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Abstract

The EU's view of decentralization in regional development policy has made a sharp U-turn since the 1990s. The earlier emphasis on the strengthening of local developmental agency in the accession countries has been replaced by renewed enthusiasim for centralization. One justification for this turn is that decentralization amplifies fiscal imbalances, encouraging excessive borrowing at the local level, thus undermining the overall fiscal stability. Drawing on the in-depth study of one such case – the rapid accumulation of municipal debt in Montenegro – this paper makes several arguments against such a simplistic view. First, the fiscal opportunism and soft budget constraints that fuelled the debt crisis have been spurred on not by decentralization, but by *partial decentralization,* i.e. the ambiguous division of powers between levels of government. Second, while most corrective measures proposed by international advisors focus on the behaviour of local authorities, fiscal imbalances at the subnational level are just as likely to be fomented by the opportunism of the central government. This suggests that re-centralization is unlikely to ensure fiscal consolidation, and may even be counter-productive. A more promising strategy would be to *strengthen* the competencies and competences of local authorities, clearly delineating their developmental responsibilities and improving their capacity to exercise them.

Keywords

Decentralization, regional development policy, EU enlargement

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Introduction

Decentralization has had a turbulent career over the past twenty years. Nearly a universal policy prescription in the late 1980s and 1990s, in more recent years it has visibly fallen out of favour among international policy advisors. In its heyday, decentralization, understood loosely as some form of devolution of power from the central to local level governments, was expected to bring a multitude of benefits, from the enhancement of political accountability and civic engagement to greater ownership of development projects, efficient allocation of resources and improved delivery of services (Oates 1972; Breton 1998; Burki et al. 1999). As a tool of the EU's regional development policy, decentralized management of EU funds also carried the added political benefit of undercutting national governments' monopoly on development projects and increasing the visibility of (and loyalty to) the EU at the local level. And as part of the enlargement policy towards East European countries, it was also expected to bolster democratization by countering the debilitating legacies of state socialism, such as the overly hierarchical decision making, lack of initiative and clientelism (Bird et al. 1995). In the post-conflict societies of the Western Balkans, decentralization was even supposed to help alleviate inter-ethnic tensions, and as such was often formally integrated into the peace agreements (Mojsovska 2011).

By the mid-2000s, however, these conventional wisdoms about decentralization had been all but turned upside down (Bruszt 2008). Within the EU, the turn was fuelled by the Lisbon Agenda's renewed emphasis on competitiveness and economic growth, which increasingly overshadowed the other aim of the Cohesion Policy: redistribution and "reducing the backwardness of the least favoured regions" (TFEU 2012 (1958), Art. 174). Competitiveness required instead directing the funds towards regions and activities with the highest growth potential – ensuring, in other words, the greatest return on the EU's developmental investments – and this improved efficiency in the use of funds was to be achieved through greater centralization of the funds' management. One of the reasons that the insistence on efficiency went hand in hand with recentralization was the mounting evidence that the much touted benefits of multi-level governance only manifested in the regions that already possessed the institutional capabilities to take on the responsibility for local development (Börzel 2002; Bailey & De Propris 2002). In the new eastern member states in particular, the increased reliance on centralized planning and implementation structures was widely justified by the fact that the subnational governments lacked the "absorption capacity" – were, in other words, too administratively or financially weak, incompetent or corrupt to be trusted with the EU monies (Hughes et al. 2004).

The focus on efficiency has only been strengthened in the recent crisis, which added worries about spending to the concerns over growth. The imperative of fiscal consolidation, both in the net contributors and in the net recipients of EU funds, has further reduced the patience with any potentially wasteful practices involved in the support of less developed regions. The backlash against local autonomy has been all the greater in those member states and enlargement countries in which the local governments contributed to the debt problems by taking part in the excessive borrowing of the pre-crisis years (Colino et al. 2014; Bohle 2015).

The combination of the weakening enthusiasm for the devolution of power to the subnational actors within the EU, and the weakness of local government units in the accession states means that decentralization has been all but eliminated from the battery of the EU's developmental policies towards enlargement countries. But while a more critical appraisal of the absorption capacities and appropriateness of allocating specific functions to local governments might be a welcome corrective to the optimism of the early years, this paper argues that abandoning all attempts to strengthen multi-level governance in the accession countries would be a mistake.

First, even if the responsibility for local development is transferred back to the central authorities, many EU policies that are to be transposed to the future member states – especially those in the domain of environmental protection – require capable actors at the local level. To be sure, there are limits to what the EU can do to empower subnational actors. As decentralization was never an explicit part of the EU acquis, and could not be, given the variety of power-sharing configurations between different levels of government in the "old" EU members, the Commission could not require the accession countries to comply with a particular type of institutional solution. What it could do, however, was offer resources for capacity-building at the local level, create bottom-up developmental coalitions, and provide them with "practice" funding to implement local projects (Bruszt 2008). While the capabilities of thus upgraded local structures may still fall short of the optimum "absorption capacity", research shows that extensive EU pre-accession assistance is associated with greater post-accession developmental agency (Bruszt & Vedres 2013).

Second, some form of decentralization has already been implemented in most accession states, and without sufficient investment in institution building these partial transfers of power could turn out to be a source of significant economic risk (see also Asatryan et al. 2015). Calls for the greater concentration of authority in the hard times underestimate the appeal that decentralization holds for central governments, in absolving them of some of the responsibility and cost of developmental efforts. Many accession countries have eagerly embraced the EU's competitive development model, pushing onto their local governments the responsibility for improving infrastructure and attracting investment. Without adequate support or resources, this process exposes local authorities to the powerful market forces that they are eminently incapable of handling.

This paper makes the case that it is precisely such unsupervised, partial decentralization that leads to the types of fiscal risk the EU is trying to avoid, and that more control by the central government may not have the expected positive effect on financial consolidation. To show this mechanism in action, the paper explores the case of Montenegro, currently the most advanced of the enlargement countries.

Montenegro illustrates well the paradox of partial decentralization. On the one hand, partly due to its small size, Montenegro is one of the most centralized countries on the European continent, with local government spending accounting for less than 5% of the GDP. Local government finances are also tightly regulated – their budgets are regularly monitored by the Ministry of Finance, and their borrowing capacity is limited by the rule that the overall debt obligations in a given year must not exceed 10% of revenues[1]. Even within this limit, each loan must receive written approval by the Ministry of Finance, and can only be taken in support of a capital investment project already planned by a multi-annual capital budget[2]. Nevertheless, Montenegrin local governments managed to ramp up an impressive amount of debt, by far the highest among all the accession countries. By the end of 2014, the total amount owed by the Montenegrin municipalities reached € 170 million, or 4.8% of the country's GDP. It was also done in record time: just seven years earlier, in 2006, municipal debt stood at a mere € 34 million, about 1.5% of the GDP. The response to this debt explosion has been to reduce local financial autonomy even further, imposing rigorous controls by central government on the financing and employment practices at the local level. Although the move has been heartily welcomed by the European Commission (EC 2015), the findings of this paper suggest that this will not remedy the root problem, and may not even prevent expansion of debt in the medium term. Limited capacities and corruption at the local level certainly contributed to the unsustainable expansion of public finances, but its main driver has been the combination of a competitive development model and opportunistic decentralization policy pursued by the central government. As long as both remain fundamental features of the Montenegrin regional development policy, tightening control of local public finances will only add to the worsening economic conditions in times of crisis, while doing little to prevent risky financial behaviour by all levels of government once the conditions improve. A far more effective, though arguably painstaking solution, would be to return to the policy of capacity building at the local level, while ensuring a clearer delineation of responsibilities between different levels of government.

This paper proceeds as follows: Section 2 describes how partial decentralization obfuscated the lines of accountability between different levels of government and, in combination with the pressure to raise large funds required for the country's economic transformation, led to an opportunistic approach to borrowing. The consequences of this arrangement – the escalation of

[1] This is one of the lowest local debt ceilings in the Western Balkans (NALAS 2010), well below the 30% threshold in Macedonia, 20% in Albania and 15% in Croatia and Serbia.

[2] Law on the Financing of Local Self-Governments, 2015 (2003, 2008).

subnational debt and the measures to restore fiscal balance by curbing local autonomy – are analysed in Section 3. Section 4 then discusses the EU's support programmes to local governments in Montenegro, and argues that they offered a promising corrective to the problems of partial decentralization, but were unfortunately abandoned before they could make a significant impact. The final section makes the case for the return to a regionalization policy in the accession states, and offers some suggestions on the ways in which it could be made more effective.

Competitive developmentalism and opportunistic decentralization in the good times

Background: The ambiguous division of powers

Unlike most state socialist countries, the Federal Socialist Republic of Yugoslavia was in fact a highly decentralized country. Subnational governments were organised around relatively large municipalities which carried out a broad range of social and economic functions, and in the 1980s accounted for as much as 40% of total government consumption. After the fall of socialism, Montenegro preserved the same territorial organisation[3], but like most of the other post-Yugoslav republics it pursued policies that concentrated powers in the hands of the republican government (Sevic 2001). It was not until the early 2000s that the first attempts were made to restore a certain level of autonomy to the municipalities, with the adoption of the Law on Local Self-Government (2002) and the Law on the Financing of Local Self-Government (2003). The two acts were drafted with active involvement of foreign experts and donors, and reflected the contemporary international enthusiasm for multi-level governance, but were initially met with reluctance on the part of the Montenegrin central authorities. So much so, in fact, that just before the Law on Local Self Government was to be adopted, the government replaced the draft carefully crafted in months of consultations with foreign experts and local representatives with its own version. The move was not only a procedural snub at the principles of partnership between different levels of government, but also offered far less devolution of power than originally envisaged. External experts protested, and after a stern intervention by the USAID, the original draft was brought back. The law that finally came into force in 2003 brought, in the words of the American consultants, "a sea change in how power and resources are allocated between the republic and the local level in Montenegro" (ICMA 2002).

On paper at least, the two laws indeed provided generous resources to the local governments to carry out their assigned functions. Own resources comprised a variety of taxes, such as the property tax, special taxes for unused agricultural and construction land and, from 2004 onwards, taxes on company name or trademark, a surcharge on the personal income tax and taxes on games of chance. An even larger chunk of income was to come from various fees for local administrative and communal services and charges for the use of communal property (public roads, construction land, access to communal infrastructure). Own sources were further supplemented by a share of nationally-collected taxes on personal incomes, real estate sales tax, motor vehicle charges and charges for the use of natural resources located on the territory of the respective municipality[4]. Finally, the Equalization Fund was set up to redistribute resources to poorer municipalities in order to close the gaps in fiscal capacity and ensure their budgetary needs were met. The Law on Local Self-Governments guaranteed autonomy in the execution of budgetary decisions and management of municipal property, and the latter was further strengthened by the 2004 Law on State Property that delineated more clearly the ownership rights over state property between the central and local governments.

[3] Until 2013, the structure consisted of a single-tier of 21 municipalities. Most recently (2013) two additional municipalities were established as spin-offs from larger units.

[4] The 2003 law allocated to the municipalities 10% share of personal income tax, 50% of the tax on real estate sales, and 30% of the charges for the use of natural resources collected on its territory (Official Journal of the Republic of Montenegro 42/2003, Art. 25-28). Amendments in 2008 and 2010 added to this revenues from the charges on registration of motor vehicles and 30% of the charge for the use of motor vehicles and their trailers (eco charge), and increased the local governments' shares of other shared taxes to 12% for PIT, 80% for the real estate sales tax and 70% for the charge on the use of natural resources.

It quickly became apparent, however, that not all of these resources were "real", as the local governments lacked the capacity or even the legal authority to collect them to any meaningful degree. Probably the best example are the taxes on unused agricultural land that were introduced by the 2003 Law but have never been collected as the Montenegrin law provides no definition of what constitutes "unused" land and thus no grounds for such charges (Union of Municipalities of Montenegro 2013). A more recent version of the Law on the Financing of Local Self-Governments (2008) and the Law on Environment (2008) created a similar conundrum with the "charge for the protection of environment" that local governments are allowed to introduce "according to their needs and specificities". As no legal definition exists of the appropriate "needs and specificities", an attempt in 2010 by the municipality of Pljevlja to introduce this charge was promptly struck down by the Constitutional Court. Subsequent attempts by other municipalities to find ways of exploiting this provision proved similarly futile, and the clause has been rendered practically inapplicable by the 2010 Law on the Improvement of Business Environment (UNECE 2015).

Revenues from property taxes proved almost equally elusive, albeit for a different reason. The law requires local governments to levy the tax according to the property's market value, but with incomplete registers, weak enforcement mechanisms and without centrally provided valuations for most regions and types of property, it took nearly another decade for this tax to become a significant source of income[5]. The situation is even worse with the charges for the commercial exploitation of natural resources (ores, stone, wood, beaches etc.) that are to be paid on the basis of concession agreements with private operators. Although the resources are nominally the property of local governments, the agreements with third parties are usually arranged by central authorities. Local governments are entitled to a share of the revenues, but often do not even have access to these contracts, let alone any control over the enforcement of payments, which is notoriously ineffective (Marović 2014; Parliament of Montenegro 2015).

Probably the most jarring from the point of view of local authorities, however, is the habit of the central government to push through secondary laws and directives that effectively cancel sources of income guaranteed by the systemic Law on the Financing of Local Self-Governments. Most of these have been done in the name of "abolishing business barriers", i.e. to lower the costs of doing business and encourage private investment. From the point of view of local authorities, however, these not only take away their own prerogative to bargain with investors by waving or reducing local charges, but can also seriously affect the stability of local budgets. Probably the most significant from this point of view has been the decisions to abolish the charge for the use of construction land in order to create an extra boost for the construction sectors (Amendments to the Law on Spatial Development and Construction, 2009). The same law offered additional incentives by moving the payment of the charge for the provision of communal infrastructure from the beginning to the end of the investment cycle and by waving it altogether for the construction of "objects of general public interest" – including four- and five-star hotels and any establishment promising to employ 50 or more persons. The combined effect of regulatory changes and the collapse of the real estate bubble in 2009-2010 had been to reduce the income from these two charges alone from € 120 million in 2008 – almost a half of total budgetary income of local governments – to € 35 million in 2011[6].

None of this is to say that the Montenegrin local governments are in particularly dire economic circumstances. More recent amendments to the Law on the Financing of Local Self Governments (2010, 2015) attempted to compensate for some of the losses incurred through lower-

5 Much of the progress was due to the World Bank-led Land Administration and Management Project (LAMP, 2008-2015), which helped to improve access to the real estate records through a unified information system and complete the cadastre (including extensive re-surveying of land, especially in the north of the country).

6 Efforts to improve the business environment through amendments to sectoral laws also eliminated other sources of revenue such as the charge for the use of local roads (Law on Roads, 2010), charge for the use of facilities for power transmission, telecommunications, TV and radio transmitters and the use of seashore for commercial purposes (Law on Local Communal Fees, 2008), and the charge for the use of motor vehicles and trailers (eco-charge) (Regulation on pollution charges, 2011).

level legislative changes by expanding their participation in shared taxes, and a decade of efforts to put the property registries in order has rendered the property tax a more reliable source of funding. But the issues listed above are illustrative of two larger problems that have pushed Montenegro's partially decentralized system into a cycle of rapid debt accumulation. The first is a development model that is committed to attracting private investment capital by providing the best possible business environment. What this means in practice is that public authorities are expected – often in competition with one another – to ensure quality infrastructure for private enterprises while reducing their costs in the provision of these general goods as much as possible. The second is a form of decentralization that, while insisting on the transfer of certain functions to the sub-national government, leaves the actual contours of the division of powers highly ambiguous. The uncertainty caused by whimsical legislative changes and the vaguely defined rights and responsibilities of different levels of government opens up space for what can best be described as "opportunistic decentralization", where both sides engage in financially risky behaviour, confident that if the payday came they could always pass the bill to the other party. A temptation at the best of times, when combined with the vertiginous investment boom of the late 2000s and the political exuberance of a newly minted country, this arrangement practically guaranteed that fiscal prudence would be thrown to the winds.

The investment imperative and opportunistic decentralization

As noted in the introduction, Montenegrin local governments have comparatively few competencies, as they are not responsible for health, education or social policy, which claim most of the revenues of their counterparts elsewhere in the region (NALAS 2012). They are, however, expected to carry out two major functions that have been rendered disproportionally burdensome by the circumstances of Montenegro's economic transition: they act as employers of last resort, and are in charge of upgrading the country's outdated communal infrastructure.

The first is especially true of the poorer northern municipalities. Despite its small size, Montenegro suffers from marked regional disparities: the centre of the country, with the capital city that is home to around 1/3 of the country's population, and the increasingly prosperous coast, attracted the majority of recent investment in the growth sectors: real estate, tourism and other services. The mountainous north, by contrast, is still largely rural, with its few urban centres clustered around declining traditional industries and suffering from a dearth of investment, high unemployment and steady depopulation (Bartlett & Šišević 2013). In 2014, the average unemployment rate in the north was 37.1% – nearly three times as high as in the central region (13.3%) and six times higher than on the coast (6.4%)[7]. Public administration dominates the employment landscape – in 7 out of 11 northern municipalities it is the leading sector of activity, and overall it accounts for about 20% of total employment in this region, compared to the national average of about 15%[8]. Although the phenomenon is most pronounced in the poorer provinces, the combination of limited employment opportunities in the private sector and political clientelism have resulted in a bloated local public administration across the country, in some cases severely weighing down local public finances (Pradelli et al. 2015).

It is, however, the second task that poses the real challenge to the limited budgets of municipal authorities. Montenegro had been one of the poorest republics of former Yugoslavia, and even though it escaped direct devastation in the Yugoslav wars, a decade of sanctions and severing of economic links to the other former republics left its economy significantly worse off. Following the fall of Milošević in Serbia and the subsequent thaw between the international community and the rump federation to which Montenegro still belonged, the smaller republic plunged into feverish reform activity in the hope of leveraging the good will of international financial institutions to relaunch its economy. The first comprehensive plan, known as the Economic Reform Agenda for 2002-2007 was drafted with the assistance of USAID and the European Agency for Reconstruction (EAR), and included additional input from the World Bank, IMF, UNDP, and numerous bilateral donors. The document contained the usual litany of general tasks assigned to all transition economies –

[7] Montenegro's Statistical Office (MONSTAT) Labour Force Survey.

[8] Data from 2011 Census of the Montenegrin Statistical Office. Includes employment in communal services.

liberalization, privatization, measures to attract private investment and increase competitiveness – but also spelled the specific objective of the Montenegrin government to steer the economy away from traditional heavy industries and towards services, especially tourism (Government of Montenegro 2002).

One obstacle to this ambitious shift was the severe state of disrepair of the country's infrastructure. This was true both of the key transport links that provided access to foreign visitors – the railway and airports – as well as of the internal roads and basic communal infrastructure. A survey by the World Bank in 2008 classified about half of Montenegrin local roads as "poor" (World Bank 2005); another study on the country's competitiveness potential found the tourist industry to be strongly constrained by failures to provide adequate water and waste management services (World Bank 2005). According to the 2002 environmental performance review of Montenegro by the UN Economic Commission for Europe, only 42% of household waste was collected by municipal waste management companies, many of which lacked sufficient vehicles and equipment. While the uncollected waste ended up in "wild" dumps or in rivers, the survey found the registered municipal landfills to be little better – without any separation, treatment, or prevention of air or groundwater pollution, not a single one of these dumps met international sanitary standards. The situation was similar with regard to the treatment of waste water; with only one waste water treatment plant in operation in the capital city, the rest would simply be pumped into the nearest body of water, compromising the quality of surface waters in the tourist-hopeful coastal municipalities. Many of these municipalities also suffered acute water shortages in the summer, when the demand peaked because of the increased number of visitors (UNECE 2003).

The economic imperative to upgrade the country's infrastructure was further reinforced by the need to adapt to EU environmental requirements once the start of the Stabilisation and Association Process confirmed – however distant – hopes of eventual membership of the EU. The original Economic Reform Agenda was revised in 2005 with the EU's assistance, giving even more weight to the support of economic growth through public investment and the focus on sustainable tourism and rural development. Accompanying it were a series of laws that aligned Montenegrin legal system with EU environmental directives[9], as well the more specific development plans for individual sectors: the 2004 Master Plan for Water Supply for Coastal Regions of Montenegro and Cetinje, the 2005 Strategic Master Plan for Sewage and Waste Waters for Central and North Regions, and the 2005 Strategic Master Plan for Solid Waste Management. Together, the three documents laid out plans for infrastructural improvements carrying a combined price tag of € 600 million, a third of which was to be invested in the following 4-5 years. Although the responsibility for maintenance and investment into communal infrastructure belonged in theory to municipal authorities, there was little hope that such major undertakings could be covered from their current revenues, or even from the national capital budget. Instead, the Government of Montenegro closed the financing gap by contracting large framework loans with the international financial institutions, including the International Development Agency (IDA), the funding arm of the World Bank, the German Development Bank (KfW) and the European Investment Bank (EIB).

It soon turned out, however, that the municipalities would indeed play a major role in shouldering the country's large investment burden, and in two distinct ways. The first is the quintessential reflection of what I dubbed "opportunistic decentralization", and consists of the Government of Montenegro simply passing on the responsibility for paying back these loans to the municipal authorities. This approach may not be financially unsound, as international development banks offer countries like Montenegro loans on terms that would be impossible for municipalities to obtain on their own, from the same institutions or elsewhere. But the manner in which these loans have been passed on has served to diffuse accountability of both central and local governments, a problem that has become increasingly evident as the deadlines for payments begin to fall due. First, the municipalities had practically no influence on project identification and planning. Most of the

[9] These included the Law on Environmental Impact Assessment (2005), the Law on Strategic Environmental Assessment (2005), the Law on Integrated Pollution Prevention Control (2005), the Law on Waste Management (2005) and the Law on Environmental Noise (2006).

projects have already been drawn up under the Ministry of Sustainable Development's Master Plans, and only minor alterations could be suggested by the local governments. They also have no say over the implementation of these projects, which is handled by a Government-founded public works company Project Consulting (ProCon). This means that the only element that is being "decentralized" in this configuration is the cost of paying back the loans. As if this weren't enough to dampen the sense of ownership and accountability of local governments, the transfer of loans is often ambiguous and suggests soft budget constraints. The best illustration is probably the bizarre spat that recently erupted in the Montenegrin media between the Ministry of Finance and the municipality of Danilovgrad after the Ministry declared that the municipality owed € 0.7 million to foreign creditors, prompting furious denials from local authorities (Dan 2015). The amount turned out to be the first disbursement of a € 5.4 million loan which the Ministry of Finance contracted with the European Bank for Reconstruction and Development (EBRD) in late 2010 for the construction of a water treatment plant and reconstruction of the water and sewage network in the Municipality of Danilovgrad. Four years later and a few months into the start of the works, no contract had been signed with the Municipality specifying the terms of financing, and while the local authorities assumed that the Government would be paying for it, the Government insisted that it was merely loaning the money to the municipality (Government of Montenegro 2015a)

Even in cases where written agreements exist between the municipal and central authorities, the terms of the transfers have often proven to be malleable to negotiation. In the first three phases of a major reconstruction project of water and sewage networks on the Adriatic Coast, which has been running since 2004, the funds borrowed from the German KfW had been passed on to the five participating municipalities as loans (about € 40 million). In 2009, however, the Government ruled that the accumulated debt obligations of these municipalities already exceeded the legal borrowing limit and disbursed the funding for the fourth phase of the project – around € 25 million – as grants. Phase V of the project began in 2015, with a fresh round of loans from KfW contracted in December 2014, but by mid-2015 the Government of Montenegro had not yet decided whether the newly raised € 36 million will be passed on as grants or loans (Government of Montenegro 2015a). There seems to be no general rule guiding these decisions: in some cases, municipalities under financial stress have managed to renegotiate transfer agreements reducing their obligation and converting parts of their loans into grants[10], while in other cases the government simply waved the legally prescribed municipal borrowing limit to allow them to take on more debt[11].

The practice of "parking" international loans with municipal authorities was not, however, the only way in which the Montenegrin local governments expanded their debt portfolios in the good years. Many of them embarked on capital investment projects of their own, emboldened by rising revenues from the real estate boom. Some of these projects were simply overdue interventions in the aged communal spaces – renovations of schools, community centres and local streets and squares. Others were at least partly pushed on by the larger government-sponsored investments, which charged municipalities with financing some aspects of the project (e.g. covering expropriation of land on their territory for the construction of inter-city transport links). The central government certainly did everything to encourage additional investment activity, going so far as to launch, in 2006, an experiment in municipal debt financing involving the creation of a market for municipal bonds. Between 2006 and 2009, 16 municipalities issued bonds for communal infrastructure projects, raising in total about € 14 million, but the market never took off, and all bonds were purchased by the Montenegrin Investment and Development Fund. Part of the reason might have been that the

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[10] In 2006, Ministry of Finance and the Municipality of Budva signed the Loan transfer agreement according to which the Municipality took on the responsibility for paying back a small part of the 10.000.000 euro loan from KfW (about € 0.7 million). The agreement was amended two years later, further reducing the municipality's share to just € 0.1 mn (State Audit Institution 2015).

[11] In December 2014, Ministry of Finance approved transfer of another loan of € 4.2 mn to the Municipality of Nikšić to continue works on the water treatment plant and reconstruction of the sewer system in the municipality (phase 3 of an arrangement started with EIB in 2008), even though the municipality had already exceeded the borrowing limit by over 100% (Government of Montenegro 2014a; Municipality of Nikšić 2014)..

commercial bank loans offered an all too easy alternative: as foreign investment flooded the country in the mid-2000s, fierce competition among banks in the tiny Montenegrin market boosted the lending volume and pushed the interest rates to record lows[12].

None of this helped to harden the municipal governments' budget constraints; on the contrary, it probably encouraged behaviours that were at least opportunistic and in some cases outright criminal. The media is rife with accusations of corruption and over-payment in various local undertakings, and the State Audit Institution confirmed violations of the Law on Public Procurement in 10 out of 12 municipal audits conducted between 2007 and 2014. Probably the most notorious is the case of the municipality of Budva, which in 2010 took a € 58 million loan from the German company WTE Wassertechnik GmbH for the construction of a waste water treatment plant, despite the protests of the opposition councillors who pointed out that having the same company as the creditor, the project designer and the executor opened up too much space for manipulation (RTB 2010b; RTB 2010a). In 2015, several former members of the municipal government were indeed arrested on charges of having embezzled at least € 8 million through this deal. It remains unclear, however, why central government allowed the municipality to enter this arrangement in the first place. WTE Wassertechnik had already been contracted to construct water treatment facilities in other coastal municipalities, all of them under the Government's Master Plan for Water Supply on the Adriatic Coast, which had been financed for years from the KfW framework loans on significantly better terms. And yet, the Government not only allowed the municipality to take on the more expensive loan without questioning its soundness, despite the fact that Budva's outstanding debt obligations already approached 40% of its revenues – nearly four times the legal borrowing limit (see Municipality of Budva 2011) – but even agreed to cover a part of this loan by a state guarantee worth € 29 million.

The crisis and the municipal debt explosion

As we have seen above, the vague and negotiable division of responsibilities between the central and local governments in Montenegro encouraged soft budget constraints and opportunistic behaviour on both sides. But what truly catalysed this casual attitude to debt was the unprecedented economic boom that swept the country between 2005 and 2009. Foreign investment soared. In the first four years of the century, foreign direct investment inflows in the country amounted to a little more than € 170 million; in 2005 alone, they reached over twice that amount, and continued to rise vertiginously for the next few years. Investments in real estate accounted for a large chunk of these flows, especially in the years 2006-2008 when they made up nearly half of all foreign investment in the country (Figure 1). This in turn buoyed up the budgets of local governments, much of whose income is legally tied to real estate and construction[13], with the total revenues rising from less than € 100 million in 2005 to nearly 350 million in 2008.

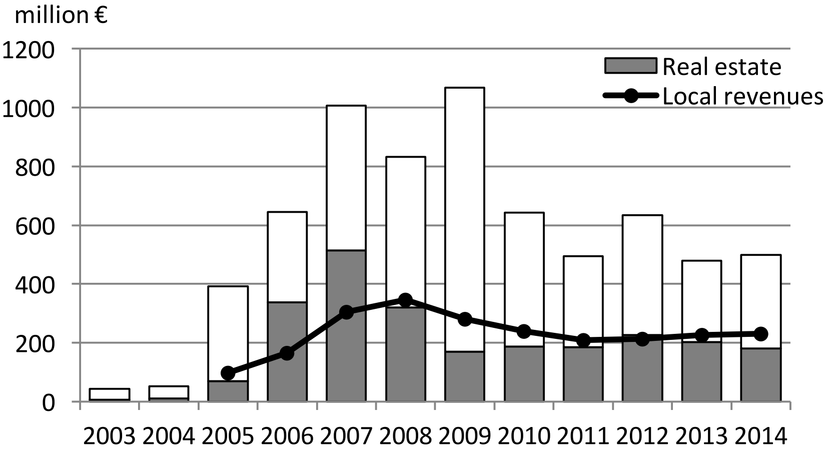
Expenditure also rose, but in a country suddenly so awash in money nobody took this as a cause for concern. As the GDP grew at an average pace of 7% a year, and the central government used some of the surplus to pay off the old debt obligations, the debt-to-GDP ratio actually declined from over 40% in 2004 to well under 30% in 2008, even as the country continued to accumulate new loans. At the local level, however, the situation was not so rosy. Municipal spending grew apace with revenue, and even in 2008, the peak year of the revenue boom, 14 out of 21 municipalities recorded a primary budget deficit. These could only partially be offset by the sales of municipal property, and about half of all municipalities had to rely on loans to cover the financing gap. Nevertheless, this was "good" spending; capital investment took up nearly a half of the municipal budgets, and even if some of it was wasteful, most local governments could point to significant improvements in local infrastructure, transport and business environment. It was only once the burst of the real estate and capital bubble brought the economy to a halt that what everybody hoped would be the engine of growth turned into a spiralling debt nightmare.

[12] Between 2005 and 2008 the cumulative lending volume increased by more than 900% (IMF 2013).

[13] Despite the changes in the structure of fees and charges, and in the collection and distribution of tax revenues, the combined revenues from construction-related charges, real estate ownership and sales tax and sales of municipal property have accounted for 50% to 2/3 of all municipal revenues between 2005 and 2010.

The crisis arrived in Montenegro in 2009, striking down several of the economy's pillars at once. Construction, hospitality and real estate services experienced a combined output loss of over 30% and overall the country's GDP shrunk by almost 6%. The total volume of foreign investment actually increased, but most of it went to beef up the reserves of the teetering Montenegrin affiliates of West European banks, some of which had all but ceased lending activity due to collapsing deposits and rapid accumulation of non-performing loans (CBCG 2011; Bartlett & Šišević 2013). Elsewhere, the investments were quickly drying up: between 2008 and 2009, the amount of foreign investment going to the real estate purchases fell by a half (Figure 1).

Figure 1. Trends in foreign investment and local government revenues, 2003-2014



Source: Central Bank of Montenegro, Ministry of Finance

The effect on the municipal budgets was immediate. Revenues shrank for three consecutive years, bottoming out in 2011 at € 210 million – almost 40% down on the 2008 peak. Clearly unable to reduce expenditure at the same rate, some municipalities resorted to emergency loans to plug the holes in their budgets, often at very high interest rates. Others simply stopped paying their bills: the accumulated arrears of Montenegrin local governments jumped from € 27 million in 2008 to nearly € 100 million in 2011, and in the past few years at least a quarter of them had their bank accounts blocked by court order as a result of various claimants seeking forced repayment.

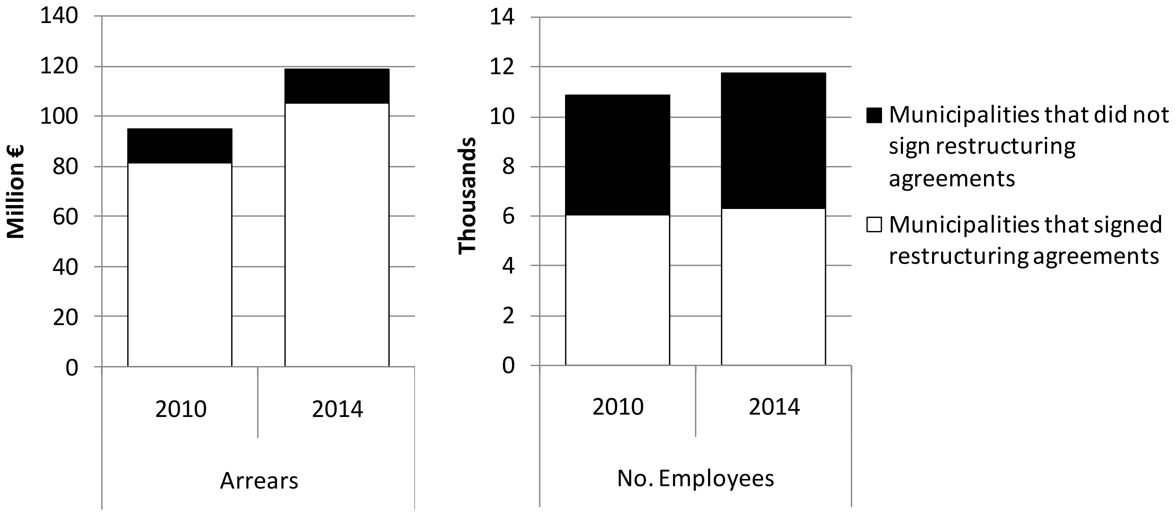
In the already familiar twist, the financial collapse was quickly turned into a morality tale. Local authorities have been accused of everything from incompetence to profligacy and corruption, and some have found themselves in the hands of criminal investigators. While some of this is undoubtedly well deserved, the larger question remains whether the more recent legal and institutional interventions into Montenegro's semi-decentralized system can be counted on to prevent such behaviour in the future.

The recommendations of the well-meaning foreign observers have so far mostly centred on the need to reduce local government spending, above all by cutting the wage bill, and to increase oversight by central authorities (Pradelli et al. 2015; EC 2015). Although some of these measures might help to tighten the budget constraints of local governments – though mostly in the short run – I argue that they nevertheless leave completely unresolved the problem that has led to opportunistic debt accumulation in the first place: the ambiguous division of responsibilities between government levels, and the political convenience of blame shifting that this ambiguity accords.

The most comprehensive measure introduced so far to restore fiscal prudence at the local level has been the 2014 Law on the Budget and Fiscal Responsibility, which requires all municipal budgets to be submitted to the Ministry of Finance for approval before they can be adopted. Though laudable from the point of view of greater transparency, this form of ex-ante monitoring does little to prevent fiscal failures arising from over-optimistic budgeting, and it conspicuously lacks a credible enforcement mechanism. This makes it very similar to the 10% borrowing ceiling that was supposed to prevent the excessive debt growth of the previous years. A retrospective analysis of municipal budgets shows that between 2008 and 2012, nearly all municipalities that took on new loans did so in violation of this limitation, without incurring sanctions. It is unclear whether the failure of central government to react was a consequence of incomplete information, tacit agreement or explicit approval – the reasons possibly varied from one case to another – but it is clear that if for several years half or more Montenegrin municipalities could safely disregard a fiscal constraint based on ex ante budget monitoring, another of the same kind is unlikely to be more effective. It is symptomatic that a number of measures launched with much pomp in 2014 as a way of putting local public finances in order consisted simply of reiterating the existing rules – such as instructing the Tax Administration to "apply, as of 01.01.2015, legal measures against all municipalities that pay employees net salaries without taxes and contributions", as if that were not one of the Tax Administration's core functions (Government of Montenegro 2014b).

All of this suggests that to really ensure fiscal prudence at the local level it is not enough to simply impose stricter control of municipalities. It is also necessary to create binding devices that prevent the central authorities from using these rules arbitrarily and at their own convenience, while shifting the blame to local actors when necessary. One approach might indeed be to restrict the autonomy of local governments further, but in this case financial accountability should also be firmly shifted to the central authorities, alongside responsibility for the execution of essential local functions. Another approach – perhaps counter-intuitively – would be to *increase* the autonomy of local actors. This would also mean that central government would on the one hand refrain from piling new duties on them without agreement or consultation, and on the other refuse to foot the bill in case of overspending. As it stands, the most recent solutions to the problem of municipal over-indebtedness promise to do neither, continuing, in the guise of rigorous oversight, the same tradition of partial and ambiguous decentralization.

Figure 2. Changes in employment and arrears in local governments in the years of "fiscal tightening"

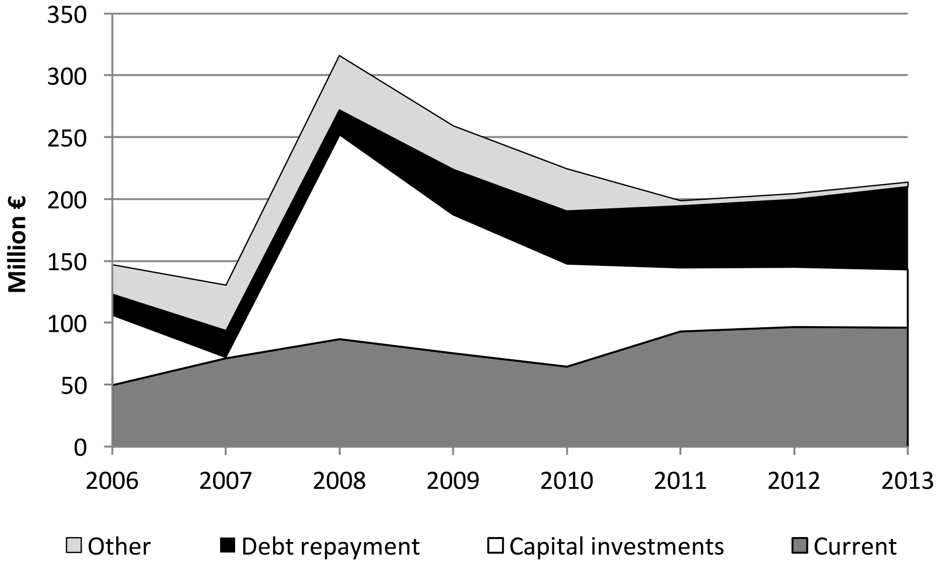


Source: Ministry of Finance

The case in point is the so-called "financial restructuring contracts" signed between the Ministry of Finance and the most financially distressed municipalities. These are meant to facilitate several forms of debt restructuring: rescheduling tax arrears or waving debt ceilings so that over-indebted municipalities can take on fresh commercial loans, sometimes with government guarantees, in order to refinance debt. In exchange, the municipalities promise to reduce spending and excess employment, refrain from accumulating further arrears, and obtain the Ministry's permission for each new loan, budgetary change or new employee. The programme began in 2010 and has thus far proved to be a resounding failure. Out of 14 municipalities that signed the financial restructuring contracts, only 5 reduced employment following the agreement, and all but 3 increased it again in subsequent years. The overall numbers thus remained practically unchanged, despite the fact that a few municipalities even obtained additional funds from central government to finance severance payments. In fact, at the end of 2014, local public administration had 10% more employees than in 2010, instead of 20% less as envisaged by the Government's plan (Figure 2). Either the importance of municipalities as the employers of last resort during lingering crisis, or the importance of public employment as a lever in the 2014 municipal elections, clearly prevented the central authorities from using their improved oversight powers to sanction such behaviour.

The contracts did even less to reduce debt, apart from a small portion acquired by the Government in exchange for municipal property. Arrears continued to increase, and in 2015 another round of debt restructuring agreements was signed. Tax arrears of 14 municipalities worth around € 90 million in total were rescheduled, to be paid off in the next 5-20 years, and 8 over-indebted municipalities received the permission, and government guarantees, to borrow another € 40 million from commercial banks to refinance other debt obligations (Government of Montenegro 2015d; 2015e; 2015f; 2015c). It would thus appear that all these contracts accomplished was for the central government to circumvent its own rules on local debt ceilings, and push repayment deadlines further into the future. The only genuine "restructuring" in this period concerned local capital budgets: as the pressure to pay off accumulated debt obligations mounted, the spending on infrastructural investments practically ceased, in some cases even affecting regular maintenance work. Capital spending fell from around half of the budget expenditure at the peak to less than a quarter in 2013, whereas debt repayment grew to an average of 1/3 of all spending.

Figure 3. Changes in the composition of local government expenditure, 2006-2013



Source: Ministry of Finance

Walk before you run: EU assistance to local governments

Compared to the ambitious, if never realised, decentralization plans and the exuberant investment campaign of the national government, the EU's own approach to regional development in Montenegro has been an object lesson in prudence. As in other accession countries, the first few years of the EU's involvement were marked by the same enthusiastic discourse about decentralization: the 2002-2006 CARDS Strategy Paper on Montenegro (at the time still part of the Federal Republic of Yugoslavia) thus professed as one of its goals the support to decentralization and improved delivery of local services, and emphasised their link to such lofty objectives as greater democracy and fairness, the easing of inter-ethnic tensions and meeting more accurately the needs of the people (EC 2001, pp.48–49). However, the programmes that were actually implemented in the area of decentralization and local government reform turned out to be – for good reason – conceptually and financially rather modest.

It soon became obvious to EU experts that a comprehensive decentralization strategy was neither necessary nor possible, given the weak capacities of local governments in Montenegro, and the subsequent reports and action plans emphasised the "coherence and efficiency" of decentralization rather than its scope. Many of them also noted the lack of alignment between the systemic laws on local governments and their financing and the sectoral laws that often subverted these provisions, and called for a better clarification of responsibilities to allow for "oversight and transparency" (EC 2007, p.10). They also repeatedly urged improvements in human and administrative capacities as well as the capacities for financial management at the local level.

These preoccupations were clearly reflected in the EU programmes directed at local governments in Montenegro. The amounts allocated through these support schemes remained rather small, and all of them included extensive training and capacity-building components to ensure that local governments could handle even these funds appropriately. The first such pilot project took place in the 2002-2004 period, under the management of the European Agency for Reconstruction (EAR) CARDS programme. The EAR helped four municipalities to develop capital investment projects that could attract external funding and provided € 4.5 million for minor infrastructural undertakings to allow municipalities to "practice" EU-compatible project management skills. Another € 2.1 million from the funds dedicated to the public administration reform was invested in capacity-building projects for local authorities, including targeted technical and procurement advice to municipalities to enable them to attract and manage investments by international financial institutions (IFIs) (EC 2004).

The transition to the Instrument for Pre-Accession Assistance (IPA) changed little in the method of the EU's assistance to local governments in Montenegro; if anything, it became even more cautious. Compared to the language deployed in their CARDS predecessors, IPA documents are far less enthusiastic about decentralization, and instead emphasise the importance of enabling the local authorities to cope with the responsibilities they already have. The emphasis remained on capacity building, with small grants occasionally made available to finance selected municipal projects. The 2008 IPA financing proposal for Montenegro thus earmarked € 7.05 million for local government reform, of which only about a half was to be used to support municipal infrastructure projects. The other half was dedicated to improving the legal framework governing decentralization, provide trainings to the Union of Municipalities, and upgrade local financial and investment planning, including teaching local authorities to prepare funding proposals for IFIs and conduct feasibility studies and impact analyses (EC 2008). In addition to providing all the necessary technical support to ensure its funds were properly managed, the EU also introduced a stronger ex-post supervision by insisting on a separate audit authority for IPA funds.

The advantage of this approach was to ensure that the EU-funded projects largely remained free of the problems plaguing other investment enterprises by Montenegrin local authorities: unrealistic planning, over-spending, and failures of implementation and oversight. However, as a way of preparing the country for the management of EU structural funds, it was also clearly impractical. Despite some improvements, Montenegrin municipalities remained incapable of managing large-scale projects on their own, and given the small size of the country most of such projects anyway cut across the municipal borders. Without a good coordination mechanism, the one attempt to create a "regional" project – a joint landfill for five northern municipalities – floundered due to the lack of cooperation (Ecorys 2013). To remedy this, the next round of financing for local government projects, launched in 2011, invited exclusively joint projects in order to encourage bottom-up inter-municipal cooperation (EC 2011).

Unfortunately, rather than a promising innovation in the EU's approach to regional development in Montenegro, this experiment with inter-municipal cooperation was also the last. From 2012 onwards, all reference to decentralization disappeared from the EU documents and financing programmes for the country, and where local governments were mentioned it was only to complain of their lack of transparency, efficiency and accountability[14]. The change in rhetoric from the earliest EU

[14] This assessment repeats almost verbatim in all Progress Reports on Montenegro from 2012 to 2015.

strategy papers is striking: where the former treated local governments as vehicles of democratization and better governance, the latter appear to consider them borderline wasteful. The 2015 Report on Montenegro thus singles out local governments as the main culprit for the country's failure to reduce employment in public administration, and expresses the hope that "since any new recruitment in local self-government is to be subject to approval by the Ministry of Finance, *there may be a leaner and fiscally tighter public sector in Montenegro in the future, which in parallel ensures the necessary capacity and skills for European Integration* (EC 2015, p.10). Although the findings of this paper suggest that such optimism is ill founded, this remark by the Commission illustrates well the renewed popularity of the conviction that centralization is both more efficient and more likely to bring the country in line with the enlargement objectives.

Discussion: What kind of regional development policy for the enlargement countries?

The change in attitude towards local governments as developmental actors described above is not a Montenegrin specialty – it is also reflected in a number broader changes to the EU support programmes for enlargement countries. First, the financing streams in the instrument for pre-accession assistance for the 2014-2020 period (IPA II) have been restructured so as to eliminate "regional development" as a separate component within the programme. The move may appear to be symbolic rather than substantive. After all, regional development has simply been disaggregated into the previously existing sub-components (transport, environment and competitiveness) and together with human resources development and agriculture bundled under a new "competitiveness and growth" heading. Nevertheless, the emphasis on sectoral, rather than the regional components of "competitiveness and growth" is indicative of the new way of thinking about development. More substantively, this restructuring also entailed a transfer of management responsibility for the programmes formerly falling under the purview of regional development from DG Regio to DG Enlargement, weakening the links to the EU cohesion policy and its regional emphasis. Second, IPA II also promised to shift from project-based financing, where each project was selected, approved and monitored either by the European Commission representatives or by EU-accredited bodies in the accession country to the so-called "sector budget support", in which the money is provided for broad policy objectives and managed by the recipient country at its discretion, as long as it promises to meet certain EU-approved benchmarks. This approach is meant to increase the beneficiaries' ownership of reforms and reduce the administrative burden on the Commission. However, it also means that the full responsibility for the policy implementation is given to the central authorities, and eliminates the kind of targeted support to local actors that has been the trademark of EU assistance so far.

This paper has argued that abandoning the efforts to strengthen local developmental agency and calling for greater re-centralization would be a mistake. For one, the findings of this paper suggest that it is not decentralization as such, but the lack of accountability stemming from the ambiguous division of powers between levels of government that leads to soft budget constraints and fiscal opportunism. This is hardly news: two decades of research into the consequences of decentralization have confirmed that the institutional design matters (Rodden et al. 2003; Escolano et al. 2012; Daniels 2016). However, most of this research focuses on the structure of incentives for local authorities, and the mechanisms to control moral hazard at the lower levels of government. The analysis of the Montenegrin case suggests that this perspective underestimates the temptation decentralization presents to central governments to "outsource" their fiscal responsibilities. Indeed, such strategies may not even require much formal decentralization; Montenegro, with its highly centralized institutional apparatus, is a good example of this. Examples from elsewhere in the region reveal even more creative ways of devolving financial responsibilities from the central government to other public and quasi-public authorities: in Croatia, for instance, it is not the local governments, but the semi-corporatized local communal service companies that have been accumulating large amounts of debt (Bajo & Primorac 2010). If this is true, and the largest risk factor for fiscal imbalances at the local level are in fact the central governments, giving the central authorities more control and responsibility for fiscal stability is unlikely to bring the expected benefits, and may even be counterproductive.

In fact, while the European Commission may have written off the Montenegrin local governments as potential partners in regional development policies, the national government seems as eager as ever to continue relying on them, their dismal financial records notwithstanding. According to the 2015 Action Plan for Chapter 22 (Regional Policy and Coordination of Structural Instruments), the Government thus expects local authorities "to become the main beneficiaries of the EU Cohesion policy in Montenegro" (Government of Montenegro 2015b), although no institutional preconditions have been set up to make this expectation even remotely realistic. The government has repeatedly rejected the proposal of the Union of Municipalities to establish a stable co-financing fund, arguing that the current method of ad-hoc supplementary financing is sufficient. This is precisely the kind of mechanism that dilutes accountability and encourages soft budget constraints, and is also politically problematic as it leaves too much discretionary power to the central government. Combined with the change in EU financing strategy and the waning oversight of the European Commission, there is little reason to hope that this will bring either improved financial management or "the necessary capacity and skills for European Integration".

A more promising strategy would be to *strengthen* the competencies as well as competences of local authorities, clearly delineating their developmental responsibilities and ensuring that they are capable of handling them. As could be seen from the experience of pre-accession assistance in the East Central European member states, this is not a simple task, and the results may well fall short of the Commission's expectations. Moreover, greater economic backwardness, institutional underdevelopment and the small scale of local government units in the Western Balkans might make this task even more onerous, as well as require a degree of innovation to adapt the EU's regional development policy to the new circumstances. Yet this is precisely the kind of state-building that has made the EU's enlargement policy one of the most successful developmental projects in the world (Bruszt & McDermott 2009). If the purpose of enlargement is to enact the deep institutional transformation that will truly prepare recipient countries for EU membership, then the weak capabilities of the subnational governments in the target states cannot be a good excuse to simply abandon them.

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