

# FISCAL DECENTRALISATION, LOCAL GOVERNMENT AND POLICY REVERSALS IN SOUTHEASTERN EUROPE

Edited by  
William Bartlett, Sanja  
Kmezić and Katarina Đulić



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William Bartlett  
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Editors

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ISBN 978-3-319-96091-3      ISBN 978-3-319-96092-0 (eBook)  
<https://doi.org/10.1007/978-3-319-96092-0>

Library of Congress Control Number: 2018952927

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The registered company address is: Gewerbestrasse 11, 6330 Cham, Switzerland

# Preface

This book arose out of a project generously funded by the Regional Research Promotion Programme (RRPP), which is funded by the Swiss Agency for Development and Cooperation, Federal Department of Foreign Affairs, from 2014 to 2016. The overall research programme was coordinated and operated by the Interfaculty Institute for Central and Eastern Europe at the University of Fribourg (Switzerland). The initial project involved a study of fiscal decentralisation in Montenegro and Serbia with research teams from the two countries led by Sanja Kmezić and Katarina Djulić (members of the European Research Academy Belgrade (EURAK) think tank in Belgrade) and mentored by Will Bartlett (from the London School of Economics and Political Science - LSE). The project was subsequently widened through a follow-on grant from the RRPP, which enabled researchers from other countries in the region of the Western Balkans and the former Yugoslavia to meet together in a series of workshops in 2016 to 2017 of which this book is the result. This research network has become a Working Group of the LSEE Research Network on Social Cohesion in South East Europe, hosted at the LSEE research unit at the European Institute of the LSE.

Interest in the relationship between central and local government in the successor states of former Yugoslavia and in Albania was visible from the start of the transition process. The imperative of the transformation from socialist to capitalist economic relations required a reduction in the power of the central state in the economy, while at the same time the

process of democratisation emphasised the importance of strengthening the powers and responsibilities of local government. In Bosnia and Herzegovina, Kosovo,<sup>1</sup> and Macedonia<sup>2</sup> fiscal decentralisation and the devolution of political authority have also been proposed as a means to defuse ethnic tensions. This points to a fundamental property of decentralisation, namely that it brings decision-making responsibility to the local level, where local preferences can influence public policies and public expenditures. As public policies become more responsive to local needs, it could be expected that social welfare at local level would increase.

Few social scientists have studied the issue of decentralisation in this region, despite the important consequences of different governance arrangements for economic development and social cohesion. In addition to its academic merit in this regard, the project and the associated research network have made a great effort to draw policy lessons based on the evidence that has been accumulated and to reach out to policy makers to disseminate the findings of the research aiming to have an impact on policy making in this field.

Almost 30 years after the start of the transition process in the region, the balance between central and local government has still not reached a stable arrangement. The findings from the research analysed in the chapters below identify the “to-and-fro” nature of policy making that has led to several policy reversals that have played out through various phases of centralisation, decentralisation, and back to centralisation again. This process has revealed the nature of the gaps between legislated intentions and actual implementation of policies and the increasingly authoritarian tendencies of central governments. It has also led to a new understanding of the importance of decentralisation for inclusive local economic development and for democratic societies capable of defusing ethnic tensions. As the region moves forward, slowly and hesitatingly, in its process of European integration, the resolution of many of the issues that face the local governments in the region and addressed in this book is likely to become even more important in the future.

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## Notes

1. This designation is without prejudice to positions on status, and is in line with UNSCR 1244 and the ICJ Opinion on the Kosovo Declaration of Independence.
2. The name for the country is recognised by the UK government, but it should be noted that the name is currently under negotiation between the government of the country and Greece, with provisional agreement at the time of writing as “Republic of Northern Macedonia”.

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# 1

## The Political Economy of Decentralisation and Local Government Finance in the Western Balkans: An Overview

William Bartlett, Sanja Kmezić, and Katarina Đulić

### Introduction

The countries that emerged from the ruins of former Yugoslavia in the 1990s present a unique laboratory for the analysis of economic, social, and political change. Along with their counterpoint, Albania, which had a far more centralised system under communism, they have traversed armed conflicts, partial transitions to market economies, varied paths of democratisation, EU accession and pre-accession processes involving deep institutional change and most recently the spillover from the

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Eurozone crisis, which led in most cases to deep recessions, high levels of unemployment, deep fiscal gaps, and dangerously high levels of indebtedness. Each of these challenges has brought the issue of the distribution of powers and resources between the central state and lower tiers of governance to the fore. Although the Yugoslav successor states shared a common economic, historical, political, and social background, each has tailored its policies towards financing local government in accordance with its specific context, while Albania began from a different, more centralised, set of initial conditions. This book analyses the political economy of fiscal decentralisation in these countries over the last quarter century. Its aim is to identify the variety of decentralisation approaches that have been adopted and to explain the reasons for their differences and similarities, rooted in different combinations of political and economic interests. In this respect, the book contributes to the body of literature on the political economy of post-communist transition as well as to the literature on the role of fiscal decentralisation in post-crisis Europe.

This introductory chapter provides a general overview of the political economy of decentralisation and presents the structure of the book. It provides a methodological umbrella for the analytical approaches applied in the country case studies, emphasising the political economy drivers of decentralisation reforms that have taken place over the whole transition period from 1990 to 2016. It argues that decentralisation has attained only partial success in addressing the specific policy objectives of democratisation, balanced economic development, and post-conflict reconciliation of ethnic communities. It also guides the reader through the main arguments discussed in each chapter of this volume, situating the eight case study countries into the wider discussion of the political economy of decentralisation in the post-communist transition process.

## **Decentralisation in the Successor States of Former Yugoslavia and in Albania**

In former Yugoslavia, decentralisation led to increased regional inequalities that were only partially corrected by regional development policies and fiscal transfers from the centre (Flaherty, 1988). Fiscal responsibili-

ties had become highly decentralised by the end of 1980s, and economic elites in each Republic carried out investment projects that were in their own interest rather than the collective interest, causing duplication of productive facilities and a reduction in macroeconomic efficiency, which damaged economic performance (Kaiser, 1990). With the break-up of Yugoslavia, most of these problems disappeared since there was no longer a single political entity responsible for regional redistribution. Instead the problems of revenue and expenditure assignments, of meeting diverse preferences of population sub-groups, of designing effective policies of fiscal redistribution between regions and municipalities, of imposing hard budget constraints and preventing local debt accumulation shifted to the erstwhile republics themselves which had become countries in their own right and now had to deal themselves with the thorny problems of the most appropriate level of decentralisation and the most appropriate territorial design.

In the Yugoslav successor states, the transition from socialist to market-oriented economies has led to a deep transformation of both economies and political institutions. The first stage of transition from socialist republics with a high level of devolved powers involved an initial centralisation as part of the process of state-building (Bartlett, Maleković, & Monastiriotis, 2013). As the transition progressed, political decentralisation reduced the dominance of central state institutions over their emerging markets, and to assist democratisation and empowerment of citizens at grassroots level. Independence of the Yugoslav successor states also triggered a wave of constitutional and administrative reforms bringing about new territorial organisation. One group of countries (Slovenia and Croatia) created a large number of local governments, raising questions about diseconomies of scale, the cost of bureaucracy, and the optimal number of municipalities. A second group of countries (Bosnia and Herzegovina, Kosovo, and Macedonia) adopted territorial-administrative reorganisation as a method of defusing ethnic tensions in a post-conflict setting, at least partially under the oversight of international peacekeeping forces. A third group of countries (Montenegro and Serbia) were reluctant to engage in redefining their territorial-administrative organisation because they wished to avoid an escalation of ethnic tensions and potential fragmentation of their territories.<sup>1</sup>

While the book focuses on the successor states of former Yugoslavia, the case of Albania is included as a comparative example of a country that began the transition process from a different set of initial conditions, namely an almost complete centralisation of political and economic power in the hands of the state. There, decentralisation accompanied democratisation from the start of transition in the early 1990s.

## The Political Economy of Decentralisation in Transition Countries

Proponents of decentralisation have argued that it has beneficial effects on efficiency. The Oates theorem, now also known as the first-generation theory of decentralisation, suggests that decentralisation has the property that it brings decisions closer to the population that votes on them, and so different jurisdictions can choose the mix of services that most reflects the preferences of the local populations (Oates, 1993, 1999). This creates allocative efficiencies and raises overall welfare compared to a centralised allocation of services. The effect is reinforced when voters are mobile and can choose which jurisdiction they wish to live in, with an appropriate combination of taxes and services (Tiebout, 1956). This aspect of decentralisation is known as the problem of expenditure assignment. However, regions or municipalities with greater economic potential can raise more taxes at lower tax rates and provide better quality services than others, creating a pressure for the migration of populations from poorer to richer regions. This effect is quite typical in the Balkans, as in many developing countries, where capital cities have become centres of attraction for both labour and capital, leading to large and growing regional disparities, in an inversion of the optimising Tiebout effect. Thus, decentralisation of responsibilities for expenditure on local public services can create problems of horizontal imbalance, as fiscal decentralisation can bring about inequalities between jurisdictions that have different resource endowments (Prud'homme, 1995). This was arguably the problem that afflicted the federalised former Yugoslavia.

In response to this, redistributive policies must be carried out by the central government through fiscal transfers, and this requires that the central government should control a large proportion of tax revenues. This aspect of the problem is known as the revenue assignment, and can give rise to vertical imbalances between the central and local government if the resources reallocated through government grants are insufficient for local government units to carry out their assigned expenditure responsibilities so that they experience difficulty in supplying the required level of local public services.

This perspective has been criticised under the so-called second-generation theories of decentralisation which argue that political actors are not benevolent and have their own self-interested mind when making decisions relating to the appropriate distribution and uses of public financial resources between different levels of government (Oates, 2005, 2008; Weingast, 2009, 2014). The focus of the second-generation theories is less on the optimal level and extent of revenue and expenditure assignments, but rather on the political interests that lie behind the actual level of assignments achieved. For example, there is no guarantee that the redistributed resources will be used to address income inequalities within jurisdictions, and will not be captured by local elites for their own benefit. Thus, rather than viewing imbalances between local government expenditure assignments and the revenues that are allocated to carry out as an accidental deviation from an optimal plan, the second-generation theories investigate the political interests and incentives that might cause such an imbalance to come about. These issues are closely related to the way in which local governments are elected and whether central governments have the power in practice to override local government decisions.

The second-generation theory is also more sceptical about the use of government grants as redistributive or equalising devices in the face of decentralised jurisdictions with different levels of wealth. Under the first-generation models, direct grants are seen as an efficient solution to the distributional imbalances that might be brought about by decentralisation, capable of being adjusted by elaborate formulas to the specific characteristics and needs of differently composed municipalities. The second-generation models however see the dangers of perverse incentives



at work, as municipalities may overstate their needs in pursuit of rent-seeking gambits, or divert the grants to uses that benefit local elites rather than the general welfare (Bardhan, 2002).<sup>2</sup> Hard budget constraints may be difficult to enact in a political economy in which local politicians support the central government and may borrow to excess in an effort to attract local voters to their cause, leading to a build-up of local indebtedness. In addition, patronage networks may be particularly strong at the local level, where personal connections are visible and votes for the local ruling party can translate into privileged access to resources such as public sector jobs (Kleibrink, 2015). Moreover, strong party networks connecting central and local party machines provide channels linking central government subsidies to local governments in which the ruling party has majority control (Gunay & Dzhic, 2016). Considerations such as these give analysts pause for thought when considering the benefits of decentralisation, which may be potentially very real where local preferences are diverse as in situations of ethnic polarisation, especially following periods of conflict like that which have taken place in some of the successor states of former Yugoslavia.

The book discusses the outcomes in the successor states of former Yugoslavia by elaborating on these two approaches. The separate chapters discuss vertical and horizontal imbalances, and the principal agent relationships between central and local governments, highlighting the political connections and divisions between the two levels of government that provide insights into why these relationships are so problematic. The chapters in this book discuss how the different countries in the WB6 have dealt with these dilemmas. These centre-local government relations are especially relevant in the context of clientelistic forms of capitalism that have developed in the Western Balkans and Albania during the transition process, in what can increasingly be called systems of political capitalism, in which business interests and political establishments are closely interconnected. In the context of the economic crisis that spilt over into the region from the global and eurozone economies since about 2009, these interconnections have favoured the recentralisation of political power, the drift towards more authoritarian and illiberal forms of government, and the reversal of decentralisation policies that had gained ground after the democratic turn in the region in 2000.

## Europeanisation and the Political Economy of Decentralisation

The armed conflicts of the 1990s had delayed the EU membership perspective (with the exception of Slovenia, which joined the EU in 2004) giving rise to a new characterisation of these countries as the “Western Balkans”.<sup>3</sup> This was a region in which democratisation had been stalled or incomplete, turning it into a super-periphery within the European economic space, characterised by political turmoil and instability, pervasive clientelism and an unattractive business environment for local economic development (Bartlett, 2009). However, following the Thessaloniki Declaration of 2003, the process of EU integration and the accompanying request for the creation of new subnational structures to absorb EU assistance funds provided a further motive for reform of centre-local relations. During this period, political and fiscal decentralisation took great strides forward, while EU assistance funds also supported the development of new administrative structures at regional level. Yet, although Slovenia was the first country from the region to become an EU member state, and therefore could have been expected to be most strongly influenced by the support for local government capacity to absorb cohesion funds and regional funds, empirical research has shown that in Slovenia the early impact of cohesion funds on central-local relations was relatively weak with the main role in allocation of EU resources maintained by the central government authorities (Andreas & Bache, 2009), while in Croatia some greater impact in empowering local government institutions in the pre-accession period could be observed (Bache & Tomšić, 2009). It may be that the lack of impact of Europeanisation on strengthening local democracy in the region and the weak capacity of local governments to fully absorb EU assistance funds have been due to the top-down nature of such assistance. Where local governance reforms have been designed with local concerns in mind they seem to have been more effective (Pickering, 2010), Chap. 3 by Anto Bajo and Marko Primorac focuses on the process of decentralisation in Croatia. They show that the decentralisation policy in Croatia was carried out in the absence of a coherent long-term strategy, creating an excessive number of small and weak local government units, which are neither financially self-

sufficient nor capable of providing effective public services. The path of fiscal decentralisation has been marked by three main phases. The first phase involved administrative and territorial decentralisation, the second phase was characterised by fiscal decentralisation, while the third phase has involved recentralisation under the influence of the consequences of the economic crisis. As Croatia became closer to EU membership, inter-governmental fiscal relations began to focus on achieving a more balanced economic development through fiscal equalisation. With this in mind, the chapter emphasises the role of instruments and methods of fiscal equalisation. Although the intensity of fiscal decentralisation has gradually increased, the fiscal autonomy of local government units is still limited or non-existent. A more suitable decentralisation policy would prove beneficial not only for fiscal reasons, but also for improving the capacity for absorbing EU funds.

Chapter 2 on Slovenia by Boštjan Brezovnik, Mateja Finžgar, and Žan Jan Oplotnik focuses on vertical imbalances in local government financing. After Slovenia achieved independence, the introduction of democratic local self-government required a radical change from the previous system. The former communes had been designed to carry out the deconcentrated duties of the state administration, but were too large to fulfil the role of self-governing municipalities. Therefore, in 1993, 212 new municipalities were established. These were based on historical developments, traditions, and political compromises rather than a rational assessment of local needs and duties that they should perform. Thus, Slovenia still lacks an efficient network of municipalities. The chapter examines the disproportion between municipal functions and the funds needed to support them. It shows that resources that are allocated to municipalities by the Constitution and the law are insufficient and not adequately aligned to their responsibilities. Slovenia became an EU member state in 2004, since when it has benefited from EU funding from the regional development funds and the cohesion funds, mitigating some of the problems of vertical fiscal imbalances. The Financing of Municipalities Act, adopted in 2016, provides for fiscal equalisation based on a formula that allocates a per capita lump sum to individual municipalities, taking into account other criteria based on demographic and geographic characteristics of municipalities.

## Crisis, Policy Reversals, and Local Government Debt

A stronger role of local governments required greater financial resources at their disposal. Thus, an essential part of the decentralisation process involved strengthening the fiscal autonomy and capacity of local municipalities. Decentralisation was an integral part of the political transition to democracy in the successor states of former Yugoslavia (albeit following an initial period of recentralisation in early 1990s linked to state-building) as it mirrored the process economic transition that aimed to reduce the power of the central state through privatisation (Bartlett et al., 2013). In the early 2000s, fiscal decentralisation took off in the Yugoslav successor states and Albania and led to the redistribution of an increased share of total government revenues and expenditures to the local level in up to the onset of the global economic crisis, as detailed in the chapters in this book. However, following the spillover of the global financial crisis and the ensuing Eurozone crisis to the region from about 2009 onwards, financial instability has pushed many countries into policy reversals involving a return to greater fiscal centralisation (Kmezić, Djulić, Jocović, & Kaludjerović, 2016). Local governments have been under a double-sided squeeze. On the one hand, the impact of the crisis has led to worsening economic and social conditions, and hence created additional pressure on local government expenditures for poverty reduction measures encompassing social protection, housing, community support, and so on. On the other hand, local government revenues have been adversely affected by falling tax revenues, and by the temptation for central governments to pursue their policies of fiscal consolidation and budgetary austerity by “raiding” local government budgets. Such raids have taken the form of transferring additional expenditure assignments to local authorities, while at the same time squeezing central government transfers to local government revenue accounts. This has provoked deep imbalances between the increased local expenditures required by delegated competences on one hand, and the reductions in the revenue base in response to the crisis on the other. These imbalances between functional and financial decentralisation have tended in several cases to undermine local public

service delivery, municipal capital investment, and local economic development; in other cases they have led to increased local government debt, potentially threatening the overall financial stability of the countries concerned. Three of the countries, Bosnia and Herzegovina, Montenegro, and Serbia, were particularly hard hit by the economic crisis leading to the growth of debt in local municipalities.<sup>4</sup>

Chapter 4 on Serbia by Sanja Kmezić and Katarina Đulić addresses the political economy of decentralisation in Serbia from 1990 until 2016. It describes the major changes that occurred in territorial, administrative, and political decentralisation, focusing on fiscal decentralisation, and analyses the effects of changes to the regulatory framework on local government revenue and expenditure from 1990 to 2016. Three phases of fiscal decentralisation are identified. The first phase, from 1990 to 2000, was characterised by a highly centralised and authoritarian governance of public services. The second phase, from 2000 to 2008, featured the decentralisation of powers, expenditures, and revenues within a wider process of democratisation and strong economic growth. The third phase, from 2009 to 2016, has seen a recentralisation of public revenues, due to the consequences of the economic crisis that hit the country in late 2008. During this phase, the shares of local government revenues and expenditures in GDP fell, while the system of local government financing suffered from instability, a lack of predictability, and legal and financial uncertainty. More than a dozen significant legislative changes affected local government revenues, leading to huge reductions in local government budgets. A continuous transfer of new mandates to local governments caused their expenditures to increase beyond their revenue capacity. This in turn led to an accumulation of debts and dramatic reductions in local government capital budgets that compromised the delivery of local public services. Additionally, the secrecy surrounding local government fiscal data has undermined the evidence base for policy-making and has led to a lack of transparency and to weak oversight of the financial system.

Chapter 5 on Montenegro by Jadranka Kaludjerović and Mijat Jocović also focuses on the issue of volatile municipal revenues. Until the beginning of the 2000s, the state administration system was extremely centralised, and municipalities were marginalised, even in terms of financing their own policies. In 2003, the government reformed the state adminis-

tration on the basis of a Public Administration Reform Strategy. Due to the simple organisational structure of public administration and the fact that some complex and financially demanding functions such as education and healthcare are not the responsibility of local government, fiscal decentralisation has been relatively straightforward. Yet, more than a decade after the process of fiscal decentralisation was initiated aiming to increase the efficiency of public finances at the local level, municipalities face high debts and arrears. The chapter identifies two distinct phases of municipal financing. In the first phase (2003–2008), the state adopted legislation that strengthened the role and fiscal autonomy of local governments. Municipalities took advantage of the economic boom experienced in this period to increase their expenditure on the basis of revenue growth, both actual and projected. However, during the second phase (2008–2015), the government imposed several centralising policies, abolishing some sources of municipal revenue in an attempt to reduce the fiscal burden on the business sector. The chapter shows how revenues were hit by a decrease in economic activity and municipalities began to accumulate arrears and debts. Montenegrin municipalities are currently in a very difficult and challenging financial situation, which can only be solved with the involvement of both local and national tiers of government.

Chapter 6 by Halko Basarić, Nina Branković, and Lejla Lazović-Pita deals with the case of Bosnia and Herzegovina, focusing on the issue of increasing local public debt. The chapter analyses intergovernmental fiscal relations, focusing on the position of local governments over the past 20 years. It identifies three main phases in the process of fiscal reforms and shows that expenditure assignments across both main political regions (or “entities”—the Federation of Bosnia and Herzegovina and Republika Srpska) are similar, even though these entities differ in their constitutional organisation. During the three phases of decentralisation reforms, the assignment of expenditures did not change in either entity, while the assignment of revenues changed in different ways. Indirect tax revenues, which make up the largest share of local government revenues in both entities since 2006, declined after the onset of the crisis triggering fiscal stress at the level of local governments. To overcome the volatility of revenues, local governments began to borrow more from 2009 onwards leading to increased local public debts.