THE IMPACT OF THE FISCAL DECENTRALIZATION PROCESS IN THE LOCAL PUBLIC FINANCE OF THE WESTERN BALKAN COUNTRIES: A COMPARATIVE ANALYSIS

Jeton Mazllami, Rufi Osmani

South East European University, Faculty of Business and Economics

Republic of Macedonia-Tetovo

Abstract

The process of implementing structural reforms and as part of them fiscal reforms, in the Western Balkan countries during the post communist phase of their development was conducted in unfavourable socio-economical and political circumstances. Even besides the strong technical and financial assistance provided by relevant international institutions such as the World Bank, the International Monetary Fund and the European Union, the process failed in terms of meeting the objectives in the field of sustainable economic development, elimination of (social, economic and fiscal) disparities on the local, regional and central level, decreasing unemployment etc.

The process of transformation of the Western Balkan countries was characterised by obvious failures and delays that in fact had consequences on the dynamics of the process of EU and NATO integration.

The process of fiscal consolidation is a very complex issue and depends on many endogen and exogen factors that determine the success of fiscal reforms both on the local and central level. In the analysed countries the implementation of fiscal reforms has been closely connected to macroeconomic stability, fiscal consolidation, socio-economic cohesion and the functionality of the state of law. Western Balkan countries have many similarities and difference both from a qualitative and quantitative point of view.

The level of fiscal decentralization in these countries is far behind the EU in terms of volume, structure and quality of funds being managed at the local and regional levels. This paper aims at determining the real level of financial and fiscal decentralization, as well as to provide a comparative analysis of the Western Balkan countries and between them and the EU.

Having this in mind, the paper will be focused on providing insides regarding the process of fiscal decentralization in the Western Balkan countries (Macedonia, Albania, Kosovo, Montenegro, Bosnia and Herzegovina and Serbia) and the EU. Based on such analysis, proper conclusions and recommendations about solving fiscal and legal deficits and the possible advancements if this process based on the successful EU models of decentralization in multiethnic countries will be made.

Key words: *Fiscal decentralization, Structural and fiscal reforms, Public revenues and expenditures*

1. Introduction

During the complex process of political and economical transition, the Western Balkan countries during the last two decades have been faced with immense challenges in implementing economical reforms and reforming the public institutions. The asymmetric progress among the transitioning countries of the Western Balkan arguments the general theoretical conclusion that discussing and analyzing the economical policies and institutional reforms is an easy task, but the creation and implementation of the policies and strategies is a very complicated issue that is affected by many factors.

Structural economical and institutional reforms impacted not only economic but also general societal issues and the implementation of particular reforming programs resulted in many negative economical,

political and social consequences for most Western Balkan countries during the first decade of transition.

The determinations of economical and social policies as well as the progress in implementing economical reforms are influenced by the political circumstances, the general social environment, the sheet of payment, financial resources and the institutional capacities available for the implementation of such reforms.

In fact, the asymmetric development during the previous system, and the low levels of economical growth followed by increasing levels of unemployment, poverty, the informal economy and fiscal evasion were the main obstacles in implementing institutional reforms and the establishing of a functional market economy in the Western Balkan's.[1]

In the fiscal sphere, a sphere that requires sufficient tax incomes in order to cover the public expenditures, a successful reformation required the creation of well functioning fiscal institutions as well as suitable expenditure programs that would assist the large number of newly unemployed that were a nus-product of the early stages of economical transition.

In unsuitable political and economical conditions, aside from the need for economical and fiscal stabilization, the Western Balkan countries began the process of political decentralization and fiscal decentralization as its part. During the last two decades the process of political and fiscal decentralization has showed some results in terms of delegating several decision competencies and fiscal founds to the local authorities.

Organizational restructuring at the local level is diverse due to the fact that some WB countries have one level local government, some have two-level local organization while Bosnia and Herzegovina has a three level organization. This on the other hand, accompanies by different systems of control over finance makes it very difficult to conduct a proper comparative analysis of the Western Balkan countries and them as opposed to the EU.

Research conducted by relevant international institutions such as the World Bank, the European Commission and the fiscal authorities of analysed countries prove that compared to the EU the Western Balkan countries have low levels of fiscal decentralization at the level 5-6% of GDP that equilibrated with 40-50% of the EU, while compared to the public expenditures this level arrives at 15-16% that equilibrated with 55% of the EU.

A more detailed analysis of fiscal decentralization measured with the public incomes and expenditures index as well as the capital investments per capita shows very low levels that achieve only 10% of those in the EU. The process of political and fiscal decentralization in the Western Balkans should be advanced through additional reforms and above all by delegating additional public finance to be managed by the local authorities.

2. Research methodology

In order to meet the set objectives of this paper, that is to determine the negative sides, the disparities and eventual similarities of the financial sectors of the Western Balkan countries we have analysed the period 2006-2012 for the following countries: The Republic of Macedonia (MKD), the Republic of Albania (ALB), the Republic of Kosovo (RKS), Montenegro (MNE), Bosnia and Herzegovina (BIH), Serbia (SRB) and the average of European Union countries (EU27).

By using common statistical and descriptive methods we will provide a proper empirical and comparative analysis of the process of fiscal decentralization among these countries and compared to the EU27 averages countries in terms of:

[1] Coletti R., Stochiero A., 2011, *Decentralization and local development in Western Balkans: convergences and divergences among different*, CeSPI.

- Local Government Revenue and Total Public Revenue as % of GDP,
- The structure of Local Revenues and Expenditures (LGR & LGE),
- The trend of Local public finance and their compared to the central level,
- The level of Local Revenue and Expenditures as % of GDP,
- The level of Local Revenue and Expenditures as per capita,
- Capital investment per capita at the local level,
- Public dept at the local and central level relative to the GDP, etc.

3. The evolution of public finance in the Western Balkan's compared to the EU

The public finance of the analysed Western Balkan countries show quite asymmetric levels and trends compared to the EU averages. This can be seen from the analysis of public incomes and expenditures in proportion to the GDP, the impact of the financial crisis in the implementation of macroeconomic policies and the different intensities in implementing the economic and institutional reforms as part of a prolonged process of economic and political transition.

The Republic of Albania has had the lowest level of public incomes in proportion the the GDP for 2013 (only 25%), but this can be mainly contributed to the high level of fiscal evasion and the highly developed informal economy *(See table 1)*. This argument serious failure of the Albanian authorities in implementing institutional reform in terms of fiscal consolidation and development of a truly functional market economy as part of the Maastricht and Copenhagen criteria.[2]

Table 1. Local Government Revenue and Total Public Revenue (% of GDP) in 2012

	MKD	ALB	KSV	MNE	BIH	SRB	EU27
Consolidated Public Revenue (% GDP)	38.0	25.0	33.0	41.0	40.0	42.0	49.0
LG Revenues (% GDP)	6.5	3.1	7.6	6.5	3.8	6.6	11.8
LG Revenues (% Public revenue)	17.1	12.4	23.0	15.8	9.5	15.7	24.0

Source: Fiscal Decentralization Indicators for SEE 2006-2012, NALAS, authors calculation

If LG Revenues (% Public Revenues) are analysed, it turns out that all of these countries are under the EU27 averages. It should be noted that the lowest values are found in BIH (9,5%) that proves a high level of concentration of incomes at the central level and a low level of fiscal decentralization. Albania also shows a low level of participation of Local Government Revenue in proportion to the GDP (3,1%) and public revenues in proportion to the GDP (12,4%).

The fiscal consolidation of Kosovo has shown positive trends during the last decade, even besides the fact that this country has the lowest budget and smallest economy in the Western Balkans and Europe due to the delayed independence from ex Yugoslavia and the low level of economic development that was caused due to many factors of both economical and non-economical nature.

An analysis of the trend of LG Revenues shows that for the period 2006-2012 Macedonia has had a considerable growth of 4,3% (from 2,2% to 6,5%), that is a growth of 195% in 2012 compared to 2006 *(See table 2 and chart 1)*. This result can mainly be addresses to the implementation of the second

[2] Osmani R.&Mazllami J., 2014 *A challenging path toward the EU: The fulfillment of the Maastricht criteria in Macedonia and Albania*, International Conference on economic and Social Studies "Regional and Economic development", Sarajevo, BH

phase of fiscal decentralization and the transfer of funds for covering wages for teachers to the local levels, as well as the transfer of 3% of GDP incomes to local authorities.

Kosovo as the youngest country from the Western Balkan region has shown improvement of 2,6% (from 5% to 7,6%) as shown in table 2 and chart 1. This can be addresses mainly to the decentralization of the health sector as well as primary and secondary education.

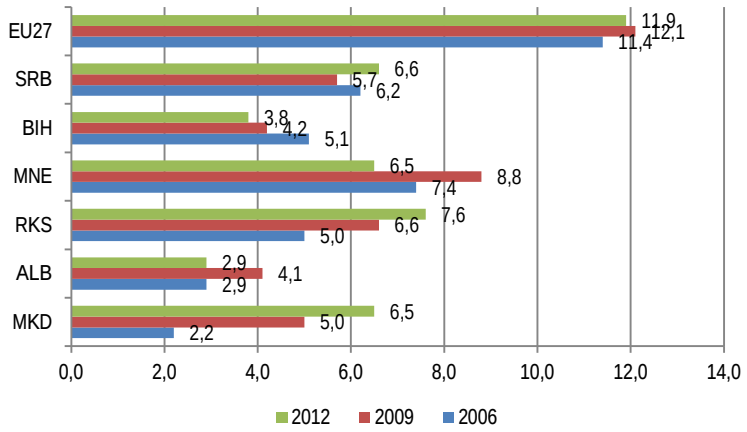
The negative trends in the other WB countries are a result of the global financial crisis and the growing fiscal and economical deficits resulting in less public money being delegated to the local authorities.

Table 2. Local Government Revenue (% of GDP and EU) 2006, 2009, 2012

	2006	**% EU27**	**2009**	**% EU27**	**2012**	**% EU27**	**2012/06**	**(%)**
MKD	2.2	19.3	5.0	41.3	6.5	54.6	4.3	195
ALB	2.9	25.4	4.1	33.9	2.9	24.4	0.0	0
RKS	5.0	43.9	6.6	54.5	7.6	63.9	2.6	52
MNE	7.4	64.9	8.8	72.7	6.5	54.6	-0.9	-12
BIH	5.1	44.7	4.2	34.7	3.8	31.9	-1.3	-25
SRB	6.2	54.4	5.7	47.1	6.6	55.5	0.4	6
EU27	11.4	100.0	12.1	100.0	11.9	100.0	0.5	4

Source: World Data Bank 2014, authors calculation

Chart 1. Local Government Revenue (% of GDP), 2006-2012



Albania, Serbia, Montenegro and Bosnia and Herzegovina show lower levels of local public revenues, but it should be noted that the health sector and public education in these countries are fully managed by the central government therefore there are no budgetary incomes as in the case of other countries that are part of this analysis.

Analysis show that WB countries delegate as much as 54% of public funds to local authorities which is only 54% of the money delegated in the EU. These levels are not sufficient and therefore should be improved by allocating additional funds from the central government to local authorities in terms of fulfilling the Maastricht and Copenhagen criteria set by the EU.

The analysis of local fiscal income per capita of the WB countries compared to the EU average shows very low levels compared to the EU. In the EU the proportion between LG Revenues (LGR) and All other Public Revenues (AoPR) is 37,1%. If compared with the individual countries of the WB, Kosovo has the highest percentage of 30,4% and then follow Macedonia with 20,6%, Montenegro and Serbia with 18,8% , Albania with 14,1% and Bosnia and Herzegovina with 11,4% *(See table 3).*

Such low levels of local incomes per capita are due to the high level of centralization of public finance, low levels of economical and social development and result in low levels of public goods, low quality of municipal services and unsolved infrastructural, social, ecological issues in the WB.[3]

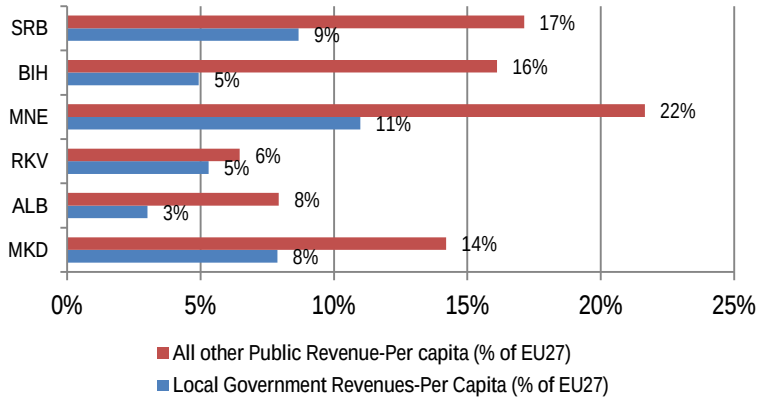
Table 3. Consolidate Public Revenue and Local government Revenue Per capita (Euro) – 2012

	MKD	ALB	KSV	MNE	BIH	SRB	EU27
Local Government Revenues	238.0	91.0	160.0	332.0	149.0	262.0	3,020.0
All other Public Revenue	1,157.0	646.0	527.0	1,763.0	1,312.0	1,395.0	8,144.0
% (LGR/AoPR)	20.6%	14.1%	30.4%	18.8%	11.4%	18.8%	37.1%

Source: Fiscal Decentralization Indicators for SEE 2006-2012, NALAS, authors calculation

If Local Government Revenues (LGR) per capita of the WB countries would be compared with EU27 it turns out that Albanian with only 91 dollar per capita is at the lowest level reaching only 3% of the EU average. Kosovo and Bosna and Herzegovina are at the level of 5%, Macedonia 8%, Serbia at 8,7% and Montenegro 11% of the EU average. *(See chart 2).*

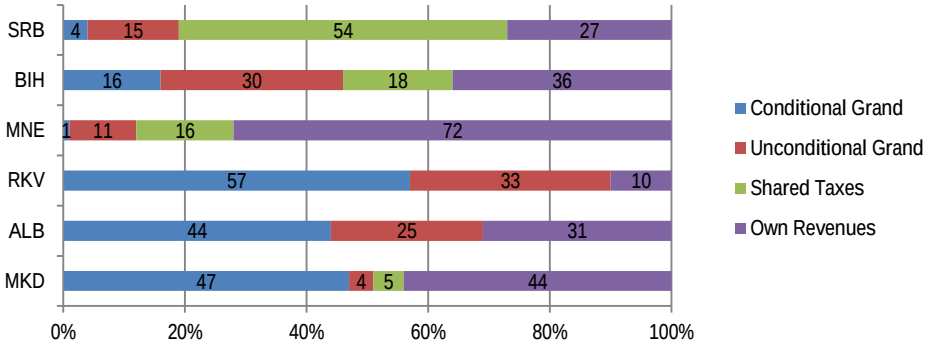
Chart 2. All Public Revenue and Local Government Revenue Per Capita (% of EU27)



The structure of local public incomes is a reflection of shared, delegated and personal competencies of the central and local authorities in the WB countries. The structure of LGR in all WB countries is comprises of: *Conditional Grand, Unconditional Grand, Shared Taxes and Own Revenues*. Serbia has had the highest level of Shared Taxes incomes in the structure of LGR for 2012 (54%) and this reflects the high level of Shared Taxes from the central government towards the local units *(See chart 3).*

[3] NALAS, *Report Fiscal Decentralization Indicators for SEE 2006-2012, 2014*

Chart 3. Structure of LGR (%)-2012



The lowest level of local public incomes in proportion to the General public incomes of found in Bosnia and Herzegovina (10%) and Albania (12%) while the highest level can be found in Kosovo (29%) as shown in table 4. The relative data for the local public expenditures are not a reflection of the real conditions due to the fact that in the case of Macedonia, Kosovo and Bosnia and Herzegovina they do not include the financial funds dedicated to primary health and public education which accounts for 50% of the consolidated municipal budgets.

Table 4. Structure of Local Government Revenue (%) in 2012

	MKD	ALB	KSV	MNE	BIH	SRB
Conditional Grand	47.0	44.0	57.0	1.0	16.0	4.0
Unconditional Grand	4.0	25.0	33.0	11.0	30.0	15.0
Shared Taxes	5.0	/	/	16.0	18.0	54.0
Own Revenues	44.0	31.0	10.0	72.0	36.0	27.0
	100.0	100.0	100.0	100.0	100.0	100.0
LGR (% of Public Revenue)	15.0	12.0	29.0	16.0	10.0	16.0

Source: Fiscal Decentralization Indicators for SEE 2006-2012, NALAS, authors calculation

In the case of the WB countries (table 4) a clear asymmetry of the participation of Own Revenues in the structure of LRG can be noticed. Montenegro compared to the other WB countries and the EU27 average is in the most favourable position. With 72% participation of own revenues in the structure of LRG. This presents an additional prove for the high level of fiscal independence of the local government in Montenegro compared to other WB countries.[4]

The Republic of Kosovo has the lowest participation of own revenues in the total structure of municipal revenues (only 10%). This proves that the youngest country in Europe is still in the early stages of the fiscal consolidation of its municipalities and the payment of local taxes is quite low due to the delayed focalization as well as the low level of economic development, high unemployment and extreme poverty[5].

[4] UNDP, 2012 *Country Report: An Assessment of Fiscal Decentralization. Reform in Serbia and Montenegro. In Fiscal Decentralization in Transition Economies: Case Studies from the Balkans and Caucasus, (2004-12).*

[5] Robert D. Ebel and Gábor Péteri, 2007, *The Kosovo Decentralization Briefing Book*, Kosovo Foundation for an Open Society and the Local Government and Public Service Reform Initiative of the Open Society Institute-Budapest.

The level of 27% in the case of Serbia and 44% in Macedonia, shows that these countries still have unutilised potential for local revenues due to the partial focalization, partial payment of local taxes, the non-consolidates fiscal evidential and the low level of coordination with state institutions and courts.

One of the most serious issues that local authorities face in managing public finance is the lack of coordination of the process of planning the public budgetary revenues and the implementation of such plans. In fact local authorities are uncap able to undertake effective measures for gathering the planned revenues mostly due to the lack of proper human resources and the lack of information regarding the real tax potential.

Due to the above mentioned reasons each year tens of millions of Euros remain uncollectability by local authorities and in a couple of years such sums get treated as old payables and cannot be gathered.

The structure of finance in all analysed countries shows a high level of dependence of the local authorities from the central governments when it comes to providing finance for covering the operative expenditures that are necessary for a normal functionality of the local institutions.

4. The trend and structure of public expenditures in the Western Balkan

The analysis of the structure of public expenditures in the WB countries shows a high participation of operative expenditures in the total expenditures compared co expenditures for public investments. Serbia should be mentioned in this sense. In fact in Serbia the non-capital expenditures cover 81% of the total structure of expenditures, while only 19% of expenditures are dedicated to capital investments. In Kosovo on the their hand operative expenditures cover 65% and capital expenditures cover 35% of the total structure of expenditures. *(See table 5).*

On first view one might get the impression that WB countries are in a more favourable position compared to the EU where capital expenditures cover only 12% of the total expenditures, but one must bear in mind the fact that the WB countries have lower levels of development meaning that now they are in the process of the creation of public goods that have been created by EU countries years ago such as: road infrastructure, municipal infrastructure, cultural and sport institutions, health care institutions etc.

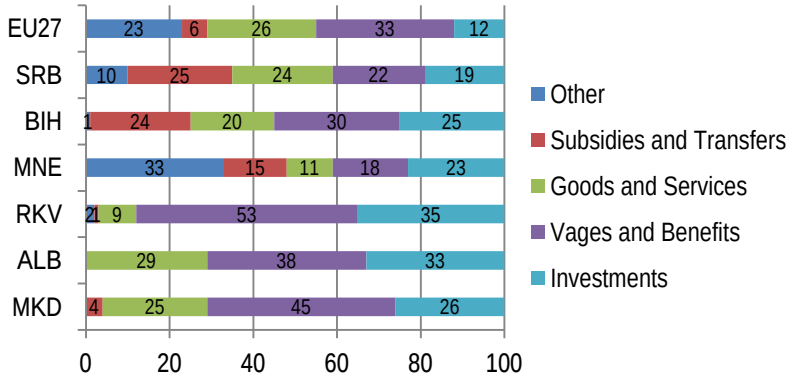
Table 5. Structures of Local Government Expenditures in 2012 (%)

	MKD	ALB	KSV	MNE	BIH	SRB	EU27
Other	/	/	2.0	33.0	1.0	10.0	23.0
Subsidies and Transfers	4.0	/	1.0	15.0	24.0	25.0	6.0
Goods and Services	25.0	29.0	9.0	11.0	20.0	24.0	26.0
Wages and Benefits	45.0	38.0	53.0	18.0	30.0	22.0	33.0
Investments	26.0	33.0	35.0	23.0	25.0	19.0	12.0

Source: Fiscal Decentralization Indicators for SEE 2006-2012, NALAS, authors calculation

A structural analysis of LGE shows that WB countries spent much more for wages and benefits compared to the 33% EU average. In fact RKV (53%), MKD (45%), ALB (38%) has higher expenditures of this nature compared to the EU average. On their hand BIH (30%), SRB (22%) and MNE (18%) have lower expenditures for wages and benefits compared to the EU27 average. *(See chart 3)*

Chart 3. Structures of Local Government Expenditures in 2012 (%)



It should be mentioned that these proportions are highly doubtful having in mind that in many cases in the WB countries capital investments are managed by the central government but evidenced as capital investments of the municipalities with the exception of investments made in the capitals of the WB countries.

An analysis of LG Investment per capita in the WB countries shows that in 2012 Albania had the lowest level (20 euro per capita), while Montenegro (78) and Macedonia (55) had the highest levels *(See table 6)*.

The average LG investments per capita for the 2006-2012 period shows that the analysed countries have retained the same position even though RKV has under the level of SRB. If LG investment per capita for the same period are compared to the EU27 average, a huge gap in LGI per capita is noticed: ALB only 6,3%, MKD (10,1%), BIH (10,7%), KSV (13,2%), SRB (15,9%) and MNE (39,5%) *(See table 6.)*.

Table 6. Local Government Investment in Per Capita (Euro)

	2012	Ø (2006-12)	Av/EU27 (%)
MKD	60.0	37.0	10.1%
ALB	20.0	23.0	6.3%
KSV	56.0	48.0	13.2%
MNE	78.0	144.0	39.5%
BIH	43.0	39.0	10.7%
SRB	55.0	58.0	15.9%
EU27	345.0	365.0	100.0%

Source: World Data Bank 2014, authors calculation

The level of LG investments per capital is an additional argument about the low level of delegated investment decision making to the local authorities. It should be noted that public investments in educations, infrastructure, ecology and other issues of local interest are managed by state agencies in cooperation with donators and external crediting institutions. As a result the fiscal decision making autonomy of local authorities in marginal.

In the Republic of Macedonia capital investments and grant transfers are made based on political and party criteria. These results in political and ethnical discrimination that in turn even further degrades these low levels of fiscal decentralization in minority dominated municipalities. [6]

The level of public debt in proportion to GDP in the WB countries is within the 60% determined by the Maastricht criteria and the fiscal deficit is within the 3% of the general public expenditures with certain exceptions *(See table 7 and chart 4)*. Is should be noted that the public data regarding the public debts in these countries are not fully correct due to the fact that in many cases the debts of the public enterprises and there are serious doubts that the central authorities in many cases manipulate the official statistics regarding the public debt.

One of the most notable examples in this sense is Macedonia which as can be noted from the data presented in table 7 has published a 34% debt in proportion to its GDP. On the other hand after the last elections of April. 2014 the government published a 500 million euro in Eurobonds and thus increased the public debt by 7% due to the lack of liquidity of the public sector and the maturation of debts made previously without full public transparency.[7]

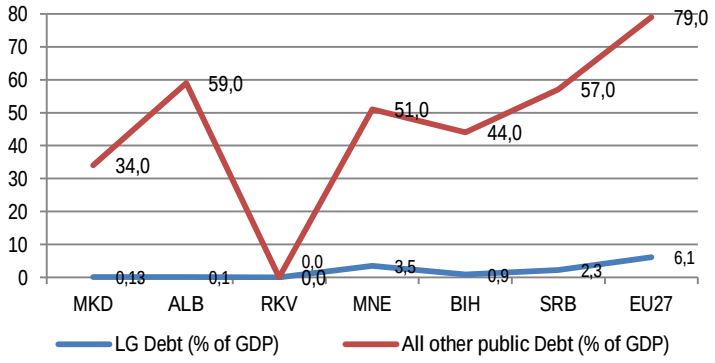
Most municipalities and public enterprises in the Republic of Macedonia have chronic lack of liquidity due to their blocked accounts because of their inability to pay matured debts even though the public statistics of the country show very low levels of public debt of the local authorities. Such situations make the public data regarding the public debts of all levels in the WB region highly doubtful.[8]

Table 7. General and Local Government Debt (% of GDP) 2012

	MKD	ALB	KSV	MNE	BIH	SRB	EU27
LG Debt (% of GDP)	0.13	0.1	-	3.5	0.9	2.3	6.1
All other public Debt (% of GDP)	34.0	59.0	-	51.0	44.0	57.0	79.0

Source: Fiscal Decentralization Indicators for SEE 2006-2012, NALAS, authors calculation

Chart 4. General and Local Government Debt (% of GDP) 2012



[6] UNDP, 2012, *Country Report: An Assessment of Fiscal Decentralization Reform in Macedonia. In Fiscal Decent. in Transition Economies: Case Studies from the Balkans and Caucasus (2004-2012)*

[7] Schlumber Sema 2004, *Technical Assistance to Ministry of Finance of FYROM on Fiscal Decentralization: Municipal Debt Assessment"*, Skopje

[8] Tony Levitas 2011, *Local Government Finances and the Status of Fiscal Decentralization in Macedonia: A Statistical Review 2008-2011*, USAID, Macedonian Local Government Activity.

The debt policies in the WB region are an exclusive competence of the central authorities and this can be proved by the low level of municipal debts due to the fact that in order to make debts municipalities must previously get a permit from the central government which in turn guarantees the debts of the municipalities.

Such public debt policies are a result of the lack of fiscal capacities on the side of the municipalities as well as the fact that a major precondition for getting loans from international financial institutions and markets is that municipalities should get credit righting from the relevant international agencies. The criteria introduces by the righting agencies are usually not fulfilled by municipalities with the exception of the capitals of the analysed countries.

5. Conclusions

The process of decentralization in general and fiscal decentralization in particular in the WB region introduced highly complex political reforms with high risks to economic and political stability that in certain cases resulted even in inter-ethnic conflicts (Bosnia and Herzegovina, Kosovo and Macedonia).

This political and fiscal process has in certain cases been used by the political representatives of the majority ethnic groups in inter-ethnic countries to create long term systematic discrimination against the minorities. This on the other hand has resulted in consequences for the political, economical and social stability of the WB countries.

The assistance and serious mediation of the representatives of the EU and USA has been of great importance in terms of projecting, implementing and guarantying a qualitative process of political and fiscal decentralization in the WB countries and the creation of institutional capacities and inter ethnic reconciliation as one of the perspectives towards the EU.

Even besides the support provided by the EU and international institutions the process of fiscal decentralization in the Western Balkan countries has been very politised, characterised by permanent inter-ethnic conflicts, an over prolonged process of fiscal reforms followed by expressed disparities between the function delegated to the local levels and financial deficits (tax transfers, grants etc), an interference of central authorities in the authorizations of local governments and systematic discrimination in capital investments.

The empirical and comparative analysis of the Western Balkan countries and the European Union showed many common problems and dilemmas that need to be addressed, but the issue of setting priorities at the central and local levels remains unsolved.

The following recommendation can be made as activities that would result in improved financial sustainability and fiscal decentralization

- Increasing the participation of local public finance of the WB countries in proportion to their GDP to the EU averages in a five year period.
- The creation of legal mechanisms that would ensure proportional allocation of grants and dotations with the purpose of eliminating local and regional disparities in public revenues.
- The creation of legal mechanisms for the allocation of public finance for financing social, health care services and education based on the number of population and pupils that are a part of the public educational system.
- Allocation of capital investments as part of the local public expenditures with the aim of eliminating the inherited discrimination based on the criteria of capital investments per capita.
- Improvement of the administrative and managerial capacities of municipalities in cooperation with the central government with the aim of improving the level of municipalities own public revenues.
- Improvement of the cooperation between the local and central authorities by creating joined agencies that would ensure a more efficient sage of IPA and IPARD funds of the EU in order to provide higher levels of local economic development.

- Elimination of the debt of municipalities and local public enterprises toward the central government as one of the precondition for stabilization local public finance.
- Revision of the legal constraints for financing capital investments of public interest through public-private partnerships and allowing Local Government Debt of 10% of their budget.

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