time, introducing safeguards against provision of unjustifiably expensive services. Development of stable equalizing mechanisms. Consolidation of the various sources for capital transfers scattered among the different ministries.

The Ministries of Finance will concentrate the efforts in the following areas:

1. Tax policy
   In defining the national tax policy, will gradually expand the scope and share of the local taxes and fees mainly at the expense of currently central revenues and by not increasing the tax burden. According the national specifics should encourage greater local government authority on tax collection, rate setting, tax base periodic

assessment. Constant monitoring and forecast of affordable overall fiscal price (taxes, fees, charges etc.) while deciding on policy choices, with special focus on future economic, environmental and social requirements of the EU.

2. Regulatory framework of the transfers
   A common weakness of the transfers systems is the lack of predictability from one year to another which, at local level, leads to increased uncertainty over the provision of recurrent services and especially to inability to plan multi-annual investments. The framework should be stable and predictable for at least a 3-year time horizon. Both the state and the local governments will benefit of having clear mid-term rules for the types of the transfers, volume determination and allocation on the basis of objective criteria.

3. Unfunded mandates
   Proposed tax policy changes should be discussed with local self-government units through their associations. Will require from the state agencies financial justification and adequate compensation while proposing to transfer additional service responsibilities to local units.

4. Support for inter-municipal cooperation
   Will develop and implement appropriate financial mechanisms to support inter-municipal investments in public infrastructure - especially in services, covering the needs of several local governments, such as water and sewer and waste disposal (both traditionally organized on regional basis).

Financial and other institutions will share and promote:

1. Key findings
   Spreading the knowledge in sensitive areas such as financial risks management will positively affect the behavior of local governments in new areas like bond issuing and financial engineering.

2. Methodologies for long-term investment planning
   In many countries the regulatory and budget frameworks have constrained the long-term investment prospective at local level. The crisis put an additional burden by increasing the level of uncertainty. At the same time the successful planning and implementation of investment projects require the use of specific knowledge and techniques, without which the investment community neglects the municipalities as credible partners. Intensive efforts are needed in building local capacity in forecasting cash flows, calculating net operating surplus, prudent assessment of the creditworthiness, prioritizing the investment needs etc.

3. Impact assessment techniques
   This is a typical „grey“ area in local capacity which can be overcome by training in using methodologies for assessing the full/future costs of a specific investment after completion - debt service, future operating costs, transferring the costs into the user fees/charges, scheduling the general repairs, and alike.

4. Creative and innovative investments tools
   The best of the worldwide knowledge should be locally adapted in order to promote local investment in a sustainable and accountable way.

Budva, 02.11.2012

III. Fiscal Decentralization in Bulgaria

III.1 Introduction

The Republic of Bulgaria is a unitary state with local self-government, as stipulated in Bulgarian Constitution. The system of local self-government consists of only one tier, with units named municipalities (obshtina). The 264 municipalities have average population of about 30 000 people covering an average area of 422 km^2 and consist in average of 25 settlements. Municipal responsibilities have been provisionally divided into state delegated activities and own local activities. Bulgarian municipalities are responsible for 2/3 of public services, hence municipal budgets have to ensure financing for: 88% of primary and secondary school education, 95% of kindergartens, 100 % of crèches, 87% of social care services, 100 % of elderly home cares, 100% of services for streets cleaning and maintenance, street illumination, water supply and sewerage, parks and green areas, maintenance of 63 % of country roads, etc.

III.2 Local Finances: Impact of the Crisis

Bulgarian local finances system is regulated by several laws: Municipal Budgets Act; Local Taxes and Fees Act; Municipal Debt Act and other laws applicable for the whole area of public finances.

The trends in municipal services financing can be seen through the macro-indicators that show the share of local expenditures in GDP and in the Consolidated State Budget (CSB).

Table: General Indicators on Local Finances

Indicator	2006	2007	2008	2009	2010	2011	2012
GDP, *(BGN, bn)*	46,7	56,5	66,7	68,5	70,5	75,2	81.4
CSB, *(BGN, bn)*	18,3	21,2	24,4	25,6	27,0	26,9	31,6
Local Expenditures, *(BGN, bn)*	3,3	4,0	4,4	4,2	4,2	4,2	4,1
Share of local finances in GDP	7,0%	7,2%	6,6%	6,2%	6.0%	5.6%	5.0%
Share of local finances in GSB	18,0%	19,2%	18,0%	16,6%	16.1%	15.6%	13.4%

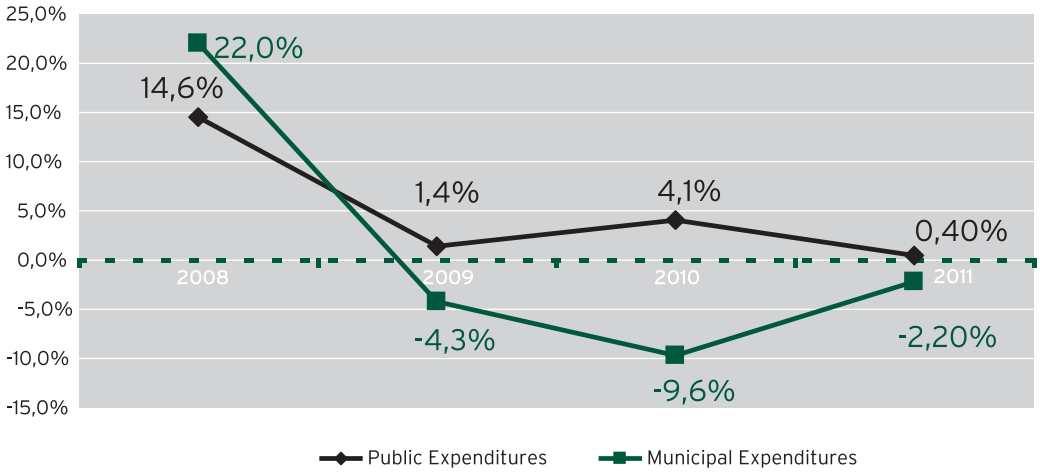
The reported data demonstrate that until 2008 the financing of municipal activities was growing smoothly. As a result, the LGU share in GDP and CSB increased steadily until 2008, though the growth rate declined towards the end of the period. Local government expenditures began to fall in 2008 and have unfortunately decreased every year since.

III.2.1.1 Municipal Expenditures

The declining trend in municipal expenditures continued throughout the period 2009-2011. Until 2008, local expenditures grew almost twice as fast as central public expenditures. A sharp decline has been observed since 2009 while expenditures of the central authorities continued to grow over the same period, though at a lower rate. This controversial trend was stronger in 2010 - municipal expenditures dropped by 9.6% whilst central public ones grew by 4.1%. In 2011, some "scissors closure" was marked but the trend was kept – municipal expenditures declined by 2.2% and central ones grew for 0.4%[1].

1 This paper makes use of data derived from NAMRB's own investigations, official data from Ministry of Finances, and from the recent study of Institute for Market Economics „Regional Profiles: Indicators of Development"

Graph: Rates of growth/decline of central and municipal expenditures for the period 2008-2011



The graph below shows that Bulgaria is at a much lower level than the EU average regarding two main indicators that determine the level of decentralization – share of public expenditures in GDP and in general public expenditures. While the EU27 average share of local expenditures in GDP is 16%, in Bulgaria it accounts for 6%. The EU 27 average share in general public expenditures is 34% and about 20% in Bulgaria.

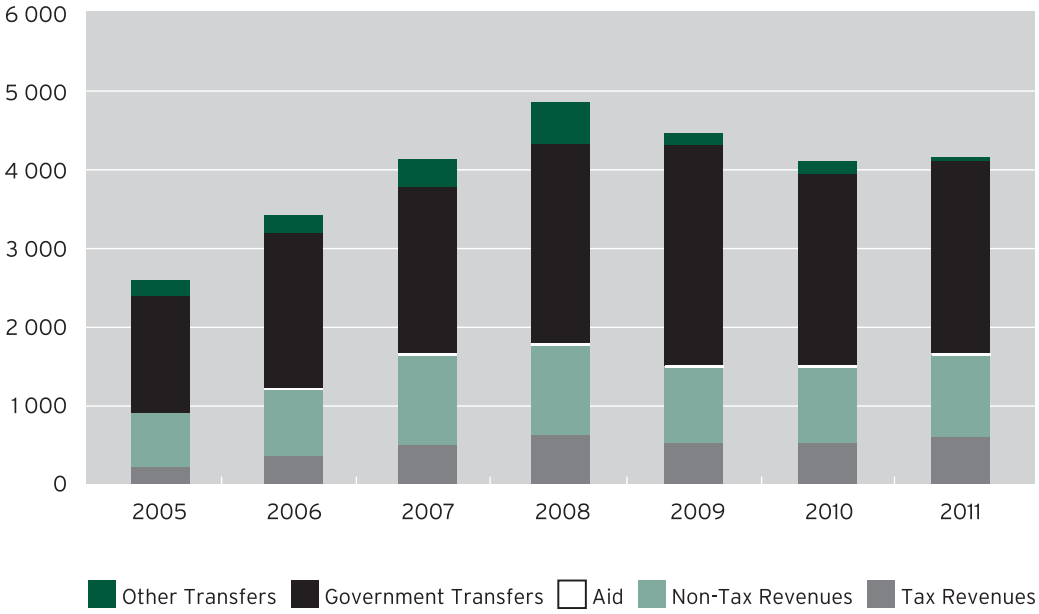
Graph: Share of regional and local authorities' expenditures in GDP and in general public expenditures.

III.2.1.2. Municipal Revenues

The revenues in municipal budgets are generated from three main sources: own revenues, state transfers and debt financing.

Basically, municipal own revenues continue to constitute a lower share of their total budgets compared to the central budget transfers, which means that their fiscal autonomy remains very limited. This trend continued despite the transfer of the license tax to municipalities (2008) and the transformation of the existing tourist fee into tax (2011) – these are only small steps with negligible impact on municipal revenues. The graph below also shows the decrease of municipal revenues after 2008; unfortunately no signs of recovery can be observed. The slight increase in 2011 was achieved precisely due to own revenues, while the size of transfers remained unchanged. In this case, the public finances situation and the high dependence of municipal budgets on central transfers are the reasons for frozen municipal budgets at a lower level than previous better years.

Graph: Municipal Budgets – Revenues and Transfers (BGN, mln)



III.2.1.3. State Transfers

The trend of state transfers for municipalities in the last 5 years, reported by basic types of subsidies, is shown in the table below.

Table: Central budget and municipal budgets relations (BGN, mln)

	Transfers	2008	2009	2010	2011	2012
	Total	1906,4	2207,2	2156,7	2136,6	2159.6
1.	General subsidy for state delegated services	1531,3	1792,1	1814,8	1791,6	1834,7
2.	Transfers for local activities	183,3	230,2	231,7	254,7	254,7
3.	Ear-marked subsidies for capital expenditures	191,7	184,9	110,2	90,2	70,2

It is evident that the amount of state transfers for each of the last three years is lower than the top 2009 level. The slight increase in the subsidy for state delegated activities is due to the raised expenditure standards for secondary school education, but it is insufficient to cover the additional responsibilities for this activity assigned during this period to municipalities. However, the decrease in state transfers total amount is mostly due to the collapse of subsidies for capital investments. This affected mainly the condition of the basic local infrastructure – municipal roads, streets, etc. In general, one can derive the conclusion that during the years of crisis, the state withdrew its support for municipalities. As a matter of fact, the financing of municipalities does not correspond to the municipal responsibilities stipulated by the law.

III.2.1.4. Own Municipal Revenues

The **Constitutional amendments** from 2007 provided municipalities with authorities that imply **real taxation powers** - to set local taxes rate within a certain range. However, in the beginning these ranges were very narrow and did not allow for specific local taxation policies.

The legal thresholds for local taxation were extended to a certain extent in recent years, allowing also greater variety in tax rates (e.g. for real assets the range is 0.1 to 4.5 per mille of the assessed value). It assisted in the establishment of actual taxation policies and even taxation competition between municipalities, however without major effect on the level and structure of revenues. Indeed, the crisis also had an impact on the local

revenues and the potentials of own taxation policy could be used by municipalities as anti-crisis measures.

Another positive change in local tax revenues was the transformation of **license tax,** which was previously state tax, into local tax (2008). This tax is levied on small businesses of natural persons and sole traders, which annual incomes are under certain threshold. Nevertheless, the revenues generated from this tax are not very significant – with a slight share in the amount of all tax revenues (barely 3.5 %). The recently introduced **tourist tax** (2011), in fact replaced the former similar fee, but generated certain increase in taxation revenues.

Other positive legislative changes were made which improved the municipal own revenues to certain extent. These were the possibility to provide local mineral water sources under concession (2010, amendments of Water Act), 50% share for municipalities of concession fees from subsurface resources (2010, amendments of Subsurface Resources Act). A new local tax is currently being debated at the Parliament – taxi transportation tax (amendments in Local Taxes and Fees Act, expected in 2012). These three new local revenue sources would practically affect budgets of only limited group of municipalities.

The number of local taxes remains very limited, their type being strictly property based - most significant are immovable property tax (buildings and lots in urbanized areas), transportation vehicle tax and tax on property transfer. Moreover, some tax exemptions were imposed by law without specified forms to compensate the local authorities for the reduced own revenues.

Within the scope of the legal framework, the share of municipal own revenues in the overall revenues is about 32%. Within the scope of own revenues, the share of taxes amounts to 37% and to 42% for fees.

Considering it from another aspect the municipal tax revenues amount to only 4% of total national tax revenues and to 0.008% of GDP. The relative EU average values are 25% from total tax revenues and 4.2% from GDP.

Table: Municipal Tax revenues

	Bulgaria	EU 27
Share of GDP	0.008%	4.2%
Share of total taxation revenues	4%	25%

Accordingly, a conclusion could be derived that the local finances system in Bulgaria has certain structural inconsistency – municipal finances depend excessively on state transfers that contradicts to the principles of the European Charter of Local Self-Government. This inconsistent structure is the reason why municipalities bore the bigger fiscal burden of crisis – reduced state transfers together with significant decrease of own non-taxation revenues, brought to local budgets' restrictions. On the other hand, property based taxes keep a low share in total revenues showing unable to compensate the shortcomings. In the same time the usual practice is still running - new responsibilities being imposed by law to municipalities with no resources for their implementation.

III.2.1.5. Deficit and Municipal Debt

Due to the recent years downtrend in revenues, municipalities have accumulated larger deficits. The level of municipal debt has gradually augmented since 2008 (BGN 446 mln), in 2009 – 645 mln, in 2010 – 830 mln, to reach 947 mln in 2011, which exceeded 20% of total municipal revenues. The structure of this debt shows the bigger part belongs to bank credits and loan agreements, with external debt slightly larger than the domestic one. Almost the half of total municipal debt is held by Sofia municipality, which is capital city.

Reduced municipal revenues led to other financial difficulties – overdue liabilities. Even being present in previous years, these liabilities level raised sharply to reach BGN 207 mln by the end of 2011. This caused some extreme effects like blocked municipal bank accounts and temporarily ceased municipal services.

By the end of 2011 municipal debt amounts to 57% of own municipal revenues which may seem stable, but the fact of rapid growth of this debt in recent years should be kept in consideration.

Graph: Municipal Debt (BGN, mln)

III.2.1.6. EU Funds absorption – a kind of cure against crisis

Bulgarian municipalities are the main beneficiaries of the bigger part of Operational programs for EU funds absorption. This source of financing significantly exceeds the municipal resources for investments (from state transfers and own revenues). During recent years the state transferred to municipalities EU funds, according to their projects implementation, as follows: BGN 151 mln in 2009; 466 mln in 2010 and 556 in 2011. Ever since 2011, it has made serious impact on the municipal budgetary indicators. This way, the share of state transfers in total municipal revenues increased from about 50% in previous years to more than 75% in 2011. In the same way, it increased the share of municipal expenditures in the total public expenditures from 16% to 20%. This was accompanied in the same time with reduction of other state transfers, mostly the earmarked subsidy for capital investments. This way the state partially replaced its own obligations for public infrastructure maintenance and investments with EU funding within the frame of general union's cohesion policy.

Despite the significant increase in municipal investments through EU projects, Bulgaria is still on the third worst position on the list of EU member states regarding the absorption of allocated resources for the period 2007-2011 (only before Italy and Romania) – with 14%, while EU27 average absorption accounts for 25%.

On the other hand, the implementation of EU projects is a new challenge for Bulgarian municipalities. The so called "financial corrections" and needed co-financing for the projects are difficult burden for municipal budgets. They are some of the reasons for significant raise of municipal debt in last years. The only financial instrument established by the state to assist the municipalities in the implementation of EU projects is the Fund for Local Authorities and Governments (FLAG). According to the situation until the end of 2012, there is need to increase the Fund capital in order to respond to the needs of the municipalities for credits that ensure the implementation of projects.

III.3. Fiscal Decentralization Process. Legal and Institutional Framework of the Dialog.

III.3.1.1. Legal Frame

The dialogue between the National Association of Municipalities of the Republic of Bulgaria (NAMRB) and the state authorities regarding the local finances is mainly regulated by the following laws: Local Self-Government and Local Administration Act (LSGLAA); Municipal Budgets Act (MBA); the annual State Budget of Republic of Bulgaria Act (SBRBA).

NAMRB *"prepares statements and proposals on the draft state budget in the part concerning the municipalities"* (LSGLAA, Art. 9,(3),3). Most of the specific indicators for the central financing for municipalities should be consulted or negotiated with NAMR according to MBA. These are financing standards for state delegated services, the general equalizing subsidy, the amount of target subsidies for capital expenditures and the criteria for their distribution etc. According to MBA, Art.37 *"during the budget procedure for preparation of the draft State Budget Act for the respective year, NAMRB shall make a proposal, stating supporting arguments, as to the total amount of relationships of municipal budgets with the central budget and shall present these to the Ministry of Finance. ... The Minister of Finance shall hold consultations with the NAMRB on the proposals made by them. ... Any differences of opinion emerging from the consultations shall be reflected in a protocol signed by both parties, which shall be annexed to the draft of the State Budget Act for the respective year, and shall be reviewed by the Council of Ministers"*.

Although not quite effective in the previous years, these regulations provided conditions to achieve slight or more significant improvements in the financing of the municipalities. In the last three years of the crisis period, unfortunately, these negotiations have been held in a quite formal manner, without taking into consideration the proposals made by NAMRB. Accordingly, no positive changes for municipalities in the draft budget were achieved.

In 2012, the government drafted a new law– **Public Finances Act**, which is still being debated in the Parliament. The aim of the draft law is to implement the requirements of the European financial stability pact (Stability and Growth Pact), thus establishing common financial rules for all public entities, in the same time abrogating two main laws in force – State Budget Procedures Act and Municipal Budgets Act. The draft law, which was submitted to the Parliament, has some improvements with regard to the initial draft version, as result from the NAMRB definite position on it. However, the law still remains contradictory and inconsistent with the principles of the European Charter of Local Self-Government and the principles of the decentralization policy.

III.3.1.2. Institutional Framework

The institutional framework of cooperation with the government regarding the decentralization process was generally based on consecutive Agreements for Cooperation, signed between the NAMRB and the Ministerial Council in 2001, 2005 and 2009. The decentralization process was institutionalized by the Strategy for decentralization of the national government and the Program for its implementation (2006-2009), which were adopted by the government in 2006. In 2010, the government adopted the revised Strategy for Decentralization and Program for its implementation (2010-2013). Moreover, a consultative body to the Ministerial Council was established, by consecutive acts of the governments in 2006 and 2010, named Council for decentralization. The main tasks of the Council were to assist the government in the implementation of the decentralization policy, to make proposals for specific measures and legal amendments, to monitor the implementation of the Strategy for decentralization and the respective Program. The Council membership was established on the basis of the principle of parity between the central and local authority representatives, and it was chaired by the Minister of regional development and public affairs. By the end of each year, the Council used to discuss and adopt the Monitoring report for annual implementation of the Program and submit it to the Ministerial council.

Unfortunately, the Council was abolished in October 2011 by an act of the government. A certain kind of transformation was planned – the members of the Council for Decentralization would form the extended plenum of the existent Council for Administrative Reform. But this extended plenum was never convened so far. The most important measures which were planned in the Decentralization Program were not implemented (especially the ones aimed at fiscal decentralization) – e.g. enlarging the base of municipal revenues through restructuring of national taxation system, the consolidation of investment transfers from the ministries to the municipalities, and other measures.

III.3.1.3. Monitoring on the Charter Implementation by the Council of Europe

In 2010 – 2011 the Council of Europe carried out a monitoring mission in Bulgaria regarding the implementation of the European Charter on Local Self-Government. The monitoring report, which was adopted in November 2011, contains important conclusions and respective recommendations.

According to the overall assessment, Bulgaria generally complies with the provisions set in the Charter and the extent to which it is included in the domestic legal system of Bulgaria was assessed as satisfactory. At the same time a conclusion was made

that the level of financial autonomy of the Bulgarian municipalities is comparatively low. This is generally due to the persisting division between the delegated and local powers - powers delegated to local authorities are still bigger part compared to their own powers. Such a kind of inherent and typical for European local authorities own competences (as education, healthcare, social cares, culture, etc.) in Bulgaria have been determined as delegated ones. That is in fact a restriction of local authorities' own competences and leads to state control and restrictions in management and financing of these services. These circumstances lead, on the other hand, to non-autonomous way of municipal budgets financing - more than half of their budget derives from governmental transfers, which is not in accordance with the provisions of the Charter. The budgetary regulations, and particularly the „consolidated budget" procedure adopted by the government, restrict local authorities' autonomy, thereby raising a problem of conformity with the Charter as well.

Basing on these conclusions, the **following important recommendations** were given to the Bulgarian authorities:

a. to revise the budgetary procedure in force and amend the current regulations in order to provide the local authorities with budgetary autonomy in accordance with the principles set in the Charter in conformity with Article 9 thereof,
b. to allocate sufficient financial resources to the local authorities commensurate with their competences and responsibilities, inter alia by revising the legal provisions on financing of municipalities in force;
c. to allocate to local authorities more powers of their own, in order to give them a level of local autonomy which conforms to the Charter;
h. to encourage the continuous dialogue between all actors in order to find the most appropriate form to implement decentralization in the interest of Bulgaria and take into account the principles laid down in the Reference Framework for Regional Democracy;

III.4. Local Government Reform Agenda

In order to respond to the challenges concerning the frozen decentralization process, and to ensure stable financial and economic development of the Bulgarian municipalities, the National Association of Municipalities has planned the following main measures:

1. Drafting a substantially new Local Self-Government Act.

The new law should guarantee that the following main objectives are met:

- To determine in a clear way the roles of the three driving forces of local self-government – citizens, municipal council and mayor as executive authority – and to ensure their unity. The citizen's leading role should be in focus, thus providing real instruments and forms for their self-government;
- Sustainable regulation of the competences of local authorities, thus providing a guarantee for real autonomy according to the principles of the Charter, and based on the Council of Europe recommendations;
- To improve local authorities' efficiency, responsibility and transparency with regard to new European realities and to provide for a real governance decentralization;
- To incorporate in law the leading Bulgarian and European local practices.

This new draft law should be presented to the Bulgarian Parliament in the beginning of 2013, along with advocating for support to all political parties.

2. Restart of the fiscal decentralization process.

This should be accomplished in 2013 by drafting the new decentralization program for the period 2014-2017. The focus should be put on the establishment of sustainable and autonomous local revenues base by restructuring the national taxation system. The budgetary procedure regulations should be rearranged with regard to the CE recommendations and the Charter principles.

4. **Elaboration of municipal-friendly design of Operational programs for the new planning period in the EU.** This new design of the programs should ensure stable economic development and financial sustainability of the Bulgarian local authorities in the implementation of the common European cohesion and social policies.

IV. Fiscal decentralization in Romania -the state of play-

IV.1. Assessment of the progress in fiscal decentralization for the last 5 years

Over the last five years, as a consequence of the financial crisis and of budgetary restrictions imposed on the public sector, the the rules governing intergovernmental transfers have been significantly modified. Romania has undergone a major financial adjustment program in order to reduce the consolidated budget deficit from 7.3% in 2009 to 2% in 2012. Local government finances and public sector wages and employment have been the targets of the restrictive measures, which will be elaborated in more detail below. The public sector decentralization agenda has been marked by the transfer of 374 hospitals to the local governments, reform in the social welfare sector and the enlargement of local involvement in pre-university education. Overall, the picture is mixed; we have simultaneously experienced advances, constraints, shortages, opportunities etc.

IV.2. Key municipal budget trends

The share of local government expenditure to GDP has been steadyfor the last 5 years, at 9.8%. Also, the ratio local government expenditure to total public expenditure has been fairly constant, averaging 26%, with a slight downward tendency. However, the i structure of local revenues has undergone important changes, many of them triggered by the economic crisis[2].

Firstly, the transfer pool from the state budget has declined both nominally and as a percentage of total local government revenues. As compared to 2008, transfers were 10% smaller in 2011; in relative terms, they fell from 78% to 64% of local government revenues. As a consequence of this nominal reduction, transfers to local governments have also become smaller relative to total public revenue (the general consolidated budget), as seen in Chart 1. Currently, it stands at 31%, almost 30 percent less than than five years ago.

In Chart 2, three main trends regarding total transfers can be distinguished: (i) shared revenues - mostly earmarked for education and social services - have fallen by almost 30% as a result of wage and employment cuts; (ii) shared income tax has declined from 2008 as a result of the government's reduction of the sharing rate from 82% to 71,5%, reductions that were meant to help cut the central government's deficit; (iii) grants from the state budget have increased, but not enough to offset the other decreases [3].

Secondly, locally generated revenues almost doubled and their share increased from 17% to 28% of total local revenues (see Chart 2). One important caveat when analyzing this category relates to its components: it includes both fiscal revenues - most notably the property tax - and non-fiscal ones - fees, tariffs, user charges, property related revenues. As a result of the decentralization of most public hospitals in 2010, non-fiscal revenues have spiked thanks to the Heath Fund's disbursements for medical services.

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[2] The data presented below is different from the information that has been presented to date to the international community about Romania's 3.228 local governments. In many respects, the numbers are revised upwards. The explanation is that the respective data take into account all the consolidated operations of local governments during 2007 and 2011, namely:

- the local budgets proper (including all public pre-university education and social services),
- expenditure from borrowed resources,
- the locally subordinated public institutions (including - from Q3 2010 - over 300 hospitals),
- up to 2010, the expenditure from previous years' surpluses.

Previously only the revenues and expenditure of the local budgets proper have been most often communicated to international partners for comparative analyses involving Romania. They total more than four-fifths of all local governments resources, but others are also important and must be accounted for. The sources of all the data for this policy report are from the Ministry of Public Finance and the Ministry of Administration and Interior.

[3] The increase in subsidies (also a breed of shared revenues) came mainly as a consequence of more earmarked capital transfers, more allowances for the disabled persons, and the central government's co financing to European Union funded local projects.

However, property tax has also grown nominally by 31%, as a result of the indexing of statutory minimum rates to inflation.

Thirdly, grants from the European Union have become a significant source of revenue, mostly for capital improvements. In 2011, they reached 7% of all revenues and are forecast to grow even higher (see chart 2).

Chart 1. Local governments' revenues and expenditure against GCB and GDP[4]

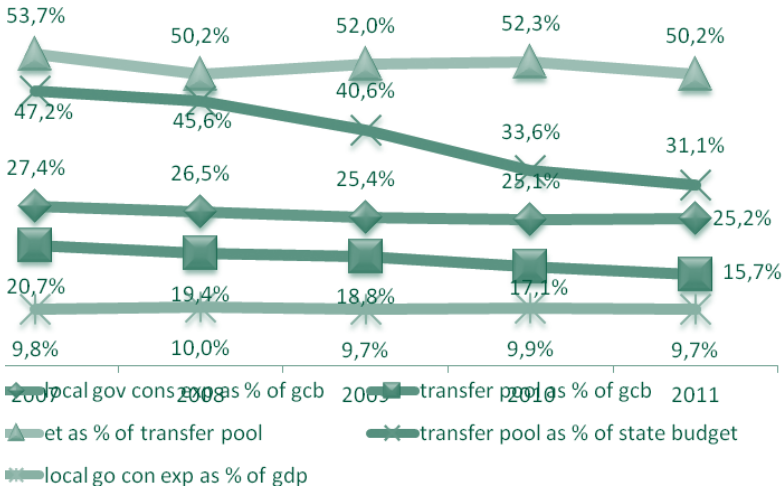
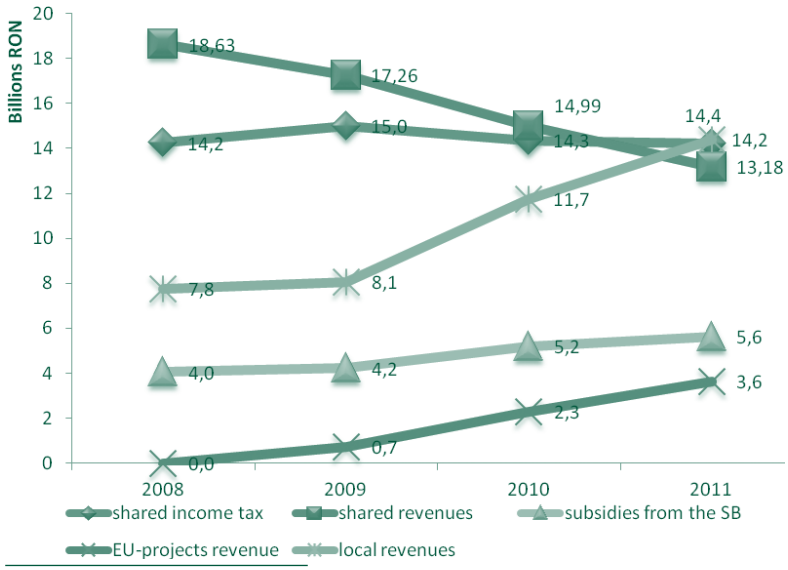


Chart 2. Trends of the main categories of local government revenues (2008-2011)



[4] "gcb" stands for general consolidated budget (all public revenues and expenditure), "et" for earmarked transfers and "local gov cons exp" for all local government and subordinated institutions spending.

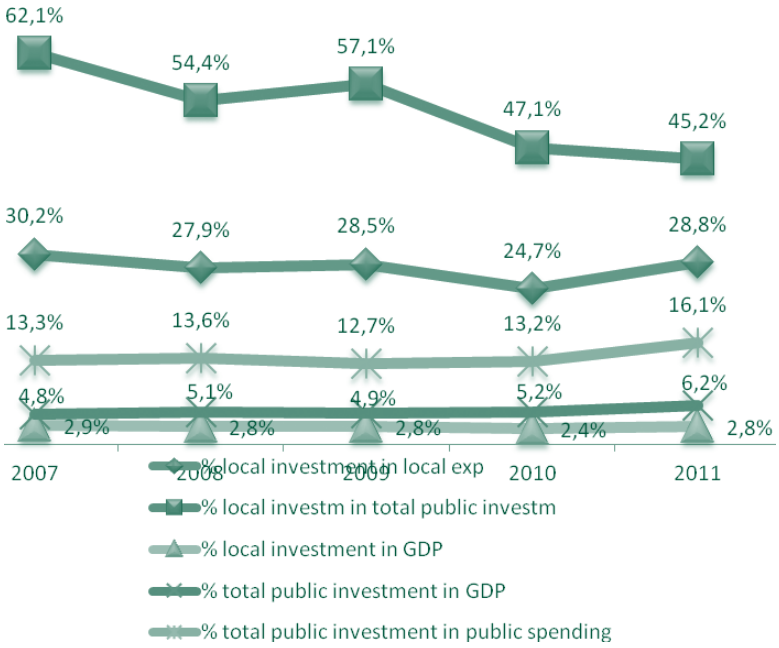
IV.3. Public investments - central vs. local, trends

For the purposes of this analysis, investment expenditures - both local and central - sum up the regular capital spending and the EU-funded projects, most of which are of capital nature. In Romanian financial statements, spending within EU-funded projects is recorded as a standalone chapter, separated from capital spending.

In nominal terms, local government investment has increased by 10% from 2008 to 2011. The increase was due to EU grants, which more than compensated the drop in crisis-impaired ordinary capital spending. As of 2011, local investments accounted for 45% of all public investments, the biggest single source of all public sector investment (see Chart 3). State budget's investment came a distant second, but significantly enhanced by EU-grants.

Total public investment increased significantly in 2011, as EU-grants gathered pace (see Chart 3). The trend is expected to continue unless the economy falters again and the government losses its ability to co-finance EU-projects. The numbers in 2011 were 16% of all public spending and 6.2% of GDP. Nominally, the increase is 75% against 2007.

Chart 3. Trends in public investment as % of GCB and GDP



IV.4. Unfunded mandates

Unfunded mandates are one of the most frequently debated issues in the analyses of fiscal decentralization. However, most of the time, they are evaluated by rule of thumb rather than statistically. In Romania, once a public service has been decentralized, it receives transfers equal to the amount previously spent by the central government agencies. Of course, if the service had been underfunded before, it remained so after the decentralization unless local governments add their own resources. In other cases, the costs of providing the service might evolve faster than the index of related transfers to inflation, hence the expansion of underfunded mandates.

Having said that, there are a number of decentralized services which have proven to be underfunded by the backlog of overdue payments, notably public hospitals and allowances to disabled persons and their assistants. Also, in 2003 district heating plants were transferred to local governments without being cleared of their arrears; their debts were subsequently carried forward from one year to another bringing the local District Heating companies close to bankruptcy. In education, the central government provides transfers for personnel expenditure and some maintenance costs with both being allocated on a per pupil basis. . Local governments are expected to close any deficit that schools may incur beyond what the education transfer actually covers..

IV.5. Own revenues system

Once the majority of public hospitals had been transferred to local governments in 2010[5], the main source of local government (own) revenue has become the user charges they receive for the provision of medical services and the biggest buyer is the National Health Fund (see Chart 5). As a result, they are dependent of the overall resources of the social health insurance system and the Health Fund's policies towards in-patient care.

The second most important source of revenues is the property tax[6], which accounts for a third of all local revenue. The receipts equal 0.9% of GDP. The minimum tax rates are set by the fiscal code and indexed to inflation every three years. Local governments have the right to increase the statutory rate by up to 20%. The determination of the base of the tax is is based on the construction or accounting value of the asset and thus is immune to economic fluctuations.

Two areas where the economic crisis did seem to have an impact are (i) fees for services and permits[7] and (ii) asset sales, which both fell by almost a third from their 2008 peak.

[5] Originally 374 of which less than 300 remain today.

[6] Buildings, land and vehicles.

[7] Mostly permits for commercial activities and building permits.

Revenue from concessions has grown marginally over the last four years, probably as a result of local governments failing to adjust the level of royalties.

Chart 4. Average weight of local (own) revenues sources against all local revenues (2008-2011)

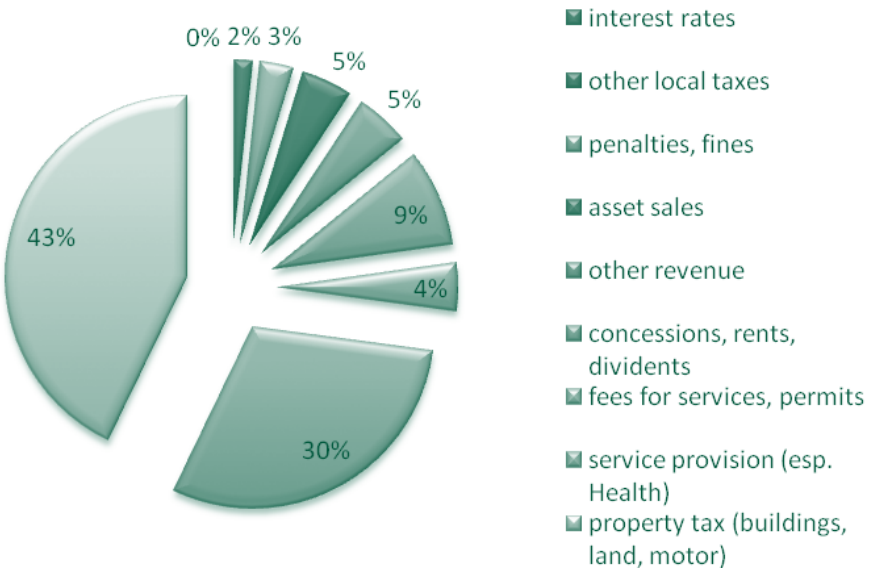
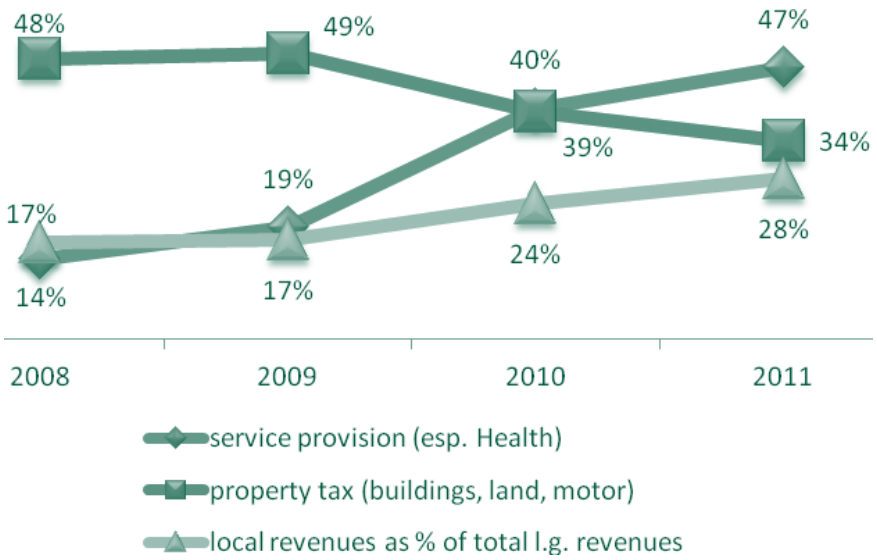


Chart 5. Trends of local (own) revenues against total local government revenues (2008-2011)



IV.6. Financial dependence on the state

If one adds the disbursements from the Health Fund and EU-grants to the all other state transfers to local governments, more than 85% of their revenues come from the central government (or the EU). To be sure, a part from the taxation of property at market value, no other measure could significantly reduce that dependency.

Within the central government transfer pool, earmarked and discretionary revenues are evenly split (see Chart 1). Most unconditional transfers come from the shared income tax.

The past four years have shown the need for greater stability and predictability in intergovernmental transfers.. Even the rates of the shared income tax provided in the Local Public Finance Law have been cut twice on the basis of emergency ordinances of the government in 2010 and 2011.

With regard to earmarked transfers, mostl are determined by the costs of wage expenditures in education and social services and they have covered payroll expenditures every year. However, the capital grants from the state budgets have been volatile, because of both (i) the availability of central government's resources and planned deficit and (ii) the bargaining power of line ministers.

IV.7. The role of the central government towards the impact of the crisis on the local governments

The Romanian government's response to the budgetary consequences of the financial crisis has been three pronged: (i) reduce public sector spending needs through wage reductions, staff layoffs and hiring moratorium, (ii) cut the public sector deficit, including measures to cut transfers to local governments and (iii) enhance budgetary discipline to avoid accumulation of arrears. The own revenue base has not been limited.

A major decentralization program was carried out in 2010 in the health sector; 374 hospitals were transferred mostly to county councils and cities along with their existing financing sources (i.e. the Health Fund and the Health Ministry budget). Accusations of unfunded mandates have been made by local governments associations.

Overall, we deem the Romanian government's response to the crisis as mostly restrictive towards local governments.

IV.8. Borrowing capacity

In Romania, local governments are not free to borrow. A decision to take a loan is made by the local council by absolute majority at the mayor's proposal. Then, the local government submits a request to the Committee for Local Loans' Authorization, based within the Ministry of Finance, which includes representatives of all local government associations.

Each year, the central government approves a national threshold for contracting new local debt and a national threshold for disbursement of local loans for the next three financial years[8]. The Committee will not review a request for a new loan unless there is room within the contracting threshold.Nor will it grant disbursement rights unless there is room within the respective threshold. Once a loan is authorized by the Committee, the disbursement schedule is made for the next three years.

In order to give an approval, the Committee evaluates the fulfillment of several conditions:

- the local government debt service for the proposed loan and any prior debt shall not exceed 30% of the previous three year average of the sum between local revenues within local budgets proper[9] and shared income tax;
- local governments do not have any payment arrears at the end of the year. All the above-mentioned conditions do not apply to loans used to co-finance or pre-finance EU-funded projects, or for debt refinancing.

Local governments are neither required to perform an audit of their finances nor forecast their operating surpluses before taking a loan. However, the bidding banks make their own assessments, based on the local governments' financial statements. Loan contracts are awarded following a public procurement procedure.

From 2002 onwards, the Committee has authorized more than 1.600 loans totaling over 5 billion euro (equivalent). 40% of all loans have been contracted in foreign currency, mostly Euros. The outstanding local debt at the end of 2010 was reported to be close to 3 billion euro, but the data is not entirely reliable given the lack of a standard method of calculation.

[8] The aim of such restrictions is to control spending from local debt as it is not matched by any revenue and generates deficit.

[9] That would exclude own revenues of locally subordinated institutions, such as hospitals.

IV.9. Association's reform agenda in fiscal decentralization - next steps

The Romanian Association of Communes agrees that some austerity measures were needed and more budget discipline is welcome. However, we see no reason (i) for keeping in place restrictions on hiring new personnel and for maintaining annual maximum thresholds for wage I expenditures while staffing norms also apply, (ii) for maintaining overlapping restrictions to borrowing, (iii) for limiting procurement of fuel, furniture, vehicles and communications. Such constraints either do not meet their goals by forcing local governments to game the system or impair the provision of public servicesFor instance, many city halls do not hire school bus drivers anymore. More particularly,the unexpected and unfounded reduction in the income tax share should be reversed.

In all, we believe that the legislation on local public finances has been significantly but chaotically amended over the last four years and that a major overhaul is now needed to set new sound rules and to remove the onerous ones. To this end, the Associations' main objective is the development and approval of a Local Finance Code, to include provisions related to both revenue and budgetary management. In the process, (i) improvements to the current equalization system should be explored to the benefit of poor but fiscally responsible local governments and (ii) a set of wiser methods to prevent the emergence of payment arrears[10].

In addition, we stand for a thorough revision of the current capital transfers from the state budget, which are fragmented and discretionarily allocated by line ministries. Instead, a set of mandatory infrastructure packages should be developed for classes of rural and urban local governments and state budget capital transfers directed towards those with major infrastructure deficits, preferably in conjunction with local co-financing and EU grants.

10 Currently, the rules in force dissuade local governments from admitting their total stock of arrears. If no progress is made in arrear reduction form one month to the next MoF automatically withholds shared PIT transfers until such progress is made.

V. Current Situation and Challenges in the financing of Local governments in Montenegro

V.1. Local Government Revenues

Montenegro has a simple structure of local self government:there is only one level with 21 local government units in total(19 municipalities, capital city and historical capital). The system of the local self government financing is stipulated in the Local Government Finance Law[11] (a "system law"). With athe doption and implementation of this law in 2004 (it has been amended several times since), Montenegro took significant step towards fiscal decentralization and the reform of intergovernmental fiscal relations.

The Law regulates the following: revenue sources, manner of fiscal equalization, theuse of conditional grants, and the financing of the competencies of local self governments. The Law stipulates that resources for funding own competences are provided for in the municipal budget and municipalities dispose of these funds autonomously.

In accordance with The Local Government Finance Law, local self-government units ensure their funding from: own revenues, assigned revenues, the equalization fund and the state budget.

[11] "Official Gazette of RMN", No 42/03, 44/03 and "Official Gazette of MNE", No 05/08 i 74/10

1) Own municipal revenues are as follows:

- local taxes (surtax on personal income tax and real estate tax);
- local charges (local communal charges and local administrative charges);
- local fees (fee for utility equipment of construction land, fee for the use of municipal roads, fee for environmental protection and improvement)
- other revenues specified by the law.

Based on the law, municipalities are authorized to introduce several types of own revenues (taxes, fees, and charges), to determine their level within the limits prescribed by law, to provide exemptions and relief, to perform billing, to control revenue collection and to prescribe penalties.

2) Montenegrin municipalities receive funds in the form of "assigned (shared)" revenues from:

- personal income tax (12% for municipalities, 13% for capital City and 16% for historical capital)
- tax on real estate transfer – 80%
- concession and other fees for using natural resources awarded by the State (70% - except for the concession fees collected for the use of ports, whereby 20% is assigned to municipalities where the port is located)
- annual fees for registration of motor vehicles, tractors and trailers
- fees for use of motor vehicles and their trailers (eco-fee) - 30%[12].

-

3) Municipalities in weaker fiscal positions have the right to revenues from the Equalization fund. The Law stipulates that the resources from the Fund are to be distributed to all municipalities in which the average fiscal capacity per capita in the three previous fiscal years is lower than the average fiscal capacity per capita of all municipalities for the same period. The criteria used for allocating theEqualization Fund fall into two categories: fiscal capacity and expenditure needs. Equalization Fund is formed from: 11% personal income tax, 10% tax on the transfer of real estate, 100% tax on use of motor vehicles and aircrafts and 40% concession fees for games of chance.

4) Municipalities also have the right to conditional grants from the state budget. These revenues must be used for co-financing local investment projects, which are of special interest to them .

12 According to the recent amendments to the Regulation on fees, method of calculation and payment of charges for environmental pollution (in effect as of January 2012), this fee has abolished.

Table 1: Structure of total local government revenues in 2011

Revenues	total amount	% of total amount
I OWN REVENUES	113.533.870	54,10
1. Local taxes	*44.446.728*	*21,18*
Surtax on personal income	14.549.830	6,93
Real estate tax	29.896.898	14,25
2. Local charges	*5.969.432*	*2,84*
Local administrative charges	2.101.784	1,00
Local communal charges	3.619.912	1,72
Other charges	247.735	0,12
3. Local fees	*38.839.648*	*18,51*
Fee for utility equipment of construction land	34.650.886	16,51
Fee for the use of municipal roads	2.924.398	1,39
Other fees	1.264.363	0,60
4. Other local revenues (fines and interest payments, revenues generated from municipal entities own revenues, etc.)	*12.644.344*	*6,02*
5. Asset revenues	*11.633.716*	*5,54*
II SHARED REVENUES	31.280.976	14,91
1. Personal income tax	13.378.754	6,37
2. Tax on real estate transfer	9.867.323	4,70
3. Concession and other fees for using natural resources awarded by the State	5.682.087	2,71
4. Annual fees for the registration of motor vehicles, tractors and trailers	1.425.978	0,68
5. Fees for use of motor vehicles and their trailers (eco-fee)	926.831	0,44
III EQUALIZATION FUND	22.761.327	10,85
IV TRANSFERS	2.450.093	1,17
1. Conditional grants	1.603.909	0,76
2. Other transfers	846.184,45	0,40
V OTHER RECEIPTS	39.839.274	18,98
1. Donations	*4.244.191*	*2,02*
2. Borrowing and loans	*21.414.387*	*10,20*
3. Funds transferred from the previous year	14.180.695	6,76
TOTAL:	209.865.542	100,00

Table 1 shows the structure of total local government revenues in 2011. As it can be seen, the largest shares in total local government revenues come from the following sources: fee for utility equipment of construction land 16,51%, real estate tax 14,25%, surtax on personal income tax 6,93%, personal income tax 6,37%, as well as receipts from borrowing and loans (10,20).

This however, is a picture of theaverage structure of local revenues in all Montenegrin municipalities. In practice, the situation in individual municipalities is very different. There are extreme regional inequities in the structure of municipal budgets. The analysis of the impact of the revised legislation on the financing of local government[13] has shown that the greatest impact on the budget structure of municipalities in the north is from the the Equalization fund (in some cases exceeding more than 60% of total revenues). On the other side, ownrevenues have the greatest impact on the budgets of municipalities in the south and in the Capital City of Podgorica.

V.2. Local Government Expenditure

The execution of the municipal competences is shown numerically in the municipal budget – on expenditure side. The economic structure of local government expenditure in the last few years is shown below:

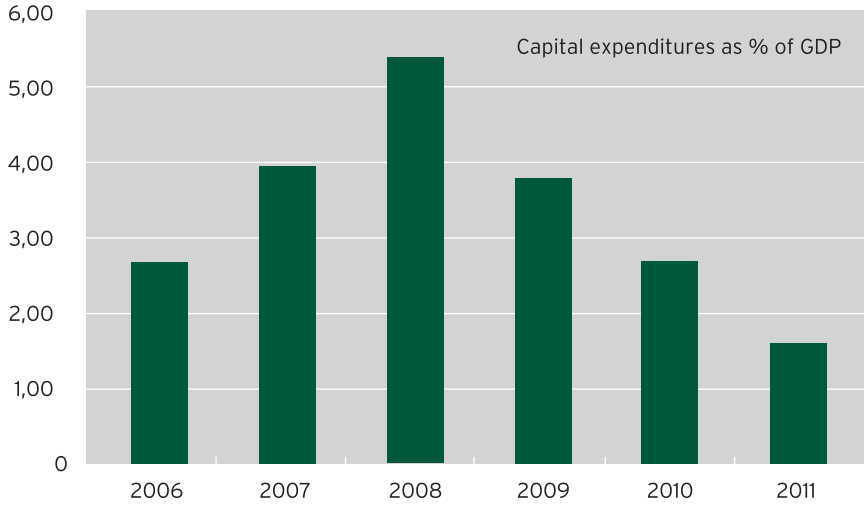
Table 2: Local government expenditure

	2006	2007	2008	2009	2010	2011
Total expenditure (in mil €)	146,9	234,12	316,27	259,23	224,56	199,9
Capital expenditure	39%	45%	53%	43%	37%	26%
Wages	19%	16%	16%	18%	17%	21%
Goods and services	13%	12%	10%	10%	10%	10%
Transfers to individuals	1%	1%	1%	1%	1%	1%
Subsidies to public companies	8%	8%	6%	10%	11%	11%
Debt repayment	12%	9%	6%	14%	19%	25%
Other	9%	8%	8%	4%	5%	6%

As shown in Table 2, the local expenditure on investment was very high for between 2007 and 2009 . Since then, however, it has decreased rapidly (especially in 2011). Now the structure of local expenditure is quite different. This especially refers to the capital expenditure and debt repayment: Unlike before, debt repayment hasrapidly increased since 2009 while local capital expenditure has decreased.

[13] http://www.uom.co.me/wp-content/uploads/2011/10/analiza-uticaja-zakonskih-rjesenja.pdf

Capital expenditures have generally been financed from current revenues, and then partly from loans and specific donor funds. The "best year" for investment was 2008 which was characterized by significant foreign investments in Montenegro. Significant privatization deals generated proceeds and thus money was available at the local level. Moreover, international markets were still healthy and Montenegro's private sector was performing well, ensuring the timely payments of taxes.All of this led to the better performance of central and local budgets. Municipalities were encouraged to undertake significant capital investments and expensive multi-year projects. [14]



However, the economic crises has led to: a radical decrease in investment activities; liquidity problems in the commercial sector; the shrinking of external markets; overstaffing in municipalities, changes in the legislation, etc., the fee for utility equipment of construction land (revenues from this fee are used for financing of the capital expenditure) and other current revenues decreased. In this situation, municipalities had to finance capital investment projects that had already been begun from a combination of asset revenues and expensive loans and credits (economic crisis affected the banking sector, too). Current revenues were nolonger sufficientto cover of all of these investments , and as a result most municipalities have reached the legal limits for borrowing[15]. Local capital expenditure decreased rapidly. At the same time, debts for capital investment have accumulated, and are now the main reason for the significant increase in local governments' outstanding debt.

14 "Montenegro Municipal Country Study" – Nataša Obradovi (*World Bank-Austria Urban Partnership Program - Municipal Finance in South-East Europe*

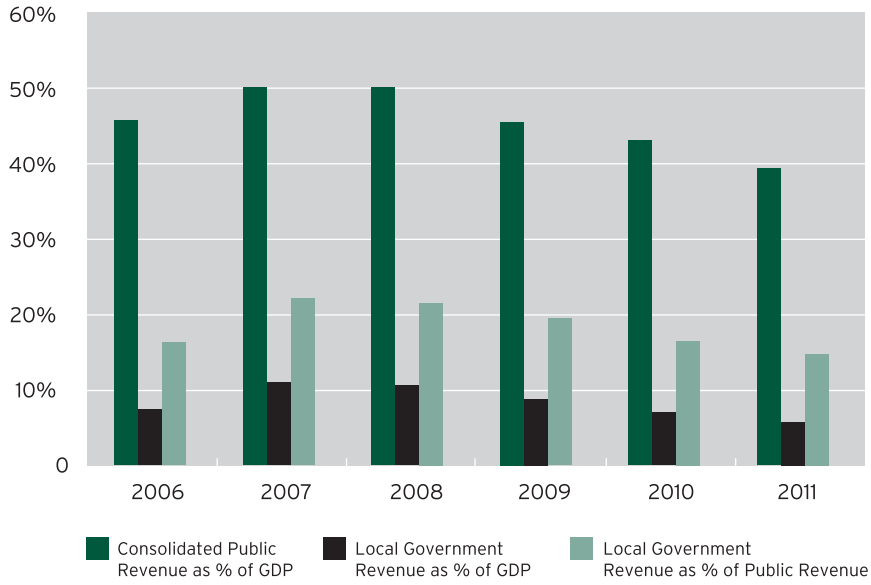
15 "A municipality may be indebted in a such way that the total payments of principal and interest, payments under a leasing contract, repayment of obligations for prior period and any other obligations that have the character of the debt may not exceed 10% of the realized current income in a year preceding the year of borrowing, with the previous approval of the Government." – article 64 – The Law on Local Government Finance

V.3. Fiscal Decentralization in Montenegro

The fiscal decentralization process is closely related to the clear definition of the municipalities' task/responsibilities (expenditure assignments)..

The Montenegrin Law on Local Self - Government[16] regulates the local government responsibilities. These include: development plans and programs, ambient and urbanism plans, capital improvement plans and investment policy, budgeting; providing conditions for community affairs and their performance and development; maintenance and protection of local and non-categorized roads, passenger transport in urban areas and suburban traffic; providing conditions for entrepreneurial development; taking care of local assets of public interest; regulation of relations in the field of housing; providing conditions for cultural development and protection of cultural heritage; managing, disposing, and protecting local property, etc. Unlike some other countries from the region, the local government units in Montenegro do not have any responsibilities in the health and education sectors. Thus, it implies a fairly very limited scope of local government functions.

The share of local public revenues (or expenditure) in the country's GDP is the single most telling indicator of fiscal decentralization because it shows the size of the local government sector in relation to the country's total economic activity. The second most important indicator of fiscal decentralization is the share of local public revenues (or expenditure) in the consolidated public revenues (or expenditure) of the central Government. This indicator tells how large the role of local governments is in the total public sector[17].



[16] "Official Gazette of RMN", No 42/03, 28/04, 75/05, 13/06 and "Official Gazette of MNE", No 88/09, 3/10 i 38/12

[17] NALAS Report "Fiscal decentralization Indicators for South East Europe 2005-2010"

This chart shows the trends of all above mentioned indicators - the decrease of local government revenues as a share of GDP, as a share of total public revenues, as well as the decrease of total public revenues as a share of GDP. The reasons for these trends are elaborated below..

V.4. Changes in the Legislation

As elsewhere in the world, the consequences of the global economic crisis significantly affected the Montinegrin economy.. Local government units, as part of the public sector, were affected by the negative impact of the economic crisis as well as by the changes in some laws which regulate (directly or indirectly) their revenues. Now the situation is difficult revenues currently insufficient to finance their basic needs or to enable the local economic development in most municipalities.

Some of laws were amended in ways that had very negative effects on local government budgets over the last several years:

- The Law on Local Communal Fees[18] abolished tlocal communal fees for the use of structures for the transmission of electricity; the use of telecom facilities, the installation of TV and radio receivers; and the use of the sea shore for business purposes. Of course, this produced cuts in municipal revenues since 2008;
- The Law on Civil Register[19], which came into force on 01.01.2009, abolished some administrative fees related to public registers, although this was combined with the some centralization of functions;
- Nevertheless, it seems that the most negative effect on the local government revenues was due to the Law on Spatial Planning and Construction of Objects[20]. This Law abolished local fees for the use of construction land without compensation (since 2009). Also, the payment of fees for equipping construction land with utilities was shifted from the beginning of the investment cycle to its end (completion of the investment). Later, under the Law on Improvement of the Business Environment[21] the payment of this fee was returned to the beginning of the investment cycle.
- In addition, the most recent amendments to the Law on Local Government Finance[22] abolished some local taxes (consumption tax, tax on company or name, tax on gambling and games), etc.

18 "Official Gazette of RMN", No 27/06

19 "Official Gazette of MNE", No.47/08

20 "Official Gazette of MNE", No 55/08

21 "Official Gazette of MNE", No 40/10

22 "Official Gazette of MNE", No 74/10

The abolishment of these revenues (without compensation), along with the economic crisis, combined with having a big number of initiated investment projects that had to be continues, created large vacuum in the local budget. After the "good investment years", municipalities now have problems adjusting to the new situation. The insolvency of tax payers; the inefficiency of municipal tax enforcement;, the insolvency of legal entities and businesses; the lack of penalty provisions for defaulters;the lack of reliable information on the yield of shared revenues are all further complicating the financial position of municipalities..

In order to overcome this situation, most local government units increased their borrowing. The local governments, however, remain well within the national borrowing limits, according to which debt service payments should not exceed 10% of the preceding year current revenues.

As current revenues decreased, local governments were unable to respond to all of their obligations (to the banks, creditors, state budget, etc.). This resulted in in significant increase in payment arrears as well as borrowing..

Table 3: credit, loans and outstanding debt

	2006	2007	2008	2009	2010	2011
credits and loans	5.890.000	10.710.000	17.310.000	17.490.000	22.060.000	21.414.387
outstanding debt	23.410.000	20.530.000	27.970.000	77.300.000	94.970.000	98.531.203
credit and loans as % of total rev.	3,71	3,64	5,24	6,65	10,21	11,36
outstanding debt as % of GDP	1,09	0,77	0,91	2,59	3,06	3,01

In order to overcome this situation, the legal framework was improved in 2010. The Law on Changes to the Law on Local Government Finance[23] and the Law on Changes to the Law on Real Estate Tax[24] were adopted and came into force on 01.01.2011. These legal changes related to the following:

- increased participation of municipalities in the allocation of revenues from tax on personal income (11% compared to the previously applicable percentage 10% from 10% to 13% for Capital City, and from 15% to 16% for the Historical Capital);

23 "Official Gazette of MNE", No 74/10

24 "Official Gazette of MNE", No 75/10

- increased participation of municipalities in the allocation of revenues from taxes on real estate (80% compared to the previously applicable percentage 50%);
- increased participation of municipalities in the allocation of revenues from concessions for the use of natural resources (70% compared to the previously applicable percentage 30%);
- new revenues included in the structure of the Equalization Fund (100% income tax on the use of passenger vehicles, vessels and aircraft and 40% of the revenues from concessions from the games of chance, while the revenue from taxes on real estate in this fund decreased from 20% to 10%);
- improved criteria for distribution of revenues from the Equalization fund;
- the real estate tax base was expanded and the maximum rate of the real estate tax was increased.c.

Furthermore, in order to assist municipalities in overcoming their financial problems, the Government of Montenegro adopted an agreement to enable the municipalities to enter into contract with the Ministry of Finance for financial restructuring. To date, eight municipalities have signed such contracts with the Ministry of Finance, and more municipalities are currently negotiating such contracts. The contracts allow for the the reprogramming of debts, central budget co-financing of municipal redundancy programs, wage renegotiations and the approval of further borrowing for the purpose of fulfilling the contract, under the condition imposed on the municipalities, mainly to cease further hiringor the rehiring of employees who received severance payments.[25]

Considering the major problems related to the overstaffing of municipalities, the Government of Montenegro in June 2010 adopted the "Information on the optimization of the number of employees in local governments" and set asode financial support for those local government units which will work on the optimization of their employment structures. For those municipalities which signed an agreement for financial reconstruction with the Ministry of Finance, the Government committed to co-fund the retirement of redundant labor in the amount of 1.926 Euros per employee. Over the medium term, these activities should have a positive effect on the expenditure side of the municipal budgets.

[25] "Montenegro Municipal Country Study" – Nataša Obradovi (World Bank-Austria Urban Partnership Program - Municipal Finance in South-East Europe

V.5. Key Issues for Future

Having implemented all these activities, the situation in the Montenegrin municipalities is still very difficult. In order to overcome this situation, it will be necessary to make joint efforts on both the local and central levels. The following activities should be planned:

- improve some provisions in the Law on Local Government Finance, the Law on Real Estate Tax and some by-laws;
- harmonize certain provisions from other laws with the system law – the Law on Local Government Finance;
- prepare and adopt missing by-laws which will help the better implementation of finance laws;
- ensure conditions for quality implementation of finance laws;
- improve efficiency of local administration in collecting own local revenues;
- provide better exchange of information between central and local level about shared revenues;
- improve the collection and control of shared revenues on the central level (especially concession and other fees for using natural resources awarded by the State);
- raise public awareness about the obligation for payment of taxes;
- use all opportunities to draft and adopt local finance acts (for municipalities that have not completed this task);
- signing contract on financial restructuring with the Ministry of Finance as soon as possible (for municipalities facing financial problems and haven't signed this contract);
- adequate implementation of the signed contracts on financial restructuring,
- precise definition of municipal property, etc.

V.6. Activities of the Union of Municipalities of Montenegro

In November 2006, the Union of Municipalities of Montenegro signed an Agreement of cooperation with the Government of Montenegro. One of the aims of this Agreement is to strengthening the financial autonomy and position of municipalities. The implementation of this Agreement is not on the expected level and a lot remains to be improved.

The UOM has significant role in improving the cooperation between the local and central levels - especially in the field of local government finance. Being guided by this principle, the UOM has prepared different analyses of local government finances, organized several meetings with competent governmental bodies, participated in the working group for drafting the finance laws, and prepared opinions on different laws and by-laws, etc. However, results achieved so far regarding the financial position of municipalities are not very satisfactory and would require improvements in the following period. Nevertheless, the, cooperation between the Ministry of Finance and UOM can be assessed as being good..

Also, another important thing is that in order to ensure monitoring of the system's development and especially in order to improve the equity of efficiency the system and transparency of the fiscal decentralization system, the Law on Local system the Law on Local Government Finance stipulates the establishment of a Commission for Monitoring the Development of the System of Fiscal Equalization of Municipalities. The Commission consist of five members from Union of Municipalities of Montenegro, one from the Ministry of Interior and one from the Ministry of Finance. The president of this Commission is always a UOM representative.

It should also be noted that UOM is currently involved in the implementation of the UNDP project "Strengthening mechanisms for public finance at the local level in Montenegro". Also, UOM participates in the World Bank-Austria Urban Partnership Program - Dialogue between cities - Municipal Finances in South East Europe".

VI. Current Issues and Challenges in the Fiscal Decentralization Process in the Federation of Bosnia and Herzegovina (Bosnia and Herzegovina)

VI.1. Current State of Intergovernmental Fiscal Relations in the Federation of Bosnia I Hercegovina (Bosnia and Herzegovina)

Federation of Bosnia and Herzegovina (hereinafter FBiH) is one of the two Entities in Bosnia and Herzegovina. Its structure and intergovernmental relations are complicated and entangled. FBiH consist of 10 cantons and 80 local self-government units (two cities and 78 municipalities). According to the Constitution of the FBiH, the FBiH has exclusive responsibility for „regulating the finances and financial institutions of the FBiH and the fiscal policy of the Federation"[26]

The main law that regulates the fiscal relations in the FBiH is the Law on Public Revenue Allocation in FBiH[27], which was adopted with the aim to improve the vertical balance between municipalities and cantons and to reduce dramatic fiscal imbalances across both municipalities and cantons.

Until the reforms in the sphere of direct and indirect taxation and the adoption of the Law on Public Revenue Allocation in the FBiH, the two most important taxes for

[26] Constitution of the Federation of Bosnia and Herzegovina ("Official Gazette" of the Federation of Bosnia and Herzegovina, 1/94, 13/97, 16/02, 22/02, 52/02, 60/02, 18/03, 63/03)

[27] „Official Gazette of the FBiH", No. 22/06, 22/09

financing the public expenditures were the Wage Tax and the Sales Tax which were collected by the FBiH and then returned to the cantons origin basis. This produced dramatic difference in the per capita revenue of the cantons, with the vast majority of the Sales Tax flowing to the capital jurisdiction of Sarajevo Canton. The cantons had their own regulation with regard to the sharing of these taxes with the local self-government units on their territories (also origin based). First, municipalities in many cantons were radically underfunded and there were severe fiscal imbalances across municipalities due in part because of difference in overall economic activity, and in part because of difference in cantonal policy.

The Law on Public Revenue Allocation in the FBiH introduced a formula based system for allocation of the revenues from VAT, custom fees, excises and road fees collected on the Sigel Account by the Indirect Tax Authority at the state level to different levels of government. The Law also defines the minimum amount of the Personal Income Tax that cantons must share with municipalities. The part of the Law regulating the allocation of revenues from the Single Account was introduced over a period of six years in order to avoid budgetary shocks. The law increased the total share of public revenues going to municipalities while also producing a significant equalizing effect on local self-government per capita revenue.

The equalizing effect of the Law is illustrated in the table below:

The Equalizing Effect of SA (and PIT) sharing on Municipal Budgets (per capita) 2005-2010						
	2005*	2006	2007	2008	2009	2010
Ratio of the municipality with the highest per capita SA and PIT revenue to the poorest	51.4	27.3	13.7	7.5	4.8	3.0
Ratio of the 25% of municipalities with the highest per capita SA and PIT revenues to the 25% with the lowest	4.8	3.4	2.6	2.2	1.9	1.7

Source: Prilago avanje formule za raspodjelu sredstava sa jedinstvenog ra una unutar i izme u nivoa vlasti u Federaciji BiH[28]

Before the Law on Public Revenue Allocation in the FBiH was adopted, the ratio between the municipality with the highest revenue from the Sales and the Wage Tax and the municipality with the lowest revenue from these sources was 51.4:1. In 2010, this ratio was reduced to 3.0:1. The same effect is also evident when comparing 25% of the richest to 25% of the poorest local self-governments in the FBiH. In 2005, the ratio between the richest 25% to the poorest 25% was 4.8:1 and in 2010 it accounted for 1.1:1.

[28] Prilago avanje formule za raspodjelu sredstava sa jedinstvenog ra una unutar i izme u nivoa vlasti u Federaciji BiH, , Projekat upravne odgovornosti – GAP, 2012, p. 17.

In the past six years, FBiH underwent a number of important fiscal reforms including the reform of Personal Income Tax and Corporate Income Tax, the replacement of a point of sales, Sales Tax, to a centrally administered Values Added Tax, and the creation of a new state level body to administer and collect all indirect taxes (Indirect Tax Authority).

All these reforms and the new Law on Public Revenue Allocation in the FBiH resulted in a more equalized fiscal system.

VI.2. Key Municipal Budget Trends

Consolidated public revenue as percent of GDP fluctuated between 36% and 41% in the period between 2006 and 2011. This percentage is far below the EU average of about 49% and refers to weak economies and inefficient tax collection.[29] It has to be stressed that the tax collection actually improved and the grey economy weakened in the past seven years since the reforms were implemented.

Local government revenue as percent of GDP in the FBiH fluctuated between 5% and 4% in the period from 2006 to 2011. The low percentage of local government revenue as percent of GDP in comparison to the EU average of about 11% indicates that that the decentralization process in the FBiH is still far from completed. Although the government structure of the FBiH (with 10 cantons with their own governments and parliaments and 80 local self-government units) implies that the FBiH was envisaged as a highly decentralized entity, the fiscal indicators show another picture. It is especially disturbing that consolidated public revenue a percentage of GDP rose from 37% in 2010 to 41% in 2011 while local government revenue as percent of GDP declined from 4.3% to 4.0% during the same period.[30] These developments imply the existence of a trend towards weakened position of the local authorities.

Local government revenue as percent of the total public revenue, i.e. 10%, is the lowest in the region and not even comparable to the EU average of 24%. Thus, it implies the minimal importance of the local level in the overall governmental structure. The fact that this percentage has been declining since 2007 is even more alarming. In 2007 and 2008, the local government revenue accounted for 13% of the total public revenue. In 2009 and 2010, it accounted for 12% and declined to 10% in 2011.[31] Partly, this low percentage can be explained through the government structure of the FBiH and the role the cantonal level of government. The cantonal level is responsible for most expensive competencies, such as education, social welfare, health and police and judiciary (wages, investment and maintenance).

[29] NALAS Fiscal Decentralisation Indicators for South-East Europe: 2011, p. 21.

[30] NALAS Fiscal Decentralisation Indicators for South-East Europe: 2011, p. 21. 52.

[31] NALAS Fiscal Decentralization Indicators for South-East Europe: 2011, p. 52.

VI.3. Financial Autonomy of Local Self-Government Units in the FBiH

The composition of the local government revenues in the FBiH does not seem to be worrisome. With 36% own revenues, 30% general grants (grants from indirect taxes allocated based on a formula) and 18% shared taxes, local self-government units in the FBiH appear to be relatively independent in comparison to the others in the region.

Own revenues consist of administrative and communal fees and charges, fines and property tax income. The fees and charges also include the land development fee and the land use fee, which are not separately reported to the higher levels, thus it is impossible to track them.

Furthermore, it is worth noting that the Property Tax and the Property Transfer Tax are reported together as „Property Taxes" without further disaggregation. The Property Tax and the Property Transfer Tax are regulated by cantonal laws. Each of the ten cantons has its own laws which regulate these taxes. The Property Tax is regulated in a similar way in almost all of the cantons: as a rate set on m^2 or a unit. Property Tax is not paid on the property which is used for private housing. A number of exemptions are included in all laws. In 2010, four of ten cantons were giving yielding 100% of this revenue to local self-government units. The rest of the cantons set different percentage for sharing this tax with local self-government units ranging from 50%:50%; in Posavski kanton to 75%:25% for municipalities in Kanton 10. The Property Transfer Tax is the tax which is paid at the moment of selling a property based on the property value. Property Transfer Tax is similarly divided like the Property Tax in most cantons.[32]

As currently being applied, the Personal Income Tax is the end result of a set of direct taxation reforms in the FBiH. The Personal Income Tax Law which is being implemented since 2009, introduced a new form of tax that replaced the former Wage Tax and a group of other taxes set by cantons. The sharing of the Personal Income Tax is regulated by the Law on Public Revenue Allocation in the FBiH. The Law on Public Revenue Allocation in the FBiH sets a minimum percentage of 34,46% as a share that belongs to local self-government units and leaves the possibility for cantons to assign a higher percentage of this tax to the local self-government units. Only two cantons are currently giving a higher percentage to their local self-government units than the minimum.

Around 30% of the local government revenues originate from indirect taxes which are allocated on the basis of a formula set in the Law on Public Revenue Allocation in the FBiH. This revenue is fairly predictable because it does not depend on ad hoc decisions of the government. It does however fluctuate with the overall growth or decline of the economy. Reforms of indirect taxes and indirect taxation administration on the state level provided an opportunity for reform of the public revenue sharing system as follows: Value added tax replaced the Sales Tax in Bosnia and Herzegovina, the

[32] Analiza pripadnosti i raspodjele javnih prihoda u Federaciji Bosne i Hercegovine sa posebnim osvrtom na poreze, FMF, 2012, p. 29.

Law on Indirect Taxation in BiH was adopted, the Indirect Tax Authority on the state level was formed and the Single Account was established. (The Single Account includes all VAT revenues, custom fees, excises and road fees). From the Single Account, the functions of the BiH state are financed first, and then the Br ko District which gets a fixed minimum amount or a fixed percentage.

Importantly, the international debt service payments of all entities and agencies of BiH are paid to foreign creditors before the two entities get their share from the Single Account. This is a major issue that is going to be given central attention by the Associations of Municipalities and Cities of the FBiH in the near future. Namely, all levels of government in FBiH do not get their full share of revenues from the Single Account, but receive only their percentages from the residual of the Single Account after the repayment of the international debt. As result since 2009 the revenues of all levels of government from the Single Account are on the decrease because the major borrower is the Federation with a share of 99% of the international debt.[33] In other words, the debt service payments of the Federation are being made at the expense of the budgets of cantons and municipalities.

Once the entities get their share, the revenues are allocated according to the entity laws. In the FBiH, it is done according to the already mentioned Law on Public Revenue Allocation in the FBiH. According to the law, each level of government is assigned a percent of the revenues from the Single Account. The Federation level receives 36,2%, the cantonal level receives 51,48%, the local level receives 8,42% and the Road Agency receives 3,9%. Both the cantonal and local government shares are then allocated between the jurisdictions of their level according to a formula based on population, area and in the case of local governments PIT per capita.

Until now, the Government of FBiH has done nothing to mitigate the impact of the 2009 financial and economic crisis on the local government level. On the contrary, the Government of FBiH signed a Stand-by arrangement with the IMF, which resulted in a decrease in the revenues from the Single Account due to the repayment of FBiH's international debt from the Single Account prior to the allocation of funds to canton and municipalities. It is worth noting that it was the Association of Municipalities and Cities of the FBiH that drew the attention of the Federal Ministry of Finance and also of the cantonal ministries of finances to this issue!

There is, however, hope: At the end of 2011, the Government of FBiH formed a Task force for the analysis and preparation of solutions in the field of public revenue allocation under the umbrella of the Federal Ministry of Finance. The Presidency of the Association of Municipalities and Cities of FBiH appointed two members to this Task force as representatives of the local authorities. The representatives of the local authorities acted in accordance with a document containing a list of priorities and requests toward higher government levels for the improvement of municipal finances. This document

[33] Informacija o vanjskom i unutarnjem dugu Federacije Bosne i Hercegovine na dan 31.12.2010.godine, FMF, juni 2011., p

was developed during a thematic session of the Committee for Economic Development of Municipalities and Cities and Finances of the Association with the input of almost all Heads of municipal finance departments in the FBiH. The Task force approached the Government of FBiH with different initiatives for changing the Law on Public Revenue Allocation. One of the initiatives is to raise the minimum share of the Personal Income Tax for local government units from 34,46% to 41%. This initiative will have to go through parliamentary procedure; nevertheless this is a positive signal from the Federal Ministry of Finance.

Earmarked grants from higher government levels account for around 18% of the overall local government revenues in the FBiH, and thus depend on ad hoc decisions and changes in the governments' political structure. In the past two years, Government of FBiH was restructured a number of times and local governments were often denied the grants based on political arbitrariness. The Association expects an increase in this arbitrariness given the results of the local elections in October 2012.

VI.4. Local Government Investment

Although the local self-government units in the FBiH face many difficulties, they all share the dedication to improve the quality of life of their citizens. It is worth mentioning that the municipalities in the FBiH not only have to improve the outdated or non-existent infrastructure, but also bear the burden of rebuilding the infrastructure destroyed during the war and to deal with the population upheavals that resulted from the war.

Around 28% of the overall expenditures of local self-government units in the FBiH are used for public investments.[34] While almost 1/3 of the total expenditures is spent on investment on local level, the total public investment spending in the FBiH is the lowest in the region with 1,8% of GDP. For higher government levels it accounts for 0,4%. Local government investment spending as percentage of GDP equaled 1,4% for the period 2006-2011. Local investment spending peaked in 2008 at almost 2% of GDP.[35] At the same time, the wages remained on a stable level at 1% of GDP for the entire period. This means that the local level has been the main driver of public investments and that little is being invested by either cantons or the federal government. If there are enough funds available (like in 2008), local governments spend them on investments.

[34] NALAS Fiscal Decentralization Indicators for South-East Europe: 2011, p. 37.

[35] NALAS Fiscal Decentralization Indicators for South-East Europe: 2011, p. 58.

VI.5. Local Government Borrowing

According to the Law on Debt, Borrowing and Guaranties in the FBiH[36], the municipalities and cities in the FBiH can contract long-term debt if their debt service payments in future years does not exceed 10% of the previous year's revenues. Only in few cases do municipalities and cities in the FBiH need permission from the Federal Ministry of Finance to borrow (for example when the FBiH is the guarantor).

LGU debt accounts for only 3% of total FBiH debt and 0,9% of FBiH GDP. However, it is worth noting that the LGU debt has increased significantly since 2008, with internal debt increased by 81% and external debt increased by 35% in 2010 compared to 2008. Overall FBiH debt increased by almost 20% in 2010 compared to 2008, partially due to budget support loans from international financial institutions and the increase of debt via treasury/bonds.[37]

VI.6. Association's Reform Agenda

- The Association of Municipalities and Cities in the FBiH signed a Memorandum of Cooperation with the Government of the Federation of Bosnia and Herzegovina in October 2011 stating that joint actions will be conducted for the improvement of the system of local self-government in the FBiH. Besides the cooperation in the sphere of legislation and especially the implementation of the Law on Principles of Local Self-Government in the FBiH, it was agreed that joint activities will be conducted in the sphere of fiscal decentralization. The next step is the signing of the Codex of Intergovernmental Relations in the FBiH, which will ensure better communication between different levels of government aimed towards full implementation of the Law on Principles of Local Self-Government in the FBiH. These two documents will be the base for all next steps of the Association in regards to improving the position of local self-government units in the FBiH.
- The inclusion of representatives of the Association in the Task force for analysis and preparation of solutions in the field of public revenue allocation in the FBiH was a major step forward in the recognition of the importance of the voice of the local authorities with regard to the negotiations about legislative solutions for the fiscal system of the FBiH. The Association will continue working with the results of the Task force, follow up the initiatives through the parliamentary procedure and propose amendments to the Law on Public

[36] „Official Gazette in the FBiH", No. 86/07, 24/09 i 45/10

[37] Municipal Finance Review for the Entity of the Federation of Bosnia and Herzegovina, World Bank Institute and Austrian Development Agency, Urban Partnership Program, Municipal Finance Review and Municipal Financial Self-Assessment Project, Naida ar imamovi Vukoti , September 2012, p.26.

Revenue Allocation in the FBiH in order to improve the fiscal position of local self-governments.

- The Association will continue working of the debt service issue with the clear request for the establishment of a debt repayment system in the FBiH where all government units will be responsible for servicing their own debt without burdening others.
- In 2013, the first census after 22 years will be conducted in Bosnia and Herzegovina. The new statistical data will provide an excellent opportunity to request changes in the Law on Public Revenue Allocation in the FBiH with regard to increasing the share of revenue from the Single Account for the local level.
- Federal Ministry of Finance does not dispose of data on revenues and expenditures on the level of individual municipalities. Only consolidated data from the cantonal ministries are provided to the Federal Ministry of Finance. The overall quality of financial reporting in FBiH is poor. The Association has started working on the design of single database with finance data from individual municipalities in the FBiH through the WBI UPP. The data will be made available to the Federal Ministry of Finance. The Federal Ministry of Finance has recently issued a new Rulebook on Financial Reporting. It is important to work with municipalities on improving the quality of reporting.
- Reform of the property tax is inevitable in the future. The Association will play an important part in this process by analyzing and comparing the legislation in the cantons and in the region, searching for the best solution and provide directions and recommendations for this reform.

VI.7. The Role of NALAS in the Fiscal Decentralization Process in South-East Europe

The region of South-East Europe is increasingly becoming recognized as a single area whereby global companies, investors and creditors are looking beyond borders of the small countries.

While it is very important that fiscal decentralization process progresses in all NALAS members to the satisfaction of local authorities in each country and that every individual municipality and city is thriving in their environments, all of them need to be connected and have access to knowledge and relationships across the region.

NALAS has the key role of interconnecting the region as well as connecting it with its European future.

VII. Fiscal Decentralisation in Kosovo[38]

VII.1. Summary of the main conclusions/messages

- The principles of municipal financing and the participation of municipal budgets in the overall Budget of the Republic of Kosovo (i.e., governmental transfers for municipalities) are structured by the Law on Local Government Financing (LGF).
- Over the last few years their have been major changes in both the vertical and horizontal balance of Kosovo's intergovernmental finance system..
- Municipalities now enjoy an increased level of fiscal decentralization. The transparency of municipal budgets, including their development, registeration and reporting has also improved.
- The aggregate amounts of grants to local governments as well as their allocation to individual municipalities is set by the Grants Commission within the Mid-Term Expenditure Framework. The Grants commission basis its work on::
    - the general criteria prescribed under the LGF
    - Analysis of sector standards provided by appropriate Ministries
    - Enhancement of the allocation formula for specific grants in health and education
    - The Macro-fiscal framework set in the Mid-term Expenditure Framework

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

- The current institutional arrangements have been developed in consultation with line ministries and municipalities, including the newly created ones.
- A Memoranda of Understanding has been signed–with the support of the donor community making secondary health care a new municipal competence .
- The current system of municipal finances represents an advanced in fiscal decentralization and local governments have been given considerable authority in spending, public service delivery, revenue collection and more broadly financial management.
    - In view of the previous experiences and in order to continue with the budget process reforms, the municipal budget 2012 shall be *based on a basic programme and sub-programmes structure*. In order to ensure comprehensiveness, transparency and a credible process of municipal budget development, we aim at compiling the budget in compliance with the requirements of the Law on Local Government Finances (LGF) and the Law on Public Finance Management and Accountability (LPFMA)Budgeting at the programme and sub-programme level, in compliance with the existing structure of the chart of accounts;
    - Improvements in the result-oriented approach to budgeting; and
    - Implementation of t multi- year budget planning and including the inclusion of provisional budget for the next two years.;
    - Implementation of the requirment to prepare separate, multi-year capital budgets, including integration of information on completeness and expected planned outcomes under the Public Investment Planning system.
- This year, municipalities will develop for every programme,strategic aims and objectives as well as the results that are expected to be achieved through the budgetary process.
- Local governments will prepare new summary financial statements for the period 2012 - 2014
- With the new municipal budget tables, the performance and transparency of budget documents has increased because all of the main stakeholders have been involved in their preparation.

VII.2. The current state (challenges and good practices) of the intergovernmental transfers at national level

VII.2.1.1. Sources of the Municipal Financing

Municipal revenues include municipal own source revenues, operational grants, grants for additional competences , transfers for delegated competences, extraordinary grants, and financial assistance from the Republic of Serbia. Municipal borrowing is possible under the LLGF, but it will become available toonly under strict conditions and be subject to approval by the Minister of Finance.

Own-source revenues include: the property tax and all municipal fees, fines, tariffs that can belevied in line with the authority vested in municipalities under the LLGF.

Municipalities receive operational grants from the Government of Kosovo, which include the general grant;the grant for primary and secondary education the health grant, and the grant for secondary health financing. The grants are based on fair, transparent and objective criteria, and allow municipalities a fair amount of autonomy in deciding how these money should be spent within particular sectors.

The municipalities also receive financing from the central level for both delegated and newly added competencies.. Changes of the budget process with the review of 2010 for 2011 are included in Table 1, for Aggregate Municipal financing 2012.

Table 1. Aggregate municipal financing 2012 (mil. Euro)

	Actual	Actual	**Budget**	Projection	Projection
1. Grants for Own Competencies	241,22	297,46	298,85	303,55	306,55
General Grant	99,80	114,20	118,70	123,40	126,40
Specific Health Grant	30,10	38,20	39,83	39,83	39,83
Specific Education Grant	109,03	143,35	140,32	140,32	140,32
Base financing:	109,03	142,85	139,10	139,10	139,10
New Policies:		0,50	1,22	1,22	1,22
Excellence Centers		0,04	0,44	0,44	0,44
English Language (Grade II)		0,46	0,78	0,78	0,78
Other Financing	2,29	1,71			
2. Grants for Enhanced Competencies	0,93	2,85	2,60	2,60	2,60
Secondaty Health Care	0,93	2,85	2,60	2,60	2,60
3. Municipal Own Source Revenues	50,40	51,88	60,00	61,00	62,00
4. Contigency Funding for Decentralization	3,20	1,50	-	-	-
MLGA (new municipalities)	3,20	1,50			
5. TOTAL MUNICIPAL FINANCING	295,75	353,69	361,45	367,15	371,15

VII.2.0.2. General Grant

Municipalities receive an unconditional general grant that they can spend any way they likein accordance with the applicable laws in Kosovo. The general grant provides reasonable amount of stability and predictability in municipal revenues; it is also an adequate way to provide equalization funds to municipalities, and also enables the allocation of additional revenues to the minority communities in their respective municipalities.

The size of the general grant is equal to ten percent (10%) of total central government revenues, excluding revenues from sale of assets, other extraordinary revenues, dedicated revenues, and revenues from loans. In order to adjust the allocation of the grant to the revenue generating capacity of smaller municipalities, all municipalities receive an annual fixed amount (lump sum) of 140,000 €, minus € 1 per capita, or € 0 for municipalities with population equal to or higher than 140,000 inhabitants.The indicators used toallocate the general grant are population, which accounts for eighty nine percent (89%) of the allocation; the number of minority communities (3% of the allocation); municipalities in which the majority of thepopulation is composed of an ethnic minority (2% of the allocation); and the area of the municipality (6% of the allocation.)

The structure of General Grant for period 2010-2014 (millions of Euro)

Criteria	Factors	2010	2011	2012	2013	2014
		Actual	RGJM	Budget	Assesment	Assesment
Aggregate amount	Budgetary revenues (mil euro)	942	1.056,0	1.187,0	1.234,0	1.264,0
	10% of budgetary revenues (mil euro)	94,2	105,5	118,7	123,4	126,4
Elements	Fix amount	3,4	3,40	3,40	3,40	3,40
	Population	2.236.963	2.236.963	2.236.963	2.236.963	2.236.963
	Parametre: 89% of the aggreg	80,8	90,91	102,6	106,8	109,5
	Municipal Zone (km^2)	10.901	10.901	10.901	10.901	10.901
	Parametre: 6% of the aggr.	5,4	6,13	6,9	7,2	7,4
	Minor Municipalities in Kosovo	116.599	116.599	116.599	116.599	116.599
	Parametre: 3% of the aggre.	2,7	3,06	3,5	3,6	3,7
	population of the minor	130.255	130.255	130.255	130.255	130.255
	Parametre: 2% of the aggre. Amo.	1,8	2,04	2,3	2,4	2,4

VII.2.0.3. Specific Education Grant

The specific education grant is based on an open financing system approach that is in conformity with LLGF, and which allows for the policy considerations of the Ministry of Education, Science and Technology (MEST).

The special education grant for 2012 was approved by the Grants Commission in the amount of 140.3 million Euros, out of which 107.2 million represents the basic grant, and 31.88 million Euro the costs of wage increase for teacher, and 1.21 million Euro the cost of new MEST policies. The formula for allocating the grant is based on the number of pupils entrolled in particular types of schools, (primary and vocational schools as well as schools in mountain regions), possible inflation, teachers salaries, teachers training The formula does not deal with special schools and large capital investments. The financing formula for the education grant is as follows:

Municipal allocation = Teachers' salaries + Salaries for administrative and support staff + Goods and Services + Small capitals + education policies

The basic implications for the calculation of pre-university education grant are as follows:

a) Number of pupils for 2012; b) Teachers' salaries as per the pay-roll list (the average of municipal salary, including the raises from licensing); C) Goods and services as per pupils, with same tariffs; d) Proportion pupil-teacher, the same for primary and secondary level, excluding vocational schools (ratio for the majority 1:21.3 and 1:14.2 for the minorities).

Table : Education pre-universitary specific grant for 2012

Base grant for 2012	107,214,097
Costs of salary increase	31,888,080
Additional implications for specific grant proposal for education for 2012	1,213,446
Excellence Centers (Ferizaj and Prizren)	435,186
English Language for II grade (second)	778,260
Proposal for Specific Grant for Education for 2012 with new policies	140,315,623

ANALYSIS: Specific Grant for Education	Year
Parameter	2012
Total Amount (€) Calculation	**140.315.623**
Total number of pupils	**458.878**
Pupils in primary schools	**344.132**
Majority (93%)	334.101
Minority (7%)	10.031
Pupils in secondary schools	**114.746**
Majority (93%)	111.811
Minority (7%)	2.935
Number of Schools	**1.303**
Primary Schools	1.170
Secondary Schools	133
Total number of teachers (primary, secondary)	**23.209**
Number of teachers for primary level	17.411
Number of teachers for secondary level	5.797
base calculations + inflation for goods and services	**139.102.177**
Wages and Salaries	**123.084.078**
Goods and Services	**12.805.953**
Capital (7€)	**3.212.146**
new Policies	**1.213.446**
English Language (second grade)	778.260
Excellence Centers (94 positions for two Excelence Centers)	435.186

VII.2.0.4. Specific Health Care Grant

The specific health grant and the definition of the amount of this grant is based on the approach of open financing system in conformity with the LLGF. The proposed specific health grant for 2012 was approved by the Grants Commission, in amount of 39.8 million Euros.

The defining of the specific health grant was based on a per capita formula, the number of health visits, and the average cost per visit. Adjustments to the formula have been made to account for nominal population increase, inflation and the cost of primary health care delivery.The applied criteria are as follows: average of 3 visits per capita, multiplied by the cost of visit (including the inflation and pay raise by Government decision), multiplied by the number of inhabitants (and nominal increase of population by MTFE) resulting in specific primary health care grant.

Table: Specific health care grant for the period 2012

Specific Health Grant parametres	Year 2010	Year 2011	Year 2012
Health Grant (mil.€)	27,1	34,1	34,17
Government Decision for salary increase (mil. €)	3	4,1	5,66
Avarage number of visits per capita	3	3	3
Population	2.236.963	2.236.963	2.236.963
Population incerase (%) MYEF	1,5	1,5	1,5
Total amount (mil. €)	**30,10**	**38,20**	**39,83**

Depending on the demographic data, subject to population census, the aim is to adjust the formula of the specific health care grant in the future and to base it on a normalized population and standards set by the Ministry of Health. Normalization would include the age and gender structure of population registered with the primary health care provider and the number of elderly persons and persons with special health needs.

Secondary health care: Hospitals in municipalities with enhanced competencies

928,814 Euro are allocated for the financing of enhanced competencies in the budget of 2010 for the Graçanica hospital. The proposal of the Ministry of Health to fund the secondary health care for the municipality of Graçanica for 2011 was 1,120,771 Euro. Other municipalities that benefited from enhanced competencies for 2011 were Shtërpcë, (522,371 Euro), and North Mitrovica, (989,935 Euro).

Proposal for the Health Grant of the Ministry of Health for 2012

The implementation of the Sectoral Strategy of the Ministry of Health aims at achieving the established strategic objectives. This Strategy consolidates the requirements of the Comprehensive proposal for the settlement of Kosovo status, European Partnership Action Plan (EPAP), and the Master Plan of the Ministry of Health.

Financing the enhanced competencies for 2012

Municipality	Staff	Wage and Salaries	Goods and Services	Municipal Expenditure	Total
Graçanicë	195	801,801	259,970	29,000	1,090,771
Shtërpcë	120	344,544	159,981	17,846	522,371
Mitrovica North	225	699,000	239,000	51,935	989,935
Total	540	1,845,345	658,951	98,781	2,603,077

Capital Investments in health for 2012-2014

The Ministry of Health has foreseen the following alocation for capital investments:

Capital Investment	2012	2013	2014	Total 2012-2014
Hospital Graçanicë	0	1,000,000		1,000,000
Hospital Shtërpcë/Strpce	0	30,000	1,000,000	1,030,000
Total	0	1,030,000	1,000,000	2,030,000

VII.3. Transfer of delegated competencies

The strategy of municipal financing under the MTEF sets out the following principles:

Delegated competencies – Central authorities of the Republic of Kosovo may delegate additional competencies to municipalities, if needed, in conformity with the law. Delegated competencies should, in any case, be accompanied with appropriate financing in conformity with the objectives, standards and requirements set forth by the Government of the Republic of Kosovo.

2.5-Establishment of new municipalities, decentralization

After the Local Elections 2009 and 2010, four new municipalities were established out of 5+1 municipalities, including the extension of Novo Brdo municipality, arising from the Ahtisaari Plan on Final Status Settlement for Kosovo.This process will continue with the local elections in Mitrovica municipality, which are strongly supported by the Government of the Republic of Kosovo, and aim to encourage and ensure active participation in public life and also in order to strengthen the good governance and effectiveness of public services in Kosovo.

The new municipalities in Kosovo have full and exclusive competences in Kosovo as far as local interests are concerned, in full compliance with standards prescribed under the applicable legislation. Additionally, 2011 Budget has been foreseen as set forth under the applicable legal framework, while the budget allocation was carried out similarly to all other municipalities in Kosovo in line with criteria established by the Law on Local Government Financing.

Expenditures from this Sources for Fiscal Years -2008-2011

Operational Government Grant			
2008	2009	2010	2011
157,577,404	211,694,090	254,323,276	303,919,808
Own Sources Revenues			
2008	2009	2010	2011
30,283,998	27,462,015	25,461,034	33,529,021
Unspent OSR Carried Forward from Previous years			
2008	2009	2010	2011
15,287,797	20,679,719	16,237,431	20,264,973
Internal Donors-Participation of the Community			
2008	2009	2010	2011
210,363	613,871		71,875
Revenues from Donations			
2008	2009	2010	2011
1,076,787	108,307		1,174,977
Total Municipalities Expenditures			
2008	2009	2010	2011
204,436,351	260,558,005	296,021,743	358,960,656.

VII.4. The current state (challenges and good practices) in the area of municipal investments – national level

Central and Local Government Budget for 2012 Fiscal Year separately for: Operational (Current) and Capital Investment Budget in the Kosovo						
	Central Government	Local Government	Total budget for 2012 Fiscal Years	% of Central Government	% of Local Government	Total %
Operational Budget	621,049,213	234,358,014	855,407,227	72.6	27.4	100
Capital Investment Budget	463,113,463	127,090,762	590,204,225	78.5	21.5	100
Total Budget for 2012 year	1,084,162,676	361,448,776	1,445,611,452	75.0	25.0	100
% of Operational Budget	57.3	64.8	59.2			
% of Capital Investment Budget	42.7	35.2	40.8			
Total of %	100	100	100			

As we have seen from this table, for example, in the fiscal year 2012, the ratio of total budget between CG and LG is CG Budget 75% and budget LG 25%. For the budget report for CG level operating expenses and LG is: CG- 72.6% and LG-27.4% .

Category Economic- Capital Expenditures, Investment- Budget for CG is 78.47% and 21:53% for LG.

The ratio between operating expenditures and capital expenditures in the total is 59.17%% Operating expenditures and 40.83% capital expenditure where CG relationship between operational expenditure is 57.28% and 42.72% capital expenditure. LG is operational expenditure report is 64.84% Capital expenditure is 35.16%.

Of the latter can be seen that the ratio of capital expenditure budget in CG level is greater than LG, which means that capital expenditure budget in Kosovo is centralized in CG, in line ministries. So during compilation budget of the LG-Municipalities do not have information on the projects to be financed by ministries in the Municipalities assets. In terms of this economic category - Capital expenditures should be pressure in the future i change this percent of budget allocation Capital expenditure at least be the

change: 42.7% for LG and CG 35.16%.

VII.5. The national scale of the fiscal decentralisation and the interchanges with the trends in South Eastern Europe

Measuring Indicators to evaluate the Scale of Local Fiscal Decentralisation:

VII.5.1.1. LG of Expenditures in % Of National GDP

Expenditures	2008	2009	2010	2011
National of GDP	3,905	3,912	4,289	4,636
LG of Expenditures	228	263	301	360
LG of Expenditures in % Of National GDP	5.84	6.73	7.03	7.76

VII.5.1.2. LG of Expenditures in % of National Expenditures

Expenditures	2008	2009	2010	2011
National of Expenditures	963	1,252	1,288	1,401
LG of Expenditures	228	263.	301.	360
LG of Expenditures in % Of National of Expenditures	23.7	21.0	23.4	25.7

VII.5.1.3. LG of Revenues in % of National Revenues

Revenues	2008	2009	2010	2011
National of Revenues	989	1,161	1,195	1,313
LG of Revenues	228	263	328	386
LG of Revenues in % Of National of Revenues	23.1	22.7	27.5	29
OSR non spend from previous year	-	-	26.5	26

VII.5.1.4. Sectoral Expenditures by LG for years 2008-2011

	2008		2009		2010		2011	
Economic Development	10,696,459	5.2	27,707,782	10.4	23,963,550	7.3	31,893,753	8.7
Education and Culture	100,332,900	48.9	117,387,467	43.9	128,493,307	42.3	159,009,659	43.7
Public Order	3,493,111	1.7	479,740	0.2	2,826,894	0.9	3,457,758	0.9
Social Welfare and Health	21,478,560	10.5	30,749,548	11.5	37,543,135	12.3	44,375,487	12.2
General Public Services	58,191,488	28.4	75,258,167	28.1	92,568,053	30.4	105,522,061	29.0
Other	10,656,389	5.2	16,132,907	6.0	19,143,963	6.3	19,523,843	5.3
Total	204,848,907	100	267,715,610	100	304,538,901	100	363,782,562	100

VIII. The Fiscal Decentralisation in Croatia

VIII.1. Assessment of the progress in fiscal decentralization for the last 5 years

In mid-2001, the Croatian Government launched an initiative aimed at loosening the high degree of centralization by extending the mandates of local self-government units and changing their sources of public finances. In 2005, the category of large cities was introduced (cities with more than 35,000 inhabitants and county capitals) and these units were assigned additional responsibilities in providing public services. Consequently, the process of differentiation among local self-government units according to the scope of their activities started. These initial steps were followed by additional measures of fiscal decentralization, but after this initial period of reform things have remained largely unchanged.

The analysis of the current financing of decentralized functions in Croatia in the last 5 years leads to a series of conclusions about the process of decentralisation in Croatia. The most important ones are presented below.

First, most of the existing ten public functions in accordance with the United Nations international Classification of the Functions of Government (COFOG) are still under jurisdiction of the central government. This is also the case with the four public functions which are partially decentralized (education, health, social protection, and fire protection), since the responsibilities and expenses for their financing are still divided between the central, regional and local levels of government. Majority of expenses, including wages and salaries, for providing services in education, health care and social welfare are covered from the state budget. The only one public function, fire protection, is entirely transferred from the state to municipal level.

Second, the financing of decentralized functions is still realized from two sources, to the minor extent from the local budget revenues (from additional share of the income tax), and to more significant extent from the central budget revenues (from the grant equalization fund for financing the decentralized functions). Financing of decentralized public functions is a shared financial responsibility between the state and city or

county level although the minimum standards for the provision of public services are determined exclusively by the state government.

Third, the existing decentralization of responsibilities and financing part of public functions did not strengthen the responsibility of municipalities, towns, and counties, nor did it enhance their autonomy in providing decentralized public function. Also, it did not increase the local self-governments responsibility for providing other public services that are the closest to the citizens or enhance their ability to perform other public functions under their competence. The responsibility and resources to perform decentralized public functions are still divided between the central state and local levels of government, where the local level of government has very limited participation in the decision making about the allocation of responsibilities and finances.

Fourth, 32 financially stronger cities and the City of Zagreb with higher fiscal capacity per capita, in other words, only one quarter of the Croatian cities have been assigned additional responsibilities to provide some of public functions locally. These 33 cities took over the obligation for decentralized financing of the primary school expenses, while the existing legal possibility for financing part of the school expenses has not yet been exploited by other sixty local units, each with more than 8,000 citizens, which did not took over the responsibility for decentralized financing of the part of the primary school expenses. This means that majority of Croatian cities do not have large enough fiscal capacity to provide the primary school services and cover their expenses. Expenses for providing primary school services in Croatian cities are covered from additional share in income tax (revenue source of the local budget) and from the grant equalization fund for financing the decentralized functions (revenue source of the state budget). Assignment of new responsibilities in providing services in primary education locally and new revenue sources did not included all, but only nine percent of total number of local government units.

VIII.2. Key municipal budget trends

The share of local budget revenues and expenditures in the consolidated general government budget has remained around 10 per cent while their share in gross domestic product (GDP) stayed at 4 per cent. Consequently, Croatia has continued to be among the least decentralized countries, not only compared to the developed EU-15 countries, but also compared to the new member states as well as to the transition countries.

VIII.3. Public investments

The local authorities use a little bit less than one quarter of the total expenditure in the local budgets to finance capital expenditures for different investment projects at local level. In the period 2007-2011, the expenditures for the acquisition of fixed assets showed a strong downward trend. This was particularly clear in the fiscal year 2010 (decrease of 35.2 per cent compared to the previous year). The situation is more or less the same at the central level. In 2010, total net acquisition of nonfinancial assets amounted to 1.2 billion, which was an annual decrease of 37.2 per cent.

VIII.4. Unfunded mandates

There is no clear division of responsibilities in performing public functions between the central, regional and local levels of government. This means that the performance of any public function is assigned to all levels of government (regardless of their fiscal capacity and other important features) and their responsibilities in the implementation of public functions often overlap. The large cities, the towns and partly the municipalities are responsible for taking care of most of local public functions, while the responsibility of the counties focuses on secondary education and covering the maintenance costs of health care and social welfare institutions. Counties often undertake the responsibility of the municipalities and directly provide public services (primary education, physical and urban planning). All municipalities and small towns are not able to provide a broader range of public services for the citizens and for primary education and urban planning they rely on the county, while the pre-school education relies on the cities. Social care services provided by the county are limited to assistance for housing costs and some additional allowances.

VIII.5. Own revenues system

Considering the tax revenues in the local budgets, there are own local tax revenues and cities and municipalities have the legal option to influence the amount of revenue collected. This type of tax revenues is not sufficient to finance the provision of local public services and goods and they constitute an insignificant part of the total budget revenues. These are revenues generated from the tax on the use of public space, which is also the only tax instrument, whose tax rate is fully decided by the local government.

The potential opportunities to increase the local budget revenues come from the surtax on income tax revenues because cities can increase the surtax rates up to the statutory maximum that is prescribed by the central government, and that differs depending on the status and size of the local government units. The surtax rate are the following: for a municipality the rate is up to 10 percent, for a city with a population below 30,000 inhabitants the rate is up to 12 percent, for a city with a population over 30,000 inhabitants the rate is up to 15 percent, and for the city of Zagreb the rate is up to 30 percent. In Croatia, still there are a part of municipalities and cities that took the opportunity to introduce surtax, and those local government units have introduced mainly the minimum surtax rate in relation to the statutory maximum rate. There are examples of local governments that firstly adopted higher rates of this local tax (surtax on income tax) and after certain period of time they decided to subsequently reduce the surtax rate.

A total number of 278 local government units, 195 of which are municipalities (45 percent of the total number of municipalities) and 85 cities (67 percent of the total number of cities), have introduced the surtax. Only 43 municipalities and 10 cities have introduced the statutory maximum rate of surtax. Dubrovnik is the only city, with status of a large city, which has introduced a statutory maximum rate of surtax. This means that only 9.5 percent of all local governments in Croatia have introduced the highest rate of surtax on income tax. Of the total number of municipalities, 23.8 percent of municipalities have introduced surtax rate to 5 per cent, 19.1 per cent of municipalities have introduced surtax rates between 6 and 10 percent. Total number of 16 cities with a population below 30,000 inhabitants have introduced the surtax rate in the range of 1-5 percent, 42 smaller cities have introduced the surtax rate in the range of 6 to 10 percent. Only 8 smaller cities have introduced the maximum legally prescribed surtax rate of 12 percent. Total number of 10 cities with a population over 30,000 inhabitants has introduced surtax on income tax in the range 6.25-10 percent, and 6 cities have introduced surtax on income tax in the range 7-15 percent.

Under special regulations, local governments collect about twenty different types of non-tax revenues which are generally earmarked as local budgets revenues. The most significant non-tax revenues in local budgets are the communal fees and charges. Considering that local governments are able to redefine the zones in the municipality or city and determine the communal fees and charges by zones, it is expected that municipalities and cities make an active and continuous review over the potential revenues from charges and fees. However, in practice the role of communal fees and charges are extremely earmarked revenue and cannot be spent to cover other budgetary expenditures other than those stipulated by the legislation. As result of numerous gaps and limitations in this part of the local government revenues, it is expected and required that fast reforms are undertaken to transform these revenue sources in modern property taxes (real estate taxes), which are one of the major sources of local government funding in the developed countries.

VIII.6. Financial dependence from the state

Despite the numerous revenue sources, such as *own sources, shared taxes, grants from the state and county budget, equalization grants for decentralized functions, shared revenues and borrowings,* the number of revenue sources which the local self-government units can autonomously influence (their base and/or rate) is rather small. Municipalities and cities only have influence over the tax on the use of public surfaces, partly on the nontax revenues that the local government units specify as special purpose revenues based on special regulations and partly on surtax on income tax in the range of rates prescribed by the central government.

Municipalities, towns, and counties can independently control the rate level for certain types of revenues, but within the limits specified by the central government. This results in having more than half of the total revenues in the local government units' budgets consisting of revenues which amount the local government units cannot influence (revenues from the income tax which is shared tax revenue, and grants). The administrative fees and special regulation revenues from almost one fifth of the total revenue, and these are the revenues on which local government units have only partial influence.

Municipalities and cities have no autonomy in determination of shared tax revenues and grants; therefore they cannot influence the total revenues from those instruments. That is the income tax which is shared tax revenue between the central government and local governments. The central government determines the tax rates, tax bases, tax exemptions and deductions as well as the allocation of tax revenues. The highest level of public authority independently decides about any change in the additional shares of income tax that belong to local governments as dedicated revenue intended to finance decentralized functions in the areas of education, health, social welfare and public fire fighting.

In practice, there is no discussion among different levels of government in Croatia concerning the criteria for allocation of grants to the local governments, but decisions are independently made by the central government. Assignment of grant revenues is not based on the calculation of the fiscal capacity, but it is subject to yearly changes. There are also grant revenues that the central government directly transfers to the municipalities and cities in the area of special state concern. Criteria for this kind of grant revenues are subject to frequent change, in which local units do not participate.

The problem with the grant system is that one type of grant revenues should solve the fiscal inequality (horizontal and vertical) in Croatia. Although the grant system (shared tax revenues, current grants and tax revenue returns in the areas of special state concern) helped local governments in the areas of special state concern, on the other hand, it did not solve the fundamental problem and did not provide the necessary assistance to the local government units with insufficient fiscal capacity.

Local government units with under average capacity are not only those in the area of special state concern, on islands and in mountainous areas.

This means that are inadequate criteria for allocation of grants. The reasons why grants are provided to local units in the area of special concern, the islands and mountainous areas are not because these local units have below-average fiscal capacity (on the contrary, there are examples of local government in areas of special concern and on islands whose financial capacity above the national average), but because of a social and other reasons. The primary goal of fiscal equalization is to increase the fiscal capacity so that the local unit could provide public services to their residents at least a minimum level of the quality, and the social and other developmental problems should be solved by other type of grants from the state budget.

Because of lack of transparent criteria for allocating grant revenues as defined in the annual Act on execution of the state budget, and because these criteria are subject to annual changes, the municipalities and cities have difficulties in planning the funds from these sources in their budgets. Since it refers mostly to the capital grants whose resources are earmarked for financing development projects, it is clear that in future the criteria for the allocation of grant revenues need to be defined at least for a three-year budget period. This is important for the local government units because in this way they can better plan the expenditures for local development.

In practice, the criteria for assigning grants to the local government units in Croatia are not based on the calculation of the fiscal capacity, but they are subject to change every year. Thus, every year new or changed criteria for assigning current grants from the state budget to the counties are adopted. Then, the counties assign these grants to the municipalities and towns in their region. Due to insufficiently transparent criteria for assigning the grants defined in the *Budget Execution Act*, and also because these criteria are subject to annual changes, the municipalities, towns, and counties have a lowered ability to plan their resources..

VIII.7. The role of the central government for the impact of the crisis on the local governments:

All levels of governments, including subnational governments, are facing the recession which has decreased revenues while requiring an increase in expenditures. The central government has adopted a restrictive financial policy towards local governments during the crisis. The explanation of this strong conclusion is based on the following. Local self-government units in Croatia are largely dependent on financing their public functions from the income tax and from the state grants. Income tax revenues dropped significantly as a direct consequence of the economic crisis. In 2010, personal income

tax and surtax revenue in local budgets reduced by 10.5 percent in comparison with the previous year. Additionally, this reduction results from the application of the new Act on Amendments to the Income Tax Act which entered into force on 1 July 2010. These amendments reduced the tax burden on income and repealed tax reliefs. Considering that part of the personal income tax revenue was allocated for the financing of decentralized functions, its reduction in 2010 also affected the financing of these functions.

VIII.8. Borrowing capacity

Only one fifth of the total expenditure in local budgets is allocated for investment projects. That is not sufficient to finance various projects necessary to meet the needs of local inhabitants. The need for local government borrowing was further emphasized with the economic crisis. As result of the decline in the regular budget revenues used to finance local investment projects, borrowing has become more urgent, and is now sometimes the only way to ensure the implementation of local infrastructure projects.

Local governments need to request approval from the Croatian Government and the Ministry of Finance for borrowing. The amount of total borrowing by local government units in Croatia is determined by central government. There are limitations imposed on individual local governments with respect to the debt they can incur. The total constraint on borrowing for all local government units is 2.5 percent of the revenue of all local government units generated in the previous year. The total debt service of an individual local government unit is 20 percent of budget revenues from the previous year (reduced by revenues from domestic and foreign grants and donations, by revenues from citizens' contribution in local government budget for special purpose and by revenues generated from additional share in income tax and equalization grants for decentralized functions).

The problem of non-transparency of criteria for obtaining consent from the Croatian Government about borrowing needs to be emphasised. In fact, there are no clear criteria by which the Croatian Government decides which local governments will be given approval for borrowing under the total annual borrowing prescribed in the Act on the Execution of the State Budget.

Furthermore, with regard to borrowing it should be also noted that a small number of local self-governments have used the legal possibility to finance capital projects by issuing municipal bonds at a lower cost of capital. The reason for that is the underdeveloped capital market in Croatia.

VIII.9. Association's reform agenda regarding the fiscal decentralization - next steps

The new Croatian Government (elected in December 2011) announced the further steps for decentralization in Croatia. In the Croatian Government Programme for the period 2011- 2015, the decentralization policy was announced as one of the Government's objectives. The level of fiscal decentralization proposed by the Programme is that 20-25 percent of public finances are allocated to the regional and local self-government units. The Government announced explicitly defined and stable rules, which refer to a clear division of responsibilities between the levels of government, a clear division of public functions (application of the subsidiary principle) and sources for their financing. Croatian Associations of local self-government units are willing to be actively engaged in the announced broad public debate of all interested parties concerning the further models of decentralization and public sector reform in Croatia.

VIII.10. Proposals for key messages of the association

Local and regional self-government units in Croatia are highly dependent on tax revenue sharing (income tax) and grants from the central government. The fiscal capacities of the local government units differ significantly, while all municipalities and all cities (except large cities and cities that are county centers) have equal responsibilities. Consequently, it is not possible to ensure the comparable quality of public services. In order to address these imbalances, the following proposals are made for decentralization aimed towards more efficient and more balanced provision of public services:

- *A clear division of mandatory responsibilities among municipalities, cities, large cities, and counties* is seen as fundamental requirement for future efficient decentralization.
- *A change in funding of the local and regional self-government units* is related to their mandatory responsibilities and provision of stable, adequate and foreseeable revenue.
- It is recommended that *tax policy changes that affect the budgetary revenue of local units are reduced to a minimum during the fiscal year*. All such changes should be discussed with local self-government units through their associations.
- *Preparation of strategic development document at city and municipality level* should be introduced. This document would provide the local government unit with an appropriate tool to monitor the implementation and realization of the

planned development goals. This would improve the system of planning, implementation and financing of development projects. Financing of developmental projects should be based on development strategies.

- It is recommended that, on the basis of the implementation plan for development projects, *requirements for borrowing for a longer period (2013-2020) should be established*.
- *Budget constraints on local government units should be transparently defined*. In practice, there is a discrepancy between the amount of the annual budget limit on new borrowing prescribed by law and the actual amount of new borrowing by counties, cities and municipalities. It is proposed to review and improve legislation in the part concerning the limit on total new borrowing by local units and to develop clear criteria.
- *Development of a methodology for evaluating the creditworthiness of local government units* (including local utility companies which are founded by the cities and municipalities).
- *Municipalities and cities should develop long-term debt management strategy* to provide support for sustainable and smart local public finances.

IX. Moldova: State of Local Public Finance

IX.1. Summary

The overall situation with local public finance in Moldova remains very difficult, significantly inhibiting local development and enormously downgrading local autonomy . Local public finance reform is considered to be the first, second and third priority for decentralization and the consolidation of the local autonomy. Financial resources remaining with local authorities are rather insignificant with enormous unfunded mandates. However, much more important is that local authorities almost completely lack any discretion for raising local revenues or for spending their budgets. All local expenditures are dictated by central government institutions andelegated competencies form a huge share of all spending. In fact, one can say that what local public authorities (LPAs) are mostly doing is that they are fulfilling the central government's competencies which are delegated to them, thus not serving their localities according to their mandates and their set of competencies. Moreover all financial relations between LPAs and central public authorities (CPA) are governed byto heavy administrative involvement and interference in LPA functions by CPA both through ex-ante regulatory and withexcessive ex-posted controls and verification. Vertical power and authoritarian tendencies in the country are being strongly supported by the hyper-centralized system of public finances when all financial decisions belong to CPA institutions --primarily to the Ministry of Finance. Vertical power also influences the relations between Local Public Administrations of the 1st tier (LPA1) and Local Public Administrations of the 2nd tier (LPA 2) with significant financial and administrative dependence of LPA 1 upon LPA 2.

Very significant problems also exist regarding the efficiency of the public finance system. Own fiscal efforts by LPA are 100% penalized through the reduction of transfers. The own revenues of local governments are very insignificant, especially thosespent partly on financing the delegated competencies. Municipal investments are very limited and almost completely originate from international funds or from national (centrally managed) funds on a project-based approach. There is no difference between transfers for special purposes andtransfers for general purposes. Shared tax proportions are not specified by the Law and are at the discretion of LPA 2, which projects it power vertical upon LPA 1. The lack of financial autonomy in the country is confirmed in the latest country report of the Congress of Local and Regional Authorities of the Council of Europe. The budgetary process is rather obsolete and quite authoritarian (both in the financial and in administrative sense), being based on rigid ambiguous norms in basically every single item of expenditures, with budgets of LPA 1 being included in budgets of LPA 2. Operational autonomy does not exist – LPAs cannot determine on their own their personnel structure as well as the remuneration for either elected officials or civil servants.

Having recognized this, in 2012, the Ministry of Finance elaborated a Concept for draft modifications in the legislation concerning the local finances. The suggested reform is sufficiently comprehensive, radical and beneficially streamlined towards significant increase in local financial autonomy. It seems that wide support is now given by both CPA and LPA, but there are still questions about whether there is enough political will to actually pass the amendments.

IX.2. Scale of the fiscal decentralization

. The consolidated budgets of local governments account for 25% of total public budged in Moldova. This may seem relatively high, but it is misleading for at least three major reasonss:

1. Overall, the country is very poor and the absolute amount of public resources is very small. The overall consolidated LPA budget (LPA 1 and 2) is about EUR 500 MIL.
2. Significant parts of the own revenues of local governments are being spent on specific "delegated" competencies such as education. Huge unfunded mandates exist, which on the whole comprise 26% of the overall consolidated budget of LPA 1 and 2. About 90% of the funds for delegated competencies are used for education, and the overall expenditures for delegated competencies account for more than 80% of the consolidated LPAs budget (Annex 1)

3. Practically, all LPA funds are earmarked and dictated both administratively and financially from the central level. Discretion in spending resources, even of LPA own resources, is extremely low.

According to the recent UNDP JILDP study, the financial autonomy in quantitative dimension accounts for 2.8% for LPA 1 and roughly to 5% for LPA 2.

The following strategic considerations and issues are characteristic of the overall situation with local public finance in Moldova

- advanced vertical power and authoritarian tendencies in the country supported by hyper-centralized system of public finances in which all financial decisions belong to CPA institutions and primarily to the Ministry of finance
- significant interference of LPA 2 in the transfers to LPA I often amounting to an administrative dictate on behalf of the LPA2 to LPA1
- total inefficiency of local public finance when all fiscal efforts of LPAs are completely penalized by reducing the transfers
- LPAs have minimal amount of discretion over their expenditures
- lack of financial autonomy and therefore a very depressed local autonomy - as confirmed in the latest country report of the Congress of Local and Regional Authorities of the Council of Europe
- inadequate distribution of total public revenues between CPA and LPA and CPA (75% to 25%) when LPAshave a lot of unfunded mandates and when LPA enjoy a much higher level of public confidence according to all opinion polls
- delegated competencies (mainly education) are not covered by transfers – huge unfunded mandates
- LPA operational autonomy practically does not exist – wages and LPA personnel structures are determined by Laws or by CPA.
- budgetary process is rather obsolete and quite authoritarian (both in the financial and in administrative sense) being based on rigid ambiguous norms in basically every single item of expenditures, whereby budgets of LPA 1 are being included in budgets of LPA 2.

IX.3. Context and problems

IX.3.1.1. Own revenues

So far, ceilings with regard to local taxes do not existed. However, there are several issues, which downgrade the possibilities of local authorities to establish taxes on their own

- major consideration - raising taxes is being penalized by reduced transfers
- local taxes comprise rather insignificant share of revenues- 10% for the country as whole, much less if the capital city is not included
- lack of adequate tools and methodological support for certain taxes, which probably shouldn't be an impediment under normal circumstances, but which is certainly an impediment in over-centralized system with a lot of abusive controls and interference of CPA in LPA affairs

There is a ceiling on real estate tax for Chisinau and the second largest city of Balti as well as for bigger towns. No ceilings for rural communities. However, there are also several other aspects which downgrade the LPAs possibilities to establish their own rates:

- major consideration - raising taxes is being penalized by reduced transfers
- lack of proper evaluation of real estate combined with the lack of clarity as to the law requirements on the mode of collection/tax base for this tax (market price of real estate or other tax base can be used – for ex. per square meter)
- lack of adequate tools and methodological support

In total, there are 16 local taxes, but in fact according to the laws these area mixture of tariffs and charges For example, solid waste payment is considered a tax, which in somewhat logical in Moldovan conditions, because all tariffs are mostly social non-commercial based payments. On the other hand, real estate tax, which is going exclusively to LPA 1 is not considered as local tax. Only a few local taxes, bring in at least some revenues. All other local taxes generate almost no revenues.

There is an important lack of clarity as to what level of LPA – 1st or 2nd – the local taxes belong to. In particular, this lack of clarity is very serious for the natural resources' taxes, which in fact are not even considered as local taxes, butwhich are sometimes shared with local budgets.

IX.3.1.2. Shared Taxes

- *Personal income tax (between LPA level I and level II)*

The sharing rates for the PIT between LPA 1 and LPA 2 are not established by law and are left to the discretion of LPA 1. Many conflicts arise from this issue. In fact, the sharing of PIT between LPA 1 and LPA 2 is mostly being left to the discretion of LPA 2.

- *Corporate income tax (LPA level I, II and CPA)*

The sharing between LPA 1 and 2 are also not being established by law. This was a less burning issue until this year, considering that CIT was not being collected for about 3 years. The previous government abolished this tax in 2008. However, once it was re-introduced in 2012, continuous efforts are made to keep this tax at central level to the maximum possible extent.

- *Road tax (CPA, LPA II)*

Road tax is not even mentioned in the Law as being shared tax with LPA 1

- *VAT and excises are not shared taxes*

IX.3.1.3. Transfers

This is the most problematic part of the whole fiscal system, which significantly downgrades the entire local autonomy. The main problems regarding transfers have an overall impact on the efficiency of the entire system:

- There is no difference between transfers for general purposes and transfers for special purposes. More precisely, transfers for general purposes practically do not exist
- Transfers are not being channeled directly to the communities but through an intermediary of the LPA 2, which introduces additional element of bias, political partiality and administrative control into the entire system
- Transfers serve to punish the communities for their own fiscal efforts (more tax collections - less transfers with 100% quantitative coincidence/correlation)

The reform of the transfer system is crucial for the entire LG finance reform.

IX.3.1.4. Municipal investments

Municipal investments come from four general sources (in order of available resources coming from these sources):

1. International funds and donors' programs. This so far has been the major source of funds for local investments
2. National funds delivering resources on competitive by-project basis. Major national funds are Regional Development Fund, Ecologic Fund and Energy Efficiency Fund. Until very recently these funds were almost non-existent. However, starting from 2010 these Funds acquire much more significant importance and proportions. The Government is regularly pouring resources into these funds and donors' resources are also concentrating around these funds. So far, donors' resources in these funds have not acquired a significant scale, but the process is accelerating.
3. Another source of funds, which used to be of major importance, but which is permanently decreasing is targeted investments in particular communities by the central government. This source of financing is losing its importance as more and more funds are being channeled into the above described national funds which are comparable in scale to the Regional Development Fund. This source of investments was heavily criticized in Moldova and by international organizations as non-transparent and politically biased because the financing of local communities is based mostly party affiliation
4. Finally, a small source of funds are the own resources of communities and raions (LPA 2). This source especially with regard to the communities is rather insignificant and is almost exclusively used for project co-financing.

At the end of the day, one can make several key conclusions regarding the municipal investments:

- Municipal investments are extremely limited, and not even remotely comparable (both in absolute and in percentage basis) with EU accession countries' or moreover with EU members. For example, the Regional Development Fund's resources per year amount to about EUR 10,000 000 and that is one of the biggest national sources of funds. Of course, far less than this figure is being spent per year due to a variety of factors.
- Still, there is strong element of partiality (primarily, political partiality) in investments, including those financed from project-based funds
- Own resources of local authorities and the discretion of LPAs in spending are extremely limited even for project co-financing. Therefore, project co-financing is a huge burden, which is mostly accessible to more affluent communities, while many communities are simply lagging behind in project implementation due to this factor. Moreover, that it is an absolutely unfair requirement since

the central government does not co-finance any projects although they have a huge bundle of both national and international resources at their disposal. CALM is actively advocating for cancelling all co-financing requirements both in the Council of Europe and in the EU Committee of Regions.

- Municipal borrowing is significantly underdeveloped based on a variety of factors, the major reason being extremely limited local financial autonomy.
- Rigid procedures and regulations for LPAs in all their activities have serious implications also in project implementation (procurement, personnel, project documents, feasibility studies, etc.)
- Despite the quite bleak background, still there are some several positive developments. International funds are increasingly being made available in Moldova, though in far lower amounts than the commitments and declarations that have been made. National funds have, with time acquired a certain experience and operational adequacy. More resources are being supplied through the competitive based funds and less through non-transparent direct targeted investments from the state budget, though it is questionable how many competitive funds (versus state budget targeted investments) reach the vulnerable and poor communities. The most positive factor has been the declaration by the Ministry of Finance regarding local public finance reform, according to which the discretion of local authorities in using local resources should be significantly increased.

Reforms initiated by CPA in local finance

In the spring of 2012, the Ministry of Finance with the support of UNDP experts drafted and proposed the discussion note about the Concept of the local finance reform. Later in September 2012, the Ministry of Finance provided the draft modifications of the legislation related to the financial decentralization based on the concept proposed earlier.

The suggested reform is sufficiently comprehensive, radical and beneficially streamlined towards significant increase in local financial autonomy. It seems that this reform is given wide support by both CPA and LPA. But it remains to be seen whether there will be enough political will to approve the proposed legislative modifications. Modifications need to be approved by the end of 2012 so that the budgetary process in 2013 and the Budget Law for 2013 can be established on the new legal basis. Thus, the system of local finance will be completely changed on the basis of the proposed Concept and changes in the legislation in 2014.

The proposed reform is based on he following main considerations:

- The proposed concept generally tends to preserve the existing financial envelope, meaning it is revenue neutral for the public sector as a whole.

- The concept is in accordance with all international standards, the European Charter of Local Self-Governance and the general logic of the public finance is supposed to provide financing of delegated competencies from the state budget and to eliminate the unfunded mandates to the greatest possible extent
- Separation of transfers to LPA 1 and LPA 2
- Separation of special purpose transfers from those with general a purpose
- Sharing quotas/proportions for shared taxes are to be specified by law
- Elimination of any punishment of LPAs for their own fiscal efforts.
- Equalization transfers will not be based at all on local taxes, only on shared PIT

It is worth mentioning that this reform is being developed on the basis of two quite serious factors, which significantly affect the local public finance and local autonomy:

1. Education reform and transfer of basically all competencies in education from LPA 1 to LPA 2
2. Re-introduction of CIT in 2012 with new additional resources incoming both to CPA and to LPA

IX.4. Consolidated LPA budget (2011)

based on year 2011	LPA consolidated MDL	LPA consolidated EUR
Local revenues		
Local taxes	607,500,000	39,193,548
Fees	209,700,000	13,529,032
Special funds	9,600,000	619,355
Real estate tax	280,700,000	18,109,677
Shared taxes		
PIT	1,769,100,000	114,135,484
CIT	313,000,000	20,193,548
Road tax	77,600,000	5,006,452
Transfers		
VAT	0	0
Excises	0	0
Transfers with special destination	4,155,700,000	268,109,677
Transfers for investment projects	26,600,000	1,716,129
Transfers to republican social protection fund	166,200,000	10,722,581
Grants		
Internal	12,800,000	825,806
external	70,900,000	4,574,194
TOTAL*	**7,660,900,000**	**494,251,613**
Expenditures for delegated competencies	6,333,000,000	408,580,645
State Services with special destination	538,800,000	34,761,290
Army	8,200,000	529,032
Law, order, security	275,000,000	17,741,935
Education	5,025,300,000	324,212,903
Health	91,700,000	5,916,129
Social protection	768,900,000	49,606,452

X. Fiscal Decentralization in Serbia – Current Issues and Challenges

X.1. Resume of the main conclusions/messages

a. LSG Finance Law - The most important step for Fiscal decentralization (FD) process in Serbia was the adoption of the new Law on Local self-government Finance (LSG Finance Law) in 2006. Ensuring that the gains from passage of this legislation continue will require proper support, capacity building, changes and adjustments in the legislative framework, as well as the measurement of effects and results. For certain, many activities need to be taken inton account inthe forthcoming period if we want to say that the FD process in Serbia is implemented successfully, and that it enables the economic growth of the country.

b. LSG responsibilities - When the FD process started, the new scope of responsibilities for local self-governments (LSG) became much larger, therefore better public finance management became one of the major goals for local government units. Most importantly, local governments need to separate the collection of local public revenues from short-term political decisions. Or put another way, the reluctance of local governments to collect their own revenues –primarily the property tax– can be thisthe strongest argument for the central government to slow the decentralization process. In fact, however cities and municipalities have improved the administration of local revenues since the local tax administrations i were created in the period 2007- 2009.

c. Reduction of transfers – During the economic crisis, LSGs bore a larger share of the fiscal adjustment burden than the central government. Transfer were

reduced, and LSG share of consolidated public revenues declined for the first time after eight years of continuous growth. The LSG revenues from real-estate transaction tax also fell significantly (especially in the cities) due to a dramatic decline in the volume of real-estate transactions. Between 2009 and 2010, LSGs share in consolidated public revenues declined by 1.5 percent in relation to the previous two year period.

d. Dialogue between central and local level - One of the most important goals that has to be reached, because it directly affects the FD process, is the improvement of the dialogue between the Serbian Government and the cities and municipalities. This is very important to be underlined because it is the only way to improve the whole system of LSGs finance. According the LSG Finance Law, the Intergovernmental Finance Commission (IFC) is constituted as a joint body of the Republican government (members are representatives of Ministry of finance and other ministries), and the Standing Conference of Towns and Municipalities (members are representatives of local governments). The aim of IFC is to ensure the principles of fairness, efficiency and transparency of intergovernmental finance system and to propose recommendations for improvement.. Since the IFC was constituted, the functioning of the Commission has been partial and has produced partial results, in part because the IFC president has been replaced several times. Regular and organized institutional dialogue between these two levels would result in significant improvements of the legal framework and LSG finance system, and that is the basis for a successful FD process in Serbia.

X.2. The current state (challenges and good practices) of the intergovernmental transfers at national level

Local self-government (LSG) system in Serbia has been reformed several times in the previous five years, and we have witnessed frequent changes in legal framework, including the suspension of certain key provisions regarding transfer during the current economic crisis period. The Law on Local self-government Finance (LSG finance Law) was adopted in 2006, and it was certainly the most important step towards the strengthening ofSG finance in Serbia in the last 10 years. Unfortunately, all good results which were achieved by application of this Law were short-lived, because the most important part of the Law was suspended in the period from May 2009 up to mid-2011.

The revised national budget for 2009 was adopted in mid-2009. It called for a reducation in public expenditure because an increase in the budget deficit, and was in accordance with the requests of the International Monetary Fund (IMF). The simples and most

effective way to reduce public expenditure was to reduce unconditional transfers to LSGs. In fact, no other expenditure item in the national budget was cut so much.. Also, this was one of the few austerity measures of the Serbian Government, which was fully implemented in accordance with the revised budget and in agreement with the IMF.

According to the LSG Finance Law *„the annual amount of total unconditional transfers to local government units shall amount to 1.7% of the gross domestic product as published in the latest information from the Republic statistical bureau"*. In 2009, the total amount of *unconditional*transfers should have been about 40.7 billion of dinars[39], but because of the governments ad hoc decision, transfers were reducted byto 15 billion dinars (a decrease of 36.8%). Worse, all of the cuts were carried out during the second half of 2009 budget year. Additionally, in the Law on the Budget of the Republic of Serbia for 2010 unconditional transfers were left at the same nominal level as in in 2009 (25.7 billion of dinars). This means even greater decrease of transfers in 2010 compared with 2009, because the official GDP data showed an increase of 5.3% in GDP in 2008 compared with the GDP in 2007 (for calculating transfers for 2009, GDP data from 2007 were used).

In 2010, LSGs received the amount of 25.7 billion of dinars for transfers, instead of 46 billion they were supposed to receive in accordance with the suspended LSG Finance Law (a decrease of 42%). The two year period during which the Law was suspended basically returned the whole LSG finance system to the level it was before the Law was adopted.

Finally, the amount of transfer funds for 2011 was 31.8 billion instead of 48 billion (over 16 billion less). In summary, the total loss of all LSGs caused by the reduction in unconditional transfers, during the three respective years, was a little over 51 billion of dinars, or more than half billion of Euros (according to average exchange rate in that period).

After the two and a half year of suspension of the Law, in mid-2011, the National Assembly of the Republic of Serbia adopted changes and amendments to the law. Many are of the opinion that the only thing that had to be done was just to return all previously suspended parts of the Law, thus restoring the stability of the LSG finance system.

Instead,, the legislation went much further, but in very unclear ways. . The formula for determining the distribution of *unconditional*transfers, which was already complicated, became even less transparent with the the new changes, because the "level of LSG development" became one of the key criteria for the allocation of transfers.. Without more detailed elaboration on the formula, it is most important to stress that some LSGs, which belong to the first and to the second group of least developed LSGs , according to the new methodology, could receive smaller amounts of *unconditional* transfers than they did before.

[39] In May 2009, middle exchange rate of 1€ was around 95 dinars. During 2010, middle exchange rate of 1€ was around 96.7 dinars.

However, the most important changes of the Law were not related to the transfer funds. These changes involve shared revenues, specifically the payroll tax which is the most important shared revenue in local budgets. The amendments to the LSG Finance Law came into effect at the beginning of the fourth quarter of 2011. The Law increased the LSGs share in the payroll tax from 40 % to 80 % withBelgrade contributing 10 percentage of its share to a new Solidarity Fund, with the aim to mitigate the initial regression of the proposed Law. Since the new changes came into the forcevirtually, all cities' and municipalities' (excluding Belgrade) revenue from the payroll tax increased by 100% because of the change of the sharefrom 40 to 80%.

Nevertheless, from 1 October 2011 (the beginning of the implementation of the amended law) these revenues started to increase significantly. Thus, in the first part of 2012, the total income of all cities and municipalities from payroll tax amounted to EUR 44.9 billion, which was more than during the entire 2011 and this may be considered as the most significant contribution to the recovery of the LSGs budgets.

Shortly after the amendment of the Law from 2011, the Law was changed once again in September 2012. This time, the major changes were in the part related to the LSG original revenues. In fact, a number of fees and charges which are in the group of original revenues, were either totally abolished, or their maximum amount is limited according to the specific criteria.

If we summarize: for more than 5 years of implementation, we had a partial suspension of the Law for a period of two and a half years, and then two significant amendments over the next two years. This practice is certainly not conducive to the stability and predictability of LSG finance system and complicates the budgeting process at the local level. Definitely, one of the most important taxes for LSGs, which is now abolished, was the local communal fee on company sign on business premises (popularly called „firmarina" in Serbia). The Ministry of Finance proposed, and National Assembly adopted, that this fee be limited; small businesses and entrepreneurs will no longer pay this fee starting from 1 October 2012 (except small legal entities with annual turnover of more than 50 million of dinars, they will pay annual amount of one average salary in individual LSG), and large legal entities will pay smaller amount than they used to pay before, starting from 1 January 2013 (large entities will pay the annual amount of three average salaries i). Also, the communal fee for the keeping of motor vehicles will be paid in a range of 2.000 to 5.000 dinars, depending on the type of vehicle[40].

[40] 1 € = 113.96 dinars; middle exchange rate on 22.10.2012

X.3. The current state (challenges and good practices) in the area of municipal investments – national level

In 2011, the LSGs realized investments in the total value of approximately 48 billion of dinars[41] or 1.5 percent of GDP, while the expenditures for the procurement of goods and services were approximately 49 billion of dinars or 1.5 percent of GDP. Therefore, the overall expenditures of local governments for the acquisition of current and capital assets were RSD 97 billion or nearly 3 percent of GDP.

In the course of the previous decade, there has been a big improvement public utility infrastructure, which deteriortiated during the 1990s, when there were practically no expenditures on maintenance. The general trend of improvement is visible, but the progress very much varies from one local government to another. Some utility infrastructure segments, such as wastewater treatment and waste processing, are still at the initial stage of development.

Construction permitting is linked closely to investments, and delays in the permitting process represent a sort of a cost that investors have to take into account when selecting a location for investing. The slow issuance of construction permits has a negative impacton investments, decreases employment and slows down economic growth.

The adoption of the Law on Public Property ensured the legal conditions for the restitution of property to LSGs. Now, the property actually has to be transferred to them legally. The independence of LSGs will be increased once they are given their own property. Clear ownership relations will encourage increased investments in t urban construction land.

In this context, it is also very important to mention municipal bonds as a new financial instrument in Serbia and a new source of funds for capital investments. One of the important indicators for FD is the position and autonomy of LSGs on the credit market. Cities and municipalities in Serbia have years of experience with long-term borrowing as a way to collect the necessary funds to finance capital investments in municipal infrastructure.

Municipal bonds (MB) are particularly important aspect of the long-term borrowing (City of Novi Sad and City of Pancevo are first issuers of municipal bonds in Serbia), as an alternative financial source to conventional bank loans. However, before the MB market was established in 2010, LSGs were borrowing only from banks. According to newamendments to the Law on Public Debt public bond offerings have been possible since the second halve of 2011..

Key measures in this area that have to be implemented in the future are as follows:

- Further improvement of the oversight role of the Ministry of Finance – Public debt administration department, through detailed assessment of, not only

[41] During 2011, euro was in interval from minimum 97.06 up to maximum 106.81 dinars

LSGs borrowing capacities, but also LSGs ability to project and manage debt over the entire period of its repayment,

- Further amendments to the Law on Public Debt, which would more precisely determine the current revenues category in relation to LSGs borrowing potential; opening up the possibility for LSGs to give guarantees to their public utility companies (PUCs); precise definition of the procedures which have to be followed if an LSG cannot service its debtobligations, etc.,
- Further development of the MB market, to include public emission so that all citizens can be purchase municipal bonds .,
- Continued support to the LSGs in multi-annual financial planning and budgeting, as well as the further development of capital investments plans, as a precondition for responsible borrowing and long-term debt management.

MBs offer significant potential for the further development of communal infrastructure. It is usually a cheaper way of borrowing for LSGs than bank loans, and it also represents alternative form of savings for citizens.' Being a new financial instrument in Serbia, it deserves special attention by the Ministry of Finance, local governments and other actors on the capital markets, because it may lead to overall development of local governments.

The cases of Novi Sad and Pancevo are the examples of good practice in MB issuing. The City of Novi Sad is the first city in Serbia that issued municipal bonds in 2011, and the total amount of the emission amounted to 35 million of Euros. The effective interest rate is 6.25% annually, with maturity of 12 years and grace period of 2 years. The resources collected by the issuance of municipal bonds will help to finance projects from the City development plan. City of Pancevo is the second issuer of MB in Serbia, and the amount of emission is 1 million of Euros. Following the amendments to the Law on Public Debt, which have completely removed the obstacles for purchase of bonds by individuals, it is expected that more cities will issue municipal bonds in the future.

X.4. The national scale of the fiscal decentralisation and the interchanges with the trends in South Eastern Europe

Many changes should be made in the area of property tax, both legislative and administrative. In the first place, the key weakness of the current property tax system is the taxation of legal entities (taxpayers who keep books). The current system of property taxation is completely inappropriate, because the tax base for the property tax for legal entities is the book value.There are many cases when a property with a

market value of millions of Euros, has a book value of almost zero . Therefore, the Law on Property Tax should be changed so that the base of the tax for legal entitites is a property's market value. This however will not be easy since it is hard to determine the market value for assets that are rarely subject to market transcations. The reform of the property tax has to be followed with the reform of fee for construction land use, which can be integrated into property tax of legal entities only partially. Currently, this area is one of the key and most troubling parts of the reforms of LSG own revenues.

Furthermore, Serbia has to undergo serious reform of public services, which should certainly start with the reform of public utility companies (PUC). Serbian PUCs need serious organizational reform, including their managerial structures..

According to the Law on the Budget System, local governments have to move towards the the implementation of programme budgets bythe end of 2014. That means that budget preparation process during 2014 (related to final budget for 2015) will be implemented on programme basis. In this sense, a number of joint activities will have to be coordinated between the Ministry of Finance and Economy and LSGs in order to implement all necessary activities to ensure the successful implementation of program basis in 2015, such as preparation of programme budget methodology, programme classification etc. Programme budgets will represent a fundamental change in LSG management, which will change not only their financial departments, but also all other parts of their administrations.

According to the data of the Fiscal Council of the Republic of Serbia, the fiscal deficit and public debt in Serbia have been on the increase throughout 2012, and there is possibility that the deficit will be over 6% of GDP by the end of the year. This is not only a consequence of the stagnation of the Serbian economy, but even if economic growth was normal, Serbia would still record a fiscal deficit of 4-5 % of GDP. Stagnation and decline in the economic growth of the countries in region is very risky for the Serbian economy, because Serbia has strong trade cooperation with the EU countries and countries from region. Prognoses about decline in economic growth of the main Serbian foreign trade partners could be reflected in reduced export and fewer investments, and also changes in the current macro-economic trends.

XI. Policy Note on Fiscal Decentralization in Slovenia

In Slovenia, local governments are responsible for a wide range of local public services including water supply, sewage service, garbage collection and disposal, local public transport, maintaining local streets and public lighting, social welfare , kindergarten service and primary education (but with responsibility for for teacher wages...) and local infrastructure. Until now, Slovenia has had a single-tier self-government system.

Local authorities can ensure the efficient implementation of their respective tasks and competences only when all the constitutive elements of a system good of intergovernmental relations are maintained, particular respect for their financial autonomy. In this review, we shall focus on three elements of the fiscal decentralization process in Slovenia:

- the autonomy of lower tiers of government in prescribing local taxes, fees and charges as well as their ability to access the capital market,
- their ability to freely decide about how to spend their revenues and thus the basic rules safe guarding their autonomy and accountability. and participating in financial matters which affect the local governments.

According to the Constitution and general Law on Local Self Government, the financial system of local government financing in Slovenia is based on own resources, additional state funds for economicly weaker municipalities which cannot adequately finance their responsibility from own resources and possibility for borrowing for capital investments.

XI.1. The revenue structure

We reviewed the main type of local government revenues in Slovenia in the Report of Fiscal Decentralization Indicators for SEE countries for the period 2006-2010. We experienced an increase in the share of tax revenues in total revenues in 2007 after amendments to the Law on Financing Local raised local government share of the Personal Income Tax (PIT). This improved the , vertical balance of the system. However, the new financial framework does not give local governments greater control over own-revenues, which remain limitied.

Following this change of the financial system, the state just assigned a higher share of personal income tax to local governments to adjust the disproportions between available sources and obligations which exert pressure for additional financial equalization from the state. In the year following the change of the financial framework, the need for financial equalization fell down from 11, 5 % in 2006 to only 0,5 % in 2007. At the same time, the number of municipalities receiving state transfers was reduced by half, so after the change in 2007 only half of the total number of municipalities receive the equalization and the amount of equalization has decreased significantly. The financial equalization is delivered all the time to local governments as a general grant. Only additional transfers for co- financing local investment purposes are assigned as earmarked grants on the basis of specific criteria defined by law.

In 2010, own revenues accounted for only 8% of total local government revenues, while shared taxes accounted for 65%. Only for own revenues do local governments determine the tax base, tax rate and tax exemptions are set by local governments only for this source of. Other taxes are state taxes assigned to local governments or shared taxes. According to Slovenia law, however, shared taxes are considered local government own revenues, a classification that does not comply with the European Charter's definition of local taxation[42]. The personal income tax is distributed to local authorities on the basis of the proper expenditures which consist of funding the current expenditure for statutory public needs, and the local authorities have no impact on this income.

The next important source of local government own revenue aref non tax revenues. These include rents from the use of property, interest, fees and fines, proceeds from asset sales and most importantly the so called special fee - the mandatory contribution exacted from investors for building permits. For the last 5 years these revenues represent an important share of 13 - 15 % of the total revenue.

Local public revenues as a share of GDP increased from 5, 1 % in 2006 to 6, 2 % in 2010, which is seen as a significant improvement. This measure of decentralization

[42] According the European Charter's definition shared taxes are not treated as own local revenue. Article 9 paragraph 3 of the Charter states that "part at least of the financial resources of local authorities shall derive from local taxes and charges of which, within the limits of statute, they have the power to determine the rate".

shows that in comparison with other countries in the region Slovenia is at or above average. However, if one compares this indicator with the EU average, the degree of fiscal decentralization is very low.. Similarly local revenue as a share of total public revenue increased from 12 % in 2006 to 15 % in 2010. This is again average for the region but very low in comparison with the EU average is about twice as much. [43].

Although local borrowing in still restricted by law, some additional resources for capital investment can be provided through borrowing. The limit of borrowing within the current Law on Local Public Finance restricts debt service payments to 8% of the previous year revenues. The amount of borrowing in Slovenian municipalities was rising until 2007 when the rigorous limits were put in place ; Overall borrowing remains low and most municipalities have the space under the current limits for additional borrowing.. The subnational borrowing in 2010 was equal to less than2% of the GDP.

XI.2. The main stress on expenditure structure indicators

The autonomy of local governments on the expenditure side is much better than it is onthe revenue side. Local authorities are free to decide how they spend their revenues with the exception of earmarked state grants which are not that large a share of local budgets. As a conclusion, one can say that local governments are fully independent in making expenditure decisions.

On aspect of local government expenditure in Slovenia needs to be underlined. The data show that the share of local government investment spending has been on continuous growth path forthe last ten years. Also, during the difficult times of economic and financial crisis, i.e. between 2008 and 2010, local government investments increased nominally and as a share of total local government expenditure. The investment expenditure accounted for 40 % in 2006 and increased to 45 % in 2010. The main capital expenditures are allocated for school buildings, kindergartens, local roads and urban public infrastructure, housing, waste disposal and waste water infrastructure.

Thus, considering the low degree of fiscal decentralization, local governments in Slovenia are still the main actors in public capital investments. Compared to the whole public investment in 2010, the share of local government capital expenditure accounts for 67 % of the total public investments. This level of capital investment expenditure was partially supported by local borrowing and additional sources from EU structural funds. Nonethelessa major share of current budget revenues are spent on capital investments. It should be mentioned that some useful supporting measures were undertaken based on proposals by the local government associations to improve the efficiency of the absorption of EU structural funds bylocal governments. Finally, it

[43] In the analysis of these figures, one has to take into consideration that Slovenia has only one tier of subnational government because the regional level has not been established yet.

should be stressed that the new crisis pressure in 2011 and 2012 and the expected additional cutting of system funds in 2013, will necessarily lead to a reduction in local investment expenditure.

XI.3. The institutional dialog on financial matters

According to the principles of the European Charter of Local Self Government, and in line with recommendations made by the Council of Ministers, intergovernmental financial relations should be subject to intergovernmental consultation and discussion.

In Slovenia, the Law on Financing Local Governments stipulates that the Government should sign an agreement with local government associations on the amount of the average per capita proper expenditure before the budget proposal for next fiscal year is submitted to the Parliament. Since this arrangement came into force with the law in 2006, the Government reached an agreement with local government associations in 2009, and surprisingly for the second time, this year for the amount of the average per capita expenditure in 2013 and 2014. We see this as an important step towards building an institutional dialog, which is currently still insufficient.

XI.4. Main conclusions

Having taken into consideration the advantages and the incentives made concerning the fiscal decentralization and the results of this research on the indicators of fiscal decentralization in Slovenia, the remaining challenge is to protect the fiscal autonomy and to strengthen its main components according to the European Charter of Local Self Government. It is obvious that the financial crisis requires improvements in the efficiency of the whole public sector governance and the use of public finance.

We are convinced that ensuring the proper autonomy of local governance structures can be the right path towards achievement of this objective, thus simultaneously improving the democratic control mechanisms. The adjustment of the local government financial framework is still an important and persistent objective in Slovenia. Considering the burden of this task, the challenge for the future improvements shall not be the prescribing of additional local taxes, but rather to reallocate the tax sources between the state and local level. At the same time, it also entails the necessity of improving the efficiency of local public management and of developing innovative public-private partnerships that maximize disposable resources and make possible the better governance of public matters.

XII. Fiscal decentralization perspectives in Republic of Srpska (Bosnia and Herzaegovina)

Given that local government is one of the fundamental values of the constitutional system of the Republic of Srpska, one must always insist on the future development of local democracy in the Republic of Srpska, based on the principles of the European Charter of Local Self-Government, along with the Memorandum of understanding on the commitment of ministers responsible for local self-government in Southeast Europe, and according to which the Minister for Local Government of Republic of Srpska confirmed the readiness to cooperate with the Association of Municipalities and Towns of Republic of Srpska.

The development of local communities should be based on a continuous process of decentralizating of functions and creating a a system of local government financing which will guarantee the wide sovereignty local governments.

Considering the fact that all local government units in the Republic of Srpska are brought together in the Association of Municipalities and Towns of Republic of Srpska, pursuant to Article 94 of the Law on Local Government, cooperation with the Government of the Republic of Srpska is essential for all issues of importance for the local government units, whereby the objectives of cooperation are as follows:

- Implementation of mutual cooperation, coordination and efficient institutional dialogue in activities for promotion of the local self-government;
- Implementation of the decentralization process in accordance with the Law on Local Self-government;
- Providing full implementation of the subsidiary principle by ensuring civil rights for direct participation in the public affairs at local level;
- Ensuring responsible and unique execution of public affairs at all authority levels in the local community.

XII.1. Activities in the field of decentralization

The Government of the Republic of Srpska and its agencies cooperated with the Association of Municipalities and Towns of Republic of Srpska during the drafting of the regulations governing the implementation of the Law on Local Self-Government, where:

- Two representatives of the Association of Municipalities and Towns were allowed to participate in the working teams for analysis and evaluation of necessary changes in laws;
- Two representatives of the Association of Municipalities and Towns were allowed to participate in the working teams for the preparation of certain laws and procedures;
- Two representatives of the Association of Municipalities and Towns were allowed to participate in the work of working bodies of the Government of Republic of Srpska throughout the reviewing process of laws and procedures that regulate issues of importance for the local government;
- Prior consultation with local government units is conducted for all major legal projects which are crucial for the functioning of local self-government;
- The tendency of the Government of the Republic of Srpska to undertake previous consultations with the Association of Municipalities and Towns about devolvement of activities to the local government units;

XII.2. Activities in the field of fiscal decentralization:

- Active participation of the Association of Municipalities and Towns will be provided throughout the evaluation of current conditions and future needs for fiscal decentralization of local self- government units;
- Association of Municipalities and Towns took over the activities regarding the special Law on Financing the Local Government Units;
- Proposals of the Association of Municipalities and Cities will be considered during the process of drafting the budget of Republic of Srpska related to the allocation of finances to the LSG units for the realization of the competences defined by law;
- Mutual efforts are made to ensure conditions for fulfilling the promise to transfer of state property to the LSG units;

In December last year, the World Bank Institute, within the Urban Partnership Program - started the project „Dialogue between cities- municipal finances"(City 2 City). The main objective of this project is to improve the dialogue between cities in the Balkans and to increase the opportunites for their learning from each other. The project includes the organization of a series of thematic workshops on municipal finances, as well as other activities in between. The key project partners are the municipalities, cities, associations of local authorities and NALAS as an umbrella organization.

The following topics shall be included in the program:

- Level of fiscal decentralization in South-East Europe/state transfers/shared revenues;
- Capital investments at local level in the region;
- Own revenues;
- Planning of capital investments during the time of economic, political and social crises;
- The role of public-private partnership in the financial strategies;
- Use of EU structural funds, as well as other important topics;

XII.3. Challenges and good practices

The Best practices program in local government "Beacon Scheme" was implemented by the Association of Municipalities and Towns of the Republic of Srpska in cooperation with the Ministry of Public Administration. The quality of citizens' life is largely defined by the services provided by their local authorities. Given this role, local governments

have the responsibility to ensure the delivery of public services to their communities in the best and most effective way. Through recognition and promotion of the best practices on the local level, the Beacon Schemeprovides direct support to this process. Over the past six years, this program has became an integral part of the process of developing local government in the RS

In its seventh year of implementation, the project has shown that members are supportive of this kind of actions, and consider them as very useful, which was also confirmed by the enormous number of applications during the previous competition processes for selection of best practices in the local self-government.

Thematic areas which are especially interesting for local government units include the following:

- **Tracking and managing the property in the local community;**
- **Planning and budget management;**
- **Providing services through partnerships - public-private partnerships;**

The transfer of functions and responsibilities from central to local government would include the identification of state functions which are currently performed at the central level, but which can be more efficiently (or at least as efficiently) be performed at local level. The transfer of functions requires a suitable and credible plan which is not contained in the current proposal for decentralization.

The association may create the legal conditions to achieve high level of functional and fiscal decentralization, in accordance with the adopted Strategy of local government development.

The EU integration unit within the Association of Municipalities and Towns of Republic of Srpska was established in order to introduce certain changes in the work of Association; to provide information to members about the process of EU accession; to support them in the preparation and implementation of measures in that will bring them closer to to EU standards; and to facilitatethe cooperation with relevant EU Institutions (DEI, EU Delegation) in light of the possibility that BiH will be given the status of an EU candidate country**The civil society is imperative for the development of quality of life and increasing the citizen participation in the local development processes and opportunities to strengthen the role of local communities (expected changes in legal framework).** There is an emerging need for specific changes in the activities of the Association in respect to the services that the Association provides to the LSG units (foster and facilitate the exchange of best practices and advice for applying the approaches of participatory planning and management of development processes, the important role of MZ's) and cooperation with relevant stakeholders (different groups of population in local communities)

XII.4. Implementation of fiscal decentralization

The economic crisis has led to major problems regarding the execution of local government budgets. Therefore, it is necessary to do as much as possible to accelerate fiscal decentralization.. This is an economic, strategic and political imperative.

The Association can play its role in the formulation and advocacy for a common platform of local government units in cooperation with the Government of RS in the process of transfer of control, as well as in the capacity building and training of local governments for asset management (especially for the public companies); as well as representing the interests of the members in the transfer of competences from central to the local level and defining the property of local governments. Therefore, it is necessary that the Association is better and more engaged in the redistribution of tax revenues so that the situation is more favorable to the local governments, in order to achieve greater impact on the fiscal policy in RS.

Bigger and better engagement of the Association inplanning of the general framework of the budget, and in the granting of credits to LGUs).

Local communities are faced with the problems generated by the migration of people from rural to urban areas and with the falling birth rate. These problems requires solutions. The Association can articulate the interests of the local communities in terms of program planning at the entity level for balanced development of all regions (advocating for the introduction of legal obligations to apply the European Charter for balanced development) and programs funded by donors which can help the solution of the problem.

The association may represent the interests of local communities in terms of the fair distribution of responsibilities and resources among the various actors in the society for resolution of social problems and also it can work to secure funds for addressing these problems in the framework of international cooperation (donor projects, cooperation with relevant institutions and organizations).

The association can promote cooperation and build understanding between citizens and government, and between the relevant actors in local government units.

The association may take all measures for significantly better horizontal and vertical coordination in social services (education, culture, sport).

The association may represent the interests of local governments and coordinate the activities for increased degree of accuracy in the distribution of responsibilities and funds between state and local authorities.

The association can play a role in the preparation of projects and securing donor funds to local governments so that they can increase the level of use of modern technologies in their work.

The association can play a role in the preparation of projects and securing donor funds to local governments so that LGUs could increase the level of use of modern technology to communicate with target audiences and receive technical assistance to improve the communication of the association with the local governments and the relevant organizations and control environment.

The application of contemporary technologies in the communication, promotion of the use of modern technologies in the local government units and standardization (harmonization), as well as preparation of guidelines for the solutions that are being implemented in local government units are required so the systems could be compatible and comparable. However, it should be noted that there are fewer donations for these projects, and adaptation of the hardware and software require costs and in some cases abandonment of the already accepted, functional solutions (functional decentralization without fiscal decentralization).

XII.5. The association as an effective catalyst for reform and decentralization

The strategic guidelines for functional and fiscal decentralization in the Republic of Srpska are defined in the Development strategy of local self-government in the RS (2009-2015)., It is not realistic to expect that the Government of RS and the ministries will transfer the necessary competencies, particularly those concerning the redistribution of income in favor of the local authorities, without having strong, well-prepared and coordinated efforts of the local governments.. This is a major advocacy challenge for the Association, as well as to accelerate the key solutions provided in the first strategic objective of the Development strategy of the local self-government, which includes both the territorial reorganization, and the functional and fiscal decentralization.

Based on the importance and urgency, the Association should first focus its efforts in advocacy and accelerating decentralization, especially fiscal decentralization for two main reasons:

1) the higher level of government, by inertia, is least willing to transfer the source of funding; and
2) local governments are most interested in solutions that increase their revenue, especially sources of revenues.

The effective engagement in addressing these strategic interests can significantly enhance the credibility of the Association, and contribute to the faster achievement of other strategic objectives, particularly those pertaining to financial sustainability.

The first strategic objective of the Development strategy of the local self-government focuses on the effective exercise of the full range of original competencies, with the corresponding private sources of funding, resources and property. There are three programs for its realization: territorial reorganization, and the functional decentralization program and the fiscal decentralization program.

The strategic objective for the functioning of the Association and its image as catalyst of decentralization and local government reform will be achieved if the following operational objectives are accomplished:

In terms of increasing the direct revenues of local governments, the Association will systematically and in organized fashion advocate for the LGUs to administer and collect taxes, which constitute their own revenues (property tax), in accordance with the best practices in the implementation of such solutions in Serbia. In addition, the Association shall develop and implement new solutions in terms of increasing the share for local governments from the allocation of personal income tax (or part of the personal income taxes), increased participation in local government decision-making and revenue from concessions, the right to control and collection of underground(fiber) infrastructure, and so on.

The main goal should be the significant increase in the direct revenues of the local governments. It is necessary to successfully perform the transfer of assets and the recovery and restructuring of public enterprises, the transfer of property rights matters with the local government cadastre, with the transfer of appropriate resources, relieving local government in terms of financing social protection and establishing mechanisms for the inter-municipal cooperation and regional development, constantly insisting that local governments have more impact to manage local resources (land, forest, water and other natural resources, ...).

XIII. The Current Issues in Municipal Finances in Albania

XIII.1. Summary

This paper on the financial situation of the local government in general, and in particular of the municipalities in Albania, is prepared under the auspices of the Albanian Association of Municipalities (AAM).

The Albanian legal framework in terms of the government authorities division and the history of the financial system in Albania, makes it impossible to divide and analyze the municipal finances and the local finances in general; therefore, this paper deals with the local finances in general, thus implying that municipal finances are fully involved in them.

The aim of this paper is to accomplish two main objectives:

1. Provide a comprehensive overview of the current situation and possible actions to be considered by policy makers for further implementation of decentralization.
2. Provide means to stimulate the dialogue between the central and local level and consensus building on further actions to be implemented to support the continuation of the fiscal decentralization efforts in Albania.

Given that the current financial situation is the main and most delicate problem, this paper elaborates the main areas of fiscal decentralization, along with assessment of the current situation supporting decentralization and a more detailed examination of the main areas, such as:

1) Legal framework,
2) Administrative territorial structures and expenditure assignments,
3) Revenues and intergovernmental transfers, and
4) Local borrowing.

XIII.2. Assessment of Current Situation

During the past 20 years, Albania has made significant progress towards decentralization. In 1998, the country's new constitution was adopted which included clear provisions regarding local government; the European Charter on Local Self-Government was signed, the National Decentralization Strategy was adopted and the Law on the Organization and Functioning of Local Government was adopted in 2000. However, a number of challenges for further decentralization and strengthening of local governance remain to be addressed. The dimension of fiscal decentralization and ensuring that local governments have a predictable and equitable financial base and capacity to deliver the basic public services are of particular importance.

The progress made regarding the fiscal decentralization can be summarized with the conducted SWOT analysis (i.e. analysis of advantages, weaknesses, opportunities and threats).

SWOT Analysis

Strengths	Opportunities
The main strengths supporting progress toward fiscal decentralization are as follows: 1) enactment of the basic legal framework which describes and defines the authorities and functions of the local government units, 2) expenditure assignments are relatively clear with the exception of some shared functions, 3) own source revenues have been defined, 4) an attempt was made to promote equalization across the local government units with the unconditional grants, and 5) Local government budgeting capacity and citizen involvement has generally increased.	Identified weaknesses always produce some opportunities for improvements. The primary opportunities for improving the fiscal decentralization situation are as follows: 1) improving the dialogue between the national and local government stakeholders, 2) enacting a Law on Local Government Finances that was drafted several years ago, 3) revising the intergovernmental transfers to provide more objective, transparent, stable and simple allocation criteria, and 4) enhance the capacity of the local government units to generate own source revenues.
Weaknesses	**Threats**
Despite the progress made over the past decade, a number of weaknesses still need to be overcome in the next several years. The weaknesses can be grouped into three main areas: 1) National policy development framework, 2) Legal and regulatory framework, and 3) Local government authorities and capacities. Although there has been substantial progress regarding the overall legal framework with several different laws enacted;	The following main threats to overcome the weaknesses and grasp the opportunities for improvements remain: 1) The continuation of divisions within the local government associations, 2) Lack of efforts on national level to promote policy dialogue through organizational structures, 3) No improvement in the legal framework on local finances to clarify areas of expenditures, revenues and transfers, and 4) No adjustments in the administrative territorial structures that would improve service delivery in a more rational and economical manner.

The main weakness regarding the national policy framework is the failure to formally approve the National Decentralization Strategy, although great efforts have been

made in this direction in recent years. This is mainly due to the lack of a mechanism at the national level that provides organizational and policy coordination, which would ensure active work on the development of the National Decentralization Strategy. Another weakness that contributed to this situation is the division of local government associations, which hinders the development of a coherent policy for local government units. These factors have deterred the efforts to promote the political dialogue and consensus building that will produce the document and decentralization policy on national level.

At local government level, there is an ongoing problem that many very small units of local government are still not able to provide services. Other weaknesses that create uncertainty with local government structures are as follows:

1) The role of the regions,
2) Common functions that are not clearly defined,
3) Lack of capacity to collect revenues from some sources, particularly the property tax and to a lesser degree the small business tax, and
4) Unpredictability of transfers to local governments.

Although considerable progress has been achieved regarding the overall legal framework with the entry into force of various laws, the main weakness is the absence of a comprehensive law on local finances that would provide a more logical and consistent regulatory framework. . Existing laws have some major gaps and inconsistencies, which have been a source of conflict at the local level. In some cases, such as with the law on the small business tax and the by-laws regulating local borrowing the national government policies has influenced the the ability of local governments to use these fiscal instrumentsefficiently .

XIII.3. Legal Framework

The basic legal framework has been put in place over the past decade with laws defining the authorities, functions, and resources of the local governments. These have functioned reasonably well in spite of some inconsistencies in the legal framework. There is a however a need to clarify the role of the mayor and local councils with regard to the budget authority.

The main gap in the legal framework is the lack of aLaw on Local Finance that would clarify the fiscal and financial authorities, stabilize the transfer system bydefining the source of the transfers; allocation formulas based on objective criteria; and improvements in the revenue raising capacity of the local governments. Although a comprehensive Law on Local Finances was drafted in 2008, it has yet to be fully

debated and adopted by the central government.

This framework shall provide the following:

1. Definition of the key budget and finance terms
2. Rules/methods/ways for ensuring openness and transparency of local public finances;
3. Rules for the separate national taxes, including specific taxes to be shared, the percentage transferred to the local government and the procedures for transfer of funds to the local accounts.
4. Rules for unconditional transfers, including the principles and the formula for their calculation and allocation.
5. Rules for local government borrowing

The legal framework would be greatly enhanced through the National Decentralization Strategy that was developed in 2010, which will be revised and adopted as the main guide for furthering decentralization. This would serve as the focal point for the central/local dialogue and consensus building that is necessary in order to achieve further progress.

The AAM can provide support for improvement of the legal framework and the national decentralization strategy through the following activities:

- Activate a national level working group on decentralization to revise the Decentralization Strategy and have the strategy adopted by the central and local governments
- Require the establishment of a technical working group comprised of national and local governmental officials with expertise in the laws on local government to review and identify the specific areas of the current legal framework that need to be amended
- In the context of the working groups, establish a consultation and dialogue mechanism between the central and local governments through the organization of roundtables.

XIII.4. Administrative Territorial Structures and Expenditure Assignments

Albania has a fragmented local government system with too many small LGU-s that do not have either the fiscal or the human capacity to deliver reasonable public services. There appears to be bipartisan agreement that addressing the administrative territorial structures is one of the main priorities in furthering fiscal decentralization process and improving service delivery.

Uncertainties in population data is a significant complicating factor in determining the appropriate restructuring of the administrative territorial structures, expenditure assignments, and the intergovernmental transfers to the LGU-s,. The recently completed census is significantly different from the population data in the civil registry. In most cases, the census data are much lower than the civil registry data. A reconciliation of the difference in the population data is needed and a clear and transparent decision has to be taken about the purpose of using the respective data in order to ensure the needed reforms of the administrative territorial structures, expenditure assignments, and intergovernmental transfer formulas.

The problem of the differences in the population data is presented in the following example which is based on different sources of population data.

According to the civil registry data, there are 46 communes in Albania with a population of less than 2.000 inhabitants, and another 107 LGUs (103 communes and 4 municipalities) with 2.000 to 5.000 inhabitants, comprising a total of 41% of LGUs with less than 5.000 inhabitants. These numbers are even higher according to INSTAT census data with 69 LGUs (68 communes and 1 municipality) with population less than 2.000 inhabitants, and other 125 LGUs (110 communes and 15 municipalities) with 2.000 to 5.000 inhabitants, comprising a total of 52% of LGUs with less than 5.000 inhabitants.

The current method of expenditure assignments provides for the *exclusive* and *shared functions*.

The *exclusive functions* are assigned at both municipal and commune level, even though there are substantial differences in the capacities of these local government units to provide services. A new approach should be taken to provide for an asymmetrical assignment of functions based on the population size and capacity to deliver services.

The alternative of introducing asymmetric expenditure assignments at the local government level (municipalities and communes) should be considered in conjunction with the voluntary or compulsory amalgamation of the LGs. This strategy could take different forms, but it would basically give fewer responsibilities to smaller LGs for some critical services that are negatively affected by their small size, while givinge the responsibility to the regions (qarks) for providing those critical services in the

smaller municipalities. The responsibility for additional services and the accompanying funding sources would be devolved in the future to those LGs that reach the minimum prescribed scale through voluntary amalgamation.

Shared functions are a confusing area for expenditure assignments. The roles of different government levels should be clarified. Some of the shared functions could be assumed by some LGUs within their levels of capacity. This transfer of shared functions should be based on the size, capacities, and willingness of the LGUs to undertake these tasks, along with appropriate transfer of funds from central to local level to compensate for the additional costs.

The AAM can support the improvement of the administrative territorial structures and expenditure assignments with the following activities:

- Facilitate a dialogue on administrative territorial restructuring and reconciliation of population data
- Support the development of expenditure assignments based on population data and asymmetrical assignment of functions to LGUs based on provided support for service delivery capacities
- Assist the clarification of the roles at different government levels with regard to shared functions.
- Support the definition and adoption of national level service standards for the LGUs

XIII.5. Revenue Assignment and Intergovernmental Transfers

The revenue sources of local governments require substantial improvementboth in terms of their sources as well as their collection,. This area would require reaching a substantial consensus between the central and local authorities to ensure improvements over the next year.

There is a very worrying trend regarding the decline in intergovernmental transfers and changes in local revenue sources, which needs to be addressed. A review of the fiscal changes in the period 2009- 2011 reveal the magnitude of this trend. In 2009, local government revenues were equal to 3.1% of GDP but declined to 2.6% in 2010 and 2.2% in 2011. Local government revenue as percentage of the total public revenue declined from 11.9% in 2009 to 9.8% in 2010 and 8.8% in 2011.

The unconditional grant declined from 14.859,000 Lek in 2009, to 11.215,700 Lek in 2010 and 11.113,200 Lek in 2011. The drop in the conditional grant was even more dramatic. In

2009, the conditional grant was 5,500,000 Lek and then dropped to 2,867,000 Lek in 2010 and, then increased slightly to 2,900,000 in 2011.

It should be noted that during the same period, the national level budget also suffered a significant decline.

This decline was approximately 10% for each of the years as reflected in the following data.

PUBLIC REVENUES					
Year	Forecast	Supplemental Budget	Collection actual	Reduced by Supplement Budget	Reduced by actual
2009	334,823,000	326,117,000	299,502,000	3%	11%
2010	360,955,000	333,658,000	324,721,000	8%	10%
2011	362,223,000	344,047,000	330,475,000	5%	9%

Source: Ministry of Finance

When compared to other countries in the region, Albania has provided less funding to local governments.. Bringing Albania closer to these levels requires further attention. Some of the changes would be realized by providing bigger revenue authority to the local governments by allowing them more flexibility in setting the tax rate and tax base for some taxes. Also, if shared taxes are provided to assume the existing shared functions, that would rebalance the expenditure and revenue levels.

The improvement in the property tax collection should be one of the main areas of further development. One of the key requirements for this improvement is a more coordinated information sharing between the central and local authorities. Also, there is a need to shift more rapidly to a market based valuation system for property taxes. The World Bank and other donors have provided substantial support and the basics of a market valuation system are in place. Until this is achieved, the property tax will not be a significant source of local revenues or it shall not impact the land development practices that require more attention.

The application of the small business tax by the local governments has proven to be politically very contentious and the decisions of the central government to limit the rates and the lowering of the VAT threshold have severely constrained this tax as a source for local governments.

One of the key constraints on improving the revenues of the local governments is the limited use of tax sharing from the central to local level. Although this is allowed under the current legal framework and is continuously mentioned as solution to some of the problems with local government revenues, still the shared taxes of PIT/CIT have not been provided. This need to be taken into consideration and tax sharing should be implemented

in the very near term. PIT sharing may be based on either the origin of the taxpayer (residence) or per capita basis. Both methods are used in the European countries.

Utilizing PIT on origin basis must be examined in the light of the high concentration of the PIT revenue in the municipality of Tirana and the low level of PIT across all the other LGUs. For the year 2011, approximately 70% of the PIT was collected in Tirana. The sharing of PIT on origin basis would significantly enhance the revenues for the municipality of Tirana and require a substantial increase in the transfers to the LGUs in order to overcome this inequitable distribution. Presently, the PIT cannot be assigned on an origin basis since tax districts do not overlap with the local government boundaries. That would require that changes are introduced in the present taxpayer identification system.

The tax sharing system for the local governments implies certain number of advantages and disadvantages.

The main advantages are:

1) The efficiency of tax collection by the the central government,
2) Expansion of the taxable base for LGUs;
3) Increased local decision-making authority regarding expenditures since tax shares would be unconditional transfers.; and
4) Stability of revenue for local governments.

The main disadvantages of separate tax system are:

1) Decreased accountability of LGUs to make decisions on revenue growth;
2) Considerable efforts to promote fiscal equalization depending on the yield of the tax in different areas of the country;
3) The potential reduction of central government revenues;
4) Potential volatility of tax sharing level from year to year due to national policies on the level of taxes.

The local governments began to receive the motor vehicle tax on a shared 18% basis and a shared mining royalty during the last year. Although it is still too early to obtain data about the amount of collection, it seems that the shared motor vehicle tax may produce substantial increase in the LGU revenues. However, since the distribution is done on an origin basis, this may be concentrated in the larger LGUs, especially Tirana and Durres.

The growth of the conditional versus unconditional grants over the past several years is a trend that needs to be reversed. Largely, this growth is due to the provision of the competitive grants, now Regional Development Fund, as means of providing more directed capital expenditures funding for specific projects at the local government level.

The transformation of the competitive grants has been extensively analyzed by UNDP in terms of improving the new Regional Development Fund. The UNDP report gives recommendations regarding the improvement of the criteria for selection of projects, maintenance of the level of funding to a constant level of GDP or national investment budget, and distribution of funds based on regional, rather than national or local priorities. These recommendations should be implemented.

The difficulty of tracking the expenditures and revenues due to changes in the accounting for funds, makes it very difficult to assess the equity of the transfers. . There changes in the transfer formula made from year to year in the annual budget, a practice which is not recommended and which needs to be addressed through a Law on Local Finance. In addition, there should be a definition of the source of the transfers as a percentage of GDP or total public revenues. These issues should be addressed in the near term, thus providing more stability, sustainability, and predictability of the transfers.

The per capita analysis by population quartiles indicates a large number of small local governments by population size which have limited own source revenues, but receive substantial share of the grants to produce relatively high level of horizontal equalization. The situation is closely linked to the existing administrative territorial structures. The respective adjustments to the size of the LGUs would provide a more rational and efficient allocation of funds across all LGUs.

The equalization system needs to be comprehensively reviewed and the rules for allocation of grants need to be stabilized with greater certainty. This should be done in the context of adopting the Law on Local Government Finances, which should be the priority effort in the following year.

The central level of government has repeatedly complained that the LGUs have not assumed bigger responsibility and accountability for their revenue situation. However, the central level has constrained the LGUs ability to achieve more by restricting the revenue sources and inhibiting the implementation of the property registration records as well as the transfer of public assets to the LGUs which could have been utilized for these purposes. Enhanced dialogue with the intention to improve cooperation is needed in order to improve the revenues and transfers for the local governments.

XIII.6. Local Borrowing

The legal framework on local borrowing is stipulated in the Law on Local Borrowing, which was enacted in 2008. With the passage of the law, LGUs demonstrated considerable interest in using borrowing for capital investments. With the assistance of a USAID project, local governments were able to initiate some borrowings from banks and respective agreements on borrowing were reached. Unfortunately, the central government issued administrative orders that severely restricted the use of debt by the local governments and some agreements were cancelled because of this action. This effectively eliminated the possibility for local governments to borrow under the present circumstances.

In addition to the centrally imposed limitations, the central government also adheres to a total public debt limit of 60% of GDP. The extensive use of external and domestic debt at central level now approaches the 60% limit and further restricts the possible use of borrowing by the local governments within this overall public debt limitation.

In summary, unless the restrictions are relaxed on the local governments, there is little possibility that the LGUs will be able to access any borrowing to provide the much needed funds for financing capital investments and infrastructure improvements.

There are some potential solutions that should be considered in order to improve the situation and allow the local governments to borrow. These need to be innovative methods that provide some new approaches to local governments borrowing.

One approach would be to revise the debt limitation and allocate some level of debt to the local government units. One possibility is to revise the debt limit to 65% of the GDP and allocate this additional 5% to the domestic debt limits for the local governments to utilize. This would need to be done in conjunction with loosening the present overly restrictive limits on the use of debt.

An additional approach would be to allow local governments to utilize special entities and special funds to support borrowing outside the present local government limits. The use of water authorities or the creation of public private partnerships with some borrowing capacity may be feasible under the existing laws or amendments to the existing laws.

Local governments might also be empowered to utilize some innovative financing methods, such as special assessment for capital improvements, more directed use of impact fees to the infrastructure projects, and the use of tax increment financing to fund projects in some areas of the local government.

A longer term solution would be to transform the Albania Development Fund into a bond bank that would pool credit needs of the local governments, issue bonds to fund these needs, and distribute the bond proceeds to the municipalities with repayment provisions to support the investment projects.

The previous USAID program provided substantial technical support to the local authorities when applying for loans from local commercial banks. This program also developed the manual that LGUs can use when they develop projects and loans for the implementation of these projects. This experience is still present under the current PLGP project. In addition, USAID has supported the development of local government borrowing in other countries in the region and it is an added value to the experience required in Albania in order to develop the market of loans to local government units.

The AAM can also promote dialogue between stakeholders from the central government, local and local financial institutions to examine the current legal framework and to identify new approaches for borrowing.

XIII.7. Recommendation from the Consultations with LGU-s on Improvements to the Local Financial System

With multitude of problems and issues to be resolved, it is difficult to set the priorities and specify which issues in the local government system should be addressed.

Among the local governments, there was an agreement that improving the revenue capacity of the LGUs was a high priority with clarifying the expenditure assignments and the basis of the intergovernmental transfers ranking very close.

As far as improving the legal framework is concerned, there was an overwhelming consensus that developing a Law on Local Finances was the most important. No other issues ranked even close to this priority.

The expenditure assignment problem would be solved by assigning functions based on the size of the LGU population. The problem of administrative territorial restructuring and the clarifying of shared functions ranked close behind.

The LGUs overwhelmingly considered that the revenue capacity problem should be improved by providing more authority for the LGUs to establish the rate and base of the taxes. There was more limited support for using shared taxes or improving the collection of the property taxes.

The problems with the intergovernmental transfers require a more objective and transparent allocation criteria according to most of the LGUs. This was followed with improvements in the stability of the transfers and assigning a percentage of GDP or total public revenues as the basis for determining the transfer pool of funds.

Finally, there was overwhelming consensus that the present restrictions on local borrowing should be relaxed so that local governments can meet their borrowing needs and finance important capital investments.

The search for solutions to the problems that have been identified in this paper on fiscal decentralization needs to be continued with some significant level of effort and dialogue across the levels of government. There are practical and feasible solutions to these problems based on the experiences from other countries facing similar problems, which can be applied in Albania with a spirit of cooperation and compromise in order to improve the overall financial situation of the central and local governments.

XIII.8. Main Conclusions

Some of the recommendations can begin without further delay. These include:

- Reactivate the revision and updating of the National Decentralization Strategy
- Finalize the existing Draft Law on Local Finance
- Reconcile the census and civil registry data
- Accelerate the property registration process with transfer of property record information to the LGUs
- Initiate better distribution of the motor vehicle tax with more allocation to the LGUs

The other recommendations that would require additional time and consideration include:

- Redefine the administrative territorial structures following a period of voluntary structuring and then compulsory amalgamation
- Transfer the shared functions to LGUs based on willingness and capacity
- Initiate shared taxes on PIT once the technical problems of implementation are resolved
- Define the role and responsibilities of the regions

The above list of actions is only intended to highlight the importance of taking into account the timeframe and sequence of fiscal decentralization actions in order to be implemented in an orderly and systematic manner without any significant disruptions in the present operations and functioning of the local governments.

An important consideration, particularly with regard to changing the expenditure assignments and the transfer formulas is whether to proceed with undertaking the changes before or after the completion of the administrative territorial restructuring.

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