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Revenue Mobility in a Transitional Economy: "Casino Royale" in Montenegro and the negative effects towards the local units[1]

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Abstract

The union between Montenegro and Serbia was decided by the referendum on Montenegrin independence of 21 May 2006. Following independence Montenegro experienced a real estate boom from 2006 until 2009, with wealthy Russians, Britons and others buying property on the Montenegrin coast. Montenegro received, as of 2008, more foreign investment per capita than any other nation in Europe. However, the financial crisis has stopped these huge foreign investments as well as the real estate boom and therefore the local units were confronted with declining revenues from taxes as well vertical grants. For this reason, this paper describes briefly the different forms of equalisation with the main distinction being between revenue equalisation versus cost equalisation. In addition, some international experiences are presented and suggestions made as to how to avoid some pitfalls in the area of Montenegrin fiscal federalism.

JEL Classification: H7; H2; H1

Keyword: Fiscal Federalism, Grants, Fiscal Autonomy, Montenegro

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Introduction

The decentralisation of expenditure and public functions is only "one side of the coin" of fiscal federalism. Just as well it has to be settled how this delegation is financed and how independent the subnational and local authorities are in their provision of public goods and services. A reasonable intergovernmental finance system has to consider the following principles[2]:

- Revenue autonomy, subsidiarity and connectivity (*local accountability*)
- Transparency of the tax system and direct impact of the tax burden (*benefit tax link*)
- Reference to local circumstances and neutrality of the taxes with regard to the private sector
- Tax bases which are not affected by economic fluctuation and are also viable
- Simplicity of the tax system

At first glance, these five principles seem to be trying to "square the circle" and even at second glance, it has to be admitted that no federal or unitary country in the world has implemented a public finance system that fulfils these five principles completely. Various countries have chosen different ways to reach these goals and thus the conception of how to finance subnational and local services differs significantly. The respective advantages and disadvantages of each method can best be assessed in a general comparison.

The Anglo-Saxon countries like Canada, the USA and the United Kingdom provide their local authorities with a very extensive system of property taxation. A local property tax has the advantage that a direct link between benefit and cost of the public goods can be established. This direct link between the preference of the citizens in local public goods and the policy makers, who have to provide the local public goods, cannot be created by grants or transfers. Besides a local property tax, a group of European countries – namely Switzerland, Belgium, Croatia and the Scandinavian countries – gives significant tax autonomy to their local authorities and therefore a local surcharge on personal income tax is common.

Furthermore, a third possibility for financing local authorities has been chosen by Austria, Germany and Poland, which have developed a local tax system with its own revenues as well as tax-sharing. Nevertheless, vertical grants are also needed in the Anglo-Saxon model and the Scandinavian model and the German model. Grants and transfers avoid external effects and spillovers; for example a local jurisdiction benefits from services of other local authorities without participating in the cost. This situation often exists in the relationship between a metropolitan city and its suburbs.

Sometimes a country restricts local accountability, because it substitutes local taxation for vertical grants. These negative scenarios can be found in the Netherlands, Wales,

[2] For detailed description see for example Spahn, 1995 as well as Werner, 2008a.

Ireland and Scotland. In the case that local authorities cannot generate sufficient finances from taxes and grants, municipalities will use charges and fees to fill the financial gap.

At the conclusion of World War II, Montenegro became a constituent republic of the Socialist Federal Republic of Yugoslavia. When the latter dissolved in 1992, Montenegro became part of the State Union, first as part of the Federal Republic of Yugoslavia and, after 2003, in a looser union of Serbia and Montenegro.

The union between Montenegro and Serbia was decided by the referendum on Montenegrin independence on May 21, 2006. The vote for independence exceeded 55% - the threshold set by the European Union - allowing Montenegro formally declare its independence on June 3, 2006.

Like Kosovo, Montenegro has adopted the euro unilaterally and uses the euro as a *de facto* domestic currency, as both countries have no agreements with the European Central Bank as well as no representation in the ECB or the Euro Group.

Together with €as an official currency and combined with the fact that Russians do not require any visa to enter the country, Montenegro experienced a real estate boom from 2006 to 2008, with wealthy Russians, Britons and others buying property on Montenegrin coast. When Montenegro became a nation in 2006, the cost of a square meter of land on the picturesque Adriatic Coast doubled every few months — from 100 euros, in the summer of 2006, to 1,000 euros in the summer of 2008. In mid-2009, the bubble finally burst and prices fell by as much as 60 percent. Currently the land price has settled at 400 euros per square meter of land. At the climax of this real estate boom the price for dwellings of the coastline was over 8,000 €per square meter and in mid-2012 the same sort of property was sold for 3,700 €per square meter.

Montenegro received, as of 2008, more foreign direct investment (FDI) per capita than any other nation in Europe. Moreover, Montenegro attracted very high levels of FDI compared with the emerging market economies of Central and South Eastern Europe. The FDI boom mostly targeted the tourism, real estate, financial and energy sectors and was mainly driven by financial flows from Italy, Russia and Switzerland.

The following figure highlights the FDI in % of GDP, averaged for 2005–2010, for various countries with transitional economies. Considering the economic boost from FDI for Montenegro, the real estate bubble and finally the luxury yacht marina Porto Montenegro in the costal city of Tivat, the economic situation of Montenegro was in the first three years after the independence, defiantly like that depicted in the famous James Bond movie "Casino Royale" (2006). However, a standard phrase from any economic lesson is that "Every bubble will burst some day".

The following chapter will describe briefly the different conception of revenue and cost equalisation, chapter three will deal with the negative effect of the "Casino Royale situation" for the local units in Montenegro and finally some policy recommendations recontamination will be provided in the conclusion.

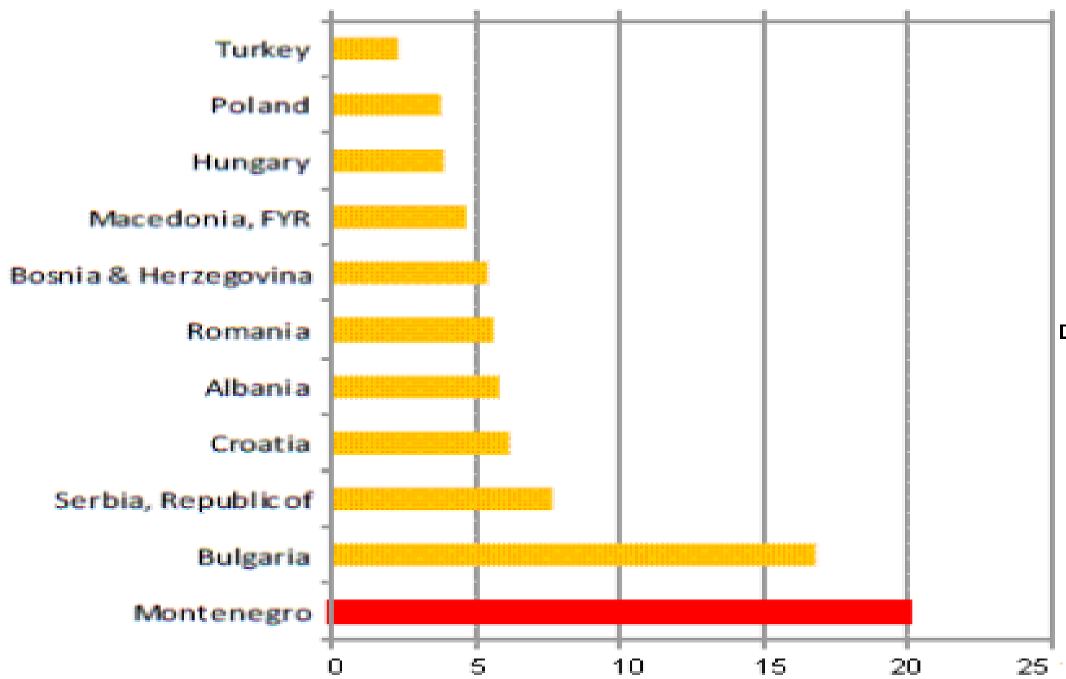

Figure 1: FDI in % of GDP, averaged for 2005–2010

Source: IMF, 2011, page 31

Revenue or cost equalisation

The reasons for a nationwide or multinational equalisation system are for example:

- bridging vertical fiscal gaps
    - Canada
- bridging fiscal divide through fiscal equalisation
    - Indonesia and the province of Aceh
- setting national minimum standards
    - Denmark and Sweden at their respective education sectors
- compensating for benefits spillovers
    - Switzerland and Germany with their city states
- influencing local priorities or political pork barrelling
    - US Homeland Security grants, earmarked grants for capital investments
- dealing with infrastructure deficiencies and creating macroeconomic stability in depressed units
    - Cohesion Fund of the EU, bailout dilemma in federal countries

An equalisation system can be mainly based on revenue equalisation or cost equalisation. Well-known examples of revenue equalisation are the Canadian equalisation system between the provinces (see Boadway, 2004 and Bird / Vaillancourt, 2007) and German equalisation between the Länder (Werner, 2003 and Spahn / Werner,

2007, Werner 2008b and Werner 2008c). In contrast, Australia and Scandinavian countries such as Denmark or Sweden (see Werner / Shah, 2005) base their respective equalisation systems on the concept of cost equalisation.

Revenue equalisation means that the different revenues of regions or even municipalities available are equalised. Germany uses the complete collected tax revenues as a calculation basis for the equalisation the between the 16 federal states, while in Canada the tax base of the ten provinces is used in the respective equalisation system.

Cost equalisation means that the different expenditure needs or cost factors are considered in the equalisation system. For example in the Nordic countries the number of inhabitants and even the age structure of the local units is measured by the vertical grants from the central government to the local authorities.

In the context of the educational cost, in Switzerland a very smart solution for the financing of the universities exists: there are 12 universities and two of these – the Swiss Federal Institutes of Technology (*Eidgenössische Technische Hochschule*, ETH) in Lausanne and Zurich – are institutions of the central government. The remaining 10 universities are located in 10 different cantons and therefore 16 of the 26 Swiss cantons do not have to finance a university directly. However, it happens very often in Switzerland that a student is resident in one canton but attends the university of a neighbouring canton. This situation can be used as a classical example of spill-overs, and a possible solution could be the concept of functional, overlapping, and competing jurisdictions (FOCJ) developed by Frey and Eichenberger (see Frey and Eichenberger 1995).

Nevertheless, the cantons do not use the FOCJ concept to solve this problem, but the canton where a university is placed receives funds from the other cantons where the commuting students have their residence. The calculation of the funds is very detailed, which means that the different costs of a faculty towards a university as well as the respective duration of every student have to be borne in mind for the calculation.

The total expenditure cost of the 12 universities amounted to €6.611 billion in 2010, while over 20% originated at the ETH Zurich and 50 % was generated by the ETH Zurich, the University of Zurich and the University of Geneva. Moreover, the impact of the inter-cantonal university equalisation differs from university to university and has it highest influence at the University of Freiburg and the University of Luzern .[3] A detailed overview of the financial structure of the twelve universities can be observed in the following figure:

[3] In 2004, the impact of the inter-cantonal university equalisation had its highest influence at the University of Basle city and the University of Italian Switzerland; See Werner, 2009a and Werner 2009b.

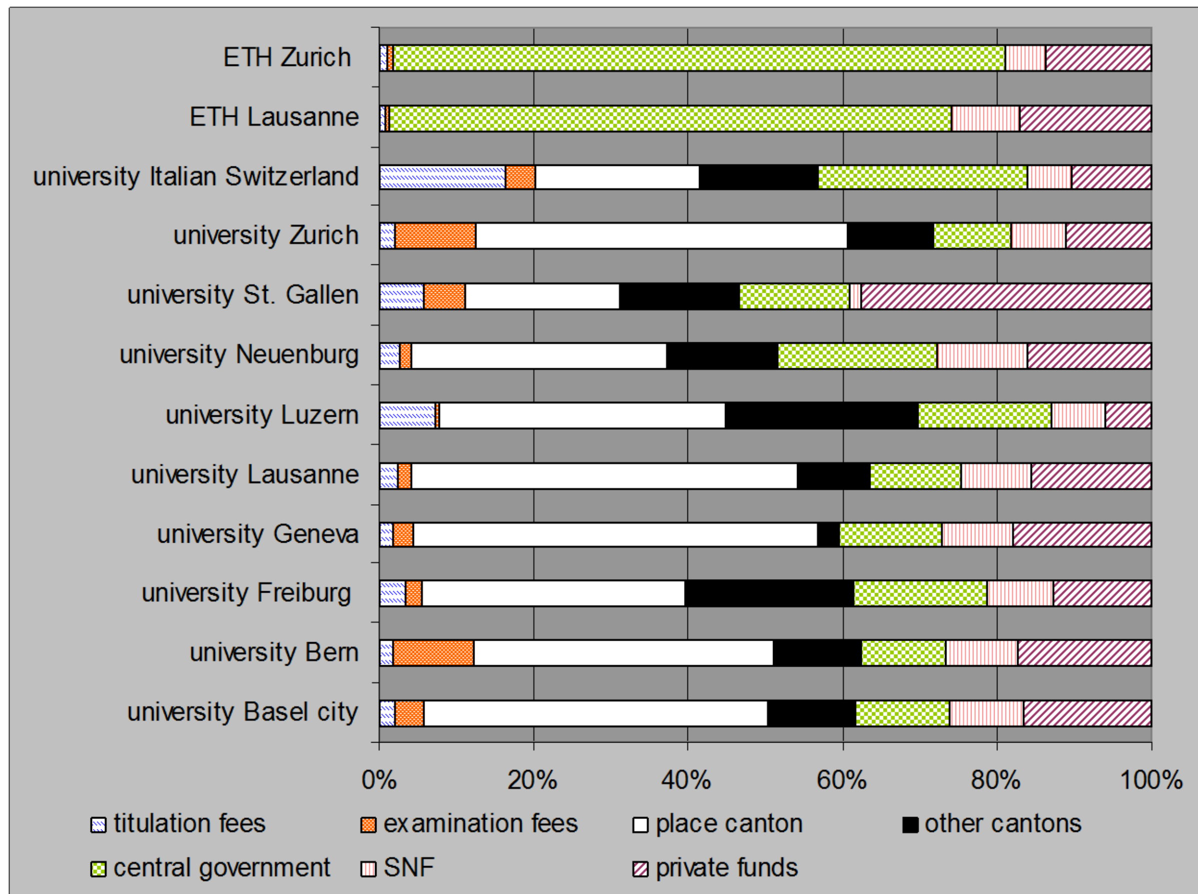

Figure 2: Financing structure of the 12 Swiss universities in 2010

Source: Werner, 2012, page 165

The advantages of an equalisation system which is based on revenue equalisation is that it is easier to administer and more transparent. However, revenue equalisation systems are generally unable to consider spillovers. For this reason, revenue equalisation should be used solely for regions or provinces, while a local equalisation system should be based on cost equalisation.[4]

"Casino Royale" at the local level

After independence, the economy of Montenegro has grown with high rates, but this economic success story was interrupted in 2009. The following figure presents the real GDP increase in % for the time period 2001 to 2012.

Montenegro consists of 21 municipalities[5] and the capital is Podgorica. The municipalities possess about a huge number of their own revenues such as, for example, the surtax on personal income tax, the real estate tax, the beverage tax, the tax on vacant construction plots, the tax on company or title and the tax on games of chance and fun games. Moreover, municipalities have the right, but not the obligation, to introduce the surtax on personal income tax at a rate of 13%, and the rates of the real estate tax can be

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[4] For a general description of a local equalisation system based on revenues and local needs, see Werner, 2006.

[5] A map of Montenegro is located in the appendix.

freely set within a range of 0.08% to 0.80% of the real estate market value. Moreover, the municipalities can borrow funds from the capital market and receive vertical grants from the central government.

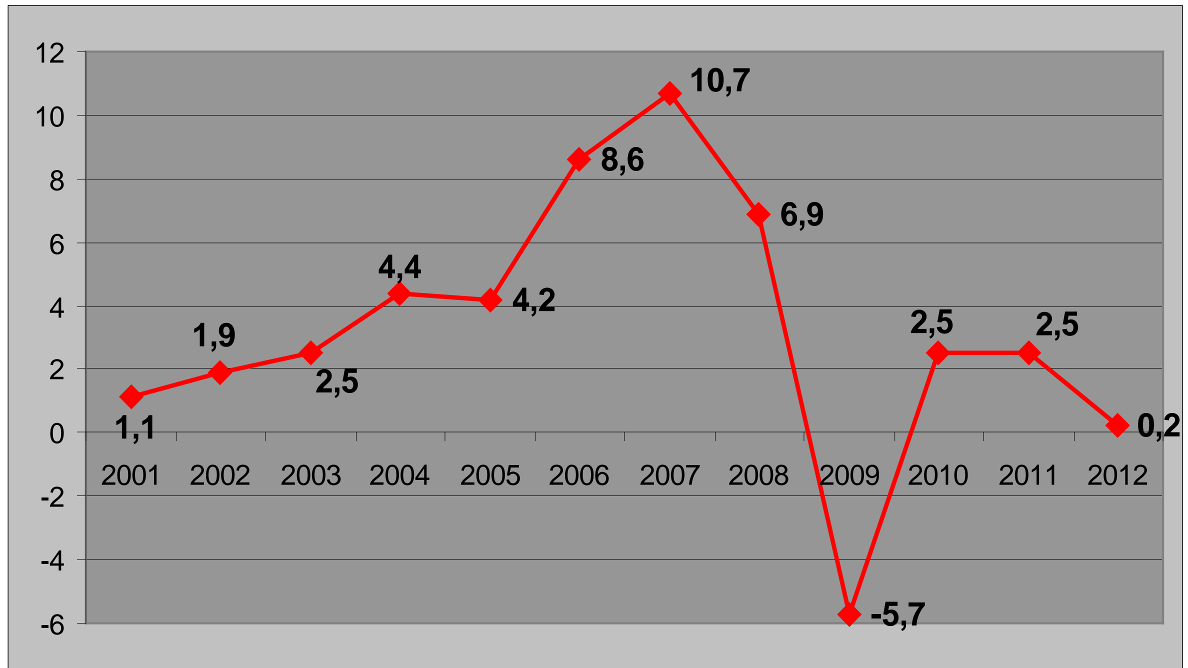

Figure 3: Real GDP growth in % in Montenegro from 2001 to 2012

Source: various data from Zavod za statistiku Crne Gore

However, from 2006 to 2009 the most important revenue flow for the local units were revenues from privatisation, selling property and the revenues from the conveyance duty. The following figures highlight the development of the local own revenues and total revenue as a share of GDP from 2002 to 2009:

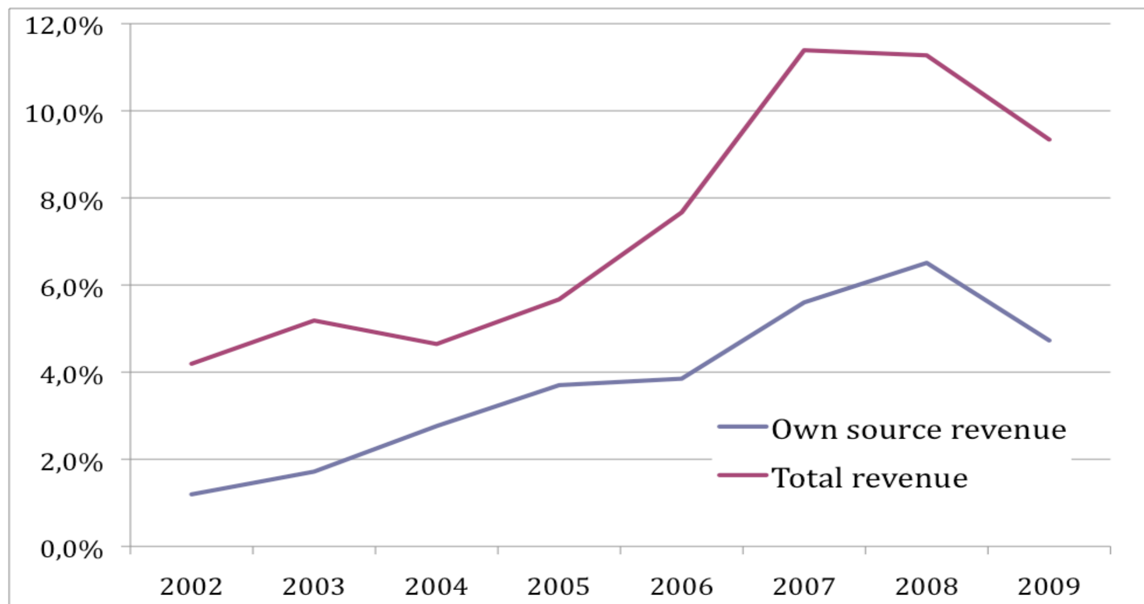

Figure 4: Local own revenues and total revenue as a share of GDP from 2002 to 2009
Source: Spahn, 2010, page 12

Since 2009 the fiscal situation of the municipalities has dramatically weakened, because the total revenue volume of the municipalities was 280.5 million € or 9.6 % of GDP in 2009, declining to 238.5 million € or 7.6 % of GDP in 2010, decreased again to 209.8 million € or 6.4 % of GDP in 2011 and is estimated for 2012 to be only 194 million €[6] For the local units this manifests an enormous collapse in fiscal resources and it has to considered for the absolute term of the fiscal resource that Montenegro is a country of 625,000 inhabitants. The respective local revenue structure for the years 2009 to 2012 is presented in the following figure:

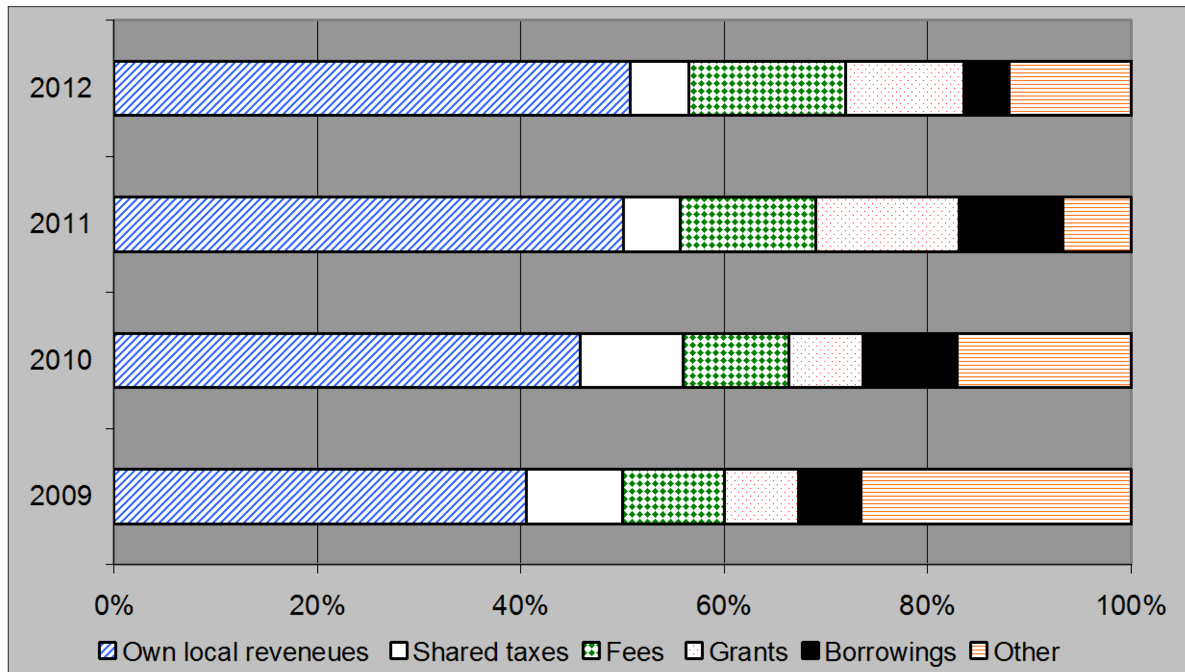

Figure 5: Local revenue structure in Montenegro from 2009 to 2012
Source: own illustration based on various data from the Ministry of Finance

The relative and absolute reduction of the component "Other" in the municipal budget was caused by the price decline in the property market, because the local units were no longer able to sell property at a high price. Moreover, the local units were, especially in the costal region, dependent on the conveyance duty and with the collapse of the real estate market, only a small number of persons were selling property. This leads to the situation where the local units have no revenue flows from the conveyance duty anymore. For this reason, the public employees of the city of Budva, which is the richest city of Montenegro, have accepted a "delay" in the money transfer of their salaries for some months.

In the years with huge revenues the municipalities spent a lot of their money on questionable projects, for example the majority of cities in Montenegro run their own radio station or local TV company. Some employees of these media companies were relatives of the local mayor. Furthermore, no nationwide regulation of the salary

[6] In the first six months of 2012 the total revenue flow was 88.2 million € For the 2012 estimate this amount was doubled and to included the economic effects from the tourism sector of the months July and August it was finally multiplied by 10 %, a figure comparable with earlier seasonal effects.

structure of the local mayor exists, because the volume is fixed independently in the local parliament and not by the Ministry of Finance. This unregulated salary structure has led to a situation where some mayors were earning even more than the Prime Minister of Montenegro.

Finally, the cities were operating many local companies and during the positive period of the “Casino Royale” they hired a lot employees. For example, “*Budva municipality’s administration is oversized and needs urgent systematisation. Currently, there are 598 employees who work for the municipality’s administrative centre or its public companies, while the optimal number of employees is 432*” (see Marovic, 2011, page 8).

In the first three years after Montenegro’s independence the local units disposed about revenue flows which increased year upon year, which could be described as a gold rush, but since the banking crisis of 2009 the local units were suffering a lot and had to cut some expenditure.

Conclusion

After the proclamation of its independence Montenegro was exposed to a huge economic boost, which was mainly driven by a huge volume of foreign direct investments, an overheated real estate market and an increasing tourism sector. This amazing positive economic development was supported by the circumstance that Montenegro uses the euro as a de facto domestic currency. Surely a minor part of the money from abroad is also affected by money laundering, but to explain the successful story only with this issue is too short-winded. Montenegro has attracted a lot of money with a flexible and friendly environment for foreign investors. Whether Montenegro might yet prove to be the Monaco of the Balkans – as the owners of Porto Montenegro expected – will become clear only in the next few decades. Regardless, for the local units the last six years have been like in a casino, where sometimes you are winning and sometimes you are losing and finally you are as poor as a church mouse. It is not by accident that one of the latest James Bond movies took place in Montenegro, because the international community spending their summer vacation on the lovely coastline has swilled a lot of money within the county.

A standard economic lesson is that “every bubble will burst some day”, but the art of economics is to announce the exact burst. Since the economic bubble burst, the local units and the central government have been emotionally discussing the volume of the equalisation system. However, if we remember figure 5 and compare the fiscal years 2009 to 2011, it becomes clear that the central government has not disregarded the local units. On the other hand, a future option for stabilising the local revenue flow is an additional revenue-sharing at the VAT, which is always rejected by the central government.

In no country in the world are taxes and grants stable over a long period and therefore the political stakeholders should discuss a stabilisation fund to reduce the variability of

the local own revenues. Generally spoken, in years with huge tax revenues the fund "saves" some money and this money can be used in years with less available tax revenues to restock the fund with some additional money and the fund guarantees the local units a constant revenue flow.

During my work for UNDP in Montenegro, it was greatly emphasised on a couple of occasions that the Montenegrin local units have major problems in collecting their own tax revenues mainly in the area of property taxation (Porez na nepokretnosti) as well as conveyance duty (Porez na promet nepokretnosti). However, even given the best taxation system together with an honest tax administration, it is impossible to improve a tax collection rate without any political willpower, and in my personal opinion some local units are still not interested in collecting the complete tax revenues available.

Municipal bonds are not the best solution for all local units – especially in the northern part of Montenegro. Such a general borrowing system for financing major infrastructure projects, for example, is based upon predictable revenue streams. For this reason, the concept of polled financing like the Indian Tamil Nadu Urban Development Fund is especially suitable for smaller and less creditworthy local authorities.

Debt management is the most underestimated component of PFM and here the local administrations need some capacity development support to avoid the normal casino circumstances that ultimately the bank always wins.

Appendix

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