

SOUTH EAST EUROPE MUNICIPAL FINANCE REVIEW

Local Government Finance in the Western Balkans

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*Local Government Finance
in the Western Balkans*

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Acronyms and Abbreviations

BiH	Bosnia and Herzegovina
ECA	Europe and Central Asia
EU	European Union
FBiH	Federation of Bosnia and Herzegovina
LGA	Local Government Association
LGU	Local Government Unit
MFR	Municipal Finance Review
MoF	Ministry of Finance
MoLG	Ministry of Local Government
NALAS	Network of Associations of Local Authorities of South East Europe
PIT	Personal Income Tax
RS	Republika Srpska
SEE	South East Europe
UoM	Union of Municipalities
UPP	Urban Partnership Program
VAT	Value Added Tax

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Executive Summary

1. BACKGROUND AND OBJECTIVE

The importance of local government finance has increased over the last two decades. Decentralization in the South East Europe (SEE) Region has given municipalities increased autonomy and shifted more responsibilities for service delivery and resource management to local governments. An ever growing share of public investment decisions is made by local authorities. Their relative weight in public spending and revenue raising has been increasing constantly over the last decade. On average, sub-national government expenditure in the SEE region accounts for around 5 percent or more of GDP and are in charge of around 15% of overall public expenditures. Municipalities, and the public utilities reporting to them, manage large and important infrastructure assets and need to secure financing for operation, maintenance, and capital renewal.

Despite local government's important functions, the knowledge of municipal finance issues in SEE is limited. Although reliable municipal finance data is critical for fiscal forecasting, good financial management, and to assist evidence-based planning and policy making, data is usually not accessible, or only to a limited degree. Overall data coverage and quality varies greatly among, and within, countries. While information is generally available in individual municipalities and at the national level, there is a general lack of fiscal data across municipalities. Regional comparisons and benchmarking are mostly absent, both within and across countries in the region. Although the majority of municipalities usually prepare some type of revenue and expenditure forecasting, not all attempt to make systematic longer-term projections, partly due to the lack of

empirical information, since municipal finance time-series are not regularly available, let alone reliable data for more sophisticated analytical approaches. Although Local Government Associations (LGAs) acknowledge the need for better municipal finance data to strengthen their position in inter-governmental negotiations, most lack comprehensive data collection mechanisms or have limited access to already available information.

The Western Balkans Municipal Finance Review (MFR) aims to address this shortcoming. Against this background, the objective of the analytical work under the SEE Municipal Finance Review aims to (i) contribute to improved understanding of local government management and finance in the SEE Region; and (ii) contribute to improving the quality and consistency of key municipal finance data for improved evidence based policy making. The analysis presented in this report comprises the first attempt to review and analyze a regional set of disaggregated sub-national finance data in the SEE Region. This analysis does not aim to be complete and fully comprehensive, but to present options for using disaggregated datasets for in-country and cross-country comparison. In particular, data collection designed and implemented under the MFR has the goal of leveraging the added value of disaggregated municipal finance data in a sub-region where generally, to date, municipal finance analysis has been limited to aggregated, national datasets.

This analysis is embedded in a regional capacity building program to support local governments and their associations. Analytical activities and technical assistance provided under the MFR were co-financed and implemented jointly under the

World Bank-Austria Urban Partnership Program (UPP) in close collaboration between the ECA Sustainable Cities Initiative and the World Bank Institute's Urban Practice. One of the key issues identified by national and municipal stakeholders consulted during preparation of UPP was the weak financial management performance and low fiscal capacity of municipalities. MFR aims at increasing institutional capacity of local government for better municipal management in addition of demonstrating the benefit and value added of disaggregated municipal finance data collection and analysis.

MFR has applied a 'bottom-up' approach for data collection and analysis. First, municipal finance data sets were generated by involving LGAs and local MFR experts in each country. A standardized framework on quantitative and qualitative dimensions of municipal finance was developed, to ensure quality and comparisons of data collected in each country. Second, these disaggregated expenditure and revenue data were linked to socio-economic data sources, i.e, population size, density, urban/rural classifications, location, national GDP and public expenditure, among others. The comprehensive combined datasets provide the platform for detailed analytical work, as well as support to local governments and LGAs in achieving an in-depth understanding of drivers and composition of municipal finance.

2. DIFFERENT SHAPES OF DECENTRALIZATION IN THE WESTERN BALKANS

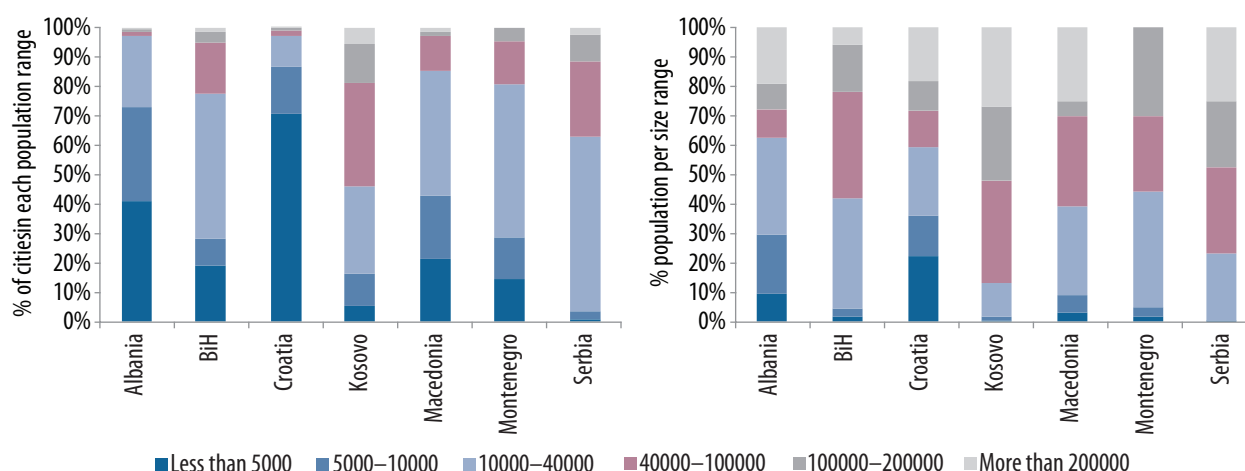
The specific institutional framework and administrative structure differs—despite the common history and overall perspective of European Union (EU) accession shared by many countries in the SEE region. However, after more than a decade-long decentralization reforms in the region, the overall institutional framework has been put in place and stabilized in the seven Western Balkan countries. In general, SEE is characterized by a single tier local government system with relatively large size municipalities; only Albania, Bosnia and Herzegovina, and Croatia have two and three tier sub-national government systems. Typically, municipalities provide core

utility services such as water supply, sanitation, solid waste management, local roads, and basic social services. Health and education services are usually provided at a higher government level. However, the level of decentralization and functional assignments differ between and within the two groups of one and multi-tier sub-national government systems. Serbia, Montenegro, and the Republika Srpska (RS) in Bosnia and Herzegovina (BiH) have a more centralized system in which the central government is responsible for provision of health, education, and social welfare. In Kosovo and Macedonia, municipalities are allocated broader roles in primary and secondary education, and primary health care. In addition, the role and weight of central and regional governments are very distinct in the different types of two and three tiered sub-national government systems in the SEE region.

But also the size and structure of municipalities varies widely across the SEE region. There are considerable variations in the distribution of municipalities by population size. The average population size of local government units in one tier sub-national government systems ranges between around 23,000 inhabitants in the RS in BiH to close to 59,000 in Kosovo. On the other hand, countries with two-tier sub-national governments like Albania and Croatia have a considerable amount of municipalities with a population below 5,000 inhabitants. However, despite an overall large number of small municipalities in SEE, the highest population share concentrates in medium and large cities (see Figure 1). Municipalities in SEE are also very diverse in terms of population density. Variations in the group of largest municipalities with more than 200,000 inhabitants range from more than 1,600 inhabitants per km² (Serbia) to less than 200 per km² in the RS. Within countries, divergences in densities are particularly striking in Croatia, Kosovo and Montenegro.

Overall, capital cities dominate the local government system in SEE. Despite the seemingly balanced population distribution, there is a spatial concentration in metropolitan areas. From the 7 countries in SEE included in the analysis, 4 have more than 15% of their population living in the capital city. Most accentuated in Montenegro, 30% of the total

Figure 1: Distribution of municipalities across different sizes (left) and population distribution across different size municipalities (right)



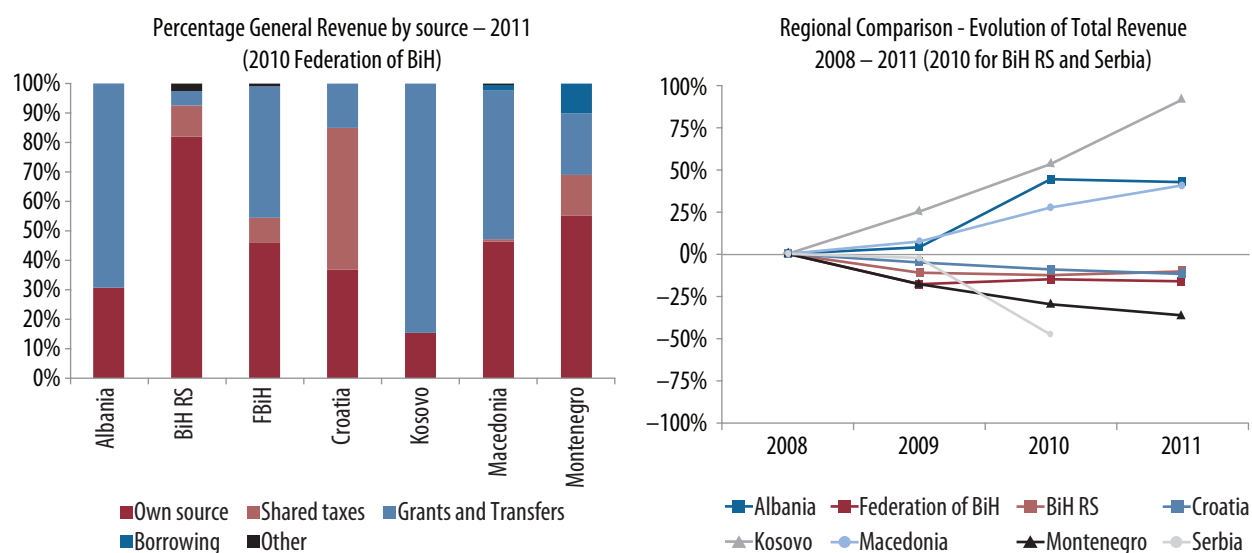
population resides in the capital city. Capital cities generally also generate the largest share of GDP. For example, in Macedonia, Skopje accounts for about 25% of the total population and contributes to around 45.6% of the country's GDP.

3. COMPOSITION AND STRUCTURE OF LOCAL GOVERNMENT FINANCE IN THE WESTERN BALKANS

Local government funding and expenditure structures are very diverse. Variations in the revenue composition across the SEE region are large, with the share of own source revenues ranging between 15% in Kosovo to 82% in the RS. Variations in the sub-national expenditure structure are caused by the different functional assignments—regardless of general government spending—but are also a reflection of the diversity of intergovernmental arrangements. For example, while the overall public sector in Albania and Kosovo is markedly smaller than in the other countries, the importance of sub-national government varies almost by a factor four: sub-national governments in Albania account for 8.8% of total public expenditures, while in Kosovo, almost 49% of all public expenditures are handled by sub-national governments.

Overall, grants, shared revenues and transfers dominate local revenue composition. Grants and transfers account for a particularly large share of sub-national budgets in Albania and Kosovo. Only in the RS and Montenegro, own-source revenues account for more than half of sub-national budgets (see Figure 2; left side). However, weight and composition of own-source revenues varies across and within countries. In Albania and the RS, the largest share of own source revenue originates from taxes, while Croatia, Kosovo and Macedonia have a more diversified revenue composition which includes revenue from rents and capital. During the period of analysis, total local revenues have increased in Albania, Kosovo and Macedonia, but took a hit in the other countries (see Figure 2; right side). The decline of local revenues was only partially compensated by national transfers, since central government budgets also contracted during the same period, and was particularly contrasted in Croatia, Montenegro and Serbia. In Macedonia, various earmarked transfers from line ministries dominate local budgets. Kosovo municipalities benefitted from an overall increase of close to 92% during 2008–2011, driven largely by growing grants and transfers such as in Macedonia (40%).

Overall, local government expenditures in SEE range between of 2–8% of GDP. At that level,

Figure 2: Composition and evolution of local government revenues

countries in the SEE region are generally in line with comparable countries in the EU, but below the EU27 average of 14%. The shape of decentralization influences general government expenditure. For example, Bosnia and Herzegovina pays a premium for the more complex institutional structure inherited as a result of the Dayton Peace Agreement in 1995: although BiH's GDP is below the regional average, public sector spending reaches 49.2 percent. However, on average, the overall weight of local government spending has decreased since 2008, less two exceptions: local expenditures increased in Macedonia from 4.3% of GDP in 2008 to 5.6% in 2011; and in Kosovo from 5.2% to 8.4% in the same period. This reverse trend, however, is largely the result of education spending which was assigned to municipalities in both countries. The weight of local government spending has decreased the sharpest in Montenegro, from 5.5% of GDP in 2008 to 3.9% in 2011.

However, per capita local government expenditure in the Western Balkans is low. On average, local governments in the SEE region spend EUR288 per capita, compared to EUR 2986.3 in the EU27. Croatia and Montenegro are an exception with an average of around EUR500 per capita. Local government spending is much lower in the Federation of BiH and

Kosovo: here, local expenditures are less than half of the average in Montenegro. However, by far the lowest level of per capita spending is observed in Albania. On average, Albanian municipalities only spend 10 percent of the per capita average in Montenegrin municipalities. While this may be a reflection of the multi-tier sub-national government system, equally to the FBiH, it also reflects the generally low level of local expenditure as share of GDP in Albania.

General public services typically dominate local expenditure. This category, which generally covers services of elected organs and the local administration, accounts for more than half of sub-national expenditure in Albania and Montenegro, and close to 50% in the FBiH. Only in Kosovo and Macedonia, education accounts for the largest share of local expenditure. In both countries, municipalities have full responsibility for primary and secondary education, including teachers' salaries and wages, which make up the lion share of local spending with 48.7% in Macedonia and 42.2% in Kosovo.

Housing, communal services and economic affairs account for the largest share of urban services. Typically, local governments are responsible for housing development and maintenance, water supply and

public street lighting, accounted under 'housing and communal services'. This category constitutes a significant part of local budgets in Macedonia (19.6%), Croatia (17.2%), the Federation of BiH (17.7%), and Montenegro (14.4). Public transportation is the largest single item accounted for in 'economic affairs'. This sub-sector covers road building and maintenance, grants provided to operation of roads, railway and other public transportation systems. If local governments are directly involved in tourism, restaurant and hotel businesses, then they are also accounted here. Economic affairs are present in all local budgets, but they have the highest shares in Albania (26.8%) and Croatia (15.2%). Environmental protection services, such as municipal solid waste management and sewage treatment are less visible among the local government expenditures, because they are either underdeveloped or reported by public utilities responsible for communal service provision.

Grants and transfers form an important part of sub-national budgets. However, the size and nature of 'grant dependency' varies significantly. Grants and transfers account for more than 50% in Albania, Kosovo and Macedonia. Apart from Montenegro, the share of grants in total has increased in all countries. In Albania and Kosovo, the grant share was increased significantly over the considered period, reaching 69% and 85% respectively in 2011, while Macedonia saw a much more moderate development. In Montenegro, on the other hand, grants and transfers from the central government decreased by more than 10 percent from 26.4 in 2008 to 15.4 in 2010; and only recovered somewhat again in 2011, stabilizing at 20.8 percent. The relative little importance of grants and transfers in Croatia and Montenegro should be seen in the context of the overall funding profile: as the only two countries in the SEE region, Croatia and Montenegro benefit significantly from shared taxes as funding source. In Croatia, shared taxes are the most important funding source, covering about 50% of expenditures. Although shared taxes play a much less important role in Montenegro, they still cover 12–13% of the sub-national government funding.

However, the type of grants defines dependency beyond their share in local budgets. To fully understand and assess the inter-governmental fiscal

system, it is important to understand the nature of grants and transfers, in addition to their size. For example, while sub-national governments' expenditure in Albania are funded to a large extent by central transfers (69% in 2011), the funds are almost fully provided as unconditional grants which leave room for spending decisions at the sub-national governments' discretion. On the other hand, while grant dependency per the share of local government financing seems much lower in Croatia and Montenegro, the grant 'picture' is also much more complex with a larger share of ear-marked grants. Although ear-marked grants are used to ensure standards and quality of core public services like education and health, they leave no or little financial discretion to sub-national governments.

Overall, sub-national borrowing remains a minor source of revenue in SEE. Total accumulated local government debt is not significant, at less than 1% of GDP, even in countries with more actively borrowing sub-national governments, such as Montenegro and Serbia. Among others, this reflects the strict sub-national borrowing regulation across the SEE region. All countries have borrowing laws which control local government debt and limit sub-national borrowing by revenue and outstanding debt. In all countries, sub national governments need consent or approval from the central government in order to take a loan, guarantee or issue a bond. However, the role of municipal credit would be expected to increase with greater financing needs for local infrastructure investments and more restrictive central government budgets.

Imbalances in sub-national debt may become a cause of future fiscal stress. The distribution of debt across sub-national borrowers is very uneven across municipalities and may pose a serious fiscal risk for some highly indebted local governments. In Albania, mostly larger municipalities and local governments in less developed regions borrow. The concentration of debt in weaker municipalities is of particular concern. In Montenegro, some of the poorer municipalities are more actively acquiring loan funds, despite the heavily regulated local government borrowing procedures. Annual debt repayment in percentage of the total current expenditures has reached 53.6%

in Montenegro where local debt is concentrated in the coastal cities and the local governments in the Northern region. These municipalities cannot cope with the high debt repayment burden, so a special financial recovery plan had to be signed with the Ministry of Finance.

4. VARIATION AND DISPARITIES ACROSS MUNICIPALITIES WITHIN COUNTRIES

The composition of local revenues differs across but also within the SEE countries. A closer review of the disaggregated data reveals significant variations across local governments within countries. Factors such as the local economic base and property values, among others, determine the room for collecting property related taxes or business fees. For instance, property values tend to be higher in larger municipalities when compared to small municipalities. Overall, bigger municipalities tend to have higher per capita tax revenues compared to municipalities with a smaller population.

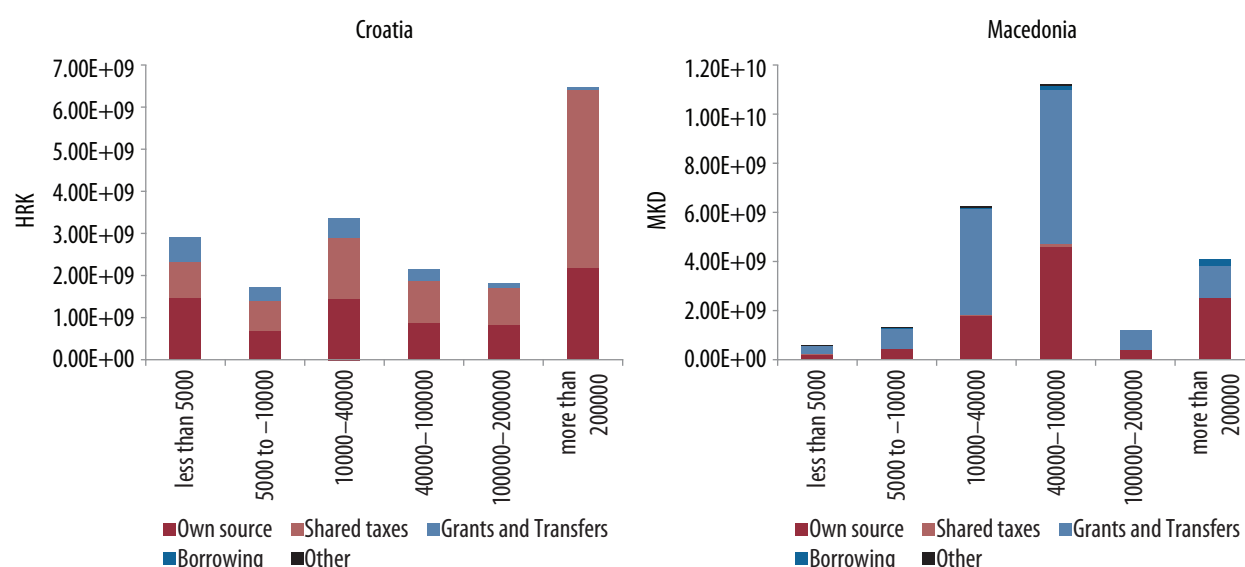
Total revenue trends suggest large variations across municipalities of different size in Albania and Montenegro. While, overall, down- and upward trends in total local revenues show comparably similar patterns in the municipalities of BiH, Croatia, Kosovo, and Macedonia; trends vary significantly for municipalities of different size in Albania and Montenegro. In Albania, we find overall stagnation of total revenues across municipalities after an increase from 2009–2010. However, municipalities with a population between 100,000–200,000, MFR data indicate a strong decline in total local revenues. In Montenegro, on the other hand, smaller municipalities have increased their total revenues; in particular municipalities with less than 5,000 inhabitants registered a steep increase in total revenues after 2009.

However, own-source revenues are not necessarily concentrated in the biggest municipalities. While in some countries, e.g., Croatia and Kosovo, we find a high concentration of own-source revenues in the larger centers, this is not a consistent pattern across the SEE Region. In Croatia, municipalities with

more than 200,000 inhabitants represent around 45% of the total own source revenues of local governments, while they are home to only around 18% of the population. Similar results are found in Kosovo. In Albania, Macedonia and Montenegro, on the other hand, medium size municipalities concentrate most of the countries' own-source revenues—despite the lower per capita own-source revenues in those smaller municipalities. This is mainly the result of the large number of medium size municipalities in this latter group of countries. At the same time, smaller municipalities seem to underutilize fees and charges in Macedonia and Montenegro. Overall, findings suggest that particularly municipalities with a population smaller than 10,000 have significant revenue enhancement potential.

Expenditure variations are largely caused by the service function concentration in geographical centers. For example, in Albania, half of the total local public education spending is made in Tirana. In the Federation of BiH, water services (housing and community amenities), health care, recreational, sports and culture, and social protection services are concentrated in Sarajevo and the cantonal main cities. However, asymmetric functional assignments amplify variations. For example, during the decentralization process in Croatia, local government functions were devolved to the city level very selectively. Only the 32 financially stronger municipalities were authorized to take over additional responsibilities, such as education, housing and community amenities, reflected in a higher expenditure share of those categories in these selected municipalities.

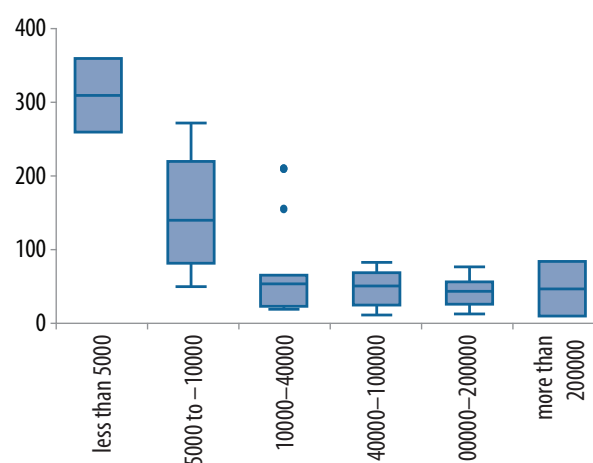
General public service expenditure per capita tends to decrease with larger population size. By and large, findings suggest that the share of general public service expenditure of total local expenditure increases in smaller municipalities. In Kosovo, for example, municipalities with less than 5,000 inhabitants have much higher spending than medium and large municipalities. A similar pattern can be found in the Federation of BiH. This might be a reflection of economies of scale, since smaller municipalities generally face higher per capita fixed costs for provision of a minimum service level.

Figure 3: Geographic concentration of total revenues by city size

Overall, urban areas generate a higher share of own-source revenues. Among the countries included in the MFR, Macedonian municipalities are classified as urban or rural which allows for additional analysis along this categorization. There are considerable variations between urban and rural municipalities in the composition of total revenues, but also the share of own source revenues. Revenue trends in Macedonia suggest rural municipalities outperform their urban peers in mobilizing revenues. During 2008–2011, rural municipalities' total revenues grew faster than urban municipalities total revenues. However, a closer review of the data reveals that rural municipalities' better performance in total revenue mobilization was largely the result of increasing grants and transfers from the central government. In addition to a higher share of own-source revenues, urban municipalities also generate a higher percentage of own-source revenues from taxes, fees and charges. More surprisingly, capital revenues are significantly higher in rural areas. However, this may suggest underused revenue enhancement potential from taxes, fees and charges in rural municipalities and might also be a reflection of recent asset sales: starting in 2009, Macedonian municipalities gained control over land transactions which resulted in numerous asset sales and an

increase in own-source revenues. It is possible that capital sales in rural areas have a higher effect on their total revenues when compared to urban areas.

Rural municipalities tend to have higher per capita expenditure than urban municipalities—particularly in the functional categories of environmental

Figure 4: Variations on per capita expenditures in General Public Services within municipality ranges – Kosovo

protection, education, health and general public services. Housing is the only expenditure item in which urban municipalities spend more per capita compared to rural municipalities. This might be explained by larger economies of scale in urban municipalities. However, although urban areas concentrate a larger share of total capital expenditure, per capita capital expenditures are slightly larger in Macedonia's rural municipalities.

Urban density partly explains disparities among local governments' expenditures in the SEE Region. Density is relevant for the unitary cost of provision of selected municipal services, such as water supply and sanitation, solid waste management, and public transport, among others. Based on the MFR analysis, density effects can be observed predominantly on environmental protection expenditure. In the case of Croatia and Macedonia, density correlates with a significant reduction in per capita expenditures for environment protection. These results provide evidence to support the assumption that denser municipalities tend to have lower per capita cost for environmental protection expenditures.

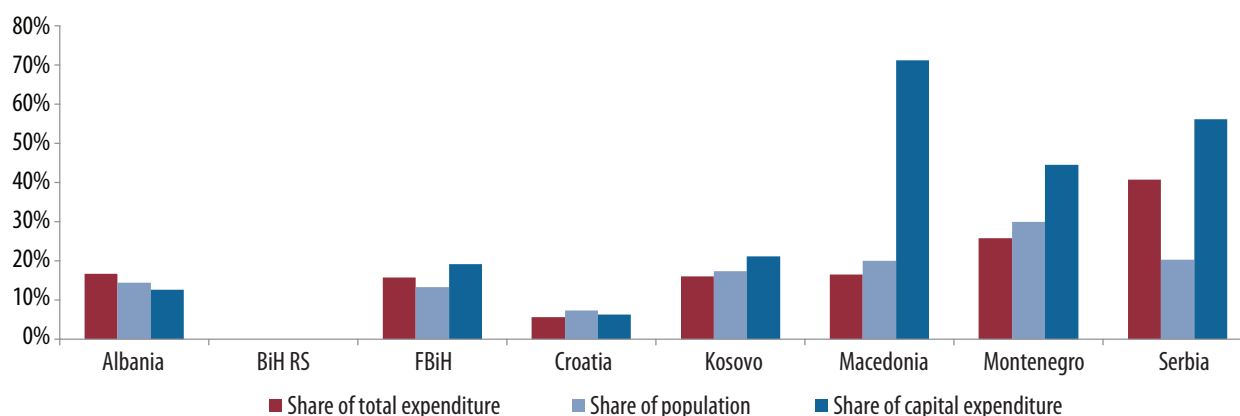
5. CONCENTRATION IN CAPITAL INVESTMENT EXPENDITURE AND THE ROLE OF CAPITAL CITIES

Generally, the scope of local capital expenditures varies with the level of economic development. Capital expenditures constitute a major part of local expenditure in the SEE region. Municipalities spend more than 25% of their available funds on capital investments, with the exception of Croatia (17%). Overall, local capital expenditures per capita vary between EUR48 in Albania and EUR459 in Croatia, or 2.2% and 6.8% percent of GDP. Overall, variations in local capital expenditure levels are in line with the differences in economic development. However, Kosovo is a noteworthy exception: per capita local capital expenditure is above the average at 8.4% percent. Functional assignments and funding mechanisms have a large influence. Local governments in more decentralized countries spend more on capital expenditures than their peers in less decentralized countries.

Capital expenditures are concentrated in cities and larger municipalities. Although no major conclusions can be made from capital expenditure data limited to a one year period and should be interpreted carefully, some observations can be noted. Overall, capital cities and other urban centers dominate capital spending across the SEE region, particularly in Serbia (Belgrade: 68%), Macedonia (Skopje: 59%) and Montenegro (Podgorica: 45%). In Albania, BiH and Croatia, mid-size municipalities account for the highest share of total capital expenditure. This concentration is the result of the large number of smaller and medium size municipalities in these countries. However, despite the similar share of total capital expenditure in these countries, the share of capital expenditure to total local expenditure varies significantly: from only 17% in Croatia to over 33% in Albania.

However, there are large variations between total and per capita capital expenditures. In Albania, for example, the biggest share of total capital expenditures is concentrated in municipalities with 10,000–40,000 inhabitants. However, the largest mean capital expenditure can be found in municipalities ranging with more than 200,000 inhabitants (Durrës and Tirana). The per capita capital expenditures analysis reveals a more or less homogenous national scenario, although Durrës and Tirana—the two biggest cities in Albania—have the highest per capita capital expenditure.

Overall, capital cities dominate total sub-national expenditures. Spatial concentration of local expenditures in the capital cities is especially prevalent Albania (Tirana), Bosnia and Herzegovina (Sarajevo) and Serbia (Belgrade), where the share of local expenditures significantly exceeds the population share living in the capital. In addition, in all of the SEE countries, except Albania and Croatia, there is a disproportionate concentration of capital expenditures in capital cities (see Figure 5). Macedonia and Serbia are exceptional cases even among countries with the highest concentration. In Belgrade, local spending is more than two times higher than the share of local residents: 44.6% of overall local government budget is spent in the capital city, while only 20% of the population lives in Belgrade. Skopje, in Macedonia, concentrates more than 70% of total capital expenditure in the country. The concentration

Figure 5: Concentration of expenditures and population in the capital city

of expenditures in capital cities might be partly explained by the fact that most of these cities are assigned additional responsibilities for public service delivery.

At the same time, capitals benefit from larger property tax revenues. Across the SEE region, capital cities collect the lion share of property related revenues, including property taxes and fees, and communal charges levied on the property of businesses or residents. Overall, the concentration of property related revenues in the capital city exceeds both the share of population and the budget. They benefit from the disproportionate concentration of the tax base, but also typically higher property values.

6. KEY TRENDS, DISPARITIES AND INEQUALITY ACROSS WESTERN BALKANS' MUNICIPALITIES

Local governments in SEE felt the downturn at different points in time. The 2008 economic and financial crisis had a strong influence on public finances since 2008 and continues affecting fiscal policies in the SEE region and beyond. From the MFR data, covering 2008–2011, it is not possible to differentiate the effects of the crisis from general structural trends. However, an analysis of the trends over this period suggest that some local governments might

have been hit earlier by the fiscal restrictions and contracting economic outputs. Already in 2009, local expenditures dropped significantly in Montenegro (–18%) and in the Republika Srpska (–8.6%); and decreased slightly in Serbia (–3.7%) compared to the previous year. In comparison, the crisis was delayed and less drastic in, e.g., Kosovo and Macedonia, but also Albania and Croatia. Particularly in Kosovo and Macedonia, local government expenditures continued to increase in real terms throughout this period, albeit with a slower pace. In Albania, local expenditures were still growing in 2009; and in Croatia, local expenditures did not decline—possibly due to the national elections in 2010 and increased EU funding that was made available to local authorities. However, cutbacks were more serious later in 2010 (–9.8%). These trends are also reflected by the changes in local expenditures as share of in GDP.

Large cities didn't necessarily do better than their smaller peers during 2008–2011. For example, Prishtina (Kosovo) and Tirana (Albania) seem to have been hit harder by the crisis than other local governments in their countries, while Zagreb (Croatia), Podgorica (Montenegro) and Belgrade (Serbia) appear to have done better during the first year of the crisis. Partly, this can be explained by the local revenue structure: Croatia and Serbia rely on shared revenues which automatically delayed the decline in resources. In Montenegro, however,

coastal municipalities, which dominate total local expenditures, had a more sudden fall in property related tax revenues and tried to compensate the revenue decrease with asset sales. Poorer municipalities, on the other hand, were forced to increase borrowing. Macedonian municipalities were able to maintain their own sources revenues by following different policies in the urban and the rural municipalities. The immediate reaction of the rural municipalities was to increase local fees. They also started to borrow from a very low base. The urban municipalities and Skopje had the option to sell their assets. They also increased the revenues from loans.

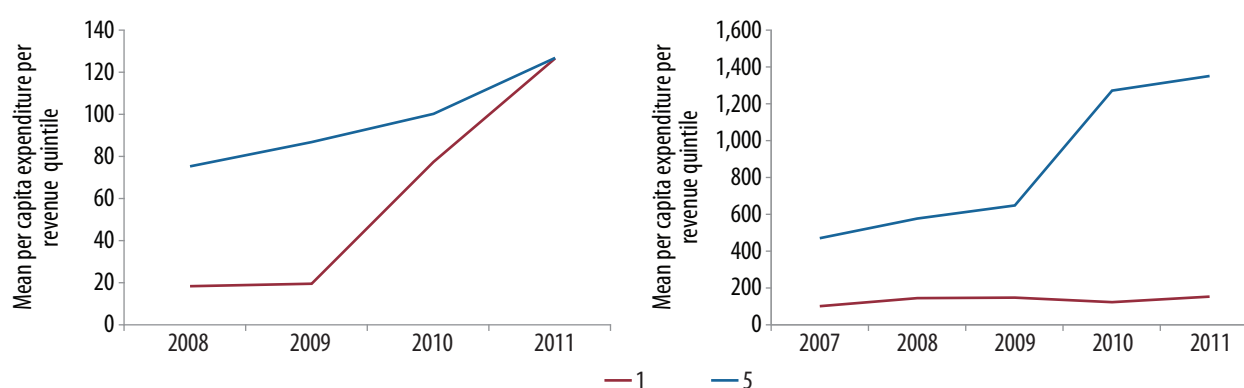
Local revenues in Albania and Kosovo were stabilized by transfers and grants. In Kosovo, local government revenues recovered relatively soon after their fall in 2010. Prishtina seem to have been hit most by the economic downturn, causing a sharp fall in own source revenues, while local governments in the rest of the country were able to keep previous levels of own source revenues. But local government budgets in Kosovo are mostly financed by grants, which were stabilized at a lower level of growth, but still continued to increase in 2010–2011. Albanian sub-national governments faced restrictions with some delay since unconditional transfers remained stable in 2009 and later, the cuts were spread equally among the different types of local governments.

Poorer municipalities could not consistently catch-up with their richer peers. Per capita expenditure trends reveal increased disparities between rich and poor municipalities in some countries, and convergence in others. In Kosovo, poorest municipalities have achieved to close the gap to richer municipalities in their per capita expenditures. In Macedonia, on the other hand, poorer municipalities have not achieved to close the gap. Here, per capita expenditure increased overall in parallel in the richest and poorest municipalities, although with a slightly diverging trend. Worryingly, the spending difference between poor and rich municipalities grew considerably in Montenegro (see Figure 6). In Croatia, disparities were maintained during 2008 and 2011, and Albania experienced a slight increase in the gap between the poorest and the richest after 2010.

Spending patterns differ remarkably in municipalities with high and low per capita expenditure. In Kosovo, while there is convergence in per capita expenditures, poor and rich municipalities have very different spending priorities. Poor municipalities increased considerably their expenditures on health and general public services while, during the same period, rich municipalities increased their expenditures on environmental protection and housing.

Per capita own-source revenue inequality increases in Albania, Kosovo, Montenegro, and the RS. Findings suggest a visible growth of per capita

Figure 6: Per-capita expenditure trends in poorest (1st Quintile) and richest (5th Quintile) municipalities for Kosovo (left) and Montenegro (right) (reference year: 2008)



own-source revenue inequality during the period of analysis, measured by the *Gini* coefficient methodology. In Croatia and Macedonia, results suggest a slight reduction in per capita own-source revenue inequalities during 2008 and 2011. Total per capita revenue inequalities grew in RS, Kosovo and Montenegro, but were reduced in Albania, Croatia and Macedonia. However, for all years and countries, except for the RS in 2009, the level of per capita revenue inequality is greater when computing own source revenues as opposed to general revenues, suggesting that equalization grants are working.

Overall, the general grant transfers seem to meet equalization objectives across the SEE region. Generally, local governments with the highest amount of per capita transfer received 1.5–3.8 more than the average in the respective group of cities or municipalities in the majority of SEE countries. In addition, the level of grant per capita is decreasing by size of municipalities, reflecting the efforts to compensate for low fiscal capacity / higher expenditure needs in the smaller, often rural municipalities, which may not be in a position to afford service delivery without raising tax efforts excessively.

Per Capita Expenditure, own sources, and grant transfers by size of municipalities vary significantly across countries. In Albania and Kosovo, the per capita grant is by all measures the dominant fund source in smaller municipalities, while in Montenegro and Macedonia own fiscal efforts per capita are more important, although not equal to grants. Expenditure variations and levels, i.e., expenditure needs, by size of municipalities vary across the countries. In Kosovo, the per capita expenditure is *decreasing* by size of municipalities, implying that per capita spending in the largest municipalities amount to less than 50% of per capita spending in the smallest municipalities. In Albania and Macedonia, on the other hand, while per capita expenditure do not differ significantly across the various sizes of municipalities in these two countries, a minor *increase* by size is observed in Albania, with expenditure of +20% in the largest municipalities. Finally, in Croatia, a somewhat similar pattern to Albania is observed, although the expenditure is much higher in the larger municipalities than in smaller.

7. MUNICIPAL FINANCE DATA COLLECTION AND ANALYSIS IN SEE: DIRECTIONS FOR A POSSIBLE WAY FORWARD

This report has demonstrated the increasing relative weight and role of sub-national governments in the SEE region. Greater fiscal authority and responsibilities drive a need for improved planning, budgeting and financial management—both at the local and central level. Reliable and high quality municipal finance data is critical to better understand and improve local government management and finance in the SEE Region. In this context, this report has aimed to address identified capacity issues by the creation of a regional dataset for disaggregated municipal finance analysis with the goal to contribute to improving the quality and consistency of key municipal finance data for improved evidence based policy making. Although limited in scope and expandable in depth, MFR has piloted disaggregated data collection and analysis for in-country analyses and regional comparison in SEE.

MFR has established a regional municipal finance database available for further analysis—with the support from regional and local experts and the Local Government Associations in the participating entities. However, the potential use and application of disaggregated data go beyond the initial analysis possible within the scope and limitations of the MFR. For example, compared to aggregated national datasets, disaggregated sub-national finance data allows for benchmarking across municipalities. Municipal current and capital expenditures analyzed together with service performance indicators and statistics may provide opportunities for comparing facility unit costs, but also to reviewing variations in service delivery outcomes against different expenditure needs; spending- and revenue trends.

Going forward, a number of questions for follow-up actions may be considered. These include, among others: How to sustain regional and country-specific datasets and analytical capacity within SEE countries for continued analysis, including outreach to national authorities on data and analysis? How

to establish further capacity of local associations in each country to maintain, expand and update the database? How would a regional database be maintained, and by whom? How to broaden the concept of a database and analytical review and include other countries in the ECA region? A number of issues would need to be addressed to respond to these questions with the goal to (i) make municipal finance data collection regular; and (ii) develop a user friendly system of information management.

The model templates and analysis piloted under MFR can be used for further scaling-up. In all countries in the SEE region, disaggregated financial reports on local government expenditures and revenues are available at the Ministry of Finance or at the Treasury. The only exception is the Federation of BiH, where the local government association with the support from the MFR has launched a survey to collect municipal fiscal data. The survey format was similar to the financial reports used by local governments. The approach for data collection and clean-up applied under MFR can be replicated in the future.

Public access to data may contribute to enhanced transparency. Disaggregated municipal finance data can be used for various purposes. Among others, the goal of municipal finance data and analysis is to inform local government officials, investors, media, civil society organizations and the general public about the financial position and

overall performance of a municipality. This requires public access to selected information, or to indicators, depending on the level of available municipal finance data. Publicly accessible databases can also offer search options, such as aggregation by regions, comparison of local governments, or the averages for the a subset of municipalities (e.g. similar size, administrative status).

However, data management capacity needs to be strengthened. Generally, local government associations are not prepared for the complex task of managing municipal finance data and present the generated information in an accessible and user-friendly format. In the past, LGAs have not had a business model for developing and operating municipal finance data and typically relied on donor support. For example, the LGAs in Albania, Montenegro, and the Federation of BiH have expressed their interest in leveraging donor financial assistance for regular municipal finance data management. At the regional level, if demonstrated demand exists, NALAS would be a natural host for a regional municipal finance database. However, related costs of data collection and maintenance need to be planned and budgeted upfront to ensure sustainability. Since local government associations in the target countries are in different positions with regard to their mandates, organizational, and staff capacities, business models for long term sustainability necessarily will have to be different.

1.1 BACKGROUND

Local governments in South-East Europe (SEE) have a history of assigned responsibilities for delivering municipal infrastructure and services, while national governments provided financing and approved local investment projects. More recently, decentralization has given municipalities increased autonomy and shifted more responsibilities for service delivery and resource management to local governments. Fiscal transfers continued to constitute the larger portion of local government revenues. However, with the fiscal and financial crisis, these resources never commensurate with the rising needs. At the same time, an ever growing share of public investment decisions is made by local authorities. Their relative weight in public spending has been increasing constantly over the last decade. Municipalities, and the public utilities reporting to them, manage large and important infrastructure assets and need to secure financing for operation, maintenance, and capital renewal. In parallel, sub-sovereign borrowing restrictions have been eased widely throughout the region to provide additional financing means to local governments. A growing number of municipalities aim at improving creditworthiness and municipal financial management performance to gain access to commercial funding sources.

Against this background, the way municipalities raise, allocate, and manage their financial resources becomes increasingly important. Greater fiscal authority and responsibilities fuel the need for improved budgeting and planning—both at the local and central level. Reliable municipal finance data is critical for fiscal forecasting, good financial management, and to assist evidence-based planning and policy making. Furthermore, commercial lenders will assess municipal creditworthiness based on the available financial data.

Typically, in SEE countries, key municipal finance functions include revenue and expenditure management, cash and debt management, local budgeting, and accounting, but increasingly, municipal asset management and capital investment planning. However, despite those

important functions, the knowledge of municipal finance issues in SEE is limited. Data is usually not publicly accessible, or only to a limited degree, and data coverage and quality varies greatly among, and within, countries. Recent surveys conducted on behalf of the Network of Associations of Local Authorities in South-East Europe (NALAS) suggested that expenditure data is available only at very different levels of specification, even at the national, aggregate level. On the other hand, revenue data, in particular own source revenues, are usually reported in great detail, although classification differs significantly and the information on shared revenues and intergovernmental transfers is limited.¹ Given the tight sub-sovereign borrowing controls, information on municipal debt is generally good. Usually, local government fiscal data are collected by the Ministry of Finance (MoF) and/ or the Treasury, who control access to the disaggregated data. In some countries, alternative sources of municipal data exist, often generated with support from donors and/or collected through the Local Government Association (LGA). In general, however, while information is available in individual municipalities and at the national level, there is a lack of fiscal data across municipalities.

As a result, municipal budgeting and fiscal management practices often remain based on judgment. Central government capital and current grant allocations often lack the datasets required to establish consistent and formula-based models. Regional comparisons and benchmarking are mostly absent, both within and across countries in the region. Although the majority of municipalities usually prepare some type of revenue and expenditure forecasting, not all attempt to make systematic longer-term projections, partly due to the lack of empirical information, since municipal finance time-series are not regularly available, let alone reliable data for more sophisticated analytical approaches.

One of the key issues identified by national and municipal stakeholders consulted during scoping missions in preparation of the World Bank-Austria

Urban Partnership Program (UPP) in December 2010 was the weak financial management performance and low fiscal capacity of municipalities. Local authorities perceive municipal financial management predominantly as centrally imposed planning, reporting and control systems, rather than as a management and policy making tool. Mayors and municipal councilors have little incentives to demand better municipal financial performance, since comparative data is rarely available, or made accessible, and the link between improved financial performance, higher service level outcomes, and better access to market-based capital investment funding remains blurred. Although LGAs acknowledge the need for better municipal finance data to strengthen their position in inter-governmental negotiations, most lack comprehensive data collection mechanisms or have limited access to already available information.

1.2 OBJECTIVE AND METHODOLOGY

Against this background, the objective of the analytical work under the SEE Municipal Finance Review aims to (i) contribute to improved understanding of local government management and finance in the SEE Region; and (ii) contribute to improving the quality and consistency of key municipal finance data for improved evidence based policy making. In the short-term, the report would inform government authorities in the decision making process through the provision of empirical data for evidence-based policy making. In the medium-to-long term, access to municipal finance information would contribute to increasing transparency and accountability of local governments, improving revenue collection and expenditure performance, optimizing budget allocation procedures, and strengthen local authorities' role and position in intergovernmental fiscal considerations and negotiations in the SEE countries.

In particular, data collection designed and implemented under the MFR has the goal of leveraging the added value of disaggregated municipal finance data. Generally, to date, municipal finance analysis in the SEE region has been limited to aggregated, national

¹ NALAS (2012), Report of Fiscal Decentralization Indicators for South-East Europe 2006–2011.

datasets.² In this report, municipal data are established in two steps: First, municipal finance data sets are being generated ‘bottom-up’ by involving Local Government Associations and local MFR experts in each country. A standardized framework on quantitative and qualitative dimensions of municipal finance was developed, to ensure quality and comparisons of data collected in each country. The framework unbundles finance data to a larger extent than what is normally available in national datasets, with expenditures and revenues distributed by type and size of cities and other municipalities, and by establishing additional measures on categories of revenues and borrowing. Second, these disaggregated expenditure and revenue data are then linked to socio-economic data sources, i.e, population, urban/rural classifications, area, GDP, and national expenditure, revenue, debt, and capital investments. The comprehensive combined datasets provide the platform for detailed analytical work, as well as support to local governments and LGAs in achieving an in-depth understanding of drivers and composition of municipal finance, which in turn may lead to improved fiscal performance. The datasets also allow for regional comparison among the SEE countries participating in the MFR. Where data in time series is available, this report will also identify the impact of the economic downturn in the period of 2008–2011 and assess the fiscal responses developed in the region.

The analysis presented in this report comprises the first attempt to review and analyze a regional set of disaggregated sub-national finance data, including from municipalities, cities, counties and other intermediary government-levels from various countries. This analysis does not aim to be complete and fully comprehensive, but to present options for using disaggregated datasets for in-country and cross-country comparison. Different reporting standards and practices across the region required reclassification and re-coding of data during the process of data cleaning. For the data analysis, all values were adjusted for inflation and correspond to 2008 prices. Wherever different interpretations would be

possible, this report explains the selected approach and underlying rationale. Detailed methodological guidance was provided to the LGAs and summarized in the country-specific reports. A summary overview with further details and explanation on the data collection approach is attached in Annex 3.

National governments, during fiscal planning, usually assess local governments as one, compact unit of general government finances. In some cases, policy makers assess impacts of regulatory changes based on simulations by different types of municipalities or geographic regions. However, usually the results are not shared with a broader group of stakeholders who contribute to the policy dialogue on local government finance. MFR has developed an approach to establish disaggregated municipal finance datasets and equip stakeholders with reliable fiscal information to contribute to this policy dialogue. In particular, the tools and findings of MFR would be deemed to help strengthening LGAs planning capacity and better position them in the emerging policy dialogue on local government finance—both at the country-specific and regional level.

Main findings of the MFR are presented in this report. Following this introductory chapter, Chapter 2 will provide an overview of the decentralization framework in the SEE Region, including on the administrative and political structure of sub-national governments, their population size and distribution, and the service functions assigned to local governments. Chapter 3 explains in more detail the local government finance framework. This includes an overview of the structure and composition of sub-national finances, in particular (i) revenue and expenditure assignments; (ii) transfers and inter-governmental fiscal relations; and (iii) the evolving framework and realities of sub-national borrowing and debt. Chapter 4 provides a summary of the key trends and findings from the cross-country, regional analysis, complemented by detailed analysis of the disaggregated datasets, where available. Finally, Chapter 5 summarizes conclusions and provides some recommendations for a possible way forward.

² NALAS 2012

Overview: Decentralization in the Western Balkans

2.1 ADMINISTRATIVE STRUCTURE AND FUNCTIONS OF SUB-NATIONAL GOVERNMENTS

South Eastern European countries have reached the second stage of development in establishing local governments. After more than a decade-long decentralization reforms and based on the local self-government traditions in the region, the overall institutional framework has been put in place and stabilized in all seven countries. However, despite the common history and overall perspective of European Union (EU) accession shared by many countries in the SEE region, the specific institutional framework and administrative structure differs significantly. The following summary provides a brief overview of the main features in each of the seven countries.

SEE countries have different sub-national government structures and service responsibilities. However, in general, the region is characterized by a single tier local government system with relatively large size municipalities. Most of the SEE countries, i.e., Serbia, Kosovo, Macedonia, and Montenegro, inherited large political/ administrative entities which were kept, or partially restored, e.g. in Macedonia. In those countries, municipalities as the lowest level of sub-national government represent the core functional units. Only Albania, Bosnia and Herzegovina (BiH), and Croatia have two and three tier sub-national governments: counties, communes and municipalities in Albania; entities, cantons and municipalities in Bosnia and Herzegovina; and counties, county centers, large cities and municipalities in Croatia.

Generally, municipalities provide core utility services such as water supply, sanitation, solid waste management, local roads, and basic social services. Health and education services are usually provided at a higher government level. However, the level of decentralization and functional assignments differ between and within the two groups of one and multi-tier sub-national government systems. Serbia, and Montenegro, and Republika Srpska (RS) in BiH have a more centralized system in which the central government is responsible for provision

of health, education, and social welfare. In Kosovo and Macedonia, municipalities are allocated broader roles in primary and secondary education, and primary health care.³

The two and three tiered sub national government systems in the SEE region also feature different levels of decentralization. In Albania, the central government plays an important role in the field of education and health, but quarks have intermediary roles between central and local governments, such as social assistance and environmental protection. In the Federation of BiH, *cantons*, as regional governments, have wider responsibilities in the field of education and social welfare. In Croatia, *counties*⁴ fulfill a comparable function at the regional, intermediary level, and at the same time represent units of self-government. Croatian county centers and large cities are subject to specific functional assignments and also provide education, healthcare, physical planning, and local development planning. Key functional assignments per country are summarized in the overview Table 1. A brief summary per country follows below.

Albania. Albania's two-tier organizational structure comprises 12 counties (*quarks*), 65 municipalities, and 308 communes. Functional assignments are stipulated in the Law on Organization and Functioning of Local Government, enacted in 2000. However, the Law assigns only generic responsibilities to sub-national governments within the framework of exclusive, shared, and delegated functions. Exclusive functions enable sub-national governments exercising full administrative, service and regulatory authority; shared functions are assigned to both sub-national and central government units; and delegated functions define actions subject to authorization of the central government. Generally, municipalities and communes are responsible for core functions such as infrastructure and public services, cultural and recreational functions, local economic development and civil security. Quarks have

been organized as coordinating bodies with very little exclusive responsibilities for preparing regional policies and implementing them in harmonization with national policies such as regional and urban planning, regional transportation services and environmental protection. Education, including curricula development and staffing, and health care services are essentially provided by the central government. Although the organic law on local government has established a sound foundation for the assignment of expenditure responsibilities, the initiative for further specifying responsibilities has essentially been left to the decisions of line ministries which, in many cases, has caused unclear assignments in areas such as urban planning, environmental protection, education and health, and social assistance.

Bosnia and Herzegovina. BiH consists of the State Institutions, two entities, the Federation of Bosnia and Herzegovina (FBiH), and Republika Srpska; and the Brcko District. The Brcko District is a neutral, self-governing administrative unit, under the sovereignty of BiH, formally part of both entities. The structure of local self-government is governed separately by both entities and differs significantly. The Federation of BiH has a two tier sub national government structure comprised of (i) cantons; and (ii) cities and municipalities. There are 10 cantons, 78 municipalities, and 3 cities in the FBiH. The ten highly autonomous cantons have full-fledged legislative and executive structures; the canton heads are elected by a majority of the cantonal Assembly from candidates nominated by elected legislators. The main organizational units of cantons are ministries. Each canton has its own legislation, regulation, decrees, administrative decisions that might affect the municipal level. Municipalities with more than 30,000 inhabitants can establish city status to amalgamate and coordinate policies among urban municipalities. Main responsibilities of municipalities and cities include the core functions such as local roads, water, sanitation, and solid waste management. There have been cases with unclear division of competence between cantons and cities or municipalities, in particular in the Sarajevo Canton. Overlaps in functional assignments between cantons and municipalities are not uncommon, such as the responsibilities for local infrastructure maintenance and social welfare. Similarly, assignments differ

³ In Kosovo, municipalities with a significant Serbian population have enhanced functions, such as secondary health care and education.

⁴ The county government has a dual role and represents both a unit of regional and local self-government: it is a local unit of public administration and a directly elected sub-national government. Since 2001, members of the county councils are directly elected.

among cantons. Some cantons, but not all, have taken on the responsibility of preschool and primary school maintenance and capital investments. The RS has a one tier local government structure, comprised of 61 municipalities and 2 cities. Municipalities are responsible for basic municipal service provision, often with the assistance from the entity government. The entity government is also responsible for education and health services.

Croatia. Croatia has a two-tier sub national government structure consisting of counties representing the regional government and municipalities and cities representing the local level of self-government. In addition, large cities with more than 35,000 inhabitants are considered part of the municipalities and cities. There are 126 cities, 429 municipalities and 20 counties. In 2001, Croatia launched a partial decentralization, 32 large cities and all of 20 counties have been assigned additional responsibilities. The county carries out matters of regional significance, particularly matters related to: education, health care, physical and town planning, economic development, traffic and the transportation infrastructure. A county is at the same time a unit of deconcentrated local administration and of local self-government. This dual role affects the work of the counties' bodies, which also have a certain dualism. Cities and municipalities in their self-governing area of competence carry out matters of local importance through which the needs of citizens are met directly and which are not by the Constitution or law assigned to bodies of central government such as community and housing planning, physical planning and zoning utility services, child-care, social welfare and primary health care.

Kosovo. Kosovo has a one tier government structure, comprised of 38 municipalities. According to the Law on Municipalities enacted in 2008, only the capital city Pristina, shall be regulated by a separate Law due its population size and importance as capital city. Municipalities are the basic unit of local self-government. The organs of a municipality are the Municipal Assembly and the Mayor which shall have the right to enact acts and take any implementation measure within their areas of competence and shall be elected for a term of four years. Municipalities shall exercise own, delegated

and enhanced competencies in accordance with the Law on Municipalities. Municipalities shall have full and exclusive powers, as they concern the local interest under the own competencies. Central governments shall delegate responsibilities when it is necessary. Certain municipalities shall have their own competencies providing for equal access to public services in the areas of health (Mitrovicë, Graçanicë, Štrpce) and education (Mitrovicë); and shall have participatory right in selecting local station police commanders.⁵

Macedonia. Macedonia is comprised of 84 municipalities and the City of Skopje, which consists of 10 municipalities.⁶ Macedonian municipalities are responsible for a wide range of services with functional assignments⁷ as per the law on local self-government from 2002. Macedonia signed the European charter for local government in 1996 and ratified it in 1997. In 1998, the Ministry of Local Government (MoLG) was established. The process of decentralization was further supported by two important documents adopted in 1999, namely the Government program and the Government strategy for reforming the public administration. As a result of these two initiatives, a working team within the MoLG was established in March 1999, to start the process of decentralization. The Ohrid framework agreement in 2001 ended the ethnic clashes and gave new momentum to the decentralization initiatives of 1999. In 2005, the government adopted a detailed plan for the transfer of competences and

⁵ http://www.assembly-kosova.org/common/docs/ligjet/2008_03-L040_en.pdf

⁶ The 10 municipalities comprising the City of Skopje are: Aerodrom, Butel, Čair, Centar, Gazi Baba, Gjorče Petrov, Karpoš, Kisela Voda, Saraj, and Šuto Orizari.

⁷ A wide range of responsibilities are listed in the provisions of article 22 of this law which include: urban planning and space arrangement; environmental and nature protection; local economic development; communal services; cultural development, in accordance with the national program for culture; sports and recreation; social care and child protection; foundation of education, financing and managing of primary and secondary schools in cooperation with the central government; organization of transport and food supplements for students and student housing; health care, managing the system of public health organizations and primary health care; undertaking measures for the protection and rescue of citizens and material goods in the case of destruction in war, natural disasters and other accidents; fire protection that is provided by the local fire departments; and supervision over activities regarding the municipality's responsibilities and other matters determined by law.

resources to local authorities. The process of fiscal decentralization is envisaged by the law on financing local government from 2004 to evolve in two phases. The first phase started on in July 2005 with the introduction of earmarked grants. In the second phase, block transfers were launched. The major principle of this phased approach was to project a gradual devolution of responsibilities proportional to the demonstration of greater capacity by local governments to undertake those responsibilities, and to provide an equitable and adequate transfer of funds for an efficient and ongoing execution of transferred competencies.

Montenegro. Montenegro has one tier structure comprised only of municipalities. There are 21 municipalities and their roles are defined in the Law on Local Self Government which could be characterized as positioned between having only core functions and extended local autonomy. Main public functions related to health, education and social welfare are centralized and therefore, financed by the central government budget. Municipalities are assigned with core functions and certain extended functions, excluding the provision of power, local police, basic health services, and construction and maintenance of school buildings and hospitals. Although the payment system is supported by well-functioning Treasury Single Account, almost fifty percent of the municipalities do not keep records and do not report on budget execution according to functional classification, which forms the requirement for a capacity building in order to keep consistent records.

Serbia. Serbia has a one tier government structure comprised of 122 municipalities and 23 cities, plus the Autonomous Province of Vojvodina. Cities are municipalities with a population above 70,000. Executive power of municipalities and cities is held by the council, while the legislative power is held by the assembly. Cities and municipalities are regulated in the same way with close to similar functions. Municipalities and cities exercise original and delegated functions. They have complete autonomy in exercising original functions, such as local utilities, urban planning and environmental protection. Delegated functions fall within the

central and provincial scope and can be delegated to municipalities and cities for the purpose of efficient execution, including voter records and inspectorial supervisions. Historically, sub-national governments in Serbia have less responsibilities for education, health care and social welfare. However their role in the delivery of social services has been increasing over the last couple of years.

2.2 SIZE AND STRUCTURE OF MUNICIPALITIES

Municipalities in the SEE region are very diverse.

They vary significantly in size, income, and density, among others. Differences among sub-national governments arise, among others, from variations in delineations and the structure of the sub-national government system. The following analysis presents variations of sub-national governments within and across the SEE Region by reviewing their size and density. A classification of municipalities by urban and rural is only available in Macedonia, so specific trends in those two categories will be reviewed in more detail in Chapter 4. The analysis in this section focuses on the lowest level of sub-national governments, i.e., municipalities, towns, and cities, to allow for comparison across the region. Intermediate government tiers, such as *cantons* in the FBiH or *quarks* in Albania, are not considered in the following review.

The distribution of municipalities by population size varies considerably in SEE countries. The average population size of local government units in one tier sub-national government systems ranges between around 23,000 inhabitants in the RS in BiH to close to 59,000 in Kosovo (see Table 2). Here, the share of really small municipalities which are below the European population average of 5,000 is not higher than 30% of the total local government units. On the other hand, countries with two-tier sub-national governments like Albania and Croatia have a considerable amount of municipalities with a population below 5,000 inhabitants. In Croatia, this group of fairly small sub-national governments account for the large majority of all municipalities (71.7%); and in Albania, close to half of the total (44.2%).

TABLE 1: OVERVIEW OF SUB-NATIONAL GOVERNMENT FUNCTIONAL ASSIGNMENTS IN SOUTH-EAST EUROPE

Level of sub-national government (tier)	Assigned function	Comment
Albania		
Counties (<i>Quarks</i>)	<ul style="list-style-type: none">• Social Assistance• Environmental Protection• Education and health (shared)	Central government responsible for curricula and hiring staff in education and health.
Municipalities and communes	<ul style="list-style-type: none">• Urban Planning• Social Housing• Legalization• Urbanization• Water Supply and sanitation• Maintenance and construction• Solid Waste Management• Road Infra structure• Social Care• Veterinary Services• Local Economic Development• Public Transportation	
Bosnia and Herzegovina		
Federation of Bosnia and Herzegovina		
Cantons	<ul style="list-style-type: none">• Pre-school• Primary Education• Social Welfare	Functional assignments and shared functions differ across cantons. All cantons are responsible for wages and salaries of teachers; municipalities usually cover operation and maintenance cost; but some cantons maintain full responsibility for pre-school and primary education (including operation, maintenance, and capital expenditure).
Municipalities	<ul style="list-style-type: none">• Water supply and sanitation• Solid waste management• Local Roads and Public Transportation• District Heating• Pre School• Primary Education• Basic health (ambulance services)• Birth and death certificates• Building permits and cadastre• Business Licensing• Culture, Sport and Leisure• Communal Inspections• Social Welfare• Housing	
Republika Srpska		
Municipalities	<ul style="list-style-type: none">• General public services• Defense• Public order and safety• Economic affairs• Protecting the environment• Health care• Recreation, culture and religion• Education• Social protection	There is a one tier structure in the RS. The government structure is very centralized. Although many functions are ensured under the responsibilities of cities and municipalities, impact and the broadness of these functions are limited.

(continued on next page)

TABLE 1: OVERVIEW OF SUB-NATIONAL GOVERNMENT FUNCTIONAL ASSIGNMENTS IN SOUTH-EAST EUROPE *(continued)*

Level of sub-national government (tier)	Assigned function	Comment
Croatia		
Counties	<ul style="list-style-type: none">• Education• Health care• Physical planning and zoning• Economic development• Traffic and transport infrastructure• Planning and development of the network of educational, medical, social and cultural institutions• Issuing of building and location permits and other document in relation to construction in the county area excluding the area of the big city	There is a two tier structure in Croatia: Cities -Municipalities and Counties. Municipalities and cities represent the local level of self-government and counties represent the regional level of self-government. In order to facilitate the service, some functions are given under the responsibilities of large cities (cities with more than 35,000 inhabitants) and county centers different than cities and municipalities such as delivery roads maintenance and issuing bond and location permits Counties in their self-governing scope of authority are responsible for the functions of regional character. Financially strong local governments, 32 large cities and 20 counties, have been assigned additional responsibilities to provide some of public functions locally such as road maintenance and issuing building and location permits.
Large cities and county centers	<ul style="list-style-type: none">• Cities and Municipality functions +• Public roads maintenance• Issuing of building and location permits	
Municipalities	<ul style="list-style-type: none">• Community and housing planning• Physical planning and zoning• Utility services• Child-care• Social welfare• Primary health care• Primary school education• Culture, physical culture, and sports• Consumer protection• Protection and improvement of the• Natural environment• Fire protection and civil defense• Local transport	
Kosovo		
Municipalities	<ul style="list-style-type: none">• Social protection• General Public Services• Protection Order and Public Safety• Economic Relations• Protecting the Environment• Housing and Community• Health• Public Education• Recreation, Culture• Religion Education	There is a one tier structure in Kosovo. Municipalities shall exercise own, delegated and enhanced competencies in accordance with the Law on Municipalities acted in 2008. Some municipalities have enhanced competencies in Secondary Health Care, University Education, Area of Culture and Local Police Station Commanders. Local governments with a large Serbian population have enhanced functions, such as secondary health care, education, culture, local police, etc.
Macedonia		
Municipalities	<ul style="list-style-type: none">• Health Improvement• Environment Protection• Education• Social Protection• Development Programs• Sport• Culture• Communal Activities• LED• Urban Planning• Administration	There is a one tier structure in Macedonia. Only City of Skopje, territorial organization, comprises 10 municipalities and operates under different law.

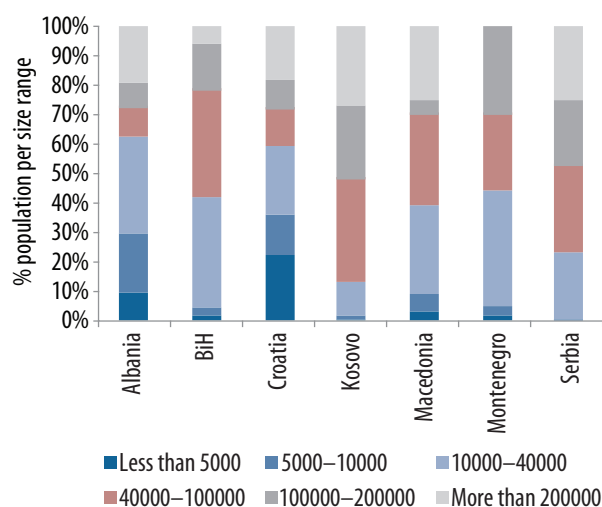
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TABLE 1: OVERVIEW OF SUB-NATIONAL GOVERNMENT FUNCTIONAL ASSIGNMENTS IN SOUTH-EAST EUROPE (*continued*)

Level of sub-national government (tier)	Assigned function	Comment
Montenegro		
Municipalities	<ul style="list-style-type: none"> • General Public Services • Public Order and Safety • Economic affairs • Environment Protection • Housing and community affairs • Sports Culture and Religion • Education • Social Protection 	There is a one tier structure in Montenegro. Municipalities are assigned with core functions and certain extended functions, excluding the provision of power, local police, basic health services, and construction and maintenance of school buildings and hospitals.
Serbia		
Municipalities	<ul style="list-style-type: none"> • Housing and community Development • General Public Services • Economic Activities • Education • Social Protection • Sport and Culture • Environmental • Public order and safety 	There is a one tier structure in Serbia, plus the Autonomous Province of Vojvodina. Municipalities and Cities exercise original and delegated jurisdictions. They have complete autonomy in exercising original jurisdictions such as utilities, urban planning and environmental protection. Delegated jurisdictions fall in within the republic and provincial scope and delegated to municipalities and cities for the purpose of efficient execution such as voter records and inspectorate supervisions. Historically sub national governments in Serbia have less jurisdictions in the spheres of education, health care and social welfare. However their role in the delivery of social services has been increasing over the last couple of years.

Despite an overall large number of small municipalities, the highest population share in SEE countries concentrates in medium and large cities. In Albania and Croatia the majority of the population lives in cities having between 10,000 and 40,000 inhabitants.

Bosnia and Herzegovina, Macedonia and Serbia, on the other hand, have a large number of medium size municipalities which are home to the biggest share of the population. In Montenegro, a large number of medium size municipalities prevail, but the largest share (30%) of the population lives in the capital city.

Figure 7: Distribution of the population across different municipalities sizes

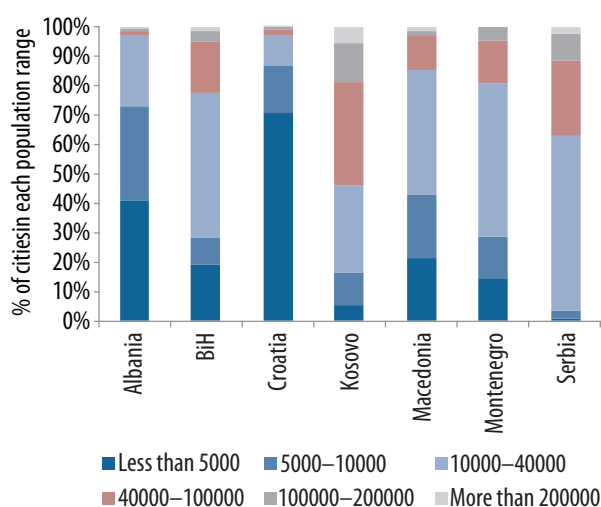
Despite the seemingly balanced population distribution, there is a spatial concentration in metropolitan areas. Figure 8 suggests that “Urban Primacy”, i.e., a large urban center dominating a country’s population distribution and economic development, would not seem to be a major issue in the SEE region. However, this perception might be misleading since in most countries, capital cities are composed of a number of municipalities with different administrative entities. For example, Belgrade in Serbia comprises of 10 “urban” municipalities and 7 “suburban” municipalities; and Skopje in Macedonia consists of ten municipalities. While statistically these municipalities might be identified as independent Local Government Units, together, they constitute one metropolitan area. The difficulty of defining, re-defining and merging physical and

TABLE 2: LOCAL GOVERNMENT UNITS IN SEE COUNTRIES AND POPULATION DISTRIBUTION

	Population	Number of LGUs	Average population of LGUs	LGUs below pop 5000 (%)	Capital city in % of total	Average Density (people/sq.km)
Albania	4,202,098	385	11,460	41.0%	14.5%	NA
BiH	2,337,660	80	29,591	13.8%	18.7%	268.75
BiH RS	1,433,038	63	23,114	25.4%	15.8%	63.42
Croatia	4,290,582	576	7,751	70.5%	18.5%	97.31
Kosovo	2,236,963	38	58,867	5.3%	11.4%	290.47
Macedonia	2,529,473	85	26,967	21.3%	25.0%	85.77
Montenegro	620,029	21	29,525	14.3%	30.0%	61.69
Serbia	7,748,519	170	55,836	0.6%	21.0%	395.22
EU-27 average	—	—	5,580	—	7.0%	116.92

administrative boundaries is enhanced by the suburbanization of cities. For instance, in Tirana, although many towns and villages have been merged with the capital city, some large suburbs such as Kamez (76,000) and Kashar (20,327) continue to be listed as separate entities. In Montenegro, the capital city Podgorica consists of two administrative units, the sub-municipality of Golubovci and the sub-municipality of Tuzi.

Overall, capital cities dominate the urban structure in the relatively small countries of the SEE region.

Figure 8: Distribution of municipalities across different sizes

As presented in Table 2, concentration on the capital city is particularly visible in Montenegro, with 30% of the total population residing in the capital city Podgorica. In addition to the largest population share, capital cities generally also generate the largest share of GDP in a country. In Macedonia, Skopje accounts for about 25% of the total population and contributes to around 45.6% of the country's GDP. In Serbia, the largest country in the region, Belgrade concentrates about 21% of the population. From the 7 countries in SEE included in the analysis, 4 have more than 15% of their population living in the capital city. As a contrast, only 7 countries in the EU have capital cities concentrating more than 15% of their total population (Austria, Bulgaria, Cyprus, Estonia, Hungary, Latvia and Lithuania).

Municipalities in SEE are also very diverse in terms of population density. Variations in the group of largest municipalities with more than 200,000 inhabitants range from more than 1,600 inhabitants per km² (Serbia) to less than 200 per km² in the RS (see Table 3). For urban areas, large variations in density might be a reflection of different public policies that provide intended or unintended incentives for higher or lower densities. However, it is also the result of divergences in the delineation of municipalities' administrative boundaries as described earlier. For this reason, a comparison of densities should focus on differences within and not across countries. Table 3 presents comparisons of municipalities with different

population ranges for each of the countries. Overall, smaller municipalities have lower population densities than larger cities which might be a reflection of

their rural or agricultural character. Within countries, divergences in densities are particularly striking in Croatia, Kosovo and Montenegro.

TABLE 3: MEAN DENSITY (INHABITANTS PER KM2) BY SIZE OF MUNICIPALITIES

	BiH RS	FBiH	Croatia	Kosovo	Macedonia	Montenegro	Serbia
Average density in habitants per km ²							
less than 5,000	20.4	56.3	54.5	134.6	21.7	5.2	8.2
5,000–10,000	67.8	110.6	95.6	136.4	34.8	16.9	76.9
10,000–40,000	70.9	90.1	209.7	499.7	105.9	85.9	61.5
40,000–100,000	93.7	757.7	442.5	180.3	118.1	51.7	1,015.8
100,000–200,000	148.3	853.3	1,941.1	229.8	207.2	129.0	612.9
more than 200,000	182.8		1,236.3	556.2	870.1		1,662.1

Local Government Finance: Structure and Composition of Sub-National Budgets

3.1 WEIGHT AND INSTITUTIONAL STRUCTURE OF LOCAL GOVERNMENT FINANCE

3.1.1 Importance of local governments in the SEE region

Overall, the importance of local governments has increased across the SEE region. After more than a decade-long reforms and based on the decentralization traditions in SEE, the overall framework of inter-governmental fiscal architecture has largely been put in place across the region. National legislation on local finances and local taxation set the basic rules of intergovernmental fiscal relations, financial management and local revenue raising. New grant allocation methods and revenue sharing techniques have been built into the fiscal planning practices at macro level. Table 4 provides a summary overview of local government finance, including sub-national government's proportion of total public services, their main function, and fund profile.

However, the economic weight and share of local government financing varies. Overall, sub-national governments' financial weight is defined by (i) the scope of overall public sector and general government expenditures; (ii) the proportion of public expenditures delivered by sub-national governments; and (iii) the role of sub-national governments in delivering these public services in a particular country. On average, sub-national government expenditure in the SEE region accounts for around 5 percent or more of GDP, except for Albania with only 2.2 percent. Overall, government expenditure increases in line with the GDP. Countries with higher per capita GDP (Croatia, Montenegro, and Serbia) spend more than 40% of GDP on public services, which is in line with the averages. Others with lower GDP per capita (Albania, Kosovo) have narrower public services, 30% of GDP or below. There are exceptions to this rule: Bosnia and Herzegovina has a complex government structure with high public spending (49.2%) and Macedonia, with more limited public sector spending (27.5%) compared to its level of economic development.

TABLE 4: MAIN FEATURES OF LOCAL GOVERNMENT FINANCE IN 2011

	General government expenditures in % of GDP*	Local Expenditures as % of GDP	Local Expenditures as % of General Government Expenditures ¹	Main Function (% of overall local government expenditure)	Funding – Own source funding out of total funding (%)
Albania	28.5%	2.2%	8.8%	General Public services (56%)	31%
BiH (RS/FBiH)	49.2%	1.6/0.0% ²	4.1/0.0	—/General Public services (48%)	82%/46%
Croatia	42.5%	6.8%	16.6%	Education (19%)	37%
Kosovo	30.0%	8.4%	48.6%	Education (48%)	15%
Macedonia	31.2%	5.6%	20.4%	Education (49%)	46%
Montenegro	43.8%	3.9%	8.5%	General public services (64%)	55%
Serbia	45.2%	5.7%	13.7%	—	—

Source: From IMF WEO data

Note: ¹ General Government Expenditures from FACE

² Data was not available for all LGUs therefore this number might under-estimate the weight of local expenditures in the economy.

On average, local governments are in charge of around 15% of overall public expenditures. Sub-national governments' role in public service delivery and administration can be measured by the size of local expenditures as share of overall public sector spending. By this measure, the level of decentralization would be highest in Kosovo, with more than 45% of all public services being delivered by local government—more than three times higher than in Albania. The remaining countries have a more similar pattern with a share of around 12–20% public sector spending by sub-national governments.

However, the funding arrangements are very diverse, with the own source revenues share varying between 15–82%. Variations in the revenue composition across the SEE region are large. Usually, local government revenues are grouped as (i) own source revenues; (ii) shared revenues; (iii) transfers and grants; and (iv) proceeds from borrowing (see Box 1). With 55 percent, sub-national governments in Montenegro rely on own sources somewhat 50% more than in Croatia, where own funding accounts for 37%. With own source funding of 46%, sub-national governments in Macedonia lie in between the two other countries. No information is available on the main sub-national government function in the BiH RS.

Sub-national expenditure structure differs with the functional assignments. The expenditure profile depends on the type of services devolved to local governments. Most of the countries are characterized

by devolution of basic municipal services, such as local administration; but also economic affairs, including public transportation; housing and community amenities, such as water supply and solid waste management (see also Table 1). In a smaller group of countries (Macedonia, Kosovo, Croatia), sub-national governments have wider responsibilities in public education—a costly public service which, as a result, dominates sub-national budgets in that group. 'General public services' account for about two thirds of expenditures in Montenegro; 'education services' take up 49% of expenditures in Macedonia; while in Croatia, the main function, education, accounts for only 19% of expenditures.

Local government share, function and funding source differ significantly in Albania and Kosovo. While the overall public sector in Albania and Kosovo is markedly smaller than in the other three countries, the importance of sub-national government varies almost by a factor four: sub-national governments in Albania account for 8.8% of total public expenditures, while in Kosovo, almost 49% of all public expenditures are handled by sub-national governments. In Albania, 'general public services' represent the main function of sub-national governments (56% of all sub-national expenditures), while in Kosovo, education accounts for some 48%. At the same time, comparing revenue sources across all six countries, Albania and Kosovo are the two countries with the lowest share of sub-national government' own funding, with 31% and 18% respectively. For Kosovo, this implies that while sub-national

Box 1: Classification of local government revenue sources

Own revenue: Criteria for categorizing a tax as own revenue are the authority to define the tax base, the exemptions and the tax rate. If local governments have control over at least one of these elements of revenue policy, then the tax source is regarded as an own revenue.

Shared taxes: Four criteria define whether a local government revenue is a shared tax: a) A sharing ratio is defined in law; b) shared revenue is un-conditional; c) the ratio is pre-determined and predictable at least for a period of a year; d) the shared revenue is proportional to the revenues raised in the locality. If all criteria are not met, the shared resources should be regarded as grants or transfers. They cannot be classified as own revenues.

Grants, transfers and subsidies: Cover other transfers from the national budget. They are provided for various purposes: general grant, conditional grants, and equalization grant, and vary in governance (set by law/budget/admin procedure), and hence in visibility and predictability.

government are in charge of more than a quarter of all public expenditures, only a minor part of these expenditures, 15%, is funded by the sub-national governments own revenue efforts.

3.1.2 Institutional arrangements of local government revenues

Fiscal reporting systems in SEE do not always follow the standard categorization.⁸ In Macedonia, for example, VAT is shared by formula, but municipalities account it as own revenue because the law defines VAT under the account of own revenues. In spite of that, central government sees the VAT as an unconditional transfer for equalization purposes. In Croatia, the shared PIT can be supplemented by a local surcharge, which then qualifies as local own source revenue. However, since PIT revenues are reported jointly, it cannot be separated and the full amount of PIT is reported as part of the shared revenues. In Serbia, the shared revenues are an important source, but are reported as an integrated part

of own-source revenues (MoF aggregate data). For a regional overview of revenue assignments, please see Table 5. A summary is provided in the following.

Albania. The Albanian Law on Organization and Functioning of Local Governments requires that the fiscal self-sufficiency of local governments shall be guaranteed through diversified revenue sources which are local taxes, and fees arising from the rental/sale of local governments services; grants from national governments, shared taxes and local borrowing. However, legislation about local taxes and fees is confusing and in some cases contradictory. Especially fee and tax revenues are not well classified and create problems at the reporting stage. Almost 70 percent of the revenues are formed by Small Business Tax, Property Tax, Infrastructure Impact Tax and Fee on Solid Waste Collection.

Bosnia and Herzegovina. In terms of revenues, indirect taxation (VAT, customs, excises, and road tariffs) are defined and administered at the State level. The indirect taxation legislation prescribes that out of total revenues, first revenues needed for State Institutions are taken out. Then, Brcko District gets 3.55% of remaining funds. Based on a formula derived from the final consumption data on VAT forms, the remaining funds are divided between the two entities, FBiH and RS. Out of the funds available for each entity, funds needed for foreign debt servicing are subtracted first and the remaining funds are distributed among the government levels within the entities according to entity laws.

In the FBiH, 36.2% of indirect taxation revenues belong to the FBiH Government; 51.48% to the Cantons (based on population, area, number of students, and also developmental level of the Canton); 3.9% to the Road Directorates; and 8.42% to municipalities and cities. This is not a shared tax, since LGUs receive this revenue based on a formula fixed by law rather than based on proportion of revenues actually raised in that LGU. The indirect taxation revenues belonging to LGUs are distributed to the LGUs with a formula which is mostly based on weighted average population and other criteria such as area, weighted number of students in primary education and development index. Social

⁸ For regional comparison in this report, the collected data on revenues were reclassified, where feasible. Taxes shared by origin were separated from own source revenues and intergovernmental transfers. Revenues shared by a formula were merged with general grants. Local taxes were reported as own source revenues, even if municipalities cannot influence the tax base, the rate and, often, the administration is at the national level.

contributions (pension, health and unemployment benefit funds) and direct taxation are administered at the Entity level and do not belong to the LGUs. In the Federation, corporate income tax revenue belongs to the Cantons. In terms of revenues for personal income taxes, almost two third of revenues go to Cantons, while the remaining goes to municipalities. In the Sarajevo Canton, this is further complicated by a large share of revenues going to the City of Sarajevo, which reduces the LGUs' share. Property tax is administered by the local government level and revenues belong to the LGUs, although in some cases, this is also shared with the Cantons. In the RS, 72% are allocated to the central government; 24% to municipalities and towns; and 4% to the public company "Republika Srpska Roads". In addition, Personal income tax is shared between the state budget and municipal budgets in the proportion of 75:25; share of fees of use of agricultural land, water charges, use of mineral resource changes 70–50 to 30–50 percent between state and municipalities. Property tax, municipal administrative fees, utility taxes, special water fees—fees for protection against water, municipal fees for the use of natural and other resources of general interest, taxes on gains from games on chance are considered as the own source revenues of the municipalities.

Croatia. The Law on Local and Regional Self-Government Financing is the main legal framework of the local government finance system in Croatia. Local and regional self-government units realize revenues through: own sources, shared taxes, and grants from the state and county budget. Local government units are entitled to the revenue from shared taxes and fees collected within their area, at a percentage stipulated by the law. Shared taxes are income tax and tax on real estate transactions. Grants are used as funds to support local government units with poor fiscal capacity. Local governments' own sources include income from local governments' own property, from county, city, town or municipal taxes, from fines, fees and charges. The income realized through income tax is distributed in a manner that it distinguishes whether municipality, city or county finances or not decentralized functions in selected public services including education, health care, social welfare and firefighting and with respect

to the supported area that a local government unit belongs to. However, Local government revenues are quite unstable and are exposed to frequent changes in the model of income tax revenue sharing and grants from the state budget. The surtax is also the most generous source that makes up about 4% of total local government revenue. Other tax revenues are not abundant and are on average only about 0.5% of local government revenue.

Kosovo. In implementing the Law on Public Management and Accountability the Ministry of Finance and Economy has issued the Administrative Instruction 2007/2 on Own Source Revenues of Municipalities, which provides for the types of municipal own revenues, as follows: property tax, tax on municipal services, tax on municipal administrative services, traffic fee and fees for violation of municipal regulation. The own tax yield in Kosovo is not adequate to meet local public spending requirements, and grants and transfers provide for an important part of the overall funding.⁹

Macedonia. In accordance with the law on financing local governments, Macedonia initiated the second phase of the decentralization in 2007 which actually showed its effects directly on the revenues of municipalities mainly by the block grant transfers which were started to be allocated to the municipalities. Transfers from central government have highest share in the total revenues of local government in Macedonia by around 60 percent. Own revenues has the second highest share almost by 30 percent. Property tax, share of personal income tax (PIT), non-tax revenues from communal taxes and administrative taxes, capital revenues from the sale of assets, share from value added tax are the main accounts of the own revenue of the municipalities.

Montenegro. The Law authorizes municipalities to introduce and levy local public revenue types, which are municipalities' own revenues: local taxes (surtax on personal income tax and real estate tax), fees and charges (local communal fees and local administrative fees, fee for construction land infrastructure development, fee for use of municipal roads,

⁹ <http://www.osce.org/kosovo/31640>

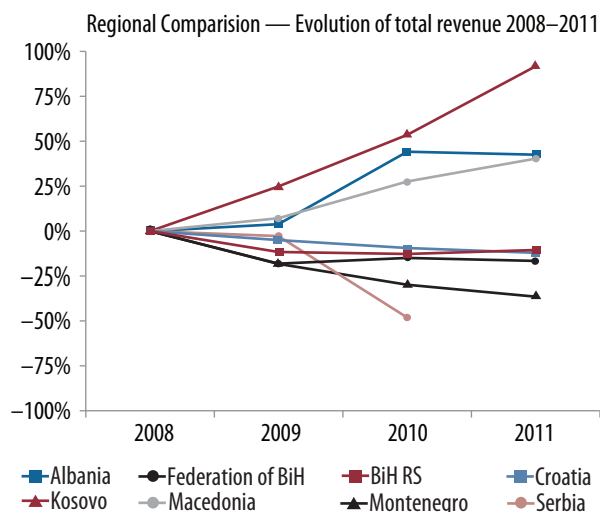
environment fee), to administer it, to determine tax rates within the limits prescribed by the law, to provide for tax reliefs and exemptions, to perform billing, collection and control of local revenues and to introduce penalty measures. In addition to own revenues, Montenegrin municipalities receive funds in the form of “assigned revenue”, i.e. shared taxes. These are shares from the personal income tax (12%; with the exception of the Historic Capital which receives 16% of revenues from personal income tax, the Capital City which receives 13%), the tax on real estate transfer (80%), fee for use of motor vehicles (30%) and concession fees (70%).

Serbia. The local government affairs are funded from: own and shared revenues, transfers, proceeds from borrowing and other revenues and earnings set forth by the Law on Local Government Finance. The most important sources of local government current financing are: shared income tax (35% on average), other local revenues including construction land development fee (26% on average), and grants and transfers (21% on average). Property tax with an average share of only 11% has potential to be increased in the future.

3.2 LOCAL GOVERNMENT REVENUES

Overall, grants, shared revenues and transfers dominate local revenue composition. Only in the RS and Montenegro, own-source revenues account for more than half of sub-national budgets (see Figure 9). However, the revenue structure differs across countries. In Montenegro, own source revenues make the largest share, comprising of tax on property, PIT surcharge and fees. Even if the property turnover tax is reported as shared revenue, own source revenues are the largest item. Own source revenues also dominate in the RS, where they comprise 82% of total revenues. In Macedonia, various earmarked transfers from line ministries dominate local budgets, so local revenue autonomy is lower, despite the fact that shared VAT was not separable and is accounted as own revenue. Grants and transfers account for a particularly large share of sub-national budgets in Albania and Kosovo. In Albania, earmarked transfers are the

Figure 9: Grants and transfers still represent a considerable share of sub-national revenues



main source of funding, which significantly limits local revenue autonomy.

Total local revenues have increased in Albania, Kosovo and Macedonia, but took a hit in the other countries. Kosovo municipalities benefitted from an overall increase of close to 92% during 2008–2011, driven largely by growing grants and transfers such as in Macedonia (40%). However, while Kosovo and Macedonian municipalities also enhanced their own revenue sources, own-source revenues declined over the same period in Croatia, the RS and Montenegro. Total local revenues shrank the most in Serbia and Montenegro: in 2011, Montenegro sub-national governments collected 39% less compared to 2008. The decline was less dramatic in Croatia (–18%) and the RS (–12%).

At the same time, the overall share of own source revenues in total revenues declined across the SEE region. In all countries, the overall share of own source revenues in municipal budgets has decreased during 2008–2011 (see Table 6). For instance, in Kosovo, despite an increase of 33% of own source revenue in the period of analysis, the share of own source revenue decreased by –8% due to the considerable increase in grants and transfers.

TABLE 5: OVERVIEW OF SUB-NATIONAL GOVERNMENT REVENUE ASSIGNMENTS IN SOUTH-EAST EUROPE

Level of sub-national government (tier)	Sources of Revenues	Comment
Albania		
Counties (<i>Quarks</i>)	<ul style="list-style-type: none">• Small Business Tax (SBT)• Property Tax (on buildings & agriculture land)• Infrastructure Impact Tax• Tax on the Immovable Property Transactions• Tax on Vehicles (shared tax)• Fee on Solid Waste Collection (cleaning fee)• Fees for Occupying Public Space• Fees on Billboards	There is some confusion in defining exactly which are the fees and the local taxes, and in some cases they are interpreted /used in different ways at local government level.
Municipalities and communes		
Bosnia and Herzegovina		
Federation of Bosnia and Herzegovina		
Cantons	<ul style="list-style-type: none">• 51,48% of indirect taxation• corporate income tax• personal income taxes, 65,5% of revenues go to Cantons	In terms of revenues, indirect taxation (VAT, customs, excises, and road tariffs) are defined and administered at the State level by the BiH Indirect Taxation Authority. The indirect taxation legislation prescribes that out of total revenues, first revenues needed for State Institutions are taken out. Then, Brcko District gets 3,55% of remaining funds. Based on a formula derived from the final consumption data on VAT forms, the remaining funds are divided between the two entities.
Municipalities	<ul style="list-style-type: none">• 8,42% of indirect taxation• 34,5% of personal income tax• Property tax• fees from lending and equity,• positive foreign exchange revenues, privatisation, and• revenues from premium and guarantees	
Republika Srpska		
Municipalities	<ul style="list-style-type: none">• 25% income tax• Fee for change of use of agricultural land %70• Concession fee for the use of mineral resources %70• Property tax,• Fines imposed in misdemeanor proceedings for offenses established by decisions of municipalities,• Municipal administrative fees,• Utility taxes• Special water fees – fees for protection against water,• Municipal fees for the use of natural and other resources of general interest,• Taxes on gains from games on chance	Revenues from indirect taxes, paid to the budget of the RS from the Unique account of Indirect Taxation Authority of Bosnia and Herzegovina, which, after separation of funds for needs of the external debt of the RS, are divided as follows: <ul style="list-style-type: none">• Budget of the RS 72.0%,• Budgets of municipalities and towns 24.0%• Public company “Republika Srpska Roads” 4.0%.
Croatia		
Counties	<ul style="list-style-type: none">• Tax on inheritance and gifts• Tax on motor vehicles• Tax on boats and vessels• Tax on gambling machines	The income realized through income tax is distributed in a manner that it distinguishes whether municipality, city or county finances or not decentralized functions in selected public services including education, health care, social welfare and fire fighting and with respect to the supported area that a local government unit belongs to. Tax autonomy of local government units is limited because the rate and the tax base determined by the central government. However, the local unit can independently determine the rates in the range claimed by the central government. A share in the distribution of revenue from tax on real estate transactions for municipalities and cities is 60 percent and for the state 40 percent. Surtax on income was introduced more than 50% of local government units (most cities) accounts for 4% of the budget.
Municipalities	<ul style="list-style-type: none">• Surtax on income tax• Consumption tax• Tax on vacation homes• Tax on firm or name• Tax on the use of public surfaces	

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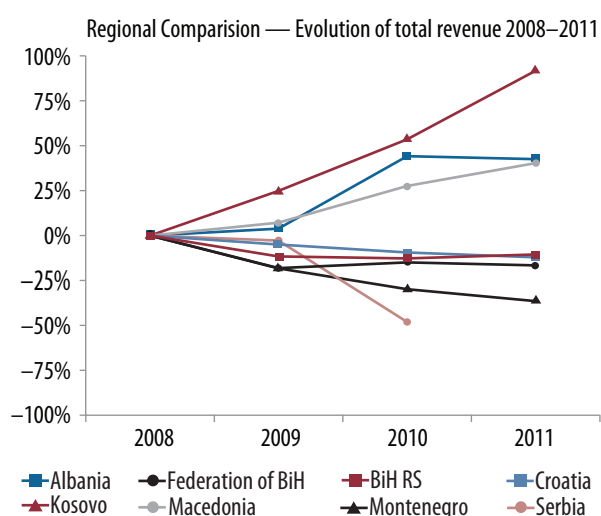
TABLE 5: OVERVIEW OF SUB-NATIONAL GOVERNMENT REVENUE ASSIGNMENTS IN SOUTH-EAST EUROPE *(continued)*

Level of sub-national government (tier)	Sources of Revenues	Comment
Kosovo		
Municipalities	<ul style="list-style-type: none"> • Property tax • Licenses and permits • Certificates and Official documents • Motor Vehicle Fees • Building related permits • Regulatory charges • Education Copayment 	The structure in Kosovo allows municipalities to set tax rates. Municipalities are responsible for property tax valuation, preparing and issuing bills, managing the property tax information system, enforcing and collecting property taxes as well as for the administrative appeals.
Macedonia		
Municipalities	<ul style="list-style-type: none"> • Property tax, • a share of personal income tax (PIT), • non-tax revenues from communal taxes and administrative taxes, • capital revenues from the sale of assets, • share from value added tax (VAT) 	Self-financing activities are a source of revenue from the local government's budget users (schools and kindergartens) like the participation of parents and the organization of excursions. Transfers from central government are mostly tax revenues for the block and earmarked grants for wages/salaries for teachers and employees in education, kindergartens and libraries and maintenance of the schools and kindergartens and culture buildings.
Montenegro		
Municipalities	<ul style="list-style-type: none"> • Real estate tax • Local communal charges • Local administrative charges • Asset revenue • Land development fee • Surtax on personal income tax • Local Roads Use Fee • Fee for environmental protection and improvement • Income from capital (interests, stakes and shares, etc.); • Fines imposed in misdemeanor proceedings, as well as gain confiscated in that proceedings; • Revenues from concession fee for performing communal affairs and revenues from other concession activities that a municipality concludes in compliance with law; • Revenues collected by municipal bodies, services, and organizations through their own activities; • Revenues from grants and subsidies; and • Other revenues set by the law 	The Law authorizes municipalities to introduce and levy local public revenue types mentioned above (local taxes, fees and charges), to administer it, to determine tax rates within the limits prescribed by the law, to provide for tax reliefs and exemptions, to perform billing, collection and control of local revenues and to introduce penalty measures.

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TABLE 5: OVERVIEW OF SUB-NATIONAL GOVERNMENT REVENUE ASSIGNMENTS IN SOUTH-EAST EUROPE (continued)

Level of sub-national government (tier)	Sources of Revenues	Comment
Serbia		
Municipalities	<ul style="list-style-type: none"> Property taxes, excluding taxes on the transfer of property rights and taxes on inheritance and gift Personal Income Tax (PIT) Local administrative fees Local utility fees Tourist fee Construction land use fee Construction land development fee Environmental protection and improvement fee Revenues from concessions for public utility purposes and revenue from other concessions the LG enters into in accordance with the law Fines imposed in misdemeanor proceedings for offenses prescribed by the LG Council and assets confiscated in such proceedings Income from lease or use of LG owned real estate Revenues from sale of moveable assets used by the LG and indirect budget beneficiaries Revenue from sale of real estate Revenue generated from activities of LG bodies and organizations Revenue from interest on funds from the LG budget 	The original local revenues are not sufficient to finance local public expenditures in Serbia. For this reason the LGF Law regulates share of the LGs in the revenues from certain taxes and fees, which belong to the Republic, calling them assigned public revenue. It is a system of joint public revenues, since the Republic shall establish the tax base and tax rate, and the revenues are shared between the LG and the Republic at the moment of collection/payment.

Figure 10: Trends in total local revenues – regional comparison

Source: Federation of BiH and RS data from aggregated data

However, weight and composition varies across and within countries. In Albania and the RS, the largest share of own source revenue originates from taxes,

while Croatia, Kosovo and Macedonia have a more diversified revenue composition which includes revenue from rents and capital. Findings suggest that municipalities in Croatia and Macedonia leverage a larger share from fees and charges, while rents play a role only in Croatia and Kosovo.

Sub-national revenues remain volatile, despite an overall increase since the start of decentralization.

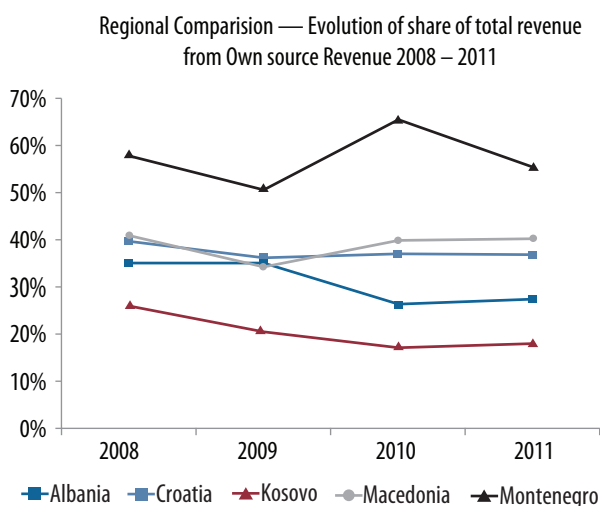
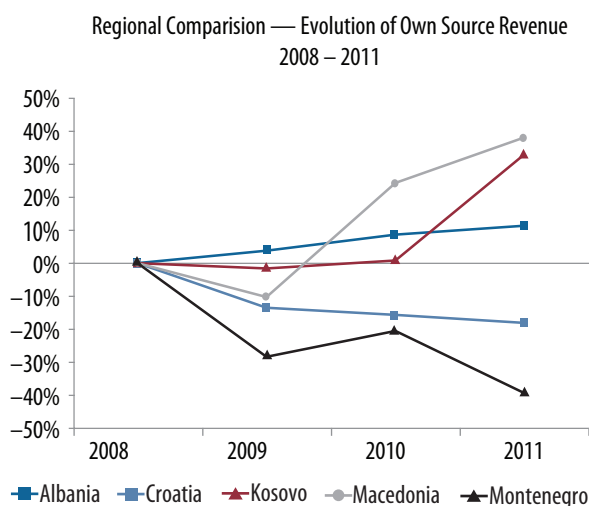
Local own source revenues decreased across the SEE Region, in particular the more volatile revenues from asset sales, urban land development, or businesses fees. This decrease was only partially compensated by national transfers, since central government budgets also contracted during the same period. The decline was particularly contrasted in Croatia and Serbia, although the source differed: Croatian local governments suffered a decline in the shared PIT; in Serbia, general transfers from the central government decreased the most. Many local governments attempted to compensate for these vertical fiscal imbalances with an increase in the local revenue raising capacity. However, only in Kosovo and Macedonia, municipalities achieved to raise more

TABLE 6: TRENDS IN TOTAL REVENUE, OWN SOURCE REVENUE AND GRANTS AND TRANSFERS

% Change in 2008–2011 period (2008–2010 for BiH RS)

	Total revenue	Own source revenue	Share of Own source revenue	Grants and transfers
Albania	34%	–1%	–7.7%	59%
FBiH	–16.3%*	NA	NA	NA
BiH RS	–10.4%*	NA	NA	NA
Croatia	–12%	–18%	–2.8%	44%
Kosovo	92%	43%	–8.0%	112%
Macedonia	40%	38%	–0.8%	43%
Montenegro	–36%	–39%	–2.5%	–50%
Serbia	–48%	NA	NA	NA

Source: From aggregate data

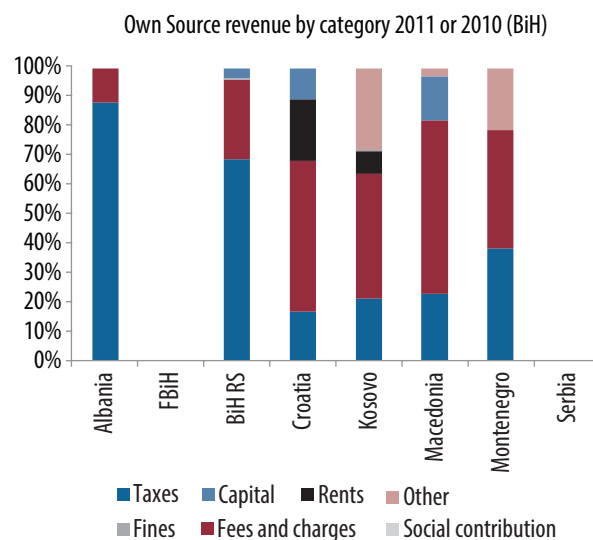
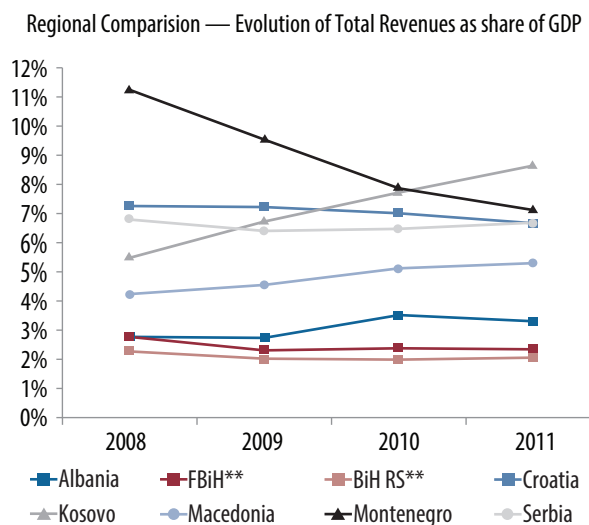
Figure 11: Trends in share of total revenue from own source revenues – regional comparison**Figure 12: Trends in own source revenues – regional comparison**

own revenues from other sources. In Montenegro, local revenues decreased by 39.3% leaving two thirds of the municipalities in deficit, measured by the balance of expenditures on core functions and own revenues.¹⁰ Decreased own source revenues in Montenegro are mainly the result of a sharp decrease in the collection of fees and charges. In Macedonia, despite there being a sharp increase in own source revenue coming from capital, the main reason for an increase in own source revenue in the 2008–2010 period is an increased collection of fees and charges.

¹⁰ See Obradovic, N. Country MFR report

In the FBiH, decline in own source revenue was mostly due to fall of property tax revenue and fall of revenues from dividends.

Property taxes provided a relatively stable source of revenue until the recent crisis. Property related revenues include the ‘classical’ taxes on land and property, but also non-recurrent property transfer taxes and various urban construction land fees and comparable land-related taxes. In many SEE countries, property tax are levied on the surface area, but the tax base is calculated using several coefficients and multipliers, which reflect the differences in

Figure 13: Composition of sub-national own source revenues in the SEE Region**Figure 14: Trends in total revenue as share of GDP – regional comparison**

Source: Date for Serbia from local consultants (Public Finance Bulletin; not from disaggregated data) and BiH from aggregate data

property value without allowing too high fluctuation in tax base.

3.3 LOCAL GOVERNMENT EXPENDITURE

Overall, local government expenditures in SEE range between of 2–8% of GDP. At that level, countries in the SEE region are generally in line with comparable countries in the EU, like Bulgaria and Slovakia (6.7% of GDP, 2011), but below the EU27 average of 14%. Measured by the share of general government expenditure to GDP, these figures reflect the typical overall trend by which government expenditure tends to vary in line with GDP (see Table 8). Overall, countries with higher GDP

per capita in the region account for a higher share of public spending, including local government expenditure. In Croatia, Montenegro, and Serbia, government expenditure accounts for more than 40 percent of GDP, in line with the EU-27 average of 49.1 (2011). Government expenditure in Albania and Kosovo, with a lower GDP, accounts for only 30 percent of GDP or below.

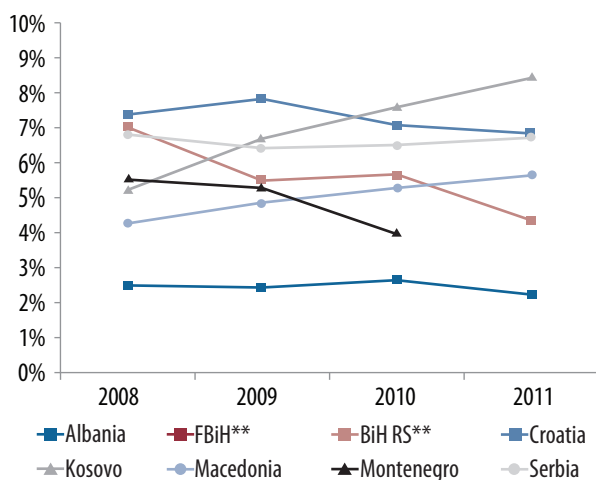
The shape of decentralization influences general government expenditure. Bosnia and Herzegovina pays a premium for the more complex institutional structure inherited as a result of the Dayton Peace Agreement in 1995: although BiH's GDP is below the regional average, public sector spending reaches 49.2 percent. At the same time, public sector spending

TABLE 7: TRENDS IN OWN SOURCE REVENUE FOR THE 2008–2011* PERIOD

	Taxes	Fees and charges	Rents	Fines	Capital	Others	Aggregate change
Albania	10.4%	11.6%	0.0%	0.0%	0.0%	0.0%	11.3%
Croatia	–12.8%	–16.4%	1.8%	0.0%	–43.5%	–100.0%	–18.1%
Kosovo	24.2%	29.2%	30.7%	303.8%	0.0%	47.5%	32.8%
Macedonia	12.4%	24.1%	0.0%	0.0%	792.9%	–0.4%	37.9%
Montenegro	17.6%	–63.5%	0.0%	0.0%	0.0%	2.8%	–39.3%

Figure 15: Trends in total local expenditures as share of GDP – regional comparison

Regional Comparison — Evolution of Total Expenditures as share of GDP



Source: BiH from aggregate data and correspondent to share of total BiH GDP.

in the less complex one-tier institutional structure of Macedonia accounts for only 31.2 percent of GDP, compared to the higher level of economic development.

Except for Kosovo and Macedonia, the overall weight of local government spending has decreased since 2008. Although the level of economic development influences public sector spending, it does not determine the level of fiscal decentralization. Although the increased number of public services

that has been assigned to the local level over the last decade reflected in an increasing share of local government spending over time, this trend was slightly reversed since 2008. The only exceptions are Macedonia, where local expenditures increased from 4.3% of GDP in 2008 to 5.6% in 2011, and even more so Kosovo, with an increase from 5.2% to 8.4% in the same period. In both countries, the increase is largely the result of education spending which was assigned to municipalities in the observed period. The weight of local government spending has decreased the sharpest in Montenegro, from 5.5% of GDP in 2008 to 3.9% in 2011.

However, per capita local government expenditure in the Western Balkans is low. On average, local governments in the SEE region spend EUR288 per capita, compared to EUR 2986.3 in the EU27 (see Table 8). Croatia and Montenegro are an exception: with an average of around EUR500 per capita, local governments there spend almost 40 percent more on local public services than the second ranking country on this scale, Macedonia; or even 75 percent more compared to Serbia, the third ranking country. Local government spending is much lower in the Federation of BiH and Kosovo: here, local expenditures are less than half of the average in Montenegro. In the FBiH, low spending is a result of the fact that a large share of typical LGU expenditures is generated in the Cantons. Hence, data for FBiH need to be analyzed with caution. However, by far the lowest level of per capita spending is observed in Albania.

TABLE 8: REGIONAL COMPARISON OF LOCAL EXPENDITURE

	GDP per capita 2011* USD	General government expenditures in % of GDP 2011*	Local Expenditures as % of GDP 2008	Local Expenditures as % of GDP 2011*	Mean local expenditures per capita 2011* EUR
Albania	8,820	28.5%	2.5%	2.2%	48
BiH RS	9,190	49.2%	NA	NA	243
FBiH	9,190				191
Croatia	18,780	42.5%	7.4%	6.8%	459
Kosovo	NA	30.0%	5.2%	8.4%	197
Macedonia	11,370	31.2%	4.3%	5.6%	367
Montenegro	13,700	43.8%	5.5%	3.9%	506
Serbia	11,550	45.2%	6.8% ¹	5.7%	290 ²

Source: * 2010 for BiH and Serbia, all in 2008 prices.

Note: ¹ Ministry of Finance of the Republic of Serbia, "Public Finance Bulletin, 2008–2011"

² Ministry of Finance of the Republic of Serbia, "Public Finance Bulletin, 2008–2011"

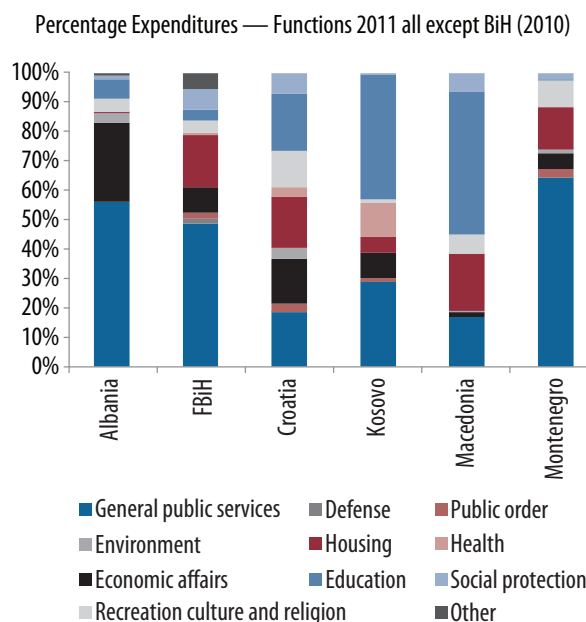
On average, Albanian municipalities only spend 10 percent of the per capita average in Montenegrin municipalities. This is also a result of the role of *quarks* in Albania's three-tier sub-national government system and reflects the overall low level of local expenditure as share of GDP.

General public services typically dominate local expenditure. This category, which generally covers services of elected organs and the local administration, accounts for more than half of sub-national expenditure in Albania and Montenegro, or close to 50% in the FBiH (see Figure 16). However, accounting practices may distort these numbers. There is a usual practice to report the minor, unspecified expenditures on the largest expenditure item. In municipalities with limited local tasks, the general public services, as the main function, also attracts other costs.

Education expenses account for the largest share in Kosovo and Macedonia. Apart of these two countries, municipalities in SEE are generally only responsible for operation and maintenance of school buildings, with small budget allocation ranging from 6.6% in Albania and 3.6% in FBiH, to only 0.7% in Montenegro. However, full responsibility for primary and secondary education, including teachers' salaries and wages, makes up the lion share of local spending in Macedonia (48.7%) and Kosovo (42.2%); and still accounts for 19.2% in Croatia.

Housing, communal services and economic affairs account for the largest share of urban services. Typically, local governments are responsible for housing development and maintenance, water supply and public street lighting, accounted under 'housing and communal services'. This category constitutes a significant part of local budgets in Macedonia (19.6%), Croatia (17.2%), the Federation of BiH (17.7%), and Montenegro (14.4). Public transportation is the largest single item accounted for in 'economic affairs'. This sub-sector covers road building and maintenance, grants provided to operation of roads, railway and other public transportation systems. If local governments are directly involved in tourism, restaurant and hotel businesses, then they are also accounted here. Economic affairs are present in all local budgets, but they have the

Figure 16: Composition of sub-national expenditure by function



Source: Data on functional expenditures was not available for BiH RS and Serbia

highest shares in Albania (26.8%) and Croatia (15.2%). Environmental protection services, such as municipal solid waste management and sewage treatment are less visible among the local government expenditures, because they are either underdeveloped or reported by public utilities responsible for communal service provision. Within this limitations, environmental services account for the highest share in Croatia (3.9%) and Albania (3.2%).

Generally, multi-tier government structures reflect in the expenditure composition. In Albania, the upper level government, the *qark* spends the most on economic affairs, which includes public transportation services. In Croatia, the counties (*zupanija*) are primarily responsible for the merit based services, such as education (34% of their budget expenditures), despite of the fact that salaries are paid by the central budget. Here health care services are the second largest expenditure item (14%). Although most of the Cantons in the Federation of BiH also are responsible for health and education services, MFR collected sub-national government data only at the level of municipalities.

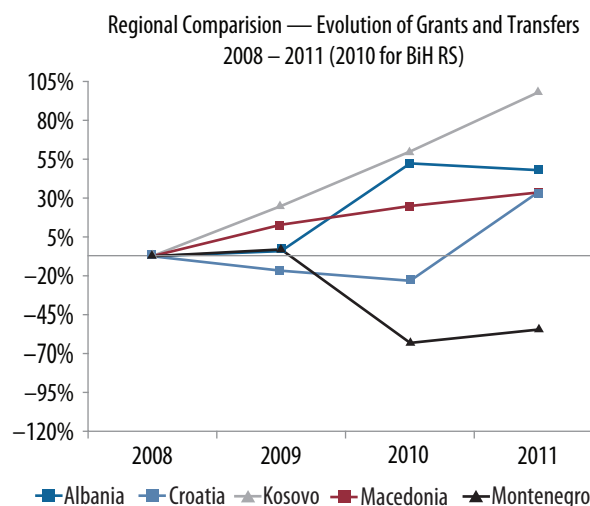
3.4 GRANTS, TRANSFERS AND INTER-GOVERNMENTAL FISCAL RELATIONS

Grants and transfers form an important part of sub-national budgets. However, in addition to their importance for sub-national revenues, central-local fiscal arrangements are equally important to coordinate fiscal decision making across levels of government. While a number of arguments may be identified in favor of increased sub-national government fiscal autonomy, strong arguments exist to maintain central government's presence and influence on sub-national fiscal matters, including public services provision. Central governments are in charge of national policies on equity and efficiency of service delivery. While revenue raising may be better organized at the central level to benefit from economies of scale in tax administration; expenditure responsibilities may be decentralized to a considerable extent for more efficient service delivery. As a result, 'vertical fiscal gap', or 'grant dependency', occurs and is common in practically all countries. However, the size and the nature of the 'dependency', varies significantly, including in the SEE region as reflected in the MFR results.

Grants and transfers account for more than 50% in Albania, Kosovo and Macedonia. Apart from Montenegro, the share of grants in total has increased in all countries. In Albania and Kosovo, the grant share was increased significantly over the considered period, reaching 69% and 85% respectively in 2011, while Macedonia saw a much more moderate development. In Montenegro, on the other hand, grants and transfers from the central government decreased by more than 10 percent from 26.4 in 2008 to 15.4 in 2010; and only recovered again somewhat in 2011, stabilizing at 20.8 percent.

Shared taxes reduce grant dependency in Croatia and Montenegro. In Croatia, grants covered some 15% of sub-national government funding in 2011, up from 9% in 2008. In Montenegro, on the other hand, around 21% of expenditures were grant-funded in 2011, which represented a significant decrease compared to 2007 when grants covered 35%. The relative

Figure 17: Real Growth Rate Index of Grants and Transfers – Regional comparison



little importance of grants and transfers in Croatia and Montenegro should be seen in the context of the overall funding profile: as the only two countries in the SEE region, Croatia and Montenegro benefit significantly from shared taxes as funding source. In Croatia, shared taxes are the most important funding source, covering about 50% of expenditures. Although shared taxes play a much less important role in Montenegro, they still cover 12–13% of the sub-national government funding. In both countries, the revenues from shared taxes remained relatively stable during the period 2008–2011.

However, the type of grants defines dependency beyond their share in local budgets. To fully understand and assess the inter-governmental fiscal system, it is important to understand the nature of grants and transfers, in addition to their size. In the SEE region, some important aspects of the level of fiscal autonomy may be highlighted. For example, while sub-national governments' expenditure in Albania are funded to a large extent by central transfers (69% in 2011), the funds are almost fully provided as unconditional grants which leave room for spending decisions at the sub-national governments' discretion. On the other hand, while grant dependency per the share of local government

TABLE 9: REAL GROWTH RATE INDEX OF SOURCES OF LOCAL REVENUES – REGIONAL COMPARISON

Albania	Own source	Shared taxes	Grants and Transfers	Borrowing
2008	41.89%	0.00%	58.11%	0.00%
2009	41.76%	0.00%	58.24%	0.00%
2010	34.22%	0.00%	65.78%	0.00%
2011	30.77%	0.00%	69.02%	0.20%
Kosovo	Own source	Shared taxes	Grants and Transfers	Borrowing
2008	21.18%	0.00%	78.82%	0.00%
2009	19.39%	0.00%	80.61%	0.00%
2010	15.44%	0.00%	84.56%	0.00%
2011	15.32%	0.00%	84.68%	0.00%
Croatia	Own source	Shared taxes	Grants and Transfers	Borrowing
2008	39.65%	51.16%	9.19%	0.00%
2009	36.11%	55.13%	8.75%	0.00%
2010	36.92%	54.63%	8.46%	0.00%
2011	36.84%	48.09%	15.06%	0.00%
Macedonia	Own source	Shared taxes	Grants and Transfers	Borrowing
2008	48.07%	0.91%	48.68%	0.13%
2009	41.27%	0.89%	56.11%	0.00%
2010	45.53%	1.07%	52.85%	0.15%
2011	46.32%	0.82%	50.69%	1.77%
Montenegro	Own source	Shared taxes	Grants and Transfers	Borrowing
2007	49.14%	11.90%	35.45%	3.51%
2008	57.76%	10.83%	26.44%	4.97%
2009	50.54%	9.30%	33.91%	6.25%
2010	65.55%	9.71%	15.44%	9.30%
2011	55.25%	13.77%	20.79%	10.19%

financing seems much lower in Croatia and Montenegro, the grant ‘picture’ is also much more complex, reflecting the larger and different role for sub-national governments in these two countries. Ear-marked grants are used to ensure standards and quality of service delivery in core public sector areas like education and health, but leave no or little financial discretion to sub-national governments. In Croatia, e.g., central governments increased grant funding to support primary and secondary education delivered by sub-national governments to compensate for shrinking revenues from income taxes. For the same reasons, expenditure needs and revenue base equalization is an important aspect of the general grant system in these two countries, and equally in Macedonia, where municipalities also are in charge of education. For further details, please refer to Table 10 on the grants systems in the countries.

3.5 SUB-NATIONAL BORROWING AND DEBT

Sub-national borrowing is strictly regulated across the SEE region. All countries have borrowing laws which control local government debt and limit sub-national borrowing by revenue and outstanding debt. In Albania for example, administration regulations severely constraints sub-national borrowing as. All of the countries’ sub national government needs consent or approval of the central government in order to take a loan, guarantee or issue a bond. According to the Law of Local Self-Government in Montenegro and Serbia, municipalities are allowed to issue bonds. In Montenegro, municipalities may also accrue debt in a way that the total payments of principal and interest, payments under a leasing contract, repayment of obligations for prior period, and

TABLE 10: ARRANGEMENTS ON GRANTS AND TRANSFERS IN SEE

Level of sub-national government (tier)	Arrangements on Grants and Transfers
Albania	
Counties (<i>Quarks</i>)	Unconditional transfers are funds from the central government to local governments based on the ratio of exclusive and shared functions performed by the local governments and for the purpose of achieving equalization of resources among local governments. Each local government have full discretion in deciding how to use the transfer. The unconditional transfer was introduced in 2001, and starting from 2002 the transfer is distributed based on a predefined formula. The unconditional transfer suffers the unpredictability. The overall level of the transfer is subject to annual budget negotiations, which implies that the level and the formula for distributing the transfer may change from year to year.
Municipalities and communes	
Bosnia and Herzegovina	
<i>Federation of Bosnia and Herzegovina</i>	
Cantons	Total grants are almost half of LGU revenues if we include indirect taxation revenues, which technically belong to general grant category, since allocated by formula and not based on origin of revenues. Significant funds in LGU budget come from transfers from higher government levels which are not based on reallocated Indirect Taxation Authority (ITA) tax revenues (18% of total LGU revenues are these transfers), which are practically all earmarked, mostly for capital expenses. This significant part of the municipal budget could potentially depend on ad hoc decision of higher-government levels The extent to which own non-delegated functions are financed by own revenues cannot be established. However, the LGUs also sometimes use own revenues for functions which should be delegated from higher levels. For example, due to unclear competence division in the area of local infrastructure maintenance, municipalities allocate resources to local community priorities even though competence is shared with Cantons. Note that Cantons are not regarded as local governments and were not subject of this analysis.
Municipalities	
<i>Republika Srpska</i>	
Municipalities	As noted above, significant funds in LGU budget come from transfers from higher government levels which are not based on reallocated tax revenues (66,71 of total LGU revenues), which are practically all earmarked, mostly for capital expenses. This significant part of the municipal budget could potentially depend on ad hoc decision of higher-government levels. The current grants are the least predictable, least reliable and the most arbitrary of all municipal revenues. The allocation of income tax is an important part of general grants to municipalities, with 25% of the collected revenue in the municipality being returned as a general grant. The sharing of information by central government on collected tax revenues may be improved.
Croatia	
Counties	There are two kind of grants allocated to LGU: i) current and capital grant from central government budget and ii) general grants based on income tax revenue sharing for funding local government units with low fiscal capacity. Grants from central government to local units are relatively small and account for only about 15% of total local government revenue. The amount of the grants varies significantly throughout the years. Counties do not have stable sources of revenue since they largely depend on funding from shared taxes (mainly income tax) and grants from the central government budget. Due to the decrease in revenue from income tax, which is a major source of revenue for the county funding decentralized function of primary and secondary education, the state has significantly increased current grants. In Croatia, there are six types of current general grants of which the Ministry of Finance currently are using four of these. current general grants for municipalities, cities and counties in Croatia are: 1 grants for decentralized functions 2 current grants of the Ministry of Finance to counties 3 current grants of the Ministry of Finance to the cities PPDS first and second groups, 4 current grants to other ministries and institutions of the central government, 5 budgetary reserves and compensation for damage caused by natural disasters and 6 current general grant to replace the profit tax. The framework on allocation of general grants may require further clarity and administrative simplification
Large cities and county centers	
Municipalities	

(continued on next page)

TABLE 10: ARRANGEMENTS ON GRANTS AND TRANSFERS IN SEE *(continued)*

Level of sub-national government (tier)	Arrangements on Grants and Transfers
Macedonia	
Municipalities	<p>The law on financing local government identifies the following channels of transfers from the central government:</p> <ol style="list-style-type: none"> 1. Value added tax (VAT) revenues (total fund equal to 3 % of the VAT collections in the previous fiscal year). This unconditional grant is distributed by a formula which states that at least 50% of the grant will be distributed according to population and not more than 50% according to other criteria. The central government sees the VAT as an unconditional transfer for equalization purposes even though it is defined in law as an own revenue for local governments. 2. Personal income tax (PIT) revenues are an unconditional grant distributed on an origin basis. The total pool is calculated as 3% of the PIT from salaries allocated to the local government where the employee resides and 100 % PIT collected from artisan activities. 3. Earmarked transfers are allocated for operational costs in the areas of education, culture and social policy. The appropriate ministries and agencies monitor the use of these earmarked funds. 4. Capital transfers are distributed in accordance with programs specified by the government. 5. Block transfers are the same as the earmarked grants plus the wages and salaries. The appropriate ministries and agencies are responsible for defining the methodology and criteria to be used in this transfer formula. Ministries define the formula by stating the scope of the transfer and the way of transfer to the specific municipalities. 6. Funds received for delegated competencies from the central to the local governments. Funds received for delegated competencies from the central to the local governments. In this case, the amount of funds is determined by way of a contract signed between the mayor of the local government and the appropriate ministry responsible for the competency.
Montenegro	
Municipalities	<p>In 2012, 13 municipalities are receiving funding transfers from the central government in the form of Equalization grants to meet their expenditure responsibilities. The central government makes significant grants to these municipalities to make up their revenue shortfall resulting from vertical fiscal imbalance. These grants to the municipalities take two forms:</p> <ul style="list-style-type: none"> • Equalization grants; and • Specific purpose payments or tied “conditional grants” to provide for financing municipal IPA (an Instrument for Pre-Accession Assistance) projects in 2011 and 2012. <p>Non-earmarking of grants – The Law on Local Government Finance establishes that all transfers to municipalities in the form of “assigned revenue” and equalization payments be unconditional, meaning that there are no constraints imposed on municipalities by the central government in deciding how to spend those transfers. Municipalities are entitled to use “conditional grants” from the national budget to finance priority investment projects that are of special interest for one or several municipalities and for co-financing of projects mainly funded by donations.</p>
Serbia	
Municipalities	<p>The Law on Local Government Financing (LGF) regulates share of the LGs in the revenues from certain taxes and fees, which belong to the Republic. The revenues that are fully or partially assigned to the LGU are:</p> <ol style="list-style-type: none"> 1. Personal income tax: 80% of PIT paid in the LGUs; 70% of PIT paid in the Capital city; and 100% of PIT from agriculture and forestry, self-employment, real estate, lease of moveable property, personal insurance; 2. Tax on transfer of property rights and Inheritance and gift tax (100%) 3. Assigned Fee (100%) for: motor vehicles, environmental pollution, use of mineral resources, extracted material from rivers, use of forests, water use, tourist fee etc. 4. In order to establish vertical and horizontal fiscal balance and to introduce solidarity with the economically weak, underdeveloped and small LGUs, the LGF Law regulates the obligation of the Republic to assign a part of its revenues to LGUs through the following transfers: <p>Unconditional transfer for all LGUs should amount to 1.7% of the GDP and is allocated to:</p> <p>Equalization transfer belongs to each LGU which revenues from shared taxes per capita is less than 90% of average shared revenues per capita for all municipalities (cities are not included). It is calculated based on the number of population and average shared revenues</p> <p>Compensation transfer is used to compensate for the revenues that are lost due to changes of the tax legislation, which is not compensated for by other revenues</p> <p>General transfer is the difference between the total unconditional transfer and the amount of the equalization and compensation transfer. It is shared between all LGUs based on: number of population; territory/area; number of classes in and number of buildings of elementary and secondary schools; number of children included in the child care program, number of buildings used for child care program and ration for the level of development of each LGU.</p> <p>Solidarity transfer is the amount of unconditional transfer calculated for the capital city, which is not paid to the City than is allocated to LGUs</p> <p>Conditional transfer is allocated by the Republic to LGUs for performing particular original and delegated functions</p>

any other obligations that have the character of debt may not exceed 10% of the realized current income in the year preceding the year of borrowing.¹¹ In Croatia, counties are allowed to sustain guarantees to municipalities to take a loan with the consent of the government. In Macedonia, municipalities can borrow with approval from the central government, but the borrowing capacity is limited by debt service (30% of operational revenues) and debt stock (100% operational revenues). Similar limits apply for BiH, although there are different debt ceilings for municipalities in the two entities. In the Federation, the debt ceiling is 10%, including loans and guarantees; while in the RS, the annual debt ceiling is 18% of current revenues from the previous fiscal year with a ceiling for guarantees of 30%. However, any debt service exceeding 10% of current revenues requires approval from the RS Government.

Overall, sub-national borrowing remains a minor source of revenue in SEE. Total accumulated local government debt is not significant. Sub-national government debt is not significant, at less than 1% of GDP, even in countries with more actively borrowing sub-national governments, such as Montenegro and Serbia. However, the role of municipal credit would be expected to increase with greater financing needs for local infrastructure investments and more restrictive central government budgets. In addition, financial reports do not always include guarantees issued by local governments. In Croatia, for example, issued guarantees to public utility companies equal the total amount of total local government debt.

However, larger cities and financially weak municipalities seem to accumulate growing amounts of debt. Measured by the share of long term local government borrowing as percentage of local revenues, findings suggest two trends: In Albania and Montenegro, borrowing has become a special supplementary funding source for weaker municipalities, while capital cities do not make large use of debt financing as a revenue source. In Macedonia and Croatia, however, mostly large cities that can afford to borrow make increasing use of loans. Here,

TABLE 11: SUB-NATIONAL BORROWING

	% borrowing to total revenue	% change in borrowing between 2008–2011	% borrowing to GDP – 2011
Albania	0.21%	NA	0.0071%
Croatia	0.00%	0.00%	0.0000%
Kosovo	0.00%	0.00%	0.0000%
Macedonia	1.98%	1836.25%	0.1049%
Montenegro	10.19%	30.06%	0.7249%
Serbia*	9.80%	346%	0.6752%

loan revenues are significantly higher compared to the national average.

Imbalances in sub-national debt may become a cause of future fiscal stress. In Albania, mostly larger municipalities and local governments in less developed regions borrow. In Montenegro, some of the poorer municipalities are more actively acquiring loan funds, despite the heavily regulated local government borrowing procedures. In 2011, borrowing was concentrated in Montenegro's Northern Region (41%) and Central Region (33.5%), outside of Podgorica, where weaker municipalities were covering revenue gaps by borrowing for operating expenditures. In Macedonia, local government borrowing is only 1.8% of total municipal revenues, but two times higher in Skopje. The City of Skopje and the ten municipalities comprising the city have become the most active borrowers in the country: their share of local borrowing accounts for 84% of total local government debt in Macedonia. In Croatia, borrowing accounts for 4.9% of local revenues, but generally only the cities qualify to borrow. Hence, the majority of debt is concentrated in the financially stronger local governments. In Serbia, Belgrade is the largest sub-national borrower: 14% of local revenues generate from debt; and in 2010, 73% of total sub-national borrowing was concentrated in the capital city.

Debt concentration in weaker municipalities is of particular concern. The present annual loan repayment (principal and interest) burden is the highest in Montenegro and the RS which have accumulated significant local debt. Annual debt repayment in percentage of the total current expenditures is

¹¹ Excluding municipal borrowing "intended for the implementation of the Rehabilitation Plan for Overcoming Financial Difficulties."

extremely high in Montenegro (53.6%) and the RS in BiH (26.3%). In Montenegro, local debt is concentrated in the coastal cities and the local governments in the Northern region. These municipalities cannot cope with the high debt repayment burden, so a special financial recovery plan had to be signed with

the Ministry of Finance. Although other countries accumulated lower sub-national government debt with more reasonable annual debt repayment rates, the trend may be a concern in some of the countries in light of overall growing public debt in the SEE region.

This section highlights a number of key observations on variations across municipalities and discusses selected findings from the analysis of disaggregated local finance data. The review focuses on local government's role in and contributions to public service delivery, but also includes observations on the fiscal structure and trends. The purpose of the section is to bring these findings into the forefront of policy considerations in the Western Balkan countries. A full-fledged analysis and assessment of these observations lies outside the confines of this report. However, the findings outlined in the following provide insights and suggestions for further analysis based on the regional, disaggregated data made available by the MFR.

4.1 VARIATION AND DISPARITIES ACROSS TYPES OF MUNICIPALITIES

4.1.1 Population size

Grant dependency and own-source revenue potential differ across municipalities within countries. The composition of local revenues differs across but also within the SEE countries. Among the studied countries, municipalities in the RS and in Croatia stand out for relying mainly on own source revenues, while municipalities in Kosovo and Albania are highly dependent on grants and transfers. However, a closer review reveals significant variations within countries. For example, small and medium size municipalities in Macedonia receive a high share of their revenues from grants and transfers, while larger municipalities rely mostly on own-source and shared revenues. In Montenegro on the other hand, municipalities appear to have a more balanced mix of own-source revenues, grants and transfers, and borrowing, although with significant differences across municipalities of different size. For example, we observe 'forced borrowing' to cover deficits in smaller municipalities, while own-source revenues dominate the large ones (see Figure 18). However, the analysis needs to take into account the differences in reporting revenues among countries,

as Montenegro was one of the most detailed and complete sets of data. A comparison of variations of total revenue sources by city size across all MFR countries can be found in Annex 1.

Local government own source revenues vary hugely within the countries. Factors such as the local economic base and property values, among others, determine the room for collecting property related taxes or business fees. For instance, property values tend to be higher in larger municipalities when compared to small municipalities. As a result, own source revenue potential differs across local governments. In Albania, for example, it is possible to see how the share of own source revenues to total revenues increases with the city size, while the share of grants and transfers decreases (see Figure 19). The same is true for the RS and Kosovo. Figure 19 also presents the mean tax revenue per capita across different city sizes in Albania, suggesting that bigger municipalities tend to have higher per capita tax revenues compared to municipalities with a smaller population.

However, own-source revenues are not necessarily concentrated in the biggest municipalities. While in some countries, e.g. Croatia and

Kosovo, we find a high concentration of own-source revenues in the larger centers, this is not a consistent pattern across the SEE Region. In Croatia, municipalities with more than 200,000 inhabitants represent around 45% of the total own source revenues of local governments, while they are home to only around 18% of the population. Similar results are found in Kosovo. In Albania, Macedonia and Montenegro, on the other hand, medium size municipalities concentrate most of the countries' own-source revenues—despite the lower per capita own-source revenues in those smaller municipalities (see Figure 20; for per capita revenues, see Annex 2). This is mainly the result of the large number of medium size municipalities in this latter group of countries.

Smaller municipalities seem to underutilize fees and charges in Macedonia and Montenegro. While fees and charges account for a comparable share of total local revenues across municipalities of different size in most of the SEE countries, findings suggest that municipalities with a population smaller than 10,000 have significant revenue enhancement potential in Macedonia and Montenegro. Noteworthy is that municipalities in Montenegro appear to

Figure 18: Variations in local revenues by population size of municipalities (Macedonia and Montenegro)

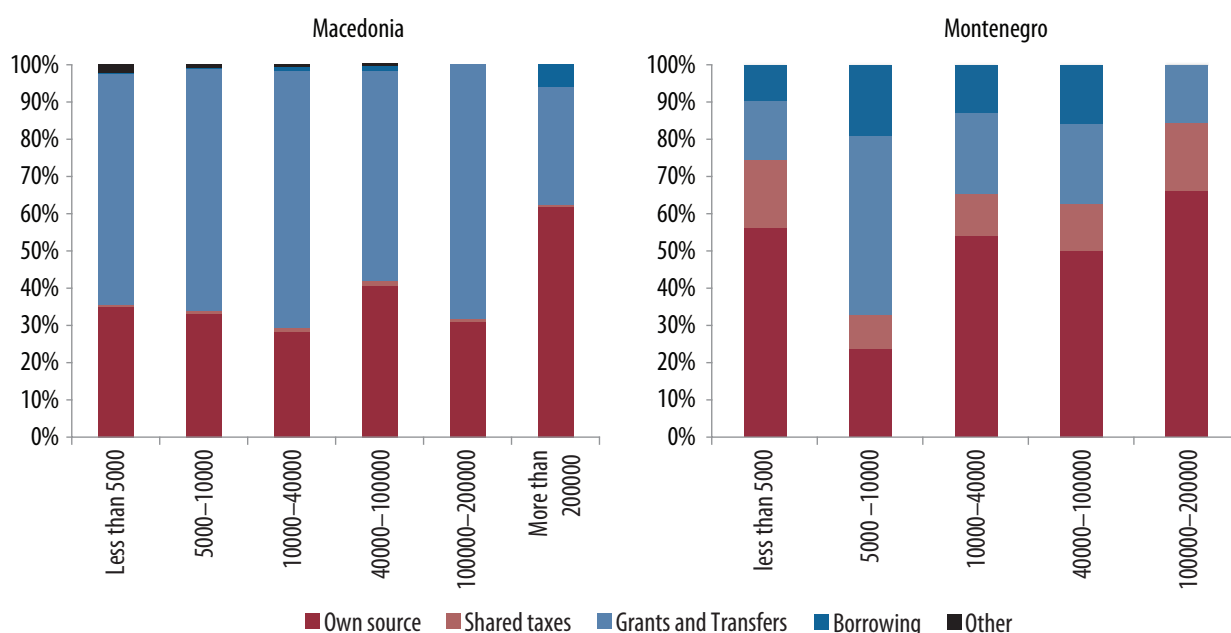
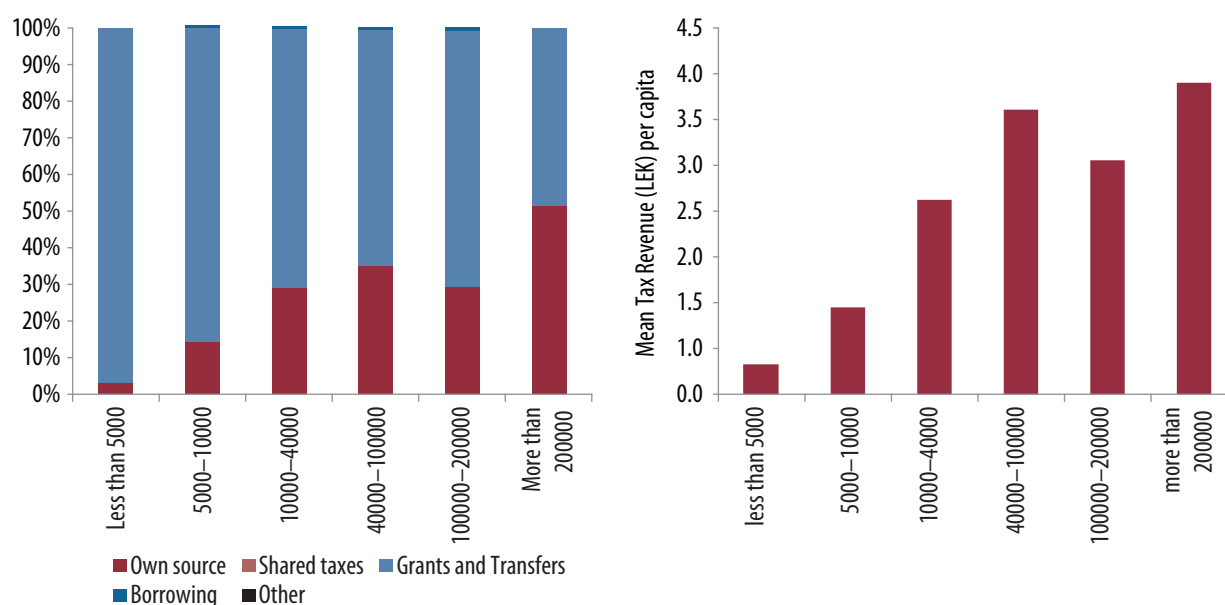


Figure 19: Variations in own source revenue (left) and mean per capita tax revenue (right) by city size in Albania

compensate smaller revenues from fees and charges with a larger tax income, while similarly sized municipalities in Macedonia have significantly higher capital revenues.

Expenditure variations are largely caused by the service function concentration in geographical centers. For example, in Albania, half of the total local public education spending is made in Tirana. In the

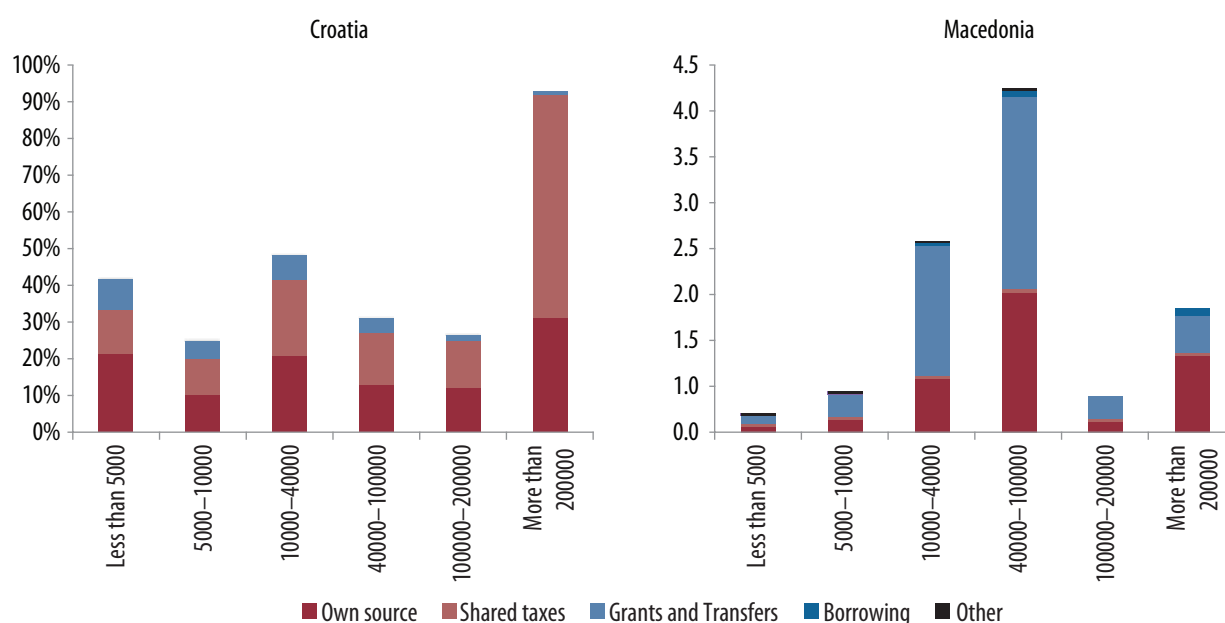
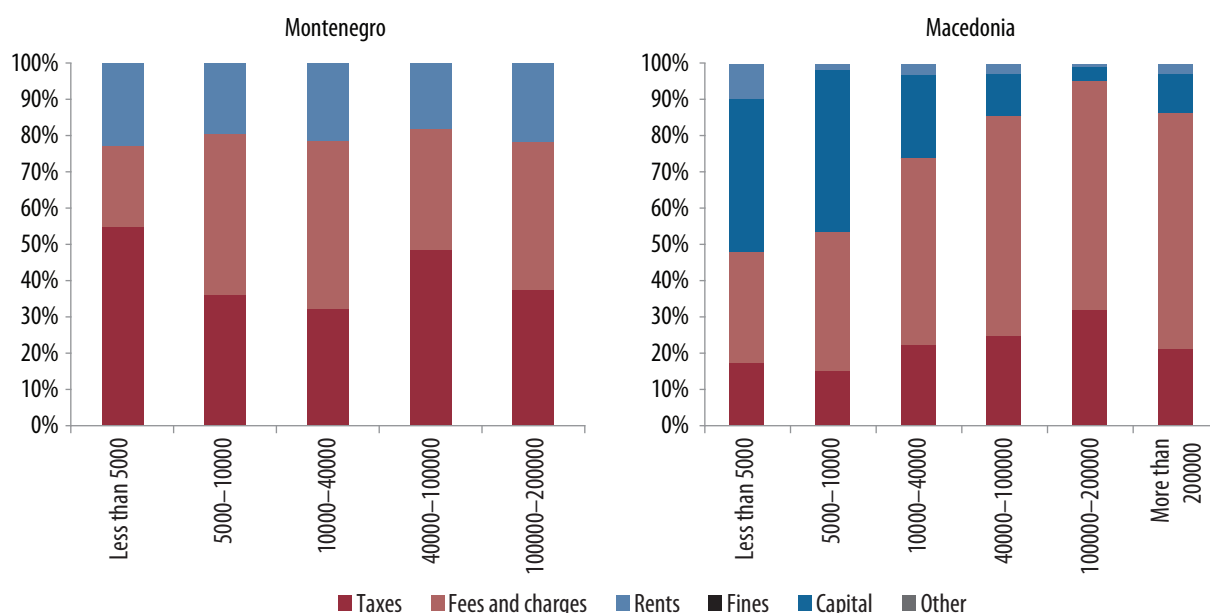
Figure 20: Geographic concentration of total revenues by city size

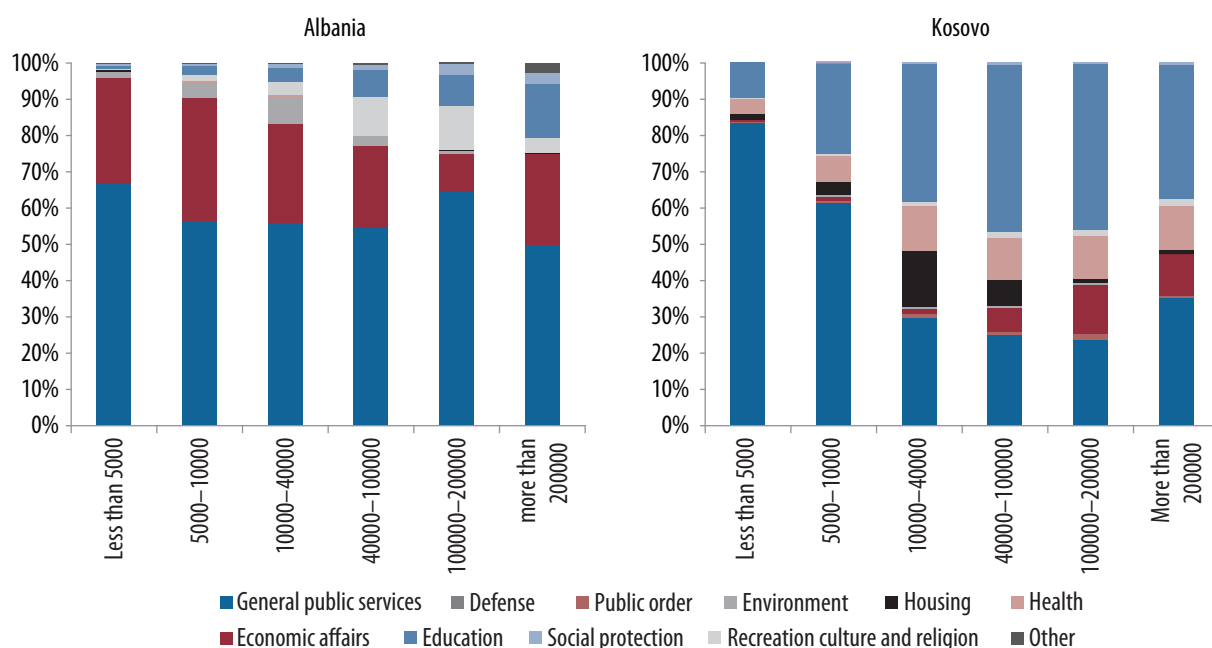
Figure 21: Composition of own-source revenues by size of municipalities (Macedonia and Montenegro)

Federation of BiH, water services (housing and community amenities), health care, recreational, sports and culture, and social protection services are concentrated in Sarajevo and the cantonal main cities. By and large, findings suggest that the share of general public service expenditure of total local expenditure increases with decreasing size of municipalities, in particular in Croatia, Kosovo, and Macedonia; but less so in Albania and Montenegro where this expenditure category shows a more equal distribution across municipalities of different sizes (Albania) or larger variations (Montenegro). Overall, a limited degree of functional assignments at the local level results in a large share of general public expenditures.

However, asymmetric functional assignments amplify variations. For example, during the decentralization process in Croatia, local government functions were devolved to the city level very selectively. Only the 32 financially stronger municipalities were authorized to take over additional responsibilities, such as education, housing and community amenities. An example of such disparities can be seen in the following figures. From Figure 23, it is possible to see how Croatian municipalities with more than 200,000 inhabitants

spend a higher share of their expenditures in education compared with smaller municipalities. Findings also suggest that large municipalities concentrate the bulk of expenditures in the education sector. In Macedonia, on the other hand, large municipalities spend much more on the housing and communal services category compared to smaller and medium-sized municipalities (Figure 24).

While the largest share of expenditures and revenues is usually concentrated in bigger municipalities, a per capita expenditure perspective provides nuances to this trend. Figure 25 presents variation on per capita expenditures for General Public Services in Kosovo. Findings suggest that as city size increases, there is a reduction in the mean per capita expenditures in this category. Furthermore, the analysis also finds that municipalities with less than 5,000 inhabitants have much higher spending than medium and big municipalities. A similar pattern can be found in the Federation of BiH. This might be a reflection of economies of scale, since smaller municipalities generally face higher per capita fixed costs for provision of a minimum service level. These results suggest that in some countries, existing expenditure assignments do not fully leverage economies of scale and a

Figure 22: Disparities of functional expenditure by size of municipalities in Albania and Kosovo

regionalization of some of the services may possibly support more efficient service provision.

Overall, per capita variations are largest in the RS, Croatia and Montenegro. In these three entities, variations of per capita own-source revenues, total revenues, and grants and transfers suggest large differences across sub-national governments (see Figure 26). At the same time, results from Albania, Kosovo and

Macedonia suggest overall lower dispersion of values for per capita own source revenues. In terms of per capita capital expenditures, the RS, Federation of BiH, and Montenegro present higher levels of dispersion.

4.1.2 Urban and rural

For Macedonia, categorization by urban-rural allows for additional analysis of the

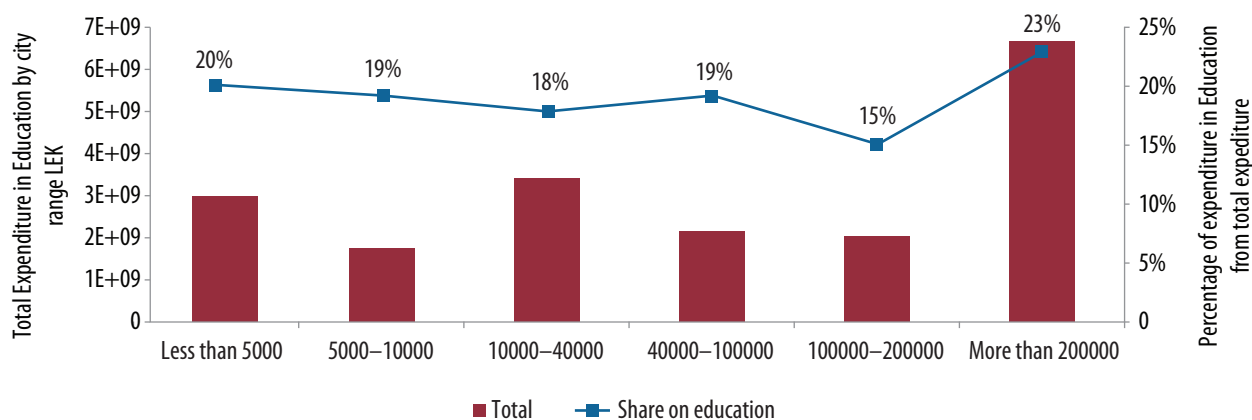
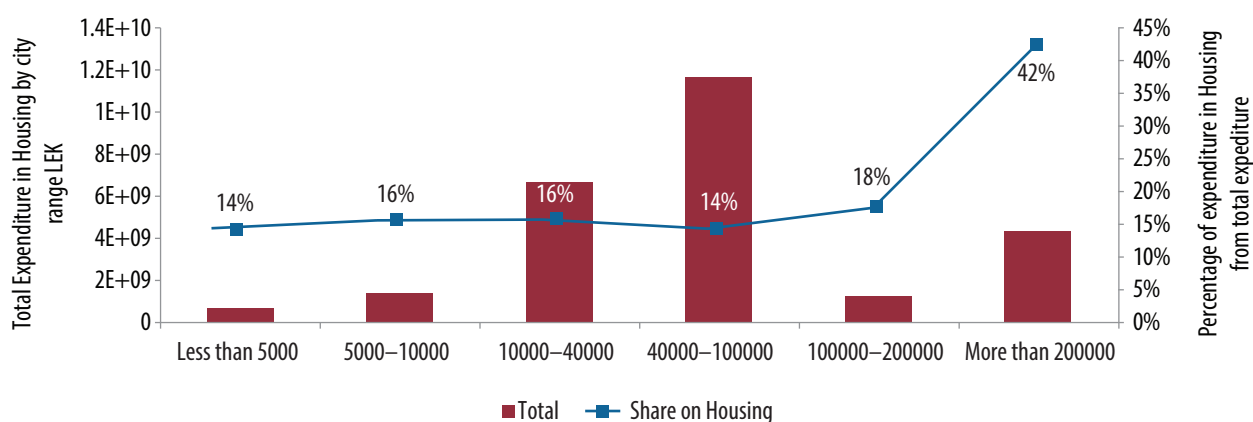
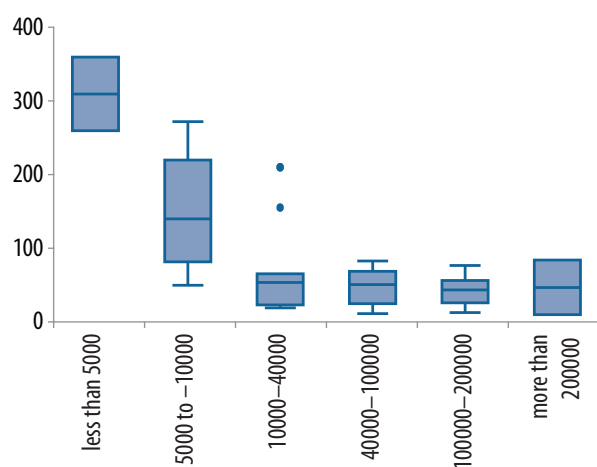
Figure 23: Variations in education expenditures by city size in Croatia

Figure 24: Variations in housing expenditures by city size in Macedonia**Figure 25: Variations on per capita expenditures in General Public Services within municipality ranges – Kosovo**

municipalities. Among the countries included in the MFR, Macedonia is the only that contains data on whether the sub-national government units are considered urban or rural. From the data, Macedonia has 41 rural municipalities and 44 urban municipalities. Urban municipalities have a minimum of 4,545 inhabitants while rural municipalities report a minimum of 1,322 inhabitants suggesting that there is some overlap in terms of population numbers. However the mean population density in urban areas (823 inhabitants

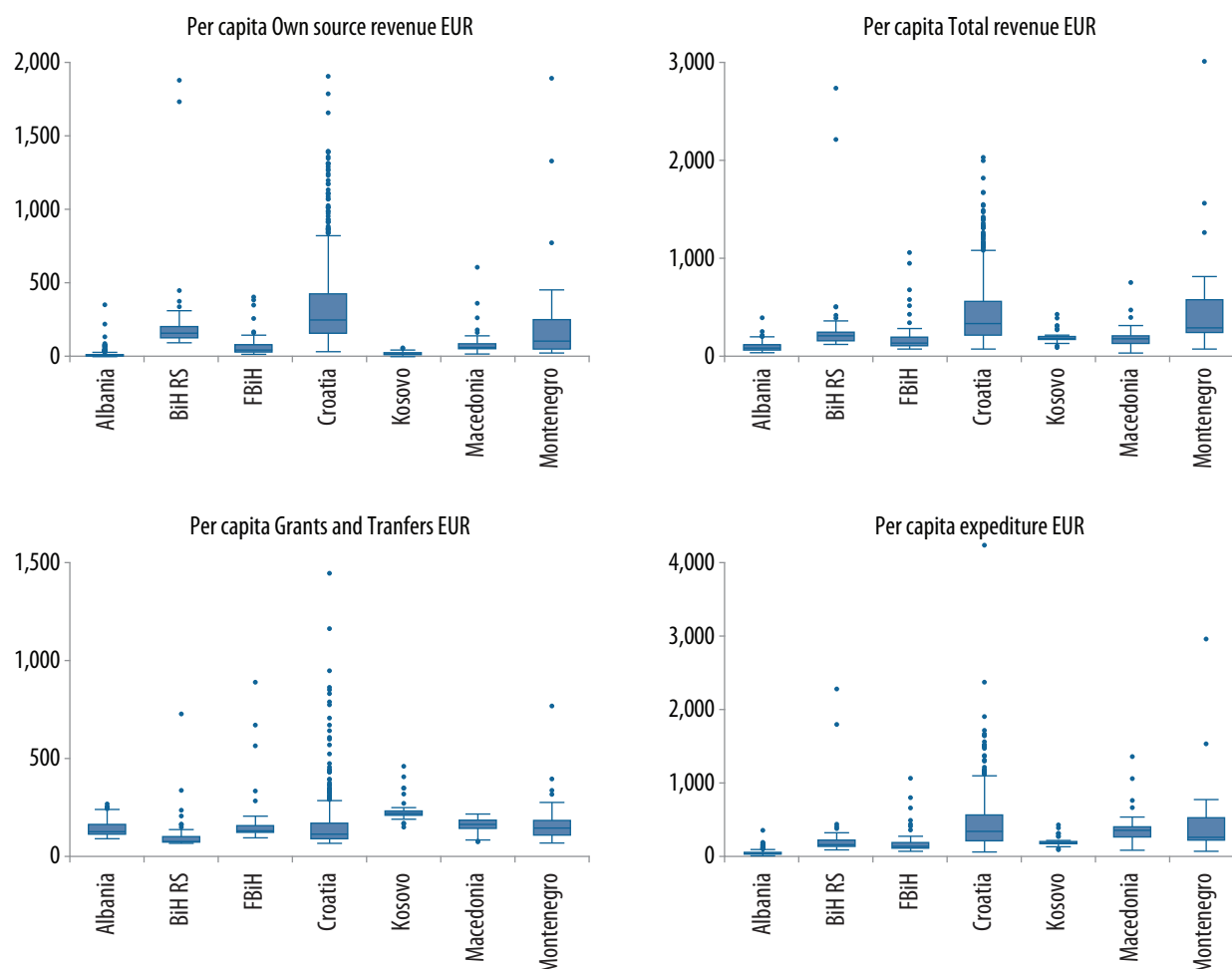
per km²) is much higher than in rural areas (64 inhabitants per km²).

Overall, urban areas generate a higher share of own-source revenues. As expected, there are considerable variations between urban and rural municipalities in the composition of total revenues, but also the share of own source revenues. In addition to the higher share of own-source revenues, urban municipalities also generate a higher percentage of own-source revenues from taxes, fees and charges.

More surprisingly, capital revenues are significantly higher in rural areas. However, this might be a reflection of the revenue enhancement potential in rural municipalities, which have not yet fully utilized their capacity to collect taxes, fees and charges. In addition, starting in 2009, Macedonian municipalities gained control over the land transactions which resulted in numerous sales of assets and increase in own-source revenues. Therefore, it is possible that capital sales in rural areas have a higher effect on their total revenues when compared to urban areas, which might explain the difference observed in Figure 27.

Functional and capital expenditures patterns also vary between urban and rural municipalities. For example, urban municipalities spend considerably more on housing, recreation and culture than their rural peers. However, rural municipalities have

Figure 26: Regional variations on per capita own source, total revenue, grants and transfers and total expenditures



higher per capita expenditure than urban municipalities in the functional categories of environmental protection, education, health and general public services. Housing is the only expenditure item in which urban municipalities spend more per capita compared to rural municipalities. This might be explained by larger economies of scale in urban municipalities. Rural municipalities tend to have lower densities which make service provision for selected public service areas more expensive; while smaller population size causes fixed costs to be divided among fewer people. Finally, although urban areas concentrate a larger share of total capital expenditure, per capita capital expenditures are slightly larger in rural municipalities.

4.1.3 Densities

Urban density partly explains disparities among local governments' expenditures in the SEE Region.

Density is relevant for the unitary cost of provision of selected municipal services, such as water supply and sanitation, solid waste management, and public transport, among others. In theory, as population densities decrease, it gets more expensive to provide those services. To evaluate how density affects per capita costs of service provision in SEE municipalities, we compare per capita functional expenditure for selected services (environment, housing, health and education) against the inverse of density. While expenditures might not be the best proxy for costs,

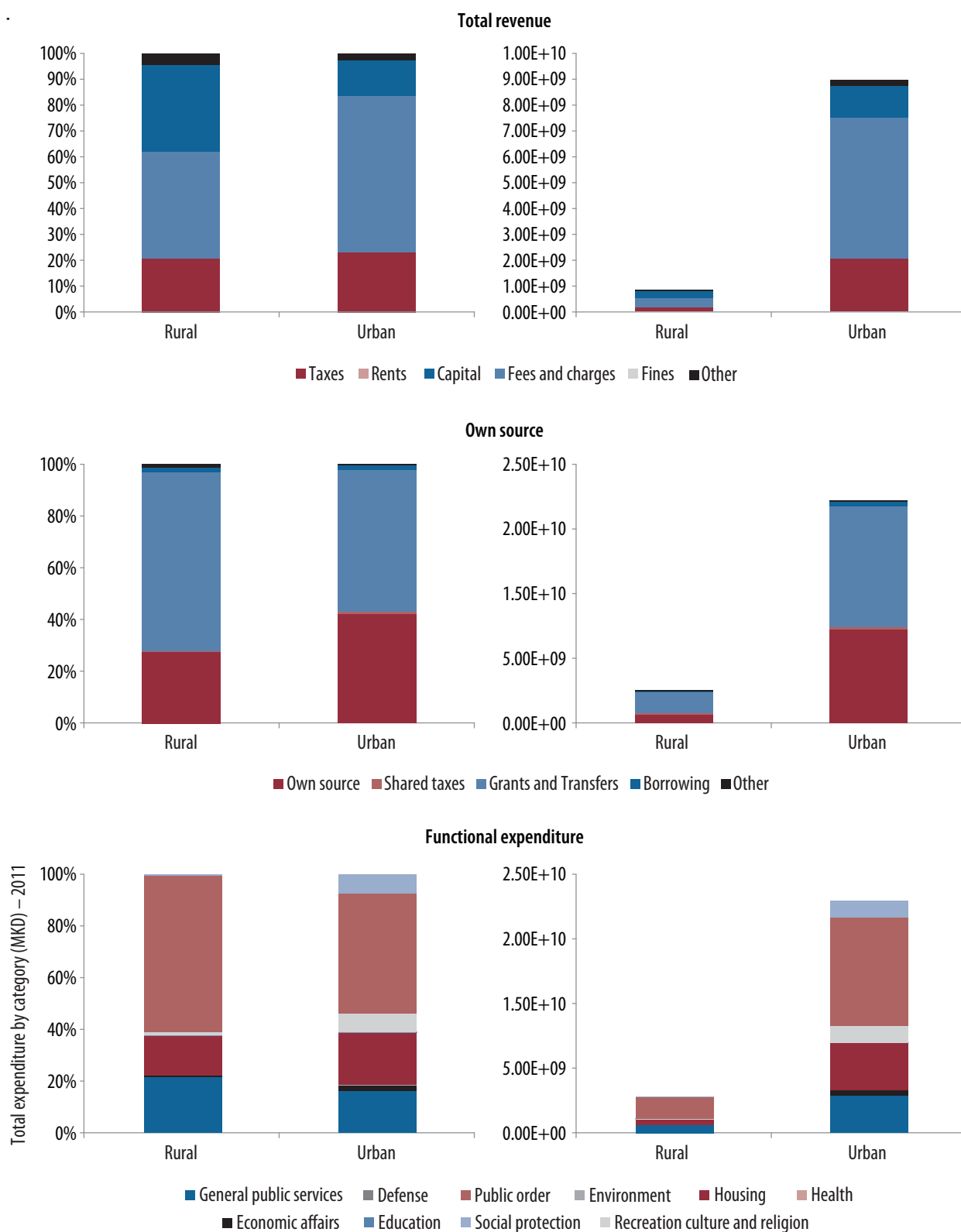
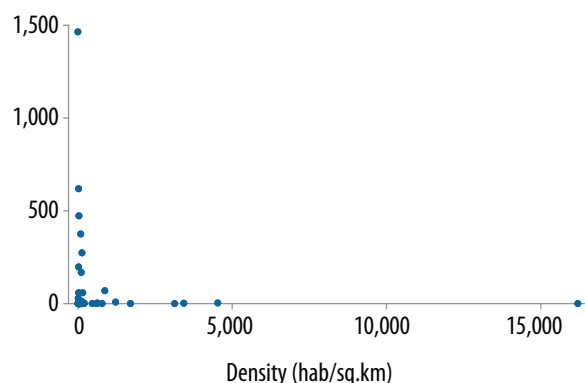
Figure 27: Variations between urban and rural municipalities in Macedonia


Figure 28: Density versus Environmental Protection per capita expenditures in Macedonia – 2011



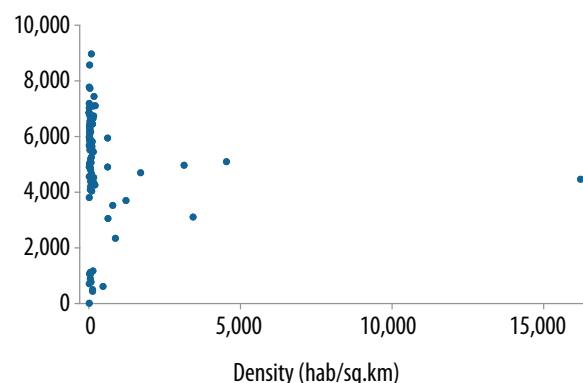
as they may include inefficiencies in services provision, they can provide a general idea of variations within a country.

Density effects can be observed predominantly on environmental protection expenditure, and less on health and education. In the case of Croatia and Macedonia, we find that increasing density correlates with a significant reduction in per capita expenditures for environment protection. A graphical visualization of this relationship for Macedonia can be seen in Figure 28. These results provide evidence to support the assumption that denser municipalities tend to have lower per capita cost for environmental protection expenditures. In the case of health, no significant relation was found between density and per capita expenditure in any of the countries analyzed in the MFR. In the case of education, a significant relation between per capita expenditures and density was found only for Croatia. Here, results suggest that as municipalities get denser, per capita costs of education increase. However, these results could reflect the fact that growing and larger municipalities tend to be both denser and have more responsibilities for the provision of higher levels of education.

4.2 CONCENTRATION IN CAPITAL INVESTMENT EXPENDITURE

Capital expenditures are concentrated in cities and larger municipalities. Although no major

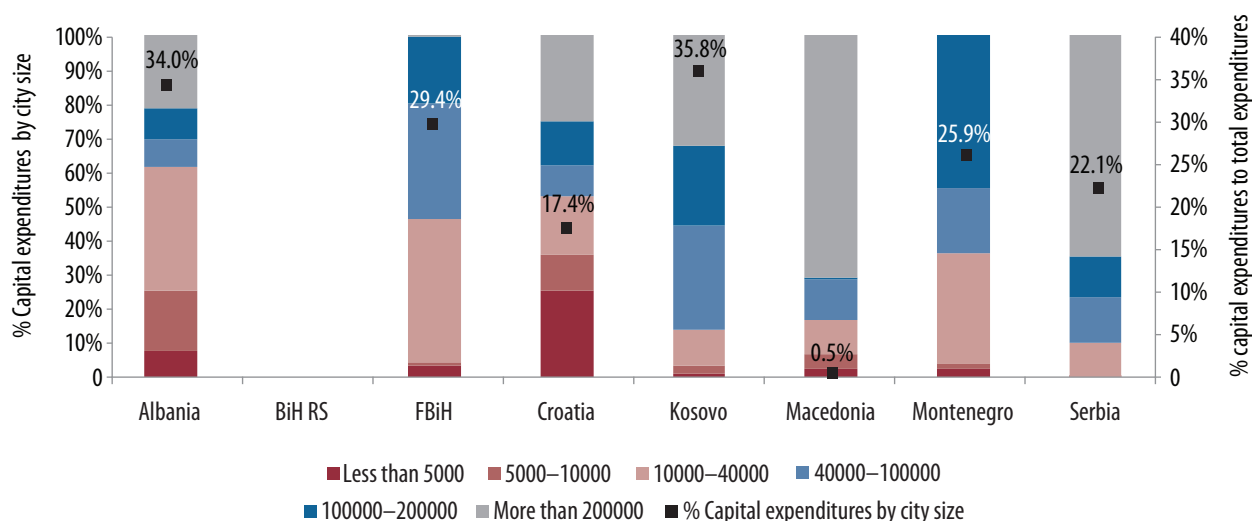
Figure 29: Density versus Education per capita expenditures in Macedonia – 2011



conclusions can be made from capital expenditure data limited to a one year period (here: 2011 or 2010, see Figure 30 below) and should be interpreted carefully, some observations can be noted. Overall, capital cities and other urban centers dominate capital spending across the SEE region, particularly in Serbia (Belgrade: 65%), Macedonia (Skopje: 71%) and Montenegro (Podgorica: 45%). Local capital expenditures are more evenly distributed in other countries, with the ratio of capital spending generally representing the proportional share of local budgets and population in the capital cities.

In Macedonia and Montenegro, large municipalities concentrate the highest share of total capital expenditures. For example, in Macedonia, 71% of total capital expenditures are concentrated in Skopje, the only municipality in the country with more than 200,000 inhabitants (see Figure 31). The mean per capita capital expenditures are also considerably higher in Skopje when compared to smaller municipalities in Macedonia. The concentration of mean per capita concentration can be seen more clearly in Figure 31, comparing total capital expenditures, mean capital expenditures, and mean per capita capital expenditure per size range of municipalities.

In Albania, BiH and Croatia, mid-size municipalities account for the highest share of total capital expenditure. This concentration is the result of the

Figure 30: Regional variations on capital expenditures by city size and total share

large number of smaller and medium size municipalities in these countries. However, despite the similar share of total capital expenditure in these countries, the share of capital expenditure to total local expenditure varies significantly: from only 0.5% in Macedonia to over 35% in Kosovo.

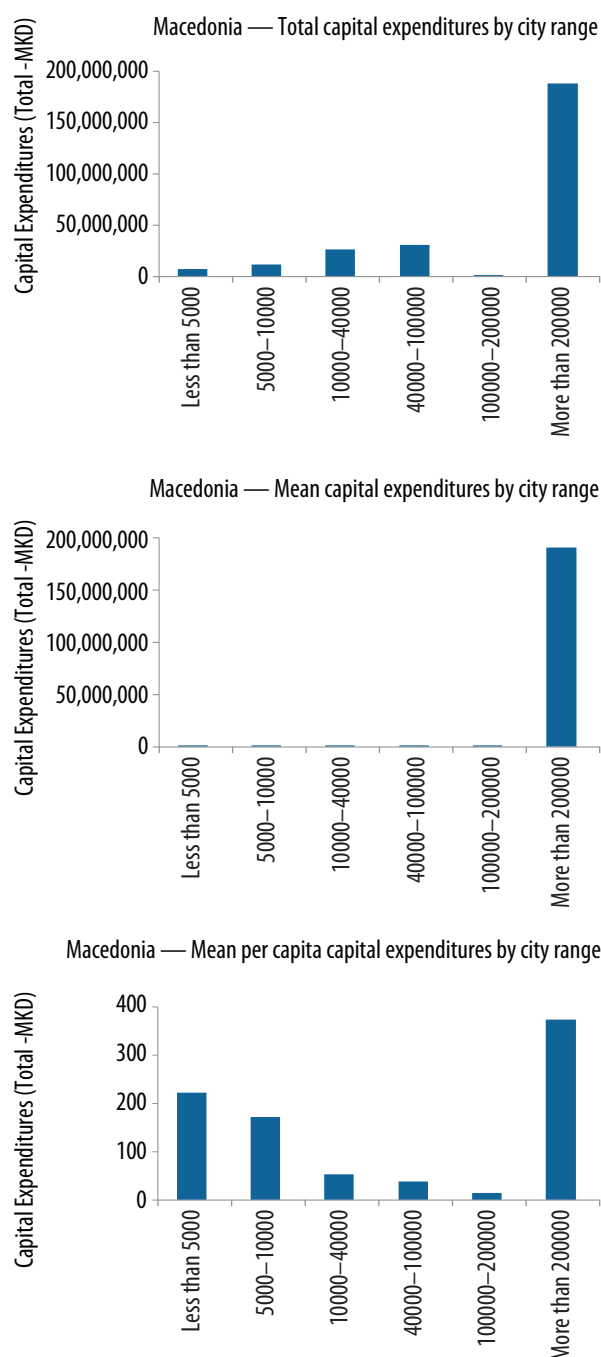
However, detailed analysis reveals large variations between total and per capita capital expenditures. For Albania, a similar analysis but with very different results can be seen in Figure 32. In this case, the biggest share of total capital expenditures is concentrated in municipalities with 10,000–40,000 inhabitants. However, the largest mean capital expenditure can be found in municipalities ranging with more than 200,000 inhabitants (Durrës and Tirana). The per capita capital expenditures analysis reveals a more or less homogenous national scenario, although Durrës and Tirana—the two biggest cities in Albania—have the highest per capita capital expenditure. In Kosovo, large municipalities concentrate the highest share of capital expenditure and present the highest average of capital expenditure. However, small municipalities have much higher per capita capital expenditures.

Generally, the scope of local capital expenditures varies with the level of economic development.

Capital expenditures constitute a major part of local expenditure in the SEE region. Municipalities spend more than 25% of their available funds on capital investments (see Figure 33), with the exception of Croatia (17%). Overall, local capital expenditures per capita vary between EUR48 in Albania and EUR459 in Croatia, or 2.2% and 6.8% percent of GDP. Overall, variations in local capital expenditure levels are in line with the differences in economic development. However, Kosovo is a noteworthy exception: per capita local capital expenditure is above the average at 8.4% percent. In addition, it is important to highlight that the data used for this analysis might underestimate the total scale of local investments, since some are executed locally but financed by the central government. This latter type does not appear on local governments' books.

However, functional assignments and funding mechanisms have a large influence. Findings from the MFR sample suggest that local governments in more decentralized countries spend more on capital expenditures than their peers in less decentralized countries. For example, the share of local capital expenditures in percentage of GDP is very similar in Macedonia, Serbia and Croatia, despite the different income levels (see Table 12). However, this

Figure 31: Macedonia: variations on capital expenditures, Skopje dominating



contradicts with findings from a recent global analysis which suggests that the level of public investment is not directly related to the overall degree of a country's level of centralization or decentralization;

or whether countries have unitary or federal organizational structure.¹²

Local governments only generate a fraction of local capital investment funds from own sources. Only a small share of local investments is financed from own capital revenues. Local capital revenues, were they were reported separately (RS, Croatia and Macedonia), constitute between 1.6 and 17.9 percent of local own revenues. Macedonia is an exception, with own source capital revenues representing around 15% of the local budget in 2011. The latter can be explained by the transfer of land ownership to municipalities which started in 2009 and allowed local governments in Macedonia to be in charge of the transactions of their assets.¹³ Predominantly, capital investments are financed by grants from the central budget, extra-budgetary funds, funding from international development programs, or municipal borrowing. Municipalities also use current budget surpluses to finance capital investments. Public companies, utilities or special asset management units are also active in financing local capital investment projects.

4.3 THE ROLE OF CAPITAL CITIES

Capital cities dominate total sub-national expenditures. In the countries of former Yugoslavia, the member republics' large urban centers usually became the new capital cities. These larger cities have often inherited extended service networks with better quality as a result of the capital investments and development programs concentration under the socialist regime. Spatial concentration of local expenditures in the capital cities is especially prevalent Albania (Tirana), Bosnia and Herzegovina (Sarajevo) and Serbia (Belgrade), where the share of local expenditures significantly exceeds the population share living in the capital. In addition, in all of the SEE countries, except Albania and Croatia, there is a disproportionate concentration of capital expenditures in capital cities as can be seen in Figure 33. This might be explained partly by the fact that most

¹² Frank, Jonas and Martinez-Vazquez, Jorge (eds.). 2013. "Decentralization and Infrastructure: From Gaps to Solutions". Georgia State University and World Bank, forthcoming.

¹³ This was previously under the National Government's control.

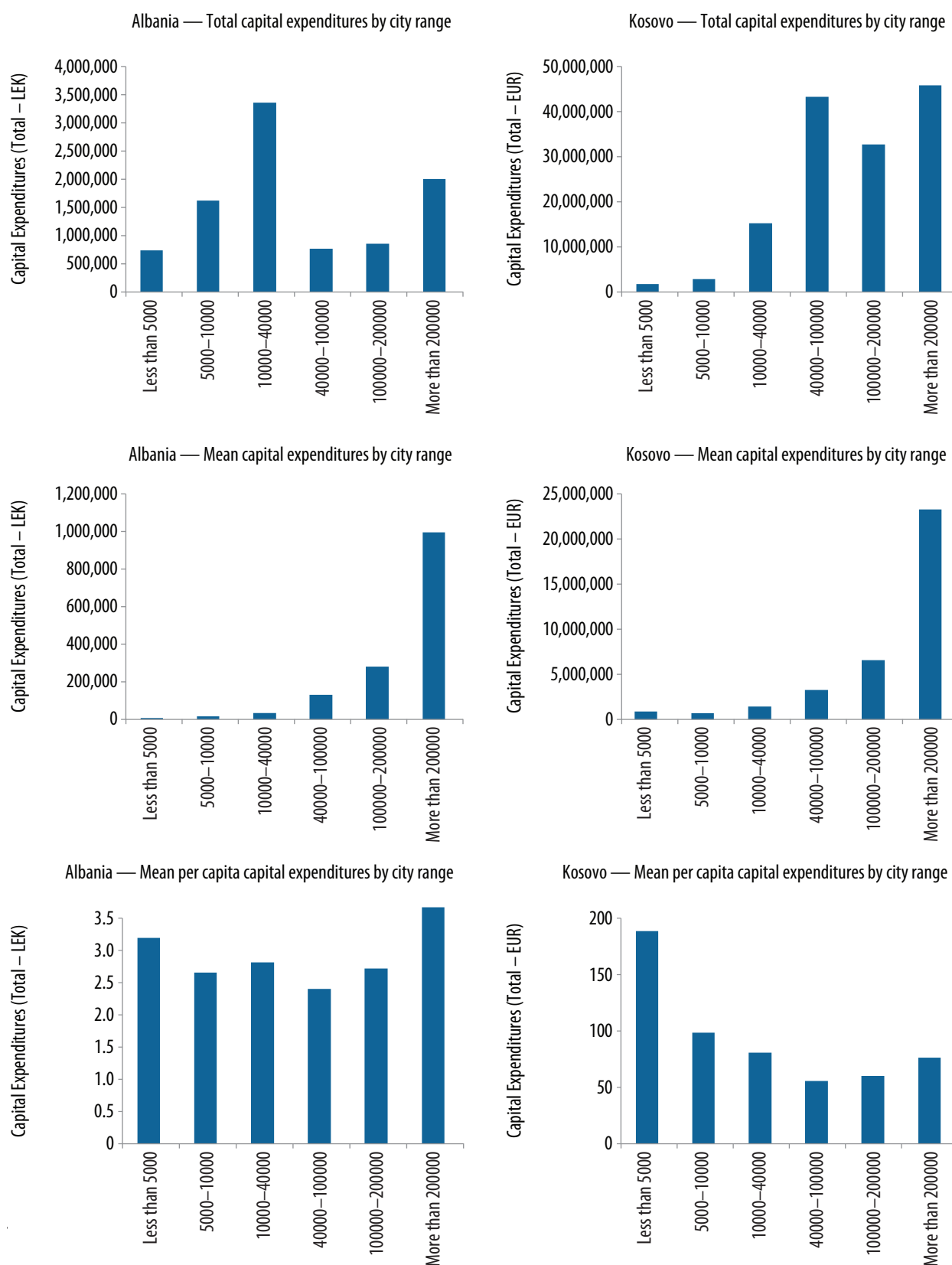
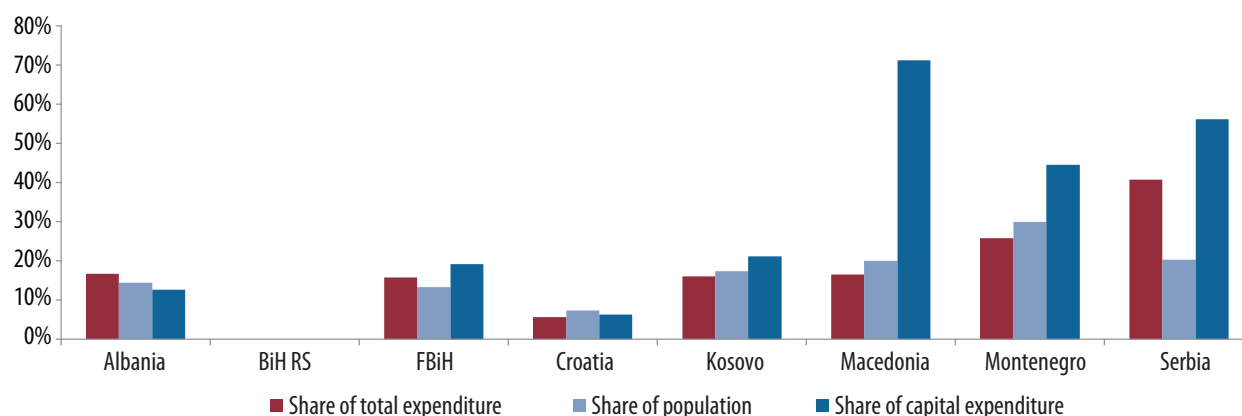
Figure 32: Albania and Kosovo: variations on capital expenditures, three different stories


Figure 33: Concentration of expenditures and population in the capital city

of these cities have additional public service delivery responsibilities given their importance in the national spatial structure.

Serbia and Macedonia are exceptional cases even among countries with the highest concentration.

In Belgrade, local spending is more than two times higher than the share of local residents: 44.6% of overall local government budget is spent in the capital city, while only 20% of the population lives in Belgrade. Skopje, in Macedonia, concentrates more than 70% of total capital expenditure in the country. Immigration from other countries of the former Yugoslavia might partially explain the concentration in the Belgrade. However, Serbia has a balanced urban network with other major cities, e.g., Novi Sad, Nis, and Kragujevac, proportionally located in the country, so the high concentration of public funds is more likely a consequence of the inherited urban services and the low level of fiscal equalization. Recently, the share of income tax reallocated to local governments in Serbia was doubled to 80%, which will further increase the differences among local governments. Personal income tax is primarily raised in the cities, so they will benefit the most from these new PIT sharing rules, although the sharing ratio in Belgrade was set at a slightly lower level (70%). The large share of capital expenditure in Skopje is likely to be explained by the large scale Government investment program in the capital city, also known as “Skopje 2014”.

However, by and large, capital cities’ budgets reflect the population ratios. Beyond Macedonia, Montenegro and Serbia, in the other countries, capital cities do not dominate the aggregate local budgets to the same extent. Their share in spending is proportional to their population size, which is below one fifth of the country’s total population (except Podgorica). The census data are outdated in some cases (Bosnia and Herzegovina, Macedonia), which might modify these proportions.

More and often better services drive higher per capita expenditure in SEE capitals. Many specific urban services are available only, or to a much larger degree, in the capital cities, including public transportation and other main infrastructure services, but also health and cultural services, including for citizens residing outside the capital, such as theaters, hospitals, and museums. In Macedonia, most of the local utility and communal service expenditures are concentrated in the capital (Skopje and its 10 comprising municipalities). In Zagreb, the shares of local spending on economic affairs (public transportation), community amenities (water supply management) and education are higher than the overall ratio of the city budget in the country. Similarly, Tirana dominates in the housing and community services (typically water supply, street lighting), public education and social protection. Prishtina is characterized by a higher proportion of general public services. Sarajevo is a special case, because most of

TABLE 12: LOCAL PER CAPITA EXPENDITURES – 2011

	General government expenditures in % of GDP	Local Expenditures as % of GDP	Local Expenditures as % of General Government Expenditures	Mean local expenditures per capita 2011* EUR
Albania	28.5%	2.2%	8.8%	48
BiH RS	49.2%	NA	NA	243
FBiH				191
Croatia	42.5%	6.8%	16.6%	459
Kosovo	30.0%	8.4%	48.6%	197
Macedonia	31.2%	5.6%	20.4%	367
Montenegro	43.8%	3.9%	8.5%	506
Serbia	45.2%	6.8%*	13.7%	290*

the municipal services are provided by the Sarajevo Canton. Unfortunately, no reliable fiscal data were available by functional classification from Belgrade.

At the same time, capitals benefit from larger property tax revenues. Across the SEE region, capital cities collect the lion share of property related revenues, including property taxes and fees, and communal charges levied on the property of businesses or residents. Overall, the concentration of property related revenues in the capital city exceeds both the share of population and the budget. They benefit from the disproportionate concentration of the tax base, but also typically higher property values, which puts the large capital cities into a favorable fiscal position.

4.4 LOCAL GOVERNMENT REVENUE AND EXPENDITURE TRENDS DURING THE PERIOD 2008–2011

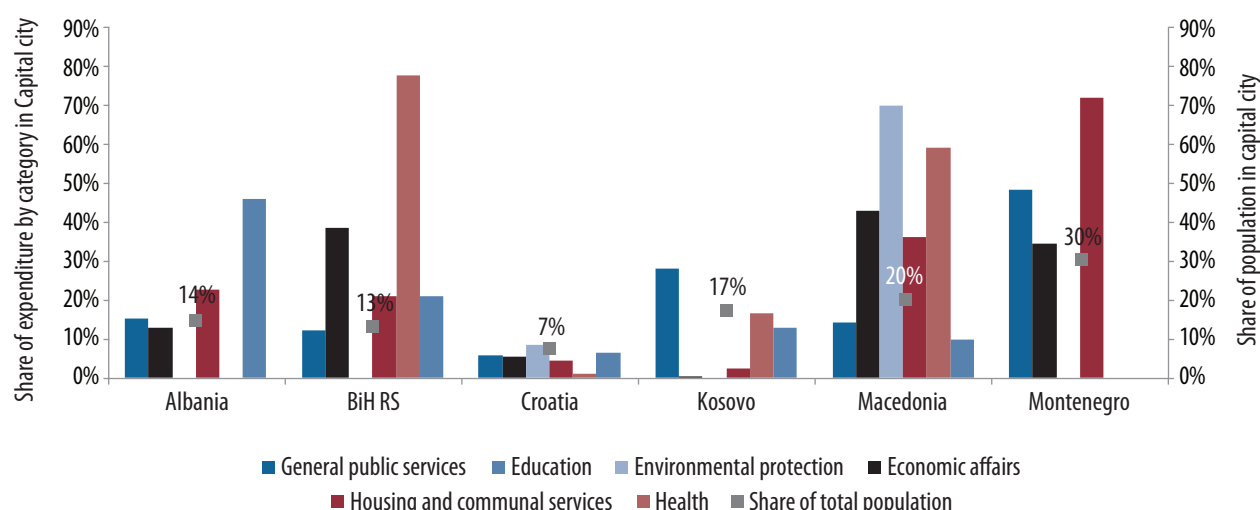
Sub-national governments could not avoid the economic crisis' fiscal implications. The economic crisis had a strong influence on public finances since 2008 and continues determining fiscal policies in the SEE region and beyond. During 2008–2011, the trend in local finances was similar in most of the European countries. At the end of 2008 and in 2009, the national governments tried to launch economic stimulus programs. They targeted local capital investments and the local election cycle has also helped to keep capital expenditures at a relatively high level. At the same time, spending on social

benefits and welfare programs were increased due to the higher unemployment.

Public expenditure reductions affected sub-national capital and current budgets. Despite initial counter-cyclical measures to soften the impact of the crisis, general government deficits and high public debt have forced most of the developed countries in Europe to halt expanding fiscal policies. Spending on personnel, goods and services were cut back or they were reduced in real terms, by allowing the nominal increases to be below the actual rate of inflation. During the crisis, local governments were faced with decreasing local property related tax revenues and some of the local business taxes were also abolished by the national economic recovery programs. As a reaction to the crisis, local governments had to search for new options of revenue mobilization and efficiency gains in local spending.¹⁴

Local governments in SEE felt the downturn at different points in time. The 2008 economic and financial crisis had a strong influence on public finances since 2008 and continues determining fiscal policies in the SEE region and beyond. From the data used for the MFR—which covers the period 2008–2011—it is not possible to clearly differentiate effects of the crisis from general structural trends. However, an analysis of the general revenue and expenditure trends over this period suggests that

¹⁴ Council of Europe, 2011: Local Government in critical times. Policies for crisis, recovery and a sustainable future. <https://wcd.coe.int/com.instranet.InstraServlet?command=com.instranet.CmdBlobGet&InstranetImage=2056216&SecMode=1&DocId=1873672&Usage=2>

Figure 34: Concentration of expenditures for different services in capital cities

some local governments might have been hit earlier by the fiscal restrictions and contracting economic outputs. Already in 2009, local expenditures dropped significantly in Montenegro (–18%) and in the RS (–8.6%); and decreased slightly in Serbia (–3.7%) compared to the previous year. In comparison, the crisis was delayed and less drastic in, e.g., Kosovo and Macedonia, but also Albania and Croatia. Particularly in Kosovo and Macedonia, local government expenditures continued to increase in real terms throughout this period, albeit with a slower pace. In Albania, local expenditures were still growing in 2009; and in Croatia, local expenditures did not decline—possibly due to the national elections in 2010 and increased EU funding that was made available to local authorities. However, cutbacks were more serious later in 2010 (–9.8%). These trends are also reflected by the changes in local expenditures as share of in GDP.

Those variations were driven mostly by different local capital investment trends. Capital expenditure was cut in Croatia, Montenegro and in the RS, while it increased or remained stable in the other countries during the first year of the crisis. Albania followed this pattern with one year delay, while others could keep (Kosovo) or even accelerate (Macedonia) capital spending by 2011. External sources of financing for local capital investments that was made available

to municipalities might explain the delayed reaction to the crisis. Capital cities followed the national trends, although with greater fluctuation.

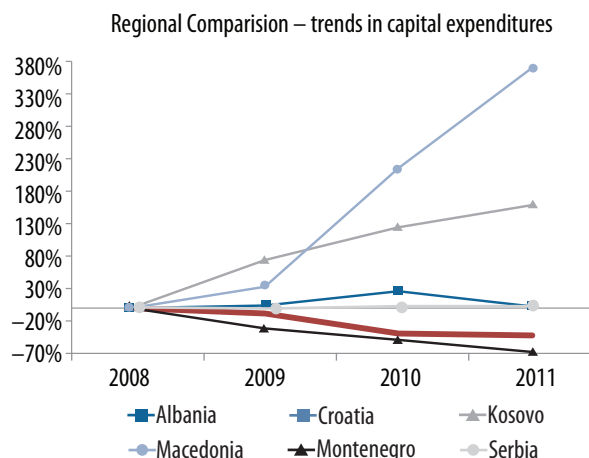
Large cities didn't necessarily do better than their smaller peers. For example, Prishtina (Kosovo) and Tirana (Albania) were hit harder by the crisis than other local governments in their countries, while Zagreb (Croatia), Podgorica (Montenegro) and Belgrade (Serbia) seem to have done better during the first year of the crisis. Partly, this can be explained by the local revenue structure: Croatia and Serbia rely on shared revenues which automatically delayed the decline in resources. In Montenegro, however, coastal municipalities, which dominate total local expenditures, had a more sudden fall in property related revenues. In Montenegro, where local expenditures fell drastically, at first, own revenues declined primarily in the Central region (outside Podgorica); and the shared PIT and property turnover tax in the Southern coastal region. Later, after 2009, these shared revenues partly recovered. The increase in grants from the equalization fund compensated the municipalities in the Central and the relatively poor Northern regions. The election cycle has also influenced capital city finances. For example, the political stalemate in Tirana delayed council authorization of the budget in 2010.

Municipalities in Montenegro and Macedonia sold assets or borrowed to cope with the revenue gaps. In Montenegro, for example, local governments have compensated revenue decrease with asset sales in the coastal cities, or borrowing in the poorer municipalities. Macedonian municipalities were able to maintain their own source revenues by following different policies in urban and rural municipalities. The immediate reaction of rural municipalities was to increase local fees. They also started to borrow from a very low base. Urban municipalities and Skopje, on the other hand, had the option to sell their assets. They also increased revenues from loans.

In Croatia, the capital city experienced the most severe fall in own revenues. Among the recurrent revenues, administrative fees and charges declined in Zagreb starting 2010, while they only began falling in 2011 in cities and municipalities. Capital revenues from sale of non-financial assets drastically declined in Zagreb in 2010, but quickly recovered in urban local governments, although not in small municipalities. Grants provided from the central following the general cuts in 2010 targeted primarily those smaller municipalities, but interestingly, also the capital city.

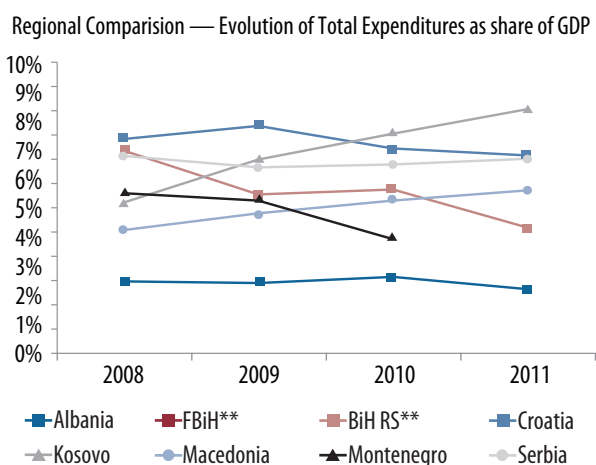
Local revenues in Albania and Kosovo were stabilized by transfers and grants. In Kosovo, local

Figure 36: Regional trends in local Governments capital expenditures 2008–2011



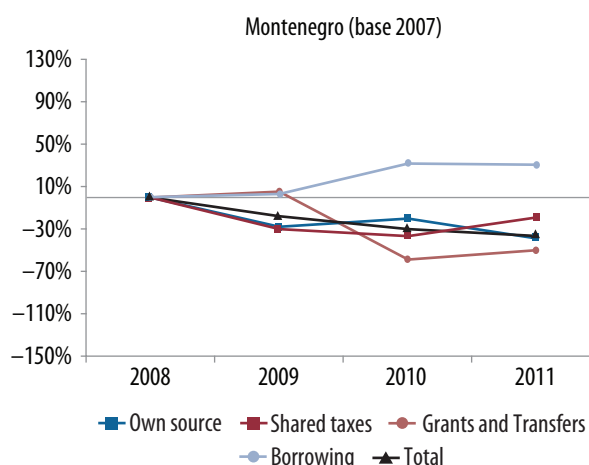
government own revenues recovered relatively soon after their fall in 2010. Prishtina seem to have been hit most by the economic downturn, causing a sharp fall in own source revenues, while local governments in the rest of the country were able to keep previous levels of own source revenues. But local government budgets in Kosovo are mostly financed by grants, which were stabilized at a lower level of growth, but still continued to increase in 2010–2011. Albanian sub-national governments faced restrictions with some delay since

Figure 35: Regional trends in local Governments expenditures 2008–2011



Source: Data for BiH from aggregate data and correspondent to share of total BiH GDP

Figure 37: Local revenue trends in Montenegro 2008–2011



unconditional transfers remained stable in 2009 and later, the cuts were spread equally among the different types of local governments. Local own revenues—mainly small business tax and the tax for building new infrastructure—started to decline first at the intermediary tier (*quark*) and in Tirana (from 2010), partly caused by the new national regulations on capping user charges, fees and limiting municipal borrowing.

Sub-national governments' approaches to compensate for the revenue decline are likely to affect their future position. Different responses across the SEE region provide some general lessons as how local governments were able to cope with the economic crisis. Cities with marketable assets chose to increase asset sales as the immediate reaction to the crisis. For example, in Macedonia, but also in Croatia first only in Zagreb, but recently in all other cities. Middle tier local governments in Albania lost their own source revenues, so probably they lacked the real incentives to go after these diverse and minor resources. Borrowing was a new option, which was used extensively first in rural, later in the urban municipalities of Macedonia.

4.5 INEQUALITY, EQUALIZATION, AND SELECTED TRENDS BY TYPES OF MUNICIPALITIES

4.5.1 Trends of increasing disparities and convergence

This subsection contains an analysis of inequalities looking at disaggregated data. The main purpose of this analysis is to review existing revenue and expenditures inequalities among municipalities and assess trends during the period 2008–2011. We use two approaches to evaluate trends in inequalities. The first approach consists of a quintile analysis in which municipalities are regrouped according to their per capita own source revenue in quintiles using 2008 as a reference year. Municipalities are considered “rich” within a country if they belong to the fifth quintile; and “poor” if they belong to the first quintile. The second approach consists of an analysis of the per capita revenue distribution

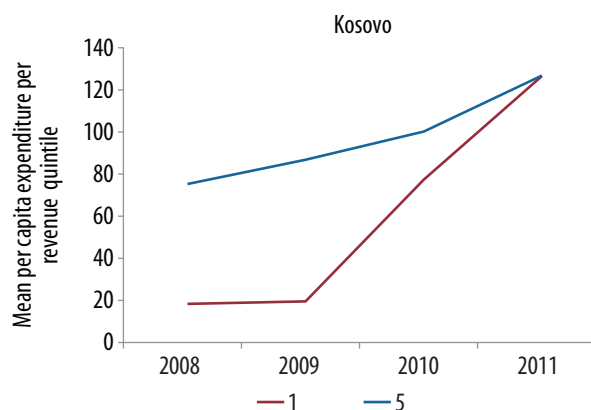
for every year, reproducing a *Gini* coefficient analysis.¹⁵ For the second approach, each municipality is treated as an individual and a country is considered as being highly unequal if the *Gini* coefficient is equal to 1. The *Gini* coefficient is calculated for own source revenues, total revenues, per capita own source revenues and per capita total revenues.

Poorer municipalities could not consistently catch-up with their richer peers. Per capita expenditure trends reveal increased disparities between rich and poor municipalities in some countries, and convergence in others. In Kosovo, poorest municipalities have achieved to close the gap to richer municipalities in their per capita expenditures (see Figure 38). In Macedonia, on the other hand, poorer municipalities have not achieved to close the gap. Here, per capita expenditure increased overall in parallel in the richest and poorest municipalities, despite with a slightly diverging trend. Worryingly, the spending difference between poor and rich municipalities grew considerably in Montenegro (see Figure 39). In Croatia, disparities were maintained during 2008 and 2011, and Albania experienced a slight increase in the gap between the poorest and the richest after 2010.

Spending patterns differ remarkably in municipalities with high and low per capita expenditure. In Kosovo, while there is convergence in per capita expenditures, poor and rich municipalities have very different spending priorities. Poor municipalities increased considerably their expenditures on health and general public services while, during the same period, rich municipalities increased their expenditures on environmental protection and housing. During the same period, expenditures from other categories, such as defense and public order, were reduced (see Figure 40). In Albania,

¹⁵ The Gini coefficient is a measure of statistical dispersion and measures the inequality among values of a distribution. For this exercise we calculate four different Gini coefficients using the following variables: (1) per capita own source revenue, (2) per capita total revenue, (3) own source revenue and (4) total revenue. The first two estimations are useful to evaluate if municipalities across the country have access to the same level of resources—taking into account their population—and if grants and transfers are playing a role in a reduction on the level of inequality. The second two estimations provide evidence on how municipal revenues are distributed in a country and might serve as a proxy of the level of urban primacy of a given country.

Figure 38: Converging trend in per-capita expenditures for poorest (1st Quintile) and richest (5th Quintile) – 2008 reference year



richest municipalities increased considerably their expenses in housing and “others” category while achieving to maintain their expenditures for almost all other categories. Poorest municipalities, on the contrary, experienced a reduction in most of the expenditures categories with social protection and health being the most affected sectors.

Per capita own-source revenue inequality increases in Albania, Kosovo, Montenegro, and the RS. Findings suggest a visible growth of per capita own-source revenue inequality during the period of analysis, measured by the *Gini* coefficient methodology.

In Croatia and Macedonia, results suggest a slight reduction in per capita own-source revenue inequalities during 2008 and 2011. Total per capita revenue inequalities grew in RS, Kosovo and Montenegro, but were reduced in Albania, Croatia and Macedonia. However, for all years and countries, except for the RS in 2009, the level of per capita revenue inequality is greater when computing own source revenues as opposed to general revenues, suggesting that equalization grants are working. The regional trends on per capita revenue inequalities using the Gini coefficient methodology can be found in Figure 42.

Own-source revenue inequality increases slightly in Albania and Kosovo. All of the other countries experienced a reduction in the level of own source inequality during the period 2008–2011 (see Figure 43). An interesting result is that the level of own source revenue inequalities is much higher than the level of per capita own source revenue inequalities. This finding suggests that, while there is a large concentration of resources in a number of municipalities, these resources are more or less proportionate to the population living there. Total revenue inequalities also grew in Albania, but were reduced or maintained in the other countries. In addition, for all years and countries, the level of revenue inequality is greater when computing own source revenues as opposed to general revenues, which in turn suggests again that equalization grants seem to be working as intended.

Figure 39: Diverging trends in per-capita expenditures for poorest (1st Quintile) and richest (5th Quintile) – 2008 reference year

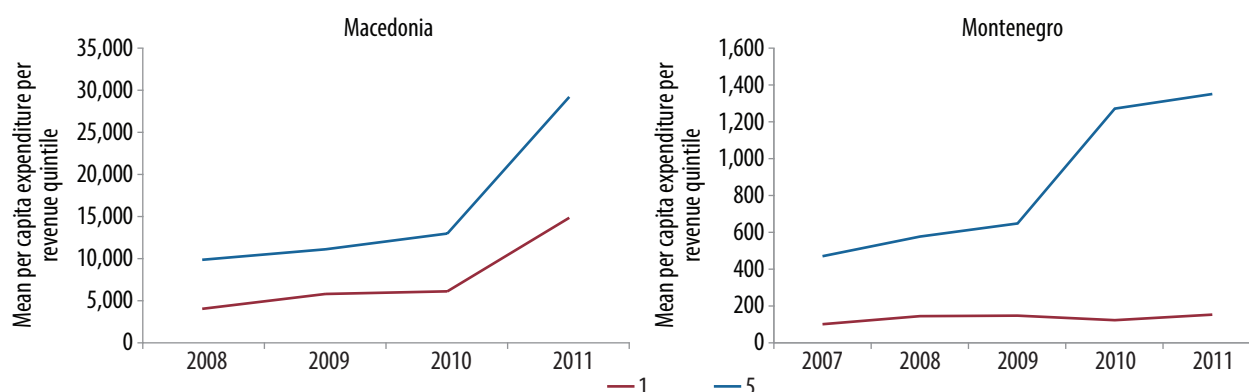
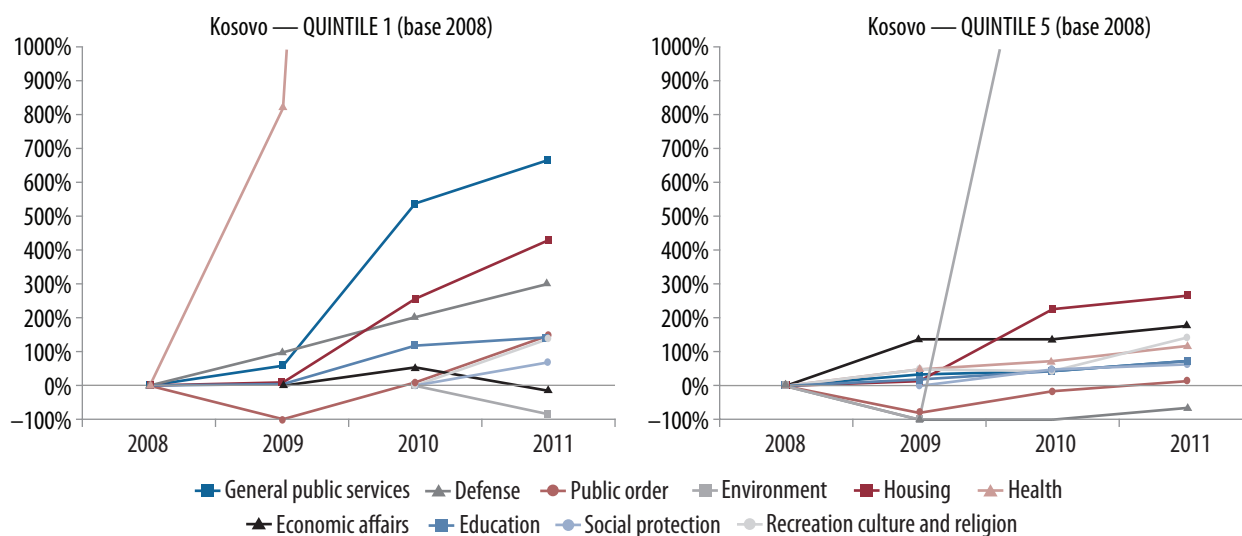


Figure 40: Trends in functional expenditures for poorest (1st Quintile) and richest (5th Quintile) in Kosovo – 2008 reference year



4.5.2 Equalization of expenditure needs and fiscal capacity

Overall, the general grant transfers, as utilized to an increasing extent, seem to meet equalization objectives across the SEE region. Unconditional budget transfers from central government may be

directed towards the equalization of expenditure needs or fiscal capacity. Differences in per capita grants may reflect efforts to equalize the underlying differences in expenditures needs arising from differences in size and composition of population and other, similar expenditure drivers. As appears from Table 13, generally, local governments with

Figure 41: Trends in functional expenditures for poorest (1st Quintile) and richest (5th Quintile) in Albania – 2008 reference year

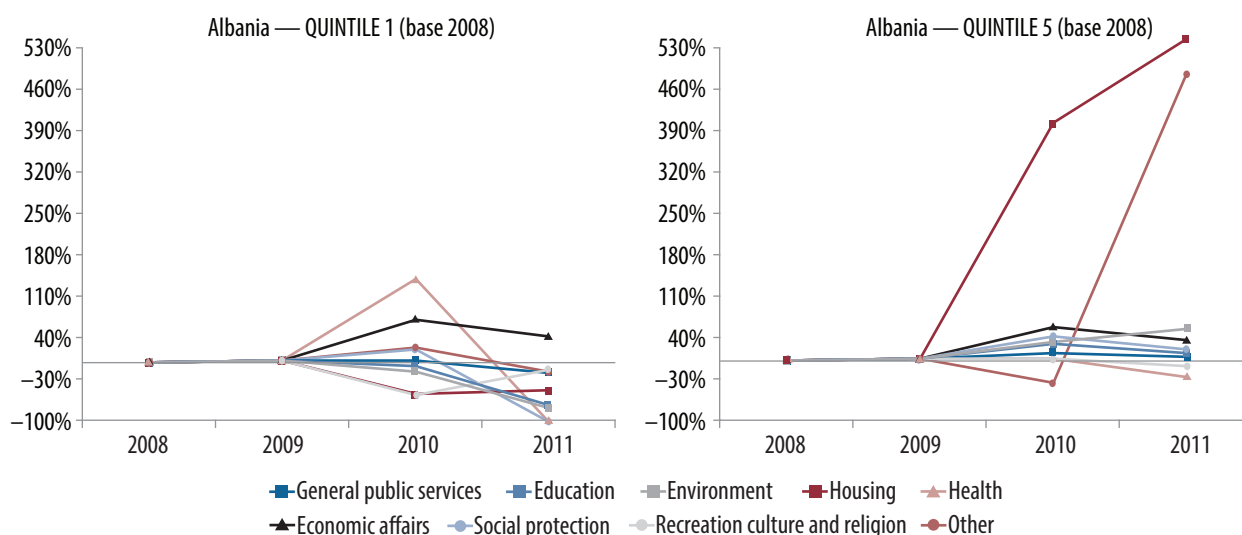
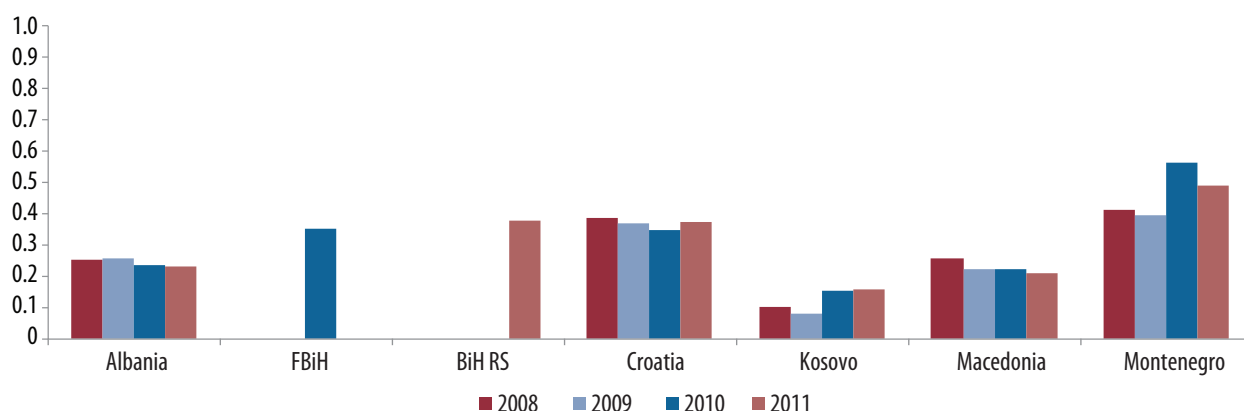


Figure 42: Regional trends of Local Governments' Gini coefficient – per capita Total Revenue

the highest amount of per capita transfer received 1.5–3.8 more than the average in the respective group of cities or municipalities in the majority of SEE countries. In addition, the level of grant per capita is decreasing by size of municipalities, reflecting the efforts to compensate for low fiscal capacity/higher expenditure needs in the smaller, often rural municipalities, which may not be in a position to afford service delivery without raising tax efforts excessively.

Per Capita Expenditure, own sources, and grant transfers by size of municipalities vary significantly across countries. Some highlights (see Table 14): In Albania and Kosovo, the per capita grant is by all measures the dominant fund source in the smaller municipalities, while in Montenegro and Macedonia, own fiscal efforts per capita is

an important, although not equal to grants, fund sources in the smaller municipalities. Expenditure variations and levels (expenditure needs), by size of municipalities vary across the countries—in Kosovo the per capita expenditure is *decreasing* by size of municipalities, implying that per capita spending in the largest municipalities amount to less than 50% of per capita spending in the smallest municipalities. Somewhat similar trend is observed in Montenegro. In Albania and Macedonia, on the other hand, while the per capita expenditure does not differ significant across the various sizes of municipalities in the two countries, a minor *increase* by size is observed in Albania, with expenditure spend of +20% in the largest municipalities. Finally, in Croatia, a somewhat similar pattern to Albania is observed, although the expenditure is much higher in the larger municipalities than in smaller.

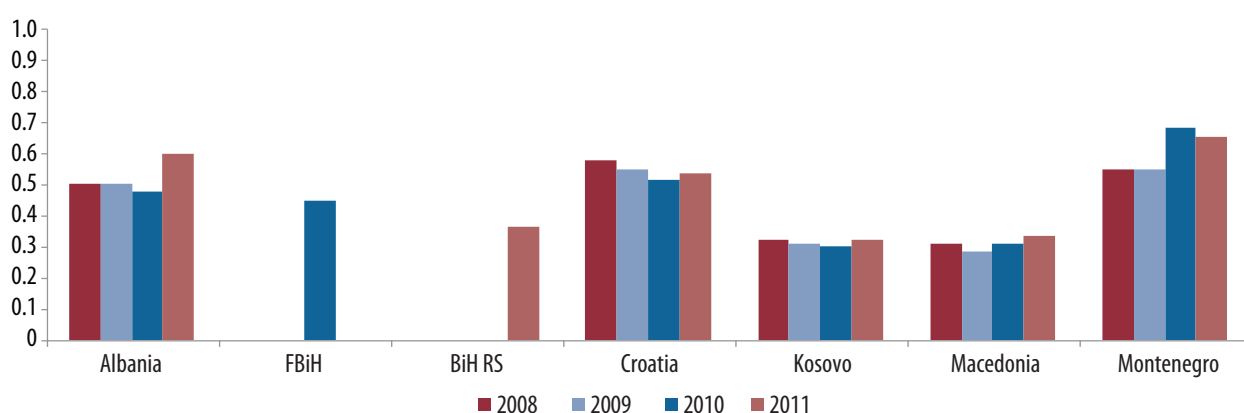
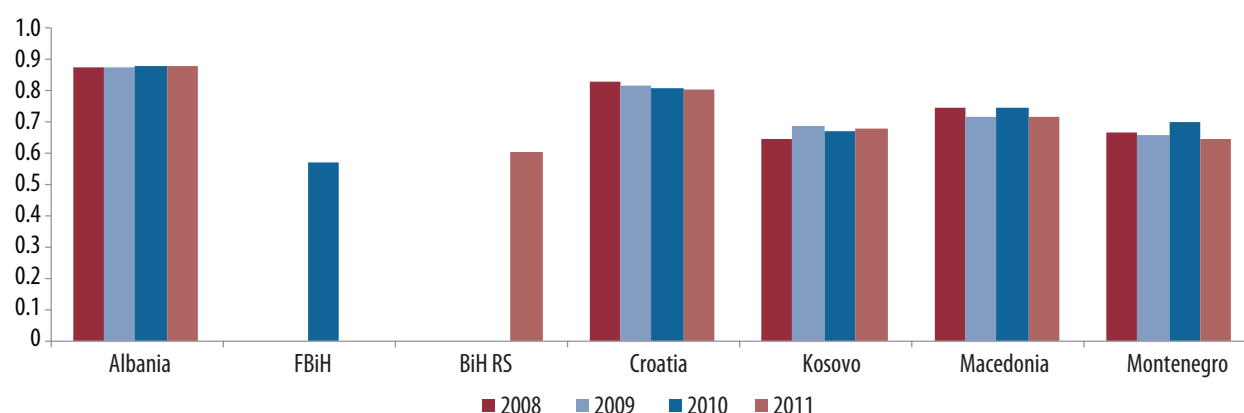
Figure 43: Regional trends of Local Governments' Gini coefficient – per capita Own Source Revenue

Figure 44: Regional trends of Local Governments' Gini coefficient – Own Source Revenue

These patterns in expenditure needs are reflected in the required need for 'gap filling' by the general grants from central government. In Kosovo, where expenditure needs per capita were highest in the smaller municipalities, the grant transfers, in absolute and as percentages, provide a core part of the funding, probably due to relatively low fiscal capacity. In Macedonia and Croatia, on the other hand, we do not see the same important role of the grant funding, in general, but also in the smaller municipalities.

4.5.3 Selected trends: who benefitted, who fell behind?

The local government finance architecture and intergovernmental fiscal relations has affected

municipalities differently in the SEE countries.

The following section provides selected insights in different revenue and expenditure trends by type of municipalities. The disaggregated data set collected by the MFR permits a more granulated analysis and allows for modeling the effects of policy decisions on different sub-sets of municipalities. The selected examples discussed in the following should be interpreted in a context of demonstrating analytical tools of the MFR data set, rather than as a basis for specific policy recommendations. To make specific suggestions for policy would require a more in-depth review of the variables influencing the trends discussed below.

Total revenue trends suggest large variations across municipalities of different size in Albania and

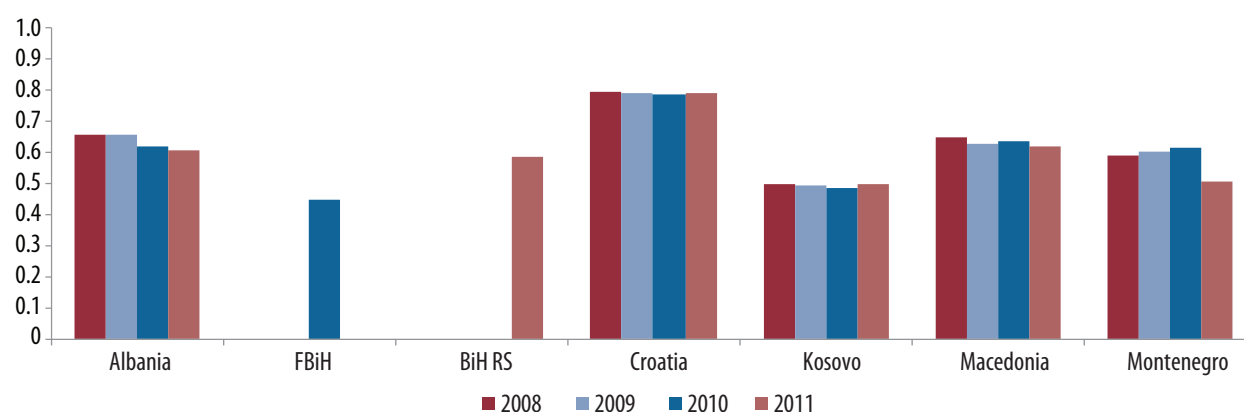
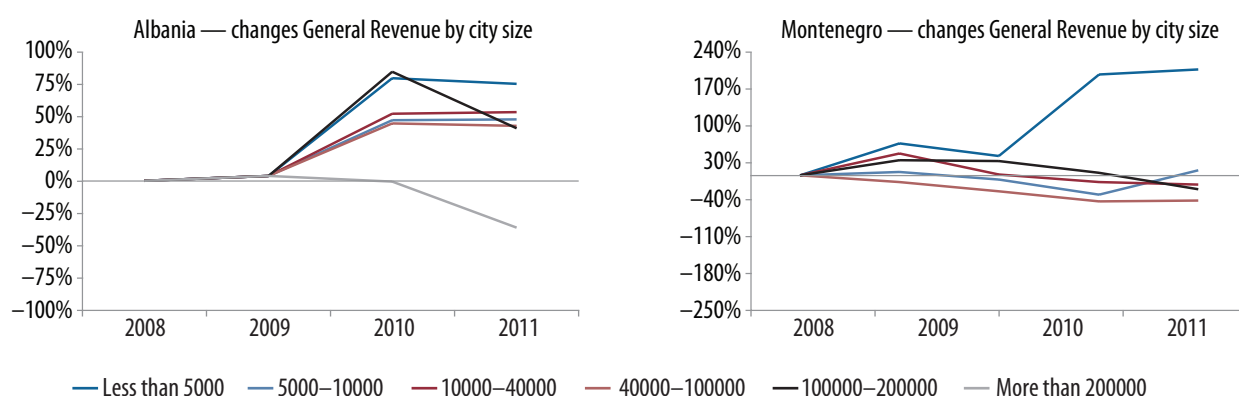
Figure 45: Regional trends of Local Governments' Gini coefficient – Total Revenue

TABLE 13: PER CAPITA GENERAL GRANTS BY SIZE OF LOCAL GOVERNMENT UNIT 2011 (FBIH: 2010)

	Size of Local Government Unit – EURO					
	less than 5000	5000–10000	10000–40000	40000–100000	100000–200000	more than 200000
Albania	109.2	63.2	56.3	56.0	64.8	36.4
BiH RS	119.8	21.3	15.5	6.1	4.6	
FBIH	413.0	89.7	77.8	58.0	54.5	
Croatia	106.9	78.0	65.8	68.6	36.4	10.5
Kosovo	364.9	230.8	175.2	166.9	156.3	124.4
Macedonia	107.4	113.5	99.4	98.9	128.0	41.9
Montenegro	359.4	220.5	87.3	56.8	45.0	

TABLE 14: PER CAPITA EXPENDITURE, OWN SOURCE, GRANTS AND TRANSFERS AND TOTAL REVENUE BY SIZE OF LOCAL GOVERNMENT UNIT 2011

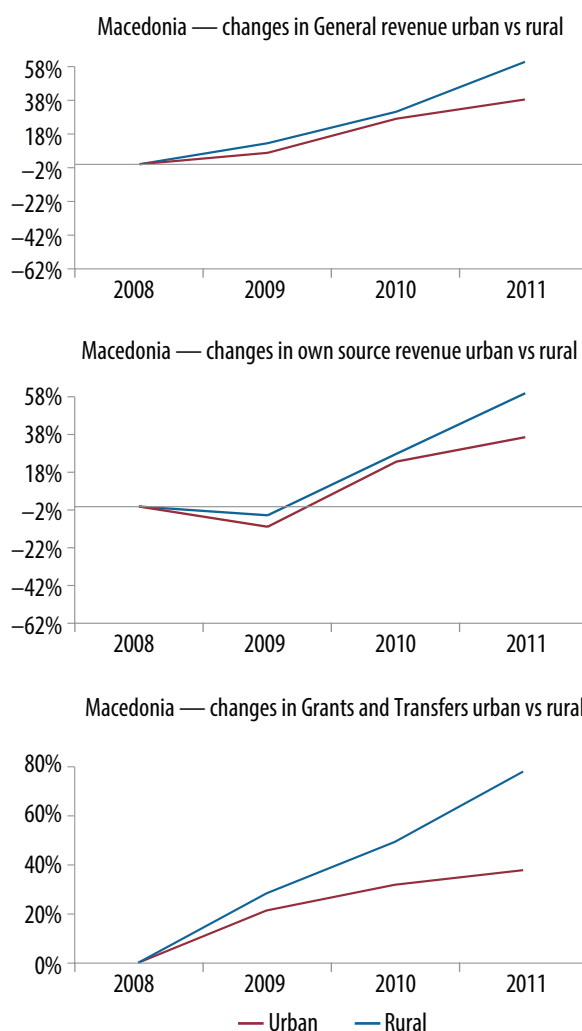
PER CAPITA	ALBANIA – Size of Local Government Unit – EURO						Average
	less than 5000	5000–10000	10000–40000	40000–100000	100000–200000	more than 200000	
Expenditure	50.6	41.4	48.9	59.0	62.5	67.5	55.0
Own source revenue	3.4	9.7	21.4	33.0	26.4	36.7	21.8
Grants and transfers	109.2	63.2	56.3	56.0	64.8	36.4	64.3
Total revenue	112.4	72.8	77.8	89.4	91.9	73.0	86.2
PER CAPITA	KOSOVO – Size of Local Government Unit – EURO						Average
	less than 5000	5000–10000	10000–40000	40000–100000	100000–200000	more than 200000	
Expenditure	372.3	235.6	196.0	185.2	182.6	165.4	222.8
Own source revenue	21.4	9.4	29.0	20.6	26.8	52.0	26.5
Grants and transfers	364.9	230.8	175.2	166.9	156.3	124.4	203.1
Total revenue	386.3	240.1	198.4	187.4	183.1	176.4	228.6
PER CAPITA	CROATIA – Size of Local Government Unit – EURO						Average
	less than 5000	5000–10000	10000–40000	40000–100000	100000–200000	more than 200000	
Expenditure	466.8	396.5	464.2	553.2	663.0	1148.4	508.8
Own source revenue	353.8	317.8	387.3	486.0	566.2	1107.7	536.5
Grants and transfers	106.9	78.0	65.8	68.6	36.4	10.5	61.0
Total revenue	460.1	394.9	453.1	554.6	602.5	1118.2	597.2
PER CAPITA	MACEDONIA – Size of Local Government Unit – EURO						Average
	less than 5000	5000–10000	10000–40000	40000–100000	100000–200000	more than 200000	
Expenditure	399.4	394.0	316.4	419.2	398.5	295.8	370.5
Own source revenue	59.2	57.5	39.2	76.9	58.6	82.3	62.3
Grants and transfers	107.4	113.5	99.4	98.9	128.0	41.9	98.2
Total revenue	164.8	174.3	142.7	182.3	188.0	132.8	164.1
PER CAPITA	MONTENEGRO – Size of Local Government Unit – EURO						Average
	less than 5000	5000–10000	10000–40000	40000–100000	100000–200000	more than 200000	
Expenditure	1417.8	348.8	386.3	263.1	289.8	—	541.1
Own source revenue	896.3	87.8	244.0	144.4	193.1	—	313.1
Grants and transfers	359.4	220.5	87.3	56.8	45.0	—	153.8
Total revenue	1693.6	412.4	421.3	274.2	291.4	—	618.6

Figure 46: Changes in total revenues by size of municipalities (Albania and Montenegro)

Montenegro. While, overall, down- and upward trends in total local revenues show comparably similar patterns in the municipalities of BiH, Croatia, Kosovo, and Macedonia; trends vary significantly for municipalities of different size in Albania and Montenegro. In Albania, we find overall stagnation of total revenues across municipalities after an increase from 2009–2010. However, municipalities with a population between 100,000–200,000, MFR data indicate a strong decline in total local revenues. In Montenegro, on the other hand, smaller municipalities have increased their total revenues; in particular municipalities with less than 5,000 inhabitants registered a steep increase in total revenues after 2009.

Revenue trends in Macedonia suggest rural municipalities outperform their urban peers in mobilizing revenues. During 2008–2011, rural municipalities' total revenues grew faster than urban municipalities' total revenues. In addition, rural ones seem to have managed offsetting an initial decrease in own source revenues. However, a closer review of the data reveals that rural municipalities' better performance in total revenue mobilization was largely the result of increasing grants and transfers from the central government (see Figure 47).

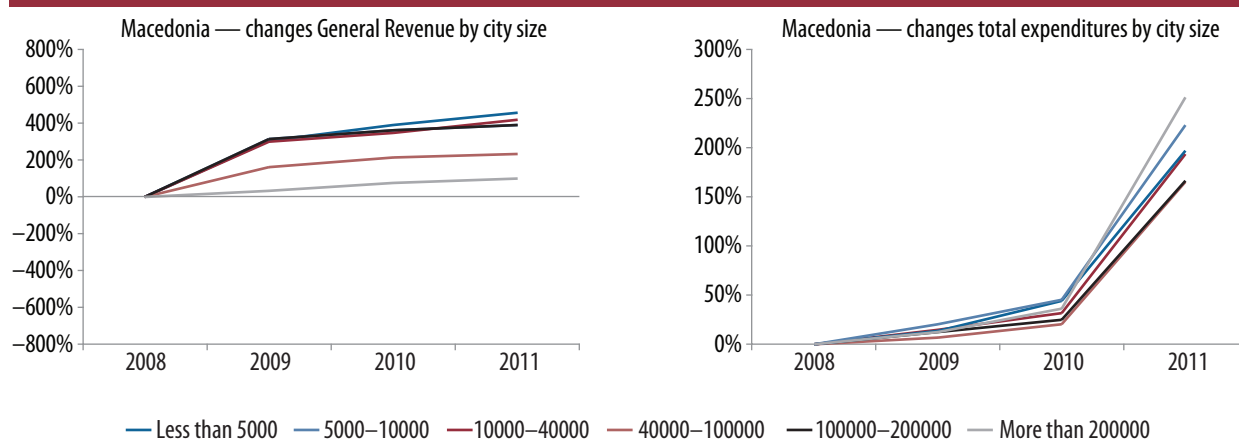
Skopje has the fastest increase in expenditure despite slower revenue growth. Another observation from the disaggregated data suggests very

Figure 47: Changes in total revenues, own source, and grants and transfers (urban vs. rural) in Macedonia

different reactions on the expenditure side given the diverse revenue trends in municipalities of different size and economic weight. In Macedonia, for example, Skopje as the capital city and largest municipality experienced the slowest revenue growth during the observed time period. However, total expenditure rose fastest in that city (see Figure 48). A possible explanation are the ongoing

long-term or multi-year investment programs, including those financed from loans and grants, or deliberate counter-cyclical investments to provide a fiscal stimulus to the local economy. However, the diverging revenue and expenditure trends also require close monitoring to avoid fiscal stress as a result of unbalanced budgets over an extended period of time.

Figure 48: Revenue and expenditure trends by size of municipalities (Macedonia)



Conclusion and Directons for a Possible Way Forward

This report has demonstrated the increasing relative weight and role of sub-national governments in the SEE region. In line with their increasing importance in public service delivery and spending over the past decade, the way municipalities raise, allocate, and manage their financial resources becomes increasingly important. Greater fiscal authority and responsibilities drive a need for improved planning, budgeting and financial management—both at the local and central level. Reliable and high quality municipal finance data is critical in this context.

However, the public finance capacity of municipalities in the SEE Region remains insufficient and only partially equipped with the appropriate tools, techniques and data. Public finance processes and procedures are viewed as institutional requirements imposed by central authorities, and further compounded by the lack of data and financial management techniques, the local authorities lack the incentives to set directions, prioritize and ensure efficiency in public service delivery and expenditure.

In this context, this report has aimed to address identified capacity issues by the creation of a regional dataset for disaggregated municipal finance analysis, with the goal to contribute to improved understanding of local government management and finance in the SEE Region; and improving the quality and consistency of key municipal finance data for improved evidence based policy making. Although limited in scope and expandable in depth, MFR has piloted disaggregated data collection and analysis for in-country analyses and regional comparison in SEE. At the outset of the analytical work and capacity building activity, knowledge and analysis of municipal finance issues in SEE was limited mostly to aggregated, national datasets.

With the support from regional and local experts and the Local Government Associations in the participating entities, MFR has established a regional municipal finance database available for further analysis. Overall, the database meets expectations as regards coverage of countries, variables and time period, and, as evidenced in the report, has provided a very strong foundation for municipal finance analyses.

A number of data gaps and data quality issues persist. These include issues typical for municipal datasets and which are outside the control of this project, including but not limited to blurred definitions of assigned functions, poor quality of recording practices on expenditures and revenue classifications, unclear definitions on administrative boundaries, and practical difficulties in applying concepts of 'own source revenues', among others. Other data gap and issues, however, may be attributed to the project as such, and efforts should be undertaken to address these going forward. This includes effort to improve data coverage, including coverage of identical periods of time, across countries.

However, the potential use and application of disaggregated data go beyond the initial analysis possible within the scope and limitations of the MFR. For example, compared to aggregated national datasets, disaggregated sub-national finance data allows for benchmarking across municipalities. Municipal current and capital expenditures analyzed together with service performance indicators and statistics may provide opportunities for comparing facility unit costs, but also to reviewing variations in service delivery outcomes against different expenditure needs; spending- and revenue trends. However, service efficiency measures are difficult to compare across countries. Different functional assignments for the same type of sub-national entities make comparisons less precise; fiscal information on the evaluated service is not always sufficiently detailed; the precise scope of service provided differs in practice; and municipal accounting practices follow different rules. Although these limitations reduce the scope for regional benchmarking, a concerted effort on service outcome data collection comparable to the MFR can overcome main constraints and further deepen our understanding of local service delivery performance in SEE.

By and large, constructing a consolidated regional database on municipal finance in the SEE countries and the related analysis provides significant value-added to the knowledge and understanding of the policy challenges facing municipalities in these countries. However, going forward, a number of questions for follow-up actions may be considered. These include, among others: How

to sustain regional and country-specific datasets and analytical capacity within SEE countries for continued analysis, including outreach to national authorities on data and analysis? How to establish further capacity of local associations in each country to maintain, expand and update the database? How would a regional database be maintained, and by whom? How to broaden the concept of a database and analytical review and include other countries in the ECA region?

A number of issues would need to be addressed to respond to these questions with the goal to (i) make municipal finance data collection regular; and (ii) develop a user friendly system of information management. The following summarizes suggestions and recommendations for a possible way forward:

Regular transfer of detailed municipal finance data and information. In all countries in the SEE region, disaggregated financial reports on local government expenditures and revenues are available at the Ministry of Finance or at the Treasury. The only exception is the *Federation of BiH*, where the local government association with the support from the MFR has launched a survey to collect municipal fiscal data (see Box 2). The survey format was similar to the financial reports used by local governments. In the first year, the response rate was rather high around 95% of total local budgets. This survey, supported by the MFR expert, is the only source of individual LGU detailed fiscal data for the Ministry of Finance, and it was agreed with the LGA to continue regular data collection on that basis.

In the *BiH RS*, with the support of the MFR, the local government association was able to collect disaggregated data from the Ministry of Finance for the first time. In *Kosovo* and *Macedonia*, detailed financial data are produced by the financial accounting and reporting systems. The 'FreeBalance' software provides sufficient information in Kosovo, which can be re-grouped according to the LGA needs. In Macedonia the very detailed data should be also recoded and transformed for analytical purposes.

In *Albania*, *Croatia*, *Montenegro* and *Serbia*, the national reporting system was able to provide municipal

finance data for use in the MFR. Only minor transformation was needed on these disaggregated fiscal data. Unfortunately, data was not requested by the LGA in Serbia and could not be included in the detailed, disaggregated analysis, but is available in principle at the MoF/Treasury.

A formal agreement between the local government association and the responsible government agency would help facilitating regular data transfer. In Montenegro, for example, the Union of Municipalities (UoM) has agreed to propose to the Ministry of Finance signing of a Memorandum of Understanding for regular data transfer from the Ministry of Finance Budget Department to the UoM on a quarterly basis.

Construction of consolidated municipal finance data sets: data clean-up and re-categorization.

Transformation of the datasets in line with the LGA needs is the next step after receiving data from the national government. As data has already been verified by the relevant ministry, there is no need to make any corrections of possible errors at this stage. However, in the case of FBiH, the survey might produce some false data, for example by different reporting, e.g., in thousands, instead of millions of local currency. Other sources of error might include, for example, that local governments fail to follow uniform accounting practices. Generally, these issues do not occur if data is transferred from the national reporting system, which usually addresses these issues already.

Data presentation. Disaggregated municipal finance data can be used for various purposes. Among others, the goal of municipal finance data and analysis is to inform local government officials, investors, media, civil society organizations and the general public about the financial position and overall performance of a municipality. This requires public access to selected information, or to indicators, depending on the level of available municipal finance data. Publicly accessible databases can also offer search options, such as aggregation by regions, comparison of local governments, or the averages for a subset of municipalities (e.g. similar size, administrative status). Such services are usually

Box 2: The implementation and application of the MFR in the Federation of BiH

In the Federation of BiH, implementation of the MFR encompassed a wider scope of activities, due to the fact that the Federal Ministry of Finance (FMF) does not collect the data from individual LGUs (FMF collects LGU data grouped by Cantons). Neither had the Association of the Municipalities and Cities of FBiH have comprehensive fiscal data needed for the MFR exercise.

Consequently, data had to be collected through a survey with requested table templates sent to each of the 80 local government units (LGUs) in the FBiH through the Association of the Municipalities and Cities of FBiH. In order to minimize the additional work required by the LGUs, existing reporting templates which they have to fill out for other purposes were used (reporting templates which the municipalities sent to Cantons, FMF or tax authorities). Total of five tables (with comprehensive disaggregated data on: revenues, expenditures and financing; balance sheet; functional expenditure categories; debt stock; and current debt categories) were prepared and sent to each LGU in FBiH through the Association in Spring 2012. The Association (with World Bank technical assistance) intensively worked on contacting LGUs to deliver data and within the data cleaning process, which spanned until late Fall 2012. In total, data was received from 72 LGUs, out of total 80 LGUs, covering around 95% of total LGU expenditures in FBiH.

The Association has already used the MFR database for various purposes, including: as inputs for NALAS reports in fiscal decentralization; for internal and external discussions about the framework of revenue distribution and budgetary legislation in FBiH; and for discussions about LGU finances and reporting with international organizations such as the IMF.

In addition, with the goal of achieving sustainability of the data collection process by the Association and regular update of the MFR database, the Association has issued another request for 2012/2013 data to all LGUs in Spring of 2013 (within this round of data collection it is also expected that the Association will collect the previous data for the 8 municipalities which did not send data last year). Given that the Association is currently the only institution in FBiH which has desegregated detailed data for individual municipalities, FMF has asked the Association to share the MFR database.

Source: Naida Carsimamovic.

developed by either national governments or statistical offices, e.g., in Denmark (<http://www.noegletal.dk/>). However, non-governmental organizations and research groups also provide comparable tools. For example, in Sweden, the local government association and national government jointly operate a municipal finance database (<http://www.>

kolada.se/). A non-profit organization took the responsibility for a similar database in Portugal (<http://www.pordata.pt/en/Municipalities/Search+Environment/Table>). A similar service is available in Macedonia, developed by a think tank in collaboration with the MFR local expert (<http://www.mkbudget.org/els/>).

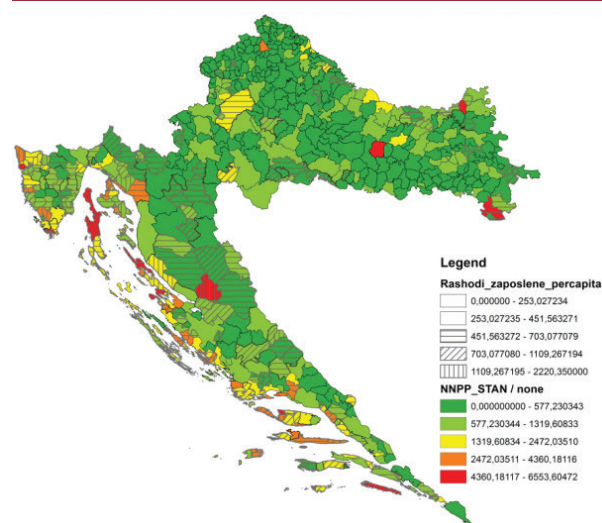
Municipal finance reports can also be combined with other data, which would allow the calculation of indicators by users. They can be reported in a more sophisticated way, using visual presentations, for example connecting financial indicators to geographic information creating maps. In Croatia, the Association of Cities already started to use MFR data and decided to develop a geo-visual form of presentation. Figure 49 provides an example of local government labor costs per capita combined with uncollected current revenues per capita.

Data management capacity. Generally, local government associations are not prepared for the complex task of managing municipal finance data and present the generated information in an accessible and user-friendly format. LGAs may employ fiscal experts and communication managers, but that would require close cooperation between these types of expertise. In the past, LGAs have not had a business model for developing and operating municipal finance data and typically relied on donor support. For example, the LGAs in Albania, Montenegro, and the Federation of BiH have expressed their interest in leveraging donor financial assistance for regular municipal finance data management. At the regional level, if demonstrated demand exists, NALAS would be a natural host for a regional municipal finance database. Regional analysis of country aggregate data can be based on national datasets, while for more detailed analysis, NALAS may use information produced by disaggregate databases in their member associations.

Funding for regular maintenance and sustainability. However, external financing and assistance bears

the risk of limited sustainability. ZELS, in Macedonia, owns a sophisticated municipal finance database and analytical tool, developed with assistance from the USAID supported Macedonia Local Government Activity (MLGA) project. However, regular updating and maintenance lacks sustainable funding since the project closed in 2011, and alternative financing solutions need yet to be developed. As a result, methods of regular data-collection and management have to be developed by or in close cooperation with the partner host organization. Related costs of data collection and maintenance need to be planned and budgeted upfront to ensure sustainability. Since local government associations in the target countries are in different positions with regard to their mandates, organizational, and staff capacities, business models for long term sustainability necessarily will have to be different. Even if interested LGAs want to raise revenues by operating a municipal finance database, it would be advisable to develop an open component of the indicators, which is accessible free of charge. This public information will generate demand for the fee based services.

Figure 49: Visual presentation of municipal finance indicators in Croatia



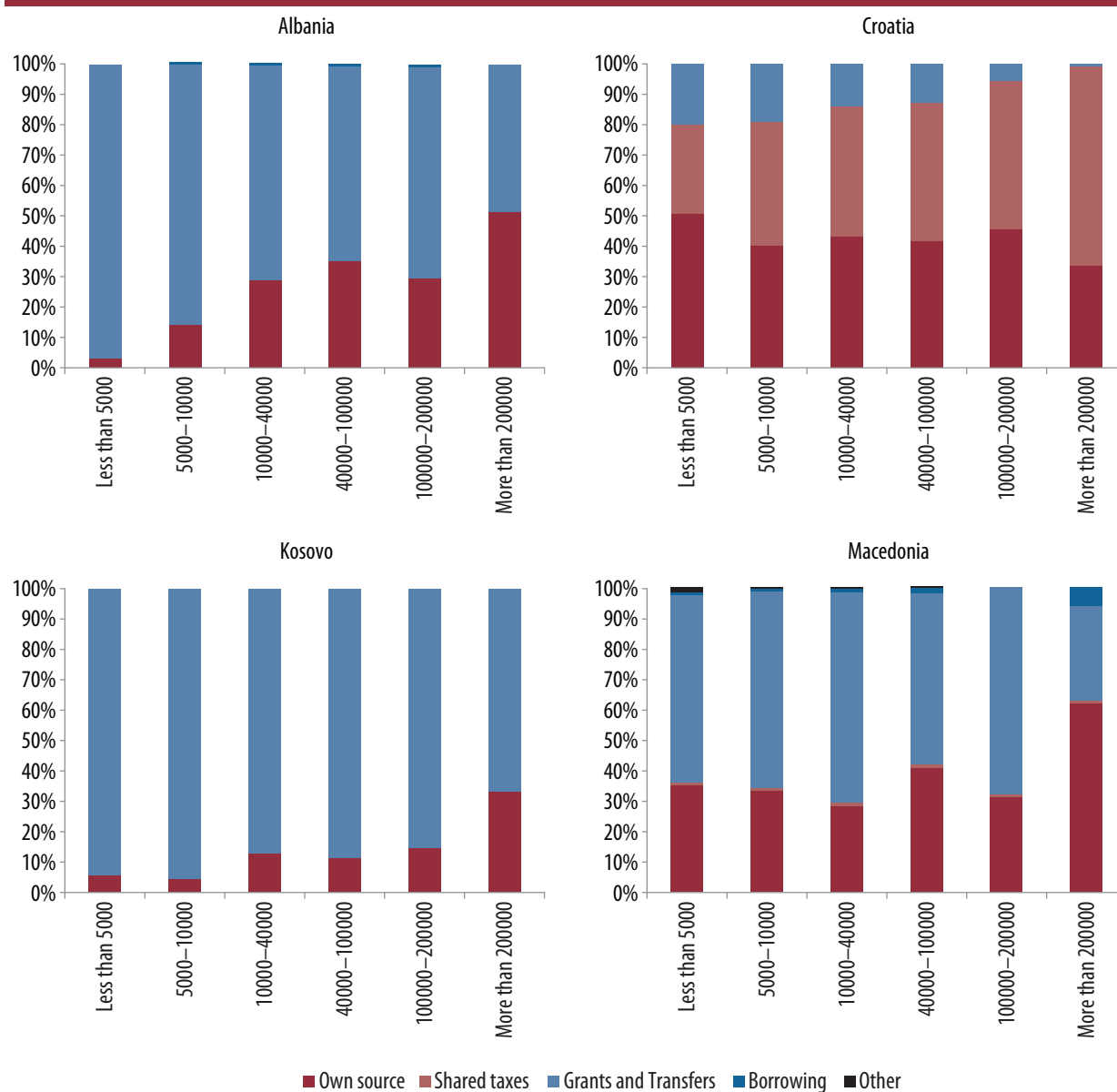
Source: Croatia Association of Cities.

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- World Bank (2013), Serbia Municipal Finance and Expenditure Review

Annexes

Annex 1: Summary Overview Graphs

Figure 50: Variations in total revenue sources by city size (As percentage of total)



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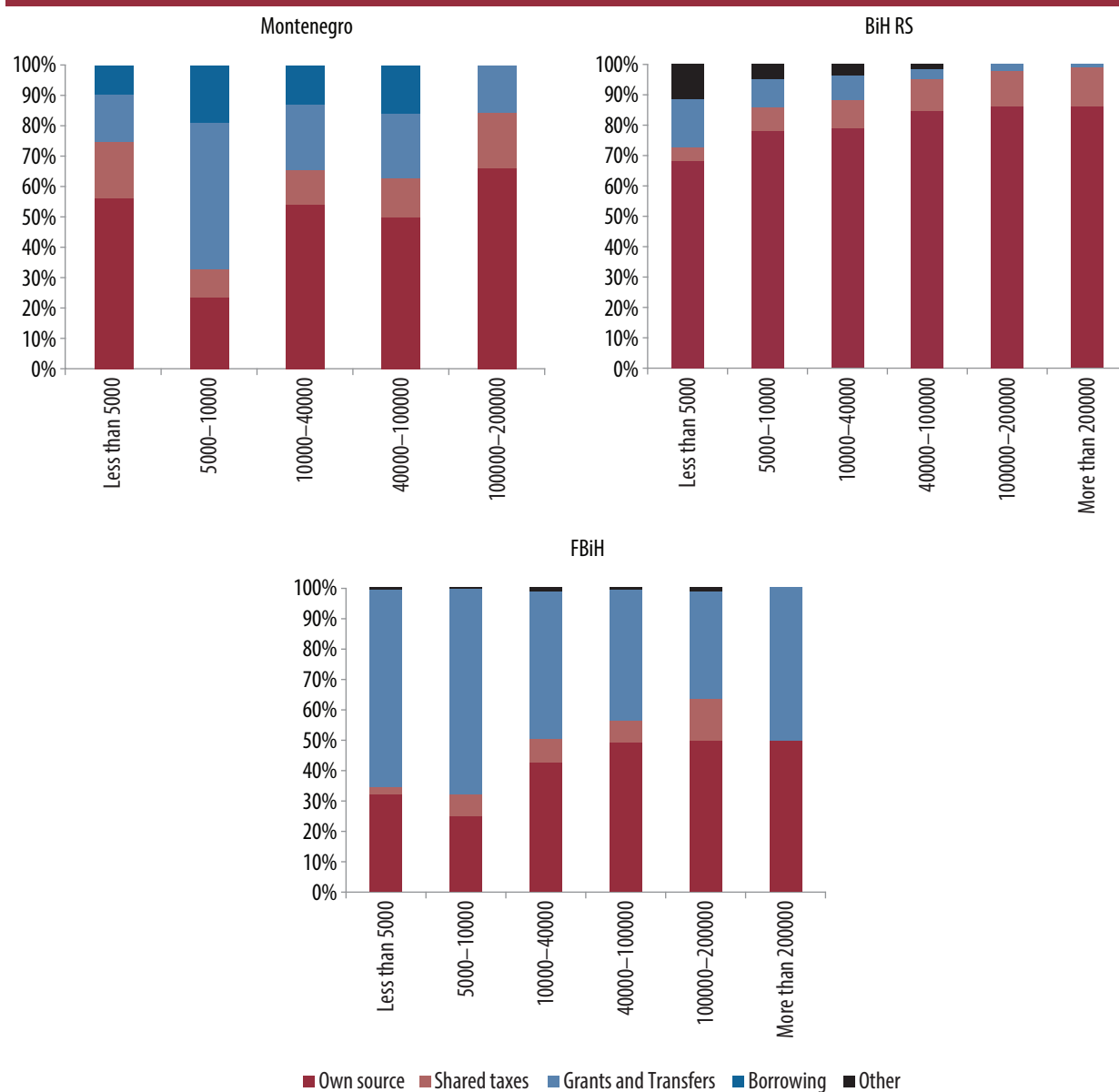
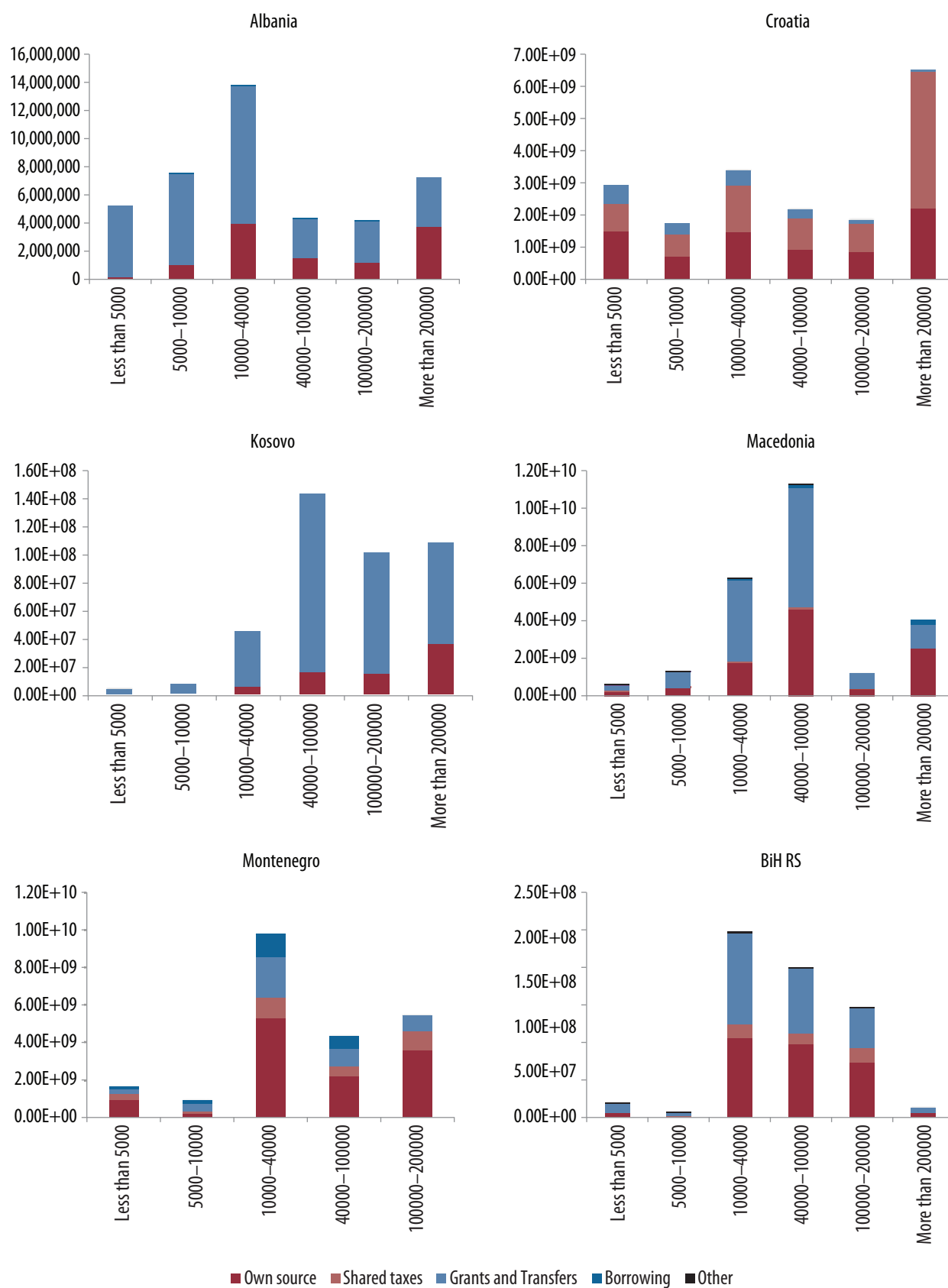
Figure 50: Variations in total revenue sources by city size (As percentage of total) *(continued)*

Figure 51: Variations in total revenue sources by city size (Absolute values)

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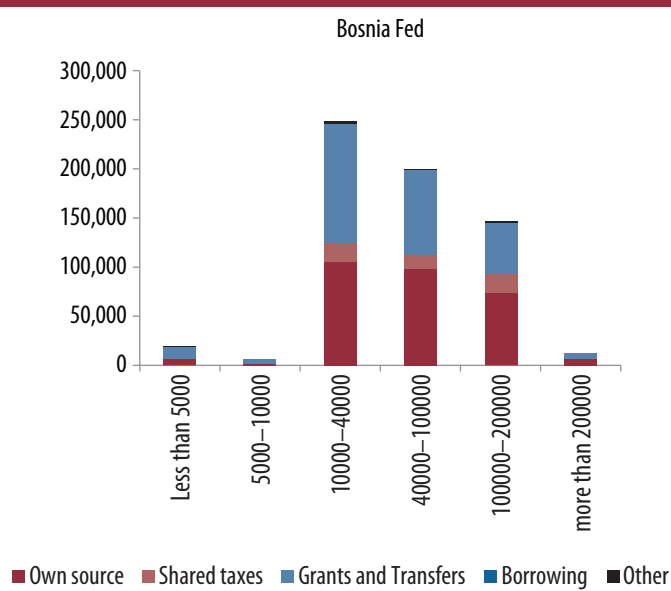
Figure 51: Variations in total revenue sources by city size (Absolute values) *(continued)*

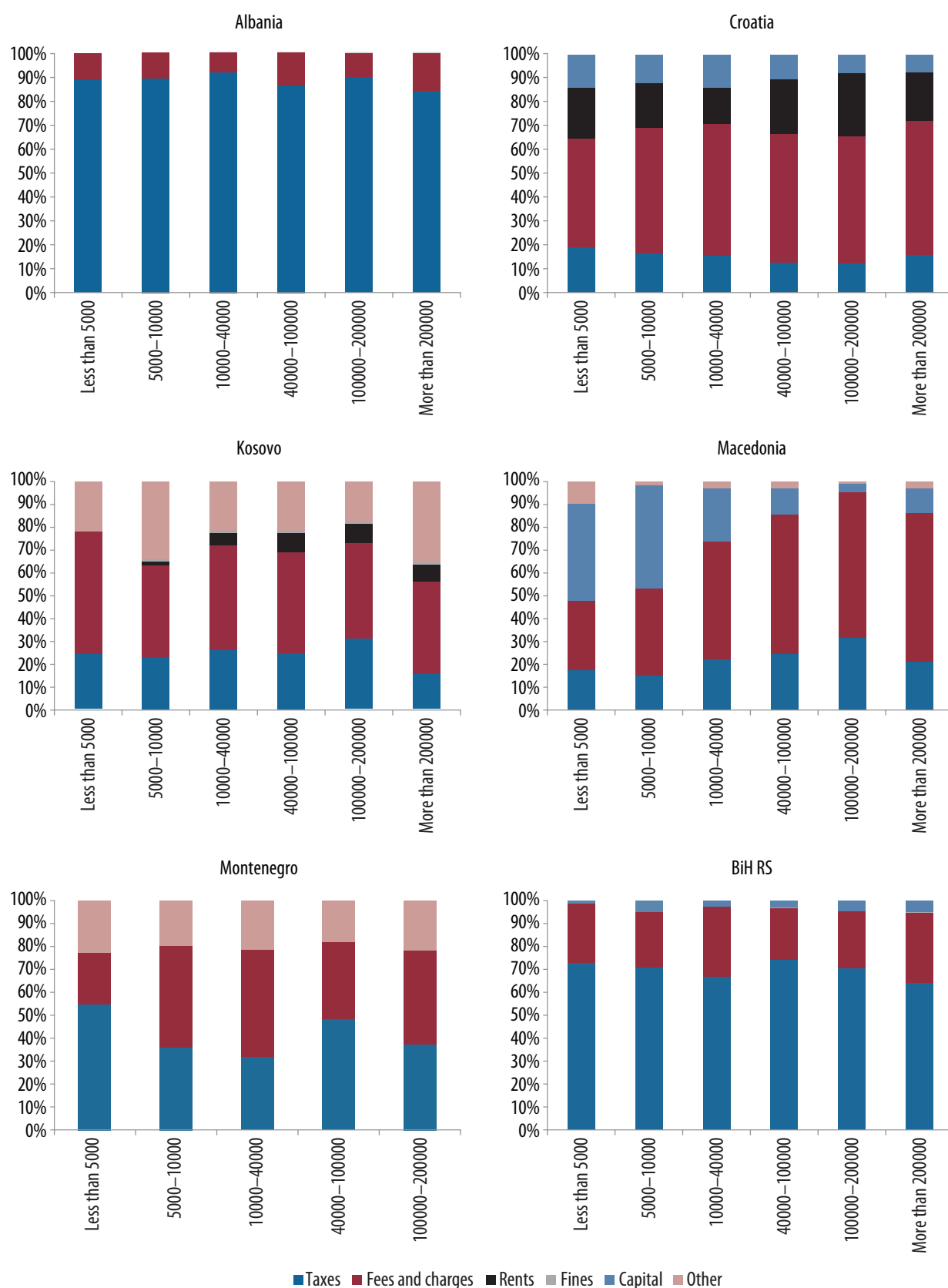
Figure 52: Variations in own source revenue sources by city size (as percentage of own source)

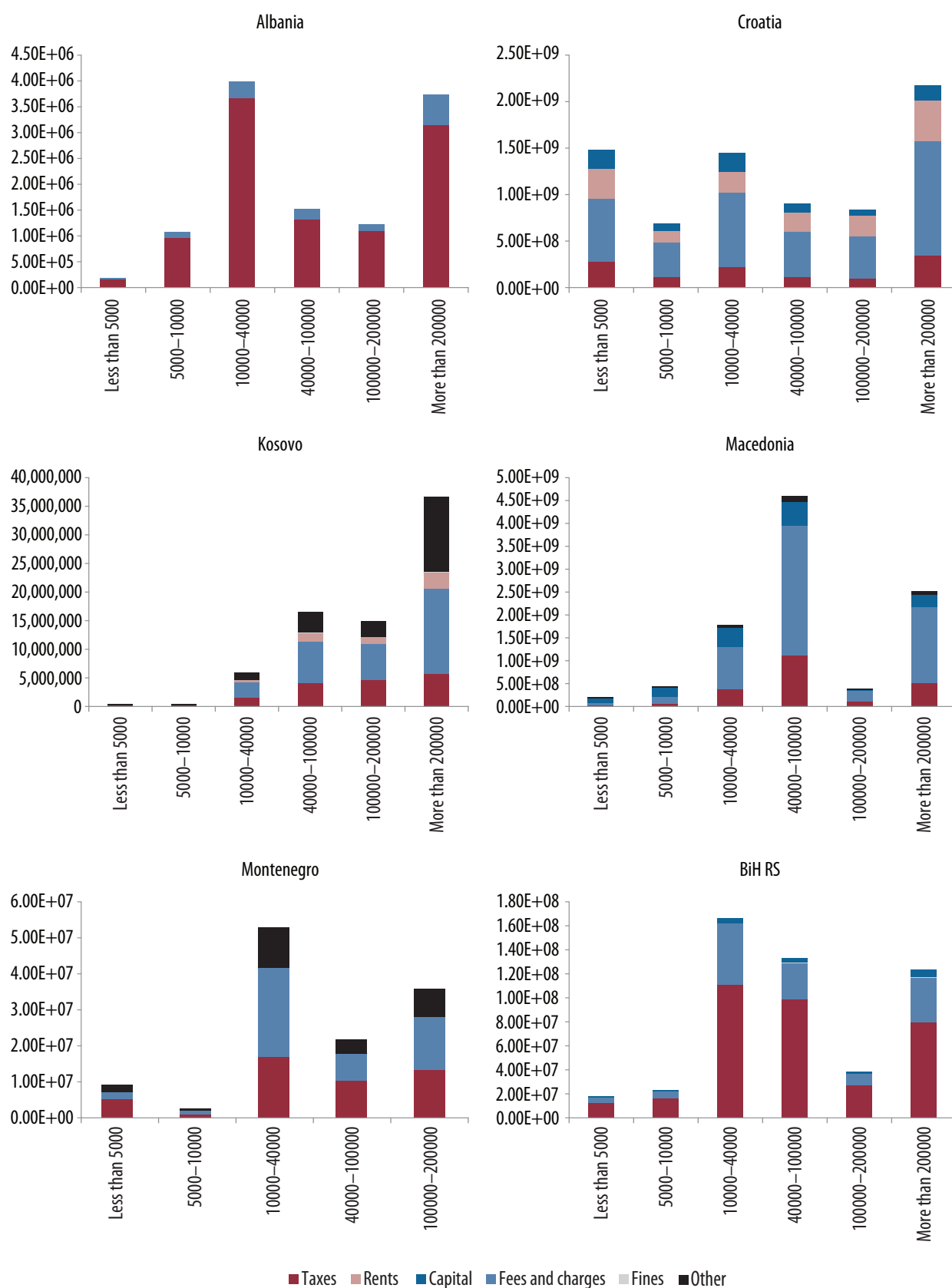
Figure 53: Variations in own source revenue sources by city size (Absolute values)

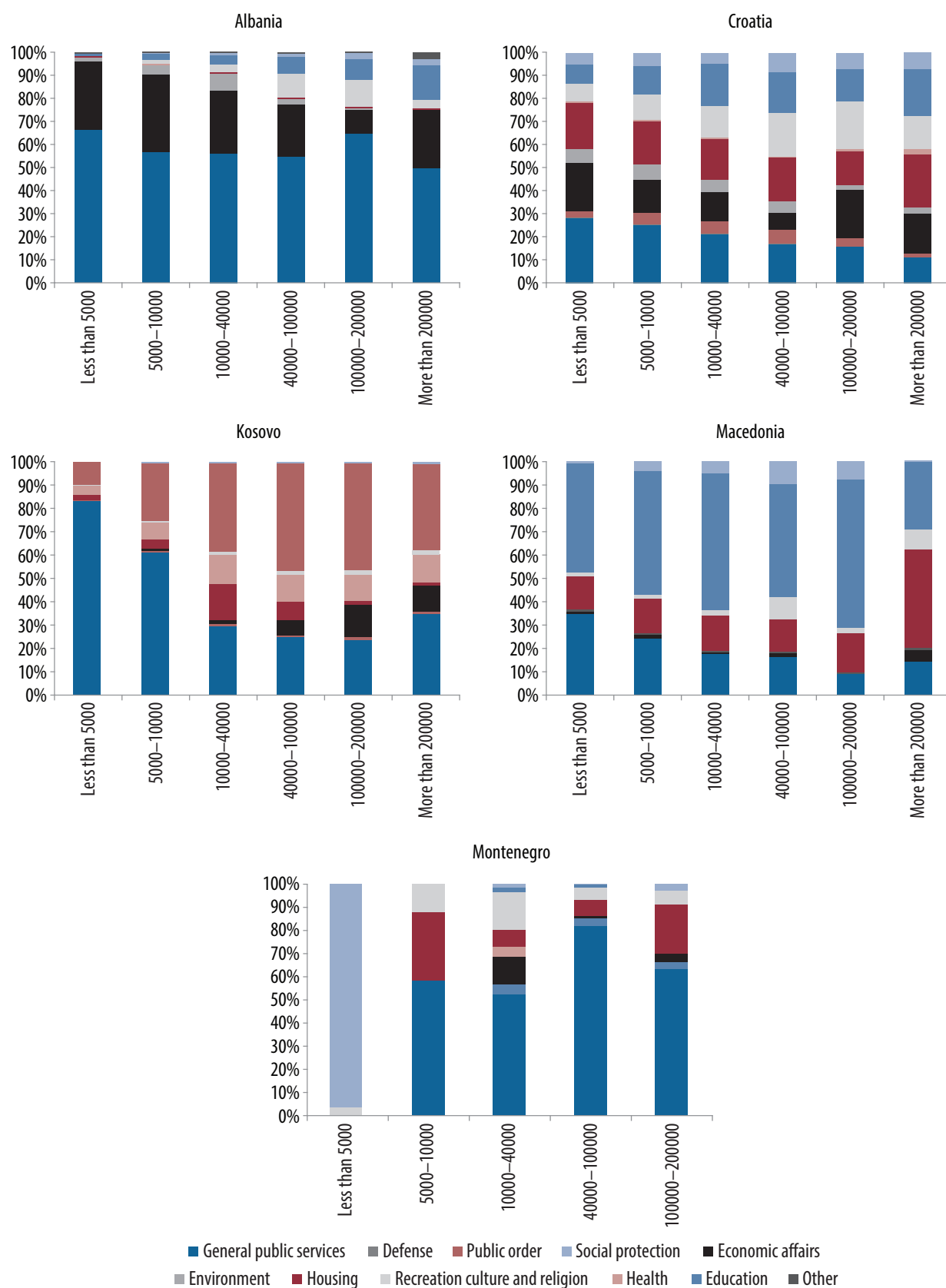
Figure 54: Functional expenditures by city size (As percentage of total expenditures)


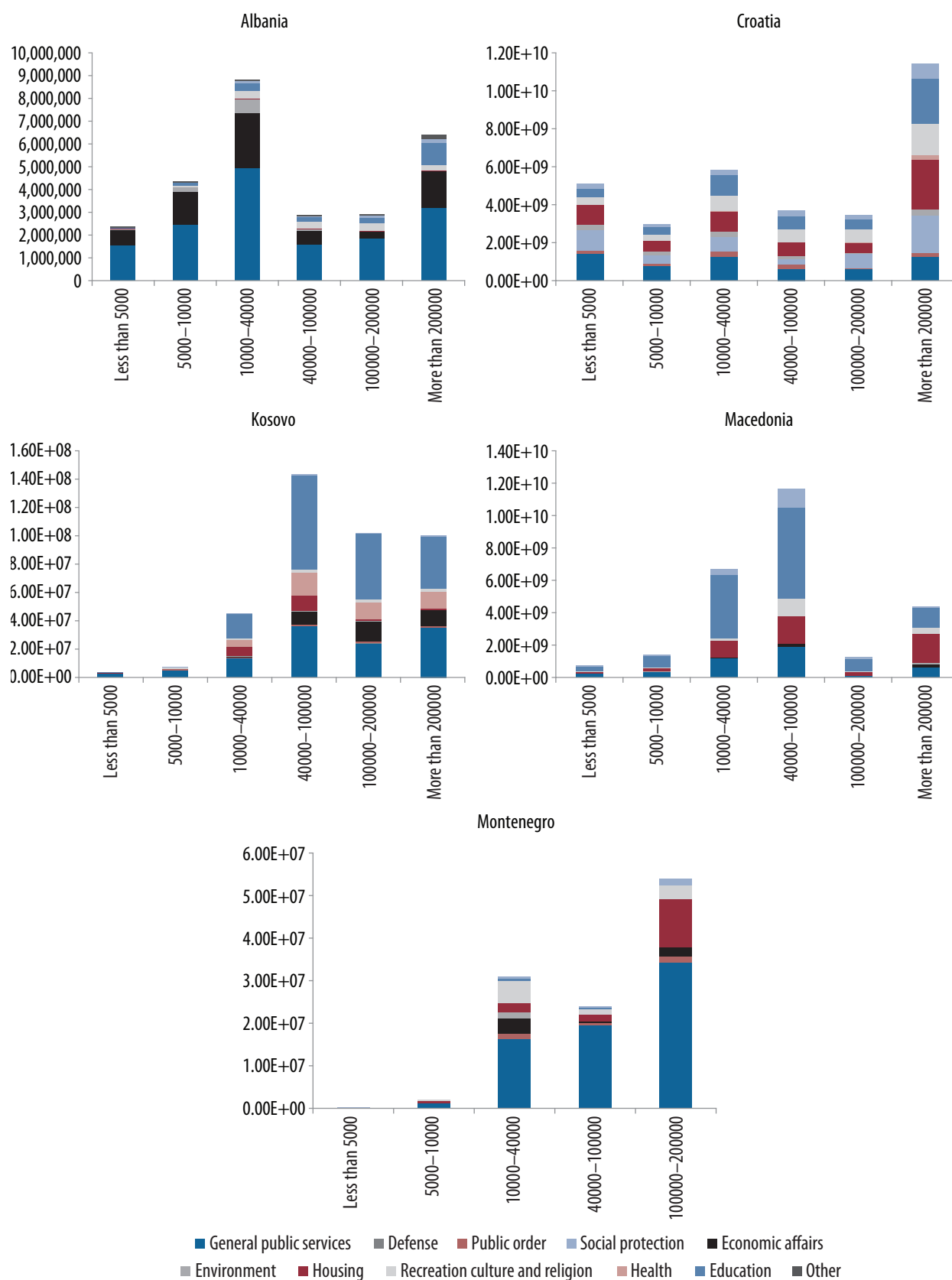
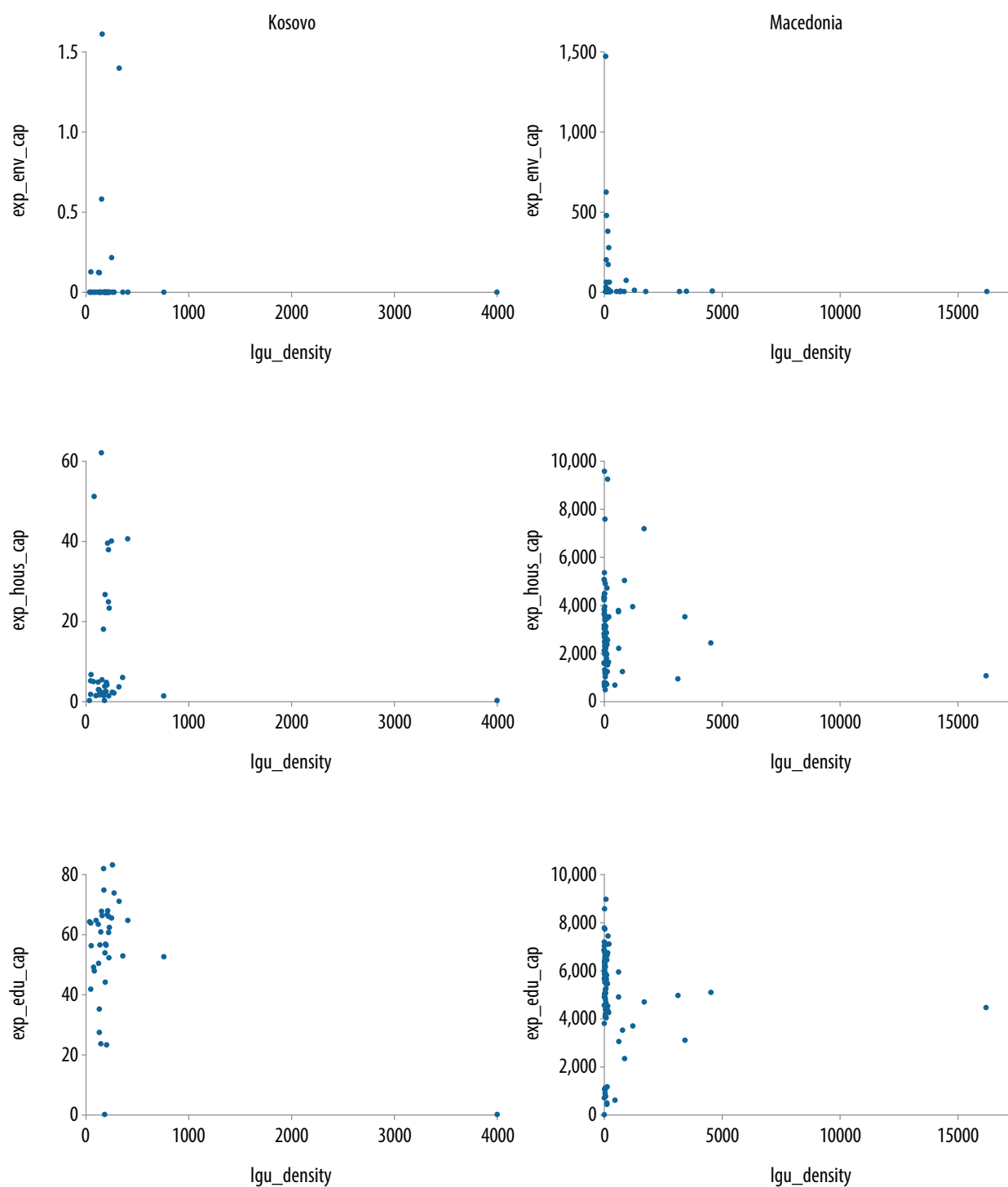
Figure 55: Functional expenditures by city size (Absolute values)

Figure 56: Per capita expenditure in Environmental Protection, Education and Housing against population density – Croatia, Kosovo and Macedonia

Density analysis (Croatia – Kosovo – Macedonia) 1 line Environment capita, 2 line housing, 3 line education



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Figure 56: Per capita expenditure in Environmental Protection, Education and Housing against population density – Croatia, Kosovo and Macedonia *(continued)*

Density analysis (Croatia – Kosovo – Macedonia) 1 line Environment capita, 2 line housing, 3 line education

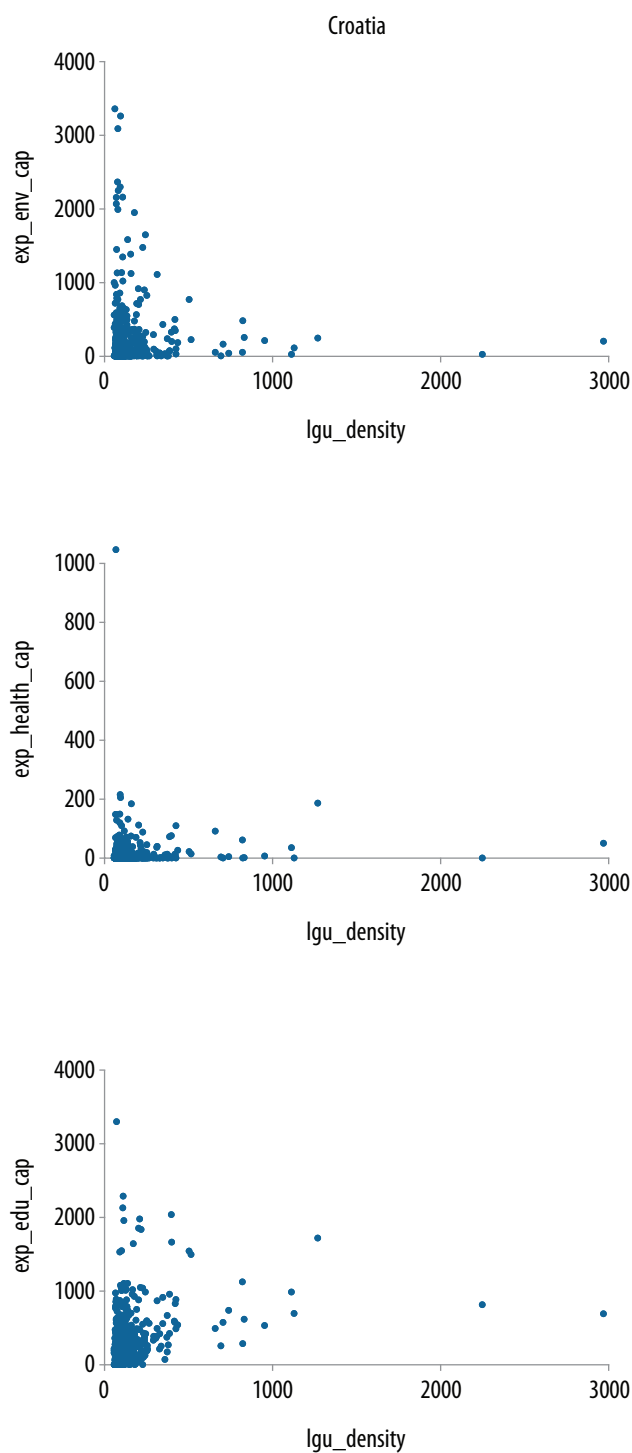
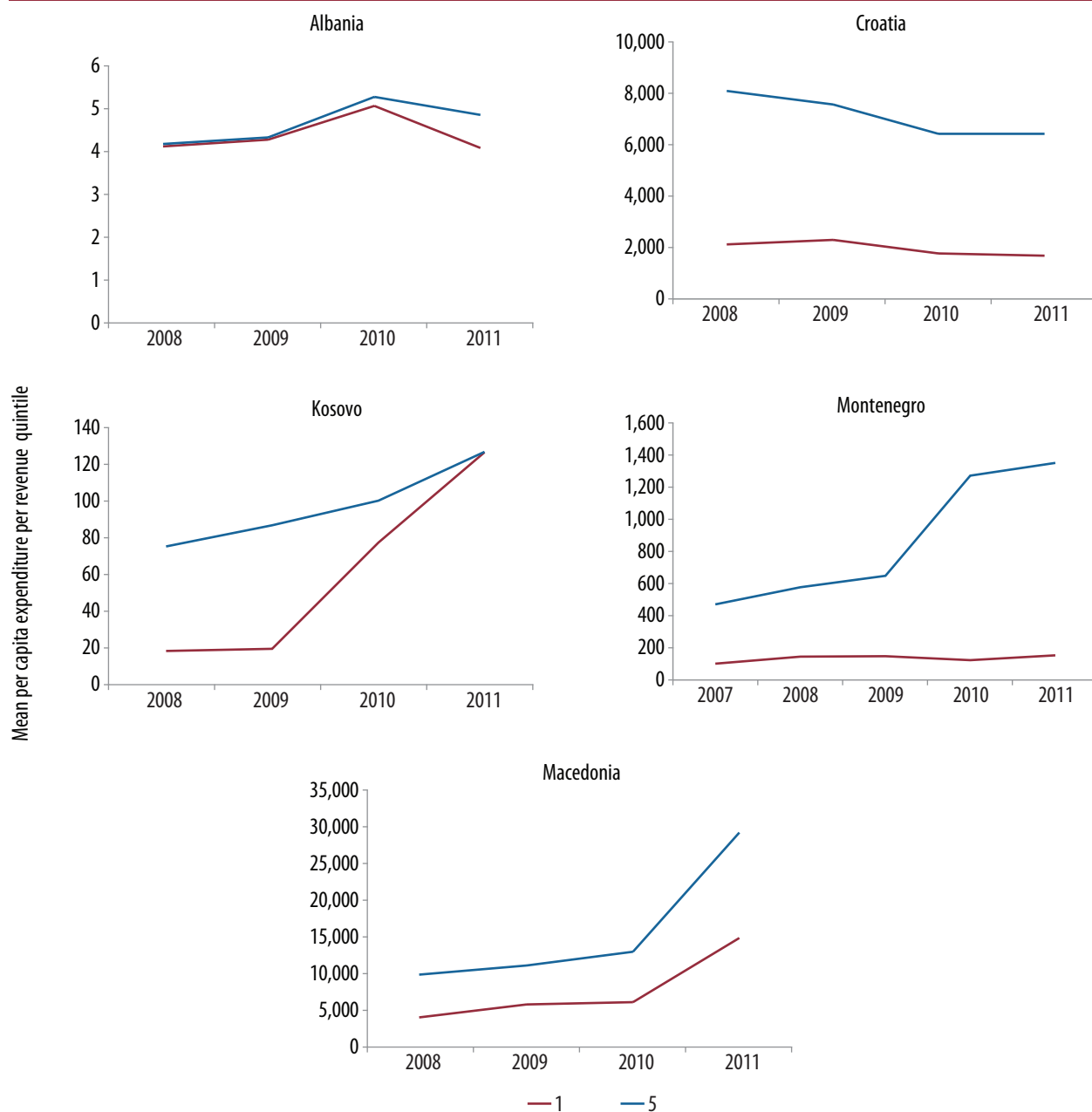


Figure 57: Diverging and Converging trends of per capita expenditures between “rich” and “poor municipalities”
Inequalities graphs for each of the countries



Annex 2: Data Gap Analysis and Reclassification

	Country	Albania	Albania	B&H		Croatia	Kosovo	Macedonia	Montenegro	Serbia
				FBiH	RS					
	Number of local government units providing data	385	386	80 but only 53 with reviewed data only for 2010	63	573 (2011), 576 (2010), 576 (2009), 576 (2008)	38	85	21	170* (More with different regions)
	Years covered for analysis	2008–2011	2008–2012	2010	2008–2010*	2008–2011	2008–2011	2008–2011	2007*–2011	2008–2011**
	Major gaps in the dataset	Data on transfers from Min Interior with some issues for year 2011. Not clear from database if “-” means missing or zero. Missing variables in 2010 (Tax vehicles), and 2011 (tax vehicles, transfer from ministry of culture and other)		Not all municipalities submitted data and some data had errors and was sent back (no correction of errors was received). Uses OCDE expenditure functional classification. The database has serious datagaps for all variables.	Inconsistent categories among years. The first stage database only contains 2008–2010. Expenditures by functional categories are missing. Data on population and area is missing for Sarajevo.	Data on borrowing has not been merged with panel. Data on statistics disaggregated very complete with additional indicators (i.e. development index, area, etc). It is also the only country with disaggregated data on assets and liabilities.	Expenditure classification is divided for each category among Expenditure by economic categories. Capital expenditure classification is very good and contains subcategories (i.e. roads, sidewalks, etc. NOTE: There is a sheet with construction of X). Statistical data contains area and also number of staff.	For expenditures by programs there is an inconsistency in the names of the variables for 2008 (M and V variables) against the rest of the years. National Statistics contain information on inflation, capital and current expenditures, etc. NOTE: There is a sheet with all indicators calculated (it seems very well done: i.e. per capita capital expenditure, creditworthiness, etc). Population disaggregated from census 2002, can calculate density with area and pop.	Information on expenditures by economic category is very complete from 2007–2011, by functional categories is very incomplete (a lot of cities missing info) and only from 2008–2011. There are considerable changes in revenues categories after 2009, and after 2010. Interesting: have number of employers, and labor costs per employer disaggregated	Database is very limited on both revenues and expenditures. Expenditures only available for a selected set of categories and until 2010.
Local Expenditures – Classification A	Current expending	YES		YES	YES	YES	YES	Might be able to calculate it	YES	YES
	Capital expending	YES		YES	YES	NO	YES	Might be able to calculate it	YES	NO
Local Expenditures – Classification B by economic categories	Labor Costs	YES		NO	YES	NO	YES	YES	YES	NO
	Grants	YES		NO	YES	NO	YES	YES	YN (Some Transfers might be actually grants)	NO
	Transfers	NO		NO	NO	NO	YES	YES	YES	NO
	Loan Repayment (interest and principal)	YES (Interest)		NO	YES (Combined with other Fees)	NO		YES	YES	NO

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	Country	Albania	Albania	B&H		Croatia	Kosovo	Macedonia	Montenegro	Serbia
				FBiH	RS					
	Number of local government units providing data	385	386	80 but only 53 with reviewed data only for 2010	63	573 (2011), 576 (2010), 576 (2009), 576 (2008)	38	85	21	170* (More with different regions)
	Years covered for analysis	2008–2011	2008–2012	2010	2008–2010*	2008–2011	2008–2011	2008–2011	2007–2011	2008–2011**
Local Expenditures – Classification B by Functional categories	General public services	YES		YES	NO	YES	YES	YN (Could be a sum of other general categories)	YES	NO
	Defense	NO		YES	NO	YES	YN (MBROJTJA – PROTECTION?)	NO	NO (N/A)	NO
	Public order and safety	NO		YES	NO	YES	YES	NO	YES	NO
	Economic affairs (sub-category transportation)	YES (Transportation separate)		YES	NO	YES	YES	YES	YES	YN (Road category)
	Environmental protection (sc, waste and wastewater management)	YN (Sanitation with Water supply)		NO	NO	YES	YES	YES (Sewerage in other category)	YES	YN (Water and Sewerage in same category)
	Housing and community amenities (sc, Housing water supply)	YES (Housing and water supply with sanitation and separate)		YES	NO	YES	YES	YN (Aggregated with sewerage, street lighting, etc)	YES	NO
	Health care	YES		YES	NO	YES	YES	YES	NO (N/A)	NO
	Recreation	YN (Sports under Culture)		YES (Aggregated with Culture and Religion)	NO	YES (Disaggregated)	YES (Aggregated with Culture and Religion)	YES (Aggregated with Culture)	YES (Aggregated with Culture)	NO
	Culture and religion	YES (Under Culture and Sport)		YES (Aggregated with Recreation)	NO	YES (Disaggregated)	YES (Aggregated with Recreation)	YES (Aggregated with recreation)	YES (Aggregated with recreation)	NO
	Education (sc, pre, primary secondary)	YES (Aggregated)		YES	NO	YES	YES	YES	YES	YES (Under schools category)
Municipal Revenues – General	Social protection	YES		YES	NO	YES	YES	YES	YES	NO
	Own source	YES		YES but some inconsistencies reported	YES	YES	YES	YES	YES	NO
	Shared taxes	NO		YES but some inconsistencies reported	NO	NO	NO	NO	YES	NO
	Grants, Transfers and Subsidies	YES		YES	YES	YES	YES	YES	YES	NO
	Local government borrowing	YES		NO	YES	YES* (Check if corresponds)	NO	YES	YES	NO

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	Country	Albania	Albania	B&H			Croatia	Kosovo	Macedonia	Montenegro	Serbia
				FBIH	RS						
	Number of local government units providing data	385	386	80 but only 53 with reviewed data only for 2010	63	573 (2011), 576 (2010), 576 (2009), 576 (2008)		38	85	21	170* (More with different regions)
	Years covered for analysis	2008–2011	2008–2012	2010	2008–2010*	2008–2011	2008–2011	2008–2011	2008–2011	2007*–2011	2008–2011**
Municipal Revenues – Own source revenues	Tax revenues	YES (Disaggregated)		YES but Mixed	YES	YES (Disaggregated)	YES (Disaggregated)	YES (Disaggregated)	YES	YES	NO
	Fees	YES (Mixed)		YES but Mixed	YES but Mixed	YES (Aggregated with Charges)	YES (Disaggregated)	YES (Disaggregated)	YES	YES	NO
	Charges	YES (Mixed)		NO	NO	YES (Aggregated with Fees)	YES	YES	NO	NO	NO
	Rents	NO		NO	NO	NO	YES	YES	NO	YES (Named as Fees)	NO
	Fines	NO		NO	NO	NO	YES	YES	NO	YES (Mixed before 2010)	NO
	Own municipal capital revenues	NO		YES	YES	YES (Property Income?)	NO	NO	YES	NO	NO
Statistical data – national	National population	NO		NO	NO	NO	NO	NO	YES	NO	NO
	National GDP	YES		YES	NO	YES	YES	YES	YES	YES (Up to 2010)	YES in report
	Annual inflation	NO		YES	NO	YES	YES	NO	YES	NO	NO
	Population	YES		YES	YES except for capital	YES	YES	YES	YES	YES	YES
Statistical data – disaggregated	type LGU	Municipality (B) or Commune (K) or Quark (Q)		YES (type of city and canton variables)	YES (Administrativ status capital=1, other cities=2, municipalities=3)	M-municipality, C-city, CO-county	NO	NO	NO	Class, from 1–6 depending on population	Classification by regions
	GDP (unit)	NO		YES	NO	NO	NO	NO	NO	NO	NO
	Density	NO		YES	NO (but can calculate it from population and area)	YES	NO (but can calculate it from population and area)	NO (but can calculate it from population and area)	NO (but can calculate it from population and area)	YES	NO (but can calculate it from population and area)
	Rural/Urban	NO		NO	NO	NO (Maybe through LGU Cat)	NO	NO	YES	NO	NO
OECD Profile Revenues	Tax revenues	YES (Disaggregated)		NO	YES	YES (Disaggregated)	YES	YES	YES	YES	NO
	Non-tax revenues	YN (Can calculate from difference)		NO	YES	YN (Can calculate from difference)	YN (Can calculate from difference)	YN (Can calculate from difference)	YN (Can calculate from difference)	YN (Can calculate from difference)	NO
	Grants	YES		NO	YES	YES	YES	YES	YES	YES	NO

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Country	Albania	Albania	B&H		Croatia	Kosovo	Macedonia	Montenegro	Serbia
			FBiH	RS					
Number of local government units providing data	385	386	80 but only 53 with reviewed data only for 2010	63	573 (2011), 576 (2010), 576 (2009), 576 (2008)	38	85	21	170* (More with different regions)
Years covered for analysis	2008–2011	2008–2012	2010	2008–2010*	2008–2011	2008–2011	2008–2011	2007*–2011	2008–2011**
General public services	YES		YES	NO	YES	YES	YN (Could be a sum of other general categories)	YES	NO
Defence	NO		YES	NO	YES	YN (MBROJTJA – PROTECTION?)	NO	NO (N/A)	NO
Public order and safety	NO		YES	NO	YES	YES	NO	YES	NO
Education	YES		YES	NO	YES	YES	YES	YES	YES
Health	YES		YES	NO	YES	YES	YES	NO (N/A)	NO
Social security and welfare	YES		YES	NO	YES	YES	YES	YES	NO
housing and community amenities	YES		YES	NO	YES	YES	YN (Aggregated with sewerage, street lighting, etc)	YES	YN (Water and Sewerage in same category)
recreational cultural and religious	YES		YES	NO	YES	YES	YES	YES	NO
fuel and energy	NO		YES	NO	YES	NO	NO	NO	NO
agriculture forestry fishing and hunting	NO		YES	NO	YES	NO	NO	NO	NO
mining manufacturing and construction	NO		YES	NO	YES	NO	NO	NO	NO
transportation and communication	NY Transportation		YES	NO	YES	NO	NO	NO	NY (Roads Category)
other economic affairs	YES		YES	NO	YES	YES	YES (Aggregated with communal activities)	YES	NO
other functions	(–)		YES	NO	(–)	(–)	(–)	(–)	(–)

Annex 3: Collection of Local Government Finance Data

The MFR, under the overall capacity building framework of UPP, has supported the Local Government Associations in developing disaggregated municipal finance datasets. The MFR local experts in cooperation with the partner LGAs collected fiscal reports by municipalities and composed some aggregate, country wide public finance and economic data. The targeted period of data collection was 2008–2011. In this report, the most recent years (2010 or 2011) are used for describing the present situation and changes are assessed for the past four years, when data were available in most the participating entities.

Common requirements on the municipal finance data were that only publicly available, official and authorized data would be incorporated in the datasets. The terms and definition used by the municipal finance datasets were specified in the country-specific reports' methodological annexes. The municipal finance datasets, together with their explanatory notes and definitions, were made available in English and local language.

The disaggregated datasets followed the same, standard structure with the following types of information:

- a. *Local government expenditures*
 1. Local government current expenditures by functions (sectors) and total
 2. Capital spending by local service areas (functions) and total
 3. Total current and capital expenditures by the main spending areas/services: water management (including water provision, waste water collection/treatment), municipal solid waste management, public transportation, kindergartens, primary education (1–8 grades), secondary education (9–12)
4. Total expenditures on own/devolved and delegated functions
- b. *Local government revenues*
 1. Total own source revenues
 2. Current own source revenues
 3. Of this: local taxes
 4. Capital own source revenues
 5. Total shared revenues
 6. Shared revenues allocated by origin (not by formula)
 7. Total and main types of transfers (grants, subsidies, contributions, etc.): general, conditional (block, earmarked, equalization funds, etc.)
 8. Capital investment grants
- c. *Municipal borrowing*
 1. Local government borrowing: net; total, short and long term, main types (bank loan, bonds, other)
 2. Local government debt (stock)
 3. Local government borrowing capacity (measured by the regulatory limit)
 4. Local government debt repayment (interest and principal)
- d. These municipal finance data were supplemented with indicators on local government typology and statistical data. They help the analysis by allowing various grouping of the disaggregated data and making possible to create some indicators:
 1. Capital city, main cities, other municipalities
 2. Urban/rural or any other special status
 3. Intermediary tier: county, planning/development region

4. Population: total, main age groups
 5. Area (km²)
 6. Other service performance indicators
- e. The general economic data aimed to support primarily the international comparison in the region:
1. Country GDP
 2. Total national budget expenditures and revenues;
 3. Total public expenditures;
 4. Total national tax revenue;
 5. Total national tax revenue shared by origin;
 6. Total public/national government assets;
 7. Total national capital investments (or general government (public sector) capital formation)
8. General government debt;
 9. Annual inflation rate
 10. Annual average exchange rate
- f. For the regional comparison, the national municipal finance datasets were reviewed in detail and revised, where necessary. Different reporting standards and practices across the region required reclassification and re-coding of data during this process of data cleaning. For the data analysis, all values were adjusted for inflation and correspond to 2008 prices. The data clean-up and reclassification followed the methodology as described in preceding Annex 2.

SUMMARY OF MFR DATASETS (AS COLLECTED)

	Number of local government units providing data	Years with available data	Major gaps in the dataset
Albania	385 (362 for 2002–2007)	2002–2011	
FBiH	57–70, depending on survey tables	2010	Survey based data collection with 88% response rate. Aggregate data are available 2008–2010
BiH RS	63	2008–2011	Revenues before 2010 and after are not comparable. Expenditures by functions are missing
Croatia	573	2008–2011	The only country with data on assets and liabilities
Kosovo	38	2008–2011	No information on borrowing
Macedonia	85	2008–2011	
Montenegro	21	2007–2011	Only a sample of expenditures by functions
Serbia	169	2008–2010	Statistical Office data, not detailed. Expenditures by functions are not reliable, because include central spending at local level. Aggregate data are available from public sources (MoF website)

