The Fiscal Decentralization Initiative
for Central and Eastern Europe

Fiscal Equalization in South Eastern Europe

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A New Stage of Fiscal Decentralization Reforms

The studies included in this volume summarize recent reforms in intergovernmental fiscal relations in Albania, Bulgaria, Moldova, and five countries of the former Socialist Federal Republic of Yugoslavia.[1] They provide an overview of municipal finance reforms, focusing primarily on fiscal equalization schemes as critical components of intergovernmental transfers. The country reports were written in a period when the reform of local government finances was high on the agenda of this region's governments after 2000.

There are several different reasons why equalization became an important issue in these countries. In Albania and Bulgaria, decentralization reforms reached that stage when political and institutional changes had to be accompanied with higher fiscal autonomy. Local governments in these two countries have gradually developed new systems of own source revenues, which has strengthened the claim for adjusting the methods of grant allocation.

In several countries of the former Socialist Federal Republic of Yugoslavia (Macedonia, Serbia and Montenegro, Bosnia and Herzegovina), the reform of municipal finances was driven by the transformation of the national tax regime. Local governments in these countries are financed primarily through tax-sharing schemes. When the most important element of the shared taxes, the sales tax, was replaced by a modern value added tax, the rules of municipal finances had to be redesigned too.

In this transformation process, various international technical assistance programs also had decisive roles. Primarily the long-term, USAID-funded projects e.g., in Albania (The Urban Institute), Bulgaria (Research Triangle Institute), Macedonia, Serbia, Bosnia and Herzegovina (DAI Inc.) had a chance to influence the policy development process. Through systematic professional support and almost daily cooperation with the relevant ministry officials and think tanks, the concepts and techniques of modern local government finances were disseminated among decision-makers.

This technical assistance was transformed into new legislation on taxation, national budgets, and local finances, followed by new methods of grant allocation. The main forces and government programs driving the modernization of intergovernmental transfers are summarized in Box 1.

Box 1.
National Programs Initiating Municipal Fiscal Reforms

Albania:
National Decentralization Strategy (2000)

Bosnia and Herzegovina:
Introduction of VAT (2006)

Bulgaria:
Decentralization Strategy and Implementation Program (2002–2005)

Croatia:
Partial decentralization of selected public functions to 32 cities, 21 counties (2001)

Macedonia:
Decentralization program of the Ohrid Agreement (2002–2004)

Serbia:
Tax reform (VAT) and Ministry of Finance decentralization programs (2004–2006)

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[1] These papers were written under the auspices of the Fiscal Decentralization Initiative, funded by USAID and managed by the Local Government and Public Service Reform Initiative of OSI–Budapest. The manuscripts were finalized on June 30, 2006.

Why Does Fiscal Equalization Matter?

The scope of decentralization is still limited in the studied countries. The general indicators of fiscal decentralization show that in these countries, even following the reforms, the ratio of local budgets in GDP is five to six percent. It is significantly lower than in the more decentralized countries of Western Europe (11 percent, Dexia 2002), or in the transition countries of Central and Eastern Europe (10 percent, Dexia 2004). Figures in Table 1 mostly reflect the status of fiscal decentralization at the beginning of the reform process (e.g., in Macedonia, the changes in 2005 doubled the share of local budgets in GDP).

Table 1.
Local Government Expenditures in Percentage of GDP

	Local budget in GDP (percent)	Local expenditures in general government expenditures (percent)
Albania (2003)	4.02	14.91[2]
Bosnia and Herzegovina (2000, municipalities):		
• Federation	4.40	4.9[3]
• Republika Srpska	4.50	1.9[4]
Bulgaria (2005, forecast)	5.10	12.9
Croatia (2003)	5.16	10.4
Macedonia (2003)	1.64	7.67
Moldova (2005)	9.50	25.9
Serbia (2004, planned)	6.30	n.a.
Slovenia (2003)	5.06	11.85

Sources: Country reports herein.

Despite the limited scale of decentralization, the differentiation of local expenditures and variations in municipal revenue-raising capacity became more visible. Earlier, these hidden differences were managed under centralized political and administrative systems through traditional methods of bargaining. Negotiations between tiers of government under the soft budget constraint allowed individual compensation for higher costs and lower local revenue bases in specific municipalities. The separation of mandatory (delegated) and own (devolved) municipal functions in the Balkans, like the "capping system" in Macedonia and the strong grant reallocation role of county local governments in Croatia, were the most typical methods for the centralization of fiscal decisions.

However, the decentralization steps implemented during the past years raised the importance of fiscal equalization. More disciplined national fiscal policies and severe austerity measures limited the discretionary role of national governments to respond to the requests of local governments with financial difficulties. Regional differences in local public service provision and municipal or shared revenue-raising capacity became more apparent. Consequently, national governments, especially the ministries of finance, were interested in developing standardized rules of grant allocation that would prevent them from the obligation of micro-managing specific problems of individual local budgets.

Beyond this administrative logic, there was also political pressure to redesign the system of intergovernmental fiscal relations. Based on the legacy of the previous egalitarian system and the low performance of municipal services, the provision of a minimum level of public services was a fundamental political objective. By emphasizing the significance of fiscal equalization, decentralization reforms were more easily manageable and could gain higher political support. Sometimes this has pushed the other main objective, an increase in service efficiency, into the background.

Equalization, As One Component of Intergovernmental Relations

Focus of Equalization

Fiscal equalization of local government expenditures and revenues addresses two areas of intergovernmental fiscal relations.[5] Firstly, equalization is needed for managing *vertical* imbalances between expenditure and revenues among different levels of government. This means that local governments need sufficient resources for providing services assigned to lower levels of government. The

[2] In percentage of state budget.

[3] In percentage of BiH consolidated general government expenditures.

[4] In percentage of BiH consolidated general government expenditures.

[5] Ebel and Peteri 2006; Shah 1994; Bird and Vaillancourt, 2006; OECD 2005; Joumard and Kongsrud 2003.

overall sum of local revenues should be in line with the tasks and functions managed locally. More specifically, local governments with different functions (for example, large cities *vs.* rural municipalities) should have access to different revenues. Secondly, *horizontal* imbalance occurs when the differences in expenditure needs and revenue-raising capacity varies across similar types of local governments.

Several factors should be taken into account when fiscal equalization systems are developed.[6] First of all, in providing the *minimum level* of mandatory public services, the differences in functions and unit costs determine the need for equalization. Local governments operating under specific conditions (e.g., in sparsely populated regions, in remote areas, under specific geographical conditions) should be compensated for higher spending needs. More resources are needed for additional services and because of specific factors. This is a critical factor in SEE countries, with lower levels of urbanization and high differences in unit costs due to geography.

Perhaps the most critical factor defining the scale of fiscal equalization is the size of local governments. Countries with more fragmented local government structures require higher and more sophisticated transfers for equalization purposes. Primarily, equalization is needed because of diversity in the revenue-raising ability of relatively small municipalities.

But compensation is needed because of *spillovers*, as well, when typically central cities provide services for neighboring municipalities. Equalization grants are needed to internalize these external costs originated from the territorial fragmentation of local governments. This way the economy of scale can be improved, and consequently the efficiency of local public services will be increased. South Eastern European countries have relatively large municipalities (with the exception of Croatia), which minimizes the impact of the size factor.

On the other side of the budget, *revenue-raising capacity* is a critical factor for inequalities. During the grant design, the type and size of revenues collected by different local governments should be taken into account separately. Local governments' financial capacity is determined by the types of own local taxes: whether they are significant, connected to local factors, buoyant, and if the local revenue administration is not too costly. Local revenue capacity should be incorporated into the transfer system by providing more resources to financially weaker municipalities. This factor is very important in SEE countries, where local budgets are primarily funded through tax-sharing schemes.

However, there are other factors, which *should not be taken* into consideration during the design of fiscal equalization schemes. Financing of the minimum services and management of spillovers has to be separated from the costs originated from higher local demand and inefficient service provision. This is why usually the standardized (or average) spending needs create the basis of equalization funds. Differences in local service preferences and divergent local service management capacities should not be compensated by the equalization transfers. Similarly, local revenue-raising efforts have to be built into the equalization schemes, otherwise the overall efficiency of the municipal sector will decrease.

Competing Objectives in Intergovernmental Finances

Local governments are financed through a combination of own source and shared revenues, and various types of transfers, grants, and subsidies. These diverse forms of funding aim to meet the competing objectives of the intergovernmental fiscal architecture.[7] There are three basic goals for a well-designed system of intergovernmental finances:

1) creating local incentives for efficient spending and utilization of the municipal revenue base;
2) guaranteeing sufficient funds to provide a minimum level of services (typically for different types of local governments); and
3) supporting horizontal equalization (usually between local governments of similar type).

These goals can be achieved through various fiscal instruments, focusing on the expenditure or on the revenue side of the budget. Each technique has a mixed impact on local government finances.

The local incentives for efficient service provision can be best achieved through own source revenues, as they directly connect decisions on service performance to municipal revenues. A minimum level of public services

6 See a good summary of factors in Council of Europe 2005.

7 This issue has been discussed in the following papers: Levitas and Péteri (2005) and Ebel and Péteri (2006).

can be achieved through flat, block grants; however, they create unfavorable incentives for finding the most efficient forms of service provision and could increase horizontal differences of local governments. Regional (horizontal) equalization can be ensured through earmarked, conditional transfers and revenue equalization grant schemes.

Fiscal equalization is only one of the important goals within this diverse set of objectives. Policymakers first have to identify a proper balance between these three major objectives. The countries studied here put fiscal equalization high on the policy agenda—sometimes even disregarding the impact of equalization schemes on the overall efficiency of the local public sector and minimizing the local motivation to find the most efficient forms of service delivery.

However, even these policy preferences can be achieved through various forms of intergovernmental fiscal transfer schemes. In transition countries, traditionally fiscal equalization was guaranteed formally through earmarked grants that *filled in the gap* between appropriated expenditures and estimated revenues. These transfers were allocated through a bargaining process, often in two steps, depending on the administrative structure of the country. This method allows the higher level of government to control public expenditures and to determine local budget expenditures for specific public services. There is no own source revenue-raising incentive, because any surplus above the planned own revenue appropriations automatically decreases the amount of transfers. (This model is summarized in the first row of Table 2.)

The second model is built on *general grants*. General grants provide greater autonomy in municipal expenditure planning and create incentives for local own source revenue raising. Under this model, the grants from the higher level of government are allocated by service-related indicators and there are no limitations on local spending. Indicators used for calculating the general grants typically are the number of population, age groups, or users of municipal services (pupils, hospital beds, etc.). Weights assigned to these indicators might be different, which could further refine these models. (See the second row in Table 2.)

Finally, the most sophisticated grant allocation method is based on the most complex model. This grant is calculated as the difference between expenditure needs and own source revenue capacity. Local expenditures are *standardized*, i.e., they are measured at a generally accepted level (refined averages, calculated through formulae). The revenue side is calculated by taking into account a minimum or average local revenue-raising effort. The transfer is the difference of these two hypothetical budget appropriations (see the third row in Table 2.).

This third method of intergovernmental transfers serves equalization purposes the best. Expenditures are estimated in a unified way, allowing diversity in spending needs. Municipalities with low revenue capacity receive higher grants, without destroying local incentives for increasing own source revenues. At the same time, local governments get no compensation for uncollected revenues below the average/standard level and the collected surplus in own revenues does not automatically decrease the amount of transfers.

The three models of intergovernmental transfers are rarely followed in these clear formats. They are often mixed, when gap-filling techniques are supplemented with standardized revenue equalization (e.g., Moldova). The simple "gap-filling" model can be also refined by using formula for estimating local expenditures (e.g., Slovenia) or when revenue equalization is combined with general grants (e.g., Hungary, Poland).

Another way of bringing together these models is to use them in a parallel way: "gap filling" for delegated functions, general grants for devolved mandatory functions, and standardized methods for designing transfers for funding optional municipal services. The seven

Table 2.
Methods of Grant Allocation

Types of transfers	Expenditures	Revenues	Transfers
1. Earmarked, "gap- filling" transfers	Individual decision on appropriations ($EI_{estimate}$)	Individual revenue assessment ($RI_{planned}$)	Individual bargaining ($GI = EI_{estimate} - RI_{planned}$)
2. General grants	Local decision on expenditure levels ($R + G = E$)	Local authority to generate revenue (R)	General grants (G)
3. Standardized expenditure and revenue capacity	Accepted expenditure levels ($E_{accepted}$)	Required/standardized revenue ($R_{required}$)	Calculated grant ($G_{calculated} = E_{accepted}$-$R_{required}$)

Table 3.
Typical Grant Schemes in SEE Countries

Type of transfers	Focus on the expenditures	Focus on the revenues
1. Earmarked, "gap-filling" transfers $GI = EI_{estimate} - RI_{planned}$	Bulgaria (for labor) Macedonia Moldova	Croatia (limited)
2. General grants| R+G=E	Albania Bulgaria (beyond labor costs) Croatia (in areas of special state concern) Macedonia Serbia	Federation of BiH (phased) Macedonia
3. Standardized expenditures and revenue capacity $G_{calculated} = E_{accepted} - R_{required}$	Slovenia (limited on the revenue side)	Albania Bulgaria (optional services)

countries studied in this report also follow a mixed system of grant allocation. Various techniques operate in a parallel way (Table 3).

The most important characteristic of intergovernmental fiscal relations in these SEE countries is that municipal finances usually are based on *revenue sharing*. Personal income tax, VAT, and sometimes even corporate income tax are assigned to different levels of government. Local governments have limited incentives to increase these shared taxes, which in practice operate as grants and transfers.

Another peculiarity of local government functions is that the assignment of public administration and public services is *separated* clearly at local level as mandatory (delegated, state) functions and as optional (own, local) services. This distinction clearly shows that municipalities still are regarded as local units of national government. Usually the forms of financing are also different in the case of these two types of functions: mandatory services are financed by shared revenues and transfers, while "own" optional functions are funded through own source revenues. In these countries often the proportion of these two groups of functions defines the level of decentralization.

The third feature of fiscal equalization in SEE is that *the type (tier)* of local government *targeted*. As there are relatively large municipalities in this region, consequently municipalities receive the equalization grants (Albania, Bulgaria, Serbia). However, in more centralized countries the intermediary tiers of government (the cantons in the Federation of Bosnia and Herzegovina, the *rayons* in Moldova) are the beneficiaries of equalization transfers. Then the middle-level governments reallocate them to municipalities[8] or to the first tier of local public administration (Moldova).

A consequence of this separation of locally managed public functions—the dependence on shared revenues, and the use of intermediary level of governments in reallocation—is that intergovernmental fiscal relations are mostly based on earmarked, conditional transfers (or shared revenues) and local finances are heavily controlled.

Issues of Fiscal Equalization

The various allocation models of intergovernmental transfers in SEE countries can be characterized along the following lines:

a) significance of equalization grants;
b) how equalization methods manage differences in expenditures;
c) what are techniques of revenue equalization;
d) is there sufficient local autonomy in using the assigned public revenues; and
e) how the planning rules and procedures help equalization.

[8] Croatia has a mixed model where most of the municipalities are parts of the county governments' budgets, but some large cities with devolved functions are more autonomous and benefit from equalization grants. Capital cities are also subject to specific regulations.

Scope of Equalization

The first question of fiscal equalization is the *scale of equalization funds*. For vertical equalization purposes the task is to define the total amount of grants allocated for equalization. Horizontal equalization also requires the pooling of public funds, which can be reallocated both for equalization of expenditures or for revenues. Ideally these funds are connected (indexed) to some national budget revenues or other aggregate economic indicators (e.g., growth of GDP). Two issues at stake are what type of local budgets (current or/and capital) is covered by the equalization funds and what is the ratio of these funds compared to total revenues or transfers.

In these SEE countries, the total amount of transfers is defined in three different ways. There are countries, like Albania, Croatia, and Slovenia, where the transfer design is based on historical costs, following the rules of incremental budgeting. In Bosnia and Macedonia, where the shared VAT is a major source of the local budgets, a predefined percentage of shared revenues is used for equalization purposes (Single Account Revenue in BiH; Joint Fund for municipalities in the City of Skopje, Macedonia).

Serbia is the only country where the transfers are calculated as a percentage of GDP for a specific fiscal year (in 2006, the amount is 1.175 percent). However, when the revenue-sharing schemes changed, this set ratio was adjusted, too. So this strict rule did not guarantee a fixed amount of transfers for a longer period.

Another alternative method used in Moldova and Serbia is to create a "solidarity" fund automatically, when extra revenues are raised at some municipalities. In Moldova, when the per capita revenues exceed the allocated per capita expenditure by more than 20 percent, those revenues are put into a Financial Support Fund of the administrative-territorial units. In Serbia, the shared revenues are reallocated in a similar way: from its two large cities (Belgrade, Novi Sad), where the per capita shared revenues are above 150 percent of the national

Table 4.
Grants, Transfers Allocated by Set Rules (Formulae) for Equalization Purposes

Country	Type of grant	Significance of transfers, allocated by formula
Albania	General purpose (unconditional) grant: mixed revenue and expenditure indicators	20.8 percent of local revenues (2003)
Bosnia and Herzegovina (2006)	Tax-sharing formula, earmarked, phased in six years	Approximately 30 percent of local revenues, different by entities (after VAT is introduced)
Bulgaria	*Mandatory services:* local budget appropriations are partially allocated by indicators *Optional services:* revenue equalization (on per capita basis)	*Mandatory services:* n.a. *Optional services:* minimum 10 percent of total municipal own source revenues
Croatia	*Areas of special state concern:* earmarked for current and capital expenditures; average revenue based equalization; partially reallocated by counties *Sectoral grants for new functions:* gap filling of minimum financial standards *minus* set PIT share for newly decentralized functions	11 percent of total local revenues
Macedonia	Shared VAT (three percent) equalization: 50 percent by population and other criteria	16 percent of total local revenues
Moldova	Capped (120 percent) gap-filling transfer at *rayon*/ATU level: adjusted expenditure per capita (calculated by total population and population groups with special need, staff input) *minus* estimated local revenues per capita (at standard rate, excluding local taxes, fees)	Approximately 30 percent of local budgets
Serbia	Revenue equalization of per capita shared taxes (up to 90 percent of the average), above 150 percent limit shared taxes are reallocated; General transfer by objective criteria (population, area, service capacity)	n.a.
Slovenia	General grant = appropriated expenditures *minus* estimated own revenues (±2 percent)	n.a.

average, the surplus is deducted from the total amount of grants and reallocated to other municipalities.

Usually the current expenditures (and revenues) are targeted by equalization grants. Even this component of local budget equalization is only a minor part of total funds provided by higher levels of government (see the right column of Table 4). Capital expenditures are not part of equalization schemes; they are financed through conditional, earmarked grants.

Equalization of Expenditures

There are two aspects of fiscal equalization on the expenditure side of the budget: what types of local functions and responsibilities are included in the equalization and how the spending needs are estimated. Among municipal competencies at least the mandatory local services should be involved in the equalization schemes. However, the real question is *how standard expenditures are estimated*. In theory, the standardized local spending level should not take into account the specific local preferences and should not compensate for the additional costs of inefficient service management.

In practice, the capacity and structure of service organizations and the forms of service delivery are formed by traditions and inherited institutions. So it is not easy for the designers of equalization grants to separate the average, minimum, or standardized expenditures from specific local needs.

Fiscal planners in the SEE countries represented in this volume follow two ways of solving these problems. Some countries use the classical, *input-based* assessment of local expenditures. This method is based on incremental budgeting, according to general rules on calculating labor costs, with set inflation rates and regulations on service performance. These expenditures are based on historical costs and any improvement agreed during the fiscal planning and negotiation process.

Obviously, the input-based assessment of local expenditures does not reflect the average or standard costs. In Bulgaria, the salaries and related labor costs are calculated by municipalities; in Moldova, the appropriations are defined partially through staff inputs; in Croatia, the "minimal financial standards" are set by a government decision. These techniques can hardly specify the extra service costs that originated from inefficient methods of service delivery or unjustifiable spending needs.

The other way to assess standard spending needs is to use *objective criteria for measuring appropriations* in specific municipalities. The best example is Slovenia, where an overall average ("appropriate expenditure per capita") is modified by different coefficients. These multipliers are proxies of local spending needs: number of population, number of population groups with special needs (young and elderly), length of municipal roads, area of the municipality. These indicators are "objective" because the local government is unable to manipulate these data. In this case the "appropriate expenditures" are allocated in a unified and fair way.

The measurement technique of the expenditures is related closely to the incentives built into the equalization formula. When the calculation method is based on the assessment of specific inputs by municipalities, then local governments are interested in increasing their expenditures and paying less attention to losses caused by inefficient service organizations. The spending needs always exceed the available resources (appropriations), but still the basic incentive at the local level is to increase the costs. When the budget appropriations (or transfers) are specified through objective indicators, then the motivation will be different. Local governments benefit more from savings and they are more interested in responding to local needs.

Revenue Equalization

On the revenue side, the equalization schemes face less complicated problems. They should target the differences in local revenue *base* or the revenue *yield*, *assessed by the standard* or average *rate* (often called revenue capacity). In this case those local governments are eligible for revenue equalization grants, which have lower revenue capacity, irrespective of their revenue-raising effort (measured by the actual tax rate or tax yield).

The other issue of revenue equalization is *what type of revenues* should be incorporated into the equalization scheme. There are two requirements that should be balanced: on one hand as many local revenues have to be taken into account as possible, so the model will be comprehensive; but on the other hand, they should represent the local own source revenues proportionally, so the least significant (nuisance) revenues are not necessarily part of the model. Obviously, the measurement of revenue effort is possible only in those systems where local governments have discretion over the tax rates.

The third basic issue is whether local governments below the national threshold (standard, average revenue) should be compensated for the *entire difference or* only up to a certain *percentage* of the average. When local government are eligible for the full amount (the difference between the average and the actual local revenues), that will create counterincentives for increasing their own tax effort. In the other case, there is pressure on local governments to levy taxes at least at the average rate, because they will not be compensated for the entire difference. (Local governments, with revenues above the average, should not be "punished" through redistribution of their extra revenues, which are collected through a higher local tax effort. The solidarity-based funds are exceptions.)

In this group of SEE countries, municipal finances are predominantly based on shared revenues. Consequently these relatively large local revenue sources are critical factors of equalization. VAT is the best candidate for equalization (Bosnia and Herzegovina, Macedonia), despite the fact that local governments have no discretion over the tax rate. So VAT is a simple indicator of the municipal revenue capacity (assuming it can be measured at local government level).

In other countries like Albania, the four *major local taxes* (small business tax, simplified profit tax, vehicle tax, property transaction tax) are pooled and faced with the national average. Similar models are used in Bulgaria for the group of optional services.

The *incentives* built into the revenue equalization models are diverse. In the case of the Albanian tax equalization scheme, local governments with a per capita revenue pool below the average, receive 35 percent of the missing part, while those with an above-average revenue pool subtract 35 percent of the difference from their unconditional grants. In the Slovenian model, the revenue side of the grant formula is guaranteed up to 102 percent. That is, a local government which collects two percent above the revenue appropriation, will receive a lower equalization fund; but in those cases where local governments are able to collect less than 98 percent of the estimated revenues, equalization funds will be proportionally reduced. So there is a very clear local incentive to collect municipal revenues up to 98 percent of the target, but not more than 102 percent of the planned amount.

Local Use of Funds

Regardless of the allocation method, the equalization funds should allow *local autonomy* in using the received transfers. In theory, these unconditional, general-purpose grants should create the incentives for efficient forms of service delivery and an increase in own source revenues. This would require local autonomy in spending own or shared revenues and grants received.

The proportion of various types of grants determines the level of local autonomy. Conditional grants are earmarked to tasks, groups of services (block grants), or specific types of expenditures (e.g., capital expenditures). In these cases local discretion over spending is limited. However, even in those instances when local governments receive general grants, other sectoral and fiscal regulations still might limit their powers.

The description of equalization techniques in this publication does not cover all aspects of local financial autonomy. They focus on basic issues of fiscal decentralization and intergovernmental fiscal relations, but discretion over all components of local budgets is not discussed in detail. However, it can be assumed that in countries allocating a higher percentage of transfers through the "gap-filling" model (first row in Table 3.), the local spending autonomy probably is lower. So in Bulgaria (on mandatory services), Croatia, Macedonia, and Moldova, the grant allocation mechanism limits municipal spending more than in countries where general grants or the standardized expenditure and revenue capacity based models were introduced (Albania, Slovenia, and Serbia, second and third rows in Table 3.).

Planning Equalization Funds

Regardless of the grant formulae used in these countries, there are some general requirements on planning and managing transfers. Primarily, local governments should be informed about the amount of national grants and the criteria of access to these funds. The *predictability* of intergovernmental transfers is one of the most important conditions for successful equalization. The types of grants, the principles, and major criteria of eligibility should be laid down by law. When the rules of grant allocation are set for several years or the local governments are able to foresee the changes in the equalization methods, then local fiscal policies will be more effective.

During the reform process this requirement of predictability can be met only *gradually*. Allocation decisions are based on imperfect information and sudden changes or shocks on public service finances should be avoided, leaving sufficient time for local adjustment. Thus the reforms usually are phased in over a longer period and *ex post* adjustments are needed. Often specific "puffer" funds are used to deal with transitional funding problems, and compensate for deficiencies in the grant formula. However, when these transitional measures are announced and the allocation criteria are transparent, then the general accountability of the entire public sector increases.

Transparency of the grant allocation formula is based partially on the information systems used by national governments. The transfers should be allocated through comprehensive and detailed indicators that are kept relatively simple and stable. The availability of data and the planning capacity of the relevant government units influence the success of the models and simulations. In developing and transition countries, the lack of information could be a significant obstacle to successful fiscal decentralization reforms.[9]

In the countries here, grant allocation policies were designed within the framework of the recent reform programs. As they usually were *legislated in new laws* on local finances, or on budgets, the refined systems of intergovernmental fiscal relations were generally made public. There was even a Committee for Monitoring the Development for Financing Municipalities in Macedonia, which is supposed to actively follow the implementation of the reform of intergovernmental finances. In other countries the rules of grant allocation are set by the *annual budget laws*, under the guidance of the ministries of finance (Bulgaria, Moldova, and Slovenia).

The introduction of formula-based grants and revenue-sharing techniques are *phased in* over a longer period. In Bosnia and Herzegovina, the grants allocated by historical data will be changed with the formula-based method over a six-year period. The ratio of the formula-based transfers from the Single Account revenues that all local governments receive annually will be increased by 20 percent (from the present 10 to 20 percent to 100 percent in 2011). Similar adjustments are planned in other countries as well.

As the formula-based transfer is only a minor component of the grant system, *individual decisions* and *corrections* might counterbalance the impact of these preset financing rules. They could compensate local governments for the major losses, like the compensation fund, set up in Albania at three levels (national, regional, and local). Here the Albanian Ministry of Local Government and Development targets local governments with financial difficulties and decisions are made case by case. In Serbia, the one-off additional fund for cities was planned for one year only, but it turned out to be a permanent scheme later on. Still, this specific financing technique has the advantage of being appropriated through the regular budget process and local governments are familiar with these financing mechanisms.

Countries in SEE are faced with the problem of imperfect information and a *lack of data*, even when the grant formula is based on a limited number of objective indicators. When the transfers are allocated by service capacity indicators (number of pupils, classes, hospital beds, etc.), then the traditional public information and reporting systems are able to provide the relevant data. Simple population figures are also available through the census and if no major migration happens, then they can be updated or extrapolated. Usually the planning capacity exists, especially until foreign technical assistance programs become active.[10]

However, in some SEE countries access to basic statistical data is not easily manageable. For example, the area of all Albania's municipalities is unknown, so this indicator had to be replaced by the lengths of municipal roads in Albania. When the grant allocation formula targets are more complex indicators (e.g., regional GDP), then serious simplifications have to be made (e.g., replacing data with simple scale values, like in Albania scoring the level of economic development from one to five).

Impact of Equalization

The real test of equalization transfers will be their impact on local public service provision and municipal finances. As intergovernmental fiscal relations are based on a complex system of revenues and budgeting regulations, the proportions of these factors have to be set properly. There is no optimal method of grant allocation, so the revenue assignment should *reflect the policy objectives* of the government in a specific period. Even OECD countries are faced with many inefficiencies in grant design, usually putting too much emphasis on earmarked matching or non-matching grants. This grant dependency creates the wrong incentives for local governments to provide services above the optimal level.[11]

It is too early to assess the impact of the recently introduced new equalization grants in the group of SEE countries studied here.[12] The transfers allocated by for-

9 Yilmaz *et al* (eds). 2003.

10 See Nikolov (2005) on Macedonia, where the grant allocation formula was further refined through professional cooperation managed by a local think tank.

11 OECD 2005.

12 Only two reports (Albania, Serbia) provided some comparable data on local finances before and after the new methods were introduced. Their interpretation is ambiguous, as several components were changed at the same time.

mula, and the tax revenues shared through new ratios, will definitely rearrange the traditional proportions of rich and poor municipalities, the relationship of cities and rural municipalities, or the regional balance. The most important advantage of the formula-based grant allocation is that it makes visible the consequences of policy decisions and limits the options for arbitrary (politically biased) decisions during the grant allocation process.

SEE countries made a critical step towards building a modern system of intergovernmental finances. Now, the emphasis of the reforms is not only on own source revenue raising, but also on a favorable financial environment, where fiscal incentives can support efficient local service provision. The formula-based grant allocation and revenue-sharing methods, introduced under the reform objective of equalization, will help to achieve these ultimate goals.

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