REPORT

Fiscal Decentralization Indicators for South-East Europe: 2006-2012

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

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Third Edition
April, 2014

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

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THE REPORT IN BRIEF:

- **Decentralization in South-East Europe is still a work in progress**: With the exception of Kosovo[1], there is no country in the region where local government revenues or expenditures reaches the average for the EU either as a percentage of GDP or of total public revenues.
- **Over the last few years, there have been only a few major changes in the allocation of public sector responsibilities between national and local governments across the region.** This suggests that the policies designed to transfer power and money to local governments that began in the late 1990s have lost momentum. While it is always difficult to make judgments about the adequacy of local government revenues relative to their expenditure responsibilities, seems like in many countries of the region they remain underfunded.
- **The global economic crisis of 2009 affected the countries of the region very differently.** In some countries, the crisis hit hard and fast. In others, it had little effect and/or its impact was delayed. With a few exceptions however, economic growth since 2009 has been slow. In most countries the financial position of local governments improved in 2010 and 2011. In a number of them, however, it deteriorated in 2012 as economies again contracted. In only a few has it recovered to pre-crisis levels.
- In most countries and entities of the region, *as in the rest of Europe*, local governments derive the majority of their revenues from general or unconditional grants, earmarked or conditional grants, and shared taxes. **In most places, own source revenues account for between 30% and 40% of total revenues, a level similar to that of most OECD member states. In a few countries, local governments derive a very high share of their revenues**

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

from conditional grants, limiting their financial independence. In many countries, unconditional grants are underutilized. This raises questions about the overall equity of their intergovernmental finance systems because it is through unconditional grants that equalization funding is usually provided to poorer jurisdictions.

> **In much of the region, local governments derive significant amounts of own-revenue from quasi-fiscal instruments imposed on real-estate transactions, new investment, and business operations.** In a number of countries, national governments have started to constrain these practices in order to improve the "business enabling environment". As legitimate as these efforts are, they will have profound effects on local budgets unless ways are found to replace the lost revenue.

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

> **Efforts to increase the fiscal autonomy of local governments should focus on transforming the Personal Income Tax from a shared tax into a tax over which local governments have some rate-setting powers.** This can be done by giving them the right to impose a surcharge above the rate set by the national government, as is already practiced in Montenegro and Croatia, or by dividing the PIT "space" between the national government and local governments, as is currently being considered in Bulgaria.

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

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

- **In a few countries, investment spending is well below the average for the EU, and still further below the average for the eight formerly communist countries that joined the EU in 2004.** This is troubling given the neglected and underdeveloped state of network (environmental) infrastructure in the region.
- Scarce investment funds tend to be spent on pay-as-you-build road projects and not on debt-financed, pay-as-you-use environmental facilities like waste water treatment plants because planning roads is simpler; construction can be delayed if money runs out; and because visible benefits can be delivered within a single election cycle. **Local governments need to radically improve their ability to prepare, plan, and cost-out complex multiyear investments - particularly in water, sewage and solid waste.**
- **EU funds are playing an important role in the modernization of local public infrastructure in new member states.** In some countries, however, national policy makers seem to be using them as substitutes for transfers funded through domestic sources.
- In a number of countries, the consolidated debt of the General Government has grown rapidly over the last few years. In a few places, local government debt has contributed to this growth, but it is still national government borrowing that has driven the process. In Albania and Serbia, public debt as a percentage of GDP is now close to exceeding the 60% limit established by the Maastricht Treaty. It is well over 50% in Montenegro, Croatia, and Slovenia. In Albania almost none of this debt comes from local governments and there is also modest in Croatia and Slovenia, though slightly higher in Montenegro and Serbia. Over the coming years, Ministries of Finance in these countries are likely to restrict the access of local governments to credit in order to preserve debt space for the national government. Local government borrowing has increased significantly in RS (of BiH), Romania, and Turkey while in Kosovo and Macedonia it is still a marginal phenomenon.
- **In many countries, the adequacy and predictability of local government revenues will have to be increased if municipalities are to have the resources against which to prudently incur debt.** Albanian, Serbian, Croatian and Montenegrin local governments my find it harder to access credit in the immediate future not because of their lack of fundamental credit worthiness, but because of the reluctance of their national governments to exceed the Maastricht limits.
- **New censuses are producing technical and political problems because there are differences between the population numbers currently used to allocate intergovernmental grants and the ones revealed by the new censuses.** This phenomenon can be observed in other European countries. For example, recent census results in Germany have produced tensions over how to rewrite intergovernmental transfer rules, creating challenges for, among other things, mid-term financial planning.

INTRODUCTION

This report has been prepared by the Fiscal Decentralization Task Force of the Network of Associations of Local Authorities of South-East Europe (NALAS). It is the third edition of what NALAS expects to be an ongoing effort to provide national and local policy makers and analysts with reliable comparative data on municipal finances and intergovernmental fiscal relations in South-East Europe. The monitoring system of the implementation of the strategy "South East Europe 2020 - Jobs and Prosperity in a European Perspective" related to the measuring clear subsidiarity, multilevel governance and regional cooperation will be based on the data and analysis conducted for this report.

The first edition of the report was published in March 2011 and covered the years 2006-2010. The second edition extended the period under review through 2011 and deepened certain aspects of the analysis.

This edition covers the period 2006-2012. As in the previous two editions we present a comparative picture of what has been happening in the region as whole. But we devote less space to methodological and terminological issues and instead focus more on the changes that have occurred within countries over the last seven years.

As before, we have made improvements in the quality of the data used in the report. Data for most members is now complete for almost all years under review and errors contained in previous editions have been corrected. But, the report, like its object of analysis, is still a work in progress and over time NALAS hopes to expand, improve and deepen it's analysis in response to the needs of both its members and outside researchers. In particular, we expect future editions to analyze expenditures by function, as well as the horizontal equity of the region's intergovernmental

finance systems. Indeed, when reading the report it is important to remember that we still do not have reliable data about the distribution of revenues and expenditures across local governments of different sizes and types. This is problematic because there is good reason to believe that in many countries revenues and investment expenditures are heavily skewed toward wealthier jurisdictions, particularly capital cities.

Nonetheless, the report provides a reasonably clear picture of the structure, functions, and financing of local governments in South-East Europe today. It also provides an overview of how intergovernmental financial relations have evolved over the economically turbulent period 2006-2012. It is our expectation that the report will be useful to NALAS' member associations, as well as to the more general policy community by providing all concerned with reliable data on the role of municipal governments in the region and in comparison with their counterparts in the EU.

The report is divided into three sections. The first section briefly discusses the data used in the report and some basic methodological issues. The second begins with an overview of the structure and functions of municipal governments in South-East Europe as well a few key macro-economic indicators, before presenting indicators of fiscal decentralization for the region in comparative perspective. The third section presents short descriptions of recent changes in the local government finance systems of each of NALAS' member countries/entities. These descriptions are then followed by the presentation of more detailed data on how the revenues and expenditures of local governments have evolved over the period 2006-2012.

Data, Terms, and Methodological Issues

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

Comparing intergovernmental finance systems is never easy. The most important reason for this is that countries assign different responsibilities and revenues to different levels of government. As a result, both what sub-sovereign governments do, and how they pay for it, varies substantially from country to country.

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Levels of Government: In this report, we concentrate on the lowest level of sub-sovereign government, meaning democratically-elected municipal or communal governments. With the exception of Bosnia-Herzegovina, municipal governments constitute the most important level of democratically elected sub-sovereign governance in the region when measured in fiscal terms. We refer to both communal and municipal government as municipal governments or local governments, though this term masks the fact that many "municipal governments" are in fact villages of a few thousand souls.

What Municipal Governments Do: Throughout South-East Europe, municipalities and communes bear primary responsibility for maintaining and improving local public infrastructure, including local streets, roads, bridges, and parks. They finance and manage water supply and sewage treatment, garbage collection and disposal, public lighting, local public transport, and district heating. In many countries, network infrastructure has been neglected or underfunded for decades. Indeed, in most of them modern environmental infrastructure has never been built.

> Most importantly, from a financial point of view, local governments must pay for the costs of building new (network) infrastructure, infrastructure that almost everywhere has been neglected or underfunded for decades. Indeed, in many places it has never existed.

The most important differences in what municipal governments do concerns the degree to which they are responsible for social sector services, particularly

education. In Kosovo, Macedonia, Moldova, and Romania local governments are responsible for financing and managing primary and secondary education, including the payment of teachers' wages. In Serbia, they are fully responsible for all the costs associated with preschools, while in other countries local governments are responsible for maintaining and improving school facilities.

Population: The population numbers used in this report are based on the last official census, or lacking an official census, the numbers used by the relevant statistical agencies. In a number of countries (e.g. Albania, Kosovo, Bosnia-Herzegovina), censuses have recently been conducted but their results have yet to be made official --mainly for political reasons. Some of these reasons are related to the fact that there are significant differences between the population numbers currently used to allocate intergovernmental grants and transfers and the ones yielded by the recent censuses.[2]

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

[2] For example, the still-to-be finalized census in Kosovo suggests that the population is 15% to 20% less than is currently assumed and that a disproportionate share of the current *overestimation* is concentrated in Pristina. Something similar seems to be going on with Albania and Tirana, where the census also remains to be finalized. See Jennifer Hronesova, Balkan Insight November 2013, "Playing Politics With Censuses in Former Yugoslavia."

GDP: The GDP numbers used in this report are those calculated by their respective Ministries of Finance according to the production method. They have been converted, where necessary, into EUR by using the average annual exchange rate for the year concerned. Tables and charts that compare trends over time across members of the group have been calculated on the basis of EUR values using average exchange rates provided by the relevant Central Banks.

Consolidated Public Revenue of the General Government: To compare the role of local governments in the public sectors of their respective settings we have used local government revenues as a share of consolidated General Government revenues. We have used revenues instead of expenditures because the data for these tend to be more available and more reliable. By General Government we mean the total revenues of the national government and its agencies, including the revenues of off-budget (social security) funds, as well as the revenues of subnational governments. In calculating total local government revenue we have excluded proceeds from borrowing, but included income from asset sales and carry-overs from previous years, despite the fact that in an ideal world these would be accounted for separately.

General Grants: In most of the region local governments receive freely disposable general grants from their central governments. In some places, the size of unconditional grant pools are defined as percentages of particular

central government tax revenues. When these tax revenues are allocated to subnational governments by formula – as opposed to being shared on the basis of their origin – we treat them as General Grants.

Conditional and Block Grants: Throughout South-East Europe, local governments receive grants from higher level governments that can only be spent for specific purposes. In a few cases, these grants should be considered block grants, meaning grants that can only be spent on a specific function (e.g. education)—but which --at least in theory-- local governments are free to spend as they see fit within that function. In practice, however, the "block" function of block grants remains extremely limited and local governments' ability to freely spend these funds within the functions they are intended for remains severely constrained by higher level governments.

The "block" function of block grants remains very limited.

Shared Taxes: In most of the region, local governments are legally entitled to shares of particular taxes generated in their jurisdictions, while the base, rates, and collection of these taxes remain controlled by higher-level governments. Across the region, the most important shared tax is the Personal Income Tax (PIT). The Property Transfer Tax is also often shared in whole or in part with local governments, and is usually misclassified as an own-revenue. In a few places, the recurrent Property Tax is also a shared with local governments, but in most it is an own-revenue.

The most important tax shared on an origin-basis with local governments in South-East Europe is the Personal Income Tax (PIT).

Own-Source Revenues: Throughout the world, data on the local government own-revenues is weak because it is often poorly collected and classified. Local government own-revenues include income from: locally imposed taxes; the sale or rental of municipal assets; fines, penalties, and interest; local user fees and charges; fees for permits, licenses and the issuance of civil registration documents. In many places, local user fees and taxes --though collected by local governments-- are fully specified by higher level governments and really should be considered shared revenues. In others, *de facto*, if not necessarily *de iure* regulation of local fees and charges is weak, allowing local governments to use them as (poorly regulated) quasi-taxes. Particularly important in this respect are two fees inherited from the past: the Land Development Fee[3], often the single largest source of own revenue, and the Business Registration Fee (or Sign Tax). The most important local tax in the region is the Property Tax, though this does not mean it is the most important source of own-revenue. Local governments in Montenegro and Croatia can impose local surcharges on the PIT.

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

II

General Overview of Local Governments in South-East Europe

Number and type of sub-sovereign levels of governance

Table 1 below presents the number and type of sub-sovereign governments where NALAS members operate. Bosnia-Hercegovina (BiH) has four levels of government: 1) the state of BiH 2) two entities, Republika Srpska (RS of BIH) and the Federation of Bosnia-Herzegovina (FBiH of BiH) as well as the District of Brcko; 3) cantons in FBiH (of BiH); and 4) municipalities in both FBiH (of BiH) and RS (BiH). In FBiH (of BiH), cantons are responsible for many public services, and the entity government is relatively small. In this report, the revenues and expenditures of cantons are not included in the revenue figures for *local governments* for either BiH or the Federation. They are however included in the figures for total public revenue and expenditure in both BiH and the Federation.

Albania and Croatia both have county levels of government (Qarks; Zupanije). In Albania, the role of Qarks is extremely limited. In Croatia, Zupanije are somewhat more important. Moldova has two levels of sub-sovereign government: the autonomous province of Gaugazia, raions/regions and communes/municipalities. The heads of raions are indirectly elected by raion councils under strong central influence and exercise significant control over the budgets of municipalities and communes. This blurs the distinction between 1st and 2nd-tier governments in Moldova, as well as the distinction between local governments and the territorial arms of the national government.

Romania has two levels of sub-sovereign government communes and cities on the hand and judets on the other. The 2nd tier plays a more important role in the delivery of public services than its counterparts in Albania or Croatia, and has recently assumed responsibility for maintaining general hospitals. Nonetheless, the 1st tier is more important fiscally. **In this report, the financial data for local governments in Albania, Croatia, Romania, and Moldova includes 2nd-tier of local governments.**

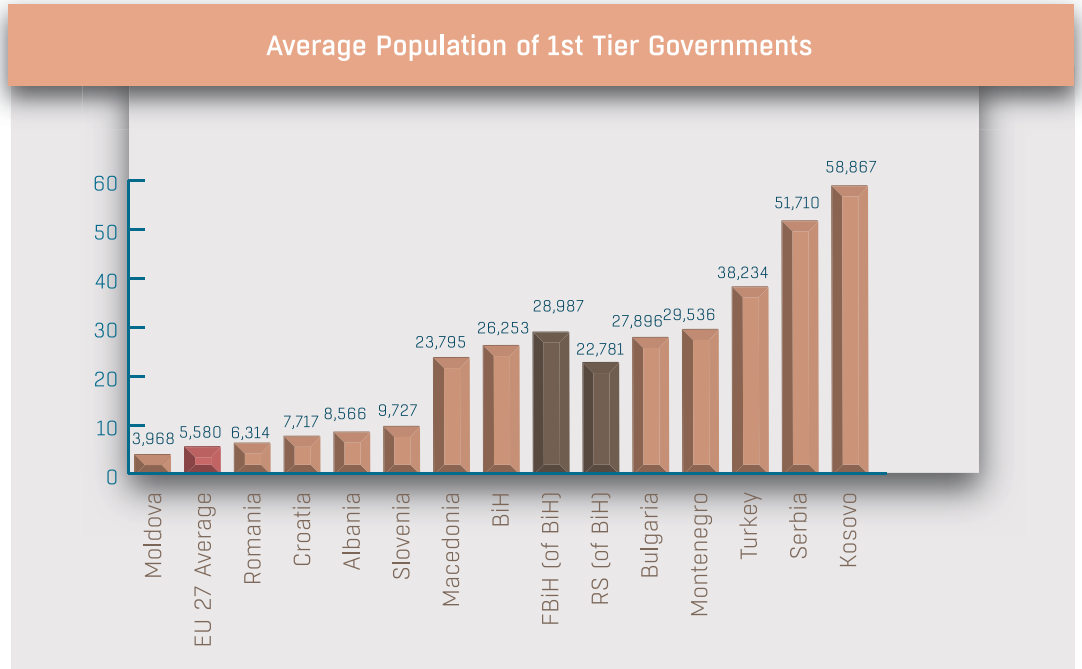
Table 1

	NALAS MEMBER	LEVELS OF SUB-SOVEREIGN GOVERNMENT	TYPES OF SUB-SOVEREIGN GOVERNMENT	# OF 1ST TIER
Albania	AAM, AAC	2	Counties; Municipalities/Communes	373
Bosnia Herzegovina		3	Entities; Cantons; Municipalities	143
FBiH	SOGFBIH	2	Cantons; Municipalities (Neighborhood Units)	80
RS	ALVRS	1	Municipalities (Neighborhood Units)	63
Bulgaria	NAMRB	1	Municipalities/Communes (Neighborhood Units)	264
Croatia	UORH, UGRH	2	Counties; Municipalities/Communes	556
Kosovo	AKM	1	Municipalities (Neighborhood Units)	38
Macedonia	ZELS	1	Municipalities (Neighborhood Units)	81
Moldova	CALM	2	Autonomous province Raions/Regions; Municipalities/Communes	898
Montenegro	UOM	1	Municipalities	21
Romania	FALR, ACoR	2	Counties; Municipalities/Communes	3181
Serbia	SCTM	2	Autonomous Provinces; Municipalities (Neighborhood Units)	145
Slovenia	SOS	1	Municipalities	211
Turkey	UMM	4	Special Provincial Administrations; Metropolitan municipalities; District municipalities; Communes	2854

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

As can be seen from Chart 1, there is considerable variation in the average size of 1st tier local governments across South-East Europe. Moldova has the most fragmented system of 1st tier local governments with an average population of less than 4,000 inhabitants. Municipal governments in Romania, Croatia, Albania and Slovenia are also relatively small, averaging less than 10,000 inhabitants. The small size of first tier local governments in these places presents obstacles to decentralization because small jurisdictions often have weak tax bases and lack the human capital necessary to reasonably support major public services. Nonetheless, what is unusual about the Chart is the relatively large size of local governments in the region when compared to those in the EU. Macedonia, BiH, Bulgaria, Montenegro, Turkey, Serbia and Kosovo all have municipal governments with average populations of greater than 20,000 inhabitants whereas within the EU only 9 (of 27) countries (including Bulgaria) have municipal governments that are similarly large.

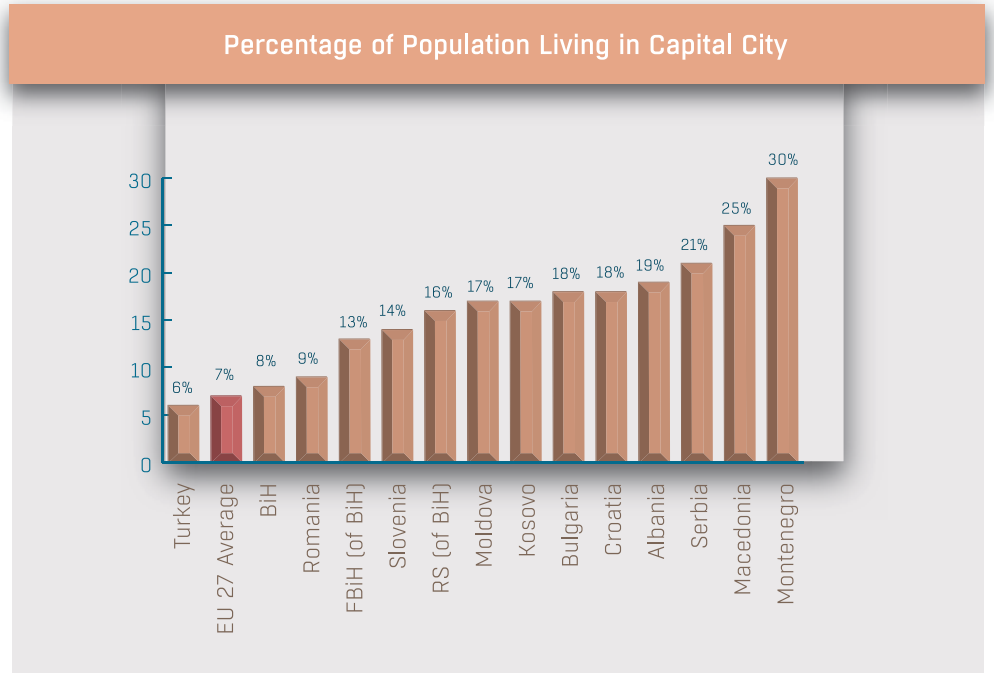
Chart 1



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

Population Distribution and Density

Chart 2



The relatively large size of capital cities In South-East Europe means that tax bases tend to be skewed toward one major urban area. This can create technical and political impediments to decentralization. Technically, it can be difficult to assign local governments robust own-revenues or to create good equalization mechanisms when so much of the economy is concentrated around one

major metropolitan center. Politically, it can make the implementation of equalization measures difficult because they frequently create conflicts between the capital city and all other jurisdictions.

The relatively large size of capital cities In South-East Europe means that tax bases tend to be skewed toward one major urban area. This can create technical and political impediments to decentralization.

The Dynamics of the Gross Domestic Product

Chart 3 presents the GDP per capita for all members of the group in 2006 and 2012. As can be seen from the Chart, there are very significant variations in the relative wealth of the members of the group. Also, Slovenia is by far the richest, with GDP per capita of 17,208 EUR, followed by Croatia (10,543), Turkey (8,519) and Romania (6,200). Moldova is the poorest of the group with a capita GDP under 1600 EUR, followed by Kosovo whose GDP per capita is now 2100 EUR. The GDP of both Slovenia and Croatia's, however grew the most slowly over the period (14% & 16%), though higher than the average for the EU (8%). Moldova's GDP almost doubled while all the rest grew by between 30% and 50%.

Chart 3

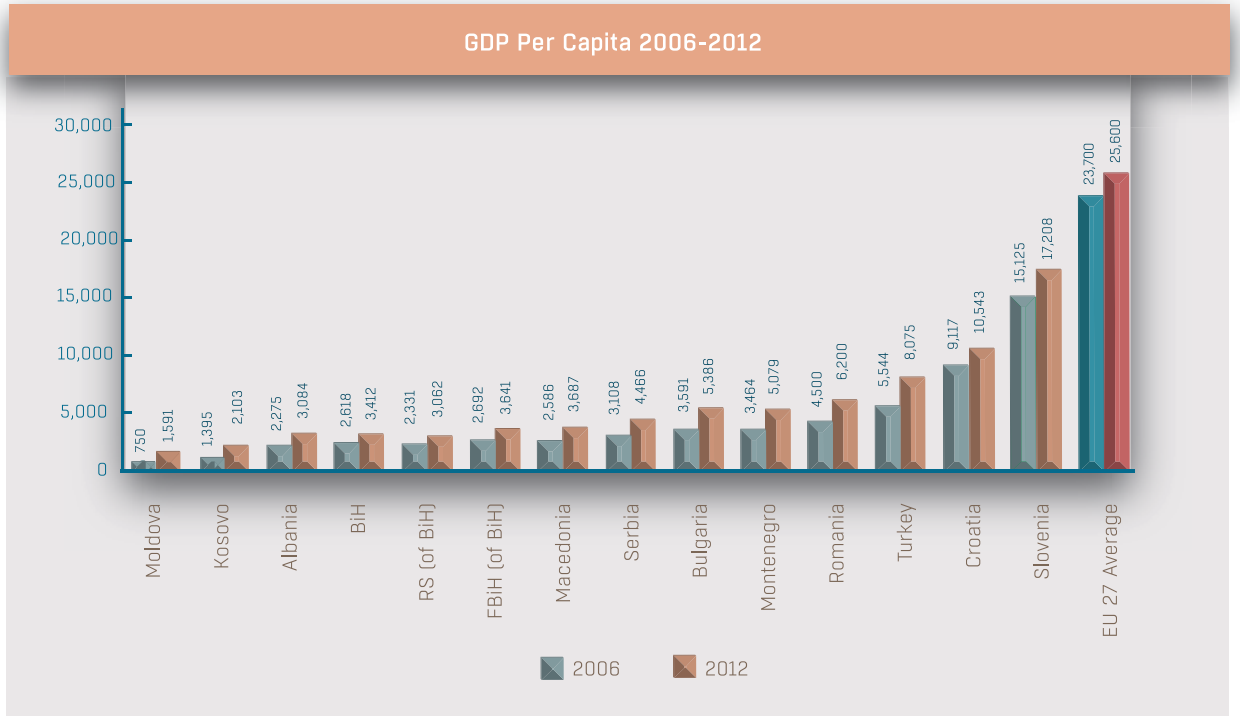


Table 2 below presents annual changes in the GDP for all countries in the group between 2006 and 2012. As can be seen from the Table, there is considerable variation in economic performance across countries for the period. Prior to the Great Recession of 2009, most were growing quite robustly. With the exception of Kosovo, Albania and to a lesser extent Macedonia, the crisis hit all of them fairly hard. But while the Turkish and Moldovan economies rebounded vigorously in 2010 and 2011 growth elsewhere has been much less vigorous. Indeed, the economies of Slovenia, Serbia, Bosnia-Herzegovina, Macedonia, Moldova and Montenegro all shrank in 2012, a trend that hopefully will not continue. Most disturbingly, the Croatian economy has yet to return to growth.

Table 2 Annual GDP Growth and Decline 2006-2012

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

Basic Indicators of Fiscal Decentralization

The share of local public revenues (or expenditures) in a country's GDP tells us how big the local government sector is in relationship to the total economy. The share of local public revenues (or expenditures) in the consolidated public revenues (or expenditures) of the General Government tell us how large a role local governments play in the overall governance structure of a country. These two indicators are among the best measures we have of decentralization. To understand their significance, however, we need two other pieces of information.

First we need to know how large the total public sector is in relation to the GDP. If a country's overall public sector is small, it is unlikely that local government revenues will represent a significant share of the GDP. They may, however, represent a substantial share of total public revenues. Such a situation suggests that all levels of government have trouble collecting taxes, but that the national government is treating local governments relatively fairly. Conversely, a situation in which the public sector is large, but local government revenues are low in relation to both the GDP and total public revenues suggests that the national government doesn't consider local governments serious partners in the delivery of public services.

We also need to know which public services local governments are responsible for. Fully inventorying these functions however, is difficult. In part, this is because the legal regimes governing local governments are different and complex; in part, it is because the services local governments actually deliver may differ from what is specified in the law; and in part it is because many local governments may not have the means to provide the services they are supposed to deliver.

Nonetheless, when looking at local government revenues (or expenditures) in relationship to the GDP, or to the size of the total public sector, some service responsibilities are so large that they become "game changers" if they have been assigned to local governments. Here, we have in mind social sector services such as health, education, and social welfare. Of particular importance in this respect is whether local governments are responsible for paying teachers wages. The reason for this is because the wages of primary and secondary school teachers typically constitute one of a country's largest public expenditures. Most OECD countries for example spend between 3 and 5% of GDP on pre-tertiary education, of which between 60% and 80% goes to teachers wages[4].

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

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

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

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

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

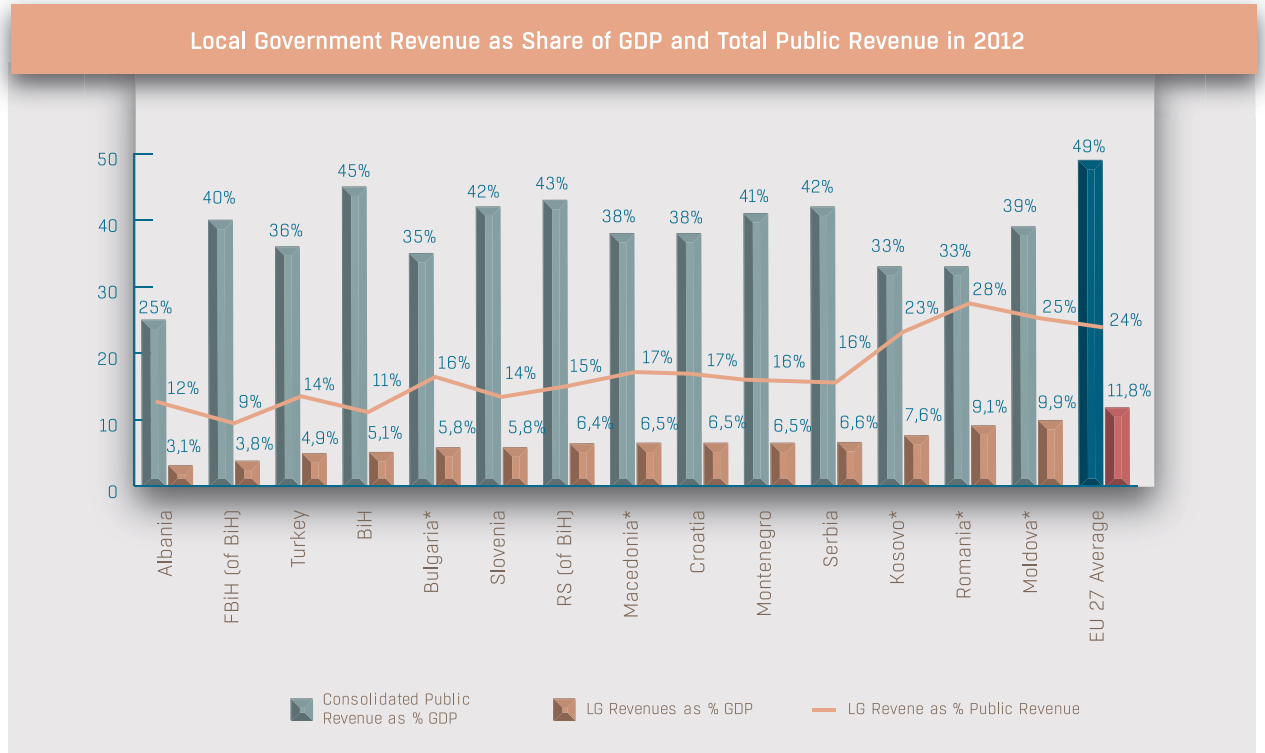
Local Governments Revenues in South-East Europe

With these conditions in mind we can now turn to Chart 4, which shows local government revenues as a share of both total public revenues and of GDP for all members of the group, as well as the average for the EU. The most important thing that can be seen from the Chart is that on average local governments in the EU play a much more substantial role in their respective public sectors than do local governments within the NALAS group. Indeed, it is fair to say that in most of South-East Europe decentralization is still very much a work in progress.

> In most of South-East Europe decentralization is still a work in progress

As can be seen from the Chart, all members of the group have public sectors that are significantly smaller than the average for the EU as a whole, and that in many total public revenues are equal to well under 40% of the GDP. This suggests tax collection is weak throughout the region. But despite this general weakness, some central governments are treating their local governments better than others. For example, the public sectors of Macedonia, Bulgaria, Kosovo, Romania and Moldova are all of similar size and in all local governments pay teachers wages. Nonetheless, in Romania, Kosovo and Moldova they receive about 25% of total public revenue –a share close to the EU average-- while in Bulgaria and Macedonia they get well under 20%. This suggests that the central governments of Romania, Moldova and Kosovo are trying harder to provide municipalities with the revenues they need to support the functions they have been assigned. It is also a little surprising that the local government share of both GDP and total public revenues is relatively modest in the three wealthiest countries of the group -Slovenia, Croatia, and Turkey.

Chart 4



* indicate that local governments pay teachers wages. ! indicate 2011 data

In Bulgaria, Kosovo, Romania, Moldova and Macedonia local governments pay the full costs of pre-tertiary education. But while the "weight" of teachers' wages can be seen in the share of GDP at the local government level in Romania and Moldova, the situation in Bulgaria and Macedonia is less clear. Here, total local government revenues are respectively 5.8% and 6.5% of GDP, shares similar to many others in the group. But because it is likely to that between a quarter and half of these shares go to teacher wages, there is reason to suspect that in Macedonia and Bulgaria local governments and/or pre-tertiary education is underfunded.

Chart 5 below shows local government revenues as percentage of GDP in 2006, 2009 and 2012. As can be seen from the Chart, local government revenues as a share of GDP have moved steadily upward in Macedonia, Kosovo and Turkey. In the RS (of BiH), Romania, and Serbia there has been an increase over the entire period, but with some ups and downs along the way while the situation in Slovenia has been more stable. Bulgaria, Montenegro, Croatia and Moldova saw growth between 2006 and 2009, but declines to levels below those of 2006 by 2012. Albanian local governments did well in 2009 but by 2012 had returned to the same low level of 2006. Finally, the financial position of local governments in FBiH (of BiH) as deteriorated since 2008. The percentages inside the Chart 5 refer to 2012.

Chart 5

Local Government Revenue as a Share of GDP in 2006, 2009, 2012

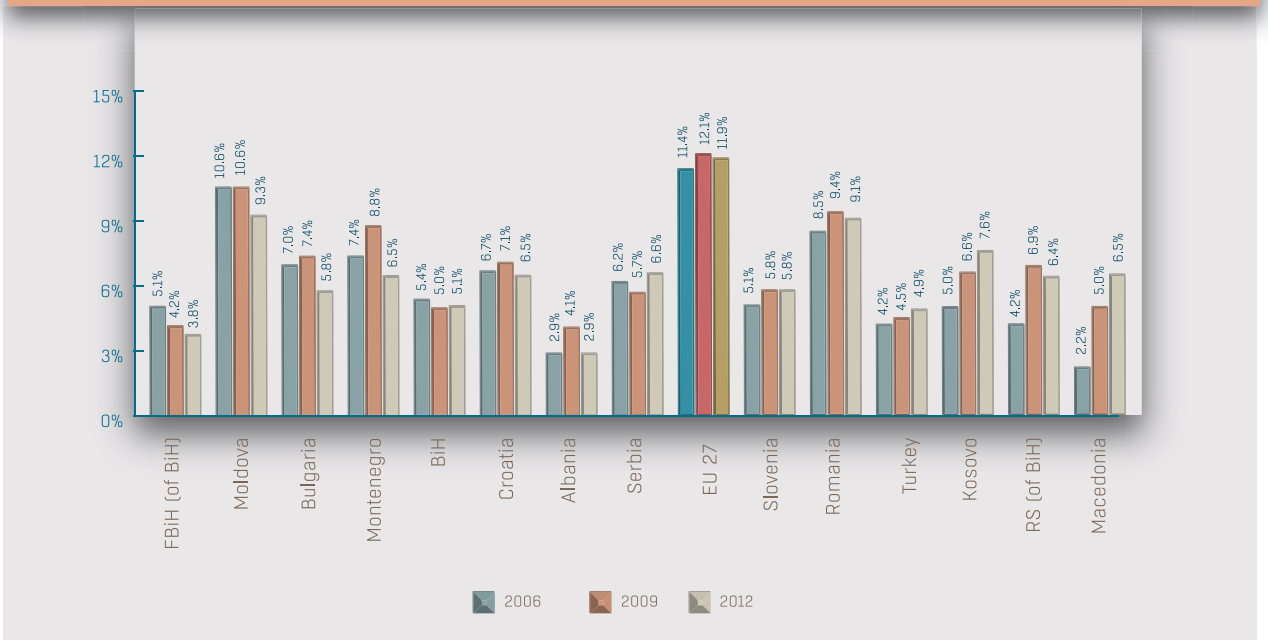
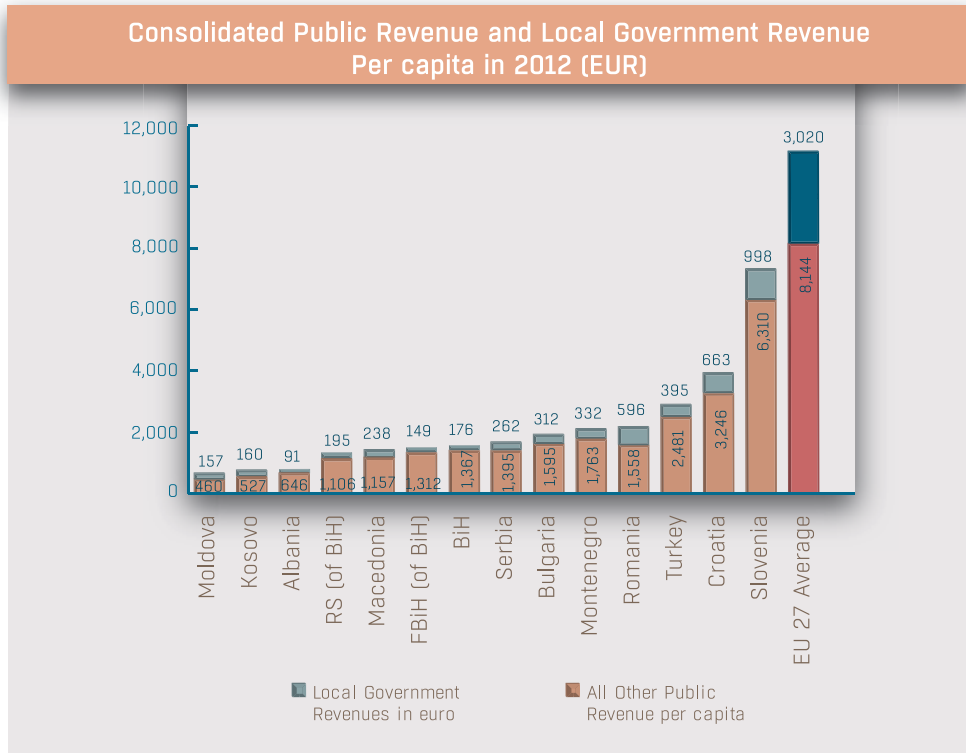


Chart 6 shows the per capita revenues of the consolidated public sector and of local governments in EUR in 2010. The Chart is a useful reminder of how much poorer the public sectors of most of South-East Europe are when compared to those of the EU, as well as how much variation there is across the region. It is particularly striking that local governments in Moldova, Kosovo and Macedonia-three of the poorest in the group - are not only paying for basic services but also teachers wages with per capita revenues of less than 250 EUR. So if decentralization has not progressed very far among the relatively wealthy, it has been pushed farthest among the poorest. This suggests that at least in some cases, decentralization has been driven less by a desire to empower local governments to deliver public services of reasonable quality, than by the desire of central governments to relieve themselves of the responsibility for reasonably financing them.

Chart 6



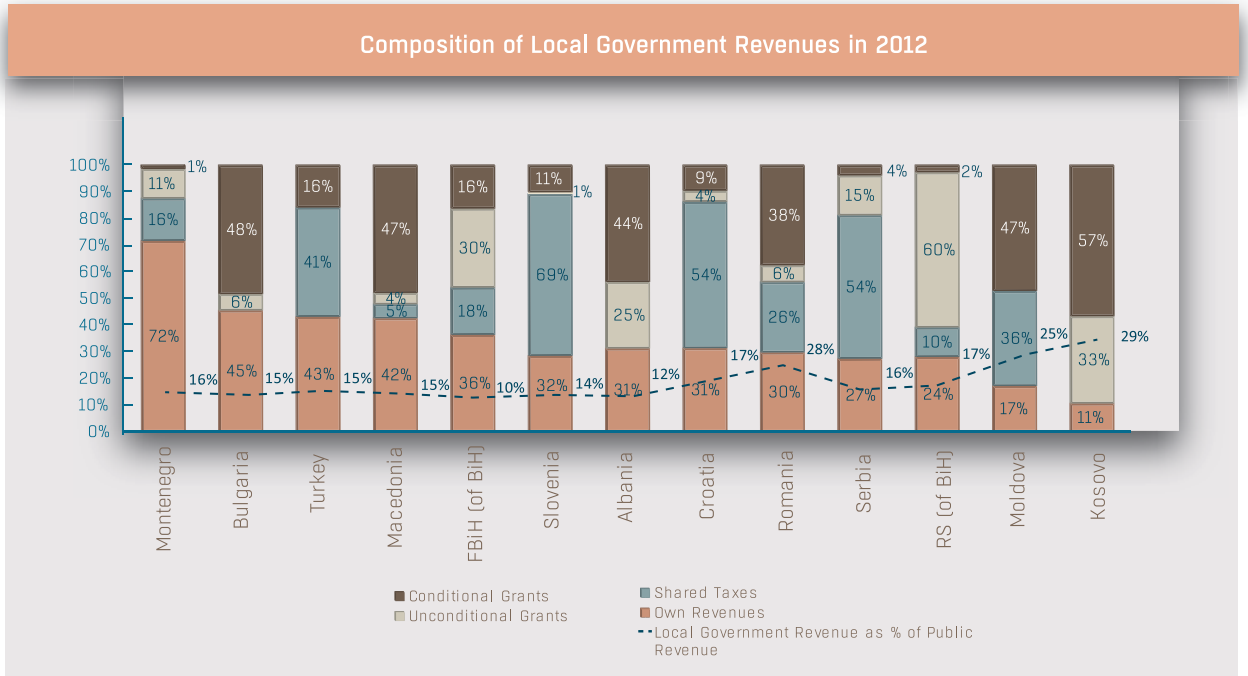
If decentralization has not progressed very far among the relatively wealthy, it has been pushed farthest among the poorest. This suggests that at least in some cases decentralization has been driven less by a desire to empower local governments to deliver public services, than by the desire of central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

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

Basic Composition of Local Government Revenues

Chart 7 shows the basic composition of local government revenues for members of the group in 2012. Unfortunately, differences in the way countries classify revenues makes this data less than fully reliable. One reason for this is that shared taxes are sometimes presented as own-revenues or grants. Another is that sometimes own-revenues from local PIT surcharges are presented as shared taxes. These and other problems weaken the comparative power of the data.

Chart 7



For example, in Turkey a number of shared taxes are pooled and returned to local governments in part on an origin basis, and in part as an unconditional grant that is allocated by formula. But it is impossible to determine from the aggregate how much of the shared taxes are really being allocated as grants. Similarly, the equalization system in Slovenia gives additional increments of PIT to poorer jurisdictions. These additional PIT increments function like equalization "grants", but again cannot be distinguished from shared taxes. Meanwhile, Croatian local governments are allowed to impose local surcharges on PIT, and the revenues from these surcharges should be considered own-revenues and not --as shown in the Chart-- shared taxes. Conversely, Montenegrin local governments also can impose PIT surcharges, but the Ministry of Finance has adjusted its classification system so that this income is correctly recorded as an own-source revenue Finally, as we have discussed earlier, many of the revenues that are typically considered own-revenues are in fact fees and charges set by higher-level governments (and sometimes collected by them) but whose yields go entirely to local governments and are thus considered (incorrectly) as local government own-revenues. As such, the Table overstates –like much of the data for other countries- the real share of own-source revenues at the local level.

Financial Independence of Local Governments

Nonetheless, Chart 7 does provide some basic information about how much financial independence local governments have. For example, in Bulgaria, Kosovo, Moldova, and Macedonia the financial autonomy of local governments in 2012 is limited because they receive more than 50% of their revenues from conditional grants. Much of this can be explained by the fact that municipalities are responsible for social sector functions in these countries and national governments have a legitimate interest in making sure that money intended for education and health actually gets spent on them. Nonetheless, it is one thing for the national government to want to make sure that funds are spent in a given sector, and quite another for them to control exactly how local governments use these funds within it. And unfortunately in most places it is probably fair to say that conditional, block grants for sector services are over regulated. Meanwhile, the situation in Albania is even more problematic. Here, local governments get close to 45% of their revenues in conditional grants, even though they provide no social sector services.

Conversely, local governments in Montenegro receive virtually no conditional grants from the central government, and have very high levels of own-revenue. Indeed, the share of own-revenue in Montenegro is about double what the average for EU countries would probably look like if we had reliable data. This is possible in Montenegro because local governments have very significant revenues from asset sales and rentals, from land development fees, and from PIT surcharges.

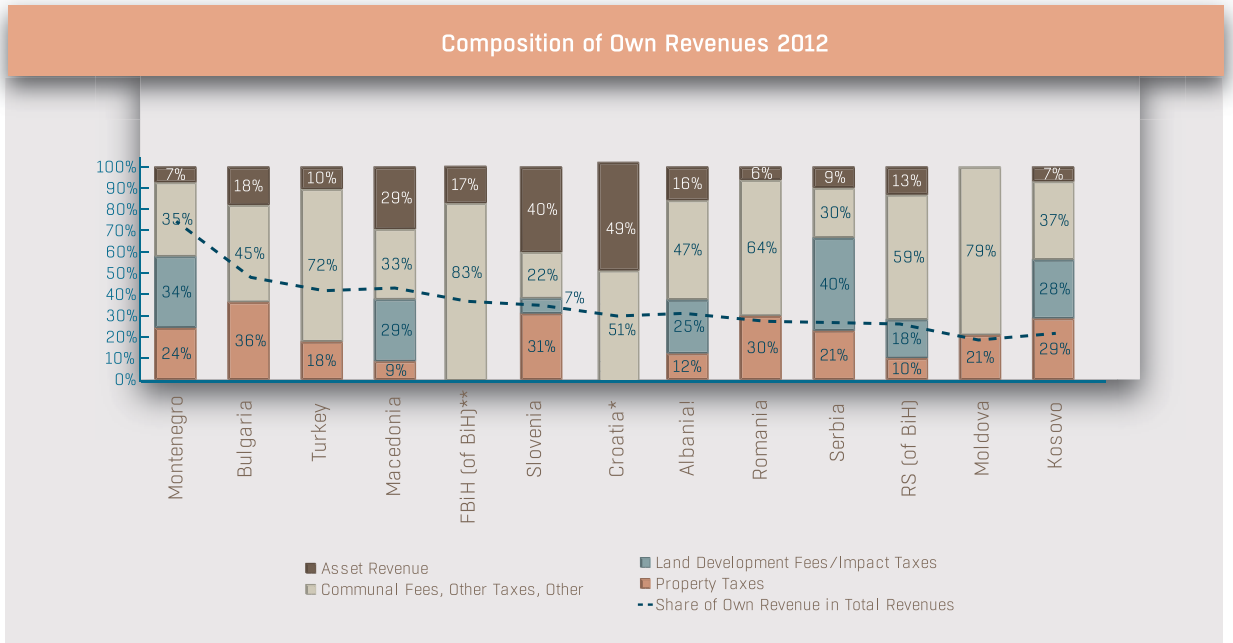
More generally, **Albania, Kosovo, and Bulgaria make no use of PIT sharing, while Macedonia makes extremely limited use of it. This is surprising since the origin based sharing of PIT is not only clearly popular in the region, but has formed a critical pillar of the intergovernmental finance systems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

Also interesting is that in 2012 local governments in Turkey, Slovenia, Croatia, and Moldova receive no income from unconditional grants while in Macedonia, Montenegro, Bulgaria, and Romania they account for less than 10% of total revenue. The absence or relative insignificance of unconditional grants raises questions about the equity of these country's intergovernmental finances systems. This is because it is generally through unconditional grants that central governments provide additional revenues to poorer jurisdictions. Nonetheless, unconditional grants can be allocated in many ways and their simple existence in a system should not be taken to mean that they are being used to redistribute national income. Moreover, and as we have already mentioned both Turkey and Slovenia do at least some equalization through other mechanisms.

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

Chart 8 below presents the composition of own-revenues with countries/entities ranked by their share of own revenues in total revenues for local governments. Unfortunately, the way own-source revenues are accounted for differs radically from country to country - including within the EU. In some cases, the reporting is quite detailed and contains many more categories than are presented in the Chart. In others, only two or

Chart 8



!=2011 data; *the property tax is not a local tax **the property tax is not a local tax in all cantons

three categories are used and it is difficult to say what these categories really contain. For example, Croatian and Turkish local governments derive significant revenues from Land Development Fees and quasi-fiscal Construction permits, but they are recorded only as Communal Fees. Similarly, revenues from the sale or rental of municipal assets are frequently presented as Communal Fees.

Because of these difficulties it is hard to come to any general conclusions about the composition of own-revenues in the group or about the relationship between the composition of own-revenues and their share in total local government revenues. What can be said is that in most places the data on own-revenues is poor and that there does not seem to be a strong relationship between the composition of own-revenues and their share in total local government revenues. Or to put the matter another way, there is no obvious relationship between the composition of own revenues and the financial autonomy of local governments. It is however worth noting that revenue from the rental and sale of assets is surprisingly important in many places, as is revenue from quasi-fiscal charges imposed on new development, charges that governments are trying to roll back throughout the region. It is also worth adding, that throughout the region own-source revenues are disproportionally concentrated in capital cities and typically tied very strongly –through land development fees, construction permits, and the Property Transfer Tax—to the real-estate market.

Own-source revenues are disproportionally concentrated in capital cities and typically tied very strongly –through land development fees, construction permits, and the Property Transfer Tax—to the real-estate market.

Table 4 below shows the per capita yield of the property tax in 2006 and 2012 for all NALAS members. As can be seen from the Table, there are very significant differences across the group in both the yield of the tax and its growth over the last seven years. In Albania and the RS (of BiH) the yield of the tax is low for the group and has actually decreased in recent years. In Croatia, where the tax has still yet to be decentralized it has also fallen but the yield remains relatively high. In Slovenia, the yield has stayed the same, though between 2008 and 2011 it was actually a little higher. In FBiH (of BiH), Kosovo, and Moldova there have also been modest gains on a very low base, though as we shall see in a moment, these gains have not kept up with GDP growth.

Table 4: Change in Per Capita Yield of the Property Tax in EUR 2006-2012

	2006	2012	% + or -
Macedonia	2	7	331%
Montenegro	16	58	263%
Bulgaria	10	29	190%
Turkey	14	31	121%
Serbia	8	17	117%
Romania	31	53	71%
Moldova	4	6	40%
Kosovo	5	7	30%
FBiH (of BiH)	11	13	20%
Slovenia	92	92	0%
Croatia	26	23	-12%
RS (of BiH)	7	6	-14%
Albania	4	3	-39%

On a more positive note there have been much more substantial gains in the yield of the tax in Serbia, Turkey, Bulgaria, Macedonia and Montenegro. Table 5 below presents the same basic information but expresses the yield of the tax as a percentage of GDP and includes the average for the EU. What the Table shows is that in nine out of the thirteen members of the group, the expansion of the property tax did not keep up with GDP growth. In Romania, Serbia, Turkey, Montenegro, and Macedonia it did and the growth was faster than in than the average for the EU.

Table 5 Change in Property Tax as a Percentage of GDP 2006-2012

	2006	2012	% + or -
Macedonia	0.06%	0.19%	207%
Montenegro	0.46%	1.14%	148%
Turkey	0.25%	0.38%	52%
Serbia	0.27%	0.37%	37%
Romania	0.64%	0.81%	27%
EU 27 Average	1.00%	1.20%	20%
Kosovo	0.33%	0.31%	-6%
Slovenia	0.61%	0.54%	-12%
Croatia	0.29%	0.22%	-21%
BiH	0.38%	0.30%	-22%
FBiH (of BiH)	0.42%	0.32%	-23%
Bulgaria	0.29%	0.22%	-23%
Moldova	0.53%	0.35%	-33%
RS (of BiH)	0.30%	0.18%	-40%
Albania	0.29%	0.12%	-58%

What this suggests is that there is a clear division within the group between countries where local governments are more aggressively using the property tax and those where not much is happening with the tax, or worse, it is declining. Indeed, it has declined in Kosovo and the RS despite significant investments by higher level governments in the improvement of fiscal cadasters and billing systems. It should also be noted that only in Romania and Montenegro does the yield of the tax approach the EU average of 1.2% of GDP. This, in turn, is low when compared to North America, Australia, France, and some of the Nordic countries where the tax accounts for between 2 and 3% of GDP.

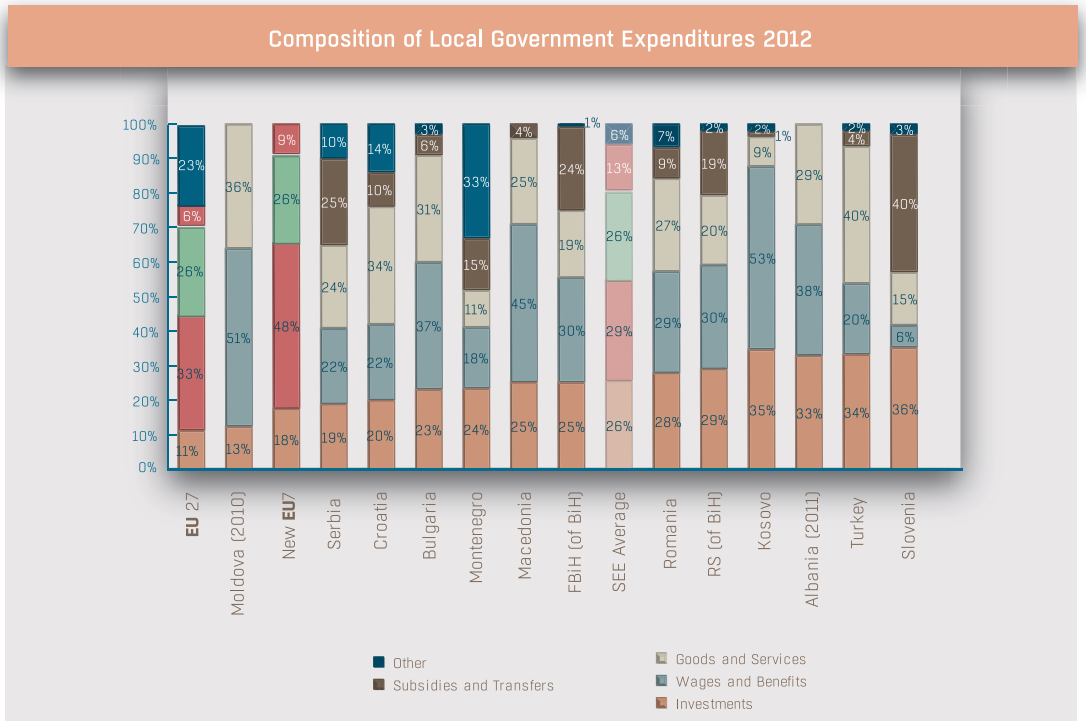
In many EU member states –as well as in some members of the group— the yield of the recurrent Property Tax is recorded with the yield of the Property Transfer Tax. The latter is imposed on the sale price of land and buildings and typically must be paid before the buyer can receive official title to the property s/he has bought. Thus compliance tends to be high and in many places the yield of this tax is higher than that of the recurrent property tax. This, despite the fact that Property Transfer Tax is imposed only on properties that have been sold during the year.

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

Local Government Investment Spending

Chart 9 shows the composition of local government expenditures by economic type for each member of the group, as well as the average for the group as a whole (SEE); the average for the EU (EU 27)[5]; and the average for the seven post-communist countries that joined the EU in 2004 (NEW EU7)[6]. The data should be treated with caution because there are differences in the way countries report expenditures as well as problems with extracting fully comparable data from Eurostat. For example, some places treat capital transfers to public utilities as investment expenditures while others record them as subsidies to legal entities. There also seems to be a tendency to record wage spending as the purchase of goods and services.

Chart 9



[5] Croatia is now the 28th member of the EU. But EuroStat has yet to update its grouping to include averages for the EU 28, so we use EU 27 throughout.

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

For the RS (BIH) transfers to individuals and to firms are not distinguished. For Serbia, investment includes capital subsidies to public companies and "neighborhood units", for Montenegro "other" includes substantial amounts of debt service payments, for EU 27 and NEW EU 7 transfers include only operating subsidies to public utilities.

Nonetheless, the most striking feature of the Chart is that investment spending as a share of local government budgets in most of South-East Europe is significantly higher than that of the their counterparts within the EU and even that of the seven post-communist countries that joined the EU in 2004. How much this reflects the fact that across South East Europe local government budgets often bearing the investment costs that in older EU member states are paid for by public utilities and financed from tariffs is hard to say. Indeed this needs further research, especially because it is quite possible that the investment rates of at least some countries in the region (e.g. Serbia) might be substantially higher if the data on local government transfers to public utilities distinguished between operating and capital subsidies.

In any case the differences in the average investment rates for the three groups (SEE, EU27, and EU7) have been remarkably consistent over the last 5 years. This suggests that local governments in South-East Europe, like those of the EU7 are playing an extraordinary game of catch-up, spending as much they can to modernize the run-down infrastructure they inherited from the past. Or to put the matter another way, local governments in South-East Europe are working harder than their counterparts in most of the EU to build new infrastructure because they are spending higher proportions of their income on investment, despite receiving significantly lower shares of public revenue – measured either as a percentage of GDP or of total public revenues (Chart 7). But while investment rates in the region have been comparatively robust, it is important to remember that we don't know how much these rates have been driven-up by a few wealthier jurisdictions and by the (likely) imbalances in the region's intergovernmental finance systems.

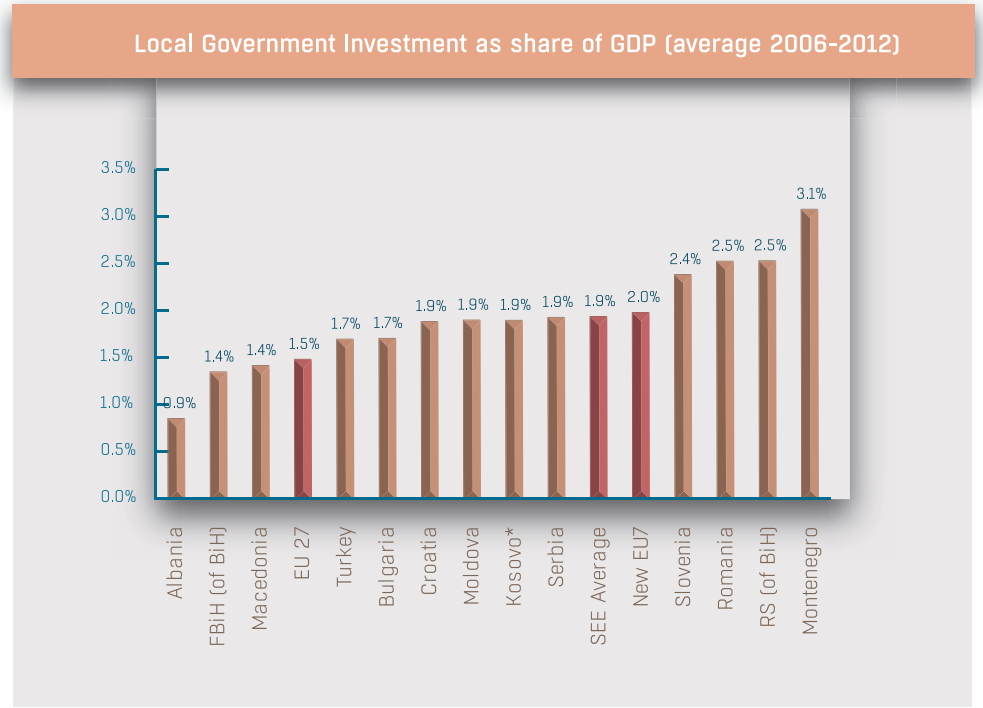
Local governments in South-East Europe are working harder than their counterparts in most of the EU to build new infrastructure because they are spending higher proportions of their income on investment, despite receiving significantly lower shares of public revenue –measured either as a percentage of GDP or of total public revenues (Chart 4).

Since 2009, they have also been falling in most countries (see country reports). And they would have fallen faster in the new member states of the region had it not been for the influx of EU funds. In Bulgaria, for example, EU grants have accounted for all most all of local government investment spending in recent years (see country report for Bulgaria). **So EU funds are undoubtedly playing an important role in the modernization of local public infrastructure in new member states. In some cases, they have also allowed national policy makers to substitute transfers from the EU for transfers generated from domestic sources.**

In other words, while investment rates in the region are generally high, what we don't know is how much these rates are being driven-up by a few wealthier jurisdictions and by the (likely) imbalances in the region's intergovernmental finance systems.

Charts 10 below presents the average share of local government investment as percentage of GDP for all members for the last six years; the average for the group as a whole (SEE Average) as well as for the EU 27 and the EU7. Chart 11 presents local government investments in EUR per capita for 2012 as well as the average for 2006-2012. These Charts demonstrate that the relatively high investment rates that we saw in Chart 8 do not necessarily translate into high levels of municipal investment when looked at as a share of GDP or in EUR per capita. Local governments in Albania, for example, have been devoting more than 30% of their expenditures to investments (Chart 8), but Albania has the lowest level of municipal investment as a percentage of GDP and –less surprisingly-- one of the lowest levels in per capita EUR. Conversely, Moldova has a low municipal investment rate and the lowest spending per capita in EUR, but nonetheless exceeds the average for the EU 27 with respect to local government investment as share of GDP.

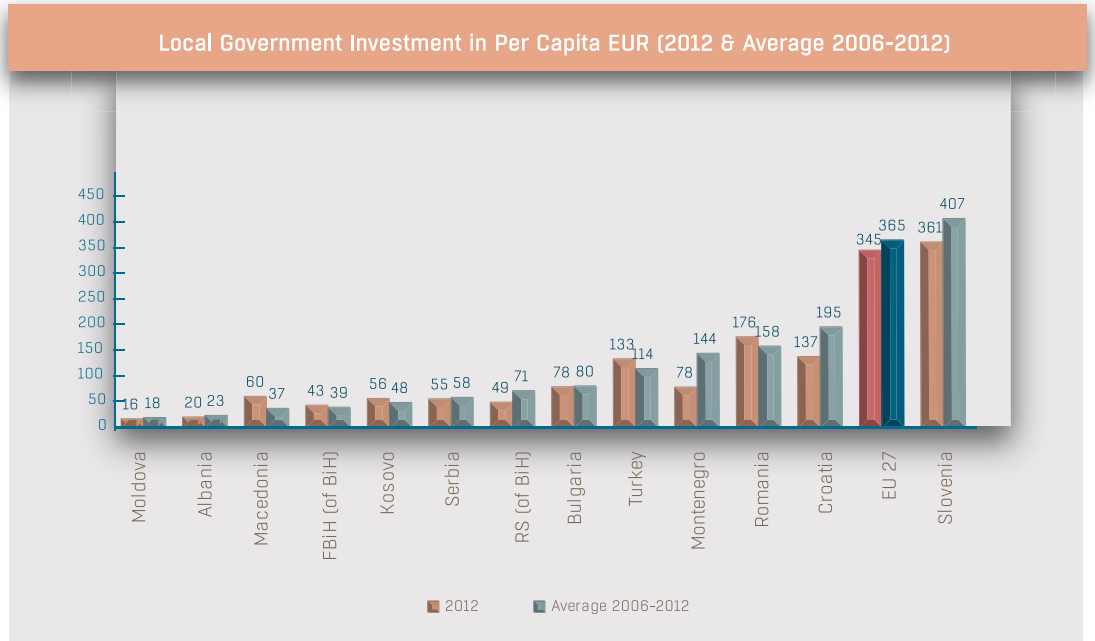
Chart 10



Average for Moldova is 2005-2010, Kosovo 2008-2012

Nonetheless, the higher municipal investment rates that we saw in Chart 8 have in general been accompanied by higher levels of municipal investment as a share of GDP when compared to the average for the EU. Indeed, local government investment as a share of GDP has exceeded not only the average for the EU27 but of the EU7 in Montenegro, RS (of BiH), Slovenia, and Romania. These are impressive achievements which hopefully will be sustained over the next decade.

Chart 11

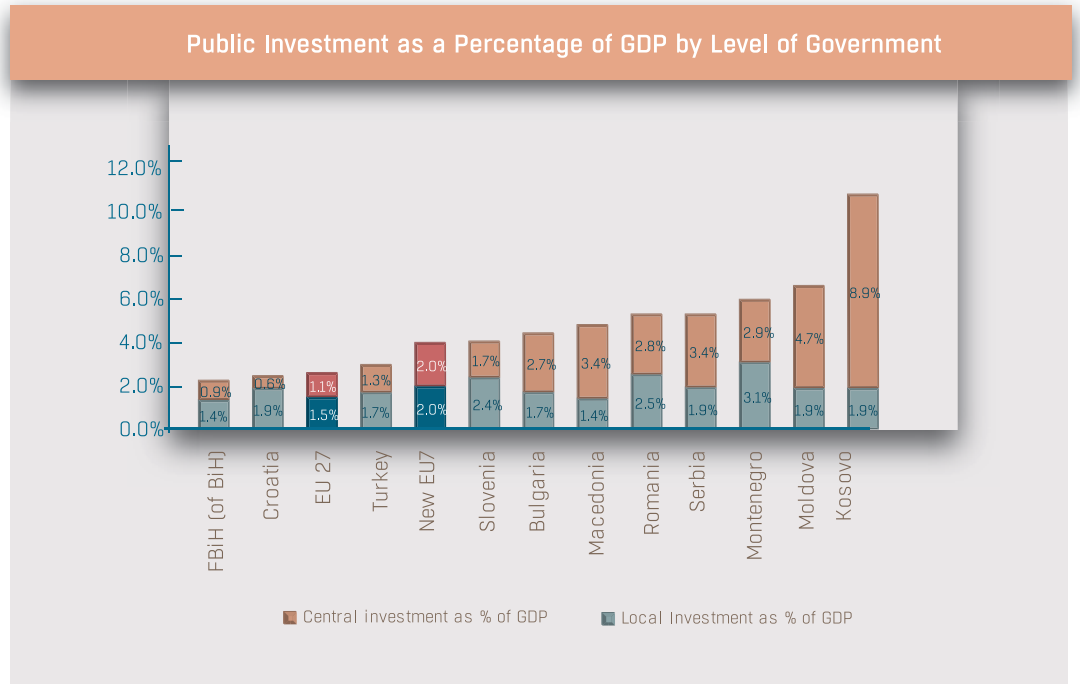


Average for Moldova is 2005-2010, Kosovo 2008-2012

At the same time, it is necessary to recognize that the situation elsewhere in the region is not so happy. Local government investment spending as a percentage of GDP is extremely low in Albania. The situation in FBiH (BiH) and Macedonia is also not particularly encouraging. Similarly, while the picture is better in Bulgaria, Croatia, Moldova, Serbia and Turkey local government investment as a share of GDP remains lower than the average for the new EU7 and thus below what one might reasonably hope to see given the catch-up game that local governments in South-East Europe must play.

Finally, it is worth looking briefly at the composition of public investment by level of government. Chart 12 below shows total public investment as a share of GDP divided by level of governments. As in the previous charts, the figures are averages for the years 2006-2012. As can be seen from the Chart, there is significant variation in the level of total public investment and its composition across levels of government. Indeed, there is so much variation that it is hard to draw any firm conclusions about patterns.

Chart 12



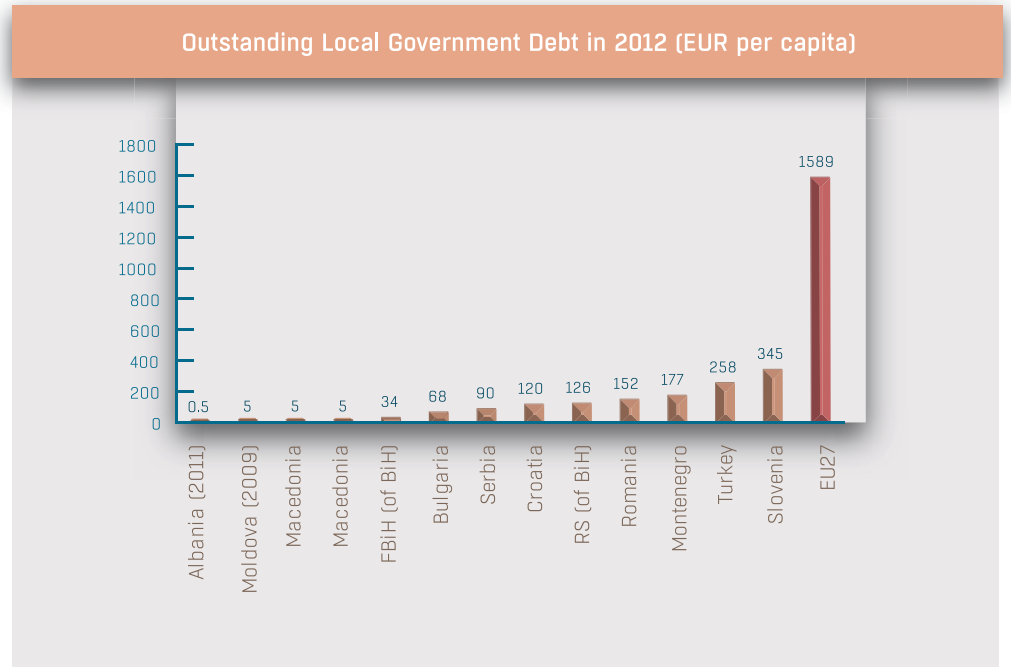
Average for Moldova is 2006-2010, Kosovo 2008-2012

The one thing that does seem clear is that total public sector investment –at least as a percentage of GDP— declines in the more developed countries of the EU, and that in these countries local governments are responsible for more of this spending then are their national governments. It also seems that within the region there are distinct differences in how governments are choosing to modernize public infrastructure. In Kosovo, Bulgaria, Macedonia and Serbia the national government is doing most of the investment, something that would be also be true in Albania if we had the data. But in Montenegro, Slovenia, Turkey, Croatia and FBiH (of BiH) it is local governments which are shouldering the burden.

Local Government Borrowing

In most of South-East Europe, local government borrowing is still a new phenomenon. This can be seen from Chart 13 below. The Chart presents data on the total outstanding debt of local governments in EUR per capita for all members of the group for which we have reliable data, as well as for the EU as a whole. 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. 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.

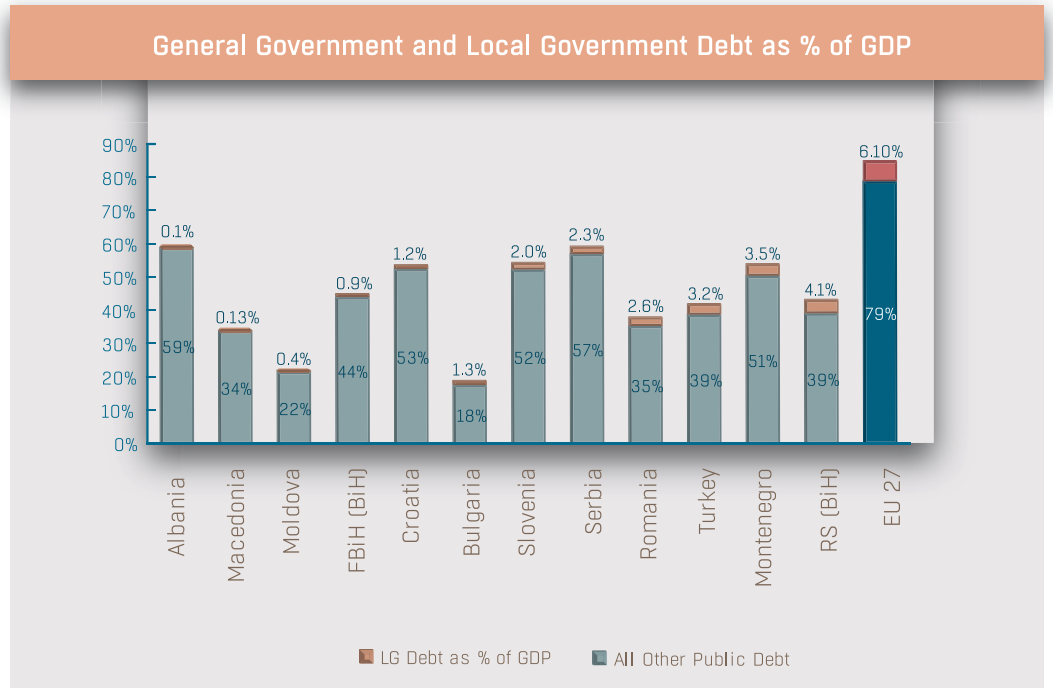
Chart 13



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

Chart 14 below presents outstanding public debt by the amount incurred by local governments and national governments as a percentage of GDP. As can be seen from the Chart, Albania, Croatia, Montenegro, Serbia, and Croatia all have level of total public debt equal to well over 50% of GDP, and Albania and Serbia are very close to reaching the 60% debt-to-GDP-ratio set by the Maastricht Treaty. This is important because the governments of South-East Europe are under significant external pressure to keep their total borrowing under these limits (despite the fact the limit that has long been exceeded by many countries within the EU).

Chart 14



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

In Albania, local government borrowing represents less than 1% of GDP. Despite this low share, however, it is unlikely that the national government will allow many local governments to borrow precisely because their debt might push the country over the Maastricht threshold. In Serbia, local government borrowing has expanded fairly rapidly over the last few years. Most of this borrowing however has been incurred by the City of Belgrade. Still, the total outstanding local government debt is equal to only 2.3% of GDP. But again, because Serbia's total public debt is very close to the Maastricht limits it would not be surprising if the national government sought to restrict the access of local governments to the debt market.

The Croatian government has already been pursuing a more restrictive policy and as a result local government debt is equal to only 1.2% of GDP. Nonetheless, total public debt is now close to 54%. Finally in Montenegro, local government debt has risen from under 1% of GDP in 2008 to over 3.5% in 2009. The sharp increase in borrowing shows that the country's local governments have turned to debt in order to maintain expenditure and investment rates in the face of the recession. A few are also now having problems meeting their obligations. Local borrowing has also contributed to Montenegro's approaching the Maastricht limits, though here too it is the national government that is really driving the trend. **In short, Albanian, Serbian, Croatian and Montenegrin local governments my find it harder to access credit in the immediate future not because of their lack of fundamental credit worthiness, but because of the reluctance of their national governments to exceed the debt limits set by the Maastricht Treaty.**

It is not clear how this problem should be addressed. The obvious answer is for the national government to reduce its own obligations and thus create some space for local borrowing. Unfortunately, experience from other countries suggests that this is unlikely. Much of the current discourse in Albania, for example, is not about excess national government debt but about why local government borrowing is premature.

The total public debt of other members of the group remains well below the Maastricht limits. In most, there has been a significant increase in local government borrowing over the last few years. In 2012, Romania's public debt amounted to 38% of GDP, of which 2.6% came from local governments, up from 1.2% in 2006[7]. There has also been a steady increase in municipal borrowing in Turkey. Our data for Turkey however, includes both bank debt and unpaid liabilities to suppliers, so the numbers probably overstate the size of the municipal capital market. In Macedonia, Moldova and to a lesser extent FBiH (of BiH) municipal borrowing remains in the early stages of development. Interestingly, however, local governments in the RS (of BiH) have aggressively borrowed and municipal debt as share of GDP is higher here than anywhere else in the region.

In many (if not all) places the overall adequacy and predictability of local governments revenues will have to be increased if municipalities are to have the resources against which to prudently incur debt.

[7] Approximately 40% of Romania local government debt is in foreign currency, leaving local governments exposed to serious exchange rate risks. This situation is even more dangerous in Serbia where virtually all local government debt is in EUR and a good case can be made that currency exchange risks are underappreciated by both national and local officials.

This will require local governments to do a better job collecting own-revenues, particularly with respect to setting higher user fees and charges, and then forcing their utilities to collect them. But it will also require central governments to improve the robustness of their intergovernmental transfer systems and to anchor these systems in rules that give both borrowers and lenders confidence that revenue streams will not change dramatically from year to year. In many places, equalization systems will also have to be strengthened if smaller municipalities are to be able to make prudent use of debt, and if local government borrowing is move beyond its current concentration in big cities.

Local governments will also have to radically improve their ability to prepare, plan, and cost-out complex, multiyear investment projects -particularly in the water and solid waste sectors.

Without the thorough preparation and costing-out of such projects it is impossible to make good use of debt capital, even if creditors are willing to lend. This sort of planning, however, requires both money and time, and unfortunately many local governments in the region are unwilling to devote either to the effort. In part, this is because many local governments remain reluctant to pay for the intangible expertise that is a prerequisite for planning the construction of good physical infrastructure. In part, it is because while the region is generally rich in engineers, financial planning skills are harder to come by and the linkages between the two often weak. And in part, it is because electoral cycles are shorter than what is required to plan and build new environmental infrastructure. As a result, scarce investment funds tend to be spent on pay-as-you-build road projects and not on debt-financed, pay-as-you-use environmental facilities like waste water treatment plants because, planning roads is simpler; construction can be delayed if money runs out; and because the benefits are more likely to be visible to voters before the next election.

Scarce investment funds tend to be spent on pay-as-you-build road projects and not on debt-financed, pay-as-you-use environmental facilities like waste water treatment plants because, planning roads is simpler; construction can be delayed if money runs out; and because the benefits are more likely to be visible to voters before the next election.

III

Country Reviews of Fiscal Decentralization Trends and Developments

Bosnia and Herzegovina - Federation of Bosnia and Herzegovina

Bosnia and Herzegovina (BiH) has an extremely complex administrative and fiscal structure. According to the preliminary results of the recent census of October 2013, BiH has a registered population of 3,791,662, a decline of 13% in comparison to the census of 1991. In the Federation of Bosnia and Herzegovina (FBiH) there are 2,371,603 people registered and in the Republic of Srpska (RS) 1,326,991 with 7.7% of the population (291,422 people) living in Sarajevo, the capital of BiH, which is also the capital of the FBiH.[8]

Despite its size, Bosnia and Herzegovina has three almost separate fiscal systems: FBiH, RS, and the District of Brcko. Indirect taxes are the single most important source of revenue for all levels of government. They are collected by the State of BiH on the so-called Single Account and then divided between the State of BiH, the two entities –FBiH and RS—and the Disctrict of Brcko according to the Law on the System of Indirect Taxation in BiH. The allocation of indirect tax revenues within each entity, as well as the regulation of direct and other indirect taxes are regulated by entity legislation.

In order to protect the interests of external creditors, the Law on the System of Indirect Taxation in BiH requires that debt service payments to foreign creditors incurred by the entities be immediately paid from their respective shares of centrally collected indirect revenues. Once debt service payments are paid, the State of BiH returns the residual to each entity. And each entity then divides this residual between itself and its sub-entity governments according to its own laws.

In FBiH, the Law on the Allocation of Public Revenues allocates ca. 60% of the Federations share of indirect revenues to cantons and municipalities by formula. But this takes place, only after the Federation's debt service costs have been subtracted from the entity's share of indirect tax revenues. As a result, the pool

[8] Unfortunately, these census results are still preliminary. Detailed data will not be available until July 2014. Lack of an accurate censure for more than 20 years has impeded policy development at all levels of government including the adoption and adjustment of rules governing the allocation of grants and transfers. Art. Preliminarni rezultati: U BiH su popisane 3.791.662 osobe. Website: http://popis2013.net/index.php?docid=1042

of revenues that would otherwise go to cantonal and municipal governments is automatically reduced by the debt services payments of the Federation government. This means that for every EUR that the Federation government decides to borrow, 60%of the costs of paying off the debt comes out of the budgets of cantons and municipalities.

The problems with this system have become particularly apparent in recent years. In 2009, during the midst of the global economic crisis FBiH took a loan from the IMF for over 250 million EUR to finance current expenditures. Now however, the entity government must pay back the loan. And because these debt service costs are being born by the budgets of cantons and municipalities, they have seen their revenues from indirect taxes fall substantially, despite an overall improvement in the economy.

In 2012 the Parliament of FBiH introduced amendments into the Law on the Allocation of Public Revenues in the Federation of BiH that should have positive effects on local government budgets. First, the share of Personal Income Tax (PIT) that cantons are legally obliged to share with municipalities is being raised from 34.46% to 41% in all ten cantons, with the exception of Sarajevo Canton. And second, the allocation of indirect taxes to municipalities within Sarajevo Canton has been changed in a way that is beneficial to them.

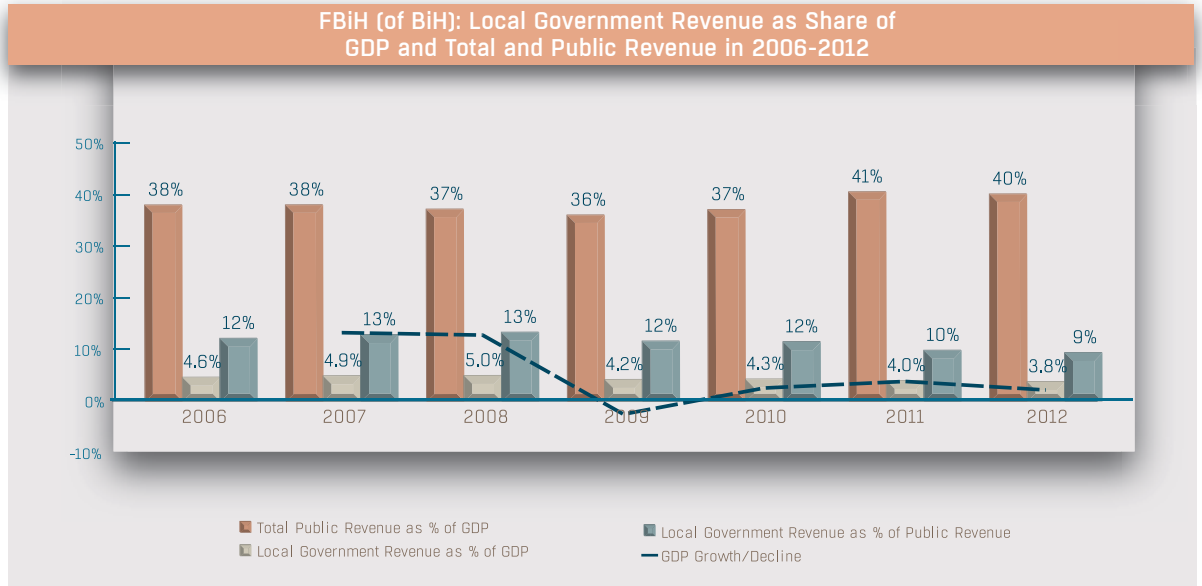
The FBiH Parliament also adopted a new Law on Budgets in the Federation of BiH that went into effect in January 2014. The Law introduced a new institution in the Federation called the Fiscal Coordination Body. The main aim of the body is to coordinate fiscal policy at all levels of government to ensure the macro-economic stability and fiscal sustainability of FBiH. This body will be responsible for determining the status of the entity's debt obligations and for taking measures to ensure that debt service payments can be met in fair and equitable way. The members of the Fiscal Coordination Body include the Federal Minister of Finance, all cantonal Ministers of Finance and a representative of the Association of Municipalities and Cities of the Federation of BIH.

The Association of Municipalities and Cities of the Federation of Bosnia and Herzegovina also drafted a new law on Financing of Local Self-Government Units in the Federation of BiH. The Law was drafted with the participation of almost all members of the Association. The effort was supported by the project "Mayors for Development" funded by the Swiss Agency for Development and Cooperation (SDC) under its larger project „Contribution to the Constitutional Reform in Bosnia and Herzegovina". At the invitation of the Associations of Cities and Municipalities of both FBiH and RS six mayors with long experience took active part in this BiH-wide project aimed at improving the performance and functioning of local self-governments in BiH. In the coming period, these Mayors will be the lead lobbyists and promoters of this and other laws drafted in the same manner.

Statistical Overview of Local Government Finance in FBiH (of BiH) 2006-12

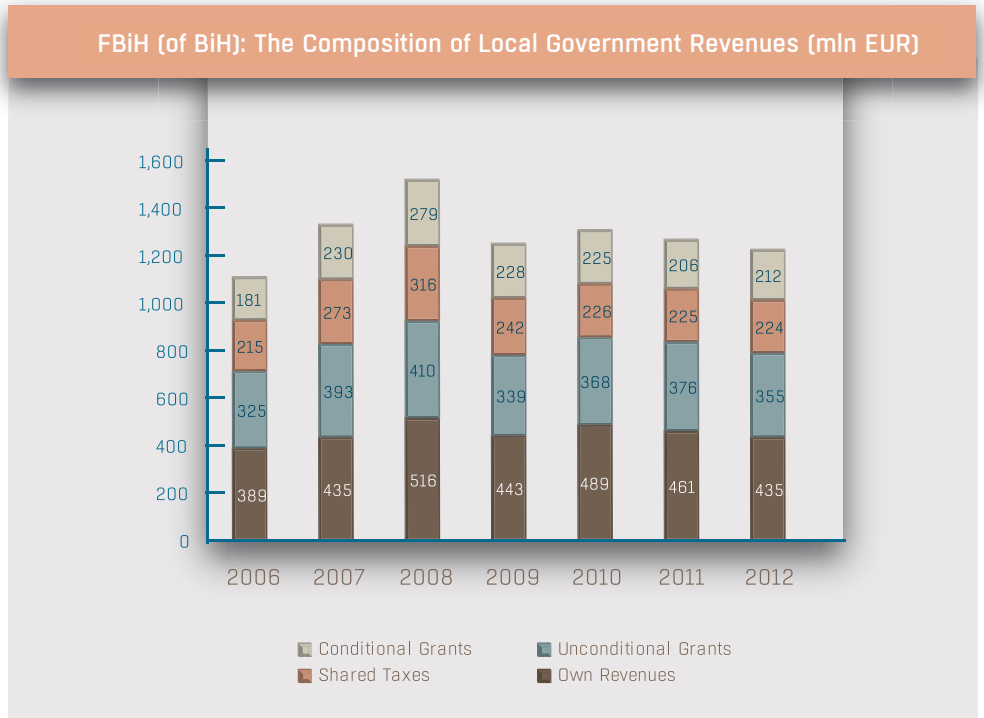
As can be seen from Chart 15, local government revenues in FBiH (of BiH) peaked as a share of both the GDP and public revenues and in 2008. But since then, they have declined substantially, despite the fact that the economy has slowly recovered and total public revenues as a share of GDP have increased. Most telling is the fact that local government revenues as share of total public revenues have fallen by more than 25% since 2008 (from 13% to 9%).

Chart 15



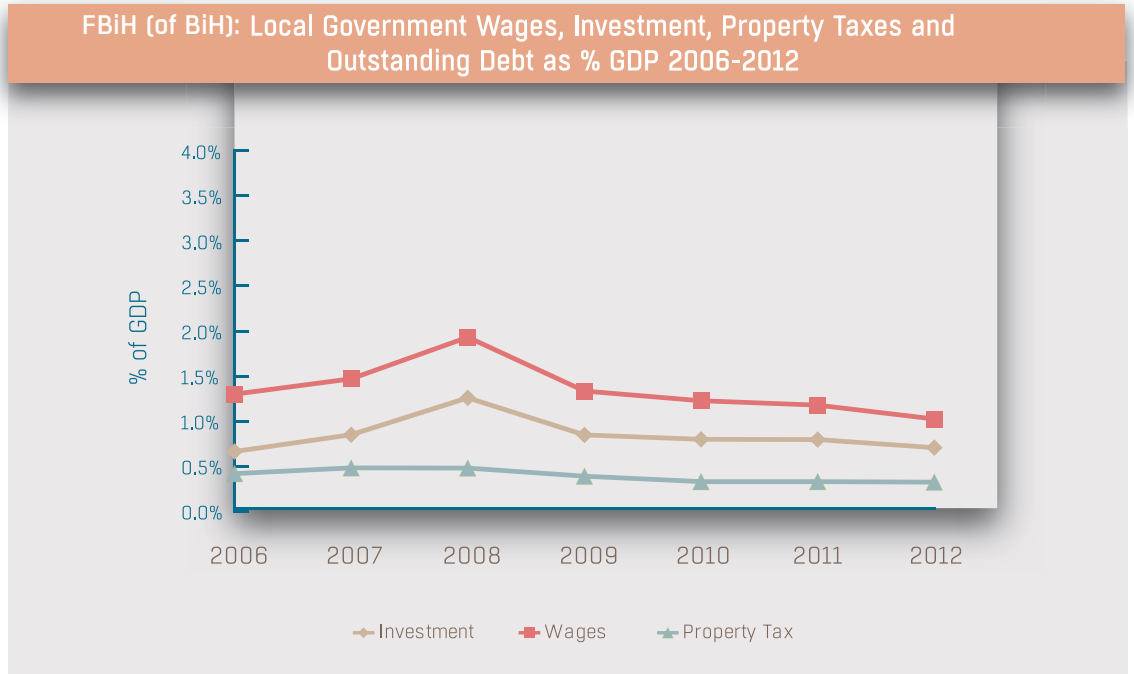
As can be seen from Chart 16 below, qll categories of local government revenue declined significantly in 2009 in response to the contraction of the economy. In 2010, local governments intensified the collection of own revenues, and there was as increase in revenues from unconditional grants as the entities share of indirect taxes went up. But there was no recovery in either conditional grants or more importantly in revenue from shared PIT, presumably because of higher levels of unemployment. Worse, in 2010 and 11, the yield of the general grant fell –in part because of the costs of servicing the entity's debt as discussed above—and local revenue mobilization declined.

Chart 16



As can be seen from Chart 17 below, local government spending on both investment and wages has been declining since 2008. Indeed, wage spending is well below what it was at the begining of the period, and local government investment as a share of GDP is well under 1% of GDP. The yield of the property tax –which in some cantons is a local tax but in most remains controled by cantonal governments—is not only very low but declining. The accounting of local government debt remains problematic, but the figures we have for 2011 suggest that it too is under 1% of GDP. None of this bodes particularly well for the future, though as discussed above the expected increase in the PIT share, and the current discussions about more fairly distributing the costs of servicing FBiH's external debt hold at least some promise for relief.

Chart 17



Bosnia and Herzegovina – Republic of Srpska

As elsewhere in the region, the economic crisis was felt in the Republic Srpska (RS of BiH) which experienced a recession in 2009, weak growth in 2010 and 2011, and a second downturn in 2012. The poor performance of the economy has had a strong negative impact on local government finance. Most importantly, the recession sharply reduced the size of the general grant which is tied to the national yield of VAT. The national government has also reduced earmarked grants by 50% since 2008.

Further complicating the situation is the new Law on the Property Tax. This Law was passed in late 2009, but its implementation was postponed until January 2012. The Law created a centralized fiscal cadaster and transferred responsibility for billing and collection –though not rate setting—from local governments to the Tax Administration of the entity. Unfortunately this has not led to an improvement in the yield of the tax. Indeed, it has declined for many reasons including the self-registration of citizens, complicated forms, and a payment system that allows people to pay their taxes in the following year.

Also in January of 2011, the entity government finally passed a law transferring the ownership rights of public utilities to local governments. Now local governments will be able to more effectively influence the policies of local public utility companies. At the same time, however, most of these companies are in serious need of new investment and many were transferred with

significant amounts of debt. As a result, a large number of local governments have had to borrow to pay off these debts and some of them have now reached their borrowing limits under the law.

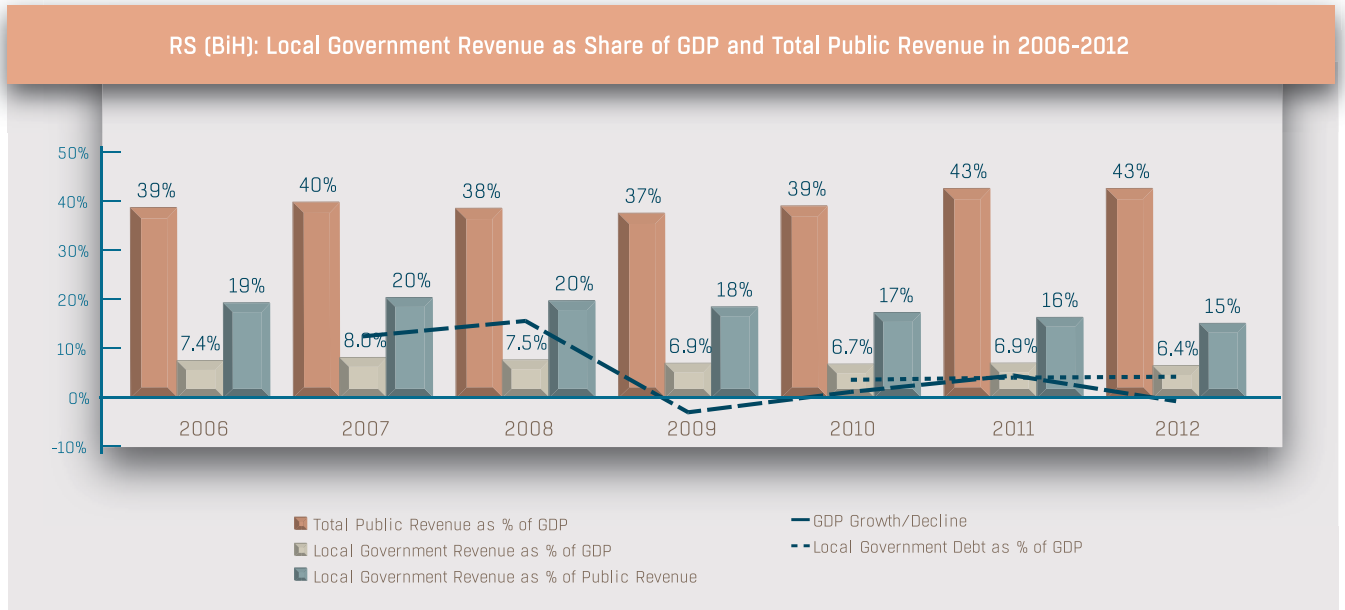
Local government revenues have also been reduced by amendments to the Law on Business Registration. These amendments reduced the amount of the annual Business Registration Fee, (Sign Tax) that local governments can impose on firms from 400 to 500 EUR a year to 70-100.

In 2013, Bijeljina, Prijedor, Doboj and Trebinje received the status of Cities, so the Republic of Srpska now has 57 municipalities and 6 cities. This change in status however does not affect their budgets. 2013 also saw Bosnia-Herzegovina's first census since 1991. The official results of census will be published during 2014 and will affect the allocation of the entity's unconditional grant to municipalities.

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

As can be seen from Chart 18 below, local government revenues as a share of GDP have declined from a peak of 7.5% in 2008 to 6.4% in 2012. Over the same period, local government revenues as a share of total public revenues have declined by 25%, suggesting that the entity government has placed a disproportionate share of the burden of fiscal adjustment on local governments. The outstanding debt of local governments has risen from 3.5% to 4.1% of GDP over the last three years.

Chart 18



As can be seen from Chart 19 below, local governments in the RS (of BiH) are heavily dependent on the unconditional grant they receive from the entity government and which now constitutes 60% of their revenues. Between 2006 and 2012, own revenues have declined as a share of local budgets.

Chart 19

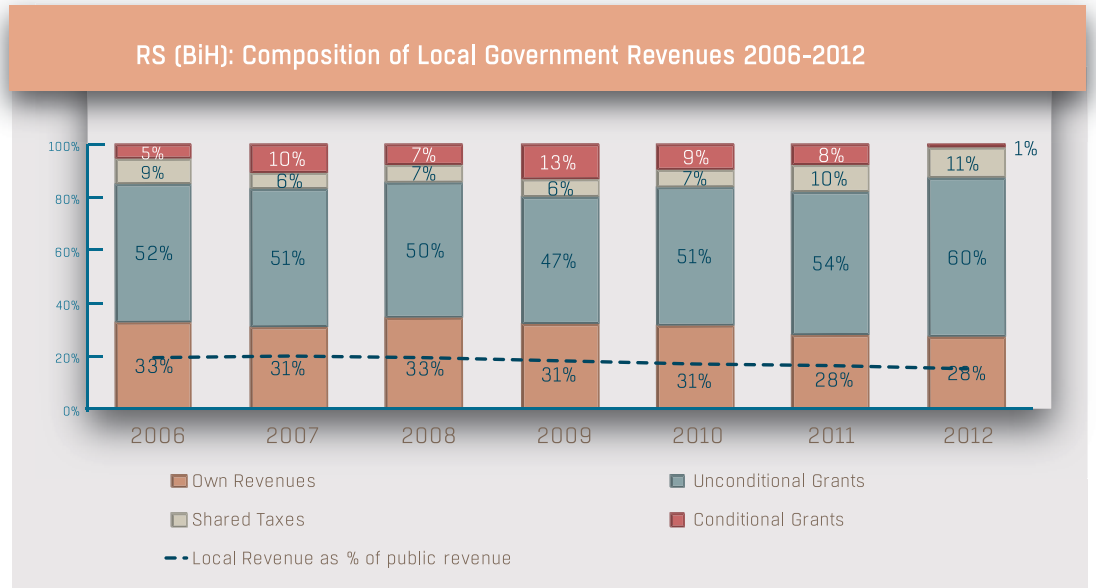
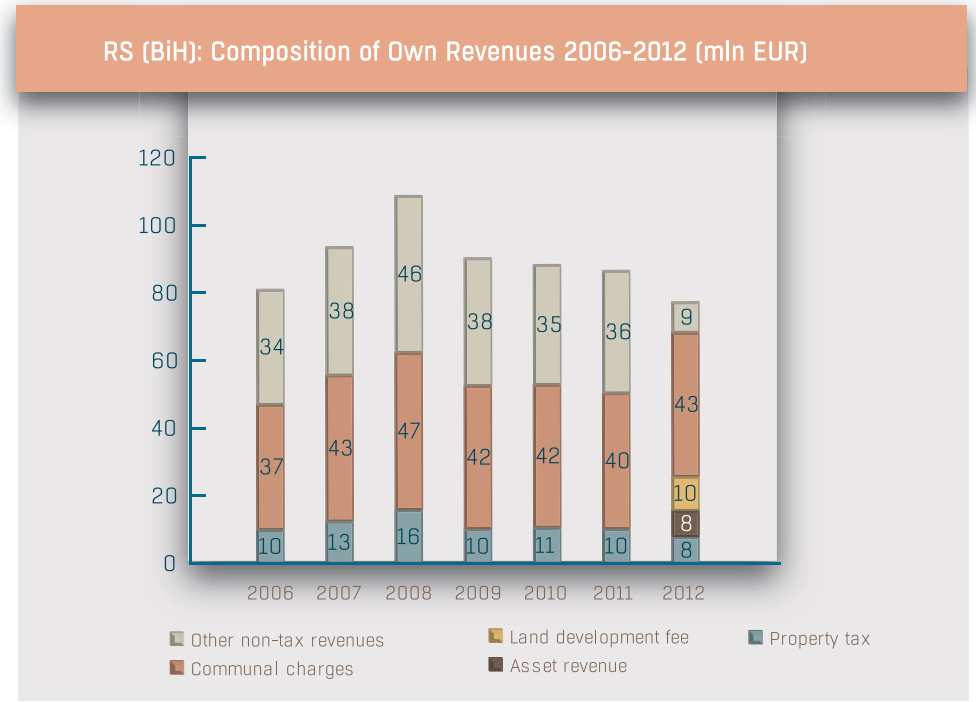


Chart 20 below shows the composition of local government revenues in million EUR. Unfortunately, the classification of the revenues is not consistent for the period, nor is it as detailed as would be desirable. Two things however are clear: First the yield of the property tax is both very low and declining. Whether this will change with the recentralization of the tax's administration is an interesting question. The second is that Non-Tax Revenues have fallen in recent years, probably because of the lowering of the Business Registration fee discussed above.

Chart 20



As can be seen from Chart 21 below, investment spending as share of local government expenditure has fallen while the share of expenditure on wages has increased. It is not clear why the category of other non-tax revenues should have increased so dramatically in 2012 but it is possible that it is related to paying down the debts of the utility companies that were transferred to local government in that year.

Chart 21

RS (BiH): Composition of Local Government Expenditures in 2006-2011

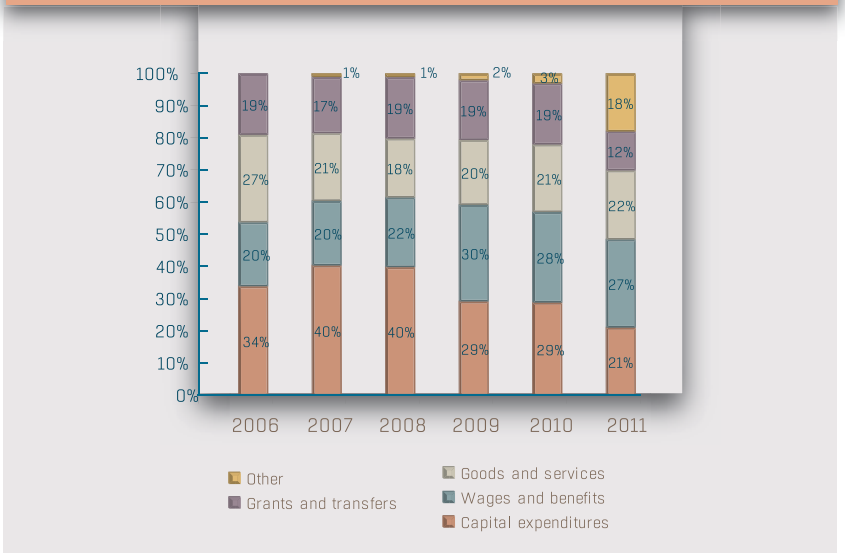
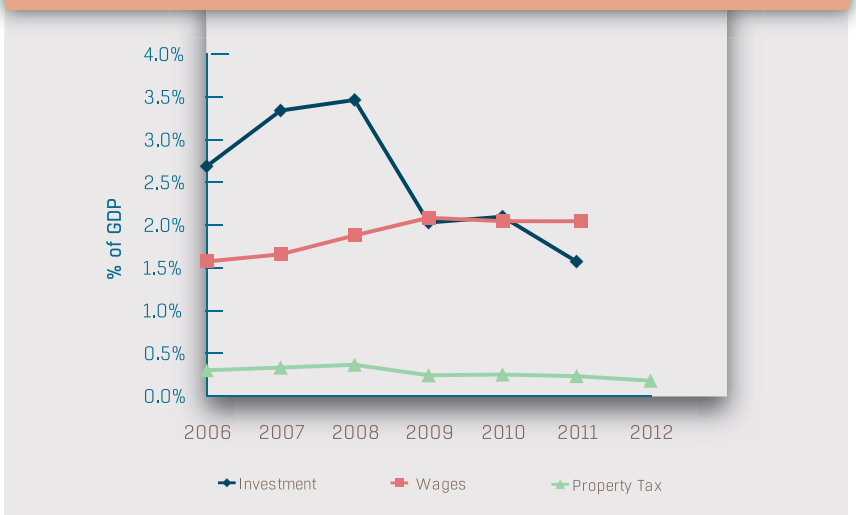


Chart 22

RS (BiH): Investment, Wages, Debt Service and Property Tax as Share of GDP 2006-2011



Bulgaria

The effects of the economic crisis

Within the public sector, the effects of the economic downturn have been felt most profoundly by local governments. In 2010 –the worst year of the crisis in Bulgaria- the national government severely cut most transfers to local governments. In addition, the yield of the Property Transfer Tax –a major local government revenue- declined significantly because of the sharp decline in private investment. Since then, despite a modest but steady increase in economic activity, (1-1.5% annual GDP growth), the financial situation of municipalities has been "frozen" at 2010 levels.

As a result, in 2013 local governments disposed of nearly 25% fewer resources than in 2008. This has resulted in a phenomenon that can be described as "basket of local deficits". These include:

- Overdue liabilities at around 100 million EUR (10% of municipal own revenues) despite a significant improvement in the net operating position of municipalities;
- Underfunding of delegated social welfare functions. The cost of these functions account for 60% of municipal expenditure and in theory should be 100% funded by state transfers. In practice, municipalities now contribute 80 million EUR to these functions out of their general revenues in an attempt to offset the gap;
- 40% of local governments face a permanent shortfall of local revenues vis-à-vis their mandatory expenditures equal to about 100 million EUR;

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

The effects of the EU membership at local level

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

2013 - A year of hope

2013 may eventually be seen as the year in which major new fiscal decentralization reforms were defined. In October, the National Association of the Municipalities of the Republic of Bulgaria (NAMRB) signed its traditional agreement with the new government (elected in June). The cornerstone of this agreement is to restart the decentralization process in accordance with a two-year roadmap that the government adopted in February 2014). The roadmap consists of the following main reform measures:

- Transferring a portion of the personal income tax (PIT) to the local level. PIT is set as a 10% flat rate and the intention is to devolve 20-30% of it to the local level as a local tax. As a result, every citizen would pay a 7% PIT rate to the national government plus up to 3% to their local governments.

This major change should go into effect in 2015 and currently NAMRB and the Ministry of finance are developing implementing scenarios. As a result, in 2015 local government tax revenue would double (additional 300 million EUR) while maintaining the overall fiscal burden on citizens would stay the same.

- Introducing a facultative municipal tax on consumption (similar to the American sales tax). The basic idea is to tax the consumption of "luxury goods and services" by excluding the food, medicines, utility bills etc. Each municipality will decide whether to impose the tax or not.
- Local taxation of agricultural land (currently non-taxable). This is an old, hot political issue. But after EU accession land owners have been receiving considerable direct payments from the EU. Mainly small and rural local governments would benefit.
- Reshaping the equalization subsidy. The new local tax system will require substantial changes in the transfer system which is currently based on measuring and comparing a municipality's tax effort with its spending needs.

New public investment program (PIP)

The government included in the 2014 state budget a new PIP called "Growth and Sustainable Development of Regions". This is the first time in the modern history of Bulgaria that local governments and ministries will compete for investments resources according to preliminary, publicly defined selection criteria. The project application process started in January and on February 5th, 2014, 70% of municipalities were granted 145 million EUR for nearly 400 investment projects.

New waste disposal fee base

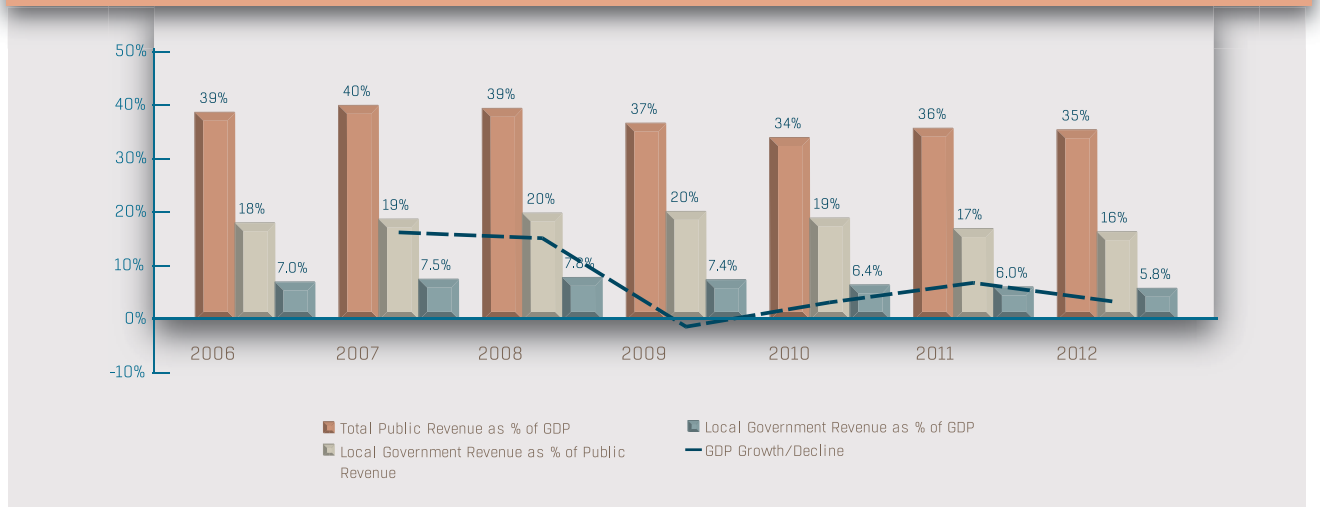
As a result of legislative changes in 2013, by the end of June 2014 a new way of setting the waste disposal fee should be developed by NAMRB and proposed to Parliament. The basic idea is to eliminate the current use of property values as a base for setting the fee and to promote a fairer system that better reflects the linkage between generated garbage and the individual polluter.

Statistical Overview of Local Government Finance in Bulgaria 2006-2012

As can be seen from Chart 23 below, local government revenue as a share of GDP has declined significantly from a high of 7.8% in 2008 to 5.8% in 2012. The local government share of total public revenue has also fallen from 20% to 16% over the same period. This is particularly disturbing because local governments are responsible for all aspects of pre-tertiary education which usually account for between 2.5 and 4.0% of GDP.

Chart 23

Bulgaria: Local Government Revenue as Share of GDP and Total Public Revenue in 2006-2012



In 2008, Bulgaria eliminated PIT sharing and increased conditional grants because poorer jurisdictions were having trouble financing their social sector responsibilities. Since then the composition of local government revenues has been dominated by own revenues and conditional grants, almost 80% of which are for education.

Chart 24

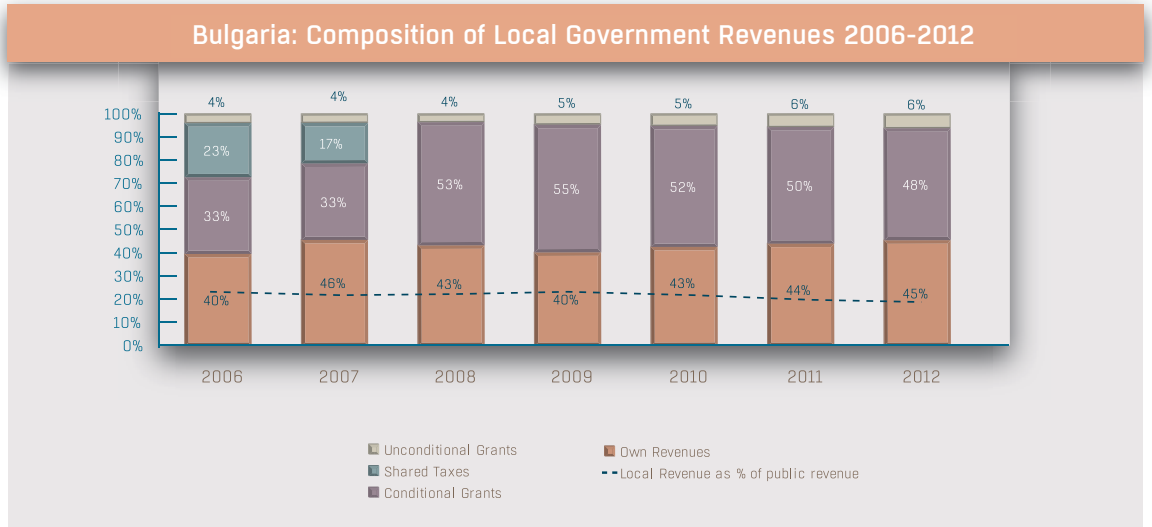
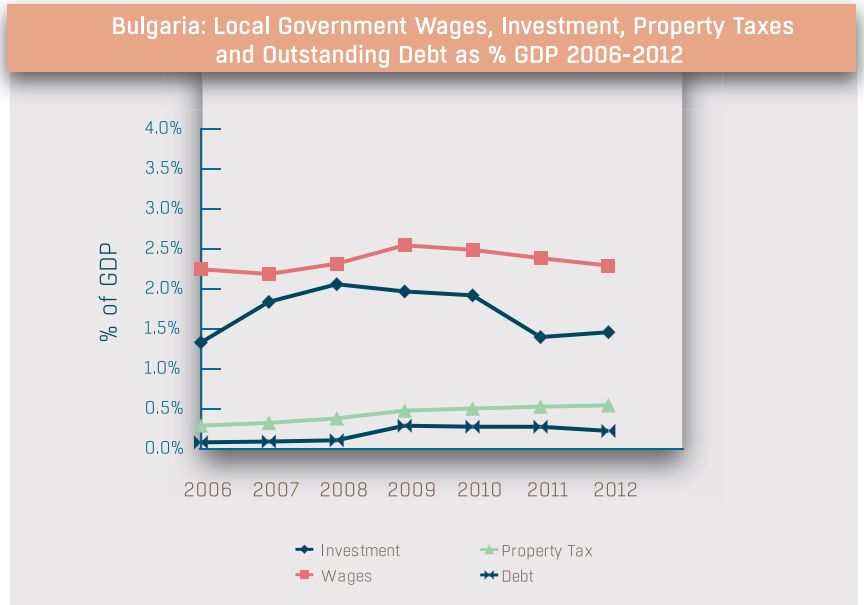


Chart 25

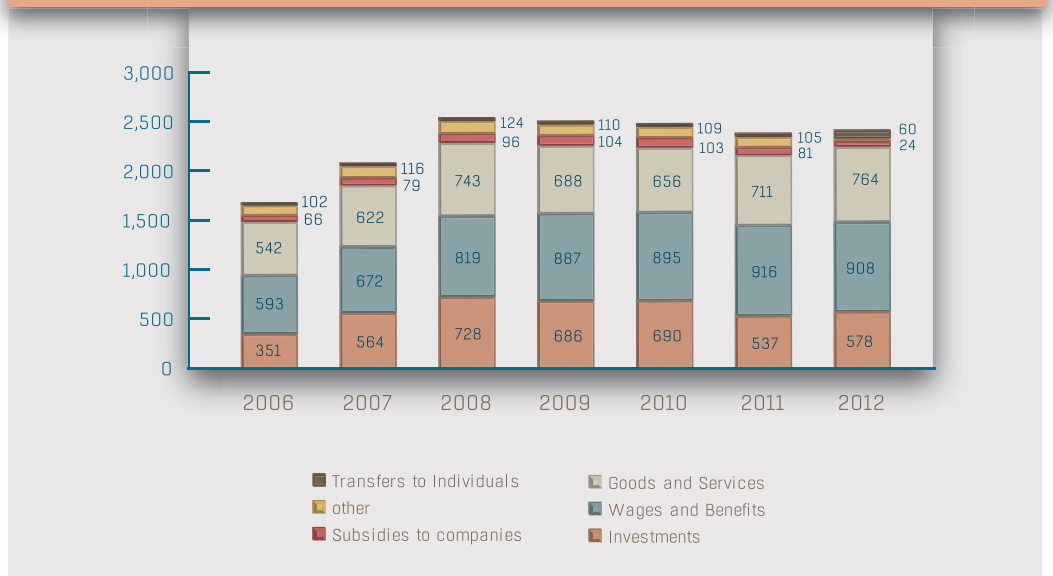


As can be seen from Chart 25, Bulgarian local governments have doubled the yield of the property tax as a percentage of GDP while lowering wages and investments in response to the economic crisis. The total outstanding debt of local governments has also increased over the period, but remains low.

Investment spending in Bulgaria has fallen significantly in since 2008 most of which is now being funded with EU monies.

Chart 26

Bulgaria: Composition of Local Government Expenditures 2006-2012 (EUR)



Croatia

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

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

Between 2006 and 2012, there were no major changes in the territorial boundaries or service responsibilities of local governments. There have however been some important changes in the tax system. The basic rate for VAT was increased from 23% to 25%, though a lower rate of 10% was introduced for some foods. Of more importance to local governments were changes introduced into the Personal Income Tax, a tax shared between central state and regional and local governments. The number of tax brackets was reduced from 4 to 3 and the base rate was lowered from 15% to 12%. Since the income tax is jointly shared between municipalities, cities, counties and the national government the reduction of these rates had a significant negative effect on local budgets.

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

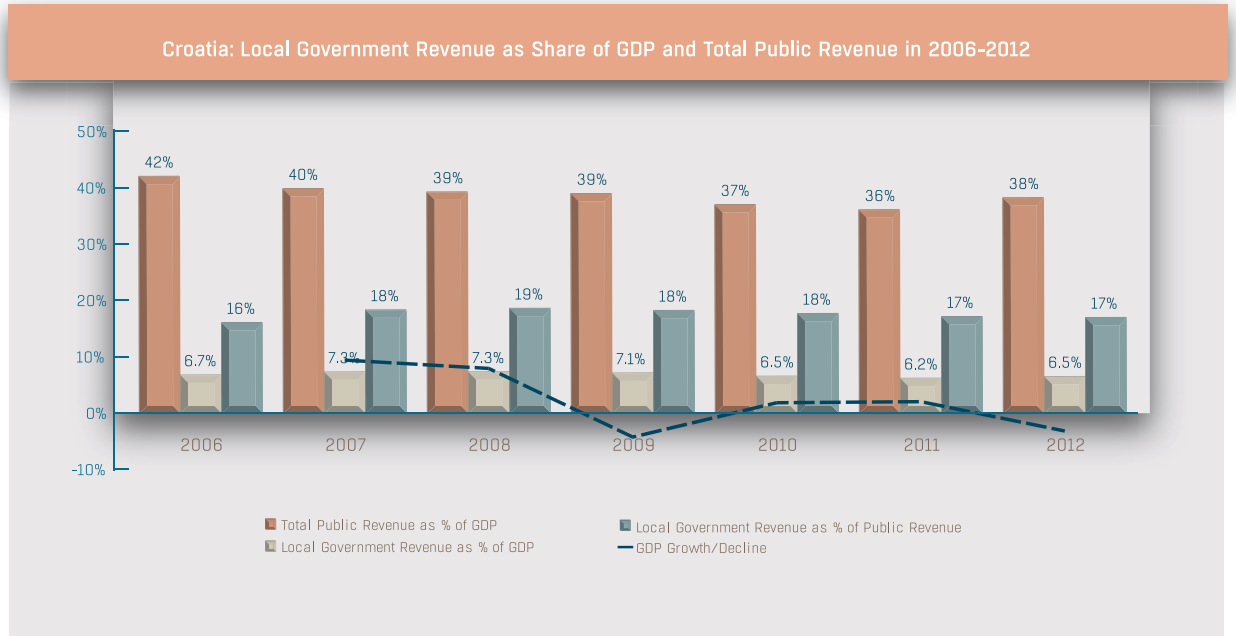
In 2012, a fee for the legalization of illegal buildings was introduced. Building owners are now required to pay a fee for the legalization any structures they built without proper permits. 50% of the fee goes to the national government, 30% to the competent body issuing the permit, and 20% to the local government in which the illegal construction is located.

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

Statistical Overview of Local Government Finance in Croatia 2006-2012

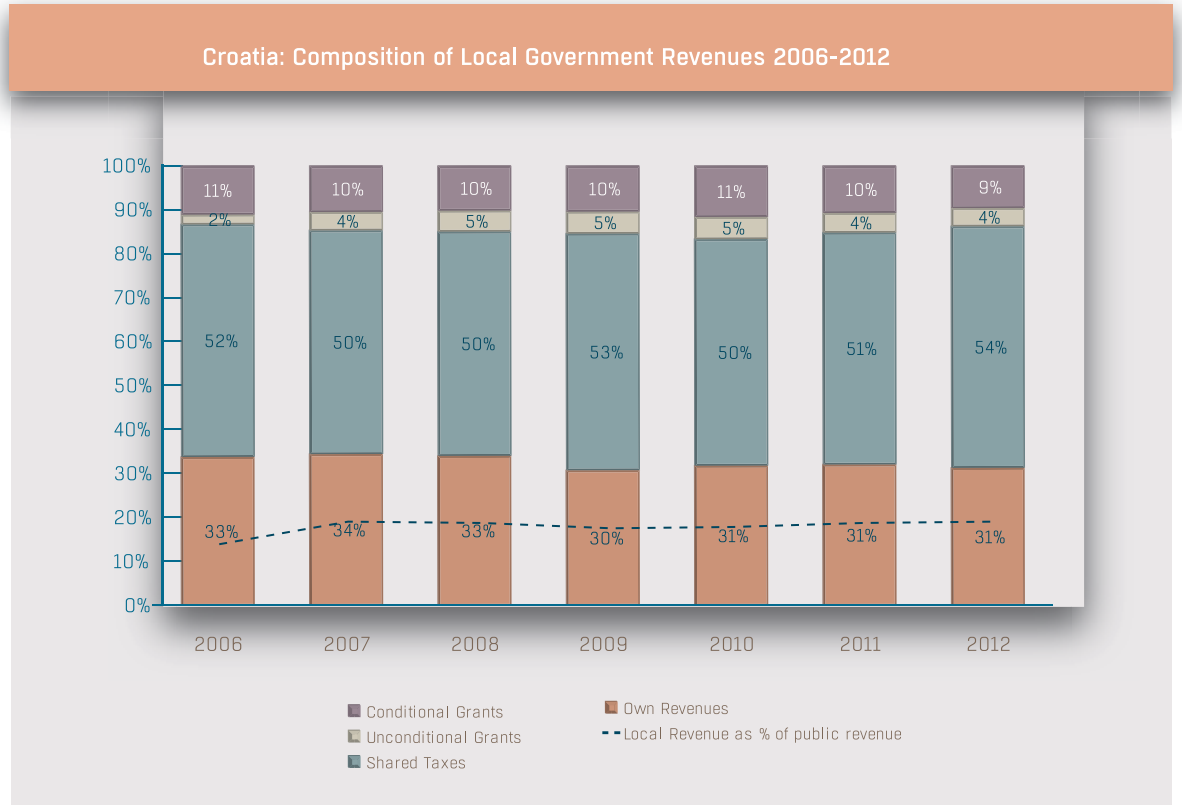
As can be seen from Chart 27 below, local government revenue as a share of GDP contracted significantly in the years immediately after the economic crisis of 2009. Their share of total public revenues however has remained reasonably stable, suggesting that the national government has not pushed the costs of the contraction disproportionately onto local governments.

Chart 27



As can be seen by Chart 28 below, between 2006 and 2012 there has been little change in the composition of local government revenues in Croatia, which remain dominated by shared taxes. Croatia has yet to decentralize the property tax, and local governments have relatively little control over other local fees and charges. Included in revenues from shared taxes are revenues from local PIT charges, which really should be accounted for as own revenues.

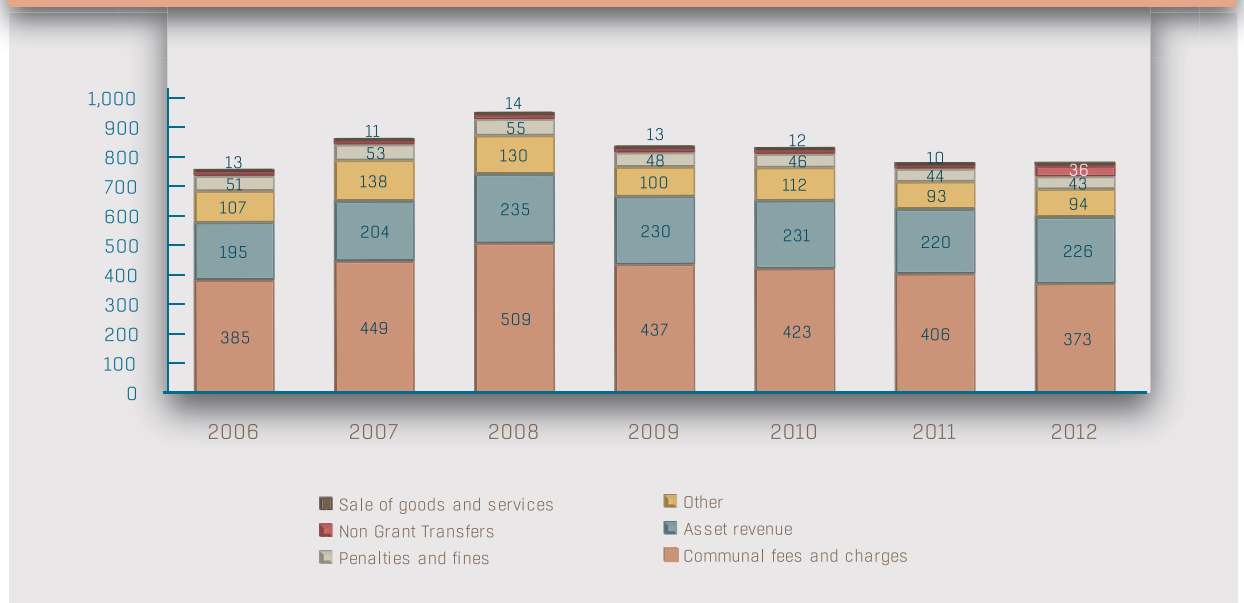
Chart 28



As can be seen from Chart 29 below, local government own-revenues in Croatia have declined in recent years and there is little evidence that the economic downturn has generated an increase in local revenue mobilization. As noted earlier however, these figures do not include revenue raised from the local PIT surcharge.

Chart 29

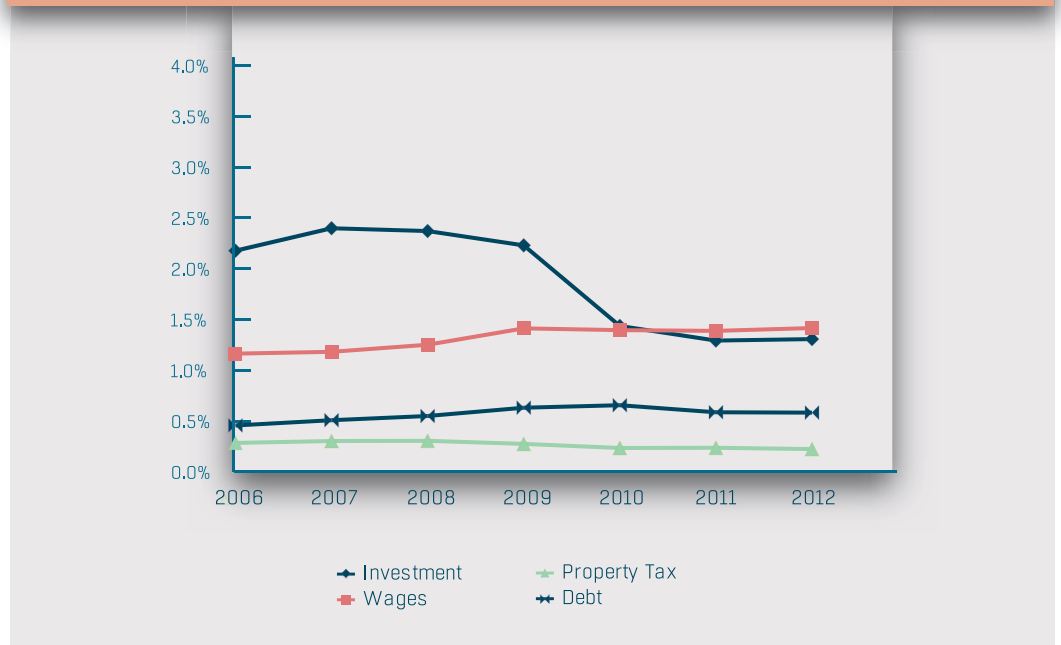
Croatia: Composition of Local Government Revenues 2006-2012 in mln EUR



As can be seen from Chart 30 below, local government investment has dropped quite substantially since 2009, though it should recove with the influx of EU funds. Wage spending has increased slightly but remains low, in part because local governments do not fund teachers wages. Local government borrowing is also both low and stable because of strict controls imposed by the national government.

Chart 30

Croatia: Local Government Wages, Investment, Property Taxes and Outstanding Debt as % GDP 2006-2012



Kosovo

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

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

Between 2009 and 2013 significant changes have been introduced into Kosovo's intergovernmental fiscal system. New rules have been put in place to increase the transparency of municipal budgeting and to improve financial reporting. A Grants Commission has also been established to determine the overall size of different grants (e.g. for Health and Education) as well as the formula's for their allocation. This Commission includes representatives of the Ministries of Finance, Health, Education and Local Government Administration. Its decisions must be aligned with Kosovo's Macro-Fiscal Plan and with the country's Medium Term Expenditure Framework. Progress has also been made towards multi-year budgeting and in 2014, municipalities will prepare for the first time program-based budgets in which all programs must include measurable performance objectives.

Statistical Overview of the Finances of Local Governments in Kosovo

Local government revenue as both a share of GDP and total public revenues have increased steadily between 2007 and 2012 as can be seen from Chart 31 below. This growth has been driven by both increased transfers for newly devolved responsibilities in health and education as well as by increases in the collection of own revenues. Given the relatively small size of the overall public sector, it is particularly striking that such a high share of total public revenues has been allocated to municipalities. Local governments in Kosovo however have yet to be able to access debt capital.

Chart 31

Kosovo: Local Government Revenue as Share of GDP and Total Public Revenue in 2007-2012

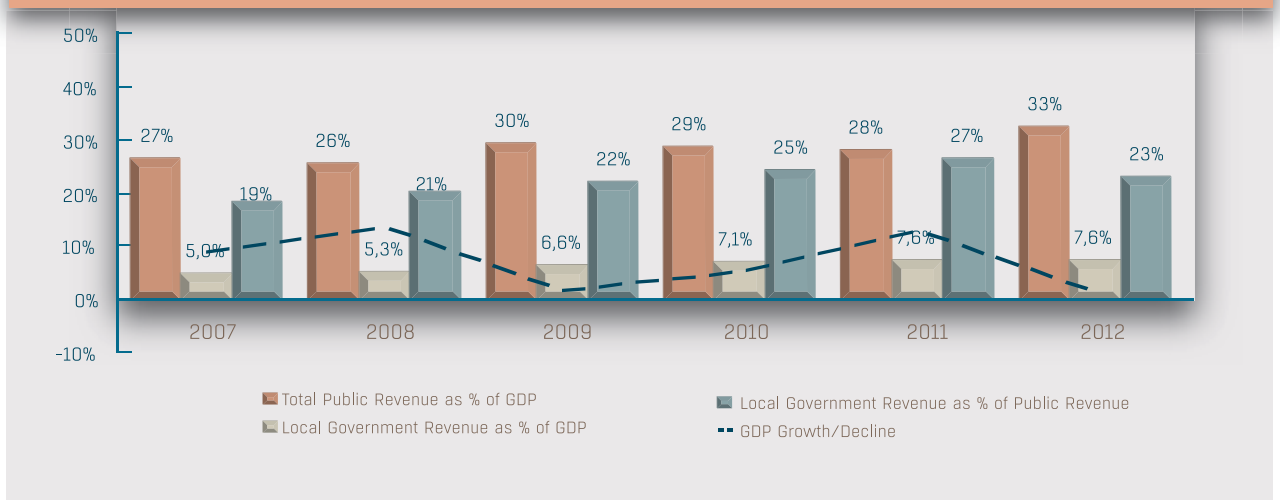


Chart 32

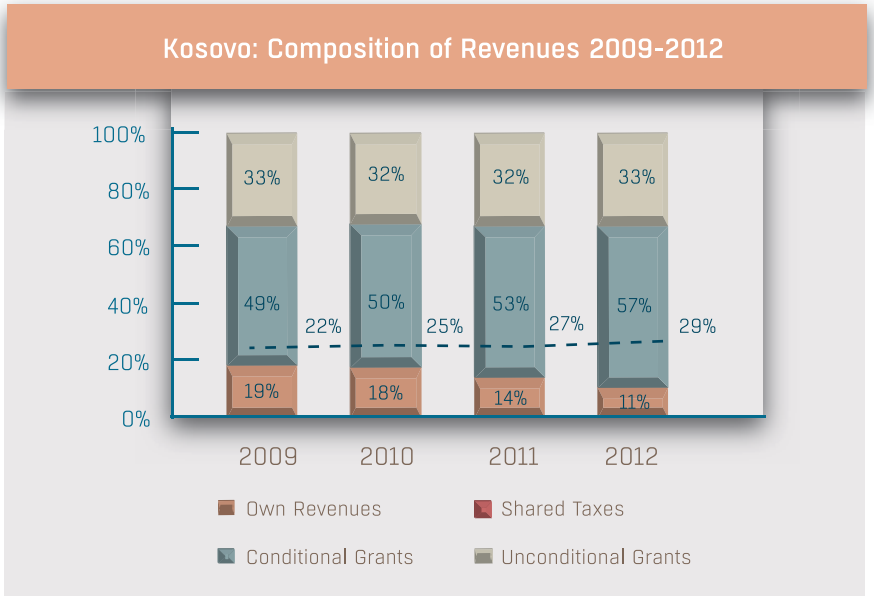
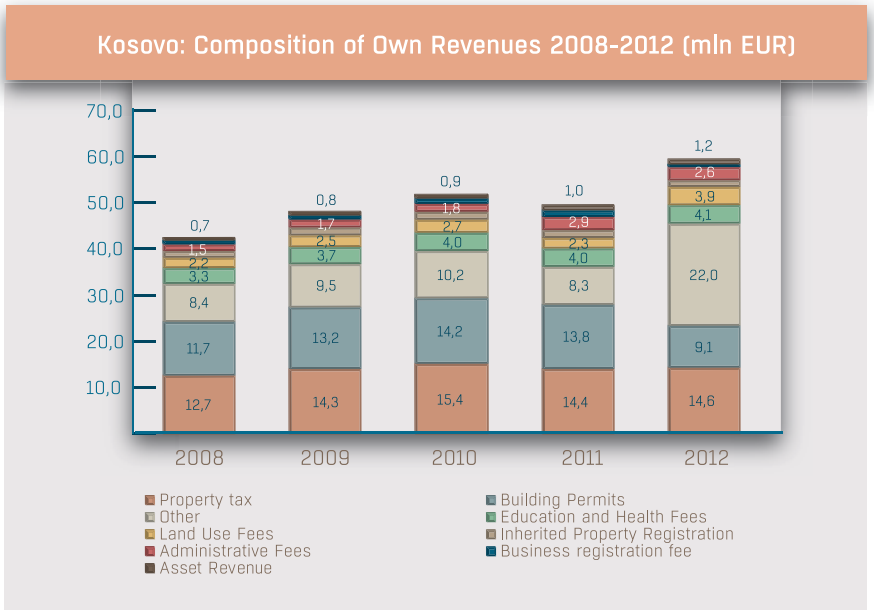


Chart 33



As can be seen from Chart 32 below Kosovar municipalities derive the majority of their revenues from conditional grants designed to finance their education and health responsibilities. The amount of actual control that local governments have over these funds within their respected purposes remains limited.

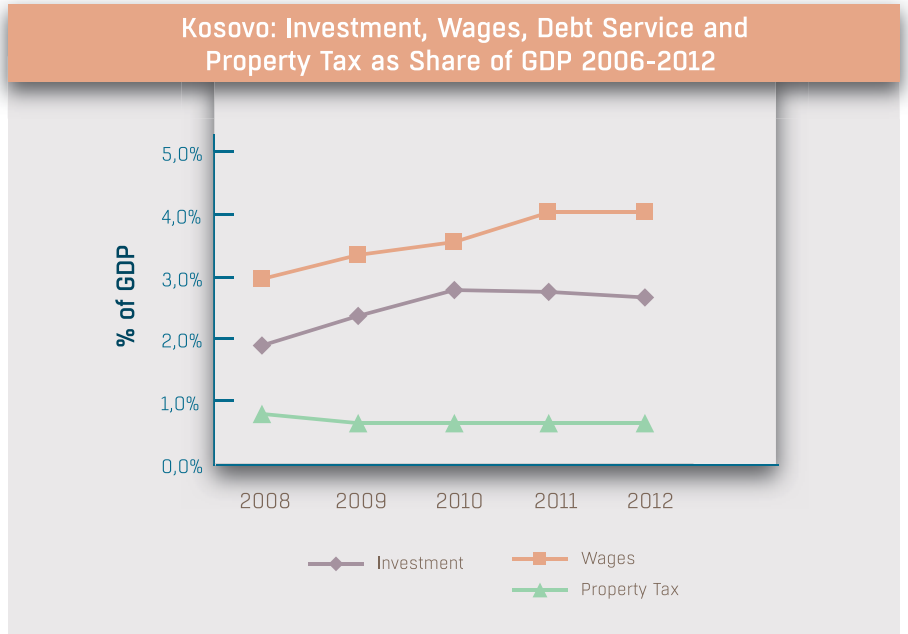
As can be seen from Chart 33 below, own-source revenues have increased about 30% between 2008 and 2012. The two most important own source revenues have been the property tax and building permits. The yield of the property tax has increased modestly over the past few years but has not increased as share of GDP and now stands at 0.34% of GDP. Building permits in Kosovo function much like the Land Development Fees in of the rest of the region. In 2011, legislation was passed to eliminate the quasi-fiscal use of building permits by putting them on strictly reimbursment basis. The yield of the income reported under this category declined in 2012, but the growth of the category other raises questions about how much local governments are actually complying with the new law.

As can be seen from Chart 34 below, Kosovar local governments have been able to devote almost 35% of total expenditure to investments, despite spending more than 50% of their budgets on wages.

As can be seen from Chart 35 below, wage growth has exceeded investment as a percentage of GDP in recent years, while the yield of the property tax has declined. This is despite very serious efforts of the national government to build a national fiscal cadaster and improve tax billing.

Chart 34

Chart 35



Macedonia

As a result of the Ohrid Agreements of 2001, and as part of the country's effort to accede to the European Union, Macedonia reduced the number of its local governments from 124 to 85 in 2005, and then to 81 in 2013. Beginning in 2007, local governments that had cleared all outstanding arrears and met other criteria for good financial management were allowed to enter the so-called second phase of decentralization. At this point, they assumed responsibility for running primary and secondary schools as well as some cultural and social welfare institutions. They also began to receive block grants for these functions from the national government. Between 2007 and today, all but one municipality has entered into the second phase of the fiscal decentralization process.

As a result, Macedonian municipalities have progressively assumed responsibility for the maintenance and improvement of local infrastructure, water and wastewater treatment, public hygiene, public lighting, local public transport, fire protection, pre-school, primary and secondary education, local cultural institutions (Cultural Houses, libraries, and museums) and care of the elderly. Since 2011, they have also been transferred responsibility for managing state land.

In accordance with the Law on Local Government Finance, local governments derive revenues from:

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

The fiscal decentralization process can best be seen through the expansion of local government revenue as percentage of GDP between 2005 and 2012. In 2005, it equaled only 1.9% of the GDP while by 2012 the share had more than tripled to 6.5% of GDP. Despite this radical increase in revenues, Macedonian municipalities still face profound financial challenges. This is because they must finance very costly social sector functions –particularly primary and secondary schools—in their entirety.

In order to strengthen their financial position, the municipal association, ZELS has lobbied the government to make amendments to the local government finance law. This has resulted in the following recent changes.

- The percentage of the national yield of VAT earmarked for the general grant has been increased from 3% to 4.5%;
- The share of income from the sale of state-owned land going to municipalities has been increased to 80%;
- The share of income from minerals concessions going to municipalities was increased to 78%;
- The municipal share of revenue from other concession (e.g. water) will be increased from 25% to 50% in 2016;
- Revenue from fees for washing and separating sand are now split 50%/50% between the national government and local governments.

- Revenues from fees for legalizing illegal structures built on agricultural state land are now split 50%/50% between the national government and local governments.
- Revenues from fees for legalization are 100% income of municipalities.

There have also been changes in the regulations governing municipal borrowing, and local government may now incur debt to finance capital expenditures from the National Government, and the World Bank, as well as from commercial lenders.

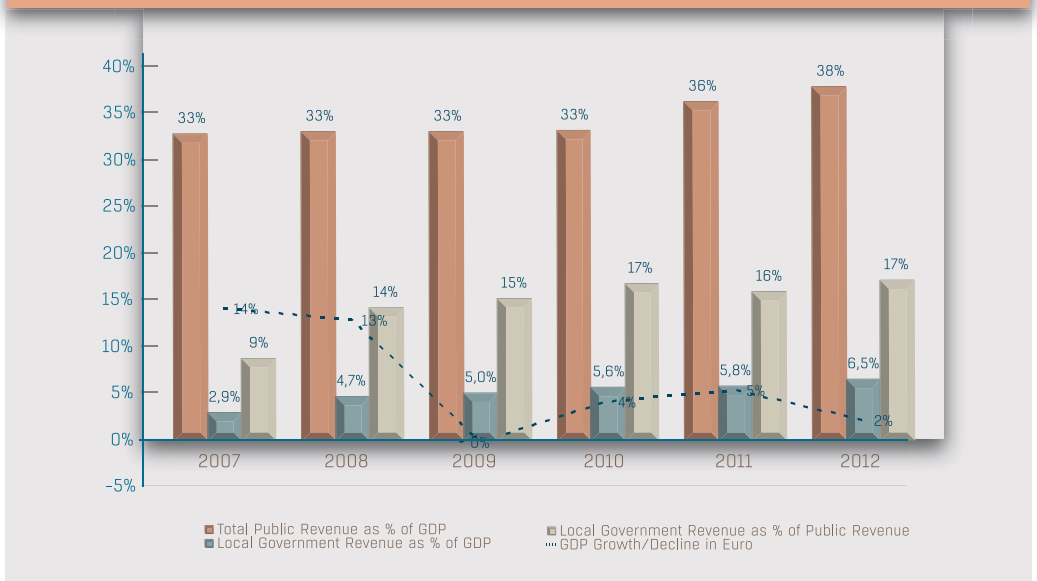
In recent years the share of own revenue in total municipal income has been increasing. In 2012, 45,5% of all municipal revenues came from own sources, up from 43% in 2011. The positive side of this development comes from an increase in the collection of local fees charge taxes which grew over 15% between 2011 and 2012. The negative side of these developments is that block grants have decreased during the same period with the education grant falling 2%, grants for social welfare 5.2%, grants for culture 12%, urban planning 6.7% and fire protection 8.4%.

Overview of Local Government Finances in Macedonia

Of all the countries in the region, Macedonia has undergone the most structural change over the last seven years. This change has been driven by the progressive decentralization of major social sector functions – particularly responsibility for primary and secondary schools- to local governments over the entire period (see above). As can be seen from Chart 36 below, this process has dramatically increased local government revenues as a share of both GDP and of total public revenues.

Chart 36

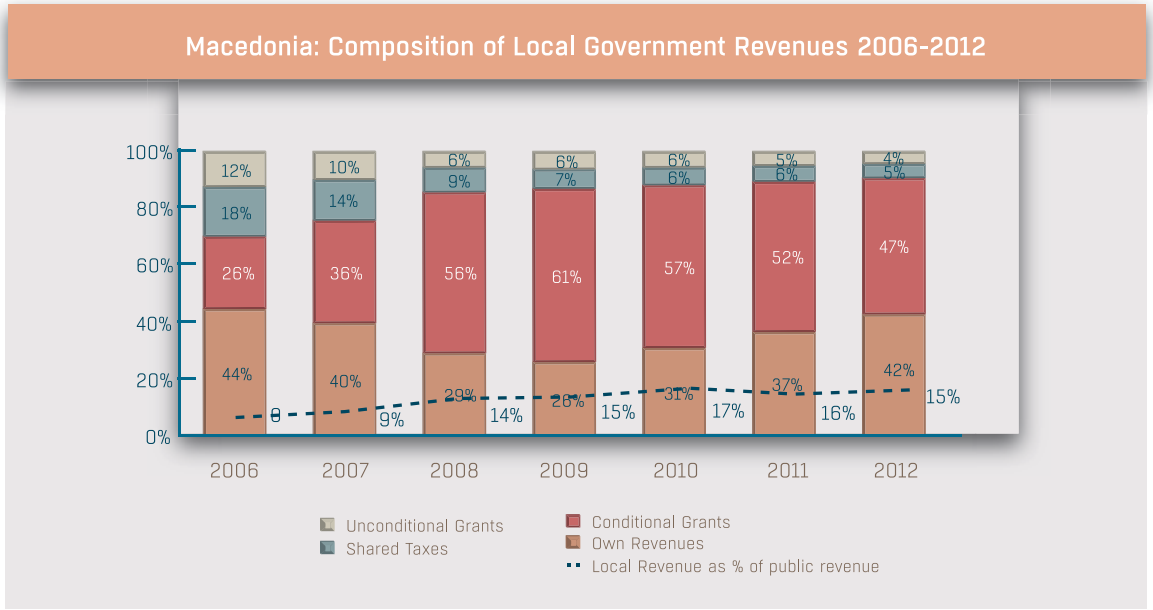
Macedonia: Local Government Revenue as Share of GDP and Total Public Revenue in 2006-2012



Macedonian local governments derive a modest share of their revenues from both shared taxes and unconditional grants, and their most important source of income has been the block grant for education.

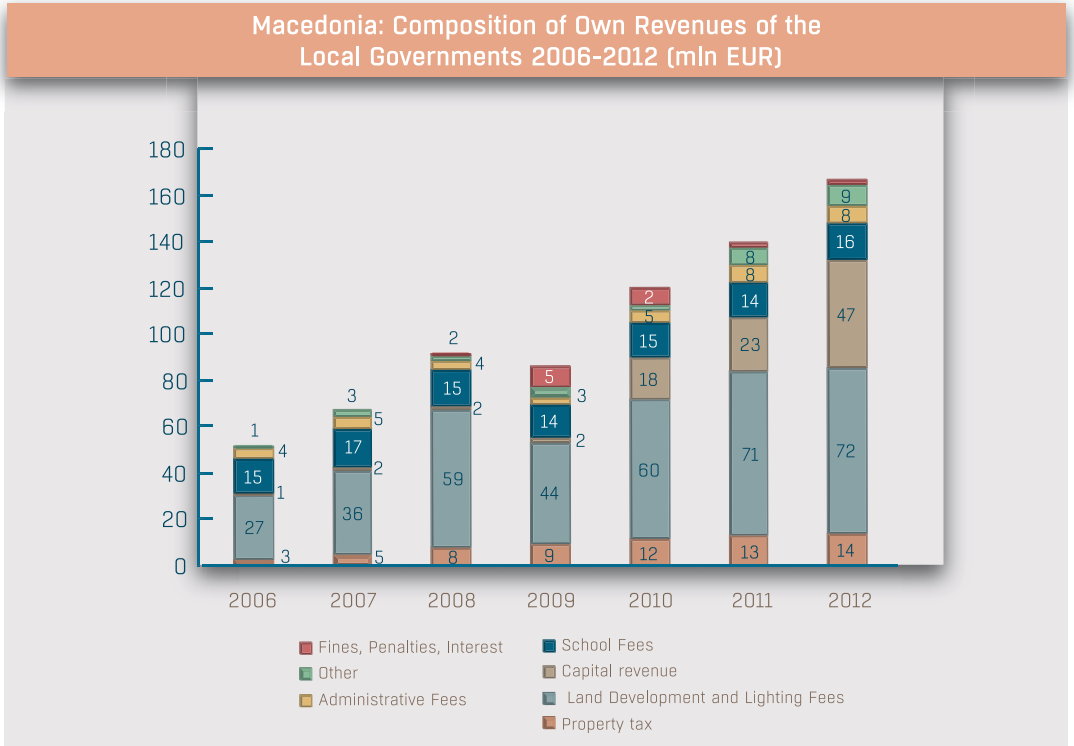
In recent year and for the reasons described above, the share of revenue from block grants has been declining, while the share of own revenues has been increasing.

Chart 37



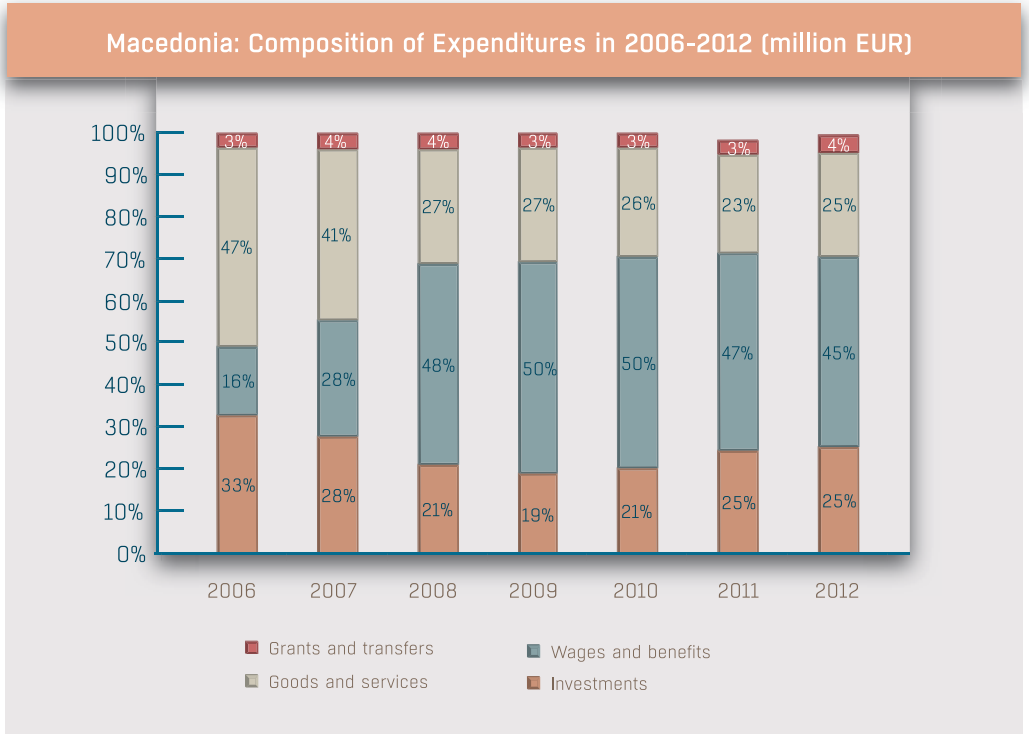
As can be seen from Chart 38 below, Macedonian local governments have done an impressive job mobilizing own source revenues since 2009. Though the overall yield of the property tax remains modest they have managed to increase collection almost five times. They are also more argressively collecting Land Development Fees, Lighting fees and other charges for the use of public space. Finally, the long delayed process of transfering state owned urban land to local government is has begun to yield significant income from asset sales.

Chart 38



The share of local government expenditures going to wages has increased steadily over the period as more and more local governments assumed responsibility for primary and secondary education. Despite this growth in wages however, they have maintained respectable investment rates.

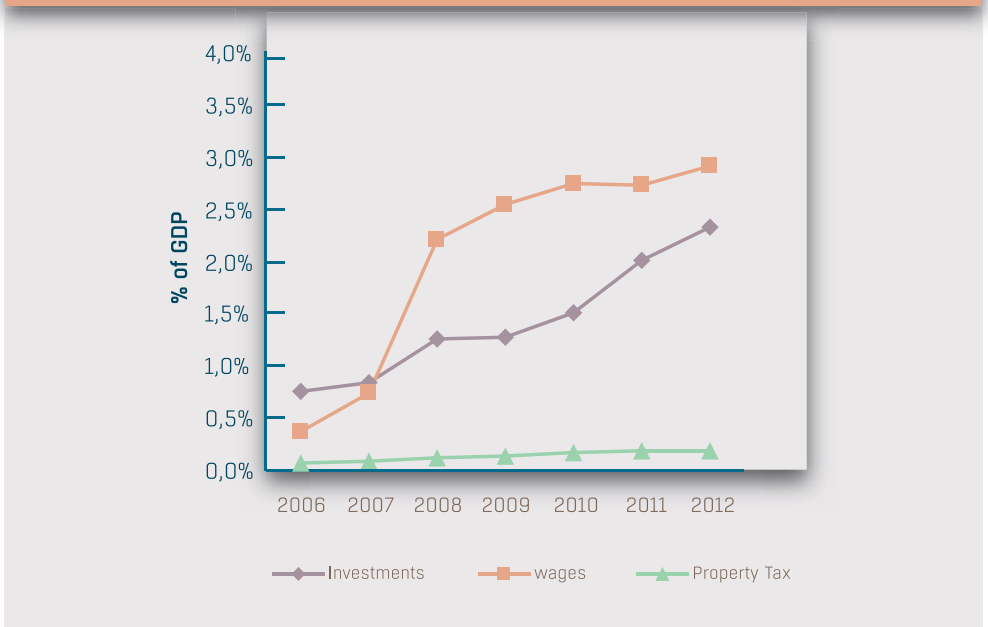
Chart 39



As can be seen from Chart 40 below, wages, and investment as a share of GDP have expanded quite significiantly over the last seven years, while to property tax has increase more modestly and is still only yielding revenue equal to 0.33% of GDP.

Chart 40

Macedonia: Investment, Wages, Debt Service and Property Tax as Share of GDP 2006-2012



Moldova

Moldova was not significantly influenced by the world crisis financially or economically. In fact, through most of the period --including in 2013-- there was quite impressive economic growth (5-7% yearly basis), with the slight exception of 2012 when there was small downturn. This, however, does not mean that financial situation of local governments situation has improved. On the contrary, instead of moving forward with long-planned decentralization reforms, the Government has reversed gears and undertaken a comprehensive effort to recentralize power in areas as diverse as local finance, public procurement, education and the police. In 2013 it also imposed new ceilings on almost all local taxes. Thus the rules of the game for local governments are becoming more and more restrictive against the background of unconstrained political patronage, non-transparency, and corruption throughout the national system of public administration.

The one bright spot in the picture is that in the spring of 2012 the Ministry of Finance –with the support of UNDP experts— developed and submitted for discussion a "Concept for the Reform of Local Finances". Later, in September 2012, the Ministry of Finance prepared draft legislation based on

a modified version of the Concept. This draft eliminates the financial subordination of lower level local governments on higher ones, and with it the vertical, dependency and authoritarian trends in relations between the national government, 1st tier local governments and 2nd tier local governments. This reform is one of the key elements of national democratization because local governments remain one of the few strongholds against authoritarian trends in society. It is also a key pillar in fighting corruption and improvement of the juridical system.

The suggested reform is based upon the following main ideas:

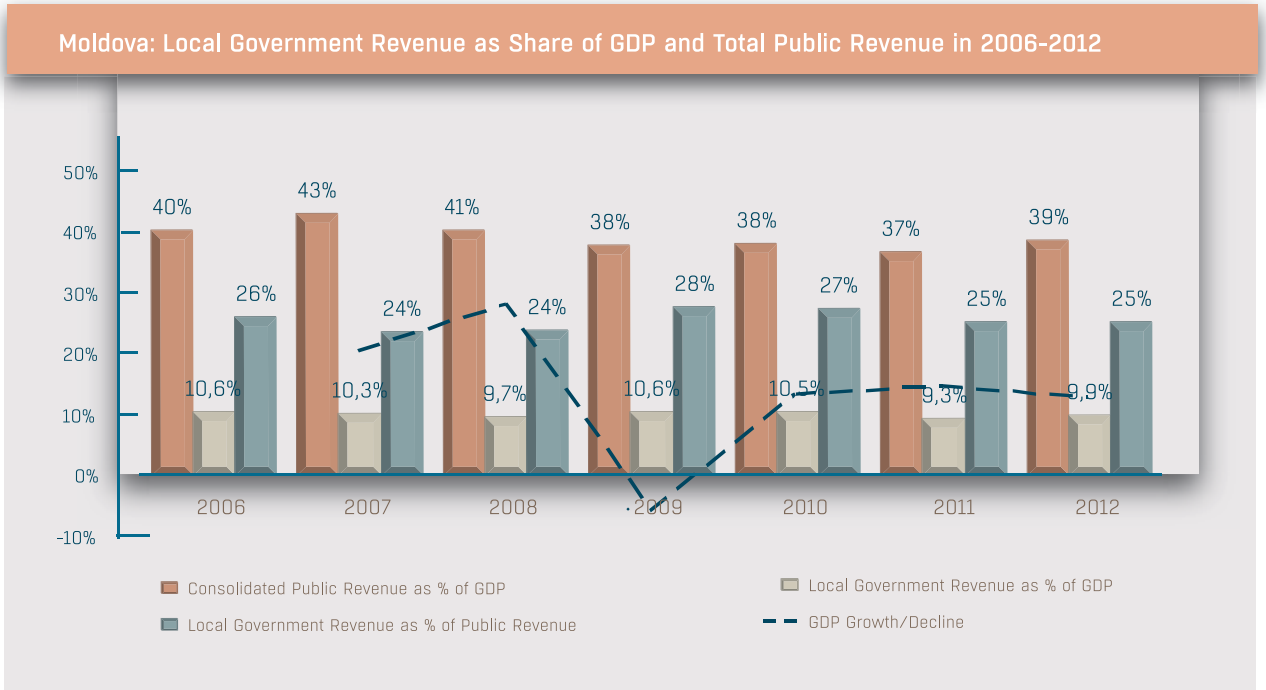
- It generally preserves the existing division of total public revenue between the national government and sub-national ones (fiscal neutrality);
- In accordance with all international standards, including the European Charter of Local Self-Government, the national government is expected to fully finance delegated competencies and to eliminate to the greatest extent possible unfunded mandates;
- Separation of transfers to 1st tier local governments and 2nd tier ones so that each will receive transfers directly from the national government;
- Separation of freely disposable general grants from earmarked grants;
- Fixing in law the percentages that shared taxes will be shared with local governments;
- Elimination of all disincentives for local authorities to collect their own revenues; transfers for equalization will only be based on shared PIT, not on locally collected taxes and fees.

Unfortunately, after the Moldavian Parliament approved the draft legislation in two readings, Moldovan politicians changed their minds because out of fear of losing political, administrative and financial influence overs mayors and local officials on the eve of the 2014 national elections. Thus, the implementation of this legislation has been postponed until after the elections and will be left to the new government. Making matters worse, the government has continued to politicize the already non-transparent allocation of national funds for local infrastructure investments while capping all local taxes. The attempt to cap local taxes however was contested and declared unconstitutional by the Constitutional Court.

Statistical Overview of Local Government Finances in Moldova

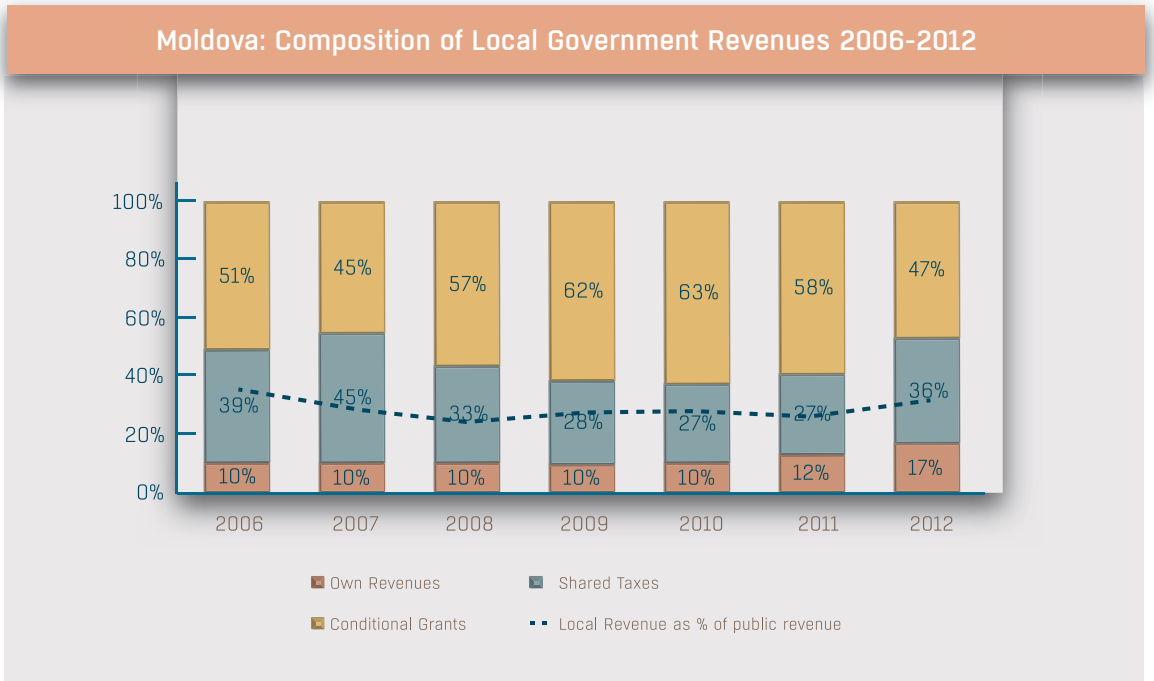
Statistically, Moldova has a highly decentralized system of public administration. As can be seen from Chart 41 below, local government revenues are equal to about 10% of GDP and 25% of total public revenues –close to the average for the EU. In practice however, the situation is quite different because of the political and economic subordination of local 1st tier local governments to 2nd tier local governments and to the line ministries of the national government.

Chart 41



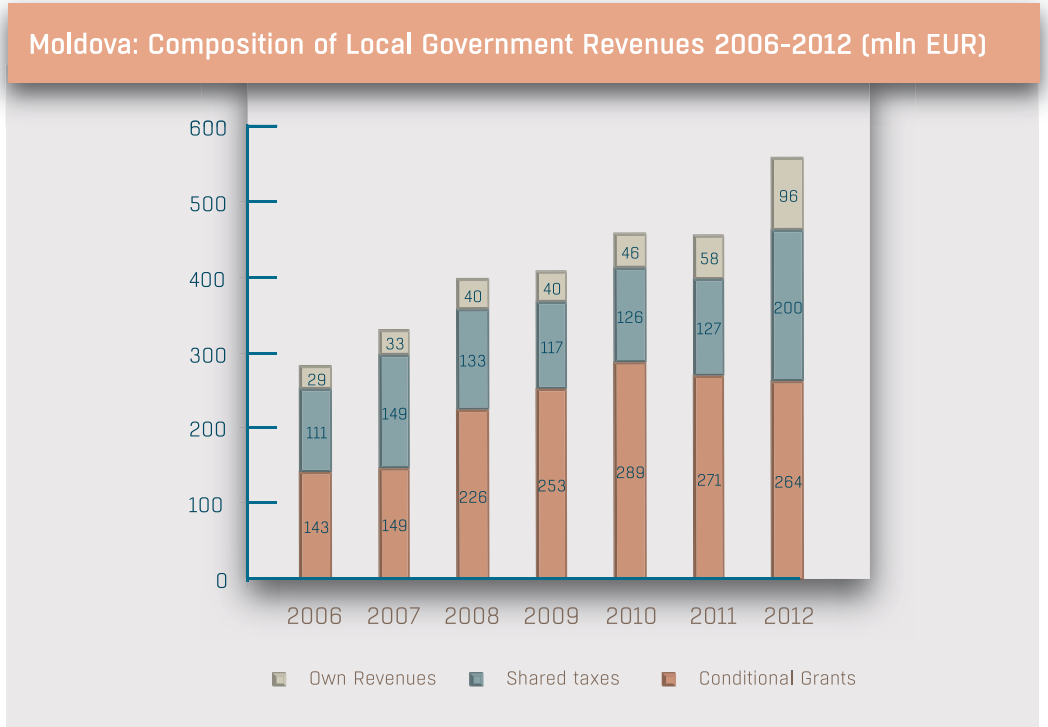
As can be seen from Chart 42 below, Moldovian local government derive the lion's share of their revenues from conditional grants. Indeed, at the moment there are no unconditional grants in the system and no clear mechanism for horizontal equalization. The rates at which PIT and CIT are shared with local governments are set with the Local Finance Law.

Chart 42



As can be seen from Chart 43 below, local government revenues increased steadily between 2006 and 2012. In 2012, this growth was driven by an increase in the rate at which shared taxes were shared with local governments, and by the greater mobilization of own source revenues. In 2012 about 30% of the 96 million EUR in own-source revenue came from the property tax, whose yield has been stable across the decade. As such, it is fair to say that most of the increase in own source revenue came from other local fees and charges.

Chart 43



Despite the relatively high share of local government revenue in total public revenues and in the GDP, Moldovan local governments spend a declining share of their expenditures on investment. Indeed, as can be seen in Chart 44 below, since 2006 local government wage spending has gone way up while expenditures on investments have dropped dramatically. Much of this wage growth may be the result of state mandated increases in teacher wages. But whatever its causes, the problem should be of serious concern to both local and national policy makers.

Chart 44

Moldova: Coposition of Expenditures in 2006-2012

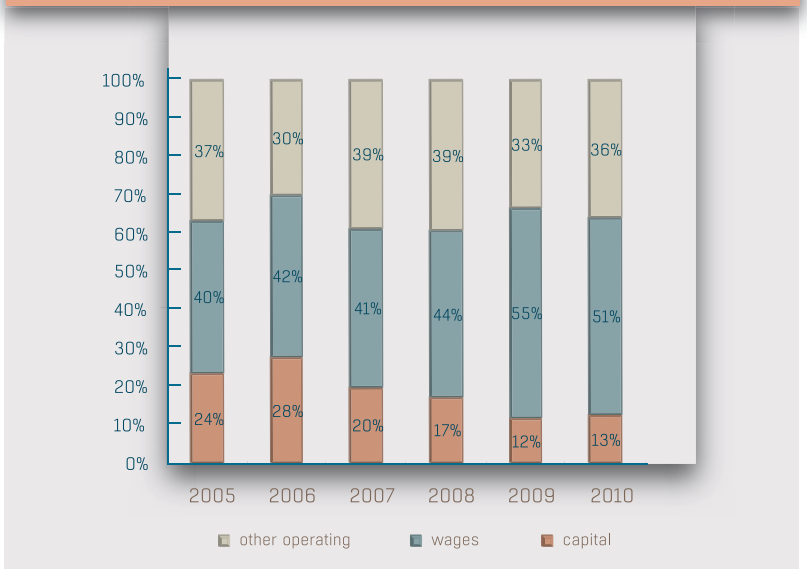
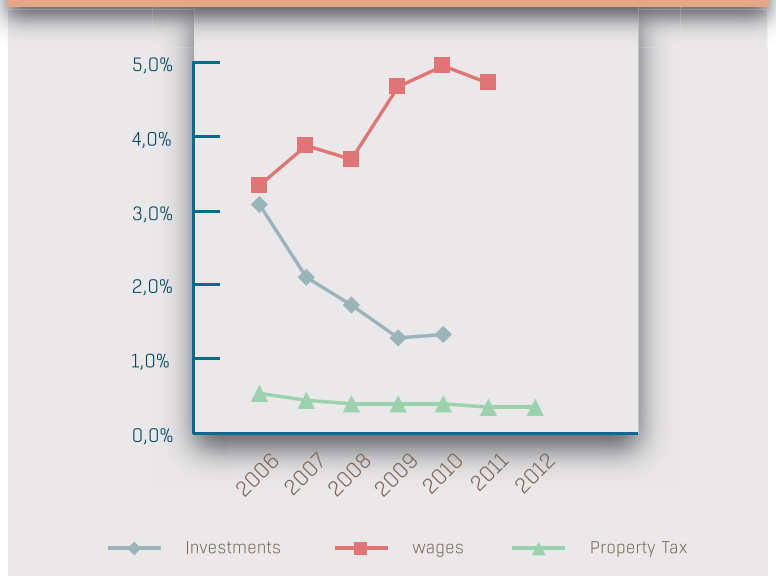


Chart 45

Moldova: Investment, Wages, Debt Service and Property Tax as Share of GDP 2006-2012



Montenegro

As in many other countries, the "great recession" had a negative effect on Montenegro's public finances. Efforts to limit the effects of the crisis through countercyclical spending led to a sharp increase in the level of the public debt. More recently, some taxes have been raised in order to service it. In 2012, the GDP declined 2.5%. But fiscal measures and economic activity picked-up in the first nine month of 2013 and the GDP increased 3.1%. Tax revenues also increased rising 10.2% over 2012 levels. As result the primary budget deficit has decreased 30%. This is particularly noteworthy because in the first nine month of 2013 debt service payments are equal to 8.1% of the estimated GDP for 2013.

The economic crisis also effected local governments. Like the national government, they borrowed heavily to limit the impact of the crisis. They also accumulated payment arrears to suppliers and contractor. So they too are now in a period of retrenchment, struggling to reduce overstaffing, collect revenues and decrease inefficiencies.

Over the last few years there have been no major changes in territorial organization, but in 2012 one new municipality was created, bringing the total to 22. Similarly, there have been no major changes in local government functions. There have however been changes in the Law on Local Government Finance that have negatively impacted municipal budgets. Beginning in 2008 a number of local fees charges and taxes have been eliminated, including local fees levied on the use of structures for transmission of electricity, on telecom facilities, on the installation of TV and radio receivers, the use of the sea shore for business purposes; administrative fees related to public registers; the land use fee, the business sign tax, and the tax on games of chance.

In 2011, in an effort to compensate local governments for the loss, the Law on Local Government Finance was amended and percentage of shared taxes going to municipalities was increased. But the changes came late, and the loss of own source revenues compounded the negative effects of the crisis. Indeed, it is one of the reasons that crisis produced such a sharp increase in local government debt and payment arrears.

The 2011 amendments increased local government share of personal income tax from 10% to 12% for municipalities, to 16% for the historic capital, Cetinje and to 13% for the Capital City of Podgorica. The municipal share of the Property Transfer Tax was increased from 50% to 80%) and revenue from concessions and other fees from 30% to 70% (except for the concession fees collected for the use of Port for which 20% is assigned to municipality where the Port is located). They also introduced changes in the way poorer municipalities are financed. The size of the Equalization Fund was increased and the criteria for allocating it were also changed.

The increase in these shares however did not fully compensate local governments for their earlier loss of own revenues, which were both more stable and robust than the shared taxes. As a result, local government budgets have not recovered to pre-crises levels and the investment of boom the early years of the millennium are clearly over. Invest spending as declined radically and most of it is financed from asset revenues and (expensive) loans and credits (the economic crisis effected on the bank sector, too) instead of from current revenues. Most municipalities

have reached their legal limits for incurring debt and many do not have enough revenue to finance all their obligations to banks, suppliers and the state budget. Indeed, payment arrears have risen 27.9 million EUR in 2008 to 109.8 million in 2012. Investment spending has fallen from 52,6% in 2008 to 23,6% in 2012, while debt service payment have increased from 6,3% of local government expenditures in 2008 to 26,9% in 2012.

Municipalities are also making much greater use of pre-accession funds to finance capital improvements. Indeed, one of the main challenges facing the whole country is to improve the administrative capacities of both the central and local governments to use these funds. It is also important, that the national government must help co-finance many of these projects.

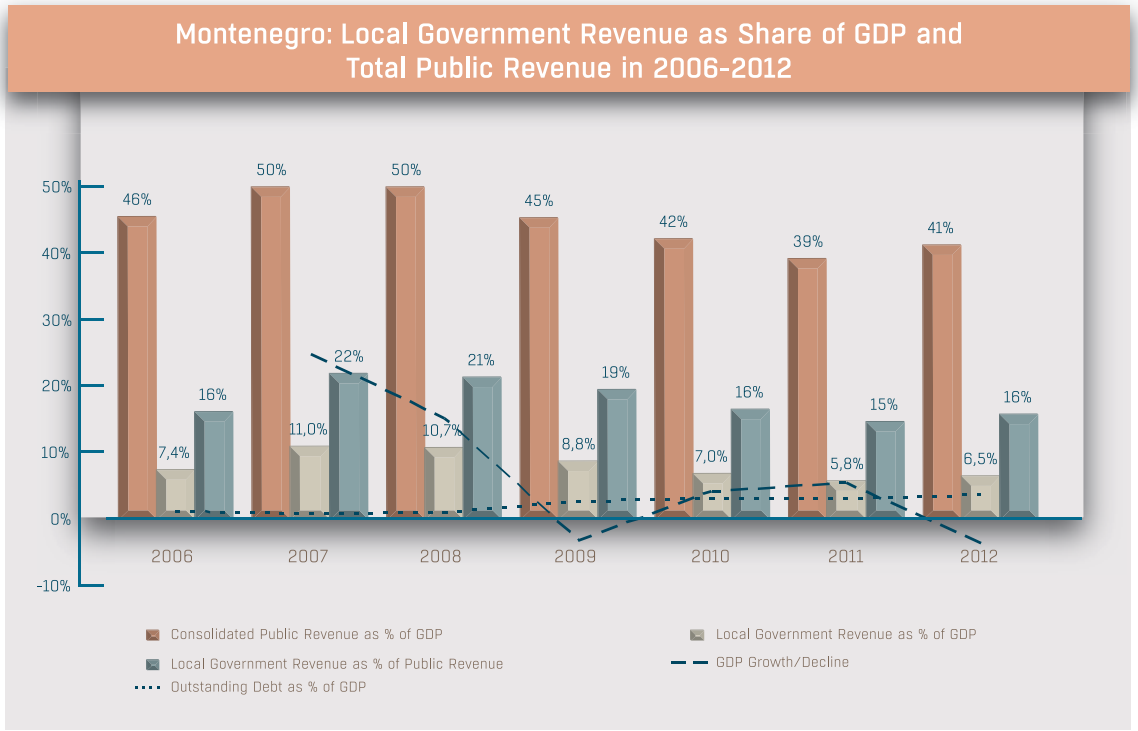
Compared with 2008, local government own-revenues are still low. But, revenues from the property tax have increased from 16 million EUR in 2008 to 36 million in 2012. Minimum tax rates have been increased, but local governments have also increased property registration and collection efforts. It is also important to highlight that some municipalities reduced the rate but made aggressive efforts to expand the base of the tax, a policy that has resulted in increased yields.

With respect to own revenues, it is very important to recognize the uncertainty regarding the fee for utility Equipment (the Land Development Fee). "The Analysis of Local Government Fiscal Capacities", which was adopted by the national government at the end of 2012 prescribed abolishing this fee in 2016. Proponents of the proposal believe it will significantly improve the business environment. But it will have dramatic effects on local government investment since this fee is one of the most important sources of local government revenue and cannot easily be compensated for by raising property tax rates, since this often results in declines in collection rates.

Statistical Overview of Local Government Finance in Montenegro 2006-2012

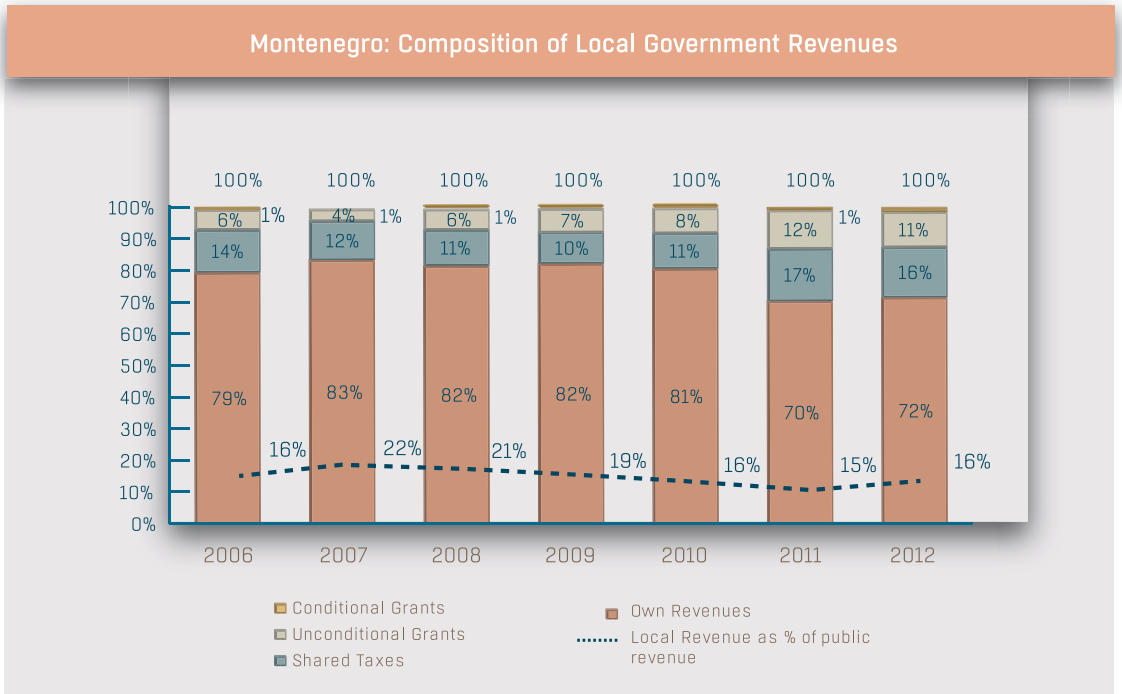
As can be seen from Chart 46 below, the impact of the global economic crises on the Montenegro has been particularly strong and has precipitated a major contraction of the public sector at both the national and local levels. In 2007, local government revenue as a share of GDP was extraordinarily high –11%-- especially since Montenegrin municipalities have no major social sector responsibilities. In 2011, it bottomed out at 5.8% of GDP and then recovered to 6.5% in 2012, primarily because of an increased shared taxes and the improved collection of the property tax. Local government borrowing also expanded rapidly after 2008 as municipalities borrowed to maintain spending levels in the face of the recession. Outstanding debt as a percentage of total local government revenue, however seems to have stabilized.

Chart 46



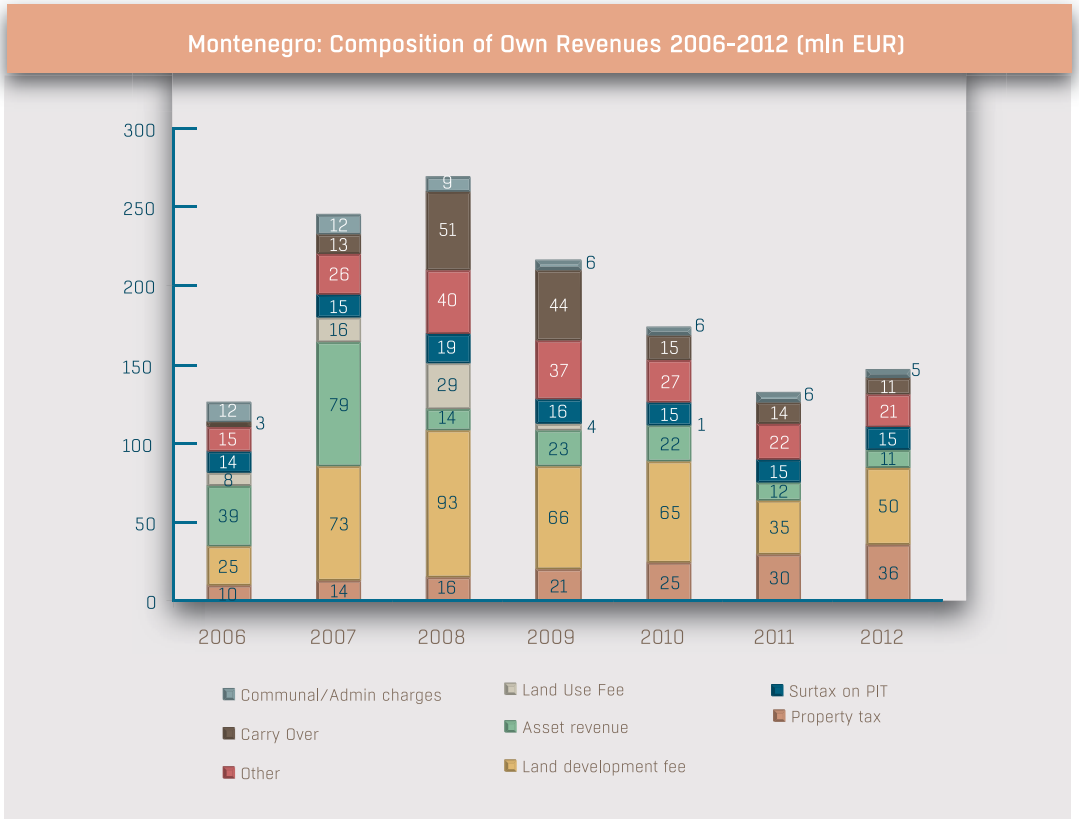
Local governments in Montenegro are unique in the region in that they derive well over 50% of their total revenues from own sources. Indeed, in the middle of the decade, own revenues accounted for more that than 80% of total revenues, and were being driven up by a real estate boom that increased income from asset sales, land development fees and other property related fees and charges. Since 2008, reforms and the effects of the economic downturn have reduced the share of own revenues to 70% stll almost double for the region.

Chart 47



The Land Development Fee has been the single largest source of local government own-revenue in Montenegro. Its potential elimination –discussed above-- will have important consequences for the financial position of municipalities. Local governments have tried –with some success-- to replace the revenue they lost when the Land Use Fee was eliminated in 2009 by increasing the yield of the property tax. But while the yield of the property tax is now the highest in the region many local governments have not yet been able to raise property tax revenues to levels comparable to what was lost with the Land Use Fee.

Chart 48



As can be seen from Chart 49 below, local government expenditures on invesment have droped from 166 million EUR in 2008 to 48 million in 2012, a decline of 70%. Meanwhile, expenditures on debt service payments have risen from 20 million EUR to 55 million an increase of 175%. Local governments have also reduced wage spending from 49 million EUR to 35 million a decline of 27%

Chart 49

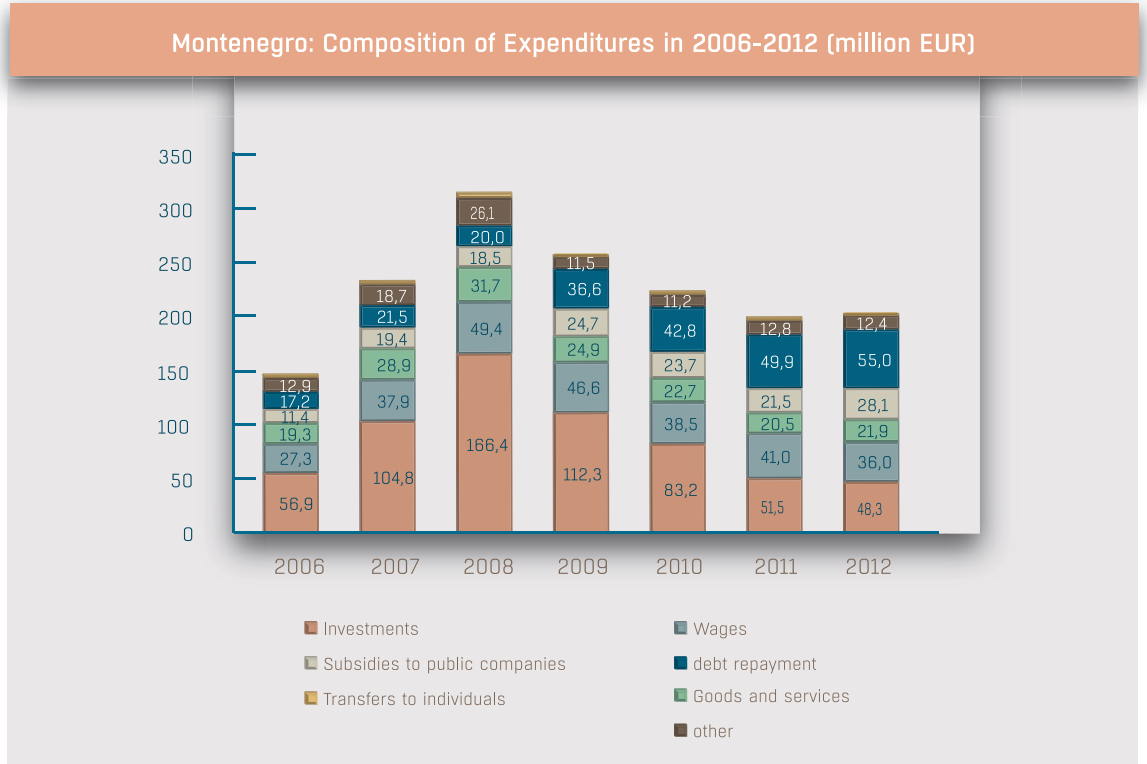
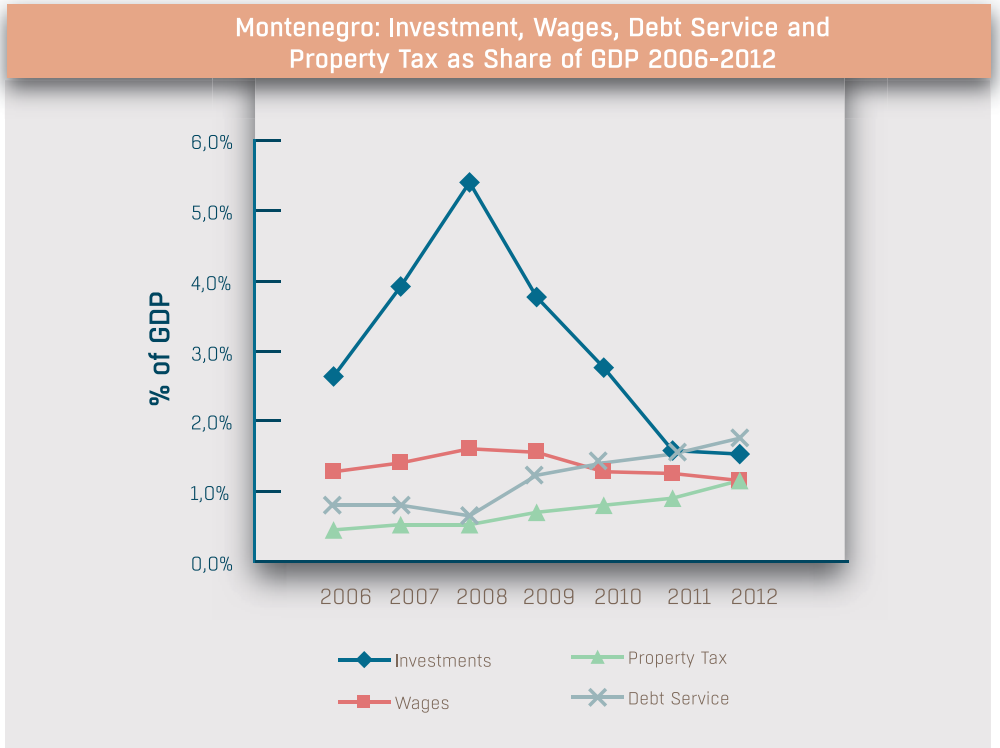


Chart 50 below illustrates the extremely rapid adjustments local governments have made on all fronts, both in response to the economic downturn and the policy changes discussed above.

Chart 50



Romania

In Romania, public sector revenues account for only 32% - 33% of GDP as opposed to a 40% EU average. In terms of expenditure, they are below 35%, again the lowest in the EU. Local governments play an important role in Romania's public sector. Their revenues as a share of n GDP is above 9%, which is high for comparable European countries. As a result, local governments have been targeted for many of the fiscal adjustment measures taken in the wake of the financial crisis of 2009. These included a reduction in their share of the personal income tax, a reduction in grants for social sector functions, wage cuts for local employees, layoffs and a tightening of debt limits. These measures are at least partially responsible for the decline in local government revenues as both a share of GDP and total public revenues shown in Chart 49 below.

The importance of LGs in Romania's public sector is underlined by the number of employees they hire. By the end of 2013, 56% of all public employees were paid from local budgets or subordinated institutions' budgets. They include almost 300,000 teachers, over 100,000 social service employees and since 2010 –when non-specialized hospitals were decentralized— health workers. Indeed, over the last four local governments at once added 120,000 hospital

employees to their payrolls while shedding 140,000 employees from other local services –a net reduction of about 20,000 people.

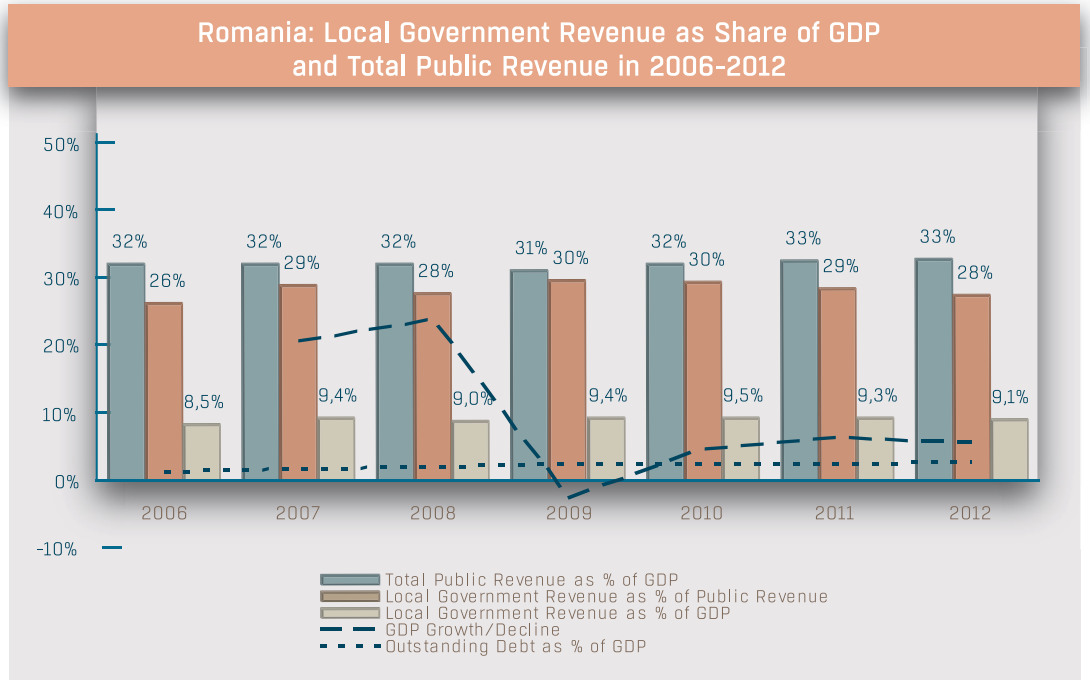
The total resources of local governments' come from their own budgets (c. 80%), the budgets of subordinated institutions –mostly 300 plus hospitals— (c. 17%) and credits which are recorded on separate accounts. Revenues over which local governments have full control amount about 40% of their budgets and come mostly from shared income tax and property taxes which they collect on their own. Grants from the national budget account for about 30% of their revenues and grants from the EU 7%. The fiscal adjustment program has mainly targeted the state transfers for recurrent expenditures on social sector functions which dropped by 4% between 2010 and 2012 (see Chart 51). A similar variation is visible for shared income tax. In this case, the explanation lies in the gradual reduction of shares from 82% to 71.5% in 2010 to 2012. In all, local budgets revenues in 2012 were only 3% over 2010, which in real terms marked a decline.

Most local government expenditure is for education (c. 20%), health (13%) and social welfare (10%) and most is for recurrent expenditures (c. 65%). Nonetheless capital spending is high by European standards, especially if one adds EU grants, which are generally for investment (19% + 10%). Expenditures on debt service however remain low –though rising—and account for only 4% of total spending. Even before the economic crisis, local government used debt capital to finance much their investment. In 2009 and 2010, new limits were set for local debt and both borrowing and investment spending declined. There are however exceptions for loans incurred to co-finance EU funded projects, a fact which has helped maintain both investment rates, and the local government capital market.

The decentralization process has continued even during the crisis, and in 2010, 374 public hospitals (over 80%) were transferred mainly to county councils. Their budgets have been integrated within the local budgetary framework since then. The current government plans to further the decentralization agenda by giving county councils some of the responsibilities currently held by deconcentrated services of various ministries (Ministry of Health, Ministry of Environment, Ministry of Culture, and Ministry of Economy). A Law to this effect was passed by the Parliament in late 2013, but overruled by the Constitutional Court for failing to abide by the principles and rules of the 2006 decentralization law. We do not foresee a renewed attempt in 2014, given the small majority of the new government and the busy election schedule.

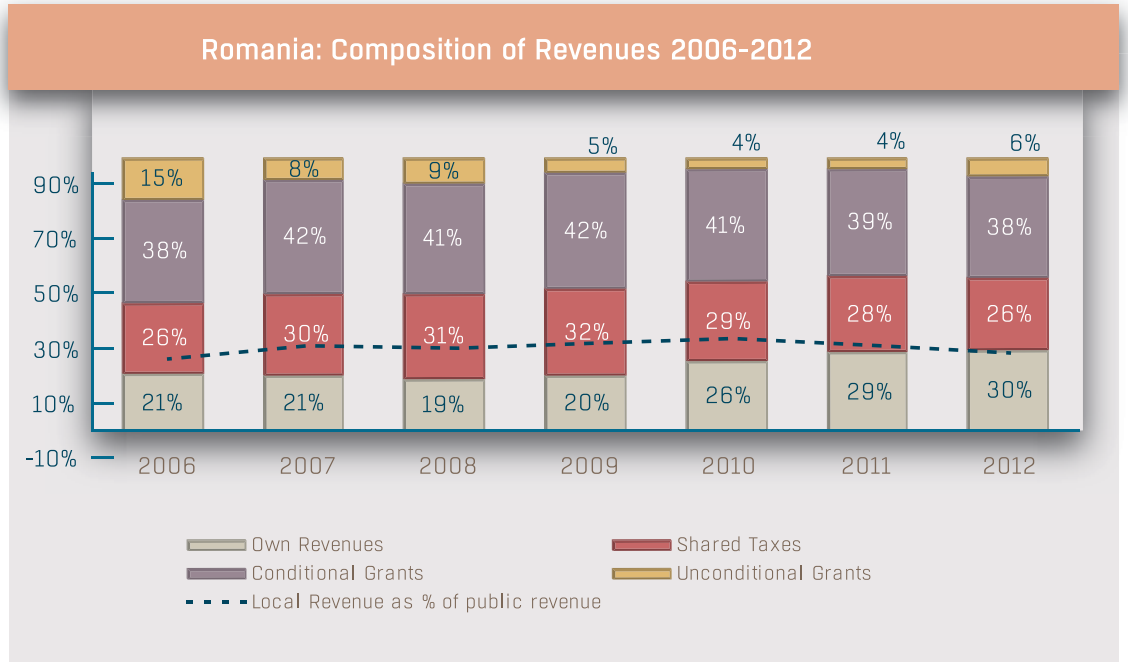
Statistical Overview of Local Government Finance in Romania

Chart 51



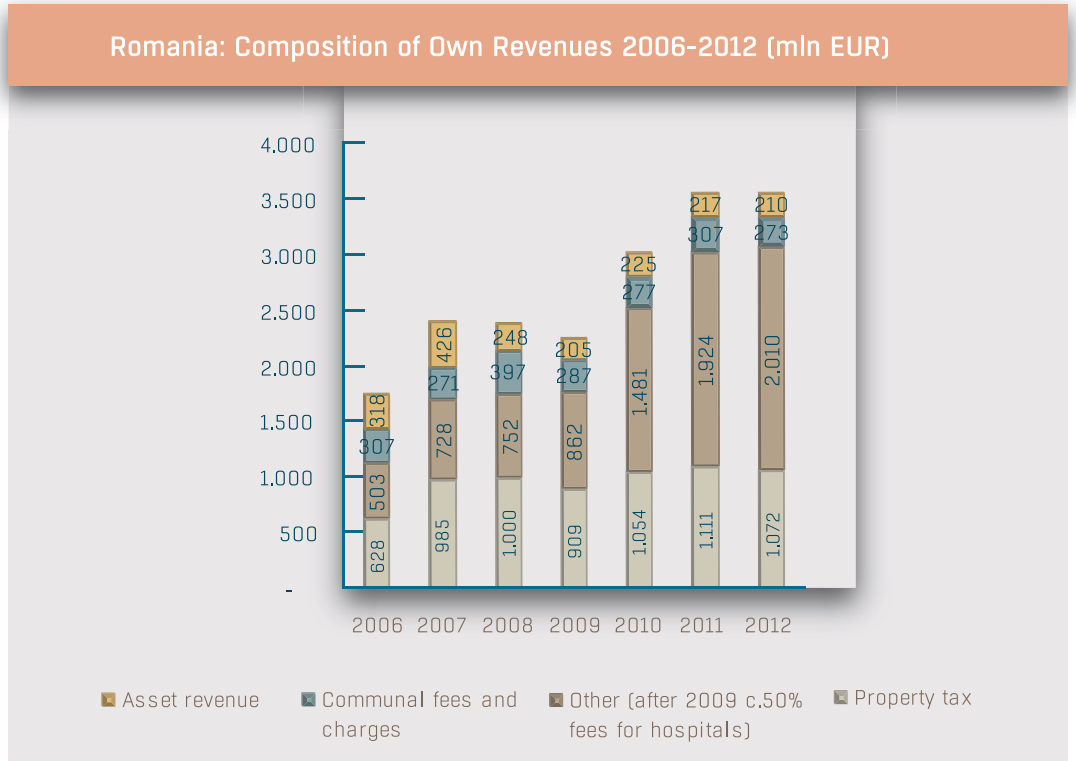
As can be seen from Chart 52 below, Romanian local governments derive only 11% of their revenues from own sources, and the most important freely dispossable own revenue remains the property tax whose yield is now equal to 0.8% of GDP.

Chart 52



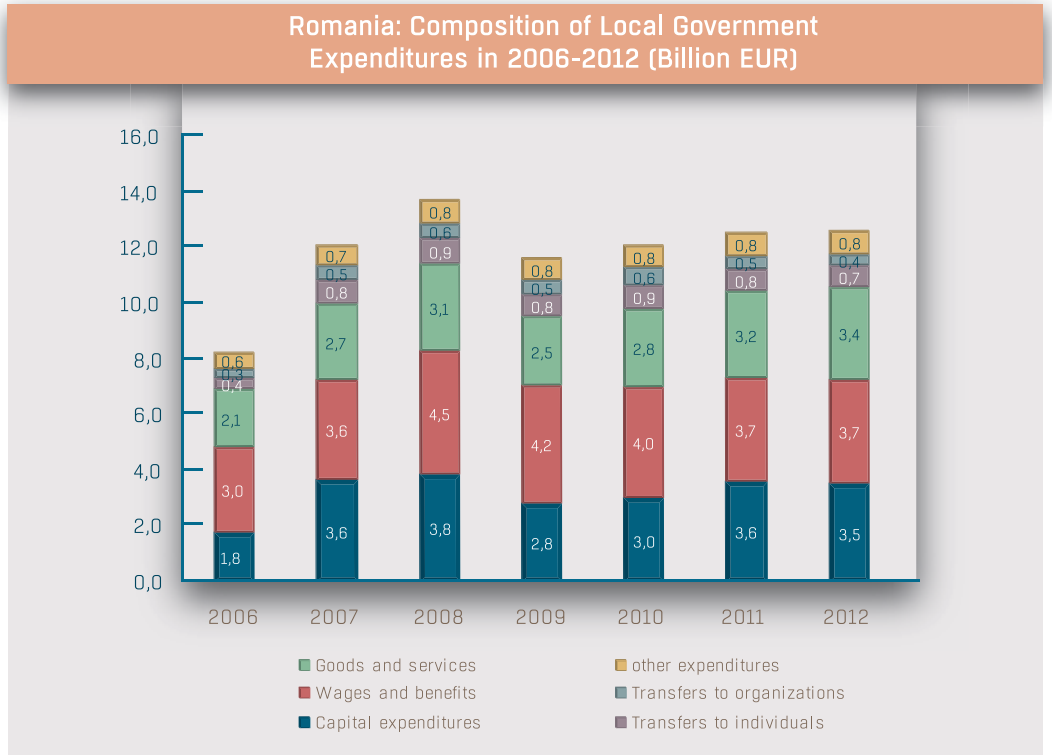
With the decentralization of hospitals in 2010, hospital fees have become also an important revenue source as can be seen by Chart 51 below.

Chart 53



As can be seen from Charts 54 and 55 below, the initial response of Romanian local governments to the economic crisis of 2009 was to slash expenditure on investments and goods and services, and to reduce –though to lesser degree—spending on wages. By 2010, however, investment spending as well as spending on goods and services increased while wage spending continued to decline (in 2010 a 25% cut was enforced on all public sector wages). As a result of these adjustments, wage and investment spending both in EUR terms and as percentages of the GDP returned to 2007 levels by 2012.

Chart 54

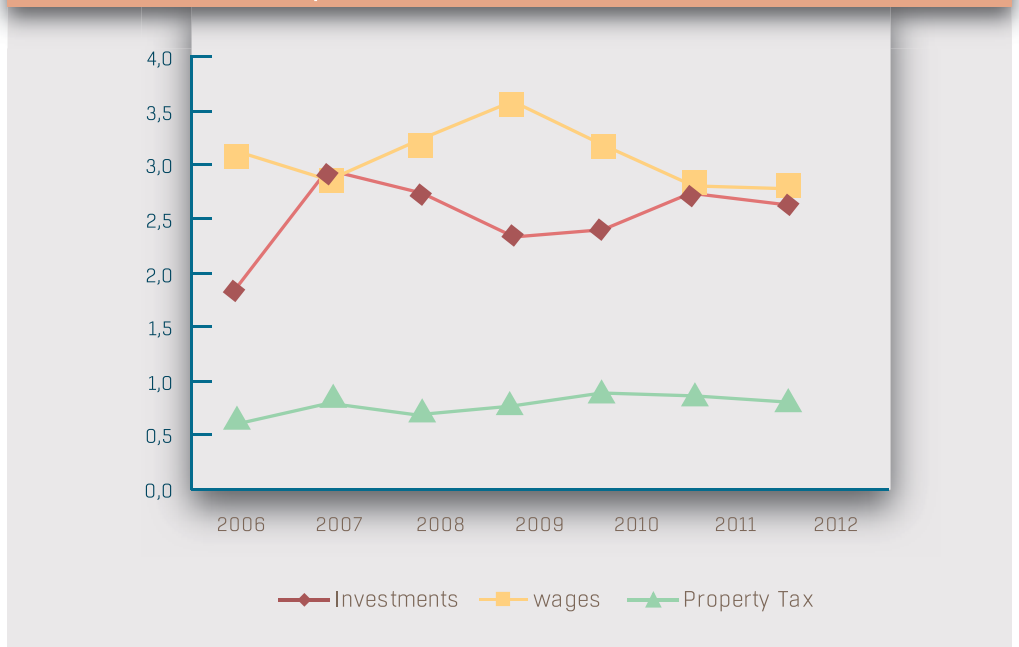


Serbia

The financial crisis of 2009 has had extremely negative consequences for the Serbian economy in general and for local government budgets in particular. In 2009 the GDP declined 3.5%, and the real-estate market seized up, leading to a sharp decline in shared taxes and own revenues associated with property transactions. But the situation was made much worse by the government's suspension of the Law on Local Government Finance between 2009 and 2011, a suspension that led to a dramatic cut in the unconditional grant. This was - at least in part - a response to the IMFs request that public expenditures be reduced. But unfortunately, the cut in transfers was one of the few austerity measures recommended by the IMF that was actually implemented.

Chart 55

Romania: Composition of Local Government Expenditures in 2006-2012 (Billion EUR)



The Law on Local Government Finance, adopted in 2006, introduced a number of very important and positive changes in Serbia's local government finance system. Unfortunately, however, its positive effects were short lived. Following its suspension, amendments were introduced into the law in 2011 that made the intergovernmental substantially less transparent. The share of the wage tax assigned to local governments was almost doubled to 80% for all local governments except Belgrade which now receives 70%. The same amendments decreased other transfers from the Republic budget to local governments in accordance with their level of development, with only the least developed getting a 100% of the transfers they received before.

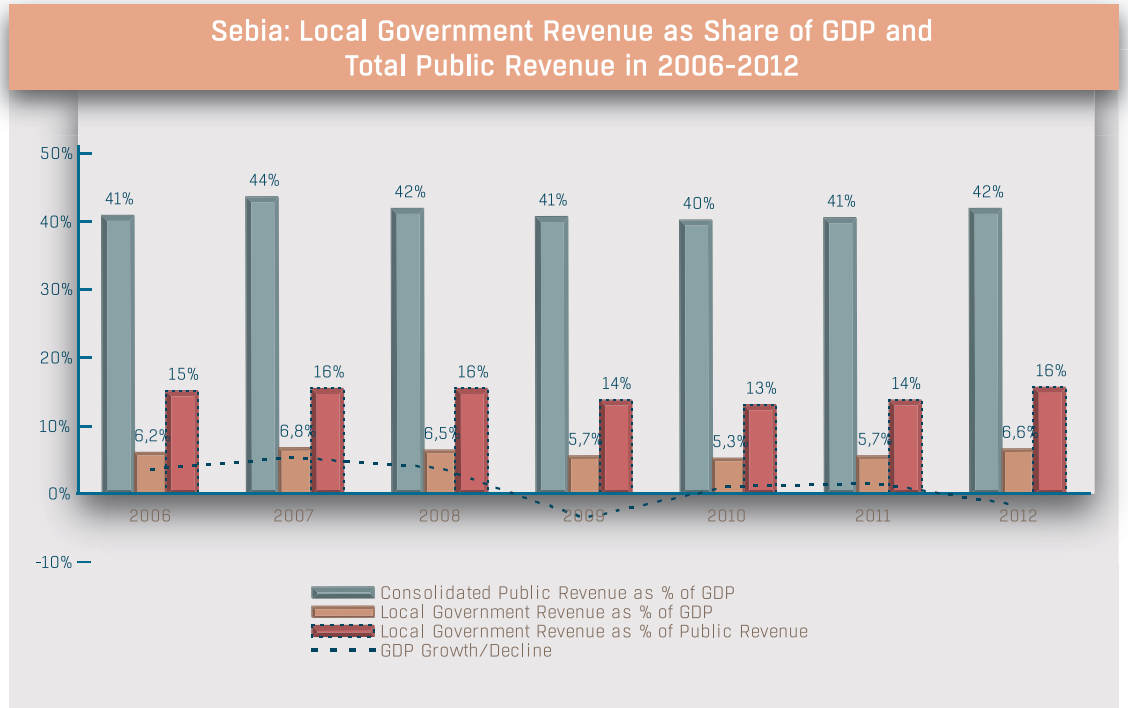
In September 2012, the Law was amended again. This time, important local government own revenues were limited or completely abolished. The business sign tax was capped, and the local fee for motor vehicles was eliminated. At the same time, central government raised all taxes that go only to the national budget including VAT, Capital Income Tax, Corporate Income Tax, Excises, and social contribution. Then in June 2013, the national government cut the wage tax rate was from 12% to 10% while increasing the threshold for untaxed wages from 8,776 to 11.000 RSD. Taken together these changes significantly reduced the value of the 80% share of the wage tax that local governments were given in 2011. Indeed, the changes cost local government more than EUR 200 million in revenues. At the same time, the national government increased the social contribution rate from 22% to 24%. So, basically, they took away EUR 200 million from LGs and transferred it to National Pension Fund (PIO fund) through social contributions.

As of January 1, 2014, the Land Use Fee has been completely eliminated. This fee was the second most important own-source revenue for Serbian municipalities. At the same time, a new Property Tax Law was put into force. This law is expected to generate additional revenues for local governments but it remains unclear how significant this increase will actually be. Also during 2014, final preparations will be made for the full implementation of Program Budgeting which will start in fiscal year 2015. According to the Serbian Budget System Law all municipalities will be legally obligated to prepare their budgets on a program basis by the end of 2014. The Ministry of Finance prepared the methodology for program budgeting in Serbia but the Standing Conference of Towns and Municipalities was assigned a very significant role in defining the necessary programs and indicators.

Statistical Overview of Local Government Finance in Serbia 2006-2012

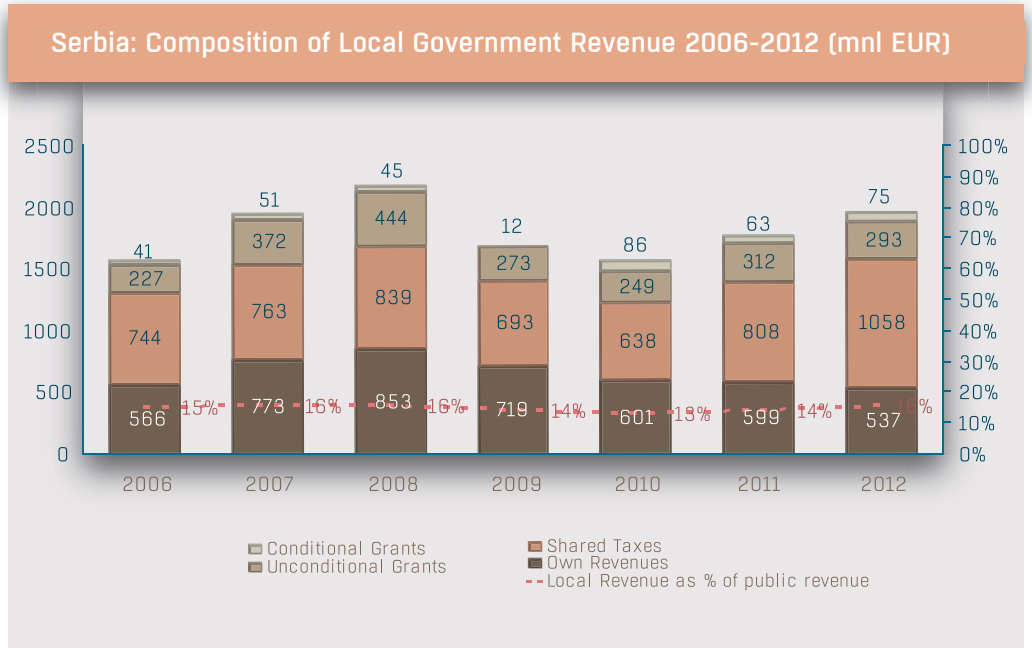
As can be seen from Chart 56 below, the global economic crisis had a profound effect on local government revenues between 2009 and 2011. In part, this was caused by the economic downturn itself, and in part by policy decisions of the national government that placed most of the burden for reducing public expenditures on the back of local governments. In 2012, local government revenues returned to levels obtained earlier, mainly because in the run up to the 2012 elections, the PIT share that local governments received was increased from 46 to 80%. These gains however are already being taken back (see above).

Chart 56



Until 2012, local governments derived about 40% of their revenue from own-sources, 40% from shared taxes, 15% from unconditional grants, and about 5% from conditional grants. In 2012, this balance was changed by the sharp increase in local governments' share of PIT, and shared taxes now account for well over 50% of municipal revenue. As can be seen from Chart 57 below, all categories of local income fell dramatically in 2009 and 2010, but it is only the PIT share that has returned to pre-crisis levels.

Chart 57



As can be seen from the Chart 58 below, there has been a radical decline in the revenue local governments derive from communal fees and charges. Some of this decline has come from the halving of the rate of Property Transfer Tax in 2009, a shared tax that has been categorized as a communal fee. Political pressure was also placed on local governments to reduce Business Registration Fees and Land Use Fees before the former was capped and the latter eliminated in 2012. Plans to eliminate the Land Development Fee –the largest single source of own revenue in the system—will obviously have important consequences for local government finances if implemented. Local governments have managed to increase the yield of the property tax 60% between 2006 and 2012, a trend that they will need to accelerate if they are to compensate for the elimination of the Land Use Fee in 2014.

Chart 58

Chart 59 below shows the composition of local government expenditures by economic category between 2006 and 2012. As can be seen from the Chart, the relative shares of different types of expenditure have been remarkably stable over the concerned period. Why this should be the case during a period when revenues have fluctuated substantially is a little unclear. It is also unclear why overall investment rates in Serbia seem to be on the low end of the regional spectrum given the fact that during most of the period the overall share of local expenditures in the GDP has been on the high end of the regional spectrum. Since 2009, the share of debt service payments in overall expenditures has risen to about 5% of total expenditure and local government debt now is equal to about 2.3% of GDP, though at least half of this is from debt incurred by the City of Belgrade.

Chart 59

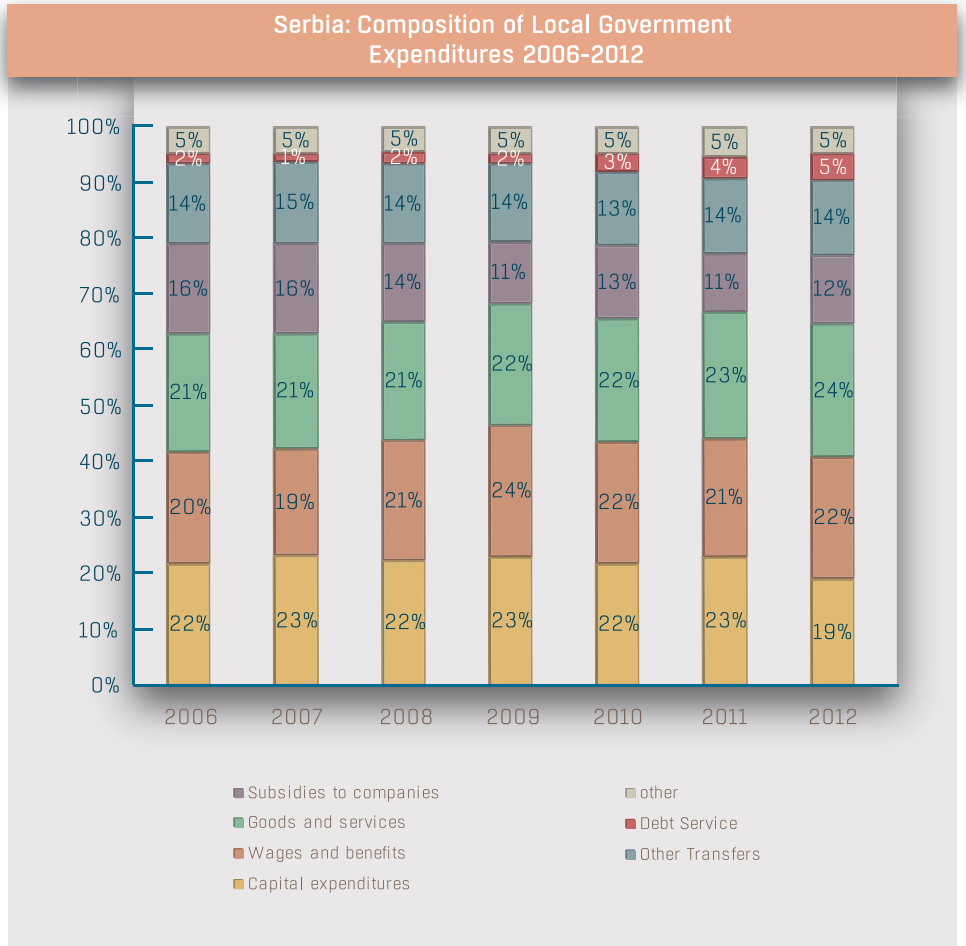
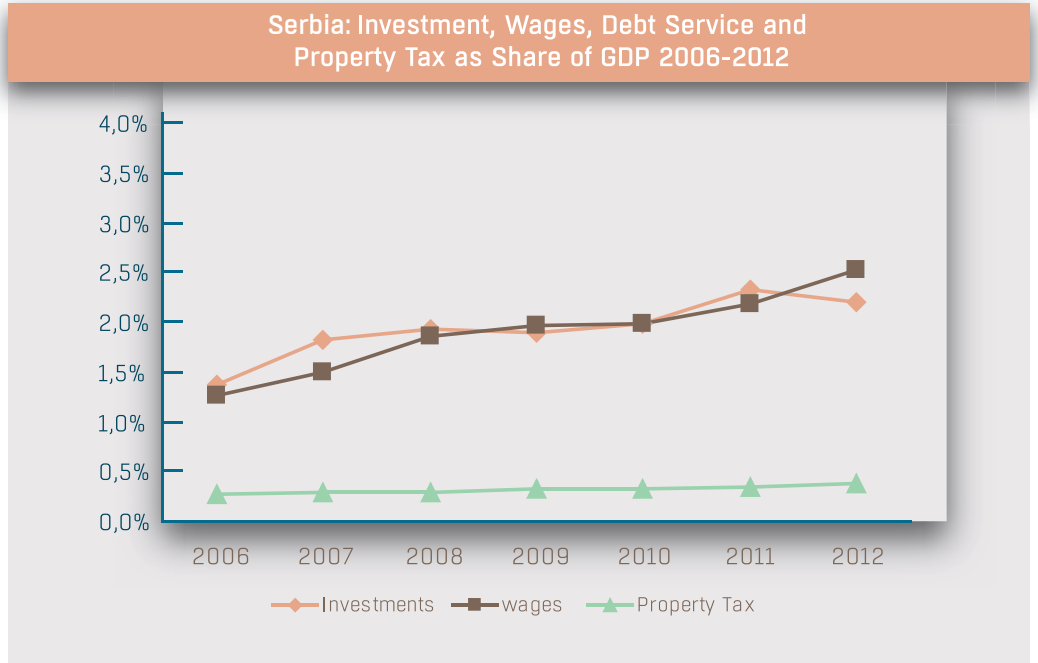


Chart 60 below suggests that despite the worsening of the financial position of local governments since 2009, municipalities continue to see the maintenance of wages and employment as one of their key functions.

Chart 60



Slovenia

In the first years of the financial crisis Slovenian municipalities didn't suffer from the overall downturn in the economy. But In 2011, municipal revenue decreased for the first time, declining 5.5% while total expenditure fell 9%. In 2012, because of the persistence of the crisis, Parliament adopted austerity measures which affected municipalities as well. On the revenue side, the national government reduced the needs calculation for determining the amount of shared taxes going to local governments by 3.7%. It also froze the national governments share of investment co-financing to the already reduced levels of the previous year. On the expenditure side, the austerity measures included a reduction in the wages of public servants. But there was also an increase in some social transfers. As a result, municipal expenditures decreased by less than 1%.

In 2012, the Government and the municipal associations also signed an agreement to further reduce the needs indicator for calculating the local government share of shared taxes in 2013 and 2014, essentially requiring municipalities to lower expenditures. Also, in 2013 additional measures for the consolidation of public finances placed new expenditure burdens on municipalities. These included

an increase in the VAT rate, a rise in social transfers and a further reduction in the co-financing of local government investment by the national government. Only the state-mandated reduction of public sector wages worked in the opposite direction.

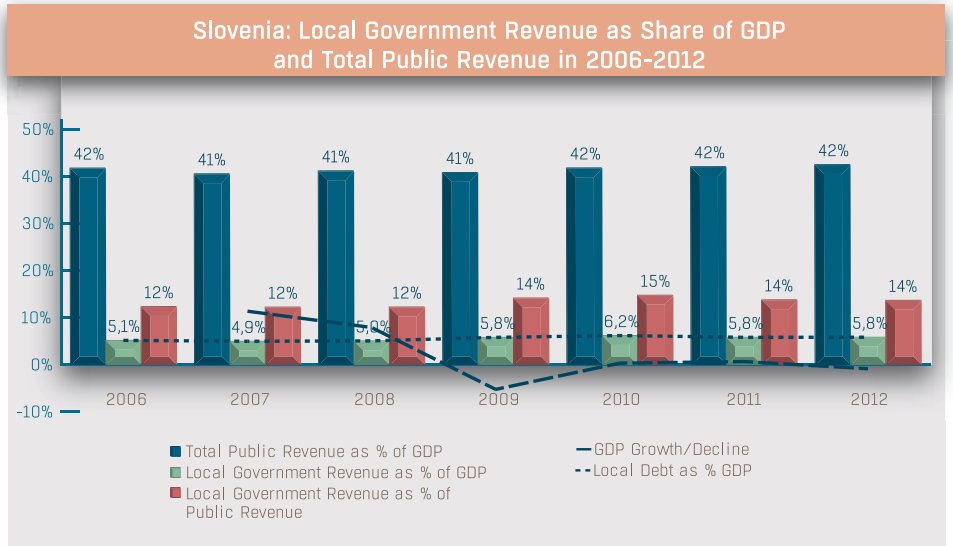
At the end of 2013, the national government adopted a new Law on Real Estate Taxation. The Law eliminates the Land Use Fee, a charge that formerly was completely under municipal control and which generated 9% of local government revenues. The Law also transformed the Property Tax into a shared tax that will be fully administered by the national government, and whose yield will be divided 50/50 between local governments and the state. Municipalities will no longer have the right to determine the base of the tax or to make exemptions, though they will retain the right to set the rate within centrally set norms. The new Law on Real-Estate Taxation thus significantly reduces the fiscal autonomy of municipalities.

The fiscal pressures generated by the financial crisis have also led to proposals to consolidate local governments in order to improve the economic efficiency of the public sector. The Ministry of the Interior, the competent authority for local governments, has stated that there are too many small municipalities with limited governance capacities, and in the summer of 2013 proposed a territorial reform that would eliminate all municipalities with fewer than 5,000 inhabitants. This would cut the number of municipalities in half (from 212 to 122) and the reform was planned to be introduced before the local elections in autumn 2014. After serious criticism of the proposal by municipalities, the associations, independent experts, as well as protests by mayors and a series public conferences the proposal was withdrawn. Instead, the Ministry of Interior promised to develop a more strategic approach to institutional and territorial reform that would include objective analysis, wide discussion, and consultation. This strategic approach is expected to be completed by 2018.

Statistical Overview of Local Government Finance in Slovenia 2006-2012

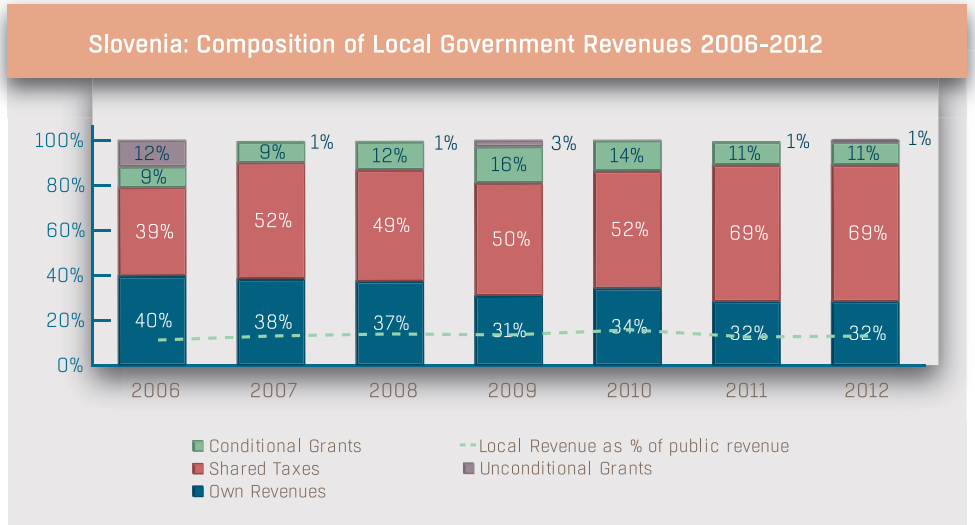
As can be seen from Chart 61 below, the overall size of the local government sector in Slovenia increased from about 5% of the GDP in 2006 to close to 6% of the GDP in 2009 and has remained at about this level despite the recession of 2009 and the indifferent performance of the economy since then. This suggests that the national government has been distributing the costs of the economic adjustment reasonably fairly between levels of government. Local government debt as percentage of GDP is at c. 5% of the GDP, high for the region. But it has also proven remarkably stable.

Chart 61



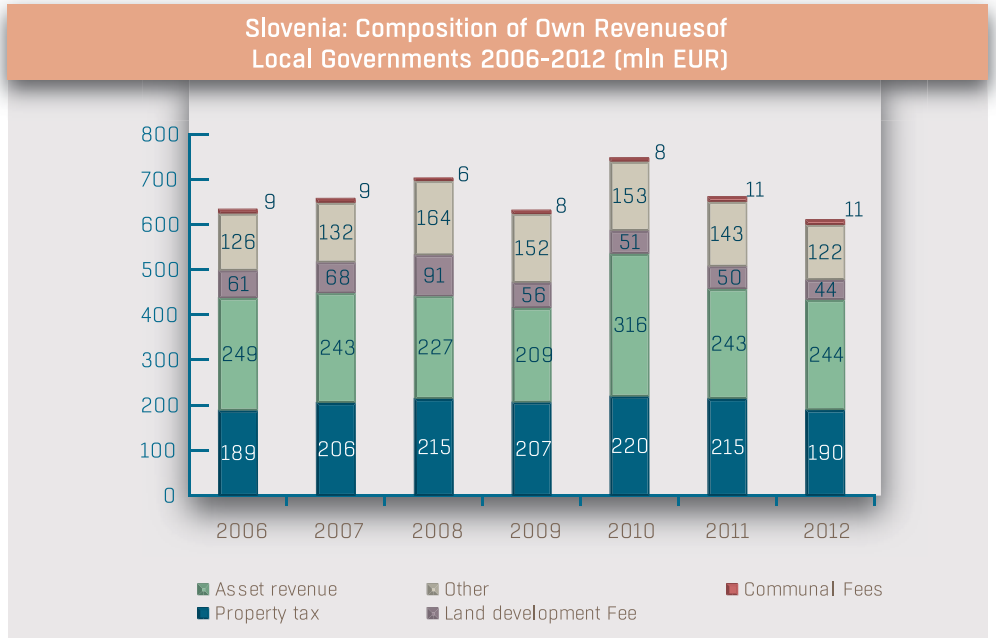
As can be seen from Chart 62 below, Slovenian local governments are heavily dependent on PIT sharing for most of their revenues, and since 2007 freely disposable equalization grants that provide additional revenues to poorer local governments have been reduced. Instead, weaker local governments are given additional increments of PIT.

Chart 62



As can be seen from Chart 63 below, local government own revenues have performed roughly in line with the economy as a whole. Slovenian municipalities derive an unusually large share of their revenues from the sale or rental of assets and the yield of the Property Tax has been significant but with no clear upward trend. The 2013 elimination of the Land Use Fee (c. 60 million EUR and included in the Chart below within the category other) and the centralization of the Property Tax will obviously reduce both local government revenues and their fiscal autonomy if not accompanied by other reforms (like introducing a PIT surcharge).

Chart 63



As can be seen from Chart 64 below, Slovenian local governments have managed to devote more than 40% of their expenditures to investment every year except for the last two. At the same time, their share of spending on wages is remarkably low, while the share going in subsidies to companies is surprisingly high. This suggests that at least some wage spending is being carried out by off-budget service providers that need municipal subsidies to pay their wage bills.

Chart 64

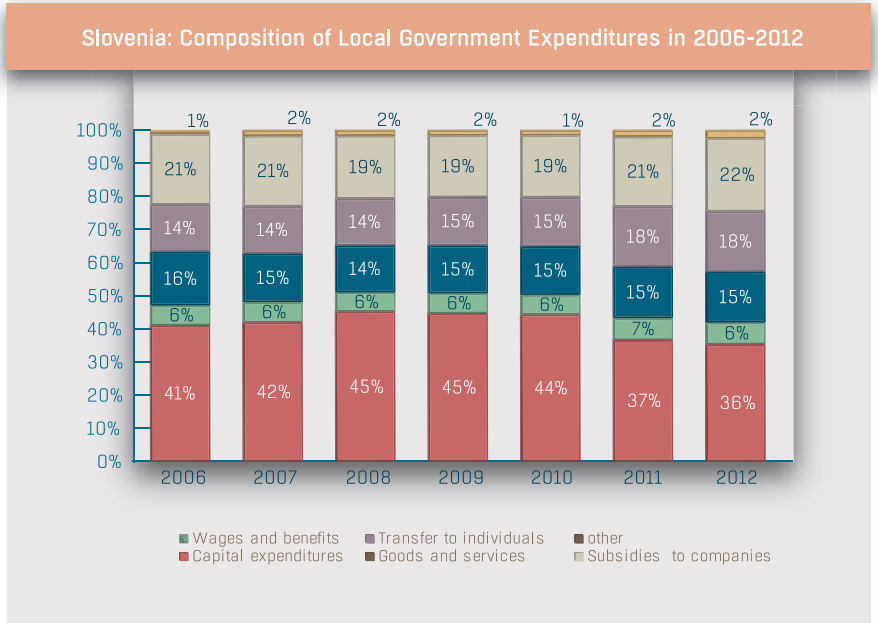
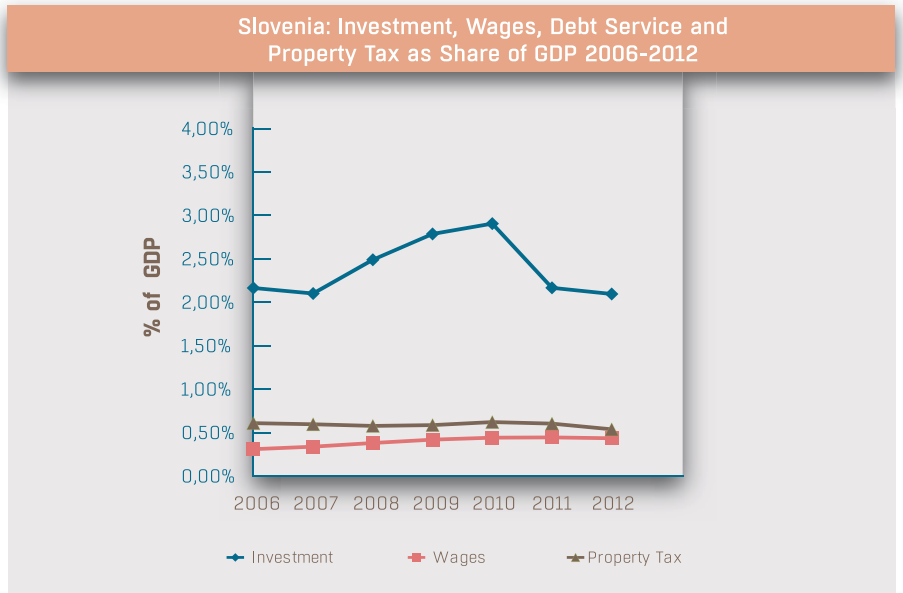


Chart 65, highlights again Slovenia's combination of robust local investment and low wage spending.

Chart 65



Turkey

Turkey is divided into 81 provinces whose capitals are the seat of the state administration and which are under the authority of a governor appointed by the national government. Within provinces there are districts, headed by a sub-governor, and four levels of democratically-elected decentralized government: Special Provincial Administrations (SPAs) which serve unincorporated areas within the province, villages, municipalities and metropolitan municipalities. Metropolitan municipalities are two level local governments composed of democratically-elected district or sub-municipalities and a separate, democratically-elected city wide authority.

In 2012, the government passed a new Law on Metropolitan Cities. This law will go into effect with the local elections of March 2014. The law will increase the number of metropolitan municipalities from 16 to 30. In provinces with populations above 750,000 people the SPAs will be eliminated and replaced by Metropolitan Municipalities, effectively making all other local governments sub or district municipalities of the new metropolitan jurisdictions.

The law will also increase the minimum population size for municipalities to 5,000. This means that smaller settlements in provinces with populations larger than 750,000 people will have all their basic functions performed by the new metropolitan municipalities. Meanwhile in provinces smaller than 750,000 these settlements of less than 5000 inhabitants will continue to be served by the SPAs.

Inter-municipal associations, particularly those concerned with water distribution, are strongly encouraged by the central government in rural areas. There are also efforts to set up programs in municipalities and provincial administrations designed to improve efficiency and promote innovation. The new Law on Metropolitan Cities also extends the functions and the authority of the metropolitan level over district or sub-municipalities, while keeping an institutional balance between the two levels.

The decade between 1990 and 2000 was economically, financially, and politically unstable for Turkey. Despite signing the European Charter of Local Self-Government in 1992, Turkey did not make substantial improvements in its intergovernmental finance system until the early 2000s. Then, several reforms were carried out to promote local self-government and the development of a modern system of local public administration. These included the 2004 Law on Metropolitan Municipalities, the 2005 Law on Municipalities and the 2005 Law on Special Provincial Authorities.

This package of institutional and fiscal reforms had a positive effect on the development of local government and on the country's overall economic performance. The amount of shared taxes going to local governments was increased, as were their competencies and powers. The central government's administrative supervision over local governments was also relaxed politically, financially, as well as in personnel matters.

The global financial crisis of 2009 hit the country with medium severity. The GDP contracted by 4.5% in 2009. But recovery had already begun in the second quarter of the same year, and growth continued for next few years. So Turkey is among the countries that has been least affected by the recent global economic uncertainties. Moreover, the crisis most mostly affected private consumption and investment in 2009 and had limited impact on the public sector, especially on local governments. In 2009 and 2010, however, the

government reduced the rates for VAT and the Special Consumption Tax to stimulate economy.

The new Law on Metropolitan Cities will change how shared taxes are allocated to local governments. SPAs with populations larger than 750,000 people will get nothing, while those with less than 750,000 will see their share of the general budget reduced from 1.15% to 0.50%. In metropolitan areas, the share of the general budget going to metropolitan municipalities will go from 5% to 6% but the money that the previously went to SPAs in these areas will disappear. District municipalities within metropolitan municipalities however will see their share of national budget revenue increase from 2.5% to 4.5%.

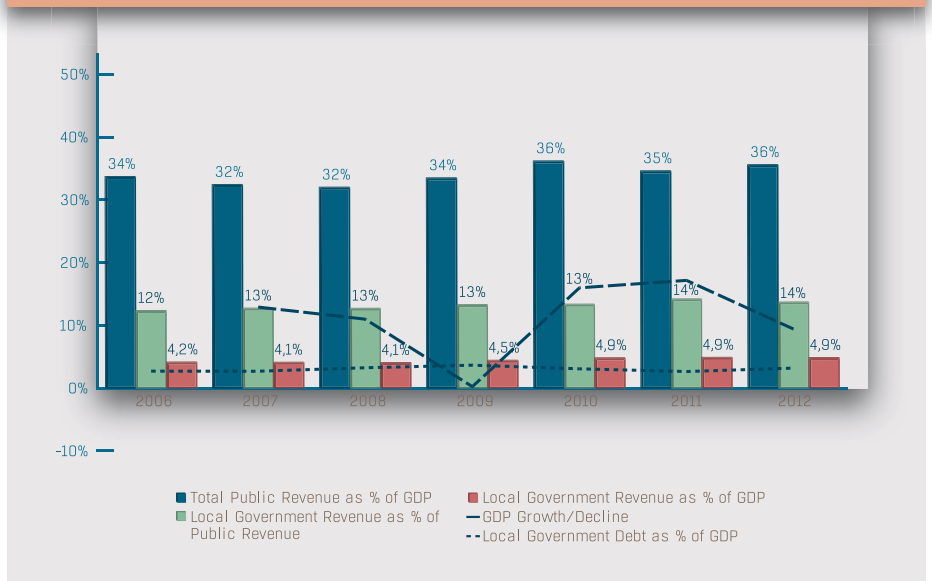
The objectives of the new Law are to increase the quality of services, as well as to extend the subsidiarity principle after the 2014 elections; the current Metropolitan municipalities will see a 16% increase in their revenues while the total public revenues of the areas under the new metropolitan municipalities will increase 54% in comparison to the situation before provincial borders become their municipal borders (service areas).

Statistical Overview of Local Government Finances in Turkey

As can be seen from Chart 66 below, local government revenue as a share of GDP has increased modestly over the last seven years, as has local government revenue as a share of total public revenues. This growth was not affected by the economic downturn 2009. Local government debt, including here unpaid liabilities to suppliers and contractors has also been stable and now stands at about 3.2% of GDP.

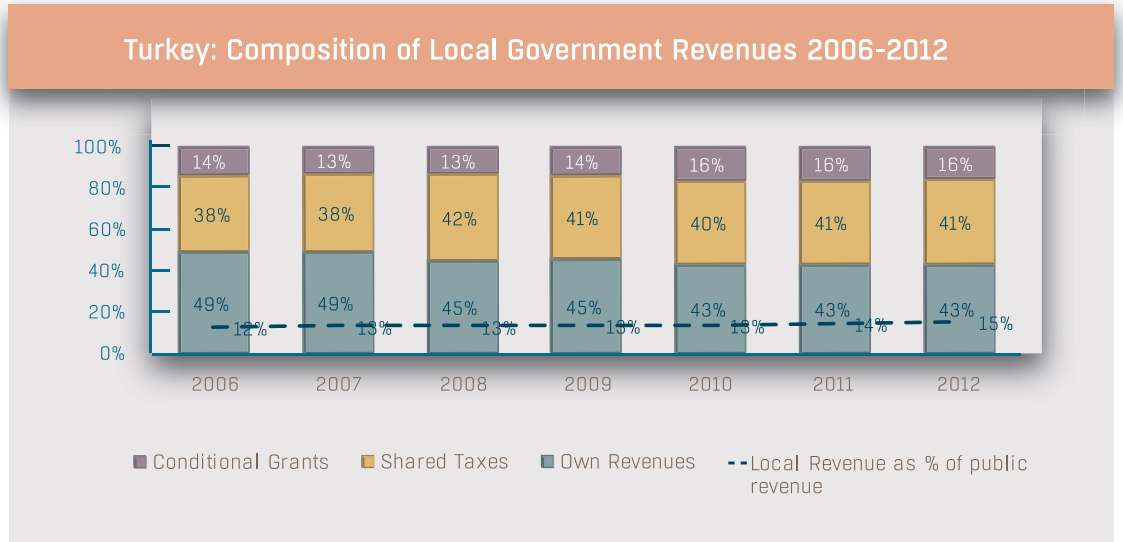
Chart 66

Turkey: Local Government Revenue as Share of GDP and Total Public Revenue in 2006-2012



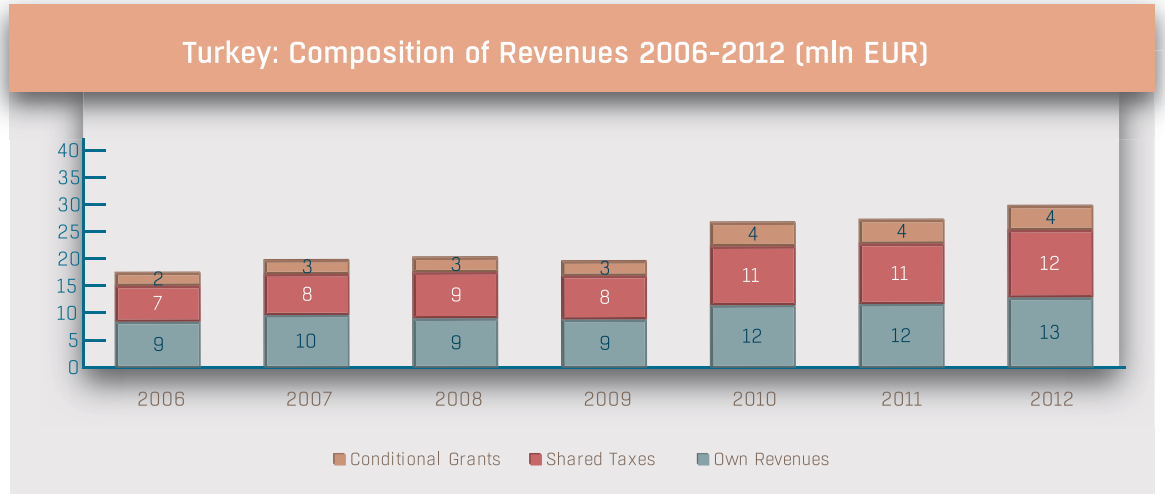
The composition of local governments revenues has also exhibited relatively little change between 2006 and 2012, though the share of revenues coming from own sources has decreased slightly. As we have noted earlier, the category of shared taxes in Turkey includes an unconditional equalizing grant that cannot be easily extracted from the data we have.

Chart 67



As can be seen from Chart 68 below, all categories of revenues increased in EUR terms in 2010 with the return of strong economic growth. Turkish local governments have also managed to improve the mobilization of own-source revenues, about 20% of which comes from property taxes.

Chart 68



Local government investment as a share of total expenditure has declined since 2006 but remains over 30%. More importantly, the absolute amount of annual local government investment has risen from 7.4 billion EUR in 2009 to over 10 billion EUR in 2012. Wages as a share of total expenditures have also declined while expenditures on good and services have increased. Why exactly this is the case is unclear, but it suggests that many Turkish governments outsourcing the provision public goods to commercialized providers.

Chart 69

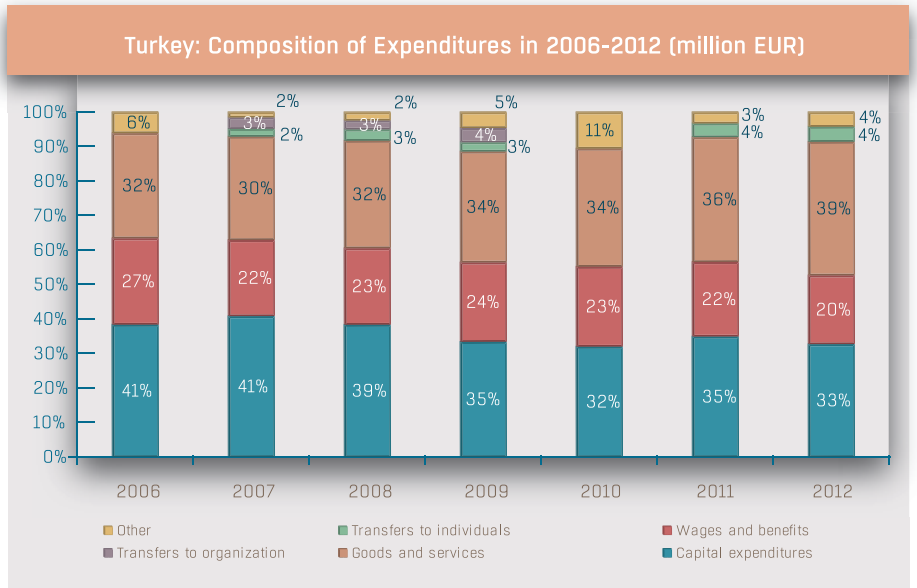
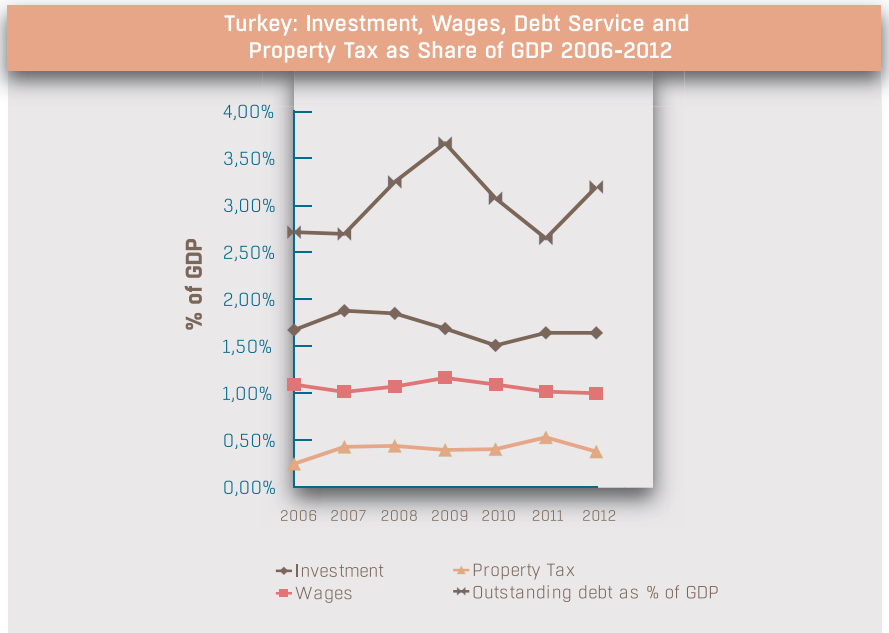


Chart 70



Albania

Chart 71

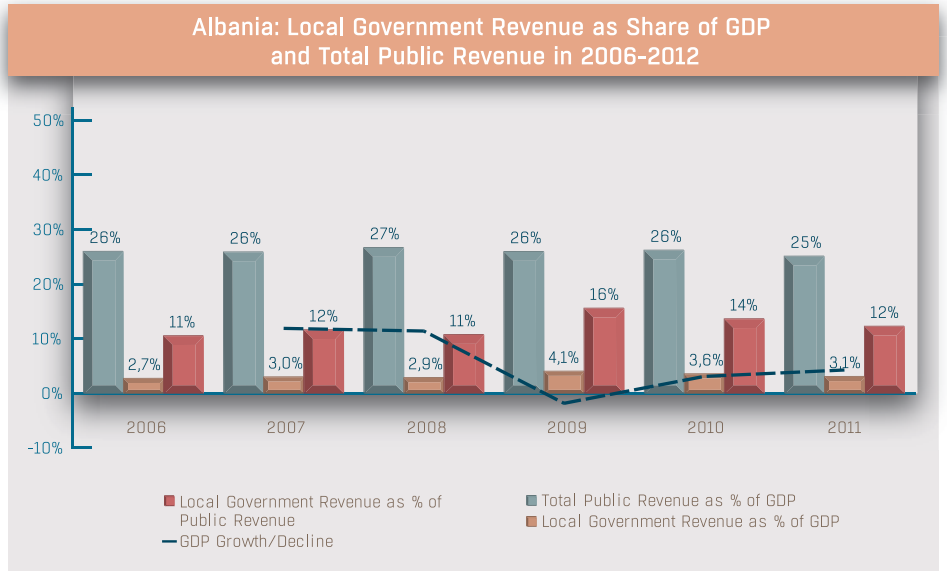


Chart 72

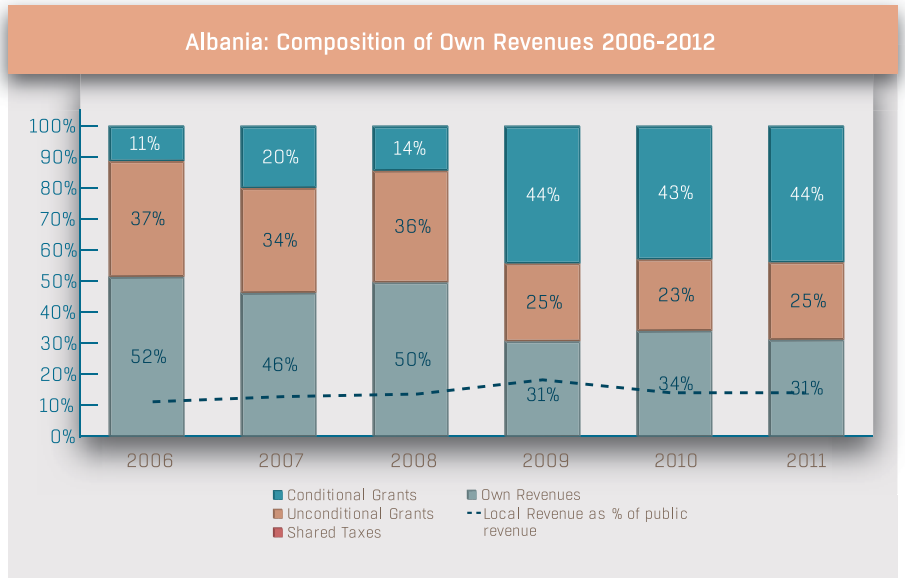
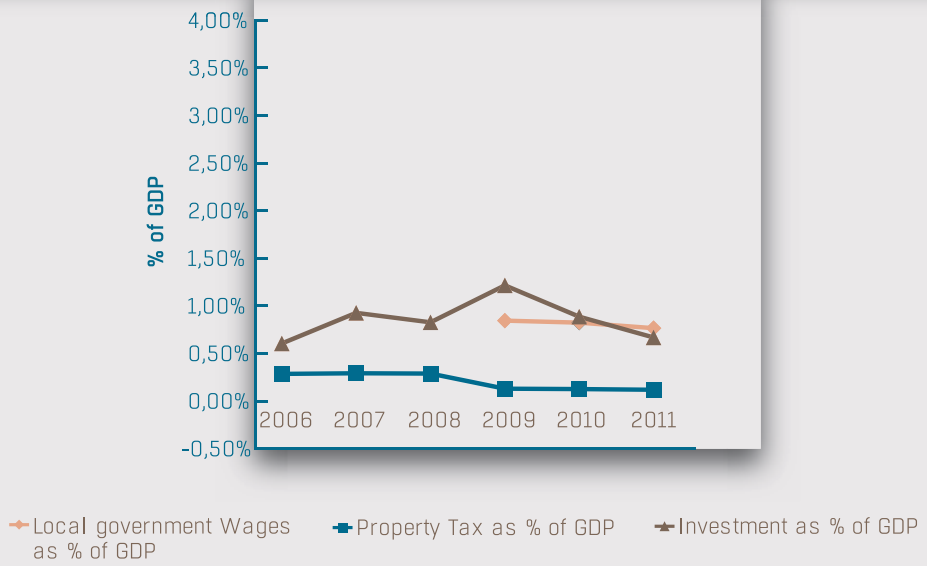


Chart 73

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



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CIP - Каталогизација во публикација
Национална и универзитетска библиотека "Св. Климент Охридски", Скопје

336.14:352(4-12)"2006/12"(047)

FISCAL decentralization indicators for South-East Europe : report
: 2006-2012 / [authors Levitas Anthony .... [и др.]. - 3. ed. -
Skopje : Network of Associations of Local Authorities of South-East
Europe - NALAS, 2014. - 96 стр. : граф. прикази ; 21 см

Фусноти кон текстот

ISBN 978-608-4680-02-4
1. Levitas, Anthony [автор]
а) Фискална децентрализација - Локална управа -
Југоисточна Европа
- 2006-2012 - Извештаи
COBISS.MK-ID 95975690