



Republic of Serbia

FISCAL COUNCIL

LOCAL PUBLIC FINANCES: ISSUES, RISKS AND RECOMMENDATIONS

Summary

Poor financial management at the local level of administration is one of the largest problems of Serbian finances, the resolution of which would require adoption of concrete measures by the Government. Fiscal problems of local governments put the national public finances at risk, but they also slow down economic growth and lower the quality of life of Serbian citizens. The budgets of many cities and municipalities are unsustainable, while the majority of public enterprises and other institutions under local governance (e.g. pharmacies) show very poor performance. Together with their enterprises, cities and municipalities owe a debt of almost 1 billion Euros; in addition, they are late with payment of outstanding liabilities to suppliers, in the amount surpassing 300 million Euros. The failure of local governments and their public enterprises to pay their liabilities spreads the problem of the local administration to the rest of the economy, especially to public enterprises (which frequently ends up being covered from the national budget), slowing down the country's economic growth. An additional way in which poor local financial management slow down GDP growth is a systemic lack of investment - the annual gap in public investments of local governments comes to about 250 million Euros. Instead of going towards the necessary investments, these funds are mostly redirected to cover the losses of local public enterprises, which receive enormous subsidies in the total amount of about 200 million Euros per year. Perhaps the most devastating effect of disordered finances of cities and municipalities is the fact that the services that local levels of government offer to citizens are at a disconcertingly low level. In terms of access to clean drinking water, waste treatment, wastewater treatment, percentage of children enrolled into pre-schools and numerous other indicators, Serbia is lagging far behind not only developed EU countries, but also behind comparable countries in Central and Eastern Europe. Due to all of the above, we deem that the Government of Serbia would have to get involved more directly into the resolution of the local governments' largest issues - i.e. to prepare and implement a credible set of measures.

The Fiscal Council has analysed the largest problems of local governments, ascertained the causes that lead to them and given recommendations for their resolution. The Fiscal Council has studied all the relevant economic aspects of the operation of local governments in Serbia. Due to a large number of topics covered, this research surpasses the standards of our regular reports in both complexity and length. *The first* part of the report looks into systemic local government issues - the collection and expenditure of funds, relationship between the local and central level, lack of control over local government budgets, quazi-fiscal taxes etc. *The second* large chapter pertains to individual analysis of the

budgets of four largest cities in Serbia - Belgrade, Novi Sad, Niš and Kragujevac. These are cities with large and complex fiscal issues; they cover a half of the total revenue and expenditure of local governments and owe 70% of the debt. *The third* section of the report covers local public enterprises. We analysed the financial reports of about 500 local public enterprises in the period from 2006 to 2015, as well as data from other available sources, to provide a comprehensive review of their operation and, specifically, their provision of individual public utility services (water supply, cleaning, heat plants, transport etc).

A large number of local government budgets is unsustainable and calls for strong consolidation measures. Even though local governments have not had a formal deficit in the previous four years, the real status of local finances is far from good. A large number of towns and municipalities in Serbia fail to meet their outstanding obligations in time, i.e. they fall into arrears default - so the fact that local governments have no formal deficit is merely the consequence of the fact that not all budget expenditures are being paid. For example, Smederevska Palanka is already late with payment of its liabilities in the amount equal to three of its annual budgets; Kragujevac, Prokuplje, Bačka Topola, Niš, Leskovac and many others also have enormous issues with arrears defaults. Although entirely reliable data on defaults are not available, based on the reports of the State Audit Institution and analyses of individual budgets of cities and municipalities we conclude that the current level of default of local governments (excluding local public enterprises, pharmacies and primary health centres) has exceeded 100 million Euros. The second reason why local budgets do not produce deficits is that the Republic of Serbia assists certain failing local governments by approving a transfer of funds from the budget reserves on top of the amounts it is legally obliged to provide. In 2016, this was the basis for approval of about 2 bn dinars of assistance, while in the previous ten years, this entirely discretionary support exceeded 100 m Euros.

In the majority of cities and municipalities, the integrity of budgeting is at risk. A major fiscal problem for the local government is the fact that the budgets of the majority of cities and municipalities lack credibility. In total, the budgets of all local governments have planned for a total revenue for the local government in 2016 of about 310 bn dinars, while in reality, only about 265 bn dinars were collected. In addition, the total expenditures were planned at 330 bn dinars, while about 260 bn dinars were realized. There are several reasons for such large discrepancies between the budget and its execution. In the process of budgeting, local governments will often include outstanding obligations from previous years in the expenditures (to allow for open appropriation in case they are paid); in addition, other expenditures, which are not likely to be implemented, are included in the planning in order to be on the safe side (usually large investment projects). This is why the planned budget expenditures are usually unrealistically high. The next step, after the unrealistic expenditure planning, is to inflate the revenue so that the planned deficit is not too large. The consequence is that local governments, on average, fail to meet about 15% of their planned revenue and about 20% of their planned expenditures, which makes their budgeting process practically meaningless. The position of the Fiscal Council is that arrears must be reliably recorded and tracked outside of the budget and should only be included in the budget when it is clear that they will be paid in the upcoming year, as a budget needs to be a realistic and binding document for the management of local public finances.

The structure of local government expenditures is very poor - too much is being spent on subsidies and too little on capital expenditures. Probably the greatest structural shortcoming of local government public finances lies in its long-standing deficit in public investments. Local governments in Serbia spend only about 1% of their GDP (about 330 m Euros) on investments, while the remaining CEE countries average about 2% of GDP. What's worse, in recent years the share of local public investments in Serbian GDP has decreased to

about 0.8% of GDP (whereas in CEE countries it increased to about 2.5% of GDP in the same period). On the other hand, poor performance of local public enterprises (LPE) constitutes an enormous and relatively stable budget expenditure of local governments, which provide, for subsidies of such enterprises alone, about 0.6% of GDP annually (about 200 million Euros), whereas total local subsidies amount to about 250 million Euros (0.8% of GDP). Expenditures for LPE subsidies in Serbia are three times higher compared to local government subsidies in CEE countries. Other fiscal imbalances of local governments are slightly smaller, but we have observed somewhat increased expenditures for staff and a lower property tax collection rate compared to the desired levels.

Local investments should be increased by at least 250 million Euros, while over a half of the funds can be secured through the reforms of local public enterprises. Due to a long history of insufficient local government investments, the state of local infrastructure in Serbia can now be evaluated as catastrophic, without any reserve. Many Serbian citizens have no access to clean drinking water, sewers, organized waste disposal, the local road infrastructure is quite poor, majority of existing landfills are not engineered, there are numerous informal landfills etc. In addition to meeting indisputable needs, an increase of investment activities of local governments would have a positive impact on Serbian economic growth as well - in the short term, while the investment works are being carried out, but also in the medium term, as the construction of local infrastructure would certainly improve the business climate. We estimate that the local government investments in the medium term should be increased by at least 75% compared to their current level, i.e. by about 250 million Euros. This investment increase is possible with a minimal (or no) increase of local government debts. Namely, more than a half of the necessary funds for the proposed investment increase can be secured through a reform of local public enterprises, i.e. by savings on subsidies. Reforms of LPEs were the subject of a detailed analysis in a separate section of this report, where we estimated that they could decrease the local government subsidies by about 150 million Euros, compared to their current level. For the subsidies to be decreased to that extent, the most prominent problems of LPEs would have to be resolved - superfluous staff, low collection rate, high technical losses and other inefficiencies.

With its poor policies, the central level of government has contributed, to a large extent, to the problems of local governments. The majority of the responsibility for the poor state of local public finances certainly lies with the local governments themselves, but the central level has contributed to the problems to a significant degree too. After the enactment of the Law on Local Government Financing in 2007 (which, in principle, was good), in 2009, local governments were stripped of 15 billion dinars by an *ad hoc* decision of the Government. Shortly after, political pressure and bargaining lead to a new Law from 2011, allocating as much as 40 billion dinars to the local level, which had previously been allocated to the central budget, without proper justification. This amendment lead to an implosion of the Republic's public finances and was subsequently revised twice (in 2013 and 2016), to increase the central level revenue and decrease the revenue of cities and municipalities. With frequent and sometimes unjustified amendments to the Law on Local Government Financing, the balance between the revenues of the local and central levels of government was disrupted, as was the balance between individual local governments. What is worse, these amendments were usually abrupt, so that towns and municipalities didn't have sufficient time to properly adjust. The Fiscal Council therefore believes that a new, systemic solution for local government funding is now needed; one that would be carefully prepared and represent a permanent foundation for the regulation of the relationship between the central and the local levels of administration, as well as individual cities and municipalities.

The central level of government is largely responsible for not preventing the accumulation of severe problems of certain local governments in the previous decade. Local government has a constitutionally guaranteed autonomy from the central government, but there are numerous instruments the central government can use to prevent escalation of financial issues in local governments. However, responsible ministries failed to react in time, while the problems were at their beginning and could have been easily resolved. It is almost incredible that the Ministry of Finance has allowed Kragujevac to accumulate debt in a period of almost ten years, to fail to pay its obligations, to adopt utterly unrealistic budgets - all without any reaction whatsoever. It was similar in Smederevska Palanka and numerous other cities and municipalities in Serbia. Even now, the Ministry of Finance has no control or data on some of the more important fiscal indicators in local governments, such as arrears- there is no data on exactly how much local governments owe, to whom and for what purpose. In addition, extremely poor performance of local public enterprises, which has also lasted for at least ten years, has failed to elicit a reaction from the Ministry of Economy, i.e. failed to mobilize their expert assistance and pressure for necessary reform. The Ministry of State Administration and Local Government has no clear mandate to control the fiscal indicators of cities and municipalities, but their direct oversight over the local government system and the efficiency of its operation should have, at least, lead them to alert the public and other competent institutions to the growing financial woes. Now that the problems of individual local governments and local public enterprises have grown as considerably as they have, we believe that the ministries will have to take active part in their resolution, as local governments can no longer be expected to resolve them on their own.

The majority of the observed local government problems appear in the four largest cities in Serbia - Belgrade, Novi Sad, Niš and Kragujevac. The second part of this report is dedicated to a detailed analysis of the budgets of four largest cities in Serbia. Systemic problems of the local government can also be recognized in the analyses of these cities. Namely, all four cities have several years of serious lack of investments. Kragujevac and Niš, in addition, have no credible budgeting process and are very late in paying their suppliers (arrears). Enormous subsidies for failing local enterprises are predominantly present in Belgrade (GSP) and Kragujevac (almost all enterprises). On the revenue side of the budget, we observed that the collection rate for property tax is not sufficient in any of the cities and is especially poor in Kragujevac and Niš (which also have lower tax rates). Although it is difficult to compare cities which have different issues, we see that Novi Sad is in a somewhat better position than the other cities, according to its fiscal indicators, while Niš and especially Kragujevac face profound problems which require a complete U-turn in local public finance management.

Belgrade has stable finances, but key challenges remain. At the moment, Belgrade has balanced revenues and expenditures from the budget and is not late in paying its obligations (no defaults). However, as much as 15% of the annual expenditures (over 100 million Euros) in Belgrade are spent on covering the losses of the public transportation system. This inefficient public transport system doesn't leave the City with much to invest, so investments were only represented with about 80 million Euros in the previous three years, whereas they should come to at least double that amount. The need to increase Belgrade's investments, however, is far more than a matter of economy. Numerous residents of Belgrade have no access to clean drinking water or sewers, the waste landfill in Vinča is problematic in many ways (the idea of a public-private partnership is over 10 years old and only now is there talk of its implementation), Belgrade is the largest city on the Danube with no waste water treatment plant, the waiting lists for kindergartens are long, etc. Together with all these necessary and undisputed investment projects, in its strategic documents, Belgrade is

considering other major and very expensive investments (tunnels under the city centre, subway, access roads to Belgrade Waterfront, relocation of the Old Sava Bridge etc).

In the past, Belgrade secured funds for investments by taking out loans - but this option has now been exhausted. Belgrade's investments in the period of 2008-2012 did amount to over 200 million Euros, i.e. they were two to three times larger than at present, but this increase in that particular time period was not economically sustainable. Namely, the problem of a lasting deficit in Belgrade's own funds for investment caused by excessive subsidies to the public transportation, was, for the most part, "resolved" by increased loans. The City's debt thus increased from about 60 million Euros at the end of 2007 to about 410 million Euros at the end of 2013. Therefore, this model for increasing investments soon turned out to be unsustainable, as it led to an almost uncontrolled increase of debt to over 65% of the city's revenue (the reference point for excessive debt of a local government is 50% of current revenue). What's worse, in the period of increased investments, the City not only failed to make savings on current expenditures, but also introduced generous populist and untargeted expenditures, such as the thirteenth pension. This led to the City being late with the payment of its obligations, mostly to the public enterprises, in addition to the debt increase.

The precondition for the recovery of Belgrade's public finances is the resolution of the public transportation problem. Belgrade's budget collects less than 10 bn dinars from the sale of transport tickets, while the expenditures for funding public transportation in the inner city and in the larger metropolitan area amount to about 24 bn dinars. The main reason for such a poor performance of public transport is the low collection rate - almost a half of the passengers do not pay their fares. In addition, the ticket prices for subsidized populations have been set too generously. Citizens older than 65 (which comprise over 15% of Belgrade's population) have been granted a symbolic annual ticket for public transport for about 400 dinars, while elementary school pupils (10% of the population) get free public transport. Finally, the large expenditure for public transport in Belgrade is also a consequence of the extremely inefficient business performance of the City Transport Company (GSP). The dominant problem of this company is a large number of employees (at least 15% of which are superfluous) and there are numerous other irrational practices in its operation. These are, indeed, problems that are difficult to resolve and that last for years, requiring the adoption of politically unpopular measures, but the city administration must face them in order for Belgrade to increase its investment activities. A new wave of investments is certainly necessary, but it must not be funded predominantly from loans, as was the case before - Belgrade is still over-indebted and a sudden growth of debt from the current level would be difficult to bear.

Novi Sad has the most stable public finance of all the analysed cities, but it too suffers from a lack of investment. Novi Sad, like Belgrade, has a credible and approximately balanced budget at the moment and is meeting its obligations in time. However, unlike Belgrade, Novi Sad is not over-indebted and does not have enormous public transportation expenditures (although Novi Sad is also allocating significant funds for JGSP subsidies). There are several factors that have contributed to a relatively stable budget and low debt of Novi Sad. It is undeniable that the city administration has managed public finances more responsibly in the last ten years than was the case in the other analysed cities, but it should also be kept in mind that, put in simplest terms possible, Novi Sad had the best luck when it came to the numerous amendments to the Law on Local Government Financing. Namely, Novi Sad's revenues from transfers and income tax, even after the last decrease from 2017, are still about a billion dinars (7% of the budget) higher than they would have been had the Law from 2006 remained in force. The largest structural problem of Novi Sad at the

moment is a lack of investments. In addition, Novi Sad is burdened with somewhat greater expenditures for employees than other local governments, and a potential risk for the City's public finances could come from the debts of pharmacies owned by the local government (300-400 million dinars) and the performance of SPENS (accumulated loss of about 500 million dinars).

Novi Sad would have to reform its public finance to prevent possible fiscal risks and fund an increase in investments. A large and justified increase in investments of Novi Sad has been announced for the upcoming years, pertaining to the rehabilitation of the water supply and sewers networks, construction of a waste water treatment plant and regional landfill, and reconstruction of the major roads (with the completion of the construction of the Žeželj bridge by the end of the year). The key, however, is for Novi Sad to avoid repeating the mistake Belgrade made, in financing the increase of investments in the period 2008-2012 mostly from loans, thus increasing its debt to an unsustainable level. In addition, a (necessary) future reform of the local government financing could easily leave Novi Sad without a significant portion of the revenue it gets now - which could push the city into a deficit. Finally, it is possible that some debts of institutions that the City is in charge of will spill over into the city budget (pharmacies, SPENS). All these are reasons why Novi Sad should implement savings and revenue increase measures. We have identified five measures and presented them in detail in the chapter dedicated to Novi Sad. These are: 1) improvement of property tax collection (the collection rate dropped significantly in 2016); 2) increase of the collection rate of revenues from real estates that the City leases; 3) reform of the local public enterprises and decrease of subsidies; 4) downsizing and reduction of the wage bill; and 5) reduction of expenditures for court proceedings and penalties. We particularly emphasize the last item, as large and fast-growing costs of court decisions are becoming a systemic problem for the majority of local governments in Serbia. The most frequent claims from towns and municipalities pertain to expropriation (frequently for roads built several decades ago), as well as for the compensation for damages due to stray dog bites. It is quite possible that there are abuses among these numerous lawsuits, which should raise the interest of the central level of government as well due to the magnitude of this problem and its systemic nature.

Niš has very serious fiscal problems but can still manage them on its own, if it changes the way the city finances are managed. At the end of 2016, Niš was late in the payment of its obligations amounting to about 3 bn dinars, which represents more than a third of its budget. The data showing that Niš had received special financial assistance from the central government (from the budget reserve) in the previous three years, in the total amount exceeding half a billion dinars, and that the City was forced to take out loans for liquidity to cover some of its more urgent expenditures, also confirm the poor state of the city budget. Long-term fiscal problems reduced the investments in Niš to a minimum, which is perhaps best illustrated by the fact that, in the last three years, Niš has invested half as much (per capita) as Belgrade, as much as four times less than Novi Sad - and both these cities suffer from a deficit of investments, too. Due to the long standing lack of investments, the local infrastructure in Niš is in a very bad state, even for the low Serbian standards. Only 38% of households are connected to the sewers network (Serbian average is 60%), 64% of households are connected to the city's water supply network (Serbian average is 84%), pre-schools and kindergartens enrol only 6,500 children while 2,200 are on the waiting lists (Novi Sad has about 16,000 children in kindergartens and pre-schools), while the issue of the old city landfill has been present for the last 50 years and represents a significant environmental hazard. Even though the fiscal problems of Niš are quite sizeable, the City still has potential and untapped resources that could stabilize its finances and increase investments in the

medium term - but this would mean a complete U-turn in the administration of public finance compared to the previous years.

Niš could stabilize its budget by adopting measures predominantly on the revenue side. To stabilize public finance, in addition to balancing the budget revenue with the budget expenditures, Niš needs to create a surplus of about a billion dinars (15% of its budget) to repay old debts (defaults) and gradually increase investments. This can be done through a strong increase in revenues or through major savings on expenditures; in the case of Niš, a somewhat stronger emphasis should be on revenue growth. Namely, Niš collects only about a half of the revenue collected by Novi Sad, which cannot be explained by the difference in sizes and levels of development of these cities. The greatest opportunity for increasing collection is in the property tax collection, which, according to our estimate, has not encompassed about 20% of real estate in the city. In addition, the tax rate for citizens (0.35%) is lower than the rate in Belgrade and Novi Sad (0.4%) which additionally lowers the revenue Niš collects from this tax, by about 15%. In addition to the property tax, the analysis of the Fiscal Council shows that there is room (in the medium term) to increase annual revenue from the collection of the contributions for the development of city construction land, as well as some other, somewhat less bountiful, revenues. On the revenue side, there is certain room for savings by downsizing, but ensuring savings is not as critical as the prevention of increase of certain categories of current expenditures that have begun growing in the previous years, such as subsidies (mostly for the Airport).

The Fiscal Council has prepared a detail plan of consolidation measures for Niš, together with forecasts. Fiscal forecasts (individual revenue, expenditures, debt) by 2020 have been prepared for all of the analysed cities. However, in the case of Niš, we made an additional step and proposed the measures of fiscal consolidation that would allow for the recovery of public finances in Niš in the medium term. It is encouraging that Niš has already begun implementing properly targeted measures to exit the fiscal crisis it is currently in. The largest debts the City has have been reprogrammed, and in 2016 the coverage of property tax has been increased by about 10% (it is possible to increase the coverage by an additional 20%). The adopted budget for 2017, in principle, is a good foundation and a credible plan for gradual regulation of the City's public finance and is in line with our basic recommendations. However, the road to permanent recovery of the public finances of Niš will be long and will comprise many challenges and risks that could jeopardize it. Even though we estimate that, with the implementation of all of the proposed measures, Niš could bring its public finance into order, it would be very important for the responsible ministries to get involved in this process, supervise it more closely and coordinate activities with the city administration as needed.

Public finances of Kragujevac have caved in and we believe a direct intervention from the central government is needed to bring them back to the path of sustainability. The fiscal position of Kragujevac is definitely the worst compared to other large cities in Serbia. Almost every activity performed by the City and its public enterprises is burdened with dire financial problems. Defaults in payments of liabilities from the budget amounted to over 4 bn dinars at the end of 2015, which is almost equal to the city's annual budget. In addition, outside of the city budget, local public enterprises founded by the city have accumulated unpaid liabilities of about 2 bn dinars (mostly the water supply companies). In addition to all these problems, Energetika - with the formal status of a state-owned company - has enormous losses; this company supplies power to Zastava Group, among other consumers, but it also acts as the City's heat plant in Kragujevac, too. Energetika owes its creditors (EPS and Srbijagas) over 12 bn dinars. This devastating situation is the consequence of many years of poor financial administration in Kragujevac and passive behaviour of the

central government that allowed the city administration to act with utter fiscal irresponsibility for a full decade. In the previous year, Kragujevac has been investing efforts to stabilize its finances. At the end of 2016, a long-term loan was taken out from commercial banks to repay a part of outstanding liabilities, which is a good first step, but the true challenges of budget consolidation and the politically unpopular measures that come with it are yet to come. We believe that the debts of Kragujevac, as well as the problems that lead to their accumulation, are complex and deep and that a direct involvement of the central government is needed for their resolution.

To bring the public finances of Kragujevac into order, a medium-term set of measures should be made, with clear objectives and deadlines. On the revenue side of the budget, the City should significantly increase property tax collection, since the property tax coverage is insufficient and the tax rate for citizens too low (it is now at 0.2%, compared to 0.4% in Belgrade and Novi Sad). In addition, contributions for the development of city construction land and collection of old tax debts should be important resources for increasing the revenues of Kragujevac. Tax debt in Kragujevac exceeds its annual budget, which is a far larger debt than in other cities, illustrating once again the long years of the City's irresponsible approach to its finances (lawsuits were not filed, no forced collections etc). The City should invest even greater efforts to bring its expenditure side of the budget to order, compared to the revenue side; there is a whole set of measures that should be implemented in that respect. We will list only the most important ones, which are discussed in detail in the chapter of the report dedicated to Kragujevac. These are: reprogramming of the outstanding defaults (EPS, Energetika); downsizing the public sector; resolution of the status and restructuring of Energetika; local public enterprise reform (about 30% of superfluous employees, low service tariffs); resolution of the issue of public transport and illegal taxi drivers; measures for decreasing expenditures for expropriation and; increase of public investments etc.

The Fiscal Council believes that the central government should formalize its relationship with Kragujevac. Even a glance at the proposed measures for stabilization of public finances in Kragujevac shows that the majority of these would only yield effects in the medium term. By then, Kragujevac (barring assistance of the central level from the budget reserve) would have accumulated new defaults and would not be able to service its debts - i.e., even with all the measures implemented, the problem would deteriorate further. In addition, the reforms of the City's public finances could lead to strong resistance. Citizens of Kragujevac have become accustomed, over the years, to not paying the full price of the functioning of local administration and utility services. The fiscal consolidation of Kragujevac would have to change that - for example, the property tax rate for natural persons would have to be increased to the level common to large cities in Serbia; the prices of certain utilities would go up; a significant number of superfluous employees would be fired from local public enterprises and from the city administration. This is why we believe it would be good for the central government to formalize its relationship with Kragujevac. On one hand, the City would be given financial and expert assistance to bridge the gap in the next three to four years, after which it would become financially completely sustainable and independent - and it would have an obligation to implement all measures consistently and to report to the central government, either quarterly or every six months, on the achievement of the predefined quantitative and structural objectives. On the other hand, the central level would on occasion be extending somewhat greater funds to Kragujevac, but it would reduce its long-term expenditures and fiscal risks that stem from the poor state of the public finances of this city.

A reform of the local public enterprises would reduce the enormous expenditures of local governments and improve the quality of utility services. Local governments use approximately 10% of their budgets (about 200 million Euros) to cover the costs of poor business performance of local public enterprises, while in some places, this percentage can be as high as 40% (Preševo). Therefore, the poor performance of LPEs is one of the main reasons why the finances of cities and municipalities are in such a disarray, with a systemic shortage of the funds for investments into local infrastructure. An additional significant problem is the quality of services provided by these enterprises. A frequent practice of the Fiscal Council is to use comparative analyses to rank Serbia among other comparable countries and get reference points for reforms. However, seldom have we encountered such a devastating lag of Serbia as we have in the case of the quality of public utility services. The growing awareness of citizens of highly-industrialized Western Europe of the quality of their environment has led, in the previous 30 years, to a strong development of public utility services - and when CEE countries joined the EU, they started catching up at an accelerated rate. This is why the majority of European cities have clean, good quality drinking water, clean rivers, practically all the generated waste is managed in an organized manner and only 25% of household waste ends up in landfills (the remainder is recycled, incinerated to produce energy or composted). The current status of Serbia is perhaps best illustrated using the example of waste collection and treatment: only two thirds of household waste in Serbia is covered by organized collection, of which about 98% ends up on landfills with no treatment whatsoever. These landfills usually don't meet even the most basic sanitary standards and over 15% of them are located less than 50 meters from surface waters. In addition to the 164 "official" landfills, there are about 3,500 "informal" landfills. Comparative analyses of other utility services lead to similarly devastating findings as the analysis for city cleaning services. Therefore, reforms and financial recovery of LPEs are necessary not only to decrease the largest non-productive expenditure of local governments (enormous subsidies covering the losses of LPEs), but also to bring the quality of public utility services in Serbia closer to European standards.

The largest problem of local public enterprises is the surplus of employees; in addition, low claim collection rate, technical losses and non-economic prices add to the problem. To provide a detailed analysis of the performance of LPEs, the Fiscal Council used financial reports from about 500 enterprises in the period from 2006-2015. In addition, we used a large number of other available reports and data from various sources, which described the performance of LPEs from different angles. The analysis has shown that, if the largest problems of the LPEs' performances were to be resolved, their losses (and, consequently, subsidies from local governments) could be decreased by about 150 million Euros in medium term. The most prominent issue with LPEs is the surplus of employees. This finding is the result of an analysis of differences between successful and unsuccessful companies in the same field of activity, based on historical data (increase in the number of employees over the last 10 years), as well as of using international standards for the performance of individual public utility services. We estimate that LPEs have at least 15% of superfluous employees (about 10,000) and that this budget item alone could save over 80 million Euros. Improvement of collection rate of public utility service charges could decrease the annual losses of LPEs by an additional 50 million Euros, while the remainder of the savings, up to 150 million Euros, could come from the reduction of technical losses, illegal connections to the water supply network and resolution of other irrational practices. The problem of low tariffs for public utility services is also indisputable. It is indicated in the comparison to the tariffs of other CEE countries, but also in comparison of public utility service tariffs among similar cities in Serbia, sometimes amounting to 1:3. Increase of tariffs is necessary, but we have maintained a certain reserve towards it, because with the current

operation of LPEs it could easily be spent on internal irrational practices, instead on the necessary investments, decrease of losses and improvement of quality of services.

Water supply and sewers comprise the largest sector of local public enterprises with the most complex issues. In Serbia, there are about 150 water supply and sewers enterprises, employing over 20,000 people, i.e. a third of all employees of LPEs. Average annual subsidies granted to the enterprises in this sector amount to about 25 million Euros, while the water supply enterprises make, even with these subsidies, an additional loss of about 20 million Euros. By their size, as well as by the sheer number of their issues, water supply enterprises are quite reminiscent of the national public enterprise EPS. Namely, just like EPS, water supply enterprises have a surplus of employees; problems with collection of service charges (especially from the failed state-owned and failing public enterprises); high technical losses and theft; extremely low investments (significantly below the maintenance level); tariffs that are too low; perhaps the only difference is that salaries of employees in water supply enterprises, unlike those in EPS, are relatively low. The analysis of the Fiscal Council shows that almost all financial difficulties and subsidies granted to water supply enterprises could be resolved by rightsizing, increasing the collection rate and providing a better monitoring of the system (illegal connections and errors in meter reading). In addition, water tariffs for households in Serbia are not at a commercial level and we believe that they need to be increased. However, as was already mentioned, the increase of prices must be directly linked to investments into improving the (low) quality of services and decrease of technical losses through the network (in Belgrade and Novi Sad, about 30% of the produced water seeps out of the distribution network).

The largest problem of city cleaning services and park maintenance services is the surplus of staff. City cleaning services and park maintenance services employ about 14,000 employees, ranking them second in size among the public utilities in Serbia. City cleaning services, like water supply enterprises, get on average about 20 million Euros in subsidies from the local governments, but unlike water supply services, they don't make any additional losses exceeding this amount. Wage bill takes up over 50% in the structure of expenditures of city cleaning services; the next large expenditure is for inputs (mostly fuel), while maintenance represents only about 5% of the total expenditures. Expenditure structure of city cleaning services is interesting for several reasons. Very low expenditures for maintenance imply the poor quality of services provided by this public utility sector, as a consequence of worn-down machinery, on average 15 years old, and the low quality of landfills which are not very valuable and do not have the necessary accessory facilities. The second important conclusion that can be drawn from such an expenditure structure is that the most important factor for stabilization of city cleaning services is the savings on labour. Our analysis shows that 15% of the employees in city cleaning services are superfluous (and this is in line with conservative criteria) - if they were to downsize by about 2,000 employees (approximately 15%), there would be no need for subsidies for this activity.

The performance of heat plants has been stable in the last few years, but due to the global decrease in gas prices and not due to the correction of their irrational practices. Distance heating is a public utility activity with a relatively small workforce (about 6,000) but with by far the highest annual revenue and expenditures of about 400 million Euros. The structure of heat plant expenditures is quite different to that of all other public utility activities, as 60% of their expenditures are the costs of inputs (mostly fuel), while the wage bill represents only about 13% of the overall expenditures. This is why the business performance of heating plants is defined, to the greatest extent, with the ratio of the price of fuel they use and the tariff for distance heating they charge. This price ratio has been inadequate for many years, i.e. citizens were not charged the full price of heating, so that heat

plants were a public utility activity showing the greatest losses, together with public transport. What's worse, due to these losses, the heating plants were not paying for all of the gas they used, i.e. they were responsible for a significant part of Srbijagas losses that were eventually covered from the national budget. However, in 2014, there was a sudden drop in global price of gas, while the prices of distance heating were not lowered. This meant a complete turn in the business performance of heat plants, so that at the moment, they are mostly making profits and some have even managed to cover their longstanding debt to Srbijagas from those profits (heat plants in Novi Sad and Belgrade). Still, even with the relatively good business performance of heat plants in recent years, there are still individual enterprises with enormous problems and losses (e.g. Energetika from Kragujevac).

Even with the improvement of the business result, heat plants still have numerous irrational practices. The fact that the heat plants are, at the moment, mostly financially sustainable does not mean that there are no inefficient practices in their operation. Certain heat plants, for example, use the circumstance that their wage bill has a smaller share in their overall expenditures - for an enormous increase in the number of employees (we estimate that the entire sector employs around 20% of superfluous employees). In addition, the average salaries in heat plants are almost 50% higher than in other public utility sectors, which cannot be completely justified with the somewhat higher qualifications needed for the employees in this sector. One of the largest problems of the sector is that a relatively large number of heat plants in Serbia use either coal or mazut (low quality fuel oil) as the main fuel (e.g. in Kragujevac, Bor, Leskovac, Kruševac), thus significantly increasing air pollution in their environments. In order for the heat plants to continue operating with a relative financial success, the imperative is to maintain the achieved favourable fuel-to-tariff ratio, i.e. to have the heating price increased if the fuel prices go up again. We also note that in the recent years, the bad practice of local governments charging immoderate dividends from the heat plant profits has been observed. Thus, in the previous two years, Belgrade has collected as much as 9 bn dinars of dividends from Belgrade heat plants. Heat plants, like all other LPEs, need a strong increase in investments (expanding the network, increasing energy efficiency, in some cases even switching fuels), and now is a good time for them to finance these investments from their own profits instead of using those profits to cover the current expenditures of local governments.

Local public enterprises from the transport sector show the poorest performance compared to all other activities, due to the losses accumulated by Belgrade's GSP. By the number of enterprises (only 13), the transport public enterprises represent by far the smallest public utility sector. However, they receive the highest subsidies of about 70 million Euros per year, on top of which they make about 20 million Euros of debt. In this sector, according to all indicators, one enterprise is dominant over all others - Belgrade's GSP. This enterprise employs over two thirds of the total workforce in the sector, its share in the financial debt is about 97% and it accounts for about 90% of losses and subsidies of the entire sector. This is why the issue of problems of transport LPEs is practically an issue of GSP's problems (low collection of fares, large wage bill, relatively high salaries and other irrational practices). A new question we have raised in the analysis of this activity is the relationship between the public and private sector within it. Namely, many cities in Serbia have no public transport companies- the public transport activity is carried out by private transport enterprises. In these cases, budget expenditures for public transport are, as a rule, lower. We believe that the option of privatizing the remaining public transport companies should not be discarded *a priori*, as a comparative analysis of private and public transport companies shows that the private sector is better equipped to deal with superfluous workforce, poor fare collection and other issues haunting the performance of transport companies. There are strong arguments in favour of letting the private sector take over bus transport, while

privatization of parts of city transport companies which directly use the city's infrastructure (trams, trolleybuses) would probably come with specific challenges and thus be difficult.

The largest issues of local public enterprises are focused in a small number of local governments and enterprises. Although a large majority of public utility enterprises face problems in operation, these problems are not equally distributed throughout the different enterprises, as well as in different local governments. This is why we have dedicated the last part of the analysis of the performance of local public enterprises to: 1) distribution of subsidies by local governments and 2) distribution of losses by individual enterprises. The motive for this analysis is to focus the attention of the line ministries to a smaller number of local governments and LPEs that have the largest problems and, judging by all indicators, are unable to resolve them on their own. For example, about 120 million Euros of subsidies is allocated by only ten local governments (more than half of the overall subsidies). This, therefore, is an enormous and narrowly focused resource for savings, which could be of interest to the Ministry of Finance (this Ministry should draft the new Law on Local Government Financing). In addition, the issue of extremely high expenditures for subsidies relative to local budget size is concentrated in twenty - mostly smaller - local governments. In these, the expenditures for subsidies take up, on average, 20% of the total budget expenditures, while in the remaining local governments, this expenditure only makes up for about 5% of the overall expenditures. The Ministry of State Administration and Local Government could investigate whether these twenty local governments can even perform the duties from their legally assigned mandate, if such a large portion of their budget is allocated to cover the losses of their LPEs. Finally, twenty least successful individual enterprises are responsible for approximately 80% of all losses of the 500 analysed LPEs, so the Ministry of Economy might want to get involved in the resolution of their problems.

The Fiscal Council has envisaged this report as a platform for resolving the main financial problems of local governments, as well as for further research into the topic. Even though the local government is fiscally - and in wider economic and social terms - an extremely important part of the public sector, this topic has never been given sufficient attention in Serbia. A large problem we encountered during this analysis was that very few useful, professional studies dealing with the financial problems of local governments and their public enterprises were available; in addition, there was insufficient reliable data available, as well. For example, there is no data on defaults (being late with payments of liabilities) of local governments and their public enterprises, and no pooled data from the final annual balances of individual municipalities and towns. Due to these problems, some of the encompassed subjects have still not been investigated completely, and it is possible that some of our conclusions and assessments will have to be changed to a certain extent with the arrival of new, higher quality data. Despite this, we believe that the report prepared by the Fiscal Council, containing the findings we have arrived to, serves as a good foundation for the resolution of the accumulated problems of local governments. In addition, we will use this report in the upcoming period as a platform for further research, to continue monitoring and improve understanding of the issues faced by local governments in Serbia.