Urban Institute Center on International Development and Governance

The Effects of the Suspension of Serbia's Law on Local Government Finance on the Revenue and Expenditure Behavior of Local Governments: 2007-2009

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IDG Working Paper No. 2010-05

October 2010

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Abstract

This note examines the revenue and expenditure responses of local governments to the current economic downturn and to the Government of Serbia's suspension of the transfer system put in place by the 2006 Local Government Finance Law (LGFL). The fiscal analysis shows that in response to the reduction of transfers, local governments significantly raised their own revenues. Most of this growth came from better collection of the property tax from physical persons, and better collection of the land use fee from businesses. Not surprisingly, local investment spending plummeted 26 percent between 2007 and 2009 and virtually disappeared among the worst-off local governments.

The only significant type of expenditure —by economic category— that increased over the period analyzed was wages, which rose 9 percent and now represents 21 percent of total local government expenditures. Much of this growth, however, was due to statutory wage increases, particularly for preschool teachers who are paid by local governments, but whose wages are effectively set by the central government. Related to this, is the rather surprising fact that when local government spending is analyzed by function as opposed to economic category, the most significant increase came in the area of preschool education. Less surprisingly —given the social distress that comes with recessions— is that social welfare spending shot up 24 percent to 2.4 percent of total expenditures. Spending on the environment also rose, though less sharply and from a lower base.

The Effects of the Suspension of the Law on Local Government Finance on the Revenue and Expenditure Behavior of Local Governments: 2007-2009

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This note examines the revenue and expenditure responses of local governments to the decrease in their revenues caused by the current economic downturn and by the Government of Serbia's (GoS) suspension of the transfer system put in place by the 2006 Local Government Finance Law (LGFL). The note summaries the findings of an earlier study, and extends this study through the analysis of previously unavailable expenditure data for 2009. It also makes some concrete proposals for a new round of intergovernmental reform.

The structure of the note is straightforward. The first section briefly reviews the short-lived achievements of the LGFL. Here, we show how the LGFL raised local government revenues by almost 10 percent while simultaneously reducing the fiscal resource gap between poorer and richer jurisdictions.

The second section examines the overall effect on local government budgets of the suspension of the LGFL and the recent economic downturn. Local government revenues declined in real terms 13 percent, falling to levels below those that prevailed before the implementation of the LGFL. Paradoxically, however, inter-jurisdictional equity continued to improve during the economic crises. . The data also suggest that the allocation of transfers from the GoS to local governments is becoming more discretionary, and the rules-based system put in place by the LGFL is unraveling.

The third section highlights how local governments behaved in response to the steep decline in their total revenues in 2008 and 2009. Here we look first at how local governments attempted to "claw back" some of their revenue losses by more aggressively using their powers to impose and collect taxes, fees and charges. Then we look at what expenditures they cut; didn't cut; or passed off to third parties as payment arrears.

In the fourth and final section we make some proposals for a next round of intergovernmental reform. These proposals hinge on the restoration of a rules-based system of intergovernmental transfers. They also entail a technical change in the way the current threshold for equalization is calculated. Less specifically, but no less urgently, they require the GoS to seriously engage with the issues of property tax reform and utility regulation, as well as with role of local governments in Serbia's education system.

1. The Achievements of the Local Government Finance Law (LGFL)

Prior to 2007 the amount of shared taxes and general grants that local governments received from the national government were determined in the annual Budget Law of the Government of Serbia and changed from year to year. This changed in 2007 with the implementation of the 2006 Law on Local Government Finance (LGFL). The LGFL introduced four fundamental changes into Serbia's intergovernmental finance system.

1. All local governments were given a 40 percent share of the Personal Income Taxes (PIT) collected in their jurisdictions by the national government (Article 35).

2. The size of the General Grant pool that the national government allocates to local governments for general revenue support every year was pegged at 1.7 percent of the value of GDP in the last year for which there is available data (Article 37).

3. An equalization rule was introduced as a first call on the allocation of the General Grant to local governments. The rule guarantees all local governments whose per capita revenues from shared taxes are less than 90 percent of the national per capita average of shared taxes (calculated without the shared revenues of the "cities") an equalization grant equal to the difference between their per capita revenues from shared taxes and 90 percent of the national average.

4. The property tax was made a local government own revenue, and local governments were given the right to set the rate of the tax (within limits determined by the national government) and to fully administer it.

The changes introduced by the LGFL were designed to give Serbia a rules-based system of intergovernmental finance; to make local government grants and transfers predictable from one year to the next; and to both increase and make more equitable local government revenues as a whole. Table 1 below shows the main gains achieved by the LGFL.

As can be seen from Table 1, total local government revenues increased by 9 percent in real terms after the passage of the LGFL. Moreover, all of this growth was driven by the growth of the General Grant, which increased from 24.6 billion Serbian Dinar (RSD) in 2006 to RSD 41.6 billion in 2007.[1] Equally importantly, the passage of the Law substantially improved the equity of Serbia's intergovernmental finance system.

[1] At the time of writing, US$ 1 approximately equaled RSD 76..

Table 1 Local Government Revenues Before and After the Passage of the LGFL (in 2009 RSD)					
	2006		2007		
	Revenue	Per Capita	Revenue	Per Capita	Percent Change
1st Quartile	7,302,569,945	8,640	12,233,153,176	10,894	**26%**
2nd Quartile	14,039,907,133	11,196	12,582,157,219	13,283	19%
3rd Quartile	22,043,581,396	14,234	25,691,667,987	16,505	16%
4th Quartile	43,720,544,993	22,140	47,081,008,310	23,591	7%
Bg, NS	91,259,962,288	48,661	97,394,642,242	51,932	7%
Total Revenue	**178,366,565,756**	**23,789**	**194,982,628,935**	**26,005**	**9%**
Revenue from the General Grant; and as % of Total Revenue	24,659,748,831	14%	41,622,462,259	21%	**54%**
Ratio of 1st to 4th quartile	N.A	2.8	N.A	2.4	-13%
Ratio of 1st quartile to Belgrade, Novi Sad	N.A	5.6	N.A	4.8	-15%

This can be seen from the fact that the per capita revenues of the poorest two quartiles of local governments increased most radically —126 percent and 119 percent— while the per capita revenues of the richest quartile and those of Belgrade and Novi Sad increased by only 7 percent. As a result of the faster per capita revenue growth among poorer municipalities the ratio of the richest quartile to the poorest quartile of local governments declined 13 percent, from 2.8:1, to 2.4:1. Similarly, the ratio of Belgrade and Novi Sad's per capita revenues to those of the poorest quartile declined 15 percent, from 5.6:1, to 4.8:1.

2. The Macro-Effects of the Suspension of the Law on Local Governments

Unfortunately, the gains introduced by the LGFL in the adequacy, predictability and equity of Serbia's intergovernmental finances were short-lived: In the Spring of 2009, and under pressure from the global economic crisis, the GoS decided to effectively suspend the law by slashing RSD 15 billion from the transfer system. Moreover, it continued these cuts into 2010. Indeed, the LGFL has now been in suspension for about as long as it was in effect. Worse, it is still unclear what the GoS will do in FY 2011.

Table 2 below shows the effects of the suspension of the LGFL in the same terms as the previous table. As can be seen from the Table, local government revenue fell by almost RSD 30 billion, or 15 percent between 2007 and 2009. Indeed, total local government revenues in 2009 were about 8 percent less (RSD 13 billion) than they were in 2006. About 13.5 billion of the 30 billion loss –

45 percent--between 2007 and 2009 came from the suspension of the transfer system, and about 16 billion from the decline in other revenues due to the economic downturn.

Table 2. Local Government Revenues Before and After the Suspension of the LGFL (in 2009 RSD)					
	2007		2009		
	Revenue	Per Capita	Revenue	Per Capita	Percent Change
1st Quartile	12,233,153,176	10,894	8,908,073,566	10,410	-4%
2nd Quartile	12,582,157,219	13,283	12,649,736,859	11,862	-11%
3rd Quartile	25,691,667,987	16,505	24,863,502,611	14,054	-15%
4th Quartile	47,081,008,310	23,591	38,376,545,706	19,871	-16%
Bg, NS	97,394,642,242	51,932	80,654,852,368	43,006	-17%
Total Revenue	**194,982,628,935**	**26,005**	**165,452,711,110**	**22,066**	**-15%**
Revenue from the General Grant; and as % of Total Revenue	41,622,462,259	21%	28,157,725,905	17%	-20%
Ratio of 1st to 4th quartile	N.A	2.4	N.A	1.9	-20%
Ratio of 1st quartile to Belgrade, Novi Sad	N.A	4.8	N.A	4.1	-13%

But while the adequacy and predictability of the intergovernmental finance system took a beating after the suspension of the LGFL, the equity of the system improved. This can be seen be the further decline in the ratios between the wealthiest jurisdictions and the poorest: The ratio of the per capita revenues of 4th quartile of local governments to the 1st Quartile declined from 2.4:1 in 2007 to 1.9:1 in 2009 while the ratio of per capita revenues of Belgrade and Novi Sad to the 1st Quartile fell from 4.8:1 to 4.1:1 over the same period.

There are two main reasons for this. The first is that the fall off in economic activity led to steep declines in property transactions and new investment, and with it the halving of local government revenues from the (shared) tax on the Transfer of Absolute rights and the (own-revenue) Land Development Fee. Most of this loss came in wealthier jurisdictions with active property markets, particularly Belgrade.

The second reason is more complicated. In the Budget Memorandum for 2009, the GoS anticipated giving local governments RSD 25.7 billion in General Transfers. This was 16 billion less than 2007, and almost 25 billion less than what it should have given if the LGFL had been applied. In fact however, the total value of General Transfers given out by the GoS in 2009 RSD 28.2 billion, or about 2.5 billion more than was initially planned.

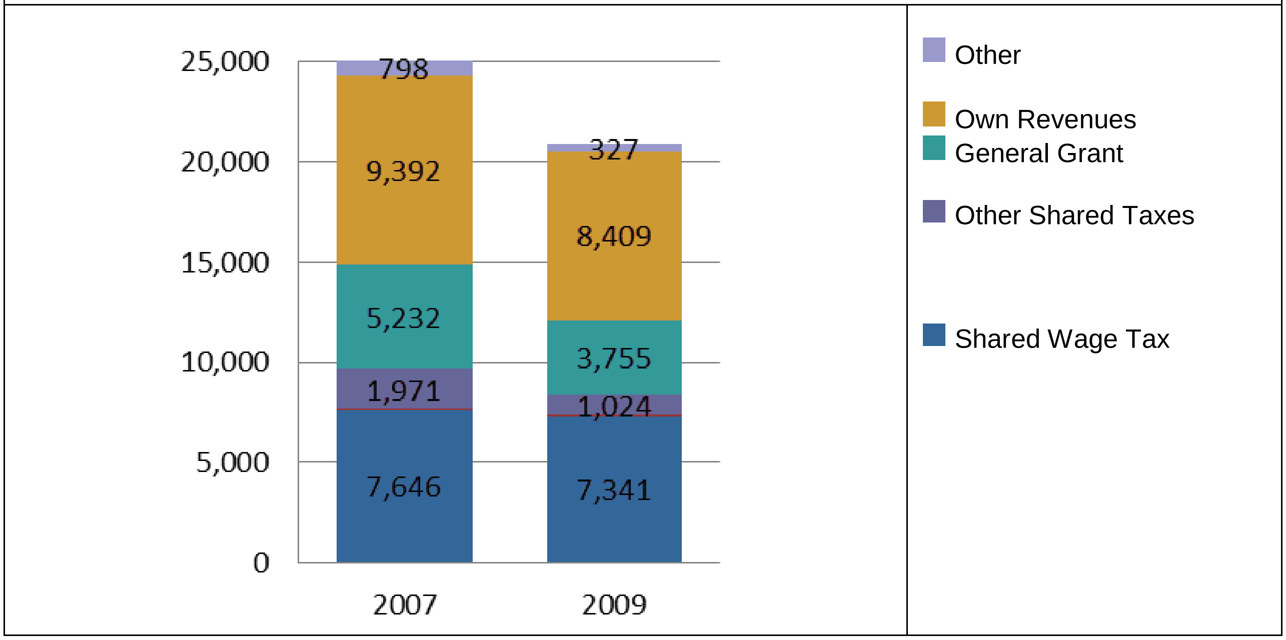
The good news here is that most —if far from all— of these unplanned grants were given to poorer jurisdictions, helping to further improve the equity of the system. The bad news is that not only did the GoS suspend the LGFL, but that old habits of highly discretionary –and politicized "giving" seem to have returned in force.

3. The Revenue and Expenditure Responses of Local Governments to the Economic Crisis and the Suspension of the LGFL

Revenues

Chart 1 below shows that all categories of revenues (per capita) declined during the recession and after the suspension of the LGFL, What is interesting however, is that while the General Transfer fell the most, revenue from shared Wage Taxes fell the least. This shows that Serbian employers --both public and private-- restrained from firing employees despite the recession.

Chart 1
Structure of local revenues in 2007 and 2009 (per capita in 2009 RSD)



Own revenues declined by 10 percent, of which revenues from the Land Development Fee —the single largest own revenue— plummeted 39 percent. As a result, local governments lost almost RSD 9 billion—a sum equivalent to close to 6 percent of their total revenues in 2009. Similarly, revenues from the sale and lease of local government assets –the Land Lease Fee and Lease income— fell 25 percent, knocking another 2.4 billion of total revenues.

These revenues fell particularly fast in richer jurisdictions and are closely connected to the fall in revenues from the (shared) Tax on the Transfer of Absolute Rights. In other words, the real estate crash that came with the recession squashed local government income from both their own property and from the property markets around them.

Nonetheless, and perhaps more importantly, local governments managed to claw back some of their losses elsewhere by making more aggressive use of their powers to impose and collect local taxes, fees and charges. As can be seen from Table 3, revenues from the Land Use Fee increased the most —18 percent— and yielded local government almost 1.7 billion in new revenue. Unfortunately, we do not know how much came from legal entities because the Chart of Accounts does not require local governments to distinguish between persons and firms with respect to the Fee. But we do know from case studies, that in most jurisdictions 70 to 90 percent of the Fee is derived from businesses. Here, in other words, it looks like local governments turned to tax businesses first in an effort to make themselves whole.

Table 3
The Structure of Local Governments Own Revenues 2007-2009
(in 2009 RSD, millions)

	2007	**2009**	**% Change**
Self-Contribution Fee	1,895	2,047	8%
Property Tax*	7,989	9,148	**15%**
of which Physical Persons	*3,576*	*4,387*	*23%*
Legal Entities	*4,414*	*4,761*	*8%*
Communal Fees and Charges and other local income	11,178	12,369	**11%**
Business Sign Tax	3,280	3,261	-1%
Land Use Fee	9,733	11,439	**18%**
Land Lease Fee and Lease Income	9,437	7,099	**-25%**
Land Development Fee	24,698	15,124	**-39%**
Fines, Penalties, Interest and Dividends	2,213	2,565	16%
Total own revenues	**70,425**	**63,052**	**-10%**
Own revenues as a % of total	*37%*	*40%*	

They also however, sharply increased —by 15 percent— their collection of the Property Tax —yielding them 1.2 billion in additional income. Unlike with the Land Use Fee, however we can see that most of this growth came not from taxing businesses –yields here grew by only 8 percent— but from the extension of the property tax to individuals who had not paid the tax before: Here yields increased by a striking 23 percent. Local governments also managed to squeeze another 1.2 billion in “new money” from “Other Communal Fees and Local Income”.

Or put another way, local governments managed —despite the hard times— to increase taxation on both individuals and firms by a total of 4.5 billion RSD —a sum equal to close to 3 percent of their total revenues in 2009. Whatever else, this demonstrates a certain seriousness in the way they used their recently expanded fiscal powers under very challenging circumstances.

Here, it is also worth noting that despite widespread —and often legitimate complaints— about local government abuse of the Business Sign Tax (also known as ‘the firmarina’), revenues from this source did not go up during the crisis. This does not mean that some local governments didn’t use the Sign Tax to engage in “predatory taxation.” It does suggest, however, that this was not a knee-jerk response to budget shortfalls.

Table 4 below shows how major revenue categories performed between 2007 and 2009 by quartile. What can be seen from the Table is that cuts in the General Grant hit richer jurisdictions particularly hard: While the 1st quartile of local governments saw no decrease in transfer payments relative to 2007, and the 2nd quartile saw a decrease of 8 percent, the losses for the 3rd and 4th quartiles, as well as for the cities of Belgrade and Novi Sad were much more profound —24 percent, 32 percent, 46 percent.

Table 4. Per Capita Revenues by Source and Quartile 2007 and 2009

	2007					2009					2009/2007				
Quartile	1st	2nd	3rd	4th	B, NS	1st	2nd	3rd	4th	B, NS	1st	2nd	3rd	4th	B, NS
Wage & Property Transfer Tax	3,598	4,553	6,550	8,801	19,044	3,063	4,008	5,773	7,652	16,463	**-15%**	**-12%**	**-12%**	**-13%**	**-14%**
General Grant	5,155	4,954	4,419	4,880	6,467	5,134	4,557	3,339	3,340	3,492	**0%**	**-8%**	**-24%**	**-32%**	**-46%**
Property Tax and Land Use Fee	546	640	1,228	2,099	5,439	494	797	1,374	2,257	6,678	**-10%**	**25%**	**12%**	**8%**	**23%**
Land Development Fee, Land Lease Fee & Lease Income	183	337	899	2,815	13,985	137	334	737	2,033	8,808	**-25%**	**-1%**	**-18%**	**-28%**	**-37%**
Other Own Revenue	941	1,525	1,936	2,728	3,943	914	1,489	2,303	3,142	4,121	-3%	-2%	**19%**	**15%**	**5%**
Other	428	633	490	795	1,335	394	251	209	521	251	**-8%**	**-60%**	**-57%**	**-34%**	**-81%**
Debt and Asset Sales	185	443	792	869	1,719	274	426	318	927	3,193	**48%**	-4%	**-60%**	7%	**86%**
Total	11,034	13,085	16,314	22,987	51,932	10,410	11,862	14,054	19,871	43,006	-6%	-9%	-14%	-14%	-17%

There are two reasons for this. The first is that the GoS allocated RSD 200 million to the 60 poorest municipalities in the middle of 2009. The other is that a larger share of the remaining RSD 2.4 billion in unplanned transfers –those above the amount anticipated in the Budget Memorandum— went to poorer jurisdictions.

With the exception of the poorest quartile, all other groups of local governments responded to extreme budgetary pressure by increasing their collection of the Property Tax and the Land Use Fee. The exceptionally high growth of these revenues —25 percent— in the 2nd quartile seems to be driven by the very aggressive attempts of the larger jurisdictions in this group —Leskovac, Loznica and Novi Pazar— to compensate lost transfers with higher land taxation.

All groups of local governments saw declines in revenues from the Land Development Fee, the Lease Fee (*zakupnina*) and Rental Income (*zakup poslovnog prostora*). But the losses for Belgrade and Novi Sad —37 percent— were exceptionally high. These cities lost almost RSD 5,000 per capita from the collapse of property markets during the recession.

The steep decline in these revenues and in revenues from the general grant for richer jurisdictions, combined with the relative stability of grants for poorer ones explains the improvement of the equity of the intergovernmental finance system between 2007 and 2009. Needless to say however, while the equity of the system may have improved, its adequacy, predictability, and transparency have sharply deteriorated.

Finally, local government revenue from borrowing increased 48 percent in the 1st quartile –but from a very low base; and even more sharply —86 percent— in Belgrade and Novi Sad, but from a much higher base and a much stronger foundation. Revenues from borrowing in the 2nd and 4th quartiles were relatively stable —4 percent and 7 percent. But they dropped sharply in the 3rd quartile (60 percent). Whether this was a conscious decision by local governments in this group to limit their exposure is unclear. What does seem to be clear, however, is that the crisis was not accompanied by a massive "flight to debt" —or at least not to bank loans (as opposed to payment arrears).

<u>Expenditures</u>

Not surprisingly, local governments responded to the steep decline in revenues caused by the recession and the LGFL's suspension by slashing investment spending 16 percent. This generated "savings" of more than RSD 12 billion–a sum close to the amount lost from with the transfer cuts. This can be seen from Table 5 below.

Even more striking than the decline in investment spending, however, is the radical reduction of both capital and operating subsidies to local communities (*Mesna Zajednica*, MZs) and local public utility companies (PUCs), particularly the latter. Collectively these subsidies fell by a whopping RSD 19.2 billion, far outstripping the reductions in direct capital spending by local governments. Local governments, in other words, clearly attempted to push a good deal of their revenues losses onto the backs of MZs and particularly PUCs –the latter of which represent 12.8 billion of the 19.2 billion in expenditure cuts.

Both the positive and negative implications of this movement can hardly be underestimated. On the positive side, the reductions in subsidies should push PUCs to pay greater attention to both the cost of their services and the collection of user charges, and thus represents –at least in theory— a positive step towards greater full cost recovery in the utility sector.

Table 5. The Structure and Composition of Local Government Expenditures in 2007 and 2009 (in 2009 RSD)					
	2007	**% of total**	**2009**	**% of total**	**% Change**
Other	7,754,128,989	4%	9,123,497,419	5%	18%
Other Operating Subsidies	8,424,912,307	4%	9,606,107,158	5%	14%
Operating Subsidies MZs	14,676,436,958	7%	13,228,167,834	8%	-10%
Operating Subsidies PUCs	17,876,503,664	9%	9,809,497,565	6%	**-45%**
Capital Subsidies MZs	8,193,354,106	4%	3,202,126,771	2%	**-61%**
Capital Subsidies PUCs	10,126,635,461	5%	5,350,496,520	3%	**-47%**
Capital Investment	50,259,506,644	25%	42,407,721,143	24%	-16%
Wages	37,079,531,560	18%	40,543,037,895	23%	**9%**
Goods and Services	47,698,925,990	24%	41,891,269,220	24%	-12%
Total Expenditures	**202,089,935,679**	**100%**	**175,161,921,525**	**100%**	**-13%**
Total Revenues	*194,981,191,727*	96%	*165,452,711,110*	94%	-15%
Expenditures Over Revenues	*4%*		*6%*		61%

Unfortunately however, we do not have information on what happened to utility prices –which still are at least theoretically capped by the GoS—or to the collection of utility fees and charges. But either way, it does seem that the crisis has created opportunities for the GoS to encourage the commercialization of local public utilities –but only if it makes substantial efforts to improve the regulatory framework in which they operate.

On the negative side, however, it is also certain that many local governments slashed subsidies to PUCs simply to balance their books and that utilities —instead of reducing costs or raising own revenues— are running-up payment arrears to suppliers, potentially on massive scale. This is an extremely disturbing possibility because it can take years to work out interlocking debt between public sector agents, as for example it has (repeatedly) in Ukraine[2].

Indeed, until recently Serbia seems to have managed to keep this not uncommon characteristic of transitional economies under reasonable control. But the question now is, is this still the case? Or has the combination of recession and transfer cuts pushed Serbia onto the slippery slope of accelerating payment arrears? This is a question that desperately needs to be researched.

Despite the budget crunch, local governments managed to raise expenditures on wages 9 percent —an increase of about 3.2 billion, and 14 percent or 1.2 billion on subsidies to institutions other

[2] In the spring of 2009, 104 out of 145 municipalities responded to a survey instrument on payment arrears conducted by the Standing Conference of Serbian Towns and Cities. According to the results of this survey, local government payment arrears had risen to 17 bln RSD (c. 10% of total annual revenue) by April 30, 2009, of which 12 bln RSD was owed by public utility companies.

than MZs and PUCs, meaning to other budget users and NGOs. The latter increase was probably driven by the social distress that accompanied the recession and was spent in the form of grants to actors somehow trying to maintain living standards or to provide services to those in needs because as we will see in a moment, spending on Social Welfare increased sharply.

The 9 percent increase in wages was evenly divided between direct employees of City hall and the employees of municipal budget users, the vast majority of which are Preschool Teachers whose wages —though not employment— is basically controlled by the GoS (in negotiation with the Teachers Unions). Some of the increase may also represent a growth in severance payments, as at least some local governments moved to reduce employment in line with GoS guidelines. Unfortunately, however, we do not have solid data in this area. Either way, however, it does seem that local governments managed to slow wage growth, if not fully contain it.

Table 6 below presents local government spending by function in 2007 and 2009. The most significant decline in spending by function came in the areas of Community Development —21 percent— Transport and Roads —29 percent— and General Economy Activity —27 percent. These areas are strongly associated with the decline in investments and in subsidies to PUCs and MZs. Together, the first two of them –Community Development and Roads—amounted to RSD 19 billion in expenditure cuts, by far the largest share of them.

Table 6.
The Composition of Local Government Expenditures by Function: 2007, 2009
(in 2009 RSD)

	2007	% of Total	2009	% of Total	% Change
Defense, Safety, Health	2,094,594,927	1%	1,452,254,669	1%	-31%
Environment	3,651,918,229	2%	4,242,111,269	2%	**16%**
Social Protection	6,583,703,628	3%	8,174,937,886	5%	**24%**
Sport	5,161,065,884	3%	6,117,118,520	3%	**19%**
Secondary Education	5,611,134,081	3%	3,854,593,662	2%	**-31%**
Housing	8,502,126,171	4%	7,339,756,264	4%	-14%
Primary Education	10,390,510,883	5%	8,716,929,058	5%	**-16%**
Culture	12,375,479,805	6%	11,221,516,031	6%	-9%
Preschools	12,673,965,257	6%	16,177,759,655	9%	**28%**
Economic Activity	14,051,464,389	7%	10,261,512,288	6%	**-27%**
Transport and Road	31,880,677,850	16%	22,769,877,360	13%	**-29%**
General Services	40,949,003,929	20%	36,787,811,038	21%	-10%
Community Development	48,164,290,645	24%	38,045,743,824	22%	-21%
Total	**202,089,935,679**	**100%**	**175,161,921,525**	**100%**	**-13%**

But by far the most surprising finding in this table is the very rapid and real growth of spending on preschools —up 28 percent and RSD 3.5 billion—, even while spending on Primary and Secondary Education fell, and this by substantial amounts (16 percent and 31 percent respectively). What is going on here is not entirely clear, though the fact that local governments pay preschool teachers wages is certainly driving some (probably even most) of the growth. What is clear is that there is a crying need for the Ministry of Education to recognize that local governments play an important role in the sector, and what they do and don't do has implications for the education of the nation.

Elsewhere, it is understandable why spending on Social Welfare should increase by 24 percent during the recession. And it is good that spending on the Environment also rose 16 percent despite the downturn. It is less obvious, however, why spending on Sport should rise 19 percent in the face of the same hardships.

Table 7 below presents the composition and structure of local government expenditures in 2007 and 2009 in per capita terms. As can be seen from the Table, investing spending declined 26 percent as while wages rose 9 percent. This affected the relative share of these expenditures in total local government spending, with investment spending declining on from 34 percent of total spending in 2007 to 29 percent in 2009. Meanwhile, wages rose from 18 percent of spending in 2007 to 23 percent in 2009.

Table 7.
Changes in the Composition and Structure of Local Government Expenditures 2007 2009, (in 2009 RSD per capita)

	2007	2009	% change	2007	2009	% change
Other	1,034	1,217	18%	4%	5%	36%
Operating Subsidies	5,465	4,354	**-20%**	20%	19%	-8%
Wages	4,945	5,407	**9%**	18%	23%	26%
Goods and Services	6,362	5,587	**-12%**	24%	24%	1%
Investment	9,146	6,797	**-26%**	34%	29%	-14%
Total	**26,953**	**23,361**	**-13%**	**100%**	**100%**	0%

The relatively high share of investment spending in total spending that local governments maintained even in the face of severe budget pressures is comforting. It is however, less comforting than it might be, after a look at that data in Table 8. This Table shows the percent of all investment spending by Quartile, as well as the share of investment in the total spending of that Quartile.

As can be seen from the Table, only 5 percent of all investment spending takes place in the two poorest to quartiles, while an enormous share (86 percent) is carried out in the richest quartile and in Belgrade and Novi Sad. Moreover, these proportions have not changed much between

2007 and 2009. What this means is that whatever the improvement in the equity of Serbian intergovernmental finances that have come from system the LGFL or as by-product of the crisis—have not been sufficient to substantially increase the investment spending of poorer local governments.

Table 8.
Total Investment Spending by Quartile and as a Percent of each Quartile's Total Spending

	2007		2009		2007	2009
Quartile	**Investment**	**% of Total**	**Investment**	**% of Total**	**% of Quartile**	**% of Quartile**
1	1,514,237,278	2%	1,281,245,435	3%	14%	14%
2	2,144,572,299	3%	1,797,270,074	4%	17%	13%
3	5,736,794,069	8%	3,836,843,781	8%	24%	16%
4	13,013,864,101	19%	8,966,146,695	18%	34%	23%
BG,NS	46,170,028,465	67%	35,078,838,448	69%	52%	40%
Total	**68,579,496,211**	**100%**	**50,960,344,433**	**100%**	**39%**	**29%**

Indeed, while the share of investment spending in the total spending of the two poorest quartiles has remained relatively stable over the last three years, it is also extremely low and now accounts for less than 15 percent their total expenditures. Perhaps even more disturbing is the steep decline in investment spending in the 3rd and 4th Quartiles: For the 3rd Quartile, investment spending as a share of total spending declined from 24 percent in 2007 to 16 percent in 2009, while in the 4th Quartile it feel from 34 percent to 23 percent. The sharpest decline however, was in Belgrade and Novi Sad where it fell from 52 percent of total expenditures in 2007 to a still robust, but substantially diminished 40 percent in 2009.

4. Conclusions and Recommendations

With respect to inter-governmental finances in Serbia, it is hard to argue that the glass is still half full: local government revenues are way down; payment arrears are going up; the allocation of grant monies is increasingly "discretionary"; and the GoS still has not articulated a clear policy with respect to transfers for FY 2011, to say nothing about its posture towards the LGFL as a whole or the development of some clearer mid-term strategy.

Indeed, if there is water in the glass most of it comes from local governments: It is they who are increasing the collection of own revenues; they who have been struggling to maintain investment rates; they who have increased spending on Preschool Education and Social Welfare; and they who have begun to impose some financial discipline on PUCS. In fact, the only water in the glass coming from the GoS is the still vague promises that "transfers will be restored", and the recent decision to reinvest the Intergovernmental Finance Commission mandated by the LGFL with the status it deserves.

So let us begin with the Commission. There is a crying need to resume a substantive dialogue between the national government and local governments about a host of pressing issues. And the decision to reinvigorate the Commission is a good start on this front, if in fact the Commission is used to discuss issues and not just to rubber stamp decisions that have already been made. With that said, let us at least identify the issues that should be on the Commission's agenda.

The first and most obvious is, of course, what will happen with the General Grant next year. Here a variety of numbers are being bandied about. But so far at least, nobody within the GoS has even mentioned the possibility of restoring the LGFL, or for that matter restoring the Law, but perhaps lowering the share of the GDP used to define the size of the General Grant. This is unfortunate because the real structural issue going forward is the restoration of a rules based system in which local government revenues are adequate, predictable, and reasonably equitable.

The second, less visible but nonetheless crucial issue is the recalibration of the equalization threshold contained in the LGFL. This is important because after the LGFL was passed the 2007 Law on Territorial Organization increased the number of local government that are considered Cities from 4 to 21. Because the current equalization rule calculates the threshold for equalization on the bases of the average per capita income of local governments "without cities" the creation of 17 new cities has significantly reduced the threshold.

In 2009 (and perhaps) 2010 the MoF continued to calculate the threshold has if there were only four Cities. If however, it begins to calculate the threshold in accordance with the rule then the threshold at which local governments begin to be entitled to equalization grants would fall from RSD 5,400 per capita to RSD 4,600 per capita. As a result, 28 jurisdictions of the 88 jurisdictions that currently receive equalization grants, including 3 new cities (Leskovac, Novi Pazar, and Loznica) would no longer receive them, and the total amount of money earmarked for equalization grants would drop from about RSD 2.8 billion to RSD 1.4 billion. This would radically worsen the situation of Serbia's already hard pressed poorer jurisdictions.

The third issue that needs to be addressed is Property Tax Reform. Here, there are three critical problems: the first is simply reducing or eliminating statutory abatements and exemptions that radically lower the yield of the tax and make it extremely inefficient to administer. The second is giving local governments the power to impose and collect taxes from tax payers who fail to file tax declarations. And third, and most difficultly, is redefining how the base of the tax should be calculated, particularly, but not only for businesses.

In any case, the real point is that the GoS cannot expect to increase the fiscal responsibility of local governments simply by reducing grants and transfers: On the contrary, if this effort is to be successful the GoS must equip local governments with the instruments they need to responsibly raise their own revenues. And at moment, the Property Tax is one of the two best instruments--that can be reasonably "given" to them.

The other, strangely enough, is better utility regulation. At a minimum, this means removing the caps on utility prices, caps that under the current circumstances are prompting the build-up of payment arrears. More importantly over the medium term however is the establishment of a regulatory framework that encourages local governments to commercialize the operation of their PUCs; which pushes them towards full cost recovery pricing; and which makes privatization of at least some communal services possible.. The current draft legislation on Local Public Utilities is a promising start in this. But so far, it seems that the legislation is not being discussed in relationship to the overall intergovernmental finance system –of which it is part—but as a sort of one-off initiative from the Ministry of the Environment.

Similarly, the GoS has to be more cognizant of the fact that not only has it cut local government revenues over the last few years, but that it is has also been assigning them new functions and increasing their operating costs. The most significant example of this is with the wages of Preschool teachers, and the absence of a serious dialogue between national and local governments about education is both disturbing and dangerous. But education is not the only area in which the GoS seems to be expecting local governments to pay for many of its good intentions. For example, in the last few years local governments have been charged with creating communal police forces; opening Youth Offices and Gender Equality Commissions; employing staff with university degrees and adopting new spatial and urban plans, without any acknowledgement that these services have costs.

Finally, the GoS should take steps to ensure that the allocation of capital grants is directed to those local governments who really cannot afford to pay for new investment on their own. As we have seen, the investment spending of poorer local governments in Serbia is still extremely low, despite the overall improvement in the equity of the system. Restoring the transfer system would obviously put more money in the hands of poorer jurisdictions. But it may not be enough to bring their investment rates up. As such, the GoS should consider requiring that poorer jurisdictions pay a smaller percentage of the total costs of investments that are receiving grant support from the national government, and of requiring the line ministries that control capital grants to articulate clearly defined grant procedures and co-financing norms that favor poorer jurisdictions.