REPORT

NALAS

Network of Associations
of Local Authorities
of South-East Europe

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REPORT

Fiscal Decentralization Indicators for South-East Europe

Ninth Edition
February 2024

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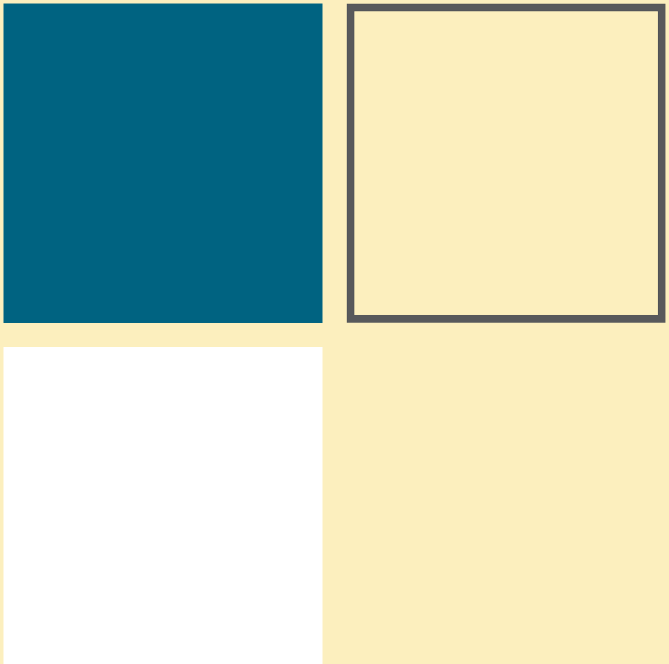

CONTENT

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ABBREVIATIONS

AAM	Association of Albanian Municipalities
ACoR	Association of Communes of Romania
ADA	Austrian Development Agency
AKM	Association of Kosovo Municipalities
AL	Albania
ALAA	Association of Local Autonomy of Albania
ALB	Albania
ALL	Albanian Lek
ALVRS	Association of Towns and Municipalities of Republic of Srpska
AOC	Association of Cities in Croatia
AUT	Austria
BACID	Building Administrative Capacities in the Danube Region
BG	Bulgaria
BGR	Bulgaria
BiH	Bosnia and Herzegovina
CALM	Congress of Local Authorities from Moldova
CIT	Corporate Income Tax
COFOG	Classification of the functions of government
COVID	Coronavirus disease
EFDF	Equalization Fund for Decentralized Functions
EU	European Union
EUR	Euro
FBiH (BiH)	Federation of Bosnia and Herzegovina, Bosnia and Herzegovina
FEF	Fiscal Equalization Fund
GDP	Gross Domestic Product
GG	General Government
GoA	Government of Albania
HLG	Higher Levels of Government
HR	Croatia
HRV	Croatia

IFI	Independent Fiscal Institutions
IIT	Infrastructure Impact Tax
KDZ	Centre for Public Administration and Research, Austria
LDF	Land Development Fee
LG	Local Government
LGA	Local Government Association
LGU	Local Government Unit
LLGF	Law on Local Self-Government Finance
LLTS	Law on the Local Tax System
LPA1	Local Public Administration Level 1
LPA2	Local Public Administration Level 2
LSG	Local Self-Government
LSGU	Local Self-Government Unit
LUF	Land Use Fee
MD	Moldova
MDA	Moldova
MK	Macedonia
MKD	North Macedonia
MMU	Marmara Municipalities Union
MNE	Montenegro
MoF	Ministry of Finance
MoFE	Ministry of Finance and Economy
MTEF	Medium-Term Expenditure Framework
NALAS	Network of Associations of Local Authorities of South-East Europe
NALAS	Network of Associations of Local Authorities in South-East Europe
NAMRB	National Association of Municipalities in the Republic of Bulgaria
NGO	Non-Governmental Organisation
OECD	Organisation for Economic Co-operation and Development
OECD	Organization for Economic Co-operation and Development
OSR	Own Source Revenues
PAR	Public Administration Reform
PFM	Public Finance Management
PIFC	Public Internal Financial Control
PIT	Personal Income Tax

PUCs	Public Utility Companies
RDF	Regional Development Fund
RKS	Kosovo*
RO	Romania
ROU	Romania
RS	Serbia
RS (BiH)	Republic of Srpska, Bosnia and Herzegovina
RSD	Serbian Dinar
SBT	Small Business Tax
SCTM	Standing Conference of Towns and Municipalities
SDC	Swiss Development Cooperation
SDC	Swiss Agency for Development and Cooperation
SEE	South-East Europe
SI	Slovenia
SIDA	Swedish International Development Agency
SNG	Subnational Government
SOGFBIH	Association of Municipalities and Cities of the Federation of Bosnia and Herzegovina
SOS	Association of Municipalities and Towns of Slovenia
SRB	Serbia
STCM	Standing Conference of Towns and Municipalities
SVN	Slovenia
TAR	Territorial and Administrative Reform
TK	Türkiye
TUR	Türkiye
UNDP	United Nations Development Program
UoMM	Union of Municipalities of Montenegro
USAID	United States Agency for International Development
VAT	Value Added Tax
WB6	Western Balkans
ZELS	Association of the Units of Local Self-government of Republic of Macedonia

* This designation is without prejudice to positions on status, and is in line with UNSCR 1244/1999 andthe ICI Opinion on the Kosovo declaration of independence

THE REPORT IN BRIEF

The ninth edition of the NALAS fiscal decentralization report captures the development of local finance in South-East Europe (SEE) for the period 2006 – 2021, explores recent regulatory changes and compares the different economies' performance related to (fiscal) decentralization indicators. The report provides an analysis of the intergovernmental fiscal relations in each of the SEE economies, as well as on local government own revenue raising capacities – identifying the major developments and challenges faced by local governments as regards the collection of local taxes, fees and charges.

The report has several purposes but the most important one, expressed by the NALAS member Local Government Associations (LGAs), is to provide guidance to the national counterparts while assessing various policy options in municipal development. The report includes a section on the key advocacy efforts of NALAS member LGAs. From this perspective, the report's findings and conclusions might be a powerful tool for informed policy choices and their possible outcomes.

The current edition of report puts more emphasis on the **COVID-19 pandemic implications** on municipal finances, both from a legislation and volume perspective as well as on the rules and magnitude of **municipal borrowing and local government debt** in South-East Europe.

The region remains quite diverse in terms of territorial organization – the number of subnational levels of governance varies from one to three (*BiH, Moldova and Türkiye*) in the different economies. The total number of 1st tier local governments (the closest to the citizens) is 6,996 but varies greatly— from 25 in Montenegro to 3,181 in Romania. The average population of 1st tier local governments in SEE is 27,679 and, compared to the EU27 average of 5,075, seems to be very favorable (*other things being equal*) for decentralization efforts. However, if we exclude the capital cities, the average population of the municipalities will be much lower (and much closer to the real status of the typical municipality). For example, if Belgrade is excluded, the average size of the Serbian municipalities would be 37,500 inhabitants – almost 11,000 inhabitants less. The diversity among SEE economies in not surprising at all, as the EU is quite diverse as well – of almost 90,000 municipalities in the EU, nearly 80% are located in just five countries: 41% in France, 13% in Germany, 9% in Spain and Italy, and 7% in the Czech Republic.

The SEE region follows the European trend of concentration of people in the capital and metropolitan cities but for a number of SEE economies (*Albania, Serbia, North Macedonia, and Montenegro*) this trend is worrisome – as between 20—30% of their population live in the capital cities. The oversized importance of capital cities poses a number of issues, which, in general, work against decentralization. This trend is not unique to SEE– in the EU as well, a large share of the population (16.3%) lives in capital cities. The size, technical capacities and political weight of capital cities implies they can be entrusted with more functions, which cause significant tensions over the intergovernmental finance system.

Over the past decade, demographic developments have been particularly challenging for South-East Europe and the Western Balkans. Overall, between 2012-2021, based on Eurostat data, the population of SEE increased by 5.7 mln. (4.4%). The increase rate seems to be more than three times the one in the EU (1.5%, or 6.5 mln), however, the increase is driven entirely by Türkiye (+12%; 8.9 mln), as in almost all SEE economies the population has declined - on average by 5%. In the Western Balkans, between 2012-2021, the population decreased by 4% (0.7 million). Migration and brain drain are fundamental development challenges for all the SEE economies. Besides the economic and social implications, emigration, low birth rates and an aging population have profound implications for the types of services that the central and local governments in the region must provide now and, in the future, and as a result on the intergovernmental fiscal relations and multi-level governance at national levels.

The COVID-19 pandemic has posed significant challenges for the SEE region, much greater than the ones from the 2008-2009 global financial and economic crisis. The decline in real GDP rates is higher during the outbreak of the COVID-19 pandemic in 2020 than in the global financial and economic crisis of 2008, except for Slovenia, Romania and Serbia who seem to have been able to weather rather well the economic downturn. Economic activity rebounded in all SEE economies in 2021. Given the downfall of 2020, growth rates are particularly high, although varying significantly across the region.

The decline in economic activity from the COVID-19 pandemic brought a severe decline in public revenues for South-East Europe. In 2020, total general government (public) revenues fell by an average of 4% in annual terms in SEE. The decline in public revenue has been more severe in Montenegro, with a sharp fall of 13%, followed by -9% in Kosovo*[1] and -8% in North Macedonia. The fall in total public revenues in tandem with an already declining fiscal space has influenced the scale in which central governments compensated local governments for the COVID-19 related increased service costs and declining revenues. However, in the majority of SEE economies, the national governments have intervened and provided financial support to local authorities.

The decline in overall public revenues from the COVID-19 pandemic led to a decline in local government revenues – although in smaller scale. Overall, the COVID-19 crisis interrupted a five-year sequence growth in local government revenues of on average 5% per annum in SEE (excluding Türkiye) and 7% per annum in the WB. Total local government revenues have fallen in particular in Bosnia and Herzegovina and Montenegro, at the level of 6% in annual terms, and to a lesser extent in Croatia and Albania with about 3% and 2% respectively in annual terms between 2019-2020.

The COVID-19 pandemic impact was most severe on own revenues of local governments. In fact, the collection of own taxes, fees and charges fell on average by 7% in SEE and 10% in the Western Balkans (WB). Local government own revenues fell by 20% in North Macedonia in 2020, followed by -16% in Kosovo and Türkiye. Local government own revenues did not decline in 2020 only in Romania. The fall in own revenue is directly related to the weakening of the tax base due to the COVID-19 pandemic, in terms of the ability of taxpayers to pay local taxes, and tax exemptions granted by local governments to support their constituencies. Ultimately, both total public revenues and local government revenues have recovered in 2021 in South-East Europe by an outstanding 18% and 13% respectively over 2020.

Local government responsibilities in South-East Europe vary across the different economies. Despite the variety and the funding sources, the function which has the greatest significance for SEE local governments is education. In Moldova (all subnational levels included) and Kosovo its share is more than 50% in Bulgaria it is 42% and in Albania, Austria, Serbia, and Slovenia it is equal or close to 20%. The local governments of the other economies have lower but still significant shares in funding education. The only exception is Türkiye where the state funds the education system directly. Austrian, Romanian and Kosovar local governments have also significant responsibilities in healthcare. There is, however, considerable variation in whether these social sector functions performed by local governments are legally defined as an 'own', 'shared' or 'delegated' responsibility. In theory, 'own' functions should be financed primarily by local government general revenues, delegated functions by categorical grants, and shared functions by some mixture of the two. These general

[1] * This designation is without prejudice to positions on status, and is in line with UNSCR 1244/1999 and the ICJ Opinion on the Kosovo declaration of independence.

principles, however, are frequently blurred in practice. For a more comprehensive analysis of the regulation and financing of decentralized social sector responsibilities in SEE, please refer to the Eighth Edition of the NALAS Report: Social Welfare at the Intersection of Municipal Finance and Governance in South-East Europe.

On average, EU economies have both larger public sectors and have decentralized more revenue to local governments than their counterparts in SEE. While there has been significant progress over the past decade, the average size of the public sector in SEE continues to lag far behind the EU average. Public revenues in SEE were at 36.2% of GDP, whereas the EU average was 46.9% of the GDP in 2021. Albania, Kosovo and Türkiye continue to have the smallest public sectors, with public revenues at 27-28% of the GDP. Moldova, Romania and North Macedonia have similar size of the public sector between 32-33% of the GDP, while Croatia, Serbia, Montenegro, Slovenia, Bosnia and Herzegovina have levels similar to the EU-average, while Austria's public revenues are higher than those of the EU-average. Despite the small public sector, local governments in Kosovo, Moldova and Romania receive 26-27% of all public revenues. Only Romania has a slightly better indicator – 26.5%. All the others' performance is below the EU average of 24.4%. Albanian and Turkish local governments have the lowest shares of public and local revenues-to-GDP.

Despite similarities in service responsibilities, local governments in SEE have significantly less revenue than their EU counterparts. On average, in 2021, SEE local government revenue was 6.1% of GDP versus 11.4% of the GDP in the EU. In per capita terms, SEE local governments have seven times less revenue than their EU counterparts. In 2021, SEE local governments disposed of 558 EUR per capita, versus 3,718 EUR per capita of EU local governments – showing with how little revenue local governments of most SEE have to work with, especially when compared to their EU counterparts. Even in the richest one, Slovenia, local governments get more than 3 times less than their EU counterparts.

Within South-East Europe itself, there are wide differences and disparities in terms of financing local government services. Across the region the variation is also striking – Slovenia's local governments are more than 5 times richer than the poorest ones – those in Moldova which get 206 € per capita. It is also particularly staggering that local governments in Moldova, Kosovo, and Macedonia pay for teachers' wages on per capita revenues of less than 316€, while Croatian and Slovenian municipalities bear little of these costs and have per capita revenues 3 to 4 times higher.

Over the past 15 years, local government revenues have increased in only about half of SEE economies. This seems to be the case for Kosovo, North Macedonia, Austria, Albania and Bulgaria where local government revenues as a hare of GDP has increased. In the other cases, local government revenues as a share of GDP are either at the same level as in 2006 or 2009 (Slovenia, Serbia, Romania, Croatia) or lower than that (Türkiye, Bosnia and Herzegovina, Montenegro and Moldova).

Fiscal autonomy in SEE is declining as SEE local governments have less and less autonomy over their budgets. On average, the share of local budgets under the full discretion of local authorities has declined. In 2021, own revenues, shared taxes and the general grant constituted 70% of local budgets, as opposed to 83% in 2006. Similarly, earmarked block grants and investment grants constituted only 17% of total local government revenues in 2006, while their share has jumped to 30% in 2021. In other terms, looking at the individual revenue streams, the share of own source revenues in 2021 has decreased by 25% compared to 2006, while the share of shared taxes has decreased by 12%, while more worryingly, the share of the block grants has increased by 87% and conditional investment grants have increased by 58% compared to 2006. Fiscal autonomy is fundamental for local governments to be able to tailor decision making for service delivery to the needs and preferences of local constituencies and therefore a fundamental ingredient for the efficiency and democracy gains expected from decentralization.

Local government's own revenue raising powers and ability vary significantly across South-East Europe. On average, own source revenues in SEE in 2021 constitute 33% of total local revenues. In the six economies of the Western Balkans, own local government revenues constitute between 33% to 67% of total local government revenues in Montenegro, Albania, Serbia, Bosnia and Herzegovina and North Macedonia. Given the extensive responsibilities in the social sector, in Moldova, North Macedonia Kosovo, Bulgaria and Slovenia, sectoral block grants make up the most important part of total local government revenues, ranging between 45-60% of total LG revenues. However, except for Kosovo and Romania, the share of own source revenues to total local government revenues has declined by 3-12% in South-East Europe over the past 15 years.

The composition of local government own source revenues has changed dramatically over the past 15 years. The share of the property tax revenues has doubled in the Western Balkan economies, from an average of 14% to 28% of own source revenues, indicating, across the region, that more effort is put into the collection of the property tax. As expected, at the broader SEE level, the share of the property tax revenues has increased, but at a more moderate pace from 20% to 27% of total own source revenues. This tendency is driven by the outstanding performance of Bulgaria, North Macedonia, Montenegro and Serbia and to a lesser extent Kosovo and Slovenia. Taxing new construction is an important source of revenue for local governments in Albania, Kosovo and Montenegro, while the land development fee has been eliminated in Serbia. From a regional perspective, local government powers to set and collect taxes, fees and charges are in continuous change – sometimes without a due process of consultation and/or compensation. Local taxes, fees and charges are amended quite frequently, and this is done mostly under the general expectations to improve business climate by reducing fiscal burdens to taxpayers. Unfortunately, this depresses local governments revenues and efforts too.

There remain wide disparities in the property tax powers and collection efforts and success in SEE local governments. Moldovan LGs' revenues from the property tax are again the lowest for the entire region with only 9 Euro per inhabitant, while Slovenian LGs collect 150 Euro per inhabitant. There are wide disparities also within the Western Balkan Economies, where Albanian LGs, despite recent reforms to move to a market value system of property taxation, still collect about half of what is collected by Macedonian LGs and about 5 times less than the amounts collected by Serbian LGs. SEE local governments continue to face similar challenges with regard to own revenue generation, regardless of the level of development and their membership in the EU. The key challenges include the frequent and continuous amendment of the legal framework, outdated fiscal registers, weak tax compliance and enforcement etc.

In most of the SEE region, local government borrowing remains a relatively new and under-utilized instrument for financing local governments. Only in Republic of Srpska (of BiH), Austria, Türkiye, Croatia and Montenegro local government borrowing constitutes above 2%— 4% of GDP. Borrowing represents a negligible fraction of local government financing in Albania, North Macedonia and Moldova, while in Slovenia, Romania, Serbia and Bulgaria and the Federation of Bosnia and Herzegovina (of BiH), local borrowing is more substantial. One of the main constrains for this important source of financing, in particular for long term capital investments, (besides other factors like very conservative, rigid and centralized regulatory framework), are high levels of public debt, budget deficits and the need (or plan) to try meet the Maastricht Treaty's guidelines for total public debt and annual budget deficits (*less than 60% and 3% of GDP respectively*). Although it is important to note that municipal debt constitutes a very small portion of public debt in South-East Europe – only 2.5% of the total, at the regional level.

There remain significant disparities across SEE LGs in their ability to use debt as a financing instrument to build and improve local infrastructure and services. The key challenges affecting local government access to debt capital are related to stringent regulations that either require prior approval or limit local government borrowing or its annual debt servicing payments; the existing high levels of total public debt that reduce fiscal space; the credibility of local budgets which is curtailed by a reduction of local government revenues, either in the form of own source revenues or intergovernmental transfers; lack of municipal capacities to engage successfully, in the lengthy and costly processes for local government borrowing.

During the COVID-19 pandemic local government debt increased by 84% in the Western Balkans and 36% in South-East Europe. local government debt increased from 0.62% of GDP in 2019 to 1.13% of GDP in the Western Balkans, and from 1.06% to 1.44% of GDP in South-East Europe. Local governments in the region increased access to LG borrowing as a means to face both short-term liquidity constraints due to declining revenues and increasing expenses and at the same time lead efforts for the socio-economic recovery of local communities by capital investments improving services and infrastructure. In 2021, the share of local government debt has declined to 0.94% of GDP in the WB and 1.37% of GDP in SEE.

Local Government in the Western Balkans and South-Est Europe manage between 10% and 25% of total public spending. Additionally, local government expenditure varies from 3% to 9% of the GDP, with averages of 5-6% of the GDP, which is about half of LG expenses in the EU. These significant differences, reflect the differences in service responsibilities and levels of income. Unsurprisingly, in Moldova, Kosovo and Romania, where LGs have extensive decentralized social sector responsibilities in education and to a lesser extent in health and social protection, the share of local government expenditures is higher than elsewhere in the region, and even higher than in the EU.

Local Governments in the Western Balkans and South-East Europe spend about 24-25% of their budgets on capital expenditures for investments. Local governments in Slovenia, Albania, Türkiye, and Montenegro – where local governments have little responsibilities in education, health and social care – spend more on capital expenditures then their peers. Within WB6 and SEE, in the economies that have decentralized social sector functions, local governments spend a higher percentage of their expenditures on wages (*up to almost 60%*). SEE local government spending for goods and services constitutes 20%-22%, for grants and transfers 13-16% while the remaining 6-9% on other categories.

WB6 and SEE local governments spend about 20-25% of total municipal budgets for general public services, about 24% on education, 16-19% on economic affairs and about 14-15% for housing and community amenities. Municipal spending for health, social protection and environmental protection varies between 3-5% each, in the WB6 and SEE. Local governments in Romania, Moldova, Bulgaria, Kosovo, and Austria spend less than their EU counterparts for general public services. Local governments Albania, Serbia, Slovenia and Croatia are closer to the SEE average and those in Türkiye and the Federation of Bosnia and Herzegovina (of Bosnia and Herzegovina) spend much more than their EU counterparts as regards general public administration services. Not surprisingly, in economies where the local governments' wage bill is larger than the EU average, local governments are responsible for costly social sector functions like education.

The infrastructure needs in SEE require increased spending levels thus higher proportions of municipalities' income should be invested in capital infrastructure. Improving the quality of and access to services will require significant upgrades of local public sector infrastructure. This is critical to improving the quality of life and life perspective of SEE and WB6 citizens and to reduce the territorial development disparities within the region and the EU. Local government spending for investment as a percentage of total local government spending is rather similar in Serbia, Austria and the EU, but when it comes to the role of LGs within total public investments, local governments in Serbia play a smaller role than counterparts in Austria and the EU. On the other hand, local governments in Moldova, Romania, Bulgaria, Slovenia and Republic of Srpska have a more important role in total public investment than their SEE counterparts, but they present profound differences when it comes to the weight of investments to total LG spending.

While spending for capital investment has increased in nominal terms, the share of municipal spending on capital investments has been downwardly unstable over the past 16 years. Compared to 2006, the share of municipal spending for capital investments in SEE has decreased from 29% to 25%. Since the global financial and economic crisis of 2008-2009, the share of municipal spending for capital investment has been declining in the decade thereafter to the lowest levels of 22% in 2018. While spending on wages and salaries has a higher rigidity – and cannot be changed swiftly from year to year – spending for capital investments is more volatile. In fact, the latter has had a negative impact on local investment in 2020 and in 2021— spending on capital investments in Euro per capita has declined by an average of 11% in 2020 in six SEE economies, (with a range of -1% to -21%), while in 2021 capital expenses in Euro per capita declined by an average of 15% (with a range of -2% to -27%) in other six economies.

There are wide disparities in the WB6 and SEE region in the ability of LGs to spend for capital investments. On average WB6 LGs spend about 77 Euro per capita on capital expenditures, while the average for SEE is 142 Euro per capita. Austria, Slovenia, Romania, and Croatia have the highest levels of capital expenditures in per capita terms. Being EU members, LGs in these economies can benefit from substantial investment funding as opposed to the WB6 economies. In per capita terms LG spending for capital investment seem to be similar in Bulgaria and Montenegro, two economies where LGs have significantly different competences.

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

The first edition was published in March 2011 and covered the years 2006-2010. This ninth edition covers the period 2006-2021 and, compared with the previous one, includes data for both 2020 and 2021. As before, the report tries to do both, capture regional trends and major developments in particular in the aftermath of the COVID-19 pandemic and the multiple crisis facing LGs.

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

Overview of Territorial Organization, Demographics and Economy in South-East Europe

Number and types of subnational governments

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

Table 1. Number and Types of Subnational Governments

	Levels of Subnational Government	Types of Subnational Government	Number of Municipalities	Second- & Third-Tier/Regional Level
Albania	2	Counties; Municipalities	61	12
Austria	2	States, Cities, Municipalities	2,093	9
Bosnia and Herzegovina	3	Entities; Cantons; Municipalities	144	11
FBiH (BiH)	2	Cantons; Municipalities	80	10
RS (BiH)	1	Municipalities, Cities	64	
Bulgaria	1	Municipalities/Communes	265	
Croatia	2	Counties; Municipalities/Communes/ Cities	556	21
Kosovo	1	Municipalities	38	
North Macedonia	1	Municipalities	81	
Moldova	3	Autonomous Province; Raions/ Regions; Municipalities/Communes	898	32
Montenegro	1	Municipalities	25	
Romania	2	Counties; Municipalities/Communes	3,181	42
Serbia	2	Autonomous Provinces; Municipalities	145	
Slovenia	1	Municipalities	212	
Türkiye (Marmara Region)	3	Provincial Self-Governments; Regional Self-Government; Municipal and Communal Self-Governments	1,390	793
Western Balkans			494	23
South-East Europe			6,996	911
European Union			89,289	1,176

Albania and Croatia both have democratically elected county level governments. In Albania, the *qarks (counties)* play a very limited role while in Croatia the *zupanije* are more important, though both are small compared to the municipal sector. Albania conducted a significant territorial reform between 2014-2015 reducing the number of first-tier local governments from 373 municipalities and communes to just 61 larger municipalities.

Moldova has three levels of subnational government: 1) The autonomous province of Gaugazia 2) *raions* or districts, and 3) communes and municipalities. *Raion* heads are indirectly elected by *raion* councils but operate under strong central influence. They also exercise significant control over the budgets of municipalities and communes. This blurs the distinction between first- and second-tier governments in Moldova, as well as the distinction between local governments and the territorial arms of the national government. Because education and other social sector functions are still at the *raion* level, Moldova appears to be a highly decentralized small state, but in fact remains quite centralized.

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

In the report, the local revenue and expenditure data for Croatia, Romania, and Moldova include both communes and municipalities (first-tier)**, and second-tier local governments at the county or regional level.**

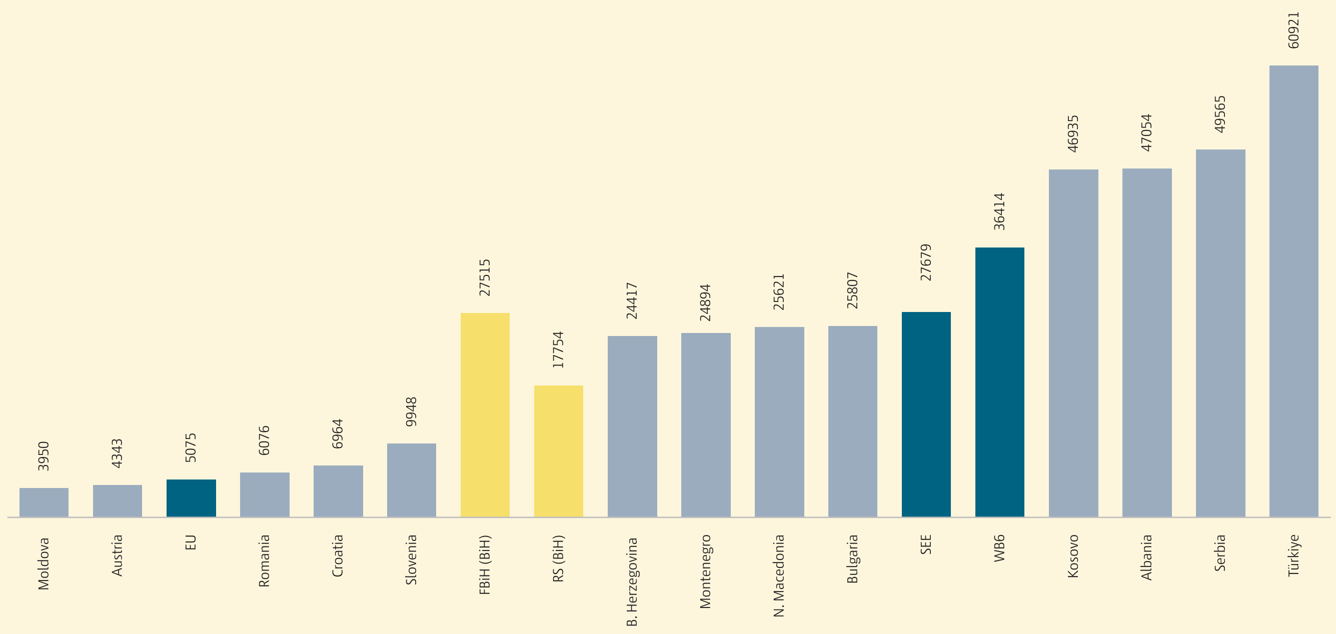
Serbia has two levels of subnational government: 1) provincial and 2) municipal. The financial data in the report refers only to municipalities.

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

Territorial and administrative organization

The average population of first-tier municipal governments differs significantly across SEE. As can be seen from Figure 1, Moldova has the smallest average population, averaging less than 4,000 inhabitants. Municipalities in Romania, Croatia and Slovenia are also relatively small, averaging less than 10,000 inhabitants. After the administrative reform in Albania, significantly reducing the number of first-tier local governments (from 373 to 61), their average size jumped to over 47,000 thus joining Türkiye, Kosovo* and Serbia which have similar average sizes (above 45,000). Nonetheless, the average size of municipalities in the SEE region (roughly 27,000) is significantly larger than the average for the EU (approximately 5,000).

Figure 1 Average Population of First-Tier Local Governments



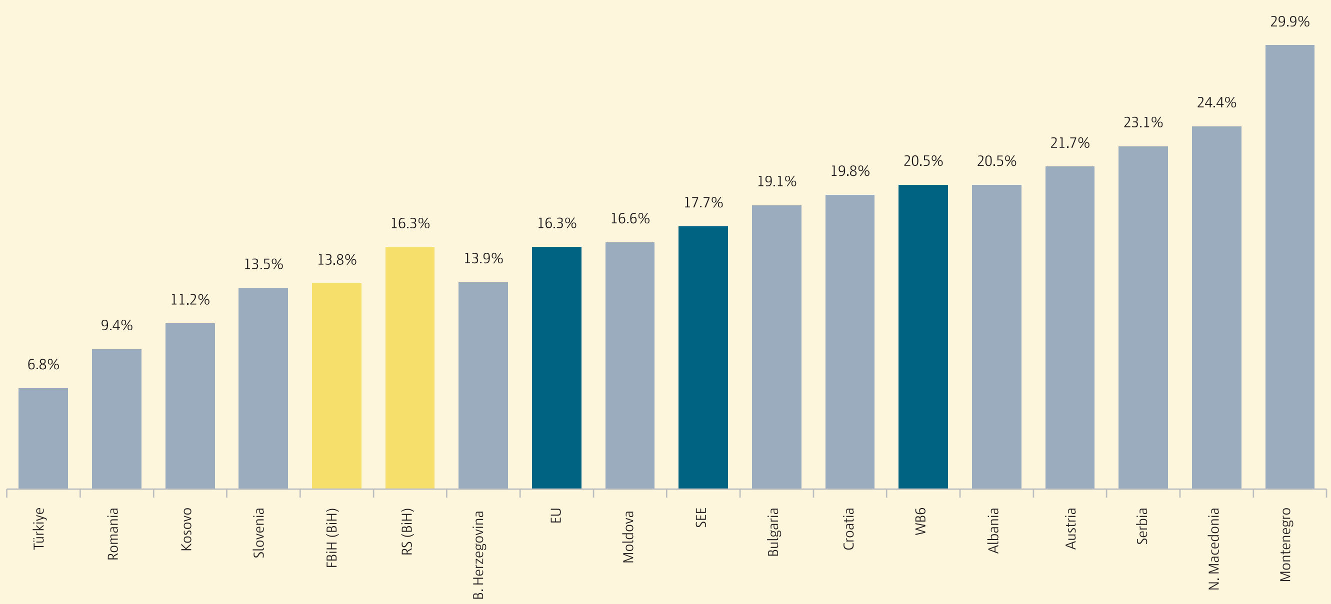
The diversity among SEE economies in not surprising at all, as the EU is quite diverse as well – of almost 90,000 municipalities in the EU, nearly 80% are located in just five economies: 41% in France, 13% in Germany, 9% in Spain and Italy and finally 7% in the Czech Republic. From this perspective, economies such as Austria, Hungary, Cyprus, the Czech Republic, France and Slovakia, are very similar to Moldova and Romania – all having less than 6,000 inhabitants on average per municipality. On the other end of the spectrum Kosovo, Albania, Serbia and Türkiye, resemble the United Kingdom, Lithuania, Denmark and the Netherlands with over 40,000 inhabitants per municipality.

The increasing concentration of people in the capital and metropolitan cities poses a number of social, economic, administrative and development issues, which, in general, work against decentralization. This trend is not unique to SEE– in the EU as well, a large share of the population lives in capital cities. Figure 2 shows that the share of EU capital cities' population reaches 16.3% of total.[2]

The 17.7% average for SEE as a region reflects similar trends, ranging from below 10% in and BiH to above 20% in Albania, Serbia, Macedonia and Montenegro. Almost 20% of the population of Türkiye lives in the Istanbul metropolitan area and, despite not being Türkiye's capital, this concentration also should be considered.

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

Figure 2 **Percentage of Population living in Capital Cities**



If we exclude the capital cities, the average population of the municipalities will be much lower (and much closer to the real status of the typical municipality). For example, if Belgrade is excluded, the average size of the Serbian municipalities would be 37,500 inhabitants – almost 11,000 inhabitants less.

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

- For an increasing number of smaller local governments, it is not uncommon that the local administration (including its financially dependent units such as kindergartens and schools or the municipal utility companies) is the major employer;
- In places with negative population growth, the quality of the municipal staff deteriorates due to competition from the private sector, i.e. two sectors compete for a decreasing number of skilled labour force;
- As a consequence, major shifts in needs for public services are registered—the pressure for social assistance increases while the own revenue base shrinks;
- Both national and local governments face a growing dilemma:
  - On the one hand, capital cities produce the lion's share of GDP and public revenues;
  - On the other, the obvious public need (but not politically obvious) to allocate less transfers to the capital cities while increasing the funding

for the municipalities from which the population is migrating. The typical example is the local infrastructure: In many areas the cost of maintaining it is not closely related to the population using it.

These developments bring with them the need to continually adapt and improve periodically the equalizing transfers based on objective and easy-to-measure indicators for both the local needs and the available local revenue base. It is important to highlight though, that, while local government finance is development finance, general purpose or equalising transfers have objective limits in addressing issues such as depopulation, poverty or decreasing economic activity. For these purposes, there is a need for new financing instruments tailored to reducing regional development disparities.

Demographics and migration

Over the past decade, demographic developments have been particularly challenging for South-East Europe and the Western Balkans. Overall, between 2012-2021, based on Eurostat data, the population of SEE increased by 5.7 mln. (4.4%). The increase rate seems to be more than three times the one in the EU (1.5%, or 6.5 mln), however, the increase is driven entirely by Türkiye (+12%; 8.9 mln), as in almost all SEE economies the population has declined - on average by 5%. In the Western Balkans, between 2012-2021, the population decreased by 4% (0.7 million). The decline rate is steepest for Moldova (-27%), Bosnia and Herzegovina (-9%) Croatia and Bulgaria (-5.6%, each), Serbia (-4.8%) Romania (-4.5%). The population decline in Albania is estimated at 2.5%. Over the past decade population has slightly increased in Austria (6.2%), Slovenia (+2.6%) and Kosovo (1%).

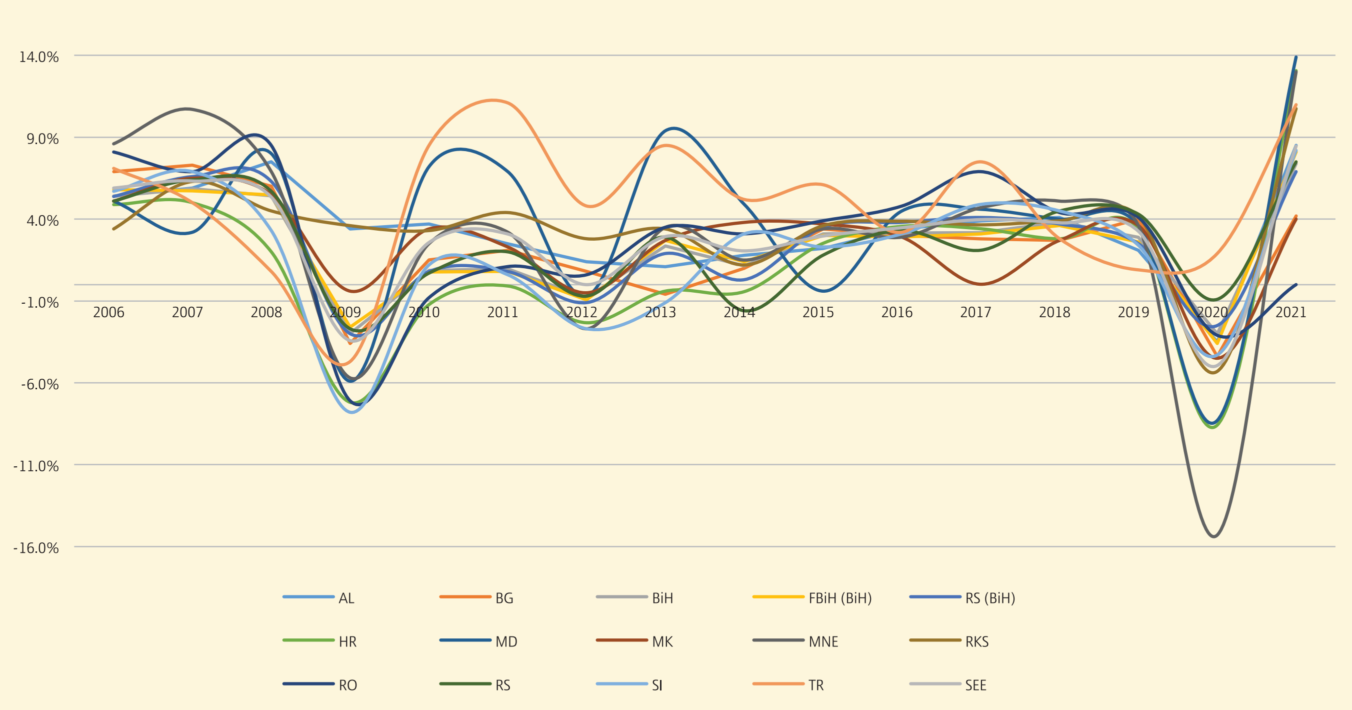
Migration and brain drain are fundamental development challenges for all the SEE economies. Besides the economic and social implications, emigration, low birth rates and an aging population have profound implications for the types of services that the central and local governments in the region must provide now and in the future. Equally importantly, they also have direct implications for the current and future revenue streams available for local authorities both in terms of own source revenues and intergovernmental transfers. In fact, in most economies in the region, general intergovernmental transfers are allocated to local governments on the basis of their relative populations, population densities, number of students etc.

Lack of skilled labour is a common challenge for municipalities in the Western Balkans and South-East Europe. There is an increasing competition between levels of government and the private sector for skilled labour. The new work reality brought on by the COVID-19 pandemic, caught municipalities un-prepared in terms of both infrastructure and capacity to work remotely. While improvements have been made, it is yet to be seen whether digitalisation and remote work can be of use for municipalities in the Western Balkans to attract skilled sectoral workers.

The Dynamics of the Gross Domestic Product in the aftermath of COVID-19

The global financial and economic crisis of 2008-09 brought dramatic implications for SEE and WB economies. The processes of steady economic growth over the previous decade were disrupted and public deficits and debt rose almost everywhere. A decade after the first global crisis, with GDP growth rates relatively low and volatile, the world faced a second global crisis, the COVID-19 pandemic. The figure below shows that the economic downfall during the global pandemic was much harder than the 2008-2009 crisis for most SEE economies. Figure 3 below shows the annual real GDP growth rate for SEE economies.

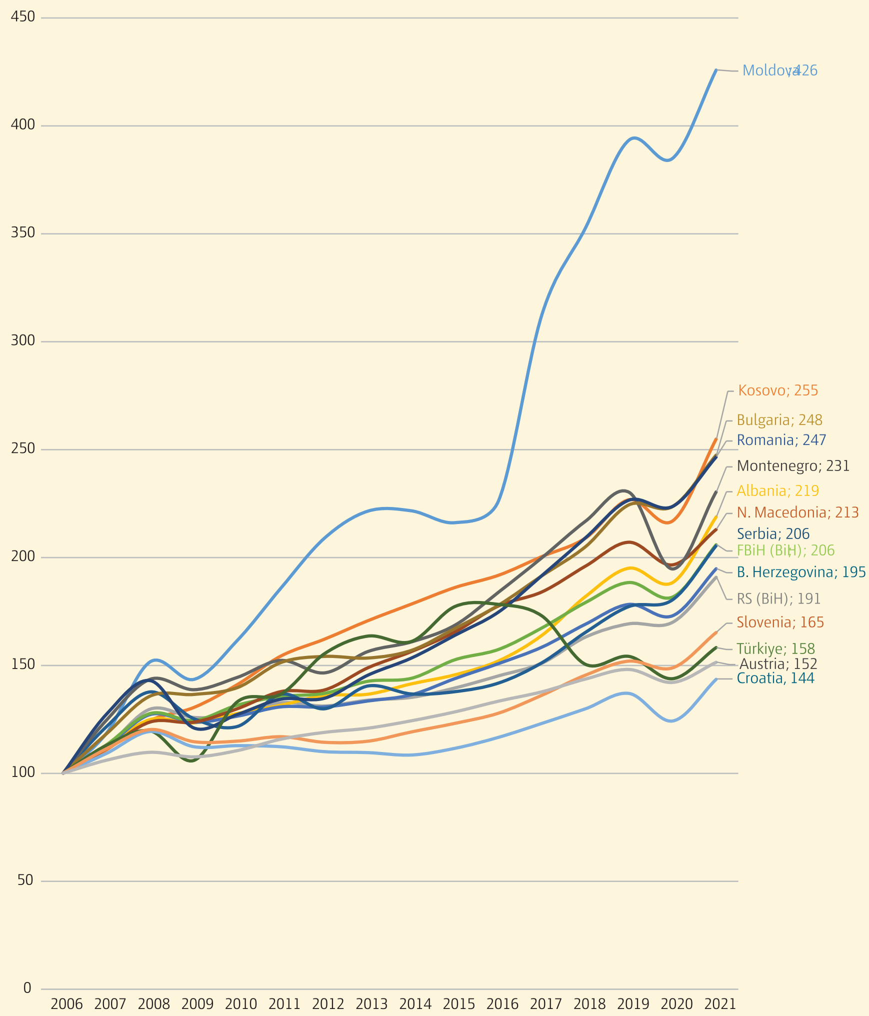
Figure 3 Real GDP Growth Rate, Annual Change (in %)



On average, in SEE and the WB6, GDP in per capita terms more than doubled between 2006 and 2021. Figure 4 below shows the change in GDP per Capita, in the SEE region for the period 2006-2021, where 2006 is the base year. The graph shows that Moldova's GDP per capita has more than quadrupled over this period, and is a clear outlier, while in Croatia, Austria, Türkiye and Slovenia' it increased between 1.4 or 1.6 times. In the rest of the region's economies GDP per capita terms has doubled.

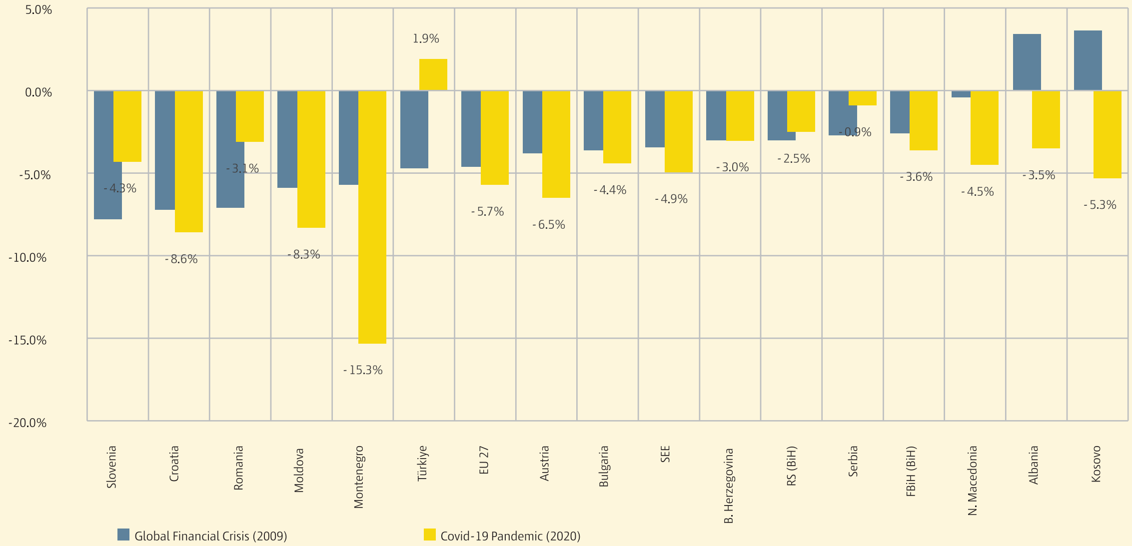
The region's growth looks like a good achievement – average annual growth of 4.5%, including the implications of the different crises. But again, a deeper overview and international comparisons show that there is considerable variation across the group in both relative wealth and GDP growth and differences in the convergence processes. Moldova has the lowest per capita income in both 2006 and 2021 despite its considerable cumulative growth of 326% (the highest in SEE). Starting from a very low base, even with this remarkable growth, the 2021 level is one third of SEE average and 11.7% of the group's "champion" – Slovenia. The two richest economies, Slovenia and Croatia, have the lowest cumulative growth – 40% and 60% respectively.

Figure 4 Change in GDP per Capita in SEE (2006 – 2021), baseline year 2006 = 100



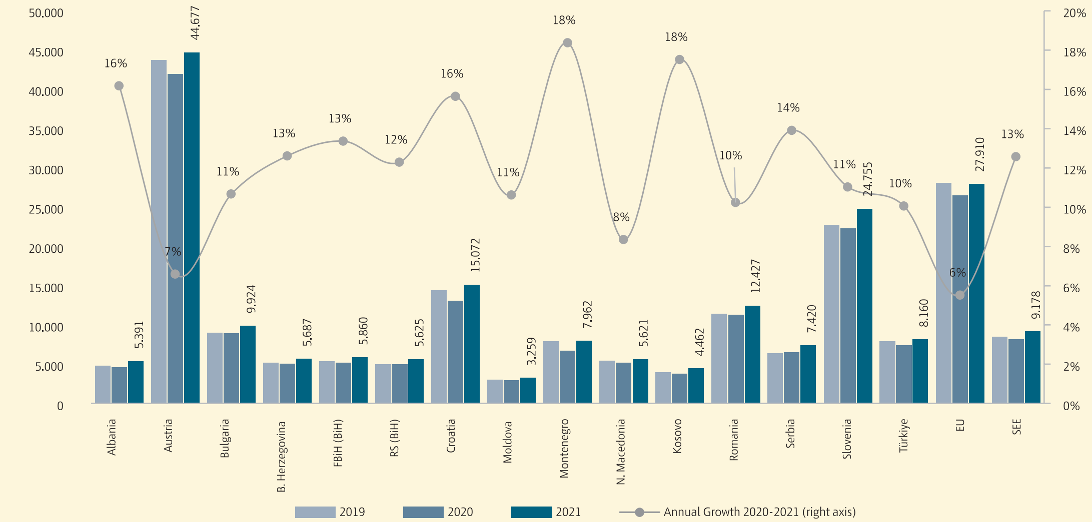
The COVID-19 pandemic has posed significant challenges for the region, much greater than the ones from the 2008-2009 global financial and economic crisis, as indicated by the economic downturn in 2020 (Figure 3 and 4). The figure below shows the real GDP growth over 2008-2009 and 2019-2020. As can be noted, the decline in real GDP rates is higher during the outbreak of the COVID-19 pandemic in 2020 than in the global financial and economic crisis of 2008, except for Slovenia, Romania and Serbia who seem to have been able to weather rather well the economic downturn. The full economic slowdown and disruption of 2020 and part of 2021 will continue to have long term implications for the recovery of the region.

Figure 5 GDP Growth in Crisis Times (2008-09 and 2019-20), Annual Changes (in percent)



Economic activity rebounded in all SEE economies in 2021. Given the downfall of 2020, growth rates are particularly high, although varying significantly across the region. Figure 6 shows the GDP in EUR per capita and Real GDP growth rate between 2020-2021.

Figure 6 GDP per capita in 2019-21 (in €), and GDP Growth 2020-21



Comparative Overview of Fiscal Decentralization Indicators in South-East Europe

II.

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

To make reasonable judgements about the role of local governments in a given economy it is important to know **what functions they have been assigned**, and in particular, **whether they are paying the wages of teachers, doctors or other social sector employees**. This is because the wage costs associated with education, health and, to a lesser extent, social welfare services, are so high that they inevitably change the nature of intergovernmental relations. For example, on average, across OECD countries, staff compensation and other current expenditure represents about 90% of the spending in educational institutions, regardless of the level of education, while 82% of resources devoted to staff compensation at primary, secondary and post-secondary non-tertiary levels are allocated to staff salaries.[3] As a result, assigning important social sector functions to local governments fundamentally alters the nature of intergovernmental fiscal relations.

Some answers to the first question can be found in Table 2, presenting the weight of local expenditure in SEE based on the Classification of the Functions of Government (COFOG).

Table 2. The Structure of Local Government Expenditure in SEE, by functions of government (in percent of total)

2021 in % of total	General Public Services	Public order and safety	Economic affairs	Environmental protection	Housing and community amenities	Health	Recreation, culture and religion	Education	Social protection
Albania	18%	6%	21%	6%	25%	0%	4%	18%	2%
Austria	16%	2%	11%	2%	1%	24%	5%	17%	21%
FBiH (BiH)	47%	2%	9%	4%	17%	0%	7%	5%	8%
Bulgaria	11%	2%	7%	9%	10%	3%	5%	42%	11%
Croatia	21%	2%	19%	5%	24%	1%	9%	12%	8%
Kosovo	15%	2%	7%	0%	1%	17%	2%	53%	2%
Moldova	8%	0%	13%	0%	10%	1%	6%	53%	7%
Romania	6%	0%	46%	8%	18%	6%	6%	9%	2%
Serbia	19%	1%	27%	5%	14%	1%	10%	19%	5%
Slovenia	20%	3%	24%	5%	6%	1%	12%	23%	6%
Türkiye	36%	3%	20%	9%	22%	1%	5%	1%	2%
WB6	25%	2%	16%	4%	14%	5%	6%	24%	4%
SEE	20%	2%	19%	4%	15%	3%	7%	24%	5%
EU 27	15%	3%	13%	5%	4%	17%	6%	16%	22%

3 OECD (2022), Education at a Glance 2022: OECD Indicators, OECD Publishing, Paris, https://doi.org/10.1787/3197152b-en, p. 314

The variety is clearly visible and is due to various factors, among which could be noted the local traditions and the legal framework, guiding the service responsibilities, and, to some extent, the fact, that for some cases the data include all subnational levels.

Despite the variety and the funding sources, the function which has the greatest significance for SEE local governments, is primary and secondary education. In Moldova (all subnational levels included) and Kosovo its share is more than 50%; in Bulgaria it is 42% and in Albania, Austria, Serbia and Slovenia it is equal or close to 20%. The local governments of the other economies have lower but still significant shares in funding education. The only exception is Türkiye where the state funds the education system directly. Austrian, Romanian and Kosovar local governments have also significant responsibilities in healthcare.

Maybe the most important difference between the EU and SEE is the role of the local governments in social protection. In the EU, these account for 22% of the expenditures while in SEE their share is much smaller – up to 8%. In Kosovo and Türkiye, from a budgetary perspective, local governments practically are not involved in this social activity.

If we examine the way the EU responded to the 2009 economic crisis and to the COVID-19 crisis, one of the lessons learned is that in economies with a high level of decentralization, the safety net for the most vulnerable people, managed and funded at local level, is crucial for absorbing the negative financial impacts. For a more comprehensive analysis of the regulation and financing of decentralized social sector responsibilities in SEE, please refer to the Eighth Edition of the NALAS Report: Social Welfare at the Intersection of Municipal Finance and Governance in South-East Europe. For a more comprehensive analysis of the COVID-19 impact on SEE economies please refer to the NALAS Survey: SEE Local Governments in Post COVID-19 Socio-Economic Recovery.

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

Table 3 summarizes some of the most important social sector functions assigned to local governments in the region. Other activities like cultural and sports or fire protection, irrigation and forestry are also included because of their importance for local governments in some of the economies. It should be noted also that the social welfare group contains a wide variety of specific services and nowhere are all of them provided at the local level – in most of the cases municipalities fund some of them. The data do not take into account important aspects of the expenditure assignments such as levels of authority to: 1) determine whether a service is required; 2) determine the service policies and standards and 3) organize the service delivery. It simply shows if local governments pay for these.

The municipalities in Kosovo pay for services in all four social functions. In North Macedonia, Bulgaria, Kosovo and Moldova local governments pay the full costs of secondary education (preschool, primary and secondary schools). Similarly, in Kosovo local governments pay for most of the costs of primary and secondary health care. Kosovar municipalities also pay for all of the listed social welfare activities. Up until 2018, Romanian communes paid for the full costs of secondary education.

There is, however, considerable variation in whether these social sector functions performed by local governments are legally defined as an 'own', 'shared' or 'delegated' responsibility. In theory, 'own' functions should be financed primarily by local government general revenues, delegated functions by categorical grants, and shared functions by some mixture of the two. These general principles, however, are frequently blurred in practice.

Table 3. Local Government Social Sector Functions in South-East Europe

	ALB	FBIH (BIH)	RS (BIH)	BGR	HRV	RKS	MDA	MNE	MKD	ROU	SRB	SVN	TUR
Education													
Maintenance of Pre-school Facilities	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	Yes	Yes	Yes	Yes	Yes
Payment of Pre-school Wages	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	Yes	No	Yes	Yes	No
Maintenance of Primary School Facilities	Yes	Yes	No	Yes	Yes	Yes	Yes	No	Yes	Yes	Yes	Yes	Yes
Payment of Primary School Teachers Wages	No	No	No	Yes	No	Yes	Yes	No	Yes	No	No	No	No
Maintenance of Secondary School Facilities	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	Yes	Yes	Yes	Yes	Yes
Payment of Secondary School Teachers Wages	No	No	No	Yes	No	Yes	Yes	No	Yes	No	Yes	No	No
Maintenance of Special Art or Sport Schools	Yes	No	Yes	Yes	Yes	Yes	Yes	No	No	No	No	No	Yes
Payment of Wages in Special Art or Sports School	No	No	No	Yes	Yes	Yes	Yes	No	No	No	No	No	No
Health													
Maintenance of Primary Health (Ambulatory) Care Facilities	Yes	Yes	Yes	Yes	Yes	Yes	No	No	No	Yes	Yes	Yes	Yes
Payment of Primary Health Care Wages	No	No	No	Yes	No	Yes	No	No	No	No	No	No	Yes
Maintenance of Secondary Health Care Facilities	No	Yes	No	No	Yes	Yes	No	No	No	Yes	No	No	No
Payment of Seondary Health Care Wages	No	No	No	No	No	Yes	No	No	No	No	No	No	No
Culture & Sports													
Maintenance of Youth Houses or Houses of Culture	Yes	Yes	Yes	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Payment of wages in Youth Houses or Houses of Culture	Yes	No	Yes	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes

Maintenance of Libraries	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Payment of Wages in Libraries	Yes	No	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Maintenance of Museums	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No
Payment of Wages in Museums	Yes	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	No
Maintenance of Theatres and Cinemas	Yes	Yes	Yes	Yes	No	Yes	Yes	Yes	No	Yes	Yes	Yes	Yes
Payment of Wages in Theatres and Cinemas	Yes	Yes	Yes	Yes	No	Yes	Yes	Yes	No	Yes	Yes	Yes	Yes
Maintenance of Local Sports Facilities	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Payment of Wages of Local Sports Staff	Yes	No	Yes	Yes	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Social Welfare													
Maintenance of Orphanages	Yes	Yes	Yes	No	No	Yes	No	No	No	Yes	No	No	No
Payment of Wages in Orphanages	Yes	No	Yes	No	No	Yes	No	No	No	Yes	No	No	No
Maintenance of Homes for the Elderly	Yes	Yes	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes	No	No	Yes
Payment of Wages in Homes for the Elderly	Yes	No	No	Yes	No	Yes	Yes	Yes	Yes	Yes	No	No	Yes
Maintenance of Homes for People with disabilities	Yes	Yes	Yes	Yes	Yes	No	Yes	Yes	No	Yes	No	No	No
Payment of Wages in Homes for People with disabilities	Yes	No	Yes	Yes	No	No	Yes	Yes	No	Yes	No	No	No
Social Welfare Payments to Individuals or households	Yes	Yes	Yes	No	Yes	No	No	Yes	No	No	Yes	Yes	Yes
Other Functions													
Fire Protection	Yes	Yes	Yes	No	Yes	Yes	No	Yes	Yes	No	Yes	Yes	Yes
Irrigation	Yes	Yes	No	No	No	No	No	No	No	No	No	Yes	No
Forestry	Yes	Yes	No	No	No	Yes	No	No	No	Yes	No	No	No

Note: In some economies in the region, some of the social sector functions are provided by second- or third-tier local governments but they are included here to better illustrate the responsibilities.

As a rule, first-tier local governments are unlikely to provide social welfare payments to individuals and households. While they usually have delegated competencies (funded with conditional/sectoral grants) in the sector, municipal own competencies are mostly focused in home caring for the elderly and people with disabilities. Conversely, local governments in Albania and FBiH pay the wages for the pre-school staff only but the Albanian local governments fully fund the culture functions. In Montenegro, they have no responsibilities in either education or health, not even maintaining facilities.

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

For a more comprehensive analysis of the regulation and financing of decentralized social sector responsibilities in SEE, please refer to the Eighth Edition of the NALAS Report: Social Welfare at the Intersection of Municipal Finance and Governance in South-East Europe.

Local Governments Revenues in South-East Europe

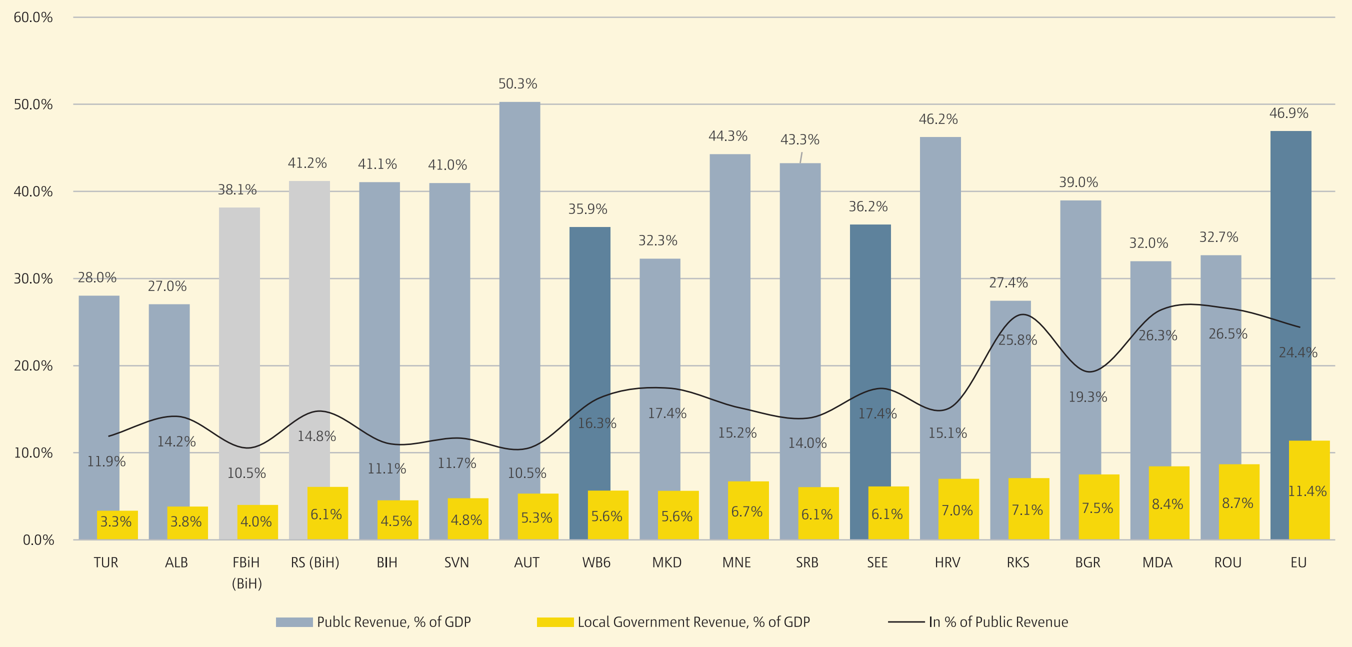
One of the key indicators for the relative size of the local government finance is shown in Figure 7, which displays the revenues of both the local government and the total public revenues (the General Government revenues).

The size of the public sector is intrinsically linked to the financing of local government and while there has been significant progress over the past decade, the average size of the public sector in SEE (36.2%) continues to lag far behind the EU average (46.9% in 2021). The difference in LG revenue is much bigger – 6.1% of GDP in SEE as opposed to 11.4% in the EU.

On average, EU economies have both larger public sectors and have decentralized more revenue to local governments than their counterparts in SEE. Albania, Kosovo and Türkiye continue to have the smallest public sectors, with public revenues at 27-28% of the GDP. Moldova, Romania and North Macedonia have similar size of the public sector between 32-33% of the GDP, while Croatia, Serbia, Montenegro, Slovenia, Bosnia and Herzegovina have levels similar to the EU-average, while Austria's public revenues are higher than those of the EU-average.

Despite the small public sector, local governments in Kosovo, Moldova and Romania receive 26-27% of all public

Figure 7 Public Revenue and Local Government Revenue in South-East Europe, 2021



revenues. Only Romania has a slightly better indicator – 26.5%. All the others' performance is below the EU average of 24.4%. Albanian and Turkish local governments have the lowest shares of revenue-to-GDP, although in the case of Albania, when considering the indicator of local revenues to total public revenues, Albanian LG revenues seem to be closer to SEE and WB averages.

Figure 8 plots the share of local government revenue and total public revenue as a percentage of the GDP. From the figure 5 main groups can be identified – which do not have clearly defined boundaries among them. The first group includes those economies that have a relatively small public sector but where local governments do not perform major tasks in the social sector, including Albania and Türkiye. The second group would include those economies with relatively small public sectors (public revenues to GDP lower than 35%) but with significant decentralized responsibilities, in particular in education and healthcare (see Kosovo, Moldova, Romania and to some extent North Macedonia. The third group includes those economies with larger public sectors and where LG financing is closer to EU averages – here we would have Croatia, where LGs have significant social sector responsibilities and we also find Montenegro, where LGs do not perform major responsibilities in the social sector. The fourth group includes Austria and Serbia, where there is a large public sector, while local governments responsibilities are limited to pre-school education only (in Austria also in social protection). The fifth group brings together those economies that are in the middle and closer to WB6 and SEE averages.

Figure 8 **Plotting Public Revenue and Local Government Revenue in South-East Europe, 2021**

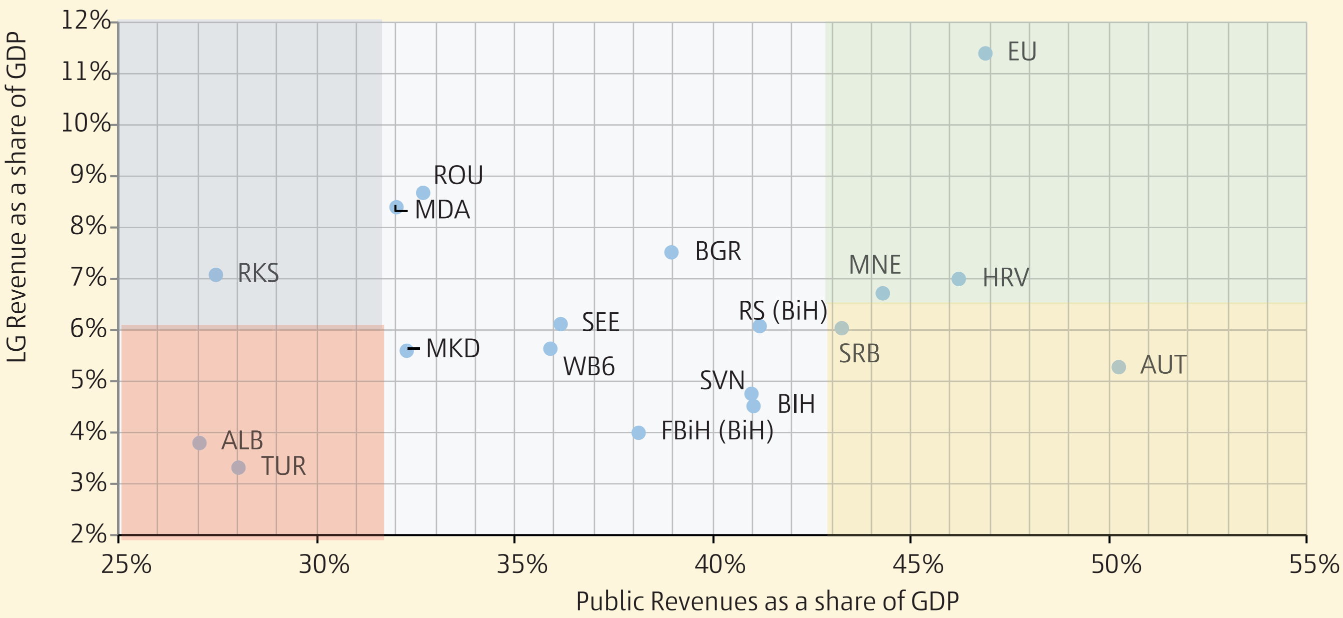


Figure 9 further explores the level of fiscal decentralization by plotting the share of local revenue as percentage of total public revenue against local revenue as a share of GDP. The figure helps identify again some main groups with different levels of (fiscal) decentralization. The NALAS members whose local government sectors most closely resemble those of the EU27 as both percentages of GDP and total public revenue are Moldova, Romania, and Kosovo. A considerable part of the reason for these rankings lies in Table 3, where the local governments' financial responsibilities for the education, health and social care/protection sector services are shown. As is often the case in the EU, local governments in Kosovo, Romania, Moldova, Macedonia, and Bulgaria are all to a significant degree responsible for educational services. In addition to that, in Kosovo and Romania they are also responsible for funding primary and secondary health care. It is thus not surprising that their local governments get larger shares of the total public sector than those of their counterparts elsewhere in the SEE and, respectively, require larger shares of their GDPs to finance these social sector responsibilities.

Figure 9 **Local Government Revenue in SEE in 2021 (as a percentage of GDP and Total Public Revenue)**

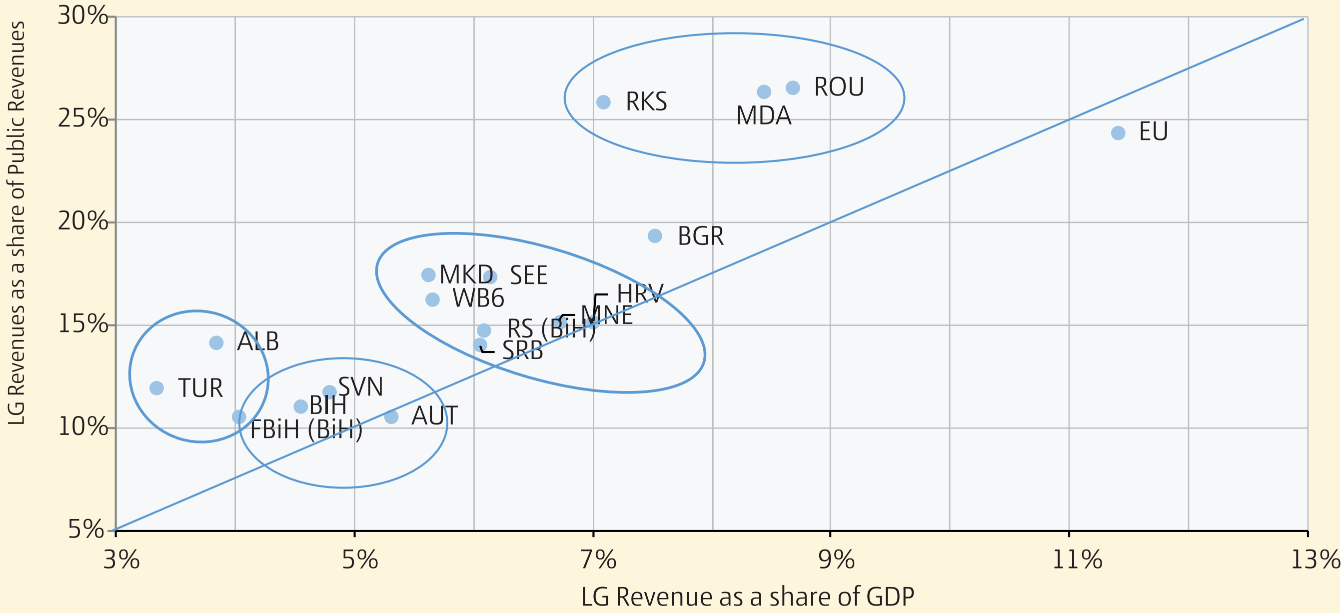


Figure 10 Local Government Revenue, in Euro per capita in 2021

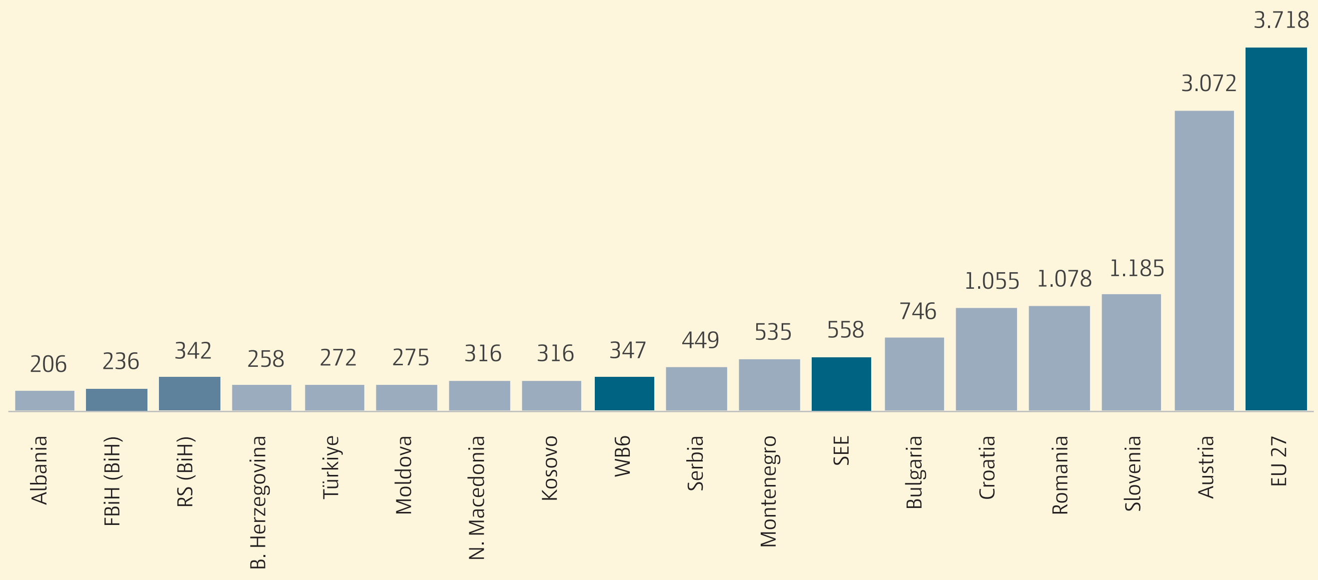


Figure 10 shows the per capita revenues of local governments in Euro in 2021. The figure is a useful reminder of how little revenue the local governments of most of SEE have to work with, especially when compared to their EU partners. On average, **local governments in SEE dispose of seven times less Euro per capita than their European counterparts**. Even the richest one, Slovenia, gets more than 3 times less. Across the region the variation is also striking – Slovenia's local governments are more than 5 times richer than the poorest ones – those in Moldova which get 206 € per capita. It is also particularly staggering that local governments in Moldova, Kosovo, and Macedonia pay for teachers' wages on per capita revenues of less than 316€, while Croatian and Slovenian municipalities bear little of these costs and have per capita revenues 3 to 4 times higher. **From this perspective, also within SEE there are wide differences and disparities in terms of LG, regardless of many similarities in service responsibilities.** On average, **local governments in WB6 dispose of 11 times less Euro per capita than their European counterparts**.

Figure 11 Local government revenue as a share of GDP in 2006, 2009, 2020 and 2021

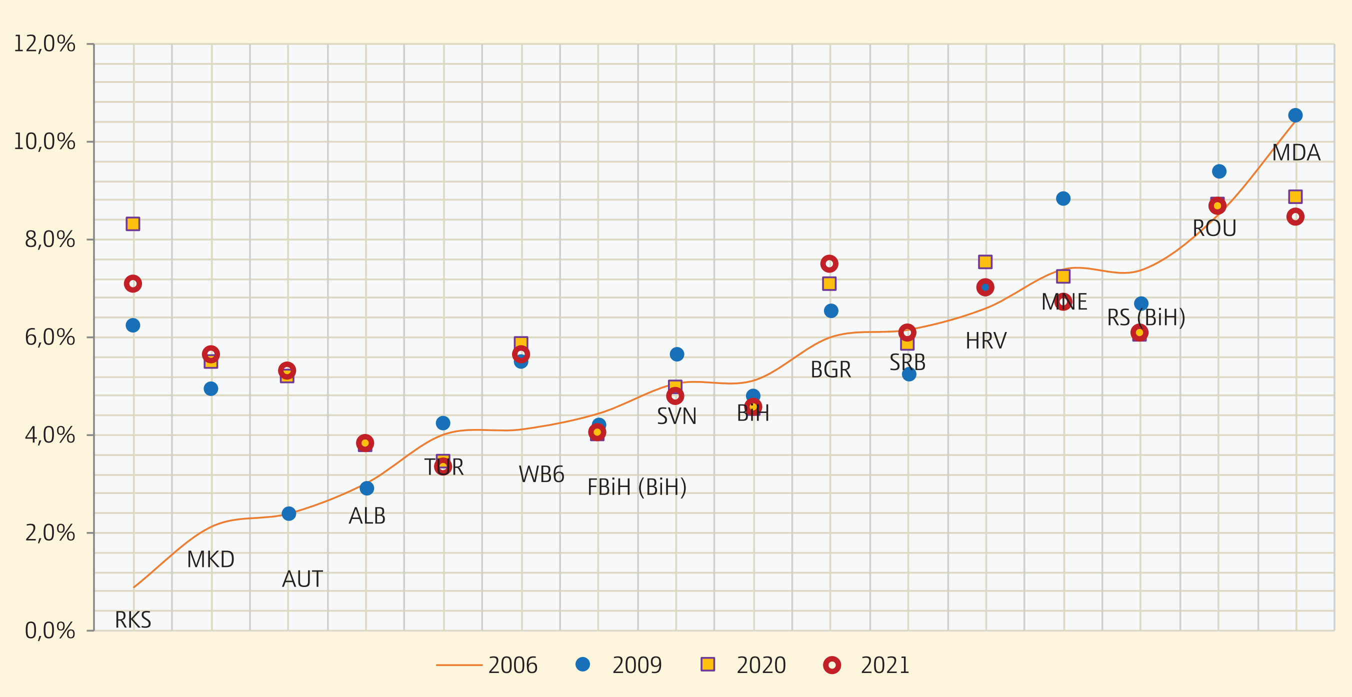
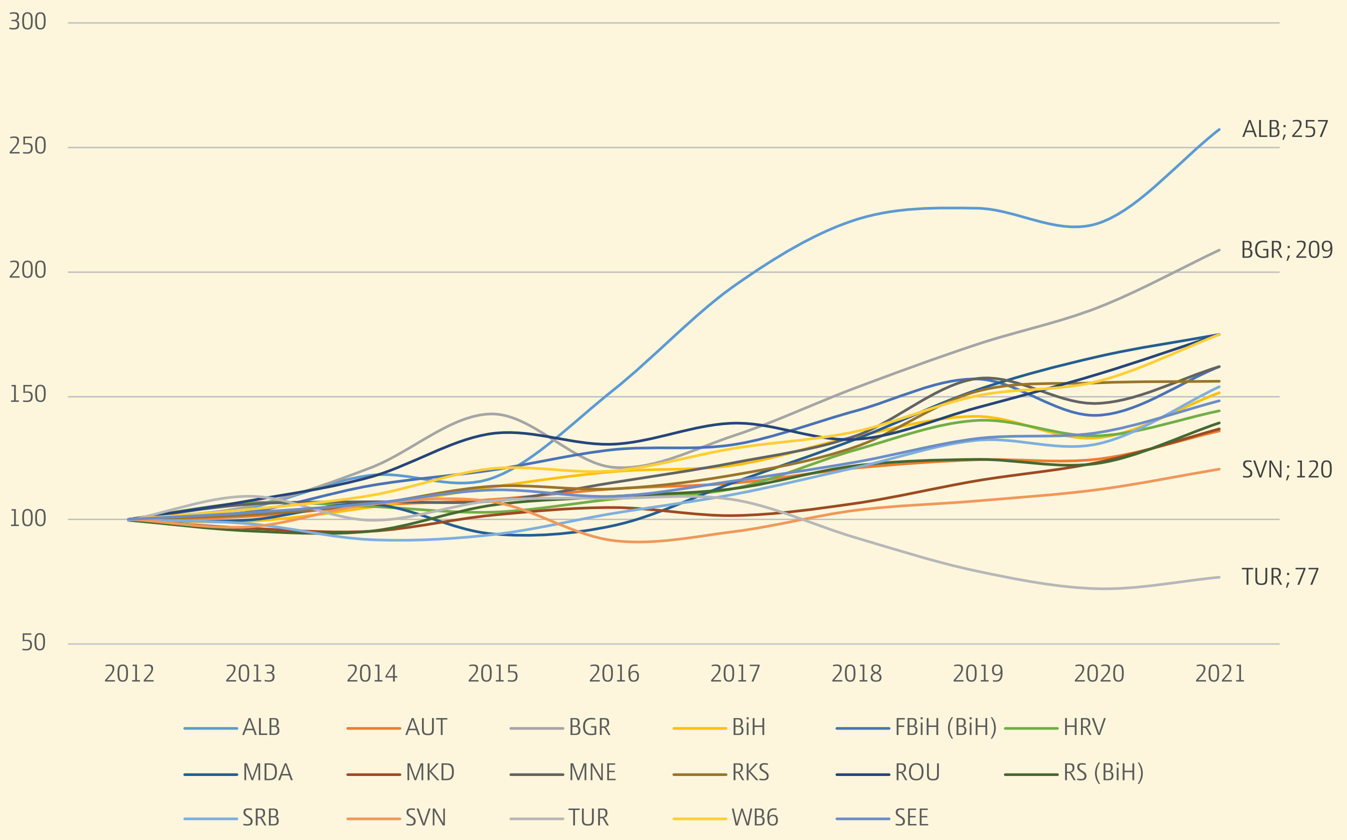


Figure 11 shows SEE local government revenue as a percentage of a GDP in 2006, 2009, 2020 and 2021. **On average, in only about half of SEE economies, LG revenues as a share of GDP have improved significantly when compared to the past decade** – this seems to be the case for Kosovo, North Macedonia, Austria, Albania and Bulgaria. In the other cases, LG revenues as a share of GDP are either at the same level as in 2006 or 2009 (see Slovenia, Serbia, Romania, Croatia) or lower than that (see Türkiye, Bosnia and Herzegovina, Montenegro and Moldova). It is important to highlight that the share of LG revenues to GDP for 2020 is influenced also by the significant fall of economic activity, and therefore appears artificially higher.

Figure 12 Change in Volume of LG Revenues per Capita (in Euro) in SEE (2021 – 2021; baseline year 2012 = 100)



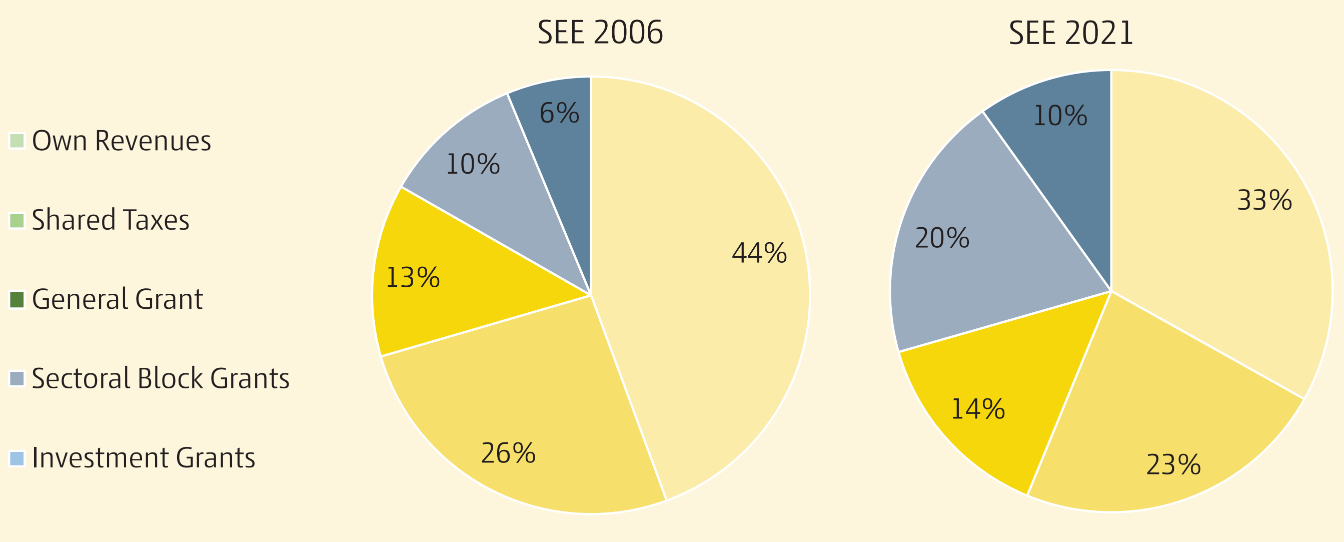
In nominal terms, except for Türkiye, LG revenues in Euro per capita terms have increased over the past decade in South-East Europe. Figure 12 shows the change in volume in LG revenues in per capita terms over the past decade, where 2012 is the baseline year. The graph shows that in Bulgaria and Albania LG revenues have increased by 2.1- 2.5 times over the past decade (reflecting both changes in political and fiscal decentralisation reforms), while in Slovenia, LG revenues in EUR per capita have increased by 1.2 times (or 20%). In Türkiye, in 2021, LG revenues in EUR per capita are one third lower than what they were in 2012.

The Evolution and Composition of Local Revenues and Local Fiscal Autonomy

Maybe the key aspect of local fiscal autonomy, besides the total amount and shares of the local budgets in comparison to the GDP or public sector, is the composition of the revenue base. And the main characteristic of the composition is the level of local decision-making authority over its components i.e., the level of local fiscal autonomy. Although the general revenue categories may appear clear terminologically, their meaning and composition varies substantially across the region and, on several occasions, one general revenue component might consist of different revenue items. The reader should have this in mind because occasional misclassification may significantly overstate the local fiscal autonomy. Bearing in mind the differences, the data is informative with regard to the composition of local revenues and fiscal autonomy.

Compared to 2006, SEE local governments have less control over their budgets. On average, local governments in SEE in practice can freely decide on less than half of their budgets, while the other half is preconditioned by the central level via the conditionality of transfers. Figure 13 below shows the change in the basic composition of local revenue between 2006 and 2021, as an average for all NALAS members. The share of own source revenues has decreased by 11 percentage points (or 25%) compared to 2006, while the share of shared taxes has decreased by 12%, while more worryingly, the share of the block grants increases by 87% and conditional investment grants increase by 58% compared to 2006.

Figure 13 Composition of Local Revenue in South-East Europe 2006 and 2021

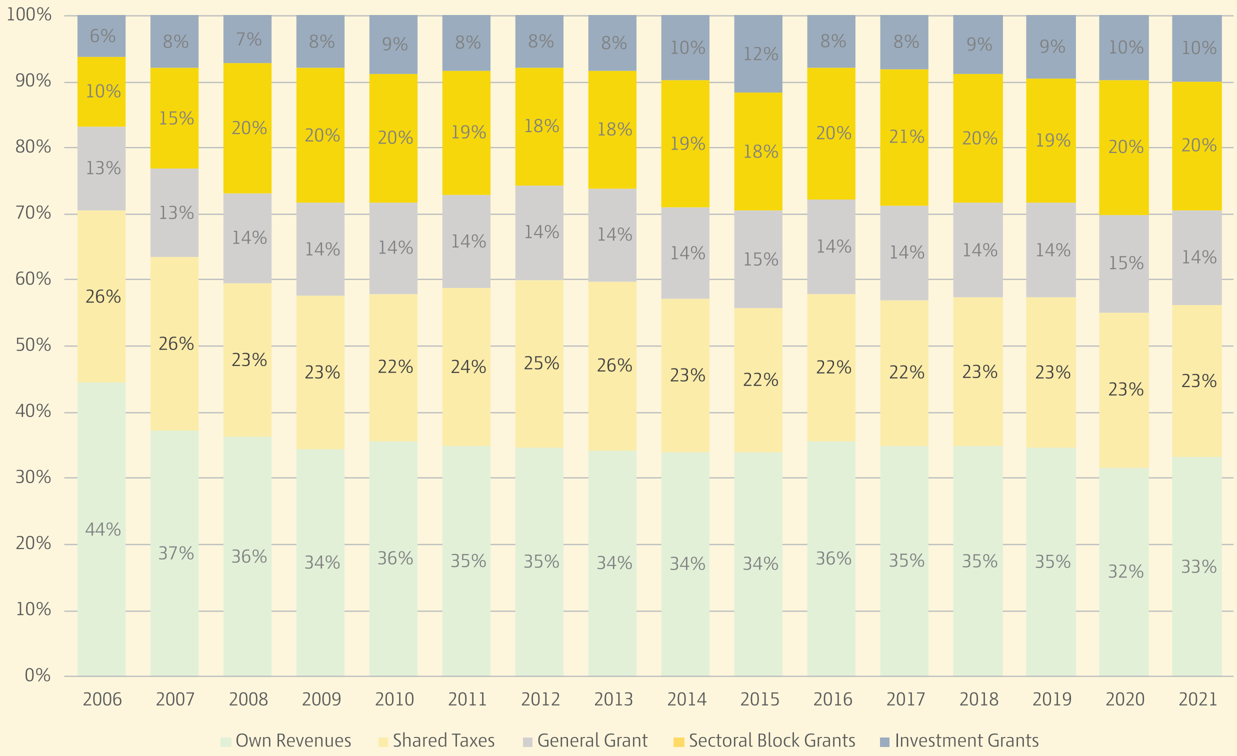


In the decade after the global financial crisis of 2008-2009, with very few exceptions, there has been a general stagnation of decentralization and fiscal decentralization reforms in SEE—the structure of local government revenues over 2009-2019 is relatively the same for the SEE region. In many SEE economies there have been attempts to curtail local government taxing powers as a response to the global crisis and to create a more favorable business environment leading to a decrease in the share of own source revenues to total local government revenues. In other economies, the recovery of local finances has been slow. Figures 14 and 15 show the change in the basic composition of local revenue between 2006 and 2021, as an average for SEE and WB6 economies.

The shares of own source revenues have dropped by 11 percentage points, compared to 2006 and over 2020 and 2021 have recorded the lowest levels ever 32% and 33%.

The COVID-19 pandemic found SEE local governments still struggling with the aftermath of the first global financial and economic crisis. As expected the share of own source revenues fell significantly (by three percentage points) in 2020 and has not yet fully recovered to the pre-COVID-19 levels, in relative terms. The fall in the share of own source revenues has been compensated by an increase in the share of most types of intergovernmental transfers, indicating some level of support from higher levels of government. A more detailed analysis on the COVID-19 implications on LG finance is provided in Chapter III, page 43-45.

Figure 14 **Evolution and Composition of LG finance in South-East Europe (in percent of total)**



In the Western Balkans, this scenario is more pronounced – the share of own source revenues has been shrinking while the share of sectoral earmarked block grants has increased its weight over time.

Figure 16 presents the current composition of local government revenue in SEE economies, as share of the total, ranked by the share of own source revenues to total LG revenues in 2021. The figure shows also the share of LG revenue in percent of total public revenue, helping us better understand the degree of local government fiscal autonomy.

Figure 15 Evolution and Composition of LG finance in the Western Balkans (in percent of total)

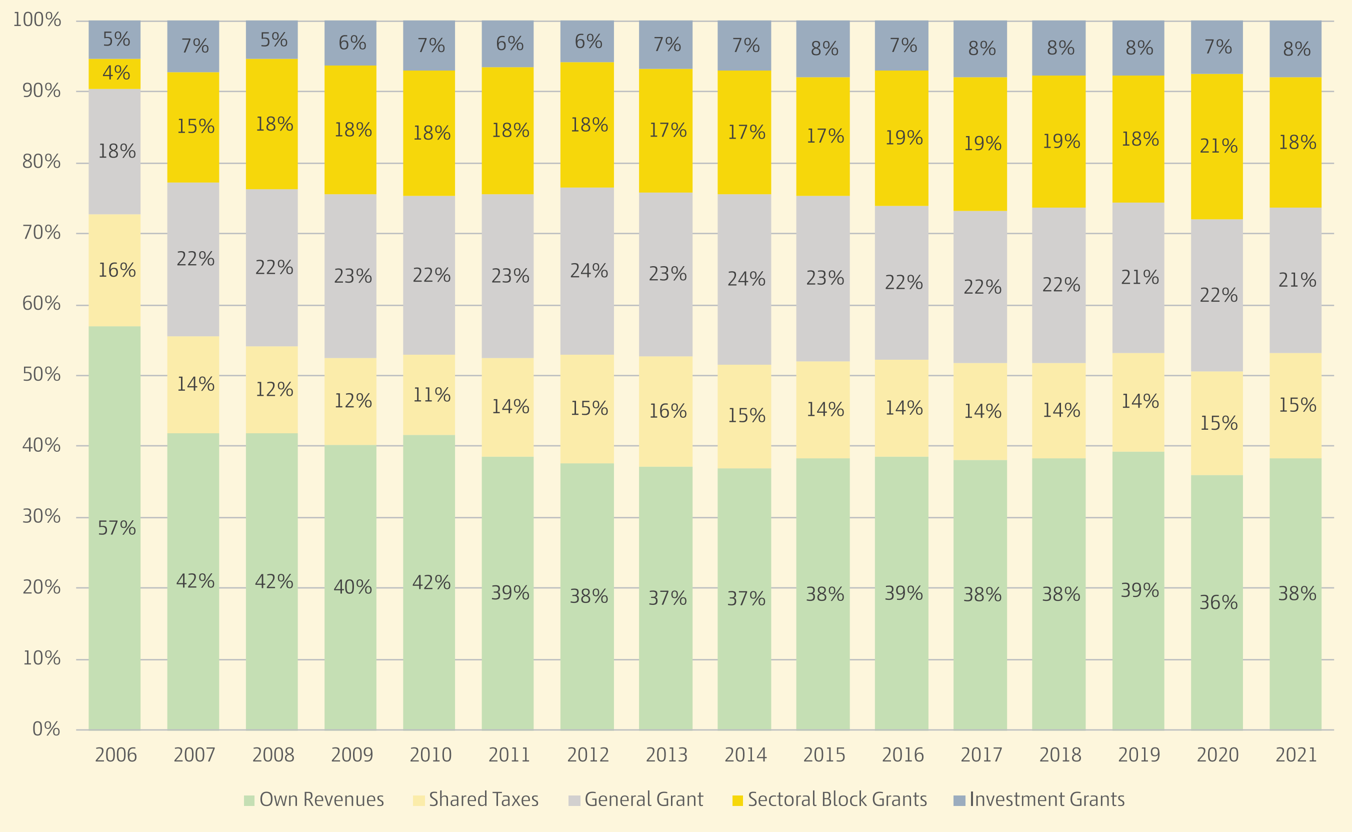
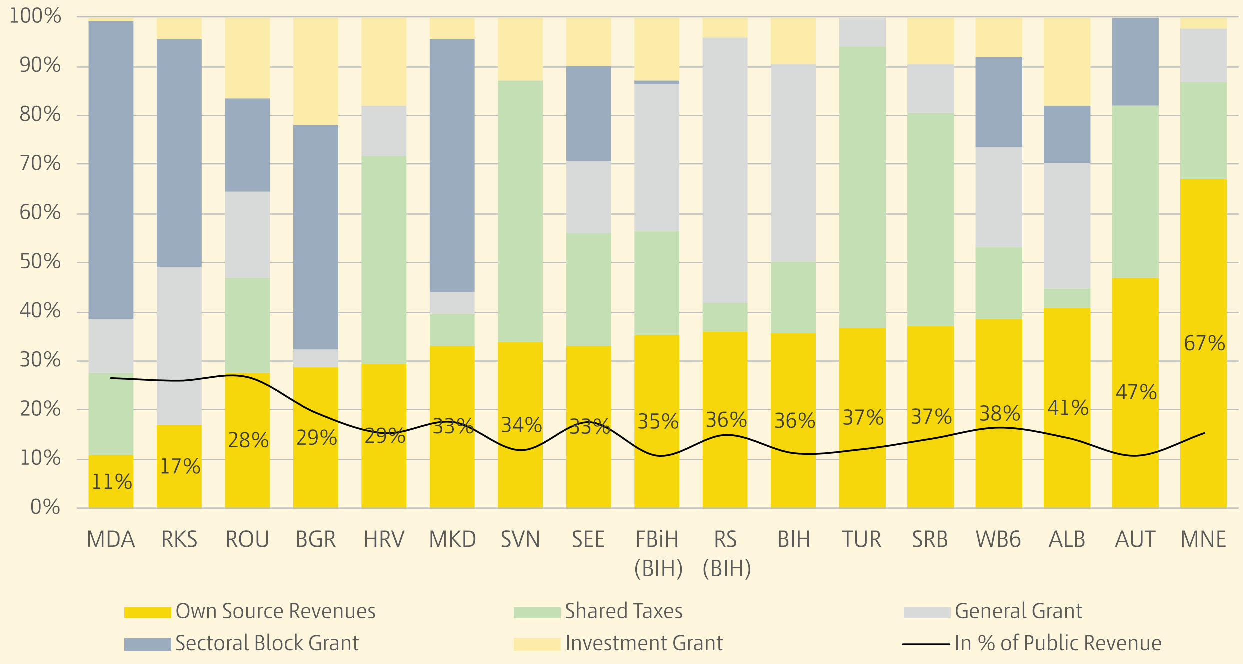


Figure 16 Composition of Local Government Revenue in 2021, as a share of total LG revenue



On average, in SEE, LGs raise on their own 33% of total local government revenues, while shared taxes make up 23% of the total, followed by the general grant that accounts for 14% of the total and sector block grants which make up 20% of the total and earmarked investment grants which make up to 10%. In the six economies of the Western Balkans, the main difference is the higher share of own local government revenues to the total, driven mostly by Montenegro, Albania, Serbia, Bosnia and Herzegovina and North Macedonia, where own LG revenue makes up between 33-67% of total local government revenues. Given the extensive responsibilities in the social sector, in Moldova, North Macedonia Kosovo, Bulgaria and Slovenia, sectoral block grants make up the most important part of total local government revenues, ranging between 45-60% of total LG revenues.

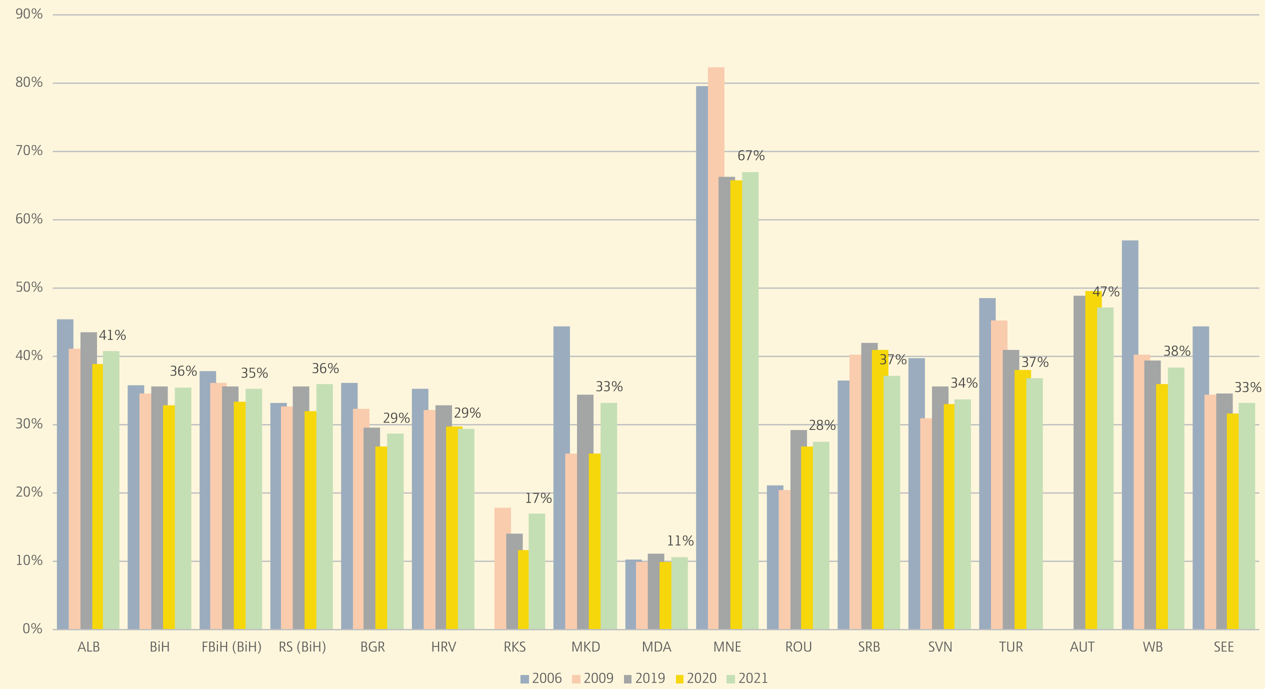
To conclude, SEE LGs raise on their own one third of their revenues, while the remaining two thirds come from higher levels of government in various forms of intergovernmental transfers, such as shared taxes and conditional and non-conditional grants. Over the past 15+ years, LGs in SEE and the WB6 in particular, have become more financially dependent on transfers from higher levels of government. Equally importantly, the data shows that there are no major changes in the structure of LG revenues over the past decade, indicating that LGs have not recovered yet to the levels of LG financing of the pre-2008 global financial and economic crisis. Ultimately, the COVID-19 crisis further exacerbated an already precarious situation of local financial autonomy.

The Evolution and Composition of Own Source Revenues

The composition of municipal own source revenues is a key indicator for fiscal autonomy— no matter what the size of the local public sector is. Its main components comprise local taxes, service fees and charges, property management revenues and other, smaller, revenue categories such as fines and fees. The accounting and reporting of local own source revenues differ substantially across the region. For some of the economies, a detailed breakdown of own source revenues is available whereas for some other economies the data is reported only on two or three categories.

Except for Kosovo and Romania, the share of own source revenues to total local government revenues has declined by 3-12% in South-East Europe over the past decade and a half. Figure 17 shows the share of own revenue to total LG revenue in SEE economies, for 2006, 2009, 2019, 2020 and 2021. On average, own source revenues in SEE in 2021 constitute 33% of total local revenues, down from 44% in 2006. Similarly, on average, the share of own source revenues in the WB6, in 2021 constitutes 38% of total local revenues down from 57% in 2006. Between 2006 and 2021, the share of own revenue to total revenue has increased only in Kosovo and Romania while in Bosnia and Herzegovina and Moldova, it has remained the same and in Serbia it has increased by a mere 1%.

Figure 17 Share of own revenue to total local revenue, 2006, 2009, 2019, 2020 and 2021.



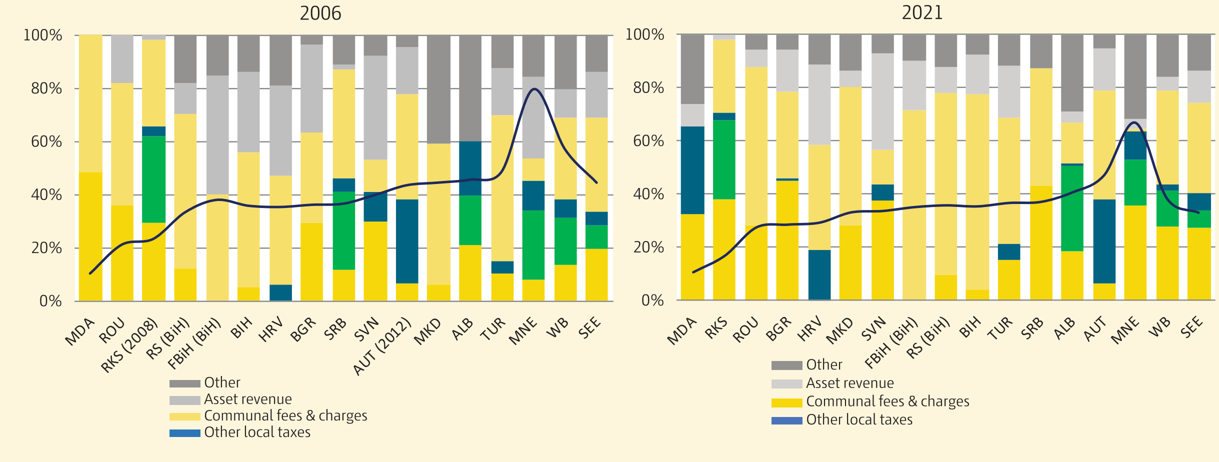
The decrease in the share of own revenue to total revenue is linked to both the elimination or reduction of local governments' tax powers on the one hand, and the decentralization of additional social sector functions that are mostly financed by sectoral block grants, on the other. In Albania the government eliminated almost entirely the local tax on small business turnovers/ profits in 2016, and its yield in 2021 was 1% of own source revenues as opposed to 20% in 2012. Similarly, the share of revenues from municipal assets has been decreasing in Bosnia and Herzegovina, Bulgaria, and Montenegro. On the other hand, local governments in Albania received new functional responsibilities as of 2016, including in particular the payment of wages for pedagogical staff in preschool education.

The recovery of the share of own source revenues to total revenues in the aftermath of the global financial and economic crisis of 2008-2009 has been slow with substantial ups and downs along the way. In 2019, the share of own revenue to total revenues had returned to the pre-crisis levels only in North Macedonia, Serbia and Romania. In Montenegro and Albania this is due to the elimination of local government tax powers, while in Kosovo and Bulgaria it is mostly related to the devolution of block grants for new functions. In Türkiye the fall in the share of own revenue is attributable to the implications of the global economic crisis rather than any change in intergovernmental transfers.

Between 2019 and 2020, the share of own revenue to total local revenue fell on average by 3% in South-East Europe, with the mildest fall of -1% and the hardest fall by -9%. The fall in own revenue is directly related to the weakening of the tax base, both in terms ability of households and local businesses to pay local tax obligations, and secondly due to the proactive measures undertaken by LGs to provide exemptions or postpone the collection of local taxes, fees and charges and the inability to benefit from revenues from the sale and rental of local assets. The COVID-19 impact on LG revenues is analysis in a separate section.

While the overall structure of LG revenues has not experienced major changes, the composition of own source revenues has changed dramatically over the past 15 years. Figure 18 presents the composition of local government Own-Source-Revenues in 2006 and 2021 for all NALAS members, ranked by the share of Own Source Revenues to total local revenues. Despite the decrease, Montenegro is still the outlier with own source revenues' share of 67% of total revenues in 2021. At the other end of the spectrum is Moldova, which still has the lowest share of subnational revenues to the total public revenues (11%) and where there is a significant decline of the property tax revenues' share – 32% in 2021 vs. almost 50% in 2006. The share of the property tax revenues has doubled in the Western Balkan economies, from an average of 14% to 28% of own source revenues, indicating, across the region, that more effort is put into the collection of the property tax. As expected, at the broader SEE level, the share of the property tax revenues has increased, but at a more moderate pace from 20% to 27% of total own source revenues.

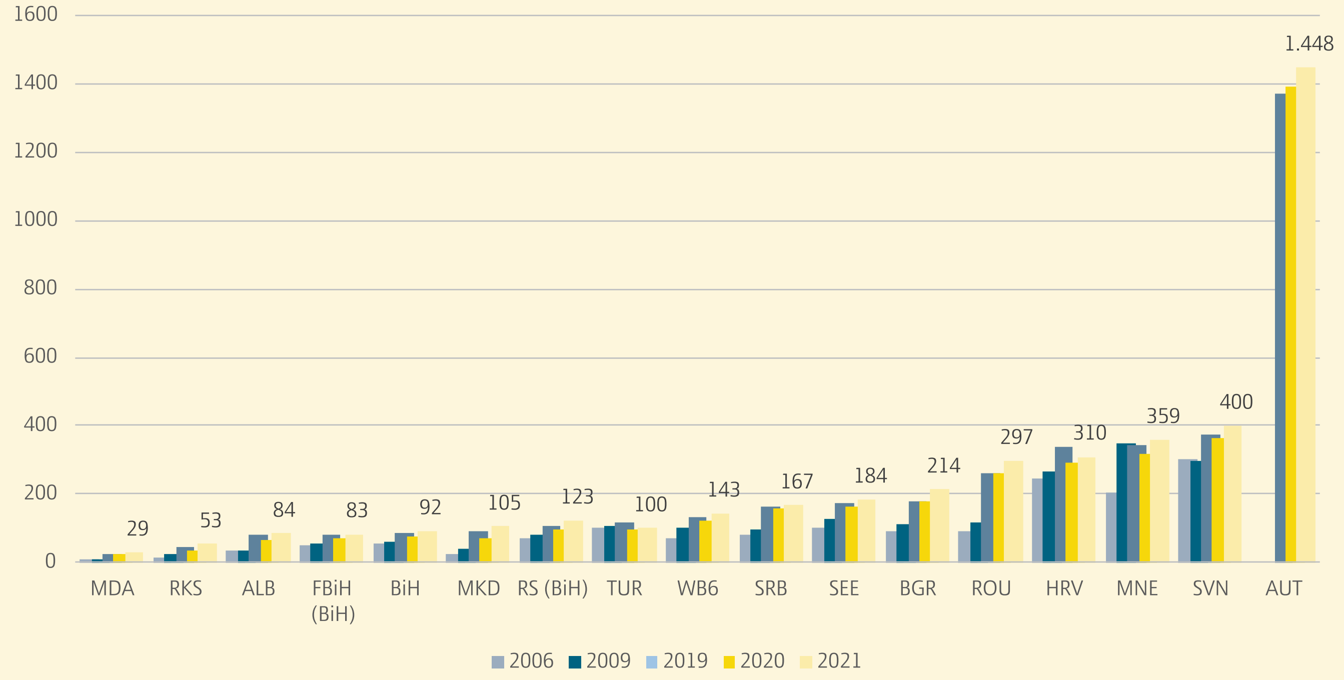
Figure 18 Composition of Own Revenue in 2006 and 2021



From a regional perspective, compared to 2006, the share of the property tax to total own local revenue has increased in almost all SEE economies, except for Albania, Moldova and Romania. In Albania the decline in the share of the property tax is related to the significant increase of other types of own revenue, such as from the taxing of new construction. On the contrary in Serbia these types of fees have been eliminated while in Montenegro their relevance has been decreasing over the past decade. However, only Albania, Kosovo and Montenegro seem to continue granting local governments taxing powers over new constructions. Asset management revenue also remains important in Bulgaria, Slovenia and Croatia, while its relevance has decreased in Montenegro, Romania and the Republic of Srpska entity of Bosnia and Herzegovina.

While own revenue in EUR per capita has increased over the past 15 years, yet, the fiscal scope, capacity and success of local tax collection varies significantly across SEE LGs. Figure 19 presents the own source revenues yield in EUR per capita for five selected years which, while showing progress over time, still demonstrates the huge variations in the ability of LGs to collect their own revenue across the region and at the same time the COVID-19 implications. Compared to 2006, own revenue in Euro per capita tripled in Moldova, Kosovo, Albania, and Romania while it quadrupled in North Macedonia. In Croatia and Slovenia, the share of own source revenues increased by 1.3 times, indicating already mature levels of revenue-raising capacity. In Türkiye the share of own source revenues in Euro per capita, is the same as in 2006, with about 100 Euro per inhabitant. Moldova still has the lowest indicator, almost two times lower than the next one – Kosovo and almost seven times lower than the SEE average. The difference among SEE remains considerable—Slovenian local governments generate almost three times more own source revenues per capita than their counterparts in the Western Balkans. There is a huge variation in the own source revenues per capita between EU and non-EU member economies. Compared to 2019, this indicator has improved in almost all SEE economies, except for Türkiye and Croatia.

Figure 19 Local Government Own source revenues, in EUR per capita



From a regional perspective, local government powers to set and collect taxes, fees and charges are in continuous change – sometimes without a due process of consultation and/or compensation. Local taxes, fees and charges are amended quite frequently, and this is done mostly under the general expectations to improve business climate by reducing fiscal burdens to taxpayers. Unfortunately, this depresses local governments revenues and efforts too. SEE local governments continue to face similar challenges with regard to own revenue generation, regardless of the level of development and their membership in the EU. The key challenges include the frequent and continuous amendment of the legal framework, outdated fiscal registers, weak tax compliance and enforcement etc.

The Property Tax in South-East Europe

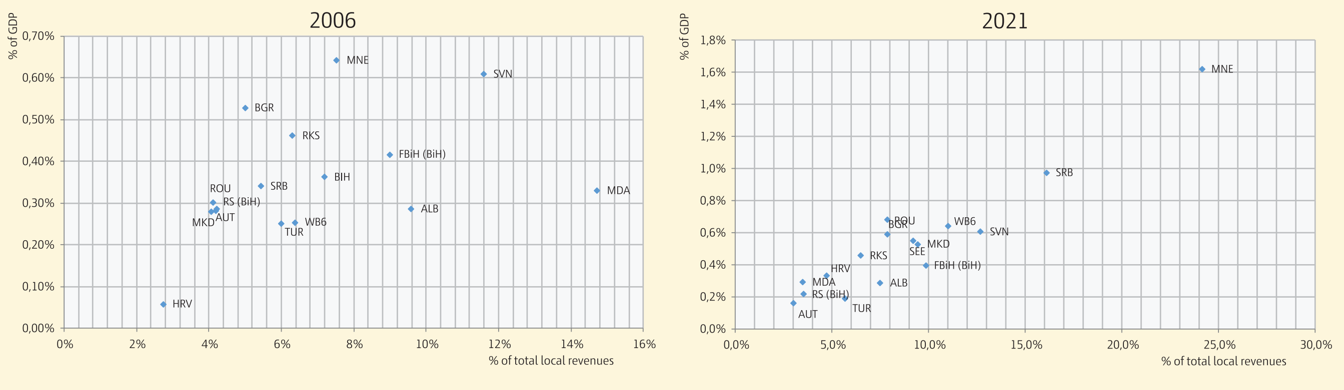
The property tax is becoming the lead local government tax in South-East Europe. From a regional perspective, between 2006 and 2021, the yield of the property tax almost doubled, increasing from 5% to 9% of local revenues and from 0.3% to 0.6% of the GDP. This tendency is driven by the outstanding performance of Bulgaria, North Macedonia, Montenegro and Serbia and to a lesser extent Kosovo and Slovenia. Figure 20 also shows that Montenegro and Serbia lead considerably above the rest of the group, which have similar indicators. Montenegro's and Serbia's indicators are the closest to the EU average of 1.6% of GDP and in line with Eastern Europe members of the EU.

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

Throughout the region, national and local governments, to a large extent with the support of the donor community, have made substantial investments in the technical infrastructure for property taxation. Despite the good results, if we follow the European history and traditions, the property tax revenues' importance in SEE, for the foreseeable future, will be probably much smaller than the PIT (sharing or local surcharges) or even asset management revenues.

There remain wide disparities in the property tax powers and collection efforts and success in SEE local governments. Figure 21 shows the property tax revenues in Euro per capita in South-East Europe in 2021. Moldovan LGs' revenues from the property tax are again the lowest for the entire region with only 9 Euro per inhabitant, while Slovenian LGs collect 150 Euro per inhabitant. There are wide disparities also within the Western Balkan Economies, where Albanian LGs, despite recent reforms

Figure 20 Property Tax as a percentage of GDP and Total Local Revenue in 2006 and 2021



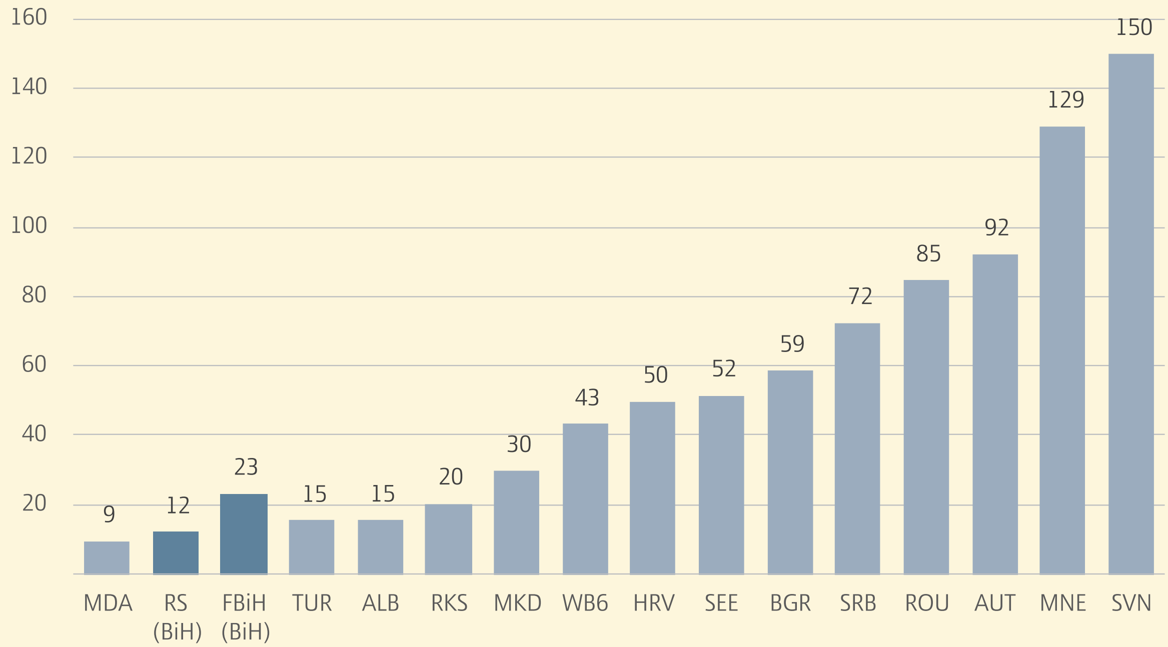
to move to a market value system of property taxation, still collect about half of what is collected by Macedonian LGs and about 5 times less than the amounts collected by Serbian LGs.

At the global level, property taxes are regularly discussed, with special emphasis on the need for their reformation. Property taxes qualify as "good" taxes because they are considered adequate sources of local financing and represent main source of municipal own source revenues (McMillan Dahlby, 2014)[4].

However, on the other hand, citizens do not like them, and politicians are sceptical about undertaking reforms for their increase.

Experience from property tax reforms in different economies shows, that it is a relatively difficult process (Slack & Bird,2014; Garnier et al. 2014, Norgaard 2013)[5]. International institutions, (International Monetary Fund (IMF), often recommend better use of property taxes, however their reformation is difficult.

Figure 21 **Property Tax Revenues, in EUR per capita, 2021**



4 McMillan, M., & Dahlby, B. (2014). Do Municipal Governments Need More Tax Powers? A Background Paper on Municipal Finance in Alberta. (School of Policy Studies, SPP Research Papers 7(33)). Calgary: University of Calgary.

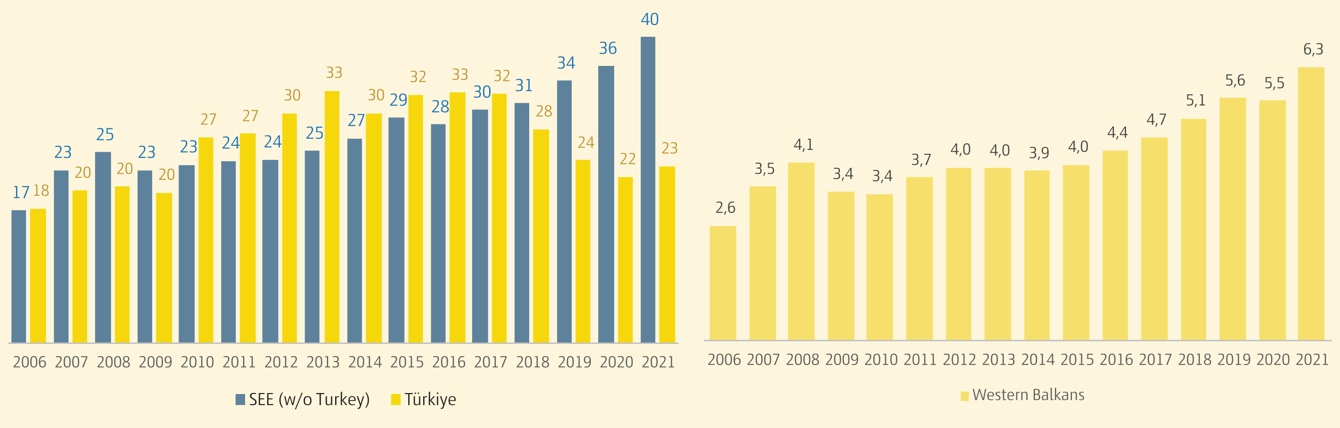
5 Slack, E., & Bird, R. M. (2014). The Political Economy of Property Tax Reform (OECD Working Papers on Fiscal Federalism No. 18). Paris: Organisation for Economic Cooperation and Development.
Garnier, G., György, E., Heineken, K., Mathé, M., Puglisi, L., Ruà, S., ... & Van Mierlo,A. (2014). A Wind of Change? Reforms of Tax Systems since the Launch of Europe 2020 (Taxation Papers, Working Paper No. 49). Luxembourg: European Commission.
Norregaard, J. (2013). Taxing Immovable Property: Revenue Potential and Implementation Challenges (IMF Working Paper, WP/13/129). Washington, D.C.: International Monetary Fund

The COVID-19 Implications on Local Government Finance

The COVID-19 pandemic has had profound implications for local governments and the structure of local government finances in South-East Europe. As elsewhere, in many cases SEE local governments experienced the difficult 'scissor effect' scenario with declining revenues, in particular from their own sources, and increasing needs for spending. In the vast majority of cases, SEE LGs approved exemptions or grace periods for local taxes, fees and charges for households and local businesses in an effort to support local communities resist the crisis. The increasing spending needs were met by increased support from higher levels of government either via increasing intergovernmental transfers in direct support of LGs and local communities or by accelerating the transfers for the first part of the year. Similarly, liquidity constraints and deficits were met with increased borrowing. Nevertheless, the economic fallout of the lock-downs and interruption of economic activity had a significant impact on own source revenues of local governments. The interrelations of these factors indicate that from 2019 to 2020, on average, LG revenues declined by just 1.1% in the Western Balkans and 0.4% in South-East Europe as a region.

The COVID-19 pandemic interrupted a five-year sequence of continuous growth in LG revenues of on average 5% per annum in SEE (excluding Türkiye) and 7% per annum in the WB6. In fact, over the five years before the pandemic (2015-2019), LG revenues in million EUR in the Western Balkans increased by an average of 7%, and a minimum and maximum rate of 4% to 10% while revenues in South-East Europe (excluding Türkiye) increased by an average of 5%, and minimum and maximum rate of -3% to 10%. Türkiye's LG revenues in million EUR have decreased by an average of 4% between 2015-2019, and by 14% and 15% between 2018-19, as a result of the domestic economic crisis and the strong depreciation of Türkiye's Lira. For this reason, the data is shown in different groups to create a better understanding of the regional trends. In the absence of COVID-19, if LG revenues in the western Balkans continued to increase by the average 7% in annual terms, LG revenues in 2020 would have been 476 million EUR higher than what they actually were. For the SEE region (excluding Türkiye), due to support measures from higher levels of government, in particular the EU member states, LG revenues have increased by an average of 6% between 2019-2021.

Figure 22 Local Government Revenue in Billion EUR, in SEE and the WB6, 2006-2021



The COVID-19 pandemic had a strong territorial dimension as different territories have been affected in different ways, within and across economies and local governments. At the individual level, LG revenues in million Euro (accounting also for currency depreciations), declined in half of SEE economies by an average of 5%, and a minimum and maximum of 1% to 9% between 2019 and 2020. LG revenues have increased in the other half of SEE economies, in particular due to increases in intergovernmental transfers. The decline in Türkiye's LG revenues shown in Figure 23, is entirely driven by the high depreciation of the Turkish Lira vis-à-vis EUR as in fact, in nominal terms, LG revenues in Türkiye's Lira have increased between 2019 and 2020.

Figure 23 **Annual Change in Local Revenues, 2020 and 2021 (in percent)**

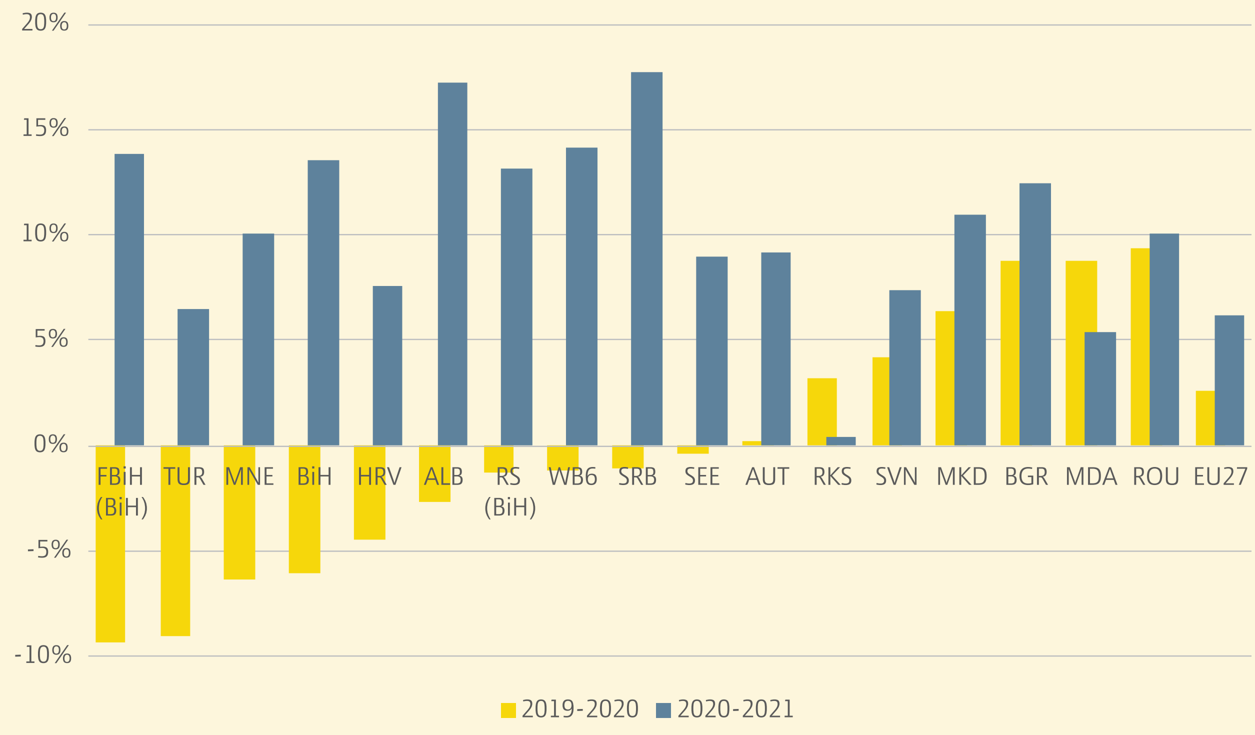
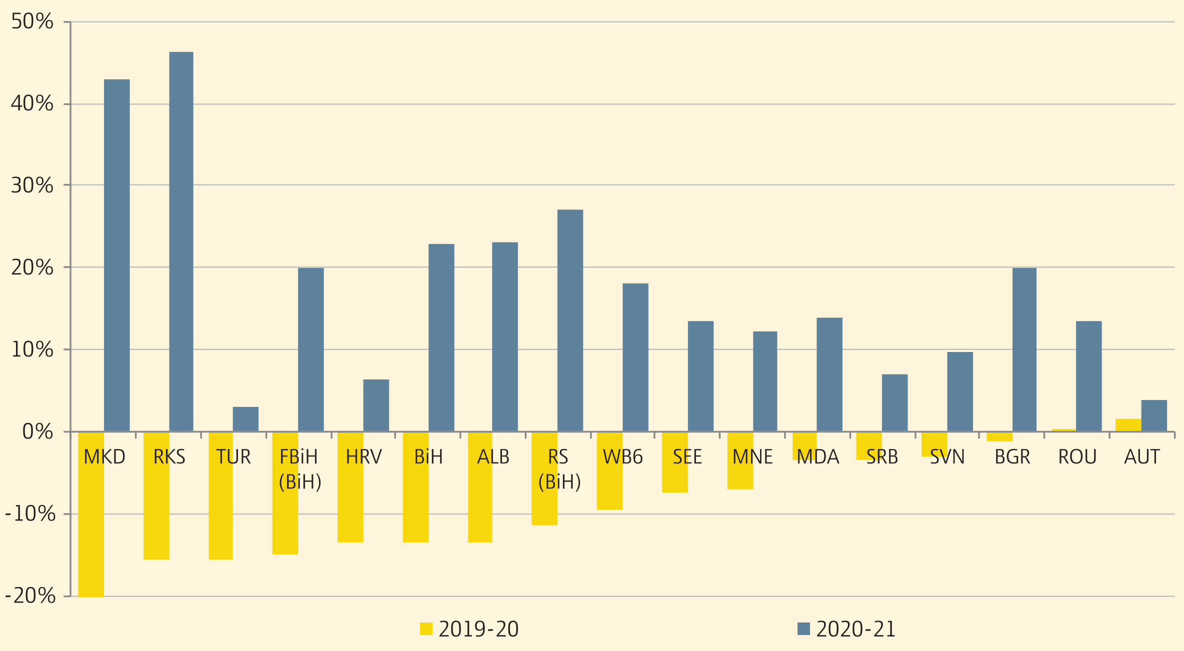


Figure 24 Annual Change in Own Local Revenues in Million EUR, 2020 and 2021 (in percent)

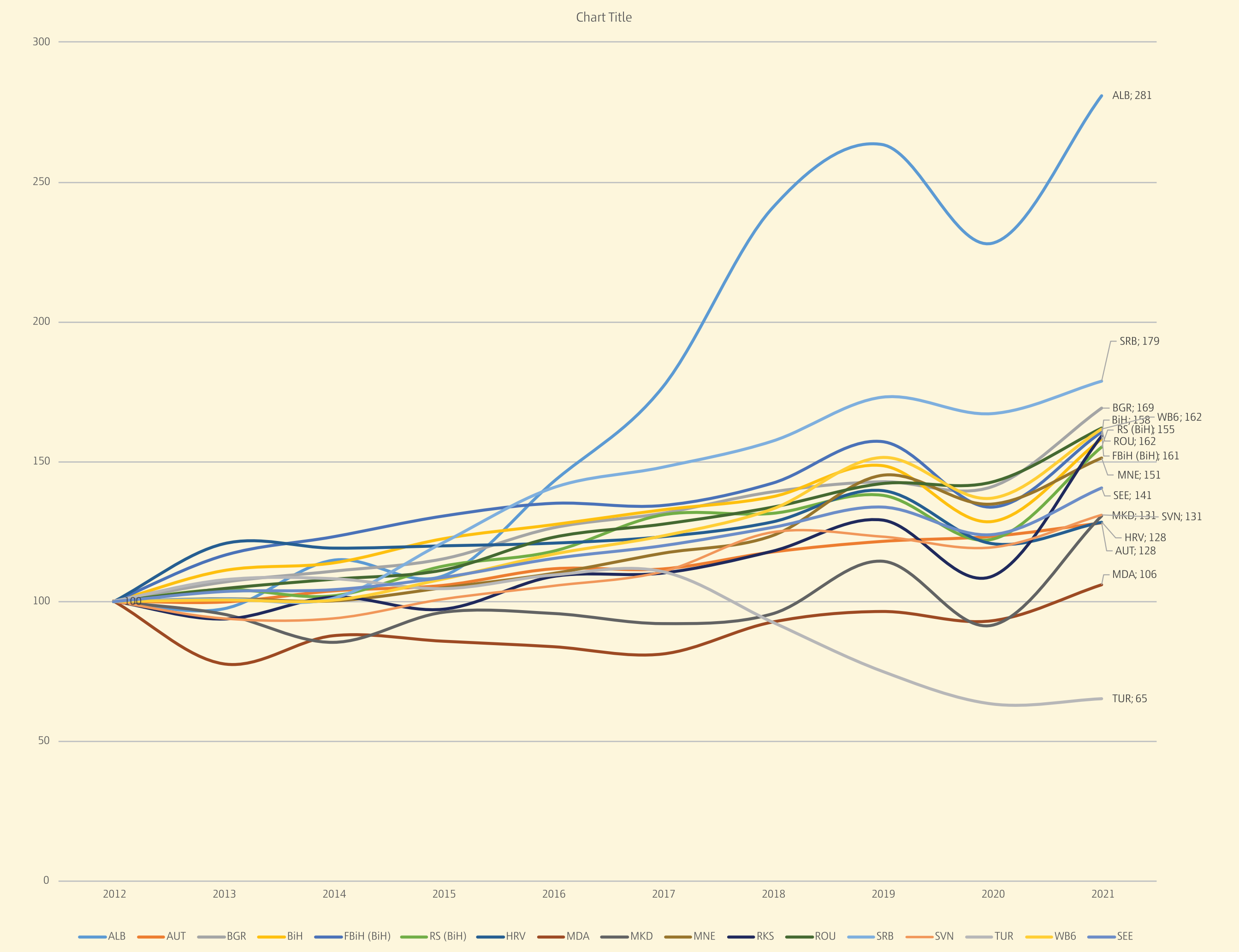


The COVID-19 pandemic had a strong impact on local government own source revenues from local taxes, fees and chargers. Except for Austria and Romania, LG own source revenues (in million EUR) declined all over South-East Europe, by an average of 7% in annual terms between 2019-2020. The decline in own source revenues has been more accentuated in the Western Balkans, with LG revenues falling by 10% on average, where own source revenues present also a higher share of local government revenues, as indicated by Figure 24.

Figure 25 shows the change in volume in local government own source revenues, in million Euro in SEE economies between 2012 and 2021, where the baseline year is 2012. The graph helps better understand the performance of own source revenues (in million EUR) over the past decade and the COVID-19 implications. In Türkiye LG own source revenues in million EUR have declined and represent in 2021 only 65% of what they used to be in 2012. Similarly, in Moldova, LG own source revenues have increased by only 6% in a decade, when in Albania, an economy of similar size and challenges, own source revenues have increased by a factor of 2.81 or 181%.

LG own source revenues have recovered in 2021, returning to the pre-COVID-19 levels almost everywhere. LG own Revenue in million Euro increased by 18% in the Western Balkans and 13% in South-East Europe in annual terms between 2020 and 2021. The high growth rate is also a direct result of the strong decline in own revenue in 2020.

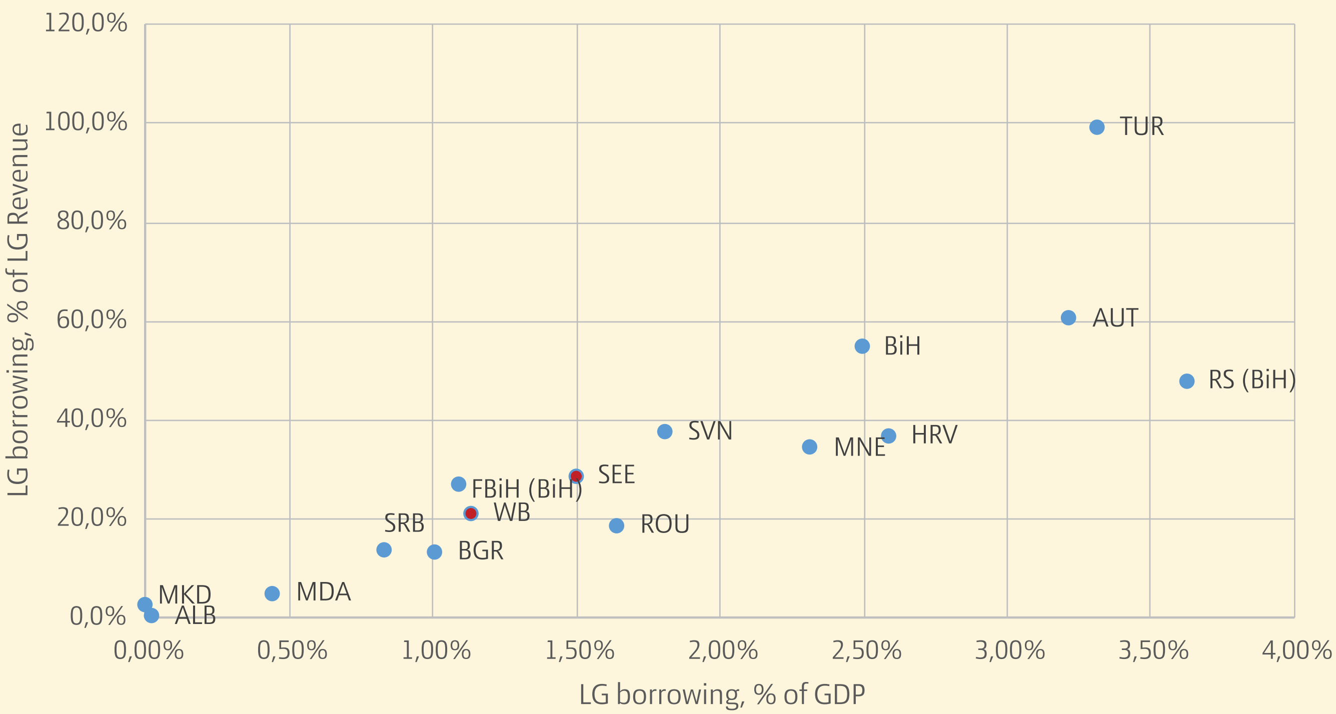
Figure 25 Change in Volume of LG Own source revenues (in million EUR) in SEE (2012 – 2021), baseline year 2012 = 100



Local government borrowing in South-East Europe

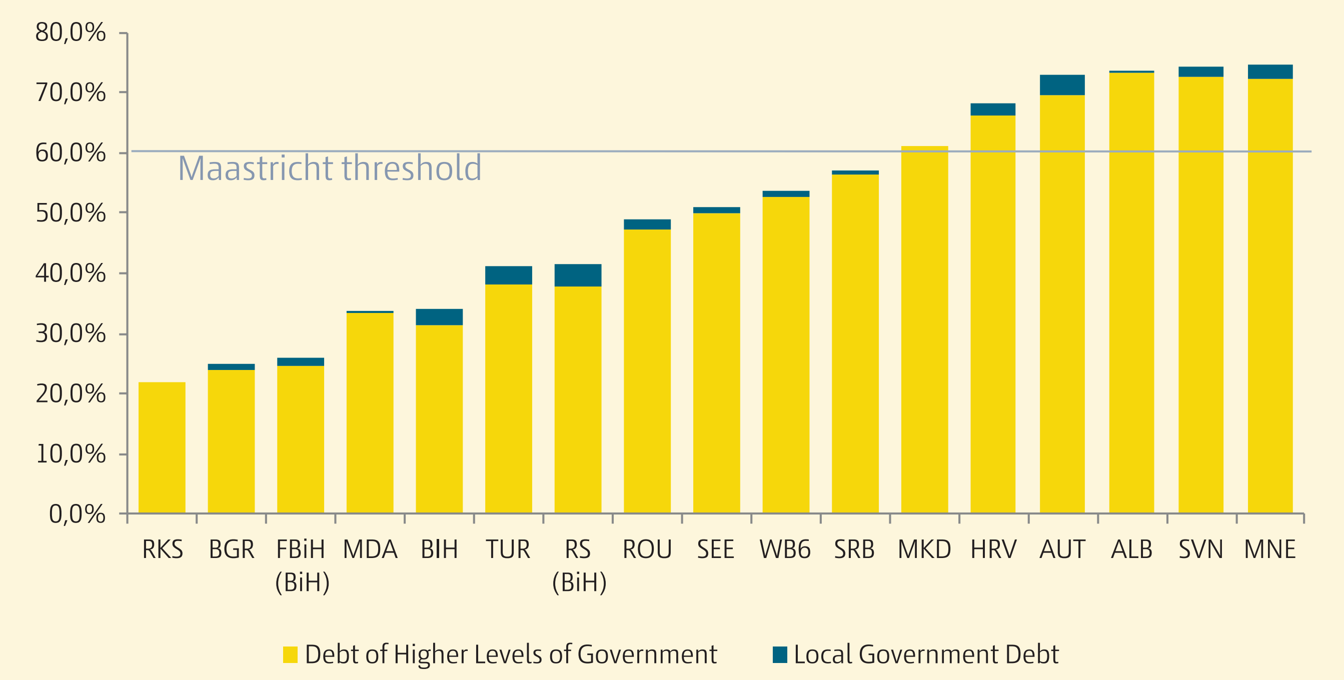
In most of the SEE region, local government borrowing remains a relatively new and under-utilized instrument for financing local governments. Figure 26 shows the level of local government debt in South-East Europe in 2021. The municipalities only in RS (BIH), Austria, Türkiye, Croatia and Montenegro have ratios above 2%—4% of GDP. In these economies, LG borrowing, as a share of municipal revenue, is rather high, either close to 40% and above. Among the SEE economies, local government debt in Albania, North Macedonia and Moldova represents a negligible fraction, while in Slovenia, Romania, Serbia and Bulgaria and the Federation of Bosnia and Herzegovina (of BiH), local borrowing is more substantial. One of the main constrains for this important source of financing, in particular for long term capital investments, (besides other factors like very conservative, rigid and centralized regulatory framework), are high levels of public debt, budget deficits and the need (or plan) to try meet the Maastricht Treaty's guidelines for total public debt and annual budget deficits (*less than 60% and 3% of GDP respectively*).

Figure 26 Local Government Debt in South-East Europe (2021)



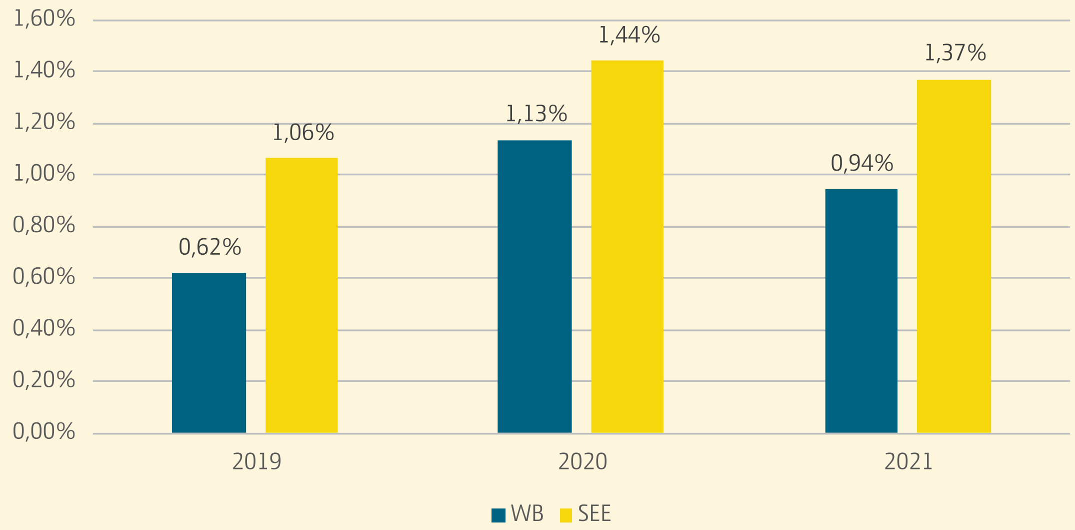
Municipal debt constitutes a very small portion of public debt in South-East Europe. Indeed, the vast majority of public debt is taken by the national government – the average local governments' share in SEE is merely 1.3% of the total public debt. However, there are significant variations across economies. In the Republic of Srpska of Bosnia and Herzegovina, Türkiye, Austria, Montenegro and Croatia local government debt constitute between 2% and 3.6% of total public debt. In Slovenia and Romania and Bulgaria the ratio is less than between 1% and 2% of total public debt. In Serbia and Moldova, local government debt makes up between 0.4% and 0.8% of the GDP, while in Albania, Kosovo, and North Macedonia local government debt in 2021 is inexistent. Among the economies above the Maastricht limit, Albanian LG debt represents a negligible fraction of the total, while in Croatia, Austria, Slovenia, and Montenegro LG borrowing is more substantial.

Figure 27 **Public Debt by Level of Government, as a percentage of GDP in 2021**



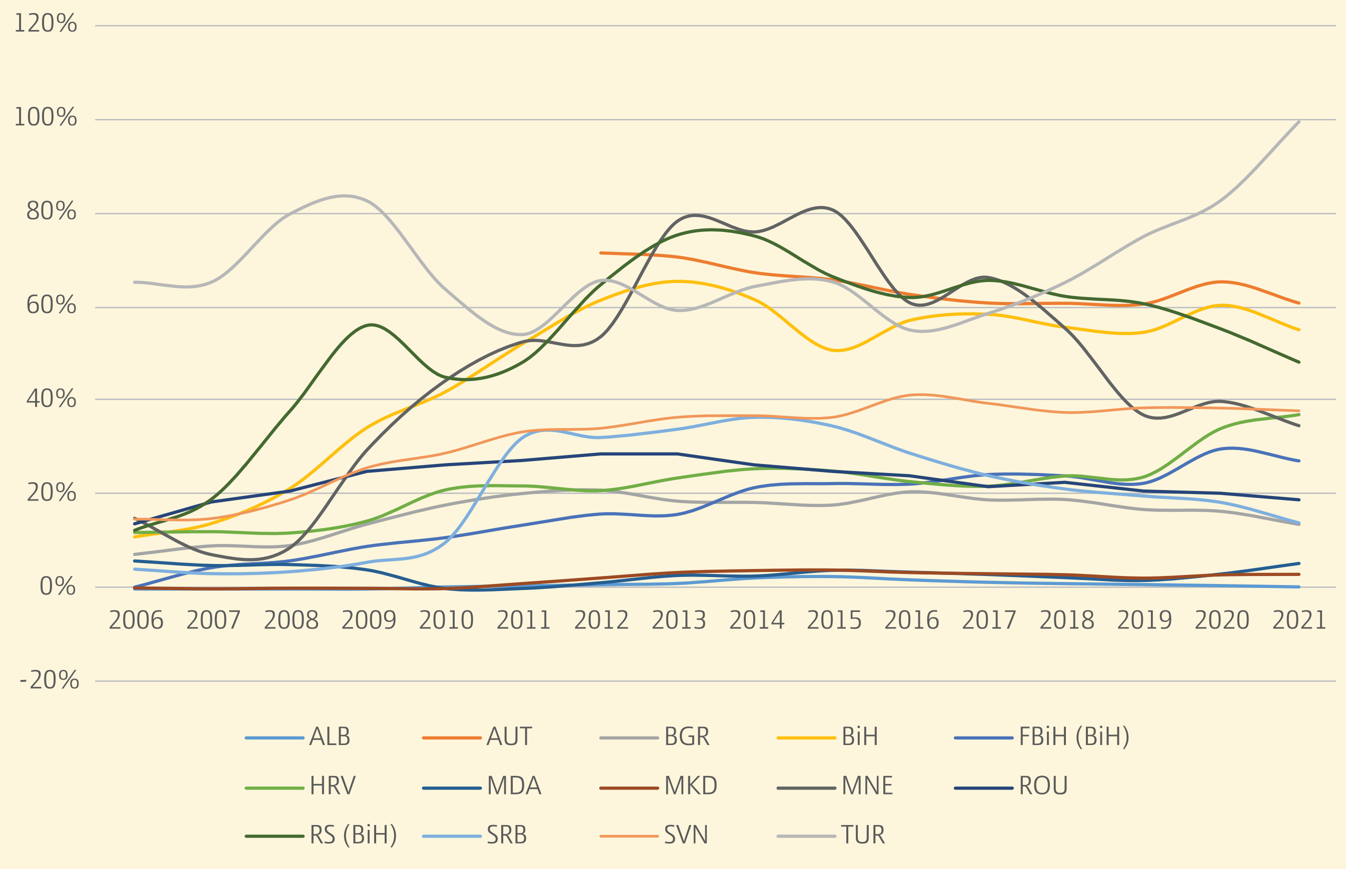
During the COVID-19 pandemic LG debt increased by 84% in the Western Balkans and 36% in South-East Europe. LGs in the region increased access to LG borrowing as a means to face both short-term liquidity constraints due to declining revenues and increasing expenses and at the same time lead efforts for the socio-economic recovery of local communities by capital investments improving services and infrastructure. Figure 28 shows the increase in LG debt over the past three years. LG debt seems to start stabilizing in 2021, levelling at an average of 0.94% of GDP.

Figure 28 **LG Debt in SEE, in percent of the GDP, 2019-2021**



There remain significant disparities across SEE LGs in their ability to use debt as a financing instrument to build and improve local infrastructure and services. Borrowing is an important source of financing for local governments in Austria, Bosnia and Herzegovina, Croatia, Montenegro, Slovenia and Türkiye with LG debt constituting between 37% to 99% of LG revenues in 2021. Borrowing an in important role also in Bulgaria, Romania and Serbia, where LG debt constitutes between 14%-19% of LG revenues in 2021. LG borrowing is not allowed in Kosovo, while it plays a very small role in Albania, Moldova and North Macedonia where LG debt in 2021 constituted between 0.4% and 5% of LG revenues. Figure 29 shows the level of local government debt, as a percentage of local government revenues, between 2006-2021, for the individual SEE economies. LG borrowing started to gain traction in particular after 2008, both as a result of the global financial crisis and the concerted efforts to develop legal frameworks supporting LGs in local borrowing. LG borrowing increased significantly between 2008-2012 and started to reduce thereafter.

Figure 29 Local Government Debt, as a percentage of Local Government Revenues, 2006-2021



The key challenges affecting access to debt capital by LGs are the following:

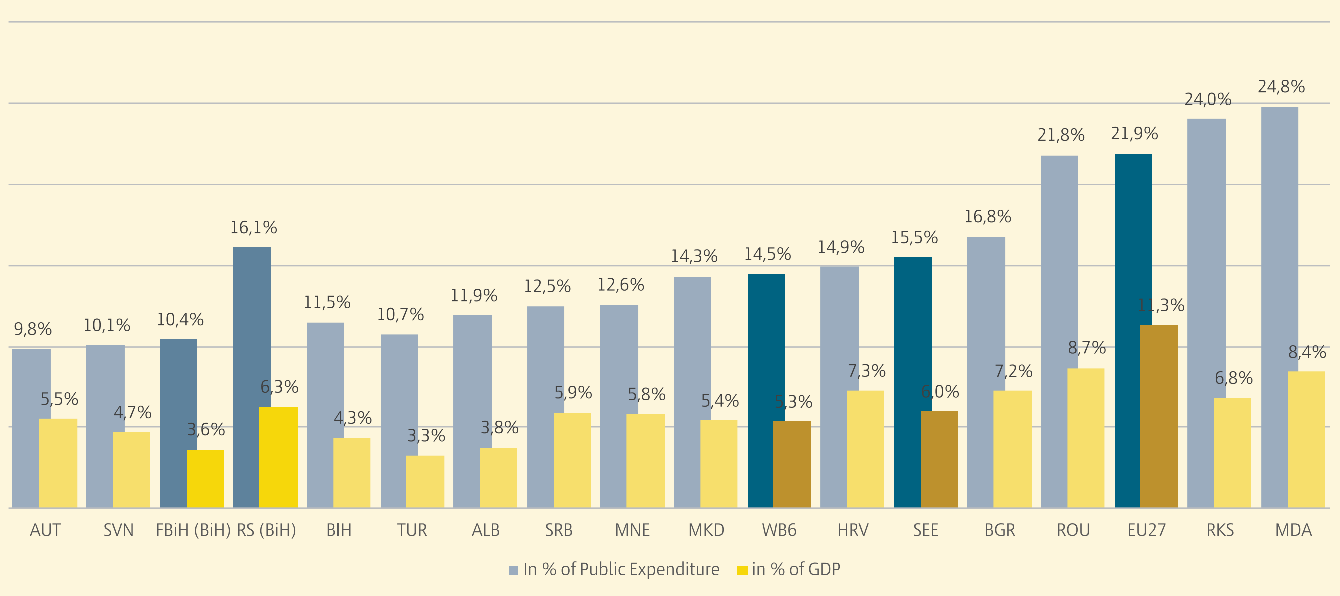
- In most of the SEE region, the law requires central government's approval prior to local debt issuing and given the current high levels of public debt facing national governments, approval for LG debt can become challenging; in particular if there are no clear and objective rules regulating local government borrowing limits;
- In more than half of SEE economies, there are legal limitations on both, the total outstanding debt and the annual debt service payments;
- Local governments will have to do a better job collecting Own-Source Revenues, particularly with respect to setting higher tariffs and then forcing utilities to collect them;
- Local governments will have to radically improve their ability to prepare, plan, and cost-out complex, multiyear investment projects—particularly in the water and solid waste sectors;
- The central governments should systematically promote incentives for investing on a pay-as-you-use basis (*mainly debt-financed*) instead of the currently predominant pay-as-you-build (*paid out of recurrent revenues*).

However, in many places, the overall adequacy and predictability of local government revenues will have to be increased if municipalities are to prudently incur debt. Given the dependency of local governments on transfers, the rules regulating intergovernmental finances and borrowing need to be clear and stable if borrowers and lenders are to be confident that municipal governments will be able to pay off their debts.

Local Government Expenditures

Local Government in the Western Balkans and South-Est Europe manage between 10% and 25% of total public spending, with averages of 14.5% and 15.5%. LG expenditure varies from 3% to 9% of the GDP, with averages of 5-6% of the GDP, which is about half of LG expenses in the EU. Figure 30 shows the LG expenditures in SEE economies as a percentage of public expenditures and the GDP, in 2021. These significant differences, reflect the differences in service responsibilities and levels of income. Unsurprisingly, in Moldova, Kosovo and Romania, where LGs have extensive decentralized social sector responsibilities in education and to a lesser extent in health and social protection, the share of LG expenditures is higher than elsewhere in the region, and even higher than in the EU.

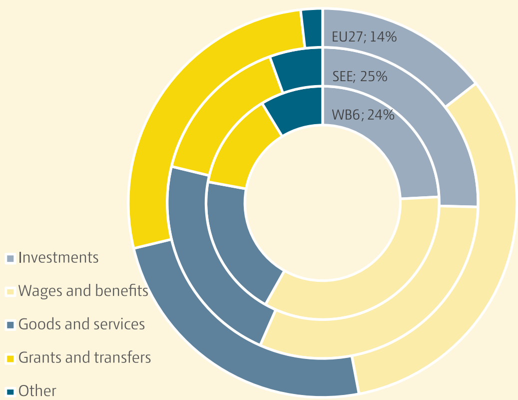
Figure 30 **Local Government Expenditure as a percentage of Public Expenditure and the GDP, 2021**

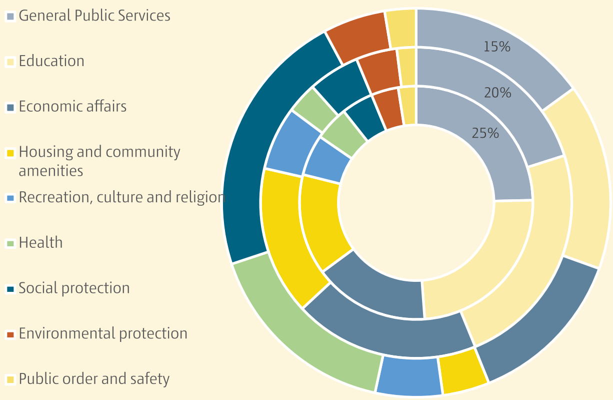


From a methodological perspective, it should be noted that, as with revenues, there are inconsistencies in the way expenditure data is reported. For example, some places treat capital transfers to public utilities as investment expenditures while others record them as subsidies, which cannot be distinguished from transfers to individuals or grants to non-governmental organizations. Similarly, in many places, debt repayment is not accounted for separately, but included in the category "Other".

Local Governments in the Western Balkans and South-East Europe spend about 24-25% of their budgets on capital expenditures for investments. Figure 31 shows the composition of the regional average local government expenditures in the six Western Balkan economies, South-East Europe and the EU, by economic type and functions of government in 2021. Spending for goods and services constitutes 20%-22%, for grants and transfers 13-16% while the remaining 6-9% on other categories. From a functional perspective, **WB6 and SEE local governments spend about 20-25% of total municipal budgets for general public services, about 24% on education, 16-19% on economic affairs and about 14-15% for housing and community amenities.** Municipal spending for health, social protection and environmental protection varies between 3-5% each, in the WB6 and SEE.

Figure 31 **Composition of LG Expenditures in SEE, WB6 and EU, 2021, Economic and Funcitonal Classification (in percent of total).**





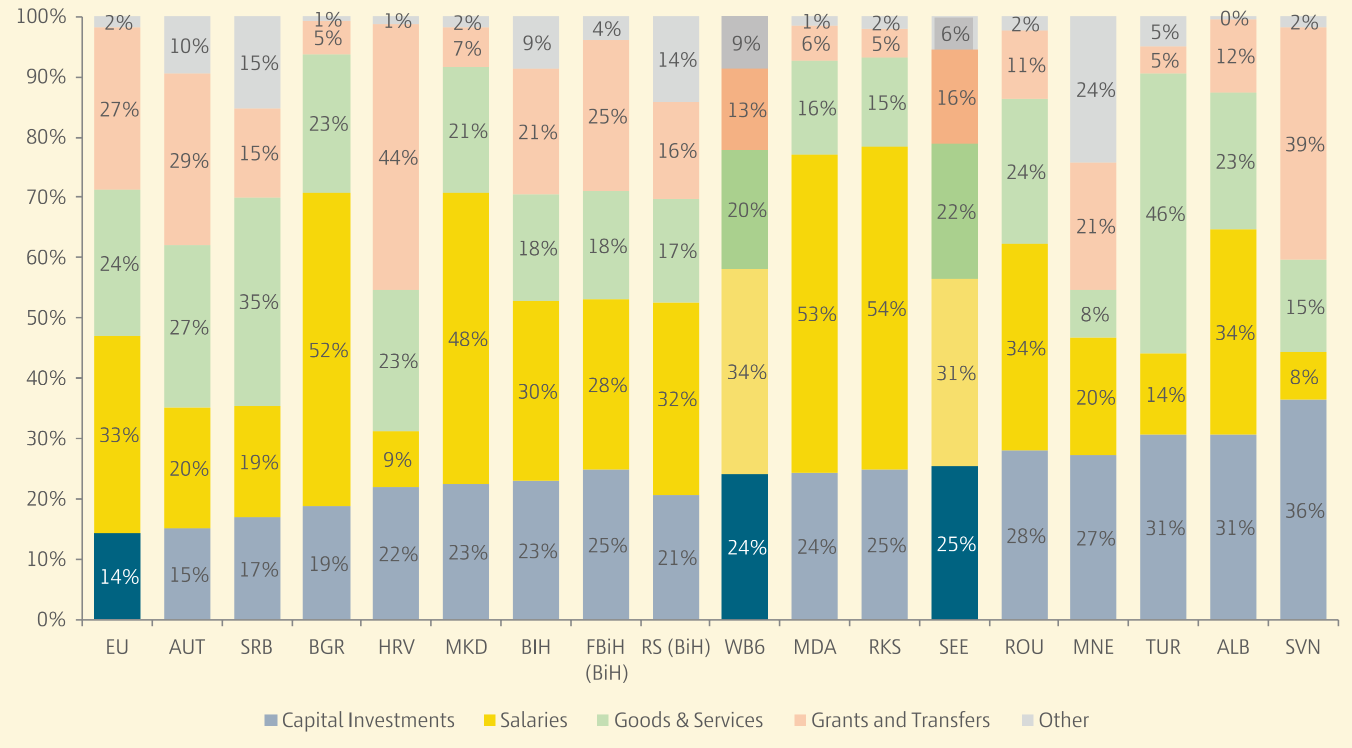
There are strong differences between WB, SEE and EU local governments in the composition of local budgets. In the EU, municipal capital expenses make up to 14% of the total in 2021, which is 10 percentage points lower than in WB6 and SEE. Spending for wages and goods and transfers in the WB6 and SEE are relatively the same as EU averages, while there are huge differences in spending for grants and transfers – which is explained by higher municipal spending in the EU for social protection. The functional allocation of expenditures helps better understand the significant differences in municipal responsibilities in the SEE and WB6 compared to the EU. Almost 40% of municipal budgets in the EU are dedicated to healthcare (17%) and social protection (22%) as opposed to 8% and 9% in the SEE and WB6.

Table 4. The composition of LG Expenditures, in the WB6, SEE and EU, Economic and Functional Classification (in percent of the total)

Economic Classification	WB6	SEE	EU27	Functional Classification	WB6	SEE	EU27
Investments	24%	25%	14%	General Public Services	25%	20%	15%
Wages and benefits	34%	31%	33%	Education	24%	24%	16%
Goods and services	20%	22%	24%	Economic affairs	16%	19%	13%
Grants and transfers	13%	16%	27%	Housing and community amenities	14%	15%	4%
Other	9%	6%	2%	Recreation, culture and religion	6%	7%	6%
				Health	5%	3%	17%
				Social protection	4%	5%	22%
				Environmental protection	4%	4%	5%
				Public order and safety	2%	2%	3%

Local governments in the WB6 and SEE spend a larger share on investments than their counterparts in the EU due to differences in service responsibilities and needs. Figure 32 shows the composition of local government expenditures by economic type for each member of the group, as well as the average for SEE, WB6 and the EU. Again, as explained earlier, within WB6 and SEE, in the economies that have decentralized social sector functions, local governments spend a higher percentage of their expenditures on wages (*up to almost 60%*). Economies are ranked on the share of spending for investments to total municipal spending. LGs in Slovenia, Albania, Türkiye, Montenegro and Romania spend more on capital expenditures. In this group spending for salaries varies significantly, except for Albania and Romania that seem to have similar shares of spending for salaries. While municipal service responsibilities in Albania and Romania are significantly different, this similarity is not surprising when considering the centralization of the wage bill for teachers in 2018 by the central government in Romania. LGs in Moldova and Kosovo too spend more on capital investments than the average for the Western Balkans, although not significantly different from North Macedonia and to a lesser extent Bulgaria where LGs have more decentralized social sector responsibilities than the rest of the region.

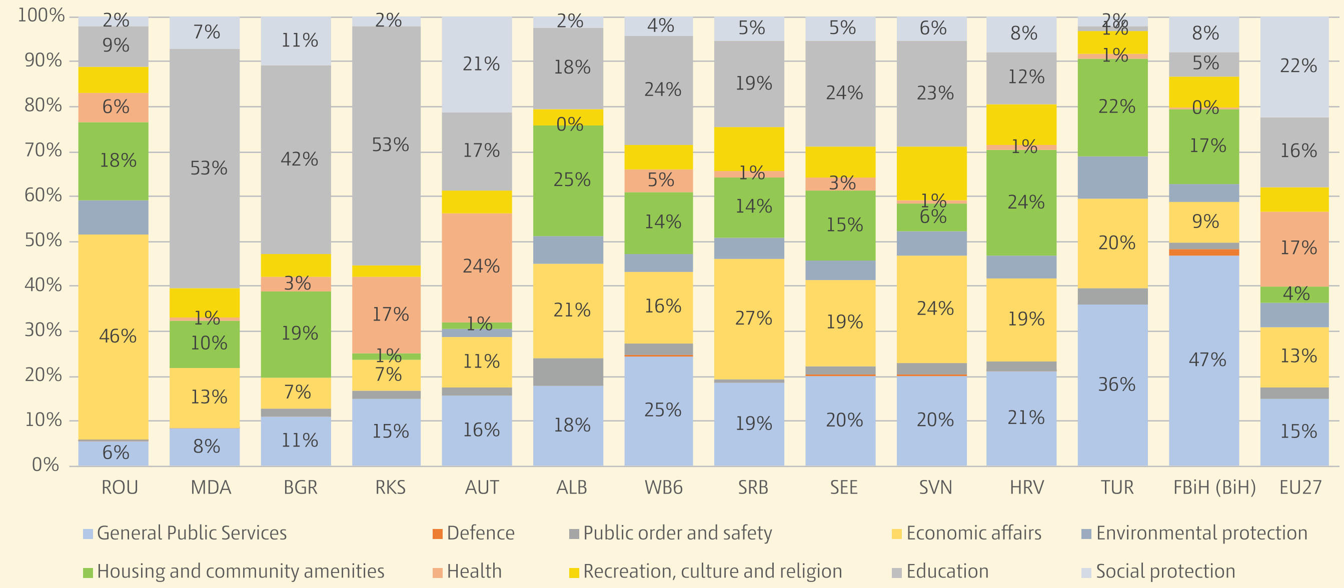
Figure 32 **Composition of LG Expenditure in SEE Economies, 2021 (in percent of the total)**



It may be perceived as surprising that LGs in the WB6 and SEE tend to spend more on capital investments than their richer counterparts in the EU. There are several factors that may help explain this tendency. In fact, the greater decentralization of social sector functions within the EU requires higher operating costs, which depresses the share of expenditure going to investment. Similarly, the investment needs of SEE and EU are different – in SEE more money is spent on building new infrastructure and reconstructing the old-one while in the EU more is spent on maintaining the existing infrastructure which is treated as operational expense. Ultimately, it is important to consider that SEE LGs often pay directly (out of their budgets) for investments that elsewhere in Europe are financed mainly through utility tariffs (water and sewer, waste collection and treatment, public transportation). Last but not least, the lower spending on capital expenses in the EU may come also as a result of the COVID-19 pandemic, where LGs may cut spending for investments to increase spending for more pressing needs in the health sector, for example. **It is also important to consider that SEE LGs investment capacity may be overstated because of centrally controlled investment grants from higher levels of government over which LGs have little discretion or decision-making authority.** This is certainly the case in Albania, which, for a number of years, has had the highest levels of LG spending on capital investments in the region.

The differences between the spending patterns of SEE LGs and their counterparts in the EU can also be analyzed based on the functional allocation of expenditures. Figure 33 shows the composition of LG expenditures based on the functions they perform, for a select number of economies that publish information on expenditures based on the classification of the functions of government methodology (COFOG). Economies are ranked based on the share of expenditures allocated for "General Public Services" function, covering mainly the functioning of the local administration (wages for the staff and local elected bodies, maintenance of public buildings etc.).

Figure 33 Composition of Local Expenditure, According to the Functions of Government (in percent of total)



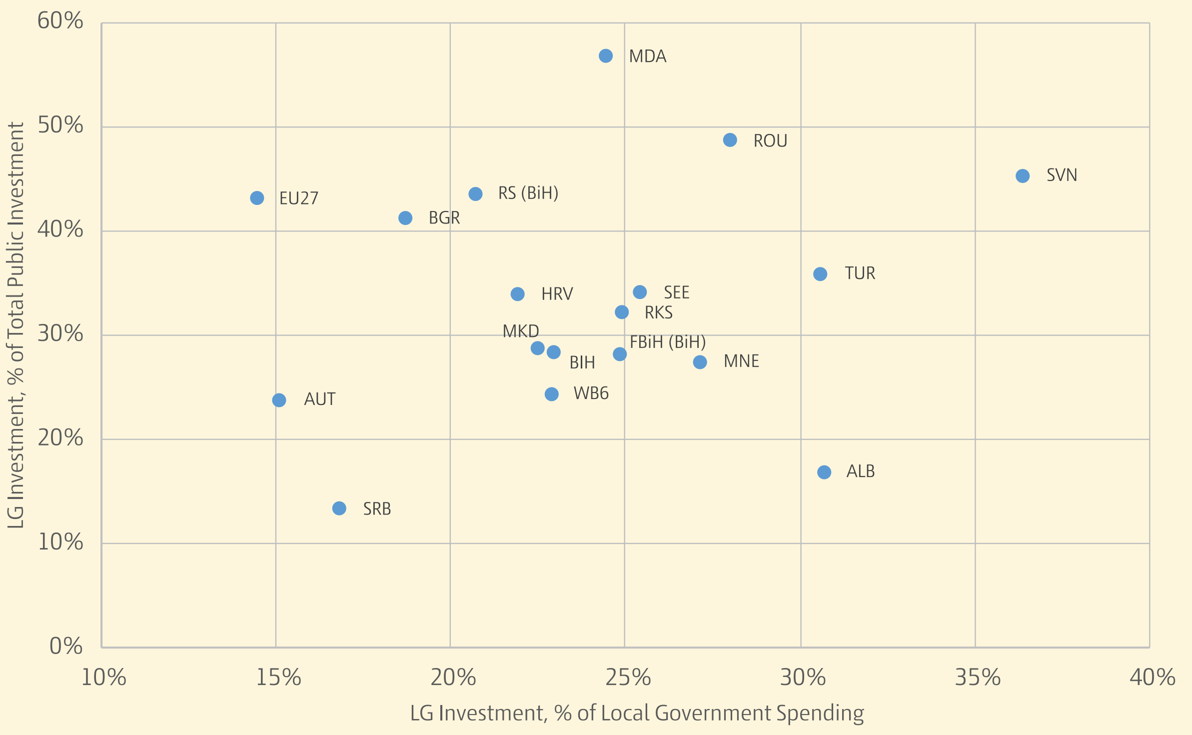
Local governments in Romania, Moldova, Bulgaria, Kosovo, and Austria spend less than their EU counterparts for general public services. Local governments Albania, Serbia, Slovenia and Croatia are closer to the SEE average and those in Türkiye and the Federation of Bosnia and Herzegovina (of Bosnia and Herzegovina) spend much more than their EU counterparts as regards general public administration services. Not surprisingly, in economies where the local governments' wage bill is larger than the EU average, local governments are responsible for costly social sector functions like education.

Local Government Capital Investments

The infrastructure needs in SEE require increased spending levels thus higher proportions of municipalities' income should be invested in capital infrastructure. Improving the quality of and access to services will require significant upgrades of local public sector infrastructure. This is critical to improving the quality of life and life perspective of SEE and WB6 citizens and to reduce the territorial development disparities within the region and the EU.

Figure 34 indicates LG spending for capital investment as a percentage of total LG expenditures and total public investments. LG spending for investment as a percentage of total LG spending is rather similar in Serbia, Austria and the EU, but when it comes to the role of LGs within total public investments, LGs in Serbia play a smaller role than counterparts in Austria and the EU. On the other hand, LGs in Moldova, Romania, Bulgaria, Slovenia and Republic of Srpska have a more important role in total public investment than their SEE counterparts, but they present profound differences when it comes to the weight of investments to total LG spending.

Figure 34 LG Investment in SEE (percent of LG total expenditures and total public investment, 2021)



While spending for capital investment has increased in nominal terms, the share of municipal spending on capital investments has been downwardly unstable over the past 16 years. Compared to 2006, the share of municipal spending for capital investments in SEE has decreased from 29% to 25%. Since the global financial and economic crisis of 2008-2009, the share of municipal spending for capital investment has been declining in the decade thereafter to the lowest levels of 22% in 2018. On average, the COVID-19 crisis seems not to have impacted the share of spending for investments, nevertheless the individual performance of SEE economies is very different, as indicated by Figure 35, below.

The share of municipal spending on capital investments is very volatile in the WB6 and SEE. Figure 36 indicates the share of municipal spending for capital investment to total municipal spending in SEE economies between 2006-2021. The share of spending on capital investments has changed significantly from year to year in the aftermath of the global financial crisis of 2008-2009 in all SEE and WB6 economies. While spending for wages and salaries has a higher rigidity – and cannot be changed swiftly from year to year – spending for capital investments is more volatile and more easily 'changeable'. In fact, in many cases LGs reduce spending for investments when needed to increase spending for other categories to respond to external shocks such as floods, floods, earthquakes or even the COVID-19 pandemic.

Figure 35 **Evolution of the Average Share of Capital Investments in LG Expenditures in SEE, 2006-2021 (percent of total)**

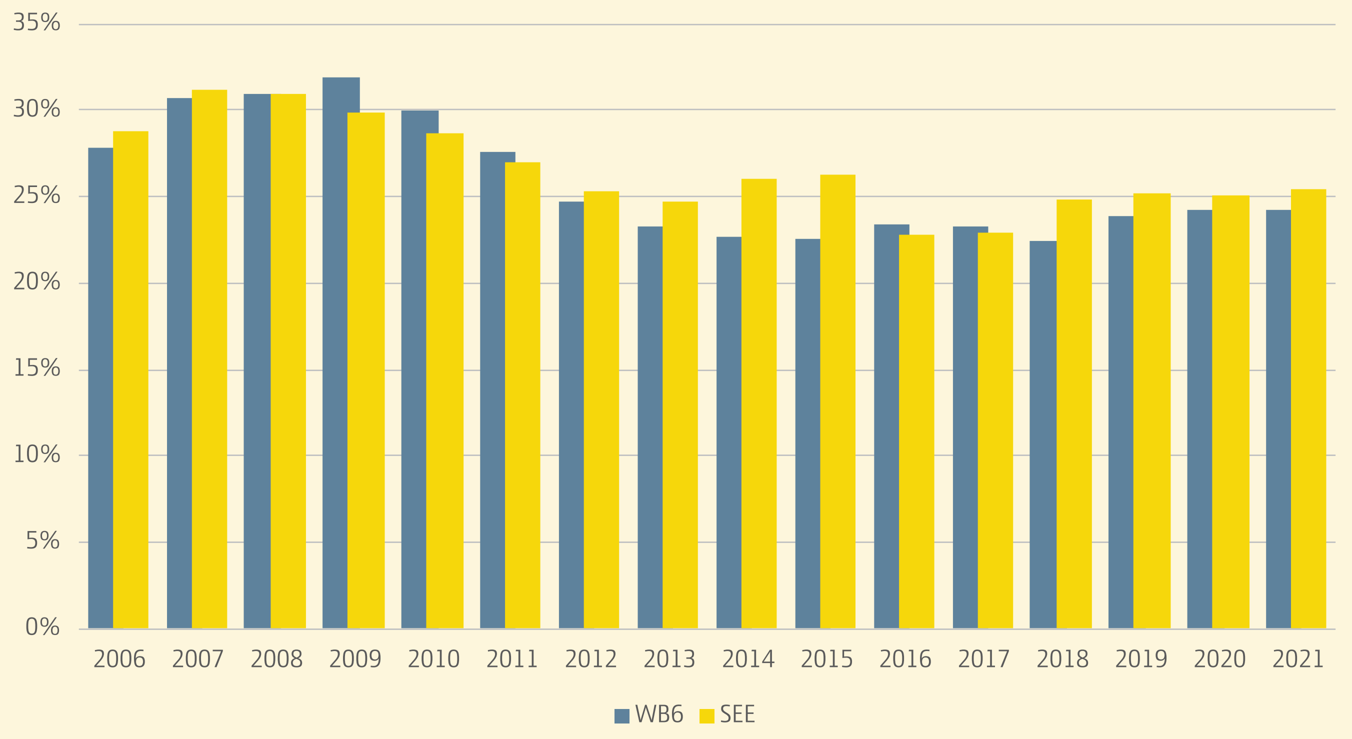
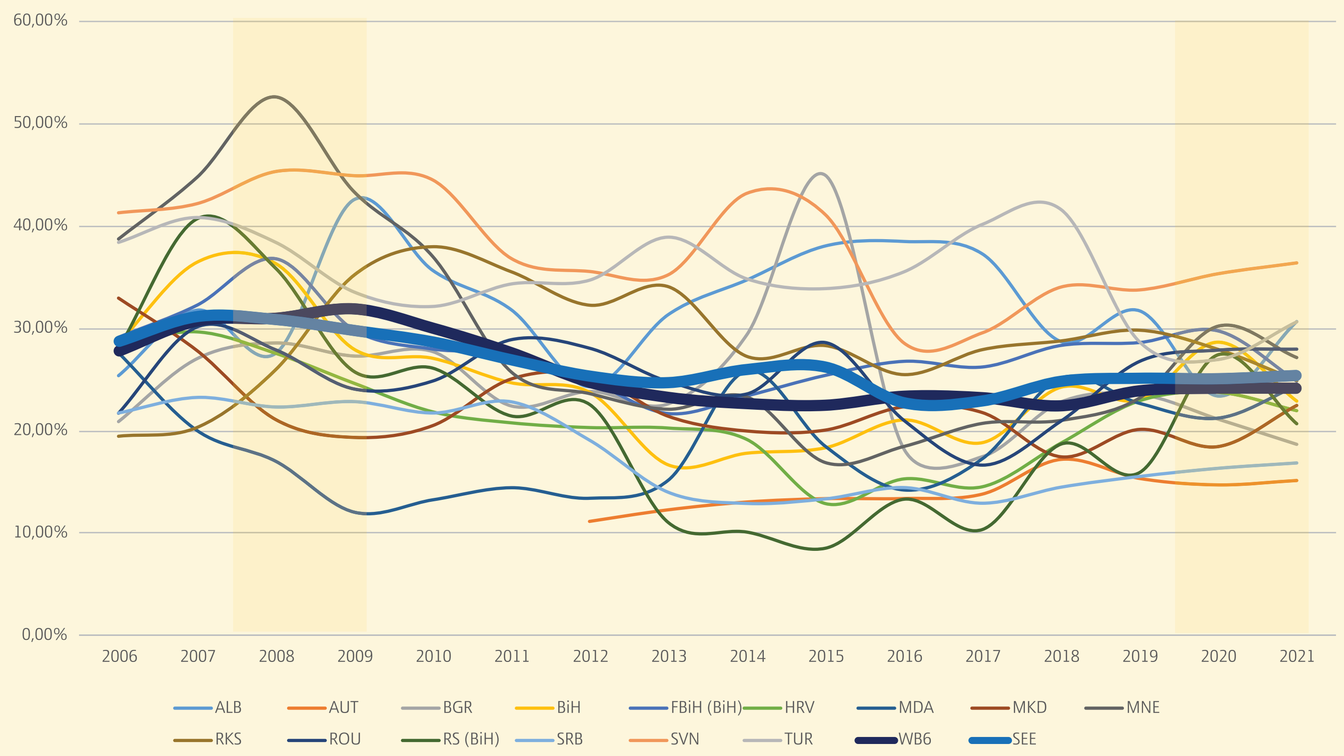


Figure 36 Evolution of the Share of Capital Investments in LG Expenditures in SEE, 2006-2021 (percent of total)



In the EU, the state and local governments have almost equal shares of public investments while the situation in the WB6 and SEE is rather different – the state is the ultimate investor in infrastructure. LG spending for capital expenditures in SEE, on average stands at 1.4% of the GDP, which is a level similar to that of the EU27 (1.4% of GDP). Figure 37 shows the composition of public investment by level of government in SEE, as a percentage of the GDP, while Figure 38 indicates the composition of spending for investment by levels of government, as a percentage of the total. Serbia and Albania have the highest shares of public investment as a percentage of the GDP in the region with 7.4 and 6.8% respectively, nevertheless in both cases, LGs provide only 13 and 17% of total public spending for investment. LGs account for more than 40% of total spending for capital investments in Moldova, Romania, Slovenia and Bulgaria. **One conclusion may be outlined – SEE and WB6 in particular, in general are heavily centralized in terms of public investment spending when compared to the EU.**

Figure 37 Composition of Public Investment in SEE Economies (in percent of GDP, 2021)

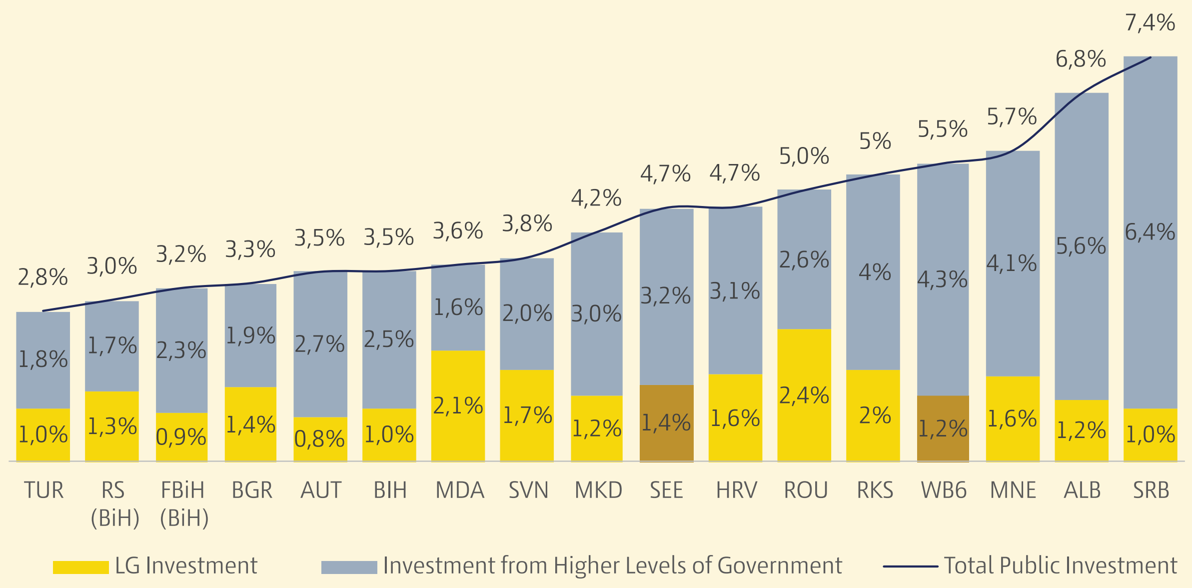
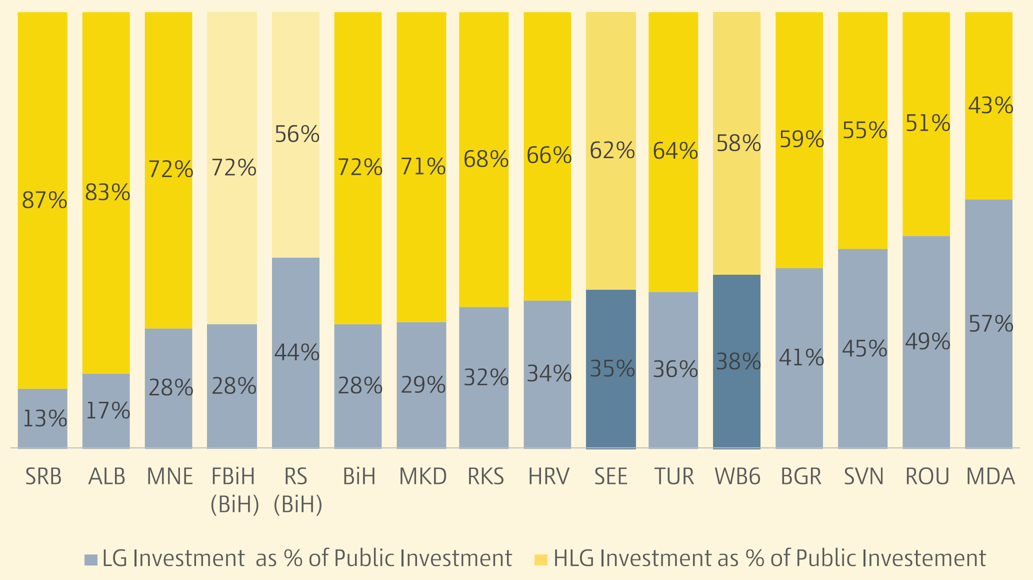


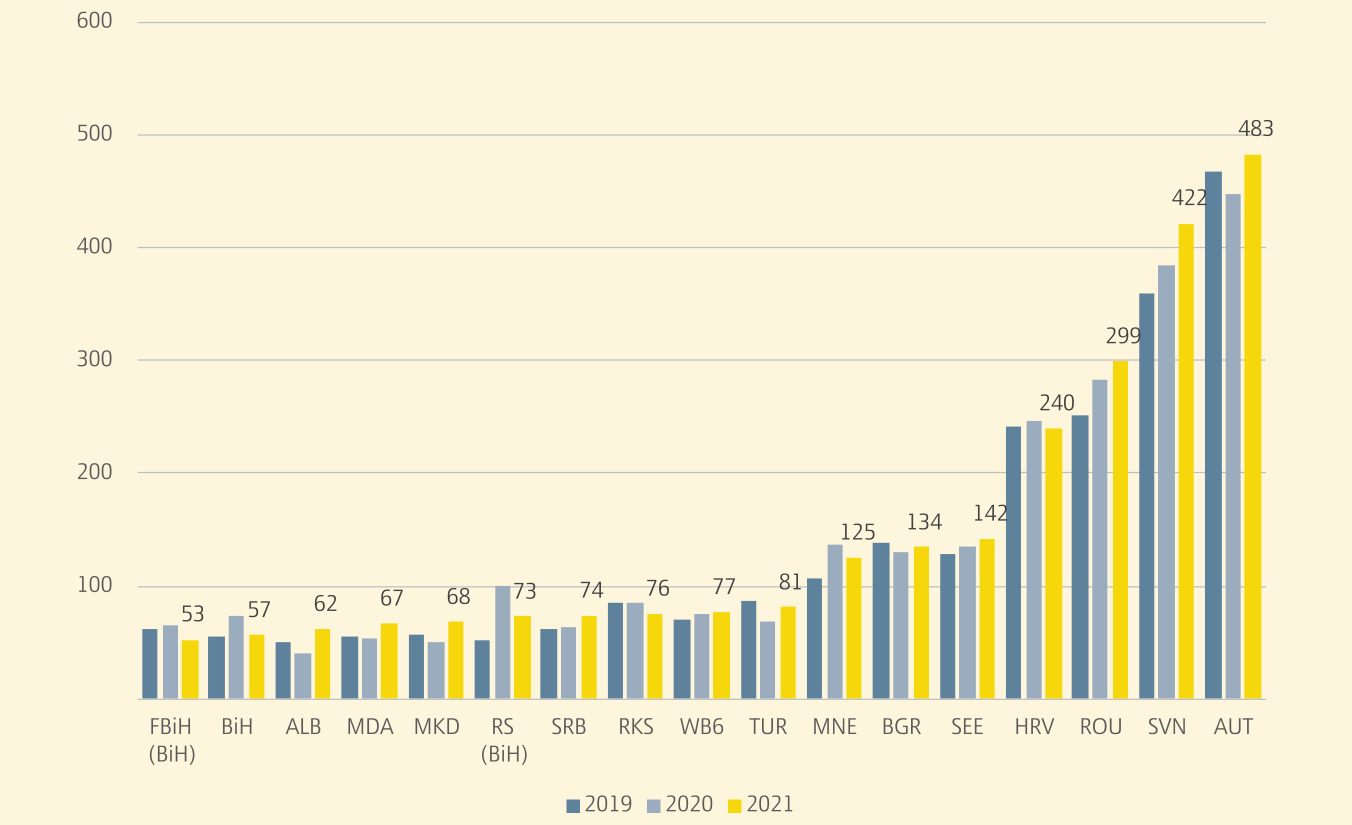
Figure 38 Composition of Public Investment in SEE Economies (in percent of total 2021)



There are wide disparities in the WB6 and SEE region in the ability of LGs to spend for capital investments. Figure 39 presents local government investment spending in EUR per capita in 2019-2021. On average WB6 LGs spend about 77 Euro per capita on capital expenditures, while the average for SEE is 142 Euro per capita. As expected, LG spending in per capita terms is smaller in the WB6 vis-a-vis other SEE economies. Austria, Slovenia, Romania, and Croatia have the highest levels of capital expenditures in per capita terms. Being EU members, LGs in these economies can benefit from substantial investment funding as opposed to the WB6 economies. In per capita terms LG spending for capital investment seem to be similar in Bulgaria and Montenegro, two economies where LGs have significantly different competences.

With very few exceptions, the COVID-19 crisis has had a negative impact on LG investment in 2020 and in 2021. LG spending on capital investments in Euro per capita has declined by an average of 11% in 2020 in six SEE economies, (with a range of -1% to -21%), while in 2021 capital expenses in Euro per capita declined by an average of 15% (with a range of -2% to -27%) in other six economies. In few cases, LG spending for investment in Euro per capita is smaller in 2021 than in 2019, as in the case of the Federation of Bosnia and Herzegovina (of BiH), Kosovo, Bulgaria, Türkiye and to a lesser extent Croatia.

Figure 39 Local Government Investment in SEE, 2019-2021 (EUR Per Capita)



III. Reviews on Intergovernmental Finance Systems in South-East Europe

Albania

By Keti Daja, Association of Local Autonomy of Albania and Elton Stafa, NALAS

Intergovernmental Finance System

With the decentralisation reforms of 2014-2018, Albania has made substantial progress in setting up the policy development framework for more effective local government. In July 2014, the Parliament of Albania marked the first step towards the Territorial and Administrative Reform (TAR) by enacting the Law "On the administrative-territorial divisions of local government units", which decreased the number of local government units from 373 very fragmented communes and municipalities to just 61 larger municipalities. Having a smaller number of local government units has been widely discussed in political and public fora for a considerable time, making it the most significant change to Albania's system of local government and providing for the opportunity to strengthen local government capacities.

After the TAR, a series of consequential legal and institutional changes occurred between 2015 and 2017: i) local elections took place in June 2015 and 61 Mayors took office in the newly constituted municipalities; ii), a new National Crosscutting Strategy on Decentralization and Local Governance has been enacted in mid-2015, providing a roadmap to enhance decentralization and strengthening local government and (iii) a new Law on Local Self-Government was approved in December 2015, consolidating the new local governments' organization and functioning, but also enhancing their responsibilities by decentralizing a number of new and costly functions (such as fire protection, irrigation, the wages of pre-schools teachers and social service centers); iv) a new unconditional grants' allocation formula was enacted in the 2016 annual Budget Law, allocating grants to local governments in a more transparent, equitable and predictable manner; v) a new Law on Local Self-Government Finance was approved in April 2017, consolidating local financial autonomy and at the same time enhancing local fiscal discipline; vi) between 2017 and early 2018 a new property tax reform was launched, moving from an area based to a market value based system of property taxation. The property tax reform efforts are ongoing, although not without challenges in terms of implementation and political investment.

While Albania has made important progress in the area of local finance, yet, policymakers face challenges in ensuring the enabling environment for the territorial and decentralization reforms to hold their promise of improving service delivery and reducing territorial development disparities. First and foremost, there is a high dependence on intergovernmental transfers, in particular as regards capital investments to improve local government infrastructure and quality of services. While progress has been made with the unconditional grant, still line ministries and central government agencies have a strong hold on capital funds directed to improving local public infrastructure. Equally importantly, there are significant disparities across municipalities in revenue collection potential and performance. OSR have increased almost exclusively in large urban areas, and are limited to a small group of taxes, despite improvements in property tax and service fees collection. Also, there are significant horizontal variations across 61 municipalities in their revenue structure, and therefore in their fiscal capacity and ability to raise own source revenues. Own source revenues in Albania are insufficiently diversified as there are only few local government taxes, and the ability of local governments to set their base and rates is rather limited while, there is a serious weakness in the determination of taxable bases.

Additionally, given a wide variety of reasons, spending for salaries is increasing, usually on the back of spending for capital investment. In fact, there is an uneven distribution of capital spending across LGs emphasizing horizontal imbalances and infrastructure gaps— the bigger the municipality, the higher the share of capital investment in local government expenditure and the discretionary room for spending. Payment arrears at the local level constitute a significant source of risk for municipal budgets and service delivery planning and implementation. At the end of 2021, the stock of payment arrears reached 6.5 billion ALL, approximately 10% of the freely disposable resources of municipalities and 17 municipalities experienced some sort of financial problems, with 10 of them facing difficulties and 2 facing serious financial difficulties.

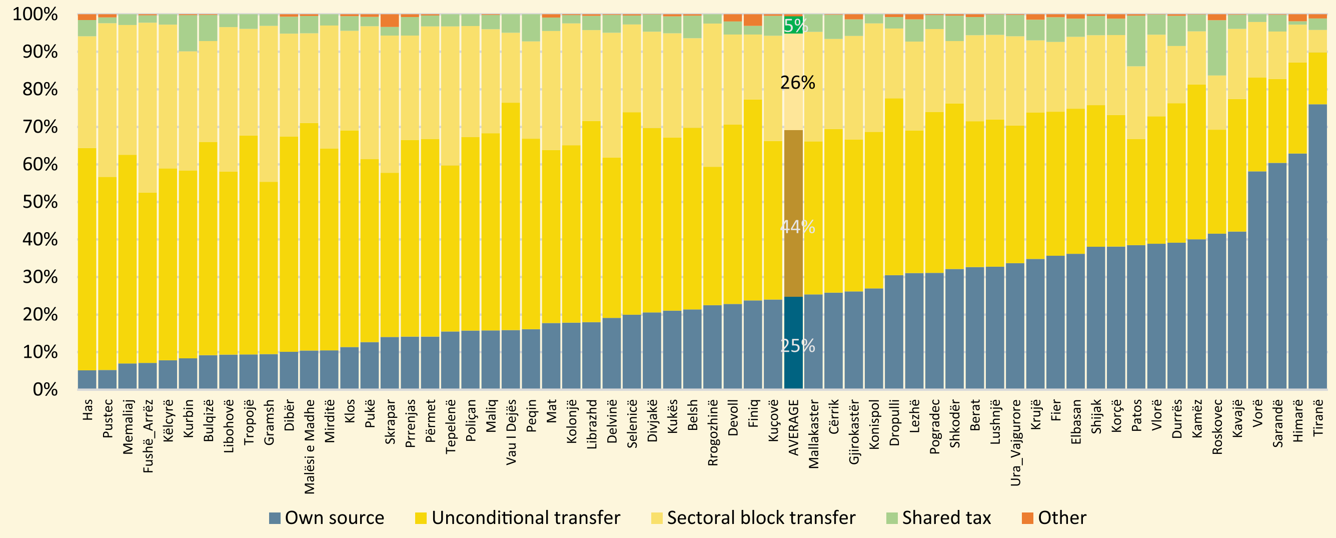
The Government of Albania (GoA) continues to identify the strengthening of local finance and fiscal autonomy as a key priority of the new Cross-Cutting Strategy for Decentralization and Local Governance 2023-2030. The new strategy includes actions aiming to: a) strengthen own revenue management in particular via the property tax and local assets; b) increase the share of local revenues from shared taxes; c) enhance the predictability and stability of the intergovernmental transfer system; d) enhance local capacities to fund local capital projects including via local borrowing; and d) strengthen Public Finance Management (PFM) at the local level. These actions of the new decentralisation strategy are very much aligned with the existing Public Finance Management Strategy, highlighting the shared understanding of key challenges and next steps.

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

Shared taxes. Sharing the Personal Income Tax (PIT) revenues has always been promised by the Albanian legal framework, but the actual shares have never been defined, until the approval of the LLGF in April 2017. The LLGF prescribes that 2% of PIT revenues should be allocated to the 61 municipalities on an origin basis. Unfortunately, this has not been implemented yet due to the difficulties of identifying taxpayers according to their residence. Nevertheless, the Government allocates the PIT revenues due to municipalities based on proxies of the origin basis. The LLGF increased also the local share of the revenues from the annual tax on vehicle circulation from 18% to 25%. Taken together, these are the two most important novelties of the LLGF as regards shared taxes. Albanian municipalities benefit also from 5% of the mineral rent. Since 2016, the government exempted almost all local taxpayers from the local Small Business Tax (SBT) and transformed the latter in practice into a shared tax also by eliminating all local government powers over its base, rate and by recentralizing its collection. This has led to a fall of more than 75% in the yield of the tax.

The **Unconditional Transfer** was introduced in 2001 and provides local governments with funds to execute their exclusive functions. It is the single most important source of revenue for Albanian local governments, historically constituting more than 50% of revenues for up to 70% of the municipalities in Albania. Intergovernmental transfers make up the core of local budgets— unconditional and

Figure 40 Composition of Local Government Revenues (in percent of total), average 2018-2022



sectoral grants constitute between 50%– 92% of LG revenue for 87% of LGs in the past 5 years.

The LLGF, for the first time since 2001, addressed the issue of the annual determination of the total size of the grant by anchoring it at no less than 1% of the projected Gross Domestic Product and no less than the amount allocated the previous year, ensuring both predictability, stability and security of financial resources over time. As a direct result of the LLGF, the unconditional grant in 2021 was 6.1 billion ALL (or 50%) higher than in 2015. The LLGF incorporated also the new formula for the allocation of the unconditional grant, developed in 2015 with USAID's support, reflecting the implications of the territorial and administrative reform and increasing the equity, predictability and transparency in the allocation of resources. The new formula's allocation criteria are: a), 80% according population (based on the concept of Effective Resident Citizens that is the 2011 Census data adjusted by adding 30% of the difference between the Civil Register and the Census[6]); b), 15% according to population density, with four different density thresholds, where less dense municipalities benefit from extra-resources; and c), 5% based on the effective number of primary and secondary education pupils.

Fiscal Equalization is performed within the unconditional grant and is based on shared tax revenues. Once the Unconditional Transfer has been calculated, then a separate set of calculations are made for those local governments whose total per capita revenues from existing shared taxes are below a certain threshold set up in the annual budget

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

law (88% in 2022), and above a certain threshold (120% in 2022). Municipalities are then compensated up to certain limits, set in the annual budget law, by taking a portion of funds from the 'richer' municipalities for the benefit of 'poorer' municipalities. While the calculations are quite complicated, the actual amount that is moved horizontally for the purpose of equalization is extremely low and it cannot provide sufficient funds to successfully resolve horizontal fiscal imbalances among municipalities.

The Law on Local Self-Government eliminated the concept of shared functions, and further decentralized several new functions to the local level, such as preschools, fire protection, forestry, and irrigation and drainage. The Law provided that these new functions would be financed through **earmarked specific transfers** for each function and each local government. Transfers are allocated to local governments based on the historical costs previously declared by the respective line ministries. The symmetric decentralization of the functions immediately was faced with the unequal distribution in the territory of the resources that line ministries previously utilized to perform the function. For example, there are 61 municipalities but only 49 fire stations. Between 2016 and 2018, the government has provided additional financial and material support, in particular for preschools, fire protection and irrigation and drainage, although there remain substantial differences in the equipment with resources. In 2019, the specific transfers were transformed into **sectoral unconditional transfers**, working largely as sectoral block grants, despite this the legislation grants full autonomy to local authorities on their utilization. Sectoral transfers are allocated to local governments mostly on a historical basis, except for the transfer for preschool education, which underwent a reform in 2018-2019, with USAID support. According to the reform, funding for preschool education is divided to municipalities on a formula where 60% of the pool is divided on a per-pupil basis while 40% on a per-teacher basis. Nevertheless, while the Government has increased their size of years, the sectoral unconditional transfers do not provide sufficient funds to cover all the necessary expenses for providing the newly decentralized services – in fact, in most cases, they provide funding only for salaries or recurrent expenses.

Conditional transfers come from two sources. The first is from appropriations from line Ministries that are allocated to local governments for delegated functions or for functions, the responsibilities over which are in practice shared by the two levels of government. The second is from the **Regional Development Fund** that allocates investment grants to municipalities on a competitive basis. Up until recent years, the size of conditional transfers from the Regional Development Fund had increased substantially (very close to the size of the unconditional grant itself), leading to concerns that it was crowding out funds that should have been allocated to the unconditional grant. Conditional transfers accounted for 15% of the total local government in 2020 (when conditional transfers are included in the total LGR), while at the beginning of the decentralization reforms, in 2015, they made up 29%. The extensive use of conditional transfers has substantially reduced local fiscal autonomy and has led to allegations that they are being allocated for political purposes, which do not reflect clear local developmental goals.

When looking at the distribution of estimated investment grants from the RDF and ministries during the period 2010-2020, half of the funds has been concentrated in 12 major urban and economic centers – the capital Tirana dominates with 17% of the total investment grant allocation. The other 49 municipalities have received the remaining half of the total funds. This graph plots the distribution of investment grants over a ten-year average vs. the size of municipalities.

Figure 41 Local government OSRs and unconditional and conditional transfers, incl. RDF, as % of total public revenues

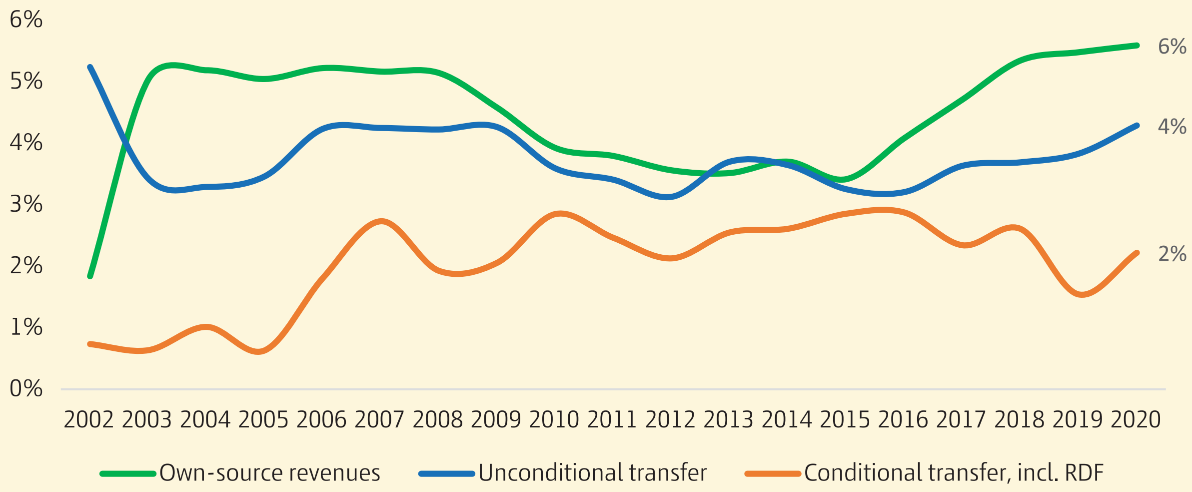
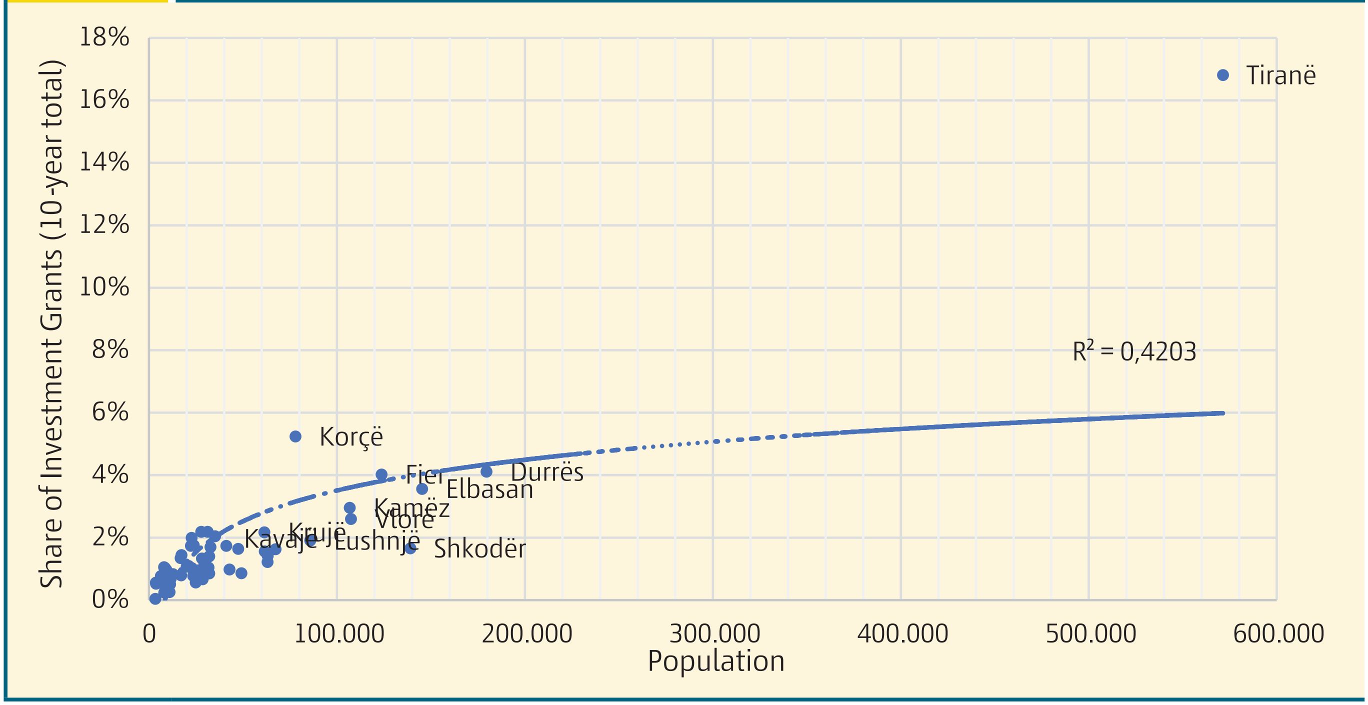


Figure 42 Distribution of investment grants over a ten-year average vs. the size of municipalities.



Local Government Own source revenues

Own source revenues are regulated by the Law on the Local Tax System (No. 9632/2006). The most relevant own revenue sources are: the recurrent property tax, the tax on the infrastructure impact of new construction (IIT) and local fees and charges for local services.

Local government own source revenues have increased by 27.5% cumulatively over the past five years, nevertheless there are significant disparities across municipalities in revenue collection potential and performance. OSR increased almost exclusively in large urban areas, and are limited to a small group of taxes, despite improvements in property tax and service fees collections. Also, there are significant horizontal variations across 61 municipalities in their revenue structure, and therefore in their fiscal capacity and ability to raise own source revenues. In 2022, due also to its proactive efforts in terms of tax management, 55% of total OSRs were collected in the capital Tirana, while the next 10 biggest LGs, with twice the population, collected less than half of Tirana.

The recurrent property tax is composed of the tax on buildings, urban land and agricultural land. In 2017, the government started reforms to expand the base of the tax, to establish a nationally managed cadastre of properties and to move tax assessment closer to market value. As a result, since 2018, the base of the property tax on urban buildings was supposed to be the market value of the building, assessed according to rules set by the national government. The tax rate was set at 0.05% of the assessed value for households and 0.2% of the assessed value of the building for businesses. The Ministry of Finance has established a special department – the Property Tax General Directorate – to lead the reform process. However, the establishment of the new property tax system is still not complete. Due to technical difficulties, most local governments continued to impose lump sum payments for the property tax on household taxpayers.

The base of the tax for urban land is the surface area in square meter of urban land while the tax rate is determined in terms of Albanian Lek (ALL) per square meter, based on the differentiation of municipalities in 4 main categories for both households and business taxpayers. The tax rates are established by the Law. The base of the tax for agricultural land is the surface area in hectares, while the tax rate is determined in ALL per hectare, based on different categories of land and municipalities, prescribed by the Law. Property owners are liable for the payment of the taxes. In case the ownership is not clear, then property users are liable for the payment of the tax, in the same way as owners. Municipal councils may change the tax rates that are preset in the Law on the Local Tax System (LLTS) by 30%.

The subjects to the property tax are individuals and businesses. Yet, the law defines significant tax exemptions for specific categories of businesses, such as luxury hotel and resort brands. Although these businesses would bring significant revenues for municipalities, particularly in Tirana and the coastal area, the GoA decided to exempt these taxpayers from both the property tax and the tax on infrastructure impact of new buildings, to support the hospitality industry. The Government's rationale for reducing the fiscal burden was to support investments in elite tourism and to attract international tour operators, with an expectation that this measure would create new jobs and increase economic activity in the tourism industry.

The biggest own-source revenue item in Albania is the "tax on infrastructure impact on new construction" that accounts for 32% of the total own-source revenues in 2021; however, this tax has much greater significance in large urban areas where the major construction activity is taking place. Introduced in 2002, the tax on infrastructure impact is a one-time tax that local government imposes on new private construction. The basis of this tax is the investment value of the new construction, as estimated in an investor's construction permit (or bill of quantities) or the market value of the new construction (based on the sale price per square meter). The tax rates range from 4% to 8% of the sales price per square meter, for residential and commercial buildings, developed by construction companies; for all other types of constructions the rates range from 2% to 4% in Tirana on the value of investment in tourism, industry, agriculture or private individual constructions, and 1% to 3% in other cities for the investment. Yet, investments in agro-tourism, as well as the construction of four- and five-star luxury hotels are tax exempted. Between 2010 and 2021, this tax revenues increased on average by 20% annually, but with a rather volatile trend. There is a wide disparity between the collection in Tirana, which accounts for 80.4% of the total collection of this tax (EUR 51.5 million in 2020), and the other 60 municipalities.

Until 2015, the Small Business Tax (SBT) also was a relevant source for local governments. Unfortunately, however, the base of the SBT has been repeatedly changed and in the period 2010-2015, by exempting more and more taxpayers from the taxable base, in practice it was transformed into a shared tax that is now collected by the national government from which the vast majority of small businesses are exempted. The yield of the SBT in 2021 is only 1% of own source revenues, as opposed to 19% in 2010. The elimination of the SBT coincided with the downward instability of the IIT because of the 2008-09 global financial and economic crisis and a centrally imposed moratorium on new construction permits until local governments adopted their General Local Territorial Plans. Local governments responded to the fall of the revenues from the SBT and IIT by improving the administration of the recurrent property tax.

Additional efforts are necessary to make sure that local governments have the systems and capacities in place for an effective administration of the property tax, and thereby for many other local taxes and fees. Currently Albanian local governments suffer from three main strategic weaknesses. First, a poor legal framework that creates confusion over local governments' real tax and fee powers from base and rate setting to assessment, collection and enforcement. Second, the practice of frequently changing (and reducing) local tax powers, without any form of consultation or effective compensation, has depressed tax efforts and discouraged any serious investment from local governments in their collection. Third, because of insufficient investment by both, the national and local governments, in the technical, regulatory and political infrastructure, the property tax has been underutilized. The main weakness here is the lack of a comprehensive register linking properties to taxpayers and the almost complete lack of cooperation between the central government agencies responsible for the registration of immovable properties and local governments although the legal framework sanctions that the former should provide LGUs with the information they have on registered properties. The lack of a fiscal cadastre and the inability to cooperate between public institutions has led to the general underperformance in local tax and fee collection.

Borrowing

Local borrowing is an important source of funding for local governments. It is one of the main pillars of fiscal decentralization and a successful instrument for financing large public investments. The latter cannot be adequately financed by municipalities through their annual budgets or by the limited capacity of the central government itself.

Law No. 9869/2008 "On Local Government Borrowing" (LLGB) created the necessary conditions to enable borrowing from local governments in Albania for short-term liquidity constraints, for short or long-term capital expenditures and for long-term debt. Loans may have fixed or variable interest rates, in domestic or foreign currency and agreements may be concluded with banks operating in Albania or in international markets. In all cases of long-term borrowing, the decision is taken by the local council with a majority vote of the members. The Ministry of Finance is informed within ten days after the decision and in case of long-term debt; LGUs shall obtain a validation from the Ministry of Finance regarding compliance with legal procedures and respect of debt limitations. The law provides the right of LGUs to issue long term or short-term securities in physical or electronic form. According to the Law on Local Self-Government Finance, the Ministry of Finance may require an independent external due diligence audit of the accounts of the local self-government unit before the approval of long-term debt.

Debt restrictions (on stock and servicing) are clearly defined in LLGB:

- Short-term debt: The total amount of short-term debt shall be less than 10% of total actual revenue (local taxes plus fees and shared taxes and fees of the previous fiscal year).
- Long-Term Debt: the ratio of the previous year's operating surplus with the long-term annual debt service should be larger than 1.4:1. The operating surplus is calculated as the sum of operating income, shared taxes and unconditional transfers.
- The annual payments to service long-term debt should be less than 20% of the total annual budget. The annual budget includes the amount of income from the unconditional transfer, shared taxes and local taxes and fees (average of the three previous years).
- Outstanding long-term debt in relation to operating income plus fees plus separate unconditional transfers shall be less than 1.3:1.

But in practice the use of these instruments is very limited. The high level of public debt has played an important role in the imposition from the central government of restrictions on disbursements or the contracting of new local borrowing. Taking into consideration that in the medium-term Albania will continue to face macroeconomic and fiscal restrictions, both at the central and local levels, there is a need for new legal regulations that would allow LGUs to access capital markets and raise funds for their financing needs. These regulations should also restrict the subjective treatment of local borrowing rules by the central government. In the absence of any ceiling on overall public debt, there are no legal impediments to local borrowing. Nevertheless, central government's decision making shows it is mostly concerned with meeting its own needs rather than the needs of LGUs.

The Law on Local Self-Government in Albania mandates the government to define an annual local borrowing limit within the annual state borrowing limits determined by the annual budget law, in accordance with the central government's fiscal policy. This should allow for an objective tool to enable municipalities to access capital markets.

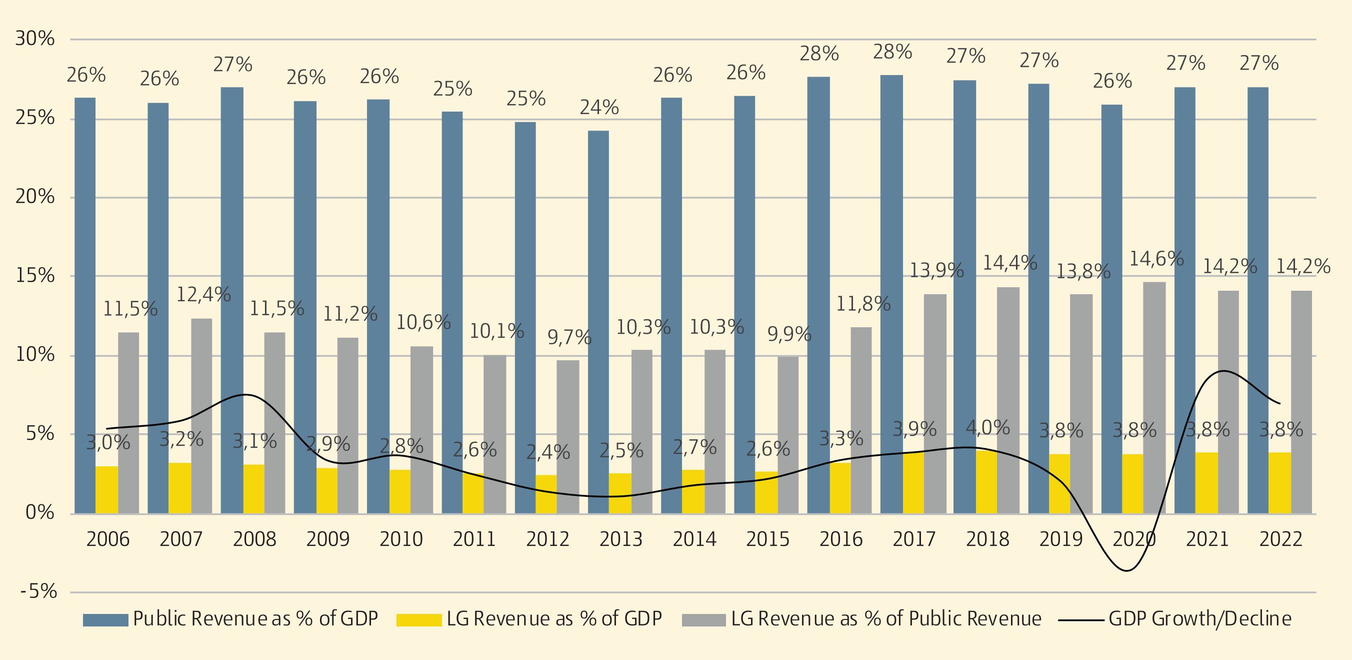
Law no. 10158/2009, "On corporate and local government bonds" prescribes LGUs' rights to issue securities. The law provides only for the type of bonds that may be issued, that may have short- or long-term maturities. The decision is taken by the municipal council. Nevertheless, this law is very vague as regards the process of bond issuance and there is no guidance on how this process should happen in practice. There are deficiencies in procedures, modalities, the specific definition of bonds, maturities, and the type of interest rates. There are no indications whether these bonds are tied to specific projects which might generate income and shall be paid from the LGUs revenues. In other terms, there is no definition of the emission mechanism and many other specifications associated with this process which should be reflected in the relevant legal framework.

Ultimately, in 2021 the stock of local debt stands at 0.02% of GDP, down from 0.07% in 2015, which was the highest level since the adoption of the local borrowing law in 2008. In other words, since then, municipalities have not been able to make good use of this instrument. Local debt constitutes 0.1% of the stock of public debt in 2021.

Statistical Overview of Local Government Finance in Albania 2006-2021

Albania has a relatively small public sector, with public revenues being making up on average 26-27% of GDP during the past decade. This provides a major limit to the financing of local governments and the central government as well. In 2016, the government transferred to the local level some new and costly responsibilities, such as wages for teaching and non-teaching personnel in preschools; non-teaching personnel in primary and secondary schools; the operation of fire protection, the management of forests and pastures, and irrigation and drainage. These new functions were financed with earmarked specific grants that help explain the jump in local government revenue as a percentage of GDP and public revenue in 2016. On the other hand, in 2017, the government approved the Local Government Finance Law that anchored the size of the unconditional grant to no less than 1% of the GDP, which led to a gradual increase in local revenues since then, together with improved own revenue collection. It is important to highlight that in the local revenues for 2020 and 2021 transfers to local governments (registered as unconditional grants) are also included to support the 2019 earthquake reconstruction process and support for families affected by the crisis.

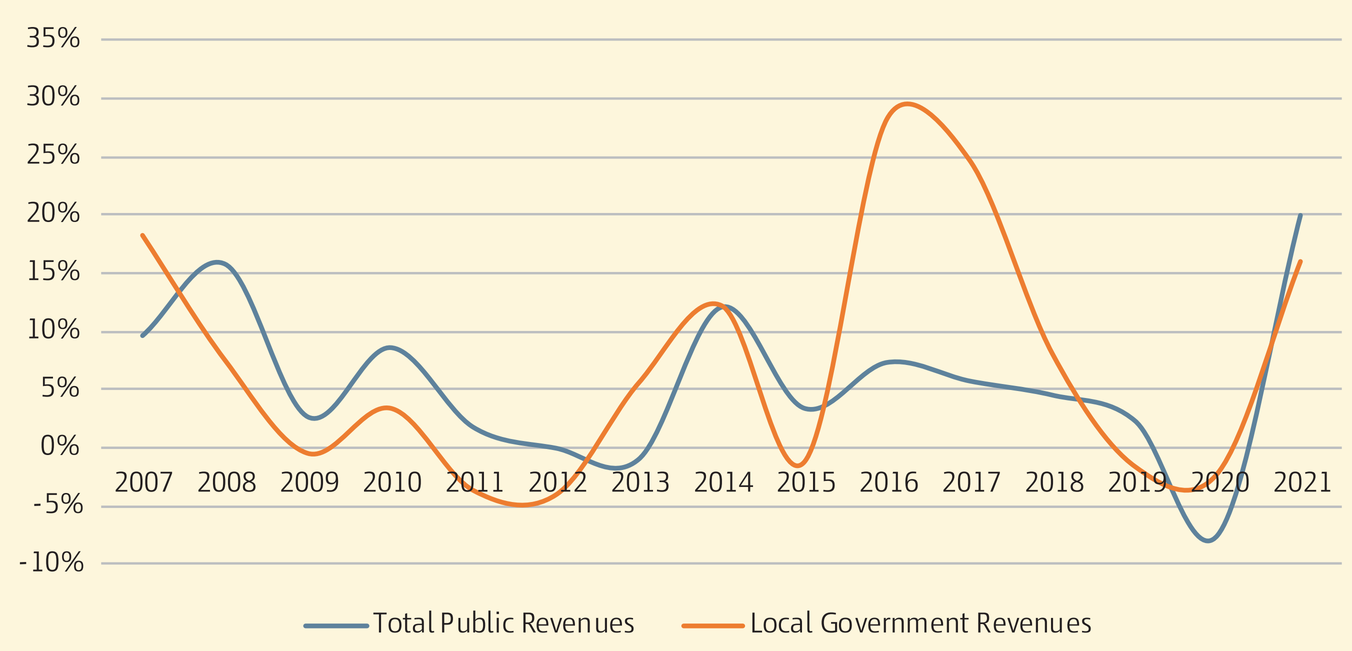
Figure 43 Albania: Local Government Revenue as a Share of GDP and Total Public Revenue



Because of the very conservative legal framework and administrative orders of the Ministry of Finance, municipalities in Albania de-facto are limited in their ability to raise funding from local borrowing. The stock of local debt constitutes 0.4% of local government revenues in 2021.

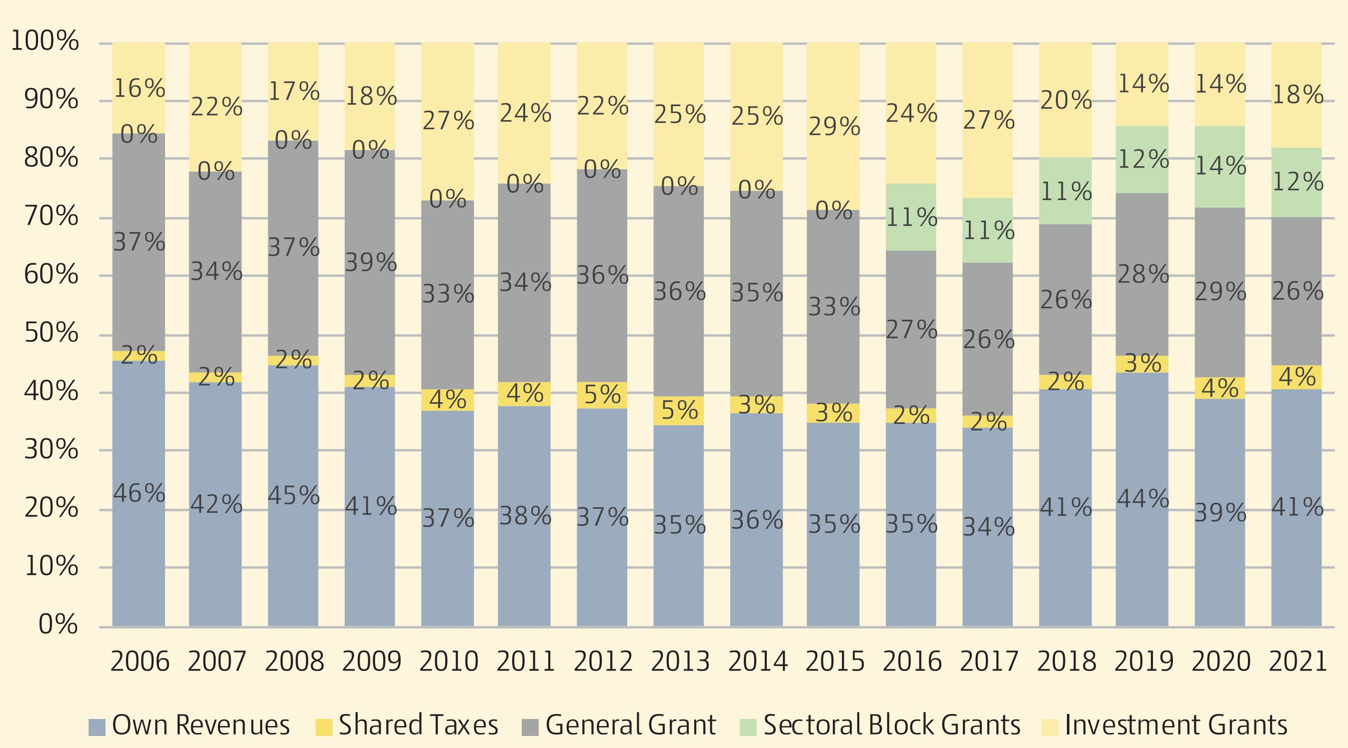
Between 2007 and 2015, local government revenues fell faster and rose slower than the revenues of the national government. This suggests that the national government was not committed to sharing the benefits and burdens of economic growth with local governments. The steep growth of local government revenues in 2016 is primarily related to the transfer of the new functions at the local level, while the continued increase in local revenues in 2017 and afterwards is related mostly to the increase in the unconditional and the very positive performance of own source revenues. In 2020, LG revenues in Albania fell by 2% as opposed to the fall by 7% of the total public revenues.

Figure 44 Albania: Revenue Fluctuations of the General and Local Governments 2006-2021



Own source revenues contribute to 41% of total local budgets in 2021, while intergovernmental transfers of different forms make up the remaining 59%. It is important to highlight, that, while OSRs make up a fundamental part of the financing system, there are significant horizontal disparities, and in fact most OSRs are collected in the capital city and a few of the other largest cities in Albania.

Figure 45 Albania: Composition of Local Government Revenue 2006-2021



Local Government Revenues in Euro per capita peaked in 2021 at 206 Euros per inhabitant (census data) or 591 million Euro in total. In 2020, they fell from 181 to 176 Euros per person or from 518 to 504 million EUR in total. This is due to the fall of own source revenues as a combination of the COVID-19 crisis and the aftermath of the 2019 earthquake. Transfers from the central government continued to increase, including for supporting the earthquake reconstruction process and supporting households that were affected by the earthquake.

Figure 46 Albania: Composition of Local Revenue Euro per capita 2006-2021

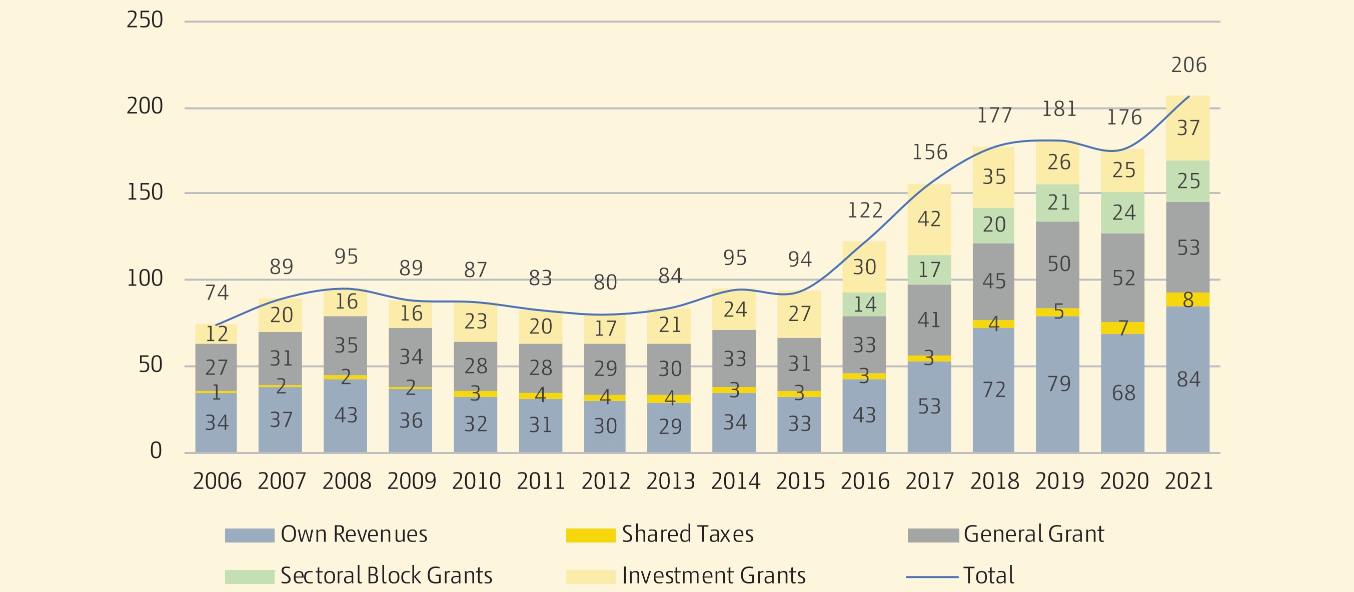
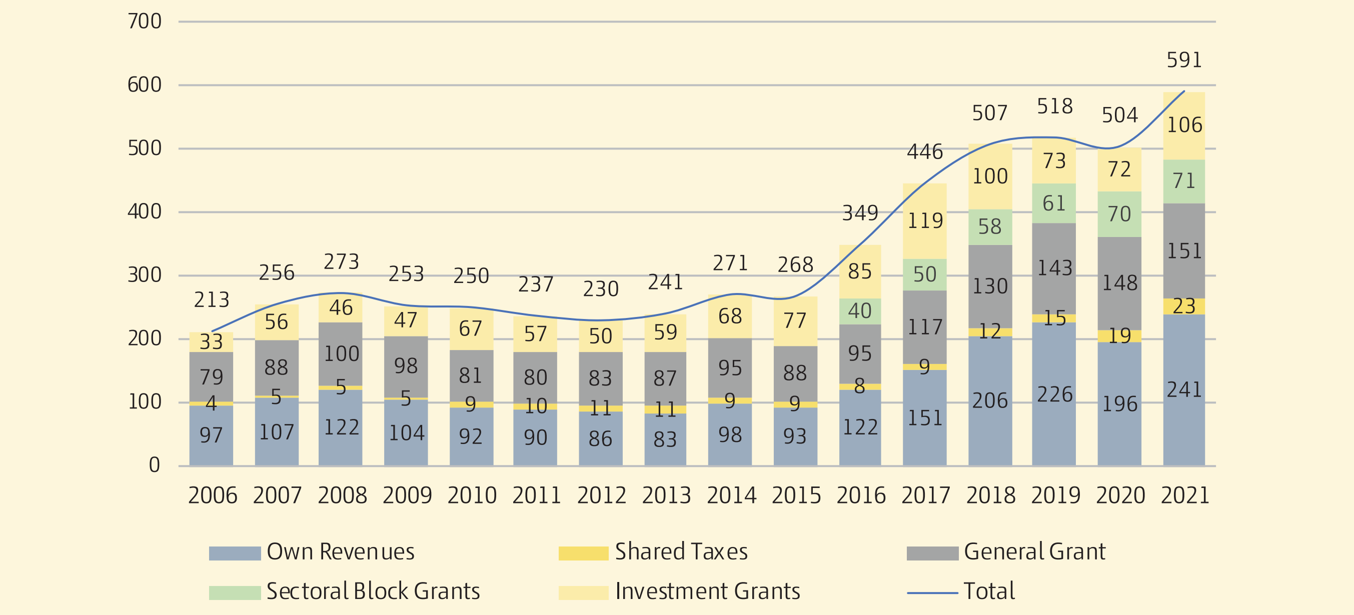
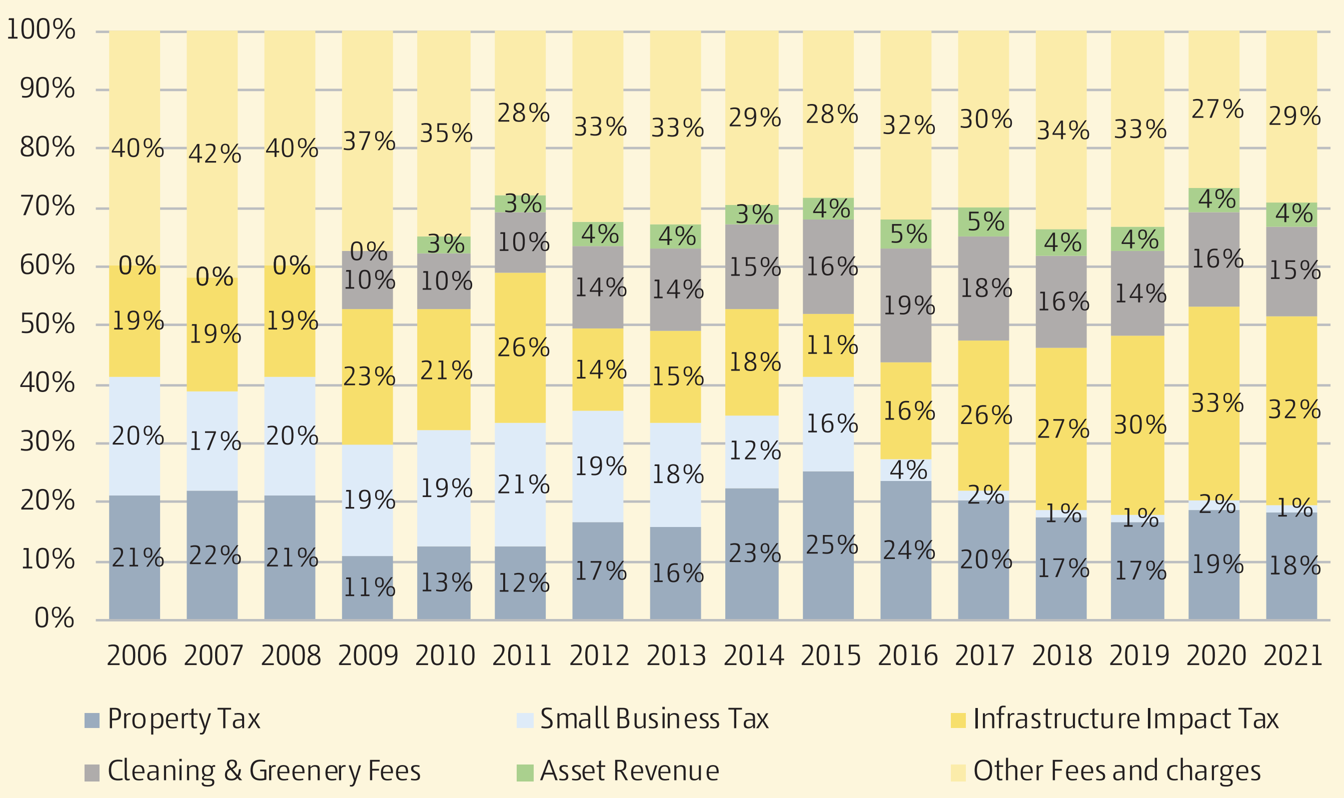


Figure 47 Albania: Composition of Local Revenue, in million Euro, 2006-2021



Regarding the composition of own source revenues, the Property Tax has been trending upward up until 2016, when the share of the Infrastructure Impact Tax began increasing significantly to the extent that in 2021 it constitutes a third of own revenue. As indicated earlier, the revenues from this latter tax are mostly concentrated in the largest urban centres. From this perspective a more detailed analysis would indicate significant disparities across municipalities in terms of capacity to raise increased revenue from this tax. The most important local fees are the waste collection fee, along with greenery and public fees, and fees for the occupation of public space.

Figure 48 **Albania Composition of Own Source Revenues 2006-2021**



Spending for capital investments fell significantly in 2020 as a result of the pandemic and the need to repurpose spending to support households affected by the COVID-19 crisis and the earthquake. On the other hand, spending for wages, as a share of total local government revenues, seems to have been declining over the past few years, giving more space to spending for goods and services and grants and transfers. It is important to highlight that the situation is not entirely clear, as the expenditure data includes also grants and transfers from higher levels of government dedicated to the post-2019 earthquake reconstruction process.

Local government spending for investments has increased from a low of 48 million Euro in 2012 to 178 million Euro in 2021. Spending for wages and goods and services have also increased over the years.

When we compare central and local government investments, we see that because of these conditional grants, local investment, as a share of total public investment, has increased over 2016 and 2017, while total public investments have remained quite stable at 4.4% of GDP. The share of public investment to GDP has increased significantly over the past two years, in particular as a result of the earthquake reconstruction process.

The yield of the Property Tax is low, as a share of the GDP, when compared to Albania's counterparts in the SEE region. The property tax collection increased in the past 8 years, as

Figure 49 Albania: Composition of Local Government Expenditures 2006-2021, in percent of total

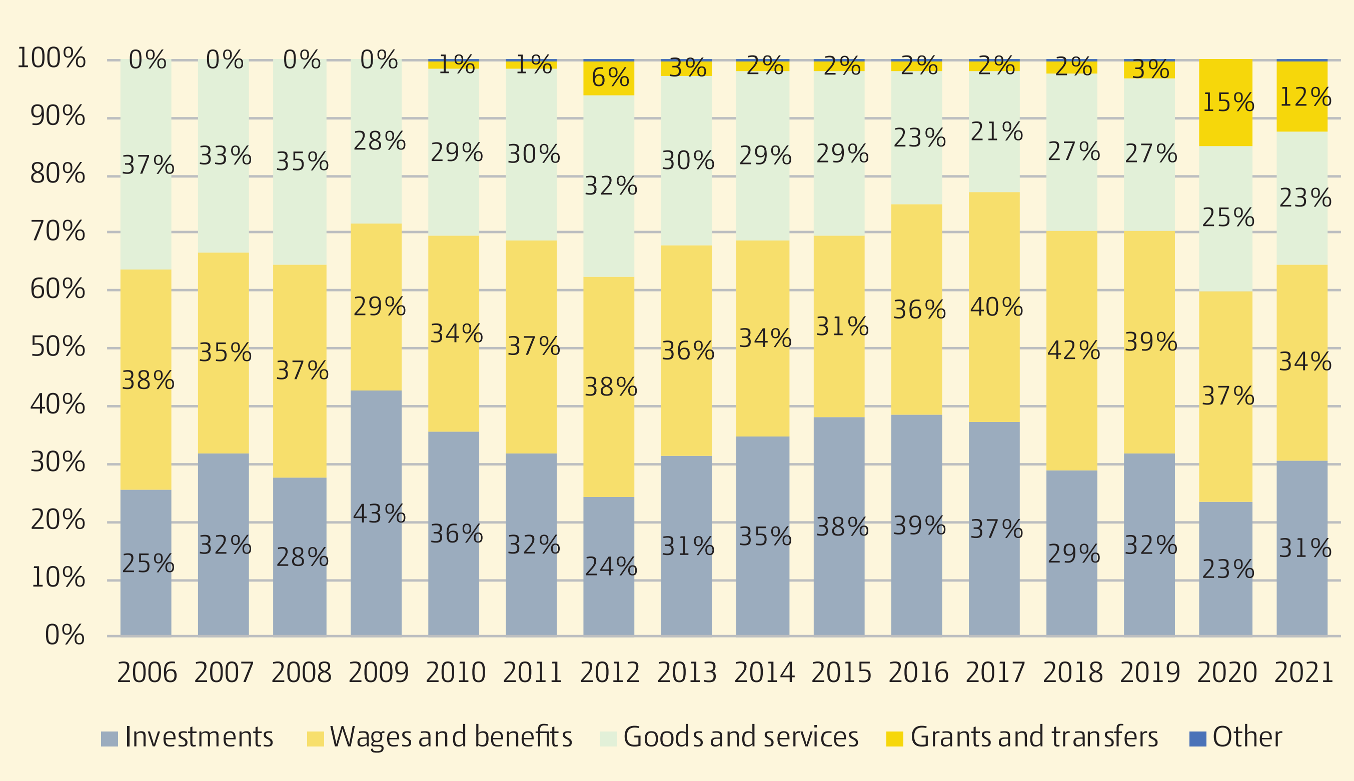


Figure 50 Albania: Composition of Local Government Expenditures, in million Euro

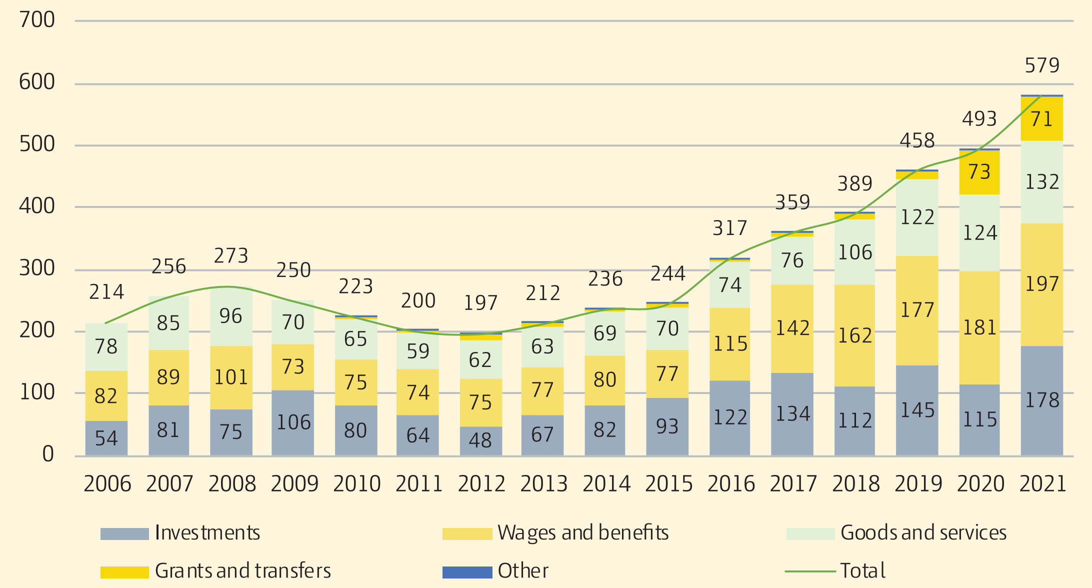


Figure 51 Albania: Composition of Local Government Expenditures, in million Euro

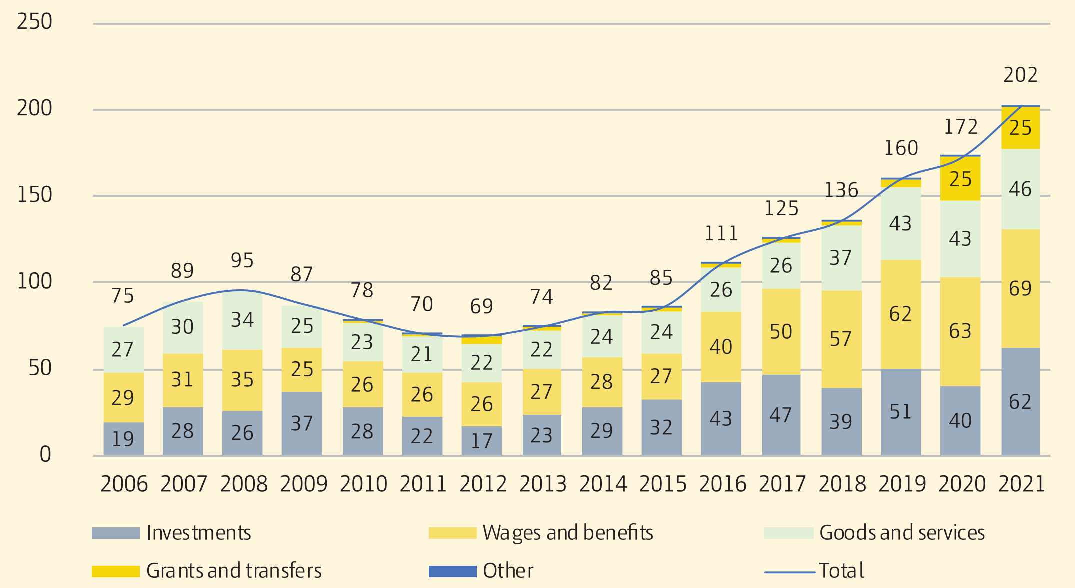
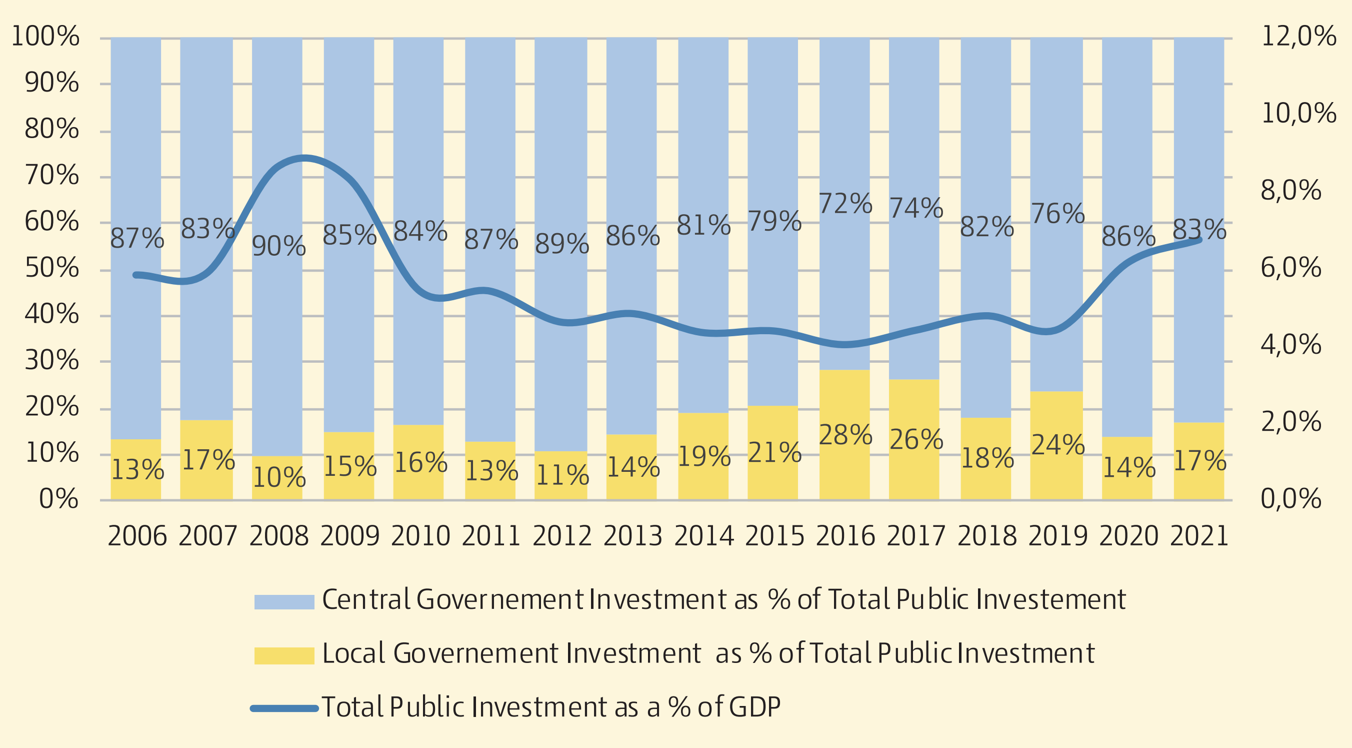
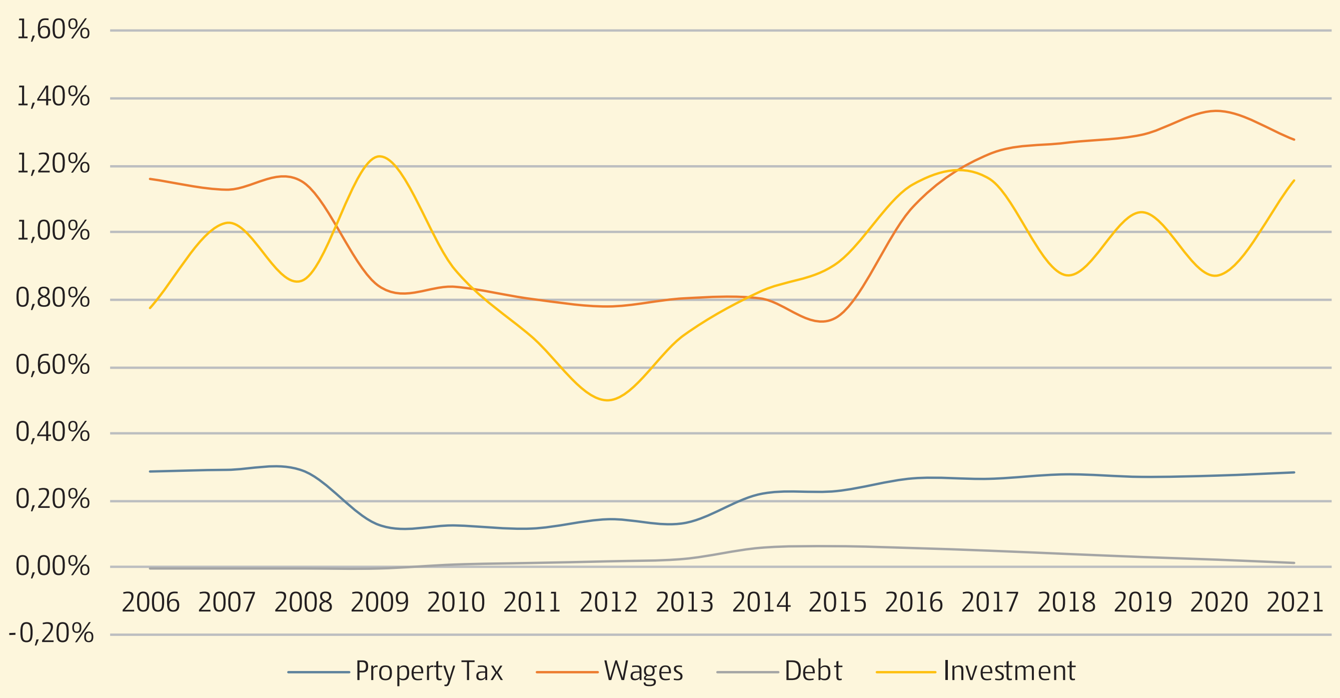


Figure 52 Albania: Investment by Level of Government and as a percentage of GDP, 2006-2021



spending for salaries. Spending for capital investments by local governments remain very volatile over time. Local debt remains low, at 0.02% of the GDP at the end of 2021.

Figure 53 Albania: Investment, Wages, Debt and Property Tax as Share of GDP, 2006-2021



Austria

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The Intergovernmental Finance System

In Austria, there are three **levels of government**: the federal level (*Bund*), the state level (*Länder)* and the local level (municipalities). The state level consists of nine *Länder* (including Vienna, (the capital- city) and the local level consists of 2,093 municipalities (as of 2022). In administrative terms, Vienna is a state and a municipality at the same time. For reasons of simplicity and consistency with common methodologies, Vienna is not included in the subsequent descriptive and quantitative analysis of the local level. In the decentralized federal system states each have their own constitution and are empowered to enact state laws. Furthermore, they are responsible for the enforcement of federal laws and the provision of certain functions and services. The principle of autonomy of municipalities is enshrined in the Austrian constitution, with the laws of the different states providing the effective legal framework.

Various financial flows between the three levels of government heavily impact the financial resources available at the local level (municipalities) and the state level (*Länder)*. State laws and regulations play an important role and so the fiscal situation of municipalities is to differ across states – even for municipalities that are otherwise similar.

Municipalities manage their budgets independently, can own assets of all kinds and operate economic enterprises. Municipalities can regulate local taxes only if they are entitled to do so by either federal or state law. Tax administration remains mostly at the federal level.

The **fiscal equalization act** (*Finanzausgleichsgesetz, FAG*) regulates the rather complex system of redistribution of revenues across all levels of government is regulated via the, which is negotiated every three to six years between the three levels of government. The fiscal equalization system is characterized by two features: Firstly, the states and local authorities—hence (*Länder* and municipalities) – levy only few own taxes, especially compared to the federal government. The system is therefore based on tax-sharing arrangements and a major share of municipal budgets comes from intergovernmental transfers. Secondly, many important services, such as education, nursing and health care and public transport are undertaken by all tiers. These two features lead to a complex system of vertical financial interdependencies.

The core elements of the fiscal equalization system are best described as equalization on three levels:

- **The primary level is** based on the fiscal equalization act, which includes the distribution of
  - shared taxes and
  - local and regional taxes.

- **The secondary level is also based on** the fiscal equalization act, which regulates transfers:
  - from the federal state to the *Länder* and municipalities,
  - from the *Länder* to municipalities (*special need transfers*) and
  - from the municipalities to the *Länder* (general payments, *Länderumlage*).

- **The tertiary level covers** all other transfers, which are not included in the fiscal equalization act, but in other agreements (e.g. article 15 of the Austrian constitution)

Shared taxes make up approximately 85% of total tax revenue. These include revenue from the personal income tax (PIT), the corporate income tax (CIT) and the value added tax (VAT). These shared taxes are distributed from the federal tot he state and municipal level according to fixed distribution keys. Currenty, the federal level retains 68% of shared taxes, while the state level receives 20% and the municipal level 12%. The population size plays a predominant role for the horizontal equalization (at the state level and at the municipal level).

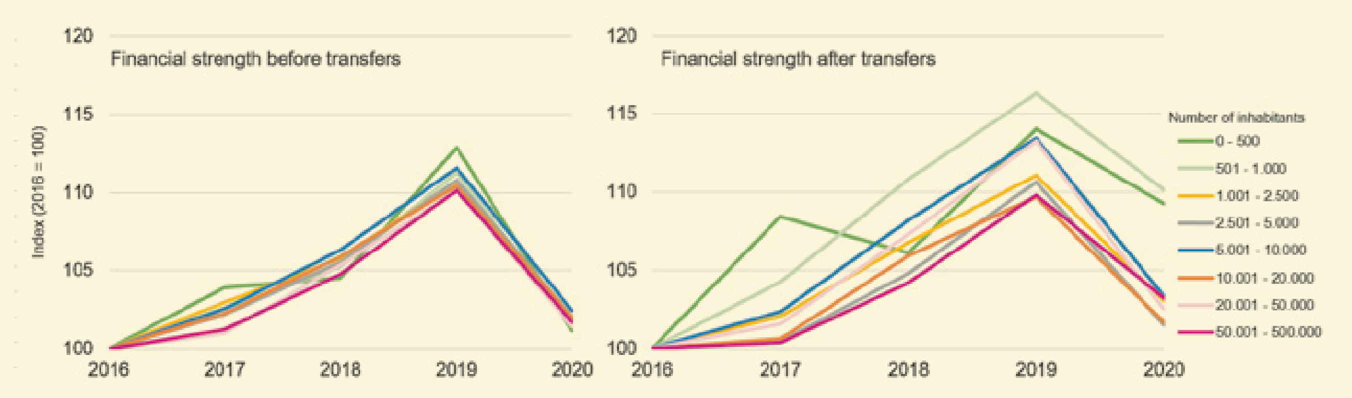
The weighted population key (WPK) ensures that the most populous municipalities receive more revenue per capita to compensate for any additional expenditure they may incur as regional or urban centers. Regional or urban centers typically offer more public services and infrastructure for sports and leisure, childcare services and cultural activities and these are typically also used by the residents of the surrounding municipalities within the commuter belt. Therefore, the idea of the WPK is that larger municipalities receive a higher share of the revenue per capita than smaller municipalities that do not fulfill a corresponding function as a regional center. While each municipality, independent of its size, finances basic public services such as water supply, wastewater and waste management with fees, shared tax revenues can be used for other, less cost-based public services (LoGov, 2021).

Besides governing tax-sharing schemes, the FAG also distinguishes financial resources between transfers and conditional grants. **Transfers** aim at equalizing the average revenue of the *Länder* and municipalities resulting from tax sharing arrangements (horizontal equalization) and are distributed from the state level to the local level . They also support municipal investments. In general, there are two types of transfers: current and one-off transfers. Special need transfers (*Bedarfszuweisungen*), for example, are one-off payments from the states to the municipalities that originate from shared taxes. Such transfers are in a first step distributed to the state level and, according to individual assessments, transferred to certain municipalities for specific tasks or functions. Other transfers cover housing development, environmental purposes and infrastructure or originate as well as transfers from the Federal Natural Disasters Fund. This Fund covers expenditures for protection against natural disasters and supports states (*Länder*) in reconstructing infrastructure. **Conditional grants** include grants for education, culture and transportation.

The main sources of municipal revenue are shared taxes (~35%), local taxes (~20%), fees and charges (e.g. from utility or educational or social services) (~20%), current transfers (~10%) and other fees and income (including capital transfers, purposed for investments in infrastructure) (~10%).

Overall, intergovernmental transfers have a strong balancing effect on financial resources (see FIGURE 1). The regulation leads to a reduction of disparities in financial strength between the municipalities and shifts funds from financially strong to financially weak municipalities. This transfer system significantly impacts the municipalities' financial capacity, supporting smaller municipalities.

Figure 54 AUSTRIA: Financial strength before and after transfers in Austrian municipalities, 2016-2020



Source: KDZ, 2021 a, FAG-Factsheets

Local Government Own source revenues

Local governments own source revenues are primarily composed of fees and own taxes (e.g. municipal business tax and property tax).

Fees are mainly generated through the provision of public services and utilities such as water supply, sewerage and waste management. There are, however, also some intermunicipal cooperation associations (*Gemeindeverbände*) that carry these services out and have their own budgets. In these cases, municipalities make proportionate payments to cover the costs of the associations.

Municipalities also levy taxes such as the municipal business tax and the property tax. Companies must pay municipal business tax amounting to 3% of the total sum of salaries and wages paid each month. Therefore, municipalities with higher employment rates and higher paying jobs enjoy a higher municipal business tax income. In general, this applies to a greater extent to urban local governments and municipalities with a strong tourism industry. Property tax is levied on individuals owning property (land and buildings) and the amounts are set by the municipalities considering a legal tax cap.

Other non-tax revenues are asset revenues, rental and leasing incomes, disposal of low-value assets and property or the repayments of loans and advances.

Borrowing:

In general, municipalities are only allowed to take on **long-term debt for capital spending**. Current expenditures cannot be covered with long-term debt. There are rules for short-term

loans which have to be paid back within the fiscal year. Furthermore, laws at the state level prohibit the use of risky financial instruments.

Over the last ten years **municipal debt slightly rose** from EUR 7.2 billion in 2013 to 9.95 billion in 2021. The local government debt-to-GDP ratio decreased by 0.4 percentage points from 3.6% in 2012 to 3.2% of GDP in 2021. From 2019 onward local debts decreased continuously and remained stable in the following years (at around 3%). The outbreak of the COVID-19 pandemic in 2020 led to an increase in the debt-to-GDP ratio (3.4%). In 2021 the debt to GDP ratio decreased by 0.2 percentage points (3.2%).

The Austrian Pact on Fiscal Stability (Österreichischer *Stabilitätspakt*) plays a fundamental role for debt financing.

The pact ensures compliance with the EU-Maastricht criteria and obliges the three levels of government to keep their debt-levels below an agreed threshold.

COVID-19 Impact and implications for Local Government Finances

The covid-19 crisis caused numerous challenges at the local level since its outbreak in 2020. In particular, the shortfall in municipal tax revenues and shared taxes drained municipal budgets. However, the effects of the covid-19 crisis were not limited to 2020 and 2021, but have also been felt in 2022.

Apart from the decrease in revenues, expenditure increased, most notably due to increased transfers to private households and due to personnel and material costs. Another challenge faced by local governments is the reduction of *gross capital formation* in 2020. This development reflects the close link between the development of revenue shares, fiscal capacity and the scope for municipal investment activities (Fiskalrat, 2021).

Furthermore, municipal budgets have been burdened even more since the economic stimulus act (*Konjunkturstärkungsgesetz, 2020*) came into force, which was implemented in response to the pandemic. The act led to a decrease in shared taxes due to tax reliefs.

In response to the effects of the covid-19 crisis on the employment situation, a significant share of salaries and wages were compensated for by covid-19 short-time work subsidies. Hence, companies were exempted from municipal business tax, resulting in a significant drop in revenues in 2020. In 2021 municipal business tax revenues rose again.

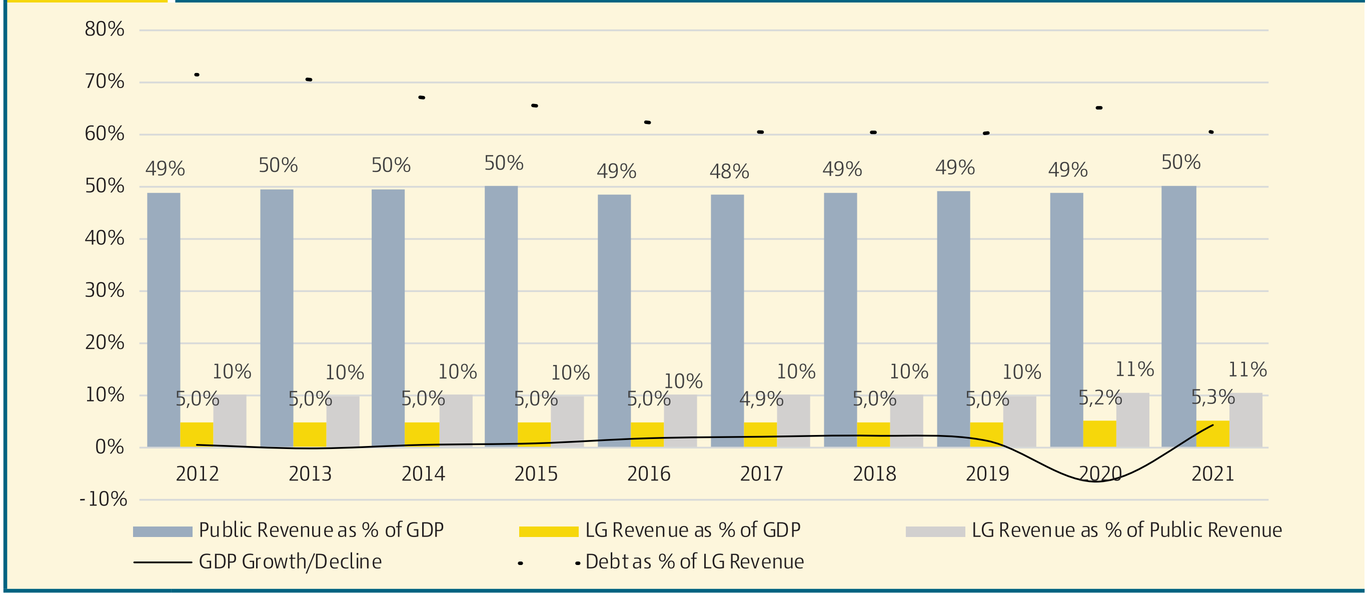
The national parliament passed the municipal investment act (*Kommunales Investitionsgesetz, KIP 2020*) in 2020, which provided one billion euros of conditional investment grants for cities and municipalities. Another municipal investment act (*KIP 2023*) has been passed to support municipalities with one billion euros in the period from 2023 to 2024. The latest municipal investment act stipulates that subsidies are to be used to increase energy efficiency and support the transition to renewable energy on the one hand. The grants from the municipal investment acts are contingent on co-funding from the municipalities themselves. This leads to additional financial burdens, which not all municipalities may be able to shoulder.

According to prognoses from KDZ (2020 a, b and c, KDZ) and Wifo (2022), the local level will face a number of headwinds in the upcoming years. First, local government revenues will be affected by regulatory changes *or* the upcoming fiscal equalization act, which will be negotiated in 2023. Second, local revenues heavily depend on the development of the economy, which in turn is affected by several rather unalterable factors (e.g. geopolitical issues, supply shortages due to covid-19 etc.), at least some of which currently make for a a challenging environment. Third, in turn, local government expenditures are influenced by inflation and increasing costs (especially in the case of childcare, health care, public transport and the green transition). These developments entail the risk that municipalities will cut back on investments, especially against the backdrop of sharp increases in construction prices, which are indirectly also caused by the pandemic.

Advocacy efforts of the Local Government Association in the area of local finances

In Austria, two local government associations represent communal interests: the **Austrian Association of Municipalities** *(Österreichischer Gemeindebund)* and the **Austrian Association of Cities and Towns** *(Österreichischer Städtebund).* The *Gemeindebund* represents almost all municipalities in Austria. The focus lies on smaller and rural municipalities. The *Städtebund* represents the interests of 255 midd-sized to larger cities in negotiations between the federal-, state- and municipal level regarding the distribution of budgetary funds and taxing rights.

Figure 55 **AUSTRIA: Local Government Revenue as a Share of GDP and Total Public Revenue, 2012-2021**[8]



Both associations are engaged in advocacy efforts to represent local authorities' interests in the fiscal equalization schemes. They play a crucial role in the negotiations between the three levels of government regarding the fiscal equalization system.

Furthermore, *Städtebund* and *Gemeindebund* are both represented at the European level in Brussels and are also members of the Council of European Municipalities and Regions (CEMR) and thus also of the United Cities and Local Governments (UCLG).

Statistical Overview of Local Government Finance in Austria 2012-2021

At first glance, the fiscal governance framework in Austria seems to be rather decentralized. Responsibilities are allocated to all government levels and in some important areas of public services are delegated from the federal and state level to the local level. But the division of competencies and responsibilities leads to overlaps in certain areas, for example in the education or health sectors. Furthermore, the fiscal equalization scheme results in a complex system of transfers and vertical fiscal imbalances.

However, municipalities' own source revenues remained stable over the past decade. From 2012 to 2021 local governments' total revenues on average made up 13% of total public revenue. Local revenues as a percentage of GDP kept stable at 5% and slightly increased in 2020 and 2021. The data, as highlighted in FIGURE 2, also reveals that local debt as a percentage of local revenues decreased continuously until the outbreak of covid-19. Furthermore, local debts developed alongside GDP growth: In 2020 the increase in local debts was accompanied by a decrease in GDP growth.

7 The underlying data stems from public authorities accounting (federal government, state governments, Vienna as a state and local government and local governments; excluding social insurance revenues). Public authorities' statistics differ from public sector data. The latter includes government units (European System of Accounts sector S.13) and other public units or public enterprises (ESA sectors S.11, S.12).

As highlighted in FIGURE 3, between 2013 and 2019 local and general governments' revenues growth rates developed rather acyclically, but with modest fluctuations. The outbreak of the covid-19 pandemic led to a drop-in growth rates, where general governments revenue fell faster and further than local governments' revenues. The trends in data show a fast recovery in general and local revenues in 2021.

Local governments' revenues originate from three main areas: own source revenues, shared taxes and grants (including transfers from the central and state level). As seen in FIGURE 4, all three areas remained roughly stable over the past decade. The data also reveals that local authorities' own source revenues witnessed a relative drop in 2021. A closer look at absolute figures (see FIGURE 5) shows that the relative drop in 2021 is caused by a disproportionate increase in shared taxes, following a relative and absolute drop in 2020.

Own source revenues are comprised of local taxes, fees, charges and other revenues. Of these own source revenues local taxes make up around 41%, fees and charges 43% and all other revenues 17%, respectively. Since local governments only have limited scope with regard to tax setting, own source revenues are highly determined by external factors—the most important tax income (around 70% of local taxes) at the local level, the municipal business tax, decreased due to the negative effects of the covid-19 pandemic.

Another major source of local finances is shared taxes. These taxes are distributed according to an allocation key and are set at the federal level. Shared taxes include revenue from the PIT (wages and salaries), VAT, CIT and other minor taxes. As stated above, shared taxes continuously increased but due to the covid-19 pandemic shared taxes fell from around 7 billion Euro to 6.4 billion Euro in 2020. The data suggests a quick recovery in 2021 (7.5 billion Euro).

Figure 56 **AUSTRIA: Annual Fluctuations in the Revenues of the General Government and Local Governments, 2012-2021**

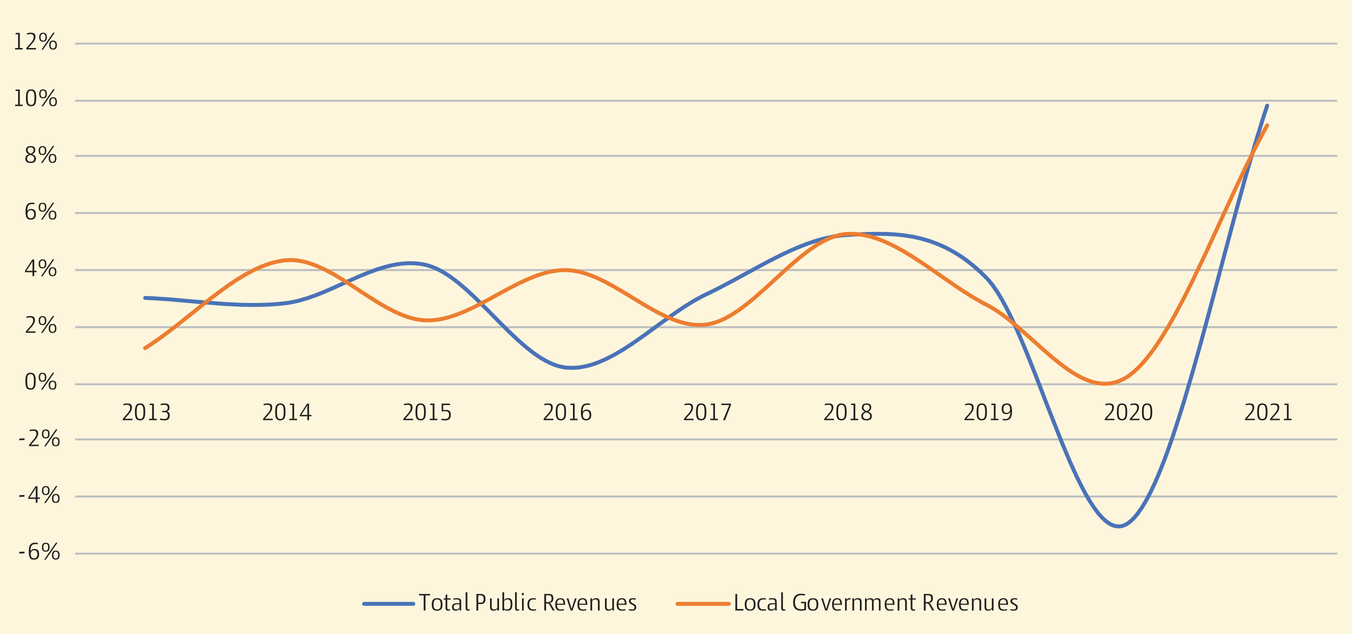


Figure 57 AUSTRIA: Composition of Local Government Revenues, 2012-2021

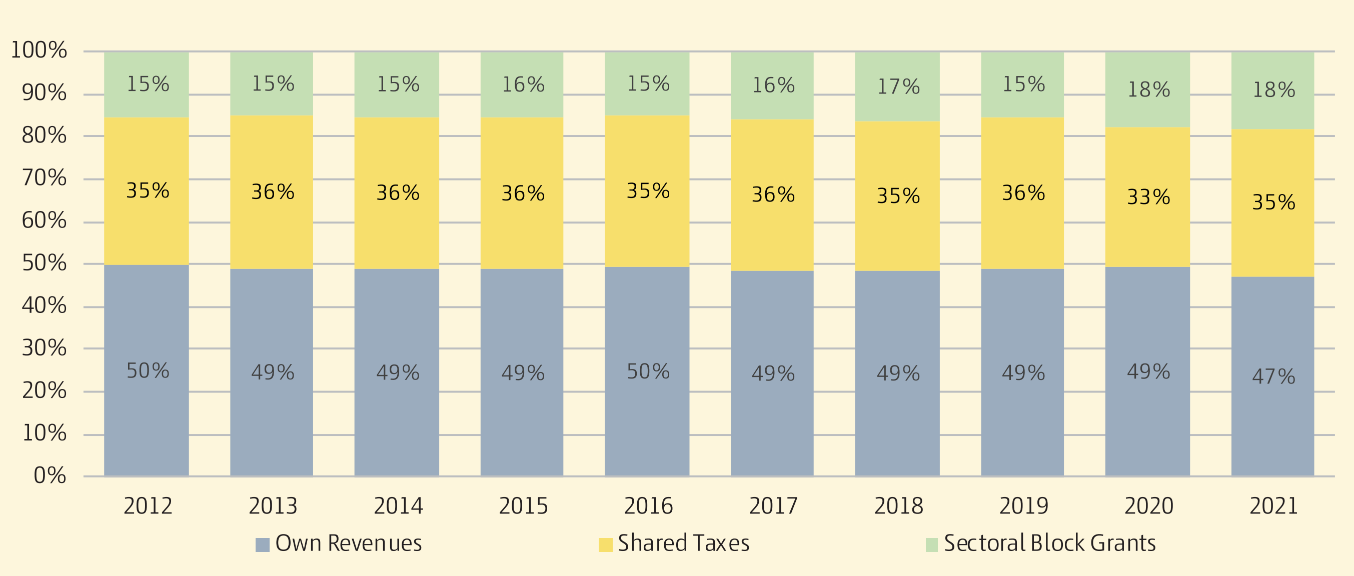


Figure 58 AUSTRIA: Composition of Local Government Revenues in mln Euro, 2012-2021

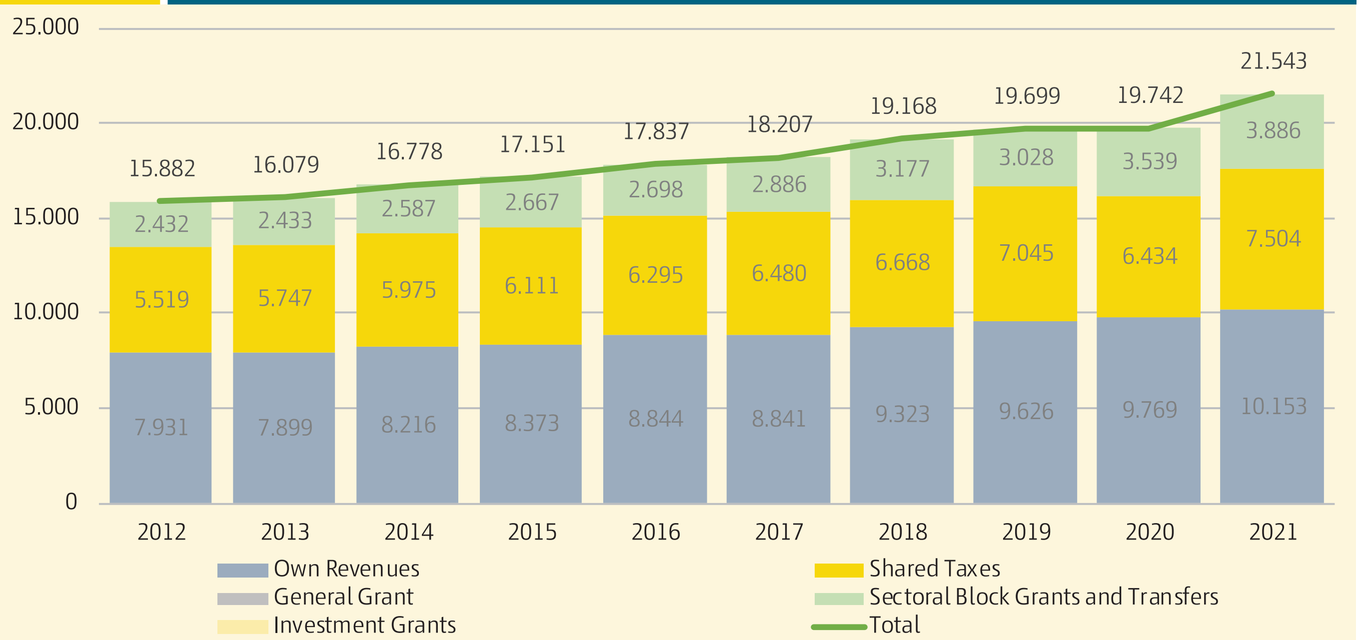
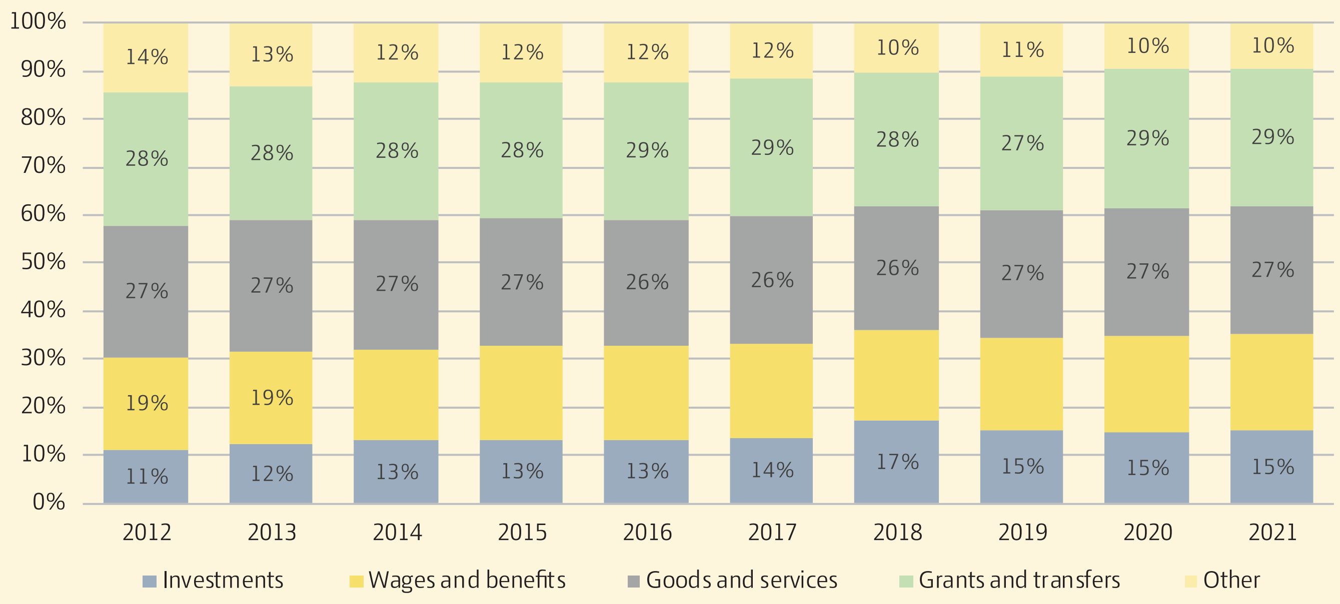


Figure 59 AUSTRIA: Composition of Local Expenditures, 2012-2021



Sectoral Block Grants and Transfers from the central (federal) and state level to the local level are dedicated to maintaining and investing in the provision of public services. The main shares of conditional grants and transfers are assigned to finance kindergartens, primary and secondary schooling, water supply, sewerage, waste disposal and road construction.

The largest share of local expenditures is represented by grants and transfers (around 30%). Within this category transfers to other tiers (central, state and local) make up the largest share (70%). The data in FIGURE 6 depicts the relative increase of local investments (from 11% in 2012 to 17% in 2018) and its drop in 2019 (15%).

According to the KDZ (2021 c) municipalities will face several different challenges in the upcoming years. Investments by municipalities already account for a large share of total investments. According to FIGURE 60[8] municipalities their share of public investments amounted to 25-30% in the past decade. This corresponds to 3,7 billion Euro for the local level in 2021 (and 14,1 billion in total). Further investments will be needed in the future, especially in the childcare and the nursing sector and for climate change related measures.

8 Data in FIGURE 60 are based on public sector statistics, as opposed to other FIGUREs, which are based on public authorities accounts, unless otherwise stated.

Figure 60 AUSTRIA: Public authorities' share of Investments, 2012-2021

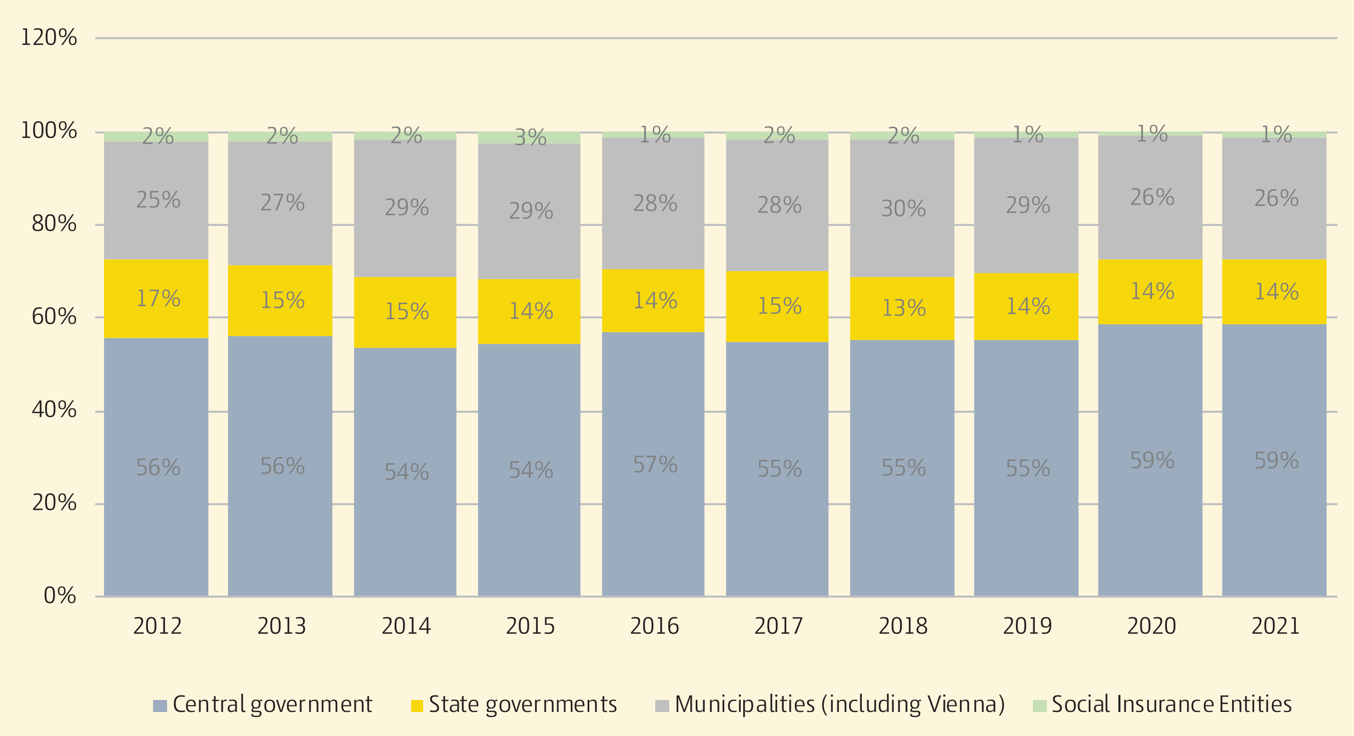
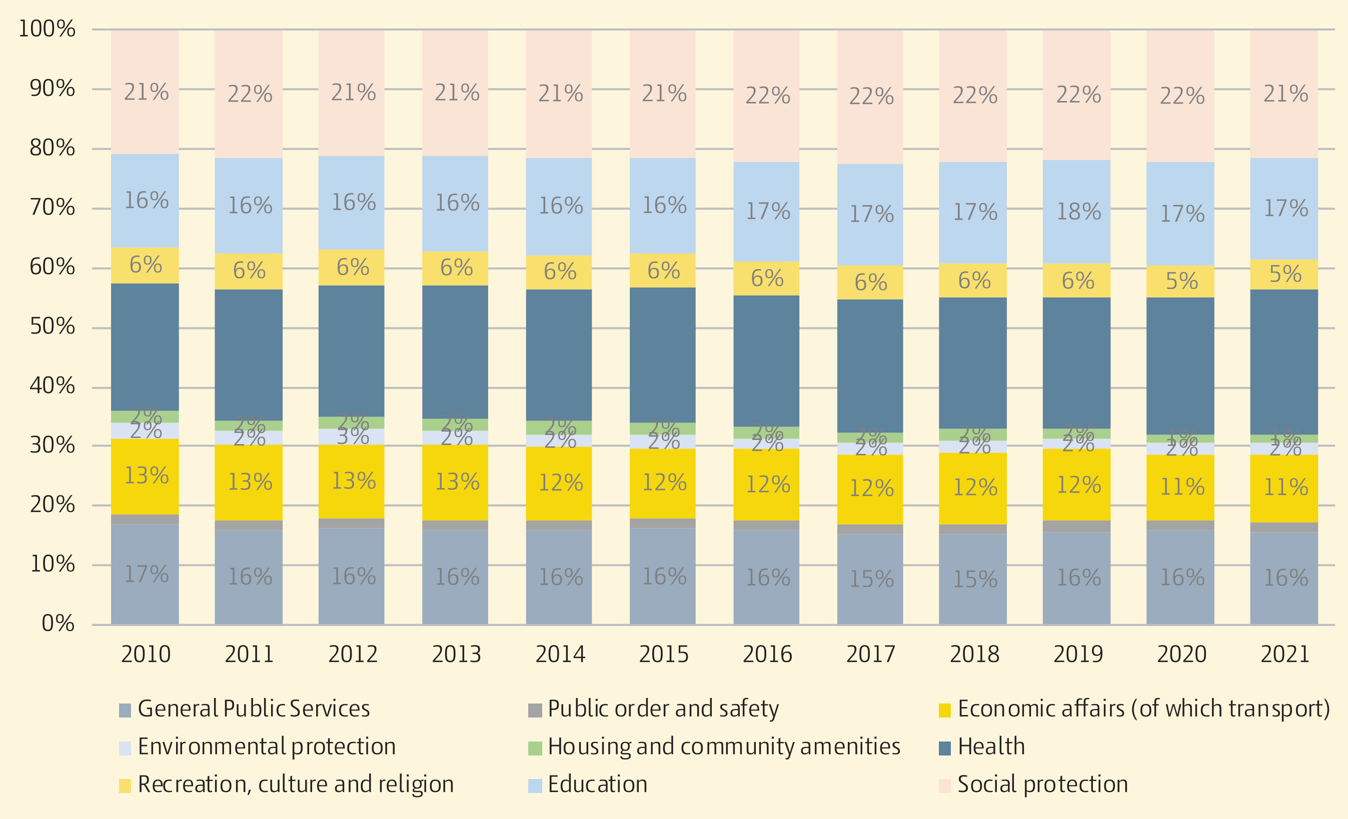


Figure 61. details expenditures based on their functional allocation (COFOG)[9]. According to this international classification, health (24%) and social protection (21%) are the largest areas of expenditures at the local level. Expenditures in the health sector increased in the past decade and therefore indicate the local responsibilities in the field.

[9] "The Classification of the functions of government, COFOG, was developed in its current version in 1999 by the Organisation for Economic Co-operation and Development (OECD) and published by the United Nations Statistical Division as a standard classifying the purposes of government activities." https://ec.europa.eu/eurostat/statistics-explained/index.php?title=Glossary:Classification_of_the_functions_of_government_(COFOG)

Figure 61 AUSTRIA: Functional Allocation of Local Expenditures (COFOG classification), 2010-2021



The negotiations in 2023 with regard to a new fiscal equalization scheme for the period beginning in 2024 are an opportunity to address the role of the local level and to strengthen its position. Local governments have to cope with several challenges in the short and long run. It is therefore imperative to increase their financial strength and autonomy.

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Bosnia and Herzegovina
Federation of Bosnia and Herzegovina

By Halko Basarić, Association of Municipalities and Cities in the Federation of Bosnia and Herzegovina

The Intergovernmental Finance System

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

In the Federation of Bosnia and Herzegovina (FBiH), the entity's share of indirect taxes is allocated to cities, municipalities, cantons and the city of Sarajevo according to fixed percentages. Cantons receive 51.23% of the total, Cities and Municipalities receive 8.42%, the City of Sarajevo receives 0.25% while the budget of the FBiH (BiH) receives the remaining 36.2%. These shares are given as **Unconditional Transfers** and are allocated by formula. The main criteria for allocating the transfer is population (68%). But there are other coefficients for surface area (5%), school age children (20%) and the municipality's development index (7%) or relative wealth —as measured by the yield of the Personal Income Tax— that have equalizing effects. In 2022, the Unconditional Transfer constituted 155.3 million € or 30.00% of municipal revenues.

The Unconditional Transfer remains unchanged for several years because of foreign debt service arrangements. Debt service payments to foreign creditors are paid directly and immediately from each entity's share of indirect revenues. As a result, the pool of revenues that would otherwise go to cantonal and municipal governments is automatically reduced by the debt service payments of the Federation government. Therefore, municipalities and cities are constantly obligated to participate in debt service, although they don't have any debt arrears. In 2022, foreign debt service for FBiH (BiH) is estimated at around 278.3 million, the external debt service effectively reduced local government's share of indirect taxes from legally defined 8.42% to 7.1% (with a revenue loss of 40 million KM or 5% local revenues). This procedure means that LGU's revenues depend on external debt servicing, implying significant volatility and instability and lower local government revenues when debt service is high. It is estimated that in 2023 and 2024, repayment of only principal of the foreign debt in FBiH (BiH) (interest excluded) will rise to 329 million Euros, additionally emphasizing the "crowding out" effect that the FBiH (BiH) government level has on local government revenues.

According to the Law on the Allocation of Public Revenues, municipalities in FBiH (BiH) are also entitled to a specified percentage of at least 34.46% of **PIT revenues** collected in their territory. The other 65.54% of PIT revenues belong to cantonal governments who are obliged to share a specified percentage of PIT with their municipalities on an origin basis. The minimum amount they should share with municipalities is 34.46%. Municipalities within Sarajevo Canton were given the right to receive a share of only 1.79% of PIT, while the canton itself receives 98.21%. In 2022, about 21% of local government revenue came from shared taxes. Another 13% comes from **conditional grants** which municipalities receive from either the entity or, more frequently, the cantons. Most are for specific investment projects. **Own Source Revenues** constitute 34% of total local revenues in 2021 and are composed primarily of local fees and charges.

Local Government Own source revenues

In 2021, local governments own source revenues are composed primarily of local fees and charges (60%), communal fees and charges (14%) and asset revenues (19%). The share of asset revenues increased compared to previous years indicating better management and own revenue collection. Unfortunately, there is no federal level account of local government own source revenues and data about the nature, type and composition of these revenues are accounted for differently in each canton.

The recurrent property tax is regulated by the ten cantonal governments and there is no entity-wide legal regulation of the tax. As a result, the FBiH (BiH) has the highest number of property tax laws in the region. In all cantons the tax is a cantonal levy, regulated and administered by cantonal authorities. Municipalities do not play an active role in levying the tax and its revenue potential is not a major concern for authorities at any level of government. Local governments are also entitled to 100% of the revenues of the property transfer tax and property tax, which constituted 10% total local government revenues in 2022. Local government powers over these taxes are significantly limited, as both the base and the rate of the taxes are determined by the cantonal governments.

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

Borrowing:

In FBiH (BiH), the Law on Debt, Debt Generation and Guarantees regulates the debt of the FBiH (BiH) level, cantons, cities and municipalities, procedure for debt generation, securing the repayment of the loans, issuing guarantees and keeping the record of debt and guarantees at all three tiers in FBiH. Further, certain provisions from the organic Law on Budgets also partially apply to subnational borrowing. There is a state-level BiH Law, but it has very few implications on municipal borrowing.

Cities and municipalities in FBiH (BiH) can generate domestic and foreign debt, as loans and securities, and in national or foreign currency. Each tier of government is obliged to pay debt generated by that level. When incurring foreign debt, cities and municipalities must obtain consent by the FBiH and BiH parliaments, and in all cases by local parliament.

The rules for **long term debt** require that at the time when the loan is approved, debt service for each consecutive year, including servicing of the **new loan** and all loans for which municipality or city issued **guarantee(s)**, does not exceed **10%** of revenues collected in previous fiscal year. Guarantees are calculated with 30% of nominal value.

Short term loans can be incurred only for financing cash flow deficits and shall be paid back in the same fiscal year. This debt cannot be re-financed or extended after the fiscal year ends. This debt also cannot exceed **5%** of the revenues in the previous fiscal year.

Cities or municipalities cannot incur debt without previous written approval from the Ministry of Finance of FBiH (BiH) in the following cases: a) they generate debt with FBiH Government or canton guarantees; b) they generate debt or issue guarantees for refinancing existing debt; and c) they have already generated debt or issued guarantees, but servicing of the debt is irregular.

Cities and municipalities can issue **guarantees** only for financing capital investment, and only if approved by the local council. A city or municipality can issue a guarantee(s) for capital investment only if the debtor is a legal entity owned by the city or municipality or under their control.

Cities and municipalities in FBiH (BiH) were banned from borrowing until 2007, which has limited indebtedness of local governments. In the past 10 years cities and municipalities have started generating debt more significantly, but current annual service is still far below the legal limit of 10% of current annual revenues in 2021. Overall, local government debt in FBiH (BiH) is at about 1% of GDP over the past five years.

Advocacy efforts of the Local Government Association in the area of local finances

The Association of Cities and Municipalities of Federation of Bosnia and Herzegovina (SOGFBiH) is constantly engaged on lobbying for a more equal distribution of public revenues. Several initiatives were proposed to the FBiH Government, aiming at resolving regulatory problems that arose after 15 years of implementation of the Law on distribution of public revenues in FBiH (BiH). The FBiH (BiH) Government in 2022 established a Working Group for the Development of New Methodology for Distribution of Public Revenues in FBiH and appointed a representative from SOGFBiH as a member. SOGFBiH has prepared a policy proposal for resolving several key issues in local finances:

- Fiscal vulnerability-sustainability of small municipalities
- Indirect repayment of FBiH foreign debt by cities and municipalities
- Horizontal equalization—use of obsolete indicators
- Transfer of additional functions and responsibilities to LG without allocating appropriate funding sources

SOGFBiH prepared two studies on LG finances, to support our stances on abovementioned key issues: *Functional responsibilities of LGs in FBiH,* and *Impact of Coronavirus Pandemic on Local Finances,* in addition to *Analysis of Local Revenues of LG* that was prepared earlier.

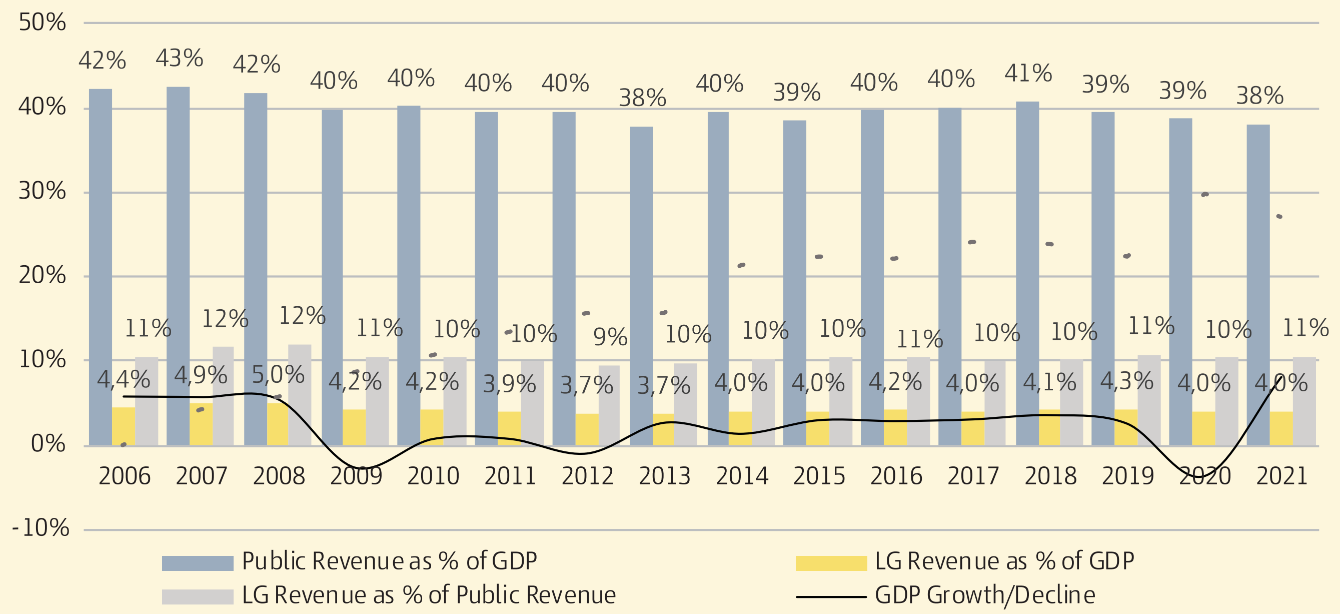
Having in mind the impact of the coronavirus pandemic in local finances that was visible through a decline of shared revenues as well as increased local spending, and negative consequences of current legislation defining foreign debt repayment, the working group acknowledged and accepted the policy proposals of SOGFBiH and decided that the new methodology needs to incorporate principles of: a) protecting small and fiscally vulnerable municipalities, b) foreign debt repayment by the tiers of government that generated debt. The working group will continue work on development of a new methodology for revenue distribution in FBiH, with SOGFBIH participation and advocacy efforts aimed at a final vision of transparent and just system of revenues sharing.

SOGFBIH has succeeded in the pandemic year 2020, through advocacy and negotiations with FBiH Government, to allocate 30 million BAM (15 million Euros) from FBiH Budget as grants for local government. Out of these, 20 million BAM is an unconditional grant, while 10 million is earmarked for capital investment in LGs. In 2021, 2022 and 2023, the grant was increased to 40 million BAM (20 million Euros).

Statistical Overview of Local Government Finance in FBiH (of BiH) 2006-2021

Local government revenues, as a share of GDP and public revenues, remained relatively stable over the past 5 years. This can be attributed to increased collection of indirect taxes (VAT in the first place) due to inflation, and consequently increased shared revenues. However, the current set-up for foreign debt repayment is reducing LGs share as percentage of public revenues, but this is offset by increased efficiency in own source revenue collection. It is noticeable that as of 2013 LGs started generating more debt relative to revenue, but FBiH (BiH) legal framework allows for long-term borrowing only for capital investment, while deficit financing must be repaid within the fiscal

Figure 62 FBIH (BIH): LOCAL REVENUE AS SHARE OF GDP AND PUBLIC REVENUE



year. LGs in FBiH (BiH) increased spending on health care and sanitation, but in terms of revenues, almost all of 80 LGs adopted a policy of waiving some type of own-source revenues (rents, communal fees etc.) in favour of local businesses. This has caused a drop of almost 50 million KM in own source revenues in 2020. Revenue growth rates in 2021 have returned and surpassed pre-pandemic levels, in both categories of shared revenues and own source revenues.

Local government revenues compared to general government revenues fell during the COVID-19 crisis in 2020. The reason for this is two-fold: Revenues from indirect taxes (shared with LGs) fell due to decreased economic activity, but even more importantly, LGs have engaged in large-scale interventions to overcome the negative effects of the pandemic.

Figure 63 FBIH (BIH): ANNUAL FLUCTUATIONS IN REVENUES

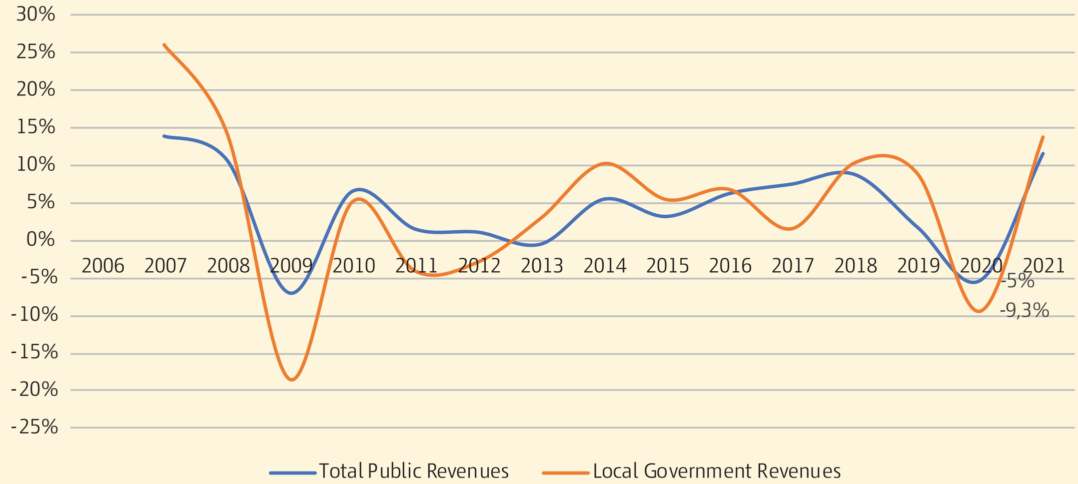
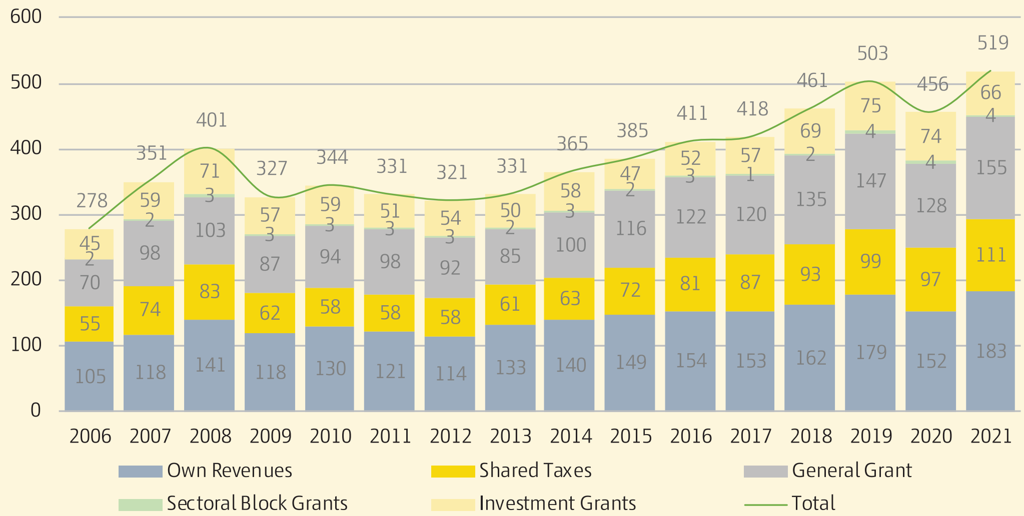


Figure 64 FBIH (BIH): THE COMPOSITION OF LOCAL GOVERNMENT REVENUE 2006-2021, IN MILLION EURO



All categories of local government revenues showed constant growth in nominal terms before the corona pandemic in 2020. This can be attributed mostly to the improved collection of indirect taxes (and increase of consumers prices in case of shared VAT) and increased efforts in own source revenue collection. The composition of local government revenues remained stable over the past 5 years: Own source revenues constitute the single most important source of revenue (34%), together with shared taxes (32%) and general grant (30%).

Figure 65 FBIH (BIH): THE COMPOSITION OF LOCAL GOVERNMENT REVENUE 2006-2021, IN EURO PER CAPITA

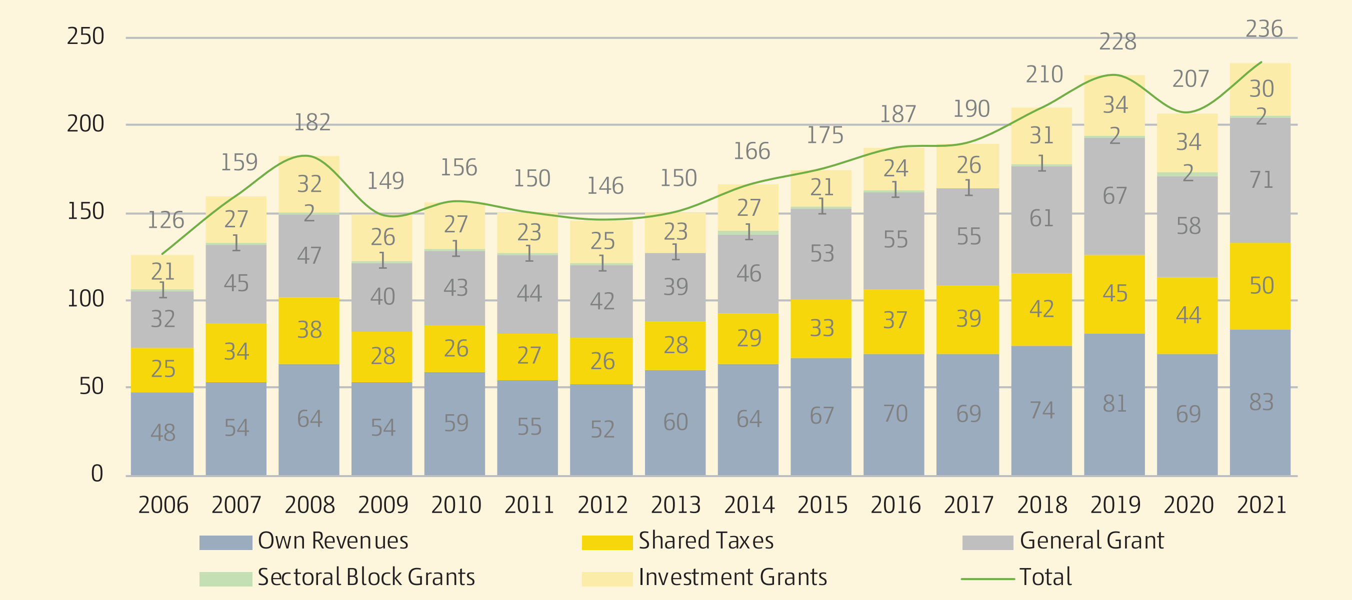
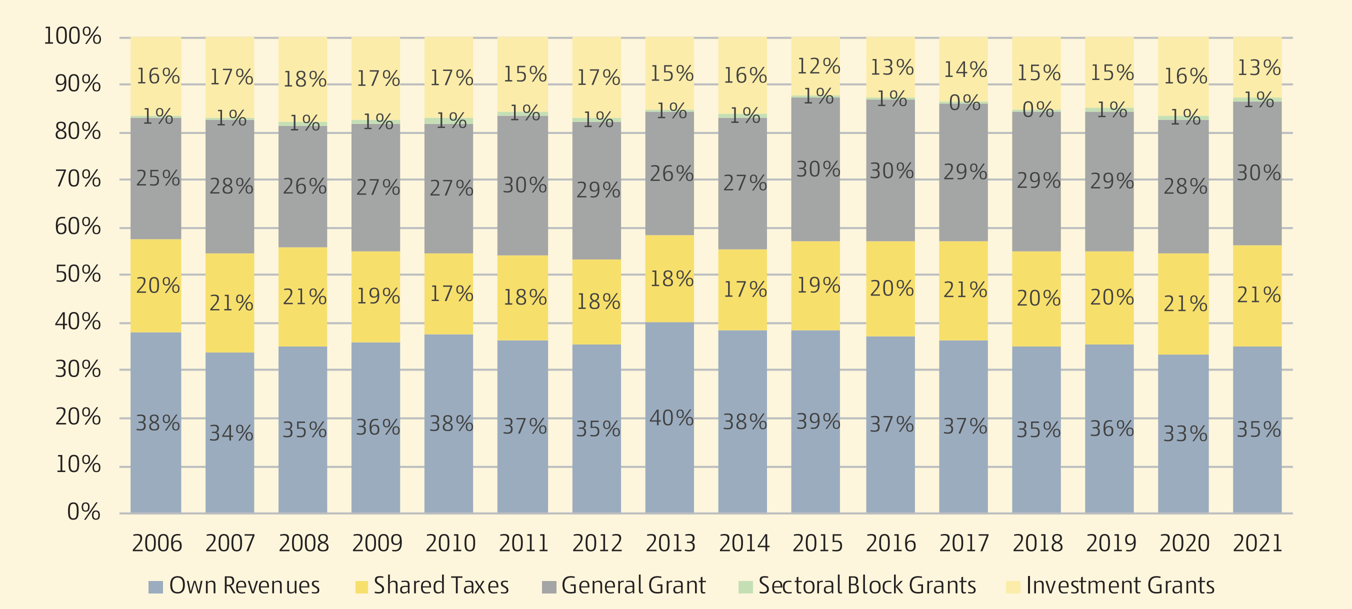


Figure 66 FBIH (BIH): THE COMPOSITION OF LOCAL GOVERNMENT REVENUE 2006-2021, IN %



On average, 65% of local government revenues are composed of intergovernmental transfers, in the form of shared taxes and grants. Investment grants have increased over the past two years constituting 16% of local revenues in 2020, but again in 2021 they dropped to 13%, much lower compared to previous years. The share of block grants remains negligible.

Since 2018, there are no substantial changes regarding the structure of LG's own source revenues except for a decrease in the yield of the property tax and an increase of the revenues derived from municipal assets. Other local fees and charges, which include all fees and charges besides administrative and communal ones, still constitute a dominant component of own source revenues with 60% in 2021. The main attribute of this category is the great heterogeneity of fees and charges among local governments. Due to this diversity, FBiH (BiH) Government introduced a Registry of Fees and Charges, that is updated regularly and contains legal sources for the introduction of local fees and charges.

Figure 67 **FBIH (BIH): THE COMPOSITION OF OWN LOCAL GOVERNMENT REVENUE 2006-2021, IN %**

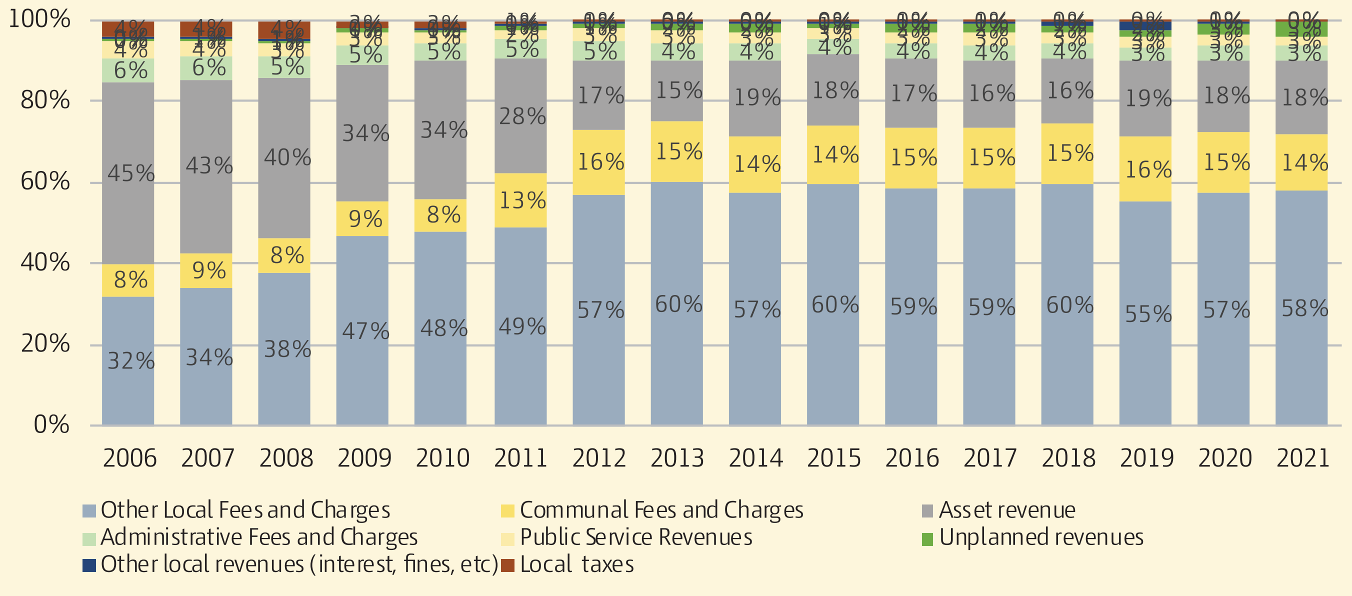


Figure 68 FBIH (BIH): THE COMPOSITION OF LOCAL GOVERNMENT EXPENDITURE 2006-2021, IN %

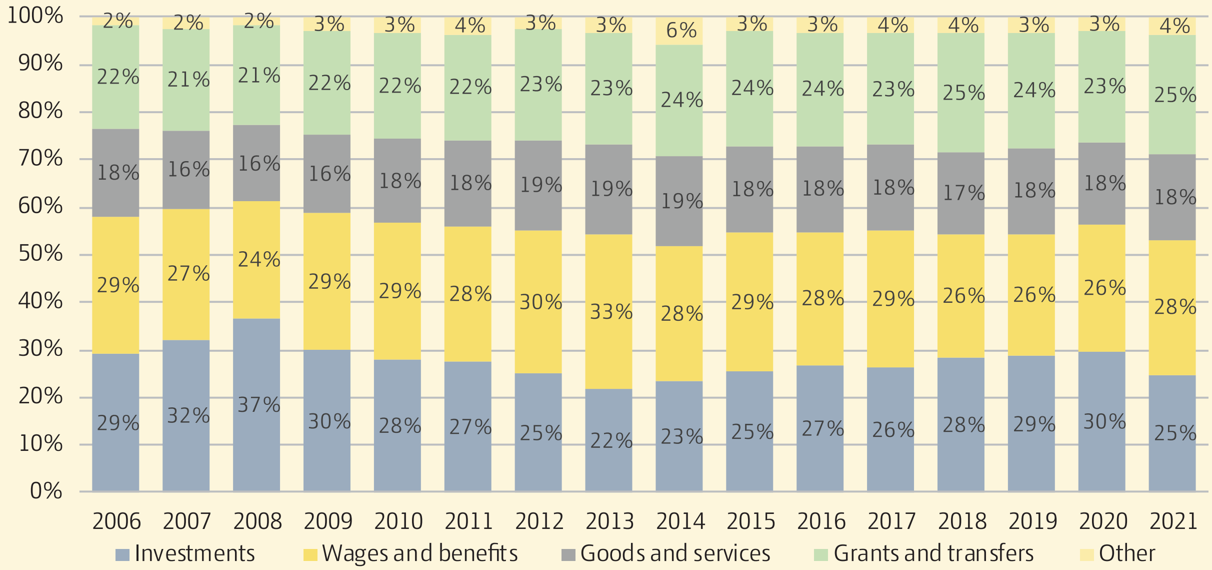


Figure 69 FBIH (BIH): THE COMPOSITION OF LOCAL GOVERNMENT EXPENDITURE 2006-2021, IN MILLION EURO

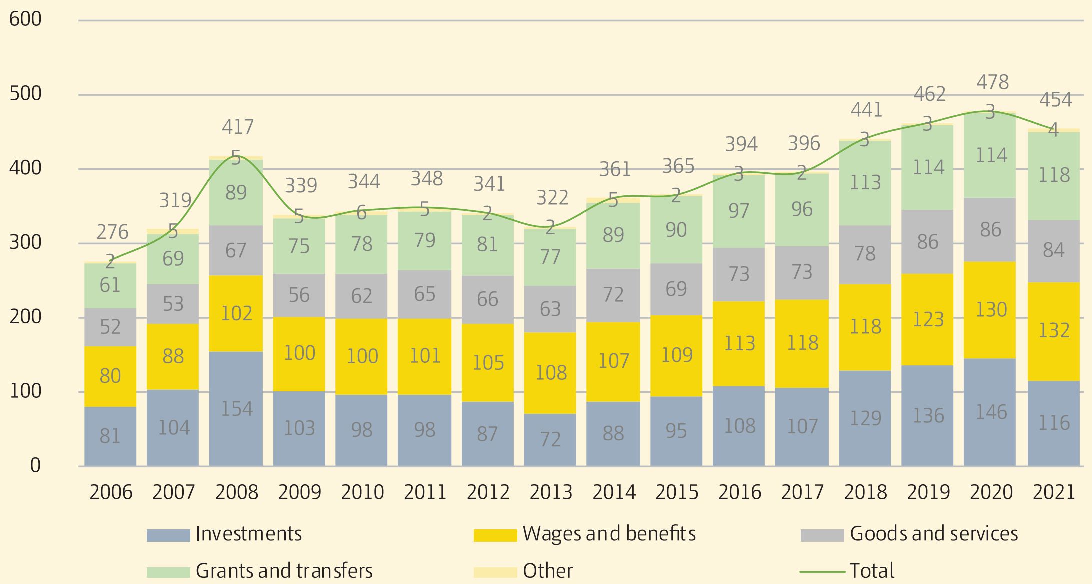
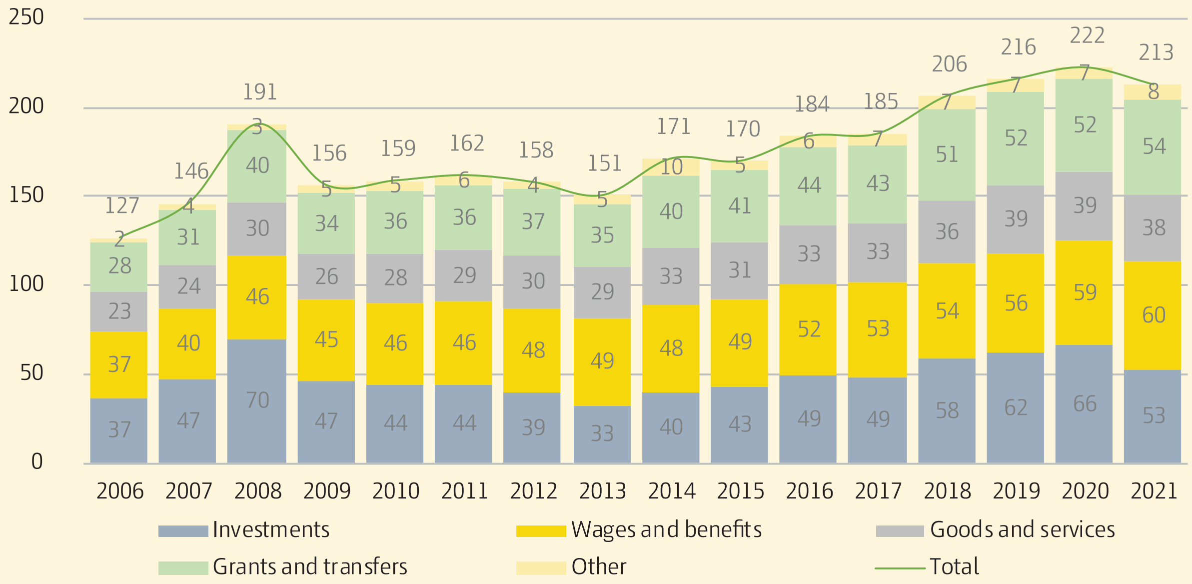


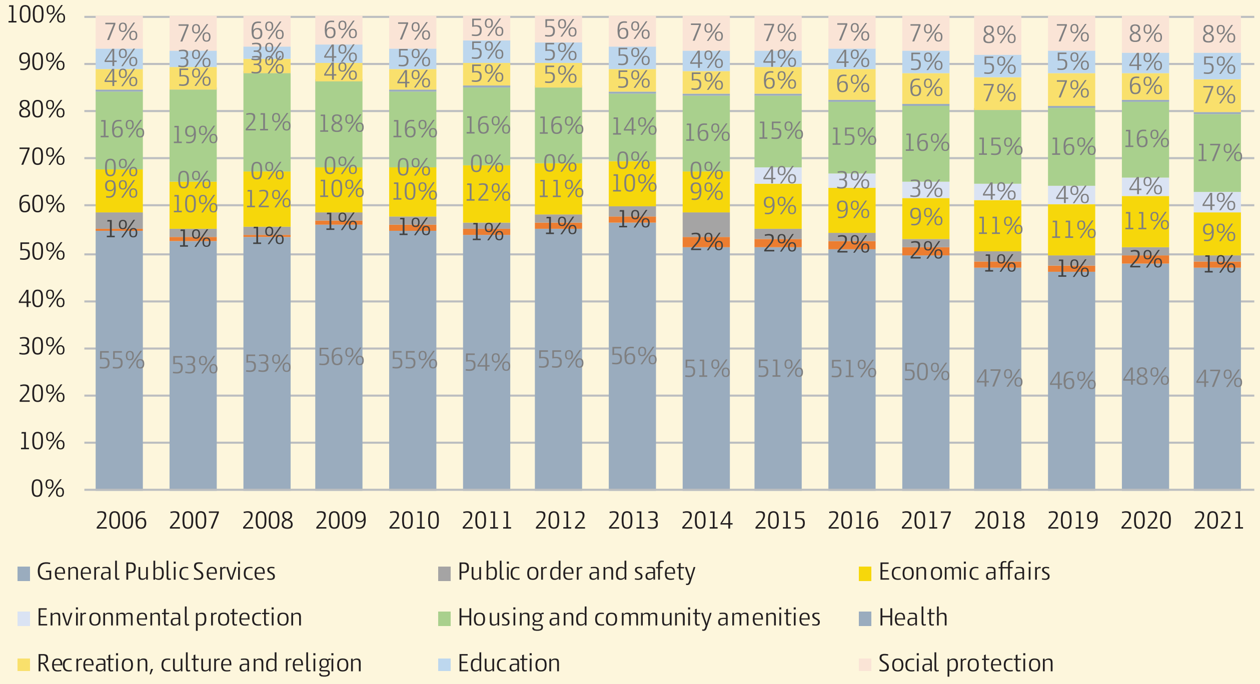
Figure 70 FBIH (BIH): THE COMPOSITION OF LOCAL GOVERNMENT EXPENDITURE 2006-2021, IN EURO PER CAPITA



Spending for wages and benefits remains the dominant and most stable component of local government expenditure, with an increase of 2% compared to the pre-pandemic period but stabilizing at 28% of local government revenues, much as the 10-year average. Investment has slowly recovered from its low since 2013 and peaked in 2020 at 30%, but in 2021, due to decreased capital transfers from LGs, it decreased to 25%. A high share of expenditure consists of subsidies to utilities, grants to NGOs and transfers to individuals, that constitute 25% in 2021. Spending for goods and services remained stable over the long term.

From a functional perspective, it can be noted that a significant share of local government spending is dedicated to general public services, while spending for economic affairs has seen significant fluctuations. Spending for housing and community amenities remains the second largest component, while spending for social care and protection has seen a slight increase in the past two years.

Figure 71 FBIH (BIH): FUNCTIONAL ALLOCATION OF EXPENDITURES (COFOG CLASSIFICATION), IN % OF TOTAL



When local government investments are compared with those of the entire entity, it can be noticed that the local ones were substantial in the pre-COVID-19 pandemic period. Yet, after the pandemic, this share has dropped significantly, reaching its lowest point in 2014. Local government investments have increased since 2014 and constitute 28% of overall public investment in 2021.

Property taxes (Tax on Property Transfer/Property Tax) remain stable over the long period of time below 1% of GDP. Local government debt was for a long time below 1% of GDP, however, in recent years, this has slightly increased to more than 1% of FBiH (BiH) GDP. Although increasing in absolute terms, the share of local government spending on wages to GDP, has decreased from 1.1% in 2020 to 1% of GDP in 2021. In the pre-pandemic period the local government investments to GDP ratio was increasing, but in 2021, for the first time since 2013, investment spending fell to less than 1% of GDP (0.9%).

Figure 72 FBIH (BIH): PUBLIC INVESTMENT BY LEVEL OF GOVERNMENT AND AS A % OF GDP 2006-2021

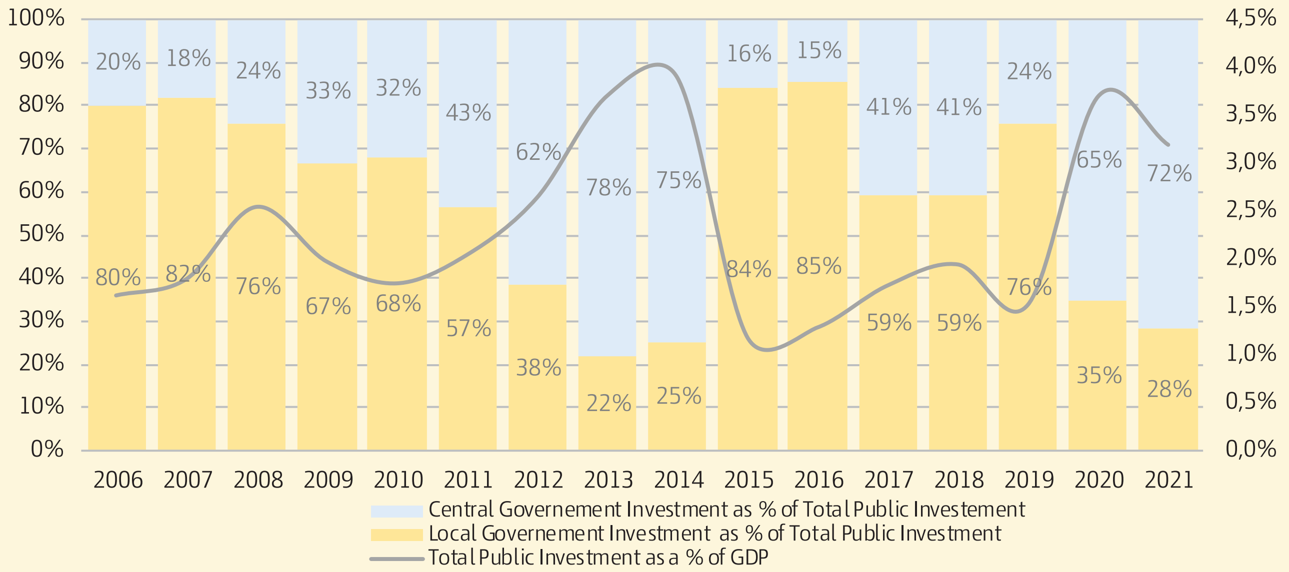
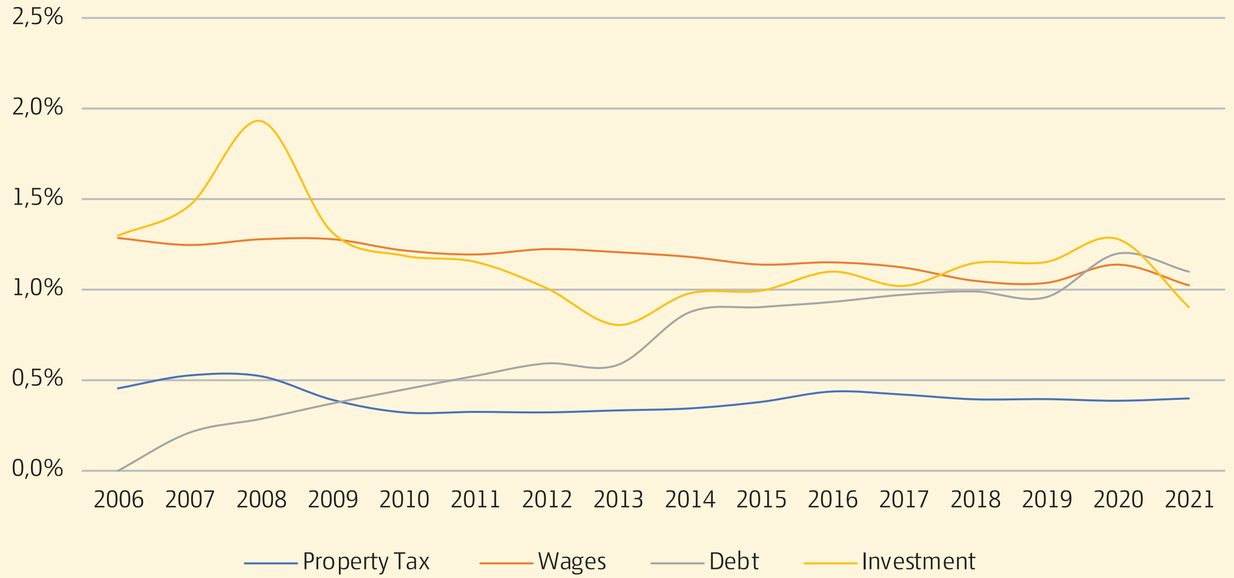


Figure 73 FBIH (BIH): LOCAL GOVERNMENT WAGES, INVESTMENT, DEBT AND PROPERTY TAXES AS % OF GDP



Bosnia and Herzegovina Republic of Srpska

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

The Intergovernmental Finance System

Local governments (LGs) in the Republic of Srpska (RS) of Bosnia and Herzegovina (BiH) derive about two thirds of their total revenues from intergovernmental transfers and about a third from own source revenues. Given the RS's (BiH) extensive responsibilities in social sector functions, including wages of preschool teachers, and other social and cultural institutions, this is rather peculiar. On the other hand, it also reflects the fact that all LG competences are defined as "original" or "exclusive" and therefore to be funded through freely disposable revenues. The definition of local government responsibilities is a subject of discussion in the RS (BiH). All local governments, regardless of size and capacity have the same functional responsibilities. Research shows, that this is often accompanied by disparities in access and quality of services provided to citizens.

According to the Law on the Budget System of the Republic of Srpska, local self-government units (LGUs) are financed from: a) **shared revenues** between the budget of the Republic, the budget of municipalities and cities, and other users, including indirect taxes, income tax, fee for changing the purpose of agricultural land, rent of land owned by the Republic, concession fees and special water fees; and b) **own source revenues**, including the property tax, municipal and communal fees, asset sales and rentals, special water fees and usage fees, the tax on winnings from games of chance, residence taxes, concession fees for the assigned right to concessions, concession fees for use, fines, and other revenues.

Since 2006, the size of the **Unconditional Transfer** has been set as a percentage of the entity's **share of indirect taxes** (24%). However, the actual amounts of the shared indirect tax revenues for towns and municipalities are determined after the payment of RS's (BiH) external debt. The anchoring of the share to this macroeconomic variable should ensure stability and predictability of local budgets. Over the period 2018-2022, the repayment of the external debt for the RS constituted between 14-20% of the total amount of indirect taxes to which the RS is entitled. The unconditional transfer is allocated to the individual municipalities and towns by formula, which has also changed over time. Currently, the formula allocates 75% of the pool of funds on a per capita basis, 15% based on the territory of the municipality, and 10% on the basis of the students in secondary schools. The table below shows the relationship between levels of government in the RS (BiH) and indirect tax revenues.

Table 5. Funds from indirect taxes for distribution in the Republic of Srpska (BiH) (million KM)

	2018	2019	2020*	2021*	2022*
Total assets	1.710	1.800	*1.884,6*	*1.965,4*	*2.033,6*
Repayment of external debt	345,6	293,5	261,6	268,9	*332,4*
Share of external debt repayment in total assets (%)	***20.2%***	***16.3%***	***13.9%***	***13.7%***	***16.3%***
Means of distribution	1.364,4	1.506,5	1.605,2	1.673,1	1.701,2
Republic of Srpska	982,4	1.084,7	1.168,6	1.221,5	1.224,9
Municipalities and Towns	327,5	361,6	371,7	383,8	408,3
PI—Roads of Republic of Srpska	54,6	60,3	64,9	67,9	68,1

Source: Ministry of finances of Republic of Srpska; Author's calculations. *Data used from the projections of the RS Ministry of Finance in budget documents.

Table 6. Distribution of Personal Income Tax revenues between levels of government (million KM)

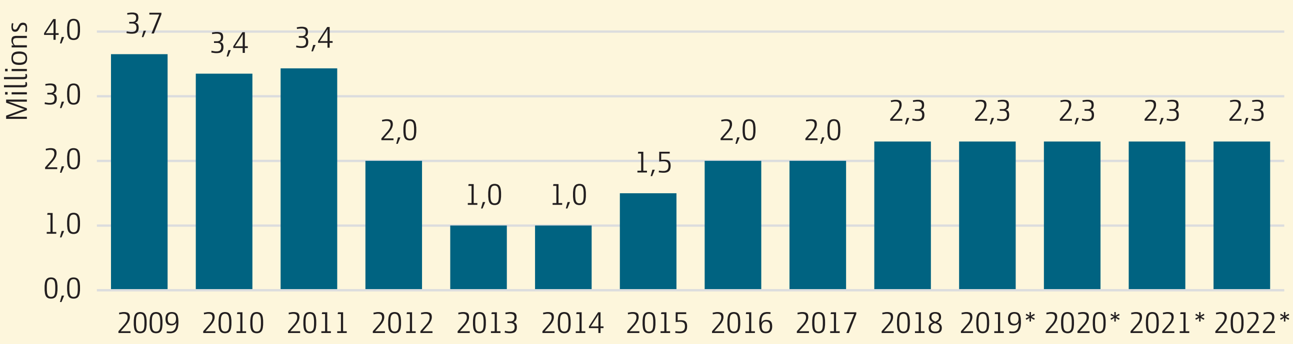
	2016	2017	2018	2019	2020	2021	2022*	2023*	2024*
Total PIT revenue	179,5	181,3	186,4	189,2	193,8	198,1	186,8	194	200,8
RS Government share (75%)	134,6	136,0	139,8	141,9	145,4	148,6	140,1	145,5	150,6
LGUs revenue share (25%)	44,9	45,3	46,6	47,3	48,5	49,5	46,7	48,5	50,2

Source: Budget framework documents of Republic of Srpska; Author's calculations.

Municipalities and towns also receive 25% of the **Personal Income Tax** (PIT) generated in their jurisdictions. These revenues are freely disposable and have accounted for between 6% and 10% of local budgets since 2006. The Association of Municipalities and Towns of Republic of Srpska has recommended to increase the share of these revenues in favour of LGUs by 5 percentage points, which would enable them to develop and provide more adequate and stronger support to entrepreneurs and agriculturists in their area.

There is also a **Transfer for Underdeveloped and Extremely Underdeveloped municipalities**. The amount of this Transfer is set in the annual budget law and allocated according to four criteria: the total per capita revenues of registered businesses (35%); the per capita budgetary revenues of the municipality in the previous year (25%); population density (20%); and the unemployment rate (20%). The Association is also advocating for the increase of such transfers to the level of 3.5 million KM, to their original values in 2009-2011.

Figure 74 TRANSFERS TO UNDERDEVELOPED AND EXTREMELY UNDERDEVELOPED MUNICIPALITIES, IN MILLION KM



Source: Documents of the framework budget of the Republic of Srpska.
*Projections from the Framework Budget Document for the period 2020-2022. Author's calculations.

When it comes to underdeveloped and extremely underdeveloped municipalities, based on the Law on Local Self-Government, it is prescribed that the rules for redistributing funds from the Government budget to LGUs are based on transparent, objective and confirmatory criteria determined by the National Assembly, and that the criteria for determining the degree of development should be updated every three years. In 2022 15 LGUs fell in the category of underdeveloped municipalities and 20 in the category of extremely underdeveloped LGUs. In short more than half (35 out of 64 LGUs) fall into this category and benefit from these supplementary resources. These municipalities face acute problems of depopulation and an aging population, scarce social protection, weak public infrastructure and underdeveloped economies.

Finally, municipalities are eligible for **conditional grants from the entity government**, most of which are for investment. The share of conditional grants increased to 11% of local revenues in 2020, up from an average of 6% in the previous 5 years. In 2021 the share of conditional investment transfers decreased to 4%. Overall, local governments in the Republic of Srpska are characterized by a high level of dependence on revenue transferred from the higher levels of government (64% in 2021).

Local Government Own source revenues

Overall, own source revenues (OSRs) make up up to 35% of total local government revenue in the RS. OSRs in the RS include: the real estate tax, tax on income from agriculture and forestry, fines for misdemeanours, municipal administrative fees, communal fees, special water fees – fees for water protection, municipal fees for the use of natural and other goods of general interest, tax on winnings from games of chance, residence taxes, concession fees for assigned rights granted by local self-government units, concession fees for the use of concessions granted by local self-government units and other income (such as: income from grants, transfers and income that budget users achieve, in the percentage determined by the decision on budget execution; and other municipal revenues). In addition to the above, according to the Law on Local Self-Government, the revenues of the local self-government unit also include fees for the development of construction land. According to the central government's projection for 2022, the revenue structure of the Republic of Srpska Government (BiH) and local self-government units looks as follows:

Figure 75. Revenue projections of the central government of the RS (BiH) and LGUs for the year 2022

	RS Government	LGUs
REVENUES (I+II+III+IV)	**3.300,0**	**723,0**
I Tax revenues (Tax revenues (1+2+3+4+5+6+7+8)	**3.005,9**	**447,0**
1. Revenues from income and profit tax	390,3	-
2. Social insurance contributions	1.053,3	-
3. Taxes on personal income and income from independent activities	-	41,2
4. Property tax (real estate tax)	18,0	25,4
5. Taxes on turnover of products and services	0,2	0,1
6. Indirect taxes remitted by ITA	1.544,3	373,0
7. Other tax revenues	-	7,3
II Non-tax revenues (1+2+3+4+5)	**278,3**	**210,0**
1. Income from financial & non-financial assets & exchange rate differences	33,2	29,6
2. Fees, charges and revenues from the provision of public services	212,5	173,4
3. Fines	22,5	0,5
4. Income from financial and non-financial assets and exchange transactions between or within government units	2,2	0,2
5. Other non-tax revenues	2,8	6,2
III Grants	**15,1**	**7,0**
IV Transfers between or within government units (1+2)	**0,6**	**58,9**
1. Transfers between different units of government	0,6	55,9
2. Transfers within the same government unit	-	3,0

Source: Document of the framework budget of the Republic of Srpska for the period 2022-2024.

The real estate tax (property tax) was introduced into the tax system of Republic of Srpska (BiH) with the Law on Real Estate Tax from 2008. After a series of amendments, the new Law on Real Estate Tax was adopted in 2015, and it entered into force on January 1, 2016. Amendments to the Law on Local Self-Government of the RS gave the possibility to cities in the Republic of Srpska to take over the responsibility of administering the Real Estate Tax from the Tax Administration, which currently administers and collects it. The income from the real estate tax is 100% income of LGUs. The decision on determining the tax rate on real estate is the exclusive competence of LGUs, and they are obliged to submit the tax rate for each year.

As many other counterparts in the region, one of the key challenges facing local governments in the RS is the update of the fiscal register of properties and taxpayers. It is estimated that 50% of real estate in the territory of Republika Srpska (BiH) has not been registered and is not included in the calculation by the tax administration. There have been attempts to regulate this also from a legal perspective. The recent Law on the Property Tax introduces the obligation for the Tax Administration of RS to share and submit data at the request of the city or municipality for properties located in their territories. This is clearly aims at establishing better coordination of these bodies for more efficient tax collection. In addition, the Law also introduces the obligation of the Republic Administration for Geodetic and Property Affairs to provide permanent access to the Tax Administration of RS and to local governments on property information. Equally importantly, recently the Republic Administration for Geodetic and Property Legal Affairs launched the project 'Mass valuation of real estate in the Republic of Srpska'. The reasons for starting the project include the need for: harmonization of data and records, better information of buyers and sellers, equal and fair taxation of real estate, possible use of international standards, as well as an increase in the number of investors.

Tax compliance also remains a challenge. To strengthen tax compliance and enforcement, the Law on the Property Tax also introduces a clause that prohibits the sale of those properties for which property tax was not paid. Compliance with this requirement shall be checked when making a notarial document that represents the basis for registration of rights on property. The deadlines for the payment of the property tax had been changed as well, to improve tax collection and at the same time improve budget sustainability.

Borrowing:

Local governments in the Republic of Srpska (BiH) can borrow in accordance with the Law on Borrowing, Debt and Guarantees of the Republic of Srpska. The debt of a local self-government unit can arise through a credit agreement or through the issue of securities. A local government unit can incur **long-term debt** only if in the period of debt creation, the total amount due for repayment, based on the proposed debt and the entire outstanding existing debt, in any subsequent year does not exceed 18% of the amount of its regular revenues generated in the previous fiscal year. Short-term debt is repaid within 12 months from the day the debt is incurred. Short-term debt cannot at any time exceed 5% of the regular income generated in the previous fiscal year. Additionally, the total exposure of the local government unit based on the issued guarantees cannot exceed 30% of the amount of regular income generated in the previous fiscal year. The municipal or town assembly decides on the indebtedness and issuance of the guarantee, and the Ministry of Finance gives its consent to the indebtedness and issuance of the guarantee.

The stock of public debt of the Republic of Srpska (BiH) as of 2021, is 6.164,2 million KM of which 7.6% belongs to the LGUs. The table below shows the stock of debt in the RS (BiH).

Table 7. Stock of total debt and projections (millions KM)

	2020	2021	2022	2023	2024
I Total external debt of RS (1 + 2 + 3)	3.526,4	4.190,2	4.662,3	5.055	4.714,3
1. Debt of Republic of Srpska	2.297,6	2.966,5	3.343,8	3.605,1	3.350,9
2. Debt of LGUs	121,4	133,4	147,5	158,3	170,6
3. Debt of public institutions and Investment development Bank	1.107,4	1.090,3	1.171	1.291,6	1.192,8
II Total internal debt of RS (1 + 2 + 3)	2.307,1	1.974	1.870,4	1.651,8	1.890,9
1. Debt of Republic of Srpska	1.723,8	1.433	1.415,8	1.283,1	1.602,8
2. Debt of LGUs	370,7	337,5	290,8	244,5	199,8
3. Debt of Funds of social security	212,6	203,5	163,9	124,3	88,3
III Total debt of Republic of Srpska (I + II)	5.833,4	6.164,2	6.532,7	6.706,9	6.605,2

Source: Ministry of Finance of the RS; Reports of local self-government units, social security funds.

Table 8. Total debt service and projections (in millions of KM)

	2020	2021	2022	2023	2024
I Service of the total external debt of the RS (1 + 2 + 3)	261,6	289	322,4	812,7	549,5
1. Debt of the Republic of Srpska	156,1	179,8	210,8	675,2	415
2. Debt of local self-government units	7,6	9,4	10,2	11,2	9,5
3. Debt of public companies and RBI	97,9	99,8	101,3	126,4	125,1
II Service of the total internal debt of the RS (1 + 2 + 3)	322,5	519,9	377,3	352,4	345,4
1. Debt of the Republic of Srpska	220,6	402,3	271,9	250,7	251,6
2. Debt of local self-government units	74,5	57	59,1	56,8	53,9
3. Debt of social security funds	27,4	60,5	46,2	44,9	40
III Service of the total debt of the RS (I + II)	584,1	808,9	699,6	1.165,1	894,9

Source: RS Ministry of Finance, reports of local self-government units, social security funds

COVID-19 impact and implications for local government finances.

The first cases of COVID-19 were recorded in BiH and the RS (BiH) at the beginning of March 2020. On March 16, the Government of Republic of Srpska passed the Decision on the declaration of a state of emergency, and on March 17 the Council of Ministers of Bosnia and Herzegovina gave its consent to the Decision on the declaration of a state of natural or other disaster in the territory of the Republic of Srpska, BiH.

Competent authorities at all levels of government, including local self-government units, undertook a series of measures and activities aimed at preventing the spread of this disease. Part of these measures included banning or restricting the work of business entities from certain activities, as well as certain institutions and services. For some time in Bosnia and Herzegovina, including in the RS, the movement of the population was also limited, both in the economy and in international traffic.

The Association of Municipalities and Cities of the Republic of Srpska prepared an Analysis of Measures Implemented in Local Self-Government Units in the Republic of Srpska during the crisis caused by COVID-19. The analysis carried out showed that the crisis caused by the COVID-19 pandemic had a strong negative impact on the finances of all LGUs, regardless of the level of development and size, and that the biggest problem for all LGUs was the lack of financial resources due to a significant drop in income. Based on the results of the analysis, a number of detailed recommendations with additional explanations were given, and the following recommendations can be considered as the most important:

- **it is necessary to improve coordination at all levels of government**, as well as the degree of consultation and information between the Government of the RS, LGUs and other institutions;
- the crisis highlighted the **need for greater transparency and participation** of the public (citizens, non-governmental sector and others) in planning and spending budget funds at the LGU level;
- it is necessary to **increase the degree of digitization of public administration as a whole**, that is, to use the advantages of digital communication with citizens and provide various online platforms, etc.;

During the COVID-19 pandemic, the Government of Republic of Srpska (BiH) established the Solidarity Fund for the Recovery of Republika Srpska, on the basis of which the necessary medical equipment was procured and measures focusing on the economic rehabilitation of the consequences caused by COVID-19 were carried out.

By declaring a state of emergency, the Government of the Republic of Srpska (BiH) was empowered to enact decrees that have the force of law. On April 10, 2020, it adopted a Decree with the force of law on tax measures to mitigate the economic consequences of COVID-19. The measures included the extension of the deadline for submitting annual returns, extension of the deadline for settlement of tax obligations, postponement of the cancellation of the decision on deferred payment of tax obligations and other measures. Another important measure included the payment of taxes and contributions for the wages of employees and self-employed individuals who had to stop working as a result of the pandemic, for March and April 2020 from the Solidarity Fund for the Recovery of the Republic of Srpska.

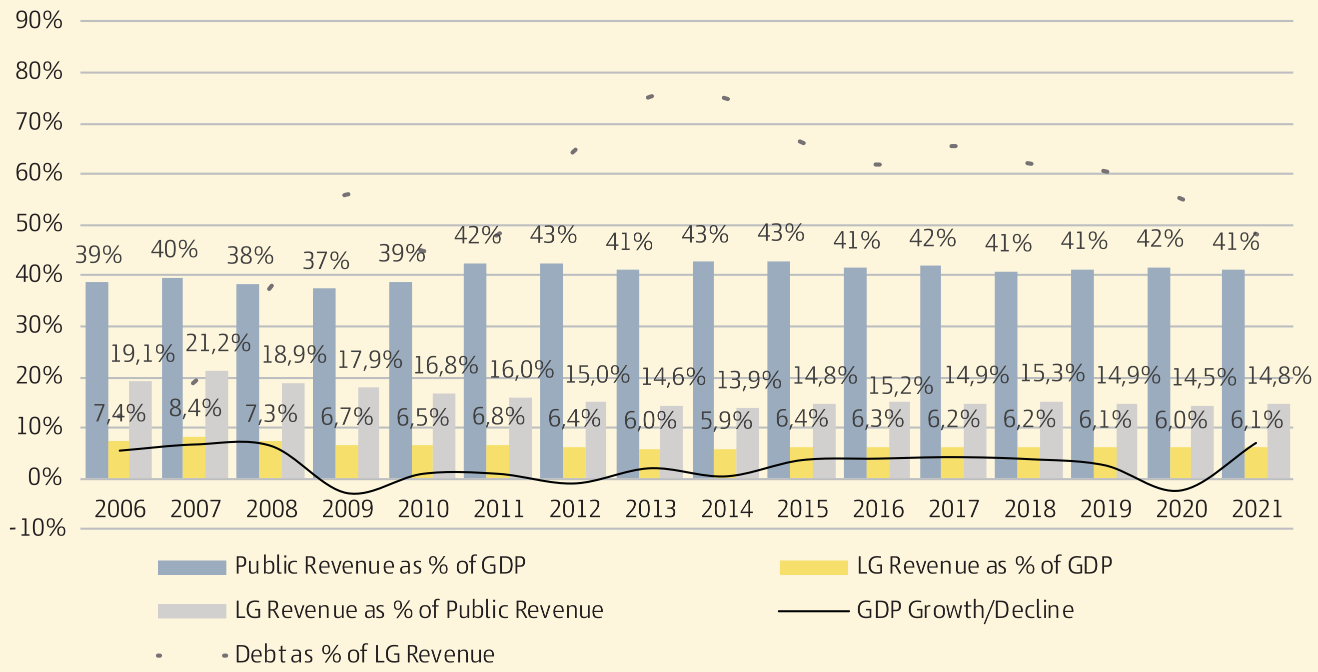
The Banking Agency of the Republic of Srpska adopted temporary measures to grant special relief to bank clients including postponing repayment of loans or similar aiming at facilitating the settlement of the client's credit obligations and maintaining the client's business.

Despite these measures, as expected, the COVID-19 pandemic has caused numerous negative economic consequences including a decline in economic activity, employment, public revenues, investments, and exports. In April 2020 alone, there was a drop of 23% in revenues from indirect taxes – the key source of financing for the RS Government and municipalities and cities. Sectorially, those activities that were affected by changes in people's lifestyles after the emergence of COVID-19 were in the most difficult position. Tourism, passenger transport, hotels, catering and entertainment and creative industries were the most affected. Also, sectors whose value chains were interrupted in the upstream (supply from China) and downstream (deliveries of the textile and leather industry to Italy) were affected. Gradually, these negative influences also affected all other activities.

Statistical Overview of the Finances of Local Governments in RS (BiH) 2006-2021

Local government revenue as a share of GDP declined from a peak of 6.4% in 2015 to 6.0% and 6.1% in 2020 and 2021 respectively. Local revenue as a share of total public revenue fell from 15.3% in 2018 to 14.5% and 14.8% respectively in 2020 and 2021. In short, the financial position of municipalities in RS (BiH) has deteriorated quite substantially over the past decade compared to the period before the global financial and economic crisis of 2008-2009 and has worsened further with the financial consequences of the major floods of 2014 and the COVID-19 pandemic in the recent two years.

Figure 76 RS (BIH): LOCAL GOVERNMENT REVENUE AS SHARE OF GDP AND TOTAL PUBLIC REVENUE 2006-2021



Local government revenues have almost always declined faster and risen slower than the revenues of the RS (BiH) government suggesting that the RS (BiH) government has placed a disproportionate share of the burden of economic downturns on local governments, except in 2015 and 2018 when the entity government revenues slightly declined and the local revenues increased. In 2020 also, LG revenues fell faster than those of the RS (BiH) government, while in 2021, LG revenues have recovered at a higher rate than those of the RS (BiH) government.

The composition of the revenues of the local governments in RS (BiH) implies they are heavily dependent on the Unconditional Grant, which in 2021 makes up to 54% of LG revenue. Own revenue has remained relatively stable for the past decade, except for 2020 impacted by the COVID-19 pandemic. The share of shared taxes has also halved over the past decade, even though the share of the PIT allocated to LGUs has not changed.

Figure 77 RS (BIH) ANNUAL FLUCTUATIONS IN THE REVENUES OF THE GENERAL GOVERNMENT AND LOCAL GOVERNMENTS

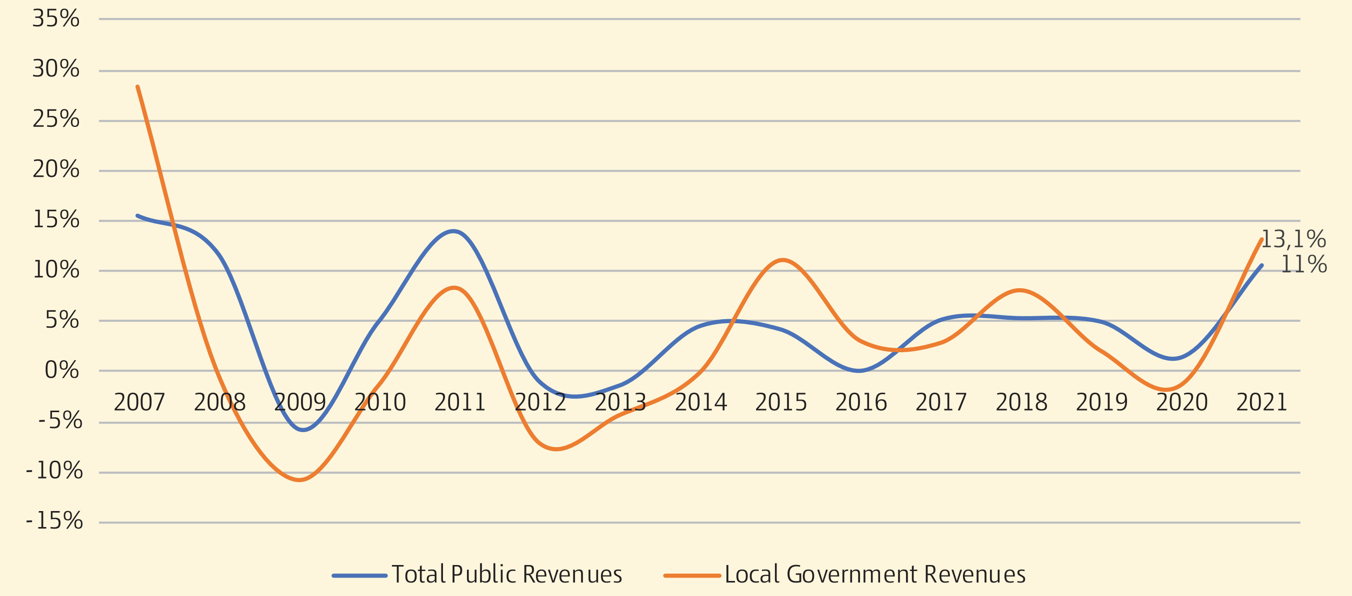


Figure 78 RS (BIH): COMPOSITION OF LOCAL GOVERNMENT REVENUES 2006-2021, IN % OF TOTAL

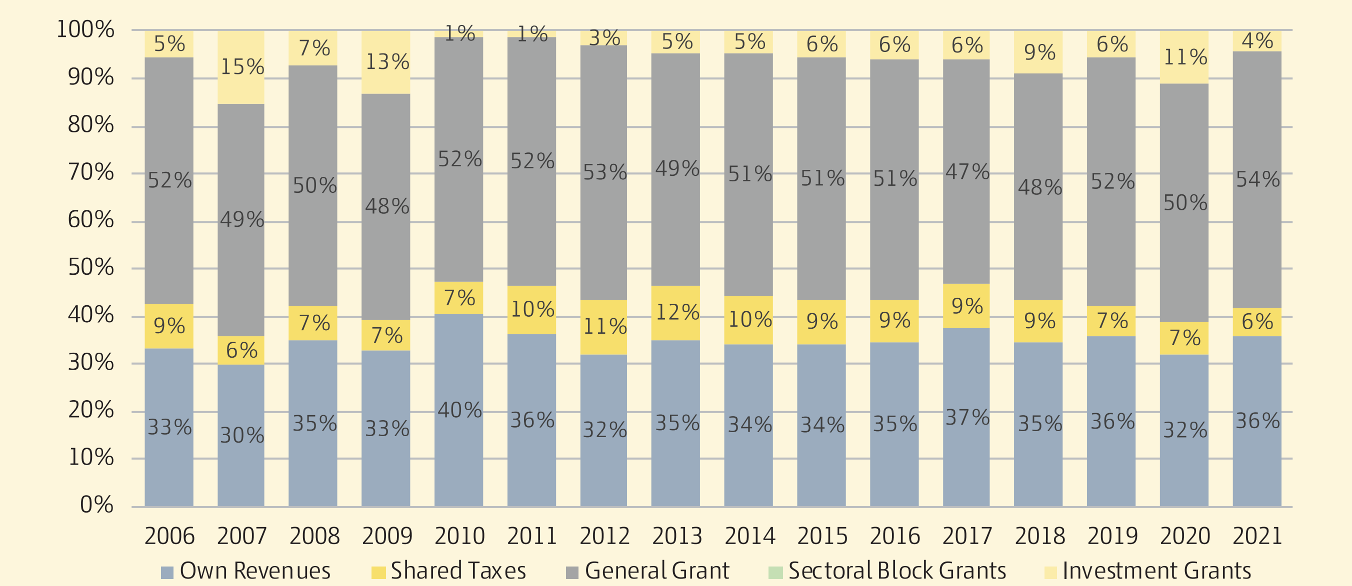


Figure 79 RS (BIH): COMPOSITION OF LOCAL GOVERNMENT REVENUES 2006-2021, IN MLN EURO

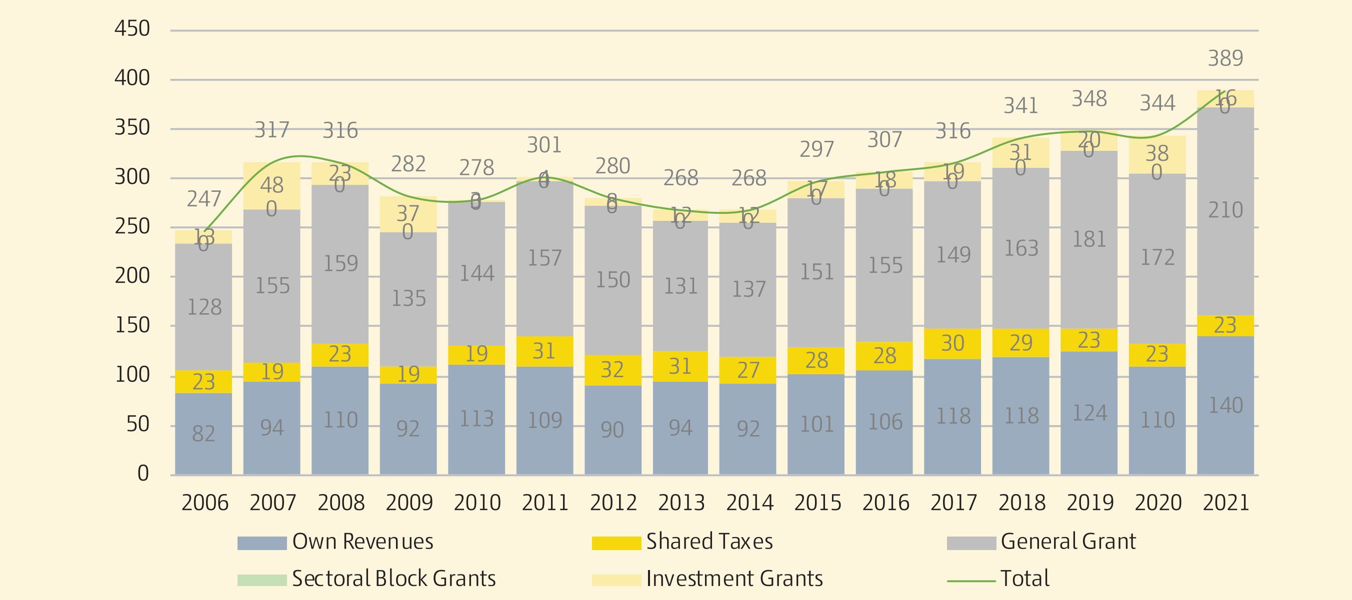
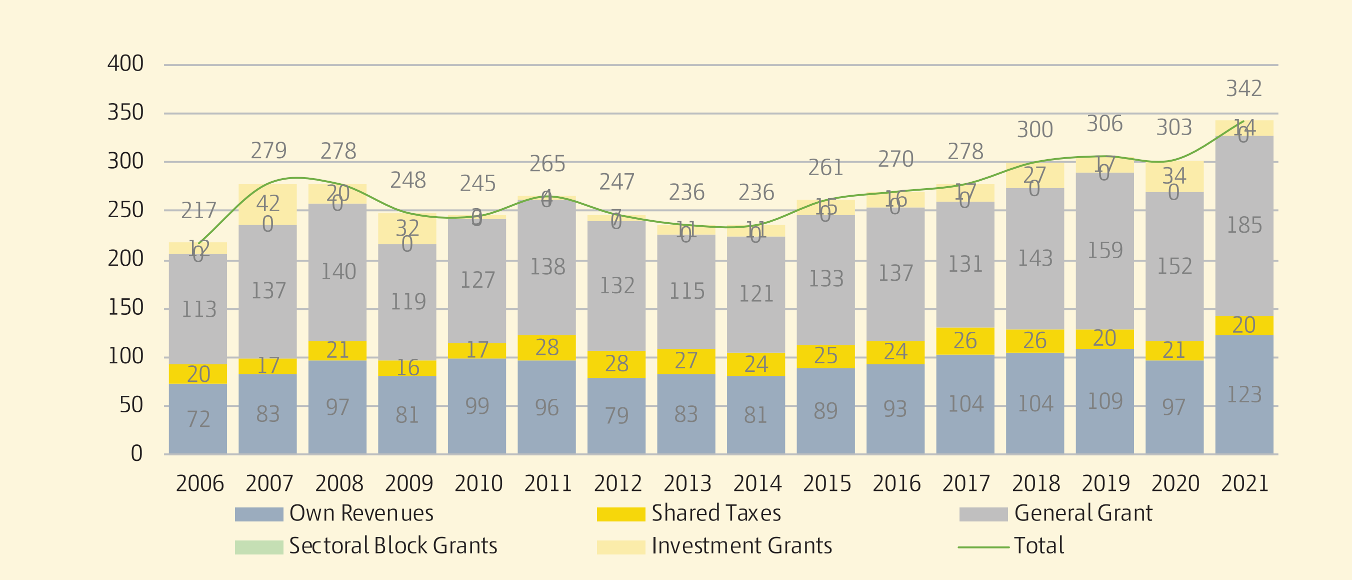


Figure 80 RS (BIH): COMPOSITION OF LOCAL GOVERNMENT REVENUES 2006-2021, IN EURO PER CAPITA



The composition of the own source revenues shows the domination of communal fees and charges (on advertisement, particular categories of entertainment, use of public space, parking, accommodation in hotels, and construction of buildings) making up 68% of the total in 2021. The revenues from property taxation remain very low, just 10% of the own source revenues in 2021, and among the lowest in South-East Europe.

Spending for capital investments has seen significant fluctuations over the past decade. Their share of total expenditure almost doubled in 2020 and then fell again in 2021, despite being significantly higher than the average of the past decade. On the other hand, spending on wages decreased in 2020 but then recovered again in 2021. Like their counterparts in FBiH (BiH), RS (BiH) municipalities spend significantly on subsidies to municipal utilities, grants to NGOs and transfers to individuals. However, their share to total local government expenditure remained relatively stable in the past few years.

Figure 81 RS (BIH): COMPOSITION OF OWN LOCAL GOVERNMENT REVENUES 2006-2021, IN % OF TOTAL

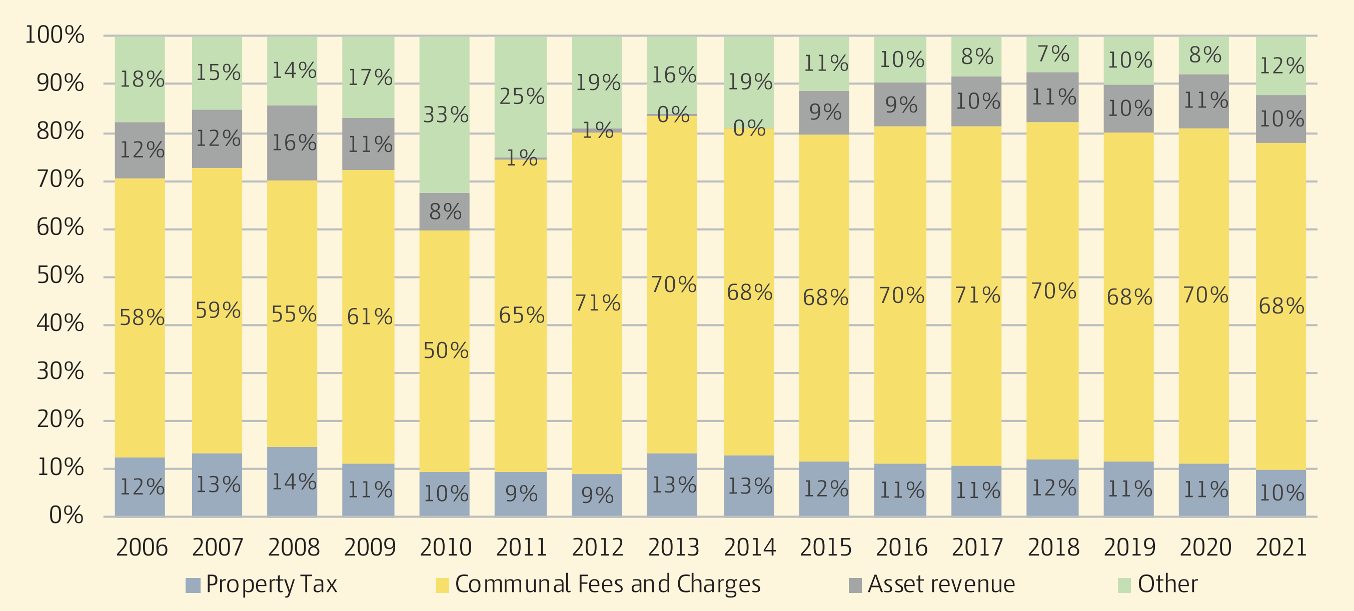


Figure 82 RS (BIH): COMPOSITION OF EXPENDITURES IN 2006-2021, IN % OF TOTAL

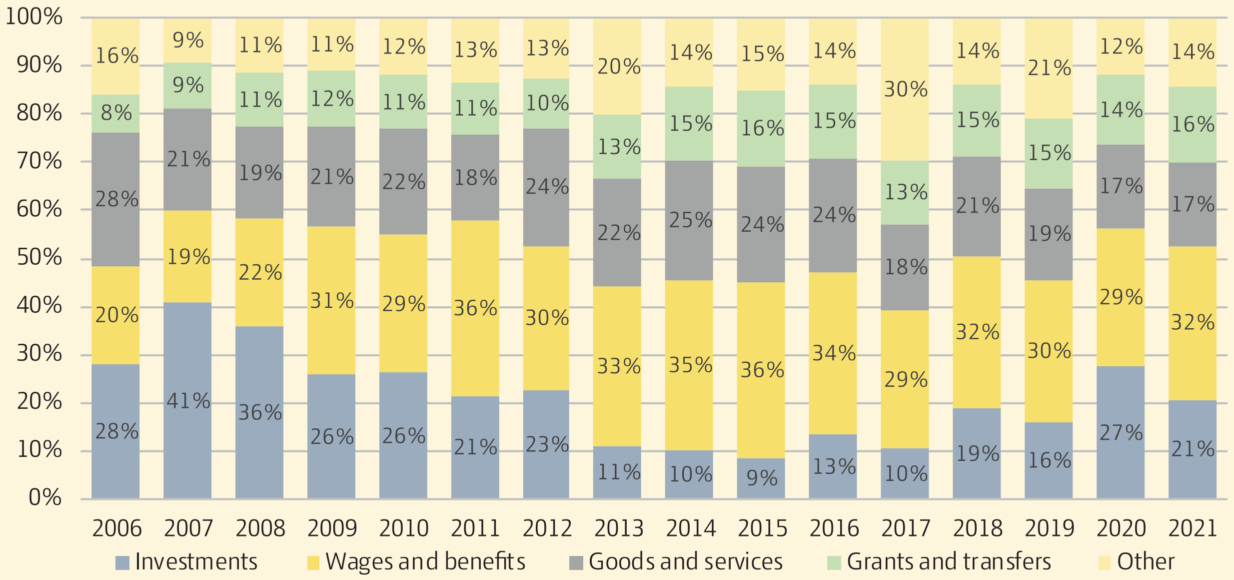


Figure 83 RS (BIH): COMPOSITION OF LOCAL GOVERNMENT REVENUES 2006-2021, IN MLN EURO

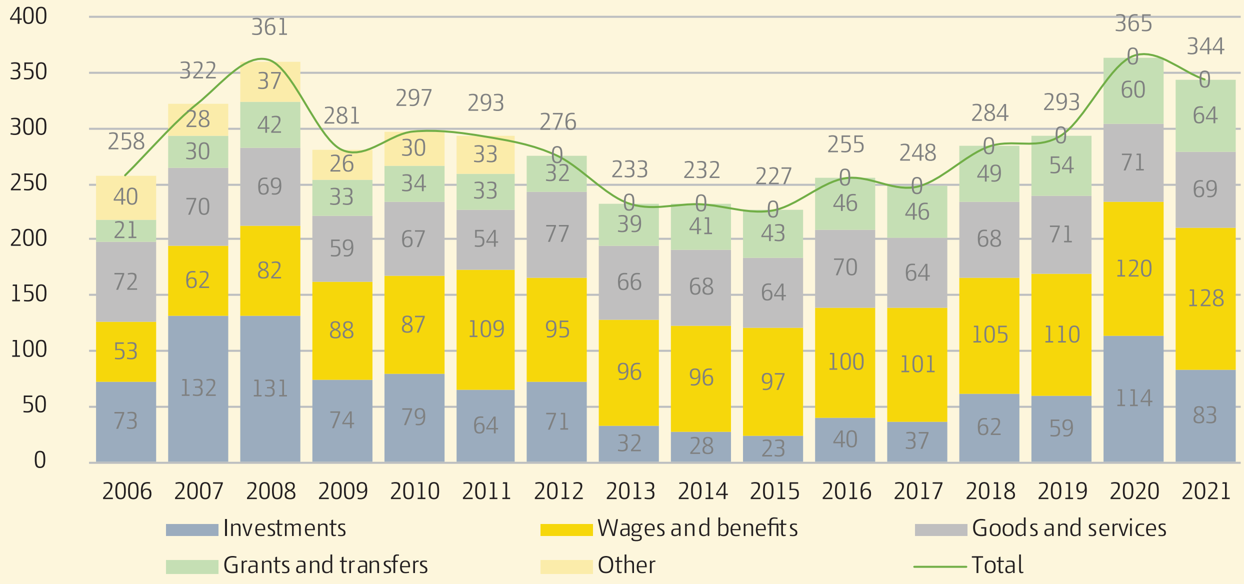
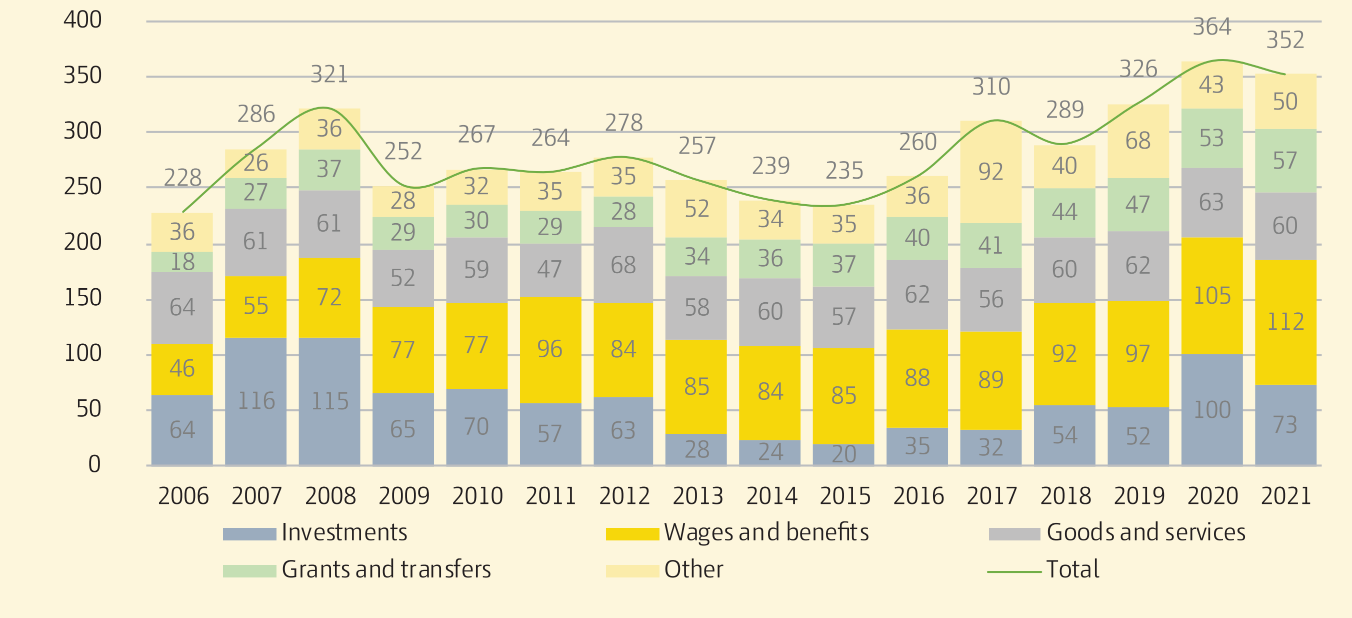


Figure 84 RS (BIH): COMPOSITION OF LOCAL GOVERNMENT REVENUES 2006-2021, IN EURO PER CAPITA



The financial position of local governments in RS (of BiH) in investment, has recovered since the lowest point in 2014 – in 2020, LG capital investments made up to 61% of total investmetns in the RS (of BiH). While the share of LG investments fell to 44% of the total in 2021, still this is the highest share that LGs in the RS (of BiH) have registered in a decade and confirms the fact that local authorities were at the forefront of COVID-19 crisis.

Revenues from the property tax and local spending for wages are relatively stable over time. LG debt as a share of GDP has been declining and registered 3.6% in 2021. Spending for LG investments has been more volatile – however the downward tendency has been reverted in the past few years. This is crucial, given the role of LGs in developing local public sector infrastructure.

Figure 85 RS (BIH): INVESTMENT BY LEVEL OF GOVERNMENT AND AS A % GDP 2006-2021

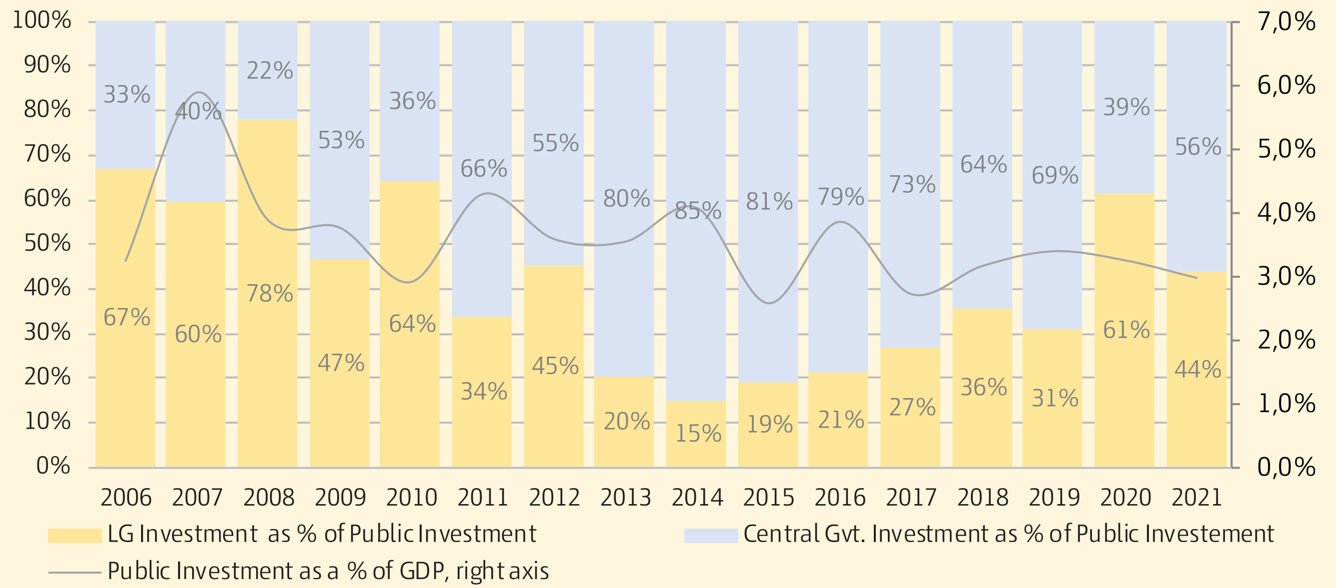
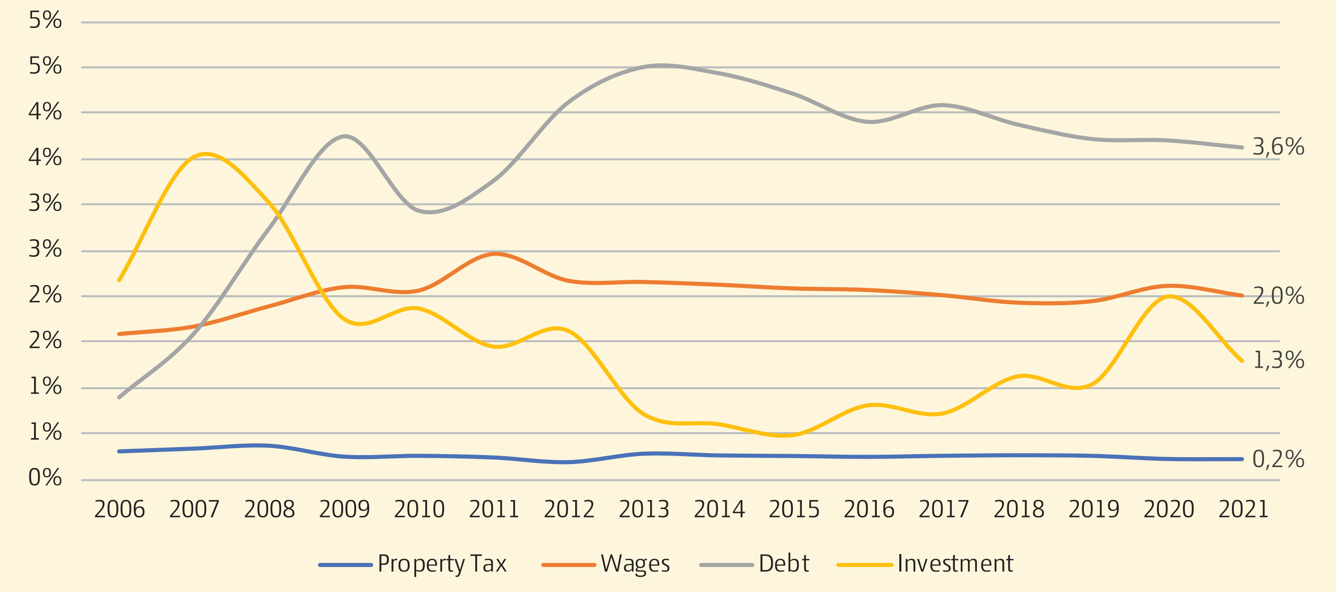


Figure 86 RS (BIH): INVESTMENT, WAGES, DEBT AND PROPERTY TAX AS SHARE OF GDP 2006-2021



Bulgaria

By Yuliya Ivanova, National Association of Municipalities in the Republic of Bulgaria

Intergovernmental Finance System

Since 2014, the overall budget framework and the structure of the public finance are regulated in the Public Finance Act, including the fiscal relations between the central and the local governments and the Municipal Debt Act, which defines the borrowing framework. These intergovernmental fiscal relations are designed as intergovernmental transfers and temporary interest-free loans.

Transfers. Bulgarian municipalities are heavily dependent on transfers from the central government. Over the years, the transfers to municipal budgets have grown to make up more than half of the total revenues of the municipalities. Their share varies between 54%— 64% in the period 2015 – 2018 and reached 73% in 2020 and 70% in 2021 under COVID-19.

There are four main transfers that the central government provides to the municipalities annually:

- General Subsidy for Financing Activities Delegated by the State
- General Equalizing Subsidy
- Earmarked Capital Expenditure Subsidy
- Transfer for Winter Maintenance and Snow Removal of Municipal Roads

Their amounts and the mechanism for their distribution among municipalities are set in the state budget act for the respective year. Together with that, the municipalities may receive also other earmarked funds and financial compensation by the state.

General Subsidy for Financing Activities Delegated by the State. The state provides a general subsidy for public services which are part of the responsibility of the central government, but which are delegated to municipalities. The subsidy is the largest of the intergovernmental transfers provided by the central government to local governments (78.8% in 2021). It constitutes also about 56.6% of total local government revenues in 2021. The total amount for the respective year, as well as its allocation among the municipalities, are determined by specific standards for the financing of the delegated functions – which are annually approved by the Council of Ministers. Natural indicators and financial resources for each indicator determine the total amounts of every delegated function, and respectively the total amount of the whole subsidy.

The largest amount of the general subsidy is allocated to education (from kindergartens to secondary school level). In 2021, the share of funds for education is 42%, followed by housing and community amenities, including environmental protection (19%), social protection (11%), and general public services (11%). The remaining 17% is allocated for the other 5 functions—health, culture, defence and security, economic affairs and costs that are not classified in the other functions. It is important to highlight that while this is called a 'general' subsidy, in practice it works as a sectoral block grant where local governments cannot change the nature and scope of expenditures for which the (sectoral) subsidy is provided, nor can they switch funding between (delegated) functions.

General Equalizing Subsidy. The main purpose of the equalizing subsidy is to ensure that each municipality is able to provide a minimum level of local services in their territory. It is the only transfer over which local governments have full autonomy and can freely distribute and spend (by decision of the Municipal council). By law, the annual size of the general equalizing subsidy cannot be less than 10% of the own source revenues of all municipalities in the previous year. Its total amount is 5.3% of total intergovernmental transfers and 3.8% of total local government revenues in 2021.

The mechanism for the distribution of the subsidy among the municipalities has changed over the years. The latest change was introduced with the State Budget Act for 2019. The "new" mechanism set a condition for access to the subsidy for municipalities with fixed tax revenues in per capita terms above 120% of the national average (*Mechanism for distribution determines as fixed taxes the immovable property tax, the tax on vehicles, the visitor tax, licence tax and tax on passenger transport by taxi*). As a result, 19 municipalities did not receive a subsidy in 2019 and 18 of them are still outside the scope of this transfer.

The distribution mechanism for the municipalities that have access to the subsidy consists of five components:

- The first component is formed on the basis of the revenue potential of the municipality to generate tax revenues. It equalizes the difference between 120 per cent of the tax revenues in per capita terms at the national level and the municipal per-capita fixed tax revenues;
- The second one is formed on the basis of the expenditure needs, measured on the basis of natural indicators: number of children up to 5 years; number of children aged 6-14, number of adults aged 65 and over, territory, length of municipal roads and population;
- The third component is for municipalities that have very low revenue capacity – own source revenues less than 25% of the total revenues of the municipality;
- The fourth component provides the amount of the total equalization subsidy, determined in the State Budget Act for the previous year;
- The last component is for the municipalities which have a "tax effort" above the national average. The "tax effort" is the average ratio of the tax rates in a municipality with fixed taxes and the corresponding average rates within the limits set in the Local Taxes and Fees Act for each of the taxes.

Earmarked Capital Expenditure Subsidy. The municipalities receive earmarked transfers for capital expenditures. The legislation determines that this subsidy can be spent on specific costs for construction and major repairs, for the acquisition of tangible and intangible fixed assets and for research, including co-financing and payments on loans for capital expenditures. They can use this subsidy for capital expenditures both for delegated and local activities on sites approved by the municipal councils. The subsidy can also be transformed into a transfer for specific other expenses for carrying out urgent current repairs of municipal roads, street network and buildings, public municipal property.

The main component of the distribution is based on objective criteria with relative shares, as follows: number of settlements, excluding places without population and with a population of up to 10 people—45%; length of municipal roads— 25%; population— 25%; size of the territory— 5%. The subsidy has an additional component, introduced with the State budget Act for 2019. It is a small share of the amount of the subsidy but is intended for improving the condition of the social and technical infrastructure on the territory of the municipalities with a certain category of the categorization of municipalities in the Republic of Bulgaria approved by the Minister of Regional Development and Public Work.

Transfer for winter maintenance and snow removal of municipal roads. This transfer is provided to support municipalities undertaking winter maintenance activities on municipal roads. It is an earmarked transfer. The mechanism for its distribution determines 85% of the amount to be distributed based on the indicator "length of municipal roads". The other 10 % of the transfer are distributed based on the indicator "number of settlements" excluding the settlements without population and the remaining 5%—based on the indicator "population". Then, the amount of every municipality is calculated based on the relative weight of the indicator concerned for the municipality compared to the total for the economy.

Own source revenues

The own source revenues retained their structure in recent years. The last change was in 2017 when the tax on passenger transport by taxi was introduced. Meanwhile, its share of tax revenue remains small and has decreased over the years. The share of tax and non-tax revenues (fees and other non-tax revenues) in the local budgets decreased, as transfers from the central government increased. In 2021 and 2020, own source revenues reached around 33% of total local revenues.

Local taxes occupy the highest share in the structure of own source revenues (46%) followed by local fees (33%) and other non-tax revenues (21%). Even though there were no essential changes in the regulatory conditions, tax revenues doubled in a ten-year period. The other types of revenues also increased by 40% for the fees and 61% for the other non-tax revenues in the last ten years.

However, non-tax revenues continue to form a significant share (54% in 2021) of municipalities' own source revenues. At the end of 2021, the revenues from fees had the highest share in the structure of own source revenues (33%) and together with the property management revenues occupied the main share of non-tax revenues— 80% in 2021. Regarding fees, traditionally the waste management fee has the highest share of all types of fees. Its share in the structure of local fees revenues increased by 12% in 2021.

Borrowing:

The regulatory framework for local government borrowing is mostly regulated in the Municipal Debt Act (2005). Municipalities may incur **long-term debt** to finance investment projects benefiting the local community, refinance existing debt, prevent and mitigate the effects of force majeure, meet payments under required municipal guarantees and others. The **short-term** debt may be incurred for capital expenditures, provision of public services, in the event of a temporary deficit of resources in cases of temporary cash disruptions, urgent expenditures on the prevention and mitigation of the effects of force majeure and others.

The decision to incur debt is made by the municipal council which determines the terms of the debt, including its maximum amount, currency, type, the manner of collateralizing and others.

The Public Finance Act regulates main requirements for the annual debt payments, municipal debt and municipal guarantees:

- annual debt payments must be lower than 15% of the annual average sum of their own source revenues and the block equalizing grant for the last three years;
- allowable level of debt for new expenditure commitments that can be made within the year, under the condition that existing expenditure commitments do not exceed 15% of the annual average expenditures for the past four years;
- the nominal value of the municipal guarantees that can be issued during the current budget year may not exceed 5% of the amount of the total revenue and the equalizing subsidy for the last year (based on the latest annual report).

At the end of 2021, municipal debt amounted to BGN 1,394 million (712.7 euro million). Its share of GDP remains relatively constant over the years— between 1.1% and 1.4%. In 2021, the local debt represents 1.2% of GDP. As a percentage of the total public debt, the local one varies between 4% and 7% over the years. In 2021 the amount of the debt decreased by 3.4% and its share of the total public debt diminished to the 2016 level—4%.

Both central and local governments use mainly long-term debt. Although short-term debt increased in previous periods (albeit with a lower share in the total municipal debt than the long-term), its amount decreased in 2021 by 0.4%. Respectively, its share in the total public debt also decreased to 5% (at 6% for 2019). Although local governments use mainly long-term debt, there is a growing tendency for municipal short-term debt to increase in size, mainly for financing under EU projects.

COVID-19 Impact and implications for Local Government Finances

Undoubtedly, the COVID-19 crisis has affected municipal budgets in Bulgaria too. Tax revenues in 2020 saw a small increase of two percentage points compared to 2019 (3% in 2020 compared to 5% in 2019). In general, all types of non-tax revenues declined in 2020 under the COVID-19 crisis. The largest declines in absolute value were in the property management revenues—a decrease of €18 million (-12%) and in property sales— by €15 million (24%). Total non-tax revenues account for €671 million (decrease of 4%). The decrease was mainly generated by the fall of revenues from grants and donations from abroad (down 63%), fees for the use of kindergartens (down 37%), crèches (down 29%), markets, fairs, sidewalks, streets, etc. (down 23%), technical services (-13%), administrative services (-13%) and property income and revenues (-12%).

There was a tendency of increasing costs in the recent years which strengthened in 2020 and 2021. At the end of 2020, expenses registered much weaker growth of 4% due to the COVID-19 crisis and the restrictions in this period which led to remote work and closure of some services. Practically, the expenses of the municipalities grew steadily, mainly due to the income policies of the national level, the financing of the education system and partly in social services and the other commitments in the activities delegated by the state.

The central government approved additional funds to the local authorities in order to handle the COVID-19 crisis. Financial resources were also provided for the municipal employees in the social and health services by increasing the standards for financing the activities delegated by the state. There were funds provided for the municipal home-care projects. Additional resources were provided to ensure effective anti-epidemic measures to prevent and limit the spread of COVID-19 in schools and the centers for special educational support. Together with that, the National Assembly adopted changes in two Acts - Emergency Measures and Actions Act and the Health Act. These changes gave new possibilities for "covering" the costs incurred for the implementation of anti-epidemic measures, including:

- *Prohibition of seizure of bank accounts of municipalities during the state of emergency and up to two months after its revocation;*
- *Granting interest-free loans at the expense of the central budget until the end of 2020 with a repayment period not longer than the end of 2021;*
- *Opportunity to use the winter maintenance transfer for anti-pandemic measures;*
- *Inclusion of the costs for implementation of anti-epidemic measures in the costs for maintaining the cleanliness of the territories for public use in the settlements and the settlement formations in the municipality;*

- *Opportunity to use up to 30% of the accumulated funds for deductions and collateral under the Waste Management Act and postponement of their payment until the end of the year without accruing interest on them.*

Advocacy efforts of the Local Government Association in the area of local finances

The epidemiological situation caused by the COVID-19 pandemic rearranged the priorities of all economic sectors, including the public sector. Since the declaration of the state of emergency in Bulgaria, NAMRB has undertaken many initiatives in order to provide flexible conditions for the work of the municipalities in COVID environment and many of the proposals were taken into consideration by the central government.

Within the framework of the consultations with the Minister of Finance on Budget 2021, additional funds were agreed to compensate the costs of overcoming the negative impact of the crisis COVID-19. Additional funds were also agreed to compensate the extraordinary expenses of the municipalities. In the update of the state budget 2021, NAMRB managed to provide additional funds for the municipalities in the form of other earmarked transfers or the payment of incurred expenses for the implementation of measures in connection with COVID-19 and others, including for local activities. Other opportunities for financing the activities of the municipalities through REACT-EU and the Plan for Reconstruction and Development of the Republic of Bulgaria were identified.

On the initiative of NAMRB, The Council for Decentralization of the state government restarted its work in 2020 after 5 years of break. An intergovernmental working group with representatives of ministries, districts and local governments was created to prepare an analysis of the status of the decentralization process, to develop an updated draft of the National Decentralization Strategy for the period 2016-2025 and Program for the implementation of the Strategy for the period 2020-2025. At this stage, the working group has already developed a draft document for the update of the Strategy and a draft Program for its implementation.

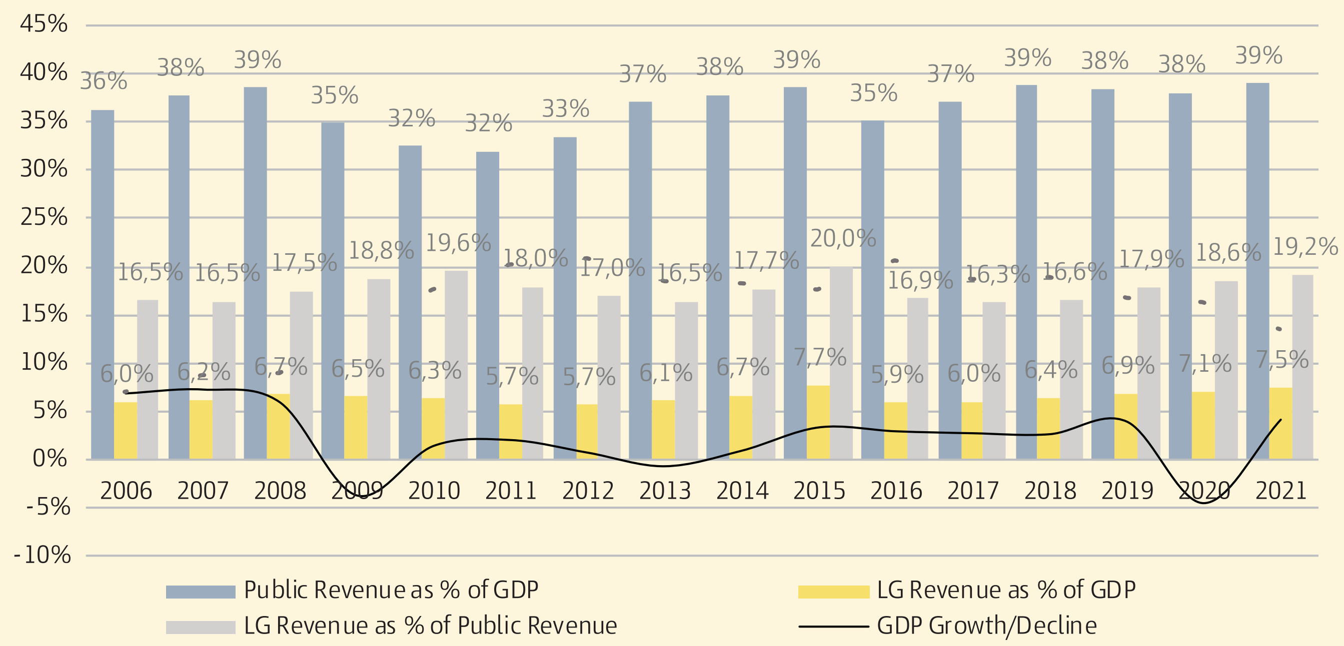
Within the budget procedures for the respective State budget Act, NAMRB actively worked to provide a better financial framework for the municipal budgets. The Association submitted to the central government proposals for both the size of the main fiscal relations of the municipal budgets with the central budget and the mechanism for their distribution among municipalities. As a result, the municipalities received significant increases in the financial support from the central budget.

Bulgaria Statistical Overview

Local government revenue as a share of GDP increased in 2020 and 2021 by 0.2% and 0.4% respectively reaching 7.5% of GDP. Thus, the indicator almost reached the highest share as in 2015 when municipalities made most of the payments for implemented municipal EU-funded projects. To a great extent, this growth is a result of the efforts of the municipalities to maintain local budgets stable and the fact that the GDP declined in 2020.

The COVID-19 crisis impact resulted in a decline of the GDP by 4.4% in 2020 (as in the case of the 2008 global financial and economic crisis). Local Government Revenues as a percentage of Total Public revenues increased over the past two years, reaching 19.2% in 2021. Local Government Debt has declined to 14% of Local Government Revenue, continuing the tendency of former years.

Figure 87 LOCAL GOVERNMENT REVENUE AND TOTAL PUBLIC REVENUE



In 2021 LG revenue increased by 12% in annual terms while general government revenues (public revenues) increased by 13%.

The COVID-19 crisis had an immediate impact on the composition of the local government revenues in Bulgaria. The share of own source revenues in the total municipal budgets declined to 27% in 2020, the lowest level ever, while the share of sectoral grants increased to 44% and 45% in 2020 and 2021.

Overall, in nominal terms, in 2021, local government revenues in Bulgaria exceeded 5.1 billion EUR. Sectoral grants for the delegated functions, in particular in the education sector, make up 45% of total local government revenues.

Figure 88 ANNUAL FLUCTUATIONS IN THE REVENUES OF THE GENERAL AND LOCAL GOVERNMENTS

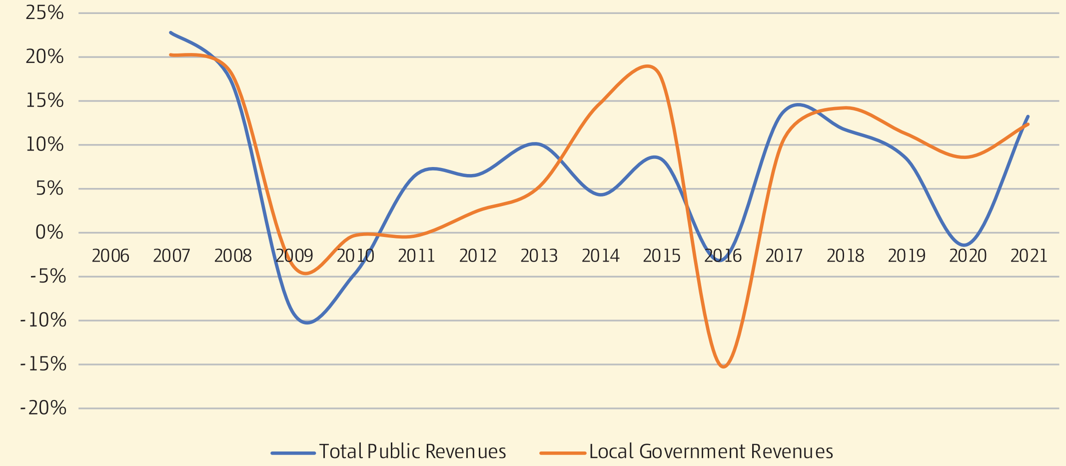


Figure 89 COMPOSITION OF LOCAL GOVERNMENT REVENUES, IN % OF TOTAL

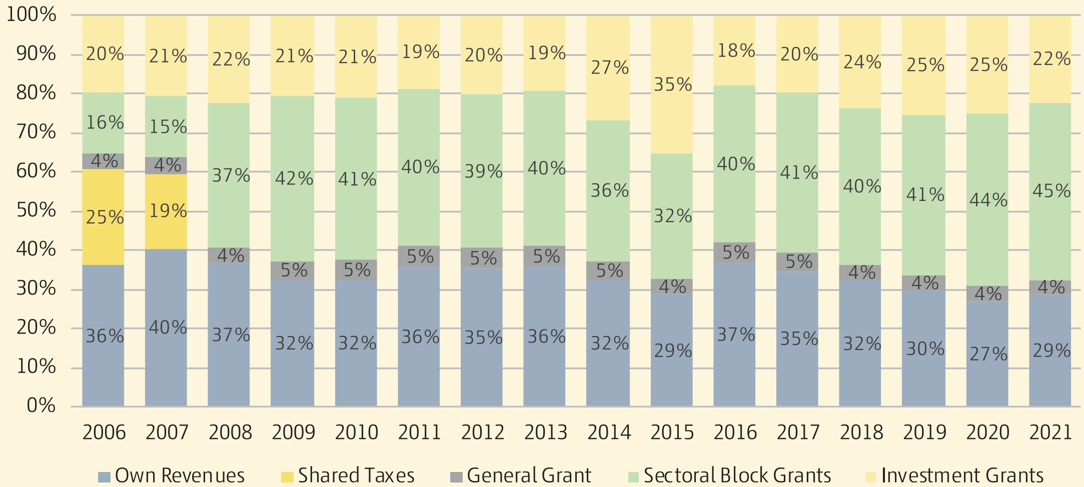


Figure 90 COMPOSITION OF LOCAL GOVERNMENT REVENUES, IN MILLION EUR

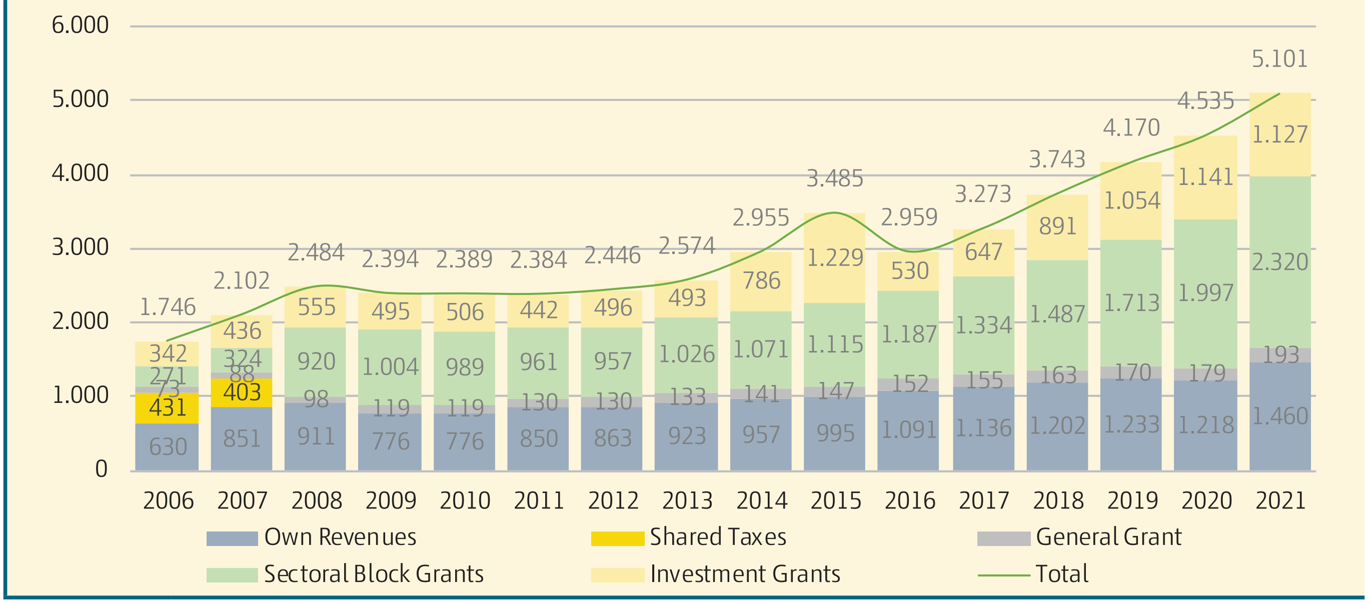
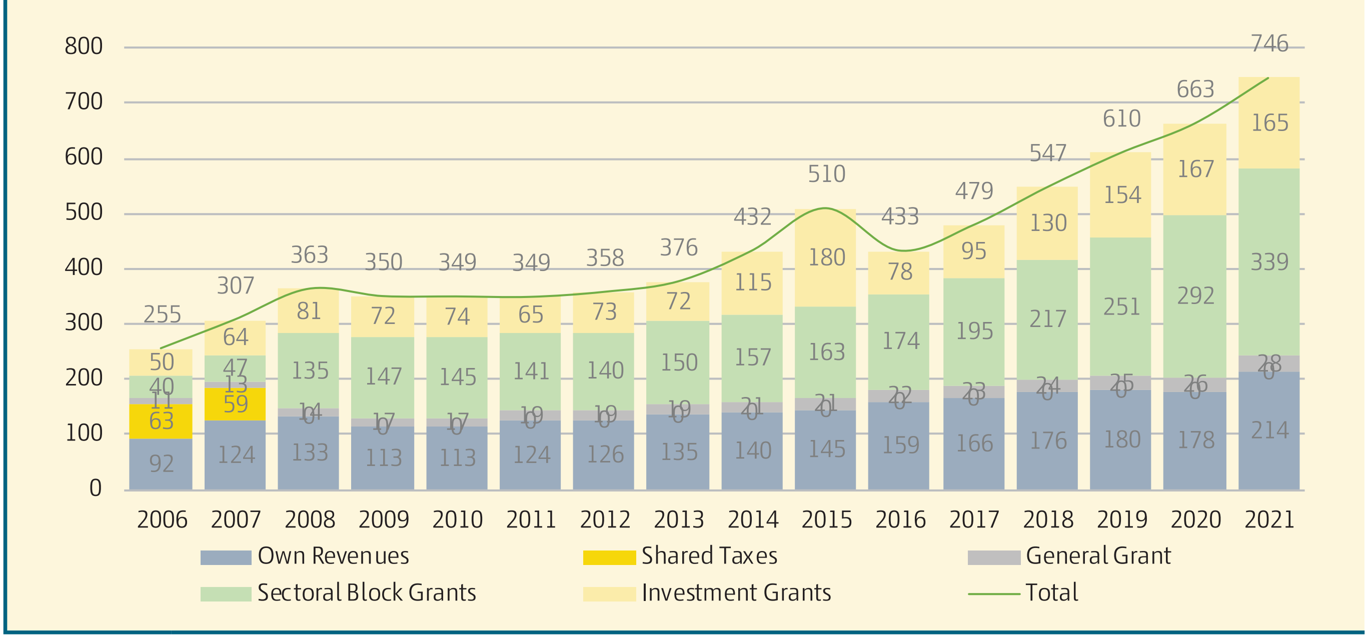


Figure 91 COMPOSITION OF LOCAL GOVERNMENT REVENUES, IN EUR PER CAPITA



At the end of 2021, local own source revenues started sharply to increase and reached 29% due to the growth of both tax and non-tax revenues. Regarding tax revenues, the growth is mainly due to the three taxes that usually have significant fiscal importance to the municipal budgets - tax on onerous acquisition of property (transfer tax), the real estate tax and the transport vehicle tax. The property related taxes (real estate tax and property transfer tax) make up 45% of total local government own source revenues, while waste management fees constitute 25% of own source revenues. Asset revenues also make up an important part of own source revenues with 16%. The increase of non-tax revenues over the past few years is mostly related to the abolition of the restrictive COVID measures imposed during the state of emergency and the extraordinary epidemiological situation in the economy. While sectoral block grants increased to 44% and 45% in 2020 and 2021 respectively, the share of investment grants declined in 2022.

Municipal expenditures increased by 17% in annual terms in 2021 in comparison to 2020 when growth was only 5%. While capital expenditures increased by only 3% in annual terms in 2021, spending for wages and goods and services increased by 21% and 19% respectively. The share of capital investments in overall expenses continued to decline in 2021, registering the lowest level over the past four years (19%). The share of spending for wages and benefits makes up to 52% of total local government spending.

Figure 92 COMPOSITION OF OWN SOURCE REVENUES, IN PERCENT OF TOTAL

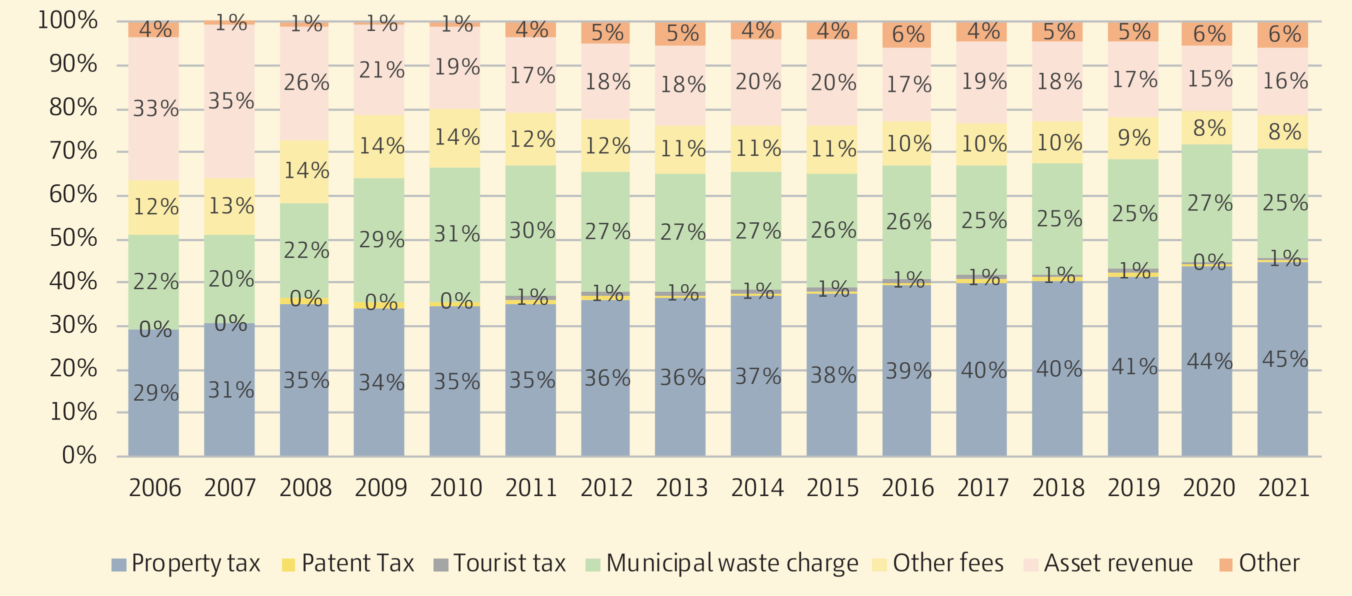


Figure 93 COMPOSITION OF LOCAL GOVERNMENT EXPENDITURES, IN PERCENT OF TOTAL

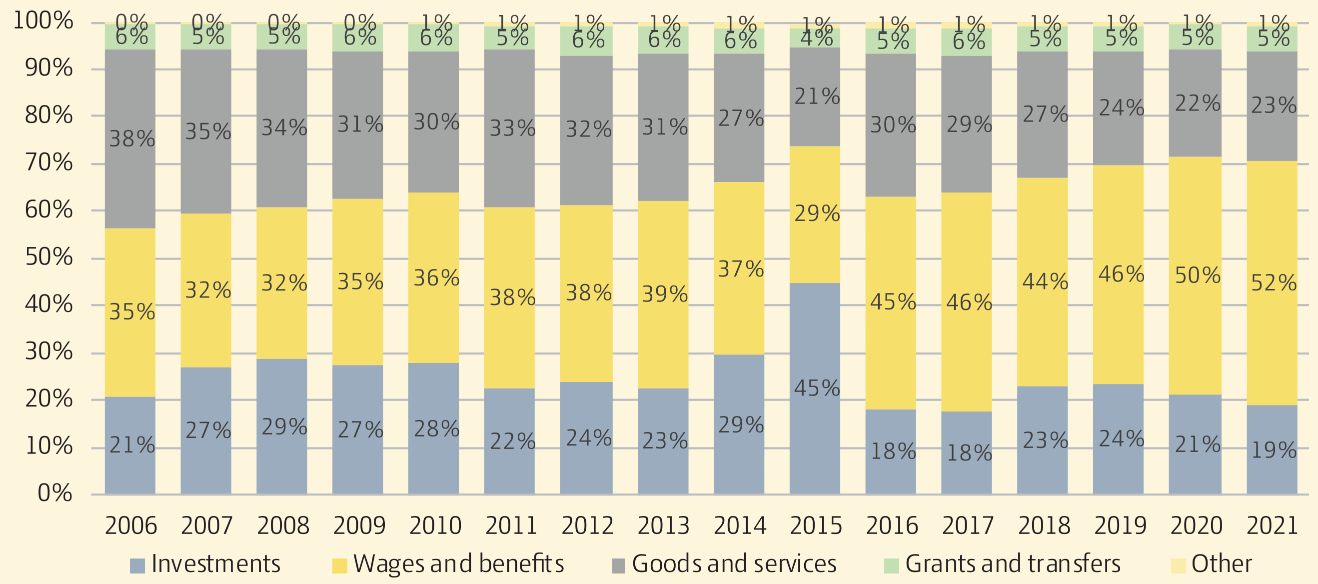
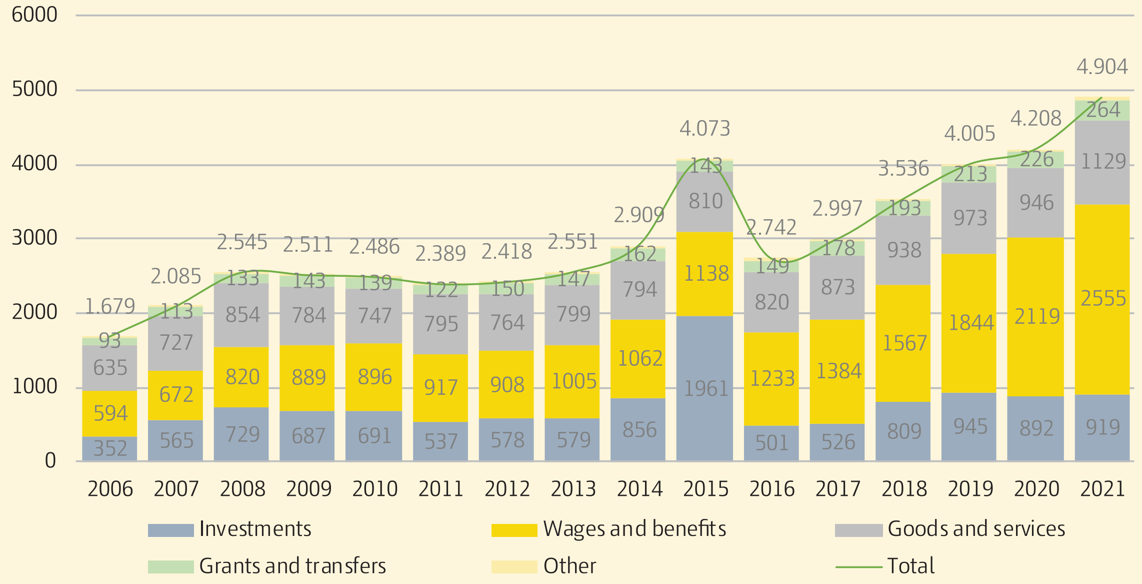


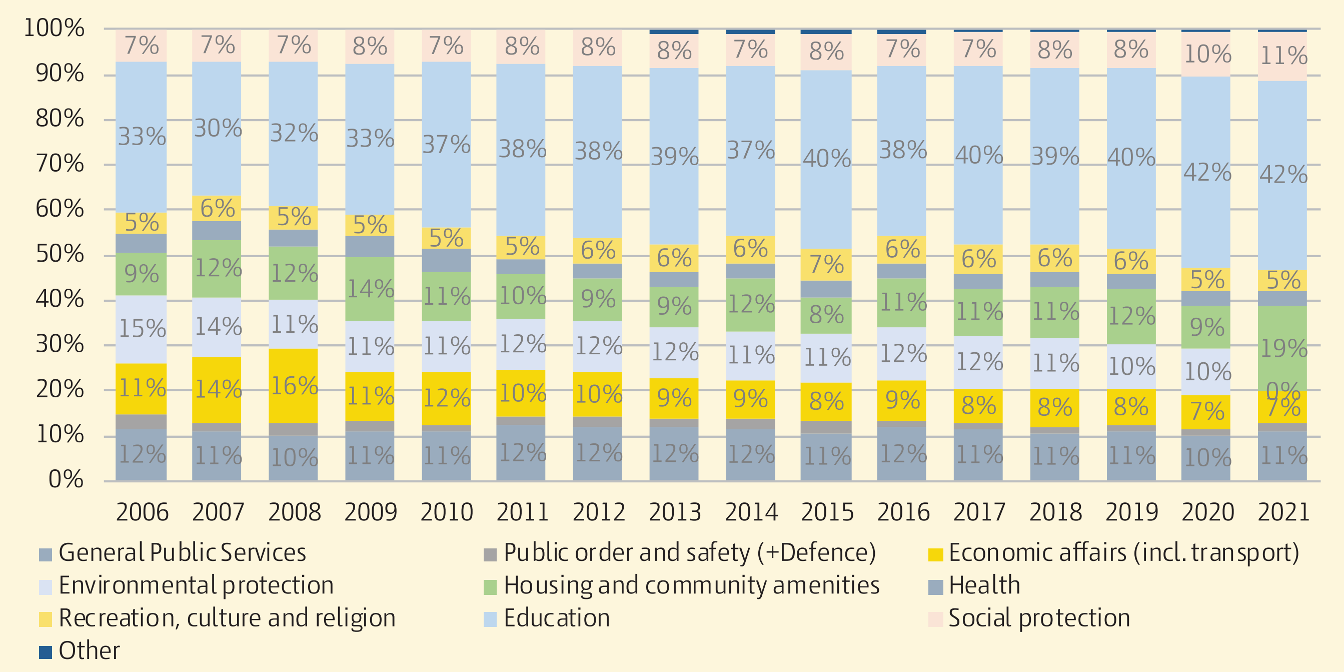
Figure 94 EVOLUTION OF THE COMPOSITION OF LOCAL GOVERNMENT EXPENDITURES, IN MILLION EUR



From a functional perspective, the biggest increase in expenditures is registered in the social protection function (+31%), housing and community amenities (+140%) and education and health (18% respectively). Spending for education makes up 42% of total expenditures in 2020 and 2021. The health function usually takes up a small share of total local expenditures (3% in 2021) as this function is mainly a national responsibility.

From a functional perspective, spending for housing and community amenities makes up 53% of municipal investments in Bulgaria, which has been growing steadily since 2006. Capital investments in the education sector have also increased over the past three years, making up to 17% of total municipal investments in 2021. The share of spending for economic affairs (including transport) has been declining steadily since 2010 going down from 33% to 10% of total municipal investments.

Figure 95 FUNCTIONAL ALLOCATION OF EXPENDITURES (COFOG CLASSIFICATION)



Given their extensive service responsibilities municipalities play a fundamental role in public investment in Bulgaria. While the share of municipal spending for capital investments to total local government expenditures has been declining over the past few years, overall, local public investments makes up 41% of total public investments in Bulgaria in 2021.

Figure 96 EVOLUTION OF THE COMPOSITION OF TOTAL PUBLIC INVESTMENTS, IN PERCENT OF TOTAL.

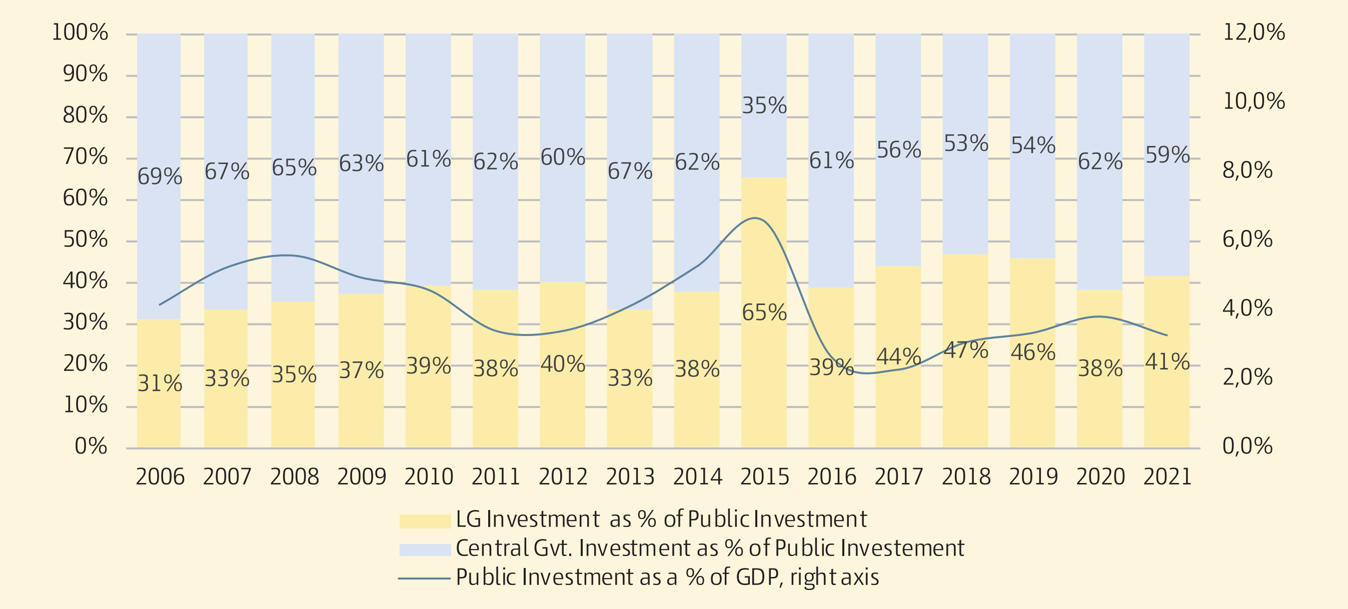
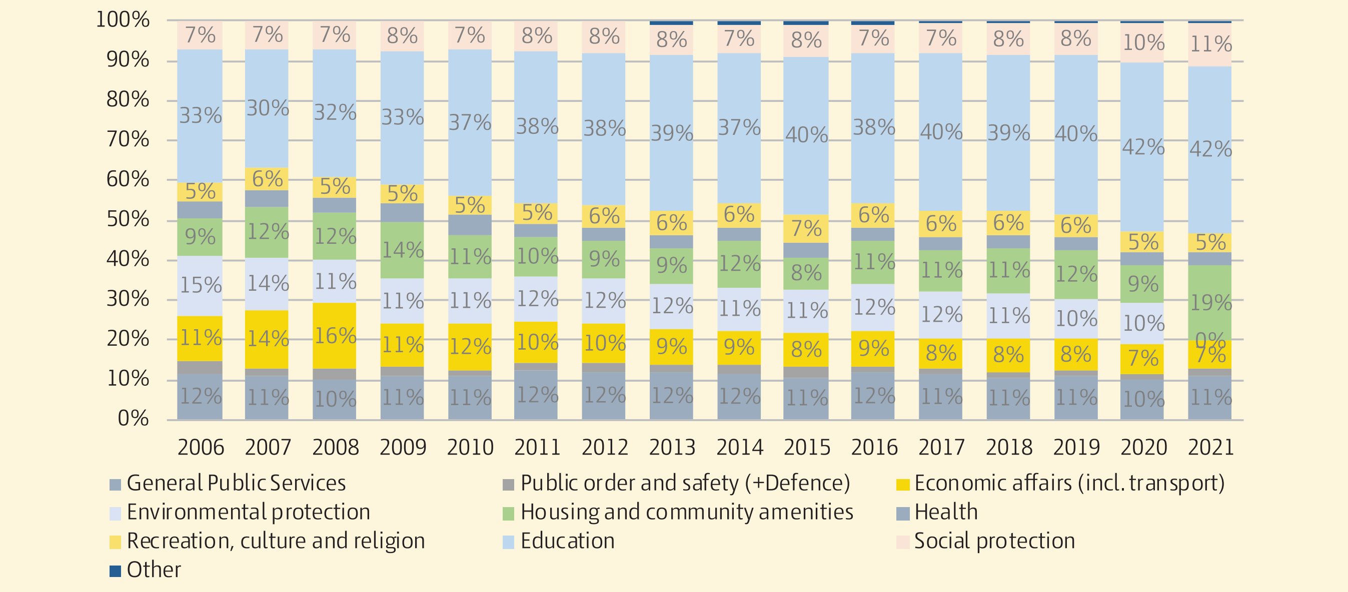


Figure 97 FUNCTIONAL ALLOCATION OF CAPITAL EXPENDITURES (COFOG CLASSIFICATION)



Croatia

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

The Intergovernmental Finance System

Croatia's intergovernmental finance system is heavily dependent on the origin-based sharing of the ***Personal Income Tax (PIT)*** revenues. Local governments receive 74% of PIT revenues collected in their jurisdiction; regional governments receive 20% of the PIT revenues and another 6% of PIT revenues are allocated and earmarked to local and regional governments for the decentralized functions they perform. As such, the rules governing PIT sharing also constitute an important segment of Croatia's intergovernmental transfer system. Local governments are allowed to impose a surcharge of up to 18% on the amount of PIT taxpayers owe to the government. The surcharge currently constitutes 10% of all local PIT revenues. Overall, PIT revenues generate 41.8% of local and regional government revenues in 2021.

There are two types of **earmarked grants** in Croatia, and they are both dedicated to financing the specific functions which the national government transferred to regional and local governments in the early 2000's, including primary and secondary education, social welfare, healthcare, and fire protection. 6% of PIT revenues are earmarked to those regional/local governments that carry out the above-mentioned specific functions. Expenditures not covered by the 6% PIT allocation are funded through ***the Equalization Fund for Decentralized Functions*** (EFDF), which is an earmarked grant funded by the State budget (approx. 260 million Euro) and legislated annually in the national bylaws of line ministries. Funding from the EFDF depends on function-specific minimal standards determined by national bylaws (i.e., for primary education – number of pupils, classrooms and school buildings). While the EFDF provides the majority of the funding for the decentralized functions, it also makes local governments vulnerable to the national budgeting process and economic trends.

The Fiscal Equalization Fund (FEF) is a non-earmarked fund of approx. 260 million Euro established in 2017 and disbursed as of 2018. It aims at equalizing PIT revenue disparities across local and regional governments. Until 2021 the FEF was funded by 17% of PIT collected and automatically distributed to the recipients daily, recorded as PIT. As of 2021 aforesaid 17% share in PIT was allocated to local and regional governments as a compensatory measure for central government dictated reduction of PIT rates. Due to this change the FEF is funded from central government revenues and recorded as a general grant as of 2021. The funding from FEF is allocated to local governments according to individual shares which are set in advance for the budget year. Local governments' individual shares are calculated as a difference between the (5-year average) *target* per capita PIT revenues and the (5-year average) *actual* per capita PIT revenues. Local governments may address the Constitutional Court at any time on the key elements of the FEF, including target levels and share calculation formula, etc. The introduction of the FEF is considered a major positive development as it reduces disparities across local governments PIT allocations and increases the transparency and predictability of local government revenues. However, recent changes to the source of funding for FEF have increased dependence of the FEF on the national government budgeting process.

Local government Own source revenues

Own Source Revenues *(OSRs)* constitute 29.4% of total local revenues, down from 32.9% in pre-COVID-19 periods. The relative decrease, higher than nominal, is fueled by the increase of property transaction tax and grants. Local governments have responded to the COVID-19 crisis by reducing or exempting local businesses from OSRs and some of these sources are yet to fully recover.

Most OSRs (39.5%) come from the *Land Use Fee (LUF) and Land Development Fee (LDF)*, with the former known locally as the "Communal Fee". Revenues from these fees are earmarked for the construction and maintenance of communal infrastructure. Croatian local governments also derive 19.8% of OSR from asset rentals and 14.7% of OSR from the surtax of the PIT.

The legal powers granted to local governments to assess, impose and collect taxes and fees from their constituencies vary. The two most important sources of Own Source Revenue, the Land Use Fee and Land Development Fee, are enacted in national legislation and further elaborated in local bylaws approved by local councils. The national law determines the method of calculation, taxpayers, general exemptions, and legal remedies. Local governments have the power to set the initial value of the fee (the LUF rate is capped by law to a max rate of 10% of the average cost of constructing one cubic meter in Croatia), zoning regulations and eventual additional factors that affect calculation, tax administration process etc. The collection and enforcement of these fees cannot be transferred to the National Tax Administration nor to any other entity under the control of third parties. National legislation defines the tax base and sets or caps the rate of all local and shared taxes, except for the LDF and the Tax on Use of Public Space.

As in many other economies in the region and beyond, the main challenge facing Croatian local governments as regards fiscal autonomy and tax administration is the establishment, harmonization and update of fiscal registers of their tax base (buildings, land, transactions etc.,) and taxpayers. The largest local fiscal register in Croatia is the Land Development Fee Register. This register serves also as a basis for the administration of other important local taxes and the delivery of public utility services. In a mid-2015 survey, the Association of Cities in Croatia (AOC) finds that the quality of the LDF register is "fair", considering that 46% of local governments had performed an extensive review in the previous 12-18 months, while 91% reported performing incremental updates to the register whenever a change occurred or was reported. Nevertheless, there remain significant discrepancies between the LDF register and the State Statistical Offices as regards tax bases (no. of buildings, surface area of buildings etc.,). The AOC Survey shows that local governments' that have smaller discrepancies with the State Statistical Office register have some common characteristics: LDF registers contain the personal unique identifier number for more than 93% of taxpayers'; extensive updates had been performed recently within the last 12 months; taxpayers are more compliant to reporting information changes, as required by law; and the register is updated with data collected in the process of building legalizations.

Along with proactive measures of local governments themselves, the regular and automated exchange of information between national and local fiscal registers remains critical. In the framework of the preparations for the introduction of the property tax, local governments were given access to the Residents Register, the Construction Permits Register, the Cadastre and Real-estate Transactions Register, all in electronic format, to facilitate updating of the LDF and the establishment of the register for the administration of the then-upcoming property tax. While the property tax itself was discontinued, local governments revenues from the LDF increased by 10 million Euro, (3.6%) in annual terms, which is attributed to the updating of the LDF register.

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

Borrowing

Local governments in Croatia may incur short-term and long-term debt, pending approval of the Government or the Minister of Finance, at domestic and foreign market by taking credits, loans and issuing securities. The national borrowing cap for local and regional governments equals 3% of total revenues of all local and regional governments.

Local governments can borrow short term exclusively to bridge the gap caused by the different dynamics of the inflow of funds and the maturity of liabilities for a maximum of 12 months, without the possibility of further reprogramming or taking out new short-term credits or loans.

A Local government unit may incur long-term debt:

- for an investment financed from its budget (expenditures for the acquisition of non-financial assets (other than passenger car) and other expenditures directly related to such an investment)
- for capital assistance to companies and other legal entities majority-owned or co-owned by LGU for investments that are co-financed from the EU and for investments or projects prescribed by special regulations and
- for the financing of ineligible costs that were co-financed from the European Union funds.

The Government or the Minister of Finance shall not issue prior approval for borrowing should any such new borrowing exceed the national cap or should individual local government's annual repayments exceed 20% of the actual LG revenue of the year preceding the year in which it borrows. Annual repayment includes the amount of the average annual repayment for credits, loans, obligations based on issued securities, issued guarantees, and borrowing approvals, as well as due obligations stated in the last available financial statement. Borrowing by LGs up to the amount of the total acceptable cost of the EU funded projects and borrowing for investments in energy efficiency projects is excluded from this limitation.

Budgetary users can incur long-term debt for the same purposes as local government units, refinance and reprogram the rest of the debt, with prior approval of the local government. Extra-budgetary users can borrow long-term from an international financial institution, with prior approval from the Minister of Finance.

A regional government may provide a guarantee to a local government in its territory with the prior consent of the Minister of Finance. Local or regional government may provide a guarantee for long-term borrowing to budgetary and extra-budgetary users and legal entities majority-owned or co-owned by the unit, with the prior consent of the Minister of Finance. Guarantees are included in the scope of possible indebtedness of local or regional government in proportion to the ownership share. The guarantee for borrowing up to the total acceptable cost of the project co-financed from the European Union funds is not included in the scope of possible borrowing of local and regional self-government units.

If local or regional governments borrow or issue a guarantee without the prior approval of the government or the Minister of Finance, the loan or guarantee is null and void.

Local governments can refinance or reprogram the debt if the total annual annuity and/or maturity is not increased.

Local governments are obliged to report to the Ministry of Finance within the budget year, quarterly, by the 10th of the month, for the previous reporting period, on the repayment of debt and the status of active guarantees.

Current local government debt equals 2% of GDP, down from 2.6% during COVID-19 period. Local governments have significantly increased borrowing during the COVID-19 period to sustain capital investment programs and compensate for revenue losses. Government has offered interest-free loans to local governments during that period to help with revenue losses and a number of local governments took part, primarily those along the Adriatic coast who incurred the most significant losses. Loan maturity is three years from the day of disbursement. As of 2022 local governments started a strong deleveraging program and reduced outstanding debt by 0.6% of GDP.

COVID-19 Impact and implications for Local Government Finances

Local government revenues during the COVID-19 crisis remained fairly stable due to increased inflows from EU funding and government sponsored interest free loans for revenue losses. Tourism oriented local governments along the Adriatic coast incurred most losses due to travel restrictions imposed during the COVID-19 crisis.

The Association of Cities (AOC) issued COVID-19 related business support recommendations to local governments:

- In order to ensure the liquidity of the budget, it was proposed to reduce expenses that are not necessary for regular operations, including the costs of events, grants to institutions and non-profit organizations that would not carry out activities in this period or would carry them out only to a limited extent;
- Suspend incurring new expenditures except
  - measures to help the economy and citizens affected by the COVID-19 epidemic;
  - expenditures related to the implementation of projects financed from grants and EU funds
  - expenditures for activities and measures, the postponement of which would cause damage to property, lives and health of citizens, or damage to the budget
- Exempt business entities from paying taxes on the use of public areas, the lease of public areas and the lease of business premises for the period in which the activity is not carried out, partially or fully, taking into account the liquidity of the budget.
- During the suspension of the work of kindergartens, exempt users from paying for participation in the economic price of kindergartens, i.e., take over these costs at the expense of the budget, taking into account the liquidity of the budget.
- Exempt users from paying for extended stay and meals in elementary schools during the suspension of work of elementary schools, i.e., take over the costs of extended stay and meals at the expense of the budget.
  - Postpone collection of claims and public revenues over duration of the COVID-19 epidemic
  - Postpone the collection of utility fees for March 2020 interest-free and consider the possibility of partially or completely exempting business premises from payment of utility fees in April and the following months according to the development of the economic situation.

Financial reports show that local governments have indeed acted accordingly as the most significant drops in revenues were related to communal fees and charges, revenues from asset rentals and taxes on goods and services. On the expenditure side, savings were reported on goods and services, and transfers to NGOs and political parties. Expenditures were increased in transfers to individuals and transfers to public companies and institutions (education and social protection)

Due to tax reform activities from 2019, the reduction of the tax burden and tax incentives for youth, PIT revenues of local governments in 2020 declined despite governmental support for revenue losses. Changes to the fiscal equalization classification further reduced PIT revenues in 2021, but this change was compensated by increased grant funding.

Advocacy efforts of the Local Government Association in the area of local finances

The Association of Cities of Croatia worked closely with the Government, especially during the COVID-19 crisis, on measures related to local government financial stability and economic recovery measures.

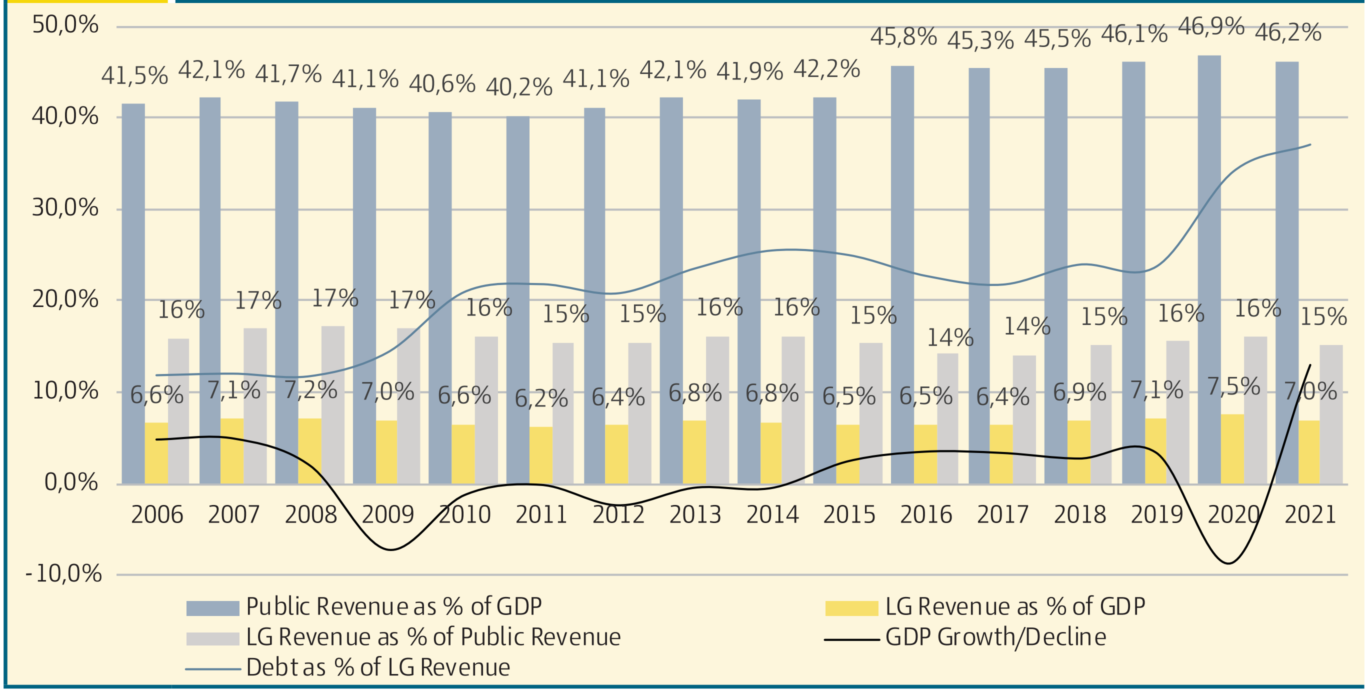
The Association issued business support recommendations to local governments, as described above, to sustain economic activity and help businesses recover as soon as conditions would permit so. Such measures have impacted local government revenues, so the Association turned to the Government to craft a local government support package, including interest free revenue loss recovery loans. Furthermore, the Association worked with local governments to enable virtual representative bodies' meetings and decision making.

As soon as conditions permitted, the Association worked with line ministries to restore operation of green markets to help small agriculture producers' recovery and supply to residents.

Statistical Overview of Local Government Finance in Croatia 2006-2021

Since 2015, the Croatian economy experienced a very strong growth with a temporary -8.6% GDP drop in 2020. Total Public Revenues in last three years hovered at around 46% of GDP. Local government revenues, as a share of GDP or share of general government revenue, kept close to their historical levels despite the PIT reforms and the COVID-19 crisis, thanks to strong economic growth and government support measures.

Figure 98 CROATIA: LOCAL GOVERNMENT REVENUE AS A SHARE OF GDP AND TOTAL PUBLIC REVENUE



The revenues of local governments and the General Government raised and declined in tandem over the course of last three years. Over the past decade, local government revenues have experienced a slower decline than total public revenues, but also smaller growth rates ,with the exception of 2018 when the new fiscal equalization mechanism was introduced and 2019 when revenue growth was fuelled by strong utilization of EU funding. Such strong growth prompted the Government to undertake another PIT rates reduction and youth incentives program which affected local governments in 2020 along with the COVID-19 crisis and earthquakes. As a response to frequent PIT rate reductions and the attempted introduction of a property tax, local governments have shifted their focus to own source revenues, which showed a steady growth in 2018 and 2019 but were affected by local government business support program during the COVID-19 crisis and since haven't fully recovered to 2019 levels yet.

Figure 99 CROATIA: FLUCTUATIONS IN THE GENERAL AND LOCAL GOVERNMENTS REVENUE

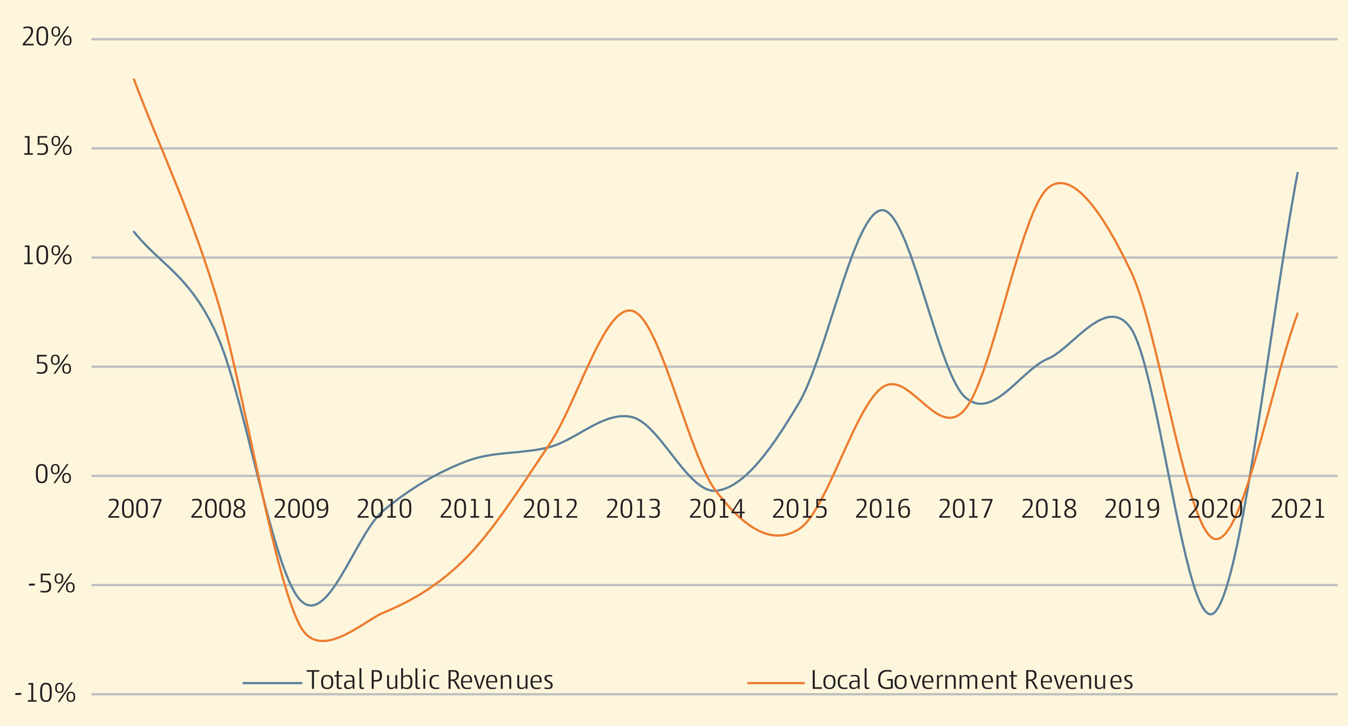
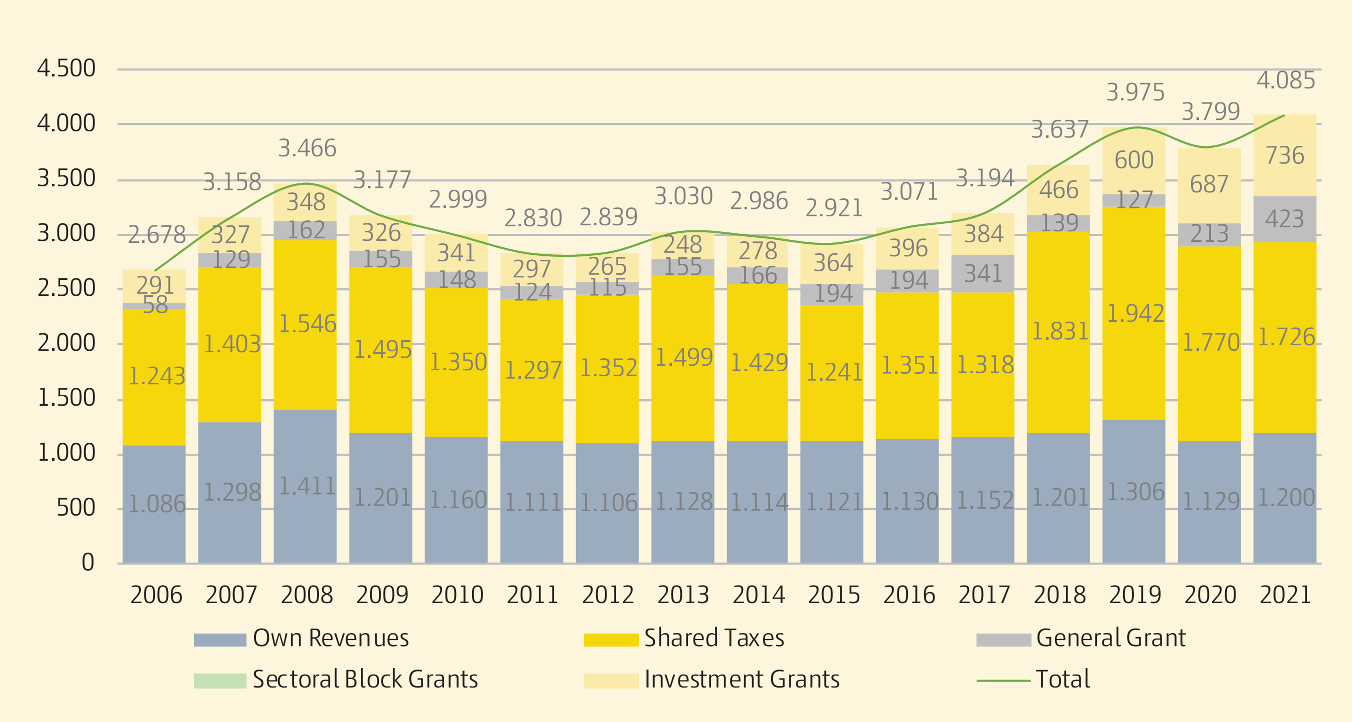


Figure 100 CROATIA: LOCAL GOVERNMENT REVENUE 2006-2021, IN MILLION EURO



It is important to note that, investment grants here include also funding for delegated functions and grants from the European Union. The growth of the General Grant in 2021 is attributed to reclassification of the Fiscal Equalization Fund from PIT to General Grant. Consequently, PIT revenues are reduced for the same reason.

In per capita terms, local government revenues in 2021 were 1.055 Euro, with 310 per person coming from locally imposed taxes and fees and 395 Euro coming from shared PIT revenues.

Figure 101 CROATIA: LOCAL GOVERNMENT REVENUE 2006-2021, IN EURO PER CAPITA TERMS

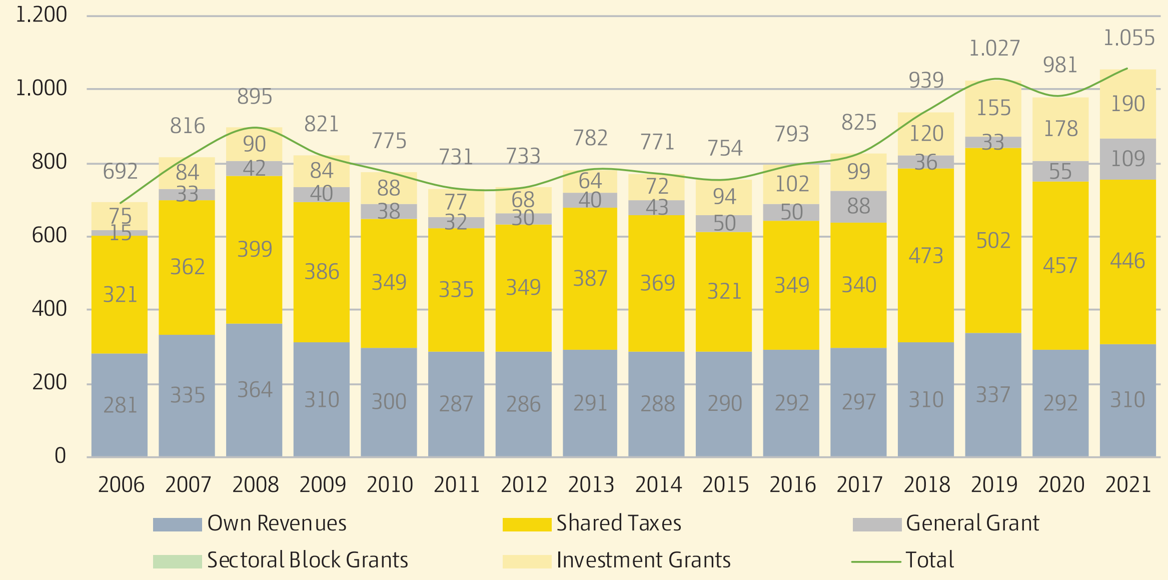
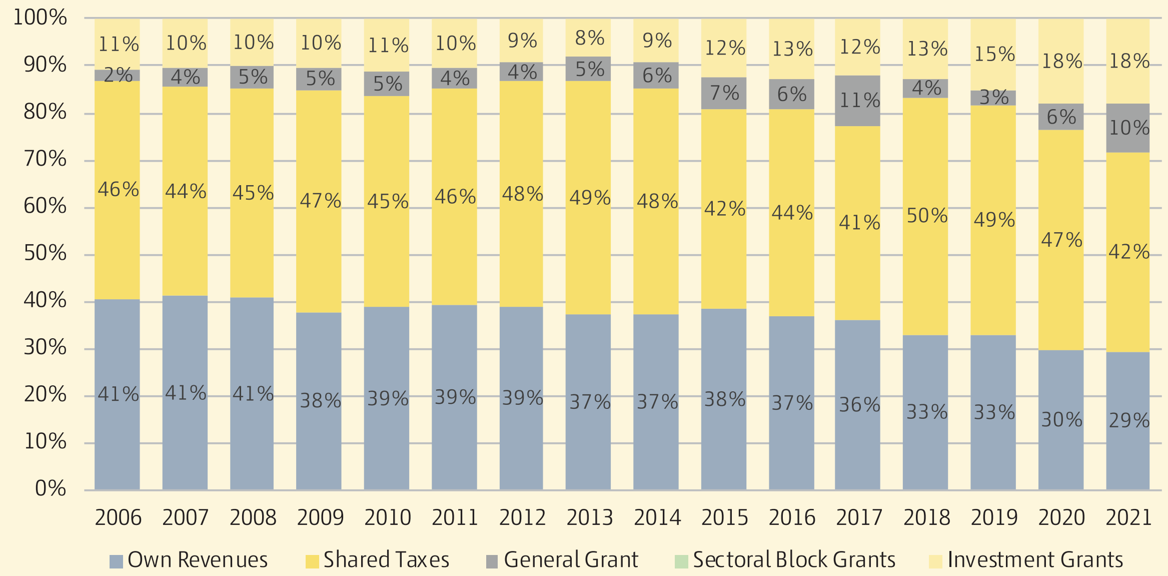


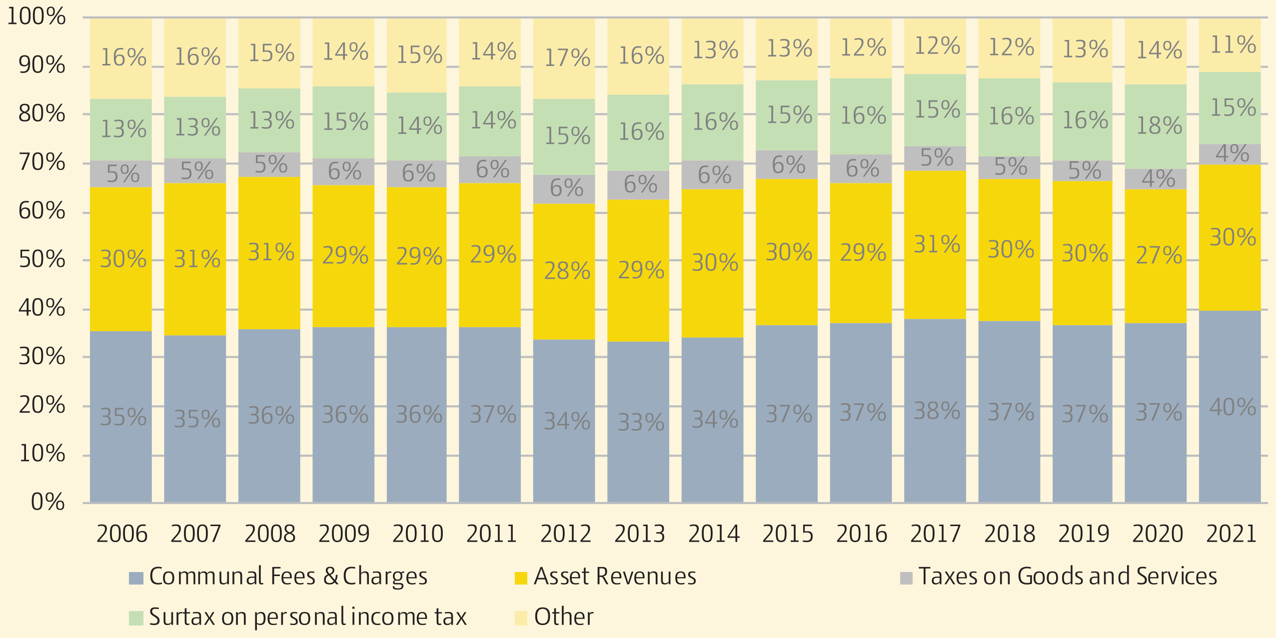
Figure 102 CROATIA: COMPOSITION OF LOCAL GOVERNMENT REVENUE 2006-2021, % OF TOTAL



There is a growing importance of general and investment grants since Croatia's accession to the EU. In 2012, a year before EU accession, these grants accounted for 13% of LG revenues and have since steadily grown to 28% in 2021. It should be noted though, that both grants include domestic and EU transfers, and the 2021 jump can be attributed to the reclassification of the FEF. However, even if the FEF is excluded from the general grant, these two grants still account for 23% of LG revenues, which is almost twice compared to the pre-accession time. Nevertheless, the LG fiscal landscape in Croatia remains dominated by shared taxes, despite the PIT reforms that decreased reliance on shared taxes.

Own source revenues make up for 29% of LG revenues in 2021, down from the average 37% prior to 2018 in which the FEF was introduced and boosted shared taxes share in LG revenues. Own source revenues showed a steep decline in 2018 to 33% because of the FEF, and its share continues to decline due to the growth of grant funding and the LG business support program. In nominal terms OSRs are the same in 2018 and 2021, at the level of 1.2 billion Euro.

Figure 103 CROATIA: LOCAL GOVERNMENT OWN SOURCE REVENUE 2006-2021



The Communal Fees and Charges dominate the composition of own source revenues with 40% (2021) of the total and have been steadily increasing since 2013. The growth has been fuelled mainly because of receipts from the process of legalization of illegally constructed buildings starting in 2013. Increased efforts to update fiscal registers and the preparatory activities for the introduction of the property tax supported the growth from 2017. The next significant groups are asset related revenues (sale and rentals) which jointly account for 30% of LG own source revenues and have kept these levels for extended periods of time.

Expenditures of budgetary users are no longer reported in the city/municipal budget according to the economic classification of each expense, but are reported as grants to budgetary users due to new reporting standards as of 2015. Hence the break in the data series in 2015. As of 2015 investments were steadily increasing from 13% to 22% of local government expenditures, as expected due to the growing share of investment grants in local government revenues. The share of wages and benefits did not change over this period, but the share of goods and services is declining, and so are grants and transfers.

Figure 104 CROATIA: COMPOSITION OF LOCAL GOVERNMENT EXPENDITURE 2006-2021, % OF TOTAL

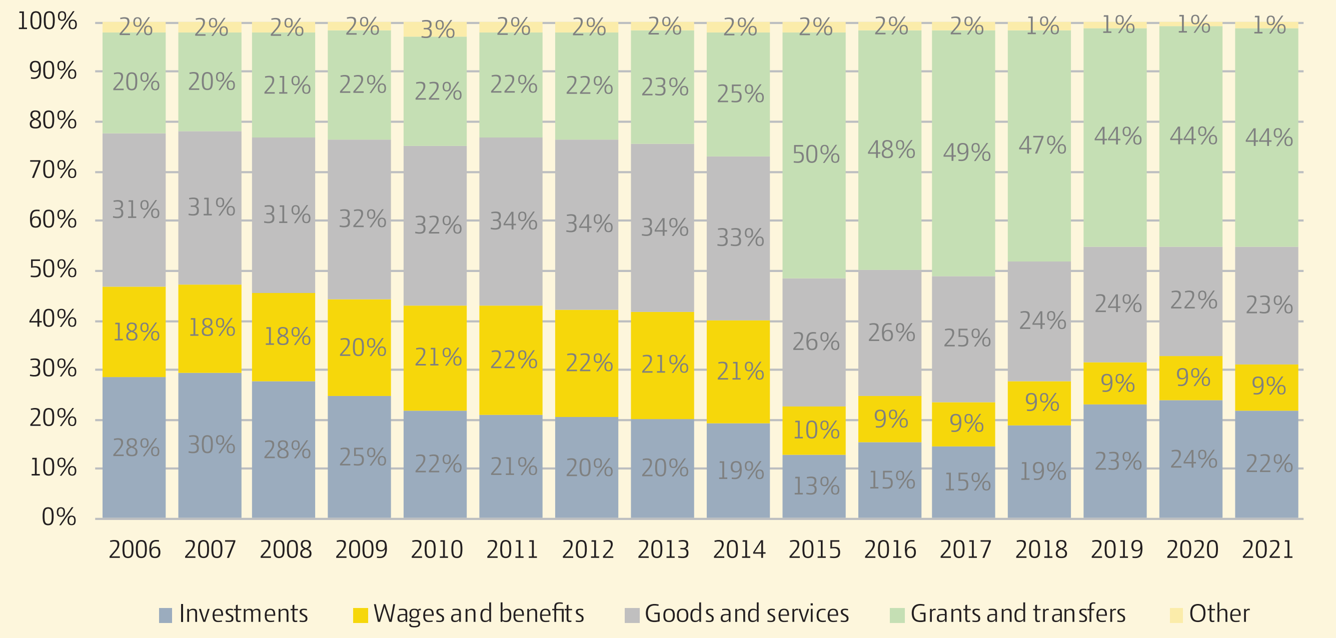


Figure 105 CROATIA: COMPOSITION OF LOCAL GOVERNMENT EXPENDITURE 2006-2021, MLN EURO

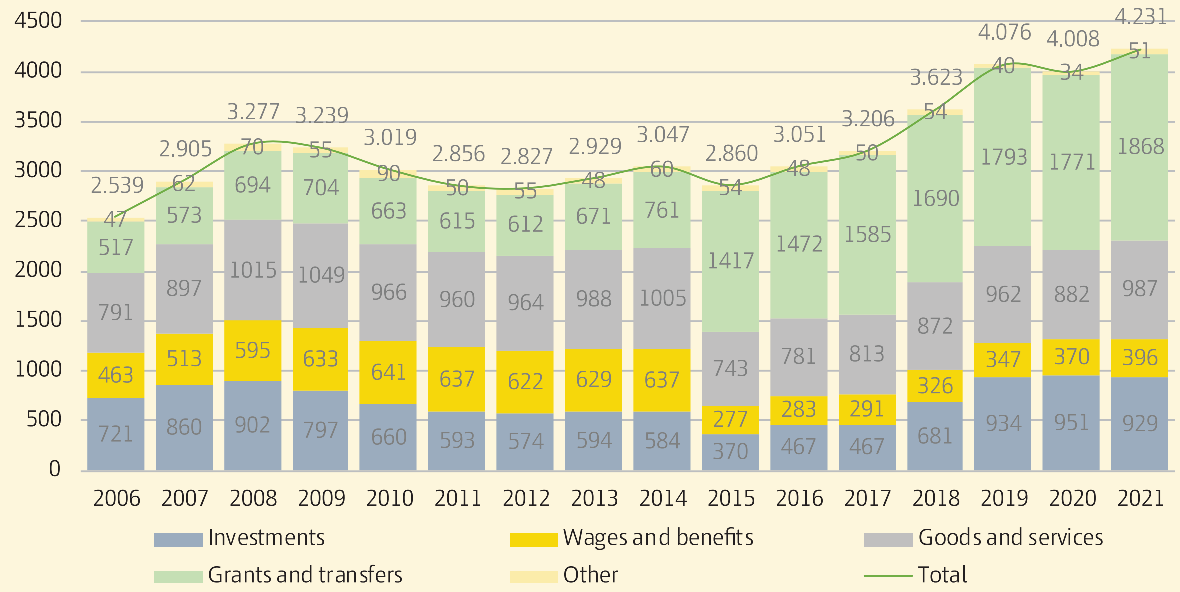


Figure 106 CROATIA: COMPOSITION OF LOCAL GOVERNMENT EXPENDITURE 2006-2021, EURO PER CAPITA

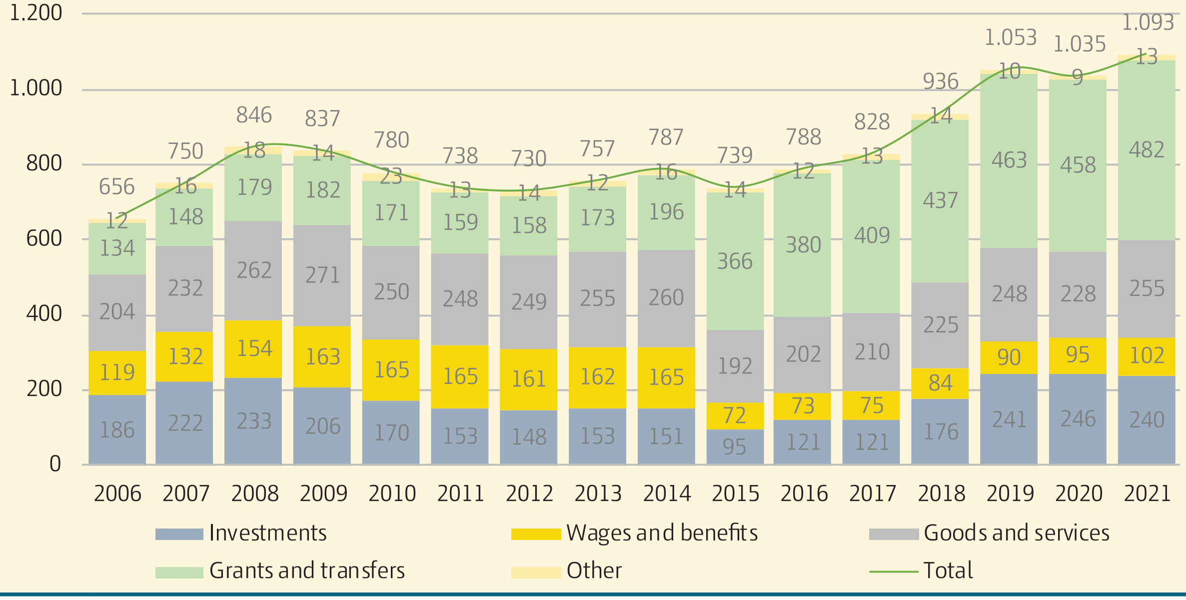
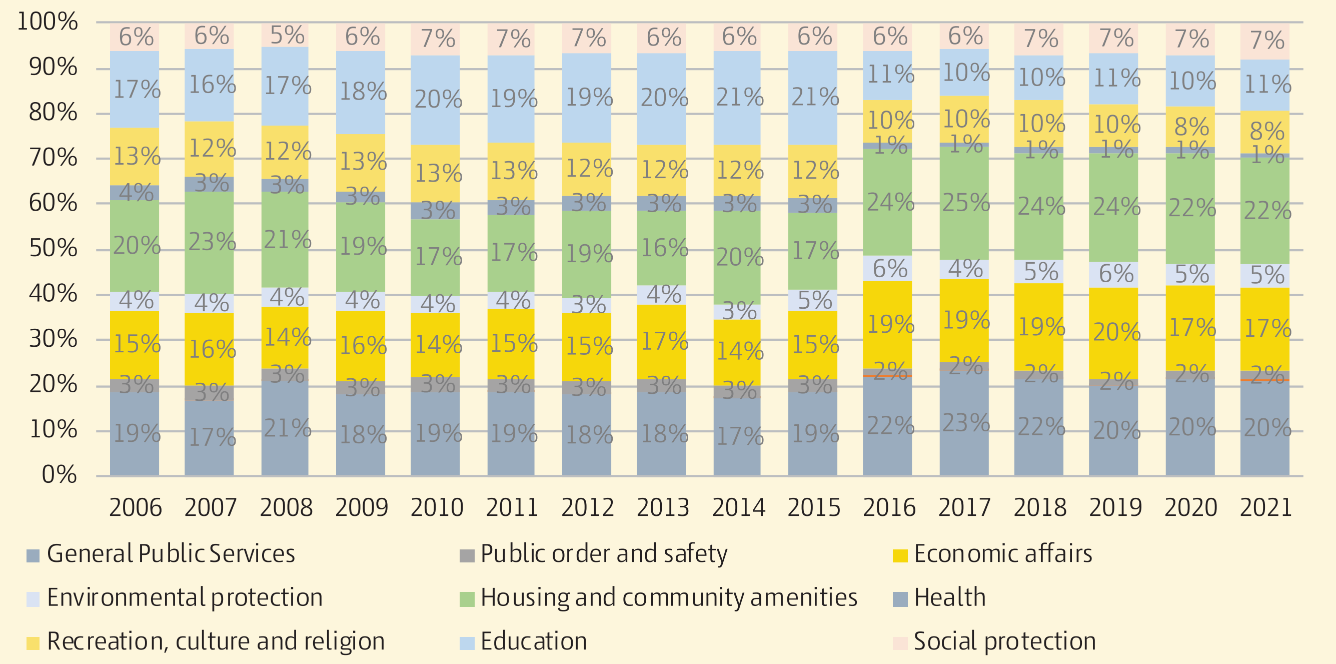


Figure 107 CROATIA: COMPOSITION OF LG EXPENDITURE, FUNCTIONAL ALLOCATION, % OF TOTAL



From a functional perspective, spending for general public services has remained relatively stable over the past few years, while the share of spending for economic affairs and housing and community amenities has increased significantly, on the back of the share of spending for education. Nevertheless, a good part of this is also most probably related to the changes in the methodology for reporting expenditures by budgetary users.

As of 2017 total public investment as a share of GDP had started steadily increasing. In nominal terms total public investments have returned to pre-recession levels. Local government investments in 2020 have exceeded peak pre-recession levels by 10%.

Local government debt as a percentage of GDP has been increasing over time, peaking in 2020 and 2021 at 2.6%, because of loans incurred during the COVID-19 crisis. Spending for LG investment has been increasing as well since 2015-16, peaking at 1.9% of GDP in 2020. Spending for municipal wages and investments has dropped between 2014-2015 because of the new reporting/economic classification methodologies.

Figure 108 CROATIA: SHARES OF PUBLIC OF INVESTMENT BY LEVEL OF GOVERNMENT AND AS % GDP

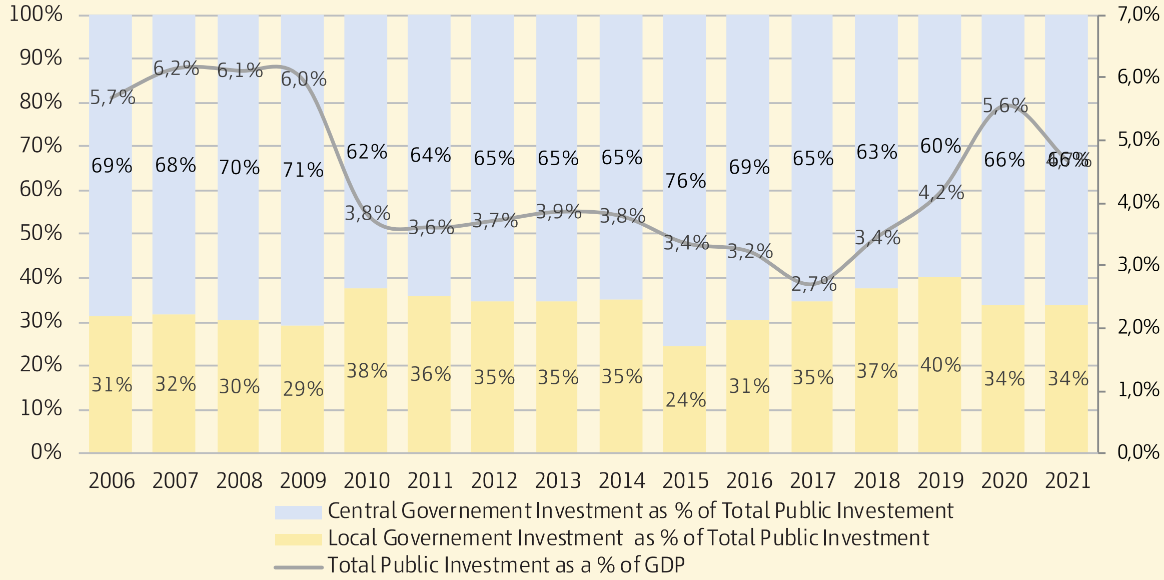
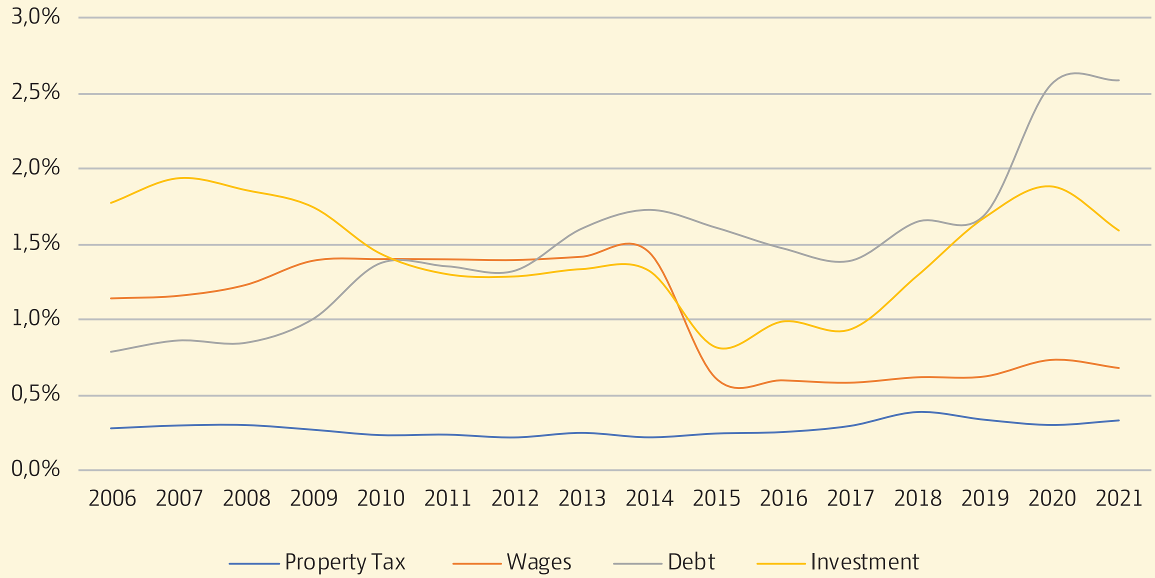


Figure 109 CROATIA: SHARES OF PUBLIC OF INVESTMENT BY LEVEL OF GOVERNMENT AND AS % GDP



Kosovo

By Osman Sadikaj, Association of Kosovo Municipalities

The Intergovernmental Finance System

Kosovo has one of the most decentralized systems of government in the region because local governments are responsible for all pre-university education as well as primary health care. For these functions, LGs receive block grants that make up to 46% of local budgets in 2021.

Based on the Law on Local Government Finance, the size of the **General Grant** is defined by law as 10% of the total budgeted revenues of the central government. In 2021 the general grant was 190.49 million Euro. All local governments receive a lump sum payment of 140,000 euro, minus one EUR per capita for all local governments - therefore municipalities with populations greater than 140,000 do not receive any lump sum payment. 2.7% of the total pool of the general grant is dedicated to local governments with less than 22,000 inhabitants, with half of the grant being distributed on a lump-sum basis and the other half on the basis of population. The remainder of the general grant pool is then allocated to municipalities by formula: 89% by population, 6% by geographic size (square kilometres); 3% by the number of ethnic minorities; and 2% for municipalities in which the majority population is a national minority. The financing of the social services transferred as a competence to municipalities by the relevant line ministry is included in the general grant of the municipality. The capital city, Prishtina, receives an additional grant from the central government at the size of no less than 6% of the total General Grant.

The size of the **Pre-University Education and Health Grants** is determined by a National Grant Commission in accordance with a Medium-Term Expenditure Framework. In 2021, the share of the grant for pre-university education is 194.8 million EUR. The Education Grant is allocated to local governments based on a formula that takes into account the wages of teachers, administrators and support staff, goods and services, building maintenance, capital expenditures and specific education policies. Pupil numbers are used to determine the amounts for salaries, goods and services and building maintenance in accordance with class size norms of: 1 teacher to 21 students in majority communities: 1 teacher to 14 students in minority communities; 1 teacher to 12 preschool pupils; 1 teacher to 17 students in vocational education in majority communities; 1 teacher to 11.5 students in vocational education in minority communities; 1 teacher to 14 pupils in mountainous areas. For goods and services, the norms are: 23€ per pupil in majority communities; 25€ per pupil in minority communities, while for capital expenditures (the maintenance of buildings) it is set at 7€ per pupil. The Healthcare Grant is also allocated by formula according to population. The formula for the primary healthcare grant considers a payment of 35€ per capita. The funding for the secondary healthcare system for three minority municipalities is determined by the Ministry of Health, in line with the projections of the Medium-Term Expenditure Framework.

Local governments receive also additional, smaller grants for residential services, for the preservation of historical and cultural sites and theatres, which are included in the Annual Budget Circular, determining the financing for local government budgets.

Local Government Own-Source Revenues

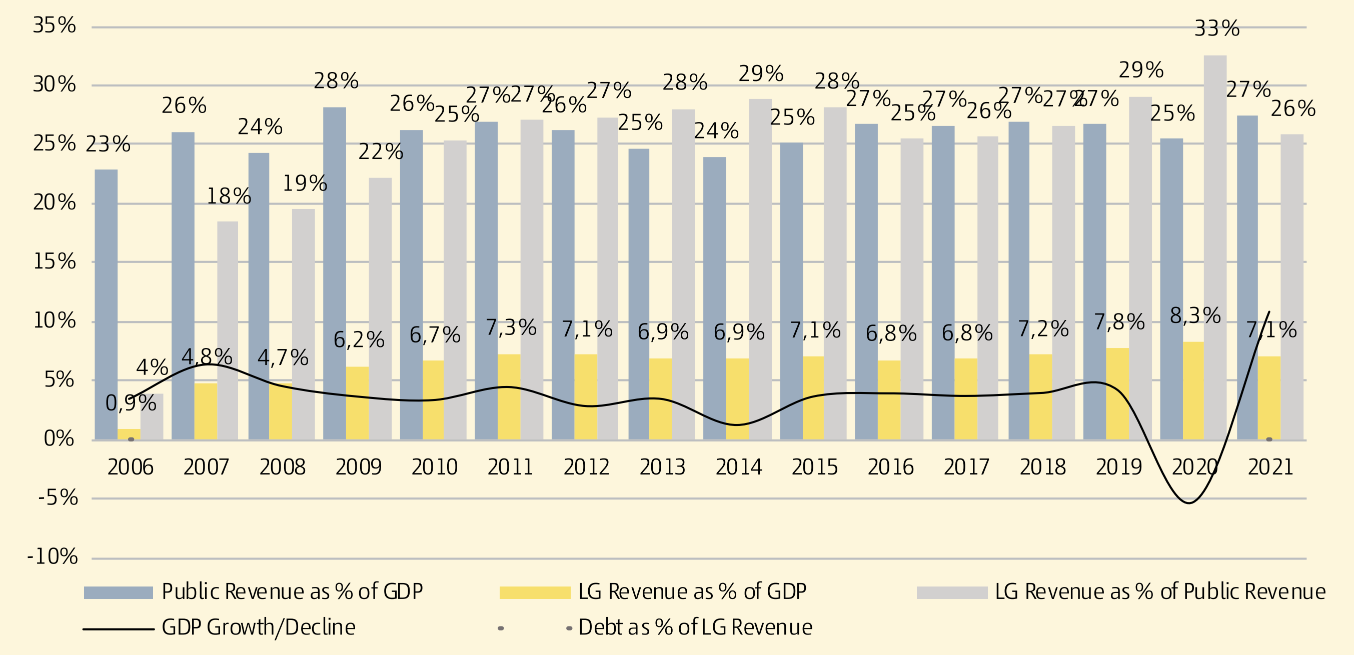
The most important **Own-Source Revenues** are the Property Tax and revenues from Construction Permits. Property tax revenues constitute 6.4% of total local government revenues in 2021, while construction permits constitute 4.4%. Municipalities have been using Construction Permits as quasi-fiscal infrastructure impact fees, a practice that the national government has been trying to stop — with mixed success — in order to improve the "business enabling environment". Municipalities are also allowed to collect fees for health and education services. Municipalities receive 100% of the national government's property transfer tax.

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

Statistical Overview of the Finances of Local Governments in Kosovo 2006-2021

In 2009, schools and healthcare clinics were decentralized to local governments. As a result, local revenue, both, as a share of GDP and total public revenue, increased sharply. Municipalities receive 26% public revenues and are getting a remarkably fair share of the overall fiscal pie in comparison to many of their counterparts in the region. This share has also increased since 2016. Local spending

Figure 110 KOSOVO: LOCAL GOVERNMENT REVENUE AS SHARE OF GDP AND TOTAL PUBLIC REVENUE 2006-2021



on education and healthcare, however, remains heavily controlled by the central government and municipalities have yet to be allowed to borrow.

The share of local finances to GDP has averaged 7.4% in the past five years, with a strong growth tendency since 2018. Similarly, the share of local government revenues to overall public revenues has declined between 2014 and 2018, to recover thereafter. In 2020, the decline in GDP has contributed to the increase of the indicator. The economy has continued to grow by an average of 3.4% over the past five years.

Unlike in many other places in the region, there has been a consistent pattern in the relationship between local and central government revenues in Kosovo: they have risen and fallen more less in tandem except for 2016 and 2021 where we notice a fall in local government revenues as opposed to an increase in overall public revenues. In 2021 the contrast between the growth rate of total public revenues and local revenues is very high.

The composition of local government revenues in Kosovo has not changed significantly over the past decade. In 2021, Kosovo local governments derived 46% of their revenues from block grants for Education and Primary Health Care. They also receive a General Grant, which in 2021 constituted 32% of their revenues. Own source revenues constitute only 15% of the total over the past five years, with a slight increase in 2021 after the expected fall in 2020.

Figure 111 KOSOVO: FLUCTUATIONS IN THE REVENUE OF THE GENERAL GOVERNMENT AND LOCAL GOVERNMENTS

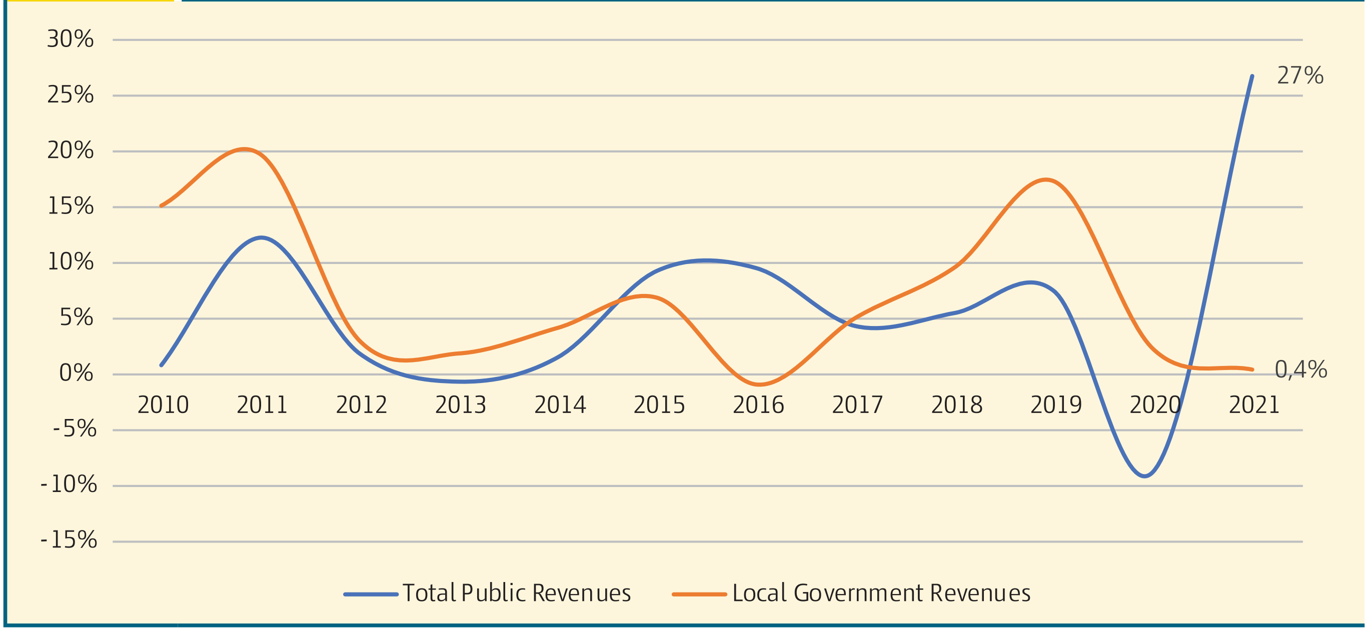


Figure 112 KOSOVO: COMPOSITION OF LOCAL GOVERNMENT REVENUES 2006-2021, IN % OF TOTAL

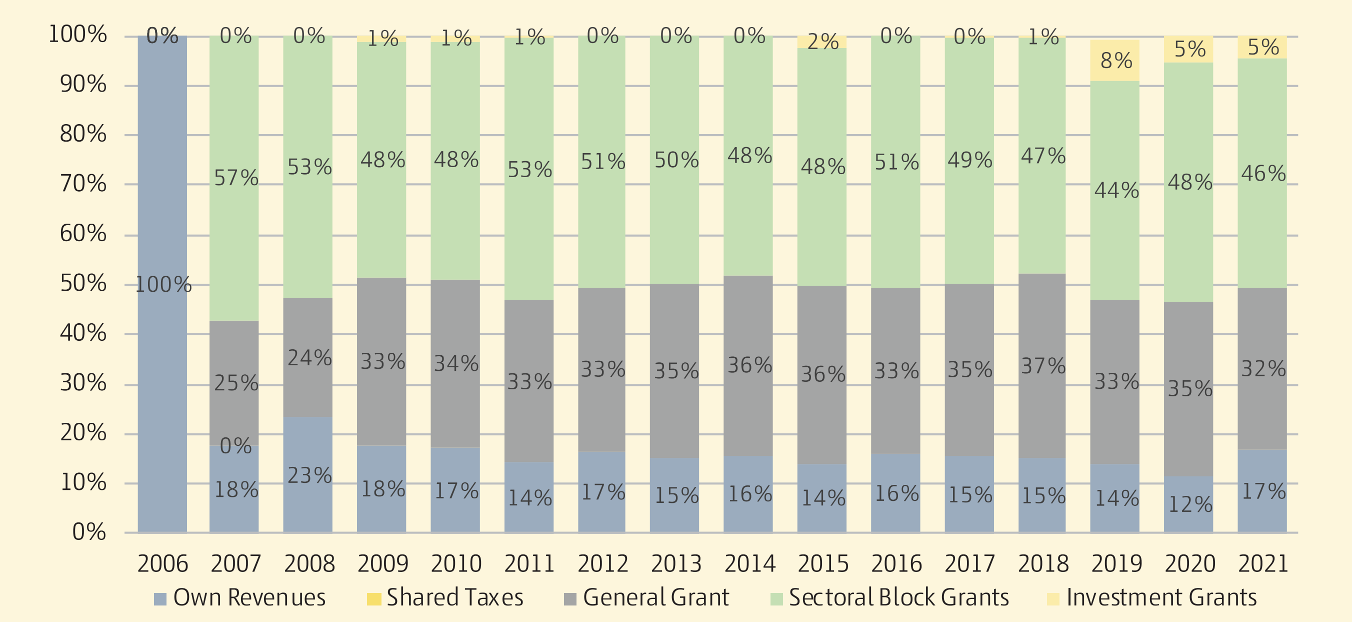
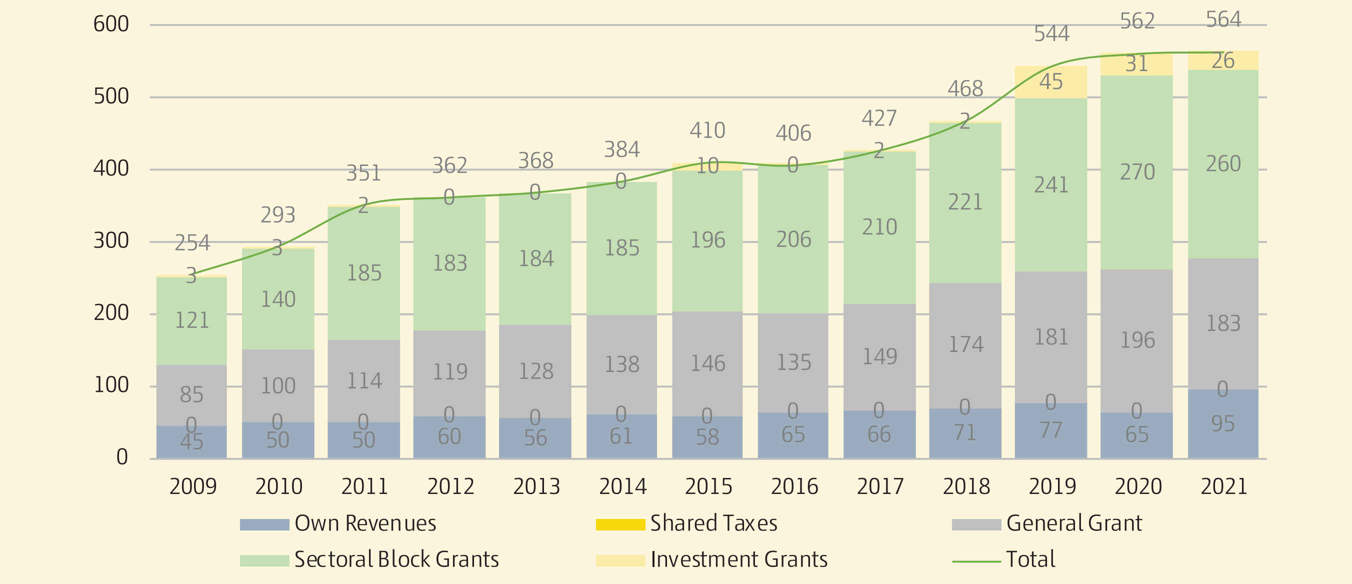


Figure 113 KOSOVO: COMPOSITION OF LOCAL GOVERNMENT REVENUES 2006-2021, IN MILLION EUR



The two most important own source revenues are the property tax and building permits. Income reported under this category shows a steady increase over the past four years. In 2014, the central government again tried to tighten up on building permits, but it appears that local governments responded by classifing the revenue under fees and charges. The property tax has been subject to several reforms over the past decade. Nevertheless its relevance to local government own source revenues has remained relatively the same.

Figure 114 KOSOVO: COMPOSITION OF LOCAL GOVERNMENT REVENUES 2006-2021, IN EUR PER CAPITA

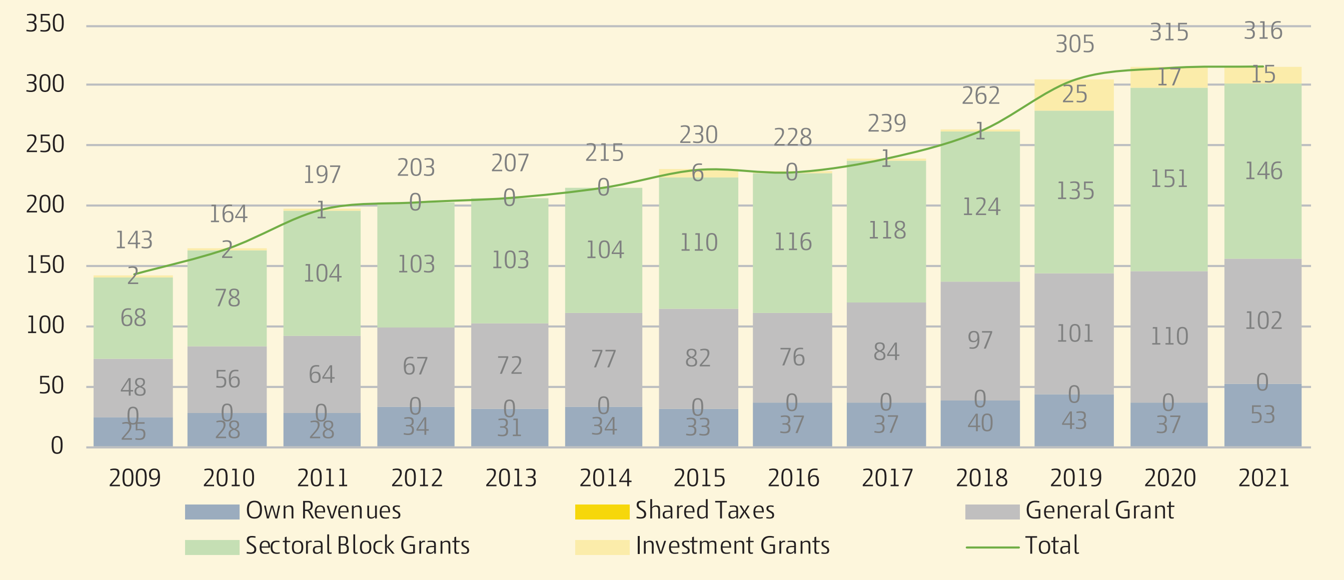
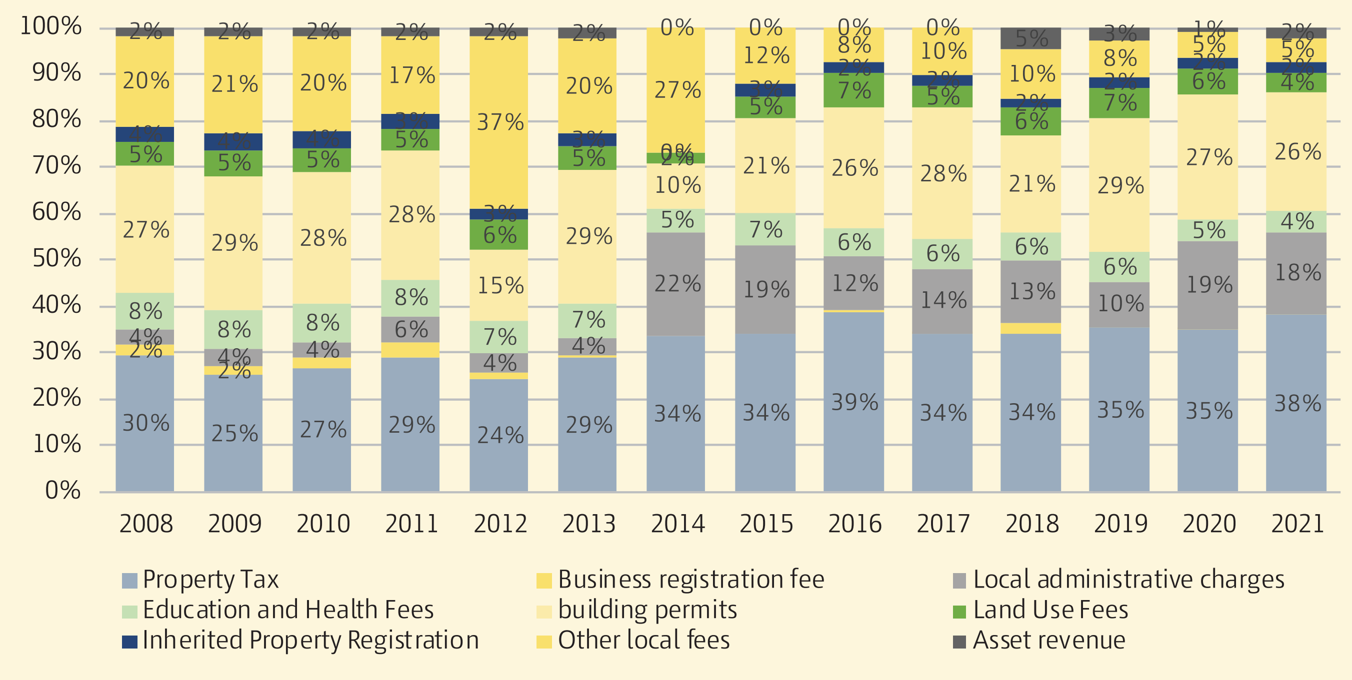


Figure 115 **KOSOVO: COMPOSITION OF OWN REVENUE 2008-2021**



In 2021, local governments have devoted 25% of their total expenditures to capital investments. Except for 2016, this is the lowest level registered since 2008. While in nominal terms spending for investment has increased (slowly), the growth rate of spending for salaries and goods and services is much higher. Indeed spending for wages has peaked in 2016 at 61% to fall in subsequent years. Central government decesions for alignment of salaries influence local government spending for wages too. Spending for goods and services has also increased over the years, and has peaked during 2020-21.

Figure 116 KOSOVO: COMPOSITION OF EXPENDITURES IN 2008-2021, IN % OF TOTAL

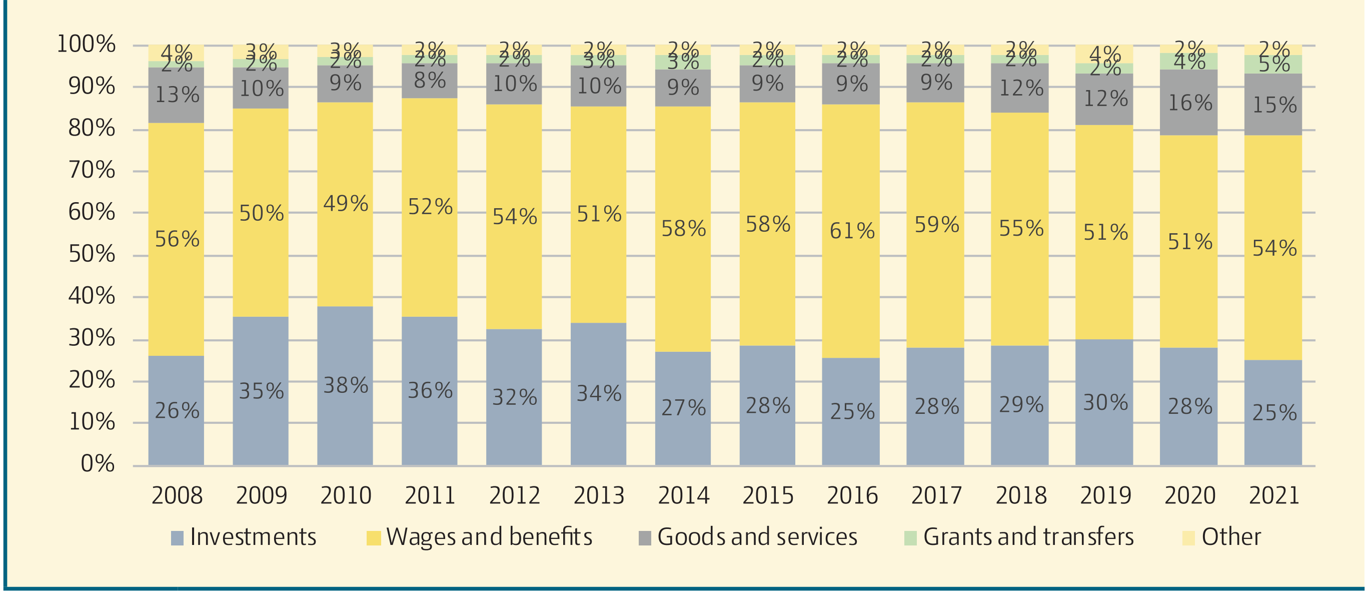


Figure 117 KOSOVO: COMPOSITION OF EXPENDITURES IN 2008-2021, IN MILLION EURO

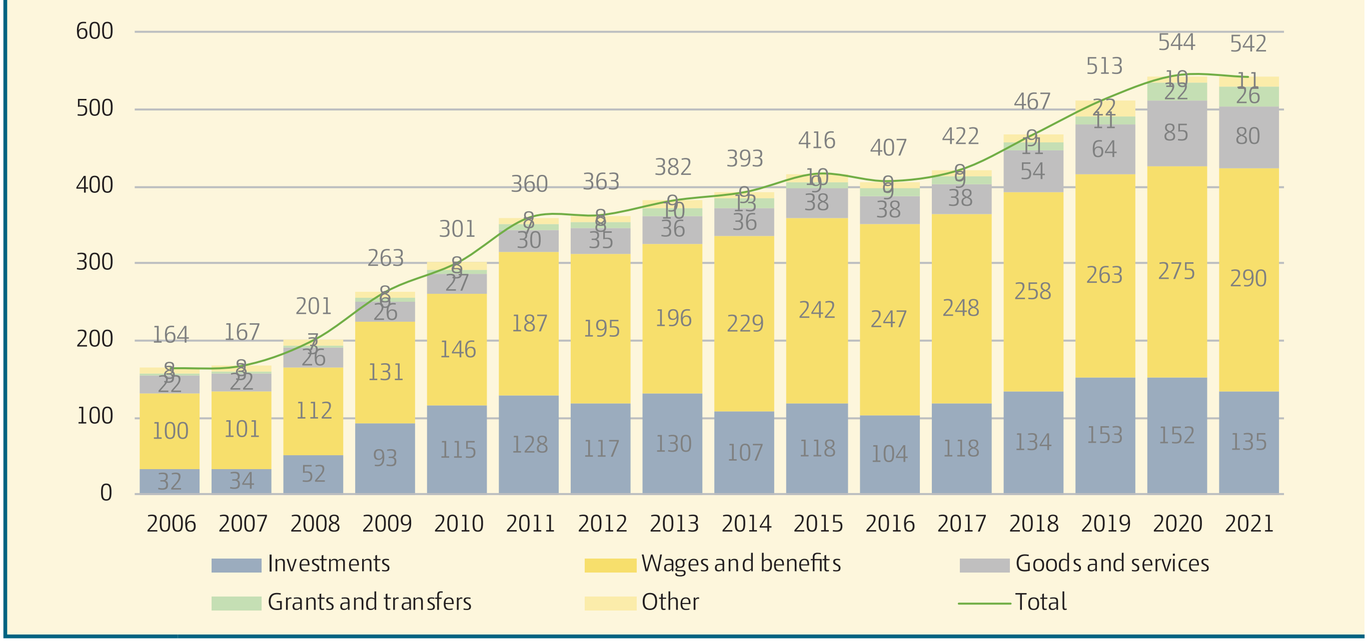
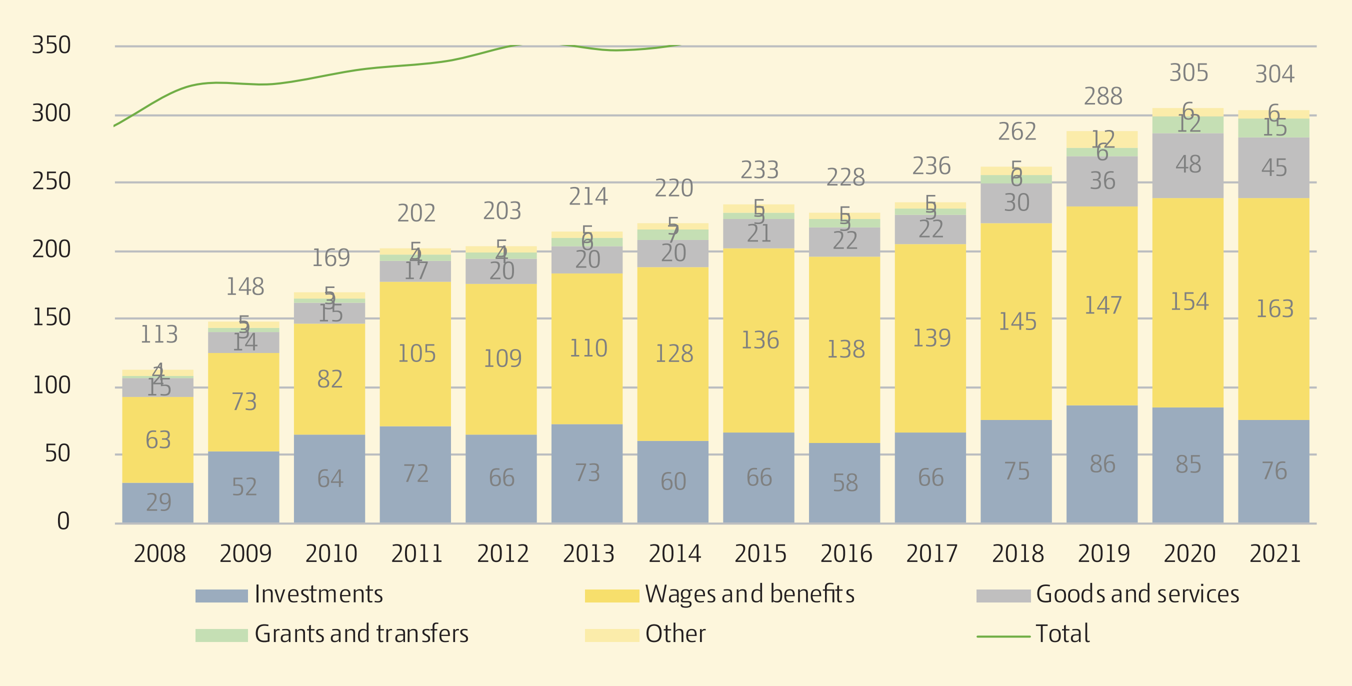


Figure 118 KOSOVO: COMPOSITION OF EXPENDITURES IN 2008-2021, IN EURO PER CAPITA



Spending for education and health constitutes about 71% of total local spending in Kosovo, while general public affairs amount to 15% of the total in 2021. Spending for public infrastructure and general economic affairs has increased over time and in 2021 constitutes 7% of total local spending. Spending for other functions (recreation, culture, social protection etc.) has increased to 7%.

Since 2015 more than half of local goverment investments focused on improving local public infrastructure (economic affairs). Spending for the functions agregated under the „housing and community amenities", supposedly financing basic local government services, has increased to 20% of total local investments in 2021, after a significant fall in 2015. Capital investments for the edcuation and health sector have been rather stable during the past decade with minor shifts. Investments in the other functions make up only 5% of total local government capital expenditures.

Total public investments in Kosovo dropped to a historical low of 5.3% of GDP in 2021. On the other hand, the share of local government investments in total public investmets has increased since 2016 to peak at 40% in 2020. The share of local government ivnvestment of total public investment in 2021, while lower than in 2020, is still much higher than any other year since 2008.

Figure 119 KOSOVO: COMPOSITION OF EXPENDITURES ACCORDING CLASSIFICATION OF THE FUNCTIONS OF GOVERNMENT, 2012-2021 (IN % OF TOTAL)

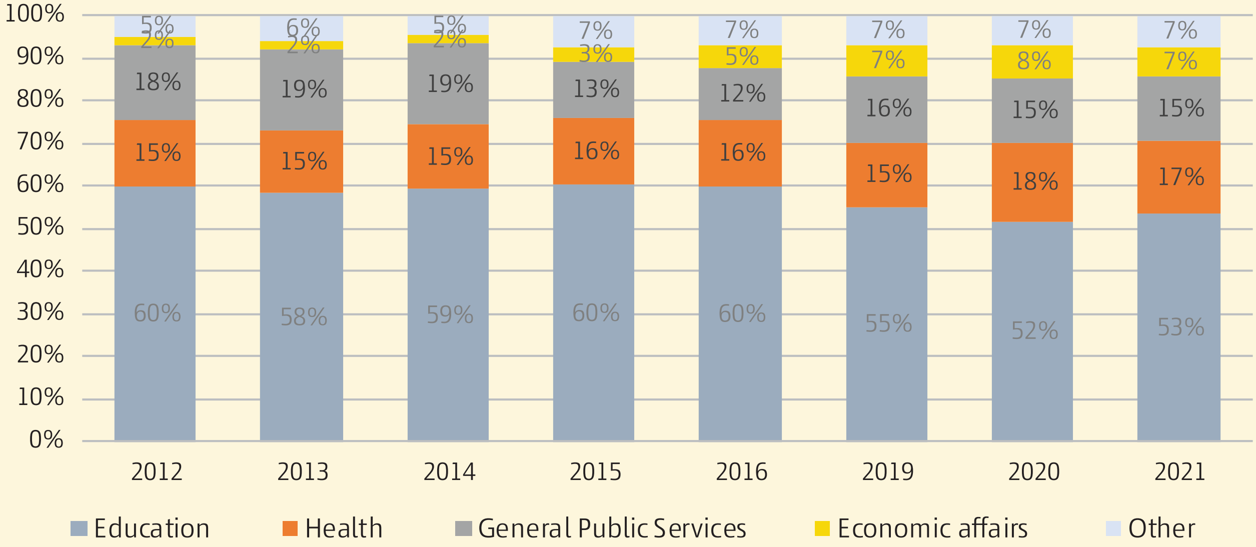
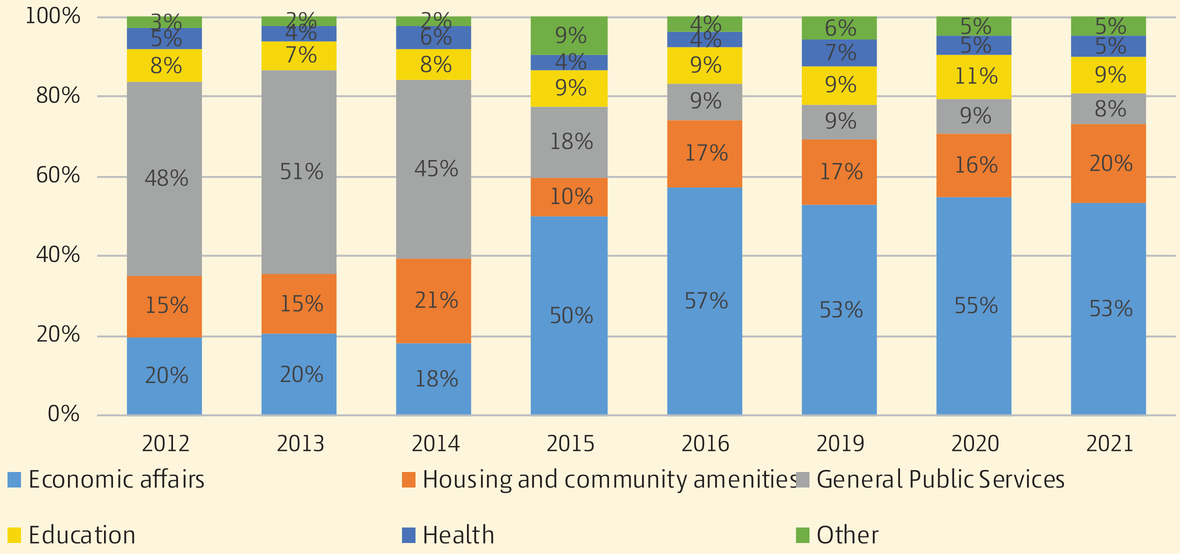


Figure 120 KOSOVO: COMPOSITION OF CAPITAL EXPENDITURES ACCORDING TO CLASSIFICATION OF THE FUNCTIONS OF GOVERNMENT, 2012-2021 (IN % OF TOTAL)



Spending for wages of local governments in Kosovo has had an upward tendency since 2008. Over the past five years spending on wages averaged 3.9% of GDP while in 2021 it decreased to 3.6%. The share of local investments to GDP, which has been increasing steadily since 2016, on the other hand has dropped from a high of 2.7% in 2011 to a low of 1.7% in 2016 and 2021.

The yield of the property tax is maintaining a stable trend of 0.4% of GDP, despite the significant investments by the central government into the Kosovo Cadastre Agency to improve registration and billing, and substantial increases in the minimum property tax rates imposed by the municipalities.

Figure 121 KOSOVO: PUBLIC INVESTMENT BY LEVEL OF GOVERNMENT AND AS A SHARE OF GDP 2006-2021

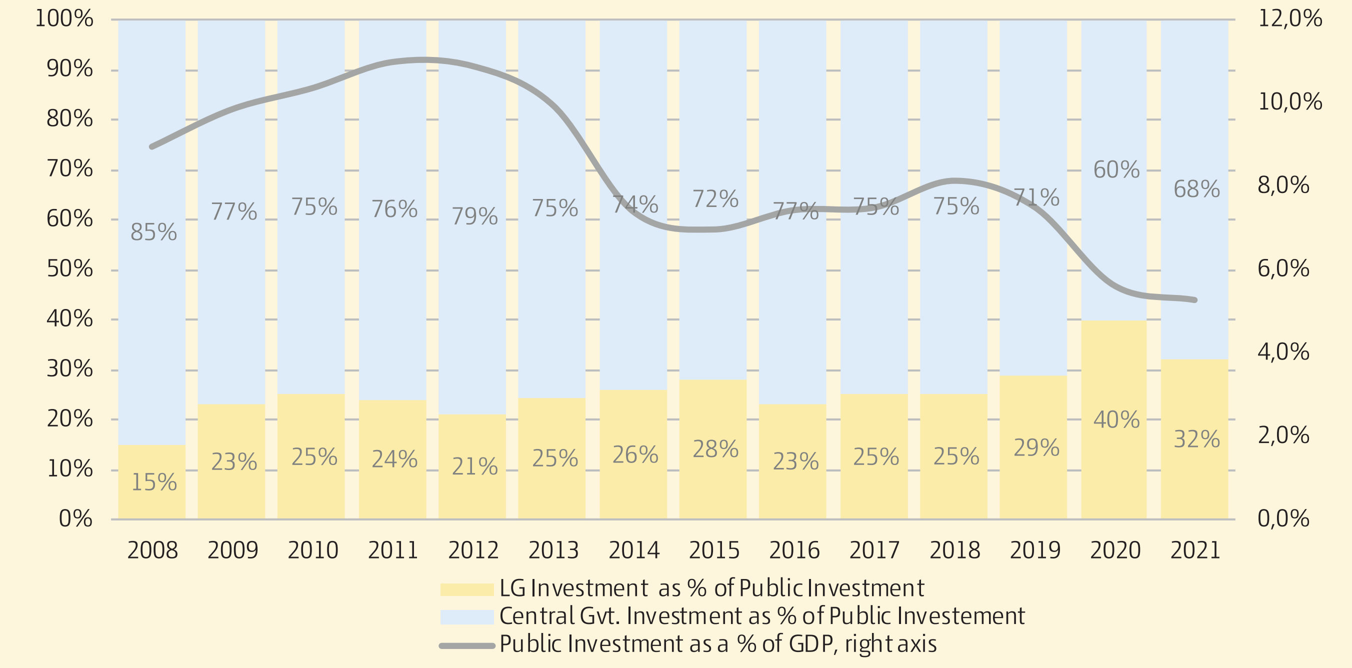
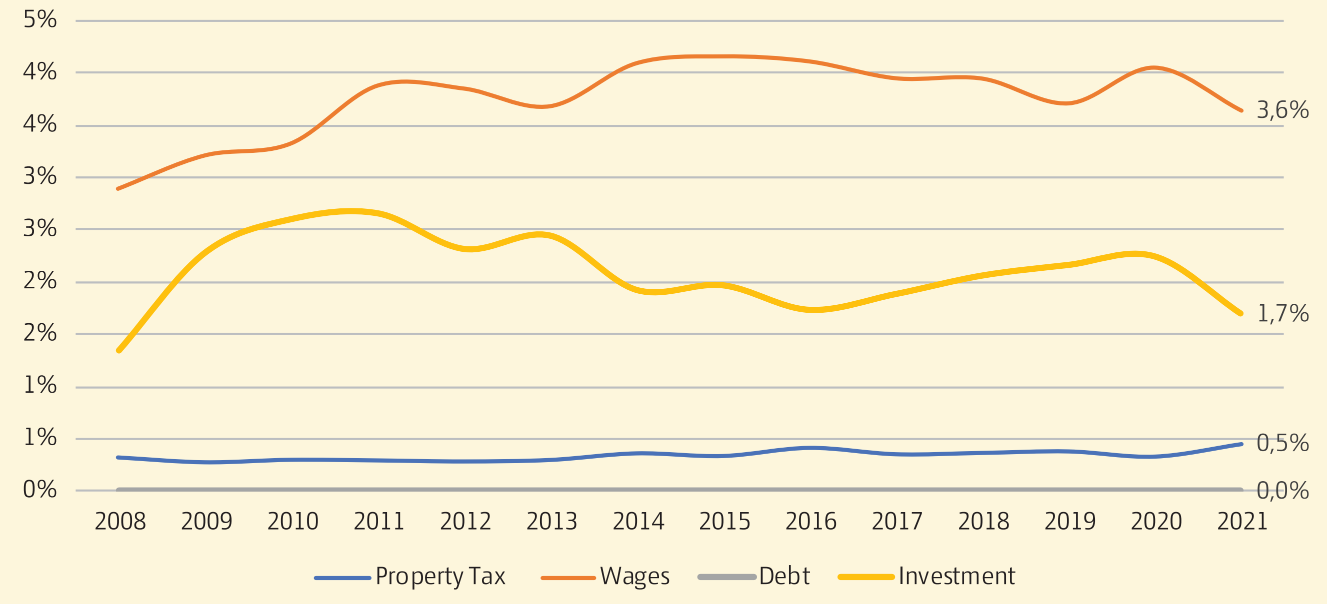


Figure 122 KOSOVO: INVESTMENT, WAGES, DEBT & PROPERTY TAX AS A SHARE OF GDP 2006-2021



Moldova

By Viorel Girbu, Congress of Local Authorities from Moldova

The Intergovernmental Finance System

At first glance Moldova has a highly decentralized public sector with rayon authorities, municipalities and first level local authorities responsible for preschools, primary and secondary education, social assistance etc. LGs in Moldova are responsible for 26% of total public revenue, among the highest levels in South-East Europe. However, this picture may be misleading because in practice, the central government and its deconcentrated structures continue to hold substantial decision-making powers. Further, due to the lack of progress in fiscal decentralization, most local governments' functions remain de-facto delegated, rather than decentralized.

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

According to the local public finance legislation, local governments in Moldova benefit from two types of transfers: **The General-Purpose Transfer**, financed from the balancing fund, and the **Special Purpose Conditional Transfers**, financed from the central budget. Between 2015 and 2021, both types of transfers provided from the state budget increased from 359 million EUR to 698.2 million EUR, making up 72% of total local revenue in 2021.

Both, cities and villages (Local Public Administration level 1 (LPA1)) and municipalities and rayon's (Local Public Administration level 2 (LPA2)), excepting Chisinau and Balti municipalities and localities from the Gagauzia region, can benefit from General-Purpose Transfers, which are allocated from the balancing fund, 45% in favour of LPA1 and 55% in favour of LPA2. The balancing fund is funded from the remainder wage tax revenue after a part of it is transferred to local governments' budgets as shared taxes, in the following proportions: 100% for the budgets of villages, cities (excepting capital cities of rayon's) and municipalities; 50% from the revenue generated by the wage tax in the Chisinau and Balti municipalities, excepting LPAs level I part of the mentioned municipalities; 50% to the budgets of the municipalities—capital cities of a rayon; 25% from the revenue generated by the wage tax in the cities/municipalities capital cities of the rayon, for rayon's.

General-Purpose Transfers are distributed to local governments based on an estimated fiscal capacity per inhabitant, multiplied by a coefficient of 1.3, population and territory of each LPA1. For LPA2, the allocation criteria refer to population and territory. General purpose transfers are limited to the share of funds allocated to LPA1 and LPA2, and to the total amount of the balancing fund created from the revenues generated by the wage tax. The rules for the distribution of the General-Purpose Transfers could lead to a situation in which available funds are lower than the amount needed to meet the average fiscal capacity per inhabitant for all LPAs. As an exception, according to the provisions of the annual budgetary law for the years 2021-2022, the balancing fund was supplemented by additional resources in the amount of 10% of the revenues generated by the corporate tax in 2019, respectively 2020. The balancing fund was further supplemented with resources for covering the supplementary costs that followed the amendment to the legislation on the salaries of the staff in the public sector and for the administrative-territorial units that certify decreases in the means received from the state budget compared to 2021.

Special Purpose Conditional Transfers are allocated to local governments to fund expenditure needs of the educational sector, road infrastructure, delegated functions and capital investments. These transfers do not finance own, rayon level, or social protection services provided by municipalities and rayons. Additionally, LPA1, have no competence in the distribution of the funds allocated for the development of the road infrastructure, which limits local financial decentralization.

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

The autonomous region of Gagauzia has a broader resource base, although it cannot benefit from transfers from the balancing fund. Gagauzia's own source revenues are composed of 100% of revenues generated on its territory by tax on wages, tax on income, VAT and excise.

The most important local governments' own source revenues in Moldova, after 2014, are the taxes on goods and services (taxes on specific services, VAT, Taxes and payments for the use of goods and for the practice of certain kinds of activity, etc.) and property taxes. On average, the property tax accounts for 44-48% of own source revenues, while the share of the VAT and excises varies between 46-54%. Overall, own source revenues have a relatively low volatility.

Local Government Own source revenues

While local governments have no authority to influence the administration of the VAT and excise as it is regulated by the central authorities, the situation for local taxes and the property tax is different. The property tax rate can be set within limits prescribed by national legislation, while LPAs have the freedom to establish any rate for the other local taxes. Yet, this reality has changed. During 2021, under the influence of foreign entrepreneurs' organizations, central authorities attempted to cap the rates of local taxes, as per nominal rates set in the Fiscal Code. Nevertheless, ultimately, the regulation on local taxes reverted to its initial text that provided higher autonomy in this area for the local authorities.

The property tax used to be most important source of own source revenues in Moldova before changes to the legislation that introduced a new taxation system. Since then, given the inability of the central authorities to enforce the implementation of the new taxation system, revenues generated from the property tax decreased by about ten times (expressed as a share of GDP). Currently, the property tax is based on the value of intravilan and extravilan land, buildings, and constructions. The value of real estate is initially determined by the cadastral authority—during the process of transition to the new rules on property taxation, a process initiated in 2002 but not yet finalized—which is subordinated to the central authorities. According to the law, re-evaluation has to be operated every 3 years, with funding from central or local government revenues. Until now, most of the intravilan and extravilan land, buildings and constructions in rural areas neither underwent the initial evaluation procedure nor any further at every 3 years revaluation, generating huge losses to local budgets, while LPAs do not have the capacity to influence developments in the mentioned domain.

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

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

Borrowing

Local governments in Moldova may incur debt and access financial markets for both short term liquidity constraints and longer-term capital investments. The legislation provides that in the case of short-term debt the executive authorities, based on the decisions of the respective representative and deliberative authorities, have the right to take out loans to cover temporary cash gaps, due in the same budget year, from financial institutions and other creditors in the economy. The total volume of loans to cover temporary cash gaps, due in the same budget year, must not exceed 5% of the total approved (amended) revenues of the local budget to which the loan is granted, except for special destination transfers, this being a mandatory condition for taking out loans.

Additionally, the executive authorities, based on the decisions of the respective representative and deliberative authorities, have the right to borrow for capital investments. In this respect the LPAs have the right to attract long-term internal loans from financial institutions and other creditors in the economy and long-term external loans from international financial institutions and can issue bonds in capital markets.

LPAs have also the right to grant, within the limits of own income, to municipal enterprises and commercial companies with full or majority municipal capital, for capital investments, guarantees for internal loans from financial institutions and from other creditors in the economy and for external loans from international financial institutions.

Borrowing for capital investments is allowed if the total amount of annual payments (repayment of the principal amount, payment of interest and other related payments) related to servicing the debts of the local budgets for the loans contracted or guaranteed and/or to be contracted or guaranteed will not exceed 20% (30% in case of Balti and Chisinau municipalities) of the total annual revenues of the respective budgets, with the exception of special destination transfers.

Local government debt is relatively constant in Moldova, being kept between 0.2% and 0.3% of GDP over 2013-2018. The stock of local debt decreased in 2019 to 0.1% of GDP and started to increase, registering 0.4% of GDP in 2021. Mainly, local government debt is concentrated in larger municipalities.

COVID-19 Impact and implications for Local Government Finances

Total local government revenues increased by 9% in 2020 compared with 2019. The increase of the LPAs incomes was mainly due to the increase in the transfers from the state budget (responsible for 84% of the growth) followed by an increase in the fiscal revenues, in particular from the Personal Income Tax (by 14.8%). As per the legal provisions the allocation of the PIT revenues in 2020 is performed on the actual data for the completed budget year, which in practical terms refers to 2018.

Freely disposable grants from the state budget increased by 62% while special purpose transfers grew by 3%. The increase in freely disposable grants is to be attributed to the specificities of the allocation formula, that considers the personal income tax data of two years before the budget year for which the allocation is performed. Nevertheless, according to the text of annual budgetary law for 2020, the balancing fund, formed by the revenues generated by personal income tax, from where freely disposable grants are allocated to the LPAs, was supplemented by an amount equivalent to 10% of the revenues generated by the corporate tax in 2018. Referring to own source revenues, during 2020 relatively little growth was achieved in the revenue generated by the property tax, while revenues generated by the taxes on goods and services decreased, as happened also regarding assets revenues.

Local government expenditures increased by 8% in 2020. The increase in expenditure was mostly concentrated in covering higher personnel costs (up to 95% of the growth in spending). According to the functional classification of spending, the sectors with the highest contribution to the increased spending in 2020 as compared to 2019 are the education sector (36%) followed by services in the economic domain (32%) and household and communal services (20%).

Advocacy efforts of the Local Government Association in the area of local finances

The Congress of Local Authorities from Moldova (CALM) has successfully advocated for the improvement of local finances and advancing of fiscal decentralization in Moldova. CALM has contributed to the recent adjustment of the rules that led to an increase of the share of the revenues from the shared tax on personal income allocated to small cities and villages (to the level of 100% collected in the respective localities); the supplement of the balancing fund with income generated by the corporate income tax; the assignment of 100% of the revenues generated by the road tax to LPAs; and the reorganization of the regional development fund. In addition, amendments to the legislation on aquatic objects were adopted, which strengthens the role of LPAs and local revenues.

Despite the recent successes, financial decentralization, and the reorganization of competencies of local authorities remain a challenging domain in Moldova. In fact, the dialog with competent authorities at the national level is limited, specifically with the Ministry of Finance. Besides the re-initialization of the parity commission on local decentralization, there are hardly any signs of thorough improvements. On these notes, the most relevant annual policy documents have been developed and approved without any consultation with CALM. A formal consultation is organized in part to policies with low financial impact on the local budgets. Yet, draft policy documents on fiscal policy, the Medium-Term Expenditure Framework (MTEF), or in the area of wages that are of paramount importance for LPAs are not consulted with CALM. Recently the central government increased the level of wages in the public sector but placed the responsibility for the increased expenditures on LPAs. There is hope to improve this situation with the reinitialization of the parity commission.

Statistical Overview of Local Government Finances in Moldova 2006-2021

From a functional perspective, Moldova has a highly decentralized system of public administration. Yet, from a regional comparative perspective, local governments are severely underfunded, with great repercussions in service delivery. In relative terms, local governments revenues have fallen from a maximum of 10.5% of GDP in 2009-2010 to 8.4% of GDP in 2021. Since 2014 Moldova has implemented a new system of local finances which seems to have not been able to bring positive developments for local budgets.

The share of local revenues has decreased, both, in terms of a percentage of GDP and of total public revenues, compared to 2010 or 2014. However, as can be noticed, the share of public revenues to GDP has also been declining since the peak of 2007. To some extent the declining tendency in local and public revenues with respect to GDP is also explained by changes in the methodologies for the estimation of the GDP that has led to an increased value of the estimated GDP. From this perspective the indicator of local revenues to total public revenues, while lower than in 2009-2010, is still relatively stable and records even an improvement over the past three years.

The growth rate of local government revenues seems to have followed to a great extent the performance of the overall public revenues for the period until 2016, suggesting that local government revenues have been increasing in annual terms at the same rate as total public revenues. In 2020, while local revenues retained a positive growth rate, total public revenues fell by 0.5% to quickly recover in 2021, at a higher rate than the total public revenues.

Figure 123 MOLDOVA: LG REVENUE AS A SHARE OF GDP AND TOTAL PUBLIC REVENUE 2006-2021

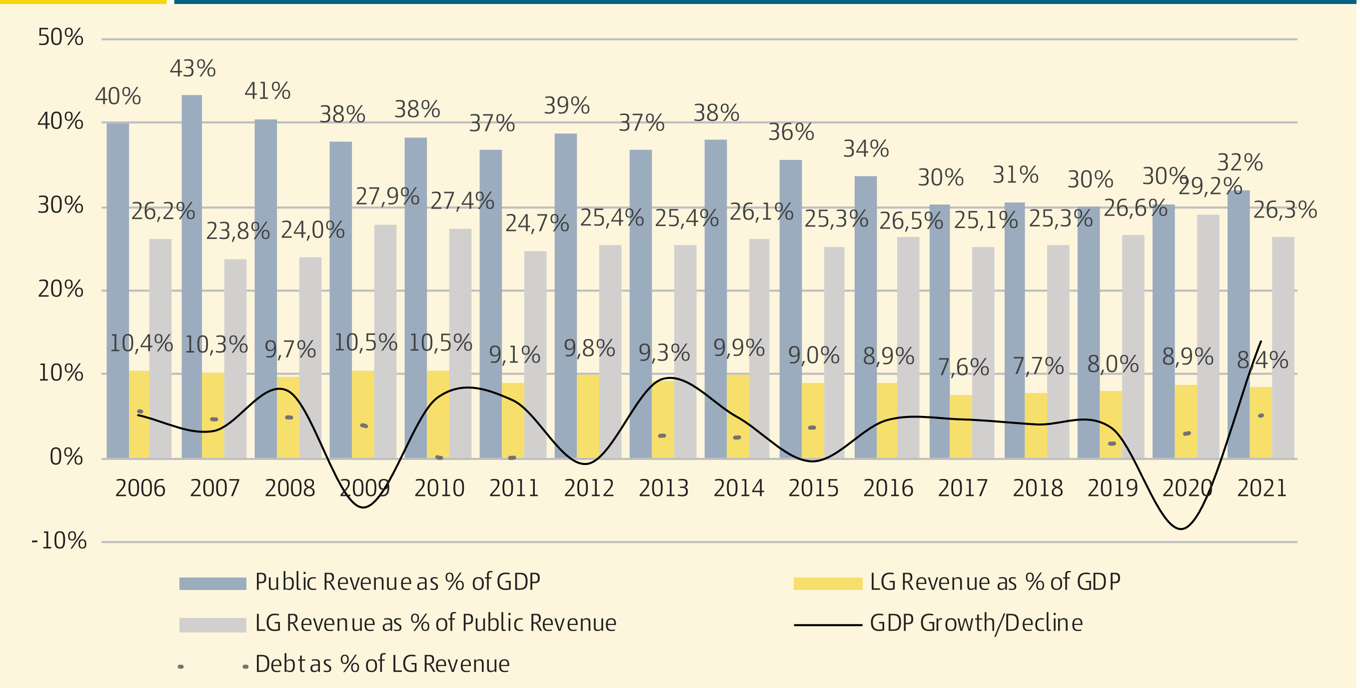
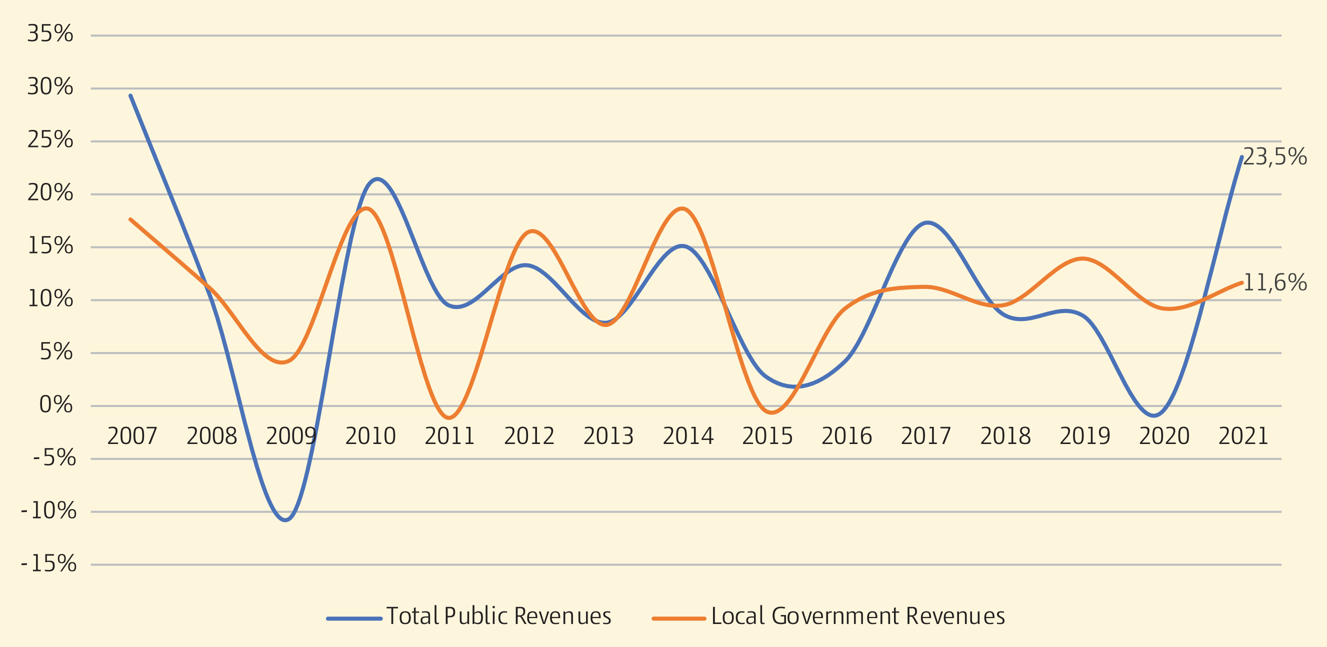


Figure 124 **MOLDOVA: FLUCTUATIONS IN THE REVENUES OF THE GENERAL GOVERNMENT AND LOCAL GOVERNMENTS 2006-2021**



Moldovan local governments derive most of their revenues from conditional sectoral block grants. Unconditional grants, introduced in 2015, play a rather modest role. The share of shared taxes in the system, likewise the share of own source revenues, has significantly decreased, specifically with the 2014 reform. Own revenue as a share of total revenue is low. In absolute terms, local revenues increased sharply in 2012-2013 and overturned sharply in 2015. Since then they've recovered with the increase in the size of sectoral block grants, over which local governments exercise little, if any, control. Overall, fiscal decentralization in Moldova remains very weak.

Figure 125 MOLDOVA: COMPOSITION OF LOCAL GOVERNMENT REVENUE 2006-2021

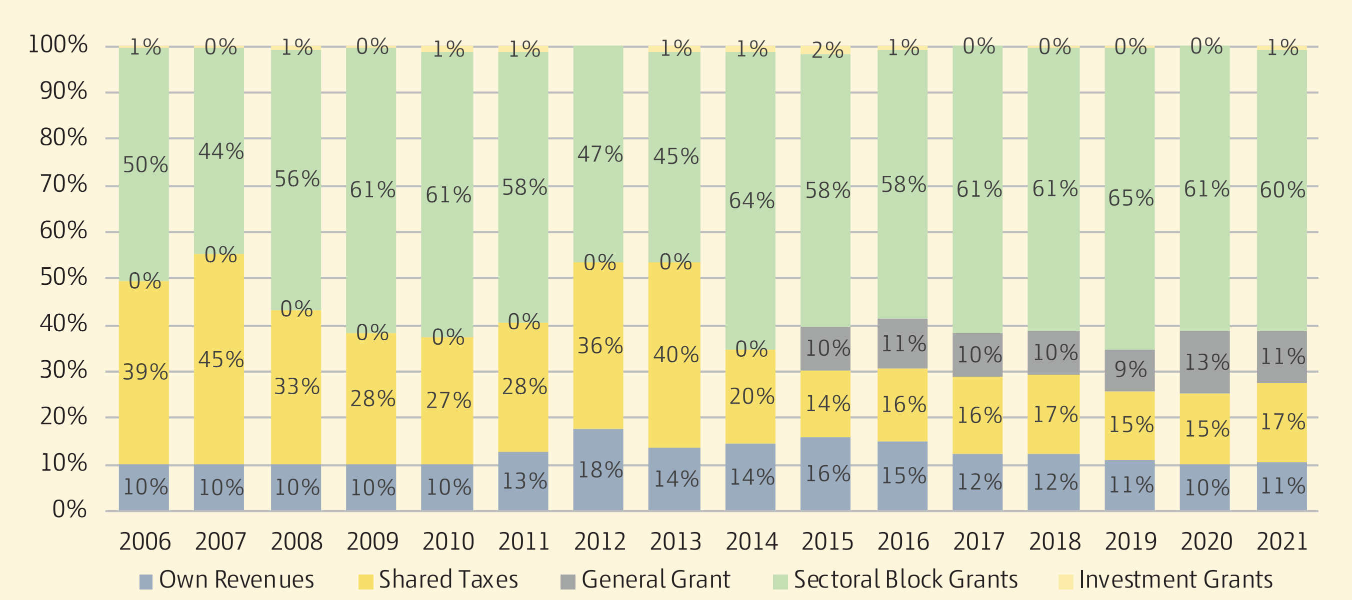


Figure 126 MOLDOVA: COMPOSITION OF LOCAL GOVERNMENT REVENUE 2006-2021, IN MLN EUR

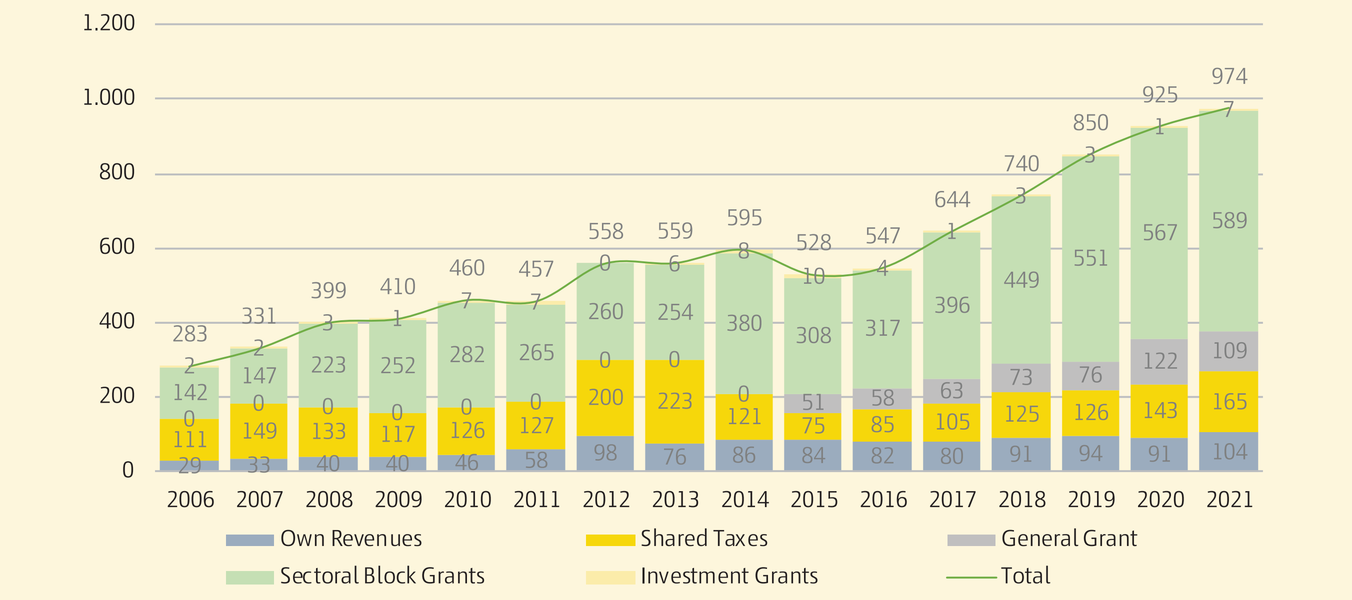
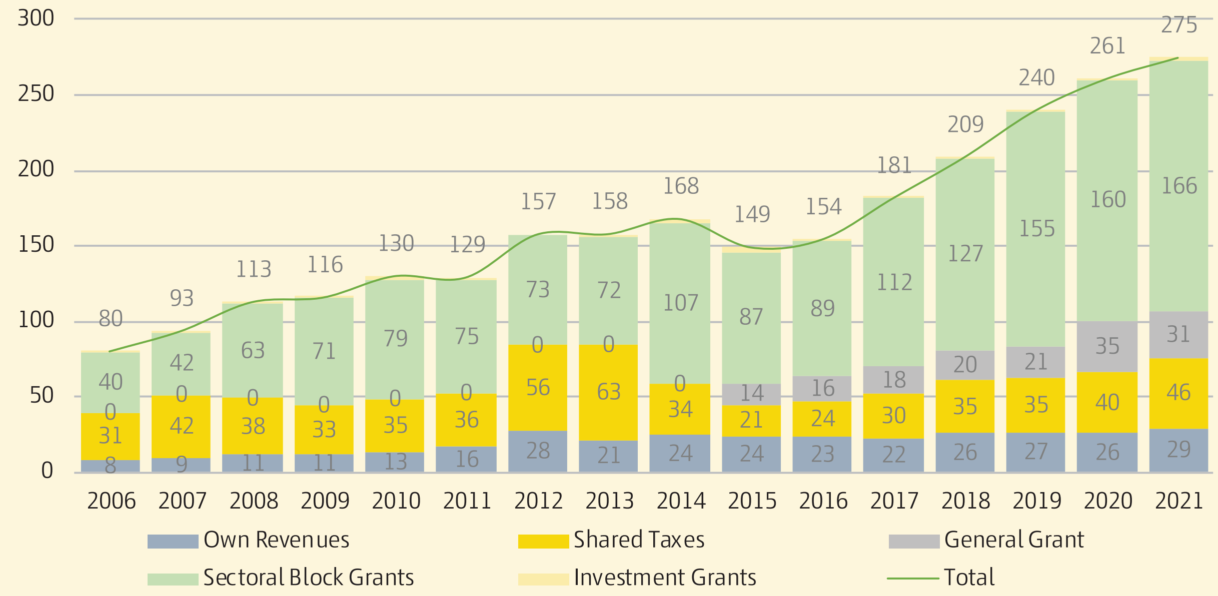


Figure 127 **MOLDOVA: COMPOSITION OF LOCAL GOVERNMENT REVENUE 2006-2021, IN EUR PER CAPITA**



According to the types of own source revenues collected at the local level, Moldova has seen a significant shift since the 2014 reform. The share of Taxes on Goods and Services in the total income of local governments increased significantly (although in fact these are revenues of the Gagauzia autonomous region, that is the only region that can benefit from this sorce of income), subsequently leading to significant disparities in financial autonomy between different types of local governments in Moldova. The share of the property tax has increased as well, over the past few years, from a minimum of 20% in 2013 to 32% of own source revenues in 2021.

In terms of expenditures, there are significant fluctuations in Moldova. After a sharp decline between 2006 and 2012, spending on investments has been increasing, since 2018. Spending on wages and benefits (salaries), in particular since jumped in 2009 because of state mandated increases in teachers' salaries but have since fallen to increase again in the past few years. Spending on goods and services has also declined over the past years.

Figure 128 MOLDOVA: COMPOSITION OF OWN SOURCE REVENUES 2006-2021, IN % OF TOTAL

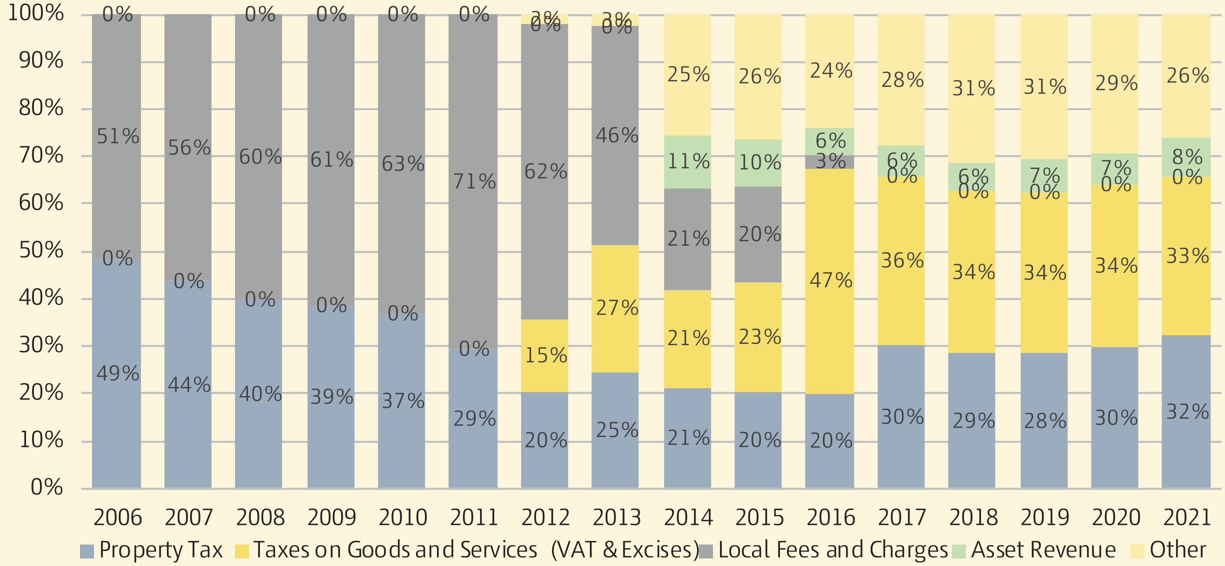


Figure 129 MOLDOVA: COMPOSITION OF LOCAL GOVERNMENT EXPENDITURES, IN % OF TOTAL

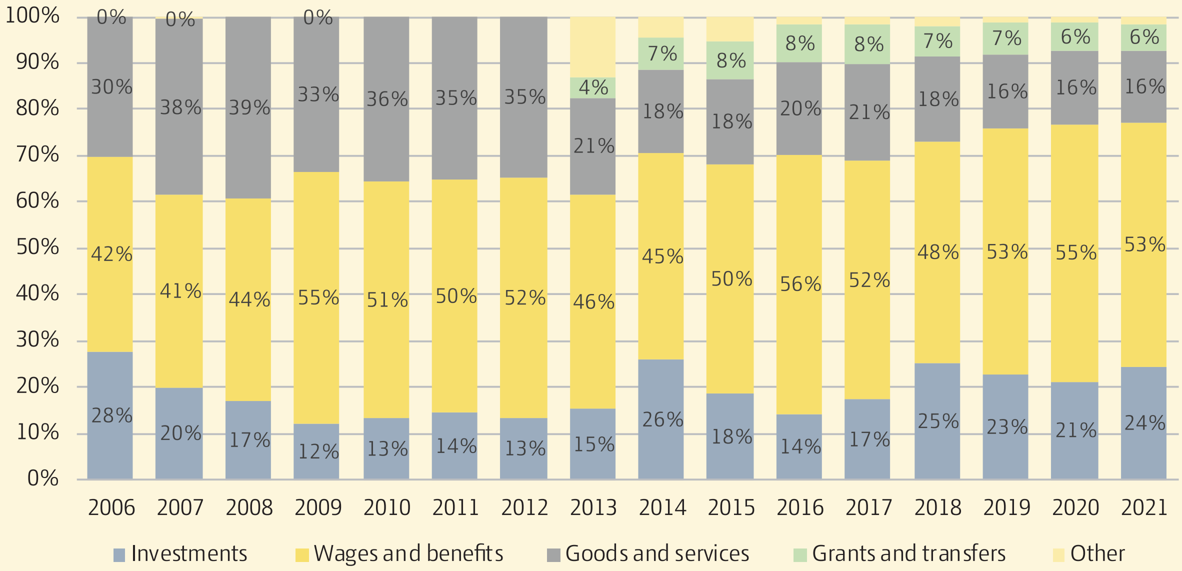
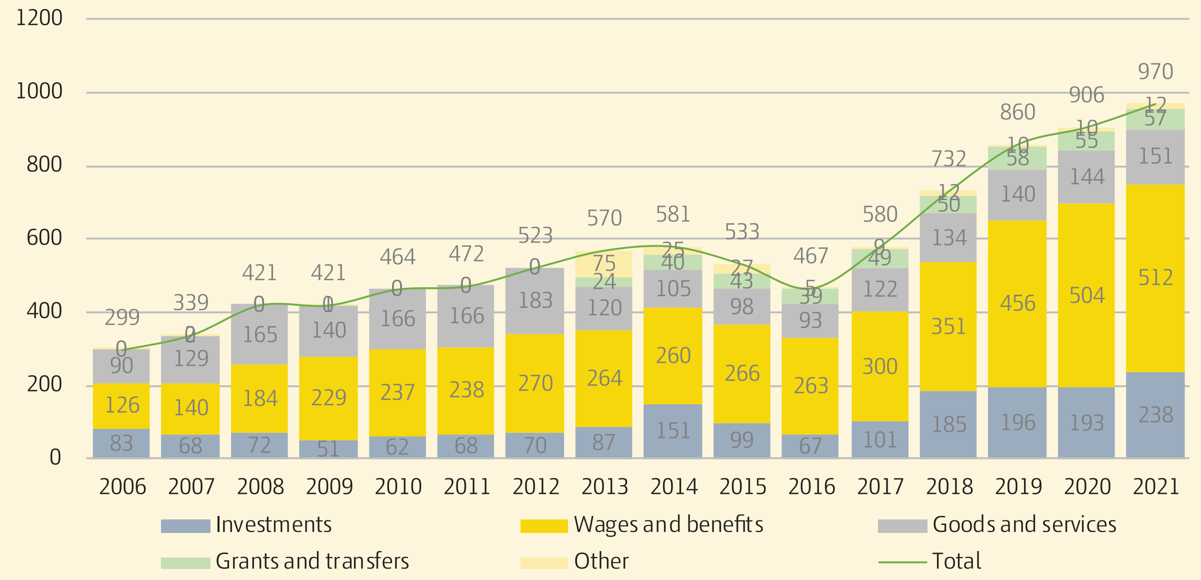


Figure 130 MOLDOVA: COMPOSITION OF LOCAL GOVERNMENT EXPENDITURES, IN MLN EUR



However, in nominal terms, spending for salaries has increased much faster than spending for investments and the growth of spending for goods and services is very limited, as indicated by the figures below, showing local government spending in million EUR and in EUR per capita.

The data on total public investment for Moldova shows a drop as a percentage of GDP from 8.5% in 2014 to 3.6% in 2021. In terms of composition of investments, since 2018, local governments drive public investment in Moldova, contributing to more than half of total public expenditure, a unique situation in South-East Europe.

Figure 131 MOLDOVA: COMPOSITION OF LOCAL GOVERNMENT EXPENDITURES, IN EUR PER CAPITA

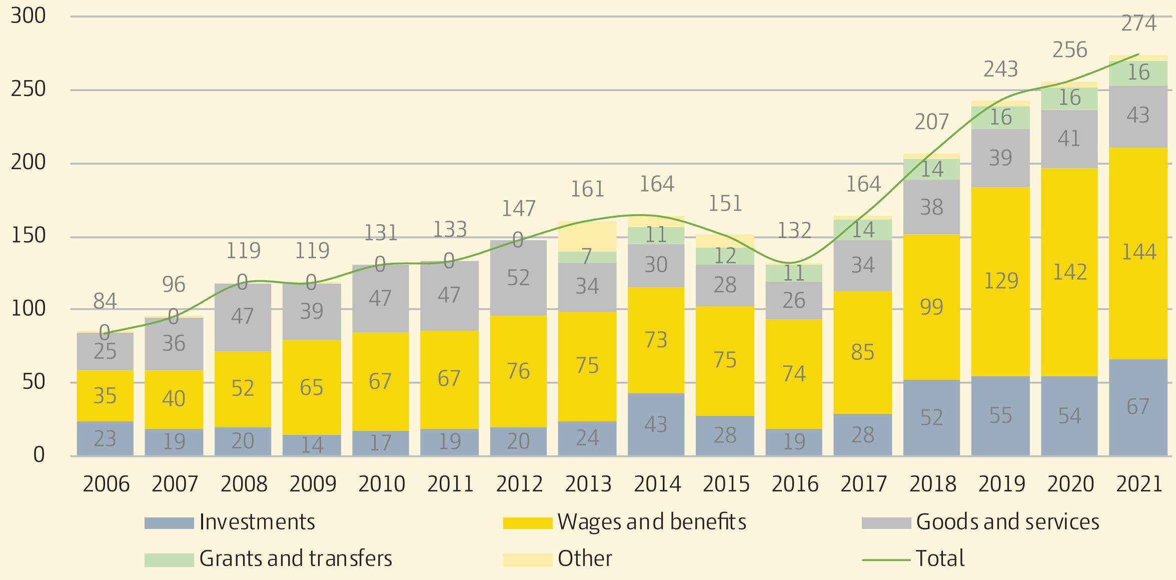


Figure 132 MOLDOVA: PUBLIC OF INVESTMENT BY LEVEL OF GOVERNMENT AS A % GDP

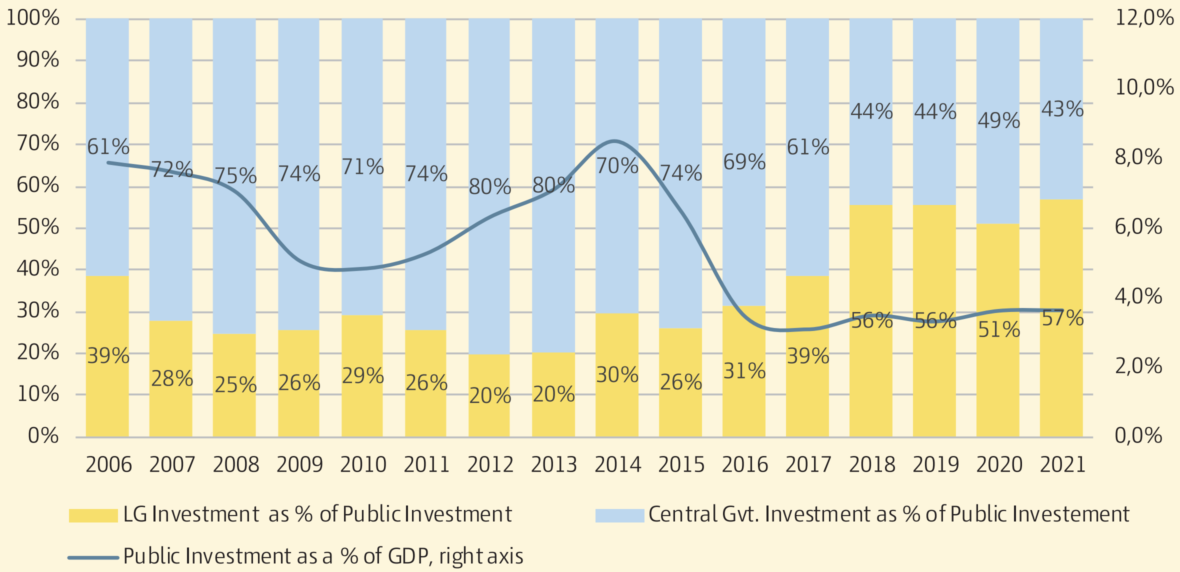
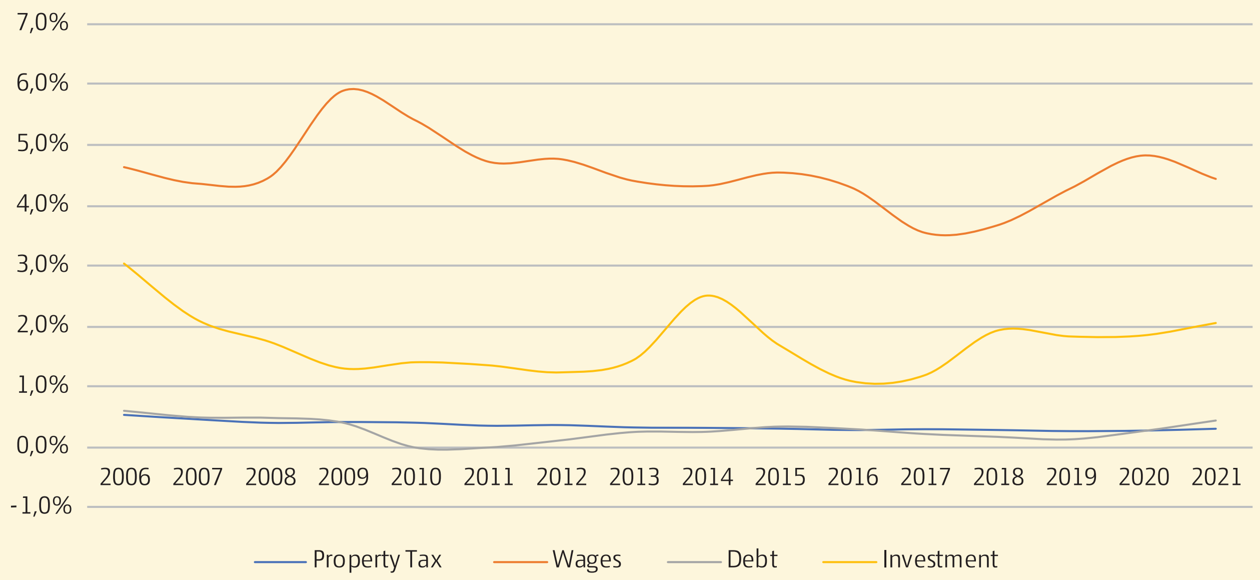


Figure 133 MOLDOVA: INVESTMENT, WAGES, OUTSTANDING DEBT AND PROPERTY TAX AS SHARES OF GDP 2006-2021



The yield of the property tax has slowly declined as a share of GDP and in 2021 stands at 0.3%. Spending for local wages as a share of GDP remains high, though it has fallen since 2009. Spending for LG investment is low, but rose in 2014 to fall and than recover again in subsequent years. Debt financing is near the same levels of the revenues from the property tax.

Montenegro

By Žana Đukić, Union of Municipalities of Montenegro

The Intergovernmental Finance System

The local self-government financing system in Montenegro is regulated by the Local Government Finance Law. In accordance with the law, municipalities receive financing from their own source revenues and benefit from shared revenues, the equalization fund and the transfers from central budget.

Advocacy in action: property tax exemptions hinder local authorities financing position.

The latest changes in 2021 of the '*Regulation on the detailed Criteria and Methodology for the Determination of the Market Value of Properties*' provided some exemptions from taxation of legal entities implying that municipalities could not tax certain properties.

In accordance with the Agreement on cooperation between the Parliament of Montenegro and the Union of Municipalities (UoM), the UoM submitted to the Parliament the Proposal of the Law on Amendments to the Law on Property Tax which includes all related provisions. The Law on Amendments to the Law on Property Tax was adopted by the Parliament in the first half of the 2022.

Montenegro's 25 municipalities[10] benefit from an intergovernmental finance system that is still unique to the region. Local governments used to derive up to 80% of their total revenues from own sources of revenue before the global financial and economic crisis of 2008-09. Since then, the share of own source revenues to total local revenues has decreased, but remained quite high compared to the region. Over the past few years, own sources constituted 63% of total local revenues. This is in part because municipalities have only a few social sector competencies and therefore are less dependent on intergovernmental grants. And in part it is because Montenegrin local governments control a variety of instruments to tax land and buildings. However, the character of the land and buildings instruments has changed substantially over the past decade, and not necessarily in the best interest of local authorities.

Own source revenues in Montenegro are listed in the Law on Local Government Finance but most of them are regulated by specific laws. The most important own source revenues are the property tax; the surtax on PIT; local administrative charges; local communal charges; the land development fee; fees for the use of municipal roads; revenues from the sale and rent of municipal property; etc.

The property tax in Montenegro was decentralized in 2003. Since then, the collection of the tax has increased significantly. The tax rates are set between 0.25% and 1.00% of market value. Local governments are responsible for tax assessments based on data from the State Statistics Office and/or State Tax Authority on the market value of a square meter of property in each jurisdiction. If these institutions don't have such data, municipalities can engage a court expert to define the market value, but this solution is very expensive and is used very rarely. Market value is calculated by multiplying a market price per m2 with the property surface area in square meters and other criteria that have influence on the market value: the use of the property; its location, its quality, size and several other elements that could influence its value. According to the Law, the owners of land and buildings are liable for the tax. However, if the owner of a

[10] In the last ten years, number of LGU increased from 21 up to 25. New LGUs (Petnjica, Gusinje, Tuzi and Zeta—Zeta was the last declared as a municipality in the August 2022) were formed to ensure better and more efficient territorial organization to provide for citizen's needs.

property is not known, the occupier or user of the property is the taxpayer. Local Tax Authorities create and update their Fiscal Registers of taxpayers based on data from the Cadastre Office, although the Cadastre data is often problematic for property tax purposes. The property valuation process is regulated by the Regulation on the detailed Criteria and Methodology for the Determination of the Market Value of Properties'.

The ***land development fee*** is regulated by the Law on Spatial Planning and Construction. It is paid by the investor as a precondition for the construction works. This is the most important local capital revenue, intended to finance building of the public infrastructure to serve the new building. It is charged by a municipal legal act, with prior Government approval. Revenues from the land development fee remain very relevant to municipalities despite their reduction after the economic downturn and the legal limitations introduced in 2009.

With the adoption of the General Regulation Plan of Montenegro (expected in 2023) the Government plans to abolish this fee and introduce a ***fee for development*** (paid for undeveloped building land, for building land utility infrastructure and for the preparation of building land for structures). On the other side, the owners of the developed building land, which was intended for building according to the planning document, will pay ***city rent***. The government believes that these revenues will, on the right way, compensate revenues from land development fee. This Law also prescribed the urban sanitation fee paid by illegal structure owners. It is especially important to emphasize that the Law on Spatial Planning and Construction from 2017 deprived municipalities of their competence for spatial management by revoking their authority to adopt local planning documents which, going forward, shall be replaced by a single General Regulation Plan to be adopted by the central government. This document is still under preparation, and the deadline for its finalization was extended until October 2023 (through the amendments to the law from August 2022). These legislative amendments curtail municipal competences in urban planning and management while also denying municipalities a key instrument in terms of the ability to create a favourable environment for local economic development and significantly slowing down the implementation of new initiatives related to domestic and foreign investments.

Montenegrin municipalities significantly use a **surcharge on the Personal Income Tax** (PIT) which makes up more than 14% of total local government revenues. The ***PIT Surtax*** is regulated by the Law on Local Government Finance and the Law on Personal Income Tax. The tax rate is 13%, except for the Capital City and Royal City where it is 15%.

At the same time, the role of the land development fee and the fees for the use of municipal roads has been reduced until 2016. After 2016, it recorded a certain growth of these revenues, except in 2020 when it declined because of the COVID-19 crisis. Additionally, land use fee and some local business taxes and charges have been completely abolished between 2008 and 2010, compounding the effects of the global crisis.

The Montenegrin system of **shared revenues** and **equalization system** is prescribed with the Local Government Finance Law (LGFL). In accordance with the Law, municipalities have the right to the shared revenues from the following sources, which taken together, provide 20% of total local revenues in 2021:

- Personal Income Tax – depends of the region—(1) 50% for Costal and Central region municipalities, and 2) 100% for Northern municipalities,
- 80% of the Property Transfer Tax;
- 70% of the revenues from concessions and other fees for using natural resources awarded by the State; 50% of the revenues from the fee for use of coastal resources;
- 100% of the annual fees for the registration of motor vehicles, tractors and trailers

Montenegro has as a reasonably robust and evolving ***equalization system***, which provides for about 11% of the total local revenues. The equalization system changed in the last few years and in accordance with the last reform, equalization monies are allocated based not on the own source revenues but based on the shared revenues. Fiscal equalization is performed through the Equalization Fund, which is formed from 11% of the national yield of the Personal Income Tax, 20% of the national yield of the Property Transfer Tax, 100% of the national yield of the Vehicle Tax and 40% of the yield of concession fees from games of chance. A municipality with a development level below 100% of the average development index value, in accordance with the law on regional development, has the right to benefit from the Fund. The Old Royal Capital has no right to benefit from the fund, because the Law on the Old Royal Capital prescribes that the budget of Montenegro provides funds in the amount of 1% of the project value of the current budget of Montenegro for each fiscal year for the needs of the development of the Old Royal Capital.

In accordance with the LGFL, Equalization Funds are allocated as follows:

- A fixed allocation of 15% in equal amounts for all municipalities eligible for using the Equalization Fund;
- further 35% based on the territory (50%) and no. of inhabitants (50%);
- the remaining 50% based on average per capita PIT revenues for each municipality for the year preceding the year when the allocation is made, in reference to the average calculated PIT revenues per capita for all municipalities for the given period.

The resulting amount is increased by applying the ratio of 1,5 for the municipalities with the total population under 3,000 as well as with the ratio of 1,1 for the municipalities with the total population above 3,000, but below 6,000.

The LGFL also prescribes the **Support Fund for pre-financing donor funded projects** with the aim to support municipalities in these projects. The Support Fund receives funding from the central government budget in a separate account from the Ministry of Finance. The annual Budget Law allocates funds for the Support Fund in line with the estimated value of funding required for pre-financing donor-funded projects in a given budget year. Municipalities that have concluded a project implementation agreement with a donor or a lead partner are entitled to use the Support Fund. The Law also prescribes the procedures for the usage of the Fund, as well as other important provisions such as the obligation for the municipality to reimburse the Support Fund after having received funding from the donor or lead partner, no later than 12 months from the utilization of the Fund.

Advocacy efforts of the Union of Municipalities of Montenegro

The Union of Municipalities of Montenegro (UoM) advocates for the protection of the fiscal autonomy of municipalities in Montenegro. Of particular relevance are the advocacy efforts for compensating municipalities for the implementation of the regulations of the 'Europe Now' Economic Reform Program that significantly hindered local government revenues.

The System of shared revenues and equalization system changed in the last few years, especially with regard to the Personal Income Tax. In November 2021, the Government of Montenegro adopted the **Economic Reform Program "Europe Now"** and the accompanying regulations for its implementation.

The most significant implication for municipalities related to the Personal Income Tax where the Law introduced the category of the "tax-free income" which implied that all income up to a gross amount of 700.00€ is not taxable. This produced a negative impact on municipal revenues via decreased revenues from the PIT, the Surtax on the PIT as well as from the Equalization Fund, considering that almost 50% of this Fund is financed from PIT revenues.

Montenegrin municipalities were not consulted or included in any way in the preparation of the program and the related laws, grossly violating the provisions of the European FIGUREer on Local Self-Government, the Law on Local Self-Government, and the Recommendations of the Council of Europe (2005).

The Executive Board of the Union of Municipalities held a session during November 2021, and submitted its deliberations to the Parliament of Montenegro, the Government of Montenegro and the Ministry of Finance and Social Welfare. The UoM Board formed a Working Group to negotiate with the Ministry of Finance and the Parliament of Montenegro and mitigate the negative impact of the Program on municipalities by compensating municipalities for their losses from the implementation of the "Europe Now" Program.

The Parliamentary Committee for Economy, Finance and Budget acknowledged the negative implications for municipalities and tasked the MoF and UoM to agree on compensatory measures. Unfortunately, while some agreements were reached, the MoF did not comply with the total set of compensatory measures – in fact only the measure that allocated €15 million from the state budget reserve fund was realized.

Because of the seriousness of the problem and the need for an urgent solution, UoM informed the President of the Parliament of Montenegro and requested convening a Parliamentary session under urgent procedure, to adopt the Amendments on the Local Government Finance Law, which would provide municipalities with compensation for lost revenues due to the implementation of the "Europe Now" Program. In this sense, a group of MPs submitted the Proposal of the Law on Amendments on the Local Government Finance Law, but the law was not included in the agenda of the Assembly session by the end of 2021.

On the other side, most of the regulations of the "Europe Now" Program that were adopted by the Parliament of Montenegro stared implementation at the beginning of 2022. As the first half of 2022 showed a significant decline of municipal revenues from the PIT, the Surtax on the PIT as well as from the Equalization Fund (because of the implementation of the Law on Amendments to the Law on Personal Income Tax), the Government of Montenegro compensated municipalities from the budget reserve, in accordance with the Budget Law for 2022.

In the meantime, the Proposal of the Law on Amendments to the Local Government Finance Law which was submitted by the group of MPs in December 2021 was included in the agenda of the Parliament session in July 2022 and adopted by Parliament thereafter. This Law came into force at the very beginning of August 2022 and prescribed the increased percentage of the PIT that is transferred to the municipalities i.e. 50% of the collected tax is transferred to the municipalities in the Coastal and the Central region and 100% of the collected tax is transferred to the municipalities in the Northern region as well as increased the percentage of allocation of the Property Transfer Tax included in the Equalization Fund from 10% up to 20% (the criteria for the distribution of the Fund are unchanged).

It is very important to emphasize that it is often the case that state authorities prepare laws and regulations that abolish or significantly reduce the revenues of municipalities or introduce new competences, without analyzing the impact of those regulations on the performance of functions. By the same token, municipalities are often times not consulted or compensated for their reduced revenues and increased expenditures due to decisions of higher levels of government. This example emphasizes the key role played by the Local Government Associations in voicing the needs of all municipalities.

COVID-19 Impact and implications for Local Government Finances

As elsewhere in the region, Montenegrin municipalities faced the implications of the COVID-19 pandemic. The 2019 provisions of the Law on Local Government Finance brought an increase in municipal own revenue collection and taxpayers' compliance. However, such gains were reversed in 2020. Municipal revenues decreased by almost 10% in 2020 (to increase again in 2021 almost on the same level as in 2019). On the other hand, municipal expenditures remained at the same level over the past three years. Total local government debt as a share of GDP increased by 0.5 percentage points compared to 2019, while the local government deficit in 2020 reached 38.5 million €, or close to 1% of the estimated GDP for 2020.

Municipal revenues from the Equalization Fund were, with minor deviations, at the level of 2019. Nevertheless, the analysis of the revenue structure shows different trends in certain types of municipal revenues. Revenues based on the PIT as well as on the Surtax on PIT in 2020 show a very slow decline in local budgets compared to their values in 2019. This is caused primarily due to the subsidization of wages in the economy through government measures. In order to limit the negative effects of the COVID-19 pandemic, the Government of Montenegro adopted several packages of measures to support the economy and citizens (assistance to the most vulnerable categories of the population and creating conditions for liquidity of the economy and the budget; ensuring conditions for preserving jobs and faster economic recovery; short-term and long-term measures aimed at recovering Montenegro's economy through economic diversification and increasing domestic production, etc.). As a result, total public revenues from PIT did not fall in 2020. Even more, during 2021 they increased by a small percentage. On the other hand, the largest part of own source revenues declined in 2020. The property tax, which is the basic own revenue of municipalities, compared with 2019 decreased almost up to 1 percentage point in 2020. Municipalities collected only 1/3 of local communal charges revenues in 2020 compared to 2019, while revenues from the municipal roads' utilization fees decreased significantly, as did the revenues from the land development fee.

These negative trends in own source revenue collection in 2020 have been caused mainly because of the measures adopted by the municipalities in overcoming the COVID-19 consequences. On this note, the Union of Municipalities of Montenegro (UoM) in 2020 developed proposals to assist municipalities in the preparation of their own municipal measures. The main proposals include the following:

- postponing the payment of the PIT surtax for 90 days, upon request of the taxpayer;
- postponing the payment of the property tax in 2 instalments: until 31 August and 30 November, at the request of tax-payer;
- reducing the amount of the local communal charge determined on the basis of occupation of public space (summer gardens, indoor gardens, and other movable objects, taxi stops, etc.) for a period of 90 days, in which a user did not use the public space due to Government measures (at the request of the taxpayer);
- reducing the amount of annual fees for the use of commercial facilities for a period of 90 days, i.e., the duration of the Government measures for which businesses did not perform any activity (at the request of taxpayer);
- releasing rent payments for a period of 90 days to tenants of business premises owned by local self-governments that did not carry out regular activities due to Government measures (at the request of the tenant);
- postponing the payment of construction land development fee, as well as fees for legalization of illegal facilities for a period of 90 days (upon request). Interest for arrears shall not be charged for the stated period;

- municipal contractors which are unable to complete works within the agreed deadline, due to lack of materials and human resources, will be extended the deadline for the completion of work, i.e., to draw up an annex to the contract, in order to avoid the payment of penalties for failure to fulfil obligations stipulated by the contract;

- reducing the amount of membership contribution to tourist organizations for a period of 90 days, i.e., the duration of measures of the Government for which they did not carry out their activity (at the request of taxpayers);

- forced collection of tax liabilities for the duration of the Government measures will not be made to the entities impacted by the measures.

- instructing local government bodies, institutions and public companies whose founder is the municipality to immediately request from the competent court, i.e., public executor the postponement of execution initiated upon their proposal, for a period of 60 days, for companies whose work is prohibited by the order of the Ministry of Health, and not to submit new proposals for enforcement, except in cases where there is a threat of obsolescence, for which they will also immediately after the decision determining enforcement, request its postponement until the expiration of the period.

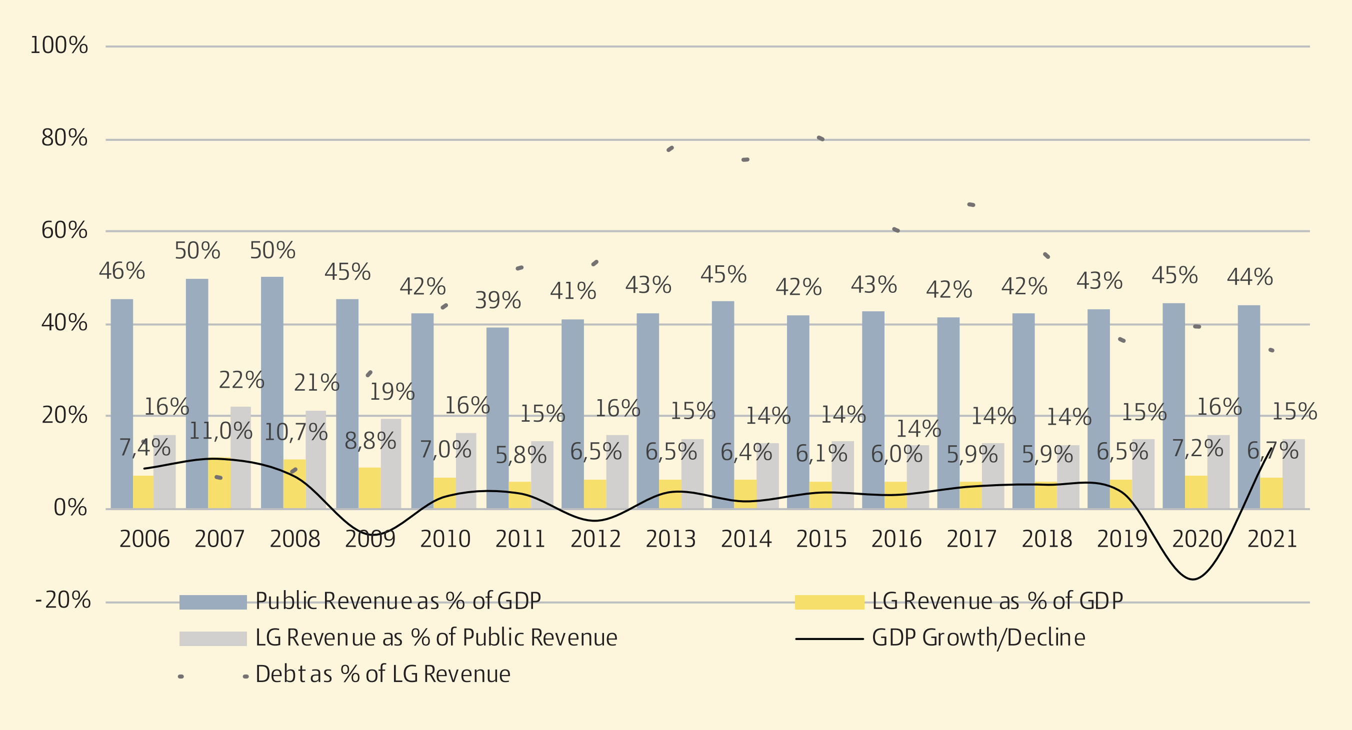
- instruct boards of directors of the public company that performs waste collection, removal and disposal services to ensure the exemption of payment of invoices for the period in which they did not perform activities by order of the Ministry of Health.

Most of these measures were implemented in 2021 as well. In these circumstances, municipalities remain under enormous financial pressure where they must ensure conditions for the delivery of their responsibilities. Given COVID-19 pandemic conditions, these responsibilities gain additional importance. Cooperation and mutual understanding between higher levels of government and local government units in defining and implementing the economic recovery strategy is necessary. Of course, municipalities themselves must contribute to that by more rational municipal spending decisions.

Statistical Overview of Local Government Finance in Montenegro 2006–2021

The share of local government revenue as a percentage of GDP in Montenegro was 11% in 2007. This almost equalled the EU average and was the highest in South-East Europe. This was fuelled by the real estate market expansion, significant public investments and considerable local revenue from asset sales, land development and land use. Since 2007, local government revenues have fallen significantly, and in 2019 their share equalled only 6.5% of GDP. The effects of the economic crisis were exacerbated by the elimination of several local revenue raising sources, in particular fees. As the COVID-19 crisis affected Montenegro's economy (GDP fell significantly), this indicator slowly increased in 2020.

Figure 134 MONTENEGRO: LOCAL GOVERNMENT REVENUE AS SHARE OF GDP AND TOTAL PUBLIC REVENUE 2006-2021



Local government revenues in Montenegro have fallen faster and recovered slower than the total revenues of the General Government for most of the period 2007-2017. The growth rate shows a better alignment in 2017. The implementation of the new Law on Local Finance, beginning in 2019, significantly improved this situation and resulted in a growth rate of 17% in 2019, while general revenues have only grown 9%. In 2020, local as well as total government revenues fell quite a bit. This situation was improved in the 2021.

Montenegrin municipalities are unique in the region in that they derive almost two thirds of their revenues from own sources. Until 2010, own source revenues accounted for more than 80% of total revenues but thereafter, there have been a series of legislative changes that cut some types of own source revenues. Changes in the Local Government Finance Law in 2019 increased the share of municipal revenues from shared taxes. In the same period, equalization revenues, nominally, were almost at the same level, while conditional grants have been abolished with the legal changes in 2019.

Figure 135 MONTENEGRO: ANNUAL FLUCTUATIONS IN THE REVENUES OF THE GENERAL GOVERNMENT AND LOCAL GOVERNMENTS

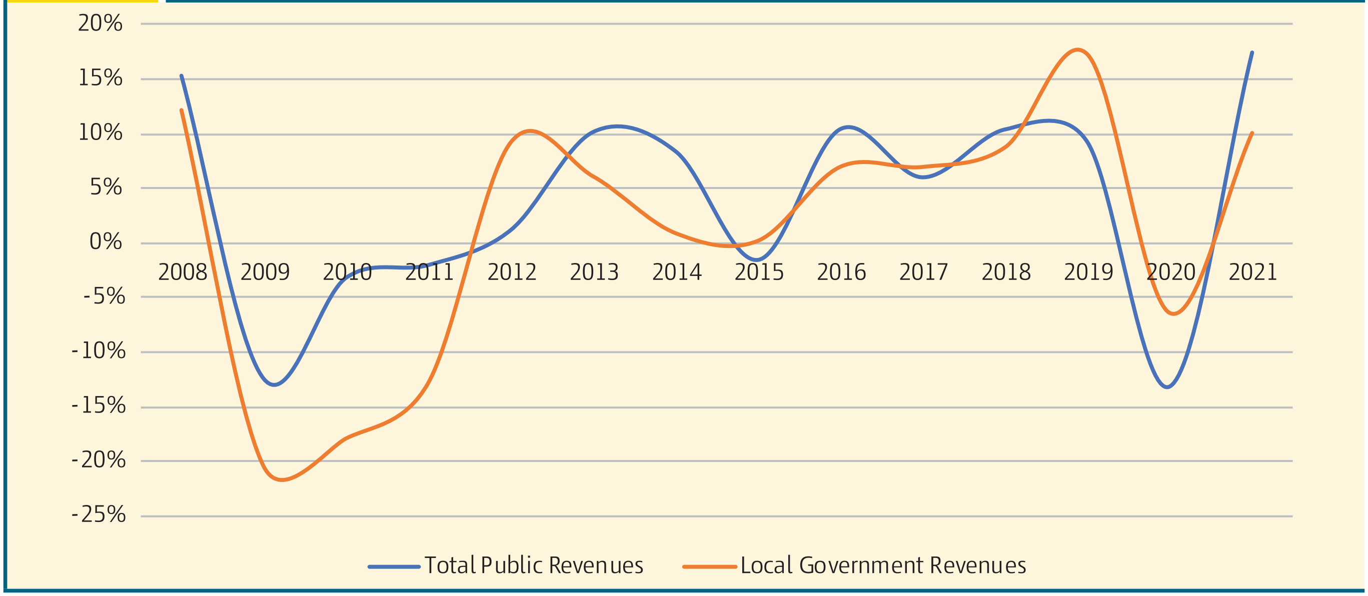


Figure 136 MONTENEGRO: COMPOSITION OF LG REVENUES 2006-2021, IN % OF THE TOTAL

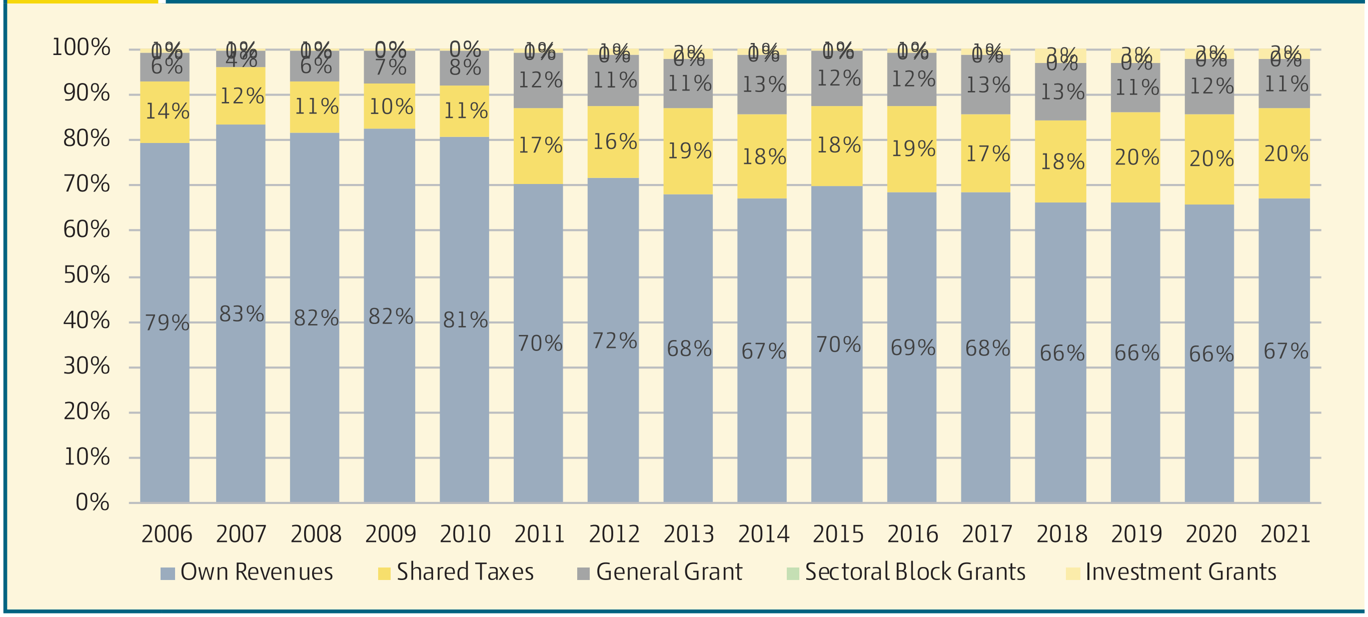


Figure 137 MONTENEGRO: COMPOSITION OF LOCAL GOVERNMENT REVENUES (MLN EURO)

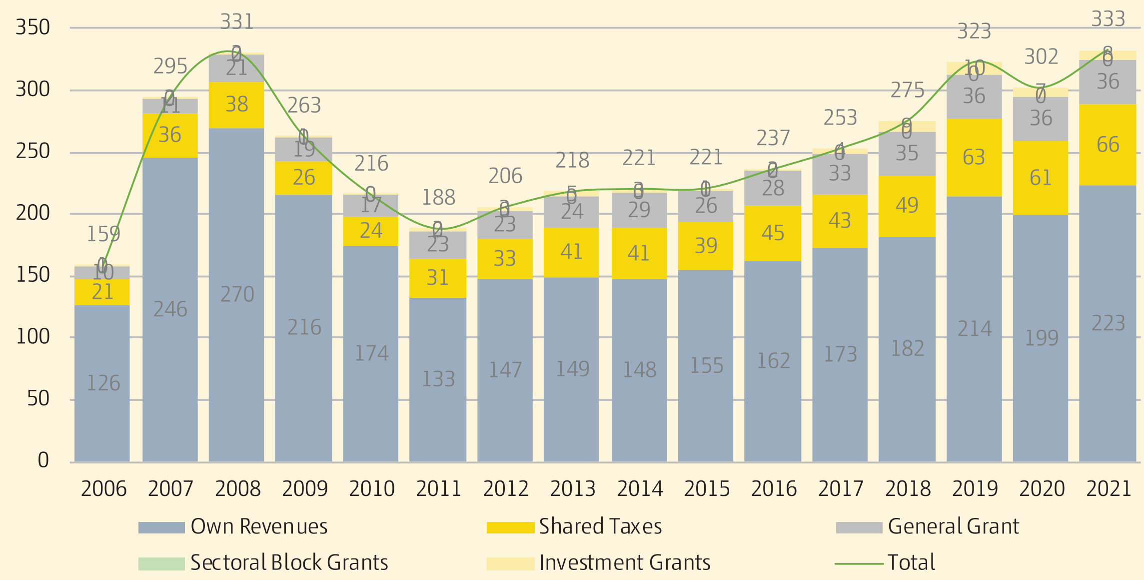
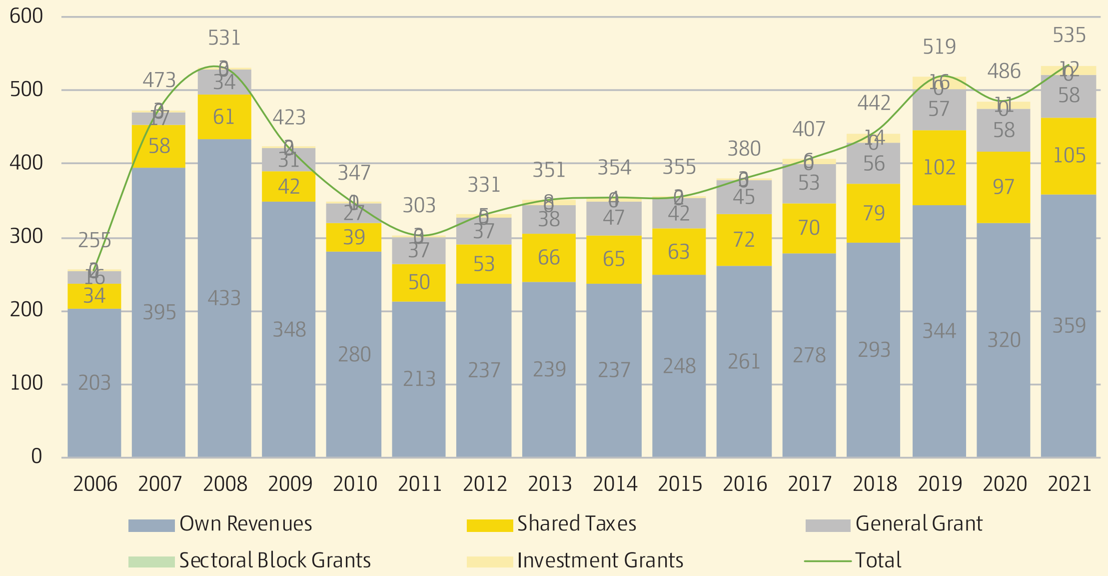


Figure 138 MONTENEGRO: COMPOSITION OF LOCAL GOVERNMENT REVENUES (EURO PER CAPITA)



Until recently, the Land Development Fee was the largest source of local own revenue, but recently government-imposed constraints have reduced its role in municipal budgets. Its share of total own source revenues has fallen from 34% in 2012 to 17% in 2021. Meanwhile, the Construction Land Use Fee was eliminated in 2009. The Law on Communal Services prescribed the introduction of the Communal Fee as a substitute for the Land Use Fee, but this part of the law never came into force. Local governments have tried to replace the lost income by making greater use of the Property Tax, which went from being a relatively insignificant own revenue back in 2006 (only 8%) to being the single most important one in the past few years. Currently the property tax represents more than third of all own revenue.

Local government investment's share to total local expenditures has dropped significantly from 2008 from 53% to a minimum of 17% in 2015, to increase again to 27% in 2021. While operating costs for goods and services have remained relatively stable, spending for wages, transfers and debt repayment have increased substantially. The issue of overstaffing is very topical in the entire public administration, including local administration.

In nominal terms local government investments have decreased from a high of 166.4 million Euro to a low of 40 million Euro in 2015, and then increasing again to 78 million Euro in 2021.

Figure 139 MONTENEGRO: COMPOSITION OF OWN SOURCE REVENUES 2006-2021, IN % OF THE TOTAL

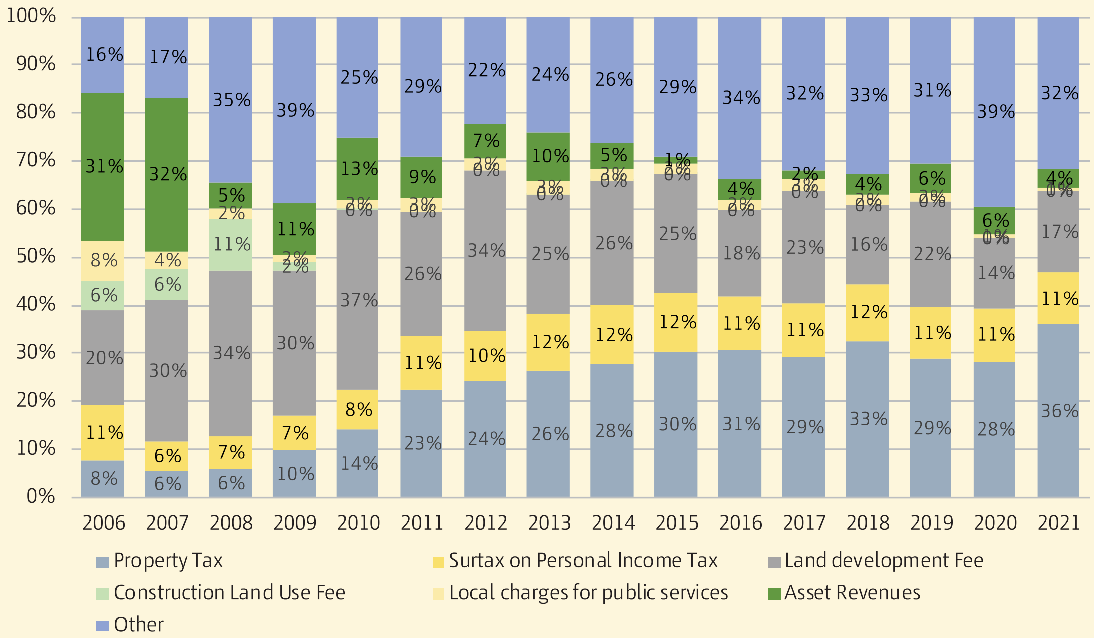
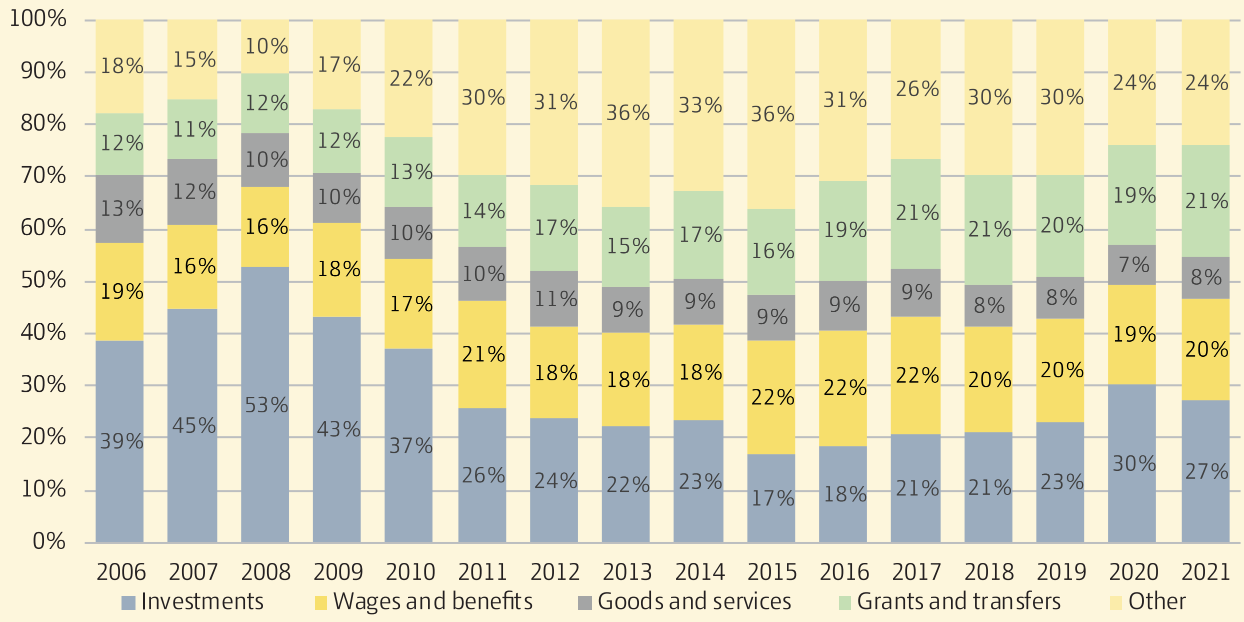


Figure 140 MONTENEGRO: COMPOSITION OF EXPENDITURE IN 2006-2021, IN % OF TOTAL



The economic downturn led to a sharp contraction in public sector investment between 2008 and 2013, which again dropped in 2015. The increase of local government revenues in 2019 was followed by an increase in spending for investment. But while total public investment recovered somewhat after 2014, the share coming from municipalities continued to decline (except in 2016) up to 2018 when it started slowly recovering up to 28% in 2021.

Figure 141 MONTENEGRO: COMPOSITION OF EXPENDITURE IN 2006-2021, IN MLN EURO

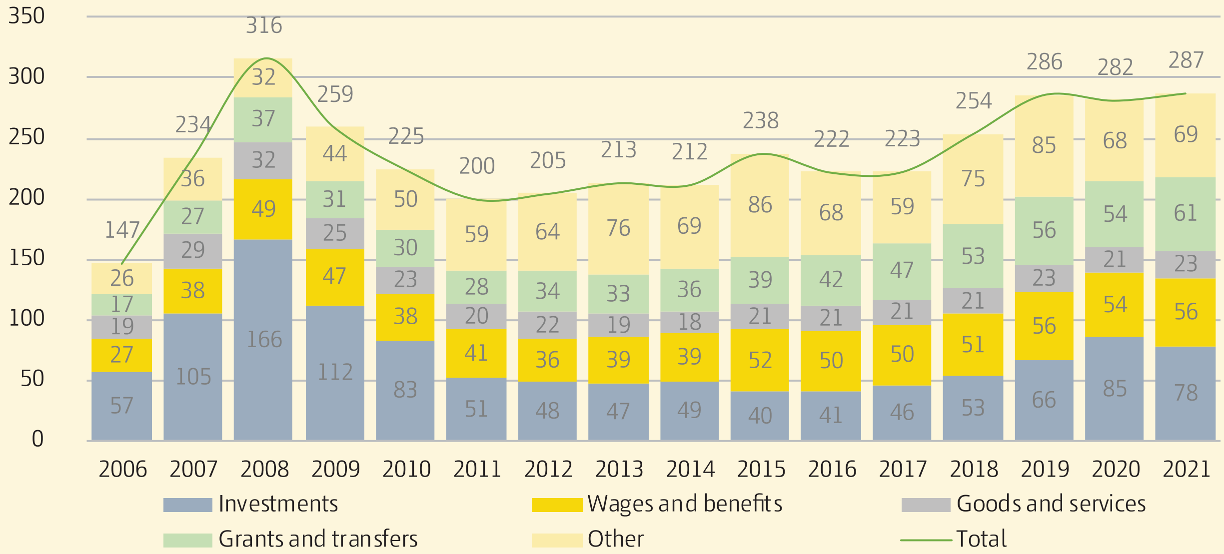


Figure 142 MONTENEGRO: COMPOSITION OF EXPENDITURE IN 2006-2021, IN EURO PER CAPITA

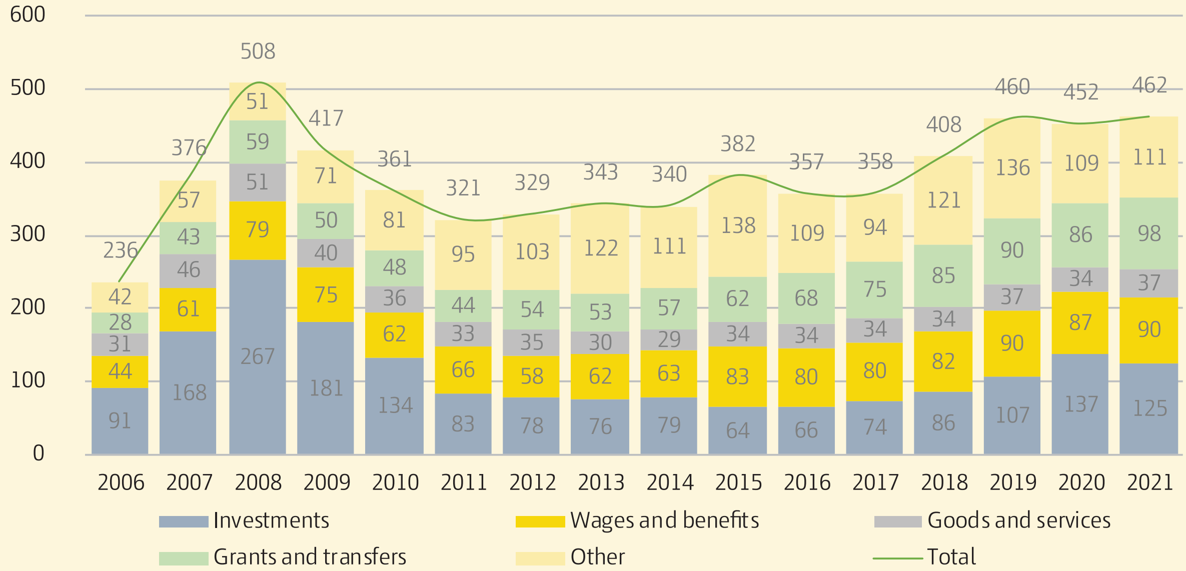
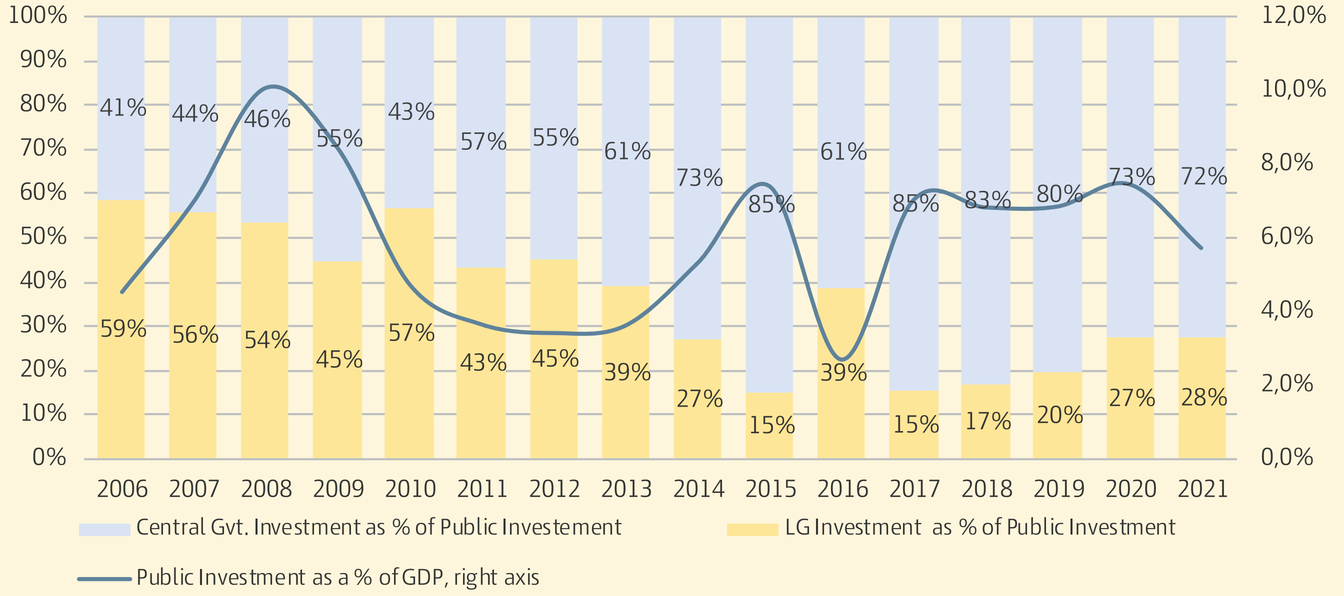


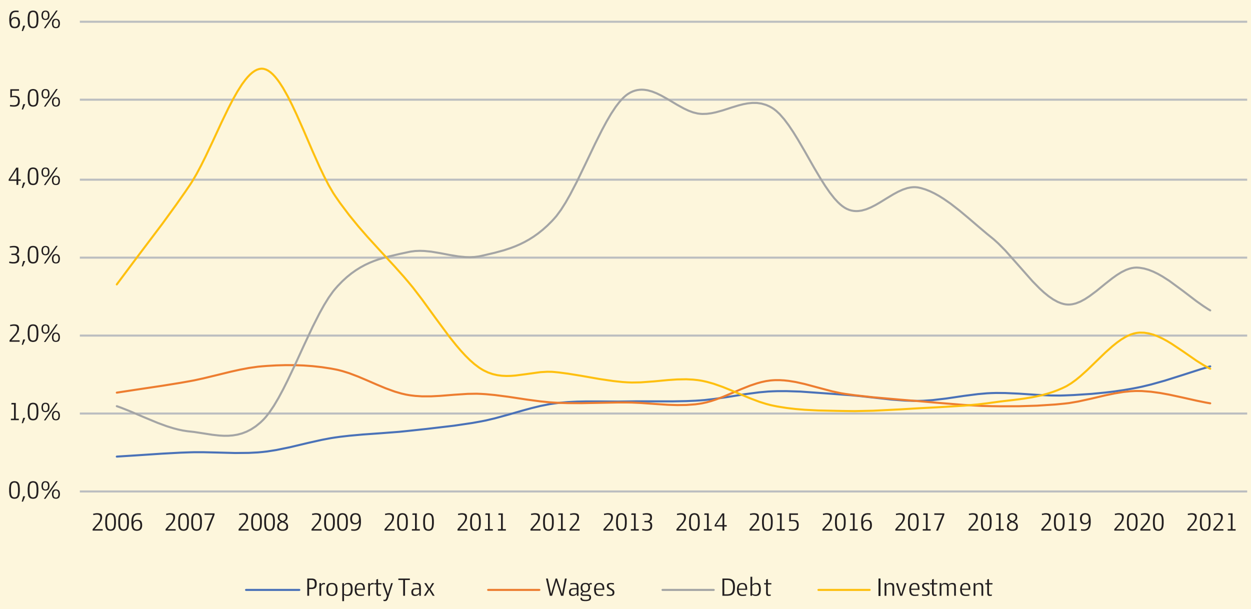
Figure 143 MONTENEGRO: PUBLIC INVESTMENT BY LEVEL OF GOVERNMENT AND AS A SHARE OF GDP 2006-2021



Local governments have responded to the economic downturn and the policy changes discussed above by raising the property tax, lowering investment, and increasing borrowing. Local debt to GDP increased to above 5% in 2013, creating unsustainable pressures on already weakened local finances. Most municipalities simply did not have enough revenue to finance all their obligations to banks, suppliers and the state budget, which required an emergency intervention by the Government of Montenegro, the relevant ministries, municipalities and the UoM. As result of all measures taken between 2014-2016, the debt service payments were contained and the share of local debt to GDP started to decline although a slight increase can be noted between 2016 and 2018. The implementation of the changes in the Local Government Finance Law started from 2019 improved the situation of local revenues and the local debt, as a share of GDP, declined in 2021 up to 2.3% of GDP.

Local investment, as a share of total public investment, has fallen from 59% in 2006 to only 15% in 2017. By the same token, local investments to GDP decreased from above 5% in 2008 to 1% in 2017. The situation did not significantly improve in the following years either, except for 2020 and 2021. The share of spending for municipal wages to GDP decreased as well compared to pre-crisis levels, also because of the inability of some municipalities to pay all taxes and contributions on salaries. This once again confirms the need to optimize the number of employees at the local level.

Figure 144 MONTENEGRO: INVESTMENT, WAGES, DEBT SERVICE AND PROPERTY TAX AS A SHARE OF GDP 2006-2021



North Macedonia

By Andrijana Babushku, Association of the Units of Local Self-Government of the Republic of North Macedonia (ZELS) & Shiret Elezi, Expert and Adviser Ministry of Finance, North Macedonia.

The Intergovernmental Finance System

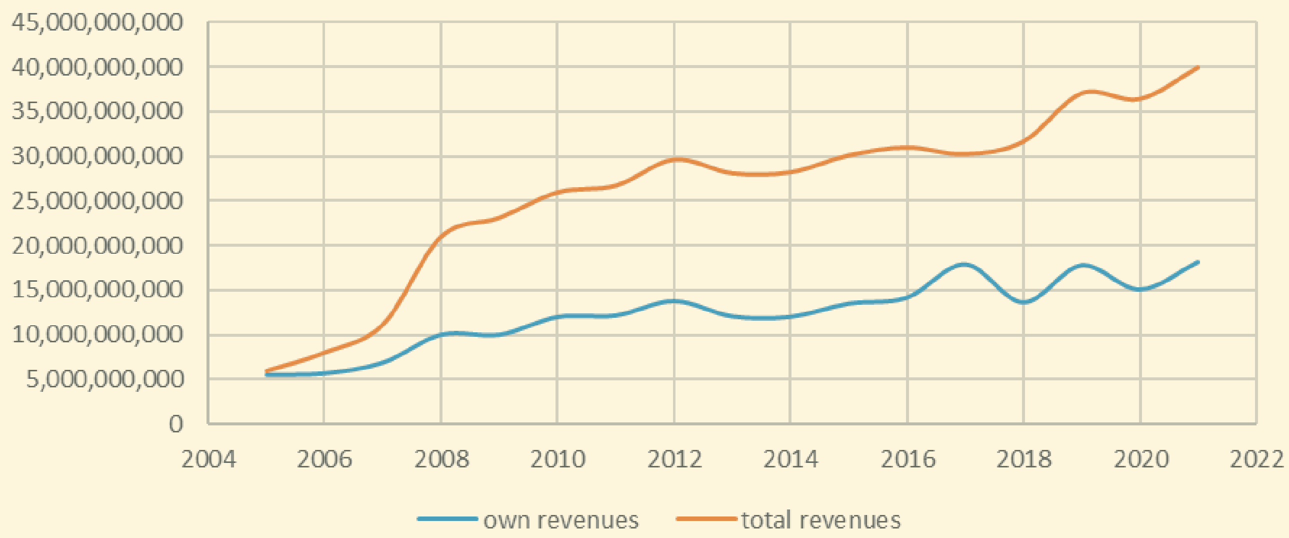
Decentralization of power from the central to the local level officially began on July 1st, 2005, according to provisions of the Law on Local Self-Government, which was adopted in 2002. The financing of local government responsibilities is regulated by the Law on Financing of Local Self-Government Units, adopted in 2004, which also included the provisions for the phased approach of fiscal decentralisation reforms. From a functional perspective, North Macedonia has a highly decentralized public sector. Local self-government units (LSGUs) are responsible for maintaining and improving local infrastructure, water supply and wastewater treatment, waste management, public lighting, local public transport, providing services in primary and secondary education, local cultural institutions (cultural centres, libraries, museums), social protection (protection of children and protection of the elderly), firefighting, and they also manage state construction land. Local authorities are also responsible for preschool education, primary and secondary education and homes for the elderly.

The Government Program for the period 2020-2024 puts a major emphasis on the continuation of policies for the development of municipalities, i.e. fiscal decentralization and balanced regional development, aiming to strengthen local financial sources of municipalities, increase accountability and transparency, as well as more efficient service delivery and enhanced local development. During 2021, the Ministry of Finance (MoF)[11] determined several priority activities and measures to advance the process of fiscal decentralization, which were submitted in the form of information to the government for consideration and adoption. The activities foresaw the enhancement of local fiscal capacities, increasing local revenues and improving the criteria for the distribution of funds for decentralized competencies in primary and secondary education, culture, child protection and protection of the elderly and firefighting. North Macedonia is one of the four NALAS members with decentralized payment of teachers' salaries in primary and secondary education (Bulgaria, Kosovo and Moldova). It is no surprise that the intergovernmental financial systems of these economies are dominated by sectoral block grants.

Compared to 2005, when the process of transfer of responsibilities and fiscal decentralization began, the revenues of municipalities increased by more than six times (in 2005 realization of 5.9 billion dinars, in 2021 over 39 billion dinars). In the same period, the tax revenues over which the municipality has the autonomy of collection increased by more than three times. Compared to the realized revenues of all municipalities in 2020, a growth of 9.63% is observed.

[11] Source: Стабилни финансии, одговорна локална самоуправа, подобри услуги за граѓаните – реформа за унапредување на фискалната децентрализација— Министерсво за Финансии (finance.gov.mk)

Figure 145 LOCAL REVENUES FROM PERIOD 2005-2021



Source: MoF, Annual accounts of the State Budget[12]

During 2021, the Government adopted all the measures proposed by the Ministry of Finance (MoF) to advance fiscal decentralisation. Within the framework of these activities, the MoF has also prepared a Draft-Law amending the Law on Financing of Local Self-Government Units, which was submitted to the Assembly in October 2021, and approved in August 2022[13], which proposed changes that enable an increase in the revenues of municipalities and improvement of the fiscal capacity through a gradual increase in the share of the Value Added Tax (VAT) revenues and personal income tax (PIT) revenues on the personal income from salaries of natural persons. At the same time, the criteria for the distribution of the VAT grant regulated in the Decree on the methodology for the distribution of the income from the value-added tax by municipalities were reviewed. In the part of the activities related to increasing financial discipline and efficiency, reducing and reprogramming the matured and unpaid obligations of the municipalities, the MoF in the draft law has provided a new legal solution with which the municipalities will have the opportunity to use credit instruments in order to overcome the problems with the matured and unpaid obligations, which will be related to the fulfilment of the conditions for declaring financial instability of the municipalities. In the part that refers to strengthening the financial responsibility of the municipalities, efforts are made to increase the transparency of the operations of the municipalities through the provision of a legal obligation to publish financial data transparently on their websites, as well as increase accountability of spending of the allocated funds by the state.

[12] www.finance.gov.mk

[13] The Law on Amendments and Supplements to the Law on Financing Local Self-Government Units, published in the "Official Gazette of RSM" No. 173/22.

The reform for the advancement of fiscal decentralization offers a systematic solution for stable municipal finances, which are a prerequisite for the delivery of quality and efficient services to citizens. The reform consists of three pillars:

- Increasing fiscal capacity and increasing the revenues of the municipalities
- Increasing fiscal discipline and reducing debts and conducting responsible operations
- Increasing transparency and accountability

The reform envisages an increase of the share of revenues that municipalities receive from the PIT revenues (from 3% to 6%) and an increase in the share of revenues from the VAT (from 4.5% to 6%). The increase in the share of VAT revenues shall be applied in 2024 while a provisional increase to 5% shall be applied in 2022 and 5.5% in 2023. The funds from the additional increase in the percentage of VAT for the municipalities will be distributed to two new funds– **the Performance (efficiency) Fund** and the **Equalization Fund**. The Performance Fund will reward municipalities that have a better collection of local revenues, while the Equalization Fund will act towards reducing the differences according to the fiscal capacity of the municipalities. Namely, the municipalities that show positive results and have a higher realization of their own source revenues will receive more funds from the Performance Fund, while the municipalities that have lower revenues due to limited resource capacity but have shown fiscal effort and good results in collecting own income, will receive more funds from the Equalization Fund.

In this direction, in 2022, the methodology for the distribution of the income from the value added tax, which is distributed to municipalities, was revised. In 2022, municipalities were allocated 5% of the collected value added tax, divided into three parts: basic part– 4.5%, part for performance– 0.25% and part for equalization–0.25%. In 2023, municipalities are provided with funds in the amount of 5.5% of the collected value added tax realized in the previous fiscal year, distributed in three parts: basic part–4.5%, part for performance–0.5% and part for equalization– 0.5% The part for performance rewards municipalities that have a better realization of own source revenues compared to planned own source revenues and a higher collection of own source revenues in the current year compared to the average of realized own source revenues in the previous three years. The equalization part is intended to overcome differences according to the fiscal capacity of municipalities due to limited capacity of resources, that is, municipalities that have lower income from personal income tax per inhabitant receive additional funds.

By strengthening the fiscal responsibility, transparency in the operations of the municipalities will also be increased. They will have the obligation to publish financial data and information for increased accountability regarding the spending of all funds transparently allocated by the state on their websites. Also, increased control by the financial inspection will be implemented for compliance with legal regulations and the rational and purposeful spending of funds, based on reports of non-compliance with the Law on Reporting and Recording of Obligations and reports of non-compliance with the Law on Financial Discipline.[14]

Financing of local governments in North Macedonia. The Law on Financing of Local Government defines the sources of municipal revenues as follows:

- Own source revenues include property tax, other local fees, duties and taxes, property revenues and revenues from fines, penalties and donations;
- Personal income tax and value-added tax are shared taxes and are distributed according to a formula;
- Block grants from the national budget for primary and secondary education, culture and social protection;
- Earmarked grants for special programs or specific investments;

[14] See Ministry of finance, www.finance.gov.mk

- Earmarked grants for the unification of firefighting protection;

Since 2006, about a third of local budgets are financed from Own Source Revenues (OSRs). Most of the own income is collected from utility fees, property taxes and compensation during the construction of buildings.

The **General Grant** is anchored by law on the Value Added Tax. The criteria used to allocate the grant are defined by an annual regulation, according to which:

- All jurisdictions receive a lump sum payment of 3 million dinars (permanent part);
- These payments are then deducted from the grant pool and the residual is divided between the capital city of Skopje and its composite municipalities (12%) and all other municipalities in the economy (88%).
- Funds for the municipalities are divided by a formula that allocates 65% of the funds on the basis of population; 27% based on surface (square kilometres); and 8% based on the number of settlements.

In 2021, the municipal revenues from shared taxes (VAT and personal income tax) registered 43 million euros or 6.5% of the total revenues of the local self-government.

Block grants. The distribution of the block grant for education across municipalities is determined by an annual decree. The main criteria in the formula for awarding the grant are enrolment, employment and the number of children who are entitled to free school transport. The formula for determining per-pupil payments is publicly available, but the amount of funds that municipalities receive through the grant is insufficient and often requires significant contributions from their general budgets. The distribution of the block subsidy for preschool education is regulated by an annual decree. The formula contains variables for the number of students, the type of heating system and the duration of the heating season, the number of teachers in the school and the utilization rate of the facility. Municipalities that have cultural institutions receive a block grant for culture based on the number of employees working in the institutions covered by the grant, the total square meters of buildings and coefficients for the specific cultural services provided by these institutions. Allocation methodologies remained unchanged in 2021. The firefighting protection grant only covers the salaries of the employees of the firefighting protection units, but even this is not enough funding, which raises serious concerns about insufficient funding. Theoretically, municipalities are autonomous in managing the funds they receive through block grants.

The Ministry of Education and Science, in cooperation with UNICEF and the World Bank, is already working on establishing new criteria for the distribution of the block grant for primary education based on a set standard per student, while proposing reforms for the optimization of the school network, reduction of the teaching staff and harmonizing the required number of teachers with the number of students, as well as improving conditions in primary schools and improving the curriculum. The goal is to improve the efficiency and effectiveness of primary education, while at the same time ensuring equal access to schools.

The Ministry of Finance, with support from SIGMA, will analyse the existing methodologies for the distribution of block grants in culture, kindergartens, and the dedicated grant for firefighters. Efforts will be made to introduce criteria that would realistically determine the necessary amount of funds that would cover all costs for the transferred competences and improve the quality of services.

The Government has established an Interdepartmental Working Group to address issues in the area of fire protection. The working group is working on amending the Law on Firefighting, especially in the part of adjusting the salaries and allowances of firefighters, determining the required number of firefighters according to the criteria established in the Law, as well as solving other problems faced by this transferred authority. During 2023, the Ministry of Finance will reform the normative framework for designing a formalized system of capital transfers, with UNDP support. In doing so, several models for the reform of the distribution of capital grants will be proposed.

Source: Fiscal Strategy for North Macedonia 2024-2028

The Macedonian intergovernmental financial system also includes **a Regional Development Fund** dedicated to promoting balanced regional development that allocates funds to the regions according to the formula contained in the Law on Regional Development. According to the law, this fund should be equal to 1% of GDP, but it has not happened until now, although the national government claims that the total amount of funds allocated by the ministries for development purposes is greater than 1% of GDP. Nevertheless, some municipalities face the problem of insufficient financial resources to carry out their responsibilities, while they mostly rely on transfers from the central government. This situation leads to insufficient and unbalanced regional development, ineffective provision and delivery of services to citizens and insufficient democratization of society.

Expected upcoming reforms

The Government has adopted the Program for Sustainable Local Development and Decentralization for the period 2021-2026 and its Action Plan for the period 2021-2023. The program reflects the continuous interest of all stakeholders in the development of local self-government, as the level of government that is closest to the citizens. It covers all significant aspects of the decentralization process that contribute to the alignment of the local self-government system with the normative, institutional, political and administrative criteria and standards of the EU and the achievement of the sustainable development goals of the UN. A Coordinating Body has been established to monitor the implementation of the Program and action plans, consisting of 22 representatives from the ministries and ZELS. At the same time, the sectoral working group for regional and local development has the obligation to carry out tasks at the expert level, related to the formulation and implementation of national sectoral policies, including those related to EU integrations and donor aid in general.

The working group was formed by representatives from the Ministry of Justice, the Ministry of Local Self-Government, the Ministry of Finance, the Bureau of Regional Development, the Cabinet of the Deputy Prime Minister for Economic Affairs, the Ministry of Political System and Community Relations, the Ministry of Information Society and Administration and ZELS with the aim of finding a legal solution for the establishment of the Agency for Regional and Local Development, which would have broader competences than those of the Bureau for Regional Development. This will give municipalities the opportunity to secure additional financial resources from various sources for financing capital investments, which will improve local and regional development. With the existence of this agency, the funds that would be provided from different sources and are intended for regional and local development would be distributed according to established criteria and according to the needs of the municipalities and the region. The work of the agency will be coordinated by the Ministry of Local Self-Government.

Access to local government borrowing in the capital markets became more accessible based on more liberal and transparent conditions for borrowing, which increased the interest of municipalities in financing investment projects through borrowing. In this direction, the Government provided credit lines from international financial institutions (World Bank, EIB, KfV and EBRD) with which significant investments are implemented in: reconstruction and rehabilitation of local streets, roads and bridges, construction and reconstruction of water and atmospheric networks, improving public hygiene and raising energy efficiency in municipal public facilities and spatial local planning.

Own source revenues of the local self-government

Own source revenues play a fundamental role in the financing of municipalities in North Macedonia. The tax powers of the local self-government, the revenues of the municipalities are regulated by the Law on Financing the Local Self-Government, the Law on Property Tax, the Law on Communal Fees, as well as other sectoral laws that affect the fees of the local self-government. The Law on Property Tax regulates the three taxes related to property, sales tax, inheritance and gift tax and property tax. The base and rate of taxes are provided in the Law, and the municipal councils approve the final rates within the predefined limits. Property tax is charged based on the market value of the real estate, determined by an appraiser (employee of the local self-government) and the methodology for assessing the market value of the real estate, is determined centrally, but it is approved by ZELS.

The optimal and realistic planning and realization of own source revenues are of exceptional importance for the realization of the planned projects regarding the expenditures and are one of the conditions for the financial stability of the municipalities, taking into account that the generation and settlement of the obligations of the LSGUs are directly dependent on the degree of realization of the revenues. To achieve greater efficiency in revenue planning, in November 2018, an amendment to the Law on Financing of Local Self-Government Units was adopted, according to which "*Own source revenues of the municipality can be planned with an increase of at most 10% of the average realized incomes in the last three years*". This ceiling on forecasted revenues was increased to 30% in November 2019 and to 50% for 2021.

Unrealistic and over-optimistic revenue and expenditure planning is one of the reasons why local self-government units created unpaid obligations (payment arrears) in previous years. To overcome this situation, in August 2022 the Law on Financing of the Local Self-Government Units was changed again to include a fiscal rule as regards planning the own source revenues which requires that the planning of own source revenues of the municipality is limited by the realization of own source revenues in the previous three years. With the amendments to the Law on Financing of Local Self-Government Units, more realistic planning of municipal budgets will be ensured, whereby the percentage of planned revenues in the municipal budget from 30% is again reduced to 10%. In doing so, an opportunity is given if the municipality, as of the third quarter, realizes its own source revenues above 75% of the planned, it can additionally increase the planned revenues to a maximum of 20%, starting from 2025. In addition, for 2023 the percentage is 20% with an additional 10% as of the third quarter, and for 2024 the percentage is 15% with an additional 15%. At the same time, exceptions are provided only if the municipality has secured a confirmation for the transfer of funds from an appropriate institution or in the case of changes related to the amount and type of own source revenues of the basic budget established by law.

During 2021, there is an increase in the collection of property taxes. However, significant differences remain in the operation of individual municipalities. Many municipalities have taken proactive measures to regularly assess properties, register new properties or changes to existing properties and update fiscal registers of tax bases and taxpayers. Furthermore, certain local governments have taken measures to ensure tax compliance enforcement by cooperating with the Public Revenue Office to block the accounts of non-compliant taxpayers. On the other hand, there are local governments that have chosen a more passive approach to update their fiscal registers.

ZELS actively works to improve policies and legislation at the national level and to support local governments to improve their systems and capacities for tax administration at the local level. ZELS proposes the development and implementation of information technology systems for all local governments for the administration and collection of all types of local taxes. This is expected to help all local governments to deal with systemic weakness. However, this proposal is limited by funding that has yet to be found.

COVID-19 Impact and implications for Local Government Finances

The emergence of the COVID-19 pandemic brought the so-called new reality, a new way of functioning, first of all to the everyday life of citizens, and then to citizens as economic entities, and hence the functioning of local authorities is no exception to this situation. This is because the local government is closest to the citizens. Municipalities witnessed financial difficulties in trying to respond to the urgent needs of citizens and to ensure continuity in providing services to citizens in crisis situations. In April 2021, the sixth package of economic measures to support the economy worth 17.8 million Euros was adopted, intended to support activities that were completely closed in order to prevent the spread of the coronavirus, as well as to improve the liquidity of companies that invested during 2021. As in the previous year, in 2021, the COVID-19 pandemic had a strong impact on the operations of local self-government units. During the crisis, municipalities did not receive support from the central government. The only thing that was accepted was the commitment of ZELS to take the average collection from the previous three years, instead of only from the last year, as the basis of the calculation for the VAT collection. Also, with the efforts of ZELS, the municipalities got more flexibility in planning the municipal budget, i.e. the limit instead of 30% to be 50% of the average realized income in the last three years, according to the data from the treasury records.

A part of the municipalities, in conditions of a pandemic, provided an appropriate package of economic measures to support economic entities and citizens. In these conditions, rural municipalities could fulfil their obligations more easily because they had a significant portion of subsidies in relation to their own incomes. To mitigate the consequences of the pandemic, and not reduce the effect of the value-added tax, a change in the methodology for the distribution of the value-added tax was adopted by municipalities in 2021, which provided that VAT revenues for 2021 will be based at 4.5% of the average VAT revenues of the past three fiscal years. [15]

The Association of Local Self-Government Units of the Republic of North Macedonia (ZELS) was active in supporting its members, through updated information and opportunities for exchange and obtaining the necessary support from the national government and the donor community. ZELS adapted its operations to support its members and continued to implement many important projects to support local government, such as the project "Strengthening of Municipal Councils", the regional project for proper integration of the "Leave no one behind" principle of the 2030 Agenda.

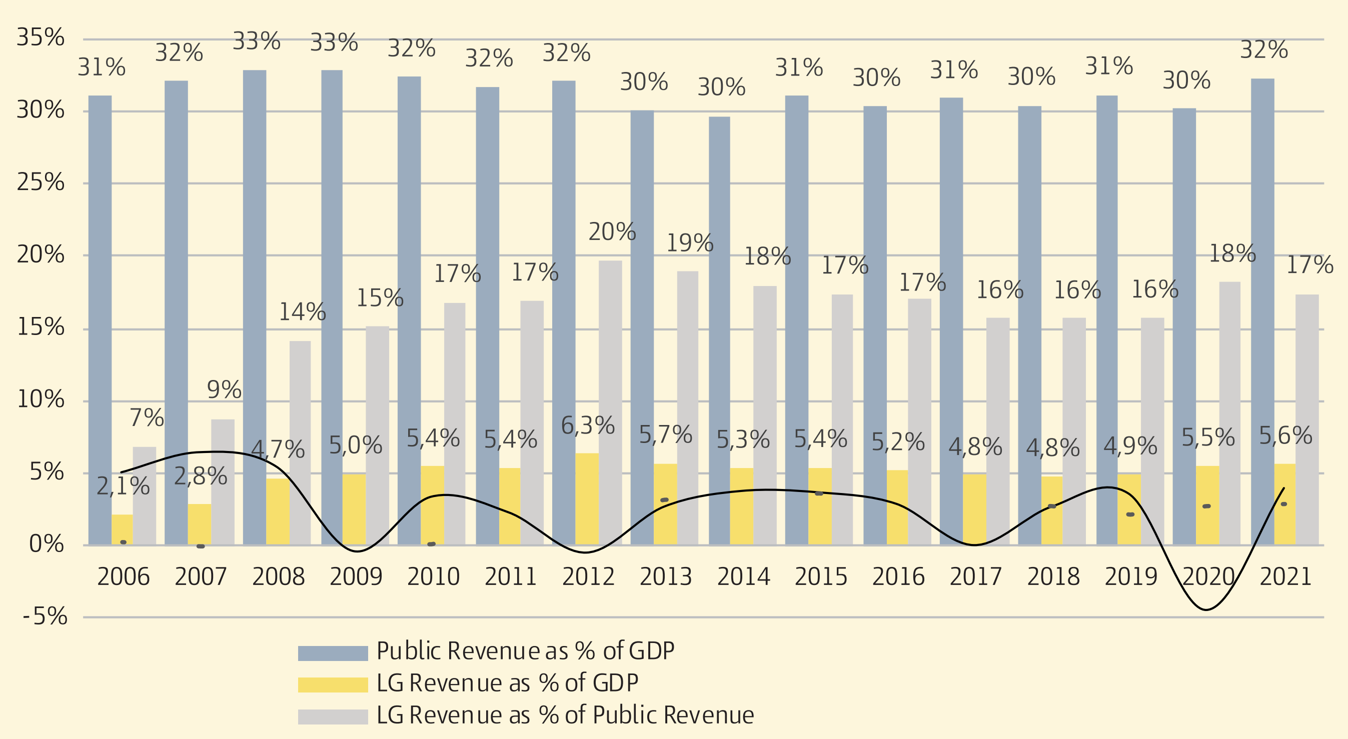
The composition of the mixed working group for the deepening of decentralization, which encouraged the continuation of the negotiations, was formally determined by a decision of the Government. In that regard, the Ministry of Finance (MoF) offered a model for advancing the process of fiscal decentralization and increasing the financial autonomy of municipalities. The Financing Commission and the Managing Board of ZELS gave several conclusions about the model, among which that the VAT increase should be at least 10%, as determined in the Systematized Positions of ZELS. Also, ZELS advocates that the percentage of the personal income tax that will be allocated to the municipalities should be at least 50% (which is the practice in many European economies), respectively, in the beginning, it should be 30%, considering the current financial resources in the economy, while the criteria for the distribution of funds from this income should remain the same as before. It was concluded that the allocation of funds from the two funds, the Equalization Fund and the Performance Fund, should be shown much more precisely and clearly. At one of the sessions, the proposal of the Ministry of Education for a new system of financing through block grants for primary and secondary education was reviewed. It was pointed out that the system was developed based on the recommendations given in the Audit Report on performance– effectiveness of the measures and activities in the function of carrying out the transferred competencies that are financed with funds from block grants.

Statistical Overview of Local Government Finances in Macedonia 2006-2021

The process of fiscal decentralization can best be seen through the expansion of local government revenues as a percentage of GDP between 2005 and 2012. However, they were downwardly unstable until 2018, to show a slight increase from 2019 onwards. In 2021 the total municipal revenues account for 5.6% of GDP. The local share in total public revenues is decreasing from the highest share of 20% in 2012 to 17% in 2021.

[15] The changes were made to help the municipalities to get more funds from VAT as an average from the three fiscal years (2018,2019,2020) and not as it was ordinary only the VAT from the last fiscal year in this case 2020 was very low because the pandemic.

Figure 146 LOCAL GOVERNMENT REVENUE AS A SHARE OF GDP AND TOTAL PUBLIC REVENUE IN 2006-2021



The revenues of the central government in Macedonia are much more stable compared to the revenues of the local governments. After 2013, for the first time since the beginning of the fiscal decentralization reforms, local government revenues decreased compared to the previous year for a slight recovery in 2015 and 2016. In 2021, local revenues grew by 12% compared to last year, driven primarily by an increase in own source revenues.

Block grants are the largest source of income, providing more than half of the funds (they participate with 52% in total revenues in 2021). These funds are used to finance primary and secondary education, including teachers' salaries, kindergartens and nursing homes, the homes of culture owned by the municipalities, as well as for firefighting protection. Own source revenues make up a third of all local revenues, i.e. 33%.

Figure 147 FLUCTUATIONS IN THE REVENUES OF THE GENERAL AND LOCAL GOVERNMENTS 2006-2021

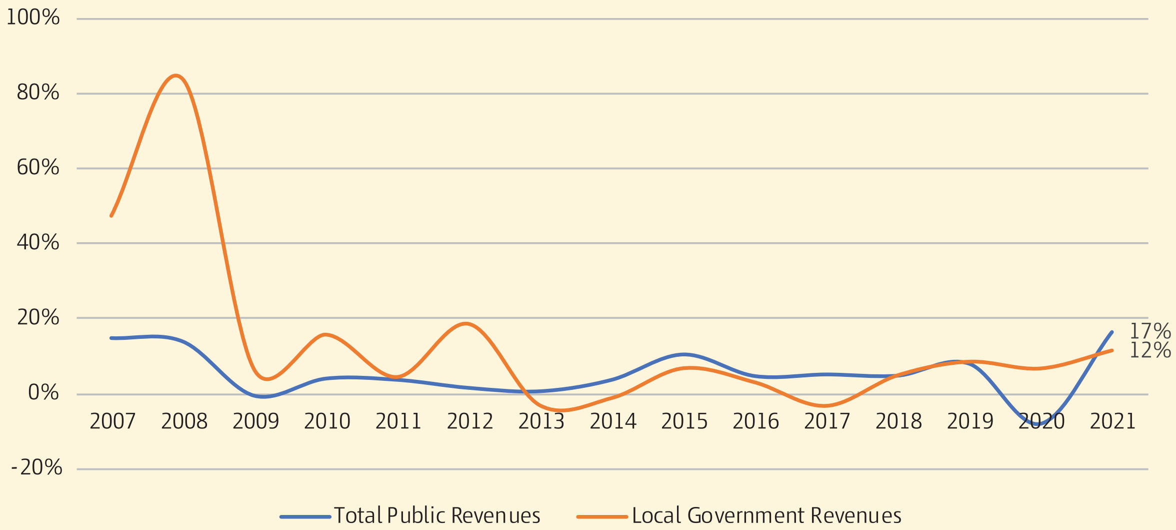


Figure 148 COMPOSITION OF LOCAL GOVERNMENT REVENUES 2006-2021

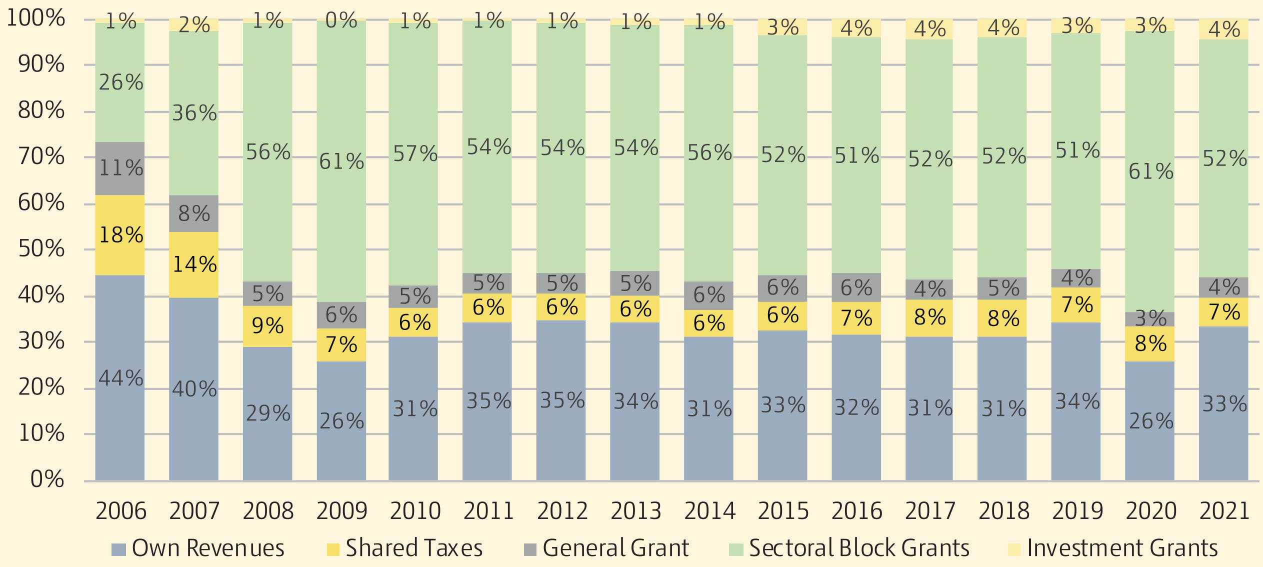
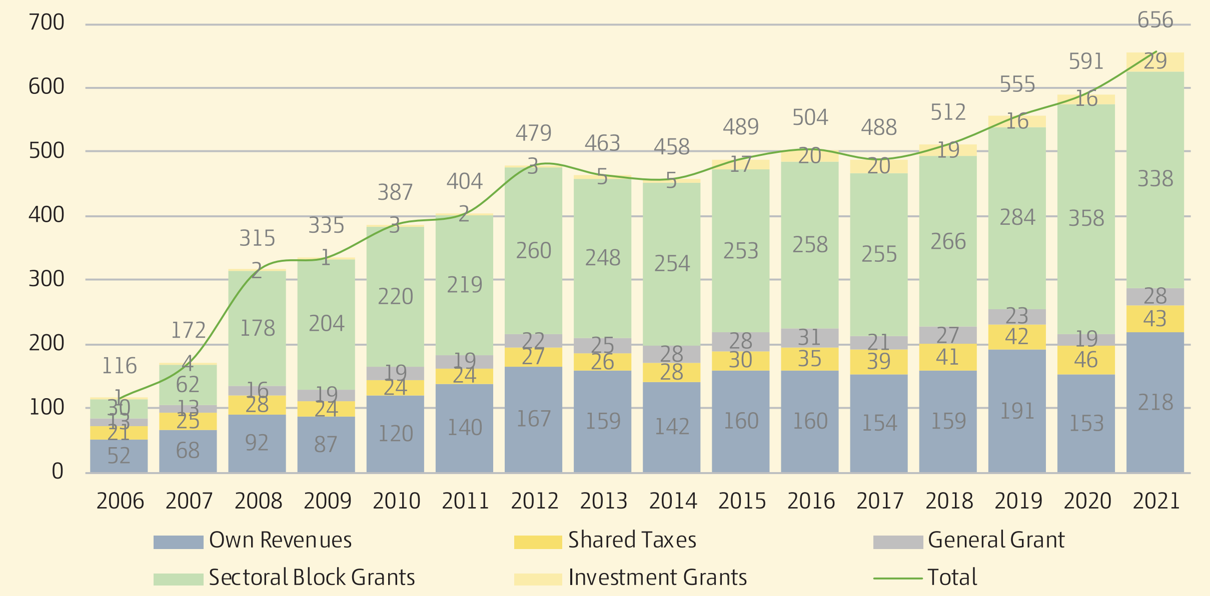


Figure 149 LOCAL GOVERNMENT REVENUES 2006-2021, IN MILLION EURO



Between 2009 and 2012, local governments did an impressive job, mobilizing revenue from their own sources, primarily through a more aggressive collection of construction land fees, lighting fees and other utility charges. The total property tax revenue remains modest over the entire period, except in 2016 and 2017 when it increased more than double given its historical pattern. In 2021, own source revenues are at the level of 218 million Euros.

Figure 150 LOCAL GOVERNMENT REVENUES 2006-2021, IN EURO PER CAPITA

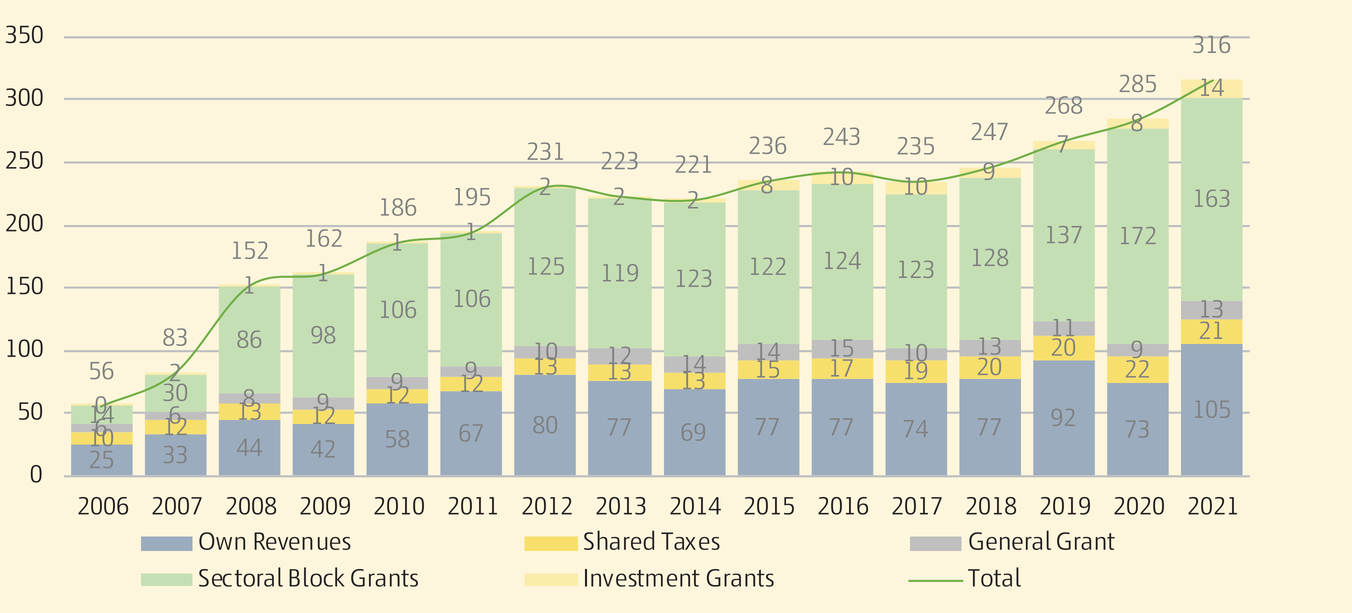
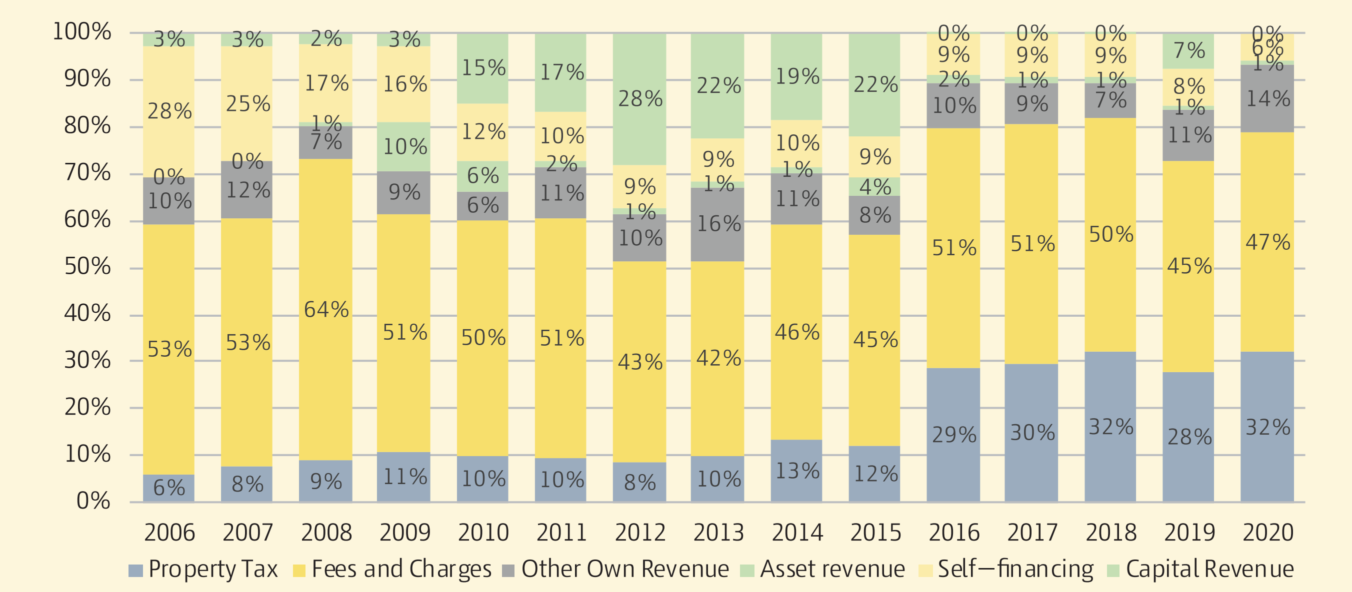


Figure 151 COMPOSITION OF LG OWN SOURCE REVENUES 2006-2021



Spending for salaries historically has constituted about half of municipal budgets in North Macedonia. This is expected given the extensive responsibilities in social sector services, including also salaries of teachers in primary and secondary education. Spending for capital investments and goods and services is relatively stable as well, with minor changes over years.

Figure 152 COMPOSITION OF EXPENDITURES IN 2006-2021, IN % OF TOTAL

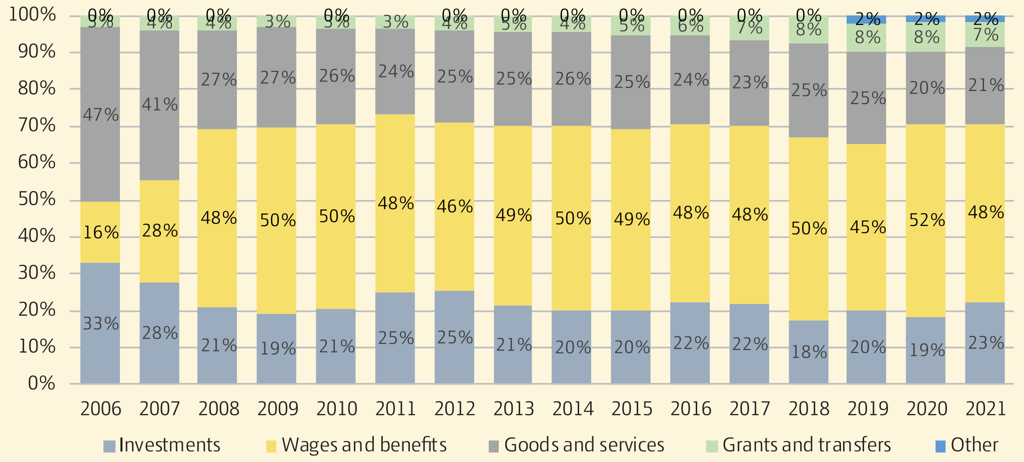


Figure 153 COMPOSITION OF EXPENDITURES IN 2006-2021, IN MILLION EURO

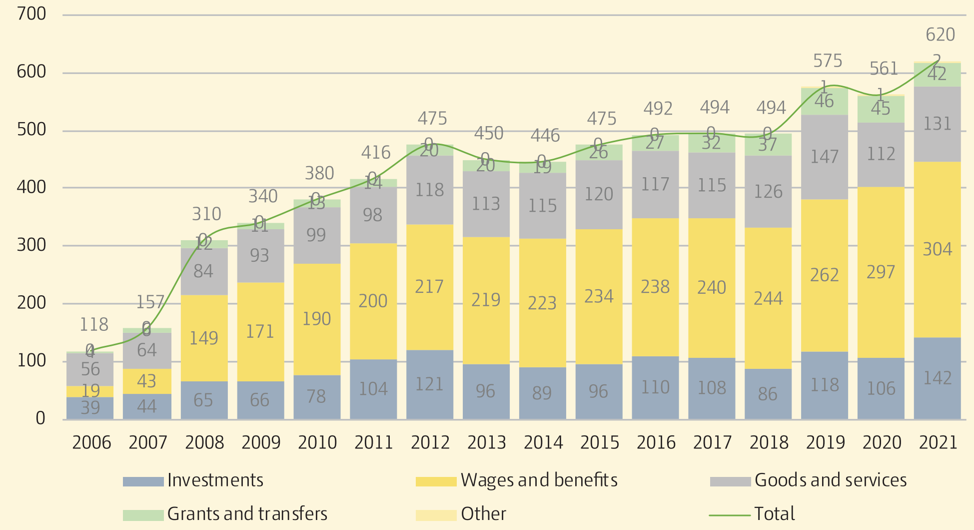


Figure 154 COMPOSITION OF EXPENDITURES IN 2006-2021, IN EURO PER CAPITA

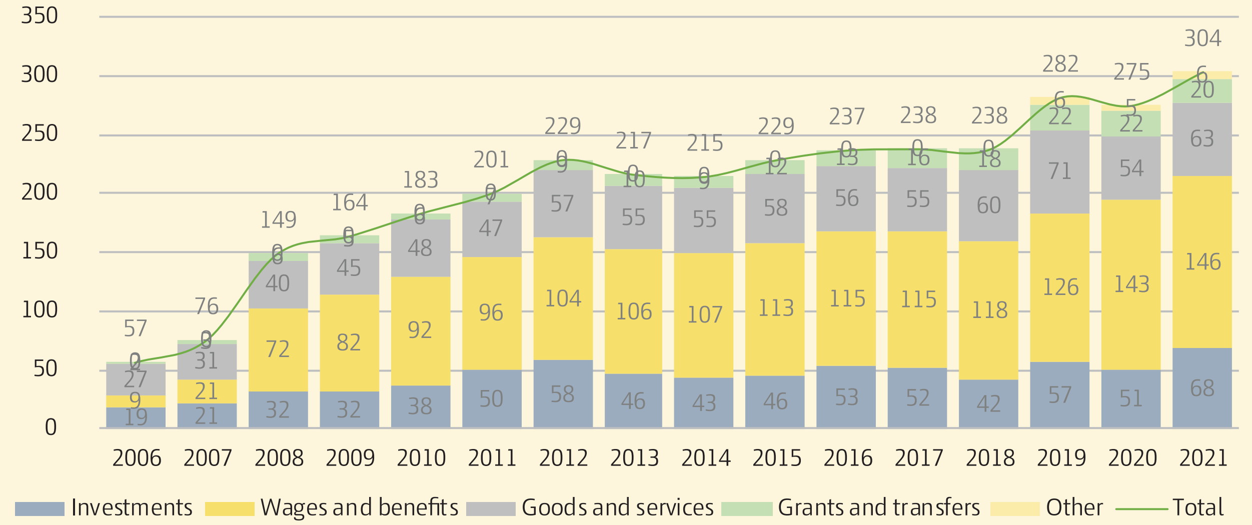
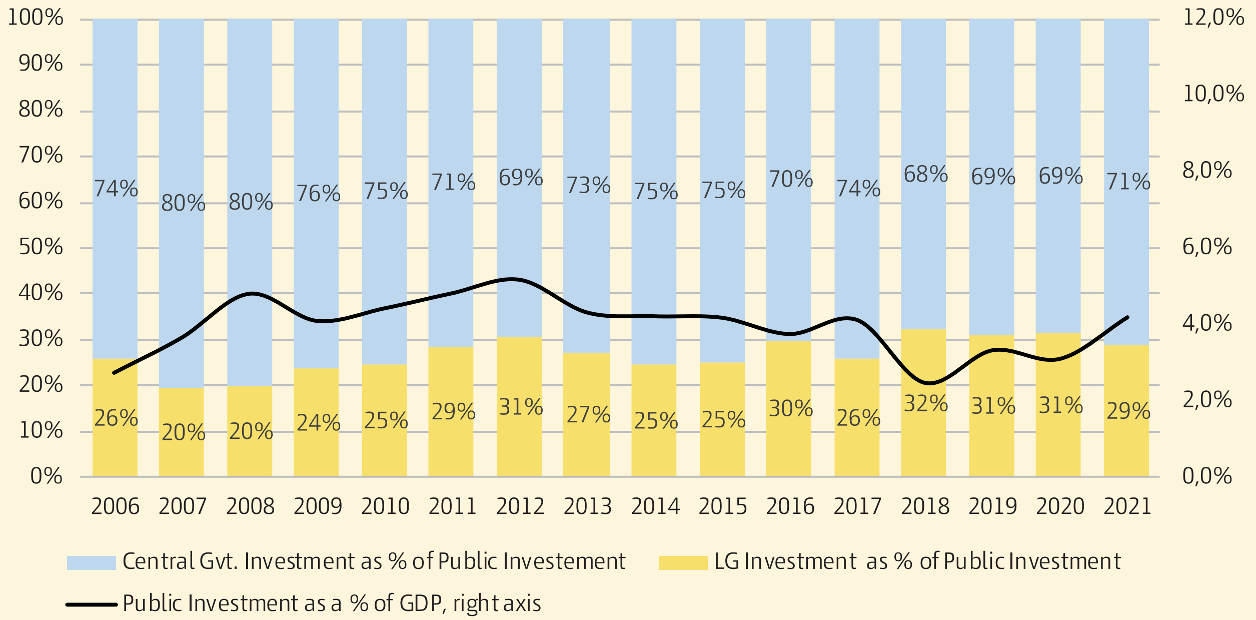


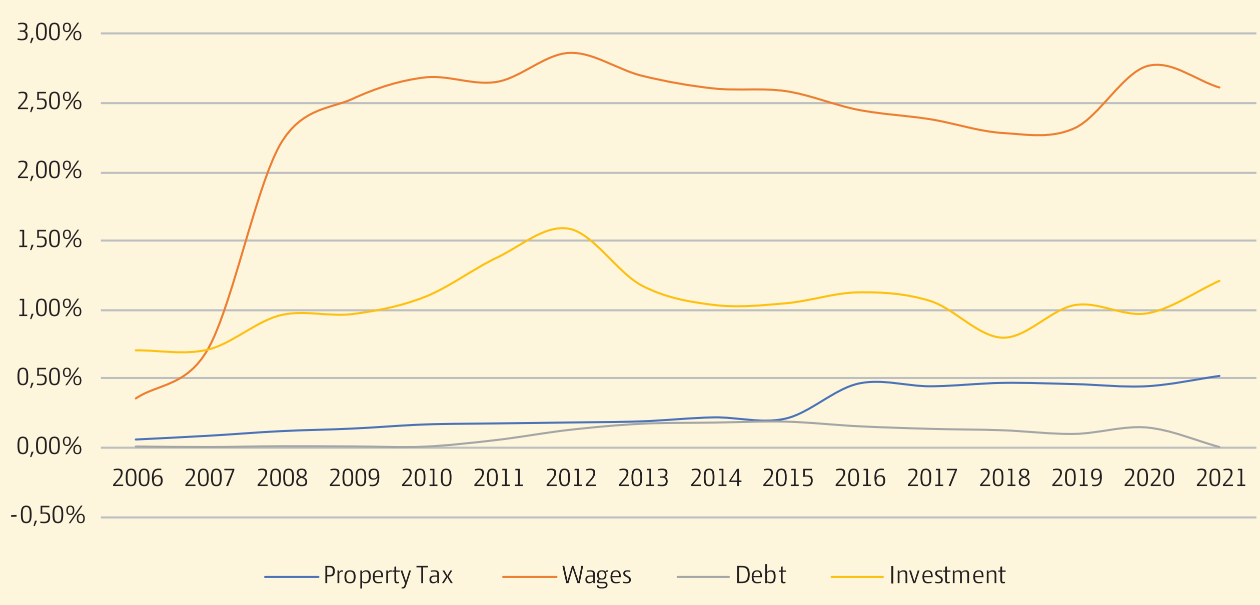
Figure 155 PUBLIC INVESTMENT BY LEVEL OF GOVERNMENT AND AS A SHARE OF GDP 2006-2021



Local government public investment makes up 29% of total public investments. Public investments in 2021 were 4.2% of GDP, which is an increase of 34% compared to 2020.

Property taxes (as a percentage of GDP) show an upward trend for the entire period. In 2021, they were 0.53% of GDP. Salaries expenses, as a percentage of GDP, decreased in the period from 2012 to 2019, while they showed an increase in 2020 and 2021. However, the share of salary costs in GDP in 2021 has decreased compared to 2020. There is no debt in 2021 as a result of the restrictive policies of the Ministry of Finance, but it showed a slight increase in the period 2012-2015, followed by a decline in the past two years. Investment costs as a percentage of GDP, after the highest level in 2012 followed by a period of reduction, showed growth in 2021 and make up 1.22% of GDP.

Figure 156 INVESTMENT, WAGES, DEBT & PROPERTY TAX AS SHARES OF GDP 2006-2021



Romania

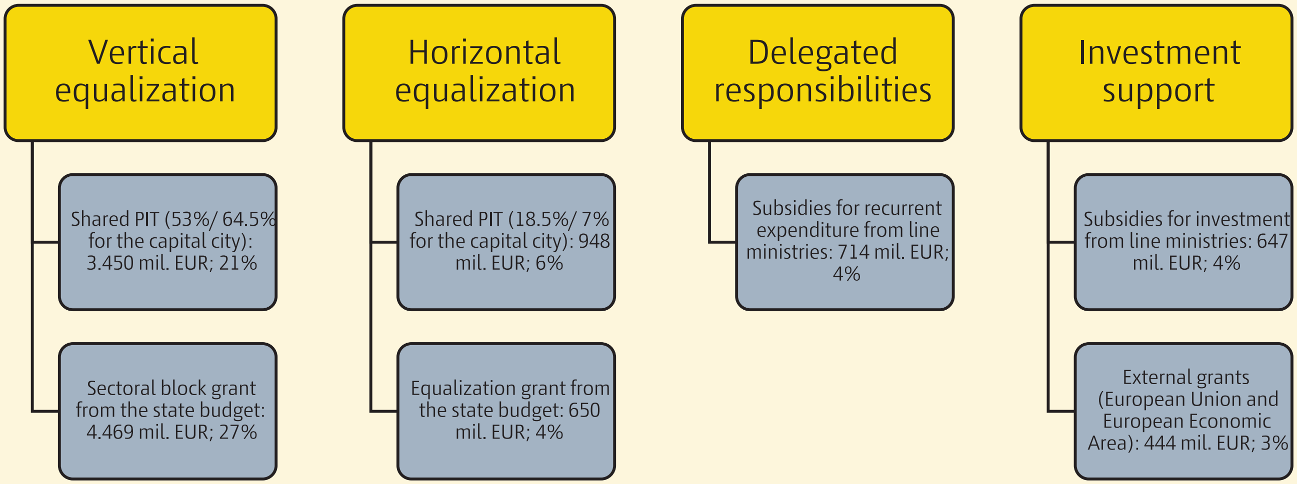
By Radu Comsa and Adrian Miroiu-Lamba, Association of Communes of Romania

The Intergovernmental Finance System

In Romania, the system of intergovernmental transfers is made up of a cluster of financial flows from the state budget to the 3,228 local budgets, serving several main purposes: (i) vertical equalization (i.e. ensuring resources for the delivery of shared and exclusive responsibilities); (ii) horizontal equalization (i.e. setting a level playing field for all local governments by compensating poorer ones for their lack of revenue generation capacity); (iii) financing delegated responsibilities (i.e. functions in which local governments act as agents of central government) and (iv) contribution to local governments investment expenditure.

The composition of the intergovernmental transfer system, as of 2021, is illustrated below:

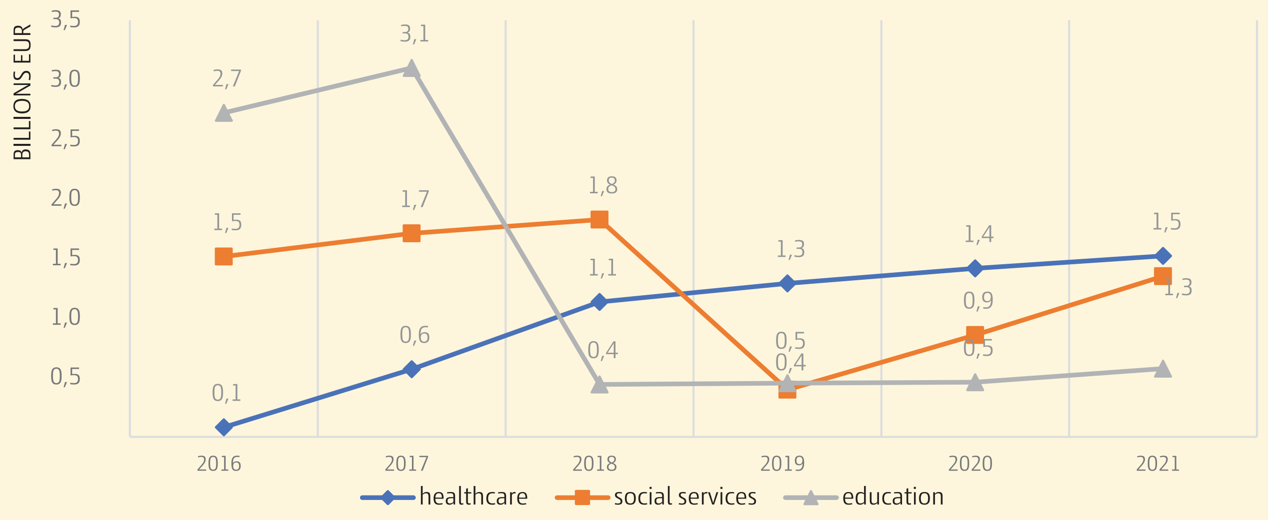
Figure 157 INTERGOVERNMENTAL TRANSFERS TO ROMANIAN LOCAL GOVERNMENTS IN 2017 (MIL. EURO AND SHARE OF TOTAL REVENUES) (SOURCE: MOF)



As of 2021, intergovernmental transfers accounted for 72% of local government revenues, totaling 14.9 billion euro. The biggest was the shared PIT allocated on derivation basis (19% of total revenue). The second category was the equalization grant, which consisted of pooled revenue from PIT (6%) and shared revenues (11%). The third source by size was the sectoral block grant from the state budget, aimed at expenditure in social services and education (8%). In the realm of investment transfers, the flows from the national budget made up 8% of total revenues, while EU grants accounted for 6%. The latter is expected to rise until 2023, as EU co-funded projects approach completion. In all, intergovernmental transfers equaled 6.3% of GDP in 2021.

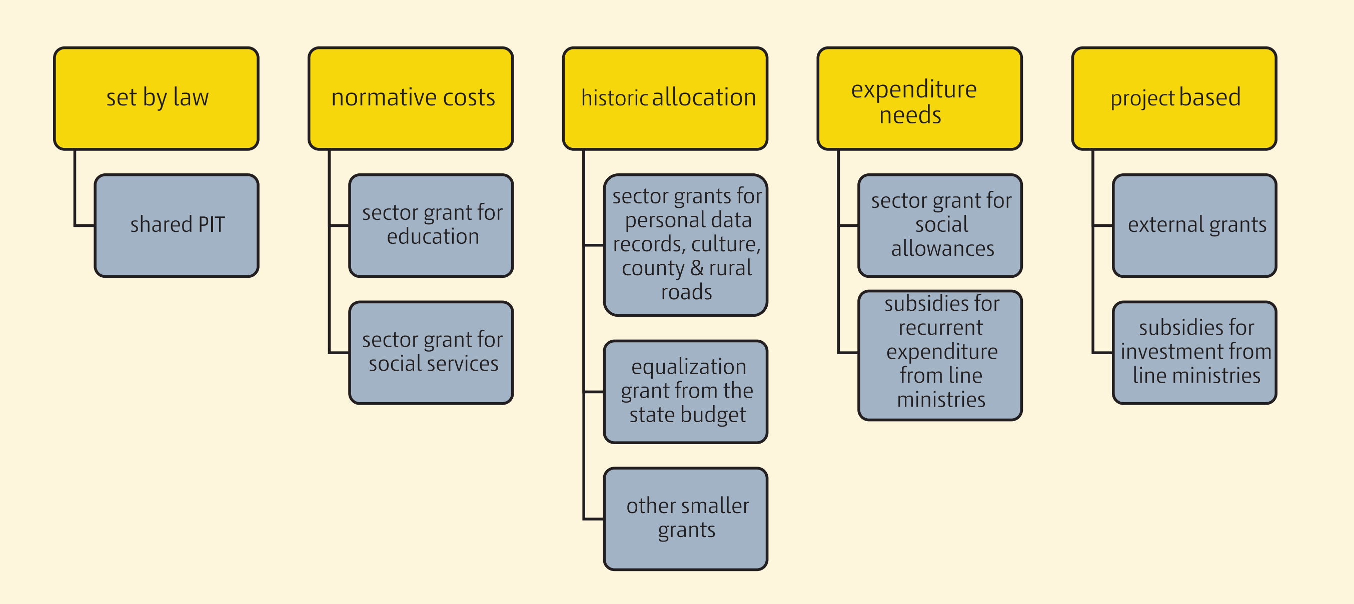
The share of intergovernmental transfers in total local government revenues has declined slightly in the past five years. Throughout, the state budget sector grant decreased significantly due to the centralization of wage bills in pre-university education in 2018, but subsidies linked to decentralized public hospitals' wage bills increased rapidly as a result of successive pay rises awarded in the Romanian public healthcare since 2016.

Figure 158 CONDITIONAL GRANTS FOR RECURRENT EXPENDITURE, 2016-2021



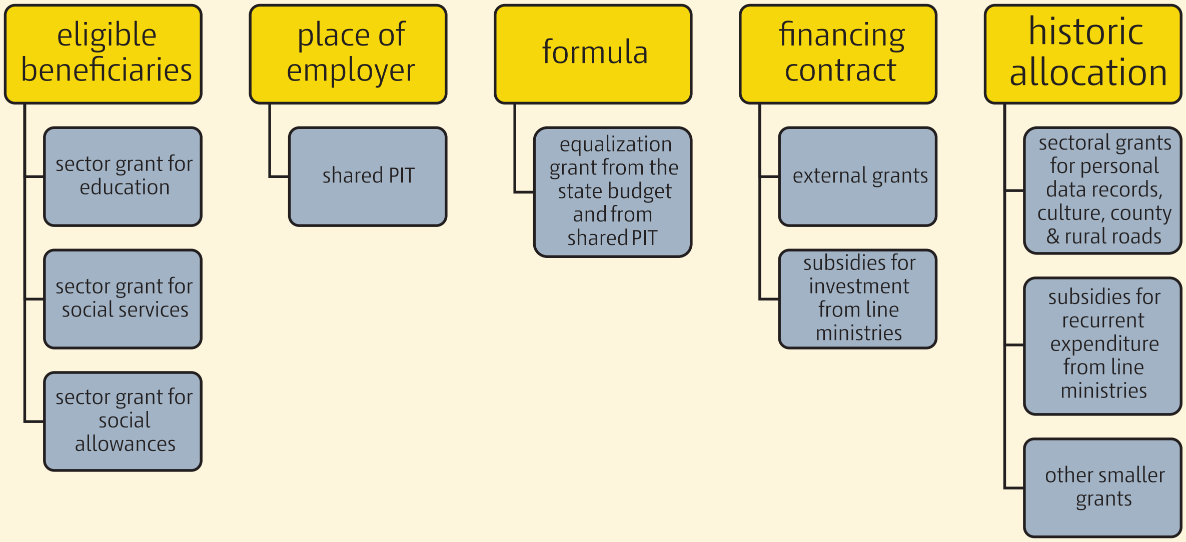
The calculation of intergovernmental transfers in the state budget or the ministries' budgets depends on the valuation method, as shown below:

Figure 159 **METHOD OF CALCULATION FOR INTERGOVERNMENTAL TRANSFERS, AS OF 2021**



As a result of the calculation method, yearly variations of the intergovernmental transfers depend on changes to the underlying legislation, such as wage policy, tax base and rate of PIT or value of social allowances. For example, pay rises in public hospitals in 2018 determined a 100% increase of the subsidy for public hospitals' wage bill in that year compared to the previous year. The allocation of intergovernmental transfers to individual local governments is determined at the county level (41 counties plus the capital city, Bucharest), for the sector block grant, and central level, for subsidies and external grants. The calculation is carried out by the Ministry of Finance's deconcentrated services or by line ministries (for subsidies), respectively, employing different criteria. Most resources are allocated to local governments using some sort of quantifiable criteria, either the number of beneficiaries or a formula (3/4 of all intergovernmental transfers) (see Figure 3). Investment contracts determine the allocations for investments, while historic allocations are decisive for the remaining transfers.

Figure 160 ALLOCATION CRITERIA OF INTERGOVERNMENTAL TRANSFERS, AS OF 2021



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

In addition to the inadequacy of normative costs, several additional flaws hinder the effectiveness of the intergovernmental transfers system. The current set-up is too fragmented, especially with regards to subsidies for recurrent and capital expenditure (more than 40 line-items in 2021). Furthermore, all the resources allocated within the sector block grant and subsidies are earmarked. Instead of giving local governments allocative autonomy in exchange for performance accountability, the Government and Parliament are micro-managing the utilization of intergovernmental transfers and pay little attention to local preferences. A growing problem in recent years has been the practice of suspending the application of the statutory equalization formula provided by the Law on local public finance. Since 2015, the state budget laws have included provisions which derogated from the Law on Local Public Finance and replaced the formula with other allocation criteria. Finally, the issue of unfunded mandates continues to impair the quality and access to local services. For example, each year local governments complain of the insufficiency of sector grants allocated for payroll of assistants to disabled persons; as a result, own source revenues are used to complete the respective payroll needs and thus to fulfill a delegated function from the central government.

Local Government Own source revenues

Romanian local governments' own source revenues consist of local taxes, user charges, fees, asset revenues etc. In 2021, they amounted to 28% of all revenues, i.e. 2.2% of GDP. The high share of own source revenues is due primarily to the hospital fees from the National Health Insurance House and the Ministry of Health, which reached 45% of all own source revenues. These are earmarked for use in hospitals.

Local taxes come second among own source revenues amounting to 8% of all local government revenues, namely 0.7% of GDP. Property taxes – on buildings, land and motor vehicles – make the biggest part of local taxes (0.67% of MEA in 2017).

All local taxes, including property taxes, are regulated by the national Fiscal Code. The current provisions have been in force since 2016. All tax administration duties – from tax setting to collection – are carried out by local governments where taxed items are located.

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

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

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

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

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

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

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

1. Achieve interconnectivity between all local governments' tax registries, relevant central government registries (State Tax Administration, Land Registry, Motor Vehicles Registry) and notaries.

2. Carry out a national campaign to increase awareness of online tax payments. Simplify procedures for registration and solve back-office difficulties (especially in relationship with the Treasury).

3. Change the tax valuation to a market-based system. Current information flows offer enough data on real estate transactions to enable a market-value tax setting mechanism. A gradual implementation and pilot projects could offer practical solutions and anticipate difficulties before the roll-out at national level. (This goal is also stated in the National Reconstruction and Resilience Plan with completion envisaged for 2025).

Borrowing

Romanian local governments are allowed to contract local public debt. Romanian local governments are allowed to take on debt directly or provide guarantees to debt contracted by subordinated institutions or municipal enterprises. All regulations regarding local public debt are provided by the local public finance law (no 273/2006) (LPFL). Local governments may issue bonds, take loans, use supplier credit facilities, contract financial leasing, endorse promissory notes and guarantee debt of subordinated entities. Debt can be contracted for any period of time in national or foreign currency.

Local public debt is guaranteed with own revenue and income from shared personal income tax. Local governments are solely responsible for the repayment of the debt they incur. Although local governments are entitled to seek state guarantees for contracted debt, this practice is very rare. Local public debt cannot be guaranteed with property. If a local government defaults on its debt, the creditor may seek to declare the local governments in financial distress or insolvency, both of which are regulated by specific legislation.

As a rule, local public debt can only be used for capital improvements or debt repayment. However, local governments are allowed to take short term loans from the MoF, to compensate cash shortages. Such loans must be repaid by the end of the budgetary year. In recent years, exemptions to LPFL were made to allow local governments to contract loans from the MoF for recurrent expenditure related to district heating systems.

Local debt can be contracted upon authorization from the local council and a central committee established within the Ministry of Finance[16]. The mayor or the president of the county council puts forward to the local (county) council a proposal to take on debt, which must be endorsed by an absolute majority. A local government qualifies for new debt if the cumulated debt service for existing and new debt is less than 30% of the average of recurrent own source revenues combined with revenue form shared taxes from the previous three years. The local government must comply with this debt threshold for the entire duration of the loan maturity. In addition to the debt threshold, local governments who want to take on new debt must clear all overdue payments stemming from previous budgetary years before the authorization by the Ministry of Finance committee. The local public finance law provides exemptions from the two rules for loans pertaining to pre-financing and co-financing projects supported through grants from the European Union or non-EU members of the European Economic Area. Exemptions are also provided for local governments in financial distress or insolvency which take loans to refinance local public debt, as per the approved redress plan.

Local public debt and drawdowns must fall within national thresholds approved by the central government. The local public finance law mandates the government to approve annual national thresholds for newly contracted debt and drawdowns to existing debt. The objective pursued through the setting of national thresholds is to control the budget deficit of the general government. By November each year, the Government approves the national thresholds for the next three years. The MoF committee must ensure that any new loan falls within the national threshold for the respective year and that forecast drawdowns fall within the applicable thresholds for the current year and the ensuing two years. If any of the thresholds is breached the authorization or the drawdown is deferred to the following years when such threshold space is sufficient. A more recent rule requires that the maximum value of loans which can be authorized for any given local government in a year is 100 million lei, i.e. 20 mil. EUR. As in the case of debt threshold, exemptions from the national thresholds are permitted for loans contracted for pre-financing and co-financing projects supported through grants from the European Union or non-EU members of the European Economic Area.

The value of annual national thresholds has been increasing in recent years, with a spike in 2021 intended to help local governments continue capital projects despite any COVID-19-related shortages. The data indicates that the contribution of expenditure from local public debt to the general government deficit remains minor.

In recent years, the Ministry of Finance has become an important lender to local governments. In most cases, local governments borrow from private lenders such as commercial banks or other international financial institutions. They can take on debt in national or foreign currency. However, in recent years a significant amount of debt was borrowed from the Ministry of Finance. From 2016 to 2020 six lending schemes funded from "privatization proceeds" have been implemented, whereby local governments could borrow for capital expenditure or district heating recurrent expenditure. They funded loans worth almost 2 bn. lei, i.e. 450 mil. USD, making the MoF the third most active lender in the local public debt market.

As for the share of local expenditure stemming from local debt, the value has not been significant at the national level, even in the pandemic years, ranging between 2% and 3% annually. While communes, towns, cities and counties spent less than 3% funded from local debt, the value in Bucharest is above 6% of total expenditure.

[16] The committee is made of 13 members of which seven are from the Ministry of Finance, two from the Ministry of Public Works, Development and Administration and one each from the Association of Romanian Cities, Association of Romanian Towns, Association of Romanian Communes, and the National Union of Romanian County Councils. The committee verifies compliance with debt preconditions and ensures that any new debt falls within the annual national thresholds for new debt and for drawdowns.

Figure 161 ANNUAL NATIONAL THRESHOLDS FOR NEW LOANS AND DRAWDOWNS 2016-2021 (SOURCE: ANNUAL GOVERNMENT DECISIONS, NATIONAL FORECASTING COMMISSION)

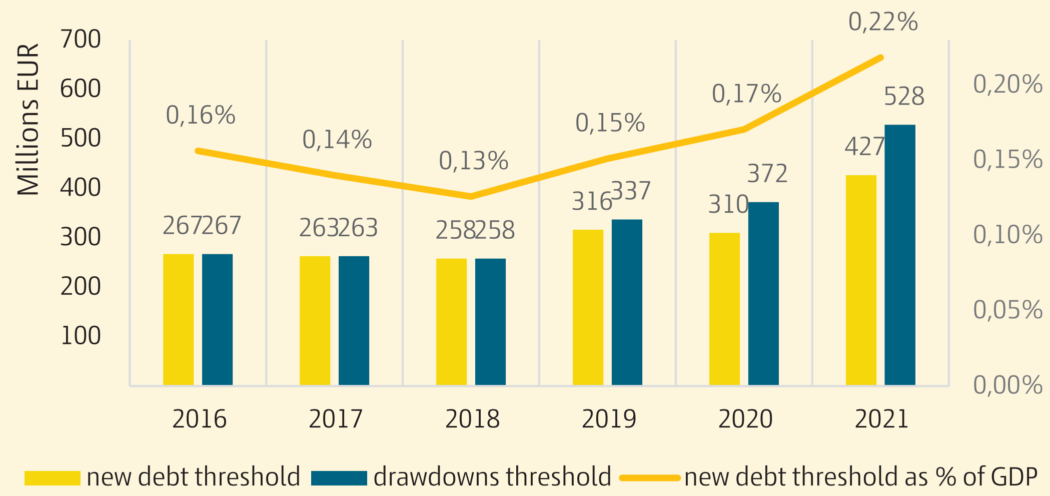
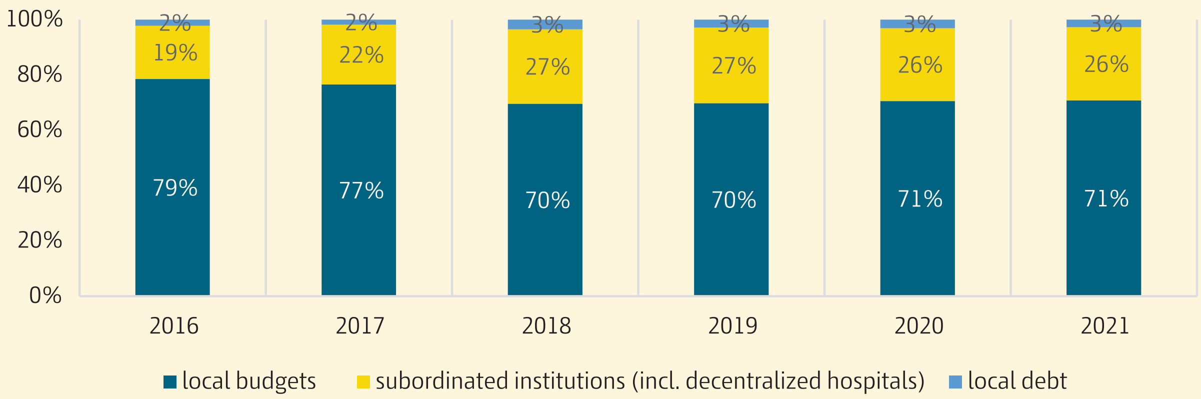


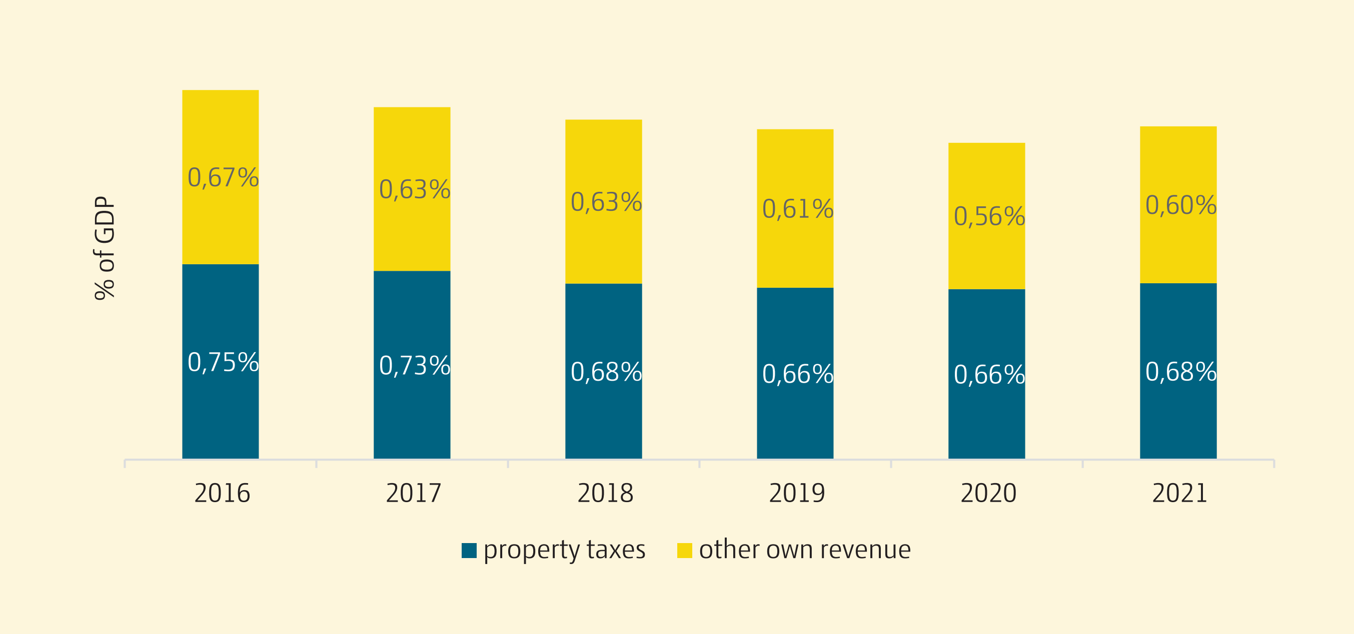
Figure 162 BREAKDOWN OF LG EXPENDITURE BY THE SOURCE OF BUDGET



COVID-19 Impact and implications for Local Government Finances

The COVID-19 pandemic did not cause any major upheaval of local finances in Romania. Local governments continued to fulfil an important role in the provision of public services and accounted for a fifth of the total general government expenditure in 2021. There was no significant change in the assignment of revenue and expenditure responsibilities. In 2020 local fees revenues did decrease in relative terms, though. The share of non-tax/ non-hospital revenues in GDP fell from 0.61% in 2019 to 0.56% on the back of lower yields from permits, royalties and rents. They reverted the next year thanks to the recovery of dues from 2020 that were deferred because of the COVID-19 pandemic. Revenue from local taxes decreased slightly in 2020 in nominal terms, but remained flat relative to GDP. By the end of 2021 they were 15% higher than in 2019, marking a rather swift recovery.

Figure 163 LOCAL REVENUES IN PERCENTUAL OF GDP, 2016-2021

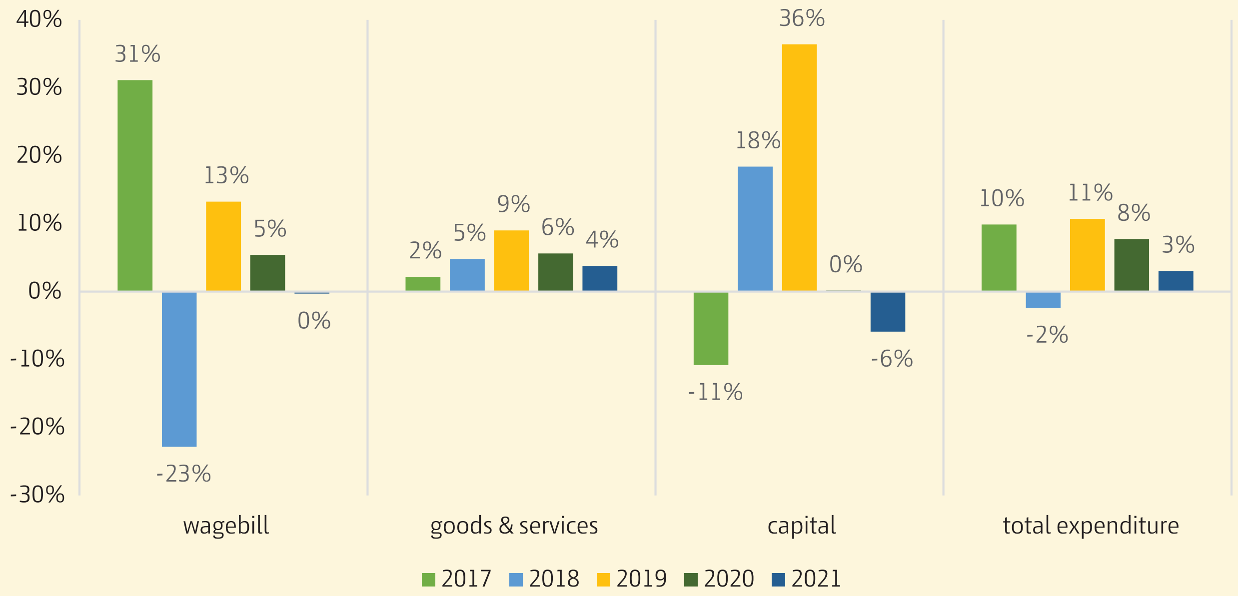


A larger impact was felt by decentralized hospitals, whose fee-for-service revenues decreased in the early months of 2020 while the number of admissions plummeted. To compensate the loss, the funding of hospital services by the National Health Insurance House switched from fee-for-service to global budgets, which helped all public hospitals to remain open until 2022.

Decreases from personal income tax were avoided thanks to the government's interventions that preserved a large share of the incomes of the temporarily laid-off workforce.

On the expenditure side, while there was no nominal decrease, a slowdown of the growth rate was recorded in wage bill and goods & services, as a result of the government freezing public sector wages and the temporary closures of many public service providers (such as cultural institutions, schools and day social services). Also, a slowdown of capital expenditure was caused by the central government reducing the funding for local infrastructure. Overall, local government expenditures did not decline nominally, but showed a clear deceleration in 2020-2021 due to less needs and less central government support for investments.

Figure 164 VARIATION OF CATEGORIES OF EXPENDITURE (2017-2021, CONSTANT PRICES 2016)



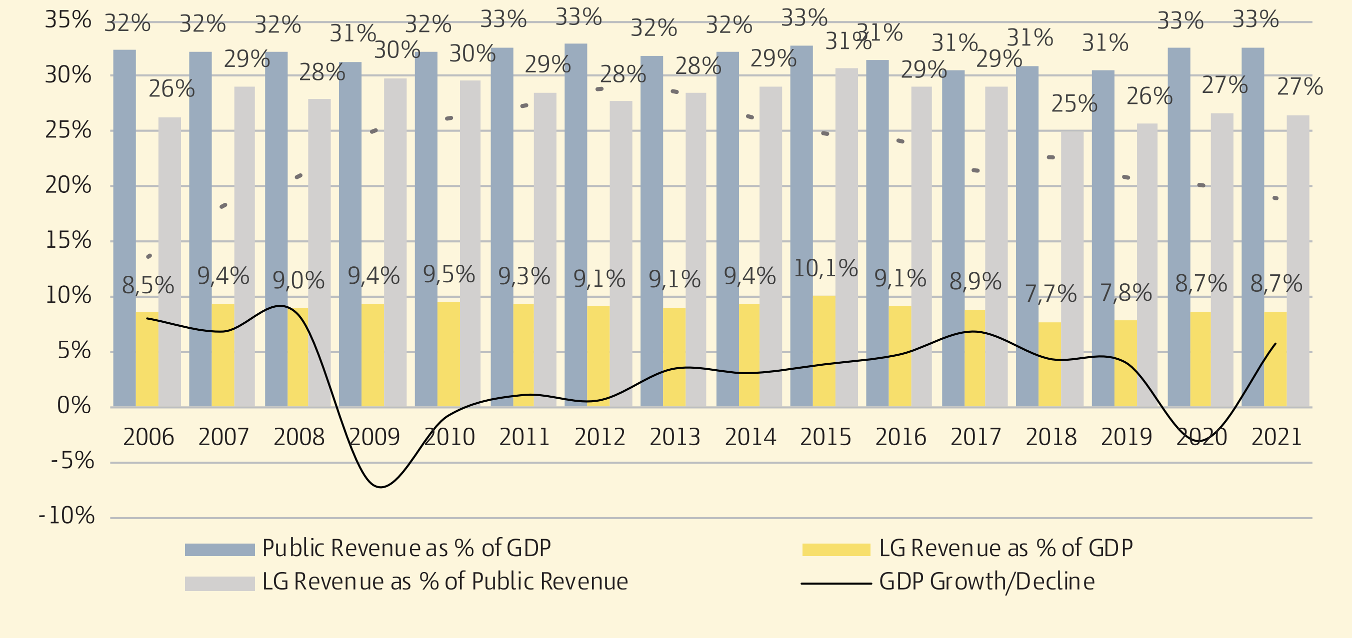
Advocacy efforts of the Local Government Association in the area of local finances

In 2020, before the pandemic, the Association of Communes presented the Government and the Ministry of Finance a public policy proposal intended to improve the equalization system and open discussions for structural reform of intergovernmental transfers. The proposal was presented to MoF representatives in a workshop in February 2020. In the meantime, the MoF, together with the World Bank, has been working on a comprehensive review of intergovernmental transfers and is expected to put forward reform proposal.

Statistical Overview of the Finances of Local Governments in Romania 2006-2021

Throughout 2014-2021, the size of Romania's public sector revenues as a share of GDP contracted from 32% to 27%, following a series of changes to the intergovernmental transfers, which decreased the value of the sectoral grants for education and social services (i.e. wage bill in pre-university education and social benefits for disabled persons were centralized in 2018 and 2019, respectively). As a result, local governments' relative weight in GDP went down from 9.4% to 8.7%. Over the past few years, the size of Romania's public sector revenues in GDP increased from 31% to 33% in 2021. While in nominal terms public revenues have increased, the real GDP fell by 3% in 2020, helping to explain the relative improvement in the indicator. As a result, local governments' relative weight in GDP increased in 2020 and 2021.

Figure 165 ROMANIA: LOCAL GOVERNMENT REVENUE AS A SHARE OF GDP AND TOTAL PUBLIC REVENUE 2006-2021



The share of local government revenues to general government revenue has increased over 2020 and 2021, nevertheless, it remains much lower than the levels of 2015 and before.

The 2016 contraction affected the entire public sector following tax cuts to VAT, excise taxes and social security contributions, but LG revenues declined due to PIT outlays. The revenue drop in 2018 was due to the sharp reduction of the conditional grants generated by the centralization of the wage bill in pre-university education. During the COVID-19 crisis LG revenues grew at a higher rate than total public revenues.

The structure of local governments revenues has seen some variations in the last three years, but the structural changes are related to a change in the methodology of presenting the data. Own source revenues, the general grant, which includes a large component of the equalization pool, shared taxes and the sector block grants have been the biggest components. The high share of own source revenues is due to hospital income from the National Health Insurance House and the Ministry of Health, which counts as fees-for-services. In 2018 the share of the sector block grants dropped significantly, following the centralization of the pre-university education wage bill.

Figure 166 ROMANIA: ANNUAL FLUCTUATIONS IN THE REVENUES OF THE GENERAL GOVERNMENT AND LOCAL GOVERNMENTS

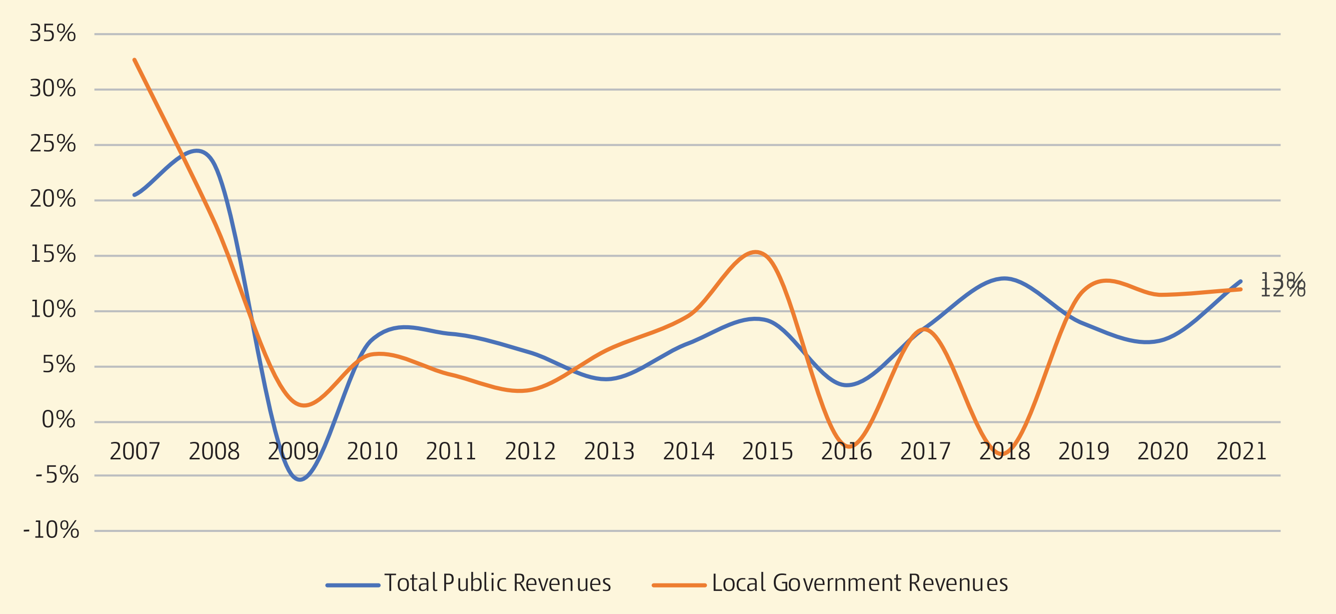


Figure 167 ROMANIA: COMPOSITION OF LOCAL GOVERNMENT REVENUES IN PERCENT OF TOTAL

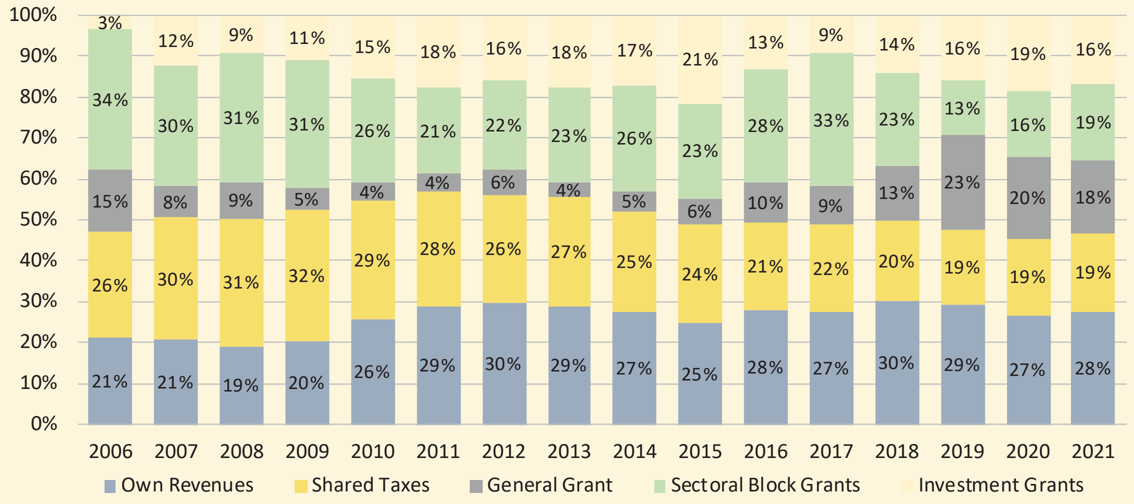


Figure 168 ROMANIA: COMPOSITION OF LOCAL GOVERNMENT REVENUES, IN MILLION EURO

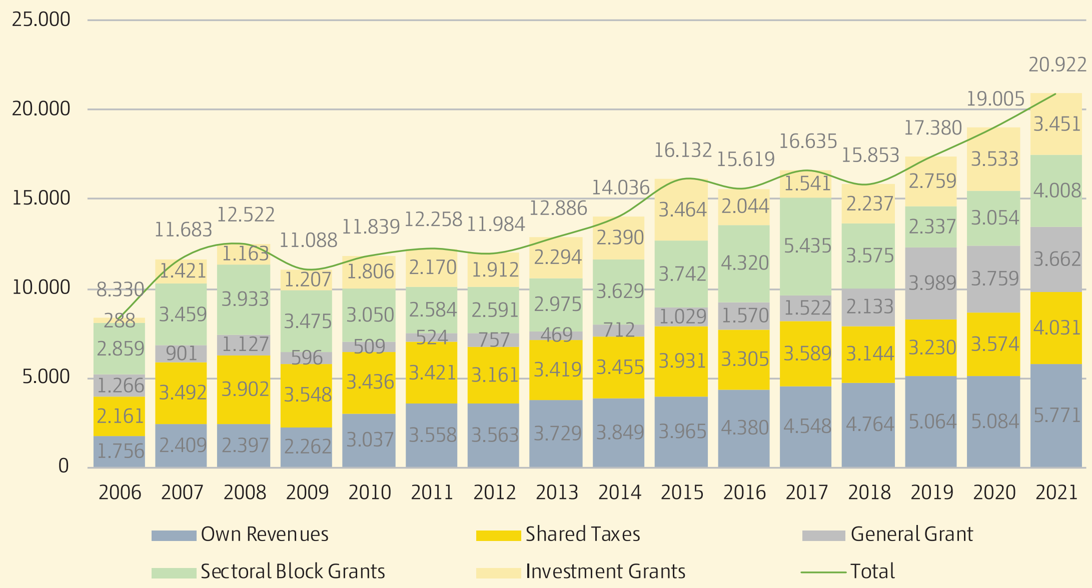
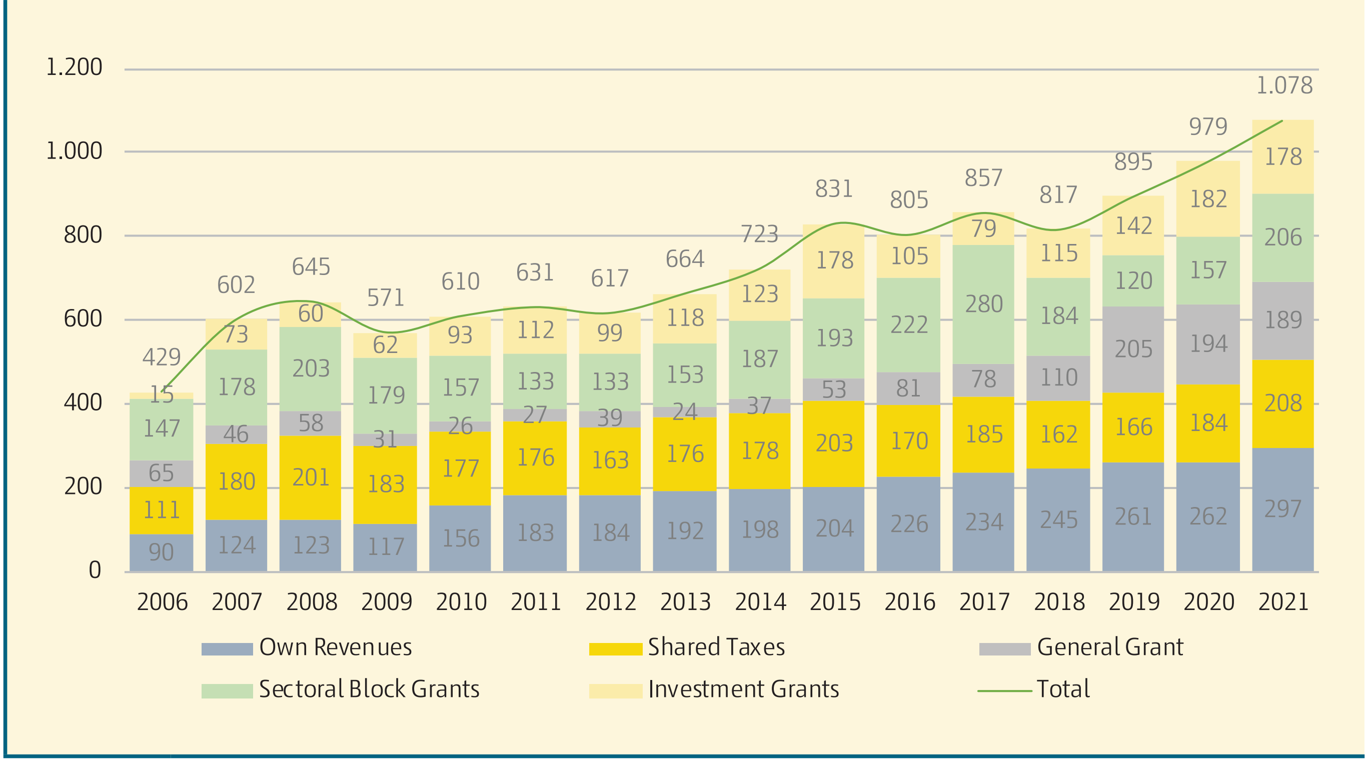


Figure 169 ROMANIA: COMPOSITION OF LOCAL GOVERNMENT REVENUES, IN EURO PER CAPITA

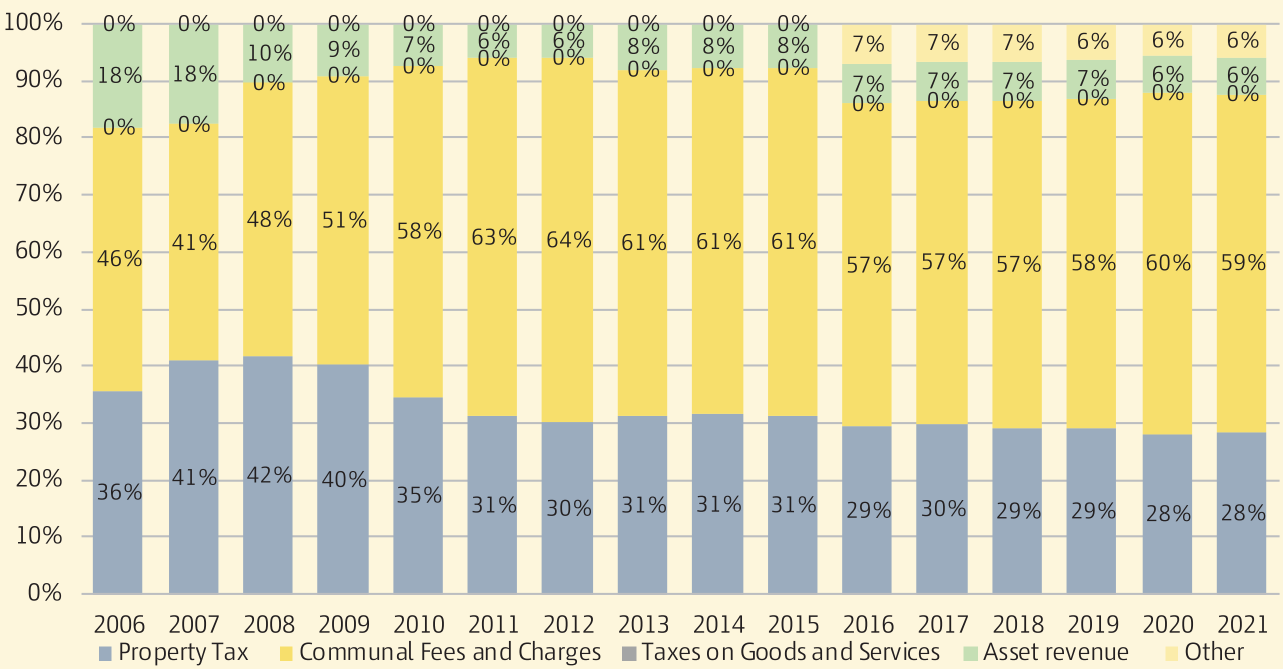


Overall, local government revenues in 2021 were 21.1 billion Euro, up from 16.1 billion Euro in 2015.

In per capita terms, local government revenues in 2021 were 1,078 Euro per inhabitant, up from 831 Euro per inhabitant in 2015.

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

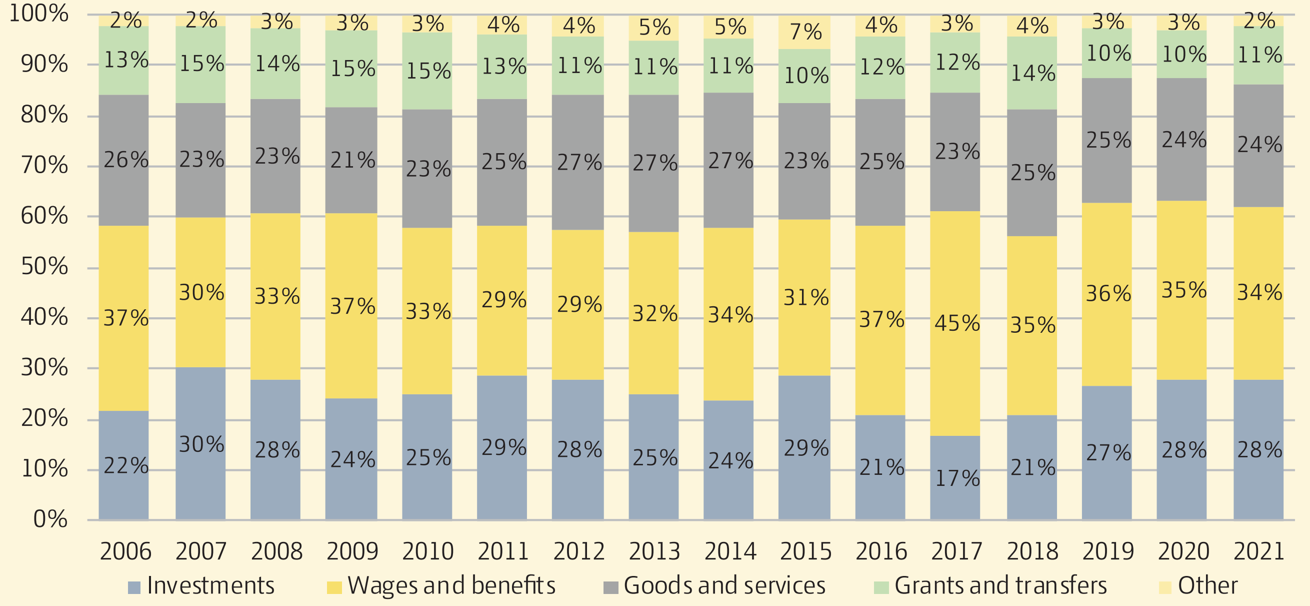
Figure 170 ROMANIA: COMPOSITION OF OWN SOURCE REVENUES, IN PERCENT OF TOTAL



Note: communal fees and charges contain revenue of decentralized hospitals from fees-for-services

In terms of expenditure, the most significant change has taken place in the share of spending for investments, which has been increasing since 2017. The share of spending for wages and benefits (payroll), which has been upwards until 2017, but then declined in 2018 due to the centralization of the wage bill in pre-university education. the peak in 2017 is due to the pay reform in the public sector which allowed local governments to set wages freely, up to a statutory threshold. The pay rises at the time came at the expense of investments, which went down to record levels. The wage bill remained constant thereafter.

Figure 171 ROMANIA: COMPOSITION OF LOCAL GOVERNMENTS' EXPENDITURE %



In nominal terms, the impact of pay rises on payroll has been significant (+40% in 2017 vs. 2015) and the drop of investment has been important (in 2017 they were below the levels recorded during the economic crisis).

Figure 172 ROMANIA: COMPOSITION OF LOCAL EXPENDITURE IN MILLION EURO

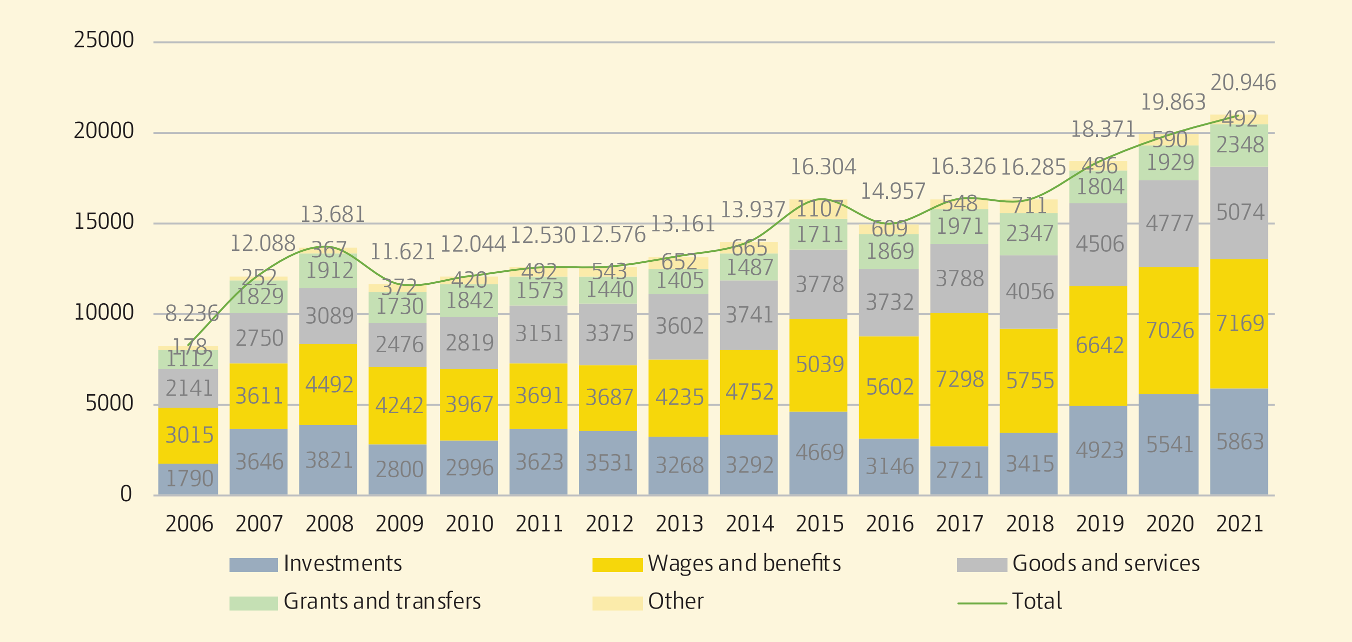


Figure 173 ROMANIA: COMPOSITION OF LOCAL EXPENDITURE IN EURO PER CAPITA

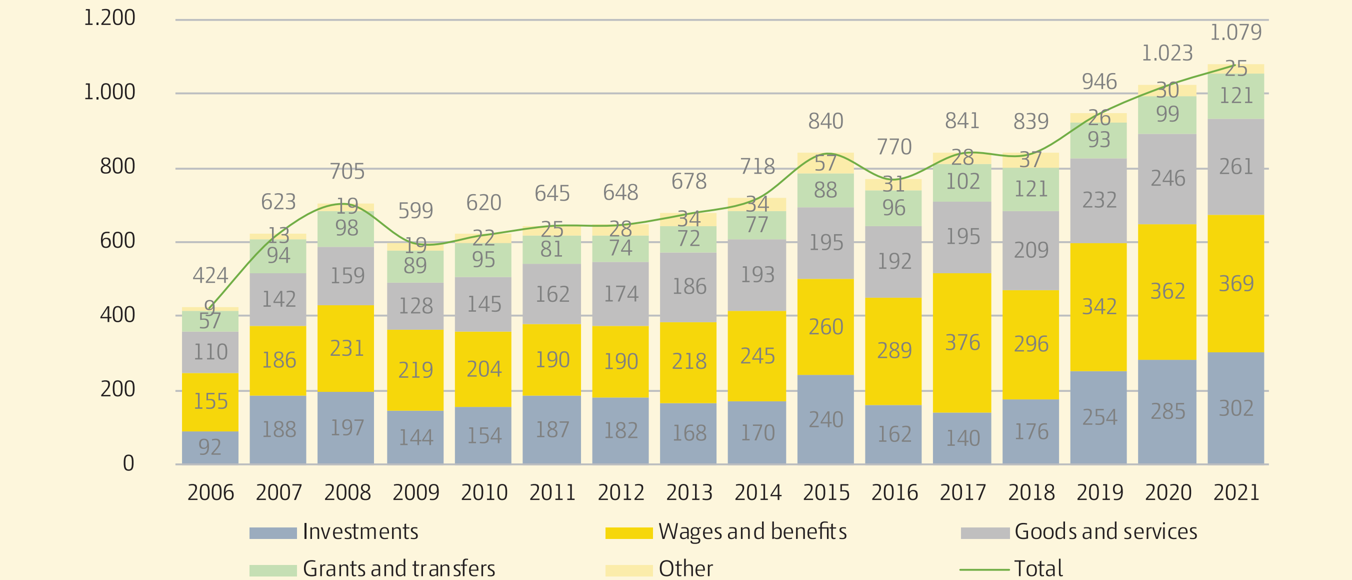
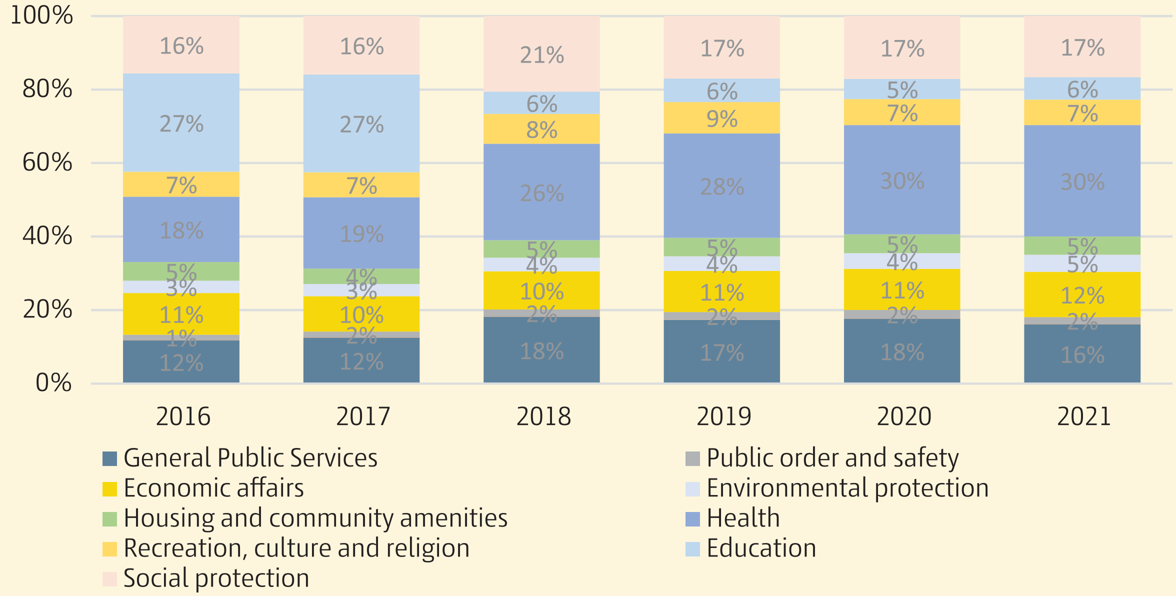


Figure 174 ROMANIA: COMPOSITION OF LOCAL EXPENDITURE ON FUNCTIONAL BASIS (COFOG CLASSIFICATION)



From a functional perspective, Romanian local governments spend more than half of their budget on the social sector responsibilities of education, healthcare and social protection. The shares have changed over time – as the education wage bill has been centralized in 2018 while cash transfers for social protection have been centralized in 2019. Romanian local governments play a fundamental role in public investment. While the share of investment has decline significantly between 2017-2018, this indicator has improved substantially over the past three years.

Over the last 3 years, the property tax revenues as a share of GDP have been constant at 0.7%, from an average of 0.9% in the previous decade. This contrasts the expenditure trends, which have seen an increase and high volatility (see spending for wages and investments). On the positive side, the stock of outstanding local government debt has also been decreasing to below 2% of GDP.

Figure 175 ROMANIA: COMPOSITION OF PUBLIC INVESTMENTS, AND AS % OF GDP

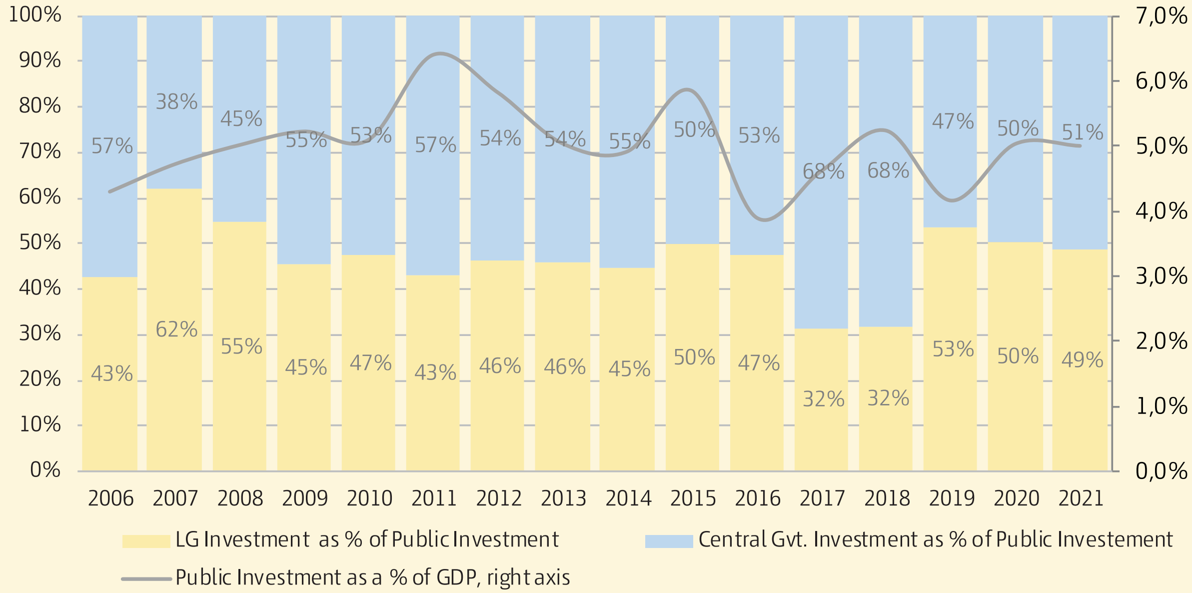
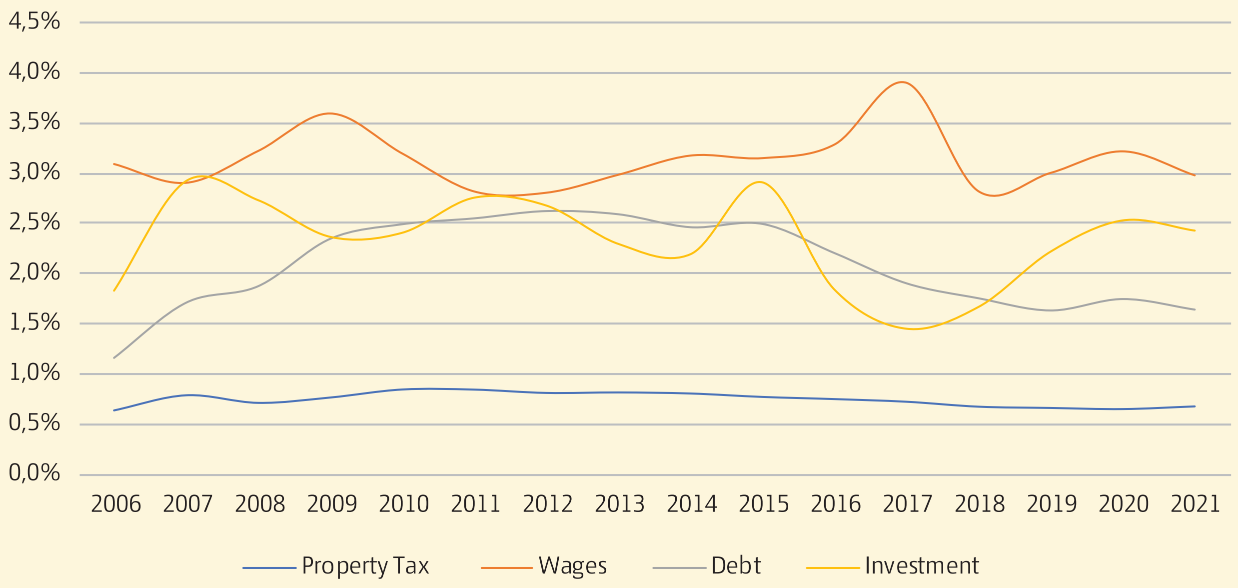


Figure 176 ROMANIA: TRENDS OF SELECTED BUDGETARY INDICATORS AS % OF GDP



Serbia

Prepared by the Standing Conference of Towns and Municipalities

The Intergovernmental Finance System

The intergovernmental finance system in Serbia is mainly regulated by the Law on Local Government Finance[17]. The Law defines, besides local government own source revenues, two types of local self-government (LSG) revenue transfers from central government: a) Assigned revenues and b) Grants (transfers) – unconditional and conditional. Besides the central level, the autonomous province can assign earmarked (conditional) grants to LSGs on its territory.

The assigned revenues include *taxes* and *fees* (effectuated in the LSG territory). The most important part of **assigned taxes** is the Personal Income Tax (PIT) which is also the most important revenue source for LSGs. The gross wages tax (shared with central level) accounts for almost 80% of total PIT assigned to LSGs. As of 2016, cities receive 77% (previously 80%), municipalities 74% (previously 80%) and the City of Belgrade 66% (previously 70%) of the wage tax. Besides shared wage tax, the other part of PIT includes revenues that come from agriculture and forestry, independent activities, leasing of movable property and personal insurance. Apart from PIT, the Law on Local Government Finance recognizes two more LSG tax revenues assigned from central government: Inheritance and gift tax, and Absolute rights transfer tax.

Grants assigned from the central government, according to the Law on Local Government Finance, can be non-earmarked (unconditional) and earmarked (conditional). Within the total **non-earmarked grant pool**, the law prescribes that the first call of funds is aimed at horizontal equalization. LSGs whose per capita revenues from shared taxes are less than the national calculated average— are entitled to an **Equalization Grant.** Their grants are equal to a percentage of the difference between their per capita revenue from shared taxes and a percentage of the national average multiplied by their populations. The remainder of the pool is allocated by formula to all LSGs (except Belgrade since 2011) through a **general grant/transfer.** The allocation of this grant to individual LSGs is determined in accordance with uniform criteria such as metrics for population, territory, number of classes in elementary and secondary schools, number of elementary and secondary school buildings, number of children attending preschool and number of pre-school buildings. The general transfer thus has an equalizing effect, independent of the equalization grant.

The 2011 amendments introduced a new grant – i.e., the **Solidarity Transfer** (as a part of total unconditional grant). All LSGs, except the city of Belgrade, are entitled to receive this transfer. The size of the Solidarity Transfer is equal to the transfer that the City of Belgrade was entitled to receive by General Grant according to the original Law adopted in 2007. The reason for introduction of this Solidarity Transfer was the increase of the share of Wage Tax for LSGs from 40% to 80% (except Belgrade, whose share was raised to 70%). This caused a reduction of the amount of the unconditional grant, leaving a smaller pool of grant funds which are being allocated to other LSGs upon a complicated development index which divides them into four groups. Besides non-earmarked grants, different ministries provide **earmarked grants** to LSGs, with the largest portion of grants coming from the Ministry of Education, Ministry in charge of Social Protection and the Ministry of Culture.

[17] Other relevant pieces of regulation include Budget System Law, annual Law on Budget, Law on Public Debt, Law on Property Taxes, etc.

Local Government Own source revenues

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

In 2012, the legal framework was amended again, this time significantly limiting some local communal fees like the business sign tax and eliminating others like the local motor vehicle fee. In June 2013, the government reduced the rate of the wage tax from 12% to 10% while increasing the threshold for non-taxable income. Furthermore, on January 1st, 2014, the government eliminated the Land Use Fee, the second most important source of own revenue with the intention to integrate it into the property tax. The amendments of the Law on Property Taxes brought a significant increase in property tax collection in 2014. On the other hand, Land Development Contribution (the previous Land Development Fee) is still one of the important own-sourced revenues.

The Law on Fees for the use of public goods adopted in 2018 is one of the most important novelties in this field in recent years. Specifically, this is the first time in Serbia that one law systematizes all public fees within one place, and it precisely determines all relevant issues for any fee separately, such as: who are the taxpayers, what constitutes tax bases, amounts, the process of tax determination and payment, fee affiliation, and other questions important for determination and collection of the fees. Among the listed/prescribed fees therein, the following represent the source of LSG own source revenues: The Fee for environmental improvement; the Fee for usage of public spaces/surfaces; the Fee for usage of natural healing factor (i.e., thermal, and mineral waters).

According to the amendments of the Property Tax Law, since November 2020 (and subsequently in 2021 and 2022), it is anticipated that in year 2024, LSGs shall be awarded competence to fully determine, collect, and control inheritance and gift tax and tax on transfer of absolute rights. Tax rates remain, however, prescribed by the Law (i.e., LSGs are not entitled to set these tax rates). Until now, those two taxes, as shared revenues, have been administered by the central government, and have been shared in their total amount with LSGs. In line with the new law changes, LSGs will be considered as a tax authority relevant for the administration of those taxes instead of the Central Tax Administration. Besides this amendment, which is directly related to the flow of the fiscal decentralization process in Serbia, the law brought about several other changes with the aim of improving the regular administration of own source revenues, and which are related to some closer determination of the following: property average price, amortization rate, classification of auxiliary facilities, additional determination of some aspects of tax base and tax reliefs, etc.

Borrowing

Local government borrowing is regulated by the Law on Budget System and the Law on Public Debt. In line with the Law on Public Debt, local governments are authorized to borrow both on domestic and international markets (in domestic or foreign currency), with the prior approval (consent) of the Ministry of Finance. The request for approval contains the data on planned and realized revenues (expenditures) in the previous year, as well as the plan of revenues and expenditures for the following year, along with the rationale for borrowing. In addition, the request must contain the data on current public debt and the list of (un)paid obligations, on the date of submission of the request.

Besides the borrowing for the purposes of (re)financing capital investments[18], local governments are allowed to borrow to finance current liquidity (caused by disparity of LGs revenues and expenditures), which is limited at 5% of revenues collected in the previous year. In the case of financing capital investments, the local debt cannot exceed 50% of current revenues, collected in the previous year.

In 2021, the debt at the subnational level was at 52.3 billion RSD, which is 1.5% of general government debt and 13.8% of local government revenues. In terms of GDP, this debt accounts for 0.8% of GDP.[19]

COVID-19 Impact and implications for Local Government Finances

In nominal terms, at first glance, the COVID-19 crisis did not have a significant impact on LG revenues and expenditures. It is important to highlight though that in the five years preceding 2020, LG revenues grew constantly, with an average annual growth rate of 7.5%. The COVID pandemic discontinued the growth and brought a decrease in LG revenues of approximately 1% (compared to 2019). The decrease was in major part affected by the *Decree on fiscal benefits and grants to business entities*[20], that allowed companies to postpone the payment of the personal income tax (from 2020 to 2021). In addition, local governments demonstrated fiscal responsibility – expenditures did not exceed revenues and there was no significant change in local debt. However, compared to 2020, in 2021 both LSG revenues and expenditures increased by 17.7% and 13.6%, respectively. As stated above, the payment of PIT was postponed, which was one of the main reasons for the increase, along with inflation (4.0% on average in 2021).

When it comes to policy/structural changes in the LG finance system during COVID-19, in addition to the already mentioned Decree (application of which was limited and not long-term, i.e., it introduced temporary mitigation measures in year 2020), there were some other interventions with limited implications. For example, deadlines for elaboration and submission of final annual accounts were postponed during 2020 (budget calendar for LSGs). As for long-term changes in local finance instruments due to COVID-19, no formal/legislative changes have taken place so far.

18 Long-term borrowing, i.e., standstill period + at least 5 years of repayment deadline.

19 In line with Public Debt Administration reports, the data on public debt is available only at subnational (local and provincial cumulatively) and general government level. Data: Ministry of Finance – Public Debt Administration: Quarterly report, December 2021.

20 The Government of the Republic of Serbia adopted The Programme of Economic Measures to support the Economy, which is formed on the basis of international experiences (measures adopted in developed economies and in the economies from region), IMF recommendations and European Commission, as well as on measures proposed by domestic business associations. The Programme was focused on efficient implementation of fiscal measures without excessive procedures, with the aim that the assistance is provided timely to those in greatest need. The introduced measures had temporary character, in terms of direct payments, as well as postponements and reductions of certain tax liabilities. The Decree in question presented exactly the legal framework for implementation of the Programme of Economic Measures. It regulated fiscal benefits and direct payments from the Republic budget to the business entities in the private sector (measures) with the aim to mitigate economic consequences caused by COVID-19. Support packages continued also in 2021, mostly as grants/one-off assistance to citizens and economic operators, thus with no direct implications for LSG financing system (supporting legal acts: https://www.mfin.gov.rs/sr/aktivnosti-1/ekonomske-mere-za-pomoc-privredi-i-gradjanima-1).

As a measure of prevention and mitigation of the consequences caused by COVID-19, the national government transferred around 47 million EUR to local governments in 2020 and around 54 million EUR in 2021.**21** Further, LGs had constant support from the national government in terms of health management, relating to the conditions that affect hygiene and health – LGs were supported with human resources, materials, distribution of disinfectant products, etc. Thus, the state (national level) undertook a significant burden in terms of preventing and mitigating the impact of the pandemic to citizens and the economy.

The Standing Conference of Towns and Municipalities (SCTM) supported colleagues from cities and municipalities, collecting their questions and requests addressed to national institutions, and were devoted to finding solutions for the challenges caused by the pandemic. Furthermore, during the state of emergency, the SCTM submitted several initiatives to the Government of the Republic of Serbia, the Ministry of Public Administration and LSG and to the Ministry of Finance. The main initiatives pertaining to local finances included advocating for the extension of deadlines for submitting annual financial reports (accounts for 2019), proposals of measures that would support the financial sustainability of LSG budgets and open a dialogue on support to LSG, ensuring stability of salaries for LSG employees in case their sick leaves were caused by the virus, etc.

As for updates concerning COVID-19 impact and implications, SCTM maintained the analytical course of activities, assessing and presenting to the membership the findings on the influence of Government's mitigating measures on local finances and also published a targeted analysis on the impact of the pandemic upon the EU funds/financing designated for LSGs[22].

[21] Please refer to https://www.mfin.gov.rs//upload/media/zKFb2b_60f52876ca237.xlsx. All reports available at: https://www.mfin.gov.rs/o-ministarstvu/izvrsenje-budzeta

[22] Analysis available in Serbian language at: http://www.skgo.org/storage/app/uploads/public/163/801/820/1638018209_Analiza%20uticaja%20zdravstvene%20krize%2025112021%20web.pdf

Advocacy efforts of the Local Government Association in the area of local finances

Prospects for reforming the LSG financing system in Serbia: In July 2021 the Government of Serbia adopted for the first time the Programme for LSG System Reform for the period 2021-2025, accompanying the Public Administration Reform (PAR) Strategy (adopted earlier in April 2021). The Programme is the first policy document that lays out the reform of the local self-government system in a comprehensive and all-inclusive manner. With the Ministry of Public Administration and Local Self-Government leading the broad consultative process, SCTM was one of the key partners and interlocutors in drafting the document itself.

The Programme[23] provides a description of the current situation and key areas of the LSG system, a historical overview of the LSG system, the local electoral system, organization and activity of bodies, institutions and enterprises in the LSG system, good governance in LSGs, relations between the central, provincial, and local self-government bodies, improving the system of LSG financing, the establishment and improvement of inter-municipal co-operation, the EU accession process, as well as a comparative overview of key components of the LSG system in EU economies. The planned activities, objectives and measures have been set out on the basis of a prior needs analysis and their implementation is designed to enable and contribute to improving the legal and organizational framework, professionalization, efficiency and modernization of all aspects of the functioning of LSG, transparency and participation of citizens in public affairs management, as well as the role of local authorities in defining public policies and regulations, improving the LSG financing system, enhancing the capacity of institutions and civil servants, as well as improve services to citizens and businesses at the local level of government and facilitate all of these processes.

[23] The programme (with the Action Plan) can be downloaded at: www.mduls.gov.rs/obavestenja/program-za-reformu-sistema-lokalne-samouprave-u-republici-srbiji-za-period-od-2021-do-2025-godine/

The **special objective 2** of the Programme is dedicated to **improving the system of LSG financing** and incorporates several interlinked measures with corresponding activities. The priority measures are related to the intergovernmental finance system reform and support of the process of fiscal decentralization, improvement of the local budget planning process, increasing transparency of the LSG finance system, as well as the intensive development of the Public Internal Financial Control (PIFC) at the local level. The programme envisages measures which should lead to a stable and predictable LSG financing system, with the aim of enabling long-term planning and financing of local public functions. In terms of expected progress, indicators have been set for monitoring the achievement of various levels of the objectives and for the measures accordingly. Thus, in the forthcoming period, the implementation of the programme should lead to a larger share of LSG revenues and expenditures in total amount of public revenues and expenditures, increase in the share of local tax revenues (including an increase of LSG revenues generated from the property tax as a share of total LSG revenues), increase of the share of capital expenditures in total LSG expenditures, reforms of the systemic legislative framework (notably the Law on LSG Finance)[24]. Importantly, following the SCTM initiative from May 2021, work of the LSG Financing Commission/Committee has been reactivated in autumn 2021.[25] By end-September 2021 firstly the Government appointed a new chairman and members (6 in total), and subsequently the SCTM Presidency appointed 5 members (4 of which are representatives of LSGs directly).

Statistical Overview of Local Government Finance in Serbia 2006-2021

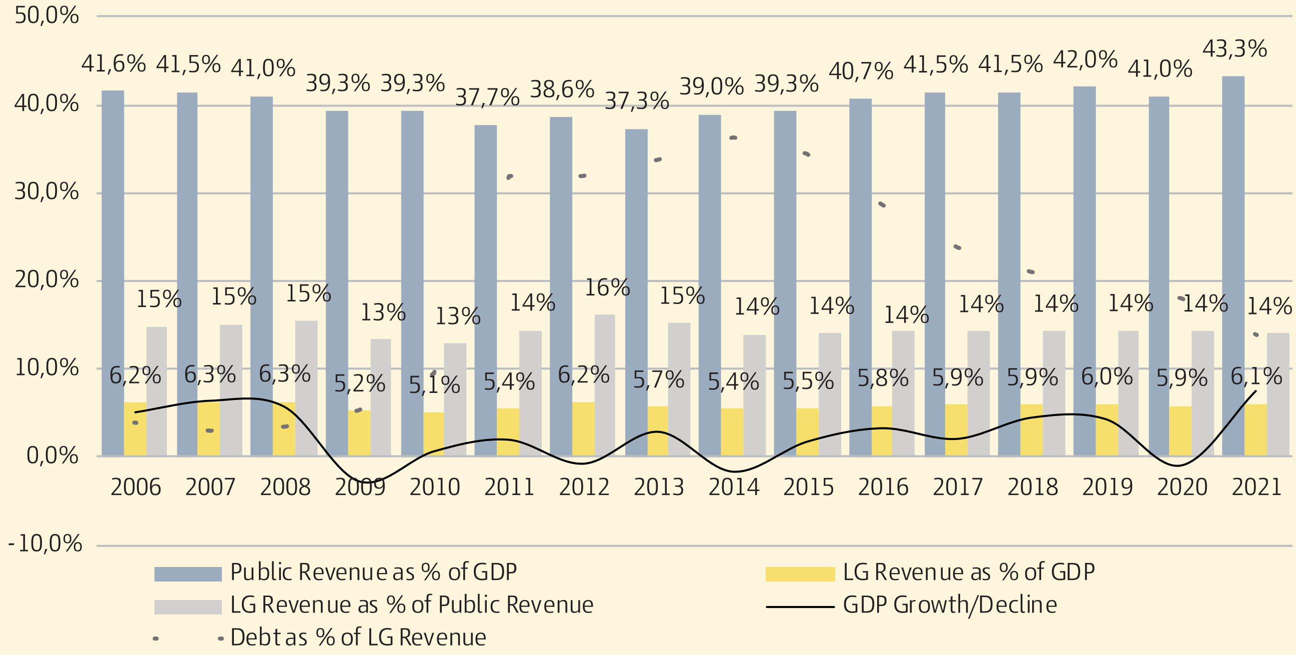
Local revenue, as a share of total public revenue and GDP, fell sharply between 2009 and 2011 as the national government dumped some of its fiscal problems onto the municipalities. Between 2012 and 2013 they recovered somewhat only to fall again in 2014. The situation didn't change much thereafter in terms of the share of local governments revenue to total public revenue, as they remained stable at the level of 14%. The share of LG revenue to GDP has been constant over the past six years (at 6%, on average), influenced by slow economic growth. On the other hand, Local Government Debt decreased by 36% when compared to 2015.[26]

24 More details, background analysis and activities intended in upcoming years so that planed objectives and measures are fulfilled, numerous other indicators, etc. – are contained in the comprehensive text of the Programme.

25 Pursuant to the Law on LSG Finance, this body is entitled to steer the observance of principles of fairness, efficiency, and openness of the LSG financing system. It should thus represent an important lever for the SCTM to pursue its advocacy efforts accordingly.

26 The data on LG debt includes debt of AP Vojvodina.

Figure 177 SERBIA: LG REVENUE AS A SHARE OF GDP AND TOTAL PUBLIC REVENUE 2006-2021

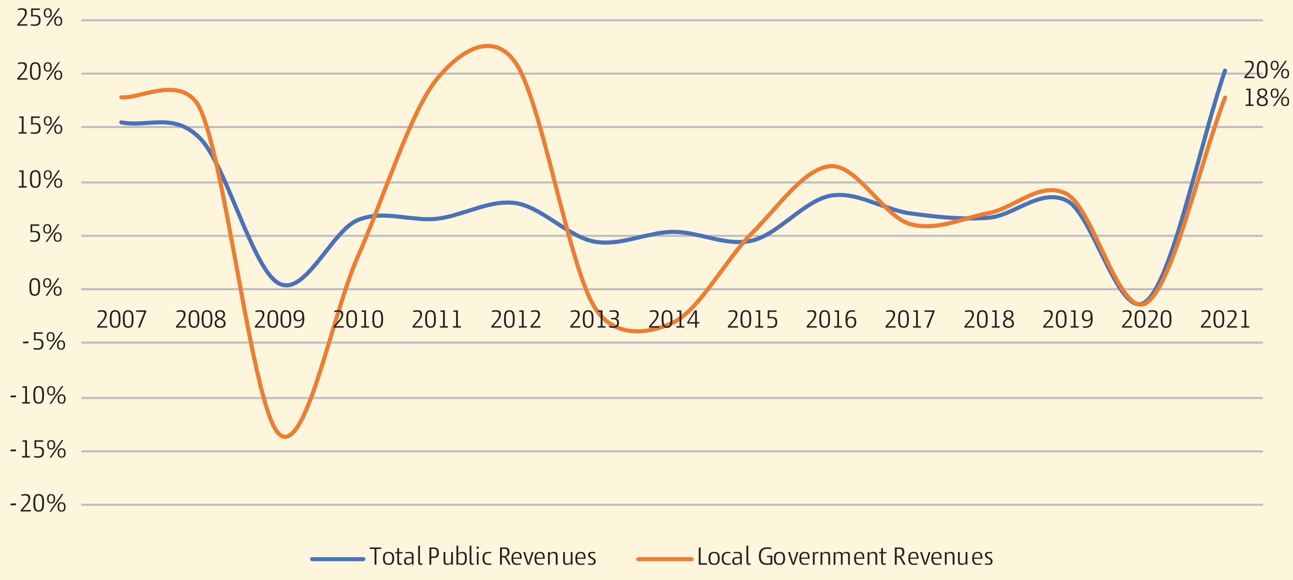


* Note: The data for the local public debt (subnational debt) are not available for the period before 2011.

LG revenues[27] have declined faster than those of the general government during the economic crisis. Local government revenues fell between 2012 and 2014 due to austerity measures but this seems to stabilize in 2015. Over the past six years, local and general government revenue growth has followed a similar pattern. Even during the COVID crisis the revenues of both levels of government had the same path. In 2020, both levels recorded a 1% decline of revenues, while in 2021 LGs and GG revenues increased significantly, 17.7% and 20.3% respectively. Overall, general government revenues have been much more stable than the local ones.

[27] The total local government revenues and total public revenues of the general government do not include proceeds from borrowing.

Figure 178 SERBIA: FLUCTUATIONS IN THE REVENUES OF THE GG AND LG 2007-2021



On average, until 2012, about 38% of local revenue came from own sources, 40% from shared taxes, 18% from unconditional grants, and about 2% from conditional grants. In 2012, this balance was changed by a sharp increase in the Wage Personal Income Tax share that increased the weight of shared taxes to 50% of all local revenue. Since 2012 however, the continuous reductions in the base and rate of the Wage Personal Income Tax have reduced the yield of the tax for local governments, consequently in 2017 and 2018, shared taxes generated only 38% of local revenues. Over the past three years, own source revenues of local governments have decreased as a share of total revenues, along with the several limitations imposed on local government powers to set fees and the elimination of a number of taxes.

Figure 179 SERBIA: COMPOSITION OF LOCAL GOVERNMENT REVENUE 2006-2021, IN % OF TOTAL

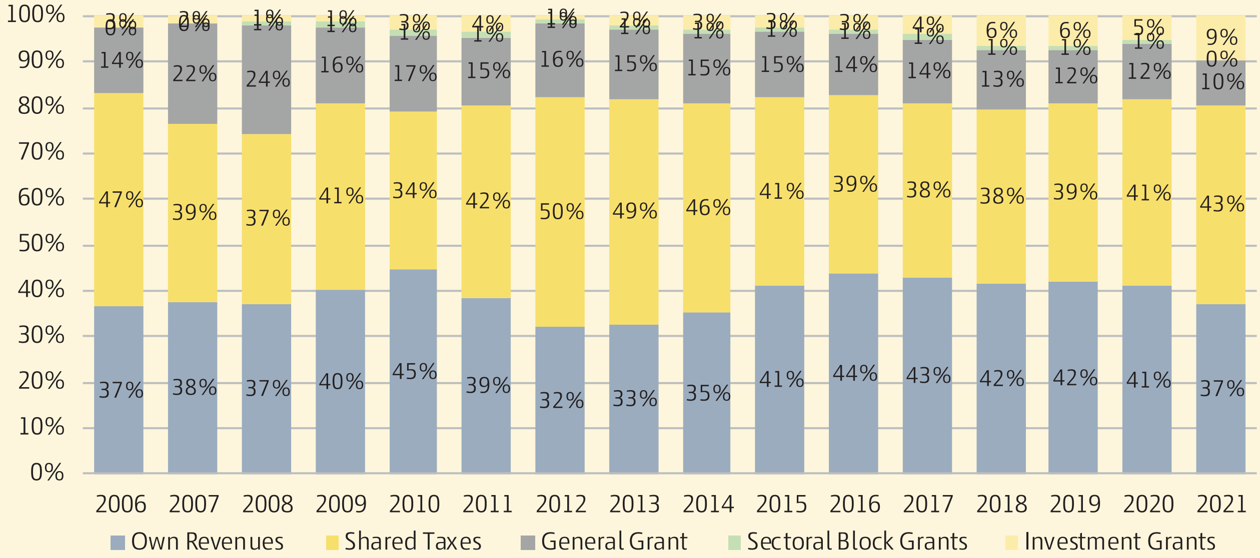


Figure 180 SERBIA: COMPOSITION OF LOCAL GOVERNMENT REVENUE 2006-2021, IN MILLION EURO

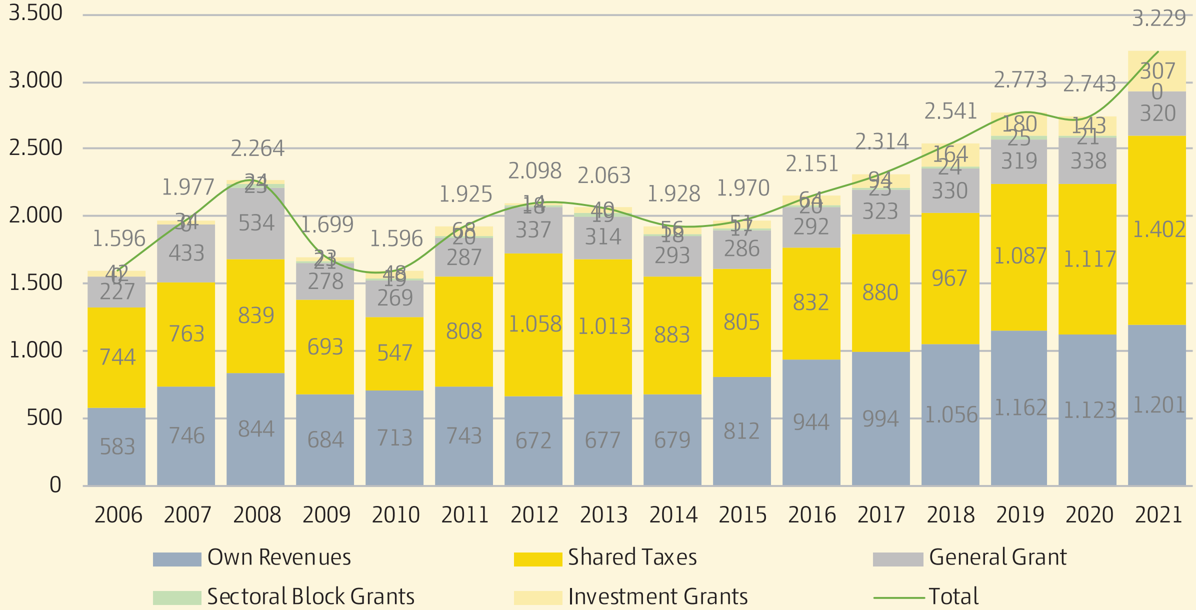
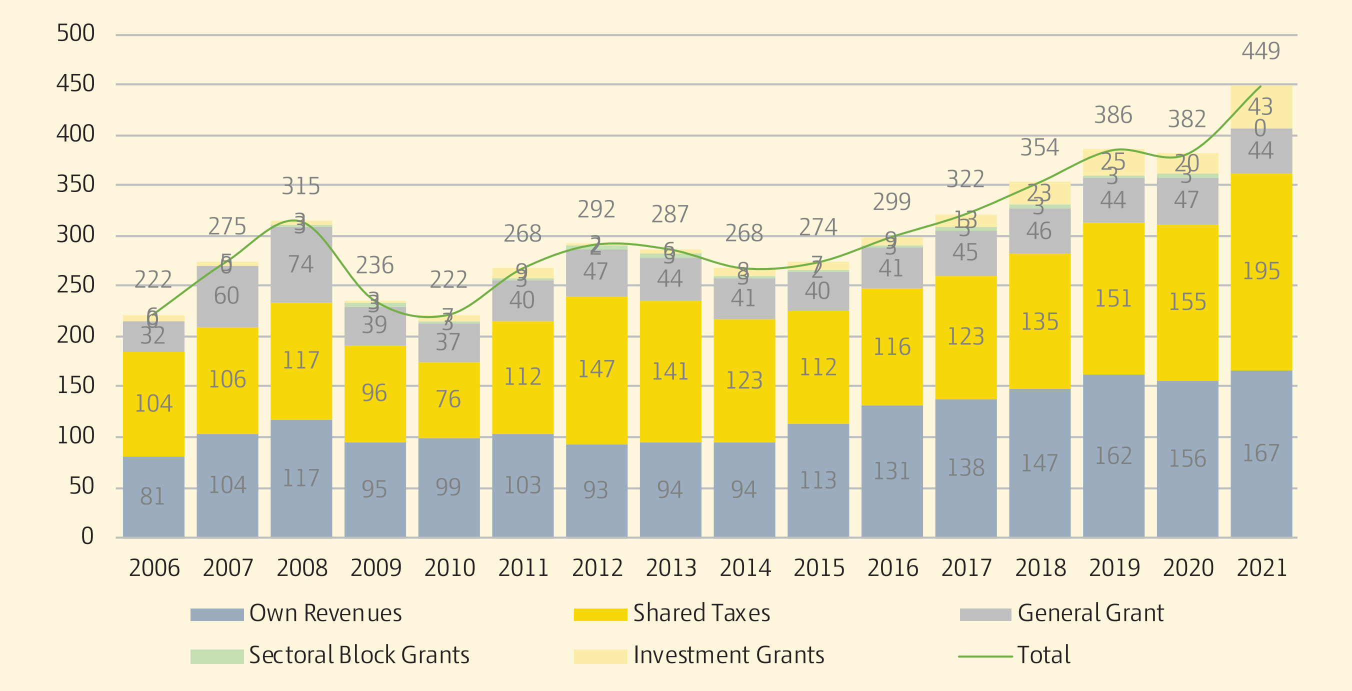


Figure 181 SERBIA: COMPOSITION OF LG REVENUE 2006-2021, IN EURO PER CAPITA



LGs have significantly improved the yield of the property tax since 2006 (when it amounted to 69 million EUR). In 2021, LGs revenue from the property tax was around 520 million EUR. The trend is especially interesting in the period 2013-2019 when comprehensive capacity building activities for the property tax were also undertaken at the local level. In 2021, the property tax remained the most important own revenue, with a share of 43.3% in a composition of LSG own source revenues.

Figure 182 SERBIA: COMPOSITION OF OWN SOURCE REVENUES 2006-2021, IN % OF TOTAL

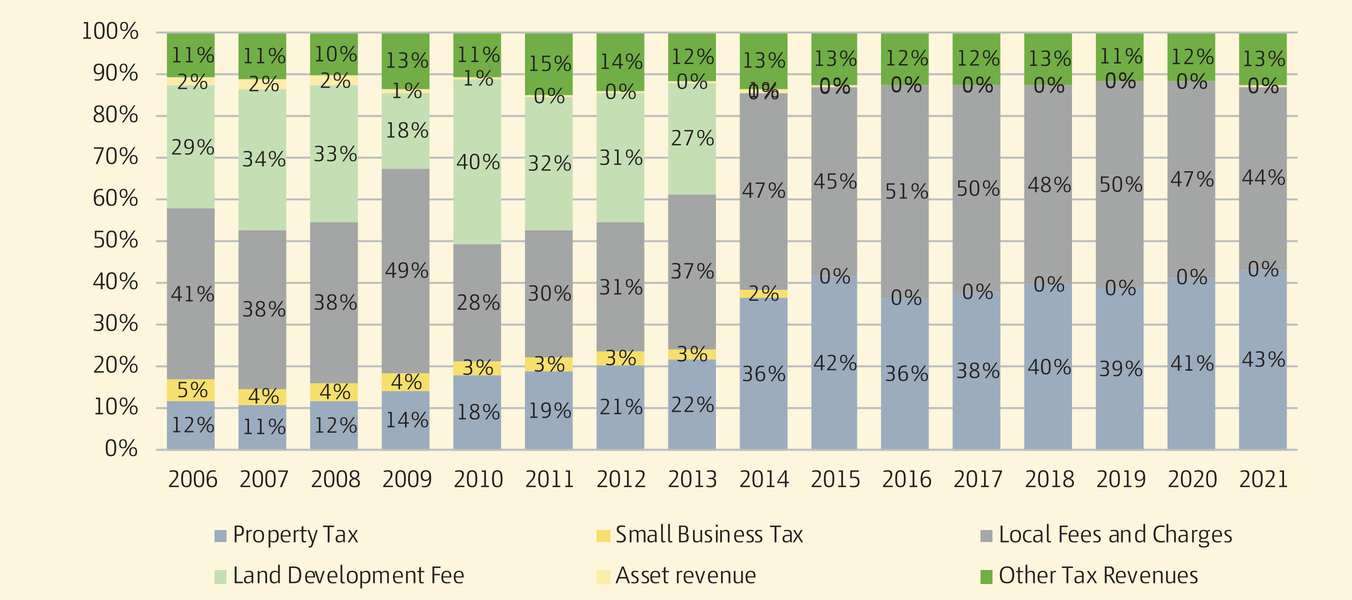


Figure 183 SERBIA: COMPOSITION OF OWN SOURCE REVENUES 2006-2021, IN MILLION EUR

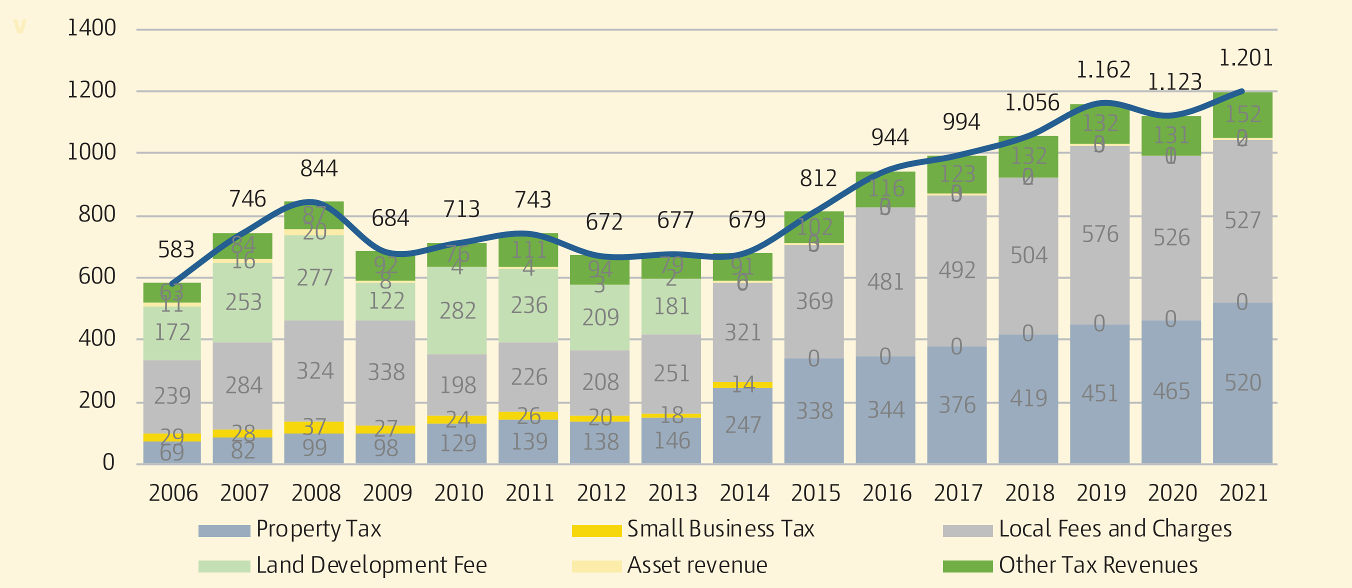
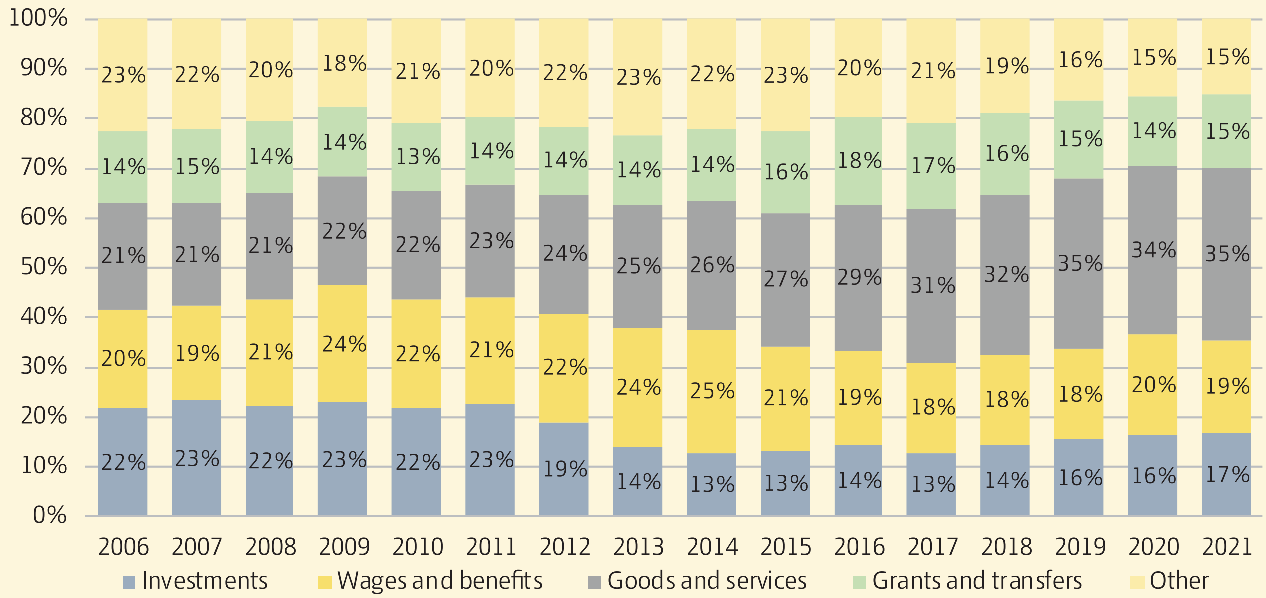


Figure 184 SERBIA: COMPOSITION OF LOCAL GOVERNMENT EXPENDITURE 2006-2021



Local government investment as a share of total expenditure[28] remained stable during the most severe years of the crisis because of large infrastructure projects in Belgrade. But they have fallen sharply since 2011 and are now under 17% for nine consecutive years. Serbian LGs also spend a share of their budgets on subsidies to public utilities (5.6%), some of which is for capital investment, thus compensating partially for the nominally modest investment expenditures figure. Debt service payments in 2021 account for 2.4% of total expenditures.

**Note: The other expenditures include interests; subsides; other current expenditures such as grants/transfers to NGO, political parties, associations and penalties and various compensations for damages; and expenses from financial transactions such as procurement of financial assets and repayment of principal.

[28] The total expenditures include expenses for debt repayment.

Figure 185 SERBIA: COMPOSITION OF LOCAL GOVERNMENT REVENUE 2006-2021, IN MILLION EURO

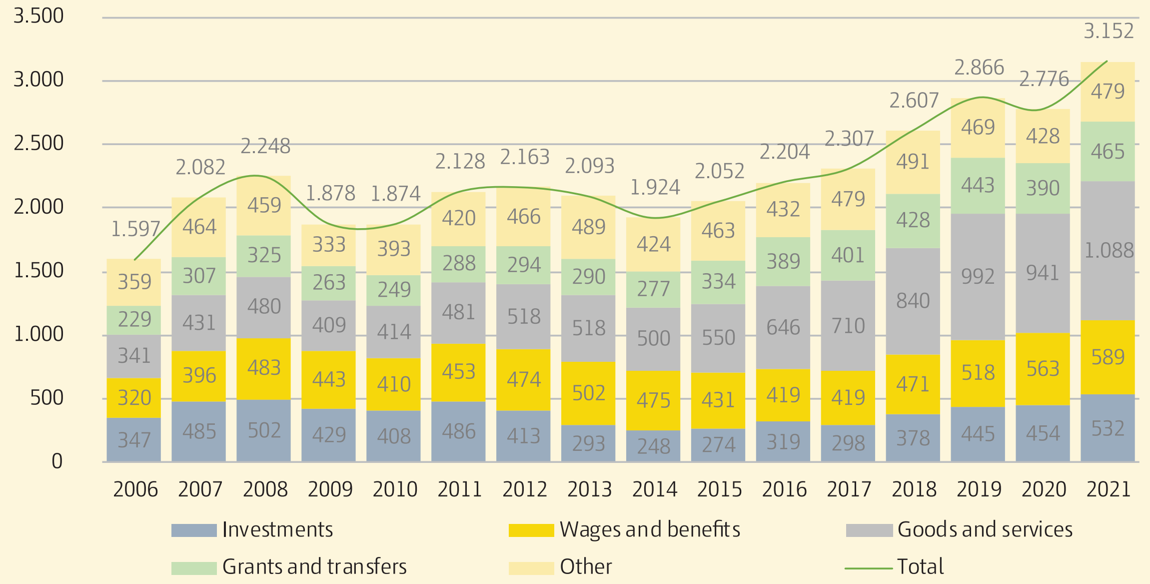


Figure 186 SERBIA: COMPOSITION OF LG REVENUE 2006-2021, IN EURO PER CAPITA

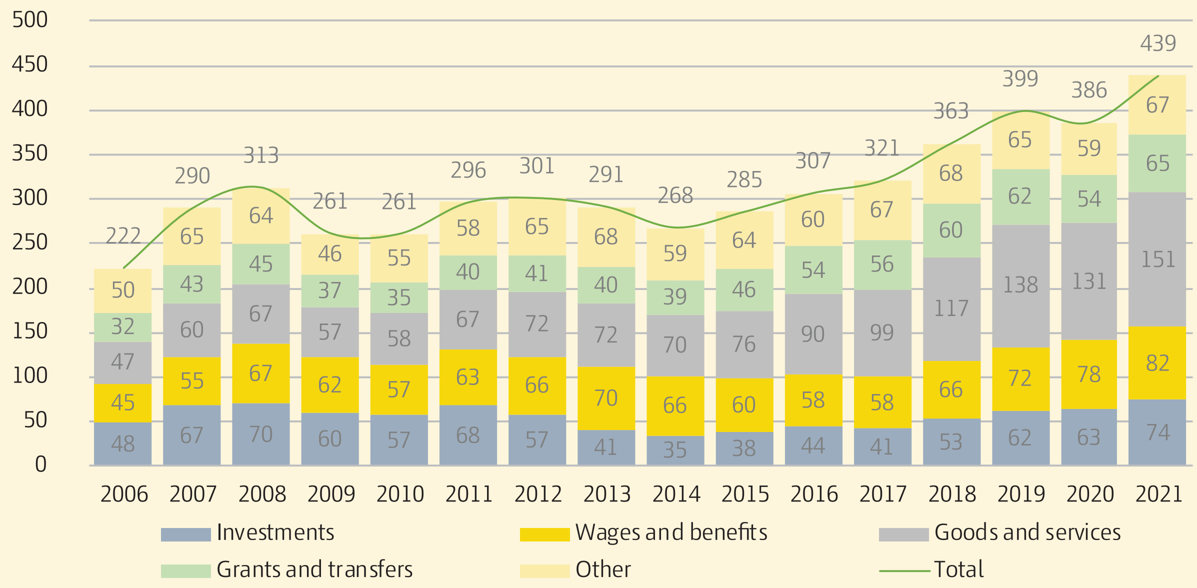
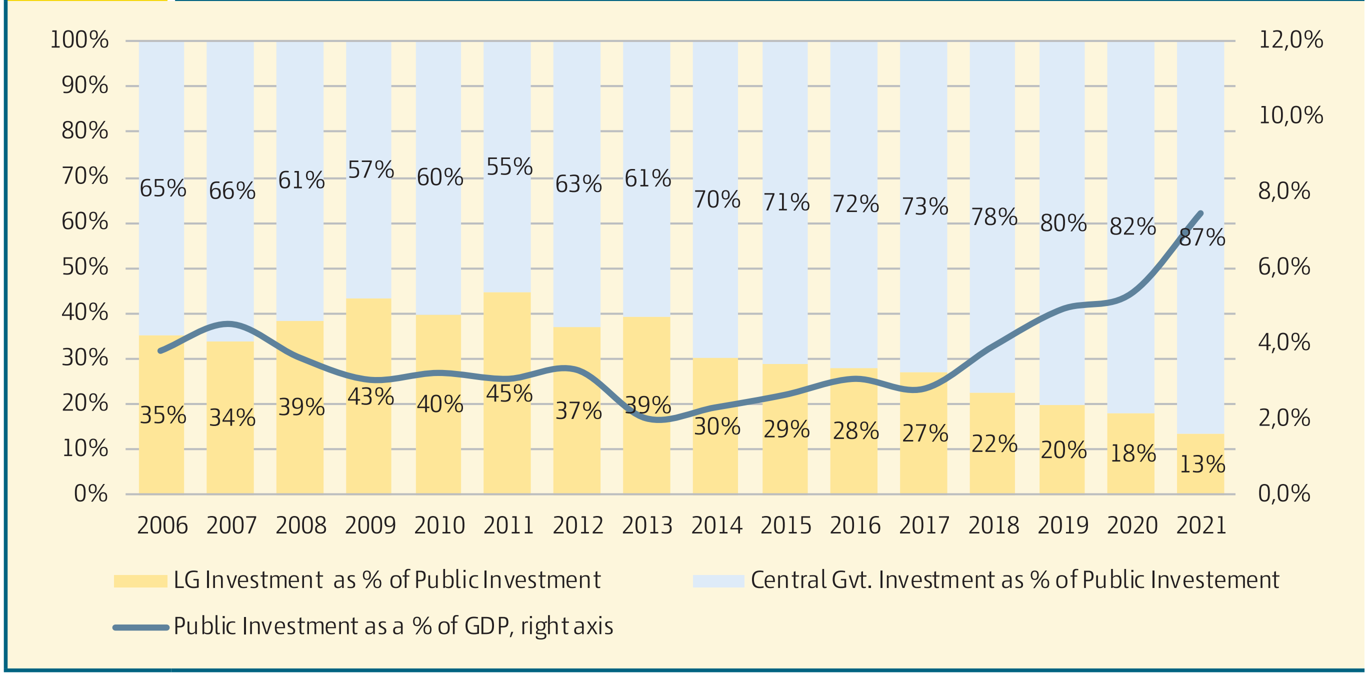


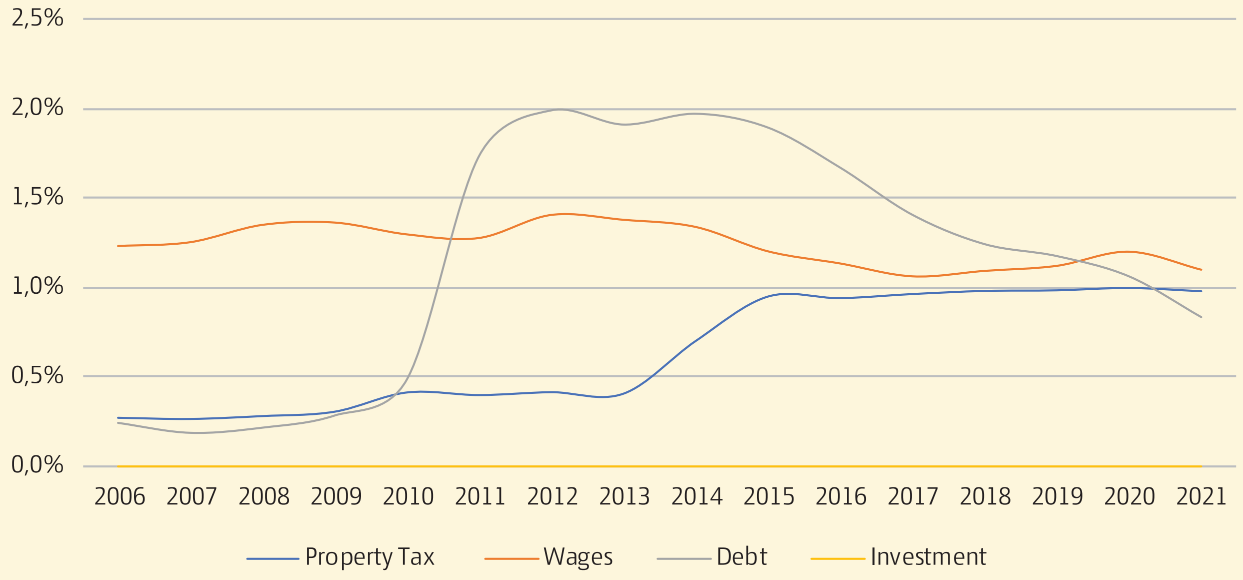
Figure 187 SERBIA: INVESTMENT BY LEVEL OF GOVERNMENT AND AS A % GDP 2006-2021



Local investment spending has fallen considerably compared to the level in 2011. As of 2021, local government investment constitutes 1.2% of the GDP down from about 1.5% in 2011. It should be noted, however, that in the last couple of years there are funding schemes allocated by the central state for investments such as infrastructure and facilities in sectors of: transport, energy, health, education, and communal infrastructure (notably in respect to waste management, wastewater treatment and water supply), which materialise at the local level.

Between 2011 and 2012 there has been an increase of subnational debt in Serbia from 1.7 to 2.0% of the GDP. Since 2015, the subnational debt has been constantly declining and reached 0.8% of GDP in 2021. Finally, the property tax constitutes 0.97% of the GDP in Serbia up from 0.4% in 2013. The increase is notably due to dedicated efforts undertaken by LSGs themselves, while targeted support to LSGs by development partners was likewise in place, backed-up by SCTM and implemented mostly as technical assistance that incentivized collection.

Figure 188 SERBIA: LOCAL GOVERNMENT INVESTMENT, WAGES, DEBT AND PROPERTY TAX AS SHARES OF GDP 2006-2021



***Note: The data for the local public debt (subnational debt) is not available for the period before 2011.

Supplementary Methodological Notes for the Chapter on Serbia

A. Macroeconomic and General Government Data

NOMINAL GDP (in million of national currency) and Real GDP Growth Rate

The data for the **nominal GDP** has been updated starting from 2015. Namely, the Statistical Office of the Republic of Serbia made some revisions of GDP data starting from 2015. Additionally, Statistical Office of the RS published (on September 30, 2022) the final data on GDP for 2020 and the new estimated value of GDP for 2021.

Source: Statistical Office of the RS database https://data.stat.gov.rs/Home/Result/09020101?languageCode=en-US

Consequently, data for the **real GDP growth rate** has been updated starting from 2015.

Source: Statistical Office of the RS database https://data.stat.gov.rs/Home/Result/09020104?languageCode=en-US

Total Public Debt and Total Local Debt (in million national currency)

For the **total public debt** we provided data on the General Public Debt.

By the methodology of RS, the General Public Debt includes Central Government Debt (direct and contingent liabilities of central government) and non-guaranteed local government debt and non-guaranteed other government debt.

The official data for the General Government Debt are available since 2011.

Source: Public Debt Administration – Quarterly Reports (sheet T4.1) http://javnidug.gov.rs/en/%D0%BA%D0%B2%D0%B0%D1%80%D1%82%D0%B0%D0%BB%D0%BD%D0%B8%D0%B8%D0%B7%D0%B2%D0%B5%D1%88%D1%82%D0%B0%D1%98%D0%B8

The official data for the total local debt are publicly available since 2011. (Note that we cannot verify nor data nor the source of data before 2011 in the Excel database "Serbia 2021 SCTM").

Source: Public debt administration – monthly and quarterly reports.

For the period of 2015 to 2021 data are available in Quarterly Reports for the end of each year (sheet T1) http://javnidug.gov.rs/en/%D0%BA%D0%B2%D0%B0%D1%80%D1%82%D0%B0%D0%BB%D0%BD%D0%B8%D0%B8%D0%B7%D0%B2%D0%B5%D1%88%D1%82%D0%B0%D1%98%D0%B8

For 2013 and 2014, data for the total local debt are calculated based on the available data on the guaranteed local government debt (available in the Quarterly Reports— sheet T4.1) and non-guaranteed local government debt (available in the Monthly Reports for December 2013 and December 2014).

Source: Public Debt Administration

Quarterly Reports (sheet T4.1) http://javnidug.gov.rs/en/%D0%BA%D0%B2%D0%B0%D1%80%D1%82%D0%B0%D0%BB%D0%BD%D0%B8%D0%B8%D0%B7%D0%B2%D0%B5%D1%88%D1%82%D0%B0%D1%98%D0%B8

Monthly Report for December 2013 (page 7)

http://javnidug.gov.rs/static/uploads/993_Mesecni%20izvestaj%20Uprave%20za%20javni%20dug%20-%20Decembar%20eng.pdf

Monthly Report for December 2014 (page 4)

http://javnidug.gov.rs/static/uploads/1018_Mesecni%20izvestaj%20Uprave%20za%20javni%20dug%20fin%20ENG%20-%20DECEMBAR.pdf

For 2011 and 2012, data for the total local debt are available in the Monthly Report for December 2013 (chart #41).

Source: Public Debt Administration

Monthly Report for December 2013 (page 27)

http://javnidug.gov.rs/static/uploads/993_Mesecni%20izvestaj%20Uprave%20za%20javni%20dug%20-%20Decembar%20eng.pdf

B. Local Government Revenue Data

Grants

The data for the **freely disposable general grant** has been updated based on data from the Laws on the Republic Budget Final Account for the period 2008-2020. (Note that Laws on the Republic Budget Final Account for the period of 2003-2019 were adopted in the end of 2019).

For 2021, the data for the freely disposable general grant are available in the report on Execution of the budget of the Ministry of Finance as of December 31, 2021 (since the Law on the Republic Budget Final Account for 2021 has not yet been adopted).

Source: Ministry of Finance– Execution of the budget of the Ministry of Finance as of December 31, 2021 https://www.mfin.gov.rs//upload/media/Qehgho_61f23bac63fcc.xlsx (https://www.mfin.gov.rs/o-ministarstvu/izvrsenje-budzeta)

The data for the **Conditional Education Grant** has been provided based on data from the Laws on the Republic Budget Final Account for the period 2008-2020. The data for 2021 will be available after the adoption of the Law on the Republic Budget Final Account for 2021.

The data for the **Other Conditional Sectoral Grant** has been provided based on data from the Laws on the Republic Budget Final Account for the period 2016-2020. This is a grant which supports social protection services and has been introduced in 2017 (piloting of this grant was in 2016). The data for 2021 will be available after the adoption of the Law on the Republic Budget Final Account for 2021.

C. Composition of local expenditures

TOTAL CAPITAL EXPENDITURES

The official data for the capital expenditures are aggregated and cannot be divided into domestically financed and from EU funds. (However, we can confirm that a small part of the local government investment is financed from EU funds.)

CURRENT EXPENDITURES

According to methodology presented in Bulletin published by MoF, current expenditures are the sum of expenditures for employees, purchase of goods and services, interest payment, subsidies, transfers and grants, social insurance, and other expenditures—but debt repayment, and net lending are not included in current exp, as it is case according to NALAS methodology. In this respect, the total amount of current expenditures in our Bulletin is 296.791,6, and the amount from table is 370.643. It is absolutely clear to us that practice among the countries is not the same, and that there is concrete reason why the steps of calculation of some specific categories do not have to be the same, but we just wanted to elaborate this, and to let you know what the situation is in the case of Serbia.

Please note also that the MFIN has further adjusted the presentation of LSG expenditure data pertaining to grants and transfers, by applying internal regrouping/summing-up of respective sub-items (within the Bulletin). This is introduced starting from financial data relevant for year 2021 and onwards, with the view of achieving the consolidated presentation for various levels of government. This is why it is no longer possible to outline separately the LSG expenditures pertaining to individuals (including social security rights) and to public companies and institutions. It is most prudent therefore for the purpose of this FD reporting, to maintain only the global figure (sum) of grants and transfers (which correlate to the sum of following items/columns of the MFIN Public Finances Bulletin: social security rights + grants and transfers).

D. Technical notes

We made some corrections within Excel: we noticed that one of the columns in the part related to the Macroeconomic and General Government Data for 2006 is duplicated, so we erased it and checked/adjusted other technical and formatting aspects so that the table and both sheets are correctly functional.

Additionally, we would need to touch upon the fact that in 2nd sheet in Excel document (calculations for various indicators), revenues are considered– without debt proceeds, while in case of expenditures – expenses for principal repayment are included. This influences the total volume of revenues and expenditures we are observing, i.e., the calculation of related indicators should be referenced with such balanced/same volume of revenue and expenditure sides (which is not the case for the time being).

Slovenia

By Miha Mohor and Valentina Šumi, Association of Municipalities and Towns of Slovenia

Local government in Slovenia is organized in 212 municipalities representing the first-tier of local government. There are 12 so-called 'urban municipalities' (such as the capital city of Ljubljana and other large cities), in which more than a third of Slovenia's population lives. More than half of municipalities have less than five thousand inhabitants while the two smallest municipalities have only a few hundred inhabitants. There is no regional level of government.

The central government in Slovenia has significant control over local revenues. Over the past decade, local government revenues constituted approximately 13% of total public revenues, equivalent to 5.1% of GDP. On average, over the past decade, own municipal revenues have constituted 33% of total local government revenues, while revenues from the shared Personal Income Tax (PIT), have constituted 54% of the total and investment grants have constituted about 13% of the total. Slovenian municipalities have access to domestic capital markets for debt financing. The stock of local government debt in Slovenia averages 38% of total local government revenues or 1.8% of the GDP over the past decade.

The Intergovernmental Finance System

Slovenian municipalities are highly heterogeneous, and therefore, the financing system is based on equalization of the shares of the origin-based allocation of the **Personal Income Tax** (PIT), which historically has provided more than 50% of the revenues for the local level (53% in 2021). There are no general purpose (unconditional) grants, but instead there is the **shared tax for current expenditures**, that allocates 54% of the personal income tax to the municipalities. This allocation is based on a formula considering a computed lump sum per capita expenditure need, known as "appropriate expenditure". In other terms, the formula computes the amount that should be sufficient to cover all current municipal costs for performing tasks defined by law. This calculation takes into account correction factors from the formula defined in the law, which account for actual differences between municipalities in terms of their size, extent of local roads, population under 15 years, and population over 65 years. Individual municipal allocations are determined based on a mathematical equation, where the yearly "lump sum" amount per inhabitant represents up to 70% of the total (54% share of PIT). If this share of personal income tax paid in the previous year is insufficient to finance the municipality's appropriate expenditure, the state provides the missing funds through a financial equalization mechanism, as mandated by law.

The funds for the solidarity equalization of municipal revenues from the personal income tax are derived from 30% of municipal revenues (54% share of PIT), as well as a portion of the revenues of each municipality that exceeds its appropriate level of funds. Local governments whose PIT share is still insufficient to fund this measure of expenditure need to receive additional increases of PIT from the national budget. The mechanism of solidarity equalization is designed to ensure that each municipality receives funds that are equivalent to their calculated appropriate expenditure for carrying out mandatory tasks. It is important to highlight that these funds do not include resources for investments. These transfers are allocated weekly by the Ministry of Finance, starting from the first week of the fiscal year for which they are calculated.

Since 2020, Slovenian municipalities have been receiving **grants for the balanced development of municipalities.** The sum is determined as 6% of appropriate expenditures for all municipalities together, but the allocation is calculated based on a formula containing different natural criteria (such as border zones, natural zones, etc.). These grants are managed and allocated monthly by the Ministry of Finance.

Special funds are allocated to finance municipalities participating in joint municipal administrations (inter-municipal cooperation) to carry out certain essential tasks together. A municipality is entitled to funds for co-financing of tasks such as the municipal police, internal audits, budget accounting, etc., up to of 30% of the expenses of its budget realized in the previous year, if it participates in a joint municipal administration with at least three municipalities. This amount is increased by 5% for each additional task, but the total amount of co-financing may not exceed 55% of the funds for salaries, other expenses, and contributions. According to the Financing of Municipalities Act, **special grants** are allocated for co-financing Italian and Hungarian national communities (0.15% of the sum of appropriate expenditures for all municipalities) and municipalities with Roma ethnic communities (3.5% of the sum of appropriate expenditures for a single municipality). In addition to general grants, individual ministries allocate **special earmarked grants** based on a local authority's application for financial support for specific projects (such as general infrastructure, heating plants, and water supply). Systematic laws or regulations of individual ministries for specific areas of funding establish the terms on which local communities can obtain funds.

Local Government Own source revenues

The Law on Financing of Municipalities, enacted in 2007, regulates the local budget and specifies the types of taxes that local authorities can collect. Local authorities have the authority to impose taxes such as property tax, tax on gifts and inheritances, tax on gambling machines, tax on water vessels, and others as determined by the law. However, local authorities are not permitted to introduce new taxes. The central government determines the rates for these taxes, except for the property tax.

Currently, the government is working on a new law on property taxation to enable local authorities to generate higher revenues. This new tax on real estate will replace the existing property tax and contributions for the use of buildings and land. It will be applicable to all buildings and land in Slovenia, including for both companies and individuals.

In addition to tax revenues, local governments also can collect non-tax revenues. The rates and fees of non-tax revenues can vary among different local governments. In 2021, non-tax revenues accounted for 19% of local revenues. However, the proportion of non-tax revenues differs significantly between small and large local governments. In smaller local governments, these revenues constituted only 5% of the available funds for public spending, while in larger ones, the proportion was as high as 40%.

Contributions for the use of buildings indeed form an important share of non-tax revenues for local governments in Slovenia. Some examples of non-tax revenues include revenue from property sales, rental fees, and residential funds. These revenues serve as the sole independent source of funds for municipalities, and their utilization is not centrally determined.

Borrowing

According to the Law on Financing of Municipalities, Slovenian municipalities can borrow from the state budget, domestic banks, domestically licensed savings banks or from domestic public funds whose activity is the granting of loans, specifically for the implementation of the municipal budget in the current year. State authorization is required for such borrowing. Municipalities must obtain approval from the Ministry of Finance for the loans, and there are limitations on the amount of municipal borrowing. Legislation does not permit borrowing from foreign public agencies or from the foreign capital market.

The borrowing limit applies to each repayment year and cannot exceed 10% of the realized income from the municipality's "balance of income and expenditure" in the year preceding the borrowing year. The amount of 'realized income from the municipalities' is reduced by donations received, transfers from the state budget for investments, funds received from the budget of the European Union, and income from overhead facilities. The annual limit takes into account all existing borrowing agreements and their annual obligations for the repayment of principal and interest. In the case of a municipality with 20 million in annual revenues, it can be indebted up to a level where all existing debts collectively represent a maximum of 2 million in annual repayments of principal and interest combined.

On average, Slovenian municipalities have revenues of around 11 million, ranging from the smallest municipality with 0.6 million to the largest with 340 million. In 2021, a total of 12 municipalities, along with legal entities of the public sector at the municipal level, were not indebted, and the average total debt per capita amounted to €511.

In the case of uneven income inflow, where expenditures exceed incomes at any point during the year and the municipality lacks funds to finance these expenditures, the municipality may resort to liquidity borrowing within the same year. However, there are certain limitations in place. Specifically, the drawing and repayment of the loan must be completed within the same year, and the borrowed amount is limited to a maximum of 5% of all expenditures outlined in the most recently adopted budget.

In 2021, local governments borrowed €136.9 million, which accounted for 5.5% of all local government revenues. The stock of total local debt in 2021 increased to €943 million. This represents 1.8% of the GDP and 2.4% of the total public debt. The debt has increased by 10% compared to 2019, which was the year before the pandemic. The growth index is slightly higher but still stable.

COVID-19 Impact and implications for Local Government Finances

Municipalities played a crucial role in dealing with the initial wave of the COVID-19 pandemic. Since there were no national-level harmonized guidelines, the responses varied from one municipality to another. The effectiveness of the actions taken and the impact on local finances depended largely on the commitment and initiative of individual mayors. However, some common measures were identified, such as information sharing and the temporary closure of municipal facilities and public gatherings.

The pandemic had a significant impact on municipalities, with varying degrees of disparity. Urban and touristic municipalities were particularly affected in terms of their revenues. They experienced a decline in income from tourist taxes, misdemeanour fines, parking fees in public areas, and business premises rents.

To mitigate the effects of the crisis, Slovenia adopted seven laws, collectively known as anti-corona packages (PKP1 to PKP7), between mid-March and December 31, 2020. These measures aimed at preserving jobs, sustaining business operations, and providing support to vulnerable individuals and groups.

In 2020, the central government increased funds transferred to municipalities, leading to a rise in municipal financing. This increase in financing continued in both 2021 and 2022. Furthermore, the Financial Relief of Municipalities Act was approved in November 2020. This act stipulates that the state would assume responsibility for financing mandatory health insurance, relieving municipalities of this burden. Additionally, the act provides for additional funding to municipalities with Roma settlements. The Act also addresses the financing of special municipal tasks, such as coroner's offices and market rent subsidies. It allows municipalities to borrow for "soft" investments in European projects and provides them with more flexibility in utilizing investment subsidies and current transfers.

Despite losses in revenue from tourist tax, gambling tax, and property sales, municipal revenue (excluding debt) increased by 4.2% between 2019 and 2020 and by 7.3% between 2020 and 2021. This can be attributed to stable property taxes and higher shared taxes during the pandemic. Shared taxes increased by 10.2%, primarily due to higher transfers from the central government. The average amount of expenditure per inhabitant increased from €589.11 to €623.96. However, local taxes decreased by 5% in 2020, and local fees and charges dropped by 17.6% due to restrictive measures and facility closures. Overall, municipal revenue displayed resilience in 2020, with a growth rate of 4.2%, followed by a 7% growth rate in 2021. On the expenditure side, municipal spending increased by 2.3% between 2019 and 2020, mainly due to extraordinary items related to the pandemic. Staff expenditure recorded the highest increase of 7% in 2020 and 4.8% in 2021, and costs for defence, public order, and safety saw an increase.

Total local debt rose by 4.1% in 2020 and 5.7% in 2021 compared to 2020. As part of the recovery efforts from the pandemic, the Slovene Export and Development Bank (SID Banka) obtained a loan to enhance building energy efficiency, improve the quality of public services, and upgrade municipal infrastructure in both rural and urban areas. These initiatives recognize that improving social infrastructure and providing long-term financing for municipalities are crucial elements for the overall recovery process.

Furthermore, the government implemented the Intervention Act of 2020, which established a list of major investment projects. The primary goal of this act is to promote economic recovery and streamline procedures for project implementation. These plans aim to significantly increase public investment at the central level and, to a lesser extent, at the local level. The government also formulated a national recovery and resilience plan aligned with the EU Recovery and Resilience Facility. This plan aims to support climate objectives and facilitate the digital transformation.

Advocacy efforts of the Local Government Association

The Association of Municipalities and Towns of Slovenia (SOS) plays a crucial role in representing the interests of local authorities in Slovenia. One of its key responsibilities is to prepare calculations of the financial needs of local governments. This involves assessing the financial requirements of municipalities and towns and considering regulations for the implementation of legal tasks of municipalities. By accurately estimating the financial needs, the association provides valuable information for effective financial planning at the local level.

In addition to preparing calculations of the financial needs of local authorities, SOS plays a crucial role in leading negotiations with the national government. In the negotiations all three associations of local authorities are involved. Through these negotiations, the association strives to reach an agreement on the allocation of personal income tax revenue to local governments. Personal income tax serves as one of the main sources of revenue for local authorities and is vital for the implementation of municipal tasks. SOS is actively engaged in dialogue and negotiations with the national government to ensure a fair and appropriate distribution of the income taxes.

Through its advocacy efforts, SOS aims to strengthen the financial position of local governments. This includes advocating for transparent financial arrangements, equitable funding mechanisms, and increased financial autonomy for local authorities. By actively participating in negotiations and dialogue with the national government, the association strives to secure sufficient financial resources for local governments, enabling them to effectively serve their communities and promote local development.

Statistical Overview of Local Government Finance in Slovenia 2006-2021

The share of the local government sector in Slovenia's GDP has decreased from 5.7% in 2015 to 4.8% in 2021. The economic crisis has contributed to this decline, as there has been a tendency for the central government to shift a disproportionate burden of fiscal stress onto the local level. In 2020, the increase in local revenues as a percentage of GDP is a result of a combination of higher state transfers to the local communities and a decrease in GDP.

The revenues of the local and general government have fluctuated significantly over the past few years, as shown by the figure below.

Figure 189 SLOVENIA: LOCAL GOVERNMENT REVENUE AS A SHARE OF GDP AND TOTAL PUBLIC REVENUE IN 2006-2021

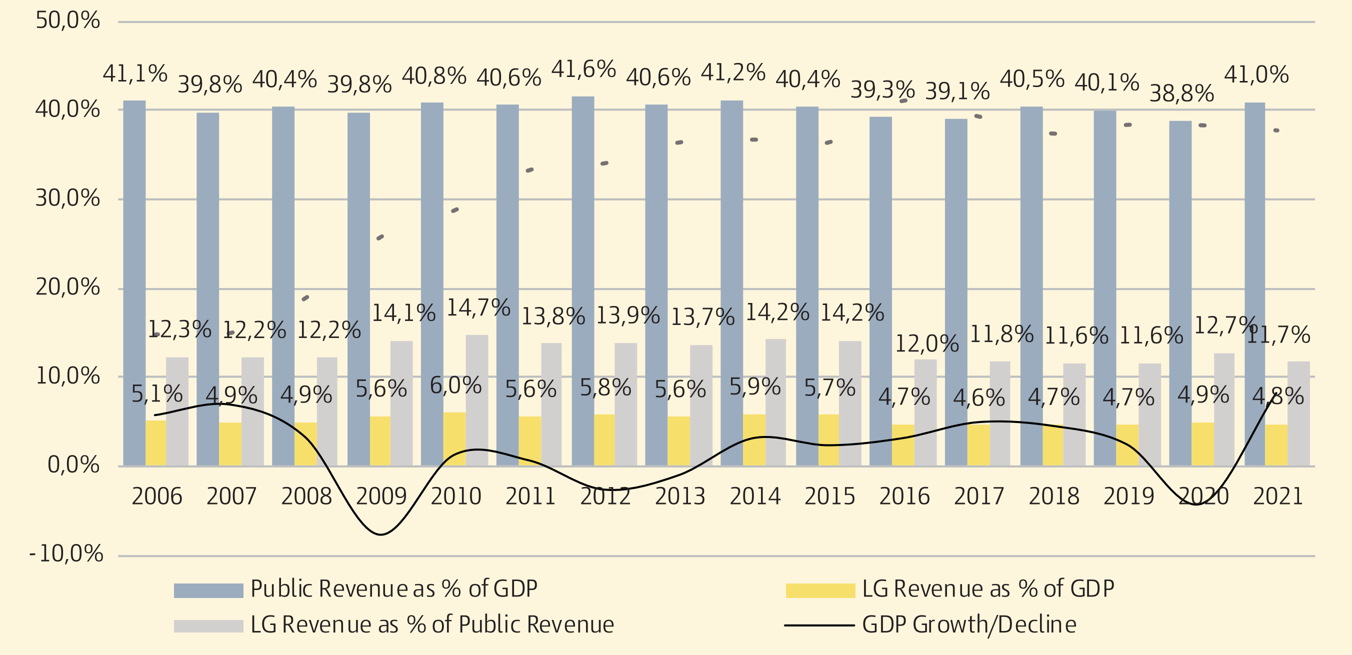
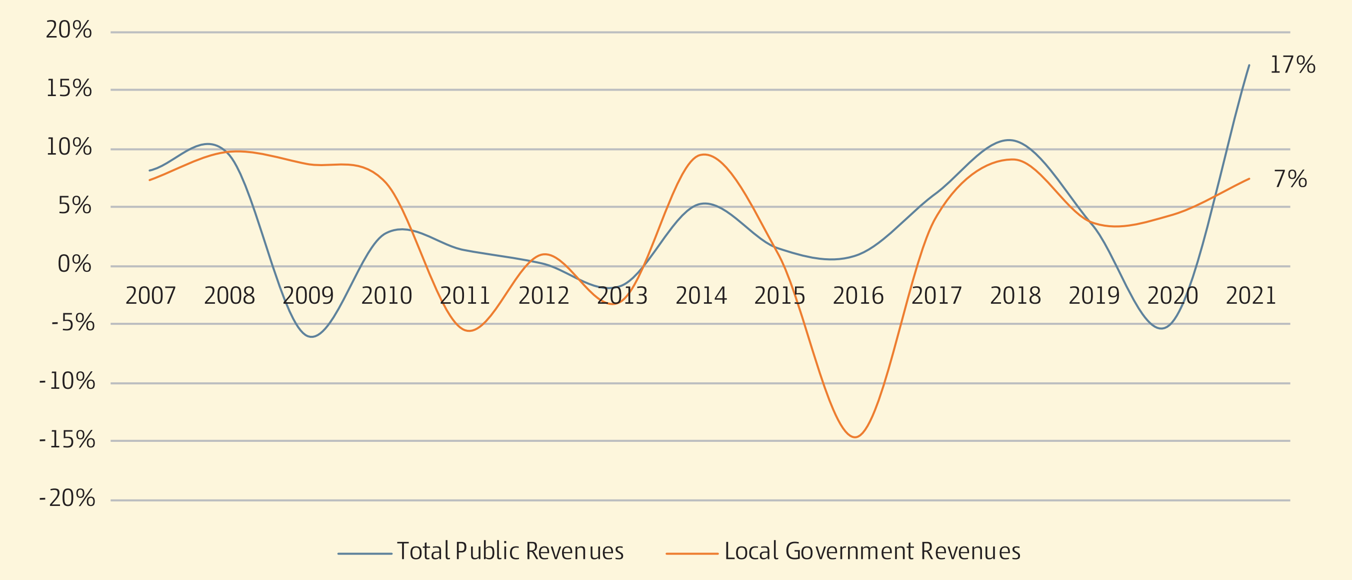


Figure 190 ANNUAL FLUCTUATIONS IN THE REVENUES OF THE GENERAL AND LOCAL GOVERNMENTS



Slovenian local governments rely heavily on personal income tax (PIT) sharing as a significant source of revenue. Since 2016, there has been an increase in the share of own source revenues and shared taxes, while the trend of conditional grants, including EU grants, has reversed. In 2020, it is evident that the pandemic has had an impact on revenues. Over the last two years, there has been a change in the revenue composition, with own source revenues decreasing and shared taxes increasing, as the government has increased municipal financing during this period.

Figure 191 SLOVENIA COMPOSITION OF LOCAL GOVERNMENT REVENUE 2006-2021, IN % OF TOTAL

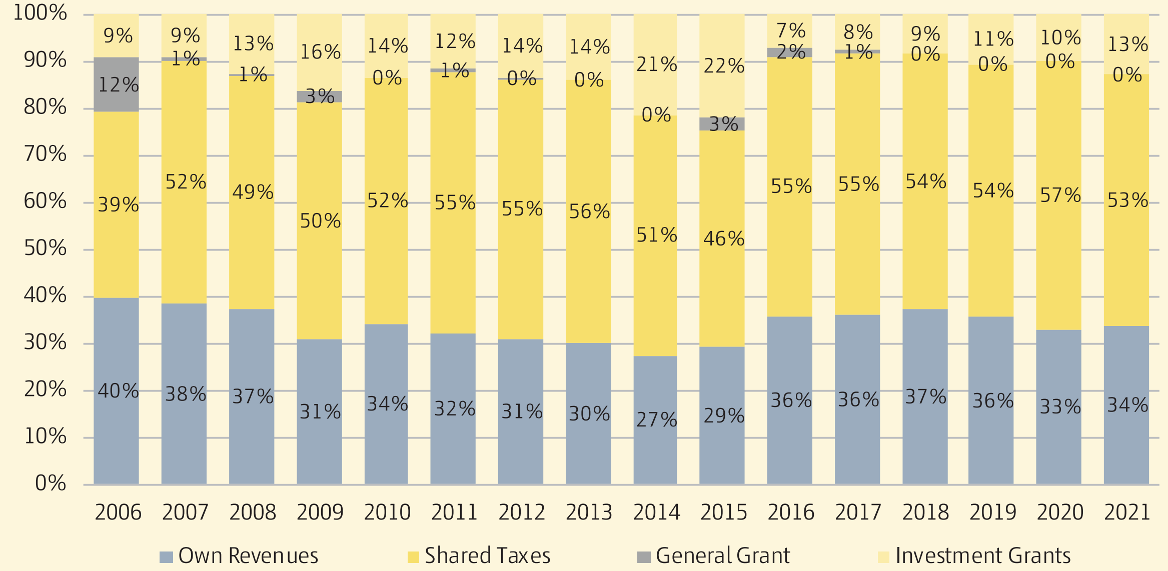


Figure 192 SLOVENIA COMPOSITION OF LOCAL GOVERNMENT REVENUE 2006-2021, IN EURO, PER CAPITA

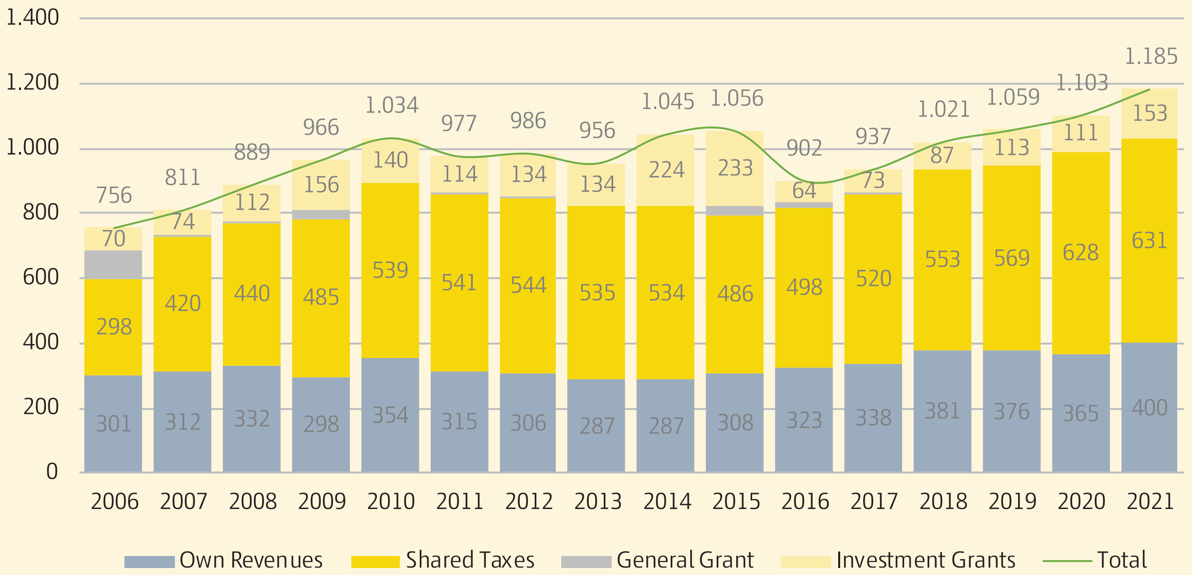


Figure 193 SLOVENIA COMPOSITION OF LOCAL GOVERNMENT REVENUE 2006-2021, IN MILLION EURO

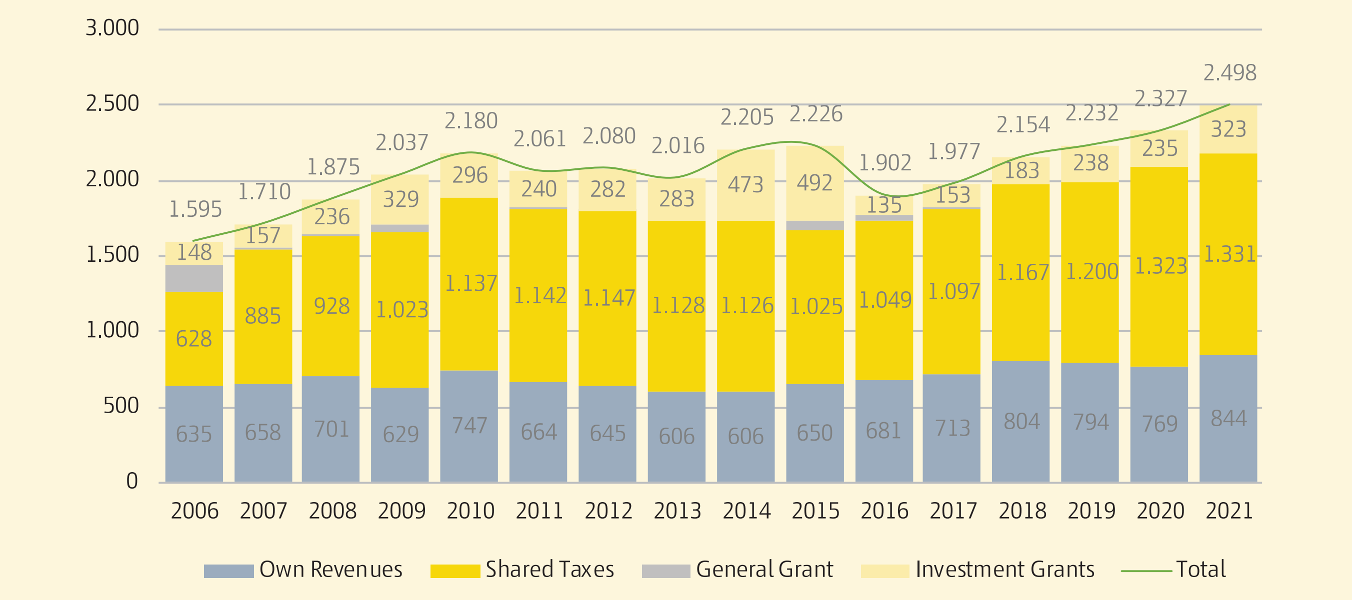
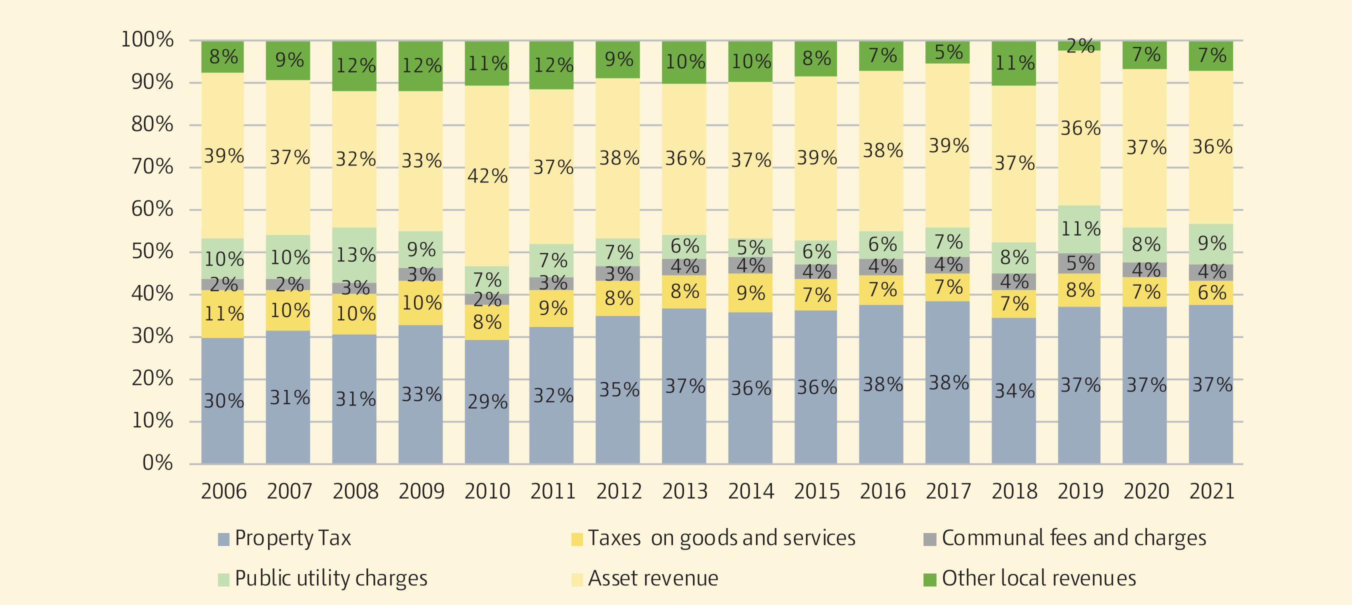


Figure 194 SLOVENIA COMPOSITION OF OWN REVENUE 2006-2021, IN % OF TOTAL



Slovenian municipalities have two main sources of own source revenues: property tax and revenues from asset sales and rentals. These revenue streams remained stable during the pandemic. However, the lower own source revenues experienced by municipalities can be attributed to state interventions aimed at preventing the spread of the epidemic, such as the ban on public gatherings. These measures have had an impact on other sources of revenue, including tourist taxes, parking fees, and rents for business premises.

The investment rate of Slovenian local governments has declined from 45% of total spending in 2009 to 36% in 2021. There was a notable increase in the share of investments in 2014 and 2015, followed by a decrease in 2016 and 2017. In the past four years, the investment rate has once again increased to reach approximately 35% of total spending. Spending for grants and transfers to individuals and public utilities also takes up a significant share of municipal budgets in Slovenia, although it seems to follow a declining tendency, in relative terms, for the past three years. Spending for salaries and goods and services seems rather stable over the years.

Figure 195 SLOVENIA: COMPOSITION OF EXPENDITURE IN 2006-2021, IN % OF TOTAL

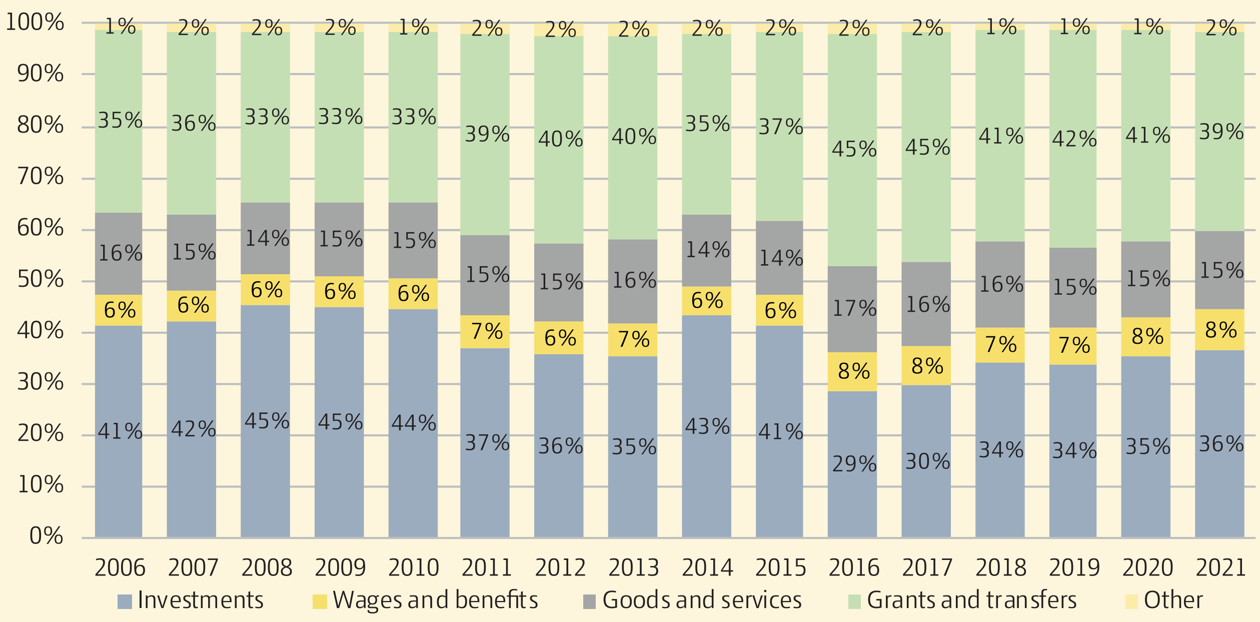
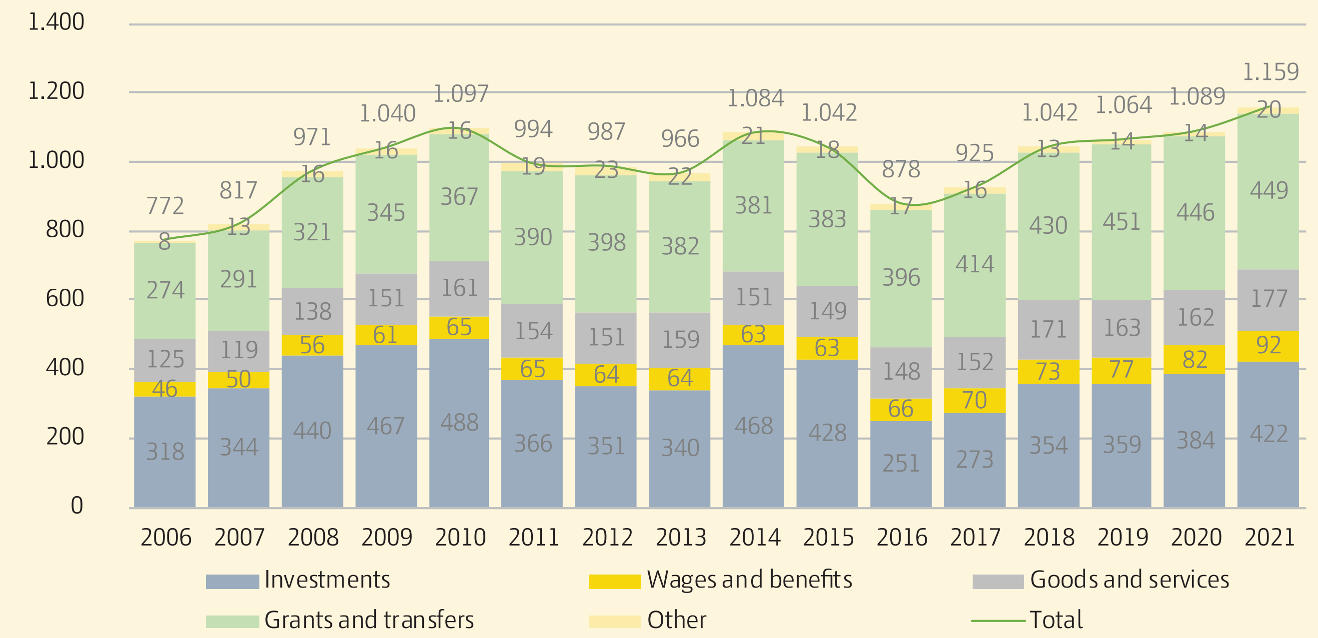
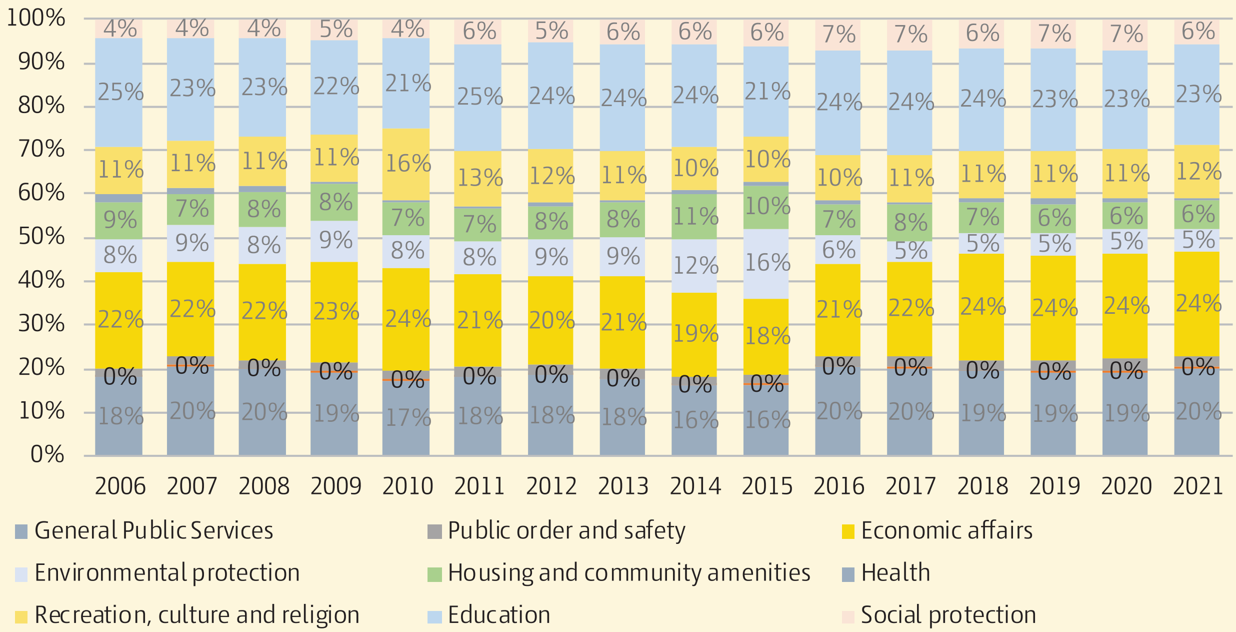


Figure 196 SLOVENIA: COMPOSITION OF EXPENDITURE IN 2006-2021, IN EURO, PER CAPITA



From a functional perspective, spending on general public services, economic affairs and education makes up up to two thirds of municipal budgets in Slovenia. From the structural perspective, there are no major changes in the functional allocation of expenditures during or after the pandemic.

Figure 197 SLOVENIA: FUNCTIONAL ALLOCATION OF EXPENDITURES (COFOG CLASSIFICATION), IN % OF TOTAL



When it comes to capital expenditures, the bulk of investments is focused on economic affairs, despite a slight decrease in 2021. Investments in the functions of recreation, culture and religion have increased significantly during the pandemic, on the back of investments for housing and community amenities and environmental protection.

Figure 198 SLOVENIA: FUNCTIONAL ALLOCATION OF CAPITAL EXPENDITURES (COFOG CLASSIFICATION), IN % OF TOTAL

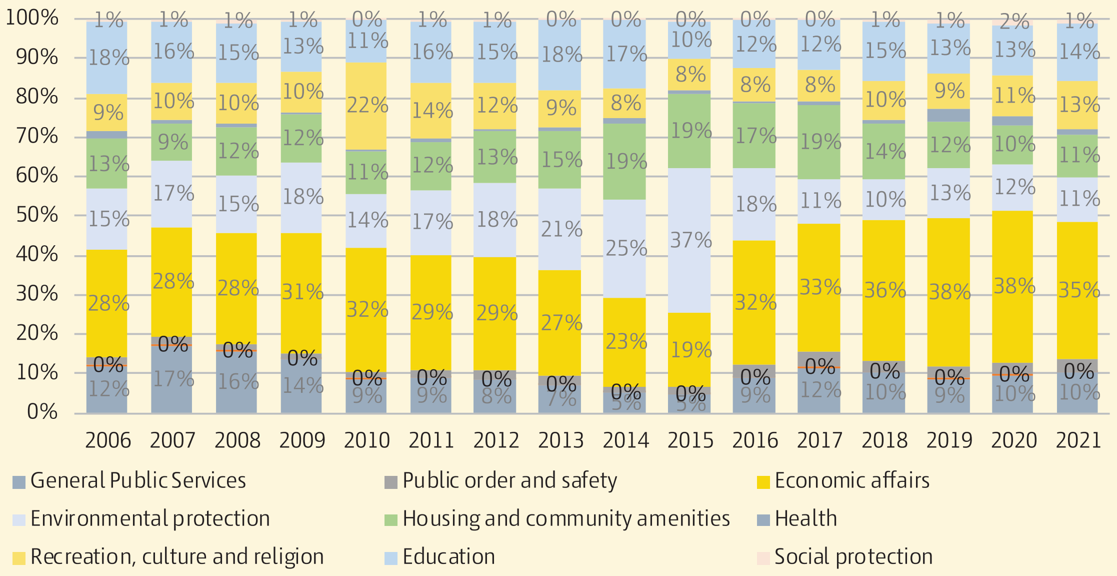
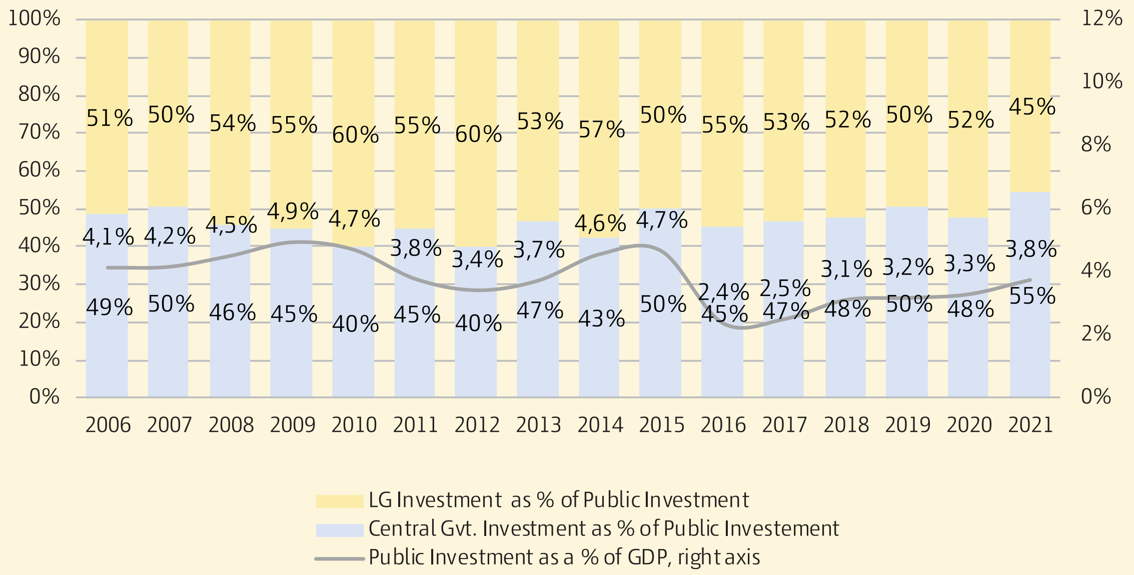


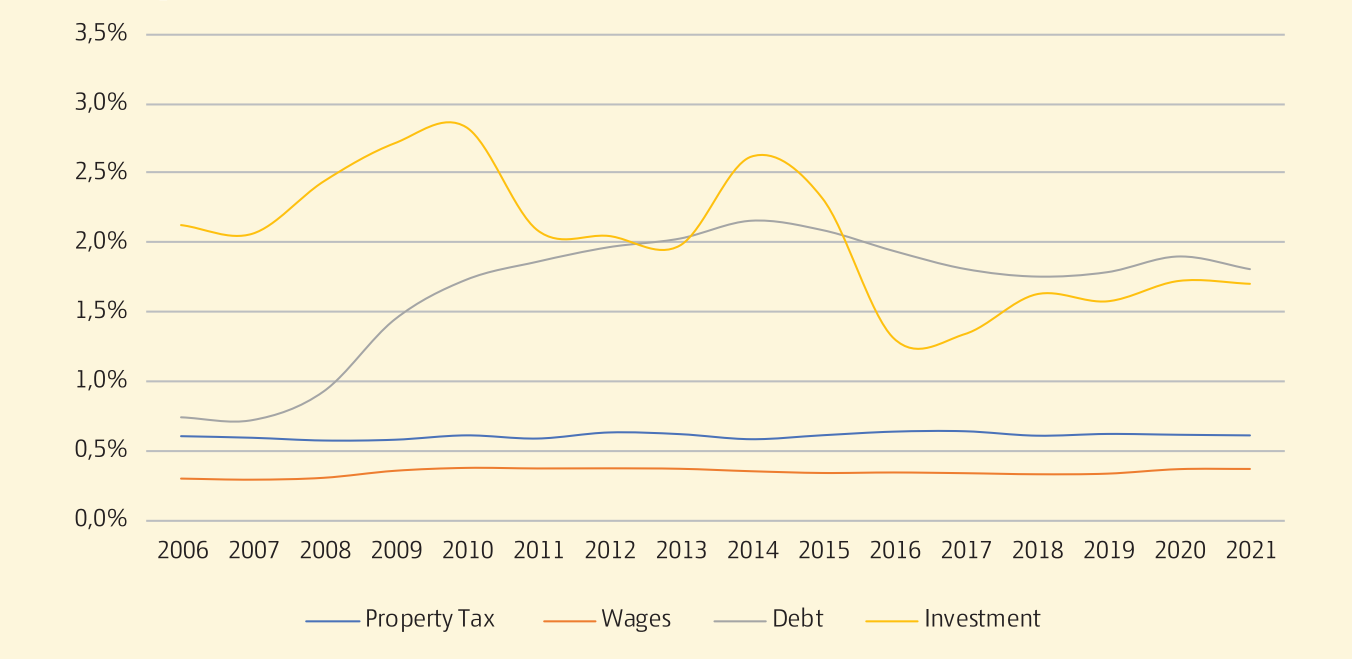
Figure 199 SLOVENIA: INVESTMENT BY LEVEL OF GOVERNMENT AND AS A % GDP 2006-2021



Slovenia has combined robust local investment with low wage spending. Property tax revenues and spending for wages have remained stable, but the economic crisis has caused fluctuations in investment and an increase in debt, although the current borrowing conditions have been relatively favourable. It appears that state investments are increasing, further stimulated by EU funding. However, in 2020, due to a significant economic downturn and measures to mitigate the effects of the epidemic, the state's fiscal position has deteriorated significantly. Therefore, it may not be sustainable to maintain such levels of state investments in the medium term, especially considering the need to increase other development expenditures as well.

The level of total indebtedness of municipalities and legal entities in the public sector at the municipal level increased in 2020 compared to 2019, but it remained stable as a percentage of GDP. Municipalities primarily utilize borrowing to carry out investments, which entail payments to contractors, create new jobs for workers, improve the quality of life for residents, stimulate economic activity, and contribute to the gross domestic product (GDP).

Figure 200 **SLOVENIA: LOCAL GOVERNMENT INVESTMENT, WAGES, DEBT, PROPERTY TAX AS SHARE OF GDP 2006-2021**



Türkiye

By Mustafa Kabil, Marmara Municipalities Union

The Intergovernmental Finance System

Türkiye has two distinct types of local government structures: First, the old system continues in provinces in which there are no cities whose populations are larger than 750,000 inhabitants. In these provinces, there are three basic types of local governments: small cities, special provincial administrations, and villages. Second, in the 30 provinces where there are cities with populations larger than 750,000, these big cities became metropolitan cities while special provincial administrations and villages were eliminated. As a result, the number of metropolitan cities increased from 16 to 30, and in 30 provinces where they exist there are only two forms of local government, metropolitan cities, and the district cities underneath them. In other words, special provincial administrations still exist in 51 provinces.

Türkiye's intergovernmental finance system is dominated by **shared tax revenues** and own source revenues. The revenue entitlements of provincial administrations and municipalities from the national budget are defined by Law No. 5779 on Tax Revenue Shares for Special Provincial Administrations and Municipalities, dated 2008. According to this law, different types of local governments are entitled to different percentages of national taxes. 6% of national taxes are earmarked for metropolitan municipalities, 4.5% for district municipalities which are in metropolitan cities, 1.5% for other municipalities and 0.5% for special provincial administrations.

Depending on the type of local governments, 60-70% of the shares of national taxes are allocated to them on an origin basis. The remaining 30-40% are gathered into grant pools specific to each type of local government and redistributed according to two criteria: 80% of these pools are then allocated to local authorities on a per capita basis and 20% according to the development index. This index divides local governments into five groups, with the least developed group getting 23% of the pool and the most developed group getting 17% of the pool. All of these revenues are classified as shared taxes, instead of being divided into shared taxes and unconditional grants. Together they account for between 45% and 50% of local government revenues, with revenues from own sources accounting for a similar share and other grants making up the difference of less than 10%.

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

Local Government Own source revenues

Turkish local governments derive 37% of their revenues from local taxes and fees. There are several local taxes such as the announcement and advertisement tax, entertainment tax, communication tax, electricity consumption tax, enviromental tax, with the most important being the property tax.

The property tax constitutes 6% of total local revenues and 15% of local own-source revenue in 2021. It is charged on the square meter value of urban buildings and land adjusted by location, use and building quality. Municipalities are legally required to value properties every four years.

Tax assessment is done on the basis of a centrally-set methodology and tax rates set by the municipality within limits set by the national government at 0.1-0.3% of the assessed value. These rates are increased by 100% within the frontiers of the metropolitan municipality. It is compulsory that a property tax declaration is submitted to the municipality where the building and land is located in case there is a reason for modification of tax value. Both owners and users (if owners cannot be identified) of land and buildings are liable for the property tax. The cadastre of all properties in the economy is maintained by the national government and managed by a department within the Ministry responsible for the environment. Local governments may access the cadastre to identify properties and owners within their jurisdictions.

Fees constitute an important part of own source revenues as well. The most important fees are "The building construction fee", charged for the construction of all kinds of buildings; the "Occupation fee" charged for the temporary occupation of the territory; "other local fees" are composed mostly of revenues from public services such as water supply and transport.

Borrowing

Municipalities may borrow loans and issue bonds in accordance with the following procedures and principles to cover the expenditures and deliver services according to Municipal Law No. 5393.

While domestic borrowing can be made for all current and investment expenses, external borrowing can only be made for the purpose of financing projects included in the investment program of the municipality within the framework of the Law No.4749 on Regulation of Public Finance and Debt Management. Legislation has introduced some restrictions on borrowing amounts.

Municipalities and their affiliated entities and companies in which they hold more than 50% of the equity capital may contract domestic loans by a resolution of the municipal council provided that such loans not exceed a total of 10%, for the year concerned, of the amount of their latest final budget revenues increased by the revaluation rate provided for in the Law No. 213 on Tax Procedures; they may contract domestic loans exceeding 10% of that amount by a resolution of the simple majority of the full membership of the municipal council and with the approval of the Ministry of Environment, Urbanization and Climate Change.

The domestic and foreign debt stock, including interest, of municipalities and their affiliated entities and companies in which they hold more than 50% of the equity capital may not exceed the total amount of their latest final budget revenues increased by the revaluation rate provided for in the Law No. 213 on Tax Procedures. The ceiling applicable to metropolitan municipalities shall be one-and-a-half times that amount.

In 2021, the ratio of total debt stock of local governments to revenues is 47%. This rate was 55% for the years 2020 and 2019. (the financing source obtained by borrowing is not included in these revenues). While the ratio of the debt stock of local governments to the consolidated revenue of the general government was 6.4% for 2018, 2019 and 2020, this ratio decreased to 5.58% in 2021. The main reason for this decrease in the rates in 2021 is the increase in both the local government and the consolidated revenue of the general government rather than the decrease in the debt stock.

COVID-19 Impact and implications for Local Government Finances

The first COVID-19 case in Türkiye emerged in March 2020 and progressed very quickly, as in the rest of the world. Although the central government is the main authority responsible for health services, local governments have also made important contributions to the fight against the pandemic.

These contributions can be listed as the services such as informing the public and raising awareness, disinfection and cleaning, mask production and distribution, social aid and support services, inspections for the measures taken, culture-arts-sports and psychological support services.

In terms of expenditures, the increase in the expenditures of local governments for 2020 is due to current expenditures rather than capital expenditures. Measures such as the curfew had some effect on the slowdown in investments. But in 2021, the share of capital expenditures in total expenditures has started to increase again.

The support activities of the central government within the scope of COVID-19 have addressed the citizens and the private sector affected by COVID-19, rather than local governments. In fact, the central government has paved the way for local governments by deciding with the "Law on Reducing the Effects of the New Coronavirus (COVID-19) Pandemic on Economic and Social Life", dated 16.04.2020/7244, that local governments can provide similar support. For example, local governments have been authorized to defer the revenues from rent, water supply and sale of real estate. It has been decided that the annual announcement and advertisement taxes and annual environmental cleaning taxes will not be collected for the private sector whose activities are suspended or cannot operate.

With Law No. 7244, several financial supports were also provided to local governments. An important resource has been created for local governments by deferring the payment of taxes and Social Security Institution debts that are required to be paid by local governments. In addition, it was decided to stop the deductions made for the debts of local governments from the general budget tax revenues for a while. According to the increase and decrease of the risks related to the pandemic, time extensions have been made for these supports, which came with the Law No. 7244, and especially with the increase in the ability of the health system to fight the pandemic, most of the supports have ended before the end of 2021.

Statistical Overview of Local Government Finances in Türkiye

In 2021, the ratio of local government revenue to GDP decreased to 3.3%, the lowest level since 2006, while its share in total public revenue was 12%.

Local governments revenue have increased by 39% in 2021 as opposed to the 36% increase in total public revenues, which is the highest level since 2006. In addition to the pandemic, 2021 has been a year of global economic difficulties due to the increase in energy prices, disruptions in global supply chains and political reasons. Türkiye has also had its share of economic difficulties in 2021 with the highest inflation rates in recent years. This high inflation rate is one of the main reasons behind the high increase in both local governments and total public revenues.

Figure 201 TÜRKİYE: LG REVENUE AS A SHARE OF GDP AND TOTAL PUBLIC REVENUE IN 2006-2021

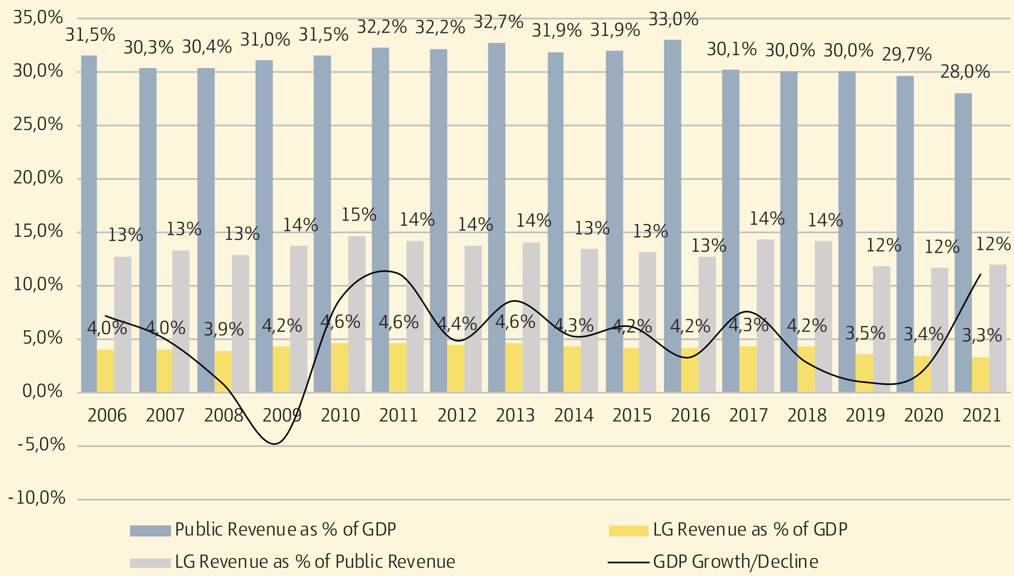


Figure 202 TÜRKİYE: FLUCTUATIONS IN THE REVENUES OF THE GENERAL GOVERNMENT AND LOCAL GOVERNMENTS 2006-2021

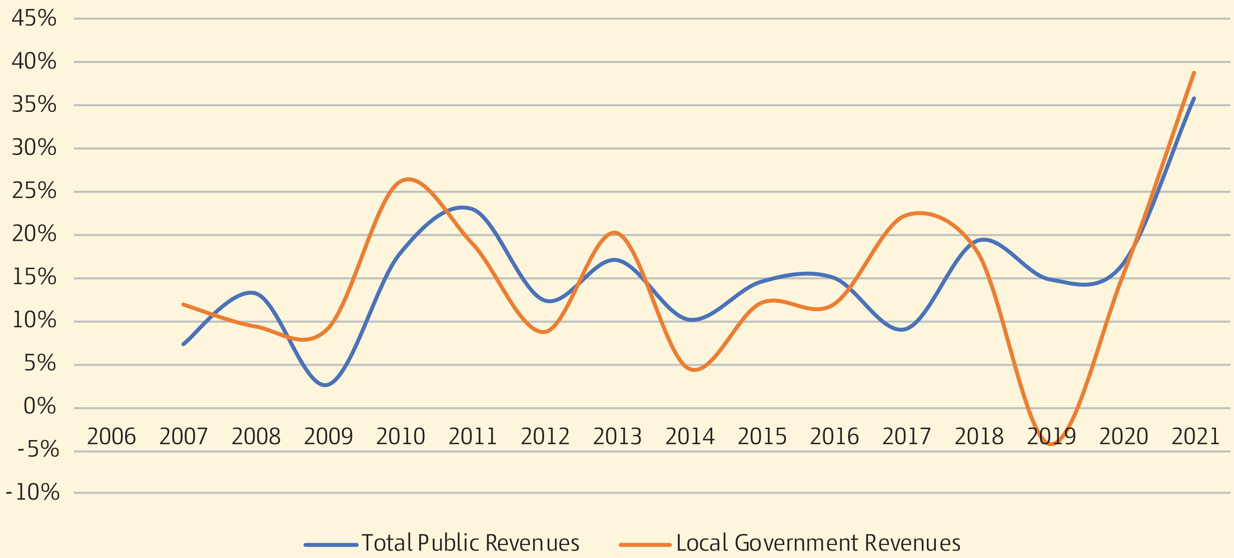


Figure 203 TÜRKİYE: COMPOSITION OF LOCAL GOVERNMENT REVENUE 2006-2021

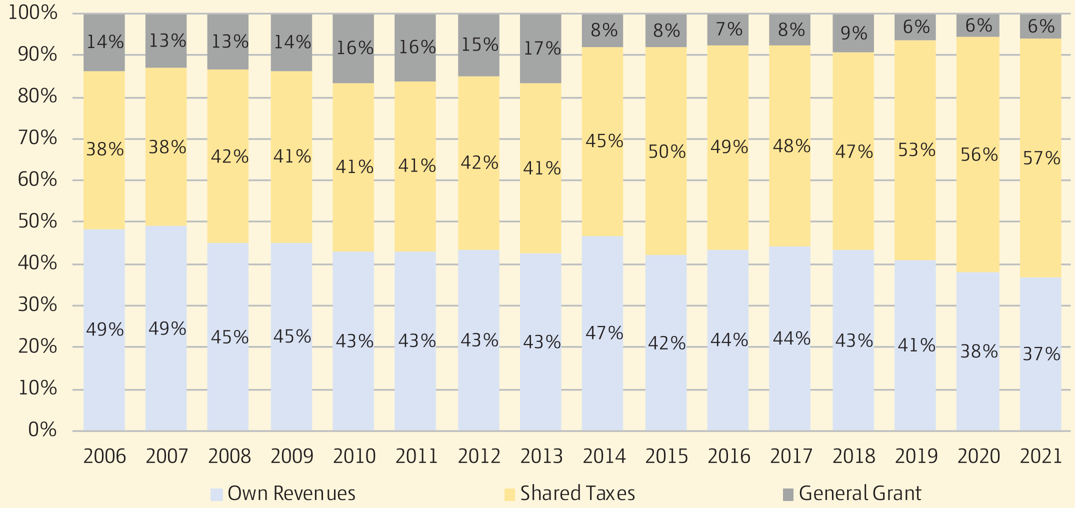
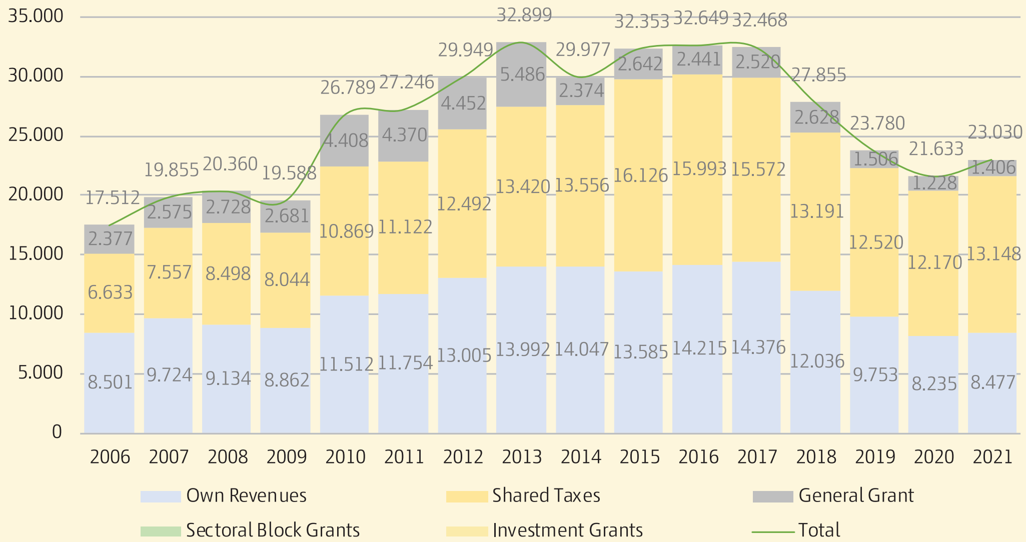


Figure 204 TÜRKİYE: COMPOSITION OF LOCAL GOVERNMENT REVENUE 2006-2021, MLN EURO



In 2021, own source revenues constitute 37% of the total. This is the lowest level since 2006. On the other hand, shared taxes increased to 57%, the highest since 2006.

The composition of own source revenues has not changed much in the last three years. In 2021, the share of property tax to own source revenues was 15%, which is 3% lower than the rate of 2020.

Figure 205 TÜRKIYE: COMPOSITION OF LOCAL GOVERNMENT REVENUE 2006-2021, EURO PER CAPITA

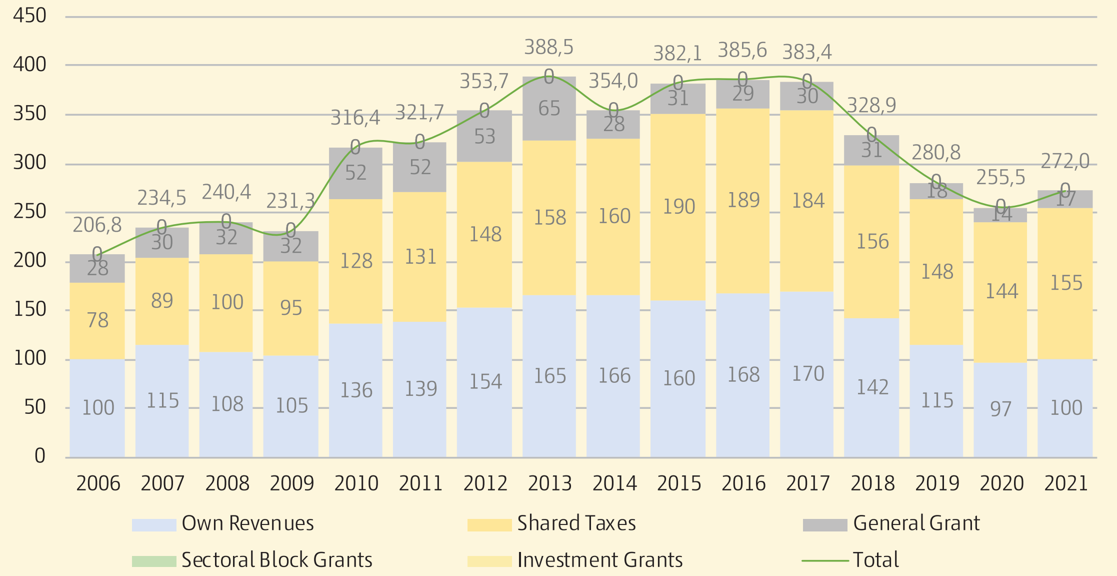


Figure 206 TÜRKIYE: COMPOSITION OF OWN SOURCE REVENUES 2006-2021, % OF TOTAL

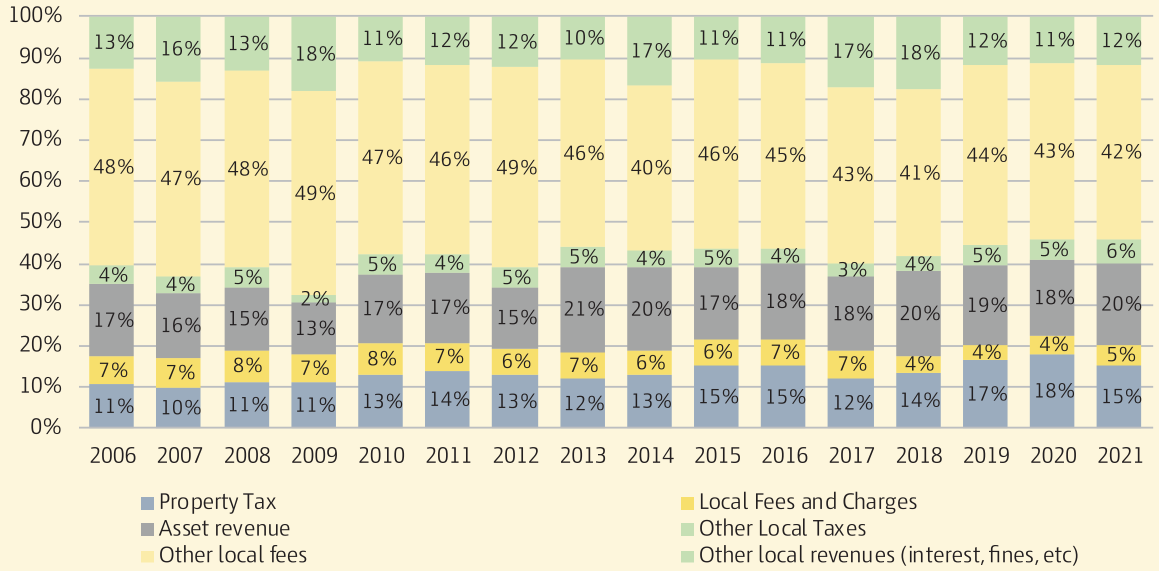
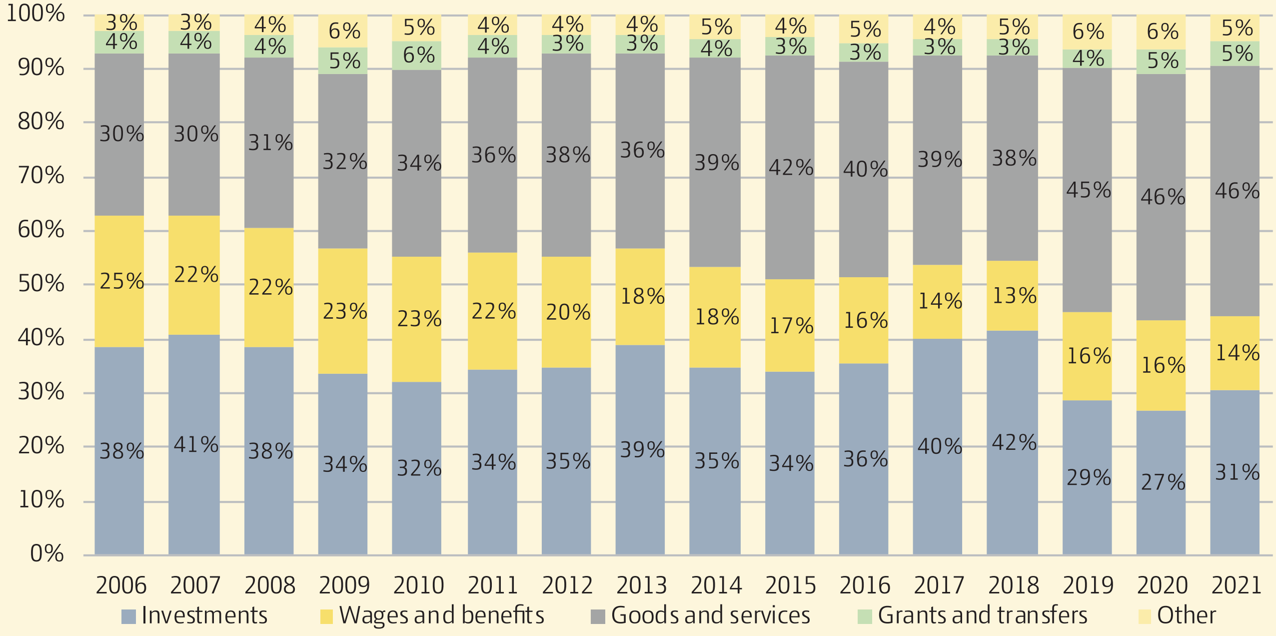


Figure 207 TÜRKİYE: COMPOSITION OF EXPENDITURE IN 2006-2021, IN % OF TOTAL



In 2021, local investment, as a share of total local expenditure, increased to 31%, after reaching the lowest level in 2020. On the other hand, goods and services remained at 46%. In 2021, the share of wages and benefits in total local expenditures reached the second lowest level since 2006.

LGs in Türkiye have historically played a fundamental role in terms of public investments. Up until the last three years, LGs contributed to up to 49% of public investments (up until 2018). Over the past three years, influenced by multiple crisis, the share of LG investments has declined significantly.

The decrease in the cost of local wages, as a percentage of GDP, continued in 2021, while property tax has remained relatively stable. Local public investment has remained same in the last three years, while outstanding debt was 3,3% of GDP. This is because of outstanding debts to suppliers and contractors rather than borrowing.

Figure 208 TÜRKİYE: COMPOSITION OF EXPENDITURE IN 2006-2021, IN MILLION EUR

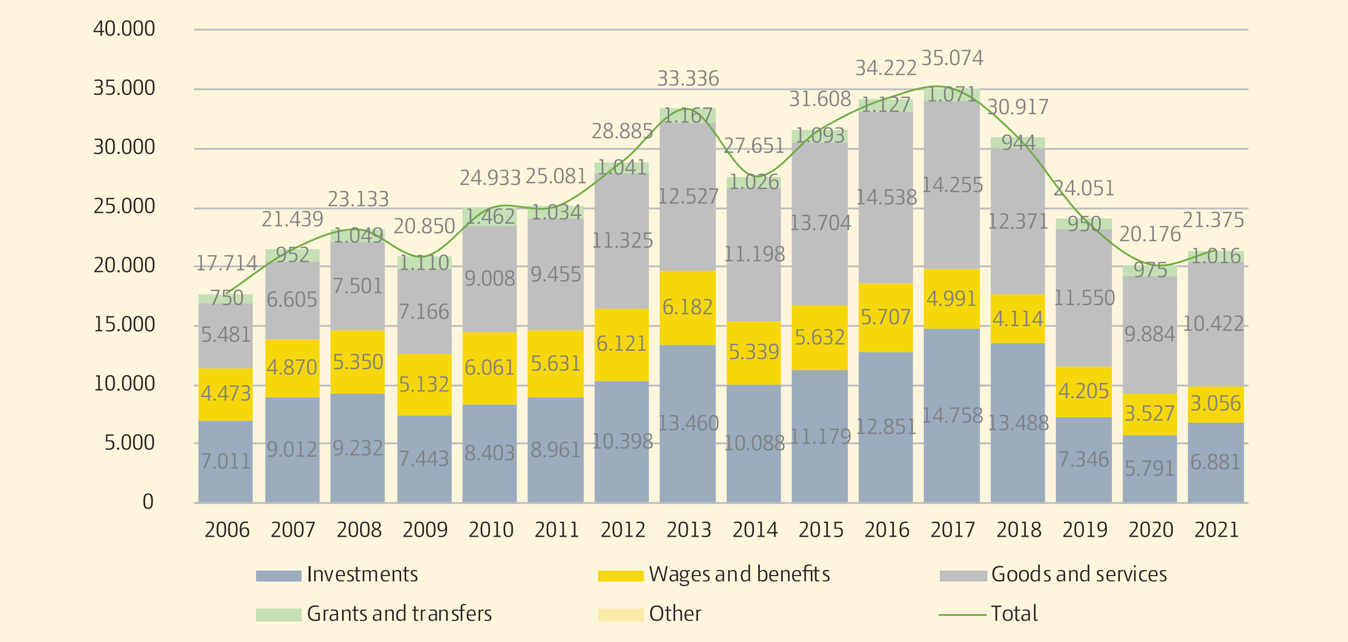


Figure 209 TÜRKİYE: COMPOSITION OF EXPENDITURE IN 2006-2021, IN EUR PER CAPITA

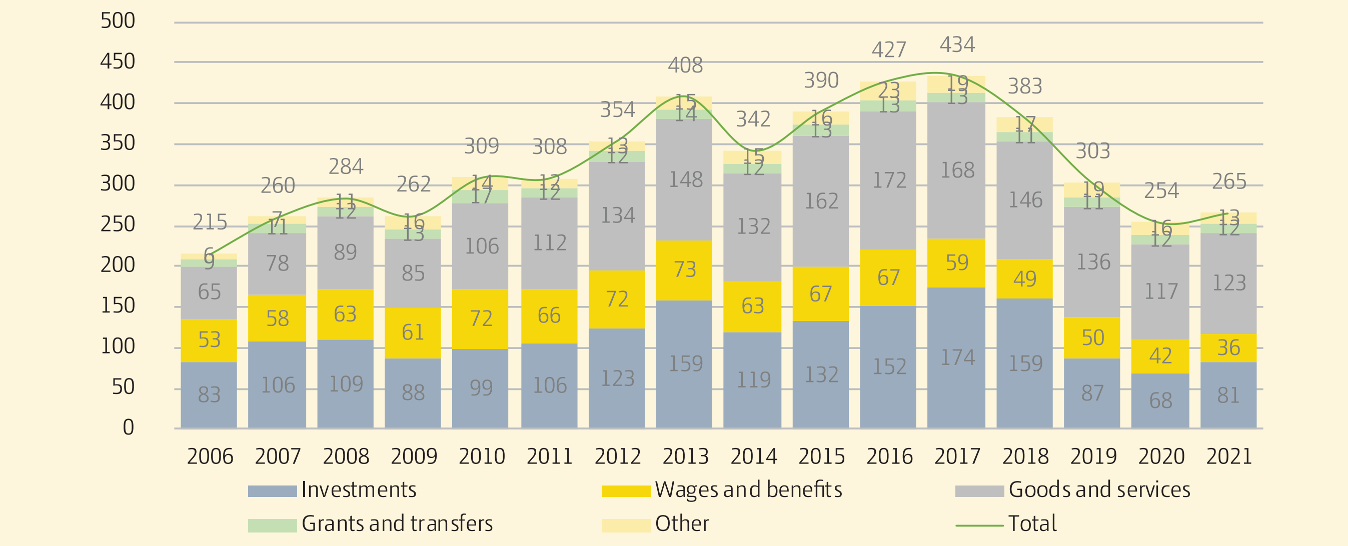


Figure 210 TÜRKİYE: COMPOSITION OF PUBLIC INVESTMENTS, % OF TOTAL

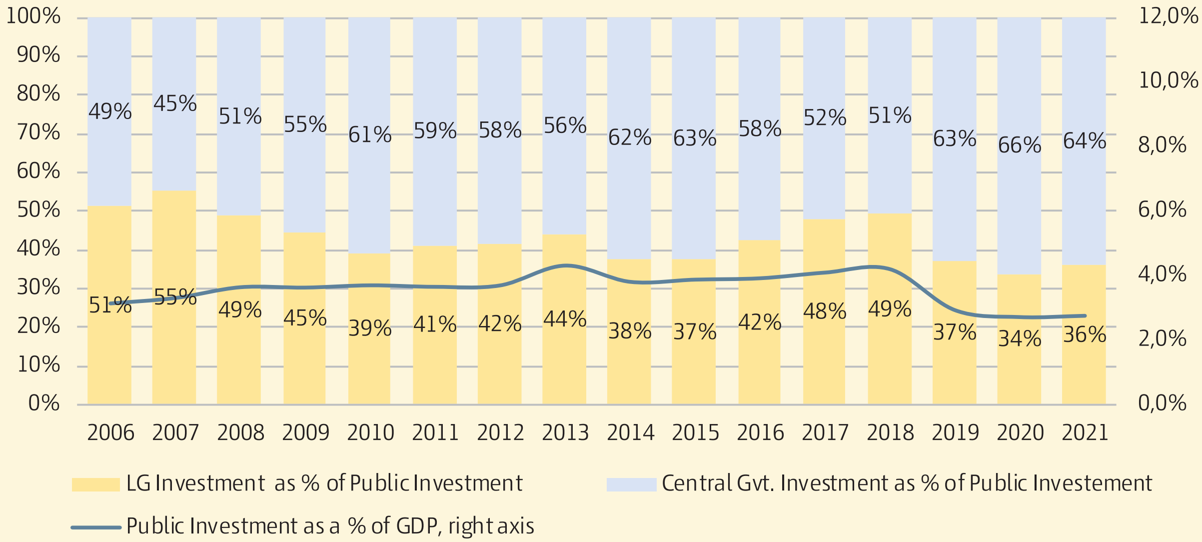
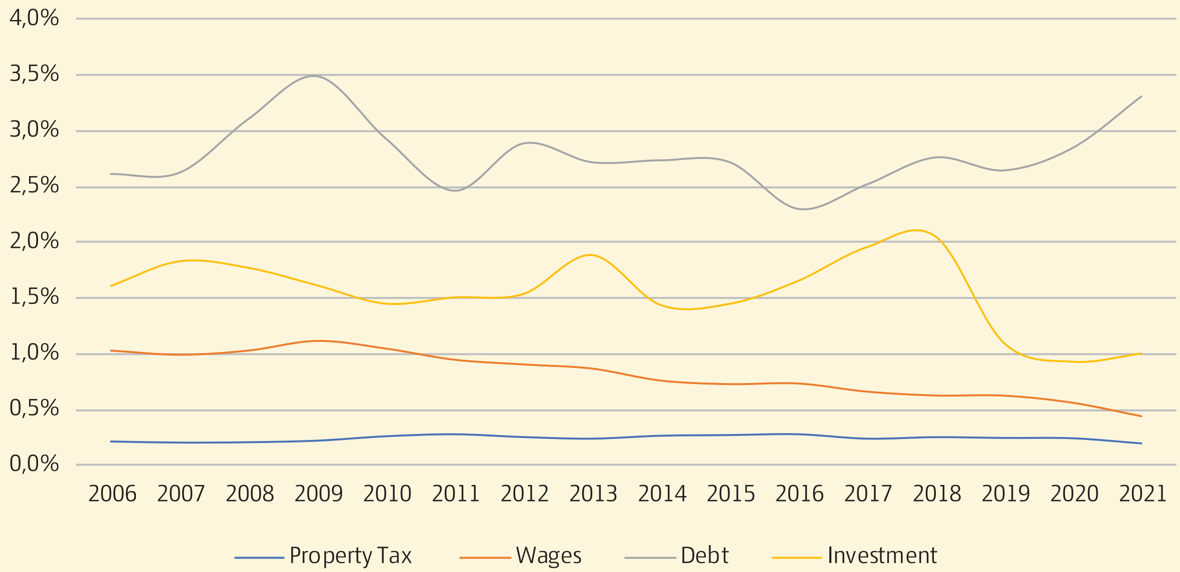


Figure 211 TÜRKİYE: INVESTMENT, WAGES, OUTSTANDING DEBT AND PROPERTY TAX AS SHARES OF GDP 2006-2021



Data, Terms and Methodological Issues IV.

The data used in the report has been provided mainly by NALAS members and comes from the respective Ministries of Finance, Central Banks and Statistical Agencies of SEE Economies. The data for Austria are provided by the KDZ, the Centre for Public Administration Research, and retrieved from Statistik Austria (covering Austrian municipalities without Vienna). 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, including the World Observatory on Subnational Government Finance and Investment of the United Cities and Local Governments (UCLG) and the Organisation for Economic Cooperation and Development (OECD) (www.sng-wofi.org); Council of European Municipalities and Regions (CEMR), Local Finances and the Green Transition (www.localfinances-cemr.eu). Additional data sources include the World Bank and the International Monetary Fund.

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

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

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

In several SEE economies, however, local governments are responsible also for delivering important social sector services, particularly in education, but also in some places, health and social care. The degree to which local governments are responsible for social sector services has a profound effect on their "fiscal weight" everywhere. It is thus important, when reading the report, to remember what social sector services local governments are providing in different places. For a more comprehensive analysis of the regulation and financing of decentralized social sector responsibilities in SEE, please refer to the Eighth Edition of the NALAS Report: Social Welfare at the Intersection of Municipal Finance and Governance in South-East Europe. We discuss these issues in greater detail in the next section.

Population: The use of correct and most recent population data is of crucial importance for all per-capita indicators. There is a variety of sources in which data greatly varies mainly because of the purposes for which the data is generated and used. The initial focus on the census data had to be reassessed because of increasing time-gaps with the current situation, which cannot reflect the profound demographic changes many economies in SEE are undergoing. We prioritized the data sources for each economy in the following way: a) Primary source – EUROSTAT; b) National Statistics— census or most recent data if available, and c) data used for the transfers systems – from the Local Government Associations' (LGA) input.

Gross Domestic Product (GDP): We have used the GDP figures according to the production method, published by the Ministries of Finance or Statistical Agencies of SEE economies. Where we converted GDP into EUR figures for comparative purposes, we have used the average annual exchange rates provided by the relevant Ministries of Finance and/or Central Banks.

Public Revenue of the General Government: To compare the relative importance of local governments across settings we have generally used revenues— and not expenditures - as a share of the consolidated finances of the General Government. This because: 1) data on revenues tends to be more consistent than data on expenditures at the subnational level, and 2) the revenue side has a direct impact on fiscal autonomy. By General Government Revenue, we mean the total revenues of the national government and its agencies, including the revenues of social, pension and health security public funds and those of subnational governments. The terms General Government and Public Revenues are used interchangeably in the report, according to the former definition, to help with the readability of the report. For local governments we have excluded proceeds from borrowing as the quantity and quality of data on LG borrowing varies significantly.

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

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

Shared Taxes: In most of the region, local governments are entitled to shares of national taxes generated in their jurisdictions (origin-based tax sharing). The most important shared tax is usually the Personal Income Tax (PIT), which is also usually accounted for officially as a Shared Tax. The Property Transfer Tax is also often shared (100%) with local governments but is usually misclassified as an own revenue. In a few places, the recurrent property tax is shared between levels of government and in Romania, a small fraction of the Corporate Income Tax (CIT) is shared with regional governments. In North Macedonia the state shares with the municipalities the central proceeds from VAT, state-owned agricultural land leases and concession payments. More information on shared taxes is provided in the individual chapters of the SEE economies.

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

Important note:

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

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

EU members in SEE

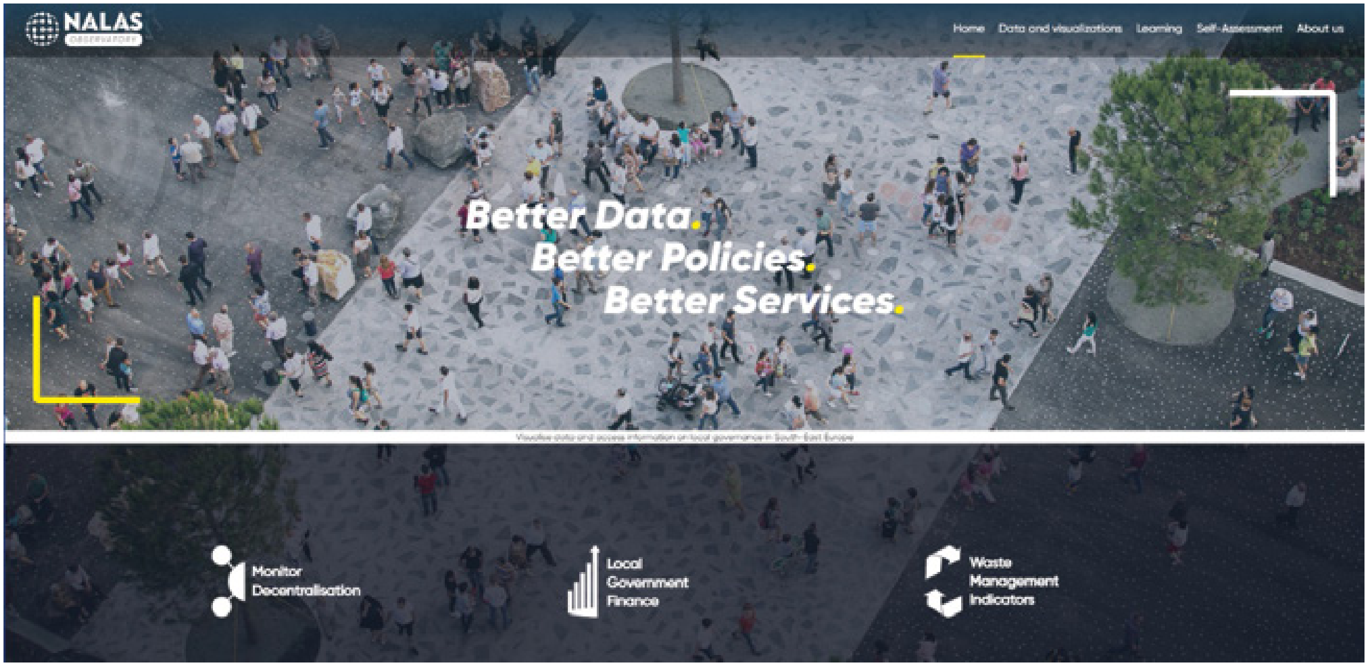
Measuring and evaluating the different aspects of decentralization is supposed to reflect exclusively the national efforts in this regard. The appropriate fiscal indicators should not be "contaminated" by external, non-domestic, factors. For economies that are members of the EU (*Bulgaria, Croatia, Romania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

The NALAS Decentralisation Observatory the knowledge hub on local government in South-East Europe

The importance

To be able to make informed decisions, develop good public policies and public services and efficiently manage scarce resources, policymakers at all levels of government have to rely on high quality data and information. But, all-around South-East Europe such data is either missing or is difficult to access.

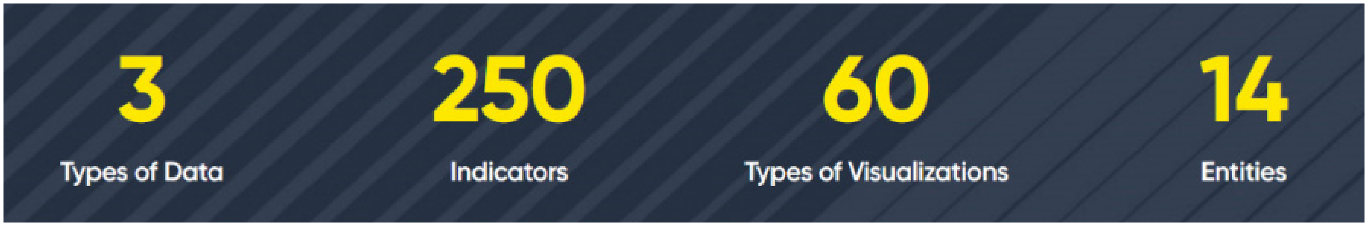
To bridge this gap, NALAS and KDZ partnered to develop the NALAS Decentralisation Observatory for South-East Europe www.nalas-observatory.eu. The Observatory facilitates the access to and utilisation of timely, accurate, reliable and comparable data and information on local government finance in South-East Europe (SEE).



The objectives

- Support policy advocacy efforts of NALAS member Local Government Associations, as stewards of local democracy and local governance in SEE;
- Help policymakers, experts, practitioners and researchers in their quest to improving local government policies and services;
- Support local government budget transparency;
- Serve as a model for national platforms to support evidence-based policymaking and local budget transparency.

What do I get from the Observatory?



The NALAS Decentralisation Observatory provides for a tailor-made **user friendly and dynamic visualisation of complex data and information**. It allows a thorough analysis of the current status and developments of local government finance for 12 SEE economies, including **regional comparisons** across economies and indicators that can be customised, downloaded and reutilised depending on users' needs and preferences.

It also serves as a **knowledge hub** for local governments in SEE, by publishing state-of-the-art research on local government finance, waste management and the overall progress of decentralisation in South-East Europe.

What do we do?

Facilitate visualisation of complex data in a user friendly manner

Facilitate regional comparison of key indicators of local government in South-East Europe

Serve as a unique knowledge hub to learn about the progress of decentralisation in South-East Europe

The Regional Decentralisation Observatory builds on about a decade of NALAS work on Fiscal Decentralisation and consolidates the knowledge developed by the NALAS Fiscal Decentralisation Task Force representing 14 Local Government Associations from South-East Europe.

The Observatory is developed by NALAS, in partnership with KDZ – Centre for Public Administration Research and with the support of the BACID III Program—Building Administrative Capacity in the Danube Region and Western Balkans, co-funded by the Austrian Development Cooperation and implemented by the Austrian Association of Cities and Town.

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With funding from Austrian Development Cooperation