United Nations Development Programme

Fiscal Decentralization in Transition Economies: Case Studies from the Balkans and Caucasus

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CONTENTS

Foreword

Fiscal decentralization in the new member states of the European Union (EU), the Balkans, and the Commonwealth of Independent States (CIS) brings together three challenges that are central to improving the quality of governance in these countries. First, it represents the fiscal manifestation of the impulse to decisively break with the centralized excesses of the pre-transition period. Second, fiscal decentralization shows the sub-national dimension of the challenges of macroeconomic stabilization, and the need for all levels of government to live within their means. Third, fiscal decentralization calls attention to the imperatives of vesting appropriate levels of government with both the authority and resources needed to fulfil their tasks.

Some 15 years into transition, responses to these challenges have met with the greatest successes in the new EU member states, but with less success in the countries of the Balkans and the CIS. Having “graduated” from the fiscal conditionalities of the international financial institutions, and thanks to their relatively well developed central governance structures and high income levels, the new member states have developed frameworks for sub-national finance that can support genuinely independent local governments within the structures of the *acquis communautaire*. Most of the countries of the Western Balkans and the Caucasus, by contrast, are not likely to join the EU quickly. Nor do they possess EU levels of incomes or central government capacity. Nonetheless, fiscal decentralization can afford these countries with important opportunities to improve the quality of governance, at both the central and local levels.

This study, which is based on research conducted by Georgia State University’s Andrew Young School of Policy Studies in Atlanta, assesses the current status of fiscal decentralization in five countries of the Western Balkans and CIS (Armenia, Croatia, Georgia, the Former Yugoslav Republic of Macedonia, and the Union of Serbia and Montenegro). It also recommends policy and institutional changes for the consideration of these governments, as they seek to find the right mix of central and local governance, as well as state and private enterprise, in navigating the challenges of transition. UNDP’s Regional Centre in Bratislava (which organized and sponsored the study), and the leadership of UNDP’s Regional Bureau for Europe and the CIS (which inspired it), believes that the lessons it contains could be valuable for many countries of the region as well.

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Executive summary

- Decentralization is seen as essential by governments and international partners in most countries in the Balkans and Caucasus region. But it must be pursued in the context of fragmented local government structures coexisting uneasily within still highly centralized public sectors. The important questions concern *how* these countries can 'get decentralization right' in this context, in order to secure its benefits while minimising its potential costs, in the form of risks to central government capacity or fiscal balance.

- While the current status of fiscal decentralization in various transition economies differs, a number of similarities are also present, particularly in terms of the shortcomings of intergovernmental fiscal relations. These shortcomings reflect: (i) the lack of comprehensive, consistent (fiscal) decentralization strategies; (ii) absent or inadequate policy coordination mechanisms; (iii) excessive fragmentation of local government structures; (iv) under-estimation of the importance of politics in determining intergovernmental fiscal outcomes; and (v) insufficient management capacities to lead and implement fiscal decentralization.

- Programmatic entry points for UNDP and likeminded development partners in the area of fiscal decentralization include: (i) supporting the development of decentralization strategies; (ii) helping to establish and strengthen decentralization agencies; (iii) advocacy for decentralization; and (iv) supporting the alignment of fiscal decentralization with poverty reduction strategies and European integration processes.

- Future fiscal decentralization agendas in the Balkans and Caucasus countries are likely to focus on: (i) linkages to line ministries, in order to improve local service delivery; (ii) responding to *de facto* changes in tax incidence that result from the ambitious tax reforms now being introduced in many transition countries; (iii) creating more effective systems of intergovernmental transfers; (iv) promoting the deepening of well-regulated municipal finance markets; and (v) facilitating the consolidation of fragmented local government structures, in order to reduce the costs of borrowing and local service provision.

Introduction

The emergence of strong, democratic subnational governments is a precondition for successful economic and political transitions in the countries of Central Europe, the Balkans, and the Caucasus region. Effective, responsive local governments that are engaged with empowered communities are needed to ensure the accountable and efficient uses of public monies and the effective delivery of local public services.[1] Their creation and consolidation should be supported by central government institutions that adhere to principles of subsidiarity without sacrificing national fiscal balance or overall policy coherence.

Promoting decentralization is a goal (implicit or explicit) of international financial and development agencies like UNDP and the IMF. With central governments, we promote the development of viable and accountable legal, administrative, and financial frameworks. At the local level, we work to build capacities and stimulate local initiative. In so doing we seek to help state structures to better exercise the regulatory functions required for sustainable economic growth and human development. In the countries of Central Europe, the Balkans, and the Caucasus, the creation of effective subnational governments requires extensive decentralization, in order to redress the legacies of the excessive centralization of the pre-transition period.

Both the IMF and UNDP have helped governments to reform state structures in these countries. IMF lending and technical assistance has helped governments gain and maintain fiscal balance, in part through building capacity in finance ministries, central banks, and other key macroeconomic policy institutions. UNDP has promoted the design and implementation of decentralization strategies and laws, and then helped build the capacity of subnational governments needed to take advantage of these laws. UNDP has also worked with civil society and private sector organizations, to create the partnership frameworks required for community engagement and local government accountability. UNDP and IMF offices have worked together in national PRSP processes to ensure that the fiscal and decentralization mandates are coordinated with the work of other development agencies, and that the work has a genuinely pro-poor character.

Nonetheless, fiscal decentralization has remained somewhat outside the centre of both organizations' attention. IMF programmes typically emphasize national (rather than local) policy frameworks and finances, while UNDP has focused on what might be called the 'softer side' of decentralization. These emphases are understandable, but they are also unfortunate. Without appropriate fiscal empowerment, subnational government autonomy remains on paper, and the full potential of decentralization is not realized. Non-transparent local finances and overburdened central governments who are responsible for local service delivery are not good, either for fiscal policy or for decentralization overall. But whereas the Central European and Baltic economies that joined the European Union in May 2004 have made major progress in creating the fiscal frameworks needed for effective decentralization, this progress has by and large eluded the rest of the region. The fiscal decentralization picture in the Balkans and Caucasus countries is generally

[1] Depending on the size of the country and the governance model adopted, regional governments occupying the space between national governments and municipalities may also be needed to achieve these ends.

characterized by *ad hoc* initiatives that both reflect and collide with inconsistent decentralization agendas.

This paper, and the national studies on which it draws,[2] represent UNDP's attempt to redress this situation by bringing fiscal decentralization closer to the heart of its extensive decentralization and local governance portfolio in the Balkans and the Caucasus. In this paper, fiscal decentralization is generally understood to refer to reform of inter-governmental fiscal relations that seek to support decentralization processes in general and the formation and consolidation of subnational governments in particular. Special attention is accorded to: (i) the division of functional/expenditure responsibilities between different levels of government; (ii) the assignment of revenue sources to subnational governments; (iii) arrangements for intergovernmental fiscal transfers; and (iv) the development of frameworks for subnational government borrowing.[3]

Decentralization and fiscal decentralization in transition economies

State socialism was not monolithic over time or across the post-communist region. Hypercentralized political and economic systems in some countries (e.g., Albania) coexisted with more benign forms of political and economic centralization (e.g., in neighbouring Yugoslavia[4]). Within the Soviet Union, periods of highly centralized economic management (dominated by the *Gosplan* state planning agency and branch ministries) alternated with less centralized structures, such as the *sovnarkhoz* reforms of the late 1950s or *perestroika* of the late 1980s. Likewise, successor states responded to the collapse of the Soviet and Yugoslav federations in the early 1990s differently, choosing varying types and tempos of transition and decentralization strategies. Differences in economic and institutional development, political orientation, and proximity to the European Union (and therefore prospects for EU accession) underpinned these differences. In addition, at least some of the decentralization challenges these countries face have multiple solutions. Their pursuit has added further variety to the region's decentralization trends that evolved over the course of the 1990s.

Despite this, the approaches to decentralization adopted in most of the Balkan and Caucasus countries have a number of similarities. These include the following:

- ***Discrediting of centralization.*** The collapse of the Soviet and Yugoslav federations, with the accompanying conflicts and declines in living standards, discredited centralized political, economic, and fiscal systems. In the EU new member states, centralization was often associated with dominance by an external power and circumscribed national sovereignty.

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[2] As part of this exercise, UNDP commissioned country papers on fiscal decentralization in Armenia, Croatia, Georgia, the Former Yugoslav Republic of Macedonia, and the Union of Serbia and Montenegro. These were written by fiscal decentralization specialists working at the Andrew Young School of Policy Studies.

[3] A broader definition of decentralization is sometimes used to also include the deconcentration and delegation of decision-making power and fiscal administration within the central government. (Litvack and Seddon, 1999).

[4] Among other things, Yugoslavia had a relatively deconcentrated budget system that let the different constituent republics operate with more autonomy from the centre.

- ***Pursuit of a more decentralized public sector.*** The conditions in which these countries found themselves in the early 1990s were by no means ideal for the rapid creation of a well-functioning, decentralized state institutions. Nonetheless, almost all the Central European, Balkan, and Caucasus governments accepted the need for decentralized state structures. Most adopted (at least in principle) the concept of decentralized local government structures, as set forth by the European Charter of Local Self Government. The creation and consolidation of more decentralized public sectors have been major post-independence goals for these countries.

- ***Lack of previous experience with market-friendly decentralization.*** The goal of decentralizing governance systems to align them with principles of market-based democracies has been constrained by a dearth of practical experience concerning the organization and operation of decentralized public sectors. This inexperience generated two important fiscal phenomena in the region's new states. First, post-independence decentralization was initially equated with the transfer of highly centralized fiscal powers from the previous capitals (Moscow, Belgrade) to new national capitals. Second, 'local self-government' was initially interpreted as applying only to the levels of government closest to local communities. 'Local democracy' in Central and Eastern Europe, the Balkans and the Caucasus often led to the creation of small, highly fragmented 'local self governments' based on small rural settlements and communities below the district level. Much less attention was paid to the economic viability of these structures, to the creation of voluntary forms of local government integration (e.g., associations of municipalities), or to the decentralization of other government structures.

Decentralization initiatives are therefore seen in much of the region as essential, but as something that must be pursued in the context of highly fragmented local government structures coexisting uneasily within still highly centralized public sectors overall. The important questions for both governments and international development agencies concern *how* these countries can 'get decentralization right', in order to secure its benefits while minimizing its potential costs, in the form of risks to central government capacity or fiscal balance.[5]

This paper treats fiscal decentralization not as a *sufficient condition* for successful decentralization and transition, but rather as a *necessary condition*—without which decentralization initiatives, and transition as a whole, are unlikely to produce the desired results in terms of sustainable human development. Other necessary conditions include:

- the creation of the appropriate legal framework for decentralization, clearly empowering subnational governments and describing their rights and

[5] Differences in the particular objectives of international development agencies and financial institutions often predispose these institutions to certain views in the decentralization debate. Annex 1 presents a foray into the roles of UNDP and IMF in decentralization reforms, which may usefully inform the reading of this report.

responsibilities vis-a-vis the central authorities, local communities, the courts, and other important stakeholders;

- public administration and other institutional reforms of central and subnational government bodies, needed to align these bodies' organizational structures with their new functions;

- training, technical support, and other capacity building measures for appropriate subnational (and central) government civil servants; and

- support for the civil society and private sector partners who can ensure local government accountability and help realize the satisfactory delivery of local public services.

Prospects for fiscal decentralization are also very much affected by the size of the state sector as a whole, as well as by the level of economic development. Countries in the Balkans and Caucasus vary sharply in this respect. Some (e.g., Armenia) during the transition have experienced sharp declines in shares of GDP redistributed via the public sector, dropping to the 15-20 per cent range. In other countries, notably Croatia, Serbia and Montenegro, the general government budget accounts for more than 40 per cent of GDP.[6] Likewise, per-capita GDP (in purchasing-power-parity terms) in Croatia in 2002 was $10,240, while in Armenia it was $3,120.[7] These proportions suggest that (*ceteris paribus*) an identical public sector initiative pursued in an identical manner in both countries would enjoy one eighth of the local government funding in Armenia that it would enjoy in Croatia. They also suggest that the costs of unwise fiscal decentralization, in terms of the possible misuse of public monies or threats to overall fiscal balance, could be much higher in Croatia than in Armenia.

An overview of decentralization in selected transition economies

This paper draws on country studies and a summary overview paper concerning fiscal decentralization trends in Armenia, Croatia, Georgia, the Former Yugoslav Republic of Macedonia, and the Republic of Serbia (as a component of the Union of Serbia and Montenegro). Table 1 presents a snapshot view of the current status of fiscal decentralization in each of these countries, in terms of subnational government structures, expenditure and revenue assignments, intergovernmental transfers, and local public-sector borrowing.[8]

Armenia. Despite the centralization inherited from the Soviet Union, Armenia's public sector is clearly structured, consisting of a central government, a regional tier of

[6] Whether public sectors of such size represent too large a burden on these middle-income countries is an important question, but one that is not taken up here.
[7] These data are taken from UNDP's 2004 *Human Development Report*.
[8] More comprehensive assessments of decentralization in each of the five countries are provided in the country reports.

deconcentrated central government agencies, and an autonomous local government level made up of 972 municipalities. While it lacks a formal decentralization strategy document, the Armenian government (together with its development partners) appears to have a clear vision for the local government's role in the public sector. The government has identified the weaknesses in the current system in terms of decentralization, and is seeking to redress them in a reasonably consistent manner. The overall subnational government structure, and the functional responsibilities and revenue sources assigned to the local government level, are stable and clear. The central government is also moving to reduce local government fragmentation by promoting voluntary consolidation and inter-municipal collaboration initiatives.

On the other hand, the decentralization that Armenia is pursuing is quite limited in scope, with relatively small responsibilities and revenues assigned to the local level. Municipalities are only responsible for a handful of minor services and local infrastructure. More important functions such as education and health continue to rest at the central government level, although the central government has provided individual service delivery units (such as schools and clinics) a certain degree of managerial and financial autonomy by allowing them to operate as non-commercial enterprises. As a result, local government expenditures only comprise some 5-6 per cent of the consolidated government budget, or about 1 per cent of GDP.[9] However, this cautious approach to decentralization may be prudent given the limited capacity and small size of local governments, the country's centralized traditions, and its limited experience with local participatory governance structures and local accountability mechanisms. Fiscal decentralization in Armenia has therefore focused on strengthening local government financial management, with an emphasis on sound local budget processes and improved tax administration. While the main intergovernmental transfer mechanism being used is a sound formula-based equalization grant scheme, there may be scope for introducing a local capital development grant scheme and for the gradual expansion of local borrowing.

Croatia. Its relatively high per-capita income and large public sector give Croatia more possibilities for fiscal decentralization than other countries in the region—and raise the costs of unsuccessful initiatives in this regard. However, as in most other countries in the region, decentralization in Croatia has primarily been pursued for political reasons without much regard for its fiscal and economic consequences. As a result, Croatia has an excessively fragmented local government structure, in which a majority of local government units fall below the minimum efficient scale for service provision. Recent steps to increase local control over local service provision (such as the authority to appoint school directors) have not been accompanied by reforms to give local governments the autonomy needed to decide how to best deliver public services. The situation looks somewhat better on the revenue side, where local governments have the power to levy a local surtax on the personal income tax. While being adequate in an aggregate sense, this tax instrument has little yield in smaller localities. Although the fiscal disparities arising from the local government fragmentation makes a sound system

[9] The limited role of local governments in the Armenian economy must be put in the context of the small size of the public sector itself, as total government expenditures only comprise approximately 18-19 per cent of GDP.

of equalization grants of crucial importance, intergovernmental fiscal transfers are divided across a multiplicity of grant channels. The total amount of grants provided by the central government is negligible compared to the amount of resources raised from local revenue sources. The adequate funding of equalization grants therefore emerges as a priority in Croatia.

Georgia. Following the 'rose revolution' of late 2003, President Saakashvili's government launched an ambitious reform agenda aimed at good governance and restoring Georgia's territorial integrity. An environment of regional and ethnic tensions, pervasive corruption, and histories of low tax performance and poor treasury management, the government (as opposed to donor agencies and civil society stakeholders) sees these challenges as having some higher level of importance than decentralization in general and fiscal decentralization. Although the Law on Local Self-Government was enacted in 1997, much of the basic legal framework for local Self-Government—including local budget and local property legislation—is still incomplete, even though some of the draft laws have been circulating for several years. The central government needs to have a clear decentralization strategy, accompanied by strong political support for implementing decentralization measures. Progress on local budget processes, local tax reform, formula-based intergovernmental grants and other key decentralization issues serve to delay dealing with questions about Georgia's autonomous regions, and the possible overhaul of the country's administrative-territorial structure. While the July 2004 formation of the 'State committee for decentralization, public administration reform and developing local self-government' (led by the President) is a hopeful sign in this respect, its impact on the reform of central-local relations must still be realized. Not dealing with these issues is unfortunate, since a well-crafted decentralization programme could help redress some of Georgia's broader political issues.

Former Yugoslav Republic of Macedonia. Macedonia has one of the region's most active decentralization agendas: reforms to empower localities in which ethnic Albanians are strongly represented are seen by political elites as key to preventing a resumption of the hostilities the country experienced in 2001. The amalgamation of smaller local government jurisdictions in 2004 has left Macedonia with a consolidated territorial structure, which now consists of the central government and 84 municipalities, along with the capital territory of Skopje. The framework for local government finances was clarified by laws on Local Self-Government (2002) and the Financing of Local Self-Government (2004), the provisions of which become effective in July 2005. These laws will increase municipalities' role in local service delivery, particularly in the areas of education, health care, social protection, and culture. They should also improve systems for revenue assignment (assigning the property tax to the local level) and inter-governmental transfers (covering revenue sharing, sectoral grants and equalization grants). In order to prevent the potential mismanagement of resources at the local level, a number of stringent conditions must be met before individual localities can assume these responsibilities.

Republic of Serbia. Intergovernmental fiscal relations in Serbia have changed substantially since the deposing of Milosevic in 2000. However, fiscal decentralization in Serbia remains a work in progress. While local governments enjoy sufficient legal and financial authority for discharging their duties (which are rather limited), unresolved municipal property ownership issues are major constraints on *de facto* municipal autonomy. Local governments in Serbia also share some responsibility for primary and secondary education: local governments maintain school buildings while the central government pays teachers' wages. The scope of local revenue autonomy in Serbia was sharply reduced in 2004 with the elimination of the local wage fund and sales taxes. But while these shared revenues had provided substantial resources to the local level, it did so in a counter-equalizing manner and without the benefit of an equalization grant system. Significant disparities in the quality of local services therefore resulted. New tax legislation introduced in 2004, which replaced the sales tax with the VAT, could force changes in this respect. Because the VAT is difficult to share on a derivation basis, this reform may force the national government to put in place new revenue sharing mechanisms, which should facilitate a more equitable redistribution of tax revenues.

Shortcomings of fiscal decentralization in transition economies

While the above summarizes the current status of fiscal decentralization in these five transition economies and highlights the differences among them, it also points to a number of similarities. These are perhaps most apparent in the shortcomings of intergovernmental fiscal relations systems in these countries, which include inadequate local government structures, unclear expenditure assignments, the lack of revenue autonomy at the margin, and poorly considered intergovernmental transfer systems. Deeper analysis suggests that these shortcomings may reflect a number of more general problems, including:

- The lack of comprehensive, consistent (fiscal) decentralization strategies;
- Absent or inadequate policy coordination mechanisms;
- Excessive fragmentation of local government structures; and
- Underestimating the importance of politics in determining decentralization outcomes.

The lack of comprehensive, consistent decentralization strategies. Conceptually, there are logical sequences to the elements of fiscal decentralization, in terms of their fiscal-technical and reform dynamics (see Annex 2). In technical terms, this sequence revolves around the 'finance should follow function' maxim. That is, the most appropriate sequence would be to first define the structure of local governments and assign expenditure responsibilities. This would be followed by the assignment of revenue sources, the development of the transfer system, and the creation of a local borrowing framework. From the viewpoint of reform dynamics, the sequence should begin with (i) establishing a strategic vision for decentralization; it would be followed by (ii) putting in place the constitutional and legal basis needed to realize this vision; then (iii) realigning the central government's institutional and regulatory framework in line with (i) and (ii);

(iv) devising the appropriate local government institutional and regulatory framework; and (v) putting in place the partnership mechanisms needed for civil society and private sector participation.

While these sequences need not be followed rigidly, problems can occur if reform processes fall too far from this logic. For instance, assigning significant revenue sources to subnational governments before expenditure assignments are determined can be a recipe for intergovernmental tension and fiscal instability. Likewise, proceeding with specific decentralization initiatives in the absence of a clear strategic vision—or at least some consensus on the government's policy direction—is likely to generate inconsistent reform initiatives that are unlikely to succeed.[10] Fiscal decentralization reforms should likewise be designed and implemented in a comprehensive and consistent manner, since a given fiscal decentralization component (e.g., greater local revenue autonomy) cannot be designed separately from related components (e.g., the scope of equalizing intergovernmental transfers). Not all implementation steps need to be taken in a simultaneous 'big bang' fashion—indeed, this may actually be counterproductive. Still, the different implementation steps need to refer to one another and be part of a comprehensive, consistent decentralization strategy. Such strategies also need to be country-specific, to reflect differing national circumstances and the inevitability of at least some political compromise.

Fiscal decentralization in the five transition countries studied here was not preceded by the articulation of a comprehensive and consistent decentralization strategy. To this day, some of these countries do not have a single strategy document to guide their decentralization efforts; intergovernmental reforms have instead been pursued on a piecemeal basis. This has resulted in major delays, as in the case of Georgia. On the other hand, governments in Macedonia and Serbia have recently developed multi-year implementation programmes for decentralization, which can provide a base on which to build comprehensive reform strategies.

Absent or inadequate policy coordination mechanisms. The design and implementation of fiscal decentralization require close coordination of both local governments and a number of different central government agencies. Reform of local budget processes and transfer mechanisms typically involves the Ministry of Finance and the Treasury; local tax reform requires collaboration with the State Tax Service as well as the Ministry of Finance's macroeconomic or fiscal departments; the decentralization of sectoral programmes requires careful coordination with the Finance and line ministries. In the absence of a designated lead institution or coordinating body, it is hard to maintain the necessary coordination between different institutional stakeholders.

Many transition economies have very weak central government mechanisms for coordinating fiscal decentralization. In some cases, no specific institution has been formally designated to take the lead on local government finance. None of the five countries studied here has an inter-ministerial forum for coordinating policy on intergovernmental issues, or an intergovernmental coordinating structure such as a local

[10] This point comes through particularly strongly in the Croatian, Georgian and Serbian country papers.

government finance commission or an intergovernmental finance planning council.[11] When a specific organization is designated the institutional leader on decentralization matters, this institution tends to be politically or administratively weak.[12]

While well-designed decentralization programmes can improve local governance and service delivery, this does not mean that all public sector agencies are unified behind the principle of decentralized service delivery. The successful implementation of decentralization programmes must take various institutional positions—some of which are implicitly hostile to decentralization—into account. Even when the government officially adopts decentralization as its official policy, sectoral ministries tend to resist devolution plans that would drastically reduce their role.[13] Careful institutional coordination can help to find the technical solutions that might be most acceptable to the stakeholders involved.

Proponents of decentralization sometimes seek to circumvent inadequate coordination within the executive branch by developing alternative coordinative mechanisms involving NGOs, donors, and parliamentarians. Although such efforts can be valuable in providing technical support and mobilizing public support for decentralization, such efforts are unlikely to render unnecessary the proper engagement and coordination within the executive branch.

Fragmentation of local government structures. Many countries in the region got off on the wrong foot early on in the transition by introducing decentralization measures for political reasons without fully considering their economic consequences. Small municipalities with local jurisdictions that are close to the people but are smaller than the minimum efficient scale necessary to effectively provide public services are one such result.[14] Governments in many countries are addressing problems of municipal fragmentation by consolidating small local government jurisdictions.[15] Unfortunately, fragmentation is not an easy issue to resolve politically; governments generally prefer

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[11] For a discussion of intergovernmental institutional arrangements, see Boex and Martinez-Vazquez (2004).

[12] Armenia's Ministry of Territorial Administration, which has been designated the lead agency on decentralization, appears to lack any technical staff. Similarly, in Croatia, the Central Administrative Office charged with intergovernmental issues is a former department of the Ministry of Justice. However, as a sub-ministerial entity, it lacks the proper authority to deal with fiscal affairs or to coordinate decentralized functions of sectoral ministries.

[13] Such opposition can be motivated by a genuine belief that central government ministries are better able to deliver sectoral services. More often, line ministries have a hard time in redefining themselves in a decentralized environment as regulators and enablers, as opposed to implementers. Thus they try by different means to preserve their turf and budgets. Ironically, line ministries sometimes find support from their sectoral counterparts within donor organizations. This is one of the many ways that poor coordination between and even within donor agencies can cause confusion in the area of decentralization (and other reforms).

[14] See Boex, Martinez-Vazquez and Timofeev (2004) for a discussion of the conceptual determinants of subnational government structures.

[15] For instance, Denmark's 2004 review of its administrative-territorial structure resulted in a proposal to consolidate smaller rural districts. South Africa pursued a round of extensive local consolidation in the late 1990s to eliminate ineffective small local governments. Of the five transition countries reviewed here, at least three (Armenia, Croatia and Georgia) have serious problems with excessive municipal fragmentation.

voluntary rather than forced consolidation approaches. Voluntary methods may be effective, but they often require the dedication of significant resources as incentives, and even successful cases of voluntary consolidation can take a long time. Other approaches that have been used in other regions include the creation of special public service districts to capture economies of scale, as well as outsourcing service delivery to private companies that may service many local governments. On the other hand, some countries may be willing to tolerate some scale inefficiencies as the price of proximity, representation, and accountability between local governments and their constituencies.

The case against mandatory consolidation is further strengthened by the sometimes problematic role of intermediate levels of public administration (particularly in the form of deconcentrated central government agencies), which can become the default instrument for facilitating this consolidation. Experience from many countries shows that deconcentrated central government agencies can be a springboard for the insertion of discretionary central political influences into local governance. Such intermediate levels can be inimical to the pursuit of local government autonomy, where local officials are predominantly accountable to local communities. The introduction of additional levels of government can also be administratively costly, reduce vertical accountability within the state sector, and can redirect resources from central to local level budgets. These problems have led a number of countries (Poland, South Africa, and Ukraine) to create bifurcated vertical structures of government, where municipalities do not report to intermediate levels. Under these arrangements, the Ministry of Finance and other central government agencies generally deal directly with the local governments.

The two main objectives behind the reforms in territorial administration should be to build up administrative capacity and preserve democratic representation. For some of these countries there is also a need to put in place a more consistent institutional framework for the implementation of the EU pre-accession and structural funds. Ideally, these new jurisdictions would coincide geographically with the NUTS III regional classification of the 'Territorial Units Statistical Nomenclature' adopted by the EU as a criterion for grants allocation.[16]

Underestimating the importance of politics in determining fiscal decentralization outcomes. The technical dimensions of fiscal decentralization do not change the fact that intergovernmental fiscal relations are a highly political matter. Fiscal decentralization affects vertical power relations and the allocation of resources between central and subnational governments. If central governments see these power relations as a zero-sum game, they may not favour—and may in fact come to fear—the political consequences of decentralization. Because decentralization (like other reforms) in transition countries requires strong political support, successful decentralization needs a champion at the highest levels of government. The slow pace of decentralization in many transition economies suggests only a limited commitment in this respect. Proponents (including those in the international community) need to be able to make the political case for decentralization, promoting in this way the 'why' of good decentralization as much as the 'how' of sound intergovernmental fiscal relations (see Box 1). The political economy of

[16] NUTS III regions are subdivisions of the EU 'basic administrative units' NUTS II regions.

fiscal decentralization in turn raises questions about its pro-poor character.[17] The political influence of wealthy municipalities (e.g., capital cities) can be a major obstacle to the design and implementation of the intergovernmental transfers needed to reduce horizontal imbalances.[18]

Box 1: Fiscal decentralization and related policy objectives

Decentralization is no panacea. If poorly designed and implemented, it can create more problems than solutions. But, when well designed, decentralization can address a number of key policy issues that countries in the Balkans and the Caucasus face today.

Territorial integrity. Some countries facing separatism have used decentralization (sometimes in combination with asymmetric federalism (Bunce 2004)) to avoid conflict and preserve territorial integrity. The 2001 Ohrid agreement in the Former Yugoslav Republic of Macedonia suggests that decentralization can empower different groups to better manage local problems while simultaneously helping them to share a common national purpose.

Fighting corruption. Decentralization initiatives can bring government closer to local communities, giving people a greater interest in ensuring that government works effectively. While decentralization can remove central controls over local elites, empirical evidence shows that, on balance, decentralization is associated with significantly lower levels of corruption.

Stimulating economic development. Central government institutions are essential to effective economic development, both in terms of macroeconomic policies and large infrastructure projects. However, evidence strongly suggests that decentralized subnational governments can play a fundamental role in developing their own economies.

Improving public sector efficiency. Providing local governments with their own revenue sources can reduce pressures on national budgets, thereby allowing more effective macroeconomic management and the realization of national priorities. The fiscal constraints facing transition economies suggest that increasing the efficiency of public expenditures should be a key priority. An effective system of decentralized public finance can help to bring this about.

Poverty reduction through better service delivery. Decentralization can reduce poverty by improving the quality of and access to education, health, and communal services. Local governments are often better equipped to provide these services than are central government agencies. However, the transfer of physical assets to local governance balance sheets and making municipalities responsible for their operational and capital expenses without providing off-setting resources and revenue generation can mean new fiscal burdens for local governments. The further decapitalization of the transferred assets, and the endangering of local government financial balance, can result instead.

[17] The linkage between fiscal decentralization and poverty reduction is a crucial one, which has not been well addressed in the literature. Although the poverty impact of transfers on horizontal fiscal imbalances may be most obvious, each of fiscal decentralization's building blocs (expenditure assignments, revenue assignments, transfers, and borrowing) can be more or less pro-poor, via their impact on income distribution and access to public goods.

[18] A recent international comparison (Boex and Martinez-Vazquez, 2005) found that the 'political economy' of intergovernmental fiscal relations is not as obvious as it may seem at first glance.

The risks of getting fiscal decentralization wrong

A recent definition of decentralization emphasizes the empowerment of local communities via the empowerment of their local governments (Bahl, 2005). This definition underscores the potential benefits of decentralization on efficiency, equity, and governance in the public sector. The potential benefits of sound decentralization (see Box 1) are numerous: decentralization can help strengthen weak states, make public sectors more efficient, encourage local economic development, reduce corruption, improving service delivery and alleviate poverty.[19] But achieving these benefits means satisfying a number of conditions for successful fiscal decentralization. These preconditions include a comprehensive, consistent decentralization strategy combined with well-designed individual components of a fiscally decentralized system (i.e., sound local government structures, appropriate assignment of expenditures and revenues, a well-designed transfer system, and the appropriate framework for local borrowing). Although an exact definition of 'sound' or 'correct' approaches to fiscal decentralization goes well beyond the scope of this study, the references in Box 2 (below) provide some context to this question.

Box 2: What constitutes 'sound' fiscal decentralization?

Fiscal decentralization is not one-size-fits-all; there is no single prescription for 'correctly' arranging inter-governmental fiscal relations. Different countries can appropriately resolve the same policy issue by using different decentralized approaches.

Despite this, a substantial consensus has emerged within the fiscal decentralization literature concerning the commonalities of 'good' or 'sound' fiscal decentralization. (The World Bank Institute's Fiscal Decentralization Initiative has since 1998 played an important role in pulling together much of this literature.) Suggested further reading on this topic includes:

§ Subnational government structure: *Subnational Government Structure and Intergovernmental Fiscal Relations: An Overlooked Dimension of Decentralization* (Boex, Martinez-Vazquez and Timofeev, 2004).
§ Sound expenditure assignments: *The Assignment of Expenditure Responsibilities* (Martinez, 1998).
§ Revenue assignments: *The Tax Assignment Problem: Conceptual and Administrative Considerations in Achieving Subnational Fiscal Autonomy* (McLure, 2000); *Subnational Revenues: Realities and Prospects* (Bird, 2001).
§ Intergovernmental fiscal transfers: *The Design and Implementation of Intergovernmental Fiscal*

[19] Despite its rapid expansion, empirical research on this topic does not convincingly prove the economic benefits of fiscal decentralization, nor does it find any systematic negative impact of decentralization on economic outcomes. Two issues presumably contribute to this lack of incontrovertible findings. First, researchers face numerous challenges in accurately defining and measuring the degree of fiscal decentralization (Ebel and Yilmaz, 2002). Second, whether the decentralization measures that are implemented are sound (the *quality* of fiscal decentralization) may be at least as important as the degree (*quantity*) of fiscal decentralization in achieving the potential benefits. Zou, Shah and Thompson (2004) present a synthesis of the empirical evidence on the impact of decentralization on service delivery, corruption, fiscal management and growth in developing and emerging market economies.

Transfers (Bahl, Boex, and Martinez-Vazquez, 2001).

§ Local government borrowing: *Subnational Debt, Borrowing Process, and Creditworthiness* (Peterson, 1999); *Intergovernmental Loans: Their Fit into a Transfers System* (Weist, 2004).

§ Implementation of decentralization reform: *Twelve Implementation Rules For Fiscal Decentralization* (Bahl, 1999).

Two long-standing service lines of UNDP's Democratic Governance Practice address issues of fiscal decentralization: *Decentralisation, Local Governance and Urban/Rural Development* and *Public Administration Reform and Anti-Corruption.* In conjunction with these two existing modules, UNDP is currently also developing a *Primer on Fiscal Decentralization* to support the global work of UNDP in the area of (fiscal) decentralization and local governance.

For decentralization to succeed, well-designed fiscal decentralization initiatives should go hand-in-hand with the appropriate decentralization of political and administrative mechanisms, and should be aligned with the country's overall fiscal capacity. Decentralized political mechanisms should enable local communities to express their preferences and priorities to their local elected officials, encourage local officials to be responsive to such priorities, and enable local communities to hold their officials accountable. A well-designed fiscal decentralization reform will fail (and the anticipated benefits and increased efficiency will fail to materialize) if the appropriate governance mechanisms are not in place for local accountability. Likewise, local officials need the appropriate administrative tools and processes (such as participatory and transparent local budget processes, sound tax administration, and control over local staff) in order to be responsive to the needs of local constituents. Decentralization likewise requires that subnational governments have autonomy over the hiring, firing and compensation of their employees.

Obviously, few countries get their intergovernmental fiscal systems completely correct. However, it is fair to say that fiscal decentralization in many Balkan and Caucasus countries leave much to be desired in these respects. This begs the question: what happens when things go wrong? What sort of fiscal and other risks appear when countries do not decentralize appropriately?

Table 2: Possible consequences of unsound fiscal decentralization

Unsound practice	Possible Consequence	Risk Assessment
Municipal fragmentation (excessively small jurisdictions)	Inefficient production of local public services; poor service delivery; problems with local revenue administration	Relative low risk, as long as small jurisdictions are only assigned minor expenditure responsibilities
Inappropriate assignment of expenditure responsibilities: devolving major responsibilities to unaccountable local authorities	Inefficient production of local public services; suboptimal delivery of local services; major potential for local corruption	Major risk, given the relatively large size of resources involved and difficulties of ensuring sound, accountable financial management across all local jurisdictions
Excessive revenue decentralization or too much revenue autonomy	Can lead to vertical fiscal imbalances (in favour of local governments) and macroeconomic tensions. Too much	Major risks. Fiscal imbalances and excessively high tax burdens could threaten macroeconomic stability.

	local control over tax rates can lead to excessively high tax burdens.	
Perverse incentives in inter-governmental transfer mechanisms (e.g., gap-filling transfers)	Poorly designed transfer mechanisms can facilitate irresponsible local spending and reduce local fiscal effort	Risk depends on the overall degree of decentralization. The greater the decentralization, the greater the potential risk posed by bad transfer mechanisms.
Vertical fiscal imbalances and unfunded mandates	Under-provision of local services	Risk depends on the overall degree of decentralization and the nature of services that go unfunded or under funded. The greater the decentralization, the greater the damage.
Lack of adequate local budget procedures and hard local budget constraints	Subnational budget arrears and local defaults could require central government bailouts, particularly in the absence of municipal insolvency and bankruptcy laws (as for example in Hungary)	High risk in the absence of sound local financial management and reporting frameworks. Low risk if sound local budget (formulation, execution, monitoring) processes and borrowing procedures are in place.

The impact of a particular weakness in the design of intergovernmental fiscal relations depends on the country's fiscal system. However, potential risks can be identified as being proportionate to the size of the 'contingent liability' associated with unsound fiscal decentralization measures—the relative share of the fiscal resource being decentralized, which would become a liability to the public sector if the decentralization is unsuccessful—multiplied by the probability of failure. Fiscal decentralization that involves fewer budgetary resources is therefore less risky than major changes in expenditure responsibilities or the distribution of tax revenues. Likewise, decentralization initiatives that face major obstacles in implementation (e.g., reforms requiring significant changes in regulatory processes and procedures) have a higher probability of failure and also imply potentially greater fiscal risks. Of course, the risks associated with fiscal decentralization can be minimized by reducing its scope. But this can mean forgoing large potential benefits associated with decentralization. Where a particular country lands on this trade off should depend not only on collective preferences for risk aversion, but also on a number of technical issues. Table 2 provides an assessment of the risk of unsound fiscal decentralization practices that are not uncommon in transition countries.

Toward a consensus on sound fiscal decentralization

If decentralization is inevitable in the countries of the Balkans and the Caucasus and significant room for improvements in the implementation of fiscal decentralization are apparent, then what can UNDP, international financial institutions, and donor agencies do to support the implementation of sound decentralization?

It is important to note that international actors can have an important influence on (fiscal) decentralization in these countries. In fact, international agencies are sometimes alleged to be the primary champions of fiscal decentralization. When they bring funding as the carrot, they can catch the attention of government officials and stimulate official discussions of decentralization issues. This is particularly the case when international organizations speak in a single, coordinated voice when it comes to fiscal decentralization, avoiding contradictory policy advice. But while strong support from the international community is a necessary condition for successful decentralization reform, it is not a sufficient condition. Successful decentralization needs strong national champions (Bahl, 1999). Otherwise, interest can wane when the money is gone, and implementation is never reached or completed.

The review of fiscal decentralization in the five selected transition economies suggests several possible entry points for UNDP and likeminded development partners.[20] These include:

- Supporting the development of overall decentralization strategies;
- Helping to establish and strengthen decentralization agencies;
- Advocacy for decentralization; and
- Aligning fiscal decentralization with poverty reduction and European integration processes.

Supporting the development of overall decentralization strategies. As described above, the development of a sequenced decentralization strategy into which fiscal decentralization can fit is critically important.[21] The development of a strategic vision and attainment of a national consensus should precede the promulgation of the relevant legislation, regulations and implementation procedures. Such strategic policy documents likewise need to address fiscal decentralization in a comprehensive fashion, in order to prevent the haphazard implementation of uncoordinated, piecemeal decentralization reforms. Implementation in all its stages should refer back to and be informed by the decentralization strategy document. While international experts and NGOs can engage in background research and draft white papers, this strategy must ultimately be owned by policymakers in the executive branch. UNDP can support the development of official decentralization strategy and policy documents, in both substantive and organizational terms. UNDP's role in PRSP processes—in terms of linking the substance of the strategy document to the consultative processes that should help generate it and the monitoring processes that should follow its implementation, thereby ensuring the document has a coordinated, pro-poor, and participatory nature—could be very useful in this respect.

Helping establish and strengthen decentralization agencies. The successful implementation of a fiscal decentralization programme is unlikely if a strong central government agency does not lead the process. The lead central agency needs to develop and impose uniform systems of financial accounts and local taxation procedures, adjust grant distribution formulas, and decide how to monitor and enforce proper legal limits on borrowing. Transparent, accountable local government finance requires effective financial reporting and monitoring systems. Many Balkan and Caucasus governments

[20] Many UNDP offices already support fiscal decentralization processes along the lines of what is suggested below.
[21] Of the five countries examined in this study, Armenia, Croatia, and Georgia could most directly benefit from this type of activity.

lack a decentralization agency and the qualified personnel needed to perform these tasks. Box 3 provides some important guidance in this respect.[22]

Advocacy for decentralization. Decentralization in general and fiscal decentralization in particular can provide many benefits. For government and society in general, decentralization can improve local service delivery, promote rural development, and encourage local development strategies. Decentralization can also free central governments from the burden of managing local service delivery, thereby facilitating the redeployment of national policy capacity for truly national problems. But despite these benefits, political commitment to decentralization on the part of central governments in many transition countries is rather weak. Even otherwise 'reformist' governments have a tendency to view decentralization as a zero sum political game in which scarce state capacity is transferred from the centre to the regions.

Box 3: International practices in coordinating intergovernmental fiscal relations

International practice offers four more or less standard options for intergovernmental fiscal coordination (Boex and Martinez-Vazquez, 2004): (1) exclusive reliance on the Ministry of Finance or the Ministry of Local Government (or its equivalent); (2) introducing one of several types of Local Government Finance Commissions; (3) reliance on parliament to monitor and coordinate intergovernmental affairs; and (4) formal reliance on a local government association for intergovernmental coordination.

During the 1990s, the introduction of a Local Government Fiscal Commission was the 'standard' institutional solution for intergovernmental coordination. This term is applied to three different types of coordinating mechanisms, which have distinctly different objectives (vertical coordination, horizontal coordination, and autonomous review). The best fiscal coordination option is very much dependent on the institutional setting of a country and the policy objective to be achieved.

As the experience of Macedonia (and other countries) shows, these perceptions can be inaccurate. In addition to reducing the burdens of local service provision from central government agencies, decentralization can provide different communities with the space needed for political accommodation and reconciliation. As an international agency that is seen by governments as a neutral partner, UNDP (and its development partners) is well placed to make this point, in part by disseminating successful international experiences with decentralization. Such support can help policymakers who are proponents of decentralization but who may not have the resources to make their case as effectively as possible. Win-win outcomes for all parties can result.

Improving intergovernmental fiscal transparency. Fiscal decentralization can improve the quality of fiscal information, both at subnational levels and for the country as a whole. Although the IMF's Fiscal Transparency Code requires governments to report the consolidated fiscal position of local governments, additional steps—such as providing basic financial summaries for individual local authorities—could greatly strengthen

[22] All five of the countries examined in this study—and Georgia in particular—could benefit from this type of activity.

public sector transparency and accountability. UNDP support for central (finance ministry, treasury) and local government efforts to put into place sound local fiscal reporting mechanisms could pay large dividends. Specific UNDP activities could range from building the capacity for independent external audits and budget evaluation procedures, to facilitating the use of capital development grants (to finance local infrastructure), to working with local credit rating agencies to help deepen and improve access to municipal bond markets.[23]

Fiscal decentralization, poverty reduction, and alignment with European integration processes. Like other policies, decentralization in general and fiscal decentralization in particular can have a stronger or weaker pro-poor character. Decentralization can reduce poverty by improving the quality of and access to education, health, and communal services, especially since local governments are often better equipped to provide these services than are central government agencies. However, the transfer of physical assets to local governance balance sheets and making municipalities responsible for their operational and capital expenses without providing off-setting resources and revenue generation, can mean new (and perhaps unsustainable) fiscal burdens for local governments. To better understand these problems UNDP could generate fiscal incidence and public expenditure tracking studies. Such analyses could quantify the scope of the inefficiencies and regressiveness of the centralized delivery of local services, as well as uncover similar problems with decentralized governance where it is already working. Additionally, the analysis of possible incentive systems to support investments and services for the poor could be conducted as well as the development of intergovernmental transfers to support poverty alleviation.

The design and implementation of decentralization policies do not occur in a vacuum. A number of partly competitive, partly complementary policy regimes are also present in the region—regimes that are associated with key international actors. These are in particular the poverty reduction strategy papers—in which the IMF, World Bank, and bilateral donors are also involved—and programmes for integration with the European Union (EU).[24] The successful implementation of decentralization strategies that are not linked to these processes is unlikely. International development agencies seeking to promote decentralization in the region may therefore wish to consider mechanisms to ensure the alignment of decentralization strategies with PRSP and EU accession processes. Since UNDP generally supports and coordinates PRSP processes, UNDP could help ensure the best alignment of decentralization strategies with PRSP and EU accession processes.

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[23] This option would be more relevant for those countries that already have international sovereign risk ratings (that could serve as a benchmark for local ratings), as well as relatively reformed domestic banking systems.

[24] For the Balkan countries, EU integration is occurring within the framework of membership negotiations (for Bulgaria, Croatia, Romania, and Turkey) and the Stabilization and Accession Agreements with Albania, Bosnia and Herzegovina, the Former Yugoslav Republic of Macedonia, and the Union of Serbia and Montenegro. For the CIS countries (except for the Russian Federation and the Central Asian states), the relevant framework is the European Neighbourhood Policy’s national action plans.

Lessons for the future

Although this paper is only a quick and modest contribution to international efforts to support fiscal decentralization in the Balkans and the Caucasus, it points to a number of common weaknesses in the decentralization approaches followed in transition economies. Perhaps the most important systematic shortcoming uncovered is the lack of a comprehensive fiscal decentralization strategy in any of the countries reviewed.[25] Roy Bahl's (1999) first 'rule' of fiscal decentralization reform states that fiscal decentralization should be viewed as a comprehensive system, and must be designed in such a way that all the pieces in this system fit together. Implementation should be preceded by the design of a comprehensive, consistent system, in which the scope and role of each systemic element is laid out in advance. Piecemeal reforms, encompassing only one (or some) element(s) of the system, are unlikely to be successful. While judiciously phased-in decentralization strategies may help to avoid 'reform shock', they do not lessen the need for comprehensive, consistent reform designs, or for preparations to deal with problems that may arise during implementation.

A second lesson concerns the importance of securing political support for decentralization of key central government from policymakers. The difficulties that decentralization initiatives have encountered in much of the region can be attributed to the absence of this support. While this lack of central government support for (or covert opposition to) decentralization reflects many factors, one is a sometimes less than full appreciation of the degree to which decentralization can help central governments to attain their political objectives. The Macedonian example shows that, in the right circumstances, decentralization can play a key conflict prevention role.

A third lesson is that policy makers in the region will, in future, be increasingly likely to focus on the following aspects of decentralization policy:

- Linkages to sectoral policies should be strengthened, particularly in terms of public service delivery. Clarifying expenditure assignments and the distribution of responsibilities for the regulation, financing, and implementation of social services vis-a-vis line ministries in the case of concurrent expenditure responsibilities is particularly important in this respect.

- Linkages to tax policies should be strengthened. Many transition economies are introducing ambitious tax reforms that reduce ('flatten') tax rates, broaden the tax base (by closing loopholes), and improve the quality of tax administration. These reforms can mean changes in tax incidence and thereby redistribute tax revenues across various levels of government. These *de facto* changes in the distribution of

[25] There are some variations in the degree to which these countries have formalized their policy vision of a decentralized system of intergovernmental fiscal relations. In some countries more clearly than others, the government's decentralization strategy is embedded in the legal framework. Furthermore, in some of the countries considered, informal decentralization strategy documents are being circulated. However, these documents tend to be drafted outside the government sector, and the level of government ownership over the documents is questionable at best.

tax revenues can introduce misalignments with expenditure assignments, leading to new vertical and horizontal fiscal imbalances that had not previously existed.

- On-going and future devolution of fiscal revenues from central to subnational governments raises the importance of intergovernmental transfers. The creation of more effective formula-driven systems for inter-municipal equalization grants, combined with the rationalization of existing conditional grant systems, is in principle the best response to this challenge. On the other hand, in countries where municipal finances only constitute 1-2 per cent of GDP (e.g., Armenia, Georgia), excessively redistributive intergovernmental transfer systems can constrain the development of decentralized finance in those relatively wealthy municipalities where it has the best chance of flourishing.

- Frameworks for subnational borrowing, in order to finance these countries' considerable local infrastructure development needs, need to be improved. In some countries (e.g., Armenia, Georgia) high real interest rates and the absence of international sovereign debt ratings result in very shallow markets for municipal finance, precluding significant municipal borrowing. Far reaching reforms of bank and non-bank financial institutions are needed in these countries in order to extend possibilities for subnational borrowing beyond the largest cities. In other countries (particularly those now negotiating for EU membership), financial deepening and good access to international capital markets are sharply reducing real interest rates and significantly improving municipalities' access to securitized and non-securitized debt finance. Here, the challenge is to improve the regulation of subnational borrowing, so as to prevent damaging excesses.

- Increasing opportunities for subnational borrowing can strengthen incentives for the voluntary consolidation of fragmented local government structures. Whether through amalgamation into larger units or the formation of municipal associations for borrowing purposes, small municipalities are likely to become increasingly interested in attaining the minimal efficient scale needed for low-cost borrowing and local service delivery.

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Country Report: An Assessment of Fiscal Decentralization Reform in Armenia[26]

Executive Summary

Notwithstanding the highly centralized structures and traditions that Armenia inherited from the Soviet Union, the country's public sector has adopted a clear, decentralized government structure, with a central government, a regional deconcentrated tier, and an autonomous local government level comprising 972 community governments. While the government lacks a formal decentralization strategy document, the government (together with its development partners) appears to have a clear vision of the local government's role in the public sector. As such, the government systematically identifies the weakest links in the decentralized system of government, and pursues them in a deliberate manner. Although one of the central government's decentralization priorities is to reduce the fragmentation of the local government level though voluntary consolidation and inter-community collaboration, the overall subnational government structure (as well as the functional responsibilities and revenue sources assigned to the local government level) are stable and clear.

Despite the systematic approach that the Armenian government is taking to local government (finance) reform, a substantive criticism of Armenia's decentralization reform is that the degree of decentralization that Armenia is pursuing is quite limited, with a relatively narrow scope of responsibilities and revenue sources assigned to the local level. Communities are only responsible for a number of minor community services and local infrastructure, while more important functions such as education and health continue to be delivered by the central government level, although the central government has provided individual service delivery units (such as schools and clinics) a certain degree of managerial and financial autonomy by allowing them to operate as non-commercial enterprises (see Box 1). Correspondingly, local government expenditures only comprise roughly 5-6 per cent of the consolidated public expenditures.[27] However, this cautious approach to decentralization may be prudent given the limited capacity and small size of local governments, the country's highly centralized traditions, and its limited experience with local participatory governance structures and local accountability mechanisms.

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[27] The limited role of local governments in the economy is further compounded by the fairly narrow role of the public sector itself, as total government expenditure only comprise approximately 18-19 per cent of GDP.

As a result, fiscal decentralization reforms in Armenia are predominantly focused on strengthening the capacity of local government financial management (including sound local budget processes and improved local tax administration). While the main intergovernmental transfer mechanism being used is a sound formula-based equalization grant scheme, there may be scope in Armenia for the introduction of a local capital development grant and for a cautious, gradual expansion of the role of local borrowing.

Introduction

The overall objective of the study on fiscal decentralization in select transition economies –of which this country report is an integral part–is to accomplish an all-encompassing review that systematically captures the entirety of the fiscal decentralization processes in each of five transition countries, including Armenia, Croatia, Georgia, Macedonia, and Serbia. In addition to producing five country reports, the study further sets out to integrate and synthesize the experiences from these five countries, and to broadly consider the role of the various stakeholders in promoting decentralization reforms. As part of this larger study, the main purpose of this country report is to provide an overview of the progress and issues with fiscal decentralization in Armenia.

In the following five sections we provide an assessment of each of the five building blocks of intergovernmental fiscal relations respectively (structure of the government sector; delineation of expenditure responsibilities, assignment of revenue sources, intergovernmental transfers, and subnational borrowing) and consider the technical nature of the strengths and weaknesses of the respective decentralization process.[28] In the concluding section, by juxtaposing the current state of fiscal decentralization reforms with recent or ongoing initiatives, we identify areas in which we judge priorities for further action should fall, and how UNDP, and potentially other donors can fine-tune their portfolios of activities to optimize their contribution to the decentralization process in the country.

While details of fiscal decentralization reforms in Armenia are discussed in the report, the annex to this report provides three two-dimensional matrices that serve for providing the 'big picture' of the decentralization reforms. The matrices consider the five functional components or dimensions of decentralization as outlined above, as well as the technical nature of the reform of the specific decentralization issues: for instance, when considering an element of the decentralization reform strategy, the matrix is able to map whether it is a policy concern, whether the issue is legislative in nature, part of the regulatory framework, part of local process and procedures, or a reform issue to be addressed through civil society. The three matrices form the basis for collating the

[28] Traditionally, expenditure assignment, revenue assignment, intergovernmental transfers and subnational borrowing are recognized as the four main pillars of intergovernmental fiscal relations. The addition of local government structure as a separate dimension (as opposed to treating it as part of the discussion on expenditure assignments) stresses the need for sound territorial administrative and political structures to be in place for fiscal decentralization to be effective and efficient.

information obtained from reviewing the available technical studies and policy reports on decentralization in Armenia, as well as the insights acquired during the discussions and meetings held in February 2005 in Armenia as the background for developing this country report:

§ Matrix 1 (The Assessment Matrix) identifies the current state of fiscal decentralization reforms and maps policy areas within the realm of decentralization and local government reform that present the current key policy issues and obstacles for the further development of decentralization in the country.

§ Matrix 2 (The Reform Initiatives Matrix) identifies and maps recent or ongoing initiatives pursued by the national government, subnational governments and their associations, as well as UNDP, other donor agencies and stakeholders within the realm of decentralization and local government reform that are aimed at addressing and resolving the obstacles and challenges noted in Matrix 1 above.

§ Matrix 3 (The Reform Priorities Matrix) identifies priorities for further action within the same dimensions of Matrix 1 and 2. That is, the matrix maps areas that are either currently underserved in the policy discussion towards decentralization, or areas in which a fresh perspective may stimulate new policy thinking.

Our overall assessment of fiscal decentralization reform in Armenia is generally quite positive. Notwithstanding the highly centralized structures and traditions that Armenia inherited from the Soviet Union, the government has a clear vision of the decentralized structure of the public sector that it would like to see materialize in the medium term, the role of local governments in that structure, and the importance of a sound system of intergovernmental fiscal relations. Although the government lacks a formal decentralization strategy document, the government (together with its development partners) has been systematically identifying the weakest links in the decentralized system of government, and pursues them in a deliberate manner.

Structure and scope of the government sector in Armenia

Armenia is a small, landlocked, mountainous country covering an area of 29,800 square kilometers. The population of just over three million people is one of the most homogeneous in the world. Although regional tension over the enclave of Nagorno-Karabakh in Azerbaijan continue to simmer in the background, increased stability since the mid 1990s has set the stage for improvements in the governance of the public sector as well as economic growth. After 1994, GDP growth averaged 6 per cent, and economic growth has achieved double digits in the recent years. However, the role of the public sector in the economy is extremely small: public revenues account for only 16 per cent of GDP, whereas public expenditures comprise about 18-19 per cent of GDP.

Description and assessment of the subnational government structure

Armenia's constitution, which was adopted on 5 July 1995, laid the legal foundation for local self-government reforms in Armenia. Armenia is divided into ten administrative regions (Marzer) and the capital city of Yerevan, governed by state appointees. Marzer are further divided into rural and urban self-governed communities (hamainkner). In summary, Armenia has 11 subnational jurisdictions at the regional level and 930 self-governed communities: 871 rural communities and 59 urban communities.

Regions (Marzer). Regions in Armenia are a deconcentrated tier of central government authority, which were formed post-independence by the consolidation of numerous Soviet-era rayons. As such, regional administrators do not have their own budgets and are not considered a local government level. The role of regional authorities (Marz) is to implement the territorial policy of the central government, coordinate central government agencies in the field and to supervise the legality of local governments' decisions. While communities are regulated through national laws, the activities of the regional governments are regulated by decrees from the President of the Republic. As the nation's capital, Yerevan has the status of a region (with an appointed mayor), which is divided into 12 district communities.

Regional councils are comprised of the mayors and heads of communities in the region, but chaired by the appointed regional governor (Marzpetz). However, in practice the role of Regional Councils goes beyond coordination and ex-post review of local decisions. In fact, regional administrations serve to ensure adherence of local governments to central government plans pretty much as it functioned in the Soviet System. In part this is facilitated by the Constitutional power of regional governments to initiate a dismissal of any elected local government authority (Art. 107-109).[29] In addition, decisions and actions of local self-government bodies may be appealed to a court by the respective Regional Marzpet.

Communities. The local (self) government level in Armenia is formed by the community-level. The community governance structure includes a Community Council and the Head of the Community (the city mayor, village head or district head). The Law on Elections of Local Governments (1996) stipulates that the community council and the head of the community are directly elected by local residents for a three-year mandate through general, equal and direct elections by secret ballot.[30] In accordance with the new Law on Local Self-Governance (2002) the number of the community head's staff is determined by the local government itself.

[29] If a community budget's actual revenues do not cover mandatory services, or perform duties delegated by the State in an unsatisfactory manner, then the Government may dismiss the head of that community upon submission of the respective region's marzpet (or if in Yerevan, upon the submission of the mayor of Yerevan). Until the newly elected head of the community accepts the office, the Prime Minister appoints a substitute mayor, or a substitute head of district in the case of Yerevan, and the regional marzpet appoints a substitute head of village.

[30] The election cycle of local officials may be extended to four years.

Communities are typically relative small self-governance areas, analogous to sub-rayon communities in the former Soviet system. Rural communities represent 97 per cent of the total number of communities and 36 per cent of the national population (see Table 1).[31] More than 93 per cent of communities (accounting for 31 per cent of the population) have populations of less than 5,000. Given that scale economies tend to be relevant in this size range for local jurisdictions, there appears to be an excessive fragmentation at the local government (community) level, resulting in fiscal disparities and the lack of administrative and fiscal capacity.[32]

Table 1 . Armenia: Local governments and population distribution

Units' size in ths. inhab.	Community Population (number, in ths. inhab.)									number of communities (adm. units)								
	Urban			Rural			Total			Urban			Rural			Total		
	Number	% dist	Ac.%	Number	% dist	Ac.%	Number	% dist	Ac.%	Num.	% dist	Ac.%	Num.	% dist	Ac.%	Numb.	% dist	Ac.%
<0.1				1.6	0.1	0.1	2	0.1	0.1				23	2.5	2.5	23	2.4	2.4
0.1-0.5				73.8	6.4	6.6	74	2.3	2.3				261	28.2	30.7	261	26.9	29.2
0.5-1.0	1.0	0.1	0.1	142.5	12.4	19.0	144	4.5	6.8	2	4.2	4.2	246	26.6	57.4	248	25.5	54.7
1.0-3.0		0.0	0.1	293.3	25.6	44.6	293	9.1	15.9	0	0.0	4.2	206	22.3	79.7	206	21.2	75.9
3.0-5.0	15.6	0.8	0.8	470.2	41.0	85.6	486	15.1	31.1	5	10.4	14.6	161	17.4	97.1	166	17.1	93.0
5.0-10.0	94.3	4.6	5.4	165.4	14.4	100.0	260	8.1	39.1	13	27.1	41.7	27	2.9	100.0	40	4.1	97.1
10.0-20.0	157.8	7.6	13.0		0.0	100.0	158	4.9	44.1	11	22.9	64.6		0.0	100.0	11	1.1	98.3
20.0-50.0	326.4	15.8	28.8		0.0	100.0	326	10.2	54.2	12	25.0	89.6		0.0	100.0	12	1.2	99.5
50.0-1200,0	1471.0	71.2	100.0		0.0	100.0	1471	45.8	100.0	5	10.4	100.0		0.0	100.0	5	0.5	100.0
TOTAL	2066.2	100.0		1146.9	100.0		3213	100.0		48	100.0		924	100.0		972	100.0	

Source: National Statistics Service of the Republic of Armenia

Legislative framework for local self-governance. Armenia has a comprehensive legislative framework for local government, although it is regularly undergoing incremental improvement and contradictions still exist between the local government laws and provisions in other legislation. The 1995 Constitution provides the context for Armenia's decentralized government structure, which is further borne out by Armenia's ratification of the European Charter on Local Self Government and the Law on Local Self Government. Local government budget processes are defined in the Budget System Law. Several laws define the revenue environment for local governments, including the Law on Local Fees and Duties, the Laws on Property Tax and Land Tax, and the Law on Financial Equalization.

Local elections are addressed as part of the Election Code. A Municipal Service Act was introduced starting 1 February 2005. The status of the regional government level is regulated through a Presidential Decree, while the distinct status of Yerevan is also arranged by Presidential Decree. Current amendments to the Law on Local Self Government which will allow the expanded use of inter-community unions (ICUs) has gone through its first reading in parliament.

[31] Table 1 replicated from Tumanyan (2001).

[32] Scale economies refer to the concept that the cost of producing a few units of a good (including publicly provided goods) is more costly per unit then when goods are produced on a larger scale (more units).

Relationship between regions and communities. The laws give broad powers to the Central Government in regard to local self-government issues. The state authorities have the following regulatory powers in the sphere of local self-government:

- adoption and amendment of laws concerning local self-government;
- legal regulation of state property assigned to community property;
- provision of necessary financial and material means for local governments to fulfil certain responsibilities in accordance with legislation;
- regulation of relations between the state budget and communities' budgets;
- reimbursement of expenditures for the implementation of powers delegated to the local governments by the state;
- protection and regulation of the rights of citizens exercising local self-government;
- provision of state guarantees for local government financial independence;
- definition of state guarantee governing citizens' election rights during the local elections;
- definition of regulations for the juridical defence of local government powers;
- definition and regulation of the amenability of local governments for legal violations.

There were only few cases where the mayors appealed to the courts in defence of their rights and in some cases they found success in such appeals (Tumanyan 2001). There is a need for judicial procedures to be established to resolve intergovernmental conflicts.

<u>Reform initiatives with respect to the subnational government structure</u>

A sound local government structure is an important foundation for a sound system of intergovernmental fiscal relations (see Boex, Martinez-Vazquez and Timofeev, 2004). The overall subnational government structure is broadly accepted as appropriate and provides for a clear division between the central government and regional governments. Despite the absence of a formal government-donor coordinating mechanism on decentralization and local governance issues, key stakeholders (including UNDP, the World Bank, the Council of Europe, and selected bilateral agencies) have been contributing to the decentralization reforms and the establishment of an overall framework for sound local government in a relatively effective manner.

An obvious critical reform activity in support of decentralization in Armenia would be to support the expansion of the Ministry of Territorial Administration with a technical support unit. This unit would allow the government to more systematically formulate its policy agenda, enable the government to formulate an official government policy on local government and/or produce an annual intergovernmental fiscal review document, facilitate the coordination of different reform efforts, facilitate the dissemination of information and sensitization of local government officials and the grass roots level, and coordinate the monitoring (oversight) of local government finances.

Yet the single greatest concern with the current government structure is the large number of extremely small local government jurisdictions; this fragmentation is broadly understood to be detrimental to the ability of local governments to effectively deliver local government services. However, the central government is seeking to accomplish consolidation of local governments while avoiding compulsory measures to force amalgamation of local government jurisdictions. Similarly, the predominant thought is that it would not be desirable (or possible, under the current constitution) to create an additional local government tier above the community level.

In order to achieve a less fragmented local government level, the government is pursuing policies that encourage and provide incentives for voluntary permanent amalgamation of jurisdictions. Alternatively, the government is broadening the options and encouraging local governments to establish community associations and especially 'inter-community unions' which could serve as a unified service delivery mechanism for multiple local jurisdictions without the permanent legal dissolution of the constituent jurisdictions.

The assignment of functional and expenditure responsibilities in Armenia

The Law on Local Self-Government provides a broad assignment of functions consistent with the European Charter on Local Self-Government. In this regard, the law states, 'Local self-government is the right and capacity of local self-government bodies acting at their own responsibility, to dispose of the community's property and to resolve the problems of community importance with a view to improving the well-being of the population'.

Unlike in the Soviet practice where lower-level government budgets were nested or 'consolidated' into the budget of the higher-level government, Armenia's State and Community budgets are combined in a Consolidated Budget (together with the Social Insurance Budget) for reporting purposes only. The Budget System Law clearly recognizes the separation between the State Budget and Community Budgets, with the latter being independent budgets of local self-governance agencies to carry out the functions prescribed to them by the Constitution and legislation.

<u>Description and assessment of the assignment of expenditure responsibilities</u>

Responsibilities of the local government level. The legislative framework for local governments clearly defines the functional responsibilities of central government versus local government. The Local Self-Government Law provides the assignment of local functions and responsibilities. In doing so, the law distinguishes between the purely own responsibilities of local governments and those delegated to the local level by the state. Own expenditure responsibilities are financed from the local budget: while most own responsibilities have to be provided by all local governments as mandatory responsibilities, other functions can be provided or discontinued at the discretion of local authorities. By contrast, delegated responsibilities are supposed to be financed by the central government, which keeps local authorities accountable for delivery.

The head of a community has mandatory and delegated powers in the following spheres: finance, protection of the rights of citizens, protection of public order, defence, planning, development, construction and land use, public utilities and provision amenities, transport, trade and services, education and culture, public health, physical culture and sport, agriculture, nature and environmental protection (Law on Local Self-Government, Articles 32-45). From among these broad areas of responsibility, the main specific local government responsibilities include:

§ operation of water supply, sewerage, irrigation, gas supply and central heating systems (mandatory) and community structures;
§ planting and improving the community (mandatory);
§ use and maintenance of non-privatized residential buildings and non-residential premises, dormitories, administrative buildings and other structures owned by the community (mandatory);
§ ensuring the proper maintenance of cemeteries (this service is not exercised by the head of the district community);
§ construction, reconstruction and operation of roads, bridges and other engineering structures under the community's jurisdiction;
§ construction, maintenance and operation of sanitation facilities (this service is not exercised by the head of the district community);
§ regulating the operation of public transport in the community (this service is not exercised by the head of the district community);
§ construction, reconstruction and operation of the community's irrigation systems;
§ collection and disposal of waste (mandatory).
§ Management and operation of kindergartens (mandatory)
§ Specialized education (music, fine arts, athletics, enhancing technical and creative potential of children);
§ Libraries, museum, cultural centres;
§ Primary health-care stations (optional).

The functions delegated to the local government level largely comprise administrative functions and broad support for central government policies. Notably absent from the list of local government responsibilities (either own or delegated) are a number of key social services that are provided at the local level in many developing, transitional and developed economies, particularly primary and secondary education. Central government is responsible for health care, primary, secondary and higher education, social services, pension and unemployment security. However, the law enables the local self-government bodies to provide similar services on a voluntary basis, provided they have the required financial resources (for example some rural communities support schools located in their territory)

While this (highly centralized) assignment of expenditure responsibilities makes Armenia among the most fiscally centralized of the former Soviet republics, this expenditure assignment is not necessarily inconsistent with the subsidiarity principle and other principles of sound expenditure assignment (Martinez-Vazquez, 1998). Yet, a natural question arises whether basic education and/or basic health care should be provided at the local level. There are a number of reasons why it might be appropriate to assign these functions to the central (regional) level, at least in the short and medium term. First, it could be argued that given Armenia's centralized history and current embryonic nature of the local government system in Armenia (including its current excessive fragmentation, communities' limited administrative capacity and the limited experience of local officials responding to community needs) devolution of these major social expenditure responsibilities would be premature. Leaving these functions to be delivered by the central government (through the regional level) can further be justified by the relative proximity of the regional level to the population (with an average population of less than 300,000).

That being said, recently Armenia has been experimenting with corporatization of schools and hospitals into self-managed entities with varying degree of participation from central and local governments and civil society (see Box 1).

Box 1
The delegation of education service provision directly to the school level

An experiment carried out starting in October 1998 put 57 schools directly under the management of school councils. Candidates for the School Council are nominated by the school's council of teachers (30 per cent); the school's council of parents (30 per cent); and the local government (40 per cent). The schools are given proper legal status and manage their own bank accounts. The council elects the school's executive director in accordance with competitive conditions defined by the Ministry of Education and Science, and in all other respects is accountable to the Ministry of Education. Schools are given a capitation grant based on the number of students enrolled (Tumanyan 2001).

Due to the perceived success of the programme, autonomous school management by school councils was rolled out nationwide with schools and certain other service delivery units being given the legal status of non-commercial enterprises (NCEs). Despite the potential advantages of the programme, concerns have been raised about the financial monitoring of school accounts by central (or community) authorities, since school councils keep their resources outside the treasury system.

Although the delegation of management authority in the education sector is an interesting and worthwhile attempt to provide greater local ownership and downward (or 'horizontal') accountability over education provision, this mechanism should <u>not</u> be considered part of the regular fiscal decentralization process. The administrative and financial relationships that are created are between the Ministry of Education and the individual school councils (NCEs), and circumvent the local government communities and their budgets (with the exception of local government involvement in establishing the school councils). Instead, this mechanism is simply a financial and administrative sectoral arrangement which fully falls within the central government's competency, similar to transfers to other public enterprises on the budget.

Rather than the term decentralization (which is generally used to signify the <u>devolution</u> of expenditure responsibilities from one government level to another), the current construct could either be considered an example of de-concentration (defined as shifting decision-making power to central government officials that are located outside the capital) or an example of delegation, which is defined as shifting expenditure responsibilities to semi-autonomous government bodies that are ultimately fully accountable to the centre (Litvack and Seddon, 1999).

Degree of expenditure decentralization. As a result of the relatively limited expenditure responsibilities assigned to the local level, the share of local budget expenditures in the total government expenditures is rather small. In recent years, total local expenditures have varied roughly in the range from 5-6 per cent of the consolidated national budget. Compounded by the limited scope of the public sector in Armenia's economy (the public sector comprises less than one-fifth of the economy), this means that local governments in Armenia have an extremely small financial resource base; consequently, they are only able to play a very limited role in delivering services to their residents.

Table 2
Expenditures of community budgets in Armenia

Expenditures	***2001***		***2002***		***2003***	
	Amount (mln drams)	%	Amount (mln drams)	%	Amount (mln drams)	%
Expenditures of administrative budget, of which	***14,596.8***	***95.0****	***17,396.0***	***91.2****	***19,892.1***	***87.8****
Administration	3,491.1	23.4	4,314.4	23.7	6,095.8	28.5
Education (kindergartens)	2,513.0	16.8	2,829.2	15.5	3,287.8	15.3
Culture, sports, religion	1,390.1	9.3	1,593.2	8.7	1,620.2	7.6
Communal and household	2,600.3	17.4	2,654.1	14.6	3,358.1	15.7
Repayment of debts	2,227.1	14.9	2,764.5	15.2	1,946.7	9.1
Expenditures of capital budget, of which	***752.1***	***5.0***	***1,608.4***	***8.8***	***2,619.1***	***12.2***
Capital repair	471.0	3.2	987.4	5.4	1,626.2	7.6
Total local expenditures *	**14,940.9**	**100**	**18,220.7**	**100**	**21,415.4**	**100**

(*) Excluding the reserve fund of the administrative budget.
Source: Modified from Tumanyan (2004), Table 3.

As of 2001, about 40% of total community budget expenditures are accounted for by wages and payroll taxes. The main functional categories are the administration of local governments, maintenance of housing stock and public utilities, preschool education, culture and sports (Table 2). These are areas in which local governments have mandatory responsibilities.

Reform challenges in expenditure assignments

Several reform activities are on the radar screen of the Government of Armenia and its development partners, including:

Improvement of local budget processes. In order for the efficiency benefits from decentralization to materialize, local governments should provide their local communities with a basket of local services that it desires and provide these services in the least costly manner. This requires that the local planning and budget cycle is arranged in such a manner that it assures community input into the formulation of the local budget plan, that execution of the budget occurs in accordance with the plan, accurate local books of account are maintained, transparency in the local budget process is assured, and the budget is audited at the end of the budget cycle. In order to achieve such a sound local budget, it is important that the local budget framework (including the regulatory framework, annual budget guidelines, the reporting format, and so on) is well-developed at the central level and well-understood (and implemented) at the local level.

Several projects are currently ongoing in order to improve local budget processes. For instance, DFID is supporting strengthening of budget processes at the national level – four Ministries are piloting programme-performance budgeting (PBB). UNDP is supporting the similar processes at the community level – piloting an introduction of performance budgeting for selected urban communities. PBB aims to refocus local budgets away from line budgeting based on the cost of inputs towards creating local budgets that focus on delivering locally-desired services and infrastructure in a cost-effective manner. In addition, the World Bank has included a local government component in its current Public Sector Modernization Programme for the strengthening and computerization of local government accounts (both on the expenditure and revenue side of the local budget), aimed at a number of pilot local governments.

Evolution of local financial management systems. According to Section 33 of the Budget System Law, the execution of community budgets shall be serviced by the state authorized agency (the national treasury) through its local treasury branches, as prescribed by this Law and the Government. There are numerous reasons cited for requiring local governments to maintain their accounts with the national treasury rather than with private banks, including the need for upward transparency, the cash-flow needs of the central government, and the weakness of the private banking system in Armenia. However, central government financial management procedures that are effective for central government agencies are not necessarily always effective for local government authorities. For instance, in the short run, given the numerous small transactions at the local level and the distance between local governments and regional treasury branches, local government officials might benefit from being allowed to keep small cash balances for petty transactions. In the longer run, it needs to be recognized that national treasury management of local treasury functions is rare in developed economies and often leads to central control over local budgets (rather than mere supervision) and unnecessary tension between different government levels. In the longer run, the regulatory framework for local budget execution should allow for highly capable local authorities to take their budget accounts outside the central government treasury systems altogether as long as accounts are kept in the context of a well-regulated financial management system.

Considering centrally assigned responsibilities. As noted earlier, in many ways, the assignment of expenditure responsibilities is rather centralized, and excludes decentralized delivery of major public services such as basic education (other than pre-school) and primary health care. This has resulted in Armenia having one of the least decentralized government structures in the CIS. As the local government level becomes less fragmented and stronger over time, it would be increasingly prudent to reconsider the possibility of reassigning (or at least devolving the provision or delegating) these expenditure functions to the community level. In the meantime, alternative ways to increase community involvement and oversight of these services could be considered (for instance, as discussed in Box 1). However, it would be wise to coordinate such sectoral de-concentration or delegation efforts in the context of a comprehensive decentralization strategy, which currently is lacking in Armenia.

Revenue assignment and local tax administration in Armenia

Once subnational governments are assigned certain expenditure responsibilities, the second traditional 'pillar' or dimension of intergovernmental fiscal relations (i.e., decentralization reform) centres around the question of which tax or non-tax revenue sources should be made available to subnational governments in order to provide them with financial resources. This issue is known to economists as the revenue assignment question.

Description and assessment of revenue assignments

In principle, two main types of resource inflows are available to local governments: own source revenues and intergovernmental transfers. Table 3 gives an overview of the importance of the main sources of community budget revenue and transfers. The system of intergovernmental transfers – which includes formula-based equalization transfers (subventions) as well as a number of discretionary subsidies or donations – is discussed in the next section. The discussion of revenue assignments in the current section contains three elements: shared taxes and shared revenue sources, true own local revenue sources, and local non-tax revenues (including duties and fees).

Table 3
Revenues and transfers of community budgets in Armenia

Revenues	***2001***		***2002***		***2003***	
	Amount (mln dram)	%	Amount (mln dram)	%	Amount (mln dram)	%
Revenues of administrative budget, of which	***14841.1***	***97.1***	***19,255.5***	***94.6***	***21,416.5***	***93.8***
Tax revenues and duties	5,221.2	34.2	5,310.3	26.1	6,794.0	29.8
• Land tax	1,667.8	10.9	1,504.1	7.4	2,015.8	8.8
• Property tax	2,811.4	18.4	3,062.2	15.0	3,960.7	17.3
Non-tax revenues	1,665.6	10.9	2,248.7	11.0	2,937.0	12.9
• Land rentals	775.2	5.1	1,104.9	5.4	1,511.4	6.6
Resources allocated to LSG for fulfilment of delegated powers	0.0	0.0	0.0	0.0	62.8	0.3
Official transfers	6,866.3	44.9	11,449.8	56.2	9,910.8	43.4
Retained balance of administrative budget	1,088.0	7.1	246.7	1.3	1,774.7	7.7
Revenues of capital budget, of which	***848.1***	***2.9***[1]	***1,888.2***	***5.4***[1]	***2,868.9***	***6.2***[1]
Capital Subventions	1.5	0.0	55.0	0.3	169.6	0.7
Proceeds from alienation of property	400.3	2.6	792.1	3.9	734.4	3.2
Revenues of administrative and fund budgets, total (*)	**15,281.1**	**100**	**20,360.1**	**100**	**22,826.1**	**100**

(*) Excluding allocations from the reserve fund of the administrative budget.
Source: Modified from Tumanyan (2004), Table 4.

Tax Revenue Sharing. The laws on Budgetary System and Local Self-government introduce tax revenue sharing in Armenia's budgetary system. The Law on Local Self-Government (Art. 57) establishes that personal income and profit taxes should be shared with communities. The Budget System Law, in turn, does not directly refer to these shared taxes and implicitly leaves it to the annual budget laws to define the amount to be shared out of these national revenues. In the first year (1997) of the new local self-government system, the land and property taxes were the only central governments taxes retained in community budgets. However, the profit tax was never shared, and only until 1999, 15 per cent of income tax was shared with communities on a derivation basis. Starting with the 2000 state annual budget, the income tax sharing was also discontinued, with the argument that it tended to increase horizontal disparities, as tax bases of small rural communities were practically nonexistent (see Box 2 for a discussion on horizontal disparities). Unpredictable fluctuations in tax revenue sharing are highly disruptive to local governance since they generate uncertainty and reduce predictability for local budgeting and planning.

Box 2
Revenue assignment and horizontal fiscal balance in Armenia

A valid concern among some stakeholders in Armenia regards the horizontal equity impact of the structure of revenue assignments. Horizontal fiscal imbalance (also known as local fiscal inequity) refers to the existence of imbalance between fiscal needs and resources between different government units at the same level of government. In other words, horizontal imbalances occur when some local government units are fiscally (much) better off than others. This results in inequitable delivery of local government services, and may be undesirable for social, governance and political reasons.

There are three components why horizontal fiscal balance may not be as severe a problem as initially believed by some. First, although local government services are an important part of the public sector, local governments do not deliver any services that are at their very core aimed at assuring equity (which is the case, for instance, for primary education or basic health services; in many countries the desire to assure equal access to these services is a critical reason for delivering these services in the public sector). As such, it is in fact not inappropriate to allow variations in service delivery across local government jurisdictions with wealthier local jurisdictions being able to collect more revenues and provide somewhat better services than poorer local governments. After all, variations in the mix of local services are part of the efficiency benefit of decentralization. Second, it is worthwhile to note that the demand for many of the local services under consideration is more closely connected to the economic base of a jurisdiction rather than to the population of the locality. For instance, the need for street cleaning and public refuse collection tends to increase proportionally with the level of economic activity (especially around markets and in urban areas), so that there is a correspondence between the demand for this local service and the level of resources provided by the revenue sources assigned to the community.

A third factor mitigating the horizontal equity concern of local government activities is that, as we discuss further in Section 5, revenue assignments can not be considered independently from the intergovernmental transfer mechanism, which is equalizing in nature. As such, if the revenue assignment causes horizontal fiscal imbalance, this can be addressed through the transfer system.

In an assessment of revenue assignments, it is important to recognize that – although the budget system classifies them as own revenue sources – shared revenues should properly be considered derivation-based intergovernmental transfers.[33] Furthermore, while derivation-based sharing of some taxes (for instance, the personal income tax) is administratively feasible and logical, revenue sharing of other taxes (especially, corporate

[33] This is true when local governments have no control over the tax base, the tax rate, the sharing rate between central and local government, or tax administration. See Bahl (1999) for a discussion of Bahl and Linn's taxonomy of intergovernmental fiscal transfers.

income taxes and the VAT) are of debatable merit at best.[34] Although revenue sharing may give local governments a potential fiscal incentive to stimulate local economic development, shared revenue sources do not provide local governments with any degree of revenue autonomy, which – at the margin, at least – is a critical component of a well-developed decentralization system.

Own local revenue sources. Only two tax revenue sources in Armenia can properly be designated 'own' local revenues: the property tax and the land tax. In April 2004, the legislative framework was reformed to assign the responsibility to collect these local taxes to the local level, although both the tax base and the tax rate for these taxes are actually defined by the central government.

Property taxes (on land and structures) are often considered a good revenue source for local governments. Property taxes act as both a benefits tax as well as an ability-to-pay tax, and localities have a comparative advantage in collecting the property tax since they are in close physical proximity to the tax base.[35] Furthermore, in the presence of a well-defined legal enforcement mechanism, it can be hard to either avoid or evade local property taxes, since it is impossible to move land and building outside of the local jurisdiction.

However, the fact that property taxes are generally assigned to the local government level does not necessarily mean that property taxes are necessarily easy to administer, particularly in transition economies. In order for local governments to be able to effectively collect property taxes, the ownership of property has to be clearly assigned and registered, the value of each property has to be determined, and the local government should have a means of enforcement if the property owner fails to pay the property taxes. With support from the international community, over the past several years Armenia has set up a central land registry that provides a cadastre of holdings in each local government jurisdiction, as well as a valuation of each property. As such, the land registry system provides a solid basis for land and property taxation at the local level by allowing the necessary data to be transferred to the local government level.

Local Tax Administration. The responsibility for the collection of land and property taxes has been gradually devolved to communities starting with Yerevan districts and other urban communities (8 April 2004 Amendment to Decision no. 192-N). The devolution of revenue collection responsibility for local taxes was based on previous studies that showed that the State Tax Agency was not interested in community budgets' tax revenue collection (Tumanyan, 2001). The transfer of this responsibility to the local level is occurring in a collaborative manner between the State Tax Agency and local governments. Yet, the delegation of tax collection to local governments requires qualified personnel. This might not be a problem in urban communities, which have been

[34] For instance, see Chapter 3 in Martinez-Vazquez and Boex (2001) for a discussion of revenue sharing issues in the Russian Federation, many of which carry over to the Armenian context.
[35] The ability-to-pay principle states that in order for a tax system to be considered fair, taxpayers should pay taxes in accordance with their ability to pay: those with greater ability should pay more. The benefits principle states that in order for a tax system to be considered fair, taxpayers who benefit from a publicly provided service should pay taxes roughly in proportion to the benefits received.

exercising their right to levy local duties and fees since 1998. However, small and mid-size rural communities are falling behind in introducing these levies and developing the administrative capacity.

Local Duties and Fees. On 26 December 1997, the Law on Local Duties and Fees was adopted in Armenia, prescribing procedures for the implementation of and requirements for nine local duties and three local fees. Under the law, community councils have the right to set rates within a defined range. Local duties are levied on the following items:

§ licenses to construct, strengthen or reconstruct a building and other civil engineering facilities (including temporary), or to change the exterior of a building;
§ licenses to demolish a building or other civil engineering entity;
§ licenses to sell alcohol and/or tobacco products;
§ licenses for open-air trade activities (except trade in markets, fairs and in temporary or non-temporary engineered construction);
§ licenses to operate public facilities for gambling, catering, saunas and other night amusement facilities after midnight;
§ licenses to keep a non- domesticated animal in Yerevan and other urban communities;
§ licenses to place an external advertisement in the community;
§ obtaining copies of documents from the community archive;
§ licenses to operate a passenger taxi (except route taxis) in the community (except district communities in urban areas).

Local fees are assessed on the following activities:

§ setting up and confirming technical and economic conditions and executive documents for the construction of a new building, or changing the exterior of an existing one—involving services provided by the local self-government body;
§ participating in auctions and tenders organized by the local self-government—in order to cover their costs;
§ measuring, reclaiming and renting local government lands—including services provided by the local self-government body.

Local duties and fees have been introduced since the middle of 1998, mainly in urban communities. As of 2000, the rate of collection for local duties and fees was below 65 per cent.

In addition to local duties and fees, communities set rates (or user fees) for water distribution to final consumers, sewage collection and treatment, rents for non-privatized residential buildings and non-residential premises, fares for public transportation, service fees for refuse collection (unless contracted out to a private provider), central heating, kindergarten fees. The collection rate for user fees is very low and municipal utility distributors have huge arrears to state-owned wholesale providers. Communities also charge a fee from other communities for using their refuse landfill.

Reform challenges in revenue assignments

The main parameters of the revenue assignment to local governments in Armenia are generally sound, and the government is currently pursuing a number of improvements to further ameliorate the situation. As such, a number of reform challenges are currently being addressed in this regard, while others should be addressed in the near future:

Lack of local revenue autonomy. A major weakness of the revenue assignment to the local government level is that local governments effectively do not have any rate-setting discretion over their own revenue sources. This means that at the margin, local governments are unable to either increase or decrease the amount of local revenues collected.[36] Instead, local governments should be allowed some discretion of some local tax rates (probably both land and property taxes) within a band defined by the central government.

Resolving the problem with revenue sharing. There is a recognition in policy circles of the main strengths and weaknesses of revenue sharing as a mechanism to provide local government with resources, but the current status has left shared revenue sources in an indeterminate state, with the income and profits taxes legally being shared with local governments, but practically being shared at zero per cent (i.e., not being shared). It is important to resolve this policy issue in a clear and concise manner, either by effectively implementing the revenue sharing rule as enacted in the legislation, or remove the relevant clauses from the law. Either way, this decision should be made in a policy debate that involves all key stakeholders and is well-informed by technical (and administrative) considerations.

Although revenue sharing on a derivation basis is a practical way to provide the local government level with fiscal resources, there are certainly many different options to provide local governments with resources. For instance, Armenia could move to reform its revenue sharing approach from a derivation basis to a formula-basis, by which a percentage of revenues from a certain revenue source (e.g., 15 per cent of national personal income tax collection) is shared among local governments on a formula-basis. For instance, this is how the VAT is shared in Germany. Alternatively, revenue sharing could simply be eliminated in favour of ‘regular’ formula-based grants. Yet another option is to replace revenue sharing by introducing a piggy-back income tax.[37] Which option will ultimately be chosen in Armenia will depend on the balance between vertical balance, horizontal balance, and incentives for local economic growth that Armenia wishes to pursue.

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[36] In practice, local governments are able to decrease their resource envelope by reducing the local level of collection effort. However, such reduced local administration and enforcement reduces local revenue collections in an arbitrary, non-transparent and unfair manner.

[37] A ‘piggy-back tax’ is a tax that is legislated and collected by the central government as a surtax on a central government tax, while local governments are allowed to set the rate for the surtax and receive the proceeds from the local surtax on a derivation basis. Common forms of piggy-back taxes include piggy-back sales taxes and income taxes. As a result of the local control over the tax rate, a piggy-back tax is considered a local government revenue source.

Local tax administration. As already noted, the local collection of property and land taxes is currently being phased in, and the tax administration capacity at the local level in Armenia is still weak – particularly in smaller and medium-sized communities. As such, there is a need for concerted effort to improve local tax administration. Some support to this effect is currently being provided under the World Bank's Public Sector Modernization credit and UNDP Strengthening Municipal Service Project, which will provide support for computerizing and strengthening of local tax administration in selected communities.

Creating a culture of (local) taxation. As part of its heritage from the Soviet era, Armenia faces a culture by which citizens have the expectation of free government services without a tradition of personal taxation. As such, the government – both at the central and local levels – faces the task of informing its base of taxpayers that there is a link between the payment of taxes and the resources available for government services. The central government is currently pursuing this strategy of broad-based taxation by introducing a universal filing requirement for income taxes in 2005.

Likewise, an important element in improving the environment for local taxation is to improve tax compliance (and thereby local fiscal performance) by sensitizing resident and communities to the need to pay local taxes, and to point out the benefits of locally funded projects and services. In addition to sensitization campaigns and advertising, common local approaches to creating such a culture of taxation include assuring the participatory and transparent nature of the local budget process (so that locally raised revenues will clearly be used for local priorities), providing clearly visible marks of local tax compliance, 'public shaming' by publishing the names of local tax evaders in local media, and the introduction of signage clearly identifying locally (co-)funded projects (e.g., 'The construction of this bridge was financed with local taxes'). Little systematic effort is currently being exerted at the local level by the government and its development partners to sensitize community leaders or residents on the importance of local taxation and to promote such a culture of taxation.

Intergovernmental fiscal transfers in Armenia

Intergovernmental transfers, often considered the third pillar of intergovernmental fiscal relations, form the cornerstone of subnational government financing in most developing and transition countries. The general term 'transfers' is often used to refer to a number of different kinds of public financing instruments between central and subnational governments, including intergovernmental grants, subsidies, subventions, donations, and (as noted above) even the sharing of tax revenues.

As was revealed in Table 3, intergovernmental transfers (even when excluding shared revenues) are an important part of Armenia's system of intergovernmental fiscal relations: on average, state subsidies (formula-based equalization grants) account for roughly 45-55 per cent of communities' total resources each year.

Description and assessment of intergovernmental fiscal transfers

Currently, there are two major channels of cash assistance to communities: (a) the so-called *subventions*, which are essentially conditional, specific-purpose capital transfers; and (b) the so-called *subsidies*, which are general purpose, unconditional transfers. The *size* of the 'subventions' is ad hoc and the allocation is negotiated each year and approved by the State ordinary annual budget law. By contrast, both the *size* and *distribution* of 'subsidies' from the State budget to the community budgets are rule-based. The Law on Local Self-Government (Art. 58) establishes that a minimum of 4 per cent of the preceding year's *consolidated* revenue of the Republic of Armenia's budget is to be allocated as unconditional 'subsidies' to communities.

The total amount of equalization subsidies is set as a separate line in the state budget by the National Assembly. The Ministry of Finance and Economy, according to the Law on Financial Equalization, distributes the budgeted equalization pool. The distribution mechanism is only partly defined in the law and allows some discretion by the Ministry of Economy and Finance, particularly on the distribution of (discretionary) capital grants. As far as the equalizing subventions, the formula appears to have been more closely adhered to in recent years as some data uncertainties were resolved by data from the 2001 Census, and the publication of the transfer formula (and the relevant data) has made the process more transparent.

In reality, the transfer mechanism is not perfect. For one, some critics have suggested that the formula is too simple (see Box 3). Also, the timing of transfers has also been inconsistent during budget execution, with some communities receiving the subsidies earlier and others later (Tumanyan, 2001). The equalization subsidies are given to the communities irregularly and with systematic delays during the whole year. This practice may have been caused by the central government's cash-flow problems; most of the subsidies are transferred at the end of the current year, primarily within the last 10 days of December.

Box 3
Formula-based equalization grants in Armenia

Formula-based subsidies are distributed separately for communities larger and smaller than 300 inhabitants. For small communities (below 300 residents), the equalization grant is simply equal to a fixed amount per community. For larger communities (above 300 residents), equalization subsidies are distributed proportionally based on a per capita basis (Component B) and based on a fiscal capacity component (Component A).

For local governments with a population over 300 residents, the transfer formula could be represented by the following formula:[38]

[38] The current equalization formula is discussed in greater detail by Tumanyan et al (2004). The notation used here has been modified for the purpose of exposition, but the formula presented here is fully

$$Transfer_i = aF \cdot \frac{g}{G} + bF \cdot \frac{p}{P}.$$

where the transfer to Community *i* is equal to the jurisdiction's share of component A plus the jurisdiction's share of component B. The relative size of Components A and B are defined by the parameters a and b (where b=1-a and 0<a<1) and the total size of the transfer fund (F).

For all communities larger than 300 residents, each jurisdiction receives Component B in proportion to its population (p) as a share of the aggregate population of all communities with a population exceeding 300 (P). Similarly, Component A is allocated in proportion to its fiscal capacity gap (g) relative to the aggregate fiscal capacity gap for all local government jurisdictions (G), where G = ? g. A locality's fiscal capacity gap (g) is defined as the gap between the locality's per capita tax potential and the national average per capita tax potential, multiplied by the locality's population. Local tax potential is measured based on the projected revenue yields from the land and property taxes, which is computed by multiplying the property valuations in each jurisdiction (drawn from the central land registry) by the statutory property tax rate.

Although the formula-based transfer approach is generally deemed sound, there is some concern that the formula takes on an excessively simple additive form with only two components. As such, the formula does not account for the higher fiscal needs of localities with a greater land area or with a more dependent population. Further discussions of the Armenian formula are provided by Gusen, Melhem, and Nersesyan (2003) and Tumanyan et al (2004). A broader discussion on the sound design and implementation of equalization grants is provided by Boex and Martinez-Vazquez (2001).

Unfunded mandates. Vertical fiscal balance is said to exist when there is a broad correspondence between the aggregate revenue sources assigned to each level of government on one hand, and the relative expenditure responsibilities of each government level on the other hand. Vertical fiscal imbalance results when one government level receives a disproportionate amount of revenue sources compared to its expenditure responsibilities, and this imbalance is not corrected through the transfer system. If local governments are assigned obligatory expenditure responsibilities for which they are not provided with corresponding resources (either by being allowed to collect own source revenues or by being provided with unconditional or conditional grant resources), then these functions are referred to as unfunded mandates.

Reaching vertical balance in a decentralized system is always a challenge, as international experience indicates: functions and revenues are provided to local

mathematically equivalent to the formula contained in the Law on Financial Equalization as presented by Tumanyan et al (2004).

government in different combinations and with varying relationships between these two building blocks of local fiscal autonomy. (Martinez-Vazquez, Boex and Ferrazzi, 2004). Some countries address this challenge of achieving vertical fiscal balance by providing local governments with autonomous revenue sources and some clarity on expenditure functions. Local governments can then, for example, increase or decrease the tax rates of some significant taxes to raise adequate revenues for their stipulated expenditure responsibilities. Such a 'revenue first' approach, with little follow-up on expenditure assignment, avoids vertical imbalances by definition, but this construction potentially can make it difficult for the national government to realize national interests and priorities through local government service delivery.

Other countries choose not to provide (significant) local revenue autonomy, and rely on alternative mechanisms to reach vertical balance at the local level. For instance, vertical fiscal imbalances could be avoided by not defining in any concrete way the expenditure responsibilities of local governments. In other words, rather than tightly defining the expenditure norms and financial requirements of local government functions, the central government may prefer to specify the implementation of local responsibilities quite openly, so that the level at which expenditure responsibilities are fulfilled is subject to the availability of local resources. In essence, these approaches mean that local expenditure choices are made at the level and quality that available local resources allow in accordance with local priorities. This has been largely the experience of most transition countries in Central Europe and the former Soviet Union (including Armenia) and it is also a common practice in Latin America. Within this context, it is very hard to determine whether local governments are in fact assigned unfunded mandates, or whether local activities are simply accorded a low priority in the national system of public finances in the presence of scarce public resources.

<u>Reform challenges in intergovernmental transfers</u>

In principle, the transfer system put in place in Armenia is generally sound. The majority of transfer resources to local governments are non-discretionary (formula-based); the size of the total grant pool is non-trivial (although it is a matter of debate whether they are 'adequate'); the resources are provided in an equalizing manner; and the unconditional nature of the bulk of the transfers assure a certain degree of local expenditure autonomy. As a result, little focused energy is currently brought to bear on the reform of the transfer system. Nonetheless, improvements in the transfer system could assure system-wide improvements in the system of intergovernmental relations.

Capital development grants. Currently, the transfer system is almost exclusively focused on the provision of recurrent resources to the local level, although an important role of the local level is to provide and maintain certain types of local infrastructure. As such, the introduction of a local capital development grant (CDG) scheme would complement the existing equalization grant very well. If appropriately designed, the introduction of a CDG system could also be used as an incentive for sound local financial management as well as for the consolidation of excessively small local government jurisdictions. (See Box 4).

Box 4
Capital Development Grant Schemes

Capital Development Grant schemes (CDGs) are a good mechanism to serve the dual purposes of promoting the development of local capital infrastructure and can be used effectively as tools to encourage good local governance. Particularly in decentralizing developing and transition economies, the World Bank, UNDP, and other bilateral agencies have been supporting the introduction of such grants. Within the UN system, the UN Capital Development Fund (UNCDF) has specialized in the development and implementation of such capital grant schemes.

Although CDGs vary from country to country, the main features of a typical CDG include the following:

§ Each local government is allocated a CDG transfer amount by a transparent, fair and objective formula.
§ This allows local governments to develop a capital development plan within known budget constraints.
§ The resources are not fully unconditional: they are earmarked for capital development only
§ Furthermore, CDG projects are subject to local matching of resources from the local budget (typically 10-20%) in order to assure local buy-in and ownership. Such matching requirements will also stimulate –albeit indirectly- local revenue collection efforts.
§ In order for a local government to receive the CDG, it needs to comply with a number of objective 'Minimum Access Conditions'. Local governments are advised in the beginning of the local budget process whether they have met these conditions, or what they have to do to achieve them.
§ If desired, local governments that fail to meet the minimum access conditions (but that meet a set of weaker criteria) can be given capacity building grants in order for them to qualify during next year's budget cycle.
§ Minimum access conditions can be fine-tuned to address country-specific concerns. Requirements could include:
    - following participatory and transparent planning and budgeting practices;
    - maintaining a book of accounts by a qualified finance officer;
    - meeting all central government reporting requirements in a timely manner;
    - receiving a non-adverse audit report for the previous budget year;
    - and specifically in Armenia, having achieved a specific minimum size, either through consolidation or through an inter-community union.

In Armenia, there are a number of potential funding sources for such a Capital Development Grant system. From within the government's own resources, the (*de jure*) derivation-based revenue sharing provisions could be eliminated in favour of a capital development grant pool of specified size. Alternatively, the current Armenia Social Investments Fund could evolve over time into a CDG, or additional World Bank credits could be targeted for such a purpose. Another possibility might be to integrate the CDG into the submission to the US Millennium Challenge Corporation; in many ways, a CDG meets all the participation, good governance, and economic growth requirements of a successful MCC activity. Of course, a CDG could be funded by a combination of bilateral, multi-lateral and own sources.

Move all transfer schemes towards formulas. The current transfer system includes both a formula-based grant as well as a number of small, discretionary grants.[39] As the conditions imposed on the formula-based grant system become stronger, there will be an incentive for non-compliant jurisdictions to increasingly lobby for discretionary resources. Since this provides a major threat to the 'hard budget constraint' faced by local governments, it will be necessary to eliminate these discretionary earmarked grants and replace them with formalized (rule-based or formula-based) grant schemes. As with the transfer system in any country, all transfer schemes and formulas in Armenia should be periodically reviewed, discussed among stakeholders, and fine-tuned as needed to assure that the transfer system continues to perform in a satisfactory manner.

Consider the structure of the transfer system. Not only is it important to review the transfer formulas from time to time, but it would also be appropriate to review at regular intervals whether the overall structure of the transfer system is still appropriate. For instance, is the reliance on an unconditional grant (in possible combination with a CDG system) the appropriate transfer structure for Armenia, or would a more diversified grant system with conditional and unconditional grants be more appropriate? It should be noted that very few countries rely exclusively on an unconditional transfer scheme for financing local governments without providing 'guidance' or minimum local service standards (i.e., indirect conditionalities) for local spending as part of the local budget process. Particularly if local governments – at some point in the future – are delegated financial responsibility for a specific delegated expenditure function, the introduction of a sectoral or conditional grant scheme may be appropriate to assure the funding of this responsibility without crowding out the funding of other (own local) responsibilities.

Subnational borrowing and infrastructure development in Armenia

The final pillar of fiscal decentralization is a logical corollary to the first three pillars. A local government's fiscal balance can be defined as the difference between its expenditure responsibilities on the one hand and its own source revenues and transfers on the other hand. If a local government fails to properly balance its expenditure needs with the resources available to it, this could result in subnational deficits and the incurrence of debt.

Description and assessment of local government borrowing

The head of the community, with the consent of the Minister of Territorial Administration and the approval of the local council, may receive short-term credits from the central government for the purpose of timely execution of budget expenditures, subject to repayment within the same fiscal year. In the case that a community's (short-

[39] Some of these transfers are for the funding of strictly discretionary local capital development projects. Other non-formalized transfers provide local budgets compensation for centrally provided exemptions on local taxes to tax payers within the local jurisdiction.

run) budget deficit is financed through a credit, the community has to elaborate a programme for the gradual phasing out of the deficit and repayment of loan obligations; the implementation of which is compulsory and should guide planning of future budgets. In this situation, the state authorized body shall perform permanent supervision of budget processes in the community.

In addition, local governments are able to borrow for capital purposes as well (budget loans). However, borrowing from the Central Government is not a common practice. In this regard, the law states:

'*For purposes of developing social infrastructure of the community through making investments, the head of community, by the decision of the council, may sign a contract to receive loans. By consent of the state authorized body, a community can receive loans up to 30 per cent of the community annual budget appropriation, after the repayment of outstanding amounts on previous borrowings. Such resources shall compulsorily be transferred to the capital part of the community budget. Community property may not be subject for collateral in signing loan contracts'*.

Reform challenges in local government borrowing

Local government borrowing currently plays only a minor role in Armenia. In some ways, this is a shortcoming of the current system of local government finance since so much of the role of local authorities in Armenia focuses on local infrastructure development, and borrowing is an appropriate mechanism to fund long-term infrastructure investments. However, local borrowing – if improperly structured – has the chance to structurally derail an otherwise sound system of local government finance. Some issues that should be borne in mind – as the system of local government borrowing evolves in the coming years – include:

§ Direct access to capital markets by local governments (through bonds) is premature and still has a long way to develop, with the possible exception of local authorities in Yerevan. As a result, to the extent that borrowing would enable local governments access to funding for capital investments, such borrowing would have to be arranged through a specialized financial intermediary, such as a Local Government Bank or a Local Government Loans Board.
§ Local government borrowing often occurs within the context of explicit or implicit loan guarantees by the central government. Such guarantees (even if implicit) generally give local governments a perverse incentive not to repay their debts, in order to use their arrears as a negotiating instrument with central authorities. Excessive local borrowing as well as local non-repayment of debt should always be a consideration in the design of the borrowing framework as it makes for a potential destabilizing force on the government's fiscal policies. As such, a sound borrowing framework should provide a mechanism for non-compliant local government, such as the diversion of unconditional transfers to pay debt arrears if needed, municipal

bankruptcy procedures, and/or political, fiscal, or criminal consequences of loan defaults.

§ It is important to recognize that a sound borrowing framework (even with the intervention of a specialized financial intermediary, such as a Local Government Bank) is only able to provide resources to local governments that have the capacity to repay such loans. As such, a borrowing framework will generally favour wealthier jurisdictions and potentially intensify inter-jurisdictional disparities in service delivery. As such, it is likely that any local government financing structure will need to rely on both borrowing and capital grant mechanisms to assure capital infrastructure development across all local government jurisdictions. An interesting combination of borrowing and grants is provided in neighbouring Georgia, where (under a World Bank credit) the Municipal Development Fund (www.mdf.org.ge) provides local capital development funding for projects that are part funded by a grant component (40 per cent), a loan component (40 per cent) and a locally-funded match (20 per cent).

Concluding Remarks

How do separate pieces of fiscal decentralization reform in Armenia fit together? While there are definite areas for improvement in the constituent components of decentralization reforms and in the management of the overall process, in our assessment the government of Armenia – together with its development partners – is following a clear and positive reform path in this regard. Although the current level of decentralization is rather limited, the trend in the ongoing fiscal decentralization reforms should increasingly empower local governments to play a positive role in the development of their local communities.

The deliberate steps taken on the road to a more decentralized government structure are intended to gradually promote greater local accountability without upsetting the national fiscal balance. Indeed, the limited role of local governments within the public sector and the economy assures that fiscal decentralization reforms cause only very limited risks to macro-economic stability and the country's overall fiscal balance. In fact, with regard to decentralization reform in Armenia – broadly considered – the IMF's biggest concern appears to be the potential lack of accountability of schools and other service delivery units that are organized as sectoral non-commercial enterprises (NCEs) under the authority of the central government (see Box 1). In this regard the IMF (2004b) notes that fiscal decentralization 'capacity building initiatives and a properly functioning reporting framework [for state-owned non-commercial organizations in the health, water, and education sectors] remain essential to ensure transparency and accountability of the operation of these entities'. In a fair assessment of Armenia's decentralization reforms, it is important to clearly separate the reform of intergovernmental fiscal relations (i.e., 'true' fiscal decentralization) from the relationship between the central government and these NCEs to which it has delegated certain financial and administrative responsibilities: as noted earlier, these NCEs are fully under the control of central government ministries, and these NCEs have no financial or legal relationship with local authorities.

Nonetheless, in the realm of intergovernmental fiscal relations there are a number of actual and potential challenges in Armenia that require policy interventions in the near future. The matrices in the annex provide the 'big picture' assessment of current fiscal decentralization reforms (matrix 1), a mapping of current key initiatives being pursued in Armenia (matrix 2), and resulting suggestions for policy reforms (matrix 3) to promote fiscal decentralization in the country. These reform proposals present the possibility for UNDP (see Box 5) and other stakeholders to adjust their programming to address these issues in their support for Armenia's fiscal decentralization agenda:

1. Given the expanding breadth and depth of fiscal decentralization reforms in Armenia, there is a clear and urgent need to institutionally strengthen the Ministry of Territorial Administration. Support from international development partners in this area may be critical. The technical staff of the Ministry would be responsible for a number of technical activities, including pursuing the formulation of the government's policy agenda on decentralization,[40] facilitating the coordination of different reform efforts, promoting the dissemination of information to local government officials, and coordinating the monitoring (oversight) of local government finances. The absence of such an implementation unit within government could risk a disconnect between the government's policy intentions and the effective development and implementation of effective decentralization projects and programmes. UNDP is well-positioned to support the development of such a unit in the context of its ongoing support to Armenia's national decentralization policy.
2. A more formal statement of the government's decentralization agenda will allow the Government of Armenia to more effectively and comprehensively address the fragmented nature of communities and to lay out a systematic policy of encouraging the formation of large local government jurisdictions. Likewise, a clear, comprehensive statement of the government's policy on decentralization will provide the context for policy discussions regarding possible mechanisms for increasing the transparency and accountability of the provision of schooling and other public services through non-commercial enterprises (NCEs).
3. With an adequate policy and legal framework in place, increasingly the focus of the decentralization reforms in Armenia will fall on the implementation of local government finance reforms. Policy implementation is represented by column C through column E in the matrices contained in the annex. Particularly, the implementation of the decentralized financial system will require the development and rolling out of sound local budget procedures and practices, as well as the strengthening of local tax administration. This will require work both at the central government level (in terms of the Ministry of Territorial Administration developing local budget procedures and guidelines and local tax administration procedures) as well as at the local level (where the improved local budget/tax practices will ultimately have to be implemented).

   Under the Municipal Service System Establishment and Strengthening Programme, UNDP has supported the process of fiscal decentralization in

[40] Initial steps in the direction of such a document are being made in the context of the draft document 'Armenia: (De)centralization of Public Service Delivery and Local Governance'.

Yerevan district communities, large rural communities and Intercommunity Unions by providing technical assistance, computers, and software for tax administration and training for community finance officers. Under the Public Sector Modernization programme, the World Bank already has resources set aside for scaling-up these processes – the computerization and strengthening of local budget processes, and local tax administration. In addition, UNDP is actively supporting the introduction of performance-based budgeting techniques (PBB) at the local level, which will encourage local governments to analyze and prioritize their expenditure needs and to use local resources more effectively. Bilateral donors – including DFID and the EU – are actively supporting regional development planning practices in a number of regions. Given the large number of local government jurisdictions and the scope of the assignment, the involvement of multiple donor agencies in the areas of strengthened local financial management is not only appropriate, but probably even desirable. However, in this context it will be critical to assure coordination between the various donors in order to assure that all local government financial management practices put in place adhere to a single, consistent national regulatory framework.

4. A fourth proposed specific area for reform in Armenia is the introduction of a Capital Development Grant system, as highlighted earlier in Box 4. This CDG would be an important tool not only to provide capital resources to the local level, but would also serve as a 'carrot' to promote local consolidation, inter-community unions and sound budget practices at the local level. In fact, the possibility of such a local development fund was already explored by UNDP in the past (see UNDP/GTZ/SC, 2002). UNDP/Armenia could – particularly through involvement with UNCDF and other partner agencies – provide core expertise and technical support in further developing such a Capital Development Grant system if the government expresses its desire to pursue this possibility.
5. Although fiscal decentralization efforts are typically led by economists and accountants, it is critical to remember that successful fiscal decentralization combines not only fiscal reforms but also governance reforms. Decentralization will only succeed when local communities become involved, participate in the local budget process, express local priorities, and hold their local officials accountable for delivering desired local services in a cost-effective manner. For this to happen, local stakeholders will need to know in basic terms what to expect from their local governments, how their local governments operate, and how local governments are financed. As such, a final area for further reform lies in sensitizing all these stakeholders, including not only local government official and community leaders, but also the public at large, including local residents, civil society and the private sector at the local level.

Box 5
The role of UNDP in fiscal decentralization reform in Armenia

A brief word on the role of UNDP in the decentralization process in Armenia: the UNDP/Armenia's country office is quite effective in engaging in fiscal decentralization reforms with a technically strong team. In an informal comparison with other UNDP country offices (not just in the EE/CIS region), we feel that the country office's technically strong staffing allows it to take a much more decisive role in policy-level reforms in the area of fiscal decentralization than would otherwise be the case.

The reliance on technically capable and experienced portfolio managers and the presence of a country economist in the country team not only provide UNDP with the requisite technical capabilities, it also forces other stakeholders to deal with UNDP in a more serious manner. For instance, UNDP has excellent access to relevant government officials and senior policymakers involved in decentralization reform, good relations with NGOs active in this area, and solid working relations within the international development community. Furthermore, the technical initiatives supported by UNDP correspond and complement well with the activities of other stakeholders, such as the World Bank's local activities under the Public Sector Modernization credit.

Initiatives and projects recently supported by UNDP/Armenia in the fields of Local Self-Governance and Decentralization include:

1. <u>Concept Paper on Local Governance Development:</u> In 2002, UNDP initiated the formulation of a draft Concept Paper (CP) for a Local Governance Programme (LGP).

2. <u>Formulation of Local Governance Programme:</u> In 2003, together with the Swedish Association of Local Authorities International Development Agency (SALA IDA), UNDP moved forward with the formulation of the LGP, based on the inter-relationship between poverty reduction and improved forms of decentralized and democratic local self-governance.

3. <u>Local Self-governance Strengthening:</u> In 2003, UNDP – at the request of the Ministry of Territorial Administration and in collaboration with the Armenian Academy of Public Administration – initiated a 'Local Self-governance Strengthening Project: Policy Review and Capacity Building for Municipal Service' which was an important input into the subsequent development of the Municipal Service Act.

4. <u>Establishment of the Municipal Service System</u>: As a logical continuation of the successfully implemented 'Policy Review and Capacity Building for Municipal Service', the new project 'Establishment of a Municipal Service System in Armenia' provides further technical assistance, political sensitization, development of training materials, as well as training of local government officials and municipal staff. The two-year project was signed in November 2004 and is now in the implementation stage.

5. <u>Performance-based Budgeting</u>: Performance-based budgeting is currently being introduced in the central government budget on a pilot basis. The new project proposal 'Performance Budgeting: Effective Mechanism for Local Development' was developed by UNDP to introduce PBB at the community level. The overall goal of the project is to support the introduction of Performance Budgeting into planning, monitoring and

evaluation processes at the community level. As such, it will be an essential part of UNDP's Local Self-Governance Strengthening Programme and will aim to complement the DFID-supported programme and Government initiatives in the field of transferring the budgeting process at all levels from input to output format.

6. E-governance system for territorial administration: During 2003-2004, an E-governance System for Territorial Administration (EGSTA) was developed, installed and put into operation in all the regions of Armenia. The second phase of the project, which started in January 2005, aims at designing appropriate solutions for the extension of e-governance technologies and provision of online public services on the community level. It is expected that by the end of the second phase (end 2006), Community E-Governance Systems (CEGS) will be established in 5-6 large urban and rural communities in each of the 10 regions of Armenia.

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Annex: An Assessment of Fiscal Decentralization in Armenia

TABLE 1
ASSESSING THE STATUS OF FISCAL DECENTRALIZATION REFORMS IN ARMENIA

	(A) Overall policy stance and policy effectiveness	(B) Constitutional & legal framework	(C) Central govt institutional and regulatory framework	(D) Local gov't institutional and regulatory framework	(E) Participation by civil society and private sector
(1) Structure and role of public sector	§ Deconcentrated regional tier; Community-level local governments § Desire to reduce fragmentation at the community level through consolidation and inter-community unions	§ General legal framework for LSG in place § Municipal service act in place	§	§	§ Communities Finance Officers Assoc., several other associations active
(2) Functional and expenditure assignments	§ Functions clearly assigned § Most social functions assigned to CG/RG § Communities are responsible for community services (including kindergarten) and infrastructure § What is the role of NCEs in the delivery of education and other sectoral services?	§ Law on Local Self-Government assigns local functions	§ According to law, local budgets should be executed by national treasury	§ Local budget process needs to be strengthened § Move towards performance-based local budgets	§ Need to increase community involvement in local budget process
(3) Assignment of revenue sources	§	§ Land and property tax assigned to local level § Law provides for rev sharing of PIT and CIT	§ Admin. strengthening needed at central level in order to share PIT and CIT in practice	§ Local tax admin capacity for prop & land taxes needs to be strengthened	§ Need to develop culture of taxation at local level (link cost of local taxes to benefits of public services)
(4) Intergov. fiscal transfers, incl. the scope of unfunded mandate	§ Grants include formula-based (equalizing) subventions and discretionary subsidies §	§ Formula defined by law	§ Possibility to use capital development grant mechanism in order to improve local budget practices and encourage consolidation	§	§
(5) LG borrowing and infrastr dev	§	§ Law allows local credits (in-year budget loans) and capital borrowing	§	§	§

TABLE 2
KEY FISCAL DECENTRALIZATION REFORM INITIATIVES PURSUED IN ARMENIA

	(A) Overall policy stance and policy effectiveness	(B) Constitutional & legal framework	(C) Central govt institutional and regulatory framework	(D) Local gov't institutional and regulatory framework	(E) Participation by civil society and private sector
(1) Structure and role of public sector	§ Initiatives to develop Inter-Community Unions (LG&PSRI, WBI, UNDP)	§ Update of Law on LSG to ease ICUs	§	§ UNDP supporting the strengthening of Municipal Service System (elaboration of regulatory framework)	§
(2) Functional and expenditure assignments	§	§ Passage of Municipal Service Act	§ DFID and EU supporting the Regional Development Planning § DFID piloting Performance Budgeting (PB) at national level (4 Ministries are involved)	§ DFID supports local budget strengthening § UNDP supporting improved local budgeting (PB) § WB support under PSM credit for IFMS	§
(3) Assignment of revenue sources	§	§ Reassignment of collection of prop and land tax to local level	§	§ WB and UNDP support computerizing local tax admin	§
(4) Intergov. fiscal transfers, incl. the scope of unfunded mandate	§	§	§ Consideration of better transfer formulas (LG&PSRI, WBI, UNDP) § Concept paper for LDF (UNDP/GTZ)	§	§
(5) LG borrowing and infrastructure development	§	§	§	§	§

TABLE 3
REFORM PRIORITIES FOR FISCAL DECENTRALIZATION IN ARMENIA

	(A) Overall policy stance and policy effectiveness	(B) Constitutional & legal framework	(C) Central govt institutional and regulatory framework	(D) Local gov't institutional and regulatory framework	(E) Participation by civil society and private sector
(1) Structure and role of public sector	§ Formalize a national strategy on decentralization § More effectively pursue consolidation of communities	§ Legislative strengthening of the Municipal Service System	§ Institutional strengthening of Min for Territorial Admin	§ Institutional strengthening of the Municipal Service System	§
(2) Functional and expenditure assignments	§ Clarify the role of delegation to NCEs in the overall decentralization framework	§	§	§ Improve and strengthen local budget processes at community level	§ Sensitization at the grass-roots level about local budget processes
(3) Assignment of revenue sources	§	§	§	§ Improve and strengthen local tax administration at community level	§ Sensitization at the grass-roots level about local tax processes
(4) Intergov. fiscal transfers, incl. the scope of unfunded mandate	§	§	§ Develop Local CDG to encourage consolidation and good budgetary practices	§	§
(5) LG borrowing and infrastructure development	§	§	§ Develop mechanisms for prudent local borrowing	§	§

Country Report: An Assessment of Fiscal Decentralization Reform in Croatia[41]

Executive Summary

Decentralization reforms in Croatia share some features with other transition economies. As in other transition economies, local self-government in Croatia has been pursued for political and democratic reasons without much regard to fiscal and economic aspects of this process. As a result Croatia – like many other transition economies – continues to have an excessively fragmented local government structure where a majority of local government units fall below the minimum efficient scale for service provision.

However, in other ways Croatia is in quite a different position from other transition economies. As noted in the introduction report, Croatia's economy is much more developed compared to other transition economies. Furthermore, the public sector plays a much more decisive role in the economy, with the government sector encompassing almost half of GDP. While this provides the opportunity for much more significant decentralization reform, destabilization caused by a faulty decentralization approach would also have the potential for greater economic instability. Despite recent steps to increase local control over the administration of local service provision (such as the authority to appoint school directors), these reforms have not been accompanied by fiscal management reforms that would allow local governments sufficient autonomy to make decisions on how best to combine inputs of production and deliver public services.

Introduction

The overall objective of the study on fiscal decentralization in selected transition economies – of which this country report is an integral part – is to accomplish an all-encompassing review that systematically captures the main trends and challenges of the fiscal decentralization processes in each of five transition countries: Armenia, Croatia, Georgia, Macedonia, and Serbia. In addition to producing five country reports, the study further sets out to integrate and synthesize the experiences and challenges facing these five countries. As part of this larger study, the main purpose of this country report is to provide an overview of the progress and issues with fiscal decentralization in Croatia.

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[41] This report was prepared by Michael Schaeffer and Andrey Timofeev, March 2005. The report was prepared by the Andrew Young School of Policy Studies at Georgia State University under contract for the UNDP Bratislava Regional Centre. The study team would like to thank Mladen Ivanovic of UNDP/Croatia for assistance and support during the in-country mission as well as comments on the report, and thanks to Teodor Antic for additional helpful comments. The team would further like to thank all policymakers, government officials and donor representatives who shared their insights and knowledge with us.

In the following five sections we provide an assessment of each of the five building blocks of intergovernmental fiscal relations (respectively, structure of the government sector; delineation of expenditure responsibilities, assignment of revenue sources, intergovernmental transfers, and subnational borrowing) and consider the technical nature of the strengths and weaknesses of the respective decentralization process. In the concluding section, by juxtaposing the current state of fiscal decentralization reforms with recent or ongoing initiatives, we identify areas in which we judge priorities for further action should fall, and how UNDP, and potentially other donors can fine-tune their portfolios of activities to optimize contribution to the decentralization process in the country.

In the annex to this report we provide three two-dimensional matrices that serve as a basis for collating information in the course of our field trips and for developing this country report:

§ Matrix 1 (The Assessment Matrix): Identifies the current state of fiscal decentralization reforms and maps policy areas within the realm of decentralization and local government reform that present the current key policy issues and obstacles for the further development of decentralization in the country.

§ Matrix 2 (The Reform Initiatives Matrix): Identifies and maps recent or ongoing initiatives pursued by the national government, subnational governments and their associations, as well as UNDP, other donor agencies and stakeholders within the realm of decentralization and local government reform that are aimed at addressing and resolving the obstacles and challenges noted in Matrix 1 above.

§ Matrix 3 (The Reform Priorities Matrix): Within the same dimensions of Matrix 1 and 2, Matrix 3 identifies priorities for further action in areas that are either currently underserved in the policy discussion towards decentralization, or areas in which a fresh perspective may stimulate new policy thinking.

General Structure and Scope of the Government Sector

The public sector of Croatia is composed of three basic levels: (i) the Central government; (ii) counties (also called regions) and; (iii) municipalities, towns (local government units or LGUs) and cities.[42] In terms of expenditure shares as a percentage of GDP, as of 2003 the central government is responsible for 41.9 per cent and subnational governments are responsible for about 7.5 per cent (see Table 1).

Table 1. The budgets of local government units as a percentage of GDP and of the budget of general government from 1999 to 2001.

[42] Cities are defined as local government units with populations exceeding 10,000 persons.

	1999	2000	2001	2002	2003
1. Revenue/expenditure of local government units as a percentage of the revenue/expenditure of general government.					
Revenue	11.2	12.6	12.9	15.1	16.1
Expenditure	11.1	11.8	12.6	14.3	15.2
2. Revenue/expenditure of local government as a percentage of GDP					
Revenue	5.9	6.2	6.0	7.0	7.5
Expenditure	6.1	6.4	6.2	7.0	7.5
3. General government expenditure as % of GDP	54.8	54.0	49.1	48.8	49.4

Source: Bajo and Pitareviæ(2004).

The Vertical Structure of Public Administration

The present system of public administration in Croatia can be generally separated into two main parts: state administration and subnational self-government. The bodies of the state administration include national ministries, state administrative organizations (10), county offices (9–11 in each county) and the city office in Zagreb. Bodies of state administration including de-concentrated offices in counties and the city of Zagreb are responsible for direct application of laws in the sphere of state responsibilities (the resolution of administrative cases, managing inquest registers, issuing various certificates) and conducting administrative supervision and other administrative and professional affairs.

Subnational self-government is composed of 426 municipalities with an average population of 3,200, 124 cites with an average population of 18,600, and 21 counties with an average population of 183,000. The City of Zagreb has a special status designation of both town and country. The November 2000 amendment to the Constitution separated regional self-government from de-concentrated state authorities and defined competences of regional (county) and local self-governments. Local self-government affairs include environment planning and the arrangement of settlements, communal activities, environmental protection, pre-school education, culture, sport and social welfare. The competence of a county involves mostly the affairs of harmonizing the interests and positions of municipalities and towns within its territory, as well as equal development for both.

Box 1
Intergovernmental relations

Communication between the levels of governments remains poor, including in areas of shared responsibility for the two subnational levels (for example concerning the joint responsibility for issuing building permits). There are no formal channels of interaction between regional self-government and state administration offices in a county. The only formal interaction is the power of state offices to supervise the legality of normative acts adopted by regional assemblies. In addition, the Ministry of Finance and other bodies, primarily the State Audit Office, are authorized by special legislation to supervise the material and financial affairs of all local governments. The State Audit Office is a body directly responsible to the House of Representatives of the Croatian Parliament. It has the authority to audit financial reports and transactions of local units and of legal persons that are financed entirely or partially from local budgets.

Overall, the current system of intergovernmental relations relies on informal communication flows between the various levels of government, highly dependent on personal and political relations and hierarchies.

A local representative body within each local government unit regulates the internal structure and scope of activities of municipal offices (MOs) — a basic unit of public administration at the local level. In municipalities of less than 8,000 inhabitants, a single municipal office is established to carry out all activities in the scope of self-government. In larger municipalities and particularly in cities, more than one MO can be—and usually is—established. In principle, the number of MOs depends on the size of the city.

Governance of MOs is based on a principle of 'one man rule'. The head of an MO can be chosen by the local representative body according to political criteria as a member of the executive board or appointed based on professional criteria by a decision of the executive board after an open competition. Although the initial intention was that the head be chosen according to political criteria, this is not always the case in practice. In those local units in which the head is chosen as a member of the executive board, there has been a high degree of politicization of the local administration. MOs can perform, apart from the self-government scope of activities, state administration activities that are delegated to the local level.

Drawback of the fragmented structure of local governments

Before 1992, there were 118 local governments with broad responsibilities and autonomy. For example, local governments were able to appoint the local police chief. However, the new Law on Local Self-Government and Administration of 1992 led to fragmentation of local government structure as every village claimed the status of an autonomous jurisdiction. For example 14 island-coastal municipalities quickly split into 53 autonomous jurisdictions. Therefore, currently a substantial number of Croatian local governments and cities are quite small. As a result, many Croatian local governments do not have the financial, administrative, and personnel resources to carry out the basic functions of local governments. In a few instances, neighbouring local governments developed some forms of cooperation. Thus, for example some larger islands (Krk, Brac, and Hvar) formed coordinative bodies, which, while being very useful for discussing matters of common interest, nevertheless lack a formal structure to implement its decisions, unless a consensus is reached so that member jurisdictions would implement it voluntarily.

The large number of Croatian local governments has resulted in many LGUs without the financial, human and organizational capacities to adequately manage public sector resources within their territorial jurisdiction. In the smallest localities, the local government has a few employees with the mayor serving on a voluntary basis. More than 30 per cent of towns and municipalities are not in a position to meet their current expenditure commitments from current revenues (World Bank, 2002). Notwithstanding central government support, the bulk of local government expenditure (around 75 per cent) is used to cover current operating expenses, with capital investment to a large extent neglected.

Another factor in determining the territorial structure is eligibility for EU regional development funds, which require larger jurisdictions than the present counties. However, for that purpose regions do not have to be self-governed but only used for statistical and planning purposes. Thus, an additional artificial layer of territorial division (statistical planning regions) will possibly be developed on top of the current counties and localities.

The Central Government does not currently perceive it as politically feasible to change the size of the lowest level jurisdictions. At the same time, according to the Central State Administrative Office, the Government does not intend to develop additional legislation on joint inter-municipal cooperation, because the current legislation does not prevent such establishments. At the same time, the same source notes that it is the wealthier municipalities that so far have utilized such a mechanism. At the same time smaller municipalities, which supposedly should benefit the most from such arrangements, weigh the preservation of 'sovereignty' over production costs, which to a larger extent are covered by the central government anyway.

Recent Decentralization Reforms

Croatia emerged as a highly centralized state after the first decade of its independence marked by the civil war. Discussions regarding the need to reform the public administration and to transfer the larger authority to the local government level began in early 1999. After the post-war normalization, some local authorities started to voice their dissatisfaction with the limited authorities given to them. The first step was devolving maintenance of fire brigades to the local level in 1999. However, the major changes occurred after a new government was elected in January 2000, whose programmes (among many other things) included specific goals related to the reform of the public administration in the direction of decentralization, including:[43]

§ Initiating a process of broad decentralization and strengthening the role of local and regional self-government (including determination of the jurisdiction of the

[43] The '21st Century' agenda was ambitious in scope but rather light on specifics by its broad nature. See Urban Institute *Local Government Reform and Decentralization (Draft)* October 2004, p. 17.

local self-government by a general clause, the introduction of subsidiarity, the increase of the fiscal revenues of local and regional units).

§ A gradual transformation of the territorial organization (including establishment of a smaller number of regional units, consolidation of local self-governing units in order to increase their capacity and the rationality of local structures).[44]

This reform initiative resulted in a number of pieces of legislation concerning local and regional self-governments: [45]

§ The Law on Regional Self-Government;
§ The Law on the Areas of the Counties, Cities and Municipalities in the Republic of Croatia;
§ The Law on the City of Zagreb;
§ The Law on Financing of Units of Local and Regional Self Government; And,
§ The Law on Local Public Utilities.

The major changes brought by gradual implementation of these laws since July 2001 have been the appointment of regional prefects by the regional assembly; and delegation to the subnational governments of certain aspects of service provision in basic and secondary education, healthcare, social welfare and culture. However, the decentralization appeared to be a top-down process, as local government units were included only in a very limited way in preparing the legal guidelines for the changes that defined the tasks to be decentralized.[46] Moreover, there did not seem to be a 'champion of decentralization' and the process essentially unfolds as the line ministries implement the legislative changes at their own pace and definitely not with the highest priority.

In October 2004, the Croatian Prime Minister announced at the Stability Pact Conference in Zagreb that Croatia is entering a new phase of decentralization.[47] In fact, the head of the Central State Administrative Office (with apparent support from the Prime Minister) has indicated his ambition to carry out a new phase of decentralization before the end of his term. About the time of the Prime-Minister's announcement the Central State Administrative Office (the main counterpart to the EU on civil service reform) circulated

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[44] Ibid p.17. The government in 2000 stated that one of its goals was the rationalization of subnational governments. However, no real reforms have been undertaken. Subsequent governments have also stated that rationalization of government structures is needed. However, there has been no minimal progress towards the rationalization of local governments.

[45] Over the past three years most if not all of these laws have been modified frequently. For example, the Law on Financing of Units of Regional and Local Self Government was amended more than eight times since 2003. The Law on the Areas of the Counties, Cities and Municipalities in the Republic of Croatia has been amended more than fifteen times since it was first adopted in 1997. While changes, modifications, and revisions are quite common in a normal legislative environment, the rather substantial number of modifications indicates that there is no cohesive, common, central decentralization strategy or goal. It appears that the decentralization strategy is rather ad hoc. These numerous modifications of rules and laws governing decentralization and subnational government development have created an environment of general uncertainty at the subnational government level(s).

[46] Urban Institute *Local Government Reform and Decentralization (Draft,)* October 2004, p. 27.

[47] South-Eastern Europe Regional Ministerial Meeting on Effective Democratic Governance at the Local and Regional Level, Zagreb, 25-26 October 2004.

a request among line ministries to identify additional functions in their respective spheres of responsibilities that can be devolved to the local level. The input from the line ministries laid the basis for the Framework Decentralization Programme for 2004-2007 (approved by the Government on 9 December 2004).

In December 2004 the Government formed the Decentralization Commission. The Commission — headed by the head of the Central State Administrative Office — is composed of senior officials from line ministries, and representatives from the associations of local and regional governments. According to the Central State Administrative Office, representatives of the subnational governments are full members of the Commission with significant influence. (For example, all their suggestions were incorporated into the drafted legislation submitted by the Commission to the Government at the end of February 2005). The Commission was tasked with extending the Framework Programme into a decentralization strategy for the central government. However, since the Programme to a large extent originates from the line ministries, the Programme has an inherent centralized bias. As such, it should come as no surprise that the Framework Programme is not considered binding, but only guides the Commission's work.

Currently the Decentralization Commission has on its agenda amending three fundamental laws: The Law On Local Self-Government, Law On Local Elections, and Law On the Territorial Structure. These amendments are expected to establish a legislative framework for the new phase of decentralization to be implemented through a series of subsequent laws and by-laws.

The primary motivation for the central government's decentralization initiatives appears to be the political empowerment of local communities; the role of economic arguments in motivating the current decentralization reforms appears to have been a secondary concern. Until the year 2000, local governments had a rather narrow scope of responsibilities, nicknamed as 'grass-clipping'. By allowing local governments to play some role in the provision of services more important to local residents, such as education and healthcare, the central government attempted to raise the status of local governments. According to various interviewees, including the representatives of the Central State Administrative Office, economic efficiency considerations are at the bottom of the guiding criteria. A related aspect is that the political composition of local councils is another factor in the decentralization process. Thus, some government officials suggested that no changes would occur before the May 2005 local elections, which can be interpreted to mean that the extent of powers devolved to the local level depends on who comes to power at the local level. On a different note, although the Decentralization Commission is led by the Central State Administrative Office, the latter has no authority over fiscal issues, which completely falls under the authority of the Ministry of Finance, which, unlike other line ministries, is represented on the Commission by a technocrat with no decision-making powers. According to the Central State Administrative Office, in 2005 the Commission will only decide on those functions that do not require resources other than for general administration costs (e.g., issuance of building permits).[48] By June

[48] The example of building permits seems to illustrate the short-term vision of the Central State Administrative Office. According to the Urban Institute (*Local Economic Development (Draft)* November

2006 the Commission intends to decide on the devolution of those functions requiring devolution of additional fiscal resources.

The Assignment of Expenditure Responsibilities

After the establishment of the new (fragmented) structure of local governments in 1992, the bottom-level jurisdictions were assigned very limited responsibilities. However, the Government formed after the 2000 elections initiated the process of broad decentralization aiming at introducing the Council of Europe principles of general competence, subsidiarity and revenue sufficiency.

The present scope of responsibilities of local governments is defined by the Local Government Act of 2001. According to this law, city and municipality governments are tasked with the following obligatory duties:[49]

- Housing and the arrangement of settlements;
- Zoning and town planning;
- Local public utilities;
- Child welfare and protection;
- Social welfare;
- Primary health protection;[50]
- Kindergartens and nurseries;
- Culture and sports;
- Consumer protection; and,
- Fire-fighting.[51]

Croatian counties (and 32 larger cities) provide functions that are of regional importance, including:[52,53]

- Elementary and Secondary Education;
- Health care;
- Social welfare;
- Economic development;
- Zoning and town planning;
- Determining the network of institutions in education, healthcare, social welfare and culture;

2004, p. 15), proper administration of building permits requires a costly development of physical plans. Instead, the tool of the 'location permit' is mostly used in practice allowing the municipality to implement an individual project without a planning procedure.

[49] Urban Institute *Local Government Reform and Decentralization (Draft)* October 2004, p. 22.

[50] Primary health protection is undertaken at the city level. Cities obtain some grant transfers from the central Government.

[51] Police protection appears to be primarily a State level function.

[52] Even though some healthcare functions have been devolved to the county government level, many counties appear to be incapable of financing these devolved functions.

[53] The Local Self-Government Law establishes that new functions can be devolved only to those municipalities, whose capacity is deemed adequate according to the central government assessment.

§ Transport and transportation infrastructure.

In accordance with general competence, local governments can engage in other activities with their own financing. Exclusive functions provide all the responsibilities for a specific function (including regulation and provision standards, financing, provision and production) to a single level of government, whereas shared competencies assigned different dimensions of a certain functional responsibility to different levels of government.[54] In fact, even before the latest decentralization, local governments did finance certain functions such as welfare, and secondary education, even though they had no legal obligation to do so. Table 2 below enumerates the relative expenditure functions of the central government, cities, local government units and counties. As can be seen from the table the only functions that are exclusively assigned to the local level are kindergarten and nursery, sewage, solid waste, and maintenance of cemeteries. For the county level, exclusive responsibility covers only ports.

Table 2. Function of the State, Counties, First Tier Local Governments (2004)

Function	**Competent authority**			**Type of competence related to implementation of function**	
	State	**County**	**First tier LG[55]**	**Exclusive**	**Shared**
General administration					
Security, police	•			•	
Fire protection	•		•		•
Civil protection	•			•	
Justice	•			•	
Civil status register	•			•	
Statistical office	•			•	
Electoral register	•		•		•
Education					
Primary education	•	•	•		•
Secondary education	•	•			•
Vocational and technical		•	•		•
Higher education	•			•	
Adult education		•	•		•
Public health					
Hospitals	•			•	
Health protection	•	•			•
Social welfare					
Kindergarten and nursery			•	•	
Family welfare services		•	•		•
Welfare homes		•	•		•
Social assistance benefits	•		•		•
Housing and town planning					
Housing	•		•		•
Town planning	•	•	•		•

[54] See Martinez-Vazquez (1998) for a more detailed discussion on the multi-dimensional nature of expenditure assignments.
[55] Includes cities and municipalities.

Table 2. Function of the State, Counties, First Tier Local Governments (2004)

Function	Competent authority			Type of competence related to implementation of function	
	State	County	First tier LG[55]	Exclusive	Shared
Regional/spatial planning	•			•	
Environment, public sanitation					
Sewage			•	•	
Refuse collection & disposal		•	•	•	
Cemeteries & crematoria			•	•	
Slaughterhouses	•			•	
Environmental protection	•	•	•		•
Consumer protection	•			•	
Culture, leisure & sports					
Theatres & concerts	•	•	•		•
Museums & libraries	•	•	•		•
Parks & open spaces	•		•		•
Sport & leisure	•	•	•		•
Religious facilities	•			•	
Other cultural facilities	•	•	•		•
Traffic, transport					
Roads	•	•	•		•
Transport	•	•	•		•
Urban transport			•	•	
Ports	•	•		•	
Airports	•			•	
Utilities					
Gas	•			•	
District heating	•			•	
Water supply	•	•	•		•
Agriculture, forests, fishing	•	•	•		•
Electricity	•			•	
Economic Services					
Economic promotion	•	•	•		•
Trade & industry	•	•	•		•
Tourism	•	•	•		•

Source: Urban Institute *Local Government Reform and Decentralization (Draft),* October 2004, p 23-24. And, Katarina Ott and Anto Bajo, *Local Government Budgeting in Croatia* in 'Decentralizing Government' p. 9.

Most expenditure functions are shared between the various levels of government. Some of these functions are divided into sub-functions assigned to different levels of government.[56] For example,

§ In the water sector Hrvatski vode (Croatian Waters) is responsible for all water source management and development and the transportation of bulk water. Local

[56] See Urban Institute *Local Government Reform and Decentralization (Draft)* October 2004 Pg 23

government units are, however, responsible for the treatment and distribution of the water. At the same time, Hrvatski Voda has significant ownership interest in virtually all Croatian local government water utilities (see Box 2).

- With respect to roads (transportation), the Croatian national government is responsible for national roads while counties are responsible for county level roads and local governments are responsible for roads within their jurisdiction.

Box 2
Hrvatske Vode

Hrvatske Vode (HV), or 'Croatia Waters', is the national government entity responsible for planning and policy setting in the area of water and wastewater treatment. Recently, the Government of Croatia has undertaken some preliminary initiatives to rationalize the institutional structure of HV. The new role envisioned for HV is premised on the corporatization of water supply services at the municipal level, the regionalization of wastewater management, and the introduction of Private Sector Participation in the financing and management of wastewater treatment facilities. In its new role, HV has regulatory authority over most water activities including water extraction, construction of domestic water supply and wastewater systems, pollution discharges, sand and gravel excavation, fish culture, and hydropower development.

The legal authority for the provision of water and wastewater services in Croatia has been decentralized to the municipal level. While this has resulted in more demand responsive and locally appropriate approaches to service provision, it has hindered the development of regional solutions to such problems as wastewater treatment, water resource management, and environmental protection. In addition, many of the municipalities in Croatia lack the capacity to finance needed investments or undertake comprehensive long-range planning in the water and wastewater sector.

Although the decentralized framework transfers the responsibility for service provision to the local level, municipalities still lack the autonomy to fulfil their obligations. For example, once a municipality determines its investment requirements and develops a plan for new capital works, it must apply to the Ministry of Environmental Protection and Physical Planning (MEEPP) for a location permit before it can break ground. In order to receive a location permit, it must first carry out an environmental impact assessment that must be reviewed and approved by the Ministry. These national level approvals and the process required to obtain them are the most time consuming aspect of the capital planning process.

Source: Michael Schaeffer (2004) 'Croatia Water Utility', mimeo.

For other functions, the sharing of responsibility over concurrent functions is less transparent. The sectoral laws on education, healthcare, and social welfare transferred the ownership of certain classes of social assets to subnational governments along with the responsibility for operating and maintaining these facilities. At the same time the line ministries retained its involvement in services provided with these facilities, for example, by paying wages of the personnel of the transferred facilities. A positive change should be acknowledged in the sector of culture, where local authorities no longer need to seek approval from the Ministry of Culture to appoint directors of institutions. Also, regarding schools the headmaster is now appointed by the school board rather than the Ministry of Education, which allegedly abused this power for political reasons.

Despite its significant regulatory powers of hierarchical oversight over virtually every service provided at the local level, the central government does seem to have the administrative capacity to effectively monitor the finances and standards of service delivery at the local level. This was manifested in the inability of the central government to fulfil its standby agreement with the IMF, in which the central government committed to improved reporting on the fiscal accounts of the local government sector.

Although there is no data on the efficiency of local government management of the transferred facilities, many experts believe that the partial responsibility has led to socially inefficient actions of local governments such as under-spending on current maintenance resulting in higher costs of capital rehabilitation covered by the central government. Also, despite underutilized social infrastructure in certain areas and having the power to rationalize the network by closing some facilities and consolidating the operations (with the central government's approval), county governments do not take such actions as it would lead to losing public jobs essentially funded by the central government. Nevertheless, according to the Central State Administrative Office, the Government does not intend to complete the 2001 reforms by making the partially decentralized functions exclusively local except where it is deemed rational (e.g., a single-window procedure for obtaining building permits).

Table 3.
Composition of local government expenditure according to the functional classification (% of total), 2002-2003

	2002	2003
General public services	19.69	18.32
Defense*	0.01	0.01
Public order and security**	2.93	3.36
Economic affairs	16.46	16.21
Environmental protection	3.78	3.85
Housing improvement services	19.17	21.33
Health care	4.21	3.94
Recreation, culture and religion	11.46	10.97
Education	17.32	17.41
Welfare	4.97	4.60

Source: MF Republic of Croatia 2004. Note: *Expenditure for civilian protection; ** This expenditure relates to financing the fire departments.

Table 3 reports the composition of local government expenditures by functional classification. Expenditures on municipal services (utilities) account for an average of about 20 per cent of local government expenditures, followed closely by general public services at 19 per cent. Education is the third largest expenditure function accounting for about 17 per cent of the total.

Revenue Assignment and Local Tax Administration

Croatia has made significant strides towards enabling subnational governments to access various sources of revenues. The current Croatian legal framework establishes the public revenue assignment system as follows: (a) state taxes; (b) local taxes and fees; and, c) off-budget revenues.[57] The Law on Financing Local and Regional Self Governing Units and the specific laws on different taxes provide the revenue framework for subnational governments (e.g., counties, local governments). The following represents a brief discussion of the various non-shared, shared and local own source revenues and taxes:[58]

§ **Non-Shared State Taxes.** Customs duties, excise and value added taxes (VAT) are non-shared taxes. In effect, these taxes are allocated solely for the use of the central government. In practice, these taxes have often been shared on a temporary and exceptional basis.

§ **Shared State Taxes.** The two most important shared taxes are the personal income tax (PIT) and the corporate income tax (CIT).

§ **Local Own Source Taxes and Fees.** Local self-governments are assigned a number of local own tax revenues. Local municipal fees include: trade permits, outdoor advertisements, permit to restrict public places and car parking.

Revenue Assignment by Level of Government

Table 4 provides a list of some taxes and their assignments. An important feature of the Croatian tax administration system is that all taxes, regardless of their legal assignments, can be collected by the Minister of Finance's (MOFs) Tax Administration upon the request of the local governments.[59] The Croatian MOF indicates that about 90 per cent of subnational governments utilize the services of the MOF's Tax Administration. (MOF, 2004).

[57] World Bank, (2000) p. 93.

[58] This commentary is not expected to be a comprehensive assessment of the pros and cons of the various shared, non-shared, and local own taxes. This section is merely intended to explain the various taxes and their applicability to local government finance.

[59] IMF Republic of Croatia: Report on Observance of Standards and Codes – Fiscal Transparency Module. Country Report No. 04/365. p. 11.

Table 4 Tax Assignment in Croatia

Jurisdiction	Taxes
National Government	§ VAT § Special Taxes (excises) on cars, motor vehicles, vessels and aircraft; mineral oil, alcohol, beer, non-alcoholic beverages, tobacco, coffee, luxury products, liability and comprehensive road vehicle insurance. § Levies on organizing lotteries, casino gambling, bookmaker gambling, and on slot-machine gambling.
County Governments	§ Taxes on inheritance and gifts § Motor vehicle licenses § Taxes on other vessels § Taxes on slot machines
City / Municipal Governments	§ Consumption tax § Taxes on vacation houses § Trade name § Surtax on income tax § Use of public land, uncultivated land, unused real estate companies, undeveloped building land.
Shared Among the Three (3) Governments	§ Corporate income tax § Personal income tax § Real estate transfer tax

Source: Croatia MOF – Tax Administration, *The Croatian Tax System, 2003.* (www.pu.mfin.hr).

Tax Sharing

The tax sharing criteria between different levels of government are established in the Law on Financing Local and Regional Self-Governing Units and various special laws. The distribution of the revenue of the shared taxes is mostly based on the amount collected in the city or municipality.

With respect to tax sharing laws, there are a number of special laws concerned with primary and secondary school education, health, social care, and firefighting. These laws direct the transfer of certain functions and costs from the central government to the cities (i.e., primary education, firefighting) and to the counties (i.e., secondary school education, health and social care).[60] Thus, local governments can retain additional shares of PIT if they assume additional functions. Local government units that took on the decentralized functions were able to increase their share in income tax by 10.4%. If they took on only some of the functions, then this share would be determined in the manner according to Table 6.

[60] IMF Country Report No. 04/365 Pg 12.

Table 6: Local government units' additional share in income tax

Decentralized functions	Elementary education	Secondary education	Health Care	Welfare	Fire Departments	Total
% points	2.9	2	2	2.5	1.0	10.4

The central government stipulates the sharing arrangement of the primary kinds of taxes with local governments. Table 7 shows the destination of revenue collected in a given local government for each shared tax. As previously noted, the primary taxes including income and corporate profit tax are shared among the various government units. Also, a certain share of the PIT revenue is now allocated to the equalization fund for subsequent redistribution among localities. An equalization fund designed to partially compensate the effects of this tax sharing system receives about twenty-one (21 %) per cent of the income tax revenue and is distributed according to criteria established by the MOF and relevant Croatian laws.[61]

Table 7. Tax Sharing in Croatia (%), 2003

Tax	Central Government	County	City or Municipality	Decentralized Functions[62]	Equalization Fund
Income	24.6	10.0	34.0	10.4	21.0
Income (Zagreb)	21.6	--	47.0	10.4	21.0
Corporate Profit	70.0	10.0	20.0	--	--
Real Estate Transactions	40.0	--	60.0	--	--

Source: MOF (2004), Institute of Public Finance, Zagreb (2004), IMF 2004, Local Government and Administration Financing Law, NN 150.02.

As is well known, tax-revenue retention is a counter-equalizing mechanism of intergovernmental transfers. The inter-jurisdictional disparities are further widened by the tax exemptions on profit and income taxes provided by the central government to residents of island and mountainous localities and also areas affected by the civil war.[63] These are exactly the localities often exhibiting larger expenditure needs with respect to local government services. However, the tax exemptions further deprive local governments of fiscal resources limiting the yield from the shared taxes. This counter-equalizing effect might be somewhat compensated by the fact that the central government cedes the whole or part of the income and profit tax, and additionally provides

[61] According to IMF Country Report No 04/365, the distribution of the equalization fund apparently concentrates tax resources in the larger subnational government units.

[62] This corresponds to the share of income tax collected locally that remains in the local government (city / municipality) if it is financing decentralized functions. In the cases where the local government is not financing these decentralized functions, these funds would be forwarded to the central government.

[63] In Croatia, as many as 270 local units (cities and municipalities) have a special status in the financing system.

equalization grants to these special status localities. However, it might not be the same as the general revenue retained from the shared taxes as, for example, the central government has ceded its share of the revenue from income tax (24.6 per cent) only to those municipalities and cities on the islands that enter into joint agreements on the financing of capital projects in their area.

Own Sources of Local Government Revenue

With respect to local government own taxes, the central government has not intervened, or supervised, the rate setting structure undertaken by local government. The introduction of new local taxes, and imposing a surtax on the personal income tax, is envisaged by many local government units. However, there is the question as to what extent the introduction of new local taxes will affect the increase in local tax revenue. Locally generated taxes currently figure negligibly in the overall local government revenue picture.

Under Croatian law, local governments have the right to define surtaxes (piggyback) on the national income tax and they can also define the rates of their own taxes provided that they conform to the provisions of the Law on Financing Local and Regional Self-Governing Units. The highest supplemental rate on personal income is set in the City of Zagreb (18 per cent of the national tax liability) with the national statutory limit ranging from 10 per cent for municipalities and 30 per cent for the City of Zagreb. Also, many local government units have a consumption tax, which they set at their own discretion (up to 3 per cent of the sales price of beverages sold in catering facilities).

Structure of Local Government Revenues

The structure of local government revenues can be allocated into tax, non-tax, capital, and grant revenue. Table 8 below illustrates that tax revenues are the dominant item in local government budgets. However, a brief review of the data indicate that local government taxes amounted to less than 10 per cent of all local government revenues. An increase in the share of tax revenue and central government grants is mostly explained by the compensation for decentralized expenditure functions provided by the central government since 2001. At the same time, the share of non-tax revenues slightly declined from about 32 per cent in 2000 to about 27 per cent in 2003.

Table 8. The structure of total revenue of local government units (%) 1999-2003

	1999.	2000.	2001.	2002.	2003.
Tax revenue	55	53	53	57	58
Grants	8	7	10	10	10
Non-tax revenue	30	32	31	28	27
Capital revenue	7	8	7	6	5
Total revenue	100	100	100	100	100

Source: Bajo and Pitareviæ(2004)

Personal income tax represents one of the most important sources of local revenue in Croatia, accounting for more than 68 per cent of local tax revenue (30 per cent of their total revenue) over the 2001-2003/04 period (Table 9). Shared corporate profit taxes account for about 17 per cent of local tax revenue (10 per cent of their total revenue). Unlike most EU countries, in Croatia shared taxes have historically been distributed on the basis of origin rather than on a per capita or some other composite criteria.

Table 9. The structure of tax revenue of local government units (%), 1999-2003

	1999	2000	2001	2002	2003
Income tax and surtax	64.17	63.60	68.75	71.72	73.01
Profit tax	21.09	21.92	16.92	16.57	16.70
Property transfer tax	11.09	10.81	11.23	7.42	6.29
Goods and services tax	3.42	3.48	3.07	4.09	3.97
Other taxes	0.24	0.18	0.02	0.21	0.01
Total	100.00	100.00	100.00	100.00	100.00

Source: Bajo and Pitareviæ(2004)

Table 8 indicates that non-tax revenues play a substantial role in filling local government budgets. In fact, in many Croatian communities non-tax revenues make up more than 80 per cent of the structure of their revenues.[64] Table 10 (below) describes local government revenues from user charges and administrative fees as a per cent of total non-tax revenue. The primary source of non-tax revenue for city and municipality governments is played by local government utilities (e.g., water, sanitation etc.). There are a few local government units prescribing high rates of utility fees and contributions to cover gaps in their operational expenses.[65] For county governments non-tax revenue mostly come from state duties and administrative fees.

The Croatian tax system remarkably misses a property tax (a recurrent tax on property ownership; as distinct from a tax on real estate transactions, such as Croatia's property transfer tax). The closest available instrument is the public utility fee, which is charged according to the square footage of housing but the revenue is earmarked for filling the gap between the costs of utility enterprises and their receipts from utility charges separately paid by local residents. Given the lack of own sources of revenue and the economic argument for taxing land rather than structures, this fee can be preserved as a proxy for benefit taxation. However, its revenue should be consolidated in the local budget and used for public services related to housing (street cleaning, lighting, fire

[64] Ott and Bajo (2002) indicate that in the municipality of Kostrena non-tax revenues comprise 85 per cent of total local government revenues. The revenue from utility charges amounts to more than 58 per cent of the total revenue.
[65] The public utility fee is budgetary revenue of the LG, and may be used to finance communal amenities. The public utility contribution is budgetary revenue of LG, which should be used to finance the construction of structures and facilities.

protection, etc), which would justify the regressive nature of this tax. Since 2001, local governments have been allowed to use revenue from the public utility fee for maintenance of education, social, and medical facilities.

Table 10. Revenues from User Charges and Administrative Fees (% of Non-Tax Revenue) (2002)

	Municipalities	Cities	County	Total
National Stamp Duty Revenue	0.5	6.4	76.6	7.8
Road Charge	0.3	4.9	0.0	4.1
Administrative Fees	0.9	0.7	18.2	1.4
Other Charges	11.4	3.4	0.96	4.5
Other Fees	2.2	0.4	4.2	0.7
Entertainment and Gambling Fee	0.01	0.01	0.0	0.01
Utility Charges	61.6	61.1	0.0	59.2
Public Utility Fees	20.2	21.9	0.0	20.9
Tourist Tax	3.0	1.2	0.0	1.4

Source: Ministry of Finance of the Republic of Croatia (2003); Ott and Bajo (2002); Numbers may not add due to rounding.

Intergovernmental Fiscal Transfers

There are regional disparities in both per capita expenditures and per capita revenue collections in Croatia. In a great number of localities own-source revenues are insufficient to cover local expenditure requirements. These issues indicate that there are substantial equity and intergovernmental fiscal issues that must be addressed by the central government in order to improve local government service delivery and accountability.

Local governments in Croatia vary substantially in terms of their ability to raise revenues. Extrapolating from the issue of fragmentation, comparison of per capita levels of own-source revenue across regions, reveals differences in the range of 1:6 (Bajo and Pitareviæ 2004). In addition, public expenditure needs among local governments vary substantially because of the unequal cost of public service provision. These factors associated with tax (revenue) capacity and local government service costs have a substantial impact on horizontal fiscal imbalances. To address these disparities, the Croatian central government provides grants to local government units.[66]

Ott and Bajo (2002: 18) state, ‘there is complete confusion in the attempts to work out the number of funds that the state gives to local units. It is impossible to arrive at these sums, because numerous grants are given via the various ministries. The Finance Ministry has no way of checking and making sure that these funds are properly used, to what extent

[66] Central government grants include capital and other targeted grants. In some cases, the central government will provide operational subsidies.

and for what purposes'. Limited discussions with local government officials indicate that to some extent the equalization grant decision-making rules are not sufficiently transparent so that they can undertake better budget projections. In fact, in preparing the current study, the study team was unable to obtain a copy of the MOF equalization grant formula (mechanism). As a result, we are not able to provide a detailed commentary as to the effectiveness of Croatian equalization grants or transfer systems.

Based on the available information, we can identify three major channels of intergovernmental transfers: compensation for decentralized expenditure functions; equalization grants, and capital grants.

Beginning in 2002, the manner of calculating the amount of transfers (grants) to 32 cities and 21 counties for decentralized expenditure functions are determined by special decrees. To implement these decrees, the central government adopts specific decision rules to define the criteria and coefficients for the minimum financial (or expenditure) standards.[67] At the recommendation of line ministries, the Government and Ministry of Finance set annually the minimum financial standards or the cost of performing some activity. In defining minimum financial standards, relevant line ministries take into account differences in needs for public resources of the local units. For example, the criterion for the allocation of resources to cover material and financial needs in secondary schools is the number of enrolled pupils in a certain year multiplied by the average annual cost per pupil. The average annual cost is set for each individual local government unit. The amount of grants is determined separately for each decentralized function as the difference between the minimum standard and the yield from the supplementary rate of central tax revenue retention associated with this function. The estimates of this gap are updated on a monthly basis. Both for counties and cities, grants cover about half of estimated standard expenditures, with the other half covered by tax revenue retention.

The distribution of resources from the equalization fund is guided by the same minimum financial standards as for financing of the decentralized functions described above. From 2001 the central government in the annual budget execution laws set criteria for the allocation of equalization (current general) grants. [68] The central government allocates such grants only to counties in the area of which there are local government units (cities and municipalities) that belong to areas of special national concern (ASNC). The definition of ASNC includes war affected areas but also island and mountainous

[67] Urban Institute *Local Government Reform and Decentralization (Draft)* October 2004, p. 25.

[68] According to MOF 2003 reference material (the only material readily available as of 14 February 2005), regarding financial equalization, Croatian law requires that: i.) In a county where per capita revenues are below the average of the Republic, excluding the City of Zagreb, the Republic shall allocate a grant from the State Budget up to 75 per cent. The grant may not be awarded to a county where the income surtax is less than 1 per cent and/or the level of taxes is lower than the highest rates or amount of taxes as regulated by law; and, ii.) In a city or municipality in a region where the revenues of cities with an average tax load are below the county average per capita, with the exception of towns with a population over 40,000, the county shall award a grant from the county budget to cover the difference between actual revenue per capita and 75% of the county average revenue per capita. The grant may not be awarded to the city where the income surtax rate is lower than 1 per cent and the rates of local taxes are lower than the highest rates or amount of taxes as regulated by law.

territories. Counties must allocate at least 50 per cent of the current general grants that they obtain from the central government to cities and municipalities that belong to ASNC. The other 50 per cent of the resources can be allocated by the county according to its own criteria to other cities and municipalities.

Criteria for the calculation and allocation of equalization grants to counties/localities are as follows: per capita revenue of the county/locality budget relative to the average per capita revenue of all countries/localities; and per capita capital expenditure in the county/locality relative to the average for capital expenditure of all counties/localities. In addition to those factors, for cities and municipalities the calculations also take into account material costs (determined by population size and expenditure per capita), and the rationality of the system (number of employees, expenses per employee), expenditures on the functions of a city (below 30,000 population), and a correction factor for the gradual transition to the new model of calculating grants.

Capital grants are spread over budget lines of individual ministries and thus are hard to account for. Grants for developing local infrastructure mostly come from the Ministry of the Sea, Tourism, Transport, and Development (MSTTD). Some projects are fully funded by the central government and for others the share of local co-financing ranges from 10-30 per cent. Apart from different ministries, capital grants are also allocated via the *Regional Development Fund*. This Fund was founded in 2001 to encourage more even regional development of areas that have a GDP lower than 65 per cent of the Croatian mean GDP.

On average the share of central government grants in local government budgets appears inadequate given the extent of horizontal disparities. However, it has increased from 6 per cent in 2002 to 11 per cent in 2003. According to Bajo and Pitareviæ (2004) the incidence of grants shows a negative relation to the per capita level of pre-transfer revenue (or GDP) only for the six most affluent counties. All other counties receive a similar amount of grants per capita.

Regulation of Local Government Borrowing

Croatian local governments must obtain approval from the Ministry of Finance for most borrowing, either from a bank or through the issuance of securities, before entering into a loan contract or issuing securities.[69] This approval is given only if the local government's annual debt service obligation after the proposed new borrowing, together with certain other obligations, does not exceed a limit described in the Budget Law.[70] Recently, local government borrowing has been subjected to an annual aggregate limit stated in the central government standby agreement with the IMF.

[69] Budget Law, Arts. 104(1) and 105(1); Ministry of Finance Borrowing Regulation, Arts. 2, 3, and 15. It is possible that agreements between the Government of Croatia and multilateral lending institutions such as the EBRD may provide for exemptions from this approval requirement for local government borrowing from such institutions.

[70] Budget Law, Art. 106.

Limits on Individual Local Governments' Debt

Under the mechanism developed by the Ministry of Finance a local government may borrow so long as the current year's debt service payments for the new borrowing plus payments under guarantees and outstanding obligations does not exceed 20 per cent of 'realized revenues' for the preceding year.[71] This formulation is consistent, in general terms, with a standard commonly used in more developed local government credit markets.[72] In brief, a local government may not legally incur debt unless the Ministry of Finance has approved the borrowing based on these criteria. The obligations of local government that are subject to the Budget Law limit of 20 per cent of 'realized revenues' comprise 'loan annuities, obligations on issued securities, outstanding guarantees[73] from preceding years, and unpaid obligations from preceding years'.[74]

Limit Imposed on Aggregate Local Government Debt

The Law on Execution of the 2004 State Budget[75] Article 12(2) imposes a total country-level limit on aggregate local and regional (*i.e.*, county) government borrowing for the 2004 budget year equal to 3 per cent of the operating revenues of all local and regional governments. Once the ceiling is reached, no subnational government can borrow. Local communal enterprises, however, can borrow on the strength of their own balance sheet with the guarantees of the local government.[76]

Certain local and regional government borrowing is excluded from this limit: (1) Borrowing approved prior to 31 December 2003 but not used in 2003; (2) Borrowing by local governments in areas of special state concern (defined in the Law on Areas of Special State Concern (NN 26/03, 26 February 2003); and (3) Borrowing from the Croatian Regional Development Fund or the Development and Employment Fund for purposes of acquisition of non-financial assets. 2004 Budget Execution Law, Art. 12(3).

The Ministry of Finance's unofficial aggregate limit on local government borrowing for 2004 was HRK 400,000,000.[77] The Law on Amendments to the Execution of the 2004 State Budget[78] subsequently reduced that aggregate limit from 3 per cent to 2 per cent of aggregate local government operating revenues. The method that the Ministry of Finance uses to allocate this credit limit among prospective local government borrowers is not clear. Reportedly, the borrowing quota is allocated on the 'first-come-first-served'

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[71]Ministry of Finance Borrowing Regulation Article 6.

[72] EBRD Municipal and Environmental Infrastructure Policy, Annex 3, p. 9.

[73] Croatian local governments can issue guarantees for public service (communal) enterprises without obtaining the approval of the Minister of Finance. However, the local government must submit general information regarding the guarantee to the Minister of Finance.

[74] Budget Law, Art. 106 (2); Ministry of Finance Borrowing Regulation, Art. 6.

[75] Hereafter referred to as the 2004 Budget Execution Law (NN 31/04, 9 March 2004).

[76] The local government guarantee for communal borrowing is apparently included in the 20 per cent debt service limit for local governments.

[77] *Cf.* Bajo, p. 5

[78] NN 104/04 21 July 2004 Art 3

principle although some review is given to loan applications requiring the central government's guarantee.

Public Procurement Law

The Public Procurement Law requires that local governments solicit by public tendering any credit that will carry an annual debt service obligation (payments of interest and principal) of more than HKN 200,000.[79] The Public Procurement Law does not require local governments to provide any information regarding the proposed use of the loan funds or about its historic, planned, or projected financial condition, source of debt service payments, proposed security for the loan, the proposed use of the loan funds, or many other types of information that lenders typically require in considering making loans to private sector organizations.

Concluding Remarks

In many ways, Croatia's reforms in the area of decentralization could be characterized more appropriately as a case of misguided decentralization driven by historical accident, rather than as a case of inadequate decentralization *per se*. In contrast to many other transition countries, local governments in Croatia are provided with 'real' fiscal resources, and have the potential for achieving real responsibilities. As such, Croatia's main challenge is not necessarily to pursue a more decentralized structure, but rather to rationalize the structure that has emerged. A large number of international financial institutions, development organizations and donors are supporting the Government of Croatia in the process of fine-tuning its approach to decentralized local governance (Annex B).

As supported by international experiences around the world, intergovernmental fiscal policy must be thought of as a whole system. While the various elements of this system (such as the delineation of functions, assignment of revenue sources, intergovernmental transfers, and local borrowing powers) can be introduced with separate pieces of legislation, the pieces of the system must fit together. A 'one-off' piecemeal reform, encompassing only one element of the system (e.g., managerial devolution), is not likely to lead to success. This rule seems to be proved again in the experience of Croatia, which has been pursuing local self-government for democratic reasons and without much regard to fiscal and economic aspects of this process. As a result, Croatia ended up with an excessively fragmented local government structure with a majority of local government units (even though representing minority of population) unable to reach the minimum efficient scale of service provision.

Moreover, although the recent devolution of certain aspects of service provision – such as the authority to appoint a school director – may raise the authority of local governments,

[79] Public Procurement Law Arts. 4(1), 7(2) and 9(2). Procurement of credit from certain bilateral or multilateral financial institutions may be exempt from this requirement if an agreement between the institution and the Government of Croatia specifies the applicable credit procurement procedure. Public Procurement Law Art. 6(3).

but fails to capture all the economic trade-offs that would lead to cost-efficient solutions. For instance, as long as local education is financed in a disjointed manner (with teachers' salaries paid from the centre, and local government financing other costs), local governments do not have the ability to prioritize and make efficient trade-offs between increasing expenditures on salaries and non-salary spending.

The situation looks somewhat better on the revenue side with the local governments' power to levy surtax on the personal income tax. However, while being adequate in the aggregate sense, given the fragmentation of local governments, this tax instrument has little yield in smaller localities with a negligible tax base. Finally, while the fiscal disparity arising from the local government fragmentation (but also from war destruction and geography) makes a sound system of equalization grants of crucial importance, in reality we have a multiplicity of grant channels as fragmented as the local government structure itself.

Given the central government's apparent reluctance to undertake a comprehensive policy intervention or to receive any technical assistance in this area, the current UNDP strategy of focusing on building the capacity of local governments appears justified and appropriate. This kind of investment in the capacity of local governments carries certain risks related to the concerns over the efficiency of the present structure of government. However, investing in the capacity of the Association of Local Governments appears a safer bet as this institution is likely to survive possible amalgamation of some of its smaller members.

A new hope for doing the decentralization 'right' was brought out by the recent establishment of the Decentralization Commission. Inclusion of representatives of all line ministries can make possible a comprehensive approach to decentralization. Given its successful collaboration with the Association of Local Governments, UNDP can enter this process by supporting the activities of the two representatives of the Association in the Commission. This support can take various forms from preparing a 'white book' on decentralization to technical support in reviewing the proposed legislation to effective methods of disseminating the Commission outputs among local governments and soliciting their feedback.

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Annex A: Decentralization Matrices

TABLE 1

ASSESSING THE STATUS OF FISCAL DECENTRALIZATION REFORMS IN CROATIA

	(A) Overall policy stance and policy effectiveness	(B) Constitutional & legal framework	(C) Central govt institutional and regulatory framework	(D) Local gov't institutional and regulatory framework	(E) Participation by civil society and private sector
(1) Structure and role of public sector	No mechanism established for dialogue between the state and local governments and within the state apparatus; decentralization has been a top-down process	Council of Europe LSG Charter; inconsistencies in the legal framework	No action plan for implementation of the strategy	Bottom level is very fragmented; disparities in fiscal and administrative capacity	
(2) Functional and expenditure assignments	Rather than by activity, delineation made by facility and expense items of facilities	Unclear delineation of responsibilities	Central government remains involved in every decentralized function; but lacks monitoring capacity	Lack of capacity and initiative to assumed new functions	Elements of self-management by governing boards of schools and hospitals; unclear status of local utilities
(3) Assignment of revenue sources	Devolved resources inadequate to decentralized responsibilities	Counter-equalizing tax revenue retention	Earmarking most of the devolved resources	Disparity in revenue base	
(4) Intergov. fiscal transfers, incl. the scope of unfunded mandate	Numerous channels of transfers	Legal framework is loose	Excessive administrative supervision	County-municipality relations lack structure	
(5) LG borrowing and infrastructure development	Administrative constraints	Legal limits superseded by IMF-agreed aggregate cap	Lack evaluation capacity for loan approvals	Lack of capacity to prepare investment packages	

TABLE 2

KEY FISCAL DECENTRALIZATION REFORM INITIATIVES PURSUED IN CROATIA

	(A) Overall policy stance and policy effectiveness	(B) Constitutional & legal framework	(C) Central govt institutional and regulatory framework	(D) Local gov't institutional and regulatory framework	(E) Participation by civil society and private sector
(1) Structure and role of public sector	State Administration Office as the champion of decentralization (political not fiscal) and embraced USAID assistance; EU pledged funds for (fiscal) decentralization but lukewarm response from the MinFin	Proposal for direct election of mayors as opposed to appointment by the local council	USAID developed operational guidelines for the Decentralization Commission spelling out entry points for technical assistance	UNDP support to the LG association	Pilot projects carried out by USAID, GTZ, UNDP, EU to introduce participatory approaches to development planning
(2) Functional and expenditure assignments	List of functions proposed for decentralization by line ministries	Amendment to the LSG law devolved building permits to cities over 40 thou.	USAID/UI enhancing LG capacity for financial management	WB enhancing management capacity of local hospitals	
(3) Assignment of revenue sources	USAID property tax project				
(4) Intergov. fiscal transfers, incl. the scope of unfunded mandate					
(5) LG borrowing and infrastructure development					

TABLE 3

REFORM PRIORITIES FOR FISCAL DECENTRALIZATION IN CROATIA

	(A) Overall policy stance and policy effectiveness	(B) Constitutional & legal framework	(C) Central govt institutional and regulatory framework	(D) Local gov't institutional and regulatory framework	(E) Participation by civil society and private sector
(1) Structure and role of public sector	Consensus building mechanism between and within levels of government	Eliminating inconsistencies in legislation	Building capacity to monitor local finances and assess decentralization progress	Mechanisms of horizontal cooperation	Strengthening horizontal accountability through local budget transparency
(2) Functional and expenditure assignments	Local discretion should allow for materializing efficiency gains	Clear delineation of authority	Output rather than input control and standards; performance measures	Capacity to exercise fiduciary responsibilities over schools and hospitals	Opportunity for outsourcing to NGOs and private sectors
(3) Assignment of revenue sources	Transforming public utility fees into benefit taxes				
(4) Intergov. fiscal transfers, incl. the scope of unfunded mandate		Consolidation of various channels of transfers into a comprehensive and transparent system	Methodology for assessing revenue capacity of LGs	Structuring county-municipality transfers	
(5) LG borrowing and infrastructure development	Allow for market-based fiscal discipline	Disclosure standards	Allocation of the debt quota based on merit	Develop capacity to prepare investment packages	Framework for public-private partnerships

Annex B: Donor activities in the area of fiscal decentralization and local governance

According to technical experts, both domestic and foreign, the government has not been particularly interested in the technical expertise in the area of decentralization; including the fiscal aspect. For example, although in 2000 the government signed a cooperation agreement with the Open Society Institute on developing technical expertise with matching funding from the Croatian government, the latter did not contribute its share and did not utilize the products from this project. Similarly, the World Bank communicated to the Government the need for proper assessment and design of fiscal decentralization reforms with little interest from the Government.

Given this attitude from the central government, most donors focused on strengthening of local self-government or in individual topic areas. In November 2004, UNDP completed a joint project with ILO on enhancing local government technical capacity through training in Turin, Italy. The participant selection for the training was carried out through the Association of Cities and Municipalities (covering about 70 per cent of LGUs). Under a separate project, UNDP was assisting the Association to build its organizational capacity including the essential elements of maintaining the membership database and collating and circulating information from is members via a newsletter.

WB had several projects on enhancing the financial management of individual hospitals transferred to the county level. Although, such capacity building is required by virtually every hospital, the national government does not seem to be interested in running such a project at the national scale. The same holds for extending kindergarten capacity in some localities, which would remove blocks on labour mobility—an issue of national importance but of little concern for the central government.

While the IMF does not have projects directly concerning decentralization, the IMF target for local debt/GDP ratio affects local development. The annual quota can be used up by some large infrastructure project of medium importance which would lead to the rejection of some other projects possibly of higher importance but submitted later that year.

Recently donors agreed on the common concepts and definitions in the area of fiscal decentralization and tentatively decided to coordinate their decentralization projects around the agenda of the newly formed Decentralization Committee. For this purpose of providing assistance to the entire decentralization process, a Donor Coordination Group was formed including Open Society Institute (OSI), World Bank (WB), European Commission Office (EU), the Urban Institute (through USAID's Local Government Reform Project) and the Council of Europe (CoE). The role of the Donor Coordination Group is to support a process of decentralization that is consistent with good practice and one that will lead to participation of all involved governments (central, regional and local) as well as citizens and be consistent with the guiding provisions of the European Charter for Local Self-Government. The USAID/Urban Institute pledged to facilitate the process/work of the Decentralization Commission (logistical support, meeting facilities, etc.) and provide experts to participate in the process, including policy level advice as well as provide international experts to support the work of the expert groups.

It is expected that after the USAID project phase out, the EU will take the lead in providing technical assistance on decentralization in Croatia.

Country Report: An Assessment of Fiscal Decentralization Reform in Georgia[80]

Executive Summary

Following the 'rose revolution' that brought President Saakashvili to power in January 2004, Saakashvili's administration launched an ambitious reform agenda aimed at restoring good governance and ensuring Georgia's territorial integrity. However, pursuing a sound fiscal decentralization strategy in an environment with regional ethnic strife, pervasive corruption, and histories of low tax performance and poor treasury management is proving a significant political and fiscal challenge. This environment to a large extent defines the mixed assessment of the country's progress on its fiscal decentralization agenda. There is strong support for decentralization among donor agencies, NGOs and civil society stakeholders. This support will need to be matched by a commitment to decentralization from the executive branch to be successful.

Although a Law on Local Self Government was enacted in 1997, much of the basic legal framework for local self government (including a Local Budget Law and a Law on Local Property Ownership) is still incomplete. Some draft laws are still circulating which suggests the need for further support in the development of these laws. However, defining a clearer overall vision of a decentralization strategy may be the best way forward. The State Committee for Decentralization, Public Administration Reform and Developing Local Self-Government, formed in July 2004 and led by the President, presents the institutional focus for providing further support in order that additional progress can be made on the decentralization issue. Support for developing the local budget processes, local tax reform, and formula-based grants, as well as examining the present administrative-territorial structure are needed.

These decentralization reforms, properly developed, can contribute to the resolution of present regional conflicts by assuring systemic buy-in by minority groups. This presents a unique opportunity to reduce regional tensions while at the same time strengthening the public sector in Georgia by improving the transparency, accountability and participatory nature of the public sector.

[80] This report was prepared by Jamie Boex, Jorge Martinez-Vazquez, and Michael Schaeffer, March 2005. The report was prepared by the Andrew Young School of Policy Studies at Georgia State University under contract for the UNDP Bratislava Regional Centre. The study team would like to thank Khatuna Sandroshvili and Gigi Bregadze of UNDP/Georgia for their assistance and support during the in-country mission. The team would further like to thank all policymakers, government officials and donor representatives who shared their insights and knowledge with us.

Introduction

This report on fiscal decentralization reforms in Georgia is part of a five-country study on fiscal decentralization in selected transition economies. The overall objective of the study is to accomplish a review that systematically captures the fiscal decentralization processes in each of five transition countries, including Armenia, Croatia, Georgia, Macedonia, and Serbia. In addition to producing five country reports, the study further sets out to integrate and synthesize the experiences from these five countries.

As part of this larger study, the main purpose of this country report is to provide a synopsis of Georgia's path towards fiscal decentralization, and assess the progress and issues faced in Georgia as part of its reform strategy. In doing so, this report builds on the substantial base of existing research and reports on decentralization and local governance in Georgia. Our assessment has further benefited from a series of discussions and meetings with policymakers, government officials and donor representatives in Tbilisi in February 2005.

In the following five sections we provide an assessment of each of the five building blocks of intergovernmental fiscal relations, respectively, (1) the structure of the government sector; (2) delineation of expenditure responsibilities, (3) assignment of revenue sources to subnational governments, (4) intergovernmental transfers, and (5) subnational borrowing. We also consider the technical strengths and weaknesses of the respective components of decentralization in Georgia. In each of the sections, we juxtapose the assessment of the current state of fiscal decentralization reforms with recent or ongoing policy reform initiatives. In the concluding section, we identify areas in which we judge priorities for further action should fall, and how UNDP, and potentially other donors can fine-tune their portfolios of activities to optimize contribution to the decentralization process in the country. These findings are summarized in a series of three matrices (see Box 1).

This report provides an assessment of the ongoing decentralization reforms in Georgia. While there is strong support for decentralization among donor agencies, NGOs and civil society stakeholders, there is a need for further commitment by the Government of Georgia. Numerous draft laws have been prepared and are awaiting parliamentary approval. This indicates that the Government of Georgia needs to develop a clear overall vision of its decentralization strategy at the political level to continue the progress of the decentralization reforms. This includes consideration of the possible changes to the administrative-territorial structure of the country.

Box 1
Capturing the 'big picture' of decentralization reform in Georgia

Given the breadth of the topic of (fiscal) decentralization, it is difficult to simultaneously provide a detailed assessment of the individual components of intergovernmental fiscal relations as well as the 'big picture' of decentralization reforms. Therefore, subsequent to the discussion of the individual building blocks of decentralization reform in this report, the annex to this report maps the 'big picture' of decentralization reform in Georgia in three two-dimensional matrices:

§ Matrix 1 (The Assessment Matrix) identifies the current state of fiscal decentralization reforms and maps policy areas within the realm of decentralization and local government reform that present the current key policy issues and obstacles for the further development of decentralization in the country. This assessment is based on the study team's review of relevant legislation, review of academic and policy studies on the topic, and discussions with relevant stakeholders conducted in the course of developing this country report.

§ Matrix 2 (The Reform Initiatives Matrix) identifies and maps recent or ongoing initiatives pursued by the national government, subnational governments and their associations, as well as UNDP, other donor agencies and stakeholders within the realm of decentralization and local government reform that are aimed at addressing and resolving the obstacles and challenges noted in Matrix 1 above.

§ Within the same dimensions of Matrix 1 and 2, Matrix 3 (The Reform Priorities Matrix) seeks to identify priorities for further action by identifying areas that are either currently underserved in the policy discussion towards decentralization, or areas in which a fresh perspective may stimulate new policy thinking.

In some respects, the government's cautious approach to furthering the decentralization process is quite understandable. The country's current territorial-administrative structure largely reflects the hierarchical structure inherited from the Soviet era, which in many ways is ill suited for decentralized governance in a market economy. Although the government of President Saakashvili is under some pressure to demonstrate tangible reforms and deliver improved public services, there is likely some hesitation to continue the process until it is understood decentralization will support the resolution of some of the regional tensions that presently need to be resolved. Decentralization could actually strengthen the central government's degree of control over its national territory if a more decentralized government system results in a more inclusive public sector that gives all communities (especially rural and marginalized ones) a greater stake in the nation's public finance system. In this sense, increasing the pace of decentralization reforms presents an opportunity to reduce regional tensions while at the same time strengthening the public sector in Georgia by improving the transparency, accountability and participatory nature of the public sector.

Structure and Scope of the Government Sector in Georgia

Georgian public spending is equal to approximately 20 per cent of official GDP, whereas public revenue collections equalled about 15 per cent of GDP (World Bank, 2002:4). Until recently, this high level of public expenditures was supported by largely unconditional foreign assistance. Georgia's public expenditure level appears to be in line with the average for non-industrialized countries. Georgian public expenditures are close to lower-income countries in the CIS region, but considerably below the average for the ECA region (35 per cent of GDP) and for the CIS countries (28.2 per cent of GDP).[81]

Description and assessment of the subnational government structure

The matter of the structure of subnational government – how many government levels exist in a country and at which levels of geographical disaggregation these different government levels are placed – is typically left to historical accident and has gone essentially unquestioned in the fiscal decentralization literature. In actuality, however, a sound structure of subnational government levels or tiers is crucial in assuring a sound assignment of expenditure responsibilities. Without an appropriate subnational government structure, it would be impossible to realize the efficient delivery of subnational government services, achieve correspondence in local taxation, and ultimately accomplish the benefits of decentralization reforms. Indeed, this is no more evident than in the Republic of Georgia, where the preponderance of the policy debate on fiscal decentralization is absorbed by the question of territorial-administrative structure.[82]

Structure of the public sector. According to the Head of State's Decree No. 362 'About Local Management Bodies in Georgia' (16 September 1995) three levels of subnational government exist in Georgia (Rekhviashvili, 2001); see Table 1. Closest to the people, sub-rayon municipalities exist, which are also referred to as local self-governments (LSGs); this government level was a modification made by the post-independence Constitution (1995) to the hierarchical government structure inherited from the Soviet era. The LSG level is codified in the Organic Law on Local Self Government. For all practical purposes, this local government level is the only 'true' level of local government.

[81] World Bank (2002) estimates indicate the average level of public expenditure levels as a per cent of GDP for low-income countries is estimated at 17 per cent of GDP (in 1998).
[82] A foray into subnational government structure and intergovernmental fiscal relations is presented by Boex, Martinez-Vazquez and Timofeev (2004).

Table 1 Structure of Subnational Governments in Georgia		
Subnational Government Level	**Number of Jurisdictions**	**Average Jurisdiction Size**
Regional Level: Administrative Regions (9), plus Tbilisi, and the Autonomous Republics of Abkhazia and Adjara	12	360,175
District level: Districts and Republican Cities	65	66,494
Municipal level: Settlements, villages and towns	966	4,474
Source: Losaberidze, Kandelaki and Orvelashvili (2001).		

The rural districts and rayon-level municipalities (also known as republican cities or cities with special status) form the next higher level in the subnational government structure. While in fiscal terms the district (rayon) level is by far the most important 'local' government level, from a legal, budgetary, and practical point of view, however, the rayon-level is really the lowest deconcentrated level of the central government apparatus. Nonetheless, this level is (somewhat ironically) referred to in the relevant legislation as 'local government' (as opposed to 'local self-government'). Republican cities fulfil both the functions of a district government as well as a local self-government.

Directly elected local government councils (*Sakrebulos*) exist at the municipal level (both for sub-rayon jurisdictions and republican cities), and – until 2002 – at the district (rayon) level. LSGs also have municipal executives (Mayors) that are elected at the local level. Since 2002, district level councils are indirectly elected: the '*Associated Sakrebulos'* comprise the mayors of towns and villages located on territory of the districts (Melua, 2004). The regional commissioners (also known as governors) appoint the district executives (*Gamgebeli*) from the district council members. The lack of directly elected representatives at the district level results in a lack of local political accountability to the electorate.

The highest level of the subnational structure is formed by administrative regions, which are deconcentrated extensions of the central government. In fact, the regions lack their own budgets.[83] The President appoints the regional executives (regional commissioners, but commonly known as governors). The regional level was put in place by Presidential decree as an intermediate level inserted into the pre-independence Soviet hierarchy. The constitutionality of the regional level is highly questionable (Rekhviashvili, 2001).

In addition to the debate whether the district level should be considered part of the central or local government, the degree of hierarchical power of the regional level over the rayon-level, as well as the control of the rayon-level over the sub-rayon LSGs further

[83] The Autonomous Republics of Abkhazia and Adjara have their own internal structures, which are beyond the scope of the current review.

reduces the degree of local autonomy in Georgia's subnational government structure. This issue is further addressed in Box 2.

Box 2
Vertical power structures in Georgia

The vertical power structure is an important concept in many former socialist economies, particularly in the ECA region. In the Soviet structure, each lower level of government was an integral part of the next higher government level, and the authority to appoint officials at the lower level secured the hierarchical nature of the system. Correspondingly, like Russian nesting dolls, each government level's budget was hierarchically consolidated into the higher-level government's budget, giving each level of government full administrative and fiscal power over the next.

In early attempts to decentralize during the transition, many former Soviet republics introduced 'local self-government' at the sub-rayon level, without providing this level with significant expenditure responsibilities or without fundamentally modifying the vertical power structure up to the rayon level. In fact, after significant decentralization efforts early in the transition, in many ways the Russian Federation is re-centralizing its vertical power structures by abolishing elected governors, and eliminating the sub-rayon level of local self-government under the reforms proposed by the Kozak Commission (Martinez-Vazquez, Timofeev and Boex, 2005).

It should be noted that central appointment of local executives is not necessarily in violation of the concepts of local self-government. For instance, mayors in the Netherlands have traditionally always been appointed by the centre. Instead, it is the local council's control over local policies – and particularly, over local budgetary resources – that establishes local self-government.

Defining the local government level. Given the complexity of the structure of subnational governments, quite possibly the first challenge with respect to the local government structure is to agree what levels of government properly constitute the local government level. As characterized in the Organic Law on Local Self-Government and Governments, by law the local government level should be understood to include district-level 'local governments' (which include both rayons and republican cities), plus the sub-rayon municipalities or 'local self-governments'. For instance, this is the common definition of 'local government level' used when measuring the level of expenditure decentralization (Box 3). Yet, the nomenclature used is in many ways confusing and impractical since both the term 'local governments' is appropriate (since rayons are really part of the central government hierarchy and budget) and the term 'municipalities' indicates subnational government units at different hierarchical levels. It would be good practice to introduce a clearer set of standard terms to designate the various government types.

To the extent that only municipalities (LSGs) currently have elected councils and executives, and is the only level that has exclusive local functions, one might wish to define only sub-rayon municipalities as ‘true’ and legitimate local governments, and consider the rayon level part of the consolidated central government. Yet reality is more complex than that. Republican cities (rayon-level municipalities) provide a further challenge, since they have municipal control over at least part of their budget (but much less so over their delegated functions).

Box 3
Measuring the relative importance of subnational governments.

The importance of local governments in Georgia is still relatively small compared to many other Eastern European economies in transition. The share of Georgian local government spending as a function of total public expenditures reportedly increased from 16.6 per cent in 1996 to 27.6 per cent in 2002 (World Bank, 2002: 56). This increase in local government expenditures reflects Georgian’s ongoing decentralization efforts, which includes the delegation of expenditure responsibilities from the central to local government (district) level. As such, this higher share of local government expenditure does not directly translate into increased local government autonomy. This is true for two reasons. First, in practice, subnational fiscal control over delegated functions is minimal, and second, in many ways, expenditure responsibilities assigned to the district level should be excluded from the definition of ‘local government’.

For 2003, based on a sample of local governments and LSGs, approximately 60 per cent of local spending took place at the rayon level, whereas only 40 per cent of reported local expenditures actually took place at the ‘local’ (i.e., local self-government or municipal) level. This means that the ‘true’ degree of expenditure decentralization (the degree of control by LSGs over public expenditures) is approximately 11 per cent (40 per cent of 27.6 per cent).

Nonetheless, the debate on decentralization in Georgia cannot ignore the rayon-level altogether. In the big picture of decentralization, it is impossible to ignore the rayon-level. But, if decentralization is about the empowerment of local communities then district-level governments will have to play an important role in future decentralization reforms, as district-level governments are responsible for the bulk of public services that are important to local residents, including basic education and health services.

Legislative framework for local self-governance. Some progress has been made in recent years with respect to the formulation of the legislative framework for LSGs. In addition to the Organic Law for LSG and Government (adopted in 1997), and the Law on Local Council Elections (1998), tax legislation was adopted in 2004 that clarified the position and role of LSG in the tax system, and assigned specific revenue sources to municipal governments (as discussed further below in Section 4).

However, the legislative framework for local self-government is still incomplete. There is still no legal basis for local (LSG) ownership of property and no local budget law.

Among involved parliamentarians and NGOs, the mood is hopeful that at least some of the remaining legislation regarding local government structure (the revised Law on Tbilisi, the Law on Property Ownership of LSGs, and the Law on Local Budgets) will be passed by parliament in 2005.

Fragmentation of the local self-government level. An additional challenge with regard to Georgia's local government structure is the fact that the size of the lowest level of government varies significantly, and that many municipalities are too small to be economically viable and the sub-rayon level is in many ways too fragmented to be an effective government level. In contrast, the rayon-level is in many ways too far removed from the citizenry to function effectively as a basic government unit for the provision of community-level public services in a participatory and accountable manner. This issue adds to the challenge for Georgia to find a stable territorial-administrative structure that is both politically acceptable while at the same time promoting more effective local self-governments.

Reform initiatives with respect to the subnational government structure.

In practice, there are two tracks with respect to the reform of the subnational government structure in Georgia. The first – most immediate – track aims at completing the legislative framework for local self-government. The second track aims to arrive at a longer-term solution for the administrative-territorial structure for the country.

Completing the legislative framework for local self-government. The first track focuses on completing the legislative framework for local self-government, which (despite introduction of the Organic Law in 1997) in many ways still lacks the appropriate legislative and regulatory framework. The reform initiatives currently being pursued are aimed at strengthening the subnational government structure. These reform proposals predominantly come in the form of legislative initiatives. These include drafts of the Law on Tbilisi (providing elected leadership), the Law on the Local Budget (assuring autonomous budgets for LSG and limiting vertical budgetary controls over LSG), the Law on Local Property of LSG (allowing LSGs to hold property), as well as revenue legislation assigning specific revenue sources to the LSG level.

Many if not most of these legislative initiatives already exist in draft form. There is some degree of optimism among NGOs and parliamentarians that this legislation will be taken up by parliament in 2005. However, there is a need for the Government to place this legislation high on the policy agenda for consideration and enactment in the coming months.

Determining the future territorial-administrative model of the country. The second track of reforms regarding the structure of the public sector in Georgia has been a longer-term track which seeks to provide a vision for the future territorial-administrative model of the country, not only dealing with central-local relations, but also very much focused on the possible role of regional administrations as well as the autonomous regions. In response to the concerns pertaining to Georgia's subnational government structure, a

Presidential Committee ('State committee for decentralization, public administration reform and developing local self-government') was appointed in July 2004. This committee will need to take a more active and effective role in promoting decentralization and the process of reform.[84] The members of the committee remain optimistic about the potential impact of the Committee, but more action and initiative will need to be demonstrated in the coming months.

It appears that the State Committee will consider at least two competing proposals, with recommendations expected by Autumn 2005. The first proposed subnational government structure in many ways mirrors the current subnational government structure of Armenia. This proposal model would:

- formally establish an intermediate regional government level with roughly 12-20 regions, which would function as a deconcentrated tier of the centre. It is likely that education and other delegated functions would be centralized at this regional level;
- reduce the fragmentation of the LSG level by promoting the consolidation of the local self governments in Georgia into 300 or so municipalities;
- eliminate the rayon level, allow it to phase out over time, or substantially weaken it.

The main alternative model currently being discussed is much more centralized, and much closer to the position currently held by the executive branch. This alternative model would do away with LSG altogether, and shift the competencies of the rayon-level to regional level governments. Which of the two models will prevail, or whether a compromise between the two models will be forged, will determine the future structure of subnational governance and intergovernmental fiscal relations in Georgia.

The decentralization debate in Georgia should not close off numerous alternative models for subnational government structures. Additional considerations, including the following, should be addressed:

- Since there is not a single 'scientific model' of designing a subnational government structure, by not considering the full set of choices available to the government of Georgia, the policy debate may be *a priori* eliminating sound and even preferable policy choices.
- For instance, why are a two-level model with a central government and a local level with 50-100 local (self) governments not among the options being considered? From an economic viewpoint, such district-level jurisdictions would be sufficiently large to provide substantive local government services.
- In either case, one might question whether it is necessary from a territorial-administrative point of view to have an intermediate (regional level) in a country the size of Georgia. While there might be certain political advantages to having an

[84] The Committee is led by the President in person. Its membership further includes Mr. Vano Khukhunaishvili, Deputy Chairman of Regional Policy, Self Government and Mountainous Regions Committee in Parliament, government officials from the executive branch, and representatives from the NGO community.

additional government level (for instance, providing a symmetrical hierarchy in respect to the autonomous regions), public expenditure tracking studies have shown that additional government levels tend to reduce transparency and produce substantial leakage in intergovernmental fiscal systems (Dehn, Reinikka, and Svensson 2002).

- § Any new subnational government structure should recognize the long history of centralized governance in Georgia, but this should not prevent a long-term vision of a more decentralized system. While we concur that it may be prudent to proceed first with firmly establishing local self government before considering the delegation or devolution of major 'delegated functions' to the local level such as education of health, we should not prejudge this to be a permanent feature of Georgia's public sector structure.
- § In any scenario that leaves the delivery of major public services such as education in the hands of central or regional officials, it certainly requires consideration how community participation and accountability can be enhanced. In Armenia, this same situation has led to an undesirable structure where the centre has delegated the administration of schools and health clinics to autonomous non-commercial enterprises, which reduce the transparency of the central government administration, yet the arrangement also falls outside the scope of LSG.
- § Arriving at a new territorial-administrative structure is much more than simply determining how many government levels will exist and what size the jurisdictions will be. In addition to the issues raised above, questions that will have to be addressed will also include: how will the different government levels interact? Will the structure be hierarchical, or will the central government deal with different subnational levels in a bifurcated manner? How will the borders of jurisdictions be determined? These are all questions that need to be answered as part of the strategic vision on Georgia's subnational government structure (Boex, Martinez-Vazquez and Timofeev, 2004).

Given that the recommendations from this activity will possibly drive the success or failure of decentralization reform in Georgia for decades to come, there is a need for a well-structured, well-informed and public debate on the future of Georgia's subnational government structure. Recent positive remarks concerning decentralization by the President provide a basis for bringing these issues to the public's attention.

The debate on the future structure of the public sector is carried forward by a number of parliamentarians along with a Working Group of interested NGOs and donors (including the Association of Young Economists, the Caucasus Institute for Peace, Democracy and Development, the World Bank Municipal Development Fund project, the Council of Europe, Urban Institute and others). This working group should set out a more proactive and coordinated public agenda of research, white papers and public advocacy.[85] There is a need to expand this Working Group to include more participants, particularly from the executive level of government.

[85] Various NGOs and donor agencies have indicated their support for such a public and political campaign.

The Assignment of Expenditure Responsibilities

The first 'pillar' or building block of a decentralized system of government is the assignment of expenditure responsibilities: what are the functions and expenditure responsibilities of each level of government? The expenditure assignment is logically the first step in designing and analysing a fiscally decentralized system. In accordance with the maxim that 'finance should follow function', the modalities of funding subnational governments (revenues assignments, intergovernmental fiscal transfers and subnational government borrowing) are all determined by the expenditure responsibilities that are assigned to the subnational government level(s).

The key principle in determining which level of government should do what in a fiscally decentralized system of government is known as the subsidiarity principle. This principle suggests that government services should be provided at the lowest level of government that is capable of efficiently providing this good or service. This principle results in a situation where, as much as possible, the area where the benefits of a government service are felt coincides with the government boundaries at each level of government. When preferences among voters are diverse and local governments have responsibility for delivering those services that do not have major external effects, the potential benefits of decentralization could include better public services, better accountability on the part of government officials and more willingness to pay for services. This is the primary economic argument for decentralization.

In addition to this economic argument, decentralization is also increasingly acknowledged as a political solution for allowing 'fragile states' to deal with regional demands for autonomy while maintaining national unity. For instance, decentralization reforms in the Russian Federation during the early transition as well as –more recently – the decentralization reforms in Indonesia had more to do with quelling centrifugal forces factors (keeping the country together) than with economic considerations. If civil society and the donor community in Georgia are to convince the government to move ahead with decentralization reforms, they will likely need to put greater emphasis on these non-economic arguments.

<u>Description and assessment of the assignment of expenditure responsibilities</u>

The *Organic Law on Local Self-Governance and Governance* recognizes two distinct types of local government activities in Georgia.[86] On the one hand, 'local governments' (district-level authorities) are assigned issues and activities of state importance based on delegations from state bodies. This means that district governments are responsible for the delivery of key social services, such as education (including pre-school as well as primary and secondary education), basic health care, culture, leisure, sports, and public utilities. On the other hand, municipalities (local self governments) deal with issues of local importance administered independently through local elected bodies. Local matters are considered to be all those activities that affect the quality of life of a local community

[86] For additional discussions on expenditure assignments, see Conway (2004); Rekhviashvili (2001); and Schaeffer (2004).

and that meet local needs and priorities. They include, among others, community housing, basic infrastructure services (such as water), waste removal, local transportation and roads, cemeteries and local amenities, such as parks. As noted earlier, republican cities take on the function of both district 'local governments' as well as 'local self-governments'.

Table 2
Expenditure Assignment in the Republic of Georgia

Functions	All Municipalities	Regional/District or Urban Governments	Central or State Territorial Administration
I. EDUCATION			
1. Preschool		X	X
2. Primary		X	X
3. Secondary		X	X
4. Technical			X
II. SOCIAL WELFARE			
1. Nurseries			X
2. Kindergartens		X	X
3. Welfare Homes			
4. Elderly and Handicapped Svc			X
5. Special Social Services			X
6. Social Housing		X	X
III. HEALTH SERVICES			
1. Primary Health Care		X	X
2. Health Protection			
3. Hospitals		X	X
4. Public Health			X
IV. CULTURE, LEISURE, SPORTS			
1. Theatres		X	
2. Museums		X	
3. Libraries	X	X	
4. Parks		X	
5. Sports, Leisure		X	
6. Cultural Centres	X	X	
V. PUBLIC UTILITIES			
1. Water Supply		X	
2. Sewage		X	
3. Electricity		X	
4. Gas		X	
5. Central Heating		X	
VI. ENVIRONMENT, PUBLIC SANITATION			
1. Refuse Collection	X		
2. Refuse Disposal	X		
3. Street Cleansing	X		
4. Cemeteries	X		
5. Environmental Protection	X		

Table 2
Expenditure Assignment in the Republic of Georgia - continued

Functions	All Municipalities	Regional/District or Urban Governments	Central or State Territorial Administration
VII. TRAFFIC, TRANSPORT			
1. Roads	X		
2. Public Lighting	X		
3. Public Transport	X		X
VIII. URBAN DEVELOPMENT			
1. Town Planning	X		
2. Regional/Spatial Planning		X	
3. Local Economic Development	X	X	
4. Tourism	X	X	X
I.X GENERAL ADMINISTRATION			
1. Authoritative Functions	X		X
2. Other State Administrative Matters	X		X
3. Local Police			X
4. Fire Brigades	X		X
5. Civil Defence	X		X
6. Consumer Protection			X

Source: Rekhviashvili (2001).

Basic consistency of expenditure assignments with subsidiarity principle. The assignment of responsibility for basic community-type services and local infrastructure to the sub-rayon (LSG) level in Georgia is principally consistent with the subsidiarity principle. However, as is commonly noted in policy circles, many sub-rayon municipalities are too small and lack the administrative capacity to carry out these functions in an effective manner. Therefore, reducing the fragmentation of the LSG level should be dealt with as part of the reform of the subnational government structure.

Furthermore, the assignment of expenditure responsibilities to the rayon level is basically in accordance with the subsidiarity principle. Particularly given the highly fragmented nature of the LSG level, the district-level jurisdiction size (and range of sizes) is generally adequate for the functions delegated to it (for instance, the administration of primary education and so on). At the local (district) level, the major policy question is not so much the responsibilities that it is assigned, but rather the status of the district level: should it continue to be a deconcentrated tier of the centre, should it evolve into a true local government unit, or should it evolve into some type of hybrid? Even if it is decided that the district-level will remain a deconcentrated tier of the central government (or become some type of hybrid), more attention could be paid to increasing transparency and assuring equality in funding across the national territory of delegated functions, as well as encouraging mechanisms for increased community involvement over rayon-level functions.

Box 4
Decentralization and local economic development in Georgia

Fiscal decentralization reforms and a sound local governance framework are not only important for the delivery of communal services, but the existence of an appropriate local governance framework is also of critical importance in order to stimulate local economic development. In order for a local government to be able to stimulate economic activity within its jurisdiction, it needs to have the ability to develop and implement local land use plans; hold and develop municipal property for communal use when appropriate; and be able to put in place appropriate local infrastructure.

While these are preconditions for effective local economic development to take place, local self-governments in Georgia – particularly outside the republican cities – are not in a position to encourage local economic activity. Not only is their capacity to develop comprehensive local plans lacking and they lack financial resources for the development of capital infrastructure, perhaps more importantly, the legal framework currently fails to give local self governments the authority to their own land or property. As such, local self-governments are effectively unable to put in place land use plans to support local economic development. While this concern falls somewhat outside the realm of fiscal decentralization reforms *per se*, this issue should be a major consideration in UNDP’s broader economic development agenda. This issue should also be part of the future discussions on the country’s subnational government structure and the broader reform of the legal and institutional framework for local governance.

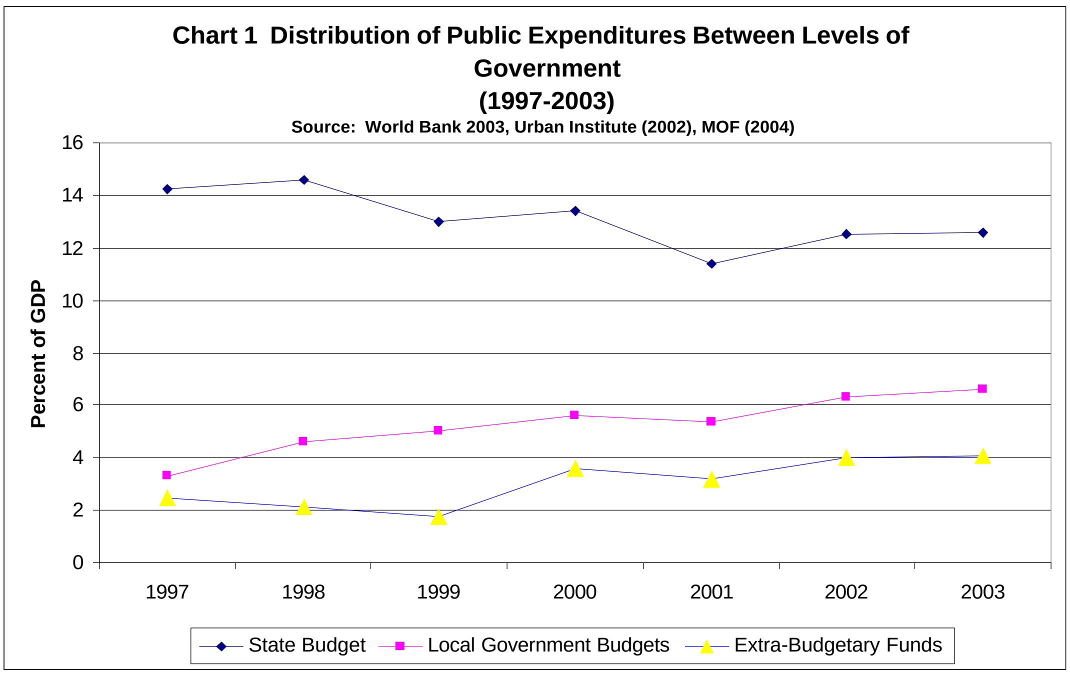
Unclear delineation of expenditure responsibilities. Although the general assignment of responsibility to deliver local services at the rayon and sub-rayon levels is more or less consistent with the subsidiarity principle, an important source of ambiguity in Georgian intergovernmental relations continues to be the degree of control by higher-level governments over these functions. To what degree – and through what mechanisms – does the central government have the responsibility and ability to regulate these services and issue minimum norms for local services?

The assignment of expenditure responsibilities is more than just a list as portrayed in Table 2; instead, the responsibility to assure delivery of public service is multi-dimensional.[87] As such, it is insufficient, for example, to state, ‘the responsibility for primary education is assigned to local governments’. Instead, the assignment of

[87] Under the highly centralized Soviet system, many public services (including education, health, housing, and so on) were defined as joint responsibilities, which allowed the central government to exert indiscriminate control over local budgets. As a result, there may be an aversion to joint assignments in favour of exclusive assignments in Georgia, in favour of a very clearly defined role for the local level. However, limiting expenditure assignments to either exclusively central or exclusively local responsibilities is not practical, since this prevents the public sector from relying on a wide array of options to assign expenditure responsibilities. In fact, in most countries, ‘local’ responsibilities are in fact shared responsibilities, where the central government is typically responsible for (co-) financing and regulating the delivery of local services. The ‘trick’ to a sound expenditure assignment in this regard is to define clearly which level of government is responsible for what dimension each functional service: see Martinez-Vazquez (1998) for a detailed discussion on the multi-dimensional nature of expenditure assignments.

functions, roles and expenditure responsibilities to different government levels should be broken down into several attributes, including the responsibility for (1) actually producing a good or delivering a service (which could be done either by the public sector or by a private firm or NGO); (2) providing or administering the service; (3) financing a service; and (4) setting standards, regulations or policies guiding the provision of government services. In order to assure a comprehensive assignment of expenditure responsibilities, the legislation should clearly address all four dimensions of expenditure assignment.

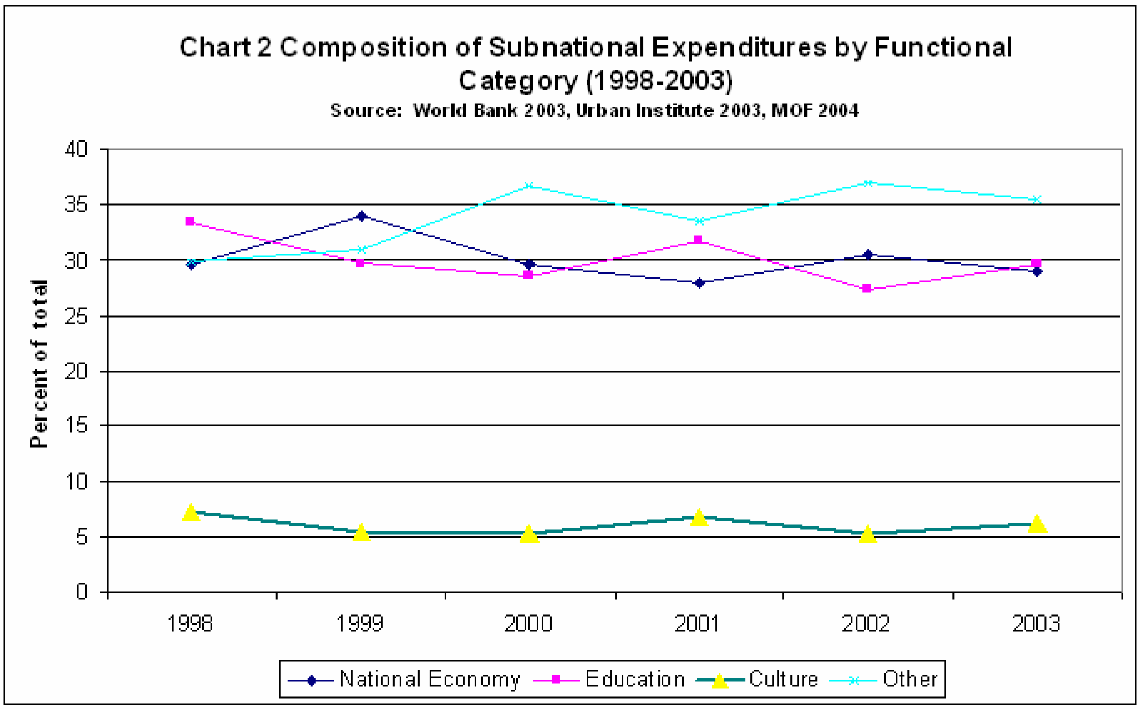
Unclear delineation of responsibilities over regulation, financing and implementation in the case of concurrent responsibilities combined with the absence of effective institutions for coordination has generally resulted in the proliferation of central mandates for which it is unclear whether local governments (rayons and/or LSGs) have adequate resources. In addition, local self-governments have been slow to rid their budgets of private market interventions (e.g., public utilities). In particular, the role of line ministries and central agencies has not been adequately clarified or adapted to assure a clear role for decentralized local government officials. This has resulted in central government agencies regulating and issuing declarative norms that directly affect the expenditure positions of local self-governments.



Distribution of public expenditures. Chart 1 offers a portrait of the distribution of public expenditures between the central government and the various subnational governments. Chart 1 shows local government expenditures as a share of GDP are increasing. However, they are still relatively low when compared to Western European standards.

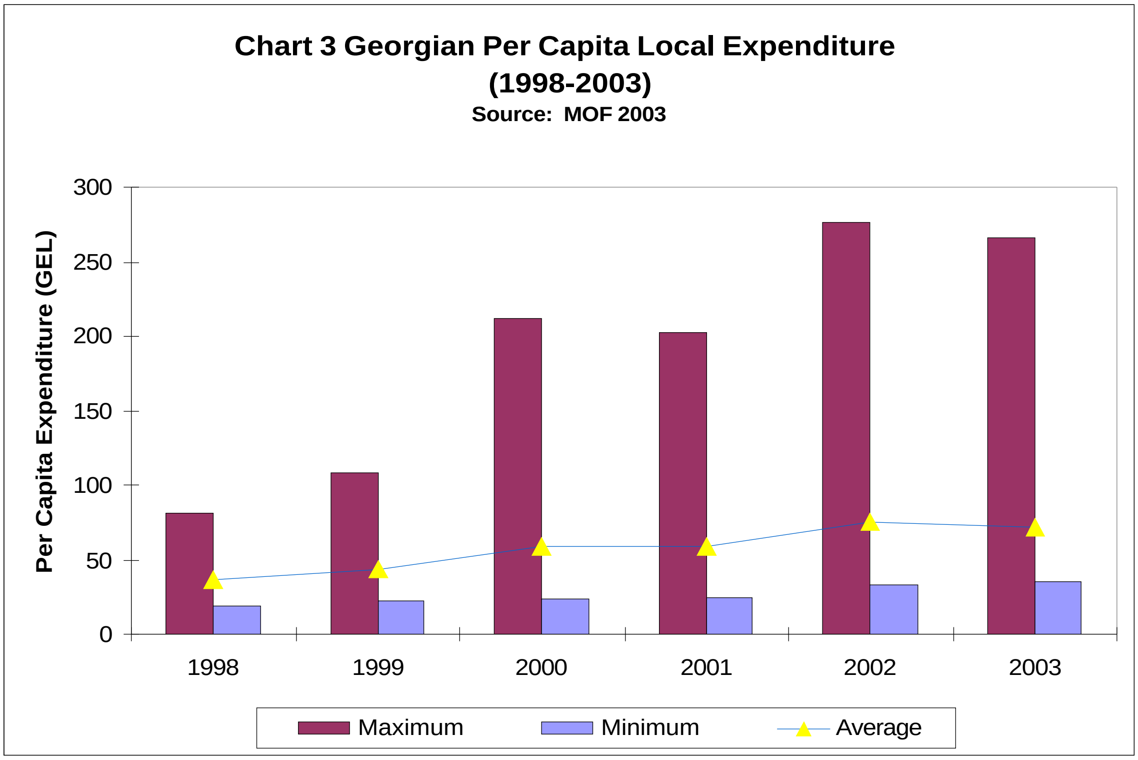
Local government expenditures comprise just slightly more than 6 per cent of Georgian GDP.

Chart 2 below illustrates the composition of subnational expenditures mapped by functional category. Except for social protection, the functional composition of local government expenditures has remained fairly stable over the past six years. The most important subnational expenditures are national economy and education. These two categories of public spending represent about one-third of local budget spending. According to the MOF, culture and health spending represent another 12 per cent of subnational government spending.



Variation in expenditures across districts. A notable feature of Georgian local subnational expenditures is its significant variation across rayons. While there was an increase in per-capita expenditure over the 1997-2002 period there are significant disparities in the aggregate functional spending categories and across rayons in functional expenditure categories. What does this imply? This translates into a skewed distribution of functional expenditures across rayons, reflecting differences in revenue capacities, local preferences, and possibly with stronger local government authorities being able to obtain better deals in the negotiation process of transfers from the central government. Of course, local governments in Tbilisi are likely doing much better in terms of revenue mobilization and transfers than the regions outside the capital.

Chart 3 below shows total Georgian per capital local expenditures. Total expenditures include subsidies, capital expenditures, utilities, stipends, and social assistance. In general, per capita spending is highly variable across regions with a coefficient of variation ranging from 0.57 in 1997 to 0.93 in 2002. World Bank (2003) analysis indicate that while per capita spending varied significantly across regions, spending on wages and contributions were relatively uniform. Although local (rayon) governments are responsible for payment of local government wages, public sector wages are generally set nationally. Most other expenditure categories are not set nationally and are adjusted according to local (regional) conditions.



Reform challenges in expenditure assignments

While the Constitution, combined with a panoply of supplementary laws and decrees, provides for constitutionally mandated interactions between different levels of government, the current legislative environment often contains inconsistent and conflicting provisions. In brief:

1. Given the one-dimensional approach of expenditure assignments followed in the Organic Law for LSG and in the absence of a Local Budget Law, the distribution of functions to local self-governments remains somewhat ambiguous with important gaps arising from the lack of well-defined criteria in the assignment of functions and powers across different levels of government.

2. Unclear delineation of responsibilities over regulation, financing and implementation in the case of concurrent responsibilities combined with the absence of effective institutions for coordination is possibly resulting in a

proliferation of unfunded mandates. (See section 5 for a further discussion of unfunded mandates).

3. Effective expenditure autonomy at the subnational government level has been limited. Expenditure norms and regulations emanating from central government agencies continue to interact with unfunded mandates serving to constrain the authority of subnational governments to adjust current expenditures. The outcome has been to undermine budget accountability at the local level.

4. Budgetary relations between local government (rayon) and local self-governments continue to suffer from ambiguities. The problem of unclear expenditure assignments continues to be particularly acute at the rayon - local government level, with rayon governments enjoying a substantial degree of discretion over assignments to their subordinate local self-governments.

Revenue Assignments

Georgia has made significant strides towards enabling subnational governments to access various sources of revenues. At present, there is an established system of tax sharing, a number of clearly defined local taxes and fees, and an attempt by the central government to define some aspects of the tax policy that local government councils can exercise. The new Tax Code, which was adopted in December 2004, further clarifies and redefines the scope for local government revenues in Georgia. Nevertheless, the preceding discussion on expenditures indicates that local municipal governments do not as of yet have any meaningful revenue autonomy. Local own source and local municipal revenues remain unpredictable. Due to the resulting vertical fiscal imbalance, local municipal governments have to continually negotiate with higher levels of government authorities for stopgap fiscal transfers.

<u>Description and assessment of revenue assignments</u>

Georgia's legal framework (Tax Code Article 11) divides the public revenue assignment into nation-wide taxes and local taxes and fees. The 2004 Tax Code established the tax base, regulates all exemptions and fixes ceilings for local taxes. In addition, local governments receive revenue sharing from certain central government taxes in accordance with the law 'On long-term Economic Norms of Provisions of State Taxes to Budgets of Autonomous Republics of Abkhazia and Adjara and Other Territorial Units of Georgia'. Local governments also collect a number of local non-tax revenues. The following represents a brief discussion of the various non-shared, shared and local own source revenues and taxes in Georgia:

§ **Non-Shared State Taxes.** Customs duties, excise and value added taxes (VAT) are non-shared taxes. In effect, these taxes are allocated solely for the use of the central government. In practice, these taxes have often been shared on a temporary and exceptional basis. World Bank (2002) provides a more detailed discussion of the events that triggered the tax sharing arrangements between the central government and regional governments.

§ **Shared State Taxes.** The two most important shared taxes are the personal income tax (PIT) and the corporate income tax (CIT). They are shared with local (i.e., rayon level) governments. The combined tax revenues from these two taxes equal about 3 per cent of Georgia's GDP. As of September 2003, the general CIT/PIT tax sharing rule has been that 15 per cent of tax proceeds from these taxes go to the state budget and 85 per cent of these taxes go to the budgets of the territorial regions on a derivation basis (i.e., where the tax was collected). According to MOF statistics, all other shared taxes for local municipal governments reach less than one per cent of total GDP or 20 per cent of total local taxes and fee revenues.

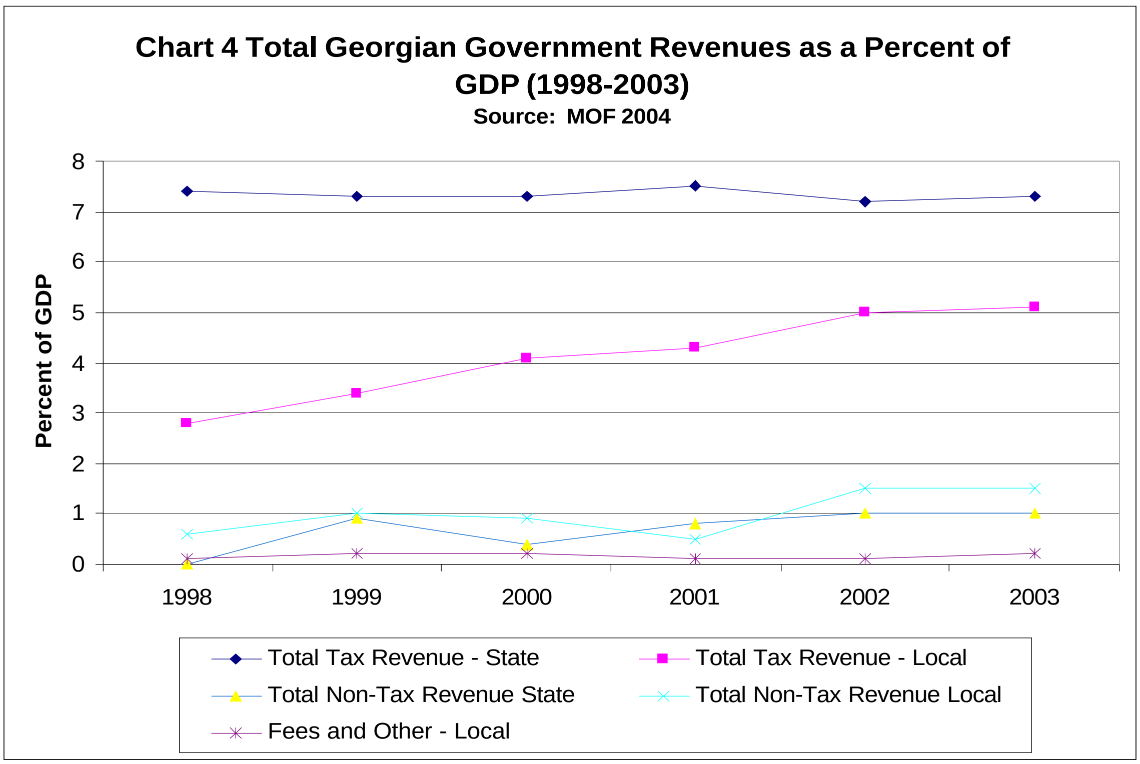
It should be noted that rather than a source of subnational revenue autonomy, all shared-tax revenues are effectively a transfer mechanism that allocates resources on a derivation basis: local governments have no influence over the tax base, tax rate or tax administration. Furthermore, while the personal income tax (PIT) in particular tends to be a stable tax and a relatively substantial tax revenue source for local municipal governments, some Georgian regions (localities) have more robust economic growth and have substantial larger employment pools. As such, the derivation basis of the PIT tax revenues generally favours those localities with the strongest economies and tends to disadvantage rural areas.

§ **Local Own Source Taxes and Fees.** According to the new Tax Code, local self-governments are assigned three local own tax revenues including the property tax, the land tax, and a tax on gambling business. (Under the 1997 Tax Code, local governments received a tax on entrepreneurial activities, gambling, health resort stations, hotel accommodations, advertisement, and on the use of local symbols.[88]) The Law on Local Fees (2000) assigns municipalities the right to collect trade permits, outdoor advertisement and permits to restrict public places and car parking. The contribution of these local taxes and fees is very limited, estimated at approximately 10 per cent of local government revenue (World Bank, 2003: 74).

Chart 4 illustrates the revenue assignment in Georgia, by showing the share of government revenues from taxes and fees as a per cent of GDP, which are retained at each government level. Total state tax revenues (after subtracting revenues shared with the local government level) have remained relatively constant at 7 per cent of GDP. In contrast, local government revenues from own and shared taxes plus local non-tax revenues (such as fees) increased to about 6 per cent of GDP in 2002 from about 3 per cent in 1997. One factor explaining this increase in local government revenues over the past six years is that there has been an increase in the statutory share of State taxes, while

[88] Most municipalities outside of Tbilisi do not have gambling, health resort stations or hotels. Casinos are found only in Tbilisi. Hotels are generally only located in the larger Georgian cities. Even though local municipalities are given the ability to tax six local activities, most do not have these local activities within their jurisdiction.

the revenues from own local taxes and fees have remained relatively constant.[89] The quantification of the revenue distribution in Chart 4 reminds us again that such an attempt is greatly influenced (and often complicated) by definitional issues, as this chart might create the false illusion that revenue sources in Georgia are highly decentralized. There are two reasons why the data reflects this. First, the budget data relied upon for the current analysis lumps LSGs and rayons together into a single 'local government' category, whereas in fact we only believe LSGs to be truly local government units. Second, the budget data in Georgia classifies the local component of nationally shared revenues sources as 'local' revenues, whereas they truly take on the nature of intergovernmental transfers. However, the practice of labelling shared revenue sources as own subnational revenue sources – based on the legal rather than economic classification of revenue instruments – is not uncommon; in addition to being common practice in CIS countries, even Germany labels its shared revenue sources as subnational own sources.



Local government revenue is overwhelmingly dependent on State shared taxes. According to World Bank (2003) estimates, more than 79 per cent of all local government revenues are derived from shared taxes. The contribution of local taxes and local fees to local government budgets is quite small. Contrary to the EU Charter on

[89] The current tax-sharing rule is that 15 per cent of tax proceeds from the CIT and PIT go to the state budget and 85 per cent goes to the budget of the territorial units from where the tax was collected. This tax sharing arrangement has been in place since January 2001. Previously, the tax-sharing rule was that 40 per cent and 60 per cent of the CIT and PIT were distributed to the State and the territorial unit, respectively.

Local Self-Governments, the general structure and trend of Georgian local government revenues indicate that local government authorities have not been provided with adequate own-source revenue capability and incentives to increase local efficiency and expenditure accountability.

As a result, at the present time local municipal governments continue to be totally dependent on annual transfer negotiations to close their fiscal gap(s). The derivation principle for corporate and personal income taxes exacerbates regional inequities. Lastly, the type and level of local own-source taxes and revenues are insufficient to build viable, autonomous municipal governments. Succinctly stated, the current system of Georgian revenue assignment does not provide for local government autonomy nor revenue predictability to ensure effective local government financial management.

Local property and land taxes. Under the new Tax Code, local governments would be provided a band (range) for property and land taxes. Local governments can establish their property taxes within the pre-determined band, but cannot exceed the maximum ceiling developed by the central government. In other words, local governments have some discretion to select property tax rates within their community.

Much can be done to strengthen the deficient level of Georgian property taxes. By definition, an effective property tax is simple to understand, calculate and collect and can be applied uniformly. Georgian local government cadastral maps are currently being developed, updated, and valuations made more consistent. Improved use should be made of flows of information from property registries and local building authorities. From a revenue perspective, more attention should be paid to improving the collection and enforcement aspect rather than to the technically more costly (and, less immediately productive in terms of revenue) mapping and surveying of the traditional cadastral approach.

The property tax is useful, but cannot provide sufficient revenues to finance significant expansion of local public services. In general, property taxes best finance such services as local municipal government roads and garbage collection. The quantity and quality of these services (or their absence) is readily linked to the property tax. Georgian property tax issues largely result, among other things, from inadequate property tax administration. Suggested policy reforms that are needed to turn the property tax into a responsive instrument of fiscal policy include: i.) Local governments must be allowed to set their own rates;[90] ii.) The tax base must be adequately maintained; and, iii.) Procedural reforms must be introduced to improve collection efficiency, valuation accuracy, and the coverage of the potential tax base.

[90] As it is currently proposed in '2004 Georgia Tax Code', property taxes will be completely devolved to local (self) governments. However, Local Self Governments will not be given complete authority to set rates. The central government will establish rates within a band (floor-ceiling). Local self-government councils will be allowed to set local property tax rates within the pre-established band. The central government tax authority will collect all property tax revenues.

Box 5
Collection and Administration of Local Taxes

Each territorial unit of the tax department of the Ministry of Revenues of Georgia is currently responsible for ensuring the collection of tax revenues for the local budget. Local fees and charges are collected at the local (self) government level. Under the proposed 2004/05 Georgia Tax Code, collection of local government taxes (e.g., property, property transfer tax, gambling) will continue to be collected by state tax collection agencies. The funds will be entered into a single treasury account and be transferred back to the local governments via the National Bank of Georgia and the state treasury financial system.

Local non-tax revenue sources. Georgian local (self) governments currently can and do make use of a number of other fees, charges, and licenses. Although these alternative sources of revenue are not easily administered or free from unwarranted efficiency or equity effects, and although they tend not be as revenue productive as local (self) governments would like, they are available resources for the regional and local government to access. The proliferation of local (self) government minor revenue sources is quite extraordinary. Although any one of these taxes and fees does not contribute much to revenues, they may jointly weigh relatively heavily on the overall financial health of local government budgets.

Reliance on user charges and fees by local governments has increased over the past few years. In part, this reflects the increased local and regional government concern about raising property (or other) taxes and the impact on their local constituency. Typically the revenues generated from a user-charge base can only be used to fund the service for which the charge has been imposed. These charges will pay for service delivery and system capital improvements. However, some local (self) governments apparently have relied (in part) on their user charge bases to help finance general-fund expenditures.

In Georgia there is a great disparity in the administration and collection of user charges and fees. Full information on these revenues is not readily available. In particular for user charges and according to the organization of service provision, revenues may be recorded in the accounts of budgetary organizations, or by departments with the local government administration, or by private companies contracted by the public sector. Even when located in the national treasury system, local government user fees and charges are aggregated into broad revenue classifications. The type and level of local own-source taxes and revenues is insufficient to build viable, autonomous municipal governments. Succinctly stated, the current and proposed system of Georgian subnational government revenue assignment does not provide for local government autonomy.

<u>Reform challenges in revenue assignments</u>

With respect to revenue assignments and the administration of subnational revenues, many challenges remain. In order for decentralization to improve the efficiency, transparency and accountability with which public resources are used, local governments will need some degree of revenue autonomy. However, revenue sharing does not provide revenue autonomy and it is further debatable that the revenue instruments assigned to the LSG level provide any true revenue-raising ability for local governments outside the main urban areas in Georgia.

Furthermore, the current administrative arrangements for local taxation further reduce the effective degree of local revenue autonomy in Georgia. While the state tax agency has no incentive to emphasize the collection of local government revenues, most municipalities are too small (and have inadequate administrative capacity) to effectively administer own local revenue sources. Revenue options that would provide local governments with a measure of revenue autonomy without the costly introduction of local tax administrations (for instance, by relying on a 'piggy-back' local income tax or other subnational surtaxes) are currently not part of the policy debate in Georgia.

Although the recent revision of the Tax Code –which provided local self-governments with clear revenue sources – was a positive step for the decentralization process, in many ways this reform will be nullified by the absence of progress on the related areas of fiscal decentralization. Without a sound framework for local tax administration and in the absence of clear and transparent mechanisms for local (self) governments to spend the locally raised resources in an effective and transparent manner, the discussion of revenue assignment and the devolution of revenue sources to the subnational level may be premature.

Intergovernmental fiscal transfers in Georgia

In Georgia, there are substantial regional disparities in both per capita expenditures and per capita revenue collections. Local government own-source revenues are insufficient to cover local municipal expenditure requirements. These issues indicate that there are substantial vertical and horizontal fiscal imbalances that must be addressed by the intergovernmental fiscal transfer system in order to provide funding for local government service delivery. On one hand, the transfer system in Georgia will have to be relied upon to provide the local (self) government level as a whole with adequate resources (assuring vertical fiscal balance), while at the same time assuring vertical fiscal balance by guaranteeing that variations in resource availability between local government units (particularly, between Tbilisi and other urban areas on one hand, and rural municipalities on the other hand) remains within acceptable levels.

Description and assessment of intergovernmental fiscal transfers

Vertical fiscal balance and unfunded mandates. Vertical fiscal imbalance is defined as the mismatch of available resources and expenditure responsibilities between different government levels. Given that the expenditure responsibilities that are assigned to local governments (and local self governments, respectively) exceed the revenues that these levels are able to collect from their own revenue sources, the transfer system is needed to achieve a certain degree of vertical balance. Unfunded mandates arise when local (self) governments are assigned specific responsibilities for which they are not provided with adequate resources, either through the assignment of local tax instruments or through the transfer system.

Although local government advocates have suggested that the resources provided to the local (self) government level is inadequate, it is less clear whether the current system of intergovernmental fiscal relations is actually giving rise to unfunded mandates. Given the scarcity of public resources at all levels of government, it is not unsurprising that the resources available to either the local government level or the LSG level are perceived to be inadequate. Yet, in the absence of specific clear expenditure norms (or national minimum standards for service delivery) for the services provided by local government levels, it is impossible to determine one way or another whether local governments are under-funded to the point that one can truly speak of unfunded mandates.[91] It may simply be the case that local (self) governments are receiving relatively fewer resources because centrally funded expenditure functions are deemed a higher national priority.

However, there is actually no evidence in Georgia to suggest that local governments are being deprived of resources; in fact, the relative amount of resources available to local (self) governments has been increasing over time (Chart 1). Similarly, there have been no drastic changes in the composition of subnational expenditures over time that would suggest that either rayon or sub-rayon governments are being disproportionately starved of resources (Chart 2).

Horizontal fiscal balance and gap-filling transfer payments. Local governments in Georgia vary substantially in terms of their ability to raise revenues, and in the degree to which they receive shared revenues (on a derivation basis). In addition, public expenditure needs among local Georgian governments vary substantially because of the unequal cost of public service provision. The impact of these factors associated with tax collection (revenue) capacity and local government public service expenditures has a substantial impact on horizontal fiscal imbalances.

Improvements in horizontal fiscal balance or regional fiscal disparities can be struck through the implementation of equalization grants (transfers) so that every region in Georgia can provide similar standards of public services. The dominant form of equalization transfers during the past several years has been a gap-filling approach. In principle, gap-filling grants are supposed to fill the gap between a locality's expenditure needs and the locality's revenue potential. However, because of the inability of the central government to effectively measure local expenditure needs (which is attempted based on a number of hard-to-quantify input norms) and because of the inability of the

[91] The case for unfunded mandates is more clear-cut when the cost of local expenditure responsibilities is readily quantifiable. For instance, if local governments are expected to provide primary education with a certain student-teacher ratio, the corresponding expenditure requirement for this level of service can be computed in a more-or-less objective manner.

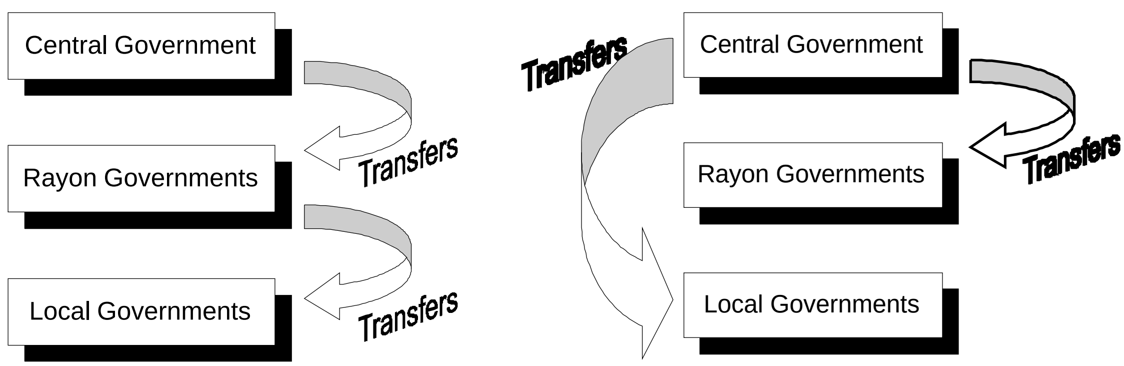
centre to accurately assess the resource potential of local governments, often the gap-filling mechanism results in the disbursement of negotiated subventions, where the negotiated subvention is not necessary equalizing. The use of ad hoc and non-transparent transfers has provided a disincentive for sound budgetary management at the subnational level.

The gap-filling nature of the transfers has provided negative incentives for revenue mobilization and the efficient provision of public services as increases in regional own revenues or budgetary savings in the provision of public services have triggered claw-backs or reductions in the level of transfers. The relative size of an equalization transfer is important in determining the ability of the central government to equalize fiscal disparities. The overall funding of Georgian equalization transfers may be inadequate, particularly since the practice of revenue sharing introduces substantial counter-equalizing subnational resource bases. In addition, the allocation of transfers has remained uneven and subjective, with a tendency for transfers to not get implemented entirely as budgeted. Furthermore, the actual transfer flows have often been unpredictable and subject to delays. The instability in transfer allocation affects the ability of subnational governments to budget and plan expenditures, thereby undermining local self-government investment, growth and budget accountability.

Proposals to move towards a formula-based equalization grant were prepared with support from the World Bank's Municipal Development Fund (Martinez-Vazquez, 2004), although the availability of local-level data is severely limiting the possible formulas that could be implemented. The current draft Local Budget Law incorporates language that would introduce a formula-based equalization grant to LSGs.

The vertical structure of intergovernmental fiscal transfers. Another important dimension of the transfer system – which truly goes deeper to the system of intergovernmental fiscal relations – is whether equalization grants should be designed at the local government (rayon) level or at both the rayon level and the self-government level. Graph 1 illustrates two possible approaches that can be applied to Georgia.

Graph 1
Approaches to transfers: Hierarchical versus bifurcated transfer schemes



The first option is that the vertical structure of government in Georgia is hierarchical: the central government relates only to local (rayon) governments, and the rayon governments, in turn, relate to the local self-governments (villages, settlements, etc.). In terms of a transfer system, this would mean that the centre would provide rayons with an equalization grant, while the rayon would be responsible for further dividing these resources up among their constituent jurisdictions. Alternatively, Georgia might pursue a bifurcated approach, where the centre would provide equalization to the rayon level, but separately would provide direct equalization resources to the LSG level. However, the latter arrangement is less likely, since there has been little evidence thus far of a direct relationship between the central government (Ministry of Finance, for example) and the local self-governments. This hierarchical structure is also respected in the draft Law on Local Budgets currently under consideration.

As is proposed in the draft Law on Local Budgets, a formula would guide not only the equalization resources distributed to the local (rayon) governments level, but the rayons would have to pass these equalization grants on to their local self-governments based on the same formula. In fact, given the low information requirements for the distribution formula, there should be not much of a difficulty for rayon governments to replicate the same methodology and approach vis-a-vis their local self-governments.

Subnational borrowing and infrastructure development in Georgia

The current Law on Local Governments allows local governments to borrow from the central government, through the Georgian Municipal Development Fund, or from multi-lateral organizations with guarantees provided by the central government. Currently, the most widely accessible mechanism of borrowing is through the Georgian Municipal

Development Fund.[92] Investment projects financed by MDF loans (along with grants) are limited exclusively for rehabilitation and repair of existing service infrastructure and facilities and/or replacement of equipment required for service delivery in water supply and wastewater; local roads and infrastructure; sanitation and solid waste management; and markets and transport support facilities.

MDF funding requirements are relatively lenient, providing loans against concessionary rates. Under the MDF mechanism, local governments are required to provide for 20 per cent of the cost of the capital project directly, 40 per cent of the investment is provided as a grant (where applicable), while the remaining 40 per cent is to be financed by loans. The applicable interest rate is 15 per cent per annum, with a maturity of 10 years and a one-year grace period for the principal.

In practice, the ability of a local government to engage in borrowing is restricted by the amount of discretionary budgetary resources available, which dictates the ability of a local government to repay the loan. As such, while borrowing has been an effective mechanism for the larger municipalities (particularly republican cities), poorer (sub-rayon) municipalities are simply not sufficiently credit-worthy to engage in borrowing, even under concessionary conditions.

Concluding Remarks

How do separate pieces of decentralization reform in Georgia fit together? It is clear that Georgia is only at the very first stages of its decentralization reforms, with many critical decisions about the future form of its system of intergovernmental fiscal relations yet to be made. It is unclear which government levels and units should be considered 'real' local governments, while – even if we consider the narrowest form of local (self) government – the legislative framework is still incomplete.

The recent step to assign the land, property and gambling taxes to the LSG level is a bright spot on the record of decentralization reforms. However, any possible gain from this small step forward will need to be supported by a proportionate progress in the other areas of decentralization reform, including clearer expenditure assignments; local tax administration reform; and an equalization transfer mechanism that eliminates any negative incentives for revenue collection. In summary, we would note the following issues with regard to Georgia's reform path with respect to (fiscal) decentralization:

§ Despite substantial external funding for the country's local government reform agenda, Georgia still lacks a comprehensive decentralization strategy where the various components of decentralization reform are inter-linked. The absence of a comprehensive strategy results in an ineffective, piecemeal approach.
§ In the absence of an overall vision on the role of decentralization in the public sector, the avenue for attempted reform has been on the legal framework. The legislative approach for reform must be given attention on the policy agenda.

[92] Information about the MDF is available online at www.mdf.org.ge.

- § Without the right subnational government structure in place (or at least a clear vision as to the decentralized nature of the public sector), it is essentially impossible to move forward with an effective decentralization strategy. In many ways, improvements in expenditure assignments, local revenue mobilization, the transfer system and the borrowing framework require more clarity on the ultimate structure of subnational government. To the extent that the State Committee will address the issue of the country's territorial-administrative structure, its recommendations should go beyond strictly the 'structure' of the public sector and consider the intergovernmental (fiscal) 'system'.
- § In fact, the executive branch must indicate a more sustained willingness to move quickly to provide clarity on the future structure of the public sector. While it typically requires a coalition of champions in various government agencies to assure the success of decentralization reforms, the main powerbrokers and stakeholders must more forward on the issue of decentralization.
- § In this regard, proponents of decentralization must not underestimate the pervasive impact of the country's centralist history on the pace of reforms.
- § In order to move forward with a positive (fiscal) decentralization reform agenda, the political establishment needs to be convinced that a decentralized system can help achieve the government's political objectives, including assuring the country's territorial integrity, reducing corruption, supporting poverty alleviation and so on (Box 6).

A controlled and gradual process of fiscal decentralization requires central government leadership on matters such as the imposition of a uniform system of financial accounts, audit rules, disclosure requirements (for borrowing), and determination of when to relax spending mandates. The completion of an effective (policy and legislative) framework for local governance, including the passage of an effective Local Budget Law (which builds upon good intergovernmental fiscal analysis and a transparent equalization mechanism) represents the first steps in improving central local government fiscal relations and transparency. Moving ahead too rapidly with any one of the components of a decentralized system, out of sync with the other components (for instance, pushing revenue decentralization without getting the transfer system right) could lead to inefficiencies or could potentially upset the country's fiscal balance.

From a technical viewpoint, the current shortcomings of Georgia's system of intergovernmental (fiscal) relations provide numerous entry points that could potentially be exploited to promote fiscal decentralization in the country. However, given the existing technical resources already dedicated to decentralization reforms in Georgia (coordinated through the existing Working Group, with the support from a wide variety of international agencies), additional technical assistance by UNDP could result in greater positive technical reform along with increased attention and support by the government to endorse a clear decentralization strategy (Box 6).

Box 6

Activities by UNDP and other donors in the area of (fiscal) decentralization and local governance

At present, Georgia enjoys the significant support of a number of international organizations and donor countries in the field of public management modernization and decentralization and local governance, including UNDP, WB, IMF, USAID, EC, OSCE, CoE, TACIS, GTZ, and DFID. In addition, a number of internationally funded NGOs are active players in this arena. In addition to several local NGOs (including the Association of Young Economists and the Caucasus Institute for peace, Democracy and Development), the World Bank (Municipal Development Fund), USAID (through the Urban Institute/Georgia), and the Council of Europe – among others – have positioned themselves as leading players, each engaging in studies, supporting the drafting of legislation.

Other donor activities are ongoing that pursue local government strengthening from the ground up; GTZ, USAID and UNDP are among the organizations that are working at the subnational level. UNDP/Georgia's main activity in the area of local governance in recent years was the regional project *Support to Democratic Governance in the Imereti Region of Georgia* that was implemented in 2002-2003. The overall objective of the project was to increase the capacity of regional and district administrations to exercise accountable and efficient public management in Imereti region. This project sought to achieve this objective through better alignment of executive and legislative branches of power at regional and district levels, ensuring the transparency of decision-making and better public accountability. Advanced technical tools and software were transferred to government officials and training was provided for officials at district and regional levels.

Furthermore, the UNDP Country Office is currently pursuing an Integrated Development Programme in the Samtskhe–Javakheti region ('Samtskhe-Javakheti Integrated Development Programme'). This programme seeks to provide a flexible mechanism for UNDP and other donors to contribute to conflict prevention and the reduction of ethnic tensions in the region by building on-the-ground regional- and district-level capacity and project delivery capability in order to serve as a catalyst for local social cohesion. Within this framework, UNDP is specifically focusing on providing internet access and IT support to regional and local government officials

Although such local government strengthening activities can help improve the setting for effective system of decentralized governance, in order for such projects to effectively contribute to a more sound system of local governance, grass-roots projects need to be linked to the policy framework. In other words, unless such projects provide policy lessons that can be up-scaled and adopted countrywide by the government, it is unlikely that the impact of such grass-roots activities will be sustainable. As such, UNDP/Georgia should carefully consider its project portfolio in the area of decentralized local governance.

UNDP's comparative advantage may be in leveraging its global experience on a number of governance themes that are closely related to decentralization. For instance, UNDP could demonstrate that a transparent decentralization approach could potentially reduce corruption by highlighting the leakages inherent in a multi-tiered deconcentrated system of governance through the use of a public expenditure tracking survey. Likewise, UNDP could support the notion that an effective decentralization strategy would promote pro-poor outcomes, which could be supported by engaging in a fiscal incidence study of local resources. As such, UNDP could provide a constructive role in clearly answering the question 'why should Georgia decentralize'?

Box 7
How Decentralization Can Assist Georgian Policy Objectives

Decentralization is no panacea. If poorly designed and implemented, it can create more problems than solutions. But, when well designed, decentralization has been successfully used around the world to effectively address the primary policy issues that Georgia is confronting today. Decentralization presents some policy and economic challenges and risks but can result in many potential benefits.

Territorial Integrity. Many countries facing separatism have used a variety of tools such as asymmetric federalism to preserve their territorial integrity. Asymmetric federalism means some subnational governments are provided with special status in the fiscal, political, and administrative structures of the country. Decentralization empowers different groups to deal with their problems at the same time that they share a common, national purpose.

Improving Transparency, Governance, and Fighting Corruption. A well-designed decentralization process can bring government closer to the people. This means that the people have an interest in ensuring that government works effectively. It is true that decentralization can empower local elites. However, the bulk of empirical evidence illustrates that decentralization is associated with significantly lower levels of corruption.

Stimulating Economic Development. There are many areas that require central government management and investment (i.e., large infrastructure development). However, there is evidence that strongly suggests that decentralized subnational governments can also play a fundamental role in developing their own economies.

Improving the Efficiency of Public Expenditures and Revenues. Providing local governments with their own sources of revenues not only increases accountability but also reduces the pressure on the national budget, thereby allowing more effective macroeconomic management policies and the pursuit of national priorities. Georgia, as many other countries in transition, faces a scarcity of resources. Therefore, increasing the efficiency of public expenditures must be a fundamental priority of government policy. An effective decentralized system has the potential of significantly increasing the efficiency of public expenditures. But this goal can only be achieved with a well-designed system that balances autonomy and accountability at the local level.

Poverty Reduction through Improved Service Delivery. Improving the conditions of the poor requires better education, health services, and more accessible basic services (i.e., water, water quality, sewerage). Decentralized governments are better equipped to meet those goals. The Government of Georgia should proceed cautiously with respect to the transfer of physical assets to local self-governments. Off-loading properties and their operational and future capital expenses to local self-governments without any offsetting revenue generation will create a fiscal gap for local governments. This may result in the further rapid deterioration of the transferred asset and place local self-governments in a financial quagmire.

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Annex: An Assessment of Fiscal Decentralization in Georgia

TABLE 1
ASSESSING THE STATUS OF FISCAL DECENTRALIZATION REFORMS IN GEORGIA

	(A) Overall policy stance and policy effectiveness	(B) Constitutional & legal framework	(C) Central govt institutional and regulatory framework	(D) Local gov't institutional and regulatory framework	(E) Participation by civil society and private sector
(1) Structure and role of public sector	§ Regional lvl. district lvl (deconcentrated 'LG'), LSG/municipalities § Only a very recent signatory to European Charter of LSG § Vertical power issue: CG control over LG § Vertical power issue: LG control over LSG § Structural concern: fragmented LSG level	§ Organic Law on LSG and Governance revised in 2004? § Law on Tbilisi § Draft Law on Property of LSG	§	§	§
(2) Functional and expenditure assignments	§ Role of LG: delegated national functions (mostly social sector) § Role of LSG: own community functions (mostly local infr & comm. svs) § Republican cities cover both functions (LG and LSG)	§ Governed by Organic Law on LSG and Governance § Draft Local Budget Law	§ Unstructured interaction between line ministries and LGs / LSGs	§ LGs and LSGs lack normative guidance on service delivery standards	§ Local (LG & LSG) budget processes basically lack practical local participation & oversight

(3) Assignment of revenue sources	§ Weak distinction between shared revs and own revs, and the links between finance and function	§ Rev legislation determines long-term rev sharing norms § Recent tax legislation assigns property tax and several other taxes to LSG	§ Complicating role of State Tax Admin in collecting local taxes / tax sharing	§ Need to develop local tax admin capacity	§
(4) Intergov. fiscal transfers, incl. the scope of unfunded mandate	§	§ Rev legislation forms basis for revenue sharing § Draft Local Budget Law contains basis for equalization grant.	§ Equal Grant (EG) continues gap-filling approach § EG should not provide discretion to region or LG, but go straight to LSG	§	§
(5) LG borrowing and infrastructure development	§	§ Borrowing allowed, with MOF permission § Focused on budget loans, not funding for capital development	§ Municipal Dev Fund combines grant and loan elements	§	§

TABLE 2
KEY FISCAL DECENTRALIZATION REFORM INITIATIVES PURSUED IN GEORGIA

	(A) Overall policy stance and policy effectiveness	(B) Constitutional & legal framework	(C) Central govt institutional and regulatory framework	(D) Local gov't institutional and regulatory framework	(E) Participation by civil society and private sector
(1) Structure and role of public sector	§ State committee for decentralization, public administration reform and developing local self-government (July 2004)	§ Reform of the Organic Law on LSG and Governance § Draft Law on Property of LSG	§	§	§
(2) Functional and expenditure assignments	§	§ Draft Law on the Local Budget	§	§	§
(3) Assignment of revenue sources	§	§ 2004 Tax Code	§	§	§
(4) Intergov. fiscal transfers, incl. the scope of unfunded mandate	§	§ Draft Law on the Local Budget	§ Mun Dev Fund / Fiscal Analysis Unit § Work on introducing formula-based equalization grant through Mun Dev Fund	§	§
(5) LG borrowing and infrastructure development	§	§	§ Municipal Development Fund	§	§

TABLE 3
REFORM PRIORITIES FOR FISCAL DECENTRALIZATION IN GEORGIA

	(A) Overall policy stance and policy effectiveness	(B) Constitutional & legal framework	(C) Central govt institutional and regulatory framework	(D) Local gov't institutional and regulatory framework	(E) Participation by civil society and private sector
(1) Structure and role of public sector	§ Excessive fragmentation of LSG level needs to be addressed § Vertical power issues between CG/LG and LG/LSG need to be resolved (for instance, bifurcated system)	§ Update legislative framework in accordance with 1A, incl. LSG property law	§	§	§
(2) Functional and expenditure assignments	§ Role of LSG –if any- in delivery of social services?	§	§ Framework for interaction between CG ministries and LGAs	§	§
(3) Assignment of revenue sources	§ Consider rev sharing and revenue assignment in context of exp responsibilities of each govt level	§	§	§	§
(4) Intergov. fiscal transfers, incl. the scope of unfunded mandate	§ Consider transfer system to each level in light of vertical and horizontal imbalances (ie, together with exp and rev assignments)	§	§ Bifurcated transfer system, or how to do LG-LSG transfers?	§	§
(5) LG borrowing and infrastructure development	§ Hard budget constraints for LGs and LSGs § Consistency between borrowing framework and infrastructure role of LSGs	§	§	§	§

Country Report: An Assessment of Fiscal Decentralization Reform in Macedonia[93]

Executive Summary

Macedonia has one of the most active decentralization reform agendas among the five transition countries reviewed in this study. As a result of the amalgamation of smaller local government jurisdictions in 2004, Macedonia has a straightforward territorial structure. The country has two government levels: one central government level and one local government level with 84 municipalities (along with the capital territory of Skopje). Local government finances are arranged in a series of laws, including the Law on Local Self-Government (2002) and the Law on the Financing of Local Self Government (2004).

Although the provisions of the new Law on the Financing of Local Self Government do not become effective until July 1, 2005, the Law introduces a fairly significant increase in the role for municipalities in the delivery of services. The new law also provides a more appropriate revenue assignment (assigning the property tax to the local level) and provides a rule-based system of transfers (covering revenue sharing, sectoral grants and equalization grants). Although the devolution of responsibilities will take place in a phased manner, the reforms are envisioned to give local governments the responsibility to deliver basic education, health care services, social protection and culture. In order to prevent the potential mismanagement of resources at the local level, a number of stringent conditions were established that have to be met before individual local authorities can assume their new responsibilities.

Introduction

The overall objective of the study on fiscal decentralization in selected transition economies – of which this country report is an integral part – is to accomplish an all-encompassing review that systematically captures the main trends and challenges of the fiscal decentralization processes in each of five transition countries, including Armenia, Croatia, Georgia, Macedonia, and Serbia. In addition to producing five country reports, the study further sets out to integrate and synthesize the experiences and challenges facing these five countries. As part of this larger study, the main purpose of this country

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[93] This report was prepared by Marjan Nikolov for the Andrew Young School of Policy Studies at Georgia State University under contract for the UNDP Bratislava Regional Centre. The study team would like to thank Vesna Bisheva of UNDP/Macedonia for her assistance and support during the in-country mission. The team would further like to thank all policymakers, government officials and donor representatives who shared their insights and knowledge with us.

report is to provide an overview of the progress and issues with fiscal decentralization in Macedonia.

In the following five sections we provide an assessment of each of the five building blocks of intergovernmental fiscal relations (respectively, structure of the government sector; delineation of expenditure responsibilities, assignment of revenue sources, intergovernmental transfers, and subnational borrowing) and consider the technical nature of the strengths and weaknesses of the respective decentralization process. In the concluding section, by juxtaposing the current state of fiscal decentralization reforms with recent or ongoing initiatives, we identify areas in which we judge priorities for further action should fall, and how UNDP, and potentially other donors can fine-tune their portfolios of activities to optimize contributions to the decentralization process in the country.

In the annex to this report we provide three two-dimensional matrices that serve as a basis for collating information in the course of our field trips and for developing this country report:

§ Matrix 1 (The Assessment Matrix): Identifies the current state of fiscal decentralization reforms and maps policy areas within the realm of decentralization and local government reform that present the current key policy issues and obstacles for the further development of decentralization in the country.

§ Matrix 2 (The Reform Initiatives Matrix): Identifies and maps recent or ongoing initiatives pursued by the national government, subnational governments and their associations, as well as UNDP, other donor agencies and stakeholders within the realm of decentralization and local government reform that are aimed at addressing and resolving the obstacles and challenges noted in Matrix 1 above.

§ Matrix 3 (The Reform Priorities Matrix): Within the same dimensions of Matrix 1 and 2, Matrix 3 identifies priorities for further action in areas that are either currently underserved in the policy discussion towards decentralization, or areas in which a fresh perspective may stimulate new policy thinking.

Structure and scope of the government sector in Macedonia

Background

The referendum on sovereignty and independence held in Macedonia on 8 September 1991 ended the era of being part of the ex-Yugoslavia system. This was immediately followed by the adoption of a new Constitution of the Republic of Macedonia on 17 November 1991.

Macedonia is a unitary country with a population of just over 2 million. The political system in Macedonia is a parliamentary democracy based on the principle of division of powers among legislative, executive and judicial branches. One of the fundamental values stated in the constitution is the right to local self-government. The constitution also states that municipalities should be financed by own sources of revenues determined by law, as well as with financial support from the Republic.

Basically, the constitution guarantees the exercising of the right to local self-government, but it also refers to the regulations of subsequent laws, which have never allowed for decentralization. In fact, since independence and the start of transition, power has been concentrated and centralized. The only competencies municipalities have had were in the area of communal services.

The evolution of decentralization has been a mixture of political inefficiency and ethnic disputes. Three periods can be identified in the process of decentralization. The period of centralization from 1991-1995 left municipalities with no competencies or a system of financing. Until 1996 GDP had been continuously declining and the unemployment level had reached as high as 32 per cent. The government was focusing on macroeconomic stabilization and privatization.

During the period between 1995 and 2001, macroeconomic stabilization was achieved, but overall economic performance was poor, with an average annual growth rate of only 2 per cent. For the first time after independence a new law on LSG was adopted in 1995, and a new law on territorial organization was adopted in 1996. Both laws were the products of ethnically and politically motivated processes. Macedonia signed the European Charter in 1996, which was ratified in 1997. The process of decentralization was backed up by two important documents: the Government Programme of 1999 and the Government Strategy for Reforming the Public Administration, also of the same year. As a result of these two initiatives, the Working Team within the Ministry of LSG was established in March 1999.

In 2001 the crises in Macedonia ended with the signing of the Ohrid framework agreement (OFA).[94] The OFA called for constitutional changes as well as the adoption of

[94] The crises ended after the Ohrid Framework Agreement (OFA) was signed by the leaders of four political parties (two Macedonian and 2 Albanian) and it stated that they 'will promote the peaceful and harmonious development of civil society while respecting the ethnic identity and the interests of all Macedonian citizens' and provided a detailed roadmap for a decentralized public sector. About the development of decentralized government the OFA states: 'A revised Law on Local Self-Government will be adopted that reinforces the powers of elected local officials and enlarges substantially their competencies in conformity with the Constitution (as amended in accordance with Annex A) and the European Charter on Local Self-Government, and reflecting the principle of subsidiarity in effect in the European Union. Enhanced competencies will relate principally to the areas of public services, urban and rural planning, environmental protection, local economic development, culture, local finances, education, social welfare and health care. A law on financing of local self-government will be adopted to ensure an adequate system of financing to enable local governments to fulfil all of their responsibilities. Boundaries of municipalities will be revised within one year of the completion of a new census, which will be conducted under international supervision by the end of 2001. The revision of the municipal boundaries will be determined by the local and national authorities with international participation. In order to ensure that police are aware of and responsive to the needs and interests of the local population, local heads of police will be selected by municipal councils from lists of candidates proposed by the Ministry of Interior, and will communicate regularly with the councils. The Ministry of Interior will retain the authority to remove local heads of police in accordance with the law. With respect to local self-government, in municipalities where a community comprises at least 20 per cent of the population of the municipality, the language of that community will be used as an official language in addition to Macedonian. With respect to languages spoken by less

a new law on Local Self-Government (adopted in 2002). Thus, the decentralization initiatives of 1999 gained a new momentum. One consequence of the politically-driven process (rather than a fiscal decentralization process motivated by the desire to improve economic efficiency) was the reverse sequencing of decentralization, with revenue decentralization preceding a loosely defined expenditure assignment.

The drive for decentralization has been more evident in the government's rhetoric than in its actions (for instance, see ICG, 2000). Essentially, decentralization of particular functions has been delegated to line ministries, which used every opportunity to slow down the process, as they had no incentives to give up control to municipalities.

The speed of decentralization reforms greatly accelerated in 2004, as the Ministry of LSG has moved forward with a number of initiatives and intensified its contacts with the Association of Local Self-Governments (known by its Macedonian acronym: ZELS). The Programme activities for the implementation of the decentralization process 2004-2007 (which were adopted by the Government in November 2004) are related to the transfer of competencies, employees, equipment and property from central to the local level and capacity building of the municipalities for taking over the devolved responsibilities successfully. As it is stated in the Programme, so far Macedonia has:

- Approved an operational programme for decentralization of power 2003-2004;
- Created coordinating body for decentralization made up of the secretaries from all ministries;
- Created a decentralization working group composed of representatives from all ministries;
- Signed memorandum of cooperation with the ZELS;
- Adopted a communication strategy for the decentralization process;
- Signed a memorandum between the Ministry of LSG, ZELS and the Civil service Agency on coordinating the training for the LSG administration.

All documents and bodies have been created, but the process is moving forward very slowly even though the deadlines in the Action Plan for implementing decentralization in 2004-2007 are very strict.

Government Sector Size and Composition

The general government sector in Macedonia is made up of the central government, LSG and the extra-budget funds. The extra-budget funds include the pension fund, health fund, road fund and the employment fund. According to January-November 2004 data, the general government expenditures are estimated at 30.9 per cent of GDP. Almost 93.9 per cent of the general government expenditures represent current expenditures, 61 per cent of which is allocated to social welfare (pension fund, employment fund, social

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than 20 per cent of the population of the municipality, the local authorities will decide democratically on their use in public bodies'. In the annex B of the OFA legislative modifications were envisaged in: Law on LSG, Law on local finance, Law on municipal boundaries, Laws Pertaining to Police Located in the Municipalities, Laws on the Civil Service and Public Administration, Law on Electoral Districts and other laws.

programmes, structural programmes, etc). Wages and salaries account for 26 per cent of current expenditures (Table 1).

Table 1 **Current expenditures of the general government, Jan-Nov 2004.**	
Category	**Share (%)**
Wages and Allowances	26
Goods and Services	10
Transfers	61
Interest	3
Source: Ministry of Finance.	

The relative roles of different levels of government in the general government expenditures are shown in Table 2. The level of 2.66 per cent of GDP for expenditures by local governments in Macedonia in comparison to the 26.90 per cent of GDP for expenditures by the central government likely positions Macedonia as one of the most centralized countries in Europe.

Table 2 **Expenditure shares of different levels of government (% of GDP), 2003.**	
Government sector	**Share (%)**
General government	35.88
Central government (*)	26.90
Extra-budgetary funds	20.63
Local governments	2.66 (0.9 in 2001, 1.38 in 2002)
Note: The central government budget includes transfers to off-budget funds. As a result, the sum of central, local and off-budget expenditures exceed the total. Source: Ministry of Finance. Author's calculations.	

Territorial division of LSG

Before 1996 there were 34 municipalities. The 1996 Law on Territorial Organization resulted in a more fragmented structure, including 123 municipalities and the City of Skopje as a special self-government (LSG) unit. Out of these 123 local jurisdictions, 46 had populations of less than 5,000. With a new Law on Territorial Organization adopted in 2004, Macedonia was restructured into 84 municipalities (15 of which still have less than 5,000 inhabitants) and the City of Skopje as a special self-government unit.

Internal organization of LSG

The current organizational structure for LSG in Macedonia provides a parallel structure of power divided between the council and the mayor (Table 3). The council is the legislative body of the LSG, it adopts the charter, the budget, establishes public institutions and communal enterprises, appoints managers upon the mayor's proposal, establishes LSG administrative organs, and so forth. In turn, the mayor's office is the executive body of the LSG, responsible for the implementation of the council decisions, management of LSG administration, property, appointment of the architect, and so forth.

Table 3
Organizational structure of LSG in Macedonia as of the new Law on LSG of 2002.

LSG Council	Mayor
President	City architect
Boards	Management bodies
Commissions	Administrative bodies
Communal enterprises	Offices

Source: UNDP (2004).

The organizational structure enacted by the new Law on LSG of 2002 is similar to the previous structure and carries the danger of conflicts between the two branches.[95] The Government report on LSG functioning in 1996-2000 stated that the 'regulations are not clear and fragmented and it frequently results in a conflict blocking the work of these bodies' (see Government Report, 2000). The basic problem with a locality's organizational structure is political in nature, and typically arises when the Mayor and the majority in the council are not from the same political party. In such cases, for example, the Council President is able to stall the council's business and block the executive responsibilities of the mayor, including in the areas of finance and urban planning.

While the fiscal decentralization legal framework is already in place, its implementation is conditioned on the qualification of the LSG administration staff. The new Law on financing the LSG of 2004 introduces certain mandatory requirements for the staff of the LSG administration:

1. At least two financial officers responsible for financial management, budget preparation and execution and accounting.
2. A chief accountant (appointed by the mayor and having economic training and five years of experience in finance).
3. Procedures and system for internal audit. (Internal auditors appointed by the LSG council upon the recommendation of the Mayor). The internal auditor should have

[95] The stake might be even higher taking into account that after 1 July 2005 LSGs will have more responsibilities and thus more areas for possible disputes.

training in economics or law and two years of experience in finance. The auditor is independent (as stipulated in the law) and accountable directly to the mayor and the LSG council.[96]

4. At least three employees responsible for tax assessment and collection.

Figure 1
The mandatory employment requirements stipulated by the new Law on Financing LSG

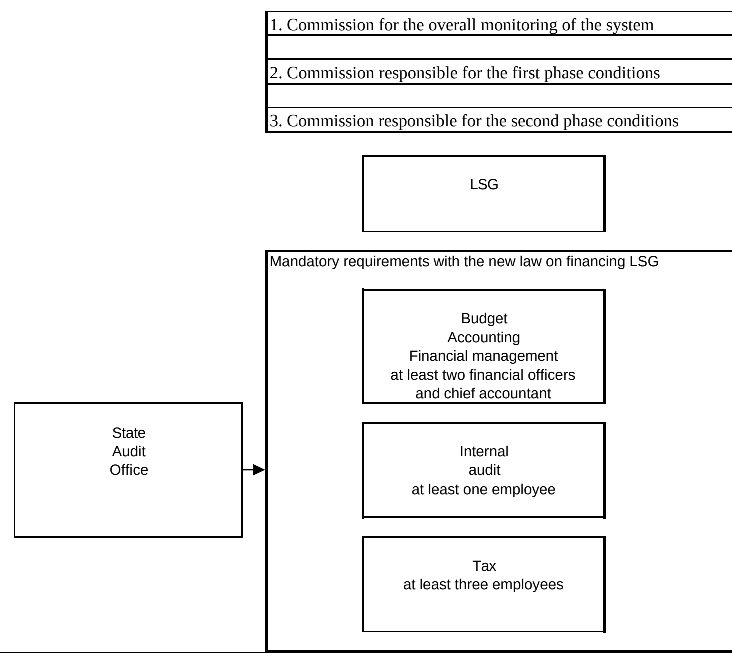


Figure 1 illustrates the mandatory employment requirements stipulated by the new Law on Financing LSG. The role of the three commissions is discussed in Box 1. Currently, employees of the Ministry of Finance and the Public Revenue Office (PRO) are deconcentrated to the 30 local government units (financial and accounting departments). Many of these employees are scheduled to join LSG staff with the devolution to the local level of responsibility for collecting property-related taxes.

[96] The internal audit can be conducted by another LSG in accordance with a contract between the two LSGs. The state audit agency is also responsible for the audit of the LSG. The transitionary provisions of the Law on Financing LSG (article 53) say that a new law on internal audit in the public sector will be enacted by the end of 2005.

Box 1

Commissions monitoring the decentralization process

The monitoring of the development of the system of intergovernmental finance will be the responsibility of a commission set up by the government (Article 15 of the Law on financing LSG).

The commission will be accountable to the Central Government for the following:

1. Monitoring the implementation of the criteria for the central government transfers,
2. Provide recommendations for improving the system and overcome the deviations identified,
3. Ensure that the system remains transparent,
4. Provide recommendations for the formula for transferring the unconditional grant from the VAT and about the methodology for distribution of block grants.

The commission's membership includes representatives from: (i) Ministries responsible for LSG, finance, science and education and labour and social policy each assigning one representative and (ii) five representatives from the association of LSG in Macedonia-ZELS. The commission will have no decision-making power. For each phase of the decentralization process there will be separate commissions that will judge whether the conditions have been met for each phase (article 45 and 46).

Thus, one should differentiate among three commissions:

1. Commission for the overall monitoring of the system
2. Commission responsible for the first phase conditions
3. Commission responsible for the second phase conditions

Citizen Participation

Citizen participation in their LSG after independence was rather limited and the citizens were not informed about what their local government provides, how it works, how it is organized, etc. This was mainly due to the complexity of instruments available for citizen participation such as initiating a referendum (requiring at least 20 per cent of voters) and citizen initiatives (requiring at least 10 per cent of the voters).

Here again the new law on LSG of 2002 provides nothing new except for the declarative right of the citizens to submit suggestions about the work of the LSG bodies. The Mayor is only required to prepare all the necessary conditions for submitting the suggestions and must respond to the suggestions within 60 days.

The assignment of functional/expenditure responsibilities in Macedonia

<u>Competencies of LSG</u>

As autonomous government units, municipalities in Macedonia settle and perform matters of public interest at the local level. The Law on Local Self-Government regulates, along with certain other laws, which competencies are the responsibility of the municipality; these competencies cannot be restricted or reduced unless determined by statute.

A wide range of municipal responsibilities are listed in the provisions of Article 22 of the Law for Local Self-Government including: urban planning and zoning arrangements; environmental and nature protection; local economic development; communal activities; cultural development, in accordance with the national programme for culture; sports and recreation; social care and child protection; foundations of education institutions, financing and managing primary and secondary schools in cooperation with the central government; organization of transport and food supplement for students and housing in student's homes; health care - managing the system of public health organizations and primary health care; undertaking measures for protection and rescue of citizens and material goods in case of destruction in war, natural disasters and other accidents; fire protection provided by local fire units; and, supervision over activities that come from the municipality's responsibilities and other matters determined by law.

According to the law, a municipality can establish public service companies for performing its responsibilities, or it can delegate certain public matters that are of local concern to other legal entities, companies or private persons. In the case of delegating the performance of certain responsibilities, the municipality is responsible for the realization of the outsourced functions.

While the 2002 law designated the aforementioned responsibilities as local, the process of devolving these functions to the local level has not been completed. In fact these functions remain in the central government domain, until respective line ministries develop sectoral laws spelling out the process of devolution of a particular function. Below, we provide a list of line ministries responsible for devolving particular functions:

1. Ministry of Culture (libraries, monuments and memorials, museums, art centres);
2. Ministry of Education (Primary and high schools, student standards);
3. Ministry of Transport and Communication (street names, management of road traffic, construction and spatial and urban planning);
4. Ministry of Economy (catering, tourism, crafts and trade);
5. Ministry of Health (primary health care–so far participation in the board of directors, protection against contagious diseases);
6. Ministry of Finance (financing of municipalities, devolution of property tax responsibility as well as local fees and charges);
7. Ministry of Labour and Social Policy (protection of children and elderly);

8. Ministry of Environment and Urban Planning (protection of environment, protection of nature, waste management, water management, air quality, spatial and urban planning);
9. Ministry of Interior (firefighting).

In summary, the legal framework for transferring a broad scope of competencies to the local level has been laid down in the Constitution and the Law on Local Self-government of 2002. So far about 32 sectoral laws have been adopted for some sectors: culture, educational and science, local economic development, healthcare, local financing, social welfare and child protection, environmental protection and firefighting.

Communal Services

Until line ministries complete the devolution of designated functions to the local level, local government responsibilities remain limited to ‘municipal housekeeping’, that is, responsibilities pertaining to communal services. But despite these minimal responsibilities, problems with service delivery abound at the local level. Even though the responsibilities of local governments expanded quite considerably with the new Law on Local Self-Government of 2002, most of the problems with communal enterprises remain. Some of these issues are discussed below.

Under the GTZ project on ‘*Improvement of the economic efficiency of public services*’, an early effort was undertaken to examine prices of services provided by communal enterprises, as well as their revenue collections, accounting systems and related issues. In particular, one component of the project uncovered a number of startling facts (see Marjan Nikolov 2004). First, there is a lack of price uniformity for the services provided by the communal enterprises that cannot be explained by apparent differences in the costs of production. Second, the communal enterprises fail to collect fees. The average revenue collection rate for all communal enterprises is about 54 per cent. Third, not all communal enterprises would recover costs even at 100 per cent collection rates. The main reason is the low level of the fees charged. Losses are more common for water supply, while solid waste management tends to be profitable (with the current cost structure and fees level). Fourth, there are elements of cross-subsidization and price discrimination in most of the tariff schedules. Finally, bookkeeping practices vary significantly across enterprises.

One unifying feature of all communal enterprises is an organization culture oriented towards revenue collection and a strategy fixed on providing continued salary payments with a lack of focus on increasing efficiency and improving the quality of the services.

A survey conducted by the Economic Institute of Skopje on a sample of communal enterprises representing around 700,000 citizens (almost one third of the Macedonian population) found that only 65 per cent of citizens were benefiting from water supply services, and only around 25 per cent of citizens were benefiting from other services such as green areas and solid waste management (see Economic Institute, 2001). This survey also found that the infrastructure of communal enterprises is obsolete, dating in most cases to the 1950s. The water waste (loss) was estimated to be from 30 to 50 per cent, while under current rules only an 18 per cent loss is recognized for accounting purposes. Most of the financing of enterprises (around 90 per cent) is from own source revenues, while about 10 per cent is from loans and donations. Recently, communal enterprises encountered additional cash flow problems as VAT liabilities are based on the amount invoiced to clients rather than on actual collections. Thus, with the currently low collections rates, compliance with VAT represents a net loss for communal enterprises.

Expenditures of LSG

The total LSG budget is comprised of the budget of the Council, the budget of the Mayor's office including its administrative organs (called the Administrative budget) and the budget of the budgetary funds (fund for communal activities, fund for street lightning, fund for roads and streets, fund for green areas etc.). The first observation is the low level of expenditure as a percentage of GDP at about only 1.38 per cent in 2002.

Table 5
Consolidated LSG budget for 2002.

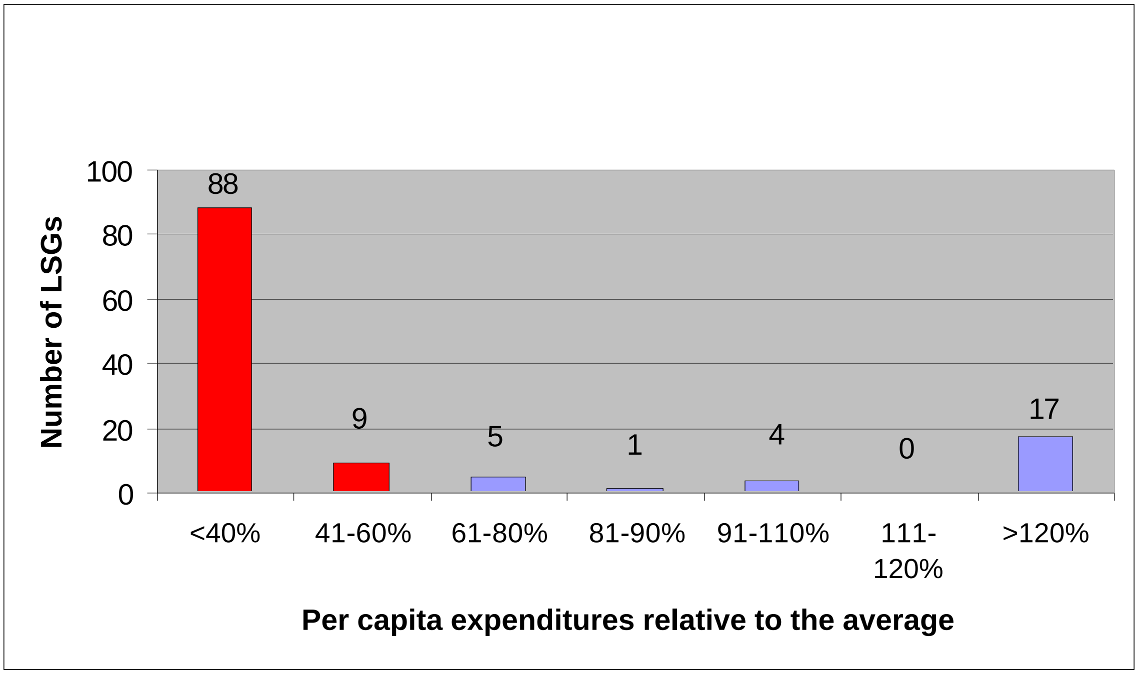
	Administrative LSG budget	LSG Funds budget	Total LSG	Total LSG as % of GDP
TOTAL EXPENDITURES	979,866,188.00	2,380,340,117.00	3,360,206,305.00	1.38%
Wages and contributions	461,685,927.00	37,938,284.00	499,624,211.00	0.20%
Goods and services	324,749,287.00	941,316,366.00	1,266,065,653.00	0.52%
Transfers and subsidies	92,110,915.00	267,876,571.00	359,987,486.00	0.15%
Interest payments	335,492.00	9,841,670.00	10,177,162.00	0.00%
Capital expenditures	95,987,757.00	1,061,851,573.00	1,157,839,330.00	0.47%
Capital transfers	3,913,035.00	34,128,421.00	38,041,456.00	0.02%
Lending	940,870.00	3,262,238.00	4,203,108.00	0.00%
Principal repayment	142,905.00	24,124,994.00	24,267,899.00	0.01%

Source: Ministry of finance.

Table 6 reveals a wide disparity in expenditure level and composition among LSGs in Macedonia. Disparities in expenditure per capita are quite dramatic. The poorest LSG spends in per capita terms only one-fourth of the average LSG and just a small fraction of that of the wealthiest LGS. Expenditure composition also varies a lot. It appears that some LSGs spend 100 per cent of their current expenditures on the wage bill; other LSGs have relatively high shares of investment expenditures.

Table 6 Disparity in LSG expenditure level and composition			
	Min	**Average**	**Max**
Expenditures			
Current (as % of total)	22	84	100
Wage bill (as % of current)	7	45	100
Investment (as % of total)	0	16	78
In per capita terms			
Current (in $ US)	3	12	102
Wage bill (in $ US)	1	5	27
Investment (in $ US)	0	3	38
Data Source: Ministry of finance. Author's calculations.			

Figure 2.
Distribution of per capita expenditures relative to the average (2002)



The high variability among municipalities related to expenditure levels are illustrated in Figure 2. On the vertical axis of the figure we can see the number of LSGs and the horizontal axis presents the distribution of those LSGs as the percentage difference from the average expenditure. For example, we can see from the figure that 88 municipalities out of 123 municipalities existing at that time were realizing less than 40 per cent of the average expenditures for all LSGs. The high level of LSG disparity in expenditures per capita is confirmed by other studies (see Nikolov, Stojkov, Bogov 2004). The observed high fiscal disparities call for immediate action towards an equalization system and for a more balanced regional economic development for the purpose of the Local Economic Development (LED) as well.

Revenue assignment and local tax administration in Macedonia

Before the new Law on Financing of LSG was adopted in 2004 (which will be in force on 1 of July 2005), the Law on Budget and the Law on Limiting Public Consumption (adopted each year) and the Budget Execution Law (adopted each year) were used to define the system of local finances and the budget process.

The 2002 data show a relatively high level of fiscal dependency of LSG on the central government (Table 7). It should be noted that 'tax revenues' are not directly allocated to those local governments where they were collected. Instead the revenues are in fact transferred into the treasury system of Macedonia and distributed once again among LSGs in accordance with a formula.

Table 7.
Consolidated LSG budget for 2002.

	Administrative LSG budget	LSG Funds budget	Total LSG	Total LSG as % of GDP
TOTAL REVENUES	1,116,125,433.00	2,497,855,240.00	3,613,980,673.00	1.48%
Tax revenues	751,914,809.00	1,505,549,501.00	2,257,464,310.00	0.93%
Non-tax revenues	45,340,295.00	180,455,058.00	225,795,353.00	0.09%
Capital revenues	1,666,607.00	16,522,872.00	18,189,479.00	0.01%
Transfers and donations	314,003,722.00	640,855,477.00	954,859,199.00	0.39%
Domestic borrowing	3,200,000.00	154,472,332.00	157,672,332.00	0.06%

<u>The sources of financing in accordance with the new law on financing LSG</u>
The new law on financing LSG identifies own and shared sources of financing.

Own source revenues:

1. Own revenues

    a. Local taxes (property tax, transfer of property tax, inheritance tax and gift tax)
    b. Local fees (communal fees, administrative fees)
    c. Local charges (construction land charges, communal activity charges, spatial planning charges)
    d. Revenues from property (rents, interests, capital revenues from property sale)
    e. Donations
    f. Fines
    g. Self contributions
2. Donations (a contract between the donor and the mayor after approval from the LSG council)
3. Self contributions (LSG council decision defines all related variables)

Shared revenues:

4. Personal income tax revenues
    a. Three per cent of PIT collections from salaries allocated to the LSG where the employee resides. The 2002 Census is instrumental in identifying the necessary data, since in Macedonia the employer is responsible for paying the PIT on behalf of the employee. The transfer will go through the treasury system automatically leaving no room for the central government's discretionary decisions (around 180 million MKD per year).
    b. 100 % PIT collected from artisan activities. (Around 5 million MKD per year).

The major change brought out by the new legislation is assignment of property related taxes to the local level. Moreover, it is not only the revenue from these taxes that is assigned to local governments but also the power to determine the rate and base for these taxes and also collect them. LSGs will also be able to contract out tax collections to each other.

Until today responsibility for the administration and collection of all taxes in Macedonia, central and local, has been with the central government. Reportedly, the centralized tax agency has used low quality data from the cadastre system for property taxes and lacked a good statistical information system. Moreover, these revenues were not directly distributed to those LSG where they were collected but rather transferred into the treasury system and then distributed among LSG in accordance with some formula (more on this, so-called 'cap system' in section 5). Clearly, there were no right incentives for higher collection rates so that the system could provide a sustainable and predictable revenue stream. Table 8 below reports the composition of revenue redistributed via the cap system.

Table 8
Composition of local tax revenues in 2002.

Own source tax revenues breakdown	Year 2002
Property taxes	18 %
Property transactions taxes	66 %
Inheritance and gift taxes	14 %
Fees	2 %
Total	100 %

Source: Ministry of Finance.

Currently, the Public Revenue Office (PRO) has deconcentrated offices in six regional centres and 30 local units. With the devolution of the property-related taxes, the existing premises, buildings and archives of the PRO in localities will be transferred to LSGs. This transformation is not going to be without a problem. Recently, the Mayor of Veles, Mr. Ace Kocevski, announced to the central government that he would not hire any of the 26,000 employees to be transferred from the central to local administration if they do not have the required competency. At the same time the Government representatives say that it is a legal obligation for the LSG to accept all of the 26,000 employees of the now deconcentrated offices.

The poor performance of LSGs' own revenue collection by the central government has led to a pilot project launched in four LSGs in 2004 to provide them with technical assistance in collecting their own revenues, in cooperation with USAID's LGRP project. The four pilot projects comprise the LSG of Veles, Gostivar, Sveti Nikole and Struga. Some recent information about the improvement of efficiency in the collection is reported in Table 9. [97]

Table 9
Increases in the collection of taxes for the period Jan-Sep 2004 after devolution of administration in the four pilot localities.

Property tax	Transfer of property tax	Inheritance and gift tax	Communal tax
41.9 %	195 %	106.4 %	16.6 %

Source: Mayor of Veles, Mr. Ace Kocevski, president of the financial commission of the association of LSG –(ZELS).

[97] We would like to thank Mr. Ace Kocevski, the mayor of Veles, for the data.

The current information system employed by the PRO is such that it is difficult to get fiscal data disaggregated for all present LSGs. It can be hoped that when the LSG take on the responsibility for tax administration, the need for statistics at the local level will be more appreciated. At this time we will use tax data available for the 30 deconcentrated PRO units to demonstrate disparities in the yield of revenue sources that are scheduled to become local governments own sources of revenue.

Figure 3 shows the distribution of own tax collections. Twenty out of thirty local units of the PRO are collecting revenue per capita below the national average. Moreover, according to Table 10, there is a five-fold difference in per capita revenue collections between the poorest and the wealthiest district. There exist many reasons for these disparities, the most important being differences in economic activity and wealth across LSGs. But, quite probably the uneven distribution is also due to low incentives for collection, deficiencies associated with the cap system, the lack of transparency in distribution of the excess revenues above the cap and the lack of motivation for those LSGs that collect revenues above the cap. In general, it is because the LSGs did not have the authority to collect own revenues. All these negative incentives can play differently across LSGs and result in disparities.

Figure 3
Distribution of per capita revenues relative to the average (2000)

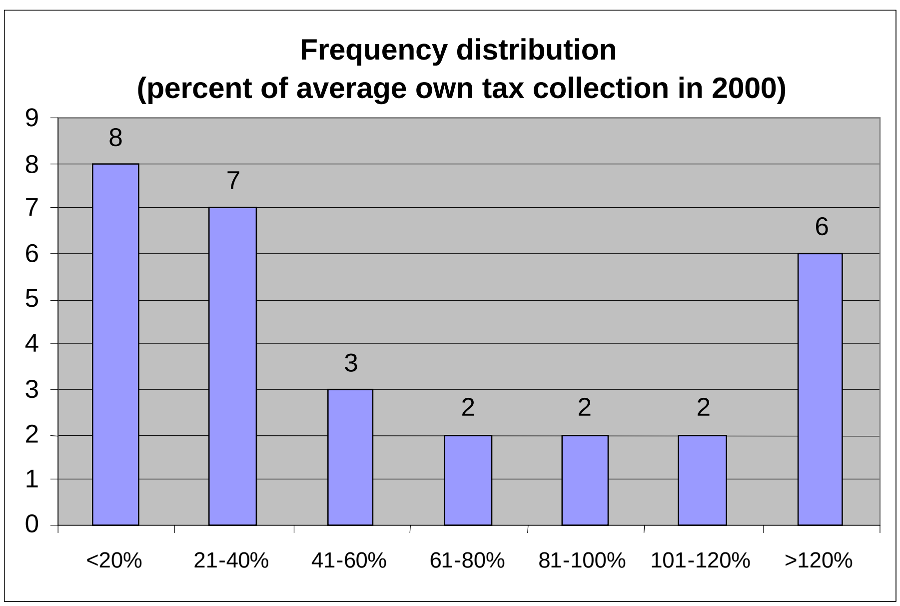


Table 10
Revenue collections per capita by PRO office.

	PRO offices	Collections per capita		PRO offices	Collections per capita		PRO offices	Collections per capita
1	PRILEP	159	11	Berovo	235	21	STIP	315
2	Krusevo	161	12	Kicevo	245	22	Gostivar	319
3	M.Brod	166	13	Gevgelija	247	23	Kumanovo	328
4	Kratovo	172	14	K.Palanka	252	24	Kavadarci	353
5	Vinica	172	15	Negotino	252	25	TETOVO	398
6	D.Hisar	186	16	Debar	253	26	Struga	418
7	Delcevo	186	17	Radovis	264	27	Resen	482
8	Kocani	198	18	Valandovo	279	28	BITOLA	556
9	Veles	220	19	Sv.Nikole	280	29	SKOPJE	757
10	Probistip	224	20	STRUMICA	311	30	Ohrid	1,017
						Macedonia		462
						Mean		313
						Maximum		1,017
						Minimum		159
						Coeff. of Var.		0.593

Intergovernmental fiscal transfers in Macedonia

In general intergovernmental transfers are used when expenditure assignments are not well matched with revenue assignments. We will consider separately transfers used for addressing a vertical fiscal imbalance from those used to address horizontal fiscal disparities.

<u>Vertical fiscal imbalance and the share of LSG in total expenditures</u>
Vertical fiscal imbalance is traditionally defined as the percentage of local governments' expenditures not financed by their own revenues. As we have seen, in Macedonia LSGs have had little revenue-raising authority. However, it does not necessary mean a vertical fiscal imbalance as expenditure responsibilities assigned to the local level have also been limited. However, the extent of expenditure decentralization is about to change with the new Law on financing LSG of 2004, and will be accompanied by the devolution of fiscal resources according to those presented in Table 11.

Table 11 **Devolution of fiscal resources during the two phases of decentralization.**
FIRST PHASE: Retention of shared taxes (3 % of PIT, 100 % of artisan PIT) and unconditional equalizing transfer (3 % of VAT): additional
SECOND PHASE: Block grants kick in (9 billion MKD for education, 30 million MKD for health, 1 billion MKD for social protection, and 200 MKD million for culture): additional
Source: Ministry of Finance. Author's calculations.

The process of decentralization as envisaged by the Law on financing LSG is to evolve in two phases (for details see Annex B). The first phase will start on 1 July 2005. The second phase will start upon the fulfilment of certain conditions and it is the phase when block transfers will start being distributed. The major principle of this phased approach is to follow gradual devolution of responsibilities in line with greater demonstrated capacity of LSG to undertake those responsibilities, and an equitable and adequate transfer of funds for an efficient and incessant execution of transferred competencies. Table 12 reports the estimates for local government revenues after completion of phase 2, when block transfers kick in.

Thus, the estimated dynamics of the share of local expenditures as a per cent of GDP is projected in Table 13. Note that the relative size of the LSG sector is expected to more than double by 2007. Nevertheless, by international standards Macedonia will still not be a very decentralized country.

Table 12
LSG revenue sources as per the new law on financing LSG from 2004

Total budget revenues (approx.)	**3.6 bn**
Total administrative budget revenues 2002	1,100 mn
Total other funds 2002	2,497 mn
Block transfers (as per 2003 central budget)	**10.23 bn**
Education	9 bn
Health	30 mn
Social protection	1 bn
Culture	200 mn
Transfers with the new law:	**885 mn**
3% transfers from PIT (2003 base)	180 mn

100 % transfers from PIT on artisans	5 mn
3 % VAT transfer (2003 base)	700 mn
Source: 2004 Budget. Authors' calculations.	

Table 13
Dynamics of the relative size of the LSG sector.

Year	**Share of local expenditures in GDP**
2001	0.9
2003	2.66
2005	3.01 (estimate with the new allocation of PIT and VAT revenue)
2007	7.07 (estimate with the new block assignments)
Source: Ministry of Finance. Authors' calculations.	

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The equalization system before the new set of laws

The cap system was first mentioned in Section 4. Within the old legal framework, local government received revenue from the property tax, property transaction tax, inheritance and gift tax and the communal fee. However, the allocation of these revenues is regulated by a law on limiting public expenditure and a Law on budget execution adopted each year. In those laws a cap was defined on the own source revenues of the LSG depending on the macroeconomic parameters. In particular, the revenues from these 'own taxes and fees' are not directly allocated to those local governments where they were collected. Instead, the revenues were transferred into the treasury system of Macedonia and distributed once again among LSGs in accordance with a formula (80 per cent population, 10 per cent LSG area, and 10 per cent number of settlements.) All the revenues that were above the legislated cap went into a fund used for equalization. It was common for the excess revenues above the cap to start to accumulate in the second half of the year and then be redistributed back to the municipalities in the form of general or earmarked grants upon the decision of the Government. The criteria for redistribution of the resources above the cap used in the Government decision were not very transparent.

Since the territory of the capital city of Skopje covers seven out of the 123 LSGs, the cap system for the city of Skopje and the seven LSGs within the territory of Skopje operated in an arrangement such that the capital city received 38.5 per cent of the corresponding own source revenues and the 7 LSGs received 61.5 per cent of the corresponding funds. These 61.5 per cent of the revenues are distributed to the seven LSGs according to the population criteria.

Other elements of the equalization system prior to 2005

Besides equalization performed through the cap system, there were several other grants in the system that contributed in some ways to the goal of equalization of fiscal resources across LSGs. The most important were the following:

The Bureau for Underdeveloped Regions (BUR). This system of equalization is based on the law for promoting the development of the economically underdeveloped regions through earmarked transfers. The transfers are for investment programmes mainly. The criteria for transferring the resources are under government discretion. The government prescribes the particular criteria like: the size, age structure and migration of population, number of settlements, contribution of the proposed facility in improving conditions for the performance and development of certain economic activities, etc. Fundamentally, this system worked through rather politically distorted decisions.

The Road fund. The Road fund is one of the four off-budget funds of the central government.[98] This fund allocates a share of its revenues to the LSG in accordance with a formula including five criteria: number of vehicles, fuel consumption, size of the road network, number of inhabitants and LSG area.

The equalization system after the new set of laws

The new law on financing LSGs envisions the following channels of transfers from the central government:

1. VAT revenues (total fund equal to 3 per cent of the VAT collections in the previous fiscal year). This unconditional grant will be distributed by formula with at least 50 per cent according to population and at most 50 per cent according to other criteria. These other criteria will be stipulated in a methodology yet to be defined by the government. A proposal for the methodology is currently with the Minister of Finance, in agreement with the commission for monitoring of the development of the financing system. The proposal for the next fiscal year has to be developed by 30 June of the current year. The methodology will have separate provisions for the city of Skopje.
2. Earmarked transfers–categorical grants (based on projects and programmes.) The appropriate ministries and agencies monitor the use of the earmarked funds. Any notified irregularities could trigger the ministries to stop the execution of transfers).
3. Capital transfers. (In accordance with programmes specified by the government.) The appropriate ministries and agencies also monitor the earmarked funds usage. Any notified irregularities could trigger the ministries to stop the execution of transfers).
4. Block transfers. (In accordance with article 22 paragraphs 5, 7, 8 and 9 of the Law on LSG.) The appropriate ministries and agencies are responsible for defining the

[98] The other three funds are the pension and disability fund, the unemployment fund, and the health fund.

methodology and criteria used in the transfer formula. These funds are distributed via at least 12 types of grants.

5. Funds received for delegated competencies. In this case the amount of funds is determined in a contract signed by the mayor of the LSG and the appropriate ministry responsible for the competency.

Thus, according to the new law (article 9) at least 50 per cent of the unconditional equalization fund formed with the VAT revenues will be distributed based on the population criterion. The pool of funds to be distributed will amount to 3 per cent of the total VAT collections in the previous fiscal year. As noted above, the current proposal for the methodology for the distribution formula is currently being reviewed by the Minister of Finance in accordance with the rules of the Commission for Monitoring the Development of the Financing System. The newly legislated equalization scheme will replace the cap system.

The BUR and the Road Fund components will still be in force but according to our discussions with government officials there are initiatives to estimate the cost effectiveness of their existence and their possible consolidation.

Subnational borrowing and infrastructure development in Macedonia

The Law on LSG (article 11) states that LSGs have the right to borrow in the domestic and the foreign capital markets.[99] In addition, the new Law on Financing LSG defines borrowing[100] (article 18), short-term borrowing (article 19), long-term borrowing (article 20) and government guarantees (article 21).

In practice, LSG in Macedonia can borrow in the international capital market with prior consent from the Government of Macedonia determined on the basis of the opinion issued by the Ministry of Finance. Short-term borrowing is allowed for cash-flow management and must be repaid by the end of the fiscal year. This borrowing is subject to a ceiling of 20 per cent of the realized revenues from the so-called current-operational budget in the previous fiscal year.[101]

[99] Although the law on LSG says that the LSGs have the right to borrow in the domestic and the foreign capital market, article 48 of the budget law says that '*the government may approve short-term loans to LSG only if means are earmarked'* and then in article 50: '*agreements for taking loans and giving guaranties shall be concluded by the minister of finance*'.

[100] For example, all liabilities to suppliers that exceed 90 calendar days shall be considered as borrowing.

[101] The current operational budget is defined as the total revenues excluding grants from the budget of Macedonia and budgets of funds earmarked for financing capital investments, revenue from self-contributions, and funds received in the form of loans. This will leave the own revenues from taxes on property, fees, and charges and retained part of the PIT as the basis for calculating the ceiling for short-term borrowing. This arrangement may give additional incentives to LSG for increasing the collection rate of those revenues.

Long-term borrowing is allowed for capital investments and fixed assets financing only. The ceiling on this type of borrowing is 15 per cent of the total revenues from the so-called current-operational budget in the previous fiscal year. In the transitional provisions (article 50) it is stipulated that a LSG can start its long-term borrowing if in a period of 24 months there is favourably reviewed financial reporting from the LSG and if within the same period there are no arrears in the LSG. It is understandable for the central government to be cautious and to have instruments to allow borrowing only by creditworthy LSGs. It reflects the lack of quality financial management capacity even at the central level, the lack of public debt management capacity, lack of manuals, training, best practices, know-how etc.

Mechanism of preventing macroeconomic destabilization

In Macedonia the needs for local infrastructure investment have been traditionally covered by the central government, mainly through the off-budget Road Fund (under specific criteria), the BUR and the Ministry of transportation, which approves funds for construction, modernization and reconstruction of local roads, the power supply network, local water supply systems, sewage network, and so on.

There is international donor funding of local investments but the allocation of donor funding often reflects the initiative of individual municipalities, which results in some arbitrariness in the local incidence of these projects. There is no legal, institutional, policy framework for regional development policy. Macedonia also lacks a strategy for regional development and so far depends on incidental donor funding in that context.

As long as local investments are funded by the national government or by international donors through capital grants, the risk of macroeconomic instability is reduced. However, uncontrolled access of municipalities to domestic or international capital markets could jeopardize macroeconomic and fiscal sustainability in principle. However, it is not likely that uncontrolled access would be allowed to these capital markets.

The country is at the moment under negotiation with the IMF and the WB over new arrangements for LSG financing. The central government of Macedonia has negotiated with the IMF an arrangement for structural reforms and a new Programmatic Development Policy Loan (PDPL) after completion of the Public Sector Adjustment Loan (PSMAL) with the WB this year.

Capital markets in Macedonia are still very narrow, which limits access of municipal governments to capital markets. This makes local borrowing difficult in an environment of no stable and predictable revenue stream. Prevailing high interest rates will limit any borrowing-capital investment plans for the municipalities in the near future.[102]

[102] Given the peg to the Euro of the Macedonian currency–the Denar–the National Bank's discount rate is at 6.5 per cent, with a Lombard interest rate of 13 per cent, an interbank money market rate of 8.1 per cent (January 2005), an interest rate of National Bank bills at 8.95 per cent (December 2004), and the weighted interest rate for the private sector at 11.76 per cent (December 2004).

Besides the legal limits on borrowing and central government discretionary control, under the new law there are certain instruments that should assure the municipalities to be credible and disciplined if they want to borrow (article 50). Finally, the government issues guarantees for local borrowing only if the liability is undertaken in accordance with the law. All these measures together should keep LSG in check in the future.

LSG debt in Macedonia

As of May 2004, the total outstanding debt of municipalities is estimated at around 43 million euros or 1.4 per cent of Macedonia's GDP (the 15 EU member countries' average is 5.6 per cent (see SchlumbergerSema 2004).
The structure of local debt is as illustrated in Table 14. It should be noted that these figures are arrears and not traditional debt. However, the law on financing LSG says in article 18 that all arrears due more than 90 days will be counted as debt.

Table 14

LSG debt structure in Macedonia in 2004

Arrears towards construction enterprises	79 %
Restitution liabilities	9 %
Arrears toward Electric Power Company-ESM	7 %
Arrears upon salaries	2 %
Other current liabilities	3 %

Source: Schlumberger Sema (2004).

Most of this aggregate amount of debt is concentrated in just 10 LSGs (72 per cent of the total debt). As can be seen from the table, local debt is dominated by arrears to employees and suppliers. Arrears represent a major problem and article 45 of the Law on Financing LSG requires that by the end of 2004 LSGs should come up with a plan for solving the outstanding debt that was accumulated up to 31 December 2001. Yet, it appears there is no plan available, although one is being considered by the government under coordination of the Ministry of Finance.

Recently, a new office for debt management was established within the Ministry of Finance, but it is too removed from the existing debt of the LSGs to be part of their competency, even though people from the budget department are asking for that.

Concluding Remarks

One problem with the current decentralization process in Macedonia is that it has so far been an instrument for achieving political objectives only. This causes a lot of problems. Thus, the lack of efficiency and coordination within the central government affects the overall level of government efficiency and the use of donor assistance. Therefore, it is realistic to expect that the same technical and practical type of problems seen at the central level will be also prevalent at the local level after the devolution. For example, there is a danger that LSGs will become the places for the employment under all kind of criteria (based on political affiliation, nepotism and ethnic type of affiliations) rather than on the grounds of expertise.

Keeping in mind the above mentioned issues, we would like to highlight the basic challenges for decentralization in Macedonia. In general, the lack of clear goals for decentralization results in different expectations of the major stakeholders: the central government, LSGs and citizens. Before proceeding to our conclusions, we would like to point out that Macedonia has benefited from several IMF missions related to the process of decentralization (see for example IMF Report, May 2002). Moreover, the Macedonian government has implemented much of the IMF's recommendations in the legal framework. See the Annex D for a summary of the IMF analysis and recommendations. To complement that analysis, what follows is our own view of the main challenges that need to be addressed to push the fiscal decentralization agenda in Macedonia.

1. The decentralization process does not have sufficient leadership

Like any process of strategic significance, fiscal decentralization needs leadership that is highly placed in the government hierarchy. This leadership can come from an institution or a person.

From the institutional point of view, this role could be played by the office of the Deputy Prime Minister. It can lead the government through the decentralization process. At present it is responsible for implementing the Ohrid framework agreement. It is necessary for this office to take a stronger role in leading the decentralization effort.

At the same time, the government session of 10 January 2005 decided that the Ministry of LSG through the Decentralization Working Group will coordinate the preparation of a detailed plan for the devolution of competencies through preparation of standardized forms with all necessarily data related to property, equipment and employees. Also, it was requested from the Minister of LSG to regularly inform the government about the process of decentralization. Consequently, this Ministry can also play a leading role in the decentralization process.

2. Lack of ownership over the decentralization process

In any decentralization process there is a compelling need for political leaders and institutions to take strong ownership. The central government needs to become more involved in this issue. There seems to be a belief that the process is exclusively about the adoption of a legal framework, and that once all the laws are in place, decentralization would be an issue to be dealt with by the local self-governments themselves. It will take more than the adoption of these laws for the process of decentralization to be successful.

However, representatives of LSGs must accept more ownership over this process. Their interest seems confined to the distribution of the revenue cake. They view the process only from the point of view of revenues without paying much attention to the implementation of the legal framework, or ensuring that they have capacity, and mechanisms to attract and retain qualified personnel.

Decentralization has been presented to the citizenry as a form of high-level politics that has to be achieved to enter the EU. The citizenry has not been informed how they can participate in the process and what are they going to gain from decentralization. The politic leadership does not fully understand that success with reforms very much depends on how well these reforms are going to be endorsed by all the citizens. You can get the necessary support if you are truly sincere about it, transparent in providing the information, plan with precisely set out deadlines, and if you manage to put aside political marketing.

3.   The lack of coordination among donors

The donors are giving an impression that the decentralization process in Macedonia is their own creation. They often connect this process with political issues which have very little to do with decentralization. For example they view this as a solution for the post conflict society, Ohrid FA, entering the EU, and so on. They often tend to discuss ideological objectives and they often tend to overlook the actual reality that prevails on the terrain and to check if the LSGs and citizens are ready to embrace the implementation of a decentralization programme. Simply put, a problem arises because it is the donors who are putting pressure on those who are making the decisions without undertaking any analyses to assess if there is readiness and capacity on the ground for this process to take place. This top-down approach is deemed to fail unless an adequate assessment is carried out of the realities in the field.

In the government of Macedonia there is a need for a stronger coordinative body to deal with donor assistance. Often there is duplication of assistance. However, most of the discussions between the government and the donors on this issue often end up only with brainstorming without making any real decisions. This often means that the donors organize themselves and take charge of coordination based on what they believe to be the Macedonian priorities.

4.   Off-loading fiscal problems from the central to the local level.

There is a risk that the IMF’s principle of neutrality concerning the central budget would lead to a spill over of problems at the central level in the areas of education, health, culture and social welfare down to the local self-government level. The economies of scale from which the central government was supposedly benefiting in the provision of those services were not enough to manage these functions in a satisfactory manner. Central government decisions were limited towards current expenditures, particularly toward salaries leaving fewer funds for supplies, maintenance and investing. The question is how LSGs can manage these services in a satisfactory manner and will be able to deliver better services with the same amount of money and no economies of scale to benefit. The key has to be in greater allocative efficiency and more accountability to citizens. It remains to be seen if these promises of decentralization will be fulfilled.

5. Territorial structure of the local governments.

The 1996 division into 123 LSGs have had deficiencies identified by the government, such as imbalances between the competencies, human resources on one side and their size, economic and financial capacity on the other side. These deficiencies together with some goals defined by the government (economic sustainability of LSG efficiency in carrying out responsibilities, etc.) and the obligations stemming from the OFA were the main ground and input to the preparation of the 2004 law on territorial organization. However, in the end these principles were not strictly adhered to and there were other overriding considerations. Also, the process of developing the law on territorial organization could have been more transparent and had a better basis for defining the territorial divisions.

No analysis was conducted to investigate the optimal territorial organization for Macedonia. Some studies related to the size of LSGs in Macedonia suggest that the optimal minimal size would be around 5,000 inhabitants (see CEA 2004). According to these criteria, 15 out of 84 LSGs would not benefit from economies of scale in their administrative costs.

6. Expenditure assignments

On 1 July 2005 many responsibilities will be given back to LSGs. The impact will be on a large scale. At last, LSGs will have a set of specific laws regulating their responsibilities. This will be a great improvement on the provisions of the constitution and the law on LSG, which only defined the responsibilities of LSGs in general terms. This might create an impression that responsibilities have been devolved because the legal framework has been adopted by the national assembly. At least, this is what the central government is arguing. But under the surface there are many problems, one of which is that the new law that should regulate urban planning has not yet been adopted. Further, the principle of neutrality of block transfers, totalling the current costs for central government in providing these services, will create problems for some LSGs. For example, as the organization of transportation is assigned to the LSGs, higher intensity of commuting will require more roads and infrastructure. Such externalities are not envisaged by policymakers and certainly will not match the expectations of neutrality for the central budget. During the first phase, only maintenance will be the responsibility of LSGs, while salaries will be paid by the central government.

The general problem is that policymakers need to have a more realistic understanding of the situation on the ground, how much it will cost, what is the impact, who will do the implementation and what regulations and bylaws are required. The government should immediately set some standards, make a real cost assessment, develop indicators, define measurable indicators of success and prepare bylaws.

7. Revenues

PRO is developing a new system for the devolution of tax administration to LSG but it still operates through its 30 decentralized offices. They are not yet aware of the need to develop a structure to reflect the new territorial organization. At the moment, the cadastre system uses the best data for administering the property base but the database is not yet complete and might not be finished by 1 July 2005. Thus, with proper data still not available for the property tax administration, and no vision of the need for changes that should reflect the new territorial division, this area might be at risk. On the other side, the low initial base for the devolved taxes will help to increase property tax collections immediately after the devolution. This initial momentum should not create space for comfort and let LSGs forget about developing further the revenue system in the area of assessment, audit, LSG asset management, collection and efficient administering. For local citizens to see progress that is meaningful to them, mayors and council members need to be able to see more than the appointment of a primary accountant or the transfer of staff from the PRO.

8. Transfers

The new transfer system appears well developed and the phased approach adequate for ensuring progression of the process in line with how LSGs develop their internal capacity. Although implementation has not yet started, the government should begin preparing the treasury system, secondary regulations and bylaws, and defining indicators to monitor progress. Reportedly, government institutions are following their own agendas without coordinating their activities. An example is the plan of the state statistical office in its work with statistics related to decentralization. There are not many countries even in the EU that provide GDP figures at the local level. For Macedonia, the subnational (NUTS 3) level is probably the optimal level for categorizing such information. There may need to be developed some system of proxy indicators. But in general a system for monitoring levels of local development does not exist. Thus, policymakers have difficulties in developing a formula for distributing the 3 per cent share of VAT simply because there are no data available.

Just as there must be *the way*; there must also be *the will.* The way is set in the new laws but the willingness of the national and municipal officials to allocate funds for training, equipment, database development, space improvements, and other costs must be increased. Support for decentralization requires a substantial commitment from the Macedonian government. These issues will need to be dealt with in order for the deadline to be met and for the local government sector to develop its capacity

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Annex A: Assessing The Status Of Fiscal Decentralization Reforms In Macedonia

TABLE 1

ASSESSING THE STATUS OF FISCAL DECENTRALIZATION REFORMS IN MACEDONIA

	(A) Overall policy stance and policy effectiveness	(B) Constitutional & legal framework	(C) Central govt institutional and regulatory framework	(D) Local gov't institutional and regulatory framework	(E) Participation by civil society and private sector
(1) Structure and role of public sector	External pressure for decentralization; lack of leadership, clear goal, ownership and selling the process to the wider public and citizens. Outdated financial management, lack of coordination in the distribution of donor funds.	Key laws under the operational programme for decentralization of power 2003-2004 are adopted. 2004 law brings the minimum jurisdiction size to 10 thousand.	The coordinating body for decentralization made up of the state secretaries from all ministries has been established.		
(2) Functional and expenditure assignments	Implementation not yet started; until recently negligible competences	Some laws and by laws yet to be adopted		Currently lack of understanding on the part of LSG on what they are responsible for	
(3) Assignment of revenue sources					
(4) Intergov. fiscal transfers, incl. the scope of unfunded mandate	Not yet started. From 1 July 2005; until recently, grants were arbitrary and earmarked	Only laws adopted, not by laws.			

(5) LSG borrowing and infrastructure development	Uncertainty about the LSG debt.	Law on financing provides provisions for borrowing and instruments for controlling; Borrowing allowed with prior consent from the central government based on the opinion of the Ministry of Finance	Body for public debt management established	Lack of initiative for solving the existing debt. Need for assistance.	

TABLE 2

KEY FISCAL DECENTRALIZATION REFORM INITIATIVES PURSUED IN MACEDONIA

	(A) Overall policy stance and policy effectiveness	(B) Constitutional & legal framework	(C) Central govt institutional and regulatory framework	(D) Local gov't institutional and regulatory framework	(E) Participation by civil society and private sector
(1) Structure and role of public sector	July 1 2004,Government declared the process of decentralization a priority. The detailed plan for the competencies transfer will be adopted by March 2005.	Completing adoption of new laws	By laws	March 2005 Elections. Signed memorandum of cooperation with ZELS. Signed memorandum on coordinating training for the LSG administration among ZELS, civil servant agency and ministry of LSG. Memorandum signed for the pilot project of property tax devolution.	
(2) Functional and expenditure assignments	Indicators and criteria for the transfers in a stage of development in the proper ministries.	Major devolution legislated in 2003 but still awaiting implementation; two-phase approach under IMF agreement; By 30 March a draft plan for assigning responsibilities should be adopted.	By laws		

(3) Assignment of revenue sources	PRO develops new forms for devolution of tax collection authority.	2004 legislation assigned property related taxes to the local level;	By laws for the VAT transfer. Treasury activities related to the decentralization (nomenclature, specifications reflecting the new territorial organization etc)	Successful pilot project in 4 LSG on administering devolved taxes	
(4) Intergov. fiscal transfers, incl. the scope of unfunded mandate		2004 legislation gives LGs 3% of PIT by origin and 3% of VAT via an equalization fund			
(5) LG borrowing and infrastructure development	Postponed				

TABLE 3

REFORM PRIORITIES FOR FISCAL DECENTRALIZATION IN MACEDONIA

	(A) Overall policy stance and policy effectiveness	(B) Constitutional & legal framework	(C) Central govt institutional and regulatory framework	(D) Local gov't institutional and regulatory framework	(E) Participation by civil society and private sector
(1) Structure and role of public sector	Maintenance and further development of the UNDP sponsored database. Developing quantity and qualitative indicators for measuring performance of the transferred competencies	Establishing the task force groups, development of financial management manual. Further implementation of the IAS.	Further development of the treasury system. Internal audit enhancing within the ministry of finance. Fiscal planning and reporting should be enhanced.	Enhancing further citizen service centres.	Database of all organizations working on LSG. Increasing awareness of the media for the process.
(2) Functional and expenditure assignments	Setting up standards and system of indicators.				
(3) Assignment of revenue sources	Raising public awareness for local taxes compliance. PRO must develop all the forms reflecting the reality of the new territorial organization.	Revising treasury activities. Adopting the new law on budget.	Transparent devolution of local taxes to the LSG following the pilot project success and the scaling. Improvements of the PRO property tax records and crosscheck them with geodetic work authority. IT enhancement.	Procedures for independent tax and audit officials, transparent and not politically driven. IT enhancement.	

(4) Intergov. fiscal transfers, incl. the scope of unfunded mandate	Setting up standards and system of indicators.	Updating the new network of institutions in accordance with the new law on territorial organization.	The decentralization working group is preparing an inventory of assets to be decentralized, inventory of human resources to be transferred to the LSG, preparing need analyses for stationary and equipment for the LSG. Measuring fiscal capacity. Research on equalization schemes (continuously).	Measuring fiscal capacity. Research on equalization schemes (continuously).	
(5) LSG borrowing and infrastructure development			Debt management body of the ministry of finance to build capacity to manage LSG debt in the future.	Capacity building for financial management. Develop credit rating procedures. Develop a sense for asset management.	

Annex B: The two phases of fiscal decentralization according to the 2004 Law

Phase	Starting date	Assignment of responsibility	Conditional on
1. Phase	1 July 2005 (with amendment of the law from 30 December 2004)	1. Transferring own revenues from tax sources (the PIT sharing) to municipalities (GOV) 2. Developing a methodology for transferring the capital and earmarked (GOV) 3. The LSG will start with the planned implementation of solving the arrears problem by 31 January 2001 (LSG)	If 90 % of all municipalities comprising 90 % of the total population will provide: 1. At least 2 financial officers 2. At least 3 tax experts
2. Phase	Conditional	Assignment of responsibilities (for the block transfers): 1. Culture 2. Social welfare and child protection (kindergartens and homes for elderly) 3. Education (primary and secondary school) 4. Healthcare (public health organizations and primary care)	1. All the conditions from phase 1 are satisfied 2. A proper capacity of the financial officers (this is already stated in the previous phase) 3. Viable results of 24 months for on time and regular reporting confirmed by the ministry of finance 4. There are no accounts payable than usual ones (up to 90 days) 5. The phase commission will evaluate whether all the conditions are satisfied 6. There is a written request from the municipalities to the proper ministry and the Ministry of Finance for granting block transfers after all the conditions are satisfied.

Annex C: Major donor-supported activities

1. **ZELS-association of the units of LSG in Macedonia:** http://www.zels.org.mk/
    a. Participation in a working group together with the Make Decentralization Work-MDW-USAID project on Equalization issues.
    b. Working on the transfer of employees, property etc. to the newly devolved activities
    c. Trilateral agreement with UNDP and the Agency for Civil Servants for training activities
    d. Trilateral agreement with MDW-USAID and World Learning-WL for training activities and building database of trainers
    e. ZELS have their policy committees and technical committees working on an ongoing bases

2. **World Bank**
    a. Community Development Project-CDP (mostly capital budgeting in communal infrastructure)
    b. Community Development Culture Project-CDCP (monuments, LED related activities)

3. **MDW-USAID**
    a. Scaling up the pilot project on 4 LSG for devolution of responsibilities for own tax revenues
    b. TA in financial management
    c. Building capacity of LED offices
    d. Building capacity of urban planning offices and issuance of construction permits
    e. Support for citizen participation activities
    f. Support to ZELS and ATKOM-Association of communal enterprises

4. **Association of Financial Officers-AFO**
    a. Training activities
    b. Issuing bulletin

5. **Swiss Agency for Development and Cooperation**
    a. Infrastructure projects
    b. Grants

6. **VNG International**
    a. LOPAD (local public administration development) sponsored by the Dutch Embassy
    b. TRAIN (training and capacity building for LSG institutions) EAR supported
    c. Handbook for the newly elected mayors and councillors OSCE supported

7. **UNDP: many active projects related to the LSG (for an extensive list see: http://www.undp.org.mk/default.asp?where=projects)**
    a. Strengthening of the Ministry of Local Self-Government:
    b. Strengthening Local Self-Governing Institutions in the FYR of Macedonia through Capacity Development, Transparency and Financial Accountability:
    c. Mapping the Socio-economic Disparities among Macedonian Municipalities:
    d. Local Governance for Sustainable Human and Economic Development:
    e. Establishment of a Training Support System for Local Government Administration in the FYR Macedonia

8. **Center for Economic Analyses (CEA): www.cea.org.mk and www.lsg-data.org.mk**
    a. Bulletin: Decentralization our goal; supported by USAID and OSCE
    b. Building database for the LSG; supported by World Learning and USAID

Annex D: Overview of IMF's general perception of Macedonian environment
Source: IMF (2003)

'1. FYR Macedonia has not yet fully recovered from the breakup of Yugoslavia and the subsequent economic and political upheavals. Following independence in 1991, the country had to cope with the loss of its foreign exchange deposits held in the National Bank of Yugoslavia, a breakdown in its trade linkages due to the embargo on Yugoslavia, the blockade by Greece, the 1999 Kosovo conflict, and the internal civil strife in 2001.

2. These intermittent conflicts and disturbances have had an adverse impact on the development of the institutions necessary to support the transition to a market economy and on the governance of those institutions. By many accounts, there has been a significant degree of corruption in the public sector, manifested in the use of public office for private gain. Corruption and bad governance in the wider economy have been compounded by the chosen methods of privatization. The judicial system is considered to be ineffective, because of excessive politicization, lack of independence, and intimidation of the judges, as well as deficiencies in the procedures and operations of the courts.

3. Weak institutions and governance have taken a significant toll on economic development and growth in the past decade**.** Indeed, FYR Macedonia does not present an environment conducive to attracting investment, whether foreign or domestic. As a result, FYR Macedonia is only midway in the transition to a stable market-oriented economy.

4. Not surprisingly, these deficiencies have also had a negative impact on financial sector development and on intermediation**.** On the one hand, financial integrity has often been threatened by opportunities for corruption and abuse, diverting resources away from potentially productive uses in the economy. On the other hand, it has been difficult for banks to develop lending activities in an environment of weak corporate governance and legal uncertainty.

5. To address these deficiencies at their roots, a two-pronged strategy is needed**.**
Remedying weak financial intermediation and regaining the confidence of the population and foreign investors is both a matter of preserving macroeconomic stability and addressing the problems of governance and corruption. The government has taken steps in both areas. These efforts are seen as the keystone for building a sound and stable financial system that, in turn, can actively contribute to economic development and growth".

'The mission's recommendations on fiscal decentralization rest on several assumptions**.** First, a new territorial structure with a significant reduction in the number of municipalities will be in place *before* a new Law on Local Government Financing is finalized, and *before* fiscal decentralization proceeds. Second, total general government spending is neutral with respect to fiscal decentralization, i.e., increased municipal spending will, in general, be offset by reduced central government spending. Third, there continues to be a clear separation of payment responsibilities between the two levels of government, and all funds municipalities receive from the central government are determined by formula instead of negotiation. Fourth, at each stage, fiscal decentralization is accompanied by carefully working out its non-financial implications, including how it affects the quality of public services.

Based on these assumptions, the mission suggests a phased decentralization, where, in each phase, specific expenditure responsibilities in different sectors are devolved to the municipalities with adequate financial resources. This will avert a situation in which the central government finds itself financing both its existing functions and a new programme of revenue sharing, or public services collapse in the absence of clear expenditure responsibilities.

The specific strategies and the timeframe needed for decentralization will vary by sector. For instance, it may be easier to achieve fiscal decentralization in the education sector than in the health sector, and it should therefore proceed at a sector-specific pace'.

And more:

'The proposed general strategy for fiscal decentralization in this report is based on three principles that the mission views as essential.

- *Total general government spending should be neutral with respect to fiscal decentralization*; that is, fiscal decentralization should not imply an increase in local spending that is not offset by a reduction in spending by the central government. This is dictated by the overall fiscal constraints and the need for further fiscal consolidation over the next few years, as set out in the government's programme.
- *The process of fiscal decentralization needs to maintain clear payment responsibilities***.** While sectoral responsibilities may be shared to some extent (e.g., there may be both state hospitals and municipal hospitals), it has to be clear who is responsible for paying what. This is particularly important to forestall ad-hoc claims for central government financial support; a phenomenon that could rapidly snowball once a precedent for such relief was established. Clear payment responsibilities also require a clear structure of financing, implying that the structure of municipal funds (i.e., taxes and transfers) has to be determined by formula rather than negotiation.
- *All steps for devolving expenditure responsibilities to the municipalities need to be accompanied by a careful working out of their non-financial implications***.** This would imply, for example, analyzing how the quality of primary education may be affected by giving municipalities the power to hire and fire staff, to set salary levels, or to deviate from national standards regarding classroom size or environmental quality. These considerations will be crucial for deciding how much space for autonomous decision making should be given to the municipalities in a decentralized fiscal system, and, ultimately, how far to take fiscal decentralization'.

Country Report: An Assessment of Fiscal Decentralization Reform in Serbia[103]

Executive summary

Fiscal decentralization reform in Serbia is still a work in progress. Although the system of intergovernmental fiscal relations in Serbia has changed substantially since 2000, several additional important steps are still needed. While local governments have sufficient discretion in discharging their exclusive duties (which are rather limited), the unresolved issue of municipal property is a clear obstacle for their autonomy. In addition to exclusive local functions, local governments in Serbia share some responsibility over primary and secondary education, as local governments maintain school buildings while the central government pays teachers' wages.

On the revenue side, the degree of local revenue autonomy in Serbia was sharply reduced in 2004 with the elimination of the local wage fund tax and the sales tax. While these shared revenues provided substantial resources to the local level, they did so in a counter-equalizing manner and without the benefit of an equalizing grant system. This has led to significant disparities in the quality of local services. The elimination of these shared revenues and the replacement of the sales tax with a VAT offers an opportunity for a realignment of the manner in which local governments are financed. Because the VAT tax is difficult to share on a derivation basis, this reform is forcing the national government to put in place a new mechanism for sharing tax revenue, which provides an opportunity for a more equitable revenue assignment and transfer mechanisms.

Introduction

The overall objective of the study on fiscal decentralization in selected transition economies –of which this country report is an integral part- is to accomplish an all-encompassing review that systematically captures the entirety of the fiscal decentralization processes in each of five transition countries, including Armenia, Croatia, Georgia, Macedonia, and Serbia. In addition to producing five country reports, the study further sets out to integrate and synthesize the experiences from these five countries, and to broadly consider the role of the various stakeholders in promoting decentralization reforms. As part of this larger study, the main purpose of this country report is to provide an overview of the progress and issues with fiscal decentralization in Serbia.

[103] This report was prepared by Snezana Stojanovic and Andrey Timofeev, March 2005. The report was prepared by the Andrew Young School of Policy Studies at Georgia State University under contract for the UNDP Bratislava Regional Centre. The study team would like to thank Tomislav Novovic of UNDP/Serbia for his assistance and support during the in-country mission, as well as for his helpful comments. The team would further like to thank all policymakers, government officials and donor representatives who shared their insights and knowledge with us.

In the following five sections we provide an assessment of each of the five building blocks of intergovernmental fiscal relations respectively (structure of the government sector; delineation of expenditure responsibilities, assignment of revenue sources, intergovernmental transfers, and subnational borrowing) and consider the technical nature of the strengths and weaknesses of the respective decentralization process.[104] In the concluding section, by juxtaposing the current state of fiscal decentralization reforms with recent or ongoing initiatives, we identify areas in which we judge priorities for further action should fall, and how UNDP, and potentially other donors can fine-tune their portfolios of activities to optimize contribution to the decentralization process in the country.

While details of fiscal decentralization reforms in Serbia are discussed in the report, the annex to this report provides three two-dimensional matrices that serve to provide the ‘big picture’ of the decentralization reforms. The matrices consider the five functional components or dimensions of decentralization as outlined above, as well as the technical nature of the reform of the specific decentralization issues: for instance, when considering an element of the decentralization reform strategy, the matrix is able to map whether it is a policy concern, whether the issue is legislative in nature, part of the regulatory framework, part of local process and procedures, or a reform issue to be addressed through civil society. The three matrices form the basis for collating the information obtained from reviewing the available technical studies and policy reports on decentralization in Serbia, as well as the insights acquired during the discussions and meetings held in February 2005 in Serbia as the background for developing this country report:

§ Matrix 1 (The Assessment Matrix) identifies the current state of fiscal decentralization reforms and maps policy areas within the realm of decentralization and local government reform that present the current key policy issues and obstacles for the further development of decentralization in the country.

§ Matrix 2 (The Reform Initiatives Matrix) identifies and maps recent or ongoing initiatives pursued by the national government, subnational governments and their associations, as well as UNDP, other donor agencies and stakeholders within the realm of decentralization and local government reform that are aimed at addressing and resolving the obstacles and challenges noted in Matrix 1 above.

§ Matrix 3 (The Reform Priorities Matrix) identifies priorities for further action within the same dimensions of Matrix 1 and 2. That is, the matrix maps areas that are either currently underserved in the policy discussion towards decentralization, or areas in which a fresh perspective may stimulate new policy thinking.

[104] Traditionally, expenditure assignment, revenue assignment, intergovernmental transfers and subnational borrowing are recognized as the four main pillars of intergovernmental fiscal relations. The addition of local government structure as a separate dimension (as opposed to treating it as part of the discussion on expenditure assignments) stresses the need for sound territorial administrative and political structures to be in place for fiscal decentralization to be effective and efficient.

Overall, fiscal decentralization reform in Serbia is in progress and still needs to take several important steps. While local governments have sufficient discretion in discharging their duties (which are rather limited, particularly in the social sphere), the unresolved issue of municipal property is a clear obstacle to further progress. Also with the elimination of the wage fund tax and sales tax in 2004, local governments' ability to affect their revenue on the margin has become very limited, which takes away from their ability for fiscal adjustment in the time of stress. Because the VAT – which is replacing the sales tax, which was previous shared with local government level – cannot be shared on a derivation basis, this causes the national government to design a new mechanism for sharing tax revenue and provides an opportunity to do it right this time.

Structure and Scope of the Government Sector in Serbia

Background

The Republic of Serbia is a member of the state union of Serbia & Montenegro. It is located in the middle of the Balkan region, has approximately 88,000 square kilometers and population of about 7 million (10 million including the area of the Autonomous province of Kosovo & Metohija). Serbia has a per capita GDP of $1,922, roughly equivalent to the per capita GDP of Macedonia. While this is considerably lower than Croatia, in per capita terms, Serbia's GDP is roughly twice the level of Armenia and Georgia.[105]

Serbia is a unitary country with two levels of political units: central and local government and with two administrative units (autonomous provinces): Vojvodina and Kosovo & Metohija. Considering the special regime of Kosovo & Metohija, we will only take into consideration Vojvodina as the autonomous province.[106] Although Vojvodina, with a population of about 3 million, has the status of an administrative unit, its responsibilities are so vast, that we could in practice treat it as a separate government level (political unit).[107]

Serbia has 167 municipalities and four cities (Belgrade (the capital), Nis, Novi Sad, and Kragujevac). Municipalities differ greatly among themselves: some of them have a large number of inhabitants, others very few. Compared with other transition economies, municipalities are relatively large, with an average population of approximately 40,000 residents. Also, municipalities differ significantly in the area of their territory, as well as

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[105] The country's GDP of 1,284.1 billions dinars (in 2004) is predicted to grow to 1,475.9 billions dinars in 2005. For comparative purposes, GDP is around $210 million for 2004, and projected to be around $242 millions for 2005.

106 Although there are two autonomous provinces in the Republic of Serbia – Autonomous province of Vojvodina and Autonomous province of Kosovo & Metohija – when we talk about an autonomous province, we mean only Vojvodina, because Kosovo & Metohija is administered under the regime of the United Nations Mission for Kosovo & Metohija. Considering that the data about this regime are inaccessible, we can not analyze it as an integral part of the intergovernmental fiscal relations system in Serbia. Later in this report we will analyze only the system implemented in the Autonomous province of Vojvodina.

107 However, during the last decade the executive branch of the EC of Vojvodina was heavily diminished. The final status of Vojvodina (political or administrative unit) will be known after the adoption of the new constitution of the Republic of Serbia. The exact date of its adoption is still unknown, because it has been continually postponed since 2002.

in their responsibilities and fiscal capacity. The capital city, Belgrade, has a special legal status. It is subdivided into 17 municipalities, of which 10 have the status of urban municipalities and seven have the status of suburban (rural) municipalities. Because of these circumstances, Belgrade has broader responsibilities and more revenues, compared with the responsibilities and revenues of other local units. At the local level, there are also 29 counties, which serve as the deconcentrated arm of the state administration.[108]

During the 1990s, economic conditions declined steadily in the former Federal Republic of Yugoslavia because of the policies pursued by the former political regime. This situation started to improve in the second half of 2000, when the old political regime was ousted and significant political changes started to unfold. The first results of these changes took place in 2001. Until that year almost the entire Serbian economy was controlled by the state. However, in 2001 the scope of the public sector started to diminish and the privatization made significant progress (although privatization had started in the 1990s, but many detrimental circumstances had put this reform on hold).

Because of privatization, many enterprises that were previously in government hands have been privatized. This has slightly boosted economic activity in Serbia. But, although the private sector is growing, the role of the public sector is still significant. As of 2004, government expenditures accounted for 46 per cent of GDP, almost half of which is represented by social welfare (19.6 per cent of GDP). Outlays on every other government service are much lower (health care – 5 per cent of GDP, economic activities – 5.1 per cent, public services – 4.3 per cent, education – 3.7 per cent).

It should be emphasized that the public sector primarily means the state (republic) sector, because the role of local governments and the autonomous province in the public sector is still very small. It is important to say that public services are still produced mainly by the public sector (public enterprises financed with subventions from the budget of the republic, autonomous province or local units). But, it could be stated that some of the public services, in a very narrow scope, are provided by the private sector (e.g. city transport in Belgrade, secondary and high education, kindergartens, hospitals, etc.).

Table 1: Consolidated public expenditures – functional classification (in % of GDP)

	2004	**2005**
Total public expenditures	**46.2**	**45.5**
Public services	4.3	4.3
National defence	3.0	2.7
Public order and security	2.2	2.0
Economic activities	5.1	5.1
Environmental protection	0.3	0.3
Housing and utilities	2.6	2.6

[108] These units are established in an illegal way, not by law, but by the decree of the Government of the Republic of Serbia. The existence of these units greatly complicates an already very complicated execution of administrative tasks at the local level of government. This is one of the reasons (beside their illegal establishment), why these administrative units should be abolished.

Health care	5.0	5.4
Recreation, culture, religion	0.4	0.4
Education	3.7	3.9
Social care	19.6	18.8
Source: Ministry of Finance of the Republic of Serbia, *Memorandum on budget, economics and fiscal policy for 2005, with projections for 2006 and 2007*, Belgrade, 2004, p. 17.		

Decentralization Reforms

Considering all the facts mentioned above, the system of intergovernmental fiscal relations in Serbia is gradually evolving as the actual process of transition should lead to accession to the European Union in the near future. This is the reason why the Serbian system of intergovernmental fiscal relations has changed a lot since the end of 2000. Political reforms that started in the second half of that year also trigged reforms in many other spheres of social life. One of the spheres that started to change was the fiscal system and intergovernmental fiscal relations.

It is peculiar that the reforms first started in the field of revenue assignment and the reform of expenditure assignment came later. Thus, in 2001, the Republic of Serbia started assigning new revenues sources to lower level governments before the approval of a clear attribution of responsibilities. A new Law on Local Self-Government (LLSG) had not been approved, but the new revenue assignment/sharing started being implemented in April 2001, and the 2002 budget made a provision of 50 billion Dinars to Vojvodina without any new responsibilities being formally assigned to the province.

On 14 February 2002 the Republican Assembly finally passed the LLSG[109] redefining the administrative structure, responsibilities and rights of local governments, aiming at bringing the system in conformity with the Council of Europe's Charter for Local Self-Governments. Also in February 2002, the Republican Assembly passed a 'Law on the Establishment of Competencies of the Autonomous Province'[110] that devolves to the province of Vojvodina some degree of fiscal autonomy and authority over most areas of public expenditures (including for education, health protection and sanitation, social assistance, culture, tourism, sports, housing, environment, urban planning, agriculture, mining and energy).[111]

Because of the above situation, the general observation regarding the Serbian system of fiscal decentralization is that it has inverse sequencing. It should be expected that reform

[109] Promulgated by the Presidential Decree no. 4 on 20 February 2002.
[110] Promulgated by Presidential Decree no.2 of 6 February 2002.
[111] The extent to which the current funding is adequate is still an open question. In this regard, the Law only brings a vague reference in Art. 66 which read: 'Funds for implementation of *certain* competencies quoted in this Law, in the area where the Autonomous Province takes over the founding rights, will be covered by the Autonomous Province budget'.

of the revenue assignment and intergovernmental transfers follow the reform of expenditure assignment, but in Serbia it was the other way around.

The assignment of expenditure responsibilities

The delineation of expenditure responsibilities in Serbia is characterized by the assignment of some expenditure responsibilities to each level of government (republic, autonomous province and local level). According to Table 2, relative roles of different levels in total government expenditures have not change much since 2002, except for an increase in the share of the republic government at the expense of the union government.

Table 2. Share of expenditures by level of government (% of total)

	2003	**2004**	**2005**
S&M Union	23.02	16.25	12.65
Republic (Net of Transfer)	51.79	61.98	64.97
Vojvodina	7.55	4.80	5.01
Local units	17.64	16.97	17.36
Total Government (excluding social funds)	100.00	100.00	100.00

Source: Ministry of finance of the Republic of Serbia and Budget Laws of the Republic of Serbia for 2003, 2004 and 2005

Regarding the scope of responsibilities, each government level has expenditures financed with its own funds (own expenditures) and/or expenditures financed by other levels (only with funds from another level or jointly with funds from the considered level and another level of government). Because of this, a distinction can be made between the own expenditures of each government level and co-shared expenditures of two or three government levels.

Own expenditures of the republic

Responsibilities (government functions) and expenditures of the republic level of government are the largest, comparing to expenditures of other levels of government in Serbia. Also, the republic is the only level that finances its expenditures exclusively with its own funds. It administers and finances the following functions: [112]

§ national defence;
§ public order and security;
§ criminal law;

[112] See: Article 72 of the Constitution of the Republic of Serbia (*Official Gazette of the Republic of Serbia, No. 1/90*) and Article 18. of the Law on public revenues and public expenditures (*Official Gazette of the Republic of Serbia, No. 76/91,..., 135/04*).

- civil procedure law;
- education;
- health care;
- social care;
- social security;
- labour law;
- economic policy and international economic relations;
- regulation of the internal market;
- environmental protection;
- culture;
- public information, etc.

Table 3 shows the economic classification of the republic budget expenditures.[113] The most peculiar category of expenditures is the outlays on social security. Namely, Serbia has special social security organizations as institutions independent from the republic budget, and most of the expenditures on social security are financed by these organizations.[114] But, what is remarkable is that these organizations receive significant funds from the budget of the republic (although they are, by law, independent from this budget!). Because of that, it could be said that social security is also one of the expenditures (partly) financed from the budget of the republic (indirect expenditure of the budget of the republic).[115]

The expenditures of the republic budget also include funds given to the state union of Serbia and Montenegro. Namely, when this union was established (on 4 February 2003) it was envisioned that the state union will not have its own revenue sources and that it will be financed with funds transferred from the member states, that is the Republic of Serbia and the Republic of Montenegro. Until today, only Serbia has been providing funds for financing the state union. In fact, the 'budget' of the state union is implemented within the budget of the Republic of Serbia. Most funds are given for national defence, which is prescribed as the responsibility of the state union.

Table 3: Expenditures of the budget of the Republic of Serbia (thousands of dinars and percentages)

Dinars	**2003**	**2004**	**2005**
Total expenditures	314 115 800 .0	407 228 659.2	473 418 377.0
out of which:			
Public administration staff salaries	58 373 000.0	76 006 561.8	91 845 255.0
Transfers to other levels of government	114 605 500.0	62 760 742.0	81 438 903.0
Transfers to the social security funds	66 389 300.0	88 062 667.0	85 795 000.0

[113] Unfortunately, a functional classification of expenditures by individual levels of government is not available.
[114] Social security organizations are founded as special non-budgetary institutions. These organizations are established for the three forms of social security: health security, security for the pensioners and disabled people, and security in the case of unemployment.
[115] See: Snezana Stojanovic, *Fiscal Federalism – Comparative Aspects with Special Regard to Serbia*, doctoral dissertation publicly defended at the University of Belgrade on 24 December 2004.

Transfers to S&M	40 967 981.0	53 267 000.0	49 906 000.8
Capital expenditures	20 395 700.0	32 154 872.0	66 999 767.0
Percentages			
Total expenditures	100.0	100.0	100.0
out of which:			
Public administration staff salaries	18.6	18.7	19.4
Transfers to other levels of government	36.5	15.4	17.2
Transfers to the social security funds	21.1	21.6	18.1
Transfers to S&M	11.56	13.08	11.98
Capital expenditures	6.5	7.9	14.2
Source: Ministry of Finance of the Republic of Serbia and Budget Laws of the Republic of Serbia for 2003, 2004 and 2005			

It can be mentioned that the republic finances many responsibilities that are not prescribed in any existing law or its constitution. The reason for this phenomenon is that in Serbia the Constitution from 1990 is still in force from the time when it was a member of the former FR Yugoslavia, which ceased to exist in 2003.[116] This situation cannot be resolved until the adoption of a new constitution.

<u>Own expenditures of the autonomous province</u>

When we are talking about the level of the autonomous province, it is useful to say that this level of government acquired new (much broader) responsibilities in 2002, when the Law on establishing certain responsibilities of the autonomous province was adopted. At that time, the province was given responsibilities in many fields where earlier the republic authorities had exclusive responsibilities. These are responsibilities in the following fields[117]: culture, healthcare, social care, social protection and child care, public information, official use of language and handwriting, sanitary control, urban and building activities, economy and privatization, environmental protection, mining and energy, agriculture, tourism, and sports. For most of these responsibilities it is not clear if they are financed from the budget of the province or from the budget of the republic. Also, one cannot be sure if these responsibilities are given to the province via the procedure of devolution or delegation. The only expenditure that can be singled out as the responsibility of the republic (not of the province!) is social security. This is the exclusive expenditure of the republican social security funds, which have been established in the territory of the province in the form of deconcentrated units.

[116] The final break up of the FRY was in 2003, when the state union of Serbia and Montenegro was founded. But the actual break up of the FRY started much earlier, in 1992 when the Republic of Croatia and the Republic of Slovenia exited the FRY and were founded as independent countries. After that, the same thing happened with the Republic of Macedonia and the Republic of Bosnia and Herzegovina.

[117] See: Law on establishing certain responsibilities of the autonomous province, *Official Gazette of the Republic of Serbia, No. 6/02.*

Table 4: Expenditures of the autonomous province budget (thousands of dinars and percentages)			
	2003	**2004**	**2005**
Dinars			
Total expenditures	13 426 100	15 745 146	19 763 744
out of which:			
Public administration staff salaries	9 299 700	11 257 858	14 477 380
Subventions for economic activities	856 500	1 792 429	1 813 656
Subventions for social care	15 700	34 304	50 361
Capital expenditures	1 270	178 263	268 626
Percentages			
Shares of certain expenditures			
Total expenditures	100.0	100.0	100.0
Public administration staff salaries	70.2	71.2	73.3
Subventions for economic activities	6.5	11.4	9.2
Subventions for social care	0.1	0.2	0.3
Capital expenditures	9.6	1.1	1.4
Sources: Ministry of Finance of the Republic of Serbia and Budget Laws of the Autonomous Province of Vojvodina for 2003, 2004, and 2005.			

Table 4 shows the economic classification of the province budget expenditures. It is worth noting that at the republic level of government, the biggest expenditure of the province budget is constituted by outlays on public administration salaries. Its share in total expenditures of the province is approximately 71 per cent. Also, the province has significant outlays on economic activity (these expenditures are much lower than salaries, but they are the second largest provincial expenditure). The share of outlays on economic activity in total province expenditures is approximately 8 per cent. This situation is a consequence of the Law on establishing certain responsibilities of the autonomous province, which introduced responsibilities of the province in many fields of economic activity within the territory of the province.

Own expenditures of local units

Considering the issue of expenditure assignment, it is very important to point out the specific situation faced by local governments. Because of the sequencing of the fiscal decentralization process in Serbia, the period from the end of 2000 (start of the fiscal reform and reform of revenue assignment) to 2002 (start of the responsibilities and expenditure assignment reform) was characterized by the existence of municipalities with high revenues that exceeded their expenditures. This situation changed when the reform of the expenditure assignment started with the adoption of a new Law on Local Self-Government in 2002. This Law introduced many new responsibilities for local government units. In fact, it was an attempt to balance local expenditures (responsibilities) with the amount of funds devolved at the previous stage. With the adoption of this Law, local government units were assigned two types of expenditure responsibilities: those financed with their own funds (own expenditures), and other responsibilities financed both from the local budget and the republic budget.

Let us start with the own expenditures of local government units. The Law on Local Self-Government enumerates 35 own responsibilities (expenditures) for the local units. These responsibilities include:[118]

- adoption of the development programme;
- adoption of the urban plan;
- adoption of the budget and financial statement;
- regulation and provision of communal services;
- maintenance of housing and buildings and making them secure;
- regulation and provision of the use of building plots and business premises;
- environmental protection;
- establishment of institutions and organizations in the fields of primary education, culture, primary health care, recreation, sport, children and social care, tourism, etc.

Also, this Law allowed for the delegation of responsibilities from the level of the republic. These responsibilities are financed from the republic budget and mainly consist of inspection duties in the fields of products and services, agriculture, water supply, forestry, etc.

Delineation of Responsibilities in the City of Belgrade

As we have already mentioned, Belgrade has a special legal status, which was the reason for introducing a special regime of expenditure assignment (and revenue assignment) within its territory. The Charter of the city of Belgrade[119] makes a distinction between responsibilities of the city self-government and responsibilities of its districts. Some of them are exclusive responsibilities; others belong to the sphere of co-shared responsibilities. Responsibilities of the city self-government consist of the following activities[120]:

- urban planning;
- communal activity;
- use of building plots and premises for business activity;
- local infrastructure (building and maintenance of local roads and streets; communal infrastructure objects, buildings, business premises, etc.)
- use of public spaces;
- education, culture, sport;
- public information;
- tourism and trade;
- environmental protection;

[118] See: Article 18 of the Law on Local Self-Government, *Official Gazette of the Republic of Serbia, No. 9/02... 135/04.*

[119] See: Statute of the City of Belgrade, *Official Gazette of the City of Belgrade, No. 14/04 and 30/04.*

[120] See: Article 10 of the Statute of the City of Belgrade, *Official Gazette of the City of Belgrade, No. 14/04 and 30/04.*

§ agriculture, etc.

Responsibilities of Belgrade's districts are also prescribed in its Charter. A distinction is made between responsibilities of urban municipalities and responsibilities of suburban municipalities. Namely, suburban municipalities are responsible for all tasks executed by urban municipalities, but they also execute some additional tasks. First, let us see the responsibilities of urban (and also suburban) municipalities. They are mainly in the following fields:[121]

§ urban planning;
§ use of the building plots;
§ building and adaptation of certain houses and buildings;
§ building, maintenance and use of the local roads and streets;
§ tourism, handcrafting, and trade;
§ environmental protection, etc.

In addition to these responsibilities, suburban municipalities are responsible for the execution of tasks that create appropriate conditions for managing and developing communal services (water supply, purification, maintenance of cemeteries, maintenance of green spaces, street cleaning, street lighting, etc.). It is useful to mention that most of these services on the territories of urban municipalities are executed by the self-government of the city of Belgrade.

Table 5 shows the economic classification of the aggregate expenditures of all local governments. The largest expenditure category is represented by outlays on economic activity mainly those related to public utilities and sanitation (e.g., water supply, sewerage, district heating, trash collection and disposal, street cleaning, cemeteries). In general, these services are delivered by off-budget companies, most of which are experiencing financial difficulties because of unrealistic tariff policies and low collection ratios. Therefore local governments have to cover the companies' losses with budgetary funds. It is worth noting the gradual decline both in the share of subventions and payroll; thus freeing some funds for material costs and capital expenditures.

Table 5: Expenditures of the local government (thousands of dinars and percentages)

	2001		2002		2003	
	dinars	**%**	**dinars**	**%**	**dinars**	**%**
Total expenditures	31 395 900	100.0	55 622 400	100.0	68 490 700	100.0
out of which:						
Public administration staff salaries	14 128 200	45.0	19 060 200	34.3	16 058 900	23.4
Subventions for economic activity	17 267 800	55.0	22 748 500	40.9	23 307 500	34.0

[121] See: Article 12 of the Statute of the City of Belgrade, *Official Gazette of the City of Belgrade, No. 14/04 and 30/04.*

Subventions for social care	4 709 400	15.0	6 230 500	11.2	-	-
Source: Ministry of Finance of the Republic of Serbia						

Co-financed expenditures

Beside the expenditures mentioned as own responsibilities of each level of government, there are also expenditures shared between two or more levels of governments (shared expenditures, co-financed responsibilities). These are, mainly, responsibilities for the following public functions: education, health care, social care, environmental protection, tourism, sport and recreation, culture, public information. Usually, the republic finances the largest part of these expenditures and lower levels of government (the province and local units) finance expenditures on activities concerning their territories. It is notable that all these responsibilities are mainly given to lower levels of government via the process of managerial devolution. This means that local units are responsible for executing some tasks that were initially the responsibility of the republic, but for the sake of administrative simplicity and lower administrative costs they were transferred for execution to the lower level of government.

The most important co-shared expenditures are social care, health care and education. All levels of government provide these public goods, but each level produces the portion of them that benefits to the inhabitants of the broader or narrower territory. In the field of *education*: the republic administers and finances university education and sometimes secondary education. Also, it finances the construction of primary and secondary school buildings and kindergartens. At the same time, the province finances the provision of university education, secondary and primary education within its territory. Local units administer and finance kindergartens, primary schools and secondary schools.

Social care is another important category of co-financed expenditures. Like in the case of education, social care is provided by all levels of government: the republic administers and finances social care services, which have significant importance for all inhabitants of the Republic of Serbia. The autonomous province and local units mainly finance construction and adaptation of social care institution buildings, but they also finance programmes to improve social care in their territory.

Different forms of health care are administered and financed by different levels of government, depending of whether a certain form of health care benefits inhabitants of the whole republic, the autonomous province or a local unit. The specifics of the financing at the republic level is that the largest part of health care is financed with funds from the special health security organization, but at the same time heath care is also partially financed from the budget of the republic. The autonomous province finances the type of healthcare that is of special interest for its inhabitants. Local units provide primary healthcare and maintenance of the local hospitals.

Considering the issue of co-shared responsibilities, it is important to say that they constitute the largest part of local expenditures, mainly social care and economic services, such as agriculture, forestry, local trade, handcrafting, tourism, etc. (see table 3).

Assignment of revenue sources

The main goal of fiscal reform, starting at the end of 2000, was to introduce the tax instruments that are in use in developed market economies. In 2001, the first result of the reform was unveiled – the adoption of many new laws that moved the Serbian tax system closer to those of OECD countries.

The following tax instruments were introduced to the Serbian tax system:

- Personal income tax;
- Corporate income tax;
- Retail sales tax;
- Excises;
- Property tax;
- Inheritance and gift tax;
- Tax on transfer of property rights;
- Taxes on using, holding and carrying goods;
- Tax on financial transactions;
- Payroll tax;
- Different forms of fees and user charges;
- Many forms of non-fiscal revenues (assigned to the budget of the republic, budget of the autonomous province and budgets of local units)

By 2005, the above listed fiscal instruments have been modified several times. Also, in 2004 the payroll tax and the tax on financial transactions were abolished, and from 1 January 2005 the value added tax (VAT) was implemented in Serbia for the first time. Implementation of the VAT (and the elimination of the retail sales tax) caused many changes in the way local self-government was financed in Serbia. This is because till 2005 the local level of government was for the most part financed from the retained share of the retail sales tax.

When we are talking about assigning revenues among levels of government in Serbia, we can state that each level has its own sources of revenues and also revenues shared with another level of government. The only types of revenues, which are common for all levels, are administrative fees paid for using the administrative services of the respective level of government. Let us start with own-source revenues.

Own revenues of the republic level of government

As might be expected, the republic level of government is assigned most sources of revenues. In general, revenues of the republic consist of its own revenues[122]. Until 2005 the main source of revenue for the republic was the retail sales tax, which was turned into the VAT. All revenues collected from the VAT are allocated to the budget of the

[122] Exceptions are taxes on property and the transfer of property rights, as well as inheritance and gift tax, which are shared with the local level of government.

republic. Besides VAT, the republic budget is financed from the following revenue sources:

- excises,
- taxes on using, holding and carrying goods,
- tax on financial transactions (until 31st December, 2004),
- customs duties,
- administrative fees,
- judicial fees,
- registration fees,
- concession charge,
- certain charges for using goods of public interest:
    - charge for using waters,
    - charge for using forests,
    - charge for using roads.

Also, the republic budget is financed from some non-tax revenues. They are the following:

- fines;
- revenues from the activity of the authorities of the republic;
- revenues from the shares of the republic and its other securities;
- revenues from the sale of immovable and movable property of the state used by state authorities;
- revenues from the interest on republic funds saved in banks;
- revenues from the sale of the republic capital funds;
- revenues from renting or using immovable republic property used by the republic authorities;
- donations.

Table 6: Revenues of the budget of the Republic of Serbia (millions of dinars and percentages)

	2003		2004		2005	
	dinars	%	Dinars	%	dinars	%
Total revenues	271,220.0	100.0	329,325.9	100.0	396,099.0	100.0
Personal income tax	52,048.2	19.2	53,657.0	16.3	49,300.0	12.4
Corporate income tax	5,123.3	1.9	6,864.0	2.1	6,400.0	1.6
Sales tax	103,481.1	38.2	132,794.0	40.3	179,000.0	45.2
Excises	56,228.7	20.7	69,158.0	21.0	83,100.0	21.0
Customs	23,266.6	8.6	32,072.0	9.7	39,200.0	9.9
Non-tax revenues	-	-	22,516.9	6.8	33,799.0	8.5

Sources: Ministry of finance of the Republic of Serbia and Budget Laws of the Republic of Serbia for 2003, 2004, and 2005.

Although revenue from the sales tax had been partially transferred to local units until 2005, according to Table 6, it constitutes the largest share of the budget of the republic (38.2 per cent to 45.2 per cent). Because of the larger productivity of the VAT, it is expected that in 2005 this tax will be the largest source of revenue for the budget of the republic. Excises constitute the second most important source of revenues for the republic. They account for 20.7 per cent to 21 per cent of the total revenues of the republic budget. Finally, customs duties[123] account for 8.6 per cent to 9.9 per cent of the republic's budget.

Own revenues of the autonomous province

Fiscal reform brought great changes in the financing of the middle level of government – the level of the autonomous province.[124] For the first time, in 2001, the autonomous province of Vojvodina was allocated shares from certain taxes introduced by the republic (corporate income tax and personal income tax[125]) and was given the right to introduce certain forms of its own revenues, which are as follows:

- administrative fees
- different forms of non-fiscal revenues:
- revenues from the interests on province funds saved in the banks;
- revenues from the sale of property used by authorities of the province;
- revenues from renting or using republic property used by the authorities of the province;
- revenues from the activities of the authorities of the province;
- donations;
- revenues from the sale of the shares of the autonomous province.

Table 7: Revenues of the autonomous province budget (millions of dinars and percentages)

	2003		**2004**		**2005**	
	dinars	**%**	**dinars**	**%**	**dinars**	**%**
Total revenues	13.342,9	100.0	15.745,1	100.0	19.763,7	100.0
out of which:						
Personal income tax	2.089,5	15.7	2.928,8	18.6	3.263,3	16.5

[123] Customs revenues became part of the republic budget on 2003, when the state union was established. Then, republics (members of S&M) introduced their own customs, because the state union does not have these sources of revenues.

[124] Although the autonomous province of Vojvodina is the administrative unit (unit of territorial autonomy), its responsibilities are so great that it could be treated as a middle level of government. It is supposed that Vojvodina will become an independent level of government when the new constitution of the Republic of Serbia gets adopted.

[125] Serbia has a mixed system of personal income tax. There exist scheduler income taxes and the global income tax. Scheduler taxes are paid on the incomes earned from different sources (royalties, income from agriculture and forestry, capital gains, income from renting, etc.) and global income tax is paid only by the residents and non-residents who earned very high income during the year (the minimum sum of income subject to global income tax is determined each year, depending on the inflation rate). Global tax is paid at the beginning of the next year for the previous year, and scheduler taxes are paid during the year, after earning a certain level of income.

Corporate income tax	809,0	6.1	421,7	2.7	384,3	1.9
Non-tax revenues	33,5	0.3	251,4	1.6	879,9	4.5
Transfers	10.314,4	77.3	10.674,3	67.8	13.858,3	70.1
Sources: Ministry of Finance of the Republic of Serbia and Budget Laws of the Republic of Serbia for 2003, 2004, and 2005						

Although the number of own sources of revenues of the autonomous province is larger than the number of transfers, the province is financed for the most part with transferred revenues (0.3 per cent to 4.5 per cent of non-tax revenues compared to 67.8 per cent to 77.3 per cent of general transfers). This leads us to the conclusion that the autonomous province is highly dependent financially on the republic-level of government.

Own revenues of local units

Starting in 2001, local units were given the right to introduce many new forms of their own revenues. They include tax and non-tax revenues, and are follows:

- administrative fees,
- local communal fees,
- tourism fees,
- charges for using building plots,
- charges for arranging building plots,
- charges for protection and improvement of the environment,
- revenues from renting and using republic property used by the local unit,
- revenues from the sale of republic movable property used by the local unit,
- revenues from the concession charge for communal services and revenues from other concession jobs concluded by the local unit,
- revenues from the interest on local-unit funds saved in the banks,
- fines,
- revenues from the activities of the local unit authorities,
- self contribution fee,[126]
- donations,
- other local revenues.

Table 8: Revenues of the local budgets (millions of dinars and percentages)

	2001		**2002**		**2003**	
	dinars	**%**	**dinars**	**%**	**dinars**	**%**
Total revenues	31 395 .9	100.0	55 622 .4	100.0	68 490 .7	100.0
out of which:						
Wage and payroll taxes	1 503 .3	4.8	18 319 .9	33.0	22 253 .1	32.5
Sales tax	7 615 .0	24.3	14 336 .7	25.8	18 107 .2	26.4
Property taxes	2 330 .1	7.4	3 736 .7	6.7	3 655 .0	5.3
Non-tax revenues	-	-	-	-	10 548 .8	15.4
Transfers	806 .3	2.6	1 468 .0	2.6	158 .4	0.2
Source: Ministry of Finance of the Republic of Serbia.						

[126] Kind of revenue introduced by the local unit; it can be paid not only in cash but also in the form of work or materials, etc.

A noticeable hike in the share of wage and payroll taxes is accounted for by a tax on salary funds of up to 3.5 per cent that local governments were authorized to levy from January 2002. After this tax was eliminated in July 2004, the ability of local governments to affect their revenue on the margin was limited to non-tax sources, accounting for less than 16 per cent in 2003. Thus, similar to the case of the autonomous province, local units are now mainly financed with funds transferred from the republic. This fact brings us to the conclusion that there is a significant financial dependence of the lower levels of government on the republic level.

Shared revenues

Formally, the system of shared revenues exists only in relations between the republic and local units, because shares of PIT and CIT allocated to the autonomous province are considered as general grants. All revenue shared between the republic and local units come from taxes introduced by the republic. These include several tax instruments (property tax, tax on the transfer of property rights, inheritance and gift tax), which are fully allocated to local budgets. Also, local units were given the authority to collect these latter revenues.

Other shared revenues include several charges for using public resources. These are the following:

- charge for using mineral springs;
- charge for water exploitation;
- charge for exploitation of the forests;
- charge for reclassification of agricultural land;
- charge for building, maintenance, and using local roads;
- charge for environmental exploitation;
- concessions.

These revenues are allocated to municipalities and cities in certain percentages. Only funds collected from the charges for building and maintenance, use of local roads and environmental exploitation belong to the local budgets in total.

Revenue Sharing in the City of Belgrade

As we have already mentioned, Belgrade enjoys a special legal status. This could also be explained in the domain of sharing revenues between the city self-government and its districts. The arrangement related to this issue is given each year in an act adopted by the city assembly under the title of Decision on the Amount of Funds for Executing Tasks of the Self-Government and Districts, and Determination of Revenues Assigned to the Self-Government and Districts. Revenues shared between the city of Belgrade and its municipalities are as follows:[127]

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[127] See for example: Decision on the amount of funds for executing tasks of the self-government and districts, and determination revenues assigned to the self-government and districts in 2004, *Official Gazette of the city of Belgrade, No. 5/04.*

- retail sales tax (till 1 January 2005);
- property tax;
- inheritance and gift tax;
- tax on the transfer of property rights;
- personal income tax;
- payroll tax (till 31 July 2004);
- charge for using building plots;
- charge for maintaining building plots;
- charge for building, maintenance, use of local roads, streets, and other public resources important to the city;
- charge for environmental protection;
- concession charge for public utilities;
- revenues from renting building plots, etc.

It is important to mention the differentiation of retention rates for different municipalities with respect to each revenue source. Differences exist not only between the rates set for urban and suburban municipalities, but also between rates set for municipalities within the same group. Generally urban municipalities get zero or a very small share and suburban municipalities get the full share or a significant share (usually more then 50 per cent of the revenue). The reason for this differentiation is the fact that suburban municipalities are mostly undeveloped and poorer than urban municipalities.

System of intergovernmental fiscal transfers

The system of intergovernmental fiscal transfers in Serbia is, generally speaking, undeveloped. There are several channels of transfers from the budget of the republic to the budget of the autonomous province and local units. However all these transfers represent general, unconditional grants.

Each year the republic transfers a fixed amount of revenues from its budget to budgets of local units and to the budget of the autonomous province. Local units get these funds according to the rules stipulated in the annual law on the distribution of transferred funds from the budget of the republic and sharing the tax on salaries with municipalities, cities and the city of Belgrade (starting in 2005). Transfer of funds from the budget of the republic to the autonomous province of Vojvodina is based on the norms stipulated in the law on the annual budget of the Republic of Serbia.

Also, the fixed share of PIT revenue assigned to municipalities (regarding the mentioned annual law) and the fixed sums of CIT and PIT assigned to the autonomous province (regarding the law on the republic budget) can be considered a form of intergovernmental fiscal transfer. This is because lower levels of governments have no right to influence the amount they receive each year – the amounts of transferred funds is the exclusive decision of the republic. Beside this, local units and the autonomous province do not collect the shared revenues in their territories and have no right to decide about elements of PIT or/and CIT (tax rate, tax base, tax credits, etc). Until now, percentages of PIT and CIT revenues allocated to the province have been changing almost every year. In 2001 and 2002 Vojvodina got 5 per cent of personal income tax (on salaries) and 10 per cent of corporate income tax; in 2003 – 16.3 per cent of personal income tax (PIT) and 50 per cent of corporate income tax (CIT); in 2004 – 18.6 per cent of PIT and 28 per cent of CIT and in 2005 it is going to get 18 per cent of PIT and 42.7 per cent of CIT. These revenues are the main source of financing for the province. This supports our conclusion that the province is financially dependent on the republic.

Until 2005, the major form of transfer from the republic to the local level and the largest revenue source for the local budgets was the retail sales tax. Revenue from this tax was transferred to municipalities and cities in two ways – the first way was the fixed amount is determined each year in the annual law.[128] The second way was through fixed retention rates determined in the Law on Local Self-Government (8 per cent for municipalities, 10 per cent for cities and 15 per cent for the city of Belgrade). The retail sales tax was abolished on 31 December 2004 and from 1 January 2005 the VAT has been implemented in its place in the fiscal system of Serbia. Because revenues collected from VAT cannot be shared on the derivation basis, it was necessary to find another source for transferring funds to local units. As a consequence of abolishing the retail sales tax, local units are now financed with a larger share of PIT (40 per cent compared with 5 per cent till 1 July 2004 and 30 per cent in the period of 1 July 2004 till 31 December 2004) and with a general revenue grant from the budget of the republic.

General grants are distributed with certain criteria that were formerly used for sharing the retail sales tax. These criteria are as follows:[129]

- area of the municipality or city's territory;
- number of inhabitants;
- number of classes and number of primary and secondary schools;
- number of children in social care and number of social care buildings;
- position of the environment in the municipality or city;
- level of development.

Another important form of transfer from the republic budget is the transfer to the state union of Serbia & Montenegro (S&M). Starting in 2003, when the state union was established, it was envisioned that S&M would be financed with funds transferred from the budgets of its members, the Republic of Serbia and the Republic of Montenegro, (state union does not have its own revenue sources). However, to date only Serbia has been transferring funds to S&M. The amount to be transferred is decided at the republic level, and it is given for financing five ministries of the state union. As it is shown in the

[128] It was the Law on participating municipalities and cities in personal income tax and retail sales tax.

[129] See: Article 99, Paragraph 2 of the Law on Local Self-Government *(Official Gazette of the Republic of Serbia, No. 9/02, 33/04, and 135/04)* and Article 3 of the Law on distribution of transferred funds and participation of the municipalities, cities and city of Belgrade in the personal income tax in 2005 *(Official Gazette of the Republic of Serbia, No. 135/04).*

table 1, transfer to S&M accounts for more than 10 per cent of the total republic budget's expenditures (11.56 per cent in 2003, 13.08 per cent in 2004, and 11.98 per cent in 2005).

Because of the fact that all forms of transfers from the republic level to lower levels of government and to the state union are exclusively decided by the republic level of government, a general conclusion about the intergovernmental fiscal system in the Republic of Serbia is that the republic level has a great amount of discretion in how funds are used. A striking feature of the transfer system is its inherently counter-equalizing nature. Not only is it a fact that the same retention rate for a central government tax would generate more revenue in wealthier localities, larger cities were in fact allowed to retain a larger share of the tax revenue than smaller municipalities. Equalization grants obviously could not mitigate this disparity because their volume was negligible relative to the volume of retained tax revenue. In fact, in 2002 the average per capita revenue of the poorest quartile of municipalities was less than half of that of the richest quartile while the richest municipality had six times more revenue per capita than the poorest one. Even among the four cities, there was a three-fold difference in per capita revenue.[130]

Subnational borrowing

The system of subnational borrowing in Serbia, like its system of intergovernmental fiscal transfers, is highly undeveloped. In The Law on Budget System it is said that only the republic and local level of government have the right to borrow funds. The autonomous province has no right to be financed with the funds borrowed in its own name.

Although, local units can borrow funds, their right to get funds from this source is very limited. Municipalities and cities can borrow only for capital purposes (*golden rule of borrowing*). They can borrow both domestically and abroad, taking credits from banks and the central government, and floating their bonds. The borrowed amount cannot be higher than 20 per cent of local revenues realized in the last fiscal year. The main condition for local borrowing is creditworthiness.[131]

The Law says that the level of republic can guarantee repayment of debt by legal persons.[132] However, there is no exact norm that would require the republic to issue a guarantee for local government borrowing. Also, in practice the republic usually does not provide such a guarantee. This is the main reason why creditors do not want to enter into any kind of contract for crediting local units, because they cannot be sure that they will get back their funds. The outcome of this situation is that municipalities and cities in Serbia rarely use borrowing as the source of their financing.

[130] Tony Levitas, 'Next Steps for Intergovernmental Finance Reform in Serbia', USAID/DAI, 2004.
[131] See: Article 58 of the Budget System Law, *Official Gazette of the Republic of Serbia, No. 9/02 and 87/02.*
[132] In Serbia local units have the status of legal persons.

The system of borrowing should be developed so that local units have the opportunity to borrow funds from different institutions. Special municipal funds could be established that would borrow for small and undeveloped municipalities that cannot borrow funds by themselves and cannot issue bonds.

Concluding Remarks

The general conclusion of this study regarding the system of intergovernmental fiscal relations in Serbia is that it has changed significantly since 2000. However the decentralization reform is not completed and more changes are needed. Although the recent changes helped the Serbian system to become more decentralized, it is still very centralized, with the republic level holding a great amount of control. Specifically, although municipalities and autonomous provinces were assigned new sources of own revenues and larger shares in the revenues of the republic, they are still highly dependent on the republic. The most important sources of financing local units are general grants from the republic budget and a retained share of the personal income tax. Although, local units were authorized to utilize some new sources of their own revenues, they do not collect too much revenue from these sources, which is the reason for their continued dependence on transfers from the republic. The most important source of financing the autonomous province is general grants from the republic budget and transferred shares of the personal income tax and corporate income tax. Since 2001, the autonomous province has had the right to introduce several sources of its own revenues, but they are not very productive. This makes the province budget financed, for the most part, with transfers from the republic. Thus it can be concluded that transfers from the republic to the lower levels of government is a way of holding lower levels of government under control of the central government.

Considering the general tendency among transition countries (with Serbia being one of them) of moving towards a more decentralized system, it is necessary to make lower levels of government more independent from the central (republic) level of government.

First of all, it is necessary to provide local units with more productive sources of their own revenues. This may be achieved by allowing higher rates of local taxes or broadening the tax base. Furthermore, some of the non-tax sources of revenues could be transformed into local taxes. It is the case with local communal fees,[133] which have most characteristics of a local tax. Namely, local communal fees can be introduced for using different services (which is the realization of the benefit-tax link principle). If these sources of revenues are reintroduced as local taxes, they should have higher rates and a broader base, which would bring many more funds to local budgets.

Also, the property tax, the tax on the transfer of property rights and inheritance and gift tax, which is now fully ceded from the republic to local units, should become the taxes of local units. These taxes should be introduced by the republic, but determining the rate and

[133] Local communal fees can be introduced in 16 cases of using rights, objects or services (e.g. for using public spaces, hosting gambling, advertising, etc.).

collection should be within the authority of the local units. They would determine the tax rate within the range (minimum and maximum tax rate) defined by the republic.

Local units should also be provided with some new revenue sources that do not exist in the present tax system in the Republic of Serbia. They could be allowed to tax income generated in their territory. It could be in the form of a surcharge on personal income tax *(piggyback tax)*, which is currently assigned to the republic.

Also, the percentage of the PIT revenue transferred to local units should be higher. The best solution would be to use this revenue for the purpose of equalization. Some formula could be used for the transfer allocation, which for example could bring each local unit's per capita revenue to a certain per cent of the total national average (e.g. 80 per cent or 85 per cent).

The financing of the autonomous province will depend on its status under a new constitution, which should be adopted soon. Generally speaking, Vojvodina should be given more sources of revenues. Also, the province could be financed with certain forms of grants from the budget of the republic, and could be given the right to borrow funds.

The steps we mentioned above are only a small part of what should be undertaken to make the Serbian system better and more decentralized. Also, as far as we know the Government of Serbia intends to achieve a more decentralized system of intergovernmental fiscal relations, but the steps that it has undertaken have not yet led to the intended system. One of the reasons for that is the wish to hold municipalities dependent on the republic level of government. However, it can be expected that one or more international donors will finance the realization of the above steps.

Currently, many international donors and agencies operate in Serbia: USAID, the US Treasury, UNDP, SDC, OSCE, the World Bank, International Monetary Fund, European Agency for Reconstruction, SIDA, and the Dutch Government. They pursue different projects, mainly focused on restoring the Serbian infrastructure and economy, and on improving living conditions in Serbia. If we take into consideration projects financed by UNDP and related to intergovernmental fiscal relations, we should emphasize the current project titled 'Municipal Improvement and Revival'. This project deals with 13 municipalities located in south Serbia, and its goal is promoting transparent accountable decision-making and good governance practices, and contributing to the implementation of the Poverty Reduction Strategy Paper (PRSP) by strengthening municipal capacities for service delivery; improving community and civil society participation in municipal planning and decision-making and relieving the effects of economic collapse through labour intensive sub-projects identified by citizens.

UNDP is currently supporting the strategic planning for a sustainable development programme in southwest Serbia, in close cooperation with the local administration, business sector and civil society.

Also, in 2003 UNDP started a project focused on the organizational change of the Standing Conference of the Cities and Municipalities (SCCM)[134]. Policy advice and training were provided to several departments of the SCCM (department for local development, department for local finance, and department for local administration).

This UNDP project also earmarked funds to support the establishment of a municipal training centre as a unit of the SCCM. However, municipal training centres still cannot be established in many municipalities, because they do not have enough financial strength. This effort is intended to be continued in the future as part of the new UNDP project development. The goals of establishing municipal training centres are as follows:

- support institutionalization and growth of the SCCM in the coming years;
- development of services for municipalities and cities to the parliament and government, such as lobbying, advocacy, training, advisory, etc.;
- review of the functions in local units (why some functions are better executed in certain municipalities and not in others);
- developing a benchmark system for the local units, where municipalities 'with good practices' will be financed by the SCCM (with funds from UNDP) and are going to be examples for other municipalities, etc.

Considering, the intention of the Serbian Government to decentralize further, especially in the fiscal sphere, UNDP's office in Serbia is very interested in projects related to this issue.

[134] Standing Conference of the Towns and Municipalities is an independent body (association of local units), which deals with the problems and different actions of local units and helps them to communicate with the Government of Serbia.

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Annex: An Assessment of Fiscal Decentralization in Serbia

TABLE 1
ASSESSING THE STATUS OF FISCAL DECENTRALIZATION REFORMS IN SERBIA

	(A) Overall policy stance and policy effectiveness	(B) Constitutional & legal framework	(C) Central govt institutional and regulatory framework	(D) Local gov't institutional and regulatory framework	(E) Participation by civil society and private sector
(1) Structure and role of public sector	§ Inherited large public sector, reverse sequencing of decentralization	§	§ national control over local government salaries	§ LG property renationalized in the 1990s	§
(2) Functional and expenditure assignments	§	§ fusion of responsibility over primary and secondary education	§	§	§
(3) Assignment of revenue sources		§ LG revenue-raising powers limited to non-tax sources	§	§	§
(4) Intergov. fiscal transfers, incl. the scope of unfunded mandate	§ counter-equalizing revenue sharing	§	§ negotiated grants; lack of transparency	§	§
(5) LG borrowing and infrastructure development	§	§	§	§	§

TABLE 2
KEY FISCAL DECENTRALIZATION REFORM INITIATIVES PURSUED IN SERBIA

	(A) Overall policy stance and policy effectiveness	(B) Constitutional & legal framework	(C) Central govt institutional and regulatory framework	(D) Local gov't institutional and regulatory framework	(E) Participation by civil society and private sector
(1) Structure and role of public sector		§	§	§	§
(2) Functional and expenditure assignments	§	§	§	§	§
(3) Assignment of revenue sources	§	§ 2004 legislation replacing sales tax with VAT will necessitate major changes in local government finance	§ Law on Financing of Local Governments in Serbia § Law on Devolution of Property	§	§
(4) Intergov. fiscal transfers, incl. the scope of unfunded mandate	§	§	§	§	§
(5) LG borrowing and infrastructure development	§	§	§	§	§

TABLE 3
REFORM PRIORITIES FOR FISCAL DECENTRALIZATION IN SERBIA

	(A) Overall policy stance and policy effectiveness	(B) Constitutional & legal framework	(C) Central govt institutional and regulatory framework	(D) Local gov't institutional and regulatory framework	(E) Participation by civil society and private sector
(1) Structure and role of public sector	§	§	§	§ Support to reform of local administration in Serbia	§
(2) Functional and expenditure assignments	§	§ Revision of the current Law on Local Self Government	§ Support to the Implementation of the Public Administration Reform Paper	§ Capacity development for the good local governance	§ Innovative PPP programmes § Strengthening of civil society in local governance
(3) Assignment of revenue sources	§ More robust revenue sources at the province and local government levels	§	§	§ Greater utilization and collection of existing sources and new revenue sources § Authority to set the rates for property and other local taxes	§
(4) Intergov. fiscal transfers, incl. the scope of unfunded mandate	§	§ New legal framework for equalizing the transfers	§	§	§
(5) LG borrowing and infrastructure development	§ Establishment of municipal bond bank to support borrowing by very small units	§ Guarantees from the republic level for local government borrowing strengthened	§	§	§