CHAPTER 15.

INTERGOVERNMENTAL TRANSFER SYSTEM IN SERBIA – CURRENT ISSUES AND CHALANGES[1]

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Abstract

Intergovernmental transfer system is one of the key components of the local governmental financing system. It role is to equalize the position of the local governments (LGS) and in this way to enable them to fulfill large variety of competencies which have been in the last couple of decades broaden far beyond the traditional one, which includes areas of local administrations and various social functions. Nowadays, these competences include issues such as local economic development, local infrastructure development, local investment programs, pro-active local employment policy and other. The issue of LG financing and the specific role of intergovernmental finance system in Serbia has been especially emphasized with enforcement of law on local government financing (2007), the intention was to insure the stable and predictable source of LGS financing which should decisively contribute to improve the effectiveness of management process in planning and implementing local budgets. Unfortunately, just after two years of applying of the law, the global finance crises broke and the strongly negatively impacted its effects, which eventually resulted in its suspension in some of its most important aspects.

Key words: *local governments system reform, shared vs. own LGs revenues, revenue equalization, fiscal decentralization, budget transfers, financial position of local governments*

INTRODUCTION

Since 2000, the local government finance system in Serbia has undergone significant reforms which have actually improved the position of local

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governments, according to financial indicators. Total local government revenues per capita were continuously growing in real terms until 2008. In 2009 and 2010, there was a decline in local revenues, but in real terms they are still higher than at the beginning of the mentioned period.

The Law on Local Government Finance, enacted in 2006 and came into force in January 1, 2007, has a very important role within the reform process. The most important aspect of this law is the introduction of a specific intergovernmental financing structure (from central government to local government units) through the system of transfers.

TRANSFERS FROM HIGHER TIERS OF GOVERNMENT AS A SOURCE OF REVENUE FOR LOCAL GOVERNMENTS

The Law on Local Government Finance established two main groups of transfers:

- ***Earmarked transfers -*** this group of transfers pertains to the funds transferred from the Republic direct budget beneficiaries (primarily from ministries) to local government units in order for them to finance concrete projects or activities. Therefore, they are not regular (they are not transferred at regular intervals, for instance annually), instead they are project based and must be spend for strictly defined project purposes.
- ***Non-earmarked transfers -*** as opposed to earmarked transfers, these funds are transferred at regular intervals and are of general purpose, i.e., are transferred to LGU budgets without any special guidelines in regard to their spending purpose. This means that LGUs may independently decide how to use these funds, similarly or identically, to the way in which they use other budget revenues.

Because of the above described features non-earmarked transfers have gained on importance within the intergovernmental finance system. They have been introduced with obvious intentions to support specific, very important functions of the newly devised system, and first of all, its equalization functions and increased stability and predictability of local government finances.

In order to additionally emphasize these specific features of the transfer system the Law has specified that non-earmarked transfers should account for a total of 1.7% of the GDP of the country. This amount is to be calculated according to the last officially available statistics at the moment of calculation (it is GDP from the previous year). Other information needed for calculation of total amounts as well as the structure and distribution of transfers by LGUs are specified according to the official data from the same year.

According to the Law on Local Government Finance the following four types of non-earmarked transfers have been defined:

- Equalization transfer
- Compensation transfer
- Transition transfer, and
- General transfer

Equalization transfer

Equalization transfer has a high-priority position among other transfers, and because of that it is to be calculated before other, the above mentioned, non-earmarked transfers. It is calculated based on the Republic average of shared revenues per capita. Municipalities which „qualify"for receiving this transfer are those with shared revenues per capita are below 90% of the Republic average, calculated without the cities. These municipalities receive the amount of equalization transfer which will bring them to the targeted level (to 90% of the Republic average of municipal shared revenues per capita).

Compensation transfers

Compensation transfers are transfers specified as funds used to compensate LGUs for revenues lost due to amendments of tax rules affecting local budget revenues passed by the Republic in previous period of time. They are defined on the permanent base – once they are calculated they became regular revenue of the LGs. It is even specified in the Law that their real value is safeguarded by correcting its nominal amount for average annual inflation rates.

According the Law, the compensation transfers are supposed to be distributed to the LGs which have lost certain sources of budget revenues due to the changes in system laws. The most significant LG system changes which are related to this transfer were canceling the tax on salary fund and the sale tax. In order to compensate the decrease of local budget revenues because of these measures the share of LGs in salary tax was increased to 40%. In the case of 39 out of 145 LGs (mostly the "richer" LGs including Belgrade) this remedy measure was not sufficient. In the case of Belgrade in order to fully compensate this gap this share should have been increased to 62% (instead only to 40%). The argument in the case of Belgrade for provide this compensation was that Belgrade is the main trade centre in which are shopping not only the citizens of Belgrade but as well as citizens from all other cities who are visiting the Capital. The same could be applied to the cases of other cities and more developed LGs. So 39 LGs has been assigned compensation transfers to the level which fully compensated the gap in revenues created in described way.

Transition transfers

Transition transfers are distributed to LGUs in a situation when calculation of their transfers changes due to change in their revenues. The transition transfers are calculated for the period of three years. In the first year the whole amount lost is compensated for, in the second 50% and in the third 25% of the same amount. In the second and third years, the initial amount is adjusted for the current inflation rate. This transfer is intended for both units of local governments, municipalities and cities. However cities may count on it only when their losses exceed 5% of their total revenues as opposed to municipalities which have the right to its total amount regardless of the degree of their losses.

General Transfer

This transfer is distributed to all LGUs, in other words to cities and municipalities alike. It is important to note that the general transfer is calculated last – after all the above mentioned transfers have been calculated and subtracted from the total amount reserved for non-earmarked transfers.

The criteria for calculation of this transfer have been defined by the law. They pertain to the size of population (65%), and territory (19,3%), number of school children in primary schools (4,56%), number of children in secondary schools (2,0%), number of buildings for primary schools (1,14%), number of buildings for secondary schools (0,5%); number of children covered by child care (6,9%) and number of buildings for child care (1,5%).

Equalization of positions of LGUs in terms of their revenues is done also by the general transfer. This additional equalization mechanism works as follows: the general transfer for local government units where shared revenues per capita are 50% above the average is reduced 40%. Funds obtained in this way are in the form of general transfer distributed to local government units whose average of shared revenues is below the mentioned limit.

"Robin Hood" mechanism (transfers redistribution)

The part of the methodology of transfers' calculations is mechanism of additional transfer redistribution colloquially called "Robin Hood" mechanism. This mechanism is applying as the second iteration in transfers' redistribution. This correction refers to reduction of transfers to LGUs with shared revenues 50% above the Republic average (index 150). Their revenues were reduced by 40% of the difference above the limit and revenues obtained in such way were distributed to other LGUs by applying the same criteria used to distribute general transfers.

THE MAIN OBJECTIVES OF THE TRANSFER SYSTEM

The above described mechanism (first of all) of non-earmarked transfers has two main objectives and two basic features stemming from them:

- ***Equalization of LGUs*** – the whole logic, as well as the manner in which the system of non-earmarked transfers works, point out that one of the system's basic goals is to make LG units equal in terms of available revenues per capita. In addition to equalization transfer where this equalization function is explicit, general transfer are as well contributing to the equalization of LGs position because it is distributed in accordance to specific unit measures like number of inhabitance, surface, etc. In addition to this general transfer has as well purpose to provide a minimum level of revenues related to locally provided services.
- ***Stability and predictability of LG revenues*** – in the period before the Law on LG Financing was introduced, one of the main remarks regarding its effect were referring to the problems and difficulties in projecting budget revenues in coming budget year and consequently in planning expenditures and all activities LGUs need to perform in a budget year. This issue has become particularly sensitive as local government functions broadened in the social domain, in infrastructure development and in the domain of local economic development in general.

FUNCTIONING OF THE TRANSFER SYSTEM

Transfer system in 2007 and 2008

The above described model of transferring funds from the Republic to local budgets functioned for only two full budget years: 2007 and 2008. Transfers were defined and then transferred to LGUs in accordance with the described mechanisms and within limits (Table 1).

Transfer system in 2009

In 2009 the world financial crisis caused dramatic changes in the area of public finances. The Republic Government entered negotiations with the IMF at that time and as a result of their negotiations a comprehensive two year financial arrangement was set up.

Part of the agreement which pertained to local government finances specified that total non-earmarked transfers to LGUs needs to be reduced from 40.7 billion dinars to 25.7 billion dinars, i.e., to be reduced by 15 billion dinars. This decision became effective when the Law on Amendments and Addenda of the Budget Law for 2009 was adopted. These changes simply suspended the main part of intergovernmental finance system: namely, the 1.7% GDP requirement was simply disregarded.[4] The suspension became effective after the first four months of 2009 (January-April). Therefore, amendments of the Budget Law were based on two basic assumptions:

- The first, and most important for the system as a whole, is the mentioned *a priori* reduction of transfers to LGUs by 15 billion dinars;
- The second is that the transfer system has not been eliminated, but rather suspended, which is confirmed by the fact that instead of changing particular elements of the system (for instance by changing shared revenues distribution ratios), the transfers for 2009 were calculated by using the described methodology and then the local government total budgets were simply reduced. The key part o this methodology refers to defining „redistribution” of the reduction across budgets of all LGUs.

Transfer system in 2010-11

When transfers for 2010 and 2011 were calculated the same suspension of the Law on Local Government Finance, in the part pertinent to calculation of total transfers and their distribution to local government units, was retained. Exemptions thereof were specified in the Budget Law of the Republic of Serbia for 2010 and 2011.

No additional calculations were used to calculate transfers for 2010; instead the Budget Law took over exact values of transfers and their distribution to LG units identical to that for 2009.

[4] It could be said that system was „frozen" as it was defined in 2009, and in the next years it was just replicated: in 2010 without any change in the amounts and structure of the transfers and in 2011 without changes in the structure, but with increased total amount.

Transfers for 2011 with 23.8% (index 123.8) increase were 31.8 billion dinars. The increase is a result of particular government's efforts to reduce discrepancy between the actual amount of transfers and 48 billion dinars which would have been transferred had the Law on Local Government Finance been fully applied. Amounts for particular LGUs were specified by a linear increase (23.8%).

METHODOLOGY FOR TRANSFER REDUCTIONS APPLIED IN 2008

Before finalizing the draft Law on Amendments and Addenda of the Budget Law of the Republic of Serbia of 2009, the simulation of the effects of transfer reductions based on total budgets has been performed. The following five basic, and the sixth one which is derived from the fifth models - were considered:

Model 1: Linear (proportional) reduction of non-earmarked transfers for all LGs

Model 2: Adjusted starting methodology for calculating LG transfer reductions

Model 3: Fixed transfer reductions - equal transfer reductions for all LGs

Model 4: Fixed transfer reductions - equal transfer reductions for all LGs – with exemption of poorer LGs

Model 5: Transfer reductions in line with economic power and flexibility of LG budgets to adjust to decreased amounts of revenues

Model 6: This model, which was eventually adopted and applied, is actually modified version of model 5.

Model 1: Linear (proportional) reduction of non-earmarked transfers for all LGs

As explained, the non-earmarked transfers for 2009 were reduced from 40.7 billion dinars to 25.7 billion dinars – the difference is 15 billion dinars or 36.9%. In this model the mentioned percentage of reduction would be applied to transfers to all local government units. This model was evaluated in the following manner:

Advantages
Easy to understand and simple to implement.

Disadvantages
Given the different share of transfers in total local budgets the linear reduction of 36.9% at the same time would mean a very different percentage of reduction of total local budgets for different LGs. The share of reductions in local budgets ranges from 3.95% to 28.6%.
The most developed local governments experience the lowest reduction, and the poorest, with the lowest flexibility to adjust to change in revenues, are affected by the highest percent of budget reduction.

Model 2: Adjusted starting methodology for calculating LG transfer reductions

This model assumes that the reduction of transfers would be performed by adjusting the original methodology for transfer calculations by applying the following steps:

- Proportional reduction of compensation and transition transfers
- Keeping equalization transfer on the planned 2009 level
- The remaining amount up to 25.7 billion dinars is distributed in the form of general transfer

This model was evaluated in the following manner:

Advantages
Provides smaller and more acceptable range of discrepancy in transfer reductions distribution among LGs compared to the linear model. Budget reductions. In this case differences would range from 2.6% to 13.5%.
Disadvantages
The largest budget reductions are seen in the least developed municipalities the same as in the linear model only to somewhat milder extent while developed local governments are affected by smaller reductions.
The burden of transfer reductions bear mostly local government units entitled to compensation transfer as a replacement for their lost revenues due to changes in distribution of shared revenues.

Eventually, this model was seen as conceptually unacceptable, because it undermines the basic concept, the methodology and the criteria for calculation of non-earmarked transfers as specified in the Law on Local Government Finance.

Model 3: Fixed transfer reductions - equal transfer reductions for all LGs

Basically this model is built on an idea to put all government units in an equal position, by defining a fixed level of reduction for all local budgets.

Reduction of revenues, at that (through transfer reductions), by 15 billion dinars of total current local budget revenues in 2008 amounted for 8.54% reduction. This model was evaluated as follows:

Advantages
Transfer reductions are adjusted to total actual generated revenues therefore all local government units experience the same reduction of their budget revenues per capita.
Disadvantages
Despite of a significant conceptual improvement and taking into consideration capacity of local government units to adjust to their revenue reduction, the fact remains that budget flexibility is not the same in developed and underdeveloped local governments and fixed percentage of reduction, apart from a significant improvement compared to the previous models still puts less developed local government units in somewhat disadvantaged position.

Model 4: Fixed transfer reductions - equal transfer reductions for all LGs – with exemption of poorer LGs

This model implies that the poorer municipalities would be exempted from transfer reductions, that is, the reduction of total budget revenues.
For this, it would be used the same criterion as the one used for calculation of equalization transfer (90% of the Republic average of shared revenues). In this way the burden of 15 billion in transfer reductions would be shifted to the remaining local government units. In this case the proportional reduction rate should be 9.58%.

This model was evaluated as follows:

Advantages
Poorer local government units, with shared revenues per capita in 2008 below 90% of the Republic average would not be affected by transfer reductions
Disadvantages
A shortcoming of this solution is unequal reduction of budgets of those local governments which are right above or below the dividing line. Thus, for instance, a municipality which is slightly below the 90% limit (e.g. 89.9%) would not be affected by transfer reductions while a municipality slightly above the 90% limit (90.1%) would experience 9.58% reduction of its total budget revenues.
Also, the same as in the previous model (fixed reduction rate applied to all LGs without exemption) when reducing revenues not much consideration is given to ability of local government units to adjust to the said reduction of their budget revenues.

Model 5: Transfer reductions in line with economic power and flexibility of LG budgets to adjust to decreased amounts of revenues

This model of transfer reductions suggested:

- Continuous reduction of transfers in compliance with limit set by the methodology.
- In order to enable such compliance it is introduced the so called „irreducible part of budget revenues“. The subject of reduction by applying a uniform rate through a process of „trial and error“method is the remaining part of total revenues.
- Within this model several sub-models have been tested which differ from each other in the amount of unreduced budget revenues and result in different, wider or narrower range of transfer reductions.

Models that were tested included „irreducible“ parts ranging from 3,000 to 7,000 dinars per capita The example in the following table shows calculation of reductions for two local government units (Aleksandrovac, representing the poor and Belgrade representing the right local government units) in the model where „irreducible part of the budget” is 7,000 dinars.

Below, an overview of transfer reductions range is provided depending on the amount of „irreducible“part of the budget per capita.

Table 1. Overview of transfer reduction in accordance with amount of irreducible part of local budgets

Part of the budget which is not subject to reduction - in dinars -	Level of reduction of total LG budget revenues	
	from	to
7,000	-1.69%	-10.39%
6,000	-3.00%	-10.17%
5,000	-4.20%	-9.82%
4,000	-5.26%	-9.51%
3,000	-6.22%	-9.24%

This illustration shows that the range of budget reduction expands as part of the budget which is not subject to reduction grows. If part of the budget which is not subject to reduction is set as 7,000 dinars per capita total budget of the poorest municipality will be 1.69% smaller, while the richest municipality will be affected by 10.39% reduction. In the case when irreducible part of the budget is 3,000 per capita the reductions are 6.22% and 9.24% respectively.

Model 6: Adopted model – upgraded version of model 5

The Local Government Finance Commission found at one of its sessions that Model 5 is the most acceptable, however, in their criticism of this model they pointed that its further implementation (should reductions in the transfer system continue throughout the following years) could negatively impact local government's motivation to collect its own revenues. With the aim of overcoming this weakness a sub-model has been suggested where the property tax and self-contribution fee would be left out from the total local budget subject to reduction. These corrections resulted in creation of Model 6.

Compared to its original model this newly suggested model where the above mentioned revenues are left out from the calculation of transfer reductions keeps almost the same range but this time at a slightly higher level of reduction (e.g. it is 1.76% instead of 1.69% and 10.47% instead of 10.39%). Problem with this model is larger number of LGUs with over 10% of budget reductions (five LGUs instead of one anticipated in Model 5).

This model was evaluated as follows:

Advantages
Transfer reductions are in line with flexibility of local budgets to adjust to their reduced total budget revenues. The poorest municipalities are affected by the lowest reductions which gradually increase as budget revenues per capita go up.
By choosing „irreducible" part of the budget it is possible to come up with various ranges of reduction and make compromises between more and less developed local government units
Disadvantages
In order to achieve the above described results it is necessary to apply somewhat complex methodology for calculation of transfer reductions, or rather, total budget revenues of local government units, as described above, which may make it difficult to understand

However, possible difficulties in understanding the methodology would not cause problems in its practical implementation considering that obtained results are clear and applicable (amount and percentage of reductions are precisely determined which clearly points what the original aim was – even reduction of revenues depending on budget revenues per capita).

The Local Government Finance Commission failed to reach consensus at its repeated session about the best model of transfer reductions, therefore after voting, the majority decided to suggest modified Model 5 to the Ministry of Finance for adoption.

Model 6: Transfer reduction methodology – adopted model

After taking into consideration all the above described models of transfer reductions and comparing their advantages and disadvantages the Government of the Republic of Serbia, in general, decided to accept the last one (Model 5). As a result of compromise a modality based on the following concrete assumptions has been defined and was applied to local government units which were affected by the highest reductions:

- Part of the budget per capita which is not subject to reduction was set at - 3,000 dinars per capita
- Transfer reductions may not exceed 50% of transfers which were specified in the budget document for 2009
- Also, an additional condition is that no local government unit may be left without transfers in the period May-December of the current (2009) year.

It is estimated that these additional assumptions enabled keeping the criterion according to which budget reduction percentage depends on the amount of revenues per capita. In this proposal, budget reduction percentage would range between 5.4% and 11.1%, and the largest number of municipalities would be affected by reductions between 8% and 10%. These ranges differ from the previously presented ranges for Model 5 because of the newly introduced corrective factor, that is, a condition that no LG unit can be affected by more than 50% reduction in transfers.

The following table shows effects of transfer reductions in the adopted methodology on illustrative examples of five LGUs: Aleksandrovac, Belgrade, Kragujevac, Čačak and Jagodina.

Table 2. Illustrative calculation of transfer reductions within the accepted model for five local government units

No	Description	Aleksandrovac	Belgrade	Kragujevac	Čačak	Jagodina
1.	Total revenues in 2008, 000 RDS	270,506	71,443,714	4,963,145	1,899,457	1,664,573
2.	Population	29,389	1,576,124	175,802	117,072	70,894
3.	Revenues per capita	9,204	45,329	28,231	16,225	23,480
Part of the budget which is NOT subject to reduction						
4.	per capita, RSD	**-3,000**				
Part of the budget which is subject to reduction						
5.	per capita, RSD	6,204	42,329	25,231	13,225	20,480
6.	total, 000 RSD	182,339	66,715,342	4,435,739	1,548,241	1,451,891
	Calculation rate	**12.28%**				
7.	2009 transfer, 000 RSD	148,956	11,133,500	843,141	540,470	342,735
8.	50% limit of transfer reduction, 000 RSD	-74,478	-5,566,750	-421,571	-270,235	-171,367
9.	Transfer reduction (up to 50%), 000 RSD	-22,398	-5,566,750	-421,571	-190,179	-171,367
10.	% of transfer reduction	-15.0%	-50.0%	-50.0%	-35.2%	-50.0%
	% budget reduction	**-8.3%**	**-7.8%**	**-8.5%**	**-10.0%**	**-10.3%**

For the initial assumption that about 3,000 dinars per capita will not be subject to reduction, with the method of „trial and error" it was calculated that the average rate of reduction of the remaining part of the budget would be 12.28%.

Reductions in transfers are calculated by applying this rate to part of the budget which is subject to reduction. For instance, for Aleksandrovac this rate resulted in 15% reduction in transfer and 8.3% reduction of total budget and for Čačak these reductions are 35.2% and 10.0%.

For Belgrade, Kragujevac and Jagodina applying the defined rate of 12.28% would cause more than 50% of reduction in transfers. Since the limit is 50% their transfer reduction is set to be 50% and consequently their total budget reduction percentage changed into 7.8% for Belgrade, 8.5% for Kragujevac and 10.3% for Jagodina.

EFFECTS OF TRANSFER SYSTEM IMPLEMENTATION IN THE PERIOD 2007-2010

The following lines show how the described transfer system has been implemented in the period from 2007 to date, including the plan for 2011. As presented in Table 1. the transfer system functioned in accordance with the Law only in the first two years (2007 and 2008). It was then when the methodology for calculation and distribution of transfers was fully applied; thus, equalization transfer, compensation and transition as well as general transfer were calculated and transferred. At the end transfer were corrected by applying the so-called „Robin Hood“transfer.

Table 3. Transfers in the period 2007-2011, in millions RSD

Transfers/Years	2007	2008	2009	2010	2011 (plan)
Earmarked transfers					
Equalization transfer	2,613.3	2,980.5	-	-	-
General transfer	11,298.9	14,829.4	-	-	-
Compensation transfer	17,830.3	20,691.8	-	-	-
Transition transfer	648.8	345.2	-	-	-
Correction of transfers (so called “Robin Hood”)	- 2,641.3	- 2,708.2	-	-	-
TOTAL earmarked transfers	**29,750.0**	**36,138.6**	**25,681.0**	**25,681.0**	**31,800.0**
Non-earmarked transfers					
Non-earmarked transfers	5,598,5	5,203.6	2,993.7	7,094.8	NA
TRANSFERS-TOTAL	**35 531.1**	**41 422 4**	**28 674.7**	**32,775.8**	**NA**

In 2007 transfers were 35.5 billion, out of which 29.8 billion dinars referred to non-earmarked transfers. In 2008 this amounts increased to 42.4, i.e. to 36.1 billion. In 2009 the whole system was suspended and 41.7 billion dinars of planned non-marked transfers were simply reduced for 15.0 billion dinars. The reduction was applied by means of a specific methodology which is described below. In 2010 the same amount of non-earmarked transfers was applied with no changes or correction while a significant nominal increase of 23.8% has been planned for 2011 (Table 4).

Table 4. Changes of non-ear marked transfers distributed in the period 2007-2011, indices

Years	**2008/2007**	**2009/2008**	**2010/2009**	**2011/2010**	**2011/2007**
Indices	121.5	71.1	100.0	123.8	106.9

Table 5 shows the structure of transfers in the mentioned period. It is interesting to note that compensation transfers, with the basic function to preserve the existing LGU positions in terms of budget revenues, had the highest share of all transfers (around 50%). As said, the compensation transfers are distributed to those LGUs which are losing part of their budget revenues on certain grounds (often due to legislation changes). They are allocated permanently and at that they are adjusted for the inflation rate every year.

Table 5. Structure of distributed non-earmarked transfers in the period 2007-2011, in %

Transfers/Years	**2007**	**2008**	**2009**	**2010**	**2011 (Plan)**
Earmarked transfers					
Equalization transfer	7.4%	7.2%	-	-	-
General transfer	31.8%	35.8%	-	-	-
Compensation transfer	50.2%	50.0%	-	-	-
Transition transfer	1.8%	0.8%	-	-	-
Correction of transfers (Robin Hood)	-7.4%	-6.5%	-	-	-
TOTAL earmarked transfers	**83.7%**	**87.2%**	**89.6%**	**78.4%**	**31,800.0**
Non-earmarked transfers					
Non-earmarked transfers	15.8%	12.6%	10.4%	21.6%	NA
TRANSFERS-TOTAL	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**NA**

General transfers are next important transfers that accounted for 32% and 36% of all transfers in respective years.

The so-called „Robin Hood“ correction although applied only to Belgrade and Novi Sad, accounted for significant 7.4% and 6.5% of all transfers in respective years.

Equalization transfers in 2007 and 2008 accounted for 7.4% and 6.5% of total transfers, which can be deemed insufficient given their function it is important to consider the number of LGUs which obtained this transfer as well as the number of them which didn't. In 2007, the transfers were distributed to 87 LGUs, and out of 145 LGUs in Serbia 58 didn't receive transfers on this ground (Table 6.).

Table 6: Overview of the LGUs which have received equalization transfers

Years	**2007**	**2008**
Number of LGUs which received equalization transfer	87	91
Number of LGUs which didn't receive equalization transfer	58	54

In 2008 these numbers changed into 91 and 54 respectively.

CURRENT CHALLENGES

During the 2011 the intergovernmental financing system has enter into the focus of public interest in Serbia due to the efforts of some of the political parties to enforce a process of decentralization of Serbian governmental system. The initiative, among other, included the following changes:

- The change of the shares of the central vs. local governments in total amount of income taxes collected at LG territories: the share of LGs increased from 40% to 80%. This applies to all LGs (cities and municipalities, except Belgrade which share is limited to 70%);
- The non-earmarked transfers for LGs are continued to be calculated by applying indicator of 1.7% of GDP, but now they are distributed unevenly in accordance with the level of LGs development. The least developed LGs are getting 100% of these funds; the following groups of LGs ranged by level of development are getting 90%, 70% and 50%, respectively.[5]

[5] The classificationof the LGs by the level of development is perfomed by applying the *Indicators of LGs Economic Development* created by Republic Ministry of Economic and Regional Development.

- The City of Belgrade is calculating, but not getting any of these transfers from the level of central government. From the funds calculated for Belgrade the so called solidarity fund is to be created and then distributed to above mentioned four groups of LGs in the following proportions: 50%, 30%, 10%, 10%, respectively.
- The transition transfer, as well as the corrective mechanism colloquially called Robin Hood" - are cancelled.

The effects of the new Law are still not quite clear since it is enforced from the beginning of July 2011. However, based on some preliminary simulations, some of the main risks and challenges could be identified:

- In financial terms the redistribution of funds between Central and local level as an effect of Law enforcement will represent 44 billion RSD. Since this change is not followed by corresponding redistribution of the competencies between these governmental levels, this amount will simply additionally burden the Republic budget. At the same time the limit to the deficit of Republic budget is already clearly set, it is not clear how this amount will be provided. The Republic Fiscal Council (the body which was established with the purpose to indicate this kind of situation) as well as IMF, has already clearly pinpoint the risks related to this solution.
- The biggest "winners" in budget transfers redistribution will be indeed the least developed LGs. On the other hand, when in this calculation are included as well as the effects of increase of the shares in income taxes, it appears that eventually the biggest "winners", in absolute terms, are the most developed LGs, first of all cities, including Belgrade.[6]

CONCLUSION

During the first decade of 21st century the system of LGs financing in Serbia has passed through significant reform changes. As a result of this process the competencies of Serbian LGs (municipalities and cities) have considerably broaden, which by definition has improved their financial position.

The key changes in the LGs finance system are related to the Law of local government financing which was adopted in 2006 and enforced from the beginning of 2007. This Law has provided to the LGs lager stability and predictability of the inflows into the local budgets. Unfortunately as a

[6] This should not be a surprise having in mind that the largest employment centers are the biggest urban areas, i.e. the biggest cities.

consequence of the financial crises, some of the major parts of the Law have been suspended in 2009, and to the present it is kept ineffective.

Restoration and then its further broadening of the reform process in this area are key for providing of the sustainable development of the LGs. This refers to the further development of LGs´s administrative and social competencies and at the same time increasing of the economic-development competencies, such as development of local infrastructure, supporting local business and employment of inhabitance.

Important aspect of LGs financing which has been paid special attention in the work is the financial position of the local governments, i.e. the level of their (un)equalization. One of the most important components of the mentioned Law has been devoted to the system transfers from central to the local level of governments, which main purpose was to equalize the financial position of the LGs.

The newest development in this area has been referred to improvement of the financial position of LGs (increase share of total funds available to LGs) and at the same time to equalization of their financial position. The newest changes in the Law of LG financing have increased the share of income taxes which are transferring to the LGs but in such a way that the poorest LGs get more and richer less of the transfers.

However, having in mind the present state of public finance in Serbia and the imperative to decrease the public deficit till 2015, which is set by the Law of Budget System, the sustainability of these solutions is questionable, and not only in a short term, but as well in the medium and longer term.

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