LOCAL GOVERNANCE IN AN INTERNATIONAL COMPARATIVE PERSPECTIVE COMPARING LOCAL GOVERNMENT FINANCES IN MACEDONIA WITH SLOVENIA

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Abstract

Local Government finance is of immense importance for a state and for the government functions of rendering services to the citizens. Local finances reflect the fiscal independence of municipalities and the financial capacity to carry out its responsibilities under the legal provisions of the central government. It is therefore very important to monitor the development of local finance in transition countries and in transferring experiences from countries with higher fiscal decentralization to countries which are pre-accesion candidates to EU. Countries with higher fiscal decentralization are more acceptable bycountries that are recently new members of the European Union under similar region. In this study, a parallel overview of the local finances of new member country in the EU, Slovenia and pre-accesion candidate country to the EU i.e. Macedonia, was taken.

Keywords: Local Government, budget, central government, GDP, revenues, expenditures, VAT, PIT, GDP, share tax, earmarked grants, regional development, EU

Introduction

This study makes a comparison between tax structure and the level of local fiscal autonomy. It analyzes the system of financial revenues, expenditures, and equalization which is an important parameter for revenue mobilization which is the lower correlation between normative local and central level. This review gives reliable comparative data on municipal finances and intergovernmental fiscal relations in Macedonia and Slovenia.

Macedonia is one of the countries where the Fiscal decentralisation system began in 2005. However, it was not accomplished due to the comparsion with Slovenia where the local finance system has a higher decentralization function, and even some parameter are the same in the share of local government finance as percentage of GDP. The share of local finance in Slovenian municipalities amounts to about 5-7% of the GDP (EU around 12%) with currently 211 municipalities. Comparing the results with that of Macedonia, there are 81 municipalities. Thus, LG finance are around 5% of GDP which are the main challenges that makes local governments finances differ in these two countries. Nevertheless, at local levels, both countries differ in terms of the development, which are the positive sides of a state that is already a member of the EU.

In particular, we are yet to obtain good data on the distribution of revenues and expenditures across local governments of different sizes and types. This is problematic because in many countries, revenues and investment expenditures are heavily skewed towards wealthier jurisdictions, particularly in the capital cities. In this study, the first step was taken towards filling and presenting the narrative description of each country's financial systems.

Nonetheless, the report provides a reasonably clear picture of the structure, functions, and financing of local governments in Macedonia and Slovenia. Furthermore, it also provides an overview of how intergovernmental financial relations have evolved economically over the period of 2009-2013. This study begins with a review of the structure and functions of municipal governments in Macedonia and Slovenia's municipalities, as well a few key macro-economic indicators. It presents comparative indicators of the fiscal decentralization of the states in general, and focuses on the main changes that have occurred in the local government finance systems of each country.

Data and Methodological Issues

Comparing intergovernmental finance systems varies substantially from country to country. Municipal governments constitute the most important level of democratically elected sub-sovereign governance in the region when measured in fiscal terms.

Throughout South East Europe, municipalities and communes bear the primary responsibility of maintaining and improving local public infrastructure. This includes local roads, bridges, and parks, as well as water supply and sewage treatment, garbage collection and disposal, public lighting, local public transport, and district heating. In most of the region, network infrastructure has been neglected or underfunded for decades, and environmental sustainable facilities are only beginning to be built.

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

In Macedonia, local governments are responsible for financing and managing primary and secondary education, including the payment of teachers' wages. While in Slovenia, local governments are responsible for maintaining and improving school facilities.

The population statistics used in this report is based on the last official census used by the relevant statistical agencies. In these countries, the population numbers currently used to allocate intergovernmental grants and transfers are significantly higher than the ones generated by the recent censuses.

The GDP numbers used are those used from the data provided by the Ministries of Finance according to the production method. Converted into EUR for comparative purposes, we used the average annual exchange rates provided by the Central Banks.

To compare the relative importance of local governments across settings, we used revenues --and not expenditures-- as a share of the consolidated finances of the General Government. By General Government revenue, we mean the total revenues of the national government and its agencies, including the revenues of off-budget (social security) funds and those of subnational governments. For local governments, we have excluded proceeds from borrowing, and have included income from asset sales and carry-overs from previous years.

In most of the region, local governments receive freely disposable (unconditional) General Grants from their central governments. These grants are defined by law as percentages of national taxes. But so long as the funds are allocated by formula, we consider them to be grants and not shared taxes. Consequently, we use the term Shared Taxes only for national taxes that are shared with local governments in an origin basis.

Throughout South-East Europe, local governments receive grants from higher level governments that can only be spent for specific purposes. In some cases, these grants should be considered as block grants, meaning grants that can only be spent on a specific function (e.g. education).

In most of the region, local governments are entitled to shares of national taxes generated in their jurisdictions. However, the most important shared tax is usually the Personal Income Tax (PIT).

The data on local own-revenues in the region is often poorly maintained and classified. These revenues include income from locally imposed taxes; the sale or rental of municipal assets; fines, penalties, and interest; local user fees and charges; and fees for permits, licenses, and the issuance of civil registration documents. In some places, local user fees and taxes --though collected by local governments-- are defined by higher level governments and should be considered as shared revenues. The most important local tax is typically the Property Tax, though it is not often the single-largest source of local own-revenue.

Numbers and Types of Sub-sovereign Levels of Governance in Macedonia and Slovenia

Municipal governments in Slovenia are also relatively small with an average of less than 10,000 inhabitants. The small size of the first tier of the local governments in these places presents obstacles to decentralization because small jurisdictions often have weak tax bases, and lack the human capital necessary to reasonably support major public services.

But on the whole, the average size of local governments in the region is larger than the average size for the EU as a whole, and the EU. Macedonia, all have municipal governments with an average population which is greater than 15,000 inhabitants.

One reason for the relatively large average size of municipal governments in South-East Europe is that the percentage of people living in capital cities is higher than the average size of the EU.

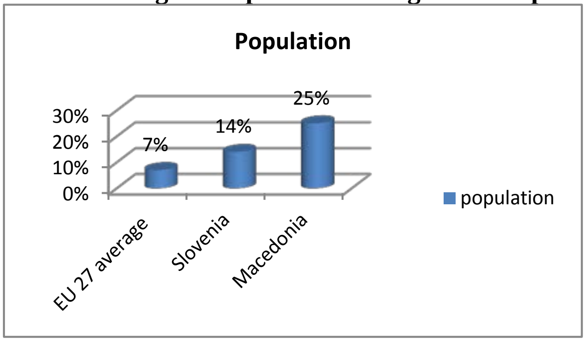
Table 1: Levels, Types, and Numbers of Sub-Sovereign Governments

	NALAS Member	Levels of Sub-Sovereign Government	Types of Sub-Sovereign Government	# of 1st Tier
Macedonia	**ZELS**	1	Municipalities (Neighborhood Units)	81
Slovenia	**SOG**	1	Municipalities	211

Population Distribution and Density

One consequence of this oversized importance of capital cities in the region is that tax bases tend to be skewed toward one major urban area. This creates technical and political obstacles to decentralization. Technically, it is difficult to assign local governments robust own-revenues or to create efficient equalization mechanisms when a disproportionate share of the economy is concentrated in a single city. Politically, it can make equalization difficult by setting the interests of all other jurisdictions against the capital.

Chart 1. Percentage of Population Living in the Capital City



The Dynamics of the Gross Domestic Product

Chart 2 presents the GDP per capita for the countries from 2005 and 2013. Not surprisingly, there are very significant variations in relative to wealth across the group. Slovenia is by far the richest, with GDP per capita of 17,186 EUR. GDP growth in Slovenia (14%) was the slowest during the period, though it is slightly higher than the average for the EU (9%).

Chart 2 GDP Per Capita 2006 vs. 2013

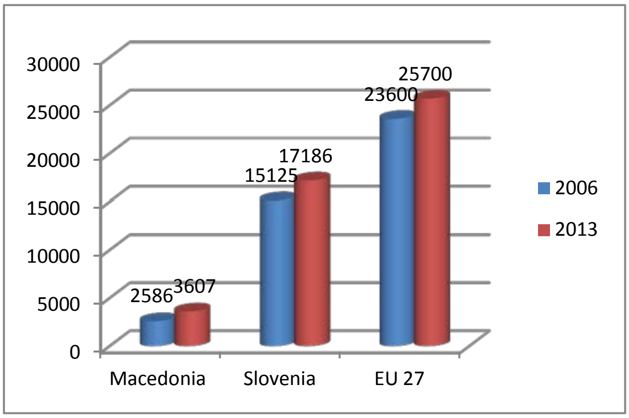
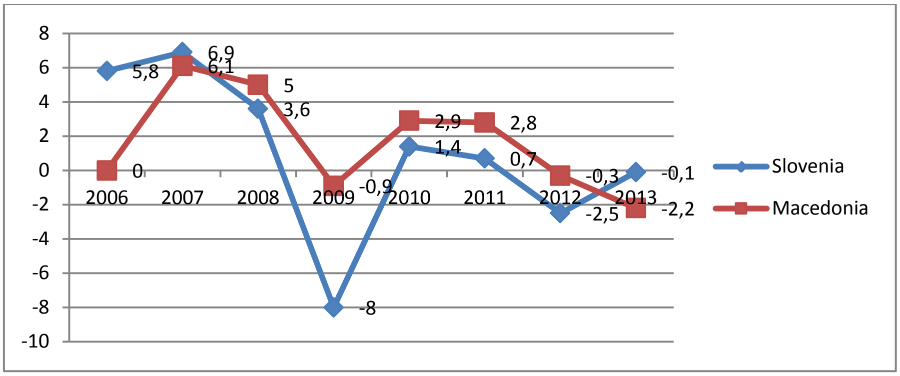


Table 2 below presents the annual changes in the GDP for the countries between 2006 and 2013. There is considerable variation in the economy as all were hit by the crisis fairly hard. Since 2009, growth has been uneven. Indeed, most of the region fell back into recession in 2012. However, Slovenia and Macedonia are still in the doldrums, and in Turkey, economic growth has slowed down.

Table 2 Annual GDP Growth and Decline from 2006-2012

	2006	2007	2008	2009	2010	2011	2012	2013
Slovenia	5.8	6.9	3.6	**-8.0**	1.4	0.7	**-2.5**	**-0.1%**
Macedonia	5.0	6.1	5.0	**-0.9**	2.9	2.8	**-0.3**	**-2.2%**



Indicators of Fiscal Decentralization

The most common indicators of the relative importance of local governments in a country's overall governance structure are local public revenues (or expenditures) in relationship to the GDP and in relationship to the total public revenues (or expenditures). To interpret their significance, however, we also need to know how large the total public sector is in relation to the GDP, and what public services have been assigned to local governments. If a country's public sector is small, it is unlikely that local government revenues will represent a significant share of the GDP. They may, however, represent a substantial share of the total public revenues. Such a situation would suggest that all the levels of government have trouble collecting taxes, but that the national government is treating local governments relatively fairly. In contrast, if a country's public sector is large, but the local government revenues is low as both a share of GDP and total public revenues, then this suggests that the national government is not treating local governments seriously. It is also important to understand whether or not local governments are responsible for delivering significant services in the areas of education, health, and social welfare. This is because these functions are so costly that assigning them to local governments really changes the nature of the intergovernmental finance game. For example, in most OECD countries, the full costs of pre-university education are usually equal to between 3 and 5% of GDP and 12 and 20% of total public expenditure, of which 60 to 80% goes for teachers' wages[1].

In Macedonia, municipalities pay teachers salaries which are 3% from GDP. But in Slovenian municipalities, they are not responsible for paying teachers salaries.

Table 3 summarizes the social sector functions that have been assigned to local governments. In Macedonia, local governments are fully responsible for pre-tertiary education, including paying the wages of

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

teachers. By all rights, local governments in these countries should have higher revenues both as a share of GDP and of total public revenues than other members of the group.

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

	Preschools		Primary Schools		Secondary Schools		Primary Health		Secondary Health	
	Buildings	Wages	Buildings	Wages	Buildings	Wages	Buildings	Wages	Buildings	Wages
Macedonia	XX	XX	XX	XX	XX	XX				
Slovenia	XX	XX	XX				XX			

Republic of Macedonia

As a result of the Ohrid Agreements of 2001, and as part of the country's effort to accede to the European Union, changes were made in the laws of the Local Government.

Macedonia reduced the number of its local governments from 124 to 85 in 2005, and then to 81 in 2013 as a result of the changes in the Law for territorial organization. In 2007, local governments that had cleared outstanding arrears and that met other criteria for good financial management were allowed to enter the so-called Second Phase of decentralization. Most importantly, they assumed the responsibility for running primary and secondary schools as well as some cultural and social welfare institutions from 2005. To fund these tasks, they began to receive block grants from the national government from 2007. As of today, only one municipality has not entered into the Second Phase of decentralization.

Macedonian municipalities are now responsible for maintaining and improving local infrastructure, water and wastewater treatment, public hygiene, public lighting, local public transport, fire protection as well as for preschool, primary and secondary education, local cultural institutions (Cultural Houses, libraries, and museums), and elderly care.

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

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

- **Debt Finance & Donations**

In 2005, local government revenues as percentage of GDP were equal to only 1.9% of the GDP. Due to the decentralization process, it had tripled to more than 6.5% of GDP by 2012, while by 2013, the share was only 5,88% of GDP.

Despite this growth, however, Macedonian municipalities still face profound financial challenges. In order to strengthen their finances, the Municipal Association of Macedonia (ZELs) has lobbied for amendments of the local government finance law. This lobbying has resulted in the following recent changes:

- The percentage of the national yield of VAT earmarked for the General Grant was increased from 3% to 4.5%; (in accordance with the requirements of ZELS, the Central Governmet has committed that in its mandate, they will increase the percentage of VAT to 6%), which means that we expect an increase in revenue from this resource.
- The municipal share of income from the sale of state-owned was increased to 80%.
- The municipal share of income from minerals concession was increased to 78%
- The municipal share of revenue from other concessions (water) will be increased from 25% to 50% in 2016.
- Revenues from fees to wash and separate gravel are now split 50/50.
- Revenues from fees for legalizing illegal structures on agricultural lands are now split 50%/50%.
- Revenues from fees for legalizing buildings on urban land now go entirely to municipalities.
- Local governments may now borrow from the commericial lenders as well as from the national government, and the World Bank.
- Starting from the year 2015, the municipalities will recieve money from concessions on agricultural land; 10% in 2015; and in 2018, revenues will be shared 50:50.

Equalization Instruments

The criteria used to allocate the General Grant have an equalizing effect. The size of the General Grant is anchored by law at 4.5% of the national yield of VAT. The criteria to allocate the grant are defined by an annual ordinance of the government according to the following rules:

- All jurisdictions receive a lump sum payment of 3 million denars.
- The costs of these payments are deducted from the grant pool and the residual is then divided between the capital city of Skopje and its

composite jurisdictions (12%), on the one hand and all other municipalities (88%) on the other hand.

- The share of funds for municipalities outside of the capital is divided by a formula which allocates 65% of the pool on the basis of population; 27% on the basis of square kilometers; and 8% on the basis of the number of settlement.

The allocation of block grants also has implications for equalization. The allocation of the education grant is governed by an annual ordinance which determines the amount of funds each local government will get for pupils enrolled in primary and secondary school and for pupils with special needs. The formula for determining these per pupil payments however are publicly available, but the amount of money that the Municiplaities gets is not enough. Thus, it needs to increase from the Central budget that determines this competence, whose per pupil costs are now substantially higher than average.

The allocation of the block grant for preschool education is also governed by an annual ordinance. The formula in this ordinance contains variables for the number of pupils in the school, for the type of heating in the school, the duration of the heating system, the number of teachers in the school, and the utilization rate of the facility. Municipalities that have cultural institution receive a block grant for culture, based on the number of employees working in the institutions covered by the grant; the total square meters of the concerned buildings; and the coefficients for the particular types of cultural services these institutions are providing. As with other block grants, the rules governing the allocation of the grant for culture is determined by an annual ordinance of the national government.

There is also a fund for balanced regional development which allocates money to regions according to a formula contained in the Law on Regional Development. By Law, this fund should be equal to 1% of the GDP, but so far, this has not been the case.

Republic of Slovenia

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

In 2012, the Government and the municipal associations signed an agreement to further reduce the needed indicator use to calculate shared taxes in 2013 and 2014, essentially forcing municipalities to lower expenditures. In 2013, additional fiscal consolidation efforts placed new expenditure burdens on municipalities. These included an increase in the VAT rate, a rise in social transfers, and a further reduction in the co-financing of local government investment by the national government. Consequently, only the state-mandated reduction of public sector wages worked in the opposite direction.

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

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

The overall size of the local government sector in Slovenia increased from about 5% of the GDP in 2006 to close to 6% of the GDP in 2009. Thus, it has remained at this level since then. This suggests that the national government has been distributing the costs of the economic adjustment reasonably fairly between the levels of government.

Slovenian local governments are heavily dependent on PIT sharing for most of their revenues, and since 2007, free disposable equalization grants that provide additional revenues to poorer local governments have been reduced. Instead, weaker local governments are given additional increments of PIT.

Local own-revenues have performed roughly in line with the economy as a whole. Slovenian municipalities derive an unusually large share of their revenues from asset sales and rentals. The yield of the Property Tax has been significant, but with no clear upward trend. The 2013 elimination of the Land Use Fee and the centralization of the Property Tax will obviously reduce both local government revenues and their fiscal autonomy if not accompanied by other reforms.

In 2011 and 2012, the investment rate of Slovenian local governments dropped from about 45% of total spending to about 36%, which is still high for the region. Wage spending is remarkably low, while subsidies to companies are surprisingly high. This suggests that at least some wage spending is being carried out by off-budget service providers that need municipal subsidies to pay their wage bills.

Furthermore, Slovenia has combined robust local investment with low wage spending and modest property tax yields. The yield of the property tax as a share of GDP has declined from 0.64% of GDP to 0.5%

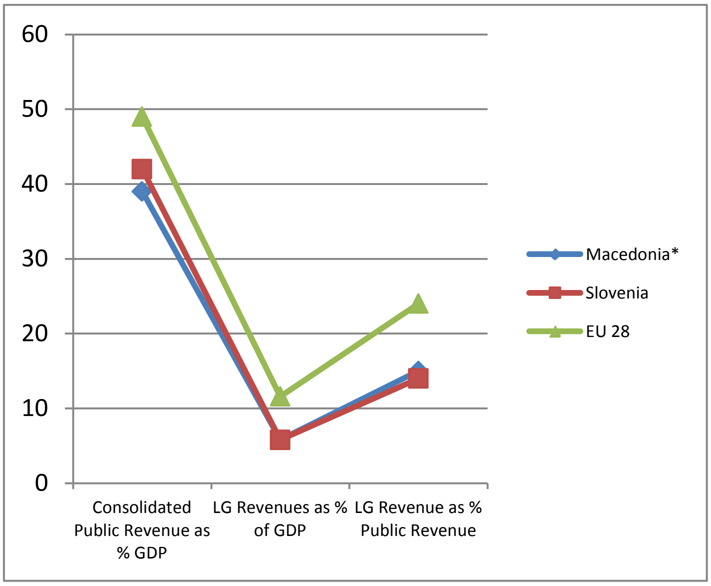
Local Governments Revenues in South-East Europe

Chart 3 shows local government revenues as a share of total public revenues and of GDP, as well as the average for the EU. As can be seen from the Chart, local governments in the EU play --on average-- a substantially larger role than countries like Macedonia.

The Macedonian municipalities have public sectors that are smaller than the EU average. As in local governments in Macedonia, they are fully responsible for financing and managing pre-tertiary education, including paying teachers' wages.

While local governments in Bulgaria and Macedonia are only receiving about 15% of all public revenues (or 6% of GDP). This strongly suggests that the national governments of Macedonia are underfunding local governments in general, and pre-tertiary education in particular. As a result, they fail to meet their obligations under the European Charter of Local Self-Governments.

Chart 3. Local Government Revenue as Share of GDP and Total Public Revenue in 2013



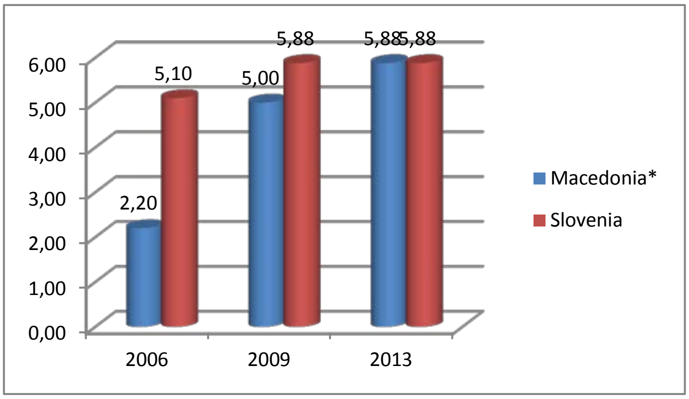
*indicates that local governments pay teachers wages.

Local governments in Slovenia, have revenues equal to between 5.3 and 7.0% of GDP (14-18% of public revenues). This is low by EU standards. At the same time, local governments in Slovenia both maintain preschools and pay the wages of preschool teachers. However, this was a significant expense particularly in urban jurisdictions with high enrollment rates.

Finally, it is important to note that while this Chart provides more useful information about the overall importance of local governments within the group, it does not provide us with information about how these revenues are distributed across local governments. In addition, it does not provide how much autonomy local governments have in actually spending them.

Chart 4 shows local government revenues as the percentage of GDP in 2006, 2009, and 2013. In Slovenia, the local government revenues have been more stable, rising or falling marginally over the entire period. Only in Macedonia, has the revenue position of local governments significantly improved over the entire period.

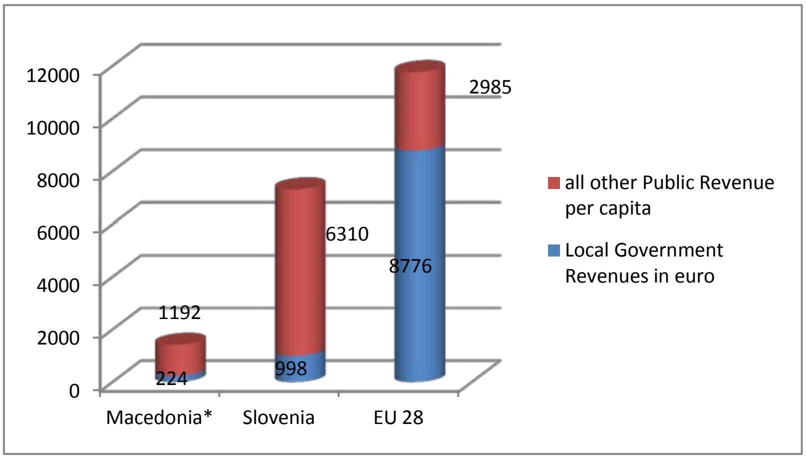
Chart 4: Local Government Revenue as a Share of GDP in 2006 – 2013 in Macedonia and Slovenia



*indicates that local governments pay teachers wages.

Chart 5 shows the per capita revenues of the consolidated public sector and of the local governments in EUR in 2010. The Chart is a useful reminder of how much poorer the government of most South-East Europe are, when compared to those of the EU, as well as how much variation that is across the region. It is particularly striking that local governments in Macedonia are paying for both basic services and teachers' wages with per capita revenues of less than 250 EUR. Indeed, it seems that decentralization has been pushed farther among the poorer members of the group, than among the more wealthy. Thus, this suggest that at least in some cases, it has been driven less by the desire to empower local governments than by the desire of central governments to relieve themselves of the responsibility of reasonably financing public services.

Chart 5 Consolidated Public Revenue and Local Government Revenue in Per Capita EUR in 2013

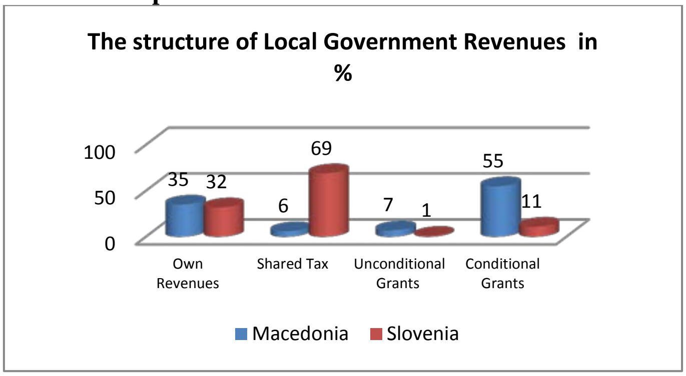


The Chart is also useful when read in conjunction with Chart 5. For example, Macedonian local governments have per capita revenues which are very small compared to those of their Slovenian counterparts or compared with the EU municipalities. However, they pay teachers' wages while the Slovenians do not.

Basic Composition of Local Government Revenues

Chart 6 shows the basic composition of local government revenues in 2013. Unfortunately, this data is less comparable than it should be because of differences in the classification schemes used by members of the group. In some places, shared taxes are presented as own-revenues or grants, while in other cases, own revenues (from PIT surcharges) are presented as shared taxes.

Chart 6 Composition of Local Government Revenue in 2013



Similarly, the equalization system in Slovenia gives additional increments of PIT to poorer jurisdictions. These additional PIT increments function like equalization "grants", but again cannot be distinguished from shared taxes. Finally, many of the revenues that are classified as own-revenues are in fact fees and charges set by higher-level governments (and sometimes collected by them), but whose yields goes entirely to the local government.

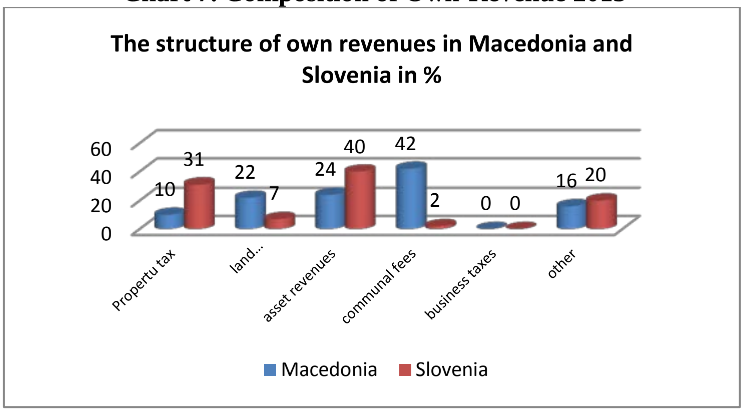
Financial Independence of Local Governments

Nonetheless, Chart 7 does provide some basic information about the financial independence of local governments. In Macedonia, local governments have limited financial autonomy because more than 50% of their revenues come from conditional grants education functions. Here, national governments have a legitimate interest in making sure that the money intended for these social sector functions is actually spent on them. Nonetheless, it is one thing for national governments to want to make sure that monies earmarked for health and education are actually spent on them, and quite another thing for them to control exactly how local governments use these funds within a sector. And unfortunately, it is probably fair to say that in most places, social sector block grants are over regulated.

More generally, there is no use of PIT sharing in Macedonia that makes extremely limited use of it. This is surprising since the origin based sharing of PIT is not only clearly popular in the region, but has formed a critical pillar of the intergovernmental finance systems of virtually all the post-communist countries that joined the EU in 2004. It is also interesting that in 2013, local governments in Slovenia received no income from unconditional grants. But in Macedonia, unconditional grants accounted for less than 10% of the total revenue. The absence or relative insignificance of unconditional grants raises questions about the equity of these country's intergovernmental finances systems. This is because it is generally through unconditional grants that central governments provide additional revenues to poorer jurisdictions. Nonetheless, unconditional grants can be allocated in many ways and their simple existence should not be taken to mean that they are effectively redistributing national income. Moreover, and as we have already mentioned, Slovenia do at least some equalization through other mechanisms.

Chart 7 presents the composition of own-revenues for local governments ranked by the share of these revenues in total revenues. In some cases, the reporting is quite detailed and contains more categories than are presented in the Chart. In others, only two or three categories are used and it is difficult to say what these categories contain. Similarly, revenues from the sale or rental of municipal assets are frequently presented as Communal Fees.

Chart 7. Composition of Own-Revenue 2013



What can be said is that in Slovenia, the property tax is much higher compared to Macedonian municipalities, the composition of own-revenues, and their share in total revenues. It is however worth noting that revenue from the rental and sale of assets is surprisingly important, as is revenue from quasi-fiscal charges imposed on new development, charges that governments are trying to roll back throughout the region. In the region, own-source revenues are disproportionally concentrated in capital cities and typically tied very strongly to the real-estate market through land development fees, construction permits, the Property Transfer Tax, and the Property Tax.

Table 4 below shows the per capita yield of the property tax in 2006 and 2013 for all NALAS members. As can be seen from the Table, there are very significant differences across the group in both the yield of the tax and its growth over the last seven years. The situation in Slovenia is similar, but of a much higher base. In Macedonia, the yield of the tax has increased almost fourfold, but still amounts to only 8 Eur per capita.

Table 4: Change in Per Capita Yield of the Property Tax in EUR 2006 vs. 2013

	2006	2013	% + or -
Slovenia (2012)	92.0	92.0	0%
Macedonia	1.6	7.8	385%

Table 5 presents the same basic information but expresses the yield of the tax as a percentage of GDP and includes the average for the EU. What the Table shows is that in Slovenia, the expansion of the property tax did not keep up with GDP growth while it exceeded it in Macedonia.

Table 5 Change in Property Tax as a Percentage of GDP 2006 vs. 2013

	2006	2013	% + or -
Macedonia	0.06%	0.21%	253%
Slovenia (2012)	0.61%	0.54%	**-12%**

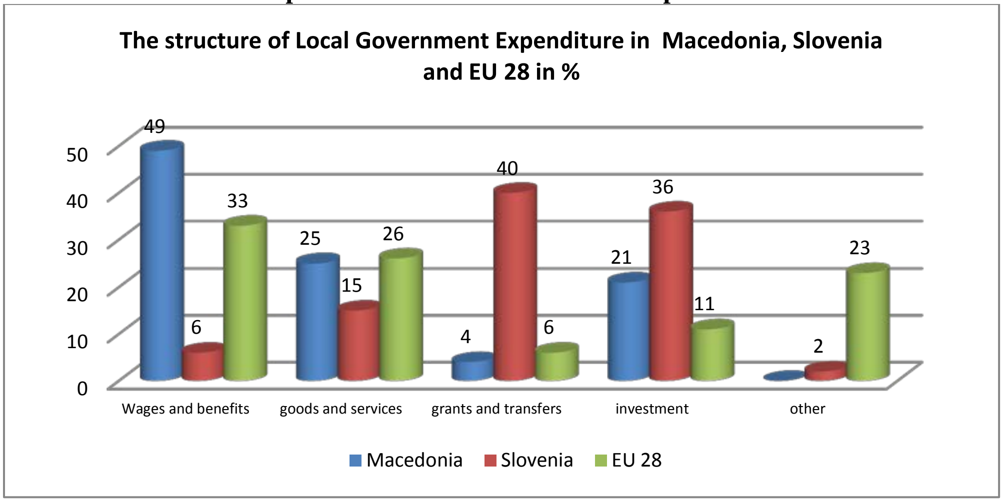
This suggests that there is a division within the states between places where local governments are more aggressively using the property tax and places where they are not. The yield of the tax exceeds the EU average of 1.1% of GDP (And the EU average is low when compared to North America, Australia, France, and some of the Nordic countries where the tax accounts are between 2 and 3% of GDP.)

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

Local Government Investment Spending

Chart 8 shows the composition of local government expenditures by economic type as the average for the EU (EU 28). The data should be treated with caution because there are differences in the way countries report expenditures as well as problems by extracting fully comparable data from Eurostat. For example, some places treat capital transfers to public utilities as investment expenditures, while others record them as subsidies. There is also a tendency to record wage spending as the purchase of goods and services for EU 28 transfers that includes only operating subsidies to public utilities.

Chart 8 Composition of Local Government Expenditure in 2013

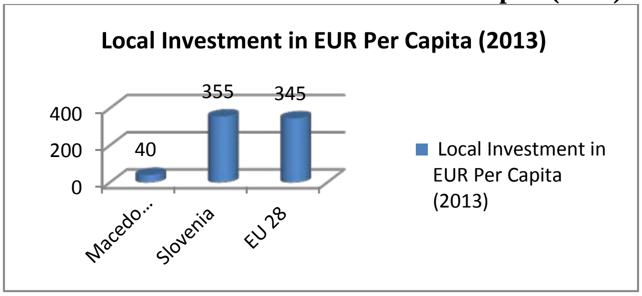


Nonetheless, the most striking feature of the Chart is that local governments in most of South-East Europe spend a larger share of their budgets on investment than their counterparts within the EU. It is hard to say how much this reflects the fact that across the region, local governments often pay for investments in public utilities; but elsewhere, utilities finance themselves through tariffs. It should also be noted that in some places in the region, investment rates would be substantially higher (e.g. Serbia) if the data on local government transfers to public utilities distinguished between operating and capital subsidies.

The differences in the average investment rates for the three groups (SEE, EU28, and EU7) have been remarkably consistent over the last 8 years. This suggests that local governments in South-East Europe, like those of the EU7 are playing an extraordinary spending as much they can, to modernize the run-down infrastructure they have inherited. Local governments in South-East Europe are working harder than their counterparts in most of the EU to build new infrastructure because they are spending higher proportions of their income on investment, despite receiving significantly lower shares of public revenue – measured either as a percentage of GDP or of total public revenues (Chart 4). But while investment rates in the region have been comparatively robust, it is important to remember that we do not know how much these rates have been driven-up by a few wealthier jurisdictions and by the (likely) imbalances in the region's intergovernmental finance systems.

EU funds are undoubtedly playing an important role in the modernization of local public infrastructure in new member states. In some cases, they have also allowed national policy makers to substitute transfers from the EU for transfers generated from domestic sources.

Chart 9. Local Investment in EUR Per Capita (2013)

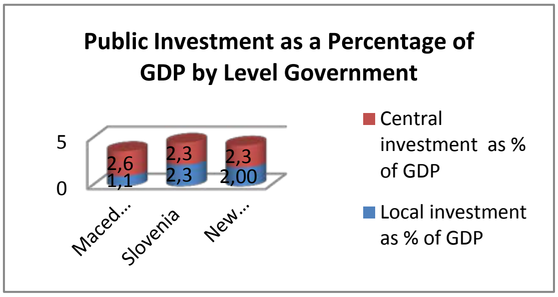


Indeed, local government investment as a share of GDP has exceeded both the average for the EU 28 and the EU7 in Slovenia.

Local government investment spending as a percentage of GDP is extremely low in Macedonia. Local government investment as a share of GDP remains lower than the average for the new EU. Thus, this is below what one might reasonably hope to see, given the catch-up game that local governments in South-East Europe must do.

Looking briefly at the composition of public investment by the level of government, Chart 12 shows total public investment as a share of GDP divided by the level of governments for the year 2006-2013. There is significant variation in both total public investment and its composition across levels of government. In general, total public investment in the South East Europe states are higher than for the more established member states of the EU. This is not surprising, given the game of catch-up they are all playing.

Chart 10 Public Investment as a Percentage of GDP by Level of Government (average 2006-2013)



Similarly, a larger share of this public investment comes from central governments in most of South-East Europe, than it does in either the EU 28 or the new EU 7. Again, this is not terribly surprising. Nonetheless, it is striking that in most of the region, local public investment as a share of GDP remains lower than in the EU 7, whose members faced similar deficits in costly environmental and network infrastructure. At the same time, it is worth pointing out that in at least some members of the group, local government are accounting for a healthy share of total public investment, both in relationship to the GDP as a whole, and to the central government (Slovenia).

Conclusion

Decentralization in South-East Europe is still a work in progress. This is because there is no country in the region where local government revenues or expenditures reaches the average for the EU either as a percentage of GDP or of total public revenues.

Since 2009, local governments have done an impressive job in mobilizing own source revenues. Though the overall yield of the property tax remains modest, they have increased collection five times. They are also more argressively collecting Land Development Fees, Lighting Fees, and other communal charges.

The share of local expenditures going to wages has increased steadily as local governments have assumed the responsibility for primary and secondary education. Despite this wage growth, they have maintained respectable investment rates. Wage and investment spending as a share of GDP have expanded significiantly over the last eight years, while the property tax has increased more modestly and still only yielding revenue equal to 0.21% of GDP.

The share of local public investment in total public investment as increased from about 20% between 2006 and 2009 to about 40% between 2010 and 2013.

Of all the countries in the region, Macedonia has undergone the most structural change over the last eight years. This change has been driven by the progressive decentralization of major social sector functions to local governments particularly primary and secondary schools.

This process has significantly increased local revenue as a share of both GDP and of total public revenue. EU funds are playing an important role in the modernization of local public infrastructure in new member states, and even in pre-accession countries.

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Other data used has been provided by their Ministries of Finance, Central Banks, Statistical Agencies, EuroStat, and other sources.

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