The Fiscal Decentralization Initiative
for Central and Eastern Europe

Local Government Finance System and Fiscal Equalization in the Republic of Serbia

by

Branislav Stipanovic

Table of Contents

Local Government Finance System and Fiscal Equalization in the Republic of Serbia

Branislav Stipanovic

Executive Summary

The foundations of the current local government finance system in the Republic of Serbia were laid down in 1994. The finance system established in 1994 was based on equalization of expenditures, determined by objective criteria. The national taxes, assigned to the local government units, were oriented exclusively towards the statutory public expenditures. Local government units also disposed their own revenues for financing municipal expenditures. This share of public expenditures was not subject to equalization.

The local finance system was criticized by the local governments, so the overall available local revenues were increased by assigning an additional share of sales tax to the local government units: five percent to the municipalities, 10 percent to the cities, and 15 percent to the City of Belgrade.

The reform of local government finance system was implemented in the period of 2001–2002. In the first phase, four out of six national earmarked taxes were eliminated. They were re-categorized as pure shared taxes. In the second phase of the reform, another six new taxes were assigned to the local government. Also, the local governments were entitled to levy an additional own tax (payroll tax).

With these modifications, implemented in the period 2001–2002, the total revenues available to the local governments were more than doubled in real terms. These modifications were more convenient for the cities and fiscally stronger municipalities. So equalization grants targeted local governments with a GDP below the republican average that is proportional to the difference of the specified revenues below the national average.

In 2004, a new cycle of tax reforms was initiated: the payroll tax (PT) was abolished and the sales tax (ST) was replaced with the value added tax (VAT). This represented approximately 47 percent of local government revenues. As for 2005, the replacement of PT and ST was made through an increase in the wage tax share to 40 percent. In cases where the realized revenues based on share in the wage tax at the rate of 40 percent are insufficient, the local government units are entitled to the compensation grant up to the level necessary to fully substitute the lost revenues.

The new Law on Local Government Financing was drafted during 2005–2006. The main objectives of the law were, as follows: (i) increased transparency, stability, and predictability of the intergovernmental finance system; (ii) improvement of horizontal equalization; (iii) institutionalization of cooperation between the local government and central authorities; (iv) strengthening local government fiscal autonomy.

Types of transfers, criteria, and the methodology for allocation of non-earmarked transfers have been defined precisely. Earmarked transfers will be allocated to local governments by the line-ministries according to transparent criteria. The level of non-earmarked transfers is connected to GDP (1.7 percent). The level of horizontal equalization of revenues that form shared taxes also has been improved (90 percent of municipal average per capita). The ratio of original revenues in total local government revenues also has been increased. In local budgets with reduction of total revenues more than five percent, a transitional three-year period has been also introduced for adjusting revenues and expenditures.

The local tax administration will be established in the coming period. A Commission for Intergovernmental Finances, a joint body of the central government and local governments, will be set up. The main task of the Commission will be to monitor the application of the new intergovernmental finance system and recommend improvements.

Introduction

The Finance System in 1994–2000

The disintegration of Socialist Federal Republic of Yugoslavia (SFRY), and especially UN sanctions, led to a complete collapse of the economic system of the Socialist Federal Republic of Yugoslavia in 1993. By the end of January 1994, the Monetary System Reconstruction Program and the Strategy of the Economic Recovery of Yugoslavia came into force and blocked the hyper-inflationary trends. The launching of a new dinar (CSD), supported by gold and foreign currency reserves and other measures, resulted in a stable economic and monetary equilibrium.

In such a macro-economic environment, a new local government finance system was established, which even today represents the basis of the local government finance system in the Republic of Serbia. The basic concept of local government finances in Serbia was to divide the local functions into two parts:

- Expenditures not financed from national tax revenues, but only by local revenues (utility expenditures);
- Expenditures financed by republican shared taxes at the amount set on the basis of objective criteria.

The key features of the local financing were, as follows:

- Communal needs were financed by own revenues. There was no equalization in this sector, but the rate of local public spending, in individual local government units, was directly dependent upon their fiscal capacity and the fiscal policy pursued;
- The equalization system was based on equalization of expenditures, using objective criteria;
- Local government administration and human services (education, child and social welfare, culture) were financed by assigned national taxes, but up to the level determined by unique criteria.
- The transfer is determined through the mechanism of sharing national taxes, by calculating the rate of the sales tax (see an example in Table 1.).

The annual budget laws specified the municipalities' and cities' share in the sales tax by using the following criteria: (i) setting the overall funds for the tasks and functions for which taxes were assigned and (ii) for each local government unit, the special portion of sales tax to be collected.

The criteria for determination of the required expenditures and the formula for their application are still used in the current finance system. It was disrupted substantially by the adoption of a new local government finance system where specific sales tax sharing ratios were introduced: five percent for the cities, 10 percent for the municipalities, and 15 percent for the City of Belgrade. This way, the finance system substantially disrupted the relations between the municipalities and cities in favor of the cities.

Table 1.
Example for Calculation of the Required Rate of Share in the Collected Sales Tax

	Municipality	
1.	Determined level of grant funds	1,000
2.	Share of grants provided through national taxes assignment	700
3.	Share to be substituted out of sales tax (item 1. – 2.)	300
4.	Collected sales tax within the municipality jurisdiction	1,700
5.	Required rate of share in the sales tax (item 3./4. x 100)	17.6%

Reforming the Finance System in 2001–2002

After the democratic changes following October 5, 2001, the reform of the local government finance system may be divided into two phases: (i) in 2001, amendments of the two systemic laws regulating the domain of financing of local government units were implemented; and (ii) in 2002, the new Law on Local Governments was passed.

The most important changes of the systemic laws (Law on Public Revenues and Expenditures; Law on Local Governments) had vital impact on the funding of local government units:

- Changes of certain shared taxes: four taxes out of six taxes, earlier classified as grant funds, were reclassified as "shared taxes" (agriculture land tax, property tax, inheritance and gift tax, and absolute rights tax).
- Consequently, only two taxes remained in the category of grant funds that are used for revenue equalization (five percent of shared wage tax; shared sales tax, assigned to the local government units at different rates).

Certain other taxes, assigned by the republic to the municipalities and cities were also changed:

- property tax: municipalities and cities' share increased from 25 percent to 100 percent;

- tourist tax: the municipalities and cities' share went from 80 percent to100 percent;
- real estate transfer tax: increased in the municipalities and cities' share from three percent to five percent;
- payroll tax: was introduced as a local tax, with a tax rate maximized at the level of 3.5 percent.

The aforementioned amendments of the first phase were incorporated in the new Law on Local Governments (2002). This law also strengthened the local self-governments by enhancing the funds at the local governments' disposal when no new tasks were assigned to them. In other words, the municipalities had doubled their funds in real terms compared to the base year 2000.

The most important changes in local governments' revenues were, as follows:

- Cities and municipalities are entitled to 100 percent of the six, previously national taxes (self-employment tax; immovable property tax; tax on rental of movables; gambling gains tax; insurance premium tax; tax on other revenues in accordance with Article 85 of the Law on Personal Income Tax).
- Municipalities' share in the sales tax was increased from five percent to eight percent.

Changes in the Finance System 2004–2006

2004 represented an intermediate step between the finance system established through the reforms of 2001–2002 and the new local government financing system to be established upon the completion of the reforms in the tax system. In 2004, the following laws were passed:

- Law on the Repeal of the Law on the Payroll Tax, effective from July 1, 2004;
- Law on the Value Added Tax, effective from January 1, 2005.

Given the fact that the payroll tax was a municipal tax, and 20 percent of local revenues, it was indispensable to adjust the local government finance system. In 2004, local governments had to be compensated for the loss in payroll tax revenues. As a provisional solution, the Annual Budget Law regulated that the local government units were entitled to an additional 25 percent share of the wage tax.

Revenues lost due to elimination of the sales tax have been compensated by increasing the wage tax share from 30 percent to 40 percent. This way, most municipalities received compensation for all their lost revenues. Municipalities and cities, where the increased share was insufficient in compensating for the loss of sales tax revenue, shall receive a special compensation transfer.

Number and Size of Local Governments

The territorial organization of the Republic of Serbia is regulated by the Constitution and the Law on Territorial Organization of the Republic of Serbia and Local Government. According to the Constitution of the Republic of Serbia, the Republic consists of two autonomous territories (the Autonomous Province of Vojvodina and the Autonomous Province of Kosovo and Metohija), municipalities, cities, and the City of Belgrade as separate territorial jurisdictions. According to the Law on Territorial Organization, there are 169 municipalities and five cities in the Republic of Serbia. An average local government unit in the Republic of Serbia has 53,943 inhabitants and a territory of 506 km^2. (Table 2.)

Table 2.
Number and Size of Local Government Units (LGUs) in Serbia

	Number of LGUs	Average in km^2	Number of inhabitants	Average	Percent
Up to 20,000 inhabitants	60	338	832,072		8.9
20–30,000 inhabitants	32	480	782,451		8.3
30–50,000 inhabitants	31	520	1,223,728		13.0
50–70,000 inhabitants	20	560	1,191,007		12.7
70–100,000 inhabitants	11	696	940,864		10.0
Over 100,000 inhabitants	15	770	1,913,194		20.4
Municipalities – total	169	455	6,883,316	40,730	73.3
Cities	5	1,185	2,502,817	500,563	26.7
Total	**174**	**506**	**9,386,133**	**53,943**	**100.0**

Local Self-government Autonomy

The Constitution of the Republic of Serbia and its legislation define the concept and basic principles of the local self-government in the Republic of Serbia. They also govern the finance system that provides the local self-government with adequate funds to finance the responsibilities delegated to them by the Constitution and law. There are three basic systemic laws regulating local finances: the Law on Public Revenues and Expenditures, the Law on Budgetary System, and the Law on Local Government.

According to the above laws, the local government units in the Republic of Serbia have their own budgets, which they adopt in full autonomy, and their own revenues. Local governments are entitled to borrow, however, only for capital investments in communal infrastructure. Until 1995, the local government units were entitled to own property, but their right for property disposal was abrogated by the Law on Property of the Republic of Serbia. The new Constitution is expected to restore the property right to local government units.

Basic Structure of Local Government Finances

Legal Grounds of the Local Government Finance System

According to the Law on Local Government, the local government units are financed out of three basic sources of revenues: (i) own revenues, (ii) shared national taxes, and (iii) a share of revenues assigned to local government units and determined by unique criteria (grant funds).

In addition to these three basic revenue sources, local government units are entitled to additional resources in case of their failure to reach the limit of grant funds. It is possible as the local government units receive the predetermined amounts of grant funds through a share of two national taxes: five percent of the wage tax collected in the local government jurisdiction and the sales tax, according to differentiated rates.

The share of these two taxes might also lead to the opposite situation, when revenue yield exceeds the level determined by law. In such a case, further transfer of the sales tax to the local government unit is suspended. Through political pressure local self-governments succeeded to acquire the collected taxes 50 percent above the grant fund determined by the law.

Predictability of Shared Taxes and Grant Funds

In the current local government finance system, the share of the local government units in the national taxes is defined by the Law on Local Governments and it is not subject to annual changes. The local government units receive the shared taxes in accordance with precisely determined percentage rates from the overall collected revenues. The sharing system is automated, so the Public Revenue Service (PRS) directly transfers the adequate portion of shared taxes to the local government units. The transfers are made on a daily basis. This way, local governments may independently plan the level of shared national tax revenues.

The grant funds from the central government are not transferred from the republic's budget, but through sharing two national taxes: five percent of the wage tax and through different shares of the sales tax. The level of grant funds in total and per individual municipality is determined by the Annual Budget Law, based on the macro-economic policy for the following year and its main parameters determined by the Memorandum of the Government of the Republic of Serbia, upon consultations made with representatives of local self-government. So, the local government units may not plan the amounts of grant funds on their own; instead they take the grants over from the annual budget law.

Financing of New Local Tasks and Functions

New functions were transferred to local self-governments in 2001–2002, at the time of the local government reform. It was estimated that for strengthening local self-governments and their capacity to exercise delegated responsibilities, the funds available for financing existing responsibilities should be increased. Similarly, grant funds were increased when certain tasks and institutions in the area of child welfare and culture were transferred.

Nonetheless, there were also cases when the transfer of tasks was not supported by additional revenues. This happened in those cases when only small funds (considerably below one percent of the total funds) were required, or when certain institutions and tasks were transferred only to a few local government units.

Sufficiency of Funds

During the local finance reforms there was an assumption that in the preceding period the total local government revenues were insufficient. Therefore, one of the chief objectives of the reform was to increase the revenues available to the local government. The results are presented in Table 3.

Table 3.
Total Revenues of LGUs and their Share in GDP, in CSD Million

Year	Total revenues LGUs			GDP	Total local revenues in percent of GDP
	Nominal value	Real value at 2004 price level	Index (base year 2000)		
2000	13,341.4	36,743.3		355,168.0	3.8
2001	30,433.5	44,370.6	120.8	708,422.5	4.3
2002	55,319.3	67,661.8	184.1	919,230.5	6.0
2003	68,195.7	74,674.3	203.2	1,088,000*	6.3
2004*	81,420.6	81,420.6	221.6	1,284,100*	6.3

Note: * Projected.

The reform of the local government finance system in 2001–2002 almost doubled the local governments' funds in real value, compared to the base year of 2000, without any increase in local government responsibilities. Also, there was an increase in the GDP share from 3.8 percent in 2000 to six percent in 2002.

Compared to other European countries, the percentage of the local government share in GDP is relatively small, though the number of local governments' responsibilities should be taken into account. Namely, compared to other countries, in the Republic of Serbia the number of responsibilities in the areas of primary and secondary education is relatively small (the salaries of the employees are financed from the national budget; 2.6 percent of GDP), while healthcare is under full responsibility of the republican government.

Equalization System

Types of Grant Funds

The Law on Local Government does not precisely define the types of grant funds to be transferred by the Republic to the local government units. Still, if we look into the manner and methodology of determining the scope of grant funds, we may say that the local government finance system recognizes two basic types of grant funds: the general grant fund and the equalization grant.

General Grant Funds

General grant funds are assigned to the local government units to accomplish two main objectives:

- vertical balance for increasing the available revenues of local self-governments, and, at the same time;
- horizontal balance among the local government units, assuming that the amount of grant funds for a local government unit is determined by unique criteria and not based on fiscal capacity, as is the case with the assignment of national taxes.

As for the allocation of grant funds for individual local governments, the criteria primarily used are those set by the Law on Local Government:

- Number of inhabitants;
- Number of classes in primary and secondary schools;
- Number of children covered by direct child care;
- Number of facilities earmarked for education and child care;

Application of the above criteria is obligatory. In addition to these mandatory criteria, it is possible to prescribe other criteria. According to the applicable methodology, each and every local government unit receives the same amount of money per capita, class, child, and facility.

In addition to the above criteria, the Law on Local Government also prescribes the "environmental status" criterion; however, the adequate methodology for its application has not been developed.

Equalization Grant Funds

The equalization grant funds are allocated by the criteria specified in the Law on Local Government: (i) level of development and (ii) size of the jurisdiction, measured by population density. This grant fund is received only by local government units that are below the average level of development and/or the average population density.

This grant became important upon completion of the local government finance system reform in 2001–2002. The increase in the total funds available to the local self-governments (through higher amounts in shared taxes) was much more favorable to the municipalities in the richest tertiary. This led to a considerable gap in available revenues of the poorest and the richest tertiary. In order to lower these differences, the local government finance system reform should have given a more significant weight to this type of grant.

Grant Design Formula

The methodology for determining level of grant funds per individual local government units may divided into three phases: (i) passing the Memorandum and Statement on Public Expenditures and Public Revenues, (ii) global allocation of grant funds, and (iii) determination of grant fund level per individual local government unit.

Determining the Total Grant Funds

Based on the Law on the Budget System, the government of the Republic of Serbia passes the Memorandum on the Budget and the Economic and Fiscal Policies for the Budgetary Year in addition to a forecast for the following two years. Passing of the Memorandum – the instructions for budget preparation and the budget itself – is performed in accordance with the budget calendar, also prescribed by the Law on the Budget System.

The Memorandum on the Budget is used also for determining the total level of grant funds transferred from the national level to local governments. The basis for planning is the level of the grant funds reached in the preceding year. In other words, the level of grant funds is not legally tied to GDP, total public expenditures, or the budget of the republic.

The reasons for the above might be found in the need for a more active macro-economic policy, forced to lessen the share of public spending. The overall level of public expenditures is inappropriate to use as a base to peg the grant level due to the necessity to change its level and structure (pension and health insurance expenditures are increased due to the aging population). Neither is the national budget level favorable due to continuous adjustment to new obligations (deficits in pension and health insurance funds, commencement of repayment of foreign credits, and others).

Despite the fact that the level of grants is not legally tied to any of the above parameters, in practice, however, the amount of determined grants has been growing year by year in accordance with nominal growth of GDP.

Global Allocation of Total Grant Funds

The overall level of grant funds is first divided into two parts: (i) general grants of 85 percent and (ii) equalization grants of 15 percent of the total amount of grants. Within the scope of general grants (85 percent of the total grants), further allocation per basic tasks and functions is made, which is expressed in percent as follows:

Table 4.
Allocation of General Grants Per Certain Tasks and Functions

	Type of tasks and functions	Percent
1	Delegated tasks	21.7
2	Primary education	19.9
	• Per number of classes	15.9
	• Per number of facilities	4.0
3	Secondary education	9.0
	• Per number of classes	7.2
	• Per number of facilities	1.8
4	Child welfare	26.5
	• Per number of children	22.7
	• Per number of facilities	3.8
5	Local government	8.1
6	Culture	10.4
	• General expenditures	3.6
	• Specific expenditures	6.7
7	Physical culture	2.7
	• General expenditures	1.2
	• Specific expenditures	1.5
8	Social welfare	1.4
9	Other expenditures	0.5
	Total	**100.0**

These percentages of allocation of total grants for specific local tasks and functions were determined on the basis of the structure of actual local government spending in the course of the years 1994–2000.

Nonetheless, certain corrections on these allocation percentages were also made, relative to the accomplished structure of spending. It has increased the percentages earmarked for primary and secondary education and child care, reducing the revenue share of local government administrative tasks. The correction was made with the aim to encourage financing of the specified functions, as well to discourage excessive employment at local government units.

The amount of the equalization grant fund (15 percent of total grants) is further allocated according to the two basic criteria: (i) 70 percent according to development criterion and (ii) 30 percent according to the population density criterion.

Determination of Grant Funds Level for Individual LGUs

In order to be able to determine grants level per individual local government unit in this phase, it is necessary to establish a relationship between legally determined criteria and basic groups of tasks (Table 5.).

Table 5.
Criteria for the Allocation of Funds for Certain Tasks and Functions

Type of tasks and functions		General grants – criteria			
		Number of			
		inhabitants	classes	children	facilities
1.	Delegated functions	o			
2.	Primary education		o		o
3.	Secondary education		o		o
4.	Child welfare			o	o
5.	Local administration	o			
6.	Culture	o			
7.	Physical culture	o			
8.	Social welfare	o			
9.	Other expenditures	o			

Allocation of General Grants

Delegated Tasks: The allocation of earmarked funds for delegated tasks is made based on two basic criteria:

- 70 percent of the overall funds, earmarked for the delegated tasks, are shared among individual local government units, in proportion to the share of the local government units in the overall *number of inhabitants* in the republic.
- 30 percent of the overall funds, earmarked for the delegated tasks, are shared among individual local government units, in proportion to the share of the local government units in the overall *area* (*km^2)* of the republic.

Elementary and Secondary Education: The allocation of funds, earmarked for elementary education to the individual municipalities and cities, is made proportionately to the share of each local government unit in the total *number of classes* in the republic.

Child Care: The allocation of funds, earmarked for childcare to the individual municipalities and cities, is made on the basis of the criterion of the *number of children covered by direct child care*. Thereby, a distinction is made between different types of child-care services (extended-day program and half-day program), in view of the different amounts of expenses incurred by local government units on the grounds of the extended-day program and the half-day program.

Culture: The allocation of funds, earmarked for culture to the individual municipalities and cities, is made on the basis of the following criteria: (i) number of citizens and (ii) funds spent for specific expenditures (to finance archives, central libraries, theaters, museums of greater importance). The allocation is made in two steps:

- As the first step, the total amount of funds, determined in the second phase of the global allocation, is divided into two parts:
  - The first part, which is allocated to the individual municipalities and cities on the basis of the share of the local government units in total *number of inhabitants* in the republic;
  - The second part, which is allocated to the individual municipalities and cities on the basis of the share of the local government units in the overall *funds* of all municipalities and cities *spent for specific expenditures*.
  - This allocation is based on the data of the municipalities and cities on the structure of general and specific expenditures.
- Within the second step, the allocation of the funds is made to the individual local government units, proportionately to the share of each municipality or city in the overall number of inhabitants in the republic, or in the total expenditures for specific purposes.

Physical Education: The Allocation of funds, earmarked for physical education, to the individual local government units is made according to the same methodology that is applied for culture.

Local Administration, Social Welfare and Other Expenditures: The allocation of funds, earmarked for the local self-government (administration), social welfare, and other expenditures to the individual municipalities and cities, is made proportionately to the share of each local government unit in the overall *number of inhabitants* in the republic.

Allocation of Equalization Grants

As already stated, out of the total budgeted grant funds, the equalization grants represent 15 percent. Allocation of the funds to the individual municipalities and cities is made on the basis of two criteria: (i) area, by using population density, and (ii) level of development, or underdevelopment.

Allocation on the Basis of Area, i.e., Population Density:
Out of the overall level of the equalization grants, 30 percent is allocated by area, i.e., population density. The allocation of the funds based on this criterion applies only to those municipalities in which the population density is below the average in the republic. The methodology for allocation of the amounts of the funds to the individual municipalities is as follows:

a) First, the average population density is calculated for each local government unit;

b) Then, the square area of the municipality is calculated according to the following formula: the number of the inhabitants of the municipality multiplied by the average population density of the republic;

c) Thus, the calculated average square area is compared to the actual square area of a municipality. The difference is calculated only for those municipalities whose actual square area is higher than the calculated average square area;

d) Then, only for the municipalities whose actual area is larger than the calculated average area, the share in the total sum of the differences (referred to above) is calculated;

e) The amount of the funds pertaining to each individual municipality is obtained when the total amount of the funds, which are allocated according to the criterion of area, is multiplied by the calculated percentage of share of that municipality.

This way, it is ensured that the funds based on this criterion are received only by those municipalities that have a below-average population density indicator, and that the amount of the funds allocated to a municipality is directly linked to the degree to which it lags behind the average in the republic. The more a municipality lags behind, the higher the allocated funds.

Allocation on the Basis of the Level of Development:
According to this criterion, 70 percent of the equalization transfer is allocated. The allocation of the funds according to this criterion includes those municipalities whose level of development is below the average in the republic. The primary indicator is the gross domestic product per capita. Later, on the initiative of the local government units, the indicator of the “amount of collected revenues without per capita limitation” was introduced as an auxiliary indicator for determining the level of development. The term “revenues without per capita limitations” includes the shared republic taxes together with own revenues of the local self-government.

For allocation of the individual municipalities’ funds on the basis of the indicator of the *gross domestic product (GDP) per capita amount, the following methodology is applied:*

a) First, the value of GDP per capita is calculated according to the following formula: the number of the inhabitants of a municipality multiplied by the average value of GDP per capita in the republic;

b) Thus, the calculated value of GDP per capita is compared to the actual value of GDP per capita of the local government unit. The difference is calculated only for those local government units where the realized GDP is lower than the calculated GDP;

c) Then, only for those local government units whose realized GDP is lower than the calculated GDP, the share in the total sum of the differences (referred to above) is calculated;

d) The amount of funds allocated to the individual municipalities is obtained when the total amount of funds, which are allocated according to the criterion of GDP, is multiplied by the calculated percentage of the share of that municipality.

For allocation of the funds to the individual municipalities on the basis of the criterion of the amount of the collected revenues without per capita limitation, the following methodology is applied:

a) First, the average amount of collected revenues without per capita limitation is calculated for each local government unit;

b) Then, the calculated revenues without per capita limitation for the municipality are calculated according to the following formula: the number of the inhabitants of a municipality multiplied by 70 percent of the average collected revenues amount without per capita limitation for all the local government units in the republic;

c) Thus, the calculated amount of collected revenues without per capita limitation is compared to the actual collected amount of revenues without per capita limitation for the municipality. The difference is calculated only for those municipalities whose collected amount of revenues is lower than the calculated amount of revenues;

d) Then, only for those municipalities whose collected amount of revenues is lower than the calculated amount, the share in the total sum of the differences (referred to above) is calculated;

e) The amount of funds allocated to each individual municipality is obtained when the total amount of funds, which are allocated according to the criterion of the amount of the collected funds without per capita limitation, is multiplied by the calculated percentage of share of that municipality.

This methodology is applied only for those municipalities that have, at the same time, below-average GDP and revenues without limitation below 70 percent of the average of all the local government units. This way, it is ensured that the funds based on this criterion are obtained only by those municipalities that have either below-average GDP, or the collected revenues without limitation below 70 percent of the average of all municipalities and cities; and that the amount of the allocated grants to a municipality is dependent upon the degree of its lagging behind the average of the republic. The higher the degree of lagging, the higher the allocated funds are.

Exceptions from the Specified Methodology

The Law on Local Government, as a systemic law, regulating *inter alia* the financing of local self-governments, does not specify any exceptions from determining the level of grant funds allocated to the individual local government units. Such a position is based on the fact that the municipalities and cities exercise the same tasks and functions set forth by the Constitution and law, so that there is no need for any exceptions.

However, in practice, when the Budget Law for 2000 was adopted, the cities were allocated *one-off additional grants* to solve problems with their utilities. Using their real economic and political power in 2001–2003, the cities managed to turn this one-off grant into a grant with a longer-term character, which was, nevertheless, finally annulled when the Budget Law for 2004 was adopted.

The Impact of Grant Allocation on Horizontal Equalization

This section presents the level of overall available funds and results of horizontal equalization by the local government units, grouped according to their population size. The level of the available funds prior to and after the implementation of the equalization system will be presented.

This grouping is also important from the standpoint of the debate on the optimal size and actual autonomy of local government units. There is a high correlation between the size of a municipality and its fiscal capacity: with the increase of the number of citizens in a municipality, its fiscal capacity increases, and thereby the amount of revenues per capita as well.

Table 6.
Revenues of Local Government Units Prior to the Implementation of the Equalization System (2003)

	Compared to average in percent		
	Own revenues	**Assigned republican taxes**	**Revenues prior to equalization**
Up to 20,000 inhabitants	40.3	37.2	38.9
20–30,000 inhabitants	45.1	41.4	43.4
30–50,000 inhabitants	46.7	47.8	47.2
50–70,000 inhabitants	56.7	55.7	56.3
70–100,000 inhabitants	55.4	62.2	58.5
Over 100,000 inhabitants	72.0	76.9	74.2
Average for all municipalities	53.8	55.0	54.3
Cities	204.3	201.5	203.0
Total	**100.0**	**100.0**	**100.0**

In Table 6., the revenues of the municipalities, prior to equalization, represent 54.3 percent of the average of the revenues of all local government units, while the revenues of the cities are higher compared to the average by 103 percent. At the same time, the revenues of the cities, prior to equalization, were 3.74 times higher than the average revenues of the municipalities. Similar relations can also be noticed within own revenues and assigned republican taxes. As for the total revenues prior to equalization, the gap between the richest and the poorest tertiary among the local government unit is 14.8 times. Within own revenues, the specified gap is 19.1 times, and in the case of assigned republican taxes it is 16.8 times. (Table 7.)

Table 7.
Total Revenues of Local Government Units

Groups of LGUs by number of inhabitants	Compared to average in percent				
	Revenues prior to equalization	Grants		Total revenues	
		Including additional funds for cities	Excluding additional funds for cities	Including additional funds for cities	Excluding additional funds for cities
Up to 20,000	38.9	90.1	120.4	46.0	47.7
20–30,000	43.4	85.4	114.2	49.3	51.1
30–50,000	47.2	75.0	100.3	51.1	52.9
50–70,000	56.3	70.5	94.3	58.2	60.4
70–100,000	58.5	77.8	104.0	61.2	63.4
Over 100,000	74.2	75.2	100.5	74.4	77.1
Average for all the municipalities	54.3	78.6	105.1	57.7	59.8
Cities	203.0	148.2	88.5	195.4	190.6
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

The data on grant funds, as well as on the total revenues of local government units, are given in two versions: including the additional funds for cities and in the second version, without any exceptions. In this case, the grants are specified according to the Law on Local Government. The reason for exclusion of additional funds to the cities is that this right has been abolished as of 2004.

Analyzing the effects of the implementation of the pure equalization system (excluding the already revoked exception in the case of cities), a considerable reduction of the above-described differences is noticeable among cities and municipalities and among certain groups of municipalities. Thus, for example, the highest rate of growth has been marked by municipalities having less than 20,000 inhabitants increasing their funds by 8.8 percent (from 38.9 percent to 47.7 percent).

In general, with the equalization system the position of all municipalities has been improved from 54.3 percent to 59.8 percent (5.5 percent), while in the case of cities there was a decline of 12.4 percent (from 203 percent to 190.6 percent). The gap between the cities and the municipalities has been reduced from 3.74 (203/54.3 = 3.74) to 3.19 times (190.6/59.8 = 3.19), while the gap between the richest and the poorest tertiary among local government units has been reduced from 14.8 times to a still high 9.1 times.

Recent Changes in Local Finances

A new Law on Local Government Finances has been drafted during 2005–2006. Major changes in the new law on Local Government Finances are discussed below.

Setting the Total Amount of Transfers

The total amount of transfers is set as a percentage of the gross domestic product. The last available data on realized GDP is used and the share of grants in GDP is set on the basis of the current amount of transfers for 2006 (1.175 percent). The Law on Income Tax was adopted simultaneously with the Law on Local Government Finances. As it reduced the wage tax rate from 14 percent to 12 percent and introduced a non-taxable part at the fixed amount of CSD 5,000, the share of transfers has been increased to 1.7 percent in order to compensate local governments for this loss.

Grants and Transfers

The Law on Local Government Finances defines two main groups of transfers: (i) non-earmarked transfers and (ii) earmarked transfers. Non-earmarked transfers can be used for any purposes set by the local government budget.

Equalization transfers are allocated to those local governments, whose average per capita revenues from shared taxes are below 90 percent of the municipal average. This transfer is the first one set for compensating underperformance in fiscal capacity. A proportionally larger amount of transfers per capita is provided for a higher level of underperformance. Shared taxes (not municipal original revenues) are used for calculating the amount of this transfer. This way, an *incentive component* was introduced into the system, because any increase in municipal own revenues remains in the local budget, i.e., it does not reduce the amount of transfers. Local governments cannot shift the tax burden to other municipalities by relieving their taxpayers and reducing their original revenues, because they are not going to receive increased transfers to compensate for reduced original revenues.

A compensation transfer is granted to local governments to compensate for lost revenues due to changes in the tax legislation. The current amount of compensation transfer is the part of the sales tax and payroll tax that was not compensated for by increasing local governments' wage tax share to 40 percent. This transfer is also for compensating future losses (e.g., reduced wage tax rate).

A general transfer is granted to all local governments on the basis of unified criteria and according to detailed methodology set by law. The total amount of the general transfer is determined according to the following formula:

- 65.0 percent allocated according to population number;
- 19.3 percent allocated according to territory;
- 4.56 percent allocated according to the number of classes in elementary schools;
- 2.0 percent allocated according to the number of classes in secondary schools;
- 6.0 percent allocated according to the number of children included in child care;
- 1.14 percent allocated according to the number of buildings of elementary schools;
- 0.5 percent allocated according to the number of buildings of secondary schools;
- 1.5 percent allocated according to the number of buildings used for child care.

These percentages were determined on the basis of the actual structure of local government expenditures. Each local government will receive the same amount per resident, per total area unit, per child included in direct child care, per class in elementary and secondary education, and per building in elementary and secondary education and child care.

A transitional transfer is of a temporary character and its aim is to introduce a new intergovernmental finance system, as painlessly as possible, in those local governments where the reduction of transfer amount will reduce significantly the total available revenues. In a transitional period of three years, this transfer shall enable these local governments to adjust their budget revenues and expenditures by undertaking measures for increasing revenues and decreasing expenditures.

The Law of Local Government Finance is to be implemented in 2007. In the first year of the new intergovernmental finance system, this transfer will guarantee that no municipality will receive fewer transfers than the amount determined by law for 2006. The transitional transfer to cities will ensure that the total reduction of the estimated revenues for 2007 is not more than five percent. So, only that portion of revenue loss will be compensated, which is over five percent. In the next two years (2008 and 2009), the amount of transitional transfer would be reduced by 50 percent, and in the fourth year of this new finance system application (2010), the transitional transfer would be eliminated and the system would start to function in full.

The reallocation of funds is known as the "Robin Hood" method in publications of the Council of Europe. A transfer reduction should be made only in those local governments that have average shared taxes over 50 percent of the average of all local governments. This condition is met only by the cities of Belgrade and Novi Sad. Transfer reduction equals 40 percent of the balance incurred over the prescribed amount. A simulation for 2006 showed that the cities of Belgrade and Novi Sad would suffer a reduction of their total transfer amount by approximately CSD 2.4 billion. The amount of reduced transfers of CSD 2.4 billion then would be reallocated to all other local governments according to the methodology and formulas used for allocating general transfers.

Earmarked transfers are new types of grants in the Serbian intergovernmental finance system. Earmarked transfers are introduced in order to provide appropriate financing for future competencies transferred from the republican level to local governments. The second reason for its introduction is to authorize the republican government financing of specific projects and programs at the local level. The total amount of transfers received by local governments from the republic is increased by the amount of earmarked transfers (greater than 1.7 percent share of GDP).

These transfers are determined by the line-ministries. Ministries submit their proposals to the Ministry of Finance, during budget memorandum development, by presenting the criteria and measures of calculation, statistical data used for calculation, and the amount of the earmarked transfers for each local government.

A block transfer can be used by local governments for certain functions (for example: elementary education, secondary education, health protection). Calculation of this amount is based on the total costs of a function, incurred by performing it at the republic level in the last year before transferring it to the level of local government.

Methods and Schedule for Determining Transfers

Pursuant to the applicable legislation, the amount of transfer per individual local government is determined by the Annual Budget Law. According to the Law on Local Government Finance, the amount of transfers would be determined in the Memorandum of the Serbian Republic Government, based on the defined methodology and formulae from the Law, with the application of parameters from the Memorandum, according to the schedule for adoption of the reviewed Memorandum.

So, for example, the amount of transfers for 2007 – in total and for individual local governments – has to be determined by October 1, 2006, based on the data on GDP for 2005. Parameters from the Memorandum (GDP growth and inflation) will be used for determining certain types of transfers. In future, local governments will be able to plan their revenues for a three-year period, based on the transfers that most significantly contribute to the improvement of the medium-term budget plan, especially its development component.

Impact of the New System

The following basic impacts may be noticed by using simulations on the new intergovernmental finance system, comparing 2006 with the existing transfers. Transfers to municipalities will be increased from CSD 7.9 to 10.1 billion or by 27 percent. At the same time, the transfer to cities will be reduced from CSD 7.5 to 5.3 billion or by 28.6 percent (Table 8.).

Table 8.
Amount of Transfers, According to the Previous and New Intergovernmental Finance System, 2006

	Grants in 2006 in CSD billion		Index	Percent
	Previous system	New system		
1. Municipalities	7.9	10.1	127.0	27.0
2. Cities	7.5	5.3	71.4	–28.6
Total	**15.4**	**15.4**	**100.0**	**0.0**

Source: Author's own calculations.

Following the increase in transfers, total municipal revenues will be increased by 4.6 percent, and for cities a reduction of 3.4 percent will be estimated (Table 9.).

Table 9.
Amount of Total Revenues, According to the Previous and New Intergovernmental Finance System, 2006

	Total revenue in 2006 in CSD billion		Index	Percent
	Previous system	New system		
1. Municipalities	46.6	48.8	104.6	4.6
2. Cities	63.0	60.8	96.6	–3.4
Total	**109.6**	**109.6**	**100.0**	**0.0**

In the first year, 99 municipalities will have higher transfers and 42 will retain the existing amount. Upon the expiry of the transitional period, these 42 municipalities will have lower transfers. It refers to municipalities with above-average fiscal power.

Simultaneously, transfers will be reduced in all four cities, especially in Belgrade and Novi Sad. Regarding individual municipalities, the index of changes in transfers ranges from the 57 percent to 257 percent. Concerning total revenues, that index ranges from 95 percent up to 167.9 percent (as the index in the first year for cities is guaranteed). Compared to the present system, the difference between the richest and the poorest municipalities has been significantly improved, from the present 9.46 to 5.60 times.

The wage tax rate reduction shall influence all public expenditure beneficiaries, starting from the republic budget to the municipal and city budgets. Due to the different ratio of these revenues in the republic and local budgets, proportional compensation for these losses in local governments' budgets shall be made.

References

Law on Amount of Funds for Municipalities and Cities. *Official Gazette of the Republic of Serbia*. No. 28/94.

Law on Public Revenues and Public Expenditures. *Official Gazette of the Republic of Serbia*. Nos. 76 /91 and 135/04.

Law on Local Government. *Official Gazette of the Republic of Serbia*. Nos. 9/02, 33/04, 135/04, and 62/06.

Annual law setting the amount of transfers for the following budget year (1994–2006):

- Law on Municipalities and Cities' Share of Goods and Services Sales Tax;
- Law on the Amount of Funds and Share of Wage Tax and Sales Tax of the Municipalities, Cities, and the City of Belgrade (until 2004);
- Law on the Allocation of Transfers from the Budget of the Republic of Serbia and Share of Wage Tax of the Municipalities, Cities, and the City of Belgrade (2005, 2006).

Law on Local Government Finances. *Official Gazette of the Republic of Serbia. No. 62/06.*

Stipanović, B. 1997. "Financing Public Expenditures of Municipalities and Cities in the Republic of Serbia." Narodna biblioteka. "Resavska škola." Despotovac.

Stipanović, B. 2000. "Financing Municipalities and Cities in the Republic of Serbia." BMG Štamparija. Užice.

Stipanović, B. 2003. "Intergovernmental Finance System in the Republic of Serbia." SLGRP-DAI.

Stipanović, B. 2003b. "2000–2003 Local Government Revenues Analyses." SLGRP-DAI.

Stipanović, B. 2004 "Reform of the Intergovernmental Finance System in the Republic of Serbia." "Savetnik" 7/2004, Zavod za unapređenje i rentabilnost poslovanja. Beograd.