

## INTERGOVERNMENTAL FISCAL RELATIONS IN KOSOVO

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### Abstract

From the fiscal perspective, this report calls for a local finance reform that is based on efficiency as well as political stability. There needs to be greater clarity in the allocation of power between the central level and the municipalities in Kosovo. Furthermore, a grants system should be better developed: which defines a new role for the Grants Commission; which ensures quality statistics; and which encourages greater analytical capabilities. Local fiscal reform projects are unlikely to achieve their goals if the basic data for the calculation of the grants do not properly reflect the reality in Kosovo.

**Key words:** fiscal decentralization, revenues, intergovernmental transfers, expenditures, efficiency, political stability.

**December 2007**

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<sup>1</sup> The Author was working as a Legal Consultant on Municipal Finance for OSCE Mission in Kosovo during the period September – December 2007. This report outlines the views of the author and not the views of the institutions mentioned in it. It is a responsibility of the authors to quote this report when it informs their future work.

## 1. Background

According to UN Security Council Resolution 1244, the OSCE Mission in Kosovo (OMIK) is responsible for human rights monitoring and institutions building. It is further mandated by the OSCE Permanent Council Decision 305 to serve as the leading agency “in matters related to institution- and democracy-building and human rights.” In this context, OMIK’s Department of Human Rights, Decentralization and Communities is currently engaged in various aspects of decentralization and local government reform in Kosovo.

Two important areas that have been in focus in 2007 in the field of local government reform include relations between the central and local levels and local finance reform. According to the Mission Implementation Plan, OMIK is responsible for producing reports and recommendations based on identified best practices and observed failures of the Provision Institutions of Self Government (PISG) and the Kosovo Municipalities. In this context, OMIK is currently analyzing the legal framework regulating the relationship between the central and local levels. It intends to expand this scope to include relationships in the financial sector.

OMIK is also responsible for contributing to the drafting of a legal framework supporting local good governance and decentralization. One of the necessary laws in this context includes a draft law on local finance. Finally, in its capacity building role, OMIK engages in leadership forums with municipal officials addressing a variety of issues, including local finance.

In light of these this report analyzes the financial relationship between the central and local authorities.

The methodology is to:

- Assess the legal framework regulating the financial relationships between the central and the local level with a view to addressing incompatibilities and bridging gaps
- Asses the capacity at central and local level for implementing the legal framework regulating the financial relationships

The methodology in writing this report consists of three steps. First, regulations and documents were scrutinized; second, interviews were held with stakeholders; third, a draft report was prepared and discussed with the OSCE Section’s personnel and was subsequently revised according to their observations and suggestions.

This report attempts to outline where Kosovo currently stands with regard to the fiscal decentralisation process and suggest improvement that can be considered as the decentralisation process proceeds. The purpose of this document is not to give answers to all questions and problems of the fiscal decentralisation process but rather a critical evaluation with identification of factual conditions that might hinder the process in the short as well as in the long run.

The report is organized following the usual categorization of the main pillars of fiscal decentralization process: scope of the government, expenditure assignments, revenue structure, inter-governmental transfers, level, financial management issues and borrowing at LSG<sup>2</sup>.

Each section reviews the conceptual principles that should be kept in mind when addressing the issue at hand together with an assessment of the actual, current situation. Recommendations follow within each of the sections.

## **2. Scope of the governments**

The institutions in Kosovo operate under the UNMIK/REG 2001/9: “Constitutional framework for provisional self-government”. The provisional institutions of self-government are the Assembly, The President, The Government and the Courts. In the regulation the responsibilities of the institutions are stated.

There is one tier system of local self government in Kosovo consisting of 30 municipalities plus the so called Pilot Municipality Units – PMU (5 PMU but only 3 of them functioning). Some central government ministries use deconcentrated units in five regions.

The scope of functions, responsibilities and powers of the LSG (municipalities) in Kosovo was regulated in the UNMIK/REG 2000/45 and now with the UNMIK/REG 2007/30. With the UNMIK/REG 2000/45, municipalities in Kosovo have had elected Assembly as a highest representative body that adopts statute and rules of procedure for effective management control. The bodies in the municipalities were the committees, the president, deputy president, chief executive officer and the board of directors. The President of the municipality used to be elected by the Assembly and was chairing it. The President of the municipality also was chairing the policy and finance committee which used to propose the budget and used to formulate the strategic directions of the municipality. The President had the execution power of decisions made in the municipality and was also responsible of the administration. She was entitled to propose the Chief Executive Officer – CEO that chairs the board of directors. The CEO was responsible for the efficient management of the financial affairs in the municipality. The board of directors was consisting of the heads of the municipal departments and was assisting the assembly in providing them with information. The CEO, the board and the staff comprised the municipal civil service of the municipality.

The UNMIK/REG 2007/30 regulates for elected Mayor as opposed to the previous regulation of assigned by the Assembly. This new proposed current organizational structure for LSG in Kosovo provides certain amount of parallel structure of power

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<sup>2</sup> Within the text I will use interchangeable the Local Self Government-LSG, Local Government Unit-LGU, subnational government, local government, county level, communes, municipalities and cities interchangeably. When necessary for more clear text I will stress what is the tier I am talking about.

divided between the council and the mayor (it is stated in section 10 of the regulation that the Assembly is the highest representative body).

The benefit of having a clear distinction of legislative from executive power is the higher level of accountability. On the other side it carries the danger of conflicts between the two branches<sup>3</sup> and blocking the work of their work. The basic problem with a locality's organizational structure is political in nature, and typically arises when the Mayor and the majority in the council are not from the same political party. In such cases, for example, the Assembly is able to stall the council's business and block the executive responsibilities of the Mayor, including in the areas of finance and urban planning for example.

### ***The general framework – the EU Charter and the Comprehensive plan***

The Special Representative of the Secretary General's Comprehensive proposal for the Kosovo status settlement – The proposal – in the Annex 3 states that the local self government in Kosovo shall be based upon the principles of the European charter of local self government – LSG – the charter.

The concept of the local self government – LSG as per the European charter of LSG denotes the right of local authorities to regulate and manage a substantial share of public affairs under their own responsibility and in interest of the local population (Article 3 from the charter). The local authorities shall exercise their initiatives up to the extent and nature of the task and requirements of efficiency and economy i.e. in accordance with the subsidiarity principle and their powers shall not be undermined by another regional or central authority (Article 4 from the charter). Local authorities shall be entitled to adequate financial resources of their own, of which they may dispose freely within the framework of their powers. The protection of financially weaker local authorities calls for the institution of financial equalization which will be designed to correct the effects of the unequal distribution of potential sources of finance and of the financial burden they must support (Article 9 from the charter).

The proposal states also that local finance will provide a framework for the LSG to determine structure and size of their own budgets. It is envisaged to revise the earmarked grants to include block grant system (the proposal is not explicit in defining what exactly block grant system should look like). The block grants should provide for a reasonable degree of stability in municipal income, an appropriate measure of equalization between the LSG with different tax bases and an adequate allocation of resources for non-majority communities in the respective LSG. The distribution formula for block grants will take into account, in accordance with the proposal, the physical size of the municipality, the number of inhabitants including the number of members of community that are not in the majority in the municipality and the relative access of the inhabitants of the municipality to public services.

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<sup>3</sup> The stake might be even higher taking into account that with the new Law on LSG the municipalities will have more competencies and thus, more area for possible disputes.

Taking into account the low level of devolution of expenditure authorities to LSG in Kosovo, the expected reform in the local level financing and the general framework from EU (that is the Charter) and the Comprehensive proposal from UN, the decentralization understood as devolution will require a lot of effort and domestic political will for this reform. The decentralization is a process and continuing it with a new momentum will require a careful planning, monitoring of implementation and evaluation.

### *Decentralization as a process*

Decentralization is a complex process. As such it is recognized by the Government of Kosovo and as a result the “Roadmap to decentralization in Kosovo” was prepared in August 2007 as a platform for an all encompassing Kosovo program on decentralization and local governance for 2008 – 2012. It is recognized that one of the main component is the strengthening of the municipal finance capacity with a thematic areas of local revenues and expenditures, land registration and cadastral system and municipal finance system. The “Roadmap to decentralization in Kosovo” document improves the “Action plan for implementation of decentralization” from May 2007 in a way that recognizes the need for strengthening the municipal finance system. In the Action plan for example in the legislative reform as basic new laws only the laws on LSG, municipal boundaries and elections were mentioned without the Law municipal finances (it was stated that this will be covered by a revision of the existing UNMIK/REG 2003/17). It is of crucial importance to once again stress the importance to have separate law on municipal finances as the area is complex and it should be regulated with a law in order to recognize the partner level with the central government. Also, clear goals as of if the decentralization will satisfy political or economic criteria should be stated and regulated clearly. If it is both it should be clearly stated if it is better services (education, clean water, garbage removal etc) or national cohesion or increased female participation, poverty alleviation etc.

Thus, a clear recommendation would be to bring a package of new laws:

1. Law on boundaries should recognize as much as possible the economies of scale for the sake of the sustainability of the future municipalities. To ensure economies of scale and efficient delivery of services, a separate Law on inter-municipal cooperation should be also considered. By considering only a clause in the law on LSG that the municipalities will be allowed to cooperate and not to regulate the registration, responsibilities of the parties and other issues will result in no action and lack of initiatives from the LSG. Not all of the municipalities will develop a tax administration office for example. Some would find it more efficient if they cooperate with other municipality.
2. A separate law on the status of Pristina is advisable but to reconsider the urban status of the city. It is better to be organized as one municipality instead of group of municipalities. The negative if it is group of municipalities is that it is difficult to develop system that will separate clearly the responsibilities of the city of Pristina of those of the municipalities within the city. Also, it might end up in a situation where the municipalities in Pristina will have less “power” than the other municipalities within Kosovo.

3. Law on municipal finances should clearly define:
  - Own source revenues from transfers.
  - The transfers should be clearly defined as to conditionality of how to spend them (earmarked, general etc) and to the source. The equalization part should be clearly defined to account for the: fiscal capacity of the LSG, the non-majority, the relative access to public services (as stated in the proposal).
  - A possible sharing system should be reconsidered (from the PIT, VAT and/or corporate tax) as well as an unconditional grant.
  - LSG borrowing should be regulated to include limits, maturity, external/internal borrowing, guarantees, interest, annuity etc. Also, what should be regulated are the processes of the approval, monitoring, disclosure, insolvency (conditions, initiation, plan etc).
  - The Budget classification and the budget calendar are already covered with the UNMIK/REG 2003/17.
  - Measures for financial distress situation should be defined as well as the insolvency.
  - Gradual versus fast shifting of devolved responsibilities should be considered.
  - Introducing certain mandatory requirements for the staff of the LSG administration: Financial officers responsible for financial management, budget preparation and execution and accounting, chief accountant, procedures and system for internal audit, tax assessment, enforcement and collection is advisable.

The process wouldn't be completely planned if there is not proper monitoring and evaluation system at government level. Such a system could have the following elements (in order to measure the quality and pace of the implementation, the administrative performance and to be informative to help in the decision making process):

1. Working group for monitoring the process (led by the Ministry of Local Government Administration for example)
2. Subgroups by functions (as per the assignments for municipalities) to assess:
  - a. The progress of legislation adoption especially secondary legislation and by-laws
  - b. The implementation of the new competencies by the municipalities
  - c. The possible transfer of equipment, human resources, property from central to local level
  - d. The needs for training and capacity building
  - e. The identification and management of possible risks to the process

The main instruments for this process can be the action plans of each functional subgroups and a register of risks related to the transfer of competencies and the capacity of the municipalities to exercise the competencies. The working group should have the decision making authority otherwise it will end as a window hall for complaints without any effective role. For example, if the subgroup of communal activities acknowledged that the low rate of fee collection harms its finances given the invoiced VAT accounting, the working group should find a solution and make a proper decision.

### 3. Expenditure responsibilities

In the UNMIK/REG 2007/30 it is stated that the municipality assembly subscribe to a solemn oath of declaration so that it will "...ensure conditions for a peaceful life for all". Thus, it is of crucial importance for the system of decentralization in Kosovo in near future to be on clear ground whether it will continue to be a tool for political and ethnic consolidation or it will appreciate as well fiscal and economic criteria. This is a serious issue to be solved before the package of new laws will be adopted because the Kosovo status itself will not solve local problems and certainly will not improve services to citizens automatically.

What the legal framework in Kosovo should define as decentralization is devolution i.e. that elected local officials should be given power and resources to make provision of public service decisions.

Functional decentralization, i.e. the devolution of competencies at the moment is left to the laws regulating each activity in Kosovo while the fiscal decentralization framework, including the inter-governmental transfers, is defined in the UNMIK/REG 2003/17 "Public Financial Management and Accountability"; UNMIK/REG 2003/29 "Property Tax".

The UNMIK/REG 2007/30 gives only a list of competencies with no clear clarity of what exactly the municipalities are in charge of. Leaving this to be solved with the laws regulating each activity will result in a not transparent situation as it is at the moment. Thus, a recommendation is to define more clearly in the new Law on LSG what exactly the competencies of the LSG should be or to solve the issue in financial terms in the new Law on financing the LSG and to make LSG for example in charge of operational and maintenance or salaries etc. whatever the decision will be it is of importance to be solved in one law better than to leave it to different laws i.e. ministries at the end of the day.

**Table 1. Competencies at Local Level in Kosovo**

<p>Within the laws regulating each activity the municipalities in Kosovo shall be responsible for</p>
<ol style="list-style-type: none"> <li>1. Providing local conditions for sustainable economic development</li> <li>2. Urban and rural planning and land use</li> <li>3. Licensing of building and other development</li> <li>4. Local environmental protection</li> <li>5. Implementation of building regulation and building control standards</li> <li>6. Provision and control of public services and utilities</li> <li>7. Fire and emergency services</li> <li>8. Management of municipal property</li> <li>9. Provision of pre-primary, primary and secondary education</li> <li>10. Provision of primary health care</li> <li>11. Social services and housing</li> </ol>

<ul style="list-style-type: none"> <li>12. Consumer protection and public health</li> <li>13. Licensing of local services and facilities</li> <li>14. Fairs and markets</li> <li>15. Naming of roads, streets and other public places</li> <li>16. Provision and maintenance of public parks, cemeteries and open spaces</li> </ul>
<p>Municipalities may take actions in relation to:</p>
<ul style="list-style-type: none"> <li>1. Tourism</li> <li>2. Cultural activities</li> <li>3. Sport and leisure activities</li> <li>4. Youth activities</li> <li>5. Economic promotion</li> <li>6. Civic promotion</li> </ul>
<p>Municipalities shall also be responsible for implementing the applicable law in</p>
<ul style="list-style-type: none"> <li>1. Cadastral records</li> <li>2. Civil registries</li> <li>3. Voter registration</li> <li>4. Business registration</li> </ul>
<p>Enhanced competencies (as per The Proposal and not in the UNMIK/REG 2007/30)</p>
<ul style="list-style-type: none"> <li>1. Health (Secondary health care)</li> <li>2. Education (Higher education)</li> <li>3. Cultural affairs</li> <li>4. Participatory in the area of police</li> </ul>

It is interesting that in Kosovo water, sewers and garbage collection services are carried out by publicly owned enterprises (POE) administered by the KTA and financed by fees paid by citizens. The 14 water and sewage POEs are organized on a regional basis, and it will be difficult to be transferred to a specific municipality. Same holds for the 13 garbage POEs. Municipalities provide the local infrastructure (local pipes) for water and sewer services. Maybe a PPP type or just privatisation can be a viable solution in future.

### ***Fair share financing***

In the administrative instruction 2004/1 on the administration of fair share financing by municipalities it is stated that under the section 4 of the UNMIK Reg. 2003/41 the municipalities are required to allocate to non-majority communities a proportionate share of their total Kosovo general budget financed from own source revenues, general, education and health grants. The fair share financing should ensure that the



needs and legitimate interests of villages, settlements and urban quarters populated by non-majority communities are adequately provided for. The UNMIK Reg. 2003/41 in the section 4 regulates the municipal budget appropriations. Revenues from education fees and/or charges and primary health care co-payments are earmarked and can be used only for education purposes and recorded separately. The UNMIK Reg. 2003/41 in its schedule 4 regulates the proportions to be used by the specified municipalities for the purpose of allocating funds under the fair share financing principle. At least these proportions shall apply to own source revenues and general, education and health grant received from the Kosovo general budget. The proportions can be revised periodically in coordination with ministry of health, ministry of education, ministry of finance and economy, and the municipal assembly.

**Box 1. How the fair share financing works in practice. Case studies from Prizren and Strpce municipality.**

Fair share financing is a problem for Prizren as the Albanian students are in need of more teachers in accordance with the standards whereas the minorities are less in numbers by the standards but the teachers must be paid as for the full number of students.

Another argument pointed in relation with the fair share financing is that the minorities are comprising less than 10% in Prizren but the budget expenditures are 22,8% of the total budget. Thus, there is unjustified disproportion in the share of minority and the budget expenditure share allocated to them.

The specific for municipality of Strpce is that after the war they welcomed in their municipality many Serb refugees from other parts of Kosovo (doctors and teachers) that were employed by the municipality. They complain that Kosovo authorities accepted at that time the fact of this employment level but after 2005 all changed when the Prime Minister signed a Memorandum of Economic and Fiscal Policies (MEFP), sometimes referred to as the "Letter of Intent." (The MEFP commits the Government to a rigorous program of budget restraint from 2006. All Municipalities shall be familiar with the policies of the MEFP. The IMF is closely monitoring the Government's actions during its quarterly visits.). It seems that the changes are too fast for Kosovo municipalities in general but especially in Serb majority LSG with its specific problems.

Within 15 days from the end of each quarter each Municipality should prepare and submit a financial report to the Ministry of Finance and Economy and the Office of Community Affairs on their fair-share financing and other relevant standards and benchmarks.

Fair share financing is considered a viable instrument to satisfy political objectives and this is legitimate. But such a sensitive instrument requires solid statistics and regular consultation with municipalities. Even though it is stated that the proportions per municipality for allocating to non-majority communities of the municipality, may be periodically revised in coordination with the Ministry of Health, Ministry of Education,

Ministry of Finance and Economy, Ministry of Local Government Administration and the Municipal Assemblies concerned, to our knowledge such a revision has not been initiated until now, or at least has not included properly the Municipal Assemblies concerned.<sup>4</sup> Fair share financing needs to strike a balance between allocating enough funds to implement the political decision taken and a coherent budgetary concept applicable to all people residing in Kosovo.

## Own Revenues

UNMIK/REG 2003/17 “Public Financial Management and Accountability” regulates how the revenue collected from the property taxes will be allocated and used by the municipalities. In the UNMIK/REG 2003/29 “On taxes on immovable property in Kosovo” there is certain devolution of power as the municipal Assembly can set the property tax rates between 0,05% and 1% of the market value of the property. Municipalities in accordance with the regulation, is responsible for property tax valuation, preparation and issuing bills, managing the property tax information system, enforcing and collecting the property tax and for the administrative appeals. There is also data exchange between the Kosovo Cadastral Agency and the municipalities on immovable property. The municipalities value the property in accordance with the administrative instruction prepared by the Ministry of Finance and Economy – MFE and taking into account the cost of construction, location, size and condition of the property.

Own source revenues account to around 20 % of the total municipal revenues in Kosovo in 2006. Grants account to 80%. The own source revenues are coming from:

- Property Taxes
- Local public utilities and charges
- Local administrative fees
- Fines
- Rents from municipal properties
- Donations
- Land use fees

Own source revenues and grants are covering each economic category of the municipal budget (wages and salaries, goods and services, capital expenditures)<sup>5</sup>.

## Intergovernmental transfers

The potential benefits from a devolved form of decentralization can be utilized by an optimal combination of functional and fiscal decentralization. That is, a decentralization framework should make clear both the spending responsibilities of

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<sup>4</sup> Joint recommendations for any readjustment of or reallocation of percentages shall be forwarded by the Director of the UNMIK Department of Civil Administration and the Minister of Finance and Economy to the Special Representative of the Secretary-General for approval.

<sup>5</sup> Known as expenditure categories – salaries and wages, other goods and services, subsidies and transfers, capital outlays and reserves.

local governments as well as their revenue-raising powers. But since local revenue-raising capacity often falls short of the ability of local governments to mobilize sufficient resources from their own sources, another important feature of a decentralization framework is construction of an inter-governmental fiscal transfer program.

Local governments are likely to view the transfers as substitutes for their own resources and decrease their efforts at raising local revenues. Also, since the existing public infrastructure is a part of the resources that must be “managed” by local governments, grant systems can have an adverse effect on the willingness of local governments to maintain that infrastructure.

In Kosovo, the municipalities have small amount of financial resources to manage at their discretion. In addition, the transfers from the line ministries were not transparent and the Grants commission was making decisions more as a result of a political negotiation than to a technical, transparent distribution. This is a rather difficult situation and the new system should be developed to improve it.

Grants are coming from:

- General grant (2008 budget proposal 20% of total budget expenditure – excluding funds earmarked for specific purposes such as the status cost, debt servicing, social programs). This grant consists of two parts. One is a fixed amount to each municipality and the other part is distributed depending on the population figures.
- Specific grant (education and health). Education grants consist of four parts. First part is the teacher cost also depending on the minority students and the teacher-student ratio. The second part is for the non-teaching personnel costs, third for the goods and services and the fourth for the capital outlays. Health grant is distributed in accordance with the population.
- Property taxes incentive grant is distributed in accordance with the performance of each municipality in collection of the property taxes. Each municipality is set a target on their revenue collection and if the target is met the municipality receives the full grant. If the target is not met but there is improvement of collection it receives whatever the percentage it meets (baseline is 2004). Municipalities that fall short of the 2004 baseline receive nothing.

First of all the new Law on financing LSG should solve in principle the definition of the systematic categories (block grants, unconditional grants, formulas etc). Then, the composition and role of the grants commission should be amended. The Grants Commission could consist of decision making authorities, including representatives from municipalities, but should monitor and evaluate the system. It should not negotiate the allocation of resources, as this will be regulated by the new law on municipal finances. If the Grants Commission finds that the system needs changes, this should be done in a proper manner through recognizing and discussing the problem with stakeholders and changing the variables of the formulae, or amending laws or subsidiary legislation, instead of ad hoc decision making with regards to budget items.

As for the grants, if they are to be systematically distributed to local governments, several policy decisions must be made and included in the new package of laws. These include: determination of the grant pool, i.e. how much will be available to be distributed to LSG; the method used to allocate that pool across all eligible LSG and the degree of restrictions associated with how the grant funds can be spent by local governments. In that regards a PIT-sharing in Kosovo could be beneficial given the current level of tax administrative capacity at local level. The percentages can and should be carefully set after a comprehensive analysis of the fiscal gap and vertical imbalance is done. Higher percentages can even provide more incentives for the taxpayers to comply and decrease the tax evasion for this tax in general if the taxpayers consider it as “own”.

However, given the high level of registered unemployment, young population maybe a VAT sharing is preferred as it is more efficient to tax the consumption than the income in this Kosovo economic set up. An argument more to tax consumption rather than income is that in Kosovo the remittances are important part of the BoP and the more self employment economic structure of output prefers the consumption taxation. Thus, for the VAT grants, the total divisible pool could be shared and the allocation could be with a formula. The VAT formula-based grant is transparent but the lack of timely and adequate data to be included in the allocation formula could be a serious deficiency given the weak statistics in Kosovo.

Also, there is the problem of quality data on which the grants system should rely on. The 2001 population data that are used as official data are challenged both by examples from municipalities and by the estimates from a questionnaire conducted by the Ministry of Local Government Administration.<sup>6</sup> Such differences have the potential to create discrepancy between municipalities and as a result to hamper the needed stability of the transfers. It also creates an awkward situation where on the one side the central government insists on procedures, precision and discipline in calculation and distribution of grants as well as reporting from municipalities; while on the other side ignores the fact that it is cannot reflect the reality due to questionable data. In other words, the current grants system cannot be adequately supported with the existing data.

Whatever the decision on the architectural design of the grants system in Kosovo, it should be clearly stated will the grant equalize the fiscal capacity, will reduce the disparities in providing public services or it is introduced to encourage the local governments to mobilize its own resources and it should rely on quality data.

## **Financial management issues**

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<sup>6</sup> Ministry of Local Government Administration 2005–2006 annual municipal statistical report. In that report it is stated that for the purpose of an efficient monitoring, the Department for Supervision, Effectiveness and Reform of Municipalities has drafted a questionnaire that was delivered to all municipalities and Pilot Municipal Units. The Department also states that it intends to create a basic set of data through this questionnaire that will serve the Ministry, and that can be used by citizens, government, donors and the municipalities themselves. This questionnaire provides also information about the results and obstacles faced by the municipalities of Kosovo. Still, everyone uses the 2001 population data.

The municipalities are responsible of running a balanced budget. The budget is clearly separated in current and capital expenditure part. Part of the financial transfers by the Central authority is designated for the responsibilities and powers of the municipalities and part are undesignated.

Municipalities are using the Budget Data Management System (BDMS) that is installed and available for use by budget organizations.

There are some constraints imposed to the municipalities on their spending autonomy like the imposed reduction of employees in the public sector (this is labeled as: “Preliminary ceilings are subject to changes as the Ministry of Public Services continues works on civil service reform”. Simple cutting the level of employment is not really a civil service reform). Given the labor intensive education sector this will be difficult to achieve without negative impact on the services. Another reason is that around 45% of the population is less than 25<sup>7</sup> thus, will require more education services at all levels from the municipalities that is labor intensive. Municipalities cannot set their own pay levels to attract better qualified and skilled employees.

Process of decentralization means devolution of power to make own decisions at local level. It seems that in Kosovo that power is not devolved and the municipalities at the moment are more of channels through which the central authorities are making their expenditures. All the grants are earmarked by end users and not much discretion is left for the municipalities. The only discretion is left for the own source revenues and part of the general grant. As reported by a municipality the specific grant for education for example does not meet the real situation on the ground. Namely, the financial calculations for the majority (Albanians) is downsized (need for more teachers but restriction is imposed to downsize the number of employees) while for the minorities is oversized (even if one child in theory the standard must be met). The fair share financing for minorities should be fulfilled and the ethnically fragmented society is more expensive to manage but better statistics and reshape of the standards if they are costly should be considered if they are expensive for Kosovo.

### ***Capital planning***

With the 2008 budget circular, planned municipal capital expenditures should be evaluated in the context of the following:

- Municipal Development Strategy in order to address local development and investment needs.
- Consistency with Government policy priorities and (when available) the Medium Term Expenditure Framework. Municipal budget organizations should aim at developing capital proposals that will contribute to the achievement of the Government’s priority goals for 2008.

Based on the 2007 experience and practice Municipalities will be required to prepare Public Investment Program – PIP analyses for all public investment projects (almost entirely capital expenditure projects). Proposals that lack a PIP analysis will not be

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<sup>7</sup> Estimate of the MLGA.

considered for funding. PIP proposals will include both those proposed for Kosovo Consolidated Budget – KCB funding consideration and for donor funding, too. They should include projects that would be initiated in 2008, 2009 and 2010 – not just projects that would be initiated in 2008. Municipalities will receive additional information on the PIP process, as well as PIP training, in the near future. It will be difficult for the proposals for new capital spending to be supported by analysis of the benefits and costs of the project (where available) and to be in consistency with Municipal priorities.

LSG investments were well below what is required to meet EU infrastructure standards over the pre-accession period in the transitional countries. Most of local infrastructure was obsolete and a large amount of effort is required for its replacement and modernization. Services such as water, sewage and solid waste systems involve large unit costs. To increase the level of such services will require considerable investments. It is evident that part of development, replacement, and renewal of local assets will need to be financed out of LSG budgets but large part need to be financed by the central authority.

For illustration, the EAR project on strengthening the capacity of the Ministry of environment and physical planning in Macedonia prepared estimates for meeting the capital and operational costs of the investments required to comply with European Union directives and policies in the “heavy investment” areas of environmental management. Within this project, the indicative estimates for the cost of accession in the heavy investment areas have been estimated as a total of 1,1 billion euros or around 550 euros per capita.

Thus, if we just roughly say that Kosovo is in an equal situation as Macedonia it will require in total around 1,4 billion Euros just to comply with the environmental legislation of EU. Thus, the capital grants from the line ministries will be important part of the grant system for a while in Kosovo. However, the central authority can reconsider establishing a Capital Financing Fund governed by the government which can also coordinate the donors programs, so that the municipalities can enhance their capital investment planning and apply for financing through the fund. This can help LSG to enhance their planning function and replace in time the donor driven process.

## **Borrowing**

If municipalities do not properly balance their expenditures with their own revenues and grants, then they will generate budget deficit and debt through the means of borrowing money. This will have further adverse effects on the macroeconomic stability and can result in an unsustainable public debt. This is why borrowing to municipalities is allowed, but only under proper control and regulation from the central government.

The Charter states in Article 9 that, for the purpose of borrowing for capital investment, local authorities shall have access to the national capital market within the limits of the law. By contrast to this, the budget law in Kosovo puts restrictions on

borrowing to all budget organizations including municipalities and authorizes the Ministry of Finance and economy to be the sole authorized agent for all borrowing activities of budget organizations in Kosovo.

The current situation in Kosovo justifies such restrictive measures imposed. In other words, borrowing for municipalities is still not advisable. From a mid-term perspective, a policy for generating debt at the municipal level in Kosovo will further require a stable intergovernmental system, strong financial management in municipalities, a developed credit market and proper legislation to regulate financial instability as well as insolvency and reporting standards, at least at the municipal level.