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SYSTEM OF FINANCING OF LOCAL SELF-GOVERNMENTS FOR THEIR SUSTAINABLE FUNCTIONING AND DEVELOPEMENT*

Sistem finansiranja lokalnih samouprava u cilju održivog funkcionisanja i razvoja

Abstract

In this paper we present the main features of the current system of financing of local self-governments (LSG) in Serbia and propose the principles and directions for its further improvements, given the current level of decentralization. For this purpose, we analyzed the current legal framework in the area of LSG jurisdiction on the one hand, and model of financing of LSGs, on the other. In addition to that, we tried to depict a financial position of LSGs and local public utility companies (LPUcs) using financial data for the period from 2011 to 2013, in order to design principles for systematic regulation of this area, the latter being of particular importance in the dominant context of fiscal consolidation policy. The general conclusions and recommendations point to the necessity to design such a concept of financing of LSGs which has a firm link between jurisdiction, i.e. type of public services provided by LSG level, and sources for financing of these jurisdictions/services – aligned in terms of quality and availability of these services with the objective possibilities. Analysis of the financial data indicates that there is relatively firm evidence in support of the conclusion that the main source of bad financial position of certain LSGs reflected in a high level of outstanding stock of payables to suppliers, lies in the inappropriate financing of public utilities and local institutions founded by LSGs.

Keywords: *local self-government units, model of financing*

Sažetak

U ovom članku predstavljamo osnovne karakteristike važećeg sistema finansiranja jedinica lokalne samouprave (JLS) u Srbiji i predlažemo principe i pravce za njegovo unapređenje pri sadašnjem stepenu decentralizacije vlasti. U ovom cilju, analiziramo aktuelni pravni okvir kojim su uređene nadležnosti, s jedne strane, i model finansiranja lokalne samouprave, s druge strane. Pored toga, pokušali smo da sagledamo finansijski položaj jedinica lokalne samouprave i lokalnih komunalnih preduzeća na osnovu finansijskih podataka za period od 2011 do 2013. godine, kako bismo predložili principe za sistemsko uređenje ove oblasti koji su naročito važni u kontekstu dominantne politike fiskalne konsolidacije. Osnovni zaključci i preporuke upućuju da je potrebno koncipirati takav model finansiranja JLS u kome postoji čvrsta veza između nadležnosti, odnosno vrste usluga u okviru JLS i izvora sredstava za finansiranje tih nadležnosti/usluga – na objektivno mogućem stepenu kvaliteta i dostupnosti različitih usluga. Analizom finansijskih podataka pokazujemo da postoje dosta uverljivi nalazi u prilog zaključku da uzrok lošeg finansijskog položaja JLS, koji se ogleda u visokom nivou nagomilanih neplaćenih obaveza, treba tražiti u neadekvatnim izvorima finansiranja lokalnih komunalnih preduzeća i lokalnih ustanova čiji su JLS osnivač.

Cljučne reči: *jedinice lokalne samouprave, model finansiranja*

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Introduction: Jurisdiction and funding of local self-governments through the evolution of legal framework

Jurisdiction/tasks

LSGs can be observed as a system consisting of three groups of entities, with their jurisdiction/tasks and mutual relationships, as conceptually coined in the report by *Zelić* [7]. Those groups of entities are: 1) governing bodies of the LSGs (GBLSG), 2) local institutions (LI), and 3) public utility companies (LPUCs) which are owned by the city or the municipality.

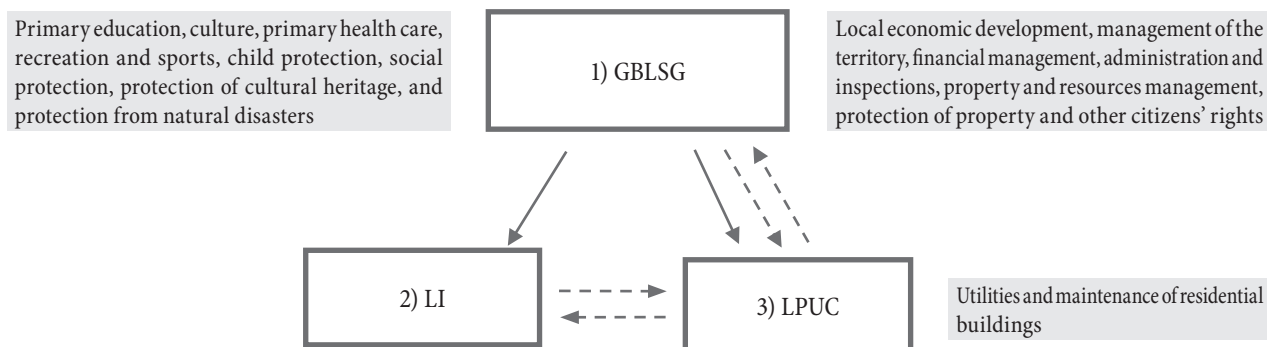
Local self-government bodies comprise the assembly, president of the municipality, municipal board and municipal administration. Regarding the jurisdiction, these bodies deal with the issues relating to local economic development, management of territory, administration, financial management and inspection, property and resources management, and protection of property rights as well as other rights of citizens. It relates to jurisdictions under items No.1-4, then 7-15, and 20-39 of Article 20, paragraph 1 of the Law on Local Self-Government (“Official Gazette of the RS”, No. 129/2007 and 83/2014). Local institutions are founded by LSG with the aim to perform through them its jurisdictions in the area of basic human rights, as stipulated by the Constitution (Articles 68, 69, 71 and 73), which include: primary health care, primary education, sports, child care, social care, protection of cultural values and citizens’ protection against natural disasters. These jurisdictions are prescribed under items No. 16-19 of Article 20, paragraph 1 of the Law on Local Self-Government. The third group of entities – local public utilities are primarily in charge of providing communal services (water purification and distribution, treatment and drainage of atmospheric and sewage waters, production and supply of steam and hot water, transport of commuters in midtown and from suburbs to midtown, waste management in cities and settlements, maintaining of landfill sites, management of open green market areas, parks, leisure areas and other public areas, public parking management, public street lighting, maintenance of cemeteries and burials, etc.), as well as maintenance of residential buildings. This is

in line with the jurisdictions under items No. 5 and 6 of the mentioned Law article.

Schematic overview of the LSG system with the main jurisdictions and mutual relations between the groups of entities 1), 2) and 3) is presented in Figure 1. Full lines in Figure 1 represent ownership relationships between subjects from groups 1) GBLSG (and those subjects can be observed as LSGs in narrow terms), and subjects from groups 2) LI and 3) LPUC; ownership link implies the right of establishing governing bodies in LIs and LPUCs owing to capital link, which means that LSG (in narrow terms) invested, and can invest in the future into assets of LPUCs and LIs. Dashed lines represent the direction of selling products and services of LPUCs to other entities and, consequently, payment for such products and services. The services provided by LPUCs to LIs as legal entities – heating, water, waste disposal, etc. – are also provided to GBLSGs, which also pay to LPUCs for these services. Besides the described services, GBLSGs also pay LPUCs for those utility services “for which end-user/consumer cannot be established” (Article 27, the Law on Utilities). Such services are, for example, “maintenance of streets and roads” or “maintenance of green surfaces”, which are all activities labelled as utilities by the Law (Article 2, the Law on Utilities), and therefore there are LPUCs established to provide such services. City or municipality pays to LPUC for the services provided to the citizens, i.e. pays in certain sense “in the name of citizens”, by funds collected from them through invoicing of respective fees by LSG. Described mutual relationships are important for further analysis of the financial position and financing model for LSGs as a whole. Next to each group of entities in Figure 1, their main tasks/jurisdictions are listed in gray boxes.

With the described set of tasks/jurisdiction under the responsibility of LSGs, their share in overall consolidated government expenditure is 13.4% in 2014, representing about 6% of GDP [3]. Decentralization policy, led by the central level since 2001 when the share of local-level expenditures was around 3.8% of GDP, can be summarized in two dominant trends over the last 15-year period, as described in details by *Kmezić & Đulić* [3]. According to these two authors, the phase lasting from

Figure 1: Institutional framework for LSG operations



Source: [7]

2001 to 2008 was characterized by the strengthening of the roles of cities and municipalities, as well as of their fiscal autonomy exercised through continuous transfer of powers/jurisdictions and funds. During this period, two key pieces of legislation were adopted: the Law on Local Self-Government (in 2002 and 2007), which sets forth the general jurisdiction of LSG, and the Law on Local Self-Government Financing (in 2006) which defines the appropriate model of financing for specific jurisdictions on local self-government level. Also, during this period the current Constitution of the Republic of Serbia was adopted (in 2006). With LSG budget expenditures participating with 15.1% in total consolidated government expenditure and corresponding to 7.2% share in GDP, the highest level of fiscal decentralization was achieved in 2007. The other typical phase in the process of fiscal decentralization, as described by these two authors, is a “trend of fiscal centralization and pseudo-decentralization”, which lasted from 2009 to 2015. This period was marked by inconsistent transfer of new mandates – and new liabilities, accordingly (often by Government decrees, Rulebook issued by Ministries, collective contracts, and even Government conclusions), with no appropriate provision of sources of financing for these new mandates. This phase is also marked by frequent ad hoc abolishment or modification in the level of revenue of LSG. All of that, as argued by the authors, “distorted the vertical balance established by the policy of government decentralization which existed until 2008.”

Although, generally speaking, the level of government decentralization has been significantly increased since 2001, compared to other countries, Serbia rather belongs

to countries with relatively low level of decentralization (see Table 1).

Current model of LSG financing

The current Law on Local Self-Government Financing formally dates back to 2006 (hereinafter: Law from 2006), but given the significance of its later amendments and supplements, and especially those from 2011 and 2012, the model of financing of LSGs which currently applies was finally shaped in 2012 (hereinafter: Law from 2012).

Although it is not so “sophisticated” compared to models in other countries, e.g. like the one in Slovenia, the financing model introduced in the Law from 2006 has its economic-financial logic and corresponds with the Law on Local Self-Government (“Official Gazette of the RS”, No. 129/2007 and 83/2014), in a way that model of LSG financing secures funding for the provision of tasks that are in jurisdiction of LSG as stipulated by the Law on Local Self-Government.

The model was based on three categories of revenue (see Figure 2): own-source revenues, shared taxes, and

Table 1: Subnational government spending/revenue as a share of total government spending/revenue in 2001

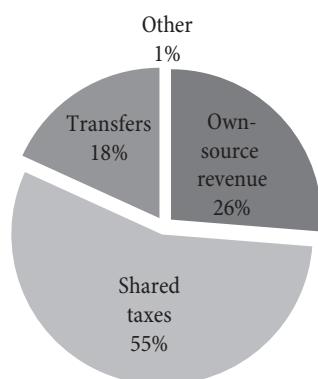
	Spending %	Revenue %
Greece	5.0	3.7
Portugal	12.8	8.3
France	18.6	13.1
Norway	38.8	20.3
United States	40.0	40.4
Denmark	57.8	34.6
OECD Average	32.2	21.9

Source: [2]

transfers (grants). Own-source revenues, for which the rates are determined by LSG (up to a certain upper limit set by respective national level regulation), consisted of: property tax, local administrative tax, environment protection fee and others. Shared revenues included: shared taxes among which the most important is income tax where 40% of collected taxes in the territory of specific LSG was assigned to the local level, as well as shared fees (for cars, the use of mineral resources, materials taken away from water streams, the use of forests and waters, etc.). Total transfers were composed of block transfers of 1.7% of GDP in total, functional transfer (in case of transfer of specific function to local level) and earmarked transfer in a narrow sense (for execution of specific tasks within the original or delegated jurisdiction of a LSG). The overall block transfer splits into transfer for equalization (it is about equalization of per capita revenue based on collected shared taxes), compensation transfer, transition transfer, and general transfer as the most significant transfer in the structure of total block transfer. Once calculated as a difference between total block transfer and its other components, the general transfer was allocated to LSGs in proportion to the number of inhabitants and other criteria regarding specific needs – based on the difference in territory area and different needs in terms of child care, primary and secondary education.

Although there was probably no explicit intention to change the original logic of the model, as the crisis significantly reflected on the fall in total revenues on the local level, first in 2009 and then in 2011 and 2012, its parameters were modified through the amendments to Law from 2006. With these amendments, the LSGs

Figure 2: LSG Budget revenue structure in 2013



Source: [4]

have got a significant rise in shared taxes. Instead of the previous 40%, LSG has received 80% from income tax of employees with residence in specific municipality or city, with the exception of the City of Belgrade, to which 70% of this tax has been assigned.

The other change followed probably because in the described way, the revenues of municipalities and cities were significantly raised due to assigned taxes. By amendments in 2011, the transfers that LSGs receive from the Budget of the Republic of Serbia have been reduced. This reduction has affected transfer for equalization and general transfer.

Transfer reduction has been done through multiplying their amount, which would be obtained in accordance with the Law from 2006 by coefficient 0.5, 0.7, and 1 for LSGs from development groups I – IV (I – the most developed, IV – the least developed municipalities, measured by GDP per capita).

Since the City of Belgrade has received significant additional funds based on the increase in shared part of income tax – despite the fact that 70% of that tax is being assigned to Belgrade, and not 80% – Belgrade had no right to the mentioned transfers. The funds that would appertain to Belgrade through the model for calculation of transfers serve for *solidarity transfer*, introduced also in 2011. 10% of these solidarity funds belong to LSGs from 1st and 2nd group of development, and 30% and 50% to those from 3rd and 4th group. Distribution of solidarity funds that are granted to groups 1st – 4th of LSGs was regulated in 2012, by amendments to Law on Local Self-Government Financing.¹ Distribution of solidarity funds to LSGs has been regulated in a way (in a format of formula) that the funds which shall be granted to 1st – 4th groups shall be split between LSGs from a specific group proportionally to their level of development in relation to the development level of Belgrade. Therefore, “calculation unit” is LSG with its coefficient, which reflects its relative level of development, irrespective of its size measured by the number of inhabitants.

In this way, through previously described changed calculation of transfers – in all three cases by adding to

¹ Later amendments to the Law have not substantially changed the existing model of LSG financing from 2012.

the system parameters that measure a development level, significant distortions occurred, and subsequently to that – illogicalities in the amounts of solidarity transfer per capita in specific LSG, and consequently in the amounts of total revenues per capita of LSG.

The average per capita budget revenues of all four groups of LSGs are quite balanced – but budget revenues per capita within one group are quite dispersed (see Table 2). Extreme discrepancies caused by the changes to the model of financing reflect in the fact that the highest per capita income has the underdeveloped municipality from 4th group, Crna Trava. Or, developed municipality from 1st group with the lowest income per capita in its group has a lower per capita budget income than average LSG revenue in any other development group.

Consequently, described changes in the system of transfers have produced a high dispersion of share of transfer in total revenue (see Table 3), and by that the dispersion of total revenues per capita as well as very illogical outcomes when development category of a specific LSG is concerned. Namely, the share of transfers in budget revenues and receipts varies a lot, both between (on average) and within development groups (dispersion of individual LSG characteristics). Also, it is quite difficult to capture a specific pattern, except that the underdeveloped municipalities are apparently having a higher share of transfers in revenues – or only on average. In these municipalities, the range of shares of transfers in total budget revenue is huge – from 27% to 81%, similarly to developed LSGs, but at the lower general level (from 5.9% to 22.3% for 1st development group, see Table 3).

In addition to the fact that essential logic of the model has been distorted, the model has not been either consistently implemented in the previous period. In fact, since 2009 it has been deviated in practice from

the application of provisions of the Article 37 of the Law, by which the total funds of block transfer are to be determined on 1.7% of GDP, this level being probably set as empirically determined need for financing of specific jurisdiction in the area of basic human rights of LSGs in the first original definition of the model. From that year onwards, less than 1.7% of GDP has been transferred as block transfer, which is a consequence of the model logic disorder due to committed amendments.

In this way, the model, perhaps not as a primary goal of described changes, has received an element of regional development, although it cannot be seen consistently, bearing in mind the transfer dispersion even within specific categories of development. Regional development policy, however, should not use the instruments for LSG financing, its place is not in the model of financing the jurisdictions of LSG. In fact, mechanism for joint equalization, which in described model is envisaged through the transfer, has a role to protect all citizens and to provide them with a minimum of availability and quality of public services which are being guaranteed to them by the Constitution and other relevant laws, irrespective of LSG territory they live in, and in the same way not to discourage a LSG to collect taxes on its territory. The point is not in non-existence of regional development policy, but its review and design are necessary within an adequate development strategy and its implementation through adequate instruments, such as public investments financed by central level. For more details on this, see the fourth section.

In 2015 the Ministry of Finance has established a working group that has prepared a new model of LSG financing. Based on the working text of the draft Law on Local Self-Government that was subject of the public debate at the end of 2015, the intention is to return to the logic of the model from the Law from 2006 by correcting for its

Table 2: Per capita budget revenue in 2013; in RSD

LSG development group	Average	Lowest	Highest
I group (20 LSGs)	32,565	23,881	52,823
II group (34 LSGs)	28,363	19,243	80,080
III group (47 LSGs)	27,110	17,207	41,376
IV group (44 LSGs)	30,843	20,646	82,005

Source: MPALSG and PPS database

Table 3: Transfers as a percentage of total revenues and inflows in 2013

LSG development group	Average %	Lowest %	Highest %
I group (20 LSGs)	13.81	5.9	22.3
II group (34 LSGs)	25.33	9.5	65.9
III group (47 LSGs)	38.38	18.5	66.8
IV group (44 LSGs)	57.86	26.6	81.2

Source: MPALSG and PPS database

logical incoherences arisen from amendments from 2011 and 2012. Additionally, based on simulated effect of the new proposed model, whose summary results have been published in comments on the Draft Law by the Fiscal Council from December 21, 2015, it is obvious that the intention of the Ministry of Finance as an author of the draft law is to transfer the part of fiscal consolidation burden to LSG budgets, in the total amount of RSD 7-8 billion. It is clear that if the proposed solution comes into force, the higher haircut on total revenues will be experienced by less developed LSGs – the ones that experienced the biggest benefits from the amendments in 2011 and 2012.

However, although the forthcoming novelties would enhance the logic of financing model, for a sustainable functioning and development of LSGs it is, however, important to understand the overall system of jurisdiction and LSG financing, as well as all the needs regarding the functioning and development on the one hand, and realistic possibilities, i.e. sources of financing, on the other. In this respect, it is particularly useful to give an overview of the financial position of LSGs and the causes of financial problems of individual LSG under the financing model that is in place.

Analysis of the financial position and the identification of the structural reasons behind the poor financial position of some LSGs

An aggravating circumstance for unbiased overview and understanding of the LSGs' financial position is a lack of detailed and publicly available data. For the purpose of this analysis we will use the data collected by the Ministry of Public Administration and Local Self-Government and the Republic Secretariat for Public Policies from several sources (the Ministry of Finance, Treasury, directly from the local self-government units, and from the Serbian Business Registers Agency for data from financial statements of the public utility companies) for the period 2011-2013. An additional problem for analyzing the financial position of the LSGs is the fact that LSG budgets, i.e. revenues and expenditures are recorded based on cash principle while the outstanding debt (unpaid payables to suppliers) and uncollected receivables do not seem to be recorded in a systematic and consistent manner. The used database with

the revenues and expenditures of individual LSGs during the observed period contains the data on balance sheet liabilities of individual LSGs as of December 31 of each of the three years. However, according to some State Audit Institution reports, it was evidenced that certain LSGs do not record all their liabilities, particularly those towards public enterprises – liabilities for electricity, heating, water supply, etc.², which additionally reduces the quality and credibility of the collected data. By 2013, DRI has audited only limited number of budget reports of LSGs.

General financial position of the LSGs

Local self-government units (LSGs) in Serbia did not have budget deficits in 2012 and 2013 if observed in an aggregate manner. The accumulated surplus of all LSGs in Serbia was RSD 4.94 billion in 2013³. However, this amount of the accumulated surplus is the result of a difference between the total surplus of RSD 6.01 billion and the deficit amount of RSD 1.07 billion in some municipalities and towns. In 2013 32 LSGs out of the 145 analyzed LSGs had a deficit, i.e. 22% of the total number. If observed in several consecutive years, the LSGs do not constantly have a deficit – which usually is the case when a country once has a deficit on a global level; afterwards, it takes a rather long period to reduce or eliminate a budget deficit by implementing relevant policies. As for the Serbian LSGs, they have “incidental” deficits – only six municipalities that had a deficit in 2013 also had it in 2012 – while other 22 municipalities had a deficit in 2012 when a total number of 28 LSGs had deficits. Both deficits and surpluses of the LSGs had specific meanings – an excess of funds, i.e. a surplus, represents unspent funds allocated for a current year, and it is often envisaged for a certain purpose in the following year in order to avoid a future deficit⁴. On the other

2 According to [5], during the audit of the 2012 final account of the Municipality of Smederevska Palanka, the State Audit Institution (SAI) found out that more than RSD 800 million of liabilities towards suppliers were not recorded (which was recorded subsequently to SAI mission). The same authors highlight that the SAI has reported their evidence that balance sheets do not often reflect realistic data about assets and liabilities.

3 The fact that the majority of data used in the analysis are from 2013, as the most recent available data, should not affect the conclusions and recommendations of the analysis since the main subject of the analysis – the model of jurisdictions and financing has not been modified since.

4 Sremska Mitrovica had a budget deficit in 2013 whereas in 2014 it had a budget surplus of RSD 46.7 million. Furthermore, Sremska Mitrovica did not have long-term debts in 2013 – but in 2015 it borrowed RSD 611.5 million, which it combined with a 2014 surplus amount of RSD 46.7 million for the purpose of funding the construction of infrastructure buildings.

hand, given the fact that the revenues and expenditures are recorded under the cash basis, thus the deficit too, the amount of a deficit is limited by the surplus carried over from the previous year or by borrowing capacity on the financial market or from banks, which is regulated under the Public Debt Law (“Official Gazette of the RS”, No. 61/2005, 107/2009 and 78/2011) and is earmarked for funding capital investments.

In relation to the aforementioned, long-term liabilities of the LSGs, which are mainly related to borrowing from financial institutions and by means of issuing municipal bonds (which is the case in only a few LSGs), are transparent and are not worryingly big.

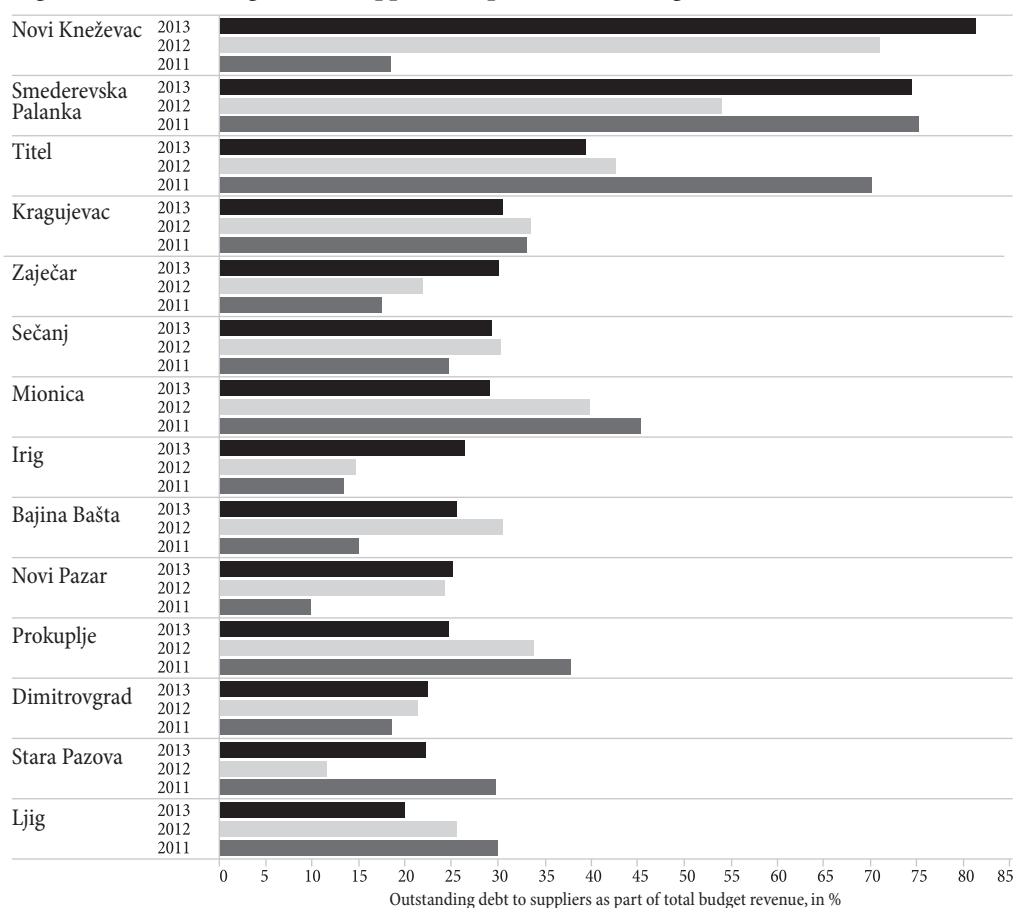
However, an insight into the amount of the outstanding debt to the suppliers (which includes unpaid bills for electricity, heating, utilities, etc.) provides more information about the financial position of the LSGs. In case the amount of the outstanding debt is higher than the amount of available current revenues of the LSGs, it is accumulated

and gradually becomes a burden on the LSG budget and is further carried over to insolvency of business entities.

The debt to suppliers is not that high on average. However, in approximately 10% of all LSGs outstanding debts to suppliers are 20% of the total revenues and higher (see Figure 3), in some cases even 80%, representing a significant burden on the overall budget. What is more problematic is accrued liabilities that are carried over year in year out since it is obviously impossible to discharge them from the current revenues in the following year. Such debts of the LSGs certainly generate consequential insolvency of the relevant companies/suppliers.

Another relevant characteristic of the LSGs’ financial position is a high share of subsidies in total expenditures at approximately 15% on aggregate level, out of which the largest part (12% of the total expenditures) refers to the subsidies granted to local public utilities. Combining the data about the absolute amount of the subsidies from the budgets of certain LSGs and the data about “other revenues”

Figure 3: Outstanding debt to suppliers as part of total budget revenue of LSG, 2011-2013



Source: MPALSG and PPS database

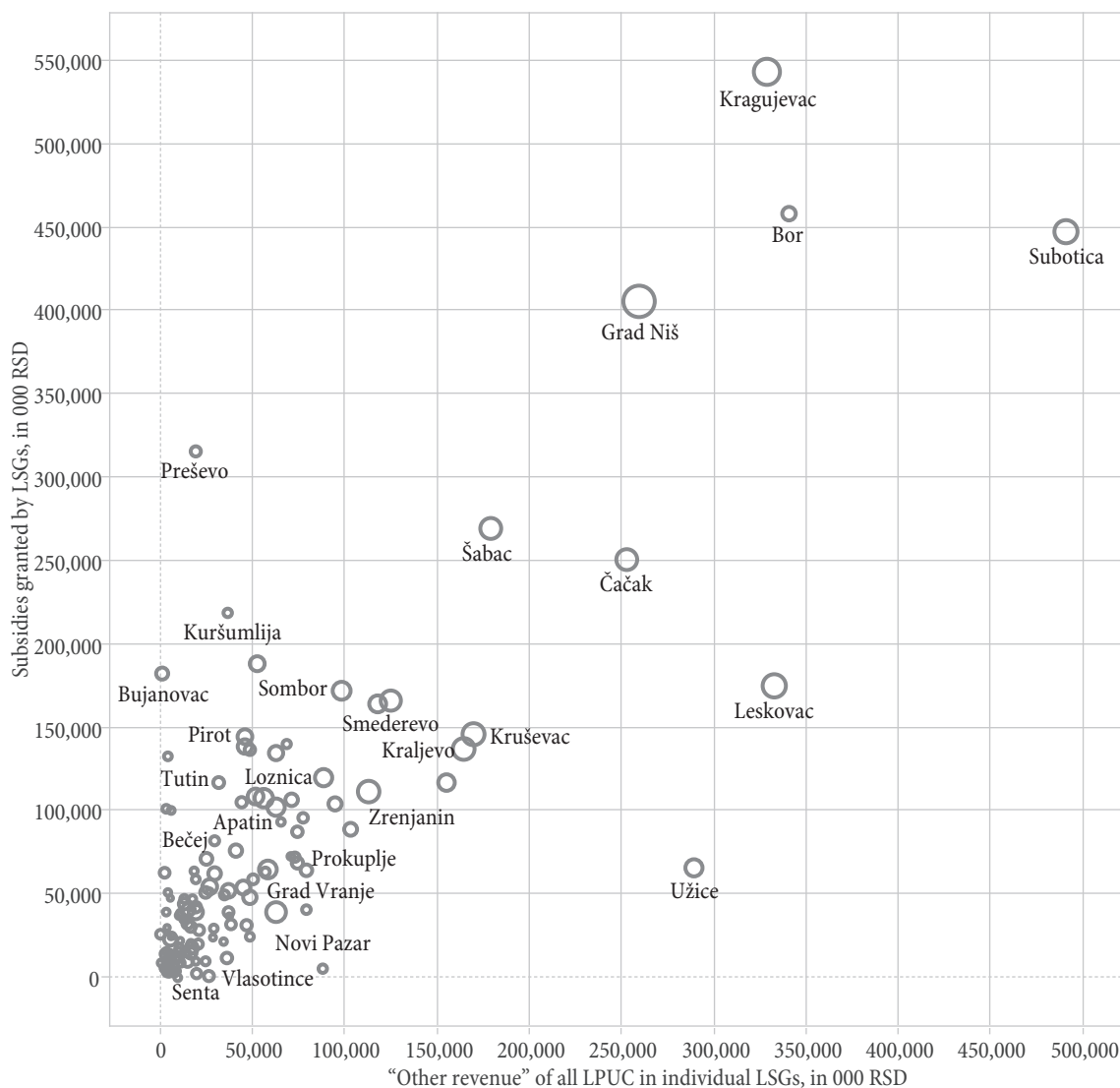
of the public utilities (the position from the profit and loss account of individual public utilities which records the revenues from the received subsidies) on an aggregate level for all public utilities in an individual LSG (see Figure 4), it can be clearly seen that subsidies granted by LSGs are largely directed to public utilities.

In relation to the abovementioned, although a further analysis of statistical significance of another finding is needed to make such a conclusion – it appears that those LSGs whose revenues are burdened with the subsidies granted to the local public utilities have the relatively largest outstanding debt to the suppliers, measured using a ratio between the debt to the suppliers and total revenue of an individual LSG (see Figure 5).

Additionally, capital expenditures, which are particularly relevant from the point of view of LSG development, when observed during five consecutive years from 2009 to 2013, their proportion in the total expenditures of the LSGs declines to the level of 16% (see Figure 6). Given the volatility of the share of those expenditures, they seem to have been rather set as a “residual” of the available funds than according to the needs for capital investments.

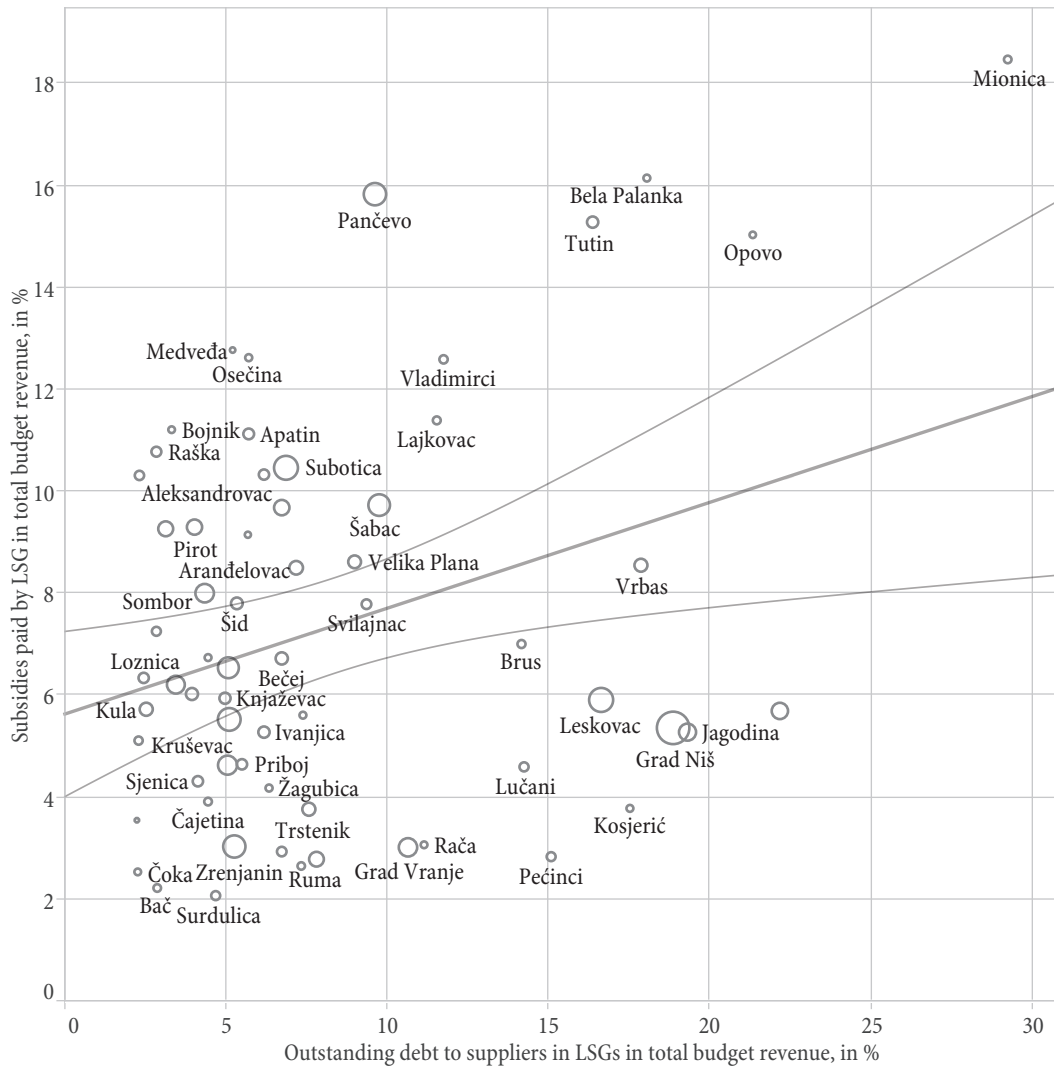
When we observe the revenue side of the LSGs budget, we can conclude that cities and municipalities do not collect own-source revenues proportionately to their economic strength, which might be the result of their significant reliance on the transfers in the overall revenue structure. Roughly measured by gross per capita

Figure 4: Subsidies granted by LSGs and “Other revenue” of all LPUC in individual LSGs in 2013*



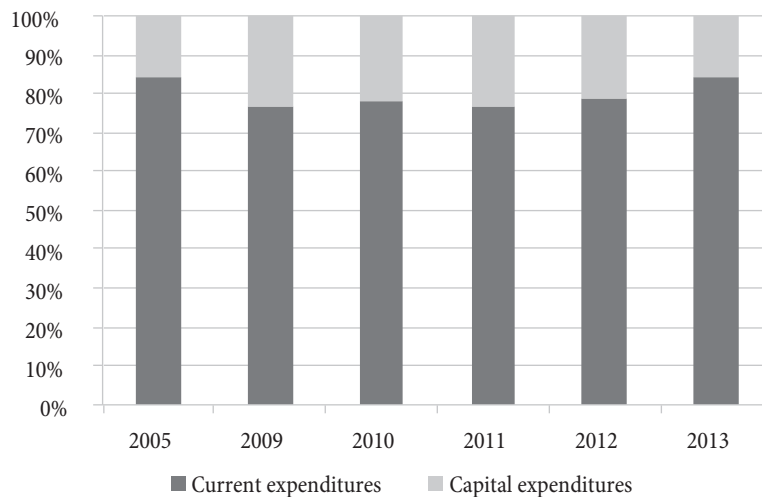
Source: MPALSG and PPS database; *Note: the size of the circle corresponds to number of inhabitants

Figure 5: Subsidies and outstanding debt to suppliers in LSGs in 2013*



Source: MPALSG and PPS database, *Notes: the outliers are excluded from the dataset; the size of the circle corresponds to the number of inhabitants

Figure 6: Current and capital expenditures of LSGs, in % of total



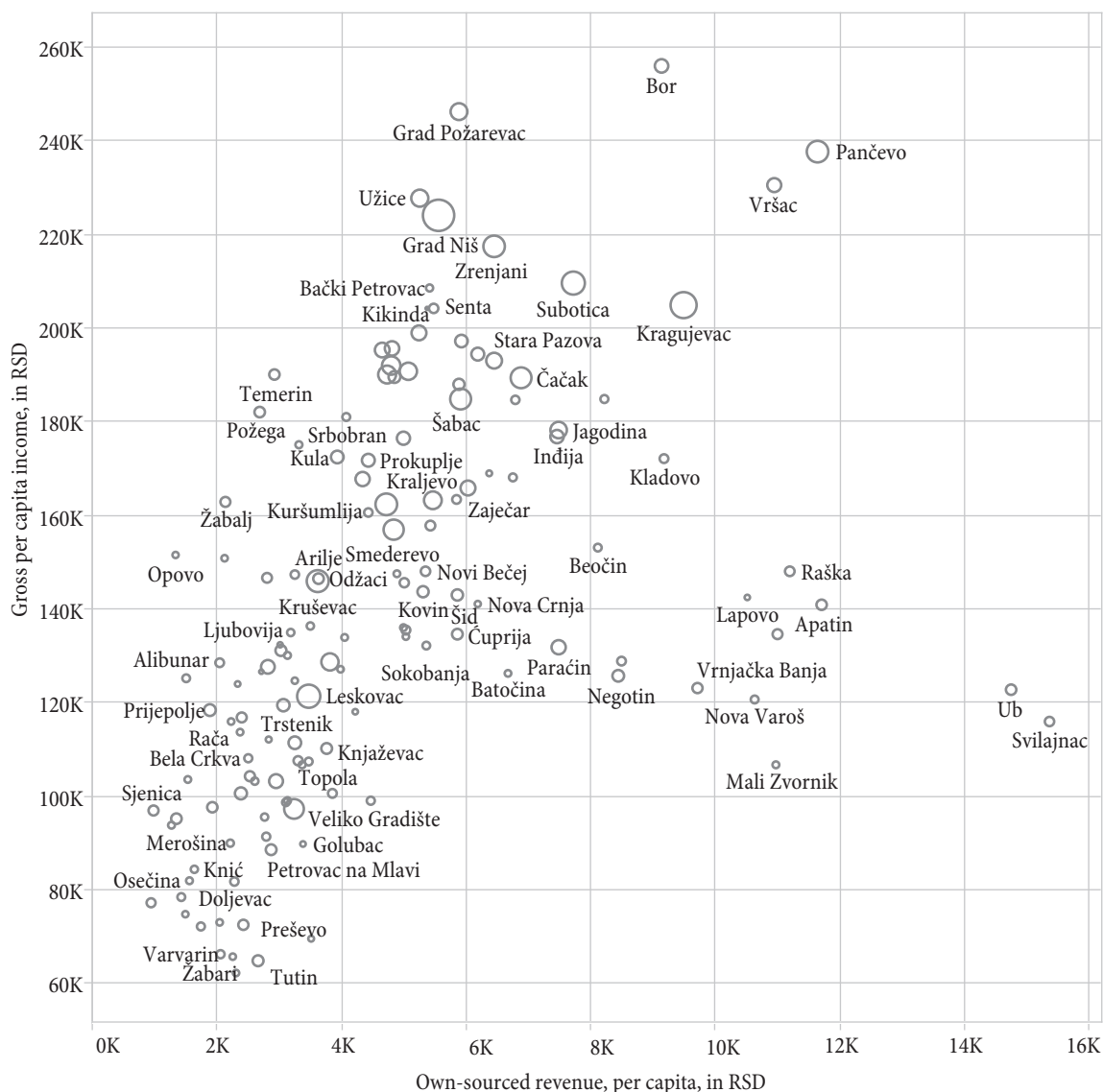
Source: [4].

income, many, relatively developed LSGs generate rather small own-source revenue per capita (see Figure 7): e.g. the city of Niš, Užice, Požarevac, etc.

In addition to the aforementioned, it should be noted here that there is significant room to improve the LSGs' management efficiency. Namely, the fact that a surplus was generated in those municipalities where there is a need for a larger scope and better quality of public services given they are of a lower level of social development (see Figure 8) indicates that there are difficulties in developing and implementing specific programs and projects. Furthermore, the conclusions of an empirical research of the authors *Radulović & Dragutinović* [6] also point to significant room

to improve efficiency of a large number of LSGs. According to an efficiency analysis using the SFA (Stochastic frontier analysis) method, which boils down to the comparison of the ratio between inputs (budget expenditures) and outputs (measured using indicators of the scope and quality of the provided services) for individual LSGs, these authors measured that an “average” LSG in Serbia generates an output at 23% bigger costs than the “best” LSGs in terms of the ratio between the inputs and outputs. Moreover, when analyzing the efficiency of managing revenues and expenditures of the LSGs, the aggravating circumstance of uncertainty about revenues and liabilities (competences) should be taken into consideration bearing in mind

Figure 7: Fiscal effort in collecting own-source revenues*



Source: MPALSG and PPS database, *Note: the size of the circle corresponds to number of inhabitants

frequent changes in the previous period (described in the first section), which alone aggravates a planned approach and makes it difficult for the management itself to be independent of management capacities.

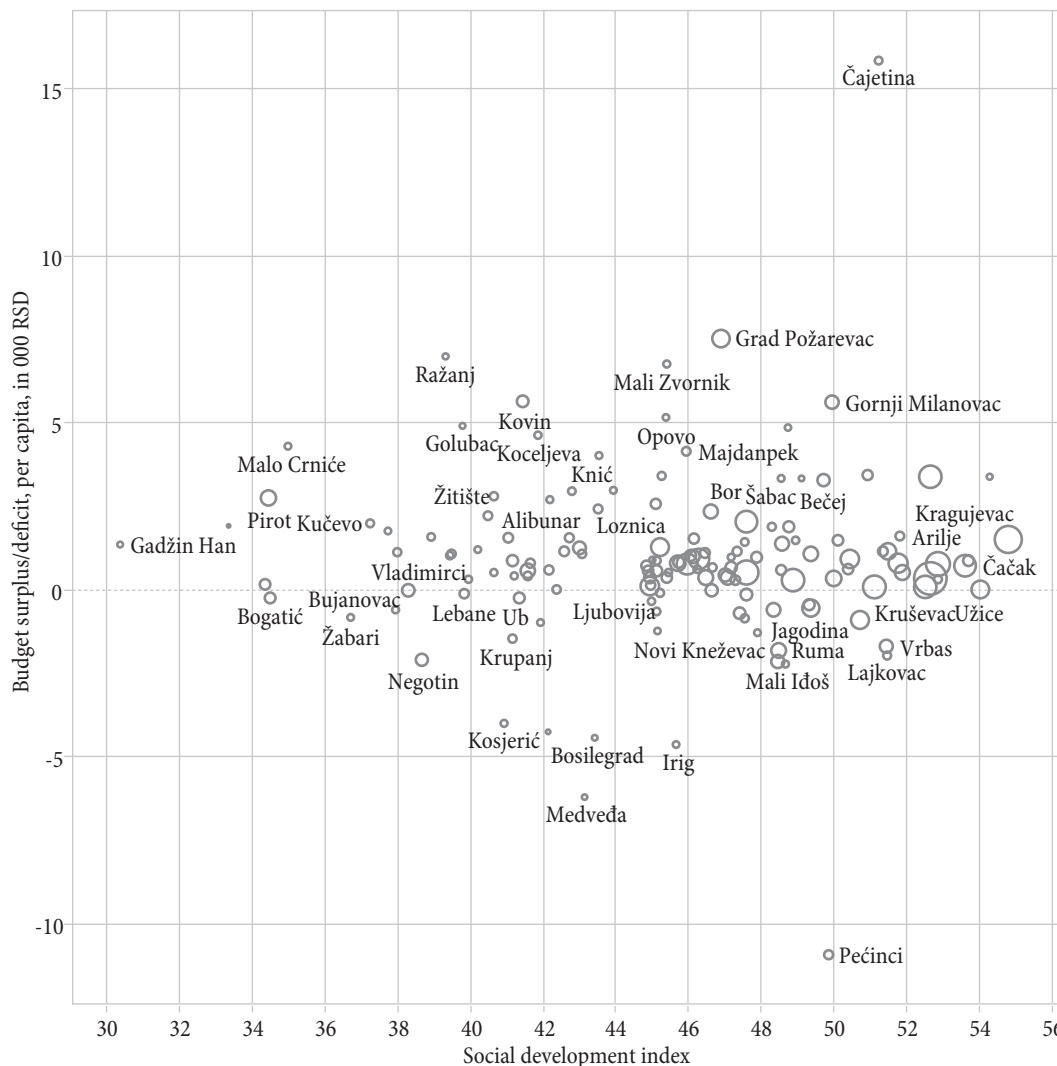
The causes of poor financial performance of LPUC
 Almost all local public utility companies (LPUC) in Serbia, which are owned by cities and municipalities, have monopoly position. And these are not so called natural monopolies operating in sectors where it would be irrational to have more market players (water supply and waste water management, railroad and trolley traffic or long distance heating), but existing LPUCs in all public

services and utilities are the sole providers of respective services on the territory of a LSG.

Above stated fact suggests that all PCUs always have the market secured, i.e. guaranteed sale of their products and services. Therefore, it can be concluded that when a LPUC generates operating loss, that loss is not the result of decreasing demand but can only be the result of (a) low sales prices and/or (b) high operating expenses.

(a) Determination of prices of public service and utilities is within the jurisdiction of the owners of LPUC, i.e. LSGs themselves – and not the market. For decades authorities in almost all LSGs have been trying not to increase the prices of public services and utilities – both

Figure 8: Budget execution and level of economic development*



Source: MPALSG and PPS Database; SIPRU; *Note: the size of the circle corresponds to number of inhabitants
 *Social Development Index has been developed by the Social Inclusion and Poverty Reduction Unit (SIPRU). In order to optimally capture all determinants of social development, i.e. the quality of life in LSGs, the Index includes 41 indicators in nine areas: demography, economic activity, education, social welfare, housing conditions, social participation and vulnerable groups and human rights.

when low prices were inherited by the previous local government or when prices should be increased due to increasing price of inputs, or inflation. This is the first cause of losses generated by large number of LPUCs.

(b) High (unjustifiable) operating expenses can be the consequence of changes in the management of LPUCs after each change in local governments, sometimes even more often than once in four years. Each optimization of LPUC's expenses directly tackles the interests of the employees, either through downsizing with an aim to decrease labor costs, or by insisting that in their work employees take care of other operating expenses. There is always the resistance of employees in implementation of each of the two measures aimed at enhancing productivity and profitability, which often results in management giving up on any measures. As an alternative, the management is more willing to ask for increase in prices for LPUCs – when they hit the second barrier listed under (a). It also sometimes occurs that the director of certain LPUC manages to significantly reduce employee expenses and other operating expenses during his mandate, and that the following director gradually returns to previous state. (The procedure of the selection of LPUC directors envisaged by the new Law on Public Companies (“Official Gazette of RS”, No. 119/2012, 116/2013 – authentic interpretation and 44/2014) in principle promised changes in this area. However, even in that new procedure – application, submission of program of operations etc., in most of the cases same directors were re-elected.)

Apart from the two most important reasons behind poor performance and indebtedness of the LPUC as mentioned above under (a) and (b), an objective reason should be also taken into consideration, under (c). Namely, providing of public services and utilities, and LPUCs who provide them, date back to few decades ago. Current level of development of Serbia, measured by GDP per capita, is at some 70% of its level from few decades ago. Additionally, social changes occurred since then, due to which the standard of living worsened as much as 30% for some citizens. Due to this fact some categories of citizens, significant in numbers, who could previously afford to pay full economic price of utilities, cannot afford to do so now.

The LPUCs compensate their disproportionately big expenditures, i.e. a lack of operating income, with subsidies (recorded under the “Other revenues” item in the Profit and Loss Account) that they receive from the LSGs, as illustrated in Figure 9. In that way, their negative operating income, in case of a loss, is inducing a higher expenditures in a particular municipality or city.

Some issues in financing of local institutions (LIs)

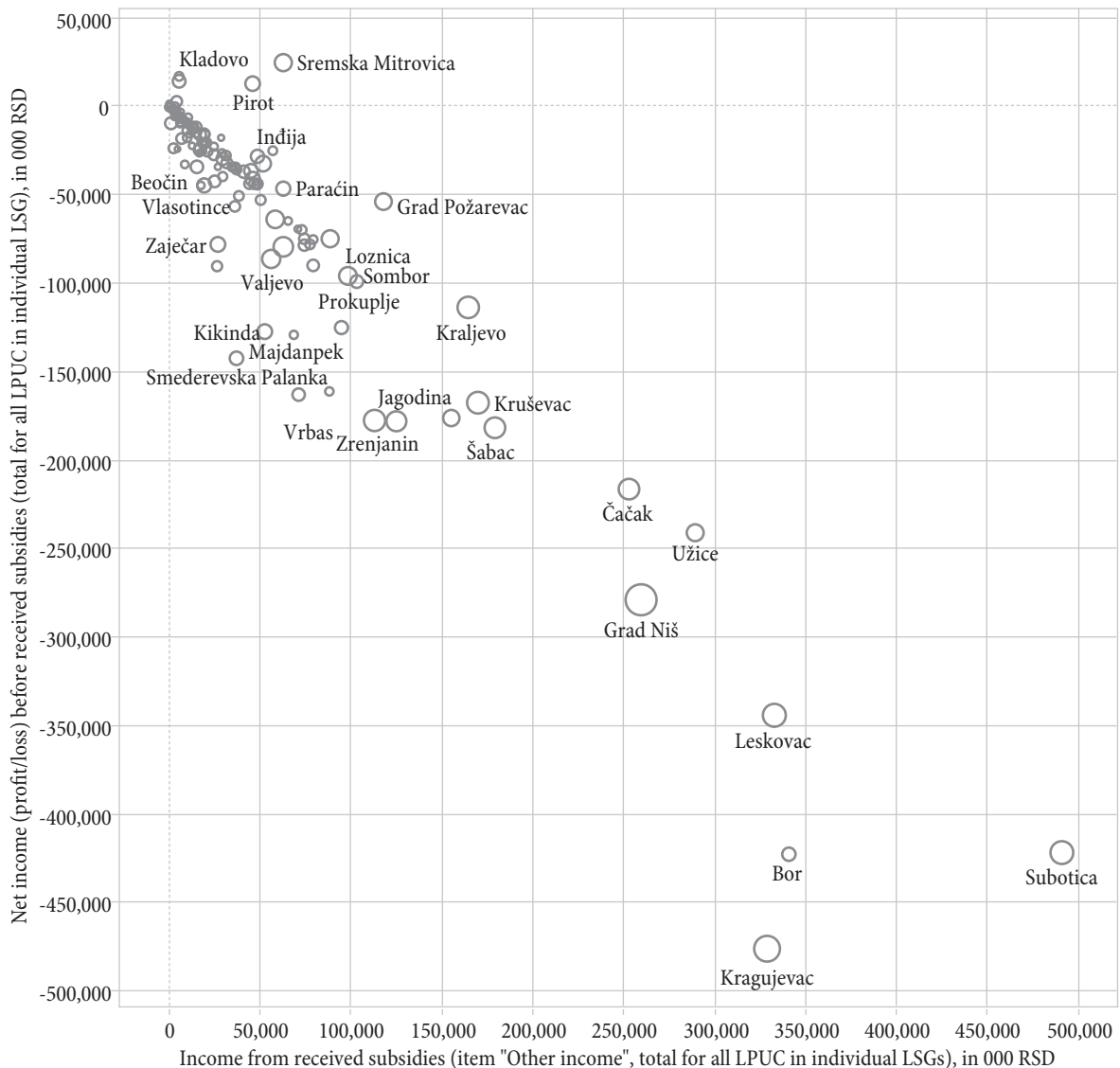
As described in the first section, LSGs are exercising several important competences in the field of basic human rights guaranteed by the Constitution in the field of education, social protection, culture, sports and recreation, health and protection against natural disasters, through the local institutions that they founded. About 31% of the total expenditures were used in practice in the previous period to exercise these functions, according to the evidence based on LSG expenditures breakdown by functional classification (see Figure 10).

Although we do not dispose with detailed financial data on operations of individual institutions for this analysis, for the sake of an integral approach in formulating recommendations in the third and fourth section, it is important to point out here a few facts typical for operations of local institutions and consider them in the model of LSG funding.

First of all, the functions of LIs are in the field of public policy, defined by its nature at the central government level, through strategies and programs for development of education, health, culture, social policy and policy of reduction of risk of catastrophes caused by natural disasters. Not all of these public policies are clearly defined through corresponding documents in Serbia, and even where the document do exist, the clear mandate of the part of the system which is under the competence of LSGs is not always defined comprehensively, as well as its objectives and direction for development.

In relation to the aforementioned, the system of financing of LIs is not clearly defined either. The LIs are mostly funded through transfers and grants by LSGs. However, some LIs, depending on the nature of their activities, have their own revenues or at least they are in the position to generate them (through provision of

Figure 9: Net income (profit/loss) before received subsidies (total for all LPUC in individual LSG) and income from received subsidies, 2013*

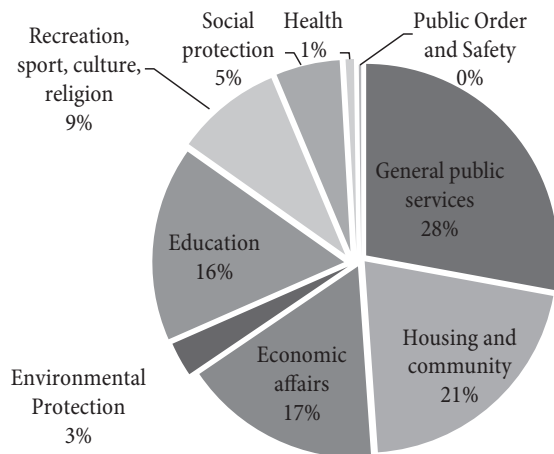


Source: MPALSG and PPS database; *Note: the size of the circle corresponds to number of inhabitants

services, renting of property, participation in projects, etc.) Still, the policy is not clear in those situations either – which is the desired extent to which a LI should strive to generate their own revenues and how much flexibility that approach offers them in order to stay motivated to be competitive and possibly reduce the burden for the state budget.

Besides all these challenges, regulations and reforms that apply to public administration in a narrow sense (the operations of which are mostly administrative in nature), frequently apply to LIs as well, although their operations are far more specific. The last is largely limiting their flexibility in terms of creating more of their own income. On the other

Figure 10: Functional breakdown of LSGs expenditures, 2013



Source: [4]

hand, a precondition to sustain a decentralized approach in the field of public policies of national significance, is to establish mechanisms for the result-based management in the context of a broader national policy in each of the concerned policy areas. These governance mechanisms are at a same time flexible and with appropriate elements for supervision and coordination.

All the above stated indicates that there should be a funding system which is adjusted to nature of operations and specificities of LIs.

Recommendations regarding financing of sustainable operations and development of LSGs

The concept of integral model of funding of LSGs that takes into account sustainability and development Based on the presented features of the present model of funding of LSGs, as well as the financial aspect of functioning of the whole system of institutions exercising decentralized competences, a funding model providing appropriate sources for all the competences, both for current functioning and the development needs, should be established.

Within the proposed model, presented in Figure 11, system (of sources) of funding of LSGs should be established on the basis of the following three revenue categories:

- (1) Permanent own revenues (own-source and shared taxes, including a mechanism of mutualized equalization)
- (2) Sector-specific transfers (block / non-earmarked grants)
- (3) Earmarked – project transfers

Permanent own revenues (1) would include all the sources of revenue that LSGs may permanently count on, regardless of the level of authority at which they are administered and set, meaning that they would include all types of the existing “own-source revenues” and all types of the existing “shared taxes”.

Sector-specific transfers (2) would be non-earmarked (block transfers)⁵, as the transferred funds would be used by LSGs to perform functions in certain sectors of public policy, particularly the ones of a broader social importance,

⁵ This is in line with the European Charter on Local Self-Government (1985)

and they would freely dispose of the actual funds, within the given framework. These sector-specific mandated consuming about 31% of total expenditure, as presented in the second section, are: Public order and security, Health, Recreation, Sports, culture and religion, Education and Social protection, and this should correspond to the percentage share of this type of transfers in revenues. Corresponding relative level to such percentage share was stipulated by the Law of 2006, as 1.7% of GDP. However, it has not been applied in practice. The procedure for implementation of the new system of funding of LSGs would naturally consist of periodical identification of needs of every LSG (or corresponding LIs) for funding of the listed 5 functions according to corresponding characteristics of municipalities and towns (population, area, etc. – like the method for allocation of the general transfer in the Law from 2012). In such a designed model, unlike in the one currently in force, there would be no risk for the local institutions (LIs) to stay short of necessary funds for provision of their functioning and required for meeting the defined objectives of a corresponding public policy. In such a way, an equal treatment of citizens in meeting the basic needs would be provided.

The remaining 70% of revenue would be used by LSGs for exercising all other functions/jurisdictions in line with available resources, except for the functions in the field of utility services provided through LPUC, as described in the first section. This means that it would be sufficient to share about 50% of collected income taxes between the central to the local level, relying on the registered income structure in the observed period (2012, 2013).

Generally speaking, the above drafted system of LSG financing would be stimulating for LSGs, as they would tend to maximize permanent own revenues that are not earmarked. At the same time, the transfers that LSGs would receive would be allocated for providing public service in certain sectors, in which the rights are guaranteed by the Constitution, and LSGs would freely use total amounts of these transfers within the given sectors.

Considering LPUCs, revenues for current operations should be provided on the market, i.e. by charging for services. As elaborated in the first chapter of the section two, almost all LPUCs in all LSGs are monopolies – and

not only natural monopolies but monopolies in the sense that LPUCs are the sole providers of utility services within LSGs. Such monopolies should have prices prescribed in a way that they *allow* LPUCs to generate revenues sufficient to cover: (1) *justifiable* operating expenses, (2) depreciation charges and (3) adequate return on assets. Regulated/approved *price is, by definition, determined by dividing approved annual revenues by annually provided/sold services/goods.*⁶

Justifiable operating expenses include 1) cost of material, fuel and energy, 2) costs of salaries and other employee related expenses, 3) cost of production services, 4) transportation expenses, 5) maintenance expenses etc. Those expenses, which LPUCs should document and justify, should be verified by the regulator of the prices, where one of the best verification approaches is benchmarking to the expenses of other comparable local utility companies, both in the country and in the region (*benchmarking*).

Other elements of approved revenues, OP, and consequently approved prices of products/services – depreciation charges and return on employed assets – are relatively straightforward to determine. However, in order to determine justifiable depreciation charges updated valuation of assets used by LPUC needs to be available. Given that recent valuations are not available in majority of LPUCs, asset valuations would need to be performed. Finally, the third product/service price component, i.e. return on employed assets that would be allowed to be generated by LPUC could be easily determined in professional and technical senses, but the magnitude of the return could also be the policy issue.

In order to finally introduce LPUCs into the regime of standard business operations – for which all conditions are currently met (because such companies received

⁶ Approved revenues are calculated according to the following formula:

$$OPT = OOTt + TAt + ASt \times sAS \quad (1)$$

where:

t – regulatory period,

OPt – approved revenue from providing specific utility services during regulatory period,

OOTt – justifiable operating expenses related to conducting specific utility services during regulatory period,

TAt – depreciation charge for assets employed in conducting specific utility services during regulatory period,

ASt – assets employed in conducting specific utility services during regulatory period,

sAS – return on employed assets (%).

their assets and are incorporated) – and in order to allow LSGs only narrow space for deviation from economic principles in their policies relating to LPUCs, it would be useful to determine an appropriate institution with a required expertise to be responsible for approving the prices for all LPUCs, through application of previously described model.

The same applies to LIs, where the fact that LSGs would receive funds through *sector-specific transfer* for their financing would secure their liquidity.

As presented in Figure 11, the overall development, in all the fields of LSGs, should be funded by:

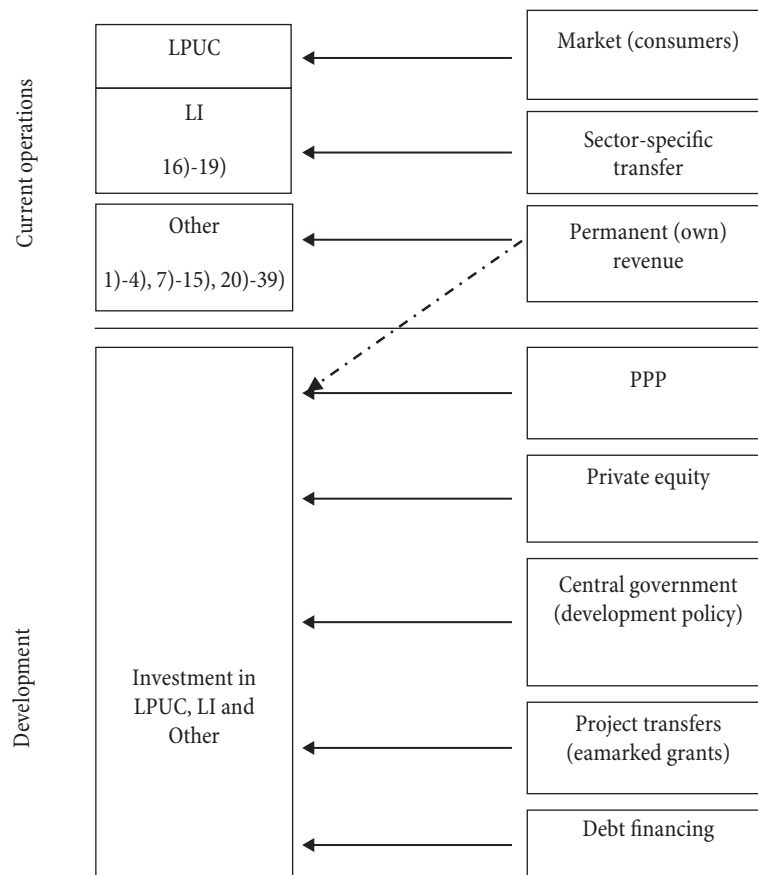
- (1) Available LSG funds, or the surplus after the current expenditures are covered,
- (2) Public Private Partnership agreements (PPP),
- (3) Independent investments of private capital,
- (4) Investments by the Republic, in the form of co-financing of projects (earmarked/project transfers) with LSGs, or independently, through investments in the context of regional development policy,
- (5) Issuing debt by LSGs.

Related to the source of funds (3) one should keep in mind that the Law on utilities allows that utility services are performed by private companies as well, with the exception that in natural monopolies (waterworks, trolley traffic) the utility company cannot be majority owned by the private capital.

Capital investments, or investments in development, would be funded by the LSG budget (1) only when the LSG generates a current budget surplus, and by borrowing (5), only in exceptional cases. LSGs that generate a surplus in current budget (current expenditure for LIs and LPUCs excluded), could be offered a stimulating co-funding grant for using the surplus for financing capital investment project, in a certain percentage of total investment. In such a way, LSGs would have incentive to generate a surplus of own-source revenue over the (above defined) current expenditures. As a result, the proposed new system of LSG financing would enable balanced and sustainable public finances on the local level of government.

Apart from investing the surplus of own funds, development in LSGs should be funded by Public Private Partnerships (PPP) and independent investments of private

Figure 11: Schematic presentation of the new model of LSG financing



capital, far more than it has been funded so far. Finally, development of infrastructure and all other investments aimed at attracting investors to local economy, particularly in underdeveloped LSGs, should be funded through projects funded from the central level under the regional development policy (earmarked / project transfers).

Application of PPPs as a means of financing development of LSGs needs to be further elaborated. This manner of financing is regulated by the Law on public private partnerships and concessions (“Official Gazette RS”, No. 88/2011), and similar laws before the current one was adopted. However, completed PPP projects are very rare in Serbia and represent insignificant portion of total financing. The conclusion that can be derived based on the analysis of mandatory procedure for finalizing PPP contract in line with the law, and based on many cases where interest of both public and private investors existed but the projects were never formalized, is that procedure is long and complex. In addition, there is *no single state*

institution which would service the partners in preparation and realization of PPPs until contract is signed.

The procedure is long because, in line with the Law, a number of subjects are involved in the process until the PPP contract is signed, where those subjects review documents relevant for PPP project two times – the first time they review “proposed PPP project”, and second time they review draft PPP contract. The most important document for PPP project is “project proposal”, which in essence needs to be a good *feasibility* study. It would be sufficient that such a study – the preparation of which can be organized by public partner, while the Law allows the private partner to do so as well – is analyzed by the competent team of experts, so that selection of private partner can be initiated through public procurement process. After this, contract would be negotiated and signed with the selected private partner, which in majority of cases could be straightforward incorporation agreement with two stakeholders – public and private one. This would shorten and simplify the whole procedure.

In the proposed, simplified procedure for PPP (requiring change in the Law) all the tasks related to organizing drafting of “project/study proposal”, preparation of a public call for selection of a private partner and organizing the conclusion of agreement with that partner – should *be performed by a single government institution* with an appropriate level of competence. It would be sufficient that public and potential private partner apply to the institution with the PPP idea. The institution would then perform all activities until signing of the PPP contract – similar to activities of the Privatization agency.

With affirmation of PPPs in the utility business, this form of investment may be spread to the activities of LIs. There may be a private partner, upon obtaining for example land as LSG share in a joint PPP enterprise, to construct a sports facility, facility for culture, kindergarten, etc., and lease that kind of facility to a LI. PPP arrangements in this area are also possible in a way that a private partner builds a facility, transfers it to a LI, and a LSG repays for the facility over a long-term; in these cases, a PPP actually means lending to a LSG, which is usually the only way to have a facility constructed at all.

In the above described manner, all 39 functions/competences of LSGs could be appropriately and sustainably funded within the new funding model, in the manner presented in Figure 11. This means that in the future, the system would not generate deficits from current operations of LSGs by induced debt generation from failure to regularly pay to suppliers.

Concluding remarks

In considering the optimal model of financing of LSGs, it is necessary to distinguish between the consideration of this topic in the strict sense and of several parallel topics in the field of other public policies that are associated with the financing of LSGs but should not have the effect on the concept of the model itself. At the same time, the model should form a logical whole but should also be flexible to allow the implementation of other policies without disrupting the performance of basic functions, i.e. local self-governments’ provision of public services and access to rights to citizens and economic operators. The related

topics include fiscal consolidation, policies to improve the business environment (business conditions), regional development policy, social policy, public administration reform, including several major topics in the field of public financial management reforms.

Fiscal consolidation has been a dominant macroeconomic policy since 2013, when after several years of alleviating the effects of the crisis through fiscal expansion, Serbia’s public debt rose to about 70% of GDP and its fiscal deficit to almost 6.8% of GDP. The necessary savings in public spending are achieved through a series of measures, primarily by reducing expenditures. In these circumstances, it is normal that a part of the burden of fiscal consolidation is transferred to LSGs by cutting their budgets. However, these savings should not be achieved by introducing distortions in the system of financing but by making necessary adjustments to the lower level of expenditures through: (a) reducing the scope and quality of services provided by LSGs in accordance with the priorities (i.e. reducing first the services that are not on the list of basic human rights), and (b) improving the efficiency of LSGs, which would mean better/more efficient use of available budget.

The policy of improving the business environment is necessary in Serbia, where economic operators and citizens are still burdened with numerous complicated and unnecessary procedures that incur a specific transaction cost expressed through unnecessary spent time and various charges related to these procedures. In the context of improving the business environment, a lot of effective measures were introduced in the past period, such as regulatory guillotine, introduction of electronic tax payment, one-stop shop for business registration (APR) and other. However, some initiatives for the improvement of business environment resulted in the abolition of fees or charges for the services actually provided by the public sector or for the use of public resources. These reckless measures have led to the erosion of financing models. Thus the model loses its economic logic and in the long run compromises the public interest since there are no adequate sources or level of financing for performing the functions of public interest. For example the fee on overutilization of local roads and water charges has been abolished. For the above-described reasons, we should not confuse the policy

of improving the business environment, where attention is paid primarily to the simplicity of procedures and the number of individual payments and related transaction costs, with the model of financing that requires that the appropriate scope and quality of public services should be adequately financed, which means that it is impossible to avoid the related expenses paid by an economic operator or citizen, but it is possible to maximally simplify the procedure of payment.

By regulating the fee system in the economically consistent manner, it is possible to mobilize additional sources of LSG revenues - their coverage and level. Regardless of the logic of presented model, there are many cases in the existing legal framework where the use of public goods is either not charged or not charged sufficiently (for example water charges).

Serbia still lacks a consistent policy on regional development in terms of clear objectives, strategies and appropriate instruments. The 2010 Law on Regional Development defines the instruments i.e. measures and incentives and their sources of funding. In general, the regional development is financed mainly through the projects at the level of central government (partly through international development assistance). In accordance with this setting, there is no need to have the elements of regional development in the part of the model related to the current operation. This model, however, should include an income equalization mechanism to protect all citizens.

In the context of LSG financing, social policy comes to the forefront particularly in the field of billing LPUC services. In fact, due to the still unresolved centralization of information on social assistance by beneficiary, the social policy is often reflected in lower than justified prices of utility services or in tolerating the non-payment of utility service bills. This undermines the sustainability of LPUCs' business operations and their management of economic resources and operations.⁷ It is true that certain categories of citizens/households are unable to pay the full "justified" price of utility products/services. This, however, does not mean that these prices should be

kept below the *justified* level. This approach to the prices of LPUC products/services results, among other things, in subsidizing also the richest citizens/households (of which has been written for decades in Serbia) – while on the other hand, LSGs must subsidize LPUCs from their budgets. The approach should be reversed - socially vulnerable citizens/households should be subsidized to be able to pay the *justified* price of utility products/services, thus avoiding the need to subsidize LPUCs.

Furthermore, the public administration reform envisages significant efforts to improve the management capacity and professionalization of administration, which is an important factor for improving the efficiency of LSGs, i.e. for achieving a better performance while using the same resources as a result of better planning, management, financial decisions, coordination etc. This process is important for improving the coordination of central and local governments, as well as for improving governance and consequently the financial situation at the local level through strengthening human resources, processes, mechanisms and instruments of governance.

Within the broader context of public administration reform, the Public Funds Management Reform Programme is of particular importance, along with all the measures to be implemented in that context.

The Law on Deadlines for the Settlement of Financial Liabilities, as amended in 2015, provides for recording the outstanding financial liabilities in commercial transactions of all direct and indirect budget users in the system of the Ministry of Finance, Treasury Administration (*RINO* system). It is an important step towards correcting deficiencies in the cash budget accounting where expenditures are recorded only at the time of payment rather than when incurred. Further reform in this area should go towards introducing the accrual accounting system in public finances. In addition, the official forms for balance sheet reports of budget users are not methodologically consistent so that there is room for significant improvement of the Rulebook on preparation, assembly and submitting of financial reports of the users of budgetary funds ("Official Gazette of RS", No. 18/2015), in this regard.

Further, in order to encourage LSGs to improve the quality of life and business environment, it is important

⁷ Write-offs of uncollectible receivables are additionally discouraging for those individuals/entities who are regular payers and create the effect of moral hazard.

to have publicly available database including indicators on financing (inputs) and performance of local authorities, local institutions and utility companies (outputs and outcomes). By publishing comparative data, individual LSGs are encouraged to reduce local tax burden, to ensure a better business environment, which means that they are able to operate in a more efficient way. This approach strengthens the role of citizens and their oversight over the operations and results of local administration.

For the purpose of settling the debts of LSGs who have found themselves in an unsustainable financial situation, which has not been systematically regulated, a special law could be drafted and adopted, whose (working) title could be the “Law on Financial Adjustment of Local Self-governments”. A similar law was passed in Hungary, and although it was not applied very often, it proved to be useful, at least because it influenced the municipal authorities to be prudent in spending budget funds. This is because they lose financial autonomy in case of bankruptcy (the bankruptcy trustee represents them for the duration of bankruptcy procedure), and particularly because the initiation of bankruptcy procedure means that the current local government loses its political reputation. In case of Serbia, such a law would not have to provide for a bankruptcy procedure for the LSGs that are unable to settle their obligations and it would be enough to prescribe a debt regulating procedure (out of court?) that would be similar (in everything else) to the existing procedure of preparation, adoption and implementation of a pre-pack reorganization plan. The procedure of such LSG debt settling would have the same positive effects as the above-mentioned pre-pack reorganization plans when applied to indebted LPUCs (immediately, as this is legally possible). An additional advantage of legally regulating a “pre-pack reorganization plan” applicable to LSGs would be (similar to enabling bankruptcy of LSGs in Hungary) that mere existence of such a law and the announcement of the initiation of “financial adjustment” procedure, etc. would discourage local authorities in excessive spending of budget funds. A positive effect could also be expected in the sense that the possible application of this law would stimulate the local government to maximize the use of

the fiscal potential of municipality/city in order to collect as much revenues as possible.

Finally, the new decentralization strategy is being considered for the forthcoming period. Being essentially a political decision, the issues of decentralization of government and fiscal decentralization are beyond the scope of this paper, even though it has certain impact on financing. Whatever be the policy in this area, regardless of the degree of decentralization, the idea of this paper is to highlight that also at the current level of decentralization, the system of decentralized government has two (currently non-existing) characteristics, important for achieving the efficient functioning of the system as a whole. Firstly, it is important to institutionalize and strengthen the mechanisms for coordination between the central and local governments in the adoption and implementation of public policies and regulations. The current lack of institutional coordination mechanisms creates a number of problems, which are reflected in the business environment (unviable regulations are adopted, etc.) and in the long run will have consequences on the development of individual regions and of economy and society as a whole. Secondly, in order to make good use of the undoubtedly positive aspects of decentralization, it is necessary to establish appropriate priorities and standards for using budgetary funds by LSGs in the best interest of citizens to avoid the situations where LSGs prioritize investment in entertainment facilities while some basic needs such as drinking water quality, safety, etc. remain unfulfilled.

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