NALAS

Network of Associations of
Local Authorities of South-East Europe

CENTRE FOR PUBLIC ADMINISTRATION RESEARCH
KDZ

REPORT

Fiscal Decentralisation Indicators for South-East Europe

10

Tenth Edition
May 2025

A Decade of Reforms, Crises, and Multilevel Governance

Fiscal Decentralization in South-East Europe:

10 Tenth Edition May 2025

A Decade of Reforms, Crises, and Multilevel Governance

This publication is a collaborative effort of the NALAS Task Force on Fiscal Decentralization.

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Abbreviations

ACoR	Association of Communes of Romania
ADA	Austrian Development Agency
AKM	Association of Kosovo Municipalities
ALAA	Association of Local Autonomy of Albania
ALB	Albania
ALL	Albanian Lek
ALVRS	Association of Towns and Municipalities of Republic of Srpska
AOC	Association of Cities in Croatia
AUT	Austria
BACID	Building Administrative Capacities in the Danube Region
BGR	Bulgaria
BiH	Bosnia and Herzegovina
CALM	Congress of Local Authorities from Moldova
CIT	Corporate Income Tax
COFOG	Classification of the functions of government
COVID	Coronavirus disease
EFDF	Equalization Fund for Decentralized Functions
EU	European Union
EUR	Euro
FBiH (BiH)	Federation of Bosnia and Herzegovina, Bosnia and Herzegovina
FEF	Fiscal Equalization Fund
GDP	Gross Domestic Product
GG	General Government
GoA	Government of Albania

HLG	Higher Levels of Government
HRV	Croatia
KDZ	Centre for Public Administration and Research, Austria
KOS	Kosovo*[1]
LDF	Land Development Fee
LG	Local Government
LGA	Local Government Association
LGU	Local Government Unit
LLGF	Law on Local Self-Government Finance
LLTS	Law on the Local Tax System
LPA1	Local Public Administration Level 1
LPA2	Local Public Administration Level 2
LSG	Local Self-Government
LSGU	Local Self-Government Unit
LUF	Land Use Fee
MDA	Moldova
MKD	North Macedonia
MMU	Marmara Municipalities Union
MNE	Montenegro
MoF	Ministry of Finance
MoFE	Ministry of Finance and Economy
MTEF	Medium-Term Expenditure Framework
NALAS	Network of Associations of Local Authorities in South-East Europe
NAMRB	National Association of Municipalities in the Republic of Bulgaria
NGO	Non-Governmental Organisation

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[2] This designation is without prejudice to positions on status, and is in line with UNSCR 1244/1999 and the ICJ Opinion on the Kosovo declaration of independence

OECD	Organization for Economic Co-operation and Development
OSR	Own Source Revenues
PAR	Public Administration Reform
PFM	Public Finance Management
PIT	Personal Income Tax
RDF	Regional Development Fund
ROU	Romania
RS (BiH)	Republic of Srpska, Bosnia and Herzegovina
RSD	Serbian Dinar
SCTM	Standing Conference of Towns and Municipalities
SDC	Swiss Development Cooperation
SEE	South-East Europe
SNG	Subnational Government
SOGFBIH	Association of Municipalities and Cities of the Federation of Bosnia and Herzegovina
SOS	Association of Municipalities and Towns of Slovenia
SRB	Serbia
SVN	Slovenia
TUR	Türkiye
UMM	Union of Municipalities of Montenegro
VAT	Value Added Tax
WB6	Western Balkan Six
ZELS	Association of the Units of Local Self-government of Republic of Macedonia

Executive Summary

The tenth edition of the NALAS Fiscal Decentralization Report examines local finance developments and fiscal decentralization reforms in South-East Europe (SEE) over the past decade. It analyzes intergovernmental fiscal relations, focusing on intergovernmental transfers, equalization models, local tax powers, and borrowing. This edition introduces a comparative overview of the frameworks for multi-level government policy dialogue, the positioning and key advocacy efforts of NALAS member LGAs, and last but not least a comparative analysis of the intergovernmental transfer systems and the programs supporting local government capital investments.

This report is the result of a collaborative effort of the NALAS Fiscal Decentralization Task Force whose members are at the forefront of the policy reforms in SEE. The purpose of this report is to provide guidance for informed policy dialogue for Local Government Associations and policymakers at national and local levels across SEE in planning, assessing and implementing intergovernmental finance reform options. The report publishes data for the past 10-years, while more data can be retrieved in the NALAS Observatory.

Overall, NALAS evaluates that significant progress has been made in the recent decades. However, challenges and disparities persist. Strengthening multi-level governance, ensuring fair revenue distribution across government levels, and improving municipal own-source revenue collection remain key priorities for LGAs.

I. Territorial, Demographic, and Socio-Economic Developments

SEE presents a diverse territorial structure. Bulgaria, Kosovo, Montenegro, North Macedonia, and Slovenia have single-tier municipal governance models, while other economies like Bosnia and Herzegovina have multi-tiered systems. Average population of first tier Local Governments (LGs) varies significantly across the region, from Moldova's municipalities with an average of less than 4000 inhabitants to Türkiye's more consolidated municipalities with an average population of over 61.000 inhabitants.

SEE has experienced notable urbanization trends. On average, 17.7 % of SEE populations live in capital cities, while this share is 22% in the WB6 economies. As urban populations grow, rural areas continue to face major challenges of aging and declining populations, leading to major shifts in demands for local services and increased pressures on the intergovernmental finance systems.

Population decline remains a significant challenge for SEE. Between 2014 and 2023, the WB6 countries saw a population decline of over 1.1 million people, with Moldova (-29.4%), Albania (-17%), and North Macedonia (-11.4%) experiencing the largest losses. Migration trends also show a growing diaspora, which provide short-term economic relief through remittances. However, the long-term effects of population decline, increase urbanization and skilled labor migration continue to undermine local service planning and delivery and public finance reforms. Cohesive strategies are needed that address the root causes of emigration.

Economically, SEE economies have weathered fairly the multiple crisis affecting the region with an average GDP growth rate of 4.2% in 2023. However, disparities persist, with Western Balkans Six (WB6) economies exhibiting lower per capita income levels compared to neighbouring EU members in SEE. Inflation rates averaged 8.1% across the region in 2023, impacting local government expenditures.

II. Multi-Level Government Dialogue

NALAS member Local Government Associations (LGAs) play a pivotal role in policy dialogue in SEE, in shaping policies and enhancing public services for citizens. SEE LGAs are officially designated as representatives of local authorities, in most cases based on the provisions of the Law on Local Self-Government and through specific Memoranda of Cooperation with higher levels of government. Their participation in policy dialogue with higher levels of government spans formal consultations, legislative task forces, and interministerial working groups, making them vital actors in intergovernmental dialogue and policy development.

SEE LGAs have structured and effective mechanisms to support their policy advocacy efforts. Many operate specialized committees and working groups focused on finance, governance, and service delivery. For example, NAMRB in Bulgaria has 14 standing committees engaging in intergovernmental consultations, while AKM in Kosovo has 21 professional collegia that provide expertise and guide policy dialogue for legislative initiatives. Similarly, SCTM in Serbia actively participates in national and sectoral committees addressing local fiscal policy, taxation, and public administration.

Advocacy efforts by SEE LGAs have yielded notable policy changes. In North Macedonia, ZELS successfully advocated for an increase in VAT and PIT allocations for municipalities, along with the provision of *e-service* platforms for their members. In Montenegro, UMM lobbied for compensation for revenue losses caused by national tax reforms, while CALM in Moldova and ACOR in Romania have advocated for improvements in the equalization system and a structural reform of their intergovernmental transfer systems. At the same time, LGAs directly contribute also to improving municipal services; for example, AOC in Croatia has played a pivotal role in supporting its members enhance revenue management through IT solutions.

III. Key Fiscal Decentralization Reforms

Several SEE economies have introduced new decentralization strategies to strengthen local governance and service deliver, but fiscal decentralization reforms remain limited. Albania's 2023-2030 strategy focuses on local development, municipal revenues, digital services, and EU alignment, though its fiscal reforms remain aspirational. **Serbia**'s 2021-2025 roadmap aims to modernize local services and enhance financial decentralization, but discussions on non-earmarked grants, a key financing and equalizing instrument are ongoing. **North Macedonia**'s 2021-2026 Strategy has made more substantial progress, increasing the share of intergovernmental transfers from 4.5% to 6% of VAT in 2024 and improving fiscal discipline and transparency.

Bosnia and Herzegovina has seen little change in intergovernmental transfers, except for property tax improvements in the Republic of Srpska (of BiH). In the Federation of Bosnia and Herzegovina (of BiH), the municipal association (SOGFBiH) continues to advocate for fairer revenue distribution.

Montenegro faces financial pressures from tax base reductions, and proposed eliminations of land development fees. Although local PIT shares have increased, 10% of PIT from wealthier municipalities is now redistributed to financially weaker ones, a change that remains contested. The government is also exploring differentiated municipal responsibilities, while UMM has challenged in the Constitutional Court wage disparities in communal utilities. In **Croatia** too municipalities struggle with staff outflows due to wage disparities between central and local governments. However, fiscal equalization has improved through a new fund, and property tax reform is underway. **Slovenia** is also advancing property tax reform to enhance municipal revenues.

Bulgaria has launched a €2.1 billion municipal investment program (2024-2026), following a €200 million initiative in 2022, where NAMRB secured a transparent funding mechanism. **Moldova** has reorganized its National Fund for Regional and Local Development and is pursuing voluntary municipal amalgamation. CALM successfully pushed for improved transfer formulas and a 10% CIT share increase for general-purpose transfers.

Romania's 2018 centralization of the pre-university wage bill reshaped intergovernmental transfers, reducing sectoral block grants. Due to reforms shared tax revenues doubled. The general grant for budget equalization surged in 2019 but stabilized after a new formula revision in 2020.

IV. Transfer Systems and Investment Grants

Intergovernmental transfers constitute up to two-thirds of local government revenue in SEE. SEE local governments generate, on average, 30% of their revenues from their own sources. Shared taxes contributed 25% of the total revenue, followed by general grants (14%), sectoral block grants (20%), and earmarked investment grants (12%). Transfers constitute a higher share of local government revenues in Romania, Moldova, Kosovo, Bulgaria, Croatia and North Macedonia, with more decentralized social service sectors.

Shared Taxes

In SEE, the design and implementation of shared tax systems vary widely, both in terms of size, composition, and the mechanisms for their distribution, reflecting differing levels and approaches of fiscal decentralization and local autonomy. Shared taxes are at the cornerstone of the local finance system in Croatia, Slovenia, Serbia and Türkiye where shared taxes constitute between 40%-60% of total local revenues. In Croatia, local governments retain 74% of PIT, while in Serbia, the municipal share ranges from 66% to 77%. In Montenegro, municipalities receive 40%-89% of PIT revenues, with higher allocations for less-developed regions.

General-Purpose Transfers

General-purpose grants serve as a key funding mechanism for local governments in Albania, Bosnia and Herzegovina and Kosovo., making up between 40% to 60% of total local revenues. In some economies, equalization grants are included within or strongly related to general-purpose transfers. In all cases, the size and allocation of general-purpose and equalization transfers are specifically regulated to ensure stability, predictability and transparency. Albania's unconditional transfer is set at 1% of GDP. North Macedonia's unconditional grants are anchored at 6% of VAT revenues to municipalities, while in Kosovo the unconditional grant is set to 10% of total government revenues. Serbia's general grant system includes multiple components, such as equalization and compensatory grants, while in Bulgaria the 'general subsidy', which in fact provides earmarked funding, integrates cost-based funding for delegated functions.

Overall, the transfer systems of the WB6 economies were typically developed in the early 2000s, prioritizing simplicity, functionality, and transparency, albeit with varying degrees of success. In contrast, EU member states in SEE, such as Slovenia and Croatia, have developed more advanced and refined systems that balance incentives for local efficiency and performance with equalization. Meanwhile, Bulgaria's local financing system remains comparatively centralized, as is the case of the block-grants in Romania. Updating and adapting the transfer system is crucial to respond to the evolving needs and challenges of local governments and the SEE region provides significant opportunities for reform options.

Investment Grants

Investment grants support infrastructure development and service expansion. Bulgaria has recently allocated €2.1 billion in municipal investment projects through 2026, but it has several other instruments supporting local government investment such as the Earmarked Capital Subsidy, which is allocated based on objective natural indicators such as no. of settlements, road length, population and surface area. Similarly, Slovenia allocates different types of grants supporting investments at the local level which are allocated based on published and transparent allocation methodologies including indicators for development, vulnerability, and development potential. In Moldova, the National Fund for Regional and Local Development consolidates multiple funding streams to finance municipal projects. North Macedonia has relaunched a reform for regional development, in a similar fashion as Albania in previous years. Albania's Regional Development Fund, however, has faced criticism over transparency in allocation.

V. Comparative Overview of Fiscal Decentralization Indicators

There are major disparities in the size of the public sector compared to the EU and within SEE economies. In fact, the average size of public revenues in SEE stands at 35.9% of GDP, compared to the EU's 45.5% in 2023. As a result, local government revenues as a share of GDP vary significantly from 3.3% in Türkiye to 9.6% in Moldova. There are major disparities also within SEE, with local government revenues in per capita terms varying from 316 EUR per inhabitant in Bosnia and Herzegovina to 1,569 EUR per inhabitant in Slovenia.

Trends in local government revenues highlight mixed progress across the region. From a comparative perspective, over the past decade, overall, local government revenues have improved only in Albania, Montenegro, Moldova, and slightly in Bulgaria, while they have declined in Türkiye, Slovenia, North Macedonia, and Kosovo. Changes in the level of financing are directly related by changes in fiscal policies, service decentralization but also the implications of the recent crises.

Fiscal autonomy has continued to decline in SEE. Over the past decade, the share of own-source revenues (OSRs) in total local revenues across SEE has declined by an average of 11.8% (or 4 percentage points). This trend reflects reduced local tax powers due to tax cuts and exemptions for specific taxpayer categories. Albania and Serbia exemplify this reduction in local fiscal autonomy, paired with a growing reliance on (earmarked) grants for municipal responsibilities and in shared taxes in Montenegro. In Bulgaria the state budget will cover the costs for the abolishment of the municipal fees for preschool education in 2022. Croatia abolished the local PIT surcharge (a local OSR), increased the share of shared taxes and transferred rate setting powers to LGs. Albania increased sectoral block grants, while North Macedonia increased the share of grants anchored from 4.5% to 6% of VAT. In Romania shared taxes have doubled over the past 6 years because of fiscal policy changes.

The structure of own source revenues varies significantly across the SEE region. Overall, local taxes constitute up to 40% of OSRs, while fees and charges constitute 34%, followed by asset management revenues which constitute 13%. In Bosnia and Herzegovina LGs do not have major tax powers. Fees and charges are also very relevant in Türkiye, Romania, North Macedonia, and Serbia making up to 50% of OSRs.

Own source revenue potential and performance varies significantly across the SEE region. The frequent changes of local taxing powers by the central level have major implications in the ability and performance of municipalities to strengthen their revenue management systems. There are huge variations in the ability and performance of SEE LGs to collect their own revenue varying from 27 Euro per inhabitant in Moldova to 467 Euro per inhabitant in Slovenia. Basically, Slovenian and Montenegrin municipalities generate two times more OSRs than their peers in SEE and WB6, due to both higher taxing authority and collection performance. Major disparities persist also within SEE economies. For example, Tirana and Albania's seven largest municipalities collect 78% of total OSRs.

SEE economies are advancing reforms, but challenges persist due to fragmented frameworks and systems and limited fiscal autonomy. Bosnia and Herzegovina struggles with an uncoordinated system of over 350 fees in FBiH, while Serbia has streamlined its fee structure through the 2018 Law on Fees. Croatia and Slovenia are shifting toward property-based taxation to strengthen local revenues. However, frequent legislative changes can hinder municipal planning. Outdated fiscal registers, lack of connectivity between systems and databases, lack of cooperation among institutions and weak enforcement further constrains revenue collection across the region. LGAs can play a fundamental role in supporting municipalities enhance revenue generation as indicated by the IT solutions promoted by the Association of Cities of Croatia.

The property tax is becoming the lead local government tax in South-East Europe. From a regional perspective, between 2006 and 2023, the yield of the property tax almost doubled, increasing from 14% to 27% of OSRs, from 5% to 9% of local revenues and from 0.3% to 0.6% of the GDP. This tendency is driven by the outstanding performance of Bulgaria, North Macedonia, Montenegro, and Serbia and to a lesser extent Kosovo, Albania and Slovenia. Montenegro's and Serbia's indicators are the highest in the region. However, despite improvements, the property tax remains an underutilized source of local revenue, contributing only 0.6% of GDP on average across SEE vis-à-vis 1.6% of the GDP in the EU.

Local borrowing remains underutilized across SEE, with significant disparities in debt levels. While Austria, Türkiye, and Slovenia have local debt ratios above 2-4% of GDP, borrowing in Albania and North Macedonia is minimal, and Kosovo municipalities cannot borrow at all. Serbia, Moldova, and Bulgaria have modest debt levels (0.52-0.73% of GDP), while Croatia, Romania, and Montenegro see higher usage (around 1.5% of GDP). Key barriers include restrictive legal frameworks, high national debt, and budget deficit constraints linked to Maastricht Treaty guidelines. Many SEE governments require central approval for local borrowing, further limiting access to debt capital. Additionally, municipalities often lack the technical capacity to develop and manage complex, multi-year investment projects. Expanding access to responsible local borrowing could enhance infrastructure development and service delivery across the region.

On the expenditure side, SEE local governments manage approximately 16% of total public expenditures, constituting up to 6% of the GDP. There are significant differences though, with Türkiye's local governments managing only 11% of total public expenditures and Moldova's and Kosovo's local governments manage 25% of total public expenditures. These significant differences, reflect the differences in service responsibilities and levels of income. Unsurprisingly, in Moldova, Kosovo and Romania, LGs have extensive decentralized social sector responsibilities in education and to a lesser extent in health and social protection.

There are significant differences in the local government expenditure composition across SEE. Overall, SEE LGs spend on average 27% on capital investments, 33% on salaries, 22% on goods and services and 16% on transfers. From a functional perspective, SEE local governments spend about 18% of total municipal budgets for general public services, about 26% on education, 16% on economic affairs and about 12% for housing and community amenities.

Local government investment in SEE varies significantly across economies due to differences in fiscal capacities, levels of decentralization, and governance structures. Local governments in the region typically operate under constrained fiscal conditions, relying heavily on intergovernmental transfers and limited options for generating own-source revenue. Local government investments in SEE constitute up to 1.6% of the GDP, close to the 1.8% in the EU. In SEE economies with larger social sector responsibilities in education and social services in particular, the share of local government investment to GDP is higher, as indicated by Romania, Moldova and Kosovo. On average, WB6 LGs allocate €108 per capita to capital expenditures, approximately half the SEE average of €209 per capita and five times less than in the EU €559.

Public investments are more centralized in the WB and SEE compared to the EU. On average, in the WB, local governments account 25% of total public investments, with Macedonian and Serbian local governments managing only up to 15% of total public investments and Montenegrin municipalities managing twice that amount, without having any major responsibilities in the costly social sectors of education and social services as in North Macedonia and Serbia.

Most SEE economies have national mechanisms to support local capital investments, though their scope and impact vary. North Macedonia's Regional Development Program aims to reduce disparities but has yet to meet its 1% of GDP target. Albania's Regional Development Fund finances municipal projects in infrastructure, transport, and education, while Moldova has tailored investment tools for municipal infrastructure. Bulgaria allocates capital funding through an Earmarked Subsidy. Slovenia provides earmarked infrastructure grants and balanced development grants. Türkiye supports rural areas through conditional grants like KÖYDES.

The EU plays a fundamental role to support municipal investments and reduce territorial development disparities in South-East Europe, although the support for the Western Balkans municipalities is rather limited. EU cohesion funds and other structural investment programs are a major source of financing for local governments in Croatia, Bulgaria, Slovenia and Romania. On the other hand, the EU supports also EU candidates in infrastructure and institutional development with IPA funds, the Western Balkans Investment Framework and the new Growth Plan for the Western Balkans. However, these instruments focus predominantly on central government investments, and do not provide opportunities for local government investments. With very few exceptions, local governments and their associations in the Western Balkans have a limited role in the programing of EU assistance. Indeed, in Serbia the Standing Conference of Towns and Municipalities and the EU have partnered for over two decades in planning and implementing instruments designed to support investments at local level.[2] In Albania, this cooperation started only lately, in 2021 when the EU delegation entrusted NALAS and the local government associations in Albania with the implementation of the EU4Municipalities program, providing investment grants to local governments from the National IPA program for the first time. Nevertheless, in most cases in the WB6, there are no regular EU programs designed to reduce territorial development disparities and upgrade local public services infrastructure. NALAS is continuing its advocacy efforts together with its partner LGAs to create a specific role for local governments within the EU's financing instruments, such as the new Growth Plan.

[2] Similarly, the EU has financed since 2010 a specific program in Serbia aiming a more balanced socio-economic development at local and regional levels, that has developed over time in a preparatory facility for local and regional actors to exercise planning/programming and implementation of projects according to the models/instruments of the EU Cohesion policy. The EU contribution over past 14 years of this initiative implemented via UNOPS amounts to almost 99 million EUR and encompasses over 1200 individual projects.

Introduction

This report has been prepared by the NALAS Fiscal Decentralization Task Force. It is the tenth edition of an ongoing effort to provide policymakers and analysts with reliable comparative data and information on municipal finances in SEE.

Over the past decade, fiscal decentralization has evolved in response to economic shifts, policy reforms, and external crises. This report aims to capture these developments, offering insights into intergovernmental fiscal relations, property taxation and local revenue generation, local borrowing, LG capital investments and multi-level policy dialogue.

Fiscal decentralization remains a cornerstone of good governance, enabling local governments to deliver essential public services efficiently. However, disparities persist across SEE economies, with some making significant strides in strengthening municipal autonomy while others face challenges related to the fair distribution of revenues across local government, fiscal authority, generation, expenditure responsibilities, and intergovernmental coordination. The report assesses these dynamics through a comparative lens, highlighting key achievements, challenges and opportunities of fiscal decentralization reforms and practices while highlighting the key policy areas where SEE LGAs have focused their efforts.

This edition places particular emphasis on a comparative overview of the intergovernmental transfer systems, key tax reforms, and investment grants and key reforms enacted in SEE economies, providing an opportunity for learning from successful and unsuccessful policy reforms. Additionally, it examines the role of SEE Local Government Associations (LGAs) in advocating for fiscal decentralization and influencing national policy. As SEE economies continue to navigate demographic shifts, urbanization, and financial constraints, the findings of this report serve as a crucial resource for Local Government Associations, policymakers, local authorities, and international stakeholders engaged in municipal development.

This edition covers the period 2014-2023 and, compared with the previous one, includes data for 2022 and 2023. The reader may retrieve more data for previous years and develop data visualisations in the NALAS Decentralisation Observatory.

The report consists of five sections. The first analyses the territorial, demographic and socio-economic developments. The second reviews the framework and positioning of NALAS member LGAs for multi-level government dialogue. The third provides a brief overview of key reforms, while the fourth gives a comparative overview of transfer systems and investment grants. The fifth section provides a comparative overview of fiscal decentralization indicators capturing the status and trends in SEE. The sixth section provides a detailed description of the evolution of intergovernmental finance systems in each SEE economy.

By presenting a detailed overview of fiscal trends, challenges, and opportunities, the NALAS Fiscal Decentralization Report aims to foster evidence-based decision-making and enhance the capacity of local government associations to engage evidence-based policy dialogue with their national counterparts. The insights provided herein contribute to ongoing efforts to create a more balanced, transparent, and sustainable fiscal framework for municipalities across the region.

I. The Territorial, Demographic and Socio-Economic Developments

The Diverse Territorial Structure of South-East Europe

The territorial organization of local government in Southeast Europe exhibits considerable diversity in terms of governance levels, administrative complexity, and functional distribution, influenced by historical, political, and socio-economic contexts.

Bulgaria, **Kosovo**, **Montenegro**, **North Macedonia**, and **Slovenia** have single-tier systems where municipalities are the primary units of governance. In Bulgaria, municipalities enjoy a degree of autonomy in fiscal matters but are heavily reliant on central funding, much of which is earmarked. Kosovo too grants significant autonomy to municipalities, emphasizing local governance in education and healthcare. Montenegro is also considering expanding municipal responsibilities in the social sector. Slovenia's decentralized model highlights local autonomy, though many of its 212 municipalities are small, often creating challenges in administrative efficiency.

Table 1. The territorial organization of South-East Europe in first-tier local governments

	Levels of Subnational Government	Types of Subnational Government	Number of first-tier local governments
Albania	2	Counties; Municipalities	61
Austria	2	States, Cities, Municipalities	2,093
Bosnia and Herzegovina	3	Entities; Cantons; Municipalities	144
FBiH (BiH)	2	Cantons; Municipalities	80
RS (BiH)	1	Municipalities, Cities	64
Bulgaria	1	Municipalities/Communes	265
Croatia	2	Counties; Municipalities/Communes/ Cities	556
Kosovo	1	Municipalities	38
North Macedonia	1	Municipalities	81
Moldova	3	Autonomous Province; Raions/ Regions; Municipalities/ Communes	898

Montenegro	1	Municipalities	25
Romania	2	Counties; Municipalities/Communes	3,181
Serbia	2	Autonomous Provinces; Municipalities	145
Slovenia	1	Municipalities	212
Türkiye (Marmara Region)	3	Provincial Self-Governments; Regional Self-Government; Municipal and Communal Self-Governments	1,393
Western Balkans			494
South-East Europe			6,999
European Union			89,289

Source: NALAS

In contrast, **Albania**, **Croatia**, **Romania**, and **Serbia** employ two-tier systems that distinguish between municipal and regional or provincial levels. Albania's 2015 reform streamlined its local governance into 61 municipalities. Albania's second tier of local governments, the regional councils, have very limited tasks though. Croatia's counties (*zupanije*) and Romania's *judets* play more substantive roles, particularly in healthcare and regional development. Serbia's subnational government is organized in two levels: provincial and municipal, though the focus remains on the municipal level for local governance.

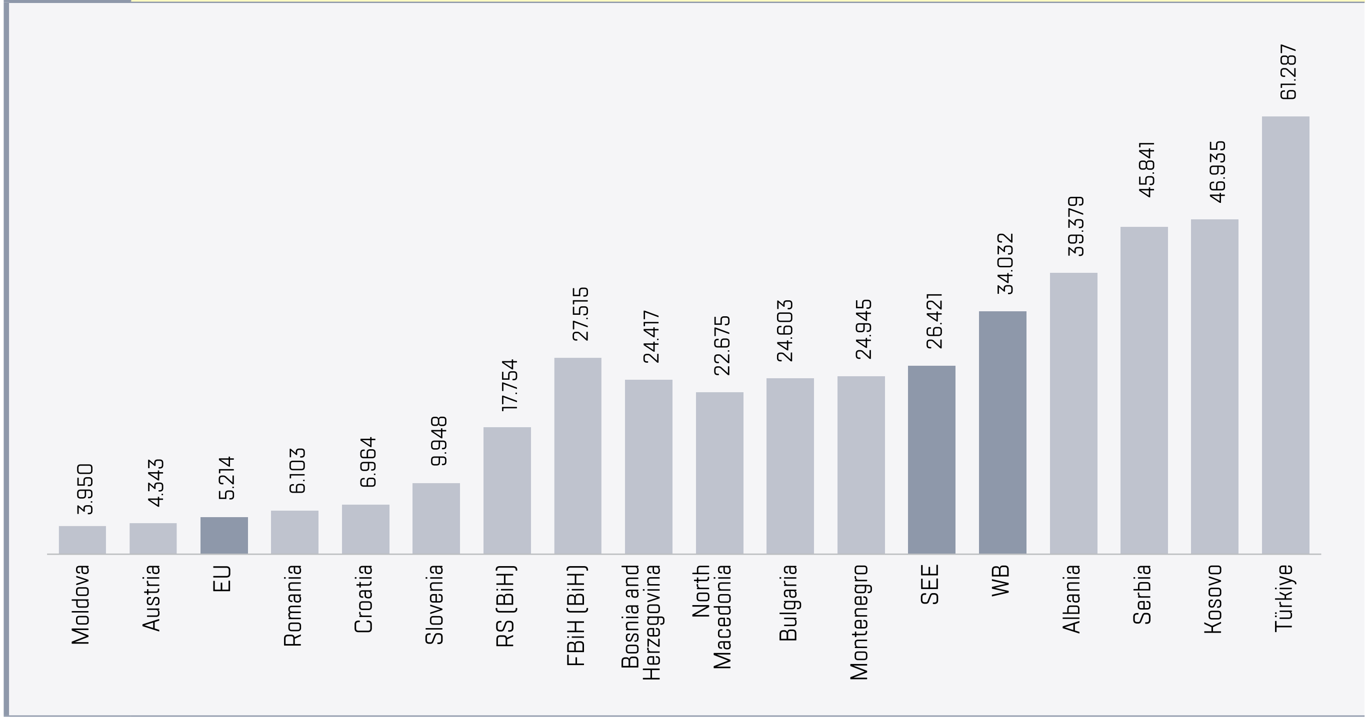
Austria and **Bosnia and Herzegovina** are federal states. Austria has three levels of government: the federal government, nine Länder (states), and 2,093 municipalities. The Länder have constitutional autonomy in areas like education and policing, while municipalities, which include both rural communities and larger urban centres, manage local services such as water supply, waste management, and local infrastructure, often funded by a mix of local taxes, fees, and intergovernmental transfers. Bosnia and Herzegovina's governance is marked by fragmentation, with state, entity, canton, and municipal levels, alongside the autonomous Brčko District. The Federation of BiH (FBiH of BiH) further divides governance through cantons, which control significant public revenues, often overshadowing municipal authority. By contrast, Republic of Srpska (RS of BiH) relies on direct relationships between the entity and its municipalities.

Moldova is a unitary state with two levels of government: central and local. Moldova's sub-national governance includes the autonomous region of Gagauzia, 32 *raions* (districts), and 898 communes and municipalities. Local authorities handle responsibilities like local infrastructure, education, and public utilities but remain reliant on central government transfers, with limited fiscal and administrative autonomy.

Finally, **Türkiye** presents a distinctive three-tier model with provinces, regions, and municipalities, allowing for a blend of regional planning and localized service delivery. In the Marmara Region, regional governance focuses on metropolitan-wide planning, while municipalities handle localized services.

The average population of first-tier municipalities in Southeast Europe (SEE) varies significantly. Moldova has the smallest municipalities, averaging less than 4,000 inhabitants, while Austria, Romania, Croatia, and Slovenia have municipalities with populations between 4,000 and 10,000. Following Albania's administrative reform, the average population of municipalities increased to over 39,000, joining Kosovo and Serbia, which have similar average sizes above 45,000. Overall, the average municipality size in SEE is about 26,000, much larger than the EU average of 5,000. This diversity mirrors the EU, where nearly 80% of its municipalities are concentrated in five countries—France, Germany, Spain, Italy, and the Czech Republic. Countries like Moldova and Romania, with fewer than 6,000 inhabitants per municipality, are similar to Austria, Hungary, and Slovakia. Meanwhile, Kosovo, Albania, Serbia, and Türkiye, with municipalities averaging over 40,000 inhabitants, resemble Lithuania, Denmark, and the Netherlands.

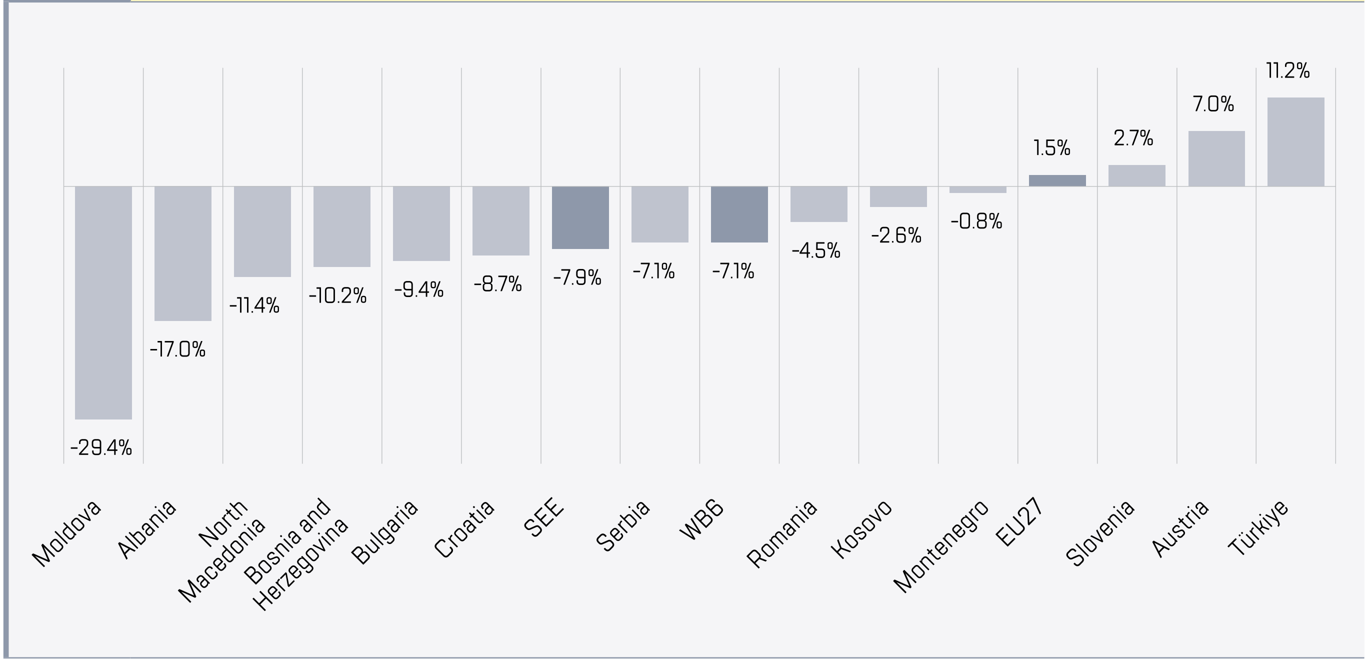
Figure 1. *Average Population of First-Tier Local Governments, 2023*



Diverging Demographics and Urbanization: Implications for Local Governance

Over the past decade, demographic trends in South-East Europe (SEE) and the Western Balkans Six (WB6) economies have presented significant challenges. While Türkiye has experienced notable population growth, the WB6 economies have collectively seen a decline of 1.1 million inhabitants, or 10% of their population, between 2014 and 2023, with Moldova (-29.4%), Albania (-17%), and North Macedonia (-11.4%) experiencing the most significant losses. In contrast, the European Union's (EU) population increased by 6.5 million (1.5%) during the same period. As the region continues to face these demographic shifts, understanding the implications for urbanization and local governance is crucial.

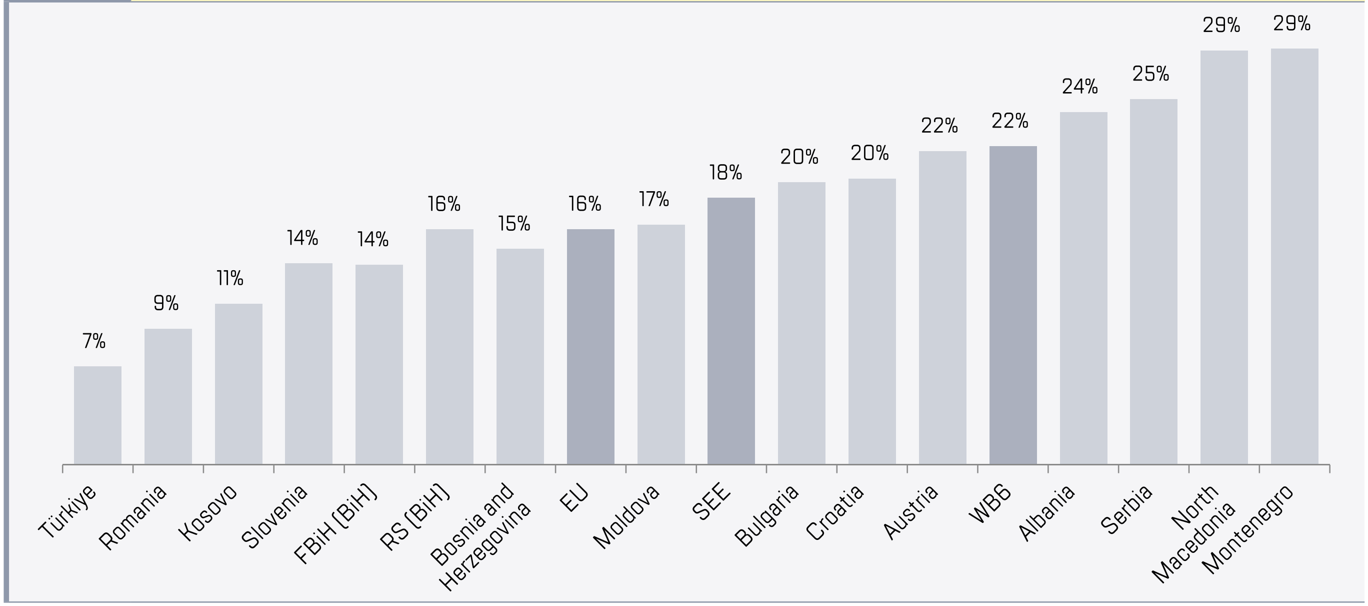
Figure 2. Changes in Population (as of January 1) between 2014-2023



The population decline across many parts of SEE and the WB6 has been accompanied by increasing urbanization, particularly in capital cities and larger urban areas. In SEE, according to existing data 17.7% of the population lives in capital cities, while on average, in the WB6 economies 22% of the population lives in capital cities. Observers point that such data may be understating the current situation. As rural populations shrink, younger generations are migrating to urban centers in search of better economic opportunities, education, and living standards. This rural-to-urban migration is leading to the depopulation of smaller municipalities, exacerbating the challenges already posed by population decline.

In SEE economies which have seen some of the steepest population losses, the rural exodus has contributed to the concentration of economic, social, and administrative functions in larger cities. The urbanization trend, while creating economic hubs, is also placing immense pressure on municipal governments, infrastructure, and social services in these cities. Urban areas are experiencing increased demand for housing, public services, and employment opportunities, often outpacing local governments' ability to provide adequate resources and services.

Figure 3. *Percentage of Population living in Capital Cities*



Population declines and the growing concentration of people in capital cities and metropolitan areas pose significant challenges to local governance in SEE and the WB6 economies. Smaller municipalities, already facing reduced revenue bases, struggle to maintain infrastructure and provide essential services for shrinking populations. With limited fiscal revenue, these local governments are increasingly dependent on state-level transfers, which may not be sufficient to meet growing needs.

In larger cities, the influx of people puts additional pressure on local systems. This creates issues such as overcrowded and unaffordable housing, rising social services and healthcare demands, overcrowded and understaffed education, traffic congestion, and limited public transport. Rapid urbanization also strains infrastructure, making it difficult for authorities to balance economic growth with environmental sustainability.

New instruments are necessary to address deep-rooted issues. As national and local governments try to balance economic growth in cities with the needs of depopulated areas, infrastructure maintenance costs often fail to match the population size, leading to inefficient resource allocation. Equalizing transfers are essential but limited in addressing deeper issues like depopulation and poverty. To effectively reduce regional disparities, new financing mechanisms are needed to promote more equitable local development and sustainable growth across the region.

Migration: Challenges and Opportunities for Local Governance

Migration continues to be a defining feature of the Western Balkans, with profound implications for its socio-economic landscape. Approximately 20% of the region's population now resides abroad, driven by better opportunities for education, employment, and living standards. Over the past decade, emigration from the Western Balkans has increased by 10%, reflecting persistent structural disparities with the EU (OECD, 2022).

The outflow of skilled workers, including healthcare professionals, engineers, and educators, poses severe developmental challenges. Labour shortages have become a critical issue, with sectors like healthcare reporting significant deficits. For instance, the doctor-to-population ratio in some economies is only half of the EU average. This "brain drain" limits the region's capacity to deliver essential services and meet the demands of modern economies (OECD, 2024).

Depopulation exacerbates these challenges, particularly in rural areas, where economic activity declines as young and skilled workers leave. This demographic shift increases dependency ratios, reduces the local tax base, and places greater strain on local governments to maintain infrastructure and social services.

Despite these challenges, migration also offers significant opportunities for the Western Balkans. Remittances from the diaspora, amounting to over €9 billion annually, play a crucial role in supporting household incomes and driving local consumption. Furthermore, the skills and expertise of emigrants present opportunities for knowledge transfer and innovation if effectively leveraged. Policies promoting the reintegration of returning migrants and engagement with the diaspora have already shown promising results in Serbia, Kosovo, and Albania. The diaspora's potential for investment is another area of opportunity. Targeted policies to attract diaspora investments, particularly in technology, education, and infrastructure, could bolster economic development. For example, initiatives in North Macedonia and Bosnia and Herzegovina to engage diaspora communities have led to increased FDI and knowledge-sharing projects (OECD, 2024).

To fully harness the benefits of migration, the Western Balkans need cohesive strategies that address root causes of emigration, such as limited job opportunities and low wages, while maximizing the economic and social contributions of their diasporas. Regional cooperation, supported by international frameworks, will be essential to align migration policies and create an environment conducive to sustainable development.

Migration significantly impacts local governments in the Western Balkans, shaping their ability to plan and deliver public services effectively. The emigration of skilled workers and young populations creates labour shortages, which directly affect the capacity of local governments to provide essential services such as healthcare, education, and infrastructure maintenance. For example, municipalities in rural areas often face school closures and reduced healthcare access as depopulation leaves these communities without sufficient demand or staff. At the same time, urban areas experience increased pressure on housing, utilities, and public services due to migration-driven population growth in cities. These dynamics complicate fiscal planning, as declining local tax revenues in depopulated regions reduce funding for services, while cities face higher costs to expand infrastructure and services. Additionally, local governments must navigate the complexities of integrating returnees and leveraging diaspora investments, requiring new policies and administrative capacity to manage fluctuating populations effectively (OECD, 2022).

Implications for Policy and Regional Development

The demographic trends in SEE and the WB6, including population decline and migration, underscore the need for comprehensive regional development policies that can address both the challenges and opportunities arising from these shifts. The decline in population in many areas, alongside the rapid urbanization of larger cities, calls for tailored solutions to manage the pressures on local governance and infrastructure. As migration remains a defining feature of the region, it presents additional complexities that must be addressed in policy planning that considers regional demographic trends and specific local needs.

- **Decentralization and Fiscal Autonomy**: For local governments to effectively address the impacts of population decline and migration, greater decentralization and fiscal autonomy are necessary. This would allow municipalities to have more control over their financial resources and adapt local policies to address demographic challenges more effectively.

- **Support for Depopulated Areas**: Areas with severe depopulation, may benefit from targeted investments aimed at revitalizing local economies, improving infrastructure, and attracting migrants back to these regions. Creating incentives for businesses to operate in smaller municipalities or offering subsidies to young people to settle in rural areas could help reverse or mitigate population decline.

- **Urban Planning and Infrastructure Investment**: In rapidly growing urban centers, local governments need to invest in infrastructure and urban planning to accommodate increased populations. This includes building affordable housing, improving public transportation, and ensuring that public services such as healthcare, education, and social welfare keep pace with urbanization.

- **Inclusive Migration Policies**: SEE and the WB6 need inclusive migration policies that address emigration's root causes and harness the potential of migrants and returnees. These policies should focus on improving living conditions, reducing youth unemployment, and addressing labor shortages in key sectors like healthcare and education. Additionally, supporting the reintegration of returnees can enhance human capital and innovation. By aligning migration policies with regional development goals, the region can turn migration into an opportunity for sustainable growth.

Economic Growth Developments and Challenges in South-East Europe

The Western Balkans have experienced notable economic growth over the past two decades, marked by a gradual convergence with the European Union (EU). Between 2003 and 2022, GDP per capita in the region increased by 80%. However, the gap with the EU remains significant, as GDP per capita in the Western Balkans is only 38% of the EU and OECD averages. At the current pace of growth, full convergence would require at least 50 years, underscoring the urgency of reform and investment (OECD, 2024).

Despite resilience during the COVID-19 pandemic and recovery with a 7.9% GDP growth in 2021, the region's economic momentum has slowed, with growth rates declining to 3.4% in 2022 and 2.6% in 2023. This deceleration is compounded by external shocks, including the economic fallout from the war in Ukraine and rising energy and food prices. Inflationary pressures, especially on lower-income households, further exacerbate socio-economic challenges, straining household purchasing power and reducing overall economic stability.

The region faces persistent structural challenges that limit its growth potential. Infrastructure deficiencies in transport, energy, and digital networks remain critical barriers. For example, road and rail infrastructure density in the Western Balkans is significantly lower than in EU member states, and energy losses in the transmission and distribution networks are twice as high as the EU average . Moreover, fragmented markets and limited intra-regional trade continue to stifle economic integration. Currently, intra-regional trade accounts for only 11% of total trade in the Western Balkans, highlighting untapped potential for regional collaboration.

Nevertheless, there are promising opportunities for economic growth. The European Commission's New Growth Plan for the Western Balkans, launched in November 2023, provides a €6 billion fund aimed at accelerating socio-economic reforms and infrastructure development. Focus areas include enhancing digital transformation, increasing energy efficiency, and fostering a common regional market. These measures, alongside regional cooperation frameworks like the Western Balkans Investment Framework (WBIF), have the potential to double the size of the region's economies within a decade (OECD, 2022). A

The economic outlook has a direct and profound impact on local governments and local government finance in the Western Balkans and South-East Europe (SEE), shaping the fiscal capacity and service delivery of municipalities. Local government finance systems in SEE are intricately tied to economic developments and the income levels of both the public and private sectors. In Albania, for instance, the primary source of local government revenue (the unconditional grant) is linked to Gross Domestic Product (GDP), making municipal budgets highly sensitive to economic growth and contraction. Similarly, in North Macedonia, the general grant is linked to the Value Added Tax (VAT), a key source of public revenue which fluctuates with consumer spending and overall economic activity.

In other economies, such as Slovenia, Serbia, Croatia, and Türkiye, personal income taxes (PIT) form a significant portion of local revenues. These taxes are directly tied to employment levels and wage growth, making them vulnerable to shifts in the labour market and broader economic conditions. Economic downturns, which reduce taxable incomes and employment rates, can lead to sharp declines in local government revenue, constraining municipalities' ability to fund essential services and infrastructure investments. Conversely, periods of economic growth enhance local fiscal capacity, enabling more robust service delivery and development initiatives. The continued interventions of the central governments to regulate PIT rates contribute to this unpredictability. This close linkage underscores the need for diversified and resilient local finance systems that can withstand economic volatility while supporting sustainable development.

European Union (EU) funding has significantly supported local government capital investments in Bulgaria, Croatia, Slovenia, and Romania since their EU accession, enabling the expansion and modernization of local public services and infrastructure. EU funding has also boosted local contributions to public investments, reflecting increased reliance on EU funds for critical development projects. However, this dependency can expose challenges, particularly in terms of the long-term operating and maintenance costs of new infrastructure, which could threaten the sustainability of public services and fiscal stability. Building resilient local financial systems is therefore essential to ensure the lasting impact and sustainability of these projects.

II. Multi-Level Government Dialogue

In South-East Europe, multi-level government dialogue is essential for fostering collaboration between local and central governments and to ensure that local governments have a voice in national policymaking, particularly on issues affecting governance, fiscal management, and service delivery. NALAS member Local Government Associations (LGAs) play a pivotal role in bridging these levels by advocating for municipal interests and promoting effective governance. This dialogue relies on diverse mechanisms to ensure inclusivity and impact. This section provides an overview of the formal platforms for the consultation of local governments, the participation of the LGAs in Multi-Level Government Task Forces and Working Groups, as well as the internal organization of the LGAs to effectively engage in intergovernmental dialogue.

Local Government Associations' Participation in Multi-Level Dialogue

Local Government Associations (LGAs) in South-East Europe (SEE) are officially designated as representatives of local authorities, in most cases based on the provisions of the Law on Local Self-Government. They play a central role in proposing, amending, and influencing the legal and financial frameworks that govern local self-government and broader policy issues affecting municipalities. Their participation spans formal consultations, legislative task forces, and interministerial working groups, making them vital actors in intergovernmental dialogue and policy development.

LGAs advocate for the integration of local government perspectives into national policies, particularly in areas of fiscal decentralization, governance reform, and service delivery. The success of LGAs in this regard often depends on their early involvement in the policymaking process, enabling them to contribute effectively to legislative drafting and strategic decision-making. A key principle, as highlighted by the **European Charter of Local Self-Government**, is that local authorities should be consulted in an effective way, as early as possible in the process, to allow them to formulate and articulate their positions and have a real chance of affecting the final decision-making.

Regional Highlights of LGA Participation in Multi-Level Dialogue

- **Bosnia and Herzegovina:** in the Federation of Bosnia and Herzegovina (FBiH), SOGFBiH participates in a **government working group on revenue distribution**, advocating for fiscal equalization and debt repayment solutions. In the Republic of Srpska, **AMTRS holds a formal role in the Committee for Local Self-Government** at the National Assembly, allowing it to contribute to legislative processes.

- **Bulgaria:** the National Association of Municipalities in the Republic of Bulgaria (NAMRB) participates as an equal partner in national decision-making processes, including **formal negotiations with the Ministry of Finance on municipal budgets** under the draft State Budget Act. NAMRB facilitates intergovernmental dialogue through a broad array of platforms, including institutional and inter-institutional consultations, working groups, and monitoring committees. NAMRB facilitates intergovernmental dialogue and cooperation, with nearly 700 municipal representatives involved in different formats – including institutional, inter-institutional, working groups, consultative councils, international organizations, and monitoring committees.

- **Croatia:** the Association of Croatian Cities (AOC) participates in several various intergovernmental ad-hoc legislative task forces and working groups. Similarly, AOC plays an important role within the **Parliamentary Board for Local Governance**, and the **informal, regular public forum** that brings together the Government, County prefects, and the Presidents of the AOC and the Association of Municipalities. These platforms allow AOC to engage on fiscal policy and governance issues, ensuring local government concerns are addressed in national reforms.

- **Kosovo:** the Association of Kosovo Municipalities (**AKM) is deeply engaged in legislative task forces and working groups,** particularly those focusing on decentralization and fiscal policies. In 2023 alone, AKM contributed to drafting 49 legislative initiatives, including draft-laws, bylaws, and strategies, ensuring local government needs and priorities were reflected into national policies.

- **Montenegro:** the Union of Municipalities of Montenegro (UoM) advocates for fiscal autonomy and compensation for revenue losses caused by national tax reforms, such as changes to the Personal Income Tax (PIT) structure. Despite limited consultations in recent years, UMM continues to participate in intergovernmental working groups and advocate for municipal interests, while preparing and submitting several initiatives for changes in tax legislation.

- **North Macedonia:** the Association of Local Self-Governments (ZELS) proactively contributes to policy development and consultation, advocating for the interest of local self-governments. ZELS successfully advocated for increased VAT and PIT shares for local governments and revised the Law on Regional Development and is also pushing for modernizing local tax administration systems.

- **Serbia:** SCTM is actively involved in the development and implementation of the **Program for Local Self-Government System Reform 2021-2025**, collaborating with the Ministry of Public Administration and the Ministry of Finance on fiscal decentralization and governance reforms. SCTM also plays a critical role in the Local Self-Government Financing Commission, addressing local government funding challenges.

- **Slovenia:** the Association of Municipalities and Towns of Slovenia (SOS) advocates for municipal financial needs by calculating budgetary requirements helping ensure that resources align with the legal mandates and operational demands of local authorities. **SOS conducts formal negotiations with the central government the financing framework for local governments**. SOS's involvement ensures sustainable financial planning for local governments.

- **Türkiye:** the Marmara Municipalities Union (MMU) acts as a **bridge between local governments and the central administration**. It organizes platforms, events, and reports to address critical topics such as local government financing, sustainable development, and legislative reforms, fostering structured dialogue.

Across South-East Europe, LGAs demonstrate a shared commitment to fostering effective multi-level dialogue, ensuring that local government priorities are represented in national policymaking. Common features of their participation include active involvement in legislative task forces, working groups, and formal platforms that address critical areas such as fiscal decentralization, governance reform, and service delivery. LGAs like **NAMRB in Bulgaria and SOS in Slovenia engage in structured processes with the central government to negotiate the budgetary and policy frameworks**. LGAs like AKM, AOC, SCTM and UMM play a pivotal role in formally representing local interests in intergovernmental, interministerial and sectoral working groups in charge to develop policies and legislation that affect local governments. These LGAs directly contribute to the working groups in charge for developing policies and legislation, on a regular basis and early in the process, therefore having a key chance to influence decision-making.

Despite differences in structure and context, a recurring strength among LGAs is their ability to act as intermediaries between local governments and central authorities, as exemplified by MMU in Türkiye and ZELS in North Macedonia. Informal mechanisms, like AOC's public forums in Croatia, complement formal processes, enabling flexibility and responsiveness to challenges. However, challenges persist, including limited early-stage consultation, irregular engagement, and polarization, as in Albania and to a lesser extent in Montenegro where despite the moderate success, UMM is included in consultations.

The collective experience of LGAs in SEE highlights the importance of institutionalized dialogue, technical expertise, and sustained advocacy to achieve tangible outcomes. When supported by early and meaningful engagement in policy development, LGAs serve as indispensable actors in promoting effective governance, equitable resource distribution, and sustainable local development.

Local Government Associations' Structures for Effective Policy Dialogue

To engage effectively in intergovernmental dialogue, LGAs must have strong internal structures that support advocacy, coordination, and representation. These structures enable LGAs to provide technical expertise, develop cohesive policy proposals, and represent the diverse interests of local governments. Across South-East Europe, LGAs have adopted a range of organizational models to ensure effective participation in policymaking processes.

Across SEE, LGAs share several commonalities in their internal organization, highlighting both strengths and areas for improvement. A key common feature is the reliance on **specialized committees, working groups, and collegia**, which allow LGAs to harness technical expertise, develop cohesive policy proposals, and represent the diverse interests of local governments. The committees enable LGAs to respond swiftly to emerging issues, provide well-informed policy recommendations, and engage effectively in intergovernmental dialogue.

- **Bosnia and Herzegovina:** AMTRS operates with **nine specialized committees** that provide professional recommendations to its presidency or assembly as needed.

- **Slovenia: S**OS manages **twelve consultative committees** to address technical issues, prepare guidance, and draft positions on proposed laws and regulations. SOS also establishes **working groups** or **networks** of municipal officials to develop solutions for systemic challenges or share best practices.

- **Bulgaria:** NAMRB relies on **14 standing committees**, composed of municipal councilors, mayors, and municipal employees, which are updated every four years. These committees contribute expertise on legislative, fiscal, and governance issues.

- **Kosovo:** AKM relies on **21 professional collegia**, which bring together sector-specific experts in fields like finance, education, and urban planning. These collegia play a vital role in formulating evidence-based policy proposals and enhancing AKM's participation in formal consultations and working groups in charge for drafting policies and legislation.

- **Moldova:** CALM organizes **sectoral committees** focused on areas such as fiscal policy, infrastructure, and public administration. These committees provide technical support for CALM's advocacy and enable rapid responses to emerging governance challenges.

- **Albania:** ALAA has established **nine technical committees** to focus on legislative and fiscal matters. These groups coordinate advocacy efforts and ensure that local government concerns are presented effectively to national policymakers.

- **Serbia:** SCTM's **sectoral committees** specialize in areas such as finance, public administration, and urban planning. These committees underpin SCTM's advocacy by providing detailed, sector-specific knowledge for engagement in working groups.

- **Montenegro:** UMM relies on seven **thematic committees** that address policy areas such as local government system, fiscal policy, infrastructure, spatial planning, social services and EU integration. These committees contribute expertise to UMM's participation in consultations and task forces. UoM has also several professional networks composed of municipal representatives focusing on peer-learning and knowledge sharing.

- **Croatia:** AOC's **thematic committees** address issues like, fiscal policy, social services, and governance. These committees prepare detailed positions and proposals, ensuring AOC's effectiveness in platforms like the Parliamentary Board for Local Governance.

- **Türkiye:** MMU organizes its activities into areas such as urbanization, migration, social cohesion, local diplomacy, and urban technology. This focus allows MMU to address pressing local and global challenges effectively.

A major strength of these internal structures lies in their **flexibility and adaptability**, such as SOS's ability to create ad-hoc networks for specific topics or AKM's professional collegia addressing diverse municipal needs. These mechanisms ensure that LGAs can coordinate advocacy efforts and build consensus among members. Furthermore, the regular updating of committees, as seen in NAMRB, ensures alignment with evolving priorities and expertise. However, weaknesses remain. **Resource limitations** can hinder the full potential of these structures, particularly in smaller LGAs or countries with less-developed local government systems. For example, in Montenegro the irregular consultation practices of the national authorities reduce the impact of UMM's well-organized internal structures. Additionally, **inconsistent consultation by central governments** often undermines the effectiveness of LGAs' technical input. This is a main concern across the region, as in many cases LGAs are not regularly involved in the processes of development of policies and legislation.

In summary, while LGAs across the region have developed robust internal frameworks to support their advocacy, their effectiveness depends on adequate resources, consistent governmental engagement, and the ability to adapt to emerging challenges in multi-level governance.

Structured Platforms for Multi-Level Dialogue

Formal platforms for consultation are institutionalized mechanisms designed to facilitate communication between central and local governments. These platforms are usually enshrined in legislation or formal agreements. These platforms often provide LGAs with a structured space to advocate for local interests on critical issues such as fiscal decentralization, governance reforms, and local service delivery.

Albania: Central and Local Government Consultative Council

- **Composition:** Equal representation from line ministries, LGAs, mayors, and other relevant authorities.
- **Role:** a forum for LGs to discuss national policies, fiscal transfers, and legislative reforms. However, has faced criticism for limited engagement, often consulting local governments too late in the policy process, which undermines the effectiveness of the platform.

Bulgaria: National Council for Decentralization

- **Composition:** Representatives from line ministries, local governments, and civil society.
- **Role:** promote decentralization and coordination, develop decentralization policies and enhance local capacities to manage public services and resources.

Croatia: Parliamentary Board for Local Governance

- **Composition:** chairman, deputy chairman, 11 members from the Croatian Parliament, and 9 local governments representing cities, counties, and municipalities, and local experts.
- **Role:** consulting legislation affecting local governments, particularly in areas of fiscal policy, tax reform, and local governance. Provides a direct link between local governments and national lawmakers. Although not obliged, the Board always invites LGAs to participate in all meetings, for over a decade.

Kosovo: Consultative Council for Municipalities

- **Composition:** Equal representation of central government and local government, including the Ministry of Local Government Administration, mayors, and AKM members.
- **Role:** Facilitates discussion on legislation, fiscal transfers, and local governance issues.

Moldova: Joint Commission on Decentralization

- **Composition:** Comprising 28 members—14 representatives from the central government and 14 delegates from local authorities, with CALM playing a central role.
- **Role:** The commission addresses decentralization reforms, local administration, and public service delivery issues. The commission was largely inactive, until the government decided to revitalize it in 2022 as part of efforts to strengthen dialogue between central and local administrations.

Montenegro: Coordinating Body for Public Administration Reform

- **Composition:** Representatives from central government ministries and local government representatives.
- **Role:** The committee facilitates ongoing communication on issues affecting local governments, including fiscal policies and legislative changes. It ensures that municipal concerns are directly communicated to central authorities, enabling more responsive decision-making.

Serbia: Local Self-Government Financing Commission

- **Composition:** Composed of 6 government members (including a chairman from the Ministry of Finance) and 5 members appointed by the SCTM Presidency (at least 3 of which need to be representatives from LSGs, while at the current set up 4 representatives of LSG are appointed and 1 representative on behalf of SCTM/association).
- **Role:** Focuses on shaping policies related to local government financing, including fiscal transfers, local tax systems, and revenue sharing. Although it was relaunched in 2021, the Commission's work has been limited, with only two meetings held since its reactivation.

Formal platforms for consultation between central and local governments play a crucial role in institutionalizing dialogue and ensuring local interests are considered in national policymaking across South-East Europe. Despite differences in structure and effectiveness, these platforms share common objectives: promoting fiscal decentralization, advancing governance reforms, and improving service delivery.

Examples like Croatia's **Parliamentary Board for Local Governance** illustrate well-functioning mechanisms that integrate local government perspectives into legislative processes and decentralization strategies. In Montenegro too, there is a Cooperation Agreement between Parliament and the Union of Municipalities. However, challenges persist. In Albania, delayed consultation undermines the effectiveness of the **Central and Local Government Consultative Council**, while Serbia's **Local Self-Government**

Financing Commission has faced operational limitations, meeting only sporadically. These gaps highlight the need for early-stage involvement of local governments, regular dialogue, and stronger institutional support to maximize the potential of these platforms.

Overall, formal consultation mechanisms are indispensable for fostering collaboration between governance levels. Their success depends on their ability to ensure meaningful, timely, and structured engagement, empowering local governments to actively contribute to shaping policies that directly affect their communities.

Overview of Key Advocacy and Lobbying Efforts by NALAS member LGAs

The Local Government Associations (LGAs) across South-East Europe (SEE) are instrumental in advocating for fiscal decentralization, governance reforms, and strengthening local government capacities. A comparative overview highlights their focus on concrete proposals and their involvement in critical policy areas.

Fiscal Decentralization and Financial Stability. LGAs prioritize reforms to increase local revenues, improve funding frameworks, and ensure financial autonomy for municipalities. In **North Macedonia,** ZELS advocates for **increasing the share of VAT and PIT** allocated to municipalities (aiming for 30%-50%), decentralizing social services, and improving local tax administration. In **Slovenia,** SOS focuses on **securing a fair share of PIT for municipalities** and ensuring that financial resources align with local mandates through transparent negotiations with the central government. In Moldova, **Moldova**, CALM **successfully increased PIT allocations** for small municipalities and reorganized development funds to enhance funding for infrastructure, energy, and rural development. In **Montenegro**, UMM advocated for **compensating revenue losses** caused by national tax reforms and strengthening municipal fiscal autonomy, particularly through amendments to the Local Government Finance Law. In **Serbia**, SCTM is playing a key role in implementing the Program for Local Self-Government System Reform 2021-2025, including reforms to local finance laws, mid-term budget planning, and internal audit procedures. In recent years, SCTM has proposed a **revolving fund for pre-financing EU-funded projects** and **increasing non-earmarked transfers** to municipalities. In **Albania,** ALAA advocates for **increasing the unconditional transfer** to at least 1.2% of GDP and introducing a performance-based grant. In **Bulgaria**, NAMRB developed comprehensive proposals for fiscal decentralization, including **sharing PIT and CIT revenues** with municipalities, and amending property tax legislation to ensure more accurate assessments.

Equalization and Revenue Distribution. Addressing fiscal imbalances and ensuring equitable resource distribution is a recurring theme for LGAs in SEE. In **Bosnia and Herzegovina**, SOGFBiH advocates for a new revenue distribution methodology with a separate pillar for fiscal equalization to support small, underdeveloped municipalities. In **Montenegro**, in principle, UMM opposes redistributing PIT shares from better-funded municipalities to less-developed ones without addressing systemic fiscal issues. UMM proposed an alternative approach to supporting financially struggling municipalities; however, their recommendation was not adopted. In **Albania**, ALAA proposed refined equalization criteria within the Unconditional Transfer allocation to reduce municipal disparities.

Public Services and Local Development. Enhancing public service delivery and infrastructure development remains a core focus for LGAs. In **North Macedonia**, ZELS advocates for improving public safety infrastructure, including collaborations with fire units, and addressing systemic weaknesses in local service delivery. In **Kosovo**, AKM advocates to secure funding for waste management, infrastructure, and urban planning, with partnerships from organizations like USAID and GIZ. In **Moldova**, CALM works on improving water supply, sanitation, and energy infrastructure through national and regional funds.

Despite their contexts and opportunities, LGAs in SEE exhibit a shared commitment to fiscal reforms, improved service delivery, and enhanced governance.

III. Overview of Key Fiscal Decentralization Reforms

Albania: New Decentralization and Local Government Strategy 2023-2030

In April 2023, Albania adopted the 2023-2030 Intersectoral Strategy for Decentralization and Local Governance. The strategy emphasizes strengthening decentralization to support local economic development, enhance municipal revenues, digitize services, promote open governance, and align local efforts with the EU integration agenda. It also aims to build the capacities of local and central actors for effective, inclusive governance.

The strategy hinges on six key objectives. First, it promotes sustainable local development by empowering municipalities to leverage natural, economic, and cultural resources. Second, it seeks to improve the quality and efficiency of local services by clarifying legal and institutional overlaps. Third, the strategy prioritizes expanding digital governance to provide transparent, efficient, and accessible public services. Fourth, it aims to enhance local financial autonomy by consolidating municipal revenue systems, ensuring stronger financial foundations for local governance. Fifth, it focuses on strengthening local democracy and advancing EU integration by improving governance, promoting transparency, and combating corruption. Lastly, the strategy underscores the importance of developing local and central administrative capacities, including improved human resource management, training, and support for European integration processes. Overall, the strategy offers a significant reform roadmap, though the mechanisms for achieving its goals of financial autonomy appear to be incomplete.

Bosnia and Herzegovina: Enhancing Revenue Distribution and Property Taxation

The Association of Cities and Municipalities of Federation of Bosnia and Herzegovina (SOGFBiH) has actively advocated for equitable revenue distribution and its efforts have led to the establishment of a working group to develop a new revenue distribution methodology while securing €20 million annually (2021–2023) in grants for LGs to support investments and operations. In the Republic of Srpska (BiH), recent reforms include a new Law on Property Tax and the "Mass Valuation of Real Estate" project, both of which aim to improve revenue collection, harmonize property data, and promote investment. Long-term plans include transferring property tax administration to local governments by 2025. The Association of Municipalities and Towns of RS (AMTRS) has successfully advocated and increased grants for underdeveloped municipalities.

Bulgaria: New Investment Program for Municipal Projects

In 2022, Bulgaria allocated 203 million EUR to fund 234 priority projects. The National Association of Municipalities in the Republic of Bulgaria (NAMRB) achieved a key milestone by securing government approval for a transparent funding mechanism for the municipal investment projects. NAMRB played an active role in shaping the investment criteria, ensuring projects were assessed based on maturity, construction permits, and alignment with municipal priorities.

Building on this foundation, the 2024 State Budget Act introduced an ambitious Investment Program for Municipal Projects, totaling 2.1 billion EUR and spanning through 2026. The program provides funding for eligible projects based on municipal categories, with co-financing required for expenditures above capped amounts. Strict regulations define the types of eligible projects, activities, and expenditure limits for 2024. The program is updated quarterly by the National Assembly, following proposals from the Council of Ministers, to address evolving municipal needs. Implementation is governed by a Council of Ministers Decree, outlining requirements for expenditure verification, reporting, and payment processes. This initiative strengthens municipal investment capabilities while fostering transparent and accountable governance.

Croatia: Enhancing Fiscal Equalization and Streamlining Revenue Management

The Fiscal Equalization Fund (FEF) was introduced in Croatia in 2017 to reduce disparities in Personal Income Tax (PIT) revenues among local and regional governments. With an allocation of 265 million euros, the fund aimed to enhance fiscal balance across municipalities and regions, accounting for 5% of total local government revenue. Initially it was funded by 17% of PIT revenues, but as of 2021 it is funded by the central government revenues, after a reduction in PIT rates. Now classified as a general grant, its allocation is based on the difference between target and actual per capita PIT revenues. While the FEF successfully reduced PIT disparities, it also increased local governments' dependence on national budget decisions.

In January 2024, Croatia abolished the PIT surcharge and integrated it into the PIT. Municipalities now have the authority to set their own PIT rates, ranging from 15% to 23.6% for lower rates and 25% to 34.5% for higher rates, enhancing local government autonomy. The central government has also shifted focus to reducing reliance on income taxes, emphasizing property-based taxation. This included reforms such as the adjustments to second home tax rates and preparations for the introduction of a property tax. Additionally, in the past two years, the Association of Cities of Croatia (AOC) has been collaborating with the government on fiscal and legal reforms, including the integration of the Euro currency and improving local government employment conditions, addressing a 14.5% decrease in local government staff between 2020 and 2023 due to the disparities in the wages of central and local government employees.

Kosovo: Preserving Local Fiscal Autonomy

The Association of Kosovo Municipalities (AKM) has been instrumental in preserving local fiscal autonomy in Kosovo through strategic advocacy and negotiations. By successfully lobbying for increased municipal budgets—resulting in an €35 million (8%) budget increase in 2018 and further increases in education, health grants, and own-source revenues in 2019—AKM secured critical financial support for municipalities. Their advocacy also ensured that 20% of mine royalties would be directly allocated to municipalities with operating mines, strengthening local revenue streams. In 2022, AKM challenged the Ministry of Finance's attempt to seize unspent municipal funds under the 2023 Budget Law, arguing before the Parliamentary Commission that municipalities have the right to retain these funds. This effort culminated in a legal amendment in March 2023, unblocking €37.5 million for local development projects and establishing a precedent that the central government cannot appropriate municipal own-source revenues. Additionally, AKM has mitigated the financial strain caused by unilaterally imposed Collective Contracts, which burdened municipal budgets by €135 million, by engaging directly with the Ministry of Finance and sector ministries, ultimately saving municipalities tens of millions of euros and safeguarding their financial independence.

Moldova: Enhancing Fiscal and Territorial Decentralization Reform

Recently Moldova has adopted changes to its rather complex intergovernmental finance system. Since 2021, general-purpose transfers have been supplemented with additional resources, including 10% of corporate income tax (CIT) revenues. In 2024, new regulations were introduced to limit the share of general-purpose transfers from the Balancing Fund, which is financed by residual wage tax revenues allocated to local budgets as shared taxes.

The Congress of Local Authorities from Moldova (CALM) has played a key role in advocating for important changes. It successfully pushed for increasing the share of wage tax revenues allocated to small cities to 100%, including CIT as a source of revenue for general-purpose transfers, and ensuring the full allocation of road tax revenues to local governments. CALM also advocated the reorganization of the National Fund for Regional and Local Development, which was established in 2022 to consolidate five existing funds and finance development programs and projects in areas like energy, rural development, water supply and sanitation, local infrastructure, and others.

In late 2023, Moldova approved regulations to allow voluntary amalgamation of first-tier local governments, aiming to address territorial fragmentation. The process is mainly driven by local political actors, with financial incentives provided by central authorities through a €4.2 million Fund for the Voluntary Amalgamation of Localities.

Montenegro: Extensive and multi-pronged changes to the financing system

Montenegro's intergovernmental finance system has faced significant changes in recent years. The 2021 'Europe Now' Economic Reform Program introduced tax exemptions for incomes up to 700 EUR, negatively impacting local revenues from PIT, PIT surtax, and the Equalization Fund, as nearly 50% of the fund is financed by PIT revenues. The Government's reserve fund partially compensated for this, but ultimately the shares of PIT for municipalities increased in 2022. Montenegro's robust equalization system has also evolved, with a shift towards shared revenues. Additionally, beginning in 2024, financially weaker municipalities in the northern region received additional support, financed by 10% of PIT collected from the wealthier coastal and central municipalities. However, this shift has been contested by both coastal and central municipalities and UMM, as the central government should bear the equalizing costs.

In 2022, the Constitutional Court ruled the regulation for property market values unconstitutional, creating a temporary void in property taxation. Legal amendments proposed by the Union of Municipalities of Montenegro (UMM) were later adopted. In turn, several members of Parliament pushed for property tax exemptions for airports and tax reductions for agricultural producers. The government also plans to replace the land development fee with new development charges and introduce city rents for developed landowners. As of 2024, the property transfer tax became a municipal own-source revenue, with municipalities retaining 80% and the remaining 20% allocated to the Equalization Fund.

North Macedonia: A new Program for Sustainable Local Development and Decentralization

A Program for Sustainable Local Development and Decentralization (2021-2026) was adopted in 2021, while in 2022 a series of reforms were adopted aiming at: a) Increasing Local Fiscal Capacity by increasing municipal revenue sources from VAT (from 4.5% to 6% in 2024) and PIT (from 3% to 6%); b) Improving Fiscal Discipline by reducing payment arrears and debts and ensuring responsible financial operations (the law allows municipalities to use credit instruments to manage payment arrears, provided they meet specific conditions related to financial stability); and c) Enhancing Transparency and Accountability by mandating municipalities to publish their financial data on their websites, and further strengthening oversight and reporting mechanisms.

The additional VAT revenues are allocated to municipalities through two new funds: a) the *Performance Fund* that rewards municipalities with better performance in collecting their own source revenues; and b) *Equalization Fund* that aims to reduce fiscal capacity disparities among municipalities by providing funding to municipalities that have lower fiscal capacity but have shown fiscal effort and good results in collecting their own income.

A new Law on Balanced Regional Development and Strategy for Balanced Regional Development (2021-2031) have been adopted to promote balanced regional development. A coordinating body and a sectoral working group for regional and local development have been established, charged to support the development and implementation of the programs. ZELS, the Association of Local Self-Government Units in the Republic of North Macedonia, plays a fundamental role in each of these bodies and is also working along with government ministries to establish an Agency for Regional and Local Development. In 2024, municipalities received a €100 million fund for infrastructure projects, which was increased to €250 million in 2025.

Serbia: Programme for Local Self-Government System Reform 2021-2025

In 2021, Serbia introduced the Programme for Local Self-Government System Reform 2021-2025, marking the first comprehensive approach to reforming the LSG system. Developed with significant input from the Standing Conference of Towns and Municipalities (SCTM), the program targets improvements in local governance, financial management, and intergovernmental relations. It outlines reforms aimed at improving the legal and organizational framework, enhancing efficiency, transparency, and citizen participation, and modernizing services at the local level. Special Objective 2 of the program focuses on enhancing local government financing through fiscal decentralization, better budget planning, transparency, and stronger Public Internal Financial Control at the local level. This aims to create a stable and predictable financial system for LGs, increase local revenue shares—especially from property taxes—and improve capital expenditures. SCTM is actively engaged in these reforms and monitors their implementation alongside the Government's Public Finance Management (PFM) Reform Programme.

In 2024, SCTM launched two initiatives: one to establish a revolving fund for pre-financing EU and donor projects at the local level and another to increase non-earmarked transfers to LSGs starting in 2025. Non-earmarked transfers have not been raised since 2014, threatening the stability of financially weaker municipalities in particular. SCTM also advocates for a comprehensive update of the Law on Local Self-Government Financing.

Slovenia: New Property Tax Reform

Slovenia has a rather stable intergovernmental finance system. Recently, the Slovenian government is drafting a new property tax law to enable municipalities to increase their revenue-generating capacity. This new real estate tax is intended to replace the current property tax, as well as the contributions associated with building and land use, and will apply universally to all buildings and land owned by both individuals and businesses.

The Association of Municipalities and Towns of Slovenia (SOS) plays an essential role in advocating for the financial and operational interests of local governments across Slovenia. A core responsibility of SOS is to calculate and present the financial needs of municipalities, helping ensure that resources align with the legal mandates and operational demands of local authorities. By providing accurate financial assessments, SOS supports effective local financial planning. In addition to preparing financial needs assessments, SOS is a key player in negotiating with the national government to secure an appropriate share of personal income tax (PIT) revenue for municipalities, a vital source of funding for local tasks and services.

Türkiye: Future Prospects for Local Finance Reforms in Türkiye

Türkiye's major reforms at local level date back to 2004 and 2005 when the Municipal Law and the Metropolitan Municipality Law were updated, expanding the roles and responsibilities of local governments. Reforms to the local financing system have been enacted thereafter in 2008 and 2014 focusing on the shares allocated to municipalities from the general budget tax revenues by the central government, bringing major changes to the metropolitan municipalities systems.

As elsewhere in the region, there is a growing need to modernize legislation governing municipal revenue sources. In response, the Marmara Municipalities Union (MMU) actively conducts research and provides policy recommendations to the central government. In 2024, with contributions from its 70 member municipalities, the MMU produced a comprehensive report titled "Problems Arising from the Revenue Structure of Municipalities and Recommendations for Restructuring." This report presents a detailed analysis of legislative gaps and proposes new revenue sources to enhance the financial sustainability of municipalities.

IV. Comparative Overview of Transfer Systems and Investment Grants

Intergovernmental Transfers are an important but highly varied component of intergovernmental finance systems in South-East Europe. Shared taxes and general and equalizing transfers constitute the most common types of non-earmarked funding for local governments. Instead, in economies with major delegated or decentralized education, social services and healthcare systems, earmarked or sectoral block grants constitute an important part of the transfer system. This section aims to provide a comparative overview of the intergovernmental transfer systems of SEE economies, while a more detailed description is provided in the individual chapters.

Shared Tax Systems

Shared taxes are a vital component of intergovernmental transfer systems, offering a mechanism to link local government revenues to the national tax base while balancing fiscal capacity across jurisdictions. By allocating a portion of centrally collected taxes—most commonly Personal Income Tax (PIT)—to subnational governments, shared taxes provide a predictable revenue stream tied to economic activity within a municipality or region. This approach strengthens the financial autonomy of local governments while preserving national oversight.

In Southeast Europe, the design and implementation of shared tax systems vary widely, both in terms of size, composition, and the mechanisms for their distribution, reflecting differing levels and approaches of fiscal decentralization and local autonomy. Economies like Croatia, Slovenia, Serbia, and Türkiye, leverage shared taxes as a cornerstone of local government financing, allocating substantial portions of PIT to municipalities using transparent formulas that consider both local service needs and fiscal capacity, while others like Albania allocate smaller shares of shared taxes, relying predominantly on unconditional (general-purpose) transfers for the financing of local government responsibilities. From this perspective, overall, except for Bulgaria and Kosovo, where there are no shared taxes, shared tax revenues constitute between 6%-57% of total local government revenues across economies.

Personal Income Tax (PIT) plays a central role as a shared tax in South-East Europe. For example, in **Croatia**, municipalities retain 74% of PIT revenues collected within their jurisdiction, providing a substantial and stable revenue source. In **Serbia**, local governments retain between 66%-77% of the Wage Tax collected in their jurisdictions. By contrast, in **Albania** and local governments are assigned only 2% of the PIT, but this is allocated to them through a formula. Similarly, in **North Macedonia**, local governments benefit from 6% of the Wage Tax. By contrast, in the **Federation of Bosnia and Herzegovina (of BiH)**, municipalities receive at least 34.46% of PIT, though the share can vary, with areas like Sarajevo Canton receiving only 1.79%. Similarly, in **Republika Srpska (of BiH)**, municipalities are allocated 25% of PIT collected in their jurisdictions, with funds distributed based on the worker's place of residence.

Table 2. Overview of Shared Tax Systems in South-East Europe, as of 2023

Economy	Relevance total LG Revenues	Types and Shares of Shared Taxes
Albania	6% of LG Revenue	2% of Personal Income Tax 25% of Vehicle Circulation Tax 5% Mineral Rent
Bosnia and Herzegovina		
FBiH (BiH)	20% of LG Revenue	34.46% PIT
RS (BiH)	6-10% of LG Revenue	25% of PIT
Croatia	46-47% of LG Revenue	74% of PIT 100% property transfer tax
Moldova	20% of LG Revenue	50% wage tax for Chisinau and Balti 50% of wage tax for rayon capital city LGs 25% of wage tax for rayons 100% of wage tax for all other LGs 50% of taxes on natural resources
Montenegro	27% of LG Revenue	40% of PIT revenues for LGs in the Coastal/Central regions, 89% of PIT revenues for LGs in the Northern region 70% of revenues from state concessions on natural resources 50% of revenues from fee on usage of coastal resources, 100% of motor vehicles registration fees
North Macedonia	10% of LG Revenue	6% of PIT (Wage Tax) 100% of PIT from natural persons engaged in craft activities 100% of Property taxes 78% of concession fees on minerals Note: Macedonian municipalities are allocated also 6% of VAT, as a share in national tax revenues, however this amount is allocated via a formula as general grant.
Serbia	51% of LG Revenue	Shared Wage Tax (the largest part of PIT:): • 77% Cities • 74% Municipalities • 66% Belgrade Other PIT parts shared 100% with local governments Property transfer tax and inheritance and gift tax (100% shared)
Slovenia	53% of LG Revenue	54% of PIT, but allocated on a estimated costs known as '*appropriate expenditure need*', corrected by factors of: population, territory, road length, youth pop (<15), elderly pop. (>65), equalization (if costs > PIT Revs).
Romania	19% of LG Revenue	PIT, on derivation basis
Türkiye	57% of LGR	Several shared national taxes, allocated as follows: • 60-70% of shared taxes on origin basis • 30-40% grants for each type of LG, allocated on: 80% on per capita and 20% on development index

Other economies, such as **Montenegro**, introduce a regional equity component by allocating 40% of PIT to municipalities in the Coastal and Central regions, but 89% to municipalities in the less economically developed Northern region. This strategy addresses regional disparities in fiscal capacity. This is also the case for **Moldova**, where major local governments receive 50% of the Wage Tax, while other smaller ones receive of up to 100% of the Wage Tax. Meanwhile, in **Slovenia**, 54% of PIT revenues are shared with municipalities based on an "appropriate expenditure" formula that aligns allocations with municipalities' legally mandated responsibilities.

In **Türkiye**, local governments receive shares from several types of national taxes, which are distributed to municipalities on both on an origin basis as well as through a formula as equalizing grants. **In Romania,** local governments receive PIT revenues as well, however, the shares are allocated to local governments based on the employer's residence rather than the taxpayer's residence. **Kosovo** and **Bulgaria** are the only two SEE economies where LGs do not receive any direct form of shared tax revenues. Bulgaria stopped PIT sharing in 2007.

Beyond PIT, other shared taxes, such as the **Vehicle Circulation Tax** and **Mineral Rent** in Albania, **Revenues from State Concessions on Natural Resources** in Montenegro or the **Property Transfer Tax** in Croatia and Serbia, contribute to local government revenues, though their overall fiscal impact is typically smaller.

General Purpose Grants and Equalization Systems

Grants are a cornerstone of local government finance systems, playing a crucial role in ensuring municipalities can meet their expenditure responsibilities, particularly in countries with limited local revenue-raising capacities. By providing a stable flow of resources, grants enable local governments to fund essential services, such as education, healthcare, and infrastructure, while addressing disparities in fiscal capacity across jurisdictions. In addition, equalization grants are especially important in fostering inter-municipal equity, redistributing resources to less affluent areas to ensure comparable service standards across regions. However, the effectiveness of grants hinges on their design—predictability, transparency, and equitable allocation mechanisms are critical to avoiding fiscal imbalances and dependency. Well-structured grant systems thus provide not only financial stability but also a platform for promoting local development and bridging regional disparities, making them indispensable in intergovernmental fiscal frameworks.

In some SEE economies, **unconditional general-purpose transfers** are the primary source of municipal funding providing critical funding for municipal operations and equalizing disparities in fiscal capacity. For instance, in **Albania**, the Unconditional Transfer historically accounts for over 50% of local government revenues, ensuring municipalities with lower fiscal capacity can deliver comparable services. Similarly, in **Kosovo** and **Bosnia and Herzegovina**, on average, the General Grant constitutes 38%-42% of total local government revenue. Unsurprisingly in all these cases, shared taxes constitute a smaller component of the local financing system.

The **annual size** of the unconditional general-purpose transfers is often tied to macroeconomic indicators, such as GDP or national revenue pools, ensuring predictability and stability over time. For example, **Albania** anchors its unconditional transfers at no less than 1% of GDP, and no less than the amount allocated in the previous year, providing a double protection clause implying that local government finances are protected also in the case of economic recessions – as happened during the COVID-19 crisis, where the unconditional grant for local governments did not decrease with the economic downturn. Similarly, **Kosovo** allocates 10% of total central government revenues to general grants while **North Macedonia** 6% of the Value Added Tax. Table 3 provides an overview of general purpose-transfer systems in SEE.

Allocation criteria for general transfers vary but commonly include factors such as population size, geographic area, and fiscal capacity. **Albania's** formula emphasizes population, density, school-aged pupils and horizontal equalization, while **Bosnia and Herzegovina** incorporates also factors like a development index tied to PIT revenues. **Moldova** and **Montenegro** apply a mix of criteria, combining population, territory, and fiscal capacity, with Moldova further differentiating allocations between first- and second-tier governments.

In **Croatia** and **Serbia**, which rely predominantly on shared taxes as the main financing instrument for local governments, general-purpose transfers constitute a smaller part of the local finance system – constituting on average 8% of total local government revenues. In Croatia, LGs benefit also from **earmarked grants** for functions decentralized in 2000, including primary and secondary education, social welfare, healthcare, and social protection which constitute up to 18% of LG revenue. At the same time, in Serbia, the general grant includes four components, the equalization grant, the compensatory grant, the general grant and the solidarity grant. Serbian LGs benefit also from earmarked grants from line ministries, where the amount, distribution criteria, and timing of earmarked transfers are determined by the relevant ministry.

Equalization funds are critical for addressing regional disparities. In **Croatia**, the Fiscal Equalization Fund redistributes – with very good results so far - PIT revenues to reduce disparities, with allocations calculated as the gap between target and potential revenues. In **Bulgaria**, although making up only 4% of total local government revenue, the General Equalization Subsidy targets municipalities with lower tax capacities, with components accounting for revenue shortfalls, demographic factors, and tax effort. Similarly, **Montenegro's** Equalization Fund which constitutes 9% of local government revenue, allocates resources also based on fiscal capacity, with multipliers favoring smaller municipalities.

Performance-based grants are being introduced. In recent years, **North Macedonia** integrated a performance component into its general grant, incentivizing municipalities to improve own-revenue raising performance although implications on sustainability and equality are yet to be fully analyzed. **Albania** introduced a 'performance grant' in 2024, co-funded by the Albanian and Swiss governments, with the allocation criteria to be determined in 2025 and linked to municipal performance on certain policy objectives. Kosovo municipalities can also benefit from a small 'performance grant' based on positive performance in some prescribed indicators.

Earmarked or **sectoral grants** also play a significant role in financing specific local functions, such as education, healthcare, or social welfare. In **Bulgaria**, the **General Subsidy for Delegated Tasks**, which constitutes up to 50% of local government revenues, provides in fact earmarked funding for local governments to carry out delegated responsibilities in education, healthcare, social services, and culture. The funds are financial/cost standards and natural indicators, including population, student numbers, health professionals, staff in kindergartens and schools, and others. Similarly, in **North Macedonia**, municipalities receive **Sectoral Block Grants** constituting up to 58% of total local government revenue. These block grants provide funding for decentralized responsibilities such as education, culture and firefighting for example. The size and allocation for municipalities are determined annually by ministerial decrees, by using data on enrolment, staff numbers, number of children/students, size of buildings etc. However, Macedonian municipalities are theoretically autonomous in managing the block grants, although many of them face financial constraints.

From a comparative perspective, the financing systems of the Western Balkan 6 economies were typically developed in the early 2000s, prioritizing simplicity, functionality, and transparency. These systems aim to balance administrative feasibility with the equitable distribution of resources, albeit with varying degrees of success. The core components of their general-purpose grant frameworks rely on natural indicators such as population, territorial size, and the number of school-aged children and educational facilities, which are intended to reflect local expenditure needs and fiscal capacity. However, while some systems have become outdated, others have undergone recent revisions without necessarily achieving greater transparency, predictability, or equity. For example, changes in central policies regarding the shared PIT base and rates have introduced further complexity to intergovernmental financing systems. In several cases, such adjustments have necessitated ad hoc compensatory measures to offset revenue losses for local governments, often resulting in transfer systems that are increasingly complicated, undermining predictability, stability and transparency.

In contrast, EU member states in the region, such as Slovenia and Croatia, have developed more advanced and refined systems that balance incentives for local efficiency and performance with equalization. Meanwhile, Bulgaria's local financing system remains comparatively centralized, with its "general subsidy" primarily serving as earmarked funding for state-delegated functions, limiting local discretion, but providing funding on the basis of more 'objective measures of need'. Despite these differences, grant systems across SEE reflect a shared commitment to equitable service provision. However, the extent of local fiscal autonomy and the alignment of grant systems with modern governance priorities continue to vary significantly across the region.

Table 3. Overview of General Purpose Transfers in South-East Europe, as of 2023

General Transfers	Relevance total LG Revenues	Annual Size	Allocation Criteria
Albania	50% of LG Revenue	Not less than 1% of GDP, no less than previous year	• Up to 80% according to population – based on adjusted Census data • Up to 15 % on population density, - Up to 5 % on pupils in public primary and secondary schools • Horizontal Equalization: redistributes funds between LGs based on their shared tax 'revenue capacity'
Bosnia and Herzegovina			
FBH (BiH)	30% of LGR	8.42% of ind. taxes	• 68% population, 5% surface area, 20% school children, 7% develop. index – equalization (% of PIT rev).
RS (BiH)	54% of LGR	24% of indirect taxes	• 75% population, 15% territory, 10% secondary school children
Bulgaria	General Subsidy: 50% Equalizing Subsidy: 4%	*Gen. Subsidy*: set annually; *Equalizing Subsidy*: 10% of LG OSRs	General Subsidy Allocation: financial/cost standards & natural indicators Equalizing Subsidy Formula: five components (revenue potential, expenditure needs, low revenue capacity, tax effort, previous year allocation)
Croatia	5% of LGR	Fiscal Equalization Fund Determined annually	Formula: estimated individual shares, as a difference between (5-year average) target per capita PIT revenues and the 5-year average actual per capita PIT revenues.
Kosovo	General Grant - 38% of LGR	10% of the total budgeted revenues of the central government	• Lump sum amount • 89% population, • 6% surface area, 3% by ethnic minorities, 2% for LGs with minority as majority population
Moldova	General Grant - 11%	Remainder of Wage Taxes; 10% CIT	• 68,5% of the pool for 1st tier LGs, allocated on three criteria: 60% on the estimated fiscal capacity; 30% on population and 10% on territory • 31,5% of the pool for 2nd tier LGs, allocated on two criteria: 60% on population and 40% on territory
Montenegro	Equalization Fund - 9%	Bundle of shared taxes	• 15% lump sum, 35% on territory and population, 50% on fiscal capacity (per capita PIT vs. national average), Multiplier for small municipalities
North Macedonia	General Grant - 4%	6% of the VAT	Base fund: 4.5% of VAT; Performance fund: 0.75% of VAT; Equalization fund: 0.75% of VAT Allocation of the Base Fund: lump sum, 65% on population, 27% on surface area & 8% on settlements
Serbia	8%	1.7% of the previous year's GDP as a calculation category, however the amount has been static since 2014.	Unconditional Grant has four components: Equalization Grant, Compensatory Grant, General Grant & Solidarity Grant General Grant Allocation: 65% population; 19.3% territory; 4.56% no. of classes in element. Schools; 1.14% no. of classes in second. Education; 2% no. of elementary schools; 0.5% no. of secondary schools; 6% no. of preschool children; 1.5% no. of preschool facilities; Adjustment for Development Index

Earmarked Investment Grants for Local Governments

Earmarked investment grants are an essential instrument in SEE intergovernmental fiscal frameworks, enabling central and local governments to finance critical infrastructure and development projects. These grants are typically designated for specific purposes, such as transportation, education, healthcare, environmental protection, or other areas of public interest. By tying funding to pre-determined objectives, earmarked grants ensure alignment between national and local priorities, bridging the gap between central policy goals and community-specific needs.

The rationale behind earmarked investment grants lies in their ability to address infrastructure and service delivery gaps, particularly in under-resourced municipalities. Many local governments, especially in developing economies, face structural fiscal limitations that prevent them from independently financing large-scale investment projects. Earmarked grants provide targeted financial support, ensuring that essential investments—such as road construction, school renovations, and environmental projects—are not hindered by resource disparities.

In addition to promoting infrastructure development, earmarked grants serve as a strategic instrument for central governments to enforce policy priorities at the local level, ensuring alignment with national objectives in areas such as environmental sustainability, education, and healthcare. However, excessive centralized decision-making and inadequate coordination with local governments and their associations can undermine the effectiveness and fairness of these grants. In several SEE economies, where political polarization has intensified, such centralized control over earmarked funding has raised concerns about transparency and the equitable distribution of resources. Without meaningful involvement of local governments in the allocation process, investment decisions risk being driven by political considerations rather than genuine development needs, exacerbating regional disparities and eroding trust in the system. Strengthening mechanisms for consultation and collaboration with local authorities and their associations is therefore critical to ensuring that earmarked grants fulfill their intended purpose of fostering inclusive and balanced development. The Regional Development Fund (RDF) in Albania over the past few years has raised several of these concerns among local governments with a different political affiliation compared to the central level, in consecutive governments starting as of 2009.

Bulgaria's Capital Subsidy:

Main component: 45% based on number of settlements, 25% on municipal road length, 25% on population, 5% on surface area.

Additional component: distributed equally among the 131 municipalities classified as needing infrastructure improvements (determined by the Ministry of Regional Development and Public Works).

In contrast, several SEE economies have developed very open and balanced systems to support municipalities with investment grants, using also natural indicators such as population, territory, settlements, length of municipal roads to allocate investment funding across local governments. **Bulgaria** has established the **Earmarked Capital Expenditure Subsidy**, aiming to support municipalities with capital expenditures. The subsidy constitutes 3% of total local government revenues (5% of total transfers) and up to 14% of total capital expenditures as of 2023. Currently it is allocated based on two main components, the first of which considers indicators such as number of settlements, length of municipal roads and population for the allocation across local governments. The capital subsidy may be used for specific expenses, such as construction and major repairs, acquiring tangible and intangible assets, and scientific research, including co-financing and loan payments for capital expenditures.

Both **Bulgaria** and **Moldova** have **transfers for municipal roads**. In the case of Bulgaria, the transfer is dedicated for the winter maintenance and snow removal while in the case of Moldova it is more general for the maintenance and development of the municipal road network. Bulgaria's case funds are determined annually and are allocated to local governments based on the length of roads, the number of settlements and population. In Moldova's case, the transfer is financed by 100% of the revenues from tax for the use of roads by motor vehicles, and funds are allocated to municipalities proportionally on their population.

Moldova established a **National Fund for Regional and Local Development** in 2022 to finance regional and local development programs. The fund consolidates and enhances five existing funds for financing regional and municipal projects, with a dual focus on promoting balanced territorial development and supporting critical local infrastructure investments. It supports projects that address priorities such as infrastructure development, water and sanitation systems, transportation networks, social services, and energy efficiency. The allocation of funds follows a formula-driven approach. This ensures that funding is directed toward municipalities and regions with the greatest need for investment, promoting equitable development. Additionally, the fund emphasizes a participatory approach, encouraging local governments to propose projects that address the unique challenges of their communities.

Moldova's National Fund for Regional and Local Development:

Aim: addressing regional disparities and strengthening local development

Size: financed through a combination of national budget allocations and external donor contributions

Allocation: formula-driven approach, including population, territory, economic indicators, needs, competition.

North Macedonia's Regional Development Fund and Agency

Fund Size: 1% of GDP

Fund Aim: Support Balanced Territorial Development

Agency: Aims to facilitate LG access to financing based on regional needs and criteria

North Macedonia has established a **Regional Development Fund** to promote balanced regional development, with a target **allocation of 1% of GDP**. However, this goal has yet to be achieved. Recently, a new Law and Strategy on Balanced Regional Development were adopted to foster territorial cohesion and reduce disparities. To further enhance financing for capital projects, a working group, including representatives from various ministries and the Local Government Association (ZELS), is working to establish an **Agency for Regional and Local Development**. This agency will have broader competencies than the previous Bureau for Regional Development, enabling municipalities to access additional financial resources based on regional needs and established criteria. The Ministry of Local Self-Government will coordinate the agency's operations.

Slovenia implements a range of instruments to support local investments and promote balanced regional development, targeting municipal infrastructure and addressing developmental disparities. In addition to general grants, individual ministries provide **earmarked grants for specific municipal projects**, such as infrastructure development, heating plants, and water supply systems. These grants are governed by laws or regulations established by each ministry and are subject to conditions such as project requirements, co-financing arrangements, and alignment with national priorities. The allocation of funds is based on government-defined criteria, ensur-

Slovenia's Model For Balanced Territorial Development

Special Earmarked Grants for specific infrastructure projects. Funds are allocated to LGs based on a **methodology** including indicators for development, vulnerability and development potential.

Grants for Balanced Development, amounting to 6% of estimated total LG expenditures, to support balanced territorial development, allocated on the basis of a **specific formula**, favoring also smaller and less-developed municipalities.

ing that municipalities with greater needs and vulnerabilities receive appropriate support. The level of co-financing for municipal investments is determined by the municipality's development ratio relative to the national average. Less-developed municipalities receive a higher cost-coverage ratio ensuring equity in accessing essential resources. Since 2020, municipalities have received **balanced development grants,** amounting to 6% of the estimated total expenditures across all municipalities. These funds, distributed monthly by the Ministry of Finance, are allocated using a formula that accounts for demographic, geographic and environmental factors, such as population density, length of roads, border and natural zones. This ensures equitable funding distribution, allowing smaller and less economically developed municipalities to meet their financial needs. More details on these instruments are provided in the Slovenia Chapter describing the intergovernmental finance system.

In **Türkiye**, conditional grants play a vital role in assisting poorer local governments to address critical development needs. A notable example is the **KÖY-DES Program**, which provides additional funding specifically for villages, enabling them to undertake investment projects that would otherwise be beyond their financial capacity. The program primarily targets essential infrastructure projects, such as improving water supply systems, enhancing sanitation facilities, fostering mobility and economic opportunities by development road networks toward urban centers. By focusing on fundamental infrastructure, the KÖY-DES Program helps to bridge the development gap between urban and rural areas, supporting balanced territorial development and improving the quality of life in underserved communities.

Accessing EU and donor funding can be challenging for local governments due to limited financial resources for pre-financing and co-financing project costs. To address this, **Montenegro** and **Serbia** have developed innovative mechanisms to **support local governments in leveraging EU and donors' funding for development projects**. In Montenegro, the Support Fund to assist municipalities with pre-financing donor-funded projects (Revolving Fund), is integrated in the Law on Local Self-Government Finance, as a permanent instrument to support municipalities access EU and donors' funding. The Fund is managed by the Ministry of Finance, with annual allocations determined by the central government budget based on the estimated need for project pre-financing. Municipalities that have signed project agreements with donors or lead partners can access the Fund. The law also specifies that municipalities must reimburse the Fund within 12 months of receiving donor funding. In **Serbia**, the Standing Conference of Towns and Municipalities (SCTM) had relaunched in 2024 the initiative for a similar Revolving Fund (to be established in the 2025 budget), although the proposal is still pending for the time being. The fund would provide short-term, interest-free loans to local governments for EU and international development projects.

Support Municipalities Access EU and Donors' funding:

Montenegro: Revolving Fund, included in the Local Finance Law, providing interest free funding for *pre-financing*. Access id inclusive and transparent, while LGs must reimburse funds within 12 months.

Albania: Fund for *pre-financing* and *co-financing* donor projects, introduced annually in the State Budget, providing non-refundable grants to LGs. Access partially regulated.

Bulgaria: Fund to support LGs for pre-financing and co-financing of projects, providing interest-bearing loans to LGs.

Serbia: the SCTM is advocating for a Fund aiming to provide short-term, interest-free loans to LGs for EU and donor development projects.

Albania has also established a fund to support municipalities with pre-financing and co-financing EU funded projects, with a value varying on needs and up to 3 million Eur over the past few years. However, this fund is not yet made a permanent component of the Local Government Finance System, as is determined annually on the basis of needs and negotiations, and also it provides non-refundable grants to local governments, as opposed to interest-free loans provided by the Montenegrin and Serbian model, which ensure a perpetual continuity of the fund. **Bulgaria** too, has a dedicated fund to support local governments with pre-financing and co-financing, but here municipalities must pay a certain interest on the funds they borrow from the Fund.

V. Comparative Overview of Fiscal Decentralization Indicators

The most straightforward indicators of the importance of local governments are their revenues and expenditures as shares of total public finances and as a percentage of GDP. However, their significance is influenced by both the specific functions they manage and the revenue sources they are allocated. The weight of local governments in governance is closely linked to whether they are responsible for essential social services like education, healthcare, and social welfare, as these services incur high costs, particularly in terms of staffing. Therefore, the delegation of these high-cost functions to local governments has a profound impact on intergovernmental fiscal relations.

To assess the role of local governments in a given economy, it is crucial to understand the functions they perform and their fiscal autonomy, especially in areas such as the wage payments for teachers, doctors, or social sector employees. These responsibilities significantly affect the balance of power and financial dynamics between local and central governments. The costs of providing services like education and healthcare are generally too high to be funded solely through local revenues, particularly in rural or economically disadvantaged areas, where the costs of delivery often exceed the local revenue generation capacity. For example, across OECD economies, staff compensation and other current expenditure represents about 90% of the spending in educational institutions, regardless of the level of education, while 82% of resources devoted to staff compensation at primary, secondary and post-secondary levels are allocated to staff salaries.[3]

The degree of fiscal decentralization is evident in countries across South-East Europe (SEE) and the EU, as shown in data from Table 4. Local governments in these regions, particularly in Moldova and Kosovo, bear a substantial share of the costs of primary and secondary education. In Kosovo, for instance, local governments fund both primary and secondary health care in addition to education. This decentralization is critical, as it directly impacts the efficiency and quality of service delivery at the local level.

[3] OECD (2022), Education at a Glance 2022: OECD Indicators, OECD Publishing, Paris, https://doi.org/10.1787/3197152b-en, p. 314

Table 4. The Structure of Local Government Expenditure in SEE, by functions of government (in percent of total)

2022 in % of total	General Public Services	Public order and safety	Economic affairs	Environmental protection	Housing and community amenities	Health	Recreation, culture and religion	Education	Social protection
Albania	18%	6%	21%	6%	25%	0%	4%	18%	2%
Austria	16%	2%	12%	2%	2%	22%	6%	18%	22%
B. Herzegovina (FBiH)	43%	2%	10%	4%	16%	0%	8%	5%	11%
Bulgaria	10%	1%	8%	8%	11%	3%	5%	39%	13%
Croatia	21%	2%	20%	6%	26%	1%	9%	9%	6%
Kosovo	10%	1%	25%	0%	6%	12%	4%	39%	2%
Moldova	7%	0%	12%	0%	12%	0%	7%	53%	8%
Romania	13%	1%	23%	5%	10%	20%	8%	9%	13%
Serbia	18%	1%	27%	5%	13%	1%	10%	19%	6%
Slovenia	15%	2%	24%	7%	8%	2%	12%	23%	7%
Türkiye	34%	3%	22%	9%	22%	1%	6%	2%	2%
WB	22%	2%	21%	4%	15%	3%	6%	20%	5%
SEE	19%	2%	19%	5%	15%	4%	7%	22%	7%

Source: Eurostat, NALAS Member LGAs

The allocation of social sector responsibilities to local governments, however, is complex and varies significantly. In some countries, local governments have full responsibility for services such as secondary education or social welfare, while in others, these functions are shared or delegated, with central governments providing key funding and guidance. The financial sustainability of decentralization depends on the clarity of these roles and whether the national government provides sufficient funding to local authorities, particularly when managing high-cost services like education and healthcare.

A notable difference between EU and SEE countries is the level of involvement of local governments in social protection services. In EU countries, local governments typically manage a significant portion of social protection spending, while in SEE countries, the role of local governments in social protection is generally much smaller. For example, in Kosovo and Türkiye, local governments are virtually absent from social protection budgets, highlighting a key area for reform in terms of decentralization.

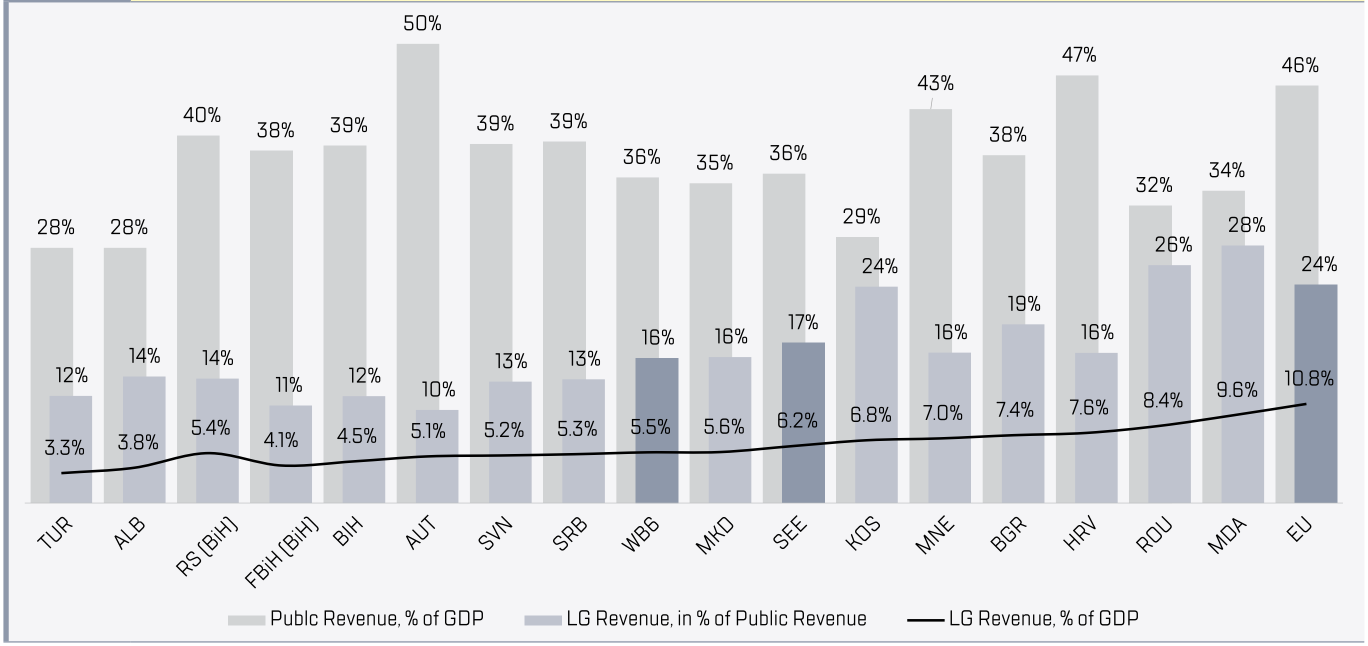
Local Governments Revenues

A well-structured local revenue system is key to balancing the responsibilities and fiscal relations between different levels of government, ensuring that local authorities can meet the specific needs of their communities. Local government revenues are crucial for the effective functioning of municipalities, as they determine their ability to provide a wide range of services—from basic infrastructure to more complex needs like education, healthcare, and social welfare. These revenues not only influence the financial autonomy of local governments but also shape the efficiency and sustainability of public service delivery.

Revenues available to local governments are intrinsically tied to the total public revenues. Despite progress in recent years, South-East Europe (SEE) still lags behind the EU average in terms of both public revenues and local government revenue levels. The average size of public revenues in SEE stands at 35.9% of GDP, compared to the EU's 45.5% in 2023. The gap is even larger when considering local government revenue. On average, SEE LGs revenues account for just 6.2% of GDP, whereas the EU average is 10.8%. From this perspective, the financial capacity of SEE local governments is significantly constrained, reflecting broader trends in public sector size.

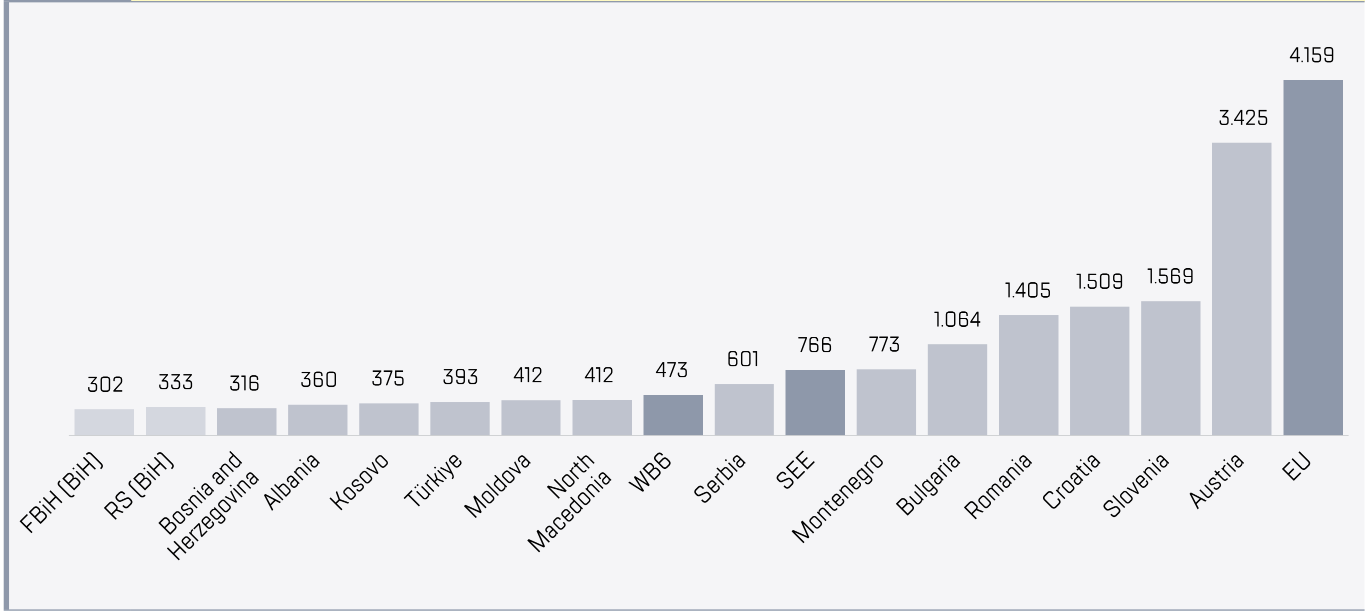
Public sector financing varies significantly across the region. Albania, Kosovo, and Türkiye have some of the smallest public sectors, with public revenues at only 28-29% of GDP, while Moldova, Romania, and North Macedonia have public sectors in the range of 32-36% of GDP. On the higher end of the spectrum, Croatia, Serbia, Montenegro, Slovenia, and Bosnia and Herzegovina have public revenues reaching up to 40% of GDP, and Austria even exceeds the EU average, showing the regional disparities in public sector financing.

Figure 4. Public Revenue and Local Government Revenue in South-East Europe, 2023



Local government revenues show significant intra-and cross-regional fiscal disparities. On average, local governments in SEE have over five times less revenue per capita than their EU counterparts, with Slovenia being the wealthiest in the region but still receiving more than twice as little as EU municipalities. Albania jumped a few places compared to 2022, due to the 2023 population Census registering a stark population decline.

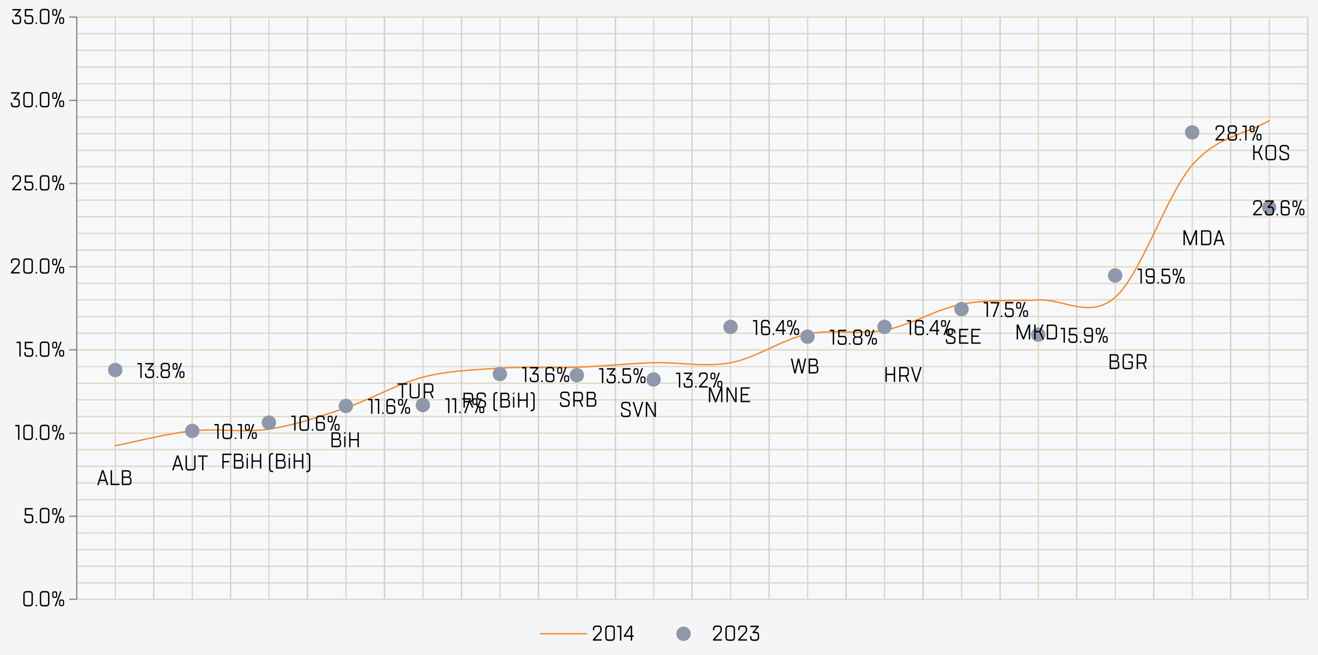
Figure 5. *Local Government Revenue, in € per capita, 2023*



Disparities are even more pronounced within SEE. Slovenia's local governments are more than five times wealthier than those in Republika Srpska (of BiH). Furthermore, local governments in Moldova, Kosovo, and Macedonia struggle with financing services, such as teachers' wages, on limited resources compared to wealthier EU municipalities. This shows significant intra-regional and cross-regional disparities in fiscal capacity.

Trends in local government revenues highlight mixed progress across the region. From a comparative perspective, over the past decade, local government revenues have improved only in Albania, Montenegro, Moldova, and slightly in Bulgaria. In the case of Albania, the increase is a combination of both functional and fiscal decentralization reforms that have increased local government financing, while in Moldova is related to predominantly improvements in the financing system. In Türkiye, Slovenia, North Macedonia and Kosovo there has been a decline.

Figure 6. *Local Government Revenues as a share of Total Public Revenues in 2014 and 2023*

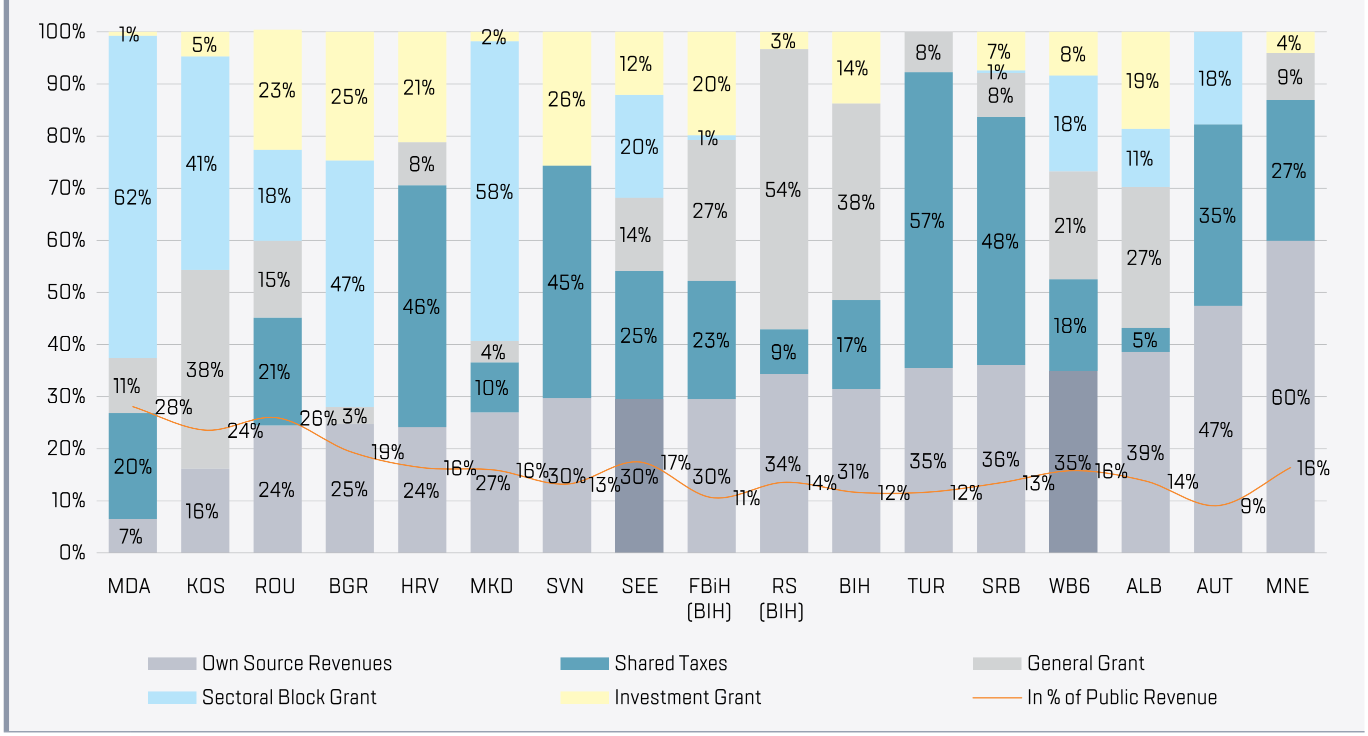


A key determinant of local fiscal autonomy, beyond the size and proportion of local budgets relative to GDP or the public sector, is the composition of the revenue base. The critical aspect here is the degree of local decision-making authority over these revenues, which reflects the true extent of fiscal autonomy. Although the general revenue categories may appear clear terminologically, their meaning and composition varies substantially across the region and, on several occasions, one general revenue component might consist of different revenue items. The reader should have this in mind because occasional misclassification may significantly overstate the local fiscal autonomy. Bearing in mind the differences, the data is informative with regard to the composition of local revenues and fiscal autonomy.

Figure 7 illustrates the composition of local government revenue in 2023 across Southeast Europe (SEE), ranked by the share of own-source revenues in total LG revenues. It also highlights the share of LG revenue as a percentage of total public revenue, providing insights into the degree of fiscal autonomy enjoyed by local governments.

In 2023, SEE local governments relied on intergovernmental transfers for two-thirds of their revenue. Indeed, SEE LGs generate, on average, 30% of their revenues from their own sources. Shared taxes contributed 25% of the total revenue, followed by general grants (14%), sectoral block grants (20%), and earmarked investment grants (12%). However, the reliance on intergovernmental transfers is evident, with LGs in SEE raising two-thirds of their revenues from higher government levels. This includes a mix of shared taxes, conditional, and non-conditional grants, which reflect a continued dependence on external sources of funding.

Figure 7. *Composition of Local Government Revenue in 2023, as a share of total LG revenue*



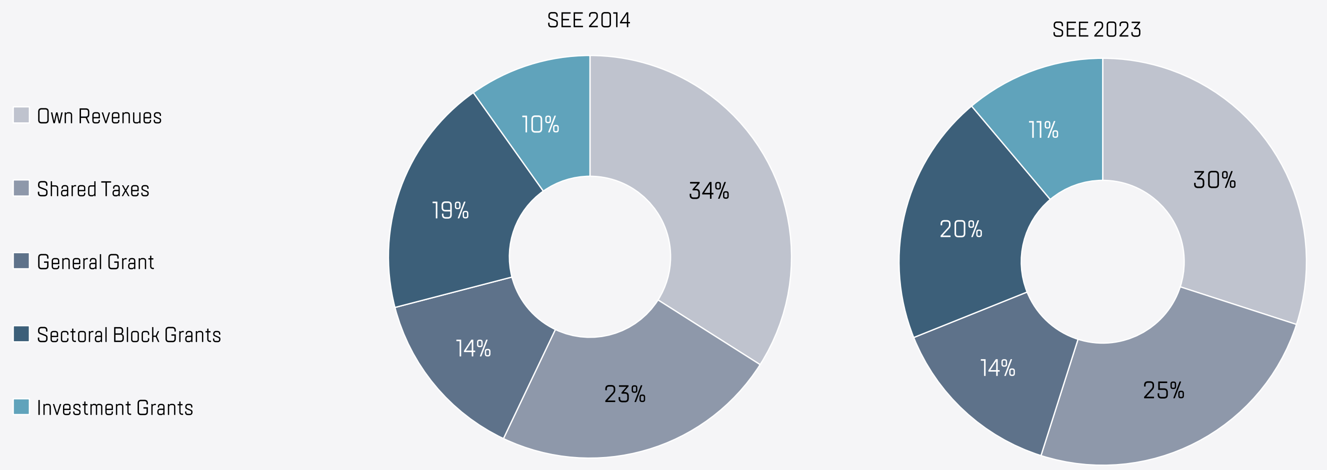
Own Source Revenues are very relevant, while sectoral block grants dominate in countries with large social sector needs. Among the six Western Balkans economies (WB6), own-source revenues account for a higher proportion of local government revenues, ranging from 27% to 60%. Montenegro continues to have the highest share of OSRs. In contrast, economies with significant social sector responsibilities, such as Moldova, North Macedonia, Kosovo, Bulgaria, and Slovenia, see sectoral block grants dominating their revenue structure, contributing 40% to 60% of total LG revenues. Investment grants play a fundamental role in Romania, Bulgaria, Croatia and Slovenia all of which are EU member states that benefit from EU funds. In Albania central government funding for capital investment is also quite high.

Own Source Revenues

The composition of municipal Own Source Revenues (OSRs) is a key indicator for fiscal autonomy - no matter what the size of the local public sector is. OSR main components comprise local taxes, service fees and charges, property management revenues and other, smaller, revenue categories such as fines and fees. The accounting and reporting of local own source revenues differ substantially across the SEE region. For some of the economies, a detailed breakdown of own source revenues is available whereas for some other economies the data is reported only on two or three categories.

Over the past decade, the share of own-source revenues in total local revenues across SEE has declined by an average of 11.8% (or 4 percentage points). At the same time, the shares of shared taxes and sectoral/investment grants have both increased by 2 percentage points. This trend reflects reduced local tax powers due to tax cuts and exemptions for specific taxpayer categories. Albania and Serbia exemplify this reduction in local fiscal autonomy, paired with a growing reliance on earmarked grants for municipal responsibilities.

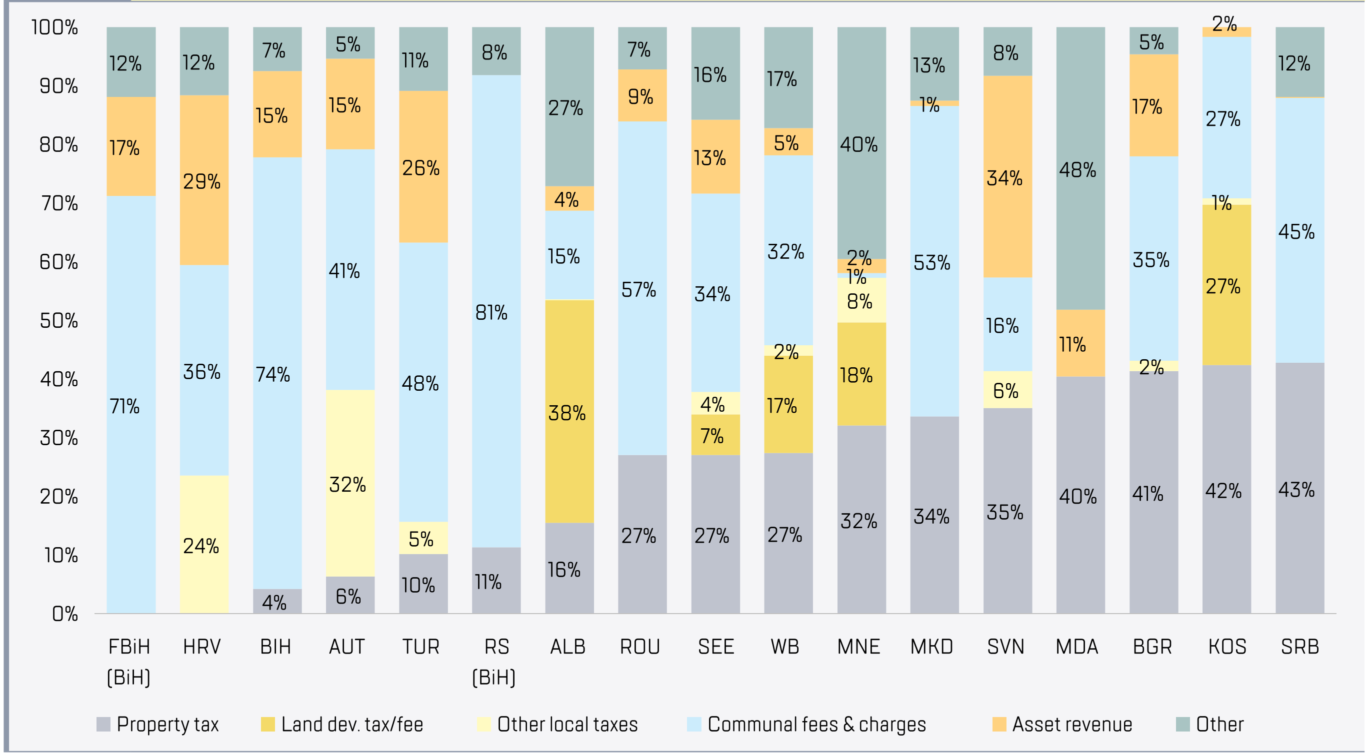
Figure 8. *Composition of Local Revenue in South-East Europe 2014 and 2023*



The decline in the share of own-source revenues across many SEE economies is closely tied to reduced local tax powers. These changes are often justified by the goal of creating a more business-friendly environment. For instance, **Albania** nearly eliminated the local tax on small business turnovers/profits in 2016, reducing its yield from 20% to just 0.3% of own-source revenues in 2023. While municipalities were partially compensated through an increased unconditional transfer, additional exemptions, such as those on property taxes, were granted to attract foreign investments. Similarly, **Montenegro** introduced tax exemptions on certain categories of personal income, negatively impacting municipal revenues from the PIT, its surtax, and the equalization fund. Further, Montenegro implemented property tax exemptions for airports and reductions for agricultural producers, while considering a replacement of the land development fee with a new system of charges for underdeveloped land and infrastructure. In **Serbia**, legal amendments restricted local taxes and fees, such as the business sign tax, and eliminated others like the local motor vehicle fee in 2012. The removal of the Land Use Fee in 2014, a significant revenue source, was intended to be incorporated into property tax but further limited municipal fiscal autonomy.

The decline in the share of own-source revenues across many SEE economies is also closely tied to shifts in revenue structures and local government competences. In other SEE economies, shifts in tax policy and the decentralization of social sector responsibilities have also influenced local revenue structures. **Bulgaria** abolished municipal fees for preschool education in 2022, transferring full funding responsibilities to the state, while **Croatia** eliminated the PIT surcharge as of 2024, with both countries seeing a corresponding increase in government transfers and shared PIT revenues. In both cases, EU funds contribute to increasing the share of transfers vs. own source revenues. In **Albania**, increased transfers to municipalities have been allocated for new responsibilities in preschool education, fire protection, and water and waste management. Similarly, **North Macedonia** expanded the general grant framework by raising its VAT anchor from 4.5% to 6% and its PIT anchor from 3% to 6%. In **Romania**, earmarked investment grants tripled and shared tax revenues doubled over the period 2016-2023. These trends underscore a growing reliance on intergovernmental transfers to offset revenue losses and support decentralized functions, such as the payment of wages for pedagogical staff in Albania's preschool education system.

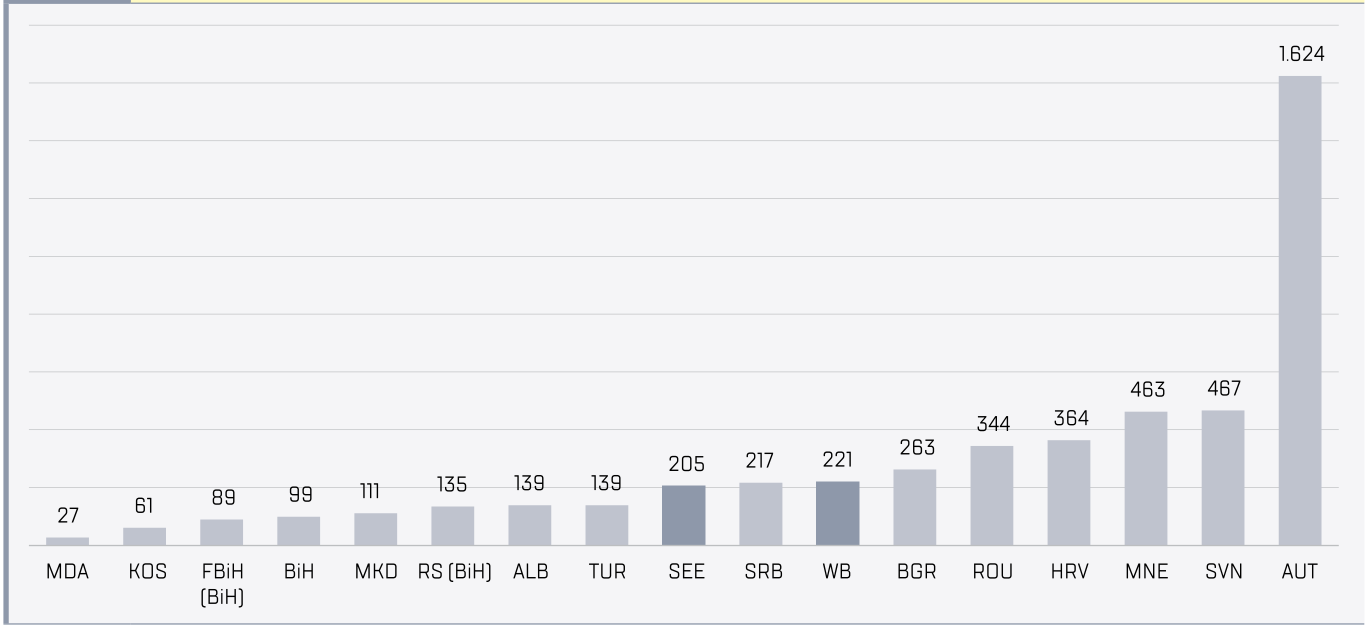
Figure 9. The structure of Own Source Revenues in SEE, 2023



The structure of own source revenues varies significantly across the SEE region. In Bosnia and Herzegovina local governments have fewer taxing powers while most of OSRs are derived by local and communal fees and charges. Communal fees and charges also very relevant in Türkiye, Romania, North Macedonia, Serbia and to a smaller extent in Bulgaria and Kosovo. In all these cases local governments have significant social sector responsibilities for which they charge service fees. It is important to consider also differences in revenue classifications across economies and how certain utility service revenues are accounted. In Albania and Slovenia fees and charges play a smaller role. Land Development Fees/Taxes are very important in Albania, Kosovo and Montenegro. Ultimately, Asset revenue is very important across SEE, with Slovenian, Turkish and Croatian LGs generating up to a third of their own revenues from this source.

Own source revenue potential and performance varies significantly across the SEE region. There are huge variations in the ability and performance of SEE LGs to collect their own revenue as indicated by the significant disparities in the per capita own source revenue data. Slovenian local governments generate almost two times more own source revenues per capita than their counterparts in the WB6. LGs in EU member states (and Montenegro) have higher than average per capita own source revenues, indicating both higher potential and better performance. There are relevant disparities across LGs also within SEE economies. For example, Tirana and Albania's seven largest municipalities have collect 78% of total own source revenues in the country.

Figure 10. *Local Government Own Source Revenues, in EUR per capita, 2023*



While SEE economies are developing reforms to enhance local revenue systems, significant challenges remain. Fragmented frameworks and limited fiscal autonomy underscore the need for coordinated, long-term strategies. In **Bosnia and Herzegovina** (BiH), local and communal fees have proliferated without a centralized framework, creating over 350 distinct fees in the Federation of BiH (FBiH) alone, as identified by the Ministry of Finance. This fragmented approach has become a barrier to local development. Conversely, **Serbia** has taken a more systematic approach. The 2018 Law on Fees consolidated and standardized public fee framework and structures, clearly defining taxpayers, obligations, tax bases, rates, and administrative procedures. Reform is underway also in **Croatia**, embracing property-based taxation to bolster local government revenues, shifting from income tax reliance. This approach is intended to benefit local government fiscal space, as property-related revenues are typically local revenues, and the tax base is immovable. As part of this policy shift, Second Home Tax rates have been adjusted from the longstanding values that were not changed for almost three decades. A property tax reform is being considered in **Slovenia** too, while being long overdue in **Moldova**. It is important to highlight however that frequent amendments to the legislation may also undermine local governments efforts and planning.

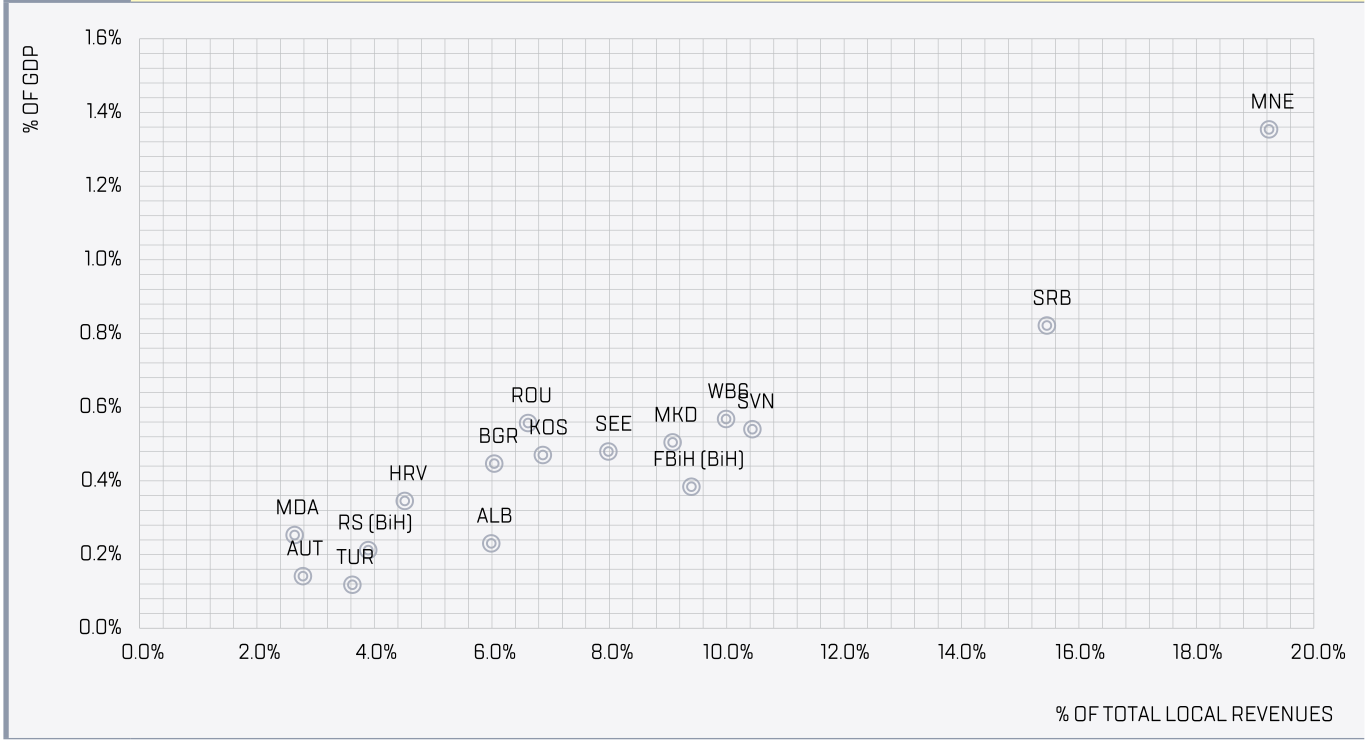
Modernizing fiscal registers, and improving intergovernmental coordination are essential for strengthening local revenue management and fostering sustainable development. SEE local governments struggle with outdated fiscal registers, limited technical capacity, and weak compliance enforcement. The lack of a comprehensive fiscal register linking tax bases to taxpayers is a common challenge for LGs in Albania, North Macedonia, Bosnia and Herzegovina, Moldova and Romania among others. In the **Republic of Srpska (of BiH)** it is estimated that up to 50% of the real estates are not registered and included in the calculation by the tax administration, posing a major barrier to municipal revenue collection. In **Romania** local government tax payment arrears account for up to 50% of all receivable property tax. At the same time, key challenges relate to the fragmentation of tax databases, low interconnectivity of central and local databases and insufficient cooperation across central and local agencies managing relevant registers. Overdue reform efforts are underway in **Albania** to develop the property cadastre, while in Bosnia and Herzegovina (RS of BiH) a new law on property taxation requires the central government tax administration to share property data with local governments. In **North Macedonia**, while property tax collection has generally decreased, performance across municipalities varied. Many Macedonian municipalities have taken proactive steps to enhance their fiscal management by updating their property registers, conducting thorough property assessments, and working closely with the Public Revenue Office to strengthen tax compliance—going as far as blocking the accounts of non-compliant taxpayers. In contrast, a number of municipalities have adopted a more passive stance, showing less initiative in maintaining and updating their fiscal records. In **Croatia**, recent legislative proposals aim to increasing penalties, with fines starting at €1,000, to enhance compliance and secure local revenues.

Local Government Associations play a fundamental role in supporting LGs to Enhance Revenue Generation Challenges. While LGAs play a fundamental role in advocating for enhanced fiscal decentralization policies and reforms, they also play a fundamental role supporting member municipalities improve revenue management. Efforts to address key underlying issues are evident in Croatia, where proactive initiatives from both the central and local government levels focus on updating fiscal registers and automating data exchanges between national and local systems. Access to several registers is facilitated by the Government Service Bus (GSB) and (no-cost) IT solutions for local governments promoted by the **Association of Cities of Croatia (AOC)** which have supported tax administration improvements. However, challenges persist, such as non-compliance by taxpayers and insufficient penalties for underreporting changes to tax information. In North Macedonia, the **Association of Local Self-Government Units (ZELS)** is working on improving local tax administration systems by advocating for the development of information technology solutions to facilitate the collection and management of local taxes. At the same time, it plays a key role in managing and providing e-services for member municipalities: the e-things system for public auctions, the e-permits system (e-building approval information system), the e-construction land information system. The **Union of Municipalities of Montenegro** (UMM) has developed specialized software to assist its members in administering local public revenues, which is utilized by the majority of municipalities to varying degrees. This software is integrated with the Cadastre through a web service and is currently being prepared for connection with the Ministry of Internal Affairs' taxpayer and citizen database.

The Property Tax

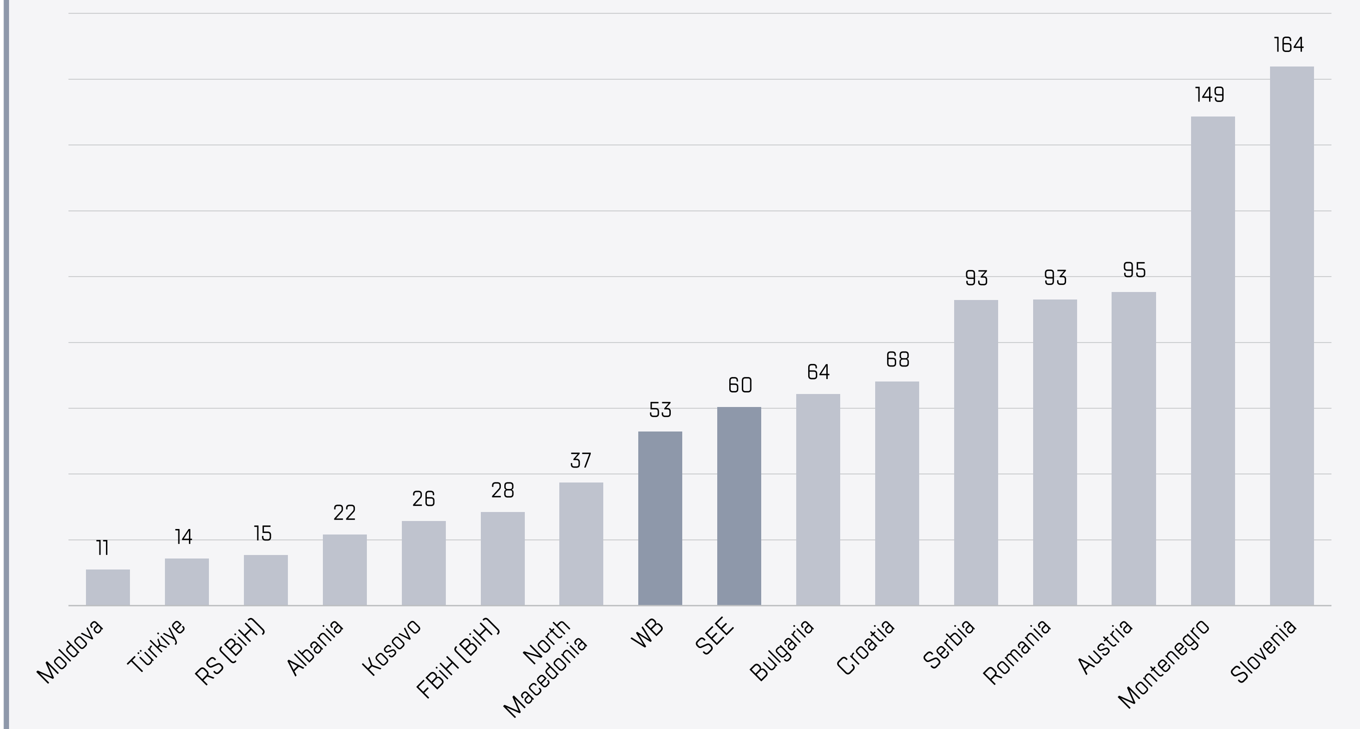
The property tax is becoming the lead local government tax in South-East Europe. From a regional perspective, between 2006 and 2023, the yield of the property tax almost doubled, increasing from 14% to 27% of own source revenues and from 5% to 9% of local revenues and from 0.3% to 0.6% of the GDP, indicating, across the region, that more effort is put into the collection of the property tax. This tendency is driven by the outstanding performance of Bulgaria, North Macedonia, Montenegro and Serbia and to a lesser extent Kosovo, Albania and Slovenia. Figure 11 shows that Montenegro and Serbia lead considerably above the rest SEE economies. Montenegro's and Serbia's indicators are the closest to the EU average of 1.6% of GDP and in line with Eastern Europe members of the EU.

Figure 11. *Property Tax as a percentage of GDP and Total Local Revenue in 2023*



Property taxation is a vital revenue source for municipalities in Southeast Europe, yet it faces persistent challenges that hinder its full potential. Property-related taxes are the most common municipal taxes in Europe. Throughout the region, national and local governments have made substantial investments in the technical infrastructure for property taxation, with very good results. However, challenges persist on this important source of municipal revenue. A significant issue is the outdated or incomplete property cadastre systems and insufficient data-sharing and digitalisation which limit the accuracy of property valuations and tax assessments and collections. Many municipalities struggle with low collection rates due to administrative inefficiencies and a lack of enforcement mechanisms. Additionally, property tax rates are often politically sensitive, leading to reluctance among local governments to adjust rates to reflect market values. In some cases, the absence of widespread public awareness about the importance of property taxes further exacerbates compliance issues. In some other cases, legal frameworks governing property taxation may be fragmented or inconsistent, creating ambiguities that complicate administration.

Figure 12. *Property Tax Revenues, in EUR per capita, 2023*

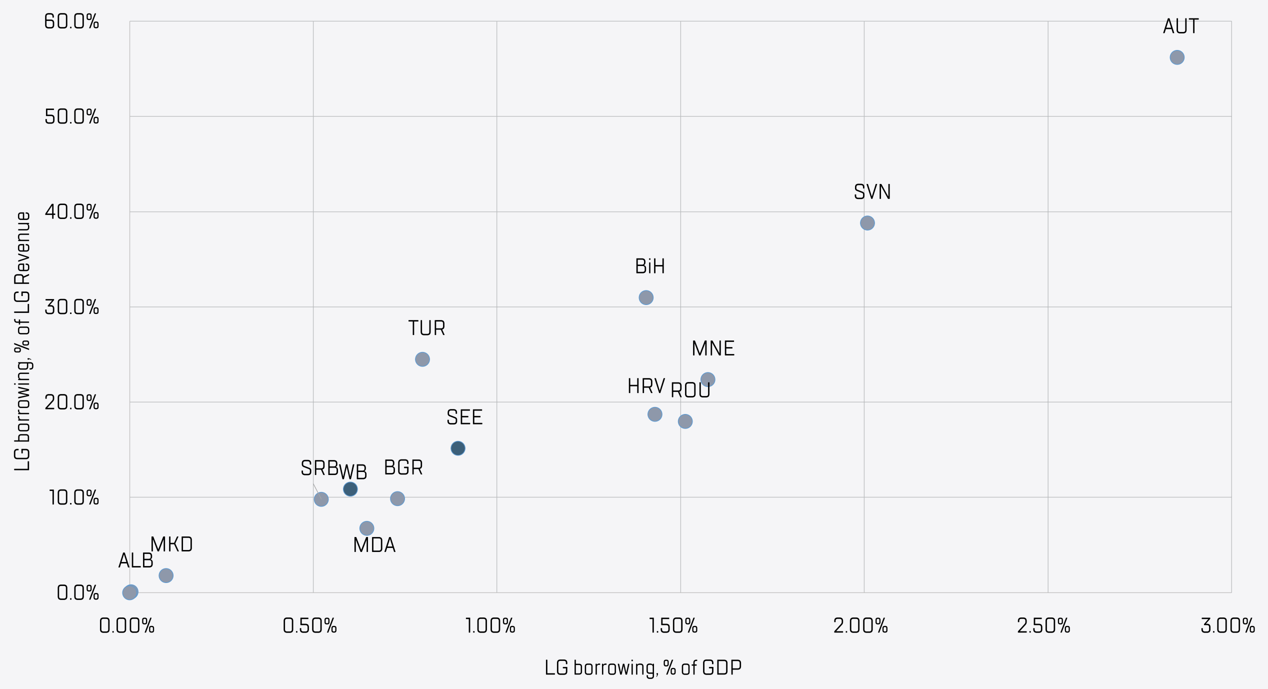


There are wide disparities in the property tax powers and collection efforts and outcomes in SEE local governments. Figure 12 shows the property tax revenues in Euro per capita in South-East Europe in 2023. Moldovan LGs generate the lowest property tax revenues in the region, with just €11 per inhabitant, while Slovenian LGs lead with €164 per inhabitant. Disparities are also evident within the WB6 economies. For instance, despite Albania's recent reforms aimed at transitioning to a market value-based property taxation system, Albanian LGs collect only about half the property tax revenue of Macedonian LGs and nearly five times less than their Serbian counterparts. Slovenia is drafting a new property tax law to replace the current system with a unified real estate tax, enhancing municipalities' revenue capacity by applying it to all properties owned by individuals and businesses. In contrast, Moldova's property tax system struggles with unreliable property valuation data, centralized evaluation authority, and a lack of differentiation between land and buildings. LGs' financial constraints further hinder their ability to address these issues.

Local Borrowing

In most of the SEE region, local government borrowing remains a relatively new and under-utilized instrument for financing local governments. Figure 13 shows the level of local government debt in South-East Europe in 2023. Municipalities in Austria and Slovenia have ratios above 2% - 4% of GDP. Among the SEE economies, local government debt in Albania and North Macedonia represents a negligible fraction, while in Serbia, Moldova, Bulgaria and Türkiye local borrowing is somewhat higher averaging between 0.52-0.80% of GDP in 2023. In Croatia, Romania and Montenegro local borrowing is more substantial, averaging at 1.5% of the GDP. On the other hand, Kosovo municipalities are not able to used debt as a financing instrument.

Figure 13. *Local Government Debt in South-East Europe, 2023*



There are several factors limiting usage of local government debt in SEE. One of the main constrains for this important source of financing, in particular for long term capital investments, (besides other factors like very conservative, rigid and centralized regulatory framework), are high levels of public debt, budget deficits and the need (or plan) to try meet the Maastricht Treaty's guidelines for total public debt and annual budget deficits (less than 60% and 3% of GDP respectively).

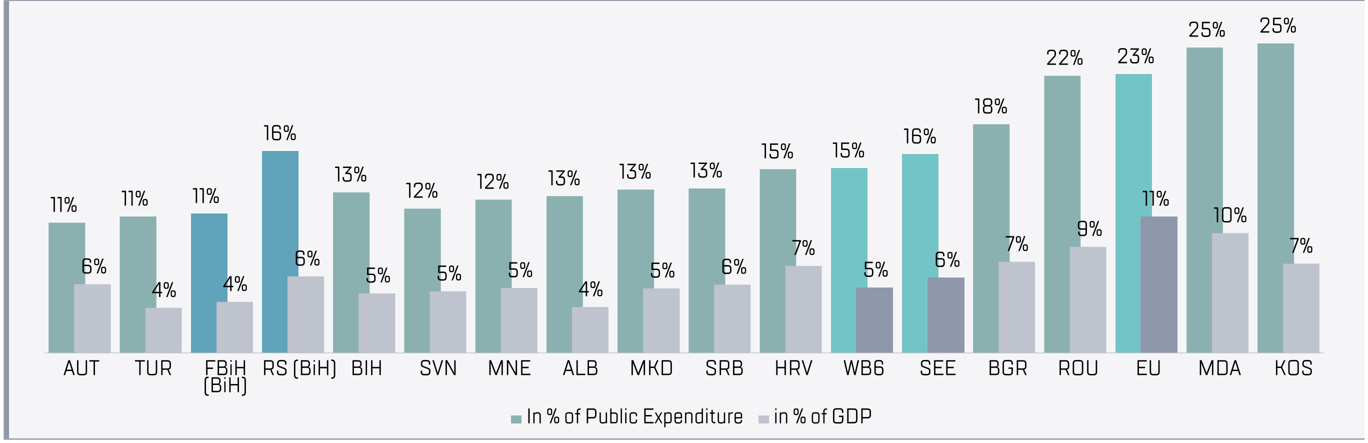
There remain significant disparities across SEE LGs in their ability to use debt as a financing instrument to build and improve local infrastructure and services. Borrowing is an important source of financing for local governments in Austria, and Slovenia and Türkiye LGg debt constitute 40% and 9356% of total local government revenues, while in Bosnia and Herzegovina, Croatia, Romania, Türkiye and Montenegro they constitute between 20%-40% of total local government revenues. In Serbia, Moldova and Bulgaria local borrowing makes up to 10% of total local government revenues, while in Albania and North Macedonia is less than 2%.

From a regional perspective, the key challenges affecting access to debt capital by local governments relate to the restrictive rules and legal limitations. In most of the SEE region, the law requires central government's approval prior to local debt issuing and given the current high levels of public debt facing national governments, approval for LG debt can become challenging; in particular if there are no clear and objective rules regulating local government borrowing limits. Furthermore, in more than half of SEE economies, there are legal limitations on both, the total outstanding debt and the annual debt service payments. Ultimately, there are also capacity constraints as in many cases municipalities miss specialized skills to prepare, plan, and cost-out complex, multiyear investment projects.

Local Government Expenditures

Local Governments in South-Est Europe manage approximately 16% of total public expenditures, constituting up to 6% of the GDP. Figure 14 shows the LG expenditures in SEE economies as a percentage of public expenditures and the GDP, in 2023. There are significant differences though, with Türkiye's local governments managing only 11% of total public expenditures and Moldova's and Kosovo's local governments manage 25% of total public expenditures. Furthermore, local government expenditures vary from 4% to 11% of the GDP. These significant differences, reflect the differences in service responsibilities and levels of income. Unsurprisingly, in Moldova, Kosovo and Romania, where LGs have extensive decentralized social sector responsibilities in education and to a lesser extent in health and social protection, the share of LG expenditures is higher than elsewhere in the region, and even higher than in the EU.[4]

Figure 14. *Local Government Expenditure as a share of Public Expenditure and GDP, 2023*



[4] From a methodological perspective, it should be noted that, as with revenues, there are inconsistencies in the way expenditure data is reported. For example, some places treat capital transfers to public utilities as investment expenditures while others record them as subsidies, which cannot be distinguished from transfers to individuals or grants to non-governmental organizations. Similarly, in many places, debt repayment is not accounted for separately, but included in the category "Other".

Local Governments in the Western Balkans and South-East Europe spend about 25-27% of their budgets on capital expenditures for investments. Figure 15 shows the composition of the regional average local government expenditures in the six Western Balkan economies, South-East Europe and the EU, by economic type and functions of government in 2023. Spending for salaries constitutes on average 31-33% of total local expenditures while goods and services make up to 20%-22%, grants and transfers 13-16% and the remaining 5-7% on other categories. From a functional perspective, **SEE local governments spend about 18% of total municipal budgets for general public services, about 26% on education, 16% on economic affairs and about 12% for housing and community amenities.** Municipal spending for health, social protection and environmental protection varies between 4-9%. On the other hand, in the EU, spending for social protection alone constitutes 22%, health 16% and environment approximately 5%.

Figure 15. Composition of LG Expenditures in SEE, WB6 and EU, 2023, Economic and Funcitonal Classification (in percent of total)

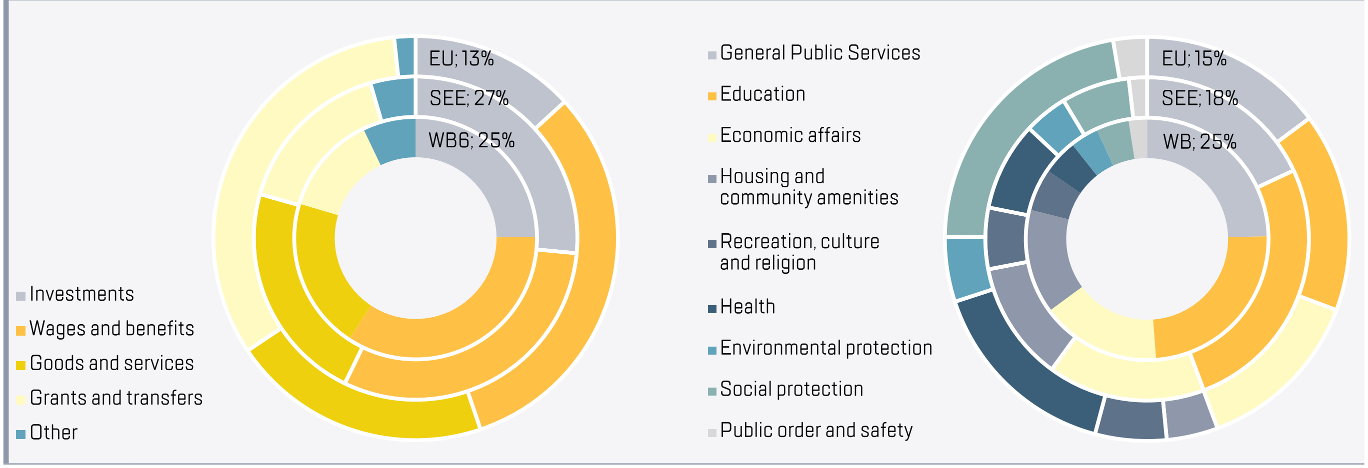
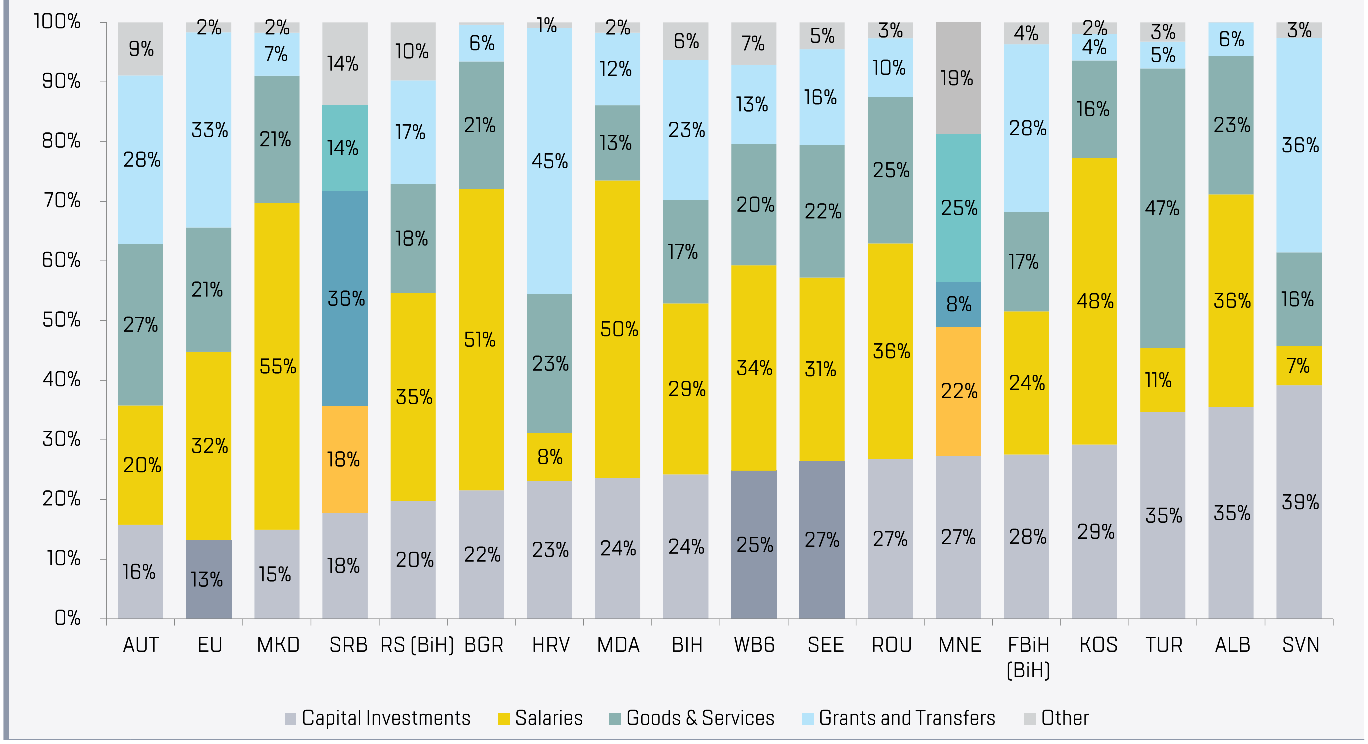


Table 5. The composition of LG Expenditures, in the WB6, SEE and EU, Economic and Functional Classification (in percent of the total)

Economic Classification	WB6	SEE	EU	Functional Classification	WB6	SEE	EU
Investments	25%	27%	13%	General Public Services	25%	18%	15%
Wages and benefits	34%	31%	32%	Education	24%	26%	16%
Goods and services	20%	22%	21%	Economic affairs	16%	16%	14%
Grants and transfers	13%	16%	33%	Housing and community amenities	14%	12%	4%
Other	7%	5%	2%	Recreation, culture and religion	6%	6%	6%
				Health	5%	9%	16%
				Environmental protection	4%	4%	5%
				Social protection	4%	7%	22%
				Public order and safety	2%	2%	3%

Local governments in the WB6 and SEE allocate a larger share of their budgets to investments compared to their EU counterparts, reflecting differences in service responsibilities and local needs. Figure 16 illustrates the composition of local government expenditures by economic type for each member of these groups, as well as the averages for SEE, WB6, and the EU ranked by the share of investment spending in total municipal expenditures. In WB6 and SEE economies with decentralized social sector functions, local governments allocate a higher percentage of expenditures to wages—up to nearly 55%. Local governments in Slovenia, Albania, Türkiye, Kosovo, Montenegro, and Romania dedicate more resources to capital expenditures. However, spending on salaries varies significantly within this group, except in Albania and Romania, which display similar wage shares. This similarity is linked to Romania's 2018 centralization of the teachers' wage bill, despite differing municipal service responsibilities in the two countries. Moldova and Kosovo also allocate a higher share to capital investments than the Western Balkans average, though their figures are not significantly different from North Macedonia and, to a lesser extent, Bulgaria, where LGs have more decentralized social sector responsibilities than the rest of the region.

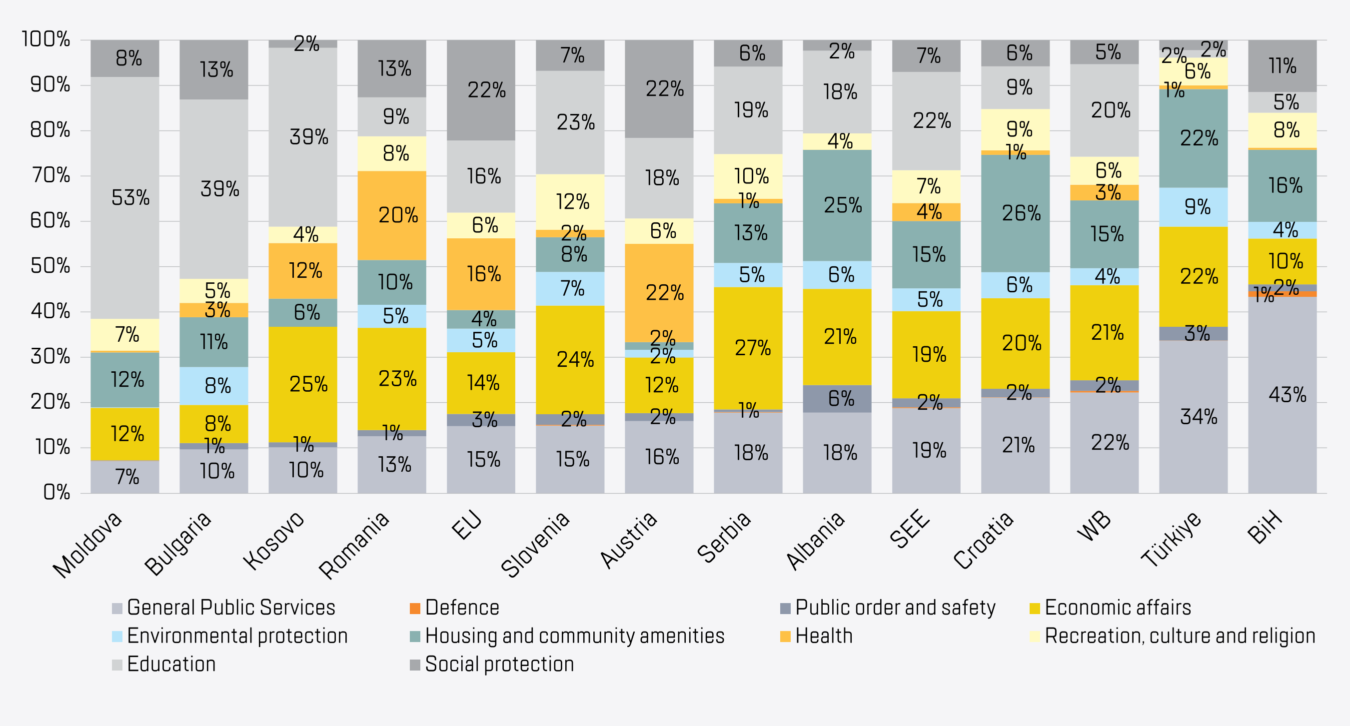
Figure 16. Composition of LG Expenditure in SEE Economies, 2023



Differences in spending patterns between SEE and EU LGs may be explained by different spending needs and financing mechanisms. First, the greater decentralization of social sector functions in the EU leads to higher operating costs, reducing the share of expenditures available for investment. Second, investment needs differ between the regions. In SEE, spending focuses on building new infrastructure and reconstructing outdated systems, while in the EU, resources are primarily directed toward maintaining existing infrastructure, classified as operational expenses. Additionally, SEE local governments often finance investments directly from their budgets, whereas in much of the EU, such expenditures are funded through utility tariffs for services like water and sewer systems, waste management, and public transportation. However, it's important to note that the investment capacity of SEE local governments may be overstated, as a significant portion of their capital spending comes from centrally controlled investment grants. These funds often provide limited discretion to local governments. For instance, Albania consistently reports the highest levels of local government spending on capital investments in the region, largely due to such centrally managed grants.

The differences between the spending patterns of SEE LGs and their counterparts in the EU can also be analyzed based on the functional allocation of expenditures. Figure 17 shows the composition of LG expenditures based on the functions they perform, for a select number of economies that publish information on expenditures based on the classification of the functions of government methodology (COFOG). Economies are ranked based on the share of expenditures allocated for "General Public Services" function, covering mainly the functioning of the local administration (wages for the staff and local elected bodies, maintenance of public buildings etc.).

Figure 17. *Composition of LG Functional Expenditures, 2023*



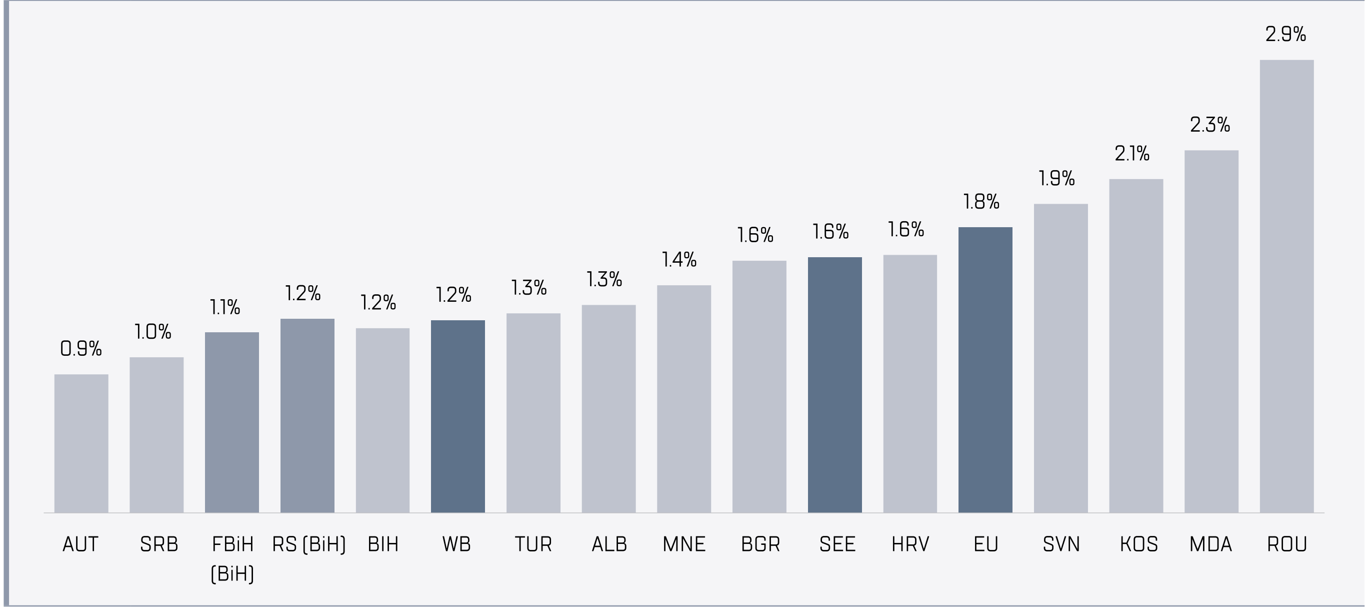
Local governments in Moldova, Bulgaria, Kosovo and Romania spend less on general public services than their EU counterparts, while those in Albania and Croatia align more closely with the SEE average. Local governments in Türkiye and Bosnia and Herzegovina significantly outspend the EU average in this area, reflecting larger wage bills tied to responsibilities for costly social sector functions like education.

Local Government Investments and Regional Development

Local government investment in SEE varies significantly across economies due to differences in fiscal capacities, levels of decentralization, and governance structures. Local governments in the region typically operate under constrained fiscal conditions, relying heavily on intergovernmental transfers and limited options for generating own-source revenue. Access to borrowing and financial markets remains restricted, although municipalities with stronger institutional capacities have been able to secure development bank loans or issue bonds.

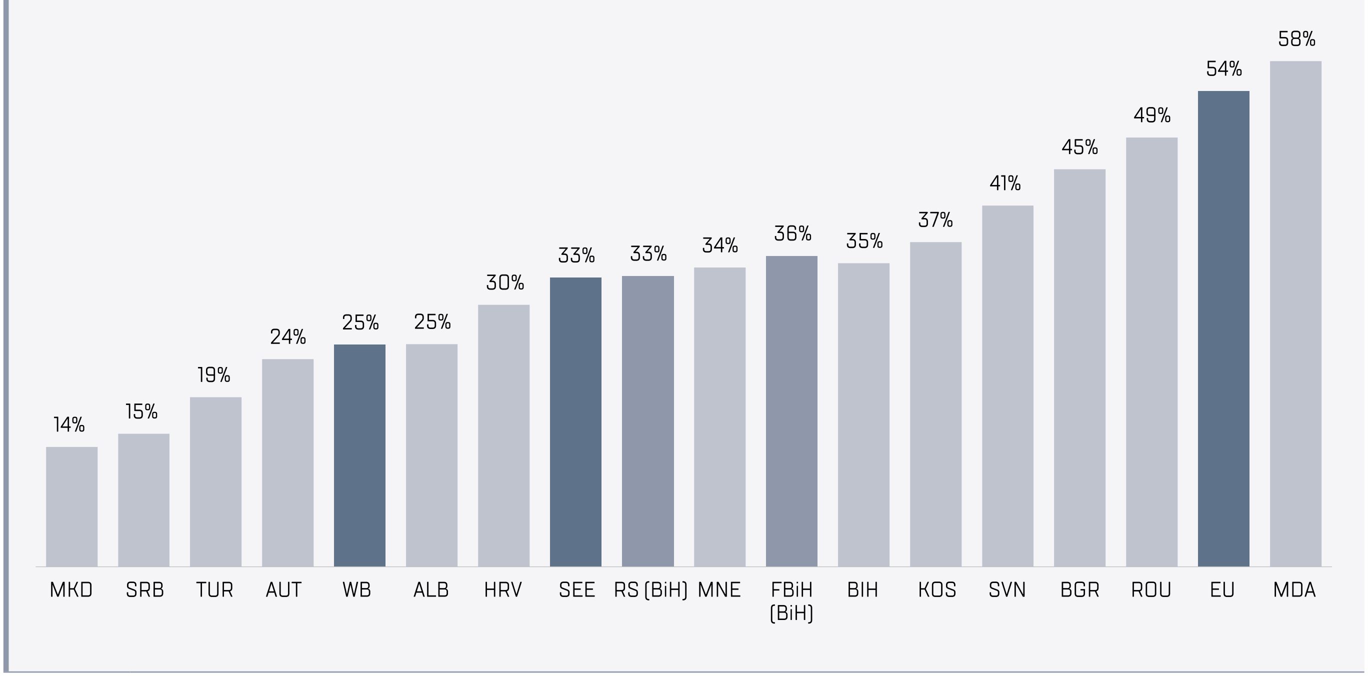
Local government investments in SEE constitutes up to 1.6% of the GDP, close to the 1.8% in the EU. In SEE economies with larger social sector responsibilities in education and social services in particular, the share of local government investment to GDP is higher, as indicated by Romania, Moldova and Kosovo. Slovenia, Croatia and Bulgaria are close to the EU average while North Macedonia and Serbia are well below the WB average for local government investments as a share of GDP. Interestingly, Austrian Local Government investments account for only 0.7% of the GDP.

Figure 18. *Local Government Investment as share of GDP, 2023*



Public investments are more centralized in the WB and SEE compared to the EU. On average, in the WB, local governments account 25% of total public investments, with Macedonian and Serbian local governments managing only up to 15% of total public investments and Montenegrin municipalities managing twice that amount, without having any major responsibilities in the costly social sectors of education and social services as in North Macedonia and Serbia. Croatian LGs manage 30% of total public investments while its EU peers Slovenia, Bulgaria and Romania have higher shares, although significantly lower than the EU average of 54%. Moldova remains a clear outlier, considering their extensive service responsibilities and rayons' spending for delegated responsibilities from central earmarked grants.

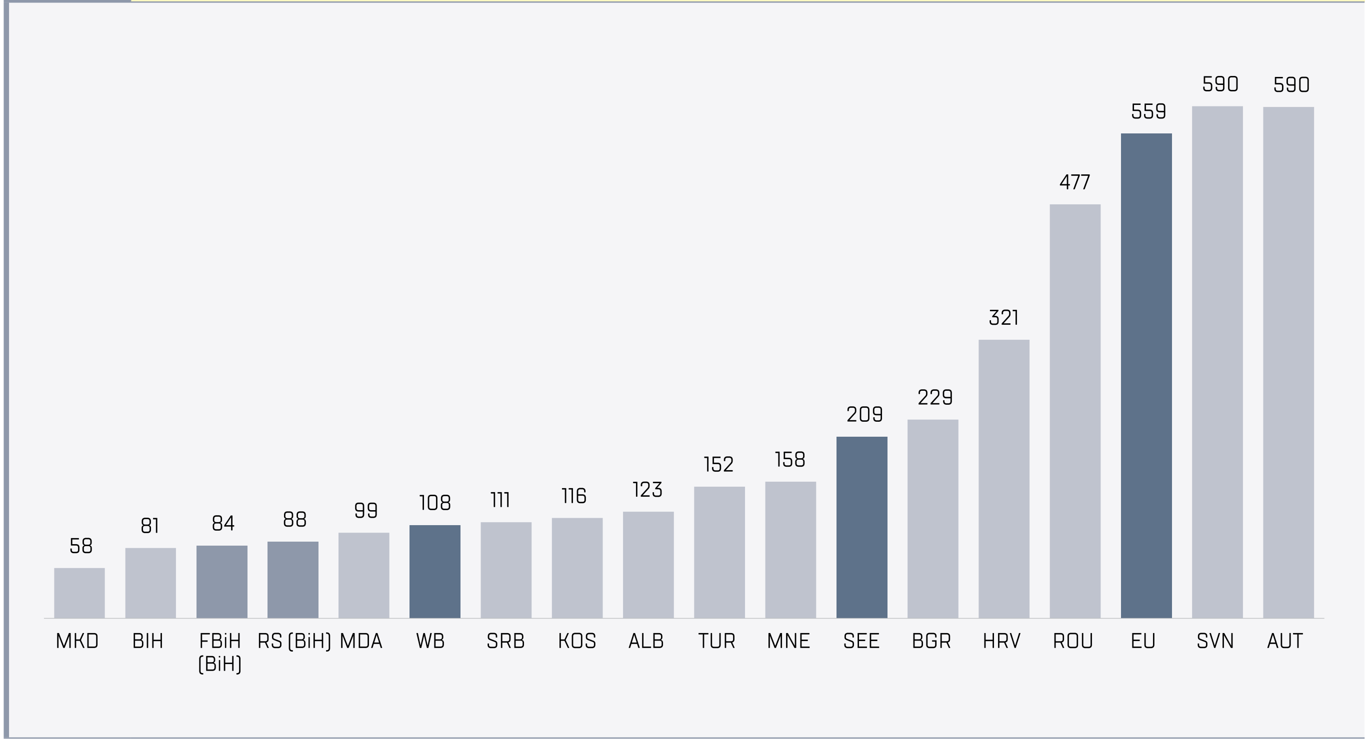
Figure 19. *Local government investment as share of total public investment in SEE, 2023*



Significant disparities exist in local government spending on capital investments within SEE economies and in comparison, to the EU. Figure 18 illustrates investment spending per capita in EUR for 2023. As expected, local governments (LGs) in the Western Balkans (WB) have lower per capita spending compared to their SEE and EU counterparts. On average, WB LGs allocate **€108 per capita** to capital expenditures, approximately half the SEE average of **€209 per capita**. The SEE average is largely driven by the higher spending of **Slovenia**, **Romania**, and, to a lesser extent, **Croatia**—all EU member states that benefit significantly from EU budget financing for capital investments. Despite this, SEE local governments still face a considerable gap when compared to their EU peers, with per capita spending on capital investments averaging **two to five times lower** than the EU average.

A notable change in recent years is the relative position of **Albania**, which now occupies a mid-range position on the chart, reflecting improved capital investment spending by its local governments. In contrast, **North Macedonian LGs** have seen a relative decline and now rank near the bottom of the table. These shifts highlight the dynamic nature of local government investment patterns in the region and underscore the importance of external funding, policy reform, and capacity-building efforts to address these disparities.

Figure 20. Local Government Investment in SEE, Eur per capita, 2023



Most SEE economies have national mechanisms designed to support capital investments at the local level, although their scope and effectiveness vary. In **North Macedonia**, the **Regional Development Program**—intended to be anchored at 1% of GDP, though this target has yet to be met—aims to reduce regional disparities. A newly adopted strategy for balanced regional development seeks to further align resources with territorial needs. Similarly, in **Albania**, the **Regional Development Fund** provides investment financing to municipalities for projects within their local functions and competences, including essential infrastructure, transportation, and education. In **Moldova**, tailored tools support local-level capital investments, addressing gaps in municipal infrastructure.

Bulgaria allocates funding for capital investments through the **Earmarked Capital Expenditure Subsidy**, which accounts for up to 14% of total local investments (including EU funding). This funding is distributed peculiarly, with the main component allocated based on natural indicators such as the number of settlements, length of municipal roads, population, and surface area, while an additional component is divided equally among 131 municipalities categorized as requiring structural improvements. In **Slovenia**, municipalities benefit from earmarked grants specifically designated for infrastructure development projects. These grants are allocated based on municipal development levels, using various indicators. Since 2020, Slovenian municipalities have also received **grants for balanced development**, which amount to 6% of local expenditures. These grants are distributed using a formula that incorporates geographic and environmental considerations, such as proximity to borders and natural zones. In **Türkiye**, conditional grants like those provided through the **KÖYDES Program** (Village Infrastructure Support Project) play a crucial role in supporting rural areas. This program offers funding for villages to complete investment projects that would otherwise remain unaffordable, addressing rural development challenges.

The European Union plays a pivotal role in financing local investments across Southeast Europe. For EU member states, **Cohesion Funds** significantly contribute to municipal capital investment budgets, supporting infrastructure development, environmental sustainability, and social services. In EU candidate economies, the EU remains a vital actor, particularly through the **Instrument for Pre-Accession Assistance (IPA)**, which helps build institutional capacity and fund development projects.

For example, under the last two IPA frameworks, **Montenegrin municipalities** implemented 167 projects with a total value of €124 million.[5] In **Albania**, during 2021–2022, 51 out of 61 municipalities reported participating in 223 projects, cumulatively funded by €34.6 million from EU sources.[6]

Similarly, in **Serbian municipalities** have benefitted from hundred of EU funded projects, with a key program being the **Exchange Programme**, implemented by SCTM over **20 years** in partnership with the **EU Delegation in Serbia**. Since **2004**, the program has gone through **six phases**, with a total budget of **over €35 million**. Four phases (Exchange 1, 3, 4, and 5) included **grant schemes for municipalities worth nearly €22 million**, funding **around 170 municipal projects**, while the remaining funds supported expert and technical assistance for local government development. Starting in **2025**, SCTM will implement a major **EU-funded initiative** focused on **local investments** through an **integrated territorial development approach**, inspired by **EU Cohesion Policy**. This builds on previous **EU/IPA-funded programs** since **2010**, carried out in partnership with **UNOPS**, which aimed at balanced socio-economic development at regional and local levels. Over the past **14 years of these programs**, the EU has contributed **nearly €99 million**, funding **over 1,200 projects**.

Recognizing the critical role of local governments in the accession process, Western Balkan candidates for EU accession are increasingly enhancing their enabling environments to facilitate municipal access to EU funding. NALAS has supported these efforts by promoting best practices among its member Local Government Associations. Recent progress has been observed in **Albania** and **Bosnia and Herzegovina** where specific instruments have been introduced to support local governments in accessing EU funds. These include mechanisms for **pre-financing** and, in some cases, **co-financing** EU-funded projects. A notable example is Montenegro's **Revolving Fund for Local Governments**, which helps municipalities manage the financial demands associated with EU project implementation or Bulgaria's **Fund for Local Authorities and Governments** (FLAG) in force since 2027. The Standing Conference of Towns and Municipalities too is advocating for the introduction of a similar instrument in Serbia.

However, for EU candidate economies, it is important to note that EU funding often reaches the local level indirectly through national governments, with varying degrees of success. This centralized distribution is also reflected in the **Growth Plan for the Western Balkans**, where funding predominantly targets central governments. NALAS is actively collaborating with its member LGAs and EU partners to advocate for a stronger role for local governments in these emerging funding mechanisms and to ensure municipalities have equitable access to resources critical for their development.

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5 Ministry of European Affairs of Montenegro: https://www.eu.me/en/the-ministry-of-european-affairs-and-municipalities-signed-a-memorandum-of-cooperation/

6 Minister of State for Local Government: Donor Funded Projects implemented by Local Government Units in Albania, prepared by the EU funded 'Municipalities for Europe' Project: https://www.bpe.al/en/donor-funded-projects

VI. Review of Intergovernmental Finance Frameworks

Albania

By Elton Stafa, NALAS and Keti Daja, Association of Local Autonomy of Albania

Local government in Albania consists of municipalities and regional councils, with municipalities responsible for key services. The 2014 Territorial and Administrative Reform (TAR) reduced 373 local governments to 61 larger municipalities, making Albania's first-tier local governments among the most populous in Europe. However, the reform was top-down and lacked full political consensus. Several functional and fiscal decentralization reforms were enacted between 2015-2017 expanding municipal responsibilities, stabilizing the unconditional grant – the key financing instrument for local governments in Albania – and initiating a property tax reform. However, the new responsibilities were not accompanied by adequate financial resources, and despite the progress made, in general terms Albanian municipalities remain heavily reliant on central government funding for capital investments.

Revenue collection potential varies significantly across municipalities, with larger urban areas seeing an increase in own-source revenues (OSR), primarily from a small set of taxes. Smaller municipalities, particularly rural ones, face challenges due to limited tax diversification and more importantly weak fiscal capacity. Local government spending is increasingly focused on salaries, at the expense of capital investment, exacerbating infrastructure gaps. Payment arrears, although declining, still pose risks to municipal budgets and service delivery.

Methodological Note

In this analysis, LG revenue refers to the total funds Albanian LGs raise on their own, plus transfers from the state budget, including shared taxes, unconditional grants, sectoral grants, and conditional grants from line ministries and agencies. Social protection transfers from the Ministry of Health and Social Protection are excluded, as LGs have no control over these funds. This approach ensures comparability with peers in Southeast Europe, where conditional grants are included in LG revenues and spending. Consequently, data may differ from other local finance reports on Albania.

The Intergovernmental Finance System

Intergovernmental finances in Albania are governed by a comprehensive legal framework that includes several key laws and bylaws. The most important of these are the new **Law on Local Self-Government**, the **Law on the Local Tax System**, the **Law on Local Self-Government Finance (LLGF)**, the **Law on the Management of the Budgetary System in the Republic of Albania**, and the **Annual Budget Laws**. These laws collectively regulate the financial relationship between central and local governments, defining four main types of transfers: **shared taxes**, **general unconditional transfers**, **sectoral unconditional transfers**, **performance grant** and **conditional transfers** for delegated functions and specific projects assigned to local authorities. This legal framework is designed to ensure transparency, fiscal discipline, and a structured distribution of financial resources between different levels of government in Albania.

Shared taxes. Shared taxes account for a small portion of local government financing in Albania, constituting only 6% of local government revenues in 2023 (excluding conditional grants). There are three main types of shared taxes: a) 2% of Personal Income Tax (PIT), b) 25% of the Vehicle Circulation Tax, and c) 5% of Mineral Rent. The local Small Business Tax (SBT) was de facto transformed into a shared tax in 2016, with local governments losing authority over its base and rate, and its collection recentralized. The government has also exempted most of its taxpayers from the tax and this change resulted in a significant drop of more than 75% in its yield.

Shared Tax Revenues

- 2% of Personal Income Tax
- 25% of Vehicle Circulation Tax
- 5% Mineral Rent

The PIT was introduced as a shared tax under the 2017 Law on Local Self-Government Finance, with the application expected to begin in January 2018. However, technical difficulties in identifying taxpayers' origin through the General Tax Directorate database have delayed full implementation. In the interim, the Ministry of Finance has allocated PIT proceeds to municipalities based on a proxy measure, using population as the base.

Intergovernmental transfers make up the core of local budgets - unconditional and sectoral grants constitute between 50% - 92% of LG revenue for 87% of LGs in the past 5 years (excluding conditional grants). The **Unconditional Transfer**, introduced in 2001, is the most crucial revenue source for Albanian local governments, historically accounting for over 50% of revenues (excluding conditional grants) for up to 70% of municipalities. It enables local governments to fulfill their exclusive responsibilities, which they cannot finance adequately from other sources. The unconditional transfer formula was revised in 2016 to enhance transparency, predictability, and equity, aligning it with the territorial consolidation reform. The key goal of the unconditional grant is to cover the gap between the costs of local government responsibilities and their own-source revenues, ensuring municipalities with lower fiscal capacity can provide services of reasonably equal standards. The Law on Local Self-Government Finance addressed the historical instability of the unconditional grant by anchoring its size at no less than 1% of GDP and ensuring it is no smaller than the previous year's allocation. This change has increased the stability and predictability of municipal budgets and has allowed the doubling of the size of the unconditional grant over the past decade (in nominal terms, not adjusted for inflation).

The allocation formula is based on four main criteria:

(1) Up to ***80% according to population*** – based on the concept of *effective resident citizens* – a population estimate that takes into account primarily the census data, adjusted by by 30% of the Civil Register-Census gap

(2) Up to ***15 % based on the population density*** – providing additional financing particularly to sparsely populated municipalities that have higher service delivery costs and potentially lower fiscal capacity.

(3) Up to **5 % based on the pupils in public primary and secondary schools**

Horizontal Equalization: redistributes funds from "richer" to "poorer" municipalities based on their 'capacity to raise revenue' measured through shared tax revenues.

Fiscal equalization is achieved through two components of the unconditional grant, aiming to address disparities in fiscal capacity across municipalities. The first component, related to population density, provides additional funds to municipalities with a population density below 110% of the national average, recognizing that these areas face higher costs due to larger territories, fewer economies of scale, and eventually weaker fiscal capacity. This component accounts for up to 5% of projected municipal revenues for 2024. About 60% of this funding is allocated to 23 municipalities, predominantly rural and mountainous, which have an average density of just 43% of the national average. Urban municipalities with densities above 110% of the national average receive a modest share of this component.

Fiscal Equalization

- Cost equalization: 15% of the unconditional grant
- Revenue equalization: 1.5% of the unconditional grant

The second component of fiscal equalization is based on horizontal redistribution, where municipalities with higher revenue-raising capacity (measured through shared taxes like vehicle tax, small business tax, mineral rent, and property transaction tax) contribute to the unconditional grant of municipalities with lower revenue capacity. Municipalities with per capita shared tax revenues below 90% of the national average benefit from this equalization fund. In 2024, municipalities with revenues above 120% of the national average contribute 64% of the excess to the fund. However, the equalization pool is small, about 3.7 million EUR, and is distributed across 40 to 50 municipalities. Also, compared to the cost equalization component, this revenue equalization is very small, making up just 1.5% of the total unconditional transfer and 0.5% of projected municipal revenues for 2024 (excluding conditional grants). As a result, horizontal equalization transfers are minimal and lack the possibility to significantly addressing the fiscal disparities.

Sectoral Unconditional Transfers in Albania are allocated to municipalities to finance the functions they were entrusted with following the 2016 decentralization process. These new responsibilities included educational personnel in preschools and the pre-university system, rural road maintenance, fire protection, forestry, irrigation, drainage, agriculture extension services, and social services. To support these functions, approximately 8,000 employees and 7.5 billion ALL were transferred from the central government to municipalities, representing about half of the unconditional grant at the time. Initially, these functions were financed through narrowly earmarked specific transfers. However, in 2019, these specific transfers were transformed into sectoral unconditional grants, granting municipalities more discretion, though the change was largely nominal, as budgets remained tied up with mandatory spending and left little room for strategic decision-making.

Between 2016 and 2024, the size of sectoral transfers grew by 56%, from 7.5 billion ALL to 11.7 billion ALL. In 2025, the sectoral transfers are projected to 13.4 billion ALL. This funding increases supported fire protection units, urban waste management, and various investments in municipal services. Ad hoc funding was also provided for capital investments, such as irrigation and drainage improvements, road investments, and fire protection modernization. However, these ad hoc allocations have not sufficiently met municipalities' investment needs. The Ministry of Finance has made strides to increase it from year to year, but the increases vary by sector and year and by the negotiating power of municipalities. For instance, in 2023, the sectoral transfer for dormitories in pre-university education saw slight increases over the years, with Tirana receiving 17% of the funds and Shkodër 11%. The sectoral transfer's growth rate has fluctuated, with a modest 5% increase in 2023, indicating a slow but steady upward trend in funding for decentralized functions.

Sectoral transfers are predominantly allocated based on historical costs, not necessarily reflecting current spending needs in the sector. In 2019, the ministry of finance adopted a preschool finance reform that introduced a formula-based allocation, based 60% on the no. of pupils and 40% on the number of teachers.

The **Performance Grant** is planned in the 2025 annual budget law as a financial mechanism to encourage municipalities to improve governance processes and service delivery. It amounts to 200 million ALL (approx. 2 million EUR) and will be complemented by at least the same amount from the Swiss Government. The criteria, procedures, and performance indicators for the allocation will be defined through a joint directive from the Minister of Finance and the Minister of State for Local Government.

Conditional transfers from line ministries or central institutions are a critical source of funding for local governments in Albania, particularly for delegated functions and special investment projects that require local government cooperation. These grants, though fluctuating annually, have been essential for financing various local development projects. Between the early 2010s and 2018, the Regional Development Fund (RDF) played a central role in financing local investment projects. The sharp increase in the RDF to a size similar to that of the unconditional grant led to concerns that it was crowding out funds that should have been allocated to the unconditional grant. The 2019 earthquake shifted the focus of Albania's investment efforts toward reconstruction, particularly in the central and western regions of the country that were most affected. The implementation of the reconstruction program was highly centralized, with the Albanian Development Fund (ADF) serving as the primary implementer. As a result, reconstruction priorities, coupled with the budget constraints caused by the pandemic, have likely sidelined capital investments for municipalities.

From 2019 to 2023, conditional investment grants from line ministries surged from 7.2 billion ALL to 13.7 billion ALL, representing around 82.5% of local capital expenditure in 2023. The Ministry of Infrastructure and Energy (MIE) is the largest source of investment funds, increasing its allocations from 1.9 billion ALL in 2019 to 10 billion ALL in 2023, primarily for water supply and sanitation. However, funding from other ministries, such as Education and Agriculture, has been less consistent, with significant ups and downs over the past five years. Additionally, within different sectors, conditional transfers are often allocated late in the fiscal year, undermining municipalities' ability to plan and execute their budgets effectively.

Own Source Revenues

Own Source Revenues (OSRs) are primarily regulated by the Law on the Local Tax System (No. 9632/2006). The most relevant own revenue sources are: the recurrent property tax, the tax on the infrastructure impact of new construction (IIT) and local fees and charges for local services.

OSRs have increased on average 9% yearly from 2018-2023 and have almost doubled since the Territorial Reform. But over 70% of the increase has been generated by the capital city Tirana. Indeed, OSRs have increased almost exclusively in large urban areas, and limited to a small group of taxes, despite improvements in property tax and service fee collections. Tirana and the seven largest municipalities have collected 78% of total own source revenues in 2022, while 44 smaller (and more rural) municipalities have altogether collected only 13% of own revenues.

The recurrent **property tax** includes taxes on buildings, urban land, and agricultural land. Starting in 2017, the government started reforms to expand the tax base, create a national property cadastre, and move tax assessments closer to market values. Since 2018, property tax on buildings is based on market value, with rates set at 0.05% for households and 0.2% for businesses. However, due to technical challenges, most municipalities still apply lump sum payments for household property taxes. For urban land, the tax is based on surface area, with rates determined by square meter and differentiated by municipality type. Agricultural land is taxed by area in hectares, with rates set per hectare. The law allows municipal councils to adjust tax rates by up to 30%. Property owners are generally liable for tax payments, but in cases of unclear ownership, property users are responsible.

The "**tax on infrastructure impact on new construction**" is the largest own-source revenue for municipalities in Albania, contributing 56% of total own-source revenues in 2023. This tax, introduced in 2002, is a one-time charge imposed on new private construction projects, based on either the estimated investment value in the construction permit or the market value of the building. The tax rates in range from 4% to 8% of the sale price per square meter for residential and commercial properties, with lower rates for other construction types. However, investments in agro-tourism and luxury hotels (four- and five-star) are exempt from this tax. Tirana accounts for 73% of the total national yield of this tax, demonstrating both the skewed nature of the country's economic development and the weakness of local finances outside the capital city.

Albanian local governments face significant challenges in administering local taxes and fees. These challenges are driven by a weak legal framework that causes confusion over tax powers, frequent changes to local tax powers without consultation or compensation, and insufficient investment in technical and regulatory capacity. A key problem is the absence of a comprehensive property register linking properties to taxpayers, worsened by poor cooperation between central and local governments despite legal requirements. This lack of coordination and the absence of a fiscal cadastre have led to underperformance in tax collection. Additionally, the government has offered significant exemptions on local taxes for certain luxury businesses, like high-end hotels and resorts, to foster investment in elite tourism. This policy aims to boost the hospitality sector, attract international investors, and stimulate local economies, particularly in tourism-heavy areas like Tirana and the coast.

Local Borrowing

Local borrowing is a key source of financing for local governments in Albania, supporting large public investments that exceed the capacity of municipal budgets or the central government's funding. The Law on Local Government Borrowing (LLGB), adopted in 2008, created the legal framework for municipalities to access short-term liquidity and long-term capital funding, including the issuance of bonds. Local governments are permitted to borrow for both operational purposes and capital projects. The loans can have fixed or variable interest rates and be denominated in local or foreign currencies, with agreements made with local banks or international financial institutions.

Decisions to take on long-term debt are made by municipal councils, and the Ministry of Finance is notified afterward. For long-term debt, the Ministry of Finance must validate compliance with legal procedures and debt limitations. The law imposes clear restrictions on local borrowing to ensure financial sustainability: short-term debt cannot exceed 10% of a municipality's revenue, while long-term debt service must be manageable relative to operating income, with strict caps on annual payments and outstanding debt.

However, despite these provisions, local borrowing has not been widely used. The central government's high level of public debt has led to restrictions on local borrowing, and while local governments theoretically have access to capital markets, these borrowing options are constrained by broader fiscal policies at the national level. In the medium-term, Albania is likely to face continued fiscal constraints, which underscores the need for new regulations that allow municipalities to access capital markets more effectively. Additionally, current legal frameworks are seen as outdated or insufficient, especially regarding bond issuance. The Law on Corporate and Local Government Bonds (2009) gives municipalities the right to issue bonds, but lacks specific guidance on procedures, bond types, and the definition of projects tied to bonds. As a result, there is uncertainty surrounding the bond issuance process, and many potential borrowing opportunities remain untapped.

The limited use of local borrowing is also reflected in the statistics: in 2021, the stock of local government debt was just 0.02% of GDP, a decrease from 0.07% in 2015, which was the highest since the adoption of the borrowing law. Local debt now constitutes only 0.1% of total public debt in Albania, indicating that municipalities are not fully utilizing available borrowing instruments. This underuse of local borrowing highlights the need for reform in both the legal framework and fiscal policies to enable local governments to access capital markets and better finance infrastructure and development projects.

Key Achievements and Challenges over the Past Decade

Over the past decade, Albania has made notable progress in local governance. The 2014 Territorial and Administrative Reform consolidated 373 local government units into 61 larger municipalities, significantly increasing their size and population. This reform, though beneficial in creating larger and more efficient municipalities, was top-down and implemented quickly without full political consensus.

The 2015 National Strategy on Decentralization and the Law on Local Self-Government expanded municipal responsibilities, including preschool education, fire protection, irrigation, and social services, but these responsibilities were not matched with adequate financial resources. Local governments received funding to cover the salaries of employees engaged in these functions, but the central government-maintained control over investment and operational funding, limiting the autonomy of municipalities.

In 2016, Albania reformed its intergovernmental finance system, updating the unconditional grant allocation formula to make it more transparent and equitable, aligning it with the new territorial structure. This reform, together with the 2017 Law on Local Self-Government Finance, bolstered local fiscal autonomy, stabilized the unconditional grant, and introduced fiscal discipline. However, despite of progress Albanian municipalities still remain heavily dependent on intergovernmental transfers for capital investments, as central ministries and agencies continue to control capital funding. A property tax reform was initiated in 2018, aiming to move closer to a market value-based system, but progress has been slow due to structural issues with property data and property registers. The reform efforts are ongoing but face challenges in implementation and political support.

In terms of revenue generation, there has been notable progress in larger urban areas, where own-source revenues (OSR) have increased, primarily from property taxes and service fees. However, there are significant disparities across the 61 municipalities, with smaller, rural municipalities struggling with limited tax diversification and weak fiscal capacity. The capacity of local governments to set tax rates and bases is constrained, hindering their ability to generate sufficient revenue. This results in horizontal fiscal imbalances across municipalities, with some municipalities facing significant difficulties in financing their local services.

Local government spending in Albania is increasingly focused on salaries, often at the expense of capital investment, which exacerbates horizontal imbalances in fiscal capacity. Larger municipalities allocate a greater share of their budgets to capital investment and have more discretionary room for spending, further widening infrastructure gaps between municipalities. Payment arrears have been more than halved over the past decade, amounting to 4.9 billion ALL by June 2024. While there is a clear decreasing trend, they still pose a serious risk to municipal budgets and hinder effective service delivery and planning.

The central government has sought to address territorial development disparities through programs such as the Regional Development Fund, the 'Urban Renaissance' Program, and the '100 Villages' initiative. Despite these initiatives, Albania's decentralization journey is ongoing, with efforts to balance fiscal equality and service provision while navigating political polarization and limited local government resistance to centralization. In recent years, there has also been a trend of centralization in sectors such as water management and urban planning, further complicating the decentralization process.

The 2023-2030 Decentralization and Local Government Strategy outlines Albania's vision for further strengthening local governance, with a focus on sustainable development, service provision, digital governance, financial autonomy, local democracy, capacity building, and EU integration. While this strategy provides an important roadmap, still it lacks clear mechanisms for achieving its financial autonomy goals.

Advocacy Efforts of the Local Government Association

The **Association for Local Autonomy in Albania** is actively engaged in advocacy to influence reforms aimed at strengthening the financial and operational autonomy of local self-government units. Over the past year, these reforms focused on the initiatives of the Minister of State for Local Government to revise the **Unconditional Transfer formula** and introduce a new **Performance Grant mechanism.**

In this context, the Association has played a key role by channeling the perspectives of municipalities into policy discussions. Through extensive consultations with local governments, the Association has developed a **Position Paper** reflecting municipalities' concerns and recommendations regarding financing mechanisms. These efforts included forming political groups with mayors and technical groups with municipal staff to analyze and propose solutions.

The Position Paper emphasizes critical issues and recommendations, including:

- Increasing the Unconditional Transfer to at least 1.2% of GDP to ensure municipalities can maintain service standards.
- Ensuring that any changes to the Unconditional Transfer allocation scheme following the 2023 Census or new criteria guarantee financial stability. Municipalities should receive, at a minimum, the same amount as the previous year to safeguard public service provision.
- Strengthening vertical and horizontal equalization mechanisms to reduce disparities between municipalities by allocating a portion of the unconditional transfer specifically for equalization and refining the criteria for greater impact.
- Incorporating local own revenues, such as property taxes, into the performance component of the Unconditional Transfer formula, supported by expanded revenue sources to enhance financial capacity.

Regarding the Performance Grant, the Association proposed:

- Establishing a legislative mechanism that includes the Performance Grant in the annual budget law as part of local fiscal indicators, ensuring its financial sustainability.
- Financing the grant through national tax revenues, such as 0.5% of VAT or carbon taxes, which would amount to approximately 1 billion ALL in 2024. This fund would be allocated to municipalities to improve service quality and management efficiency.

- Introducing evaluation criteria based on two pillars: financial performance and service delivery performance.
- Conditioning additional funds from the Performance Grant for exclusive use in public investments to enhance local development outcomes.

Mechanisms for Intergovernmental Dialogue

In Albania, intergovernmental relations are structured around the principles of subsidiarity, consultation, and cooperation, as laid out in the Law on Local Self-Government. The national government is required to consult with local governments through their associations on legislation and policies that affect them. While this framework aims to create a coordinated governance approach, political polarization and divisions within Local Government Associations (LGAs) sometimes hinder consensus-building. Nonetheless, LGAs, namely the **Association for Local Autonomy of Albania** and previously also the **Association of Albanian Municipalities**, have played a significant role in advocating for local interests, particularly in the areas of territorial, functional, and fiscal decentralization.

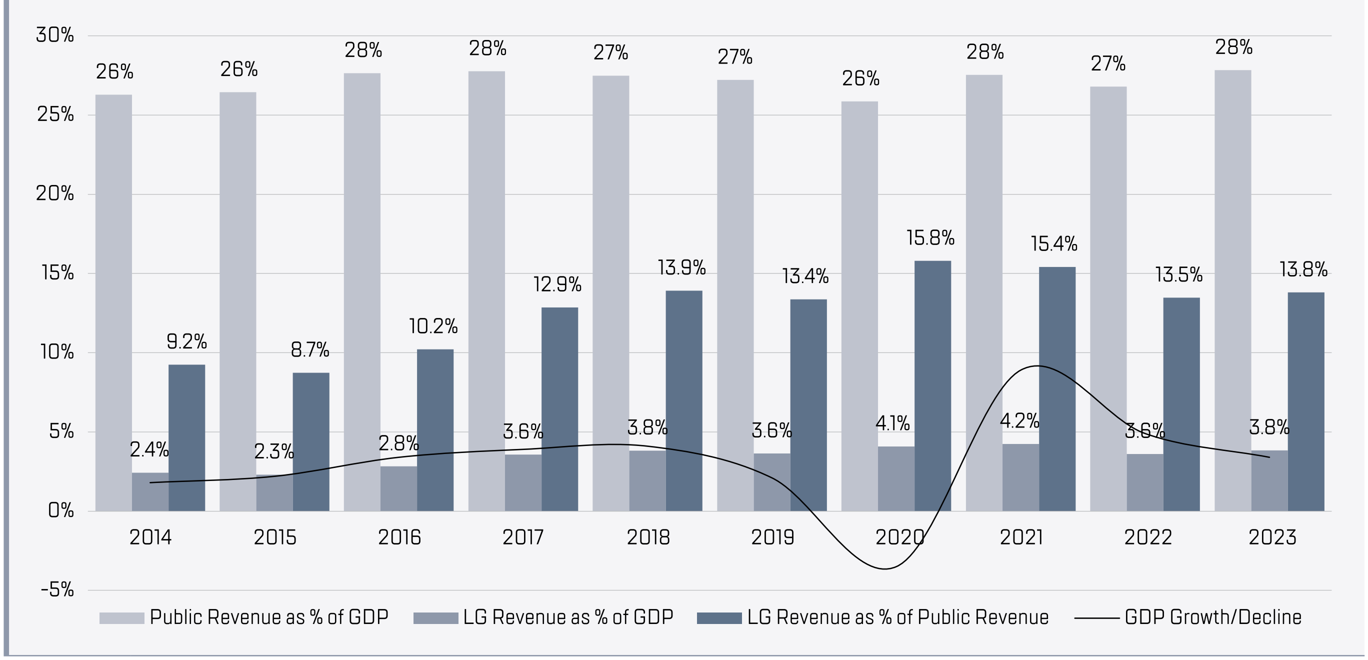
In a context of political division and polarization, the Government has the **Central and Local Government Consultative Council,** as a platform for dialogue, allowing local governments to influence national policies. With equal representation from both central and local governments—11 representatives each—the Council includes the minister of state for local government and deputy ministers, the President of the Association for Local Autonomy, six mayors, and President of the Association of Regional Councils and three regional council chairpersons. This composition is intended to ensure balanced representation from both levels of government. The Council meets regularly in plenary sessions twice a year—March and October—to discuss critical issues like the state budget and local financial policies, and additional meetings are scheduled as needed. The **Agency for the Support of Local Self-Government** assists as the Council's Technical Secretariat.

Despite its structure, the Consultative Council's effectiveness has been questioned. Local governments and their associations often receive draft policies for feedback only at final stages (instead of being invited in the early phases of policy development) and are given limited time to respond to complex issues. Additionally, the Council's meetings are not convened according to a pre-established or agreed timeline, which hinders continuous engagement, and local representatives have little influence over meeting agendas. Ultimately, the Council's co-chair position, which is meant to rotate between local representatives, has been held by the same co-chair for years, further limiting representation.

Statistical Overview of Local Government Finance in Albania

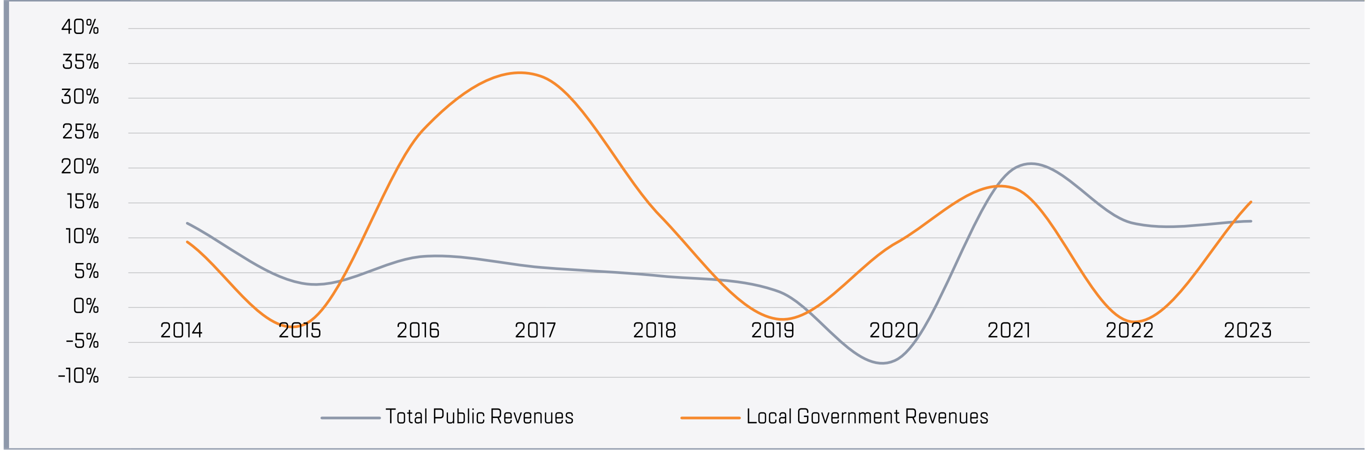
Albania's public sector is relatively small, with public revenues comprising just 26-28% of GDP over the past decade. This limited revenue base restricts the financial capacity of both local and central governments. In 2016, the Albanian government decentralized several costly responsibilities to local authorities, including funding for teaching and non-teaching staff in preschools, non-teaching personnel in primary and secondary schools, fire protection operations, and the management of forests, pastures, and irrigation systems. However, despite these additional responsibilities, local revenues remained constrained. Excluding conditional grants, LG revenues represent only 11.2% of total public revenues and 3.1% of GDP by 2023—nearly the same levels as in 2016, signalling persistent challenges and increased dependence from the central government.

Figure 21. ***Albania:*** *local government revenue as a share of GDP and total public revenue*



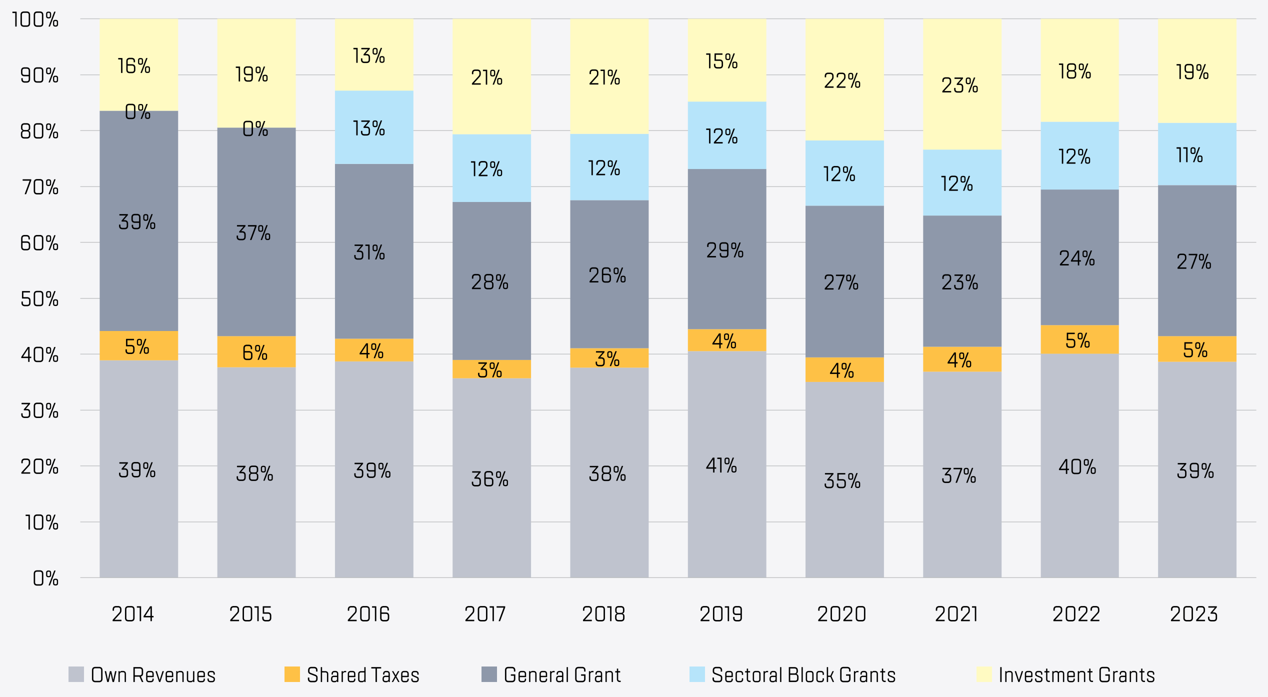
Local government (LG) revenues in Albania tend to lag behind the growth of total public revenues, with LG revenues typically falling more sharply and growing more slowly. In 2023, excluding conditional grants, LG revenues increased by 11% year-over-year, compared to a 12% increase in total public revenues. In 2022, for instance, there was a notable 6-percentage-point gap between the growth rates of total public revenues and LG revenues.

Figure 22. ***Albania:*** *Revenue Fluctuations of the General and Local Governments*



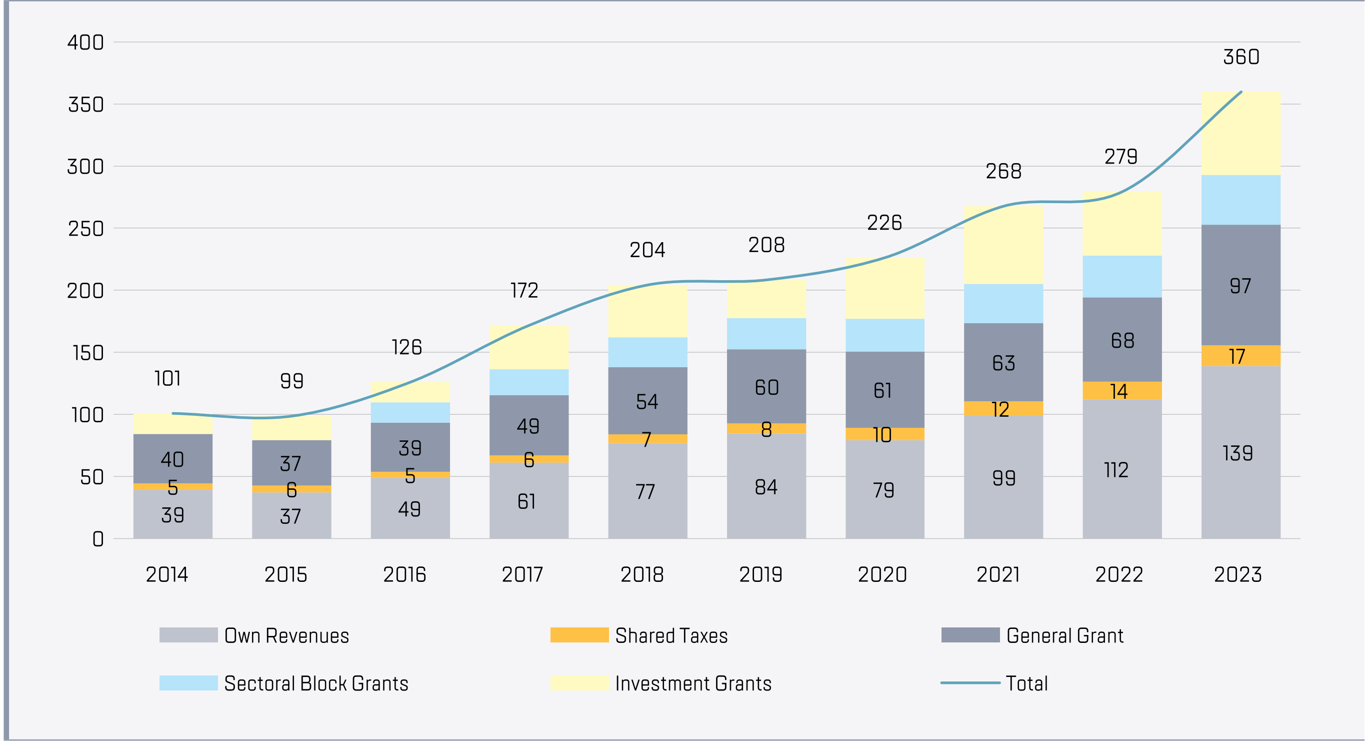
Own source revenues contribute to 39% of total local budgets in 2023, while intergovernmental transfers of different forms make up the remaining 61%. It is important to highlight, that, while OSRs make up a fundamental part of the financing system, there are significant horizontal disparities, and in fact most OSRs are collected in the capital city and few other large cities.

Figure 23. ***Albania:*** *Composition of Local Government Revenue*



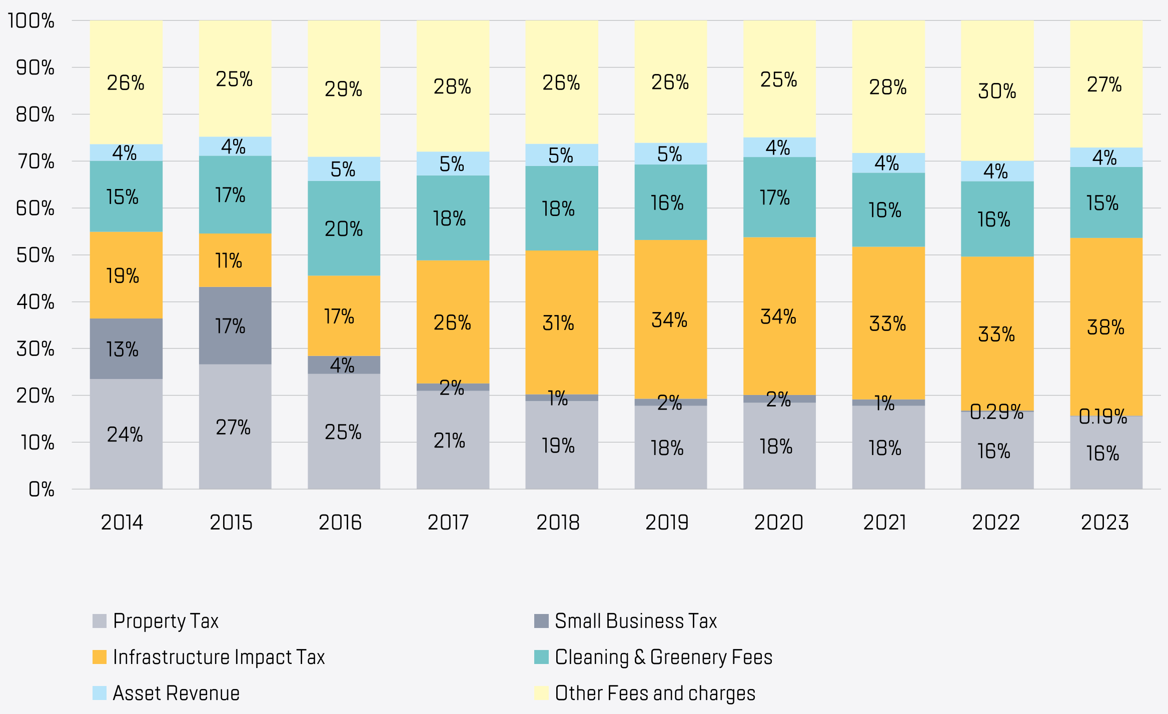
Local Government Revenues in Euro per capita peaked in 2023 at 302 Euros per inhabitant or 864 million Euro in total (including conditional grants).

Figure 24. ***Albania:*** *Composition of Local Revenue Euro per capita*



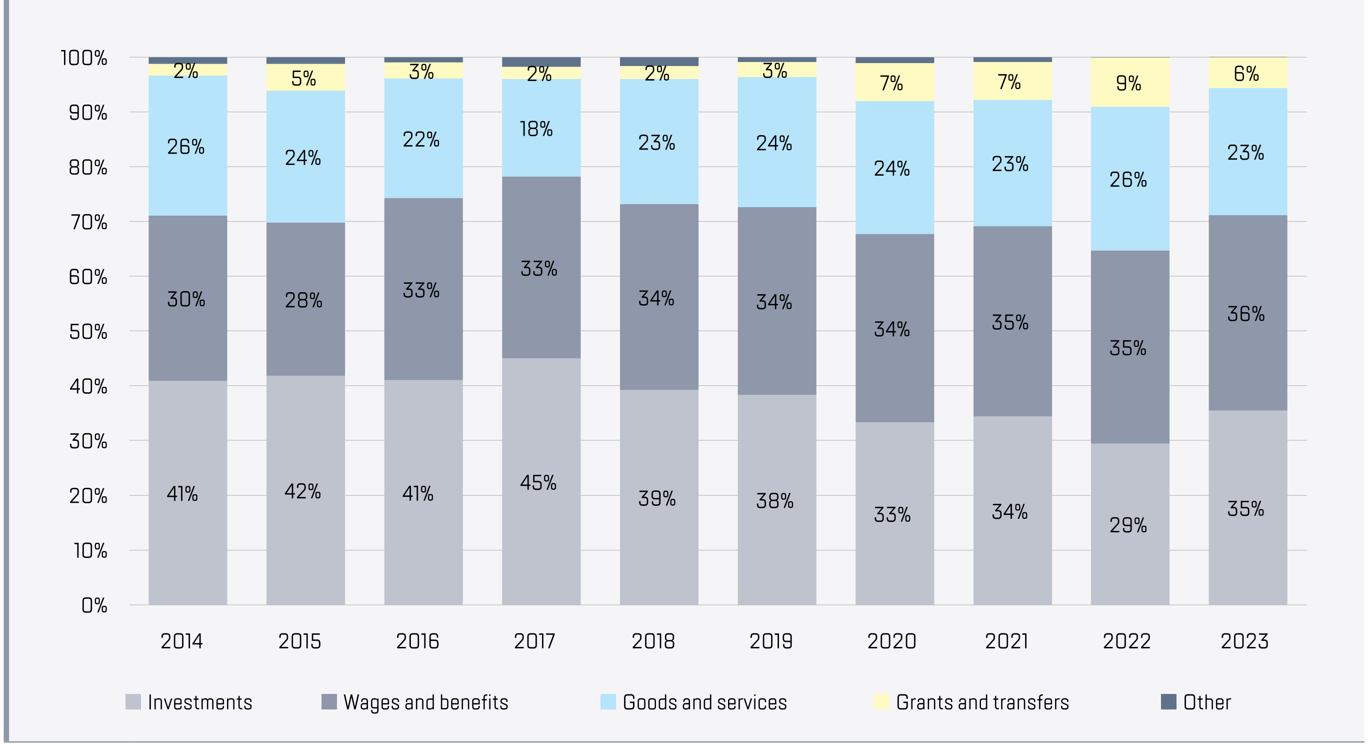
Regarding the composition of own source revenues, the Property Tax has been trending upward up until 2015, when the share of the Infrastructure Impact Tax began increasing significantly to the extent that in 2023 it constitutes 38% of total OSRs. As indicated earlier, the revenues from this latter tax are mostly concentrated in Tirana and few large municipalities. The most important local fees are the waste collection fee, along with greenery and public lighting fees, and fees for the occupation of public space.

Figure 25. ***Albania:*** *Composition of Own Source Revenues*



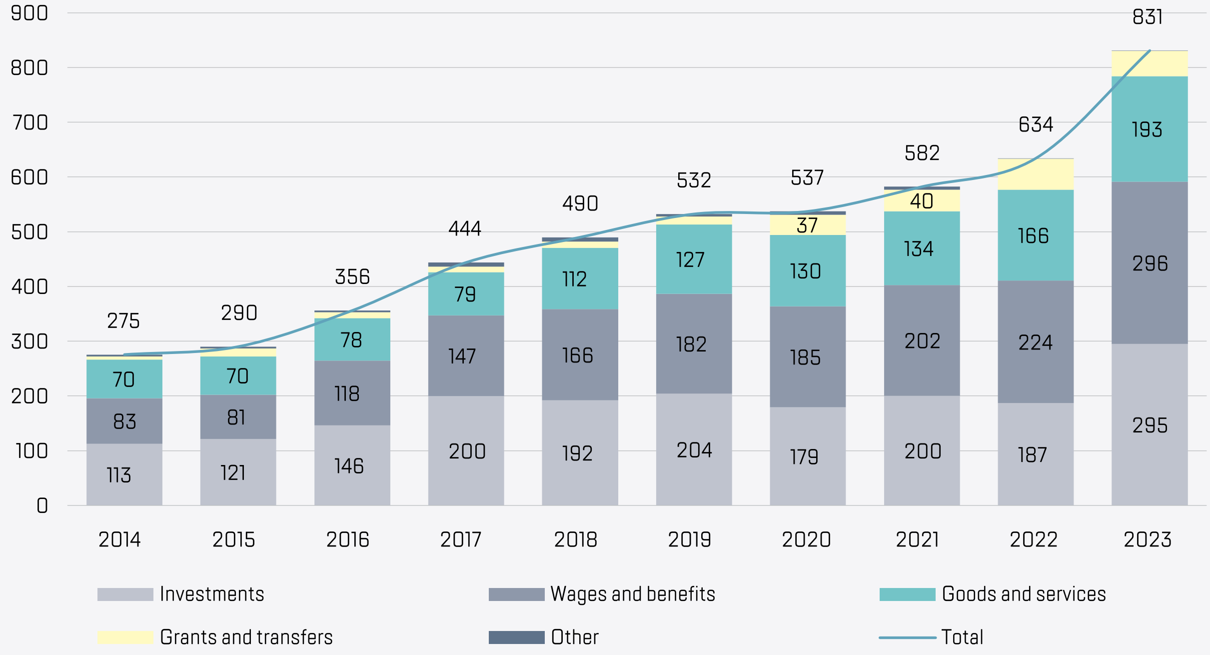
This analysis includes conditional grants from line ministries and central government agencies, 87% of which focus on capital investments. From this perspective considering also conditional grants, local government spending patterns in Albania would seem rather balanced where capital investments assume about 35% of the total, and spending for wages takes another 36%. If conditional grants are excluded from the analysis, in 2023, spending for wages stands at 42.9% of total local budgets while spending for investment stands at 24%.

Figure 26. Albania: *Composition of Local Government Expenditures, in percent of total*



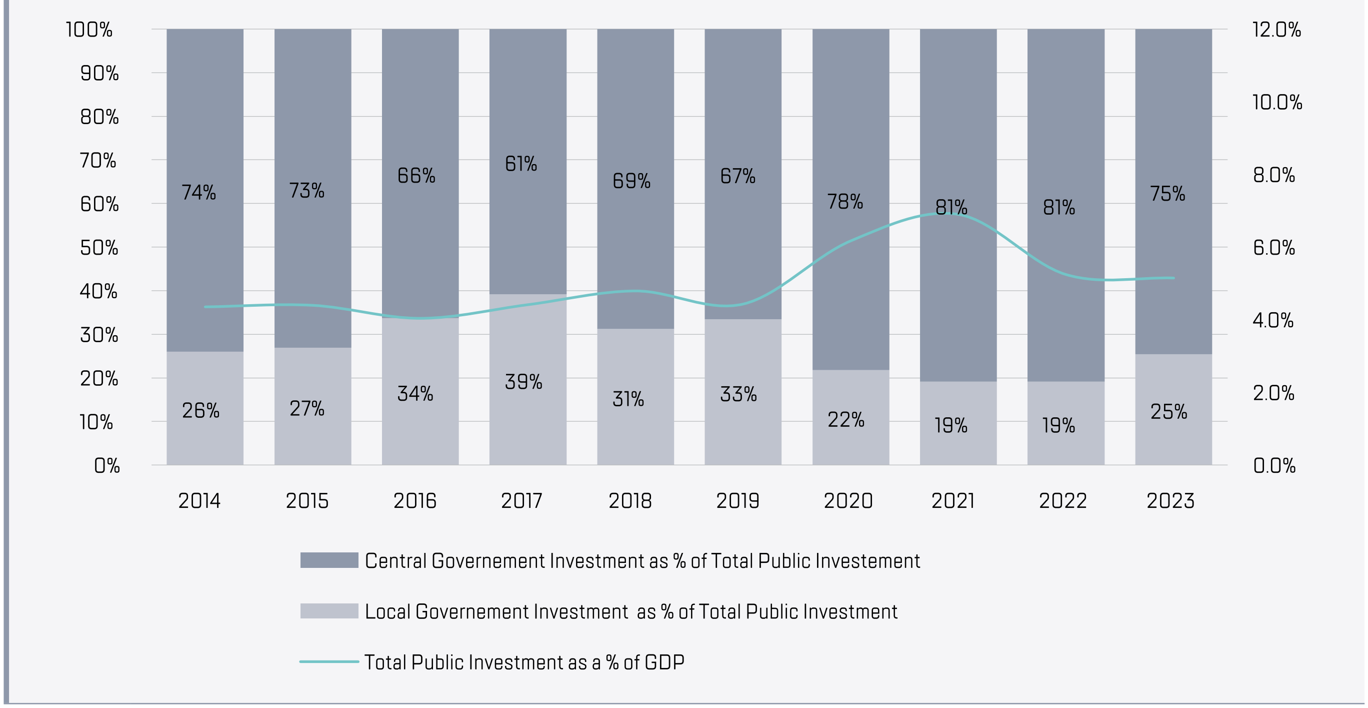
Excluding conditional grants, local government spending for investments has increased from a low of 48 million Euro in 2012 to 165 million Euro in 2023. With conditional grants, spending for capital investments is at 295 million EUR in 2023.

Figure 27. ***Albania:*** *Composition of Local Government Expenditures, in million Euro*



Even with the inclusion of conditional grants, the local government contribution to the total public investments has declined since 2019 until 2022. In 2023, local governments through their unconditional and conditional budgets contribute to 25% of total public investments.

Figure 28. ***Albania:*** *Investment by Level of Government and as a percentage of GDP*



Austria

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The Intergovernmental Finance System

In Austria, there are three **levels of government**: the federal level (*Bund*), the state level (*Länder)* and the local level (municipalities). The state level consists of nine *Länder* (including Vienna, (the capital- city) and the local level consists of 2,092 municipalities (as of 2025). In administrative terms, Vienna is a state and a municipality at the same time. For reasons of simplicity and consistency with common methodologies, Vienna is not included in the subsequent descriptive and quantitative analysis of the local level. In the decentralized federal system, the states have their own constitution and are empowered to enact state laws. Furthermore, they are responsible for the enforcement of federal laws and the provision of certain functions and services. The principle of autonomy of municipalities is enshrined in the Austrian constitution, with the laws of the different states providing the effective legal framework.

Various financial flows between the three levels of government heavily impact the financial resources available at the local level (municipalities) and the state level (*Länder)*. State laws and regulations play an important role and so the fiscal situation of municipalities is to differ across states – even for municipalities that are otherwise similar.

Municipalities manage their budgets independently, can own assets of all kinds and operate economic enterprises. Municipalities can regulate local taxes only if they are entitled to do so by either federal or state law. Tax administration remains mostly at the federal level.

The **Fiscal Equalization Act** (*Finanzausgleichsgesetz, FAG*) is the central instrument, which applies nationwide, that determines the allocation of funds across all levels of government. Several elements interact within the framework of the fiscal equalization system:

- **Shared taxes:** The vast majority of levies are shared taxes, which are distributed among the federal government, the states and the municipalities according to determined keys within the framework of the Fiscal Equalization Act.
- **Own taxes:** Only a small proportion of the levies are own taxes.
- **Intragovernmental transfers:** On the one hand, there are transfers from the federal government to the states and municipalities, and on the other hand there is a complex transfer system between the states and municipalities. In principle, intragovernmental transfers are continuously increasing in importance and significantly change the original funding through shared or own taxes.

Negotiated every three to six years between the federal government, the states and the municipalities, the latest FAG came into force in January 2024, determining the revenue allocation for the four-year period 2024-2028. Due to the lower revenue base from shared taxes resulting from federal tax reforms in recent years, it was necessary for the federal government to at least partially offset the loss of shared taxes for the states and municipalities. However, this was not achieved by increasing the share of the states and municipalities in the total tax revenue, but rather through additional financial allocations from the federal government. One example is the so-called '**Future Fund'**, recently introduced in the Fiscal Equalization Act. The fund provides for additional transfers for states and municipalities in the area of elementary education, housing and renovation and environment and climate. Here, the transfers are also linked to specific objectives. For the municipalities, the objectives in connection with elementary education are primarily relevant. The federal government has also made more funds available for the health sector. Although the state governments are generally responsible for this, the municipalities must co-finance it, which is why these funds should also benefit the municipalities.

Shared Taxes

- **Size:** 12% of shared tax revenues (PIT, CIT, and VAT)
- **Allocation:** largely based on weighted population data

Shared taxes make up approximately 85% of total tax revenue. These include revenue from the personal income tax (PIT), the corporate income tax (CIT) and the value added tax (VAT). These shared taxes are distributed from the federal to the state and municipal level according to fixed distribution keys: the federal level retains 68% of shared taxes, while the state level receives 20% and the municipal level 12%.

Horizontal distribution at municipal level is largely based on the weighted population key (WPK). This ensures that the most populous municipalities receive more revenue per capita to partially offset the additional expenditure they incur as regional or urban centres. Regional or urban centres typically offer more public services and infrastructure for sports and leisure, childcare services and cultural activities and these are typically also used by the residents of the surrounding municipalities within the commuter belt. Therefore, the idea of the WPK is that larger municipalities receive a higher share of the revenue per capita than smaller municipalities that do not fulfill a corresponding function as a regional center. (LoGov, 2021). Concretely, the per capita amounts increase with increasing municipality size: each inhabitant is multiplied by a multiplier defined in the Fiscal Equalisation Act, which currently amounts to:

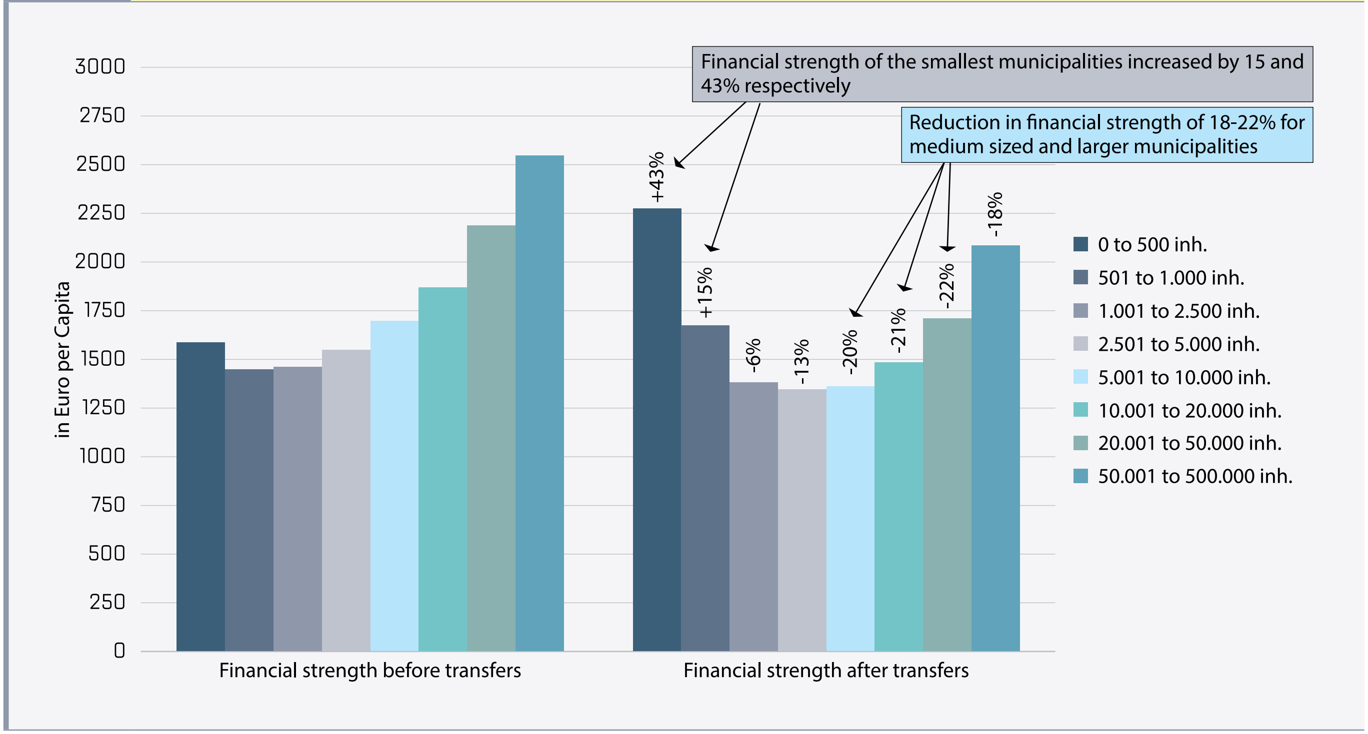
- up to 10,000 inhabitants: 1 41/67
- 10,001 to 20,000 inhabitants: 1 2/3 (this corresponds to 1 45/67)
- 20,001 to 50,000 inhabitants: 2 (twice)
- over 50,000 inhabitants: 2 1/3.

Intragovernmental transfers are becoming increasingly important. Transfers from the federal government to the state governments are particularly important. For example, the federal government covers the costs of teachers, for which the state governments are responsible, and there are special-purpose grants for the areas of health and social affairs. Federal transfers are also relevant for the municipalities. There are such transfers for local public transport or as part of expansion programs for childcare or all-day schools.

Intragovernmental transfers between the states and municipalities are complex. On the one hand, the municipalities have to pay levies to the states (primarily for health and social affairs), while on the other hand the states make transfers to the municipalities as part of the equalization of resources and to promote investment. Overall, the municipalities make significantly more transfers to the states than they receive in return. Transfers from the states to the municipalities include both ongoing transfers (e.g. for the ongoing support of financially weak municipalities or ongoing subsidies for personnel expenses in the childcare sector) and earmarked grants.

Overall, intergovernmental transfers have a strong **balancing effect** on financial resources (see FIGURE 29). The regulation leads to a reduction of disparities in financial strength between the municipalities and shifts funds from financially strong to financially weak municipalities. This transfer system significantly impacts the municipalities' financial capacity, supporting smaller municipalities.

Figure 29. ***AUSTRIA:*** *Financial strength before and after transfers in Austrian municipalities, 2023*



Source: KDZ, 2025, based on Statistic Austria: Municipal finance data 2023.

Note: Financial strength = Tax revenues from shared taxes and own taxes

Local Government Own source revenues

The main sources of municipal revenue are shared taxes, as described above. In 2023, the local budget was composed of 33% shared taxes, 18% local taxes, 20% from fees and charges (e.g. from utility or educational or social services), 15% from current and capital transfers, and 14% from other fees and income.

Overall, the importance of local taxes is decreasing over time, while transfers from the federal and state governments are increasing. This development is weakening local autonomy, which is why reforms to strengthen local tax autonomy are being called for. Fees also show below-average developments, as the demand for free services (for example in elementary education) is increasing.

Fees are mainly generated through the provision of public services and utilities such as water supply, sewerage and waste management. There are, however, also some intermunicipal cooperation associations (*Gemeindeverbände*) that carry these services out and have their own budgets. In these cases, municipalities make proportionate payments to cover the costs of the associations.

Municipalities also levy taxes such as the local business tax and the property tax. Companies must pay municipal business tax amounting to 3% of the total sum of salaries and wages paid each month. Therefore, municipalities with higher employment rates and higher paying jobs enjoy a higher municipal business tax income. In general, this applies to a greater extent to urban local governments and municipalities with a strong tourism industry.

Property tax is levied on individuals owning property (land and buildings) and the amounts are set by the municipalities considering a legal tax cap. There is a great need for reform in the property tax. The valuation of land has not changed for around 50 years, which is why revenue from property tax is not very dynamic. Although reform working groups have been in place for twenty years, no reforms have yet been implemented.

Other non-tax revenues are asset revenues, rental and leasing incomes, disposal of low-value assets and property or the repayments of loans and advances.

Borrowing

In general, municipalities are only allowed to take on **long-term debt for capital spending**. Current expenditures cannot be covered with long-term debt. There are rules for short-term loans which have to be paid back within the fiscal year. Furthermore, laws at the state level prohibit the use of risky financial instruments.

Over the last ten years **municipal debt slightly rose** from EUR 7.6 billion in 2014 to 10.9 billion in 2023. The debt ratio of local authorities (excluding Vienna) in relation to GDP is generally between 2.2 and 2.5%.

The **Austrian Pact on Fiscal Stability** (Österreichischer *Stabilitätspakt*) plays a fundamental role for debt financing for municipalities. The pact ensures compliance with the EU-Maastricht criteria and obliges the three levels of government to keep their debt-levels below an agreed threshold. Previously, the municipalities were not allowed to contribute to the public deficit. This was mostly successful before the crisis years. In 2019 and 2020, however, the deficit of the municipalities (excluding Vienna) was -0.1% of GDP, while there were surpluses in 2021 and 2022. In 2023, there is a deficit of -0.2% of GDP. It is planned to revise the Austrian

Pact on Fiscal Stability in 2025 in order to adapt it to the new EU fiscal rules. The extent to which this will result in changes for the municipalities is not yet foreseeable.

Advocacy efforts of the Local Government Association in the area of local finances

In Austria, two local government associations represent communal interests: the **Austrian Association of Municipalities** *(Österreichischer Gemeindebund)* and the **Austrian Association of Cities and Towns** *(Österreichischer Städtebund)*. The *Gemeindebund* represents almost all municipalities in Austria. The focus lies on smaller and rural municipalities. The *Städtebund* represents the interests of 255 mid-sized to larger cities in negotiations between the federal, state, and municipal level regarding the distribution of budgetary funds and taxing rights.

Both associations are engaged in advocacy efforts to represent local authorities' interests in the fiscal equalization schemes. They play a crucial role in the negotiations between the three levels of government regarding the fiscal equalization system. The fiscal equalization act negotiations are an important coordination body within the framework of multi-level governance. Not only are the funding streams adjusted, but declarations of intent for reforms are also made. In addition, there are ongoing coordination meetings in connection with the Austrian Stability Pact in which individual topics are also dealt with. There are also meetings with all three levels in individual areas of responsibility.

Furthermore, *Städtebund* and *Gemeindebund* are both represented at the European level in Brussels and are also members of the Council of European Municipalities and Regions (CEMR) and thus also of the United Cities and Local Governments (UCLG).

Due to the high growth of levies in the areas of healthcare and social services the income of municipalities is increasingly eroding. As a result, municipalities only have an average of around 50% left of each euro in income from shared taxes. By 2027 it will only be 40%.

The financial situation is also difficult, because of additional tasks for the municipalities. These concerns especially additional requirements in childcare, as Austria has not yet achieved its childcare quota requirements. However, the Austrian fiscal equalization act does not adequately cover the resulting additional expenses in ongoing operations. A reduction in group size also leads to additional expenditure in several states.

There is also a high need for investment in the area of climate protection and adaptation to climate change. These include achieving a 3% renovation rate for municipal buildings or implementing the mobility transition (e.g. through the expansion of inner-city public transport services or the decarbonization of vehicles).

Due to the difficult financial situation of the municipalities, there have been several financial allocations from the federal and state levels in recent years. Since the federal and state levels now also have to implement financial cuts, it is to be feared that financial allocations will decrease. This will lead to further financial cuts at the municipal level.

As a consequence, thereof municipalities will have to look for increases in efficiency – for example through regional cooperation – and will have to reduce services (including closures) and investments. As the municipalities are a major public investor this will lead to a decline in the quality of the infrastructure and contracts for the local economy.

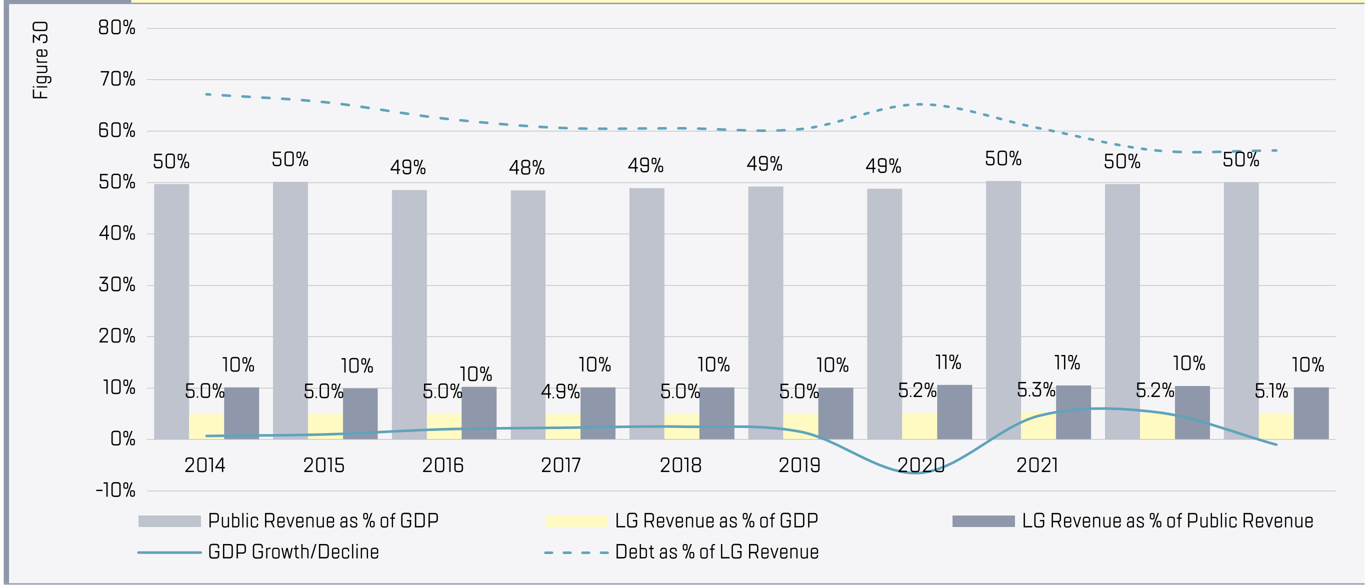
To stabilize municipal finances in the medium-term sustainable reforms are required. This could be done by strengthening the municipalities' income – for example by eliminating co-financing in the areas of social and health and increasing their own taxes.

The two local government associations are working on a number of these issues and striving to initiate reforms to increase the resilience of municipal finances. The year 2023 was very important in this respect, as this is when the negotiations on the fiscal equalization act 2024 took place. For example, additional funding was obtained for childcare. The healthcare sector also received more funding, which should have a positive impact on the municipalities' co-financing obligations. Nevertheless, from today's perspective, these funds are not sufficient to compensate for the low revenue growth in the area of shared taxes. The issue of financing climate protection and adaptation has also not yet been sufficiently resolved. The municipal councils are also represented in various reform working groups – such as on the reform of property tax.

Statistical Overview of Local Government Finance in Austria 2014-2023

At first glance, the fiscal governance framework in Austria seems to be rather decentralized. Responsibilities are allocated to all government levels and in some important areas of public services are delegated from the federal and state level to the local level. But the division of competencies and responsibilities leads to overlaps in certain areas, for example in the education or health sectors. Furthermore, the fiscal equalization scheme results in a complex system of transfers and vertical fiscal imbalances.

Figure 30. ***AUSTRIA:*** *Local Government Revenue as a Share of GDP and Total Public Revenue, 2014-2023*[7]

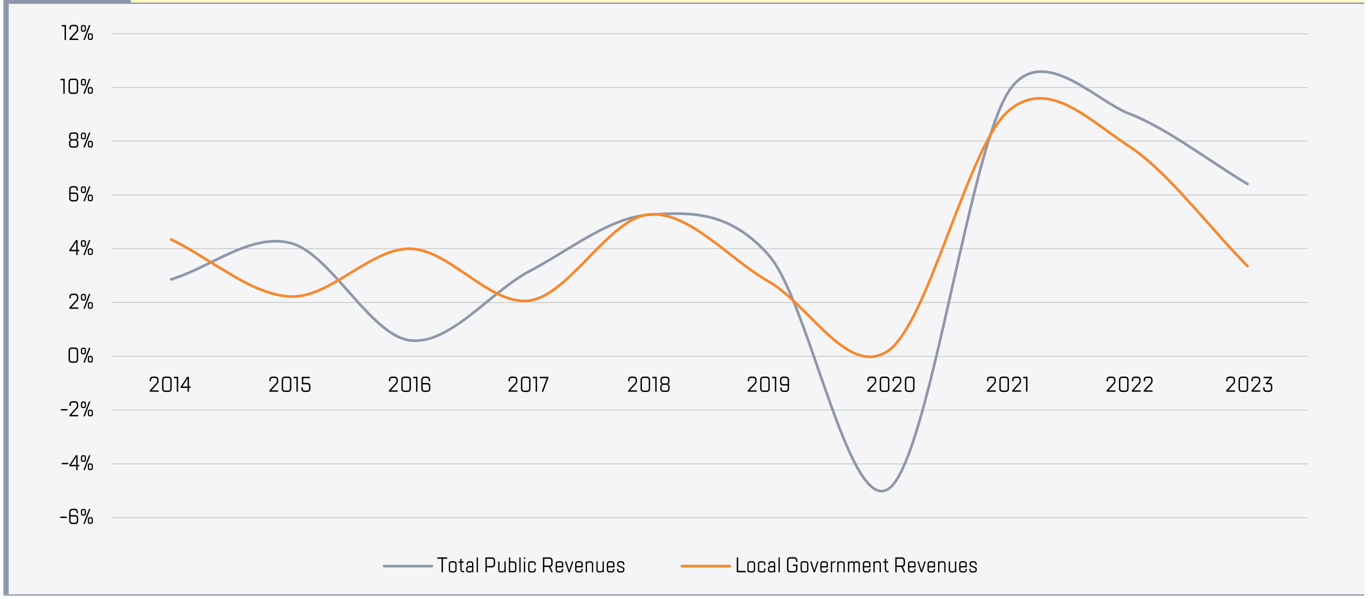


[7] The underlying data stems from public authorities accounting (federal government, state governments, Vienna as a state and local government and local governments; excluding social insurance revenues). Public authorities' statistics differ from public sector data. The latter includes government units (European System of Accounts sector S.13) and other public units or public enterprises (ESA sectors S.11, S.12).

However, municipalities' revenues remained stable over the past decade. From 2012 to 2021 local governments' total revenues on average made up 13% of total public revenue. Local revenues as a percentage of GDP kept stable at 5% and slightly increased in 2020 and 2021. The data, as highlighted in FIGURE 55, also reveals that local debt as a percentage of local revenues decreased continuously until the outbreak of covid-19. Furthermore, local debts developed alongside GDP growth: In 2020 the increase in local debts was accompanied by a decrease in GDP growth.

As highlighted in FIGURE 56, between 2014 and 2019 local and general governments' revenues growth rates developed rather acyclically, but with modest fluctuations. The outbreak of the covid-19 pandemic led to a drop in growth rates, where general governments revenue fell faster and further than local governments' revenues. In 2021, there was also a recovery in municipal revenues due to the rapid economic recovery. In addition, there were also additional transfers from the federal government. In 2023, however, there was a decline in revenues, as federal tax reforms took effect and thus the shared taxes fell.

Figure 31. ***AUSTRIA:*** *Annual Fluctuations in the Revenues of the General Government and Local Governments, 2014-2023*



Local governments' revenues originate from three main areas: own source revenues, shared taxes and grants (including transfers from the central and state level). As seen in FIGURE 57, all three areas remained roughly stable over the past decade until 2019. Since 2020 and 2021 , there have been several changes in the revenue structure. For example, the share of own revenues has fallen. This is the result of the significantly below-average development of property tax due to a lack of reforms. The increases in fees were also lower. Due to the difficult situation of municipal finances, there were additional transfers to the municipalities from the federal government and the states. On the one hand, this concerns support for general finances, and on the other hand, specific transfers, for example for the area of elementary education. (see FIGURE 32).

Own source revenues are comprised of local taxes, fees, charges and other revenues. In 2023 of these own source revenues, local taxes made up 39%, fees and charges 41% and all other revenues 21%. Since local governments only have limited scope with regard to tax setting, own source revenues are highly determined by external factors - the most important tax income (around 70% of local taxes) at the local level, the municipal business tax, decreased due to the negative effects of the covid-19 pandemic, but it quickly recovered.

Another major source of local finances is shared taxes. These taxes are distributed according to an allocation key and are set at the federal level. Shared taxes include revenue from the PIT (wages and salaries), VAT, CIT and other minor taxes. As stated above, shared taxes continuously increased but due to the covid-19 pandemic shared taxes fell from around 7 billion Euro to 6.4 billion Euro in 2020. There was a significant recovery in 2021 and 2022, while there was a decline in 2023, also due to federal tax reforms.

Figure 32. ***Composition*** *of Local Government Revenues, 2014-2023*

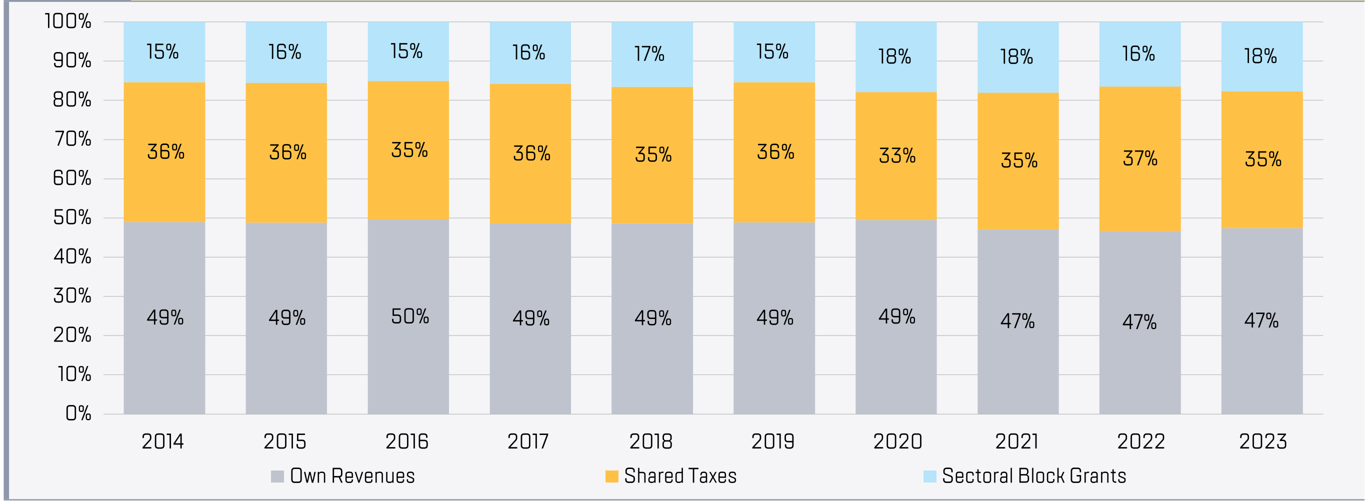
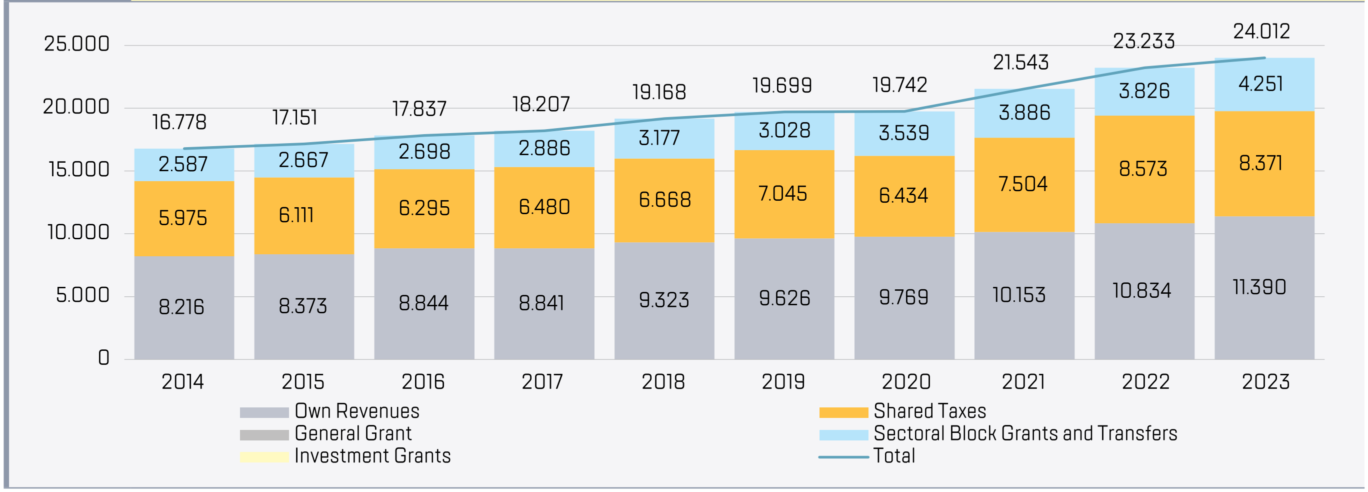


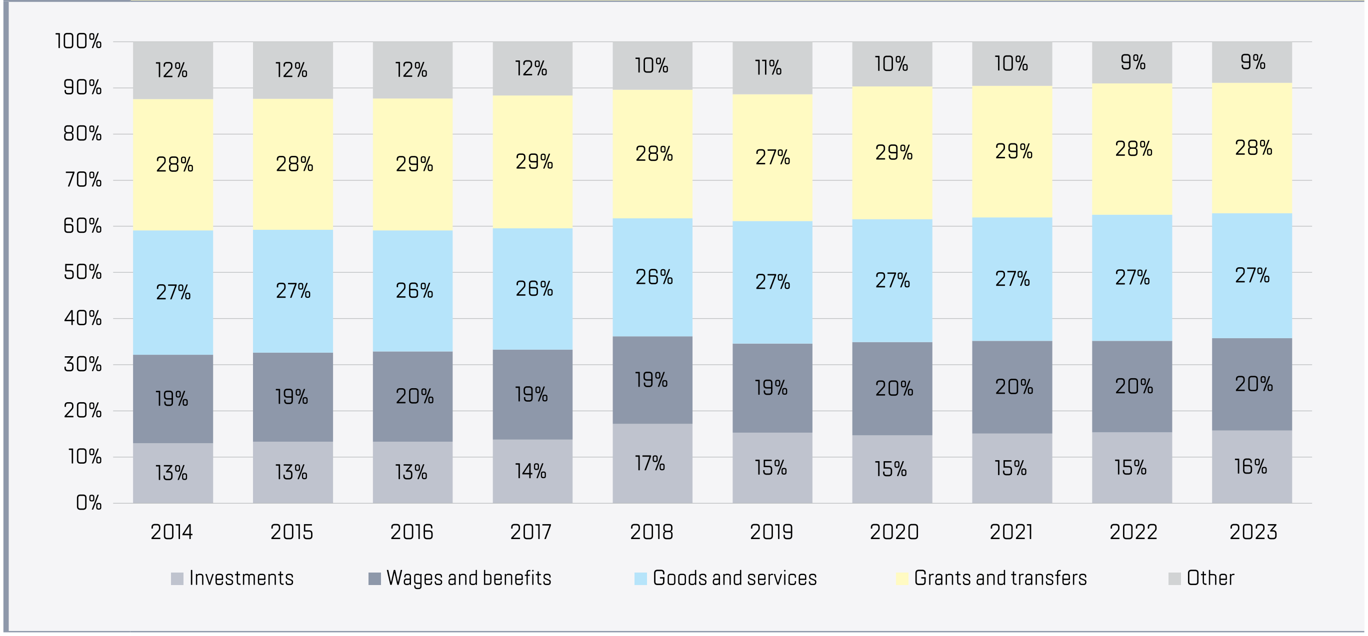
Figure 33. ***AUSTRIA:*** *Composition of Local Government Revenues in mln Euro, 2014-2023*



Sectoral Block Grants and Transfers from the central (federal) and state level to the local level are dedicated to maintaining and investing in the provision of public services (FIGURE 59). The main shares of conditional grants and transfers are assigned to finance kindergartens, primary and secondary schooling, water supply, sewerage, waste disposal and road construction.

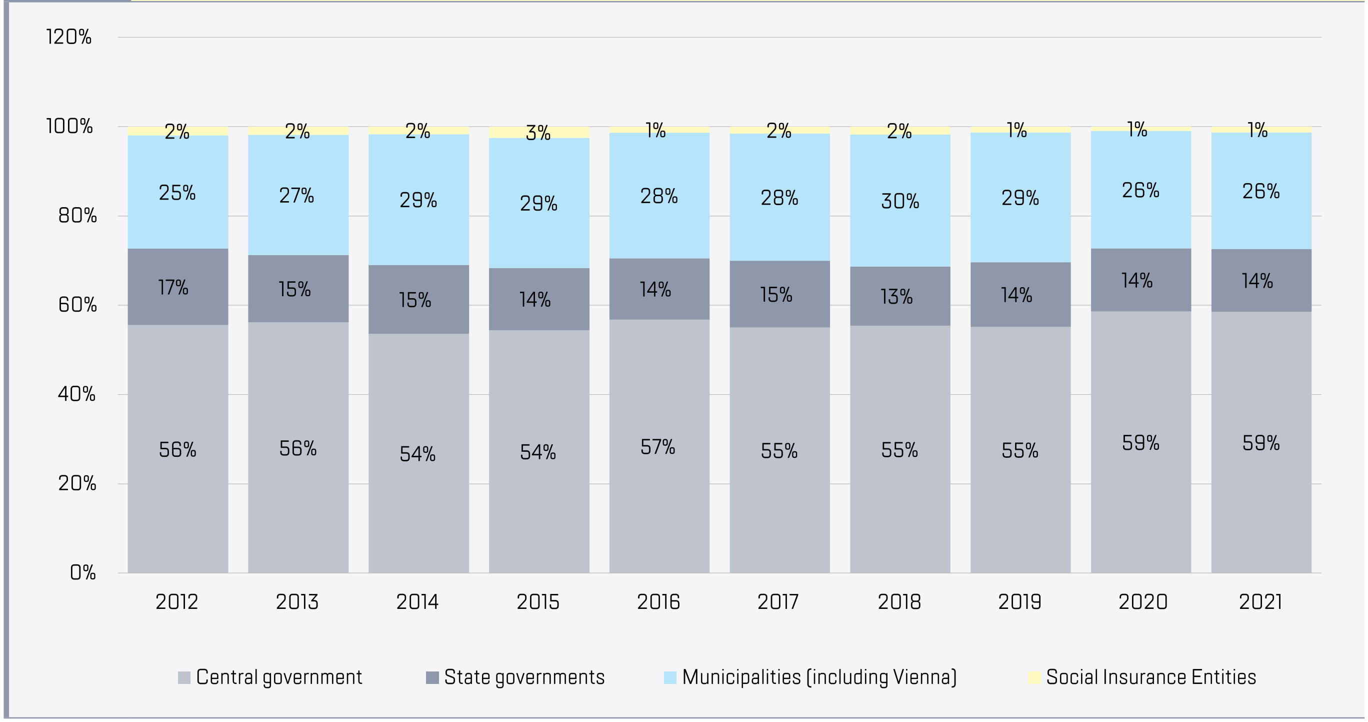
The largest share of local expenditure is represented by grants and transfers (between 28 and 29%). Within this category transfers to other tiers (central, state and local) make up the largest share (70%). The analysis shows an increasing importance of investment spending over time. While the share was 13% in 2014, it has remained constant at 15% since 2019.

Figure 34. ***AUSTRIA:*** *Composition of Local Expenditures, 2014-2023*



The share of municipal investments in total state investments (FIGURE 60[8]) was 29 to 30% in most years. Significantly lower shares were seen in 2020 and 2021, which can be attributed to the pandemic-related reduction in revenue for municipalities. However, the share has increased again since 2022.

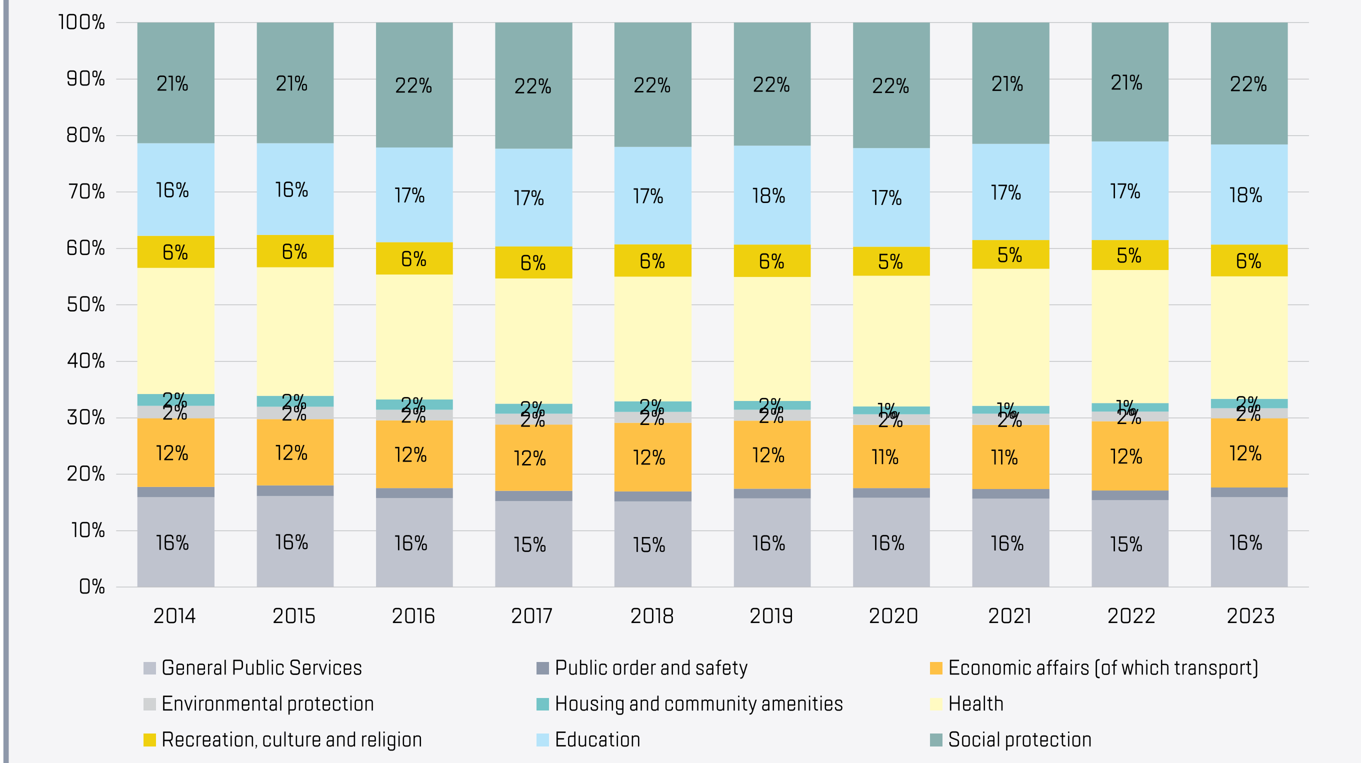
Figure 35. ***AUSTRIA:*** *Public authorities' share of Investments, 2014-2023*



[8] Data in FIGURE 60 are based on public sector statistics, as opposed to other FIGUREs, which are based on public authorities accounts, unless otherwise stated.

Figure 36. details expenditures based on their functional allocation (COFOG)[9]. According to this international classification, in 2023 health (22%) and social protection (22%) are the largest areas of expenditures at the local level. In 2020 and 2021, the sector health increased in the wake of the pandemic. Otherwise, the expenditure structure has remained fairly stable.

Figure 36. ***AUSTRIA:*** *Functional Allocation of Local Expenditures (COFOG classification), 2014-2023*



[9] "The Classification of the functions of government, COFOG, was developed in its current version in 1999 by the Organisation for Economic Co-operation and Development (OECD) and published by the United Nations Statistical Division as a standard classifying the purposes of government activities." https://ec.europa.eu/eurostat/statistics-explained/index.php?title=Glossary:Classification_of_the_functions_of_government_(COFOG)

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Bosnia and Herzegovina

Federation of Bosnia and Herzegovina

By Halko Basarić, Association of Municipalities and Cities in the Federation of Bosnia and Herzegovina

Bosnia and Herzegovina (BiH) has three almost separate fiscal systems: FBiH, RS and the Brcko District. Each has separate regulations governing local government financing. Indirect taxes are centrally collected at the state level and distributed among these entities based on a predetermined formula. This structure limits local control over revenue sources, adding complexity to the LG financing model.

The Intergovernmental Transfer System

The Federation of Bosnia and Herzegovina (FBiH) of Bosnia and Herzegovina, has a diverse local government (LG) structure, consisting of 80 local governments—22 cities and 58 municipalities. Each of these LGs, apart from those within Canton Sarajevo, is assigned responsibilities and expenditure tasks uniformly across the entity, as mandated by FBiH legislation. LGs vary significantly in terms of population, development and urban/rural division, ranging from extremely small with 800 to large urban areas with120.000 inhabitants. This creates challenges for small and medium size municipalities in terms of financing basic services that they are tasked with through various laws.

In the Federation of Bosnia and Herzegovina (FBiH), the entity's share of indirect taxes is allocated to cities, municipalities, cantons and the city of Sarajevo according to fixed percentages as **unconditional transfer**: 51.23% to cantons, 8.42% to cities and municipalities, 0.25% to the City of Sarajevo, and 36.2% to the FBiH budget. The transfers are distributed based on a formula primarily weighted by population (68%), with additional factors for surface area (5%), school-age children (20%), and a development index (7%) tied to Personal Income Tax yields, aiming to have an equalizing effect. In 2023, the unconditional transfer constituted €180 million, 27% of LG revenues—a 3% decrease from 2022 due to increased foreign debt repayments by the FBiH.

Unconditional Grant

- **Size:** 8.42% of ind. Taxes
- **Allocation:**
  - 68% population
  - 5% surface area
  - 20% school children
  - 7% develop. index (% PIT).

The Unconditional Transfer in FBiH remained largely stable for years but decreased in 2023 due to rising foreign debt service obligations. Debt payments to foreign creditors are directly deducted from each entity's share of indirect revenues, automatically reducing funds available for cantonal and municipal governments. Consequently, municipalities are indirectly burdened with debt repayment, despite having no debt arrears themselves. In 2023, debt servicing in FBiH amounted to an estimated €425.6 million, reducing local governments' share of indirect taxes from the legal 8.42% to under 7%, a loss of about €20.4 million (40 million KM) or 5% of local revenues. This arrangement creates revenue volatility for local governments, lowering their funds when debt obligations are high. Although the total VAT revenues (unconditional transfer pool) grew by 6.5% in 2023, actual distributions to local governments fell by 3% due to a 55% rise in debt servicing, which effectively "crowded out" funds for local use.

Shared Taxes

34.46% of PIT Revenues

Under the Law on the Allocation of Public Revenues, municipalities in FBiH receive at least 34.46% of **Personal Income Tax** (PIT) revenues collected within their territory, while the remaining 65.54% goes to cantonal governments, which are required to share PIT with municipalities based on origin. The minimum amount they should share with municipalities is 34.46%. However, Sarajevo Canton municipalities receive only 1.79% of PIT, with the canton retaining 98.21%. In 2023, 23% of local government revenue came from shared taxes—a 2% increase from 2022. **Conditional grants**, mainly for specific investment projects and often provided by the entity or cantons, account for another 20% of revenues. **Own-source revenues**, primarily from local fees and charges, make up 30% of local government revenues, providing a stable funding base.

In the Federation of Bosnia and Herzegovina (FBiH), **fiscal equalization** aims to address disparities in local government revenue-raising capacities through a horizontally structured system integrated into the revenue-sharing formula. In total, 7% of local government revenue from Unconditional Transfers (€12.6 million in 2023) is distributed based on a "municipal development index." This index combines per capita PIT revenues and outdated Sales Tax data from 2005, assigning each of the 80 local governments an index between 1.2 and 1.8, which is then multiplied by the population of each LG. The data on Sales Tax, that was abolished in 2005 with the introduction of the VAT, is obsolete and does not measure the current development level of LGs, while PIT data is up to date with previous year's data. Although the government adopted an updated development index methodology, the Law on Revenue Distribution has not yet been amended to reflect it. Personal Income Tax is shared between cantons and LGs on a derivation basis, with a minimum of 34.46% allocated to LGs. Some cantons, like Tuzla and Herzegovina-Neretva, voluntarily allocate higher PIT percentages to support less-developed municipalities with lower fiscal capacities.

All 80 LGs in FBiH are assigned the same functions, except for those in Canton Sarajevo, where certain services and revenues have been transferred to the canton. Thirteen LGs are classified as highly underdeveloped (by the FBiH Development Agency), facing disproportionately high service delivery costs due to small populations and high fixed costs. The current horizontal equalization system, largely based on population, does not adequately address these disparities or the limited revenue-raising capacity of these LGs, which also struggle with depopulation. In 2023, €20 million in capital transfers was allocated by FBiH through a public call, but without prioritizing underdeveloped LGs.

Own Source Revenues

In 2023, local governments in FBiH generated own-source revenues mainly from local fees and charges (57%), communal fees and charges (15%), and asset revenues (17%). Asset revenues slightly declined compared to previous years, while local fees and charges increased, indicating improved revenue management and collection. However, FBiH lacks a centralized accounting of local government own-source revenues, with each canton recording this data differently.

The recurrent property tax is regulated by the ten cantonal governments and there is no entity-wide legal regulation of the tax, resulting in the highest number of property tax laws in the region. Cantons administer this tax directly, with limited involvement from municipalities. As a result the property tax revenue potential is not a major concern for authorities at any level of government. Municipalities receive 100% of revenue from property transfer taxes, which contributed 9.3% of total local government revenue in 2023. Yet, municipalities have limited control over these taxes, as the cantons set both the tax base and rates.

FBiH also lacks a uniform system for determining or administering local fees and charges. Together with insufficient local revenues, this has led to increased fees and charges as a means to finance assigned functions. A 2017 Ministry of Finance and USAID study identified 350 different fees, averaging 20 per municipality. This proliferation of fees is viewed as a barrier to local development, business operations, and investment by increasing the cost of doing business in municipalities.

Borrowing

In FBiH, the *Law on Debt, Debt Generation, and Guarantees* regulates borrowing and debt procedures for all government tiers, including cantons, cities, and municipalities. Some elements of the organic Law on Budgets also apply to subnational borrowing, though the BiH state-level law has minimal impact on municipal borrowing.

Cities and municipalities can incur both domestic and foreign debt through loans or securities in local or foreign currencies. Each level of government is responsible for repaying its own debt. For foreign debt, cities and municipalities need the consent of the FBiH and BiH parliaments, as well as their own local councils.

Long-term debt rules require that debt service for each consecutive year, including for the new loan and other guarantees, does not exceed 10% of the prior year's revenues, with guarantees calculated at 30% of their nominal value. Short-term loans can only address cash flow deficits and must be repaid within the same fiscal year, capped at 5% of the prior year's revenue.

Cities and municipalities must obtain approval from the FBiH Ministry of Finance for: (a) debt backed by FBiH or cantonal guarantees, (b) refinancing existing debt, or (c) if they already hold debt with irregular servicing. Cities and municipalities can issue guarantees, but these are limited to capital investments and must be approved by the local council and issued only for entities owned or controlled by the city or municipality.

Local governments were prohibited from borrowing until 2007, keeping municipal debt levels low. Although municipal borrowing has increased over the past decade, annual debt service remains well below the 10% revenue cap. Local government debt in FBiH has averaged about 1% of GDP over the past five years.

Advocacy efforts of the Local Government Association in the area of local finances

The Association of Cities and Municipalities of FBiH (SOGFBiH) has organized several round tables and conferences with the FBiH Parliament, the FBiH Government, and local governments to discuss the position of small and underdeveloped municipalities within the public finance system of FBiH. Parliamentary Committee members supported reforms to the fiscal equalization system to ensure a sufficient revenue stream for these municipalities.

SOGFBiH actively advocates for a more equitable distribution of public revenues and has proposed several initiatives to the FBiH Government to address regulatory issues stemming from 15 years of the current revenue distribution law. In 2022, the FBiH Government established a Working Group to develop a new revenue distribution methodology, appointing a representative from SOGFBiH as a member. SOGFBiH presented policy proposals to address key issues in local finances, including:

- Fiscal vulnerability – sustainability of small municipalities
- Indirect repayment of FBiH foreign debt by local governments
- Horizontal equalization – Use of outdated indicators
- Transfer of new responsibilities to local governments without adequate funding

The Working Group acknowledged the need to resolve the debt repayment issue and accepted SOGFBiH's proposal to introduce a separate pillar for fiscal equalization among local governments, which was submitted for further consideration to the FBiH Government.

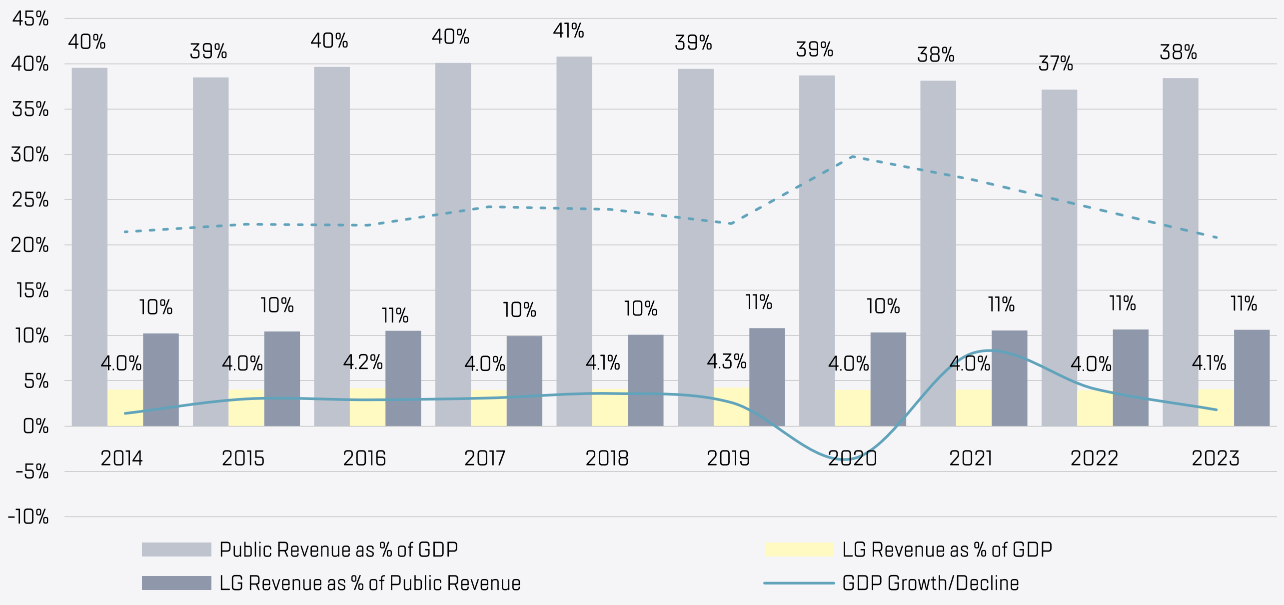
SOGFBiH also prepared two studies on local government finances to support these proposals: one on the functional responsibilities of local governments in FBiH and another on the impact of the Coronavirus pandemic on local finances, alongside an earlier analysis of local revenues. Recognizing the pandemic's impact, including decreased shared revenues and increased local spending, the Working Group accepted SOGFBiH's policy proposals. The Working Group agreed that the new revenue distribution methodology should incorporate principles to protect small, fiscally vulnerable municipalities and ensure that the tiers of government that generated debt are responsible for repayment. The working group will continue work on development of a new methodology for revenue distribution in FBiH, with SOGFBIH participation and advocacy efforts aimed at a final vision of transparent and just system of revenues sharing.

In 2020, through advocacy and negotiations with the FBiH Government, SOGFBiH successfully secured 30 million BAM (15 million Euros) from the FBiH budget as grants for local governments in the aftermath of the pandemic. This included 20 million BAM as an unconditional grant and 10 million BAM earmarked for capital investment. The grant was increased to 40 million BAM (20 million Euros) in 2021, 2022, and 2023.

Statistical Overview of Local Government Finance in FBiH (of BiH) 2006-2023

Local government revenues in FBiH as a share of GDP and public revenues have remained stable over the past five years, largely due to increased collection of indirect taxes, especially VAT, driven by inflation. However, the current foreign debt repayment structure is reducing LGs' share of public revenues. In the meantime, LGs have improved their efficiency in own-source revenue collection. Since 2013, LGs have been generating more debt relative to their revenues, but the legal framework allows long-term borrowing only for capital investment, while deficit financing must be repaid within the fiscal year.

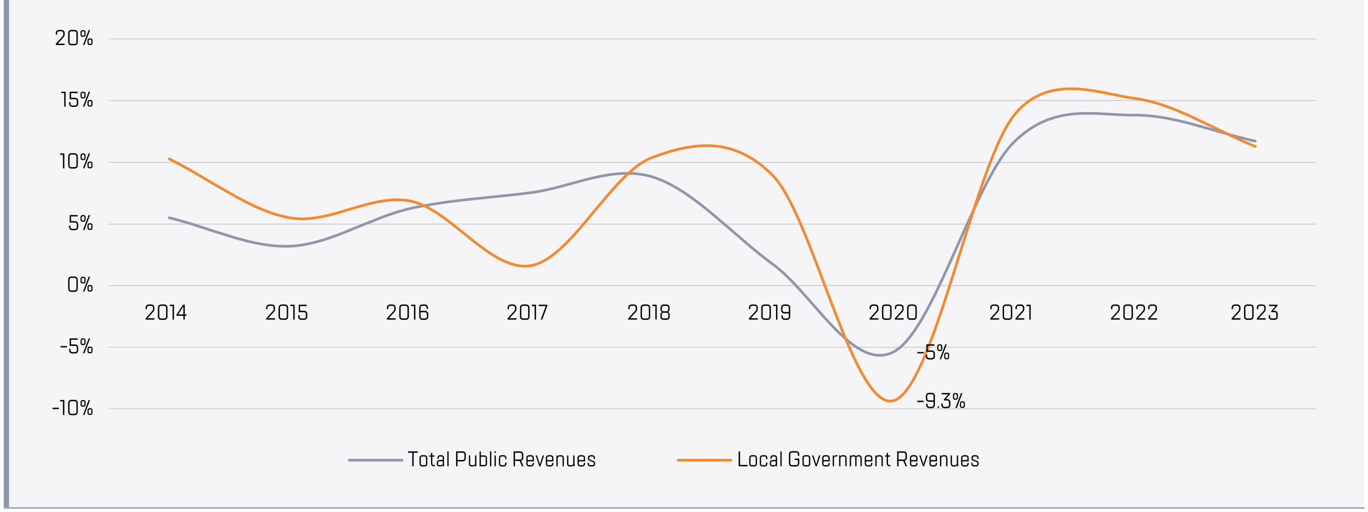
Figure 37. ***FBIH (BIH):*** *LOCAL REVENUE AS SHARE OF GDP AND PUBLIC REVENUE*



In response to the pandemic, LGs increased spending on healthcare and sanitation. Almost all of the 80 LGs opted to waive some own-source revenues (such as rents and communal fees) to support local businesses, resulting in a drop of nearly 50 million BAM in own-source revenues in 2020. By 2021, revenue growth rates returned, surpassing pre-pandemic levels for both shared and own-source revenues. However, in 2023, Unconditional Transfers remained at 2022 levels due to the foreign debt repayment mechanism, despite a 6.5% growth in the available distribution pool for FBiH.

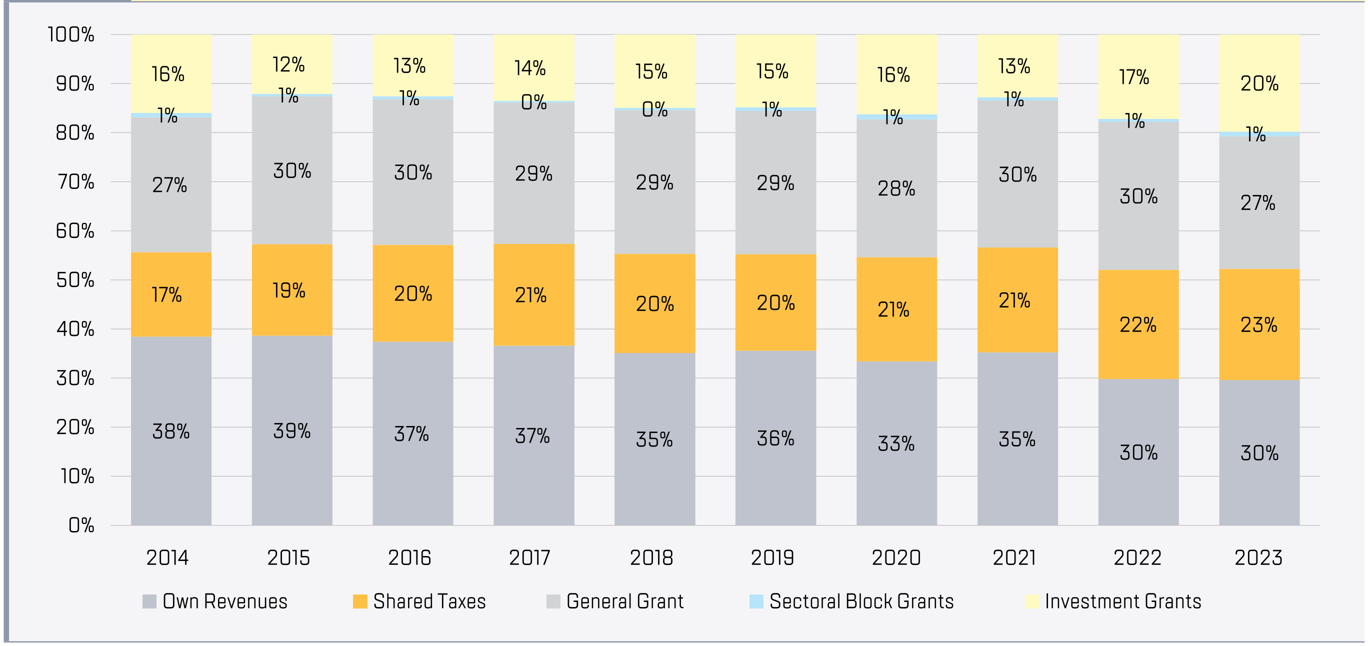
Local government revenues fell as a percentage of total public revenues during the COVID-19 crisis in 2020 due to the fall of indirect revenues as a result of decreased economic activity and large-scale interventions by LGs providing fiscal exemptions to local communities and businesses. In the post-COVID period, local government revenues have stabilized as a percentage of total public revenues and GDP.

Figure 38. ***FBIH (BIH):*** *ANNUAL FLUCTUATIONS IN REVENUES*



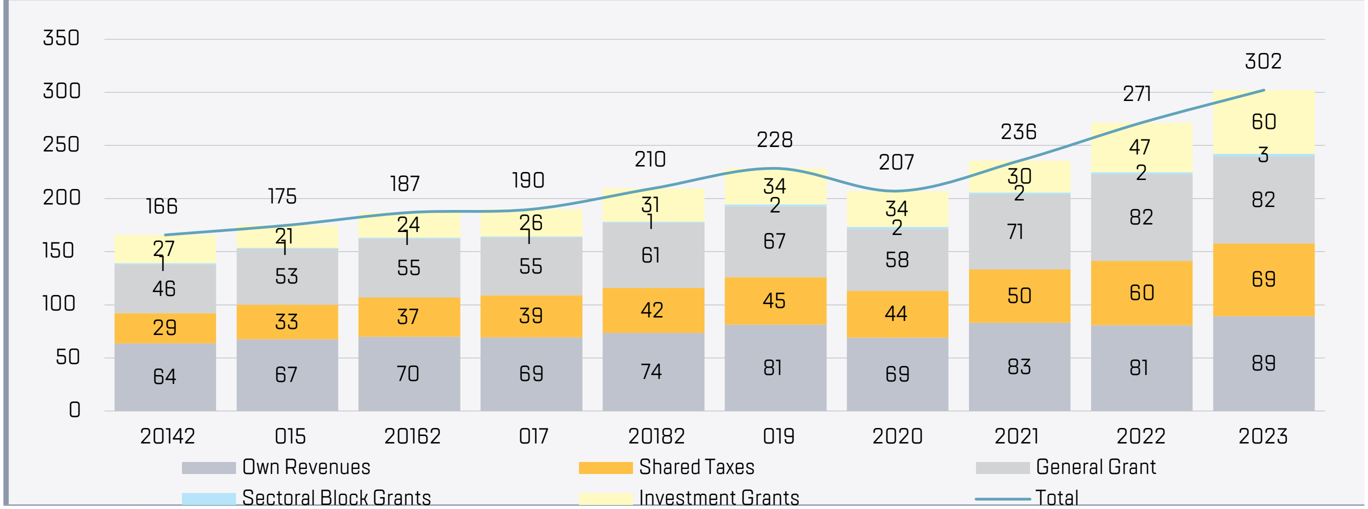
Before the pandemic, local government revenues showed consistent growth in nominal terms, driven by better collection of indirect taxes and increased efforts in own-source revenue collection.

Figure 39. ***FBIH (BIH):*** *THE COMPOSITION OF LG REVENUE, IN % of Total*



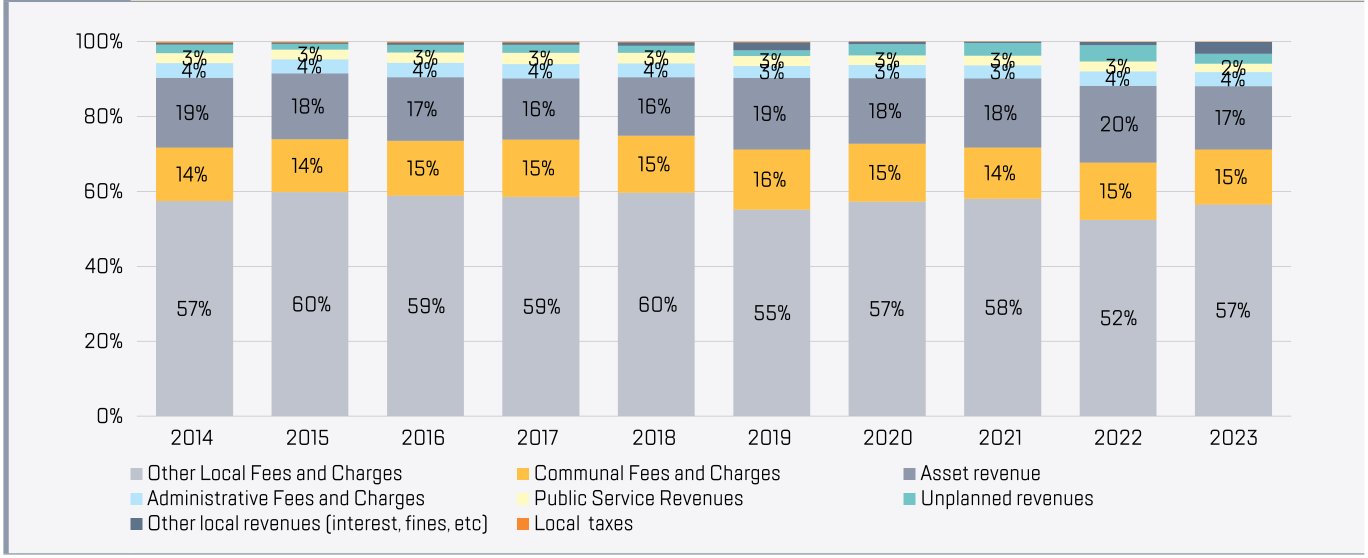
The composition of local government revenues remained stable over the past 5 years: In 2023. own source revenues constituted the single most important source of revenue (30%), together with general grant (27%) and shared taxes (23%)

Figure 40. ***FBIH (BIH):*** *THE COMPOSITION OF LG REVENUE, IN EURO PER CAPITA*



On average, 50% of local government revenues have come from intergovernmental transfers in the form of shared taxes and grants over the past two years. However, the share of Unconditional Transfers decreased in 2023 due to the foreign debt repayment mechanism. Investment grants increased to 20% of local revenues in 2023.

Figure 41. ***FBIH (BIH):*** *THE COMPOSITION OF OWN LG REVENUE, IN %*



Wages and benefits continue to be the largest component of local government expenditure, stabilizing at 24% in 2023, below the 10-year average of 28%. Investment spending peaked at 31% in 2022 but fell to 28% in 2023 due to decreased capital transfers. Subsidies, grants to NGOs, and transfers to individuals accounted for 28% of expenditures in 2023.

Figure 42. ***FBIH (BIH):*** *THE COMPOSITION OF LG EXPENDITURE, IN %*

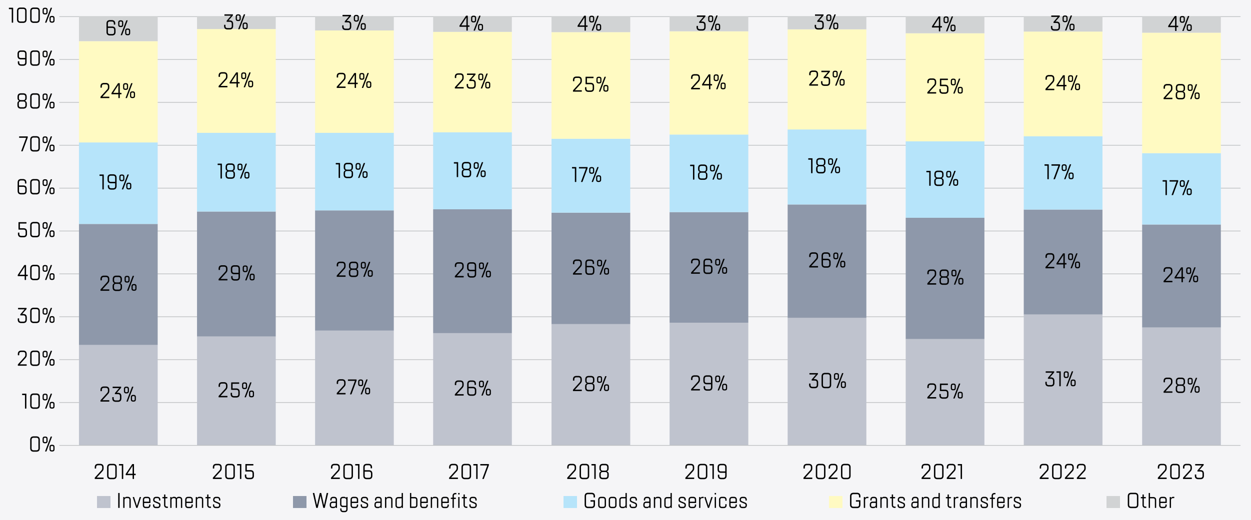
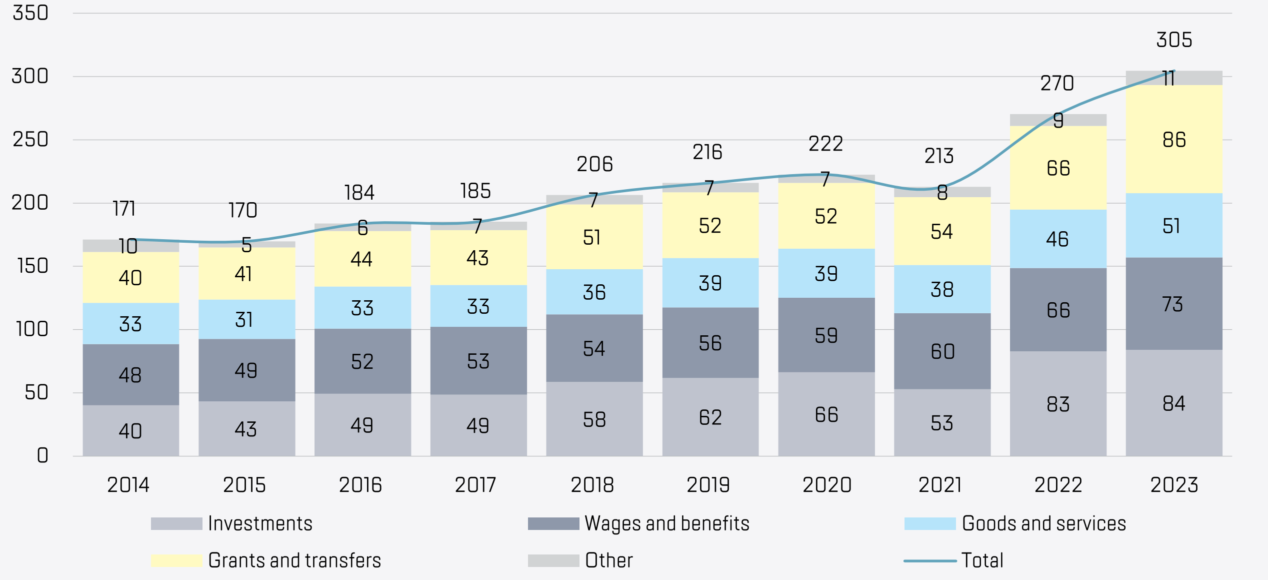


Figure 43. ***FBIH (BIH):*** *COMPOSITION OF LG EXPENDITURE, IN EURO PER CAPITA*



Functional spending shows a significant allocation towards general public services, while economic affairs have fluctuated significantly. Spending for housing and community amenities remains substantial, with a slight increase in social care and protection spending.

Figure 44. ***FBIH (BIH):*** *FUNCTIONAL ALLOCATION OF LG EXPENDITURES, IN % OF TOTAL*

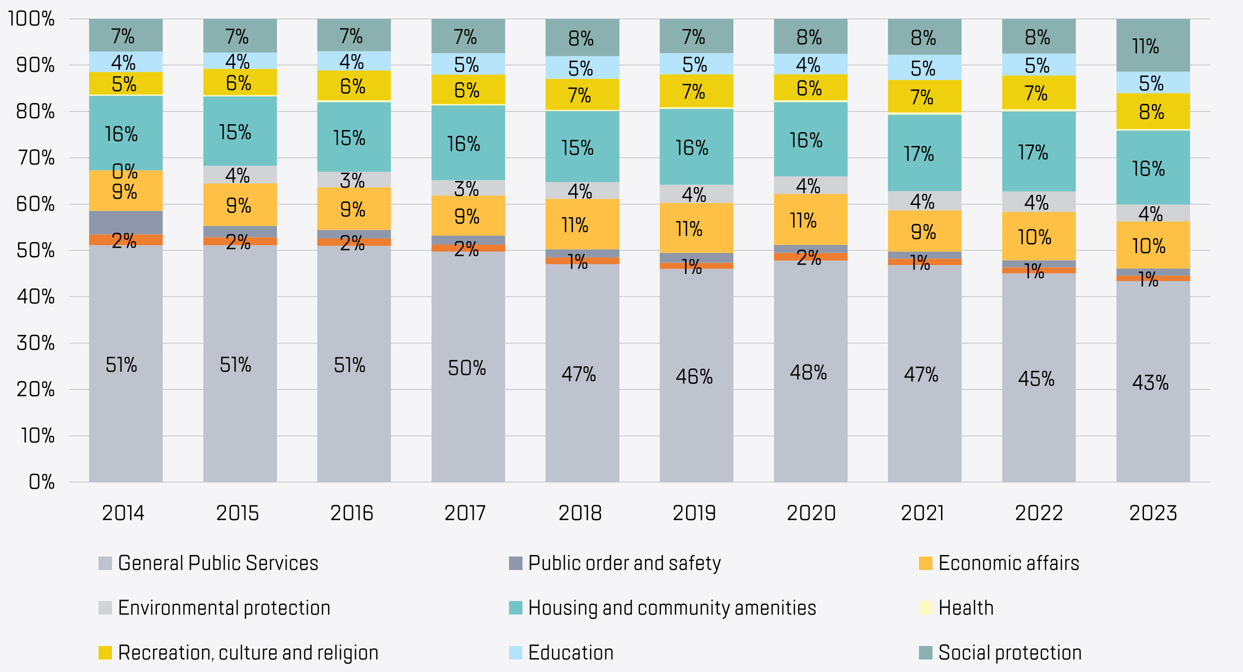
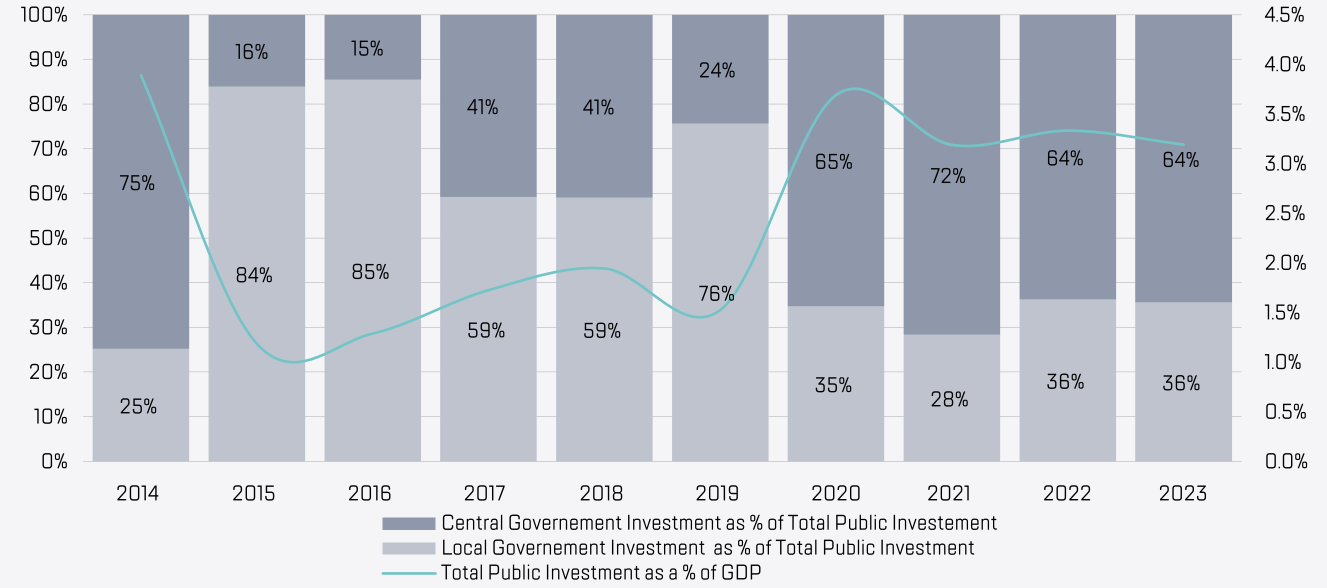


Figure 45. ***FBIH (BIH):*** *PUBLIC INVESTMENT BY LEVEL OF GOVERNMENT AND AS A % OF GDP*



Local government investments constituted 36% of overall public investment in 2023, having recovered from a significant drop post-pandemic.

Bosnia and Herzegovina

Republic of Srpska

By Goran Rakić, Association of Municipalities and Towns of Republic of Srpska

The Intergovernmental Finance System

Local governments (LGs) in the Republic of Srpska (RS) of Bosnia and Herzegovina, rely heavily on intergovernmental transfers, constituting about two-thirds of their total revenues, with the remaining third derived from own-source revenues. Given RS's extensive responsibilities in social services, such as preschool wages and cultural institutions, this funding structure is notable. LG responsibilities are defined as "original" or "exclusive," necessitating funding through freely disposable revenues. All LGs, regardless of size or capacity, share the same functional responsibilities, often resulting in disparities in service access and quality. There are 64 local self-government units in the RS: 53 municipalities and 11 cities.

Under the Law on the Budget System of the Republic of Srpska, LGs are funded through **shared revenues** and **own-source revenues**. Shared revenues—distributed among the Republic budget, LGU budgets, and other beneficiaries—include indirect taxes, income tax, fees for changing agricultural land use, rent from Republic-owned land, concession fees, and special water fees. Own-source revenues, generated directly by LGs, consist of property tax, municipal and communal fees, asset sales and rentals, special water fees, taxes on winnings from games of chance, residence taxes, concession fees, fines, and other miscellaneous income. This framework allows LGUs both financial support from higher levels of government and some autonomy in revenue generation.

The key shared revenues between the Republic's budget, municipal and city budgets, and other users include: (a) **Indirect Taxes**—collected into the Republic's budget, then allocated after debt servicing as 72% to the Republic, 24% to municipalities and cities, and 4% to the Public Company "Roads of Republic of Srpska"; and (b) **Income Tax**—split between the Republic and municipalities/cities, with self-employment and personal income taxes distributed in a 75:25 ratio, respectively.

Since 2006, the **Unconditional Transfer** has been anchored at 24% of the entity's share of indirect taxes. However, the actual funds for towns and municipalities are calculated after RS's (BiH) external debt payments. Linking the transfer to a macroeconomic factor aims at ensuring budget stability and predictability. From 2018-2022, debt repayments accounted for 14-20% of RS's total indirect tax revenue. The Unconditional Transfer is allocated to municipalities and towns based on a formula, which has evolved over time: currently, 75% is distributed per capita, 15% by municipal territory, and 10% by the number of secondary school students.

Unconditional Grant

- **Size:** 24% of indirect taxes share
- **Allocation:**
  - 75% population
  - 15% territory
  - 10% secondary school children

Municipalities and towns receive 25% of the **Personal Income Tax** (PIT) generated in their jurisdictions, providing freely disposable income that has contributed 6-10% of local budgets since 2006. It is important to note that this tax is paid based on the worker's place of residence. Therefore, if a company is located in one municipality but the worker

Shared Taxes

- 25% of PIT

resides in another, the tax is paid to the second municipality where the worker is registered. The Association of Municipalities and Towns of Republic of Srpska (AMTRS) has recommended increasing this share by 5 percentage points to strengthen LGUs' capacity to support local entrepreneurs and agriculturists.

There is also a **Transfer for Underdeveloped and Extremely Underdeveloped Municipalities**, with the amount set annually and allocated based on four criteria: per capita business revenues (35%), per capita municipal revenues from the previous year (25%), population density (20%), and unemployment rate (20%). It is important to highlight though that this transfer constitutes only 0.4% of total local government revenues in 2023. While this transfer has slightly increased over the years, it is divided between 35 underdeveloped and extremely underdeveloped LGUs that struggle with depopulation, an aging population, limited social protection, weak infrastructure, and underdeveloped economies. The allocative criteria for this transfer are set by the National Assembly, with development criteria reviewed every three years.

Municipalities are also eligible for **conditional grants**, primarily for investments. These grants rose to 11% of local revenues in 2020, up from an average of 6% over the previous five years but dropped to 4% in 2021. Overall, local governments in the RS remain highly dependent on revenue transfers from higher levels of government, which accounted for 64% of their income in 2021.

Own Source Revenues

Own-source revenues (OSRs) account for up to 35% of total local government revenue in the Republic of Srpska (RS) and include a range of taxes, fees, and other income sources. OSRs include the real estate tax, tax on agricultural and forestry income, administrative and communal fees, special water fees, municipal fees on natural and general interest resources, winnings tax, residence tax, concession fees, and other miscellaneous income. Additionally, per the Law on Local Self-Government, local governments can collect fees for land development.

Real estate tax, introduced in 2008 and revised in 2015, is fully retained by local governments and administered by the Tax Administration, although cities may assume this role. The income from the real estate tax is entirely allocated to local government units and the determination of the tax rate is solely within the authority of LGs, and they are required to submit the tax rate each year. As many other counterparts in the region, one of the key challenges facing local governments in the RS is the update of the fiscal register of properties and taxpayers. It is estimated that 50% of real estate in the territory of Republic of Srpska (BiH) has not been registered and is not included in the calculation by the tax administration, posing a significant challenge in revenue collection.

Recent legal efforts aim to improve property tax administration in the Republic of Srpska. The new Law on Property Tax requires the Tax Administration to share property data with local governments upon request, fostering better coordination for more efficient tax collection. Additionally, the Law mandates that the Republic Administration for Geodetic and Property Affairs provide continuous access to property information for both the Tax Administration and local governments. A key initiative, the "Mass Valuation of Real Estate" project, was launched to harmonize property data, provide fair and equal taxation, and attract more investors by aligning with international standards.

Despite these advancements, tax compliance remains a challenge. The Law now prohibits the sale of properties with unpaid taxes, ensuring compliance is checked when registering property rights. The deadlines for property tax payments have been revised to enhance collection and support budget sustainability. There is significant potential for increasing property tax revenues, with estimates suggesting a 70-100% increase in many municipalities. Pilot projects have shown positive results, and a long-term project to transfer property tax administration to local governments is underway. Changes to the law are expected by 2025 to further improve tax collection efficiency.

Borrowing

Local governments in the Republic of Srpska (BiH) are allowed to borrow under the Law on Borrowing, Debt, and Guarantees of the Republic of Srpska. They can incur debt through credit agreements or the issuance of securities. **Long-term debt** is permitted only if the total debt repayment in any subsequent year, including both proposed and existing debt, does not exceed 18% of the local government's regular revenues from the previous fiscal year. **Short-term debt**, which must be repaid within 12 months, cannot exceed 5% of regular income from the previous year. Additionally, the total exposure from issued guarantees cannot exceed 30% of regular income. The municipal or town assembly must decide on borrowing and issuing guarantees, subject to approval from the Ministry of Finance.

As of 2024, local government debt is estimated to stand at 6.605,2 million KM, accounting for 6.3% of the total debt and 2.5% of the GDP.

Table 7. Stock of total debt and projections (millions KM)

	2020	2021	2022	2023	2024
I Total external debt of RS (1 + 2 + 3)	3.526,4	4.190,2	4.662,3	5.055	4.714,3
2. External Debt of LGUs	121,4	133,4	147,5	158,3	170,6
II Total internal debt of RS (1 + 2 + 3)	2.307,1	1.974	1.870,4	1.651,8	1.890,9
2. Internal Debt of LGUs	370,7	337,5	290,8	244,5	199,8

Source: Ministry of Finance of the RS; Reports of local self-government units, social security funds.

Advocacy of the Local Government Association

Local governments in the Republic of Srpska (BiH) have faced several challenges in recent years, beginning with the catastrophic floods of 2014, which caused significant infrastructure damage and financial strain on municipalities. Many families were displaced, and recovery required substantial resources. Following the stabilization period, local governments saw record years in budget allocations and capital projects. However, the Covid-19 pandemic posed a major challenge, affecting both local governments and the Republic of Srpska's Government. In response, the Government established the Solidarity Fund for the Reconstruction of the Republic of Srpska to procure essential medical equipment and support economic recovery.

One of the most notable achievements during this period was the increase in grants for underdeveloped and extremely underdeveloped municipalities, from 1.5 million to 3.5 million convertible marks. AMTRS successfully prevented several attempts to transfer competences to local governments without additional financial support through advocacy and lobbying. Currently, the transfer of health centers to the treasury system in local governments is underway, presenting significant challenges due to the large debts of many health centers.

In the future, AMTRS plans to continue advocating for the transfer of property tax administration from the Tax Administration to local governments. Additionally, the development of business zones in municipalities has helped boost local economies and increase government revenues.

In the past two years, the Association of Municipalities and Towns in the Republic of Srpska has focused on addressing the challenges posed by inflation, rising energy prices, and increasing minimum wages, all of which have had a direct impact on local government budgets. Efforts were also directed towards property tax reforms, expanding its scope, and strengthening the capacity of LG staff. Additionally, the management of local government assets became a key focus.

Intergovernmental Dialogue – Structure of the Association of Municipalities and Towns in the Republic of Srpska

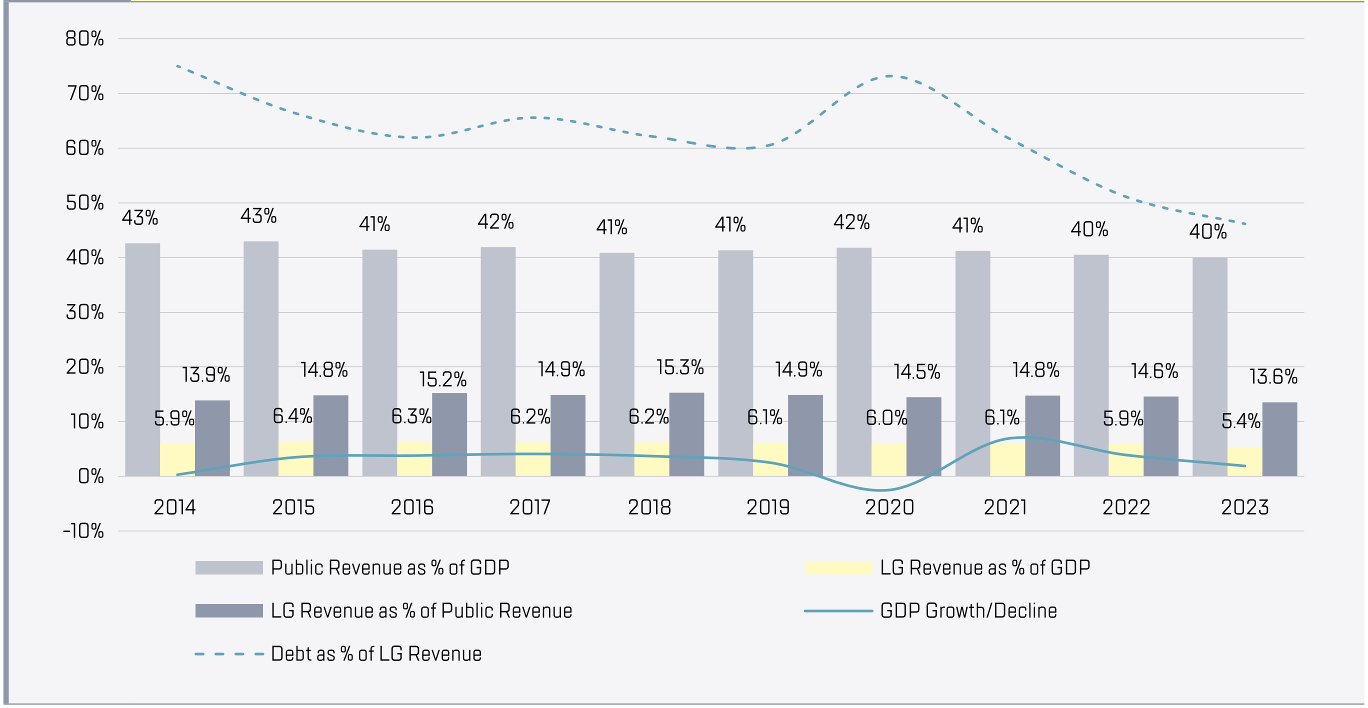
The Association operates through its governing bodies, including its annual assembly, composed of representatives from all LGs in the Republic of Srpska, and its presidency, which meets 3-4 times a year, and which is composed of 20 LG representatives. The Association also has 9 specialized committees that meet as needed to provide professional recommendations to the presidency or assembly.

The Association holds a representative position in the Committee for Local Self-Government at the National Assembly and has a seat in the Assembly with the right to speak with prior notice. Strong cooperation with various government institutions, including the Ministry of Administration and Local Self-Government, the Investment and Development Bank of the Republic of Srpska, and the Main Public Sector Audit Service, forms the foundation for successful dialogue and negotiations with the Government.

Statistical Overview of the Finances of Local Governments in RS (BiH)

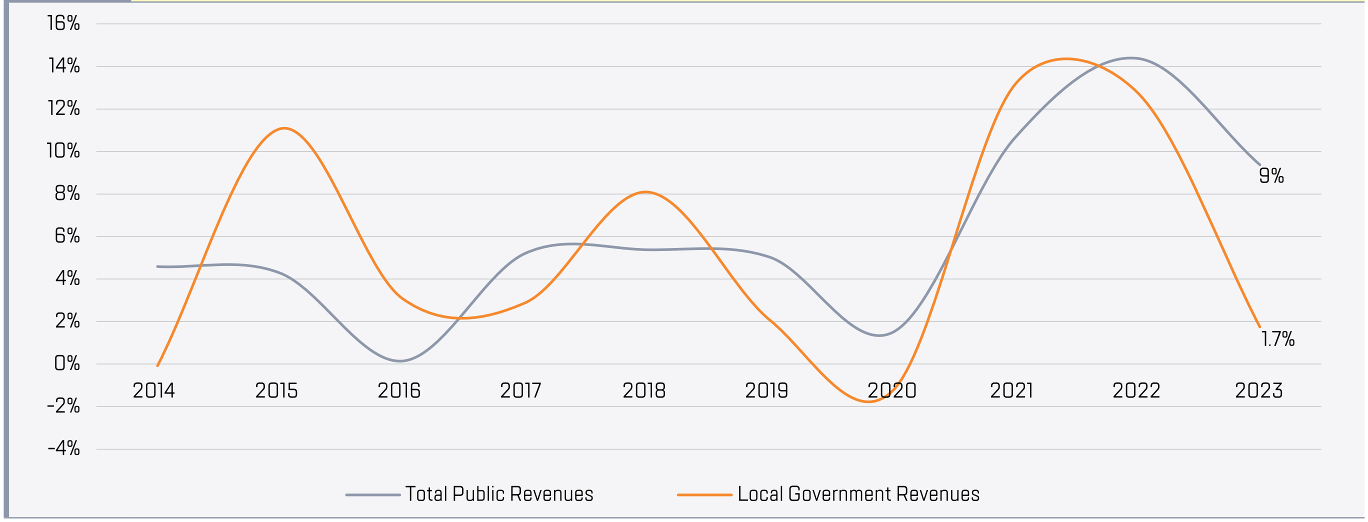
Local government revenue as a share of GDP and total public revenues has decline in 2022 and 2023. In 2023, local government revenues constitute only 13.6% of public revenues and 5.4% of GDP, the lowest levels in a decade.

Figure 46. ***RS (BiH)****: Local Government Revenue as Share of GDP and Total Public Revenue*



Local government revenues have almost always declined faster and risen slower than the revenues of the RS (BiH) government. In 2023 LG revenues increased by only 1.7% when the RS government revenues increased by 9%.

Figure 47. ***RS (BiH)*** *Annual Fluctuations in Public Revenues*



RS LGs are heavily dependent on the Unconditional Grant, which in 2023 makes up to 54% of LG revenue. Own revenue has remained relatively stable for the past decade, except for 2020 impacted by the COVID-19 pandemic. The share of shared taxes has also increased in the recent two years, recovering to 9%.

Figure 48. ***RS (BiH):*** *Composition of Local Government Revenues, in % of total*

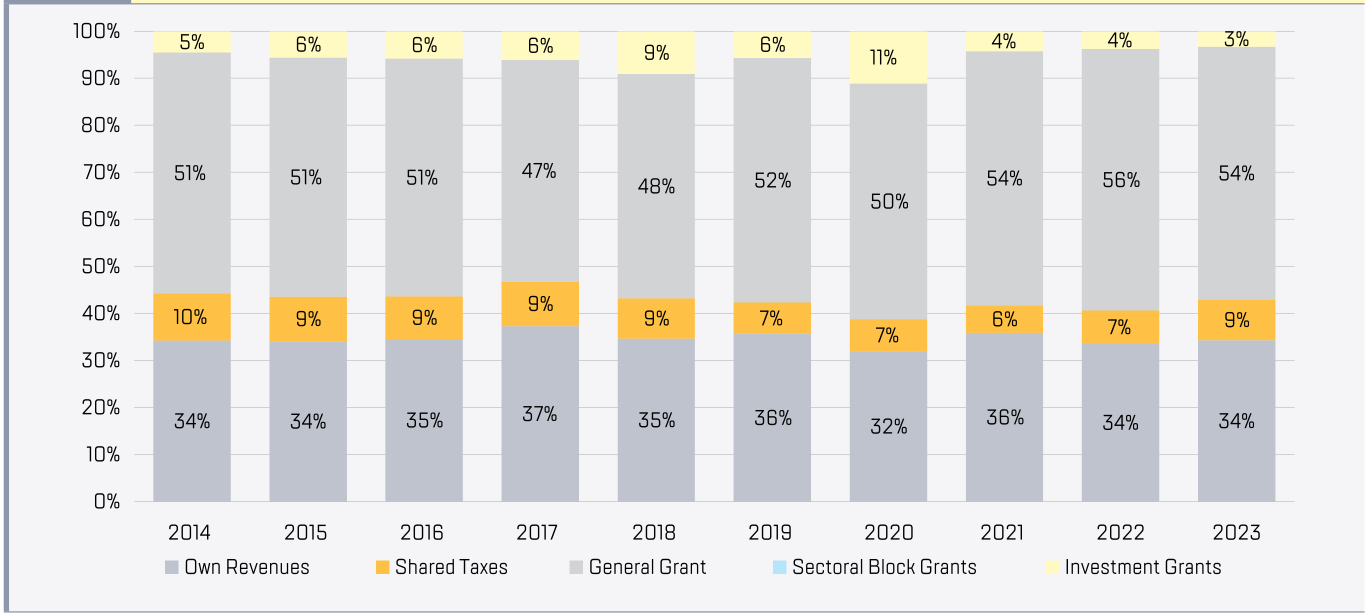


Figure 49. ***RS (BiH):*** *Composition of Local Government Revenues, in mln Euro*

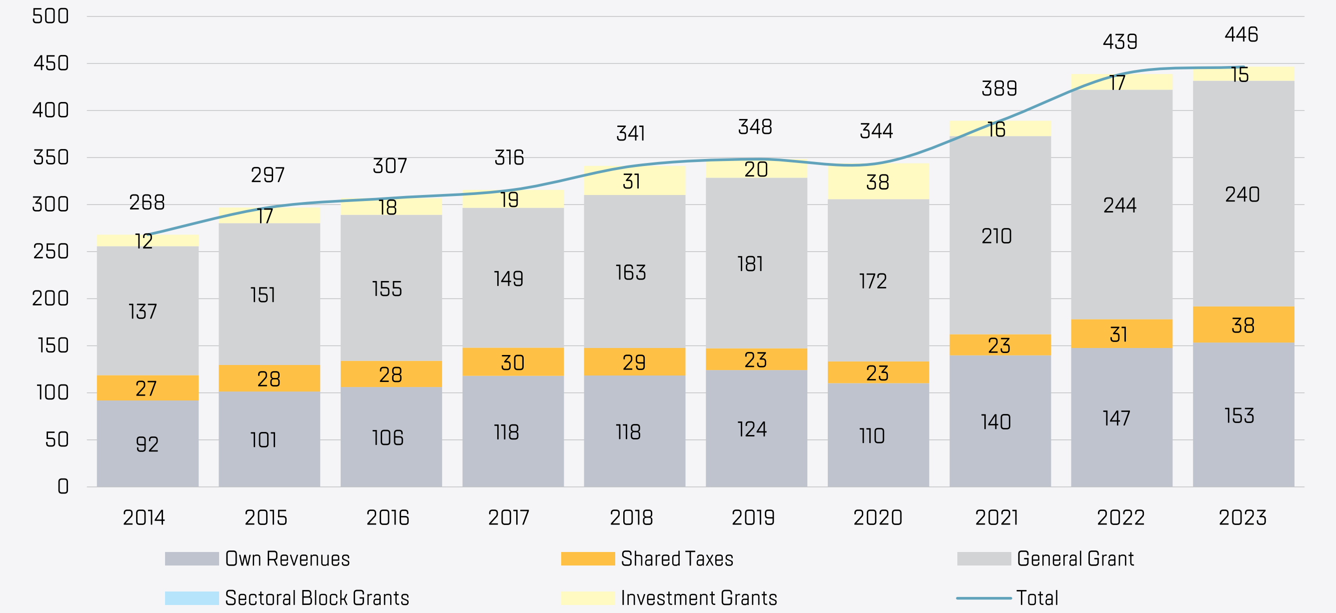
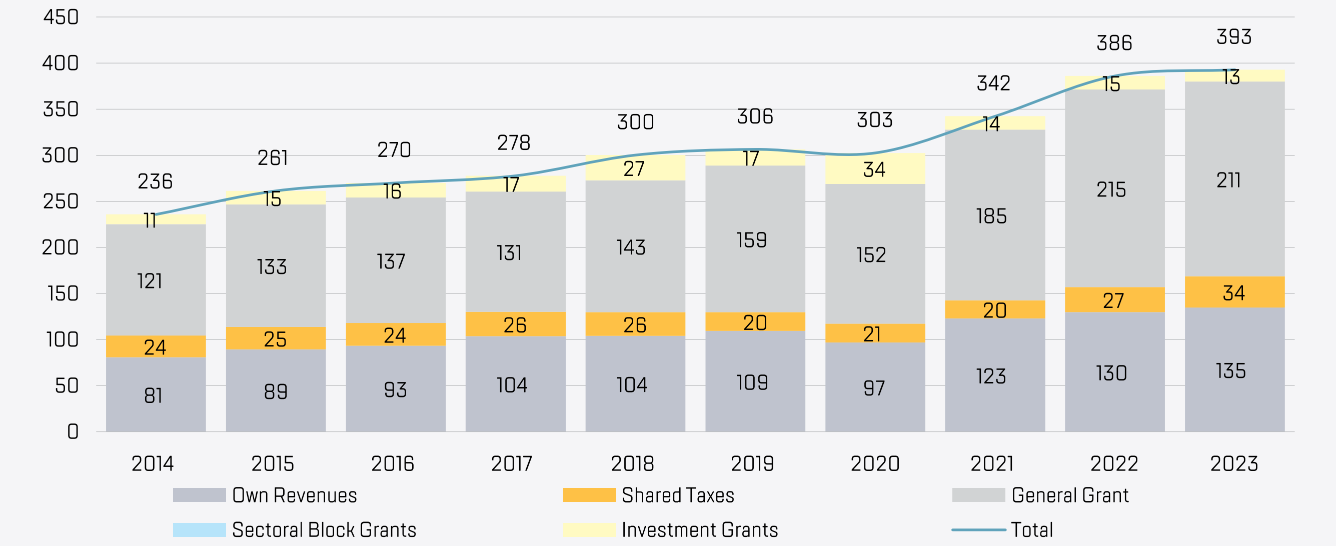
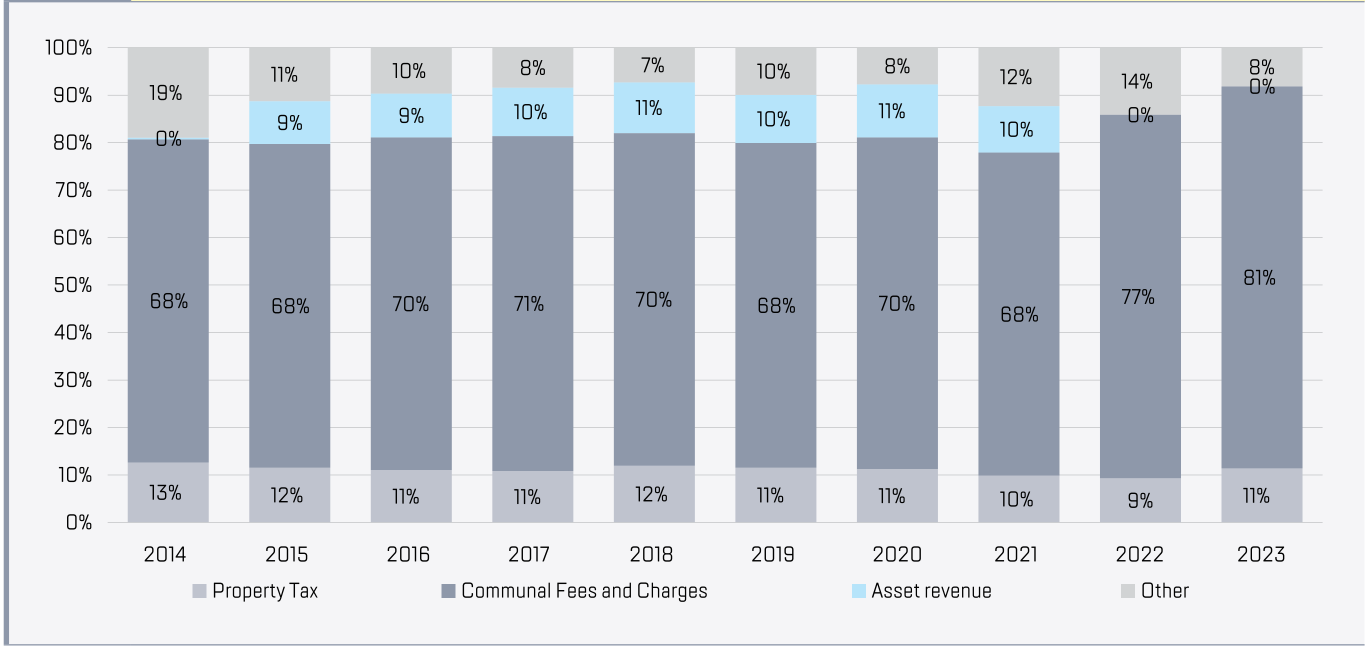


Figure 50. ***RS (BiH):*** *Composition of Local Government Revenues, in Euro Per Capita*



Own source revenues are dominated by the wide variety of communal fees and charges (on advertisement, particular categories of entertainment, use of public space, parking, accommodation in hotels, and construction of buildings) making up 81% of the total in 2023. The revenues from property taxation remain very low, just 11% of the own source revenues in 2023, and among the lowest levels in South-East Europe.

Figure 51. ***RS (BiH):*** *Composition of Own Local Government Revenues, in % of total*



Spending for capital investments has seen significant upwardly fluctuations over the past decade. Their share of total expenditure almost doubled in 2020 and then fell again in 2021 and thereafter. On the other hand, spending on wages has increased since 2020, registering 35% of total local government expenditures in 2023. Like their counterparts in FBiH (BiH), RS (BiH) municipalities spend significantly on subsidies to municipal utilities, grants to NGOs and transfers to individuals. However, their share to total LG expenditure remained relatively stable in the past few years.

Figure 52. ***RS (BiH):*** *Composition of Expenditures, in % of total*

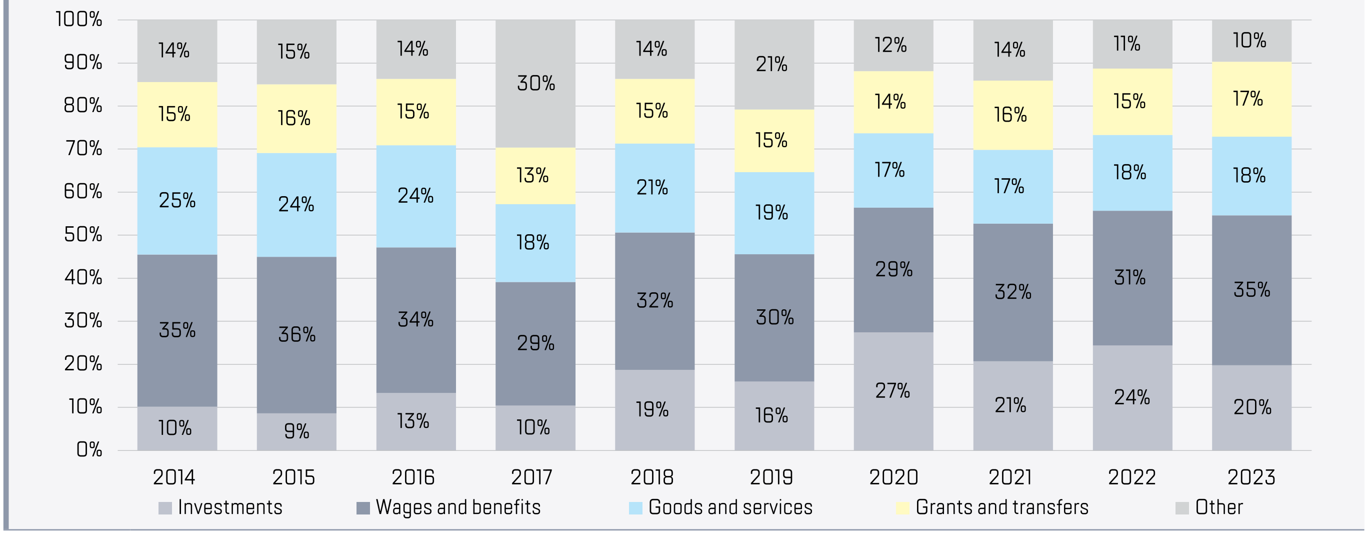


Figure 53. ***RS (BiH):*** *Composition of Local Government Revenues, in mln Euro*

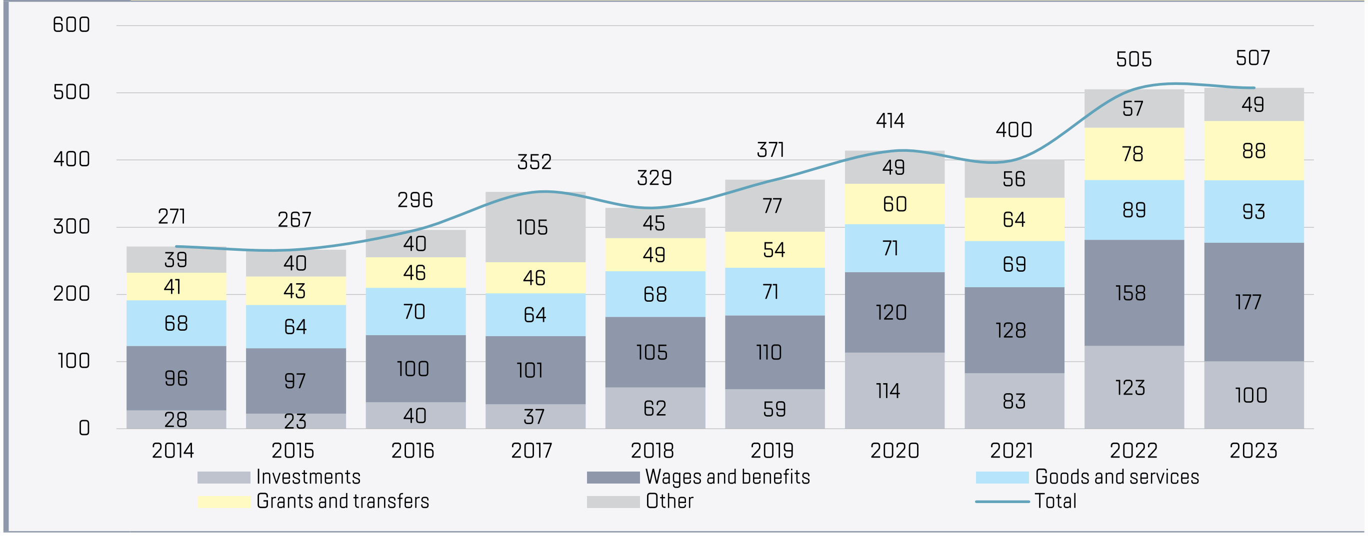
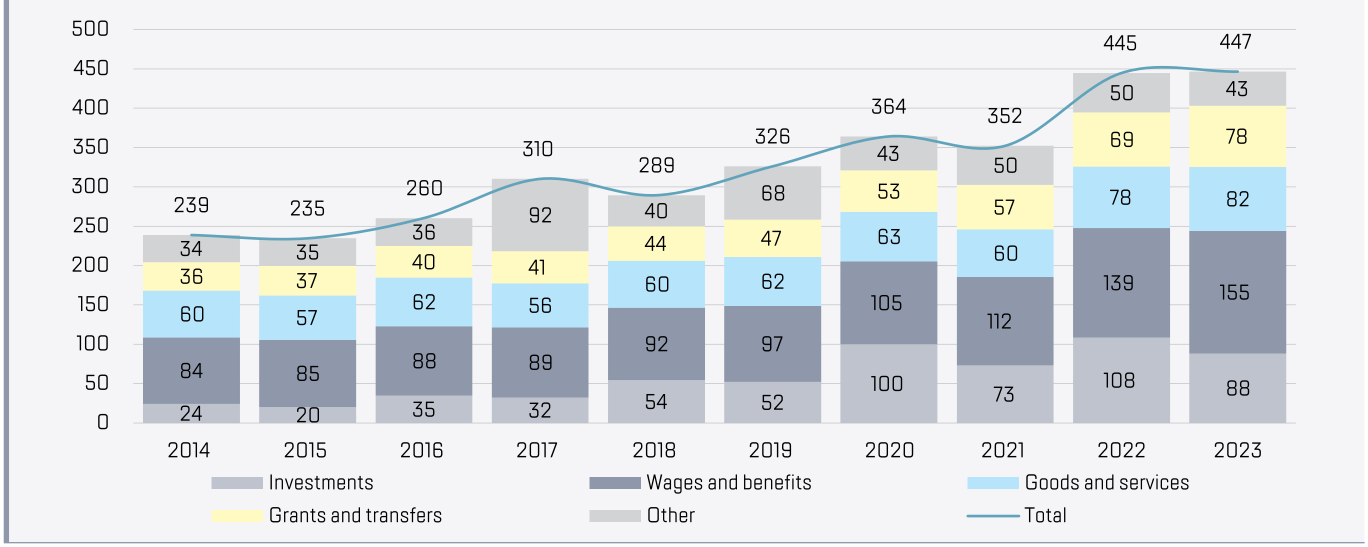
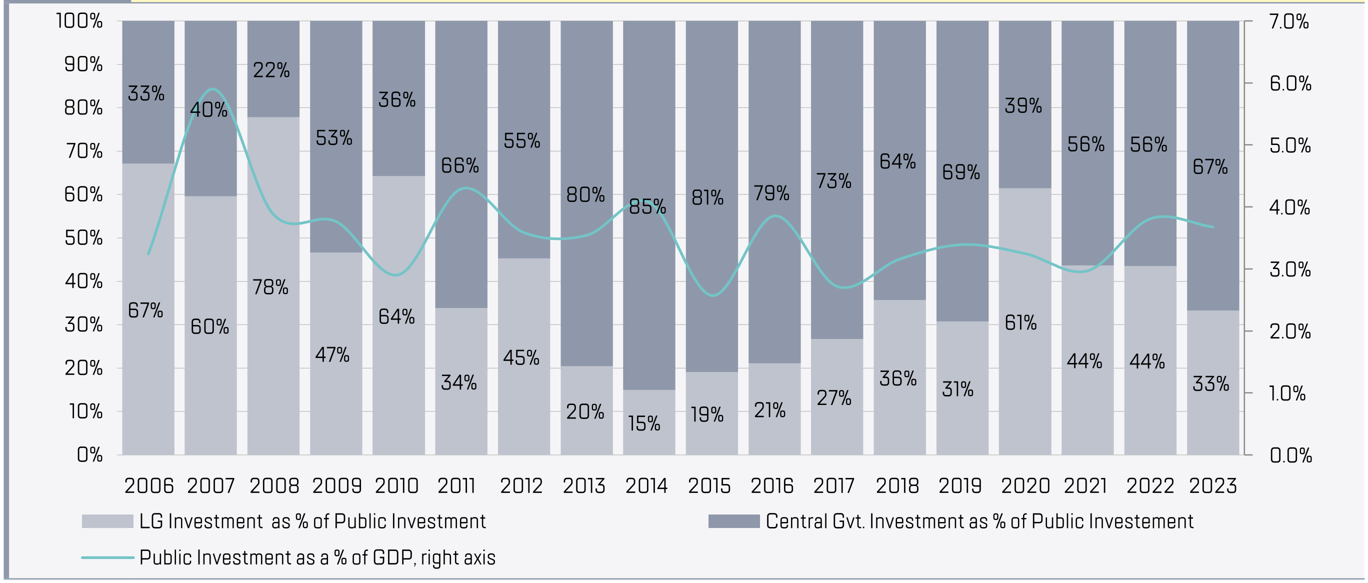


Figure 54. ***RS (BiH):*** *Composition of Local Government Revenues, in Euro per capita*



The financial position of local governments in RS (BiH) in public investment, has recovered since the lowest point in 2014. In 2020, LG capital investments made up to 61% of total investmetns in the RS (of BiH). While the share of LG investments fell to 33% of the total in 2023, still this is the highest share that LGs in the RS (of BiH) have registered in a decade.

Figure 55. ***RS (BiH):*** *Investment by Level of Government and as a % GDP*



Bulgaria

By Yuliya Ivanova, National Association of Municipalities in the Republic of Bulgaria

In Bulgaria, public finance budgetary and fiscal rules, including on municipal budgets are governed by the Public Finance Act. It defines the municipal budgets in terms of own-source revenues, state-delegated expenditures, and budgetary relationships with the central government. Additionally, the Public Finance Act outlines balance requirements and budget balance financing.[10] Budgetary relations with the central budget are defined through transfers and temporary interest-free loans. Municipalities receive four main types of transfers each year, with the possibility of additional targeted transfers and financial compensations during the budget cycle.

The Intergovernmental Finance System

The intergovernmental finance system is dominated by transfers which account for over 70% of municipal budgets in the past five years. In 2023, they represented 73%, a slight decrease from 74% in 2022, the highest level in a decade. Around 90% of these funds are earmarked, with limited flexibility for local authorities to allocate expenditures. Over 70% of these budgetary transfers support state-delegated activities, with funds specifically allocated for designated purposes. For example, municipalities receive a targeted transfer for winter road maintenance, which cannot be used for other purposes. Similarly, earmarked capital expenditure subsidies have restrictions, particularly on certain investment expenses. Among the four transfer types designated for local governments, only the general equalization subsidy can be used by local governments in full autonomy.

The State Budget Law specifies the types and distribution mechanisms of these transfers and overall, there have been no changes in the transfer distribution mechanisms in recent years. Also, there are no specific regulations in place for the determination of the annual size of the transfers, as there are elsewhere in South-East Europe anchoring the size of some type of transfers to a macroeconomic indicator.

General Subsidy for State-Delegated Activities

- **Size:** Determined Annually
- **Category:** earmarked funding for education, healthcare, social services, culture and municipal administration services.
- **Allocation:** financial/cost standards and natural indicators, including population, student numbers, health professionals in kindergartens and schools, and others.

General Subsidy for State-Delegated Activities. The General Subsidy for State-Delegated Activities constitutes up to 48-52% of total local government revenues in Bulgaria (depending on the type of revenue methodology). This subsidy provides earmarked funding for functions such as education, healthcare, social services, culture and municipal administration services. Allocations towards municipalities are determined by financial/cost standards and natural indicators, including population, student numbers, health professionals in kindergartens and schools. In 2023, education received the largest share of funds (39%), followed by com-

[10] Budget balance financing means the receipts and payments resulting from debt assumption and repayment, privatisation proceeds, operations involving external funds, operations concerning the acquisition or realisation of financial assets and liabilities that are not related to revenue or expenditure, as well as any change in the availability of cash for the relevant budget year, including the re-evaluation of cash available in foreign currencies.

munity amenities (including environmental protection) at 19%, social protection at 13%, and public services at 11%. These transfers are intended to cover employee remuneration as well as operational and maintenance costs associated with delivering these services.

General Equalization Subsidy. The general equalization subsidy constitutes only 3.4% of local government revenues in Bulgaria. It aims, however, to ensure that municipalities can provide a minimum level of local services across the country. Since 2019, this subsidy is designed to support only municipalities with lower tax capacities, specifically those with per capita revenues from permanent taxes below 120% of the national average. Permanent taxes include the immovable property tax, vehicle tax, visitor tax, license tax and the tax on passenger transport by taxi. The annual size of this subsidy is legally set to no less than 10% of the total source revenues of all municipalities in the previous year. Distribution across the eligible local governments is determined by five components:

Equalization Subsidy

- **Size:** Determined annually - not less than 10% of total OSRs of all municipalities in the previous year
- **Category:** freely disposable
- **Allocation:** through 5 components
  - Revenue Component
  - Expenditure Component
  - Low Revenue Capacity
  - Additional Component
  - Tax Effort

1. **Revenue Component** – all municipalities with per capita revenues less than 120% of the national average may benefit from this component. The transfers are calculated as per the difference between 120% of the national per capita tax revenue average and actual per capita municipal revenue, multiplied by the municipal population.

2. **Expenditure Component** – calculated using natural indicators (such as age distribution (children aged under 5 years, children aged 6-14 years, elderly over 65 years) and road length) to determine each municipality's share based on expenditure needs.

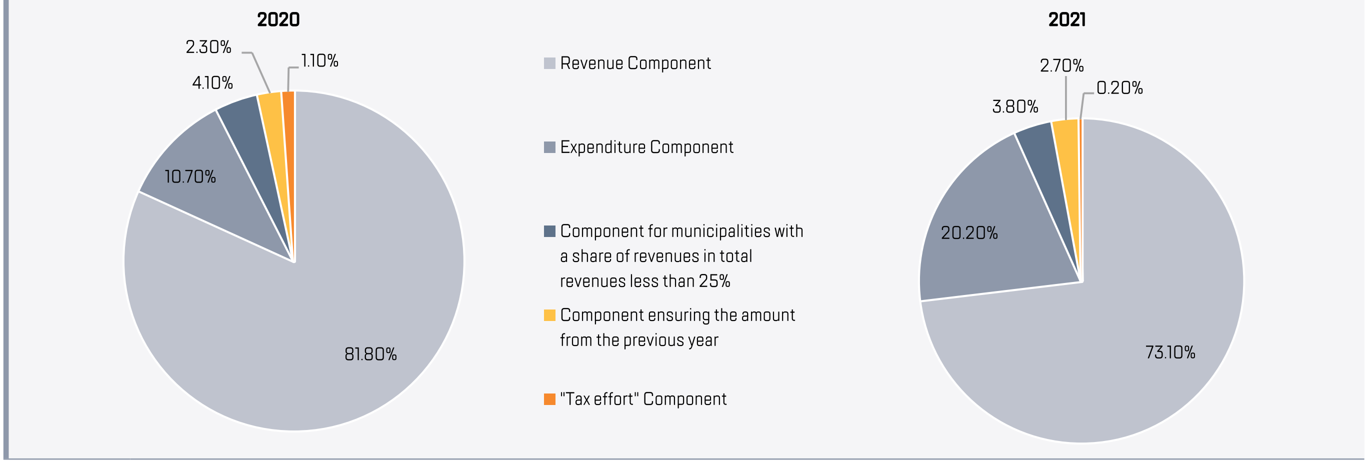
3. **Low Revenue Capacity** – allocated to municipalities whose own-source revenues constitute less than 25% of their total revenues in the previous year.

4. **Additional Component** – allocated to those municipalities that have a negative balance between the amount received in the previous three components compared to the amount of the subsidy that they perceived the previous year.

5. **Tax Effort** – rewards municipalities with tax rates above the average for certain taxes.

The bulk of the equalization subsidy is allocated through the revenue and expenditure components, with only a small share reserved for the tax effort component. Regulatory requirements on the distribution criteria have been limited. Only 2020 and 2021 the shares were defined in the medium-term budget forecasts, as shown in the figure below.

Figure 56. *The division of the equalization subsidy*



Earmarked Capital Expenditure Subsidy. The earmarked capital expenditure subsidy constitutes up to 3% of total local government revenue in Bulgaria, up to 5% of total transfers and up to 14% of total capital expenditures (including capital expenditures from EU funds). This subsidy supports capital expenditures, including construction, asset acquisition, and repairs. The subsidy allocation method has changed in 2007, 2012 and 2016. Currently it is distributed based on two components:

- **Main component**: 45% based on number of settlements, 25% on municipal road length, 25% on population, 5% on surface area.
- **Additional component**: distributed equally among the 131 municipalities classified as needing infrastructure improvements (determined by the Ministry of Regional Development and Public Works).

Similar to the equalization subsidy, the distribution of funds across components lacks a formal regulatory basis, with details available only for 2020 and 2021. Up to 95% of the funds are allocated to municipalities through the main component, while the remaining 5% is distributed through the additional component.

The capital subsidy may be used for specific expenses, such as construction and major repairs, acquiring tangible and intangible assets, and scientific research, including co-financing and loan payments for capital expenditures. Municipalities can allocate this subsidy toward capital projects for both delegated and own functions as approved by municipal councils. Additionally, it can be converted into a transfer for urgent repairs of municipal roads, street networks, and public buildings.

The central government imposes further requirements through the state budget decree, which prohibit the utilisation of the capital subsidy for certain administrative expenses, such as purchasing passenger cars, leasing contracts, mobile

Earmarked Capital Expenditure Subsidy

- **Size:** Determined Annually
- **Category:** earmarked for investment
- **Allocation:** through 2 components
  - **95% on Main Component**
    - **45% on settlements**
    - **25% local road length**
    - **25% on population**
    - **5% on area**
  - **5% on Additional Component**: equal amount among 131 eligible municipalities.

phones, and various inventory items. There are also conditions on fund disbursement timing based on municipal requests and requirements to report capital expenditures in the Ministry of Finance's centralized information systems, among other measures.

Transfer for Winter Maintenance and Snow Removal. Although there is no regulatory framework to determine the total amount for winter maintenance of municipal roads, the distribution mechanism is clearly defined. The transfer is divided among municipalities based on specific criteria: 85% of the funds are allocated according to the length of municipal roads, 10% based on the number of populated places (excluding those without residents), and 5% based on population. Each municipality's allocation is calculated based on its relative share of each indicator compared to the national totals.

Transfer for Winter Maintenance and Snow Removal

- **Size:** Determined Annually
- **Category:** Earmarked funds
- **Allocation:**
  - 85% on roads length
  - 10% on settlements
  - 5% on population

Own Source Revenues

The share of own-source revenues in Bulgarian municipal budgets has been decreasing relative to state transfers, despite an absolute increase in value. In 2023, own revenues accounted for only 25% of total municipal revenues as opposed to 36% a decade earlier in 2013. Own revenues consist of tax and non-tax income, with recent growth driven primarily by non-tax revenues, which now make up over half of the total.

Tax revenues represent 42% of municipalities' own-source income. Three key taxes—property tax, vehicle tax, and property acquisition tax—together account for 97% of all tax revenue. The remaining 3% is derived from smaller taxes, including taxes on inheritance and gifts, patents, tourism, and taxi passenger transport. Non-tax revenues constitute 58% of own revenues in 2023, split between local fees (30%) and other non-tax sources (28%). The municipal waste fee is the largest single component, comprising 77% of all local fee revenues and 40% of non-tax income.

State financing for kindergartens and nurseries

With the changes of April 2022, kindergartens and nurseries became free for parents, as fees for preschool attendance and children's meals in preschool education were abolished. The state now fully funds the maintenance of these institutions, so municipalities no longer collect these fees for early childhood care. A local fee remains only for the use of children's kitchen services in a limited number of municipalities—73 in 2023.

Other local fees constitute 23% of fee revenues, covering technical services, home social patronage, market, sidewalks and fairs usage, and administrative services. Additional non-tax income is sourced from property management (20% of non-tax revenues), property sales (14%), fines (4%), concessions (3%), and other sources (6%).

Main Challenges and Achievements in Local Government Finance

In recent years, Bulgarian municipalities have navigated multiple crises, including economic downturns, social upheavals, health emergencies, and political instability. The COVID-19 pandemic placed significant strain on local budgets due to increased demands for social support and healthcare, which deepened dependency on central funding. Many municipalities postponed or cancelled infrastructure projects, while they mobilized resources to implement local health measures, such as quarantine enforcement and coordination with healthcare services. Political instability in 2022 and 2023 further impacted municipalities by delaying the adoption of the State Budget Act, forcing municipalities to operate without approved budgets.

Despite challenges, Bulgarian municipalities have remained resilient, using flexible budget management to maintain essential public services including healthcare, social care, and education. Municipal revenues began to recover post-pandemic, thanks in part to effective resource allocation and increased support from the central budget.

In 2022, a significant step was achieved through the National Association of Municipalities in the Republic of Bulgaria's (NAMRB) initiative. Thanks to the good cooperation between NAMRB, the Ministry of Finance and the Ministry of Regional Development and Public Works, the Council of Ministers approved a list of priority municipal investment project. This transparent funding mechanism provided 406 million BGN (203 million EUR) for 234 priority projects, preceding establishing a new model for targeted investment established later in 2023. NAMRB was involved very early in the decision-making processes over the amount of additional investment funding for municipalities and the criteria utilized to allocate funding across local governments. The list of projects proposed by municipalities were reviewed, analysed and assessed on grounds of maturity for implementation, whether they had building/construction permits and are identified as high priority by the municipal administration.

With the 2024 State Budget Act, an **Investment Program for Municipal Projects** was introduced, totalling 4,193.4 million BGN and extending through 2026. The program provides funding for eligible projects based on municipal category and requires co-financing for expenditures exceeding capped amounts. The law regulates the type of objects that can be financed, the eligible activities, as well as the total maximum expenditures for 2024 under the concluded agreements. The program is updated quarterly by the National Assembly, at the proposal of the Council of Ministers, to reflect ongoing municipal needs. A Council of Ministers Decree sets the requirements for implementing the Investment Program for Municipalities, including verification and reporting of eligible expenditures and payments.

Advocacy efforts of the Local Government Association in the area of local finances

Over the past two years, NAMRB has prioritized enhancing the financial framework for municipalities amidst political instability. This effort resulted in increased central budget support for municipalities.

Decentralization has been a key focus, with NAMRB developing and consulting with all municipalities a financial decentralization model based on four elements:

- Sharing 20% of Personal Income Tax (PIT) revenues with municipalities.
- Sharing 10% of Corporate Income Tax (CIT) revenues with municipalities.
- Expanding property taxes to include agricultural land and forests.
- Improving the legal framework for accurate property tax assessments.

In 2023, NAMRB finalized comprehensive analyses and proposals for financial decentralization, including amendments to the Local Taxation and Local Fees Act and the Municipal Property Act. Among others, proposals aimed to introduce shared tax revenues, clear subsidy regulations, and updated property tax assessments. While some measures were recognized by the Council of Ministers, others were not supported by the National Assembly and were instead offset by the investment program approved in the 2024 State Budget Act. Although not all proposals gained parliamentary support (i.e. updating property tax assessments), NAMRB successfully secured commitments for the Municipal Investment Program through the 2024 State Budget Act, laying a foundation for ongoing fiscal reforms.

Mechanisms for Dialogue and Coordination Between Levels of Government

The Law on Local Self-Government and Local Administration designates NAMRB as the official representative of local authorities before state bodies in the process of developing proposals for changes and improvements to the legal framework of local self-government, during the preparation of the national budget draft concerning municipalities, and in the execution of contracts and interactions with similar organizations from other countries and within international associations.

As an equal partner in national decision-making, NAMRB is involved when new laws are enacted that affect local government competencies and financing. In terms of municipal budget financing, NAMRB and the Ministry of Finance conduct formal negotiations on the amount of funds for municipalities in the draft State Budget Act for the fiscal year.

NAMRB facilitates intergovernmental dialogue, acting as a cooperation platform between central and local governments, with nearly 700 representatives from various municipalities involved in different formats – including institutional, inter-institutional, working groups, consultative councils, international organizations, and monitoring committees.

The Association's permanent thematic committees, comprising elected officials and municipal experts, support advocacy efforts and maintain contacts with central authority representatives. Their key tasks include proposing legal improvements, sharing positive experiences, and fostering inter-municipal cooperation.

Additional collaboration mechanisms that strengthen dialogue and coordination between central and local authorities include:

- **Sectoral Consultative Committees**: These committees involve local authorities in decision-making across various sectors. They are established within line ministries (e.g., ministries responsible for education, health, and environment) and within such committees, municipalities ensure that local perspectives inform national policies.

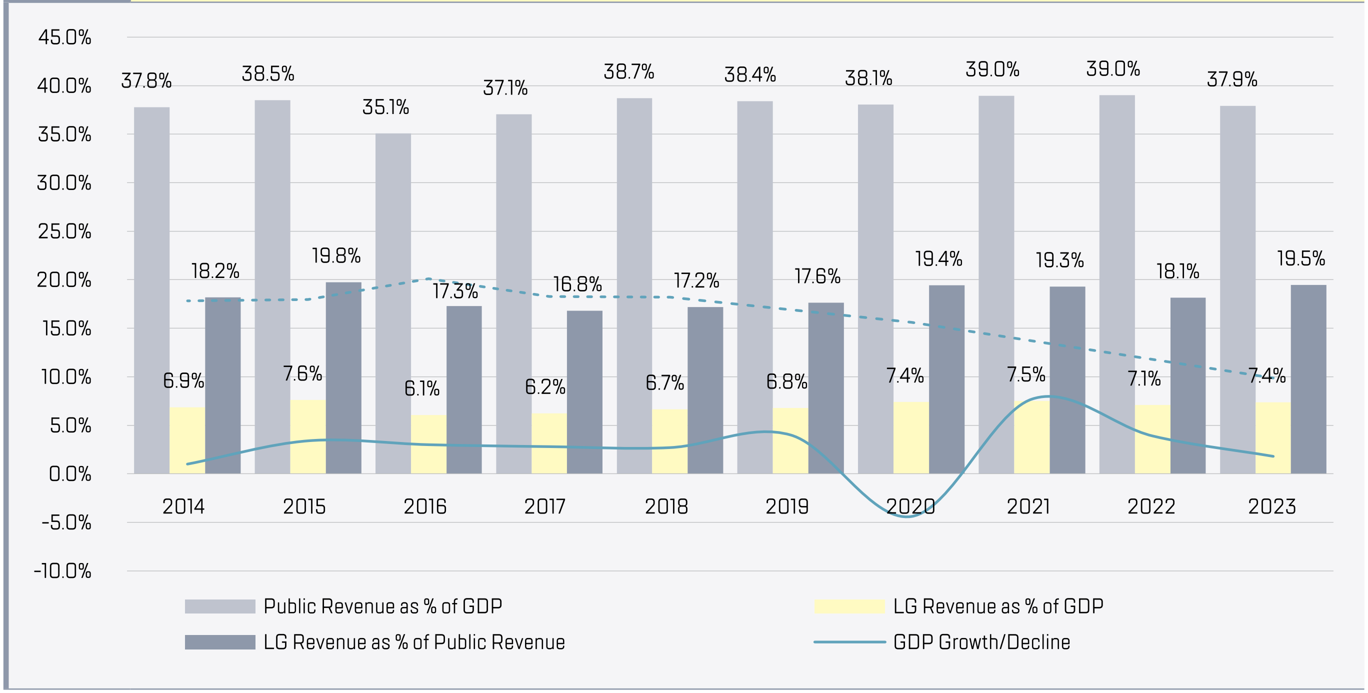
- **National Council for Decentralization**: This consultative body promotes decentralization and coordination between central and local authorities. It includes representatives from line ministries, local governments, and civil society, to develop policies that enhance decentralization and local capacities to manage public services and resources.

- **Regional Development Councils**: Operating at the regional level, these councils involve representatives of the central government, regional administrations, to coordinate development plans and EU-funded projects, aligning national and local priorities for infrastructure, economic development, and social services.

Statistical Overview

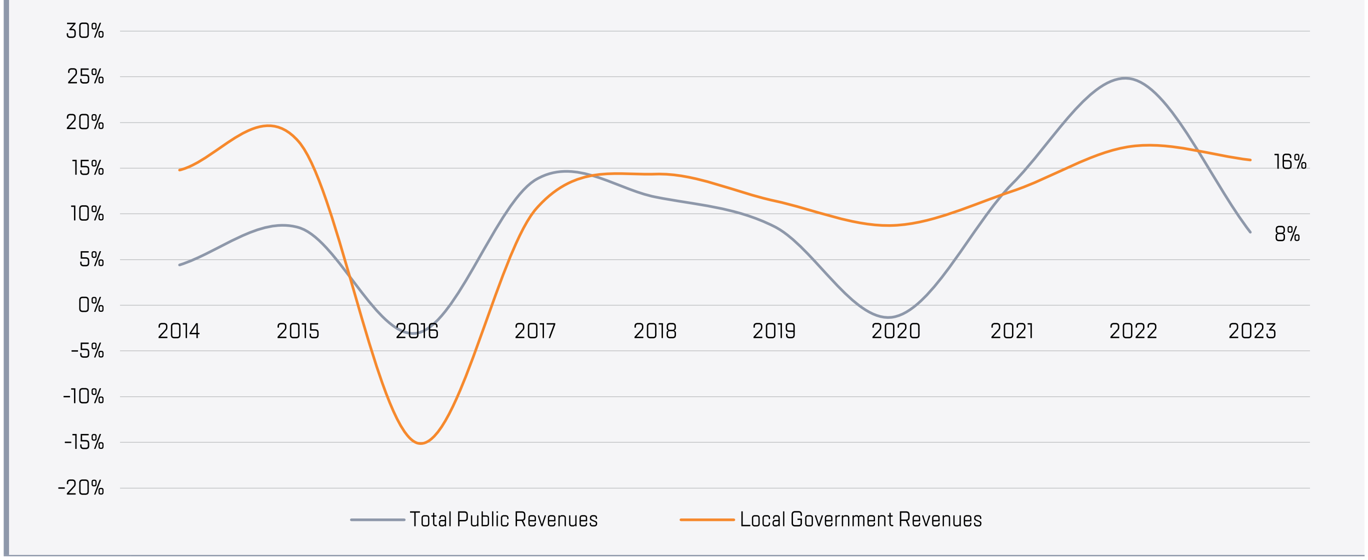
Local government (LG) revenues as a percentage of GDP in Bulgaria fell from 6.7% in 2008 to 5.7% in 2011, then began to recover, reaching 7.4% in 2023. This increase reflects municipalities' efforts to stabilize budgets, especially through the economic challenges of the COVID-19 pandemic. The 4.4% GDP drop in 2020 contributed to a higher LG revenue-to-GDP ratio, with local revenues reaching 7.1% in 2021 and further increasing to 7.4% in 2023, levels seen last in 2015 when EU-funded projects drove local government expenditures. As a share of public revenues, LG revenues followed a stable but rising trend, peaking at 20.0% in 2015, and settling at 19.5% in 2023. Despite economic shocks from the 2008 financial crisis and the pandemic, public revenues fluctuated modestly between 35% and 39% of GDP.

Figure 57. *Local Government Revenue and Total Public Revenue*



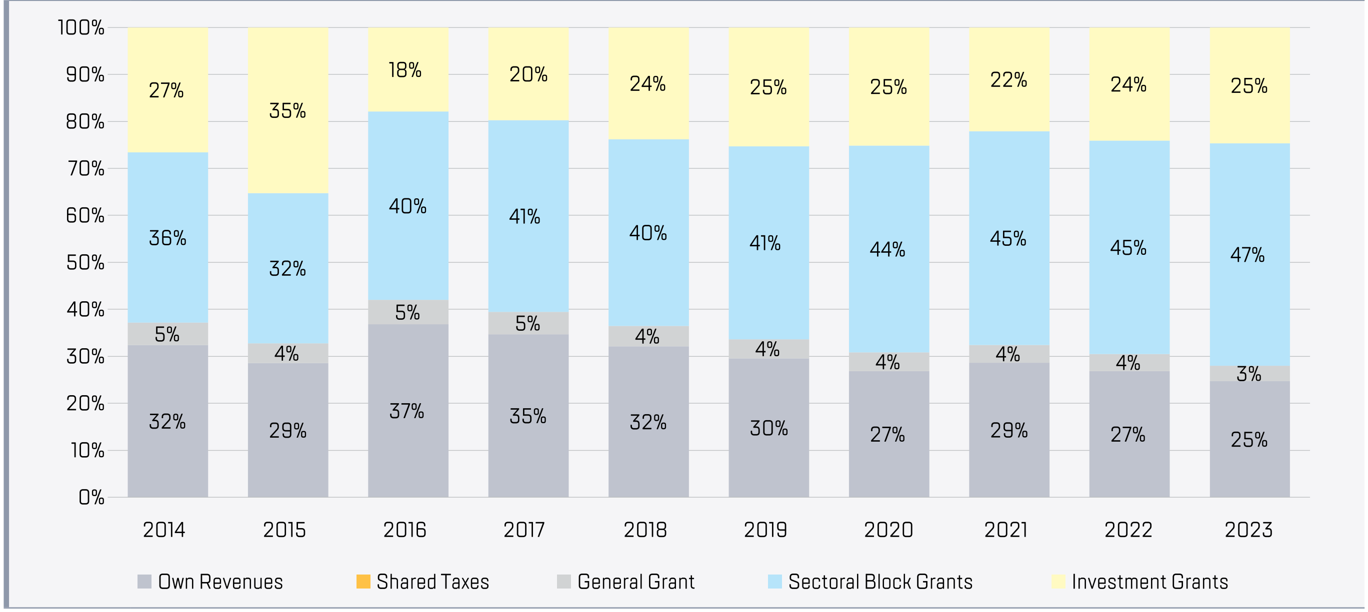
LG revenues have generally moved along the pattern of overall public revenues in the past decade, sometimes exceeding the growth rate of total public revenues. In 2023, local government revenues rose by 16% year-over-year, while overall public revenues grew by 8%.

Figure 58. Annual Fluctuations in the Revenues of the General and Local Governments



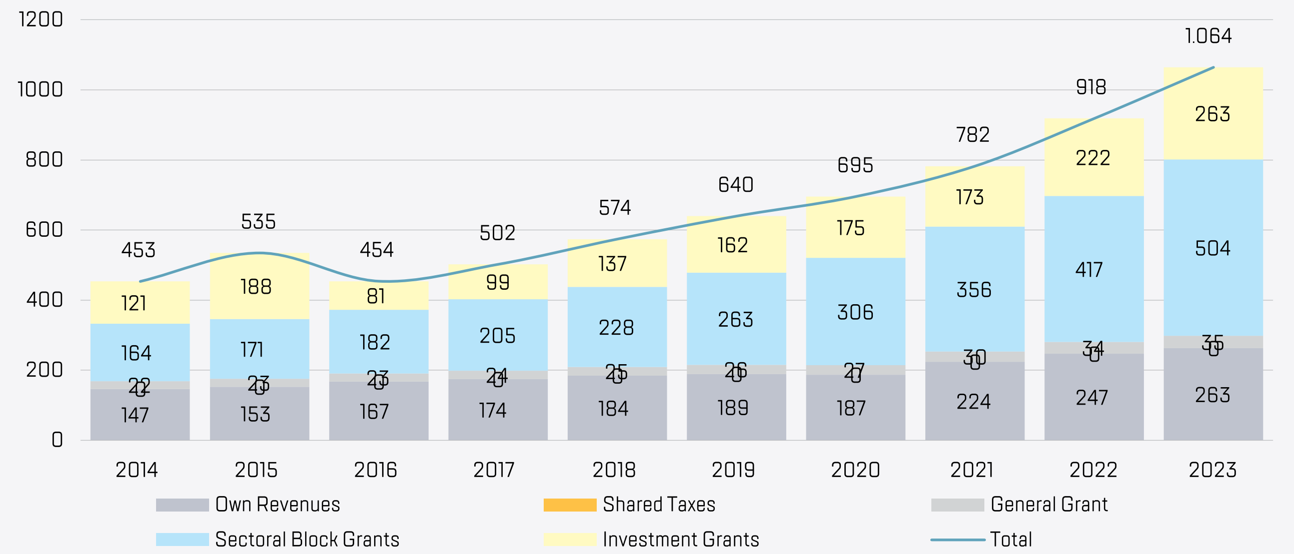
Over time, the share of local own revenues decreased from 38% in 2006 to 25% in 2023. In contrast, sectoral grants, which target specific sectors, rose from 16% to around 47-48% of total LG revenues. General grants remained low and stable, around 4-5%.

Figure 59. Composition of Local Government Revenues, in % of total



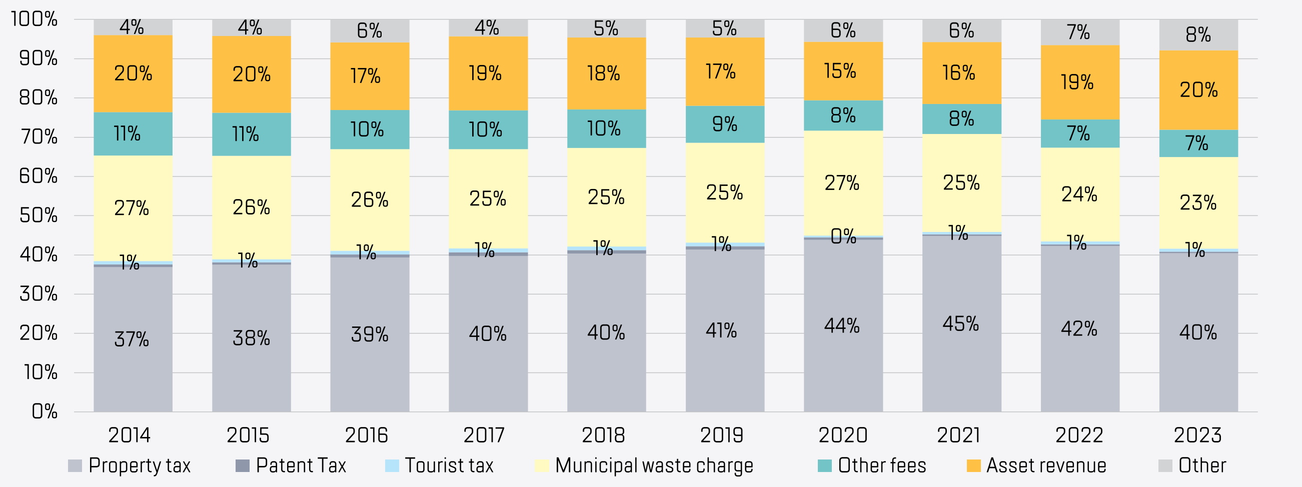
Overall, LG revenues in Bulgaria amount to 6.9 billion EUR in 2023, or 1,064 EUR in per capita terms, one of the highest in South-East Europe.

Figure 60. *Composition of Local Government Revenues, in EUR per capita*



Property taxes, waste management fees, and asset revenues formed significant portions of own source revenues. Property taxes alone make up to 40% of LG own-source revenue.

Figure 61. *Composition of Own source revenues, in percent of total*



In 2023, municipal expenditures increased by 23% compared to 2022, with expenditures for salaries and capital investments growing by 21% and 23% respectively. Indeed, capital spending recovered in 2023 after four consecutive years of decline. Given their extensive social responsibilities, Bulgarian municipalities spend more than half of their budgets on salaries for the remuneration of employees.

Figure 62. Composition of LG Expenditures, in percent of total

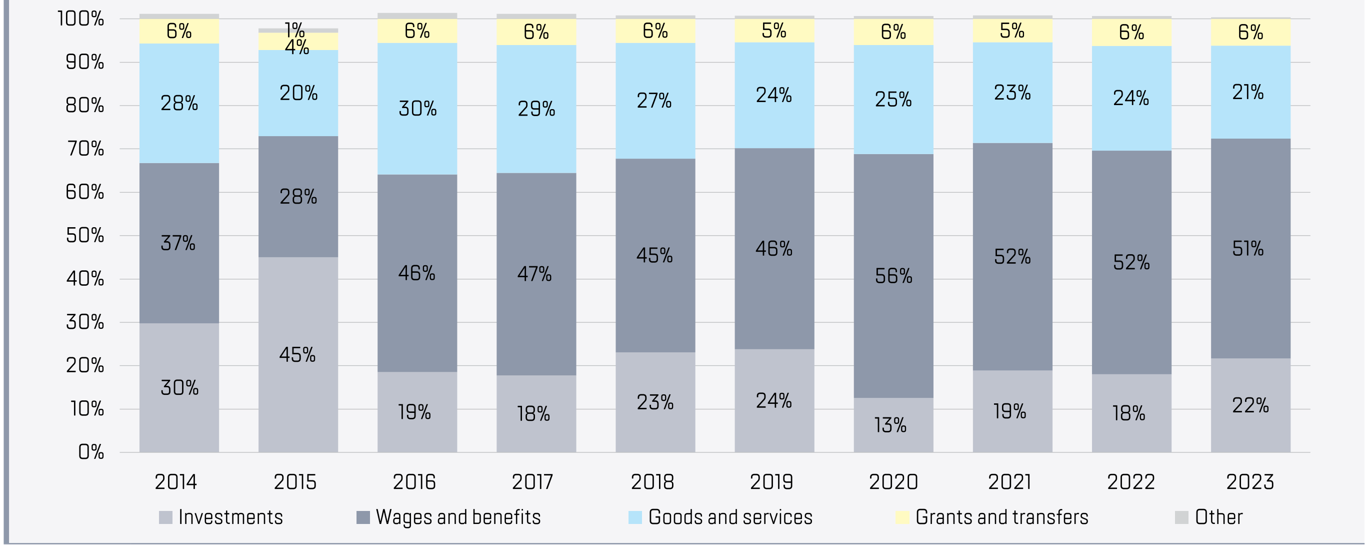
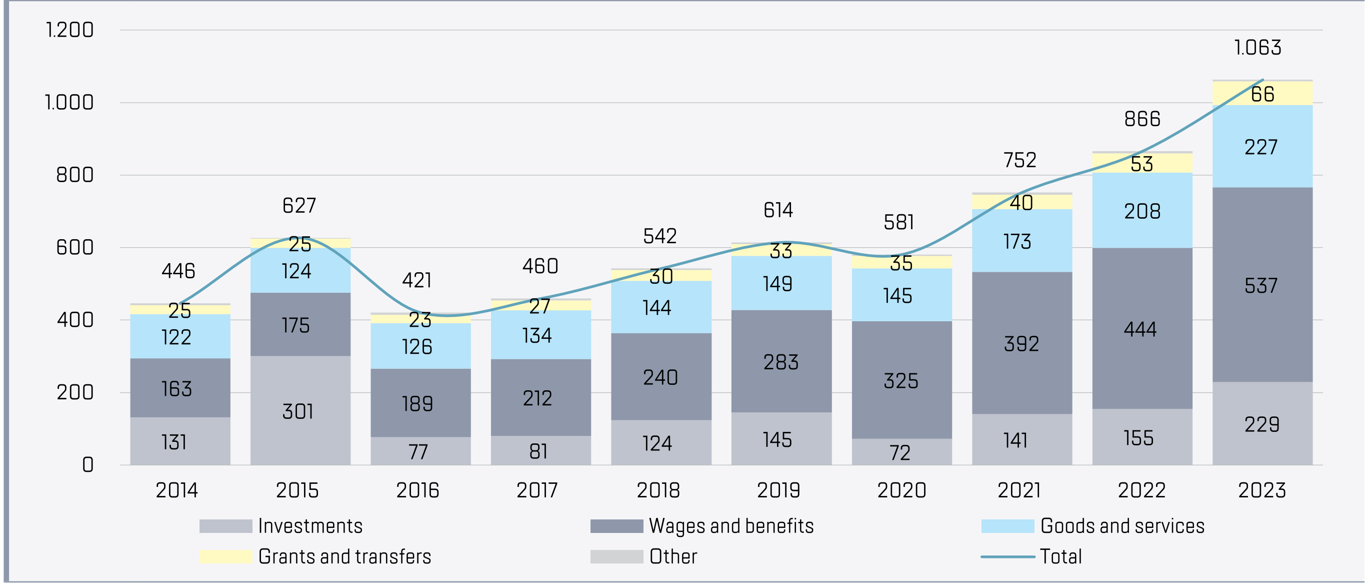
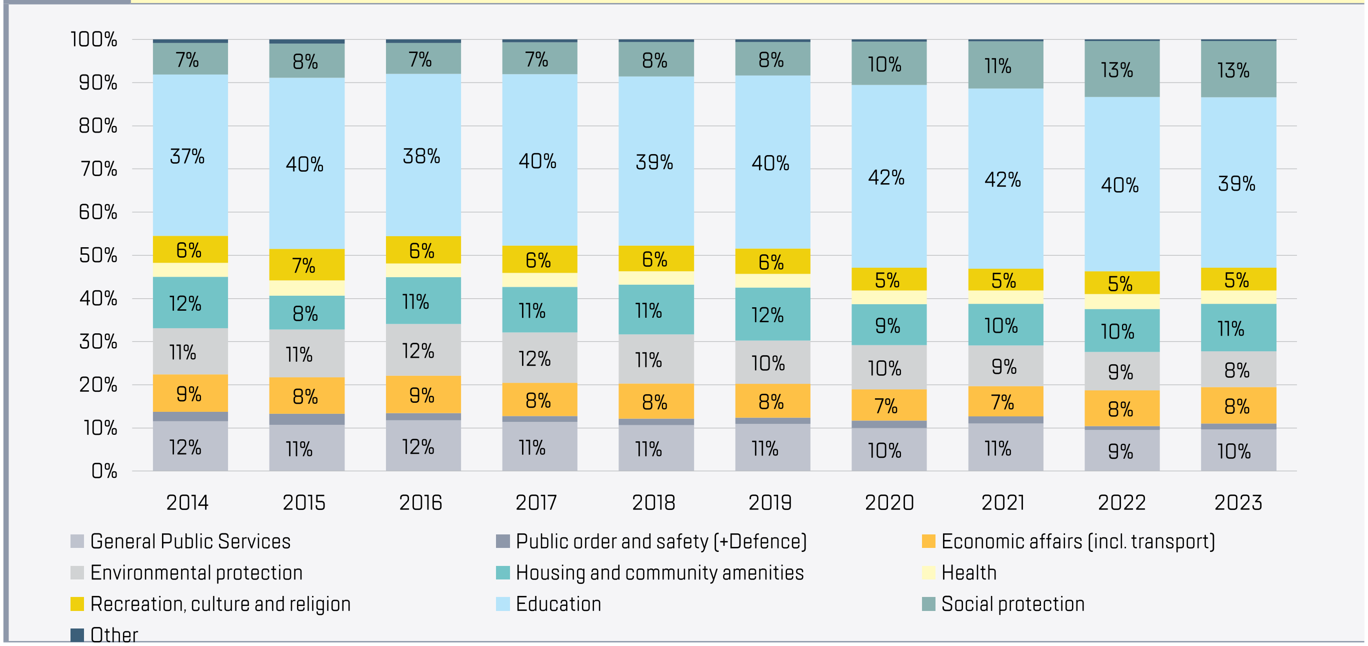


Figure 63. Evolution of the composition of LG Expenditures, in EUR per capita



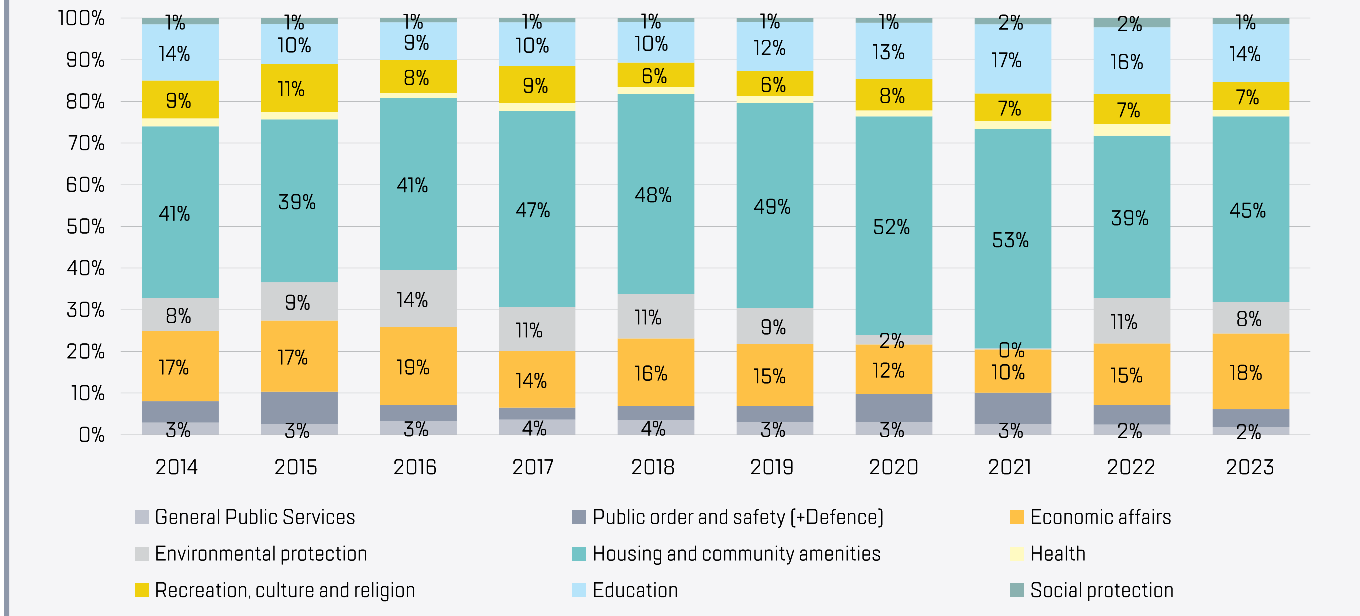
Housing, community amenities, social protection, general public services, recreation, culture, religion, education, and healthcare experienced the largest increases in expenditure in recent years. Education holds the highest share of municipal expenditures decreasing from 42% in 2021 to 39% in 2023. Healthcare expenditures remained minimal at 3%, considering that this is mainly a central government responsibility.

Figure 64. *Functional Allocation of Expenditures (COFOG classification)*



Housing and urban development dominated municipal capital investments at 45%, while education investments dropped to 14% in 2023.

Figure 65. *Functional Allocation of Capital Expenditures (COFOG classification)*



Croatia

By Dario Runtić, Advisor to the Association of Cities in Croatia

The Intergovernmental Finance System

Croatia's intergovernmental finance system is largely based on the origin-based sharing of **Personal Income Tax (PIT)** revenues. Local governments (LGs) receive 74% of PIT revenues collected in their jurisdiction, while regional governments get 20%, with an additional 6% earmarked for decentralized functions performed by local and regional governments (LRGs). Until 2024, LGs could impose a surcharge of up to 18% on PIT, which constituted 10% of local PIT revenues. In 2023, PIT revenues (including surtax) accounted for 46.5% of local and regional government revenues.

As of January 1, 2024, the PIT surcharge was abolished and integrated into the PIT. Municipalities and cities now have the authority to set their own PIT rates, ranging from 15% to 23.6% for the lower rate and from 25% to 34.5% for the higher rate. These changes simplify the tax system and increase local government autonomy in setting tax rates. Additionally, the basic personal tax deduction has increased from €530.90 to €560, and thresholds for the higher tax rate and deductions for dependents have been raised.

Personal Income Tax:

- 74% Cities & Municipalities
- 20% Regional Governments
- 6% earmarked for decentralized functions

PIT Rates:

- LGs can set PIT rates as of 2024

Property transfer tax (PTT), which is shared 100% with local governments, accounts for about 4% of local government revenues. PTT rate is 3% of the market value of the transferred property. This revenue has grown significantly in the past decade due to rising property values and increased real estate activity, making it the fastest-growing local government revenue stream. PIT Income from capital, a segment of PIT, has also seen a dramatic five-fold increase.

Croatia has two types of **earmarked grants**, both aimed at financing specific functions transferred to local and regional governments in the early 2000s, including primary and secondary education, social welfare, healthcare, and fire protection. **6% of PIT revenues are earmarked** to those RLGs that carry out the above-mentioned specific functions. Each RLG's share in PIT is increased for – 1,9% for primary education, 1,3% for secondary education, 0,8% for social welfare, 1% for healthcare and 1% for fire protection. Expenditures beyond this 6% allocation are covered by the **Equalization Fund for Decentralized Functions (EFDF)**, which is funded by the state budget and determined annually by national line ministries. For 2024, the EFDF is planned at 217 million Euro, down from 258 million Euro in 2022, due to growth in PIT revenues. The EFDF is allocated based on function-specific minimum standards, which are determined by national bylaws and include:

- Primary and secondary education: number of pupils, classrooms, and school buildings
- Social welfare: number of beneficiaries

Earmarked Grants:

- **Earmarked PIT**: 6% of PIT for decentralized functions
- **Equalization Fund** for Decentralized Functions (EFDF) funded by the state budget.
- **Allocation**: based on specific minimum standards

- Healthcare: number of insured persons, service locations, healthcare institutions, bed capacity
- Fire protection: base funding, brigade classification, number of inhabitants within a 15-minute reach

While the EFDF provides most of the funding for decentralized functions, it makes local governments vulnerable to fluctuations in national budgets and economic trends.

The **Fiscal Equalization Fund (FEF)** is a non-earmarked grant fund of 265 million Euro (5% of total local government revenue) established in 2017 and disbursed from 2018. Its purpose is to reduce PIT revenue disparities across local and regional governments. Initially, the FEF was funded by 17% of the collected PIT revenues, automatically distributed to recipients daily. However, as of 2021, this 17% share was reallocated to LRGs to compensate them for the central government-imposed reduction in PIT rates. Since then, the FEF has been funded from central government revenues and classified as a general grant.

Fiscal Equalization Fund:

- **Aim**: reduce PIT Revenue disparities.
- **Size**: National Budget, 265m€
- **Allocation**: on individual shares set in advance combining target and actual per capita PIT revenues.

The FEF funding is allocated to local governments based on individual shares which are set in advance for the budget year, calculated as the difference between *national target* per capita PIT revenues and *individual potential* per capita PIT revenues. Target revenues are based on a 5-year average of PIT revenues per capita collected by all municipalities/cities/counties, assuming maximum PIT surcharge levels. Potential revenues are similarly calculated using the surcharge, encouraging LGs to use their surcharge powers. Any difference between collected and potential revenue due to unused surcharge powers is not funded by the FEF. Local governments may challenge elements of the FEF, such as target levels or share calculations, in the Constitutional Court. The FEF is regarded as a significant positive development, reducing PIT allocation disparities and enhancing transparency. However, its reliance on national government funding has increased the dependency of the FEF on the national budget process.

Own Source Revenues

Own Source Revenues (OSRs) account for 24.1% of total local revenues, a decrease from 32.9% before the COVID-19 pandemic. While the share of OSRs in total revenues has fallen, they have increased in absolute terms by 79 million Euro from 2022 and 103 million Euro from 2019. The decline in OSRs' share is primarily due to faster growth of shared taxes (PIT) and investment grants (EU funds). In response to the COVID-19 crisis, local governments reduced or exempted businesses from OSRs, and some sources, like asset rentals, have yet to fully recover, despite significant increases in private asset rental prices compared to pre-COVID levels.

OSRs are crucial for funding local services in Croatia, comprising taxes, fees, and charges imposed on individuals, businesses, and property owners. These include communal fees (for infrastructure maintenance), surtax on PIT, taxes on motor vehicles, boats, gifts, inheritances, second homes, public space usage, and asset rentals. Municipal fees are essential for financing local services and infrastructure. Croatia employs a mixed system where national regulations set fee parameters, but municipalities have some autonomy in defining specific fees and exemptions. Some local taxes, such as those on vehicles and inheritance, are highly regulated, while others, like the communal fee and public space tax, are more flexible.

In Croatia, LGs rely significantly on two main OSRs: the **Land Use Fee (LUF)** and **Land Development Fee (LDF)**, accounting for 35.9% of OSR. The former is known locally as the "Communal Fee" and the latter as "Communal Contribution". Croatian local governments also derive 21% of OSR from asset rentals and 18.9% of OSR from the surtax of the PIT.

The legal powers granted to local governments to assess, impose and collect taxes and fees from their constituencies vary. The LUF and LDF are set in national legislation but allow local adjustments through local bylaws. The national law determines the method of calculation, taxpayers, general exemptions, and legal remedies. Local governments can set the base LUF rate (uncapped), while the LDF is capped by law at a maximum rate of 10% of the average construction cost for one cubic meter in Croatia. LGs also have power over zoning regulations and eventual additional factors that affect calculation, tax administration process etc. These fees cover property-related responsibilities and are directly administered by local authorities without the possibility to outsource to the National Tax Administration or other third parties. Also, national legislation defines the tax base and sets or caps the rate of all local and shared taxes, except for the LDF and the Tax on Use of Public Space.

Stability of Local Taxes and Fees. Local fees and taxes are relatively stable in terms of rate, base, and exemptions for extended periods of time. This consistency promotes a predictable system for taxpayers, enhancing stability and aiding in financial planning. However, prolonged periods of stagnation, due to legislative restrictions or local policy choices, can limit revenue growth. This, coupled with rising personnel and operational costs, challenges the capacity of local governments to sustain service levels. For example, the Second Home Tax rates, expressed in absolute value, have been virtually unchanged for 30 years (1-3 DEM, 5-15 HRK, 0,66-1,99€ per square meter).

In recent years, Croatia's central government has introduced a **shift in tax policy** to reduce reliance on income taxes and increase property-based taxation. This approach is intended to benefit local government fiscal space, as property-related revenues are typically local revenues, and the tax base is immovable. As part of this policy shift, **Second Home Tax** rates have been adjusted from the longstanding values, with rates now set between €0.6-5 per square meter in 2024 and planned to increase further to €0.6-8 in 2025.

Efforts to Strengthen Fiscal Registers and Compliance in Croatia. As in many other economies in the region and beyond, the main challenge facing Croatian local governments as regards fiscal autonomy and tax administration is the establishment, harmonization and update of fiscal registers of their tax base (buildings, land, transactions etc.,) and taxpayers. Both local government proactive initiatives and the **automated exchange of information** between national and local registers are essential for effective tax administration. To facilitate this, the central government has enabled access to several registers via the **Government Service Bus (GSB)** and simplified administrative processes for electronic access to the registers. The **Association of Cities (AOC)** has supported local governments by promoting register access, preparing sample documentation, and developing a no-cost IT solution for cities to access citizen income records.

Local governments can however benefit from various market solutions that integrate with national registers for enhanced service provision. However, timely access to critical real-estate data—such as usage permits and specific property transfer details—remains a challenge, requiring potential legislative or organizational reforms.

Despite these improvements, **non-compliance among taxpayers** persists, particularly in reporting changes in personal or property information, such as primary residence or ownership. Low penalties, especially for underreporting (e.g., second-home tax, with fines starting at just €10), contribute to non-compliance. To counteract this, new legislation under public consultation proposes increased penalties, starting at €1,000 for underreporting, aiming to boost compliance and safeguard local tax revenues.

Local Government Borrowing

Local governments in Croatia may incur short-term and long-term debt, pending approval of the Government or the Minister of Finance, at domestic and foreign market by taking credits, loans and issuing securities. The national borrowing cap for local and regional governments equals 3% of total revenues of all local and regional governments.

Local governments may undertake **short-term borrowing** exclusively to bridge temporary cash flow gaps - caused by the different dynamics of the inflow of funds and the maturity of liabilities for a maximum of 12 months, without the possibility of further reprogramming or taking out new short-term credits or loans.

Local governments can incur **long-term debt** under specific conditions:

- For **capital investments** from their budget related to non-financial asset acquisition.
- For **capital assistance** to companies or entities they own or co-own, specifically for EU co-financed projects (and projects prescribed by special regulations).
- For **ineligible costs** co-financed by EU funds.

The **Government or Minister of Finance** will **not approve new borrowing** if it exceeds the national cap (3% of total LG revenues) or if annual debt repayments surpass **20% of the prior year's revenue** for the borrowing local government. This **20% repayment cap** includes the average annual repayment obligations from credits, loans, issued securities, guarantees, and other borrowing approvals, as well as obligations due in the latest financial statement. However, borrowing up to the **total eligible costs of EU-funded projects** and **investments in energy efficiency** are exempt from this repayment limit.

Budgetary users can incur long-term debt for the same purposes as local government units, refinance and reprogram the rest of the debt, with prior approval of the local government. Extra-budgetary users can borrow long-term from an international financial institution, with prior approval from the Minister of Finance.

Guarantees and Refinancing. A regional government may issue a guarantee for a local government within its jurisdiction, with prior consent from the Minister of Finance. Likewise, local or regional governments can provide guarantees for long-term borrowing to their budgetary and extra-budgetary users, as well as to legal entities they majority-own or co-own, also requiring the Minister of Finance's approval. When guarantees are issued, they count towards the total allowable debt of the guaranteeing local or regional government, proportionate to its ownership share in the entity receiving the guarantee. An exception applies for guarantees on projects that are co-financed by the European Union—these guarantees do not count toward the allowable debt limits, allowing flexibility for EU-funded projects.

If local or regional governments borrow or issue a guarantee without the prior approval of the government or the Minister of Finance, such borrowing or guarantee is considered null and void.

Local governments have the option to refinance or reprogram debt, but this is only permissible if the total annual annuity (annual debt repayment) and/or maturity (the duration of debt obligations) are not increased. Additionally, local governments must report quarterly to the Ministry of Finance within the budget year, by the 10th of the following month, on the status of their debt repayment and the status of active guarantees.

As of now, local government debt in Croatia is 2% of GDP, reduced from 2.6% during the COVID-19 period. During the pandemic, local governments significantly increased borrowing to sustain capital investment programs and offset revenue losses, with the government offering interest-free loans to assist, particularly in regions like the Adriatic coast, which faced the most significant losses. These loans had a three-year maturity from the disbursement date. In 2022, local governments began a deleveraging program, reducing their outstanding debt by 0.6% of GDP.

Advocacy efforts of the Local Government Association

Over the past two years, the Association of Cities of Croatia (AOC) has worked closely with the Government to integrate the Euro currency into the legislative framework, update local government (LG) financial planning and reporting systems, and ensure the regular provision of local services.

The remarkable growth in revenues over this period stemmed from rising private sector wages, new construction, and increasing property values and rents. However, this growth also intensified internal and external pressures, particularly in relation to the local government wage bill. Local government administration in Croatia has faced significant staffing challenges, partly due to wage disparities. Between 2020 and 2023, the number of employees in local government administration decreased by 14.5%, from 22,109 to 18,904. This reduction was largely due to the fact that average wages in local government fell behind the national average, making it difficult to attract and retain staff.

The situation varied across local government types:

- **Counties** saw a 3% increase in staff, likely due to less restrictive provisions in the wage law.
- **Cities** experienced an 11% reduction in staff.
- **Municipalities** were hardest hit, losing 31% of their workforce.

Many local governments, particularly municipalities, faced constraints under the Wage law that restricted their ability to raise wages, resulting in a significant outflow of employees. The AOC engaged actively with stakeholders to address these challenges, focusing on improving employment conditions and retaining staff.

Externally, local governments faced **additional financial pressures** from central government mandates, such as significant **increases in firefighter and teacher wages**. Currently, the central government provides regular funding for firefighting from the PIT and EFDF, which now cover less than half of the costs associated for the minimum wages of firefighters. Increases in teacher salaries at the national level triggered demands for similar raises from kindergarten teachers and staff, further straining local government budgets. Despite numerous efforts by the AOC to address these issues through national-level discussions, the impact of these financial pressures remained considerable.

Strong revenue growth, while beneficial, can lead to **fiscal imbalances** if it is based on temporary factors. If local governments increase spending based on temporary revenue growth, they risk budget deficits and unsustainable debt when revenues eventually fall. Prudent fiscal management and transparent policies are crucial to mitigate these risks and ensure that strong revenue growth leads to sustainable economic development. To manage these risks, the AOC worked closely with the Ministry of Finance (MoF) on new regulations concerning budgetary accounting, the chart of accounts, investment project evaluations, and the mandatory publication of itemized local government spending data in machine-readable formats.

Mechanisms for Dialogue and Coordination between Levels of Government

In Croatia, the formal mechanism for broad intergovernmental dialogue is the **Parliamentary Board for Local Governance**. However, there is also an informal, regular public forum that brings together the Government, County prefects, and the Presidents of the AOC and the Association of Municipalities. Additionally, various ad-hoc legislative task forces and working groups, established by the Government or line ministries, facilitate specialized intergovernmental dialogue.

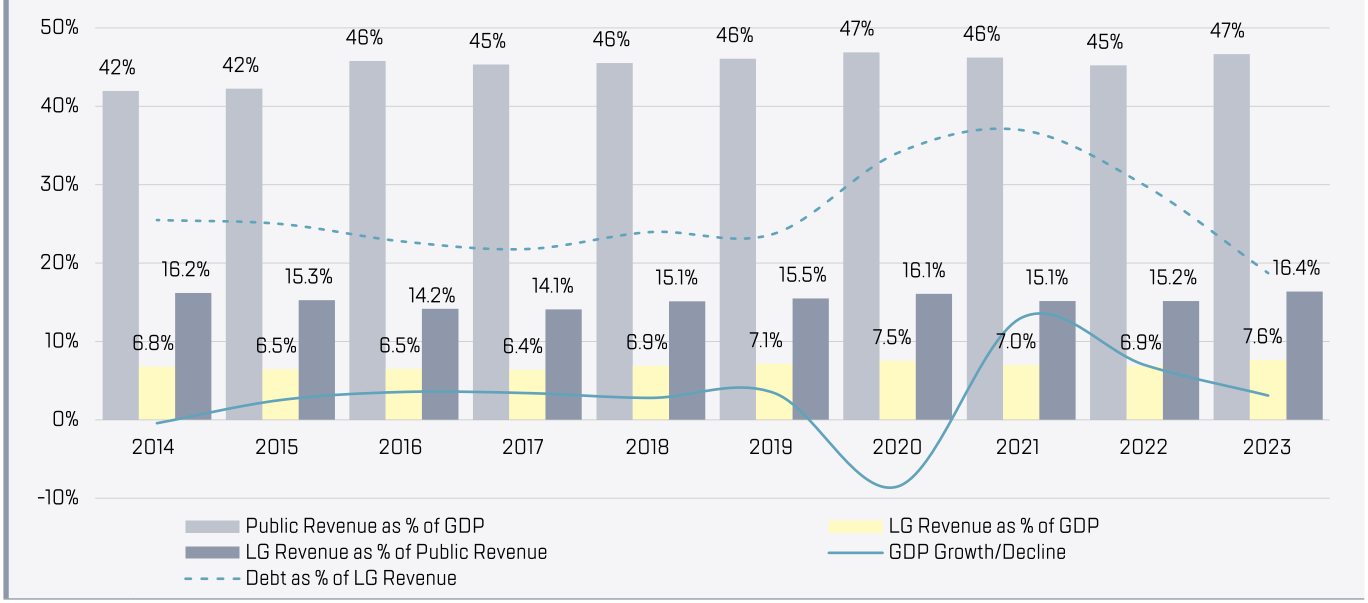
The Parliament of Croatia has institutionalized a three-level mechanism for managing intergovernmental relations - the Parliamentary Board for Local Government. The Board plays a central role in shaping the legislative landscape for local governance. It is tasked with preparing and deliberating on draft legislation, providing expert advice, and proposing amendments to Parliament. The Board has the authority to engage external expertise, including scientific and other relevant organizations and individuals, to support the preparation of proposals and legislative reviews. It can also propose that certain tasks be delegated to specific ministries and conduct public hearings on proposed acts, legislative provisions, or other matters of public interest, in its pursuit of comprehensive and transparent policymaking.

The Board's core mandate includes overseeing the structure and competencies of local governments, the processes for establishing, dissolving, and merging local government units, and the financial and legal frameworks governing local public servants. The Board's composition includes a Chairman, a Deputy Chairman, and eleven members from Parliament, as well as nine members representing major cities, counties, and municipalities, ensuring broad regional representation. Legal expertise is provided by one lawyer. Although not explicitly mandated, the Board has demonstrated a commitment to inclusive governance by consistently inviting representatives of Local Government Associations (LGAs) to participate in all meetings for over a decade, recognizing the crucial role that LGAs play in effective local governance.

Statistical Overview of Local Government Finance in Croatia

Since 2015, the Croatian economy experienced a very strong growth with a temporary -8.6% GDP drop in 2020. Total Public Revenues in last four years hovered at around 46% of GDP. Local government revenues, as a share of GDP or share of general government revenue, kept close to their historical levels despite the PIT reforms and the COVID-19 crisis, thanks to strong economic growth and government support measures.

Figure 66. ***Croatia:*** *LG Revenue as a Share of GDP and Total Public Revenue*



The revenues of local governments and the General Government raised and declined in tandem over the course of last four years. Over the past decade, frequent PIT legislation changes kept local government revenues in the channel of 15-16% of public revenues. Strong growth of wages, property prices and rents, as well as major inflow of EU funding, had driven local government revenues by 47% compared to pre-pandemic 2019, or 43% compared to 2021. Growth of this proportions in last 25 years was observed only during the first phase of decentralization when both staff, competencies and funding were decentralized to local level.

Figure 67. ***Croatia:*** *Fluctuations in the General and Local Governments Revenue*

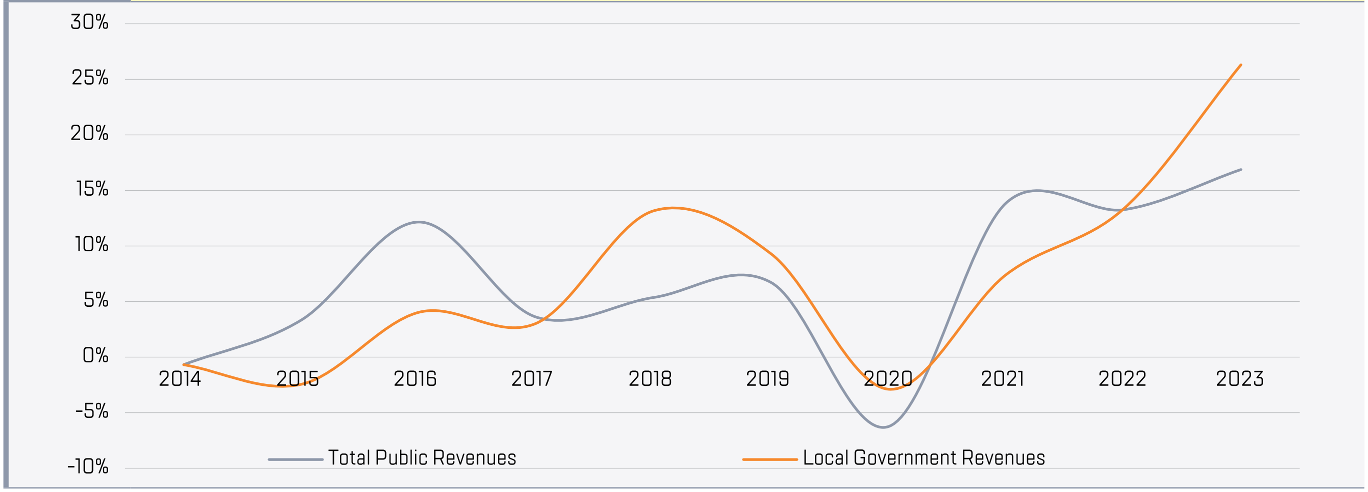
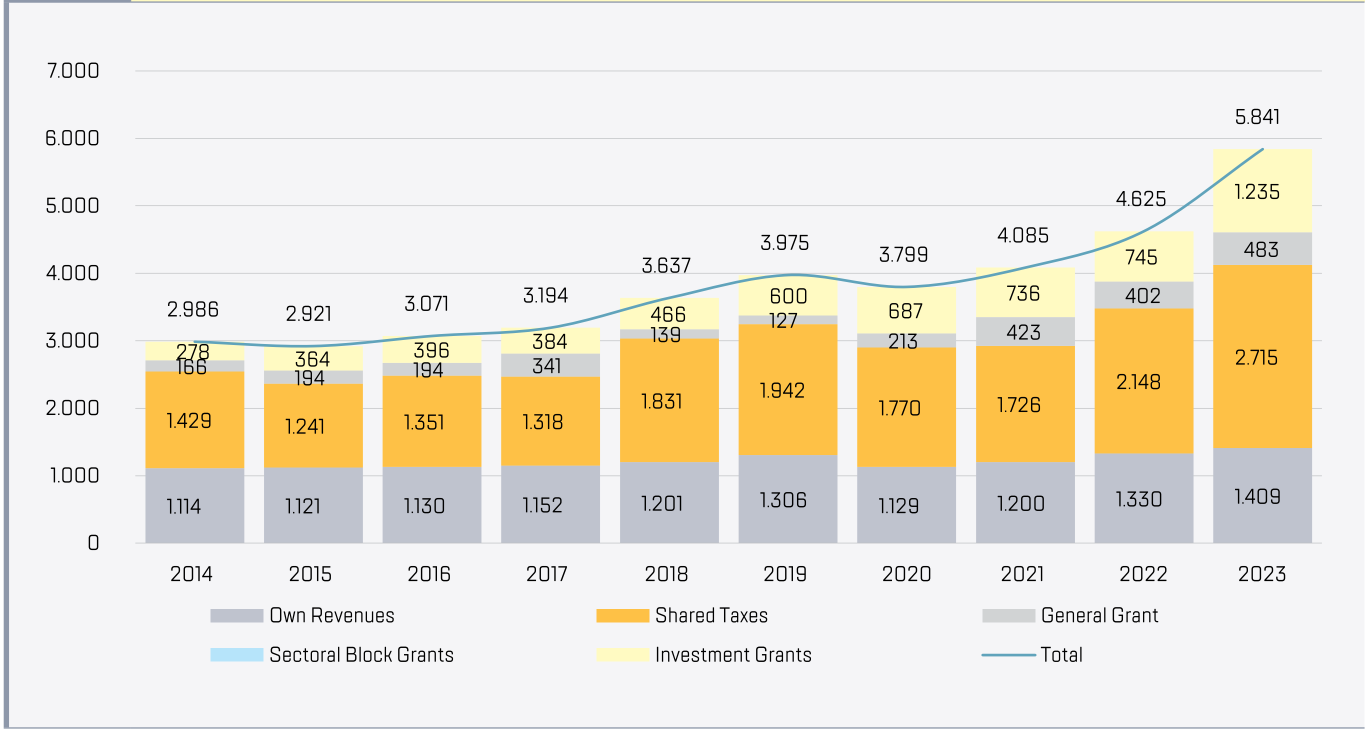


Figure 68. ***Croatia:*** *Local Government Revenue, in million Euro*

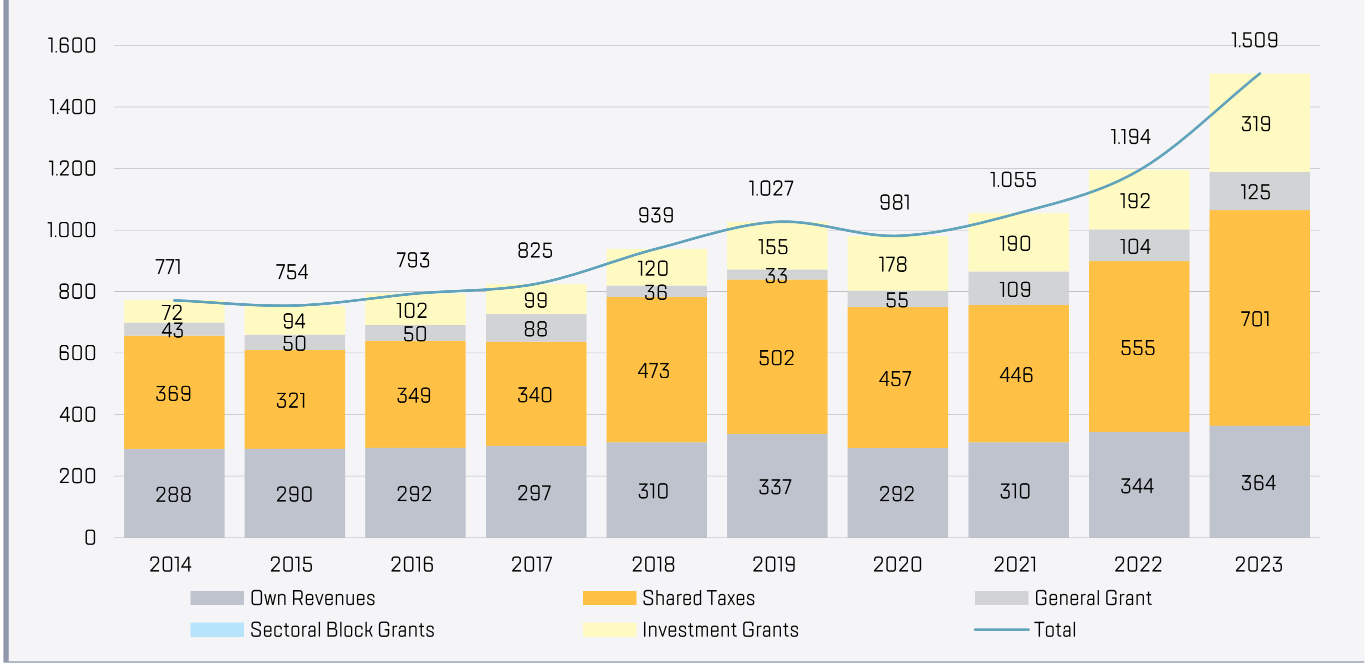


OSRs reduction had been used by LGs to assist struggling entities during pandemic times. OSRs recovered to pre-pandemic levels in 2022 and exhibited 6% growth in 2023, ending the year just 2 million euro shy of record pre-crisis year 2008. However, major increase of revenues is a result of increase of shared taxes (primarily PIT) and increase of investment grants (primarily EU grant funding).

EU funding in 2023 totaled €638 million, representing 51% of local government capital expenditure. Evidence suggests that EU funds finance 75-80% of local capital investment projects, highlighting the significant reliance on these resources. While this demonstrates the capacity of local governments to utilize EU funding, it raises concerns related to adequacy of budgetary planning and the alignment of EU and local priorities. Overlooking the true costs of EU-funded projects, including future operating expenses, particularly at this scale, could lead to future funding gaps if there is a mismatch between local and EU priorities.

In per capita terms, local government revenues in 2023 were 1.509 Euro, with 364 Euro per person coming from locally imposed taxes and fees and 701 Euro coming from shared PIT revenues.

Figure 69. ***Croatia:*** *Local Government Revenue, in Euro Per Capita terms*



Own source revenues constitute 24.1% of total local revenues, down from 32.9% in pre-COVID-19 periods. Although the share of OSRs in total revenues had decreased, OSRs have increased in absolute terms by 79 million Euro compared to 2022 or 103 million compared to 2019. Share of OSRs in total revenues had decreased due to much faster growth of shared taxes (PIT) and investment grants (EU). In the period of 2018 in which the FEF was introduced it boosted Shared tax share in total LG revenues until 2021 when it was reclassified as General grant due to legislative changes.

Figure 70. ***Croatia:*** *Composition of Local Government Revenue, % of total*

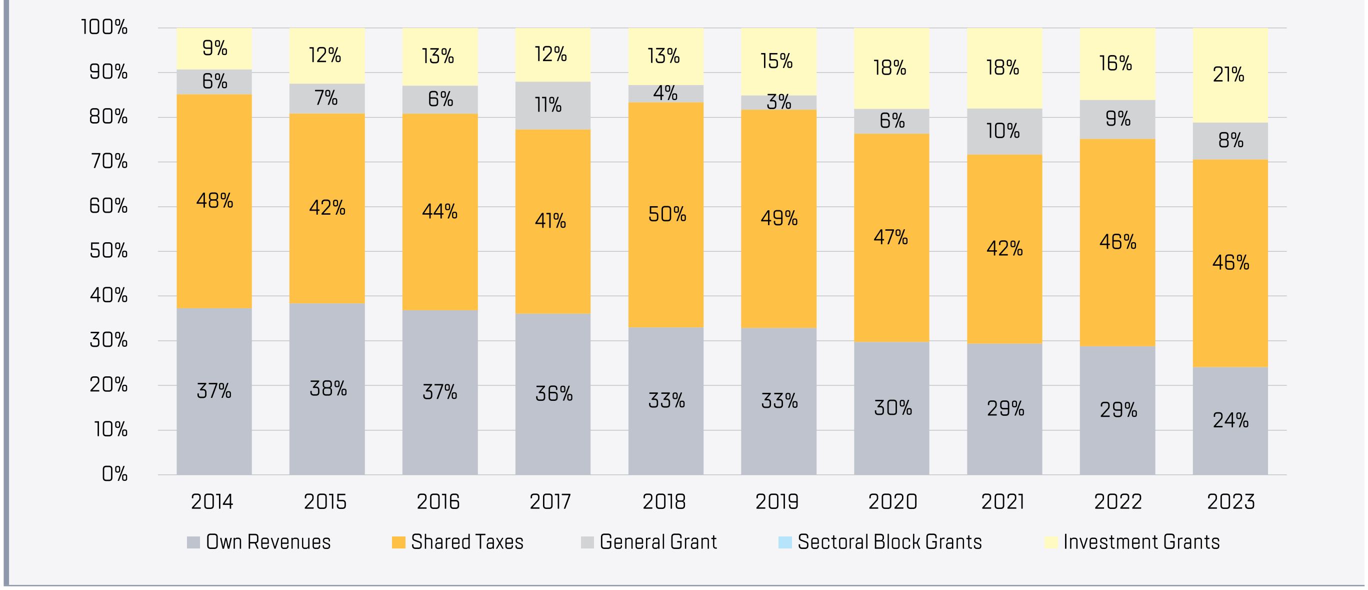
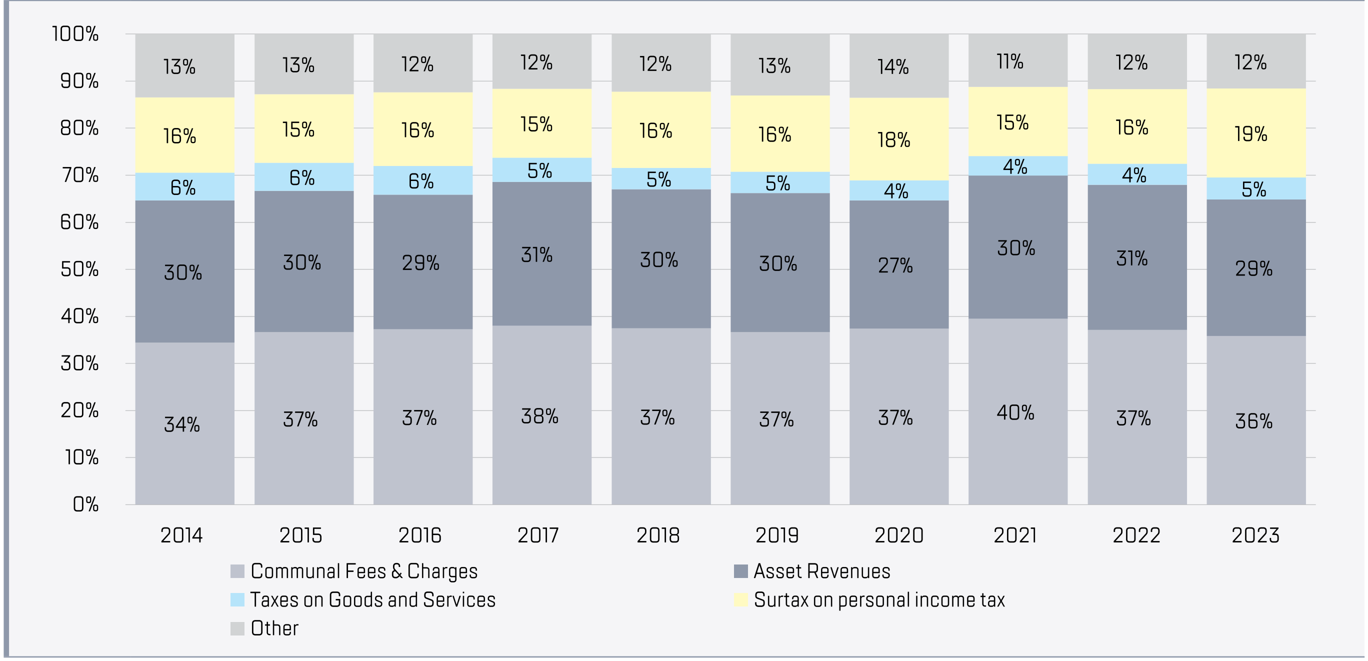
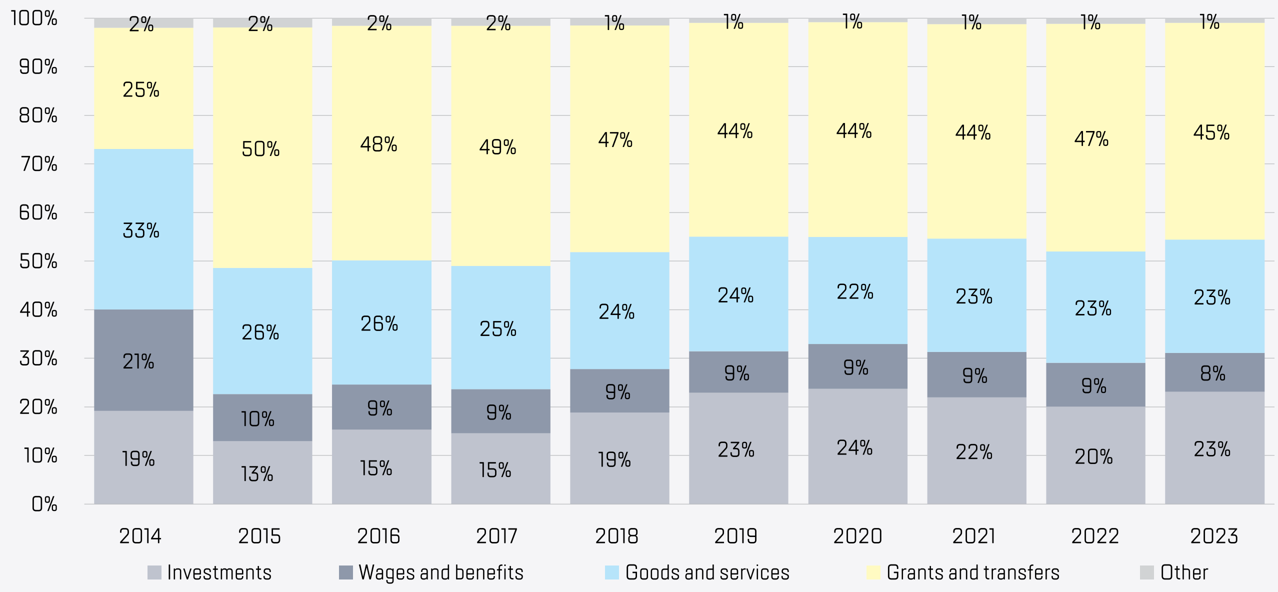


Figure 71. ***Croatia:*** *Local Government Own Source Revenue*



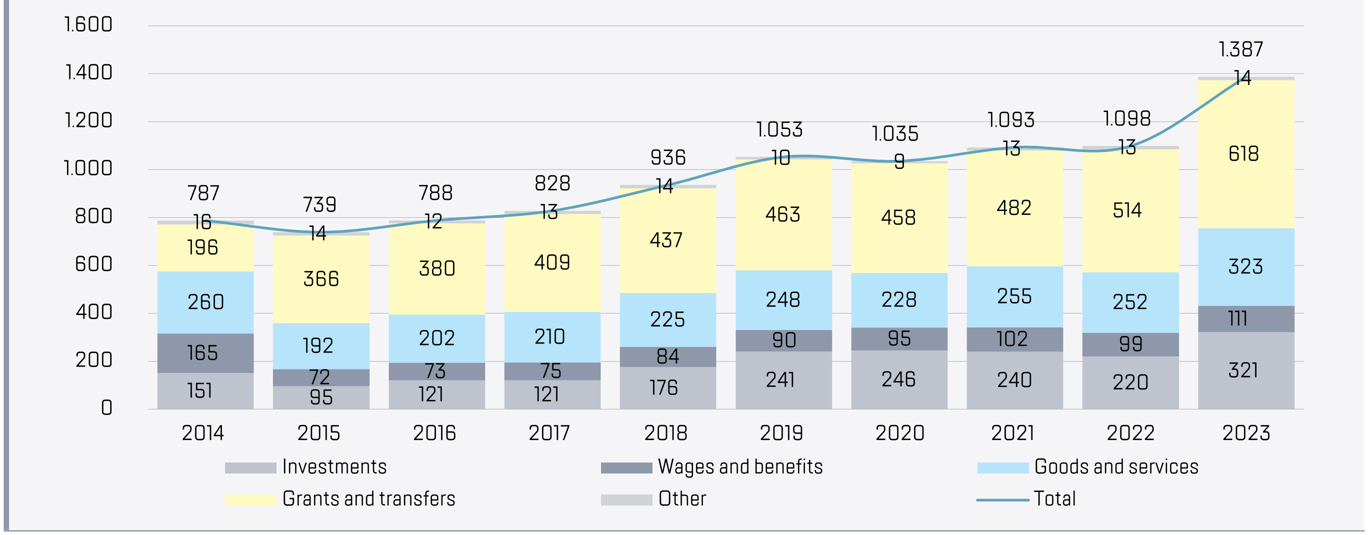
The Communal Fees and Charges dominate the composition of own source revenues with 36% (2023) of the total and have been steadily increasing since 2013 in absolute terms. The growth has been fuelled mainly because of receipts from the process of legalization of illegally constructed buildings starting in 2013. Increased efforts to update fiscal registers and the preparatory activities for the introduction of the property tax supported the growth from 2017. The share of Communal Fees and Charges in OSR fluctuates with changes of PIT surtax. The next significant groups are asset related revenues (sale and rentals) which jointly account for 29% of LG own source revenues and have kept these levels for extended periods of time.

Figure 72. ***Croatia:*** *Composition of Local Government Expenditure, % of total*



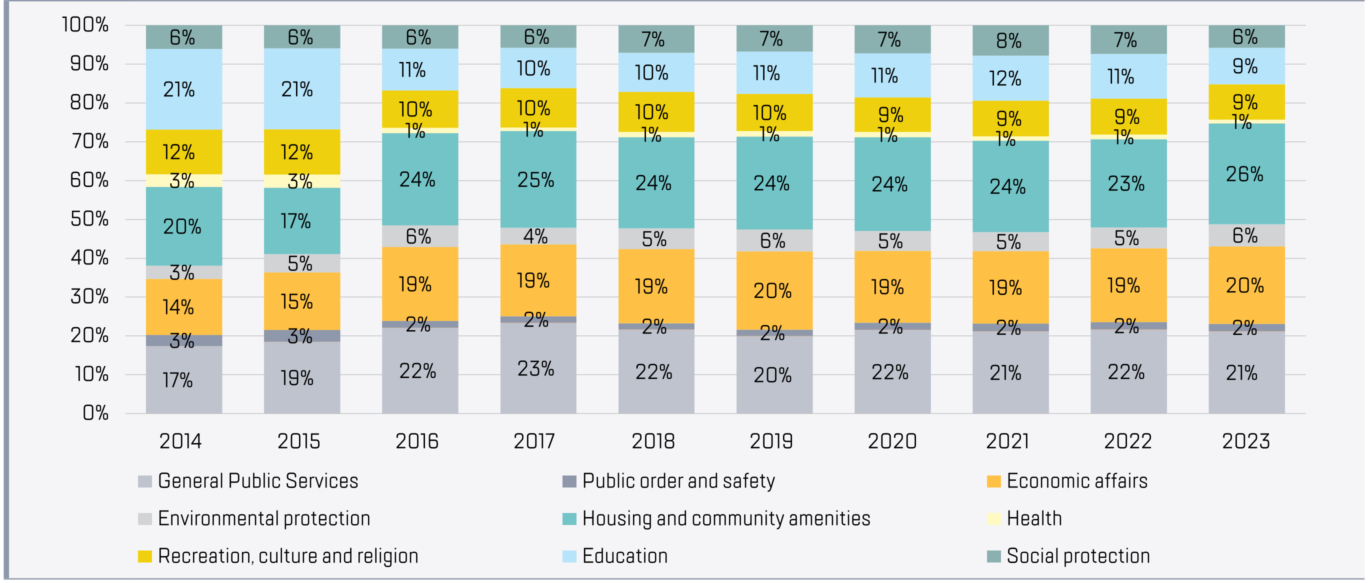
Expenditures of budgetary users are no longer reported in the city/municipal budget according to the economic classification of each expense but are instead reported as grants to budgetary users due to new reporting standards as of 2015. Hence the break in the data series in 2015. As of 2015 investments were steadily increasing from 13% to 23% of local government expenditures, as expected, due to the growing share of investment grants in local government revenues. Although other components have remained stable in relative terms, all categories of expenditures have grown in absolute terms.

Figure 73. ***Croatia:*** *Composition of Local Government Expenditure, Euro per capita*



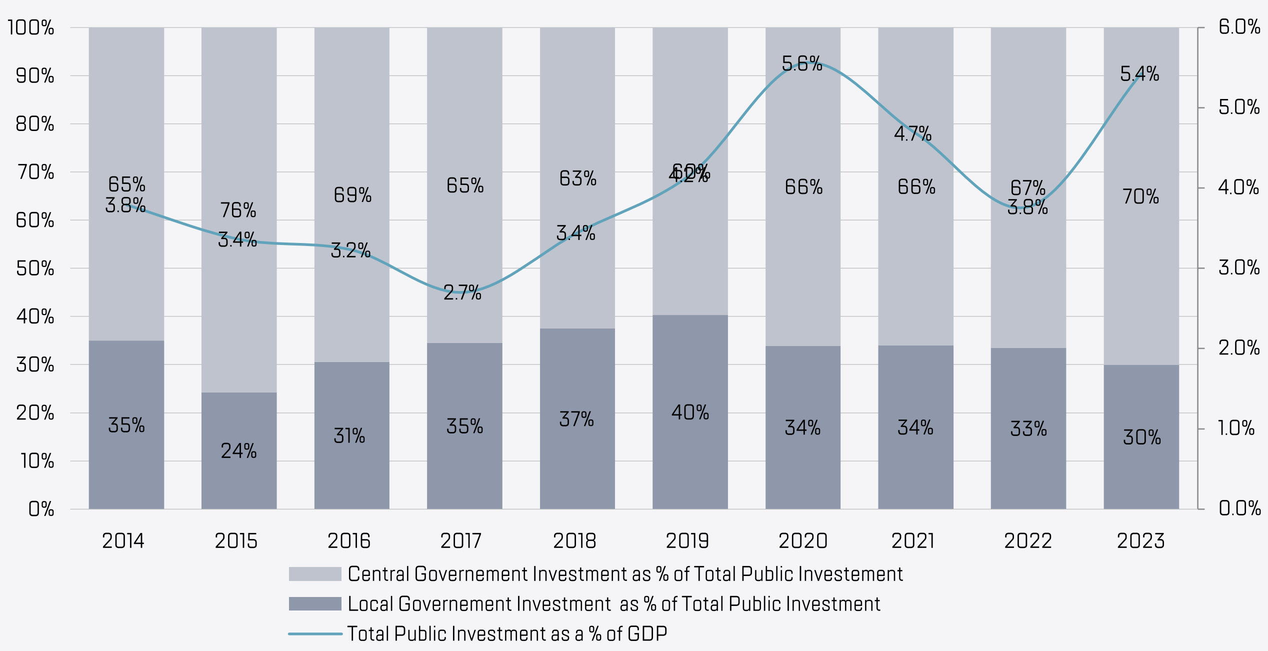
From a functional perspective, spending for general public services has remained relatively stable over the past years. The share of spending for housing and community amenities has increased, due to significant part of capital investments being (wrongfully) recorded under this category, instead under the actual functional category. Major break in series at 2015/16 period is due to the changes in the methodology for reporting expenditures by budgetary users.

Figure 74. ***Croatia:*** *Composition of LG Expenditure, Functional Allocation, % of total*



As of 2017 total public investment as a share of GDP had started steadily increasing, which is incidental to major increase of published tenders for EU funding and 2018 availability of additional funding at local level from FEF. Total public investments took hit during pandemic period and have returned to pre-recession levels. Local government investments in 2023 have exceeded peak 2020 levels by 30% in absolute terms.

Figure 75. ***Croatia:*** *Shares of Public of Investment by Level of Government and as % GDP*



Local government debt as a percentage of GDP has been increasing over time, peaking in 2020 and 2021 at 2.6%, because of loans incurred during the COVID-19 crisis. Over the 2022-2023 period local governments started strong deleveraging process both in relative and absolute terms. Spending for LG investment has been increasing as well since 2015-16, peaking at 1.9% of GDP in 2020 but exceeding the peak in 2023 by 30% in absolute terms. Spending for municipal wages and investments has dropped between 2014-2015 because of the new reporting/economic classification methodologies.

Kosovo

By Osman Sadikaj, representing the Association of Kosovo Municipalities

The Intergovernmental Finance System

Kosovo has one of the most decentralized systems of government in the region because local governments are responsible for all pre-university education as well as primary health care. For these functions, Local Governments (LGs) receive block grants that make up to 41% of local budgets in 2023.

Based on the Law on Local Government Finance, the size of the **General Grant** is defined by law as 10% of the total budgeted revenues of the central government. In 2023 the general grant was 255.2 million Euro. The grant is allocated according to a formula, defined in article 24 of the Law on Financing of Local Governments. The key criteria include: lump sum payment of 140,000 euro, minus one EUR per capita for all local governments with less than 140.000 inhabitants (therefore Municipalities with populations greater than 140,000 do not receive any lump sum payment); 89% by population; 6% by geographic size (square kilometres); 3% by the number of ethnic minorities; and 2% for municipalities in which the majority population is a national minority. The capital city, Prishtina, receives an additional grant from the central government at the size of no less than 6% of the total General Grant.

General Grant

- **Size:** 10% of total budgeted central government revenues.
- **Allocation:** Formula
    - Lump sum amount
    - 89% population
    - 6% surface area
    - 3% by ethnic minorities
    - 2% for LGs where the majority of population is a national minority.

The size of the Education and Health Grants is determined by a National Grant Commission in accordance with a Medium-Term Expenditure Framework. In 2023, the share of the grant for pre-university education is 201.2 million EUR. The **Education Grant** is allocated to local governments based on a formula that considers standards for the wages of teachers, administrators and support staff, goods and services, building maintenance, capital expenditures and specific education policies. Student-teacher ratios are used to determine the amounts for **salaries and allowances** in accordance with class size norms of: 1 teacher to 21 students in majority communities: 1 teacher to 14 students in minority communities; 1 teacher to 12 preschool pupils; 1 teacher to 17 students in vocational education in majority communities; 1 teacher to 11.5 students in vocational education in minority communities; 1 teacher to 14 pupils in mountainous areas. For **goods and services**, the norms are: 23€ per pupil in majority communities; 25€ per pupil in minority communities, and lump sums of 1,500 euros for pre-primary and primary school and 3,250 euros for secondary school. For **capital expenditures** (the maintenance of buildings) the norm is set at 7€ per pupil.

Education Block Grant

- **Allocation:** Formula
- **Wages and allowances:** student teacher ratios
    - Primary: Majority (1:21), Minority (1:14).
    - Secondary: Majority (1:21), Minority (1:14).
    - Preschool: 1:12.
    - Vocational: Majority (1:17), Minority (1:11.5).
    - Mountainous areas: 1:14
- **Goods and services norms**
    - Per student: €23 (majority) & €25 (minority).
    - Per school: €1,500 (pre-primary/primary)
    - Per school: €3,250 (secondary)
- **Capital expenditure norms**
    - €7 per student

The **Specific Grant for Primary Health**, as stipulated by the Law on Financing Local Government (LFLG), operates on an open funding system that aligns with the Ministry of Health's criteria for 2023-2025. For 2023, the grant totals €70.5 million, allocated as follows: **Basic Grant**: €62.6 million; **Ongoing and New Policies**: €8 million, including: a) **Staff Increases**: Adding 299 positions for family doctors and emergency physicians; b) **Home Visits**: Visits for pregnant women and children at €10 per visit; c) **Palliative Care**: Visits at €20 each. The funding for the secondary healthcare system for three minority municipalities is determined by the Ministry of Health, in line with the projections of the Medium-Term Expenditure Framework.

Specific Grant for Primary Health

- **Size:** determined annually
- **Allocation**:
- **Basic Grant**: €62.6 million
- **Policies**: €7.9 million

Local governments receive also additional, smaller grants for residential services, for the preservation of historical and cultural sites and theatres and funding for environmentally endangered areas, which are included in the Annual Budget Circular, determining the financing for local government budgets.

Own-Source Revenues

Local government own-source revenues in Kosovo have remained a critical aspect of municipal financing, with municipalities relying primarily on taxes, fees, and charges to fund local services. Property tax is the most significant own-source revenue stream, contributing substantially to 42% of own source revenues and 6.9% of total local government revenues in 2023. Construction permits fees constitute up to 24% of own source revenues, and administrative charges make up to 18% of the total in 2023.

Over the past few years, Kosovo has implemented reforms to enhance property tax collection, improve valuation systems, and expand the tax base. For 2023, a notable update was the continued integration of Own Source Revenue frameworks with the Kosovo Fund and KFMIS (Kosovo Financial Management Information System), ensuring transparent tracking and utilization of municipal funds. Revenues from sources such as primary healthcare co-payments and traffic fines are now recorded separately, with their usage restricted to respective municipal services. Additionally, unspent balances of OSRs from previous years are being rolled over to fund municipal projects in subsequent years, enhancing long-term financial planning capabilities for local governments. These efforts aim to strengthen local financial autonomy and encourage municipalities to mobilize their resources effectively. Despite progress, the overall revenue generation capacity varies across municipalities, reflecting differences in economic activity, administrative capacity, and enforcement of tax regulations.

However, challenges persist, including the limited scope for revenue diversification and uneven enforcement of fees and charges. External support from development partners and donor programs has been instrumental in building local capacities for revenue management and addressing these gaps. While the share of own-source revenues in total municipal budgets has increased, it remains insufficient to meet growing demands for local services and infrastructure, highlighting the need for further reforms and capacity development to achieve fiscal sustainability.

Key Reforms and Achievements Over the Past Decade

Over the past decade, Kosovo has implemented significant reforms to enhance local governance, with the Association of Kosovo Municipalities (AKM) playing a pivotal role in these developments.

Decentralization and Governance Enhancements. Kosovo made significant strides in decentralization, enhancing local government autonomy through legislative and administrative reforms. This included the transfer of powers in areas such as education, health, and municipal infrastructure management. The enactment of the Law on Local Self-Government and the Law on Local Government Finance has empowered municipalities with greater autonomy, enabling them to manage local affairs more effectively. AKM has been instrumental in advocating for these legislative changes, ensuring that municipal interests are represented at the national level.

Public Financial Management Reforms. Reforms in financial systems, including the Kosovo Financial Management Information System (KFMIS), have improved transparency and efficiency in local government financial operations. Municipalities now have better tools for revenue collection and budget management, enabling improved service delivery.

Improved Revenue Generation. Local governments have increased their reliance on own-source revenues (OSRs) through better property tax administration and diversification of revenue streams. Initiatives supported by development partners focused on enhancing tax collection systems and reducing fiscal imbalances among municipalities

Public Service Delivery. There has been progress in the delivery of key municipal services, such as waste management, urban planning, and primary healthcare, supported by investments in infrastructure and capacity-building programs. Projects funded by the EU, USAID, and other partners have contributed significantly to these improvements.

Despite these important achievements, several challenges persist. There are significant differences in revenue-generating capacities between urban and rural municipalities, exacerbating inequalities in service delivery. Many municipalities face challenges in staff training, institutional capacity, and access to modern tools and systems necessary for effective governance and financial management. Despite progress, local governments struggle to meet increasing citizen expectations, particularly in education, health, and infrastructure.

Key advocacy efforts of the Association of Kosovo Municipalities

The Association of Kosovo Municipalities (AKM) plays a crucial role in advocating for the interests of its member municipalities.

Budget Negotiations and Increased Municipal Funding. AKM plays a key role in advocating for increased municipal budgets, particularly in negotiations with the Ministry of Finance. As a result of its efforts in 2018, municipal budgets increased by €35 million (8%) while in 2019 KM successfully lobbied for further budget increases in education, health grants, and own-source revenues. AKM also secured an amendment in the new Law on Mines, ensuring that 20% of mine royalties are directly allocated to municipalities where mines operate.

Protection of Own-Source Revenues. In 2022, AKM directly presented to the Parliamentary Commission on Budget and Finance, challenging the Ministry of Finance's attempt to claim unspent municipal own-source revenues under the 2023 Budget Law. On

March 16, 2023, AKM formally requested the government and parliament to revise this decision, arguing that municipalities have the right to retain and utilize their funds. The request sought to unblock €37.5 million in unspent municipal funds from previous years for local development projects. As a result, the government amended the Budget Law, allowing municipalities to regain control over these funds.

Financial Impact and Policy Influence. AKM's advocacy ensured that municipalities retained €37.5 million for local projects, preventing stalled investments and reinforcing municipal fiscal autonomy. This also set a legal precedent confirming that the central government cannot claim municipal own-source revenues. Beyond this, AKM has actively worked to mitigate the financial burden of the so-called Collective Contracts between ministries responsible for education and health and the trade unions (without consultation of municipalities), which has negatively impacted municipal budgets by approximately €135 million. Through negotiations with the Ministry of Finance, sector ministries, and representation in the Grants Commission, AKM has helped municipalities save tens of millions of euros.

Lobbying for Decentralization: AKM actively engages with the Government of Kosovo and the Assembly to influence laws and policies affecting local governance. It has been instrumental in advancing fiscal and administrative decentralization, ensuring municipalities have the necessary resources and autonomy to meet their responsibilities. In **2023**, AKM provided **93 recommendations** for legislative changes, of which **59 (64%)** were accepted. Key priorities included amendments to laws on municipal property management, property taxation, social housing, public-private partnerships, and administrative inspection. In **2022**, AKM submitted **43 recommendations**, with **36 (84%)** being adopted. Key focus areas included legislation on salaries, public officials, property tax, local elections and healthcare. AKM actively participated in drafting 49 legislative initiatives in 2023, including project laws, sub-legal acts, and strategies, while being involved in over 32 initiatives in 2022. These efforts collectively reinforce AKM's role as a key advocate for local governance in Kosovo, addressing critical legislative and service delivery challenges while strengthening municipalities' capacity to serve their communities

Capacity Building: AKM established a Training Centre to enhance the knowledge and skills of local government officials. This initiative supports better governance by offering demand-driven capacity development programs tailored to the needs of elected and appointed municipal leaders. Through the AKM Training Centre, the association strengthens the capacity of municipal leaders and staff to address local governance challenges. For instance, one of the trainings includes modules on advocacy skills, public finance management, and EU integration processes

Public Service Improvements: AKM takes a proactive role in resolving specific issues faced by municipalities, such as infrastructure development, waste management, and urban planning. This includes lobbying for funding from both the national government and international donors. Through partnerships with organizations like USAID, GIZ, OSCE, and NALAS, AKM works on projects to improve municipal services and align local government operations with citizen needs.

Citizen Engagement: AKM promotes transparency and public participation in local governance and advocates for policies that enhance citizen involvement in local decision-making processes.

Mechanisms for Intergovernmental Dialogue and Coordination

In Kosovo, mechanisms for dialogue and coordination between central and local governments are anchored in formal institutional frameworks and platforms designed to foster collaboration and consultation. These mechanisms are vital for ensuring that municipal perspectives are incorporated into national decision-making and that decentralization is effectively implemented. The Association of Kosovo Municipalities (AKM) plays a pivotal role in this framework, acting as a bridge between local and central authorities.

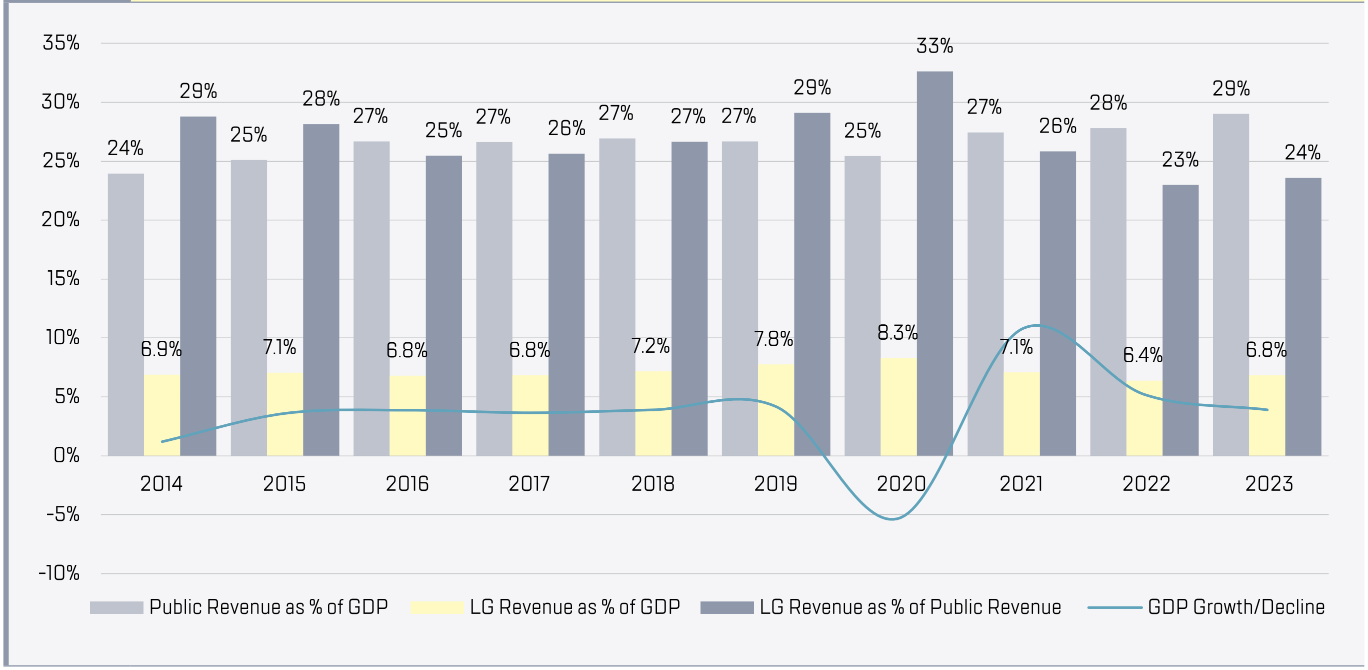
Association of Kosovo Municipalities (AKM): As the umbrella organization representing municipalities, AKM acts as an intermediary, voicing municipal concerns in national decision-making forums. AKM organizes regular consultations, workshops, and strategic dialogues with central government institutions to ensure that local governments' concerns are addressed comprehensively. AKM has established 21 Professional Collegia bringing together professionals from all municipalities in Kosovo. The Collegia provide technical recommendations and proposals for policy development and legislative changes. Also, they foster peer learning and knowledge sharing of good practices and models. The intensive work of the professional collegia build is the cornerstone of AKM's efforts for advocacy and lobbying.

Consultative Council for Municipalities (CCM): Established under the Law on Local Self-Government, the CCM is a key forum for structured dialogue between central and local governments. It comprises representatives from the government of Kosovo and municipalities and aims to serve as a platform where municipalities can propose amendments to laws and advocacy for municipal priorities. AKM ensures that municipal representatives are effectively engaged in this platform, advocating for their interests and contributing to discussions on legislation and policies affecting local governance.

Statistical Overview of the Finances of Local Governments in Kosovo

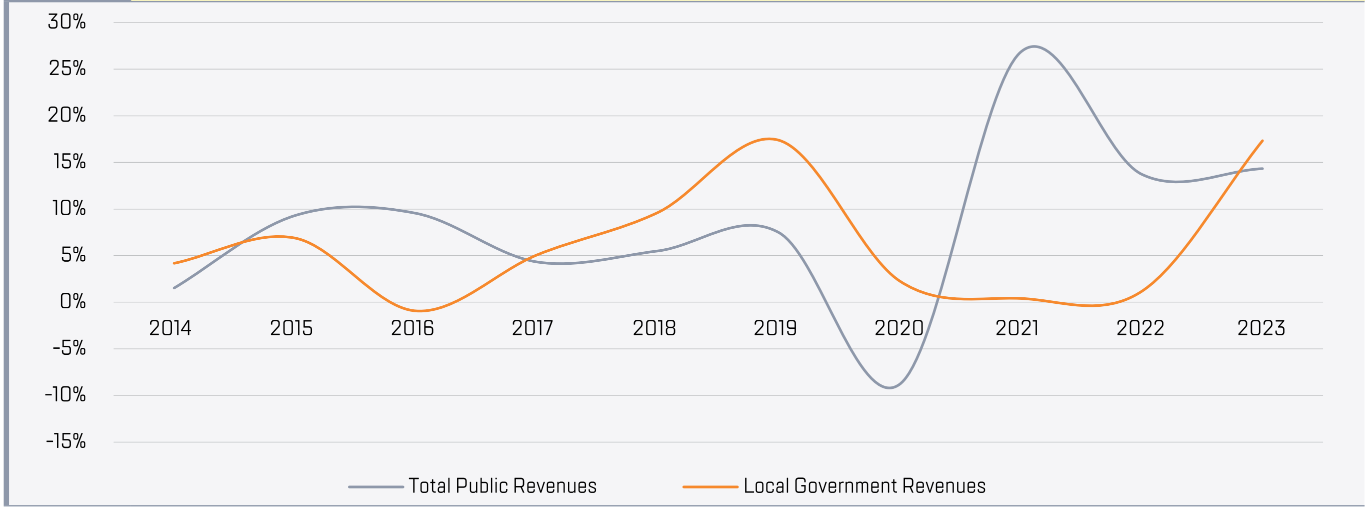
Over the past three years, public revenues have increased as a share of GDP from 27% in 2021 to 29% in 2023, however this increase is only partly reflected in municipal finance. Local government revenues as a share of GDP fell from 7.1% in 2021 to 6.4% in 2022 and slightly recovering to 6.8% in 2023. Similarly, local government revenues as a share of total public revenues have declined since 2019-2020 and are the lowest levels over the past decade, at 24% of the total. Kosovo experienced a significant fall in economic growth in 2020, with -5% compared to 2019, but recovered in 2021 registering the highest growth rates in 2022 and 2023 compared to the past decade.

Figure 76. ***Kosovo:*** *LG Revenue as Share of GDP and Total Public Revenue*



Up until 2020, unlike many other places in the region, there has been a consistent pattern in the relationship between local and central government revenues in Kosovo: they have risen and fallen more less in tandem except for 2016, 2021 and 2022 where we notice either a fall or a zero-increase in local government revenues as opposed to an increase in overall public revenues.

Figure 77. ***Kosovo:*** *Fluctuations in Central and Local Government Revenue, % change*



The composition of local government revenues in Kosovo has not changed significantly over the past decade. In 2023, Kosovo local governments derived 41% of their revenues from block grants for Education, Primary Health Care and some other services. The General Grant constitutes 38% of their revenues. Own source revenues constitute only 16% of the total over the past five years, with a slight increase in 2021 after the expected fall in 2020.

Figure 78. ***Kosovo:*** *Composition of Local Government Revenues, in % of total*

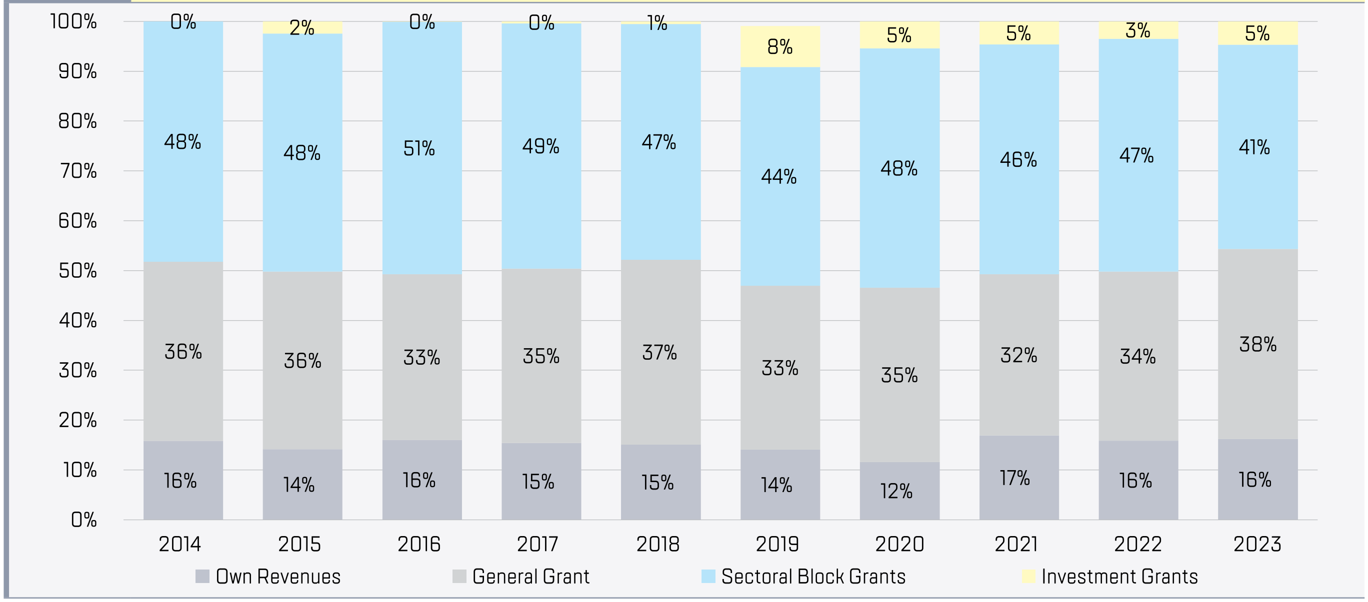


Figure 79. ***Kosovo:*** *Composition of Local Government Revenues, in million EUR*

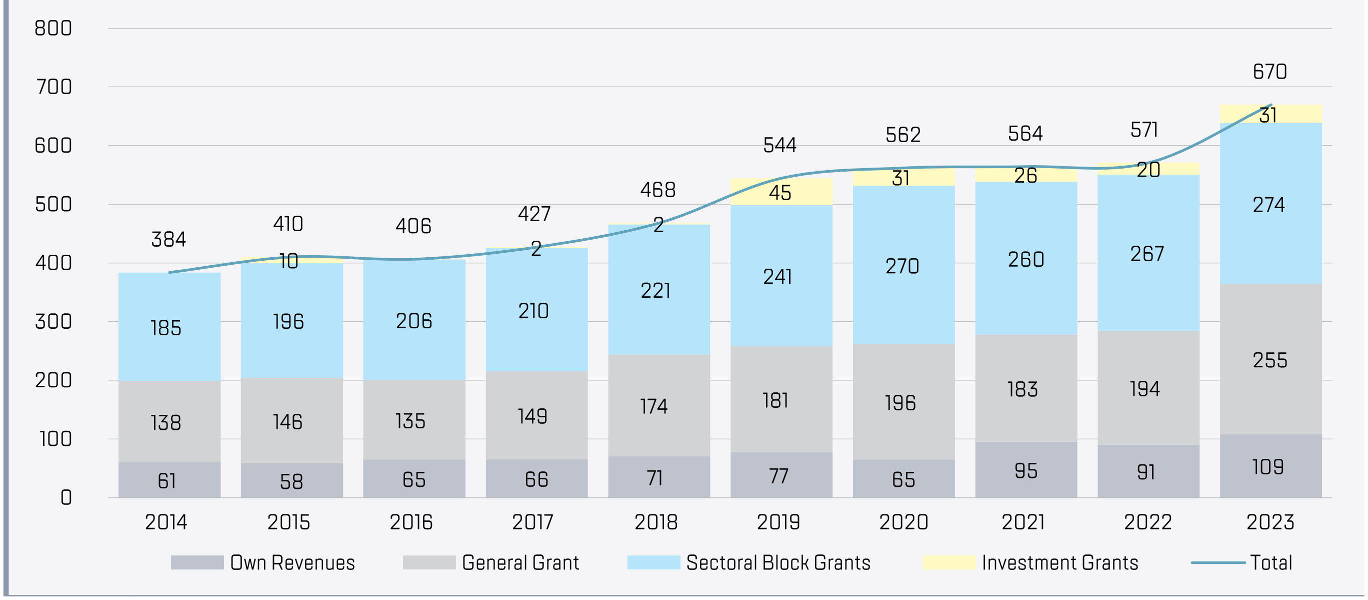
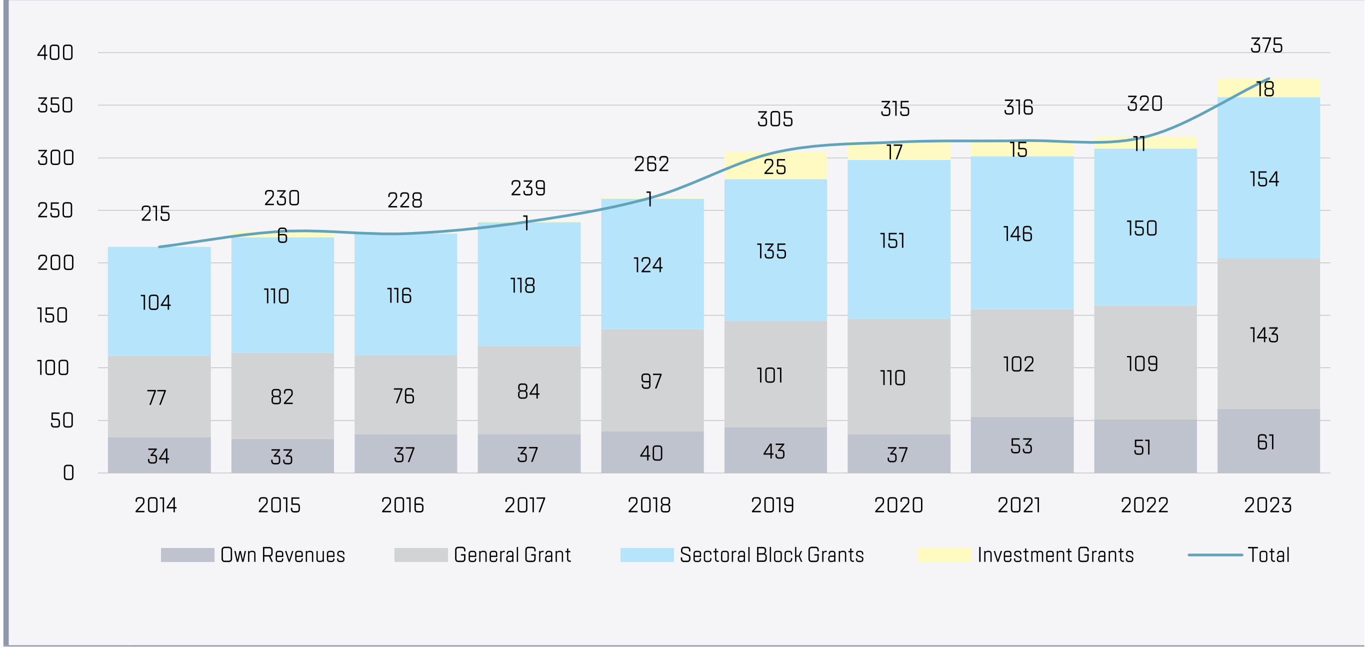
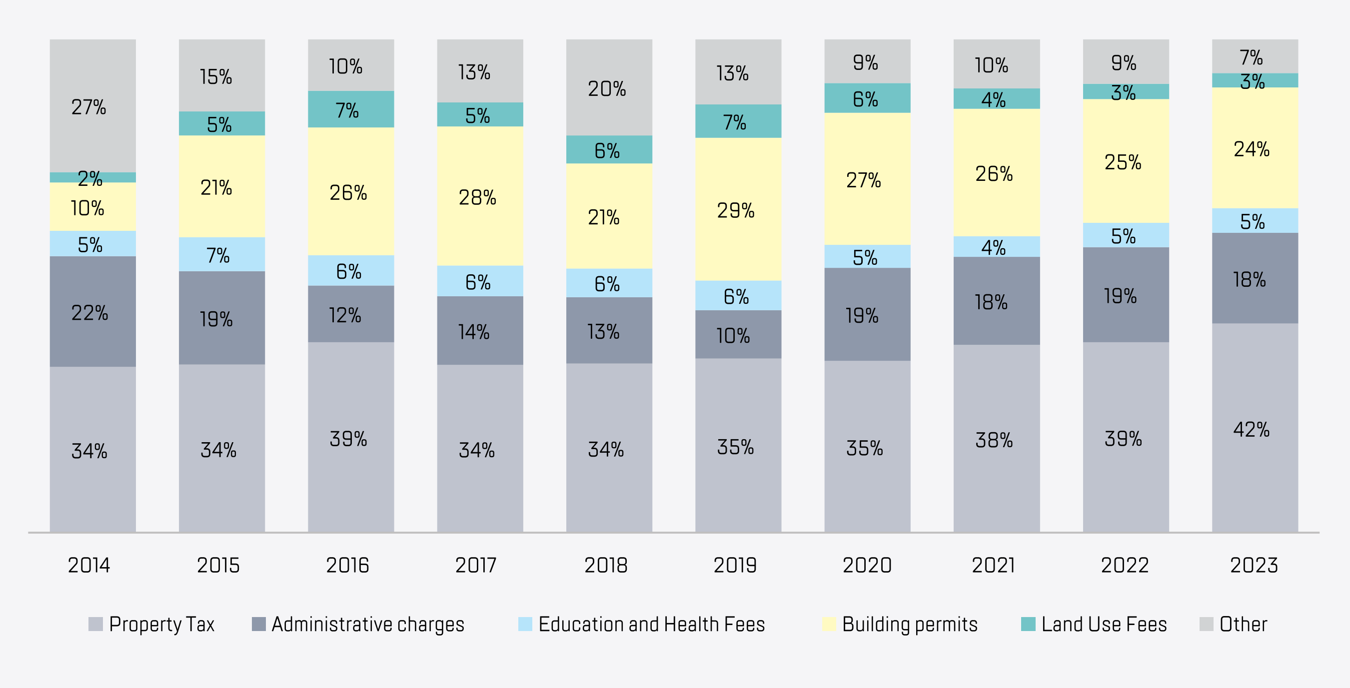


Figure 80. ***Kosovo:*** *Composition of Local Government Revenues, in EUR per capita*



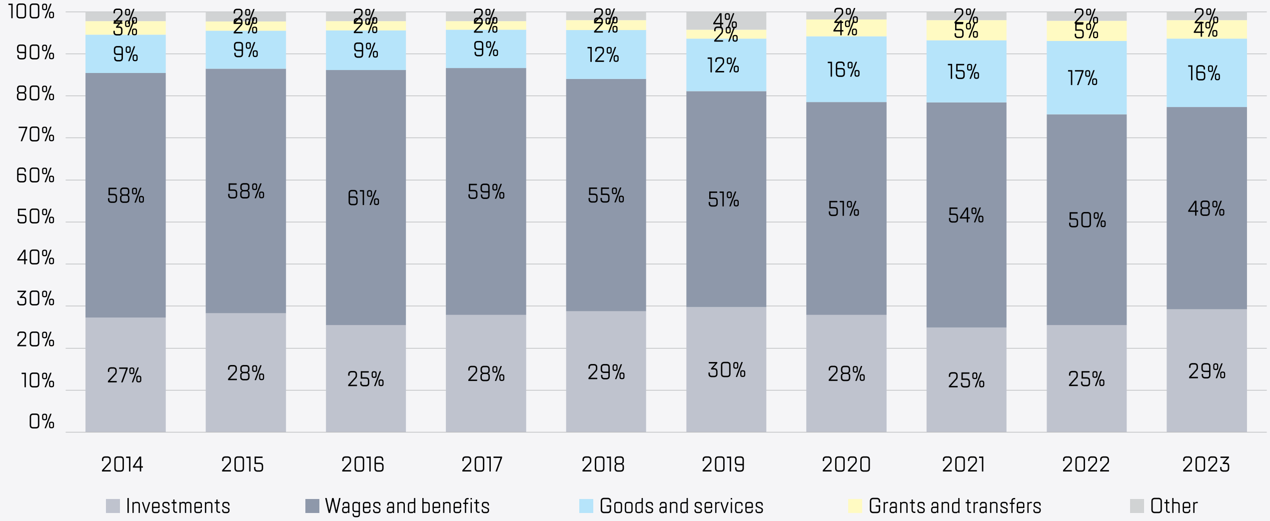
The two most important own source revenues are the property tax and building permits. Income reported under this category shows a steady increase over the past four years. The property tax has been subject to several reforms over the past decade. Nevertheless its relevance to local government own source revenues has remained relatively the same.

Figure 81. ***Kosovo:*** *Composition of Own-Source Revenue, in % of total*



In 2023, local governments have devoted 29% of their total expenditures to capital investments, returning to the pre-pandemic levels, but remaining overall at a similar level over the past decade. During the past decade, the structure of LG expenditures has changed significantly, after a peak of spending for salaries in 2016, the share of spending for salaries has declined averaging 51% ver the past five years and 48% in 2023. Similarly, there has been a slight increase in spending for goods and services and grants and transfers, in particular over the past four years.

Figure 82. ***Kosovo:*** *Composition of Expenditures, in % of total*



Kosovo Local governments, totalled 705 million EUR in 2023, registering a 25% increase in annual terms. Spending for capital investments has increaed by 44% while spending for salaries by 20% between 2022 and 2023. The increase is mainly fuelled by an increase of 17% the government grants and a 20% increase in own revenues.

Figure83. ***Kosovo:*** *Composition of Expenditures, in Million Euro*

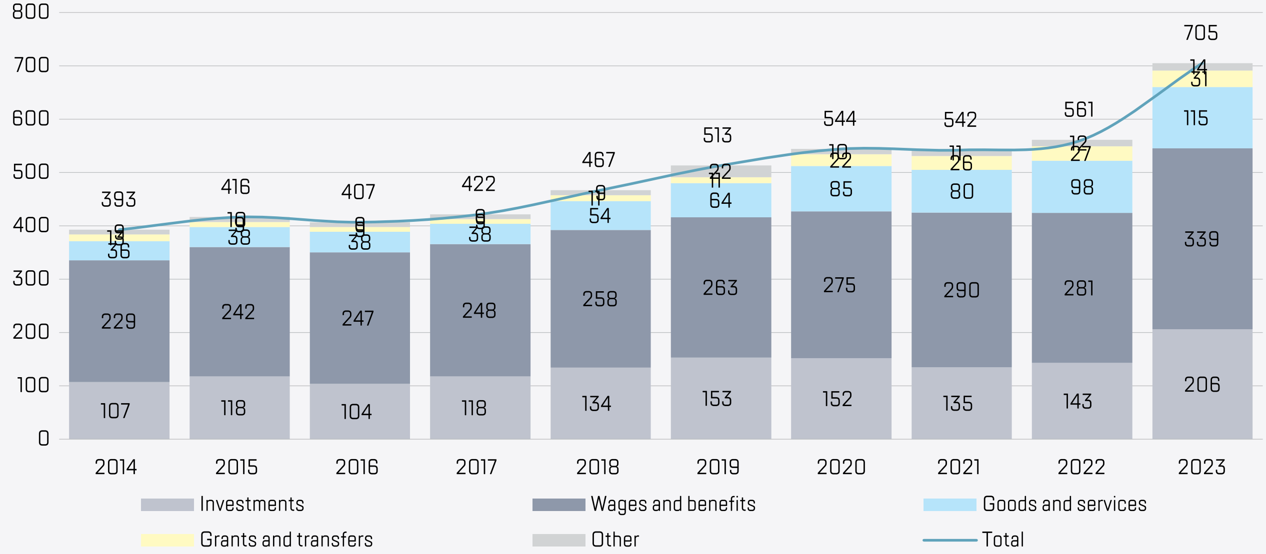
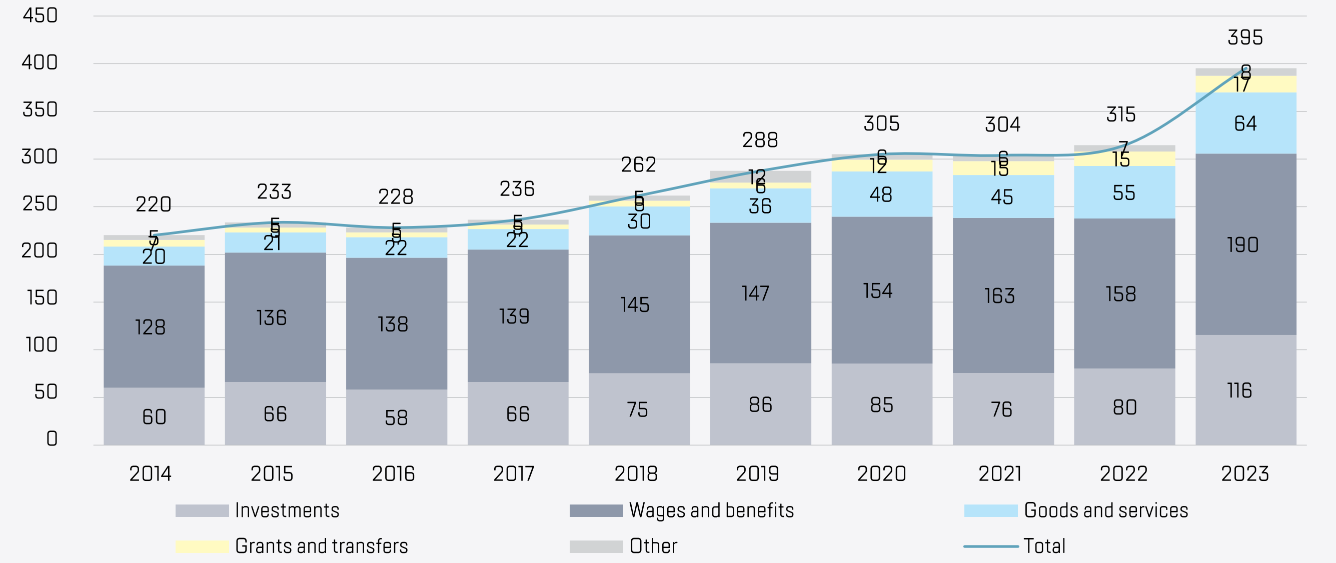
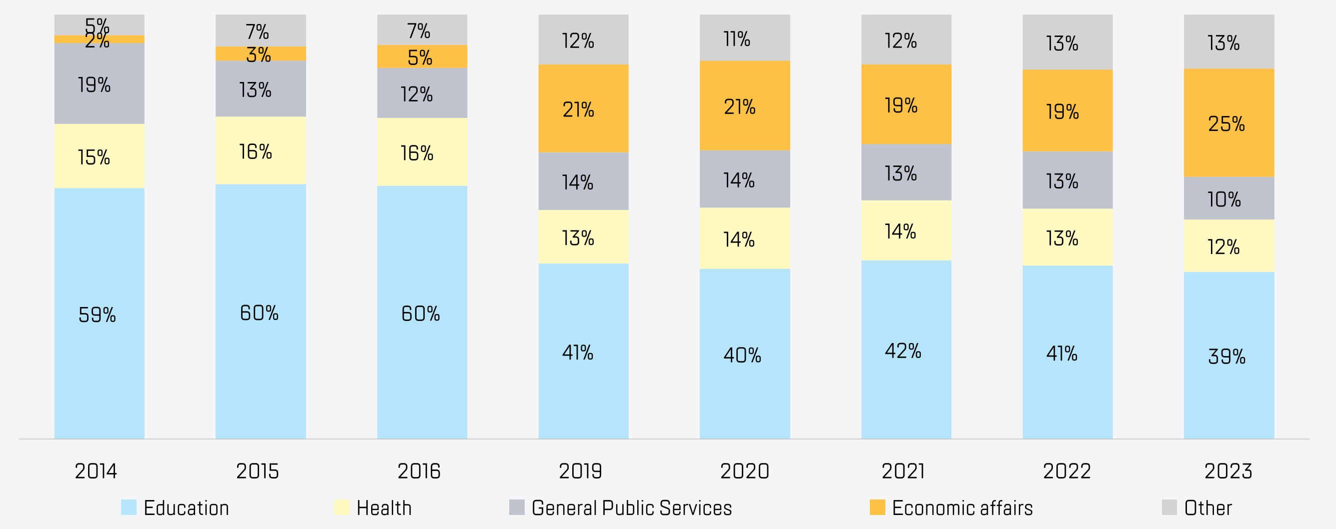


Figure 84. ***Kosovo:*** *Composition of Expenditures, in Euro per capita*



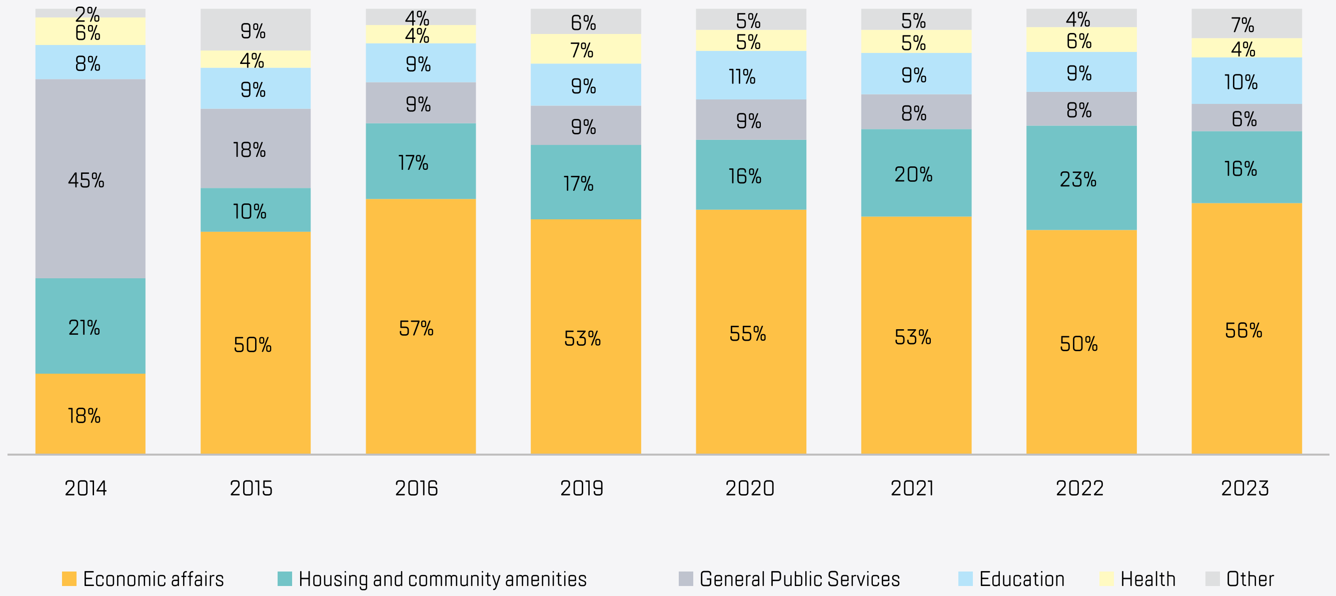
The structure of local government spending has shifted also in terms of functions, over the past decade. The share of spending for education has declined, while the share of spending for economic affairs has increased since 2019. Spending for general public services has remained at similar levels, as in the case of spending for healthcare.

Figure 85. ***Kosovo:*** *Composition of Expenditures according Classification of the Functions of Government (in % of total)*



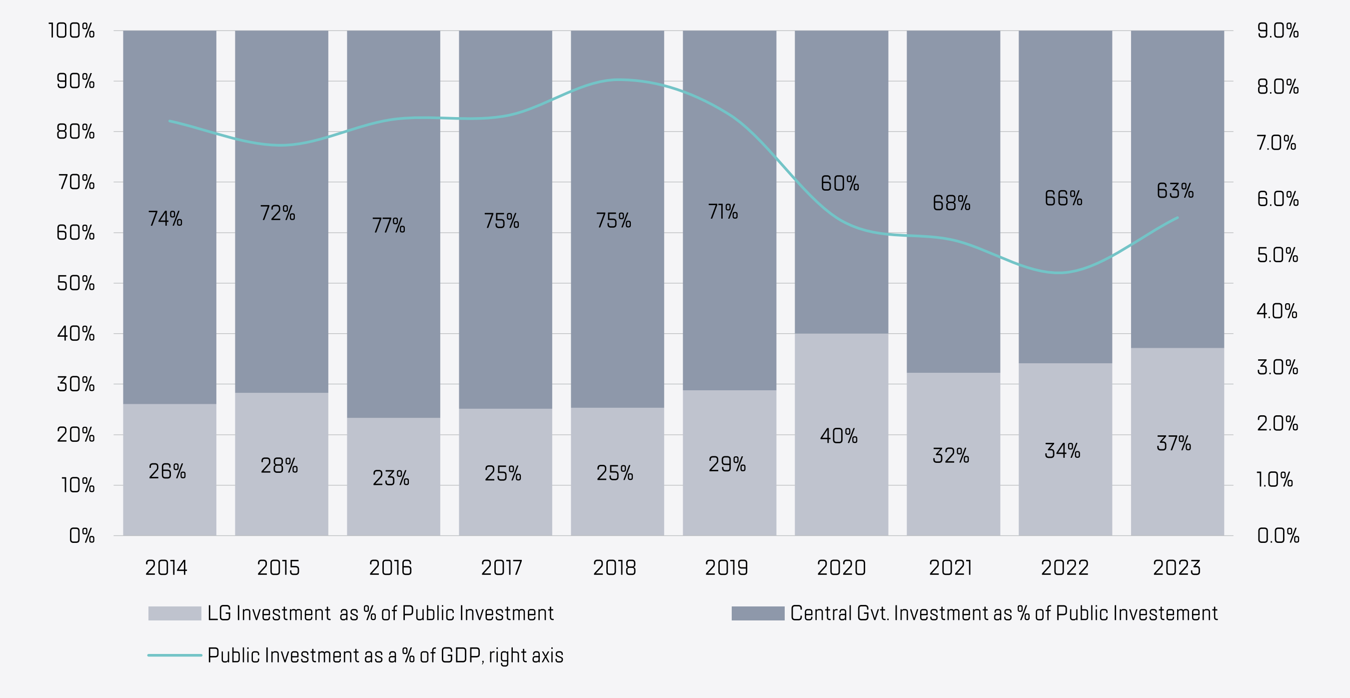
Since 2015 more than half of local goverment investments focused on improving local public infrastructure (economic affairs). Spending for the functions agregated under the „housing and community amenities", financing basic local government services, has oscillated over the past decade, settling at an average of 20% in the period 2021-2023. Capital investments for the edcuation and healh sectors have been rather stable during the past decade with minor shifts. Investments in the other functions make up only 5-7% of total local capital expenditures.

Figure 86. ***Kosovo:*** *Functional Composition of Capital Expenditures (in % of total)*



Total public investments in Kosovo dropped to a historical low of 4.7% of GDP in 2022. On the other hand, the share of local government investments in total public investmets has increased since 2016 to peak at 40% in 2020 and 37% in 2023. The share of local government ivnvestment of total public investment in 2023, while lower than in 2020, is still much higher than any other year over the past decade. This confirms the major role that municipalities in Kosovo play in developing municipal infrastructure.

Figure 87. ***Kosovo:*** *Public Investment by Level of Government and as a Share of GDP*



Moldova

By Viorel Girbu, Congress of Local Authorities from Moldova

The Intergovernmental Transfer System

Moldova has a highly decentralized public sector at first glance, with local governments (LGs) at the rayon, municipality, and first-level local authority levels responsible for services such as preschools, primary and secondary education, and social assistance. LG revenues range between 26% and 28% of total public revenue, one of the highest shares in South-East Europe. However, this picture can be misleading because, in practice, the central government and its deconcentrated structures still hold substantial decision-making power, making most LG functions effectively delegated rather than decentralized.

Local financial autonomy in Moldova is limited, hindering the effectiveness of decentralization and public sector reforms. The current framework for mobilizing LG revenue is largely ineffective, offering few incentives for local governments to improve revenue collection. Significant disparities persist between LGs. For example, Chisinau, the capital, stands out due to its higher level of local economic development compared to other regions, while the Gagauzia region benefits from the special status, providing greater flexibility and broader competencies, supported by higher resource allocation. This region exemplifies local financial autonomy in Moldova. In a system marked by strong functional decentralization but weak fiscal decentralization, LGs are often blamed for failures, and their actions are frequently interfered with by central authorities, particularly for electoral purposes.

Local governments in Moldova benefit from **Shared Taxes**, which make 20% of total LG Revenues in Moldova. LGs receive the following proportions of the **wage tax revenues** collected on the territory of a LPA: a) 100% of wage tax revenue for villages, cities (except for municipalities of Chisinau and Balti and capital cities of rayons) and municipalities; 50% for the municipalities of Chisinau and Balti (with the exception of first-level administrative-territorial units of the municipality); and 25% for cities/municipalities capital cities of the rayon, for rayons. The wage tax revenues that remain after these allocations are pooled in the Balancing Fund. Cities, villages, and the municipalities of Chișinău and Bălţi, receive also 50% of revenues from the from taxes on natural resources.

Shared Tax Revenues

- 100% of wage tax revenue for villages, cities and municipalities (excluding Chisinau and Balti and capital cities of rayons)
- 50% wage tax revenue for Chisinau and Balti
- 50% of wage tax revenue for rayon capital city LGs
- 25% of wage tax revenue for for rayons
- 50% of revenues from taxes on natural resources

There are two main transfers: **General-Purpose Transfers** and **Conditional Special Purpose Transfers**. General-Purpose Transfers are financed from the **Balancing Fund** and general resources of the central government and constitute up to 11% of total LG revenues.[11] Special Purpose Transfers (Sectoral Grants) are financed from the central budget and constitute 62% of LG revenues.

[11] General-Purpose Transfers include resources accumulated in the balancing fund and a compensation to cover revenue and cost differentials, such as missed revenues or additional costs, related to the implementation of public policies. It also includes other general purpose transfers provided by the regulatory framework, allocated from general resources of the central government.

Between 2015 and 2023, these transfers grew from 359 million EUR to 1.070 million EUR, accounting for 73% of total local revenue in 2023.

Both cities and villages and municipalities (LPA1), and rayons (LPA2), except for Chișinău, Balti, and Gagauzia, are eligible for General-Purpose Transfers. The balancing fund is financed from the residuals of the wage tax revenues which are allocated to local budgets as shared taxes. In 2024 there have been changes to the rules governing the formation of LG budgets. The balancing fund finances 65.7% of the General-Purpose Transfers, while the rest is financed by other sources of revenues of the central government. The division of the balancing fund between LPA1 and LPA2 also changed. LPA1's share in the balancing fund increased to 68.5% and LPA2's share decreased to 31,5%. In 2025, it is expected that the share of the General-Purpose Transfers financed from the balancing fund will be further reduced to 63,9%, a fall that is expected to affect LPAs level 2, that will register a decrease of the share of financing from the balancing fund to just 29,6%.

General Purpose Transfers

- **Size:** Remainder of Wage Tax Revenues not allocated as shared taxes; 10% of CIT
- **Allocation:** formula based
  - 68,5% of the pool for LPA1, allocated on three criteria: 60% on the estimated fiscal capacity; 30% on population and 10% on territory
  - 31,5% of the pool for LPA2, allocated on two criteria: 60% on population and 40% on territory

Estimated Fiscal Capacity

Based on the difference between national per capita fiscal capacity (estimated by the ratio of national revenues from the personal income tax collected in the territory of all LPA1s, divided by their number of inhabitants) versus the individual LPA1 fiscal capacity (estimated by the ratio of personal income tax revenues for natural persons collected in the territory of the LPA1 and the number of its inhabitants.

For LPA1s, general-purpose transfers are distributed based on their estimated **fiscal capacity** per inhabitant (60%), multiplied by a coefficient of 1.3, the population (30%) and territory (10%) of each LPA1. For LPA2, the criteria are 60% on population and 40% on territory.

General-purpose transfers are supplemented with additional resources since 2021, including 10% of the revenues generated by corporate income tax (CIT).

In addition to transfers with a general purpose made from the balancing fund, the budgets of villages (communes), cities (municipalities, except for the municipalities of Balti and Chisinau) also benefit from other **general-purpose transfers for local roads infrastructure**. The size of the total pool is determined as 100% of the revenues from the tax for the use of roads by motor vehicles registered in the Republic of Moldova, approved in the annual state budget law. These funds are distributed to LPAs proportionally to their population. Chisinau and Balti municipalities, LPA2 and TAU Gagauzia benefit from transfers for the maintenance of the local road infrastructure in the form of special purpose transfers.

General Purpose Transfers for Roads

- **Size:** 100% of vehicle tax
- **Allocation:** proportionally to the population of the LPAs.

Special Purpose Conditional Transfers are allocated to local governments to cover specific expenditure needs in sectors such as education, road infrastructure, delegated functions, and capital investments. In the education sector, these funds are distributed based on a government-approved formula, using expenditure ceilings and standardized calculations on *a weighted cost per student* and *institutional needs*. The Ministry of Education and Research calculates the categorical transfers from the state budget to the budgets of second-level administrative-territorial units (LPAs) to finance educational institutions. It is important to note that Special Purpose Conditional Transfers do not support services directly provided by municipalities or rayons. Instead, these transfers are exclusively intended for public primary and secondary education institutions (Cycles I and II), which are financed based on a standard cost per student.

Own Source Revenues

Local governments in Moldova generate **own-source revenues** through several mechanisms. Cities and villages generate revenue from the real estate (property) tax, entrepreneur's license tax, income tax on individuals engaged in independent activities (such as retail trade), private tax (a one-time payment for transactions involving public property in the privatization process), local taxes, special taxes, proceeds from land leases, and the lease of assets in the private domain of the administrative-territorial unit. Rayon and municipal revenues primarily consist of the private tax, while the municipalities of Bălţi and Chișinău have a more diversified revenue base, benefiting from all types of own-source revenues of both cities and rayons. Gagauzia, an autonomous region, has a revenue structure similar to that of rayons, with its own source revenues coming from the private tax. Gagauzia has a broader resource base, as it collects 100% of the revenue from wages tax, income tax, VAT, and excise duties within its territory, but it does not receive transfers from the balancing fund.

The property tax is the main local tax, accounting for 40% of total own-source revenues in Moldova. Local governments can set the tax rate, within limits prescribed by national legislation. LGs have the freedom to establish any rate for the other local taxes. Currently, the **property tax** in Moldova is based on the value of intravilan and extravilan land, buildings, and constructions. The cadastral authority, which is under the central government, initially determines the value of real estate. This process, part of a broader transition to new property taxation rules that began in 2002, is still not fully completed. By law, property re-evaluation is required every three years, with funding provided by either central or local government revenues. However, in practice, most of properties in rural areas have neither undergone the initial valuation nor the regular re-evaluations every three years. This has led to significant losses for local budgets, as LGs lack the capacity to influence or manage the property valuation process.

The current property taxation system in Moldova faces significant challenges, primarily due to unreliable property value data. Evaluation and revaluation processes are not conducted in accordance with the law, and LGs cannot perform these evaluations themselves as the authority is centralized. While LGs can finance the evaluation process, their poor financial situation typically prevents them from doing so. Additionally, the system does not differentiate between intravilan land and constructions/buildings, further complicating the tax process.

Ultimately, the existing regulations leave local governments dependent on a system where the central authorities control both property valuation and the determination of tax ceilings. In cases where property values are significantly underestimated, as is common in most local governments in Moldova, the ability of local governments to set tax amounts within a ceiling established by the central authorities offers limited benefit.

Local Borrowing

Local governments in Moldova can incur both short-term and long-term debt to address liquidity constraints or finance capital investments. For **short-term debt**, local authorities can take loans to cover temporary cash gaps within the same budget year. The total short-term borrowing must not exceed 5% of the approved local budget revenues, excluding special transfers.

For capital investments, local authorities can borrow **long-term loans** from domestic or international financial institutions and issue bonds in capital markets. They may also grant guarantees for loans to municipal enterprises or companies with majority municipal ownership, within the limits of their own income. Capital investment borrowing is allowed if annual debt servicing (repayment of principal, interest, and related payments) does not exceed 20% of the local budget's total annual revenues, or 30% for Balti and Chisinau municipalities.

Local government debt in Moldova has remained relatively low, fluctuating between 0.2% and 0.3% of GDP from 2013 to 2018. It decreased to 0.1% in 2019 but began increasing, reaching 0.6% of GDP in 2023, with most debt concentrated in larger municipalities.

Advocacy efforts of the Local Government Association

The Congress of Local Authorities from Moldova (CALM) has successfully advocated for improvements in local finances and fiscal decentralization. CALM played a key role in increasing the share of revenues from the personal income tax (wage tax) allocated to small cities and villages, ensuring 100% of the tax collected remains in the respective localities. They also helped increase financing of the LPAs, through the inclusion of the corporate income tax revenue as a source for General-purpose transfers, the full allocation of road tax revenues to local governments, and the reorganization of the development fund. The latter was created to provide financing to LPAs for various developmental needs. A **National Fund for Regional and Local Development** was established in 2022 to finance regional and local development programs and projects in energy, rural development, water supply and sanitation, local infrastructure, and other areas. All these sectors have been previously financed through five national funds: the National Fund of the Environment, the National Fund for Regional Development, the Road Fund, the National Fund for Agriculture and Rural Development and the Fund for Energy Efficiency. Additionally, amendments to legislation on aquatic objects were adopted, strengthening the role of local authorities and local revenues.

Despite these successes, financial decentralization and the reorganization of local government competencies remain challenging. Dialogue with national authorities, particularly the Ministry of Finance, is limited. Most policy documents, especially those related to fiscal policy, the Medium-Term Expenditure Framework (MTEF), and wages, are developed without a proper consultation with CALM. While policies with low financial impact may involve some consultation, more significant issues, like the recent public sector wage increases, have placed the financial burden on local governments.

The Congress of Local Authorities from Moldova (CALM) aims to address challenges in decentralization by reactivating the **Parity/ Joint Commission on Decentralization**. Established in 2010 following the 2006 adoption of the law on administrative decentralization, the commission was tasked with a broad mandate to advance decentralization efforts but struggled to function effectively. Comprising 28 members—14 representatives from the central government and 14 delegates from local authorities—the commission was largely inactive, until the government decided to revitalize it in 2022 as part of efforts to strengthen dialogue between central and local administrations. A key focus of the commission's current mandate is supporting the implementation of the Public Administration Reform Strategy, particularly its provisions related to local public administration reform.

Incentivising voluntary territorial amalgamation reform

At the end of 2023, Moldova approved a regulation on the **voluntary amalgamation** of Local Public Authorities (LPAs) at level 1, aiming to address the excessive territorial fragmentation. While previous discussions suggested a top-down, administrative solution, CALM has long advocated for a voluntary amalgamation approach. The approval of this principle in national regulation marks a significant achievement for local administration advocates. However, questions remain about the practical implementation of this principle.

The process of voluntary amalgamation is largely left to local political actors, rather than being driven by the will of the local populations. Citizens can initiate the amalgamation process through a vote from 10% of the eligible voters in a community, but the subsequent steps are under the control of local administration bodies. This has led to concerns that the amalgamation process may be guided more by political interests than by the needs of the local community. Furthermore, the law allows staff from the amalgamated town halls to benefit from the increase for strengthening the institutional capacities, but the number of newly created authorities is smaller than the combined staff of the amalgamated entities. For example, the number of local councillors elected per 1,000 inhabitants decreases as the size of the community grows. Additionally, the law stipulates that the population of the amalgamated LPA must be at least 3,000, further placing control of the process in the hands of those who may not have direct incentives to promote it.

The amalgamation process is supported by financial incentives from the central authorities, allocated through the **Fund for the Voluntary Amalgamation of Localities**. The fund provides three types of financial support:

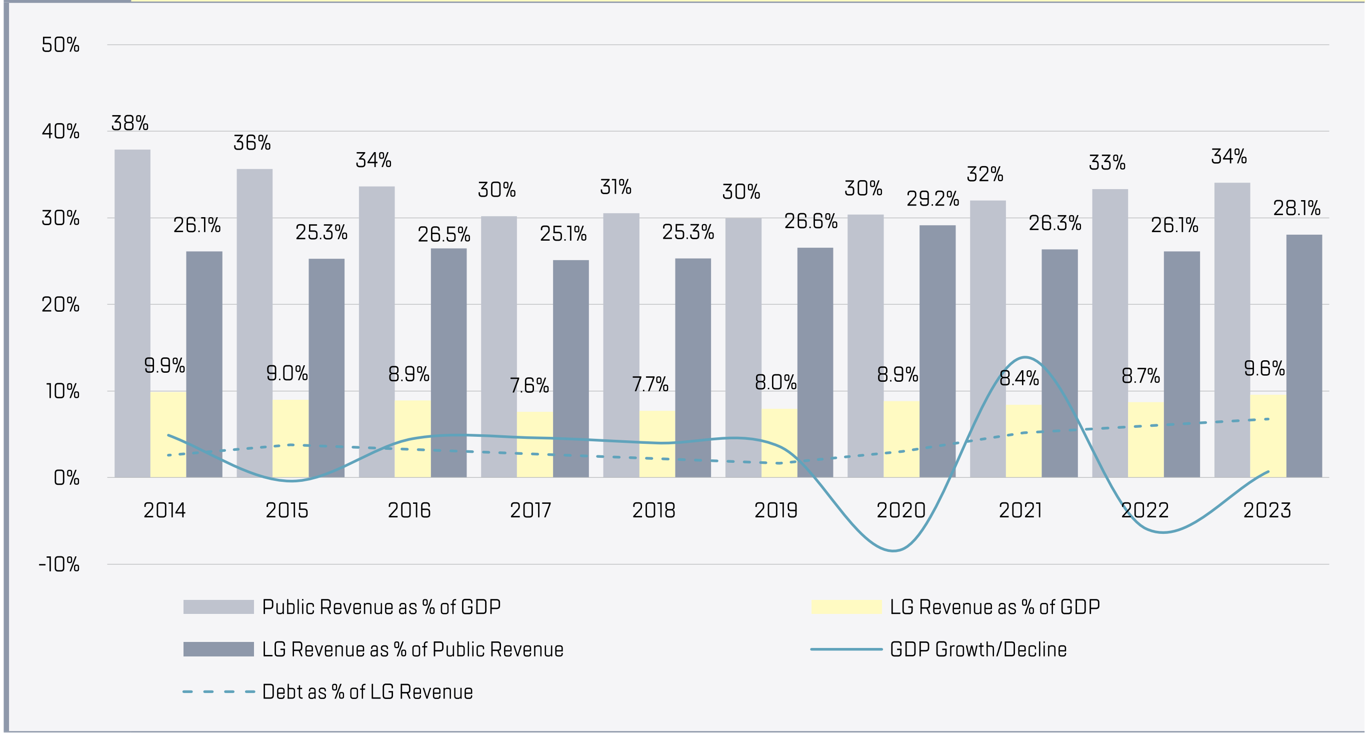
- Transfers for preparing the voluntary amalgamation process (up to 1 million lei, approximately 50,000 EUR).
- Transfers for infrastructure development in amalgamated LPAs (500 lei, about 25 EUR, per inhabitant, with additional funds based on population size).
- General-purpose transfers for supporting the local budgets of amalgamated LPAs, ranging from 100 lei to 200 lei per inhabitant, with a minimum of 300,000 lei (15,000 EUR) and a maximum of 2 million lei (100,000 EUR).

For the current year, the government allocated 83 million lei (approximately 4.2 million EUR) to the fund for voluntary amalgamation.

Statistical Overview of Local Government Finances in Moldova

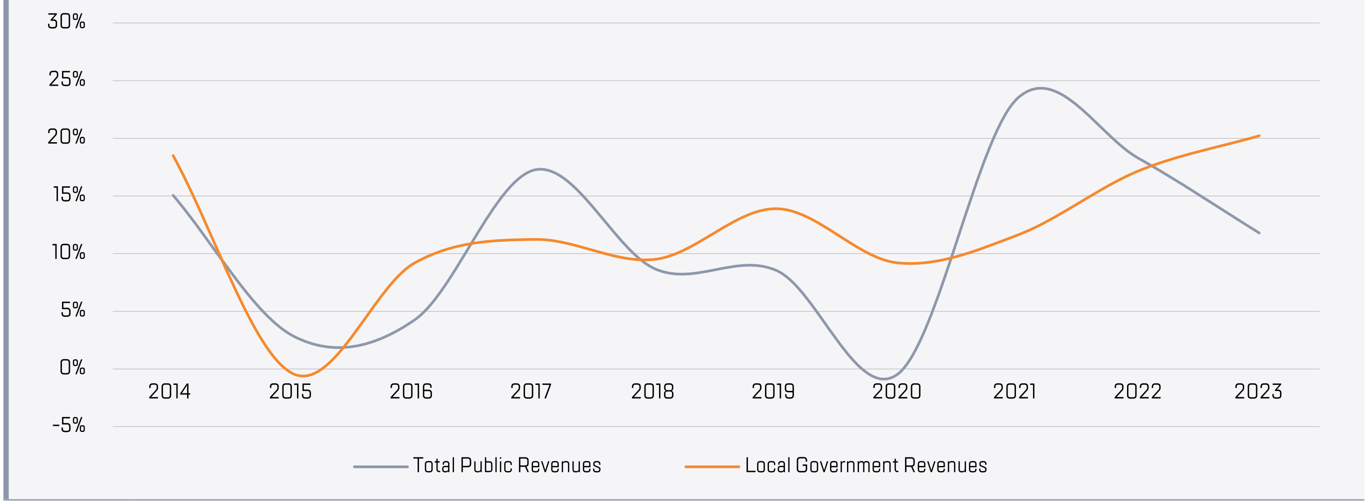
From a functional perspective, Moldova has a highly decentralized system of public administration. Yet, from a regional comparative perspective, local governments are severely underfunded, with great repercussions in service delivery. In relative terms, LG revenues in 2023 are recovering from the sharp decline in 2017, but yet lower than a decade ago in 2014. Indeed, since 2014 Moldova has implemented a new system of local finances which seems to have not been able to bring positive developments for local budgets.

Figure89. ***Moldova:*** *LG Revenue as a Share of GDP and Total Public Revenue*



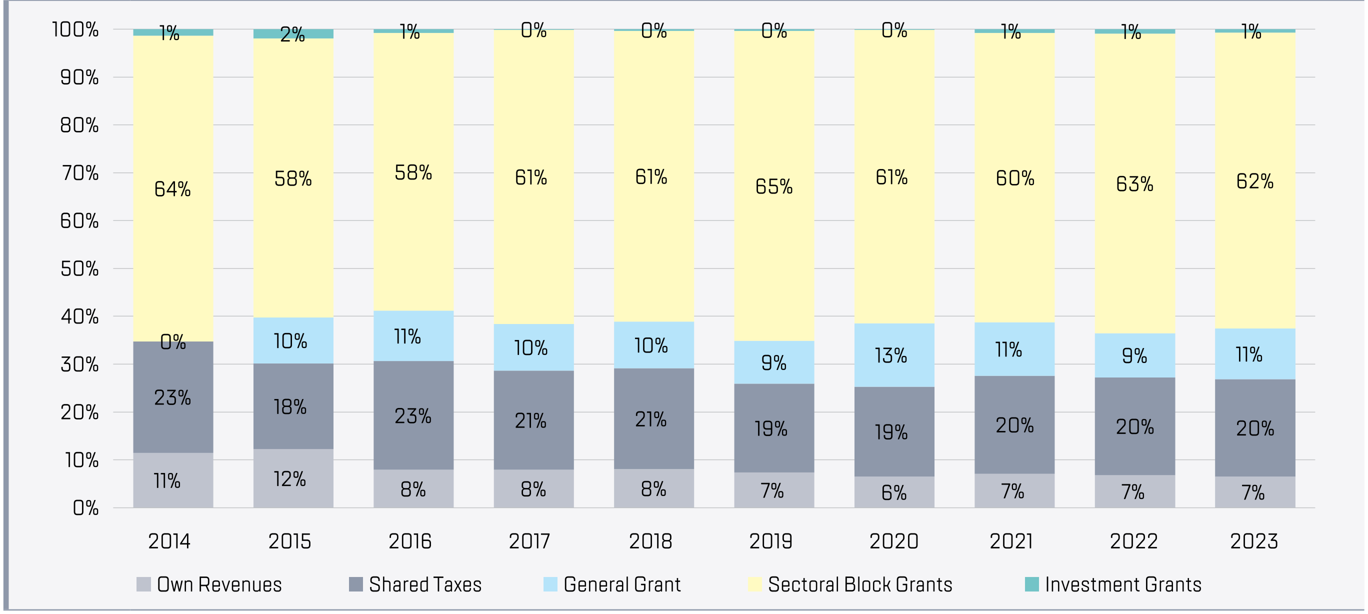
The growth rate of LG revenues seem to have followed to a great extent the performance of the overall public revenues, except for the past four years where there are significant differences. In 2023, LG revenues have increased by 20% in annual terms, compared to 2022 while the total public revenues have increased by 11.8%.

Figure 90. ***Moldova:*** *Fluctuations in the Revenues of the General and Local Governments*



Moldovan LGs derive most of their revenues from conditional sectoral block grants which make up to 62% of the totla in 2023. Unconditional grants, introduced in 2015, play a rather modest role, with up to 11% in 2023. The share of shared taxes in the system, likewise the share of own source revenues, has significantly decreased, specifically with the 2014 reform. The shares of OSRs and shared taxes have remained stable for the past three years.

Figure 91. ***Moldova:*** *Composition of Local Government Revenue*



Overall, LG revenues constitute 1.46 billion EUR in Moldova, up from 1.2 billion in 2022.

Figure 92. ***Moldova:*** *Composition of Local Government Revenue, in MLN EUR*

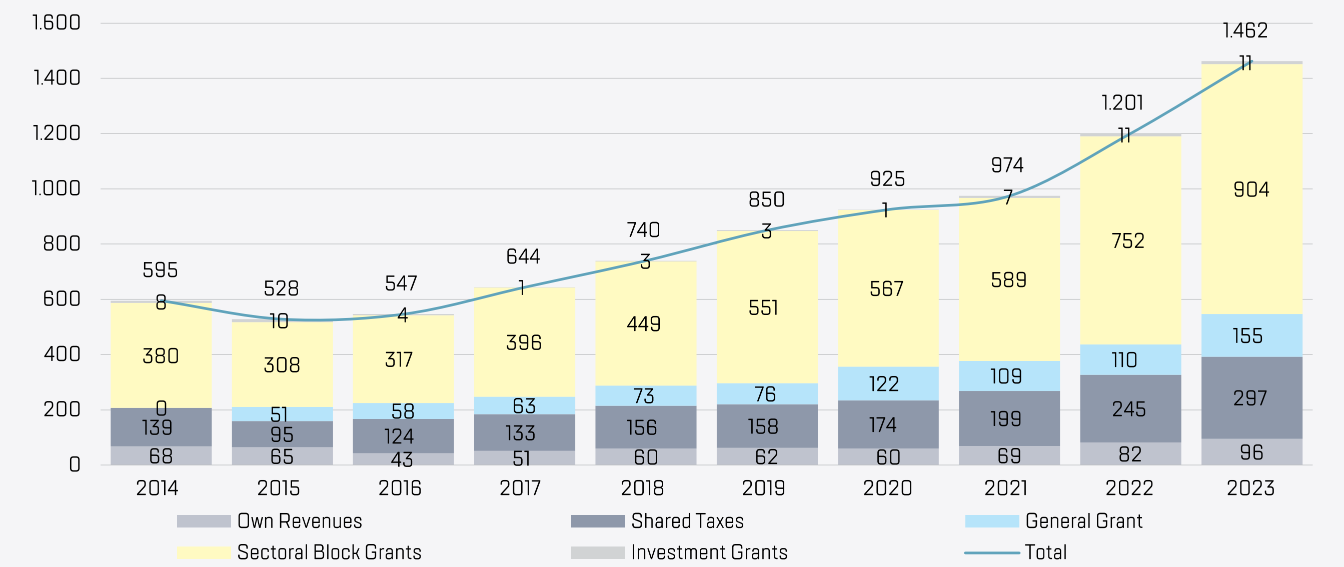
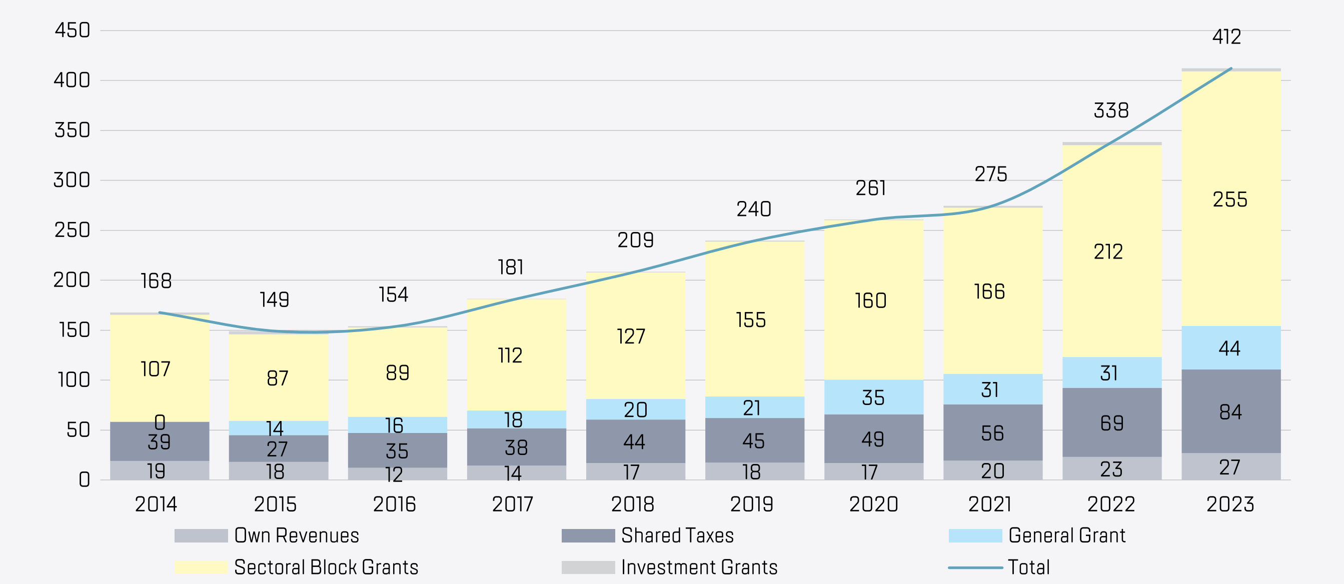
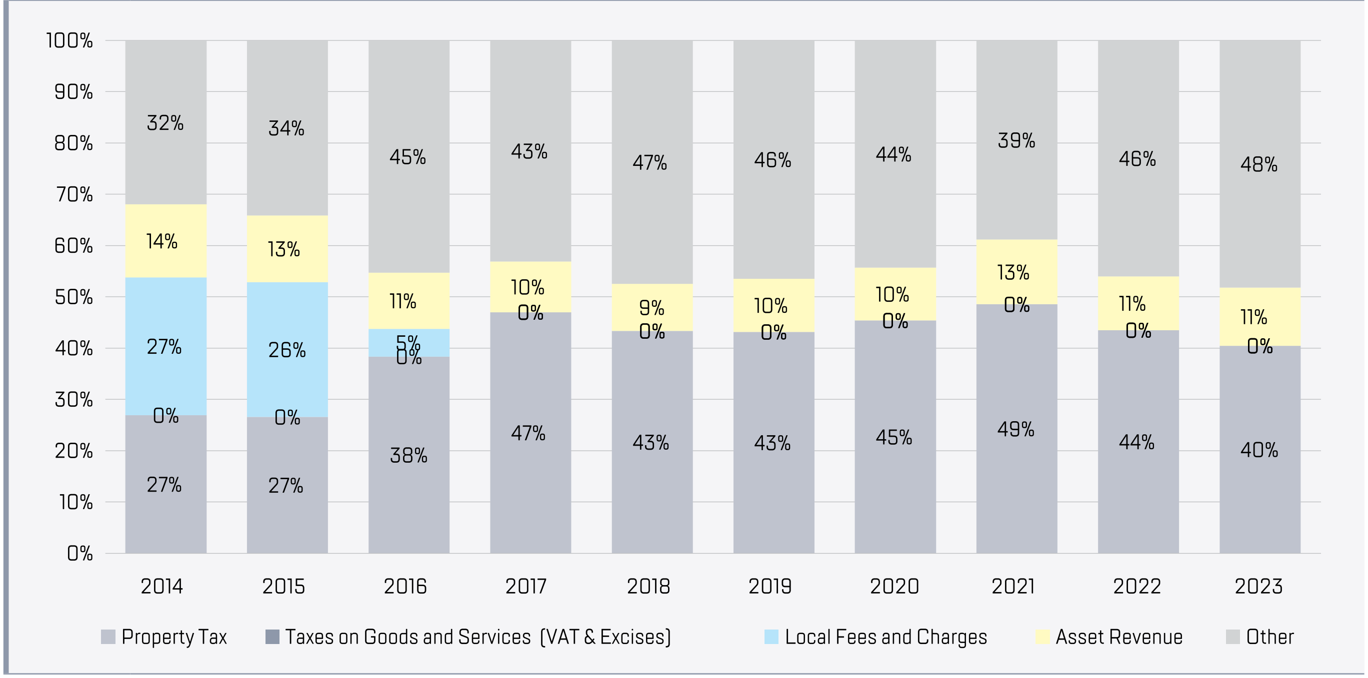


Figure 93. ***Moldova:*** *Composition of Local Government Revenue, in EUR per capita*



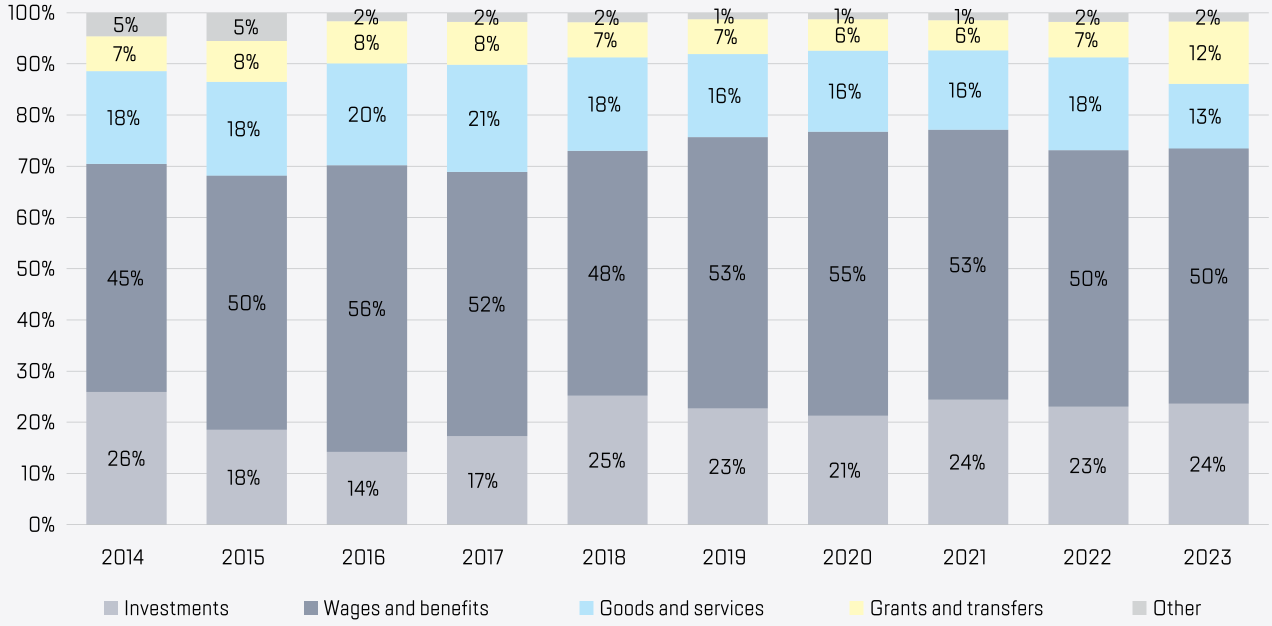
Moldova has seen a significant shift in OSRs since the 2014 reform. The share of Taxes on Goods and Services increased significantly (although in fact these are revenues of the Gagauzia autonomous region, that is the only region that can benefit from this sorce of income), subsequently leading to significant disparities in financial autonomy between different types of local governments in Moldova. The property tax share has increased too in the past few years, from a minimum of 27% in 2014 to 40% of own source revenues in 2023.

Figure 94. ***Moldova:*** *Composition of Own Source Revenues, in % of total*



In terms of expenditures, there are significant fluctuations in Moldova. Spending on investments has been increasing, since 2018. Spending on wages and benefits (salaries), make up to 50% of local budgets in Moldova, while spending on goods and services has declined over the past years.

Figure 95. ***Moldova:*** *Composition of Local Government Expenditures, in % of total*



In nominal terms, spending for salaries has increased much faster than spending for investments and the growth of spending for goods and services is very limited, as indicated by the figures below, showing local government spending in million EUR and in EUR per capita.

Figure 96. ***Moldova:*** *Composition of Local Government Expenditures, in mln EUR*

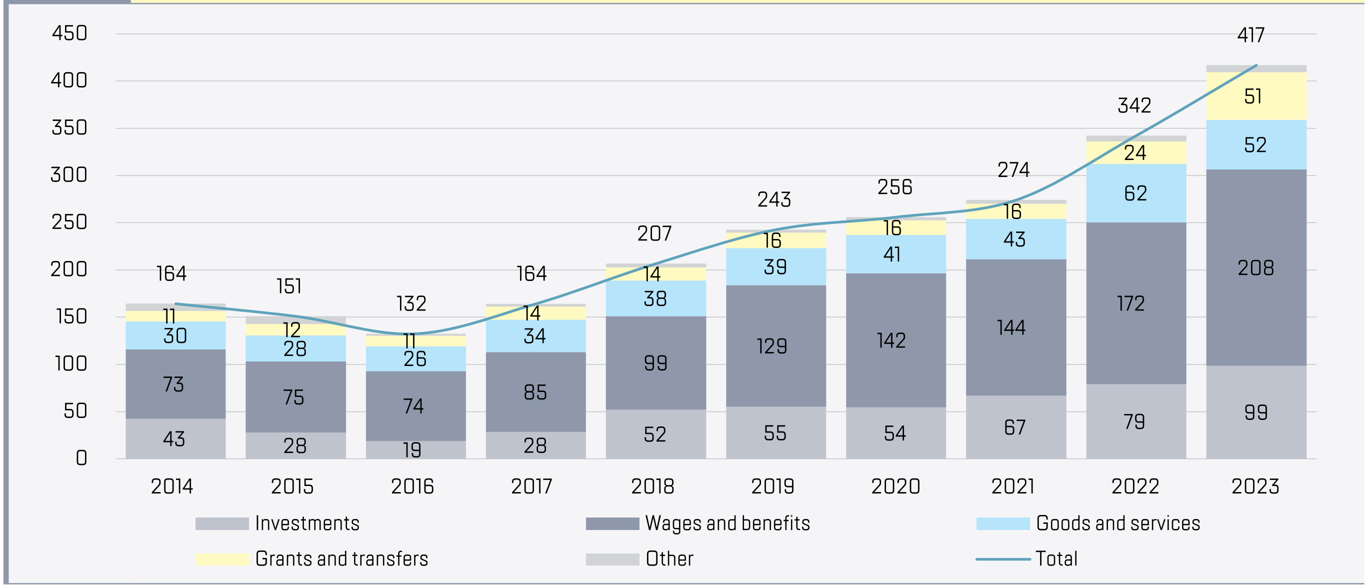
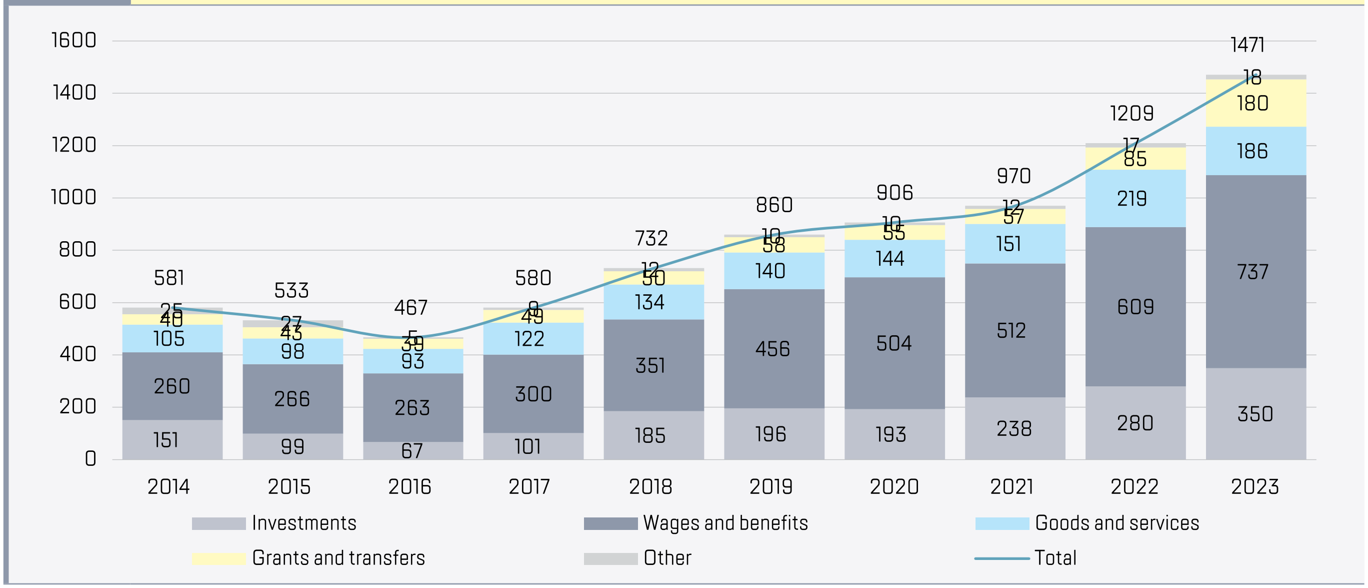
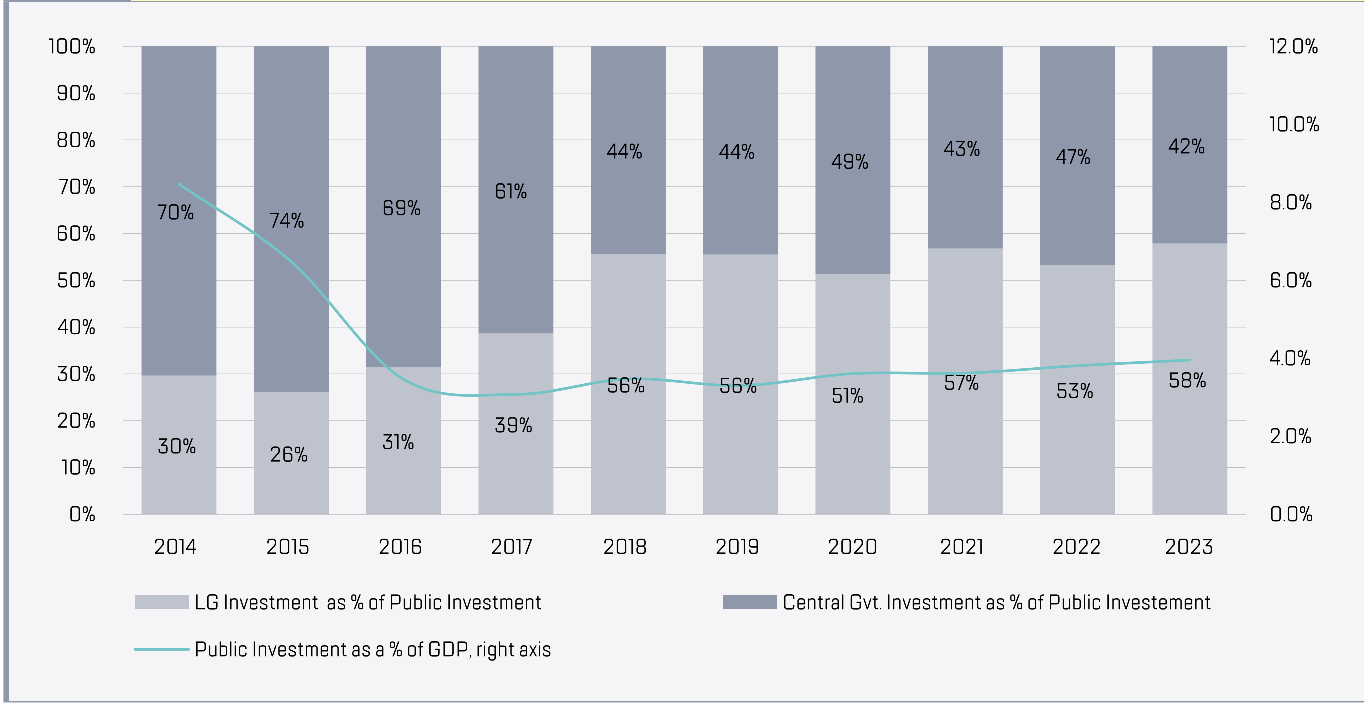


Figure 97. ***Moldova:*** *Composition of Local Government Expenditures, in EUR per capita*



The data on total public investment for Moldova shows a drop as a percentage of GDP from 8.5% in 2014 to 3.1% in 2016 and since then a slight increase to 4% in 2023. In terms of composition, since 2018, local governments drive public investment in Moldova, contributing to more than half of total public expenditure, a unique situation in South-East Europe.

Figure 98. ***Moldova:*** *Public of Investment by Level of Government as a % GDP*



Montenegro

By Žana Đukić, Union of Municipalities of Montenegro

The Intergovernmental Finance System

Montenegro's local self-government financing system is regulated by the Local Government Finance Law, which provides municipalities with funding from their own revenues, shared revenues, the equalization fund, and central budget transfers. As of 2022 there are 25 municipalities in Montenegro.

Historically, Montenegrin municipalities derived up to 80% of their revenue from own sources before the 2008-09 financial crisis. Since then, this share has decreased but remains higher than in most of the region, with own-source revenues (OSRs) currently constituting 60-67% of total local revenue. This decline is due to legal changes that increased the share of Personal Income Tax (PIT) revenues shared with municipalities, with the most recent adjustments in 2024. Despite this shift, OSRs remain the major financing source. Montenegro's high share of own revenues is partly due to local governments' control over land and building taxes, although the structure of these taxes has shifted over the past decade, often to the detriment of municipalities.

Municipalities in Montenegro are less reliant on intergovernmental grants, also because they have limited social sector responsibilities that are commonly financed through intergovernmental transfers. However, this may change as a new Local Government Law is being developed to decentralize powers gradually, including the creation of new local government units like cities, which could manage areas such as preschool education, healthcare, social protection, and spatial planning. The proposed reforms will introduce a polytype local government model, with cities, municipalities, the Historical Capital, and the Capital City having different responsibilities and levels of authority. Municipalities that meet certain criteria on population, fiscal capacity and economic development may be granted city status. However, this process presents challenges for local authorities. The draft law includes provisions that these new responsibilities will be transferred or entrusted responsibilities to local governments, with funding from the central budget in accordance with the regulation on the transfer or entrustment of tasks. While the current Local Government Finance Law includes similar provisions, their practical implementation is uncertain.

Own Source Revenues

In Montenegro, **own-source revenues** for municipalities are outlined in the Law on Local Government Finance, with most being regulated by specific laws. Key sources include property tax, surtax on PIT, local administrative charges, communal charges, land development fees, fees for the use of municipal roads and revenues from municipal property sales and rentals.

Property tax, decentralized since 2003, has seen significant growth in collection. Rates range from 0.25% to 1.00% of the property market value, which is assessed by local governments based on data from the State Statistics Office and State Tax Authority on the property square meter value in each jurisdiction. If this data is unavailable, municipalities may hire court experts, though this is costly and rarely used. Market value is determined by multiplying the market price per square meter by the property's surface area, considering factors that affect the property's value, such as its use, location, quality, size, and other relevant elements. Property owners are liable for the tax, but if the owner is unknown, the occupier is responsible. Taxpayer registers are created and updated by municipalities using Cadastre data, though these often have inaccuracies.

In early 2022, the Constitutional Court ruled that the regulation[12] for determining property market value was unconstitutional, creating a legal void that was addressed by urgent amendments to the Property Tax Law in May 2022. The amendments, developed by the Union of Municipalities of Montenegro (UMM) in collaboration with local governments, were submitted and approved by the Parliament of Montenegro. This allowed municipalities to resume property taxation, although practical challenges remain. In addition, the Parliament, by initiative of members of parliament, also introduced property tax exemptions for airports and tax reductions for agricultural producers. The UMM continues to advocate for changes, particularly concerning procedural costs and high legal fees incurred by municipalities in court cases.

From January 2024, **Property Transfer Tax** became a municipal own revenue, with municipalities receiving 80% of the revenue, and 20% transferred to the Equalization Fund. This is a significant change from the previous system where this was a shared tax, and where municipalities received 80% of the revenues, the central government 10% and 10% was transferred to the Equalization Fund. This change is a natural progression but presents also challenges for local governments, especially in the initial years as municipalities take on responsibility for determining, collecting, and controlling the tax.

The **land development fee**, regulated by the Law on Spatial Planning and Construction, is a key source of capital revenue for municipalities, used to finance public infrastructure for new developments. While its importance remains, the economic downturn and legal restrictions have reduced its impact. In the General Regulation Plan of Montenegro, the government plans to replace this fee with a new system of development charges for undeveloped land and infrastructure. Also, the owners of the developed building land will have to pay city rent. The Government assumes that these new charges will compensate municipalities for the land development fee revenues.

A shift to a centralized spatial planning system in 2017[13], which stripped municipalities of local planning authority, has not only limited municipal competences in urban planning and management but also limited their ability to create an enabling environment for local economic development, slowing down investment initiatives. Draft laws in 2022 aimed to address these shortcomings and proposed decentralizing spatial planning and construction tasks, but their final approval and implementation is pending due to the political changes in recent years.

Montenegrin municipalities rely heavily on a **surcharge on Personal Income Tax** (PIT), which accounts for over 8% of own local government revenues. The PIT surtax is governed by the Law on Local Government Finance and the Law on Personal Income Tax, with a standard rate of 13%, except in the Capital City and Royal City, where it is set at 15%.

Meanwhile, the importance of the land development fee and fees for the use of municipal roads which decreased until 2016, has recovered and these revenues have grown since then, except for a decline in 2020 due to the COVID-19 crisis.

[12] Official Gazette of Montenegro", no. 36/11, 66/15 and 39/17

[13] Law on Spatial Planning and Construction of 2017

Shared Taxes and Intergovernmental Transfers

The Montenegrin system of **shared revenues** and **equalization** is outlined in the Local Government Finance Law (LGFL). According to the law, municipalities are entitled to shared revenues from several sources, which together account for 27% of total local revenues in 2023. These sources include:

- **Personal Income Tax** – depends of the region - (1) 40% for Costal and Central region municipalities, and 2) 89% for Northern municipalities
- 70% of the **revenues from concessions** and other fees for using natural resources awarded by the State; 50% of the revenues from the fee for **use of coastal resources**;
- 100% of the annual fees for the **registration of motor vehicles**, tractors and trailers

Shared Tax Revenues

- 40% of PIT revenues for LGs in the Coastal/Central regions,
- 89% of PIT revenues for LGs in the Northern region
- 70% of revenues from state concessions on natural resources
- 50% of revenues from fee on usage of coastal resources,
- 100% of motor vehicles registration fees

Montenegro has a reasonably robust equalization system designed to reduce fiscal disparities between municipalities. In 2023, the **Equalization Fund** accounted for about 9% of total local revenues. Its purpose is to ensure financial equalization so that municipalities with lower fiscal capacity can cover their operational costs and perform their legal duties. While all municipalities currently share the same competences, there are significant fiscal disparities, with municipalities in the Central and Coastal regions generally having higher fiscal capacity than those in the Northern region.

The equalization system has evolved in recent years, with the most recent reform shifting towards a system based on shared revenues. The Equalization Fund is now funded by 11% of the national yield of Personal Income Tax (PIT), 20% of the national yield of the Property Transfer Tax, 100% of the Vehicle Tax, and 40% of concession fees from games of chance.

Equalization Fund

- **Size:** funded by 11% of PIT, 20% of the property transfer tax, 100% of vehicle tax, and 40% concession fees on games of chance.
- **Allocation:**
  - 15% lump sum
  - 35% on territory and population
  - 50% on fiscal capacity (per capita PIT vs. national average)
  - Multiplier for small municipalities

Municipalities with a **development index** below 100% of the national average are eligible for the fund, except for the Old Royal Capital, which receives separate funding for development (1% of Montenegro's current budget).

Under the Local Government Finance Law (LGFL), the Equalization Fund is allocated as follows:

- 15% is distributed equally among eligible municipalities,
- 35% is allocated based on territory (50%) and population (50%),

- The remaining 50% is based on average per capita PIT revenues from the previous year, compared to the average PIT revenues across all municipalities.

- An additional multiplier is applied to municipalities with smaller populations: a ratio of 1.5 for municipalities with fewer than 3,000 residents and 1.1 for those with populations between 3,000 and 6,000.

Special support for Financially Weaker Municipalities. Recent changes to the Local Government Finance Law (LGFL) introduced additional support for municipalities in the Northern Region of Montenegro. Starting in 2024, **10% of the PIT** collected from municipalities in the Coastal and Central Regions is allocated to a special account in the Ministry of Finance and distributed as grants to Northern municipalities (including two new municipalities from the Central Region). These funds are distributed based on the level of development in each municipality. This adjustment reduces the share of PIT allocated to municipalities in the Coastal and Central Regions from 50% to 40%, a shift aimed at improving local public finances in the Northern Region.

Supporting Municipalities Access EU and Donor Funding. Additionally, the LGFL established the **Support Fund to assist municipalities with pre-financing donor-funded projects (Revolving Fund)**. The Fund is managed by the Ministry of Finance, with annual allocations determined by the central government budget based on the estimated need for project pre-financing. Municipalities that have signed project agreements with donors or lead partners can access the Fund. The law also specifies that municipalities must reimburse the Fund within 12 months of receiving donor funding.

Advocacy efforts of the Union of Municipalities of Montenegro

The Union of Municipalities of Montenegro (UoM) advocates for the protection of municipal fiscal autonomy. In recent years of particular relevance are the advocacy efforts to compensate municipalities from the significant reduction in local government revenues from the 'Europe Now' Economic Reform Program adopted in November 2021. The most notable change has been the introduction of the "tax-free income" category in the Personal Income Tax (PIT) Law, exempting incomes up to €700. This has negatively affected municipal revenues from PIT, the PIT surtax, and the Equalization Fund, as nearly 50% of the Fund is financed by PIT.

Municipalities were not consulted in the preparation of the Economic Reform Program, violating the European Charter on Local Self-Government and other legal provisions. In response, the Union of Municipalities of Montenegro proposed amendments to the Local Government Finance Law (LGFL) to compensate for these revenue losses. Although the amendments were submitted in December 2021, by a group of Members of Parliament, they were not initially included in the parliamentary agenda. In the meantime, most regulations of the "Europe Now" Program, adopted by the Parliament of Montenegro, began implementation in early 2022. By mid-2022, a significant decline in municipal revenues from PIT, PIT surtax, and the Equalization Fund was observed, and in response, the Government of Montenegro provided compensation to municipalities from the budget reserve, in line with the 2022 Budget.

The Proposal for Amendments to the Local Government Finance Law, submitted in December 2021, was included in the Parliament's agenda in July 2022 and subsequently adopted. The law came into force in August 2022, increasing the percentage of PIT transferred to municipalities—50% of the collected tax for municipalities in the Coastal and Central regions, and 100% for those in the Northern region. Additionally, the percentage of Property Transfer Tax allocated to the Equalization Fund was raised from 10% to 20%, while the criteria for fund distribution remained unchanged. Despite these changes, Northern municipalities still struggle to replace lost PIT revenues. In December 2023, the Ministry of Finance proposed reallocating 10% of PIT from the Coastal and Central regions to a special account of the Ministry of Finance that redistributes it as a grant to the Northern region municipalities (MPs' amendments later included two new municipalities from the Central Region). The UMM and municipalities in the Coastal and Central regions opposed this initiative to address the lack of adequate funding for norther municipalities by reducing revenues of the other municipalities. Nevertheless, the law passed in early 2024, reducing their PIT share from 50% to 40%.

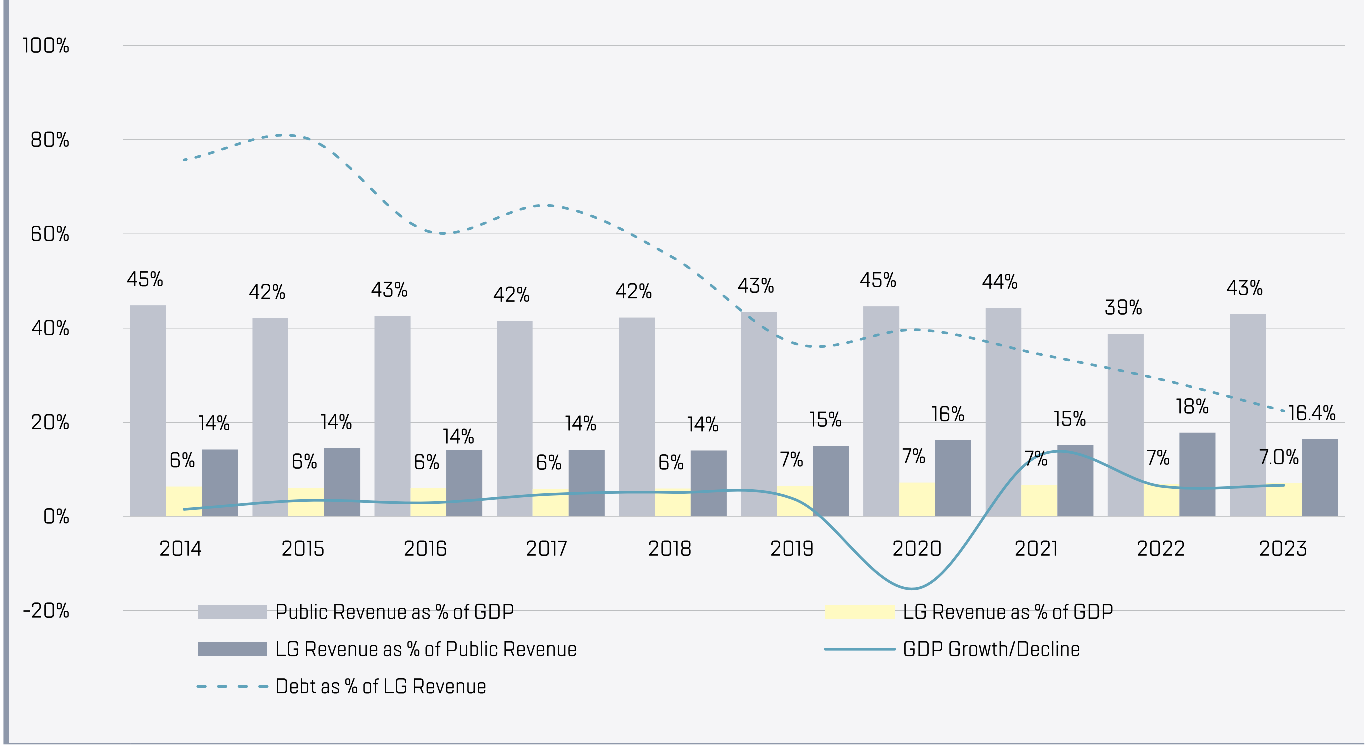
The UMM has raised concerns about state laws and regulations that reduce municipal revenues or impose new competences without proper consultation or compensation. One example is the Branch Collective Agreement for Public Administration and Justice, which impacts local employee wages including local officials and employees (expert management staff, expert staff, executive staff and employees). The Ministry of Finance did not involve municipalities or UMM in the development of this act, although it produced direct consequences for municipalities. Despite the UMM's objections, municipalities must apply this agreement, which has led to salary disparities. The UMM has called for changes to address these issues, including an amendment to the Law on Salaries of Public Sector Employees. This amendment is currently under review by the Ministry of Finance, although its future remains uncertain. A similar issue arose with the Branch Collective Agreement for Housing and Communal Affairs, which applies to municipal companies involved in these sectors. Once again, municipalities, their companies, and the UMM were not consulted. As a result, the UMM submitted a request to the Constitutional Court regarding the constitutionality of this act. Recently, this request reached a conclusion, with certain provisions of the contract being declared unconstitutional.

Last year, the UMM submitted several initiatives to amend various regulations related to local government finance, including the Local Government Finance Law, the Law on the Reprogramming of Tax Claims, the Law on Tax Administration, the Law on Property Tax, the Law on Forests, the Law on Salaries of Public Sector Employees, and the Decision on Drafting the Capital Budget. While the success rate of these initiatives has not been particularly high, there are expectations for improvement in the coming period. The challenges have largely been due to frequent changes in the government's organizational structure, shifts in ministry leadership, and ongoing political changes in Montenegro.

Statistical Overview of Local Government Finance in Montenegro

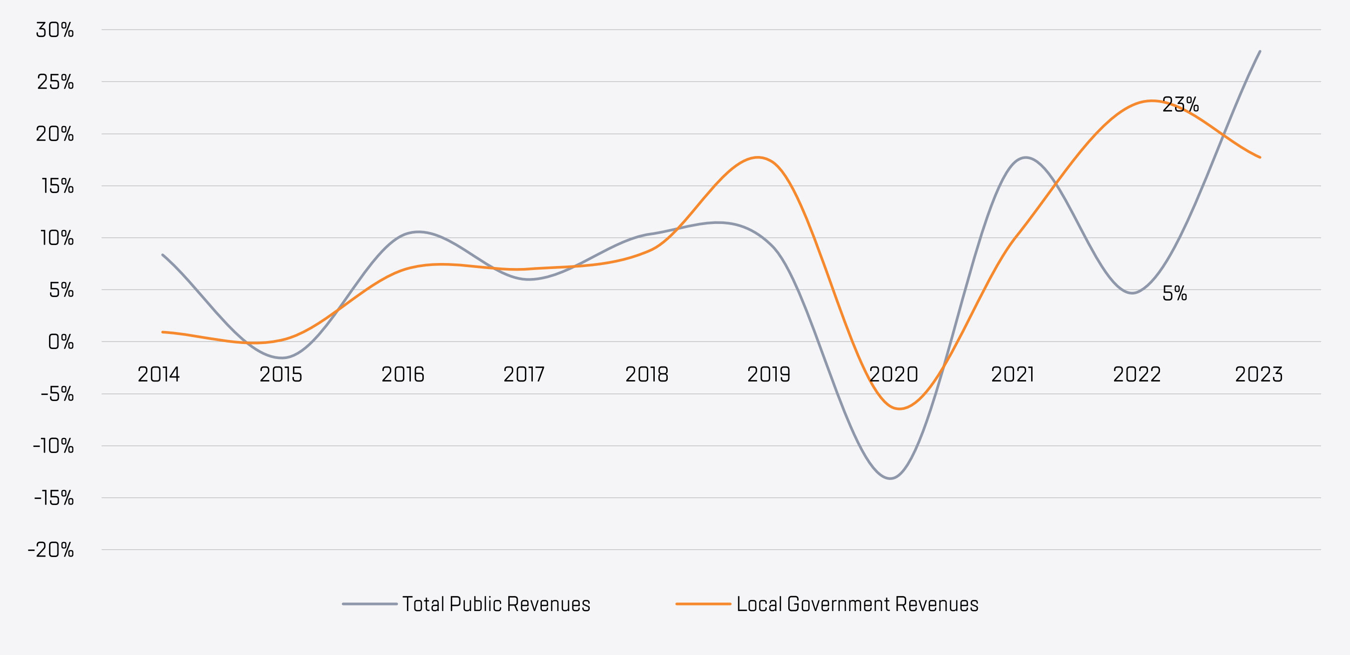
In 2007, local government revenue in Montenegro was 11% of GDP, the highest in South-East Europe and close to the EU average. This was driven by the real estate market expansion, public investments, and local income from land development and asset sales. However, by 2019, this share had dropped to 6.5% of GDP, worsened by the economic crisis and the elimination of several revenue sources, especially fees. The COVID-19 crisis further impacted the economy, but local revenue began to recover slowly in 2020, stabilizing with minor fluctuations in the following years. At the same time, local government debt has reduced from 80% of total local revenues in 2015 to 22% in 2023.

Figure 99. ***Montenegro:*** *Local Government Revenue as Share of GDP and Total Public Revenue*



Municipal revenues in Montenegro declined faster and recovered slower than total general government revenues from 2007 to 2017, though alignment improved in 2017. The introduction of the new Law on Local Finance in 2019 led to a 17% growth in local revenues, compared to a 9% increase in general revenues. Both local and total government revenues saw a significant decline in 2020 due to the Covid-19 pandemic, but recovery began in 2021, with notable improvements in 2022 or 2023.

Figure 100. ***Montenegro:*** *Fluctuations in Revenues of the General and Local Governments*



Montenegrin municipalities are unique in the region, with nearly two-thirds of their revenues coming from own sources. However, after 2010, legislative changes reduced some own source revenues. The 2019 amendments to the Local Government Finance Law increased the share of revenues from shared taxes. By 2022, shared revenues accounted for 22% of total revenues, rising to 27% in 2023, primarily due to PIT. Despite these changes, own source revenues still make up 60% of total revenue, showing nominal growth. Equalization revenues have increased nominally but now represent a smaller share of total revenues, while conditional grants were eliminated in 2019.

Figure 101. ***Montenegro:*** *Composition of LG revenues, in % of the total*

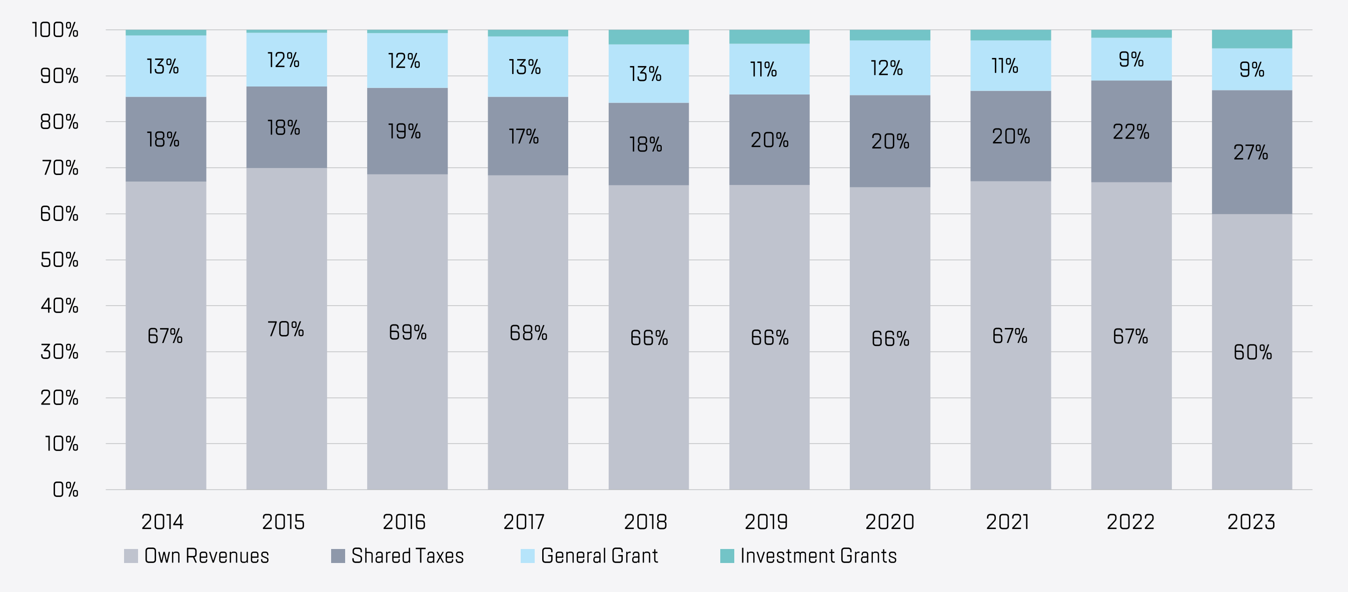


Figure 102. ***Montenegro:*** *Composition of Local Government Revenues (mln euro)*

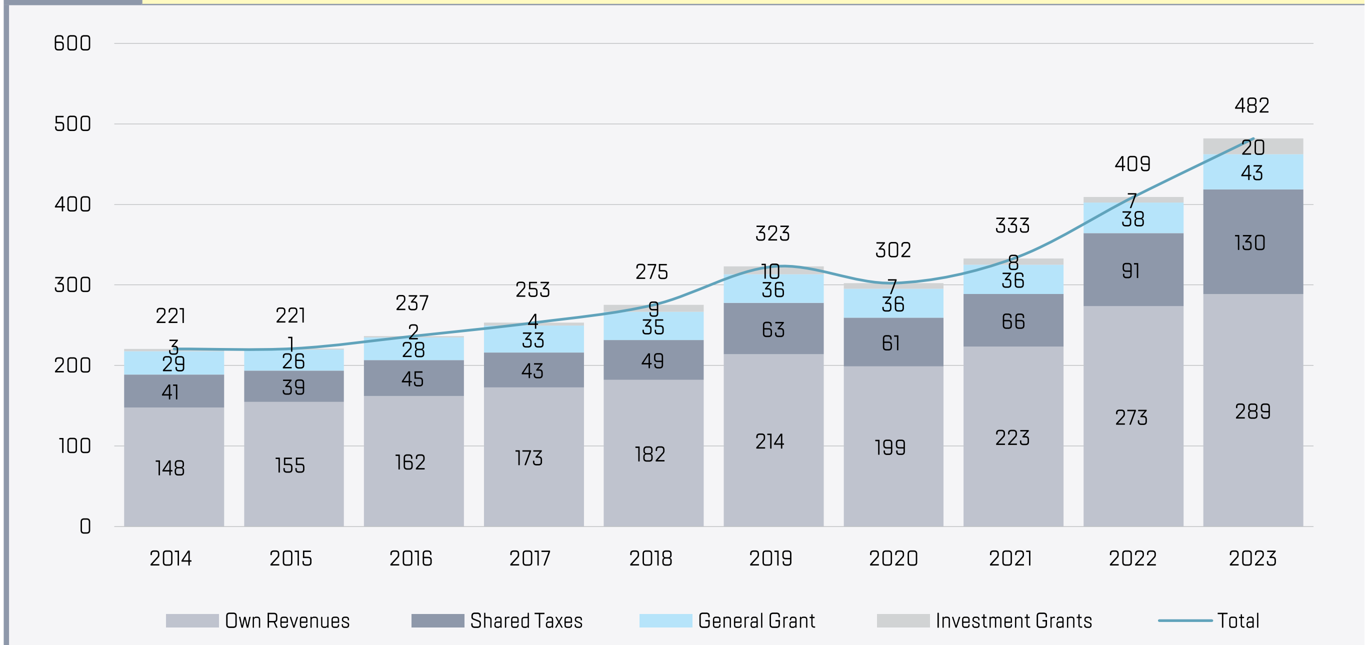
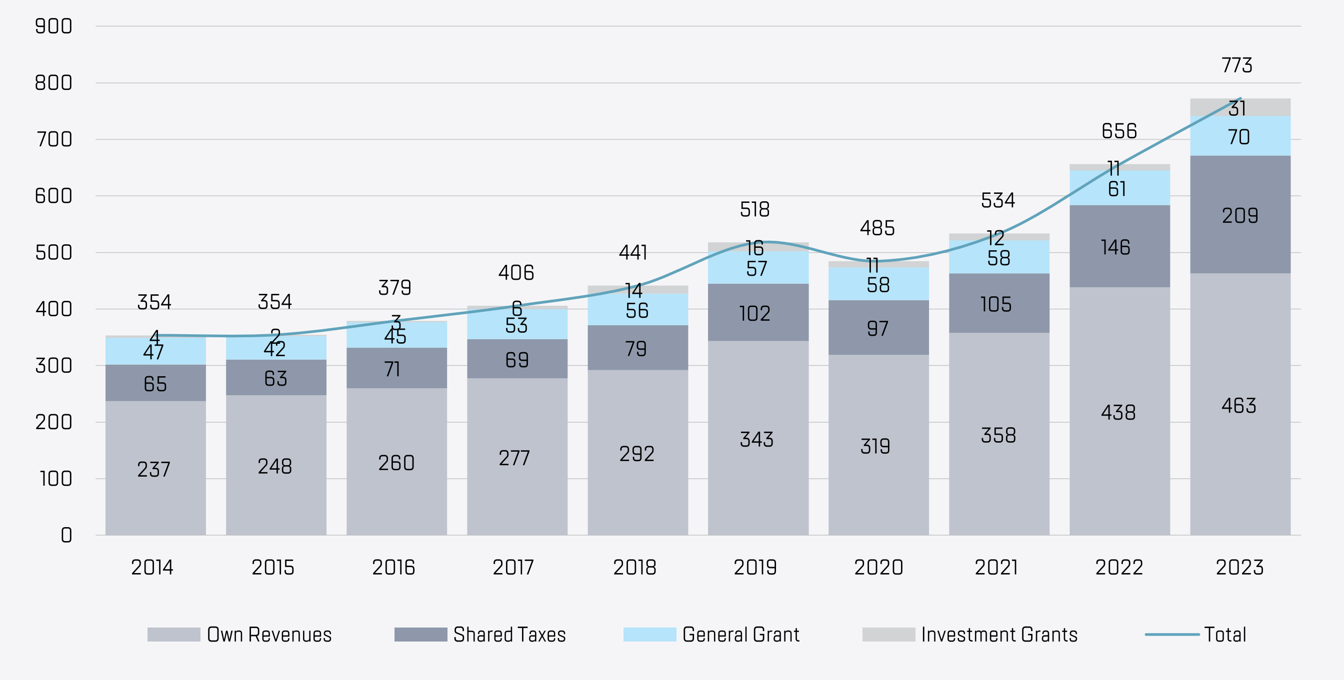
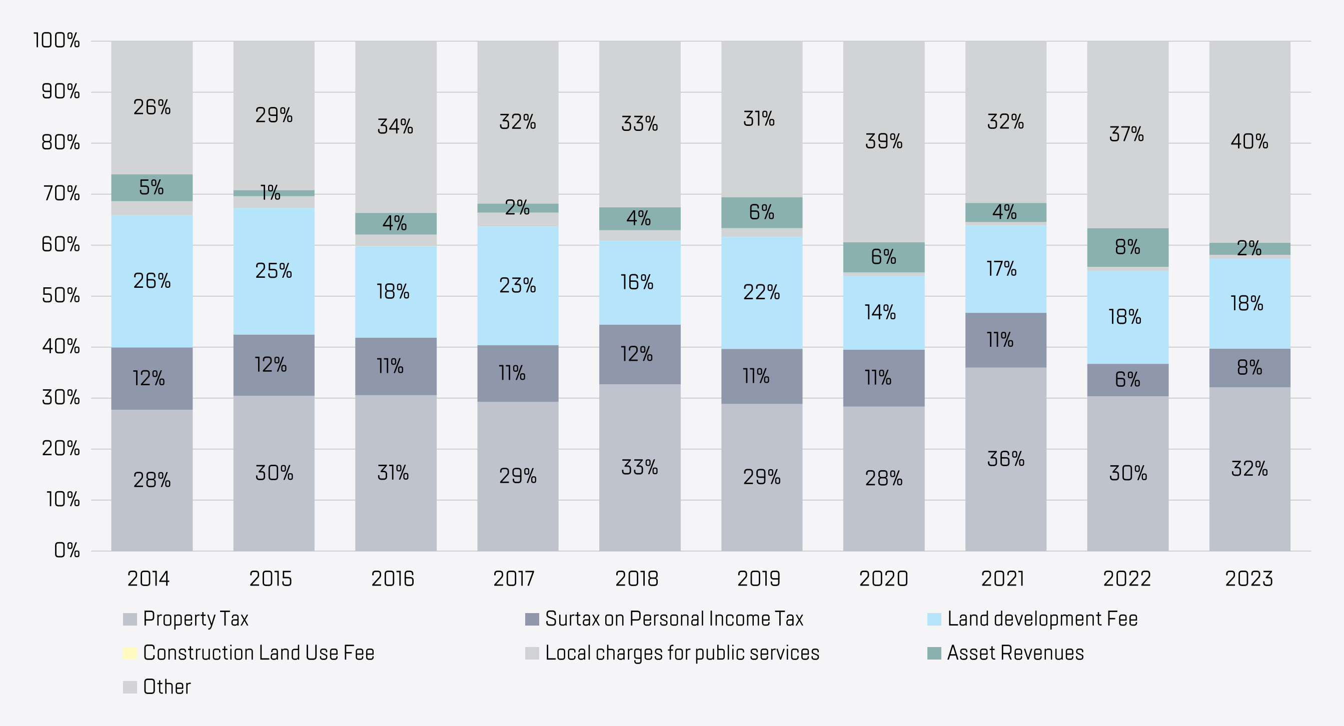


Figure 103. ***Montenegro:*** *Composition of Local Government Revenues (euro per capita)*



Until recently, the Land Development Fee was the largest source of local own revenue, but government-imposed constraints have reduced its role. Its share of total own source revenues fell from 34% in 2012 to 14% in 2020, before slowly increasing to 18% in 2023. The Construction Land Use Fee was eliminated in 2009, and while the Law on Communal Services prescribed a Communal Fee as a replacement, it never came into force. Local governments have sought to offset the lost income by relying more on the Property Tax, which has grown from 8% of local revenue in 2006 to 32% in 2023, now representing nearly a third of all own revenues.

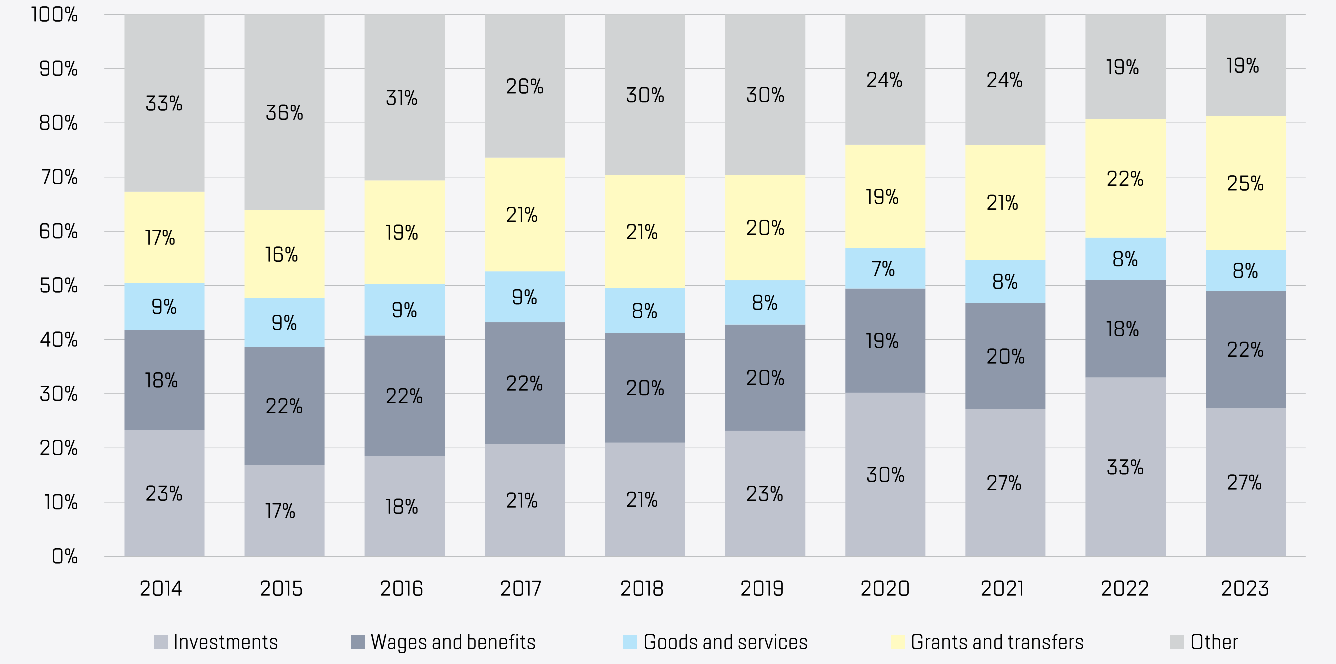
Figure 104. ***Montenegro:*** *Composition of own source revenues, in % of the total*



Following the implementation of the "Europe Now" Program in 2022, the Surtax on PIT decreased, reflecting a reduced tax base. Other revenues, such as carryovers from previous years (due to unresolved property issues or lengthy tender procedures) and transfers from the state budget related to economic citizenship, also contribute significantly to total revenues.

The share of local government investments in total local expenditure has decreased significantly from 53% in 2008 to as low as 17% in 2015, before rising again to 27% in 2021 and 2023 (with a similar share in 2022). While operating costs for goods and services have remained relatively stable, spending on wages, transfers, and debt repayment has increased substantially. The rise in wages and benefits in 2023 was largely due to changes in legislative regulations that increased wages for local officials and employees. A further challenge is the outstanding obligations of some municipalities related to unpaid taxes and salary contributions, though this issue is expected to be addressed through the reprogramming of tax obligations. Overstaffing remains a significant concern in public administration, including local government.

Figure 105. ***Montenegro:*** *Composition of expenditure, in % of total*



Local government investments in Montenegro have decreased from a peak of 166.4 million Euro to a low of 40 million Euro in 2015, before rising to 78 million Euro in 2021 and significantly increasing to 112 million Euro in 2022. Meanwhile, wages and benefits saw a nominal increase, particularly in 2022 and 2023, reaching 77 million Euro. This rise was primarily due to changes in regulations regarding local official and employee wages.

Figure 106. ***Montenegro:*** *Composition of expenditure, in mln Euro*

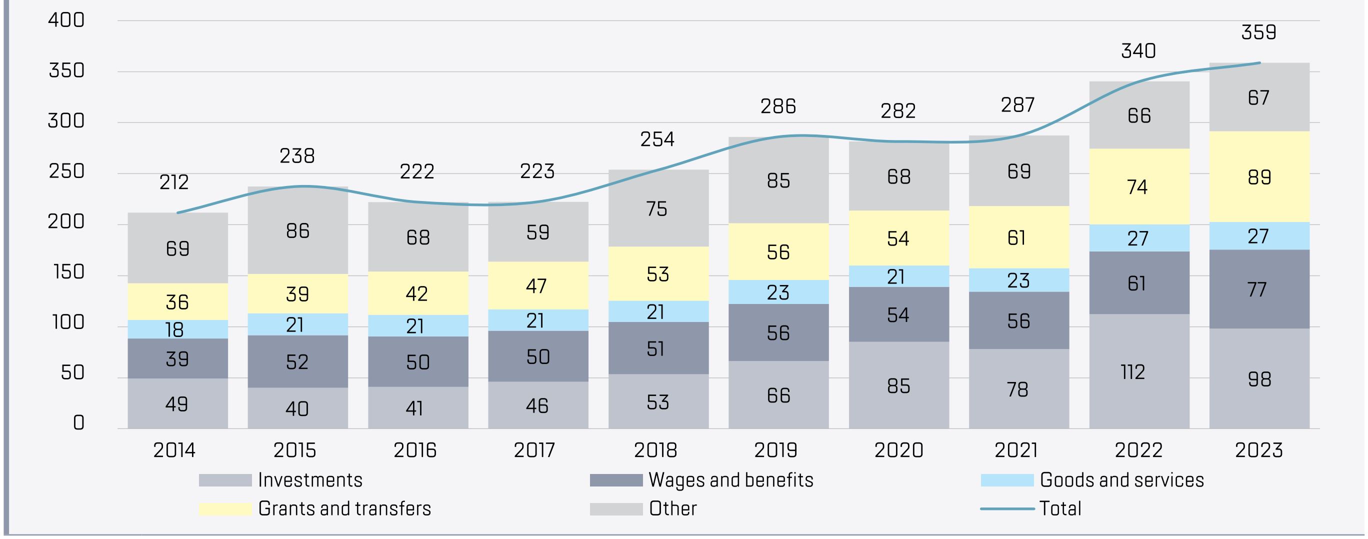
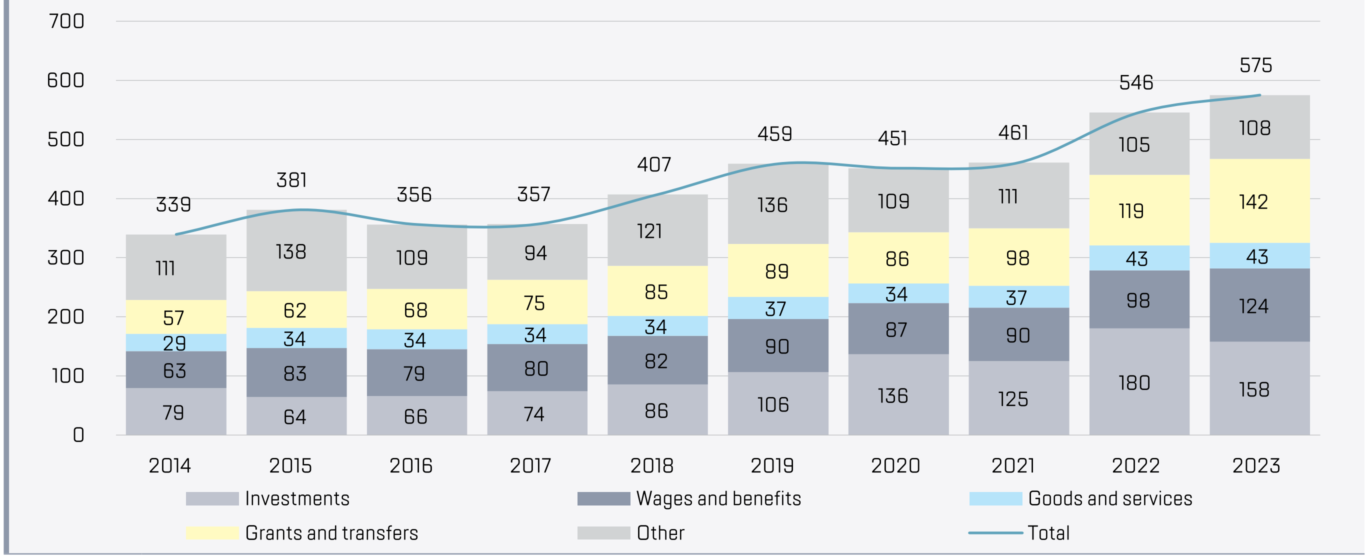
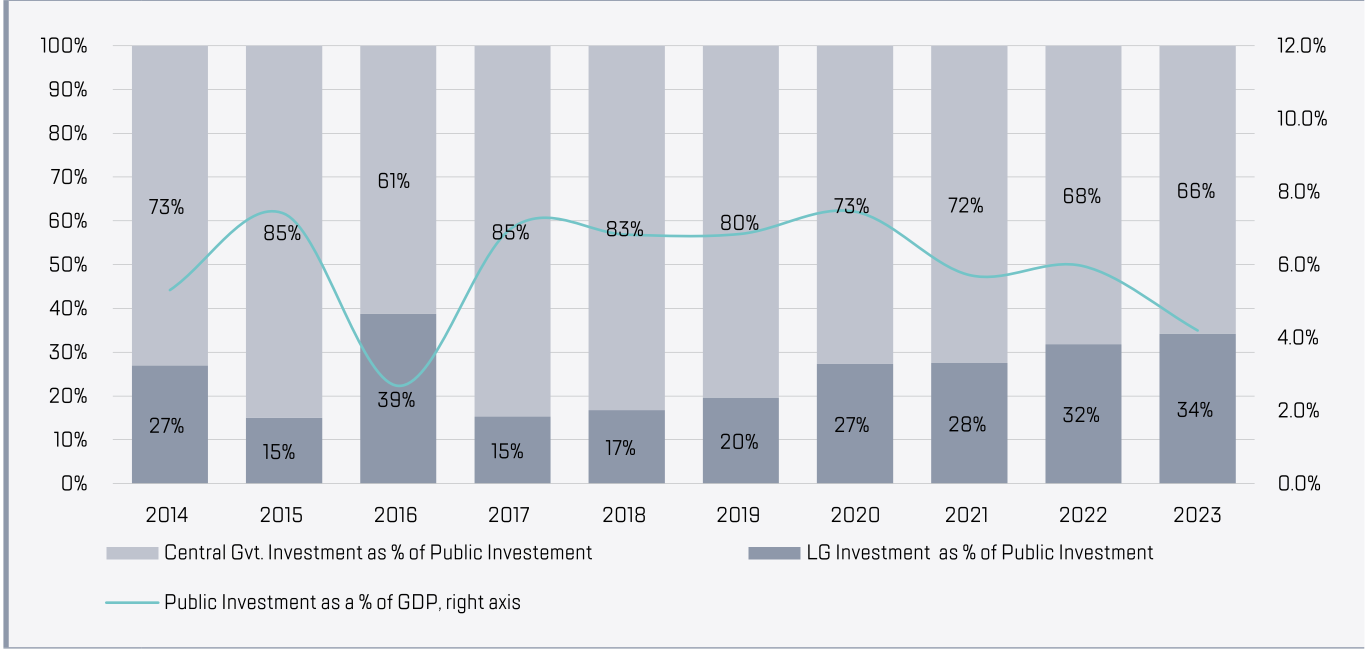


Figure 107. ***Montenegro:*** *Composition of expenditure, in Euro per capita*



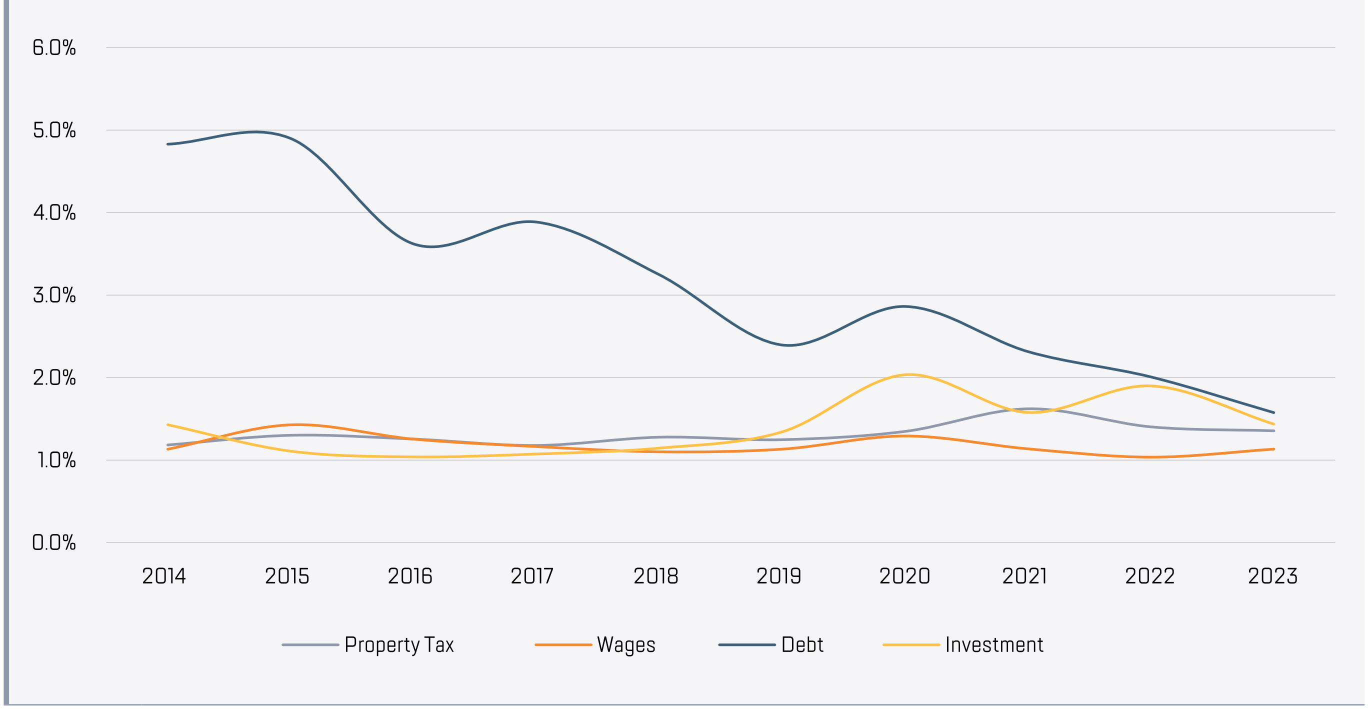
The economic downturn caused a significant contraction in public sector investment from 2008 to 2013, with another drop in 2015. However, the increase in local government revenues in 2019 led to a rise in investment spending. Public investment began to recover after 2014 (except in 2016), but slowed again in 2020, reaching 4,1% of GDP in 2023. The share of total public investment coming from municipalities continued to decline until 2018, but started to recover slowly thereafter, reaching 28% in 2021, 32% in 2022, and 34% in 2023.

Figure 108. ***Montenegro:*** *Public Investment by level of Government and as a share of GDP 2006-2023*



In response to the economic downturn and policy changes, local governments increased the property tax, reduced investments, and raised borrowing. Local debt to GDP exceeded 5% in 2013, creating unsustainable pressure on already weakened local finances. Many municipalities struggled to meet their obligations to banks, suppliers, and the state budget, prompting emergency intervention by the Government of Montenegro. As a result, debt service payments were contained, and the local debt-to-GDP ratio began to decline. The changes introduced in the Local Government Finance Law in 2019 and in 2022, helped stabilize local revenues. By 2021, local debt as a share of GDP had decreased to 2.3%, and further declined to 1.5% in 2023.

Figure 109. ***Montenegro:*** *Investment, Wages, Debt Service and Property Tax as a share of GDP*



Local investment as a share of total public investment fell from 59% in 2006 to only 15% in 2017 but rose to 34% in 2023. Local investment to GDP decreased from over 5% in 2008 to 1% in 2017, with a slight increase in the following years. The share of municipal wages to GDP also decreased compared to pre-crisis levels, partly due to some municipalities' inability to pay taxes and contributions on salaries, though wage costs still show growth.

Republic of North Macedonia

By Andrijana Babushku, Association of the Units of Local Self-Government of the Republic of North Macedonia (ZELS)

The Intergovernmental Transfer System

Local government financing in North Macedonia is governed by the Law on Financing of Local Self-Government Units, enacted in 2004, which outlines a phased approach to fiscal decentralization reforms. North Macedonia features a highly decentralized public sector. Local self-government units (LSGUs) are tasked with maintaining and improving local infrastructure, managing water supply and wastewater treatment, waste management, public lighting, and local transport. They also manage primary and secondary education, cultural institutions (cultural centers, libraries, and museums), social protection (child and elderly care), and firefighting.

Financing of local governments in North Macedonia. The Law on Financing of Local Government defines the sources of municipal revenues as follows:

- **Own Source Revenues (OSRs)**: Include property tax, local fees, duties and taxes, property revenues, and fines or donations.
- **Shared Taxes**: Personal income tax and value-added tax (VAT) distributed according to a formula as **General Grant**.
- **Block Grants**: From the national budget for primary and secondary education, culture, and social protection.
- **Earmarked Grants**: for special programs or specific investments, and for the unification of firefighting protection;

Since 2006, about a third of local budgets have been financed from Own Source Revenues (OSRs), primarily from utility fees, property taxes, and construction-related compensations. In 2023, revenues from shared taxes (VAT and Personal Income Tax (PIT) totaled €73 million, making up 9.6% of local self-government revenues.

Shared taxes include: 6% of PIT from the salaries of natural persons, allocated on an origin basis, as per the residence of the taxpayer; and 100% of the PIT from natural persons, engaged in craft activities.

Macedonian municipalities are also entitled to 6% the Value Added Tax collected in the previous fiscal year, which is allocated to them as a **General Grant (Subsidy)**. As of 2021, the general grant is composed of three components: the base component, the performance component and the equalization component. The Size of each of these components is predetermined in the legislation.

Shared Tax Revenues

- 6% of PIT (Wage Tax)
- 100% of PIT from natural persons engaged in craft activities
- 100% of Property taxes
- 78% of concession fees on minerals

The criteria used to allocate the main/base component of the general grant are defined by an annual regulation (Government Decree), according to which:

- All municipalities receive a lump sum amount of 3 million dinars (approximately €48.700);
- The residual grant pool (after deducting the lump sum amounts) is then divided between the capital city of Skopje and its composite municipalities (12%) and all other municipalities (88%);
- Funding for municipalities is based on a formula that allocates 65% on population; 27% on surface (square kilometres); and 8% on the number of settlements;

General Grant

- **Size:** 6% of the VAT
- **Category**: freely disposable
- **Components:**
  - Base fund: 4.5% of VAT
  - Performance fund: 0.75% of VAT
  - Equalization fund: 0.75% of VAT
- **Allocation of the Base Fund**
  - lump sum of 3 mln Denars per LG
  - 12% of pool for capital city and Skopje municipalities
  - 88% for all other municipalities
    - 65% on population
    - 27% on surface area
    - 8% on settlements

The Government Program for 2020-2024 emphasized the development of municipalities through fiscal decentralization and balanced regional development. In 2022 a series of reforms were adopted aiming at: a) **Increasing Fiscal Capacity** by increasing municipal revenue sources from VAT and PIT; b) **Improving Fiscal Discipline** by reducing payment arrears and debts and ensuring responsible financial operations (the law allows municipalities to use credit instruments to manage payment arrears, provided they meet specific conditions related to financial stability); and c) **Enhancing Transparency and Accountability** by mandating municipalities to publish their financial data on their websites, and further strengthening oversight and reporting mechanisms.

To increase local government revenues, the PIT share rose from 3% to 6%, while the VAT share increased from 4.5% to 6% in 2024. The VAT increase was phased in, with a provisional increase to 5% in 2022 and 5.5% in 2023, culminating in the full increase in 2024. The additional VAT revenues are allocated to municipalities through two new funds:

1. **Performance Fund**: Rewards municipalities with better performance in collecting their own source revenues. Municipalities must meet two criteria:
   - Collected OSRs in the previous year are at least 70% of the planned OSRs;
   - Collected OSRs, in the previous year are higher than the average OSRs collected in the last three years before the previous year.
2. **Equalization Fund**: Aims to reduce fiscal capacity disparities among municipalities by providing funding to municipalities that have lower fiscal capacity (measured by per capita PIT revenues) but have shown fiscal effort and good results in collecting own income.

Performance Fund

- **Size:** 0.75% of VAT
- **Allocation**:
  - LGs must meet two criteria:
  - Collected own revenues > 70% of planned revenues
  - Collected own revenues > than average own revenues in the last three years

Equalization Fund

- **Size:** 0.75% of VAT
- **Allocation:** funds only those municipalities with lower-than-average per capita PIT revenues, collected in the previous fiscal year.

Block Grants: the distribution of the block grant for education is determined by annual decree, focusing on enrolment, employment, and the number of children who are entitled to free school transport. While the formula determining per-pupil payments is publicly available, the grant amounts are often insufficient, leading municipalities to supplement the sector's funding from their own resources. The preschool education block grants consider variables like preschool student numbers, type of heating systems and duration of heating seasons, the number of teachers in the school and the utilization rate of the facility. Cultural block grants are based on staff numbers, building size (in sq. meters), and services offered. The firefighting block grant only covers employee salaries, raising concerns about funding adequacy. Ultimately, although municipalities are theoretically autonomous in managing these funds, many face financial constraints.

Regional Development Fund: Intended to promote balanced regional development, this fund is supposed to equal 1% of GDP, but this target has not been met yet. Despite claims of greater overall funding from the national government, municipalities struggle with insufficient resources, which hampers effective service delivery and regional development.

Upcoming legislation, including the new Law on Balanced Regional Development and the Strategy for Balanced Regional Development (2021-2031), aim to address these issues. The Program for Sustainable Local Development and Decentralization (2021-2026) reflects the stakeholders' commitment to developing local self-government in line with EU norms and UN sustainable development goals. A *coordinating body*, comprising 22 representatives from various ministries and ZELS, has been established to monitor the implementation of these programs. A *sectorial working group for regional and local development* will support the formulation and implementation of national policies, including EU integration and donor aid. Municipalities often rely on state budget funds through line ministries, donations, IPA funds, and credit lines for infrastructure projects, limiting their ability to finance capital investments also due to resource and personnel constraints.

To enhance financing opportunities for capital projects, a working group comprising representatives from various ministries and ZELS is working on establishing an *Agency for Regional and Local Development*. This agency will have broader competencies than the previous Bureau for Regional Development and will enable municipalities to access additional financial resources for local and regional development based on established criteria and regional needs. The Ministry of Local Self-Government will coordinate the agency's operations.

Own Source Revenues

Own source revenues are crucial for financing municipalities in North Macedonia. The tax powers and revenue generation of local self-governments are governed by the Law on Financing Local Self-Government, the Law on Property Tax, the Law on Communal Fees, and other relevant sectoral laws. The Law on Property Tax covers property-related taxes, including sales, inheritance, gift, and property taxes. While the law defines the tax base and rates, municipal councils set the final rates within these limits. Property tax is based on the market value of real estate, determined by a local appraiser, with the valuation methodology determined by the central government but approved by the Association of Local Self-Governments (ZELS).

In 2023, property tax collection decreased, although performance varied among municipalities. Many municipalities have proactively updated their fiscal registers, assessed properties, and collaborated with the Public Revenue Office to enforce tax compliance by blocking non-compliant taxpayers' accounts. Conversely, some local governments have adopted a more passive approach to updating their records.

Effective planning and realization of own source revenues are essential for funding planned projects and ensuring financial stability, as the generation and settlement of local self-government obligations depend on revenue realization. Unrealistic own-source revenue planning has contributed to unpaid obligations in North Macedonia. To enhance revenue planning efficiency, an amendment to the Law on Financing Local Self-Government Units in November 2018 stipulated that municipalities could plan own source revenues with a maximum increase of 10% over the average realized incomes from the last three years. Municipalities that achieve over 75% of their planned own source revenues by the third quarter may increase their planned revenues up to 20% starting in 2025. For 2023, municipalities could plan 20% with an additional 10% after the third quarter, while for 2024, the percentages are set at 15% with an additional 15%. Exceptions are allowed when municipalities secure confirmation of funds from appropriate institutions or experience changes in their basic budget revenues.

Local Government Borrowing

Access to local borrowing in the capital markets has improved due to more liberal and transparent borrowing conditions, increasing municipalities' interest in financing investment projects. In this context, the government has facilitated credit lines from international financial institutions such as the World Bank, European Investment Bank (EIB), KfW Bank, and the European Bank for Reconstruction and Development (EBRD). These funds have enabled significant investments in the reconstruction and rehabilitation of local streets, roads and bridges, construction and reconstruction of water and stormwater networks, improving public hygiene and raising energy efficiency in municipal public facilities and spatial local planning.

Advocacy of the Local Government Association

The Association of Local Self-Governments (ZELS) in North Macedonia proactively advocates for several key initiatives aimed at enhancing the financial autonomy and operational capacity of municipalities:

- **Fiscal Decentralization**: ZELS has proposed a model to enhance the fiscal decentralization process in North Macedonia, which includes advocating for an increase in VAT allocation to municipalities and a larger share of personal income tax revenues. They suggest that at least 50% of the personal income tax should be allocated to local governments, with an initial recommendation of 30%

- **Decentralization of Social Services**: ZELS has been actively involved in discussions regarding the decentralization of social services, particularly in relation to Centers for Social Work (CSWs). They are conducting workshops and consultations to analyze the current situation and challenges faced by these centers and aim to enhance the capacities of local authorities to manage social protection services effectively

- **Enhancing Tax Administration**: ZELS is working on improving local tax administration systems by advocating for the development of information technology solutions to facilitate the collection and management of local taxes. This is aimed at addressing systemic weaknesses in tax administration across municipalities

- **Gender Equality Initiatives**: ZELS has organized workshops focused on promoting women's entrepreneurship at the local level, reflecting their commitment to gender equality and empowerment within local governance

- **Public Safety and Infrastructure**: They have also held discussions regarding public safety and infrastructure improvements, including collaborations with fire units to enhance fire protection measures within municipalities

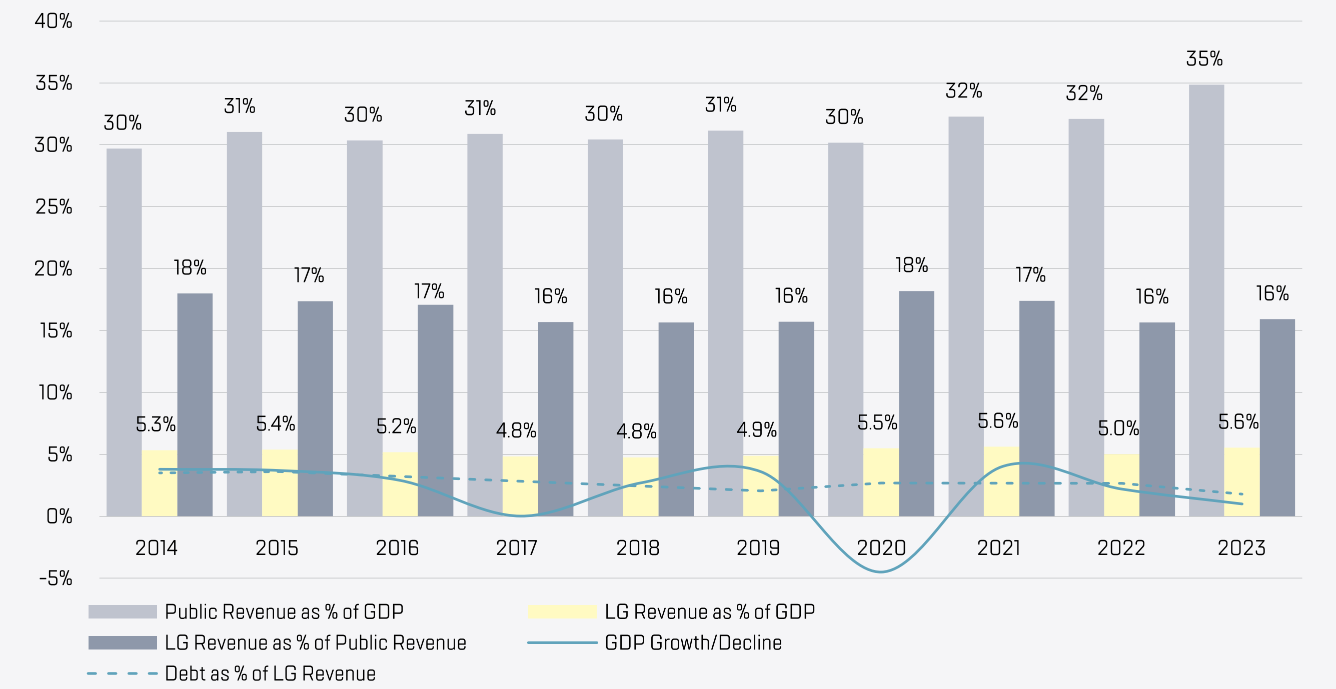
- **Clearer Fund Distribution**: ZELS has advocated for clearer guidelines regarding the allocation of funds from the Equalization Fund and Performance Fund, ensuring municipalities understand how these funds are distributed based on their fiscal performance and efforts.

These efforts reflect ZELS' ongoing commitment to strengthening local governance, increasing financial resources for municipalities, and promoting local social and economic development.

Statistical Overview of Local Government Finances in North Macedonia

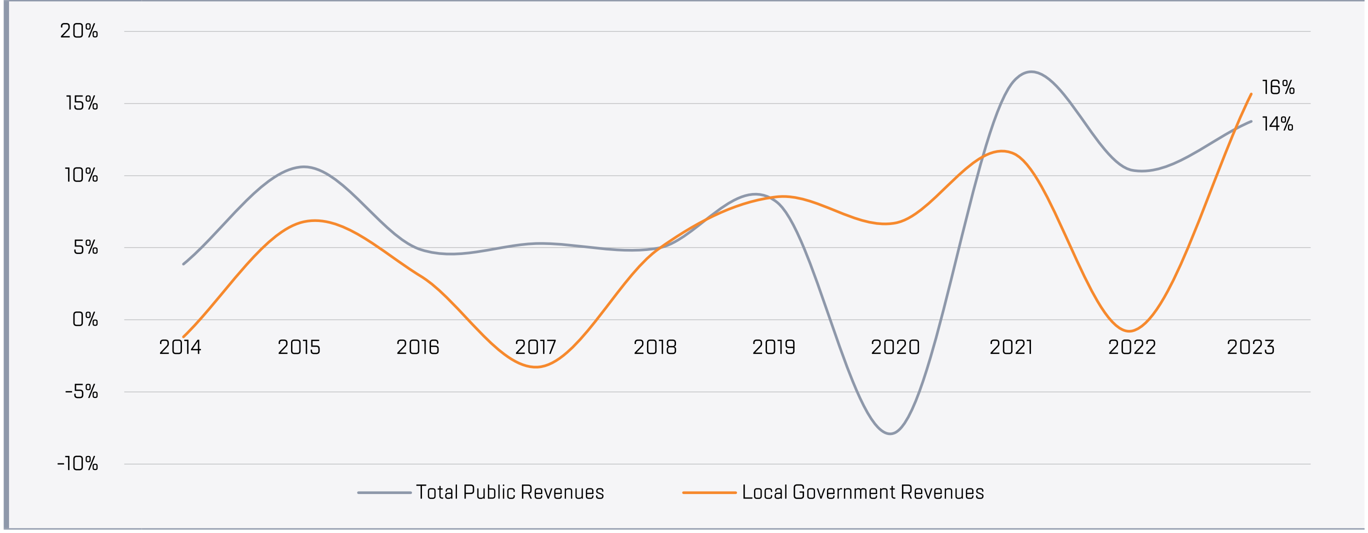
The share of LG revenues as a percentage of GDP peaked in 2012 but has shown a downward trend, thereafter, falling to 16% in 2023. Total municipal revenues reached 5.6% of GDP in 2023.

Figure 110. ***Local** Government Revenue as a Share of GDP and Total Public Revenue*



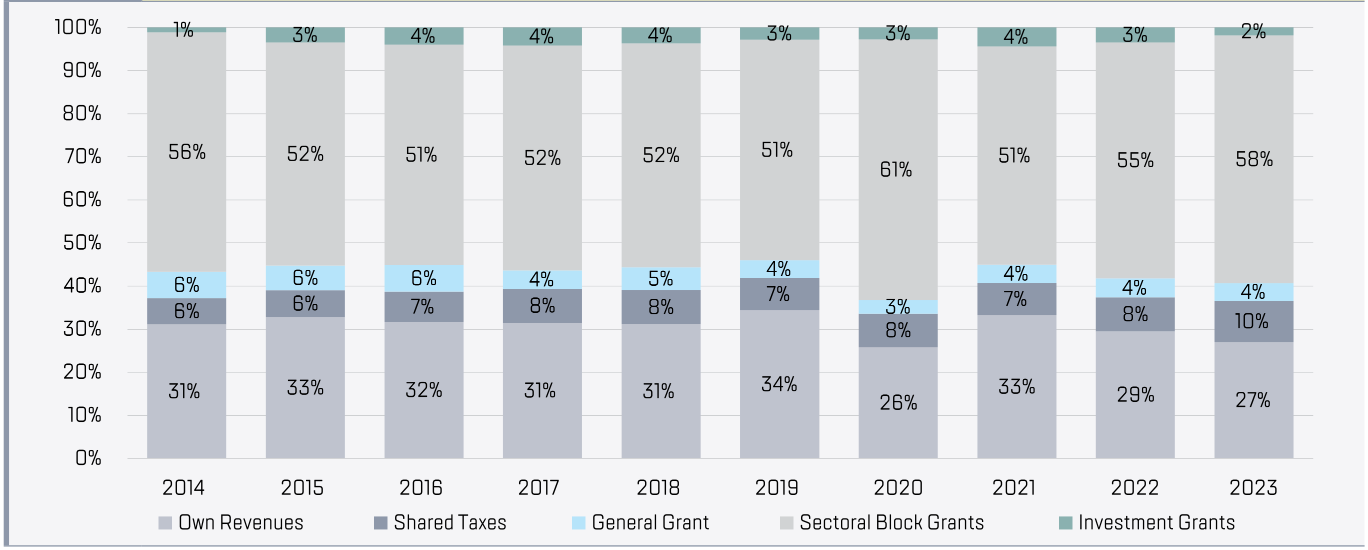
In 2023, local revenues grew by 15.6% compared to last year, a similar rate with the increase in total public revenues. The increase in local government revenues is driven primarily by the increase in own revenues.

Figure 111. ***Fluctuations*** *in the Revenues of the General and Local Governments*



Block grants remain the largest income source for local governments, accounting for 58% of total income in 2023. These funds are primarily allocated for financing education, cultural centers, and fire protection services. Own revenues constitute 27% to the total in 2023.

Figure 112. ***Composition*** *of Local Government Revenues*



In 2023, own revenues reached EUR 204 million while in per capita terms, Macedonian local governments raised on their own only 111 EUR per inhabitant in 2023. Sectoral Block grants have increased as well between 2006-2012 but have remained more or less at the same pea level of 2012 until 2020 when there was a major increase in the block grants.

Figure 113. Local Government Revenues, in Euro per capita

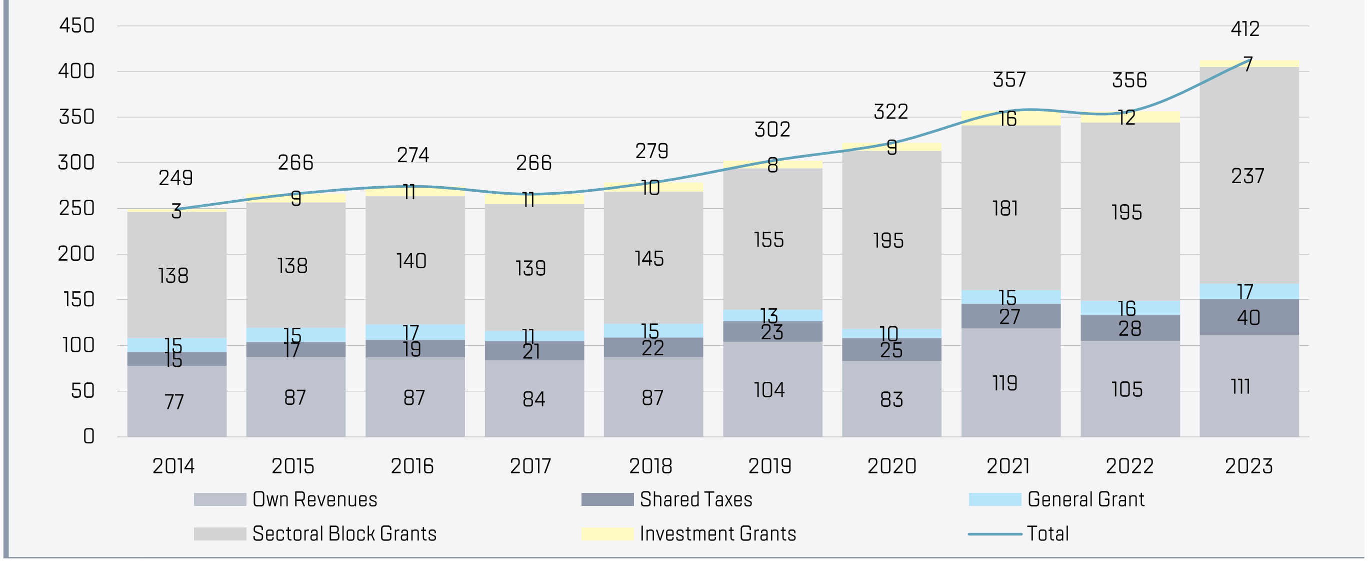
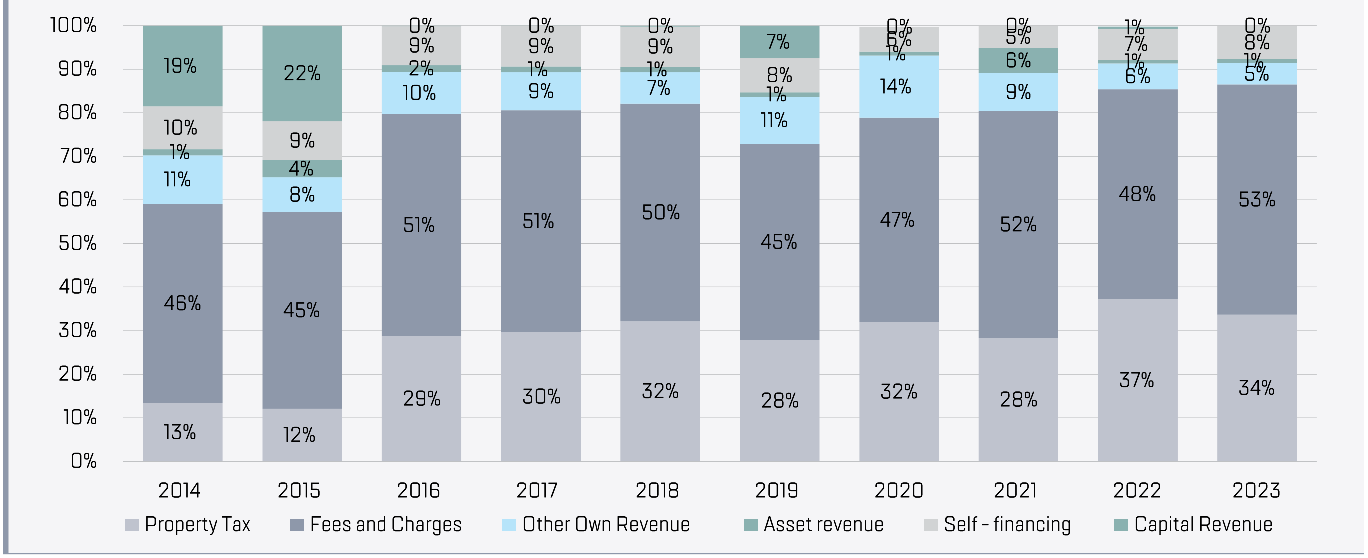


Figure 114. Composition of LG Own source revenues



Salaries constitute a major part of municipal budgets, driven largely by costs associated with primary and secondary education. Overall, spending on capital investments has shown a declining pattern, while spending on goods and services has remained relatively stable. Spending for grants and transfers have slightly increased in the recent years due to an increase in the social responsibilities of local governments.

Figure 115. *Composition of Expenditures, in % of Total*

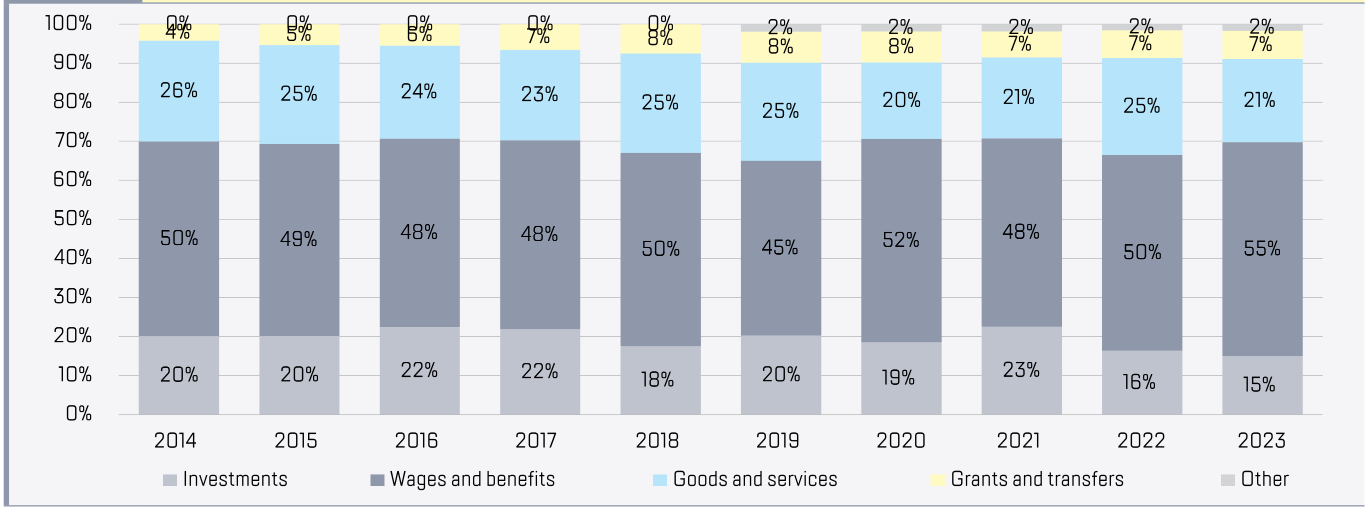
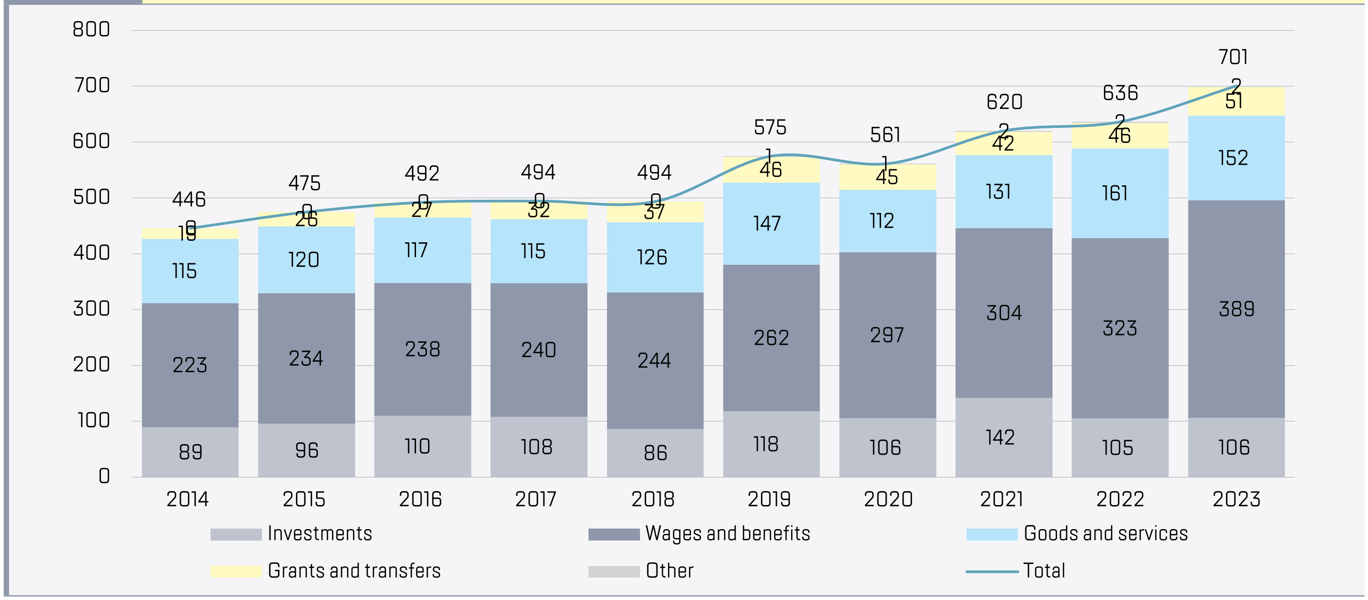
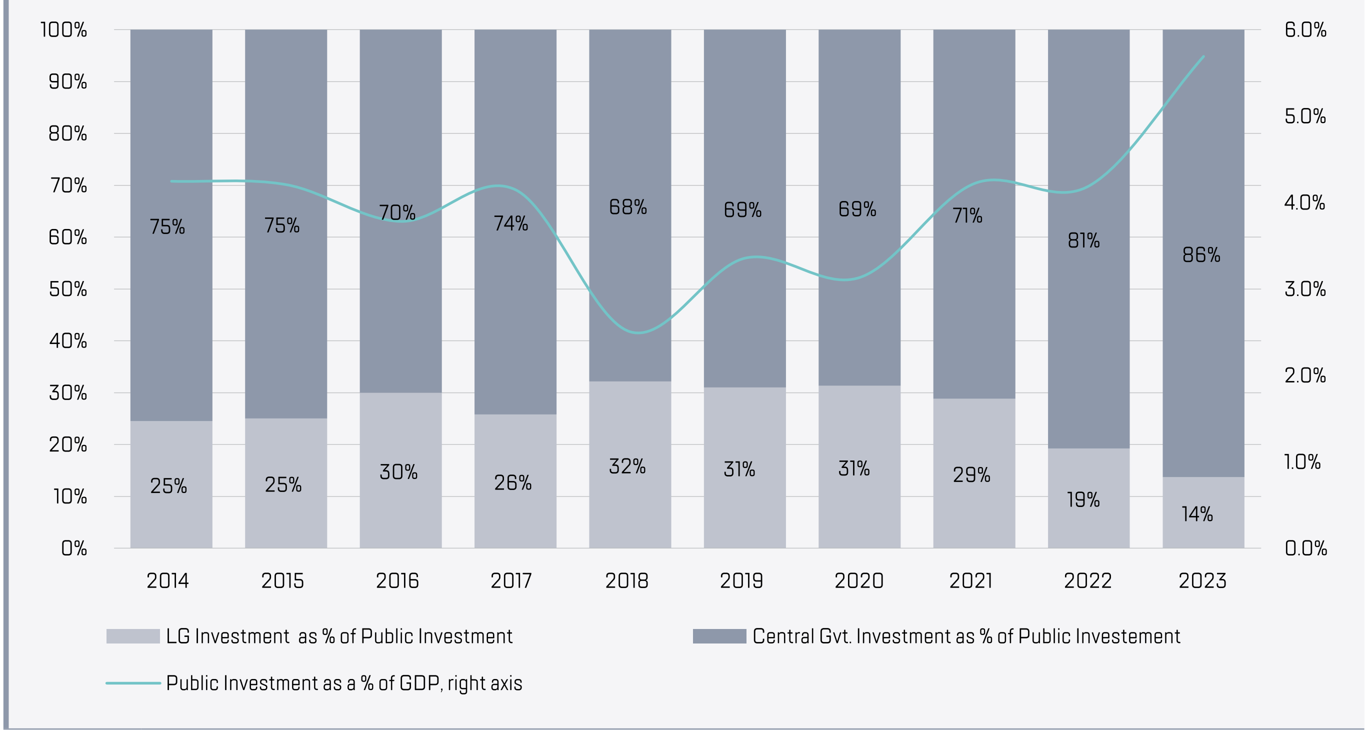


Figure 116. *Composition of Expenditures, in Million Euro*



Local government public investment makes up 14% of total public investments. Public investments in 2023 were 5.7% of GDP, which is an increase of 35% compared to 2022.

Figure 117. *Public Investment by Level of Government and as a share of GDP*



Romania

By Radu Comsa and Adrian Miroiu-Lamba, Association of Communes of Romania

The Intergovernmental Finance System

In Romania, the system of intergovernmental transfers is made of a cluster of financial flows from the state budget to the 3,228 local budgets, which serve several main purposes: (i) vertical equalization (i.e. ensuring resources for the delivery of shared and exclusive responsibilities); (ii) horizontal equalization (i.e. setting a level playing field for all local governments by compensating poorer ones for their lack of revenue generation capacity); (iii) financing delegated responsibilities (i.e. functions in which local governments act as agents of central government) and (iv) contribution to local governments investment expenditure.

The composition of the intergovernmental transfer system, as of 2023, is illustrated below:

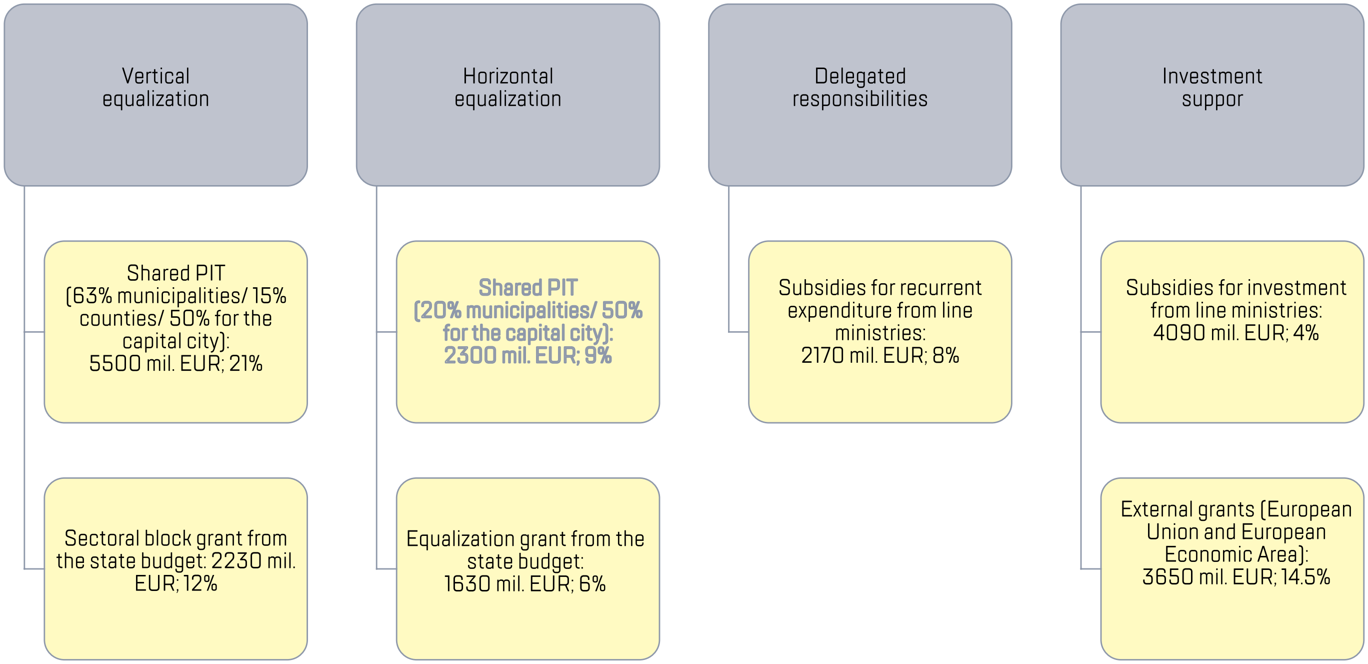
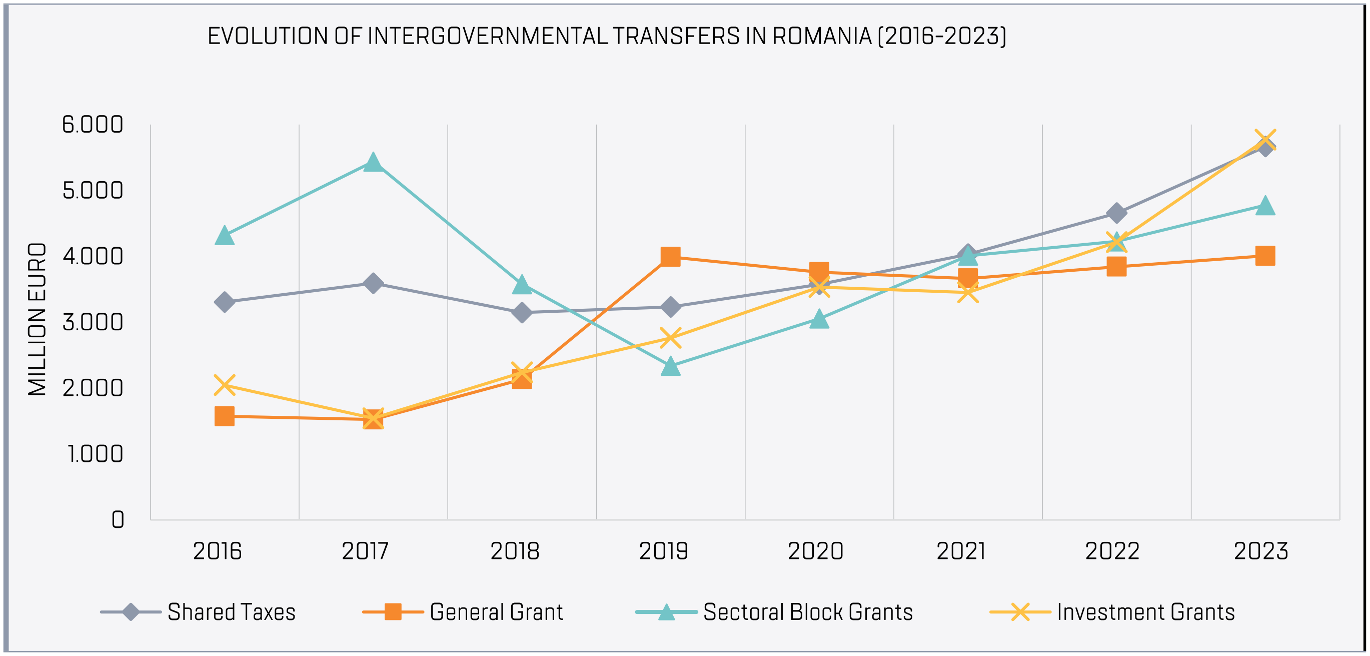


Figure 15. Intergovernmental transfers to Romanian local governments in 2023 (mil. euro and share of total revenues)

source: MoF reports on the annual budget execution of local governments, the legislation in force.

As of 2023, intergovernmental transfers accounted for 75% of local government revenues, totaling 20 bn. euro. The biggest was the shared PIT allocated on derivation basis (21% of total revenue). The second category was the equalization (general) grant, which consisted of pooled revenue from PIT (9%) and shared revenues (6%). The third source by size was made of EU grants, earmarked for investments, including state budget support for co-financing, which rose to 14.5% of total as the program cycle 2014-2020 was completed. The fourth source was the sectoral block grant from the state budget, aimed at expenditure in social services, education and county and rural roads (12%). The fifth source consisted of conditional (sectoral) grants for recurrent expenditure from line ministries (designated in the budget classification as subsidies), mainly for healthcare, totaling 8% of local government revenues (of which, ¾ subsidies for wage bill in public hospitals). The last source of funding from the state budget was made of investment grants provided by line ministries, which amounted to 4% of total revenues. In all, intergovernmental transfers amounted to 25 bn. euro or 6.23% of GDP, similar to the share recorded in 2021 and 2022, i.e. 6.3% of GDP and 6% of GDP.

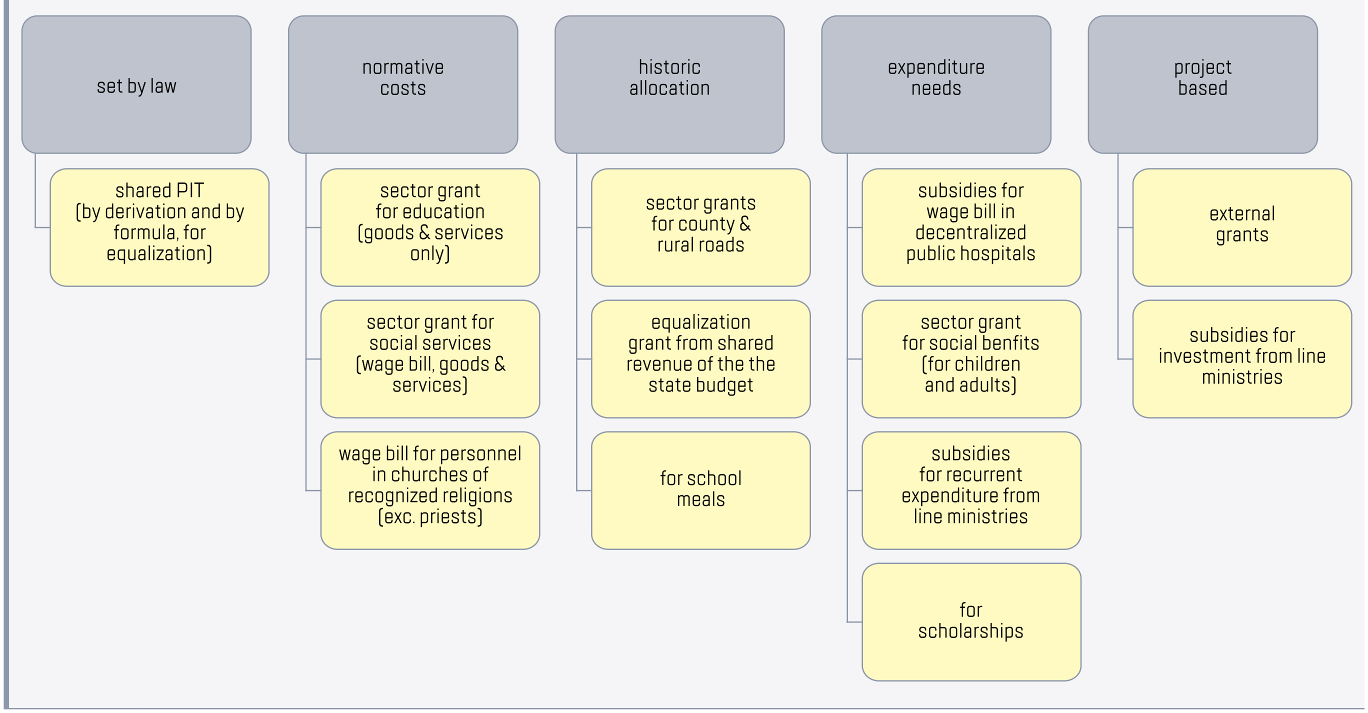
The total share of intergovernmental transfers in total local government revenues has fluctuated marginally in the past five years between 70%, in 2016, and 75%, in 2023. However, throughout this period there have been large fluctuations within the transfer system. Earmarked grants for investments have experienced the largest increase almost tripling in size between 2016 and 2023. Following the tax reform in 2018, the shared taxes have been steadily growing, doubling their proceeds in six years. The state budget sector grant decreased significantly due to the centralization of wage bill in preuniversity education in 2018, but subsidies linked to public hospitals' wage bill increased rapidly as a result of successive pay rises awarded in the Romanian public healthcare since 2016. As a result, the sectoral block grants returned to growth since 2019. Finally, the general grant, aimed at equalization of local budgets, increased spectacularly in 2019, as the equalization system was briefly overhauled, and then remained steady after the allocation formula underwent a new structural change in 2020.



Source: MoF reports on the annual budget executions of local governments

The value of intergovernmental transfers from the state budget or the ministries' budgets is determined by several valuation methods, as shown below:

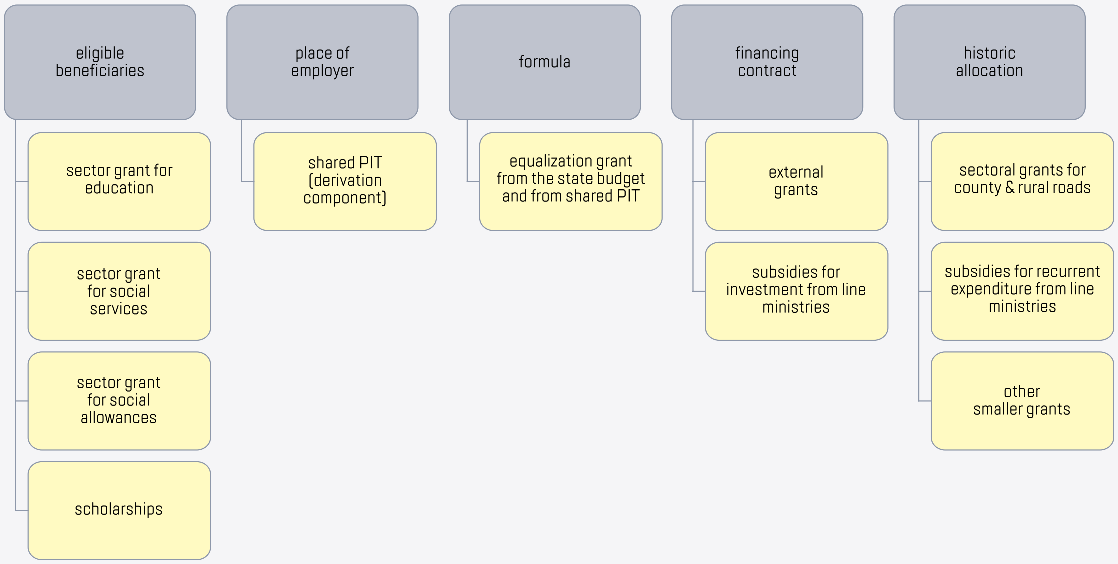
Figure 118. Algorithms for calculation of intergovernmental transfers, as of 2023 (Source: the legislation in force)



As a result of the calculation method, yearly variations of the intergovernmental transfers depend on changes to the underlying legislation, such as wage policy, tax base and rate of PIT or value of social allowances. For example, pay rises in public hospitals in 2018 determined a 100% increase of the subsidy for public hospitals' wage bill in that year compared to the previous year. The same situation occurred in relation to scholarships in preuniversity education, in which case coverage was extended and financing was assigned to the state budget through regulatory amendments in 2021. As a result, a new earmarked grant to local governments was set up in 2021.

The allocation of intergovernmental transfers to individual local governments is determined at county level (41 counties plus capital city, Bucharest), for the sector block grant, and central level, for subsidies and external grants. The calculation is carried out by the Ministry of Finance's deconcentrated services, in some cases with help from the deconcentrated services of line ministries, or by line ministries themselves (for recurrent subsidies), employing various criteria. Most resources are allocated to local governments using some sort of quantifiable criteria, either the number of beneficiaries or a formula (3/4 of all intergovernmental transfers) (see Figure 3). Investment contracts and the status of implementation determine the allocations for investments, while historic allocations are decisive for the remaining transfers.

Figure 119. *Allocation criteria of intergovernmental transfers as of 2023 (Source: the legislation in force)*



Intergovernmental transfers have been a constant feature of Romania's intergovernmental fiscal relations as the allocation of responsibilities exceeded the own revenue generation capacity of local governments. During the economic crisis of 2009-2012 the central government attempted to rationalize expenditure by setting normative costs as criteria for the calculation of education and social services grants. While this aim was correct, the efficiency gains were diminished by (i) delays in structural reforms (in education, wage bill is paid directly by the Ministry of Education (MoE), school closure remains complicated, personnel is managed by MoE, while school principals continue to be appointed by MoE), (ii) shortcomings of the allocation flows to individual local governments (in education, schools with funding shortages get additional resources on top of the normative costs allocations by ah-hoc decision of MoF and MoE deconcentrated services) and (iii) delays in the update of normative costs (in social services, the normative costs did not reflect the pay rises awarded to employees in recent years; as a result, Government puts additional ad-hoc resources to the respective sector grant annually via the Government Reserve Fund).

In addition to the inadequacy of normative costs, several additional flaws hinder the effectiveness of the intergovernmental transfers system. The current set-up is too fragmented, especially with regards to subsidies for recurrent and capital expenditure (more than 40 line-items in 2021). Furthermore, the resources allocated within the sector block grant and subsidies are earmarked. Instead of giving local governments allocative autonomy in exchange for performance accountability, the Government and Parliament are micro-managing the utilization of intergovernmental transfers and pay little attention to local preferences. A growing problem in recent years has been the practice of suspending the application of the statutory equalization formula provided by the Law on local public finance. Since 2015, the state budget laws have included provisions which derogated from the Law on local public finance and replaced the formula with other allocation criteria. Finally, the issue of unfunded mandates continues to impair the quality and access to local services. For example, each year local governments complain of the insufficiency of sector grants allocated for payroll of assistants to disabled persons; as a result, own revenues are used to complete the respective payroll needs and thus to fulfill a delegated function from central government.

Local Government Own Revenues

Romanian local governments' own revenues consist of local taxes, user charges, fees, asset revenues etc. In 2023, they amounted to 24% of all revenues, i.e. 2.1% of GDP. The high share of own revenues is due primarily to the hospital fees from the National Health Insurance House and the Ministry of Health, which accounts for 10.3% of all local government revenues. These are earmarked for use in hospitals.

Local taxes come second among own revenues amounting to 7% of all local government revenues, namely 0.6% of GDP. Property taxes – on buildings, land and motor vehicles – make the biggest part of local taxes. Of the other non-tax and non-hospital revenues, the biggest are (i) fees for various services provided directly by local governments or by subordinated entities and for permits issued to private entities[14] and (ii) income from property management (royalties, rents).

All local taxes, including property taxes, are regulated by the Fiscal Code with national application. The current provisions have been in force since 2016. All tax administration duties – from tax setting to collection – are carried out by local governments where taxed items are located.

The tax value of properties is not related to the market value. Instead, for buildings owned by natural persons, the tax value is determined by multiplying area with predefined values and coefficients related to physical characteristics and location. For buildings owned by legal persons the tax value is either the accounting value, the construction value or the transaction value. The tax rate is applied differently for buildings owned by natural and legal persons. The law provides a range from which local governments chose the applicable tax rate, namely 0.08% to 0.2% for natural persons and 0.2% to 1.3% for legal persons. For land, the tax is determined by multiplying area with predefined values and coefficients related to location and land use. For motor vehicles, the tax is determined based on the volume of the engine: the bigger the engine capacity the higher the tax per unit measure. Local governments are free to increase the property tax dues beyond the limits set by the Fiscal Code by up to 50%. In the case of unfarmed land and derelict buildings the tax owned may be increased up to five-fold. The predefined values provided by the tax code, including tax values for motor tax, which act as floor values, are updated every year with the inflation rate from two years earlier[15].

Taxpayers are owners of buildings or land or vehicles. In the case of publicly owned property that is rented or given to concession, it is the occupier who pays the tax. The legislation provides for numerous exemptions from the property tax. As a rule, public property is not taxed unless used for economic activities. In addition, public infrastructure of any kind, educational, religious and healthcare facilities, as well as residences of disabled and impoverished persons are tax exempt, too. A series of tax reliefs may be granted by the local government (i.e. to historical buildings, buildings occupied by social services providers etc.).

The tax calculation is performed every year by the local government where the property is placed. The local government also sends the tax bills to payers and manages tax collection. An discount of 10% is provided by law if the tax is paid before due date. Payment methods vary from cash or electronic card at the tax administration desks to online payments or bank transfers. There is a national portal for online payments, www.ghiseul.ro, which has gained popularity rather slowly because of complexity and lack of awareness.

[14] For instance, local governments authorize retail stores, restaurants and any commercial private facility that provides goods & services directly to the population.

[15] As a result of the yearly updates, the values provided by the tax code, as was approved in 2016, have become obsolete.

In case of non-compliance, the local government sends summons and then begins the forced execution procedure, which consists of garnishment of bank accounts, seizure and eventually sell-off of the respective property. Oversight of tax administration is ensured ex-post by the Court of Accounts. The Ministry of Finance and Ministry of Regional Development and Public Administration provide technical support. Dissatisfied owners may appeal the tax bill at the tax administration or at the Administrative Court.

The biggest challenge faced by local governments in tax administration is collecting tax due from earlier years. They manage satisfactorily the collection of dues arising in the current year, but are very slow to clear historic dues, which account for around 50% of all receivable property tax. One of the major barriers in this respect is the fragmentation of databases. Each local government uses tailor-made fiscal registers which are not interconnected. In addition, connectivity with State Tax Administration, Land Registry, Motor Vehicles Registry and notaries is irregular and depends on local initiatives.

Property tax valuation requires modernization. The current system dates from communist times when transactions and information were scarce. As a result, tax values are significantly below transaction prices and, hence, local governments miss the opportunities provided by the continuous expansion of the housing market.

Against this backdrop, the principal recommendations put forward with regards to property tax administration in Romania are the following:

- Achieve interconnectivity between all local governments' tax registries, relevant central government registries (State Tax Administration, Land Registry, Motor Vehicles Registry) and notaries.
- Carry out a national campaign to increase awareness of online tax payments. Simplify procedures for registration and solve back-office difficulties (especially in relationship with the Treasury).
- Change the tax valuation to a market-based system. The current information flows offer enough data on real estate transactions to enable a market-value tax setting mechanism. A gradual implementation and pilot projects could offer practical solutions and anticipate difficulties before the roll-out at national level. (This goal is also stated in the National Reconstruction and Resilience Plan with completion envisaged for 2025).

Borrowing

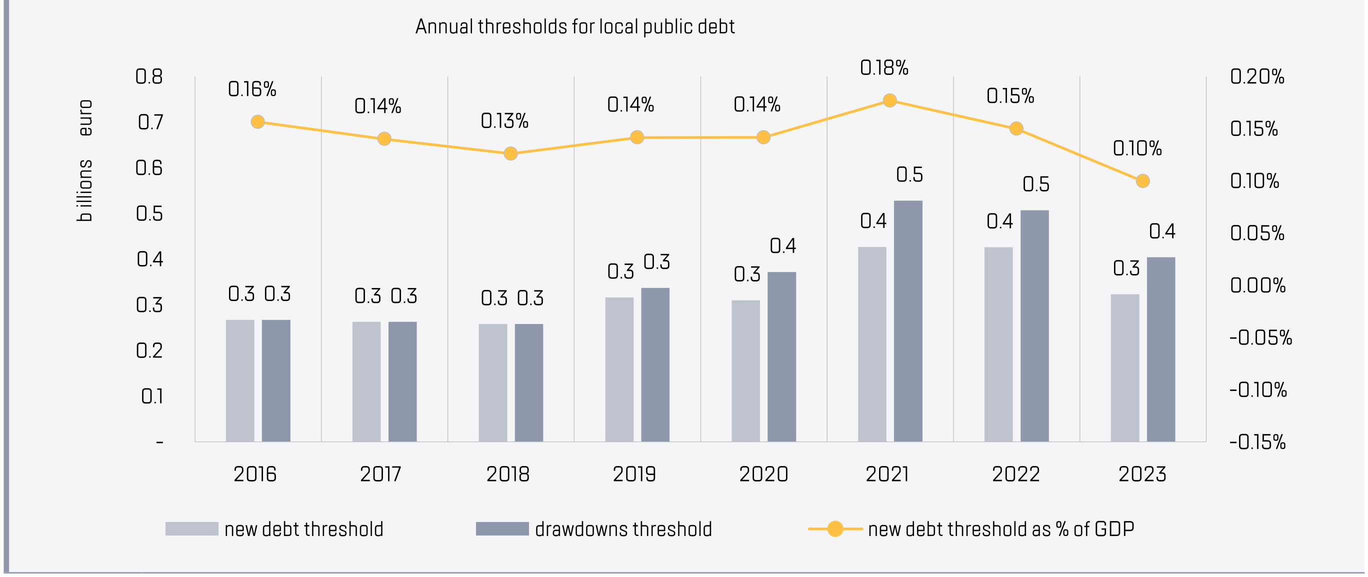
Romanian local governments are allowed to contract local public debt. They take on debt directly or provide guarantees to debt contracted by subordinated institutions or municipal enterprises. All regulations regarding local public debt are provided by the local public finance law (no 273/2006) (LPFL). Local governments may issue bonds, take loans, use supplier credit facilities, contract financial leasing, endorse promissory notes and guarantee debt of subordinated entities. Debt can be contracted for any period of time in national or foreign currency.

Local public debt is guaranteed with own revenue and income from shared personal income tax. Local governments are solely responsible for the repayment of the debt they incur. Although local governments are entitled to seek state guarantees for contracted debt, this practice is very rare. Local public debt cannot be guaranteed with property. If a local government defaults on its debt, the creditor may seek to declare the local governments in financial distress or insolvency, both of which are regulated by specific legislation.

As a rule, local public debt can only be used for capital improvements or debt repayment. However, local governments are allowed to take short term loans from the MoF, to compensate cash shortages. Such loans must be repaid by the end of the budgetary year. In recent years, exemptions to LPFL were made to allow local governments to contract loans from the MoF for recurrent expenditure related to district heating systems or to finance EU co-financed investment projects.

Local debt can be contracted upon authorization from the local council and a central committee established within the Ministry of Finance[16]. The mayor or the president of the county council puts forward to the local (county) council a proposal to take on debt, which must be endorsed by absolute majority. A local government qualifies for new debt if the cumulated debt service for existing and new debt is less than 30% of the previous three-year average of the sum of recurrent own revenues and revenue from shared taxes. The local government must comply with this debt threshold for the projected duration of the loan maturity. In addition to the debt threshold, local governments that want to take on new debt must clear all overdue payments stemming from previous budgetary years before the authorization by the Ministry of Finance committee. The local public finance law provides exemptions from the two rules above for loans pertaining to prefinancing and cofinancing projects supported through grants from the European Union or non-EU members of the European Economic Area. Exemptions are also provided for local governments in financial distress or insolvency which take loans to refinance local public debt, as per the approved redress plan.

Figure 120. *Annual national thresholds for new loans and drawdowns 2016-2023 (source: MoF reports on local public debt, National Forecasting Commission)*



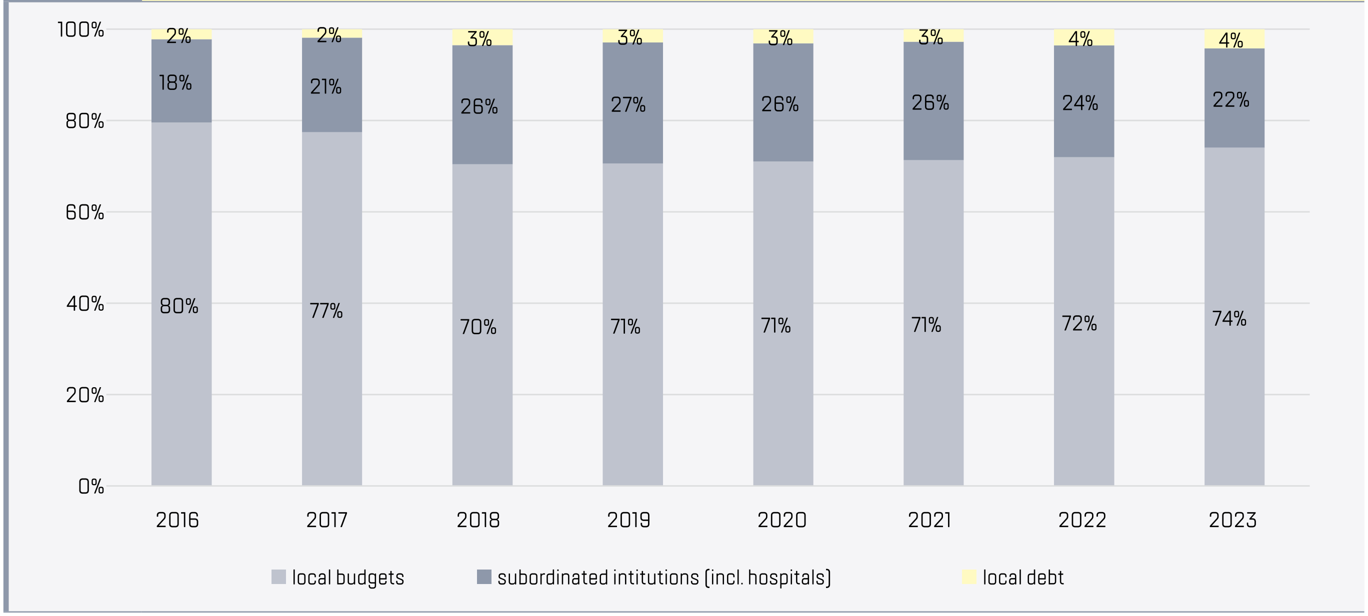
[16] The committee is made of 13 members of which seven are from the Ministry of Finance, two from the Ministry of Public Works, Development and Administration and one each from the Association of Romanian Cities, Association of Romanian Towns, Association of Romanian Communes, and the National Union of Romanian County Councils. The committee verifies compliance with debt preconditions and ensures that any new debt falls within the annual national thresholds for new debt and for drawdowns.

New local public debt and total drawdowns must fall within the annual national thresholds approved by the central government. The local public finance law mandates the government to approve annual national thresholds for newly contracted debt and drawdowns to existing debt. The objective pursued through the setting of national thresholds is to control the budget deficit of the general government. By November each year, the Government approves the national thresholds for the next three years. The MoPF committee must ensure that any new loan falls within the national threshold for the respective year and that forecast drawdowns fall within the applicable thresholds for the current year and the ensuing two years. If any of the thresholds are exhausted, the authorization or the drawdown is deferred to the following years when space is available. A more recent rule requires that the maximum value of loans which can be authorized for any given local government in a year is 100 million lei, i.e. 20 mil. EUR. As in the case of debt threshold, exemptions from the national thresholds are permitted for loans contracted for prefinancing and cofinancing projects supported through grants from the European Union or non-EU members of the European Economic Area.

The value of annual national thresholds has been increasing in recent years, with a spike in 2021 intended to help local governments continue capital projects despite any COVID-19-related shortages. However, aggregate data indicates that the contribution of expenditure from local public debt to the general government deficit remains minor. As of 2023, total local debt stock was less than 5 bn. euro, accounting for only 3% of total public debt and 1.5% of GDP. Over the past fiver years it increased by 7% annually.

In most cases, local governments borrow from private lenders such as commercial banks or other international financial institutions. They can take on debt in national or foreign currency. However, in recent years a significant amount of debt was borrowed from the Ministry of Finance. From 2016 to 2023 nine lending schemes funded from "privatization proceeds" have been implemented, whereby local governments could borrow for capital expenditure or district heating recurrent expenditure.

Figure 121. *Breakdown of LG expenditure by source of financing (Source: MoF reorts on annual budget executions of local governments)*



As for the share of total local expenditure, the value stemming from local debt has not been significant at national level even in the pandemic years, between 2% and 4% annually. While communes, towns, cities and counties spent less than 3% from local debt, the value in Bucharest is above 9% of total expenditure.

Key achievements of the past decade

Over the past decade, the budgets of Romanian local governments have doubled. For revenues, the main sources of growth have been the general (equalization) grant, the shared PIT and the investment grants. On the expenditure side, the biggest growth was recorded for wage bill and investments. With regards to the assignment of revenue, three important developments occurred: *(i)* the volatility of the equalization formula between 2015 and 2020 and the stabilization thereafter, *(ii)* the growing share of the investment grants and *(iii)* the changes within the sectoral block grant (i.e. the drop of the education grants and the growth of earmarked grants for healthcare). On expenditure, the changes to the assignment of responsibilities that took place in 2018 and 2019 with regards to preuniversity education and social allowances, were reflected in the structure of functional expenditure: by 2023, the biggest items were healthcare, transportation and general public services.

In the budgetary field, Romanian local governments still confront structural challenges with regards to *(i)* untapped potential of property taxes, *(ii)* the inefficiency of intergovernmental transfers and *(iii)* the lack of transparency with regard to the quality of public services. The main concerns within these three areas are listed below and require coordinated responses from the central government, materialized in policy and regulations. However, in recent years, the policy collaboration between the ministry in charge of local governments, the MoF (and other line ministries) and local government associations has deteriorated to the extent that such complex undertakings are no longer feasible and, instead, piecemeal responses are being delivered. Against this background new vision on the future of Romanian local governments is needed.

Table 6. Main challenges of Romanian local governments as of 2023

Untapped potential of property taxes	The inefficiency of intergovernmental transfers	The lack of transparency regarding the quality of public services
• Property taxes are undervalued because they are not linked to the market value of assets (buildings owned by natural persons, land). • Data on properties is not shared between local governments and with the central government. • Data quality in the local tax rolls is poor. • Software for tax administration is fragmented and not compatible with the registries of the central government.	• The structure of shared PIT is biased towards big and rich municipalities - the derivation share of 63% is too high - which have become overfinanced. This has led to growing disparities between local governments, which need to be offset by higher equalization grants from the state budget which puts additional pressure on the general government budget deficit. • The equalization grant accounts for revenue disparities, but not expenditure needs, which results in overfunding a significant number of local governments. • Sectoral grants are fragmented, generate unfunded mandates and impose no conditions on local governments regarding service quality. • Investment grants are allocated to local governments based on their request, but not in keeping with area or county development plans. As a result, many of the funded projects have no multiplication effects.	• Little meaningful data is collected centrally about the outcome of local governments' activity (e.g., average driving speed in big municipalities, the share of travels by public transportation, the state of the disabled persons supported by allowances or personal assistants paid by local governments, the satisfaction of pupils with regard to school meals). • Except for financial statements, local governments do not report data on the output of the local services funded from earmarked grants (e.g., the length of rural/ county roads maintained/ upgraded, the number of elderly persons cared for in residential facilities, the number of abandoned children looked after in non-residential facilities). • Potential new policies regarding local governments and local services lack critical evidence on the status quo.

Advocacy efforts of the Local Government Association

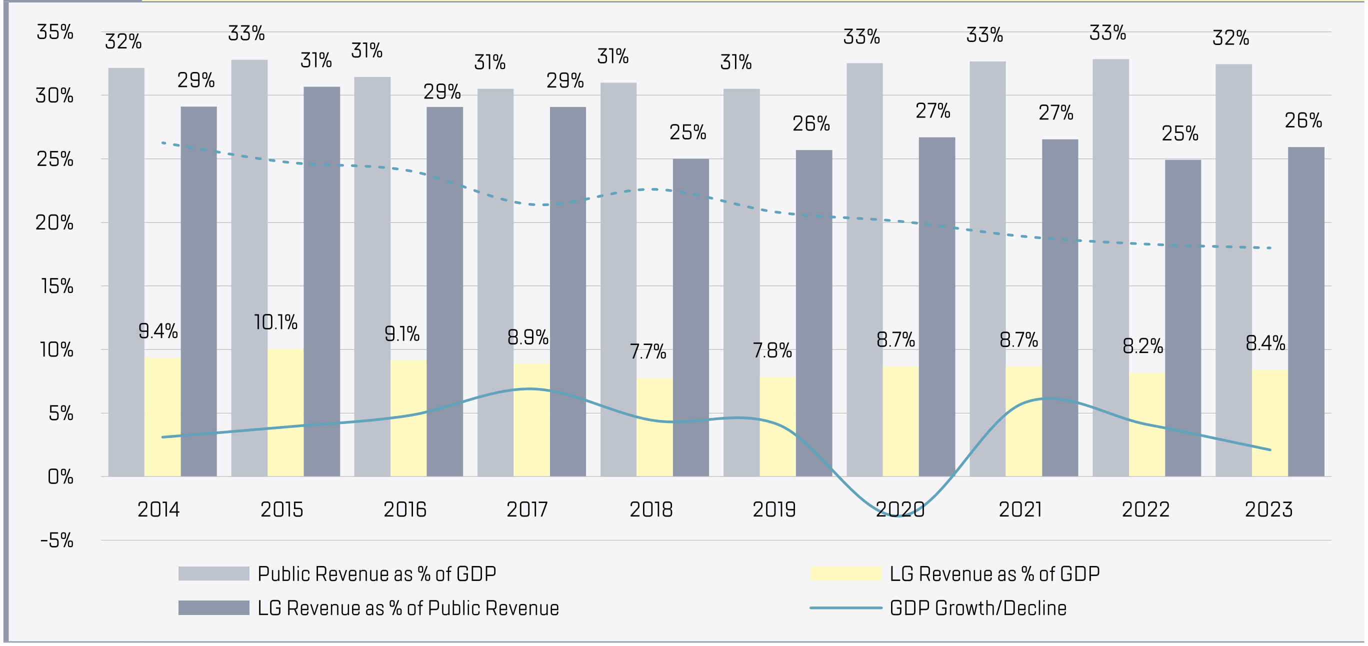
In 2020 before the pandemic the Association of Communes presented the Government and the Ministry of Public Finance a policy proposal intended to improve the equalization system and open discussions for structural reform of intergovernmental transfers. The proposal was presented to MoPF representatives in a workshop in February 2020. In the meantime, the MoPF together with the World Bank have been working on a comprehensive review of intergovernmental transfers and are expected to put forward reform proposal.

Statistical Overview of Local Governments Finances in Romania

Throughout 2015-2023, the size of Romania's public sector revenues in GDP remained constant at about 32% of GDP, which is one of the lowest ratios in the European Union and one that does not cover the expenditure needs that the country has had over the past five years. As a result, big budget deficits ensued, which prompted the European Union to initiate the excessive deficit procedure for Romania.

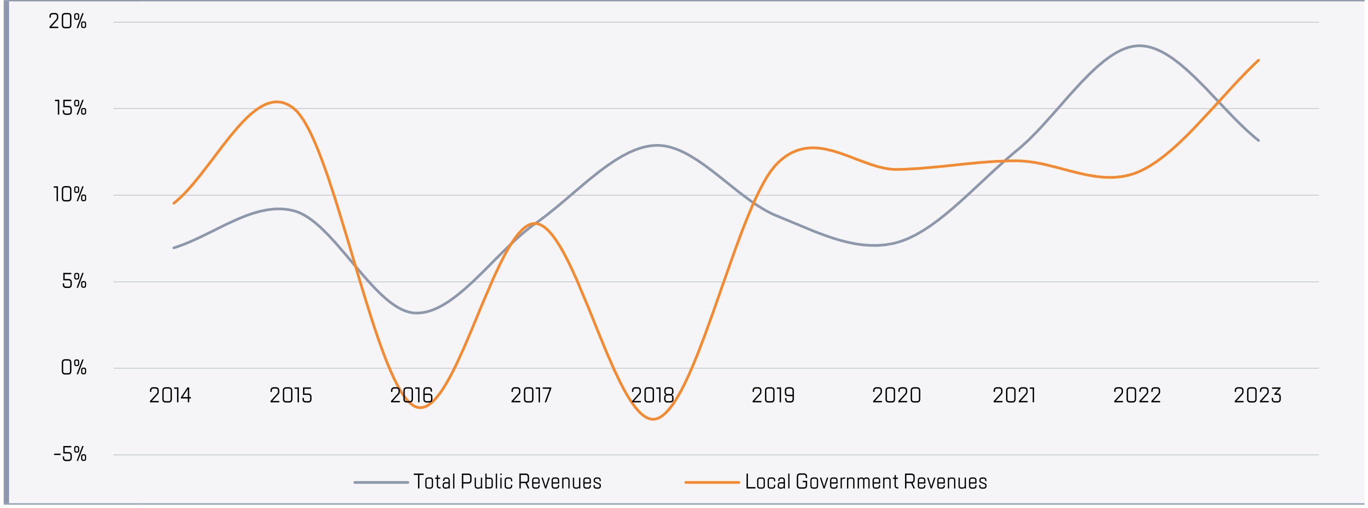
During the same period, the share of local government revenue in total public revenue contracted from 31% to 26%, following a series of changes to the intergovernmental transfers, which decreased the value of the sectoral grants for education and social services (i.e. wage bill in preuniversity education and social benefits for disabled persons were centralized in 2018 and 2019, respectively). As a result, local governments' relative weight in GDP went down from 9.4% to 8.4%.

Figure 122. ***Romania:*** *Local Government Revenue as a Share of GDP and Total Public Revenue*



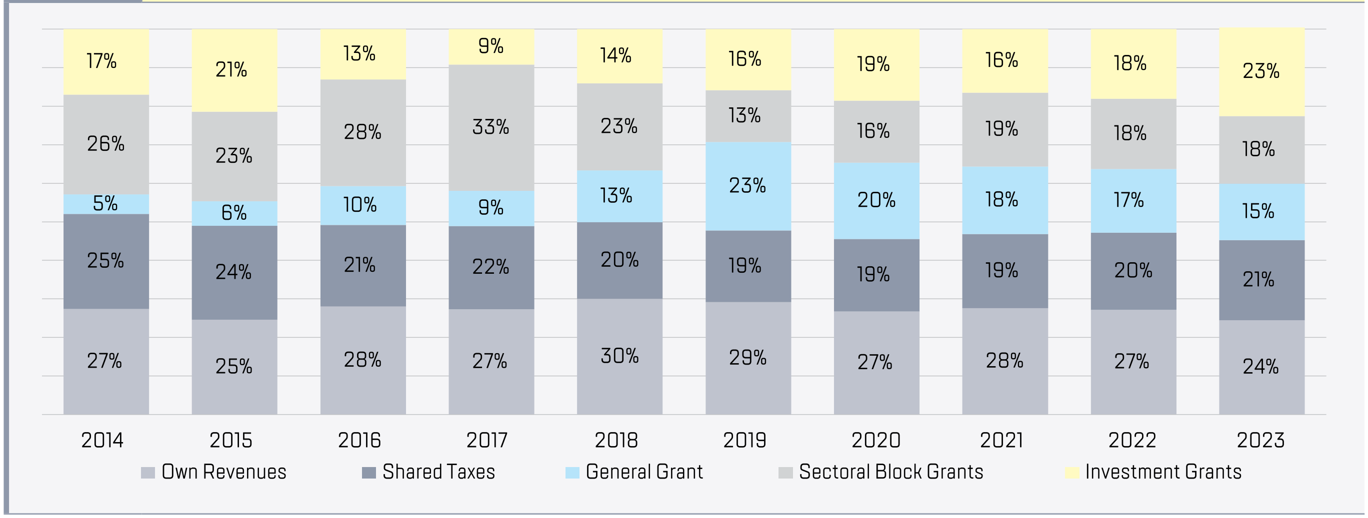
In the past five years the dynamic of local government revenues has been somewhat different from the total public revenues. In 2022, the former grew slower, but in 2023 it accelerated mainly due to increased proceeds from EU-grants and a growing PIT.

Figure 123 ***Romania:*** *Annual Fluctuations in Public and Local Government Revenues*



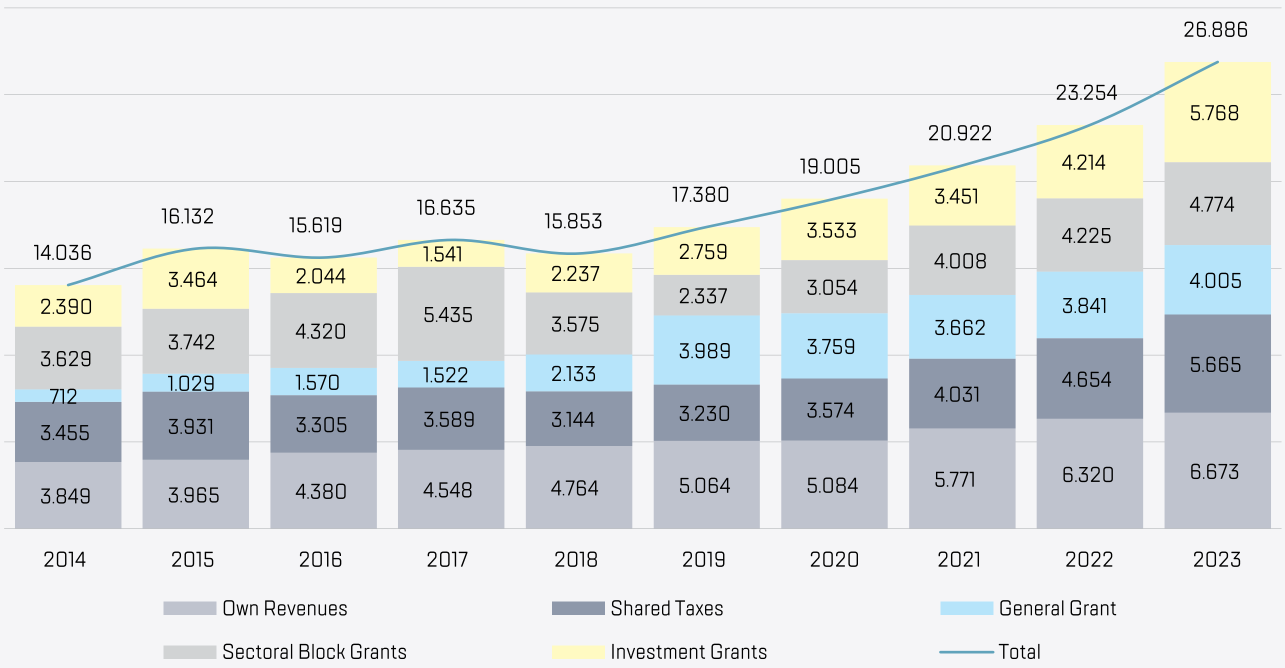
The structure of local governments revenues has seen minor variations in the past five years, but the structural changes are to be related to a change in the methodology of presenting the data. In 2023, investment grants overperformed the other sources of revenue, especially own revenues and the general grant (i.e. equalization), which advanced below average.

Figure124. ***Romania:*** *Composition of Local Government Revenues in percent of total*



Overall, local government revenues in 2023 were 27 billion Euro. Over the past ten years, the value has almost doubled. The most rapid pace of growth occurred in 2022-2023, mainly from investment grants and shared PIT.

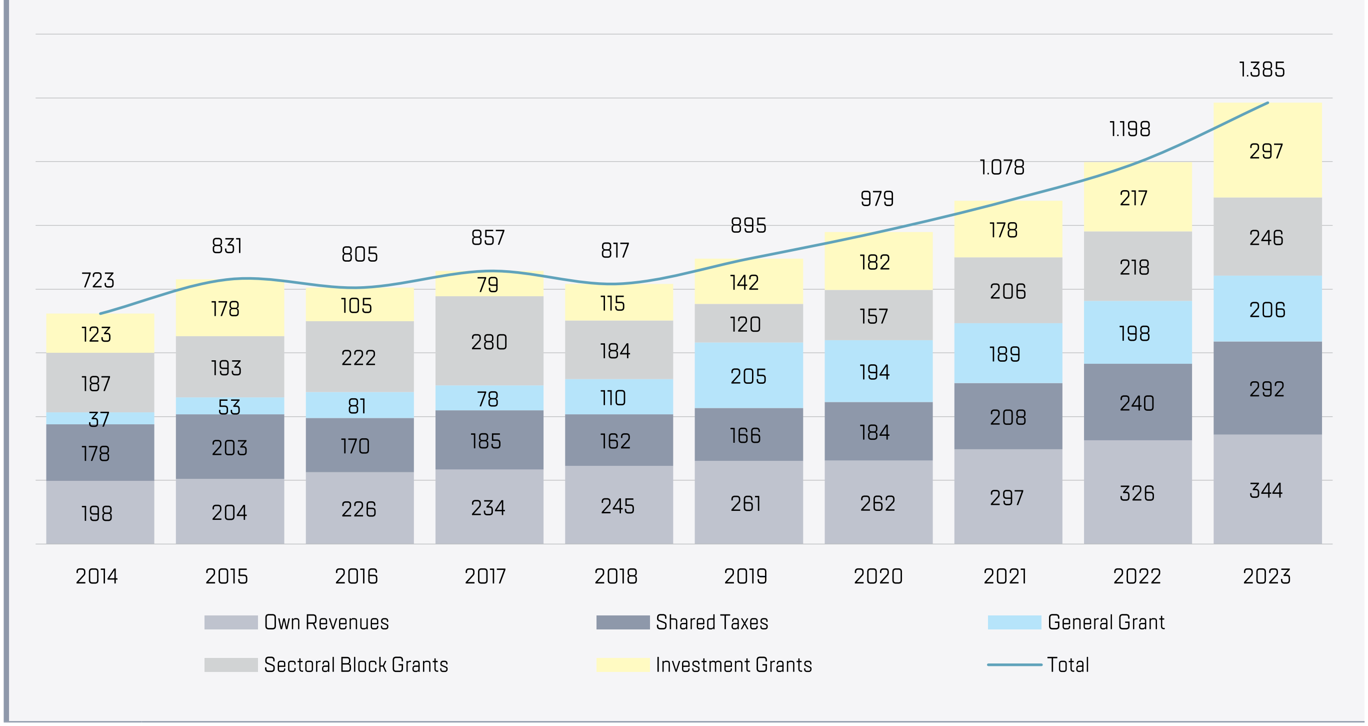
Figure 125. ***Romania:*** *Composition of Local Government Revenues, in million Euro*



Year	Own Revenues	Shared Taxes	General Grant	Sectoral Block Grants	Investment Grants	Total
2014	3.849	3.455	712	3.629	2.390	14.036
2015	3.965	3.931	1.029	3.742	3.464	16.132
2016	4.380	3.305	1.570	4.320	2.044	15.619
2017	4.548	3.589	1.522	5.435	1.541	16.635
2018	4.764	3.144	2.133	3.575	2.237	15.853
2019	5.064	3.230	3.989	2.337	2.759	17.380
2020	5.084	3.574	3.759	3.054	3.533	19.005
2021	5.771	4.031	3.662	4.008	3.451	20.922
2022	6.320	4.654	3.841	4.225	4.214	23.254
2023	6.673	5.665	4.005	4.774	5.768	26.886

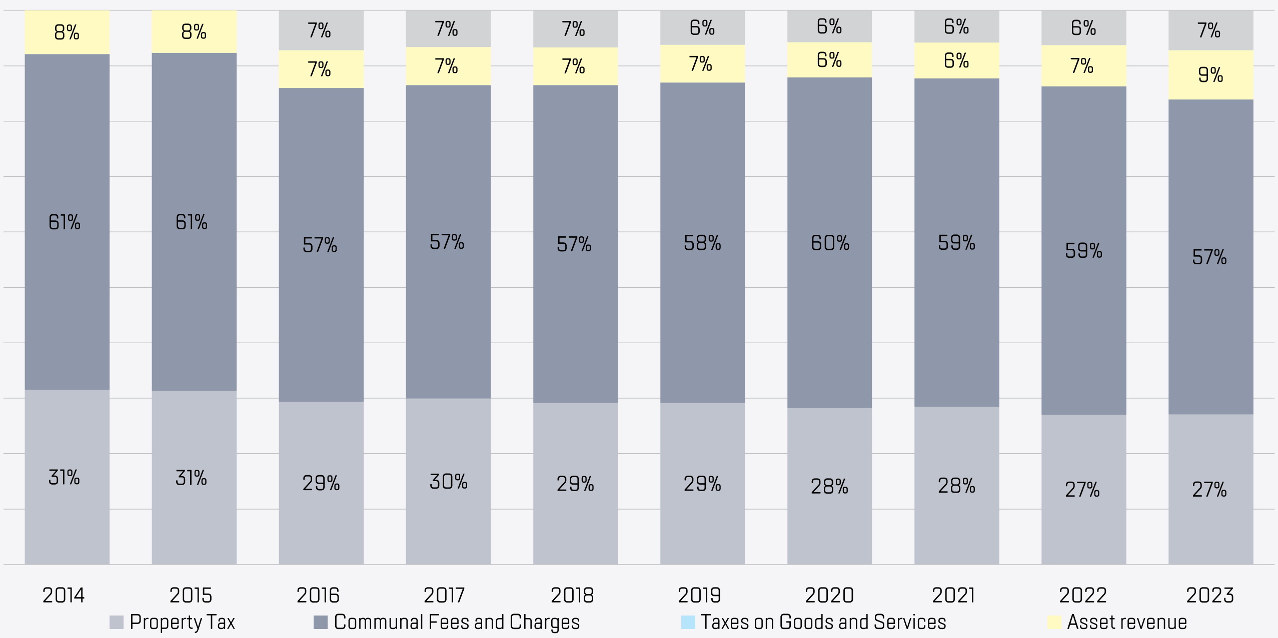
In per capita terms, local government revenues in 2023 were 1385 Euro per inhabitant, up from 723 Euro per inhabitant in 2014.

Figure 126. ***Romania:*** *Composition of Local Government Revenues, in Euro per capita*



Almost half of local governments' own revenues is made of hospital fees for services. Apart from that, the share of property taxes has been marginally declining, while other communal fees and charges went upwards following improvements in the collection. The income from municipal property (rents and concessions) has increased notably in 2023 thanks to a share of the mining royalty collected by the state budget (i.e. for mineral waters and surface mining operations).

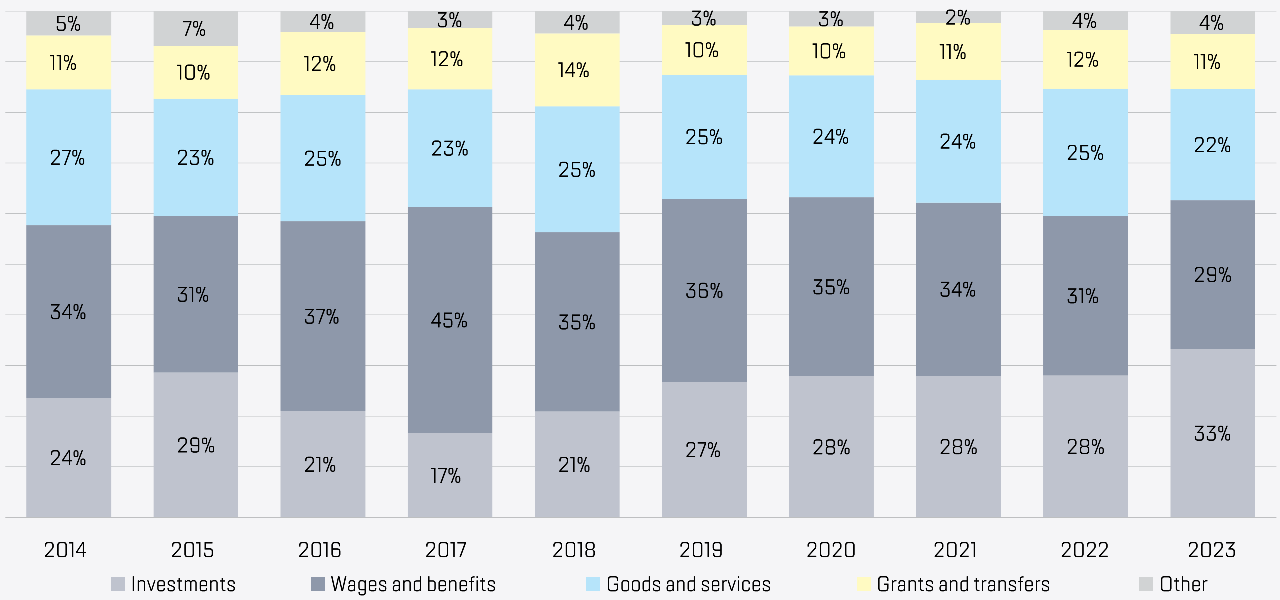
Figure 127. ***Romania:*** *Composition of Own Revenues, in percent of total*



Note: communal fees and charges contain revenue of decentralized hospitals from fees-for-services

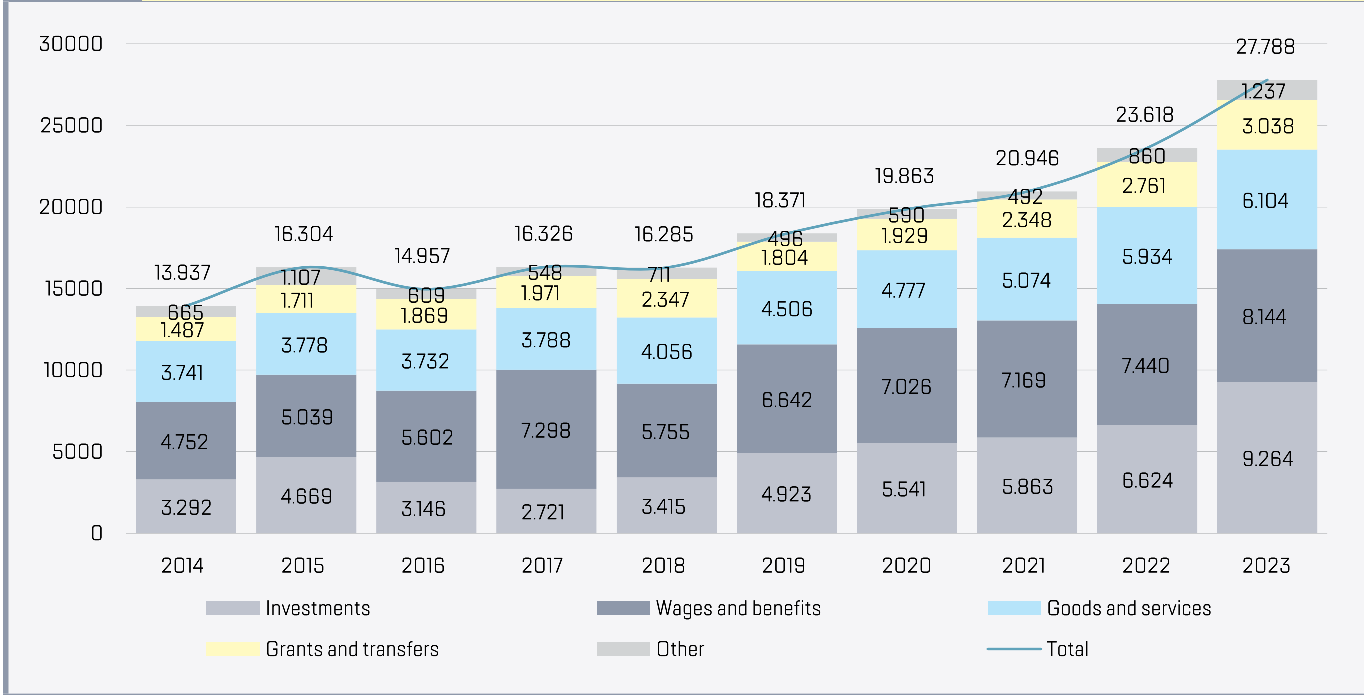
In terms of expenditure, the most significant change has taken place in the share of spending for investments that has been increasing since 2017. The share of spending for wages and benefits (payroll), which has been upwards until 2017, but then declined ever since. In 2023, expenditure on goods & services was also relatively slower compared to other items due to limits imposed by the central government in an attempt to control the budget deficit.

Figure 128. ***Romania:*** *Composition of local governments' expenditure %*



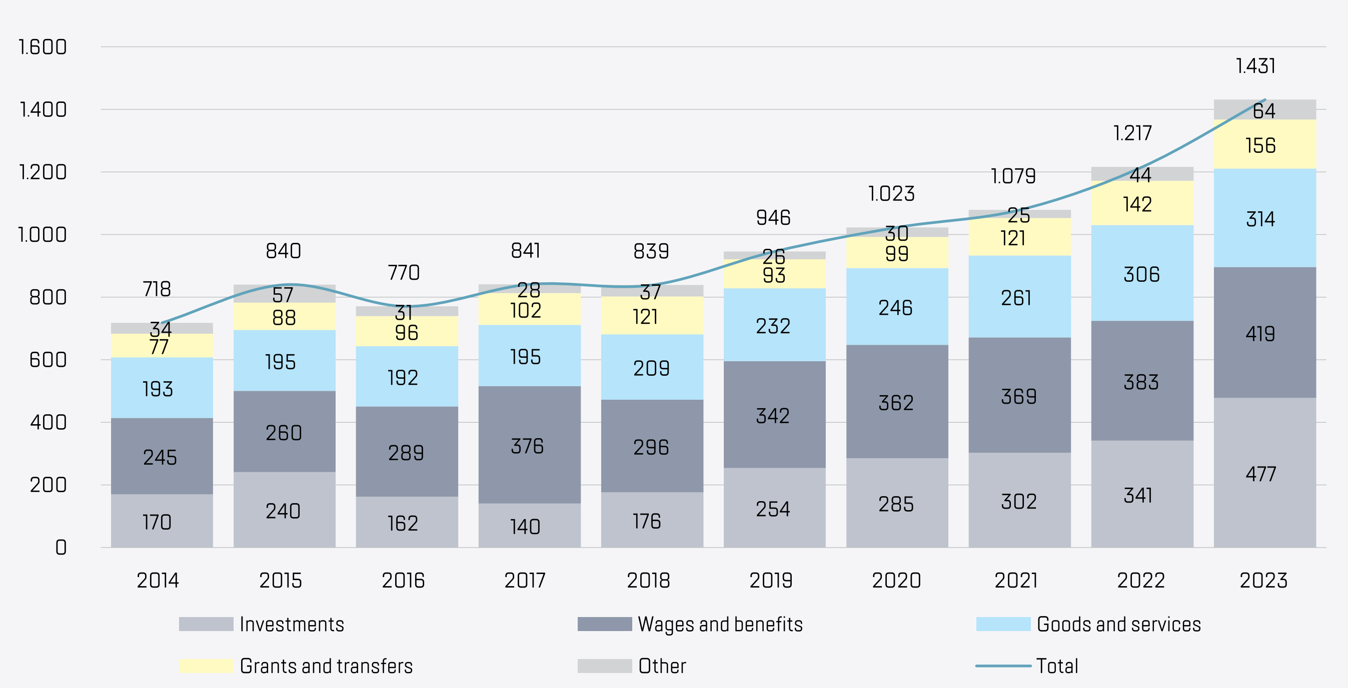
In nominal terms, the growth of investment expenditure in 2023 has been 40%, especially in relation to the implementation of EU co-funded projects. 2023 was the final year for the implementation of the projects funded from the 2014-2020 EU budget cycle. In 2015 a similar situation occurred, but the values involved were much smaller.

Figure 129. ***Romania:*** *Composition of Local Expenditure in million euro*



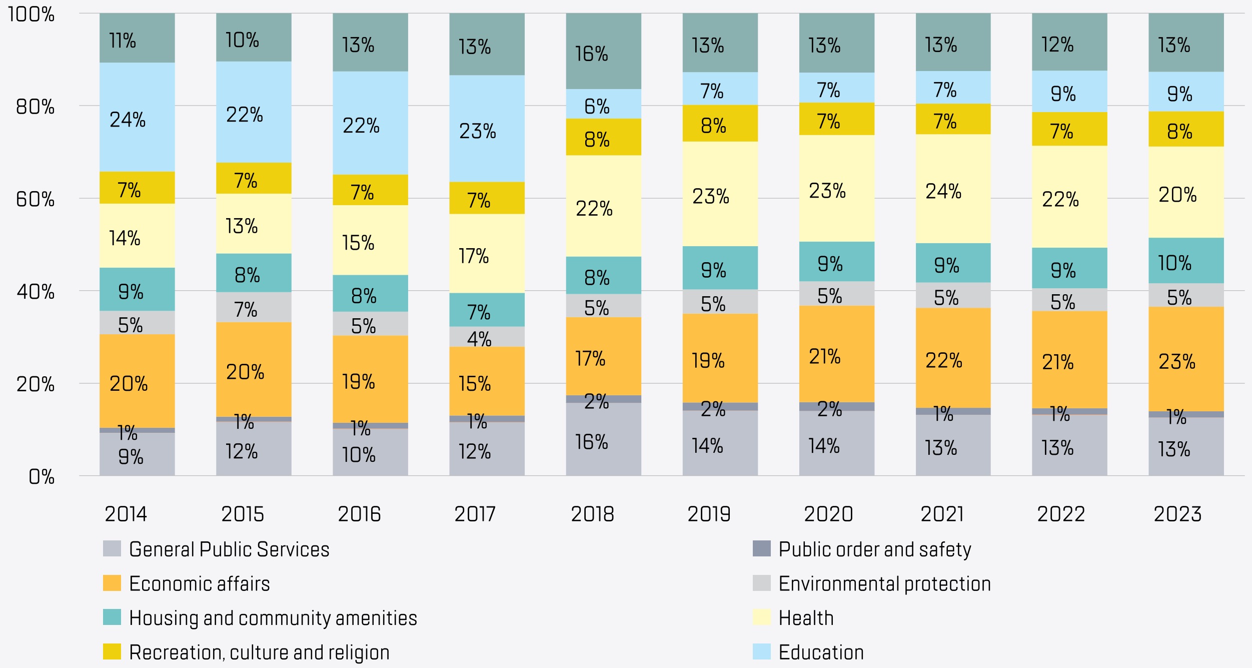
In nominal terms, a general upwards trend can be observed for all expenditure items. A notable slowdown of wage bill took place from 2019 to 2022, but then resumed as pay rises were approbe in mid-2023 throughout the public sector. As or the goods & services, the deceleration in 2023 stemming from nationwide spending constraints resulted in a near stagnation compared to the previsous year.

Figure 130. ***Romania:*** *Composition of Local Expenditure in euro per capita*



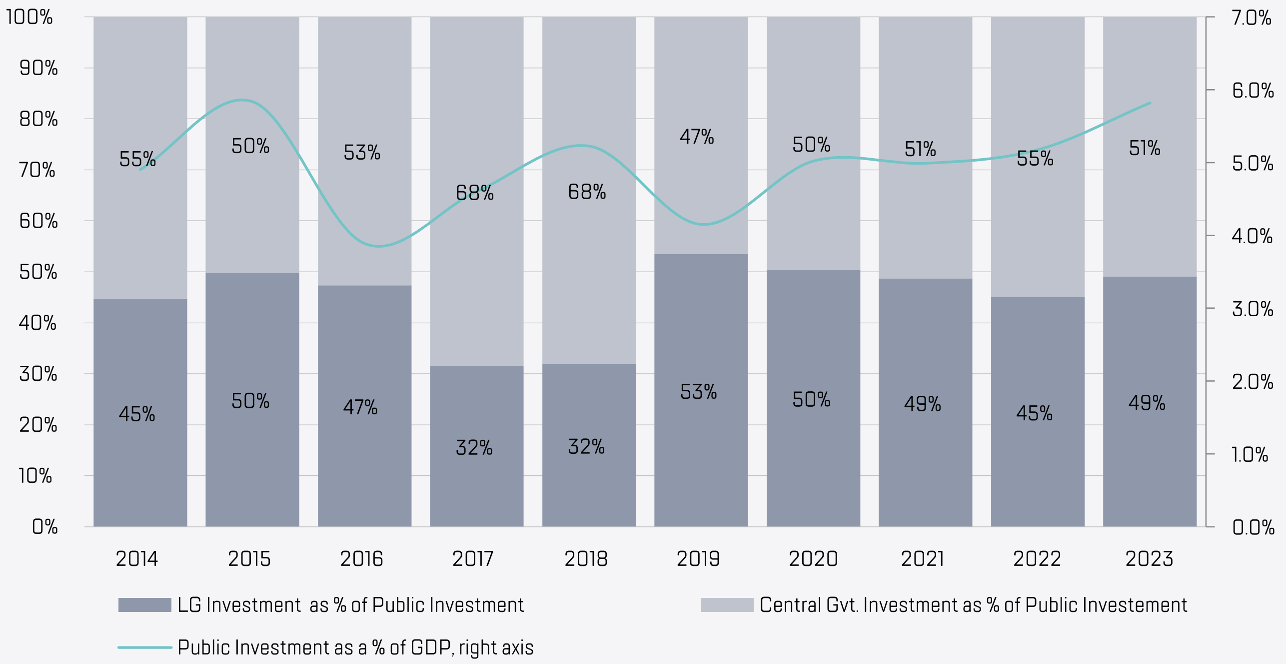
From a functional perspective, Romanian local governments spend half of their budget in the social sector, i.e. on education, health-care and social protection. In the past five years the expenditure structure has been fairly stable as no major change has occurred to the assignment of expenditure responsibilities.

Figure 131. ***Romania:*** *Composition of recurrent Local Expenditure on Functional Basis (COFOG)*



Romanian local governments play a fundamental role in public investment, which has varied in the past ten years between 4% of GDP and 6% of GDP, mainly spurred by EU grants. Within it, the share of local governments is almost half.

Figure 132. ***Romania:*** *Composition of Public Investments, and as % of GDP*



Serbia

Prepared by Aleksandar Marinković and Jelena Pločić, Standing Conference of Towns and Municipalities

The Intergovernmental Transfer System

The intergovernmental finance system in Serbia is governed primarily by the Law on Local Government Finance. This legislation outlines local self-governments' (LSGs) own-source revenues (OSRs) and two types of central government transfers to local self-governments (LSGs): Shared (Assigned) Revenues and Grants, which are further categorized as unconditional and conditional.

Shared Revenues: These include specific taxes and fees generated within LSG territories. The most significant shared (assigned) tax is the Personal Income Tax (PIT), the main revenue source for LSGs. Besides the gross wages tax shared with the central government, LSGs receive 100% of PIT from agriculture, forestry, independent activities, leasing of property, personal insurance, and other incomes as defined by law. The gross wages tax forms the largest share of PIT, accounting for about 80% of the total PIT assigned to LSGs. Since 2016, cities receive 77%, municipalities 74%, and Belgrade 66% of the gross wage tax collected by the central tax administration. Additionally, LSGs receive revenue from two other assigned (shared) taxes: the inheritance and gift tax and the property transfer tax, as well as from fees for activities such as emissions, disposed waste and forest usage.

Shared Wage Tax:
- 77% Cities
- 74% Municipalities
- 66% Belgrade

Shared Fees for:
- Emissions
- Waste disposal
- Forestry usage

Grants: Central government grants to LSGs, under the Law on Local Self-Government Finance, include unconditional (non-earmarked) and conditional (earmarked) grants. **Unconditional Grants** encompass four components: *Equalization Grant*, *Compensatory Grant*, *General Grant*, and *Solidarity Grant*. The total unconditional transfer amount is legally set at 1.7% of the previous year's GDP, however the amount has been static since 2014.

Unconditional Grant:
- Four components:
- Equalization Grant
- Compensatory Grant
- General Grant
- Solidarity Grant

The first allocation of funds of the unconditional grant goes to **horizontal equalization**, which supports LSGs whose per capita shared tax revenue is below the national average. The equalization grants provided to LSGs are equal to a percentage of the difference between their per capita revenue from shared taxes and a specified percentage of the national average, multiplied by the LSG's population size.

The second round of calculation of the unconditional grant aims to compensate LSGs' lost revenue due to tax policy changes that are not offset by other revenue sources. The **Compensatory Transfer** aims therefore to balance the burden of the lost revenue between levels of government. The compensatory transfer amount from the previous year is also adjusted annually, based on the projected price growth index from the fiscal strategy.

The third component of the unconditional grant includes the **General Transfer** which allocates remaining unconditional funds, distributed through a formula (except Belgrade, since 2011). The allocation of the general grant to individual LSGs is based on uniform criteria, including population size (65%), territory size (19.3%), the number of classes in elementary and secondary education (4.56%

and 1.14%, respectively), number of elementary and secondary school facilities (2% and 0.5%, respectively), number of preschool children (6%), and preschool facilities (1.5%). The general grant amount calculated through these criteria are then adjusted by a development coefficient: 1 for LSGs in development group IV, 0.9 for group III, 0.7 for group II, and 0.5 for group I. This adjustment ensures the general transfer has an equalizing effect, independent of the horizontal equalization grant.

General Grant Allocation Formula

- 65% population
- 19.3% territory
- 4.56% no. of classes in element. schools
- 1.14% no. of classes in second. education
- 2% no. of elementary schools
- 0.5% no. of secondary schools
- 6% no. of preschool children
- 1.5% no. of preschool facilities
- Adjustment for Development Index

The 2011 amendments introduced the **Solidarity Transfer** as a new component of the total unconditional grant, available to all LSGs except Belgrade. The size of the Solidarity Transfer matches the amount that Belgrade would have received under the General Grant as stipulated in the 2007 law. This transfer was established due to an increase in the Wage Tax share for LSGs—from 40% to 80% for most LSGs, and from 40% to 70% for Belgrade. This adjustment reduced the total pool of unconditional grant funds, leading to the creation of the Solidarity Transfer, which is allocated to LSGs based on a development index that categorizes them into four groups. The amount of solidarity transfers allocated to individual LSGs is determined by their level of development. Specifically, 50% of the solidarity transfer funds go to LSGs in development group IV, 30% to those in group III, and 10% each to groups II and I. Within each development group, solidarity transfer funds are further distributed based on the development ratio between the City of Belgrade and each LSG. This means that the LSG with the lowest development level within a group receives the largest share of the solidarity transfer funds allocated to that group.

Challenges in Financial Autonomy and Stability: A significant issue affecting local financial autonomy is the reduced share of unconditional transfers, both in terms of total transfers and overall revenues. Specifically, these transfers from the national budget to local budgets declined from 78% of total transfers in 2015 to just 43% of total transfers in 2023 (or from 13.4% of total revenue in 2015 to just 7% of total revenue in 2023). Despite the Law on LSG Financing originally stipulating that non-earmarked transfers should amount to 1.7% of GDP as a calculation category[17], the total transfer amount has been static since 2014, and the annual Budget Law instead sets a fixed amount for each LSG. Additionally, although the law mandates distribution according to a method based partly on LSG development level, this calculation has not been updated since 2014, though it should be revised annually.

While calculating non-earmarked transfers as per the law is complex and often unclear to LSGs, they are instructed by the Ministry of Finance to budget for these transfers at the same level as the previous year. However, with the transfer amount "frozen" for nearly a decade, LSGs face significant horizontal fiscal imbalances, placing some in challenging financial positions. This stagnation contrasts with the law's stipulation that non-earmarked transfers should adjust with GDP changes, creating fiscal strain for many LSGs.

LSGs receive also **earmarked grants** from line ministries to support specific tasks within their original or delegated responsibilities. According to the Law on LSG Finance, the amount, distribution criteria, and timing of these transfers are determined by the relevant ministry. During the fiscal strategy drafting process, ministries are required to submit the distribution criteria and benchmarks as well as the amounts for each LSG.

Earmarked Grants: Size and Allocation

The amount, distribution criteria, and timing of earmarked transfers are determined by the relevant ministry. However, during the fiscal strategy (Budget) drafting process, ministries are required to submit the distribution criteria and benchmarks as well as the amounts for each LSG.

[17] Since the changes of Law in 2011 the total unconditional transfer amount was set at 1.7% GDP as calculation category (not as nominal value).

Article 46 of the law further specifies that if transfers are misused, the finance minister may recommend withholding a portion of the unconditional transfer equal to the amount misused.

Prior to 2021, most earmarked grants were provided by the Ministry of Education, the Ministry of Social Protection, and the Ministry of Culture. Since then, the volume and number of conditional transfers have risen, particularly with contributions from the Ministry of Infrastructure, the Ministry of Energy, and the Ministry of Environment. In addition, the autonomous province offers conditional grants to LSGs within its territory, in accordance with the Law on LSG Financing.

Own Source Revenues

In Serbia, **Own Source Revenues** (OSR) are governed primarily by the Law on Property Tax, the Law on Tax Procedure and Administration, and the Law on Local Government Finance. Before 2007, property tax was managed by the national government, with revenues allocated to local governments based on origin. The Law on Local Government Finance transferred responsibility for property tax administration to local governments, enabling them to set tax rates within legally defined limits. The Law on Property Tax outlines property types, taxpayer obligations, and rules for exemptions and abatements, while the Law on Tax Procedure and Administration regulates assessment, collection, and taxpayer responsibilities.

In 2012, legal amendments restricted certain local taxes and fees, such as the business sign tax, and eliminated other fees like the local motor vehicle fee. Further changes in 2014 removed the Land Use Fee, a key revenue source, intending to incorporate it into property tax. This shift led to a substantial rise in property tax revenue collection in 2014. However, the Land Development Contribution (the previous Land Development Fee) remains one of the main OSR sources.

One of the main novelties in recent years is the 2018 Law on Fees for the Use of Public Goods that introduced a unified regulatory approach. The law systematizes all public fees and clarifying separately for each fee who are the taxpayers, the taxpayer obligations, tax bases, rates, and procedures for public fees. LSG revenues under this law include fees for environmental improvements, public space usage, and use of natural resources like thermal and mineral waters.

Amendments to the Property Tax Law in 2020 aimed to transfer administration of the inheritance and gift tax, as well as the property transfer tax, fully to LSGs. While the national government previously handled these taxes as shared revenue, under the new regulations, LSGs will become the tax authority. Tax rates remain, however, prescribed by the Law (i.e., LSGs are not entitled to set these tax rates). The transition, expected in 2021, was delayed due to operational challenges. Other amendments continue to refine tax administration, addressing issues like property valuation, amortization rates, facility classification, tax base adjustments, and tax reliefs. These ongoing changes aim to enhance the efficiency and transparency of OSR management.

Local Borrowing

Local government borrowing in Serbia is regulated by the Law on the Budget System and the Law on Public Debt. Local governments are allowed to borrow on domestic and international markets, subject to approval by the Ministry of Finance. The approval request must include data on past revenues and expenditures, the planned budget for the following year, a justification for borrowing, and details on current debt and eventual unpaid obligations. Local governments can borrow for two primary purposes: financing capital investments[18] and addressing temporary liquidity needs. Borrowing for capital investment cannot exceed 50% of the local government's revenue from the previous year, while borrowing for liquidity purposes is limited to 5% of annual revenue. As of 2023, the total debt at the sub-national level was 46 billion RSD, which accounts for 9.8% of local government revenues, 1.1% of the general government debt, and 0.5% of GDP.[19]

Advocacy efforts of the Local Government Association

In 2021, the Government of Serbia adopted the Programme for Local Self-Government System Reform 2021-2025, marking the first comprehensive policy document to address the reform of the LSG system.[20] This Programme developed in consultation with key partners like Standing Conference of Towns and Municipalities (SCTM) and led by the Ministry of Public Administration and Local Self-Government, covers various aspects of the LSG system, including local governance, financial management, and intergovernmental relations. It outlines reforms aimed at improving the legal and organizational framework, enhancing efficiency, transparency, and citizen participation, and modernizing services at the local level.

The Programme provides an overview of the current state of the LSG system, including its history, local electoral system, organization, and activities of bodies, institutions, and enterprises within the system. It also addresses key issues such as good governance, relations between central, provincial, and local bodies, and the improvement of the local finance system and fostering inter-municipal cooperation. Additionally, the Programme outlines the EU accession process and offers a comparative analysis of LSG systems in EU countries. The activities, objectives, and measures have been developed based on a needs analysis and aim to improve the legal and organizational framework, increase professionalization and efficiency, and modernize all aspects of LSG functioning. The Programme also seeks to enhance transparency and citizen participation in governance, strengthen the role of local authorities in shaping public policies, improve the LSG financing system, build institutional capacity, and improve services for citizens and businesses at the local level.

Special Objective 2 of the Programme focuses on improving LSG financing, including measures for fiscal decentralization, better budget planning, increased transparency, and strengthening Public Internal Financial Control (PIFC) at local level. The goal is to create a stable and predictable financing system for LSGs, enabling long-term planning and support for local public functions. It also aims to increase the share of local revenues, particularly from property taxes, and to enhance capital expenditures within local expenditures, and reforming the legal framework for local government finances. This Programme goes hand in hand with the Government Public Finance Management (PFM) Reform Programme 2021-2025, whereby SCTM closely observes all aspects of PFM relevant for the local level therein, and actively contributes to annual reporting upon implementation of both Programmes.

SCTM has been actively involved in advocacy and practical work to advance these reforms. This includes working closely with the Ministry of Finance on issues such as capital project regulations, mid-term planning, programme budgeting, amending the rulebooks

[18] Long-term borrowing, i.e., standstill period + at least 5 years of repayment deadline.

[19] In line with Public Debt Administration reports, the data on public debt is available only at sub-national (local and provincial cumulatively) and general government level. Data: Ministry of Finance – Public Debt Administration: Quarterly report, December 2023.

[20] The programme (with the Action Plan) can be downloaded at: www.mduls.gov.rs/obavestenja/program-za-reformu-sistema-lokalne-samouprave-u-republici-srbiji-za-period-od-2021-do-2025-godine/

on internal audit, proposals for the Law on Fees for the Use of Public Goods, the Law on the Property Tax, the Law on Tax Procedure and Administration. SCTM's efforts have been supported by development partners, facilitating dialogue between LSGs and the government to address challenges and propose necessary adjustments.

In 2024, SCTM launched two key initiatives in the area of local finance. The first initiative aimed at **establishing a revolving fund to support pre-financing of EU and donor projects implemented by LSGs**, proposed to start in the 2025 budget cycle. The fund would provide short-term, interest-free loans to LSGs for EU and international development projects. This initiative would align Serbia with regional best practices and includes a proposal for opening the dialogue to introduce state-funded, non-refundable support for co-financing LSG projects from EU funds. This involved working with the Ministry of Finance, Ministry of Public Administration and Local Self-Government, and the Ministry of European Integration, but the efforts in this respect need to continue as the initiative has still not been formally endorsed.

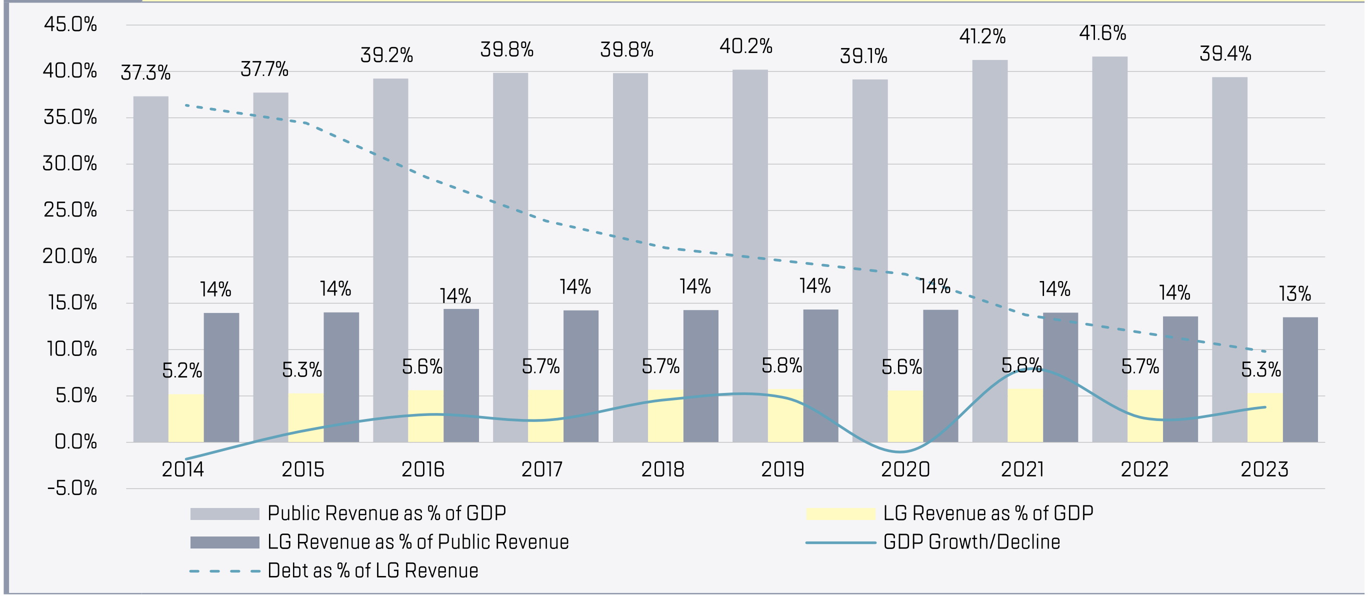
The second initiative aims to **increase the annual non-earmarked transfer to LSGs** starting in 2025. Since 2014, this transfer has not been raised, threatening the financial stability of less developed LSGs with weaker fiscal capacity, for which the transfer constitutes a significant share of their revenues. The stagnation of this transfer has worsened both vertical and horizontal fiscal imbalances and reduced its equalizing function. For many LSGs, the transfer is no longer sufficient to finance key competencies, a problem that became more pronounced in 2022 and 2023, when LSG revenues grew significantly.

SCTM also advocates for a comprehensive review and update of the Law on LSG Financing, a process that is now expected in 2024-2025. The **LSG Financing Commission**, a key body tasked with ensuring fairness and efficiency in LSG financing, is also central to this dialogue. Although it was relaunched in 2021, the Commission's work has been limited, with only two meetings held since its reactivation. The Commission is composed of 6 government members (including a chairman from the Ministry of Finance) and 5 members appointed by the SCTM Presidency (4 of which represent LSGs). The Commission's mandate includes analyzing LSG financing, earmarked transfer programs, and proposing improvements to the financing system. According to the Law, the Ministry of Finance should provide the Commission and SCTM with a comprehensive overview of LSG revenues and expenditures annually, but this has not been consistently done. Going forward, there will be increased focus on improving data availability and public disclosure of LSG financial data in accessible formats.

Statistical Overview of Local Government Finance in Serbia

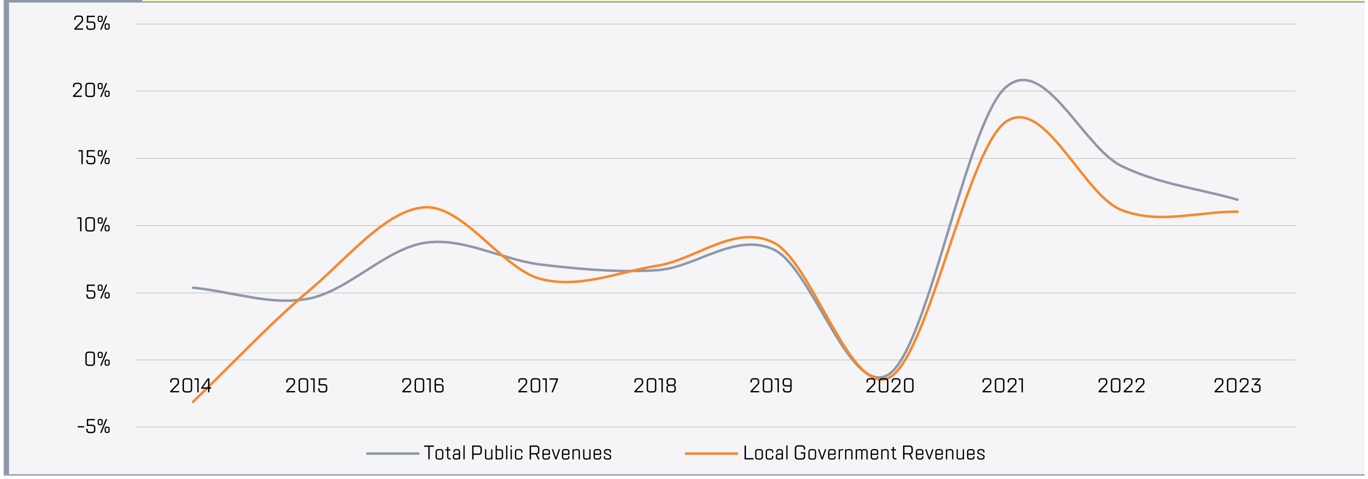
The share of local government revenue to total public revenues has been constant over the past decade, with a decrease to 13% in 2023. Total public revenues have fallen from 41.6% to 39.4% in terms of the GDP, as a result of the GDP growth. In terms of the GDP, LG revenues have been declining over the past three years indicating that local revenues have not increased at the same pace to the economic growth. On the other hand, LG Debt decreased to 10% of LG revenues, down from 36% in 2014.

Figure133. ***Serbia:*** *Local Government Revenue as a Share of GDP and Total Public Revenue*



Over much of the past decade, the revenues of the local[21] and general government have grown and declined together at the same pace. Even during the COVID-19 crisis the revenues of both levels of government had the same decline of -1%. In 2021 LGs and GG revenues increased significantly, 17.7% and 20.3% respectively, with total public revenues registering higher levels in the subsequent years.

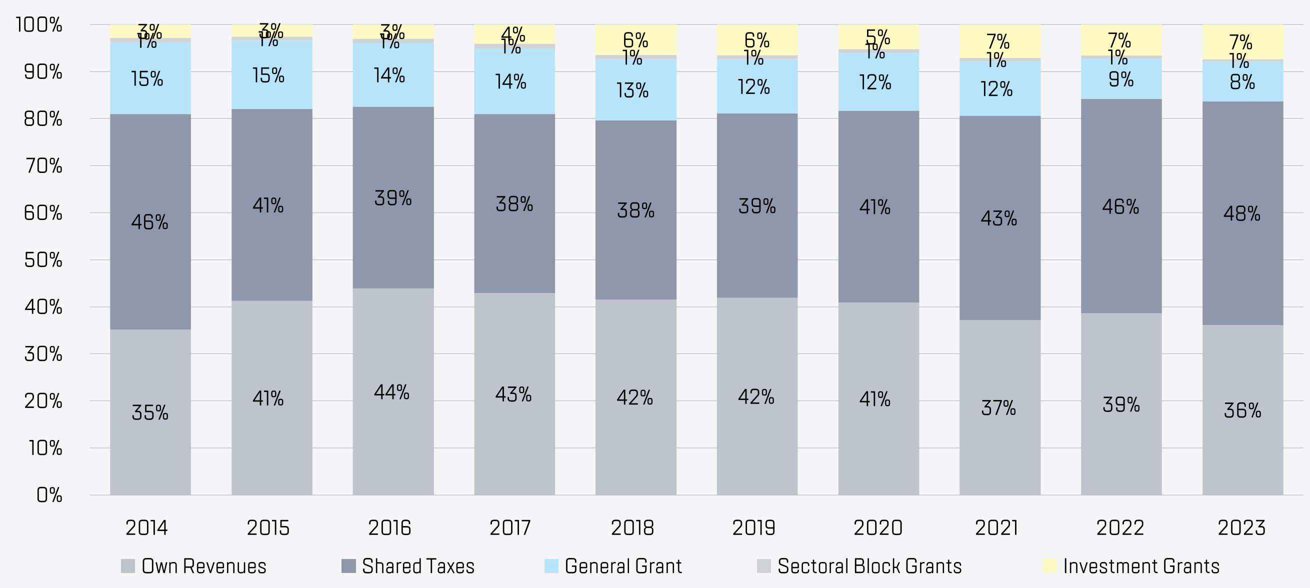
Figure 134. ***Serbia:*** *Fluctuations in the Revenues of the General and Local Governments*



[21] The total local government revenues and total public revenues of the general government do not include proceeds from borrowing.

Until 2012, LSG revenues were divided as follows: 38% from own sources[22], 40% from shared taxes, 18% from unconditional grants, and 2% from conditional grants. In 2012, the balance shifted due to a sharp increase in the share of the Wage Personal Income Tax, which raised shared taxes to 50% of local revenues. However, since then, reductions in the PIT base and rate have decreased its yield. Over the past five years, the share of own revenues for local governments has decreased, partly due to restrictions on their ability to set fees and the elimination of certain taxes.

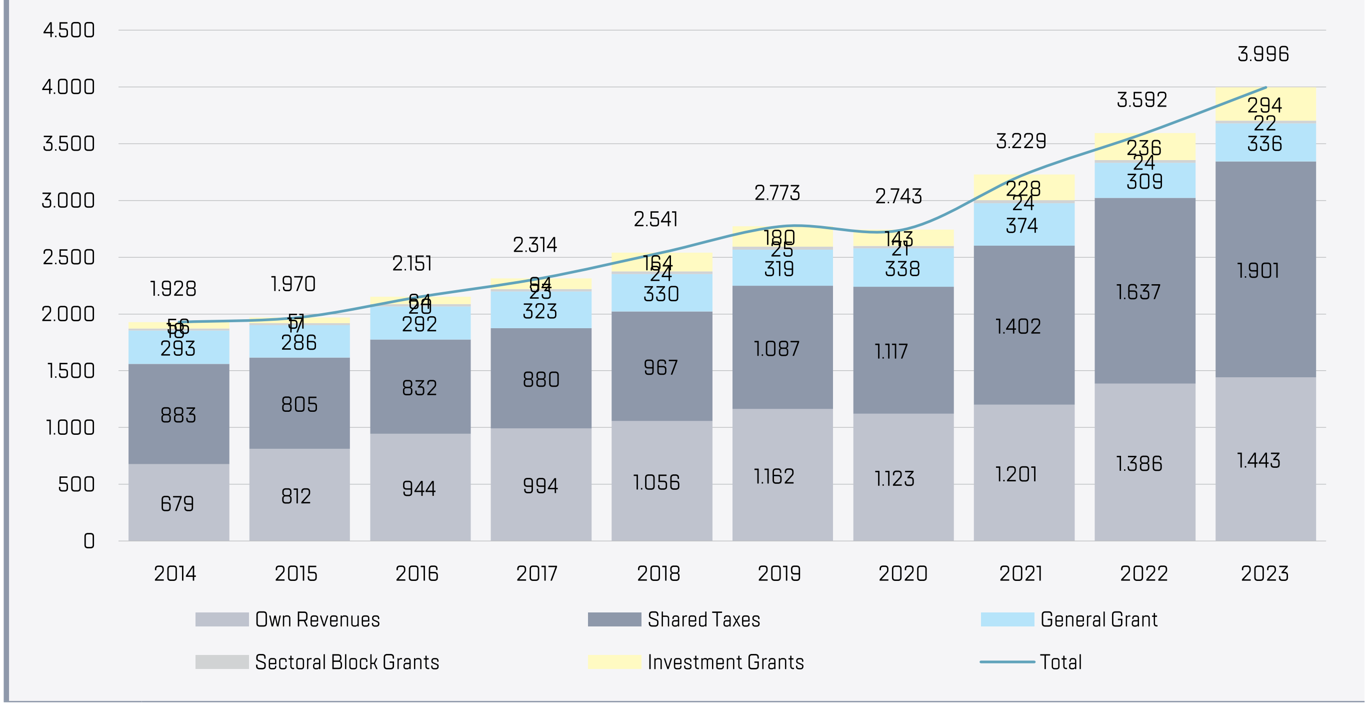
Figure 135. ***Serbia:*** *Composition of Local Government Revenue, in % of total*



[22] Please note that the inheritance and gift tax and the property transfer tax are included in this report as own revenues although according to the Law on Local Government Finance they are shared (assigned) taxes. Within the official reports by the Ministry of Finance of Serbia (Bulletin Public Finance) they are included in the Property tax section that includes beside these two taxes also the Tax on Immovable Property which is the most important own-source tax. The share of these two assigned taxes according to SCTM estimations varied between 3-4 % of total LSG revenue depending on the year.

Despite these challenges, LSG revenues have doubled in the past decade, growing from 1.9 billion EUR in 2014 to 4 billion EUR in 2023. A major shift in recent years has been the increase in PIT revenues, which rose by 95.6%, accounting for 48% of total local revenues by 2023. This increase is largely due to higher wages, as the gross wage tax constitutes the largest part of PIT. Additionally, the property tax yield has improved.

Figure 136. ***Serbia:*** *Composition of Local Government Revenue, in million EUR*

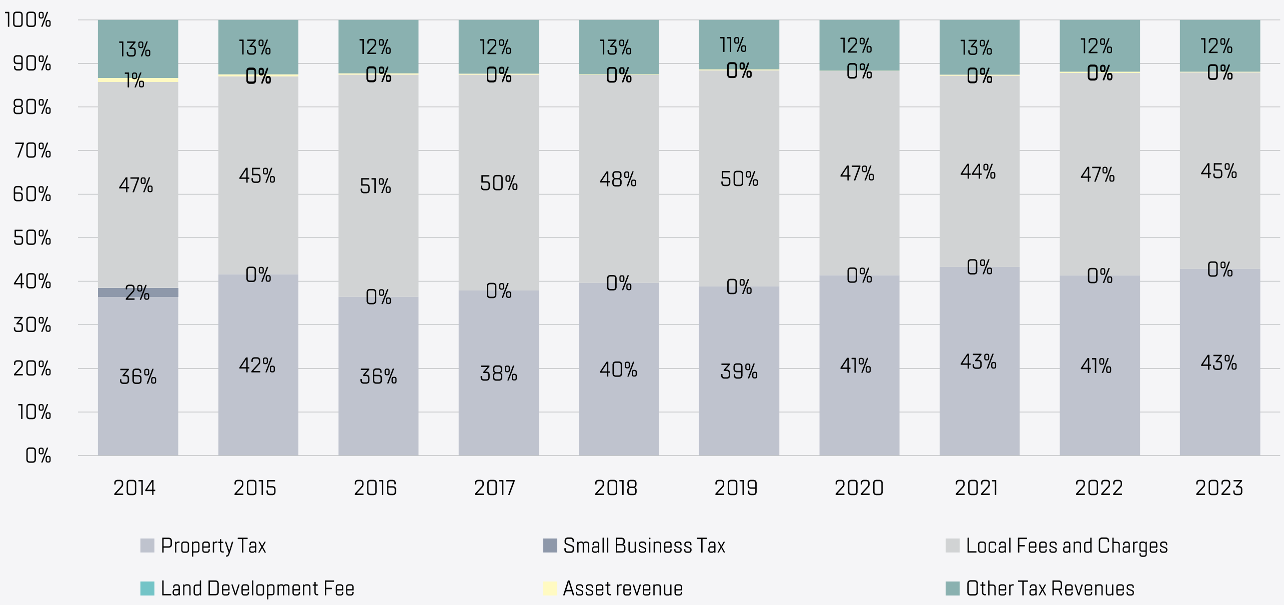


The share and structure of transfers from the central government has also changed.[23] While the share of transfers remained stable at 18-20% of local revenues from 2015 to 2021, it dropped to 15.5% in 2022 and slightly increased to 16.2% in 2023, contributing to vertical fiscal imbalance. The share of non-earmarked transfers has also decreased significantly, from 82% of total transfers and 15% of total revenues in 2015, to 55% and 8% respectively in 2023. The total amount of non-earmarked transfers has not changed annually since 2014, due in part to changes in the methodology for determining these transfers after the 2011 amendments to the Law on Local Self-Government Financing. In fact, the amount of the total non-earmarked transfer was changed from 1.7% of GDP to 1.7% of GDP but as 'calculation category'.

[23] Share of other types of main revenues (such as wage tax and property tax) remained largely stable, although changes of some fees like fee for environmental protection and fee for pollution, brought losses of revenues for some LSGs.

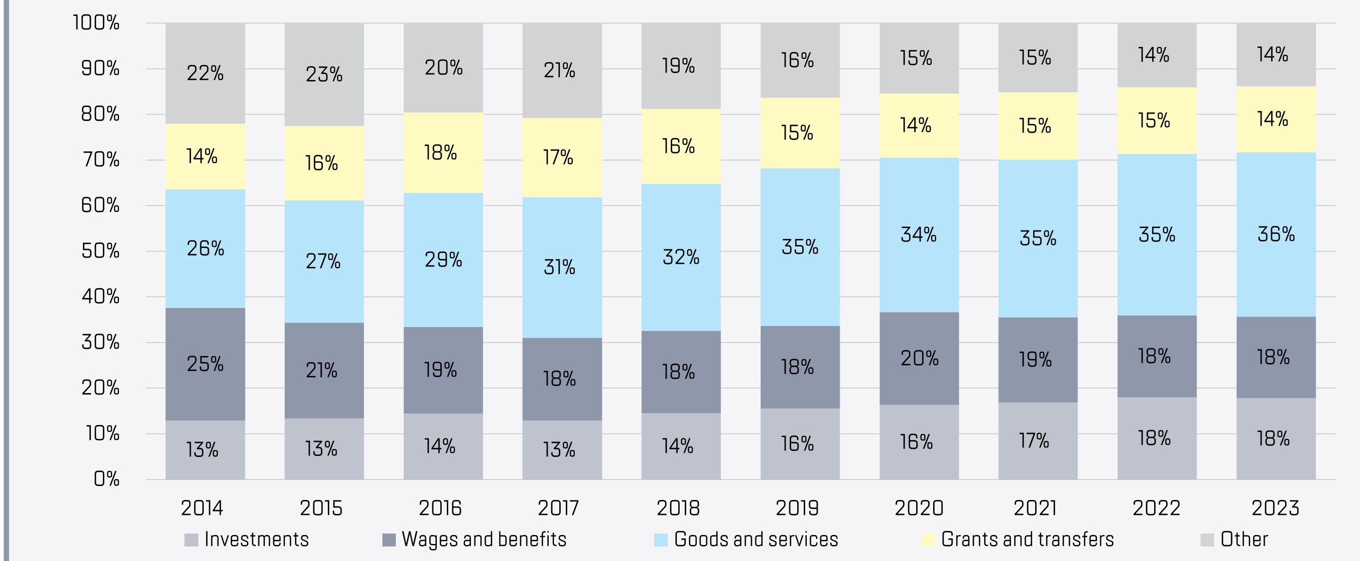
LSGs have significantly improved property tax revenue since 2006, when it amounted to 69 million EUR. By 2023, LSG revenue from property tax had reached around 617 million EUR. The most notable increase occurred between 2013 and 2019, during which comprehensive capacity-building activities for property tax were carried out at the local level. In 2023, property tax remained the most important own-source revenue for LSGs, accounting for 42.8% of total own revenues.

Figure 137. ***Serbia:*** *Composition of Own Revenues, in % of total*



LSG spending for investment as a share of total expenditure remained stable during the most severe years of the recent crises, largely due to major infrastructure projects in Belgrade. However, investment has sharply declined since 2011 and has remained below 18% for eleven consecutive years. Serbian local governments also allocate about 5.6% of their budgets to subsidies for public utilities, some of which are directed towards capital investment, partially offsetting the relatively low investment expenditure. Debt service payments in 2023 account for approximately 1.7% of total expenditures.

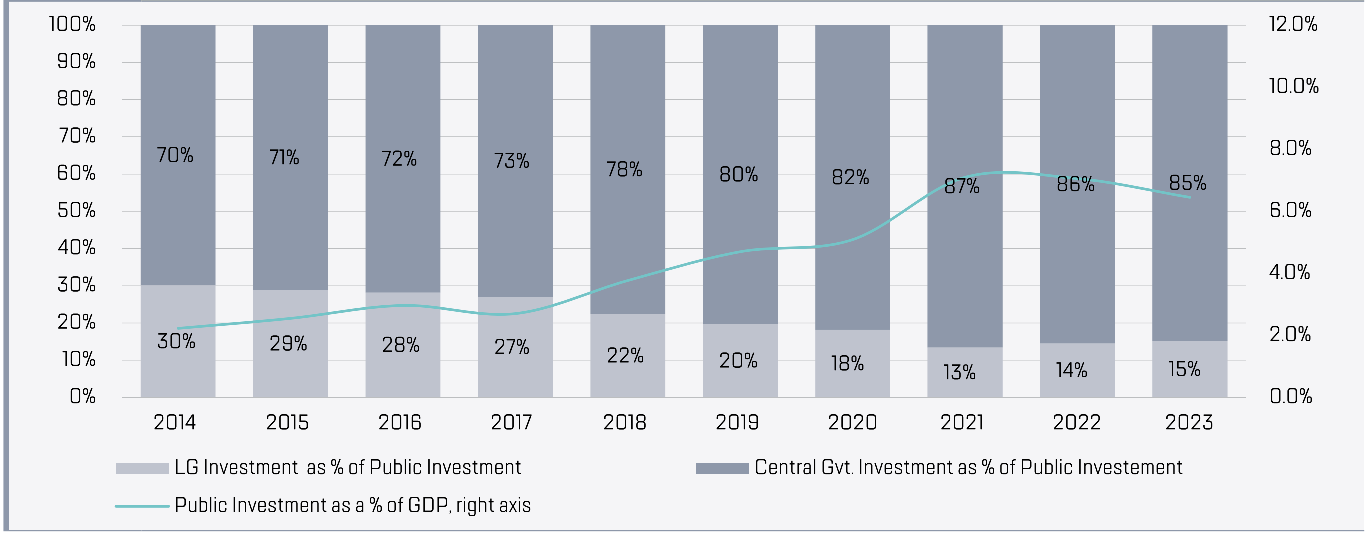
Figure 138. Serbia: *Composition of Local Government Expenditure*



****Note:** The other expenditures include: interests; subsides; other current expenditures such as grants/transfers to NGO, political parties, associations and penalties and various compensations for damages; and expenses from financial transactions such as procurement of financial assets and repayment of principal.

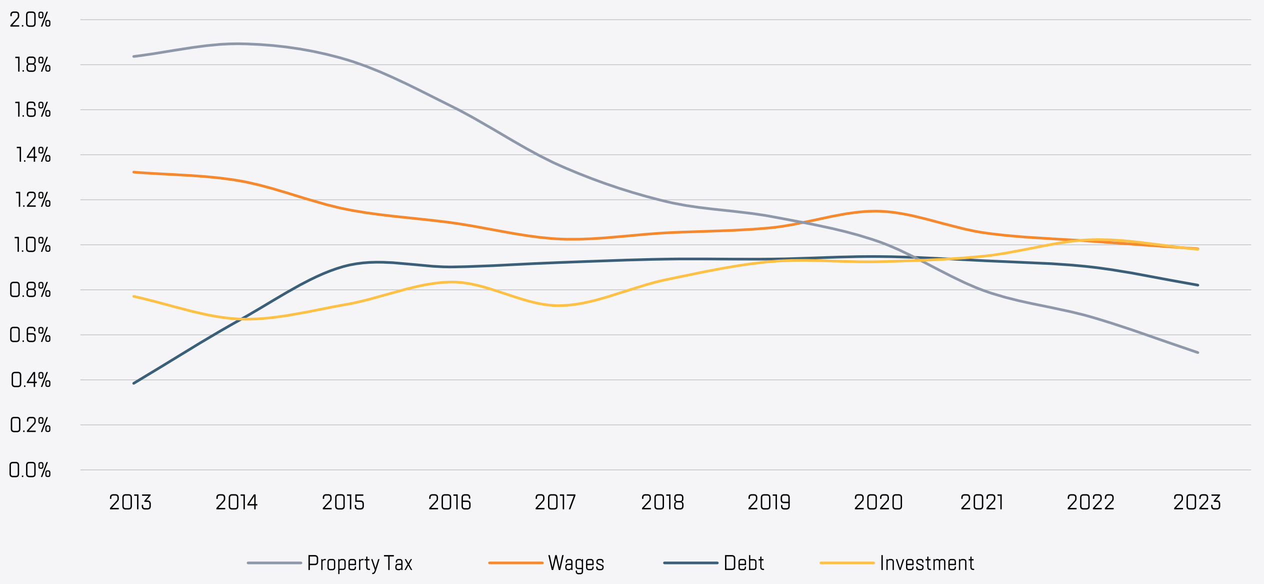
Despite the financial difficulties, local wage spending has remained stable over the past eight years, after a significant decrease in 2015 due to restrictions imposed by the central level.

Figure 139. Serbia: *Investment by Level of Government and as a % GDP*



The contribution of LSGs to public investments has fallen significantly since 2011. As of 2023, local government investment accounts for 1.0% of GDP (and only 15% of total public investments), down from approximately 1.3% in 2011. However, in recent years, the central government has allocated funding for investments in sectors such as transport, energy, health, education, and communal infrastructure (notably waste management, wastewater treatment, and water supply), which are implemented at the local level.

Figure 140. ***Serbia:*** *LG Investment, Wages, Debt and Property Tax as Shares of GDP*



LSGs debt in Serbia rose to 1.9% of GDP in 2014 and has steadily declined, reaching 0.5% of GDP in 2023. Property tax revenue has increased from 0.4% of GDP in 2013 to 0.8% in 2023. This growth is primarily attributed to efforts by LSGs, supported by targeted assistance from development partners, with SCTM playing a key role in providing technical support to incentivize property tax collection.

Slovenia

By Miha Mohor and Valentina Šumi, Association of Municipalities and Towns of Slovenia

Slovenia has a decentralized local government structure consisting of 212 municipalities. There are 12 urban municipalities, including Ljubljana, the capital city. Over a third of Slovenia's population resides in these urban municipalities. These municipalities are granted the ability to take on certain tasks from the state, particularly related to city development.

More than half of Slovenia's municipalities have fewer than 5,000 inhabitants, with the two smallest municipalities having only a few hundred people. Slovenia does not have a regional level of government. In 2021, the municipality of Krško was granted urban municipality status, highlighting its growing significance and development in the region.

The central government maintains substantial control over local revenues in Slovenia. Over the past decade, local government revenues have accounted for about 12.5% of total public revenues, or roughly 5.0% of GDP. Within local government revenues, 33% come from own municipal sources, while 52% come from the shared Personal Income Tax (PIT), and about 14% comes from investment grants. Slovenian municipalities have access to domestic capital markets for debt financing, with local government debt constituting an average of 38.8% of total local revenues, or 1.9% of GDP over the past decade.

The Intergovernmental Finance System

Slovenian municipalities are highly heterogeneous, which necessitates a financing system that equalizes revenues across municipalities. This system primarily relies on the equalization of teh allocation of Personal Income Tax (PIT), which historically has provided more than 50% of local government revenues. In 2022, the PIT share was 49%, and in 2023, it dropped to 45%.

Slovenian municipalities do not receive general-purpose (unconditional) grants. Instead, the **shared PIT for current expenditures** allocates 54% of PIT revenues to municipalities. This allocation is based on a formula that considers a *computed lump sum per capita expenditure need*, known as „**appropriate expenditure**." Essentially, the formula determines the amount that should be apropriate to cover the costs of tasks municipalities are required to perform by law. The formula used for calculating individual municipal allocations includes correction factors that account for differences between municipalities in terms of size, extent of local roads, and the proportion of the population under 15 or over 65 years old. Up to 70% of the total municipal allocation from the PIT share is determined by the yearly „lump sum" amount per inhabitant (54% share of PIT). If this PIT share is insufficient to cover the municipality's ‚appropriate expenditure', the state provides additional funds through a financial equalization mechanism. This ensures that municipalities have sufficient resources to meet their mandated responsibilities.

Appropriate Expenditure Calculation

- 13% length of roads
- 6% municipality area
- 12% residents < 6 y.o.
- 4% residents 6-15 y.o.
- 1.5% residents 65-75 y.o.
- 2.5% residents over 75 y.o.

The appropriate expenditure of a municipality for each budget year in Slovenia is determined using the following equation, as set by the Ministry of Finance:

$$PP_i = (0.61 + 0.13C_i + 0.06P_i + 0.12PM_i + 0.04SM_i + 0.015SU_i + 0.025SD_i) \cdot P \cdot O_i$$

Where:

PP_i = Appropriate expenditure of the municipality

C_i = Ratio of the length of local roads and public paths per capita in the individual municipality compared to the length of local roads and public paths per capita in the entire country

P_i – the ratio between the area of each municipality per capita and the area of the whole country per capita;

PM_i = Ratio of the share of residents under 6 years old in the municipality to the total population of the municipality, relative to the average of these shares in the country as of January 1 of the year in which the appropriate expenditure of the municipality is determined

SM_i = Ratio of the share of residents aged 6 to 15 years in the municipality to the total population of the municipality, relative to the average of these shares in the country as of January 1 of the year in which the appropriate expenditure of the municipality is determined

SU_i = Ratio of the share of residents aged 65 to 75 years in the municipality to the total population of the municipality, relative to the average of these shares in the country as of January 1 of the year in which the appropriate expenditure of the municipality is determined

SD_i = Ratio of the share of residents over 75 years old in the municipality to the total population of the municipality, relative to the average of these shares in the country as of January 1 of the year in which the appropriate expenditure of the municipality is determined

P = Average per capita amount

O_i = Number of residents in the municipality

Slovenia's **solidarity equalization mechanism** ensures that each municipality receives adequate funding to meet its "appropriate expenditure" for essential tasks. This mechanism is funded by 30% of municipal revenues from the Personal Income Tax (PIT) share—specifically, the 54% of total PIT revenues allocated to municipalities—and includes additional contributions from municipalities whose revenues exceed their calculated expenditure needs. For those municipalities whose PIT revenue share remains insufficient, the national government provides extra funds from the PIT from the state budget.

Equalization Mechanism

- **Size:** 30% of local share of PIT + contributions from LGs whose per capita PIT revenues exceed their 'appropriate' expenditure needs
- **Allocation:** difference between the estimated 'appropriate expenditure' needs and the PIT revenue shares.

These funds cover operational requirements for mandatory tasks, excluding investment projects. The Ministry of Finance distributes these equalization transfers weekly, beginning from the first week of each fiscal year, ensuring that municipalities have the resources necessary to fulfill their basic responsibilities. This system aims to minimize financial disparities across municipalities, allowing all local governments, regardless of their revenue-generating capacity, to adequately deliver essential services.

In Slovenia, in addition to general grants, individual ministries provide **special earmarked grants** that local authorities can apply for to support specific projects, such as general infrastructure, heating plants, and water supply systems. The terms and conditions for these grants are defined by systematic laws or regulations established by each ministry. Primarily intended for infrastructure development, these investment grants are conditional and may be subject to specific project requirements, co-financing arrangements, or alignment with national strategic priorities.

When allocating funds, the development level of each municipality is assessed according to criteria set by government methodology based on several factors, ensuring that the distribution of grants reflects municipal needs and government priorities:

Earmarked Grants

- **Size:** determined by ministries
- **Allocation:** based on development level considering:
  - Development indicators
  - Vulnerability indicators
  - Development potential indicators

- **Development indicators** include metrics such as the gross value added by business entities per employee, the per capita income tax base, and the ratio of jobs to the economically active population within the municipality.
- **Vulnerability indicators** measure factors like the aging index of the population, the registered unemployment rate, and the overall employment rate in the municipality's area.
- **development opportunity indicators** assess aspects such as the supply of public utility services, cultural infrastructure (including cultural monuments and public cultural facilities), the percentage of Natura 2000 protected areas, and population density. These comprehensive indicators ensure that grants are directed toward municipalities based on their developmental needs, vulnerabilities, and growth potential.

The level of co-financing for municipal investments is determined by law and depends on the municipality's development level relative to the national average. If a municipality's development ratio is below 0.9 of the national average, it qualifies for full coverage of eligible investment costs, excluding value-added tax (VAT). This system aims to support less-developed municipalities by reducing their financial burden for essential projects, encouraging balanced regional development across the country.

Special funds are allocated to support municipalities participating in **inter-municipal cooperation** to jointly manage essential tasks. Municipalities involved in a joint administration with at least three other municipalities receive up to 30% of the previous year's budget expenses for tasks such as municipal policing, internal audits, and budget accounting. This support increases by 5% for each additional task, but it cannot exceed 55% of the expenses for salaries, other costs, and contributions.

The Financing of Municipalities Act also provides **special grants** for municipalities with Italian and Hungarian communities (0.15% of the total appropriate expenditures for all municipalities) and for municipalities with Roma communities (3.5% of the appropriate expenditures for individual municipalities), promoting inclusive financial support across diverse local needs.

Financing balanced municipal development. Since 2020, Slovenian municipalities have received grants aimed at balanced development, amounting to 6% of the estimated total appropriate expenditures across all municipalities. These funds, distributed monthly by the Ministry of Finance, are allocated based on a formula that considers various geographic and environmental factors, such as border and natural zones. This system promotes equity by ensuring that even smaller or less economically robust municipalities can meet their financial obligations. However, the heavy reliance on PIT and conditional grants leaves municipalities dependent on central government policies and funding decisions.

The allocation of **additional funds for balancing municipal development** in Slovenia is determined by the following formula:

$$SVSo = ((FIo \text{ x } KFI){:}\ \Sigma FI) + ((OCo \text{ x } KOC){:}\ \Sigma OCd) + ((OOo \text{ x } KOO){:}\ \Sigma OOd) + ((ODo \text{ x } KOD){:}\ \Sigma OD) + ((NAo \text{ x } KNA){:}\ \Sigma NA) + (((\sqrt{}\ (Po{:}\ \check{S}Po) \text{ x } Po) \text{ x } KRP){:}\ \Sigma RP)$$

Where:

SVSo: Total funds available to each municipality.

FIo: Municipal income from solidarity and financial equalization.

KFI: 20% of the quota funds designated for "solidarity and financial equalization."

ΣFI: Total funds allocated for solidarity and financial equalization.

OCo: Length of local roads and public paths in the municipality.

KOC: 30% of the quota funds for "municipal roads."

ΣOCd: Total length of local roads and public paths nationwide.

OOo: Area of the 10-kilometer border zone in the municipality.

KOO: 10% of the quota funds for the "border area."

ΣOOd: Total area of the 10-kilometer border zone in the country.

ODo: Agricultural land area in regions with limited natural resources in the municipality.

KOD: 20% of the quota funds for areas with "limited natural factors."

ΣOD: Total agricultural land area with limited natural resources nationwide.

NAo: Natura 2000 area within the municipality.

KNA: 10% of the quota funds for "Natura 2000" regions.

ΣNA: Total area of Natura 2000 regions in the country.

Po: Total area of the municipality.

ŠPo: Number of residents in the municipality.

KRP: 10% of the funds from the quota designated for "population density."

ΣRP: Sum of the population density factors for each municipality, calculated as: sum $\sqrt{}(Po : \check{S}Po) \text{ x } Po$.

Own Source Revenues

The Law on Financing of Municipalities, introduced in 2007, regulates local government budgets and outlines the specific taxes that municipalities are authorized to collect. These taxes include property tax, inheritance and gift tax, tax on gambling machines, and tax on water vessels, among others specified by the law. However, municipalities do not have the power to introduce new taxes, and the central government controls the tax rates, with the exception of property tax.

Presently, the government is drafting a new property tax law to enable municipalities to increase their revenue-generating capacity. This new real estate tax is intended to replace the current property tax, as well as the contributions associated with building and land use, and will apply universally to all buildings and land owned by both individuals and businesses.

Beyond tax revenue, municipalities also collect non-tax revenues, which vary among local governments. In 2021, non-tax revenues made up 19% of local government revenues. However, the significance of non-tax revenues varies significantly, with smaller local governments deriving just 5% of their spending resources from these revenues, whereas larger municipalities sourced up to 40% of their funds from non-tax revenues.

Contributions from building use, property sales, rental fees, and residential funds constitute a substantial portion of non-tax revenues for Slovenian municipalities. These revenues provide municipalities with a level of financial independence, as their usage is not regulated by the central government.

Advocacy efforts of the Local Government Association

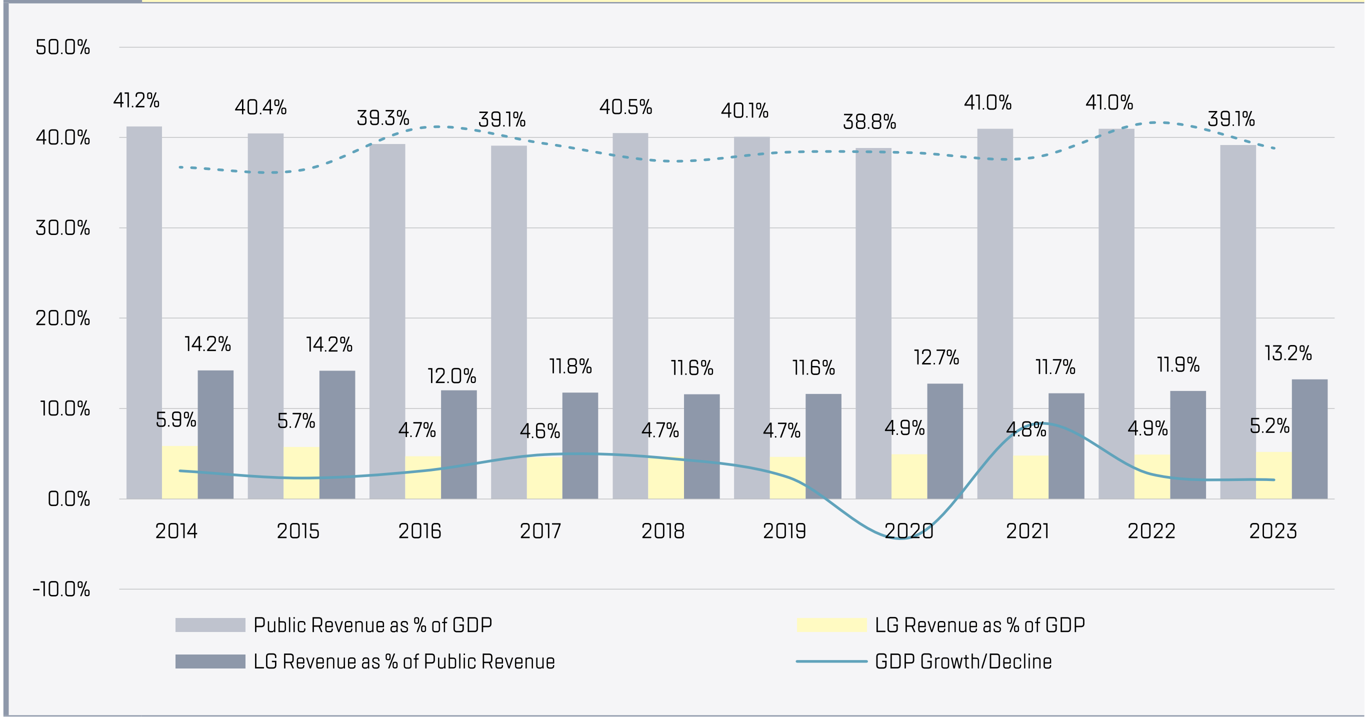
The Association of Municipalities and Towns of Slovenia (SOS) plays an essential role in advocating for the financial and operational interests of local governments across Slovenia. A core responsibility of SOS is to calculate and present the financial needs of municipalities, helping ensure that resources align with the legal mandates and operational demands of local authorities. By providing accurate financial assessments, SOS supports effective local financial planning. In addition to preparing financial needs assessments, SOS is a key player in negotiating with the national government. These negotiations, involving all three local government associations, focus on securing an appropriate share of personal income tax (PIT) revenue for municipalities, a vital source of funding for local tasks and services. Through active engagement in these discussions, SOS aims to achieve fair PIT distribution to sustain municipal functions effectively.

SOS's advocacy efforts extend beyond negotiations, as it works to reinforce the financial standing of local governments. This involves promoting transparency in fiscal arrangements, advocating for fair funding formulas, and pushing for greater fiscal autonomy for municipalities. By championing these issues in the negotiations, SOS seeks to empower local governments with the financial resources needed to support community services and foster local development.

Statistical Overview of Local Government Finance in Slovenia

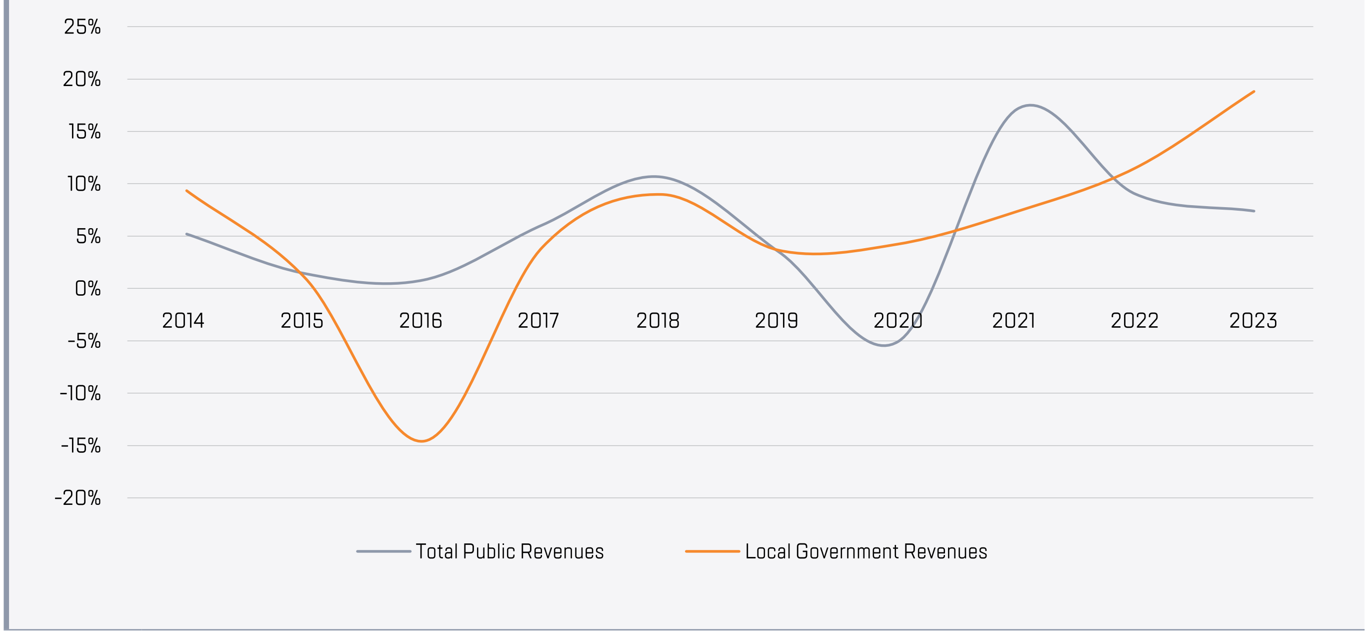
In Slovenia, the share of the local government sector in GDP has decreased from 5.7% in 2015 to 4.9% in 2022, largely due to fiscal pressures linked to the economic crisis. This decline reflects a broader trend in which the central government has shifted a disproportionate share of fiscal stress onto local governments. However, in 2023, local revenues as a percentage of GDP saw an uptick, driven primarily by increased state transfers to local communities, which provided some fiscal relief at the municipal level.

Figure141. ***SLOVENIA:*** *LOCAL GOVERNMENT REVENUE AS A SHARE OF GDP AND TOTAL PUBLIC REVENUE*



The revenues of the local and general government have fluctuated significantly over the past few years.

Figure 142. ***SLOVENIA:*** *ANNUAL FLUCTUATIONS IN THE REVENUES OF THE GENERAL AND LOCAL GOVERNMENTS*



Slovenian local governments are heavily reliant on personal income tax (PIT) sharing, which serves as a major source of revenue. Since 2016, the share of own-source revenues and shared taxes has increased, while the trend for conditional grants, including EU grants, has started to reverse. The impact of the COVID-19 pandemic in 2020 disrupted revenue patterns, leading to a decline in both own-source revenues and shared taxes. Over the past three years, there has been a shift in the composition of revenues, with a notable decrease in own-source revenues and shared taxes. During this period, municipalities have increasingly relied on investment grants to support their fiscal needs.

Figure 143. ***SLOVENIA:*** *COMPOSITION OF LOCAL GOVERNMENT REVENUE, IN % OF TOTAL*

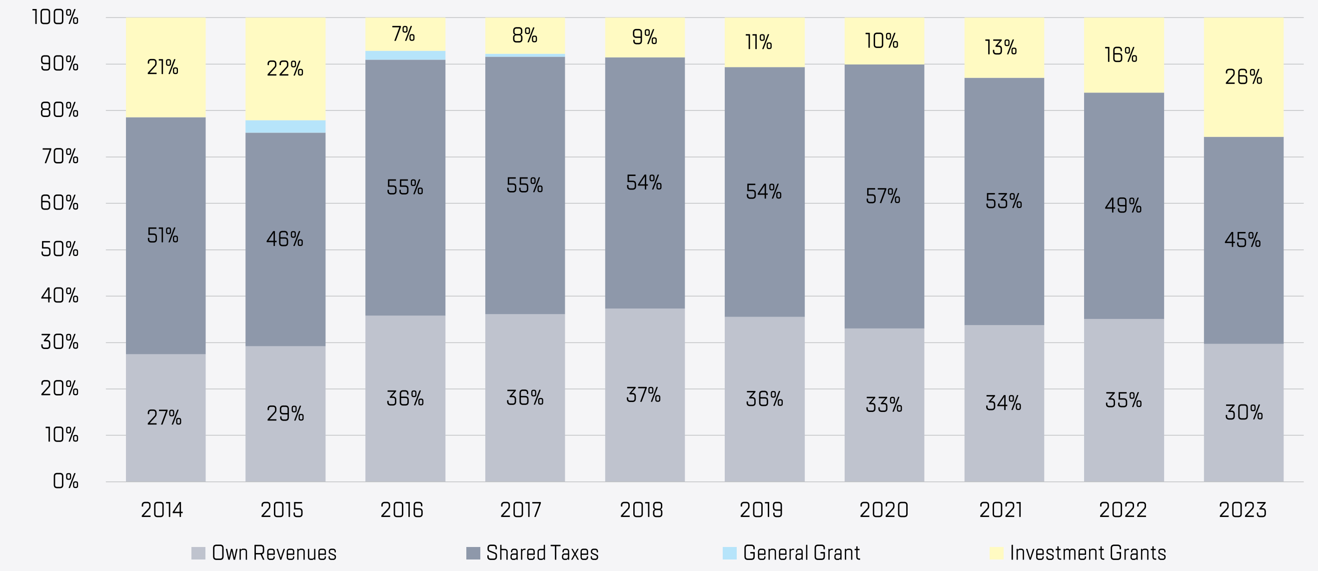
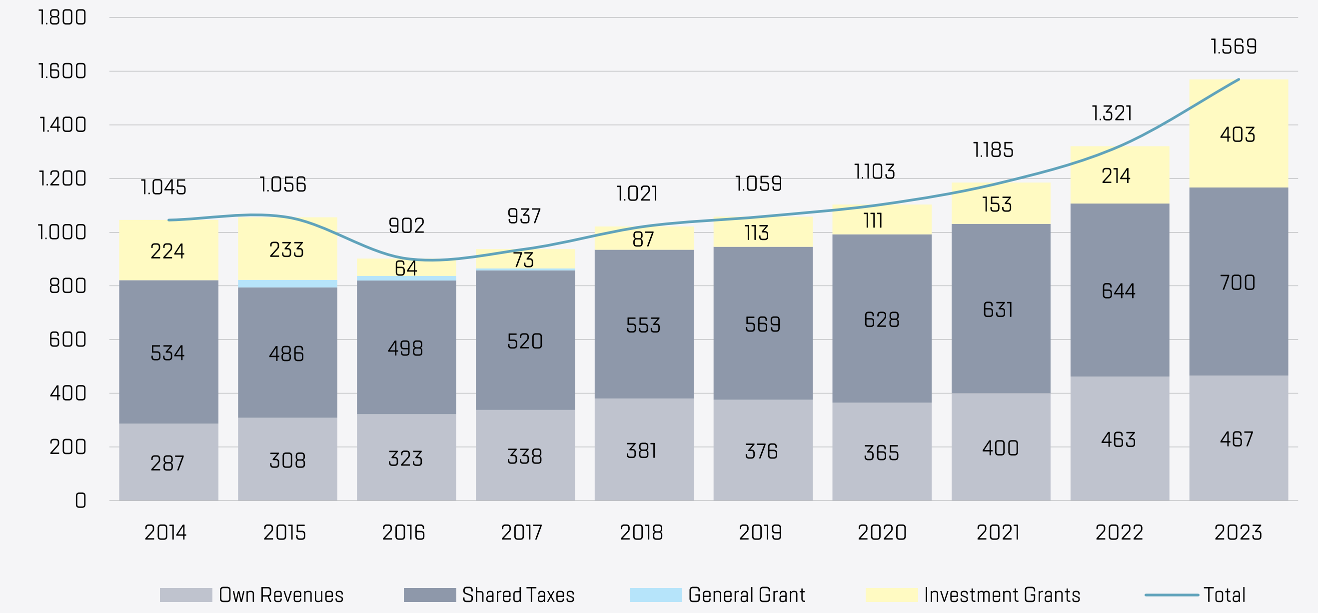


Figure 144. ***SLOVENIA:*** *COMPOSITION OF LG REVENUE, IN EURO, PER CAPITA*



Slovenian municipalities have two primary sources of own-source revenue: property tax and revenues from asset sales and rentals. While all local revenues have generally increased in recent years, the composition of municipal revenues has been notably influenced by a rise in investment grants. This increase in investment grants has shifted the balance of revenue streams, reducing the relative importance of own-source revenues like property tax and asset-related income.

Figure 145. ***SLOVENIA:*** *COMPOSITION OF LOCAL GOVERNMENT REVENUE, IN MILLION EURO*

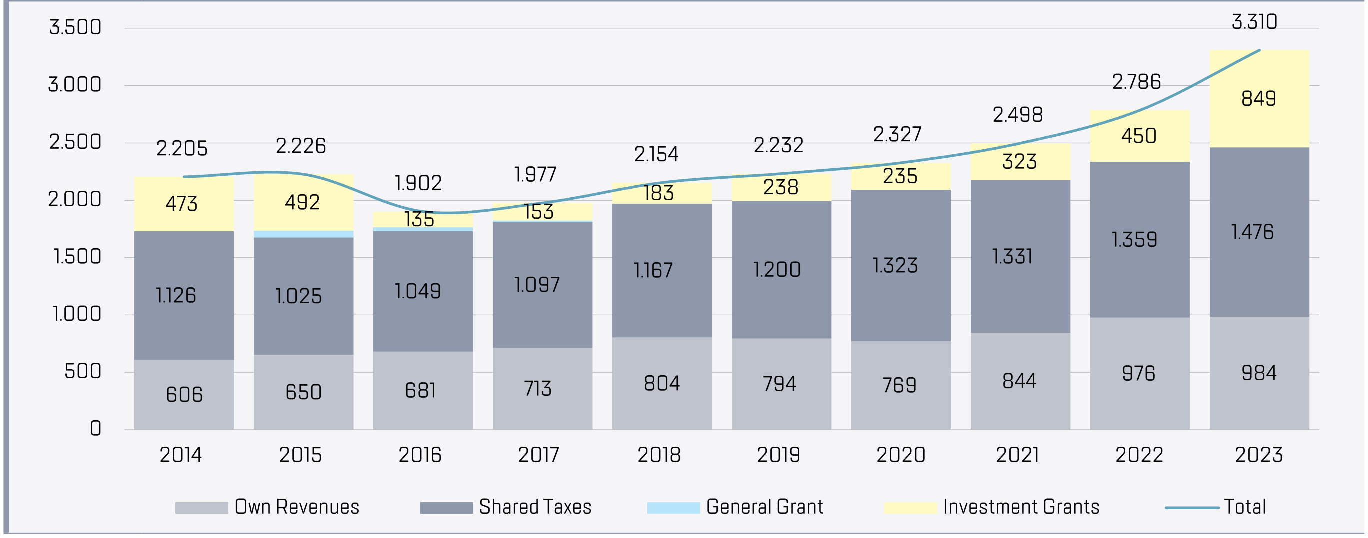
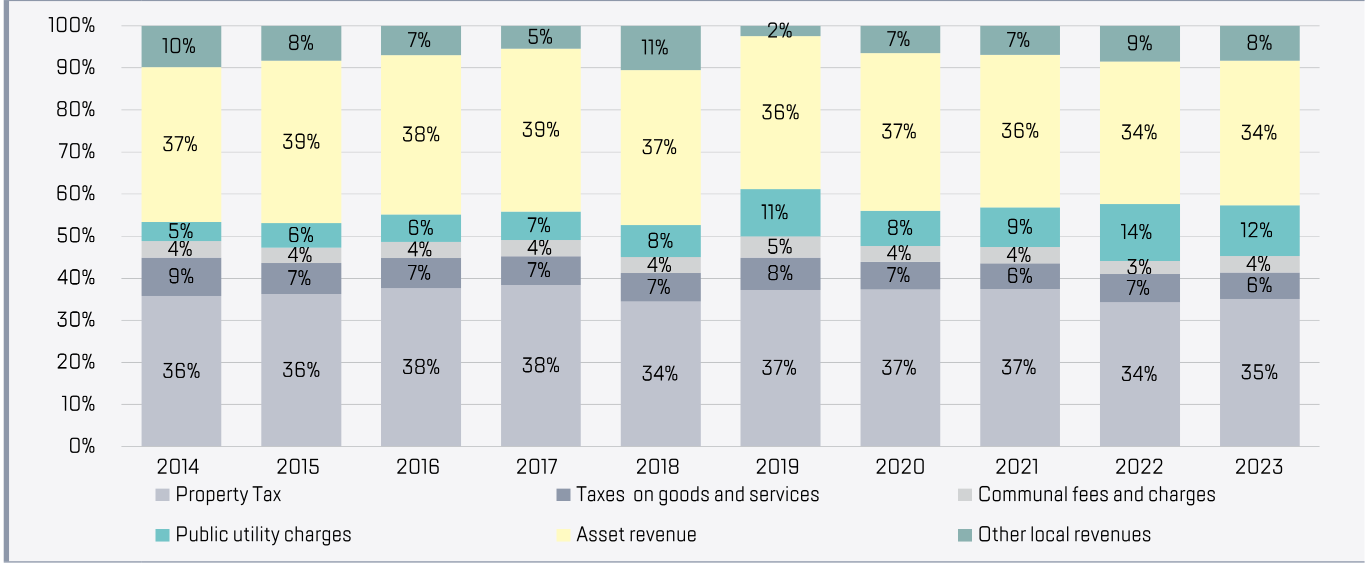


Figure 146. ***SLOVENIA:*** *COMPOSITION OF OWN REVENUE, in % of TOTAL*



The investment rate of Slovenian local governments has seen a gradual decline from 45% of total spending in 2009 to 39% in 2023. This trend includes a notable increase in investment share in 2014 and 2015, followed by a decrease in 2016 and 2017. In the years that followed, the investment rate began to rise again, stabilizing at approximately 39% of total spending by 2023. In addition to investments, a significant portion of municipal budgets is allocated to grants and transfers to individuals and public utilities. However, these expenditures have been showing a declining trend in relative terms over the past three years. Conversely, spending on salaries and goods and services has remained relatively stable over the years, reflecting a more consistent allocation for these operational expenses.

Figure 147. ***SLOVENIA:*** *COMPOSITION OF EXPENDITURE, IN % OF TOTAL*

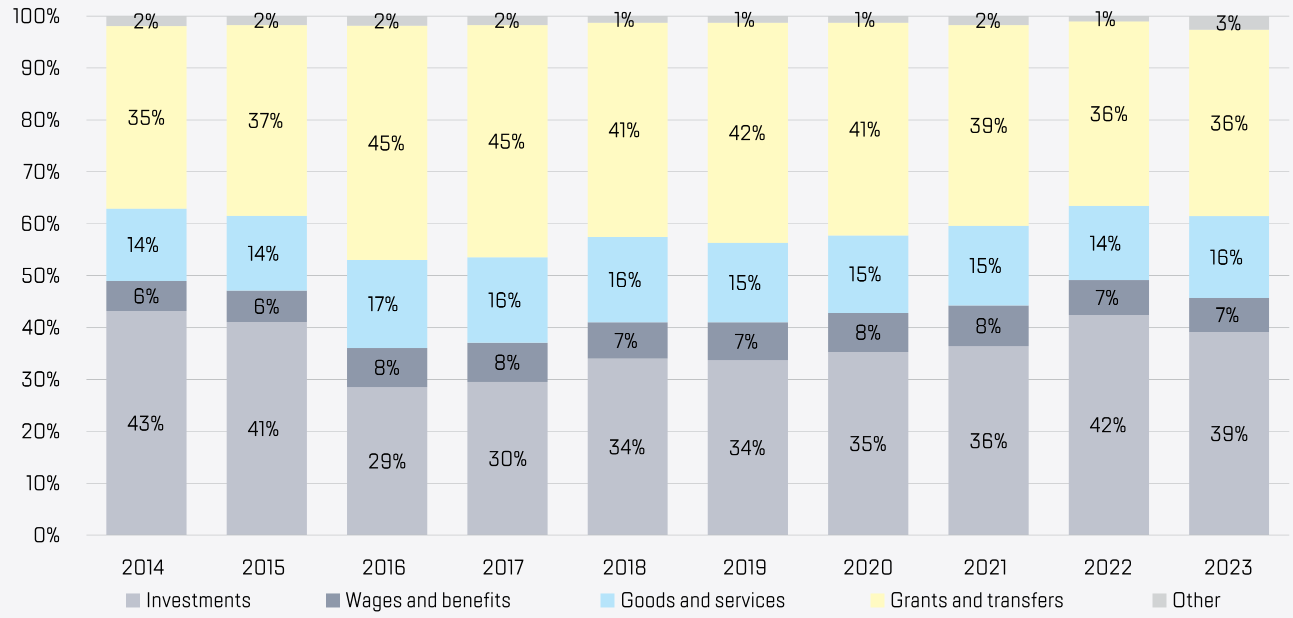
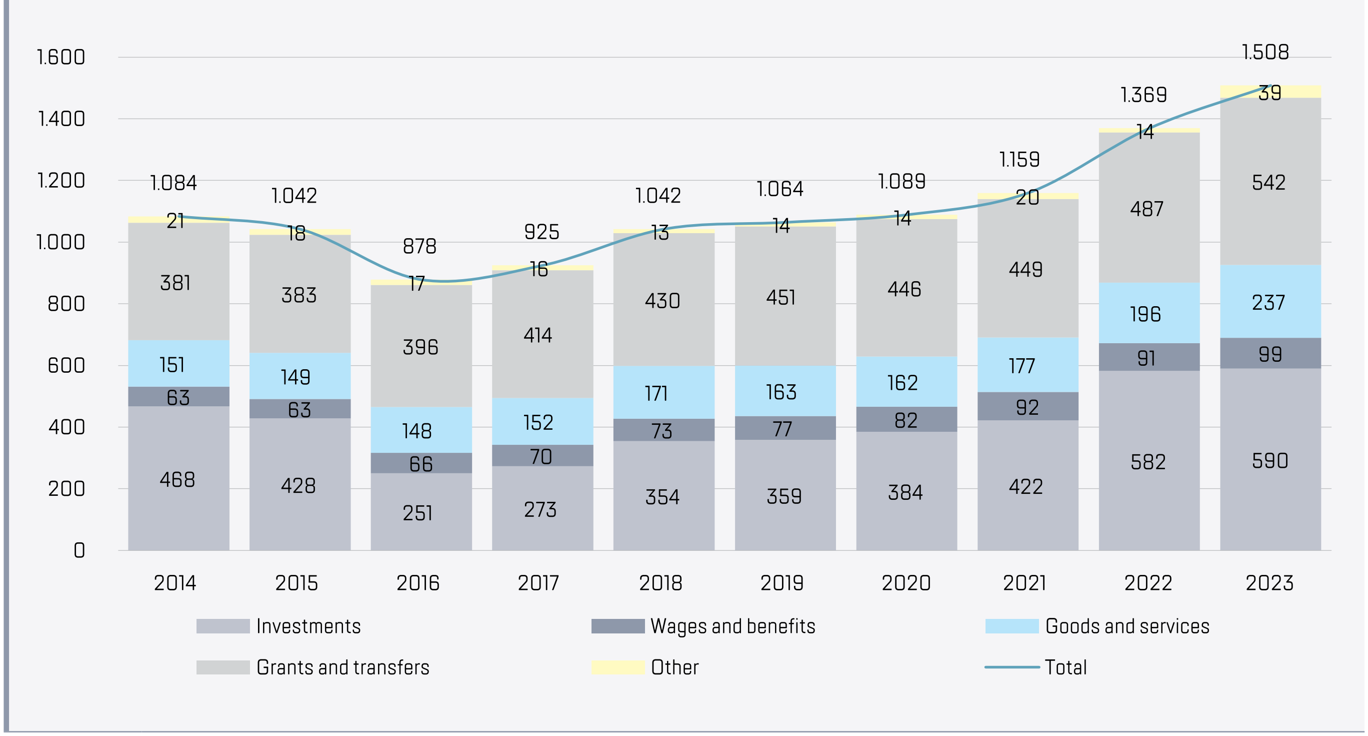
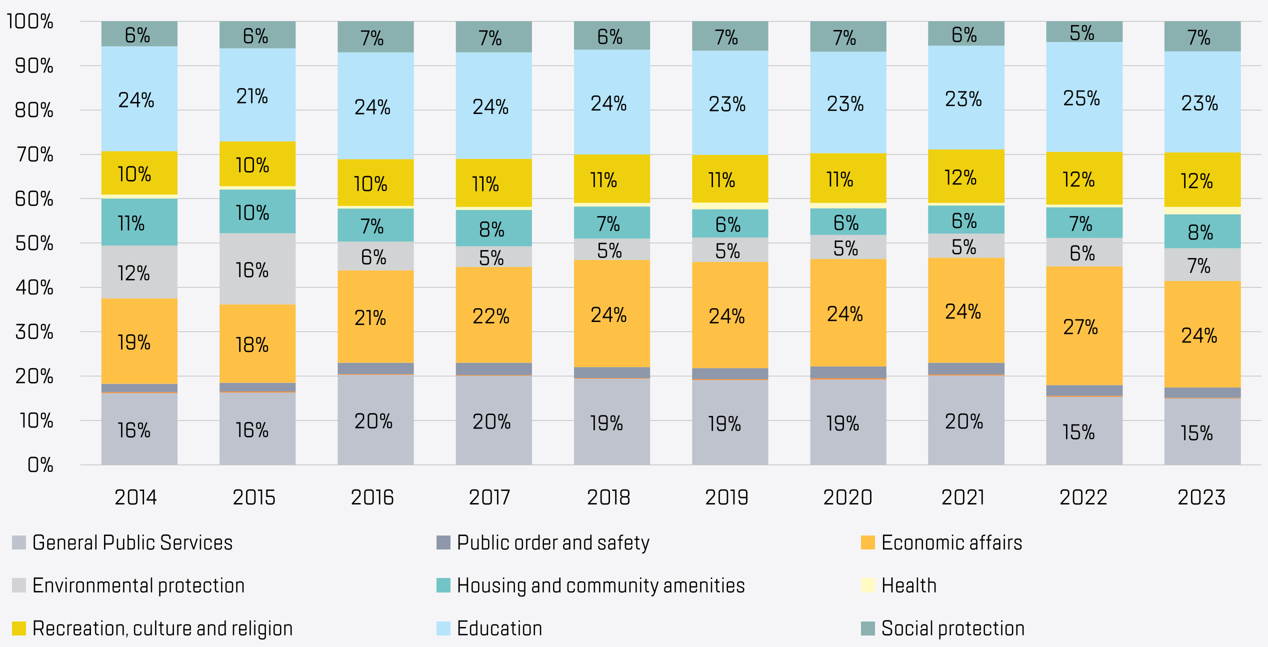


Figure148. SLOVENIA: *COMPOSITION OF EXPENDITURE, IN EURO, PER CAPITA*



From a functional perspective, two-thirds of Slovenian municipal budgets are allocated to general public services, economic affairs, and education. This highlights the importance of these sectors in local government spending. Structurally, there have been no major changes in the functional allocation of expenditures over the recent period, indicating a consistent approach in prioritizing these areas within municipal budgets.

Figure 149. ***SLOVENIA:*** *FUNCTIONAL ALLOCATION OF EXPENDITURES, IN % OF TOTAL*



Capital expenditures in Slovenian municipalities are primarily directed toward economic affairs, reflecting the importance of infrastructure, transportation, and local economic development. However, during the pandemic, there was a notable increase in investments in the functions of recreation, culture, and religion. This shift was largely driven by the need to invest in housing, community amenities, and environmental protection, which gained prominence as municipalities sought to address public health and social needs.

In 2023, Slovenian municipalities saw a structural shift in their spending priorities. Environmental protection gained a larger share of the budget, reflecting growing concerns over sustainability and the need to address environmental challenges. Conversely, expenditures on recreation, culture, and religion were structurally reduced. At the same time, there was a continued rise in spending on housing, community amenities, and environmental protection, highlighting the municipalities' focus on improving living conditions, public infrastructure, and environmental sustainability.

Figure150. ***SLOVENIA:*** *CAPITAL EXPENDITURES, by FUNCTIONS, IN % OF TOTAL*

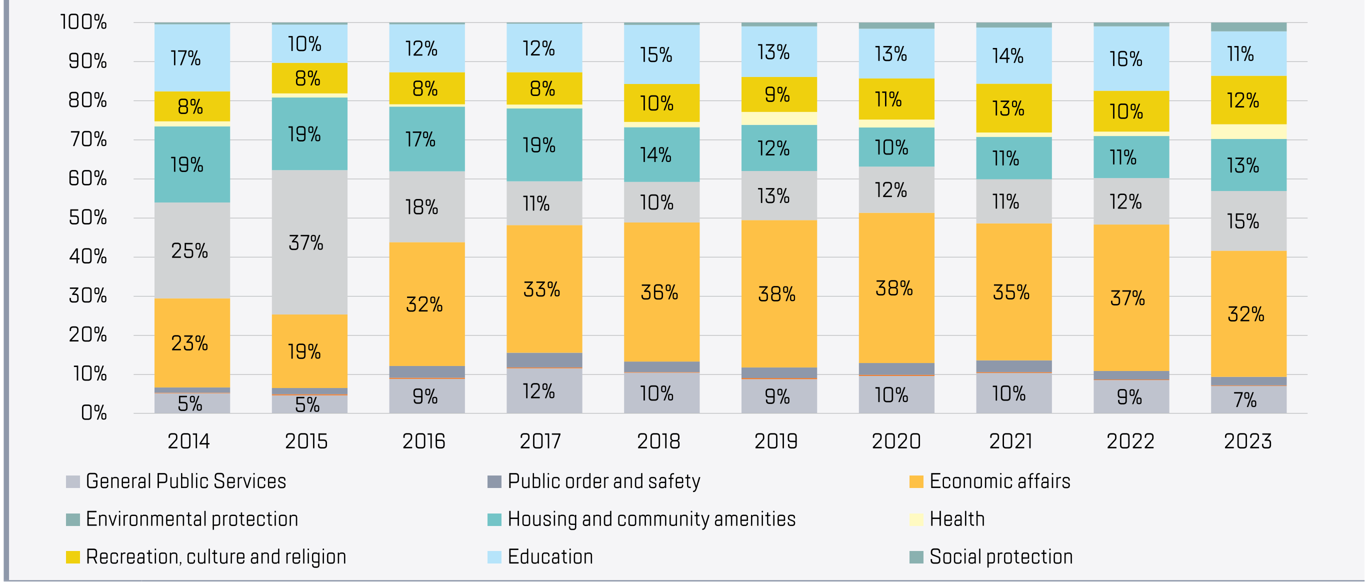
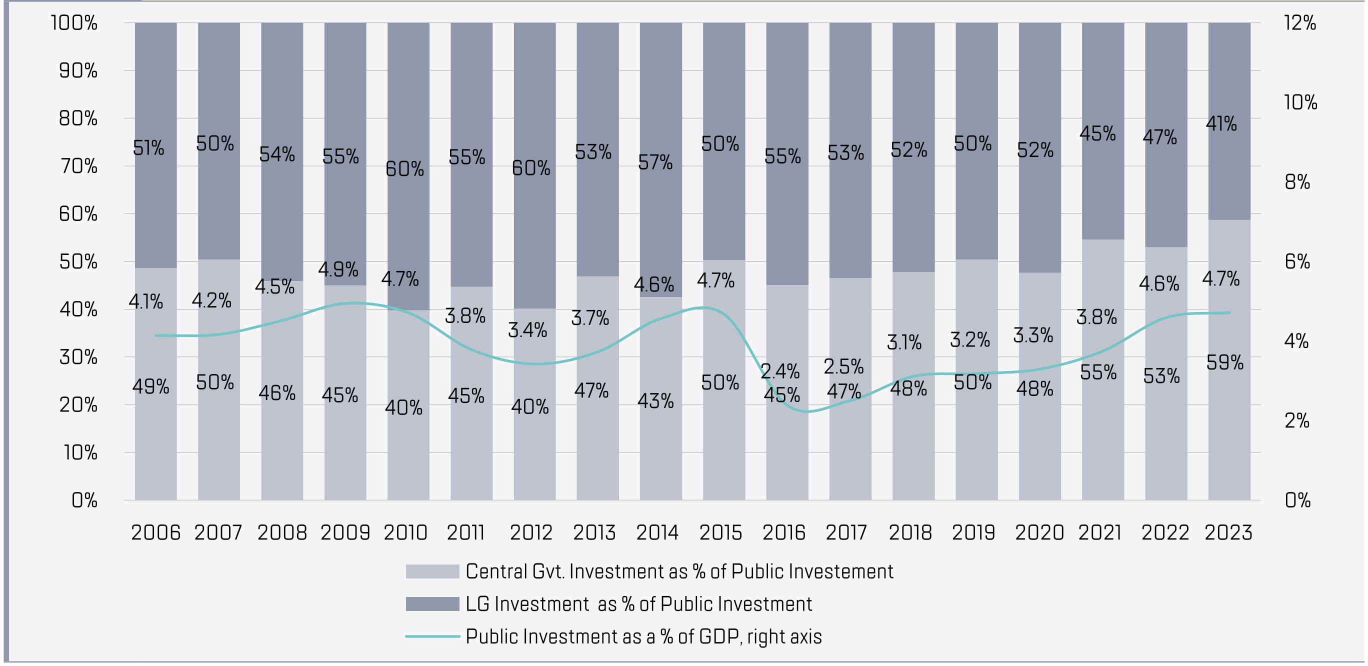


Figure 151. ***SLOVENIA:*** *INVESTMENT BY LEVEL OF GOVERNMENT AND AS A % GDP*



Slovenia has managed to combine robust local investments with relatively stable wage spending. Property tax revenues have remained consistent over time. However, the economic crisis has caused fluctuations in investment levels and an increase in municipal debt. State investments have been rising, bolstered by EU funding, which has played a significant role in stimulating growth in various sectors. Despite this, the economic downturn in 2020, compounded by the fiscal measures taken to mitigate the effects of the pandemic, significantly deteriorated the state's fiscal position. This raises concerns about the sustainability of maintaining high levels of state investments in the medium term, especially when considering the growing need for other development expenditures.

In 2023, the total indebtedness of municipalities and public sector entities at the municipal level increased compared to 2022 but remained stable as a percentage of GDP. Municipalities primarily borrow for investments, which support contractors, create jobs, improve residents' quality of life, stimulate economic activity, and contribute to GDP.

Figure 152. ***SLOVENIA:*** *LG INVESTMENT, WAGES, DEBT, PROPERTY TAX AS SHARE OF GDP*

Türkiye

By Mustafa Kabil, Marmara Municipalities Union

The Intergovernmental Finance System

Türkiye's local government structure consists of two distinct systems. The first, the old system continues in provinces where no cities have populations greater than 750,000 inhabitants. In these provinces, local government structures include small cities, special provincial administrations, and villages. The second system applies to the 30 provinces with cities having populations over 750,000, which have become metropolitan cities. In these provinces, special provincial administrations and villages were eliminated, leaving only metropolitan cities and their district cities. As a result, the number of metropolitan cities increased from 16 to 30, while special provincial administrations still exist in 51 provinces.

Türkiye's intergovernmental finance system primarily revolves around **shared tax revenues** and **own-source revenues**. The revenue entitlements for provincial administrations and municipalities from the national budget are outlined by Law No. 5779 on Tax Revenue Shares for Special Provincial Administrations and Municipalities, enacted in 2008. This law defines the revenue shares for different types of local governments based on national taxes. Specifically, metropolitan municipalities are entitled to 6% of national tax revenues, district municipalities within metropolitan cities receive 4.5%, other municipalities are allocated 1.5%, and special provincial administrations are entitled to 0.5%.

Local governments receive 60-70% of these national tax shares on an origin basis, meaning the amount is allocated based on where the revenue is generated. The remaining 30-40% is pooled into **specific grant pools** for each local government type. These funds are allocated to local governments using two criteria: 80% of the pool is allocated on a per capita basis, and 20% is distributed based on a development index. This index categorizes local governments into five groups, with the least developed group receiving 23% of the pool and the most developed group getting 17%.

Shared Tax Revenues

- 6% metropolitan cities
- 4.5% district municipalities within metropolitan cities
- 1.5% other municipalities
- 0.5% special provincial admin.

Size:

- 60-70% of shared taxes on origin basis
- 30-40% grants for each type of LG

Allocation of grant pools:

- 80% on per capita
- 20% on development index

These revenues are formally classified as shared taxes, not as unconditional grants, and together, they account for between 45% and 50% of local government revenues. Revenues from local government's own sources account for a similar share, with other grants making up the remaining less than 10%.

Conditional grants are typically used to help poorer local governments. For example, the Koy-des Program provides additional funding for villages enabling them to complete investment projects that would be otherwise unaffordable. These projects generally focus on essential infrastructure such as water supply, sanitation, and road access to urban centers.

Fiscal equalization in Türkiye is governed by the "Law on Allocation of Shares from General Budget Tax Revenues to Special Provincial Administrations and Municipalities." According to this law, one-thousandth of the latest finalized general budget tax revenues is allocated as an equalization allowance for municipalities with populations up to 10,000. The Ministry of Finance transfers this appropriation to İlbank A.Ş., which distributes it in two equal installments in March and July. Of the total allocation, 65% is distributed equally among eligible municipalities, while 35% is distributed based on population size.

Fiscal Equalization

- **Size:** one-thousandth of the general budget tax revenues
- **Eligible:** only municipalities with up to 10.000 inhabitants
- **Allocation:**
  - 65% lump sum equal for all eligible municipalities
  - 35% on population size

Own Source Revenues

Local governments in Türkiye derive approximately 35% of their revenue from local taxes and fees. There are various local taxes, including the property tax, which is the most significant local taxes. Other local taxes include the announcement and advertisement tax, entertainment tax, communication tax, electricity consumption tax, and environmental tax.

The property tax constitutes 4% of total local revenues and 10% of local own-source revenue in 2023. It is charged based on the square meter value of urban buildings and land, with adjustments for location, use, and building quality. Municipalities are legally required to reassess property values every four years. The tax assessment is based on a centrally-set methodology, and tax rates are determined by the municipality, within limits set by the national government (ranging from 0.1% to 0.3% of the assessed value). These rates are doubled for properties within the metropolitan municipality's boundaries. It is compulsory that a property tax declaration is submitted to the municipality where the building and land is located in case there is a reason for modification of the tax value.

Property owners and, in cases where the owner cannot be identified, property users of lands and buildings are liable for the tax. The cadastre, which maintains records of all properties in Türkiye, is managed by the national government through the Ministry of Environment, and local governments may access this database to identify properties and owners in their jurisdictions.

In addition to taxes, fees play a significant role in local revenue generation. Key fees include the building construction fee, charged for constructing all types of buildings; the occupation fee, levied for temporary occupation of territory; and other local fees, which mainly come from public services such as water supply and transport.

Borrowing

Municipalities in Türkiye are authorized to borrow loans and issue bonds according to Municipal Law No. 5393, which governs local government financial operations. Domestic borrowing is allowed to cover both current and investment expenses, whereas external borrowing is restricted to financing projects included in the municipality's investment program, in compliance with Law No. 4749 on the Regulation of Public Finance and Debt Management. Several restrictions apply to borrowing amounts.

Municipalities and their affiliated entities or companies (where the municipality holds more than 50% of the equity capital) may contract domestic loans by a resolution of the municipal council, provided these loans do not exceed 10% of the municipality's latest final budget revenues, increased by the revaluation rate specified in Law No. 213 on Tax Procedures. LGs they contract domestic loans exceeding 10% of the municipality's latest final budget revenues by a resolution of the simple majority of the full membership of the municipal council and with the approval of the Ministry of Environment, Urbanization and Climate Change.

The domestic and foreign debt stock, including interest, of municipalities and their affiliated entities and companies in which they hold more than 50% of the equity capital may not exceed the total amount of their latest final budget revenues increased by the revaluation rate provided for in the Law No. 213 on Tax Procedures. The ceiling applicable to metropolitan municipalities shall be one-and-a-half times that amount.

Advocacy efforts of the Local Government Association

The Union of Marmara Municipalities (UMM) is a leading regional local government association in Türkiye, representing 192 municipalities across the Marmara Region. UMM actively advocates for strengthening local government revenues and fiscal autonomy, recognizing these as critical to municipal service delivery. One key focus is addressing the proportionality of tax revenue shares allocated by the central government to local governments, ensuring they align with the increasing duties and responsibilities of municipalities. UMM also emphasizes the need to modernize outdated legislation governing municipal revenue sources, which currently leads to significant revenue losses for local governments. By conducting studies and facilitating communication between central and local governments, UMM plays a vital role in advancing reforms and fostering cooperation.

These advocacy efforts complement UMM's broader initiatives to enhance financial management and sustainability among its member municipalities. Platforms like the Financial Services Platform, events like the Local Governments Finance Summit, and collaborations with international organizations such as the Carbon Disclosure Project help municipalities optimize budget management, adopt innovative financing mechanisms, and integrate sustainable practices. UMM's report, *Localization of Sustainable Development Goals: The Case of the Marmara Region*, highlights these efforts by showcasing best practices in integrating SDGs into financial strategies. Collectively, these activities demonstrate UMM's commitment to ensuring municipalities are financially resilient, capable of addressing environmental risks, and equipped to meet evolving governance challenges.

Additionally, UMM supports capacity-building initiatives, to strengthen local governance and financial resilience, ensuring its members are equipped to meet evolving socio-economic and environmental challenges.

Mechanisms for Dialogue and Coordination between Levels of Government

UMM plays a pivotal role in fostering intergovernmental dialogue in Türkiye by acting as a bridge between local governments and the central administration. UMM facilitates communication and collaboration through organized platforms, events, and reports that address key issues such as local government financing, sustainable development, and legislative reforms. By gathering municipalities' concerns and presenting them to central authorities, UMM strengthens the collective voice of local governments. It also promotes partnerships between stakeholders, both nationally and internationally, to advance solutions for urban challenges and advocate for greater fiscal and operational autonomy for municipalities.

Until 2018, the General Directorate of Local Administrations under the Ministry of Interior managed central-local government dialogue. Afterwards, this role shifted to the General Directorate of Local Authorities under the Ministry of Environment, Urbanization, and Climate Change.

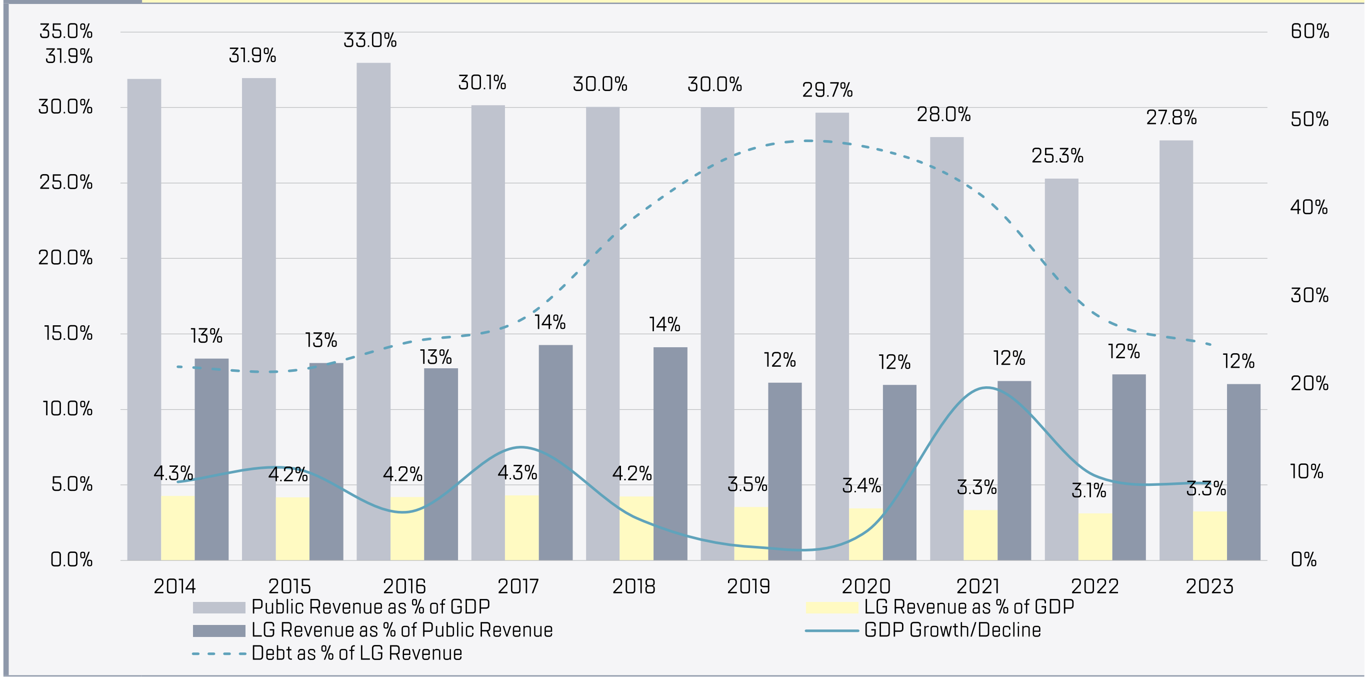
The General Directorate of Local Authorities oversees several key functions, including ensuring that local investments and services comply with development plans and annual programs, developing and managing tasks assigned by legislation, and conducting research and statistical evaluations to support municipal development. It also handles planning and monitoring in-service training for local government personnel and setting standards for organization, vehicles, and staffing within local administrations.

Local Government Associations (LGAs), primarily coordinate their activities with this Directorate, emphasizing its central role in facilitating intergovernmental relations and municipal development.

Statistical Overview of Local Government Finances in Türkiye

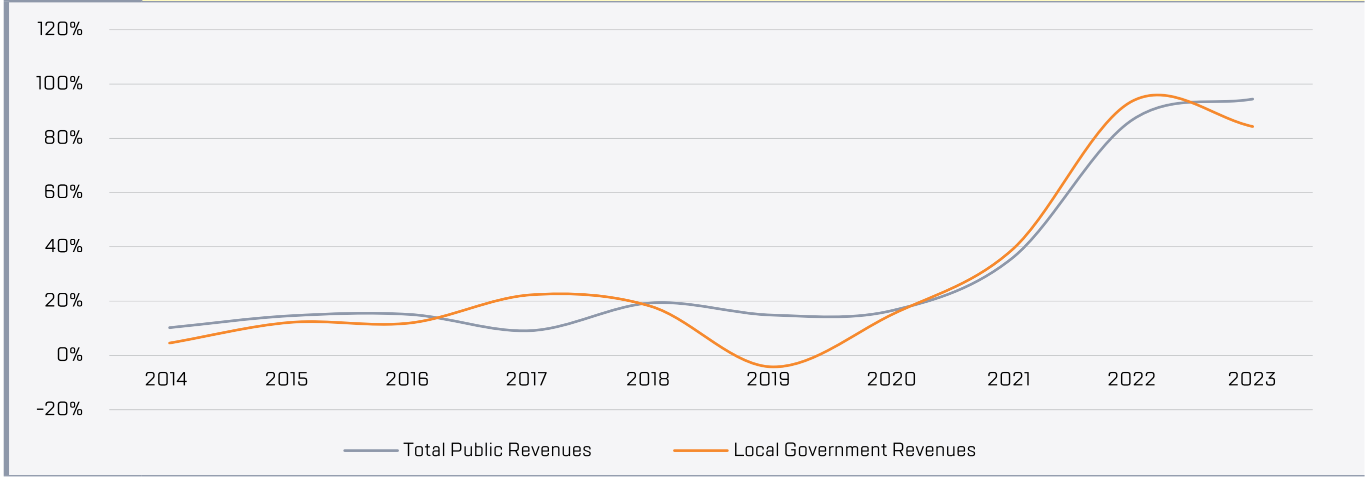
In 2023, local government revenue in Türkiye accounted for 3.3% of GDP and maintained a 12% share in total public revenue since 2019, reflecting a stable but modest financial position within the national economy. Türkiye's economic challenges, compounded by the COVID-19 pandemic and two devastating earthquakes in February 2023, have impacted both national and local revenues, limiting fiscal flexibility for local governments.

Figure153. ***TÜRKİYE:*** *LG Revenue as a Share of GDP and Total Public Revenue*



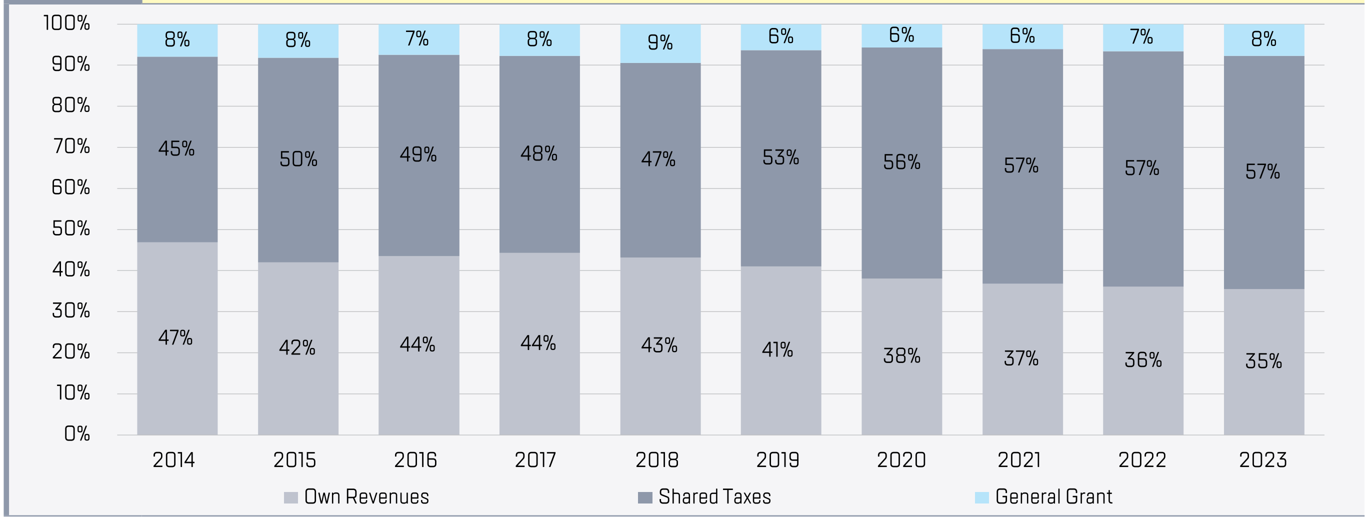
In 2023, local government revenues in Türkiye rose by 84%, while total public revenues grew by 95%, marking the second-highest revenue increase since 2006. This significant growth is primarily driven by high inflation, which began in 2021 and continued to accelerate through 2022 and 2023, inflating revenue figures but potentially straining purchasing power and service delivery at the local level.

Figure 154. ***TÜRKİYE:*** *Fluctuations in the Revenues of the General Government and Local Governments*



In 2023, own-source revenues for local governments in Türkiye made up only 35% of their total revenue, marking the lowest level since 2006. Meanwhile, shared taxes have consistently accounted for 57% of local government revenue over the past three years. This indicates an increasing reliance on centrally distributed funds, potentially limiting local fiscal autonomy and flexibility.

Figure 155. ***TÜRKİYE:*** *Composition of Local Government Revenue, in % of total*



In 2023, Türkiye's local government revenues totaled €33.5 billion, translating to per capita revenues of €392.5. However, these figures were significantly impacted by the sharp depreciation of the Turkish Lira, which affected the real value of local revenues and the purchasing power for local services and investments.

Figure 156. **TÜRKİYE:** *Composition of Local Government Revenue, in mln Euro*

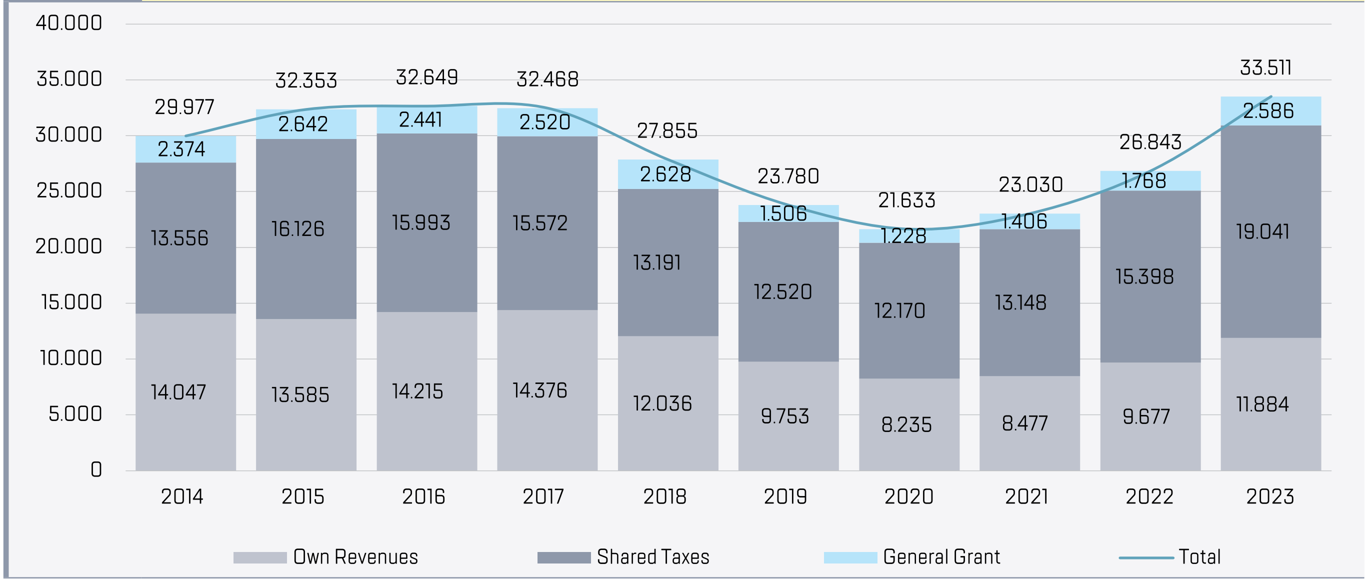
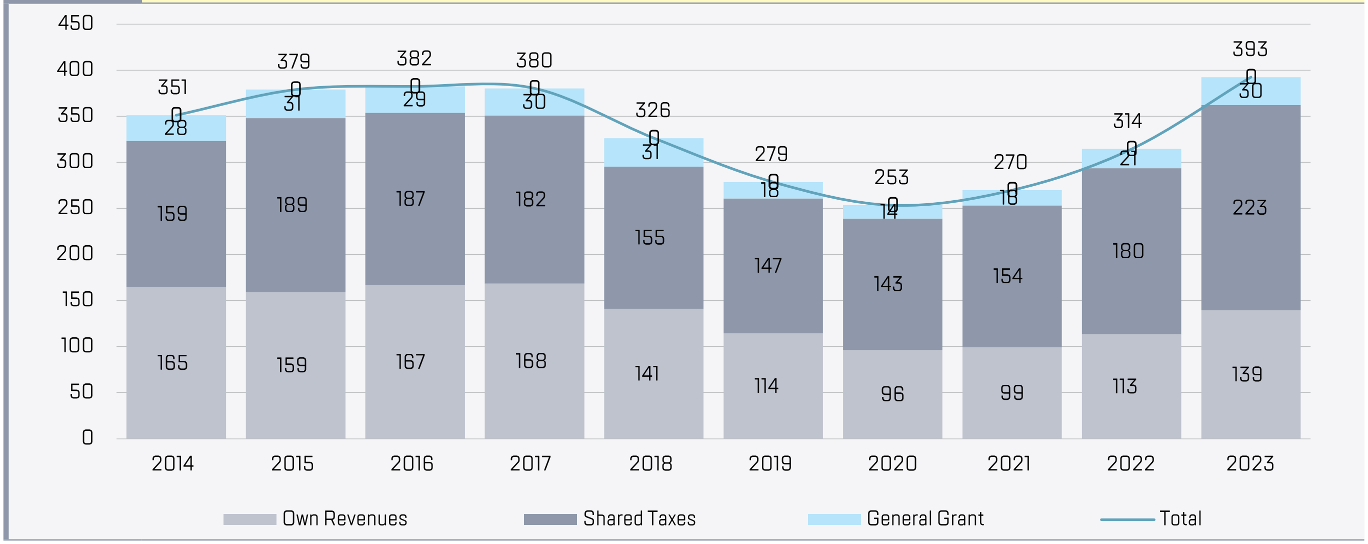
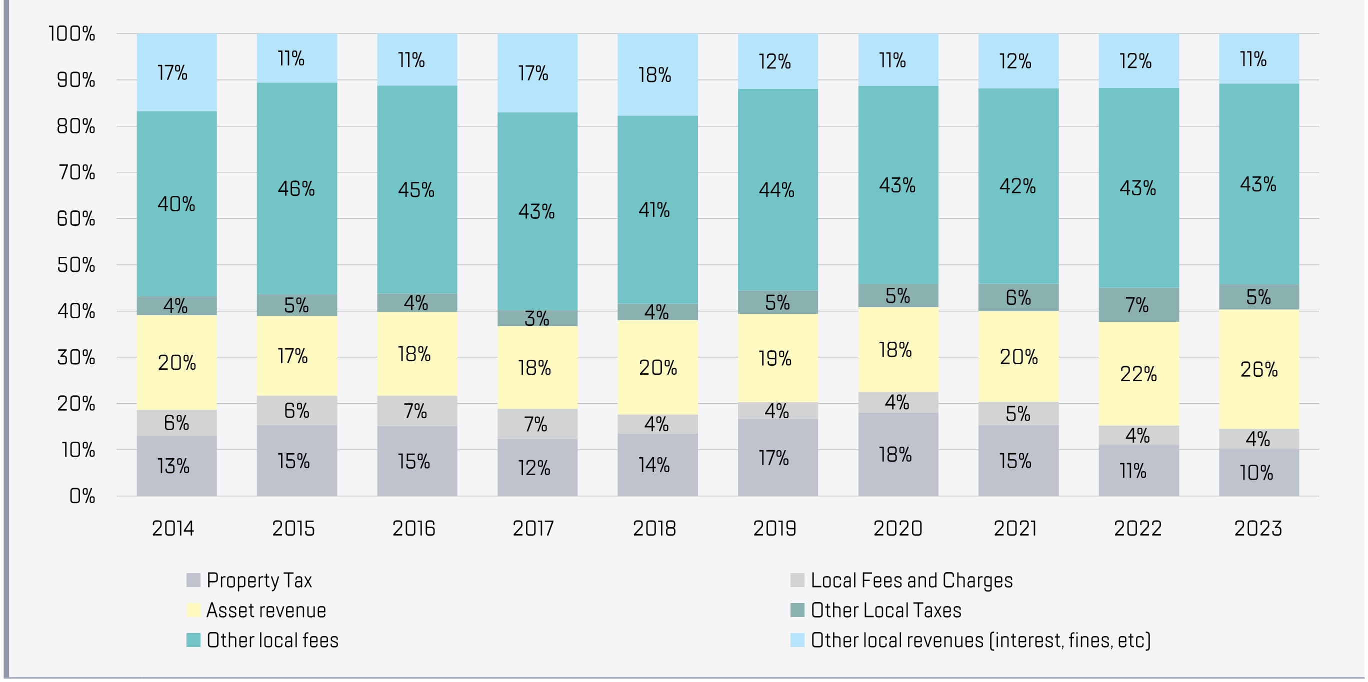


Figure 157. **TÜRKİYE:** *Composition of Local Government Revenue, Euro per capita*



In 2023, property tax revenues for local governments in Türkiye fell to a historic low of 10% of total revenues, the lowest level since 2006. Conversely, asset revenues—primarily from the sale of immovable property—rose to 26%, marking the highest level since 2006. This shift suggests a growing reliance on one-time asset sales over sustainable property tax income, which may impact the stability of local revenue streams in the long term.

Figure 158. ***TÜRKİYE:*** *Composition of Own Source Revenues, % of Total*



In 2023, local investment in Türkiye rose to 35% of total local expenditure, rebounding from its pandemic low in 2020. Expenditures on goods and services have held steady at 47% over the past five years, while spending on wages and social benefits has declined to 10% and 11% over the last two years, marking the lowest levels since 2006. This trend suggests a shift in spending priorities, with increased focus on investment and stable operational costs, while personnel and social expenditures have been reduced.

Figure 159. ***TÜRKIYE:*** *Composition of Expenditure, in % of total*

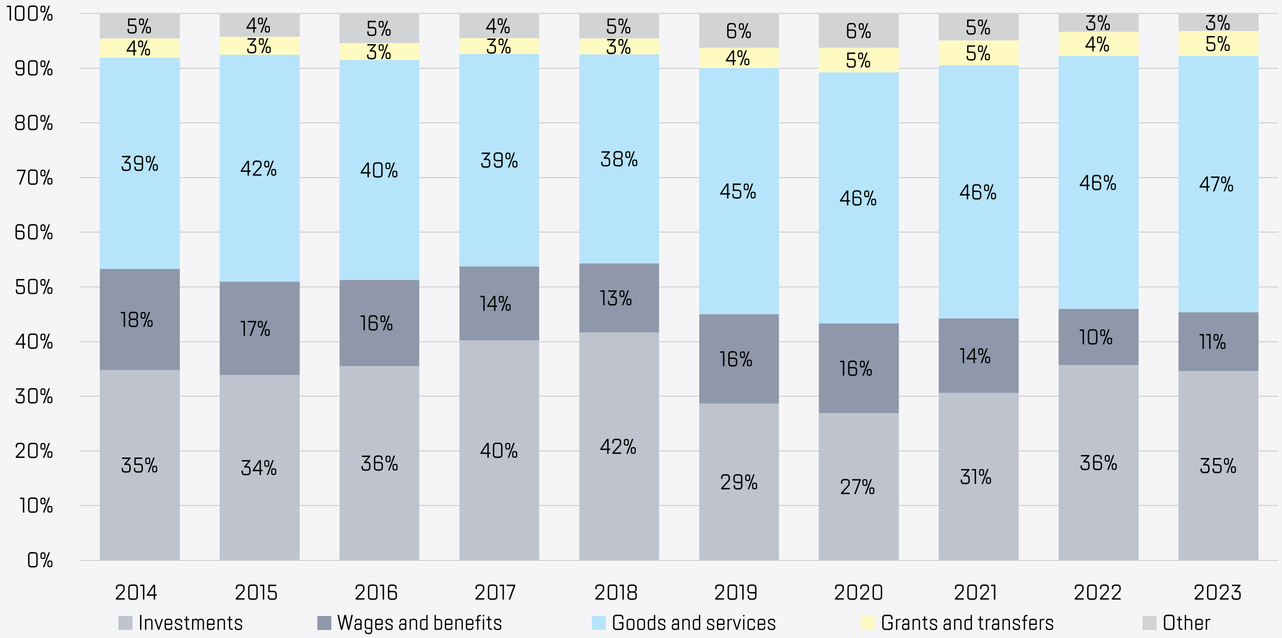


Figure 160. ***TÜRKİYE:*** *Composition of Expenditure, in million Eur*

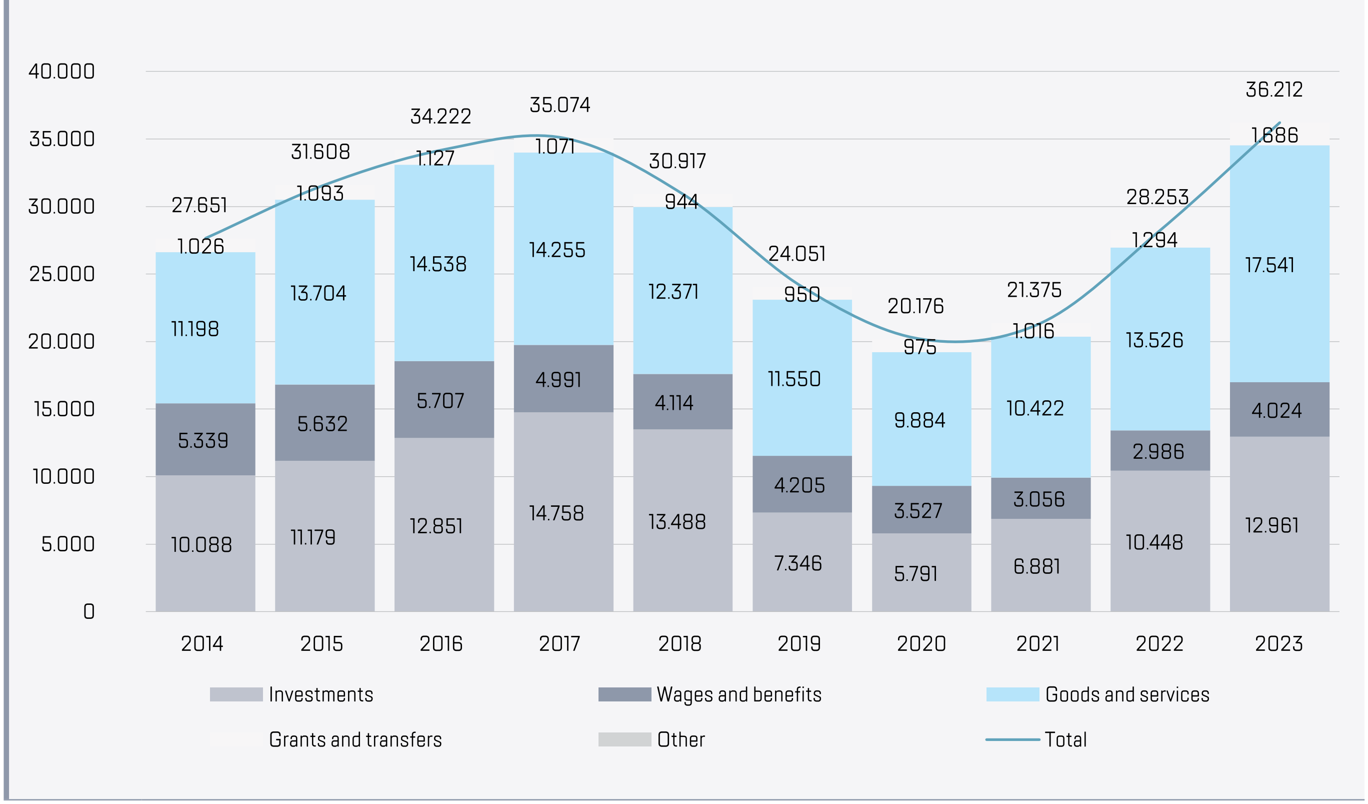
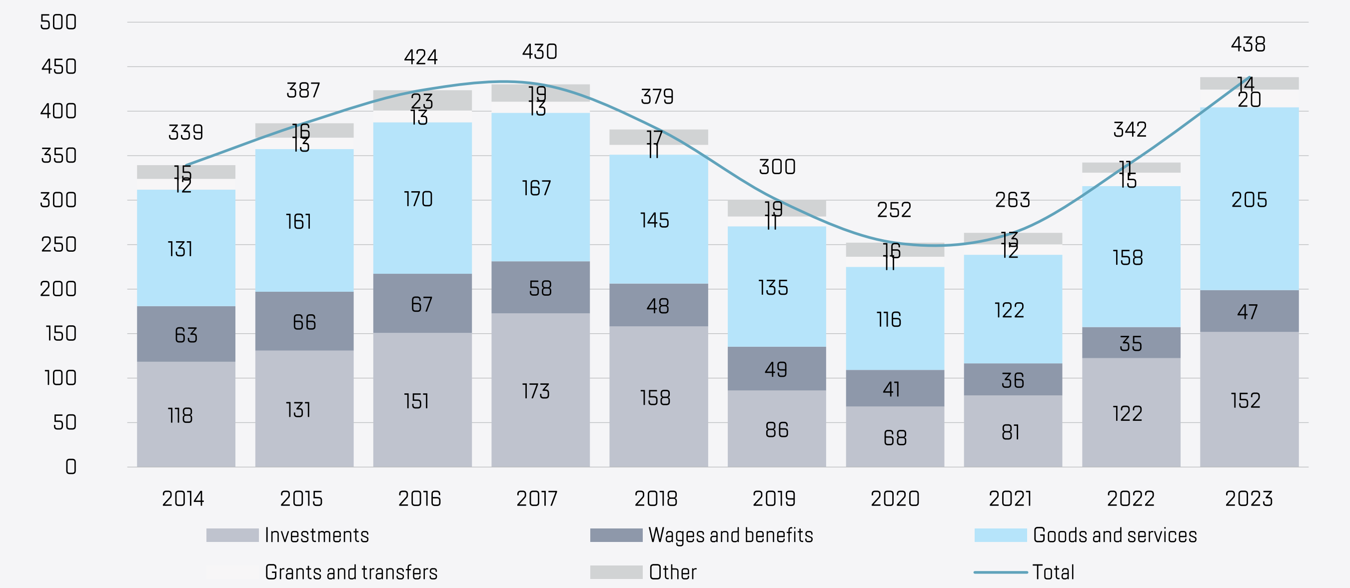
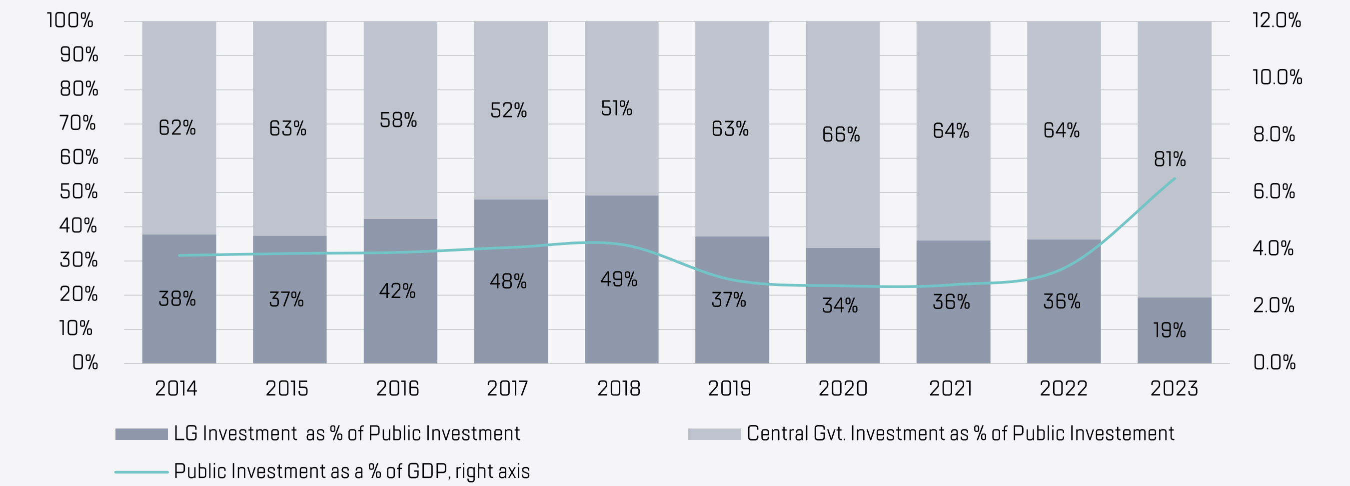


Figure 161. ***TÜRKİYE:*** *Composition of Expenditure, in Eur per capita*



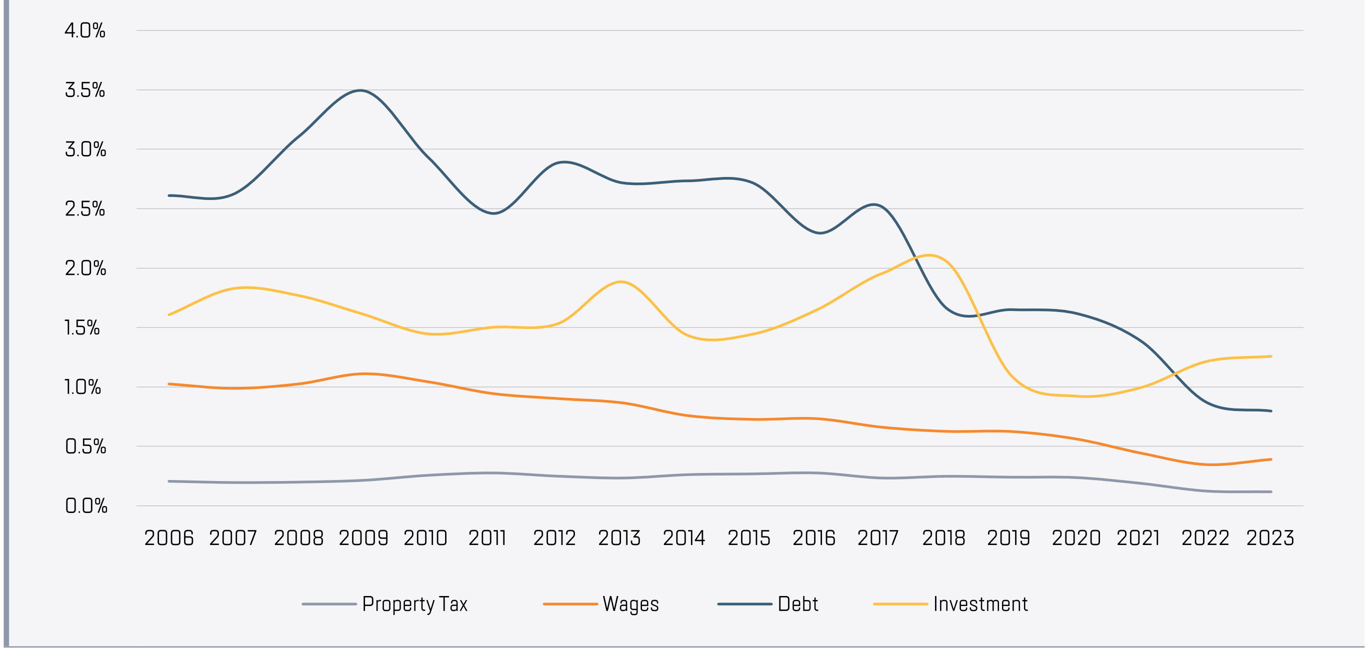
Historically, local governments in Türkiye have been major contributors to public investment, accounting for up to 49% of investments until 2018. However, this share has declined sharply over the past three years due to various crises. In 2023, the central government's role in public investment surged, primarily to fund post-earthquake reconstruction efforts, including rebuilding damaged homes, repairing infrastructure, establishing new settlements, and restoring public administration facilities.

Figure 162. ***TÜRKİYE:*** *Composition of Public Investments, % of total*



In 2022 and 2023, property tax revenues in Türkiye fell to their lowest level as a percentage of GDP since 2006. As local public investment, which had declined during the pandemic, began to recover, outstanding local government debt reached 3.0% of GDP. This debt is primarily due to unpaid obligations to suppliers and contractors rather than new borrowing, indicating fiscal strain from accrued liabilities rather than expanded credit use.

Figure 163. ***TÜRKİYE:*** *LG Investment, Wages, Outstanding Debt and Property Tax, % of GDP*



VII. Data, Terms and Methodological Issues

The data used in the report has been provided mainly by NALAS members and comes from the respective Ministries of Finance, Central Banks and Statistical Agencies of SEE Economies. The data for Austria are provided by the KDZ, the Centre for Public Administration Research, and retrieved from Statistik Austria (covering Austrian municipalities without Vienna). The data was checked for consistency and compared, where possible, with similar data from EUROSTAT - the statistical agency of the European Union - and other sources, including the World Observatory on Subnational Government Finance and Investment of the United Cities and Local Governments (UCLG) and the Organisation for Economic Cooperation and Development (OECD) (www.sng-wofi.org); Council of European Municipalities and Regions (CEMR), Local Finances and the Green Transition (www.localfinances-cemr.eu). Additional data sources include the World Bank and the International Monetary Fund.

Comparing intergovernmental finance data and systems however is never straightforward because of differences in how data is compiled and published and differences in how subnational governments are organized, what they do, and how they get the money to pay for what they do. In the following, we discuss how the report addresses some of the methodological issues involved in making reasonable comparisons with the available data.

Levels of Government: The report's primary object of analysis are first-tier local governments, meaning democratically elected municipal or communal authorities. They constitute the most important level of subnational government in the region and in the report are collectively referred to as municipalities.

What Municipal Governments Do: Throughout SEE, municipalities bear primary responsibility for 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 several SEE economies, however, local governments are responsible also for delivering important social sector services, particularly in education, but also in some places, health and social care. The degree to which local governments are responsible for social sector services has a profound effect on their "fiscal weight" everywhere. It is thus important, when reading the report, to remember what social sector services local governments are providing in different places. For a more comprehensive analysis of the regulation and financing of decentralized social sector responsibilities in SEE, please refer to the Eighth Edition of the NALAS Report: Social Welfare at the Intersection of Municipal Finance and Governance in South-East Europe. We discuss these issues in greater detail in the next section.

Population: The use of correct and most recent population data is of crucial importance for all per-capita indicators. There is a variety of sources in which data greatly varies mainly because of the purposes for which the data is generated and used. The initial focus on the census data had to be reassessed because of increasing time-gaps with the current situation, which cannot reflect the profound demographic changes many economies in SEE are undergoing. We prioritized the data sources for each economy and entity in the following way: a) Primary source – EUROSTAT; b) National Statistics - census or most recent data if available, and c) data used for the transfers systems – from the Local Government Associations' (LGA) input.

Gross Domestic Product (GDP): We have used the GDP figures according to the production method, published by the Ministries of Finance or Statistical Agencies of SEE economies. Where we converted GDP into EUR figures for comparative purposes, we have used the average annual exchange rates provided by the relevant Ministries of Finance and/or Central Banks.

Public Revenue of the General Government: To compare the relative importance of local governments across settings we have generally used revenues – and not expenditures – as a share of the consolidated finances of the General Government. This because: 1) data on revenues tends to be more consistent than data on expenditures at the subnational level, and 2) the revenue side has a direct impact on fiscal autonomy. By General Government Revenue, we mean the total revenues of the national government and its agencies, including the revenues of social, pension and health security public funds and those of subnational governments. The terms General Government and Public Revenues are used interchangeably in the report, according to the former definition, to help with the readability of the report. For local governments we have excluded proceeds from borrowing as the quantity and quality of data on LG borrowing varies significantly.

General Grants: In most of SEE, local governments receive freely disposable (unconditional) General Grants from their central governments. In some places, the size of the relevant grant pools is legally pegged to some national macroeconomic indicators, such as GDP or the proceeds from the Value Added Tax (VAT) or the Personal Income Tax (PIT). Because these funds are allocated by formula, we consider them Grants, despite the fact that in some places they are popularly referred to as shared taxes. Unless otherwise indicated, we use the term Shared Taxes only for national taxes that are shared with local governments on an origin basis.

Conditional and Sectoral Block Grants: Throughout SEE, local governments receive grants from higher level governments which they can only use for particular purposes. We refer to these as **Conditional Grants**. Grants that are designed to help local governments fund a particular function (such as primary education), but which they are free to spend across that function as they see fit, we refer to as **Sectoral Block Grants**. In many places however, the "block" function of Block Grants is limited due to other centrally imposed constraints on local spending. In the extreme, some "Block Grants" (particularly for primary and secondary education) make local governments little more than paying agents of the national government.

Shared Taxes: In most of the region, local governments are entitled to shares of national taxes generated in their jurisdictions (origin-based tax sharing). The most important shared tax is usually the Personal Income Tax (PIT), which is also usually accounted for officially as a Shared Tax. The Property Transfer Tax is also often shared (100%) with local governments but is usually misclassified as an own revenue. In a few places, the recurrent property tax is shared between levels of government and in Romania, a small fraction of the Corporate Income Tax (CIT) is shared with regional governments. In North Macedonia the state shares with the municipalities the central proceeds from VAT, state-owned agricultural land leases and concession payments. More information on shared taxes is provided in the individual chapters of the SEE economies.

Own-Source Revenues: Own-Source Revenues (OSRs) include locally imposed taxes, income from the sale or rental of municipal assets, fines, penalties, and interest, local user fees and charges, fees for permits, licenses, and the issuance of official documents. Typically, the most important local tax is the Property Tax, though it is often not the single-largest source of Own-Source Revenue. Montenegrin and Croatian municipalities can impose local surcharges on PIT. In many places, the regulation of local fees and charges is weak, allowing local governments to use them as quasi-taxes. Particularly important in this respect are three fees inherited from the (Yugoslavian) past: the Land Development Fee, the Land Use Fee, and the Business Registration Fee (or Sign Tax). In most of the region however, the Land Development and Business Registration fees are being phased-out in the name of improving local "business enabling environment", while the Land Use Fee is being eliminated or constrained with the introduction or expansion of the Property Tax.

Important note:

The local revenue data might be problematic because different places account for different revenues in different ways, and because in some places accounting classifications have changed over time. The classification of shared taxes is, maybe, the most misleading because of its substantial share of all local revenues. For example, in most places, only shared PIT is considered a Shared Tax, with shared Vehicle Registration and Property Transfer Taxes misclassified as Own-Source-Revenues.

In Türkiye, some shared PIT revenues are accounted for as Unconditional Transfers while in Slovenia some Unconditional Transfers are accounted for as shared PIT. Meanwhile in Croatia, some of what is accounted for as shared PIT should be recorded as an Own-Source Revenue because it comes from locally imposed surcharges on personal income and not just from the centrally set shares. Finally, in most places we cannot separate Conditional Grants for specific investments or programs from Block Grants for social sector functions.

EU members in SEE

Measuring and evaluating the different aspects of decentralization is supposed to reflect exclusively the national efforts in this regard. The appropriate fiscal indicators should not be "contaminated" by external, non-domestic, factors. For economies that are members of the EU (*Bulgaria, Croatia, Romania and Slovenia*), one such factor are the EU funds which flow primarily to the local level. Ideally, the data we have from member associations would clearly identify these grant flows. But, unfortunately, this is often not the case, and in a number of economies EU grants are simply not included in the national data we have or, if included, not separated from domestic revenues. As a result, for the economies that are EU members, there are differences in the data we have on subnational revenues and expenditures and those reported by the EU. In some economies, these differences amount to between 1% to 3% of GDP when local government revenues or expenditures are calculated as a share of GDP.

VIII. NALAS Observatory: the Decentralisation Knowledge Hub in SEE

The importance

To be able to make informed decisions, develop good public policies and public services and efficiently manage scarce resources, policymakers at all levels of government have to rely on high quality data and information. But, all-around South-East Europe such data is either missing or is difficult to access.

To bridge this gap, NALAS and KDZ partnered to develop the NALAS Decentralisation Observatory for South-East Europe www.nalas-observatory.eu. The Observatory facilitates the access to and utilisation of timely, accurate, reliable and comparable data and information on local government finance in South-East Europe (SEE).

The objectives

- Support policy advocacy efforts of NALAS member Local Government Associations, as stewards of local democracy and local governance in SEE;
- Help policymakers, experts, practitioners and researchers in their quest to improving local government policies and services;
- Support local government budget transparency;
- Serve as a model for national platforms to support evidence-based policymaking and local budget transparency.

What do I get from the Observatory?

The NALAS Decentralisation Observatory provides for a tailor-made **user friendly and dynamic visualisation of complex data and information**. It allows a thorough analysis of the current status and developments of local government finance for 12 SEE economies, including **regional comparisons** across economies and indicators that can be customised, downloaded and reutilised depending on users' needs and preferences.

It also serves as a **knowledge hub** for local governments in SEE, by publishing state-of-the-art research on local government finance, waste management and the overall progress of decentralisation in South-East Europe.

The Regional Decentralisation Observatory builds on about a decade of NALAS work on Fiscal Decentralisation and consolidates the knowledge developed by the NALAS Fiscal Decentralisation Task Force representing 14 Local Government Associations from South-East Europe.

The Observatory is developed by NALAS, in partnership with KDZ – Centre for Public Administration Research and with the support of the BACID III Program - Building Administrative Capacity in the Danube Region and Western Balkans, co-funded by the Austrian Development Cooperation and implemented by the Austrian Association of Cities and Town.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